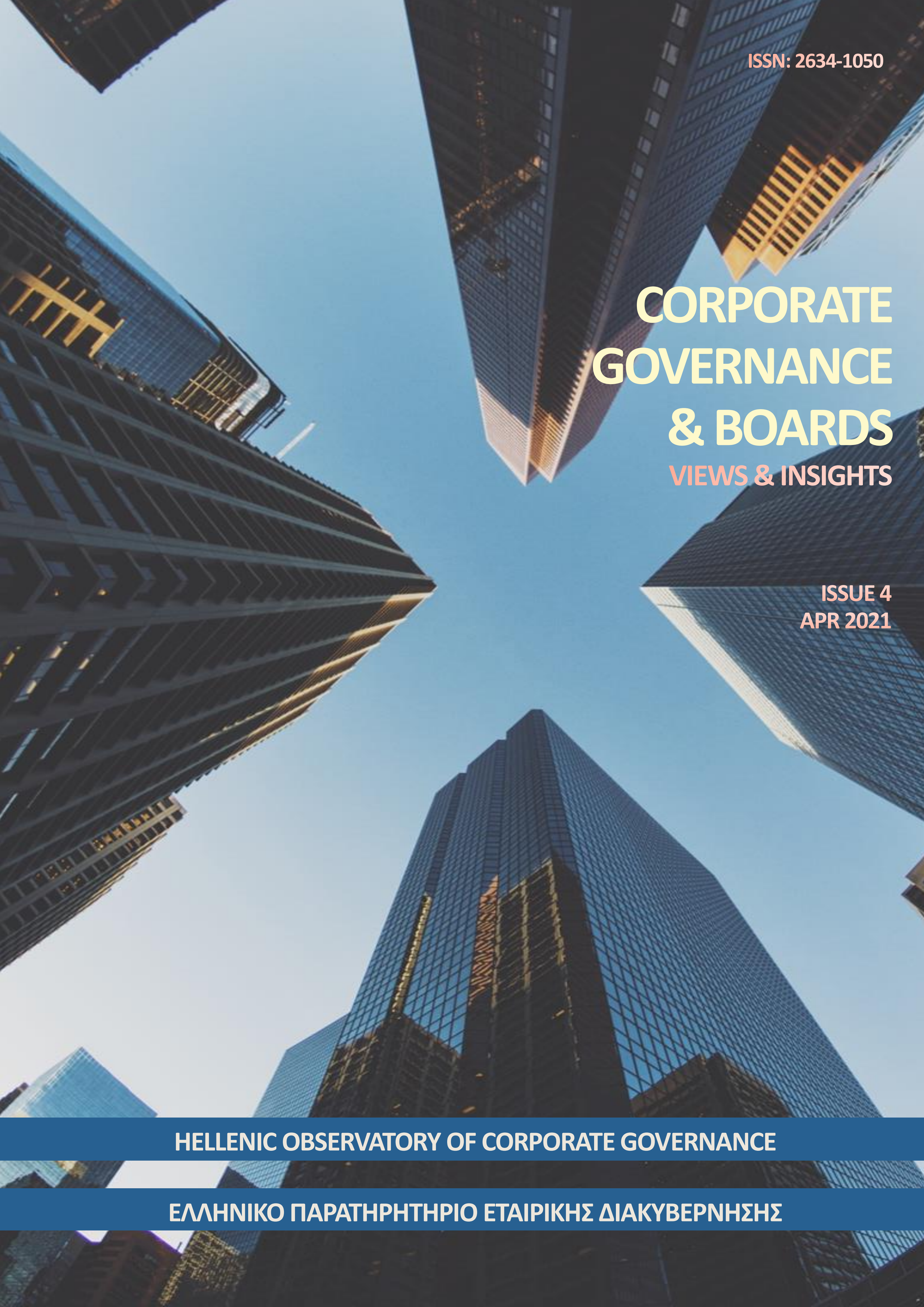

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Sustainable Investing in the Post-Pandemic World

1. The emergence of ESG investing.

"I believe that the pandemic has presented such an existential crisis – such a stark reminder of our fragility – that it has driven us to confront the global threat of climate change more forcefully and to consider how, like the pandemic, it will alter our lives" (Larry Fink, 2021).

Today more than ever, policymakers, shareholders and corporations alike, start placing environmental, social and governance (ESG henceforth) issues at the core of their strategic agenda. It takes BlackRock's Larry Fink only a handful of phrases before he mentions the term "climate change" in his recent annual letter to CEOs[i]. The asset management behemoth invested more than $68 billion in sustainable products in 2020; an annual growth of more than 60% compared to the previous year[ii]. Following years of growing dynamic, ESG is now at the epicentre of BlackRock's investment spectrum. The $9 trillion giant now requires its firms to disclose their strategy on achieving a "net-zero" emissions mandate by 2050 (the threshold year by which firms must emit less carbon than they remove). In like manner, State Street votes against companies that fail to articulate underperformance in terms of their in-house ESG metrics[iii], and Goldman Sachs does not underwrite IPOs for firms that do not have at least one diverse board member[iv].

In that context, it is not surprising that socially responsible investing (SRI hereafter) is now considered among the most rapidly growing investment strategies. In its latest SRI investing report, PwC characterises ESG as "the growth opportunity of the century," evincing that by 2025 more than 50% of the mutual fund universe in Europe will be ESG-focused[v]. This pattern is even more striking in the US. According to data from the US SIF Foundation, the US-domiciled assets under management (AUM henceforth) following ESG strategies have experienced a 25-fold growth over the last 25 years. As can be seen in Figure 1, US-domiciled sustainable AUMs have increased from $639 billion in 1995 to $17.1 trillion in 2020, whereas the number of funds that apply at least one ESG criterion during the formation of their portfolio (i.e., the number of "SRI funds") has risen from 55 in 1995 to 1,741 in 2020. It is worth mentioning that only in the last two years, the universe of sustainable investing has surged more than 40% (growing from $12.0 trillion in 2018 to $17.1 trillion in 2020), while at the start of 2020, one out of every three dollars under professional management in the US, is invested under some form of ESG principles (see Figure 2)[vi].

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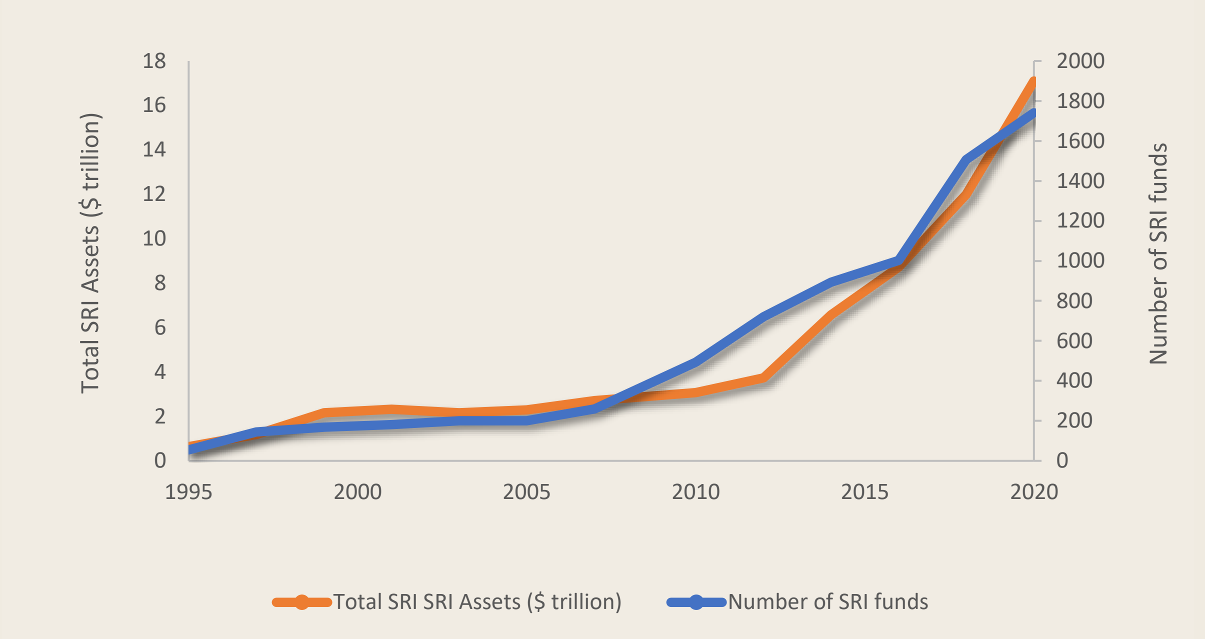

Figure 1: SRI Investing in the US between 1995 and 2020

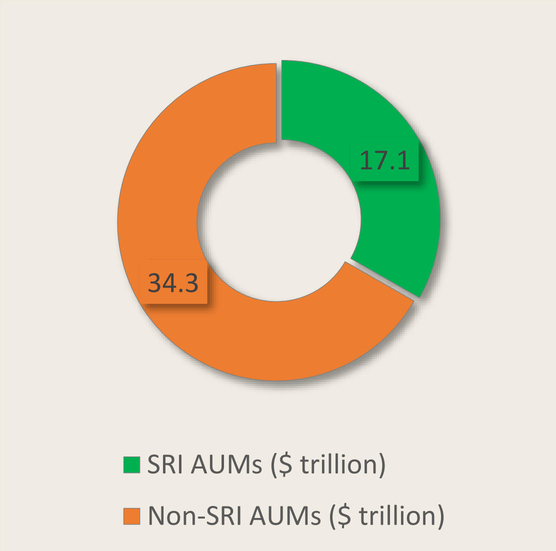

Figure 2: SRI and Non-SRI AUMs in the US, 2020

2. Definitional, technical, and empirical conundrums

At the dawn of the new decade, ESG is the irrefutable front-runner of the global investing trends, yet every silver lining has a cloud[vii]. The first intricacy regarding the notion of ESG, and the Corporate Social Responsibility (CSR) establishment as a whole, is the definitional obscurity of the latter. From Berle and Dodds' debate[viii] on whether social concerns should be integrated in the purpose of the corporation, to Friedman's doctrine[ix] that a firm's only responsibility is to increase its profits, to Porter and Kramer's recognition[x] of social responsibility as a vital tool of a company's value proposition, the world has not yet given CSR a definition of catholic acceptance[xi]. This lack of a coherent theoretical and empirical framework - similar to what the CAPM model is for asset valuation - drives organisations to provide their own notions of CSR, which in turn creates inconsistencies in the respective research[xii]. In addition to its definitional problems, CSR is plagued by lack of relevant data. According to S&P Global, even though more than 90% of SP500 constituents publish ESG reports, only 16% specifically mention ESG data in their SEC

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proxy statements[xiii]. The absence of standardised information with respect to firms' ESG initiatives poses a series of methodological challenges in CSR research[xiv]. Meanwhile, the definitional and technical inconsistencies can inevitably lead to endogeneity concerns. The idea here is simple: is the firms' incorporation of ESG principles that leads to superior financial performance, or is it that firms with "slack resources" invest more in ESG initiatives hence improving their social performance[xv]?

One way to look at this issue is to investigate the relationship between CSR and corporate performance (CFP henceforth). Verily, academia has been examining the CSR-CFP link for the last four decades. Yet, results are not conclusive. In point of fact, if one had to give an answer in the question whether a firm's CSR enhances its financial performance based on the respective research, she would say that.. it surely doesn't hurt it[xvi xvii xviii]! Now, if you put that into mutual fund context, conventional wisdom in portfolio analysis suggests that limiting the range of one's investment choices may give rise to problems surrounding possible sub-optimal allocation of resources. Howbeit, mutual fund research in terms of the CSR-CFP association corroborates the "no-consensus" argument; SRI mutual funds do not appear to either outperform or underperform their non-SRI counterparts[xix]. In light of the aforementioned CSR intricacies one may wonder: why do people "really" invest in CSR?

3. Could the coronavirus pandemic give the answer?

Glimpses of an answer to the aforementioned question are beginning to emerge recently. The Covid-19 pandemic, beyond its devastating impact on the whole spectrum of human wellbeing, also exposed something else; the importance of the ESG cause. Previously acknowledged as critical only by a niche part of "ethical" investors, ESG is now entering every home through the daily news in unforeseen ways. Ford employs part of its assembly lines to produce respirators and medical equipment[xx]. Johnson & Johnson commits to provide its Covid-19 vaccine at a non-for-profit basis[xxi]. Intel pledges $50 million in technology initiatives related to Covid-19 diagnosis, treatment and vaccine development[xxii]. For the first time in many generations, companies direct their operational and capital resources towards the most fundamental aspect of people's lives; their health. JP Morgan had already identified this turning point in ESG perception since last July. In a survey of investors from 50 global institutions, representing $12.9 trillion in assets under management, 71% of respondents had seen positive implications of Covid-19 on ESG momentum[xxiii].

Less than 9 months since that survey, the ESG landscape could not be more aligned with that intuition. The first two months of

2021 have seen nearly $8 billion flows in US SRI funds; almost the amount of SRI flows for all 2019. Europe experienced a staggering 84% fourth-quarter increase in SRI flows during 2020[xxiv]. Yet, one could clearly demonstrate the ESG phenomenon just by looking at the pattern of the AUMs of its most prominent ambassador. BlackRock's iShares ESG Aware MSCI USA ETF is currently the largest ESG investment asset in terms of AUMs, with $15.2 billion as of March 2021. However, according to ETF Research Center, BlackRock's ESG-themed ETF had only $3.3 billion a year ago, and $151 million at the start of 2019[xxv]. The accelerated surge of the ETF's AUMs can be seen in Figure 3. It thus comes as no surprise that Vanguard, a company with historically limited presence in the ESG picture and 2nd largest asset management player in the world with $7.2 trillion AUMs at its disposal as of Jan. 2021, is now setting the stage for future expansion in the field[xxvi].

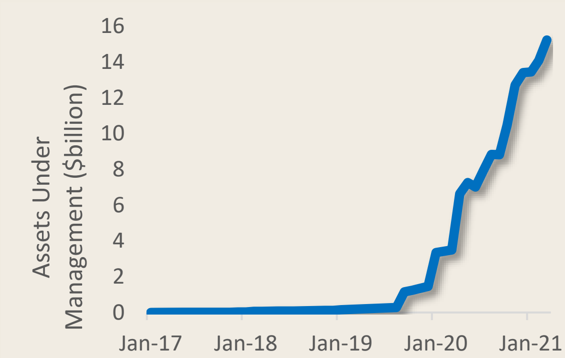

Figure 3: iShares ESG Aware MSCI USA ETF Assets Under Management 2017-2021

But is the recent increased ESG demand accompanied by better returns for investors? The most sincere answer to that is: "it remains to be seen." A recent study from Morningstar compared the returns of all 203 sustainable US equity and exchange-traded funds with those of their respective peers during the first quarter of 2020 and found that 69% of ESG funds ranked in the top half, while 42% of them ranked in the top performing quartile against 12% that ranked in the worst performing quartile[xxvii]. Could it be that sustainable investing is the "vaccine" for bear markets? An earlier Morningstar study showed that 72% of ESG indexes lost less than the market during bear periods between 2014-2019, while 51 out of 59 ESG indexes beat their market peers in the first quarter of 2020[xxviii]. Yet, only time will tell whether we witness the beginnings of a robust relationship between sustainable investing and performance. A legitimate concern in this case, would be that most ESG funds are populated with technology stocks; a sector that outperformed almost every other sector in 2020[xxix]. Figure 4 provides a brief idea of an ESG fund's most preferred holdings[xxx]. Will the positive link between sustainable investing and performance hold in the post-pandemic world, making ESG a goose waiting to lay its golden eggs? Larry Fink closes his letter to CEOs by saying that the companies that embrace the challenges of our times and seek to build long-term value with their stakeholders "*will help deliver long-term returns to shareholders and build a brighter and more prosperous future for the world.*"

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We are not sure whether ESG manages to live up to the expectations, but the idea of a prosperous future world has never sounded more beautiful to investors.

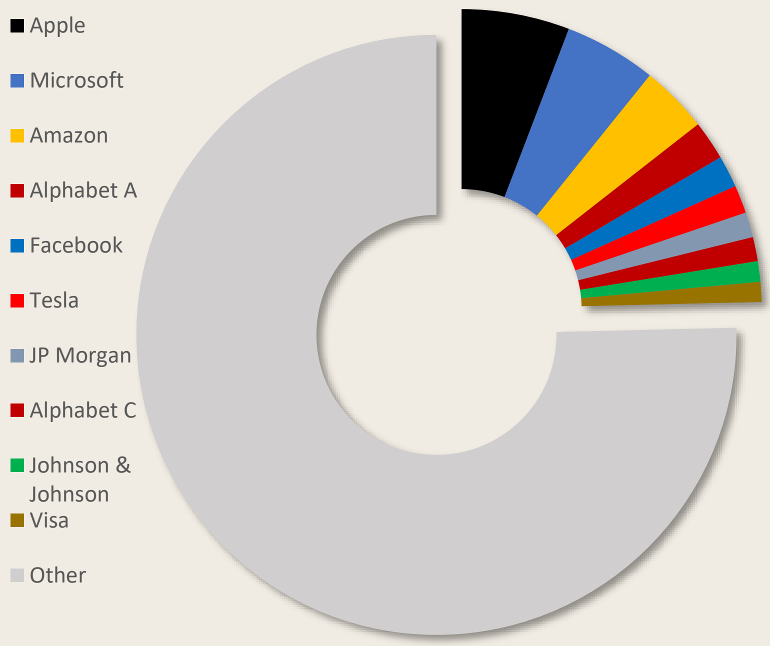

Figure 4: iShares ESG Aware MSCI USA ETF Top 10 Holdings, as of March 2021

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