Emerging stronger: building an economically and environmentally resilient AC world

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While lockdown measures have been necessary for public health, they have inflicted enormous economic cost and exposed the vast inequalities in South Africa.

The COVID-19 crisis has highlighted the imperative to create an improved local and global economy that is better able to cope with any future catastrophes. Efforts to address the immense social and environmental challenges we currently face will be of prime importance in both the public and private sectors once the restrictions are lifted.

How might we use this current crisis to catalyse collective action to build more resilient economies? And how is the role of responsible investors being redefined for an after-coronavirus (AC) world? Tarryn Sankar, Head of Listed Credit, shares her thoughts on how COVID-19 might be used as an opportunity to build economic and environmental resilience.

1. Crises don't create, they reveal

While the exact origin of the COVID-19 virus is yet to be scientifically established, the World Economic Forum estimates that 60% of infectious diseases originate from animals, and 70% of emerging infectious diseases originate from wildlife. According to Standard Bank Securities, scientists have found that between two and four new viruses emerge annually as a result of human infringement on the natural world and the vast illegal wildlife trade.

Pandemics are often a hidden side effect of economic development and inequalities that can no longer be ignored, and illuminate the devastating ripple effects when one element in an interconnected system is destabilised. Just as carbon is not the actual cause of climate change, it is often human activity – rather than nature – that causes pandemics.

The spread of the coronavirus pandemic has emphasised the global interconnectedness of all stakeholders. Parties now have to collectively grapple with the real-time implications of how non-financial risks (in this instance, a global public health crisis caused by COVID-19) translate into significant financial risks.

Although the current crisis has its roots predominantly in a health emergency, it highlights the extent of damage a non-financial disaster can inflict on the world and the crucial interdependence between businesses (the economy) and their environmental, social and governance contexts. It has also highlighted how the health of the society on which companies depend for their financial sustainability, relies on the existence of adequate social welfare systems and the absence of extreme poverty and inequality.

Even if we find a vaccine for this novel coronavirus within the next 18 to 24 months the potential for further severe outbreaks is likely to remain significant, thanks to the combination of human travel and migration, illegal wildlife trading and climate change. The only solution is to use this opportunity to build systems better able to avert or absorb future shocks. And we need to do this together.

TAKEOUT:
COVID-19 has revealed the interconnectedness of societal and economic risks – and the need for a collective response.

2. Climate change, virus pandemics and responsible investing

Our recent collective experience, whether in the public or the private sector, has more often been shaped by financial shocks than physical shocks. The current pandemic has shown just how far-reaching and cataclysmic a physical shock of this magnitude can be – and opened our eyes to what we can potentially expect from future crises.

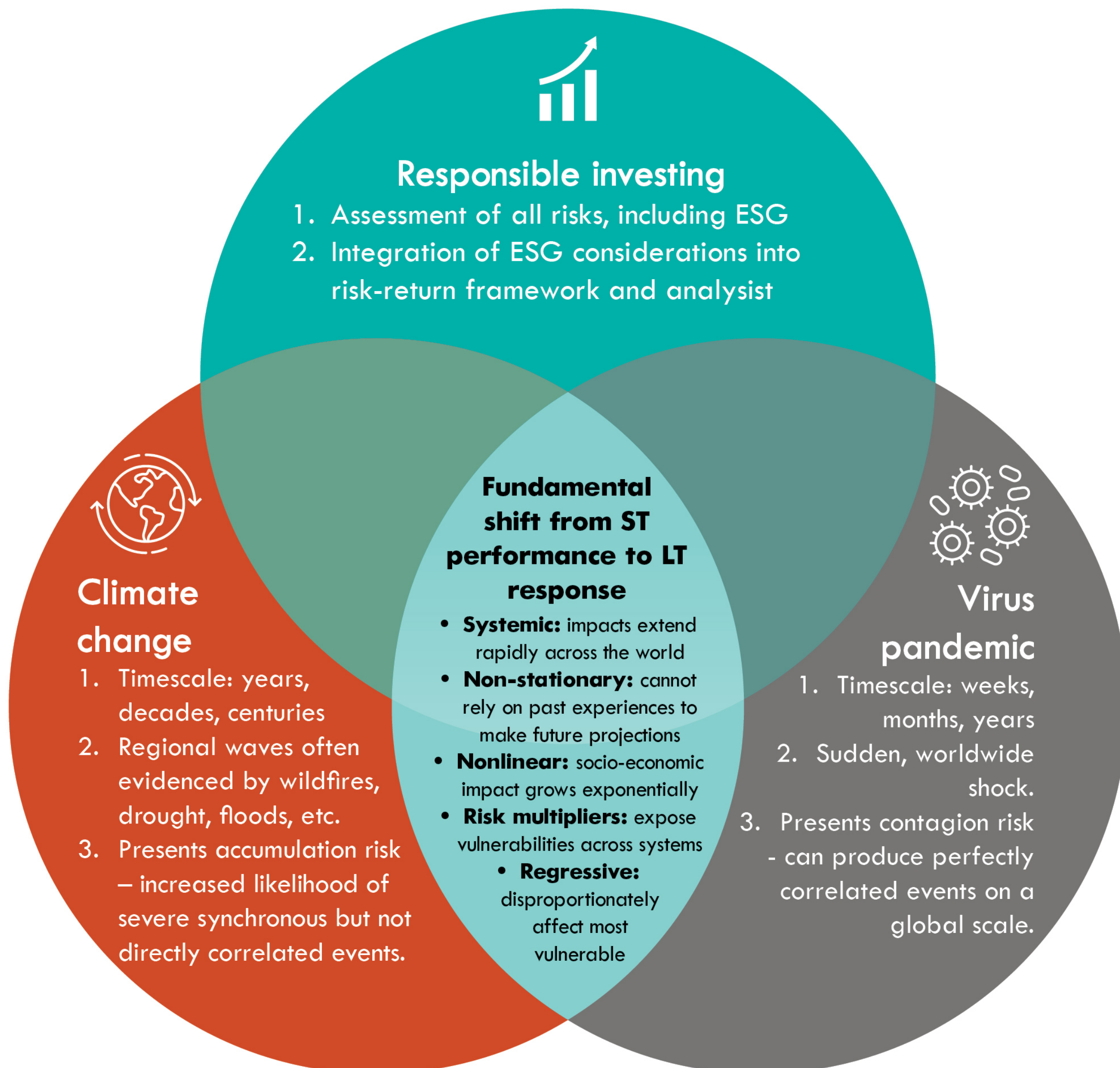
While the global financial crisis in 2008 was a financial upheaval of significant proportions, its economic and social impacts were ultimately narrower and, with the benefit of hindsight, relatively short-lived, compared to the expected economic impact of this novel coronavirus.

After 2008, global financial markets went on to win back much of their initial loss over the following decade, leading to their longest bull run in history. The 11-year rally only came to an abrupt end when COVID-19 began to spread uncontrollably into the Western world in March this year, with the S&P 500 dropping by 26.9% in a mere 17 days. This compares starkly to the 39 days it took in 1987 for the S&P 500 to lose roughly a third of its value in the wake of Black Monday.

One of the defining features of physical shocks is that they can only be remedied by understanding and addressing the underlying physical causes. The question arises: can this be applied to financial shocks? The Venn diagram below shows the differences and similarities between climate change and virus pandemics. On top of this, we can overlay the financial component of responsible investing, which must inevitably intersect with both of the first two categories.

Climate change and virus pandemics share several defining features in terms of their impact, including their ability to rapidly and exponentially impact societies, particularly the most vulnerable elements. Climate change can act as a potent risk multiplier for virus pandemics, with a 2003 study, for example, finding that the death rate for SARS (Sudden Acute Respiratory Syndrome) was twice as high for those living in cities with high air pollution.

One of the critical differences between climate change and virus pandemics is the aspect of manifestation, with climate affecting different regions in different ways and at different times, and pandemics presenting more of a synchronous, sudden shock. There has been much criticism regarding the lack of a globally coordinated fiscal and monetary response to the COVID-19 crisis. We have already seen how hard it has been to coordinate a global response to a climate change crisis that has been developing over years, decades or even centuries.



Source: McKinsey, adapted by Futuregrowth Asset Management

While we note that human activity (rather than nature) causes most pandemics, many of the factors that mitigate environmental risks may also minimise the risk of virus pandemics. These include reducing the demands we place on nature by optimising consumption, shortening and localising supply chains, and decreasing pollution. Achieving these behavioural changes is within our reach as we emerge from the pandemic in the months and years ahead.

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Both virus pandemics and climate change require the same fundamental shift in response: from optimising primarily for the shorter-term (ST) performance of systems to ensuring, equally, their longer-term (LT) resilience through investing responsibly. As a responsible investor and custodian of clients' funds, we have a responsibility to assess all risks, including non-financial risks, i.e. environmental, social and governance (ESG) risks, when we make our investment decisions.

As an asset manager, ESG considerations are an integral part of our fundamental credit and investment analysis process and risk-return framework. Once we have assessed these risks, we can choose to express our views in one of two ways, either by:

- choosing to embargo a company or reducing our exposure to zero (we can do this because we are not benchmark cognisant); or
- choosing to invest in the company and ensuring that we price risks (including non-financial ESG risks) appropriately.

In both instances, there is an opportunity, as a capital provider, to champion change by engaging companies on the issue of climate risk, along with a host of other ESG risks, as these relate to their businesses.

TAKEOUT:
Climate change, virus pandemics and responsible investing are inextricably linked and require a fundamental, focused and holistic shift in our response.

3. Transitioning from sustainability to resilience

Globally

In a working paper published by Harvard Business School, researchers studied investor behaviour during the 2020 COVID-19 induced market crash, from the market high of 3 373 on 20 February 2020 to the market low of 2 447 on 23 March 2020, during which the S&P 500 experienced a 27% decline.

Human capital, supply chain and operating crisis responses were found to be critical drivers of investor behaviour and stock returns during this period, given the impact of the crisis on supply chains and labour. The hypothesis is that more positive public sentiment around corporate responses to the COVID-19 crisis will mitigate investor distrust during a market collapse. During a period of volatility and crisis, how a company responds could increase investor confidence and make the company more resilient to the market shock.

At the time of writing, COVID-19 has not yet been contained globally, and markets are still in flux. We note, however, that this working paper aims to shed light on the ongoing and evolving crisis, building on a limited but growing bank of literature that examines the quality of corporate responses during sharp market declines, such as during the global financial crisis of 2008 (Flammer and Ioannou 2018).

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Locally

Top-down response

While COVID-19 represents a global growth and fiscal shock, the risks are particularly pertinent in South Africa, given elevated pre-COVID-19 unemployment rates and fiscal strain. Locally, our main concern regarding the bond market remains the strong link between lacklustre economic growth and a weakening fiscal position. The impact of the recent COVID-19-related events elevates this concern considerably. The duration of the virus cycle will be critical in determining the local economic recovery trajectory.

Policies that are put in place to build economic resilience should have a strong focus on predominantly environmentally friendly initiatives. The most important of these would be a systematic approach to decarbonising our energy sources, but not at the expense of a host of other social imperatives such as open markets, robust institutions, economic growth, low unemployment, education, and skills development. Other measures that would improve the long-term health and sustainability of communities and businesses alike, would be policy initiatives and investments into securing sustainable food and commodity supplies. It must be noted that the risks to food security have been laid bare in South Africa in the wake of the recent Land Bank liquidity crisis, given the dependence of agriculture on this funding resource.

Bottom-up response

When it comes to resilience, a major priority is building the analytical capability to truly understand, qualitatively and quantitatively, corporate vulnerabilities against a much broader set of scenarios, including, notably, physical events. Markets may better price in risks (and, in particular, climate risk) as the result of a greater appreciation of physical and systemic dislocations. It is our role as responsible investors to have a better understanding of the range of possible outcomes that the counterparties we invest in on behalf of our client funds may face in an AC world.

In the absence of a clear virus inflection point in the near term, corporate balance sheet strength and earnings, and cashflow resilience remain critical measures of credit quality across the asset classes that Futuregrowth manages. In our view, the likelihood of continued operational disruptions as our economy re-opens - and the inevitable second (and third) wave of infections - mean that stringent contingency planning, scenario assessment and risk management will remain an important element of business strategy and the robustness of our credit assessments going forward.

Investment industry

To address the vast inequalities that have become painfully apparent during the crisis, we will need to redefine accountabilities. Shareholder returns at all costs will, and should, give way to basic principles, such as a company's treatment of staff, suppliers and customers. As the Harvard Business School working paper referred to earlier suggests, society and investors at large will likely become more sensitive to the quality of a corporate's response to crises and demand more accountability in future.

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The investment industry, too, will need to step up to its responsibilities as long-term holders of capital. In the before-coronavirus (BC) world, it was a rarity to attend a conference or field questions from asset consultants and others without discussing ESG risks at length. While this may suggest that sustainability has at long last entered the mainstream, those of us who work in this space know that we are far from a world where all investors fully, meaningfully and consistently consider and appropriately price for ESG risks. This must surely change and, when we emerge from this crisis, the AC world that awaits us demands that responsible investment is the only acceptable norm.

Futuregrowth's journey of integrating ESG risks into our investment process over the better part of the past 20 years has shown us that this is a path of ongoing learning that we continue to walk, hand in hand with the counterparties in which we invest.

TAKEOUT:
Evidence is emerging that the quality of business response to the COVID crisis could mitigate investor misgivings and that the corporate world will be expected to exhibit greater accountability in an AC world.

4. Where does this leave us?

During the 2008 financial crisis, sustainability shot to the top of the agenda in the investment industry. This pandemic quite clearly shows that we haven't done nearly enough in the intervening years to enhance the resilience of our financial systems, economy, health services and physical environment.

A number of analysts estimate that, in the wake of the COVID-19 pandemic, we could experience the most significant drop ever recorded in global emissions of between 2 and 2.5 billion tons as a result of inadvertent, globally synchronised recessions, as opposed to good climate policies. Even an annual reduction of this magnitude still falls short of what would be required to limit global warming to 1.5°C above pre-industrial levels (the acknowledged mandatory target). It is sobering to be reminded that global emissions would need to fall by 2.8 billion tons a year to limit warming to 1.5°C by 2030.

This COVID crisis is going to fundamentally reshape the world going forward and will, no doubt, have long-lasting effects on the global economy and societal behaviour. These structural shifts could leave the global economy even more vulnerable to other crises down the line; or we could choose to build a more appropriate and resilient economy that puts us in a far stronger position to withstand the next onslaught we face.

By continuing to collaborate and coordinate our actions, the public sector, private sector and communities at large have an opportunity to reimagine a more sustainable way forward for the world. We believe that responsible investing can play a crucial role in bringing this vision to life, provided asset managers use this opportunity to engage flexibly and responsibly with companies that need support in their crisis management responses, while maintaining a long-term focus on investment decision-making. It will be critical in the weeks and months ahead that we leverage the power of collaboration to ensure that the standards of engagement on these key issues are not dropped during this crisis.

We have an opportunity to reimagine a more sustainable way forward for the world and responsible investing can play a crucial role in bringing this vision to life.

Both the climate crisis and the unfolding virus pandemic threaten the one thing we all care deeply about: the health and safety of our loved ones, and, by extension, the health and safety of our communities, country and fellow global citizens. We need to start now – and we can, and must, do better.

TAKEOUT:
If we learn anything from this crisis, it is that we need to do much more, collaboratively, to address future crises such as climate change and to build a resilient, sustainable world economy, for all our sakes.

Sources

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