# 10 questions for 10 years: The Global Equity ESG Fund

The team reflect on a decade of ESG investing led by pioneering research.

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Since 2014, the Global Equity ESG Fund's philosophy has been underpinned by pragmatism, sustainability, responsibility and longevity. Now, with ten years under its belt, the Fund has demonstrated an improved ability to generate outperformance using its proprietary QESG score. In this retrospective piece, our team reflect on the Fund's history of innovation and why their approach to ESG investing is not simply about achieving the 'feel good' factor.

## Fast reading:

- The Global Equity ESG Fund offers a hybrid quantitative and fundamental investment approach which has been successful not only in identifying global outperformers across sectors, but has grown to become one of the largest ESG funds available in the market[1].
- The quant model identifies the best companies to evaluate in greater detail. Our focus on ESG improvers has meant that we are finding tomorrow's ESG leaders across industries.
- Our best-in-class risk model ensures we avoid the pitfalls of concentrated macro risks, navigating volatile markets and providing 'all-weather' returns.

## 1. What does the Fund offer?

Our Fund provides exposure to a diverse range of companies that have attractive combinations of long-term fundamentals with good or improving ESG characteristics. We are not seeking to take a moral or ethical stance, instead we are looking to get a better, more-rounded understanding of the companies that we invest in. We like companies that are ESG improvers as we recognise that the ESG environment does not stand still, and the laggards of today, could be tomorrow's leaders, if the mindset is right.

Diversification is a key part of our approach. History suggests that investors struggle to predict the macroeconomic environment and, crucially, how that will affect the equity markets. We aim to manage and control macro factor risks, using MultiFRAME[2], to ensure that portfolio risk remains diversified and is not dominated by a one or two factors. This provides protection in volatile markets.

We identify opportunities from a bottom-up perspective. We seek companies that have attractive combinations of long-term fundamentals. It is not enough for a company to look cheap or have robust growth or margins, we want our companies to look attractive from multiple perspectives.

The result of this approach is a diversified, all-weather portfolio that is broadly neutral on a sector and regional basis and one that has exposure across the style spectrum, but no structural biases. This style-neutral approach ensures we can capture winners, irrespective of the market environment.

## 2. What are the strengths of the team?

We are a stable and highly experienced team of investors. The portfolio management team of Geir Lode, Lewis Grant and Louise Dudley have worked together since 2009 and have complementary skills.

In addition to his investment experience, Geir, the Head of the Global Equity team, has built, and listed, a company on the Norwegian stock market, which provides unique insight that cannot be taught. Lewis, who is responsible for the wider research agenda, has an actuarial background and has been instrumental in building many of the models, such as MultiFRAME, our multi-factor risk model, that the team use to this day. Louise joined the team from EOS, our in-house stewardship team, sits on UK Sustainable Investment and Finance Association board and leads our pioneering ESG research agenda.

[1] The Fund has grown from an initial US$40m in 2014, to US$2.4bn as at 31 March 2024.
[2] The team use their proprietary risk-management system, MultiFRAME, to manage and diversify macro and factor risks, ensuring that stock selection is the dominant source of relative risk and returns.

A key strength is the focus that the team has on innovation. Over the years this has included providing bespoke solutions that meet client-specific needs, the continuous improvements in the Alpha Model[3], the enhancement of MultiFRAME, and our pioneering research into ESG that proved there is a link between ESG and performance. We have also been able to draw upon the knowledge and expertise of EOS, who will celebrate 20 years of stewardship this year, in the development and evolution of our QESG Score over the past decade.

## 3. What is the investment philosophy behind the Fund?

### We seek durable businesses

We favour companies with attributes that have proven to drive long-term shareholder returns, such as good and improving ESG characteristics, exposure to sustainable revenues, competitive advantage over peers, wide and widening margins, robust capital structure, proven ability to earn excess return on capital, market share capture and expanding revenues.

### …with no material weaknesses

Low quality companies are more exposed to negative externalities, therefore avoiding companies with weak balance sheets, substandard governance, poor relationships with stakeholders or other sources of potential distress yields excess returns over the long term.

### …at an attractive valuation

We are not seeking cheap – we are seeking undervalued given the characteristics above. We invest with the aim to generate return, and valuation is at the heart of stock selection – we value companies relative to peers based on the methodology appropriate to the nature and maturity of a business and its cashflows.

### …with favourable market dynamics

Even long-term investors must consider market timing, with price behaviour, analyst recommendations and market-sentiment key predictors of whether a valuation gap will normalise within our three-to-five-year investment horizon.

## 4. Can you tell us about your ESG definition?

A key part of our philosophy is that we favour companies with good or improving standards of ESG with the objective of delivering superior shareholder returns. That is, we integrate ESG into the process because we believe ESG can make you money.

We have a proprietary ESG assessment framework that uses the unique engagement insights generated by EOS, market leaders in stewardship, allowing us to identify companies that are improving their ESG behaviour – and hence unlocking value – ahead of the market. We supplement the EOS intelligence with a wide range of third-party ESG vendors, including MSCI, Trucost and Sustainalytics – recognising the strengths and weaknesses of the various providers and the limitations of quantitative ESG data in general.

The resulting assessment of ESG – the QESG Score – is embedded directly within our stock selection model and is a crucial part of how we determine the attractiveness of a company. We have recently enhanced the QESG Score so that it includes our Sustainable Opportunities score, differentiation by industry, improved granularity and a reworking of EOS information to better assess engagement sentiment.

## 5. What sets this fund apart from peers?

Our investment process combines a quantitative approach, using our proprietary Alpha Model, with a qualitative approach. We recognise that a quantitative approach can only get you so far and we use our investment experience to challenge the results of the model to identify any weaknesses that it may have not picked up. This is an important risk control and has proven to add value over the years.

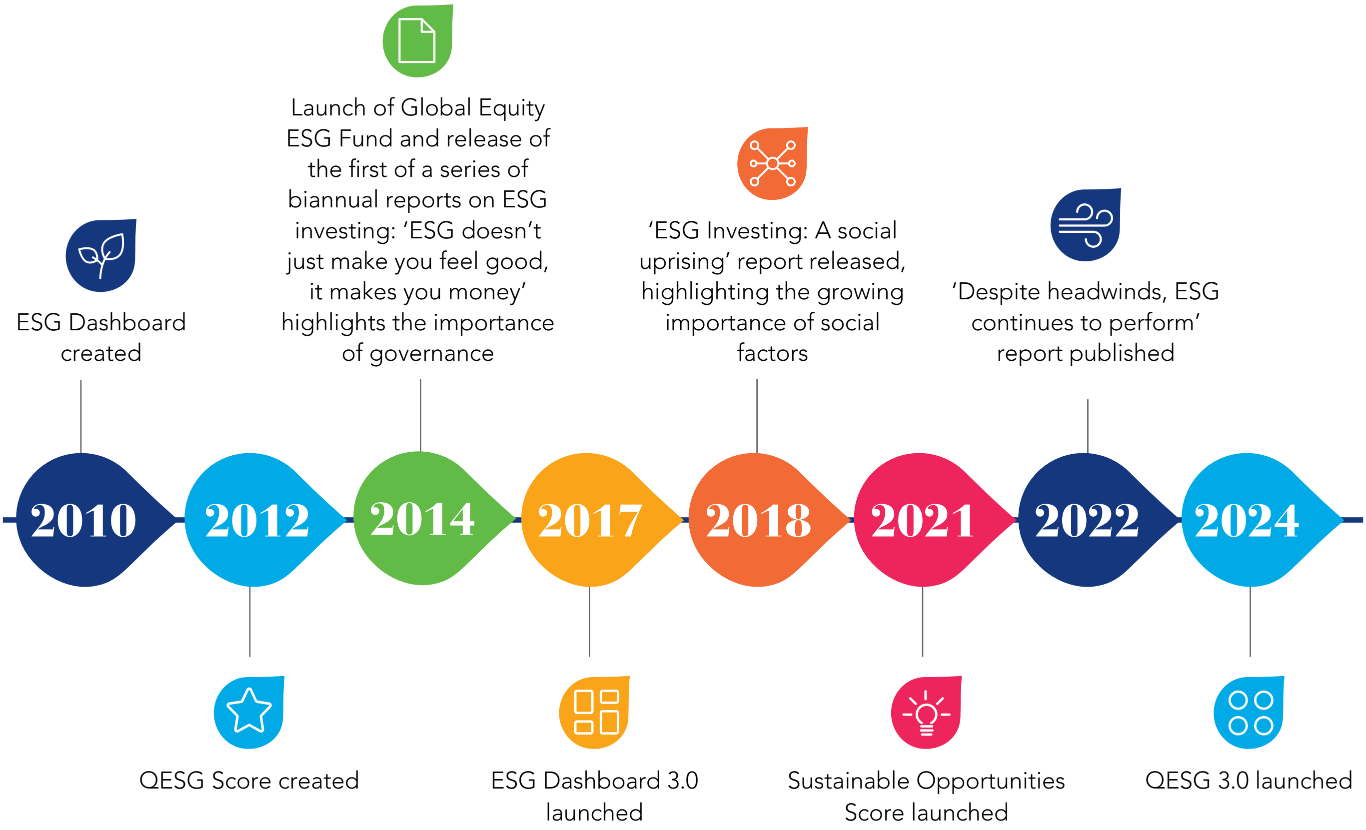
The Alpha Model is our 'automated analyst'; it conducts analysis of proven, long-term fundamentals for each stock in the investment universe on a daily basis, seeking to identify companies that look attractive from multiple perspectives. The combination of fundamentals is vital as a significant weakness can have a disproportionate impact on the overall attractiveness of a company. The Alpha Model provides an objective view of the investment landscape and ensures we avoid one of the biggest pitfalls of investing: emotional bias.

[3] The team use a systematic approach, our Alpha Model, which seeks to identify companies with an attractive combination of fundamental and ESG characteristics. This is combined with a disciplined subjective analysis that interrogates the model's efficacy and assesses the ESG characteristics of a company to identify potential weaknesses not captured by the model. The Axioma Optimiser combines stocks in an optimal portfolio to favour stock-specific risks and diversify top-down exposures.

ESG intelligence from engagement with companies that EOS conduct on our behalf helps us look beyond the ESG ratings providers. How a company approaches these interactions provides a useful signal and the unique insights into how a company is actually dealing with a particular issue or managing its ESG risks gives us a more forward-looking view. Sustainability reporting only offers a part of the picture – some of the softer, non-quantifiable aspects and an understanding of the nuances can set companies apart.

## 6. How has the Fund evolved since inception?

**Figure 1:** A history of innovation




When the Fund was launched, it was on the belief that ESG does not just make you feel good, it also makes you money. Our research certainly suggested this was the case, but the results could only show that avoiding the worst governed companies could be proven to add value. The results for environmental and social factors, while encouraging, could not offer the required proof.

This has changed over the years. Social factors started to become more important, particularly outside of the US, but the Covid-19 pandemic accelerated its influence across the globe. More recently, our research has proven that environmental factors also now add value. With instances of extreme weather events becoming more regular and more extreme, focus has turned towards climate change and the transition to a greener world.

Engagement will play a significant role in this transition, and EOS are central to our efforts in this area. They have seen impressive growth over the years with US$163bn AUA back in 2013, which has risen to US$1.4tn AUA at the last count[4]. The importance of this growth cannot be underestimated because it gives us an outsized influence with companies that we would not otherwise have.

Another area of evolution has been in ESG data, both from data providers and the companies themselves. When we first started researching ESG there were only a handful of data providers, while company disclosures tended to be poor. ESG data provision is now a significant industry in its own right and the challenge facing investors is that there is too much data. Some of this data is not always good or reliable, making it difficult to separate the signal from noise, and the inevitable 'greenwash'. That said, we are comfortable with many

[4] Source: Federated Hermes, as at 31 December 2023.

different perspectives – as long as they are credible, which is where our extensive experience becomes invaluable and also underscores the importance of engagement.

A major reason behind the increase in the amount of ESG data is regulation. The EU's Sustainable Finance Disclosure Regulation (SFDR) regime, for example, has sought to provide clarity to investors and, alongside the EU Taxonomy for sustainable activities, supports the European Green Deal that envisions an economy that is climate neutral and biodiversity positive by 2050. Regulation such as this improves transparency and helps prevent 'greenwashing', which we wholeheartedly welcome. It also serves to educate all market participants which helps to improve the overall sustainability of the financial markets.

## 7. Has the Fund achieved what you set out to achieve in 2014?

The QESG factors that we use as part of stock selection have delivered an improved ability to generate outperformance over the last decade. This has been shown initially for governance factors, followed by social factors and most recently environmental factors.

When the Fund launched, we believed that investing in a diverse range of companies with attractive combinations of long-term fundamentals that had good or improving standards of ESG could outperform the broad market. This belief has not changed and has largely been borne out, with a couple of notable exceptions.

The onset of the war in Ukraine in early 2022 had a negative effect on funds that were tilted towards ESG or sustainability, as the energy crisis saw investors flock towards oil companies and other areas that are typically off limits, such as defence and tobacco, creating a significant headwind. As we entered 2023, the extremely narrow market and volatility around interest rates created another tough environment for active investors.

However, the diversification of the Fund and its exposure across the style spectrum has provided some insulation from these headwinds, especially when compared to other, more concentrated funds – many of which have had a torrid time over the past couple of years. It is also notable that over the past six months or so, when markets have broadened and the macro has reduced in importance, the Fund has performed extremely well.

Our approach has also resonated with investors with the Fund growing from an initial US$40m in 2014, to US$2.4bn currently[5].

## 8. Has the growth of ESG regulation around the world helped or hindered the team's approach?

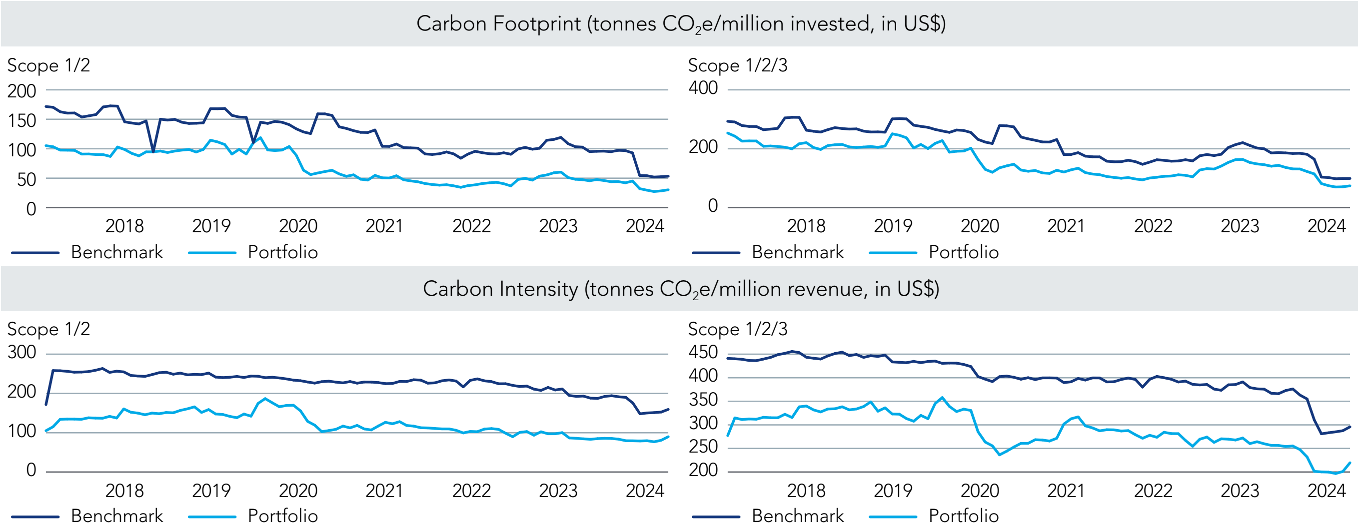
Eventually, improved regulation should help the wider investment community to agree on common ESG objectives and definitions. We have long recognised the importance of ESG, having been researching the topic for well over a decade. We have also been advocates of increased transparency, not least because it has increased the levels of disclosure, providing us with more reliable data. For a team that has a quantitative foundation, this has been a real benefit and has helped with the evolution of the QESG Score.

The benefits go beyond conducting a more thorough analysis of a company in our models, however. They have real-world impacts too. Increased regulation and standardised rules around disclosures, such as TCFD[6], enable us to compare companies on a like-for-like basis and, crucially, hold them to account in our engagements.

ESG reporting is a crucial for clients to understand the product and what has been achieved. Our annual reporting contains a variety of datapoints, particularly from a climate change viewpoint. We report on the greenhouse gas (GHG) intensity and GHG footprint of the Fund compared to the benchmark, which has been consistently lower than the benchmark, as shown in Figure 2 below:

[5] Source: As at 31 March 2024.
[6] **TCFD:** The Taskforce on Climate-Related Financial Disclosures is an organisation that was established to develop a set of voluntary climate-related financial risk disclosures. These disclosures would ideally be adopted by companies which would help inform investors and other members of the public about the risks they face related to climate change.

**Figure 2:** Fund's greenhouse gas (GHG) intensity and footprint, versus the benchmark




Source: Federated Hermes, as at May 2024.

In addition, we also report on the proportion of the Fund and benchmark that has set Science-Based Targets[7]. On a more forward-looking basis, we look at the Fund's exposure to the UN Sustainable Development Goals and the proportion of the Fund exposed to green revenues. This all helps clients understand where the Fund sits currently, but also how it has changed over time.

## 9. Companies and investors have faced greenwashing challenges, and and in recent years, backlash. What is the team's view on this?

We believe that the best way to make money for our clients is to combine smart use of ESG data with the proprietary insights we achieve through engagement with companies. Although ESG investing can have a positive impact on the world, we see that primarily as an outcome of asset allocation rather than stock-picking. We make no claims to have a positive impact on the wider world through our stock selection. Instead, we understand ESG as maximising our clients' returns by recognising the changes that our world and society are undergoing and picking the stocks that are best placed to withstand them. In doing this, we see our engagement with companies as both a source of investment intelligence and a means of achieving positive impact at the company level.

Having a clear definition is crucial, and we also believe that there is convincing evidence for the value of both ESG integration and ESG engagement. In an environment of increasing political polarisation, this will be extremely important. Our contention is that strong and improving ESG performance correlates with strong returns over the long term. Better data and disclosures should make this correlation more obvious, and that in turn should draw some of the heat from the current clash over ESG.

We continue to enhance how we measure ESG in a quantitative way, for example integrating more explicit assessments of long-term sustainability through our Sustainable Opportunities score, which is embedded in our QESG Score. By more explicitly focusing on the sustainability of a company's future revenue sources, our assessment of ESG will better capture the industry effects which have been so important to investment returns in recent markets.

In our view, sustainability will be an increasingly compelling destination for investors' capital. Although there has been a distinct lack of progress on mitigating the causes of climate change since 2016, it is not too late to reverse some of the damage. However, if we are to meet the 2030 climate goals of the Paris Agreement[8] and the challenges laid out by the UN SDGs, investment in sustainability will have to accelerate at an unprecedented level. For ESG-focused investors like us, this is an opportunity not to be missed.

## 10. This is an active investment strategy. How does the rise of passive ESG strategies impact the ability to generate alpha?

One of the most important arguments for active management is that you can be selective, whereas with passive investing you end up being exposed to the good and the bad: ESG is, therefore, a hugely important consideration.

[7] **Science-based targets:** Provide a clearly defined pathway for companies to reduce greenhouse gas (GHG) emissions, helping prevent the worst impacts of climate change and future-proof business growth.

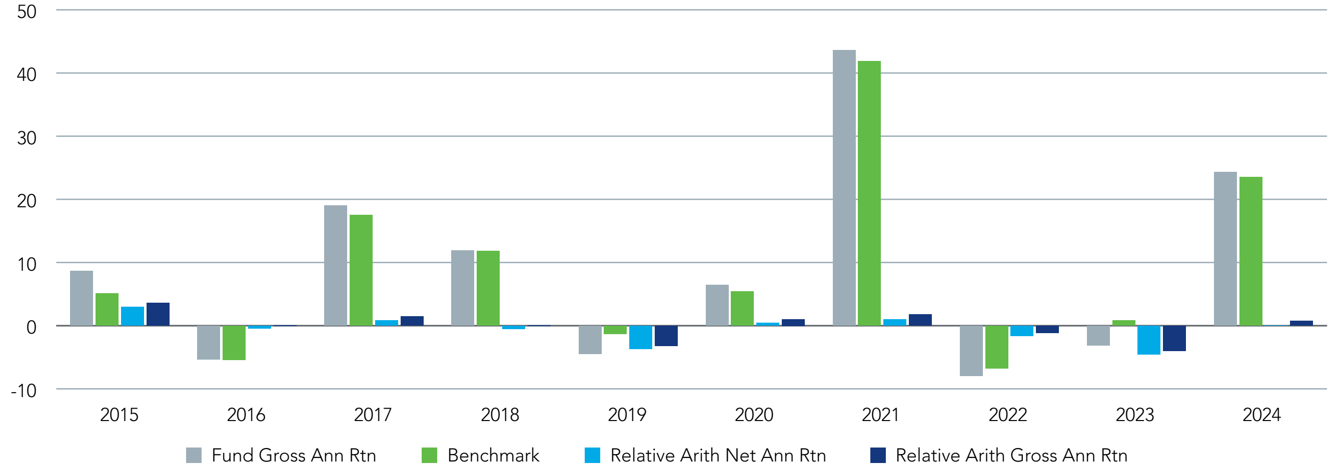
[8] **Paris Agreement:** The Paris Agreement's central aim is to strengthen the global response to the threat of climate change by keeping a global temperature rise this century well below 2° Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5° Celsius.

Our view is that investors cannot afford to go passive on ESG as data is inherently backwards looking. Many issues are fast-moving, and the team are adept at managing these risks through their own ESG analysis. We also have the huge benefit of EOS, who are engaging with companies on our behalf to bring about positive change and highlight risks.

Our hybrid quantitative and qualitative approach ensures we capture the latest data insights through advanced analytics, as well as being able to use our experience to make a subjective judgement on potential issues affecting companies. ESG standards and expectations are moving very quickly, and the annual reporting cycle from companies (and the third-party data providers) is not able to advance frequently enough to capture this latest information. However, we can act upon issues and gain exposure to emerging opportunities in a far quicker manner than a passive fund.

It is also worth remembering that all companies are a shade of green (or brown) and, similarly for ESG, there is a spectrum. Some investors will pay a green premium for certain names, but as active investors we can identify other, less obvious names and be more discerning as to the valuation today and going forward, using information which may be released, but not officially reported through annual reports. We have also been able to demonstrate the outperformance from ESG factors including ESG momentum, which we believe we are better able to capture than a passive approach, given the inclusion of engagement data from EOS.

## Fund performance




Source: Federated Hermes as at 31 May 2024. Performances shown are that of the FH Global Equity ESG fund in $US gross and that of its relative performance, calculated on an arithmetic basis, net and gross in $US against its benchmark. Benchmark: MSCI AC World Index. **Past performance is not a reliable indicator of future returns.**

## Rolling year performance (%)

| | 31/05/14-31/05/15 | 31/05/15-31/05/16 | 31/05/16-31/05/17 | 31/05/17-31/05/18 | 31/05/18-31/05/19 | 31/05/19-31/05/20 | 31/05/20-31/05/21 | 31/05/21-31/05/22 | 31/05/22-31/05/23 | 31/05/23-31/05/24 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Fund Gross Ann Rtn** | 8.67 | -5.34 | 18.99 | 11.92 | -4.48 | 6.46 | 43.64 | -7.91 | -3.16 | 24.31 |

Source: Federated Hermes as at 31 May 2024. Performance shown is the Federated Hermes Global Equity ESG Fund in US$, gross of fees using close of business prices. Benchmark: MSCI AC World Index. **Past performance is not a reliable indicator of future returns.**

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