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ESG integration in small- and mid-cap equity investing

Hermes Small & Mid Cap
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HERMES
INVESTMENT MANAGEMENT

Environmental, social and governance (ESG) analysis is firmly encoded in the Hermes Investment Management DNA. As an early adopter of ESG integration, Hermes has demonstrated the power of the once-fringe approach in generating outperformance linked to real-world sustainability concerns – and developed it further to generate holistic returns that benefit investors and the society and environment in which they live.[1]

ESG analysis has evolved into another source of potential alpha for active managers as well as a risk management tool. It has mainly been applied to large companies, given the depth of information available about them, with the small-and-mid cap (SMID) sector less heavily explored on the sustainable investment map.

This is, perhaps, understandable: integrating ESG factors into investment processes is difficult at the best of times. Even at the large-cap level, ESG assessments often rely on subjective judgments that don't immediately translate into top-line revenue or bottom-line profits in financial projection models.

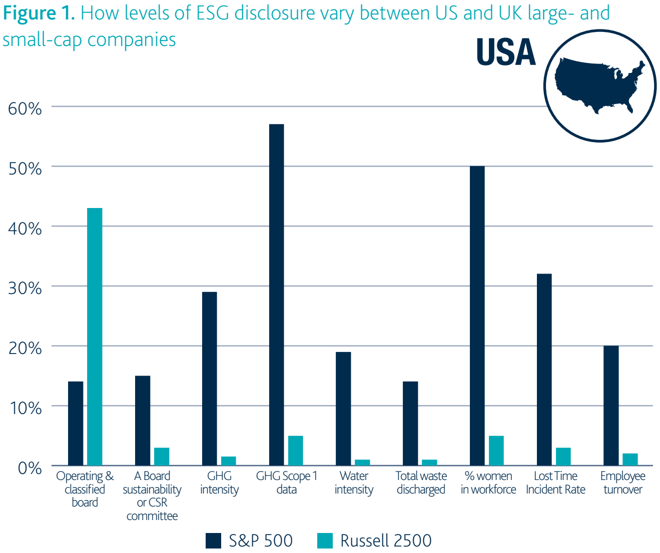
For smaller companies, ESG analysis is further complicated by a couple of factors:

- the quantity and quality of related disclosures is poorer; and,
- the relevance of any individual metric is unlikely to be material when such businesses are typically growing fast.

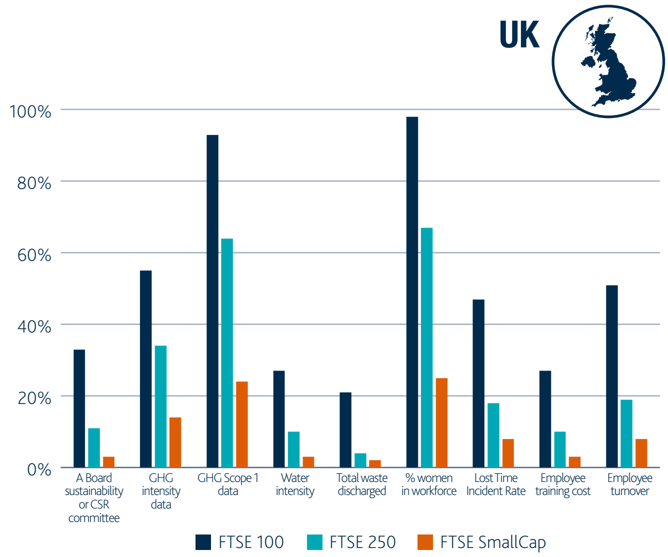
ESG DISCLOSURES: CONSISTENTLY INCONSISTENT

The disparity between larger and smaller companies regarding the disclosure of basic ESG metrics, or the implementation of ESG risk-management practices, is striking. The two charts in figure 1 illustrate the extent of the chasm in the US and the UK equity markets. In less-developed markets, ESG disclosure levels can be even more patchy.

Figure 1. How levels of ESG disclosure vary between US and UK large- and small-cap companies



Source: Bloomberg as at December 2018.



Source: Bloomberg as at December 2018.

Irrespective of the size of a company, the same ESG factors are undoubtedly in play. Analysing a company's exposure to relevant ESG factors can help an investor determine whether they are efficient, productive and sustainable in a world of finite and diminishing natural resources, tightening regulation and evolving consumer preferences. These forces don't discriminate by the size of a company's market capitalisation.

These large gaps demonstrate the need to gain further sources of ESG information, and more importantly, to meet with corporate boards and management teams to develop a fuller picture of a company's governance and management of important environmental and social risks.

Given the lack of readily available ESG information in the SMID sector, active managers with the right tools to perform ESG analysis on these companies can generate profitable insights. In our view, investors won't find those tools on the shelf, because engagement is necessary to uncover the right information and gain a more accurate picture of the ESG performance of companies ESG performance. Judgment is key: a one-size-fits-all approach is less likely to yield valuable information.

PICTURE IMPERFECT: WHY RATINGS DISTORT ESG OPTICS

Integrating ESG thoroughly into an investment process requires managers to sift through a wide variety of corporate disclosures and consider a raft of issues that include, but are not limited to:

- Supply chain practices;
- Resource usage;
- Workforce management;
- Product development; and, of course,
- Governance

[1] For supporting research and commentary, please see the following:

1) "ESG investing and performance: the evidence," published by Hermes Investment Management in 2019. Available at: https://www.hermes-investment.com/ukw/about-us/esg-investing/esg-investing-performance/

2) "ESG investing: a social uprising", published by Hermes Global Equities in November 2019. Available at: https://www.hermes-investment.com/ukw/insight/equities/revision-esg-investing-a-social-uprising/

3)"Delivering holistic returns," published by Hermes Investment Management in 2019. Available at:: https://www.hermes-investment.com/ukw/about-us/responsibility/delivering-holistic-returns/

Ideally, investors should consider the ESG data, where it is available, alongside traditional fundamental analysis with more detail on sustainability issues to be derived through direct contact with management: this is not easily outsourced to third parties. In fact, if investors are committed to credible and meaningful ESG analysis they cannot, and should not, depend upon ESG ratings.

These ratings should be considered as inputs to analysis rather than a final view. ESG ratings can raise red flags about major issues within companies. But on the whole, the scores have some clear shortcomings. First, most ratings rely on published data, which is by definition historic. Given the need to create scale, the off-the-shelf ratings are also often constructed without analysts forming a fundamental understanding of businesses or specialist industries. This can result in ESG ratings missing genuinely material factors influencing the performance of companies. Further, to avoid the criticisms about missing such information, ESG research can often take a kitchen-sink approach and combine the meaningful with the trivial to form a confusing array of data points.

Researchers[2] have identified four key failings of ESG ratings, which are amplified when applied to smaller companies:

- Market-cap bias – companies with more communication resources tend to score better;
- Disclosure/geographic bias – national regulatory disclosure requirements drive scores, and scores reward disclosure (not necessarily performance);
- Industry bias – ratings do not discern between very different business models in the same industry, with more mature and regulated industries generally scoring higher; and,
- Reactivity – ratings are dragged down for an extended period of time following a controversy, despite the high likelihood that the companies responsible have consequently implemented changes that could improve their performance relative to peers[3].

To further illustrate the clear water between ratings-driven decisions and in-depth ESG investment analysis, let's consider some SMID companies currently in Hermes portfolios that would likely be cut, or less favoured, if scores from third-party research houses set the agenda.

KIRBY CORP

Figure 2. Kirby Corp sinks in the estimations of ESG ratings providers

MSCI ESG	Sustainalytics	ISS Governance QualityScore	Bloomberg ESG Disclosure Score
CCC (bottom 11%)	52/100 (average performer)	6 (10 indicates maximum ESG risk)	21.5 (100 indicates strong ESG performance)

Source: MSCI, Sustainalytics, ISS and Bloomberg as at March 2019. Bloomberg score based on the past fiscal year's disclosure.

Kirby, a US operator of inland and coastal tank barges, is among the poorest ESG-rated company in our SMID strategies. In our view, however, it is a long-standing holding and a high-quality company. The company's governance structures do not necessarily reflect the best practices expected of larger companies. For example, there is very limited gender diversity among its staff, a classified or staggered board in which not all directors are put forward for election each year, the former CEO is the current chair and incentive metrics are the same across management's short- and long-term incentive plans. But these features overshadow good practices and a strong culture within the board and throughout the company. Diversity is slowly improving, there is a good mix of tenured directors on the board, pay outcomes are modest and the chair relinquished executive responsibilities in 2018. In executing strategy, the management team has done a consistently good job of managing capital allocation, improving the company's competitive position through cycles by acquiring smaller fleets and therefore gaining market share.

Tank barges primarily carry liquid, solid or gaseous commodities or cargoes in bulk along rivers and inland waterways.

[2] "Ratings that don't rate: the subjective world of ESG ratings agencies," by Timothy Doyle. Published by the American Council for Capital Foundation in July 2018.

[3] It is interesting to note that MSCI's own analysis of the impact of controversies on company performance, covering the period from February 2007 to June 2017, found that the smallest firms with alleged wrongdoing outperformed the average MSCI World stocks of similar size. This indicates that the returns of smaller companies were not penalised by moderate or even severe events. In our view, this should not make the case for seeking out smaller, more controversial companies, but it does highlight the need for the impacts of controversies to be carefully considered. MSCI's analysis can be found in "Have corporate controversies helped or hurt performance," by Nagy Zoltan et al. Published by MSCI in August 2017.

But Kirby's level of ESG disclosure is poor and this is the principal driver of its low ESG rating. Nonetheless, we have consistently found its management team to be open to dialogue and, more recently, we have begun to press the company to better communicate its commitment to sustainability. It has started to respond to this challenge: in May 2018, the management team presented on sustainability at its analyst day and provided further disclosure on Kirby's website.

In meetings with the company, we have been reassured that sustainability is embedded in the corporate culture and that safe operations are prioritised. With public disclosures now improving, we expect Kirby's ESG rating to rise.

EAGLE MATERIALS

Figure 3. Eagle Materials: flying under the radar of ESG researchers

MSCI ESG	Sustainalytics	ISS Governance QualityScore	Bloomberg ESG Disclosure Score
B (bottom 42%)	46/100 (laggard)	4 (10 indicates maximum ESG risk)	19.4 (100 indicates strong ESG performance)

Source: MSCI, Sustainalytics, ISS and Bloomberg as at March 2019. Bloomberg score based on the past fiscal year's disclosure.

US-listed Eagle Materials produces and sells construction products, principally cement and gypsum wallboard. The industry is inherently energy-intensive and, based on the ESG scores above, Eagle would appear among the worst of a seemingly bad bunch.

But is Eagle really less efficient and more exposed to the growing regulatory risks concerning emissions than its peers? It would be easy, and to an extent justifiable, to look at the company's most recent sustainability report, published in 2011, and conclude that Eagle is not committed to managing its ESG risks. While the company was progressive in publishing a sustainability report in 2011, the absence of further disclosures amid growing stakeholder interest is less impressive.

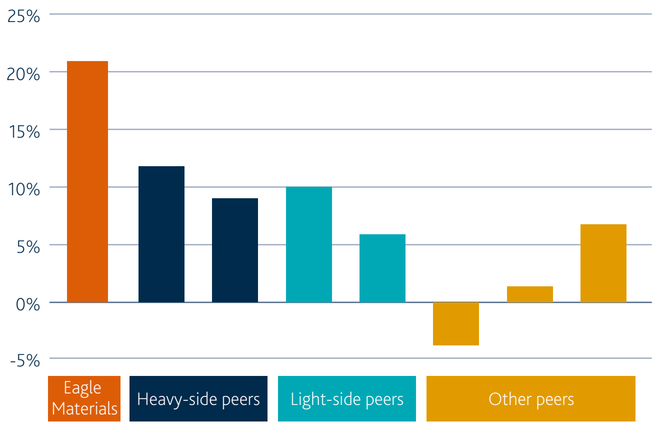
Drywall: Eagle Materials helps make a ubiquitous product more sustainable.

In our view, the opposite is almost certainly true. On page one of Eagle's 2018 Annual Report, the company states that it is: "… committed to using less raw material, less energy, less water, less of everything – to produce the same commodity products as others… This is the key to our competitive margin performance."

As figure 4 shows, Eagle is a stand-out achiever among its peers by being the lowest-cost US producer. It is self-evident that the company's margin performance is only possible because it uses fewer resources to produce the same products as its competitors. Its facilities are located next to naturally occurring raw materials, benefitting its vertically integrated structure, and its plants are kept in excellent condition.

We considered Eagle's sustainability credentials before first investing in the company in 2008. Following its sustainability report, we noted that the company's holistic approach to using scarce resources generates a measurable economic benefit. With an increasing focus on mitigating climate change, we ramped up our engagement in 2016. Based on our own detailed research and direct contact with the business, we believe Eagle is arguably one of the industry's sustainability leaders: a fact that, because of its poor levels of ESG disclosure, ratings providers fail to identify.

Figure 4. The eagle has landed a healthy profit – thanks to its resource efficiency



Source: Eagle Materials as at 2019.

For more case studies, please see the appendix on p.9.

GETTING REAL: HOW TO INTEGRATE ESG IN THE SMID MARKET

Sustainable investing requires much more than best-practice guidelines: investors need to clearly discern which ESG factors matter most in any given industry and company.

Materiality matters in ESG analysis, as a collective and growing body of evidence shows. For instance, the 2015 Harvard Business School study, "First Evidence on Materiality", found that companies which perform well on *material* ESG factors – those with real impacts on their businesses – outperform in financial terms. Furthermore, companies that rate well on *material* ESG factors and poorly on *immaterial* ESG factors perform best. This finding backs the common-sense intuition that there is little point in a company – especially a smaller company with more limited resources – committing cash to address a non-material risk when it should be put to better use elsewhere.

By targeting the most relevant and material ESG issues faced by portfolio companies, investors can then identify which practices can be mitigated or improved through engagement, and thereby support long-term outperformance. This should also help them decide whether a firm's behaviour relative to the most important ESG factors is improving or deteriorating – and if that data merits inclusion within a discounted cash flow model. For example, an ambitious carbon-intensity reduction target (denominated as CO^2 per dollar of revenue) for a materials company could suggest that the firm has potential to reach higher operation margins.

ESG integration also means investment managers must translate that high-level focus on material issues into robust and repeatable processes, including:

- Requiring all investment analyses to succinctly identify those ESG issues that matter most to a company's investment case: the factors that may impact upon the company's value with a three-to-five-year view. Analysts should also consider whether the ESG issues highlighted can be qualitatively or quantitatively factored into an investment appraisal – this might be in the form of explicit adjustments to prospective revenues or costs, or less explicit in the form of potential rating implications or analysts' conviction levels;
- Systematically assessing ESG opportunities within a company's direct operations and across its supply chains, and considering whether its products and services could generate a positive societal impact. This assessment can prove to be a useful catalyst for understanding how companies are positioning themselves to attract and retain workers, adapt or sell their products to cater to unmet needs in new markets, and build brand value by going beyond regulatory standards; and,
- Assessing company performance on key issues with a clear view that talk is cheap – little credit should be given to a company that has disclosed a policy but no associated performance metric (or a penalty levied for non-disclosure). Quantifiable ESG metrics are what matters.

We suggest that investors need to develop a repeatable process for analysing ESG considerations. Figure 7 presents the lines of enquiry that should be standardised.

ESG FOCAL POINTS

The Materiality Map produced by the Sustainable Accounting Standards Board (SASB) draws on evidence to identify ESG issues that are likely to be financially material on an industry-by-industry basis, providing a useful starting point for analysis.[4]

SASB's identification of those material sustainability topics is informed by robust assessment of available evidence. But the absence of certain data prevents research into other causal relationships. Materiality is therefore still a subjective concept: it is not possible to nail down precisely what issues will be material at the outset of an ESG investment analysis. Time horizons help to narrow the scope of materiality but there is still a great deal of judgment involved. And risks can rapidly emerge from the fringes.

More broadly, there is also so much value stored in a company's brand. With the internet and social networks expanding the number of voices influencing the perception of a company, it is reasonable to assert that a broader range of stakeholder relationships are increasingly material – particularly those with employees, customers and local communities.

Figure 7. Lines of ESG enquiry: a template for analysing the materiality of a company's ESG risks

<table>
<tr><th></th><th colspan="2">NEGATIVE/NEUTRAL/POSITIVE</th><th>KEY POINTS</th><th>ASSESSMENT</th></tr>
<tr><td>GOVERNANCE</td><td colspan="2"></td><td></td><td></td></tr>
<tr><td colspan="5">– Governance risk: does the company's governance structure and practices support sound decision making and promote and safeguard the interests of long-term investors?</td></tr>
<tr><th></th><th>SCALE OF RISK (HIGH, MEDIUM OR LOW)</th><th>MANAGEMENT OF RISK</th><th>KEY POINTS</th><th>ASSESSMENT</th></tr>
<tr><td>SOCIAL AND ENVIRONMENTAL RISK</td><td></td><td></td><td></td><td></td></tr>
<tr><td colspan="5">– Environmental and social risk: what principal, environmental or social risks is the company incurring as a result of its direct operations, processes and practices?</td></tr>
<tr><th></th><th colspan="2">NEGATIVE/NEUTRAL/POSITIVE</th><th>KEY POINTS</th><th>ASSESSMENT</th></tr>
<tr><td>IMPACT OPPORTUNITY</td><td colspan="2"></td><td></td><td></td></tr>
<tr><td colspan="5">– Impact opportunity: to what extent are the company's products and services contributing positively or negatively to overcoming a social or environmental challenge, or does it have a neutral influence? What more could the company do to enhance its value while generating a positive impact?</td></tr>
</table>

Source: Hermes. For illustrative purposes only.

[4] To access the Materiality Map, an interactive online tool, visit: https://materiality.sasb.org/.

Despite the growing complexities, there are three key components of any ESG analysis: corporate governance, human-capital management and resource efficiency.

1. CORPORATE GOVERNANCE

Governance is critical for all companies. According to the UK Corporate Governance Code, its purpose is to facilitate effective, entrepreneurial and prudent management that can guide a company to long-term success. For smaller companies, good governance is arguably more important because boards make decisions that will often result in transformative changes in short time periods.

Astute governance can help navigate a smaller business through challenges typically inherent in smaller companies, including:

- Fast expansion and a tendency to seek inorganic growth;
- Dominance of founder-CEOs or controlling parties; and,
- They have less sophisticated or mature risk-management processes in place.

These dynamics point towards a number of questions that we consider in our ESG analysis of SMID companies.

Ownership and shareholder rights

- Is there an adequate balance of powers, and are the interests of the owners aligned with the long-term objectives of the company?
- Is the board classified or staggered (about half of the Russell 2500 still operate this way), and if so, how accountable are individual directors to shareholders?
- How familiar and credible are the auditors and/or other advisers?

Leadership

- Are we investing in the company or the CEO? If the latter, how severe is the key-man risk? What succession plans are in place for key individuals in the short-, medium- and long-term?
- Is the CEO also the chair? If so, to which board member(s) are they accountable?

Board composition

- Does the board have expertise, or representation from, the markets in which the company is generating revenue or aims to enter in the future?
- Is there sufficient diversity of age, gender, and professional background to ensure that there is a diversity of views expressed? The 'stale, male and pale' stereotype is more stubborn among smaller than larger companies.
- Is the company consumer-facing, and if so, does the board have a sufficient understanding of its consumer base – for example, millennials?

Is the company experiencing or exposed to technological change? If so, is there adequate understanding of this rapidly evolving area?

Management pay

- Is the level of pay incentivising the right behaviour and aligning the actions of management with the interests of long-term shareholders? We expect to see lengthy holding periods attached to equity awards, with similar shareholding guidelines and broad clawback provisions.
- Most incentive metrics are outside the control of management teams, and evidence[6] demonstrates that vesting cliff-edges can distort behaviour. What checks are there against these unintended consequences?
- Incentives are there for a reason, and changes in metrics often signal the forward-looking focus of a company. Is there a mis-match or conflict between stated strategy plans and new metrics?

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3. RESOURCE EFFIC

The ability of companies – particular efficiently use resources has regulat and a direct impact on margins and

- Carbon intensity is a solid indicator demonstrate it is an efficient user of
- Water-scarcity risk: are the compan provide site-specific water-intensity and is the use of the resource equita

[6] "Equity vesting and investment," by Edmans, A. et al. Published by Oxford Academic in The Review of Financial Studies in 2017.
[7] Edelman Trust Barometer 2018. Accessed at: https://www.edelman.com/trust-barometer
[8] "There Are Significant Business Costs to Replacing Employees" by Heather Boushey and Sarah Jane Glynn. Published by the Center for American Progress on 16 November 2012.

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2. HUMAN CAPITAL MANAGEMENT

Automation may be displacing workers, but competition for certain skill-sets in many industries remains fierce. The war for talent is intense in certain manufacturing sectors, and the engineering and technology industries.

And this talent can speak volumes about a company. The opinions of employees about the businesses they work for are more trusted than those of senior executives[7]. The prevalence of company-review websites such as Glassdoor further amplifies the power of workers to influence corporate brands. For example, because Unilever is rated by its workers as the third most-desirable place to work, behind Google and Apple, it attracts bright and motivated candidates.

However, as the figures at the beginning of this paper demonstrate, companies' disclosure about how they manage human capital is patchy at best. Nonetheless, the key human capital issues we seek to consider include the below:

Gender diversity

- What is the level of gender diversity across the workforce? There is little excuse for low levels across any industry: anything below a 25% threshold can be indicative of poor accommodating practices and, therefore, limited use of available talent and sub-optimal productivity.

Employee turnover

- Unnecessary turnover is expensive: research[8] suggests that replacing an employee who quits costs on average 21% of annual pay (and 16% for the lowest paid).
- Companies need to appeal to different generations of workers. This means retaining existing talent, being inclusive of older employees – especially in the many countries with aging demographics – while also attracting younger workers who may be more transient and have different expectations from previous generations.

Importantly, while there are limited human-capital disclosures from companies, Glassdoor and other similar websites provide immediate and rich insights into workforce sentiment across a company and at individual sites. It is no surprise to note that high ratings on Glassdoor, for instance, have been correlated with corporate outperformance.

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rly heavy industrials or manufacturers – to tory and ultimately environmental implications returns. Common key metrics we consider include:

of operational efficiency: can the company similarly f scarce natural resources?

y's assets based in a high-water-risk area, and if so, does it metrics? How good are relations with local communities able? Ultimately, is the facility viable?

Any other questions? Further lines of ESG enquiry

- Does the company have designated accountability for material environmental and social issues at the board level?
- Has the company identified its key stakeholders, and how does it monitor their satisfaction levels? (For example, does it perform employee engagement surveys, track net promoter scores, record the number of complaints about its operations or outputs, and survey the local community?)
- Has the company adopted meaningful targets in relation to its foremost environmental and social risks?
- Is performance on the primary environmental and social issues included – formally or informally – within annual management incentive awards?
- How are risks in the supply chain monitored? Is there a reliance upon third-party audits or does the company undertake its own assessments?
- Does the company aim to provide local employment opportunities and contract local suppliers?
- How is product quality monitored – how many instances of product recalls have there been?

WHY ESG IS A NEVER-ENDING STORY

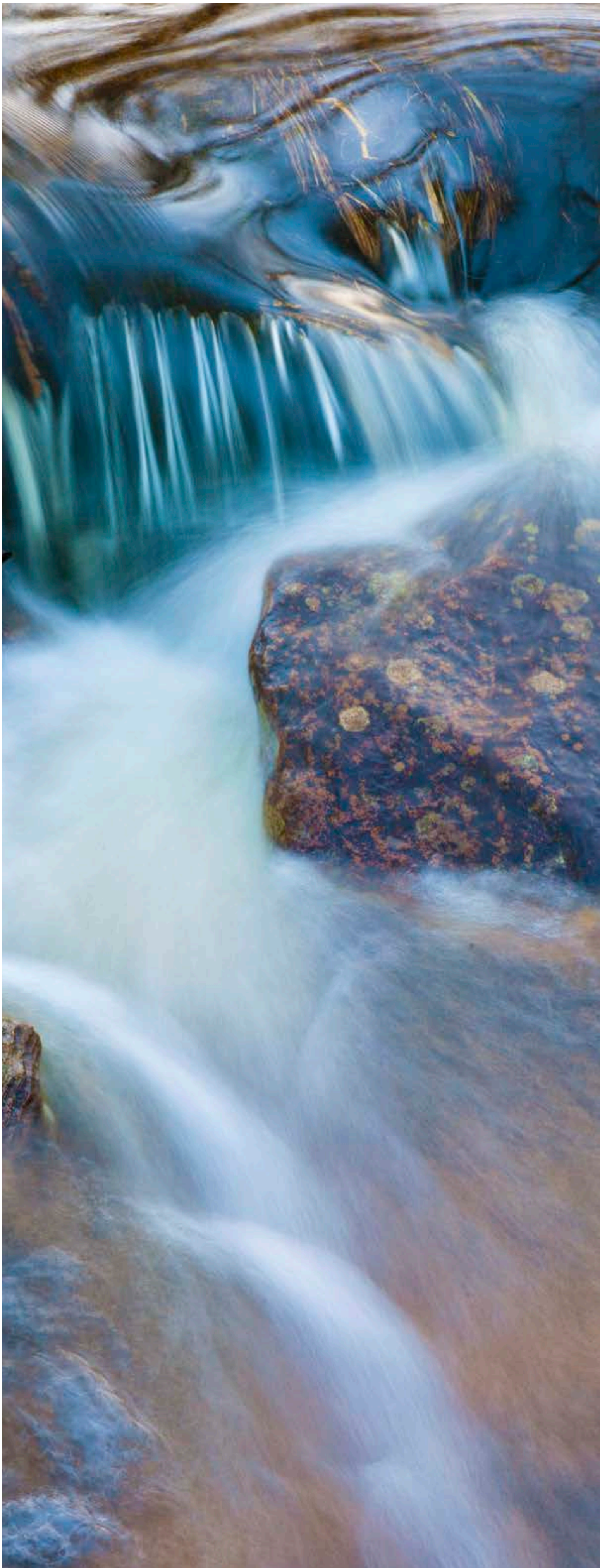
Identifying ESG issues during an initial analysis of a company does not mark the end of the process. As with traditional financial analysis, assessment of a company's ESG performance is ever-evolving, demanding regular re-evaluation.

As well as keeping up to date with corporate disclosures, where practical we discuss with senior executives and non-executive directors in meetings, calls and company visits how they view and manage ESG risks.

Ongoing contact with companies provides us with a much deeper understanding of their practices compared to what can be gleaned from corporate reports alone. Similarly, engagement with management teams on matters not typically seen as financial provides us with additional insights, which in turn improves our knowledge and understanding of the company.

These insights can be used explicitly in our regular composition review process, where a stewardship score forms part of the overall quality rating for an individual holding. This has a direct influence over the sizing of the holding in the portfolio.

Our hands-on, and ongoing, ESG analysis process is just as important – if not more so – for gauging the quality of SMIDs as much as for large firms. We believe that considering and speaking with companies about their environmental, social and governance issues helps us identify small firms with big futures.



APPENDIX

Further evidence of how major ratings houses often do not accurately capture the ESG risks of SMID companies are illustrated by the following two case studies. Both companies are held in Hermes SMID equity portfolios.

Amerisur Resources

Figure 5. Amerisur Resources: out of sight of ESG ratings houses

MSCI ESG	Sustainalytics	ISS Governance QualityScore	Bloomberg ESG Disclosure Score
Not covered	Not covered	N/A	N/A

Source: MSCI, Sustainalytics, ISS and Bloomberg as at March 2019.

Amerisur Resources is another company operating in a heavily ESG-risk exposed industry: oil and gas. Unlike Eagle, Amerisur is listed in the UK, a market with typically higher disclosure requirements. But it is listed on the AIM market for smaller companies, which has less stringent reporting requirements than the UK's main exchange.

While the company does provide some sustainability disclosure, it is fairly limited. Amerisur's governance has improved significantly over the past couple of years, with more oversight upgrades to come. The company's principal ESG risks arise from its operation in the Putumayo basin – an often-neglected region of south-west Colombia, bordering Ecuador and Peru on the margins of the Amazon rainforest. In a very real sense, then, Amerisur's licence to operate is dependent upon its relations with local communities, which the firm cultivates through engagement policies. For example, it has worked with a number of villages to deliver long-term benefits such as developing agricultural projects that provide locals with the opportunity to tap into a secure and sustainable income stream.

In a similar vein, Amerisur does not flare gas, despite being entitled to do so, choosing instead to use what others see as a waste product to fuel its temperature control systems. Our stewardship colleagues in Hermes EOS engage with many other oil and gas businesses on the controversial practice of gas-flaring, and have confirmed to us that not all companies are as progressive as Amerisur.

Both before and during our time as shareholders in Amerisur, we have kept a close eye on its status as a good corporate citizen. But public statements about ESG behaviours are not convincing enough: only our direct engagement with the company's management and board provided substantive evidence that Amerisur's commitment to corporate sustainability is more than talk. To that end, we have welcomed the October 2018 appointment of Elodie Grant Goodey to the company's board. She brings significant experience in social responsibility and stakeholder engagement and should enable even greater board leadership and oversight of the company's local capacity-building initiatives.

Brunswick Corp

Figure 6. Brunswick Corp: left in the wake of competitors, according to its ESG rating

MSCI ESG	Sustainalytics	ISS Governance QualityScore	Bloomberg ESG Disclosure Score
B (bottom 22%)	46/100 (laggard)	1 (10 indicates maximum ESG risk)	21.1 (100 indicates strong ESG performance)

Source: MSCI, Sustainalytics, ISS and Bloomberg as at March 2019. Bloomberg score based on the past fiscal year's disclosure.

Brunswick Corp is the leading US boat- and marine-engine manufacturer as well as a major producer of fitness equipment. New York Stock Exchange-listed entity is another high-quality company with below-average ESG ratings.

Brunswick has recently improved aspects of its corporate governance that were lagging best practice, including declassifying its board in 2018 to ensure that all directors face election each year. The firm also provides limited group-level ESG disclosures: its engine business produces a good sustainability report but this has historically not been promoted well or replicated at the group level. However, Brunswick has been consistently open to our engagement on these issues.

ESG ratings suggest that it is, at best, an average ESG performer compared to its peers, but our interactions with the company and visits to its manufacturing sites lead us to have a more positive view.

Mercury Marine, probably the most well-known Brunswick brand, was presented with a Wisconsin Business 'Friend of the Environment Award' in August 2018 for the second time in four years. New Mercury products – the V6 and V8 four-stroke outboard engines – have been well received by customers, with the motors boasting much greater fuel efficiency than competitors' models.

Brunswick Corp is under the radar of ESG researchers, but is putting clear water between itself and competitors in ESG terms.

Brunswick's manufacturing facilities are cutting-edge in terms of energy usage, air quality and waste reduction, which we witnessed during a visit to the group's Fond Du Lac facility in May 2018. However, we do think that the business could apply circular-economy principles to the manufacturing of marine craft, as fibreglass vessels are difficult to recycle. The site visit also showcased the high proportion of female employees in the Brunswick workforce, which reflects the company's investments in lifting devices and robotics. Similarly, all Mercury employees – from top to bottom – have the same health insurance plans, avoiding an us-and-them culture.

Operating in the US Mid-West, away from the big cities but near many other large manufacturers means that there is strong competition for talent. Brunswick is clearly doing well to recruit and retain staff: it has very low employee turnover as well as a large number of referrals from current workers.

The marine industry, with its dependency on clean air and water, should naturally regard sustainability as a priority. In our view, Brunswick understands this.

Our capabilities

- **Hermes Global Small Cap Fund**
  - Targeting above-benchmark returns for below-benchmark risk by focused stock selection among high-quality companies
  - Benchmark: MSCI World Small Cap

Hermes Global Small Cap Fund: net returns

	28/02/18 to 28/02/19	28/02/17 to 28/02/18	28/02/16 to 28/02/17	28/02/15 to 28/02/16	28/02/14 to 28/02/15
Fund	-3.9	20.3	22.5	N/A	N/A

Source: Hermes as at March 2019. Performance shown is that for the Hermes Global Small Cap Fund F USD Accumulating share class. Fund inception date: 15 May 2015 Returns shown are in US dollars and are net of fees and costs.

- **Hermes US SMID Equity Fund**
  - A portfolio of quality businesses with economic moats – defensible franchises – that aims to deliver long-term outperformance
  - Benchmark: Russell 2500 Total Return Net

Hermes US SMID Equity Fund: net returns

	28/02/18 to 28/02/19	28/02/17 to 28/02/18	28/02/16 to 28/02/17	28/02/15 to 28/02/16	28/02/14 to 28/02/15
Fund	2.5	6.4	27.8	-6.0	12.1

Source: Hermes as at March 2019. Performance shown is that for the Hermes US SMID Equity Fund F USD Accumulating share class. Fund inception date: 26 September 2012. Returns shown are in US dollars and are net of fees and costs.

- **Hermes SDG Engagement Equity Fund**
  - Investing in attractive companies with the potential – through engagement aligned with the Sustainable Development Goals – to generate outcomes that benefit people, the planet and investors
  - Benchmark: MSCI All Country World SMID Index

Hermes SDG Engagement Equity Fund: net returns

	28/02/18 to 28/02/19	28/02/17 to 28/02/18	28/02/16 to 28/02/17	28/02/15 to 28/02/16	28/02/14 to 28/02/15
Fund	-0.5	N/A	N/A	N/A	N/A

Source: Hermes as at March 2019. Performance shown is that for the Hermes SDG Engagement Equity Fund F USD Accumulating share class. Fund inception date: 29 December 2017. Returns shown are in US dollars and are net of fees and costs.

Past performance is not a reliable indicator of future results and targets are not guaranteed. The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Any investments overseas may be affected by currency exchange rates. Investing in smaller/medium sized companies may carry higher risks than investing in larger companies. Investments in emerging markets tend to be more volatile than those in mature markets and the value of an investment can move sharply down or up.

OUR INVESTMENT APPROACH

We are fundamental stock pickers, managing strategies that seek to outperform global and US benchmarks at lower levels of risk than what these indices hold over long time horizons. We concentrate our efforts on stock selection – our core competence – at the expense of sector and geographical allocations. Over time, returns are driven by companies themselves – not the sectors or countries in which they are based.

Quality is key

To identify investment opportunities, we focus on the quality of companies. Quality has many characteristics – such as sustainable growth, capital discipline and durable competitive advantage. While it is not necessary for any one company that we invest in to produce outstanding metrics in relation to all of them, we believe that they must be strong on an overall basis. By focusing on quality, we aim to generate a high return on equity and consistency of returns compared to our benchmark indices.

Coming full circle on quality

Source: Hermes. For illustrative purposes only.

Time is on our side

We are deliberately long-term focused. In our view, this is an important factor in generating alpha by investing in small companies: long timeframes are often necessary to capture the growth in market share that successful smaller businesses experience, and to take advantage of short-termism in the market, which often results in stocks being mispriced and therefore available at unjustifiably low valuations.

Face time

We undertake a large number of company meetings each year to identify new investment ideas and to monitor existing holdings. We continually work with the engagement specialists in Hermes EOS to understand the businesses we assess, their ESG challenges and how these can be mitigated to increase value for shareholders.

Engaging for SDG impact

In one of our strategies, we aim to go beyond financial outperformance and ESG integration. We aim to generate impacts, through engagement, that support the Sustainable Development Goals (SDGs), a universal set of goals aiming to preserve the environment and boost prosperity worldwide by 2030.

Small- and mid-cap companies are largely unaccustomed to being engaged on sustainability matters. Yet these businesses, along with their supply chains, have significant potential to create positive societal impacts in addition to strong investment returns. Engagement has the potential to unlock value for all stakeholders – investors, companies, employees, local communities and the planet – and therefore help deliver the SDGs.

We believe that there are compelling opportunities to create such change and long-term value among SMID businesses, whose operations and supply chains provide rich potential for improvement and the direct access to corporate boards and management teams that is essential for successful engagement. By helping to drive such change, the Fund aims to deliver strong investment returns as businesses improve, become more sustainable, and increase their exposure to the underserved needs represented by the SDGs – which are, in essence, sources of future growth.

SDG-focused investment and Engagement

Example sector: consumer goods (food) and retail

For example, an engagement with a global food and dairy producer could focus on ensuring that its products are produced and marketed in a responsible way and sold for a reasonable price, thereby aligning its activities with SDG 12. The companies in its supply chain, many of which operate in the emerging world, could be required to take more aggressive steps to mitigate climate change and land degradation, satisfying SDGs 13 and 15. The engagement could also encourage the company to ensure that any foods manufactured for infants and the elderly are more nutritious and that its workforce shows greater levels of diversity, thereby contributing to SDG 2, SDG 3 and SDG 5.

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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:

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