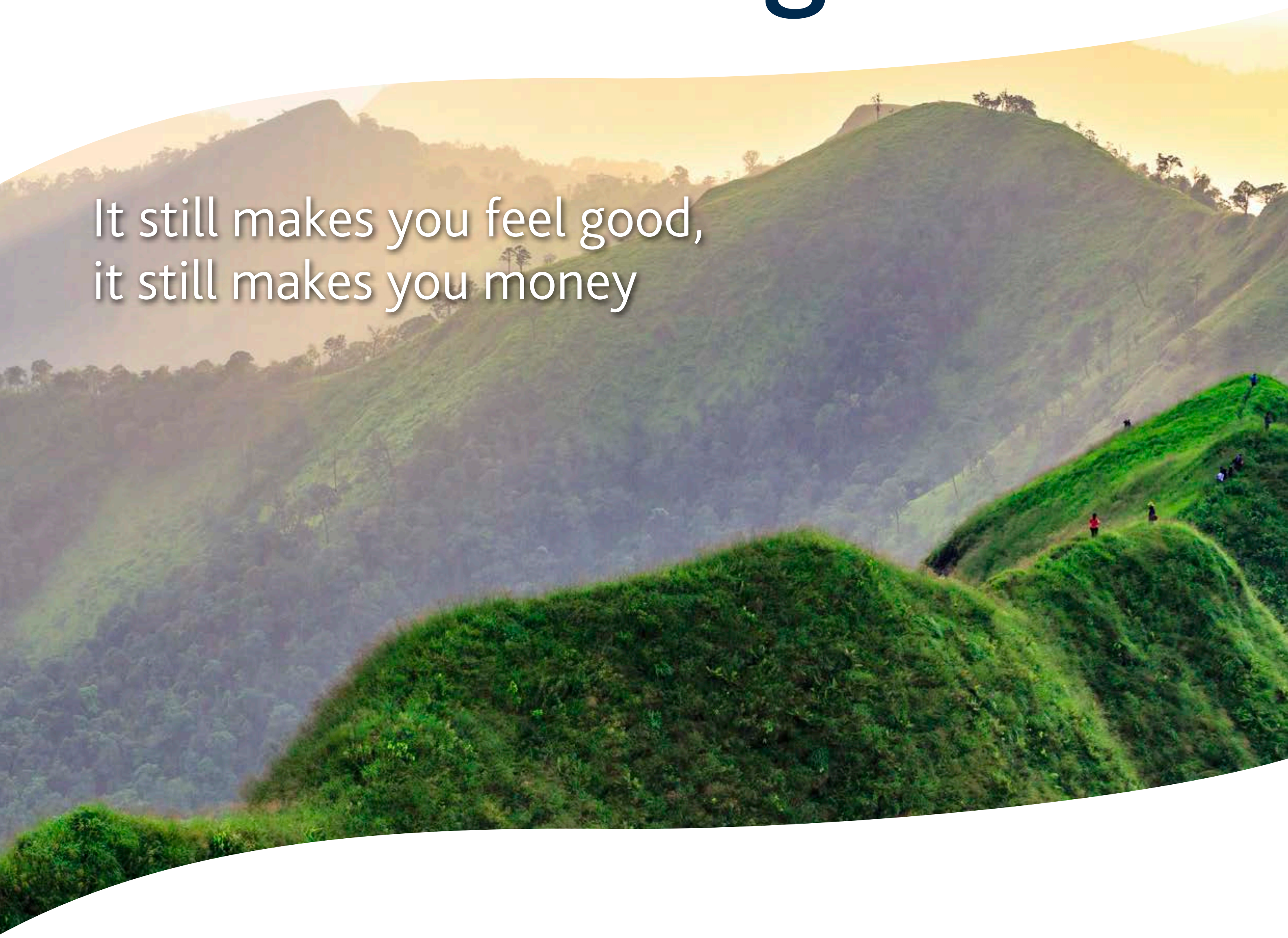
Excellence. Responsibility. Innovation.

Investment commentary, Q3 2016

Hermes Global Equities

# ESG investing



## It still makes you feel good, it still makes you money

### Key points

- Companies with strong corporate governance have been shown to outperform those with poor governance practices
- We believe that engagement is more effective than divestment for both society and investors
- The quality of governance affects financial performance in every developed region
- We incorporate ESG considerations into all of our strategies, not just those labelled ESG

# As proven in our 2014 report, environmental, social and corporate governance (ESG) investing provides more than a feel-good factor: it can also be good for portfolio performance.

But if the question we posed in 'ESG Investing: Does it just make you feel good, or is it actually good for your portfolio?' was a niche concern at the time, in the space of two years the subject has moved to centre stage. Today, both retail and institutional investors across the globe are broadening their understanding of fiduciary duty to include responsible investing. And rather than viewing their ESG efforts as a charitable enterprise, investors can now see – backed up by a growing body of research – that a principled approach to investing can enhance portfolio performance.

While there is no penalty for pursuing sustainable, responsible business practices, our research suggests that exposure to stocks with high ESG risk does detract from performance. Our 2014 report unearthed a strong correlation between corporate responsibility and shareholder returns, finding that companies with poor governance practices consistently underperformed their peers by up to 30bps each month.

This 'governance premium' is now entrenched: companies with strong corporate oversight have tended to outperform their poorly governed competitors by an average of over 30bps per month since the beginning of 2009. Furthermore, our latest study shows that the premium holds true across different geographies and sectors – albeit with a few caveats – proving the widespread power of effective corporate governance.

ESG has become an inseparable component of best-practice investment management, as opposed to a feel-good optional extra, for all investment strategies.

As well as theoretical insights, however, investors need practical tools to help them integrate ESG considerations into company valuations and investment portfolios. We will detail the ESG ratings methodology that we have developed in-house – which has been enhanced since our earlier study due to the growing availability of new data sources. While measuring ESG factors remains very much a work in progress, these new metrics provide an additional power of magnification. Indeed, the process has become so effective that ESG is now a fundamental input to our stock-selection process, with particular emphasis on the materiality of ESG considerations and the factors that impact financial performance.

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## 2016: responsible investing comes of age

ESG concerns have become mainstream. From Mark Carney, Governor of the Bank of England, highlighting the risk that climate change poses to financial stability, through to the adoption of ESG market indices, it seems that the investment world has accepted that factors beyond traditional financial metrics can be material. For pension funds, the definition of fiduciary duty is evolving to include reputational risk, negative externalities and beneficiaries' concerns about the conduct of corporations and their impact on society and the environment, such as the long-term damage done to society by polluting companies seeking short-term private gains. Yet, while investors now agree that these issues matter, there is no consensus about how to assess ESG risks, or what to do with the information.

Some investors argue that ESG considerations should be treated separately from financial rewards. These hard-core practitioners typically seek to invest capital where they believe it will have the most positive impact on the world. Others invest only in companies with the best ESG profile they can find: either on an absolute basis, favouring green energy, clean technology companies and the like; or on a relative basis, investing in the top-rated firm within each peer group. Alternatively, some investors simply divest from any company with exposure to industries or business practices that present ESG or sustainability challenges. This approach has grown in popularity, with many prominent investors electing to divest from companies with exposure to tobacco or fossil fuels, for example.

## Our approach to responsible investing

At Hermes, we prefer to engage with companies rather than divest. In our view, successful engagements reduce risks to shareholders, unlock value, and benefit wider society. We believe investors should be involved shareholders, encouraging responsible behaviour and effecting positive change. Alongside communicating with senior management and board members, we undertake filing or co-filing shareholder proposals, where appropriate, and voting proxies in accordance with investors' views and policies, supporting transparent and effective governance structures that encourage stakeholder dialogue.

We believe that working with firms to mitigate ESG risks – while reserving the option to sell down where a company is unable or unwilling to improve – can provide the greatest holistic benefits. As such, we seek investments with good or improving ESG characteristics, which should contribute to outperformance over the long term. While ESG issues are important in themselves, we recognise that helping a company to lift its ESG performance can both benefit society and realise financial gains for investors.

In 2013 we developed a scoring system to identify companies that fall into our ESG sweet spot. Our aim was to build an objective measure of corporate ESG performance, assessing where the company is today and anticipating where it will be tomorrow. Our corporate governance and engagement team, Hermes EOS, provided substantial input. It identified the key performance indicators for each sector, drawing on information from internal sources, maintained as part of our voting and engagement records, and from carefully selected, reputable external providers.

The result is our ESG Scoring Methodology, an objective process that uses market-leading data to identify companies with the best or most improving ESG risk profiles.

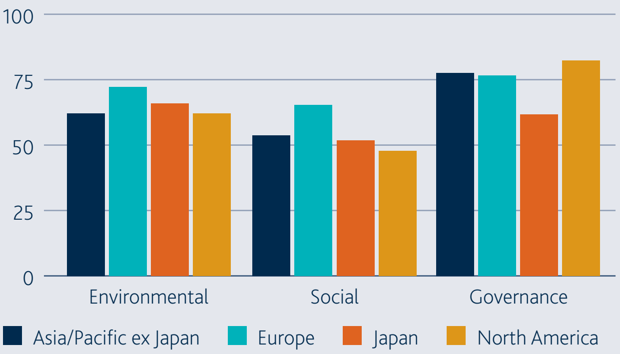
## ESG across the globe

We assess companies relative to their industry peers: miners with miners, banks with banks, retailers with retailers, and so on. Clearly, there are universal ESG standards that would apply to any company regardless of the market in which they operate, such as reducing pollution and honouring workers' rights. Nonetheless, the vast differences between industries demand that we focus on sector-specific nuances of ESG risk. In most cases, it does not make sense to compare across sectors: the QESG Score (one of our bespoke metrics for the overall ESG risk of a stock) of a mining company, for example, is virtually meaningless when measured against the QESG Score for a bank.

The vast differences between industries demand that we focus on sector-specific nuances of ESG risk.

However, it is valid to group companies within broad geographic areas to make regional comparisons. Figure 1 shows the average ESG score for companies in each of the four major developed regions as at 30th June 2016.

**Figure 1.** Average ESG scores by region, June 2016




Source: Hermes Investment Management as at 30 June 2016.

As shown, Japan is the major corporate governance outlier, scoring significantly lower than all other regions. This is not surprising given the country's historic business culture, which places little importance on independent representation at board level, has almost no focus on diversity and a general lack of transparency for shareholders. But the Code of Corporate Governance for Japan, enacted in 2015, is beginning to change this, although how quickly this will be evidenced is unclear. We are hopeful that the ESG scores within Japan will soon begin to increase.

North American companies score well on corporate governance but their environmental and social performance lags. It would appear that while many companies are meeting their governance responsibilities, this is not necessarily extending to other areas of risk.

## Why 'E' and 'S' are good, but 'G' is better

Armed with our objective method of assessing ESG, we have created historic scores for companies, enabling us to test whether those with the highest scores or most-improving ESG characteristics have tended to outperform.

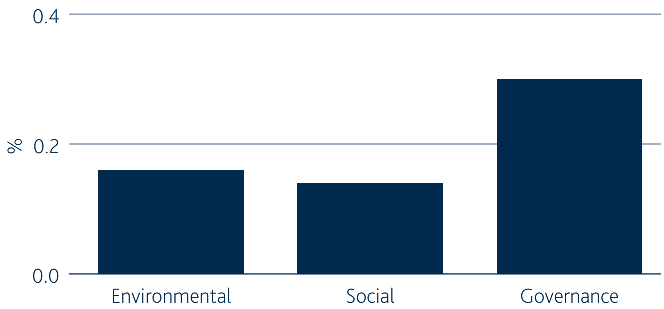
We found that companies with favourable environmental or social characteristics have on average outperformed companies with negative characteristics in these areas – however, the degree of statistical significance is low. As with our previous research, it is still too early to conclude that companies with attractive environmental and social characteristics outperform.

More positively, we have found no evidence that companies with attractive environmental and social characteristics have tended to underperform. Our data suggests that investors are able to integrate environmental and social considerations into their stock selection without systematically lowering their returns. Hence it still has merit in lowering risk (and doing good).

The impact of governance, however, is unequivocal and reaffirms the key insight from our previous paper: companies with good or improving corporate governance have tended to outperform companies with poor or worsening governance by 30bps per month on average since the beginning of 2009.

**Figure 2.** ESG value is driven by corporate governance

Average monthly dispersion in total returns between companies in top-decile and lowest-decile on environmental, social and governance scores from 31st December 2008 to 30th June 2016.

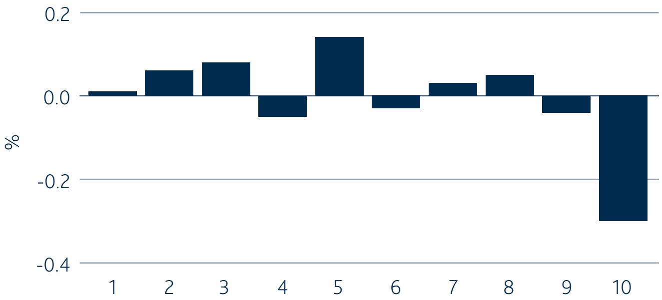



Source: Hermes Investment Management as at 30 June 2016.

As before, this is largely driven by the companies with the lowest-ranked governance scores tending to underperform the average, as opposed to the higher-scoring companies outperforming. This suggests that poor governance detracts from performance rather than good governance boosting it.

**Figure 3.** The most poorly governed companies underperform the average company

Average monthly relative performance of companies, split by decile, on governance scores from 31st December 2008 to 30th June 2016.




Source: Hermes Investment Management as at 30 June 2016.

These results are also incredibly consistent. The average return of companies with poor governance is below that of the wider universe in almost 70% of months, indicating that governance matters regardless of the economic environment.

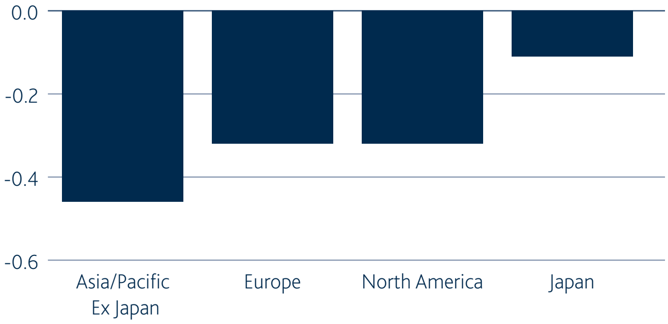
## The periods when poorly-governed companies tend to outperform often correspond to market swings in which cheap companies also outperform

The periods when poorly-governed companies tend to outperform often correspond to market swings in which cheap companies also outperform – for example, the 'junk rallies' of October 2015 or March 2016. In this type of environment, investors focus purely on the relative valuation of companies and ignore fundamentals such as quality or governance.

Contrary to our earlier study, however, the governance indicator is now shown to be just as effective in North America as in the rest of the world.

**Figure 5:** Relative returns of the most poorly-governed companies by region

The average monthly return of stocks in the lowest governance decile relative to the return of the average company in the MSCI World, from 31st December 2008 to 30th June 2016.



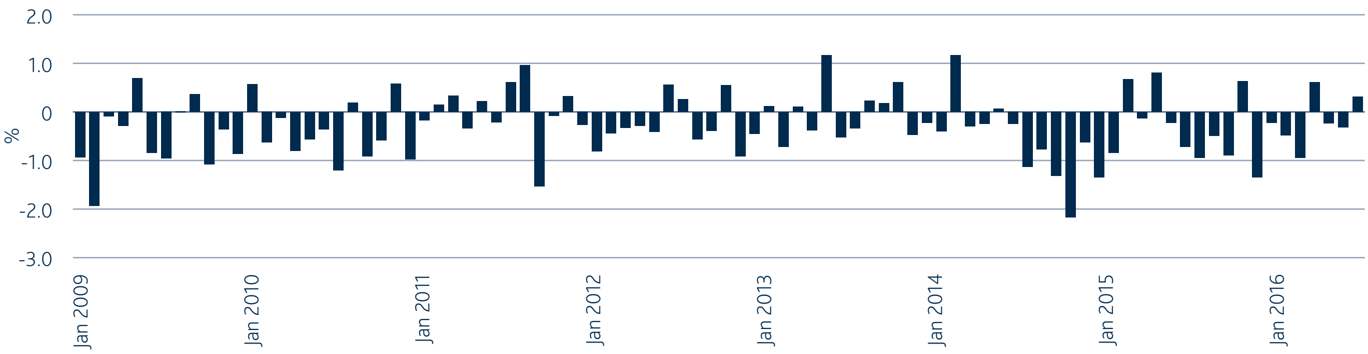

Source: Hermes Investment Management as at 30 June 2016.

We can safely conclude that governance is useful in identifying underperforming companies in almost all developed regions. This 'governance premium' also shows up in our sector analysis, although at first glance the effect does not seem to be universal. For instance, figure 6 reveals an apparently negative relationship between governance scores and shareholder returns for IT firms.

The IT sector can be dominated by start-up companies which rapidly grow from micro- to mega-cap businesses, often driven by a strong dominant founder. From a governance perspective, these companies can look weak – dictatorships are not the ideal corporate governance structure – but the returns achieved can be exceptional. Once these companies mature they tend to implement better standards of governance.

**Figure 4.** Poorly-governed companies have tended to underperform

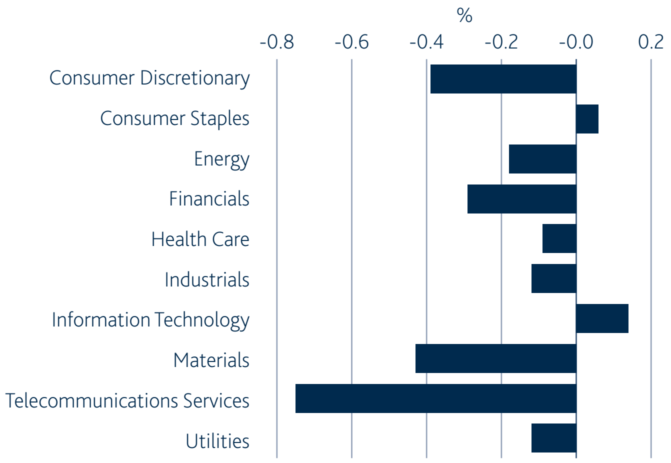
The monthly average return of stocks in the lowest governance decile relative to the return of the average company in the MSCI World, from 31st December 2008 to 30th June 2016.




Source: Hermes Investment Management as at 30 June 2016.

**Figure 6:** Relative returns of the most poorly governed companies by sector

The monthly average return of stocks in the lowest governance decile relative to the return of the average company in the MSCI World, from 31st December 2008 to 30th June 2016.




Source: Hermes Investment Management as at 30 June 2016.

## The rewards of responsibility

Our study shows that ESG considerations are crucial for all equity investments, whether made in the context of a specific mandate or in a more general strategy. Furthermore, our research shows that investors do not need to sacrifice returns in order to invest in accordance with ESG principles. In fact, investing responsibly enhances excess returns.

The study, which analysed correlations between companies with high ESG scores and shareholder returns since 2009, reinforced our earlier findings of a strong link between underperforming firms and poor corporate governance.

However, our research did not prove that a statistically significant relationship between outperformance and environmental or social metrics exists. As more data becomes available, and more asset owners focus on environmental or social considerations, the E and S exposures of companies may exhibit a positive correlation with performance. Nevertheless, ESG investors should not be discouraged by the finding: our research also confirmed that favouring companies who are better managing their environmental and social risks (relative to their peers) does not tend to lead to underperformance.

For now, we can conclude that favouring well-governed companies can enhance the return of equity strategies – and integrating environmental and social metrics into investment decisions will not harm portfolios either. That's a feel-good result for do-good investors everywhere.

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# Appendix

## ESG scoring methodology

We have built a bespoke quantitative scoring methodology, which considers environmental, social and governance matters, evaluating each company's current ESG characteristics and identifying positive change. The score combines data from Hermes EOS, CDP, Sustainalytics, Trucost, FactSet and Bloomberg.

The assessment methodology was applied to the constituents of the MSCI World index. There was sufficient data coverage for this index since 31 December 2007, allowing for scores to be created since 31 December 2008 (to allow for one year of data to measure changes in ESG practice). The test was conducted using monthly rebalancing, to match the greatest frequency at which the data set is updated.

Companies are assessed relative to their sector and geographic peers to remove any biases in the results.

Since our 2014 paper, we have improved the methodology used to create the scores. These changes have been driven by the availability of new data sources, allowing us to increase our focus on forward-looking metrics particularly regarding environmental and social risks. These new metrics assist in identifying which companies are setting robust programmes to reduce emissions, are better managing their supply chain risks and have a favourable outlook regarding any historic controversies impacting their business.

**Key ESG risk factors that we used in the research included:**

**Environmental Factors**

| | |
|---|---|
| Carbon footprint | Exposure to litigation |
| Water usage | Impact ratio |
| Waste management | UN Global Compact watchlist |
| Pollution | Greenhouse gas targets |

**Social factors**

| | |
|---|---|
| Human rights | Fatalities |
| Controversial products | Health and safety management system |
| Employee turnover | Supply chain monitoring |
| UN Global Compact signatory | |

**Governance factors**

| | |
|---|---|
| Board independence | Combined CEO/Chair role |
| Poison pills | Risk management |
| Remuneration | Business ethics |
| Independent directors | Proxy voting |

## Integrating ESG at Hermes

The easiest and most common (as measured by total assets under management) method of integrating ESG considerations into an investment process is by negative screening, or an exclusions-based strategy. The next most common, especially in the UK, is by engagement. Best-in-class strategies, where managers seek out stocks with positive ESG characteristics, are gaining interest.

At Hermes, we benefit from our large corporate engagement and stewardship services team, Hermes EOS, which advises on proxy votes and engages companies about ESG risks that concern shareholders.

With their help, we have developed a number of tools for assessing ESG risk within companies and then monitoring a portfolio's ongoing exposure to them: the **ESG Dashboard**, a risk tool that collates the most important ESG measures for each company; the **QESG Score,** a proprietary rating measuring current and trend ESG risk; and the **Portfolio ESG Monitor,** which shows ESG risk across a portfolio.

- The **ESG Dashboard** amalgamates Hermes EOS' records on voting and engagement on ESG issues with data from a range of carefully-evaluated external providers. It gives transparent access to key ESG-related information on every company across a global universe. The risk factors which each company is measured by are either generic, such as board structure, or sector specific, focusing on the major risks in their respective industries, such as carbon dioxide emissions and fleet consumption for the automobiles industry, paper sourcing for media and energy efficiency for airlines.
- The **QESG Score** is a ranking applied to each company, distilling the information collated on the ESG Dashboard into a single number. Not only does this score capture how well a company manages ESG risks, but also the trend in its exposure to these risks. The score gives a greater weight to governance factors, which, as shown in this paper, are currently more material to stock returns over the long-term than environmental and social considerations.
- The **Portfolio ESG Monitor** delivers a portfolio perspective of ESG risk exposures. It reports on the ESG characteristics of holdings, both in absolute and benchmark-relative terms, and highlights companies with potentially controversial practices. The monitor captures thematic ESG risks as well as identifying the best and the worst companies according to various ESG metrics.

The tools can be used to analyse ESG risks in any equity strategy. We use them to integrate ESG considerations into all our strategies. The QESG Score plays an important role in identifying stocks with positive or improving ESG characteristics for inclusion in our ESG-focused strategies.

Encouraged by the results discussed in this paper, we now integrate governance metrics into our analysis of company quality for all strategies, whether labelled ESG or not. These metrics, included in our assessment of corporate behaviour within our stock-selection model, are combined with measures of valuation, sentiment and growth to produce diversified portfolios that are designed to outperform in any market environment.

In general, we do not see ESG as a separate category of equity investing and we believe that all equity investments should be made with an understanding of all the risks/opportunities, including ESG considerations. The Hermes Global Equity team integrates responsibility and ESG into all of our products and across all parts of our investment process, including idea generation and portfolio construction. We believe, and our research has demonstrated, that investors do not need to sacrifice returns to invest responsibly; investing responsibly actually enhances excess returns.

The team is a fervent believer that it is important to assess not only a company's current ESG characteristics but also how these are changing over time. Clearly, if a company's ESG profile is improving it makes the investment more attractive and vice-versa. The team does this using our proprietary QESG score and through regular dialogue with our engagement specialists in Hermes EOS. This offers valuable insights and gives a more accurate reflection of the true ESG profile of a company relative to its peers.

This approach has proved to be vital from a risk management perspective. Companies may look good from an ESG standpoint at first glance, but if standards are declining or a company has experienced a number of small controversies the likelihood of a more significant issue may have increased which could lead to a fall in its share price. The team can also gain comfort when the ESG score is improving that a company is addressing areas of concern, which reduces risk and presents a more compelling investment opportunity.

As such, we do not believe that the use of a specialist ESG index is required nor prudent. Such indices often introduce additional biases to the investment universe and typically fail to capture the investments that will be re-rated through improving their ESG characteristics, or those whose headline ESG characteristics are hiding a more subtle or emerging risk. We recommend to our investors that we use ESG metrics alongside more traditional fundamental investment factors to create a portfolio that can generate consistent outperformance when measured against traditional equity indices.

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## Hermes Investment Management

Hermes Investment Management is focused on delivering superior, sustainable, risk-adjusted returns – responsibly.

Hermes aims to deliver long-term outperformance through active management. Our investment professionals manage equity, fixed income, real estate and alternative portfolios on behalf of a global clientele of institutions and wholesale investors. We are also one of the market leaders in responsible investment advisory services.

### Our investment solutions include:

**Private markets**

International real estate, UK commercial real estate, UK private rental sector real estate, infrastructure and private equity

**High active share equities**

Asia, global emerging markets, Europe, US, global, and small and mid cap

**Credit**

Absolute return, global high yield, multi strategy, real estate debt and direct lending

**Multi asset**

Multi asset inflation

**Responsible Investment Services**

Corporate engagement, intelligent voting and public policy engagement

### Offices

London | New York | Singapore

## Why Hermes Global Equities?

**Transparency**

Our accessible investment process and analysis is based on clearly defined statistical and economic evidence. It is not a 'black box' and the drivers of returns can be clearly explained.

**Expertise**

Our bottom-up stock-selection model systematically analyses companies' financial statements and gauges investor sentiment to generate an optimal portfolio. The team draws on its deep investment experience to identify unquantifiable risks such as negative news flow and regulatory change.

**Flexibility**

We partner with clients to create portfolios addressing their needs, amending the risk profile, investment universe and benchmark, and portfolio characteristics such as dividend yield and ESG exposure as required.

**Broad risk awareness**

MultiFRAME, our proprietary risk modelling system, detects exposures to all quantifiable risks. The Hermes Investment Office performs independent risk management services for clients and sustainability risks are identified by our ESG Dashboard.


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