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COVID19 Silver Linings Playbook: Resilience

IVKA KALUS
Chief Investment Officer
and Portfolio Manager
Promethos Capital, LLC

EMMY SOBIESKI
Contributor
Promethos Capital, LLC

> A resilient business strategy must consider how to deliver returns by both enhancing social justice and adapting to climate change, while managing at the intersection of the two.

Resilience as an investment factor describes companies with the capacity to adapt in the face of new circumstances and adversity. Resilient companies:

- **have survival tactics at the ready to thrive another day.**
- **have the flexibility to try new ideas and strategies, immediately if necessary.**
- **examine past mistakes, learning and course correcting.**
- **have diversity of background, expertise and perspective contributing to strategy and execution.**
- **build optionality up and down the value chain and providing agency to all stakeholders.**
- **focus on skating to where the puck is going.**

Resilience is the opposite of living on the edge and operating at the margin.

One of the silver linings of working from home (assuming one is fortunate enough to be able to do so) is having several extra hours each day for quiet reflection and deep thought. During this time, we have learned so much from the thought leadership of others, and we hope to continue to learn and benefit from the growing body of COVID expertise. At some point in the future, we may better understand what the crisis has meant to us as investors and human beings. At Promethos, while we continue to monitor COVID, our increasing focus has been exploring the *resilience* required for the "next normal" world that has been laid bare in front of us.

This is the final installment in our COVID-19 Silver Linings Playbook series. We have written about the implications of the *Synchronicity* of the crisis, the *Forbearance* required in assessing options for moving forward, and about social justice and how it is critical to investing during COVID (in *Social Justice Investing as Antidote to the Growing COVID Chasm,* and *Social Unrest as Investment Catalyst for Change)*. This final *Silver Linings* piece ties together our recent work under the topic *Resilience*.

A crisis is something unexpected and unplanned. The COVID crisis hit us like a Tsunami. We saw the huge wave on the horizon. As it drew closer and then crashed down on us, it exposed massive cracks and gaps in the social, economic and policy frameworks that define our daily lives. As poorly managed as the crisis response

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has been, it has brought forward the day of reckoning. We must address these cracks and gaps and our lack of resilience! COVID has forced us to look backward at our failings and look forward to what we must get right.

In hindsight, social justice is our greatest failing. *"We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness."* The Black Lives Matter movement has shown us how false these noble words from 1776 ring in our inequitable application. We know from research by Economist Lisa Cook how much social inequity has cost everyone, including investors, in lost opportunity, innovation and growth.[1] She estimates about 2.7% foregone GDP per capita each year due to innovation lost from racial and gender disparities. Likewise, Raphael Bostic, Former Atlanta Fed Chairman, has written that systemic racism is a "yoke that drags down the American economy."[2]

Looking forward, we see climate change and social inequity as inextricably linked.[3] Racial and indigenous minorities have always carried a greater environmental burden, as demonstrated by "Asthma Alleys" and "Cancer Corridors." And now they face a much greater burden from climate-related breakdown of infrastructure in disadvantaged communities, as laid bare by the disproportionate devastation of minority communities by hurricanes Katrina and Maria. As the world becomes increasingly dangerous and unpredictable, we require disruptive, paradigm shifting strategies. Surviving the COVID crisis intact in order to thrive in the future requires all hands on deck. Businesses must tap the innovation and contribution from ALL of the diverse talent and perspectives available. A resilient business strategy must consider how to deliver returns by **both** enhancing social justice and adapting to climate change, while managing at the intersection of the two.

The term "Resilience" has become a cliché over the past three months. That is why we define what it means for us as an investment factor right up front. However, translating our long-form definition of *Resilience* into investment decision-making still requires a thoughtful analysis of individual securities, as well as a system-wide, macro-scale assessment of the environment for which resilience is required.

THE OCTOPUS AS A MODEL FOR RESILIENCE

The octopus is the ultimate resilient survival machine[4] because it constantly learns and modifies its behavior using diverse inputs and has multiple adaptation strategies at the ready to deal with predators, prey, and environmental change. Its "distributed brain" includes a central processing unit, with separate learning centers in each of its tentacles that perform decentralized analysis, problem-solving, and decision-making. The octopus can shape shift through, into, or around objects and prey it encounters, and can "disappear" with a cloud of ink or instant camouflage when in danger or in service of confusing potential prey. It can also drop a wriggling tentacle and regrow it later in the service of adapting to the situation at hand.

Resilient businesses would do well to emulate the octopus:

- Understand their constantly changing environment, and develop mechanisms to handle a range of challenges and opportunities.
- Employ centralized and decentralized decision-making, constantly learning and innovating at every level and location, with every employee empowered to contribute.
- Use scenario planning, including worst case scenarios, to have diverse adaptive strategies at the ready.
- Cooperate with diverse parties up and down the stakeholder chain, including employees, suppliers, communities, customers, and society at large.

- Embrace and promote diversity of background, life experience, thought, expertise and ability at every level.
- Assess physical and transition risk of assets and business model to climate change. Be ready to drop a "tentacle" business or strategy that is no longer viable. Be open to regrow a new one.

For investors, looking for octopus-like resilience is a time and judgement-intensive endeavor that involves analyzing a business strategy in detail and understanding how the people that comprise an organization function and learn as a whole. To narrow down the opportunity set of business models more likely to be resilient, we rely on widely reported, measurable proxy data that stand in for better resilience practices. The GRI, or Global Reporting Initiative, has been working on Sustainability reporting standards since 1997, allowing investors to benefit from the constant improvement and ubiquity of ESG/Resilience data.[5] Investors can identify opportunities with higher expected resilience based on reported data such as gender diversity, quantity of sustainability reporting, CO2 emissions reduction, and employee labor relations. Natural language AI data scraping tools also provide valuable insight into contemporaneous controversies and issues that we can then use to focus our detailed analysis as we look for resilience.

ASSESSING THE COVID NEXT NORMAL TO INVEST WITH A RESILIENCE FRAMEWORK

Resilience is the ability to adapt on the fly. A business needs to know *what it is adapting to*, requiring an assessment of what the world will look like during the "Next Normal" post-COVID. We can't go back. Here are a few COVID-related trends likely to persist into the Next Normal that companies must adapt to if they are to survive and thrive:

Politics

Decreased sense of stability and leadership from government, with states and city-states like NYC and LA taking on a bigger role, due to mistrust of federal government interests. The power play between mayors, governors and presidents exacerbates political chaos.

Populism and power grabs will continue to gain favor as each crisis shows governments favoring the elite, further angering populists. Governments globally are using this crisis as a cover to further their power and control agendas, reversing trends towards democracy.

Consumer psychology

Rise of the unbranded, decline in consumer debt and spending. The consumer was bifurcating prior to COVID with Millennials and Gen Z moving towards unbranded products, linked to minimizing spending, gig economy jobs, and valuing purpose over pay. We may be seeing a down-shift in spending psychology to something much closer to exiting the Great Depression: less leverage, less frivolous spending, and less ownership in the stock market. COVID is showing that younger generations may not "evolve" as expected to be more like Boomers.

Conscious consumption: Since the beginning of the COVID crisis, there has been a dramatic increase in values-aligned spending, from boycotting a local establishment that mocks the Black Lives Matter movement, to purchasing fair trade and organic products.[6] Using the power of the purse to signal values and influence corporate behavior seems to be a significant and lasting trend.

Economy

No V Shaped recovery. We are seeing economic activity slow down **again** in areas where the virus infection rate rises. The sustained wave nature of COVID means a prolonged adjustment to living with many new restrictions that tend to suppress discretionary spending. While we saw many unintended consequences of shutting down, we will likely see more as we restart, as small businesses and parts of supply chains may have gone bankrupt.

Stagflation setup? Record deficits, corporate debt already at all-time highs pre-crisis, record student debt with job losses inhibiting ability to service, and now all corporations just drew down their credit lines to hoard cash they may well need. Debt issuance combined with record fiscal and monetary stimulus is a setup for stagflation akin to the 1970s as we "restart" the economy.

Dry powder gone? Central banks globally are close to being out of ammunition. What happens if/when we have another shock? The feeling that we may not be able to handle future shocks makes consumers, companies and governments more cautious, conservative and anxious going forward, reinforcing the sluggishness of the recovery.

Business

OPEX and cash focus. Businesses will be looking to invest OPEX vs CAPEX even more than prior to COVID. Cash conservation will remain a number one priority until there is more visibility towards effective treatment and immunity.

Margin pressure. COVID brings higher worker safety costs and business continuity costs. Most insurance premiums, from healthcare to business continuity and cyber, are set to increase meaningfully as insurance companies globally redesign their actuarial models.

Supply chain security hits profits. COVID has refocused businesses and investors on supply chain vulnerabilities and the dangers of wholesale outsourcing. If the US and other countries do indeed try to bring manufacturing home in its present state, we would reverse years of improving margins and wage growth by re-importing lower margin and lower wage work.

Technology

Remote: no going back. Increased disaster planning naturally moves companies towards more remote work, and they have quickly discovered that communal offices are not as necessary as previously thought. This will require a re-architecting of the internet infrastructure with a focus on the last mile, equipment that brings faster more redundant data speeds to neighborhoods, and drive adoption of 5G technologies for resilience.

Advantage SaaS? Given companies preference for cash preservation and OPEX spend, SaaS companies should be well positioned. However, companies have already spent on must-have technologies for the immediate work-from-home shift. What comes next? Investors will be wary of spending for growth when these companies' customers are retrenching. Technology companies that deliver profits, cash flow and collections will be favored.

Robotics can ease the costs of transition of factories coming back "home."

Biotech/Healthcare

Drug development in high gear. The healthcare system from pharmas to biotechs to regulators like the FDA just found a new gear and will stay in it at least for the next 18 months. This can drive a new normal of innovation, right at the time when CRISPR techniques and RNA modeling are coming to the point of commercialization.

BioTECH. Biotech is increasingly being run by software and breakthroughs driven by AI. This crisis has leapfrogged us into the next generation of biotech, which will have changed and matured into a new industry that embraces more of the "tech" in Biotech. However, near term biotech cash runways can become an issue in weaker markets.

COVID cost allocations hasten single payor? The "elective" nature of most of the healthcare sector that has been sidelined by COVID has resulted in tremendous losses for hospitals and specialized practices, but also significant cuts in overall healthcare spending. This has been a boon for health insurers but not for most product and services providers and likely not for patients. COVID reveals how much is spent on general versus specialized care and may force a policy rethink, perhaps hastening a capitated, single payor system.

Infrastructure

Decarbonization. COVID is a catalyst to begin reinventing cities and the physical backbone of the global economy. Many governments are looking at using post-COVID stimulus to fast forward de-carbonization projects. See our colleague Jonathan Kabeya's excellent piece *Infrastructure Investment and ESG Analysis: a Natural Fit.*

Climate-related physical risk. Infrastructure is being damaged by sea level rise, heavy downpours, fire, and extreme heat and the potential for damage will increase with continued climate change. A disruption in any one system affects others, such as a failure of the electrical grid affecting water treatment and public health. New infrastructure design has to incorporate these risks.

Social Justice. Our time of social unrest is a call for more equitable infrastructure planning that moves more people out of poverty and into the middle class where they become the engine of the economy.

Investing

Conscious Capitalism and Intentional Investing. As with conscious consumption, investors are seeking to use their capital as intentionally as they consume, using the power of the purse to influence corporate behavior.

Not without a fight. The monoculture, conservative philosophy and capital control methods of the asset management industry are resistant to any change of the status-quo. The industry has much to lose from involving intentional capital providers in the investment process, and will resist the values-aligned investing trend, despite paying lip service to "ESG." Even the DOL has come out with guidance limiting "ESG" inputs into retirement plans if that detracts from performance, the implication being that it does.

RESILIENCE INVESTING REQUIRES MOVING AWAY FROM THE MARGIN

In our *Synchronicity* piece, we noted that investors tend to live in the moment and allocate capital to business models that bring them returns TODAY. They tend to reward companies who live and profit on the margin and return any "fat" to shareholders. However, that same "fat" is a source of resilience in a crisis, since it provides the fuel for survival. Likewise, corporate policies that focus on stakeholders like employees, communities, and suppliers are often punished by investors because they buy long-term resilience with short term costs. However, investors who honestly claim to incorporate risk into their investment decisions should allocate capital to companies who plan for the future by valuing the externality risks they face and create, as these are the businesses most likely to survive future crises. This means valuing and managing with climate change and social justice risks in mind. But as markets have come roaring back from their March lows in a liquidity rally, investors have embraced the usual marginal metrics. Or have they?

One significant driver of differential investment performance during COVID has been a dramatic increase of capital flows into ESG indices and funds composed of securities which have a more proactive approach to stakeholder value and resilience. These flows demonstrate that capital providers are focusing on the future beyond short term central bank liquidity considerations. They are using their capital to drive change. **Capital is voting for Resilience.**

1. Cook estimates about 2.7% loss in GDP per capita each year due to innovation lost from racial and gender disparities. https://equitablegrowth.org/the-implications-of-u-s-gender-and-racial-disparities-in-income-and-wealth-inequality-at-each-stage-of-the-innovation-process/
2. "By limiting economic and educational opportunities for a large number of Americans, institutionalized racism constrains this country's economic potential. The economic contributions of these Americans, in the form of work product and innovation, will be less than they otherwise could have been. Systemic racism is a yoke that drags on the American economy." https://www.frbatlanta.org/about/feature/2020/06/12/bostic-a-moral-and-economic-imperative-to-end-racism
3. https://www.huffpost.com/entry/solve-racial-injustice-climate-crisis_n_5eea2d48c5b63c66bcffe189
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5. https://www.globalreporting.org/Pages/default.aspx
6. https://www.bloomberg.com/news/articles/2020-06-25/events-of-2020-are-reshaping-the-american-consumer

Promethos Capital, 75 Virginia Road White Plains, NY 10603

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