OUTCOMES BEYOND PERFORMANCE

EQUITORIAL

Bringing clarity to ESG investing

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For professional investors only

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HERMES INVESTMENT MANAGEMENT

KEY POINTS:

- Our history of ESG investing means that we are well placed to cut through the noise and provide some much-needed clarity on the various forms of ESG investing.
- Prevalent responsible investment approaches can be categorised into four different activities: negative exclusion, positive screening, impact investing and mainstream ESG investing.
- Our Global Equities team adopt a mainstream ESG integration approach – that is, incorporating ESG considerations alongside insights from engagement, valuation, growth prospects and market sentiment, among others.

Environmental, social and governance (ESG) investing has entered the mainstream as governments, regulators and clients demand that both companies and their owners consider the wider implications of their business activities. But this shift in attitude has also been accompanied by a surge in ESG-related terminology. Today, we cut through the noise and provide some much-needed clarity on the various forms of ESG investing.

It's a noisy world for investors. Whether its climate change mitigation, electric vehicle penetration, the transition from a linear to a circular economy, or achieving the UN Sustainable Development Goals (SDGs), the debate on ESG investing has been pushed to the forefront of the investment industry.

But what seems to be missing from the discussion is how the rapid ascent of ESG into mainstream has been accompanied by a sharp rise in the volume of terms used to describe ESG.

Today, the investment landscape is saturated by a plethora of ESG-related terminology. To demonstrate this, we scoured five ESG-terminology guides produced by our industry peers. We collated all of their definitions to highlight the vast range of words used to describe ESG within the asset management industry (see Figure 1). And as investors wade through vague definitions, from ESG to sustainability, it is not surprising that many are confused.

Of course, ESG investing has long been with us. At Hermes, our history of ESG investing spans more than three decades (see Figure 2). We adopt a responsible approach to investing across all of our strategies: for example, our Global Equities ESG strategy has integrated ESG factors into its idea generation since its inception in 2013. In addition, Hermes EOS has been a pioneer of stewardship since 2004. That's why we are well-placed to cut through the noise and provide some much-needed clarity on the various forms of ESG investing.

In this issue of *Equitorial*, we present the Hermes view on the abundance of confusing ESG terminology in the investment universe and explain how we integrate it into our team's strategies.

Figure 1. The investment landscape is cluttered with a slew of ESG-related terminology

Source: Hermes as at January 2019. Note: the bigger the word, the more frequent it appeared in our research study.

Figure 2. ESG investing: a 200-year history

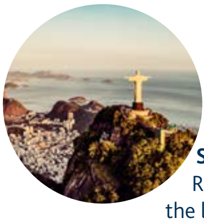
1800s — SRI originates in religious groups. **Quakers and Methodists** establish investing guidelines for their followers.

1928 — An ecclesiastical group in Boston, US launch the **pioneer fund**. It is the first public offering of a screened investment fund.

1960s — The rise of civil rights and **anti-war movements** prompt investors to consider shareholder advocacy when influencing corporate behaviour.

1971 — **Pax** World launches the first socially responsible investing mutual fund in the US.

1983 — **Ralph Quartano** former Hermes CEO, urges companies to do the right thing: "I expect M&S to be on the side of the angels."



1992 — **The UN's Rio Earth Summit** takes place in Rio de Janeiro, marking the largest environmental conference ever held.

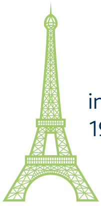
1998 — **The UK Combined Code** on Corporate Governance is published.

2000 — **Focus shifts to ESG:** As investors' focus shifts ESG issues, ESG investing becomes the latest iteration of sustainable investing.

2004 — **Hermes EOS founded:** Hermes EOS, our specialist stewardship services team, is founded.

2006 — **UNPRI:** A set of 6 investment principles encouraging ESG matters to be incorporated into investment practice are launched by the UN.

UN Sustainable Development Goals are established. They serve as a blueprint for significantly changing the world by 2030.



2015 — The **UN Climate Change Conference COP21** takes place in Paris. The Paris Agreement sees 195 countries adopt the first-ever universal, legally binding global climate deal.

2017 — **Hermes joins the UN Global Compact,** the world's largest corporate sustainability initiative.

2018 — **New York City** files a lawsuit against 5 oil majors accusing them of contributing to climate change.

2018 — **51.84**
MSCI EM ESG Index: MSCI Emerging Markets ESG Leaders Index hits a record high of 51.84.

Source: Thomson Reuters, Financial Times, The Guardian, United Nations and Hermes as at January 2018.

ESG IS NOW MAINSTREAM

In the past 20 years, the number of asset managers offering ESG strategies has grown by more than 400%[1].

That's according to the Global Impact Investing Network (GIIN). The surge of ESG investing during this period can be attributed to the seminal report *Who Cares Wins* published by the UN Global Compact in 2005. It found that integrating ESG into capital markets resulted in more sustainable markets as well as better outcomes for societies. At the same time, the *UNEP Finance Initiative* released a report that showed ESG issues are relevant for financial valuation. Together, these two reports laid the foundations for the launch of the Principles of Responsible Investment (PRI) in 2006 – of which Hermes became a founding signatory.

That was 13 years ago. Today, the PRI is an established body, boasting more than 1,600 members and represents over $70tn assets under management. Governments and regulators are demanding that companies and their owners consider the wider ESG implications of their business activities by introducing or strengthening stewardship codes. For example, the UN SDGs were established in 2015, serving as a blueprint for significantly changing the world by 2030, while in the same year, 195 countries adopted the first-ever universal, legally binding global climate deal – the Paris Agreement.

What's more, there is a growing body of research supporting the integration of ESG. In our recent research paper *ESG investing: a social uprising*, we found that companies with good or improving social characteristics have tended to outperform their lower-ranked peers on average by 15bps per month, while companies with good or improving corporate governance have tended to outperform companies with poor or worsening governance by 24bps per month.

ESG is therefore no longer on the periphery of the investment management industry, it has become standard practice industry-wide: in fact, GIIN found that 225 investors invested $35.5bn in 11,136 impact investing deals in 2017[2].

GETTING THE LANGUAGE RIGHT: THE HERMES ESG LEXICON

Even though ESG investing has become standard practice among asset managers, a standard set of ESG definitions has not yet been established industry-wide.

For this reason, we have decided to wade through the noise and present our view on ESG investing.

At Hermes, we believe there are two mutually reinforcing strands of responsible investment management: **responsible investment** and **responsible ownership**. Together, these aim to generate sustainable wealth creation for the end beneficiary investor encompassing both investment returns and their social and environmental impact.

Prevalent responsible investment approaches can be categorised into four different – but not mutually exclusive – activities:

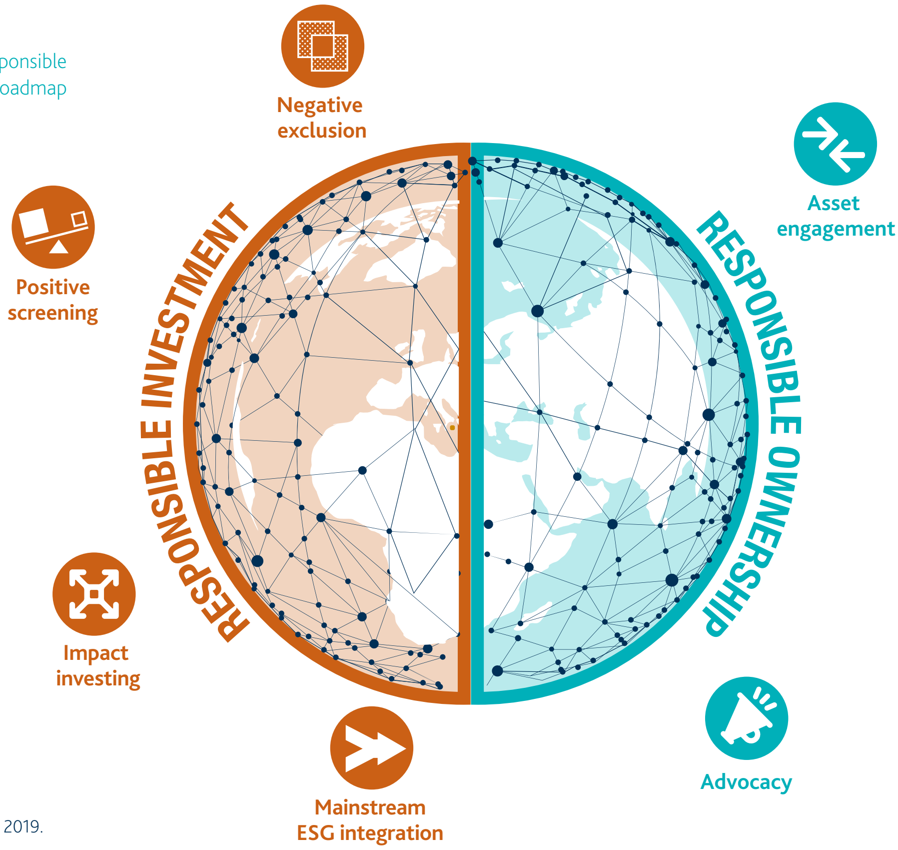
- **Negative exclusion:** applying exclusions – or negative screening – to the investment universe at sector or thematic level, typically based on moral, ethical or religious beliefs. For example, avoiding investments in the tobacco industry or those based on climate change;
- **Positive screening:** actively investing more in – or overweighting – companies and assets that demonstrate relatively better environmental, social and governance credentials;
- **Impact investing:** investing in (or engaging with) companies which have (or could have) a central purpose of solving societal problems, such as those set out by the UN SDGs; and
- **Mainstream ESG integration:** integrating material ESG and other sustainability factors as well as insights from engagement, alongside fundamental business-performance factors, in mainstream investment decisions.

Another integral element to responsible investment management is responsible ownership – that is, being a good steward and owner of companies and assets through asset engagement and advocacy:

- **Asset engagement:** actively engaging with companies to align their behaviours with the long-term interest of clients and their beneficiaries by improving the strategic, financial and ESG performance of companies and assets; and
- **Advocacy:** engaging with public policy makers, regulators, governments and industry bodies on enhancing governance, environmental, social and stewardship standards globally as well as regionally, at a thematic-level (such as climate change or diversity) or by industry sector.

[1,2] "Annual Impact Investor Survey 2018," published by the Global Impact Investing Network in June 2018.

Figure 3. The Hermes responsible investing and ownership roadmap



Source: Hermes as at January 2019.

INTEGRATING ESG

Armed with a better understanding, investors should be able to identify the four distinct approaches to ESG investing.

Importantly, our definitions highlight that our Global Equities team adopt a mainstream ESG integration approach. Indeed, we have followed this approach since the team's inception in 2007 – long before ESG investing had entered the mainstream.

By combining quantitative tools with a qualitative assessment and active ownership of positions through our responsible investment and engagement specialists, Hermes EOS, we aim to achieve capital appreciation by investing in global equity securities with favourable ESG credentials. We use four main tools:

The Alpha Model is our "automated analyst" which assesses the attractiveness of every investable company in our universe on a daily basis. The metrics used to select stocks are justified by both economic reasoning and statistical effectiveness, and have a long-term focus that leads to low portfolio turnover. They are grouped into six categories: valuation, corporate behaviour (including governance), growth, profitability, capital structure and sentiment. The model identifies which stocks have the most attractive combinations of these characteristics and the output is subsequently used to create an optimised portfolio that aims to maximise risk-adjusted returns. The Alpha Model also uses proprietary data from Hermes EOS to incorporate an assessment of corporate governance in every valuation (see *The Alpha Model: laying the path to consistent returns*).

MultiFRAME is our proprietary risk model which assess top-down market risk. It has the flexibility to stress-test the portfolio, interpret how it would respond to different market environments and measure its exposure to any quantifiable risk.

The ESG Dashboard forms an important part of our qualitative analysis, enabling analysts and portfolio managers to easily incorporate ESG analysis into their stock-picking processes and, importantly, to flag stock-specific sustainability risks. The Dashboard provides a concise digest of the ever-increasing amount of data on ESG risks. As well as incorporating a wide range of research from leading data providers, the report includes proprietary information from Hermes EOS on voting and engagement. Indeed, Hermes EOS has helped define the key performance indicators or risk factors on which each company is measured. These are either generic, such as board structure, or sector specific, focusing on the major risks by industry – such as CO_2 emissions and fleet consumption for the automobiles industry, paper sourcing for media and energy efficiency for airlines (See *ESG Dashboard 3.0*).

The ESG Portfolio Monitor shows aggregate ESG risks within a portfolio, in absolute and relative terms. By knowing the source and magnitude of these risks, portfolio managers can better manage them. It contains data from Hermes EOS, as well as leading data providers and our proprietary QESG Scores.

These tools allow us to follow a mainstream ESG integration approach – that is, incorporating ESG considerations alongside insights from engagement, valuation, growth prospects and market sentiment, among others. Our model favours companies with an attractive blend of these characteristics.

Our case studies below – Bank of America and Thermo Fisher – demonstrate the practical application of a mainstream ESG investing approach, where we have seen the significant impact that the consideration of ESG characteristics can have on our valuations.

BANK OF AMERICA: ENGAGING FOR CHANGE

Bank of America is one of the world's biggest financial institutions, serving individual consumers, small and middle-market businesses and large corporations with a full range of banking, investing, asset management and other financial and risk management products and services.

We have long held a position in Bank of America, and our proprietary Alpha Model views the company as positive according to its profitability, growth and capital-structure characteristics. We see Bank of America as a strong brand, one which can use its size and diversity of offering to deliver growth, even in a difficult environment.

Most recently, the company posted solid Q4 2018 revenue growth – ahead of analysts' expectations – driven by its consumer bank. Under the helm of chief executive Brian Moynihan, Bank of America has adopted a conservative approach, cutting costs and tightening risk controls: in fact, over the last decade, the company has cut $30bn in annualised costs[3]. Its peer JPMorgan Chase missed profit estimates in Q4 2018, citing a decline in its fixed-income trading revenue, while Citigroup also posted a fall in bond trading.

A decade of ESG-focused engagement

We began engaging with Bank of America in April 2009 on a number of long-term ESG-related issues, ranging from risk management, governance and culture to remuneration. Initially, our ESG Dashboard flagged the company for its exposure to high-profile lawsuits, which related to the global financial crisis.

So far, our engagements with Bank of America, which span the last decade, have focused on:

- **Board composition:** In 2009, we urged the company to consider the board composition, particularly longstanding members and the need for refreshment.
- **Pay:** In 2010, we raised concerns about remuneration structures and the need to establish a policy that effectively aligns employees and the long-term shareholder interests.
- **Corporate culture:** In 2011, we pressed for greater alignment between risk-taking practices and the interests of long-term shareholders.
- **Climate change:** In 2016, we pressed for the company to increase its 2020 funding target for clean energy and other environmental activities. Last year, we asked the company to report against the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).
- **Board independence:** In 2017, we raised that we would like to see a good-quality candidate for its lead independent director. Separately, in 2018, we requested that the holding company discloses the names of the main bank subsidiary board's members and how they convene.

Driving progress on long-term ESG issues

Over the last decade, Bank of America has acknowledged our concerns and, in many cases, it has made great strides in tackling ESG-related risks.

The bank has made a number of changes to its board. During our engagements, we have discussed these changes as well as the appointment of directors with relevant expertise, such as risk management, financial and regulatory experience. In addition, Bank of America has transformed its culture, adopting a zero-tolerance approach to unethical conduct issues and questionable lending practices. In fact, its 2015 Corporate Social Responsibility Report highlighted how the company's purpose statement is driving its decision-making and strategy throughout the bank.

What's more, we were pleased that the company embraced our discussion on the living wage for its own staff. It has acknowledged our concerns about board independence and climate change. The bank has been a strong advocate of the TCFD, forming an internal working group comprising of regional leads and internal risk and ESG committee team members. We expect to see a response to the TCFD recommendations this year.

Our dialogue continues today – and we await further improvements on long-term sustainability issues that we have raised in recent years.

[3] "BoA's loan growth drives better-than-expected profit," published by Reuters on 16 January 2019.

THERMO FISHER: SERVING SCIENCE

Thermo Fisher Scientific produces instruments, equipment, software, services and medical consumables that help scientists accelerate life sciences research, improve patient diagnostics, deliver medicines to market and increase laboratory productivity. From lab plastic ware to mass spectrometry, the company's products are used across pharmaceutical, biotechnology, academic, government, environmental and industrial research, as well as the clinical laboratory.

We have a position in Thermo Fisher. The diversified nature of the company's product portfolio is attractive, given no single product or end-market materially impact its performance. In addition, the company targets an organic revenue growth rate of 4-6% and an earnings per share of about 12-15% per annum, reflecting its cost-cutting culture and process improvements.

Our proprietary Alpha Model also views Thermo Fisher as very attractive. That's because it boasts strong and stable growth as well as good and improving margins. What's more, it is attractively valued. Indeed, it ranks ahead of its peers in the six factors – valuation, corporate behaviour, growth, profitability, capital structure and sentiment – used to generate our Alpha Score. It is broadly neutral on corporate behaviour. Understandably, sentiment towards Thermo Fisher is strong.

A healthier, cleaner and safer world

Encouragingly, the company also generates a significant portion of its revenue through activities that have a positive impact on society, such as access to healthcare or sustainable solutions that help customers reduce its environmental footprint. It offers 45 'greener' products, which strive to provide customers with alternatives that are less hazardous, more energy efficient and reduce waste.

Thermo Fisher is also contributing to the UN SDGs. Its diagnostic tools are helping achieve the SDGs by diagnosing some of the world's most infectious diseases. In addition, the company produces environmental tools and IT systems, such as soil analysers that help produce healthier and safer crops, water analysers that help deliver safe drinking water, and air quality measurement tools that help track pollutants and assist industrial manufacturing monitor compliance.

Scalable solutions to real-world problems

In 2017, Thermo Fisher formed a partnership with Mars Inc. to tackle aflatoxins – naturally occurring poisons that contaminate an estimated 25% of food crops and 4.5bn people worldwide[4].

Aflatoxins originate in certain species of fungi that grow on feed and food, such as groundnuts, peanuts, spices and corn. They are near-impossible to destroy. They are considered a Class 1 carcinogen by the International Agency for Research on Cancer.

The project aims to identify a protein to reduce the impact of the aflatoxin in food. Importantly, this have a positive impact in developing countries, where the amount of aflatoxins in food products is not well regulated.

Engaging on ESG risks

Interestingly, Thermo Fisher is not highlighted as a clear leader by ESG data providers. That's because many data providers apply the same level of scrutiny to healthcare providers as they do to pharmaceutical companies – a highly regulated industry. However, the diverse nature of the business means it is exposed to lower levels of risk. That said, it does have some weaknesses – or at least areas of risk that could be better addressed – particularly around disclosure.

We are engaging with the company. We are encouraged by the strength of its governance – notably, the appointment of an independent chair, which serves to highlight its positive corporate mind-set. In addition, Thermo Fisher has developed policies and systems to address some environmental and social issues. Nevertheless, we are encouraging the company to extend its programmes and policies to better demonstrate key risks, such as business ethics.

BRIDGING THE GAP FOR BETTER INFORMED ESG INVESTING

ESG investing has entered the mainstream, but education is still needed.

Many people – including asset managers, trustees and consultants – use ESG-related terminology interchangeably. For investors, we therefore need to bridge the gap for better informed ESG investing while also ensuring that we focus on meeting evolving clients' needs.

As an asset manager, we can contribute to this effort, not just by integrating ESG into the investment process, but shaping the ESG agenda by educating investors about it too.

The environment that businesses – and we, as investors – operate in continues to change: there is an increased focus on a wider range of issues. Our approach to investment management – responsible investment and responsible ownership – ensures that we are not only meeting these increasingly demanding requirements but we are also at the forefront of driving improvements within society.

[4] "*Corporate Social Responsibility Report*," published by Thermo Fisher Scientific in 2017.

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:

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 | New York | Singapore | Denmark | Frankfurt

Why Hermes Global Equities?

Transparency
Our accessible investment process and analysis is based on clearly defined statistical and economic evidence. It is not a 'black box' and the drivers of returns can be clearly explained.

Expertise
Our bottom-up stock-selection model systematically analyses companies' financial statements and gauges investor sentiment to generate an optimal portfolio. The team draws on its deep investment experience to identify unquantifiable risks such as negative news flow and regulatory change.

Flexibility
We partner with clients to create portfolios addressing their needs, amending the risk profile, investment universe and benchmark, and portfolio characteristics such as dividend yield and ESG exposure as required.

Broad risk awareness
MultiFRAME, our proprietary risk modelling system, detects exposures to all quantifiable risks. The Hermes Investment Office performs independent risk management services for clients and sustainability risks are identified by our ESG Dashboard.

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