OUTCOMES BEYOND PERFORMANCE

HERMES IMPACT OPPORTUNITIES

Understanding and measuring impact

Impact Opportunities Equity
Q3 2019

For professional investors only

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HERMES INVESTMENT MANAGEMENT

Impact investors need to adopt a proactive approach to understand and measure the impacts that businesses have on society and the environment. However, the practice of measurement is not straightforward: it can be seen as an imprecise and multidimensional art. Against this backdrop, we present our impact measurement philosophy.

Key points:

- **Robust impact measurement fulfils two crucial functions: accountability for impact performance; and validation of the Theory of Change.**
- **We have designed our own impact-measurement framework to guide internal investment decision-making.**
- **We treat impact measurement according to its complexities – and so, we do not believe it should be quantified as a single metric. We use quantitative metrics alongside other qualitative inputs to form an opinion on a company's impact performance.**

"What gets measured, gets managed."

So goes the oft-quoted business maxim, commonly attributed to management guru Peter Drucker. But how readily does it apply to impact measurement?

Measurement is one of the key concepts of impact investing – alongside intentionality and additionality – that distinguishes it from other, more traditional forms of investing. However, in a rapidly growing market, impact measurement is not a straightforward science. Often, investors employ a disparate, opaque set of practices which lack standardisation, as evidenced from the Global Impact Investing Network's (GIIN) 2018 Annual Survey[1].

Measurement is one of the key concepts of impact investing ... that distinguishes it from other, more traditional forms of investing.

Impact measurement is an imprecise, multidimensional and, at times, counterintuitive art that is still evolving – though crucial to the integrity of the profession. As such, it does not naturally lend itself to standardisation or quantification into a single, convenient metric.

We treat impact measurement according to its complexities, using a framework that prioritises understanding these complexities over simple numbers.

Why measure impact?

Impact investments are made with the intention of generating positive benefits for society or the environment, in addition to the goal of delivering positive investment returns.

The measurement of societal and environmental impacts is a cornerstone of this style of investing – so much so that measurement is often used to differentiate impact investing from 'responsible', SRI or environmental, social and governance (ESG) investing.

From an investor perspective, robust measurement fulfils two crucial functions:

1. **Accountability for impact performance:** Impact investing, as commonly defined, aims to generate both a risk-adjusted financial and impact return. The promise of a dual return renders the investor accountable to systematically report both forms of return to their clients. Arguably, this accountability for impact performance is even more important at the company level.

2. **Validation of the Theory of Change:** Being able to track impact performance is important to validate the impact thesis, or 'Theory of Change', that is articulated at the start of the investment process. In other words, it allows the investor to demonstrate, over time, that the investee company has met the set impact goal. This prevents investors from retroactively claiming intentionality.

THE HERMES PHILOSOPHY

In designing our own impact measurement framework, our priority was to create a meaningful approach that guides internal investment decision-making, rather than a tool simply for external reporting.

Our philosophy is also cognisant of the constraints that we operate within as intermediaries between listed companies that create positive change and our clients. Our impact-measurement framework, therefore, is focused on the company-level impacts (as opposed to investor-level impacts), and highly dependent on the quality of data that our portfolio companies disclose.

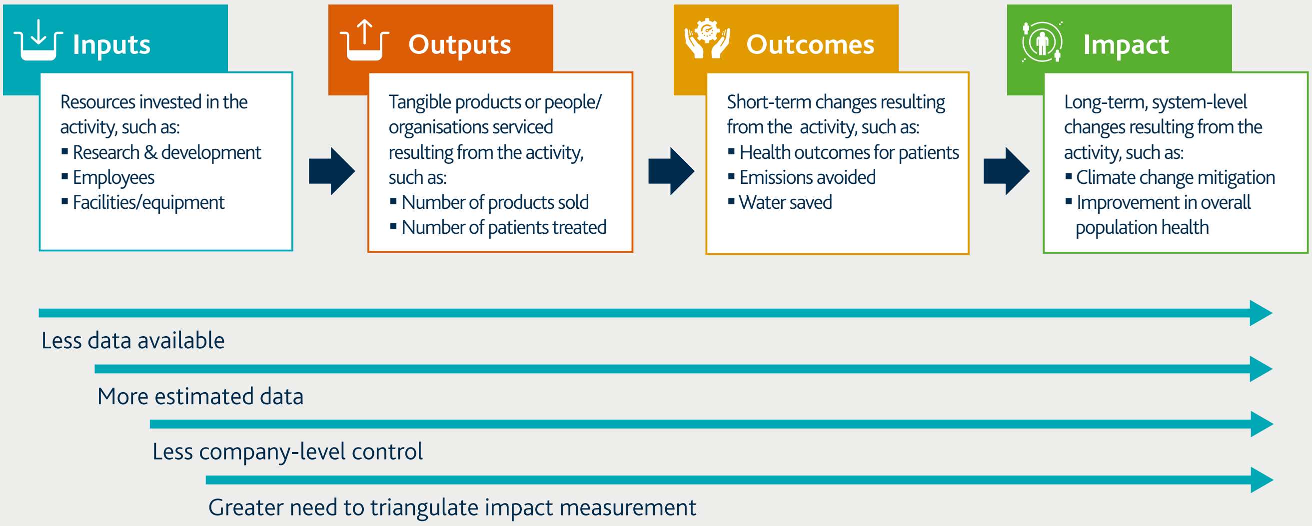
'Impact' measurement is a Sisyphean task

'Impact' constitutes a sustained, positive change at the system-level. Investors, therefore, encounter a natural limit when trying to measure impact at company level. In turn, this makes impact measurement seem like a Sisyphean task – one which can never be completed.

In order to understand the 'cause-and-effect' chain of impact, we use a 'Pathway of Change' (PoC) model for each company we invest in. Because the more we can track progress through the PoC (by populating each PoC stage with trackable, reliable metrics), the richer our understanding of the company's impact becomes (see Figure 1).

[1] "2018 GIIN Annual Impact Investor Survey," published by GIIN in 2018.

Figure 1. The Pathway of Change: tracking impact progress
An example of the PoC for a portfolio company in our Health & Wellbeing theme



Source: Hermes Investment Management as at June 2019.

For publicly-listed companies, the availability of input data is generally good. Indeed, the majority of resources that companies use to manufacture products and deliver services, such as the number of employees and capital expenditure, are typically reported as part of their financial statements.

Data availability, however, deteriorates as we approach the output stage. Output data, which include metrics like the number of products sold, are often not published for competitive reasons.

At the outcome level, most companies provide one data point rather than a time series. While this gives us an indication of the outcomes that their products can produce, it is not helpful for tracking outcomes over time. Broadly, the exceptions to this are environmental outcomes, such as emissions avoided, and educational outcomes, such as grades obtained, which can be tracked over time.

We draw on independent research to understand the link between company-produced outcomes and the broader impact.

Upon reaching the impact level, a lot of different variables are at play. This interplay of different variables (the company's outcomes are only one of many) all feed into the resulting impact.

We therefore question whether impact can meaningfully be measured at company level, especially in complex entities. This is why we draw on independent research, provided by inter-governmental organisations, academia and non-governmental organisations, to understand the link between company-produced outcomes and the broader impact.

In the future, improved disclosure and innovative technology may help bridge the gulf between impact and outcomes, but it is still early days.

Impact goes beyond ESG

Today, public-market investors have more access to ESG data than ever before. In the scramble for data, there has been a temptation to use this increasingly rich dataset for impact measurement. However, we caution against such an approach. That's because we believe ESG data is not designed for this purpose.

For the most part, ESG data is focused on how sustainably a company is run, particularly its operations, and the impacts generated during the production of its products or services. This is a much-needed part of investment analysis for any investor. But impact measurement goes beyond this by focussing on the impact that results from the utilisation of the company's products or services.

Instead of monitoring operational impacts, we believe that impact measurement should first and foremost validate or nullify the Theory of Change, which underpins the investment case. This ensures that impact measurement is linked to intentionality, both on account of the investor and the investee company. Otherwise, we risk rewarding the investor for positive impacts that were never part of the original investment or impact thesis.

However, we do recognise that ESG analysis is extremely important to any investor, including ourselves. We therefore recognise that focusing on the positive impact that companies have by means of their products and services is too narrow: it needs to be complemented by carefully assessing the company's negative operational impacts. We are cognisant that companies in our portfolio have their fair share of negative impacts too.

Numbers are the starting point, not the end in itself

Quantitative data without context is, at best, unhelpful and at worst, misleading. Numbers should be used to enrich understanding of impact, not supplant it. However, quantifying impact down to a single metric is increasingly seen as the end-goal of impact measurement, suggesting that the lesson of the McNamara fallacy – named after former US defence secretary Robert McNamara's over-reliance on metrics during the Vietnam War – still hasn't stuck.

We use quantitative metrics alongside other qualitative inputs, such as independent research studies, to form a holistic opinion on a company's impact performance.

While true as a general principle, recognising that numbers are a mere starting point is particularly important for listed companies. The bigger the company, the greater the geographic spread, the more dendritic the supply chains and the broader the product portfolio, the more difficult it is to convincingly distil a company's impact down to a few numbers.

Even if it was desirable to quantify impact measurement as a single figure, it would not currently be possible, owing to poor data availability in public markets. Similarly, attempts have been made to quantify ESG scoring into a single number, but such an approach has been deemed too simplistic to capture the broad array of sustainability issues that fall within the remit of ESG.

Over the past few years we have witnessed a significant uptick in companies reporting on their ESG performance and operational footprint. Nevertheless, corporate reporting on the outcomes or impacts generated by companies' products or services remains scarce. This likely reflects the resource-intensive and complex nature of impact measurement as well as a dearth of shareholders pushing for these disclosures.

To compound these difficulties, when companies report on the impact of their products and services, the data quality tends to be poor.

Unlike financial statements, few impact data points are audited or adhere to a common reporting standard. Indeed, many only receive a brief mention in sustainability reports and fail to explain the measurement methodology and assumptions employed.

As part of our impact-measurement process, we have engaged with our portfolio companies that have published impact metrics in an attempt to better understand the methodologies employed. We only include metrics in our framework that, we believe, will be reported on an ongoing basis.

For this reason, we use quantitative metrics alongside other qualitative inputs, such as independent research studies, to form a holistic opinion on a company's impact performance.

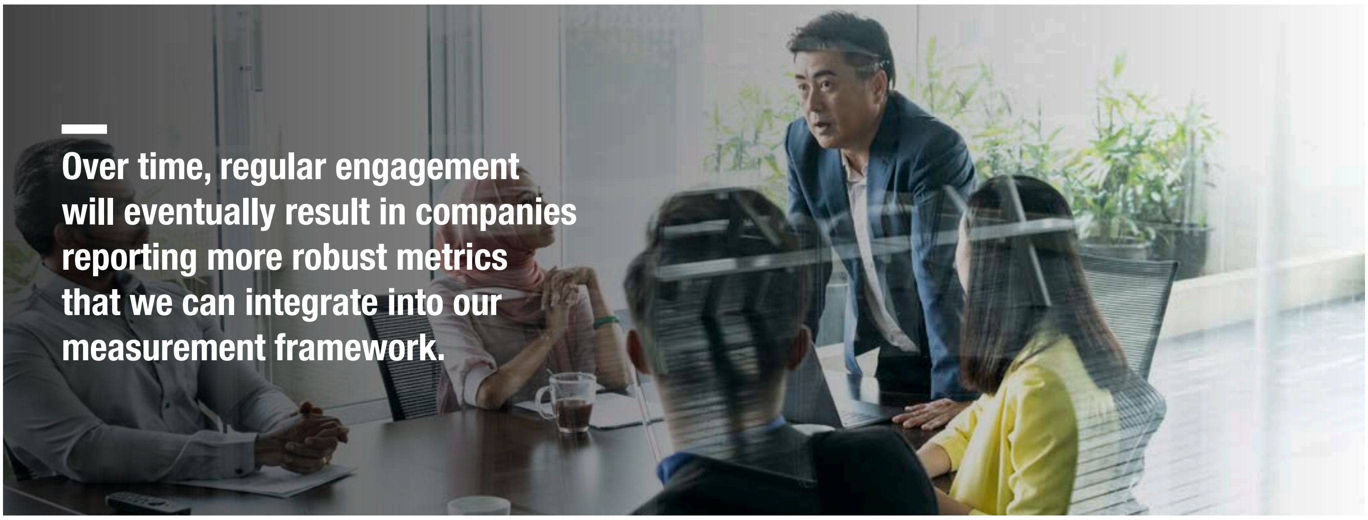
Engagement tops estimation

In the absence of company-provided and third-party data, we have decided to not currently estimate impact for two reasons:

1. As public-market investors, we are the intermediary. Companies generate value by creating positive impact. As such, companies are better placed to measure and manage those impacts.
2. Many of our portfolio companies lack confidence in the robustness of their output and outcome data. For this reason, we do not estimate metrics that companies themselves cannot confidently measure.

We pursue regular, constructive engagements with companies in an attempt to understand the impact they generate. Engagement is a key aspect of impact measurement as it encourages companies to understand, measure and, ultimately, be accountable for their impact.

Over time, we hope that regular engagement will eventually result in companies reporting more robust metrics that we can integrate into our measurement framework. However, even then, impact should never solely be viewed through the lens of a simple metric.



Collaboration is key

We are a young fund operating in a nascent industry. As impact measurement continues to evolve, so too must our thinking. Inherently, our bespoke framework is a tool subject to ongoing improvement, and we will not hesitate to overhaul it, should a better framework become available.

70%
of impact investors use …frameworks that are not aligned to external methodologies.

£502BN
estimated impact-investing assets under management

The standardisation of impact measurement practices and reporting is still a long way off, with the GIIN 2018 Investor Survey revealing that almost 70% of impact investors use proprietary metrics or frameworks that are not aligned to external methodologies. And so, collaboration will be instrumental in devising shared principles in the long-term. In 2019, we created the *Hermes SDG Taxonomy* – an open resource created by investors, for investors – that seeks to prove clear links between the 169 targets within the Sustainable Development Goals (SDGs) and potential investments in a logical and transparent way. It is a living document, open to ongoing updates as and when we interact with academics, companies and research addressing the Theory of Change for each underlying SDG target.

Moreover, contributing to measurement and reporting initiatives is crucial as they have the capacity to develop a shared performance standard for impact measurement, such as the Impact Management Project.

Indeed, it is particularly pertinent to develop a shared standard now as the impact investment industry is rapidly moving into the mainstream. Estimates of impact-investing assets under management have recently been significantly revised up to $502bn as a result of a new market-sizing study.[2]

As Clara Barby, Chief Executive of the Impact Management Project, argued, impact measurement needs to become a "pre-competitive issue": investors should not be competing on how good our impact measurement approaches are but "rather on how much impact we have"[3].

Understanding impact measurement

A sole reliance on quantitative metrics is as dangerous for impact measurement as relying on an isolated proposition like "what gets measured, gets managed" to guide one's thinking.

Indeed, when placed in context, the aforementioned business adage takes on a very different meaning. Contrary to popular belief, the coining of the phrase has been attributed to the academic V.F. Ridgeway rather than Drucker.

Rather than advocating the reduction of complexities to simple numbers, it can be seen as cautioning against it. In 1956, Ridgway famously noted: "What gets measured gets managed – even when it's pointless to measure and manage it, and even if it harms the purpose of the organisation to do so."[4]

After all, an appreciation of the nuances of impact is a necessary precondition to understanding it.

[2] "Impact investment universe grows to $502bn," published by the Financial Times in March 2019.
[3] "Raising the bar for impact management practice, with stakeholders at the center," published by Impact Alpha in November 2018.
[4] "The rule is simple : be careful what you measure," published by The Guardian in February 2008.

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:

High active share equities, private markets, credit and responsible investment advisory services.

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