Doing Good and Doing Well: Why ESG Matters in Turbulent Times - Evidence from Brazil

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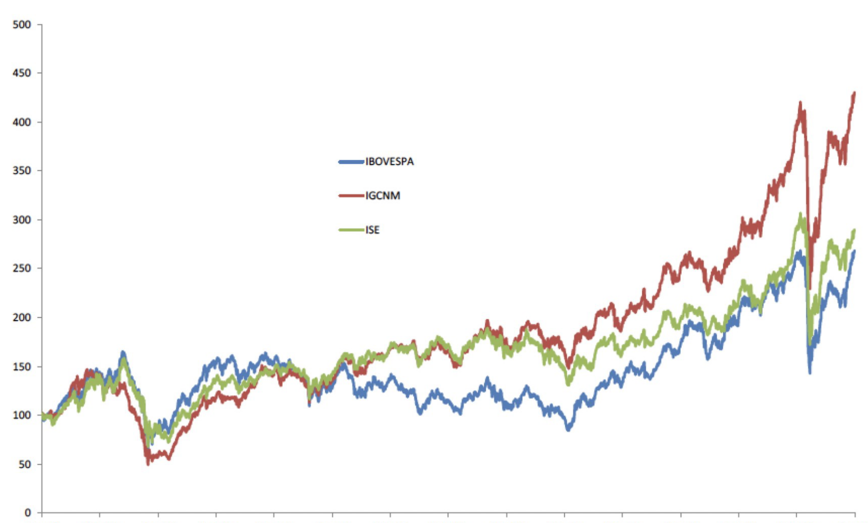
Embracing environment, social, and governance (ESG) has become a priority for corporations in recent years. Yet, not everyone in the business world is convinced. Warren Buffett, for instance, believes profitability should come first and at the latest World Economic Forum gathering in Davos, some frustrated executives commented off the record that the topic is too broad and distracting. Recent evidence from Brazil, however, suggests that ESG practices may be crucial for publicly-traded companies—especially during extreme events such as the COVID-19 pandemic. This may change the hearts and minds of ESG skeptics.

A closer look into the coronavirus impact on the stock performance of Brazilian companies that follow ESG principles offers valuable insights that might appeal to an audience beyond domestic stakeholders for three reasons. First, as an agricultural powerhouse and home to Earth's largest rainforest, Brazil plays a significant role in shaping the global climate change agenda. Second, emerging markets were generally more vulnerable to the COVID-19 pandemic than advanced economies. Finally, COVID-19 hit Brazil hard, having the second-highest number of deaths worldwide, which caused considerable disruption to its productive sector.

ESG-compliant firms, particularly those with more robust governance, have historically outperformed the Brazilian market, as shown in the chart below. In 2005, the Brazil Stock Exchange (B3) created a Corporate Sustainability Index (ISE)—the fourth of its kind in the world—and, a year later, a Corporate Governance Index (IGC-NM) for companies that voluntarily adopt additional practices beyond those required by Brazilian legislation. Using ISE as an alternative for ESG and IGC-NM for governance, we find that companies with adherence to ESG standards saw a total return of 315 percent compared to 273 percent for Ibovespa, B3's benchmark index and the Brazilian equivalent of the Dow Jones, between 2007 and 2020. Over the same period, the total return for the IGC-NM was even higher and gains accelerated after 2015, further emphasizing the importance of good governance. Besides better returns, both the ISE and IGC-NM displayed slightly less volatility than Ibovespa.

Performance of ISE, IGC-NM, and IBOVESPA from 2007 to 2020



Source: Authors with data from B3.

At the start of the COVID-19 pandemic, Brazilian companies that were ESG-compliant fared significantly better than their non-compliant peers. The conclusion lies in the “abnormal returns” of stocks, computed by taking the estimated returns if COVID-19 had not happened away from the actual returns during key event dates associated with the pandemic. For our research, we considered the announcement of the first COVID-19 case in Brazil confirmed by the Ministry of Health (February 26, 2020), the World Health Organization declaration of COVID-19 as a global pandemic (March 11, 2020), and the confirmation of the first death caused by the virus in Brazil (March 16, 2020). Around those dates, ESG companies generated between 0.57 percent and 0.67 percent of average abnormal returns, whereas for those that did not follow ESG, the figures ranged between -1.16 percent and -3.21 percent. We used control variables to adjust for the fact that the superior abnormal returns of ESG companies may be associated with firm and industry characteristics (ESG companies are bigger, more profitable and valued than non-ESG firms).

In addition, at the onset of the pandemic, superior performance correlated with adopting ESG practices broadly rather than solely governance practices. That is, firms embracing good governance without improving their environmental and social standards did not experience higher abnormal returns when the pandemic hit. Considering that two-thirds of the most negotiated listed Brazilian companies already pursue better governance practices, addressing environmental and social factors might be the secret to better performance, especially during crises.

The connection between ESG practices and increased stock market returns seems particularly crucial in turbulent times. This was evident in Brazil when the COVID-19 pandemic started. To create a more resilient economic environment, regulators should thus aim to improve ESG standards by incentivizing firms to operate more sustainably. Investors and analysts would do well to actively monitor and encourage firms to prioritize ESG. Incorporating ESG as part of their core principles, planning, and execution might enable firms to better withstand extreme volatility.

Warren Buffet famously stated “you never know who's swimming naked until the tide goes out.” Despite the Oracle of Omaha's reluctant stance on ESG, his quote serves as a wake-up call considering the superior returns of Brazilian public companies with good environment, social, and governance practices—particularly during the COVID-19 crisis. To survive and thrive, businesses pursuing their own self-interest should still seek to contribute to the common good.

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