HERMES IMPACT OPPORTUNITIES

SDG investing taxonomy

HERMES
INVESTMENT MANAGEMENT

The Sustainable Development Goals (SDGs), an ambitious set of global goals aiming to create prosperity for all and safeguard the planet, are focused on addressing unmet and underserved needs. We believe that companies whose activities contribute to achieving the SDGs are not only likely to create positive social and environmental impacts, but are also exposed to the drivers of future growth. To identify investment opportunities directly connected to the goals, we have created an SDG taxonomy that is both precise and flexible, enabling us to target today's impactful companies, and those of tomorrow.

WHY WE NEED AN SDG TAXONOMY?

The SDGs are now widely accepted as the key collective reference point for impact investing across asset classes. When the 17 goals were agreed upon by the international community, they were designed to appeal to the broadest audience possible and were therefore, not conveyed in a format that was tailored to investors.

As a result, very different approaches have been taken towards investing for achieving the SDGs. For many investors, the default position has been to retrofit the SDGs within existing frameworks and processes i.e. to relate them to current positions. This leverages the breadth of the 17 goals, but fails in achieving their objectives: to change attitudes and behaviours, and to attract incremental capital to address the goals.

Given this situation, in what remains a nascent approach, we believed that it was essential to develop a rigorous and structured taxonomy to demonstrate clear connections between the underlying targets of the SDGs and investment opportunities.

First and foremost, we aimed to establish which of the SDGs are actually investable through public equities or other asset classes. In order to deliver this, we delved much deeper than the 17 high-level goals which are overarching objectives. Instead, we focused on the underlying 169 targets, which are much more specific in nature and require a thorough assessment of the opportunity set they represent.

The Hermes SDG Taxonomy distils both targets and goals for sustainable development, and in doing so identifies the investable areas and themes on which investors should focus to support a positive contribution towards achieving the 2030 objectives.

The taxonomy brings integrity to our impact assessment, as well as full traceability of our portfolio investments back to the underlying SDG target. It also serves as a precursor to our thematic investment approach. Our nine sustainable investment themes, for example, can be traced back to SDG targets. It is through this taxonomy that we can demonstrate the complex interlinkages between the underlying SDGs and targets and ensure we only invest in areas that directly address these.

HOW WE DID IT

We believe the SDGs, if viewed through a taxonomy lens, are a valuable tool to identify investment opportunities and work towards 2030 targets. The taxonomy can be a powerful source of investment ideas that address unmet needs and represent the beta of future growth.

Hermes' SDG Taxonomy focuses on a detailed assessment of the targets underpinning the SDGs, analysing them through the theory of change – the sequence of events from inputs, outputs and outcomes that lead to impact – and the risks to the case for impact – the potential reasons why the theory of change may fail – as they relate to public companies. These are essential concepts in understanding impact potential.

We began with a deep examination of each of the 169 underlying targets, first assessing whether an SDG target was something that could be addressed through public equities. If it could, we moved on to consider the breadth of investable areas that could help achieve this target, thereby identifying emerging growth opportunities.

We then undertook a detailed theory of change exercise for each investable area identified. We used peer-reviewed academic research or reputable industry reports to validate the issues and contribution potential through investment in these areas. We concluded with a consideration of the impact risks i.e the likelihood that impact will be different than expected through investment in the target area.[1]

To explore the Hermes SDG Taxonomy, visit: **www.hermes-investment.com/sdg-taxonomy**

[1] Hermes is a member of the Impact Management Project. We integrated aspects of its outcomes, including the broad terminology used, for consistency.

1. Example of how the taxonomy works

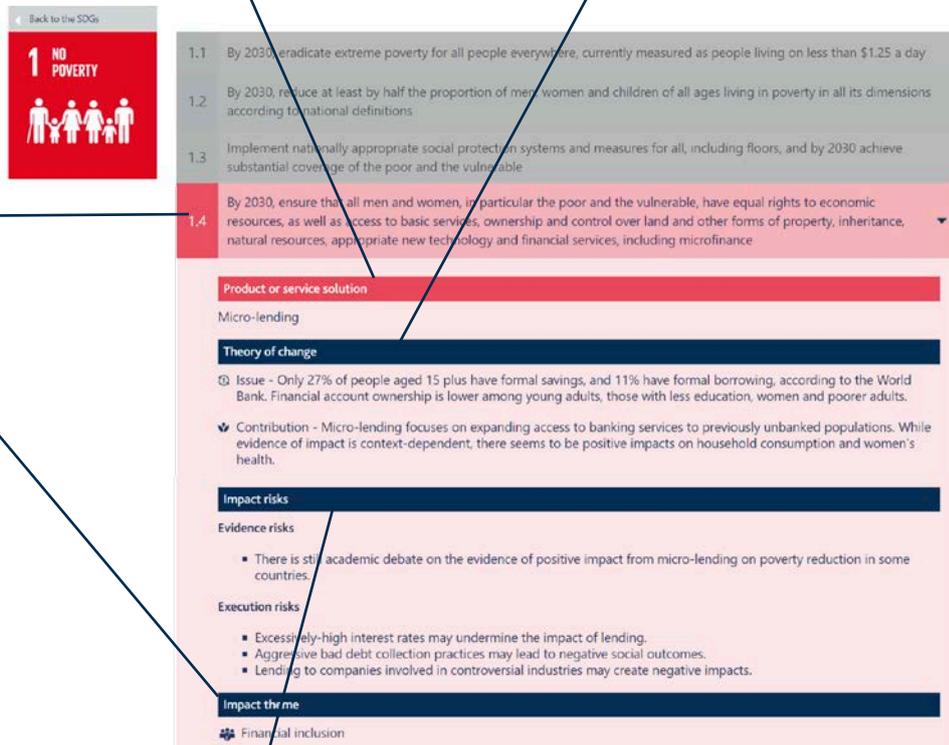| SDG	SDG target	Directly investable	Investable areas	Theory of change		Impact risks
				Issue	**Contribution**	
14: Conserve and sustainably use the oceans, seas and marine resources for sustainable development.	**14.1** By 2025, prevent and significantly reduce marine pollution of all kinds, in particular from land-based activities, including marine debris and nutrient pollution.	Yes.	Waste collection and recycling.	As much as 40% of the world oceans are heavily affected by human activities, including pollution, depleted fisheries, and loss of coastal habitats, while over 3bn people depend on marine and coastal biodiversity for their livelihoods. Marine pollution such as plastic packaging in oceans, fertiliser leaching into rivers etc. has a negative impact on marine ecosystems, potentially reducing biodiversity.	Recycling allows for a closed-loop system where less resources are required from the environment, thus limiting environmental degradation. If managed sustainably scarce natural resources can benefit current and future generations. While the OECD recycling average is only 25%, countries such as Germany or Taiwan are able to achieve the highest recycling rates of above 55%.	Working conditions of staff and contractors. Environmental impact of the recycling process. Disposal of non-recyclable materials.

14 LIFE BELOW WATER

SDG – one of the UN's 17 sustainable development goals – in this case, "1. End poverty in all its forms everywhere."

Product or service solution – goods and services that could help achieve this particular SDG target.

Theory of change – this section describes in further detail the relevant issues, as well as the potential for related investments to contribute positively.

SDG target – an example of the 169 specific SDG targets as outlined by the UN.

Impact theme – one of Hermes Impact Opportunities' nine sustainable investment themes. In this case, the investment area of Microlending has been identified as coming under the larger impact theme of Financial Inclusion.

Back to the SDGs

1 NO POVERTY

1.1 By 2030 eradicate extreme poverty for all people everywhere, currently measured as people living on less than $1.25 a day

1.2 By 2030, reduce at least by half the proportion of men, women and children of all ages living in poverty in all its dimensions according to national definitions

1.3 Implement nationally appropriate social protection systems and measures for all, including floors, and by 2030 achieve substantial coverage of the poor and the vulnerable

1.4 By 2030, ensure that all men and women, in particular the poor and the vulnerable, have equal rights to economic resources, as well as access to basic services, ownership and control over land and other forms of property, inheritance, natural resources, appropriate new technology and financial services, including microfinance

Product or service solution

Micro-lending

Theory of change

Issue - Only 27% of people aged 15 plus have formal savings, and 11% have formal borrowing, according to the World Bank. Financial account ownership is lower among young adults, those with less education, women and poorer adults.

Contribution - Micro-lending focuses on expanding access to banking services to previously unbanked populations. While evidence of impact is context-dependent, there seems to be positive impacts on household consumption and women's health.

Impact risks

Evidence risks

■ There is still academic debate on the evidence of positive impact from micro-lending on poverty reduction in some countries.

Execution risks

■ Excessively-high interest rates may undermine the impact of lending.
■ Aggressive bad debt collection practices may lead to negative social outcomes.
■ Lending to companies involved in controversial industries may create negative impacts.

Impact theme

Financial inclusion

Impact risks – here we outline the unintended or unexpected actual or potential negative consequences of investment in the target area.

2. What does the SDG Taxonomy tell us?

In our assessment, only 42 of the 169 underlying SDG targets, or 25%, are currently directly investable through public equities. This differs from a simple mapping of existing activities back to SDGs, where all the goals can be made to appear to be addressed, while in reality there has been no fundamental change in the investment decision making process.

The taxonomy demonstrates that the SDGs are complex and interconnected: addressing them is more an art than a science. Without the taxonomy, there is no way of verifying with a high degree of certainty that impact investments contribute to the delivery of the SDGs in an expected way.

The Hermes SDG Taxonomy identifies all the investable areas captured by the SDGs, which, when collated and refined, produced our nine impact themes – a valuable source of insight for identifying future investment ideas.

For example, Figure 1 shows the investable areas we identified and how they match the SDGs and targets that resulted in circular economy being identified as one of our nine impact themes. What is clear from this is the complexity of these relationships, leading our team to make judgments about investment opportunities based on available evidence.

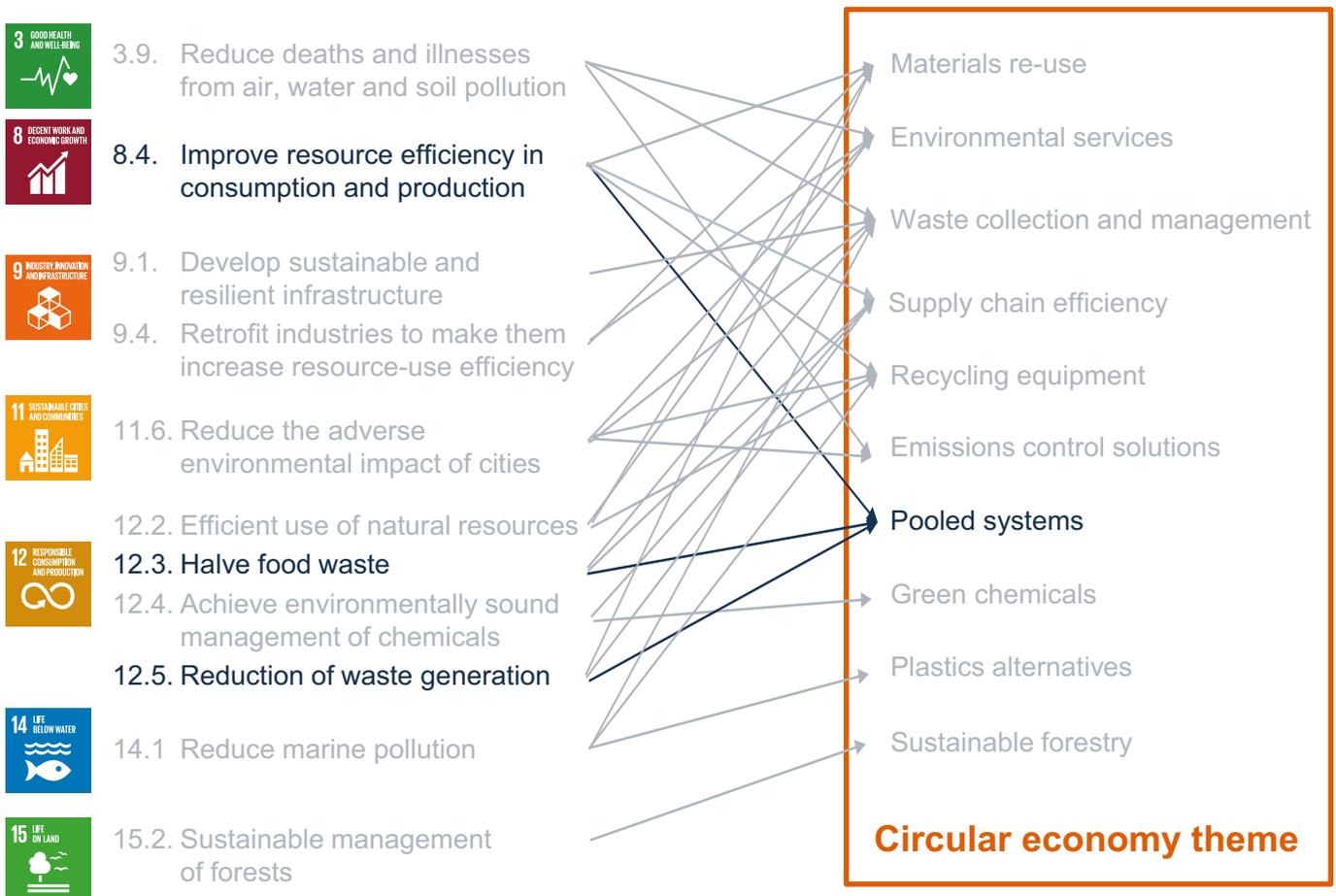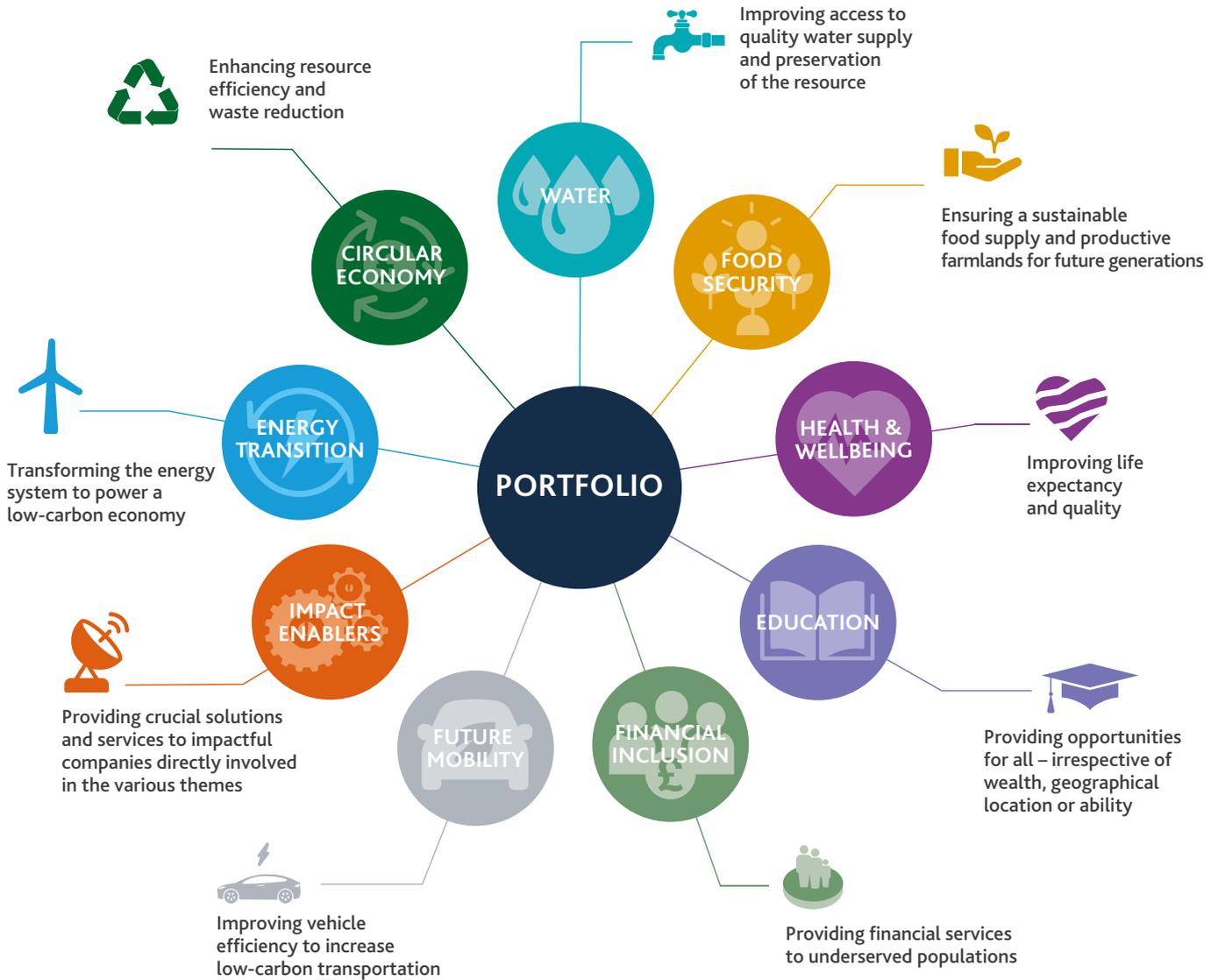**Figure 1.** Deriving Circular Economy as an investment theme from the SDGs

Figure 2. The nine impact themes of Hermes Impact Opportunities

Enhancing resource
efficiency and
waste reduction

Improving access to
quality water supply
and preservation
of the resource

Ensuring a sustainable
food supply and productive
farmlands for future generations

Transforming the energy
system to power a
low-carbon economy

Improving life
expectancy
and quality

Providing crucial solutions
and services to impactful
companies directly involved
in the various themes

Providing opportunities
for all – irrespective of
wealth, geographical
location or ability

Improving vehicle
efficiency to increase
low-carbon transportation

Providing financial services
to underserved populations

CIRCULAR ECONOMY · WATER · FOOD SECURITY · ENERGY TRANSITION · PORTFOLIO · HEALTH & WELLBEING · IMPACT ENABLERS · EDUCATION · FUTURE MOBILITY · FINANCIAL INCLUSION

3. How will the taxonomy be used in the future?

The taxonomy can only be considered a starting point, albeit an important one, in identifying investment opportunities that can address the SDGs. We must then assess value chains and potential investments to look for impactful companies that can best deliver holistic returns, taking into consideration both financial merits and non-financial returns. This is followed by detailed impact-validation and measurement processes, and engagement with companies, before we make an investment decision.

The Hermes SDG Taxonomy 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. This is an adaptive process, not a prescriptive one.

As we continue to learn and interact with more parties, both internally and externally, the taxonomy will be refined to become a transparent resource in the development of impact-investing.

The process is not asset-class specific. For illustrative purposes, only the public equities taxonomy has been presented here. The same approach can be applied to all asset classes, as well as in corporate engagement and stewardship, to determine how goals and tasks can be addressed irrespective of whether the asset is an equity or bond.

Over time, as we work towards targets and the investable universe evolves to reflect a constantly changing world, so too will the taxonomy. This will ensure it remains an essential component of our process for impact investing.

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, small and mid-cap and impact

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

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices

London | Denmark | Dublin | Frankfurt | New York | Singapore

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