Outrunning a crisis: Sustainability and market outperformance

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Executive summary

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No asset was spared as investors realised the severity of the economic shutdown needed to contain the Covid-19 outbreak. The quickest US bear market in history, from February to March this year, was also the first broad-based market crash of the sustainable investing era and the one in which our research shows it came of age.

To test the effect of this volatility on companies with different environmental, social and governance (ESG) characteristics, we carried out a performance comparison across more than 2,600 companies, using Fidelity International's proprietary ESG rating system.

The ratings, from A to E, are derived from our fundamental analysis and engagement with the companies themselves and, like our overall ratings, are intended to be a forward-looking assessment of a company's sustainability profile. The rating system gave us a wealth of data to analyse the dispersion of returns between the five levels during the recent crash.

Our hypothesis, when starting the research, was that the companies with good sustainability characteristics have more prudent and conservative management teams and will therefore demonstrate greater resilience in a market crisis.

The data that came back supported this view. We found that a strong positive correlation existed between a company's relative market performance and its ESG rating over this turbulent period. The equity and fixed income securities issued by companies at the top of our ESG rating scale (A and B) on average outperformed those with average (C) and weaker ratings (D and E) in this short period, with a remarkably strong linear relationship.

While some caveats remain, including adjustments for beta, credit quality and the sudden market recovery explored below, we are encouraged by evidence of an overall relationship between strong sustainability factors and returns, lending further credence to the importance of analysing ESG factors as part of a fundamental research approach.

Equity

In the 37 days between 19 Feb and 27 March, the S&P 500 fell 844.7 points, or 25 per cent. Meanwhile, the price of a share in companies with a high (A) Fidelity ESG rating dropped less than that on average, while those rated B to E fell more than the benchmark.

Table 1: Attention to ESG earns market outperformance

Fidelity ESG rating	% of total rated	Stock return (%)	Stock return vs S&P 500
A	12%	-23.1	+1.9
B	39%	-25.7	-0.7
C	33%	-27.7	-2.7
D	14%	-30.7	-5.7
E	2%	-34.3	-9.3

Source: Fidelity International, April 2020.
Note: Data from 2,689 company ratings.

On average among the 2,689 companies rated, each ESG rating level was worth 2.8 percentage points of stock performance versus the index during that period of volatility.

Sector view

The unusual circumstances of the market crash - a broad-based economic shutdown to slow the spread of the deadly Covid-19 virus - meant that some sectors naturally outperformed others depending on the threat that the virus outbreak posed to their businesses.

Companies in the information technology and healthcare sectors behaved defensively compared to peers in, for example, the industrial or financial sectors.

Within almost all sectors we found that the dispersion of returns of companies rated A-E reflected that seen at an overall level.

For example, in healthcare, which was the second best performing MSCI sector index with a 16 per cent decline, the dispersion follows a similar pattern. The A-rated ESG stocks fell 12 per cent, while the Bs fell 18 per cent and the only E-rated stock dropped 32 per cent. While there was no difference in returns for C and D-rated healthcare names, which fell an average of 20 per cent, they still underperformed the more highly rated companies.

Table 2: Dispersion in the healthcare sector

Fidelity ESG rating	% of total rated	Stock return (%)
A	13%	-12
B	44%	-18
C	34%	-20
D	8%	-20
E	1%	-32

Source: Fidelity International, April 2020.

It's worth noting that the overall unadjusted dispersion pattern may have been even stronger, were it not for the collapse in oil prices. Companies in the energy sector, the worst performer with a -40 per cent drop, behaved in exactly the opposite way to their counterparts elsewhere.

Those with the top ESG rating underperformed, falling 49 per cent on average, while the companies with the lowest rating outperformed the sector by 3 per cent. This reversal may have been provoked by the sudden fall in oil prices to around US$20 a barrel, undermining the equity performance of those companies focused on clean energy sources, given the relative cheapness of their fossil fuel competitors.

Rating direction

In assigning the companies an ESG rating, our analysts also indicate whether they think a company ESG's performance is improving, deteriorating or stable. It is notable that 31 per cent of companies have an improving outlook, with only 4 per cent seen to be in decline, which is broadly indicative of how seriously ESG is being taken at the highest levels of company boardrooms.

Looking at returns, those companies with a deteriorating outlook underperformed stable and improving peers for most rating levels. Taken as a group, their stocks fell an average of 29.6 per cent in the market selloff, compared with 26.5 per cent for companies with a stable outlook and 27.6 per cent for improving names.

Table 3: A deteriorating ESG outlook worsened performance

Fidelity ESG rating direction	% of total rated	Stock return (%)
Improving	31%	-27.6
Stable	65%	-26.5
Deteriorating	4%	-29.6

Source: Fidelity International, April 2020.
Note: Data from 2,689 company ratings.

Adjusting for market beta

As well as the dispersion of returns mapping to ESG rating categories, we observed a similar dispersion of beta, or volatility, relative to the movement of the overall market. This indicates those stocks with a higher ESG rating also have a bias towards being lower beta stocks, losing less when the market drops, but also gaining less when it recovers.

There's a danger, when analysing how differently rated stocks behave against a market benchmark, of drawing conclusions about ESG that can be explained by beta.

With that in mind, we took raw beta data from Bloomberg and calculated beta-adjusted returns for each ESG rating category. On an overall basis, the dispersion noted before holds up under this new analysis. The A- and B- ESG rated stocks still managed to outperform those in lower categories, although the difference between the levels does become compressed.

The underlying securities have a wide range of beta, from 0.75 to 1.5. Overall the Bloomberg-derived average beta number is about 1.06. And while we might expect something closer to 1 with our broad coverage of more than 2,600 stocks, it does not change the overall direction and inference from the analysis.

Market recovery

The picture becomes a bit murkier when comparing the performance of the ESG ratings over a single day in which the market went up sharply.

We analysed the performance of stocks on 6 April 2020, a day in which the average share in our ratings universe increased by 5.7 per cent. During this rally, the dispersion pattern dissolved. The A-rated stocks increased by 5.2 per cent, underperforming the average by 0.5 per cent. Meanwhile the shares of companies rated C and D increased by an average of 5.8 per cent. However, the companies with the poorest ESG rating underperformed that day's rally by the widest margin, increasing by an average of just 4.5 per cent.

Table 4: Pattern remains after beta adjustment

Fidelity ESG ratings and stock performance

Fidelity ESG rating	% of total rated	Stock return (%)	Rel. performance v/s FIL universe avg. return (%)	Raw beta	Beta adjusted stock return (%)	5 year Avg ROE
A	12%	-23.1	4.0	0.93	-25.0	20.5
B	39%	-25.7	1.3	1.04	-24.7	17.1
C	33%	-27.7	-0.7	1.09	-25.4	14.0
D	14%	-30.7	-3.6	1.12	-27.4	12.7
E	2%	-34.3	-7.3	1.10	-31.2	16.3

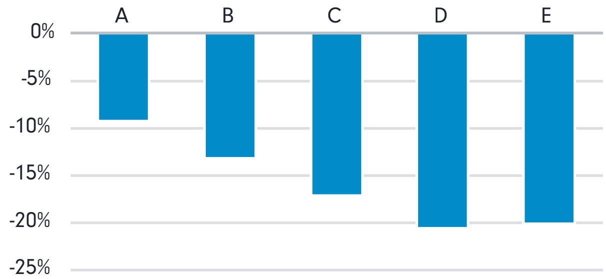
Source: Fidelity International and Bloomberg LP, April 2020
Note: Data from 2,689 company ratings.

Fixed Income

The findings in fixed income are similar to those in equity. The securities of higher rated ESG companies performed better on average than their lower rated peers from the start of the year up to March 23, on an unadjusted basis.

The bonds of the 149 A-rated companies returned -9.23 per cent on average, compared with -13.16 percent for B-rated companies and -17.14 per cent for C rated companies. There is some bunching between D- and E-rated companies around the -20 per cent level, which may be explained by the latter's low sample size of 27 companies.

Chart 1: High quality ESG leads to better fixed income returns
Credit excess return



Source: Fidelity International, April 2020.
Note: Data from 1,398 company ratings.

Adjusting for credit quality

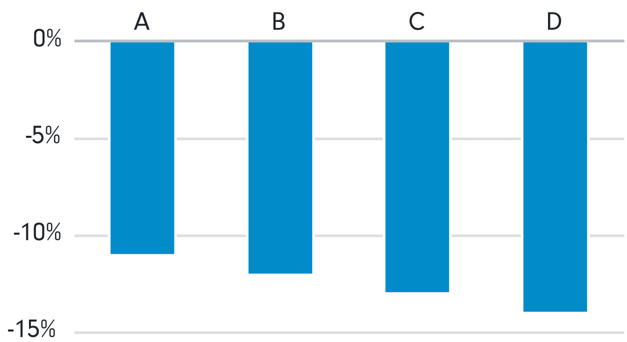
Not all bonds are created equal. We observed that companies with a high ESG rating also had a lower average credit spread (OAS) to start with, indicating that they are high quality names and would be expected to outperform lower rated peers in volatile markets.

Table 5: Lower spread for higher ESG-rated names

	OAS
A	95
B	142
C	218
D	300
E	399

When we control for the starting level of credit beta of each issuer, performance across the Fidelity ESG rating grades is less pronounced but bonds from higher rated companies still fared better than their lower rated counterparts.

Chart 2: Adjusting for starting spread gives similar dispersion pattern
Credit excess return (quality-adjusted)



Source: Fidelity International, April 2020.
Note: Data from 1,398 company ratings.

For this calculation, we separated the tickers by their starting credit spread into quintiles and calculated the average return for each combination of quintile and ESG rating, averaging again by the credit spread buckets to get a single number for each A-E rating. We removed all E-rated tickers and all tickers in the lowest credit quality quintile from the analysis, due to low numbers of both.

Conclusion

The recent period of market volatility was shocking in its severity. A natural behavioural reaction to market crises is to lower investing horizons and focus on short-term questions of corporate survival, pushing longer term concerns about environmental sustainability, stakeholder welfare and corporate governance to the background.

But this short-termism would indeed be short-sighted. Our research suggests that, what initially looked like an indiscriminate selloff did in fact discriminate between companies based on their attention to ESG matters.

It supports our view that a company's focus on sustainability factors is fundamentally indicative of its board and management quality. This leads to more resilient businesses in downturns that will be better positioned to capture opportunities when economic activity resumes, and demonstrating that ESG is more than earning its place at the heart of active portfolio management.

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