Sustainable and Impact Investing: Defining characteristics begin to emerge with COVID-19

Summary

- Sustainable and impact investing’s potential has attracted investor interest during the COVID-19 pandemic.
- During 2020’s volatile first quarter, ESG-tilted indices tended to outperform their broad-market index counterparts, S&P index data showed. ESG fund strategies tended to have higher performance rankings than traditional funds, according to Morningstar.
- Corporate policies toward employees — social factors in ESG ratings — have varied widely during the pandemic, creating potential financial and reputational risk.

Since the COVID-19 outbreak, our Sustainable and Impact Investing team has received three broad questions about the pandemic’s effects: How have ESG strategies performed, how are investors responding and is corporate behavior an ESG issue? The team’s insights are summarized below. In addition, we provide definitions of terms commonly used to describe different categories of sustainable and impact investing, particularly ESG Integrated and ESG Mandated.

1. How have ESG strategies performed during the market’s extreme volatility?

ESG integrated and mandated strategies have long been touted in academic research as offering a lower volatility profile with less steep drawdowns than traditional counterparts.1 Reviewing first-quarter results, we have seen evidence of this characteristic.

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1 DWS-Hamburg Meta-Studies
Performance of ESG indices versus broad-market indices

Exhibit 1 below compares the performance of six ESG-tilted S&P indices to their conventional counterparts for March and the first quarter ended March 31. All six ESG indices covering U.S. developed and global markets outperformed their traditional counterparts in March, the month exhibiting the steepest drawdown. These ESG indices are designed to largely mirror their respective non-ESG versions, excluding only companies that meet very specific criteria. As we address in the following section, while some may cite fossil fuel exclusions as the driver of recent outperformance, the ESG-tilted indices shown below maintain the same fossil-fuel sector weights as non-ESG index peers.

Exhibit 1: Comparing performance of ESG-tilted indices vs. traditional market indices

<table>
<thead>
<tr>
<th>Traditional vs. ESG-tilted Indices</th>
<th>March</th>
<th>First Quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>-12.51%</td>
<td>-20.00%</td>
</tr>
<tr>
<td>S&amp;P 500 ESG</td>
<td>-11.63%</td>
<td>-18.98%</td>
</tr>
<tr>
<td>S&amp;P Europe 350</td>
<td>-14.45%</td>
<td>-24.49%</td>
</tr>
<tr>
<td>S&amp;P Europe 350 ESG</td>
<td>-14.40%</td>
<td>-24.91%</td>
</tr>
<tr>
<td>S&amp;P Global 1200</td>
<td>-13.18%</td>
<td>-21.23%</td>
</tr>
<tr>
<td>S&amp;P Global 1200 ESG</td>
<td>-12.57%</td>
<td>-20.72%</td>
</tr>
<tr>
<td>S&amp;P Global LargeMidCap</td>
<td>-13.54%</td>
<td>-21.56%</td>
</tr>
<tr>
<td>S&amp;P Global LargeMidCap ESG</td>
<td>-13.04%</td>
<td>-21.27%</td>
</tr>
<tr>
<td>S&amp;P Developed LargeMidCap</td>
<td>-13.16%</td>
<td>-21.20%</td>
</tr>
<tr>
<td>S&amp;P Developed LargeMidCap ESG</td>
<td>-12.59%</td>
<td>-20.81%</td>
</tr>
<tr>
<td>S&amp;P Emerging LargeMidCap</td>
<td>-16.44%</td>
<td>-24.36%</td>
</tr>
<tr>
<td>S&amp;P Emerging LargeMidCap ESG</td>
<td>-14.40%</td>
<td>-24.91%</td>
</tr>
</tbody>
</table>


ESG Manager Performance

An analysis of the Q1 2020 performance of “sustainable” mutual funds — as defined by Morningstar — also supports the thesis that ESG strategies may outperform in stressful environments. The broad sustainable funds category includes ESG Integrated, ESG Mandated and Thematic strategies discussed above.

Exhibit 2 includes the 203 “sustainable” mutual funds and ETFs domiciled in the U.S. As shown, 44% of sustainable funds ranked in the top quartile of their peer groups in the first quarter. Additionally, about 70% of sustainable funds ranked in the top two quartiles of their peer groups.

Significantly, the ESG index and sustainable fund performance comparisons provide a recent set of data points illustrating that ESG integration on the whole may indeed mitigate downside risk.

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2 S&P Global Index Methodology
3 Morningstar
Exhibit 2: Sustainable fund performance rankings in Morningstar peer groups

As of March 2020. Morningstar category is a proprietary Morningstar data point and is assigned based on the underlying securities in each portfolio. The Morningstar US Sustainable Equity funds universe is determined by Morningstar and includes 203 sustainable mutual funds and ETFs in the US across ESG integrated, ESG mandated, and thematic approaches.

Fossil fuel underweights are unlikely the primary cause of ESG index outperformance

Some might attribute this performance difference entirely to ESG funds underweighting fossil fuels, which lagged in March due to Saudi Arabia’s price cuts. In our view, fossil fuel exclusions alone cannot explain the performance differential. First, these holdings represent a small portion of the overall market. In fact, the energy allocation in the S&P 500 is only about 3%, so the impact of fossil fuel price moves on either traditional or sustainable funds is modest. Second, very few sustainable mutual funds and ETFs — as defined by Morningstar — have hard exclusions on fossil fuels. For context:

- 50% of sustainable funds are ESG integrated, which means they are not exclusionary, but take into account material ESG factors in the investment decision-making process. ESG integrated strategies do not limit the stock universe and, by default, will not have exclusions in place.
- Another 40% of sustainable funds are ESG mandated. These strategies are on average underweight fossil fuels versus traditional counterparts.
- Only 10% of sustainable funds are “thematic,” meaning that they specifically exclude fossil fuels, which would have resulted in better performance.

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4 Yahoo Finance  
5 FundFire  
6 Morningstar
2. Did the market's pullback change the level of interest in sustainable and impact investing?

Ten years ago, when sustainable and impact investing predominantly involved sacrificing returns to create a strong, localized impact, a decline in demand might have been expected. But more recently, disciplines such as ESG integrated and ESG mandated have emerged for many clients as more attractive from a risk/return standpoint. We think that’s due predominantly to mounting academic research suggesting that the incorporation of ESG factors in investment portfolios on average can result in positive or neutral risk-adjusted results.

**Academic research shows ESG’s potential to benefit performance**

A meta-study analyzing results of 2,250 studies — conducted by DWS and Hamburg in 2015 and updated in 2018 — for example, notes a positive result from ESG integration was found in 63% of studies and a neutral result in another 29%, with only 8% of studies showing a negative result. So, it’s not surprising we’ve seen growing demand for these strategies over the past year and favorable fund flows data on a relative basis through the first quarter of 2020.

**Sustainable ETFs had large inflows during March and Q1 despite market volatility**

Exhibit 3 below compares fund flows in U.S. sustainable ETFs versus the rest of the U.S. ETFs universe during March and the first quarter. In March, sustainable ETFs had inflows of $1.6 billion, while non-sustainable ETFs had modest outflows. For the quarter, sustainable ETFs had inflows of $10.5 billion, a new quarterly record, while the traditional universe had inflows of $61.4 billion. The magnitude of sustainable ETF inflows is remarkable, considering they represent only about 4% of the traditional ETF market. While the scale and breadth of sustainable offerings pales in comparison to traditional strategies, continuing inflows during March were a strong indication of investor interest.

<table>
<thead>
<tr>
<th>ETF Type</th>
<th>Total Market Size</th>
<th>March</th>
<th>YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sustainable ($B)</td>
<td>$159.5 (3.6%)</td>
<td>$1.60</td>
<td>$10.50</td>
</tr>
<tr>
<td>Traditional ($B)</td>
<td>$4280.5 (96.4%)</td>
<td>$(-1.4)</td>
<td>$61.40</td>
</tr>
</tbody>
</table>

Morningstar, ETF.com as of March 31, 2020.

**Pandemic has raised social issues relevant to many sustainable and impact investors**

The pandemic has raised issues of interest to many sustainable and impact investors, such as the effects of inequality on different populations in stress situations and the adequacy of global health infrastructure. The amplification of social issues in today’s environment may spur further interest in using capital to address income and healthcare inequality.

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7 DWS-Hamburg Meta-Studies
8 ETF.Com
9 Morningstar
3. Is corporate behavior in managing COVID-19 an ESG issue?

ESG analysis of a company is rooted in the review of key indicators based on their materiality to financial performance. The Sustainable Accounting Standards Board (SASB)’s Materiality Framework is one source we use as a starting point to assess these key indicators. A corporation’s handling of COVID-19 can be analyzed under SASB’s “social” factors, such as labor practices, employee health and safety, and engagement.

**Wide dispersion in corporate behavior toward employees is evident during the pandemic**

More specifically, policies governing employee leave, flexible work arrangements and severance policies are areas where we see significant dispersion in corporate behavior — and the market is reacting accordingly. For example, two well-received announcements included Delta’s CEO forgoing his entire salary to avoid layoffs and Taco Bell’s decision to pay all employees, regardless of business shutdowns. On the flip side, Whole Foods’ CEO urged employees who are healthy to donate their vacation time to sick employees. This statement was not as well received by the public or the markets, where negative reaction was reflected in the stock price of the parent company, Amazon.

We’re also monitoring corporate global supply chains — a core tenet of the governance pillar of ESG analysis — and how the virus affects their operations from a safety and business continuity perspective.

Please reach out to your Glenmede contact for more information. Our Sustainable and Impact Investing team can review historical performance across our model portfolios, including specific manager attribution. Glenmede offers a full spectrum of strategies, including ESG integrated and ESG mandated solutions.

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