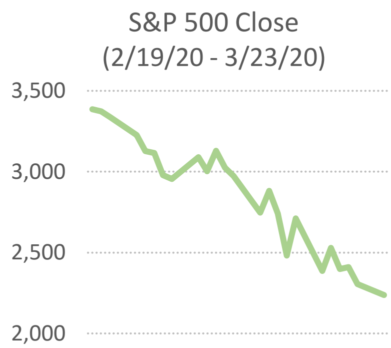
ESG Investing during COVID:
Short-Term Outperformance Shows Where Investors are Headed

May 19, 2020 By Andrew Koski

As the COVID-19 pandemic reached the United States in late February, markets worldwide experienced one of the sharpest short-term selloffs in recent memory—the S&P 500 declined by nearly 34% from February 19 to March 23, and two days in March ***are now among the six worst in S&P 500 history***.[1] A price war between oil producing countries compounded market declines. The United States entered an extended lockdown, driving down demand for fuel. The resulting glut of American crude after two months and counting of nationwide lockdowns, caused WTI futures to close negative for the first time in history on April 20, 2020. Over the past decades, markets have weathered downturns, recessions, bear markets, selloffs, bubbles, corrections, and a litany of other crises, economic or otherwise—and yet, the effects of the COVID-19 crisis feel uniquely historic.



Given the unpredictability of the crisis as a market event, investors were left to scramble for risk-off assets, safe bets during an extended quarantine (upstart communication technologies like Zoom come to mind), and any other way of shoring up portfolios. Amid all of this, ***one strategy outperformed***, perhaps to the surprise of many seasoned investors: ***sustainable and socially responsible investment strategies, otherwise known as ESG.***

To be sure, ESG outperformance over the short term should be taken with a grain of salt. At the end of the day, the consensus of investors is that ***ESG is a long-term outlook strategy***. Investment risks linked to global climate change may be accelerating, but they are still longer term in nature. Firms with poor social and governance ratings may continue to be successful, even over the coming years. However, ESG-minded investors predict that, over time, investments in firms with unsustainable environmental practices, a lack of diversity, and poor worker engagement and governance will be exposed to greater risks and losses over time.

Short-Term Potential in a Unique Crisis

Despite ESG's long-term thesis, the COVID-19 crisis has demonstrated that perhaps these strategies have greater short-term potential—or at least, potential during such a unique market event, as ***they hedge against many of its unique risks***. Fossil fuel avoidance hedges against decimated demand for auto and jet fuel. Increased scrutiny on worker benefits and protections bodes well for firms with strong ratings in these areas. ESG investors and funds are less likely to be caught up in panicked selloffs, as they take a longer view.

Multiple studies of the market rout, spanning roughly late February through March, demonstrate that ***ESG investments tended to outperform their peers during this period***: ESG ETFs, mutual funds, and well-rated companies tended to decline less than the broader market, while firms who rated poorly on ESG metrics tended to underperform their benchmarks.

S&P Global ***analyzed 17 ETFs and mutual funds***, which select stocks based in part on ESG criteria, and found that ***12 lost less value than the broader market***, as represented by the S&P 500.[2] The top performer had a 5.4% decline through the year as of close April 9, versus a 13.7% decline in the S&P 500. Similarly, the Wall Street Journal found that ***60% of the largest ESG ETFs and mutual funds lost less than the S&P 500*** during the first quarter.[3] Perhaps the outperformance of ESG funds is due to obvious factors in weighting: They tend to be weighted more heavily towards technology stocks—

[1] "Sizzlers and Fizzlers," *S&P Dow Jones Indices.*

[2] "Major ESG investment funds outperforming S&P 500 during COVID-19," *S&P Global Market Intelligence*, 13 April 2020.

[3] "Sustainable Funds Fell Less During the Selloff," *The Wall Street Journal*, Maitane Sardon, May 3, 2020

some of the better performers in March—and generally avoid all or part of the fossil fuel supply chain, some of the worst performers during the lockdown.

Favorably weighted ESG ETFs and mutual funds were not the only outperformers during the February to March selloff, however. A study carried out by Fidelity International demonstrated that equities and fixed income securities of firms rated highly on ESG factors outperformed their peers, while poorly rated firms' stocks and debts underperformed.[4] The study found that each level of Fidelity's proprietary ESG rating scale (A down to E) translated to an additional 2.8 percentage points of stock performance versus the S&P 500 on average, among the 2,689 companies rated.

ESG as a Metric of Long-Term Viability

As long-term investors, some ESG investors have viewed the present crisis as a litmus test for firms' capabilities to handle the next global crisis. The *Journal* has reported that since March, an investor coalition with a combined AUM over $9 trillion, representing more than 300 investors including big names such as Invesco and BMO, has formed to pressure companies to provide paid sick leave and protections for worker health.[5] ESG investors believe that well-rated companies that handle the current crisis with the appropriate care will perform better in the short term, but, more importantly, these firms' handling of the current situation ***will translate into longer term sustainability and viability***, especially when facing similar future crises.

The COVID-19 crisis shows that while ESG investing is a long-term thesis, its emergence as a competitive strategy was closer than we may have previously thought. The unique pressures of a pandemic and lockdown put a brighter spotlight on how well or poorly companies engage with their workforce, potentially accelerating the struggles and demises of poorly ESG-rated firms. Demand for fuels are down, creating short-term pressures on the nonrenewable energy sector, but these short-term pressures have come during a paradigm shift in the fuel sources of our nation's electric grid. The COVID-19 crisis may be a snapshot of where we are headed as investors—***a world where ESG strategies are not just wishful thinking, but integral to sound investing policy***.

Credit Ratings Increasingly Tied to ESG Ratings

ESG considerations have already begun to affect how issuers access capital markets. In April, Moody's reported that ***material ESG risks were cited in one-third of its 7,637 private-sector rating actions*** in 2019.[6] Of these rating actions, 88% cited governance concerns, 20% cited social concerns, and 16% cited environmental issues, and in many instances, the ESG concerns were the key drivers in the rating change. The report states that ESG considerations are of "growing importance" in Moody's assessment of issuer credit quality, as "the materiality of key environmental and social issues continues to increase."

Accelerating Transition to Renewables

Long-term ESG risks linked to global climate change are already becoming material—due to massive structural changes in the U.S.'s energy consumption habits—not the COVID crisis. The U.S. Energy Information Administration's May 2020 Short-Term Energy Outlook shows that for the first time in U.S. history, the EIA expects both ***nuclear and renewable energy sources to overtake coal burning plants*** in terms of billions of kilowatthours of electricity generated.[7] In 2020, the EIA expects coal generation to fall by 25% and renewable energy sources to grow by 11%, and the EIA expects renewables to ***continue to outproduce coal in 2021***.

Despite the Trump administration's efforts to boost America's coal producers by loosening clean air regulations, coal burning plants have continued to shutter, with major utilities ***planning to retire dozens of***

[4] "Survival and sustainability," *Fidelity International,* Anne Richards, Chief Executive Officer, 16 April 2020.
[5] "Coronavirus Fuels Investor Push for Worker Benefits," *The Wall Street Journal,* Dieter Holger, 6 May 2020.
[6] "ESG risks cited as material in one-third of Moody's private-sector rating actions," *Moody's*, 14 April 2020.
[7] "Short-Term Energy Outlook (STEO)," *U.S. Energy Information Administration*, 4 May 2020.

plans in the next five years, according to *S&P Global*.[8] No new coal plants are currently slated to be built, according to *The New York Times*¸ and in the first four and a half months of the year, renewables "***produced more electricity than coal on 90 separate days***—shattering last year's record of ***38 days for the entire year***."[9]

Even if the pandemic's short-term effects—specifically, decreased energy demand—may play a small part in these changes, ultimately we are adopting renewable energy sources at an astonishing pace and moving away from coal simply because ***renewables have gotten so much cheaper***: The cost of building wind projects declined by 40% over the past decade, according to the Department of Energy's Lawrence Berkeley National Laboratory, and the cost of solar projects declined by 80% from 2010 to 2018, according to the National Renewable Energy Laboratory. Increasingly cost-efficient renewables, coupled with a fracking boom that has pushed natural gas prices to some of their lowest prices in history, will all but guarantee that we leave costlier and dirtier coal behind in the dust.[10]

ESG: Where Investors Are Headed

The importance of ESG considerations will only grow in magnitude over the coming years due to all of these changes: ESG criteria will increasingly impact credit ratings and creditworthiness; the long-term viability of firms will depend on robust governance, transparency, and worker engagement; and the ways we produce and consume energy—not just as a nation, but as a whole planet—will change as we transition away from nonrenewables to cheaper renewable sources.

In the near term, some investors may see the potential for ESG as a defensive play during the COVID-19 crisis. Increasingly, investors are seeking out ESG funds and strategies to build their long-term portfolios. However, the present crisis demonstrates that in the end, all firms and investors will eventually need to start paying attention ESG factors, or otherwise risk their performance lagging behind their peers. For all these reasons, HFR Investments believes that an ESG framework is modern finance, and we continue to use ESG metrics to target alpha.

NEXT TIME: Alternative ESG Strategies

Stay tuned for the next edition, which will cover the emergence of alternative ESG investing strategies.

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[8] "So far, COVID-19 fallout not altering plans to retire US coal-fired plants," *S&P Global Market Intelligence,* 6 May 2020.

[9] "In a First, Renewable Energy Is Poised to Eclipse Coal in U.S.," *The New York Times*, Brad Plumer May 13, 2020.

[10] "Henry Hub Natural Gas Spot Price," *U.S. Energy Information Administration*.