OUTCOMES BEYOND PERFORMANCE

ESG MATTERS

Integrating environmental, social and governance risk analysis into our investments.

OUTCOME #13

Being active owners of our investments has helped to identify areas of improvement in environmental, social and governance matters to improve

For professional investors only

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HERMES INVESTMENT MANAGEMENT

SUSTAINABLE PROGRESS

Hermes is an experienced, active and engaged investor seeking to deliver long-term, risk-adjusted outperformance – responsibly. We aim to lead debate and contribute to the transformation of the investment industry to benefit our clients, their stakeholders and, ultimately, society at large.

Key to achieving our aim is the integration of environmental, social and governance (ESG) risks into our analysis of companies and management of investment portfolios. Another integral element is our approach to being good stewards and owners of those companies and assets in which we have invested through active monitoring, engagement and advocacy.

Responsibility governs both the way we run Hermes and the way we invest. When we invest, we are not just investing for returns, we want to go beyond that and act in a way that manifests a stakeholder view of investment.

Saker Nusseibeh,
Chief Executive Officer, Hermes Investment Management

Our early advocacy of strong corporate governance has evolved into a rich understanding, reinforced by evidence, about how ESG risks can have a significant impact on the long-term performance of companies. The tangible benefit of good governance, or as we refer to it – the 'governance premium' – is no longer a matter of opinion. It is a conclusion founded on research that clearly demonstrates companies which choose to neglect their responsibilities towards investors, society or the environment will suffer adverse financial consequences in the long term.

The expertise of our engagement team, Hermes EOS, developed over many years, enables our investment managers to better mitigate ESG risks and identify those companies exploiting the benefits of astute governance, environmental preservation and skilful stakeholder management.

A decade ago, the value of considering ESG risks was seen as adding little more than a 'feel-good factor' to investment returns. Today, ESG risks are increasingly core concerns for asset owners. For the benefit of clients, we are committed to being at the forefront of this positive change.

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RESPONSIBILITY AT OUR CORE

We believe that in order to deliver sustainable, risk-adjusted outperformance to our clients over the long term, responsibility is integral, and therefore lies at the heart of our approach.

We believe that companies with strong governance and astute management of their environmental and social responsibilities, such as emissions control or labour rights, not only make a more positive contribution than those that do not, but also provide greater long-term value for shareholders.

To put this belief into practice, we analyse the financial, environmental, social and governance (ESG) risks which our investments are exposed to, and exercise shareholder voting rights. We also engage with companies, becoming more active when investor involvement can clearly contribute to better long-term performance. By participating in public policy debates, we work to ensure that the global financial system operates in the interests of ultimate asset owners rather than their various agents. It is through such means that we aim to contribute to the overall success of the economy within and beyond the timeframe of our investment mandates, because it is important to our clients and helps to deliver strong long-term returns.

Alignment of interests

To align our interests with those of clients, senior investment managers co-invest in the funds they oversee and their bonuses are linked to long-term performance. The Hermes Investment Office acts as a champion for clients by independently reviewing and, where appropriate, challenging the way our strategies are managed.

Responsibility to our clients

Our responsibility to clients, including the 320,000 pension fund beneficiaries that ultimately own our business, is realised in three principal ways:

- Financial analysis of companies and assets, to identify the most attractive long-term investments
- Integration of ESG risks into investment decisions, to ensure that we are informed but not constrained by ESG considerations
- Shareholder voting, engagement, and public policy work to promote the long-term interests of shareholders

In this brochure we discuss a fundamental part of our responsibility to clients: integrating ESG risks into investment decisions.

We will always act in the interest of clients and their beneficiaries: to maximise long-term value while striving to improve the society they live in through our investment decisions.

Saker Nusseibeh,
Chief Executive Officer, Hermes Investment Management

Our ESG heritage

Hermes' focus on ESG risk began in the early 1990s, when Alastair Ross-Goobey, then CEO of Hermes' forerunner PosTel, wrote to the chairman of each FTSE 100 company seeking shorter contracts for CEOs. Later, we definitively stated what we expect of listed companies, and what listed companies should expect of us, in the *Hermes Principles*.

Engagement and voting

We then launched Hermes EOS, a pioneering engagement service that acts on behalf of investors to increase long-term value by improving the strategic and ESG performance of companies. It is now one of the largest shareholder stewardship resources in the world. With £155bn* in assets under advice and an experienced team speaking a breadth of languages and applying diverse business skills; it is a hugely important resource both to clients and to Hermes' investment teams.

Responsible property investing

Since our Real Estate team defined the responsible property investment (RPI) principles that it instils in its investment process, it has been at the forefront of sustainable property development and management practices aiming to benefit investors, communities and the environment.

Integrated, proprietary ESG analysis

More recently, our Hermes Global Equities team developed ESG risk analysis tools that combine proprietary research and engagement data from Hermes EOS with leading external research. These tools, which assess stock-specific and portfolio-wide ESG risks, are used by all of our investment teams.

*Source: Hermes as at 31 December 2015.

RECORD OF RESPONSIBILITY

1983
Ralph Quartano urges companies to do the right thing: "I expect M&S to be on the side of the angels."

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Alastair Ross-Goobey seeks shorter contracts for CEOs

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Hermes sets up a dedicated governance team

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Hermes Real Estate establishes energy strategy

2002
Hermes explains what shareholders should expect of companies

04
Hermes Equity Ownership Services is founded

06
Hermes Real Estate clarifies the responsible property investment principles

Hermes becomes founding signatory of UNPRI

07
Hermes Real Estate publishes Responsible Property Investment Annual Report

10
Hermes signs the UK Stewardship Code

Hermes Responsible Ownership Principles published

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300

Saker Nusseibeh, Hermes CEO, founds the 300 Club

Hermes GPE implements its proprietory ESG Framework into all its investment decision making processes

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Hermes GPE wins the Private Equity International (PEI) Responsible Investor of the Year award

The ESG Dashboard created

Hermes Global Equities awarded customized SG mandate for large Australian Superannuation Fund

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The ESG Portfolio Monitor created

Hermes Emerging Markets appointed by leading US sustainability focused investor

Hermes signs banking and Finance Oath

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Hermes becomes a signatory for further global agreements.

Hermes Global Equity ESG Fund is launched.

Dedicated responsibility team established

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Hermes announces a pledge of responsibility and transparency

CEO joins UK National Advisory Board to the Global Impact Investment Steering Group

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Hermes GPE wins BVCA Responsible Investment Award – Overall ESG Framework award for firms with £1bn+ AUM

Hermes Low Carbon Strategy launched

INTEGRATING ESG

Our ability to identify and mitigate ESG risks as well as capture investment opportunities arising from these considerations, is essential to achieving consistent investment outperformance.

ESG considerations are important for the following reasons:

- **Environment:** the responses of governments and corporations to climate change, natural resource depletion, pollution and global energy needs **materially impact both investment returns and society**
- **Social:** the observance of basic human and labour rights, developing the full potential of human capital and effectively combating bribery and corruption are **essential for the long-term sustainability of companies**
- **Governance:** the quality of corporate governance within businesses is linked with **better risk management, company performance and higher investment returns over long periods**

Delivering better outcomes

We believe that by acting as owners of the assets in which we invest, engaging with companies and policy makers and exercising our proxy voting rights puts us in the best position to identify and mitigate ESG risks.

Research by our stewardship team, EOS, and the unique insights that it acquires through engagement, help to inform our investment analysts and portfolio managers about ESG risks affecting the performance of companies in which they invest or are considering for investment. Investment teams can also ask for further research on specific risks and suggest particular topics to be raised during engagements.

This is complemented by frequent company-specific discussions and formal quarterly meetings between investment and stewardship teams to review portfolio ESG risk exposures and discuss engagement progress on current or prospective investments.

ESG risk mitigation at a company level

Companies are primarily responsible for generating shareholder value and do not have limitless societal obligations. However, we believe that businesses must consider how their impact on society and the environment affects their long-term prospects. We expect them to successfully manage relationships with employees, suppliers, customers and other stakeholders with a legitimate interest in their activities. Externalities, such as environmental pollution, should be minimised because supporting negative practices – however indirectly – does not serve the interests of diversified, long-term investors or society.

Given Hermes' long-term focus, both the potential for ESG risk at companies to improve or worsen, and the track records of management and boards, are assessed. Two online, proprietary risk-management tools developed by our Global Equities team – the ESG Dashboard and ESG Portfolio Monitor – enable all of Hermes' investment teams to pinpoint ESG risks and opportunities at both the company and portfolio levels.

We believe that identifying change in ESG exposure is equally as important as determining the absolute level of risk.

Proprietary ESG intelligence

ESG Dashboard

The ESG Dashboard is our bespoke company report for collating and viewing data on the most important ESG matters. It is used by investment teams across Hermes, enabling our analysts and portfolio managers to easily incorporate ESG analysis into their stock-picking process, and, importantly, to flag ESG risks.

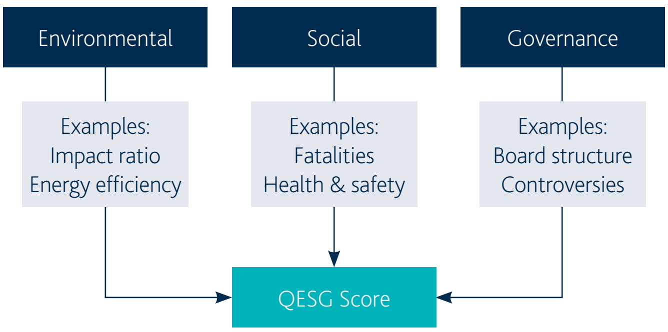
Developed by Hermes Global Equities in conjunction with Hermes EOS, the dashboard delivers an immediate and thorough analysis of each listed company's exposure to ESG risks. Key engagement insights and research and voting activity from our stewardship team is presented alongside data from specialist external researchers Sustainalytics, Trucost and Bloomberg.

Each company is compared against peers on a sector, region or global basis against generic ESG considerations, such as board structure, and industry-specific considerations, like energy efficiency for transportation businesses. Our stewardship team's controversy indicator, which spotlights elevated risks and progress on engagements aiming to mitigate them, is provided alongside the latest *Controversial Company Report* (CCR).

The CCR highlights:

- Breaches of international conventions
- UN Global Compact Principles relating to the environment, human rights, labour rights, bribery and corruption, infringements of trade and arms embargos
- Controversial weapons (e.g. involvement in nuclear weapons, the Ottawa Convention on landmines and the Oslo Convention on cluster munitions)
- Significant governance concerns

The proprietary ranking generated by the ESG Dashboard, the **QESG Score**, conveys how well each company is managing ESG risk. Importantly, it includes the trend in ESG risk for each company: we believe that identifying change in ESG exposure is equally as important as determining the absolute level of risk. By detecting such change, the QESG Score can provide an early warning of harmful ESG performance, or signal a turnaround. It is a valuable input to investment decisions.



Unique aspects of the ESG Dashboard

Multiple sources of data are utilised – Rather than using just one or two commercial providers of data, the ESG Dashboard incorporates many providers with specialist areas of focus.

Proprietary data – The Dashboard includes proprietary data from Hermes EOS, such as engagement and voting activity on thousands of companies worldwide. It can also highlight company-specific risks utilising Hermes EOS' Controversy Indicator.

Customisable peer group – Investment managers are able to evaluate a company's ESG risks relative to other companies in their investable universe, regionally or by market capitalisation.

QESG Score – Giving a ranking to companies that captures both how well a company manages ESG risks and the trend in its exposure to these risks distils an enormous amount of information into one data point. This can then be used in stock screens.

Portfolio ESG Monitor

The Portfolio ESG Monitor provides a whole-of-portfolio assessment of ESG risks and reports on data from Hermes EOS, Sustainalytics and Trucost, as well as QESG scores.

Hermes' portfolio managers use the monitor to view aggregate and specific ESG risks of potential investments or existing holdings within their portfolios. Knowing the source and magnitude of these risks enables better management as well as promoting discussion about thematic ESG risks within investment teams.

The monitor shows the distribution of the QESG Scores across portfolios and relevant benchmarks. Scores are also shown for individual companies' exposures to ESG risks as well as how these risks are being mitigated. Importantly, it enables portfolio managers to identify which companies are exhibiting positive change and which companies are worsening so they can avoid those with the greatest risk.

Research based on back-tests using the QESG Score revealed that avoiding companies with poor governance characteristics can improve returns. We believe that good governance can enhance the performance of companies, thereby generating a 'governance premium'.

THE GOVERNANCE PREMIUM

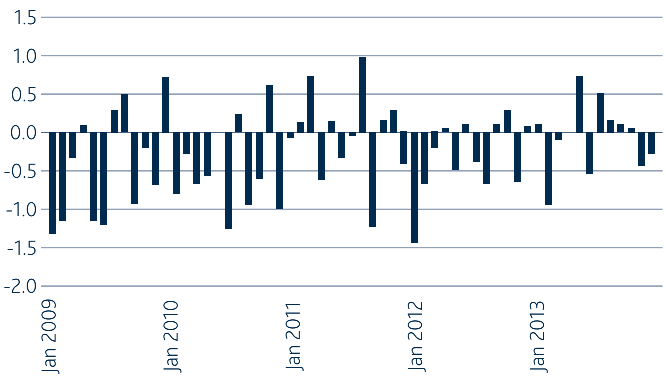
Better-governed companies consistently outperform poorly-governed peers, research from our global equities team shows.

Better governance, better performance

We believe that companies which choose to neglect their responsibilities towards investors, society or the environment will suffer adverse financial consequences in the long term. Indeed, over the five years to 31 December 2013, research carried out by Hermes Global Equities revealed that companies with poor corporate governance underperformed in 62% of months.

From 2009 to the end of 2013, our research showed that well-governed companies have tended to outperform poorly-governed companies by an average of 30 basis points per month[1]. This shows that good governance, a strong indicator of a company's quality, should be seen as essential. Capturing this consistent source of value can enhance the returns of equity strategies.

Figure 1: Poorly-governed companies have tended to underperform (%)



The monthly average return of stocks in the lowest governance decile relative to the average return of companies in the MSCI World, from 31 December 2008 to 31 December 2013

Source: Hermes Global Equities research paper, "ESG investing: does it just make you feel good, or is it actually good for your portfolio?" published January 2014

While our research has helped dispel the myth that ESG investing does nothing more than add a feel-good factor, many investors may continue to hold the view that investing in well-governed companies can help protect against downside risk, but can also restrict potential upside. And that to have an ESG risk-mitigated mandate means an extensive – alpha restrictive – exclusion list built-in as standard.

We hold the view that ESG integration and strong performance are not mutually exclusive and we have proved this through our fully customisable asset allocation for bespoke client mandates.

One size does not fit all

The Hermes Global Equities team's core investment process recognises good or improving corporate governance as an attractive attribute, but if an investor holds specific ESG views regarding companies or industries, the team can build an exclusion list that accurately reflects the clients' standpoint.

However, compiling an exclusion list is only the first stage of the customisation process. It is also important to understand the impact of excluding these companies and how excluding them will influence performance. Equally important is understanding how exclusions influence the risk profile of a portfolio.

Before implementing a client's exclusion criteria, the team work with them to produce a detailed report that highlights any further risks that could arise as a result. This involves suggesting ways to both enhance the screen and mitigate risks through clarification of metrics used to determine whether companies are investable or not.

Underpinning this customisable approach is a deep understanding of the underlying stocks available. Hermes EOS engagements play a vital role in providing insight into a company's credentials and in the team ascertaining whether they meet their 'best in class' selection criteria.

Therefore, the 'governance premium' is two-fold, as investment solutions can be aligned with ESG views, providing potential downside risk mitigation without sacrificing performance potential.

1. Source: Hermes as at 31 January 2015, performance calculated gross of fees in Sterling.

PIONEERING STEWARDSHIP

We strive to be active owners of the companies we invest in. For more than a decade, our stewardship team has driven positive change at companies worldwide through constructive engagements, informed shareholder voting on strategic and ESG matters and our advocacy of investor rights in industry and regulatory forums.

Key elements of stewardship

Advice
Helping clients to develop responsible ownership policies, which include systems that integrate ESG and other long-term risks and opportunities into their investment processes.

Research
Identifying a full range of strategic, financial and ESG factors that can lead to long-term value creation or destruction within companies. Assessing companies that are considered to be violating client policies, detailing these violations and assessing whether engagement is feasible through the *Controversial Company Report*.

Voting
Assisting investors in using their shareholder votes to manage long-term risks at companies worldwide.

Engagement
Engaging corporate directors and senior management teams on clients' behalf to promote and achieve beneficial change relating to risk management, governance, sustainability and corporate strategy.

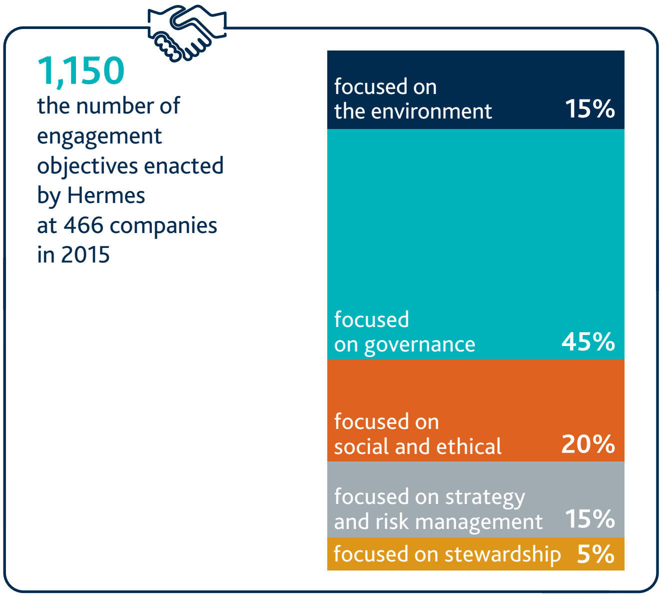
Advocacy
Working with policy makers and industry bodies on policies to ensure that markets support active ownership, and to promote stewardship and sustainability.

Engagement and voting

The intelligent voting service we offer covers over 10,000 companies worldwide. By providing or withholding support from corporate decisions, shareholder votes can be used as an engagement tool. Our stewardship team believes that shareholders should have the right to be sufficiently informed about and participate in:

- Fundamental corporate changes
- Constitutional amendments
- Capital requirements
- Major acquisitions or disposals
- Nomination, election and removal of board members and external auditors
- Remuneration policies for top managers and board members

Engagement in action



A comprehensive approach

Our approach to voting helps investors move beyond compliance-based methods and better manage long-term risks. We target companies experiencing serious financial, strategic and ESG risks, or those contravening clients' responsible investment policies. The boards and senior management teams of such companies are approached and, if appropriate, other investors too, in an effort to create greater long-term shareholder value.

Prior to voting, Hermes EOS analyses companies' annual reports, the meeting agenda and other relevant, publicly available information. Its extensive database of company contacts, which includes all communications with companies since 2004, is used where appropriate. Voting recommendations are made by and for experienced investors, aiming to support companies' sustainability and long-term performance.

Clients can access ESG and engagement data about portfolio companies through EOSi, an interactive online portal. It provides assessments of company-specific and portfolio-wide ESG risks, summarises live engagements and allows investors to filter portfolios by theme, sub-theme, sector and country to identify which companies are exposed to specific strategic and ESG concerns.

EOSi shows excerpts from key research, particularly our stewardship team's *Controversial Company Report*, alongside voting activity and relevant public policy work. A discussion board and private Twitter account enable clients to directly discuss matters with the team.

Engagement has defined, realistic and measurable objectives that can take several years to achieve. It is constructive and conducted discreetly – preferably without media coverage – because the best results are usually attained in private discussions. It requires a broad range of skills – including legal, consulting and management capabilities – to be deployed in an integrated approach. Practiced globally, it also requires fluency in multiple languages and knowledge of business practices in various markets.

The impact of engagement

Engagement on ESG risks provides "clear shareholder value-generation opportunities," according to a research team led by Andreas Hoepner from the Centre for Responsible Banking and Finance at the University of St Andrews.

On average, downside risk falls significantly during engagement and annual stock returns rise considerably. The impact is stronger in less efficient markets, such as those of emerging economies, and in specific industries with clear ESG risks, like oil and gas, consumer services and industrials.

Pioneering stewardship on ESG risks provides "clear shareholder value-generation opportunities".

Advocacy

We work with politicians, regulators and industry bodies on a range of subjects: fiduciary duty and pensions policy, responsibility in asset management, financial market regulation, and on improving the standard of corporate governance in the UK and abroad. In these discussions, we champion the rights of long-term investors and the need for a more sustainable global economy.

Our stewardship team participates in many investor associations focused on responsible investment, including the United Nations Principles for Responsible Investment (UNPRI), the International Corporate Governance Network, the Asian Corporate Governance Association and a range of national social innovation forums. As a founding signatory of the UNPRI in 2005, Hermes helped draft the principles in the previous year. Colin Melvin, CEO of EOS and Hermes Global Head of Stewardship, was the founding chair of the UNPRI and currently sits on its advisory council.

OUR PLEDGE

I pledge to fulfil, to the best of my ability and judgment and in accordance with my role, this covenant:

- I will act ethically, responsibly and with integrity
- I will put the interests of our clients and their beneficiaries first
- I will encourage responsible behaviour in the firms in which we invest and on which we engage
- I will act with consideration for society and the environment both now and in the future. I will encourage others to do the same
- I will work with industry colleagues and other key stakeholders to develop and improve our industry's contribution to society
- I will treat my clients, my colleagues and all other stakeholders with respect and as I would wish to be treated
- I will deal with our regulators in an open, co-operative and timely way
- I will communicate clearly and honestly with all parties inside and outside our firm
- I will manage conflicts of interest fairly between all parties

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

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