the day after

#3 update | November 2020

Covid-19 crisis and the ESG transformation of the asset management industry

Amundi
ASSET MANAGEMENT

Authors

Jean-Jacques BARBÉRIS
Head of the Institutional and Corporate Clients Division

Marie BRIÈRE
Head of the Investor Research Center

Simon JANIN
Head of Public Affairs[1]

1. The authors would like to thank Cosmina Amariei, Monica Defend and Stefano Ramelli for their feedback.

The Covid-19 crisis -- which unleashed an economic and financial shock of unprecedented magnitude -- has impacted businesses in a variety of ways. The asset management industry was confronted with sell-offs of traditional assets, but investment flows in environmental, social and governance (ESG) funds proved resilient. With household savings at a robust level, the challenge facing the sector is to drive the transition to a low-carbon economy. The latest regulatory initiatives taken by the European Commission should help move this challenge along.

Covid-19 pandemic: an underestimated risk

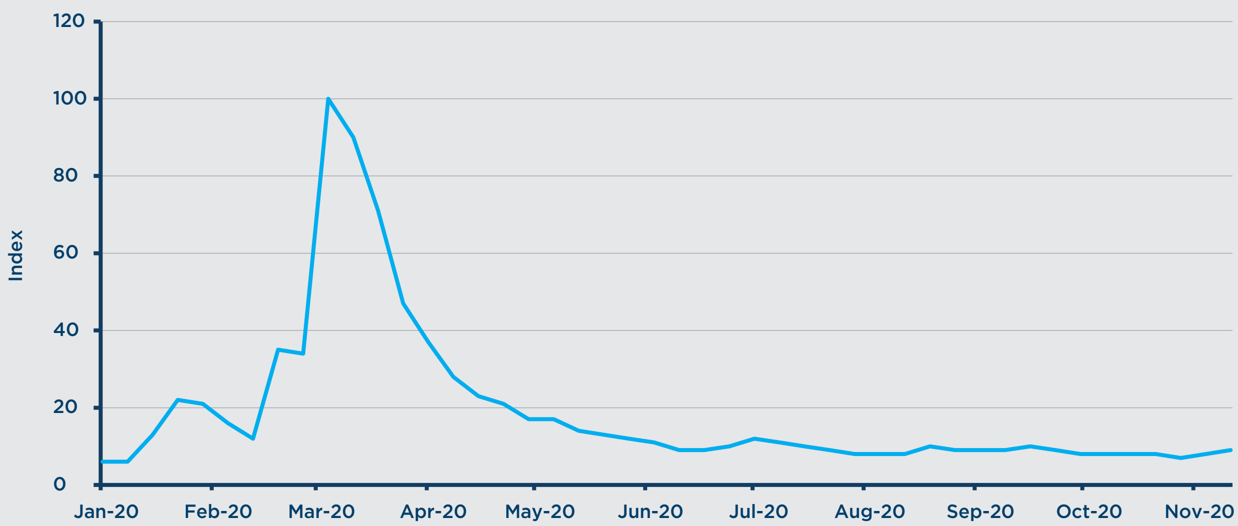
On 20 February 2020 — when the first locally transmitted Covid-19 case was found out in Italy — and then, on 11 March 2020, when the World Health Organization (WHO) officially declared Covid-19 to be a public health emergency of international concern (PHEIC), what started out as an emerging disease in China transformed over just a few weeks into a devastating global health crisis. Equity markets around the world plummeted in its wake.

The scope of the response can be attributed not only to the severity of the economic shock, but also to the fact that markets were taken by surprise and were unable to anticipate shocks of such magnitude. For instance, the pandemic risk was nowhere to be found among the top ten most likely risks mentioned in the *Global Risks Report 2020* published by the World Economic Forum. Rather, survey respondents listed environmental risks, followed by technological risks, as the most worrying issues, despite the pandemic having already been identified in multiple forward-looking studies, including the research conducted by national security agencies in major western industrialised countries. Google searches for the word 'epidemic' were rare before Covid-19 came along (see Figure 1). Of course, epidemics are not exactly unheard-of in recent history (e.g., SARS in 2002, H1N1 in 2010, Ebola in 2014, MERS-CoV in 2019), but the Covid-19 epidemic represents an extreme case due to its global magnitude.

Devastating economic consequences, unevenly distributed

Recent academic studies have sought to assess the macroeconomic impact of the

Figure 1. Google trends global search index for the word '*epidemic*'



Source: Google Trends, Amundi. Data as of 20 November 2020. The index refers to the search interest with respect to word 'epidemic'. The value 100 indicates the highest search frequency of the term, 50 indicates half of the searches. A score of 0, on the other hand, indicates that not enough data was found for the term.

pandemic [Barro *et al.*, 2020; Gourinchas, 2020; Eichenbaum *et al.*, 2020][2]. Estimates are tricky in that the extent of the impact depends not only on the spread of the disease (sick people no longer contribute to GDP), but also -- and more importantly -- on the policy response made in an effort to curb this spread. While lockdown measures, national/international travel restrictions, and border closures dampened consumer spending and reduced business output capacities, stimulus measures have lessened the severity of the crisis by shoring up wages and lending, and also preventing lay-offs, manufacturing disruptions and chainreaction bankruptcies. Policy responses are endogenous and, in turn, depend on the scope of the a situation and the expected economic crisis. Furthermore, the impact of the crisis on net savings in the short and medium term is subject to potentially opposing trends -- i.e., an increase in short-term savings owing to limited spending capacity and propensity, followed by the potential, but not certainty, that consumers will dip into the resulting savings. For example, the saving rate in Europe climbed significantly, from 16.6% in Q1 2020 to 24.6% in Q2 2020, up 8% compared to precrisis levels, the kind of increase not seen since 1999.

According to the IMF, the global economy should contract by 4.4% in 2020, representing more significant fallout than during the 2008-09 global financial crisis (GFC). In its baseline scenario, economic activity is expected to normalise in 2021, aided by policy support. However, the risk of more severe impacts is significant. The uncertainty surrounding the development of health and economic conditions, on both the household and business fronts, could accentuate the negative impact of the crisis.

For corporates, this macroeconomic shock can show up in different ways: it could disrupt manufacturing chains, create a shortage of job offers, cause certain production sites to close down, send demand falling or make it difficult to access credit lines. The uncertainty surrounding the epidemic shock sent many investors flocking massively away from risk assets. However, the crisis has had a very different impact between sectors, not to mention between corporates within the same sector. Ramelli and Wagner [2020] analysed the effects of the crisis on US firms between 2 January and 20 March 2020. The least affected sectors were healthcare, utilities and food & staples retailing, whereas energy, consumer services, consumer durables and real estate took major hits. Within each sector, firms with activities related to China and international firms were hit hardest early in the crisis (between 2 January and 20 February). Since the viral epidemic began in Europe and some lockdown measures were announced in Italy on 23 February, the markets showed greater discrimination between firms, based on their leverage and cash holdings. These trends are reflected in the corporate conference calls organised for investors: although analysts were initially focused mainly on international trade, they subsequently turned their attention to cash problems. Lastly, it was apparent that corporates exposed to previous epidemics were deemed less vulnerable by analysts during this crisis [Hassan *et al.*, 2020].

An ESG approach for stronger resilience during the crisis

Before the current pandemic, Corporate Social Responsibility (CSR) had already become a major investment criterion, so much so that it influenced significantly prices of financial assets, both in equity markets (in terms of

2. Barro et al. [2020] estimated the economic impact of the Spanish flu epidemic, which killed 39 million people in 1918-20. The estimated impact on GDP per capita in the 43 companies reviewed was -6%. Gourinchas [2020] predicts a 6.5-10% drop in US GDP compared to 2019, depending on the duration of the lockdown period. Lockdown measures help flatten the epidemic curve but worsen the severity of the recession. Eichenbaum et al. [2020] extend the epidemiology model to study the interaction between economic decisions and epidemics, finding that an optimal policy could save 0.6 million lives in the United States but would increase the severity of the recession by reducing consumption by -2% to -9%.

cost of capital) and for debt issuers. Multiple studies found that, recently, firms enjoying a better non-financial performance (also known as ESG performance) saw their share prices climb higher relative to their competitors. This phenomenon can be explained in large part by the investor demand effect, as investors were increasingly incorporating ESG criteria into their investment decisions. So, what can be said about the recent pandemic crisis?

First, we can observe that the MSCI World index shed 14.5% in March, but 62% of large-cap ESG funds outperformed the index. 42% of open-end and ETFs available on US markets were ranked in the top 25% of their category, according to Morningstar. Such outperformance is partly attributable to the funds' exposure to sectors that were less impacted by lockdowns or social distancing measures, such as new technologies and telecommunications, and to firms boasting favourable attributes, especially in terms of intangible investments [Demers *et al.*, 2020]. However, investment flows recorded by ESG funds were also more resilient during the crisis.

We analysed investment flows recorded by 1,662 ETFs listed on US markets, including:

- 75 ESGranked ETFs;
- 24 specialising in environmental issues (eg, low carbon, water, clean energy);
- 53 specialising in the new technologies sector; and
- 30 in healthcare[3].

Cumulative flows were on the rise throughout the crisis period while -- over the same period -- massive sell-offs were observed in traditional equity ETFs during the initial lockdown phase in Italy, including for ETFs specialising in little-exposed sectors such as new technologies and, to a lesser extent, healthcare. Similar results were highlighted for mutual funds, particularly in the institutional investor segment [Pastor *et al.*, 2020; Döttling *et al.*, 2020].

The phenomenon of ESG resilience is not completely new. A similar trend was seen during the subprime crisis, though to a lesser extent. For example, the average growth rate for outstanding units of ETFs listed on US markets was, on average, 1.7x higher for equity ESG funds than for conventional equity funds during the *subprime* crisis (daily growth of 0.80% for ESG funds vs 0.46% for conventional funds), as opposed to just 1.3x higher before the crisis. During the Covid-19 crisis, the daily growth rate was 4.6x higher for ESG vs conventional funds (1.28% vs 0.28%) compared with 1.3x over the period between the two crises (see table 1).

We can list several reasons for the resilience of ESG funds:

- First, **it is possible that investors saw ESG funds as being 'pandemic-proof'.** ESG funds are built to overweight resilient sectors like healthcare and new technologies and to underweight harder-hit sectors such as transport, energy and materials.
- Another reason may have to do with **segregation of the two markets.** Investors with different profiles and investment strategies may invest separately in the ESG and conventional ETF market segments. If investors aiming for short investment periods and having higher liquidity needs tend to go for conventional equity ETFs — which trade in higher volumes and offer greater liquidity — this could explain why they flock in mass out of these funds when a crisis hits. Meanwhile, investors targeting a longer investment period keep their money in ESG funds.
- Finally, it is possible **that investors showed greater 'loyalty' to their ESG investments.** Bollen [2007] showed that investor cash flows into ESG funds were more sensitive to lagged positive returns than cash flows into conventional funds, but less sensitive to lagged negative returns. A hypothesis compatible with this behaviour is that

3. The choice to focus on the ETF market, and not on all investment funds, was guided by the real-time availability of investment flow data for ETFs. Compared to the US market, the European ETF market is smaller (€700m vs $5.4bn, respectively, in March 2020), more condensed and structured differently (11% of households have invested in ETFs vs 40% in the United States).

Table 1. Average daily growth of US-listed ETF units

Variable	Average	%	Ratio (average ESG/ conventional)	Number of observations
Before *subprime* crisis (1 January 2007 – 9 October 2007)				
ESG ETFs	2.67%	2.96%	1,271	2,424
Conventional ETFs	2.10%	16.21%		72,922
***Subprime* crisis (10 October 2007 – 10 March 2009)**				
ESG ETFs	0.80%	1.01%	1,732	5,550
Conventional ETFs	0.46%	1.18%		162,060
Before Covid-19 crisis (11 March 2009 – 30 December 2019)				
ESG ETFs	4.37%	21.99%	1,272	202,968
Conventional ETFs	3.44%	67.53%		4,392,002
Covid-19 crisis (31 December 2019 – 14 April 2020)*				
ESG ETFs	1.28%	8.78%	4,618	**5,700**
Conventional ETFs	0.28%	1.59%		**120,612**

Source: Bloomberg, Amundi calculations. Data as of 18 November 2020. *End of study.

investors derive positive personal value simply from investing responsibly, which can offset the lack of personal value associated with negative performances during crises and lead them to keep their investment in place [Brière and Ramelli, 2020].

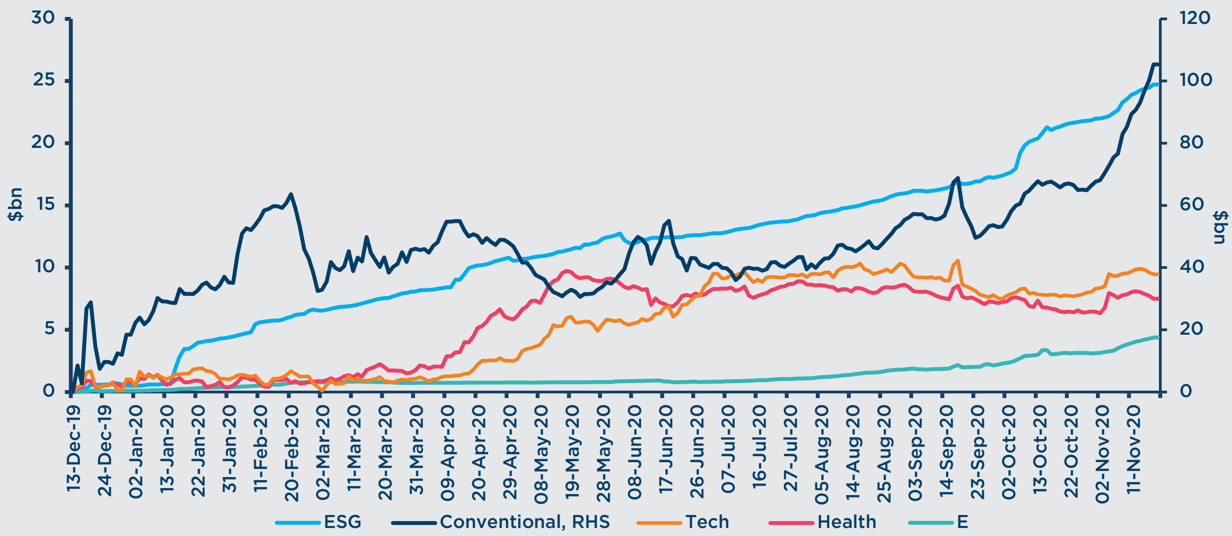
- There is one further possible reason. Even without any particular sense of 'loyalty', ESG funds could have been preferred by investors and **served as safe-haven assets in equity markets for no other reason than that investors expected others would do the same.** These types of conventional preferences show up during a crisis, as capital flows not only between asset classes, but -- also within a given asset class -- between different market segments: i.e., in the government bond market between on-the-run and off-the-run bonds or between nominal and inflation-linked bonds [Brière *et al.*, 2009]. The Covid-19 crisis, perceived as having strong social and environmental implications, may have influenced investors to think that ESG would be seen as a defensive feature by other investors.

Outlook on future ESG trends

With the advent of the Covid-19 crisis, social issues returned to the forefront of ESG investing. Decisions made by companies regarding their employees -- mainly about protecting their health and employment, telework or unemployment policy, and making production chains available to manufacture medical equipment -- became critical. It is likely that a wider range of investors began looking at companies through this lens. Corporate environmental and climate actions could be better priced-in by the market. It is becoming impossible to support the premise that investors do not need to worry about environmental impacts generated by corporations. The Covid-19 episode reminds us that natural disasters can happen suddenly and unexpectedly, and that we are more vulnerable than we think.

It is difficult to predict if ESG issues will continue to be a priority for investors in light of the major economic and financial problems we will be facing in the years to come. **Our analysis suggests that investors have not lost their taste for ESG during this crisis.** Quite the

Figure 2. Cumulative flows into US-listed ETFs



Source: Bloomberg, Amundi's calculations. Data as of 23 November 2020. Note: cumulative flows are reported in $bn. Cumulative flows posted by conventional equity ETFs are shown on the right-hand side. ESG ETFs, environmental ETFs and ETFs specialising in healthcare and new technologies are shown on the left-hand side.

contrary, as recent cumulative flows into ESG demonstrate (see figure 2). In that sense, let us hope that the new trends observed in ESG assets over the recent period will stay with us and even grow in the coming months. The fact of the matter is that these trends are already being helped along -- or outright amplified -- by regulations, especially on the European front.

The EU shines a spotlight on ESG

Within the framework of its March 2018 Sustainable Finance Action Plan[4], the Commission launched a number of legislative and non-legislative initiatives aimed at transitioning the financial sector towards a low-carbon economy. Some of the most noteworthy of these initiatives include the unified classification system (taxonomy) set up in the EU to define what is sustainable and identify the areas in which sustainable investments can have the greatest influence; the creation of EU certifications for green financial products, based on this green taxonomy, or the obligation requiring asset managers and institutional investors to incorporate sustainability factors in the investment process while also enhancing their reporting requirements.

These initiatives should be rounded out in the coming months by the Commission's renewed strategy[5], centred on the global ecosystem, completion of the toolbox and the implications of systemic risks. This renewed strategy is central to the green compact for Europe, presented as the top priority for the Commission headed by Ursula von der Leyen. It should be noted that the EU's reaffirmed ambition in the field of sustainable finance is likely to find a highly operational counterpart via the implementation of the €750bn stimulus plan greenlighted by Europe's leaders in July 2020, with the Commission having already indicated that nearly one-third of the plan would be funded by issuing green bonds[6].

The key issue now lies in how quickly market operators can grasp these new regulations, and how well European authorities can assemble the various pieces of the

4. Sustainable Finance: Commission's action plan for a greener and cleaner economy.
5. See: European Commission consultation on the renewed sustainable finance strategy.
6. On 16 September 2020, European Commission President Ursula von der Leyen announced a €225bn green bond programme (ie, 30% of the Next Generation EU's target).

legislative puzzle into a cohesive picture. For example, the new regulation on disclosure of sustainability information[7] requires financial market operators to report on the policies they plan to implement starting from March 2021 in order to incorporate sustainability risks and factor into the potential adverse impacts of their investments on these risks. Even so, much of the data needed to implement these obligations may be lacking, especially without sufficiently accurate and harmonised information from issuing entities.

Another key issue, echoing the direct consequences of the Covid-19 crisis, lies in how quickly the EU can factor social concerns into sustainable finance regulations. While the aforementioned initiatives on green taxonomy and green certification in Europe are already under way, the social (and governance) aspects of investment are still in the very early stages for most regulations[8]. From that standpoint, upcoming talks for the purposes of revising the European Non-Financial Reporting Directive[9] will be strategic with respect to the EU's ability to establish an independent non-financial reporting standard that incorporates the social dimension specific to the European social market economy. It will be just as important for Europe to develop a harmonised social taxonomy to effectively round out the green taxonomy currently being finalised.

Last, but definitely not least, a prerequisite for a sustainable recovery is the capacity for European regulations to better promote long-term investment. A number of proposals have already been made in that regard, particularly as part of the Capital Markets Union (CMU) new action plan[10] published at the end of September by the Commission. One such proposal is to revise the European Long-Term Investment Funds regulation[11] with the aim of promoting the development of pan-European long-term investment funds. It is unfortunate that no mention is made of ESG criteria in the majority of the new action plan objectives, and that nothing is done to address the short-term focus favoured by current financial regulations. Nevertheless, these initiatives are necessary in order to redirect savings, and especially retail client savings, towards long-term investments. This is where the asset management industry has a key role to play, especially when it comes to offering products that meet the requirement of funding the economy while incorporating genuine ESG criteria.

Bibliography

Barro R.J.; Ursúa J.F.; Weng J., **"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 Papers*, No.26866, National Bureau of Economic Research, March 2020.

Bollen N.P., **"Mutual Fund Attributes and Investor Behavior"**, *Journal of Financial and Quantitative Analysis*, Vol.42, No.3, 2007, pgs. 683-708.

Brière M.; Ramelli S., **"Responsible Investing and Stock Allocation?"**, *Amundi Working Paper*, 2020.

Brière M.; Signori O., **"Do Inflation-Linked Bonds Still Diversify?"**, *European Financial Management*, Vol.15, No.2, March 2009, pgs. 279-297.

Demers E.; Hendrikse J.; Joos P.; Lev B., **"ESG Didn't Immunize Stocks Against the Covid-19 Market Crash"**, NYU Stern School of Business, August 2020.

7. Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.
8. Such as green taxonomy social protection mechanisms and the social exclusions to be included in the upcoming eco-certification of green financial products.
9. Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.
10. EU Communication of 24 September 2020: "Capital markets union new action plan: A capital markets union for people and businesses".
11. Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds.

Döttling R.; Kim S., **"Sustainability Preferences Under Stress: Evidence from Mutual Fund Flows During Covid-19",** SSRN, 2020.

Eichenbaum M. S.; Rebelo S.; Trabandt M., **"The Macroeconomics of Epidemics"**, *NBER Working Papers*, No.26882, National Bureau of Economic Research, March 2020.

Gourinchas P.O., **"Flattening the Pandemic and Recession Curves"**, in *Mitigating the Covid Economic Crisis: Act Fast and Do Whatever it Takes*, CEPR Press, Centre for Economic Policy Research, 2020.

Hassan T.A.; Hollander S.; van Lent L.; Tahoun A., **"Firm-Level Exposure to Epidemic Diseases: Covid-19, SARS, and H1N1"**, *NBER Working Papers*, No.26971, National Bureau of Economic Research, 2020.

Pastor L.; Vorsatz B., **"Mutual Fund Performance and Flows during the Covid-19 Crisis"**, CEPR Press, 2020.

Ramelli S.; Wagner A.F., **"Feverish Stock Price Reactions to Covid-19"**, *The Review of Corporate Finance Studies,* 2020.

Date of first use: 24 November 2020.

REF-2939