

# ESG Materiality

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**International**

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# Introduction

## Responsible investing in practice

Over the past decade, we have sought to act as responsible investors in emerging markets by focusing on companies that can tackle sustainability challenges as they arise. To explore our vision for responsible long-term investing in emerging-market equities, please [read our commentary](#).

In our ESG Materiality Newsletter, Q3 2020, we seek to demonstrate our engagement activity with portfolio companies and showcase holdings that have been able to create a positive impact aligned to the Sustainable Development Goals (SDGs). We also explore an environmental, social and governance (ESG) theme and its implications for the asset class.

## Corporate engagement overview

Engagement is a key part of our process. We believe it helps us gain a deeper insight into companies' past and future opportunities, and it can contribute to unlocking shareholder value and/or limiting downside risks. We engage alongside our colleagues at EOS at Federated Hermes ('EOS'), who are leading experts in stewardship and advocacy.

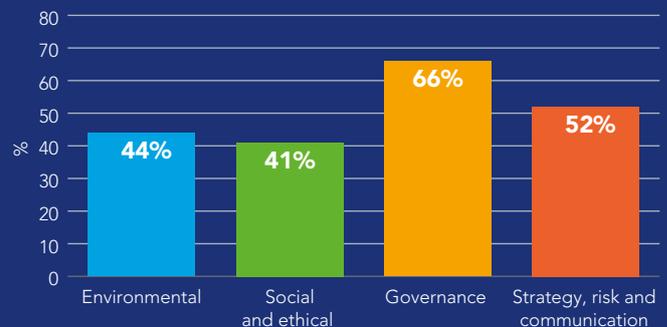
Our engagement approach is systematic and transparent. To measure our progress and the achievement of engagement objectives, we use a four-stage milestone strategy.



## Engagement highlights, Q2 2020

% of holdings engaged: **78%**

### % of AUM engaged by theme



Source: Federated Hermes, as at 30 June 2020.

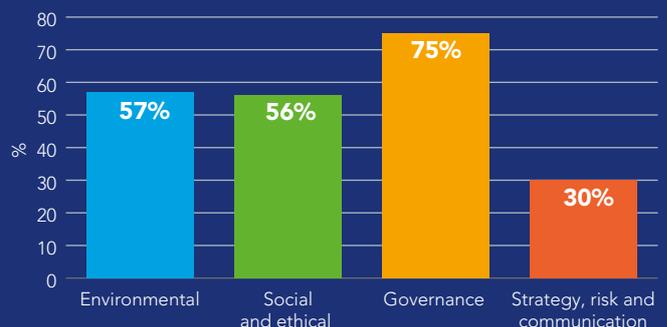
### Engagement progress over the last 12 months

Actual: **56%**

Internal target: **40%**

Source: Federated Hermes, as at 30 June 2020.

### Engagement progress by theme



Source: Federated Hermes, as at 30 June 2020.

## Our portfolio's carbon footprint, Q2 2020

Our portfolio is considerably greener than the MSCI emerging-market benchmark in terms of scope 1, scope 2 and scope 3 greenhouse gas (GHG) emissions.<sup>1</sup>

### Our portfolio v MSCI EM benchmark



Source: Federated Hermes, as at 30 June 2020. The benchmark is the MSCI Emerging Markets Index.

<sup>1</sup> We adopt the methodology set by the Task Force on Climate-related Financial Disclosures (TCFD) to measure our portfolio's emissions, carbon footprint and emission intensity. See [Implementing the recommendations of the Task Force on Climate-related Financial Disclosures](#) for further information.

 ENGAGEMENT CASE STUDY

## Tencent Holdings Ltd

Tencent operates the largest communication and social platforms in China, Weixin (whose overseas version is known as WeChat) and QQ, and provides users with digital content spanning online games, video and music to literature and news. Its FinTech services connect people with payment solutions and wealth management products. The group offers enterprises advertising solutions and business services.

### Engagement themes

- Social: users' digital rights, gaming
- Governance: board diversity
- Environment: disclosure and governance of climate-related risks and opportunities



Internet giant Tencent enables digital inclusion through platforms that have changed the lives of over a billion users, transforming the way they interact, transact, travel and relax.

The Tencent ecosystem opens up a vast online market for small and medium enterprises that would otherwise be inaccessible to users and companies with limited resources. Weixin/WeChat connects people with an ever-expanding range of services while Tencent's cloud technology fast-tracks productivity gains for businesses. Tencent is also investing heavily in artificial intelligence (AI), especially in the healthcare sector where the firm has developed a medical imaging application.

But the upbeat user statistics and the influence of the sector mean that various ESG themes – from digital rights to climate change – have become relevant for this industry. Local authorities have recently started to focus on anti-trust issues. Geopolitics has become part of the picture too since President Donald Trump announced a ban on any transaction that is related to WeChat<sup>2</sup> in the US – sending an unfriendly message to Beijing. Our engagement with Tencent has prompted some encouraging responses – particularly on board diversity ([as shown here](#)) – and we are also making progress on climate disclosure and digital rights.

### Privacy and surveillance: more transparency please

According to data published by Washington-based research programme Ranking Digital Rights (RDR), most online platforms and telecoms evaluated globally have feeble records on freedom of expression and user privacy. And emerging market companies rank at the bottom of the RDR scale, partly due to the different types of political systems these firms operate under.

Via our stewardship experts in EOS, we have been engaging with Tencent on digital human rights for years. In April this year, for example we discussed our concerns with the company about data privacy in the Tencent health code mini system in China. Specifically, we wanted assurance that health code user data is treated in compliance with applicable data privacy laws and best practice expectations. The company told us that the health code does not track location data without users' explicit consent; it is based on a user's self-declaration of personal health information collected by government online health surveys. According to Tencent, the health code information is only stored on user devices and the public health database run by the government, which Tencent has no access to and there is no copy in Tencent's cloud.

The Cybersecurity Law in China has also sparked change for the better in the country's data privacy settings. The Chinese regulations include requirements to protect personal information and individual privacy online. Furthermore, the rules require companies to be transparent about how and why they use any personal information.<sup>3</sup> In general, the Chinese Cybersecurity Law follows the example set by the earlier European Union General Data Protection Regulation. Since the new regulations came into force, Tencent has made improvements to its privacy and security disclosures – especially by providing more clarity on the underlying purpose of personal data collection and how it processes that information. And we suggested to Tencent that it could improve standards further through steps such as providing more clarity on how the company implements and monitors its privacy policies in offshore jurisdictions, where local laws and regulations differ from Chinese legal standards, especially around human rights.<sup>4</sup>

Tencent is not alone in facing regulatory risks, which are rising for social media companies across the globe from San Francisco to Shenzhen. In fact, the bar could rise higher soon as authorities and/or the public worldwide demand that online social platform companies take more vigorous actions to label fake news and ban 'hate speech' globally (see page five for further information).

<sup>2</sup> For more information, see <https://www.whitehouse.gov/presidential-actions/executive-order-addressing-threat-posed-wechat/>.

<sup>3</sup> Note: other requirements include the legalisation of data requests by authorities and the storage of data in local servers.

<sup>4</sup> Privacy policies of international products and services are publicly available. For instance, WeChat's privacy policy for overseas markets is available [here](#).



## POSITIVE IMPACT CASE STUDY

# Hangzhou Tigermed Consulting Company (Tigermed)

Tigermed is a leading Chinese Contract Research Organisation (CRO), providing full clinical trial services for the research and development (R&D) activities of pharmaceutical companies.

## Theory of Change

Tigermed aims to accelerate medical product development with cost-efficiency and quality. Its business serves UN SDG 3.

## SDG 3: Ensure healthy lives and promote well-being for all at all ages

**3.3** By 2030, end the epidemics of AIDS, tuberculosis, malaria and neglected tropical diseases and combat hepatitis, water-borne diseases and other communicable diseases



**3.4** By 2030, reduce by one third premature mortality from non-communicable diseases through prevention and treatment and promote mental health and well-being

## Driven by structural reforms

As the most-populous country in the world, China records at least its fair share of human diseases in any given period.<sup>5</sup> And yet up until just a few years ago, the Chinese people were largely ignored in clinical trials designed to approve drugs. The long and inconsistent timelines required to authorise clinical drug trials saw most Chinese study centres shut out from global research programmes, which, in turn, deterred global pharmaceutical sponsors from operating in the country. Meanwhile, local pharma companies typically focused on manufacturing generic drugs rather than developing innovative medicines.

But in 2015 the Chinese National Medical Products Administration (NMPA) implemented significant reforms, triggering an acceleration in the country's medical drug research programmes. Post the NMPA changes, generic drug prices dropped dramatically in a move that not only made essential medicines more affordable but also encouraged local pharmaceutical companies to move higher up the research ladder. The NMPA also introduced tight requirements aimed at improving the quality of generic medicines based on more studies.<sup>6</sup> At the same time, the new rules addressed the bottlenecks for clinical drug research in China – lifting restrictions on phase I trials that had previously hampered innovation in the sector. In parallel, the NMPA revamped its system of certifying clinical trial sites, enabling more hospitals to participate in research. And, crucially, the regulatory body improved the process and timeline for the review of trials and approval of drugs: it used to take NMPA more than a year to publish a decision on a clinical trial versus 60 days now. Officials also tightened CRO qualification, product quality control and practice standards to counter data fraud in the sector.

Overall, the NMPA reforms have significantly boosted the Chinese involvement in developing new drugs. In 2007, Chinese trials represented just 1% of all those registered on the ClinicalTrials.gov database – the largest repository

of drug research data in the world. By 2018, three years after the NMPA changes, that same statistic had jumped to 5%.

## Tigermed by the tailwinds: positioned to deliver growth

Tigermed performs Phase I-IV clinical trials, bioequivalent (BE) tests, registration filings, data management and statistical analysis, offering pharma clients a one-stop solution for the Chinese market. The therapeutic areas it covers range from infections to oncology and paediatrics.

The company enjoys tailwinds on the back of the regulatory reforms that should spark further growth in China-based clinical drug trials. And those drug trials are likely to shift further to CROs such as Tigermed in line with structural outsourcing trends in the global pharmaceutical industry. For instance, US and European pharma firms outsource about 40% of their total research and development budgets compared to only 32% for Chinese drug companies. And global consulting firm Frost & Sullivan estimates that the research and development outsourcing trend is set to ramp up globally as drug manufacturers seek further cost-efficiencies.

Given the ample growth opportunities and the company's strong balance sheet to fuel them, Tigermed is currently trading at high multiples. To date, it has accrued a good track record for product quality control. The recent secondary listing in Hong Kong – adding to its A listing in Shenzhen – increased liquidity and might trigger improvements in terms of disclosure should the company decide to comply with the Hong Kong Stock Exchange's (HKEX's) corporate governance code and ESG reporting requirements.<sup>7</sup> Tigermed is also one of the few of its kind in China to carry out multi-centre clinical trials after it expanded offshore in the small and medium enterprise biotech sector. We believe this is a competitive strength as the firm's global platform could increase customer stickiness.

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<sup>5</sup> For example, around 40% of new lung cancer diagnoses worldwide are recorded in China.

<sup>6</sup> A generic drug manufacturer now has to conduct on-site trials to collect tangible evidence that the effectiveness of a generic drug is equal to the off-patent original drug.

<sup>7</sup> We would like to see better disclosure on Tigermed's quality assurance procedure and anti-fraud monitoring methods, including whistle-blower protection, alongside better human capital management and transparency on how the remuneration programmes incentivise key talents.

**IN FOCUS:**

# Human rights risks in the social media sector

## Should social media platforms control the content they disseminate?

Social media platforms have become ubiquitous, connecting us with friends and colleagues. The online networks have also carved out a significant role in disseminating news and views.

The United Nations (UN) recognises that public access to information and the protection of fundamental freedoms – in accordance with national legislation and international agreements – is instrumental in achieving sustainable development across the world. According to the United Nations Educational, Scientific and Cultural Organisation (UNESCO), press freedom is increasingly challenged in the digital age. The UN agency points to “growing threats via government surveillance overreach”, citing a statistic that every five days a media worker is killed for doing their job.

In particular, government persecution of media has often been connected with poor democracy standards in emerging markets (EM) such as Saudi Arabia, China and Russia where fundamental freedoms are notoriously weak<sup>8</sup> – a situation amplified by local legislation that demands internet companies to act as guardians of “social security” and “national interest”.

However, social media has also come under increased scrutiny in the West for its role in influencing public opinion ahead of the Brexit referendum and the US Presidential elections in 2016, for instance. And following a public outcry about fake news on the platform, Facebook launched a major fact-checking effort and hired tens of thousands of content moderators to police its service.<sup>9</sup> Meanwhile, Twitter, which had previously received complaints about posts abusing and harassing women and people of colour, banned dehumanizing speech against certain categories of users. The social media company also embarked on a broad effort to solicit public comment about its speech policies. Subsequently, in May 2020 Twitter added labels to a few tweets by US President Donald Trump for violating Twitter’s rules about glorifying violence or for fact-checking.<sup>10</sup> The move re-ignited debate about the role of social media, prompting an executive order by Trump curtailing the legal protections that shield social media companies from any liability for the content posted on their platforms.

In June 2020 Vera Jourova, the European Commission’s vice president for values and transparency, defended Twitter’s decision to append labels to some tweets, saying that social media companies need to take responsibility for the content posted on their platforms.<sup>11</sup> The European Union (EU) is looking to modernise its rules under the Digital Services Act to set clearer obligations and responsibilities for user activity with the aim of tackling illegal content, violent hate speech, disinformation surrounding the Covid-19 virus among other issues. As well, the EU has ambitious plans to protect elections and democracy against the impact of disinformation spread via social media. In June the EU launched a consultation inviting feedback from the public until September with the goal of putting rules in place by the end of 2020.<sup>12</sup>

In Brazil, social media may have distorted the 2018 presidential elections when, according to media, a significant number of fake news messages circulated undetected and unlabelled on the Facebook-owned WhatsApp group.<sup>13</sup> Following the election, the Brazilian national congress convened a panel to determine how fake news influenced the public debate. According to press reports, the investigations on who was involved in these manipulative efforts could potentially lead to the annulment of the election result. In May 2020, Brazil’s Supreme Court stepped in to issue search-and-seizure orders that were carried out by the federal police, targeting allies of President Jair Bolsonaro in connection to the dissemination of fake news.<sup>14</sup>

## Emerging markets network effect: between propaganda, censorship, connectivity and entertainment

Political risk is a key driver for investment performance in EM countries (and elsewhere), especially in an election year. Investors, therefore, need to keep a close eye on the ever-increasing role of internet platforms, not only because they have had stellar performance over the last few years, but also because of the impact they have on society. The EM social media scene is generally dominated by Western companies but there are some significant exceptions such as Kakao in South Korea, and Tencent or Sina Corporation’s Weibo in China.

<sup>8</sup> The World Bank’s Worldwide Governance Indicators measure six broad dimensions of governance, including Voice and Accountability (VA), which captures perceptions of the extent to which a country’s citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media. Saudi Arabia receives the worst score within the group of MSCI EM countries, China is a level comparable to the Middle East, followed by Russia and Thailand. The remaining emerging countries receive a positive score, while Chile leads the pack with a VA level similar to Western countries.

<sup>9</sup> “How Twitter decided to label Trump’s tweets,” published by the Washington Post on 29 May 2020.

<sup>10</sup> One of these tweets related to violent protests that continued in Minneapolis over the death of a man in police custody, George Floyd, and drew a warning saying that Trump had “violated the Twitter Rules about glorifying violence.” Two of Trump’s tweets related to mail-in ballots and triggered the “get the facts” warning after triggering Twitter’s “fact checkers” attention. Within minutes, Trump accused Twitter of “interfering in the 2020 Presidential Election.”

<sup>11</sup> “EU urged to keep social media protections after Trump lashes out,” published by Bloomberg in June 2020.

<sup>12</sup> The new framework might include concrete rules to manage illegal hate speech on internet, but the EU is unlikely to propose hard rules on disinformation. Measures around disinformation will focus on the impact of posts ahead of elections and will become part of EU Democracy Action Plan later this year.

<sup>13</sup> In response of concerns raised, Facebook’s WhatsApp has made significant product changes and worked with partners across civil society to help address the harmful consequences of misinformation.

<sup>14</sup> “Bolsonaro allies targeted by probe into spread of fake news,” published by Bloomberg Quint in May 2020.

In Russia, our portfolio has exposure to tech companies Mail.ru's VK and Yandex. We built our position in Yandex in October 2019, taking advantage of a depressed valuation due to the risk of new regulation targeting the ownership and governance of Russian internet companies. However, amid concerns over foreign ownership, in December 2019 the company agreed a restructuring with the Kremlin that would increase government influence over the company.<sup>15</sup> As the regulatory risk dropped, we built our position and started engaging with the company.<sup>16</sup>

In China, where Facebook and Amazon are banned, we have exposure to Tencent's WeChat, including its local version Weixin, and Alibaba's Taobao. EOS has done a lot of engagement work to encourage best practice in the use of artificial intelligence (AI) and the treatment of private data by digital platforms. Despite the progress, we remain aware of the ESG risks (see our engagement case study on page three).

In Q2 2020, we saw social media in emerging markets come under scrutiny. For example, in June 2020 Zoom – the US video communication company whose app has become a staple for remote working and socialising since the Covid-19 lockdowns – disabled the accounts of a group of Chinese dissidents in the US who had used the service to commemorate the 1989 Tiananmen Square massacre.<sup>17</sup>

The Tiananmen Square video-commemoration was hosted by activists in the US, but it included participants dialling in from China, which upset the Beijing government. Zoom's buckling to pressure from Chinese authorities highlights how local and foreign companies face a trade-off between freedom of speech and respect of national legislation that puts "social security" and "national interest" first.<sup>18</sup>

Also, in June this year, hundreds of journalists and students in the Philippines claimed that false accounts had been set up in their names on Facebook. The fake accounts multiplied a few days after the government of President Rodrigo Duterte passed an "anti-terror bill" that will give authorities far-reaching powers to detain and prosecute government critics.<sup>19</sup> The identity thefts could provide grounds for the government to prosecute political enemies, or at least present a false online picture of opposition views.

In August, Trump opened a new front in the escalating US-China Cold War, when he ordered a ban on WeChat. The move affects a fraction of Tencent's users but sends a strong message to Beijing (and American voters).

According to data published by Ranking Digital Rights (RDR), emerging market companies rank at the bottom of the peer group of listed internet companies on the issue of data privacy and freedom of expression. The RDR finding should not come as a surprise to anyone who understands the context in which EM businesses operate. In addition, RDR data reveals that only five companies out of the 24 assessed in the internet and telecom sectors globally have achieved a score above 50%, which highlights the scale of the problem both in emerging and developed markets.

### **Our stance: users deserve more respect; investors must engage with companies and regulators**

In our digital era, social media, messaging apps and internet companies in general are at the front-end of innovation. Internet platforms drive connectivity, efficiency and (digital) inclusion while harnessing big data and bypassing physical barriers. And while we are aware of the risks to democracy

caused by fake news or hyper-surveillance, we believe that on balance internet platform companies contribute positively to society (and long-term wealth creation).

In our view, investors have a duty to engage with social media firms and regulators to ensure human rights are respected in the cyber-world as well as the offline one: excluding this important sector from portfolios would remove our power to lobby for positive change.

Regulators are mostly struggling to keep up to speed with the pace of innovation in the social media landscape. The regulatory gap implies that engagement is a key resource to use to foster change. Ranking Digital Rights founding director Rebecca MacKinnon, who is also a founding member of the Global Network Initiative (GNI),<sup>20</sup> made the point well when in a recent phone conversation with us she argued that investors have more leverage with ICT companies than any other non-government stakeholder, particularly with companies headquartered in authoritarian jurisdictions. "If you divest, it will be harder to get companies to change," she said.

As investors and stewards we can raise international standards through advocacy and corporate disclosure through engagement. Extensive research on data privacy and surveillance has informed EOS' position paper on this (see [Investors' expectations on responsible artificial intelligence and data governance](#) for more information).

We know that if a citizen of an oppressive regime does not have freedom of expression, this will apply not only offline but also online – and we expect companies to obey local (and international) legislations to maintain their social licence to operate. However, when the law compels companies to violate users' rights, companies should be transparent with users about how they handle government demands.

Even by Western standards censorship is considered acceptable to counter paedophilia, terrorism, hate and – increasingly – fake news. However, in some countries, the interpretation of what constitutes a threat to national security or public interest is far wider than in others.

More needs to be done. Yet our role as investors does not extend to human rights activism aimed at re-writing constitutions or investing in companies that pursue a regime-change in authoritarian jurisdictions: typically, such an approach does not yield robust long-term investment returns.

Nonetheless, investors and regulators must work harder to understand the obscure 'algorithms' underpinning internet platforms as well as to differentiate socially acceptable censorship from secretive treatment of personal data used for unauthorised brainwashing, manipulative targeted advertising or other Cambridge Analytica-style activities.<sup>21</sup>

Data is commonly referred to as the new oil because of its value. In 2014 Shoshana Zuboff, professor *emerita* at Harvard Business School,<sup>22</sup> coined the term *surveillance capitalism* to describe a market process where personal data becomes a commodity. Six years down the line, Zuboff's vision is our reality: the realm of social media both in emerging and developed markets remains loosely regulated, eminently influential, strongly innovative and rich in investment (and engagement) opportunities if we choose wisely.

<sup>15</sup> "Yandex approves changes to corporate governance to allay Kremlin fears," published by Reuters in December 2019.

<sup>16</sup> We reluctantly voted in support of management to approve such governance reforms as we deemed that it was the only way for the company to avoid more punitive legislation.

<sup>17</sup> "Zoom disables account of former Tiananmen Square student leader," published by the Financial Times in June 2020.

<sup>18</sup> Zoom is working on a feature that will enable it to remove or block participants based on their geography, while still letting participants in other countries take part in a given event. Zoom has almost a third of its workforce in China along with subsidiaries and servers in the country.

<sup>19</sup> In the first quarter of 2020, Facebook removed 1.7bn fake accounts from its platform worldwide. It estimates that fake accounts represent 5% of its worldwide monthly active users.

<sup>20</sup> GNI is a multi-stakeholder platform set to protect digital human rights ([globalnetworkinitiative.org](http://globalnetworkinitiative.org)).

<sup>21</sup> The Cambridge Analytica data breach occurred in early 2018 when millions of Facebook users' personal data was harvested without consent by Cambridge Analytica to be predominantly used for political advertising.

<sup>22</sup> "A Digital Declaration: Big Data as Surveillance Capitalism" by Shoshana Zuboff. Essay published in September 2014.

## Federated Hermes

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Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes now form the international business of Federated Hermes. Our brand has evolved, but we still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important new strategies from the entire group.

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- **Private markets:** real estate, infrastructure, private equity and debt
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