HSBC Private Banking

Sustainability Insights

How To Find Income In a Sustainable Way?

Invest in Corporate Resilience

9 November 2020

COVID-19 pandemic has taken the world by storm. Apart from taking a huge toll on human health and life, this crisis has also put global markets in flux, highlighted the importance of sustainability, and accelerated the search for yield in a 'low rates and low growth' world. But is it possible to get a decent amount of yield in a sustainable way? Yes, it is still possible to achieve comparable risk adjusted yield over the investment cycle in a sustainable way by investing in resilient companies.

- The outbreak of the Coronavirus pandemic led to extreme market volatility, triggered a sudden and sharp global recession and has further accelerated search for yield amongst investors in a 'low rates, low inflation and low growth' world.
- Corporate response to deal with the crisis has been heterogeneous, especially with regards to employees' working conditions and health benefits, supply chains and repurposing of operations.
- But at the corporate level, one important factor that has come to the fore is the importance of the **'R-element'**, i.e. **'Resilience' of corporates** to deal with unforeseen shocks like COVID-19. Companies are now realising that climate change too could bring about similar tail risks which could hugely disrupt their operations, diminish profitability and threaten their very existence.
- But '**how do corporates become resilient to such shocks?**', we hear you ask. The answer is, by taking into consideration the **financial materiality of Environmental, Social and Governance (ESG) factors** and embedding the principles of sustainability in the core of their existence. Environmental sustainability has permeated all aspects of business strategy and is becoming increasingly synonymous with business sustainability.
- But can sustainable companies perform financially well and deliver decent returns in this environment? Does one not need to give up profitability for doing good for the environment and society? Can yield and sustainability go hand in hand? In this paper, we discuss these important questions which are in every investor's mind and look to find ways of earning a decent yield, with sustainability, in this uncertain, post COVID-19 world.

The chase for yield in the post COVID-19 world

To minimise the severe adverse economic impact of the ongoing pandemic, global governments have rolled out huge fiscal support packages. Global central banks too have cut interest rates and started additional monetary policy stimulus with an unprecedented vigour. The prospect of yield curve control in major economies isn't entirely impossible now. In fact, some countries like Japan have already engaged in it. Consequently, bond yields have been supressed to record lows across the spectrum. As experienced after the 2008 Global Financial Crisis, all this additional QE is leading to an era of financial repression, where additional liquidity leads to asset price inflation and compresses the yield earned by investors. Real yield (nominal yield minus inflation) is already negative in several DM economies. This is clearly bringing about a considerable income challenge for investors, who feel forced to take on additional risk to increase their return.

Bond yields have come down across the spectrum, posing a big income challenge

Source: Bloomberg, HSBC Private Banking, October 2020

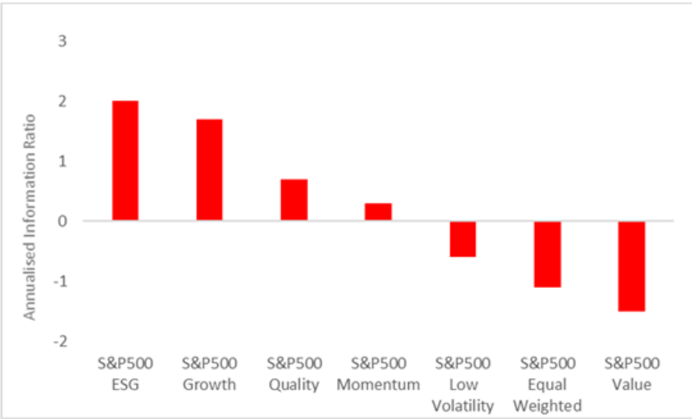
So how do investors earn a fair yield in a sustainable way, without taking on additional risk in this post COVID-19 era full of uncertainties? The answer is, by investing in '**Corporate Resilience**' which only comes about when companies embrace ESG and focus on sustainability. Companies that build resilience into the core of their existence will be better able to weather storms like pandemics, climate change, financial crisis and geopolitical tailrisks as well as be able to explore new opportunities like demand for new products and servies. But before we discuss this topic in detail, we need to address a long held myth about ESG:

Does ESG investing lead to lower returns? Not really!

There's one long held myth in the investor community that ESG investing implies lower returns. However, evidence suggests that earning a decent yield whilst minimizing societal and/or environmental impact need not be mutually exclusive. In fact, they could be complimentary in nature. Market performance in the first few months of 2020 has actually supported this theory. Over the first four months of 2020, when global markets saw a rout triggered by COVID-19, the Good Governance S&P500 long/short index outperformed the standard S&P500 index by 0.66% [1]. Globally, the MSCI Emerging Markets ESG index and its more Asia focused version, the AC Asia ESG outperformed their parent indices by 0.5% and 3.83% respectively, as per the Asian Infrastructure Investment Bank in Beijing.

Also, since its launch in January 2019, the S&P500 ESG index has shown a steady outperformance over the S&P500 index. To further understand the steady outperformance of the S&P500 ESG index, S&P Global conducted an analysis of the excess return of this index versus other S&P Factor and style indices. Normalising the relative performance (excess return/tracking error) of the various indices, they found that the resulting information ratios showed that the S&P500 ESG index provided a superior return per unit of tracking error (see chart below). This analysis points to the fact that sustainability is fast becoming a key driver of financial returns.

The S&P500 ESG index provided a superior return per unit of tracking error



Source: S&P Dow Indices LLCI, Data from January 2019 to May 2020. Index return based on total return in USD; HSBC Private Banking, November 2020

Readers will note here that this analysis mainly comprises of equity indices. This is because availability of a broader set of equity indices makes such comparison and analysis relatively easy. But this analysis can be broadly extended to Fixed Income too as a stronger equity market performance should also support credit spread performance in general. Moreover, with the growth of Green, social and sustainability bond markets, deriving yield with sustainability should no longer be a farfetched idea for investors.

[1] Tavares R (2020)
[2] US Chamber of Commerce, 11 Agust 2020
[3] Harvard Law School forum on Corporate Governance, 17 June 2020
[4] Financial Times, 8 July 2020

Green, Social and Sustainability bonds

Generating income is an important consideration for most investors and with the structural decline in yields globally, one needs to cast the net wider to find the level of yield which is appropriate for each investor's risk appetite. To this effect, Green, Social and Sustainability bonds are an important tool in the toolbox.

Green bonds are an attractive alternative to regular bonds, with a positive impact on the planet, without sacrificing returns. They allow the issuer to invest in green activities or projects, the credit risk of the bond is not linked to the project, but only to the issuer. Hence, the default risk is the same as for any other bond of that issuer, with the same seniority. There is, therefore, no trade-off between the yield and the sustainability aspect. Sometimes, the issues are smaller in size, leading to concerns over liquidity. But the growth in the market in recent years has much improved the liquidity. Germany has now issued its first green bond and we expect it to issue the full curve in twin format, i.e. bonds to be issued in both Green and non-Green format. The green issuance was more than five times oversubscribed, showing investor appetite for environmental projects. With only 0.8% of EUR sovereigns being green and with the launch of EU's next generation fund, there is definitely scope for more green bonds to be issued. These generally have the same coupon and maturity as an existing non green bond but may not be as liquid in secondary markets. They are therefore often held until maturity, though they don't need to be. With a growing pool of issuers of green bonds, liquidity in secondary market too should improve.

Social and Sustainability bonds: While green bonds' proceeds are typically used to build infrastructure projects, proceeds from social bonds are more about doing things that achieve positive social outcomes - by supporting healthcare, employment or SMEs for instance. Social issuance is up 399% year to date and issuance of sustainability bonds (which fund both social and environmental projects) are up 81% year to date.

Overall, the broadening pool of issuers means that investors can increasingly determine their bond strategy (rating, sector, geography, duration, currency) and find adequate representation in the green, social and sustainability bond market to implement their strategy in a sustainable way.

But what is driving the recent outperformance of global ESG indices?

1.) Firstly, a part of this **recent out performance can be attributed to lower investment in fossil fuels like oil and thermal coal.** This worked well for low carbon indices, especially as the energy sector suffered a major demand blow during the COVID-19 pandemic. Evidence suggests that companies which are focusing on technology to innovate, accelerating low carbon transition, offering health and wellness services, focusing on food sustainability and green infrastructure, have performed well in this crisis. For example, a recent McKinsey survey shows that consumers' adoption of telehealth soared from 11% in 2019 to 46% in 2020, largely due to the COVID-19 pandemic [2].

2.) **Another reason for outperformance is that these companies have embedded sustainability into their long-term strategy, be it better stakeholder management** (for e.g. focus on supply chain management and reducing their carbon footprint, employees' welfare and productivity, better governance structures etc.) **the quality of their senior management, focus on reputational risks or better balance sheet management.** In the long run, ESG informed corporate decisions tend to lead to better operational performance, are more likely to create value and are less risky. A focus on all stakeholders should lead companies to outperform in the long run. We find that these companies by their very nature depict the attributes of '**quality companies**', which are relatively defensive and/or focus on long term growth and did well in the Q1 2020 market sell-off. These companies are better able to adapt to environmental challenges and changes in social trends, and use their resources in an efficient manner. Given their long term focus, discerning nature and focus on social responsibility, they are less likely to face regulatory reprimands and minimize the risk of reputational damage.

3.) **Companies are starting to add ESG disclosures in their earnings call content[3] and sell side analysts are starting to incorporate ESG impact into their valuation models, which directly impacts companies' valuation multiples**: A recent research conducted by Harvard Law school concluded that market pressures lead to executive decisions that sacrifice long term value creation simply to meet short term financial targets. To subvert these market pressures and suboptimal capital

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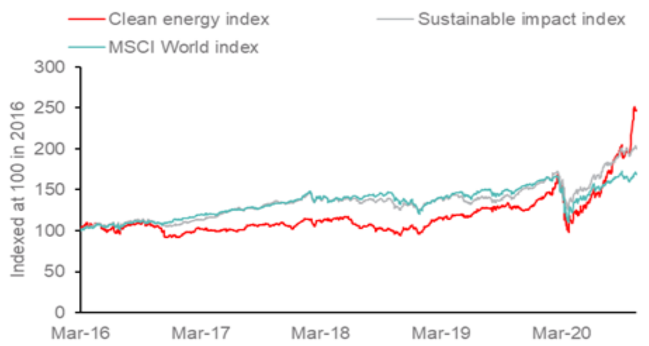
allocation decisions, there has been increasing interest by corporate leaders to focus on the long term strategy and company performance. Therefore, a reporting framework has been developed which integrates companies' long term and ESG strategy and their impact into earnings calls and other investor-facing presentations. These help analysts assess the impact of ESG on companies' financial performance. Incorporating ESG disclosures into valuation analysis should help uncover potential tail risks and discover companies which are better positioned to perform well in the long run.

ESG investing has historically had a large cap bias due to the greater resources these companies can allocate towards Environment, Social and Governance disclosures and reporting. They also face greater scrutiny on those issues by activist shareholders and corporate engagement teams. Large cap companies also often have the wherewithal to pour resources in social and environmental causes and have the finances to treat their employees and other stakeholders to the highest possible standards. Their strong balance sheets help them tide over periods of crisis like the current pandemic.

Exposure to various sources of uncorrelated ESG Beta and Alpha: another interesting fact that has emerged about sustainable investing during this pandemic is that while it provided resilience and relative downside protection when most needed at the height of the health crisis and the ensuing market rout in Q1, when the markets recovered, ESG informed companies recovered with the market. At the beginning of the crisis, we saw sectors like clean energy, healthcare and assets like green bonds provide resilience to portfolios, but as markets turned around, certain cyclical areas like lithium miners and electric vehicles provided portfolios with the required level of cyclicality, when markets went up. Sustainable investing therefore is not limited to one specific asset class, geography or sector. It transcends all assets, sectors and geographies. This exposure to different sources of uncorrelated ESG alpha (additional risk adjusted return) and beta (market risk) effectively lends to it the well-known benefits of investment diversification.

Clean energy index has outperformed in the wake of COVID-19



Source: HSBC Priavte Banking, October 2020

Sustainable investing in this new reality of a post pandemic world

The onset of COVID-19 has changed the ways of human beings like no other – how they behave and interact, their movements, changing demand patterns and above all, their beliefs and mind set. Coronavirus has essentially served as a wakeup call. There is a growing realization that health and wealth are very much intertwined. Humans are having to reassess the sustainability of their actions and are taking cognizance of the fact that wealth can only be made, preserved, enjoyed and passed on, if health and the planet are preserved.

By the same token, the corporate world too has been shaken to the core. With operations severely disrupted, many companies have suffered heavy losses due to unviability of current business models. The ones that are resilient enough to survive this storm are likely to materially repurpose their business models to better prepare for the likelihood of such unforeseen exogenous shocks.

So, how are businesses reshaping in the wake of the pandemic?

i. 1.) **Better supply chain management**: Almost no company had planned for the pandemic. According to a Bloomberg tally, more than 110 big US businesses have declared bankruptcy this year and have cited the Coronavirus pandemic as the cause. Just like COVID-19, climate change is a global phenomenon with its effects likely to be felt everywhere. It can create a lack of supply, lower the quality of supply, increase the cost of supply or may delay the delivery of supply, putting the continuity of corporate operations at risk. Given the new reality we all live in, the COVID-19 episode has triggered a reset in customer and corporate priorities, in our view. It has created both an opportunity and an imperative for corporates to focus on supply chain risk management and operational continuity. Effectively, demand patterns and supply chains are likely to alter. More and more customers are demanding local products with low carbon footprint, whilst corporates are re-evaluating their supply chains and trying to re-shore them or at least bring them closer to home. Along with avoiding supply chain disruptions, this will also enable them to have better corporate governance and hopefully more transparency. This reduces their tail risk and defends corporate profitability. For example, Walmart pledged 3 years ago to cut its carbon emissions by 18% by year 2025. During the review, it found that suppliers accounted for 90% of its carbon emissions. The company now constantly scrutinises its suppliers and is working with 2,300 of its suppliers to cut a Gigaton of its emissions by 2030 [4]. An increasing number of companies are making the public commitment of being carbon neutral in the decade to come, some like Microsoft, even pledging to become carbon negative. Apart from environmental benefits, such

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forensic assessments also increase companies' resilience to weather storms such as COVID-19. Companies are now analyzing and taking the impact of extreme events more seriously and attempt to map out adequate contingency plans.

2.) **Shift in corporate focus from 'Shareholders to Stakeholders' and social responsibility has emphasized the importance of being a good 'corporate citizen'**: In the post COVID-19 world, corporates that wish to perform well will be expected to work not just for shareholders' return, but also shoulder more environmental and social responsibility by focusing on employee welfare, better customer outcomes and treating their suppliers well. They will need to adjust their operations so that they minimise the damage to the environment. Any lapse in these exposes them to severe reputational and existential risks. Consumers, investors, NGOs and the wider civil society demand more transparency and accountability from companies on societal and environmental issues.

3.) **Focus on Corporate Resilience**: Corporate Resilience is an important attribute which most quality companies exhibit. Companies that are swift enough to adjust their operations, products and services in times of crisis are better able to shield their margins, maintain profitability and deliver resilient dividends. These companies are more likely to have sustainability embedded in their strategy and processes. Most resilient companies have de-risked supply chains and focus on stakeholder management- as discussed above. A recent Harvard Business Review report suggests that such companies enjoyed positive public sentiment for the way they responded to COVID-19 crisis and their effects on employees, suppliers and customers lead to a competitive advantage. They thus outperform their peers during periods of market drawdowns. The report says "*firms that commit to stakeholder relations provide a signal of resilience to investors, leading to less negative stock returns during market collapse*." (Source: HBS report on Corporate resilience and Response during COVID19, June 2020).

4.) **Future-proofing investment portfolios**: Finally, for investors, sustainable investing is not only a way to do good for the environment and the society at large, but also an important risk mitigation tool. Investors that take into account potentially financially material ESG factors are more likely to future-proof their portfolios against known and unknown sources of risks (like climate change and COVID-19 respectively) and to allocate capital to investment opportunities that generate social and environmental benefits. ESG integration is about identifying ESG risks and opportunities and assessing their potential financial impact on the company though it is challenging to know if and when those ESG risks may materialize. Making ESG an integral part of the due diligence and investment process is no longer a PR or reputational exercise. It has become a necessity to navigate climate related uncertainties of the future. Incorporating ESG principles into security valuation and portfolio construction can lead to reduction or avoidance of tail risks and effectively reduce the probability of sharp drawdowns.

Summary

In a nutshell, the COVID-19 pandemic and the ensuing market slump have put a spotlight on the need to plan for extreme events. They highlighted that it is important for companies to try to become resilient to shocks from different angles, and think about becoming more sustainable. This includes planning for climate change - which happens to be a known long term risk -but can sometimes get ignored by corporates. Evidence suggests that when companies take financial materiality of ESG factors into account and adopt sustainability, this does not reduce the investment merit of such companies, it rather increases it, by making them resilient and hence future proof. They adapt quickly to changes in environment and social trends, focus on the well being and productivity of their employees and use their resources judiciously. Such discerning companies therefore face fewer tail risks of falling foul of regulations (hence have lower probability of getting fined and rebuked) and have low risk of reputational damage, which can be hugely detrimental in today's world of social media and constant news flow. All this culminates into better financial performance overall.

Similarly, investing in such resilient companies, (whether it is in their equity or debt) is prudent for investors who wish to preserve their capital, build resilient portfolios and make a positive return on investment. Investing sustainably leads investors to invest in quality companies, which focus on long term strategy and display the desired level of corporate resilience. ESG integration is also as an important risk management tool for investors. It not only protects investors from downside risks but also brings to fore potential new opportunities. Data suggest that one does not need to sacrifice investment return to invest sustainably. Sustainable investments can rather outperform the market during sharp sell-offs and investors reap the benefits of downside protection in times of extreme market drawdowns, like the one seen in Q1 2020.

There is sufficient data on the recent equity outperformance of ESG informed companies. On the fixed income side, investors are likely to look for resilient companies, but they will also still want comparable yield in accordance to their risk appetite. Is this possible? We believe this is now possible over an investment cycle by investing in high quality bonds of resilient companies and by investing in Green, Social and Sustainability bonds. A bigger pool of issuers means that investors can increasingly define their bond strategy (rating, sector, geography, duration, currency) and find adequate

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representation in the green, social and sustainability bond market in order to generate yield in a sustainable way.

Risks to our View

Investors should be mindful that no investment style or megatrend performs well all the time or in all markets conditions. Markets can be temporarily driven by greed or fear, leading to short lived episodes of "dash for trash" where by there's a rush to buy cheaper stocks which may eventually turn out to be 'value traps'. It is in times like these, that ESG and sustainable investing trends may underperform in the short term or may appear out of vogue. But sustainable investing is for the long term and switching in and out in the short run, to time the market, should best be avoided. In Fixed Income, Green bonds may be less liquid than their non-green counterparts, when comparing the age of the bonds.

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Risks to our view

Risks to our view stem from the developments in the pandemic and their impact on economies, households and businesses. The execution of existing and new policies by global governments and central banks could have negative long-term consequences on consumption through, for instance, the expectation of higher taxes to repay the fiscal spending related to COVID-19.

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[1] Tavares R (2020)
[2] US Chamber of Commerce, 11 Agust 2020
[3] Harvard Law School forum on Corporate Governance, 17 June 2020
[4] Financial Times, 8 July 2020