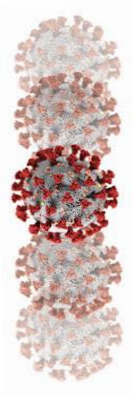
Ethical Capital Opportunity ECO Advisors

RESEARCH SPOTLIGHT

Q1 2020 COVID-19 AND ESG



ESG investing and performance in challenging markets The coronavirus crisis, and the reaction of governments, business, and individuals to the virus, are likely to have profound effects on virtually every aspect of our lives. The nature of relationships between governments, businesses, employees, consumers and investors are undergoing a process of realignment and reevaluation, and at this stage the long term outcome is far from clear. However, we can already see the emergence and development of particular themes that relate to ESG investing, and in this section we discuss how we view the benefits of an ESG focused investment process in the current investment landscape.

Addressing the critics Prior to the crisis, we had heard criticism from ESG skeptics that ESG investment was a “nice to have”, but would likely be abandoned by “hard nosed” investors in a time of crisis. Needless to say, so far, nothing has been further from the truth. In fact, this crisis has very much helped to demonstrate the benefits of an ESG investment approach. In a recent article, the WSJ highlighted that “the recent volatility in financial markets due to the coronavirus pandemic could provide investors with more of an incentive to grill companies on nonfinancial [i.e., ESG] risks.”[1] As such, **we strongly believe that ESG issues are becoming more, not less relevant**, as investors look to assess how companies react and respond to the crisis.

We associate ESG with company-specific superior long term operational risk management, and believe the market will assess companies on this basis and price further differentiation. We have always maintained that companies who excel at ESG tend to be better managed, both operationally and financially. We also find that they tend to have superior corporate risk management as well as stronger balance sheets, and consequently are typically better able to withstand unexpected shocks. In contrast, those companies that ignore ESG considerations tend to be less operationally robust, often use more “financial engineering” to deliver shareholder returns and are often more vulnerable to legal, political and other external shocks. COVID-19 has offered a powerful test of this thesis. **from an ethnic minority background by 2021. Jon Thompson, Financial Reporting Council chief executive, said in response to the report “it is unacceptable that talented people are being excluded from succession and leadership simply because companies are failing to put in place appropriate policies on boardroom ethnicity.”** [8,9]

COVID-19 & workplace inequality: a life and death issue The COVID-19 pandemic has brought to the surface a number of important ESG themes. Analysis of S pillar issues, including labour practices and HR policies, forms a key input in our ESG security selection process. One area where we can see important impacts is general employment practices and specifically the “gig economy”.

Unfortunately, some of the most severe economic impacts of COVID-19 are falling on the part of the economy which is least able to afford them.[2] For example, approximately 70% of US workers do not have the luxury of working from home, including factory workers, grocery staff, and those who work in industries such as waste disposal, retail and health care.[3] Many gig economy workers such as taxi and delivery drivers, cleaners and events staff who do not receive company sick pay are speaking out about concerns over not being able to pay bills and put food on the table.[4] Almost 36% of Americans participate in the gig economy in some way.[5] Making matters worse, some countries, including the USA, do not mandate paid sick leave. About a quarter of US workers currently get no paid sick leave at all.[6]

COVID-19 as a catalyst for change In our view, recent events may well be acting as a catalyst for fundamental changes in a number of countries in the area of employment practices, instigating a pushback against companies offering precarious employment conditions. For companies that employ or rely on questionable labour practices, these changes are likely to have material effects that are not necessarily included in financial forecasts, earnings estimates or equity market pricing. Companies that already employ best-in-class labour standards, on the other hand, are much more likely to be resilient to this change and will have already incorporated these upfront costs in their business models.

In the UK, the government has announced that it will pay the wages of employees unable to work due to the pandemic. In a radical move aimed at protecting people's jobs, lasting three months, but potentially longer if necessary, it will pay 80% of salary for staff who are kept on by their employers, covering wages of up to £2,500 a month.[7] Other governments have announced similar measures to mitigate the employment impact of social distancing.

We expect that governments who have shouldered the burden of protecting workers during this crisis will seek to ensure that in the future the costs of such interventions are shared with employers. In our view, ESG leaders in this area are likely to have the advantage over their peers.

In the US, the federal government signed the biggest economic support package since the 2008 financial crisis, estimated to be $2.2tn, focussed on industries hardest hit by the coronavirus pandemic, including airlines, steel, cement and tourism.[8] A bailout is not strictly free money from the government, and can come in the form of loans or grants with limitations, such as conditionality based on company-employee relations.[9] Again, we expect that corporate welfare will likely need to be associated with changes in the employee relationship, and governments may expect a quid-pro-quo in exchange for aid and support.

Beyond regulatory pressure, there is also general societal pressure to provide extended sick pay and a higher standard of benefits for employees. Elizabeth Warren asking Uber and InstaCart CEOs to reclassify their workers as employees[10] does not have regulatory teeth (yet), however it sends a strong signal to these brands. Walmart announced a new emergency-leave policy for its hourly workers after a store employee tested positive for the virus.[11] Uber, which largely operates in the gig economy, will expand its policy on sick pay so drivers placed in quarantine or asked to self-isolate by public health officials will be eligible for up to 14 days of paid sick leave.[12]

Emergency policies, conditional bailouts, other government policies and societal or employee-level pressure are likely to be expensive. This is evidenced by the fact that McDonald's is pushing for changes to the Families First Act that would require its restaurants across the US — 95% which are owned by franchisees — to give workers two weeks of paid sick leave, describing it as an effort to protect franchisees' financials.[13]

We believe companies that implement best practices in labour management, including flexible policies or paid leave, are better prepared to manage in this period and will be less impacted by this crisis or future disruptions. These companies are less likely to need to rely on conditional loans or grants, or be regulated into bearing unexpected (and unbudgeted) costs.

One example of corporate leadership in this area is Novo Nordisk, which we believe implements best practice in all labour management categories, including compensation and non-compensation benefits. These benefits cover all employees. In seven years, the company has been granted 16 awards as an employer, and enjoys low employee turnover rates. It is unlikely that Novo Nordisk will have to assemble an ad hoc extended sick leave policy, for example, to deal with the current crisis.

This is in contrast to companies with poor labour management policies and company-employee relations, and a reliance on precarious work. We feel that such companies are at higher risk of being pressured, either by regulation, employees, or society, into scrambling to put together emergency policies or relying on government handouts.

Conclusion The coronavirus crisis, and our society's reaction to it, is still at an early stage. The long term ramifications for investors are still to be fully understood. However, at ECO Advisors we are confident that the importance of ESG in the investment process and as an alpha driver has never been greater.

We end this section with the recent words of Mark Cuban, billionaire investor and entrepreneur, on corporate management and the current crisis.

"If you're a great company, your shareholders will understand and will expand their P/E out of respect, because they're all dealing with the same circumstances ... If you get branded as a company that acted in bad faith, laid off all your employees, or really cut back and you took a bonus or whatever, you're going to get crushed and your brand is going to go straight into the toilet."[14]

Well said, Mark.

REFERENCE FOOTNOTES

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