Q2 2022 GROWING IMPORTANCE OF SOCIAL FACTORS IN THE POST-COVID ECONOMY

"RIP ESG?" In 2022: Acknowledging the Critics, Addressing the Challenges

The first half of 2022 has seen a noticeable, vocal increase in criticism of ESG investing. From the underperformance of certain ESG and low carbon long only strategies in recent months, to Elon Musk's loud criticisms after Tesla was removed from a major ESG index[1] and increased focus on so-called "greenwashing", it is evident that the proverbial mood music around ESG has changed. Claims around ESG are under closer scrutiny than ever before, and it appears taking a cynical view of ESG investing has quickly become the new, fashionable contrarianism. We see a few reasons for this development.

Recent political and macroeconomic trends have been challenging, and in some cases have created short term headwinds for certain ESG thematics, particularly with respect to Environmental factors which we have discussed in prior newsletters.[2] The political difficulties in the US advancing Biden's Green New Deal agenda, the very recent US Supreme Court decision regarding the scope of the EPA's regulatory scope around greenhouse emissions regulation and the Clean Air Act,[3] and a more vocal conservative opposition to so-called "woke capitalism" must be acknowledged. And as increasing post-COVID demand collided with production capacity constraints and more recently the impact of Russia's war on Ukraine and subsequent sanctions and uncertainty, the Energy sector – particularly "brown" energy – became the best performing equity sector in H1 2022. Sector tilts common to many long only ESG investors, typically with a Growth/Tech overweight bias (vs. Value/Energy), acted as a headwind to the performance of many well known and popular ESG strategies in 2022, further fueling scepticism about the investment value of ESG. All these factors have encouraged a narrative of ESG facing a "reckoning", and the FT to publish headlines such as "RIP ESG?"[4]

We do have sympathy for some of the concerns raised by various ESG critics; for example, it is evident that regulators may have identified some evidence of "greenwashing" which does need to be addressed by the asset management industry.[5] Furthermore, the outperformance of the Technology sector and the relative weakness of the Energy sector in the earlier part of the COVID pandemic did encourage some ESG proponents to perhaps "declare victory" somewhat prematurely, with respect to rather crude and short term evaluations of investment benefits of ESG-focused strategies.

However, while we believe it is only right to acknowledge some of the fair criticism of the ESG industry, alongside some of the cyclical headwinds that have recently been problematic for "E" focused investment thematics, it is equally important to recognize that other important aspects of ESG have in fact been strengthening in the post-COVID market environment.

We firmly believe that a balanced, diversified approach to ESG investing is critical for delivering alpha in the long term over the market cycle. Given the impending climate emergency, compelling new scientific research and the political and media coverage received on the topic, it is no surprise that the Environmental themes have received the most attention in recent times. However, it is important to remember ESG investing is much more than just "E". In this Research Spotlight, we look to illustrate that while some aspects of the near term environment may have been challenging for Environmental themes, other aspects have in fact been accelerating the impact of Social factors.

Below, we review some of the "S pillar" drivers that we see becoming ever more material to investors in the post COVID economy; while we have discussed these themes in our prior work and newsletters, our ongoing research continues to support the thesis of their growing importance for ESG investors.

The S Factor: Employee Relations, Human Capital & the Link to Corporate Value

The past year has proved challenging for many companies in the wake of COVID. Rising inflation levels and interest rates, coupled with historically tight labour markets and the struggle to manage supply chain disruptions have all posed a significant challenge for companies. In such an environment, management of human capital has become even more critical for companies. We suggest that companies with superior labour management practices, healthy employee relations, and generally more satisfied employees can have a competitive advantage relative to their peers in this period. Let's review some of the aspects of this environment that have supported this thesis.

Challenges to the Gig Economy: Regulation & Labour Market Developments

In our Q1 2020 newsletter, we discussed at length the impact of COVID on the gig economy, and how some of the most severe economic impacts of COVID fell on the part of the economy which is least able to afford them. With approximately 70% of US workers not having the luxury of working from home, benefits such as sick leave and more stable working conditions, as well as corporate culture around employee wellbeing, have taken on a new importance and value – not just to the employees, but in the corporate fight for retention. In a competitive post-COVID labour market, companies that provide a superior environment for their workers can have an advantage, reducing turnover and improving productivity.

The tight labour market conditions resulting from COVID, and the subsequent discussion of the "Great Resignation", with a significant number of persons leaving the labour force, is acting as a catalyst for fundamental changes, instigating a pushback against companies offering precarious employment conditions. In the words of Anthony Klotz, a management professor at Texas A&M University's Mays Business School who coined the phrase, "The pandemic brought the future of work into the present of work".[6] And "S pillar" leaders who are ahead of the curve should adapt much more easily, and at a lower cost, than laggards.

For companies that employ or rely on questionable labour practices, these changes are likely to have material effects that may not be fully reflected in financial forecasts, earnings estimates or equity market pricing. Uber is one recent landmark example in UK labour law on employment rights, where the Supreme Court mandated that the company pay its drivers the national living wage, provide paid holidays and sick pay, and be classed as workers rather than being self-employed. [7] [8]

Supply Chains, Transparency and Risk

While supply chain risk is not a new concern for business, the post COVID environment has put a renewed spotlight on supply chains, while the political environment has also increased the dangers for companies of relying on outsourcing with low levels of scrutiny or transparency.

Despite the fact that U.S. businesses have been aware of supply chain risks stemming from the ongoing trade dispute between China and the U.S., outsourcing to countries where low-wage workers are abundant, and labour, health and safety protections are weak, has persisted. According to an ISM survey, COVID disrupted supply chains for nearly 75% of U.S. companies[9] and at the rise of the pandemic, nearly 50% of respondents said they did not have a plan in place to address China-related supply chain disruptions.

Pandemic induced stress in global supply chains handed an advantage to those firms that excel at supply chain risk management, and have superior transparency into outsourced labour practices. Crackdowns on negative working conditions in industries like industrials and consumer staples are also ramping up, as shown recently by the U.S. ban on goods produced in Xinjiang, China, citing slave labor as the reason for the ban,[10] demonstrating that relying on staff employed in substandard working conditions can be costly for all stakeholders. But the risks are not strictly limited to offshoring or emerging markets: in 2020, damaging media reports about factory working conditions in the UK and poor supply chain labour standards at Boohoo surfaced. The online fashion retailer saw its share price fall close to 50% after the scandal was made public.[11]

According to McKinsey, many businesses do not have a good idea of what is going on lower down in their supply chains, where subtiers and sub-subtiers may play small but critical roles. This is where many disruptions originate, but two-thirds of companies say they cannot confirm the business-continuity arrangements with their non-tier-one suppliers.[12] The risks are real, and superior supply chain practices with a focus on transparency and risk management in this area can give ESG leaders an edge over their peers.

Employee Satisfaction and Corporate Performance

Our Q1 2021 Research Spotlight focused at length on the topic of staff satisfaction, examining developments in the literature and evidence for the link between satisfied employees and superior corporate performance. Our review found that the theoretical and empirical literature provide support for linking employee satisfaction with firm value and competitive advantage.

We do not wish to repeat the content and literature review that we provided in our prior Spotlight (and would refer those interested in more detail on the topic to the Spotlight, which can be found here) but rather highlight some of the linkages between employee satisfaction and value creation for companies, and call out how the current post-COVID macroeconomic environment is likely to accelerate the impact of this important Social pillar issue in the current climate.

This is an area of ongoing research for us, and much of our empirical work to date corroborates the hypothesis that companies with higher levels of staff satisfaction can have an edge in outperforming their industry peers.

Importantly for this discussion, we believe that the post-COVID environment has only increased its materiality and impact for investors, for reasons we discuss below.

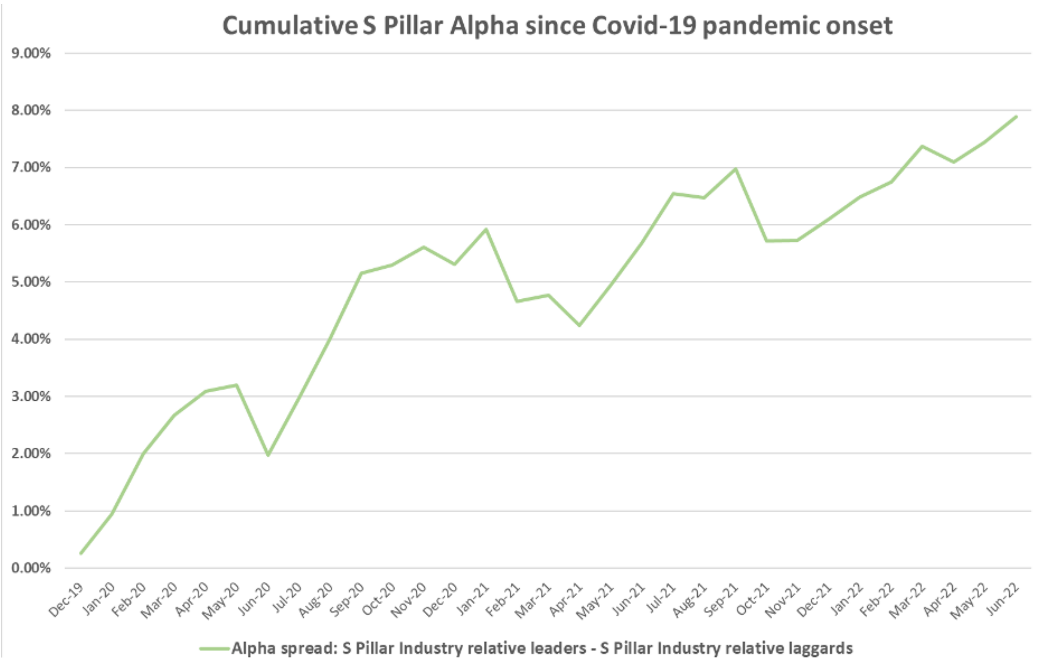
Research demonstrates that higher levels of staff satisfaction correlates with lower staff turnover. In current tight labour market conditions, the cost of turnover to firms is higher than ever, and more satisfied employees are likely to provide an indicator of which firms are winning the “war for talent”. It is evident that industry understands this, with articles like LBS’s “What’s driving the Great Resignation?”[13] becoming common, and underlining that for companies to succeed, business needs to offer an attractive environment for employees. Ultimately, the goal is to ensure higher levels of employee satisfaction.

Better employee satisfaction can also help avoid customer disruption and ESG controversy events. Across the U.S., in Illinois, Minnesota, New Jersey, and many other states, Amazon employees have walked out of distribution and delivery centres over the past few years, calling on the company to stop understaffing the facility and stating that the mega-retailer was treating them like "warehouse machinery" rather than people.[14 15 16] The work stoppages at Amazon delivery stations in Chicago in December 2021 came at the height of the holiday rush, disrupting a link in the company’s distribution chain, which aimed to offer one-day delivery in time for Christmas.[17] In the current post-COVID environment and tight labour market conditions, the risks of inadequate labour management and dissatisfied employees are only growing.

The Value of “S” in the Post-COVID Environment: an Empirical Example

The thematic hypothesis is clear: we should expect to find evidence of superior performance (after adjusting for industry and style factors) for companies leading the way in “S” pillar considerations, in the post-COVID market environment. Can we find data to support the hypothesis?

Below, we examine the performance of an industry-relative S Pillar evaluation score,[18] and look to compare returns from the “leaders” vs. the “laggards” on this S pillar evaluation during the post-COVID period – while controlling for other risk factors that may drive the performance.



Disclaimer: This analysis is based on one particular ESG data methodology and our investible universe parameters. The post-COVID time period under review is relatively short and does not represent a full market cycle. It may not be possible in practice to fully hedge all risk factors, some securities may not be borrowable, and the analysis does not include any potential transactions or borrowing costs. This above chart does not represent an investable strategy or the returns an investor may have received.

To do so, we calculate the “fully hedged” monthly returns on equally weighted fractile (decile) portfolios generated from our global equity investable universe,[19] removing the explanatory effects of exposure to market, industry, country, and style factors: these portfolio returns thus represent the theoretical returns of a “fully hedged” portfolio to all model risk factors, i.e. “alpha”.[20] We then calculate the cumulative difference in the “fully hedged” portfolio returns, representing an “alpha” from the Social pillar evaluation: the difference in average returns from the “best” S pillar securities compared to the “worst”, after controlling for other risk factors. The results are illustrated in the chart below.

The chart demonstrates the alpha differential between S pillar leaders vs. S pillar laggards since the onset of COVID, and is supportive of our hypothesis with respect to the importance of S-pillar issues in the post-COVID environment.

Our ESG research process has led us to increase both the range and importance of S pillar data evaluations used in our ESG security selection process across a number of industries. In our view, the S Pillar is becoming an increasingly more vital part of the investing landscape, which we look to reflect in our data evaluation and our portfolio.

In conclusion, to paraphrase Mark Twain, our ongoing ESG research work on S pillar topics leads us to believe that the “death of ESG” (as claimed by some of the more vocal critics in 2022) has been greatly exaggerated.

REFERENCE FOOTNOTES

1. https://www.barrons.com/articles/elon-musk-tesla-esg-51653336436 "ESG is a scam. It has been weaponized by phony social justice warriors," Musk wrote.
2. We discussed and highlighted the challenges of ongoing "brown" performance in our Q3 2021 newsletter and the underperformance of low Carbon Intensity at the universe and industry-relative levels; our Q1 2022 newsletter discusses crowding and relative valuation in key industries such as Energy and Utilities.
3. https://www.bloomberg.com/news/articles/2022-06-30/supreme-court-curbs-epa-s-climate-authority-in-blow-to-biden?sref=iVJMQjfY
4. https://www.ft.com/content/3d9436f4-f341-4885-817a-b2dd340c9868
5. This is one of the reasons we formed ECO Advisors – to put ESG front and centre in the investment process, rather than as a supplement to a preexisting investment process. This can be a struggle to implement effectively, particularly in large organisations.
6. https://www.cnbc.com/2022/05/10/-the-great-resignation-has-changed-the-workplace-for-good-.html
7. https://jordanssolicitors.co.uk/2021/04/impact-of-uber-ruling-on-drivers-holiday-and-sick-pay/
8. https://www.bbc.co.uk/news/newsbeat-56433922
9. https://www.supplychaindive.com/news/44-of-supply-chain-pros-have-no-plan-for-china-supply-disruption/573899/
10. https://www.cnbc.com/2021/12/23/us-bans-imports-from-chinas-xinjiang-region-citing-uyghur-forced-labor.html
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13. https://www.london.edu/think/whats-driving-the-great-resignation
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15. https://news.wttw.com/2021/04/07/amazon-employees-stage-walkout-distribution-center-over-working-conditions
16. https://www.business-humanrights.org/en/latest-news/amazon-workers-to-stage-a-walkout-monday-demanding-closure-of-staten-island-facility/
17. https://www.cbsnews.com/news/amazon-workers-walkout-pay-working-conditions/
18. For the purpose of this example, we utilise an industry-relative S Pillar score from one of our third-party ESG data sources to create and evaluate the hedged returns on equally weighted fractile (decile) portfolios. This S field encompasses an evaluation on a range of Social key issues/KPIs relevant to the above discussion, including employee satisfaction, diversity & inclusion, work conditions, health & safety and worker training. Readers are invited to contact us for further detail upon request.