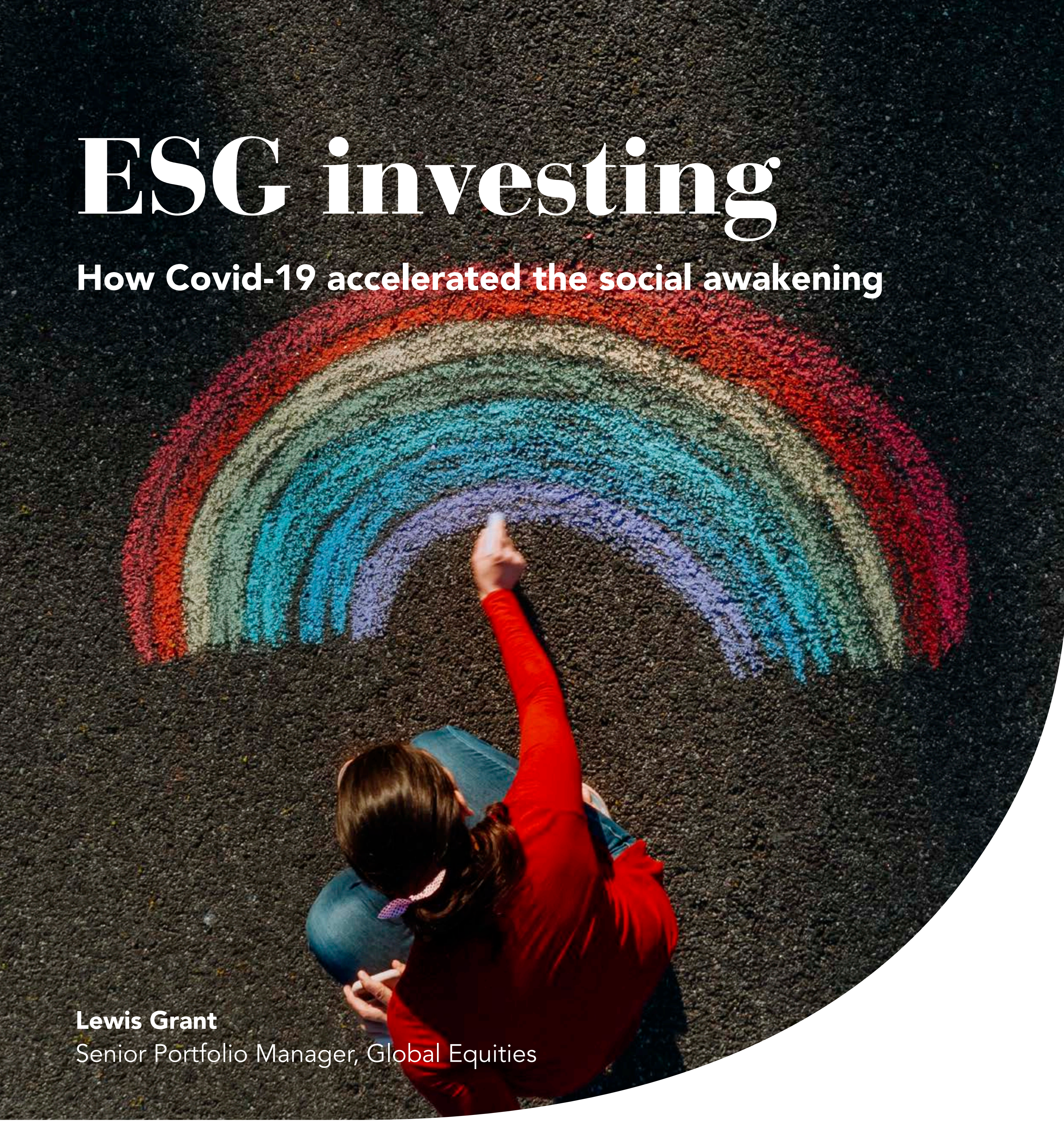
ESG investing

How Covid-19 accelerated the social awakening



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Investment commentary, Q4 2020

Federated Hermes
International

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Key points:

- The strength of social: companies with good or improving social practices can potentially add up to 17bps each month to returns – up from 15bps in 2018.
- The qualities that mattered during the coronavirus-induced market crash in March were strong balance sheets and operational efficiency.
- Integrating sustainability factors into investment decisions requires a long-term mindset.
- Social metrics have become increasingly important for hyper-growth names: companies with more social awareness than their peers have tended to outperform.

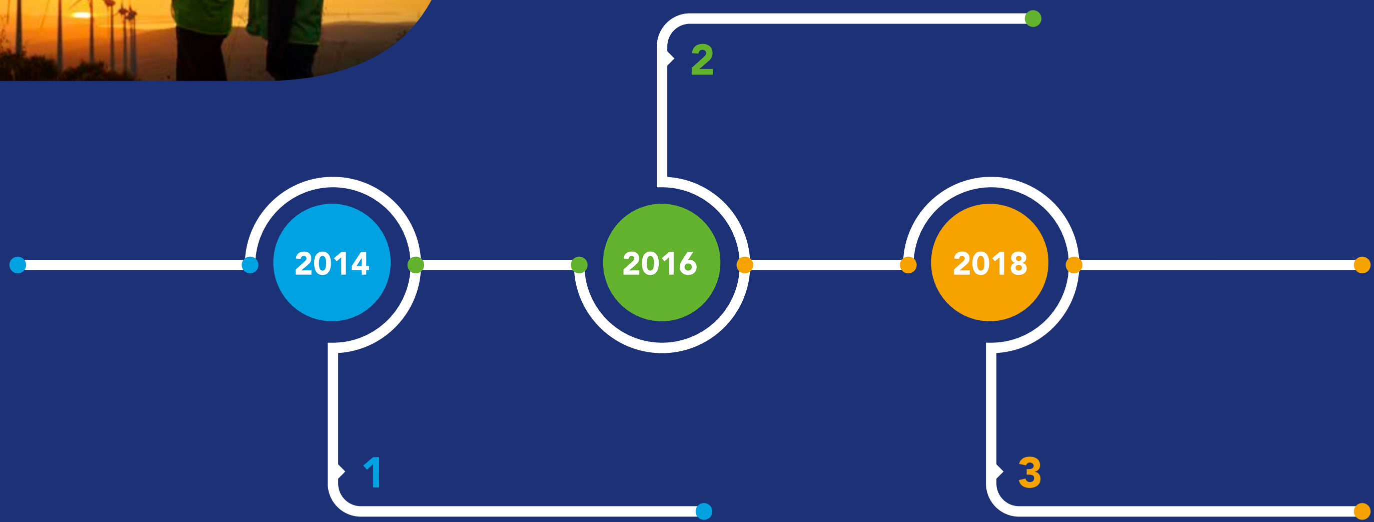
ESG is in our DNA

Since first engaging for stronger UK corporate governance in 1983, to becoming a founding signatory of the Principles for Responsible Investment in 2006, to spearheading the global 2017 Climate Action 100+, we have always shaped the conversation on investment and sustainability.

For us, investment outperformance should also seek to generate positive outcomes in the world – and so, since our inception, we have pioneered global stewardship and developed innovative environmental, social and governance (ESG) strategies. To ensure investing sustainably is our past, present and future, we use our innovations and expertise to research, verify and advance best practices.

In 2014, to determine if ESG made a difference to shareholder returns, we analysed five years' worth of data. In doing so, we proved that ESG investing is more than just a feel-good phenomenon. Since then, we have continued to monitor how ESG factors impact shareholder returns – and every two years, we publish an intellectually honest assessment of the ESG investing environment (see figure 1).

Figure 1. We've proven that ESG is more than a feel-good phenomenon



Our inaugural study, ESG investing: does it just make you feel good, or is it actually good for your portfolio?, unearthed a strong correlation between corporate responsibility and shareholder returns. It found that companies with poor governance practices consistently under-performed their peers by up to 30bps each month.

In our subsequent study, ESG investing: it still makes you feel good, it still makes you money, we found that the 30bps governance premium held true across different geographies and sectors, proving the widespread power of effective corporate governance.

In our third investigation, ESG investing: a social uprising, we found that companies with good or improving governance can add 24bps each month to returns, while positive social factors added 15bps to returns across Europe and Asia.

Source: Federated Hermes, as at November 2020.

So far, our research has found that both social and governance factors are statistically significant, allowing us to further integrate sustainability into our investment portfolios. But since we published our last research paper in 2018, the world has changed dramatically.

While the number of investment and sustainability practitioners has continued to rise significantly, equity markets have been driven by growth stocks, big companies becoming even bigger and, more recently, by the coronavirus pandemic, global lockdowns and the trend towards remote working.

Today, we revisit our study, updating our results to examine how ESG factors have behaved during this period of market tumult. We also consider the interplay between growth and sustainability.

A global wake-up call

From the coronavirus pandemic to the climate emergency, social injustice and political tumult, today the world is in turmoil. Against this backdrop, capital markets are in the midst of a sea change.

In our 2018 study, we contended that ESG investing had transformed from a niche to a mainstream activity. Since then, the trend towards sustainability and investment has accelerated: this year the UN-backed Principles for Responsible Investment (PRI) welcomed its 500th signatory and the total assets it represents exceeded $100tn. That compares to 63 investment companies with $6.5tn in assets under management at the PRI's 2006 inception.

Public awareness of sustainability has also continued to grow, with Greta Thunberg's meteoric rise from schoolgirl to global activist bringing the climate emergency to the mainstream news. Climate protests are now commonplace (and well attended) across the globe. However, the coronavirus pandemic has prevented the Fridays for Future movement that Thunberg inspired from holding large weekly gatherings for much of 2020.

That said, the urgency of the climate crisis has not diminished: from extensive fires across California, Australia and in the Amazon to cyclones in Mozambique and Typhoons in Japan, the world has experienced extreme weather events this year. 2020 is projected to become one of the five hottest years on record.[1] The effects of climate change are not waiting for some far-flung future, we are experiencing them right now.

Indeed, these climate-related disasters disproportionately hit the poorest and most vulnerable parts of society. Reassuringly, the climate protests have stoked support from sections of society who are not in direct, imminent danger but who are willing to offer their time and resources to try to a make a change for the better, for all.

This social awakening extends beyond the climate crisis: we are all more aware of the social impact of where we, and our choices, fit in our communities, as well as the companies in which we invest. For example, the Black Lives Matter movement has shone a light on the long-standing systemic racism which many people have failed to acknowledge or address. Much of society is recognising that actively contributing to discrimination is not the only way to perpetuate the issue: we all need to actively challenge injustices and ask difficult questions about our own privileges and inherent unconscious biases.

Meanwhile, the coronavirus and the imposition of lockdown restrictions across the globe have changed the way people live and work. Tales of shop shelves being emptied by panic buyers attracted criticism, but the pandemic has also brought out the best in people: many communities are working together to protect vulnerable members of society from the virus and the challenges of lockdown. Companies, too, have been asked to consider the welfare of their employees and customers in ways unimaginable just a year ago. For example, banks are faced with widespread economic damage owing to the pandemic – and so, they are questioning how to balance the needs of shareholders with those of society. Against this backdrop, banks need to redefine their purpose from a social perspective.

These considerations – the climate crisis, the Black Lives Matter movement and the pandemic – have concentrated investors' minds and, as they have integrated them into their investment decision-making, more companies have been challenged for their substandard behaviour. Engagement and stewardship have become an integral part of the investor toolkit. Today, shareholder resolutions challenging the world's top polluters are proving successful in awakening companies, and investor initiatives, such as Climate Action 100+[2], are bringing asset owners together to effect real change.

Nevertheless, companies are still making missteps and the ESG investing landscape continues to evolve to improve foresight. The recent accounting scandal that engulfed a German payments group and the wave of negative publicity about working conditions at a UK online fast fashion retailer demonstrate that even with an increased focus on governance and social behaviour and the availability of more data, some scandals will slip through. And although ESG investing has gone mainstream, it is unable to stop or spot all misdeeds.

[1] "Global Annual Temperature Rankings Outlook," published by the National Centers for Environmental Information in March 2020.
[2] Climate Action 100+ is an investor initiative launched in 2017 to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change.

Our approach to ESG investing

Before we delve into the results of our latest study, it is important to revisit our approach to ESG investing.

Since we published our 2018 report, the lack of standardisation in reporting and data on ESG matters remains an issue in the investment industry. Ratings providers continue to use companies' sustainability reports as an information source and, as such, they are reliant on voluntary disclosures from companies.

At the international business of Federated Hermes, we believe there is no leading source of ESG data. We obtain research from 10 different data vendors, including Sustainalytics, Trucost, Bloomberg, MSCI, FactSet, ISS and CDP. This enables us to strengthen our conviction when assessing specific ESG practices. We also draw on insights from EOS at Federated Hermes (EOS), our stewardship team. EOS advises on proxy votes and engages companies on investors' long-term interests in a constructive way, cultivating relationships at the board and executive level to drive change.

We assess a company's ESG profile relative to its geographic location and the industry in which it operates. We also use forward-looking metrics. This provides a view of both current and future ESG risks. By assessing a company's ESG profile in this way, it helps us identify whether it is undergoing a real improvement or deterioration in its ESG metrics.

In addition, understanding the materiality of a company's ESG risks is an imperative. Some risks are deemed so severe, such as the use of child labour in the supply chain, that they completely cancel out sound ESG corporate practices, such as a strong remuneration policy or low carbon emissions.

Together, these principles helped us to construct our proprietary ESG ranking, the QESG Score – a quantitative assessment of a company's ESG metrics compared to its peers and, crucially, how its ESG profile is changing.

Figure 2. Our QESG score: unique perspectives on ESG risks

	E Environmental	S Social	G Governance
Processes Does the company have appropriate policies and procedures?	Water management, quality of disclosure, etc	Health and safety policy, human rights policy, etc	Business ethics policy, remuneration policy, etc
Reality How is the business performing?	Carbon risk reporting, waste from production, etc	Lost time incident rate, exposure to inequality, etc	Board independence, exposure to controversy, etc
Trend How is the company changing over time?	Carbon intensity levels, renewable energy targets, etc	Number of fatalities, employee turnover rate, etc	Change in diversity score, engagement progress, etc

Source: Federated Hermes, as at November 2020. Please note this illustration uses example metrics to depict the QESG composition, it is not an exhaustive list.

Reaffirming the link between ESG and performance

Through our systematic approach to assess ESG, we created historic QESG Scores for companies, spanning 31 December 2008 to 30 June 2020. In turn, this enabled us to test whether those with the highest scores or most-improving ESG characteristics have tended to outperform[3].

This year's results confirmed the trends we have seen since our inaugural research study in 2014: companies with good or improving environmental, social or governance characteristics (those in the top decile) have, on average, outperformed companies with negative characteristics (those in the lowest decile). Figure 3 demonstrates that, for each factor, the stocks in the lowest decile have tended to underperform.

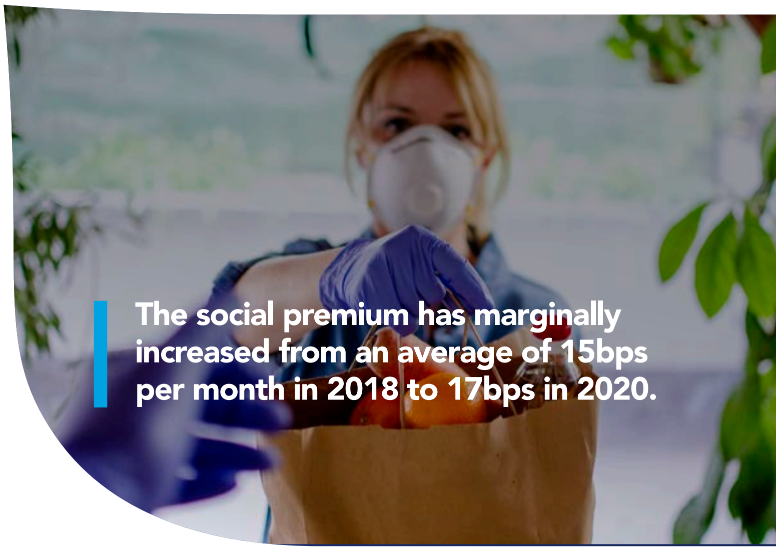
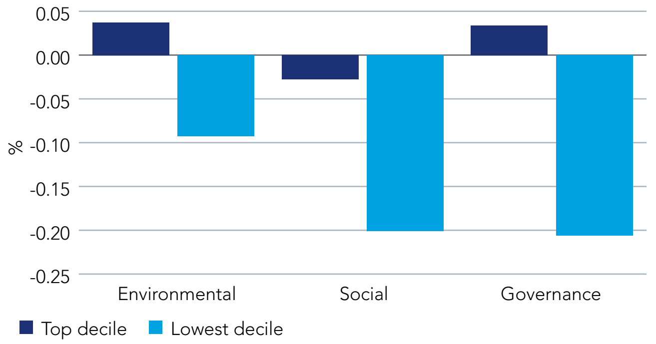


Figure 3. Companies with poor ESG practices have historically underperformed over the long term

Average monthly total relative returns of companies in the top decile and lowest decile based on environmental, social and governance scores from 31 December 2008 to 30 June 2020. Figures are calculated using constituents of the MSCI World index assuming monthly rebalancing.



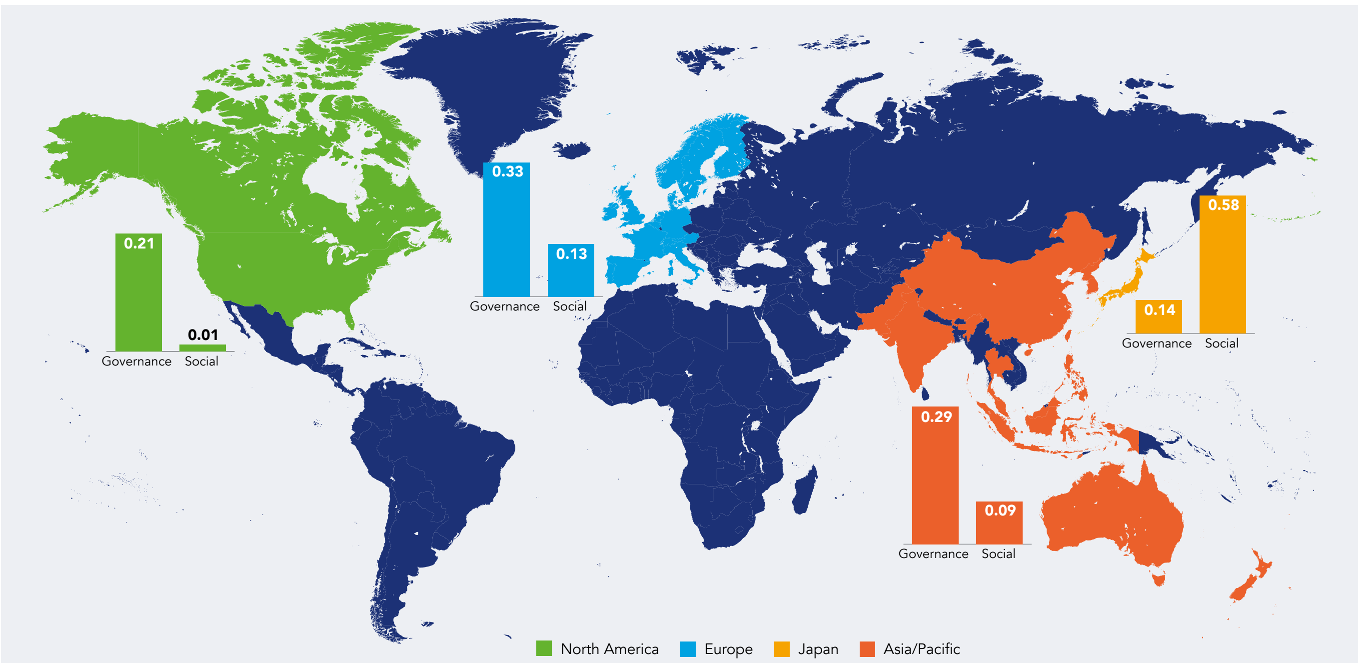
Source: Federated Hermes, as at 30 June 2020.

As with our 2018 research, the results for both the governance and social factors are statistically meaningful. Companies with good or improving corporate governance have tended to outperform companies with poor or worsening governance by 24bps per month on average – unchanged from our 2018 study. The social premium, however, has marginally increased from an average of 15bps per month in 2018 to 17bps in 2020. As illustrated in figure 3, companies with the highest social scores have on average marginally underperformed, while those with the weakest social metrics have significantly underperformed.

Our regional analysis yields similar results to our previous research: social factors continue to prove effective outside of North America, particularly in Japan, while our governance metrics are uniformly important across the globe (see figure 4).

Figure 4. One size does not fit all: the effectiveness of social and governance factors by region

Average monthly dispersion in total returns between companies in the top decile and lowest decile based on social and governance scores by region from 31 December 2008 to 30 June 2020.



Source: Federated Hermes, as at 30 June 2020.

[3] See Appendix for further information about our testing methodology.

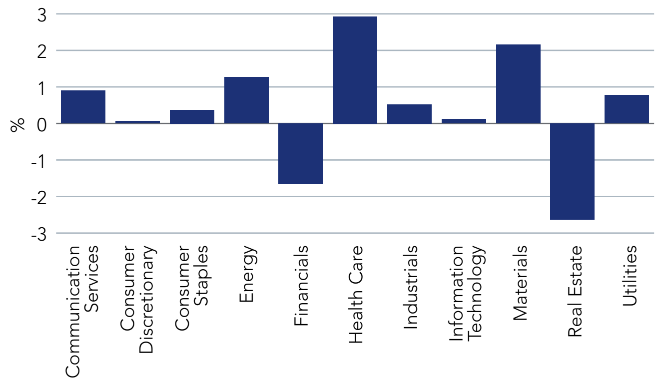
The impact of environmental considerations is not statistically significant. Although the environmental factor demonstrates the same shape of returns as the social and governance metrics, the magnitude is smaller, the consistency is lower, and the results show considerably more noise. The top-ranked stocks outperformed the bottom-ranked stocks, on average, in 53% of the months since 31 December 2008 – this compares to 58% and 62% for social and governance metrics, respectively. The difference in consistency is less pronounced when the average monthly returns for each factor are assessed by calendar year.

Coronavirus puts social factors in the spotlight

Social factors have, on average, been effective in each of the last six calendar years – and in 2020, when the coronavirus pandemic proved its virulence, these factors have proved especially important. The ESG spotlight has turned to how companies treat their employees, customers and suppliers – and figure 5 demonstrates social factors have correlated with outperformers in nine of the 11 GICS[4] sectors in the first six months of 2020. The strong relative performance of the Health Care sector dominates. This was particularly true in March when pharmaceutical names, which tend to have better social characteristics, outstripped the performance of health care providers and cannabis companies.

Figure 5. Health Care dominates the sector analysis in 2020

Average monthly dispersion in total returns between companies in the top decile and lowest decile based on social scores by sector from 1 January 2020 to 30 June 2020.



Source: Federated Hermes, as at 30 June 2020.

ESG investing: a long-term mindset matters

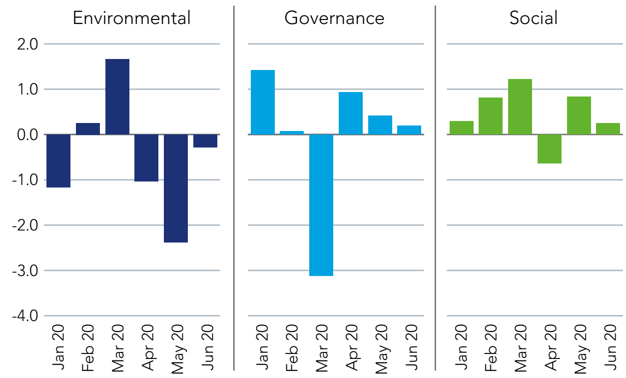
The rapid spread of the coronavirus pandemic and a crash in the price of oil rocked financial markets in late February and March. As lockdown measures were announced around the world, economic upheaval challenged many businesses and threatened entire industries. Companies' standard operations were upended as they were forced to adapt their normal working arrangements or close temporarily to stem the spread of Covid-19. Some faced serious challenges to their ongoing viability amid significant uncertainty about their earnings prospects.

During this period, the qualities that mattered most to investors were strong balance sheets and operational efficiency. Other measures of quality or attractiveness were simply ignored by investors, and this included corporate governance. With the immediate future of companies at risk, it was understandable that investors focused on ensuring that the companies in which they were invested stayed afloat. Within our Global Equities team, we have always favoured well-capitalised companies with strong balance sheets, even in an era of cheap money and excess liquidity. During the market crash earlier this year, such an approach was the only reliable way to outperform.

Indeed, the events of late February and early March remind us – and many other investors – that in extreme circumstances the key consideration is cash, while characteristics such as good governance were considered 'nice-to-have'. Our results show that companies with the highest rated governance scores have on average outperformed the lowest ranked companies in the first six months of 2020 with the exception of March (see figure 6). In fact, the negative governance premium observed in March is the most extreme divergence between the highest and lowest ranked deciles of governance in our dataset, positive or negative. Governance factors have never had such a strong impact as in March and, somewhat surprisingly, the impact was negative.

Figure 6. ESG investing during the coronavirus crisis (monthly returns in 2020)

Average monthly dispersion in total returns between companies in the top decile and lowest decile based on environmental, social and governance factors for each month from 1 January 2020 to 30 June 2020.



Source: Federated Hermes, as at 30 June 2020.

[4] The Global Industry Classification Standard (GICS) is a method for assigning every public company to the economic sector and industry group.

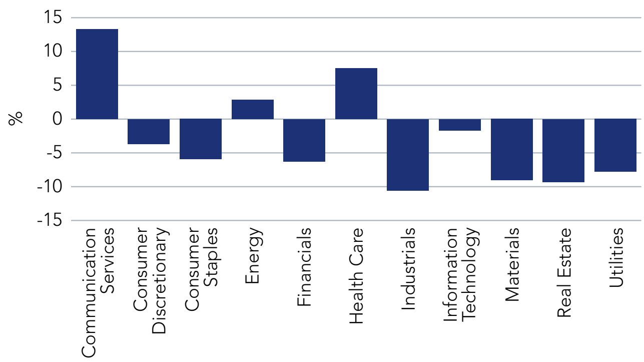
At the international business of Federated Hermes, we have long argued that ESG metrics are measures of quality and will help to determine business resilience. At the same time, we have also been clear that ESG metrics measure more than quality: they suggest a mindset of long-term thinking which investors should favour, not just because of the here and now but because sustainability requires a long-term focus and will deliver long-term results. We argue that ESG factors can generate alpha in both bull and bear markets, while traditionally quality factors have favoured bear markets. Importantly, our view has not changed.

The governance factor: an important determinant of crisis-period returns?

Figure 7 illustrates the spread between the returns of well-governed and poorly governed companies during the pandemic-induced market turmoil in March. During that period, good or improving governance was rewarded in three sectors – Communications Services, Health Care and to a lesser extent Energy. The remaining sectors were negative, with the most extreme result for Industrials.

Figure 7. The pandemic-induced market turmoil disrupted the governance factor in March

Average dispersion in total returns between companies in the top decile and lowest decile based on governance scores by sector from 1 March 2020 to 31 March 2020.



Source: Federated Hermes, as at 30 June 2020.

It is, however, important to caution that although our headline results are not explained by industry effects, the results for individual months, particularly during periods of extreme dispersion, may display industry biases[5]. By analysing the returns by decile, our results showed that well-governed Communication Services companies (in the top decile) tended to outperform during March 2020. Companies in this top decile tend to be stable and diversified businesses. This compared to the lowest ranked decile which was comprised of 'growthier' stocks and family-controlled legacy businesses, both of which are often considered lower quality and suffered during the market sell-off. The reasons these businesses became less attractive during the economic rout are more closely aligned with corporate governance.

Meanwhile, our study found that well-governed Industrials companies (in the top decile) underperformed meaningfully during March. Within this decile, we have materially more exposure to airlines and airports: these companies have suffered disproportionately during the coronavirus crisis, but they typically score better on governance issues than their peers. The underperformance of the better-governed Industrials is more attributable to the industry effect than the ESG thesis. While this industry effect does not fully explain the difference in performance, it does exaggerate the magnitude of the underperformance.

The pandemic-induced market crash earlier this year had an adverse impact on specific businesses, such as cruise-lines and airlines, while the general demand slowdown prompted an oil price collapse, which in turn hurt energy stocks. As a result, many traditional 'sin' sectors – shunned by ESG investors – underperformed. This had little to do with their ESG thesis: the pandemic is a unique event and so, we should be careful not to imply an ESG-related causation, but rather a simple correlation.

Growth factor dominates as markets rebound

After the market crash in March, markets rebounded – and by May, the dominance of the growth factor was evident. Our study found that investors did not focus on the environmental factor in this environment of extreme growth. Instead, investors became so focused on growth that other characteristics, such as valuation and environmental performance, were considered secondary – or not considered at all.

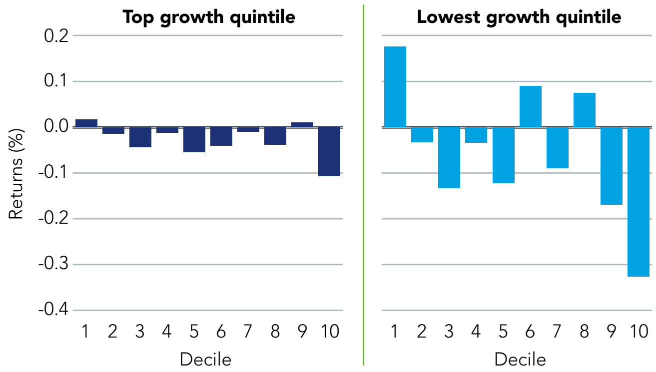
Historically, environmental factors have shown no relationship with returns in growth environments. Social and governance metrics, however, have been effective in such environments, but less so than in non-growth (value) environments.

We also analysed the performance of the environmental factor, controlling for growth exposure. Figure 8 shows the returns for each of the 10 deciles split between high growth (the top 20%) and low growth (the bottom 20%), as measured by our blended growth score. In both the high and low-growth segments, we see a familiar downward skew to the returns – and the underperformance of the lowest ranked companies in decile 10 is the most striking observation. For the high-growth stocks, the magnitude of this underperformance is smaller. This suggests that environmental considerations are less important for these stocks. However, overall, the shape of this chart indicates that these factors do continue to matter, even for high-growth stocks. Of course, we are cautious about drawing conclusions from these findings as we have concluded that the overall results for the environmental factor are not statistically meaningful.

[5] Note: our assessment of ESG has proven to have little persistent factor bias and our results are adjusted to remove sector and region effects. However, within sectors some industries tend to score better than others and the scores can have an industry bias over time.

Figure 8. Environmental factors matter, even for high-growth stocks

Average monthly relative return of companies in each decile based on the environmental factor, split by growth quintile, from 31 December 2008 to 30 June 2020.

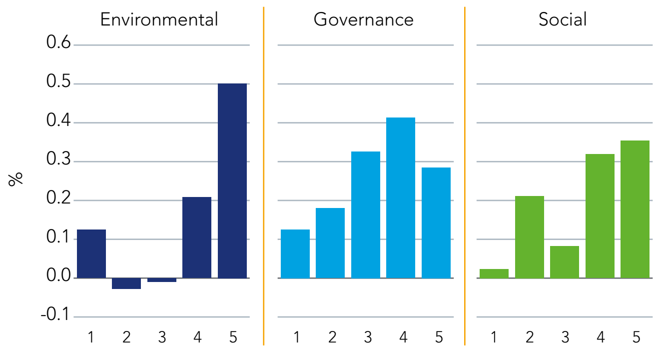


Source: Federated Hermes, as at 30 June 2020.

Again, using our blended growth score, we analysed the spread between the top and bottom-ranked stocks for each factor – environmental, social and governance for May 2020. We found that companies with good social and governance metrics tended to outperform across the growth spectrum. However, there was a clear skew towards the lower growth groups, where these metrics are more important. Notably, there was more noise in the results of the environmental factor than the other two metrics, which is understandable given its lack of statistical significance. Figure 9 therefore indicates that environmental, social and governance factors are most effective at distinguishing between lower growth companies but do retain predictive power even within high-growth companies.

Figure 9. E, S and G factors are effective at distinguishing between lower growth companies

Average monthly dispersion in total returns between companies in the top and bottom deciles based on the environmental, social and governance factors, split by growth quintile (1 is high growth and 5 is low growth) from 31 December 2008 to 30 June 2020.

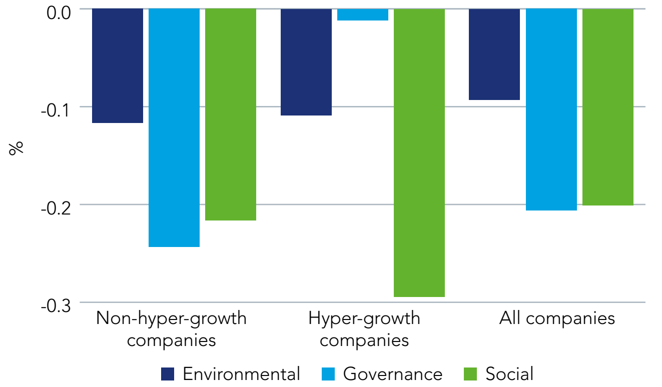


Source: Federated Hermes, as at 30 June 2020.

In our previous research, we demonstrated that the governance factor is less important to investors in hyper-growth companies – a subset of the highest growth names that meet a myriad of other criteria and trade almost entirely on short-term market sentiment. Meanwhile, the performance of the social factor and the statistically insignificant environmental metric are broadly similar across hyper-growth and non-hyper-growth companies.

Figure 10. The social factor is increasingly important among high-growth companies

Average monthly relative total return of companies in the lowest decile on the environmental, social and governance scores, and split into hyper-growth, non-hyper-growth and all companies from 31 December 2008 to 30 June 2020.



Source: Federated Hermes, as at 30 June 2020.

Indeed, figure 10 demonstrates that social metrics have become increasingly important for hyper-growth names: investors are willing to forgo traditional safeguards around company management to gain exposure to a hyper-growth company, but they appear less willing to sacrifice the treatment of employees and the broader society.

Cash to survive, sustainability to thrive

This study, which analysed correlations between companies with high ESG scores and shareholder returns since 2009, reinforced our earlier findings of a robust link between underperforming firms and poor social and governance metrics. While the governance premium remained unchanged from our 2018 study at 24bps per month on average, the social premium strengthened to 17bps. Companies are now thinking beyond their shareholders – they are thinking about their employees, customers and suppliers.

Against the backdrop of the coronavirus crisis this year, the world has had to deal with disruption of vast proportions – and amid heightened uncertainty about earnings prospects, investors have focused on the survival of the businesses in which they are invested. It is therefore unsurprising that the qualities that mattered during the pandemic-induced market crash were strong balance sheets and operational efficiency.

What's more, as the world continues its fight against Covid-19, many investors have sought high-growth, often speculative, companies.

These high-growth names have historically often been run under dominant management with little regard to traditional standards of corporate governance – and this has not yet been to the company's detriment, as measured by shareholder returns. However, high-growth names in Europe and Asia have not been immune to the social awakening in recent years. Those companies with more social awareness than their peers have tended to outperform. As with our previous research, North American investors have not yet rewarded social nicety.

Today, the business case for protecting our environment continues to grow stronger. The transition to a more sustainable economy represents an exceptional market opportunity. Companies which play an active role in adapting to and mitigating some of the greatest challenges that we face today are likely to be rewarded through future policy and legislation, promoting greater sustainable development. The coronavirus crisis will perhaps hasten the speed of transition, and markets for obsolete, unsustainable products and services will decline. For this particular scenario, ESG investments are well positioned.

In these unprecedented times, we see growing awareness of sustainability across every sector. Embracing sustainability is not just about avoiding risks, it is about finding business opportunities. In this environment, it is that type of thinking which will enable businesses to thrive.

Appendix

Our testing methodology

Our score is built to use the data that we had available at the historic point in time, adopting new sources as they became available to us. In order to ensure sufficient historic data, we have limited the universe of companies to the MSCI World Index. This means our study only investigates developed markets.

We use the historic scores to create sector-neutralised rankings of companies based on the E, S and G scores. We subsequently form region-neutralised portfolios of companies with the highest E, S and G rankings and those with low rankings. This methodology ensures we are comparing like-for-like companies and eliminating sector or regional biases from our portfolios.

Federated Hermes
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Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

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

All activities previously carried out by Hermes now form the international business of Federated Hermes. Our brand has evolved, but we still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important new strategies from the entire group.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

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