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# CORPORATE EXCELLENCE INSIGHTS

Hérens Quality AM is a specialized provider of systematic Quality Investment Solutions and one of the few providers of Quality equity investment strategies worldwide. Corporate Excellence Insight is our monthly publication that includes a brief update on markets and our thoughts about major trends that are impacting the investment management industry.

## MARKET UPDATE: BEST MONTH SINCE JUNE

The S&P 500 climbed 3.4% in November and recorded its biggest one-month gain since June. Performance was driven thanks to optimism around the U.S.-China trade negotiations. Back in October, President Donald Trump said the two sides had reached a "phase one" trade deal to be signed in November.

### €10bn

#### BMW LOCKS UP BATTERY ORDER AHEAD OF EV ONSLAUGHT

BMW announced Thursday it will spend more than €10 billion euros on battery cells from Chinese battery cell manufacturers. It expects sales of electrified vehicles to double between 2019 and 2021.

### 128 000

#### JOBS ADDED IN US IN OCTOBER, BEATING EXPECTATIONS

The monthly jobs report was far stronger than expected, beating economists' forecasts for a gain in 89,000 jobs. A 40-day GM strike, which took 46,000 autoworkers out of the workforce, was expected to serve as a bigger drag on the job market.

### \$25bn

#### EXXON AIMS TO SELL ITS ASSETS TO FOCUS ON MEGA-PROJECTS

Exxon Mobil plans to sell up to \$25 billion of oil and gas fields in Europe, Asia and Africa in its biggest asset sales for decades, seeking to free up cash to focus on a handful of mega-projects.

## MONTHLY TOPIC: ESG MOMENTUM

The biggest contributions to the environment preservation and increased social responsibility can be made by yet imperfect enterprises, which, however, made a commitment to improve and are consequently heading for their goal. With originally lower ESG standards, these companies tend to have higher leverage, as the effect of adopting higher ESG standards will likely have more positive effect on their cost discipline, risk control, etc. Research indicates that companies with positive ESG momentum tend to perform better than their peers with already developed ESG culture.

Average momentum ratings for the sectors did not come as a surprise: Utilities are the best in improving their ESG standing, followed by Materials and noteworthy they both have low absolute ratings. Healthcare companies, which are already playing in higher ESG league, have lowest ESG momentum.

The question is whether ESG momentum is worth the same pile of analyst attention as does the static ESG score. The research on ESG momentum says that, in fact, it could generate even more value (Factset, 2019; Societe Generale, 2019). We found a supporting evidence, too: companies with improving ESG ratings managed to beat the ones with deteriorating ESG KPIs

[Read full Article on Page 2](#)



# IMPACT INVESTING: ESG MOMENTUM TO ADDRESS CLIMATE CHANGE AND EARN ALPHA RETURNS

## Static vs. momentum-based ESG rating

Glaciers meltdown, frequent forest fires, Venice under water – more and more cases point to the alarming problem of global warming. Further attention to the climate change has been attracted also by Greta Thunberg giving emotional speech during UN summit. Growing awareness about the environmental issues is likely to help the funds with ESG tilt in attracting more funds. Caring and conscious investors are willing to contribute to the improving climate conditions with their impact investing – term applied when the effect from investments outweighs the investment returns.

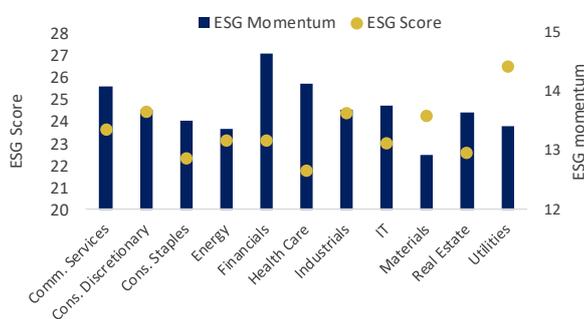
Usually ESG ETFs and funds aim to invest in the companies with the highest ESG ratings or in the companies with already established socially responsible and environment-friendly operations, lowest CO<sub>2</sub> emissions, lowest amounts of waste generation, with lowest amounts of water use. Interestingly, the biggest contributions to the environment preservation and increased social responsibility can be made by yet imperfect enterprises, which, however, made a commitment to improve and are consequently heading for their goal. With originally lower ESG standards, these companies tend to have higher leverage, as the effect of adopting higher ESG standards will likely have more positive effect on their cost discipline, risk control, etc. Research indicates that companies with positive ESG momentum tend to perform better than their peers with already developed ESG culture.

## Our perception of ESG momentum

To exclude any subjectivity in our judgement on ESG improvement, we have selected only numerical KPIs, which companies publish in their sustainability reports. Therefore, analytical sample includes only those companies, which care about ESG as it was evidenced in published ESG reports, so that the minimum level of compliance with standards of being socially and environmentally responsible is ensured. In total 12 criteria were selected: four in each area - Environment, Social and Governance. ESG momentum rating covers most important quantitative ratios, including board independence, salary gap, lost time incident rate as well as resource consumption and CO<sub>2</sub> emissions to name a few. All absolute values, such as energy consumption or CO<sub>2</sub> emissions, were taken in the context of total sales.

We have also concentrated our analysis on European companies as US firms are not yet sufficiently advanced in providing extensive data on ESG performance indicators, leaving scarce possibility for thorough analysis.

Fig. 1: ESG score and ESG momentum by industry



Source: Hérés Quality Asset Management, MSCI

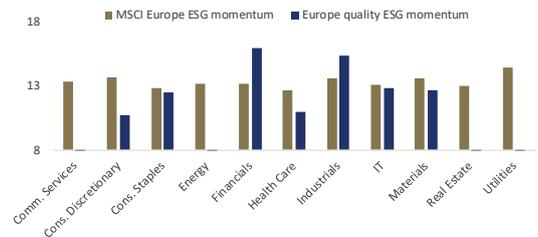
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## Fundamental Quality = Good ESG. Is there space for further ESG improvement?

It was stated many times that fundamental quality goes hand in hand with good ESG management, which facilitates risk reduction, operational transparency, capital attraction, cost control.

Knowing that quality companies usually have high ESG scores, one would expect them to demonstrate lower ESG momentum – utmost efficient companies cannot make a leap in improvement in every dimension every year. So, the average ESG momentum rating for quality companies in 2019 is 12.4, while the market's average is 13.3. Still, Financials and Industrials within the attractively valued quality universe managed to do better than the market in ESG improvement.

Fig. 2: EU Quality companies vs. MSCI Europe: ESG Score and ESG momentum



Source: Hérés Quality Asset Management, MSCI; no quality identified in the following industries: communication services, energy, real estate, utilities

There are also few ESG role models among quality firms. For instance, world's leading software company, SAP, not only has excellent financials, but also excellent rating on ESG score and ESG momentum (improved on 9 out of 12 metrics in 2018). German IT giant has improved particularly well in the environmental area dedicating itself to the sustainable development: uses 100% green energy for datacenters and buildings, phases out single-use plastics, plans to become carbon neutral till 2025.

## ESG momentum and performance

Now, the question is whether ESG momentum is worth the same pile of analyst attention as does the static ESG score. The research on ESG momentum says that, in fact, it could generate even more value (Factset, 2019; Societe Generale, 2019). We have checked this statement by considering the value added of ESG score and ESG momentum to the equity performance in the comparative analysis, which covers the assessment of the last four years – longer range is unavailable due to the insufficiency of older ESG data.

Fig. 3: Relative performance of good vs. bad companies according to ESG score and ESG momentum (MSCI Europe)



Source: Hérés Quality Asset Management, MSCI

During this short period considered, stock selection based on pure ESG rating did not help in generating excess returns, while companies with improving ESG ratings managed to beat the ones with deteriorating ESG KPIs.

## Conclusion

ESG hype gains popularity, so more research will follow on static and dynamic ESG scores. But already now there is a lot of evidence in favor of the positive influence they have on corporate performance, reputation and valuation. And obviously the current situation speaks in favor of picking the companies that make greater leap in becoming more environment-friendly, socially responsible and well-governed.

## References

- Factset (2019). Incorporating ESG Momentum Into an Investment Strategy. <https://insight.factset.com/risk-and-esg-momentum>.
- Societe Generale (2019). Is "best-effort" the next frontier of ESG analysis? <https://www.securities-services.societegenerale.com/en/insights/views/news/best-effort-next-frontier-esg-analysis/>.