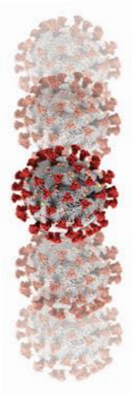
RESEARCH SPOTLIGHT

Q2 2020 S PILLAR POST-COVID



In our Q1 Research Spotlight, we observed that the COVID-19 crisis has highlighted the importance and benefits of ESG investing, and that "S pillar" themes like workplace inequality were only likely to increase in importance for corporations and investors alike. There clearly has been a growing awareness and recognition of the "S in ESG". But is it a temporary shift in focus, or a more structural shift in how investors will assess ESG materiality?

Several S pillar ESG themes have developed in 2020 which we are monitoring closely. This quarter, we share our perspectives on two important S pillar ESG themes emerging in the post-COVID landscape that we believe may have a growing influence on both investment decisions and corporate outcomes: Supply Chains and Diversity.

Supply Chains Post-COVID, we believe global supply chains may begin to change significantly. Increasing numbers of observers have been arguing that the tendency of companies to systematically pursue low-cost resources and suppliers is not compatible with resilience, which focuses on having diversified and sustainable sources.[1] COVID-19 has put supply chain resilience in the spotlight.

Agriculture is one industry that shows particular vulnerability. According to Farm Animal Investment Risk & Return (FAIRR), an investor network that focuses on factory farming, COVID-19 has been a "warning of the role modern animal production systems can play in increasing zoonotic disease risk." In fact, the animal protein industry is not only one of the most "vulnerable industries to zoonotic outbreaks, but also plays a role in creating them." In their report entitled "An Industry Infected", FAIRR showcased that meat processors were one of the hardest-hit sectors by COVID-19. 73% of the 60 listed meat, fish and dairy companies studied were classed as high-risk. Four of the worst five were suppliers of eggs and poultry, including China's Sunner and Cal-Maine Foods.[2] Lax safety standards for food and workers, close confinement of animals, and overuse of antibiotics in agribusiness will likely come under closer scrutiny.[3] Reflecting this theme, Cal-Maine Foods and JBS, one of the world's largest meat processing businesses, are both positions in our short portfolio.

Outside the agricultural sector, the practice of outsourcing to countries where labour, health and safety protections are weak has persisted, despite the fact that many U.S. businesses have been aware of supply chain risks stemming from the ongoing trade dispute between China and the U.S. We observe that this cost-saving practice is not without its risks. Almost 75% of U.S. businesses experienced supply chain disruption as a result of the COVID-19 outbreak, according to a survey by the Institute for Supply Management conducted between February 22nd and March 5th.[4] This comes after a survey conducted in mid-February by Thomas, a major North American industrial sourcing platform, found 60% of North American manufacturers' operations had been affected by the COVID-19 outbreak. 56% of respondents indicated that they have a plan in place to address supply chain disruption from China, with 28% saying they were looking for alternative suppliers internationally and 28% saying they were looking for new suppliers domestically, according to the Thomas survey.[5] These changes come at a time when many are asking: "Is this the end of globalisation as we know it?"[6]

While the magnitude of change is still uncertain, we feel confident that supply chain transparency and robustness is increasing in importance for many industries, and a key part of ESG leadership in many sectors is the ability to manage operational "tail-risks" associated with supply chains.

Diversity In many countries, COVID-19 has disproportionately affected minority communities, and has drawn further attention to the issue of diversity. The push for diversity and minority representation within companies, particularly at senior levels, has been brought to the forefront in the post-COVID period by increasing tensions surrounding racial injustice. Many investors and asset managers alike are calling for the recognition of racism and its associated inequality as an important ESG issue.[7]

The issue of diversity was recently highlighted in the UK this year by the Parker Review, an influential government-backed diversity assessment. The review found that half of FTSE 100 boards had no representation from black, Asian and minority ethnic (BAME) groups in 2017, and recommended a target for all FTSE 100 boards to have at least one director 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]

While a laudable social goal, should diversity be a key consideration for investors when viewed through a lens of ESG materiality? Although the literature around the question of whether diversity directly translates into better firm performance is not unequivocal, much of it strongly suggests that the answer is "yes". Examples include research that shows a positive relationship between board diversity and firm performance, specifically indicating that diversity boosts firm reputation and innovation.[10] One study concludes that board diversity is positively correlated with return on assets and other investment indicators of firm performance.[11] Another study finds that board diversity increases firm performance when half of the board consists of independent directors.[12]

Although we have not found full consensus on the topic in the academic literature,[13] recent events suggest the positive effects of diversity (and the negative business consequences stemming from a lack thereof) are likely to be increasing in the current climate. It is clear that expectations are changing, and consumer and employee attitudes towards diversity are having a greater impact. As just one example, tens of thousands of consumers have participated in the viral Instagram hashtag #pulluporshutup, which challenges brands to be more transparent around minority representation in corporate roles as well as leadership roles. Consumer decision making is already being affected, with many consumers voicing that they will no longer be purchasing goods or services from brands that do not disclose this information or from those brands that demonstrate poor diversity.

We can observe that grassroots campaigns can have material impacts on companies, and Facebook provides a very recent example. Civil society groups, including the National Association for the Advancement of Colored People, Sleeping Giants, Free Press, and Common Sense, called for a boycott of advertising on Facebook due to its refusal to remove posts inciting racially charged hate speech. These organisations sent a joint open letter to companies advertising on Facebook, asking them to pause their spending on ads from July.[14] More than 160 companies, including Coca-Cola, Honda, and Starbucks, joined the #StopHateForProfit movement.[15] The material link between civil society, consumer perceptions and company reputation is becoming clearer around race and diversity issues.

As investment managers, we believe that what we can term "diversity risk" is only in the early stages of being recognised and priced by the market. We feel it is reasonable to conclude that diverse organisations at the employee and management level are far less likely to see brand impairment or other negative financial consequences as a result of such consumer campaigns. Investors are now calling on companies to provide more extensive disclosures required to accurately assess this broad S pillar issue, including board diversity, diversity in corporate management roles more broadly, and pay equity disclosure across race and gender.

Conclusion It is clear that S pillar trends are likely to become more material to investment outcomes in the post-COVID landscape. Nasdaq's chief economist Phil Mackintosh believes that calls for social justice and the spotlight on racial inequality in corporate America will fuel interest in ESG. "What you want is so much money chasing those good factors that the corporates themselves want to project better factors and behave better," he is quoted in a recent interview.[16]

As the demand for transparency rises, improved company disclosures on board diversity, compensation, ethical practices and policies, and other metrics for these ESG issues may translate into better investment decisions as materiality is demonstrated, while a lack of transparency may be a disincentive in and of itself for equity investors.

At ECO Advisors, we believe that social justice and fairness is something we should all strive for as a society as a whole. We also believe that incorporating diversity considerations in the investment process makes sound investment sense.

REFERENCE FOOTNOTES

[1] https://www.cips.org/Documents/About%20CIPS/2/CIPS_Ethics_Guide_WEB.pdf

[2] https://www.fairr.org/article/industry-infected/

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[6] https://www.investorschronicle.co.uk/comment/2020/03/03/covid-19-the-end-of-globalisation-is-nigh/

[7] https://www.responsible-investor.com/articles/it-is-time-for-investors-to-recognise-that-systemic-racism-is-an-esg-issue#.XtiP4aX06_M.twitter

[8] https://www.ft.com/content/945ce30e-4762-11ea-aeb3-955839e06441

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[10] https://onlinelibrary.wiley.com/doi/10.1111/j.1467-6486.2009.00839.x

[11] https://onlinelibrary.wiley.com/doi/abs/10.1111/1467-8683.00011

[12] https://ideas.repec.org/a/ids/ijmefi/v11y2018i3p260-270.html

[13] We have found fewer studies that suggest a *negative* relationship between board diversity and firm performance, but one study concludes that firms with more diverse boards have greater fundamental volatility and hypothesise that board diversity makes decision-making more erratic (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2766447)

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[15] https://www.stophateforprofit.org/participating-businesses

[16] https://www.cnbc.com/2020/06/13/how-the-george-floyd-protests-can-drive-esg-investing.html