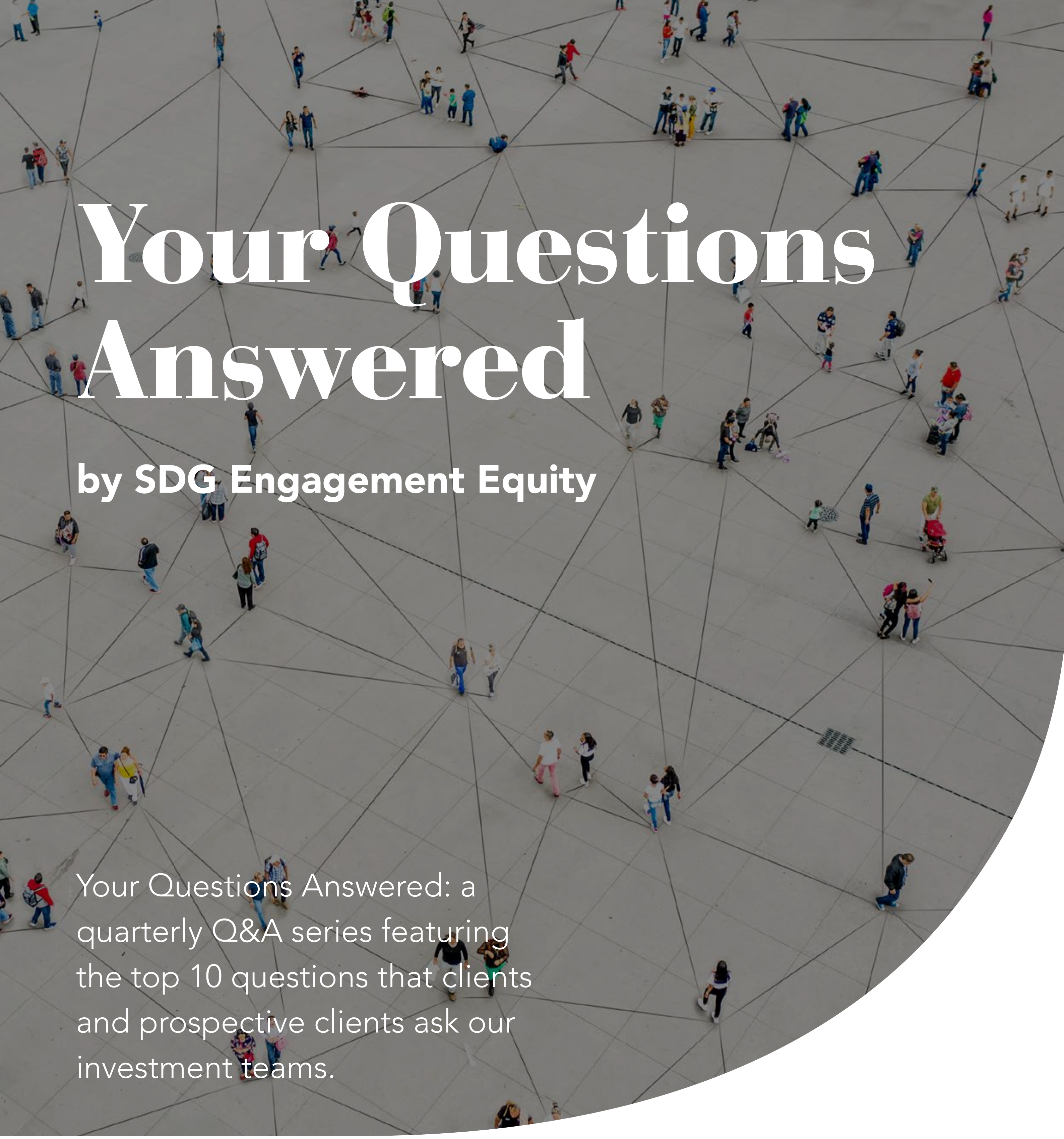

Your Questions Answered

by SDG Engagement Equity

Your Questions Answered: a quarterly Q&A series featuring the top 10 questions that clients and prospective clients ask our investment teams.

Q2 2021

For professional investors only.

Federated Hermes

www.hermes-investment.com

1 Describe the philosophy of the SDG Engagement Equity Fund and why you engage with companies on the UN Sustainable Development Goals (SDGs) specifically?

We focus on investing in attractive companies with the potential – through engagement aligned with the UN SDGs – to generate outcomes that benefit people, the planet and investors.

Amid growing evidence that a company's long-term success is correlated with the health of the economies, communities and environments in which it operates, our team is committed to delivering attractive returns whilst also engaging for positive societal and environmental impact.

By engaging with companies on specific, relevant SDGs, we gain valuable insight into investment risks and longer-term opportunities that the company is exposed to. Such insight includes how a firm manages scarce resources, how it invests in its people, and how it supports equitable economic growth.

The 17 SDGs provide a common reference point for us to identify, assess and measure a company's impact on society and the environment. Companies that can build and deliver innovation to help the world meet these goals are poised to benefit significantly as structural shifts in policy, technology and sentiment, create a fertile backdrop for them to capitalise on.

Our research has found that approximately 40% of the SDGs 169 targets are relevant points of dialogue between investors and corporations.[1] Indeed, every company is affected by, or can contribute to, one or more of these goals – and, by so doing, they will almost always improve their overall business prospects.

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targets are relevant points of dialogue between investors and corporations.

[1] Source: Federated Hermes, as at 2020.

2 What do you aim to achieve in your engagement conversations?

As investors, we have the opportunity to influence what companies do and how they do it.

We will only invest in companies in which we see the potential for engagement to help the company create positive impact towards one or more of the SDGs. In assessing opportunities, we look at a company's entire supply chain, including its relationships with and influence over its supply partners. We consider the company's direct operations, including its resource efficiency and its approach to its workforce. We also examine its products and services – do they have the potential to reach under-served markets or to develop product offerings supportive of a more circular economy?

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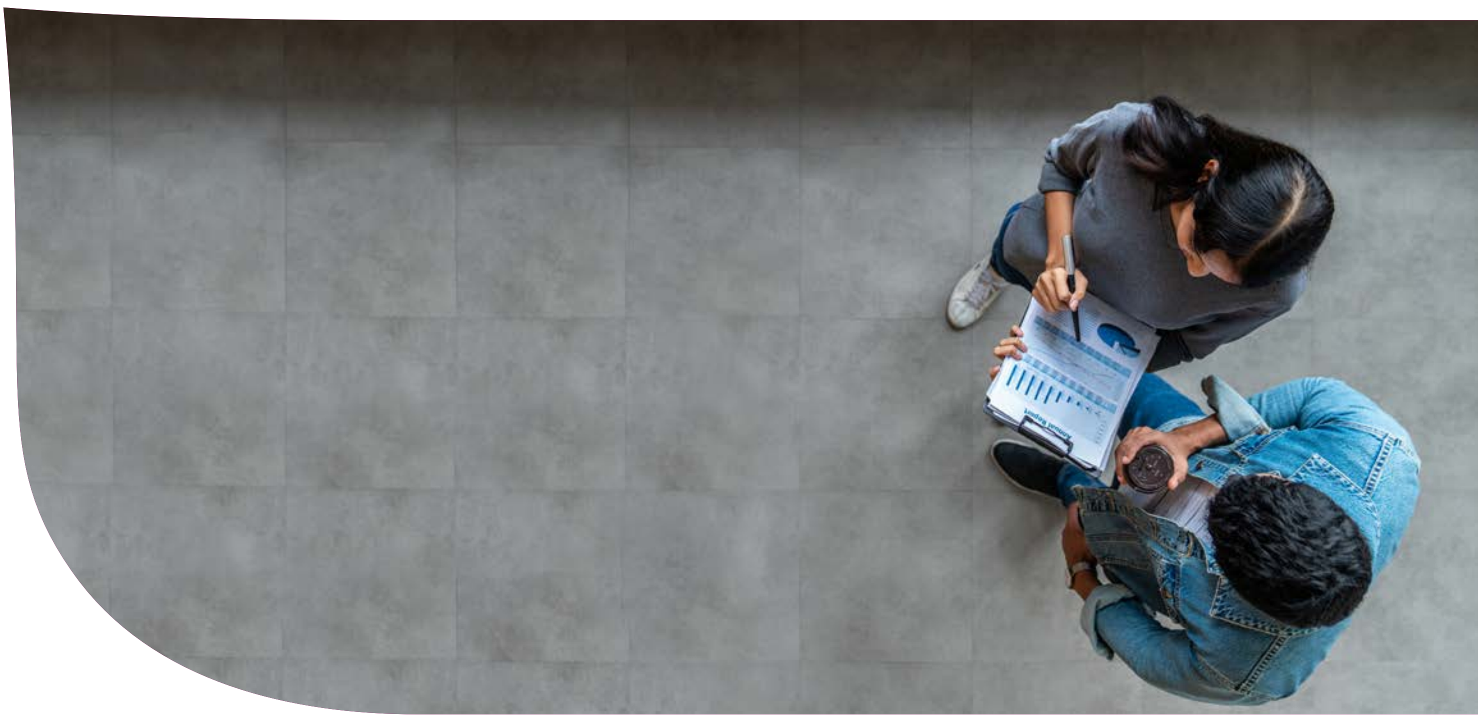
Through our engagement, we hope to encourage new initiatives, create new relationships, accelerate progress and raise ambitions, with a view to improving both the business' long-term success and its contribution to SDG attainment.

While we shall cajole where necessary, we want to give management the confidence to be bold and ambitious by supporting companies in implementing new approaches.

We execute a customised engagement plan for each portfolio company, which consists of general and specific objectives. The topics we engage on with every company include eliminating discrimination among employees and fair pay (which address the gender equality, no poverty and reduced inequalities SDGs). However, for example, in an engagement with a food retailer, we would also challenge it on a range of company-specific practices, such as the nutritional value and prices of the goods it sells, and the sustainability of the producers in its supply chain (which relate to the SDGs of good health and well-being, responsible production and consumption, life below water and life on land).



3 Are companies responsive to your engagements and why?

Our engagement is integrated into the investment process, and is informed by a real understanding of the business and realistic expectations. For this reason, we have found high levels of engagement from the majority of the companies we work with.

When identifying companies for inclusion in the fund, we consider how 'engageable' a company is as well as its scope for making an improved contribution towards the goals.

Successful engagement must include the following three characteristics in order to be both meaningful and impactful:

Purposeful: Engagement must be fully integrated into the investment process, informing the decision to buy the stock and allowing active and ongoing portfolio manager involvement.

Informed and constructive: Effective engagement must develop from a deep understanding of a company's particular business model and geographic footprint, rather than being derived from a one-size-fits-all framework.

Patience: Meaningful and sustainable change requires deep corporate buy-in and resource deployment. This ultimately takes time.

By engaging with companies on specific, relevant SDGs, we gain valuable insight into investment risks and longer-term opportunities that the company is exposed to.

Our understanding of effective shareholder engagement has been developed over many years. In our experience, dialogue with board members and senior executives is more effective than blunt coercion. What matters most is the strength of our argument, not the size of our proxy vote (although, sometimes, that can help).

4 Why does the fund choose to focus on investing in small- and mid-cap companies?

We invest in, and engage with, high-quality small- and mid-cap stocks globally because this is where we think the greatest opportunity for influence lies.

These companies are typically less well known than blue-chip names, and many have not previously been engaged by active shareholders. As a result, we believe that they have the potential to go on a more profound sustainability journey and, therefore, drive greater positive change. Their smaller size also enables us to directly access their management teams and boards, improving our ability to work constructively.

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5 How do you determine if a company is 'engageable'?

In principle, all companies are engageable to some extent; they all have employees, operations and some form of supply chain that could be more efficient.

However, we only seek to invest in those companies that have clear potential to make a positive contribution to the SDGs, and whom we believe are open to engaging on the matter. We start this process of identifying quality businesses with a high return on equity and high returns stability. Not only are these quality characteristics important from an investment standpoint but, in our experience, a strong balance sheet and stable returns means a company is more likely to have the bandwidth to invest in and manage new sustainable initiatives.

To assess how receptive a company will be to engagement, we consider management quality and governance, and speak with management prior to investing. In general, we have found that companies with better governance structures are more open to engagement.

When assessing an opportunity for engagement we look for a diverse range of characteristics, such as:

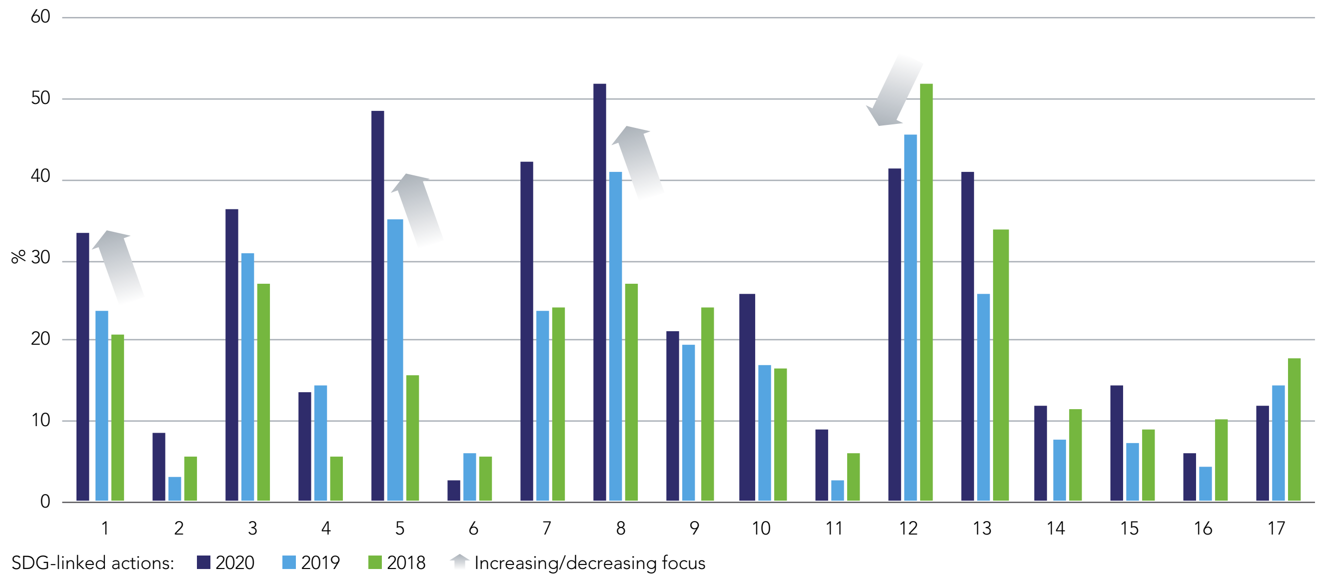
- A company that has not previously established a sustainability programme, or has only just started one.
- A company with scope to make internal improvements, such as those that have a large number of low-skilled employees or energy intensive manufacturing.
- A company with a supply chain that includes natural resources or manufacturing.
- A company that has products and services that can facilitate the SDGs.
- A company that has Emerging Markets operations and/or revenue.
- A company that is acquisitive and takes on subsidiaries that require investment/upgrading.
- The company has a high market share in its industry and can influence the way that industry develops.

6 Are there any specific SDGs that you engage on more than others?

As figure 1 shows, we have engaged on all 17 SDGs. However, we focus our engagement on the SDGs towards which companies can make the most tangible and direct contributions.

The provision of employment is among the most direct ways that companies impact individuals and society.

Figure 1. SDG engagement: relative to share of activity



Source: Federated Hermes, as at 31 December 2020

The provision of employment is among the most direct ways that companies impact individuals and society. Through the provision of decent employment with stability, safe environments, training, and fair pay and benefits companies directly influence our economic, physical and mental wellbeing and in so doing can address issues around gender, economic and health inequalities. At the same time, companies commonly assert that employees are their most valuable asset. A company's approach to working practices and employee benefits are a critical component in recruiting, retaining and motivating its people, and by doing so it maximises the productivity and value of this most important asset. For investors, employee job satisfaction and engagement offers important clues to the health and future performance of a company. More recently, we have increased our focus on SDG 5 – gender equality – among others, which corresponds to our enhanced emphasis on the topic among our holdings in Japanese companies, in particular, during 2020.

7 How do you track your engagement progress?

We use our proprietary milestone system, shown below (developed by EOS at Federated Hermes ('EOS')), to track our progress towards each engagement objective.

All company engagements are logged according to the issue being addressed, the corresponding SDG and the objective we are working towards. While all of our interaction is mapped according to the same broad framework, the concerns and related objectives of each engagement vary according to the company and its circumstances.

Our engagement framework:

While we set SMART engagement objectives and have recordable milestones along the way, measuring engagement is, in our experience, an art rather than a science. For this reason, we have developed meaningful governance processes. As a team – and in conjunction with colleagues from across EOS, and other investment teams – we formally review each engagement case and its progress every six months.

This review informs our engagement priorities with the company and helps us to decide the position weighting in the portfolio. It also ensures that we remain focused on the fund's dual objectives of delivering investment returns, and social and environmental impact.

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8 How do you report on the effectiveness of your engagement activities?

We are committed to reporting on the progress and outcomes of our engagement efforts at both stock level and aggregated portfolio level.

At portfolio level we are focused on measuring how our engagement enhances a company's contribution to the SDGs. At present, we report on how our engagement aligns with the SDGs and the changes that have occurred on a number of proxy measures for sustainability performance over three years. These measures include:

- Carbon intensity;
- ESG scores (MSCI, Sustainalytics and our internal QESG score[2]); and
- Glassdoor overall ratings.

As disclosure from held and benchmark companies continues to increase, we hope to build on our reportable metrics and are currently expanding the scope of our fund-level measurement and reporting.

On an individual company basis, we first outline our theory of change and use narrative to show how our corporate engagement is generating real change within companies. We then explore the impact these changes are having on the ground in communities and the environment.

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[2] The QESG Scores, generated by our Global Equities at the international business of Federated Hermes, rank each stock worldwide in accordance with its ESG risk.

9 What data sources (external and internal) do you use to determine a company's level of SDGs alignment?

The fund aims to improve a company's contribution towards the SDGs through engagement rather than seeking to buy companies that are already aligned with one or more of the goals.

We note that reporting on SDG alignment currently appears to be very subjective and particularly sparse within many global mid-sized companies. Furthermore, most analytics tools focus solely on a company's products and services, and often fail to take account of impacts – negative or positive – generated upstream or within a company's direct operations. Finally, we recognise that impact is often location-specific and therefore difficult to aggregate. As a result, we do not compute alignment of individual companies in the portfolio with the SDGs.

We are instead focused on measuring how our engagement has changed the way a company is contributing to the SDGs. Ahead of investing in a company we will analyse the opportunities for engagement towards the SDGs. As a result, we focus our reporting on tracking engagements and their progress through completion; also, where possible, monitoring and reporting improvements on relevant metrics aligned to those objective (e.g. carbon emissions, waste production).

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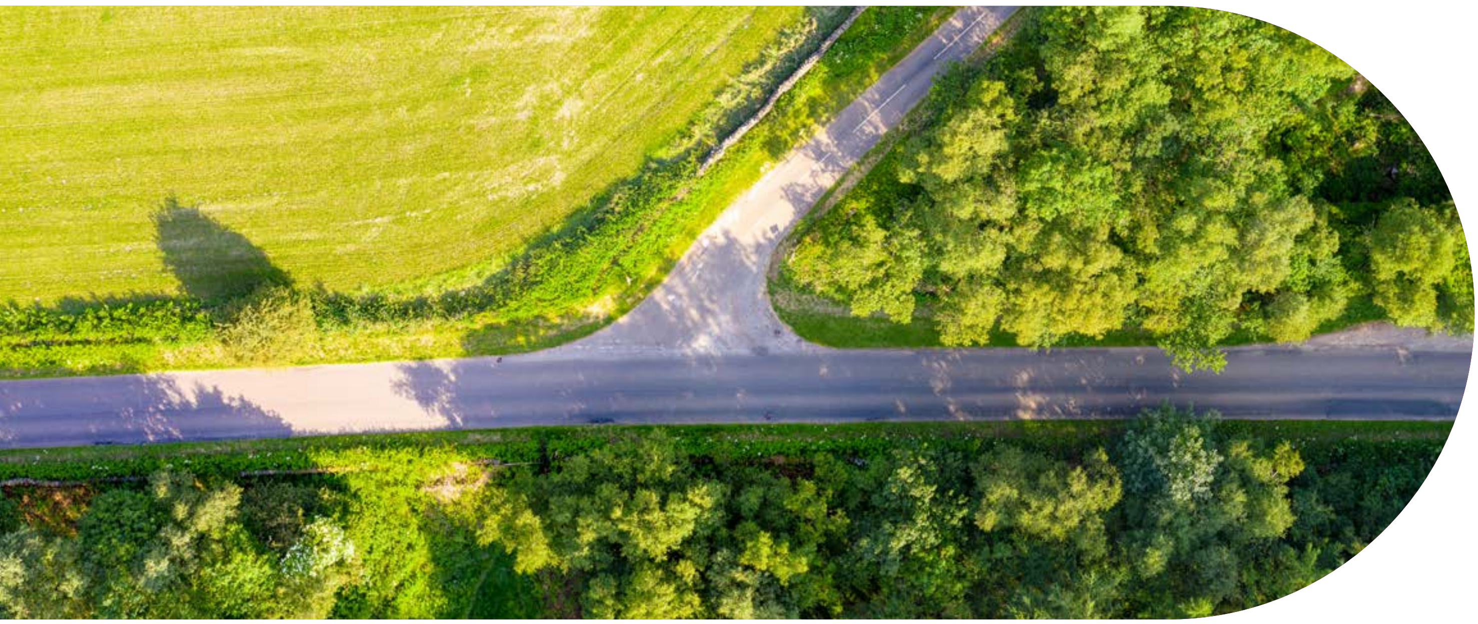

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What is your sell discipline? If a company is attractive from the investment perspective, but your engagement efforts stall, what is your course of action? If the engagement objective is already achieved, but there is still investment upside, do you sell or hold?

All holdings should provide engagement opportunity and investment upside potential. The natural time to sell a stock will be the point at which a stock is fully valued, and the engagement programme has reached maturity, i.e. when the engagement targets set have been met and reflected fully in the share price.

A company may be held if the stock price, at the time of review, does not reflect the underlying value of the business and where selling the position would deprive investors of relatively low risk upside over a short- to medium-term horizon. Equally a fully valued stock may continue to be held if it still has strong investment merits and unfulfilled engagement potential. Sizing in these instances would be adjusted accordingly.

> **Investments are reviewed on a six-monthly basis, with a stricter view taken after 18 months to assess progress towards the engagement target.**

Investments are reviewed on a six-monthly basis, with a stricter view taken after 18 months to assess progress towards the engagement target. If the engagement plan is not being fulfilled, or is unlikely to progress further, a sell process will be initiated.

A stock should, in principle, be sold if:

- There is a material change to the investment thesis.
- There is a fundamental unwillingness of a company to engage with shareholders on constructive change or another specific engagement agenda.
- The share price rises significantly above what is believed to be its intrinsic value.
- A better investment opportunity arises.

Progress of Engagement case ↑ / Progress of Investment case →		
Higher engagement progress	• Continue to hold to realise upside potential • Weighting likely to be scaled back • Use as potential source of funds for better opportunity	• Continue to hold if momentum on stock still positive • Use as source of funds for new holding • Sell if stock trading at materially above intrinsic value (20%+)
Lower engagement progress	• Normal risk/reward-based weighting (adjusted for engagement tiering) • Weighting refined using Composition Review	• Continue to hold as predisposed to run winners • Strong engagement case (still) a reason to maintain holding • Weighting likely scaled back

Engagement and investment pillars both needed:

- If investment or engagement case deteriorates, holding will be sold and better opportunities identified

Selling triggers:

- Company meetings and visits (holdings, competitors, other points in value chain)
- Industry and event-driven research
- Portfolio monitoring and Composition Review
- Portfolio engagement review and advisory committee meetings

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. Past performance is not a reliable indicator of future results and targets are not guaranteed.

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: