HERMES INVESTMENT MANAGEMENT

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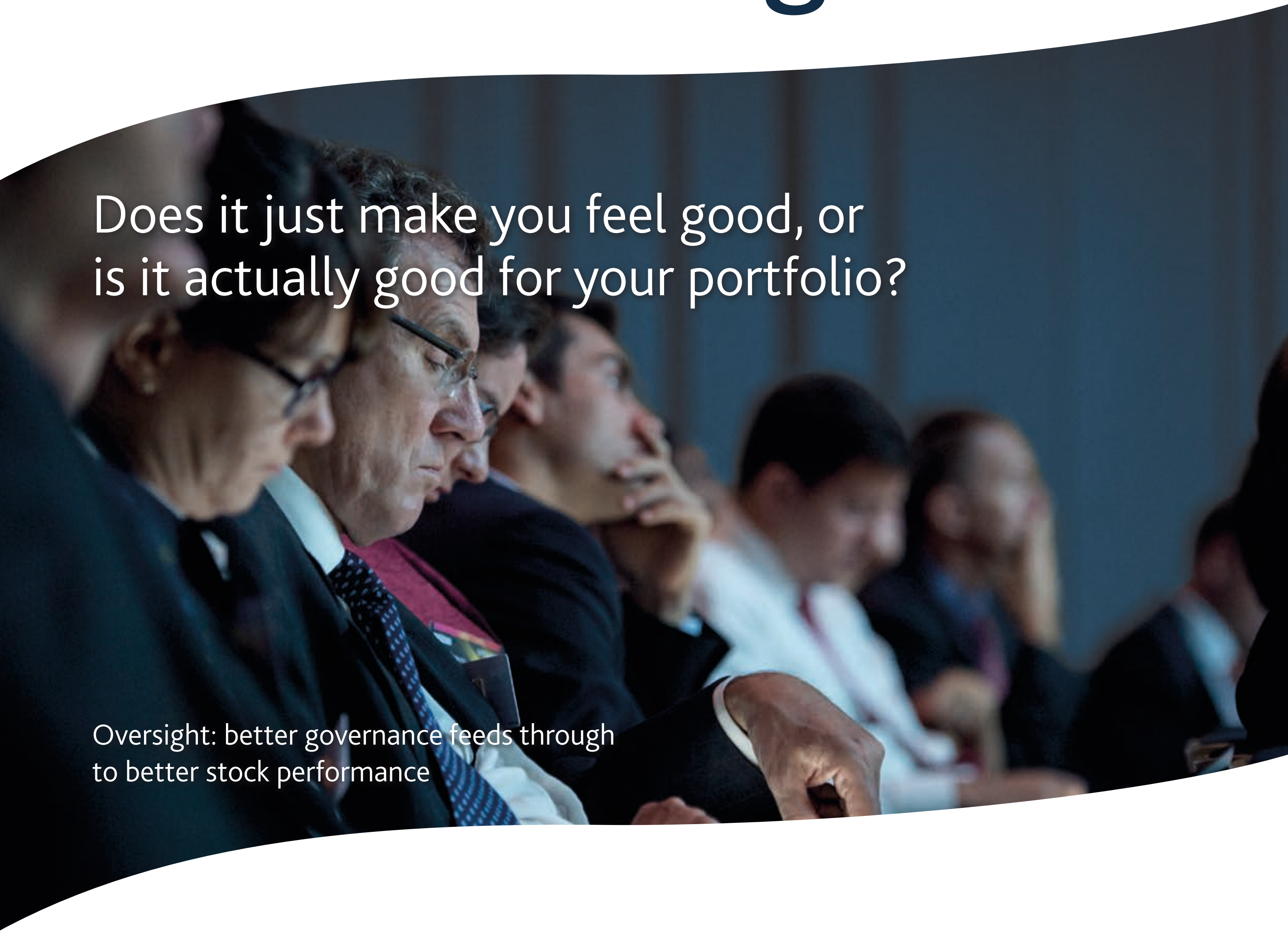
Thought Piece January 2014

Hermes Global Equites

ESG investing



Does it just make you feel good, or is it actually good for your portfolio?

Oversight: better governance feeds through to better stock performance

Introduction

Investing with consideration of environmental, social and corporate governance (ESG) criteria has increased significantly in recent years. However, for a long time, the perception of investors was that ESG-focussed investing detracts from investment performance. This perception is starting to change.

In this paper, we show that focussing on ESG factors can enhance returns. In particular, we show that well-governed companies have tended to outperform poorly governed companies by an average of over 30 basis points per month over the last five years. Capturing this consistent source of value can enhance the returns of equity strategies.

This note explains our testing methodology, a breakdown of the results and describes how we integrate ESG analysis into our investment process.

Well-governed companies have tended to outperform poorly governed companies by an average of over 30 basis points per month.

Reasons for ESG-focussed investing

ESG-focussed investing is going mainstream. In fact, recent surveys suggest that investors who think about ESG-related considerations now outnumber those who don't, and the reasons for doing so are changing:

- **Financial risk:** To mitigate financial risk and the impact on a company's share price should there be an ESG-related 'blow up'. For example, an oil company that has sub-standard environmental policies may be more prone to an oil spillage, leading to a sharp fall in its share price.
- **Reputational risk:** Concern that an organisation's brand would suffer by association with companies with poor ESG characteristics or who are involved in unethical business practices.
- **Moral obligation:** Some investors avoid companies with poor ESG characteristics, or favour companies with positive attributes, based on their own ethical beliefs. This often takes the form of an exclusions-based strategy that prohibits investment in certain companies according to mandated social or environmental goals.
- **Better returns:** Research is starting to quantify the potential performance benefits from ESG investing in addition to risk mitigation. This is the focus of this paper.

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Why ESG investing can be good for you

When studying the relationship between ESG risk and shareholder returns, the experience of our in-house corporate governance and shareholder engagement specialist, Hermes Equity Ownership Services (Hermes EOS), is a significant advantage.

We observed the behaviour of companies in relation to a large number of ESG metrics identified by Hermes EOS as the most important key performance indicators in each sector. We measured each company's current behaviour and – importantly – we measured how each company's behaviour changed. We believe it is crucial to identify not only companies who have favourable ESG characteristics but also to spot those companies who are improving their behaviour.[1]

We found that companies with favourable ESG characteristics have tended to outperform companies with negative characteristics, and this is driven by the governance metrics. The impact of environmental and social factors was negligible. This is shown clearly in Chart 1.

Unfortunately, despite increasing suggestions that companies seeking to tackle environmental and social challenges are more likely to achieve a lower cost of capital, better risk-adjusted returns and are therefore more resistant to share price volatility, we do not find evidence to support this assertion over this time period.

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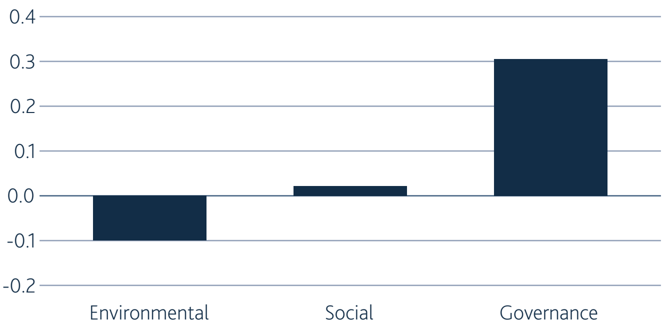
[1] We used internal sources (maintained as part of our voting and engagement records) as well as carefully-selected leading external providers such as Trucost, Sustainalytics, Bloomberg and FactSet. We analysed companies in the MSCI World index from the end of 2008 to the end of 2013.

Chart 1. 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 31 December 2008 to 31 December 2013

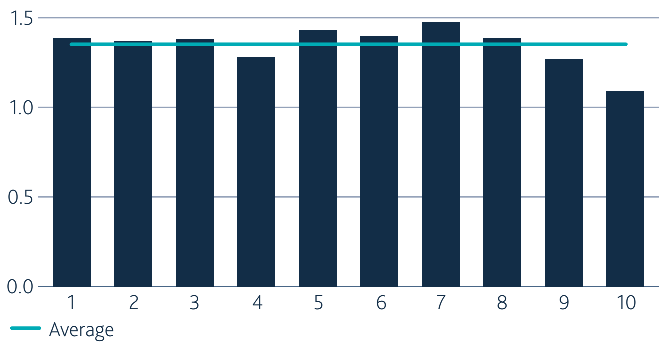
Source: Hermes Fund Managers

As can be seen in Chart 1, the average dispersion in total returns between companies rated in the top decile and those rated in the bottom decile in terms of governance is over 30bp per month.

It is not good governance that leads to outperformance, but poor governance that leads to underperformance.

Interestingly, we found that companies with the lowest-ranked governance scores have tended to underperform the average, as opposed to the higher-scoring companies outperforming, as shown in Chart 2. This suggests that it is not good governance that leads to outperformance, but poor governance that leads to underperformance.

Chart 2. The most poorly governed companies underperform the average company (%)



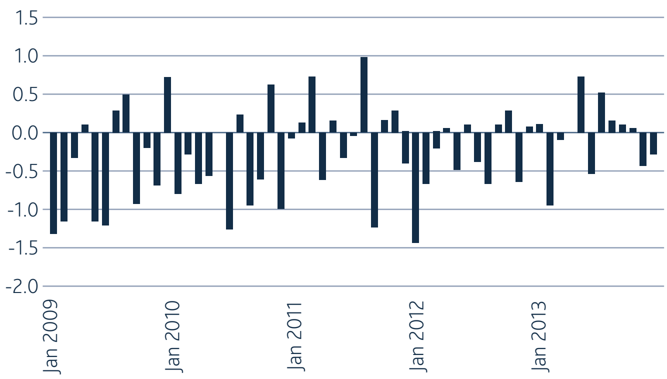
Average monthly performance of companies, split by decile, based on governance scores, from 31 December 2008 to 31 December 2013

Source: Hermes Fund Managers

Our research shows that companies with a poor standard of corporate governance underperformed in 62% of the months during the time period.

Furthermore, our research shows that companies with a poor standard of corporate governance underperformed in 62% of the months during the time period. This consistent underperformance is shown in Chart 3.

Chart 3. Poorly-governed companies have tended to underperform (%)



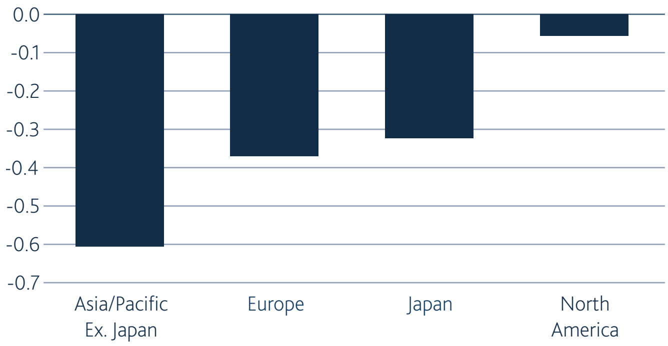
The monthly average return of stocks in the lowest governance decile relative to the average return of companies in the MSCI World , from 31 December 2008 to 31 December 2013

Source: Hermes Fund Managers

A key finding was the ineffectiveness of using governance as an indicator of shareholder returns in North America.

The difference in returns relating to governance scores between regions and sectors is also worth highlighting. A key finding was the ineffectiveness of using governance as an indicator of shareholder returns in North America. These markets are subject to more robust regulation than others, and companies are at higher risk of litigation, which we believe has led to a generally better standard of governance across companies (although there are some notable exceptions). Governance was particularly useful in identifying underperforming companies elsewhere, as shown in Chart 4.

Chart 4: Relative returns of the most poorly governed companies by region (%)



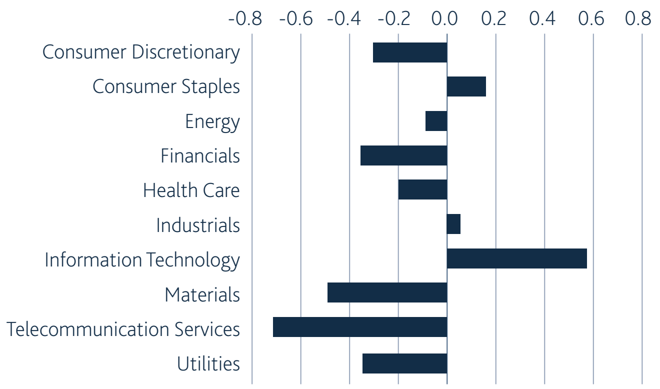
The average monthly return of stocks in the lowest governance decile relative to the return of companies in the MSCI World , from 31 December 2008 to 31 December 2013

Source: Hermes Fund Managers

This distortion in returns is also apparent by sector. Chart 5 reveals how for IT companies there appears to be a negative relationship between governance scores and shareholder returns. The IT sector is dominated by a small number of companies whose performance over the past five years has been stellar despite a lower focus on their governance structure.

For IT companies there appears to be a negative relationship between governance scores and shareholder returns.

Chart 5: Relative returns of the most poorly governed companies by sector (%)



The average monthly return of stocks in the lowest governance decile relative to the return of companies in the MSCI World , from 31 December 2008 to 31 December 2013

Source: Hermes Fund Managers

ESG Scoring Methodology

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 the variables indicating how ESG practice changes). The test was conducted using monthly rebalancing, to match the greatest frequency at which the data set is updated.

Importantly, we observed change in behaviour as well as current exposure to ESG risks, believing that companies which are actively improving governance, or actively reducing use of scarce resources are likely to generate better shareholder returns.

ESG risk factors that we used in the research included:

Environmental factors	Social factors	Governance factors
Carbon footprint	Human rights	Board independence
Water usage	Controversial products	Poison pills
Waste management	Employee turnover	Remuneration
Pollution	UN Global Compact signatory	Independent directors
Litigation	Fatalities	Combined CEO/ Chair role
Impact Ratio		Risk management Business ethics Proxy voting

Conclusion

There has been a strong link between underperforming companies and poor corporate governance. We did not see either a statistically significant relationship between shareholder return and environmental or social metrics. As more data becomes available, and more asset owners focus on environmental or social considerations, this may change. For now, we conclude that favouring well-governed companies can enhance the return of equity strategies.

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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 a large team within Hermes EOS who advise on proxy votes and engage companies about ESG risks that concern shareholders.

With their help, we have developed a number of tools for assessing ESG risks within companies and then monitoring a portfolio's ongoing exposure to these risks: the **ESG Dashboard**, a system for collating the most important ESG measures for each company; the **QESG Score**, a proprietary rating measuring ESG risk and changing practices of companies; and the **Portfolio ESG Monitor**, which summarises risks across a portfolio. All of these are explained more fully below.

- 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 much of 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 towards governance factors, which, as shown, 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 exposures. It reports on 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 on any equity strategy. They are used by Hermes Global Equities to integrate ESG considerations into its core global equity and exclusions-based ESG strategies. The QESG Score plays an important role in identifying stocks with positive or improving ESG characteristics for inclusion in the team's best-in-class strategy, launched in May 2013.

Impressed by the results discussed in this paper, the team now integrates governance metrics into its analysis of company quality for all strategies, whether labelled ESG or not. This metric, included in the team's assessment of Corporate Behaviour within the stock-selection model, is combined with measures of valuation, sentiment and growth to produce diversified portfolios that are designed to outperform in any market environment.

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:

Alternatives
Commodities, Hedge Fund Solutions, Infrastructure and Private Equity

Equities
Asia, Emerging Markets, Europe, Global and Small & Mid Cap

Fixed Income
Global High Yield Bonds, Multi Strategy Credit, UK Government Bonds and UK & Global Inflation-Linked Bonds

Real Estate
International Real Estate, Pooled Funds, Segregated Mandates, UK Real Estate and UK Real Estate Debt

Responsible Investment Services
Corporate Engagement, Intelligent Voting, Public Policy Engagement and PRI

Offices
London | New York | Singapore | Sydney

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
Partnering with clients, we set risk limits, universes and benchmarks, and investment characteristics such as dividend yield and volatility thresholds to meet their defined needs.

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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