# Global Equity ESG: Introducing the next generation of the QESG score


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Federated Hermes
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## Philosophy and approach

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' at Federated Hermes Limited, our dedicated stewardship arm, allowing us to identify companies that we believe are improving their ESG behaviour – and hence unlocking value.

We supplement the EOS intelligence with a wide range of third-party ESG vendors – more than 10, including MSCI, Trucost and Sustainalytics – recognising the strengths and weaknesses of the various providers and the limitations of quantitative ESG data in general (For more on this, please read our evolution of ESG piece).

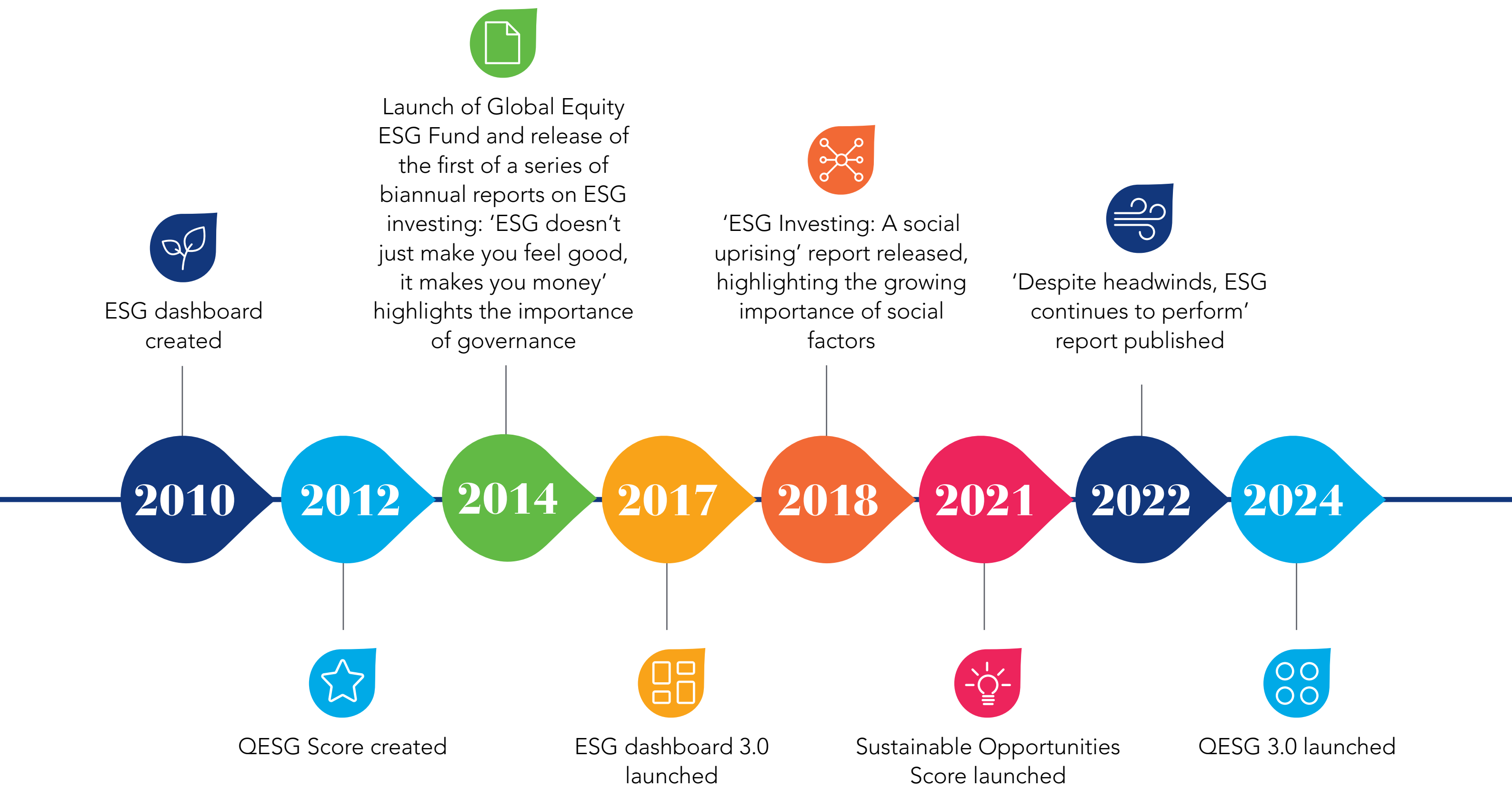
The resulting assessment of ESG – the QESG Score – is embedded directly within our stock selection model and is a crucial part of how we determine the expected return of investments.

**ESG Dashboard/ESG Portfolio Monitor/QESG Score:**
Proprietary tools used by our Global Equities team to capture a company's ESG profile.

## QESG 3.0: Building on over a decade of research into ESG integration

The Global Equities team has a history of innovation, whether providing bespoke solutions that meet client-specific needs, the continuous improvements in the Alpha Model, or our pioneering research into ESG which provides a strong foundation for the new QESG Score to build on.

**Figure 1:** A history of innovation



## What has changed?

The broader philosophy of the score remains the same, in that it remains vital to avoid the worst companies and identify those that are changing for the better. However, the availability of better and more granular data sources has enabled improvements in several key areas:

- New and better data enhances our ability to capture ESG issues and opportunities such as climate targets and gender equality. Additional data points, in particular from our internal Stewardship team enhance our forward looking assessment of companies.
- We consider a wider range of negative product exposures and apply differing levels of severity, with the penalty depending on both the severity of the issue and the proportion of revenue exposed. For example, involvement in coal mining would be more heavily penalised than involvement in natural gas. We also consider a much wider range of company policies and practices.
- Data used in the Sustainable Opportunities Score is now embedded directly into the QESG Score.
- Dynamic selection of metrics based on relevance and coverage within industry. As the data availability improves or as third-party providers increase coverage, the score will automatically pick up the metrics most relevant to an industry.
- The substantial improvement in ESG data and reporting has led us to reassess how we treat missing data.

## Separating the good, the bad, the ugly (and everything in between)

QESG 2.0 was good at separating the bad from the rest, but as the amount and quality of ESG disclosure has increased we are now able to produce more granular assessments of companies. In this new iteration, QESG 3.0, we favour continuous and multi-level categorical factors wherever possible, improving – or avoiding – some of the binary indicators used previously. For example, for many metrics the methodology assigns companies into one of five groups – quintiles which represent 'leaders', 'above average', 'average', 'below average' and 'laggards'. This provides more interesting distribution for comparing companies, but also allows us to place more emphasis on where ESG change has most impact. The score that we assign to a company that has moved out of the bottom ('laggards') quintile is greater than for a company that has moved from quintile 3 ('average') to quintile 2 ('above average'). In other words, an improvement from a lower level is likely to reduce risk to a greater degree and potentially unlock more significant shareholder value than if an already good or safe company improves.

> **QESG 2.0 was good at separating the bad from the rest, but as the amount and quality of ESG disclosure has increased we are now able to produce more granular assessments of companies.**

We have always used a similar approach with regard to controversies, which are considered on two dimensions: their severity and materiality. A severe controversy, such as a breach of the UN Global Compact Principles, would prompt an exponential penalty on the QESG Score, while lower-level controversies would have a considerably smaller impact. The effect of these controversies has been increased within QESG 3.0 to reflect some companies which have exposures to some of the very worst environmental or social abuses, balancing these material risks with a deluge of disclosure - this is not possible in the new scoring regime. Likewise, a company with a high number of low-level controversies would see an increased penalty based on the frequency of these issues. We have also enhanced the timeliness and importance of recent upgrades and downgrades.

> **An improvement from a lower level is likely to reduce risk to a greater degree and potentially unlock more significant shareholder value than if an already good or safe company improves.**

## A reworking of EOS-supplied information

The information provided by EOS is the most important and proprietary part of the QESG Score, and it is the information we rely on most heavily when considering a company's ESG trajectory.

In QESG 3.0 we have expanded the use of this data to include a shorter term 'engagement sentiment' assessment and a more granular assessment of the long-term progress a company is making against its engagement targets. As a result, we consider three distinct engagement signals within the score:

1. **Engaged indicator:** This indicates whether a company is engaged or not. Effectively, this demonstrates that EOS believe a company can make engagement progress, which provides a small boost to the overall QESG Score for engagement impact.
2. **Engagement score:** This assesses a company's engagement milestone progress over the past three years. More emphasis is placed on the recent success and more significant milestones achieved (i.e. completing an engagement is more valuable than acknowledging the existence of an issue). The speed in which the milestones are completed is also considered, with reference to the target timeframe supplied by the engager (typically three years).
3. **Engagement sentiment:** This is a direct input into the score from the engagers. It is a measure of how long a firm is taking to make progress on current milestone objectives compared to expectations and reflects the most recent meetings with a company (independent of whether there has been actual milestone progress).

### New data sources: Drawing on a variety of new data sources to assess emerging ESG themes

We have been able to increase the amount of data from MSCI and Sustainalytics that offer additional insight into how a company is managing its ESG risks.

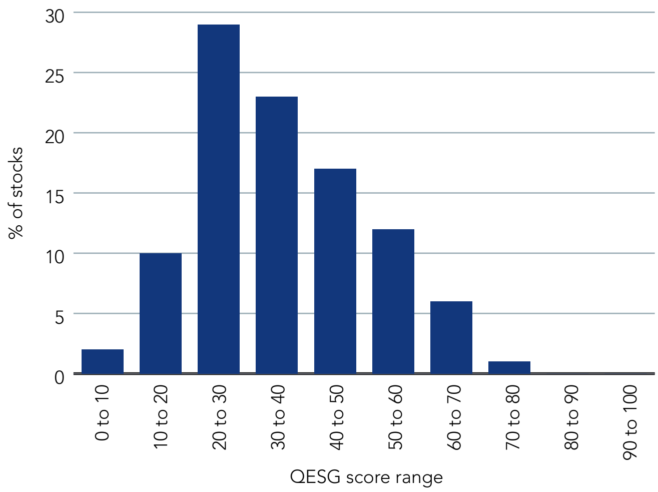
- **Theme-specific management scores:** These scores evaluate how well management prepare and deal with ESG risks, such as biodiversity and land-use management.
- **Business risk exposure:** This is similar to product involvement, but offers additional information, such as packaging waste.
- **Greenhouse gas (GHG) emissions targets flag:** This indicates whether a company has set emissions reduction targets and evaluates Scope 1, 2 & 3 targets independently.

There are also a range of other metrics that we have included, covering forest and water stress ratings, gender equality, ownership type and board independence.

## How have the changes influenced the QESG Score?

While the overall philosophy is not meaningfully changed, the new framework results in lower scores for most companies such that the new and old scores are not directly comparable. The changes result in a greater skew to the left, as seen in Figure 2. This is a result of the increased emphasis on penalising negative indicators, such as controversies and product involvement, among others.

**Figure 2:** The QESG Score (3.0) for MSCI ACWI

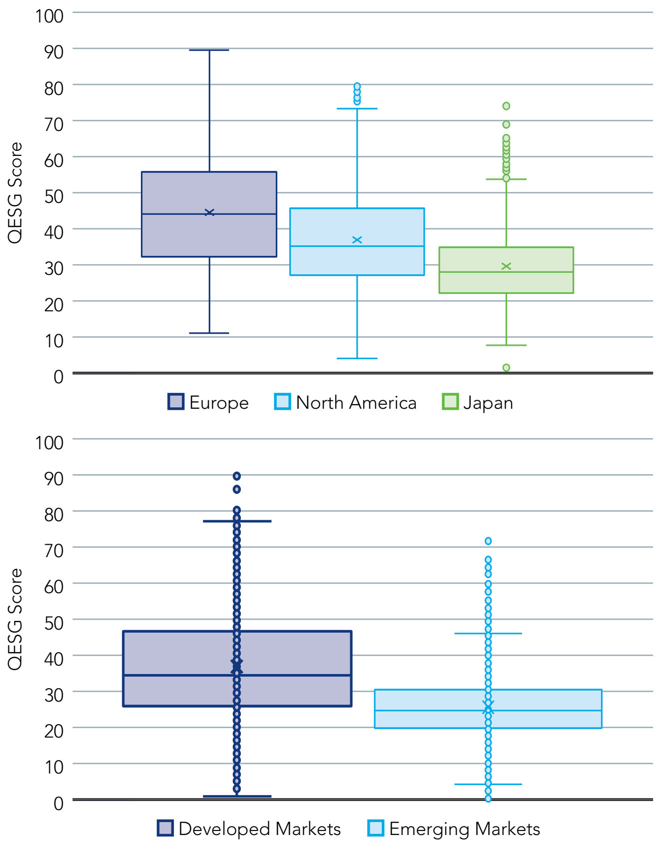



Source: Federated Hermes Limited as at 30 September 2024.

### Regional differences:

From a regional level, Europe continues to lead the way, followed by North America and Japan, reflecting the higher standards demanded by the regulatory environment in Europe. Unsurprisingly, Developed Markets continue to rank higher than Emerging Markets.

**Figure 3:** QESG Score Distribution for MSCI ACWI




Source: Federated Hermes Limited as at 30 September 2024.

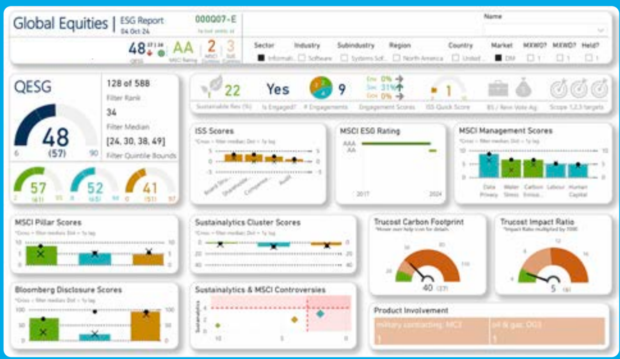
The move to the improved Score also means that metrics taken from our Sustainable Opportunities Score are 'baked into' the QESG Score. This enables the team to highlight companies that have good and improving ESG characteristics and also a favourable balance between the positive and negative influences a company has, taking into account double materiality for companies. This helps the team identify potential investment candidates that are driving the sustainable transition. We believe these companies have a structural growth advantage over peers and the higher QESG score for these names will help our portfolios to favour these more attractive opportunities.

Ultimately, QESG 3.0 offers a more robust, more dynamic assessment of ESG with more relevance for the industry in which a company operates. How a company manages its ESG risks continues to be of utmost importance, but it also gives more consideration to social and environmental opportunities that could help unearth a wider variety of potential investments.

# Enhancing the subjective overlay

While QESG 3.0 has enhanced how the model assesses ESG risks and opportunities, we have also taken the opportunity to revamp the ESG Dashboard. The overall subjective overlay process has stayed the same, but the new Dashboard has made our analysis of the inputs affecting the QESG Score more comprehensive.

## ESG Dashboard: Same aim, but more functionality




Source: Federated Hermes. For illustrative purposes only.

Similar to previous iterations, the new ESG Dashboard continues to provide a concise overview of a company's ESG profile across a variety of metrics, compared to peers. It helps direct the team towards areas that may need further investigation, such as controversies, product involvement or differences in ratings provider assessments, as part of our due diligence.

We are able to dynamically select the peer group, going from a 10,000ft view of the universe, down to the sub-industry and country level to understand the company's overall position and how it compares to its closest peers.

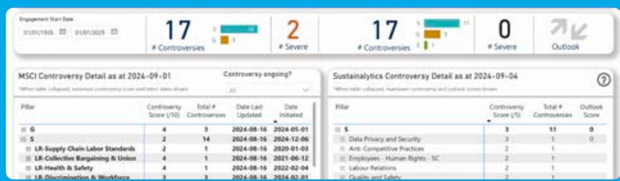
## Assessing the level and trend of the most pertinent ESG metrics


We can still scrutinise the ESG metrics to see how they compare to peers, but we can also view the longer-term trend of all of these metrics. This helps us more easily identify areas that may need further investigation or direct our engagement with a company.

## Decomposing the drivers of the QESG Score

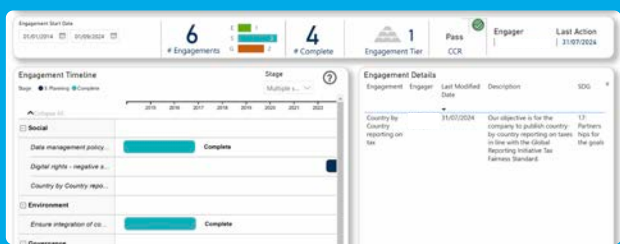

The ability to see which metrics are most important and how they drive the QESG Score for each company enables us to gain a more thorough understanding of the Score, particularly in terms of materiality.

## Controversy analysis



The new Dashboard also allows us to view the details behind the controversies identified by MSCI and Sustainalytics and drill-down into their respective analysis.

## Engagement progress and notes



The Dashboard provides an overview of historic and current EOS engagement activities. It provides information on where progress has been made, the duration of the engagement and the associated meeting notes, helping direct our conversations with the EOS engagers in our regular meetings.

QESG 3.0 builds on our pioneering ESG research over the past 15 years and demonstrates our continued desire to improve and enhance our models and investment process.

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