COVID-19 and ESG: Prepare for the New Normal

May 18, 2020

by Bonnie Wongtrakool

of Western Asset Management

As we claw out of the rubble from the pandemic, it is increasingly clear that we will not suddenly resume our pre-COVID ways of life. Though some of the changes made in response to the pandemic may ultimately revert back to normal, in other areas our understanding of what is "normal" has been irreversibly altered. One such case is our understanding of the role of the corporation in society, and the real drivers of enterprise value.

Pre-pandemic, there was plenty of talk, but not so much walk, about ESG and the need to move beyond the shareholder primacy model. Despite the Business Roundtable pledge last August[1], corporations remained narrowly concentrated on quarterly earnings and short-term performance, rather than taking a long-term perspective on value creation that accounts for multiple stakeholders and external societal concerns.

The pandemic has detonated the shareholder primacy model. Corporations, shareholders, customers and employees are now unified around a singular goal: protecting public health. Regardless of their prior corporate mandates, leading companies have donated products and supplies, leveraged their intellectual capital to conduct research initiatives, contributed funds to developing countries, and repurposed their manufacturing facilities to produce ventilators and hand sanitizer[2].

Although all businesses have of course been rocked by the pandemic, companies that were operating under strong ESG practices pre-COVID have weathered the storm a bit better, as their workers already had paid sick leave (which strikingly, one out of four American workers lack)[3], health insurance benefits and flexible work arrangements. Many companies that did not share these priorities pre-COVID have suddenly found religion.

At some point in the future, businesses and consumers will start returning to some form of normalcy. But what is *not* likely to return is our cramped, pre-COVID view of the corporation. The pandemic has helped bring about a "paradigm shift" in how we understand corporate responsibility and value creation. There is no going back.

Evidence of this paradigm shift goes well beyond any self-serving corporate public relations efforts. A paper published by HBS Professor George Serafeim and colleagues shows that the stocks of companies that signaled positive employee and supply chain practices, such as those described above, outperformed those of their industry peers as the market dropped between February 12 and March 24.

Similarly, studies by Bloomberg and Morningstar[4] demonstrate that ESG fund returns exceeded those of non-ESG funds during the highly volatile correction, while MSCI analysis[5] identifies better bond performance over the first quarter for corporate issuers with higher and improving ESG ratings versus their competitors.

More fundamentally, the pandemic has put the world on notice that, while we cannot predict the nature or timing of the next "black swan," another will come, and we need to prepare now. The path of preparation lies in being more, not less, attentive to the external societal conditions and concerns within which businesses operate. It is no longer sufficient for businesses to focus exclusively on shareholder value, and those businesses that do will find themselves that much less prepared for the next crisis—whenever and whatever that is.

Under the new post-COVID paradigm, ESG will become an even bigger competitive differentiator. While many companies have forcibly improved their social practices in response to the pandemic, there is still plenty of room for progress toward fair compensation, diversity of ideas, and inclusive recruiting and talent development. Companies will need to apply the experience gained from adapting their business models during COVID to fill emerging market gaps and combat the future challenges that will come with ongoing climate change. Companies must ensure better environmental and social practices among their partners to protect against future supply chain disruptions. And they will need to further align stakeholder interests through prudent dividend and repurchase policies, and the incorporation of multi-year ESG goals into executive compensation.

Companies that embrace the deeper lessons of the pandemic will be better positioned to add value over future economic cycles. Companies that cling to the old paradigm do so at their own peril.

1https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.
2https://www.weforum.org/agenda/2020/03/how-are-companies-responding-to-the-coronavirus-crisis-d15bed6137.
3https://www.pewresearch.org/fact-tank/2020/03/12/as-coronavirus-spreads-which-u-s-workers-have-paid-sick-leave-and-which-dont/.
4https://www.bloomberg.com/news/articles/2020-03-13/older-esg-funds-outperform-their-newer-rivals-in-market-tumult?sref=y2G81i2m,https://www.morningstar.com/articles/972475/sustainable-equity-funds-are-outperforming-in-bear-market.
5https://www.msci.com/www/blog-posts/corporate-bond-performance-by/01771274418?utm_source=esg&utm_medium=email&utm_campaign=esg_covid-19_2020.