HERMES IMPACT OPPORTUNITIES FUND

Quarterly Impact Report

Hermes Investment Management
Q2 2019

For professional investors only

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HERMES
INVESTMENT MANAGEMENT

SDG INVESTING TAXONOMY

Identifying investment opportunities directly connected to the United Nations Sustainable Development Goals (SDGs)

The why

- The UN SDGs, an ambitious set of global objectives to tackle issues, including climate change, poverty, ocean pollution and gender inequality by 2030, were created from a development rather than investment perspective.
- As a result, many investors have simply retrofitted the SDGs into their existing investment frameworks and processes. This fails to properly capture the opportunities and impact from contributing to the SDGs.
- The SDGs call for a deep transformation of economic activities to align them with sustainable development, thereby presenting opportunities for solution providers in the private sector and their investors.
- A rigorous and structured taxonomy is essential to demonstrate clear links between the 169 targets underlying the SDGs and potential investments opportunities.

Our methodology

1. **A deep examination:** we assessed whether each of the underlying 169 SDG targets could be addressed through public equities.
2. **Identifying solutions:** we considered the breadth and depth of product or service solutions that could help achieve each target.
3. **Theory of Change:** we examined the issue addressed by each target and the contribution that was identified for each investable area.
4. **Independent research:** we triangulated research to validate the contribution potential of investing in the identified solutions.
5. **Impact risks:** we considered the likelihood that impact will be different than expected[2].

Figure 1. An example of how the taxonomy works

SDG Goal	SDG Target	Directly investable	Product or service solution	Theory of Change: Issue	Theory of Change: Contribution	Impact risks
14: Conserve and sustainably use the oceans, seas and marine resources for sustainable development. 14 LIFE BELOW WATER	**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%.	**Efficiency risks:** some recycling processes have a high environmental impact, especially when factoring in energy needs, which may be less attractive than using virgin materials in some cases. **Execution risks:** disposal of non-recyclable materials needs to be handled carefully in order to not generate pollution. **Stakeholder participation risks:** working conditions of staff and contractors may be problematic, especially in terms of health and safety.
SDG: one of the UN's 17 sustainable development goals (SDGs).	**SDG target:** an example of the 169 specific targets as outlined by the UN.	**Directly investable:** yes or no.	**Product or service solution:** goods and services that could help achieve this particular SDG target.	**Theory of Change:** describes in further detail the relevant issues, as well as the potential for related investments to contribute positively.		**Impact risks:** outlines the unintended or unexpected actual or potential negative consequences of investment in the target area.

Source: Hermes as at July 2019.

Results

- Our assessment shows that only 42 of the 169 underlying SDG targets are currently directly investable through public equities.
- The SDG taxonomy allows us to define the investable universe of listed companies that directly contribute towards the SDGs.
- It is the first step in our idea generation process; it does not prove whether a company has a positive impact. Impact assessment is the next step, where we scrutinise a single company by examining its nature, intentionality, additionality, balance and improvement.

42/169 SDG targets are currently directly investable through public equities

To explore the Hermes SDG Taxonomy, use the following link:
www.hermes-investment.com/ukw/sdg-taxonomy

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

CASE STUDY

HANNON ARMSTRONG SUSTAINABLE INFRASTRUCTURE

SDG target 7.2: By 2030, increase substantially the share of renewable energy in the global energy mix.

SDG target 7.3: By 2030, double the global rate of improvement in energy efficiency.

SDG target 9.4: By 2030, upgrade infrastructure and retrofit industries to make them sustainable, with increased resource-use efficiency and greater adoption of clean and environmentally sound technologies and industrial processes, with all countries taking action in accordance with their respective capabilities.

Theory of change

Hannon Armstrong Sustainable Infrastructure (HASI) provides debt and equity that directly fuels the transition to a low-carbon economy. Its investment activities primarily comprise of energy efficiency and renewable energy projects, with sustainable infrastructure constituting a smaller share. Moreover, most of its pipeline consists of behind-the-meter projects, which means that HASI not only enables the decarbonisation, but also the decentralisation of the US energy system.

Climate change: the defining issue of our generation

The world must invest $2.4tn in the energy system every year through 2035 to limit global warming to 1.5 degrees Celsius, according to the Intergovernmental Panel on Climate Change . And that's where current holding HASI plays an important role. It provides financing for climate-change solutions, focusing on three areas:

1. **Behind-the-meter (BTM):** renewable energy systems, such as solar panels, electric storage or energy efficiency improvements, that are uniquely designed and built for a building or facility, thereby reducing energy usage or cost;
2. **Grid-connected projects:** deploying renewable energy sources, such as solar and wind, to generate power where the counterparty is part of the wholesale electric power grid;
3. **Sustainable infrastructure:** upgrades in transmission or distribution systems, water infrastructure and seismic retrofits that improve water or energy efficiency, boost energy-system resilience and positively impact the environment.

HASI: making a difference

The Hermes SDG Taxonomy identifies target 7.3 as directly investable through public equities – a target to which HASI is strongly linked.

The company's investment portfolio is comprised mostly of energy efficiency and renewable energy projects; these two areas represent the majority of the cumulative CO_2 emissions savings in the International Energy Agency's (IEA's) Sustainable Development Scenario – the lowest-cost scenario to achieve three of the energy-related SDGs (see Figure 2). Indeed, the IEA's research, notably the Sustainable Development Scenario, validates the contribution potential through investment in our Energy Transition theme.

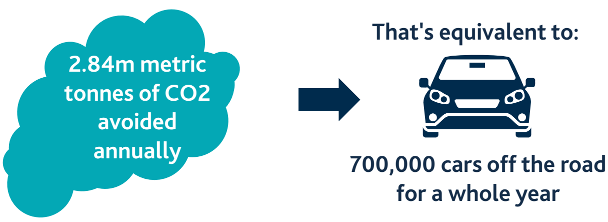
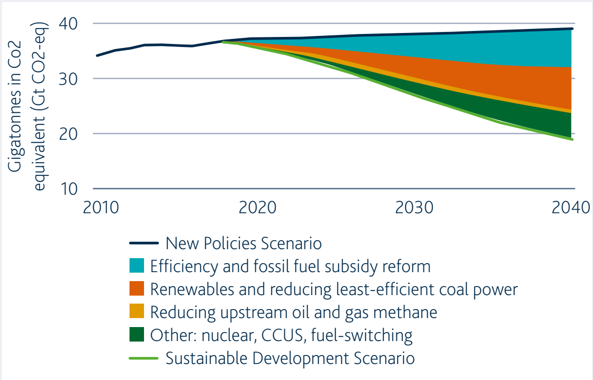


Figure 2. Energy efficiency and renewables account for the bulk of the CO_2 emissions savings in the Sustainable Development Scenario

CO_2 and methane emissions reductions by measures in the Sustainable Development Scenario relative to the New Policies Scenario

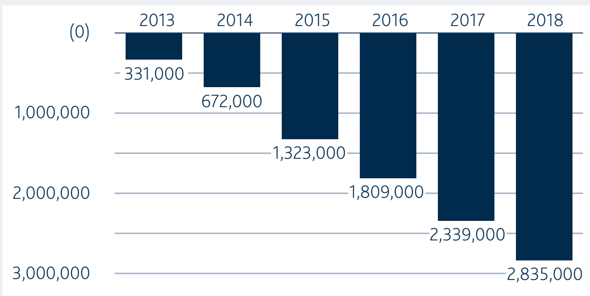


Source: International Energy Agency as at 2018.

'A finance problem'

In an interview last year, CEO Jeffrey Eckel described the issue of climate change as "primarily a finance problem", adding that "to make a difference, investment has to ramp up very quickly"[4]. Already, HASI has made a significant impact. Since its IPO in 2013, HASI's investments have resulted in the avoidance of 2,835,000 metric tonnes of CO_2.

Figure 3. Progress towards a clean energy future: cumulative metric tonnes of CO_2 avoided annually



Source: HASI as at 31 December 2018.

[3] "Global warming of 1.5 °C," published by the Intergovernmental Panel on Climate Change in October 2018.
[4] "Sustainable energy investor Hannon Armstrong: 'the equity tide is coming in our direction," published by Forbes in October 2018.

CASE STUDY

ANSYS

9 INDUSTRY, INNOVATION AND INFRASTRUCTURE

SDG target 9.4: By 2030, upgrade infrastructure and retrofit industries to make them sustainable, with increased resource-use efficiency and greater adoption of clean and environmentally sound technologies and industrial processes, with all countries taking action in accordance with their respective capabilities.

SDG target 9.5: Enhance scientific research, upgrade the technological capabilities of industrial sectors in all countries, in particular developing countries, including, by 2030, encouraging innovation and substantially increasing the number of research and development workers per one million people and public and private research and development spending.

Theory of change

As a global leader in simulation solutions, ANSYS enables faster R&D, makes manufacturing more efficient and less wasteful, thereby reducing costs, as well as permitting environmentally-friendly specifications to be embedded at the design phase of products.

Industry transformation drives opportunity

To achieve the SDGs by 2030, a profound economic transformation is required: new solutions need to be developed and implemented across a plethora of industries, which in turn requires greater and faster investment in research and development (R&D).

One example of such far-reaching transformation can be found in our Energy Transition theme – and according to the IEA, energy efficiency improvements are the biggest contributor to CO_2 emissions savings (at 44%) to the Sustainable Development Scenario[5]. That's where simulation software can make a significant contribution as identified by our SDG Taxonomy under SDG target 9.5 (see Figure 4).

Figure 4. The SDG Taxonomy in action

SDG: 9 – Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation.

SDG target: 9.5 – Enhance scientific research, upgrade the technological capabilities of industrial sectors in all countries, in particular developing countries, including, by 2030, encouraging innovation and substantially increasing the number of research and development workers per one million people and public and private research and development spending.

Directly investable: Yes.

Product or service solution: Modelling & simulation software.

Theory of Change – Issue: Research advancements are limited by the ability to model things with great accuracy. Often models are tested with physical prototypes, which are costly and time-consuming to produce.

Theory of Change – Contribution: Research and development (R&D) and innovation are major drivers of competitiveness and employment in a knowledge-based economy. Greater investment in R&D provides new jobs in business and academia, increasing demand for scientists and researchers in the labour market. Modelling and simulation software are used extensively in industrial R&D as it helps speed up the process.

Impact risks: Execution risks – privacy and data security risk may materialise if not addressed with suitable policies and processes.

ANSYS, a holding in our portfolio, is a global leader in simulation software; it helps customers achieve considerable efficiency and performance gains, while simultaneously producing significant cost savings. Indeed, the vast majority of its customers can be grouped in the manufacturing industry – a sector that is accountable for almost a third of the world's energy consumption and 36% of CO_2 emissions.

Manufacturing industry:

1/3
of the world's energy consumption

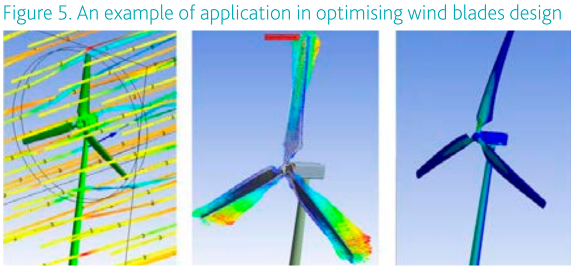
36%
of CO_2 emissions

Moreover, the company's products use R&D more efficiently than other companies, who often rely on physical testing. According to research by Berenberg, companies currently spend approximately seven to 10 times more on physical development than on simulation. ANSYS therefore helps companies innovate faster and at a lower cost – characteristics of simulation software that were identified by our SDG Taxonomy (see Figure 4).

Here are some examples of the impacts that ANSYS has had so far:

- Granta, one of the group's latest acquisitions, creates an audit trail for materials, including their environmental and social footprints, that ensure full traceability from design through to production. It also enables eco-design and incorporates environmental impacts into design decisions.
- The company's simulations helped Volkswagen develop its battery electric ID.R race car by optimising battery design around cooling fluids. ANSYS's expertise in fluid simulation demonstrates how this technology can be used to enable dramatic improvements in battery performance, a key factor for scaling up electric vehicles.
- According to ANSYS, integrating simulation into the design stage means that warranty costs are 89% more likely to increase. But introducing simulation in the manufacturing stage can reduce the weight of a part by 25%.

Figure 5. An example of application in optimising wind blades design



Source: ANSYS as at 30 June 2019.

The future of simulation software

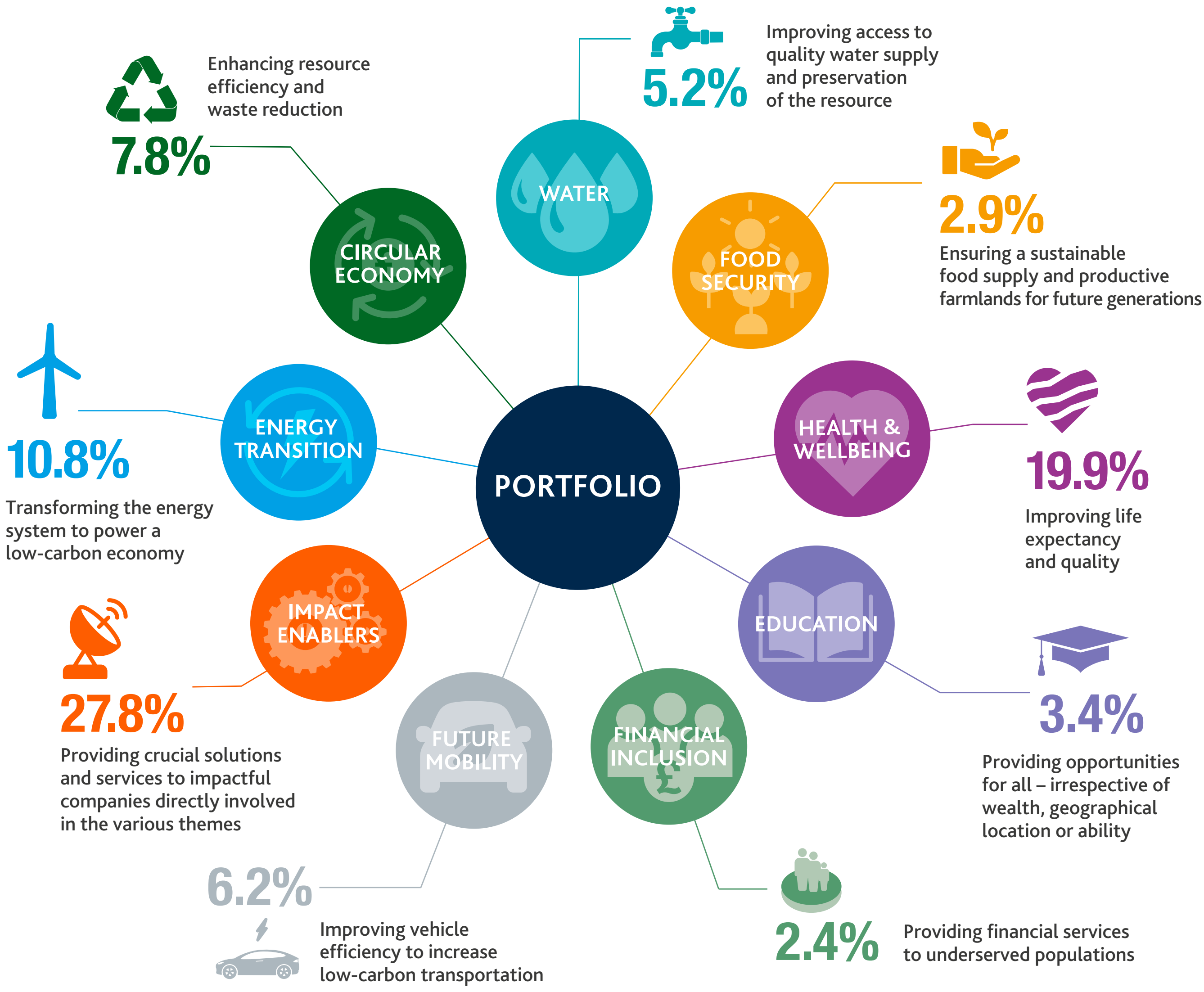
ANSYS aims to dramatically increase its impact in the future by moving out of its specialist, highly technical niches and seeking to 'democratise' the use of simulation – that is, bringing simulation software to less skilled users, such as designers.

Furthermore, the company's 2020 vision is pervasive simulation (the ability to model the whole product and its environment), and it aims to deliver this by developing easy-to-use, cloud-first software programmes that targets the ideation stage of the product lifecycle (which accounts for 80% of the cost[6]).

[5]The IEA's Sustainable Development Scenario outlines a major transformation of the global energy system, showing how the world can change course to deliver on the three main energy-related SDGs.
[6] ANSYS as at June 2018.

The Hermes Impact Opportunities Fund is a high-conviction global equity strategy with a bold objective. It aims to generate long-term outperformance by investing in companies succeeding in their core purpose: to generate value by creating positive and sustainable change that addresses the underserved needs of society and the environment. In this way, it focuses on tomorrow's leading companies, today.

EXPOSURE BY IMPACT THEME[1]



Source: Hermes as at 30 June 2019.

[1] Note: Our thematic exposure methodology has been revised to provide a more granular attribution of thematic exposure for each portfolio holding. As at 30 June 2019, 13.6% of our exposure was not directly related to any of our nine impact themes.

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

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