



COVID-19 Drives ESG Demand

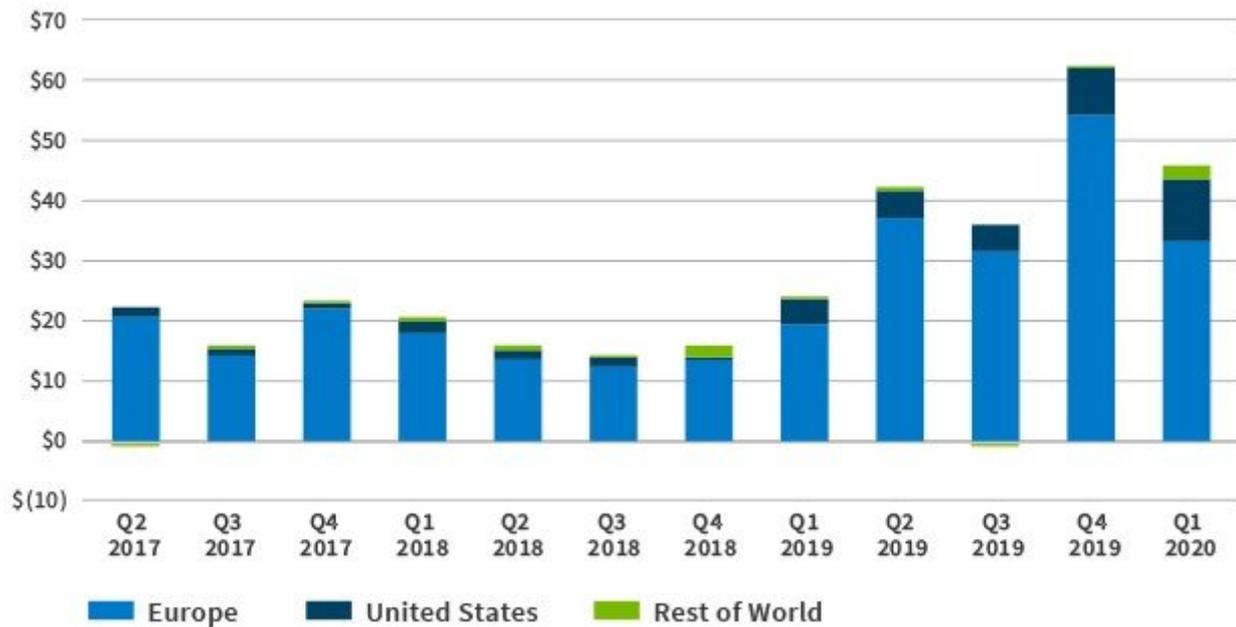
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Investor demand for environmental, social, and governance (ESG) integration has increased rapidly across regions and asset classes in recent years and is now poised to accelerate in the wake of COVID-19.

To help frame the ESG outlook from here, it is important to consider which factors contributed to greater investor adoption of sustainability objectives before the pandemic. We believe a key fundamental driver of ESG adoption has been a growing recognition among asset owners that ESG factors can be material to corporate financial performance and thus investment performance.

Recent fund flow activity demonstrates this point. According to Morningstar, the global sustainable funds universe experienced net inflows of nearly \$46 billion during the first quarter of 2020, compared with net outflows of \$385 billion for the overall funds universe.¹ As illustrated below, Europe accounted for the majority of flows (approximately 73%), but less than prior quarters. Global inflows were down nearly 30% from the fourth quarter of 2019, but were still 90% higher year-over-year.

Quarterly Global Sustainable Fund Flows (In Billions)



Source: Morningstar Direct, Manager Research, as of March 2020.

We believe ESG issues have become more financially material due to the influence of structural themes, including shifting demographics and societal attitudes, natural resource scarcity, and risks associated with climate change. Interestingly, a growing list of U.S. business leaders are advocating for a greater focus on customers, employees, suppliers, and communities—challenging the conventional belief that companies exist solely to generate profits for shareholders.² COVID-19 has clearly solidified this stakeholder mentality.

The pandemic has already significantly increased scrutiny of companies’ social and governance practices, including the treatment of employees and suppliers during the crisis, community engagement efforts (including healthcare system support), and executive pay and capital allocation decisions—particularly for those companies that have received government funds.

There is heightened sensitivity among executives to the virus being a litmus test of their true commitment to ESG principles. The media spotlight has been intense, with heightened scrutiny of how companies are treating their employees, customers, and suppliers. No one wants to be seen as lacking compassion in this environment. This scrutiny will likely moderate as virus fears begin to subside, but the underlying structural forces that are driving executives’ growing stakeholder orientation are more enduring.

From an environmental perspective, near-term momentum in green policy initiatives may temporarily stall in the immediate aftermath of COVID-19 as governments prioritize stimulus “at any cost.” Europe remains the notable exception, having recently unveiled a €750 billion recovery package—25% of which is earmarked for climate-friendly initiatives, including green building and clean technology investment.

Companies and asset owners are unlikely to abandon their increasingly public commitments to reduce the carbon intensity of their businesses and portfolios. The private sector could thus become even more important to achieving the Paris Agreement goal of limiting global warming to significantly less than 2 degrees Celsius by the

end of the century.

Against this backdrop, we believe investor demand for greater ESG integration in traditional equity and fixed-income portfolios will continue to accelerate beyond Europe.

Although relatively modest, institutional demand for dedicated ESG strategies may increase as more asset owners seek to orient investments toward positive environmental and social objectives—particularly given heightened sensitivities to the role of a strong global healthcare system in combating future pandemics.

1 Morningstar Manager Research, Global Sustainable Fund Flows, May 2020

2 [Business Roundtable Redefines the Purpose of a Corporation to Promote an Economy that Serves All Americans](#), August 2019

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Disclosure:

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