OUTCOMES BEYOND PERFORMANCE

EQUITORIAL

ESG Dashboard 3.0

Evolving with an ever-changing investment environment

Hermes Global Equities
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For professional investors only

www.hermes-investment.com

HERMES
INVESTMENT MANAGEMENT

Environmental, social and governance (ESG) integration has become a salient component of best-practice investment management in recent years. This has helped drive the growth of valuable ESG data sources, thereby fuelling the evolution of our bespoke analytical tool, the ESG Dashboard.

Our core investment strategy is built on a solid and proven process. It aims to generate consistent, positive relative returns by investing in companies with strong fundamentals – including robust financial results, competitive strength, leading management teams who appreciate the potency of ESG risks, improving market sentiment and of course, an attractive valuation. These fundamental characteristics constitute a strong investment. But the tools and data used to identify companies which embody these attributes are subject to continual change and improvement. This evolution is illustrated well through our focus on ESG considerations.

OUR APPROACH TO RESPONSIBLE INVESTING

Responsible investing is entrenched in our investment decisions. Indeed, it is part of our heritage as a business, and we are proud to have led the charge as early adopters of ESG analysis in the investment industry and to continue being at the forefront of this positive change. In a world with a growing population and finite resources, ESG analysis drives fundamental value for all businesses. Given the rapidly evolving global marketplace, companies must ensure that their business models are fit for purpose and maintain a social licence to operate.

Factors beyond traditional financial metrics can be material. We have sought to demonstrate the effectiveness of ESG factors in predicting outperformance since the team's inception in 2007. Devoid of a broad set of quantitative data, however, it was not possible to do so in a systematic way until 2012. Our proprietary research, which was initially published in 2014, demonstrated the performance benefits of integrating ESG factors into investment decisions[1]. It found a statistically significant link between the quality of corporate governance and shareholder returns. This finding enabled us to systematically integrate analysis of corporate governance into the stock-selection process.

At the same time, we also upgraded our bespoke tool, the ESG Dashboard. It was originally created in 2010 using a limited dataset of feeds from external providers. Subsequently, in 2013, we expanded its capabilities to incorporate qualitative and quantitative information. For each company in our universe, the Dashboard provides a concise digest of the ever-increasing amount of data on ESG risks. In this way, analysts and portfolio managers across Hermes can easily incorporate ESG analysis into their stock-selection processes. Furthermore, it flags any stock-specific sustainability risks. The Dashboard also draws on the insights of Hermes EOS, which advises on proxy votes and engages company directors and executives about ESG risks that concern shareholders. This provides an information advantage: proprietary insights into engagement progress and forward-looking views of the ESG risk exposures of companies, compared to the retrospective analysis of external data vendors.

PROPRIETARY INSIGHT: THE ESG DASHBOARD

The ESG Dashboard quantifies a company's ESG profile across a broad range of metrics, producing an overall ranking: the QESG Score. This score is used to systematically direct the capability towards companies with an attractive ESG profile. Indeed, the QESG Score, and the Dashboard as a whole, was developed to reflect our ESG assessment philosophy. The proprietary score also acts as an early indicator of changing ESG risks, thereby alerting analysts and portfolio managers to potential issues and opportunities.

[1] Source: "ESG investing: Does it just make you feel good, or is it actually good for your portfolio?" published by Hermes Investment Management as at January 2014 and "ESG investing: it still makes you feel good, it still makes you money," published by Hermes Investment Management as at September 2016.

ASSESSING ESG EXPOSURE

For long-term investors, like ourselves, there are a number of key considerations when assessing ESG risk:

Transparency

Investors need to understand why a company received a specific ESG ranking. Since its origin, the aim of the Dashboard has been to provide a broad, easy-to-interpret summary of a company's ESG profile, while clearly highlighting key ESG risks. Synthesising data from a range of carefully evaluated external providers and voting and engagement records from Hermes EOS, the Dashboard generates a QESG Score. This is simply a proprietary measure of the current level and trend of ESG risk within a given company.

The Dashboard provides the tools we need to interrogate the QESG Score, questioning the validity of both the data used and the calculations employed. While there are many strong commercially available ESG rankings, investors can struggle to interpret them. For example, one individual ESG issue may have a disproportionate impact on a company, yet it may be overlooked in the overall ESG ranking. Through the ESG Dashboard, we can identify the contributions of each ESG risk factor and therefore demonstrate ESG integration in a transparent, quantifiable way.

Appropriate peer group

ESG factors must be assessed relative to geography and business segment. For example, a mining company is subject to radically different risks than a financial company, and these risks vary depending on the regions in which it operates. As such, companies must be compared against industry peers functioning in similar locations. By using the Dashboard, we are able to evaluate a company's ESG risks relative to industry leaders and laggards.

Best-of-breed approach

There is no single leading source of ESG data. Instead, there are a plethora of commercial offerings. We incorporate data from leading providers into our Dashboard, including Sustainalytics, Trucost, Bloomberg, FactSet, ISS and CDP. Ratings providers often use a company's sustainability report as an information source. But this information can be stale, inconsistent in its scope, and at worst, potentially biased since it is based on information that a company discloses. Using a number of different sources has allowed us to strengthen our conviction when assessing specific ESG practices.

Furthermore, our ability to use proprietary insights from Hermes EOS is a key differentiator. In this way, investors benefit from multiple perspectives from ESG analysts and can therefore better understand companies.

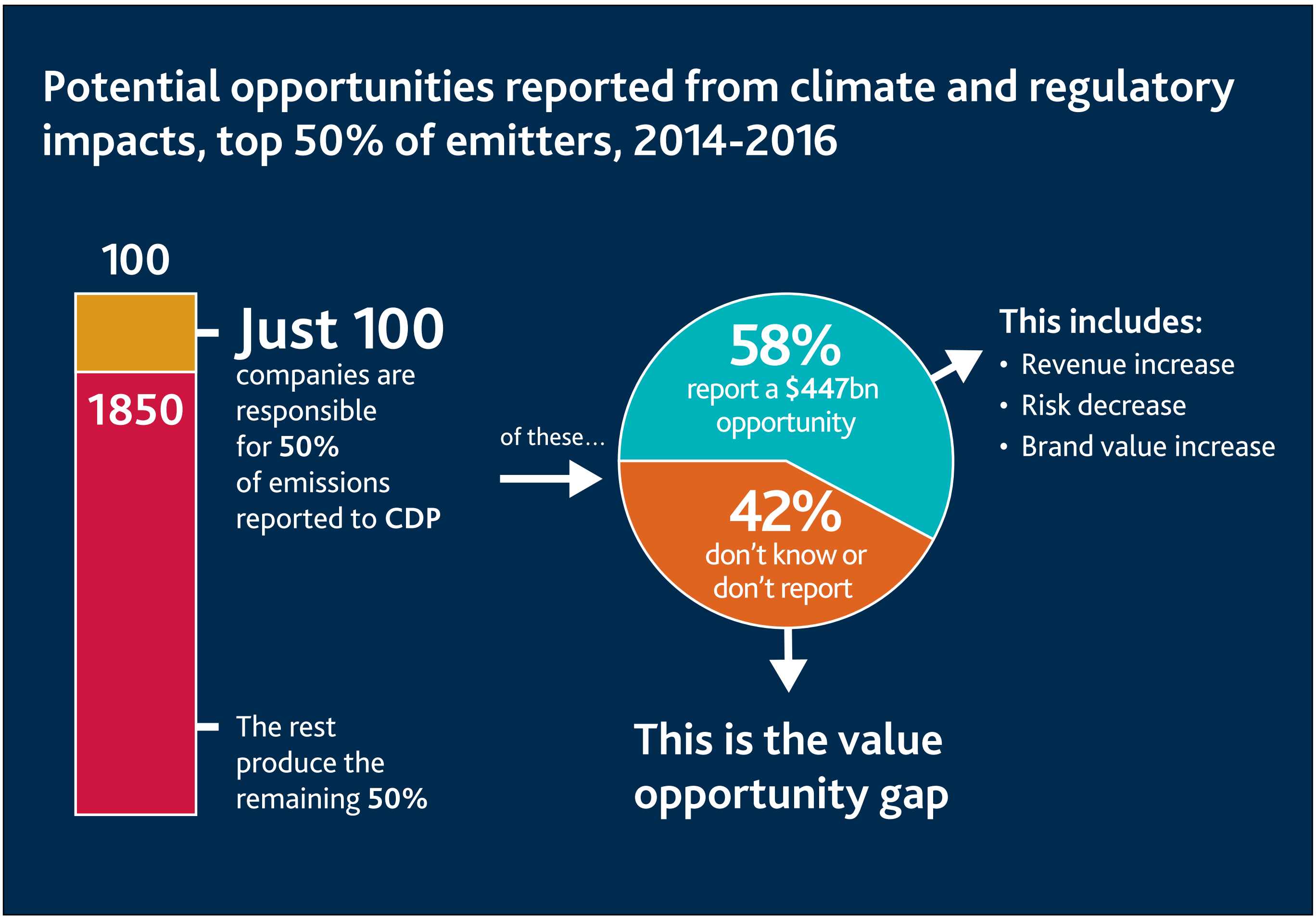
Change

Perhaps the most pertinent insight to a company's ESG profile comes from how it is changing over time. It is important for long-term investors to look beyond a company's behaviour today, and the Dashboard gauges both the current level and projected change in ESG risk. Through an established, results-driven voting, corporate engagement and policy implementation service, Hermes EOS creates a powerful force for positive change. By drawing on insights from Hermes EOS, the Dashboard can identify companies undergoing a real improvement in their ESG metrics, and vice versa.

There is a clear theoretical link between the current level of a company's ESG characteristics and its expected valuation, since companies with a lower overall risk profile are likely to attract a higher valuation. And research shows that this is not fully reflected in current market valuations, providing opportunities for ESG-observant investors. A deep-dive analysis of CDP data revealed 40% of companies fail to capture or report any financial value from strong environmental performance[2]. Despite almost $500bn in disclosed value at stake across all reporting companies, trillions of dollars in opportunities are unquantified. Furthermore, more than 1,389 companies are disclosing their plans or current practice of putting a price on carbon emissions to CDP – that's an 11% increase on last year[3].

1,389
The number of companies disclosing their plans or current practice of putting a price on carbon emissions.

Figure 1. Potential opportunities reported from climate and regulatory impacts, 2014-2016



Source: "Understanding the financial value of environmental performance in consumer goods," published by Accenture Strategy, CDP, Hermes Investment Management, as at September 2017.

Indeed, the same logic can be applied when assessing companies that are increasing their focus on ESG issues and essentially de-risking their businesses. Such companies are lowering the discount rate that should be used to value their businesses, thereby increasing the expected valuation. In this way, companies making improvements to their ESG metrics have the potential to unlock shareholder value. This can manifest as competitive advantages, reduced risk or an enhanced reputation, translating directly into increased value for the firm.

[2] Source: "Understanding the financial value of environmental performance in consumer goods," published by Accenture Strategy, CDP, Hermes Investment Management, as at September 2017.
[3] Putting a price on carbon: Integrating climate risk into business planning," published by CDP as at October 2017.

INTRODUCING THE ESG DASHBOARD 3.0

Since its inception the ESG Dashboard has enhanced our ESG analysis. But as ESG integration continues to evolve as an investment concept, so too must our thinking. Inherently, the Dashboard is a tool subject to ongoing improvements – never complete, as we always seek to improve it.

In 2010, the first iteration of the Dashboard came to fruition. A couple of years later, the ESG Dashboard 2.0 was launched, offering users a cleaner, more intuitive interface[4]. There have been a myriad of small changes to the Dashboard since 2013, including the addition of individual metrics examining board diversity and tax transparency, and data providers such as CDP.

Further change is imminent. We will release an updated version of the Dashboard before year-end, which reflects recent developments within ESG investing and the availability of more information. The changes include:

Alignment with the UN Sustainable Development Goals (SDGs): Our new SDG metric will decompose a company's revenue across the 17 SDGs. With a total of 169 targets and 230 indicators, the goals seek to realise the human rights of all and achieve gender equality, among other issues. They are integrated and indivisible and balance three primary dimensions of sustainable development: the economic, social and environmental. We have written previously about the value of embedding the SDGs in an analytical framework, and are pleased to make progress in this regard[5].

The fundamental methodology of the Dashboard's new metric will use the SDGs to identify a company's specific focus within an industry, highlighting its reliance on green revenue sources, such as renewable energy or transformative technologies, or brown revenue sources, such as coal mining or military contracting. Companies aligned with the SDGs will ultimately reap the rewards of responsibility and the enhanced Dashboard will identify such forward-thinking companies.

Company classification: Companies will be classified by their significant business streams, reflecting their exposure to a specific range of products and services using a granular set of sub-industries using our vast data set. This new methodology for decomposing revenue goes far beyond the traditional 68 GICS industries, and even the 157 sub-industries. This compares to traditional classification methods, which categorise companies by a single industry. The new data set will break with tradition, allowing us to assess companies in a more granular way based on their relevant KPIs across their lines of business.

New QESG Score: The new scoring mechanism will pit companies directly against the KPIs of the industries to which they are exposed. The Dashboard also presents any KPIs which could represent a weakness for the business, thereby alerting investors to any red flags or issues worthy of corporate engagement. We also use raw data metrics, where available, and apply our experience to assess materiality. This is a crucial part of our investment approach, as it identifies value and opportunity from ESG signals.

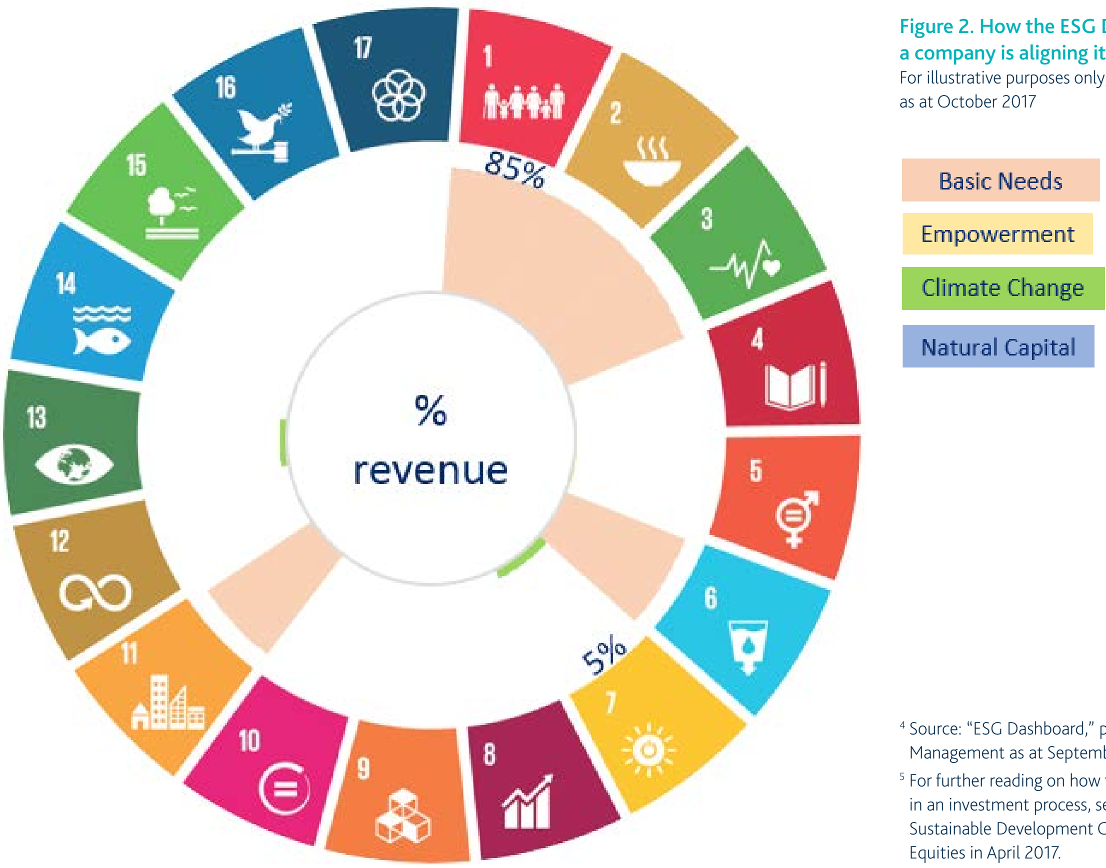


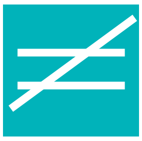
Figure 2. How the ESG Dashboard reports on how a company is aligning its activities with the SDGs
For illustrative purposes only; Source: United Nations, Hermes as at October 2017

[4] Source: "ESG Dashboard," published by Hermes Investment Management as at September 2015.

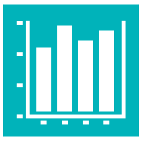
[5] For further reading on how the SDGs can become integrated in an investment process, see "Within investors reach? The UN Sustainable Development Goals," published by Hermes Global Equities in April 2017.

Geographic revenue exposure: A new data source will identify the countries in which a company generates revenue, which is of greater salience for investors than country of listing. It isolates companies that generate a significant portion of their revenue from less-developed countries, or those at risk of corruption. In this way, users can ensure companies have the appropriate safeguards in place to tackle any potential issues.

Water scarcity metric: By measuring water scarcity across countries, the QESG Score can pinpoint companies with material exposure to water stress, an issue of growing importance to investors.

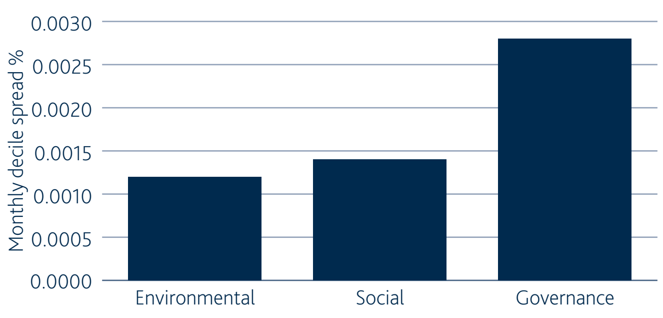


Inequality metric: A similar technique to our water scarcity metric is applied to the Gini coefficient[†], identifying companies exposed to countries suffering from extreme inequality that may result in potential risks to their operations and customer base.



MSCI ESG data: For the first time, the Dashboard will incorporate the MSCI ESG database. The MSCI data provides broad coverage of ESG matters and offers an idiosyncratic perspective on each company. It will distinguish a company's ranking across each individual E, S and G metric. The different interpretation offered by MSCI, as compared to other data providers, will help investors fully comprehend the materiality of any ESG risks. Following the launch of the ESG Dashboard 3.0, there will be over 10 different data providers connected to the Dashboard.

Figure 3: Performance from ESG factors: Monthly decile spread (%)



Source: Hermes Global Equities, 30 June 2017. Note: Monthly decile spread is the average difference in monthly return between companies ranked in the top 10% and companies ranked in the worst 10%. Figures calculated using constituents of the MSCI World index assuming monthly rebalancing.

User interface: ESG change will continue to be an imperative consideration of the Dashboard. We emphasise the evolution of a company's ESG profile over time and how it compares to industry peers. In situations where a company has experienced an historical controversy, it is important for users of the Dashboard to understand its response, outlook and the industry impact. These subtleties are prominently displayed on the new Dashboard. Companies will now be examined across an elongated time horizon, including retrospective and forward-looking perspectives. In this way, it alerts analysts and portfolio managers to potential issues at an early stage.

Remuneration: Transparent remuneration and incentive structures are key corporate governance themes. We see remuneration practices as being key to aligning the activities of management teams with a company's purpose, strategy and performance. A well-structured, transparent remuneration policy can contribute positively to long-term business success and align the interests of management and other stakeholders, including employees. As such, it is important that companies communicate their objectives clearly to employees, particularly the distribution of profits.

Often companies with effective pay packages employ numerous metrics, including a 'balanced scorecard' approach. We recognise that there is a plethora of remuneration frameworks and legal structures worldwide. For this reason, no single metric can be applied to companies. As documented in the Hermes Remuneration Principles, we seek to pragmatically improve existing executive director pay practices, for large publicly listed companies[6]. We apply this framework when evaluating a company's incentive structures through the Dashboard. In its latest iteration, we have improved the method by which we access a company's incentive structure thanks to greater transparency and regulation on remuneration data. This means we can now capture additional remuneration data points, which allows us to identify companies that are not aligned to the Hermes Remuneration Principles with greater ease. It also pinpoints areas for improvement.

ENGAGED AND EVOLVING

Our team continues to adapt to the ever-changing investment environment. And 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.

We will continue to assess new and enhanced data sources, as and when they become available, in order to understand whether they can enhance portfolio performance. And as shareholders, we will continue to act as engaged owners with the aim of helping companies to improve and to limit idiosyncratic events that can be detrimental to performance. This contributes to our efforts to meet our performance objective: to generate consistent excess returns, irrespective of the market environment.

[6] Source: "Remuneration Principles: clarifying expectations," published by Hermes Investment Management as at November 2016.

[†] The Gini coefficient is based on the comparison of cumulative proportions of the population against cumulative proportions of income they receive, and it ranges between 0 in the case of perfect equality and 1 in the case of perfect inequality. Further information available here.

HERMES INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

HERMES INVESTMENT MANAGEMENT

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, and small and mid cap

Credit
Absolute return, global high yield, multi strategy, global investment grade, real estate debt and direct lending

Multi asset
Multi asset inflation

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices

London | New York | Singapore

Why Hermes Global Equities?

Transparency
Our accessible investment process and analysis is based on clearly defined statistical and economic evidence. It is not a 'black box' and the drivers of returns can be clearly explained.

Expertise
Our bottom-up stock-selection model systematically analyses companies' financial statements and gauges investor sentiment to generate an optimal portfolio. The team draws on its deep investment experience to identify unquantifiable risks such as negative news flow and regulatory change.

Flexibility
We partner with clients to create portfolios addressing their needs, amending the risk profile, investment universe and benchmark, and portfolio characteristics such as dividend yield and ESG exposure as required.

Broad risk awareness
MultiFRAME, our proprietary risk modelling system, detects exposures to all quantifiable risks. The Hermes Investment Office performs independent risk management services for clients and sustainability risks are identified by our ESG Dashboard.

For more information, visit **www.hermes-investment.com** or connect with us on social media: