Intelligence MEMOS

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To: Businesses and Institutional Investors

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Re: **ESG Investing Will Get a Boost from the Pandemic**

Pension fund fiduciaries and other institutional investors in Canada are increasingly using environmental, social and governance (ESG) considerations to better understand and predict financial risks and opportunities. They have become, in recent years, essential tools to assess value, rather than promote values.

How will this growing recognition be affected by the COVID-19 pandemic? Will uncertainty lead fiduciaries to retrench and focus on the usual economic fundamentals and established financial metrics, or will it expand the recent momentum to place more reliance on ESG factors by institutional and other investors?

My view is that ESG investing will get a boost from the pandemic, and that the emphasis in the short-run will shift from governance and the environment – the 'E' and 'G'– to giving more airtime for social factors – the 'S' in ESG. The crisis will lead to improvements in ESG disclosure and analysis, particularly as it relates to social factors.

Although still in its early days, it appears that risk management techniques and financial strategies that involve or are informed by ESG factors and scenario testing may be leading to better results during the pandemic; namely, that investors who take into account ESG factors may be doing better than, or at least not as poorly as, their non-ESG counterparts.

The pandemic is likely to validate the financial objectives behind integrating ESG factors, and disprove the mistaken belief that ESG factor integration is simply a means for do-gooders to impose or promote socially responsible operations.

Consideration of "social" factors will grow in importance. Investors and businesses appear increasingly concerned about reputational risks. The pandemic is not sector-specific. It affects everyone. And the concern is that consumers are likely to remember how companies treated their people and their communities. As a result, social concerns about employee health and safety, fair treatment, childcare considerations, mental health considerations and the welfare of the communities in which companies operate may be front and center considerations for investors assessing how corporations will fare during the pandemic.

Another "social" area of concern to investors and corporations is the supply chain. Are provider agreements, systems and policies in place to continue with business as usual, even if staff are required to work from home, shopping restrictions are imposed, borders are sealed, or complex supply networks and relationships begin to splinter or disengage?

A possible consequence of the pandemic and the application of ESG factors by lenders and investors may be to dig deeper into understanding supply chain management of investee entities. It may also stimulate more human scale production, with an emphasis on localized supply chains, and improved community relations.

ESG disclosure might also get a boost from the pandemic. Pension and other institutional investors and creditors will not only want information about a corporation's approach to ESG issues, but will demand it. Just as the urgency of climate change has fostered more and more standardized environmental reporting, the pandemic may broaden the scope of urgent social factors to be assessed.

Production of an ESG policy, demonstrating how ESG factor considerations generate financial growth and mitigate financial risk, may become a standard expectation of investors and lenders.

As ESG factor integration has matured, governance concerns and, increasingly, environmental concerns, have led to development of more objective performance indicators. The subtlety and subjectivity of social factors will no doubt benefit from a more disciplined review that could be imposed because of the pandemic.

Companies that are seen to be proactively engaged in disclosing and developing better "social" performance metrics may be better able to differentiate themselves from the competition during and after the pandemic to gain market share. Consequently, the pandemic may generate more quantifiable targets or more objective analytic approaches, including better scenario testing.

Finally, the pandemic may shift the perspective that ESG considerations are only relevant to the long term. The major effects of current carbon levels on climate change may not be fully realized until three decades or more in the future, so there is none of the urgency that attends the pandemic. The pandemic may strengthen the appreciation of ESG factors as important metrics for managing short to medium-term risks, as well as long-run sustainability.

It's early days; but I think it is more likely than not that the pandemic will not hinder ESG considerations. I think it may in fact accelerate ESG integration and lead to improvements in ESG disclosure and analysis, particularly as it relates to social factors.

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