Federated Hermes SDG Engagement High Yield Credit

H1 2020 Report
August 2020

Federated Hermes International

www.hermes-investment.com
For professional investors only

Contents

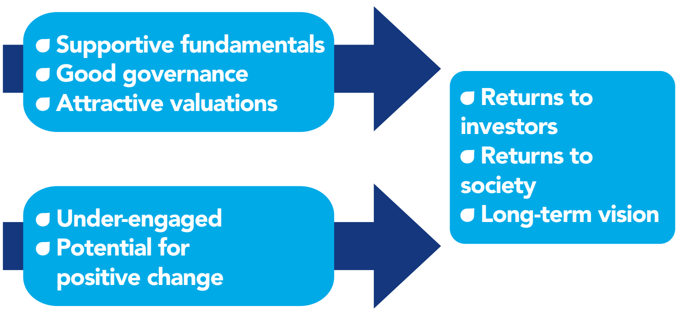
SECTION 1

How we invest and engage

In launching the SDG Engagement High Yield Credit Fund (SDGHY) in October 2019, we aimed to deliver into two, colinear objectives: strong financial performance for investors and positive social and environmental impacts that contribute to achieving the 17 Sustainable Development Goals (SDGs).[1] This objective embodies a core belief of the international business of Federated Hermes: that investment outperformance and superior ESG outcomes are self-reinforcing.

Throughout development and launch, we planned for SDGHY to be a long-term strategy capable of weathering credit cycles. Of course, we did not expect its resilience to be tested so soon by the coronavirus pandemic. That said, we are encouraged by what we saw: outperformance of its benchmark in the most volatile year since the financial crisis and substantial progress on engagement activity.

Figure 1. Drivers for the colinear objectives of SDGHY



Source: Federated Hermes, as at June 2020.

Throughout development and launch, we planned for SDGHY to be a long-term strategy capable of weathering credit cycles.

As a global high-yield credit fund, the financial performance of SDGHY is benchmarked against the ICE BAML GHY Index. The impacts it seeks are reported in line with the objectives we set in engagement with companies, and through their contribution to the SDGs. The impact objective extends from our investment philosophy that an investor's position as a financial stakeholder allows – if not obliges – them to engage in constructive dialogue with companies. By positively influencing corporate behaviour, investors, the companies they invest in and engage with, society and the environment can all benefit.

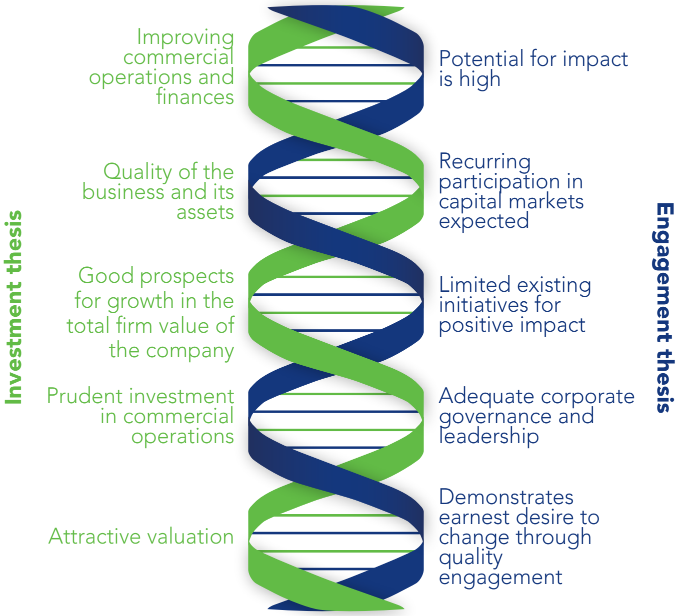
SUSTAINABLE DEVELOPMENT GOALS

Embedding this impact objective into a traditional, long-only high-yield fund presents challenges. We seek companies which have both attractive investment fundamentals and a willingness and ability to effect positive change for society and the environment.

Creating enduring change takes time, so we also require our portfolio companies to be survivors in a highly levered universe. Within the global, hard-currency high-yield market, we favour companies with a recurring presence in capital markets, a stable shareholder base, a proclivity to strong disclosures, reporting and transparency, and the credit strength needed to participate in long-term engagements with us and change their businesses for the benefit of a wide range of stakeholders.

Creating enduring change takes time, so we also require our portfolio companies to be survivors in a highly levered universe.

Figure 2. Stronger as one: the investment and engagement theses of SDGHY



Source: Federated Hermes, as at June 2020.

Portfolio companies must satisfy thresholds for governance and credit strength. This must be the case because we expect to work with these under-engaged companies – many of whom could be considered laggards when viewed through the lens of the SDGs – for the long term. By leveraging more than 37 years of intellectual capital and experience in active ownership, we seek to convert the potential to create positive change into real impact. In doing so, we assert that these companies become more sustainable, profitable and resilient, delivering returns to our investors.

[1] For more information on the SDGs, visit: https://www.un.org/sustainabledevelopment/sustainable-development-goals/

SECTION 2

How we assess corporate potential for SDG impact

Our colinear objectives for investment outperformance and SDG impact are the bedrock for how we established and manage our portfolio.

We seek to deliver returns to society by identifying companies with *ex-ante* potential to effect positive change, in the context of the SDGs, and engage them to advise on and help deliver that change. However, there are a complex range of factors we consider when assessing how likely a company is to contribute to positive outcomes for relevant SDGs.

SDG scoring

Assessing businesses for positive SDG impact is no easy task and is compounded by the state of some companies within the high-yield universe. Some companies we invest in do not always lead their sector in disclosing how products, services, operations or strategic investments can drive positive SDG-related impact or have done so already. Some impacts that we believe are possible, or even highly likely, cannot be assessed without substantive engagement dialogue. To do this, it is essential to hold a financial stake. We must therefore establish a hypothesis for potential change in our pre-engagement assessments for each company. Ultimately, this manifests as an SDG score of one to five, with a score of one representing a high likelihood for delivering positive, substantial outcomes in line with one or several SDGs in the future, helping us assign an appropriate weight to the company within our portfolio.

Crucially, the SDG score confirms our focus on companies that we believe demonstrate a promising combination of *potential for impact and willingness to change*, as demonstrated in engagement and publicly available data, and reflects our level of conviction in the ability of companies to drive positive change over time. Moreover, this pre-engagement assessment helps focus engagers on the right conversations to have with management teams from the start and contributes to the deeper analysis and research we conduct to drive substantive engagement.

SDG scores have been integral to our approach since day one. Before launching SDGHY, we built a detailed heuristic to help assess companies across six factors prior to engagement (see figure 3 overleaf). Within each factor, there are five levels of achievement used as a common lens for assessing SDG potential, assessed using publicly available knowledge. Quantitative data related to SDG impact is sometimes available. For example, current achievements or targets related to climate change (SDG 13) or clean energy (SDG 7) are quantified at many companies. However, the heuristic allows us to make reasonable SDG-based assessments where disclosure is purely qualitative, only part-quantified, or is retrospective with little insight on future ambitions.

Our sixth factor, *engagement insight*, is unique among asset managers. Thanks to the 15-year history and reputation of our global stewardship team, EOS at Federated Hermes (EOS), we draw on established relationships and past insights for many companies. Indeed, 50% of EOS's engagements are currently longer than nine years in duration, and a significant number have been running for a decade or longer. This helps us to understand influential qualitative factors, such as corporate and management team cultures, or the viewpoints that companies hold regarding material risks and opportunities. A long-term focus is anchored in our deep understanding of the fundamentals of the companies we invest in, and these engagement insights strengthen our views.

Crucially, the SDG score confirms our focus on companies that we believe demonstrate a promising combination of potential for impact and willingness to change

Evolving our lens for impact

In H2 2020, we will pilot a selection of sector heuristics for identifying potential for ex-ante SDG-impact. This will provide three main benefits:

1. When we assess companies for impact before investing, our hypotheses are strengthened earlier in the process by leveraging the latest specific insights gleaned through previous research, analysis and engagement from a range of invested peers in that sector.
2. It will allow us to compare issues which are perennial across the sector and have greater potential to drive SDG impact. A comparative benchmark aids us in quickly focusing engagement on where the greatest potential lies.
3. It informs a future basis for better measuring some SDG impacts, as non-financial data becomes more widely available across companies.

Figure 3. Preparing to engage: six assessment factors

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 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.
3. 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.
4. 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.
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.

EOS: a unique advantage

The companies we engage often understand that EOS, our global stewardship team, works on behalf of asset owners from many countries with like-minded priorities for responsible investment and engagement.

EOS, which has US$1.1tn in assets under advice, is a pioneer of global stewardship and continues to advance best practice. Acting on the priorities set by clients, it develops company-specific engagement strategies, informed by the deep understanding of sectors, engagement themes and markets within its team.

SDGHY benefits from highly experienced senior engagers that lead efforts to initiate relationships or deepen long-running dialogues at 44 companies in our portfolio. Many of these companies are also held by EOS clients. Representing combined, outsized financial stakeholdings at many companies affords EOS deeper access and more enduring dialogue over the long term.

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Representing combined, outsized financial stakeholdings at many companies affords EOS deeper access and more enduring dialogue over the long term.

EOS: leaders in stewardship and engagement

$1.1tn

assets under advice

and engaging a market capitalisation of

$3.2tn

Source: Federated Hermes as of 30 June 2020

43
people

13
nationalities

10
languages

Diverse industry and academic expertise

Launched
2004
with a legacy dating back to
1983

Almost
50%
of engagements have taken place for
8 years or longer

Co-leader of
370
investors in the Climate Action 100+ collaboration

2020 vision:
stewardship to evolve beyond integration to drive investing

SECTION 3

Investment update

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

Fraser Lundie, CFA
Head of Credit

Nachu Chockalingam, CFA
Senior Portfolio Manager

By the time the coronavirus outbreak drove volatile swings in valuations throughout debt capital markets, SDGHY was fully invested.

Although the Fund has outperformed its index since its 2 October 2019 inception, it was not immune to the acute, short-term swings in sentiment in March and April.

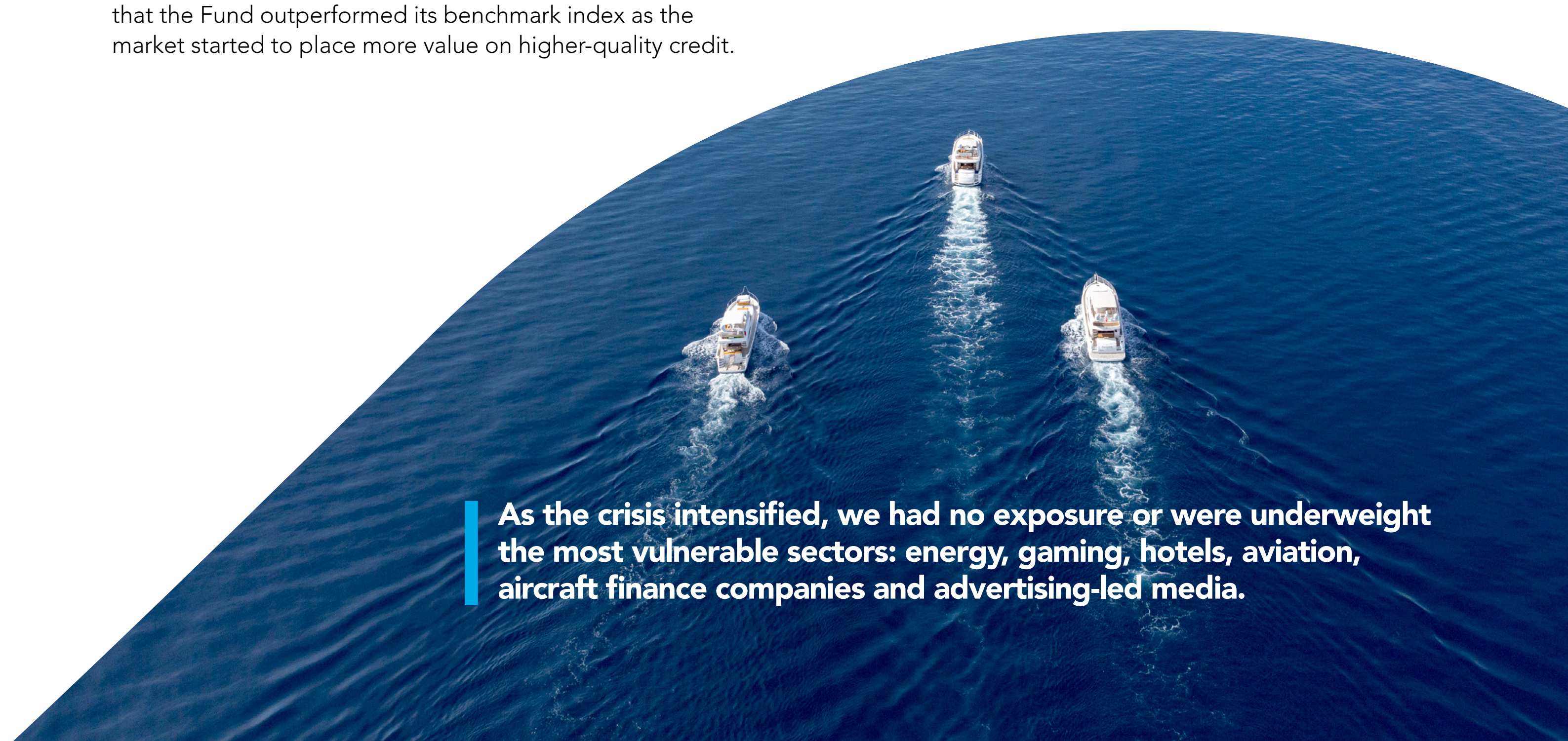
> **We found it particularly encouraging that many companies continued to discuss long-term sustainability issues and planning, including activities that will help achieve the SDGs, throughout this period.**

As the crisis intensified, we had no exposure or were underweight the most vulnerable sectors: energy, gaming, hotels, aviation, aircraft finance companies and advertising-led media. March and April were challenging, as there was a sell-off in higher-quality and liquid names as investors sought cash. However, our lack of exposure to troubled sectors meant that the Fund outperformed its benchmark index as the market started to place more value on higher-quality credit.

In our view, the nearly seamless progress of our engagement activity proves the enduring qualities of sustainable investing. In H1, led by Aaron Hay, our Lead Engager, Fixed Income, 17 engagement professionals have driven 205 engagements across companies comprising some 78% of the fund. Prior to the global lockdowns that commenced in March in the UK and Europe, this included an expansive engagement trip to meet companies across the US, including General Motors, Dell Technologies, Altice USA, Alcoa Corp, EnLink, Huntsman, Range Resources, Calpine and Enterprise Products Partners. Although our ability to meet face-to-face has been highly restricted by current conditions, we made significant engagement progress in the first half of the year. We found it particularly encouraging that many companies continued to discuss long-term sustainability issues and planning, including activities that will help achieve the SDGs, throughout this period. This underscores the merit of our approach of investing in and engaging with larger high-yield companies with a recurring presence in capital markets, which are more likely to have the resources and management vision to focus on sustainability matters.

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 the above 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.



> **As the crisis intensified, we had no exposure or were underweight the most vulnerable sectors: energy, gaming, hotels, aviation, aircraft finance companies and advertising-led media.**

SECTION 4

Engagement progress and highlights

Aaron Hay
Lead Engager, Fixed Income

Our engagement strategy and annual programme of activity are focused on engaging all of the companies in SDGHY. As of 30 June 2020, we engaged 78% of the 105 companies we invest in.

This is an exceptionally strong result in the first six months of our inaugural engagement programme, and gives us confidence that we can achieve 100% engagement across the portfolio by the end of the year.

As of 30 June 2020, we engaged
78% of the **105**
companies we invest in.

In H1, we completed 205 engagement actions at 82 companies. This is indicative of the robust activity required to quickly initiate engagements with companies – particularly those the international business of Federated Hermes is approaching for the first time. A matrix of senior engagers undertook this work: our Lead Engager, Aaron Hay, conducted 79 engagement actions with 44 companies, and was thoroughly supported by EOS, with 16 engagers carrying out an additional 126 actions.

In H1, we completed
205 engagement actions with **82** companies

Although some companies are being engaged through SDGHY for the first time, many continue longstanding dialogues with EOS. For example, Jaime Gornsztejn, who leads EOS's corporate engagements in Latin America and Russia and in the industrials and capital goods sectors, carried out 24 engagement actions on behalf of the fund in H1. Similarly, senior engagers Roland Bosch, Kimberley Lewis and Andy Jones performed a combined 61 actions in the financial services, mining and materials and healthcare sectors. Without EOS, it would be challenging to meaningfully engage more than 100 companies on a regular basis.

In August 2020, a second dedicated engager will join the SDGHY team, doubling our capacity for bespoke high-yield engagement.

In the first half of 2020, our Lead Engager conducted
79 engagement actions, and
16 EOS professionals delivered a further **126** actions

EOS senior professionals led engagement for 35 SDGY companies in H1

Kimberley Lewis
Sector lead: Pharmaceuticals & Healthcare

Jaime Gornsztejn
Team lead: Emerging Markets (ex-China)
Sector lead: Industrials & Capital Goods

Roland Bosch
Sector lead: Financial Services

Andy Jones
Team lead: Continental Europe
Sector lead: Mining & Materials

Diana Glassman
Sectors: Financial Services, Oil & Gas, Technology

Marija Rompani
Sector lead: Chemicals

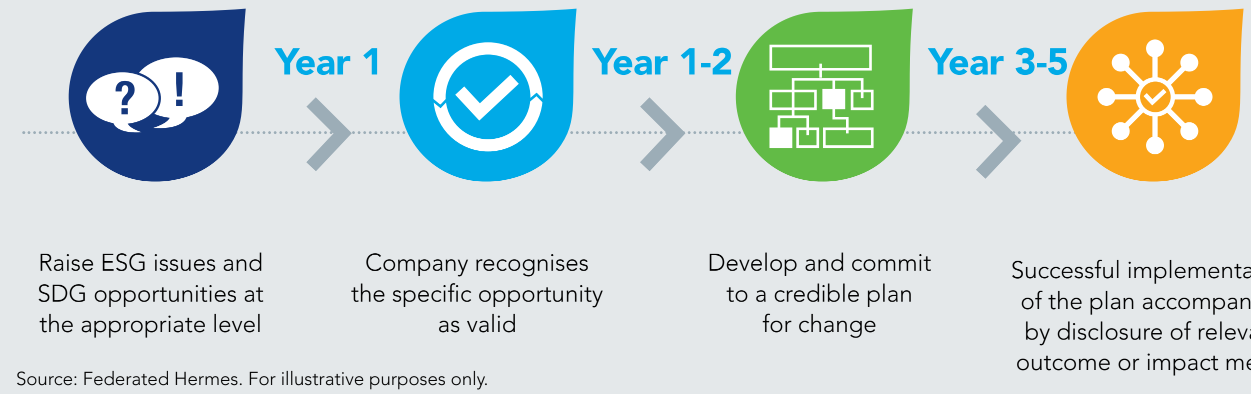
Engagement-driven investing: our approach

We assess where and how to achieve positive SDG impact in each portfolio company and engage their boards and management teams to understand and help achieve such change. For example, through engagement, we may identify and discuss new markets for much-needed products, more equitable employment models, ambitious climate action targets, or how companies can exert their influence to improve sustainability practices throughout their value chains.

Engagement dialogue must, however, start where companies are at today. We see the SDGs, and the range of ESG risks and opportunities we engage on, as part of a long-term journey for companies (see figure 4). The nature of high-yield issuers means that not every company is able to immediately respond to or act on ambitious, impact-based feedback, advice or engagement from progressive investors. For example, it would be challenging to ask a telecommunications company in emerging markets to quantify social impact for individuals across each of its service offerings.

However, it is reasonable to ask the company to consider piloting an approach in the short term for measuring SDG-related socioeconomic outcomes from one service, thereby starting to demonstrate SDG-linked purpose and impact to investors and stakeholders.

Figure 4. Process with purpose: engaging companies on the ESG issues and the SDGs



Source: Federated Hermes. For illustrative purposes only.

We always consider where a company is starting from and what positive developments it could achieve on short, medium and long-term timescales. This is reflected in many of the issues and objectives for change we identify and establish after we begin engaging each issuer. For some high-yield issuers, the objectives we set are engagement building blocks. For example, before fully exploring the potential for SDG impact, we may seek an objective of considerably enhanced, quantifiable, year-over-year ESG disclosures across all material issues so we can later consider setting objectives that focus on measurable, SDG-linked initiatives for the company.

Building influential long-term relationships

From the engager's perspective, starting where companies are at is a necessity. It would be difficult to offer challenging feedback or ask for escalations in nonfinancial disclosure, sustainability targets or even core strategy in a first engagement. The early stages of engagement require us to establish credibility through sophisticated perspectives on the SDGs, a nuanced understanding of the pressures faced by the company and the sector it operates in, and by demonstrating our understanding of its business model. We also develop an understanding of the cultures within businesses and their management teams, their strategic perspectives and thinking about the future. Such discussions are informative for our *ex-ante* SDG-impact hypotheses, and for the influence we seek to exert on business models, operational practices, disclosure standards, corporate governance and more.

At this stage in the portfolio's life, it is not unusual for engagement commence with investor-relations (IR) teams before involving senior management and the board. Yet we are pleased with the access we have been afforded to management teams and directors. Although 41% of our engagement participants were members of IR teams in H1, 36% consisted of C-level executives, other senior managers and heads of sustainability. We held six engagements that included CEOs and 10 with chairs or board directors. We have fertile ground for relationship building.

Figure 5. Corporate roles of the people we engaged with in the first half of 2020

	%
Investor relations	41.2
Executive management team	12.4
Other company executive	12.4
Head of sustainability	10.7
Company secretary	9.0
Other	5.1
CEO	3.4
Chair	3.4
Board director	2.3

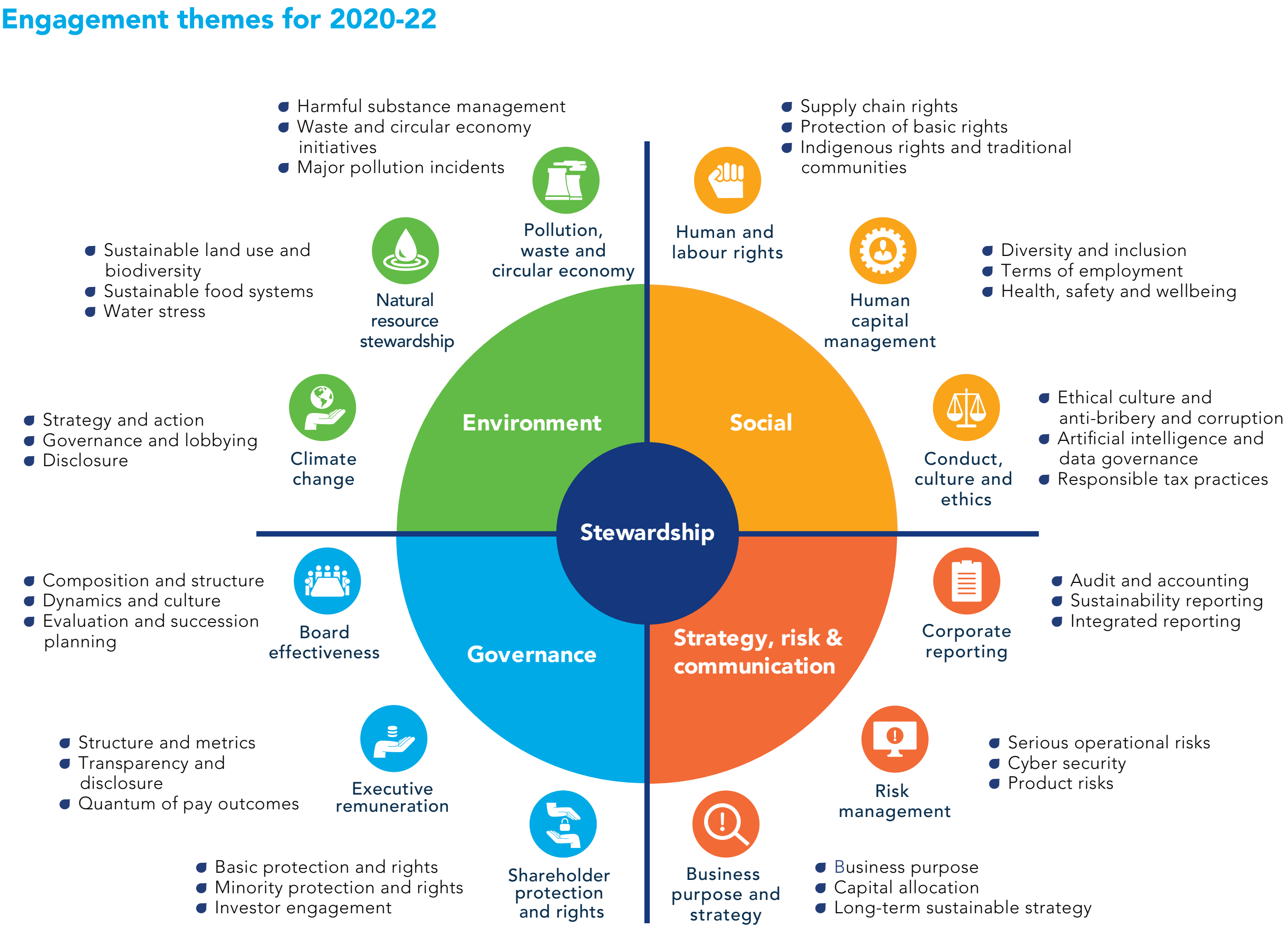
Source: Federated Hermes as at 30 June 2020.

Holistic engagement across the ESG spectrum, six months in

The foundation of our strategy is a thematic model for holistic engagement across ESG opportunities and risks, developed by EOS through decades of experience. Our engagement planning radiates from the EOS Engagement Plan and key themes for 2020-2022 (see figure 6).

In H1 our engagement dialogues reached well beyond the SDGs. We always engage on material issues that companies face – even when the SDGs are the focus – because of the holistic nature of the stewardship model we believe is crucial to successful engagement and financial performance.

Figure 6. Holistic engagement: EOS's current agenda

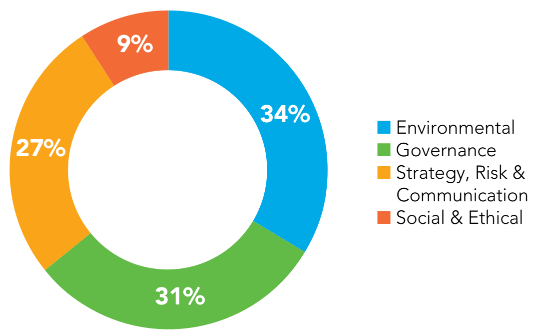


Source: EOS at Federated Hermes as at March 2020.

Key engagement themes and focus areas in H1

Through 205 engagement actions, we discussed and advised on 522 issues and objectives identified among 82 companies. The volume and depth of the dialogue we achieved reflects the resources and influence that 17 active engagers brought to the portfolio in only six months. Looking back on the first half of the year, our focus on environmental, governance, strategic and communication issues is evident. Based on our many years of experience in initiating new engagement programmes, we are delighted with the engagement cadence, or rate of activity, that we have achieved at this stage of the Fund's life.

Figure 7. H1 engagements categorised by ESG and strategic themes



Environmental and governance topics featured prominently in 205 engagements throughout H1, reflecting strategic conversations linked to the annual general meeting (AGM) season and the universal urgency of climate change.

Source: Federated Hermes as at 30 June 2020.

Governance: a gateway to wider dialogue

In the first half of 2020, 31% of our engagements focused on governance. This is due to the strategic engagement avenues available in voting season, centred on AGMs in March and April for most companies in the portfolio. We engaged not only on behalf of SDG High Yield but also fixed-income and equity assets in the EOS engagement plan. This means we often provided voting recommendations for 1% or more of the voting rights at many companies, placing our voice amongst the top 20 owners.

In the first half of 2020,

31%

of our engagements focused on governance.

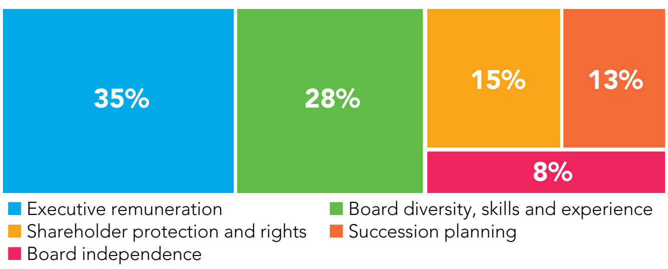
We provide meaningful, practical and actionable advice through a combination of pre- and post-AGM discussion and correspondence to senior management teams and directors, informed by governance principles developed for each geography by EOS. This is a valuable foundation for building wider dialogues on meaningful enhancements to enterprise risk oversight, remuneration, board skills, composition and independence, among many other material matters, reflecting the interests of equity and fixed-income investors with long-term mindsets.

Based on the collective experience of EOS, we cannot understate the power of voting on equity holdings as a strategic engagement tool. Done well, it leads to broader and deeper dialogue, through an initial path of substantive and frank discussion on how companies can improve governance to benefit *all* external investors. Moreover, many companies now face shareholder resolutions which focus on corporate action for societal challenges, including climate change, fair employment practices, diversity and inclusion, and labour practices for workers in extended supply chains. This can be a direct doorway to deep discussion of challenges with close links to many SDGs. Given our collaborative work with EOS, our fixed-income engagements through SDGHY can be complemented by voting decisions on the equity side.

This is reflected by the range of topics we raised, including 52 engagements which focused on changes in executive remuneration, and 42 that highlighted potential enhancements to the skills, experience and diversity of boards which we believe should improve company oversight on behalf of long-term investors and wider societal stakeholders.

This naturally opens doors to SDG, strategy and risk dialogue over the course of annual engagement cycles, so we expect the focus to shift towards non-governance conversation in the second half of each year.

Figure 8. Governance focal points in our H1 engagements



Source: Federated Hermes as at 30 June 2020.

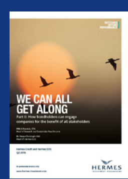
Aligned through engagement: fixed-income and equity investors

It is not always evident at a glance, but our work on strengthening governance by making voting recommendations for EOS's equity investors, combined with our subsequent strategic engagement, is also beneficial to the interests of long-term creditors.

After meeting **Country Garden** in February, we wrote to the company explaining why we recommended voting against management on several items at its AGM. This led to a far deeper exchange of views: the company responded by explaining the skills and knowledge of several directors we believe are over-boarded or insufficiently independent. We indicated that although these directors understand Country Garden, a refreshment programme should emphasise the comprehensive skillsets required, a deliberate transfer of knowledge to newer directors, avoidance of over-commitment at other boards, and recruitment that emphasises a definition of independence which is acceptable to international equity and credit investors. The company indicated it will seriously consider how to reform the board's accountability to investors in light of this feedback.

Similarly, after meeting with **Levi Strauss & Co,** our voting and governance assessment found that there was potential for reforming how minority investors' interests were represented to its relatively new board after a recent public flotation. We believe the board should phase out staggered director elections to provide annual accountability to minority shareholders and investors. We also indicated support for efforts to demonstrate how, over the long term, the multiple share class structure might be 'sunsetted'. Conversely, we believe the company's executive remuneration programme is aligned with interests of long-term equity and credit investors. This thoughtful approach is indicative of investor-friendly reforms that Levi Strauss may be willing to consider.

Engagement for the mutual benefit of long-term equity and credit investors was a highlight of "We Can All Get Along", the 2018-2020 paper and podcast series by Mitch Reznick, Head of Research & Sustainable Fixed Income at Federated Hermes, and Dr Hans-Christoph Hirt, Head of EOS at Federated Hermes. We assert that the shared interests of bond and shareholders in companies provide incentives to jointly engage companies – and generate positive outcomes by doing so.



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

Dr Hans-Christoph Hirt
Head of EOS at Federated Hermes

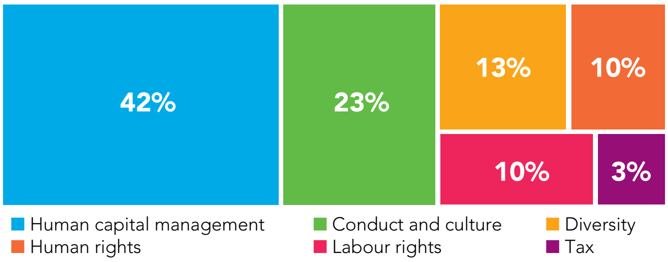
Encouraging data-driven ESG reporting across the high-yield universe

Social engagement: responsive corporate action in the coronavirus era

Unsurprisingly, engagement on social issues in 2020 has focused on workforce and human-capital risks companies faced during the coronavirus pandemic. We focused intensely on this topic given the risks to workforce management and the individual health of employees. Moreover, this is often a natural place to start with companies that are new to engagement with Federated Hermes.

We expect our 2020-2021 engagements on social matters to diversify and encompass a range of topics relevant for driving impact on SDGs including decent work (SDG 8), increasing gender equity across management teams and workforces (SDG 5), and action on reducing wider economic, cultural and ethnic inequalities in companies and their value chains (SDG 10). However, conversations on gender and ethnic diversity on boards has already featured prominently in governance-focused engagements, given that our voting recommendations cover decisions on directors, independent chairs, and chairs of nominating committees.

Figure 9. Key social themes in our H1 engagements

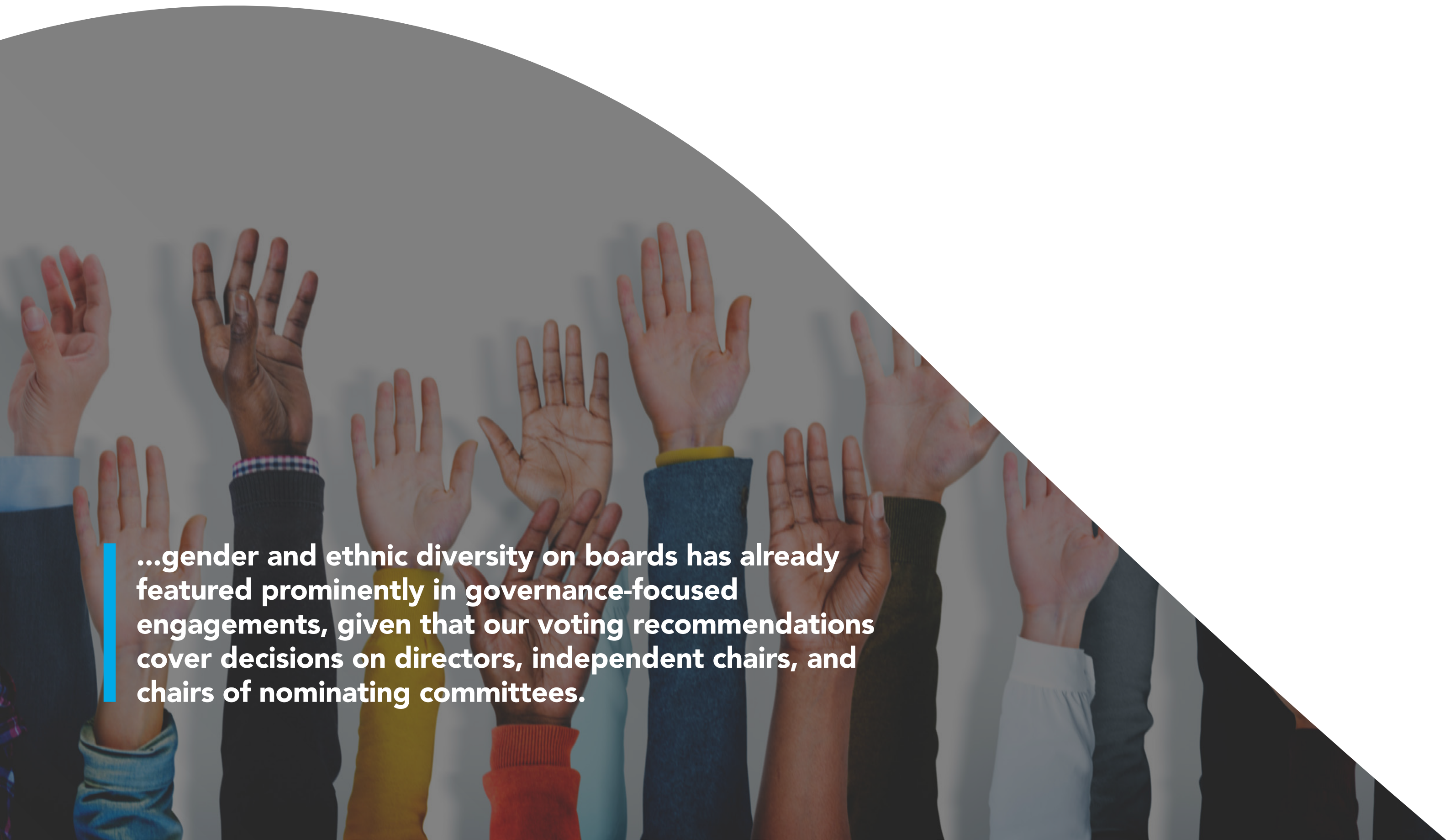


Source: Federated Hermes as at 30 June 2020.

We focused intensely on social issues given the risks to workforce management and the individual health of employees during the pandemic.

Responsible employment practice in a crisis

The coronavirus crisis featured in human capital management and corporate strategy engagements, given concerns ranging from financial challenges to how jobs are safeguarded and employees protected from an epidemic that poses risks to entire sectors. We discussed worker safety and the continuity of voice and data communications services at several telecommunications firms, including **T-Mobile US Inc, Ziggo BV,** and **Virgin Media Limited,** and were heartened that all demonstrated a high degree of preparedness and rapidly executed business continuity and disaster-response plans. Common among these companies was a dual objective to ensure the health of the workforce and critical infrastructure could cope with increased usage volumes. Similarly, product-based companies **Ball Corp, Orbia, Alcoa, Trivium, Aker BP** and **Country Garden** were all impacted by the pandemic in unique ways, but avoided negative impacts on workforces while adjusting plans to account for production challenges, volatile inventory, logistics and operational bottlenecks, and longer term changes to how employees perform duties.



...gender and ethnic diversity on boards has already featured prominently in governance-focused engagements, given that our voting recommendations cover decisions on directors, independent chairs, and chairs of nominating committees.

Climate action: front and centre in environmental engagement

Climate change (SDG 13) is a systemic risk for many companies we engage. It can manifest in physical and transition risks – and present commercial opportunity. As a prominent theme across our portfolio, and given the urgency we believe it warrants, it has dominated our environmental dialogues in the first half of 2020. We engaged companies on climate change 107 times, across 169 engaged issues and objectives. This exceeds the total number of companies we engaged in H1 because engagers often identify multiple cross-cutting objectives or issues for each company due to the wide scope and systemic nature of climate-related risk and opportunity.

> **As our programme continues, we expect dialogue will address a broad range of environmental risks and opportunities.**

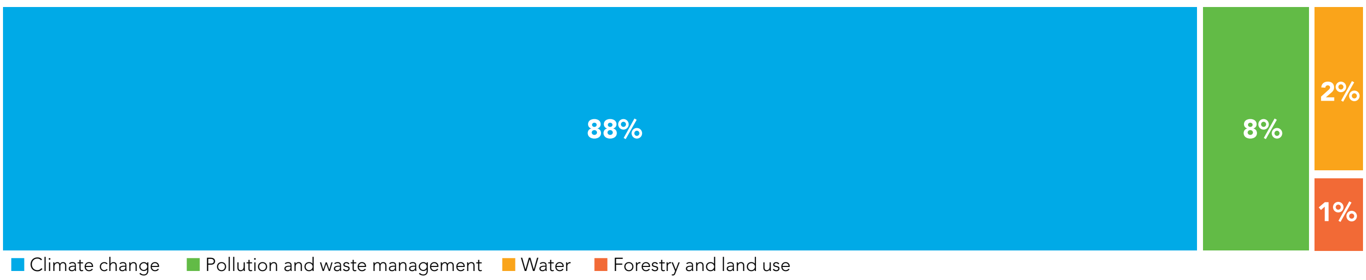
We engaged companies on climate change

107 times, across

169 engaged issues and objectives.

In addition to engagement on SDG-driven climate topics – including emissions reduction, establishing and working to meet science-based targets and disclosures aligned with the Task Force for Climate-related Disclosures – we deliberately prioritise engagement in sectors where climate issues pose the greatest risk. These include the energy, automotive and basic materials sectors. As our programme continues, we expect dialogue will address a broad range of environmental risks and opportunities.

Figure 10. Seeking climate action: environmental engagement themes in H1



Source: Federated Hermes as at 30 June 2020.

Sectoral approaches to setting climate-related objectives

Following an intensive six months of engagement on systemic climate-related challenges, we are focused on new corporate objectives that we believe reflect how the greatest positive contributions within traditionally emissions-intensive sectors can be made, while confronting direct climate-related risks.

Mining and materials	Chemicals
As a significant industrial user of energy and heat for its smelting and refining operations, we believe that **Alcoa** has an opportunity to demonstrate leadership by setting a science-based target for reducing emissions. It is already targeting renewable electricity use of over 80% by 2030 and scope 1 and 2 emissions reductions of 20% in the same timeframe, based on a production model that is already among the most carbon efficient versus its peers. We believe the company has an opportunity to align its target with a below 2°C pathway. Moreover, it would be one of the first aluminium producers to do so. We expect that further 2020 engagement with other mining and metals peers is likely to lead to similar objectives for goals which drive meaningful climate action.	After meeting **Huntsman** in Texas, we set an objective seeking validation of a science-based emissions target once it announces new greenhouse-gas reduction targets in 2020. Similarly, we set an objective for **Orbia Advance** to consider science-based targets which can achieve validation, once it completes internal analysis of lifecycle emissions for its Scope 3 footprint. As the Science-Based Targets Initiative seeks to pilot a methodology for the chemicals sector, we believe forward-thinking chemicals peers can shape viable emissions-reduction pathways that are compatible keeping global warming well below 2°C.
Packaging	**Energy**
We were pleased to see **Ball Corp** set a validated science-based target for its emissions intensity, which includes a Scope 3 goal and necessitates working with its value chain. For sector peer **Sealed Air Corp**, our new objective is for the company to seize the opportunity to set and verify a science-based reduction target for 2030 which includes Scope 3 emissions, given it is considering 2025 and 2030 targets.	**Aker BP ASA** stands out as an upstream, pure-play oil and gas company with significant potential to set a climate target that aligns with the requirements of the Paris Agreement. It is already one of the lowest-carbon-intensity producers in its European peer group, has made substantial investments in emissions-reduction technologies, and indicates it seeks to align with the Norwegian energy industry's long-term aim of net-zero emissions. We therefore have an objective set to achieve disclosure of long-term climate targets.

Strategy, risk and communication: Deepening our understanding and identifying commercial drivers for SDG 13

Following climate change, business strategy was the second-most-engaged topic for SDGHY in H1, with 44 engagements. Our data demonstrate close links between strategy discussions and climate action. It is no accident that of 44 strategy-focused engagements, 54% focused on how the business can support SDG 13 through commercial opportunities and execution.

Following climate change, business strategy was the second-most-engaged topic for SDGHY in H1, with

44 engagements

Topics within the natural resource efficiency and circular economy themes featured in 56% of strategy engagements. This strongly reflects the impact potential of SDGHY, which invests in many companies with opportunities to drive environmentally oriented SDG outcomes, such as those in the packaging, consumer goods, materials, capital goods and automotive sectors.

Packaging and the circular economy

The SDGHY portfolio includes nine packaging companies that we believe can help deliver a range of SDGs, including innovation within value chains (SDG 9), sustainable production by promoting recycled raw inputs (SDG 12), and climate action (SDG 13), as the sector consumes energy and fossil fuel-derived feedstocks in production, particularly for plastics. In line with our buoyant expectations for how this sector is set to transform over the next decade, we set a range of business strategy objectives linked to the circular economy, climate change and wider environmental outcomes:

Sealed Air Corp has committed to making all packaging 100% recyclable by 2025, and to use at least 50% recycled content by that time. This is a very ambitious, commercially strategic commitment to scaling up recycled supplies of plastic inputs. We therefore set an objective for the company to provide year-over-year reporting on its progress in meeting these commitments, and to inform investors and stakeholders on how its business is shifting to adapt to regulatory challenges and circular economy principles.

Ball Corp is well-positioned to take advantage of circular-economy opportunities, given the high recycling rates it enjoys in its glass-production supply chains. We have identified two issues in order to focus ongoing engagement. We believe goals related to recycled content and collaboration with its value chain should feature in a commercially centric sustainability strategy. Moreover, we will continue to assess its capital allocation to sustainable growth opportunities in packaging.

Silgan Holdings Inc is known for producing metal packaging using easily recycled materials with relatively high diversion rates. It also shares insights about its medium- and long-term opportunities for growth in relation to sustainable packaging and the circular economy on an ad hoc basis. We believe the company should disclose quantitative insight that includes targets or ambitions for packaging products which are recyclable or reusable, have a high degree of diversion from landfill, or make use of recycled materials.

Aaron Hay
Lead Engager,
Fixed Income

Lisa Lange
Engager, Sectors:
Transportation,
Financial Services,
Consumer Goods

In April 2020, our Lead Engager, Aaron Hay, authored a report, "Investor expectations for global plastics challenges", with EOS colleague Lisa Lange. Companies reliant on the take-make-waste model of packaging face substantial commercial risks in coming years, and this report addresses engagement strategies on sustainable plastics, and governance and disclosure in the chemicals, consumer goods and retail sectors. We will advance this work to include our key precepts for engagement within the packaging sector to further strengthen our approach to working with these companies to create positive change.

> **Companies reliant on the take-make-waste model of packaging face substantial commercial risks in coming years**

SECTION 5

Clarifying our approach: identifying issues and setting objectives

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.

SECTION 6

SDG engagement review

Where we've focused so far

Engaging on the SDGs in H1 2020

Since inception, we have engaged on 16 of the 17 SDGs. Our H1 2020 engagement focus was on environmentally focused SDGs, making climate action (SDG 13), sustainable consumption and production (SDG 12) and affordable and clean energy (SDG 7) the most intensively engaged SDGs in our portfolio.

We believe that boards and management teams must reflect the composition of the societies in which companies ultimately intend to serve, but this has historically not been the case.

Our SDG engagement themes reflect the crucial linkages between climate change, clean energy and sustainable production within commercial strategy for many of the businesses we invest in. It is no mistake that engagement on innovation, industry and infrastructure (SDG 9) was a focus in 25 engagements. We believe the sustainable product and service innovation that many companies in the Fund bring to markets can achieve longer term SDG outcomes related to full value-chain decarbonisation and reduced carbon consumption by end customers (SDG 12 and 13). Similarly, collaboration and innovation are required across many value chains to achieve meaningful decarbonisation, resource efficiency or social outcomes, making SDG 17, partnerships for achieving the goals, relevant to 19 engagements.

Our engagement on social issues across companies also emerged in H1. We addressed gender equality (SDG 5) at the board and senior management levels through client voting recommendations, and subsequent corporate engagement on behalf of all financial stakeholders drove 31 engagements. Broadly, many companies across the geographies we engage in do not meet the gender balance expectations we hold, as defined by EOS's country-level corporate governance expectations, and this inequality is not confined to companies in the global high-yield universe. We believe that boards and management teams must reflect the composition of the societies in which companies ultimately intend to serve, but this has historically not been the case. It is therefore no surprise to see SDG 5 feature strongly in governance-oriented engagements, which are most common around AGM voting season.

We also engaged heavily on decent work (SDG 8) and the reduction of wider inequalities within workforces and across the societies that companies operate in (SDG 10). This thematic focus reflects many of the near-term challenges of the coronavirus pandemic that companies are grappling with. However, we believe companies have a great deal of power to drive meaningful shifts in the equality of outcomes for individuals they employ.

We addressed gender equality (SDG 5) at the board and senior management levels through client voting recommendations, and subsequent corporate engagement on behalf of all financial stakeholders drove 31 engagements.

9 INDUSTRY, INNOVATION AND INFRASTRUCTURE

12 RESPONSIBLE CONSUMPTION AND PRODUCTION

13 CLIMATE ACTION

Some companies we hold aim to deliver societal benefit at the intersection of SDGs 9, 12 and 13. Few businesses are investing more capital in low-carbon, sustainable product development than **General Motors.** Through a robust set of climate-related engagements over 2019-2020, we are nearing the achievement of our objective for the company to set a zero-emissions vehicle-sales target, which was confirmed in March to be about 1m units by the mid-2020s and a $3bn capital allocation to electric vehicles and battery development annually. This was discussed in detail by the CEO and her management team at the company's March 2020 electric-vehicle investor day in Detroit, Michigan.

8 DECENT WORK AND ECONOMIC GROWTH

10 REDUCED INEQUALITIES

At an **emerging-markets mining and metals company,** we pressed for an explanation of why its injury and fatality rate had risen in the previous year. We understand that the business is beginning to focus more sharply on the wellbeing of its employees (SDG 8), many of whom work in facilities where safety standards are not the same as in highly regulated developed markets. We have set an objective for the company to continually reduce fatality rates and ensure that its performance does not exceed the average for its sector within three years.

In a different context, we will engage several **European banks** on gender and ethnic diversity and pay gaps at senior levels in the second part of 2020. We believe there are considerable direct contributions that these high-value employers can make in closing gaps on inequality within their respective home markets, in line with the indicators of SDG 10. We look forward to setting objectives which focus ongoing engagements on how these banks will bring greater action to their stated diversity and inclusion strategies.

Although we had 43 engagements with ties to SDG 8 and 10 in the first half of 2020, we expect that socially oriented SDGs will continue featuring among the themes most engaged in SDGHY. The corporate sector has a great deal of work to do in helping to improve the workforce composition and socioeconomic, skills and career outcomes for employees across gender and ethnic lines. Within our portfolio, many companies have opportunities to generate impactful social outcomes. For example, our banking holdings have wide-ranging opportunities to drive inclusive financing for underserved individuals and microbusinesses, while the telecommunications operators in our portfolio that serve emerging economies can help close socioeconomic gaps by using digital services, such as 'first-time' digital bank accounts, small-business tools, remedial skills and education platforms.

As with many social challenges and opportunities reflected by the SDGs, increasing equality of opportunity throughout society is a complex, nuanced, and often challenging topic to comprehend through disclosed numbers alone. We will have the opportunity for deeper and more meaningful discussion related to SDGs 8 and 10, and additional social-impact goals sponsored by the UN, as we continue to develop relationships with the companies we engage.

Within our portfolio, many companies have opportunities to generate impactful social outcomes.

Quantifying impacts: progress and challenges

Not every corporate achievement is easily quantifiable in SDG terms. This is often true where there are multiple diffused or indirect social benefits to customers and society through a company's products or services, or how it operates. Moreover, impact measurement can be resource-intensive, and sophisticated time-based studies of social benefit are sometimes out of the reach for high-yield issuers with limited sustainability or social impact teams. Therefore, our *ex-ante* SDG impact hypotheses, engagement strategies, and the issues and objectives we identify point to where qualitative or quantitative evidence of SDG outcomes can be reasonably expected.

However, we encourage companies to be bold and imaginative in considering which of the SDGs are the most important to their corporate purpose and commercial health, and in turn establishing what they can do to contribute towards their delivery. Moreover, as corporate disclosures on non-financial impact continue to evolve, we believe an ever-larger arena of high-yield issuers will begin to describe the impact they are having in quantified environmental and social terms which can be linked closely, or even directly, to many of the key performance indicators within each SDG. In fact, identifying and quantifying material impact itself forms a key objective or issue at many companies, given our ability to provide feedback on how we believe ESG disclosures and nonfinancial reporting may be adopted across companies and within sectors.

The corporate sector has a great deal of work to do in helping to improve the workforce composition and socioeconomic, skills and career outcomes for employees across gender and ethnic lines.

SECTION 7

How do we drive continuous improvement?

Internal governance: maintaining integrity

Most engagements happen behind closed doors, which makes it difficult to connect investor influence with long-term corporate outcomes that support the SDGs. We are, however, deeply committed to maximising the value of our long-term dialogues. To this end, we regularly ensure that our *ex-ante* SDG hypotheses remain realistic about the potential scope and likelihood of impact for each company to ensure we remain focused on both investment performance and positive outcomes.

All SDG scores for our portfolio holding are formally reviewed at least annually by the assigned engager, the SDGHY Lead Engager and the Portfolio Manager, with input from relevant analysts and team members. These reviews investigate whether the SDG engagement hypothesis is valid and whether its strength has increased or decreased based on engagement insight and performance on material ESG and SDG-linked issues. This may lead to changes to the SDG *ex-ante* score and thus the weight of the company in the portfolio. For companies requiring closer monitoring due to a low SDG score, or a score which is declining due to negative developments, quarterly reviews might be necessary.

Outside formal reviews, the Lead Engager for Fixed Income meets with engagers for every company twice each year to understand current engagement progress and the strategy for dialogue, what new or existing issues and objectives require attention or analysis, and the responsible engager's own outlook on the progress companies are making in light of our expectations. Moreover, all engagers hold clinics with senior directors in EOS to review and critique the holistic engagement case for companies. This is a frequently used diagnostic for ensuring that engagement is effective for companies with elevated risk exposures, which we believe require a particularly intensive focus.

Deploying engagement where it will be most effective

We prefer to engage rather than divest, because invested capital has a voice. However, there are sectors or companies in which engagement is unlikely to bear little fruit. We are likely to avoid investing in industries where engagement is very unlikely to counteract the adverse effects of the underlying products – such as tobacco or gambling. Generally, though, we consider each company on a case-by-case basis, weighing up positive and negative factors and, importantly, each company's capacity and willingness to improve. Indeed, although our subjective analysis of the corporate potential for change determines whether a company should be included in the portfolio, we actively manage holdings based on investment performance and our long-term view on potential SDG impact.

We are not compelled to hold credit in any one company. By looking for companies that we perceive as suitable for long-term investment, we have screened out industries and businesses where we feel that potential for change is low, thereby reducing the value of engagement. But sometimes this insight can only be gained through engagement. This, in itself, is a valuable insight in managing SDGHY.

Our critical friend: the SDG Fixed Income Engagement Committee

The Fund convened an SDG Fixed Income Engagement Committee at the beginning of 2020. This advisory panel, chaired by Dr Christine Chow, EOS's lead for Asia-Pacific engagement, is composed of EOS engagement directors who all work independently of the Fixed Income team on behalf of all EOS clients. The committee will meet three times in 2020 and quarterly from 2021 onwards. Its remit is to provide constructive challenges to the team managing SDGHY, including objective critiques for SDG hypotheses, our assessment, scoring and investment processes, thematic and individual company engagement strategies and relevance to the SDGs, and feedback on improvements to ensure the fund is delivering strongly against its stated objectives over the long term.

The SDG Fixed Income Engagement Committee will meet for its second and third sessions in H2 2020, focusing on strengthening the *ex-ante* assessment processes, deepening this approach at a sector level, and critiquing how SDG scores have changed in the first two full quarters in the life of the portfolio, along with a selection of companies to review for engagement progress.

Chair:

Dr Christine Chow
Team lead:
Greater China
Sector lead: Technology

Members:

Roland Bosch
Sector lead: Financial Services

Andy Jones
Team lead: Continental Europe
Sector lead: Mining & Materials

Kimberley Lewis
Sector lead:
Pharmaceuticals
& Healthcare

From SDGHY:

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

Aaron Hay
Lead Engager,
Fixed Income

We publish two engagement stories from the SDGHY portfolio each quarter. Please find two included here: on aluminium manufacturer Alcoa and global bank Barclays.

CASE STUDY:

Alcoa

Anna Chong
Senior Credit Analyst

Aaron Hay
Lead Engager

SDG Engagement High Yield Credit Fund, Q1 2020

Alcoa is a global producer of bauxite, alumina, and aluminium products. It operates bauxite mining operations across four continents, and its global refining system processes it into alumina. Alcoa's aluminium division combines smelting and casting to produce primary aluminium, cast foundry ingot and value-added products including billet, rod, and slab.

Alcoa's global network:

14,000 employees working across **10** countries

Source: Alcoa as at February 2020.

Investment case

Alcoa has a creditor-supportive financial policy which has emphasised balance sheet repair and net pension and other post-employment benefit liabilities, while providing a mechanism for shareholder returns. Its current policy plans to maintain liquidity of a minimum of $1bn cash balance and capital expenditure in order to sustain and improve operations, with residual cashflow allocated to reducing adjusted net debt over the next two to four years, returns to shareholders, transforming the portfolio, and investing in growth projects.

As a result of this financial policy, the company's net leverage remains modest. It is exposed to the aluminium commodity chain, with lower cost bauxite and alumina production providing vertical integration through the value chain for the aluminium production business segment. In terms of future growth, aluminium is expected to benefit from the shift to lightweight electric vehicle designs, among other significant trends driving the growth of aluminium use.

Engagement context

The company's value chain – focused on mining, smelting and refining – is resource intensive and has significant environmental impacts. This remains a challenge for the company. Given Alcoa's leading cost position among its peers, there is an opportunity to enhance its position further through strategic investments in production. These investments – often focused on doing more with less – can deliver positive benefits in terms of reduced or eliminated environmental impacts as well as greater energy and resource efficiency in production. Moreover, the company must carefully manage the health, safety and wellbeing of its employees, ensure positive and mutually beneficial relationships with many communities, and carefully steward the ecosystem and biodiversity impact from its mining operations.

In terms of future growth, aluminium is expected to benefit from the shift to lightweight electric vehicle designs.

SDG-focused engagement

The drivers of our SDG-aligned engagement with the company, and our objectives, are described below:

SDG alignment
Carbon-emissions reduction

Aluminium refining, smelting and casting is a highly energy-intensive process – and a substantial portion of greenhouse gases (GHGs) in the aluminium value chain are generated from the direct operations of companies like Alcoa. The smelting process involves passing electrical currents through a large block of carbon called an anode, which burns off during the process and releases carbon dioxide into the atmosphere. Other major sources of emissions include non-renewable energy to feed aluminium production and other heat or electricity-driven processes. The company has committed to reducing the intensity of its carbon footprint by 20% by 2030.

How we will engage
Emissions targets

In 2018, the company announced the formation of a climate strategy team to address emerging challenges and opportunities. We want to engage the company to understand its challenges in more detail. We also want to ask whether more robust long-term target-setting would be possible given the company's focus on production innovation, increased renewables availability, and greater use of recycled aluminium, which has only a fraction of the carbon footprint that new aluminium has. We believe the company can contribute to the development of science-based targets for the sector in which it operates, given its experience in tackling emissions thus far. Although more than 500 companies have established science-based emissions targets to align their emissions reduction strategies with the goals of the Paris Agreement, none are from the aluminium sector[2].

SDG alignment
Sustainability-driven innovation

In 2018, Alcoa formed a joint venture with Rio Tinto to develop ELYSIS, a technology that emits only oxygen and eliminates direct GHGs from the smelting process, with investments from Apple and the governments of Canada and Québec. This is a significant breakthrough and has the potential to considerably reduce emissions and operating costs. According to the company, the new technology could reduce carbon dioxide production by 6.5bn tonnes a year in Canada (the equivalent to taking about 1.8m cars off the road.)

How we will engage
Combatting climate change

In December 2019, Apple bought its first-ever batch of carbon-free aluminium produced by Alcoa and Rio Tinto. Alcoa has indicated that ELYSIS will be commercially available from 2024. If compatible with a wide range of smelting facilities, it could be a disruptive technology with commercial promise for Alcoa. We want to engage the company to understand how it is preparing to maximise the extension of its business model and its support and technical services. We also want to understand whether such a technology might be licensed to other smelting operators.

SDG alignment
Sustainable production environment

Alcoa offers SUSTANA, a line of products designed to help downstream customers reduce the carbon intensity of their supply chains. Its verified carbon footprint is 75% better than the industry average, owing to its use of renewable energy in smelting – which accounts for 72% of smelter electricity use across the business[3]. The company sought external sustainability certifications for certain products, verifying their total environmental footprint, in order to qualify for sustainable building specifications, such as Leadership in Energy and Environmental Design (LEED). There is already ample evidence to demonstrate how Alcoa is working with its customers to bring sustainable products to market.

How we will engage
Recycling and reuse

Although Alcoa has achieved an aluminium recycled content rate of 30% at one of its plants and continues to increase its scrap consumption globally, we want to engage to find out how this may increase, given the recyclable nature of this metal and the opportunities it presents. We also want to ask about the company's corporate commitment to set targets for the reuse of co-products or by-products in 2020.

SDG alignment
Social value creation

The company's sophisticated approach to social value creation in its supply chains is underpinned by supplier sustainability and stakeholder engagement programmes, both of which disclose audit results as well as problems and issues raised by stakeholders and the actions they have taken. In addition, the company clearly discloses its health and safety performance, which allows investors to understand the safety inherent to key roles across a global workforce.

How we will engage
Increasing social value in the supply chain

In 2018, the company began to develop a new Supplier Sustainability Programme. We want to understand how this will increase social value in extended supply chains once it is in place. More broadly, we believe Alcoa's social disclosures could be enhanced to quantify and demonstrate how social value is being created for individuals, their families and communities, through safe, fair and meaningful employment opportunities in emerging markets.

[2] As of January 2020.
[3] Alcoa as at 31 December 2019.

CASE STUDY:

Barclays

Filippo Alloatti
Senior Credit Analyst

Roland Bosch
Engagement Professional

Federated Hermes SDG Engagement High Yield Credit Fund, **Q2 2020**

Barclays plc is the holding company of Barclays Bank plc, a systemically important UK-based bank with sizeable international operations. Barclays is a major global financial-services firm that provides personal banking, credit cards (Barclaycard), corporate and investment banking and wealth and investment-management services. It has an extensive presence in Europe, the Americas and Asia Pacific, with an increasing focus on the UK and US. Founded in 1690, Barclays traces its origins to two goldsmith bankers in London. In 1736, James Barclay joined as a partner and the company's name and London headquarters have remained the same ever since.[4] Barclays employs 80,800[5] people and delivers services in 41 countries.[6]

Investment case

Barclays is one the UK's market-leading banks, with strong franchises across retail, business and corporate banking. The group focuses on the UK and US markets, which make up one half and a third of the group's revenues respectively. Barclays also has a strong risk-management framework, shown by its relatively low annual cost of risk, although this will be put to the test this year. The bank has a conservative liquidity position of £237bn, a strong liquidity-coverage ratio of 155% and access to liquidity facilities from central banks across the world. Unlike other UK-based banks, Barclays has adopted a bondholder-friendly approach to exercising the call options on its debt, which we see as a key differentiating factor. Barclays also has an above-target common-equity tier one (CET1) ratio of 13.1%. Our analysts have covered Barclays since 2004 and engaged with it since 2011 and note its good track record of managing regulatory ratios (mostly CET1 and total capital ratios) through volatile earnings periods.

Engagement context

Banks face pressure from diverse stakeholders beyond their traditional investor bases. Apart from the challenge of shifting regulatory requirements, there is an evolving set of expectations from society and shareholders on the role that banks such as Barclays should play in society. Banks are high-quality job creators and systemic financiers of value creation and consumer and business activity, and also face pressure to manage their social and environmental impacts.

Climate change presents a systemic, unpredictable and potentially disruptive long-term financial risk to diversified banks. Due to the critical role that financing plays in intensive greenhouse-gas emitting sectors, it has become an acute point of focus for investors, campaigners, policymakers and swaths of the banking public. But climate action also presents a remarkable opportunity for banks that seek to finance consumer, business and value-chain decarbonisation and contribute to an orderly long-term transition to lower-emission economies that are compatible with the Paris Agreement and national and international climate-action frameworks.

Expectations for the social purpose of financial-service firms are also evolving. The sector provides a critical service to the real economy and there is a recognition that banks must articulate, deliver and quantify social value creation and improve diversity and equality. Globally, around 2bn people do not have access to finance, or lack financial literacy or digital tools, which is an opportunity and a challenge to the sector's social licence to operate. Beyond basic services which may reduce inequalities, banks have the opportunity at regional and community levels to build or partner with others to create bespoke strategies for inclusive financing and lending. These should include measurable outcomes that focus on reducing socioeconomic inequality, creating resilient local infrastructure or helping to grow small-and-medium enterprises (SMEs).

Banks also have a direct impact through job creation and skills development, and in some regions play an outsized role in offering high-quality jobs. Banks need to proactively and meaningfully tackle corporate-culture weaknesses, gender and ethnic-diversity gaps in the workforce and investments in current and future employee skillsets. We believe that banks that do not comprehensively address these issues may face heightened retention and reputational risks, avoidable human and intellectual capital depreciation and reduced competitiveness.

[4] 'Our history', published by by Barclays. https://home.barclays/who-we-are/our-history/
[5] 'Barclays PLC Annual Report 2019', p.82, published by Barclays in February 2020.
[6] 'Barclays PLC Country Snapshot 2019', p.1, published by Barclays in February 2020.

SDG-focused engagement

The drivers of our SDG-aligned engagement with the company, and our objectives, are described below:

Financing global climate action
SDG 13

The world is at a critical juncture on climate change. We strongly support climate action from firms that are willing to make commitments and invest in goals and strategies which transform value chains. For banks, this means financing the transition to a low-carbon economy while avoiding disruptive long-term risks. The Paris Agreement, which calls for financial flows to be aligned to low-carbon development, demonstrated the emerging political consensus on the risks of climate change (and was publicly endorsed by many banks). For the banking sector, the deployment of capital through financing, loans and asset ownership must be based on a precise understanding of where the risks and opportunities of the climate transition are. For banks like Barclays, this has serious ramifications for the long-term cashflows generated by financing assets and activities and is most acute in carbon-intensive energy sectors.

From commitment to decarbonisation

Through our long-standing engagement with Barclays, we seek to ensure it is run in the interests of long-term investors and that it plays a role in building a more sustainable banking system by focusing on financing solutions that deliver a positive social and environmental impact. We set an objective for Barclays to develop a strategy and lending policies to reduce its exposure to parts of the energy sector that are not aligned with the goals of the Paris Agreement, and which present long-term risks to the bank and society. We then intensively engaged the bank, its Chair, company secretary and senior management team on its climate-change strategy, and also involved all members of the Institutional Investors Group on Climate Change. We were heartened by the bank's climate-policy announcement ahead of its 2020 annual general meeting, although we acknowledge that the bank is behind where we would like it to be. Barclays asked its shareholders to vote on its ambition to become a net-zero emissions bank by 2050 and on a commitment to align all of its financing activities to the goals and timelines of the Paris Agreement.[7] This alignment will start with the energy and power sectors and will eventually extend to its entire portfolio. We were delighted to learn that over 99% of shareholders supported the management's proposed strategy and ambition in 2020. Our next phase of engagement will focus on how Barclays will execute and deliver against its strategic intent.

Purposeful socioeconomic lending
SDG 10, 11 & 17

Providing socially inclusive, purpose-driven financing is an emerging imperative for banks but turning this into meaningful action is a complex challenge. Barclays has an opportunity to provide capital that helps create positive socio-economic outcomes. In the UK, this includes community and low-carbon infrastructure financing, home energy-efficiency retrofits and loans or trade financing for low-carbon SME business models which create next-generation jobs. These examples can deliver tangible benefits to the people and communities Barclays relies on for its turnover. While there are considerable national and international efforts to codify frameworks for classifying whether a loan or asset is truly sustainable and socially inclusive, we share the frustration of banks about a lack of progress in this area.

Evolving a meaningful approach

Barclays measures the value of its socially inclusive or 'green' financing offerings and products, which grew by 45% to £7.8bn in 2019. Its social and environmental financing portfolio was worth £34.8bn in 2019 (almost 70% of this is considered social). This is part of its focus on "making growth green, sustainable and inclusive"[8] and it aims to reach £150bn in cumulative social and environmental financing.[9] In its 2019 ESG report, the bank acknowledged the lack of industry-wide frameworks for green-finance definitions. This would help the bank clarify its own reporting[10] and remains a weakness across the sector. We believe that Barclays has an opportunity to sharpen its own definition of what these commercial strategies entail and to show how it has sought opportunities to provide a measurable impact. The bank has reported its progress in contributing to Sustainable Development Goals 3, 4, 7, 9 and 11, but indicates that "as better information becomes available, [it] will refine methodologies in order to provide more granular insights".[11] In addition to reporting its purpose-driven financing as a share of its total commercial operations, Barclays could encourage the banking sector to create robust, comparable and transparent standards and benchmarks for these activities.

[7] "Barclays PLC 2020 Annual General Meeting (AGM)', published by Barclays on 7 May 2020.
[8] 'Making growth "green", sustainable and inclusive', published by Barclays.
[9] 'Barclays PLC Environmental Social Governance Report 2019', p.22, published by Barclays on 30 March 2020.
[10] Ibid.
[11] Ibid.

Structural challenges in gender and ethnicity equality
SDG 5 & 10

The legacy of the global financial crisis means that banks now face intense scrutiny on corporate cultures and their ability to avoid undue or unethical risk-taking. More recently, the focus has shifted to how wider values and norms are embedded in activities and acted on. Barclays will face pressure to ensure that its workforce reflects the population of the countries it operates in and may be asked to advocate for structural changes in public policy. Improving the equality of employee pay and talent progression is also a way to engage employees and improve productivity and the retention of diverse talent. As the workforce can represent the largest cost for financial-services firms, Barclay's ability to engage, retain and improve social outcomes for employees is crucial to its long-term competitiveness. Finally, regulatory scrutiny – such as the UK's 2018 gender pay gap disclosure – could formalise these pressures. It is likely that fast action on gender and ethnicity pay-gap disclosures will be required, particularly given the recent anti-racism protests in the US and elsewhere.

Values-led culture development over the long term

We have engaged with Barclays on human capital management and corporate culture since the bank was involved in the 2012 LIBOR scandal. Our dialogue with the Chair and management team originally focused on creating a conduct framework, which sought to combat non-compliant or unethical risk-taking and which could be embedded into the culture of operational and strategic decision-making. Over the last few years, we have been impressed by the progress in embedding a 'values-based' culture across the bank, such as through dashboards which monitor cultural attributes across the firm. We will continue to pursue an objective for Barclays to solidify a culture which is responsible, customer-centric and aligned to stakeholders. For our part, this also means looking at where gender and ethnic diversity is lacking and actions the bank can take to remedy this. This could demonstrate to stakeholders that it is committed to implementing the structural changes required to combat gender and racial inequality and set an example to the whole sector.

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