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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: RECOVERY AFTER PANIC IN AUGUST

In August 2024, the MSCI World Index rose by 1.7%, with U.S. and European markets expanding by 2.3% and 1.1%, respectively. Stock volatility spiked in early August as thin summer trading, U.S. growth worries, and Japan's carry trade unwind caused a surge in the VIX Index, which later stabilized. Despite the turbulence, global stocks recovered to record highs, though with a shift toward more defensive sectors.

$1tn

CHINA NEEDS SPEND $1 TRILLION TO ADDRESS ITS PROPERTY SLUMP

In its annual review of China's economy, the IMF's staff recommended a substantial solution to the country's property slump where they proposed a package equivalent to 5.5% of GDP over four years, nearly $1 trillion according to Bloomberg's estimates.

90%

EUROPE REACHES 90% GAS STORAGE CAPACITY

The EU's November 1st gas storage target was exceeded by over two months, helping ease a price rally sparked by concerns over Russian supply disruptions. Increased storage has provided stability, reducing fears of winter energy shortages.

$36bn

MARS AGREED TO ACQUIRE KELLANOVA FOR NEARLY $36 BILLION

In the largest deal of the year, Mars will pay $83.50 per share in cash, a 33% premium over Kellanova's closing price on August 2, before the talks were disclosed. This acquisition brings together two major food companies, expanding Mars' portfolio with brands like Pringles and Eggo waffles.

MONTHLY TOPIC: ESG AS A LITMUS TEST

It may seem that ESG investing is losing momentum. The trend has slowed, as evidenced by the inflows into ESG funds. Several factors may explain this cooling off: the valuations of companies with high ESG ratings are often high, the impact of ESG investing is not immediately seen, ESG data are not 100% reliable.

In our view, this recent shift is not necessarily negative but rather a natural and beneficial maturation of the ESG market. As the initial excitement wanes, investors and stakeholders are now focusing more on the substance behind ESG claims, demanding greater transparency and accountability.

The adoption of ESG principles to become a better corporate citizen requires top management to recognize the importance of these issues; otherwise, ESG compliance risks becoming merely a financial burden of reporting metrics mandated by law. Implementing ESG not solely for reporting purposes, but to improve processes, and increase efficiency could serve as a litmus test for corporate quality.

Fears that companies are merely complying on paper without making real progress in ESG are not supported by the data. There is clear evidence of incremental improvements across the globe, particularly in environmental initiatives and key social and governance areas such as employee safety and better gender balance on boards.

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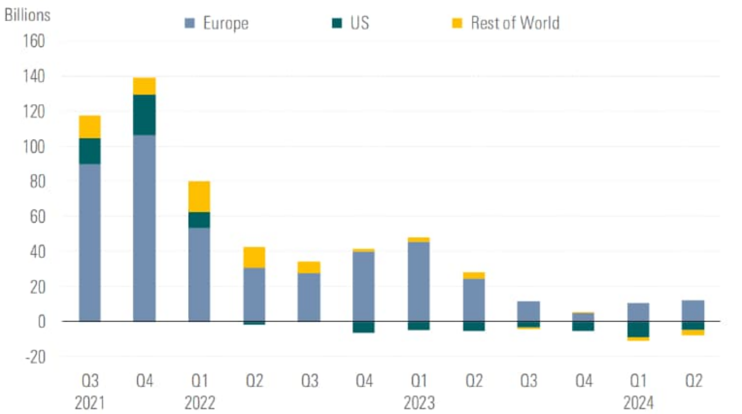
HOW FAST CORPORATE WORLD BECOMES BETTER?

ESG Adoption and Corporate Quality

It may seem that ESG investing is losing momentum. The trend has slowed, as evidenced by the inflows into ESG funds (Fig. 1). Several factors may explain this cooling off: the valuations of companies with high ESG ratings are often high, the impact of ESG investing is not immediately seen, ESG data are not 100% reliable.

Figure 1: Sustainable fund flows



Source: Morningstar Direct, as of June 2024

In our view, this recent shift is not necessarily negative but rather a natural and beneficial maturation of the ESG market. As the initial excitement wanes, investors and stakeholders are now focusing more on the substance behind ESG claims, demanding greater transparency and accountability. A tightening regulatory environment should further support and promote the transformation of companies to improve their ESG performance.

The adoption of ESG principles to become a better corporate citizen requires top management to recognize the importance of these issues; otherwise, ESG compliance risks becoming merely a financial burden of reporting metrics mandated by law. Implementing ESG not solely for reporting purposes, but to improve processes, and increase efficiency could serve as a litmus test for corporate quality.

ESG adoption offers valuable insights into the quality of governance. Moreover, it provides benefits such as improved risk management, potential cost savings, and an enhanced corporate image — all of which can contribute to sustainably higher profitability.

In this article, we examine how quickly companies are improving their ESG performance by analyzing the dynamics of key performance indicators (KPIs) that reflect changes in environmental, social, and governance criteria over the past three years.

Environmental layer

The environmental pillar is a key focus for governing bodies, as climate change has become critical. We examined how efficiently companies are reducing their environmental footprint, using less energy, and generating less waste. The good news is that all selected environmental KPIs showed improvement, with significant gains in CO_2 emissions reduction (-20%) and energy use decrease (-18%).

Figure 2: Environmental ratios dynamics during 2020-2023, MSCI World AC

CO2	Energy Use	Water Use	Waste generation
-20%	-18%	-10%	-11%

Source: Hérens Quality AM, Reuters

The most substantial improvements were seen in traditionally high-polluting industries, such as energy, materials, and real estate. The slowest progress was observed in the financial and healthcare sectors, which typically have limited opportunities to make significant improvements in the environmental dimension.

Figure 3: ESG ratios dynamics during 2020-2023 by industries, MSCI World AC

	Gender Pay gap	Lost time injury rate	Salary gap	Energy Use	Water Use	Waste generation	CO2	Board Independence	Female % in BoD
Communication Services	-1%	-53%	27%	-13%	-24%	-21%	-39%	5%	62%
Consumer Discretionary	2%	13%	-19%	-22%	-14%	-7%	-23%	0%	22%
Consumer Staples	0%	-28%	6%	-17%	-20%	6%	-6%	0%	25%
Energy	1%	-13%	20%	-31%	-39%	-33%	-38%	0%	0%
Financials	2%	0%	0%	-10%	0%	-26%	-4%	3%	25%
Health Care	3%	-10%	-29%	-14%	-4%	13%	-20%	1%	9%
Industrials	2%	-23%	-2%	-17%	-14%	-10%	-25%	-8%	33%
Materials	-4%	-41%	-7%	-15%	-33%	-20%	-28%	-8%	33%
Real Estate	1%	-74%	-32%	-35%	-9%	-24%	-24%	9%	13%

Source: Hérens Quality AM, Reuters

Social layer

When examining indicators related to the social dimension, often considered the most sensitive of the three ESG pillars, there has been a clear improvement in employee safety, as evidenced by a substantial decline in the lost time injury rate (LTIR). However, the statistics on salary gaps, both in terms of gender disparity and CEO pay ratio, have shown little to no progress over the past three years.

Figure 4: Social ratios dynamics during 2020-2023, MSCI World AC

Gender Pay gap	Salary gap	Lost time injury rate
0%	-1%	-25%

Source: Hérens Quality AM, Reuters

LTIR was, as expected, considerably lower in the Real Estate and Materials sectors (Fig.3). A decline in the Energy sector was both anticipated and welcomed, and while it did occur, it lagged behind the majority of other sectors.

Governance layer

We analyzed two key ratios that reflect the situation on company Boards of directors: the independence ratio of board members and the gender ratio. The global median independence ratio stands at 53% and has remained largely unchanged over the past three years. The gender ratio, however, shows a different trend, improving year-over-year, either due to regulatory pressures or a growing recognition of its value.

Figure 5: Governance ratios dynamics during 2020-2023, MSCI World AC

Board Independence	Female % in BoD
0%	23%

Source: Hérens Quality AM, Reuters

By industry, the most notable improvements in both ratios were observed in Communication Services (Fig.3). Financials also performed well on average. While the Materials and Industrials sectors made progress in gender balance, they saw a decline in board independence.

Compliance with stakeholder expectations or real improvements?

The ESG reporting burden imposed by regulators and financiers on companies may be too heavy in terms of organizational changes and the cost of compliance. An IBM study highlighted the risk that the cost of reporting could outpace investments in meaningful action to improve corporate citizenship[1].

However, fears that companies are merely complying on paper without making real progress in ESG are not supported by the data. There is clear evidence of incremental improvements across the globe, particularly in environmental initiatives and key social and governance areas such as employee safety and better gender balance on boards. That said, progress in areas like fair remuneration processes and increasing board independence has stalled, as these seem not to be top priorities for many companies. While there is still room for improvement across all ESG dimensions, the corporate world is undeniably moving in the right direction.

References

1. IBM study, https://newsroom.ibm.com/2024-02-28-IBM-Study-Sustainability-Remains-a-Business-Imperative,-But-Current-Approaches-are-Falling-Short