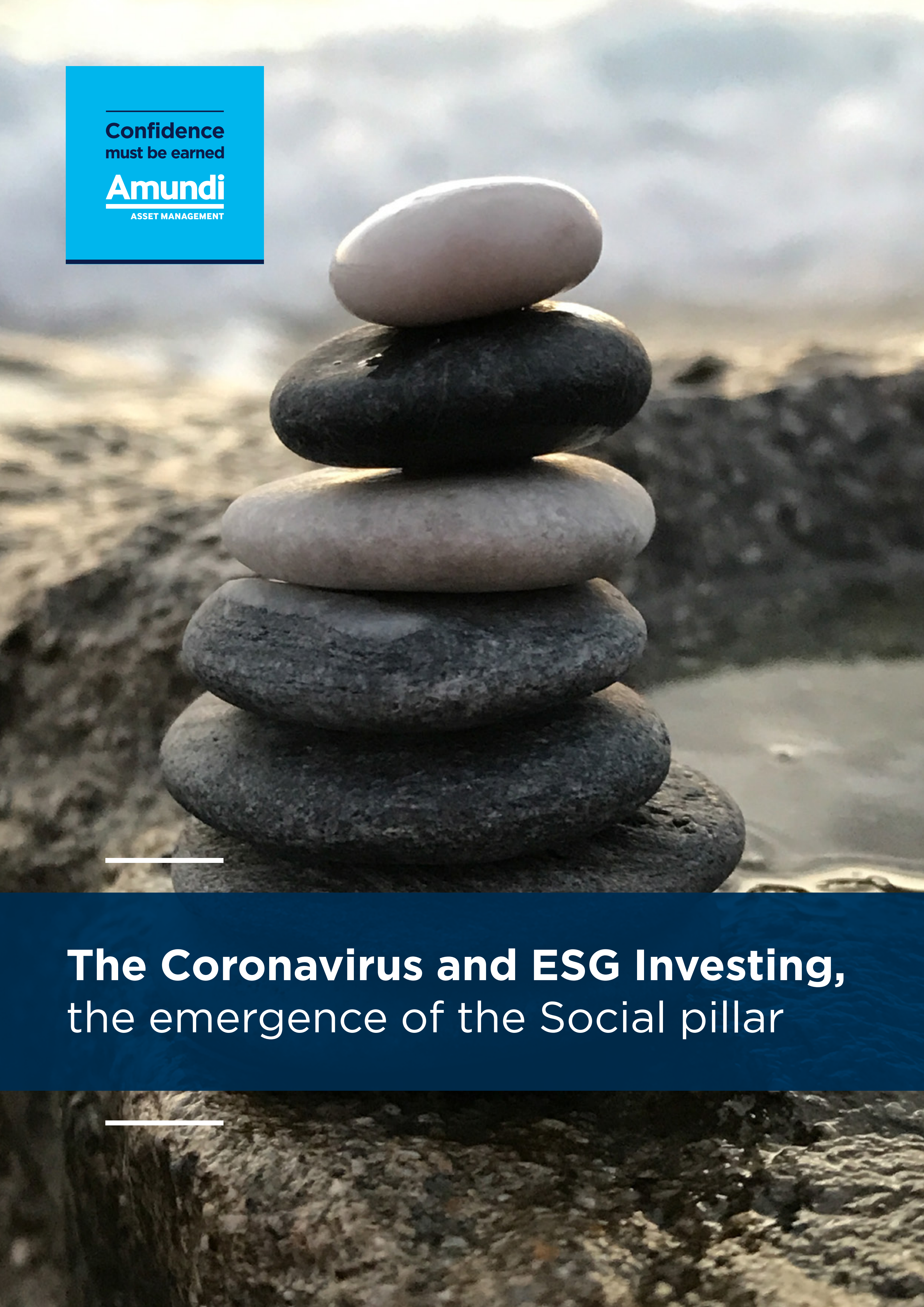

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The Coronavirus and ESG Investing, the emergence of the Social pillar

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Amundi's Quantitative Research team has been studying the evolution of ESG investing across asset classes and geographies for the past several years. With the coronavirus pandemic, we have carefully examined these Responsible Investing trends and have identified some interesting findings:

- Our research over the past two years has showed that ESG is becoming financially material, meaning that it is a source of outperformance, in equity and in bond markets. We have also shown that there is a growing transatlantic divide, between Europe and North America. Finally, while the E and G pillars had been outperforming from 2014, we have shown that the S pillar has caught up from 2016 onwards.
- The recent period and market turmoil confirms our recent research findings that show the financial materiality of integrating ESG criteria in investment decisions.
- The transatlantic divide that we had previously identified has continued during the crisis, but not in the way we expected it to. Indeed, the Social pillar, which had initially been lagging behind other pillars in terms of contribution to performance, has caught up spectacularly, but only in North America and not Europe.
- By studying these trends and the VIX, we have shown that the outperformance of the S in North America is tied to increased investor aversion to risk during this pandemic period.

Q Since the beginning of the coronavirus crisis and the subsequent global lockdown, we have seen a lot of market turmoil putting corporates' sustainability under tremendous scrutiny. In this context, we have also seen discussions around a possible reinforcement of the materiality of ESG criteria on corporate resilience. This would have a huge impact on potential relative investor preferences.

Amundi's research department has been closely studying ESG investing in recent years, looking in particular at ESG integration's impact on market prices. Before we dig further on current situation, can you summarize the outcome of your most recent study related to ESG behavior on markets?

For the past two years, we have published several papers[1] showing that ESG criteria, usually called "extra-financial", are in fact metrics that are financially material. We identified a breakthrough in 2014 on equity markets, meaning that from 2014 onwards, ESG has been a source of outperformance. In addition, we identified that ESG is increasingly integrated into the pricing of corporate bonds, and how ESG affects the cost of corporate debt.

However, some discrepancies have been identified between Europe and North America. In both research for Equity and Credit, we confirmed the emergence of a transatlantic divide for the integration of ESG (by which we mean that ESG integration is more advanced in Europe than in the United States). Annualized returns following ESG, E, S or G integration are much higher in the Eurozone than in North America, over the 2014-2019 period, and that gap has been growing recently.

Q Coming back to the specific period we're currently experiencing, have you observed any different outcomes or key findings?

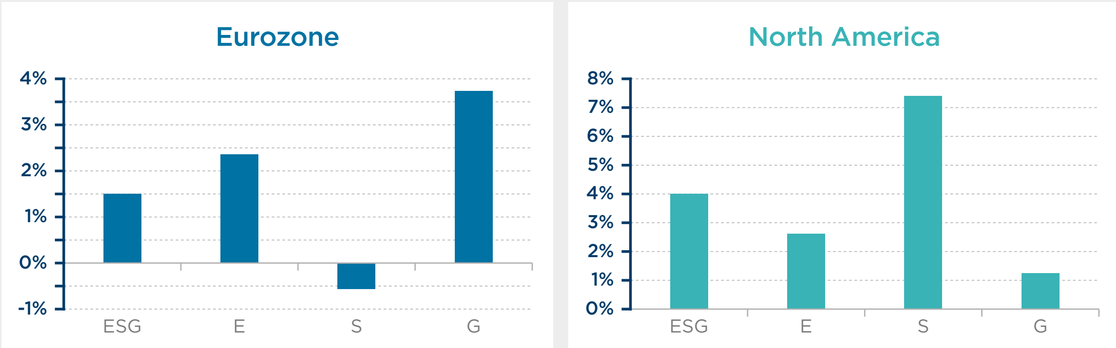
When focusing on this very specific Pandemic crisis period (Q1 2020), we have identified three major findings regarding how markets have behaved.

1. The traditional factor returns dislocated during this period.
2. Partly owing to the sector-neutral construction of Amundi ESG scores, ESG returns have been stable during the crisis.
3. The Social pillar has shown a very positive response in North America in this COVID-19 environment.

More precisely, the big story in the outbreak of COVID-19 is the significant dislocation of traditional factor returns between a very negative performance for Valuation and very strong factor returns for Quality and Momentum as we can see in Figure 1.

1. Bennani, L., Le Guenedal, T., Lepetit, F., Ly, L., Mortier, V., and Sekine, T. (2018a), The Alpha and Beta of ESG Investing, Amundi Working Paper, 76, http://research-center.amundi.com. Drei, A., Le Guenedal, T., Lepetit, F., Mortier, V., Roncalli, T. and Sekine, T. (2019), ESG Investing in Recent Years: New Insights from Old Challenges, Amundi Discussion Paper, 42, www.research-center.amundi.com. Ben Slimane, M., Le Guenedal, T., Roncalli, T. and Sekine, T. (2019), ESG Investing in Corporate Bonds: Mind the Gap, Amundi Working Paper, 93, http://research-center.amundi.com.

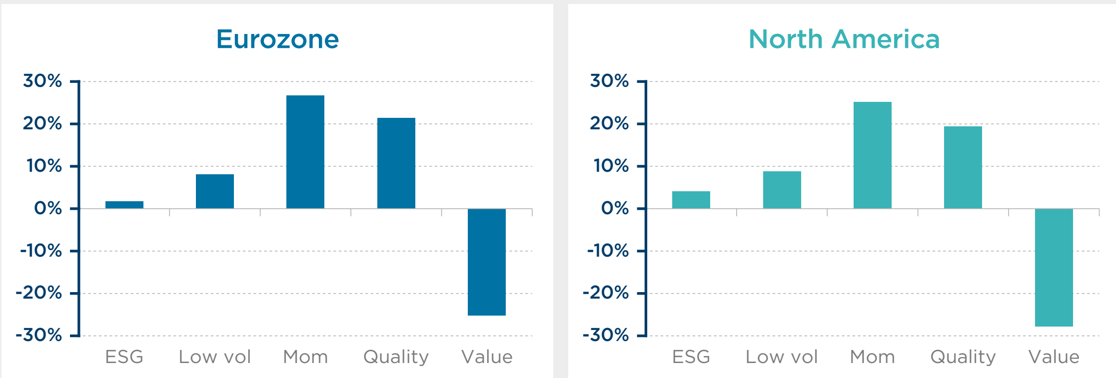
Figure 1: Factor Long-Short performance in Q1 of 2020



Source: Factset and Amundi

Within this environment, ESG Factor returns were stable, but looking separately to each dimensions the results are more heterogeneous. Indeed, there were some significative differences in the E, S and G pillars with a strong outperformance of the S pillar in North America. This is an important finding: the highest ESG performer, during this short period, has been the S in North America (Figure 2).

Figure 2: ESG, E, S and G Long-Short performance in Q1 of 2020



Source: Factset and Amundi

Q

Is this S-related outcome in line with your previous studies?

This outcome is relatively new, actually. In our previous research, we had highlighted the Social pillar as a laggard. Indeed, if Environment and Governance had enjoyed positive performance since 2014, the Social pillar's performance started to emerge only from 2016.

During the coronavirus crisis, the social pillar has witnessed very strong performance, but in North America only. Therefore, the transatlantic divide in ESG still exists, but in the times of the coronavirus, it has taken on a new form: outperformance of the S in North America, relative to the Eurozone.

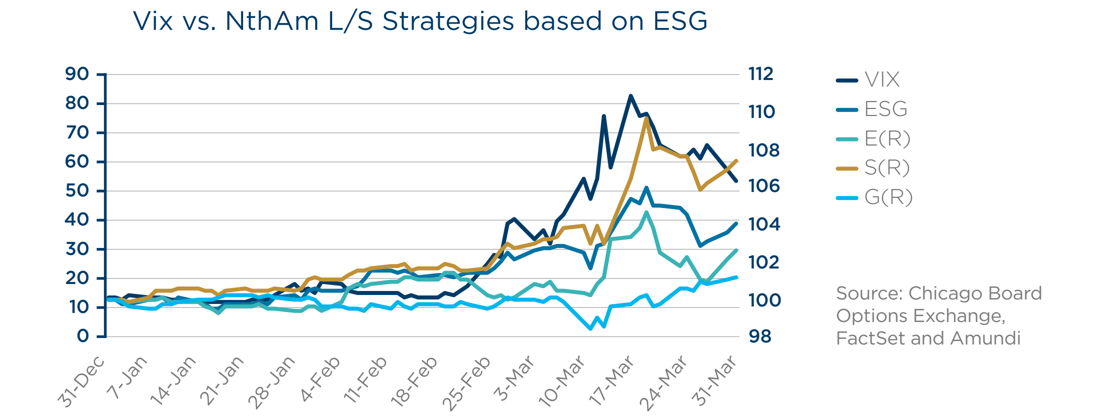
Q How do you explain this outperformance of the S pillar? Is it related to embedded sectorial bias?

The Amundi ESG scores are built with a sector neutral approach. When looking at compounded return of S in North America, we are therefore not capturing sector allocation movements, which were spectacular in the first quarter of 2020. So, the explanation is elsewhere.

It is interesting to highlight the link that exists between this outperformance of the S pillar and investors' risk aversion. The VIX index is a good proxy for investor risk aversion, as its movements correspond to market expectations of volatility. When the VIX increases, risk aversion is high, while when the VIX declines, risk aversion is receding.

Over the past three months, the VIX increased, proving investors' increasing risk aversion, and the outperformance of the S pillar followed the same path. We can confirm, at the 95% significance level, that the performance of the Social pillar in North America was dependent on the investors' risk aversion during the Q1 2020 Covid-19 related market turmoil. Conversely, we do not observe such a close relation between the VIX index and the others pillar like the Environmental pillar for stance.

Figure 3: Vix vs. North America ESG, E, S and G Long-Short Strategies



Source: Chicago Board Options Exchange, FactSet and Amundi

Q Do you mean that the S-pillar is embedding some sort of "flight to quality" features? Is there therefore an implicit style bias that would explain this excess return?

Only partially. Although the strong performance of the Quality factor permeated its performance attribution in this short period[2], the Amundi S pillar outperformance in North America remains a specific return story, which cannot be traced to traditional factor returns. Indeed, when looking at the return decomposition, most of the return difference between the long leg and the short leg of the Social Long-Short strategy in North America is attributed to stock-specific effects (between 89.1% and 126.0% of the return difference on a monthly basis during Q1 2020).

2. We analyzed the distribution of T-stats of industry and style common factors in monthly performance attributions with the MSCI Barra Global Equity Model (GEM3).

If we still can identify a spike by the end of Q1 2020 in the source of return due to the Quality effect, this component has not become dominant in the performance attribution compared to stock-specific effect. Those first outcomes would indicate that during this recent period, the S return is specific to investor choices going beyond the choice for Quality.

Q What are some of the reasons you are contemplating to explain such a phenomenon?

To understand the forward-looking anticipation of investors, the general economic context is very important. To set the scene, between the first quarter and the third quarter of 2019, the probability of having a recession in the US, as predicted by the treasury spread, had significantly increased, crossing the 30% threshold[3] which is historically followed by contractions. The spread level translates the perceived significant fragility of the US and global economies.
In this exceptional context, and while in the Eurozone all eyes are on emergency public policies to support employment conditions, investors tend to assess North American and especially US corporates through the angle of their financial stability and their extra-financial social dimension. In such a case, S features would have been under greater focus, weighing on investment decisions for their link to employment conditions and expected materiality on company resilience. Investors would have searched in the S pillar the capacity of corporates to weather the crisis and to maintain a workforce enabling a rebound in output.

Q How these recent results are directing your future research and what are the upcoming dimensions that worth being explored?

The ESG world is moving. For the past couple of years, we have demonstrated that financial markets have started to integrate those extra-financial criteria, but through diverse rhythms and dynamics. Whether it is related to the Transatlantic divide or the recent emergence of the S, past performances are a testimony of growing integration of ESG criteria, triggered by "responsible investment" interests per say or the search for their indirect materiality.

As proof of this growing materiality awareness, we can refer to our latest Equity update (Drei *et al.*, 2019), showing a shift towards ESG forward-looking strategies, with investors betting on improving companies on the ESG dimensions. Research in the field of ESG is therefore critical in helping any investor to not only address ESG-related risks and opportunities, but to better understand market developments themselves.

This is why we are strengthening our research efforts on several streams, including the following:

1. **First,** we are continuing our research on the materiality of ESG in investment processes. Our research indicates that innovative ESG resources to support accuracy and ESG materiality of information in the investment processes have increased dramatically in coverage in the recent years. We do not expect this trend to decelerate or stop with the COVID-19 crisis, all-the-more that new questions formerly considered as extra-financial require accurate and material answers.

3. Federal Reserve Bank of New York

2. **Second,** we have been looking at the integration of climate change in economic models. These require a set of socioeconomic and policy assumptions, and enable researchers to produce scenarios, otherwise known as "shared socioeconomic pathways". These SSPs, as they are sometimes called, project socioeconomic changes until 2100, and are useful tools to derive climate change scenarios such as greenhouse gas emissions and climate policies[4]. Although we have only a short window of observation on the Covid-19 market perturbation, the S in North America has emerged as a significant factor for the present. It will be fascinating to identify if our reality transforms towards a Shared Socioeconomic Pathway.

3. **Third,** we believe that the mainstreaming of the Environment pillar for investors and issuers is a very strong trend. We have multiple research items in this dimension ranging from formalizing a carbon factor in a conservative investment process, assessing emission intensity trajectories, formalizing the green premium. One of our recent papers, "Credit Risk Sensitivity to Carbon Price" (Bouchet and Le Guénédal, 2020)[5], shows that the impact of a carbon price on EBITDA and credit default probabilities has limited materiality in the medium term (by 2023), increasing to very material in the long term (by 2060).

The ESG world is moving fast and it opens a wide range of analysis.

In light of these results, we will be pursuing our research efforts on the S, which has been clearly growing in importance in the ESG universe. The coronavirus pandemic has not halted this momentum, on the contrary. We are convinced that the crisis is and will continue to put the S dimension in the limelight, making it crucial for investors.

4. Le Guenedal, T. (2019), Economic Modeling of Climate Risks, Amundi Working Paper, 83, http://research-center.amundi.com.
5. Bouchet, V. and Le Guenedal, T. (2020), Credit Risk Sensitivity to Carbon Price, Amundi Working Paper, 95, http://research-center.amundi.com.

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