
Market Update – Commentary

COVID-19 and the Rising Importance of the ‘S’ in ESG

COVID-19 has brought to light the importance of the workforce, community and customer to a company's bottom line. We've long known that a company's ability to be resilient in times of distress is rooted in both financial and nonfinancial factors, including Environmental, Social and Governance (ESG) factors. While the focus in ESG has historically been on governance practices and environmental metrics, we are now seeing social issues at the forefront.

In some ways, this is not as much a new revelation as it is a more visible one; 2018 saw more CEOs stepping down due to ethical lapses as opposed to financial performance, and stakeholders have increasingly been engaging with companies to disclose more on 'S' metrics. The global pandemic has both amplified and accelerated the push of social issues as an economic reality, driving forth the evolution from the 'S' as a values-based question to the 'S' as a material business question.

Prepared for the Unexpected

There will be increased acknowledgment that 'S' factors can help investors to understand how resilient a company may be. Investors are tracking the responses of companies and simultaneously taking a forward-looking approach to understand how the response to COVID-19 may be an indication of how a company might respond to other challenging environments. This is rooted in the belief that a company's actions today can have long-lasting implications related to material social factors, such as employee satisfaction, worker safety, and productivity. As asset owners join forces to call for corporate action to support crisis efforts, it has become clear that today's decisions regarding community engagement and societal benefit have the potential to meaningfully impact a company's reputation. COVID-19 demonstrates a stress test of sorts for performance on ESG metrics, and investors are seizing the opportunity to use 'S' factors to assess whether companies are prepared for future crises or unexpected events. For example, asset managers are assessing issues such as how employers deal with contract workers, whether they cut loose employees or keep paying them during the pandemic and if the company has a strong work from home policy as these can be factors that drive long-term productivity and create greater **employee loyalty**.

Focus on the Metrics That Will Matter in the Long Run.

The heightened focus on 'S' factors will require investors to understand how companies approach social considerations in their core business model in the long-term, not just how they respond in the moment. Understanding the role social factors can play as part of an overall approach to risk management can help to identify key metrics that can drive competitive edge and financial outperformance. In the near-term, investors may be focused on the response to COVID-19 and societal contribution, but in the long-term we believe it will be important to assess company performance on social issues across their business to better understand how companies treat their broader set of stakeholders over time, as opposed to looking at a point in time. Identifying and understanding the strong business practices that underpin a positive response to COVID-19 today may help to determine longer-term

performance on material social issues, in part because a company's response to COVID-19 is dependent upon the level of impact of COVID-19 on their industry, while fundamental business practices persist beyond the pandemic. For example, we have observed companies in the restaurant industry that face constraints on allowing remote working setups focus on providing personal protective equipment (PPE) and more stringent sanitization protocols to ensure a working environment that is as safe as possible, increasing employee safety and potentially garnering employee loyalty and positive reputational impact in the longer-term. The focus on employee safety from these companies demonstrating a positive response is likely not unique to the COVID-19 pandemic, and understanding the company's pre-existing practices on fair wage, benefits, and safety in the workplace could indicate a company's broader investment in their employees through all time periods, as opposed to pandemic response alone.

We believe assessing these practices is important as companies that invest in their people, customers and communities may be poised to outperform, with engaged employees leading to more productivity; a focus on product quality and safety leading to increased customer satisfaction; community engagement contributing to overall positive reputational impact, with all of these factors generating loyalty from multiple stakeholders and an enhanced financial bottom line for shareholders. A 2018 study conducted by JUST Capital showed that companies in the Russell 1000 that performed within the top quintile on metrics such as worker treatment, customer satisfaction, and community support generated a Return-on-Equity 6.4% higher than their peers, had higher net and operating margins, and commanded a meaningful valuation premium over their lower-scoring peers. In the first quarter of 2020, the companies of the Russell 1000 that ranked within the top quintile on these metrics outperformed their lower-ranked peers by 4.65%, outperforming the market throughout the COVID-19 crisis.

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