Stewardship:

the 2020 vision

Federated Hermes International

www.hermes-investment.com
For professional investors only

At the international business of Federated Hermes, we believe that the investment management industry could be a potent force in building a better world; but today that potential is largely unfulfilled.

Here, we set out our vision for how investment management can deliver on that promise through active stewardship of the businesses it owns. This is vital. Success means delivering better, sustainable returns for investors while helping solve some of the world's most intractable problems.

We believe the purpose of investment is to create wealth sustainably over the long-term. That's why focusing on wealth creation at the expense of the planet and society, the very future for which investors are saving, is counterproductive.

Our world faces multiple challenges – from climate change to inequality to Artificial Intelligence. Investment management has a key role in addressing those challenges. It must behave in a way that is consistent with solving the world's problems rather than compounding them. This will have notable positive financial implications for investors and society, guarding against significant risks to the long-term health of the economy.

This is our vision for how stewardship can create that change.

Saker Nusseibeh, CBE
CEO – International at Federated Hermes

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Executive Summary

Stewardship has come a long way since 1983 when visionary CEO, Ralph Quartano, who ran the Post Office pension fund, stood alone in challenging the cosy remuneration packages of company management teams. Today, stewardship has become more widespread, but corporate disasters, scandals or failures, like those at BP, VW and Carillion respectively, demonstrate that much more needs to be done.

As we celebrate the 15th anniversary of our stewardship services for institutional investors at the international business of Federated Hermes, it is a natural moment to take stock. Here, we consider the role and practice of stewardship by investors and lay out our vision of how it can fulfil that role more effectively over the next decade.

The purpose of investment is to create wealth sustainably. Success provides investors with income to spend as they get older, an ability to buy the goods and services and helps to build a world in which they are happy to live.

This can only be achieved if investment returns are generated by well-managed and responsibly-governed businesses in a way that improves the lives of employees, creates opportunities, promotes diversity and supports communities, while contributing to wider society by paying taxes and safeguarding the environment and health.

Arguably, the industry is guilty of being too short-term in its focus, rather than fulfil its role of providing long-term, supportive capital to business. This has helped contribute to a lack of progress on environmental, social and governance (ESG) issues ranging from climate change to wealth inequality.

We argue that the principal role of investment management is to ensure that investors' capital is deployed to deliver sustainable wealth creation. Active stewardship is the best way to achieve this, but today it only commands a small proportion of the resources available within investment management firms. This needs to change.

Our vision for the 2020s is active stewardship taking its place at the heart of the activity and purpose of investment management firms and how they operate. This will need to apply across all asset classes, from equities and corporate credit to real estate, infrastructure, private equity and even sovereign debt and hedge funds.

Getting there will require a step change in the level of resources devoted to engagement, with new skills and experience integrated into investment management teams.

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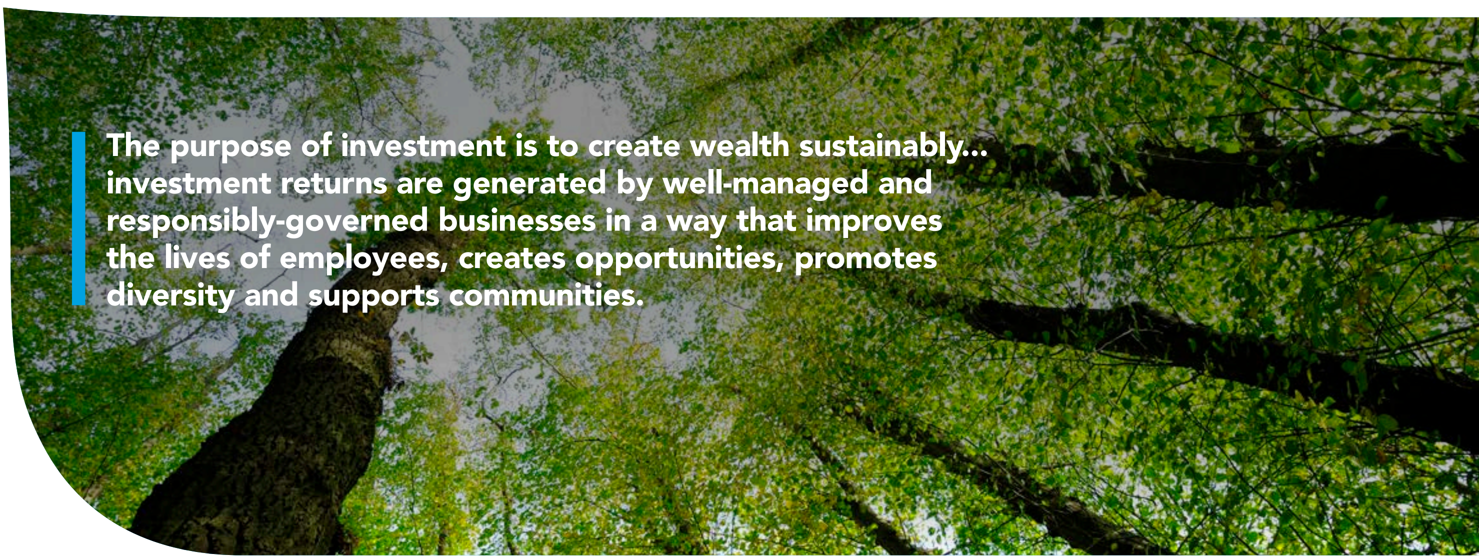
Stewardship needs to be a determining factor in investment decision-making, product development, client relationship management and reporting. Boards of companies must continue to be held accountable by investors, but we see that relationship evolving to be more collaborative – in particular in support of long-term business strategies and objectives.

Ultimately, active stewardship is the investment management industry's social licence to operate. As pressure builds to incorporate ESG factors and pursue positive societal outcomes, the importance of investor engagement with the businesses we invest in is paramount.



Our vision for stewardship in the 2020s:

Strong stewardship will be at the heart of the way investment managers fulfil their business purpose: sustainable wealth creation for all investors who entrust us with their capital.

The international business of Federated Hermes has been an industry leader in promoting strong and effective stewardship of our clients' assets for over 30 years, but we continue to evolve our approach. We see several critical success factors to realise our vision on the conduct of stewardship over the next decade.

Where it becomes necessary to protect long-term, sustainable wealth creation, investment managers both individually and collectively will use all the influence and powers of ownership at their disposal to any extent necessary to shape a better outcome.

Investment managers will need to substantially increase, broaden and integrate different skillsets in their investment teams to deliver effective stewardship and collaborate with others.

Stewardship will be a driving force in investment decision-making and fully integrated into every area of investment management, from product development to client relationship management to reporting.

Whilst boards will continue to be held accountable by investment managers, stewardship will evolve to provide collaborative support and empower companies to deliver sustainable returns to their investors.

Stewardship will be highly objective-focused, and its effectiveness measured by robust systems and processes.

Stewardship: evolution

The concept of stewardship by asset managers has come a long way since it first emerged in the UK in the 1980s. The launch of the Principles for Responsible Investment in 2006, and the UK Stewardship Code in 2010 in the aftermath of the Global Financial Crisis (GFC), led to the worldwide adoption of Stewardship Codes, including in Japan (2014) and the United States (2018). In 2019 we have seen the UK Stewardship Code go through a further and substantive update, we can expect more to follow suit.

Across Europe, stewardship continues to develop: the amended EU Shareholder Rights Directive (SRDII), a response to the GFC, will introduce an obligation on asset owners and managers to publish an engagement policy and report against it. The GFC firmly established the view that investors can and should play a role in the governance of the companies in which they invest.

To date, stewardship in public markets has been seen mainly through the lens of voting at annual general meetings by larger asset owners and investment management firms with the help of proxy agencies. There may also have been selective monitoring and engagement on issues such as strategy, capital structure, performance, risk, corporate governance and culture, and material environmental and social issues. Private markets have attracted a more hands-on approach to stewardship, including – in some cases – a seat on company boards.

Increasingly, however, robust research supports the positive impact of stewardship on investment performance. High-quality academic evidence shows that engagement pays off financially and non-financially. Successful engagement can translate into significant outperformance; studies have shown that engagement can generate higher annualised returns of up to 7.1% per annum[1] while also leading to lower downside risk.[2]

30+yrs of active stewardship at the international business of Federated Hermes

15yrs of our systematic stewardship programme

In 2018, we engaged with:

746 companies on **2,084** issues and objectives

At the international business of Federated Hermes, we have been active stewards for over 30 years and have had a systematic stewardship programme in place for more than 15 years. For us, the impact of engagement is clear. In 2018, we engaged with 746 companies on 2,084 issues and objectives. We have made significant progress and effected real change on the companies with which we have engaged.

There has also been pressure from institutional clients for asset managers to raise their game. However, this has not necessarily led to an improvement in the quality of stewardship: the independent review of the Financial Reporting Council (FRC), which oversees the UK Stewardship Code, noted in a report issued in late December 2018 that the regulator's existing approach focuses "predominantly on checking the content of stewardship statements, not on actual effectiveness or outcomes". It concluded that: "If the Code remains simply a driver of boilerplate reporting, serious consideration should be given to its abolition." That's quite an indictment of what is widely and rightly regarded as the world's leading stewardship market.

Unfortunately, surveys and anecdotal evidence confirm that, even in the UK, stewardship is generally centred on the largest companies. Activity is typically reactive and AGM-focused, or crisis-driven rather than continuous and proactive. There is too much focus on executive remuneration at the expense of strategy, risk management and material ESG issues. Even today, engagement often involves just asking add-on questions following financial updates and is information-seeking rather than change-seeking. In addition, engagers' corporate counterparts are too often relatively junior rather than senior executives and board members.

With the substantively updated code –published in October 2019 – focusing on outcomes not processes and expectations that it will apply to all asset classes and geographies, we hope this will start to change.

[1] Dimson, E., Karakaş, O. and Li, X. (2015). Active Ownership. The Review of Financial Studies, 28(12), 3225-3268, analysis of corporate social responsibility engagements with US public companies from 1999-2009.
[2] Hoepner et al, 2013: ESG Engagement, Risk & Return: An Interim research progress project (2013); Hoepner, A., Oikonomou, I., & X.Y. Zhou (2015): ESG Engagement in Extractive Industries: return and risk. Research Paper.

> **Unless investment managers and every link in the investment chain can turn their focus to long-term sustainable value creation … the potential for stewardship to transform financial, social and environmental outcomes will not be realised.**

The quantity and quality of engagement in markets without active and well-resourced local investors – or a lack of stewardship tradition – is poor. While SRDII and the UN Sustainable Development Goals (SDGs) provide an additional impetus, more radical changes are required in order to unleash the full potential of stewardship in the 2020s. If these changes are to be effective, they will need to come from the asset management industry itself with the support and encouragement of clients.

Unless investment managers and every link in the investment chain can turn their focus to long-term sustainable value creation and abandon its obsession with short-term, relative returns, the potential for stewardship to transform financial, social and environmental outcomes will not be realised.

Changes to structure and mindset

To our mind, the use of benchmarks has diminished investment managers' motivation to do stewardship well. If a fund is trying to control tracking error (versus a benchmark), it is likely to have many holdings. The impact of any single company doing better as a consequence of the manager's stewardship is limited. Equally, if a company in which the fund is underweight does better than the index, it harms the fund's relative performance. Why would a manager put in the effort to engage with a company where they are underweight to help it improve? It may improve investors' absolute returns but it harms the manager's relative return, on which they are often measured and incentivised. This is a perverse consequence of index-relative active management.

Passive investing has its own hurdles in the context of the delivery of sustainable wealth creation. It provides a commodity service, where the strongest point of competitive advantage has been cost. This means that there is less margin available for passive managers to devote resource to stewardship and engagement. Increasingly, passive managers are recognising that it is part of their responsibility to their clients and are setting up and growing stewardship programmes. The principal barrier to effective stewardship for passive managers is the sheer number of holdings that they will own. It is simply not possible for passive firms, as currently constituted, to recruit the highly skilled and diversified teams necessary to hold thousands of individual companies to account.

We argue that all investible assets need responsible investors and credit providers who act as engaged stewards, who support long-term sustainable wealth creation and who hold boards and management accountable. Active managers who do not engage where they are underweight or passive managers who only deploy their resources to a tiny fraction of their holdings act as a brake on the achievement of that objective.

What does this mean for asset owners, asset managers and regulators?

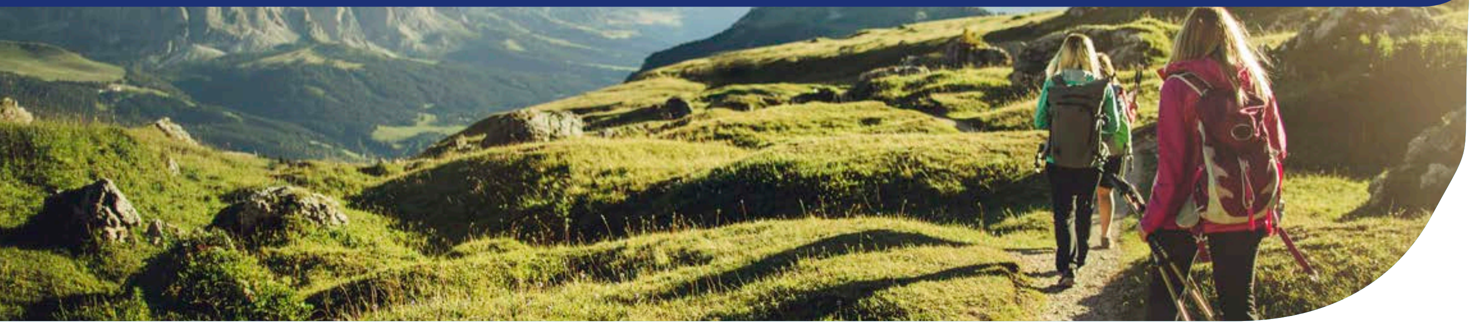
Relying on market forces to drive behavioural change is naïve. For this reason, we believe that the implementation of SRDII along with the updated Stewardship Code can help drive significant changes in market attitudes. It will require those purporting to be effective stewards of their clients' assets to move well beyond boiler-plating, veneer and lip service and into a new world of transparency about objectives, measurement and reporting that may also serve as a model for guidance in other markets.

These major regulatory changes and expectations also provide a good opportunity to consider how stewardship can truly add value. Greater clarity about the purpose of different entities in the investment chain is vital; not least for fund managers themselves, with better disclosure on their governance, including information on fee and remuneration structures. It is time for regulators and policymakers to be much clearer in defining the purpose of stewardship, and to be given stronger monitoring and enforcement powers.

Our hope is that by fundamentally overhauling the approach to stewardship, institutional asset managers and asset owners will be much readier to support and, where necessary to intervene to ensure that sustainable value creation becomes and remains the objective of investment.

We are clearly a long way from that ideal today, but investors and their agents collectively have the power to change the conduct of the investment industry for the better.

How this will work in practice



Relentless focus on purpose

Meeting the needs of investors in the 2020's and beyond requires a shift in mindset: from a narrow view of the delivery of investment returns – often relative to a benchmark – to one of sustainable wealth creation. To achieve this, investment management firms will need to make effective stewardship a substantive part of their activities across all asset classes.

The interests of investors come first

Asset managers and institutional asset owners act as agents for the individuals on whose behalf capital is being invested – these individuals are the true investors. It is in their interests that their capital is used to create wealth sustainably, both because it delivers sustainable long-term growth, but also because it helps build a better world for them and future generations. Those with a direct relationship to investors need to build a mandate for sustainability, articulating its benefits and how it fits with their priorities.

Through active stewardship, the power of our clients' assets can be used to influence companies to address the world's most pressing challenges and ensure better overall outcomes for investors. Companies that recognise the importance of an orderly climate change transition, decisive progress on gender equality and elimination of pay gaps not only do good for the world, but, by their nature, carry less risk. This is vitally important for any investor who seeks a long-term, sustainable return from their investments.

Full integration of stewardship into key investment and management processes

For stewardship to be taken seriously, it needs to be embedded in the way a firm carries out its business and become a core part of the investment activity, as the new Stewardship Code in the UK envisages. Investment managers need to act as responsible owners of the assets in which they invest and leave the asset in a better state than when it was acquired by the time they eventually dispose of it. Effective stewardship should alert investment managers to both financial risks and growth opportunities.

Companies that engage responsibly on issues such as business strategy, executive remuneration or climate change policy and diversity tend to be better companies. Stewards need to ensure that the investment purpose of shareholder wealth creation is not corrupted by perverse incentives and that all the

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links in an investment chain (clients, advisers, trustees, asset managers, executive managers and boards) support and hold their counterparties accountable.

There can be conflicts in stewardship objectives between different asset classes (e.g. credit and equity when a company is in distress) or indeed between two investment strategies. These need to be addressed through a robust conflict management process. The touchstone must be that the objective of sustainable wealth creation by the company for investors comes first.

The integration of stewardship does not simply lie with investment activities. Client mandates and fund objectives need to incorporate effective stewardship and require relevant reporting to clients. Fee structures should reflect the importance of stewardship and guard against short term risk-taking.

Investment managers need to ensure that their own governance and incentive schemes align with the stewardship parameters they impose on investee companies. Investment managers should disclose and articulate how their remuneration policy is consistent with and supports sustainable wealth creation and effective stewardship. Stewardship should also be considered in new product development and processes which review delivery of objectives to clients.

Empowering companies to deliver sustainable wealth creation

Many of the governance structures in place today were born from the disasters, scandals and failures in the 1990s. Investment firms began to recognise the need to hold company boards to account on pay and the interests of minority shareholders. This has evolved to include environmental and social policies.

The next stage of stewardship is to foster positive outcomes. Investment managers need to engage collaboratively with corporate management, explicitly empowering them to take action to deliver sustainable wealth creation, while encouraging them to resist short-term financial pressures that may corrode a company's long-term sustainable value.

Implementing systems and processes which support effective stewardship

Early on, stewardship came with only a vague brief: investment managers may meet companies to discuss issues of governance, the environment or pollution. Today, investment firms are clearer on what they are trying to achieve. However, there is a significant variability of the quality and preparedness of an engager, even within individual investment management firms.

A principal challenge of engaging effectively is often the sheer number of investments owned and a lack of resources. Knowledge management systems are key to ensuring that a firm's intellectual capital – in terms of sector, country and theme knowledge – should be properly stored, updated and shared. Robust systems and processes need to be put in place to clarify the background to strategic and governance issues, including those of an environmental and social nature, the specific objectives being sought, the actions taken and how successful these have been. Anyone in the firm should be able to access this knowledge and communicate it to investors.

Stewardship information should be integrated into the investment processes, bringing it directly into investment decision-making.

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Proper resourcing of stewardship and co-operating with others

Stewardship activities cannot be an afterthought. Understanding companies, carrying out meaningful dialogue and intervening with impact takes resources. Whether these activities are carried out by in-house portfolio managers or outsourced specialists, the investment industry will need to add significant resources and bring in a broad set of experience and skills. This includes hiring people of diverse talent and different nationalities, with experience across the sciences, accounting and law, banking and investment, human capital management, strategy consultancy and sustainability. They must be able to operate effectively at board and senior management level and have the experience and understanding of how businesses are governed and make decisions to achieve influence and support change. Research[3] into the nature of the link between engagement and performance shows that senior-level engagement has more impact on achieving engagement outcomes.

The leading stewardship houses already draw on the experience of current or former senior corporate executives and board members of listed public companies.

Passive managers will also need to have standalone teams to deliver engagement. Some passive managers have already embraced this and have devoted resources and built impressive teams. However, they continue to be limited by the sheer number of holdings they carry.

Active stewardship requires sufficient quantity and quality of resource to employ enough engagers such that they are able to know each investment inside out. For active managers, it will be important that engagement is an integrated part of the team operating either directly within fund managers or by outsourced engagement specialists. This is most readily achieved in investment strategies which have high conviction models with absolute return targets but can work for high active-share strategies with above-index-benchmark performance targets too. Some firms may seek to utilise an engagement resource across active funds. If this approach is taken, then it is critical that engagers integrate effectively with fund managers.

However, in the foreseeable future not even the largest asset managers will have adequate resources in all key markets. As a result, meaningful and impactful stewardship work will also require better co-operation. This should take the form of formalised investor coalitions, or looser, informal cooperation. There are many opportunities to collaborate – for example, through the PRI, Climate Action 100+, the Task Force on Climate-related Financial Disclosures (TCFD) and national investor forums. The success of these initiatives ultimately depends on adequate resourcing and commitment by investment companies.

Measuring, assessing and reporting the impact of stewardship

Stewardship activities will differ depending on an asset manager's investment style and strategy. As it stands, many engagement objectives focus on governance matters, such as the development of policies and processes, and disclosure on issues such as executive remuneration, carbon emissions and human capital management. In future, stewardship objectives must be much more outcome-oriented, with clear actions, such as asking for the appointment of a director with specific skills or setting quantifiable environmental or social performance targets. This will need to be complemented by externally verifiable key performance indicators (KPIs), such as emissions reductions. The targets underlying the SDGs will provide a useful framework for investors when choosing relevant KPIs.

[3] Hoepner et al, 2013: ESG Engagement, Risk & Return: An Interim research progress project (2013); Hoepner, A., Oikonomou, I., & X.Y. Zhou (2015): ESG Engagement in Extractive Industries: return and risk. Research Paper

The focus needs to shift from corporate governance and disclosure towards impact and positive outcomes for society and the environment. Investment managers will also need to be more open about the specific stewardship actions they are taking. The use of different engagement techniques, such as private dialogue with the company, at all levels, including the board, but also the placing or supporting of shareholder resolutions, or interventions at annual general meetings, should be evidence-based.

What does this mean for asset owners, asset managers and regulators?

The implications of the stewardship success factors outlined above will significantly differ based on investment style, the markets, sectors and the businesses and the size of companies fund managers target for investment purposes.

The aspiration that market forces will drive behavioural change remains a hope rather than reality. For this reason, we believe that the implementation of SRDII and the new strengthened Stewardship Code by the FRC must deliver substantive changes.

Our hope is that by fundamentally overhauling the approach to stewardship, institutional asset managers and asset owners will be much readier to intervene to ensure that sustainable value creation becomes and remains the objective of business.

We are clearly a long way from that ideal today. But investors and their agents collectively have the power to change the conduct of the investment industry for the better. Whilst government regulation may need to be called upon, it will be far more effective if investment managers use the powers and the votes to support, encourage, exhort, pressurise or, if necessary, to force businesses to focus on long-term sustainable value creation rather than short-term wealth extraction.

In an ideal world, stewardship would be fully integrated into offerings across the fund management industry. However, for practical and commercial reasons this will not happen in the foreseeable future. Therefore the systematic and client-driven stewardship services, like those offered by the international business of Federated Hermes, will continue to play an important part in helping asset owners and managers fulfil their fiduciary duties and contribute to the creation of long-term value.

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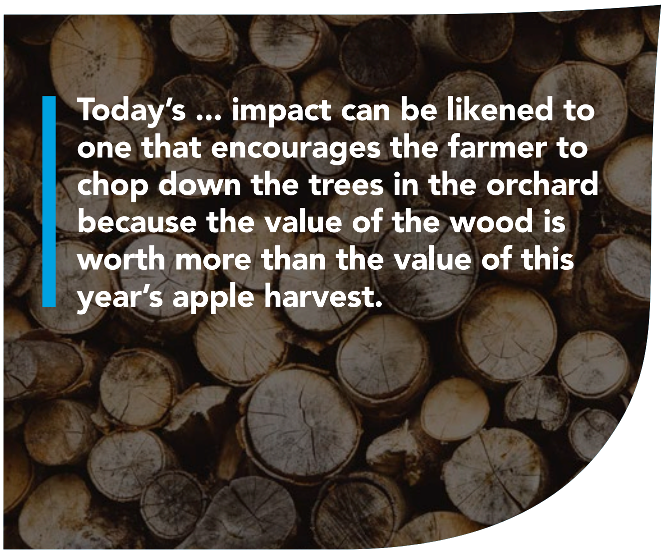
A final analogy and a test of success

It has become commonplace for the investment management industry to focus on delivering a higher return than a relative benchmark, rather than sustainable wealth creation. Making this disconnect worse, this outperformance is often measured over short time periods.



This puts pressure on corporate management teams to deliver short term share price rises at the expense of long-term sustainable growth, with consequences for investors, the economy and the planet. It can create perverse incentives for senior executives leading to weaker long-term returns, less innovation, reduced opportunities for employees and greater risk-taking.

When we look back in 2030, we should ask ourselves whether the investment management industry has evolved. Today, in many respects its impact can be likened to one that encourages the farmer to chop down the trees in the orchard because the value of the wood is worth more than the value of this year's apple harvest.

In 2030, the investment management industry must have transformed into one that has successfully encouraged the farmer to plant more trees, to invest in better-tasting apples, to conserve the land and to create better jobs by investing in more efficient growing and harvesting techniques.

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Federated Hermes International

Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

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.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

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