riaa Responsible Investment Association Australasia

BRIEFING NOTE
COVID-19 AND PERFORMANCE
OF RESPONSIBLE INVESTMENTS

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November 2020

In a time of massive market disruption brought on by the global COVID-19 pandemic, this briefing note explores how responsible investment funds that integrate environmental, social and governance factors have performed compared to the rest of the market.

The evidence is overwhelming, showing that more sustainable companies are performing better and responsible investment funds are largely continuing to outperform the general market.

In recent years there's been a significant rising tide of interest and engagement in responsible investment: assets managed in accordance with responsible investment principles now represent 37% of Australia's total $3.14 trillion assets under management (AUM) and 52% of New Zealand's total NZ$296.3 billion AUM.

The bulk of our financial institutions have made visible and public commitments to responsible investment, and at a minimum, integrate the consideration of environmental, social and governance (ESG) factors into investment decision-making.

The key drivers for responsible investing include:

1. Consumers and clients expect their savings and investments to contribute to positive social, environmental and economic outcomes, as well as to avoid significant harm;
2. ESG factors comprise fundamental investment risks and opportunities and systematic analysis of these helps to avoid the worst of the downside and capture upside opportunity; and
3. Responsible investment funds typically outperform their average mainstream counterparts.

What does responsible investing have to do with COVID-19?

All businesses, and therefore all investments, have an impact on people and the planet, both positive and negative. Companies or assets are unlikely to thrive if they ignore environmental issues (such as pollution, climate change, water and other resources scarcity), social issues (for example, their employees, local communities, health and safety), governance issues (such as corruption, strong boards and appropriate executive pay) or ethical issues.

Responsible investing, including the consideration of ESG factors such as these, helps investors identify a broad array of themes that are influencing markets and returns, and provides an important means for investors to navigate turbulent times; to avoid the most significant risks and to capture more opportunities.

In addition to its devastating death toll, the COVID-19 pandemic has resulted in significant economic turmoil, having wide-ranging and severe impacts on many people's livelihoods and financial markets globally. These include substantial stock market declines and many countries entering into a recession.

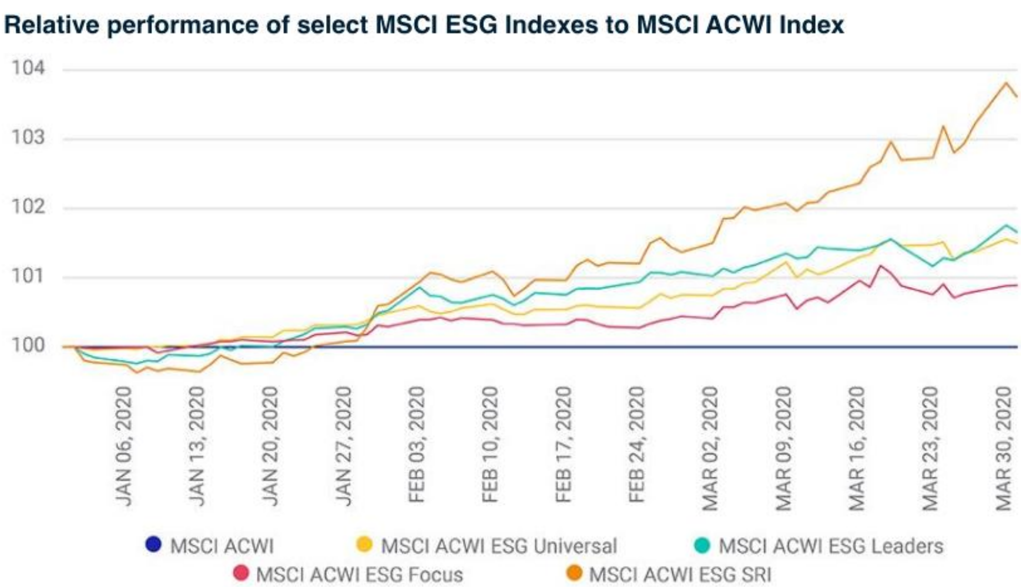
Yet while there has been widespread market downturn, the various analysis by commentators including investment managers, research houses and ratings agencies is consistently showing that more sustainable companies are performing better and responsible investment funds are outperforming the general market during this time.

What are investors and research houses saying?

1. MSCI

Research firm MSCI conducted a comparison of its ESG indexes compared to its parent indexes for the first quarter of 2020 highlighting that the COVID-19 pandemic "is the first real-world test since the 2008 global financial crisis of the resilience of companies with high MSCI ESG Ratings".

As per the chart below, the four ESG indexes comprehensively outperformed their parent MSCI ACWI index from 1 January to 30 March 2020 with MSCI concluding this was largely "attributable to the systematic tilt of these indexes toward higher ESG-rated stocks."



Data from Dec. 31, 2019, to March 31, 2020. MSCI ESG Universal Index represents an ESG weight-tilt approach; MSCI ESG Leaders a 50% best-in-class sector approach; MSCI SRI a 25% best-in-class sector approach; and MSCI ESG Focus an optimized approach designed to maximize ESG exposure.

2. AXA IM

AXA Investment Managers undertook an analysis of how leading ESG companies (issuers) had performed in the first quarter of 2020 compared to laggards, applying their research across equities and bond markets.

AXA IM concluded unequivocally that "Companies with the highest ESG ratings have proven more resilient in the coronavirus market crash than those with the lowest." Their findings highlight that ESG leaders not only outperformed the benchmark MSCI ACWI index (>5% outperformance), but left the ESG laggards for dead with a staggering outperformance of 16.8% points in Q1 2020.

Uniquely, AXA IM also applied this same analysis to the bond market and found a similarly significant outperformance, of 5.2% points of ESG leaders over ESG laggards in that same time period as well as an outperformance against the benchmark.

However responsible investment is not all just about ESG integration, with many leading responsible investors also employing strong exclusion policies to screen out sectors. A frequently argued point is that this could risk limiting the universe of stocks available to fund managers and so leave them more exposed to market changes. AXA IM's analysis on this point finds that when assessing the impact of their company-wide exclusion policies, that a portfolio of stocks which apply their exclusion lists outperformed the parent benchmark index by 47 basis points.

3. Fidelity International

Fidelity International analysed 2,600 companies to understand the link between their ESG characteristics and their performance during the market downturn, specifically looking at period from 19 February and 26 March 2020.

The findings are that in this period, while the S&P 500 index fell by 26.9%, the companies rated most highly on ESG characteristics fell by 23.1%. Those rated worst fell much more than the market as a whole (down 34.3%) while the companies in between traced a straight-line correlation.

4. Schroders

Schroders says that "In terms of performance, we have long argued that sustainable companies should have lower declines due to lower incidence of controversies and occupational mishaps; greater loyalty from customers, employees and even shareholders; and often more conservative balance sheets."

Their COVID research tests this hypothesis citing leading ESG indices outperforming their mainstream indices, for example, the FTSE 100 ESG Leaders index returning -27.3% in the period assessed compared to -33.7% for the FTSE 100 index, and citing evidence of ESG leading stocks outperforming broader markets.

Their research also notes that ESG exchange traded funds (ETFs) have been more resilient to the rush of outflows compared with mainstream ETFs.

Schroders concludes that "this crisis has actually increased the visibility and perceived importance of sustainable business practices."

5. BlackRock

New research by BlackRock argues that COVID-19 presents a test to their conviction that companies managed with a focus on sustainability should be better positioned versus their less sustainable peers to weather adverse conditions while still benefiting from positive market environments.

Encouragingly, their analysis concludes that in the first quarter of 2020, they have observed better risk-adjusted performance across sustainable products globally, with 94% of a globally-representative selection of widely-analysed sustainable indices outperforming their parent benchmarks.

BlackRock's research highlights that in similar notable market downturns in recent years, the findings have been consistent: that is that sustainable indices outperform their non-sustainable counterparts.

The message is getting through – in this downturn, where outflows accelerated across many funds, sustainable funds continued to see strong inflows with BlackRock finding record inflows to sustainable funds in the first quarter of 2020.

BlackRock states "we believe these inflows during a period of extraordinary market drawdown suggests a persistence in investor preferences toward sustainability".

6. Morningstar

Longitudinal research by Morningstar measures the performance of sustainable open-end and exchange-traded funds versus traditional peers, spanning nearly 4,900 funds domiciled in Europe, including 745 sustainable open-end and exchange-traded funds.

Morningstar says that the average returns and success rates for sustainable funds suggest that there is no performance trade-off associated with sustainable funds. In fact, a majority of sustainable funds have outperformed their traditional peers over multiple time horizons. Notably, the outperformance continued during the COVID-19 pandemic, finding "in all but one category considered in the study, sustainable funds outperformed, with average excess returns in Q1, 2020 ranging between 0.09% and 1.83% across categories".

Responsible investing is central to avoiding or mitigating future crises

The thesis that responsible investing supports stronger outcomes for society and the environment, alongside delivering superior financial returns, has been put to one of its toughest market tests with the COVID-19 pandemic.

While the social and economic fallout from the crisis is still playing out, and most responsible investors are guided by a longer time horizon, initial analysis and results are emphatic. The research reinforces that responsible investment supports the achievement of better investment outcomes, and is central to navigating our way towards a more sustainable and resilient world that can mitigate or avoid such crises in the future.

ABOUT RIAA

The Responsible Investment Association Australasia (RIAA) champions responsible investing and a sustainable financial system in Australia and New Zealand. RIAA is dedicated to ensuring capital is aligned with achieving a healthy society, environment and economy.

With over 300 members managing more than $9 trillion in assets globally,
RIAA is the largest and most active network of people and organisations engaged in
responsible, ethical and impact investing across Australia and New Zealand.