Introducing our Sustainability Assessment Framework

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Federated Hermes
International

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As the sustainability landscape continues to evolve so too does the innovative approaches and tools of the Federated Hermes Global Equities team. In the first part of our sustainability series, we present the Global Equities' team new sustainability assessment framework and discuss how we leverage our in-house engagement insights to improve appraisal.

Key points

- Through our innovative tools and approaches as well as our pioneering research, we continue to evolve and advance best practice in the way that we evaluate ESG risk and sustainability.
- We have constructed a framework for evaluating a company's capacity to facilitate Sustainable Wealth Creation while minimising Sustainable Wealth Destruction.
- This framework lays the foundations of our proprietary Sustainable Opportunities Score, a quantitative measure of our sustainability assessment that aims to systematically identify companies that are best placed to benefit from the ever-increasing number of sustainable growth opportunities.

Sustainability: our past, present and future

Everything we do aims to deliver Sustainable Wealth Creation that enriches investors, benefits society and preserves the environment – for current generations and those to come. It's been our firm's sole purpose since its 1983 inception. One such pathway to achieve Sustainable Wealth Creation is Active ESG – responsible, active investing for long-term performance.

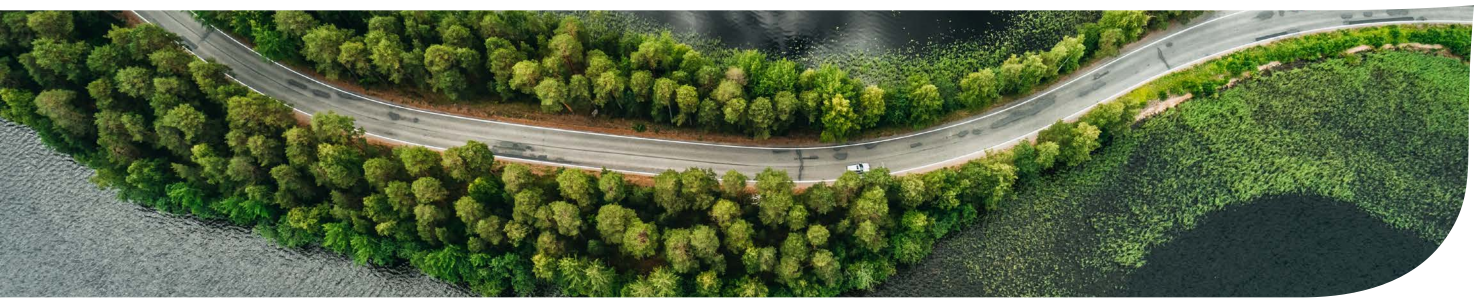
In 2007, the Global Equities team was established. We were tasked with integrating environmental, social and governance (ESG) criteria into the investment process. As a team, we achieved this, developing innovating ESG strategies, building proprietary tools and producing pioneering research.

In 2014, we conducted our inaugural study research to determine if ESG made a difference to shareholder returns, analysing five years' worth of data. In doing so, our research proved that ESG investing is more than just a feel-good phenomenon. Since then, we have continued to monitor how ESG factors impact shareholder returns – and every two years, we publish an intellectually honest assessment of the ESG investing environment. Our most recent study reinforced our earlier findings of a robust link between underperforming firms and poor social and governance metrics (see 'ESG investing: how Covid-19 accelerated the social awakening' for more information).

For almost a decade we have been incorporating ESG and sustainability metrics into our investment process through both a qualitative and quantitative approach (for more information, see 'A truly integrated approach to ESG'). The latter is achieved through our proprietary QESG score: a weighted measure of deliberately selected ESG metrics that rank the relative attractiveness of a company's ESG profile. Although both risks and opportunities are considered as part of our approach, the risk side has dominated due to the data that is systematically available, and our bottom-up approach. Our qualitative approach leverages industry-leading engagement insights from our stewardship business, EOS at Federated Hermes ('EOS'), to get a comprehensive understanding of which ESG-risk factors are most important to a particular industry or company, and how well management react to current and expected future ESG exposures. EOS seeks to address the most material ESG risks and opportunities through long-term, constructive, objective-driven and continuous dialogue at the board and senior executive level. With almost half of its engagements now more than nine years in duration, EOS is committed to realising positive, enduring change for our clients, the companies and the societies in which they operate. We therefore believe that quantitative and qualitative considerations are the best way to build a holistic view of a company's ESG behaviours.

Through our innovative tools and approaches as well as our pioneering research, we continue to evolve and advance best practice in the way that we evaluate ESG risk and sustainability, particularly as new data becomes available.

Whilst we have always assessed sustainability to some extent within our ESG framework, improved disclosure and data availability has now made it possible to appraise sustainability – and the opportunities that come with it – in its own right. And so, we have constructed a framework for assessing a company's capacity to facilitate Sustainable Wealth Creation while minimising Sustainable Wealth Destruction. In turn, this forms the foundation on which our Sustainable Opportunities Score, a proprietary, quantitative measure of our sustainability assessment, is being developed.



Appraising sustainability

At the international business of Federated Hermes, we believe that Sustainable Wealth Creation can be defined as delivering sustainable and superior long-term returns for investors. We also believe that stewardship is vital in achieving our purpose of generating Sustainable Wealth Creation.

Less frequently discussed, but equally as important, is the antonym of Sustainable Wealth Creation: *Sustainable Wealth Destruction*. For example, if a company derives 70% of its revenues from the construction and operation of wind turbines and 30% from building and operating coal plants, should the company be ranked positively in a sustainability assessment? Of course, the company's relative contribution to the delivery of Sustainable Wealth Creation is high: its investment in renewable energy sources are benefiting current and future generations. However, to us, an assessment of sustainability simply cannot be measured as the positives minus negatives, or Sustainable Wealth Creation less Sustainable Wealth Destruction. Certain behaviours cannot be cancelled out. – and so, this forms the foundations of how we appraise a firm's sustainability.

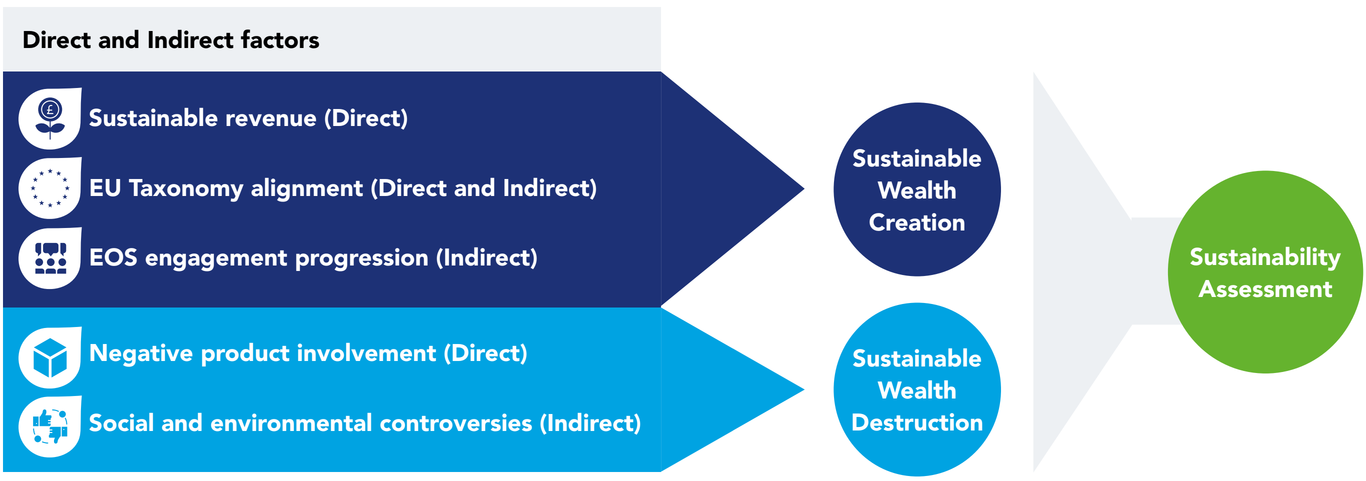
In our proprietary sustainability assessment, Sustainable Wealth Creation and Sustainable Wealth Destruction are comprised of various subcomponents. Broadly speaking, they can each be categorised in two separate themes: social (for example, the treatment of major diseases, nutrition, education, etc.) and environmental (for example, sustainable water, pollution prevention, alternative energy, etc.). In turn, each of these themes can be further disaggregated into direct and indirect factors.

- **Direct factor:** a product, service or investment of a company that has a tangible or quantifiable impact on Sustainable Wealth Creation or Sustainable Wealth Destruction (for example, revenues aligned to mitigating climate change).
- **Indirect factor:** a company's actions, strategic objectives or policies that are likely to facilitate or act as catalyst for Sustainable Wealth Creation or Sustainable Wealth Destruction (for example, a conflict minerals policy does not directly require a company to generate wealth sustainably, but it is likely to mitigate Sustainable Wealth Destruction, and may ultimately encourage direct Sustainable Wealth Creation going forward).

For each stock in our universe, we evaluate companies using a selection of both direct and indirect factors, before ranking them against their peers to create separate Sustainable Wealth Creation and Sustainable Wealth Destruction assessments. The criteria we are using are more narrowly focussed on sustainability, rather than ESG metrics which are quite broad. While factors may pertain to either the creation or destruction of sustainable wealth, we are careful to only incorporate indirect factors when a company has demonstrated some form of initial direct contribution to Sustainable Wealth Creation. Put simply, if a company does not directly invest in, or derive revenues from a product or service that can be explicitly linked to positive externalities for society or the environment, indirect factors will have no effect on a company's overall sustainability assessment. In Figure 1, we highlight some of the key factors used in our appraisal.

From our distinction between direct and indirect factors, it is clear that sustainable wealth is a multifaceted, complex variable that cannot be fairly measured using outcome-based metrics in isolation. Simply ranking firms based on their total sustainable dollars generated, or as a percentage of their total revenues aligned to sustainable themes, would paint an incredibly distorted picture of sustainability. Similarly, it would be naïve to label firms or industries as perpetual destroyers of sustainable wealth because part of their existing operation adds to global carbon emissions, for example. We believe that both redeeming factors, such as committed capital expenditure in sustainable investments, as well as harmful ones, must be considered. And so, we seek to measure the relative importance of these factors, how they interact with one another and the magnitude of their impact.

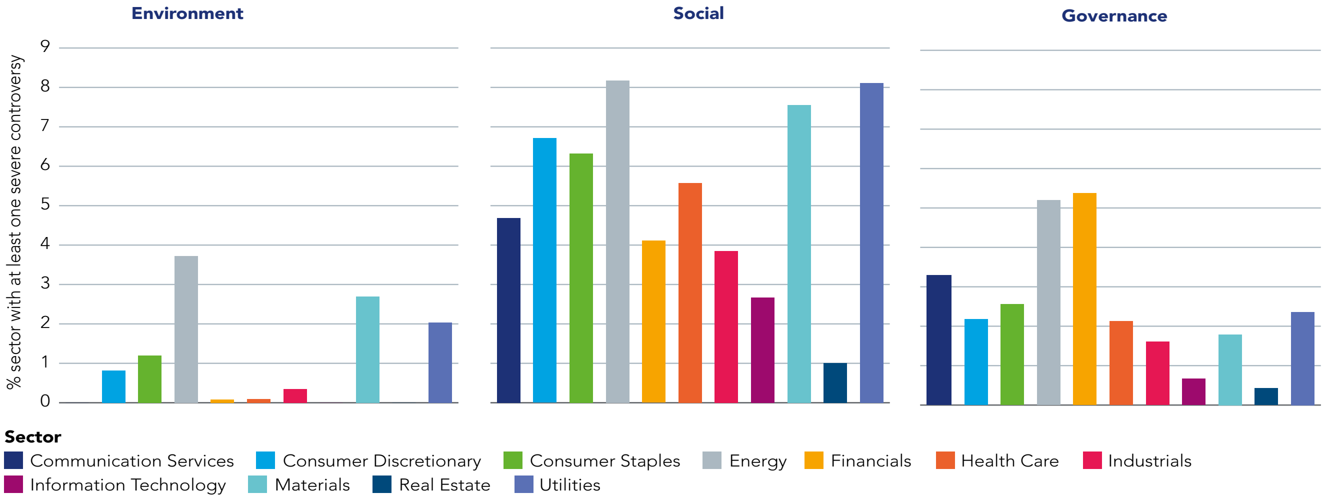
Figure 1. The Federated Hermes Global Equities Sustainability Assessment



Source: Federated Hermes, as at April 2021.

Figure 2. Environmental, social and governance controversies

Social controversies are the most prevalent for all sectors except Financials



Source Federated Hermes, MSCI, at 31 March 2021.

While all of our sustainability factors approach the measurement of sustainable wealth from different angles, there is one commonality: wherever possible, both the level and change are incorporated into the factor. Within our Sustainability Assessment framework, we systematically favour companies that are strong contributors to Sustainable Wealth Creation as well as firms that are contributing to Sustainable Wealth Creation at an increasing rate. Indeed, we believe this concept – that is, evaluating both the level and change simultaneously – should be a feature in any sustainability model.

A deep dive into sustainable revenue: third-party metrics, frameworks and taxonomies

Today, investors can use a plethora of publicly available and third-party datasets to measure the sustainability of their investments and rank their holdings accordingly. These vary from estimates of carbon emissions (direct factors), for example, to qualitative assessments of the relative strength of policies or strategies that outline sustainability goals (indirect factors). Furthermore, a number of taxonomies and frameworks have been proposed, sometimes industry-specific, that set out standardised methodologies for improving the way in which some of these direct factors are calculated. Examples include the framework proposed by the Partnership for Carbon Accounting for calculating financed emissions and the Science Based Targets Initiative.

Another example that is currently in its infancy but expected to have a meaningful impact is the EU Taxonomy classification system, establishing a list of environmentally sustainable economic activities. A product of the EU Technical Expert Group on Sustainable Finance, it was created, in part, to provide appropriate definitions to stakeholders on which economic activities are aligned with Sustainable Wealth Creation. Although the EU Taxonomy is still being tested through its initial implementation, it is incredibly detailed, and provides specific screening criteria and metrics to establish whether a particular economic activity, investment, or project, makes a substantial contribution to climate change mitigation and/or adaption. This goes beyond simply listing economic activities that are aligned with sustainable themes: it also sets out activity- and project-specific expectations in terms of compliance with globally accepted environmental standards, science-based targets, and emissions thresholds, for example. As such, the EU Taxonomy will be particularly important for assessing forward-looking Sustainable Wealth Creation. There are already discussions on a UK and Singapore taxonomy, highlighting the potential global adoption.

Currently, our Sustainability Assessment accounts for EU Taxonomy alignment on an eligibility basis – that is, if a firm's subindustry is directly linked to activities that are designated as contributing substantially to climate change mitigation or adaption, they are viewed favourably. As more data becomes available, we plan to evaluate individual firm activities and projects against activity- and project-specific criteria. The criteria are subject to revisions, but they will be refined as more companies start to report against the Taxonomy.

While many datasets, frameworks and taxonomies exist for the purpose of evaluating sustainability, perhaps one of the most well-known and longest-standing approaches is to measure the percentage of sustainable revenue a company is generating. As we mentioned previously, we consider this type of metric to be a direct factor, or contributor to, sustainable wealth. We have been making use of this data for many years.

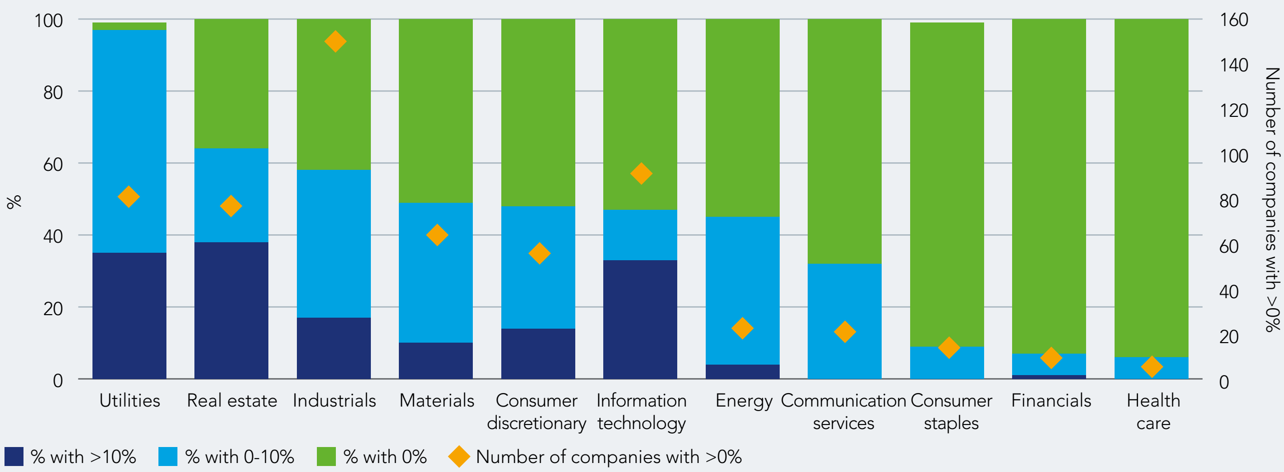
CASE STUDY

Sustainable revenue percentages

The sustainable impact dataset from MSCI identifies revenue from products or service with positive impact on the society and environment. It is updated at least quarterly and includes various indicators that estimate the percentage of revenue aligned to pre-defined environmental and social themes at a company level. Individual metrics are provided for specific environmental and social themes, (for example, the percentage of revenue aligned to "alternative energy") as well as metrics that aggregate these percentage revenues at a social or environmental theme level. We view such metrics as a good proxy for sustainable revenues, a direct factor in the creation of sustainable wealth. Within key MSCI indices, for example, the MSCI World, coverage is close to, if not 100%. Naturally, as new constituents are added to the index, it is unlikely that coverage is ever consistently 100%, but it is close enough for robust analysis within common global indices.

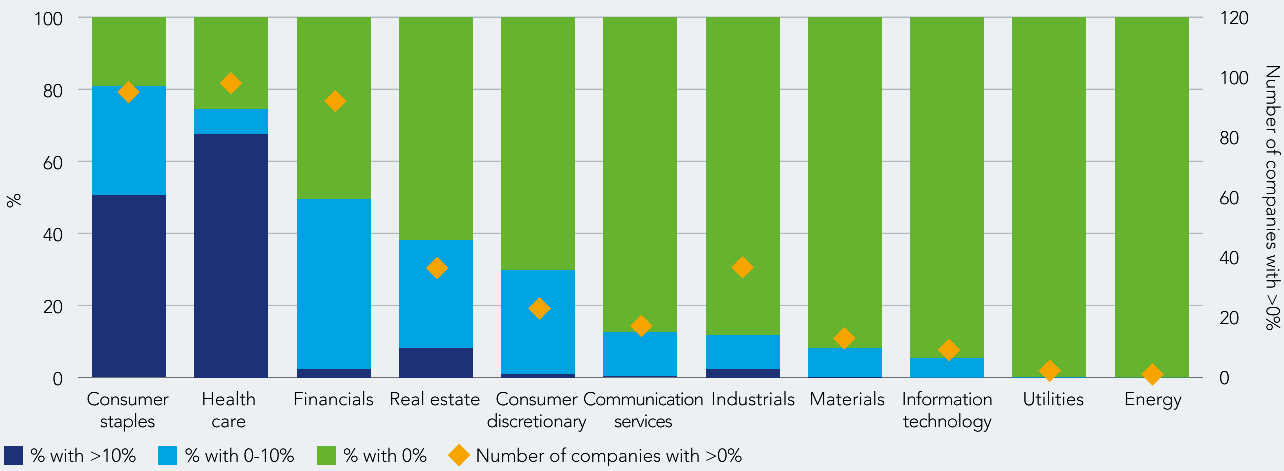
By using environmental and social percentage revenue indicators and calculating sector-level averages, we can gain insight into a key component of Sustainable Wealth Creation. Figures 3 and 4 demonstrate the number of companies identified as having at least some sustainable revenue and greater than 10% of revenue aligned to the environmental and social theme, respectively.

Figure 3. Percentage of sustainable revenue attributable to the environment theme



Source: MSCI, as at December 2020.

Figure 4. Percentage of sustainable revenue attributable to the social theme



Source: MSCI, as at December 2020.

Our observations from Figures 3 and 4:

- Sustainable revenue exposures for sectors and themes differ considerably. For example, more Utilities companies have environmentally sustainable revenue than companies from the Consumer Staples, Financials and Health Care sectors. This shows an almost opposite result for Social revenue. The data shows that 97.92% of MSCI World Utilities companies generate at least some sustainable revenue from environmental themes compared to only 0.14% for social.
- The difference in the magnitude of exposure to sustainable revenue within sectors is striking. Staying with the Utilities sector, 81 out of 85 companies were flagged as having sustainable revenue attributed to the environment. But this drops to just 26 when focusing on sustainable revenue alignment of more than 10%. It is also worth noting that MSCI estimates sustainable revenues when they have not been reported by the firm.
- The measurement of sustainability is highly dependent on the measures and conditions used. This becomes more exaggerated at company level. Figure 5 shows sample data from three companies in the automobile industry. Here we show this environmental data to highlight that depending on the methodology applied in ranking companies, there are different results or outcomes. It is helpful to acknowledge that each of these companies is a leader on at least one metric.

Figure 5. Measuring sustainability: different methodologies yield different outcomes

Environmental Revenue Exposure

1 **Tesla Inc:** 100.0%

2 **Suzuki Motor Corp:** 20.9%

3 **Toyota Motor Corp:** 18.7%

Environmental Revenue (Millions USD)

1 **Toyota Motor Corp:** $51,928

2 **Tesla Inc:** $24,578

3 **Suzuki Motor Corp:** $6,750

Environmental $ Revenue Growth (2019-2020)

1 **Suzuki Motor Corp:** 69.1%

2 **Toyota Motor Corp:** 3.1%

3 **Tesla Inc:** 0.0%

Environmental Revenue % Exposure Growth

1 **Suzuki Motor Corp:** 9.5%

2 **Toyota Motor Corp:** 0.3%

3 **Tesla Inc:** 0.0%

MSCI World Weight as at end May 2021

1 **Tesla Inc:** 0.84

2 **Toyota Motor Corp:** 0.31

3 **Suzuki Motor Corp:** 0.03

Contribution ($ per bps)

1 **Suzuki Motor Corp:** $2,250

2 **Toyota Motor Corp:** $1,675

3 **Tesla Inc:** $293

Source MSCI, Federated Hermes, FY2020.

So, which metrics matter? This is dependent on what it is you are trying to measure. Our Sustainability Assessment framework focuses on identifying companies that are highly exposed to sustainable themes and well-positioned to capitalise on sustainable growth opportunities. As such, within our framework we take a broad holistic approach to assess and identify strong sustainability exposure and also change in exposure.

That said, portfolio managers and asset owners may face potential issues when trying to interpret and use such statistics. They may ask: what percentage of sustainable revenue should be considered material, or immaterial? Does an arbitrary cut-off make sense? Are percentages sufficient, or do sustainable *dollars* need to be considered?

Of course, the answers to such questions are not straightforward. However, we think there are two key takeaways:

1 Portfolio managers and analysts need to employ a multifaceted, holistic approach when measuring sustainability. Sustainable revenues should be dissected with the same vigour as accounting revenues – exposure and growth should be appraised in their own right, and comparisons made against peers.

2 Asset owners and investors should be mindful of the nuances in sustainability data, and scrutinise such statistics, particularly when presented with aggregations or "binary flags".

In our view, looking at the percentage of sustainable revenue in isolation is not sufficient. We believe there are inherent biases in using such an approach: large cap conglomerates are not likely to rank well, for example, because their businesses often cover many product segments. Some conglomerates will be more sustainable than others, for example a food company which produces nutritional products as well as sugary snack foods, as opposed to a company which is a dedicated nutritional food supplier. Conversely, large caps will naturally fair well on dollar revenue variants, as we discussed previously. This emphasises why we must look at the multiple variants of a metric and, crucially, the level and the change of such variants, where appropriate.

Of course, sustainable revenues are just a small component of sustainability. One factor we believe to be equally important is the progression of the engagements conducted by EOS. Their engagement insights already form a significant part of our ESG integration process. For our Sustainable Opportunities Score, we use insights from our engagers and convert them into a signal for our assessment.

Engagement is a core component in Sustainable Wealth Creation

We believe that engagement is vital in promoting Sustainable Wealth Creation, reducing Sustainable Wealth Destruction, or both. Our engagement programme has seen a renewed focus on real-world economic impacts tied to environmental and social issues. With the creation of Climate Action 100+, we have seen strong collaborative engagement across many large institutional investors on environmental topics driving meaningful change at companies. Similarly on a social topic, the creation of the Investor Alliance for Human Rights in 2018 which we support as members has recently been involved in issuing practical guidance for investors following concern about alleged human rights abuses in the Xinjiang Uyghur Region. A collaborative engagement approach is beneficial: it ensures companies have a clear set of requests from shareholders.

Through our stewardship service, EOS addresses the most material ESG issues and the potential poor management of these issues through long-term and continuous dialogue, thereby seeking positive change. EOS links engagement objectives to environmental and social sustainable themes and measure their progress and outcomes on a rules-based milestone tracker (see Figure 6). Last year, EOS engaged with 1,245 companies – up 20% on 2019 – covering 3,965 issues and objectives (compared to 2,854 in 2019). Almost half of these issues were linked to social or environmental themes.

Figure 6. The EOS engagement milestone tracker

Source: Federated Hermes, as at April 2021.

CASE STUDY

Engaging with Proctor & Gamble

In Q3 2020, we had a call with Proctor & Gamble to engage on governance, climate change, diversity, and human rights issues. We discussed the topic of increasing minimum shareholding requirements and the need to consider diverse candidates in its appointment of two new independent directors – a governance issue that we have raised previously. Proctor & Gamble said there will be public communication on these topics soon. The company also agreed to align its next sustainability report with the TCFD recommendations. In addition, we discussed how the company can use its brand influence to stand for racial justice and disclose gender and racial breakdowns at all hiring levels. The company agrees it can do more. In response to the Rainforest Action Network's allegations of human rights violations in its palm oil supply chain, the company confirmed that not all of its palm oil is Roundtable on Sustainable Palm Oil (RSPO) certified. However, it is improving supply chain traceability capabilities, with the goal of full RSPO certification by 2022.

While this engagement tackles an array of issues, our Sustainability Assessment focuses only on environmental- and social-linked objectives – that is, climate change, diversity, and human rights. The engagement progression component of our Sustainability Assessment will systematically capture the company's decision to align its sustainability report to TCFD, indicating progression on the climate change objective and incorporating this information in our appraisal. However, as no clear diversity-related commitments were made, no information would be incorporated into our assessment, other than a small contribution as the company is continuing to move towards disclosure of a specific target by acknowledging the need for greater ambition. Similarly, as the firm had previously announced its 2022 RSPO certification goal, it would not be recognised in our assessment. When it achieves this goal, thereby completing our human rights objective, it will have a significant positive impact on the company's overall Sustainability Assessment.

Our Sustainability Assessment leverages engagement progression, by systematically rewarding companies that have realised milestone progression or objective completion on an issue that can be directly linked to the creation of sustainable wealth. By rewarding past objective completion, we capture the *level* of indirect Sustainable Wealth Creation. By rewarding milestone progression, we capture *change* in an indirect sustainability factor. Simply put, the company has acted in a way that increases its facilitation of Sustainable Wealth Creation or a reduction in Sustainable Wealth Destruction.

Naturally, the relationship between Sustainable Wealth Creation themes and the Sustainable Development Goals (SDGs) is strong. Unlike some of the SDGs which are linked to governance themes, our assessment only considers milestone progress or objective completion for social and environmental themes.

Identifying sustainable opportunities

Our sustainability framework is a multi-factor assessment that evaluates a company's capacity to facilitate Sustainable Wealth Creation while minimising Sustainable Wealth Destruction. We have demonstrated that dollar or percentage contributions to Sustainable Wealth Creation cannot be the sole basis for an appraisal. Growth in sustainable revenues, however small, must be considered, as well as a company's ability to execute on strategies linked to Sustainable Wealth Creation or the mitigation of Sustainable Wealth Destruction. Operations, investments, or actions that destroy sustainable wealth need to be accounted for, with particularly egregious instances heavily penalised.

Ultimately, companies that are best placed to benefit from the ever-increasing number of sustainable growth opportunities, should by construction, also outperform on that journey to self-sustainability. Our Sustainability Assessment, which lays the foundations of our Sustainable Opportunities Score, will help us to identify these opportunities early and seek to deliver strong, risk-adjusted returns while simultaneously benefiting society and the environment along the way.

- *In the second instalment of our sustainability series, we will provide an in-depth exploration of our Sustainable Opportunities Score.*

Federated Hermes

International

Federated Hermes

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

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

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

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

Our investment and stewardship capabilities:

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

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