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PERSPECTIVE

Pandemic as a catalyst for purpose: ESG investing trends.

By Sara L. Terheggen

The COVID-19 pandemic did more than just expose the inequities in our health care system. The pandemic busted open a Pandora's box of shortcomings in the US economy. In addition to economic contraction that rivaled the Great Depression, small businesses are dying on a daily basis. Unemployment is severe and people across the country are struggling more than ever to put food on the table and pay rent. At its core, our societal systems revealed themselves as severely lacking when systemic inequality was brought to the forefront through the Black Lives Matter movement.

Amidst all of this, investors plowed capital into funds focused on environmental, social and/or governance, aka ESG, factors, and sustainable assets. Investors in these funds believe ESG principles are fundamentally important for building a solid, successful business. It is estimated that assets under management for funds that mandate ESG rose by $5 trillion in just the last two years and investors in mutual funds and ETFs invested $288 billion globally in sustainable assets from January 2020 through November 2020. This represented a 96% increase over 2019 investing levels.

Most importantly, we saw better performance in 2020 from those companies with better ESG profiles. It became a year when purpose and performance catalyzed a movement that is not going anywhere. The aftermath of COVID-19 has changed investor priorities — many are now focused on technologies that transform. No longer will basic platitudes about social good be sufficient, real progress must be made. This will necessitate a continuing focus on refining business strategy, establishing metrics and assessing performance and providing investors with transparent disclosure.

The pandemic is not the only catalyst. A generational wealth transfer is occurring that will provide some long-lasting momentum to the current trends. Over the next thirty years, an estimated $30 trillion wealth transfer is occurring from baby boomers to millennials, the largest in history. While ESG has already seen significant momentum in the markets, this shift in capital will fuel the market in a much more targeted way. This is predominantly the result of millennials desire and responsibility to do good. It is expected that they will put their money where their mantras are and invest their dollars where it counts the most from an ESG perspective. This will provide stability and longevity to the ESG landscape.

In addition to a continued and growing interest in environmental factors, such as climate change, sustainability, green bonds and pollution, two trends have emerged that will continue to garner attention: a pressing demand for companies to focus on social factors and a more urgent need for real accountability in data collection, analysis and disclosure.

The Need for "S" More than Ever

While the primary focus has been on environmental when it comes to deployment of capital, racial justice, income inequality and worker safety became pressing issues in 2020 with the onslaught of COVID-19. 2020 brought these conversations to the forefront with an urgency never quite seen before.

Racial and gender equity has long been a focus but demand for true equity is pushing this beyond talk. We have obviously seen the push for change in our most basic of social systems and companies have not been excluded from the rising pressure for change.

Large institutional money managers are pushing public companies to disclose more concrete data on their racial diversity. State Street pledged, beginning with this year's proxy season, to vote against election of the chair of the nominating and governance committee of a company if the company does not disclose diversity data and in 2022, they will vote against chose committee chairs at companies that do not have at least one director from an underrepresented community. BlackRock also made plans to vote against directors who fail to act to improve board diversity.

In December 2020, NASDAQ proposed a rule that would require all NASDAQ-listed companies to have at least one woman and one diverse director. The SEC delayed their decision of whether to approve the NASDAQ proposal in an effort to seek more public comment and take more time to deliberate. A final decision is not expected until the summer. While some are adamant that the NASDAQ proposal will be rejected because of its quota system approach, others are encouraged that such discussions are an important step in implementing baseline standards for equity in our corporate systems.

Other social factors which have received significant focus in 2020 and are expected to continue to receive scrutiny is supply chain sustainability and worker conditions. Efforts to improve conditions for workers has been heightened by consumer awareness of what safety means in the workplace. Companies are being expected to act ethically and sustainability when it comes to their entire supply chain and make changes where needed.

Accountability and Action

The increasing push for companies to focus on the S in ESG has also fueled increasing demand for accountability. Fluffy disclosure and empty commitments about ESG will no longer be sufficient to satisfy most ESG investors and consumers. There is a sustained push for accountability built upon the tenets of data and transparency. Improvement in data collection, analysis and disclosure are being demanded. Data and technology will continue to drive the ability of companies to measure, calculate and monitor ESG initiatives and strategies and then disclose findings to investors.

Corporate board directors will see increasing pressure and focus on their role as stewards for the company and ensuring that E&S issues are addressed and integrated into the very fabric of the companies they oversee. While everyone has been talking for a while about ESG, 2020 catalyzed the call for integration. There has been a push for some time now to create a global ESG accounting standard. This movement has been fueled by groups such as the Sustainability Accounting Standards

Board and the International Financial Reporting Standards foundation. It is expected that these groups will put forth a proposed standard in 2021.

It will be critical for the procedural framework, measurement and reporting methodologies relating to ESG factors to become front and foremost in the minds of companies. Assessment of progress and performance as it relates to ESG cannot be an afterthought. Companies and their boards must do the work to critically assess business strategy, outline purpose and tie performance outcomes directly to compensation. The companies that are most successful at integration will come out ahead.

ESG: Catalyzing a Movement

The COVID-19 pandemic has fundamentally changed almost every facet of the economy. Despite all of the havoc wreaked upon us by the pandemic, one thing has emerged, a desire for more purpose. Investors are demanding change and progress on ESG factors and dictating penalties for the stewards of companies who choose not to move these initiatives forward. Corporations are instrumental in demonstrating a path forward for ESG. Corporations employ our people, develop our technology and pioneer our advancements. If corporations and their boards can marshal their knowledge, skill and resources towards integration of ESG, there may be hope for broader systemic change. ■

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