ESG: It's time for the S to shine

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Social factors – the S in ESG – have taken a back seat to the E and the G. We believe that's about to change.

WHY NOW?

The speed at which ESG principles have been adopted within financial and corporate communities has been exceptional. Improving corporate governance (the G) is already a multi-decade practice, with executive management teams increasingly held accountable to all stakeholder groups. With governments reuniting behind the goals of the Paris Accord, focus among investors, corporates and regulators is currently very much on environmental factors (the E).

We fully expect this momentum to continue, but we believe that more and more attention will be placed on social factors (the S). Why so, and why now? The answer is the Covid-19 pandemic, which has exposed so many issues driven by the ever-increasing divide in society. Why is it that good healthcare – now including the vaccine – isn't uniformly available to all? Why is it that many children have had to forgo education through the pandemic due to lack of access to digital infrastructure?

Further impetus to tackle the damage to the fabric of society resulting from inequality comes from the UN Sustainable Development Goals (SDGs) laid out in 2015. And the corporate sector recognises that it has a huge role to play, with companies increasingly pursuing social initiatives in the same way they have embraced environmental ones.

But why should investors care? Are company efforts to tackle S factors just box ticking, or a distraction from their core aims? We don't think so. We see the S as the next big megatrend in sustainable investing, and expect companies with a focus on social advancement to increasingly command a valuation premium, in much the same way that those addressing the climate challenge already do. Given that the investment focus on social initiatives is still at an early stage, we believe there is an early mover opportunity to invest in and actively engage with businesses that are driving the social agenda.

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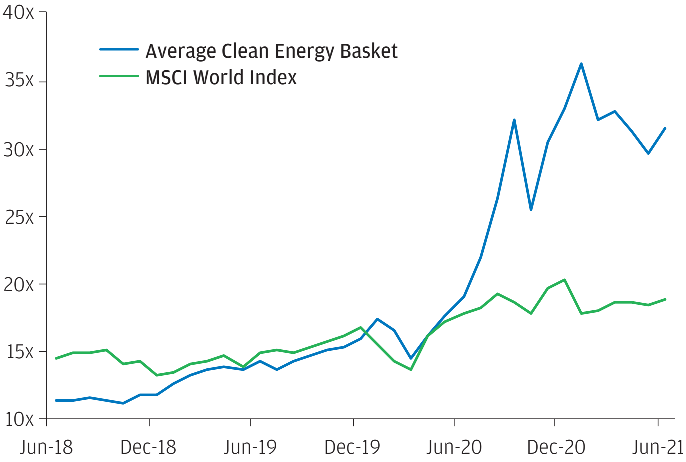
THE NEXT MEGATREND

We view clean energy as a good illustration of how the increasing focus on some of the S factors could play out for investors. The market is increasingly rewarding clean energy companies by giving them a higher valuation multiple, reflecting both their profit growth opportunity as the world seeks solutions to the climate challenge and the appetite among investors to align their values with their financial ambitions.

EXHIBIT 1: VALUATION PREMIUM OF CLEAN ENERGY STOCKS

Consensus 1-year forward P/E ratio



Source: Bloomberg, J.P. Morgan Asset Management; data as of June 2021. Clean energy basket defined by J.P. Morgan Asset Management as the arithmetic average of a basket of names representing different aspects of the energy transition: Orsted, RWE, Iberdrola, Enel, SSE, Neste, Vestas, Siemens Gamesa, Prysmian, Tesla, Schneider, Nextera, First Solar, Sun Power, Signify.

We believe a similar secular trend could play out for companies with a focus on some aspects of the S, and believe we are just at the beginning. Again, there are two drivers. First, good S has the potential to improve financial performance – we look at this further below. Second, as with E, we believe investors will be willing to pay a premium for stocks that play a strong role in societal advancement.

Broad flows into sustainable funds suggest this trend is well underway. However, dedicated social funds are still in their infancy. Since the beginning of 2012, sustainable funds have seen approximately USD 488 billion of inflows, but just USD 30 billion of that has gone into social funds.[1] As with climate investing, we expect to see a rapid change.

CAPTURING THE S

How can investors identify companies with a strong focus on the S? The starting point is internal: companies need to have their own house in order before we can consider whether they are doing good for society. Key internal factors that impact our assessment of a company's S credentials include diversity & inclusion, employee empowerment and supply chain relations. Companies that don't get these internal social practices right are increasingly scrutinised by their customers and face reputational damage – consider, for example, the scandals around the working practices of Apple supply chain companies in China, or Sports Direct in the UK.

Internal social issues can manifest themselves in several ways, from gender pay gaps to inadequate labour rights to dissatisfied employees. If the internal culture is inclusive and diverse, employees are happier, and suppliers are treated fairly, then the business will have greater productivity and creativity. This is borne out in research by McKinsey, which showed that companies with a top-quartile approach to ethnic diversity and gender diversity were 36% and 25% more likely to have strong financial performance, respectively.[2] And strong financial performance ultimately drives strong share price performance.

From an external point of view, strong S companies are those providing solutions to some of the biggest challenges we face, from expanding quality healthcare to providing equal access to technology. By addressing urgent problems and supporting new customer bases, we believe these companies have strong growth opportunities – which, as with climate innovation, are likely to be underpinned by policy and regulatory shifts.

[1] Source: Bank of America Global Research team, July 2021.

[2] Source: McKinsey, 'Diversity wins: How inclusion matters', 19 May 2020. www.mckinsey.com

OPPORTUNITIES ACROSS SECTORS

We believe investing through the lens of the S provides a strong opportunity to capture secular growth across sectors, as well as allowing investors to be part of the solution to the challenges created by inequality. We have identified seven subthemes, which between them align with 11 of the 17 UN SDGs. Within each subtheme, we provide an example of a company that we have identified through our research and engagement as an S leader. We provide these examples for illustrative purposes only. The inclusion of these company names should not be interpreted as a recommendation to buy or sell. Their past performance should not be seen as a reliable indicator of their current or future results.

Providing social protection

SDGs: 8 16

Companies protecting society and providing the right to live peacefully, to work and to protect oneself and one's family.

EXAMPLE: AIA GROUP

AIA Group is a market leader in the provision of life and health insurance products across south-east Asia (including China). While the region is forecast to have the largest global increase in its over-65 population by 2050, life insurance penetration is still very low, at rates of 1-3.5% across many of AIA's key markets, compared with close to 10% in many developed markets. In 2020, AIA made 13 million benefit payments equating to more than USD 16 billion, which helped customers and families cope with personal challenges.

Health and wellbeing

SDGs: 3

Companies investing in and providing solutions for physical and mental health and wellness.

EXAMPLE: NOVO NORDISK

Novo Nordisk is a market leader in the treatment of diabetes (insulin) and obesity (GLP-1). Its provision of affordable and even free insulin has been stepped up significantly during the pandemic. The company recently received regulatory approval for a new drug, Wegovy, for the treatment of obesity. A recent study by the World Health Organisation showed that 650 million people globally suffer from obesity.

Education and training talent

SDGs: 4 8 10

Companies providing educational materials and platforms across society or helping to skill populations.

EXAMPLE: RELX

The Science, Technical and Medical business at RELX is a global leader in the provision of reference materials and insights via journals such as Cell and The Lancet, which help researchers and healthcare professionals advance science and improve healthcare. Analytics products such as Clinical Key help users find the most relevant answers through a wide breadth and depth of trusted content across specialties. The ongoing Covid pandemic has led to a significant increase in the amount of scientific research, which RELX has made freely available. Relx has shown consistent and stable profit growth over history. Our base case is for this growth profile to continue, but we also believe there is a case for acceleration.

Affordable housing & infrastructure

SDGs: 9 11

Companies providing affordable housing and infrastructure for all.

EXAMPLE: TAYLOR WIMPEY

Taylor Wimpey is a housing developer based in the UK. Almost a quarter of the 15,000 houses the company builds annually are affordable. Taylor Wimpey also contributes to the local community through community and leisure facilities, transport infrastructure, educational funding, jobs for local people and public art and green spaces. Taylor Wimpey offers an attractive 8% dividend yield.

Essential amenities for all

SDGs: 1 2 6

Companies providing products or solutions for basic human survival needs.

EXAMPLE: WALMART DE MEXICO
Walmart de Mexico is a Mexican retailer that provides essential goods for the broad population. In 2020, the company donated 34,400 tons of food to local communities and supported 102 foodbanks. Walmex actively promotes an inclusive and local supplier base, with SMEs representing 92% of its self-service suppliers. The company is also a leader on gender diversity, with 52% of promotions in 2020 being women. We believe Walmex is well positioned to see sales growth, driven by population growth, alongside improving (and partly diversity-driven) financial productivity.

Access to the digital ecosystem

SDGs: 1 2 6

Companies facilitating digital access through hardware, software or platform infrastructure.

EXAMPLE: TAIWAN SEMICONDUCTOR MANUFACTURING COMPANY (TSMC)
TSMC is the world's largest manufacturer of semiconductors. The UN SDG framework identified that only one in five people in lower developed countries have access to the internet, let alone affordable computing equipment. Increasing scale of production at TSMC means lower cost, helping to make computing equipment affordable.

Affordable financing

SDGs: 1 8

Companies providing financial services to all or providing microfinancing solutions.

INVESTMENT EXAMPLE: FINECOBANK
Finecobank is a pure online financial services and investing platform based in Italy but now scaling across Europe. According to a recent study by Citigroup, Italian citizens have a combined EUR 2 trillion of savings in bank accounts earning low to negative returns. Fineco has a strategic focus on fair pricing and offers extremely affordable products, helping to democratise investing across income groups.

CONCLUSION

The S has been called the overlooked middle child of ESG, but we think that's about to change. We see the S theme as a compelling investment opportunity, with some S factors having the potential to pay off through much the same route as clean energy: a combination of higher growth and a valuation premium. Accordingly, we believe good companies that do good things for the world will increasingly see this reflected in their share prices.

NEXT STEPS

For more information, contact your J.P. Morgan representative.

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