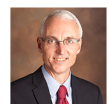
Sustainability Drives Success in a Post-Coronavirus World

ESG matters more than ever in choosing good companies.

September 2020

KEY INSIGHTS

- The coronavirus pandemic has pulled forward environmental, social, and governance (ESG) trends by years in a matter of months.
- Societal pressures are driving unprecedented change and the need for real solutions from governments and businesses alike.
- In the current environment, it is more important than ever for companies to incorporate sustainability into their long-term strategies.



Scott Berg
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Crisis causes change. We know this both as human beings and as experienced global investors. The 2008 global financial crisis (GFC) led to a reckoning in how businesses were run, especially in financial services. The GFC ultimately redefined fiduciary responsibilities, shifting more emphasis toward clients and shareholders. Fueled by government bailouts, new regulations, and shareholder activism, the crisis led to more transparency and fundamentally changed the financial world—in most ways for the better.

In the years following the GFC, we have seen seismic shifts in the global economic landscape: In particular, technology has permeated all sectors and industries, creating remarkable efficiencies and capabilities. In some ways, technology has been a significant democratic force, spreading power, knowledge, and sophisticated tools to many. But technology has also been hugely disruptive: Generating significant efficiencies has led to job losses and some industries disappearing altogether. Meanwhile, we have also seen wealth concentration and natural monopolies created with clear winners and losers, which in turn contributes to social and political tensions.

The coronavirus pandemic has pulled forward many disruptive trends to a staggering degree. Social distancing and the shuttering of brick-and-mortar businesses have accelerated e-commerce and communication adoption by years. Businesses are leaning on technology to help employees function in a work-from-home status that may become a more permanent way of life even after the pandemic wanes.

However, even as governments around the world have applied unprecedented monetary and fiscal policy stimulus to create and protect jobs, they have struggled to ease growing societal pressures.

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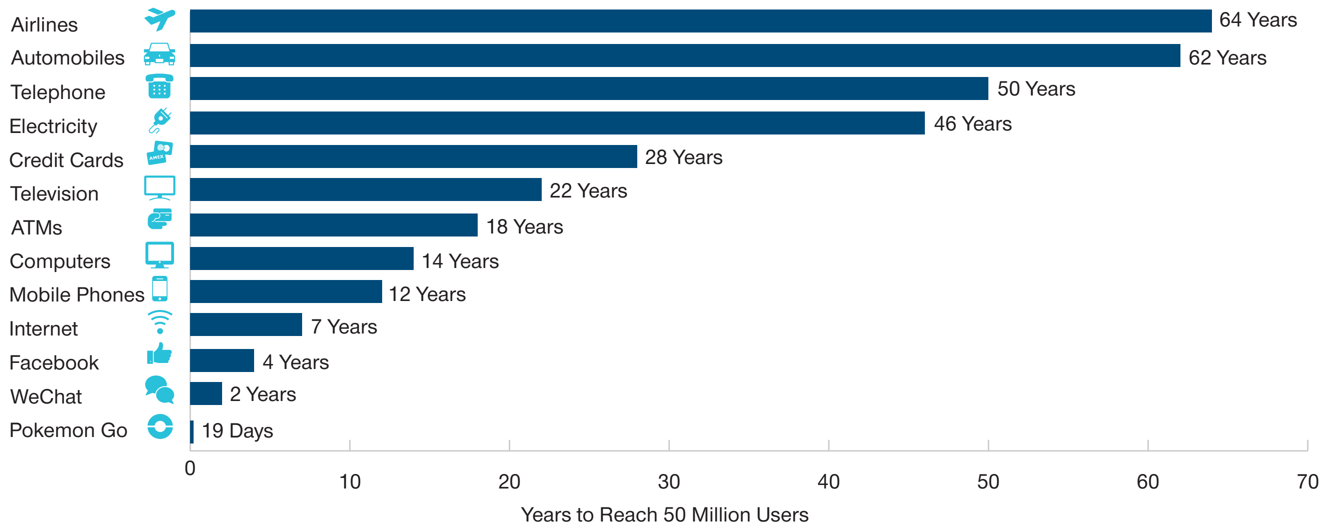
Technology and an Era of Accelerated Change

(Fig. 1) A monumental era of investment, fueled by credit and new technology, has accelerated and enabled disruption



As of March 31, 2020.
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One of the consequences of the coronavirus has been an intensified debate about how to address various dimensions of inequality, both societal and economic.

Given the current environment, it is more important than ever for companies to incorporate sustainability into their long-term strategies. By this, we are not talking about good governance and corporate citizenry, we are talking about developing a robust business strategy for navigating environmental and social change. Sustainability is fundamentally intertwined with and a function of visionary thought, disciplined leadership (especially in crisis), being on the right side of societal change, and contributing to the needs of others.

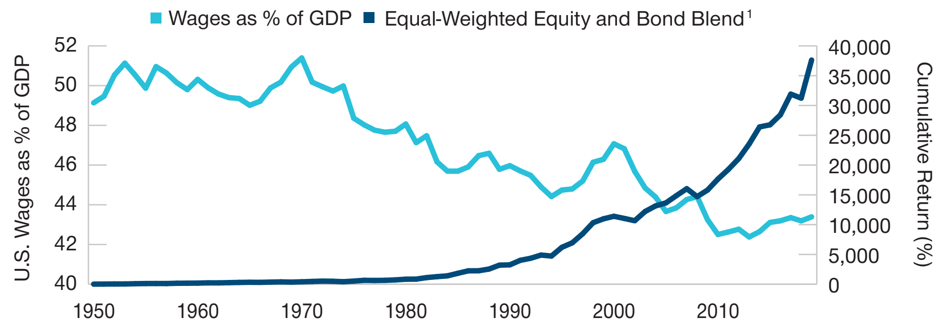
With Great Power Comes Great Responsibility

Just as the GFC was a reckoning for financial companies, so has the current health crisis been for the technology sector. Big tech companies like Apple, Amazon, and Netflix are not unfamiliar with ESG controversy. Their business models have driven and benefited from tremendous societal changes in the way we communicate, shop, and watch TV. While these societal shifts have driven topline growth, they also have created more operational risks. With so much at stake, many technology companies have been taking material steps to address their approach to ESG considerations in human capital management and ethics (supporting increased payment of international taxes).

In his 2020 annual letter to shareholders, Amazon CEO Jeff Bezos acknowledged the extraordinary role the company has in customers' lives, stating, "Customers count on us to be there...Amazon can make a positive impact and be an organizing force for progress." He also outlined the great lengths the company is going in order to invest in logistics to keep pace with customer demand, strive to ensure employee safety and quality of life, reduce packaging waste, and support the diversity and skills of future generations. These are all core tenets

Will the Coronavirus Catalyze Political Populism

(Fig. 2) 1950–2019: Wall Street boom, main street bust



As of December 31, 2019.

Past performance is not a reliable indicator of future performance.

Source: FactSet (Standard & Poor's Bureau of Economic Analysis/Haver)/Haver Analytics (see Additional Disclosures).

[1] Equal-weighted total return of U.S. equities (S&P 500) and U.S. 10-year government bonds.

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of creating an increasingly sustainable business. That one of the most influential CEOs of one of the largest companies in the world chooses to focus on them shows that sustainability has become not just a part of the conversation, but increasingly an important consideration in corporate strategy.

It's not just large firms that are recognizing their importance in supporting and improving our lives: Since the pandemic, smaller companies have also seen the difference they are making to help us through challenging times. E-commerce platforms are playing a pivotal role in helping small businesses transition from offline to online. In health care, there are several smaller, niche biotech companies that are at the forefront of the coronavirus battle due to their capabilities in creating accurate testing, serology research, and vaccine support. Never in history has such a collective focus been applied to a problem, and the hope is that society can emerge with a greater sense of collective goals from this period.

We are seeing the results of this shift firsthand: Companies are initiating discussions on ESG themes and outlining detailed plans, where historically it was more common for us at T. Rowe Price to begin the conversation. The conversation around ESG factors has always been important to us, as we believe it creates better companies over the long term. We use a variety of tools to influence change, including dialogue from our analysts, formal letters and communications, face-to-face engagements, and public advocacy. We understand that good ESG practices often breed more sustainable and durable businesses.

How Do We Factor in ESG?

One reason we feel we are well suited to the era's increasing focus on ESG is that we fully embed ESG analysis within our investment process. With an emphasis on durability and positive change, we feel informed and seek to be on the right side of change with respect to the next stage of the ESG journey. Our Responsible Investment team provides analysis on industry-level and stock-specific ESG issues, which we then incorporate into our company-specific analysis and investment theses. We also screen the entire portfolio using our proprietary Responsible Investing Indicator Model to not only help understand the characteristics that relate to ESG, but also to make us aware of any elevated exposures to specific ESG factors.

When we look at the world today, there are several sectors that stand out to us as potentially fertile areas for sustainability and positive impact, which should help quality participants benefit from these sea changes.

Materials: The last few years have been some of the hottest on record, and catastrophic weather events (forest fires, hurricanes, flooding) are demonstrating the reality of climate change. We are increasingly looking for companies that address climate change through carbon capture and storage, sustainable packaging, and green alternatives that are actively reducing their carbon footprints. For instance, paper and packaging companies are well positioned for the shift from plastics to more sustainable materials. We also focus on companies producing materials like industrial gases that function as greener fuel alternatives.

Utilities: Companies in this sector are going to be central to improving environmental sustainability given their large infrastructure, durable income structures, and ability to invest in renewables to aid the energy transition that is critical for society. We look for high-quality, well-run utilities that are putting significant resources into renewable energy infrastructure.

Health Care: The coronavirus has intersected a period of growing demand and cost for health care provisions and created a bifurcated landscape in health care. Pre-pandemic, we favored biologics companies given the innovation occurring, and the spread of the coronavirus has shown the importance of these types of businesses. The pandemic has also pulled forward telehealth trends by years, and companies that provide these services are seeing rapid adoption while helping patients to maintain essential and safe communication with doctors.

Information Technology: Massive and rapid growth in any sector creates growing pains, and the technology sector has not been absent from negative focus as it has tried to balance economic gains with its obligations to workers and society.

Given political and societal oversight, tech companies are rapidly coming to terms with their responsibilities to act as good stewards of sustainability, even if it comes at the expense of short-term returns. Facebook hiring thousands of employees to address content concerns and Amazon hiring and investing to fulfill dramatically raised demand while seeking to protect its employees are examples of a focus on long-term sustainability and potential protection of the core business model that relies on reputation and societal acceptance.

We actively engage with a number of large technology companies to help guide their ESG journeys and influence their decision-making where possible. Given the size of our company and the level of exposure we may have to the technology sector, we at times have unique access to high-profile management teams and a meaningful ability to influence change directly.

ESG Considerations Are Crucial to Finding Good Growth Companies

A changing economic landscape powered by technology has brought significant disruption to societies around the world, and it has become clear that some form of intersection between society, companies, investors, and governments is crucial to perpetuating economic stability and success. The coronavirus pandemic has accelerated adoption of sustainability trends by years, making it critical to understand this increased emphasis and how it will reshape the investment landscape.

ESG is a permanent part of this new order. Businesses will need to think carefully about their effect on industries; people; and, ultimately, the planet.

Companies that understand these connections are often the innovators that are positioning themselves for real and future growth. We believe this is a good disruption that we will seek to be on the right side of and make a positive contribution to.

Securities mentioned in this material comprised the following percentages of the Global Growth Stock Fund as of 6/30/20: Facebook: 1.84%, Amazon: 3.62%, Apple: 1.10%, Netflix: 0.71%.

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