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Today both retail and institutional investors across the globe are broadening their understanding of fiduciary duty to include responsible investing. And rather than viewing their ESG efforts as a charitable enterprise, investors can now see – backed up by a growing body of research – that a principled approach to investing can enhance portfolio performance.

While there is no penalty for pursuing sustainable, responsible business practices, our research suggests that exposure to stocks with high ESG risk does detract from share price performance. We found a strong correlation between corporate responsibility and shareholder returns, finding that companies with poor governance practices consistently underperformed their peers.

As well as theoretical insights, however, investors need practical tools to help them integrate ESG considerations into company valuations and investment portfolios. We have developed an ESG ratings methodology in-house, which is now a fundamental input to our stock-selection process, with particular emphasis on the materiality of ESG considerations and the factors that impact financial performance.

For pension funds, the definition of fiduciary duty is evolving to include reputational risk, negative externalities and beneficiaries’ concerns about the conduct of corporations and their impact on society and the environment, such as the long-term damage done to society by polluting companies seeking short-term private gains. Yet, while investors now agree that these issues matter, there is no consensus about how to assess ESG risks, or what to do with the information.

Some investors argue that ESG considerations should be treated separately from financial rewards. These hard-core practitioners typically seek to invest capital where they believe it will have the most positive impact on the world. Others invest only in companies with the best ESG profile they can find: either on an absolute basis, favouring green energy, clean technology companies and the like; or on a relative basis, investing in the top-rated firm within each peer group. Alternatively, some investors simply divest from any company with exposure to industries or business practices that present ESG or sustainability challenges. This approach has grown in popularity, with many prominent investors electing to divest from companies with exposure to tobacco or fossil fuels, for example.

At Hermes, we prefer to engage with companies rather than divest. In our view, successful engagements reduce risks to shareholders, unlock value, and benefit wider society. We believe investors should be involved shareholders, encouraging responsible behaviour and effecting positive change. Alongside communicating with senior management and board members, we
undertake filing or co-filing shareholder proposals, where appropriate, and voting proxies in accordance with investors’ views and policies, supporting transparent and effective governance structures that encourage stakeholder dialogue.

We believe that working with firms to mitigate ESG risks – while reserving the option to sell down where a company is unable or unwilling to improve – can provide the greatest holistic benefits. As such, we seek investments with good or improving ESG characteristics, which should contribute to outperformance over the long term. While ESG issues are important in themselves, we recognise that helping a company to lift its ESG performance can both benefit society and realise financial gains for investors.

In 2013 we developed a scoring system to identify companies that fall into our ESG sweet spot. Our aim was to build an objective measure of corporate ESG performance, assessing where the company is today and anticipating where it will be tomorrow. Our corporate governance and engagement team, Hermes EOS, provided substantial input. It identified the key performance indicators for each sector, drawing on information from internal sources, maintained as part of our voting and engagement records, and from carefully selected, reputable external providers.

We found that companies with favourable environmental or social characteristics have on average outperformed companies with negative characteristics in these areas in terms of return to shareholders – however, the degree of statistical significance is low. As with our previous research, it is still too early to conclude that companies with attractive environmental and social characteristics outperform.

More positively, we have found no evidence that companies with attractive environmental and social characteristics have tended to underperform. Our data suggests that investors are able to integrate environmental and social considerations into their stock selection without systematically lowering their returns. Hence it still has merit in lowering risk (and doing good).

The impact of governance, however, appears unequivocal and reaffirms a strong link between underperforming firms and poor corporate governance. This is largely driven by the companies with the lowest ranked governance scores tending to underperform the average, as opposed to the higher-scoring companies outperforming. This suggests that poor governance detracts from performance rather than good governance boosting it.

Our study shows that ESG considerations are crucial for all equity investments, whether made in the context of a specific mandate or in a more general strategy. Furthermore, our research shows that investors do not need to sacrifice returns in order to invest in accordance with ESG principles. In fact, investing responsibly enhances excess returns.

However, our research did not prove that a statistically significant relationship between shareholder returns outperformance and environmental or social metrics exists. As more data becomes available, and more asset owners focus on environmental or social considerations, the E and S exposures of companies may exhibit a positive correlation with performance.
Nevertheless, ESG investors should not be discouraged by the finding: our research also confirmed that favouring companies who are better managing their environmental and social risks (relative to their peers) does not tend to lead to returns underperformance.

For now, we can conclude that favouring well-governed companies can enhance the return of equity strategies — and integrating environmental and social metrics into investment decisions will not harm portfolios either.