OUTCOMES BEYOND PERFORMANCE

ESG INVESTING

A social uprising

Hermes Global Equities
Investment Commentary, Q4 2018

For professional investors only

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HERMES INVESTMENT MANAGEMENT

KEY POINTS

- Companies with **good or improving social characteristics** have tended to **outperform their lower-ranked peers** on average by 15bps per month from 31 December 2008 to 30 June 2018.
- This **bolsters our decision to include social factors** in our idea generation for the **Hermes Global Equity ESG** strategy since inception in 2013.
- The **stock-selection process of the Hermes Global Equity Core strategy,** which only integrates the governance component of the QESG Score, will be **enhanced to include social factors** for markets outside North America.
- The **FAANGs** – major US technology stocks that have driven the market recently – have **disrupted the usually consistent performance** of the governance factor, making it particularly ineffective in the past 12 months.

Our seminal paper, *ESG investing: does it just make you feel good, or is it actually good for your portfolio?*, published in 2014, demonstrated the performance benefits of integrating environmental, social and governance (ESG) factors into investment decisions.

It found a statistically significant link between the quality of corporate governance and shareholder returns: companies with strong corporate oversight have tended to outperform their poorly governed competitors by an average of 30bps per month from 31 December 2008 to 31 December 2013. This allowed us to systematically integrate the analysis of corporate governance into our stock-selection process. Two years later, we reaffirmed this finding in *ESG investing: it still makes you feel good, it still makes you money*[1].

Today, we revisit our study, updating our results to better understand how ESG factors have impacted shareholder returns in the past 24 months. Contrary to our earlier analysis, we find that the governance premium has weakened and, for the first time, social factors now qualify as statistically significant.

We also detail how the investment landscape has changed since we conducted our inaugural study in 2013, as well as the evolution of our ESG investment process.

ESG INVESTING, 2013-2018: FROM NICHE TO NORM

The world and the investment landscape have changed dramatically since 2013. One of the major developments has been the emergence of ESG integration, climate risk and transitioning to a low-carbon economy as important points of focus for investors, policy makers and companies alike.

Today, an onslaught of sustainability challenges exist due to policy, technological or climatic changes – and they are happening faster and more dramatically than many could have anticipated.

A slew of corporate scandals that have weighed heavily on share-price performance, including Volkswagen's cheating in emissions tests and Facebook's data privacy breach, in the past five years have also highlighted the importance of – and accelerated the push towards – ESG integration in investment decisions.

The slow-burning success story of the past 10 years, the tobacco sector, has also come under fire recently as regulatory pressures, the move towards alternatives such as vaping, changing consumer habits and expectations of further interest rate rises weigh on the industry. The resulting stock-price reversal – following a decade of outperformance – is reassuring for investors that have feared sustainability concerns could be overlooked by the market.

[1] See appendix for further information on our previous research.

Investors and asset owners that are serious about considering climate-change risk recognise that more regulation and pressure is coming. Investors must therefore be prepared.

Meanwhile, climate change is no longer a risk of the future: the climate has and will continue to change. So far this year, Europe has experienced record heatwaves, the US has been devastated by deadly wildfires, flood-inducing downpours have pounded parts of Asia, and Cape Town has suffered severe water shortages. Meanwhile, new shipping lanes have emerged as ice caps melt in the Arctic.

The 2015 United Nations Climate Change Conference (COP21) marked a significant step forwards in the world's approach to tackling climate change. But the Paris Agreement, which commits signatory countries to keeping a global temperature rise this century well below 2ºC, does not go far enough. Investors and asset owners that are serious about considering climate-change risk recognise that more regulation and pressure is coming. Investors must therefore be prepared.

However, the widespread and rapid adoption of ESG analysis has led to a surge in ESG data providers, with some even attempting to build their own offering by drawing on data from other providers' to create a market consensus of ESG scores.

OUR APPROACH TO ESG INVESTING

At Hermes, we believe there is no leading source of ESG data. The lack of standardised data on ESG matters means that ratings providers often use a company's sustainability report as an information source, thereby relying on information that companies voluntarily disclose. For that reason, we use research from more than 10 different data vendors, which allows us to strengthen our conviction when assessing specific ESG practices. As well as incorporating a wide range of research from leading providers – Sustainalytics, Trucost, Bloomberg, MSCI, FactSet, ISS and CDP – we draw on the insights of Hermes EOS, which advises on proxy votes and engages company directors and executives about ESG risks that concern shareholders.

We also believe that a company's ESG profile must be assessed relative to its geographic location and the industry in which it operates, as well as using forward-looking metrics, which provide a view of current and future ESG risks. This helps us identify companies that are undergoing a real improvement – or deterioration – in their ESG metrics.

It is also crucial to fully understand the materiality of a company's ESG risks: some companies' risks are deemed so severe, such as the use of child labour in the supply chain, that they counteract sound ESG corporate practices, like a strong remuneration policy or low carbon emissions.

These principles help us construct a quantitative assessment of a company's ESG metrics – its QESG Score – relative to its peers and to determine how its ESG profile is changing[2].

Figure 1. The QESG Score acts as an early indicator of changing 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: Hermes Investment Management as at October 2018. Note: this illustration uses example metrics to depict the QESG Score composition, it is not an exhaustive list.

[2] See appendix for further information on our ESG Dashboard.

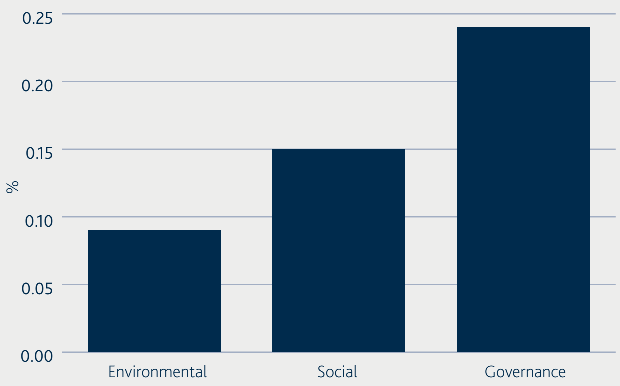
ESG INVESTING: FINDING VALUE IN ENVIRONMENTAL AND SOCIAL FACTORS

Armed with our objective method of assessing ESG risk, we have created historic scores for companies, enabling us to test whether those with the highest scores or most-improving ESG characteristics have tended to outperform[3].

We found that 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). This is being driven by the strength of their corporate governance and, for the first time since our investigation began in 2014, social metrics. The impact of the environmental considerations is not statistically significant. This is clearly illustrated in figure 2.

Figure 2. ESG value is driven by corporate governance and social characteristics

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 30 June 2018.



Source: Hermes Investment Management as at 30 June 2018.

As with our previous research, we found no evidence that companies with attractive environmental characteristics have tended to underperform. Investors can therefore integrate environmental considerations into their portfolios without fear of them detracting from performance.

We found that companies with good or improving environmental, social or governance characteristics have on average outperformed companies with negative characteristics.

Encouragingly, the result for the social factor is statistically meaningful: companies with good or improving social characteristics have tended to outperform their lower-ranked peers on average by 15bps per month from 31 December 2008 to 30 June 2018.

Meanwhile, the impact of governance reaffirms our key insight from our previous papers: companies with good or improving corporate governance have tended to outperform companies with poor or worsening governance, but by 24bps per month on average – down from a monthly average of 30bps.

We now explore the results of each factor in further detail.

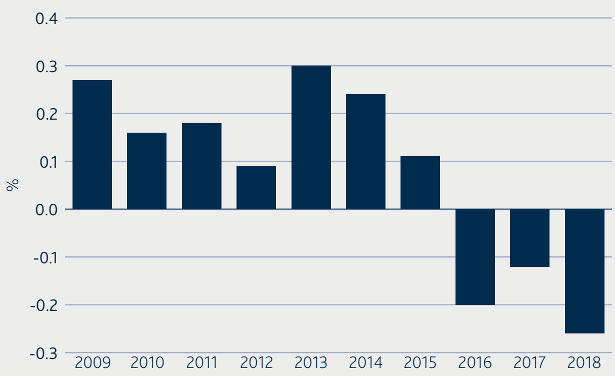
The environmental factor: a promising future?

While the impact of the environmental factor is not statistically meaningful, two interesting observations emerged during our research:

- The average monthly spread between the highest- and lowest-ranked companies is more consistent when categorised by calendar year, rather than across the entire nine-year time period: for seven consecutive years in the run-up to COP21, companies with better environmental characteristics outperformed those in the lowest decile, and they have underperformed thereafter (see figure 3).
- Environmental factors are more effective during down markets than bull markets: in downturns, companies with poor environmental performance have lagged their peers by 19bps. Our findings indicate that environmental factors should be viewed through a quality lens, perhaps – in recognition that they can be useful in helping to limit downside risks but ineffective during bull runs.

Figure 3. The environmental factor is more consistent on an annual basis

Average monthly dispersion in total returns between companies in top decile and lowest decile on environmental factors for each calendar year from 31 December 2008 to 30 June 2018.



Source: Hermes Investment Management as at 30 June 2018.

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. It should be noted that any investments overseas may be affected by currency exchange rates. Past performance is not a reliable indicator of future results.

[3] See appendix for further information on our testing methodology.

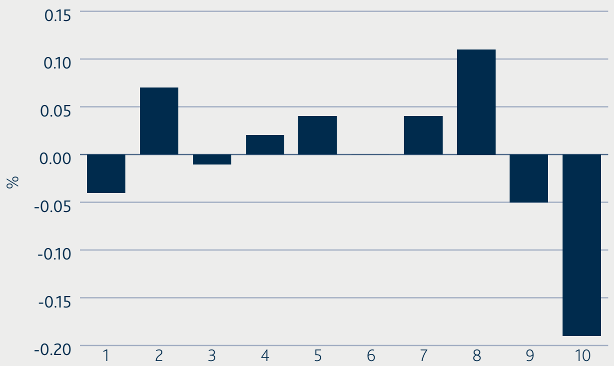
The power of social

As aforementioned, social factors now qualify as statistically significant, with our latest study revealing that companies with poor or worsening social practices consistently underperformed their peers by 15bps each month since the beginning of 2009. This follows the same pattern as previously observed for governance: the value of the social factor is its ability to identify underperforming companies as opposed to outperformers (see Figure 4).

The consistency in the underperformance of these companies is further highlighted by plotting the dispersion in total returns on social factors by calendar year (see Figure 5). There is, however, some volatility among the highest ranking companies. This suggests that we should focus on avoiding the lowest ranked companies rather than seeking the highest ranked stocks.

Figure 4. Companies with the lowest ranked social scores tend to underperform

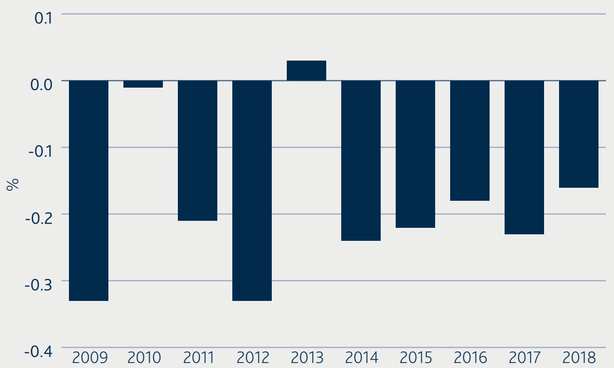
Average monthly total returns for companies in each decile based on social factors, from 31 December 2008 to 30 June 2018.



Source: Hermes Investment Management as at 30 June 2018.

Figure 5. Relative returns of companies with the poorest social practices compared to the average company

Average monthly dispersion in total returns between the average company and companies in the lowest decile on social factors for each calendar year from 31 December 2008 to 30 June 2018.



Source: Hermes Investment Management as at 30 June 2018.

According to our study, companies with poor or worsening social practices consistently underperformed their peers by 15bps each month since the beginning of 2009.

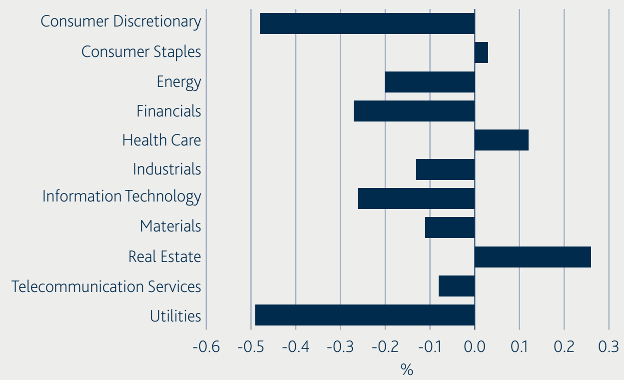
Interestingly, the social premium also emerges in our regional analysis: it is shown to be effective in Japan and yielded moderate payoffs elsewhere in Asia and in Europe. However, it has been ineffective in North America.

Meanwhile, the social indicator is also present in our sector analysis, although the effect does not seem to be universal (see figure 6). For instance, there is a negative relationship between social scores and shareholder returns in the following sectors:

- Consumer Staples: this reflects the dominance of tobacco companies, which score poorly on social factors but have delivered strong returns before 2017
- Health Care: changes in regulation, discrepancies across regions, repeated product recalls and miss-selling scandals may be clouding the ability of quantitative ESG data analyses to fully understand the sector
- Real Estate: this is a new sector, which means that the data available on the effectiveness of ESG factors spans a shorter time series than in other industries

Figure 6: The social premium shows up in our sector analysis

Average monthly dispersion in total returns between the average company and companies in the lowest decile on governance scores by sector from 31 December 2008 to 30 June 2018.



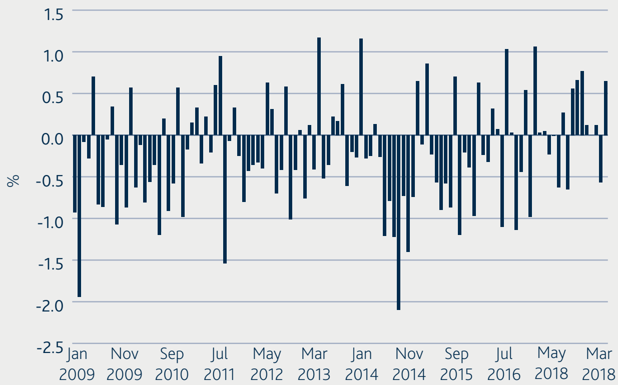
Source: Hermes Investment Management as at 30 June 2018.

FAANGs take a bite out of the governance premium

As we concluded in our earlier studies, the governance indicator has been shown to be effective: well-governed companies have tended to outperform poorly governed companies since the start of 2009. And while our latest research reaffirms this, it also shows that the governance factor has been particularly ineffective in the past 12 months: during this period, poorly governed companies have tended to outperform well-governed companies.

Figure 7. Role reversal: poorly governed companies outperform well-governed peers in the six months to April 2018

Average dispersion in total returns between the average company and companies in the lowest decile on governance factors for each month from 31 December 2008 to 30 June 2018.



Source: Hermes Investment Management as at 30 June 2018.

Before November 2017, the longest period during which poorly governed stocks outperformed well-governed companies was three months in 2013. But in the six months to April 2018, poorly governed companies have outperformed their well-governed peers (see figure 7).

Why the step-change?

Although the long-running bull market owes a lot to the electrifying rise of the tech sector, this six-month period highlighted the narrow leadership of the US stock market: it was dominated by the headlines of FAANGs – Facebook, Amazon, Apple, Netflix, and Google, now Alphabet.

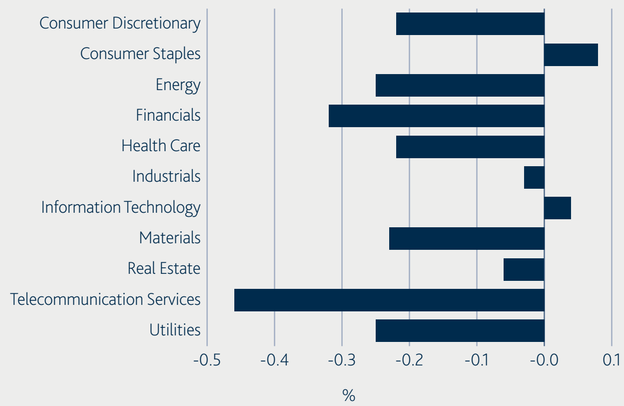
These hyper-growth companies – businesses typically at an early stage of their life cycle and experiencing stellar growth rates but often trading at high multiples – have delivered incredible returns, propelling the market to record highs despite already lofty valuations. But these names, as relatively young disruptive companies, often do not meet traditional ESG standards and score quite poorly on governance factors. Indeed, three of the five FAANGs ranked in the lowest decile of governance in the six months to April 2018. This finding suggests that the FAANGs disrupted the performance of the governance factor significantly during the six-month time period. What's more, the result is not entirely surprising. As with our previous research, figure 8 reveals that corporate governance was a less effective predictor of shareholder return within the technology sector.

In the six months to April 2018, poorly governed companies have outperformed their well-governed peers.

Furthermore, we hypothesised that it was the presence of hyper-growth companies that led to this result. Hyper-growth companies exist beyond the IT sector, and in figure 9, we partition the universe into hyper-growth and non-hyper growth companies to confirm our hypothesis: governance is less important for companies experiencing hyper growth (see our 2017 commentary *Valuation, not value* for further information).

Figure 8. Baring their teeth: FAANGs disrupt the governance factor

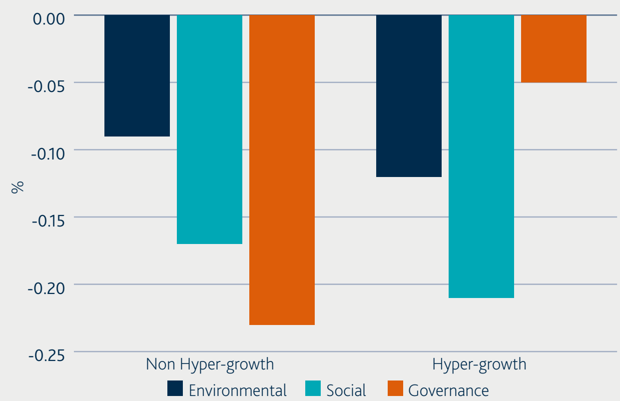
Average monthly dispersion in total returns between the average company and companies in the lowest decile on governance scores by sector from 31 December 2008 to 30 June 2018.



Source: Hermes Investment Management as at 30 June 2018.

Figure 9. Governance is less important for hyper-growth companies

Average monthly dispersion in total returns between the average company and companies in the lowest decile on environmental, social and governance scores, and split into hyper-growth and non-hyper-growth companies from 31 December 2008 to 30 June 2018.



Source: Hermes Investment Management as at 30 June 2018.

THE VALUE OF ESG

This study, which analysed correlations between companies with high ESG scores and shareholder returns since 2009, reinforced our earlier finding of a robust link between underperforming firms and poor governance. But this has 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 serves to not only bolster our beliefs about the benefits of integrating ESG factors into investment decisions but it justifies our decision to systematically include the social component of the QESG Score, alongside the environmental and governance components, in our idea generation for the Hermes Global Equity ESG Strategy since its inception in 2013.

Contrary to our previous study, social factors now qualify as statistically significant. This serves to bolster our beliefs about the benefits of integrating ESG factors into investment decisions.

Unlike our other strategies, the Hermes Global Equity Core Strategy only systematically integrates the governance component of the QESG Score into the team's stock-selection process. This will now be updated at the end of the year to include social factors in every company valuation for markets outside North America (where it has not yet been proven to be effective), enhancing our analysis of these risks. Meanwhile, environmental considerations will continue to be assessed as part of our fundamental due diligence on companies.

This ensures that ESG analysis is integrated into all of our investment decisions across each of our strategies – from idea generation to portfolio construction – helping us deliver more than just 'a feel-good factor'.

APPENDIX

ESG investing: our previous research

2014: 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 underperformed their peers by up to 30bps each month.

2016: 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.

The ESG Dashboard: evolving to reflect developments in ESG investing

Since our 2014 study, ESG integration has evolved as an investment concept. As such, 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. The latest iteration of the ESG Dashboard demonstrates our continued focus on innovation and change, with the aim of improving our analysis of companies and therefore the long-term performance potential of our investment strategies. These changes include:

- Incorporating the MSCI ESG database with our ESG analysis
- Industry-specific key performance indicators to better align the QESG Score with the issues that matter to each company
- Geographic revenue decompositions to better determine how issues such as water scarcity and inequality impact a company's business
- A broader range of metrics, covering issues such as controversial tax planning exposure and diversity.

For more information, read about our ESG Dashboard and the improvements made to it in January 2018.

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.

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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

Offices

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