Global Equity ESG marks six-year anniversary

Take Note, May 2019
Hermes Global Equities

Six years ago, we launched our Global Equity ESG strategy. The aim was simple: achieve capital appreciation by investing in global equity securities with favourable ESG credentials. Today, we assess how it has achieved this objective since inception.

Lewis Grant
Senior Portfolio Manager

Louise Dudley
Portfolio Manager

Since the inception of our Global Equity ESG strategy in May 2013, we have adopted a disciplined investment process with environmental, social and governance (ESG) factors at its core – and along the way, we've proved that doing so provides more than just a 'feel-good factor': it can improve returns.

Building on strong foundations

From the outset, we have employed the core investment process of the Hermes Global Equity strategy, which was launched following the team's inception in 2007 – long before ESG investing had entered the mainstream.

This process combines a quantitative assessment with a qualitative assessment and active ownership of positions through our responsible investment and engagement specialists, Hermes EOS (for more information about our investment process, see our H1 2019 Equitorial newsletter).

Stocks with the most attractive combinations of fundamental and ESG characteristics are selected for a portfolio that aims to maximise expected risk-adjusted returns. Companies with a good or improving ESG track record are favoured.

Identifying positive change

We gather our insights from a number of proprietary tools – and they have also evolved since May 2013. For example, we have updated the methodology used by our bespoke analytical tool, the ESG Dashboard, to reflect developments within ESG investing and the availability of more information. We now use research from more than 10 different data vendors, which allows us to strengthen our conviction when assessing specific practices. Alongside this research, we draw on the unique insights of Hermes EOS, which advises on proxy votes and engages company directors and executives about ESG risks that concern shareholders. Their insights help us identify companies that are undergoing a real improvement – or deterioration – in their ESG metrics (For more information, read about our ESG Dashboard and the improvements made to it in January 2018).

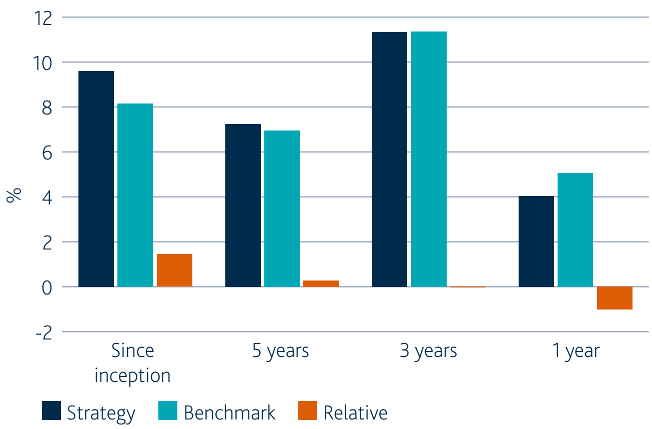
Our bespoke tools together with best-of-breed ESG intelligence from Hermes EOS has helped us generate robust performance over the past six years.

A long-term focus

Our strategy has a long-term focus and since inception in May 2013, it has delivered net returns of 9.61%, compared to 8.16% for the benchmark MSCI ACWI index.

Figure 1: Global Equity ESG net returns since inception

Annualised return v benchmark since inception in US dollars (%, net returns)



Rolling performance (net)

Strategy	31/04/18 to 31/04/19	31/04/17 to 31/04/18	31/04/16 to 31/04/17	31/04/15 to 31/04/16	31/04/14 to 31/04/15
	4.04%	15.13%	15.21%	-6.26%	9.65%

Source: Hermes as at 30 April 2019. Performance shown is in USD net of all costs and management fees.

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. Any investments overseas may be affected by currency exchange rates. Past performance is not a reliable indicator of future results and targets are not guaranteed.

Listen to Lewis and Louise reflect on the past six years

In our latest episode of *Amplified*, we join Lewis and Louise during one of their weekly catch-ups at our head office as they reflect on how the investment landscape has changed since the launch of the Global Equity ESG strategy six years ago.

Louise says: "The people at the top end of the financial food-chain have started to articulate how some climate-related financial risks should be taken into account, including scenario testing, thinking about green terminology and frameworks."

Click here to listen

Reeling in the years: ESG performers

Looking back over the past six years, there are a number of examples of ESG performers. Here is a sample:

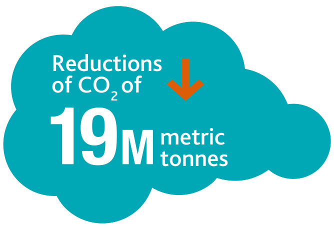
Siemens Gamesa

We have held this company since the strategy's inception in May 2013. Originally, we were invested in Gamesa Corp, which subsequently merged with Siemens Wind to create one of the world's largest wind turbine manufacturers.

Wind power is a major force in the transition towards global sustainability and the delivery of the UN Sustainable Development Goals (SDGs) – and here Siemens Gamesa plays an important role.

Since the merger, the company has faced elevated governance risks and there has been a change in management. Nevertheless, we continue to see the investment as attractive given its strong growth potential in emerging markets such as China, Brazil and India.

In 2018, the new wind power capacity installed by Siemens Gamesa (7,434MW) resulted in CO_2 reductions of 19m metric tons when compared to conventional fossil-based energy production sources[1]. In addition, it has committed to reaching carbon neutrality by 2025.

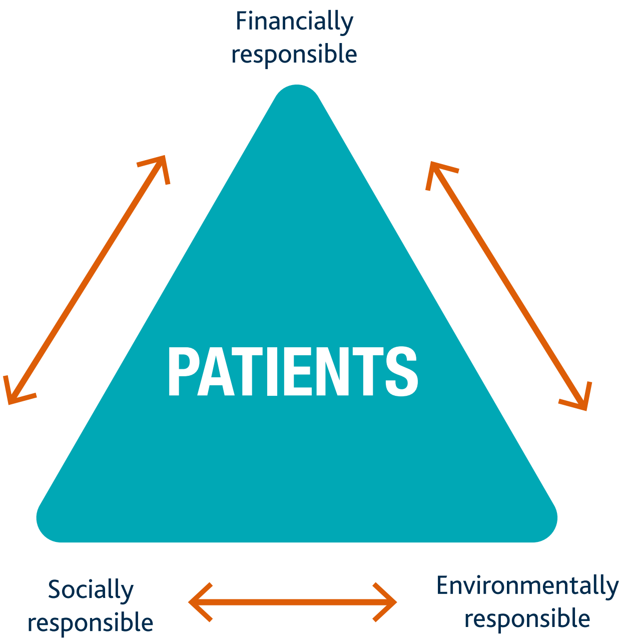


Novo Nordisk

Danish healthcare group Novo Nordisk is uniquely positioned to take a leading role in the fight against diabetes. It focuses on diabetes care, offers insulin delivery systems and other products.

Together with its sustainable product offering, the company also employs sustainable business practices: it exhibits strong business ethics and maintains a compressive 'Access to Medicine' programme to ensure its products are available to those living with diabetes that would otherwise be unable to afford treatment. In addition, Novo Nordisk is guided by its Triple Bottom Line principle of financially, socially and environmentally responsible business and its performance across the Triple Bottom Line has been added to the company's Articles of Association.

Figure 2: Novo Nordisk's Triple Bottom Line



Source: Novo Nordisk as at May 2019.

Orsted

In 2016, our participation in Orsted's (formerly DONG Energy) IPO elicited surprise due to the company's exposure to oil, gas and coal-fired power plants. However, Orsted is perhaps the investment that most easily demonstrates the strategy's desire to find companies that are increasing their focus on sustainability.

Orsted has since divested its oil and gas business and made a commitment to reduce its coal consumption to zero by 2023. Today, it is a global leader in offshore wind farms. Since its IPO, shares have doubled in price as investors have realised the power of the company's transformation. In addition, the company has made a commitment to operate in a way that creates progress towards the UN SDGs

[1] Siemens Gamesa as at 31 December 2018.

Delta Air Lines

An airline may seem an unusual choice for an ESG strategy: the high emissions of the industry will inevitably lead to increased costs for airlines through taxes and fleet replacement. However, global travel is an integral part of modern society and demand will remain strong.

Airlines that demonstrate a commitment to responsibility are more likely to be prepared for these future industry-wide disruptions.

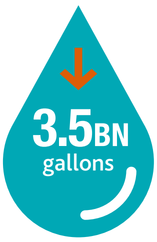
Delta has an ageing fleet, which will need to be updated. But the company has committed to emission-reduction targets and recognises the importance of climate change, receiving a level four rating (the highest level) in a recent Transition Pathway Initiative analysis. The company was the first US airline to offer carbon offsets to customers. Since 2005, Delta's fuel-saving efforts have contributed to a 13.3% reduction in absolute emissions since 2005, putting the company on track to meet its goal of reducing emissions by 50% over 2005 levels by 2050[2].

In addition, it has been prominent in fighting human trafficking: this is a company that continues to lead peers on sustainability issues.

American Water Works

US water utility company American Water Works has very transparent earnings growth. It has proven to be a successful investment as investors have sought safe yield and the regulated water business has offered a steady source of reliable growth.

As a water utility, the company's revenue is generated by addressing SDG 6 Clean Water and Sanitation, making this a very attractive thematic sustainability investment. It is reducing annual water use by 3.5bn gallons through conservation every year, while it is recycling over 1bn gallons of water annually and producing reuse water at 30 facilities[3].



In addition, the company has good governance. Its continued infrastructure upgrades have resulted in a relatively better performance than its peers, with lower carbon emissions intensity and water leakage rates.

Kurita Water Industries

We recently took a position in Japanese firm Kurita Water Industries, which produces water treatment and purification systems and chemicals. We consider it a high-quality investment that trades at an attractive valuation.

The company mainly targets industrial customers, helping businesses reduce the amount of water they use as well as neutralise, reclaim and/or reuse wastewater. It is growing globally through acquisitions, yet it retains defensive characteristics thanks to its cash-rich balance sheet.

Gaztransport Et Technigaz

Another new holding of ours is Gaztransport Et Technigaz. Its structural growth opportunity emanates from concerns over climate change.

On a broad level, LNG is a key fuel that will help the planet transition to cleaner energy sources. It is estimated that this transition will see demand for LNG grow by 65% to 2040, partly driven by the substitution of coal as a source of energy.

Regulation will also create a further growth opportunity, which has yet to be recognised in market forecasts. More challenging shipping regulations have been brought into effect by the International Maritime Organisation that aim to reduce the amount of Sulphur and Nitrous Oxide deposited in the atmosphere from emissions. In turn, this will reduce Sulphur Oxide emissions by 99.9%, Nitrous Oxide by 85% and Carbon Dioxide by 25%, making LNG the only viable alternative that will ensure new ships adhere to these regulations. In order to meet these new requirements, ships will need to be fitted with a membrane, known as 'LNG Bunkering', to ensure the LNG does not contact the ship's hull. The company's membrane technology forms an impermeable lining that prevents such contact and uses the space more efficiently than other solutions, which is particularly important for cargo ships.

Furthermore, as LNG becomes more widely used demand for more storage and refuelling infrastructure will increase, thereby benefitting the company. As yet, this opportunity is not reflected in any market forecasts, which assumes zero growth for the company. However, the improving outlook for LNG demand and fast-growing spot market alone provide ample evidence that forecasts are too conservative.

[2] "Tons of ways Delta makes the world a better place," published by Delta in September 2018.
[3] American Water accessed data in May 2019.

Engagement progress

Our engagements – which we undertake alongside our colleagues in Hermes EOS – are focused on providing both improved long-term financial returns on investment and fostering better, more sustainable outcomes for the society and environment for the future – that's what we call holistic returns.

Good governance and strategy provide a foundation for us to engage effectively with our portfolio companies so as to achieve ambitious improvements on their most material environmental and social issues. Through our engagements, we aim to help companies achieve long-term outcomes, such as:

- ensuring strategies and actions are aligned to the goals of the Paris Agreement to limit global warming to well below 2°C (ideally to 1.5°C);
- building a circular economy to achieve sustainable levels of consumption and ensure accessible and affordable food, clean water and critical natural resources; and
- controlling pollution of air, land and water to below harmful levels for humans and other living organisms.

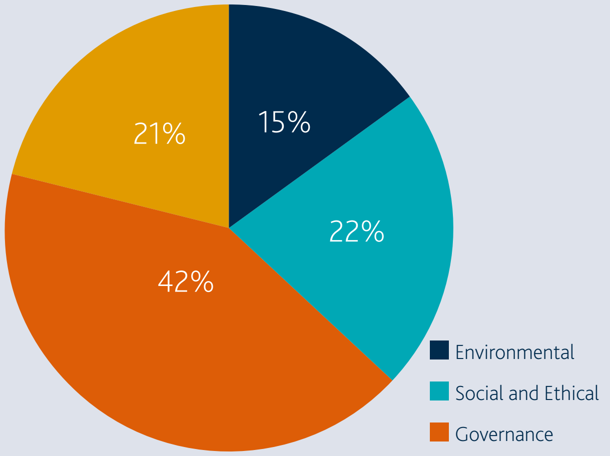
It's not just meaningful market engagement that constitutes active ownership, it also includes considered voting on all shareholdings in support of stewardship objectives and working collectively in support of shared objectives, including the SDGs.

In 2018, we engaged on 202 objectives and issues with our portfolio companies, making progress on 55 engagement objectives[4].

Climate change is a dominant engagement theme within our portfolio, and in Q1 2019 we made progress with two portfolio companies on the issue of encouraging them to implement the TCFD recommendations – that is, disclose climate-related financial information as part of their reporting process.

What's more, the carbon footprint of our portfolio is 22% lower than the benchmark index, while 27% of the portfolio (by weight) has exposure to environmental themes linked to the SDGs[5].

Figure 3: Engagement objectives and issues by theme (2018)



Source: Hermes Investment Management as at 31 December 2018, covering the previous 12 months.

The value of ESG

Over the past six years, we have also maintained a particular focus on our ESG investing research, publishing *ESG investing: does it just make you feel good, or is it actually good for your portfolio?* in 2014 and *ESG investing: it sill makes you feel good, it still makes you money* in 2016.

Last year, we published our latest study: it analysed correlations between companies with high ESG scores and shareholder returns since 2009. This paper, ESG investing: a social uprising, reinforced our earlier finding of a robust link between underperforming firms and poor governance. However, this had weakened since 2016, reflecting the narrow leadership of the US stock market, which has been dominated by the FAANGs in recent times. Contrary to our previous study, social factors now qualify as statistically significant. This justifies our decision to integrate ESG factors into the strategy's idea generation since its inception – and we continue to enhance how we measure our performance on ESG including using individual metrics and broader overall risk frameworks.

[4] Hermes Investment Management as at 31 December 2018.
[5] Hermes Investment Management as at 31 December 2018.

A proven track record

Our disciplined approach to investing in global equity securities with favourable ESG credentials as well as our continued research in this space has driven our strong performance in our Global Equity ESG strategy since its inception.

By combining quantitative tools with a qualitative assessment and active ownership of positions through Hermes EOS, we will continue to identify companies with good or an improving ESG track record, creating an optimised portfolio that aims to maximise risk-adjusted returns for our investors as we have done in the past six years.

- Past performance is not a reliable guide to future performance
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HERMES INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit
Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

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