Upstart Co-Lab

2020: The Case for Sustainable Investing

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A note on terminology: The field of impact investing encompasses many overlapping terms. Sustainable; socially responsible; and Environmental, Social, Governance (ESG) are the terms most used when describing public company investments seeking to generate financial performance while meeting a set of social and environmental standards. This brief on financial performance in 2020 necessarily focuses primarily on public equities which can quickly be measured, assessed and compared. "Sustainable investing" is used as the over-arching term throughout, except where the available data explicitly references ESG investments.

The financial performance of funds that actively manage Environmental, Social, and Governance (ESG) factors has been superior relative to the broad market in 2020 YTD. Public equities showed the resiliency of sustainability strategies during volatile markets responding to the economic impact of COVID-19.

During the 1Q2020 sell-off, sustainable and ESG funds held their own: nearly 60% of the biggest U.S. sustainable and ESG mutual funds and exchange-traded funds (ETFs)[1] out-performed the S&P 500, according to the *Wall Street Journal* [2]; 59% of all U.S. ESG-tied ETFs outperformed the S&P 500 Index as reported by *Bloomberg*.[3]

These trends continued through the end of the 2Q2020: 72% of 212 sustainable equity funds available to US investors ranked in the top half of their Morningstar categories, and all of the 26 ESG (environmental, social, and governance) index funds outperformed their respective conventional index fund counterparts.[4]

As of October 5, 2020 the iShares MSCI USA ESG Select ETF (based on MSCI's index of approximately 140 socially and environmentally responsible companies) returned positive 12.53% and the iShares MSCI KLD 400 Social ETF (based on one of the oldest and most reputable ESG indices which was launched in 1990) returned positive 9.25% on a year-todate basis, outperforming their conventional counterpart the iShares MSCI USA Equal Weighted ETF which returned negative 0.15%.

The driver of sustainable investing's positive relative performance was not just fossil fuel avoidance, or the overweighting of surging 'FAANG' tech stocks,[5] but a broad range of material factors. Cambridge Associates' Tom Mitchell suggests that, beyond divestment, smart ESG integration has added value in multiple sectors, across global markets for many years, particularly in consumer, healthcare, and technology sectors, among others.[6] BlackRock attributes strong performance to factors including job satisfaction of employees, the strength of customer relations, or the effectiveness of the company's board. This period of market turbulence and economic uncertainty has further reinforced BlackRock's conviction that ESG characteristics indicate resilience during market downturns.[7]

According to Morningstar, companies that perform well on ESG rating schemes are proving to be more resilient, quality companies which tend to hold up in difficult markets such as the current crisis.[8] Companies that responded to the crisis by increasing healthcare benefits, increasing pay for workers on the front lines, lowering executive compensation to help avoid layoffs, and taking extra steps to protect worker and customer safety benefit from having a more engaged and productive workforce and a more loyal customer base during a recovery.[9]

Consistent with this, JUST Capital reported that public companies in the top quintile on worker issues significantly outperformed companies in the bottom quintile, on both return on equity and cumulative returns from the start of the year through May.[10]

A May 2020 study from Harvard University reviewed the news coverage of more than 3,000 companies over the period spanning the S&P500 high on February 20, 2020 to the market low on March 23, 2020 and showed more positive sentiment in coverage (around issues such as labor practices, supply chains, and repurposing of operations) is associated with better returns, especially for companies in industries most negatively impacted by the COVID-19 lockdown.[11]

Investors are sticking with sustainable investment strategies. In 2020, sustainable fund flows in the U.S. surged at a record pace with estimated net flows of $20.9 billion through June 30 nearly matching the *annual* record of $21.4 billion set in 2019, which itself was already four times the record set in 2018 (Morningstar).[12] According to J.P. Morgan, ESG ETFs had not seen a negative week of YTD flows through 2Q2020.[13]

Goldman Sachs describes the crisis as a "stress test" for the ESG field which came into the mainstream during an historic bull market.[14] While some thought ESG issues would be pushed aside by the COVID-19 economic volatility and uncertainty, these issues have grown even more important as investors pay greater attention to business continuity efforts and how companies are weathering the pandemic.[15] *Investor Relations Magazine* observes that a fuller discussion around ESG and risk mitigation is expected as investors seek out healthy businesses that can drive long-term value creation.[16] *The Financial Times* reports that nothing about the coronavirus crisis will dislodge the prevailing trend of ESG: "The link between sustainability and index-beating returns is clear — if anything [COVID-19] has probably put a period at the end of that sentence."[17]

Current findings on sustainable investment performance during the 2020 downturn and volatility are consistent with the past periods. In May 2020, BlackRock compared the performance of its iShares ESG US Equity ETFs with broad benchmarks during two market selloffs: the 2007-2009 Global Financial Crisis and the shock of the onset of COVID-19. They concluded that ESG ETFs may help investors manage market downturns by investing in companies with strong ESG characteristics which are better positioned to manage sustainability-related risks.[18]

In 2019, BlackRock found ESG funds do better than traditional funds during times of market volatility. Companies with higher ESG scores typically exhibit quality and low-volatility characteristics — such as strong balance sheets and cash flows — which provide portfolio resilience and a buffer against market downturns.[19]

MSCI research over the past five years has found companies highly rated on ESG factors are less exposed to systematic risks such as exogenous shocks.[20] A 2018 Morningstar analysis found that when the S&P 500 fell by more than 7% during the first week of February 2018, two-thirds of ESG funds outperformed their peers.[21]

Endnotes

1 An ETF, or exchange-traded fund, is an asset that tracks a particular set of equities, similar to an index. It trades as a normal stock would on an exchange, but unlike a mutual fund, prices adjust throughout the day rather than at market close. ETFs can track stocks in a single industry or an index of equities. Sustainable ETFs track a particular sustainable index which includes public companies that consider financial returns as well as social and environmental good.

2 Wall Street Journal, per data from FactSet, "Sustainable Funds Fell Less During the Selloff" www.wsj.com/articles/sustainable-funds-fell-less-during-the-selloff-11588422269?mod=hp_jr_pos1&mc_cid=a9be914195&mc_eid=9b4f57e1a3

3 Bloomberg, "ESG Stock Resilience Is Paving the Way for a Surge in Popularity" www.bloomberg.com/news/articles/2020-03-31/esg-stock-resilance-is-paving-the-way-for-a-surge-in-popularity

4 Morningstar, "Sustainable Stock Funds Held Their Own in Second-Quarter Rally," www.morningstar.com/articles/991091/sustainable-stock-funds-held-their-own-in-second-quarter-rally

5 FAANG is the acronym that represents the 'big 5' of Facebook, Amazon, Apple, Netflix, Alphabet (formerly Google).

6 Tom Mitchell, Cambridge Associates, "Our Museums" Convening, Upstart Co-Lab, July 16, 2020.

7 BlackRock, "Sustainable investing: resilience amid uncertainty" www.blackrock.com/corporate/literature/investor-education/sustainable-investing-resilience.pdf

8 Morningstar, "Sustainable funds weather the first quarter better than conventional funds" www.morningstar.com/articles/976361/sustainable-funds-weather-the-first-quarter-better-than-conventional-funds.

9 Morningstar, "Coronavirus Crisis Highlights Need for Stakeholder Capitalism" www.morningstar.com/articles/979155/coronavirus-crisis-highlights-need-for-stakeholder-capitalism

10 JUST Capital, "Companies That Prioritize Workers See Higher ROE and Cumulative Return" www.justcapital.com/news/chart-of-the-week-companies-that-prioritize-their-workers-outperform/

11 The study by George Serafeim and State Street Associates compared news coverage of corporate responses to the coronavirus with their financial performance to see if favorable sentiment would mitigate investor distrust during the market collapse. The study, using data derived from natural language processing, focused on labor practices, supply chains and repurposing of operations for more than 3,000 companies. The authors conclude that more positive sentiment is associated with less negative returns. This is especially true, they note, for companies with more salient responses, in industries with tasks that entail more manual routine labor and those most negatively impacted by COVID-19 lockdowns. via Harvard Business School, papers.ssrn.com/sol3/papers.cfm?abstract_id=3578167

12 Morningstar, "Sustainable Funds Continue to Rake in Assets During the Second Quarter," www.morningstar.com/articles/994219/sustainable-funds-continue-to-rake-in-assets-during-the-second-quarter

13 Jessica Matthews, J.P. Morgan, "Our Museums" Convening, Upstart Co-Lab, July 16, 2020; cited from Bloomberg Finance L.P. January 6 to June 26, 2020. Equity and FI US and Europe based ETF flows

14 Bloomberg, "COVID-19 may change corporate sustainability as we know it" www.bloomberg.com/professional/blog/covid-19-may-change-corporate-sustainability-as-we-know-it/

15 Bloomberg, "COVID-19 may change corporate sustainability as we know it" www.bloomberg.com/professional/blog/covid-19-may-change-corporate-sustainability-as-we-know-it/

16 IR Magazine, "Covid-19 response highlights shift to stakeholder value" www.irmagazine.com/covid-19/covid-19-response-highlights-shift-stakeholder-value

17 Financial Times, "Coronavirus is strengthening the hand of ESG investors" www.ft.com/content/19047cda-0648-48a9-a512-87653149026c

18 Morningstar Webinar, "How to Have a Client Meeting in 2020: Framing ESG in the context of the current crisis," May 21, 2020

19 BlackRock, "Sustainability: The future of investing" www.blackrock.com/us/individual/literature/whitepaper/bii-sustainability-future-investing-jan-2019.pdf

20 MSCI, "MSCI ESG Indexes during the coronavirus crisis" www.msci.com/www/blog-posts/msci-esg-indexes-during-the/01781235361

21 Marketwatch, "Sustainable funds outperformed the broad market in the recent correction" www.marketwatch.com/story/sustainable-funds-outperformed-the-broad-market-in-the-recent-correction-2018-02-15?mod=article_inline