Equitorial

ESG is here to stay – and we're better for it

Federated Hermes Global Equity ESG 2025 Newsletter

Federated Hermes Limited

www.hermes-investment.com
For professional investors only

'ESG' (Environmental, Social and Governance) has become increasingly polarising in recent years, dividing opinion across economic, political and social lines. For the Federated Hermes Global Equity team, however, ESG has always been about one thing: enhancing returns.

The Global Equity team first started researching ESG in 2007, alongside EOS, our in-house stewardship service founded in 2004. The aim of this research was to establish whether there was a relationship between ESG and performance – chiefly, how do ESG factors impact shareholder returns?

The first link was established in 2014, where the team's seminal research paper, "ESG investing: Does it just make you feel good or is it good for your portfolio?", demonstrated governance was additive to returns. Subsequent research over the intervening period established the relationship between environmental and social factors and performance.

Our conclusion was that ESG integration should be active, making use of constructive, long-term stewardship with company management and boards. This enables us to capture the dynamic nature of industry trends and company pathways, providing a forward-looking view that is otherwise unavailable from merely looking at company disclosures.

We also concluded that we needed to be pragmatic about investing in the world that we are in. We should not just favour the best today; we should also seek those that are on the pathway to be future leaders.

In this paper, we explore why ESG still matters in 2025 and beyond, and how the integration of ESG can have a positive impact on portfolio returns.

What does ESG mean to us and how can it be additive to returns?

Before we describe how it can be additive to returns, it is worth putting into context how we define ESG. 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 those changes or benefit from them.

There is a great deal of academic evidence that shows strong ESG performance can benefit companies. For instance, in 2015 a meta-study[1] concluded that companies with better ESG performance, on average, had a lower chance of going bankrupt, more stable cashflows and were more resilient to external shocks, such as tighter regulation. These findings were broadly confirmed by a 2021 meta-study[2].

In a study conducted by Hoepner et al[3], which uses data from EOS at Federated Hermes Limited, our leading in-house stewardship team, the authors found that engagement on ESG issues reduces companies' downside risk. Using EOS's milestone system to track engagement progress, the findings suggested that the risk-reduction effect increases as engagement progresses. Where engagers raised issues, but the companies did not acknowledge them, risks were not reduced.

Our own pioneering research, conducted over the past 15 years, has also proven a link between ESG and returns. This research has provided one of the cornerstones of the Global Equity team's investment philosophy – the belief that:

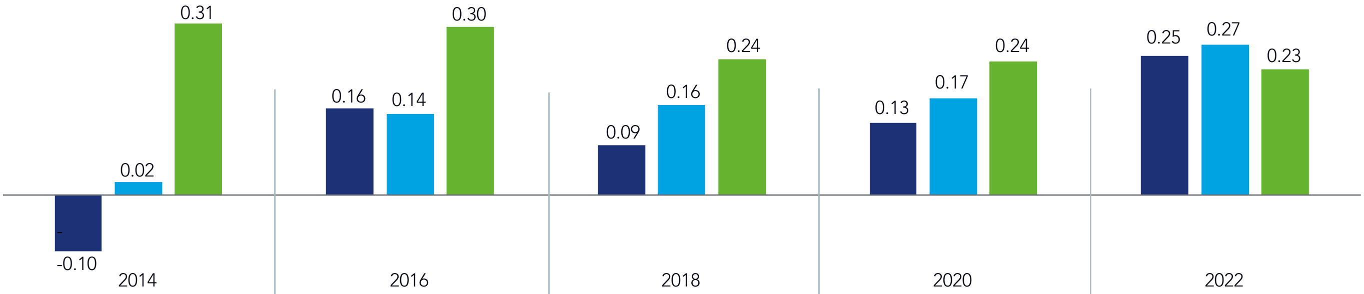
- Companies with poor standards of ESG tend to underperform over the long-term
- Those that are on a pathway of improvement can unlock significant shareholder value

1 From the stockholder to the stakeholder.
2 NYU-RAM_ESG Paper_2021.
3 ESG shareholder engagement and downside risk | Review of Finance | Oxford Academic.

Pioneering research for over a decade

Figure 1: Results of our ESG Investing studies (2014-2022)

Average monthly dispersion in total returns between companies in the top-decile and bottom decile on ESG characteristics since 31 December 2008



2014
- Governance consistently adds value
- Social metrics have a negligible impact on returns
- Environmental factors detract

2016
- Governance consistently adds value
- Environmental and Social results are encouraging, but not consistent enough

2018
- Governance continues to consistently add value
- Social characteristics outperform outside of North America
- The environmental factor results are not yet statistically meaningful

2020
- Governance adds value
- Social factors continue to add value outside of North America
- Environmental factors are not yet statistically significant

2022
- The best companies in each ESG pillar consistently outperform the worst

■ QE (environmental) ■ QS (social) ■ QG (governance)

Source: Federated Hermes. The results relate to the following Global Equities Studies: 2014: ESG investing: Does it just make you feel good or is it good for your portfolio? 2016: ESG investing: It still makes you money, it's still good for your portfolio. 2018: ESG Investing: A social uprising. 2020: How Covid-19 accelerated the social awakening. 2022: Despite headwinds, ESG continues to perform.

Past performance is not a reliable indicator of future performance. The value of investments and income from them may go down as well as up, and you may not get back the original amount invested.

Our latest research confirms that the relationship between good and improving ESG and returns continues to hold.

In our 2022 update, we demonstrated that environmental metrics, which had not been statistically significant previously, had become important. The latest results shows that this continues to be the case and that the relationship remains non-linear. Companies with leading or improving ESG scores outperform peers with poor or worsening standards. However, the ESG premium is largely driven by the underperformance of the laggards.

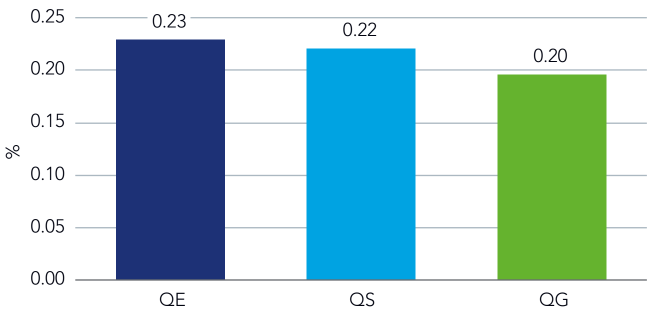
The results are also broadly consistent across sectors, although there a couple of notable exceptions that break the pattern of outperformance.

Environmental factors within the lowest decile in the Energy sector have modestly positive returns, while underperformance in Materials is driven by the top decile. Similarly, the lowest decile governance factors in the Consumer Staples and Industrials sectors have posted small gains over the period, while the top decile in Materials have posted a moderately negative return.

> **Environmental factors within the lowest decile in the Energy sector have modestly positive returns, while underperformance in Materials is driven by the top decile.**

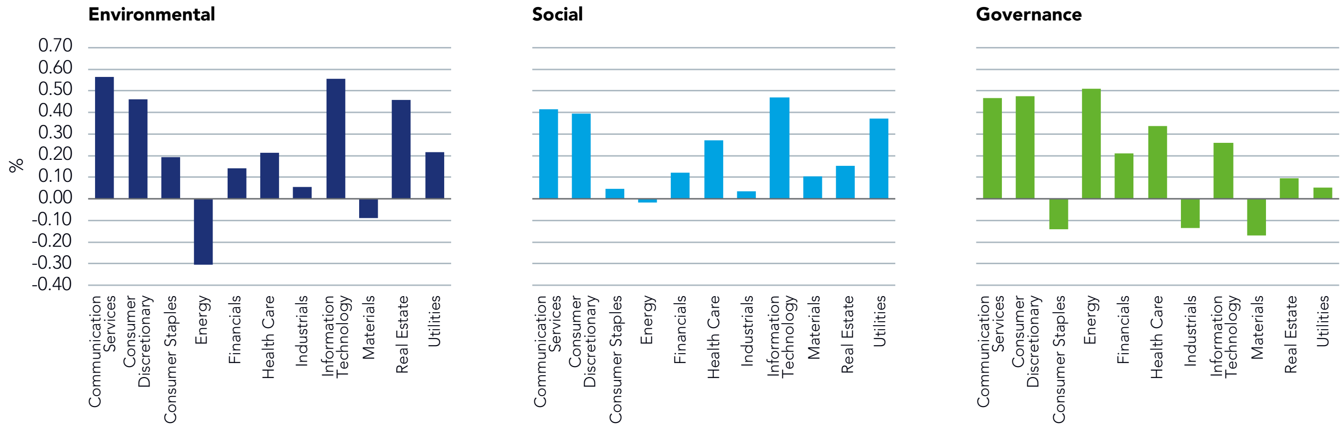
Figure 2: Average monthly dispersion in total returns between companies in the top decile and bottom decile on ESG characteristics (between 31 December 2008 and 31 March 2025)

Figures are calculated using constituents of the MSCI World Index, assuming monthly rebalancing.



Source: Federated Hermes as of 31 March 2025.

Figure 3: Average monthly dispersion in total returns between companies in the top decile and lowest decile, based on ESG scores by sector (between 31 December, 2008 and 31 March 2025)



Source: Federated Hermes as of 31 March 2025.

The QESG Score

The team's research also resulted in the creation of the team's proprietary QESG Score, which is embedded directly within our stock selection model and is a crucial part of how we determine the expected return of investments.

The recently enhanced QESG Score helps the team systematically understand whether a company 'walks the talk'. A company may have policies, procedures and targets in place, but it is important to understand whether they are reflective of how the company is performing and whether it's on a pathway to improvement. A disconnect could suggest a company is not managing its risks particularly well.

It is based on our proprietary ESG assessment framework that combines the unique engagement insights generated by EOS with a wide range of third-party ESG vendors.

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Figure 4: ESG assessment framework

Proprietary QESG Score framework measures level and change

Wide range of ESG data

- **EOS**
- Sustainalytics
- MSCI
- S&P Trucost
- CDP
- Bloomberg
- FactSet
- ISS

QESG Score

Example metrics

	Environmental	**Social**	**Governance**
Policies and processes What does the company claim?	Emissions targets Renewable energy policies Disclosure quality	Human rights policy ESG certifications/awards Supply chain commitments	Quality of disclosure Board independence Board structure
Real-world performance What is the reality?	Emissions/resource use Exposure to green opportunities Exposure to controversies	Employee turnover Third party ESG ratings SDG revenue generation	Compensation and alignment Third party ESG ratings Exposure to controversies
Trend Is the company improving?	Change in emissions Improvement in ESG ratings Engagement progress	Resolution of controversies Improvement in ESG ratings Engagement progress	Vote progress Improvement in ESG ratings Engagement progress

Source: Federated Hermes, as at April 2025.

How ESG influences financial performance

Although our research has provided a statistical link with performance, how does it translate to the real world? For the Global Equity ESG team, there are several areas where ESG can have a material impact on financial performance.

Operating efficiency:

- The efficient use of resources can reduce operating costs and increase profitability. The opposite is true for inefficient operations.

Manufacturing process:

- Strong product quality & safety can attract customers and reduce the risk of reputational damage and fines.
- Sustainable, transparent manufacturing can encourage brand loyalty and reduce the risk of fines.
- Ineffective oversight of the supply chain can lead to social and environmental controversies that can impact brand loyalty and increase regulatory scrutiny.

Human capital:

- Companies treating their employees well can have lower employee turnover, avoid disruptions such as strikes, and increase productivity.

Capital allocation:

- A robust capital allocation framework with well-aligned incentives can enable management to avoid taking unnecessary risks when setting strategy.
- Investment to drive innovation can improve long-term sales.
- Returning capital to shareholders when can be viewed as a positive.

Social license to operate:

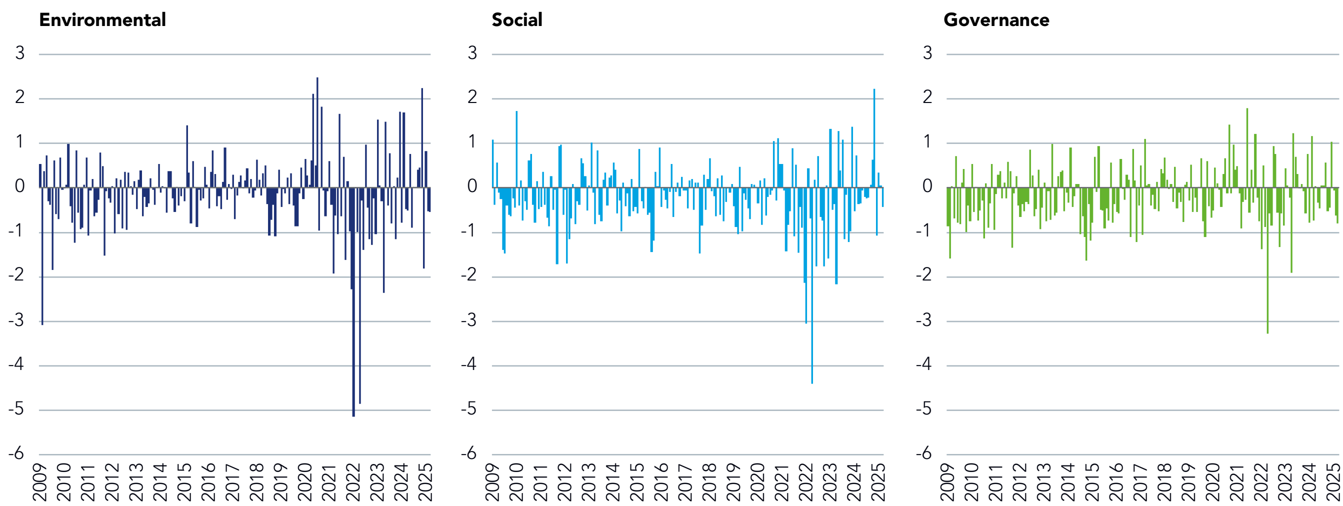
- Companies with strong ESG practices often have better community relationships, making it easier for them to operate and reducing the risk of significant controversy.
- Poor ESG track records can lead to disruption through protests, strikes, etc. This can also lead to reputational damage.

Regulation:

- Products that benefit society or the environment can benefit from regulatory tailwinds and incentives.
- Companies that avoid falling foul of regulations can preserve an enhanced/robust brand and/or reputation and particularly benefit from being seen as a 'good player' at times when competition is strong.

Implementation

Figure 5: Monthly performance of the bottom decile of the QE, QS and QG score (between 31 December 2008 and 31 March 2025)



Source: Federated Hermes, as at 31 March 2025.

Risk management: Avoiding the worst

A key element of our approach is that we want to avoid companies facing material ESG risks that their peers don't. This is borne out in our research, illustrated in Figure 5 above, that shows companies in the bottom 10% consistently underperform.

A company can have great fundamentals, but it makes little sense to invest if it has poor ESG standards when there tend to be alternatives with similar characteristics and a good or improving ESG profile.

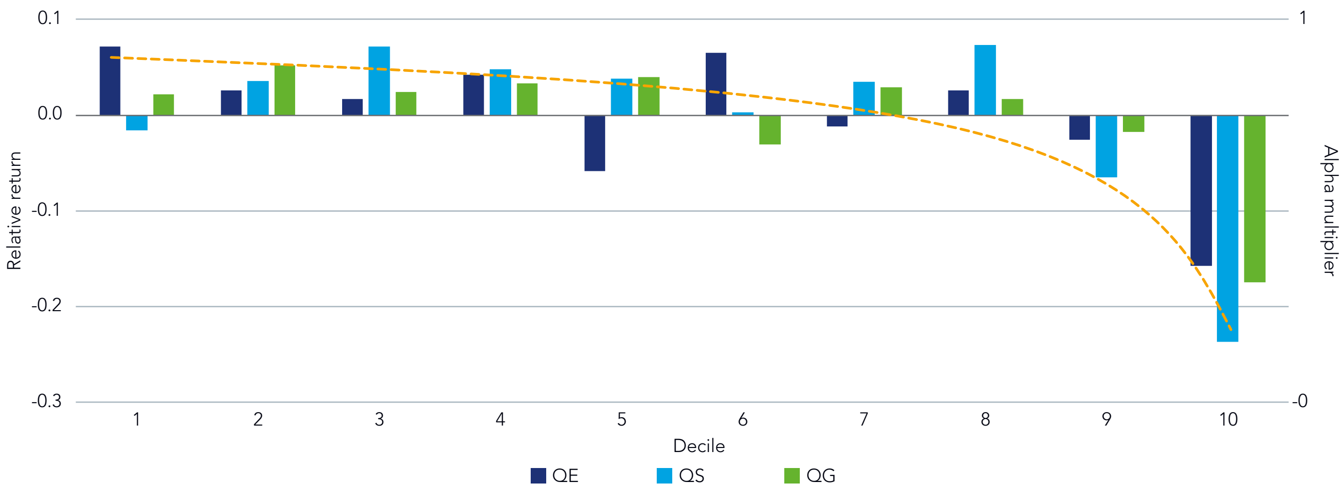
Put another way, a company that faces unnecessary risks that its peers mitigate, on balance, will have more chance of underperforming. As such, we view companies with the poorest ESG standards as having a risk so material that it can negate other attributes, such as an attractive valuation or an exceptional growth rate.

Within our model, we separate each pillar of the QESG Score so that we can assess the individual facets of a company's E, S and G characteristics. This enables us to have a greater understanding of the underlying drivers of the score and to more easily pinpoint weakness: a company's strong governance should not lead investors to ignore its environmental risks, for example.

Within our model, each pillar of the QESG Score is separated so that we can assess the individual facets of a company's E, S and G characteristics.

Figure 6 (below) shows that the influence of good ESG is broadly positive, albeit modest, and its influence on the Alpha Model's assessment of a company (the Alpha Score) is modestly positive. However, when you get to the lowest deciles, particularly decile 10, the impact on returns is so material that the Alpha Model penalises the company (as seen by the orange dotted line) to the extent that it is rejected as an investment.

Figure 6: Average monthly relative return by decile of the QE, QS and QG Score



Source: Federated Hermes as of 31 December 2025.

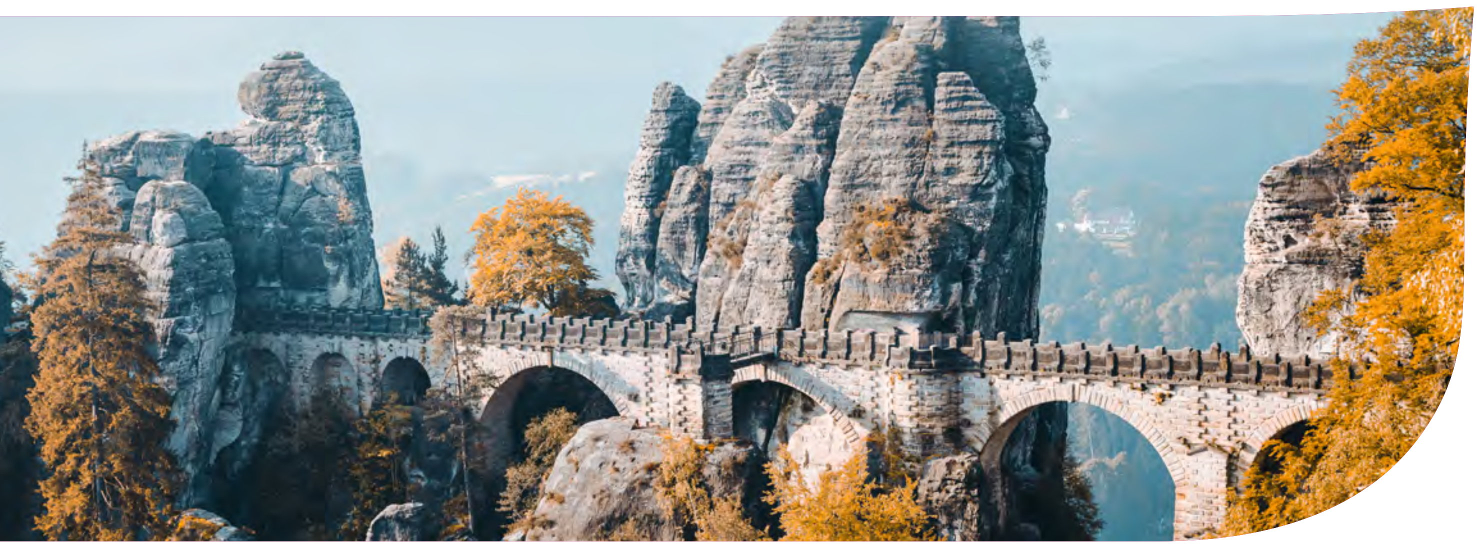
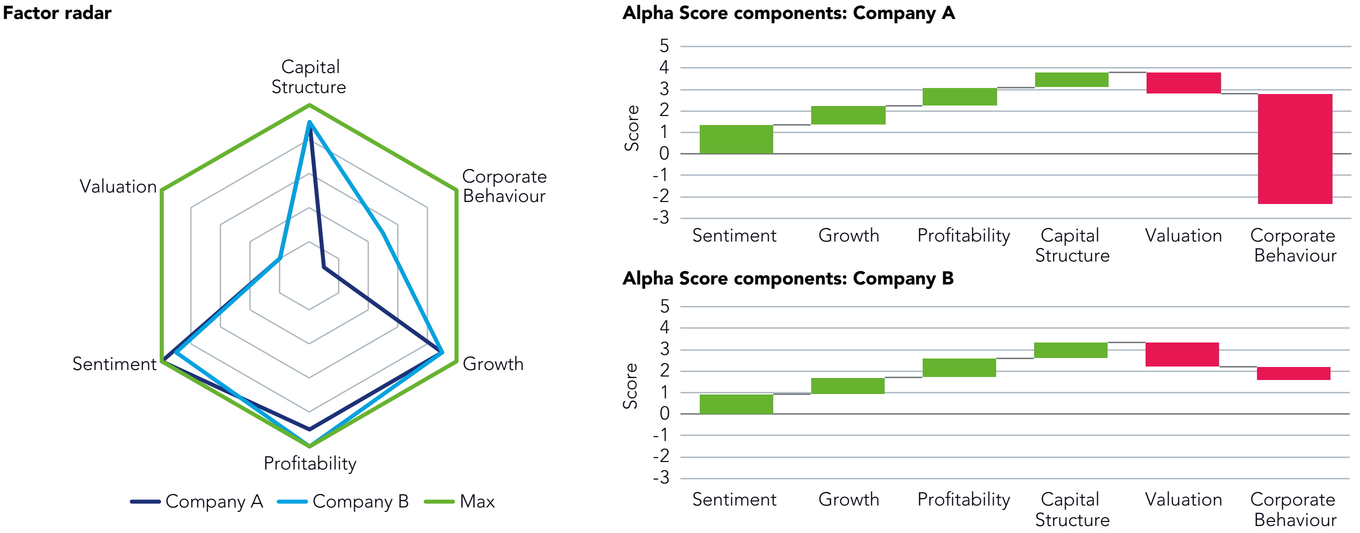


Figure 7: How poor ESG affects the Alpha Model assessment of a company

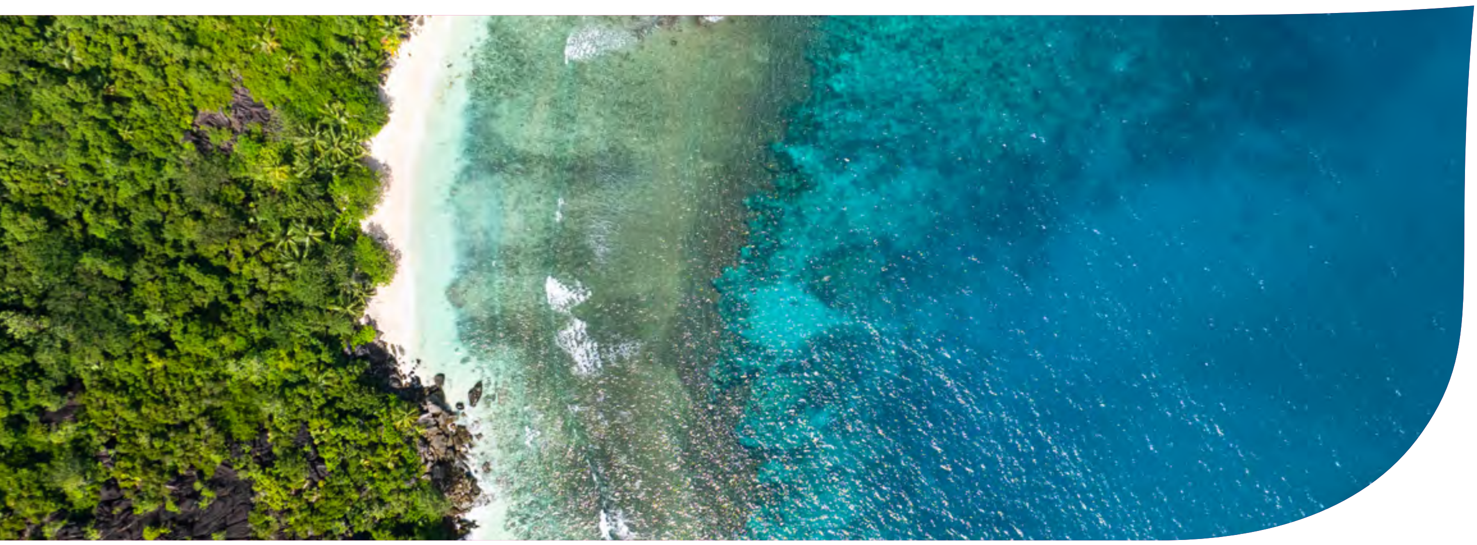


For illustrative purposes only.

In the example above, we have compared two companies that operate in similar areas and have similar fundamental characteristics, except for Corporate Behaviour in which each pillar of the QESG Score is included.

In this scenario, Company A has an extremely poor QG Score and is subject to material ESG controversies. The result is that Company A's QESG Score is ranked in the bottom decile since, in our view, it is exposed to unnecessary risks that are not faced by its peers.

To reflect the significant risk that Company A faces, the model performs a non-linear transformation on the Corporate Behaviour factor: the lower the score, the more heavily the company is penalised. In this example, the penalty leads Company A to have a negative overall Alpha Score and the model recommends Company B instead.



On the pathway to improvement

We believe that there is strong evidence for the value of both ESG integration and ESG engagement. Indeed, we see our engagement with companies as both a source of investment intelligence and a means of achieving positive impact at the company level with the intention of improving returns.

Engagement is an effective tool for investors to ensure that businesses are managed in a way that aligns with their long-term interests. It can mitigate risks and support resilience, helping companies identify opportunities for responsible growth.

CASE STUDY

AstraZeneca

In 2014, British-Swedish multinational pharmaceutical and biotechnology company AstraZeneca rejected Pfizer's overtures, which led EOS to open an objective into how shareholders should hold the board to account for the target of delivering US$45bn in revenues by 2023; the basis of its defence against Pfizer's bid.

At the time, the target seemed ambitious. Over the preceding years several blockbuster drugs had come off patent, while the low productivity of its research and development (R&D) activities had triggered a restructure whose effectiveness was as yet unknown.

EOS initially met with the company's Chair and CEO to gain reassurance into how it intended to achieve its target. The CEO emphasised that the success of the long-term strategy was underpinned by a highly collaborative and innovative atmosphere that would increase the size of its pipeline. Regular meetings were held with the company between 2015 and 2024, including the Chair, to ensure progress was being made.

The strategy was ultimately achieved in 2024 with the company successfully launching new treatments and expanding indications within existing products for treatments across a range of cancers as well as diabetes.

EOS also identified robust succession planning for both the CEO and Chair as being integral to the long-term success of the company, as well as the alignment of incentives with long-term revenue targets. The objectives surrounding succession planning were completed in 2023 for the Chair and in 2024 for the CEO, and we have also seen improvements in the company's bonus structure and disclosure on targets.

It's no exaggeration to say that this engagement has played a role in our continuing to hold a position over the past decade. The ability to measure progress and momentum through EOS's engagement milestones provided the team with crucial intelligence into how the company was progressing. Milestone progress and engager sentiment indicators provide a unique, forward-looking input into the QESG Score that is unavailable from standard ESG ratings.

In this case, the positive signals provided by the engagement, coupled with relatively high standards of ESG, supported a consistently high QESG Score. Moreover, the overall Alpha Score has improved over the years, driven in large part by Growth and Sentiment, as the company made progress and ultimately delivered on its targets.

Looking ahead, we will continue to engage with AstraZeneca on how it approaches its next growth phase: the company has announced another ambitious target of achieving US$80bn revenues by 2030. Focus will be on how the board governs this level of ambition, while ensuring the company's risk management practice remain grounded by a well-articulated culture and a robust approach to ethics.

Figure 8: AstraZeneca's engagement timeline

Source: Bloomberg as of 30 April 2025.

Identifying sustainable opportunities

Although there is a lot of "noise" around ESG, advocacy for access to health and nutrition and a stable, climate-resilient planet remains strong from a consumer and investor standpoint. This influences not only the way a company manages its business, but also the products and services it offers, which encompasses all corners of the economy.

Our approach is not explicitly concerned with "sustainability" in the way the investment community has come to use the word in recent years. Excluding the Energy sector or fossil fuels, for example, does not necessarily lead to a sustainable portfolio. This approach limits the ability to invest in companies with renewables revenues – some of which have fossil fuel exposure - which could fulfil a role in the energy transition, and fulfil our "pathway" criteria.

We are concerned with making sustainable investments in the true (dictionary) definition of the word sustainable. It forms part of our view of what good ESG looks like. After all, we are looking for companies that can withstand or benefit from the changes the planet and society is undergoing.

> **We view sustainable solutions as not being solely about the percentage of revenues aligned to products; the real economic impact in terms of volumes and monetary value is also important.**

In the examples below, we explore how companies thinking about sustainable solutions can find growth opportunities and deliver superior financial outcomes. It's also worth highlighting that we view sustainable solutions as not being solely about the percentage of revenues aligned to products; the real economic impact in terms of volumes and monetary value is also important.

Trane Technologies: Energy efficiency for the AI revolution

American-Irish domiciled company Trane Technologies is a leading provider of heating, ventilation & air conditioning (HVAC) and refrigeration systems. A key area of growth has come from the company's commercial HVAC division, which is benefiting from increased demand for more energy efficient cooling. This has been particularly important for energy-intensive data centres, which themselves have benefited from the extraordinary demand for increased computing power, driven by the AI revolution.

Trane Technologies' Alpha Score has improved significantly since the end of 2022; around the time that ChatGPT was launched. The improvement was driven by Sentiment, Profitability and Growth. Indeed, the Alpha Model now views it as a hyper growth company. This means that the company is profitable, has outstanding growth expectations and is loved by the market, demonstrated through price momentum and universally positive analyst recommendations. The company has also consistently scored well on the model's quality factors; Capital Structure and Corporate Behaviour.

BYD: Innovation driving market share; engagement insight provides clarity

Chinese company BYD is emerging as a major force in the electric vehicles (EV) industry as it benefits from its near decade-long foundation as a rechargeable battery manufacturer. The company has gained market share, experiencing strong domestic demand and is gaining traction overseas through highly competitive pricing and innovative products. These innovations include the development of a 1000kW charging system that can add 400km of range in five minutes and the provision of its "God's Eye" advanced driving system, that help improve road safety, as standard.

Over the past couple of years, the Alpha Model has consistently found the company to be attractive, driven by its exceptional growth, strong capital structure and, more recently, sentiment. It has, however, lagged global peers from an ESG perspective, but is broadly in line with its Chinese counterparts. That said, EOS have had several interactions with the company who also provide good access to the board, in contrast to many Chinese companies.

EOS's interactions revealed that the company had disposed of its e-cigarette business in 2024, although there had been no public announcement. The company also confirmed that key metrics in its ESG report had been independently assessed to improve the quality of the disclosure, in line with our recommendations. So, although the company does not have the strongest ESG profile, the disposal of its e-cigarettes business and the encouraging engagements ultimately enabled our investment in the company.

Intuitive Surgical: Improving outcomes for patients
American biotech company Intuitive Surgical is one of the pioneers of robotic-assisted surgery, and is best known for its Da Vinci machine that offers surgeons greater control and precision, which can lead to better outcomes for patients.

The company received FDA approval in March 2024 for its next generation 'da Vinci 5' system, which is expected to be fully launched in the middle of this year. The system has over 150 enhancements that include improved accuracy and precision, enhanced 3D imaging and force feedback technology. It has also been designed for a broader range of surgical procedures, helping the company retain its leading position in robotic surgery.

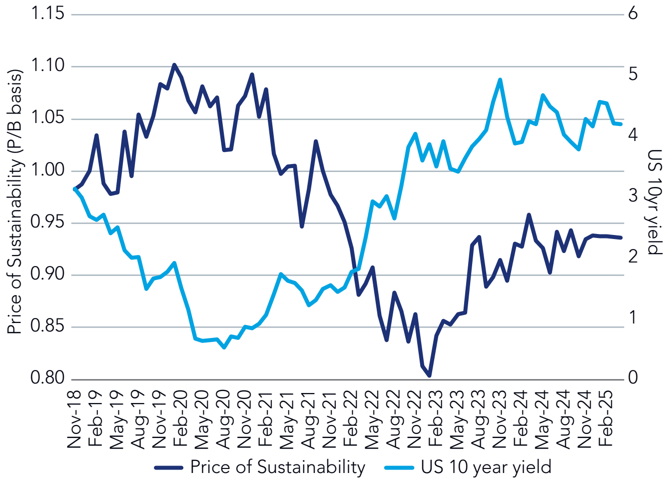
The new system has received very positive feedback within the industry, and Its leading position is reflected in its high growth score. The Alpha Model also shows that it is a quality company, reflected in strong capital structure, profitability and corporate behaviour scores. The company looks attractive from an ESG perspective too, particularly with regards to environmental and governance metrics. We would highlight that the company has a separation of roles for Chair and CEO, 100% of board directors own stock, and the company exemplifies good gender diversity with 45% of the board being female and above 80% being independents.

The price of sustainability

On a general level, sustainable companies have historically traded at a premium to the market due to the visibility they tend to offer from their exposure to long-term structural trends.

However, Figure 9 below, which shows the price-to-book ratio of companies in the investment universe with a positive Sustainable Opportunities Score, suggests that this cohort continue to be available at a discount. They also tend to correlate with growth factors, which is understandable when you consider the secular growth trends they are often exposed to.

Figure 9: Sustainability remains attractively valued



Source: Federated Hermes as of 30 April 2025. The price of sustainability as: (Average P/B of Quintile 1 SO score stocks) ÷ (Average P/B of Quintile 5 SO score stocks).

The Sustainable Opportunities Score is embedded within the QESG Score and measures the balance of ESG risks and opportunities a company is exposed to. The assessment covers sustainable revenues, EU Taxonomy alignment and engagement progress, which are counterbalanced by the consideration of negative product involvement and controversies. A positive score indicates that a company can be considered sustainable.

The portfolio tends to have a positive tilt towards sustainable companies, although given that another cornerstone of our philosophy is diversification, the tilt tends to be modest and spread across a variety of themes and sectors, reflecting our belief that sustainability affects all corners of the market.

The portfolio tends to have a positive tilt towards sustainable companies, although given that another cornerstone of our philosophy is diversification, the tilt tends to be modest

Conclusion

The best approach to integrating ESG within investment includes using a vast array of data inputs, but it takes experience to determine materiality and how the metrics should impact company valuations. Within portfolio construction, using ESG factors integrated into a model provides a systematic, disciplined way of taking ESG into account. It is also important to acknowledge that, qualitatively, it may be necessary to override the model either due to data quality or how a company is specifically responding to the most material ESG risks and opportunities it faces.

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Federated Hermes

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Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns and, where possible, to contribute to positive outcomes that benefit the wider world.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by five decades of experience
- **Private markets:** private equity, private credit, real estate and infrastructure
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