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ESG: a matter of value, not values

As a result of the Covid-19 pandemic, the world has dramatically changed: it is clear that industry must take a more holistic approach to ESG, as we remain engulfed by a pandemic, the effects of which will continue to pose profound social, political and economic challenges around the globe for years to come. Some argue that the COVID-19 crisis will be a catalyst for climate action, given that the speed with which events unraveled during the pandemic could bear similar resemblance to the effects of climate change. The question is then how fast we will see the repricing of assets and changes in the economy as a result of this action.

The crisis also underscores the importance of social issues, intensifying social and economic inequities where certain demographics are more vulnerable to the virus and economic shutdown. COVID-19 has escalated ESG issues, making them demonstrably integral to corporate resiliency. As fiduciaries of our clients' assets, State Street has a duty to act in their best interests and, increasingly, this includes consideration of ESG factors relevant to the performance of investee companies. Addressing material ESG issues is essential to a company's long-term performance – a matter of value, not values.

From an investor perspective, it is important to distinguish between "values-driven investing", i.e. strategies aligned with an investor's own ESG preferences that prioritise environmental or social impact over returns, and "value-driven" investing, which incorporates material ESG factors alongside other traditional financial metrics while still seeking to maximise returns (known as ESG integration). There is a growing body of research demonstrating the value of ESG integration in investment strategies: stronger cash flows, lower borrowing costs and higher valuations are common features of companies focused on managing material sustainability risks.

ESG issues have been growing in significance for some time, as structural shifts in economies and business models driven by technology are elevating the value companies derive from intangible assets, such as brand value and employee engagement. Traditional financial accounting is becoming less complete for investment decision-making, as knowledge-based companies leverage technology and talent as major sources of competitive advantage rather than the tangible assets of old-style manufacturing. It is hard to argue that investors should ignore companies' governance or their exposure to non-linear risks, such as climate change.

Now Covid-19 reinforces our view that social characteristics are a proxy for resilience. Our research illustrates that the stocks of companies with strong ESG characteristics – such as good employee safety practices, effective supply chains and agile operations able to repurpose products to meet new market needs – suffered lower declines during the March equity sell-off than the shares of competitors with comparatively weaker ESG characteristics. This indicates that ESG integration can be an effective means for promoting a long-term investment focus on value creation.

The public and private sector responses to the crisis serve as a timely reminder of how policymakers and financial market participants can collaborate to address critical challenges. With ESG, and sustainability more broadly, firmly at the heart of the EU's economic recovery, grey areas between material and non-material ESG issues must be resolved, to further facilitate the development of better metrics, methodologies and reporting standards. This cannot be fully achieved without greater international coordination, including leveraging the work of the Sustainability Accounting Standards Board and the global Task Force on Climate-related Financial Disclosures. Researchers are already making progress on ways to help investors better measure the financial impact of intangible ESG value drivers, such as human capital development. Improving the quality, consistency and comparability of ESG information is in everyone's interest and will clarify the relationship to financial materiality.

In an uncertain world in which ESG matters more, not less, to strong corporate resilience and sustainable performance, promoting material ESG considerations in investment decision-making is good for the long-term interests of all our clients. ●