Federated Hermes SDG Engagement High Yield Credit

H1 2021 Report

August 2021

Federated Hermes

International

www.hermes-investment.com

For professional investors only

SDG Engagement High Yield Credit: H1 2021 highlights

263 **engagement actions** carried out at **105** **companies**

Driven by our **2** **dedicated fixed income engagers** and

17 **stewardship professionals in EOS at Federated Hermes (EOS)**

Our holistic approach is based on **our pioneering engagement model** and **planning process** developed by EOS over decades

Our engagement in H1 2021 was comprised of:

- 40% Governance
- 24% Strategy, risk and communication
- 22% Environmental
- 14% Social and ethical

49 objectives for companies in the strategy added in H1 – a 25% increase

199 total active objectives in the strategy

32% of our objectives progressed in H1 2021 (we expect at least 40% to achieve progress annually)

Most intensively engaged Sustainable Development Goals (SDGs):

- 13 Climate Action: **153 engagements**
- 12 Responsible Consumption and Production: **128 engagements**
- 10 Reduced Inequalities: **84 engagements**
- 5 Gender Equality: **70 engagements**
- 7 Affordable and Clean Energy: **69 engagements**

> **Our accelerated levels of interaction are an outcome of relationships being built with high-yield companies new to holistic engagement.**

Our dialogues with companies featured a holistic mix of ESG themes. Intensive engagements included:

- **Climate change** — **105** engagements
- **Business strategy** — **50** engagements
- **Integrated reporting and other disclosure** — **38** engagements
- **Executive remuneration** — **112** engagements (p. 14)
- **Risk management** — **41** engagements (p. 13)
- **Board diversity, skills and experience** — **64** engagements (not reported in body)

15% of engagements included CEOs, board chairs and directors

> **Our engagements relating to other SDG areas have shifted substantially, with a greater spread of SDG coverage across the strategy.**

Source: Federated Hermes, as at 30 June 2021.

Contents

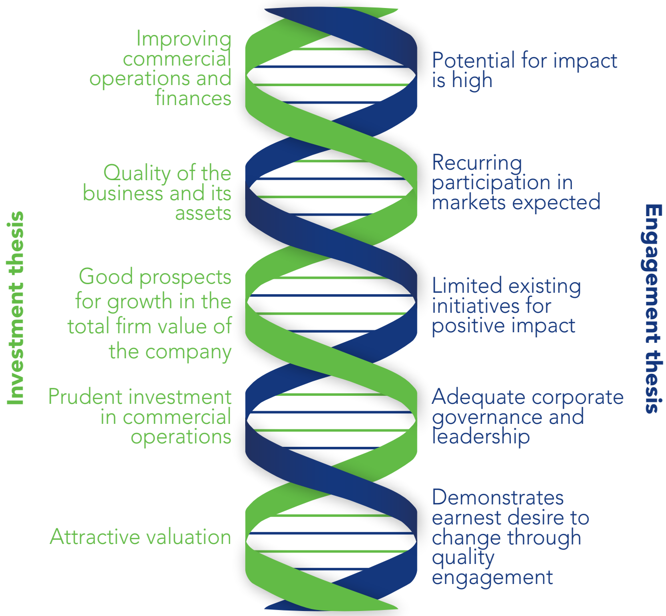
SECTION 1

Introduction

From the launch of our SDG Engagement High Yield Credit (SDGHY) strategy in October 2019, we aimed to deliver on two colinear objectives: strong financial performance for investors, and positive social and environmental impacts that contribute to achieving the 17 United Nations Sustainable Development Goals (SDGs). To this end, we seek companies which have both attractive investment fundamentals, and a willingness and ability to effect positive change for society and the environment. We think the two objectives are self-reinforcing; engagement is a catalyst in converting potential to realised change.

From its inception, we planned for SDGHY to be a long-term strategy capable of weathering credit cycles. Looking back on credit market conditions of 2020 and early 2021, we remain heartened by what we have experienced since our Q4 2019 launch. Overall, we have been delighted both with our financial results and with the substantive, high-touch engagement outcomes of our inaugural engagement year.

Figure 1. Investing with co-linear objectives



Source: Federated Hermes, as at 30 June 2021.

The success and impact of the strategy has been bolstered by the greater intensity and breadth of our engagement activity in the first six months of 2021; at midyear we had already engaged 105 of the 126 issuers held in our portfolio on a myriad of SDG and environmental, social and governance (ESG) topics.

Figure 2. SDG-aligned engagement: our six assessment factors[1]

Source: Federated Hermes, as at 30 June 2021.

Investment performance and engagement activity completed in H1 2021 – explored in depth in this half-year report – has further validated our approach. As you will see, we remain focused on our SDG impact hypotheses and the resultant engagement strategies and objectives we develop for every company we hold. Our red thread through all of this is a simple, key question: what can each investment meaningfully contribute to the SDGs while delivering strong financial returns?

Our impact objectives extend from our philosophy that an investor's position as a financial stakeholder allows, if not obliges, them to engage in constructive dialogue with companies. Exerting a positive influence on corporate behaviour means investors, companies, society and the environment can all benefit.Turning substantive engagement into meaningful change takes time, however, so we require portfolio companies to be survivors in a levered universe. Within the global hard-currency, high-yield market, we therefore favour companies with a recurring presence in capital markets, a stable shareholder base, a strong ethos of transparency in disclosures and reporting, and the credit strength needed to be able to participate in long-term dialogue and evolve their businesses for the benefit of a range of stakeholders (see Figure 2).

> **Turning substantive engagement into meaningful change takes time, however, so we require portfolio companies to be survivors in a levered universe.**

With 18 months of engagement experience under our belt, we have learned a great deal about the process of investing with SDG impact alignment and engagement in mind (our six factors of assessment are summarised in Figure 1 and covered fully in our 2020 Annual Report). This update illustrates the substantive progress we continue to make on our journey to impact.

Why proxy and voting-based engagement matters for creditors

Throughout this paper readers will see reference to equity-style engagement actions and activity, such as proxy season. In sustainability, the interests of shareholders and creditors are aligned. As such, where relevant we engage and act on behalf of all financial stakeholders. We see this as a more effective path to create positive change, because we are wielding as much influence as possible.

[1] Appendix A contains a detailed summary of our six-factor framework for assessing SDG scores.

SECTION 2

Investment Review

Mitch Reznick, CFA
Head of Credit Research and Sustainable Fixed Income

Nachu Chockalingam, CFA
Senior Portfolio Manager

Fraser Lundie, CFA
Head of Credit

Our focus on higher-quality credit in markets with strong engagement potential meant we didn't benefit from the outsized rally in Covid-ravaged sectors in H1 2021, but the strategy continues to outperform its benchmark since inception.

In the first half of 2021 the strategy returned 2.24%, gross of fees[2]. It underperformed its benchmark by 0.93% over the period but has outperformed that same benchmark by 0.96% since inception[3]. Short-term underperformance in H1 2021 can be explained by the strategy's higher quality rating bias in the context of a market that saw lower-quality high-yield credit outperforming in the first six months of the year. The principal forces behind the rally in lower quality credit should be familiar to all at this point in the post-Covid credit cycle: central bank liquidity; fiscal stimulus; rising vaccination levels and macroeconomic optimism predicated on economies starting to reopen. These factors also led to an outsized rally in sectors like Energy, Leisure and Transportation that had been particularly punished in 2020. The strategy is underweight in these sectors because engagement potential is more limited than in others, where the potential to realise positive change is much greater.

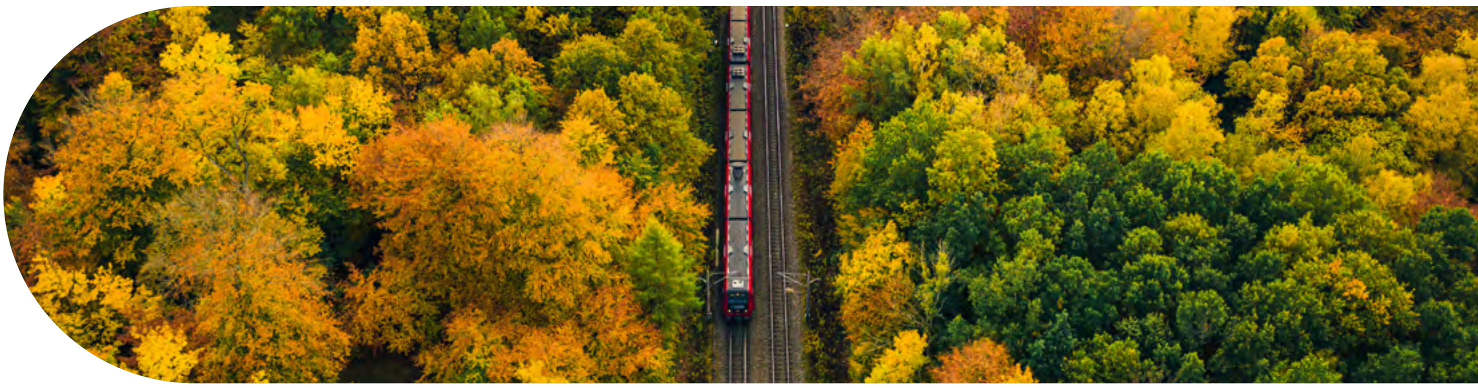
Figure 3. Rolling year performance (%)

	30/06/2020 to 30/06/2021	30/06/2019 to 30/06/2020	30/06/2018 to 30/06/2019	30/06/2017 to 30/06/2018	30/06/2016 to 30/06/2017
SDG Engagement HY Credit Strategy	13.8	–	–	–	–

Past performance is not a reliable indicator of future results. Source: Federated Hermes as at 30 June 2021. Performance shown is the Federated Hermes Int'l SDG Engagement High Yield Credit Hedged to USD Strategy. In USD, gross of fees. Inception date: 30 September 2019. Benchmark: ICE BofAML Global High Yield Constrained Index hedged to USD. Data is supplemental to the GIPS® report that can be found in the Appendix. Past performance is not a reliable indicator of future returns.

Important information:
Past performance is not a reliable indicator of future results. Targets cannot be 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. The holdings discussed in this report do not represent all of the securities held in the portfolio and it should not be assumed that those securities were or will be profitable. This information does not constitute a solicitation or offer to any person to buy or sell any related securities or financial instruments.

On a sectoral basis, overweight positioning in Basic Industry also detracted from performance, however, the strategy's overweight positioning in Banking, Insurance and Automotive made a significant positive contribution to relative performance. From a ratings perspective, the strategy's positioning in BBB-rated issues positively impacted its relative return the most, while being underweight in B, CCC and lower-rated issues had the biggest negative impact on returns. At the regional level, the strategy's overweight positioning in Western Europe and the UK was the major contributor to its relative performance, whilst being overweight in North America and underweight in Latin America and the Middle East detracted the most.



[2] Source: Federated Hermes as at 30 June 2021. Performance shown is the Federated Hermes Int'l SDG Engagement High Yield Credit Hedged to USD Strategy. In USD, gross of fees. **Past performance is not a reliable indicator of future results**.

[3] **Past performance is not a reliable indicator of future results.** Source: Federated Hermes as at 30 June 2021. Performance shown is the Federated Hermes Int'l SDG Engagement High Yield Credit Hedged to USD Strategy. It is annualised, in USD and gross of fees. Inception date: 30 September 2019. Benchmark: ICE BofAML Global High Yield Constrained Index hedged to USD.

Default rates have fallen rapidly through 2021 as macro and corporate fundamentals have strengthened. As a result, we have seen investors become more comfortable reaching into low-rated credit in search of better yields and relative shelter from rates volatility. This has driven a sharp rally in CCC and lower-rated credit; in H1 2021, total return for the CCC and lower-rated segment of the global high yield market is 9.6%, against 3.1% for the high yield asset class as a whole.[4] Investors will be acutely aware that if volatility increases when a large part of the market is trading above call it increases the risk of extension, i.e. many bonds are now trading to their next call date rather than to maturity. This means that security selection becomes ever more important, and investors should be mindful of misleadingly low volatility when sizing positions.

This has driven a sharp rally in CCC and lower-rated credit; H1 total return for the CCC and lower-rated segment of the global high yield market is

9.6% against **3.1%**

for the high yield asset class as a whole.

As H1 2021 progressed and we saw lower-quality high yield outperforming against BB-rated credit, we took the opportunity to selectively add to issuers in the BB space with good fundamentals and engagement potential.

SDG scoring: a process of constant re-evaluation

We constantly review SDG scores for invested companies; this can result in companies being downgraded if evidence materially affects our engagement and investment case hypotheses. During H1 2021 we exited a small number of investments because it became clear that they were less willing to engage with us or were unlikely, or inadequately equipped, to drive change in their businesses.

- We downgraded Mexico's national oil company **Pemex** to an SDG score of 5 and subsequently exited the position due to multiple ESG problems: these included a lack of climate-related planning or strategy, poor health and safety performance, fuel theft risks, and top-down political influence on the business's ability to change in the short and medium term.
- We sold out of **Silgan**, a US-based packaging company, because we were underwhelmed by its progress compared to its peers on the key issues of packaging sustainability, the circular economy and full-scope emissions reduction planning; moreover, it has not provided sufficient quality non-financial and ESG disclosures to investors and wider stakeholders.
- **Calpine** is a large, US-based utility company focused primarily on natural-gas fired power generation, as well as a small geothermal energy asset base. The company has not produced any material ESG reporting or carbon data on its fleet, nor has it disclosed how it intends to decarbonise electricity generation over the medium-to-long term, for example by publishing a long-term resilience and transition plan for its gas-fired assets. We engaged on these issues and did not believe any changes were forthcoming in the near term, so we sold our holdings as a result.

[4] Source: Bloomberg, 30 June 2021.

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SECTION 3

Engagement Review

Aaron Hay
Director, Engagement & Strategy, Sustainable Fixed Income

Jake Goodman
Engagement Manager, Fixed Income

Bertie Nicholson
Engagement & ESG Associate, Fixed Income

Accelerated engagement, deepening relationships & increased influence

In the year to 30 June 2021, we engaged 105 of the 126 companies in the strategy. We thereby achieved 83% of our annual goal of engagement at all companies. This was significantly ahead of H1 2020, during which we engaged 78% of 105 issuers. Given that our portfolio contains 21 more issuers than a year ago, this represents 28% growth in the number of companies engaged.

We engaged

105 of the **126**

companies in the strategy.

We thereby achieved

83% of our annual goal of engagement at all companies.

Our team drove 263 actions in H1 2021, considerably exceeding the 205 carried out in H1 2020. Notably, our engagement firepower for this strategy has doubled with the addition of our second dedicated engager, Jake Goodman, to join Aaron Hay. Together, Aaron and Jake delivered 134 engagements in H1 2021.

At the same time, our network of lead engagers from our stewardship practice EOS at Federated Hermes ('EOS'), which represents assets-under-advice of $1.5trn[5], remains crucial to the effective engagement of a complex portfolio (see Figure 4). Collectively, 17 of our colleagues carried out 129 engagements at 52 companies – almost 50% of the total – demonstrating the collective power of our stewardship platform. Of particular note is the benefit provided by lead engagers in our Pittsburgh headquarters, whose local market and sector knowledge broadens EOS's ability to engage high-yielding North American issuers.

> **From experience, we know our model of stewardship as pioneered by EOS tends to deepen conversations beyond year one, so we can expect these relationships to continue to develop in the coming years.**

Our accelerated levels of interaction are an outcome of relationships being built with high-yield companies new to holistic engagement. Meanwhile, as illustrated by the analysis of engagement by role in Figure 5, the nature of engagements has shifted towards an additional frank dialogue with senior counterparts, who have begun to seek advice proactively.

From experience, we know our model of stewardship as pioneered by EOS tends to deepen conversations beyond year one, so we can expect these relationships to continue to develop in the coming years. Long-term, open dialogue remains critical to influences that can shift companies to greater impact across SDGs – whether in operations, the business model, or products and services provided to society.

[5] Source: Federated Hermes as at 30 June 2021.

Collectively,

17 of our colleagues carried out

129 engagements at 52 companies.

Figure 4. EOS lead engagers continue to be crucial to success, delivering 129 engagements at 52 companies in the first half of 2021

Roland Bosch,
Engagement Professional

EOS financial services co-lead: drove 33 actions across 12 companies

Andy Jones,
Engagement Professional

EOS mining, materials and oil and gas co-lead: drove 17 actions at four companies

Jaime Gornsztejn,
Engagement Professional

EOS emerging-markets specialist: engaged four Latin American companies through 12 actions

These new members of our strengthened US team collectively drove 21 engagements at 10 companies

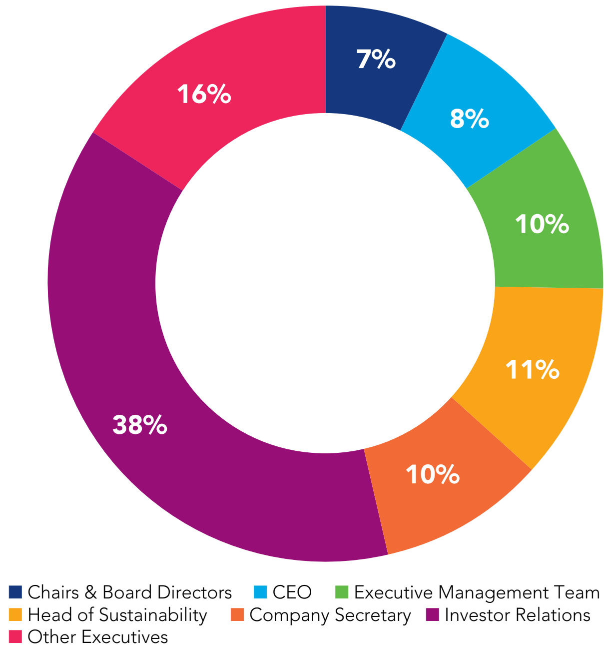
Michael Yamoah,
Director – Engagement

Emily DeMasi,
Director – Engagement

Joanne Beatty,
Director – Engagement

Source: Federated Hermes, as at 30 June 2021.

Figure 5. Our deepening dialogue has shifted the majority of our conversations beyond investor relations; 15% of dialogue was with CEOs, Board Chairs & Directors in H1 2021, and a majority now include senior business leaders



Source: Federated Hermes, as at 30 June 2021.

We are often asked how we attribute outcomes to ongoing dialogue. Our experience of delivering this strategy over the 18 months since its inception indicates that our investor voice is akin to 'a soloist in a chorus' in articulating the case for change. Our dialogues with firms stand out given that, based on anecdotal discussions with companies we have invested in, the 'chorus' of investors focusing on objectives-driven engagement in the high yield space remains limited.

> **Our investor voice is akin to 'a soloist in a chorus' in articulating the case for change.**

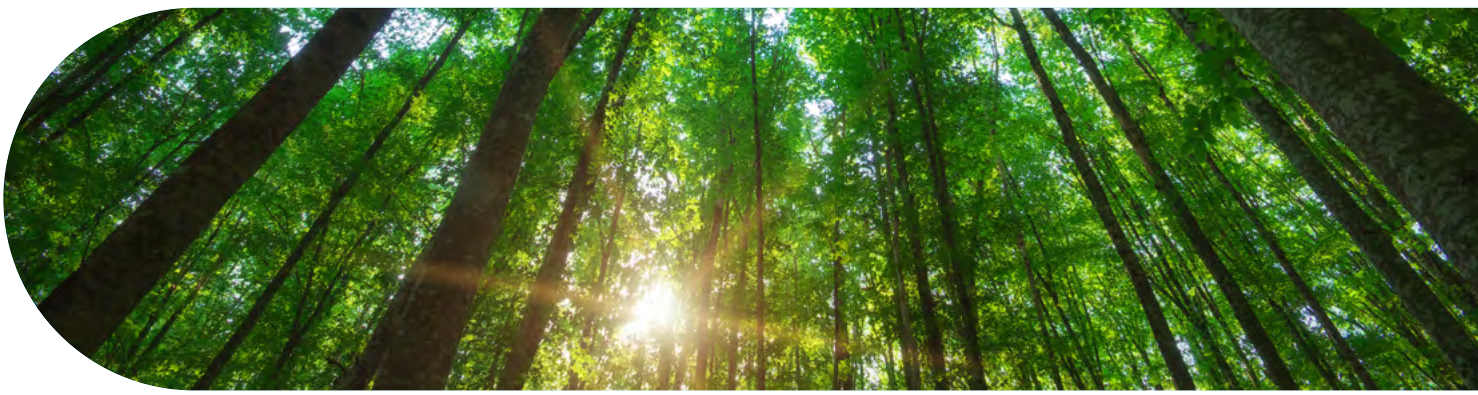
Key Themes: what did we engage on in the first six months of 2021?

The foundation of our SDG High Yield strategy remains the EOS model of holistic engagement across ESG and SDG-based issues, and we continue to find strength in the EOS 2021-23 plan and themes, as illustrated in Figure 6. Even as SDGs form engagement focal points, holistic stewardship implies dialogue on a broad range of highly material risks and opportunities facing each issuer, and is foundational to our approach.

Even as SDGs form engagement focal points, holistic stewardship implies dialogue on a broad range of highly material risks and opportunities facing each issuer, and is foundational to our approach.

Figure 6. Engagement themes for 2021-23

Source: Federated Hermes, as at January 2021.



An increased focus on governance

We've driven significantly greater dialogue in governance in 2021 so far, which made up 40% of engagement against 31% in H1 2020. There are two reasons for this. Firstly, the addition of 21 new issuers to the portfolio since July 2020 necessitated proxy-based engagement on behalf of all investors (much of which has been driven by our second dedicated engager, Jake Goodman). Secondly, our growing Pittsburgh-based engager team has made it possible to deliver substantive proxy-related engagement with a broader range of North American issuers – this is important in a market which has inconsistencies in remuneration and governance when assessed against our own market-by-market principles.

The remainder of engagement topics in H1 2021 are an expected balance between environmental, social and ethical issues on the one hand, and strategy, risk and communication issues on the other, which we'll deal with in detail in the pages ahead.

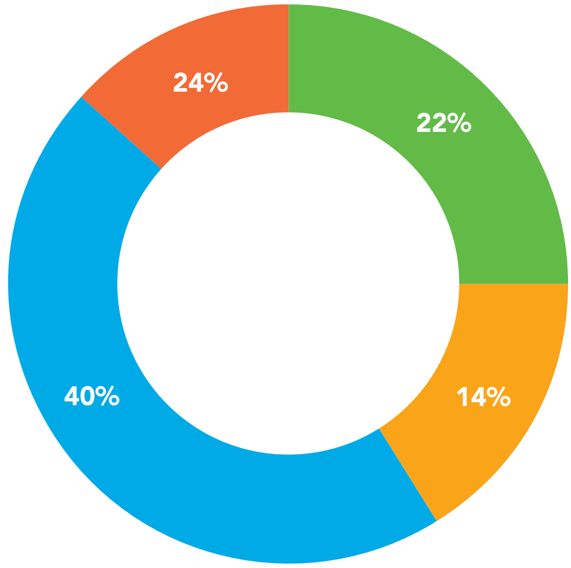
As with H2 2020, we expect non-governance topics to again feature heavily in our engagements through H2 2021, balancing out the governance focus which is customary during the traditional proxy season of company AGMs.

We've driven significantly greater dialogue in governance in 2021 so far, which made up

40% of engagement against

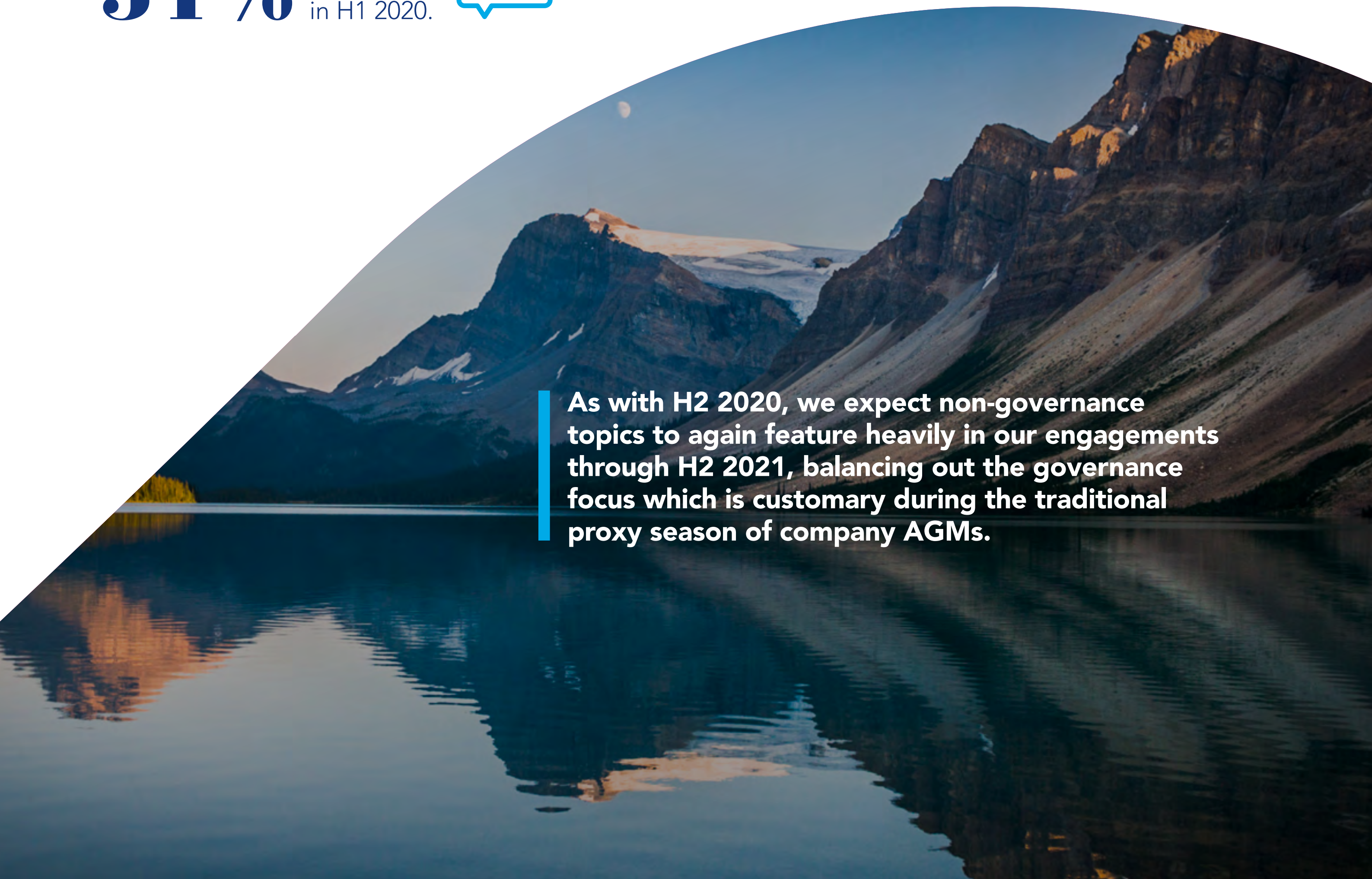
31% in H1 2020.

Figure 7. Governance made up 40% of our engagement in H1 2021



Environmental Social & Ethical Governance
Strategy, Risk & Communication

Source: Federated Hermes, as at 30 June 2021.



Key Themes: Environmental & Social Engagement Highlights, H1 2021

Environmental engagement: broadening beyond systemic climate challenges

Environmental themes featured in 129 of our engagements in H1 2021. Climate change continued to dominate, forming part of our discussions in 105 engagements (almost matching the 107 climate dialogues held by midyear 2020). This made up 82% of our environment-related actions, down from 88% in 2020, with engagement broadening to cover other environmental challenges.

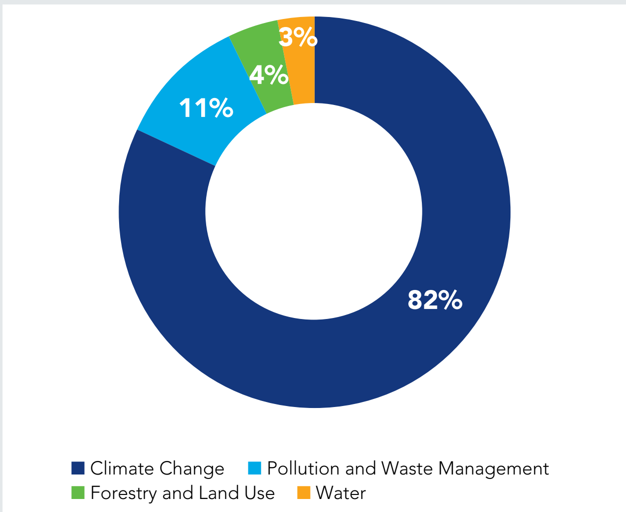
Our engagement with **Akbank** characterises the almost continual dialogue we carry out on climate matters with most investments. We were pleased to engage on enhancements to the company's sustainable finance framework and environmental and social risk policies, as well as the climate risk framework it intends to use for lending and asset portfolio decisions. Many of these developments draw indirectly from feedback in our engagements with the bank in 2020, based on objectives we set.

Meanwhile, follow-up engagement over the last 12 months has allowed us to focus on other environmental matters, including 14 pollution and waste management discussions, and five on sustainable forestry and land use.

In our 2021 engagement with **Seagate** we learned more about its specific plans for improving waste management, including pilots for circular reuse of electrical components. The company views such an approach as a commercial imperative given the scarcity of rare earth metals, the environmental impacts of virgin materials sourcing and production, and alarming risks from e-waste.

At **Suzano**, we expanded engagement to cover forestry and land use. In a recent meeting we explored the company's technical approach to new targets, including its consultation with 55 experts to develop an approach intended as a 'reference point' for ambition in pulp and paper. Suzano's approach centres on the social impacts of biodiversity and regenerative land management, community delivery of strategies, and the potential positive implications for Brazilian ecosystems and forest carbon sequestration.

Figure 8. Environmental engagement, H1 2021



Source: Federated Hermes, as at 30 June 2021.

Key Themes: Environmental & Social Engagement Highlights, H1 2021 (continued)

Social engagement: significant forays on diversity & inclusion

Social themes featured in 86 engagements in the first half of 2021. These included 34 engagements on human capital management and 24 on improved gender and racial diversity outcomes in management and workforces. Both topics link to SDGs 5 (Gender Equality), 8 (Decent Work and Economic Growth) and 10 (Reduced Inequality), offering companies an outsized and direct opportunity to positively contribute to these goals.

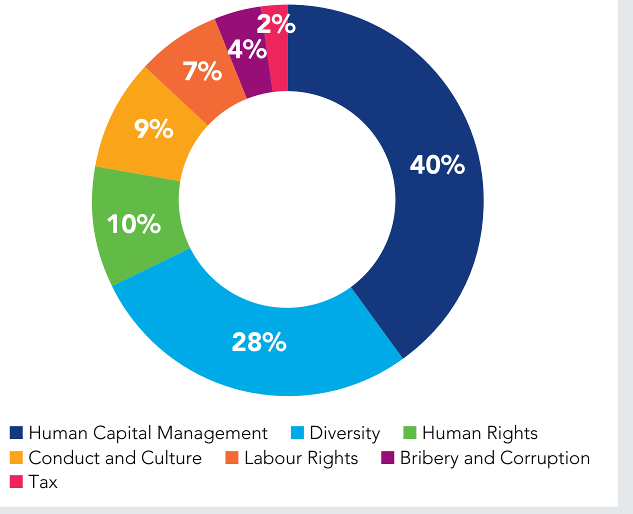
Diversity and inclusion-based engagement increased markedly from 13% to 28% of our engagement on social issues. This reflects the deeper discussions on social challenges we can more readily drive in ongoing engagement.

For example, in a meeting with **Levi Strauss & Co** we discussed the CEO's 2020 open letter, which addressed some uncomfortable truths regarding racial diversity in its workforce. The company has since hired a chief diversity officer to design a long-term diversity strategy, which is set to include gender and ethnic diversity incentives in executive pay. Meanwhile, at **Orsted** we encouraged greater ambition in the company's talent targets for gender diversity at senior levels.

As economies begin to recover from the worst impacts of the pandemic, human capital management dialogue has begun to shift away from safeguarding workforces. In many instances conversations are focusing instead on how to prepare workforces with the skills and knowledge needed to capitalise on business opportunities with impact at the core.

At **Tenet Healthcare**, for example, we met the senior leadership team to review its human capital approach in line with our objectives and to better understand the impact of the pandemic on the business. These discussions helped us gain a better understanding of the financial and medical protections the firm provided for its furloughed employees, as well as how it supported flexible working to help working parents. Similarly, in two meetings with **General Motors**, we sought clarity from the company's chief diversity officer regarding its stated ambition to become 'the most diverse company in the world', in line with an objective to set workforce diversity targets. We also discussed its announced support for unionisation in its joint-venture electric vehicle (EV) battery plants.

Figure 9. Social engagement, H1 2021



Source: Federated Hermes, as at 30 June 2021.

Diversity and inclusion-based engagement increased markedly from 13% to 28% of our engagement on social issues. This reflects the deeper discussions on social challenges we can more readily drive in ongoing engagement.

Key Themes: Strategy, Risk & Communication Engagement Highlights, H1 2021

Strategy, risk & communication engagement: a focus on commercial planning, risk management and continued disclosure evolutions

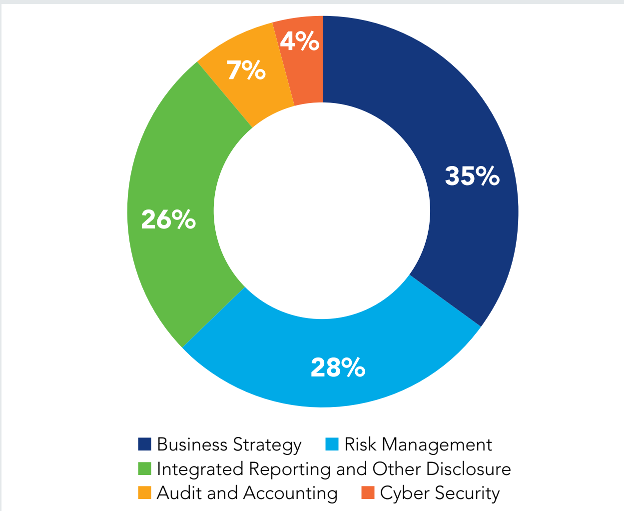
We are pleased to see our engagements with companies on strategy, risk and communication increase to 144 in H1 2021 (compared to 87 conversations carried out in the same period last year). As we develop a deeper understanding of business models, growth potential and financial drivers, strategy and risk discussions in particular come to the fore; 50 engagements over the last six months have involved core strategy, while 41 addressed enterprise risks.

For example, we engaged with **Bank of Ireland** on its notably evolved sustainable business strategy. We were pleased to note this featured considerably increased lending commitments in line with the Irish government's ambitious net-zero policy – something we had suggested in previous discussions with the company on sustainable financial solutions for consumer and business borrowers. At **Intesa Sanpaolo**, we voiced feedback on the bank's climate and environmental risk practices. Whilst it has embraced an array of sustainable finance initiatives, we think the former need to be clearly defined and set out publicly as soon as feasible, given a rapidly changing context for banks.

A continuing focus on improving corporate reporting, transparency and disclosures saw it feature in 38 engagements – doubling the 19 interventions in H1 2020. Gaps clearly remain in sustainability and impact reporting in high yield issuers, so this data is vital to quantify positive changes underway, as well as to help identify potential harms which could raise concerns in our investing hypotheses at each issuer.

At **DCP Midstream**, for example, a recent engagement featured discussion on improving disclosure on Scope 1 and 2 emissions reduction actions, methane emissions assurance and human capital performance.

Figure 10. Strategy, risk & communication engagement, H1 2021



Source: Federated Hermes, as at 30 June 2021.

Key Themes: Governance Engagement Highlights, H1 2021

Governance engagement: proxy season provides a strategic moment for holistic engagement

With AGMs abounding, we again intensively sought engagement on matters of governance, addressing this as part of 241 engagements. This reflects the prevalence of the topic in proxy season and a universal need to raise governance opportunities and concerns alongside other engagement topics we raised this year.[6] Indeed, the season remains a strategic moment for holistic engagement on governance and wider ESG risks and the changes we want to see in this regard.

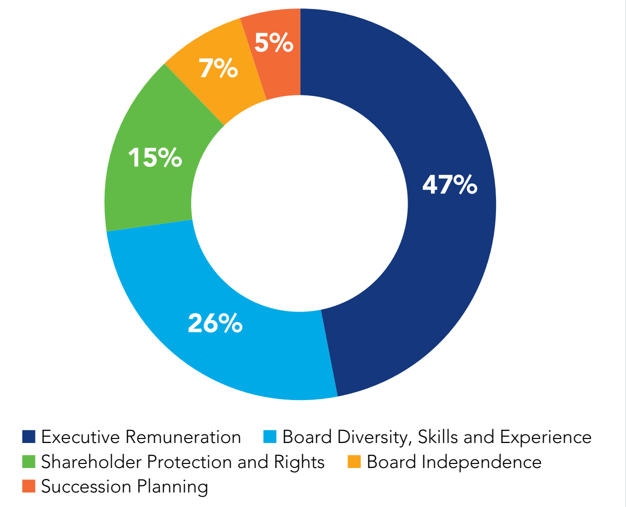
Our engagement on voting matters starts with analysis of each item being brought to a vote. We then drive advocacy through actionable correspondence with executives and boards, complementing this with dialogue on where we think change is needed.

Our focus on remuneration intensified in 2021, being addressed on 112 occasions. Observed disconnects between executive pay, corporate performance and pandemic-related financial issues for workforces led us to recommend voting against a range of pay packages that were inappropriate or undeserved relative to business outcomes. Similarly, we increased our scrutiny of remuneration incompatible with long-term SDG or ESG needs (we use the example of the energy sector to explore this issue further in Section 4 of this report).

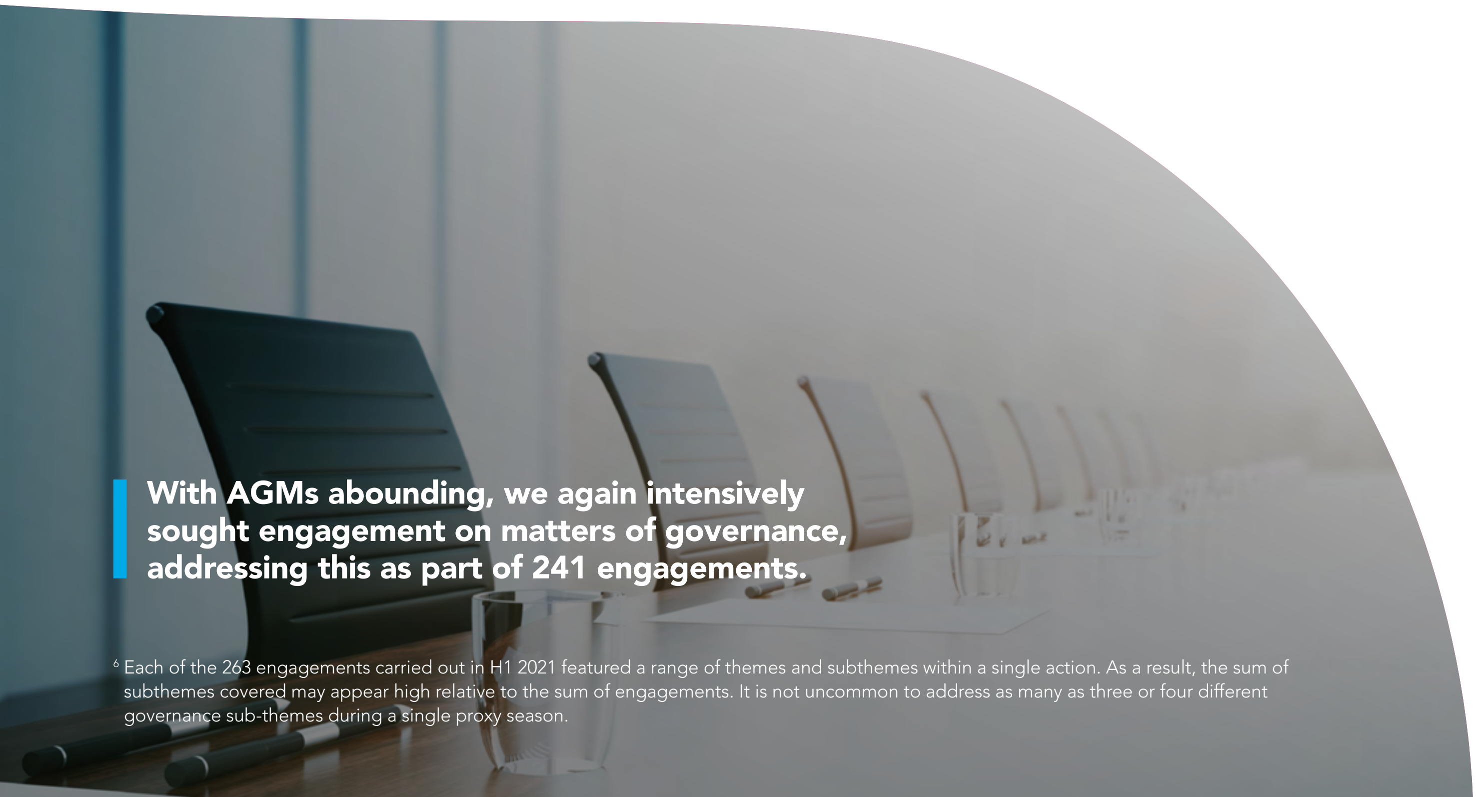
As an example, our exchange with the chair of the remuneration committee at **Natwest Group** led us to understand how the bank took into account the adverse impact of the pandemic on its customers, other stakeholders and society in showing significant restraint on pay. In addition, the bank has introduced a framework to mitigate the risk of windfall gains arising on long-term incentive awards.

Conversely, during engagement with automotive supplier **Faurecia**, we expressed our concerns that its variable compensation is complicated and that one-time awards may not succeed in retaining executives; pay reforms remain an ongoing topic of engagement with the company.

Figure 11. Governance engagement, H1 2021



Source: Federated Hermes, as at 30 June 2021.



With AGMs abounding, we again intensively sought engagement on matters of governance, addressing this as part of 241 engagements.

[6] Each of the 263 engagements carried out in H1 2021 featured a range of themes and subthemes within a single action. As a result, the sum of subthemes covered may appear high relative to the sum of engagements. It is not uncommon to address as many as three or four different governance sub-themes during a single proxy season.

Our Objectives: Demonstrating our progress towards meaningful change at companies across the strategy

Eighteen months into our engagement strategy, we are seeing a diverse range of objectives being set and progressed. The addition of 49 new objectives for companies in the strategy in H1 2021 represented a 25% increase, bringing us to a total of 199 active objectives. This is an outcome of both increased portfolio size and deeper insight in each engagement, which allows us to identify where and how we can further influence positive outcomes. The objectives we set are important markers in how we account for driving outcomes, given that they focus on material, meaningful change we think is possible with time and effort. Our enhanced objective setting in H1 2021 also demonstrates our ability to drive greater, substantive dialogue with feedback and advice provided proactively.

Our overall mix of objectives across ESG and strategy & risk topics shows the balance we take in holistic engagement. Each objective is regularly reviewed and is tracked using a system of four milestones which measure progress and achievement until the objective is completed (see Figure 12). Notably, a majority of objectives set and driven in 2020 are now at Milestone Two (concerns acknowledged) or Milestone Three (plan established) within each engagement theme. Taken together, this means lead engagers are starting to realise progress on objectives in a large proportion of the portfolio, and this is further explored on the next page.

Figure 12. Progress on Objectives, by Theme – H1 2021

Objective – Environment	**82**
Concerns raised	13
Concerns acknowledged	26
Plan established	26
Plan being implemented	17
Objective – Strategy, Risk, Communication	**52**
Concerns raised	7
Concerns acknowledged	21
Plan established	15
Plan being implemented	9
Objective – Governance	**34**
Concerns raised	1
Concerns acknowledged	19
Plan established	11
Plan being implemented	3
Objective – Social and Ethical	**25**
Concerns raised	2
Concerns acknowledged	12
Plan established	6
Plan being implemented	5

Source: Federated Hermes, as at 30 June 2021.

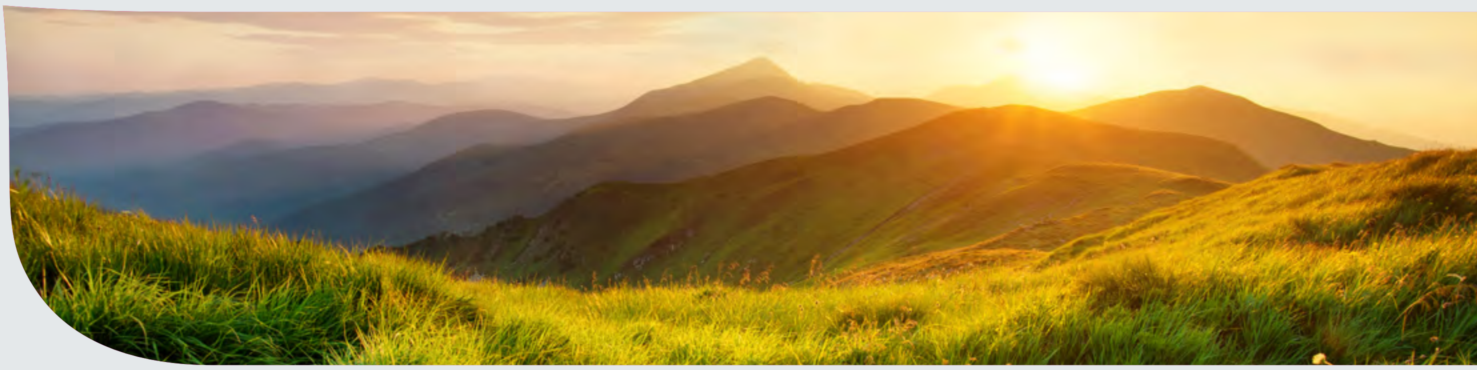
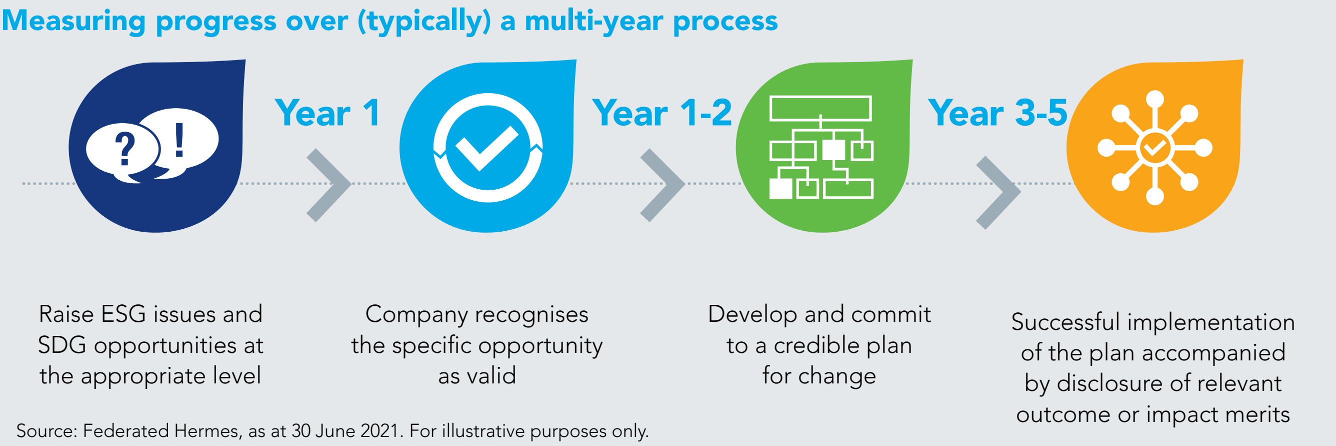


Figure 13. Measuring progress



Source: Federated Hermes, as at 30 June 2021. For illustrative purposes only.

Next steps in long-term engagement: Highlights from objectives added in H1 2021

Environment	Social	Strategy	Governance
As a privately-held packaging business, **Canpack** has an opportunity to quantify and highlight its emissions reduction progress for fixed income investors and wider stakeholders. We therefore set an objective for it to disclose full-scope emissions and targets.	In early 2021 we established an objective for **NRG Energy** to adopt and disclose a human rights policy, with an emphasis on addressing the possibility of human rights risks in its supply chain.	**KB Home** serves millennial homebuyers who have sustainability in mind. As such, we set an objective for the business to define a sustainable, circular materials strategy, including clear targets and transparency regarding the sustainable sourcing of materials.	**Turk Telecommunications**' remuneration reporting practices are not at the level we expect in markets outside Turkey. As a prominent issuer in the country, we think it has an opportunity to lead the Turkish market in this respect. We have set an objective seeking disclosure in line with the expectations of international investors.
Range Resources has already reduced its direct emissions by 80% since 2011. Its climate strategy focuses on a further intensity reduction of 75%, so we set a new objective for it to report annual progress on this target and explain the additionality of its offsets in reaching its ambition of net-zero operational emissions.	**DCP Midstream** now reports on its gender diversity, which is improving. However, it is yet to introduce reporting on measures to increase racial and ethnic diversity. Given generational changes in its workforce, it has a key opportunity to recruit diverse candidates at all levels. This should drive greater diversity of its workforce and management, so we set an objective in this respect.	In continued, extensive engagement at **BP**, an objective was established to ensure that it puts in place principles, policies and disclosures which demonstrate its carbon offsetting strategy is robust. This is highly material because offsetting plays a key role in BP's decarbonisation plans.	At **SIG Combibloc**, we praised the company's current remuneration disclosure practices for transparency. However, we see an opportunity for it to go further and incorporate commercial ESG incentives in targets for at least 20-30% of short-term remuneration, with imperatives such as value chain decarbonisation reflected in long-term targets.

Our Objectives: Highlights of progress and achievements through engagement

Since the start of 2021, we have made significant progress on our objectives with an array of companies, with a total of 63 objectives advancing through at least one milestone. With significant time needed to deliver on meaningful objectives, we customarily expect at least 40% to achieve progress annually. We are therefore pleased to see 32% of our objectives progressed within the first six months of 2021.

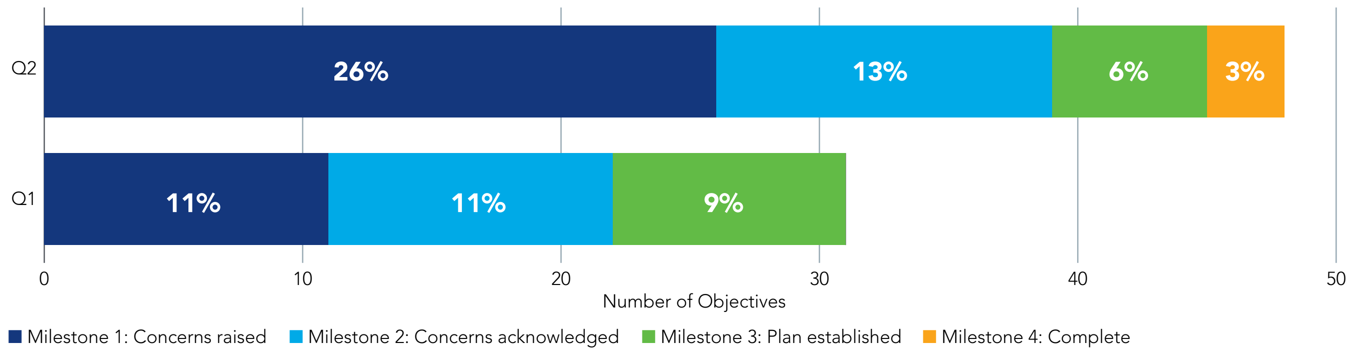
Importantly, lead engagers touched on nearly three-quarters (74%) of all objectives across the strategy during H1 2021, even if progress observed wasn't always sufficient to advance a milestone. As well as being a natural outcome of objectives-centric dialogue, this coverage illustrates the multifaceted nature of each action, whether it be a meeting, a call, or feedback to (and correspondence with) boards and management.

32%

of our objectives progressed within the first six months of 2021.

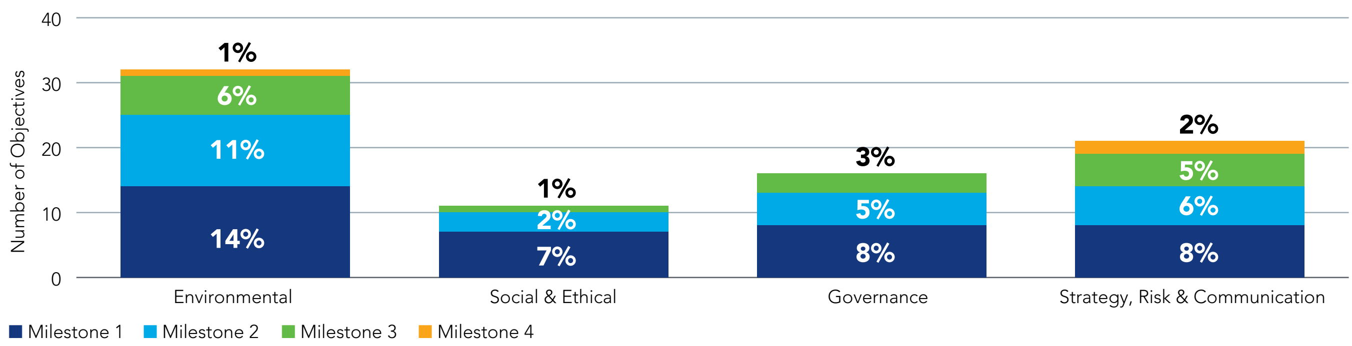
A total of 79 milestones were achieved in H1 2021,[7] and we have observed progress in companies listening to us and formulating plans related to objectives we have advanced in 2021 so far (see Figures 14 and 15). Of these, 37 were first milestones (concerns raised), creating a large cohort of issuers with objectives now progressed to Milestone Two. A further 24 objectives passed Milestone Two based on company responses to our feedback or concerns, while 18 objectives advanced through Milestone Three thanks to the formulation of company plans or changes getting underway.

Figure 14. Milestones reached in H1 2021



Source: Federated Hermes, as at 30 June 2021.

Figure 15. Milestone progress by theme, H1 2021



Source: Federated Hermes, as at 30 June 2021.

Achieving results in long-term engagement: highlights from objectives we advanced in H1 2021			
Environment	**Social**	**Strategy**	**Governance**
We want to see **Banorte** establish an enhanced sustainable finance framework aligned to SDGs. We passed a milestone after engaging the head of sustainability regarding climate ambitions this may include.	Auto parts recycler **LKQ** acknowledged that low pay for some of its 44,000 strong workforce creates retention issues; we advanced our objective after raising the potential for a living wage for hourly workers.	We advanced an milestone for **Anglo American** relating to stress testing of resilience against climate change and carbon price scenarios; the company confirmed it is undertaking further scenario analysis of potential demand disruption for commodities it sells.	When we commenced engagement, **Energias de Portugal** was behind the market on some remuneration principles. With the company's 2021 policy disclosure having embraced much of the feedback previously provided, we were able to advance our objective for improved practices to our final milestone.
We think **Aker BP** is in a unique position to develop a strategy for emissions removal in its long journey to absolute net zero. The company acknowledged this potential when we raised it, enabling us to advance our objective.	**Akbank** is one of the most gender-diverse emerging market banks. Having raised the potential to continue its diversity leadership through gender parity in management, we advanced on this objective.	At **Ford**, after engagement and attendance at an investor day we advanced our objective for the company to disclose its ambitions for decarbonising its future fleet, with a raft of strategic updates confirming progress. We now want to see validation of emissions goals to complete our objective.	German affordable rental housing provider **Adler** needs to deliver sufficient remuneration disclosure. We advanced our objective by raising this issue with the company and describing changes we think it can implement; we will discuss potential for changes in our follow-up engagement.

Source: Federated Hermes, as at 30 June 2021.

[7] There are more milestones reached (79) than objectives with progress (63) since some objectives passed through more than one milestone during the relevant time period.

Our Objectives: Achieving outcomes for substantial future impact

We are pleased to note that several objectives were formally completed in H1 2021; we expect many more objectives to be fully achieved as the strategy grows and long-term engagement continues. Below we provide insight on the outcomes for the three objectives completed so far this year.

Zurich Insurance:
Transparently accounting for complex climate risks through TCFD, alongside ambitious emissions targets

7 AFFORDABLE AND CLEAN ENERGY
12 RESPONSIBLE CONSUMPTION AND PRODUCTION
13 CLIMATE ACTION

Roland Bosch
Engagement Professional

Filippo Alloatti
Head of Financials (Credit)

Since late 2017, Zurich Insurance has captured progress on climate risks and opportunities according to recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD). Initially, these were limited, so we engaged with the Chairman four times between 2017 and 2021 regarding improvements. We were pleased when the company's extensive 2020 reporting and standalone materials detailing climate challenges ahead enabled us to complete our objective on best-practice TCFD reporting. The climate agenda is not without opportunity, however, and Zurich complemented TCFD reporting with climate goals which from 2021 commit every lever at its disposal, including investments, operations, product and services. Accelerating the transition to a net-zero economy requires significant emissions reduction targets consistent with a 1.5°C temperature pathway.[8] Zurich's targets to 2025 address three areas: emissions reduction in its portfolio (specifically, a 25% reduction in emissions intensity of equity and bond investments, and by 30% in direct real estate investments); engagement with companies to bring change; and direct investing in solutions. The company plans to disclose annual updates on progress.

Deutsche Bank:
Strategic commitments & clear governance for driving sustainable & climate finance outcomes

13 CLIMATE ACTION

Roland Bosch
Engagement Professional

Filippo Alloatti
Head of Financials (Credit)

As well as engaging Deutsche Bank on a range of ESG, risk and ethical conduct problems, we have also engaged with the company on its sustainability agenda. This was addressed in intensive discussions with the CEO, Chair, supervisory board members and senior executives across 11 engagements in 2020-2021. As part of this, we set an objective for the bank to commit to a strategy which seeks to develop products and services sustainably, taking into consideration the needs of all relevant stakeholders. Following last years' publication of the bank's sustainability targets – including expansion of its sustainable finance and ESG investments and strengthening of its sustainability governance structure – it held its inaugural 'Sustainability Deep Dive'. This event, which we had given input on and participated in, comprehensively outlined the bottom-up divisional sustainability strategy, which demonstrated a focus on sustainable finance, climate risk management, diversity and inclusion. At the bank's 2021 AGM we commended accompanying changes to the new remuneration system, which starts to align variable incentive schemes to the execution of the sustainability strategy. These include sustainable finance commitments and the development of climate risk management – a suggestion we previously provided. Thanks to the bank's considerable progress, we were able to complete this objective.

General Motors:
Plan to reach 1 million + annual electric vehicle sales – and retiring tailpipes in the long term

9 INDUSTRY, INNOVATION AND INFRASTRUCTURE
12 RESPONSIBLE CONSUMPTION AND PRODUCTION
13 CLIMATE ACTION

Aaron Hay
Director, Engagement & Strategy, Sustainable Fixed Income

Robin Usson
Credit Analyst

General Motors has dedicated significant capital to electric vehicles (EVs) and automated vehicles (AVs). In 2019 we set an objective for the company to disclose a target for EV sales to demonstrate its commitment to decarbonising transportation (as several peers had already done). At that point, sales of EVs were low in its overall mix of 8.5 million vehicles. We engaged with senior executives on 11 occasions between 2019 and 2021. Discussions focused on its modular, scalable EV platform, which the company believed would drive sales of up to 1.5 million units on a rough timeframe, as well as how EV execution might be robustly reflected in executive pay. General Motors now targets annual EV sales of 'well over 1 million units' in the US and China by mid-decade, which increased from a softer commitment of 'at least 1 million units' announced at investor days and in some disclosures in 2020. Importantly, in 2021, it published a commitment to cease selling light-duty vehicles with tailpipe emissions by 2035, as well as an interim science-based target of 51% intensity reduction for Scope 3 vehicle emissions by 2035. Based on these commitments we are pleased to be able to complete our original objective. However, we will continue to engage on how the company plans to disclose its science-based pathways and the development of targets in line with short and medium-term EV strategy execution over the next five years.

[8] A 1.5°C temperature mitigation pathway aims to limit global warming to 1.5°C above pre-industrial levels, which is the preferred goal set out in the Paris Agreement.

Impact: reviewing our SDG focal points, 18 months into engagement

Figure 16. SDG focus in engagement, H1 2021

Note: Due to low portfolio materiality of SDG 14, Life Below Water, this is omitted. Two engagements addressed SDG 14 in H1 2021.
Source: Federated Hermes, as at 30 June 2021.

Over 50% of the total of 263 H1 2021 engagements featured a focus on climate action.

SDGs tied to the climate crisis, carbon emissions & physical value chains continue to dominate agendas

As in the first half of 2020, in H1 2021 we engaged intensively on the interlinked SDGs 12 (Responsible Consumption and Production) and 13 (Climate Action) more than any other goal. Over 50% of H1 2021 engagements featured a focus on climate action, whilst 128 included discussions of sustainable production.

SDGs 12 & 13 in Focus: Huntsman

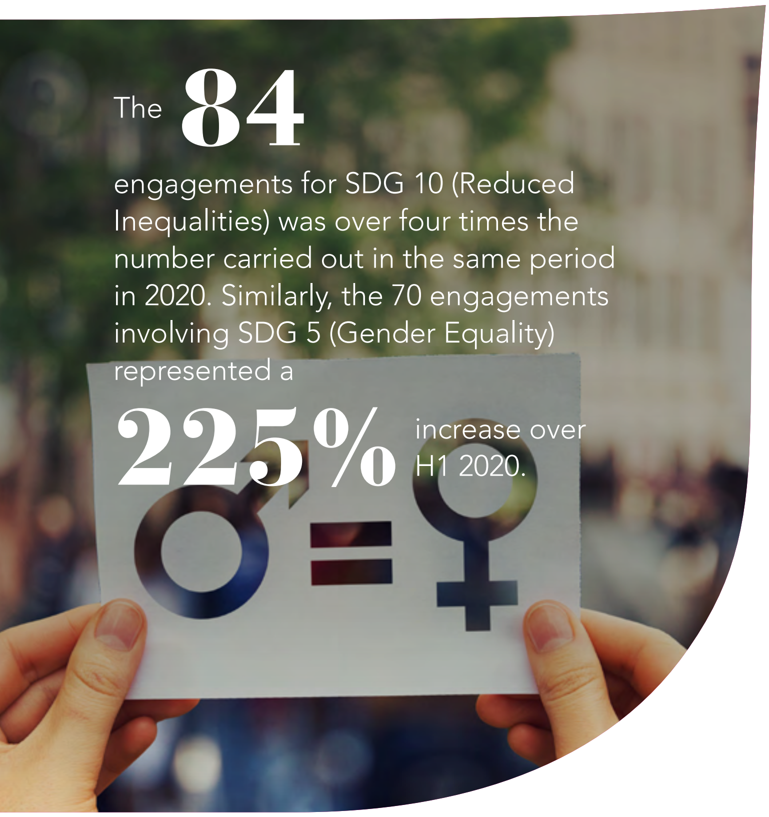
The chemicals sector is reliant on fossil fuels as a raw input but has immense potential as an emissions reduction 'enabler' in solving problems for customers. As such, we engaged with **Huntsman** on its latest work on product lifecycle analyses and internal carbon pricing. We understand that, in line with the company's focus on downstream, value-adding customer solutions in chemistry, it will undertake mapping of Scope 3 emissions. We support this initiative, which could help identify opportunities for abatement both upstream and downstream.

Given the configuration of our high-yielding, future impact-focused portfolio, this result is unsurprising. Our strategy features outsized materiality in regards to climate action and carbon emissions reductions, along with evolving physical production value chains and products for more sustainable outcomes. Our intensive focus on heightened risks we want companies to confront within Materials, Metals and Mining, Packaging, Chemicals, Utilities, Energy and Automotive sectors is also an important factor making SDGs 12 and 13 prevalent in dialogue. Whilst climate change is a systemic risk for many firms we hold, we think that underlying, core changes to business models and products by these sectors are amongst the most powerful ways they will drive climate action and responsible production and consumption.

SDGs 12 & 13 in Focus: Levi Strauss & Co

We engaged the company on its circular economy initiatives twice in H1 2021; we believe this is a key responsible production issue for the entire apparel manufacturing sector and is in line with a circular economy innovation objective we have set. In our meeting we focused on targets it plans to introduce as part of 2025 and 2030 sustainable business goals it is currently formulating. We later provided feedback on the inclusion of decarbonisation and circular materials outcomes in both its disclosures and executive pay incentives.

SDG 7 (Affordable and Clean Energy) is often closely linked to SDG 13. It also continued to feature prominently in engagements, but was joined in popularity by additional themes that have grown in importance. Further SDG 13 engagement highlights follow on page 23.



Our engagements relating to other SDG areas have shifted substantially, with a greater spread of SDG coverage across the strategy.

Balanced SDG focus beyond climate and production, with intensive engagement on matters of inequality

Our engagements relating to other SDG areas have shifted substantially, with a greater spread of SDG coverage across the strategy. The 84 engagements for SDG 10 (Reduced Inequalities) was over four times the number carried out in the same period in 2020.

SDG 10 in focus: Turk Telecommunications

As the name suggests, **Turk Telecommunications** provides a wide range of telecoms services across Turkey. Given divergent socioeconomic backgrounds across the nation, the ability of consumers to pay for such services varies widely. During two engagements in H1 2021 we discussed how the company can position itself to be able to offer mobile, data and wider digital services in an inclusive and accessible way; this is also a priority of the Turkish government, which is a 32% shareholder in the firm. We observe that Turk Telecommunications' leadership position in coverage and price makes it well positioned to increase access to communications. However, we feel the company needs to refine its non-financial reporting to better illustrate the positive impact of affordability and accessibility-driven services for disadvantaged populations, as well as how such services may contribute to closing economic or social inequality gaps.

SDG 5 in focus: ArcelorMittal

One engagement objective at **ArcelorMittal**, now at Milestone Four, seeks a credible plan and supportive actions to continually increase female representation in senior management, with evidence that this is the case to complete the objective. This year we have engaged with the company regarding its renewed focus on diversity in its workforce; we welcomed this and encouraged the company to increase the level of disclosure around diversity and other metrics. It has set a target for doubling the percentage of women in senior management positions to 25%, however, we raised concerns about this figure not being ambitious enough, given that some peers are aiming for at least a third of women in senior management. The company reassured us that it would be making significant efforts to create an equal environment and tackling unconscious bias within the organisation.

Similarly (though less dramatically), the 70 engagements involving SDG 5 (Gender Equality) represented a 225% increase over H1 2020. These are nuanced topics requiring greater learning and discussion, so we expect them to become more prevalent as engagement progresses and dialogue becomes more open and comfortable.

In instances where inequalities are stark this may imply periods as long as five to ten years – making it all the more crucial to build the right approach to inclusion today.

To this end, we have sought and developed a clear understanding of gender, racial, sexual orientation, disability and economic inequality in workforces and management teams. This enables us to engage in productive dialogue regarding how companies can use the human capital powers at their disposal to drive more inclusive employment outcomes. Given the limitations of turnover on how quickly firms can deliver inclusive recruitment, retention and culture development, this is a long journey. We therefore often advise that diversity-focused employment and culture strategies need defined targets which are ambitious but achievable on appropriate timescales. In instances where inequalities are stark this may imply periods as long as five to ten years – making it all the more crucial to build the right approach to inclusion today.

Turning to future-focused commercial innovation and the role employers can play in achieving the SDGs

Engagements touching on SDGs 8 (Decent Work and Economic Growth) and 9 (Industry, Innovation and Infrastructure) have also increased significantly, with each receiving almost three times as much attention as in H1 2020.

Again this is something we expected, as an initial focus on the most material and serious risks and opportunities facing companies across the ESG spectrum gives way to broader discussions; for product value chains that employ significant numbers of people, these conversations inevitably begin to touch on both commercial innovation and social impact.

SDGs 8 & 9 in Focus: Orbia Advance

Innovation in specialised materials, chemicals and production is at the heart of the commercial agenda at **Orbia**. This is quantified in increasing annual R&D budgets, with much of the spend focused on sustainability. However, given historical safety problems, we set an objective for the company to demonstrate two additional years of positive health and safety outcomes for its large labour force. This objective currently sits at Milestone Two – concerns acknowledged. The protection of labour rights and safe, secure working environments for all is covered by target 8.8 of SDG 8.

We see SDGs 8 and 9 as complementary: in order to succeed as part of a thriving, sustainable economy, companies must innovate. Thriving, future-focused businesses which deliver positive impact in terms of innovation and infrastructure have the best potential to remain strong long-term employers and job creators. We believe they also have a duty to share their success with employees beyond paying fair wages; in line with SDG 8 they can make continued advances in quality of employment to support employee health, education and training, fair terms of labour, and worker economic stability.

We look forward to deeper engagement in these areas in the second half of 2021, with a focus on the commercial strategies which allow businesses to compete sustainably, as well as the human capital practices which enable both employees and their employers to thrive.

SDGs 8 & 9 in Focus: Sealed Air

Sealed Air packaging's strategic intent is to ensure 100% of its products are recyclable and over 50% of production volume uses recycled material by 2025. This requires operational investments, value chain innovation and recycling infrastructure at scale, all of which are either directly or indirectly influenceable by the company. One of our objectives, now at Milestone Three (planned), is for Sealed Air to report progress against this commercial goal annually, as well as reporting on how it is investing to overcome challenges in this circular manufacturing shift. As Sealed Air futureproofs its business for compatibility with a carbon-efficient economy, we believe this will also benefit the economic livelihoods of almost 16,000 employees in 123 countries, serving in both manufacturing and corporate roles.

Systemic change takes a village… or a value chain

All of the SDGs require collaboration, but this is particularly acute in sectors such as packaging which comprise many fragmented competitors. Without cooperation, few firms can exert enough influence to alter supply chains in the name of more resource-efficient and sustainable production. Similarly, from engaging over 20 financial institutions for our strategy, we note that the banking sector has yet to implement a highly robust, transparent and comparable standard of practice for articulating sustainable financing programmes and impacts. This is frustrating for many of the smaller and mid-sized financial firms we engage with, who urgently wish to redirect capital to sustainable financing but lack the gravity to drive the entire sustainable lending space forward at pace.

SDG 17 in Focus: Berry Global

Increasing recycled content in products is part of **Berry Global's** sustainability plan. Plastic packaging is under competitive pressure from an expanding range of sustainable alternatives. High rates of recycling and reuse in production are a way to counter alternatives whilst reducing reliance on virgin hydrocarbon-based chemicals. Berry and its peers are challenged by a lack of control of plastics at end-of-life, but the company is working closely with resin producers on solutions as well as encouraging these suppliers to take the Operation Clean Sweep® (OCS) pledge. It is also a founding member of the Alliance to End Plastic Waste and partners with the Ellen MacArthur Foundation to contribute to value chain solutions for this problem. Such multi-stakeholder partnerships to facilitate sustainable development are a target under the umbrella of SDG 17 (Partnerships for the Goals).

SDG 13: Where are we on climate action, 18 months into engagement?

Climate change indirectly affects all SDGs, but Goal 13 (Climate Action) specifically addresses the issue. In alignment with the 1.5°C aim of the Paris Agreement, it calls for greater climate resiliency and integration of climate action into strategies to reach net zero global emissions.[9] In engagement, we seek to translate this into relevant objectives for companies to positively impact emissions reductions; these vary between sectors and companies based on the strategic and operational choices they can make.

Enel: delivering against SDG 13 under intense pressure on the utility sector

Utilities have a more material opportunity than almost any other sector to decarbonise value chains and economies, and as a result face intense pressure to act. Our longstanding engagement with **Enel**, which dates back to 2008, has included past objectives to develop a long-term decarbonisation strategy; this was achieved in 2018. More recently, we raised concerns about the company's indirect supply chain emissions: purchased electricity, fuels and basic materials used by Enel originate from high-carbon upstream operations that must also decarbonise if the company is to reach net zero across Scopes 1, 2 and 3 (i.e. indirect as well as direct emissions). The company acknowledged this as an area to address in 2021 and is developing a strategy to work with its suppliers to decarbonise upstream emissions, beyond the impact it can have on SDG 13 through decarbonising its actual electricity generation.

Cemex: great promise in a sector with an outsized chemistry challenge

The basic materials sector is energy intensive and has a significant Scope 1 and 2 emissions footprint to decarbonise. This is a particularly acute challenge in making concrete, given that emissions originate from the basic chemical reactions that largely drive today's production methods. We started our engagement with **Cemex** in 2013, with our more recent engagement efforts focusing on the demand for lower carbon concrete. In 2018 we enquired about the possibility of the company developing decarbonisation targets verified by the Science Based Targets initiative (SBTi). Positive engagement followed, with the company acknowledging the need to develop a climate strategy and emissions targets. This led to Cemex setting 'well-below 2 °C ' temperature-aligned, SBTi-verified targets and committing to net-zero concrete by 2050 – no small feat considering the chemical process involved.

ArcelorMittal: forging a new environmental pathway in steel manufacturing

Transitioning away from the use of fossil fuels in steel manufacturing is vital for this sector to play its part in decarbonising the global economy. Until recently, this has been difficult due to a lack of low-carbon technology alternatives for adequately heating blast furnaces used in steelmaking. We have engaged with leading steelmaker **ArcelorMittal** since 2008 and in recent years have raised concerns over the company's climate footprint, setting an objective in 2018 to develop GHG emissions targets. The company has since developed a pathway to reach net-zero emissions, crucially involving electric arc furnaces and hydrogen rather than high-carbon fuels. The decarbonising potential of this technology is highly material; we expect the industry to rapidly integrate it as it becomes increasingly commercially viable, with ArcelorMittal leading the transition.

Caixa Geral de Depositos: aligning with Iberian net-zero imperatives

Indirect Scope 3 emissions – in the form of the emissions driven by assets bankers have lent money against – are a big challenge in banking. It is possible to decarbonise these 'financed emissions': for example, banks can offer loans that fund capital investments in efficiency or low-carbon solutions; they can develop lending and financing exclusions or wind-down policies for high-carbon assets; and they can engage with clients and owned assets on climate action and risk. In light of this, in 2020 we set Portuguese bank **Caixa Geral de Depositos** an objective to develop SBTi-approved targets for Scope 1, 2 & 3 emissions, including their lending and asset portfolios. Calculating its financed emissions has since become a focus for the bank, and in recent engagement it confirmed it will publish SBTi-approved targets for all scopes of emissions in the near future. This would demonstrate a degree of leadership on the issue amongst its Iberian peers, as well as alignment with the direction of Portuguese and European Union climate policies.

[9] Climate Change – United Nations Sustainable Development.

SECTION 4

Paying for what matters: incentives to drive impact in energy sector remuneration

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Adapting pay to the changing context of climate action is imperative in the energy sector

This commentary is oriented towards upstream or midstream oil and gas companies, rather than global, integrated energy firms. Whilst large firms have latitude in capital allocation across a range of options, such as commercial ventures which diversify out of hydrocarbons, this is not always the case with pure exploration or fuel transportation businesses. With this in mind, we provide guidance on pay principles which focus on medium-term risks in energy demand, resilience, and operational impact choices aligned with SDGs, as well as action on Scope 1 and 2 emissions. We also touch on the longer-term potential for diversification and Scope 3 actions where this is feasible to pursue. It should be noted that integrated firms with wider capabilities may require pay which incentivises activity to address immediate Scope 3 emissions opportunities, as well as investments beyond hydrocarbon energy.

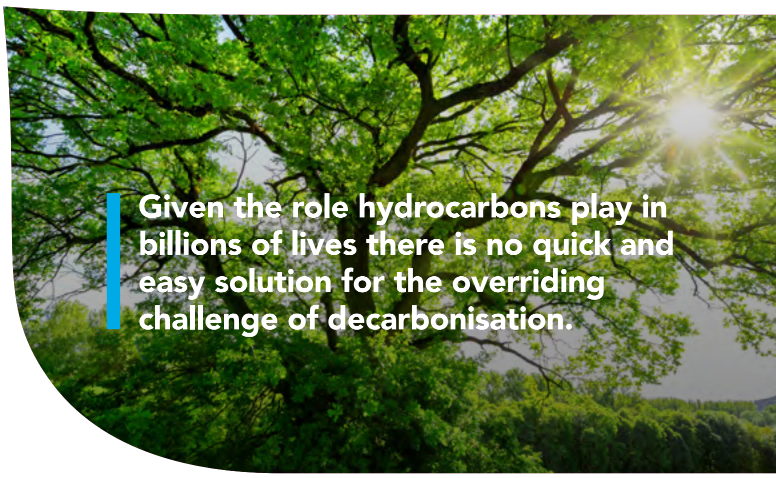
We regularly scrutinise how executives are paid based on a simple rationale: remuneration drives behaviour. Executive pay is an acute focus for us in the high-yield energy space, since management behaviour dictates how, when and where companies participate in energy transitions and the contributions they can make to the SDGs. Incentives need to encourage management teams to think differently about value creation, yet in many energy companies, pay targets based on business-as-usual hydrocarbon growth thinking remain worryingly common.

We recognise that, for reasons including capital inflexibility, insufficient capabilities for diversification and structural business model incompatibilities, not every high-yielding producer of hydrocarbons has the option to decouple from core products. However, we think transition-prepared firms – regardless of longer-term destiny – can play a role in delivery against the SDGs. Whether the focus is on resilience for the transition or a strategy that shifts from or abates hydrocarbons, time is of the essence; progressive strategy must find roots in decision-making incentives today.

What links the SDGs to impact in the energy sector?

Given the role hydrocarbons play in billions of lives there is no quick and easy solution for the overriding challenge of decarbonisation. Clean and renewable energy in its various forms contributed 29% of electricity generation in 2020,[10] and it will increasingly become dominant as the economics involved progressively improve. However, a diminishing but ongoing role remains for hydrocarbons in the transition towards a mix which will be dominated by low and zero-emissions energy solutions.

The climate crisis necessitates a multifaceted response and the 17 SDGs reflect this by linking success to a series of underlying indicators. Most of these consist of quantified measures of environmental or social progress that, due to specificity, can be meaningful in the context of an energy company's positive or negative contributions to society. For example, SDG 7's headline is affordable and clean energy, while underneath this, metrics provide a proxy for how companies operate, or what their business delivers: indicator 7.1.2 measures the 'proportion of population with primary reliance on clean fuels and technology', while 7.2.1 measures 'share of renewable energy in total final energy consumption,' both of which can be tied to the choices of an energy firm. However, for firms which may not have this option, SDG 9 includes a relevant indicator which measures emissions per unit of value added. For an energy firm, this is effectively the Scope 1 and 2 emissions intensity of its products, improvement of which is in direct control of the company. Figure 17 provides more details of these and other indicators which are highly relevant to SDG impact potential for energy firms.



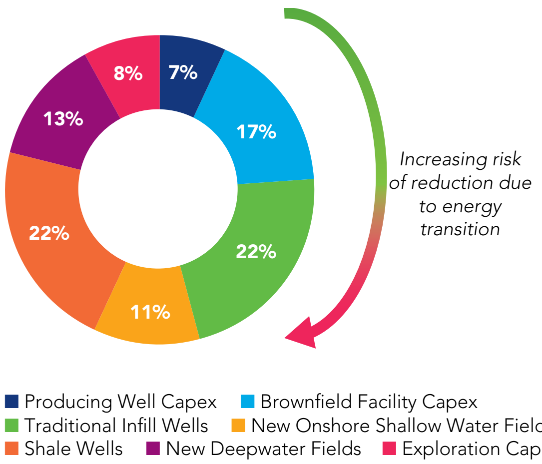
[10] Roadmap to 2050, published by IEA, May 2021.

Figure 17. SGDs relevant to oil and gas

SDG	Examples of indicators relevant to Oil and Gas
3 GOOD HEALTH AND WELL-BEING	Air pollution from hydrocarbon value chains and consumption is harmful to human health; indicator 3.9.1 seeks to improve mortality rates attributed to air pollution.
7 AFFORDABLE AND CLEAN ENERGY	Increasing clean fuels in the global energy mix (indicator 7.1.2), as well as pure renewables in the share of final energy consumption (7.2.1), are key to reducing runaway climate change. However, under indicator 7.3.1, energy intensity measured in terms of primary energy and GDP – or revenue, all energy firms have a role to play in reducing energy intensity in their own operations and across their value chains.
9 INDUSTRY, INNOVATION AND INFRASTRUCTURE	It is possible for many carbon-intensive businesses to decrease emissions from making something. The investments and management to do so would contribute to indicator 9.4.1, CO_2 emissions per unit of value added.
13 CLIMATE ACTION	Comprehensive decarbonisation strategies that include a pathway to net zero for energy firms would demonstrate alignment with indicator 13.2.2, total greenhouse gas emissions per year.

Energy incentives: historic challenges, ongoing misalignment

Figure 18. % of upstream oilfield capital expenditure



Source: Morgan Stanley.

Executive remuneration across the energy sector remains unevenly aligned with firms' plans for energy transitions and climate readiness. In 2020, Carbon Tracker found that 90% of the 30 largest listed oil and gas companies in Europe, Asia and North America reward executives directly or with indirect influence for production or reserves growth, little changed from 2017.[11] This included firms with net-zero goals – creating a potential conflict between emissions reduction and high-risk production growth.

Absolute growth of hydrocarbon resources involving major up-front investments, long paybacks, and poor embedded emissions performance may create hazards to investor returns. Morgan Stanley observed in 2021 that "capital markets are already forcing the hand of upstream producers to restrain capital spending and reallocate capital to transition-friendly strategies, even if there is meaningful recovery in oil demand".[12] It summarised these risks in an example using oilfield capital allocation choices – see Figure 18.[13]

Absolute growth targets – whether through share price incentives or operational goals to add to reserves and production volumes without consideration of risks involved – present significant concerns. These concerns have been further cemented by the International Energy Agency's (IEA) Roadmap to 2050 (expanded upon below) which projects oil demand will never return to its 2019 peak, whilst natural gas demand has a future that appears volatile, unpredictable and far from guaranteed.

We think there is a case for responsible firms to succeed in a long race to net zero. The IEA's highly-anticipated 'Roadmap to 2050' stated that no oil and natural gas fields or coal mines, beyond those already approved for development, are required to achieve net-zero emissions (NZE) by 2050. The key hydrocarbons play different roles in this scenario:

- Demand for coal, the most carbon-intensive fuel, is expected to fall by more than 50% by 2030 and by 90% by 2050.
- Demand for oil is estimated never to return to its 2019 peak, falling almost 75% by 2050.
- Demand for natural gas is expected to rebound from its recent drop; it benefits from emissions per unit of energy which are 40% lower than for coal and 20% lower than oil, making it a more useful transition fuel where renewables and storage may not yet be feasible. Demand is expected to rise through to the mid-2020s, before dropping to 55% below 2020 levels by 2050.[14] As with other assets, no new natural gas fields are needed for NZE beyond those under development.

The high-yield energy space has demonstrated disconnects between capital expenditure, debt levels, returns and cash generation at various energy price levels in the past, although much of this occurred before pressures from climate policy and action were as acute as they are now. It's worth noting that there are some signs of improvement: SailingStone Capital observed that some independent exploration and production firms have since adopted returns-based incentives to avoid unsustainable growth,[15,16] while Carbon Tracker observed firms such as EQT and Occidental incentivising absolute growth in a significantly reduced manner.[17]

[11] Groundhog Pay: How executive incentives trap companies in a loop of fossil growth, published by Carbon Tracker Initiative, December 2020.
[12] https://ny.matrix.ms.com/eqr/article/webapp/f610dc28-da8c-11ea-bbfc-1c2757c8e579?ch=rpext&sch=pcw.
[13] https://ny.matrix.ms.com/eqr/article/webapp/f610dc28-da8c-11ea-bbfc-1c2757c8e579?ch=rpext&sch=pcw#/exhibit=4.
[14] Roadmap to 2050, published by IEA, May 2021.
[15] Shale 2.0 Revisited a Year Later, published by Sailingstone Capital, October 2018.
[16] Don't Blame COVID-19, Just Embrace Shale 2.0, published by Sailingstone Capital, March 2020.
[17] Groundhog Pay: How executive incentives trap companies in a loop of fossil growth, published by Carbon Tracker Initiative, December 2020.

Tough decisions lie in the hands of energy executives. Do they look to move early on clean energy diversification or hydrocarbon abatement (SDG Indicators 7.1.2 & 7.2.1)? Do they aim to improve efficiency and focus on long-term, carbon-advantaged fuels, whilst adapting operations and performance to medium-term regulatory, environment and climate imperatives (SDG Indicators 9.4.1 & 13.2.2)? How do they focus on low-risk, accessible reserves and improving profit margins to deliver safe returns to investors? To better focus executives on the risk ahead, we believe that behavioural incentives in pay must confront a long-term business reality: absolute growth in perpetuity is no longer a feasible, straight-ahead choice.

Building blocks for incentivising responsible participation in energy transitions

We engage companies on short and long-term pay objectives (typically over one and three years respectively) to seek alignment of strategy, capital allocation and operational choices. Given that we have just over nine years left to progress on the 2030 aims of the SDGs, that translates into a *mere trio* of long-term pay plans. With this in mind, we advocate an expedient approach to evolving pay at high-yield energy companies. We believe that the learning we share here, explored through H1 2021 engagement, deserves timely consideration by management teams, boards and remuneration committees preparing pay policies which will be presented to shareholders in the 2022 proxy season. We continue to engage energy firms on pay with these challenges in mind.

Core drivers of responsible pay – challenges to consider

Challenge 1: *Targets for absolute production, reserves growth or reserves replacement drive too much decision making in low-risk environments.*

We believe energy companies must allocate capital to low-risk projects that remain resilient under varying price conditions, demand disruption, and a future of stringent climate regulation. Incentives which encourage a risk-resilient, future-conscious production base may include:

- Production or cashflow targets calculated on a dividend or debt-adjusted, per-share basis to drive value without inappropriate trade-offs;
- Drilling or extraction rate-of-return targets which incentivise exceeding the cost of capital – a robust hurdle reduces the risk that per-share or earnings targets continue to indirectly incentivise risky choices;
- 'Volume targets' (for example, based on forecast of demand) should be absent, or heavily counter-weighted by 'value targets' which dictate how growth must create positive returns;
- Costs-per-unit incentives or 'stage gates' to achieve other targets ensure executives are not pursuing options with disadvantaged costs – well cost per foot or expenses per unit of energy marketed are examples.

Challenge 2: *Long-term incentives are too focused on share price with inadequate regard for reliable returns, creating the prospect of risky short-term decision-making.*

This has remained a concern for years. We believe companies need to think more carefully about models for long-term incentives, including:

- Long-term total shareholder return (TSR) incentives that clearly emphasise dividend return value as well as share price appreciation. It may be time for some firms to have a separate dividend target if they truly believe that their business can produce reasonably good cashflow for investors, regardless of energy prices, for some time to come;
- Relative TSR performance incentives that do not pay at target simply for exceeding the median of a peer group of poorly-performing businesses. Inclusion of wider economic peers (such as a broad market index) can counter this problem of highly-elevated pay simply for being 'the best of a bad lot' in terms of investor returns;
- Limitations to the weight of share-driven incentives, which can be implemented by focusing on underlying health factors, as outlined in Challenge 4.

Challenge 3: *Long-term incentives do not factor in challenges of balance sheet health and capital effectiveness adequately.*

Although we have seen new emphasis on strategic issues such as capital effectiveness and debt, some pay packages do not do these issues justice. To address this, we think companies should move away from a majority TSR focus and implement policies which embrace additional indicators of health:

- Long term return on capital employed (ROCE) incentives, which ensure that over time executives are choosing to spend capital on advantaged, lower-carbon assets whilst making investments in future-proofing. ROCE incentives should not pay when results do not exceed cost of capital, so if there is a deficit in value creation caps may be required;
- Long-term deleveraging or debt-to-income ratio targets are even rarer today. These can ensure that the business can generate adequate average returns overall to ensure debt levels remain at or below acceptable levels of risk, in line with the expectations of creditors.

Challenge 4: *Inadequate skin in the game.*

Energy sector executives should share the risks investors in their companies are taking on. For the US market, where we have a series of engagements, we believe management teams should embrace levels of required equity ownership in excess of ten times base salary for CEOs, along with holding periods of at least three years and post-retirement holding requirements of at least two years. Unfortunately, we do not yet observe these conditions widely applied across the sector and therefore continue to engage on this concern.

Incentivising SDG action in a climate & energy transition – challenges to consider

Challenge 5: *Targets relating to environmental performance, science-based emissions-reduction pathways or the SDGs are only paid lip service, despite firms being in the crosshairs of climate action.*

Climate targets were absent from the majority of 2019 pay packages at North American firms[18] although they are now present in some remuneration targets, as demonstrated by the engagement examples below. Overall, we remain disheartened by a lack of incentives for climate action in operations and value chains and have made it clear through engagement that operational impact must be part of remuneration. These are measures to consider as starting points:

- Long-term Scope 1 and 2 emissions reduction targets which, where possible, align with intensity reduction implied each year by science-based pathways. This may include Scope 3 reduction targets which align with emergent solutions upstream or downstream, where this is feasible for the company in question;
- Short- or long-term methane emissions reduction targets which account for immediate, continuous action to drive this damaging greenhouse gas as close to zero as technologically feasible;
- Ambitious targets for non-climate-related environmental impact reduction or remediation, including water use, treatment and recycling, local air pollutant and effluent intensity reductions, and hazardous waste;
- Climate-related targets must be unbundled from 'general ESG incentives' so that thresholds, targets and maximums are visible to investors;
- Climate-related targets should have a weighting of at least 20% of overall ESG incentives, given the existential nature of this risk.

Challenge 6: *Given that the future of hydrocarbons is not guaranteed, there is insufficient provision in pay incentives for longer-term value-additive solutions, or strategic, wider diversification.*

We observe that many high-yielding energy firms have few incentives for exploring step changes in emissions or environmental impact, except where there are highly meaningful emissions alignment goals for executives. Part of the challenge is that these changes may only produce value beyond the next three-year cycle but are likely to need action now.

To resolve this problem, companies could consider introducing ringfenced incentives for forays that are long term in nature but may produce value in a changing energy world. For example, projects likely to produce returns beyond a three-year cycle, and therefore have poorer near-term ROCE outcomes, may require a separate incentive.

This could create leeway beyond a three-year cycle to invest in deeper changes or diversification appropriate to the business at hand, such as:

- Emissions-management technologies;
- Scope 3 decarbonisation solutions with upstream or downstream partners;
- Joint ventures or minority stakes in new models;
- Asset repurposing for alternative fuels;
- Investment in carbon capture, storage and abatement.

Challenge 7: *Disclosure is opaque, leaving ambiguity between stated strategic intents and/or climate readiness and what incentives actually pay out for.*

We are unimpressed by the quality of proxy disclosure at some firms. An effective articulation of what kind of value creation is targeted should be explicitly connected to how the incentives will drive this. For example, this could include an indication of how the business expects to make returns for investors. With remuneration disclosure, companies should provide guidance on how TSR, deleveraging or hurdle-rate-passing projects are delivered, as well as the intended use of cashflow: e.g. for deleveraging, investment, dividends or stock repurchases.

We think non-financial metrics should be disclosed in advance to demonstrate the intended direction of travel on emissions pathways and environmental impact. For emissions, this may link to an explanation of how targeted reductions align with science-based emissions pathways the company has set.

[18] Groundhog Pay: How executive incentives trap companies in a loop of fossil growth, published by Carbon Tracker Initiative, December 2020.

Engagement in action – driving future impact through today's remuneration

Since the inception of the strategy, remuneration has been a point of focus for engagement with the energy sector. Reform is often needed, but encouragingly some firms have begun to align executive incentives with principles outlined here. Below are some examples of engagement we have progressed so far. Given the time required to move from strategy through incentive alignment to executives' resultant actions in planning and execution, pay will be a continuing theme in our engagement activities.

EQT: *Future emphasis on returns on investment, prudent cost management and operational decarbonisation.*

We have discussed remuneration with **EQT** several times. Helpfully, EQT does not use absolute growth incentives, and added greenhouse gas (GHG) intensity targets in 2021 remuneration, beyond existing ESG drivers which together are 25% of short-term incentives.

We support **EQT**'s multiple incentives focused on prudent and continuously-improving management, such as adjusted well costs, expenses to achieve output, recycle ratio, and adjusted free cash flow. We discussed the inclusion of broader market peers and absolute returns for TSR incentives, beyond potentially ill-prepared peers which may be poor comparators for benchmarking.

We will continue to engage on rigour and transparency in GHG targets and seek clarity on how it sees TSR being driven longer term, as well as on future potential differentiation of long-term incentives.

Range Resources: *Cost effectiveness, capital efficiency and a journey to net zero.*

Range Resources recently reduced emphasis on production and reserves growth targets from incentives, moving instead to a focus on cost-effectiveness and capital-efficiency measures. As with EQT, we appreciate **Range**'s use of cash unit costs, drilling costs per foot, and drilling rate-of-return metrics in its annual targets; return on average capital employed is an addition that cements focus on real value creation.

With respect to long-term compensation, the company is also sunsetting incentives relating to production and reserves growth per share. It introduced three-year incentives for improving debt-to-EBITDA ratio and Scope 1 emissions performance, with an initial 30% weighting for these metrics. TSR receives a 30% weighting in long-term award targets (avoiding the bias towards value creation derived solely through share price that options introduce). **Range**'s remaining time-based compensation has cliff vesting, requiring awards to be held for at least three years.

These are considerable changes in the firm's remuneration policies that align with several principles outlined here. We will continue to suggest further possible reforms in engagement.

Hess: *Reducing focus on absolute growth and increasing emphasis on returns and emissions, but monitoring needed.*

Hess recently added methane intensity and Bakken flaring reduction incentives to its remuneration policy; we have suggested that it also consider a long-term incentive for reducing overall Scope 1 and 2 emissions intensity. This could align executive incentives with a long-term pathway for emissions reductions which contains 2025 to 2030 targets. The company could unbundle its ESG targets to make individual goals more visible.

Importantly, it added cashflow and EBITDA-based metrics to balance the potential for riskier growth. The company awards resource additions at 15% and production growth at 15%. It incentivises capital spending and cash costs on an absolute rather than returns basis, with these making up a total of 40% of annual incentives. This should counter a motivation to chase assets with significant risk, but we will scrutinise whether this proves to be the case.

In long-term compensation, **Hess** uses TSR performance to award equity. This does not consider strategic energy transition factors, but the S&P 500 total return index was added as a peer to provide performance benchmarking beyond energy.

The company uses options exposed to share price rather than other means of value creation such as dividends; these could be phased out or provide for longer vesting periods.

Aker BP: *ESG incentives are in place, but partial absolute growth targets and limited equity risk for executives remain concerning.*

Due to differences in how Norwegian firms compensate executives, **Aker BP** does not award equity to its CEO or senior leaders. Instead, long-term compensation is in cash, based on share price growth relative to Norwegian and European energy peers. Although individuals on the management team hold stock, participation does not appear to be managed through defined holding periods or shareholding minimums. We believe this is inappropriate, given that the company is exposed to the same risks that all energy investors and peer management teams face.

We are supportive of the reforms Aker BP has made in relation to annual bonuses, which include targets for safety, relative shareholder return, carbon intensity and production costs.

However, metrics also includes absolute production targets. Since **Aker BP**'s emissions intensity is amongst the lowest among operators globally, and the company has strong expectations from Norwegian peers, policymakers and society, its success in the energy transition seems more certain. We therefore question whether absolute production growth requires a bonus, given the company's value-creation prospects from environmentally-advantaged outputs. We will continue to engage on this and other issues around remuneration.

SECTION 5

Safeguarding livelihoods: How will insurance help?

Jake Goodman
Engagement Manager – Fixed Income

Filippo Alloatti
Head of Financials (Credit)

When it comes to the impacts of climate change, insurance is reassurance

Insurance fulfils one of the foundational purposes of finance: to manage risk. Many ESG issues constitute risks to people or businesses, and insurance helps mitigate these. It is a systemically important sector that touches virtually all areas of the economy and many of the SDGs. Because of its unique position in the economy and the risk management skillset associated with the sector, insurers are emerging as a valuable contributor in the fight against climate change. The levers through which insurance companies contribute to climate change mitigation and adaptation can broadly be divided into three areas.

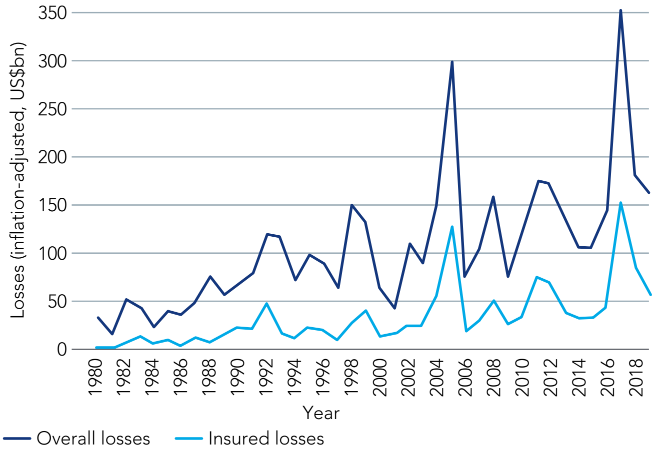
Risk protection

A wide range of insurance products exist covering almost every risk. Their common trait is that they help people and businesses reduce the financial impact of risks by transferring these to an insurer – which indirectly means risks are transferred to the customer base as a whole. In this way insurance helps protect against the risks from an uncertain future. Insurance works best when a risk is low probability, high impact and affects a small section of the population at any one time. Extreme weather events, which are one of the most tangible impacts of climate change, are one example of this type of risk; extreme weather is estimated to have caused damage totalling $4.2tn since 1980, only a third of which was protected by insurance.[19]

Flooding: an issue on the rise

Flood damage to houses is costly to repair yet unavoidable for the growing numbers of people living in flood-prone areas as a result of climatic changes and rising sea-levels. This risk is geographically isolated from a global perspective but damaging at a local level, which can be ideal for insurance coverage. This can help reduce the devastating costs faced by a minority of people at the frontline of a changing global climate.

Figure 19. Losses from weather disasters worldwide, 1980-2019



Source: Munich Re.

Insurance also enables innovation in other areas of the economy by reducing risk to an acceptable level which allows entrepreneurial activity to take place. Small-scale renewable energy projects are one such example where cover is available for development delays, liability and damage to equipment.

On the other hand, insurance products can enable destructive activities that are not in the best interests of society. For example, the coal industry is a major contributor to climate change whose value chains require insurance for routine operations. Insurance companies are acting on this issue: at least 23 insurers and reinsurers have ended or limited cover for coal projects, while nine have taken a similar approach to oil-sands-based hydrocarbon production.[20] This attitude is echoed within insurance asset management, with around 40% of the industry having adopted divestment policies – or committed to doing so.

Swiss Re: Exiting fossil fuel

In March 2021, **Swiss Re** updated its thermal coal policy to include exposure thresholds for highly material segments of its business. It requires complete phase-out in OECD countries by 2030, and by 2040 for other countries. The firm is also beginning to phase out insurance coverage for most carbon-intensive production methods in oil and gas.

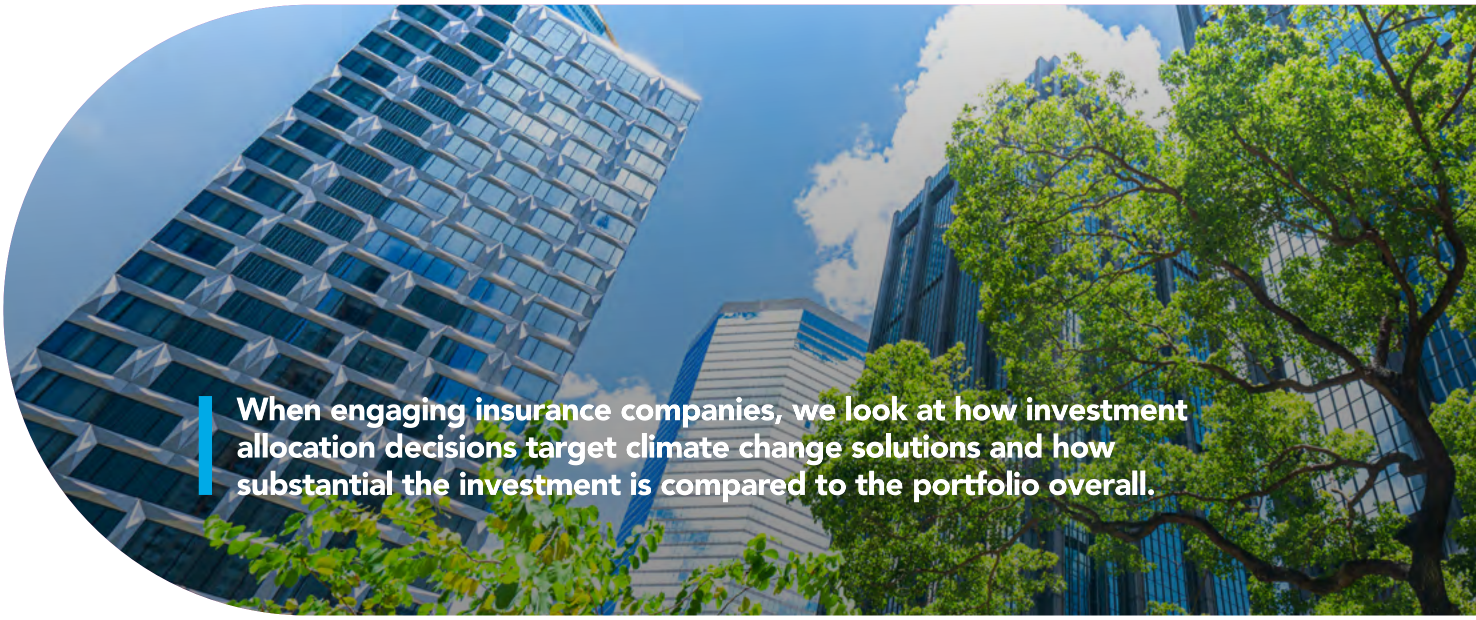
SwissRe ranked second on the Insure Our Future 2020 scorecard for fossil fuel insurance and is often at the top of this annual benchmark.*

We will engage **Swiss Re** on progress towards its fossil fuel commitments and encourage the firm to accelerate its ambitions for particular activities wherever this is feasible.

* Insure Our Future. '2020 Scorecard on Insurance, Fossil Fuels and Climate Change'. Accessed 14/05/2021. https://insureourfuture.co/wp-content/uploads/2020/12/IOF-REPORT-FINAL-1.pdf

[19] Munich RE. 'Extreme Weather Risks'. Accessed 14/05/2021. www.munichre.com/en/risks/extreme-weather.html.

[20] Insure Our Future. '2020 Scorecard on Insurance, Fossil Fuels and Climate Change'. Accessed 14/05/2021. https://insureourfuture.co/wp-content/uploads/2020/12/IOF-REPORT-FINAL-1.pdf.



For citizens of developed nations, insurance is generally available at low cost in a matter of minutes – it is essentially a matter of preference whether customers want to pay for protection. Unfortunately, this is not the reality in many developing parts of the world, where less formalised economies mean financial services, including insurance, are difficult to access. This is ironic given that effective insurance is even more relevant where families and whole regions rely on precarious employment, have little savings and can face financial ruin from events outside their control. As a result of the lack of cover, any risk – from ill health preventing someone from working to property damage when a home is also a workplace – can have a serious financial impact.

Another way to look at the investment portfolio of an insurance company is in relation to systemic risks, including climate change.

Investment

As institutional investors, insurers represent a major pool of capital, with an estimated $27tn of assets under management.[21] That financial firepower can make a major contribution to driving the transition to a low carbon economy, which is estimated to require annual investment of around $2.4 trillion.[22] When engaging insurance companies, we look at how investment allocation decisions target climate change solutions and how substantial the investment is compared to the portfolio overall.

Another way to look at the investment portfolio of an insurance company is in relation to systemic risks, including climate change. The globally diversified portfolios of the largest insurance companies make it difficult for them to hide from the effects of climate change, since the portfolio is exposed to many areas of the economy. As a result, the biggest insurers potentially have a vested interest in directing capital towards investments that mitigate climate change because it can reduce portfolio risk.

UnipolSai Gruppo: Targeting low-income households through microinsurance

UnipolSai Gruppo primarily operates in the Italian market but participates in a micro-insurance project, 5-5-5 Mutual Microinsurance, in developing countries. This aims to expand the reach of mutual microinsurance in the Philippines, India, Kenya, Sri Lanka and Colombia. The target is to reach five million previously uninsured, low-income households with the support of insurers from developed economies like UnipolSai. While outside the company's typical operating profile, the project offers significant potential to contribute to risk mitigation for households with insecure livelihoods. We intend to engage on how the firm plans to use the lessons learned to seek out new sustainable value opportunities within core growth areas.

An estimated 26% of its premiums, amounting to €2.4bn, come from products with an environmental and social benefit, and it has a target to increase this to 30%. These products fall into four categories: underinsured people and businesses; sociodemographic changes; mitigation; and adaptation to climate change. The percentage of revenue from these categories is unusually high, and so we have discussed the company's approach to quantifying such benefits in engagement.

Phoenix Group: Targeting net zero

Phoenix Group made a series of ambitious sustainability announcements in 2020 and 2021, including setting a target for its investment portfolio to be net zero by 2050. It is also the first UK insurer to join the Partnership for Carbon Accounting Financials. The firm has quantified some investments that target sustainable development activities, including renewable energy. Given its momentum, we believe it can be more targeted in how it uses its £338bn portfolio to invest in SDG-orientated solutions.

[21] OECD. 'Insurance balance sheet and income 2019'. Accessed 14/05/2021. https://stats.oecd.org/Index.aspx?DataSetCode=INSIND.

[22] IPCC. '2018: Summary for Policymakers'. In: Global warming of 1.5°C. An IPCC Special Report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways, in the context of strengthening the global response to the threat of climate change, sustainable development, and efforts to eradicate poverty. World Meteorological Organization, Geneva, Switzerland, 32 pp.

Modelling

Profitability in insurance relies on being able to accurately predict aggregate (rather than individual) outcomes, including how frequently an event will occur and the average value of the loss. As a consequence, insurance companies have become experts at techniques including the analysis, modelling, forecasting and pricing of risk; these techniques can be applied to sustainability issues to help understand and manage them more effectively. Many sustainability issues are difficult to predict on a micro level, but on a global level such trends become more predictable; climate change is a good example of this, where forecasting local, acute impact is notoriously difficult since it is variable from year to year. However, the insurance industry has access to detailed data on costs stemming from climate-related events and consequent insurance pay-outs. This ability to quantify and assign a value to climate-related risk is vital not only to insurers but to the entire financial services sector. In fact, as well as being used internally for underwriting, insurance company data is now used by banks, asset managers and pension funds that seek to model changing risks across investment portfolios.

Zurich Insurance: Modelling climate-related risk

Zurich Insurance offers its modelling expertise as a service to help businesses understand natural hazard and climate-related risks. It employs three different climate modelling options with increasing levels of complexity depending on customer requirements: scenario mock-up; coupling climate models with existing catastrophe models; and in-house natural catastrophe modelling incorporating climate risks. The customer can then take action to manage risks identified, which could lead to reduced disruption from severe events and thus lower insurance premiums. We have engaged with the company on climate change reporting since 2017; further detail is available in highlights on completed objectives earlier in this update.

Appendices

Appendix A. Summary of six-factor heuristic framework for SDG *ex-ante* scoring

Factors to assess	Some evidence of SDG *ex-ante* potential, but requires deeper engagement…	… to more certain SDG *ex-ante* potential, and requires less intensive engagement
1. Business purpose & strategy How are SDG-related opportunities reflected in the company's purpose and the strategy it articulates to investors and society?	There may be articulation of how the company benefits society, but this is not central to its vision or strategy. The company may mention contributions to the SDGs but does not yet illustrate how it may deliver such benefits, nor how they guide culture, strategy or execution.	The company is focused on how its actions benefit society, and this is part of its core strategy. The company articulates how it will contribute to achieving the SDGs in its corporate purpose and through its culture.
2. SDG-related benefits of products & services How are SDG-related benefits provided through products or services? Are these key to the value proposition for customers or society?	Little articulation of the social or environmental benefits of products or services. Products or services with SDG-related benefits may not generate significant revenues today but might in the future. Engagement may be required to validate potential benefits.	Strong articulation of the social and/or environmental benefits of products or services. Value propositions are intended to deliver SDG-related outcomes. These may already generate substantial revenue.
3. SDG-related impact of operations How is the company driving SDG-related benefits through its operations, across the environmental and social dimensions within its control, or through its influence over its value chain?	Weak articulation of how the company's operations have a positive or negative impact. Intensive engagement may be required to determine the future potential for greater positive impact.	Material operational impacts are disclosed in positive and negative terms and how these may be improving over time. The company may exhibit leadership on some impacts relative to peers or has time-bound targets for a range of social and environmental risks and opportunities.
4. SDG-related capital allocation Is the company allocating capital to invest in growing products or services with SDG-related benefits? Has the company disclosed or quantified this?	Less disclosure of capital allocations to products or services with SDG-related benefit, or to investments which deliver impact through operations. Future opportunities are difficult to identify prior to engagement.	Disclosed capital allocation includes clear priorities for products and services with SDG-related benefits, or delivery of positive SDG impact through its operations.
5. Evidence & disclosure of SDG outcomes What SDG-related outcomes has the company, its customers or society realised? Have ESG or SDG impacts been quantified and disclosed?	Little evidence to demonstrate how the company is contributing to SDG-related outcomes for customers or society in quantified or qualitative terms. Disclosure may be a key area for engagement.	Ample evidence to demonstrate contributions to SDG-related outcomes for customers or society. Some quantification for incremental or total impact over time. The company explains its methodology for measuring such outcomes.
6. Engagement insight What have we learned from engagement in the past, and what is our engager's assessment of the company's future potential for impacting SDGs?	Demonstrates interest in engaging on SDG-related matters or opportunities, but this is unlikely to influence the business in the short term. Longer-term potential may exist, but significant barriers are apparent through engagement. More engagement is required to develop insight here.	Open to engagement dialogue and constructively acts on feedback and advice. The company actively applies the SDGs as a framework for informing its strategy, and will continue to build on opportunities for sustainable development.

Appendix B. Clarifying Our Approach

Our engagement approach is systematic and transparent. Our proprietary milestone system allows us to track the progress of our engagements relative to the objectives set for each company.

Objectives

We set clear and specific objectives within our company engagements to ensure we achieve positive outcomes. An objective is a specific, measurable change defined at the company – an outcome we are seeking to achieve. Each objective is tracked using milestones. Objectives are regularly reviewed until they are completed – when the company has demonstrably implemented the change requested – or discontinued. Objectives may be discontinued if the objective is no longer relevant, or because the engagement is no longer feasible or material.

> **We only consider companies to be engaged when we have an individual interaction with the company which relates to an objective or issue.**

We may engage with a company on multiple objectives at any one time, covering a variety of material ESG issues. An example of an objective could be: "Development of a strategy consistent with the goals of the Paris Agreement, including setting science-based emissions reduction targets for operating emissions (scope 1, 2 emissions)." Each objective relates to a single theme and sub-theme.

Issues

How does an objective differ from an issue, another term we use within our engagement? An issue is a topic we have raised with a company in engagement, but where we do not precisely define the outcome that we are seeking to achieve. This can be more appropriate if the issue is of lower materiality and so we do not anticipate engaging with the frequency required to pursue an objective. Or perhaps we are still in the process of identifying what type of change we may want to see at a company and so are not yet able to set a precise objective. Issues are frequently used for companies outside our continuous engagement programme, for example those where we typically engage only around the annual shareholder meeting and our voting recommendation.

> **We set clear and specific objectives within our company engagements to ensure we achieve positive outcomes.**

Milestones

To measure our progress and the achievement of engagement objectives, we use a four-stage milestone strategy. When we set an objective at the start of an engagement, we will also identify recognisable milestones that need to be achieved. Progress against these objectives is assessed regularly and evaluated against the original engagement proposal.

Actions

These are the interactions that take place between our engagement professionals and the companies or public-policy bodies with whom they are engaging. Every call, meeting or correspondence is recorded as an action. Actions can be linked to objectives or issues. We only consider companies to be engaged when we have an individual interaction with the company which relates to an objective or issue.

Appendix C. SDG Engagement High Yield Credit Hedged to USD GIPS® Composite

GIPS® Composite

Composite: **Federated Hermes Int'l SDG Engagement High Yield Credit Hedged to USD**

Index: **ICE BofA Global High Yield Constrained (USD Hdgd)**

Periods ending: **30 June 2021**

All information is quoted in USD

Annualised Returns (%)

	Composite Gross Return	Index	Composite Net Return (Assuming Maximum Fee)
Q2 21	2.24	2.41	2.08
YTD	2.24	3.17	1.91
1 Year	13.80	14.40	13.06
Oct-19 – Jun 21 (Annualised)^^	8.21	7.25	7.51

Annual Returns (%)

Year	Composite Gross Return	Composite Net Return	Benchmark Return	*Composite 3-Yr St Dev	*Benchmark 3-Yr St Dev	No of Portfolios	**Dispersion	Composite Assets (Million)	Firm Assets (Billion)
2019	4.04	3.87	2.90	N/A	N/A	<5	N/A	276.3	40.2
2020	7.94	7.23	6.48	N/A	N/A	<5	N/A	680.6	585.7

^^Represents composite inception period. See below for additional notes to the schedule of rates of return and statistics.

*Represents the 3-year annualised standard deviation for both the gross composite and the index returns. Statistic is used to measure the volatility of composite returns.

**Standard deviation is calculated using gross returns. Dispersion is not applicable ("N/A") for any period if fewer than five accounts are in the composite for that period.

The composite includes all discretionary portfolios following the SDG Engagement Global High Yield Credit Hedged to USD strategy run by the Federated Hermes Int'l Global Credit team and has an inception date of 1 October 2019. The objective of the strategy is to exceed the return of the benchmark over a rolling five-year period whilst delivering positive societal impact aligned to the United Nations Sustainable Development Goals ("UN SDGs"). The strategy may invest in a broad range of assets, either directly or through the use of derivatives, (including, but not limited to, equities, equity-related securities, Eligible CIS and/or financial indices, futures, options, swaps, debt, fx and money markets). The strategy through its investments in FDIs may be leveraged. The composite's benchmark is the ICE BofA Global High Yield Constrained Hedged to USD Index, which is designed to measure the debt market performance of global high yield debt. The benchmark contains primarily USD and EUR issues. The Index is rebalanced on the last calendar day of the month and the return is calculated on a total return basis. This composite was created in November 2019. Performance shown for 2019 is for a partial period starting 1 October 2019. Federated Hermes claims compliance with the Global Investment Performance Standards ("GIPS®") and has prepared and presented this report in compliance with the GIPS® standards. Federated Hermes has been independently verified for the period of January 1, 1992, through March 31, 2021. The verification report is available upon request. A firm that claims compliance with the GIPS® standards must establish policies and procedures for complying with all the applicable requirements of the GIPS® standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS® standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report. The management fee schedule for this strategy is 0.65% per annum. Gross of fees returns have been calculated gross of management, custodial fees and reclaimable withholding taxes, but after all trading commissions.

Federated Hermes is a global, independent, multi-strategy investment management firm. For GIPS® purposes, Federated Hermes is defined to include the assets of registered investment companies that are advised or sub-advised by the various Federated Hermes advisory companies. Effective September 30, 2020, for GIPS® purposes the name of the firm was officially changed to Federated Hermes. Firm assets on this report exclude assets affiliated with Hermes GPE and the advisory-only, model-based assets that may be included in other reports providing total firm assets. Interest income and dividends are recognized on an accrual basis. Returns include the reinvestment of all income. All market values and performance information are valued in USD unless currency is denoted in composite description. Annual composite dispersion is measured and presented using the asset weighted standard deviation of the gross returns of all of the portfolios included in the composite over the entire year. See the composite description language for a discussion on appropriate fees currently applied to calculate composite performance. Net composite results are based off model fees using the stated fee schedule. In addition, further fee information can be obtained from the firm's respective Forms ADV Part 2 Brochure Item 5. Additional information regarding the policies for valuing investments, calculating performance, and preparing GIPS reports, as well as a complete list and description of the firm's composites and pooled funds is available upon request. Past performance is not indicative of future results. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. See disclosures on the Schedule of Rates of Return and Statistics Reports for additional information.

Where the strategy invests in debt instruments (such as bonds) there is a risk that the entity who issues the contract will not be able to repay the debt or to pay the interest on the debt. If this happens then the value of the strategy may vary sharply and may result in loss. The strategy makes extensive use of Financial Derivative Instruments (FDIs), the value of which depends on the performance of an underlying asset. Small changes in the price of that asset may cause larger changes in the value of the FDIs, increasing either potential gain or loss.

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.

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

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

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

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- **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

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