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ESG resilience during the Covid crisis:
Is green the new gold?

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Pandemic: a risk ignored

Equity markets plunged across all financial centres in the short weeks between Italy announcing the lockdown of Lombardy on February 23rd and the WHO classifying Covid-19 as a pandemic on March 11th. An emerging disease in China turned into one of the most serious health crises ever known in under three weeks.

The magnitude of the immediate market reaction was commensurate with the severity of the social and economic shock, and related to the fact that markets not set up to anticipate shocks of this nature were taken by surprise. Despite the recent epidemics: SARS in 2002, H1N1 in 2010, Ebola in 2014, and MERS in 2019, and although risk of a pandemic had been identified in many prospective studies, including by the national security agencies of large Western democracies, it was not on the list of the 10 most probable risks cited in the World Economic Forum's Global Risk Report, published in January 2020. Survey respondents cited climate risks, followed by cyber risks, as top concerns. Worldwide searches for 'epidemic' on Google (see Figure 1) were also relatively rare before the onset of the Covid-19. This disease, due to its magnitude, represents an extreme situation.

US equity markets started to recover after March 23rd, when the Federal Reserve announced two new facilities to support credit to large corporations. In Europe, financial markets were further reassured by a gradual easing of measures such as fiscal stimulus, liquidity support for companies facing disruptions and liquidity shortages, the introduction of a Pandemic Emergency Purchase Programme (PEPP) by the ECB, the launch of European Union solidarity fund and many others.

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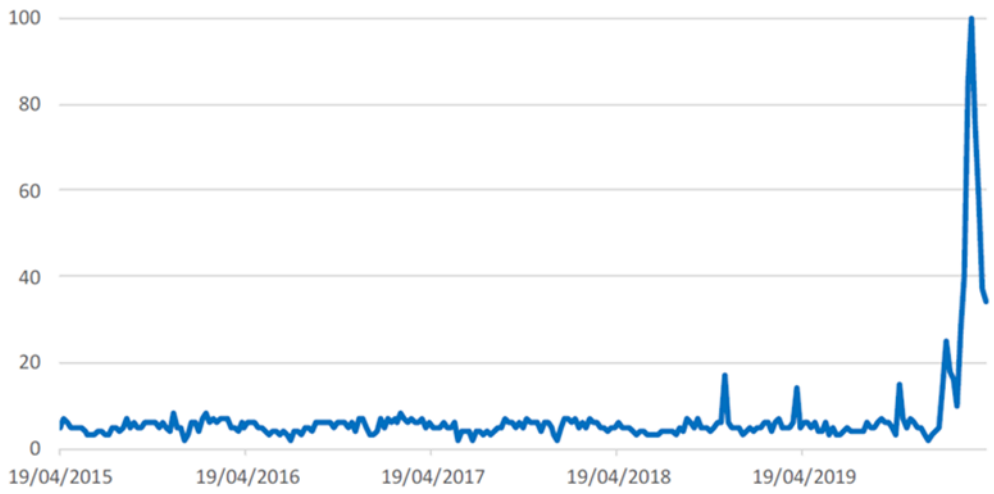
Figure 1. Daily global Google Trends search value index for the term 'Epidemic'



Source: Google, as of 16 April 2020. Scale from 0 to 100.

Serious economic consequences affect businesses unevenly

Recent academic work has been attempting to assess the potential macroeconomic impact of the pandemic (Barro et al, 2020,[1] Gourinchas, 2020,[2] Eichenbaum et al. 2020[3]). Estimates are difficult because the magnitude of the impact depends on the spread (sick people no longer contribute to GDP), but also, and above all, on political responses to limit the contagion.

For example, containment measures, national and international travelling restrictions, and border closures reduce household spending and firms' production capacity, while supportive measures help maintain wages and businesses' access to credit, avoid layoffs, disruptions to production chains, and cascading bankruptcies, and thus theoretically reduce the severity of the crisis. But political responses are endogenous and themselves depend on the scale of the epidemic and the anticipated economic impact.

Furthermore, the effect of the crisis on short- and medium-term net savings is subject to potentially contradictory developments: an increase in short-term savings due to limitations on the propensity to consume, and the possible use of the accumulated savings thereafter, but with no certainty about how much will be used. Further, the uncertainty surrounding the development of the health and economic situation may exacerbate the negative impact of the crisis.[4]

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[1] R.J. Barro, J.F. Ursúa and J. Weng (2020), "The coronavirus and the great influenza pandemic: Lessons from the "Spanish flu" for the coronavirus's potential effects on mortality and economic activity", NBER Working Paper No. 26866, National Bureau of Economic Research.

[2] P.O. Gourinchas (2020), "Flattening the pandemic and recession curves", in *Mitigating the COVID Economic Crisis: Act Fast and Do Whatever it Takes*.

[3] M.S. Eichenbaum, S. Rebelo and M. Trabandt (2020), "The macroeconomics of epidemics", NBER Working Paper No. 26882, National Bureau of Economic Research.

[4] Barro *et al* (2020) estimated the economic impact of the Spanish flu epidemic, which killed 39 million people from 1918 to 1920. The average GDP per capita of the 43 countries in the study fell by 6%. Gourinchas (2020)

According to the IMF, the global economy is projected to contract by -3% in 2020, much worse than during the 2008-09 Global Financial Crisis. In their central scenario, containment measures should be gradually unwound and economic activity should normalise in 2021, helped by policy support. But the risks of more severe outcomes remain substantial.

At the corporate level, this macroeconomic shock is manifesting itself in different ways. For example, it is disrupting production chains and causing labour shortages, closures of production facilities, falls in demand, and difficulties in accessing credit lines. The high degree of uncertainty surrounding the shock has led many investors to divest massively from financial assets considered risky, in particular equities, and to rush into cash. But the impact of the crisis so far has been very different, both across and within sectors.

Ramelli and Wagner (2020)[5] analyse the impact of the crisis on the US stock markets between 2 January and 20 March 2020. By sector, pharma, telecom, food and staples retailers did relatively well, while energy, consumer services, consumer durables, and real estate firms suffered more. Within sectors, companies whose business is more exposed to China and to international trade in general were particularly affected in the initial phases of the crisis, between 2 January and 20 February 2020.

After the beginning of the outbreak in Europe and the announcement of the first containment measures in Italy on February 23rd, investors started to differentiate between companies mostly on the basis of their levels of debt and cash holdings. These patterns were also reflected in corporate conference calls. While analysts were initially more concerned about international trade, they later turned their attention to liquidity issues. Also, companies that have been exposed to previous epidemics were considered less vulnerable by analysts (Hassan et al., 2020).[6]

Companies integrating an ESG approach recognised by investors and ESG funds have been more resilient in the crisis

Before the current pandemic, corporate social responsibility (CSR) had already become a major investment criterion, significantly influencing the valuation of financial assets in both the equity and debt markets. Numerous recent studies have shown that companies with better extra-financial (ESG) performances saw their share prices increase more than those of their competitors. We believe that this phenomenon was mainly due to demand from investors, i.e., investors increasingly incorporating these issues into their investment decisions.

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estimates a reduction in US GDP of 6.5% compared to 2019 for a two-month confinement, and 10% for three months. Current containment measures are helping to flatten the epidemic's curve but can also accentuate the severity of the recession. Ultimately, the optimal containment policy from an economic point of view depends on trends in the epidemic and the related economic impact. The estimates of Eichenbaum et al (2020), which are based on a canonical epidemiology model expanded with the modelling of interactions between economic decisions and epidemics, show that an optimal containment saves 0.6 million lives in the US, but amplifies the severity of the recession by reducing consumption from 2% (without containment) to 9% (with containment).

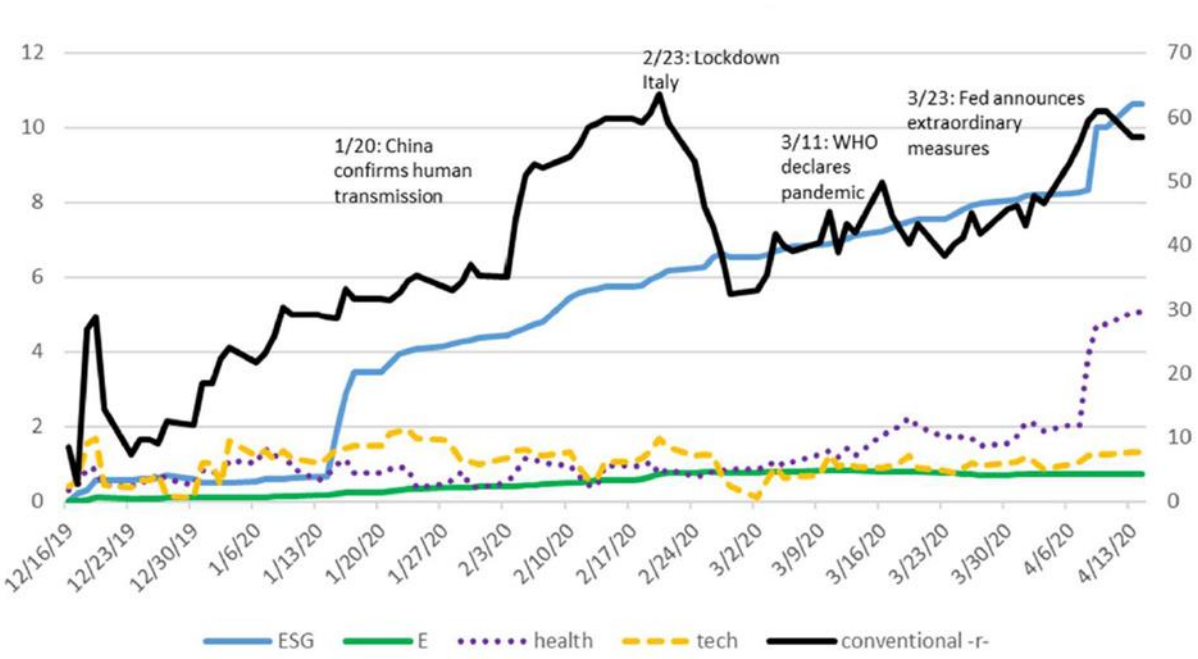
[5] S. Ramelli and A.F. Wagner (2020), *Feverish stock price reactions to Covid-19*.

[6] T.A. Hassan, S. Hollander, L. van Lent and A. Tahoun (2020), *Firm-level Exposure to Epidemic Diseases: COVID-19, SARS, and H1N1*.

What about the recent pandemic crisis? The MSCI World index dropped 14.5% in March, but 62% of large-cap ESG funds outperformed the index. Forty-two percent of funds (open-ended funds and ETFs available in the US market) were ranked in the first quartile of their category, according to Morningstar. This outperformance is partly due to the exposure of these funds to sectors less impacted by containment and social distancing measures, such as tech or telecoms, but not only these issues. Investment flows into ESG funds were also much more resilient during the crisis.

We analysed investment flows in 1,662 ETFs listed on the US market, including 75 ETFs classified ESG, 24 specialised in environmental issues (low-carbon, water, clean energy, etc), 53 specialised in healthcare and 30 in tech.[7] Cumulative flows have continued to increase throughout the crisis period, while massive sales occurred after the initial phase of the Italian lockdown in traditional equity ETFs, but also for ETFs specialised in sectors with little exposure, such as tech, and to a lesser extent, healthcare (see Figure 2).

Figure 2. Cumulative flows into US-listed ETFs during the Covid-19 crisis (USD bn)



Source: Bloomberg, authors' calculations. Cumulative flows are in USD bn. Conventional US listed ETFs cumulative flows are displayed on the right axis, ESG, E, healthcare and tech on the left.

[7] The choice to focus on US-listed ETFs, while not including the broader mutual fund market in the analysis, is due to the availability, almost in real time, of flow data for ETFs while there is a much longer lag for mutual funds. Compared to the US market, the European ETF market is smaller (approx. €700 bn vs $5.4 tn in the US in March 2020), more concentrated, and with a different structure, with only 11% of households holding ETFs vs 40% in the US.

Table 1. Average daily growth in shares outstanding, US listed ETFs

Variable	Mean	Standard Deviation	Ratio (mean ESG/conventional)	Number*
Before subprime crisis (1/1/2007 - 9/10/2007)				
ESG ETFs	2.67%	2.96%	1.271	2424
Conventional ETFs	2.10%	16.21%		72922
Subprime crisis (10/10/2007 - 10/3/2009)				
ESG ETFs	0.80%	1.01%	1.732	5550
Conventional ETFs	0.46%	1.18%		162060
Before Covid crisis (11/3/2009 - 30/12/2019)				
ESG ETFs	4.37%	21.99%	1.272	202968
Conventional ETFs	3.44%	67.53%		4392002
Covid crisis (31/12/2019 - 14/4/2020)				
ESG ETFs	1.28%	8.78%	4.618	5700
Conventional ETFs	0.28%	1.59%		120612

Source: Bloomberg, authors' calculations.
*Number of points of observations = Number of funds x number of days in the sample.

This resilience of ESG funds is not completely new. During the subprime crisis, we witnessed a comparable phenomenon, but on a smaller scale. For example, the average growth rate of the shares outstanding of US-listed ETFs was on average 1.7 times higher for ESG equity funds than for conventional equity funds during the subprime crisis (daily growth of 0.80% for ESG funds vs 0.46% for conventional funds), whereas it was only 1.3 times higher before the crisis. During the Covid-19 crisis, this daily growth rate was 4.6 times higher for ESG vs conventional funds (1.28% vs 0.28%), as opposed to 1.3 between the two crises (see Table 1).

There are several possible reasons for the resilience of ESG fund flows. On the one hand, in our view, it is possible that investors have perceived ESG as 'pandemic-proof' funds. By construction, ESG funds tend to overweight sectors that have weathered the crisis better, such as healthcare and tech, and underweight those that have been most impacted, such as transport, energy, materials, etc.

Another reason may come from a segregation of the two markets. Investors with different investment characteristics and strategies can invest separately in the ESG and conventional ETF market segments. Thus, in our view, investors with shorter horizons and higher liquidity needs could position themselves in conventional equity ETFs, with larger traded volumes and higher liquidity, explaining a massive disinvestment from these funds during crises, while investors with longer horizons could remain invested in ESG funds.

Finally, it is possible that investors have shown greater 'loyalty' to their ESG investments. Bollen et al (2007)[8] showed that flows into ESG mutual funds were more sensitive than conventional funds to positive past returns, but less sensitive to negative returns. An assumption consistent with this behaviour is that investors derive positive utility from the simple act of investing responsibly, which can compensate for the disutility associated with negative performance, and lead them to keep their investments during crises. Of course, past performance is no guarantee of future results.

There is one final reason. Even without particular loyalty, we believe that ESG may have benefited from investor preference and played the role of perceived safe havens within equity markets for the sole reason that investors anticipated that others would do the same. Historically, such conventional preferences have usually manifested themselves during crises in terms of capital shifts between asset classes but also within each asset class among different market segments: for example, within government bonds, between on-the-run and off-the-run securities, or between nominal and inflation-indexed bonds.[9] During the Covid-19 crisis – which clearly has strong social and environmental implications – it seems that investors perceived a strong ESG performance as a defensive characteristic.

Outlook for future ESG trends

The Covid-19 crisis has given prominence to social dimension among the ESG factors. Company decisions affecting workers (in particular, the health and social protection of employees, telework or unemployment policies, as well as providing production chains to produce medical equipment) have become increasingly important. Companies' environmental and climate-related action could also be better valued by market participants. In our view, it is becoming impossible to argue that investors do not have to worry about the environmental externalities generated by companies. The Covid-19 situation reminds us that natural disasters can happen suddenly and unexpectedly, and that we are more vulnerable than we might have imagined.

It is difficult to predict today whether ESG issues will continue to be a priority for investors, considering the major economic and financial issues we are going to face in coming years. But our analysis suggests that investors' taste for ESG has not lessened during this crisis — quite the opposite, in fact. At the EU level, the focus on ESG is likely to remain strong for asset managers and institutional investors. On a policy level, this has been supported so far by the Action Plan on Sustainable Finance and will continue with the upcoming Renewed Strategy.

[8] N.P. Bollen (2007), "Mutual fund attributes and investor behavior", *Journal of Financial and Quantitative Analysis*, 42(3).
[9] M. Brière and O. Signori (2009), "Do Inflation-Linked Bonds Still Diversify?", *European Financial Management*, 15(2).

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