SDG Engagement Equity Fund

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2022 H1 Report

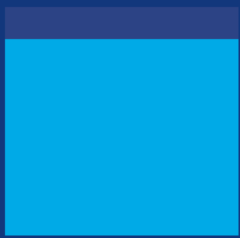
Federated Hermes Limited

www.hermes-investment.com
For professional investors only

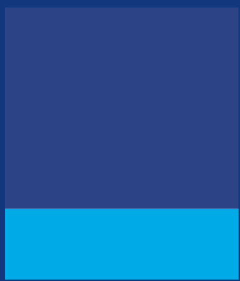
Federated Hermes SDG Engagement Equity Fund H1 2022 highlights

106 **engagement actions** were carried out in H1 2022

86% of portfolio companies were engaged with



Progress was made on **26%** of engagement objectives during the period



Companies are uniquely positioned to have significant impact on real lives due to their position within communities, their direct relationships with employees, and their connections with suppliers. No company is an island.

In H1 2022, the proportion of our engagements were focused on:

20% environmental issues and objectives

32% social issues and objectives

34% governance issues and objectives

15% strategic issues and objectives

The most intensively engaged Sustainable Development Goals (SDGs) were:

5 GENDER EQUALITY **61%** of engagement actions

8 DECENT WORK AND ECONOMIC GROWTH **61%** of engagement actions

10 REDUCED INEQUALITIES **51%** of engagement actions

13 CLIMATE ACTION **48%** of engagement actions

12 RESPONSIBLE CONSUMPTION AND PRODUCTION **46%** of engagement actions

In terms of engagement, we have continued to maintain positive dialogues with companies across our portfolio. With no new names added in the period engagements are often now mature with relationships established and dialogues progressing.

Completed objectives: **17**

Total meetings voted: **48**

Number of meetings voted against management on at least one resolution: **33%**

Source: Federated Hermes, as at 30 June 2022.

Contents

Federated Hermes SDG Engagement Equity Fund

Launched in January 2018, the Federated Hermes SDG Engagement Equity Fund has the dual purpose of delivering attractive returns and measurable real-world impact.

We seek this by targeting both traditional financial performance goals as well as aiming for positive social and environmental change through engagement with companies around their ability to support the attainment of the Sustainable Development Goals (SDGs).

What are the SDGs?

The SDGs, created by the United Nations, are a universal set of goals, targets and indicators for global development. They serve as a blueprint for significantly changing the world by 2030. They are focused on ending global poverty, safeguarding the planet and creating prosperity for all.

There are **17** goals, **169** targets and **230** indicators.

Our core beliefs

A number of core investment beliefs underpin our strategy, including that:

Public companies can contribute to and benefit from efforts to achieve the SDGs. Meeting the SDGs will be a primary driver of future economic growth, providing opportunities for firms to boost revenues and earnings. Companies are uniquely positioned to significantly impact lives due to their integral position within communities, direct relationships with employees and connections with suppliers.

The long-term commercial performance of companies is connected with the success of the environments in which they operate and in which their employees and customers live. Firms that fulfil their responsibilities towards society will be rewarded with greater brand loyalty, employee motivation and more innovative products and services.

Investors can influence companies to improve their operations in support of the SDGs, creating a virtuous circle of change, benefiting employees, communities, supply chains and other stakeholder groups. Engaging with companies on the SDGs provides investors with valuable insights into their current levels of sustainability and longer-term commercial risks and opportunities.

There are 17 goals, 169 targets and 230 indicators. The targets are integrated and balance three primary dimensions of sustainable development: economic, social and environmental. They, in effect, provide a sustainability roadmap for the world.

Every company is affected by, or can contribute to, at least some of these goals – often in so doing, benefiting society and their own business prospects. Attaining these goals means reducing harm and finding ways to generate positive impacts. It requires company boards and management teams to be bold and ambitious.

Economic

Human capital

- A healthy, skilled and productive workforce is increasingly being seen as an intangible for investors and individuals to value companies and brands

Public Health Issues

- Covid-19 has highlighted disparities in health care systems

Environmental

Deforestation

- Healthy forests help stabilise climate, clean the air and guarantee water supply

Ocean Pollution

- By 2050 it is estimated that there will be more plastic than fish in the ocean due to plastic leakage

Social

Human Slavery

- Forced labour is estimated to generate annual profits of over $150bn[1]

Inequalities

- In the world's poorest countries, slightly more than 1 in 5 children are engaged in child labour – reducing opportunity for education[2]

[1] International Labour Organisation, 'ILO says forced labour generates annual profits of US$ 150 billion' (20 May 2014).
[2] UNICEF data (August 2021).

We have assessed that approximately

40% of the **169**

targets are relevant for dialogue between investors and corporates.

How do we consider impact?

Companies are uniquely positioned to have significant impact on real lives due to their position within communities, their direct relationships with employees, and their connections with suppliers. No company is an island.

Importantly we, as investors, can influence companies with regard to what business they do, and how they conduct business. We contend that, in liquid public markets, purposeful engagement is the only means by which investors can generate impact.

Assessing a company's contribution to the SDGs is not easy nor always quantifiable. Such an assessment, however, fits naturally alongside our research to understand the business models and risks of potential investments.

When identifying companies for inclusion in the strategy, we consider both how 'engageable' a company is and its scope for making an improved contribution towards the goals. Having potential without being 'engageable', or vice versa, is no use.

Importantly we, as investors, can influence companies with regard to what business they do, and how they conduct business.

In assessing the potential for an improved contribution, we look at a company's supply chain, including its relationships with and influence over its supply partners. We consider the company's direct operations, including its resource efficiency and approach to its workforce. We also examine its products and services – do they have the potential to reach under-served markets, or to develop product offerings supportive of a more circular economy?

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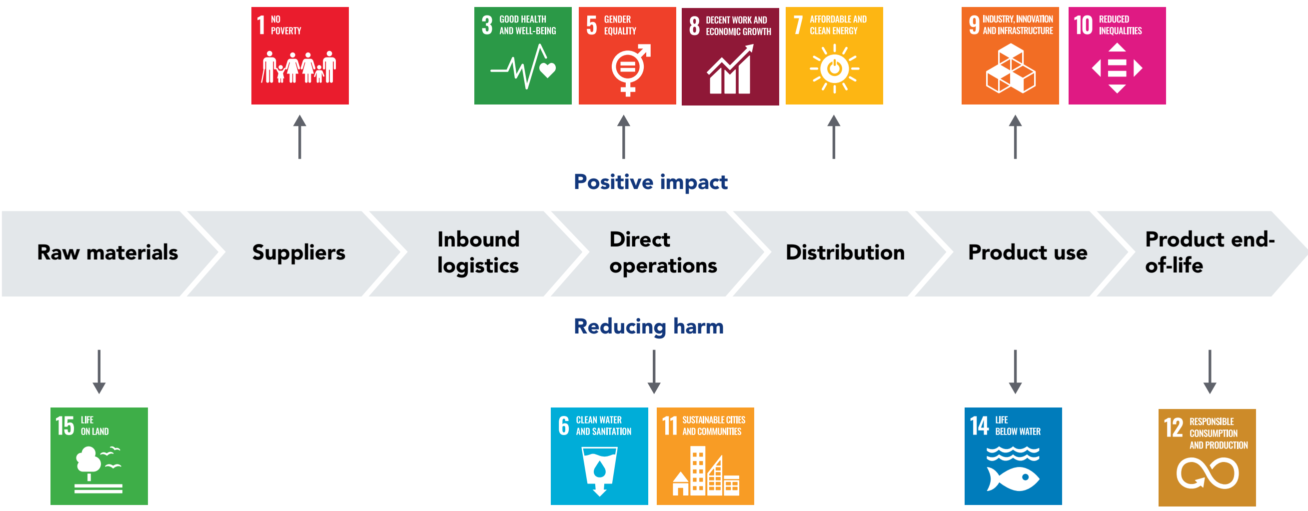
Figure 1: SDGs through the value chain



Source: Federated Hermes.

While we have to be confident in our engagement thesis before deciding to invest, the reality is that these assessments become more fully formed the more we interact with a company. What we hope to create is a meeting of minds. Management should know the business better than we ever can, and as such they need to encourage change and embed the commitment to sustainable practices within the company's culture. Our role is to bring ideas to the table – making connections between companies and other parties – and to give management the confidence to be bold and ambitious with their decisions.

How do we, as investors, play our part in the attainment of the SDGs?

Our role is to catalyse new ideas, practices and activity; to encourage where necessary and to support companies in their implementation of new approaches.

> **This best flows from engagement being fully integrated into the investment process: informing the decision to buy the stock, and allowing active and ongoing portfolio manager involvement.**

We believe there are three characteristics needed for a genuinely impactful approach to investor engagement:

- Impactful engagement needs to be **purposeful.**

  This best flows from engagement being fully integrated into the investment process: informing the decision to buy the stock, and allowing active and ongoing portfolio manager involvement. Identifying an engagement thesis at the outset allows for an intentional dialogue with a clear purpose – namely realising positive outcomes that are beneficial for society and the business too.

- Achieving change means engaging as **informed and constructive partners.**

  The success of an engagement is dependent upon speaking to the right person, about the right issue, at the right time. Being able to deploy respected colleagues to speak to company management in their native tongue is very helpful in building relationships, especially in certain regions like Japan and China. Equally, requests need to develop from a real understanding of a company's particular business model and geographic footprint, rather than being derived from one-size-fits-all frameworks.

- Successful **engagement takes time.**

  Substantive, meaningful and sustainable change requires deep corporate buy-in and resource deployment. Given this, the meaningful results worth pursuing are those also worth waiting for.

Purposeful | Integrated | Informed and constructive | Patient | Real-world outcomes

Targeted exclusions

Recognising that certain industries are unlikely to contribute to the SDGs, irrespective of any changes achievable through engagement, the fund explicitly excludes the following from investment consideration:

- Companies that generate over 5% of their revenues from the extraction or exploration of fossil fuels
- Electricity utility companies with a carbon intensity not aligned with a below 1.5 degrees scenario
- Companies that generate revenue from the production of controversial weapons and companies that generate over 5% of their revenues from production of conventional weapons
- Companies that generate revenues from the production of tobacco products and companies that receive over 5% of their revenues from tobacco distribution
- Companies that generate over 2% of their revenues from gambling products; and
- Companies that are in contravention of the principles of the UN Global Compact

Investment review

Hamish Galpin Lead Manager

To borrow a sports commentator's cliché, it was very much a game of two quarters in the first half of 2022.

In addition to the obvious geopolitical concerns over Ukraine, pricing power was a major worry for the market in the first quarter. A number of holdings in the fund – in the Industrial and Materials sectors in particular – were impacted by this and these comprised two of the three largest underperforming sectors in Q1. Such holdings had typically seen strong price increases in 2021, and the ability to pass on further rises was under question.

Consumer Discretionary stocks and stocks exposed to those end markets suffered alongside others in the sector, as did stocks we hold in Technology, but holdings here fared relatively well. This was particularly evident in Technology which was the sector with the greatest outperformance, with the result coming from both stock selection and our underweight position (where it was good to see some catch up after suffering in 2020).

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Rates and oil prices

Outperformance in Q1 came from 'reopeners' and stocks benefitting from higher interest rates and higher oil prices. Indeed, our holdings in oil-sensitive stocks offset the effect of having no direct Energy holdings in Q1.

Q2 saw a reversal for many of the pricing power stocks after reassuring statements in the reporting season (which has been reiterated in current statements for Q2), with Materials producing the second-best outperformance. Defensively-positioned Consumer Discretionary stocks resulted in that sector being the best performer.

While a weakening economic outlook hit stocks in Industrials and Financials, the impact from the zero weight in Energy was much reduced and Technology was again strong.

All in all, in Q2 the fund gained back the underperformance it experienced in Q1 and ended up flat year-to-date on a relative basis (in gross terms).

All in all, in Q2 the fund gained back the underperformance it experienced in Q1 and ended up flat year-to-date on a relative basis (in gross terms). The fund therefore continues to show very different characteristics to other Impact and Sustainability funds which typically have a much greater exposure to growth[3].

[3] Past performance is not a reliable indicator of future performance.

Engagement commentary

Will Pomroy Lead Engager

As 2022 progresses, we have continued to maintain positive dialogues with companies across our portfolio. With no new names added in the period (and few new holdings in the last period) engagements are often now mature with relationships established and dialogues advancing. As such, many initial discussions around disclosure have moved to being increasingly focused on the development of strategies to executive on broader ambitions.

A focus on decent work

Back in early 2019 we wrote to all of our holdings on the topic of 'decent work' and subsequently published three papers outlining our thoughts, covering the *who* of company employment and the *how*. This encompassed both pay and broader benefits. The global pandemic of 2020 onwards exacerbated a range of pre-existing inequalities, creating huge uncertainties for many employees worldwide. Following the pandemic, inflation is soaring across multiple markets, causing cost of living challenges for many. With this context in mind, we are continuing to engage with many of our holdings around their treatment of, and support for, their lowest paid workers, and/or those workers in more precarious circumstances upstream in their supply chains. A couple of examples of positive progress include those holdings outlined below. This will be a theme we will continue to focus on and look to report on in our annual report for the year.

Back in early 2019 we wrote to all of our holdings on the topic of 'decent work' and subsequently published three papers outlining our thoughts, covering the who of company employment and the how.

Vistry Group

Our UK housebuilder achieved living wage accreditation last year and will be closing the gaps with its few outstanding contracted workers by November 2023. This supplements their expanding training academies which are supporting training and upskilling in the house building supply base.

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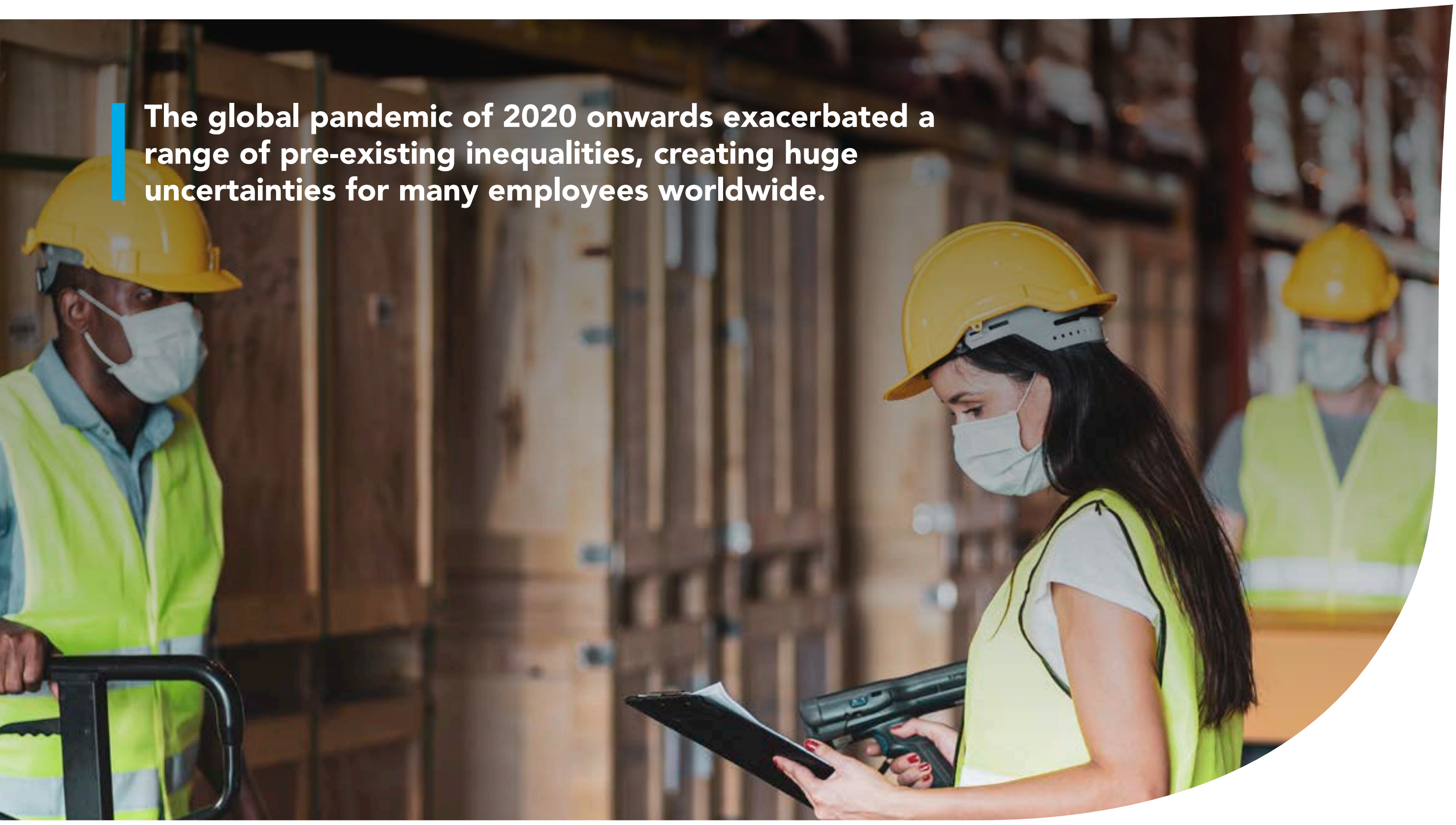
LKQ Corp

With 80% of its North American workforce on hourly contracts, we have had extensive conversations with the company around their support for this cohort of employees. In addition to rising wage floors, several initiatives have been, or are being put in place, to drive higher employee engagement and retention. These include a particular focus on financial wellbeing. On the latter point, the company has partnered with PNC bank to provide their employees with a new benefit, enabling them access to earned pay throughout any point in the pay cycle, accompanied by significant efforts around financial education.



Industry engagement – US Dairy

Beyond the company-specific engagements that typify the strategy, we also recognise that substantive change typically necessitates change at an industry level. For that reason we are fortunate to be able to lean on our colleagues within EOS at Federated Hermes, who are often engaging with companies in the same industry and/or with their customers and supply chain partners. It is also why the fund's lead engager (as well as colleagues across the firm) is involved in wider industry initiatives (e.g. Will Pomroy chairs the Corporate Governance Expert Group of the UK's Quoted Companies Alliance and is a member of the PRI's SDG Advisory Committee).

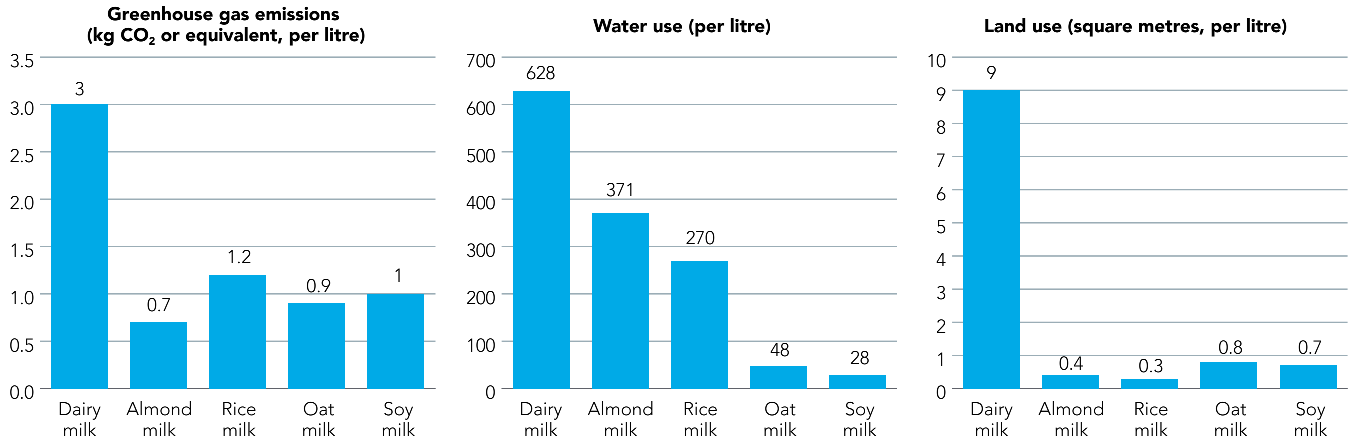
A further example of our industry level engagement was our presenting at the **US Dairy** Export Council's Spring conference in Denver, Colorado, this year. This presentation followed from our speaking at the Innovation Center for US Dairy's virtual conference in 2020 on the topic of sustainability, both of which arose as a result of our ongoing engagement with Irish dairy nutrition company Glanbia.

The conference was attended by representatives from across the dairy value chain – farmers through to food producers. The industry is rightly waking up to the need to address fundamental sustainability challenges and to better communicate its efforts in so doing.

The main headwind for the industry is of course its environmental footprint:

- Agriculture represents approx. 11% of North America's greenhouse gas emissions[4] and approx. 18% globally[5] – 2% arises from the dairy industry alone in the US[6].
- Agriculture is responsible for around 70% of global water use. Livestock production accounts for nearly one-third of that use[7].
- Around 70% of antibiotics in the US and two-thirds of antibiotics in the EU are given to farm animals[8]. The cost of treating resistant infections in humans has added an additional $2bn in healthcare expenditures in the USA[9].

Figure 2: Environmental footprint of dairy milk vs. plant-based alternatives[10]



Source: United States Environmental Protection Agency (2018).

It is perhaps no surprise that because of growing environmental concerns alongside rising interest in health and wellbeing, and existing preferences around animal welfare, there has been an increase in consumers in developed markets eating and purchasing more plant-based products.

The other side of the story, however, is the positive nutritional profile of milk itself (with alternatives relying on fortification) as well as the economic value to the local, typically rural, communities built on and around farming.

Our message to the industry, therefore, was that the societal and investor interest in sustainability is not a passing fad. If you are a supplier to a large corporate then you are likely in scope of their emissions reduction targets. Large corporates are increasingly setting public targets; in particular around emission reductions but often around other matters too – waste, water, antibiotic usage, biodiversity to name just a few that are relevant to the dairy industry. While many of these targets are in the future, commonly 2030 and 2050, the accountability for making progress on these targets is increasing. Those targets are not able to be achieved if their suppliers do not work them accordingly, and purchasing decisions will increasingly be informed by this judgement.

Dairy is highly emissions-intensive, irrespective of the significant strides towards productivity, in particular in North America. Therefore, the challenge to the industry is to meet these rising expectations head on.

The Innovation Center for US Dairy established a stewardship commitment[11] in 2020 which included the goal of achieving greenhouse gas neutrality by 2050. This was a positive step forward. However, it is self-evident that much more progress is needed, and we look forward to continuing to engage constructively with industry participants to maintain and build further momentum.

[4] United States Environmental Protection Agency
[5] World Resources Institute
[6] Dairy And The Environment | U.S. Dairy (usdairy.com)
[7] FAIRR, Managing Environmental Risks in Meat and Dairy Supply Chains
[8] Ibid
[9] KE Thorpe, P Joski, KJ Johnston - Health Affairs, 2018
[10] J. Poore and T. Nemecek, Reducing Food's environmental impacts through producers and consumers
[11] Stewardship Commitment | U.S. Dairy (usdairy.com)

H1 engagement highlights

Summarised below are some other specific highlights from our engagement activity during the first half of 2022.

Ansell

At this Australian personal protective equipment company, we have discussed labour conditions in its single-use glove supply chain, where the production for a significant majority of their more commoditised product is outsourced.

The company's view, similar to our argument for engagement, is that it can make a bigger impact by remaining in a position of influence. A small number of Ansell's suppliers were affected by US import bans in relation to alleged forced labour practices, including Top Glove, the world's largest manufacturer of latex gloves. The ban was later lifted following improvements.

In response to the greater focus on labour standards, Ansell committed last year to ensuring that no fees are levied for recruitment and the company has revamped its supplier management framework. This year, Ansell was one of seven founding members of the Responsible Glove Alliance – this is testament to the company's desire to take a leadership role across its industry, not least when one recognises that there is a need for cross-industry action to address the sector's pervasive forced labour issues.

We have also been in discussions with the company about their approach on the issue of low wages, which can be an underlying factor in human rights abuses. While excessive overtime has been a bigger problem recently given product scarcity against the backdrop of the pandemic, Ansell did undertake a living wage gap analysis for its own employees during 2021. Positively, most of its plants are already paying above the defined living wage, although a few gaps were identified at its Southeast Asian plants, which the company has committed to address by the end of 2023.

The allegations around modern slavery in the rubber glove industry are illustrative of the challenges in enforcing standards in supply chains, and demonstrate the need for a collective multi-stakeholder response on living wages by outsourced suppliers. The company, in addition to becoming an inaugural member of the Responsible Glove Alliance, is also in the progress of joining other relevant multi-stakeholder initiatives which are focused on issues upstream in its supply chain. We are supportive of this approach and look forward to ongoing dialogue with Ansell on these matters. We will also be continuing to engage with Ansell around the company's role in supporting safe working practices in factories around the world through its smart personal protective equipment (PPE), as well as mitigating the end-of-life impacts associated with many of its single-use glove products.

Soitec

We have had a series of interactions with this French manufacturer of high performance semiconductor materials.

> **A CEO succession communication in January 2022 triggered revelations of wider governance concerns, following the leaking of an internal letter from executives raising concerns around governance.**

A CEO succession communication in January 2022 triggered revelations of wider governance concerns, following the leaking of an internal letter from executives raising concerns around governance. While the communication around this CEO succession process was initially not well managed, to their credit the company responded quickly and has been very open to dialogue during the period.

> **Following that January governance fall-out, we spoke with the Chair, CEO and others and have been pleased that the company acknowledged the need for a review of governance practices and the involvement of an independent third party in such a review.**

Following that January governance fall-out, we spoke with the Chair, CEO and others and have been pleased that the company acknowledged the need for a review of governance practices and the involvement of an independent third party in such a review. The subsequent review proposed the appointment of two new independent directors, the establishment of a lead independent director and training to be provided to all board and executive members around governance and the company's code of conduct. While positive developments include the company-identified board independence level rising from 42% to 58%, we do continue to note that certain behavioural elements of the executive's leaked critique remain unacknowledged (at least explicitly) and we continue to have concerns over the real independence of certain individuals. On that basis we are very welcoming of the incrementally positive steps but will continue to seek further reassurance about governance in practice.

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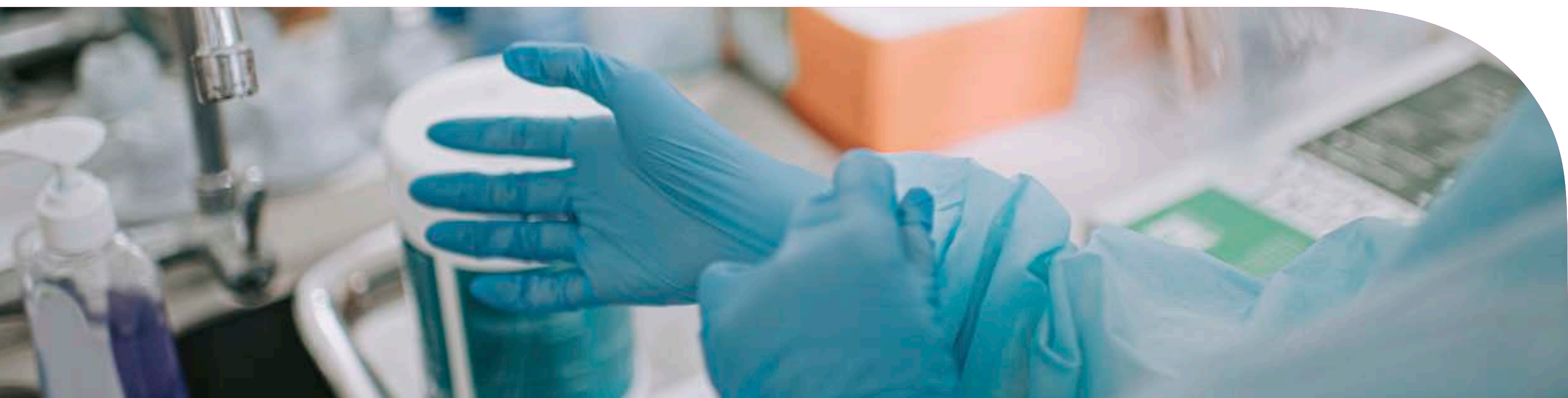
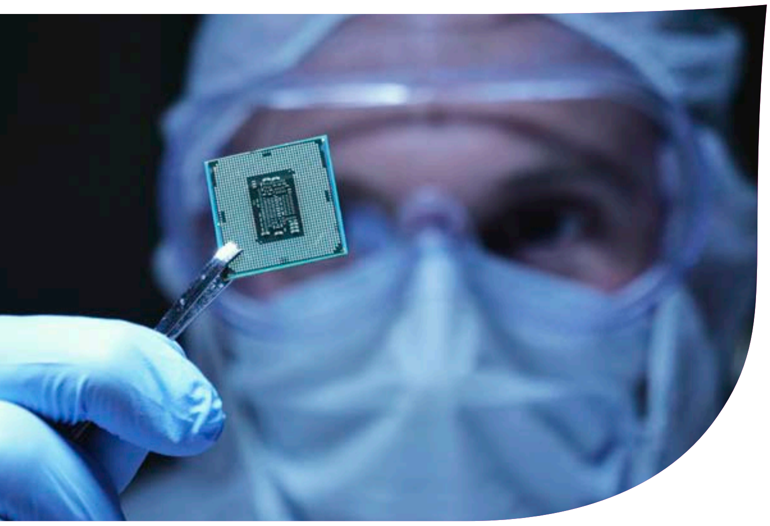




In parallel to these governance dialogues, we spoke again with the company around human capital management. Further to a spontaneous week-long strike in June that occurred when workers on a weekend shift walked out, we discussed with the company its relationships with its unions and engagement with its employees. We had previously spoken with the company in Q4 2021 and had been left reassured at that juncture, and as such we were surprised to hear news of the strike. We put this to the company, which was able to convey some positive news. The company acknowledged that the doubling of headcount in the past five years had resulted in an exhausted workforce. They did also acknowledge that insufficient progress had been made on the issues raised the previous year around work conditions, specifically moving employee relations from the site level to team level.

The company's pay and benefits practices are already generous (both in absolute and relative terms), and their levels of workforce diversity are industry leading.

The company's pay and benefits practices are already generous (both in absolute and relative terms), and their levels of workforce diversity are industry leading. While it was disappointing that strike action was felt necessary by workers, the outcome is likely a positive one. We will look to continue this dialogue later in the year to retain reassurance that employee wellbeing (both physical and mental) is being adequately safeguarded during the period of going growth in demand.

Overall, we welcome the opportunity to engage with this company and look forward to continuing our relationship.

DCC

We continued to meet and engage with the management of this fuel distribution business (which also operates in the Healthcare and Technology sector) regarding its strategy for the much-needed energy transition.

DCC is by a distance the company with the highest carbon footprint in our strategy by dint of the emissions associated with the use of its distributed fuel products across domestic heating, transport and industry.

DCC is by a distance the company with the highest carbon footprint in our strategy by dint of the emissions associated with the use of its distributed fuel products across domestic heating, transport and industry. To that end, it was particularly pleasing that in this period we were able to discuss with the company its new detailed energy transition strategy. The headline commitments from the new strategy include a new Scope 3 emissions target (15% reduction by 2030, and net zero by 2050 or sooner) as a result of 6% reduction in fuel volumes by 2030. These supplement existing net zero direct emissions targets. Over the remainder of this decade the share of the group's profits from traditional fossil fuels will reduce to 25-30% from well over 50% today. Overall, we very much welcome this new strategy and believe the company has done a good job of outlining the opportunities it has to support its customers transition to new, cleaner, energy solutions which span biofuels, electric vehicle (EV) charging and heat pumps. The new strategy is evidently underpinned by deep analysis. In the near term, the pace of decarbonisation across its end markets will be modest but this is expected to accelerate post 2030.

Irish international sales, marketing and support services group DCC have formally committed to a Scope 3 emissions target, which works towards achieving a

15% emissions reduction by 2030, and net zero by 2050 or sooner.

We also once again took the opportunity to raise with the company the vulnerability of a number of its domestic off-grid heating customers with respect to fuel poverty this coming winter. The company acknowledged being mindful of this. It has, it believes, a good knowledge of who vulnerable customers are and will be encouraging individuals to keep tanks filled up prior to a likely spike in winter prices. After careful assessment the company remains confident that it has the lowest price in the market. While these are welcome steps, we will continue to raise this matter with the company to explore what, if any, other actions can be taken to safeguard the small number of particularly vulnerable households from falling into fuel poverty. While ultimately the problem of soaring fuel prices is outside the hands of DCC and there is a responsibility on national government to ensure that their populations have adequate support, we nonetheless recognise that the reputational risk to DCC is significant and may outweigh the cost of further actions to protect the most vulnerable.

Progress of our engagements in H1 2022

Figure 3: Progress of our engagements in H1 2022

2022 H1 engagement overview

% of companies engaged
86%

Total engagement actions
106

Live objectives
163

% objectives with progress
26%

Completed objectives
17

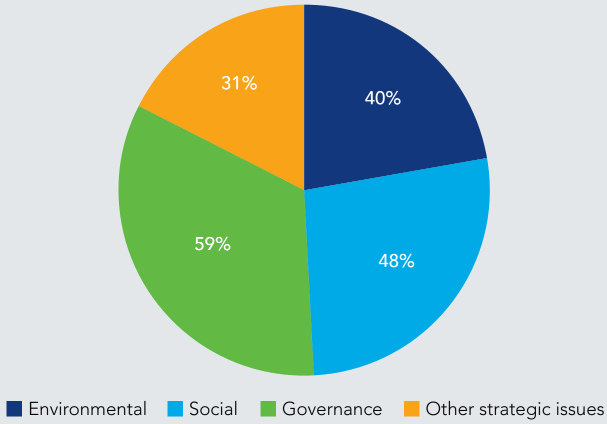
Total meetings voted
48

Number of meetings voted against management on at least one resolution
16 (33%)

Total resolutions voted against
32 (4.9%)

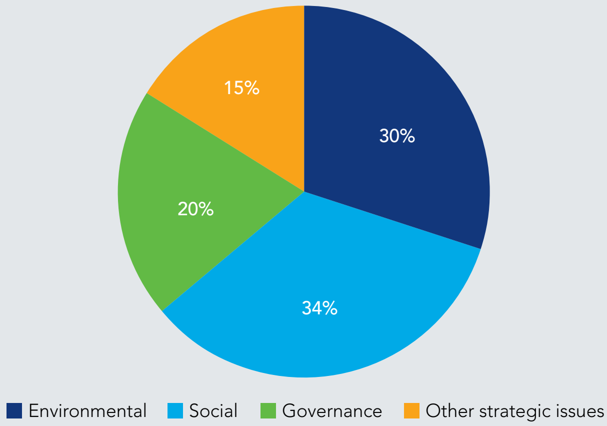
Source: Federated Hermes, as at 30 June 2022.

Figure 5: Proportion of engagement actions in H1 2022



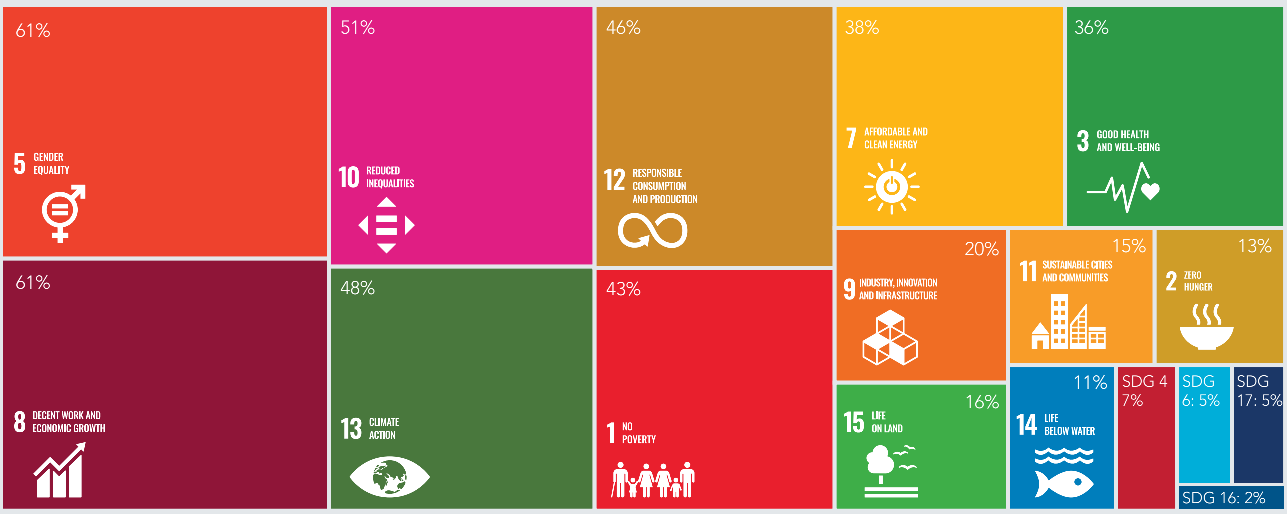
Source: Federated Hermes, as at 30 June 2022.

Figure 6: Proportion of engaged issues and objectives in H1 2022



Source: Federated Hermes, as at 30 June 2022.

Figure 4: H1 2022 engagement actions per SDG



Source: Federated Hermes, as at 30 June 2022.

Sustainability in executive compensation

Last autumn we wrote to every company in our portfolio to request that boards start, or accelerate, the development of sustainability targets for integration into compensation plans.

The letter explained that the pandemic and its resultant societal impacts had shone a spotlight on the good and the bad of today's world. Governments and the private sector collaborated in their response, sustaining jobs and rapidly developing and rolling out lifesaving vaccines. However, there is no hiding from the reality that pre-existing inequalities – social and economic – have been exacerbated. Absolute poverty levels have increased for the first time in decades, and women have consistently been hit hardest by the pandemic fallout, putting back years of progress towards improved gender equality. In response it is evident, and right, that societal expectations towards those in leadership, including within corporations, has grown.

It is generally now accepted that companies that have strong sustainability credentials, in the right places, and with respect to the right things, perform better. Sustainability metrics can often be leading indicators of future financial performance and help illustrate the health of necessary and critical stakeholder relationships, such as those with your customers, suppliers, or employees.

Executive pay

Our first principles with respect to executive pay are that it is better when it is simple, and better still when it is longer-term. We are now contending that it is likely even better when sustainability issues relevant to *what* business a company does, and *how* it does that business, are explicitly incorporated.

With others, we have long recognised that an excessive focus on prescribed cliff-edge performance periods and specific targets can distort decision making and risk unintended and/or adverse consequences. We have now come to the view that incorporating meaningful sustainability targets within pay schemes can powerfully communicate priorities, both internally and externally. Incentive targets can provide a clear indication of where a company is placing its focus and what it expects to achieve. If they are afforded a meaningful weighting then a strong message is sent from the board, and indeed the CEO, that this is an agenda of importance. As such, they are a mechanism for mobilising the organisation, especially if these performance metrics are cascaded down through the company.

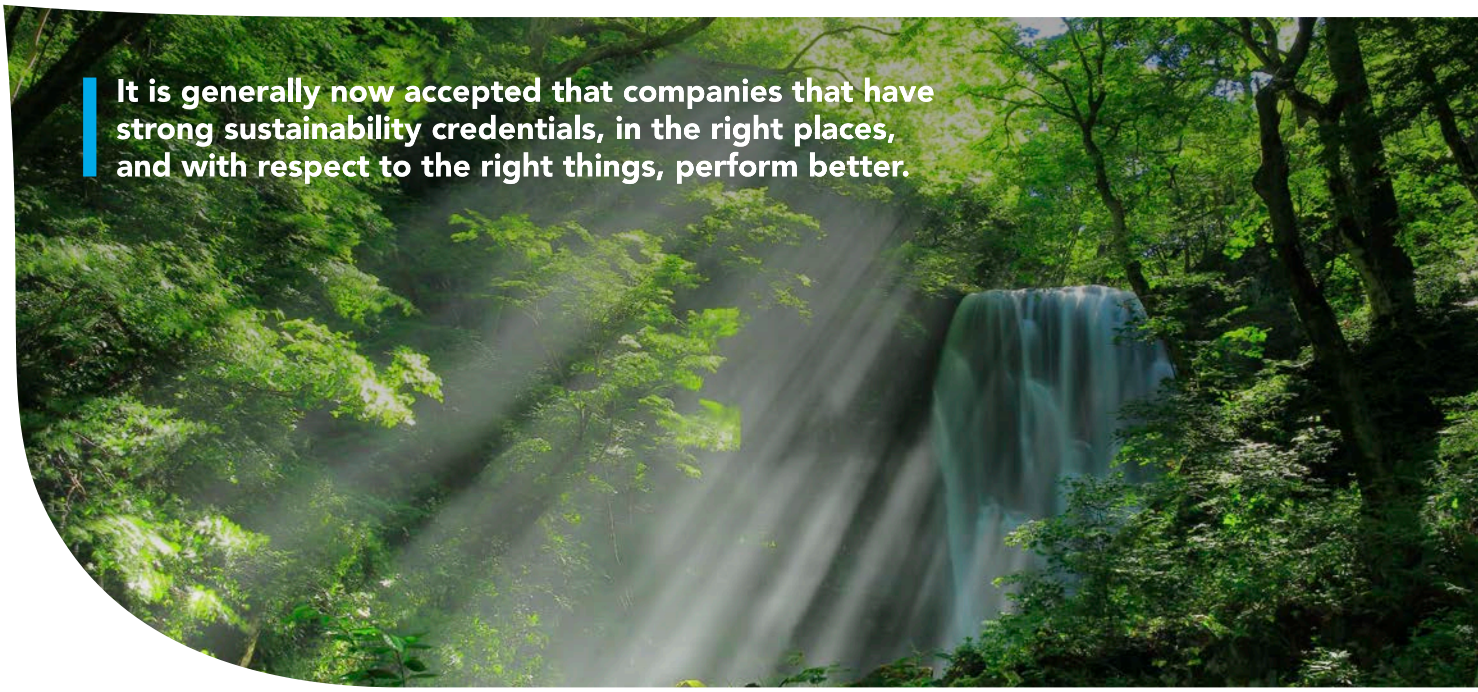
What we would like to see

Less is more

We are keen to see company boards give careful consideration to the inclusion of meaningful and strategically relevant sustainability metrics within their incentive pay schemes. We encourage boards to identify those issues that are most relevant to their long-term business model, and/or those sustainability issues towards which the company can make the most meaningfully positive contribution and for which they wish to be recognised for achieving. Not all issues and topics need including in pay schemes – indeed, most do not. We favour fewer, focused, and ambitious targets.

Measurable is better

There is understandable scepticism and concern in some quarters that the inclusion of sustainability metrics within incentive schemes simply results in higher pay-out ratios. Objectives are often too vague. It is therefore hard for outsiders to assess how stretching such targets are and how outstanding the performance has been.



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In the above context therefore, while we believe there is space and often need for remuneration committees to make a holistic assessment of performance, we encourage the setting of quantitative targets. In particular, we prefer to see objective output measures utilised with a threshold and maximum. Contextualising the ambition of the goal set is also important in this regard. For example, climate change-related targets should speak to a company's greatest climate impact (this could be through its operations, or it could be impacts generated upstream or downstream), and, where practicable, be aligned with targets set by the Paris Agreement.

Where a quantitative target is not used, a clear and thoughtful explanation as to why such target setting was not practicable is needed.

In considering what it is right to measure, we note that certain issues such as the provision of a safe working environment and the upholding of human rights are basic pre-requisites of a responsible business.

At the same time, it is important to acknowledge that not all ESG topics are appropriate for scalable performance measurement. In considering what it is right to measure, we note that certain issues such as the provision of a safe working environment and the upholding of human rights are basic pre-requisites of a responsible business. As such, we prefer to see these topics incorporated as underpins to pay-outs rather than justifications for pay-outs themselves.

Longer-term preferable

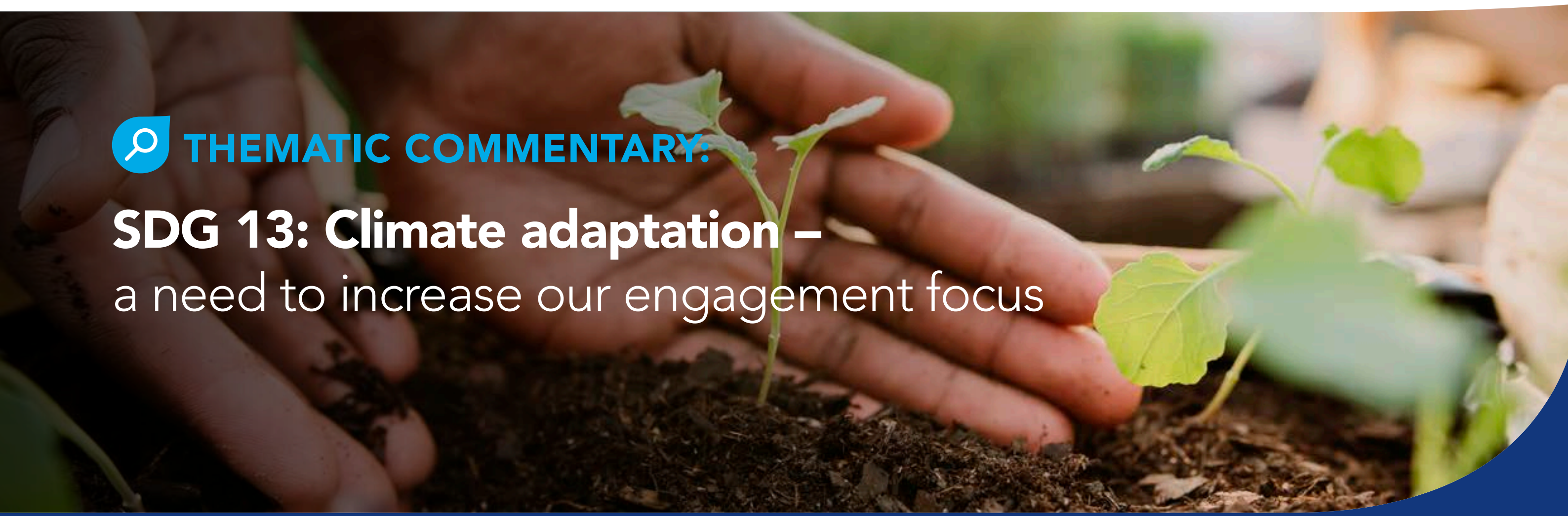
Whether such targets are included within the annual bonus or long-term incentive plan is highly dependent upon the issue at hand. While in principle we favour the replacement of long-term incentive plans with simple restricted stock, we nonetheless recognise that long-term incentive plans (LTIP) remain the market-norm. As such, our starting position is that if the identified sustainability issue being measured is significant and strategic in nature, then it is likely to be more appropriate to set targets over a multi-year period recognising that change takes time and is rarely linear.

Progress

Now nine months on from sending that letter, and on the other side of the main annual general meeting (AGM) season, we can reflect on the evolving situation with respect to meaningful incorporation of relevant sustainability metrics within pay schemes.

% of companies incorporating sustainability metrics within incentive schemes	49%
% of above utilising a quantifiable metric	38%
% of above affording sustainability a material weighting (>20%)	42%
% of above incorporating sustainability metrics within long-term incentive schemes	35%
% of companies above having made changes subsequent to our letter	42%

Source: Federated Hermes / investor proxy statements / annual reports



THEMATIC COMMENTARY:

SDG 13: Climate adaptation – a need to increase our engagement focus

The Sustainable Development Goals (SDGs) are a blueprint for a better and more sustainable future for all. As nations across the globe continue to adapt to changing weather patterns, rising sea levels and record-breaking greenhouse gas emissions, we acknowledge that the targets outlined by SDG 13 to combat climate change and its impacts are crucial to our planet's survival.

SDG 13.1: Strengthen resilience and adaptive capacity to climate-related hazards and natural disasters in all countries

We recognise that as a result of cumulative emissions to date, profound changes in climate and severe weather are locked in for the next several decades and will comprise 'the new normal'.

While each tonne of CO_2 emitted is of equal equivalence in terms of the damage it contributes too, the impacts of climate change are often very local. The physical impacts of climate change are already becoming clear, with extreme weather events from hurricanes to floods and droughts along with greater more sustained heatwaves. In the UK, the recorded temperature exceeded 40°C for the first time this summer[12].

A 2020 study by the UK's Met Office[13] concluded that towards the end of the century parts of the UK could see **40°C days every 3-4 years** on average under a high emissions scenario. The return time for the 40°C threshold is reduced to around 15 years by 2100 under a medium-emissions scenario.

Before this summer the highest recorded temperature in the UK was **38.7°C** in July 2019, and the top 10 warmest years for the UK since 1884 have occurred since 2002.

The reality is that the past decade has been the hottest in recorded history. Tropical storms are getting worse, and sea levels are rising. Countries face proliferating droughts, an acidifying ocean, and shrinking sources of freshwater. Farming is becoming more difficult, and deforestation is continuing.

Therefore, even if transition risk is managed within our portfolios, unmanaged physical risk could still destroy value through business operations or supply chain interruption caused by factors outside the control of our investee companies.

Emissions reduction targets are often easy for incumbent CEOs to agree to – they can be viewed as the next CEO's problem problem.

Against this backdrop, we recognise that companies, regardless of sector, industry, and the location they are in, need to understand and plan to manage the potential physical risks to their operations and supply chains that are inevitable. While we engage on climate matters with near enough all the companies in which we invest, we intend to broaden these dialogues more consistently to cover both transition risk *and* adaptation risk.

Practically speaking, we believe that building climate resilience does not mean reinventing the wheel. It means integrating climate considerations within existing risk management and planning procedures. From setting corporate strategy, to upgrading the design and operation of assets.

We intend to increasingly question whether management have given this matter adequate consideration. The depth of thought given to this agenda and the time-horizon over which they, the management team and board, are focused tells us much about their risk appetite and the diligence of their climate preparedness.

It is possibly fair to suggest that climate mitigation and the associated, typically long-dated emissions reduction targets are often easy for incumbent CEOs to agree to – they can be viewed as tomorrow's problem. But responding to adaptation needs for some is more likely to be salient for today or the short-term. Accounting losses, for example, might be real in this next financial period.

[12] https://www.bbc.co.uk/news/science-environment-62335975
[13] Chances of 40°C days in the UK increasing - Met Office

Asset locations and physical risk

The growing physical risk has implications for asset locations, with the potential need to rethink production bases and/or accelerate depreciation of existing assets. We are keen to understand from companies how changes in extreme weather events and incremental climatic changes are considered in the design phases for new developments and refits for existing assets.

It will be increasingly important to understand whether companies, and similarly their auditors, have considered the risk of needing to accelerate depreciation of assets? Furthermore, have they obtained adequate insurance against such risks and how has the cost of this insurance changed?

Beyond the likes of utilities for which the need for asset resilience is a self-evident, there are others at the extreme. Beverage and bottling companies provide one such example. Given their highly water-intensive operations, these companies need to consider both the absolute and the equitability of any availability of water as they locate new sites. They also need to appraise the same risk for existing assets.

> **We are keen to understand from companies how changes in extreme weather events and incremental climatic changes are considered in the design phases for new developments and refits for existing assets.**

We have one such company in our portfolio today. While water accounts for a tiny proportion of their cost of goods sold, it is a critical input to both their production and more pertinently to their agricultural supply chain. Our dialogue with **Varun Beverages** to date has included discussion around their production in 'over-exploited' zones which comprises over 30% of their total production volume[14].

Elsewhere, water stress is the biggest climate-related risk facing the most populous US counties under moderate scenarios for projected temperature increases. This is particularly true for counties in Arizona and California, which are suffering from an extended drought. In the strategy we hold **Retail Opportunities Investment Corporation**, a west coast US shopping centre operator which has 50% of its assets (by sq ft) located in highly water-stressed locations. To that end, as per the company commentary later in this report, we have had many conversations with them about water usage on their assets.

> **Procurement and distribution systems will likely need to extensively integrate predicted climate impacts and more agile methods as supply chains become increasingly susceptible to the effects of climate change.**

On the flip side, we are invested in **Fortune Brands**, a US home plumbing equipment manufacturer. During the period of our dialogue, this company has significantly improved water-flow rates for its products as well as developing smart-home offerings which manage water usage and detect leaks; the output of these offerings being reduced excess water usage in the home. With 80% of US states expecting water shortages in the coming decade, and, according to the EPA, 300 gallons of water used per day by the average US family[15], this is both an environmental impact and market share gain opportunity for the company – one that it is realising.

Supply chains

Many companies have already over-extended their supply chains and have eliminated redundancies to the point at which they have become insecure and subject to failure, or/are not resilient enough to withstand additional shocks to the system. Procurement and distribution systems will likely need to extensively integrate predicted climate impacts and more agile methods as supply chains become increasingly susceptible to the effects of climate change.

In the long term, risk management could call for changes to supply chains (to build in geographic variability or redundancy), including moving away from suppliers and/or locations that are highly exposed to physical climate risk.

Water stress, as already mentioned, is one example of a location-specific risk. Upstream in agricultural supply chains is often where the tension really bites. Larger corporates will need to collaborate with their growers to establish water efficiency standards for cultivating commodity inputs.

> **Larger corporates will need to collaborate with their growers to establish water efficiency standards for cultivating commodity inputs.**

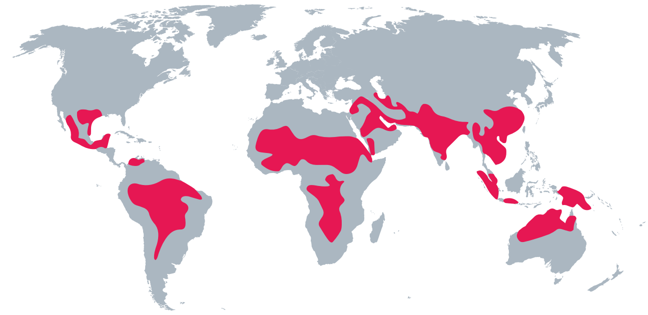
Workforce

Finally, the workforce will be impacted by climate change and our need to adapt to it. In some areas, outdoor workers face an increase in the number of days with temperatures beyond safe operating conditions.

[14] Varun Beverages H1 2022 report
[15] How We Use Water | US EPA

The map below shows the parts of the world that could reach high heat stress with a 4°C temperature rise (based on wet bulb global temperature – a measurement that accounts for both temperature and humidity), when those working outside should be taking more frequent rest breaks to lessen the effects of extreme heat.

Figure 8: Global areas at risk of high heat stress with a 4°C temperature rise



Source: UK Met Office

Areas accustomed to heat stress are already activating hot weather protocols earlier on in the summer period. However, even office workers can suffer from heat stress if buildings are not properly air conditioned. Again, this raises more questions around both locations of production sites and investments needed to adapt existing sites to ensure worker safety and wellbeing is prioritised.

The payback

In simple terms, we believe that building resilience can lead to increased efficiency in the short and long-term. Sensible investments today should help by extending asset lifetimes and reducing depreciation. They should also lower input costs and reduce business interruptions. A climate-resilient business should ultimately be more insurable, more profitable, and more investable.

As opposed to the climate transition however, where emissions reductions can be tracked, adaptation investments generate returns through estimated avoided losses which are difficult to measure. It is always hard to prove a counter factual.

Adaptation plans

We believe each company should prepare for the inevitable climate change that is occurring. This will require development and disclosure of adaptation and action plans that demonstrate resilience to the physical impacts of climate change in a range of climate scenarios.

- Assessment of exposure to the physical risks throughout operations and supply chain across a range of climate scenarios, including some indication of financial implications.
- Development of adaptation and action plans to manage the physical risks of climate change.

Engagement questions

1 Has the company conducted a baseline assessment of physical risks and opportunities for hazard types relevant to its footprint and supply chain?

- Does the company assess direct and indirect physical risks using at least two scenarios (including a 2°C scenario and a 4°C scenario)?
- Has the company identified trigger points for adapting, shutting down, or disposing of assets?

2 Has the company defined a strategy to build resilience to climate-related physical risks?

- How are changes in extreme weather events and incremental climatic changes considered in the design phases for new developments and refits for existing assets?
- How does the company prioritise and financially provision for climate resilience actions?
- What actions are the company taking to ensure physical risks are managed across value/supply chains?

3 What governance mechanisms are in place for the management of current and future physical risks?

- What incentives are in place – at the board level and throughout the company – to achieve climate resilience goals, and are these in conflict with any other incentives?

4 How is the company assured of the adequacy and rigour of its policies and practices?

- Has the company obtained appropriately qualified external specialist advice in the area of physical climate risk? How has this contributed to enhancing in-house capabilities and challenge internal bias?
- Have physical climate risks been raised as key audit matters?
- What are the impacts of physical climate risks on depreciation and operational costs?
- How are internal and external audit processes incorporating these considerations into existing processes, including provisions and impairment exercises?

ENGAGEMENT COMMENTARY:

Retail Opportunities Investment Corporation (ROIC)

In a nutshell

ROIC is the largest publicly-traded, grocery-anchored shopping centre real estate investment trust (REIT) focused exclusively on the west coast of the US.

Equity market capitalisation:
$2bn
(as at July 2022)

Size: owns
10m sq ft
across 89 shopping centres

Employees:
68
(FY21) of which 68% are female

Headline progress

The company has moved markedly over the past few years. From zero sustainability reporting and limited internal initiatives in 2018, the company has since established inaugural policies, published inaugural reports and set out measurable, time-bound targets for reducing its environmental impact.

- 13% cumulative reduction in same-centre greenhouse emissions (2021 vs. 2019 base year)
- 20% cumulative reduction in same-centre energy consumption (2021 vs. 2019 base year)
- But also an 18% year-on-year increase in same-centre water consumption (2021 vs. 2020)

Theory of change

The construction and operation of buildings contribute around 40% of worldwide greenhouse gas emission[16]. In the United States, the Department of Energy estimates that commercial buildings account for c18%[17] of energy usage and account for 40% of carbon dioxide (CO_2) emissions, and 88% of potable water consumption[18].

Western US states, such as California, have been experiencing a worsening water crisis with more frequent and severe droughts. Indeed, the American west has spent the last two decades in what scientists are now saying is the most extreme megadrought in at least 1,200 years[19], and 2021 was the second driest year on record[20]. However, water use intensity per capita in the western states tends to be higher than the US average[21].

The need for action is therefore clear. In most countries, the buildings that will principally constitute the urban environment in 2030 already exist. Therefore, improving the energy efficiency of these buildings is one of the most cost-effective and fastest ways to reduce electricity demand, while indirectly slashing carbon emissions as well as improving local air quality and public health.

The Global Alliance for Buildings and Construction (GlobalABC) however, notes that in its 2021 Global Status Report[22], investment in the energy efficiency of buildings continues to climb and reached more than US$180bn in 2020, up from $129bn (in 2020 dollars) in 2015. However, most of this increase has arisen in just a small number of European countries. Without broader investment, this level is unlikely to be sufficient to tackle efficiency improvements among the existing global building stock. Furthermore, the IEA notes that buildings remain off-track to achieve carbon neutrality by 2050. To meet this target, all new buildings and 20% of the existing building stock would need to be zero-carbon-ready as soon as 2030[23].

Commercial building operators can contribute to reducing carbon emissions by switching to cleaner energy sources and reducing energy consumption via energy efficiency measures.

[16] Comprehensive Carbon Footprinting in Real Estate | GRESB
[17] EIA.gov.uk
[18] Use of energy in commercial buildings in depth - U.S. Energy Information Administration (EIA)
[19] US west 'megadrought' is worst in at least 1,200 years, new study says | Drought | The Guardian
[20] Current drought conditions (ca.gov)
[21] A guide to California's water crisis — and why it's so hard to fix - Vox
[22] 2021 Global Status Report for Buildings and Construction | Globalabc
[23] Buildings – Topics - IEA

Furthermore, operators such as Retail Opportunities Investment Corp (ROIC) can contribute to water use savings by adopting a series of water upgrade measures.

Finally, with increasing demand for 'green' buildings from larger building tenants and with utility costs impacting commercial real estate profits, it makes business sense to adopt greener building practices. Doing so ultimately presents a win-win possibility of attracting stickier tenants and maximising rental income and asset values while reducing environmental impacts.

Practice of change

We have been invested in ROIC for many years, including since inception of the SDG Engagement Equity strategy at the start of 2018. During that time we have had approximately 20 interactions which have included meetings and calls with the senior management team, most commonly the CEO, as well as with the chairman and others.

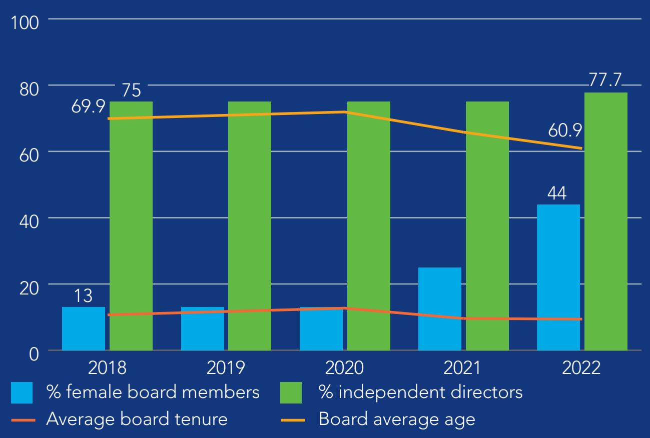
Many real estate companies are now including ESG information as part of their investor and public reporting and include numerous key performance indicators, including energy usage, greenhouse gas emissions, waste management, number of sutainability certified assets among other metrics. This level of disclosure remains patchier in some markets such as North America than for Europe, however, there is progress.

When we first began engaging with ROIC on sustainability matters the company was notably lagging, although in a market as per above with lower levels of ESG disclosure than elsewhere. After multiple, predominantly positive and constructive conversations with the ROIC management team over a sustained period, we have been pleased at the progress the company has made to date. Indeed, management noted that our dialogues were the catalyst for them to accelerate their practices and investment around this agenda.

- 2019 – The company established an internal ESG committee.
- 2020 – ROIC adopted ESG metrics as part of its long-term incentive plan – well ahead of many of its peers.
- 2021 – The group formally set out its inaugural ESG plans policies at the beginning of the year and later published its first ESG report. These included data and forward looking, measurable and time-bound reduction targets for energy, water, waste, and greenhouse gas emissions.
- 2022 – ROIC was selected as a 2022 Green Lease Leader by the US Department of Energy's Better Buildings Alliance and the Institute for Market Transformation. Specifically, ROIC was awarded 'Gold' level designation in recognition of its continued success in collaborating with tenants on energy efficiency, decarbonisation, air quality and other environmental and social issues.

Beyond the 'E', the company has made large strides on governance with much improving levels of diversity – spanning age, gender and ethnicity.

Figure 9: Board composition – a rise in diversity and refreshment



Source: ROIC.

In 2018 and 2019 we voted against the chair of the governance committee (Edward Meyer) due to ongoing lack of board diversity and the ongoing restriction on shareholders ability to amend the company's bylaws – in addition to the fact that the board member was well into his 90s. We were also concerned that the board was exhibiting a worrying tendency of ignoring the will of its minority shareholders.

At the 2019 AGM, non-executive director Lee Neibart received a majority of cast votes against his re-election and in 2020, the aforementioned Ed Meyer similarly received two-thirds opposition. In both cases the individuals offered their resignation. In both cases too, the board voted in response to decline the resignations.

In Q1 2021 however, the company announced that Edward Meyer would not stand for re-election at the 2021 AGM. Alongside Ed Meyer's retirement, Angela Ho joined the board bringing increased diversity. Furthermore, it was later confirmed that Zabrina Jenkins and Adrienne Banks Pitts were to join the board as independent directors with director Charles Persico not standing for re-election at the 2022 AGM. These changes were accompanied by welcome amendments to the company's bylaws. As a result, as of July 2022 the company now operates a refreshed and diverse board and has for a couple of years afforded a material weighting (25%) towards ESG metrics within the performance-share element of the long-term incentive plan granted to management.

Next steps

While the rate of progress has been laudable, there remains scope for more to be achieved. We continue to speak with the company around its installation of energy efficient lighting and solar arrays, as well as its installation of EV charging units and its support for more efficient waste management.

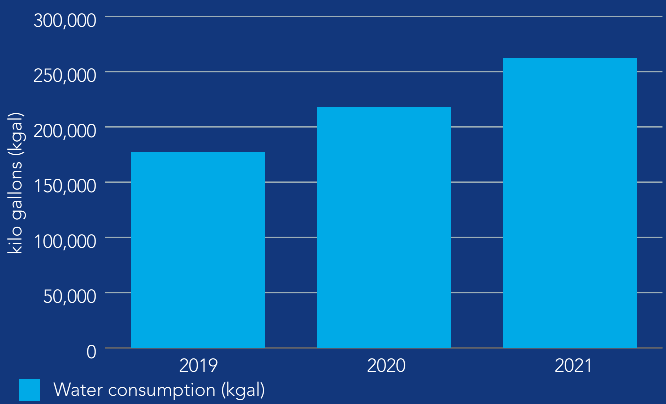
Management have noted that car park lot lighting is a significant drain, commonly comprising 70-80% of total electricity usage. As such they are systematically shifting the lighting of these to LEDs (estimated by the US Department of Energy to be approx.75% more efficient)[24]. At one of its major sites (Fallbrook) the company's switch to LED lighting resulted in a 70% reduction in parking lot lighting consumption. **As of the end of 2021, 10 properties had LED lighting installations, illustrating the scope for progress ahead.**

During an early 2018 call with the company's CEO it was confirmed to us that 'green initiatives' are now a 'very high priority', and to that end, the company was tendering for bids to roll out a series of improvements across all of its sites with all centres to be assessed for installation of electric vehicle charging stations and solar panel installations.

On the installation of solar arrays, as at the end of 2021, the company had **finalised solar agreements for nine of its properties,** representing approximately 19% of its portfolio by gross leasable area.

With respect to electric vehicle (EV) charging units, as at the end of 2021, the company had **installed 51 EV charging stations at five properties**. In addition, anchor tenants have lease rights to add an additional 32 stations across seven properties by the end of 2022.

Figure 10: Although data coverage has improved, water consumption has increased



Source: ROIC as at end 2021.

Finally, we note **50% of the company's assets by square footage are located in extremely water-stressed areas of California.** The company committed to attaining 80% common area water data coverage by 2023 (vs. just 33% data coverage in 2020), something which it comfortably achieved as of the end of 2021. It has also committed to the installation of irrigation controls at 80% of properties by 2023. However, water consumpton has continued to increase in this period. Given the severity of the water stress in many of its locations we continue to encourage the company to prioritise this area.

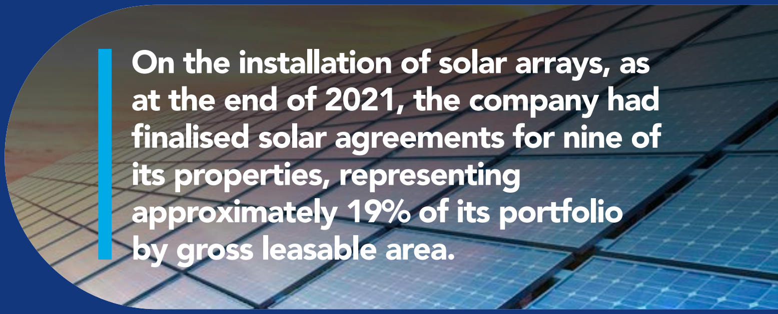
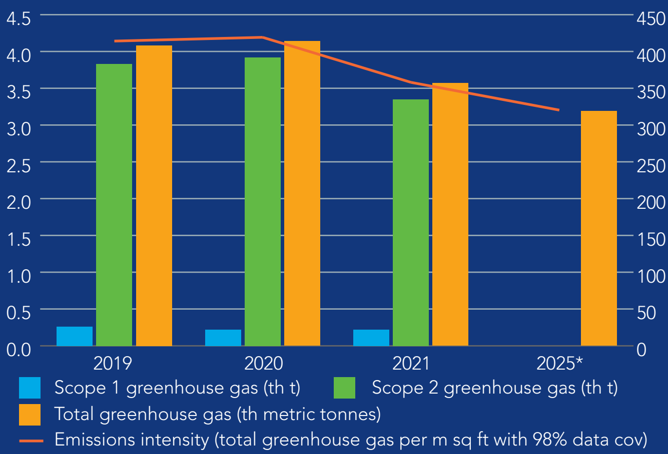

On the installation of solar arrays, as at the end of 2021, the company had finalised solar agreements for nine of its properties, representing approximately 19% of its portfolio by gross leasable area.

Figure 11: Emissions are projected to continue declining

Emissions targeting a 15% reduction in like-for-like Scope 1 and 2, greenhouse gas emissions vs. 2019 baseline. Achieved to date a 13% reduction from 2019-21[25].



Source: ROIC.

Overall, we continue to engage constructively with ROIC. We are very cognisant of the difficulties in attaining baseline data from tenants and the difficulties this presents in terms of understanding the full environmental footprint and impact of the company's assets. The company has set itself measurable and time-bound targets around emissions generation and energy use, however, these remain relatively modest in our view.

We have highlighted examples of best practice observed elsewhere and are encouraging the company to set itself suitably high ambitions. We continue to press the case for targeting to be net positive for landlord controlled impacts and then subsequently for tenanted areas too.

To date, there has been evident progress but undoubtedly more to achieve too.

In conclusion, we commend the company on the progress it has made to date. We nonetheless hope to see longer-term energy and emissions reduction targets be set, and a real prioritisation and focus on water savings at the company's self-identified water-stressed assets. We are hopeful we will see the positive momuntum maintained during the course of 2022 and beyond.

The above does 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 does not constitute a solicitation or offer to any person to buy or sell any related securities or financial instruments.

[24] LED Lighting | Department of Energy

[25] LFL data comprises six properties for Scope 1 and 85 properties for Scope 2.

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