Federated Hermes Limited

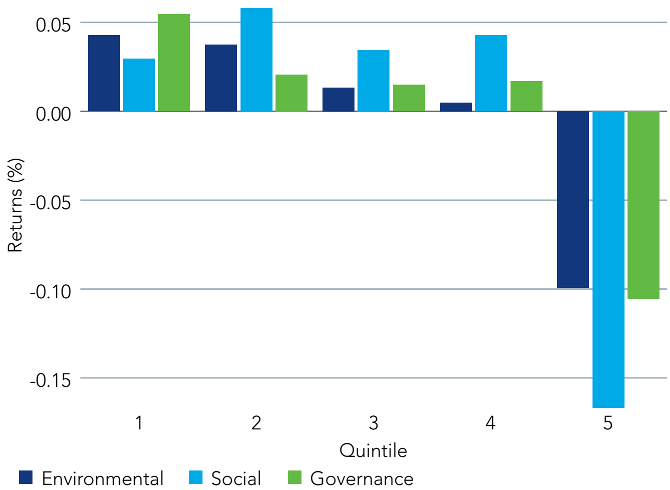
Despite headwinds, ESG continues to perform

The latest research from the Global Equities team at Federated Hermes indicates that despite market volatility and the energy crunch, ESG continues to be an effective performance indicator. Our previous research confirmed the link between social and governance factors[1]. In the latest findings, the importance of environmental metrics is evidenced, with the best placed companies performing ahead or in line with peers, while poorly ranked companies tend to significantly underperform.

In our 2020 release, we demonstrated that governance and social factors were a statistically meaningful driver of shareholder returns. The pandemic cemented the importance of social impact, with more socially responsible companies tending to outperform[2]. Previously there was weak evidence that environmental factors had similar properties, but the historic relationship was volatile and did not reach the necessary hurdle to be considered significant. That has changed over the last two years, with environmental factors performing on a par with social and governance. This confirms that across the environmental, social and governance pillars, the link between ESG and performance is clearly in evidence.

Figure 1. Companies with poor ESG practices have historically underperformed over the long term

Average monthly total relative returns of companies in each quintile, based on environmental, social and governance scores, from 31 December, 2008, to 30 June, 2022. Figures are calculated using constituents of the MSCI World Index, assuming monthly rebalancing.



For illustrative purposes only.
Source: MSCI, Federated Hermes, as at 30 June 2022.

The non-linear shape of ESG

In our inaugural ESG research, published in 2014, we demonstrated a striking aspect of the relationship between governance and shareholder returns, often overlooked in other studies. Namely, the relationship is non-linear. Companies with leading or improving corporate governance scores outperform peers with poor or worsening standards. However rather than performance deriving from the leaders outperforming, the governance premium is largely driven by the underperformance of the laggards. This same pattern exists for the social factor and for the environmental factor. For investors, avoiding the ESG laggards, and those whose standards are slipping, is a crucial way to capture the ESG premium.

A worrying exception

The findings are surprisingly consistent across economic sectors, with the notable exceptions of Real Estate and Energy. Within these sectors, the companies with the worst or worsening environmental practices relative to peers have tended to outperform. For the Energy sector in particular, this result is concerning, if sadly not surprising. Some investors simply avoid the entire sector in the name of environmental considerations. Does this exclusion by many sustainable investors result in the sector being more influenced by those less concerned by sustainability? If sustainability-focused investors are not acting as stewards of the Energy sector, it may be asked, who is?

[1] FHL, 'Reaffirming the link between ESG and performance' (2020)

[2] FHL, 'ESG Investing: How Covid-19 accelerated the social awakening' (2020)

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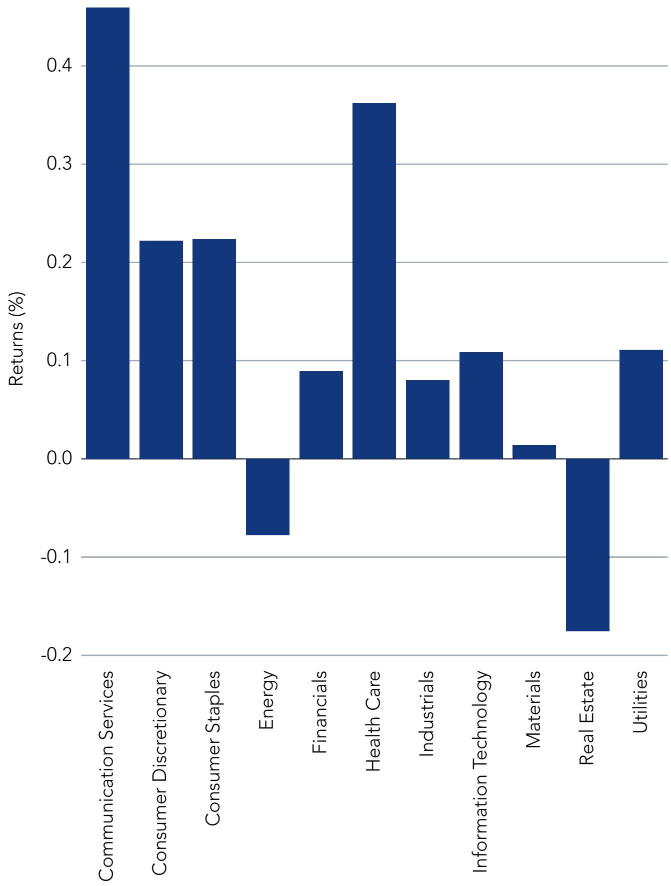
Figure 2. Notable exceptions: Real Estate and Energy break the pattern of environmental outperformance

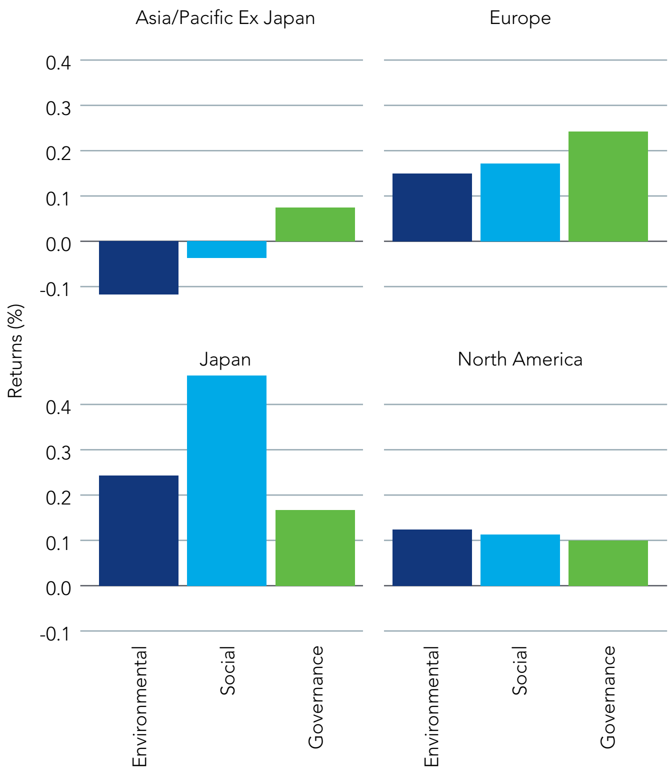
Average monthly dispersion in total returns between companies in the top quintile and lowest quintile, based on environmental scores by sector, from 31 December, 2008, to 30 June, 2022.



For illustrative purposes only.
Source: MSCI, Federated Hermes, as at 30 June 2022.

Figure 3. One size does not fit all: the effectiveness of ESG factors by region

Average monthly dispersion in total returns between companies in the top quintile and lowest quintile, based on environmental, social and governance scores by region, from 31 December, 2008, to 30 June, 2022.



For illustrative purposes only.
Source: MSCI, Federated Hermes, as at 30 June 2022.

Long-term thinking

Awareness of sustainability continues to grow across every sector. Embracing sustainability in general is not just about avoiding risks, it is about finding business opportunities. We stand by the belief that sustainability requires a long-term focus and can deliver the opportunity for long-term results. In the developing environment, we believe businesses with the right longer-term focus will be the ones who thrive.

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