Wealth Management
Dominion Securities

# The year of the S

The Environmental and Governance components of ESG investing are increasingly important to investment decisions. As the world faces unprecedented challenges and grapples with persistent problems, we believe 2020 is the year that the third ESG element—Social impacts—comes to the fore.

## Prove it

In August 2019, the Business Roundtable—an association of CEOs of major global companies—published a "Statement on the purpose of a corporation."[1] This statement committed the association's 181 CEO members to redefining the idea of a corporation's purpose, which has traditionally been understood as the maximization of shareholder returns.

In seeking to redefine the purpose of a corporation, the Business Roundtable asserted that the corporation exists to benefit all stakeholders. In addition to shareholders, this includes customers, employees, suppliers, and communities. Shifting from a singular focus on shareholder returns to addressing a wider range of stakeholder interests is a lofty ideal that requires more than words to achieve. In walking the walk, corporations are challenged to address the complex impacts their decisions and actions have on diverse stakeholder interests.[2]

What sounded good in 2019 has been challenged in 2020. The events of this year—the impacts of a global pandemic and urgent efforts to confront the problem of systemic racism—have intensified the ongoing challenges facing our global society. This year may be the proving ground for corporations to demonstrate what "benefitting all stakeholders" truly means.

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## Corporate purposes and ESG investing

RBC Wealth Management published "What is responsible investing?" in June 2020 to lay out different approaches to this topic. The article breaks down responsible investing into three subcategories: Socially Responsible Investing (SRI); Environmental, Social, and Governance (ESG) investing; and Impact Investing.

ESG investing has rapidly become a key topic in wealth management,[3] with issues such as climate change (under the E) and the composition of corporate boards (under the G) establishing themselves at the forefront of investors' decision-making. But while some companies and investors have also focused on social issues such as treatment of employees, worker safety, and/or a company's contributions to communities, these issues have generally featured less prominently in investment decisions. The events of 2020, however, have changed the landscape, elevating the social component of ESG investing and making this the Year of S.

## Oh-so-social 2020

Social factors include the relationships that corporations have with their key stakeholders. Issues such as employee engagement and corporate culture; diversity, equity, and inclusion policies; and customer and community relations are considered social factors that characterize a corporation.

In 2020, companies have been forced to confront, respond to, and make massive changes in many areas of social consideration—in particular, stakeholder interactions. The COVID-19 pandemic has required companies to develop policies and standards to manage health risks in the workplace. Firms in many industries, including many businesses that have traditionally been reliant on face-to-face interactions, must now adapt to new methods of customer service. Managing personal and professional spaces is challenging, while the future path of job and health security remains uncertain. Systemic racism, which has marked societies for centuries, has inspired new demands for global action. Some of the same corporations that claimed in 2019 to be on their way to redefining the purpose of a corporation are struggling to adjust to the realities of 2020.

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## More than words, sooner than tomorrow

What does effective action look like? Firms are being asked to provide information about their social initiatives and achievements to help investors and other stakeholders assess their overall ESG efforts. While the following is by no means comprehensive, below we explore two examples of social concerns and ways companies may be assessed in their responses.

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## Diversity and inclusion: Getting it right

As many companies issue statements decrying systemic racism, the question remains: What are businesses doing, really?[4] When companies remain silent, or if their responses are deemed inadequate, their employees—especially people of color—are understandably upset and frustrated.

Research indicates that U.S. businesses spend nearly $8 billion a year on diversity and inclusion (D&I) training. Despite this, 40% of employees still say they feel isolated at work, expressing a lack of inclusion and lack of acceptance.[5] This figure directly impacts a corporation's productivity, profitability, and value creation: High employee belonging is linked to a 56% increase in job performance, a 50% drop in turnover risk, and a 75% reduction in sick days.

Attempts to build D&I do not always work. Diversity and inclusion are often lumped into one function within a corporation's HR efforts, but diversity alone does not beget inclusion. Corporations that seek to walk the walk need to recognize that initiating D&I efforts requires thoughtful follow-through. In fact, well-meaning yet problematic efforts may lead to a diversity backlash without proper inclusion practices.[6] ESG investing looks at how firms measure the success of their D&I efforts, employee turnover, and metrics for employee engagement. Employees at firms with successful D&I efforts will feel heard and included during difficult times.

## Health and wellness: Employee management during a global health crisis

In the face of the COVID-19 pandemic, companies are being challenged to create and implement new workplace safety protocols and address a myriad of employee health and wellness concerns. Employees are accepting that this pandemic may permanently alter the way we work.

The "North Star" in navigating these issues is maintaining a cohesive corporate culture despite all the challenges. Why? Research indicates the importance of company culture to a company's future performance. A recent study analyzing employees' reviews of their companies found that improvement in employee reviews correlates with improvements in sales growth, profitability, and predictability of earnings. On the flip side, the same study found that declining employee reviews were associated with deterioration in the same corporate metrics.[7] Mismanagement may negatively impact employee retention rates, at great cost to the company. Meanwhile, companies that provide income protection, job guarantees, and expanded sick leave may see positive knock-on effects.

## Inclusion and empathy create opportunity

These are just a few examples of what ESG-focused investment managers evaluate when looking at the social aspects of a company. How a company treats its employees can have a significant impact on its performance, and 2020 has clearly shown what a vital resource people are to value creation, growth, and long-term performance. ESG investing is premised on the idea that focusing on what benefits all of a corporation's stakeholders creates value and enhances returns for shareholders as well.

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Although ESG investing is still a new concept to many, its tenets are becoming more and more important as the world around us changes. The events of 2020 have shown how essential it is for corporations to consider and protect their employees and customers. In our view, 2020 is the Year of the S, and firms that enact policies consistent with positive social factors stand to be the leaders as the world evolves. Those that do not are likely to fall behind.

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[2] Is the Business Roundtable Statement Just Empty Rhetoric? Harvard Business Review, Aug. 30, 2019.

[3] ESG Investing Comes of Age: A Timeline. Morningstar, 2020.

[4] From Cosmetics to NASCAR, Calls for Racial Justice Are Spreading. New York Times, June 13, 2020.

[5] The Value of Belonging at Work. Harvard Business Review, Dec. 16, 2019.

[6] Diversity Doesn't Stick Without Inclusion. Harvard Business Review, Feb. 1, 2017.

[7] Crowdsourced Employer Reviews and Stock Returns. Journal of Financial Economics, April 1, 2018.