Connecting the COVID-19 Pandemic: Importance of Environmental, Social, and Governance (ESG) Investing-development in the China Market

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ABSTRACT

With the global spread of COVID-19, countries, enterprises, and individuals face severe challenges. Sustainable development has been widely concerned, and the importance of integrating environmental, social, and corporate governance (ESG) into investment decision-making has gradually become prominent. The paper is divided into three modules. The report researches many kinds of literature on ESG investment and analyses the critical impact of ESG investment on the benefits and risks of enterprises and the sustainable development of society. This paper mainly studies the essential role of ESG investment, how the three aspects of ESG investment affect by COVID-19, and the analysis of the risks and benefits of ESG investment. Finally, it leads to the opportunities and challenges China's ESG investment development faces. Enterprises should actively undertake social responsibility and promote the economic and business model with sustainable development, promoting the development of enterprises and social progress.

Keywords: *Financial investment, Covid-19, ESG, Investment decision*

1. INTRODUCTION

1.1. Background

COVID-19 has a broad impact on people's lives, families, and communities. As the international community responds, people know that countries and businesses face several potentially significant challenges. There is also a growing awareness that sustainable development is more than just dealing with environmental risks. The social and corporate impact of the pandemic highlights the importance of integrating environment, society, and governance into investment decisions.

ESG investment excludes stocks and entire industries from investments related to business operations in conflict zones. It includes three core factors in its examination: Environmental impacts (E), energy and material use, carbon emissions, and climate change—social impact (S), including employee health, industrial relations, diversity, and inclusion. Governance elements (G) include the behaviors or strategies adopted by the company to achieve effective internal management or satisfy stakeholders, such as business ethics, shareholder rights, and compensation policies. In general, ESG practice is the foundation of socially responsible investment and is essential for the green finance system.

1.2. Related Research

COVID-19 has countless impacts on markets, including responsible investment (RI) markets with environmental, social, and governance (ESG) factors. Professor Lanz examines four market trends to watch in the relationship between ESG and COVID-19: 'S' is moving to the forefront, ESG is delivering alpha, assets are still flowing into ESG funds, and impact investment opportunities are on the rise [1]. Pisani and Russo studied the sample financial performance of financial investment returns, volatility, and contagion risk during the COVID-19 pandemic in 2019. Studies have shown that sustainability funds outperform ESG's lower-rated funds during financial crises determined by external shocks [2]. David and Louis studied the role of ESG performance in the entire market and even the global financial crisis and

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paid attention to the financial crisis caused by COVID-19. The conclusion is that the sharp decline in global stock values during COVID-19 reflects strong negative investor sentiment. The research shows that ESG performance is positively correlated with the short-term cumulative returns of stocks surrounding the COVID-19 crisis and empirically illustrates the stock resilience of ESG's superior performance during the entire market crisis. Investors may interpret ESG's performance as a signal of future stock performance and risk mitigation [3].

COVID-19 has fundamentally impacted the global economy, accelerating the need for different investment approaches. ESG investment focuses on environmental protection and human development and requires international cooperation to realize ethical investment potential fully. Roy et al. studied ESG investment in the context of the pandemic and presented application examples of ESG investment in different industries. For example, the FMCG industry is looking to better manage the working conditions of employees throughout the supply chain; Financial service providers are doing their best to offer investors better risk-adjusted returns. In addition, it examines aspects of corporate governance that benefit stakeholders. Boards must address rewriting strategy, tracking broader operations, monitoring risk, rethinking compensation policies, and re-understanding employee health and experience [4]. Their research on COVID-19 noted that the occurrence of the high impact risk of COVID-19 would increase global awareness and action. Overall, COVID-19 could be a significant turning point for ESG's investments or a strategy that aligns the company's environmental, social, and governance performance with traditional financial metrics [5]. ESG stands for environmental, social, and corporate governance. ESG investing is a socially responsible form of investment that prioritizes financial return and the company's impact on the environment, stakeholders, and the planet. Lomax et al. concluded that, for most investors, ESG investments represent good corporate behavior and mean better operating results [6].

1.3. Objective

The paper is divided into three modules to discuss the impact of COVID-19 on ESG. First, describe what role ESG plays in investment, how it benefits business and the change through a flexible society. Then, the specific impact of ESG on COVID-19 is described from environmental, social, and public security aspects. The benefits and risks of ESG investment during the pandemic are explained, including an overview of the market investment environment during the pandemic, the impact of ESG investment on stock valuation, and the development trend of ESG investment in China.

2. WHAT ROLES DOES ESG PLAY IN INVESTING

2.1. ESG stands an important role

With the development of society, many countries implement regulations like the carbon tax, and most financial and banking industries incorporate ESG rules into financing standards. Therefore, it is essential to demonstrate evidence of robust sustainability and ESG strategy to avoid non-performing loan conditions and reduce the likelihood of exclusion from capital markets [7].

According to a report by the Global Sustainable Investment Alliance (GSIA), in 2020, 62 percent of Investments in Canada are ESG investments, 42 percent in Europe are ESG investments, 38 percent in Australia and New Zealand are ESG investments, 33 percent in the US are ESG investments, and 24 percent in Japan are ESG investments. Figure 1 shows the percentage of ESG investment stands in each country from 2014 to 2020.

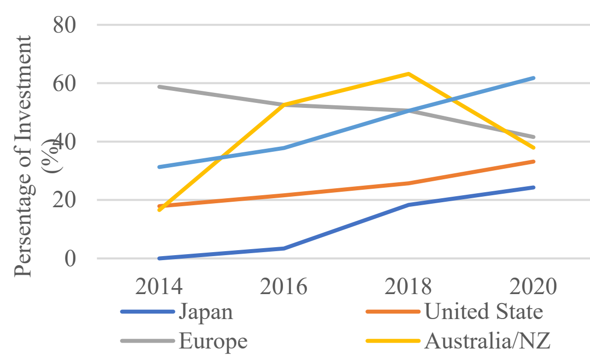

Figure 1. ESG investment percentage between countries [8]

2.2. The benefits of ESG

A strong ESG proposition helps create significant business value across the enterprise in the following ways:

Mature ESG proposals can help companies develop new markets and expand into existing ones. This is especially true for start-up companies seeking funding: "Since 2019, European investors invest €120bn in sustainable investment options," with ESG factors gradually being incorporated into the investment process and accounting for an increasing proportion. Figure 1 can also confirm this fact. It can be found that the proportion of ESG investment in the United States, Japan, and Europe has been on the rise from 2014 to 2020. Investors put more interest in how start-ups score on their ESG policies and practices. Companies that implement ESG policies and perform well on these factors will better convince investors. When investors trust companies, they are more likely to grant them access, approvals, and licenses to provide new growth opportunities [9].

ESG could also better appeal to consumers. When the happiness index reaches a certain level, and people's basic needs are met, people will pay more attention to environmental protection. McKinsey's research shows that consumers say they are willing to pay to be “green.” In purchasing surveys across multiple industries, more than 70 percent of consumers said they would pay an additional 5 percent for green products if they met the same performance standards as non-green products [10].

Quality employees are more likely to attract to companies with a strong ESG proposition. A sense of purpose makes employees more motivate and improves overall productivity. A strong ESG proposition highlights a diverse work environment and vital inclusion, positively associate with employee satisfaction. In addition, employee satisfaction is positively correlated with shareholder return. Weak ESG claims drag down productivity, such as strikes, Worker slowdowns, and other Labor actions.

A strong ESG proposition gives companies a greater return on investment because they can allocate capital to more promising, sustainable opportunities to reduce unnecessary costs. Nestle, for example, announce it will invest in moving from virgin plastic packaging to food-grade recycled plastics and developing other sustainable packaging solutions. Not only does this help them reduce their carbon consumption, but it also avoids stranded investments that cannot pay off because of environmental concerns [11].

2.3. ESG from a developmental perspective

ESG is an open and changing system, and the company needs to adapt to the social needs under different circumstances, improve the corporate image, and achieve sustainable development. To integrate ESG into the investment process, how investors deal with ESG also changes with time and society.

As society evolves, the pressure to implement ESG factors increases, and companies face pressure from legislators, investors, and business ecosystems. It also includes non-governmental organizations, social and activist groups advocating for a range of environmental issues, the communities they rely on, their employees and customers, and, most importantly, the pandemic that has the most significant impact on society. To remain attractive as an employer or brand, a company must always be aware of social dynamics and implement active and effective programs to meet ESG standards as the social environment changes.

Therefore, the company should focus on or implement the following points: They should consider and evaluate the ESG risk of an investment project before developing it for better management, communicate the ESG strategy of the company or project to stakeholders and demonstrate alignment with business objectives to gain the trust of investors and seize more potential investment opportunities. Also, they need to highlight the ESG policies and programs that have been developed, share the company’s specific ESG goals and indicators, and finally assess the company's or project's progress and participation in crucial ESG areas. These actions can help companies build a robust ESG framework that withstands time, investor needs, social environments, and cultural shifts [12].

3. HOW HAS ESG BEEN AFFECTED BY COVID-19

In the first months of 2020, a sudden outbreak of a market-wide financial crisis was triggered in response to an emerging global health crisis whose consequences resonate more with the 1929-1933 Depression than with the 2007/2008 global financial crisis. In this case, the environment plays a role in the outbreak. The global climate itself is undergoing abnormal changes. After the epidemic outbreak, how enterprises shoulder their social responsibilities and whether they can timely adjust governance and prevention are also the scopes of THE ESG system.

3.1. Impacts between COVID-19 and the environment

Nowadays, the lifestyle of human beings causes a drastic impact on the environment. The population has increased from 1 billion (1800) to 7.7 billion in 2020 [13]. Human beings are drastically utilizing natural resources for new developments of industries, infrastructure, and habitats. Due to the increase in the human population, the demands for dairy and meat products, such as eggs, meat, and milk, are also increased. This encourages poultry farming and livestock raising, which are considered the main door for persuading the transmission of various viruses from the wildlife world to the human world [14].

As COVID-19 continues to spread across the globe, a mysterious virus that 90% of its genes cannot be identified emerged in Brazil. A rare four-month bushfire in Australia is severely damaged the Australian ecosystem and further deteriorated the global atmosphere. At the beginning of 2020, Canada was hit by severe snowstorms. A massive eruption of mount Taal in the Philippines; Rain and cyclones in many parts of Australia; Heavy rain causes flooding in many parts of the UK... There is no doubt that COVID-19 has a subtle impact on air (e.g., air pollution, global warming), water pollution, and wildlife.

During the COVID-19 pandemic, travel restrictions and the global economic recession led to a drop in human-caused air pollutant emissions. Including the specific implementation of the community and office buildings closed management, personnel flow restrictions, and the frequency of the use of vehicles declined sharply, as well as most of the industrial engineering shutdown during this period have a subtle impact on the air environment.

3.2. The impact of COVID-19 on society

Perhaps the word "social" is very distant to us, and we often think that a company or corporate social responsibility must do something extraordinary to deserve the name. However, the importance of social responsibility is well demonstrated by the timely response of several enterprises during COVID-19. During the current COVID-19 pandemic, businesses, restaurants, entertainment, and tourism suffer from various impacts. The COVID-19 pandemic is drastically affecting the micro, small, and medium enterprises (MSME). According to the All-Indian Manufacturer Association, 19% to 43% of different enterprises may disappear if the crisis persists for a long duration (i.e., more than eight weeks) [15]. Due to the lockdown and quarantine period, people show limited working possibilities. Consumers purchase essential and restricted items directly affecting the demand-supply chain [16].

The COVID-19 pandemic is also affected the film industry. However, digital commerce and technology are raised in this discussion [17]. This is one of the most prominent sectors. In this pandemic situation, online gaming, radio, digital media subscriptions, and the over-the-top (OTT) media service platform increased. They may provide more revenues in the upcoming years. During the COVID-19 pandemic, most people chose to work from home or were forced to stay home quarantined. During this period, more and more people join the ranks of mobile games, computer games, and social software, even using mobile phones for more than 12 hours a day. The film industry, theatre, and live events face a massive loss, as stated by the Event and Entertainment Management Association (EEMA) [18]. The dwindling of these revenues is the shutdown of theatres and cinemas. These setbacks are not limited to the end of the pandemic. As cinemas close and people choose to watch films at home, cinema revenues fall. In addition, the cost of watching a movie at home will be much lower than the cost of watching it in the cinema.

Travel and tourism play a vital role in social and economic development [19]. During COVID-19, the demand for tourism consumption slowed down, but the confidence index of tourists remained unchanged. Low density, suburban areas, and self-driving will become the new direction of tourism development in the era of COVID-19. Internationally, economic globalization is facing headwinds in recent years, and this epidemic may intensify the trend of globalization, with tourism becoming more concentrated at home. Domestically, the epidemic is developing in a positive direction, but the risk of clustering and the mobile spread of the epidemic caused by the movement of people still exists. The shadow of the epidemic slows down the pace of tourism, and in the short term, near-field trips and self-driving trips will be favored by tourists. COVID-19 awakes people's awareness of life and health in the long run. The attention to low-density tourism, eco-tourism, rural tourism, and other products will significantly increase, becoming a new direction of tourism development in the post-epidemic era.

3.3. The impact of COVID-19 on governance

The COVID-19 pandemic is the most catastrophic in human history: the virus spread worldwide at the fastest pace, spreading to more than 200 countries and territories in months. It is caused severe harm to human health and everyday life, spread widely, and directly deprived the lives of countless people. Its impact on the development of the global epidemic control economy is so significant that it can be called an actual test for humanity. Government control of COVID-19 in each country is undoubtedly a considerable task.

COVID-19 dramatically promotes the popularity of ESG's investment philosophy. The epidemic make us aware of the vulnerability of the global political and economic system. For example, the shortage of supply chain caused by city lockdown has not been adequately solved yet. Ensuring the stability of the supply chain and other production and operation activities in extreme conditions is a factor that both enterprises and investors need to consider. From this perspective, sustainable development is a variable that needs to be analyzed in the objective function of investment in the future. Combined with the concept of ESG, it can appropriately promote the economic modules and business models with sustainable growth capacity in the future, thus providing feasible direction choices for investment.

4. THE BENEFITS AND RISKS OF ESG'S INVESTMENTS DURING THE PANDEMIC

4.1. Overview of market investment environment during the epidemic

The trade barriers formed by the epidemic affect China's import and export trade and the overall liquidity of the foreign exchange. The periodic stagnation of production and business activities leads to the depression of the industry, which brings the risk of capital depreciation. In addition, the change in investors' risk preference and market expectations affects the flow of funds and greatly aggravates the market's volatility. Influenced by the market's negative sentiment caused by the epidemic, the stock market may fall, and the market value may evaporate, endangering the market's stability. The spread of the epidemic has accelerated the risk exposure and slowed down the economic activities of various industries, which has a direct impact on the supply and demand environment of the macroeconomic market. Therefore, the capital liquidity problems of enterprises increase and the repaying ability of liabilities decline, which increase the risk of default.

4.2. The impact of ESG investment on stock valuation, risk, and return

In recent years, many researchers have analyzed the relationship between the ESG investment profile and the company's financial risk and performance. Most studies have found a positive correlation between ESG investment and the company's stock valuation and financial performance. Conclusions have been explained that companies with high ESG scores usually have better corporate governance models and are better at managing the risks and benefits of investment, resulting in higher valuations.

4.2.1. Cash flow transmission mechanism

Companies with higher ESG ratings are more competitive. These companies can make more effective use of raw materials, labor, and other resources to innovate management models. For example, they are better at long-term programs within the company and incentives for executives and employees. At the same time, they pay attention to social development and make more remarkable contributions to society, making them more competitive. They take advantage of their competitive advantage to generate higher profits and dividends.

The research on the ESG score of CSI shows that the group with a high ESG score has a high ROA and dividend level in the next year [20]. It shows that the companies with high ESG scores have more sustainable profitability and more vital dividend willingness, which reveals the profit improvement mechanism of ESG investment.

4.2.2. Risk transmission mechanism

Companies with higher ESG ratings generally have a higher risk control ability in corporate management, usually lower downside risk. The result is that they have less impact on some regulatory penalties, litigation, and controversial cases. The reduction of risk events such as this negative news reduces the impact on the company's stock price.

The research shows that companies with high ESG scores involve significantly fewer lawsuits and have a lower beta value, which shows that the risk level is low relative to the market [21].

4.2.3. Valuation transmission mechanism

Companies with higher ESG ratings are not vulnerable to systemic risks and will have better valuation improvement in the future. The research on total profit and risk mechanism shows that companies with high ESG scores improve PE more in the next year, which indicates that ESG, as a factor, has an impact on listed companies through profit and risk mechanism [22]. Companies with excellent ESG performance have lower risk and higher market valuation in the future.

4.3. Development trend of ESG investment in China

The construction of market mechanisms relate to ESG investment in China still needs to be improved. Most of the evaluations focus on some aspect of ESG, and the evaluation objects mainly focus on listed companies with good information disclosure. ESG investment faces many opportunities and challenges in the Chinese market.

4.3.1. Opportunity

China's economy is in the stage of transformation and upgrading, and industries with low-carbon and sustainable development characteristics such as science and technology and clean energy are developing rapidly. Comprehensively consider the medium and long-term goals of global climate change and domestic green “carbon neutrality.” ESG theme investment, especially environmental protection, may become the mainstream.

Green finance and inclusive finance policies have been issued one after another, advocating investors to practice ESG investment, which has improved an excellent development environment for ESG investment. The tightening of relevant information disclosure policies provides a reasonable basis for ESG investment. China's financial market is more open to the outside world, attracting international investors to bring advanced ESG investment practical experience and accelerating the popularization of ESG investment philosophy. In addition, the issuance of green bonds has increased, providing diversified investment products for ESG investment.

4.3.2. Challenge

Compared with global ESG investment, China's ESG investment scale is small, the number of investors is small, and the ESG investment products available for the market are limited. Additionally, the construction of market mechanisms related to ESG investment is weak, including ESG rating standards, ESG risk, investment benefit evaluation, etc., Regarding regulatory policies, it is mainly the government's single direction regulation of ESG, and the framework of integrating ESG information disclosure is not perfect. Most listed companies in China do not pay attention to the disclosure quality of ESG and do not integrate the concept of ESG into corporate governance.

5. CONCLUSION

This paper studies the investment philosophy of ESG in the environment of COVID-19. It is mainly divided into three parts. It introduces the critical role of ESG investment, the changes in ESG investment under the COVID-19 from three aspects: environment, society, and corporate governance, and the analysis of the risks and benefits of ESG investment.

It is concluded people pay more attention to the development of society and the innovation and transformation of the corporate governance model. Investors are increasingly concerned about the scores of start-ups in ESG policies and practices. Mature ESG proposals can help companies develop new markets and expand existing markets. A strong ESG proposal brings a more significant return on investment to the company. In addition, through investigation and research, it is found that companies with high ESG scores usually have a better corporate governance model and are better at managing investment risks and returns, so they have a higher valuation. Finally, companies face many opportunities and challenges facing China's economic and policy environment. The market mechanism construction related to ESG investment still needs to be continuously improved. It is crucial to improve the information disclosure system and strengthen the publicity of ESG investment.

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