



Federated Hermes SDG Engagement High Yield Credit

Annual Report 2021

April 2022

**Federated
Hermes** 
Limited

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For professional investors only

SDG Engagement High Yield Credit: 2021 highlights



388 engagement actions were carried out at **100%** of

138 companies in the strategy



Driven by our

3 dedicated fixed income engagers and



24

lead engagers in EOS at Federated Hermes (EOS)



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



228 environmental engagements



Social engagement dialogue vastly increased –

66

combined actions on **human rights and diversity**



Governance engagement actions grew from

242 to **303**

in 2021, via deepening critiques on executive pay



Progress on engagement objectives accelerated; we vastly increased objectives set at portfolio companies

Out of **187** progressed objectives,

we completed **20** in 2021

On the SDGs...

Engagements focused on **SDGs 7, 12 and 13** (Clean & Affordable Energy, Sustainable Production & Consumption, Climate Action) continue as the mainstay of impact potential for our strategy, as does **SDG 9** (Industry, Innovation & Infrastructure)

Engagements focusing on **SDGs 5, 8 and 10** (Gender Equality, Decent Work & Economic Growth, Reduced Inequalities) increased

67% over 2020 through **281** engagements

Top SDG Engagement Themes



197 actions



159 actions



105 actions



102 actions



96 actions



95 actions



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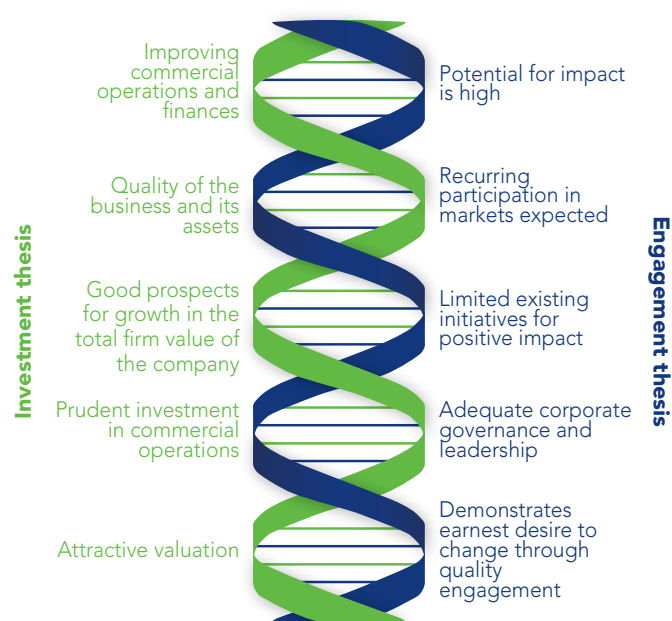
SECTION 1

Introduction

The beating heart of SDG Engagement High Yield Credit: positive impact & strong financial returns

The SDG Engagement High Yield Credit (SDGHY) strategy seeks to deliver on colinear objectives: strong financial performance for investors, and future, positive social and environmental impact that contributes to achieving the United Nations' Sustainable Development Goals (SDGs), as described in Figure 1.

Figure 1. Investing with co-linear objectives



Source: Federated Hermes.



We believe that an investor's financial stake-holding allows, if not obliges, them to engage in constructive dialogue with companies. Turning engagement into meaningful change takes time, so we require portfolio companies to be survivors in a levered universe. Within the global hard currency, high-yield market, we favour companies with:

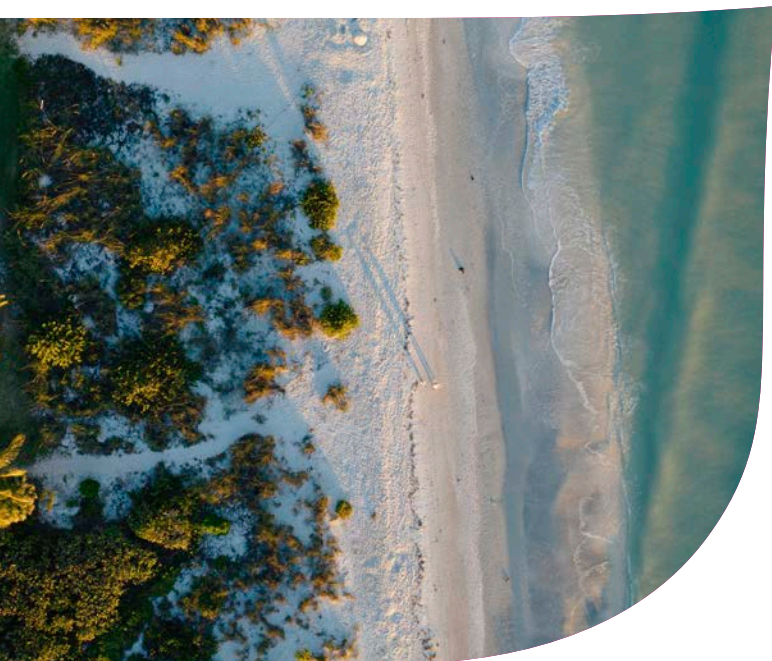
- a recurring presence in capital markets
- a stable investor base
- an ethos of transparency in disclosures and reporting
- the necessary credit strength to participate in long-term dialogue and evolve their businesses to the benefit of a range of stakeholders.

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

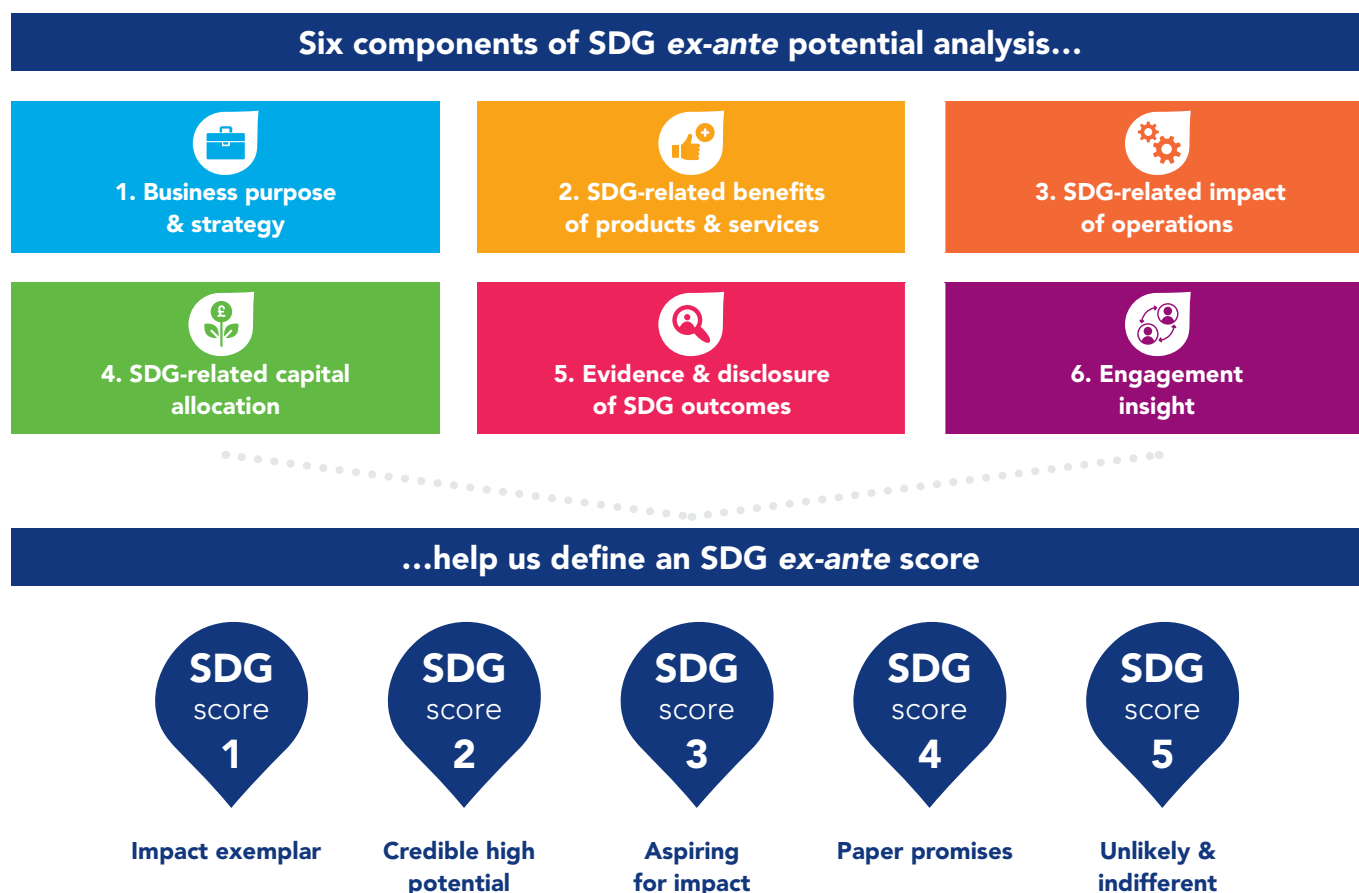
SDG scores: a building block for portfolio construction

Assessing a company's contribution to achieving the SDGs is no easy task and the difficulty is compounded by the nature of some companies within the high-yield universe. The companies we invest in do not always lead their sector in disclosing how their products, services, operations or strategic investments can drive positive SDG-related impact. Some impacts that we believe are possible cannot be fully assessed without substantive engagement. To do this, it is essential to hold a financial stake. To invest, we must establish an outlook for potential change in our pre-engagement assessment of each company. Ultimately, this manifests as an SDG score of one to five (one representing a high likelihood of delivering positive, substantive outcomes in line with one or several SDGs). The score helps us assign appropriate weight to each company within our portfolio.¹ SDG scores and hypotheses help us to assess companies across six factors and are integral to our investment approach (Figure 2).

To invest, we must establish an outlook for potential change in our pre-engagement assessment of each company.



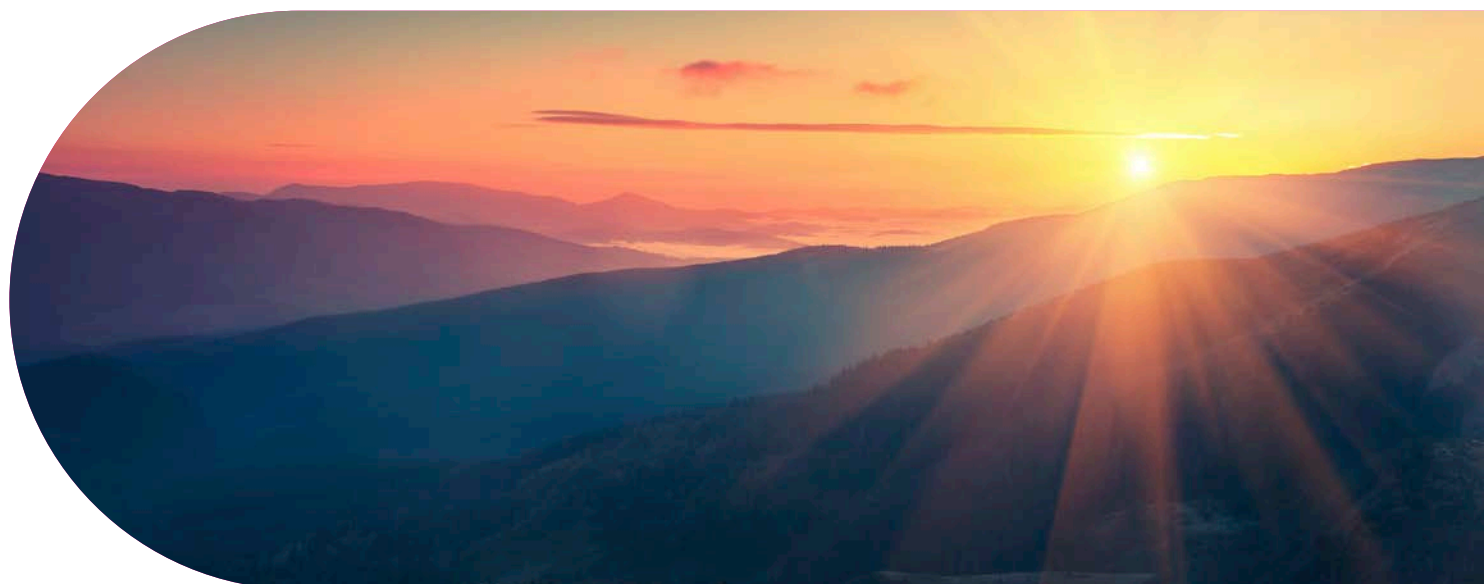
¹ A summary of our scoring framework is provided in the appendix.

Figure 2. SDG-aligned engagement – our six assessment factors

Source: Federated Hermes.

Our sixth factor, Engagement Insight, is unique. Thanks to the 15-year history and reputation of our stewardship team, EOS at Federated Hermes (EOS)², we draw on established relationships and insights from engaging with many companies. Indeed, 75% of EOS's relationships with companies in the core engagement programme have lasted eight years or more, and a significant number have been running for a decade or longer.

This helps us to understand influential qualitative factors, such as management team culture or the company's view on material risks and opportunities.



² Visit the EOS website to find out more.



How our processes evolved in 2021

During the year, we continued to create sector-level methodologies to assign SDG scores. This enables greater specificity about the SDG contribution we expect from a company given its sector, and enables cross-sector comparison. For example, the oil and gas tool shows us which companies perform best on driving methane emissions intensity to near zero now or in the future.

Why proxy and voting-based engagement matters for creditors

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

Measuring our progress and impact using milestones and objectives

Establishing a causal link between engagement efforts and real world outcomes is often difficult. There are occasions when a company directly credits our intervention for actions it has taken, but we often need to rely on other measures of success.

We use a four-stage milestone system (Figure 3) to track the progress of our engagements relative to the objectives set for each company. When we set an objective, we also identify the milestones that need to be achieved. Progress is regularly assessed and evaluated against the original engagement objective.

Figure 3. Engagement milestone system



There are occasions when a company directly credits our intervention for actions it has taken, but for the most part we need to rely on other measures of success.



SECTION 2

Investment review



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



Fraser Lundie, CFA
Head of Credit

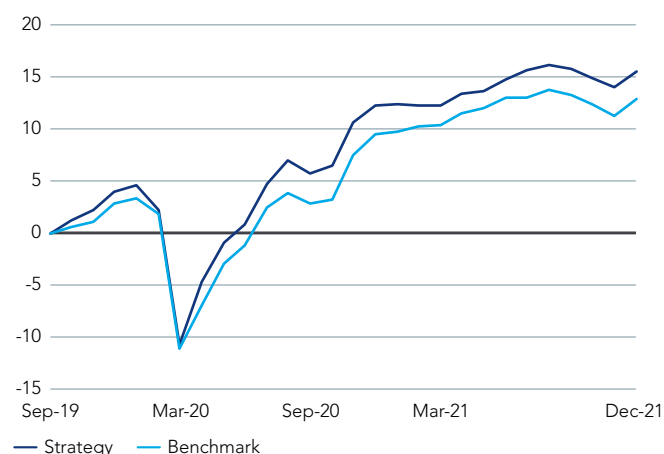


Nachu Chockalingam, CFA
Senior Portfolio Manager

The strategy marginally lagged the benchmark in 2021 largely on account of its underweight to the energy sector and CCC-rated issues (both sectors materially outperformed the broader high-yield market during the period). Optimism for high beta, more-cyclical credit, was apparent at the start of the year amid elevated oil prices, the reopening of economies and the success of the Covid-19 vaccine roll out in some countries.

The strategy continued to have a higher-quality bias throughout the year and, once again, avoided any defaults and distressed sales. One area of market stress during the year was the Chinese real estate sector, which saw many developers face extreme liquidity pressure and ultimately witnessed the default of the country's largest developer, Evergrande. The strategy benefited from being significantly underweight this part of the market along with Asia, in general, which initially suffered from contagion from events in Chinese real estate.

Figure 4: The SDG Engagement High Yield strategy versus the benchmark since inception



Rolling year performance (%)

	31/12/20 to 31/12/21	31/12/19 to 31/12/20	31/12/18 to 31/12/19	31/12/17 to 31/12/18	31/12/16 to 31/12/17
SDG Engagement HY Credit Strategy	2.87	7.94	–	–	–

Source: Federated Hermes as at 31 December 2021. Performance shown is the Federated Hermes Int'l SDG Engagement High Yield Credit Hedged to USD Strategy. In USD, gross of fees. Inception date: 30 September 2019. Benchmark: ICE BofAML Global High Yield Constrained Index hedged to USD. Data is supplemental to the GIPS® report that can be found in the Appendix.

Past performance is not a reliable indicator of future returns.

One area of market stress during the year was the Chinese real estate sector, which saw many developers face extreme liquidity pressure and ultimately witnessed the default of the country's largest developer, Evergrande.



Over the course of 2021, the strategy's benchmark spreads were rangebound between mid-300 basis points (bps) and mid-400bps; a stark contrast to the preceding year when they reached a peak of 1,100bps at the height of the pandemic.

Over the course of 2021, the strategy's benchmark spreads were rangebound between mid-300 basis points (bps) and mid-400bps; a stark contrast to the preceding year when they reached a peak of 1,100bps at the height of the pandemic. The widest levels seen were in November 2021, when the emergence of the Omicron variant of Covid-19 threatened to derail the global recovery. Throughout the latter part of the year, we also saw US treasury yields rising as markets priced-in the increasing likelihood of a more rapid rate hiking cycle as high inflation was looking potentially less transitory. Most high-yield issuers have spent the past 18 months strengthening balance sheets and extending maturities, allowing more flexibility in refinancing decisions, particularly following recent retracements in government bond yields. However, the market continues to be difficult to access for the above-mentioned stressed Chinese real estate issuers.

Figure 5. Global high yield spreads during 2021



Source: Bloomberg 31 December 2021.

Past performance is not a reliable indicator of future returns.

Our credit analysts and engagement specialists delivered a substantial list of engagement successes over the year. We initiated dialogues with several new issuers in the strategy, including SNF Floerger and Solenis in the basic materials sector, Heimstaden and Iron Mountain in the real estate sector, Schaeffler in the automotive sector, and Nokia in the technology sector.

A wide range of the companies in our strategy have the potential to benefit society and the environment – their key challenge is in the progressive development of clean, future-resilient and more equitable industries. In short, it is the job of many of these companies to provide the building blocks for economies and the essentials for everyday life and employment. However, their value chains must be transformed if society is to meet the aims of a cross-section of the SDGs.

Unsatisfactory engagement outcomes: a valuable outcome in positioning our portfolio for greater impact

While we had engagement successes with many of our holdings in 2021, we accept that not every SDG impact and engagement hypothesis is going to succeed. This was true at some companies, where we failed to realise engagement progress or the outcomes we initially targeted. This can happen for a variety of reasons – from unexpected merger activities, to developing a nuanced understanding of management, board culture and decision-making styles. Such developments can lead to downgraded SDG scores which can either dilute our holdings in companies, or cause us to exit the investment completely.

- **Domtar:** we exited the holding following its acquisition by Paper Excellence. While we previously believed it had strong potential to markedly evolve its sustainability and impact approach within forestry, after secondary research and interactions with management, we were not convinced that its new owners would pursue such potential to the same degree.
- **Adler Group:** over the course of the year, we significantly diluted our position in the company and ultimately exited the holding following a lack of meaningful progress in engagement. Throughout 2021, the company faced mounting pressure to restore investor confidence and deleverage amid concerns about its ownership structure and accounting policies. Our engagers struggled to make meaningful progress with the company, particularly in relation to social inclusion and emissions reduction.
- **Coca-Cola Icecek:** we exited the holding as, through our engagement, we discovered that the company lacked a proactive health and wellness portfolio strategy, particularly in relation to nutritious food and beverages. Moreover, we felt that its sustainable packaging goals were insufficiently ambitious compared to its peers.

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 information does not constitute a solicitation or offer to any person to buy or sell any related securities.



SECTION 3

Engagement Review

In the second year of the strategy, we accelerated the pace of our engagement with every company we invest in

In 2021, we carried out 388 engagement actions across 100% of the 138 companies held in the strategy – 24 more actions than in 2020³.

This represents an average of 2.8 actions at every company and includes governance interactions during proxy and voting seasons⁴.

While the Sustainable Fixed Income (SFI) team's dedicated engagers drove 216 engagement actions, the team's activity was bolstered by 172 actions carried out by EOS's lead engagers. Our stewardship platform remains a bedrock of our comprehensive approach.



Aaron Hay,
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Jake Goodman, CFA
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Bertie Nicholson,
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Engagement & ESG Associate, SFI

Materiality-led dialogue across a spectrum of ESG opportunities and risks

We continue to base our core engagement strategy on EOS's industry-leading model and processes, and we remain committed to our core engagement themes and subthemes (Figure 6)⁵.

Figure 6. Engagement actions in 2021, by subtheme



Source: Federated Hermes, as at 31 December 2021.

³ Source: Federated Hermes, as at 31 December 2021. For more information on our previous year, see the [2020 report](#).

⁴ SDG HY Annual Report (<https://www.hermes-investment.com/uki/insight/fixed-income/sdg-engagement-high-yield-credit-2020-annual-report/>)

⁵ For more information on EOS engagement planning, themes and subthemes, refer to the appendix.

Engagements on governance grew from

242 to 303

in 2021, driven by deepening critiques on executive remuneration



Environmental themes increased to

228 in 2021

including more focus on pollution and waste management and supply chain management



Our engagement on human rights and diversity, at

66 combined actions, grew 300%



Within strategy, risk and communication engagement, we increased focus on integrated reporting and other disclosure to

72 actions in 2021.



Governance and **environmental** subthemes continued to feature prominently in 2021 (303 and 228 engagements respectively). During the year, we broadened topical engagement within the environment theme. While climate change remains the focal point (featuring in 177 engagements, the most-addressed subtheme in our strategy), we increased focus on pollution and waste management, forestry and land use, and supply chain management. This reflects SDG-linked objectives we are pursuing across the strategy.

We intensified engagement on **social and ethical** themes with 141 actions (compared to 69 in 2020). As we deepen relationships with corporate stakeholders, we were able to move from risks and opportunities with high urgency (particularly in environmental challenges, given our holdings in energy, basic materials, chemicals and industrials) to initiating dialogue on issues which, by their nature, only progress positively over long periods of time. For example, the subthemes of human capital management, diversity and human rights saw notable increases in engagement saliency in 2021, featuring in 114 engagements (compared to 43 in 2020).

Finally, within **strategy, risk and communication**, our engagement remained relatively constant at 242 engagements in 2021, compared to 233 in 2020. We continue to engage on matters of firmwide performance and its direct or indirect links to

the SDGs. Indeed, as illustrated in the progress highlights below, we believe that a company's potential is often intrinsically driven by core business model shifts and resultant performance.

2021 cemented what we think are the most material and fundamental areas of positive future impact in our portfolio. Our 'delta of impact' has become apparent for many companies within each of their SDG impact hypotheses and scores.

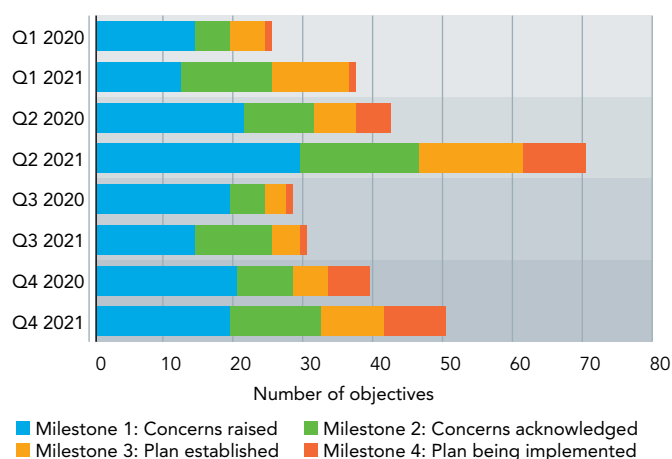
The remainder of this chapter outlines how we progressed on the key objectives, in line with the potential for SDG 'deltas of impact' at each firm and within peer sectors.

We continue to engage on matters of firmwide performance and its direct or indirect links to the SDGs.

Our strategy demonstrates considerable progress on our objectives for change

Our objectives are focused on the key medium- and long-term changes we think are necessary or desirable for an issuer to demonstrate.

Figure 7. Number of milestones achieved per quarter – 2020 versus 2021

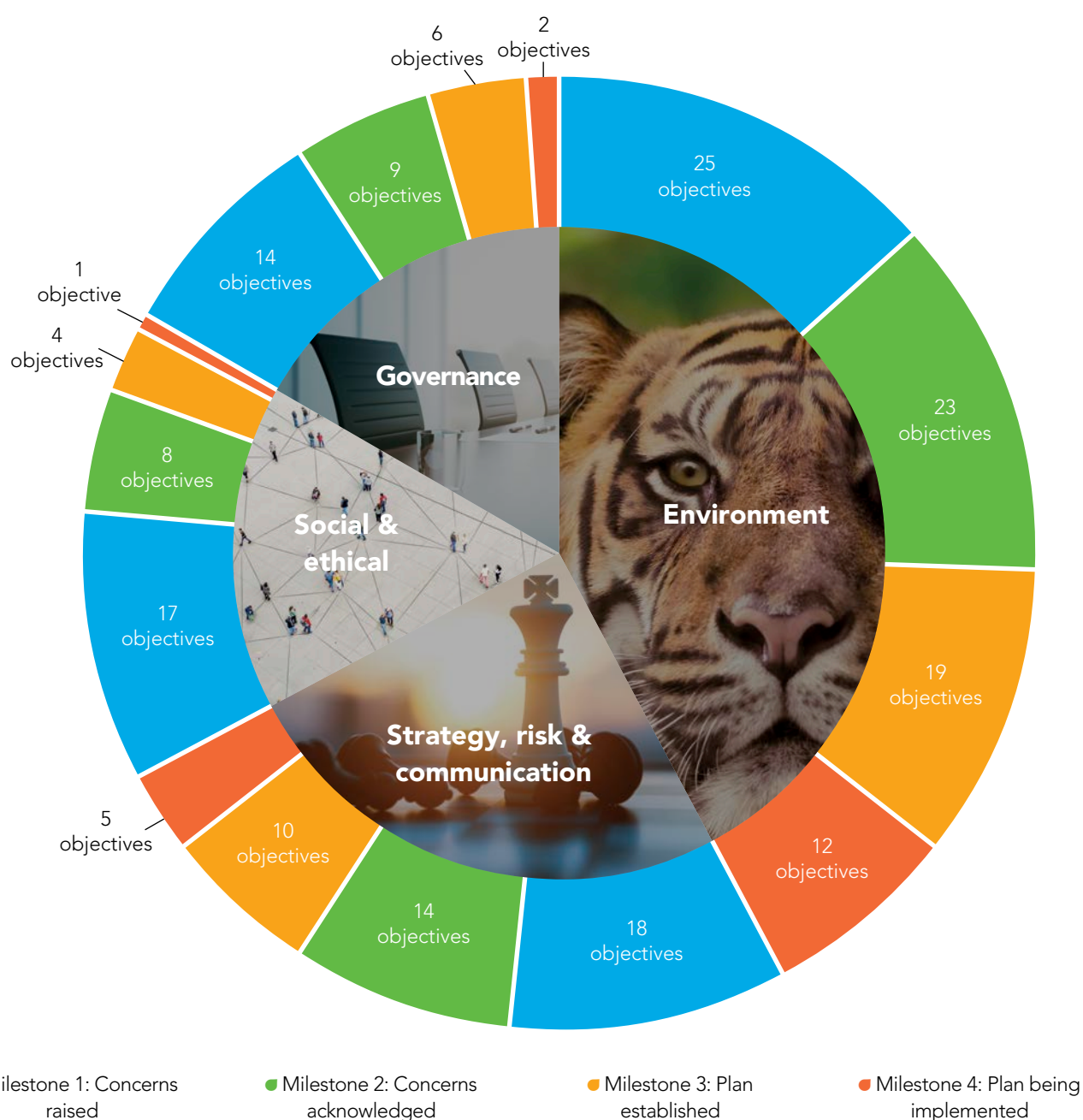


Source: Federated Hermes, as at 31 December 2021.

Figure 7 compares the quarter-on-quarter progression of milestones at each new stage of engagement. The analysis shows:

- We vastly increased the range of objectives set at portfolio companies, with every quarter featuring more progression relative to 2020. For example, we progressed 70 objectives in Q2 2021 through a flurry of activity on governance and beyond, relative to 42 milestone advancements in Q2 2020.
- In 2021, progression to milestones 2, 3 and 4 matched or increased every quarter. This is evidence of our focused engagement of objectives over several years.

Figure 8 shows completed milestones for all objectives in 2021. When compared to objectives and milestones in FY2020, we have widened dialogue across a greater range of objectives, and advanced progress through continued engagement on existing priorities.

Figure 8. Milestones completed in 2021

Source: Federated Hermes, as at 31 December 2021.

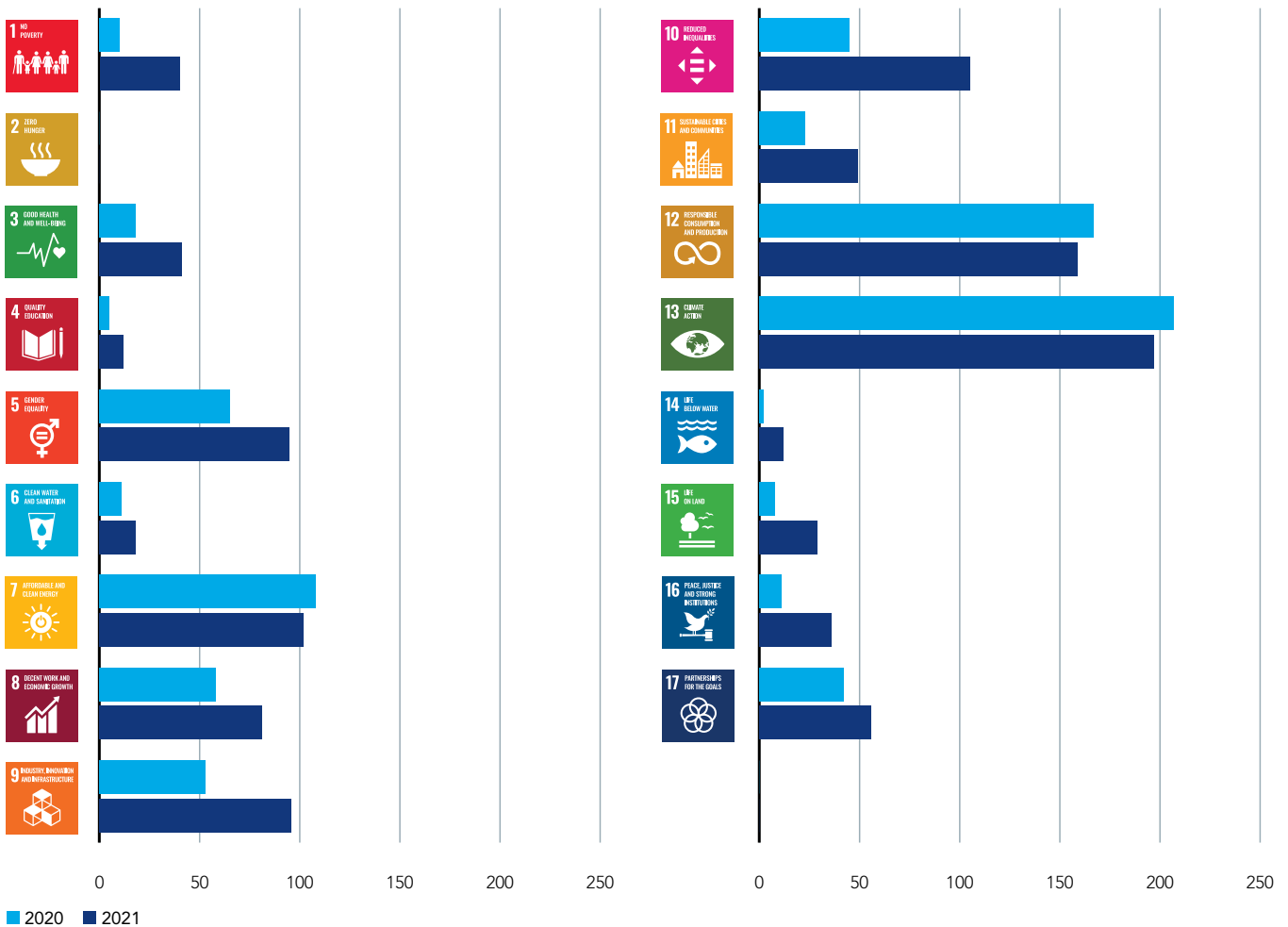
Climate action, industrial innovation, and sustainable consumption and production opportunities remain acute for thematic future impact in the SDGHy strategy.

Real world outcomes: SDG highlights in engagement

We have developed an authoritative sense of the underlying indicators of potential SDG impact that a company might have. Climate action, industrial innovation, and sustainable consumption and production opportunities remain acute for thematic future impact in the SDGHY strategy.

Our engagement on indicators in SDGs 7, 12 and 13 (Clean & Affordable Energy, Sustainable Production & Consumption and Climate Action) continue to be the mainstay of future impact potential, as does engagement on SDG 9 (Industry, Innovation & Infrastructure) as Figure 9 shows. This is a result

Figure 9. Unique engagement actions by SDG, 2020 & 2021



Source: Federated Hermes, as at 31 December 2021. We did not engage on opportunities relevant to SDG 2 in 2020 or 2021, as the strategy does not hold companies able to materially and directly impact this SDG

SDGs focused on impact for workers, communities and societies takes equal engagement prominence

At the end of 2020, we set out to deepen engagement on matters of social impact. Figure 9 demonstrates the visible outcomes of this work in 2021. When engagements that focused on SDGs 5, 8 and 10 (Gender Equality, Decent Work & Economic Growth, and Reduced Inequalities) are considered together, these themes were touched upon 67% more often – 281 engagements – than in 2020. Indeed, SDGs








of our positive views on utilities, basic materials, packaging, pulp and paper, and automotive sectors, which offer opportunities to invest in and engage upon 'deltas of impact' which may deliver future value chain decarbonisation, improved resource efficiency, and sustainable industrial innovation. Similarly, banks that we engage with are differentiated within SDG scores based on the 'delta of impact' potential of their sustainable finance strategies.

We have developed an authoritative sense of the underlying indicators of potential SDG impact that a company might have.




1, 3, 4, 5, 8, 10 and 11, all of which focus on social impact, drove significantly more dialogue in 2021 (Figure 9). Conversely, our focus on environmental impact through the SDGs featured the same or slightly reduced intensity in engagement. We see great value in continuing to broaden engagement on social impact issues in 2022.

The following pages highlight notable SDG-linked objectives progression and resulting achievements we have engaged on through our approach of active dialogue and engagement for all issuers in the strategy, from January 2020 to the present.




2021 Progress Highlights: SDG Environmental Impact

SDG 13: Climate action			
	Our objectives	2021 engagement progress	Status ⁶
Orbia	Validate science-based targets: Orbia enhanced recent ESG disclosures and has more robust data on its full scope of emissions. We believe the company should set an emissions reduction target which achieves validation from the Science-Based Targets Initiative (SBTi).	The company informed us it will publish revised targets to reduce Scope 1 and 2 emissions by 47% by 2030. It aims to have this validated by SBTi. We commended the company for its ambition and asked that the target can be expanded to include Scope 3. It is mapping its Scope 3 emissions and needs to complete this work. We continue engagement to understand capital investment required to achieve those targets.	Progressed to Milestone 4 
Alcoa ⁷	Scope 1, 2 & 3 science-based targets: As a significant user of energy for smelting and refining, the company has an opportunity to demonstrate leadership by setting a full-scope science-based target. It is targeting emissions reductions in Scopes 1 and 2 of 30% by 2025, based on production that is already among the most carbon efficient. We believe the company has an opportunity to further align all scopes of emissions reduction with the ambitions of the Paris Agreement.	We engaged on inclusion of ESG metrics in executive remuneration. The long-term incentive plan includes a metric for becoming the lowest emitter in the industry on a Scopes 1 and 2 basis. We asked for an update on its zero-carbon smelting research and development (R&D), which would contribute substantively to emissions reductions. The company also announced a partnership with Audi to supply the carmaker with material for electric vehicle (EV) production.	Progressed to Milestone 3 
Aker BP	Long-term climate targets: The company stands out from its peers in applying a relatively high carbon price in planning, and has a breakeven limit for projects that include the impact of carbon pricing. It is among the least carbon-intensive operators globally. We believe the company is one of a few upstream energy firms that may be able to set a long-term emissions target that aligns with the Paris Agreement. We think the company should consider a target to at least 2030, and a long-term net zero target validated by the SBTi.	We sought deeper understanding of the approach to long-term climate-related risks. The company's 50% reduction target by the mid-2030s will be driven by electrification in operations. The company indicated it may change its strategy to move faster and clarified to us that its 'nearly zero' 2050 commitment is on an absolute basis, and will not employ offsets. New assets will be renewably electrified using shore power, which would leave one production asset hydrocarbon-powered after 2032.	Progressed to Milestone 3 
SDG 12: Responsible consumption & production			
	Our objectives	2021 engagement progress	Status
Sealed Air	Progress to sustainable plastics: The company has committed to making all products 100% recyclable by 2025, and to use at least 50% recycled content in manufacturing. We believe the company needs to report on the progress of its commitments to disclose how it is adapting to regulatory pressures and circular economy principles.	We continued discussions about advanced recycling technologies as this is essential to help the company reach its 2025 circularity goals. Pyrolysis and other conversion technologies for advanced recycling of contaminated mixed waste plastics are available but this requires a sufficient supply of waste plastics. This has driven the company's investment in Plastic Energy, and it believes offtake agreements between plastic feedstock suppliers and petrochemicals producers could provide reliability of supply, and funding for suppliers scaling this business model. We were encouraged to see that it achieved about 50% of its goal of full recyclability, and 20% of its 50% recycled content goal in 2020.	Progressed to Milestone 4 
Berry Global	Recycled content volume target: The company seeks to use at least 10% recycled materials as a proportion of total raw materials volume by the mid 2020s. However, we note that packaging peers and downstream consumer goods buyers have set targets which are higher. We believe the company should set at least a 25% recycled content goal for its materials, in line with some peers.	The company has been working closely with customers to address food safety and concerns on recycled content, and is investing \$500-\$600m in innovation and sustainability initiatives. We also note interim progress on its initial goal to reach 10% recycled content.	At Milestone 1 
Levi Strauss	Circular economy innovation: The company pioneered circular economy-based innovations, including textile dye re-use, certified second-hand apparel, and recycled materials in new apparel. However, it does not have a disclosed strategy with goals and end-dates for scaling up circularity. We believe the company can highlight its leadership, and its future shifts in circularity of its business model, through better articulation of ambitions and targets.	During a wide-ranging engagement, we discussed the company's uneven approach to transparency, which makes it challenging to assess proactive work on circular products and fair working conditions in supply chains. We suggested this could be resolved using consistent, comprehensive reporting across material issues. The company indicated this work is underway for its sustainability strategy focus areas, with 2025 or 2030 goals to be set.	Progressed to Milestone 2 
KB Home	Sustainable & circular housebuilding strategy: The company has experience with home designs that incorporate energy and water-saving features and energy-generating capabilities. We believe the company has an opportunity to define and quantify the volume and type of materials and components which are sustainably sourced. It also has the opportunity to offer superior sustainability designs or performance over the life of the homes built, and then build a strategy and targets for sustainable and circular materials in procurement, design and use.	In early 2021, we discussed US policy developments, as the company is cautiously positive given the Biden administration's climate and housing affordability focus, and KB's strengths in energy and water-saving designs and installation of renewables. Later in 2021, we discussed its achievements and target to reach a 45 HERS score average by 2025 down (this measures energy efficiency performance compared with older homes). This implies that it has to improve emissions intensity of homes built by 8% annually. Energy efficiency, all-electric homes which are renewables ready, and growth of solar-powered home uptake are contributors, as is the emergent arena of community-scale renewables.	Progressed to Milestone 2 

⁶ For objective and milestone definitions, see appendix.⁷ See Alcoa case study on page 22.

SDG 7: Clean & affordable energy			
	Our objectives	2021 engagement progress	Status
Barclays	Alignment of energy financing to the Paris goals: We want the bank to have a strategy and lending policies that reduce exposure to those parts of the energy sector that are not aligned with goals of the Paris Agreement, and which present long-term risks to the business.	We discussed the framework for aligning financing with the Paris Agreement across lending and capital markets activity. We commended the multiple steps taken by the bank, following the announced ambition to become a net-zero bank by 2050 – and, in particular, development of its own methodology for measuring financed emissions within energy and power portfolios. We also discussed the bank's progress with a board director and learned more about its proprietary methodology for accounting for decarbonisation progress in energy and power.	Progressed to Milestone 3 
AES Corporation	Reduce exposure to coal in electricity generating mix: AES has a proactive approach to reducing exposure to risks linked to coal use, and has sought to retire or sell coal assets. It has a policy in place prohibiting new coal-fired investment. It has committed to reducing exposure to coal to less than 10% of its generating mix by 2030, and to a series of asset sales or retirements in the near term, with significant government agreement in Chile. However, we are closely monitoring the short- and medium-term risks of its strategy. Therefore, we have an objective to engage on and monitor the company's progress against its annual coal divestment and retirement plans.	After the company announced its generating mix, we engaged on its decarbonisation plans. Having met its 2021 generating growth goal in the first six months of 2021, it continues to grow its backlog, and has a deal pipeline to 2023. We asked for clarification around accelerated closures of Chilean coal assets. Chilean regulators are focused on capacity, grid reliability and decarbonisation, and view coal-fired power as backup. This syncs with AES's plans to develop renewables and storage capacity in Chile that outweighs coal capacity removal by about three to one, on a 2025 timeframe.	Progressed to Milestone 3 
Range Resources	Provide net zero target & TCFD-aligned⁸ disclosure: The company has indicated that it will move to net-zero carbon emissions in operations to produce cleaner natural gas with minimised environmental impact, but without a timeframe. This achievement would be unique in the US natural gas sector, and we want to ensure a timeframe is established for net-zero and TCFD-aligned disclosure is provided to stakeholders.	In a board engagement, we discussed efforts to reduce methane emissions intensity, which has been very successful over 2017-2021. The company's existing achievements and ongoing efforts to minimise methane and greenhouse gas (GHG) emissions puts it in a strong position to reach operational net zero by 2025. We encouraged the company to share its efforts as widely as is feasible with its sector peers, associations and in policymaker discussions, given practical meaningful investments it has made. We provided feedback on details of its offsetting plans, disclosure of its certified responsible gas efforts and inclusion of IEA 2050 net zero scenarios in its TCFD approach.	Progressed to Milestone 4 

2021 Progress Highlights: SDG Social Impact




SDG 10: Reduced inequalities			
	Our objectives	2021 engagement progress	Status
Smurfit Kappa	Enhance diversity strategy to focus beyond gender inclusion: The company set 2025 targets for gender inclusion in its workforce and management team, and we would like to see regional targets for wider measures of inclusion tied to ethnicity and regionally material measures of social diversity. While the company can set top-down targets for the workforce, we believe regional targets on measures of diversity are more relevant as they are able to take into account the composition of societies for ethnicity and other factors in regional populations.	During 2021 engagements, we addressed the new gender diversity targets which apply to management and the workforce, and were able to offer additional feedback on 'what good looks like' beyond gender inclusion for a sector that has not been known for diverse employment. We provided additional feedback to the company on observed best practices, and how regional targets can account for composition of local populations.	Progressed to Milestone 2 
Brookfield Renewable	Improve workforce ethnic diversity & disclosures: While Brookfield addresses age and gender diversity in reporting, it provides no information on the racial and ethnic composition of its workforce or management. Monitoring and disclosing this information will provide a platform for the company to build on through initiatives and targets to improve on multiple measures of diversity, including ethnicity.	We discussed human capital during our engagement with the company. Retention in a competitive labour market is driven by strong feedback mechanisms, competitive benefits and a focus on work-life balance. Externally, it partners with universities and runs programmes to attract talent. We questioned the potential lack of age diversity in its workforce, which could pose risks if there is an insufficient pool of earlier-career talent being developed. We asked about the lack of ethnic diversity measures within disclosures, and learned that changes are forthcoming.	Progressed to Milestone 2 
Levi Strauss	Long-term gender & racial diversity strategy: Levi's published an honest letter about its racial diversity at various levels in its workforce and the work needed to ensure its workforce reflects the gender and racial diversity of US society. In line with this commitment, we want to see the company publish a long-term strategy for gender and racial equity at all levels, with interim targets set to at least 2025, and regular reporting on progress.	During a 2021 engagement, we were encouraged to learn that the company's new chief diversity officer had completed strategy design for diversity and inclusion. This has been included as a pay driver for executive compensation. We recommended that details of this pay award be included in the company's proxy. The company published new gender and racial equity pay reports in February 2021, which demonstrate narrower gaps than the company had first anticipated.	Progressed to Milestone 2 

⁸ Task Force on Climate-related Financial Disclosures.

SDG 5: Gender equality

	Our objectives	2021 engagement progress	Status
Akbank	Achieve gender parity in management: As of 2021, the bank is among the most gender-diverse emerging market banks with 53% women in its workforce in 2020, and almost 40% in management. We believe the bank should strive for gender parity at all levels, and expect management to be made up of more than 40% women by 2024.	During a 2021 engagement, the bank indicated that it is designing a general diversity strategy. These may include ambitions for pay and role equity based on gender, ethnicity and other minority factors. We continue to engage on this development as the bank is setting an example of good diversity practice for wider emerging market peers.	Progressed to Milestone 2 
Taylor Morrison	Enhanced diversity & inclusion strategy and reporting: The company does not provide standardised data on diversity of its workforce, and has not yet set diversity targets for its workforce and management team beyond what it has accomplished on gender. Given its sector-leading performance on gender diversity in construction, corporate and management settings, we believe it is in a strong position to design and drive a wider diversity strategy and report on its progress moving forward.	Labour shortages in US construction are a challenge and the company is focused on widening its talent net beyond traditional sources. For example, the Building Talent Foundation seeks 100,000 diverse recruits to the sector. The company is also focusing on internships, which will help to change the perception of construction among young talent. We fed back on the company's positive gender equality outcomes and discussed expanding its strategy to wider measures of diversity. We aim to engage on this with the CEO in 2022.	Progressed to Milestone 2 
Banorte	Gender diversity on the board: We are engaging with the bank to ensure that it meets, and eventually exceeds, our expectation that the board comprises at least 20% women. This is particularly important in emerging markets such as Mexico, where gender divides in management and supervisory roles remain challenging.	We outlined our expectations, and suggested an independent board assessment. We explained that we are concerned not just by the lack of gender diversity, but also with other factors that may affect Banorte's board effectiveness, such as over-commitments and the poor alignment between corporate strategy and directors' skill-sets. The company acknowledged progress has been slow on diversity, and explained that the chair has this as a priority.	At Milestone 3 

SDG 8: Decent work & economic growth

	Our objectives	2021 engagement progress	Status
LKQ	Living wages, employee retention and good employment: 80% of LKQ's 44,000-strong workforce are hourly workers, making between \$14 and \$16 per hour. We would like to see the company move towards paying a living wage to all workers.	During engagement, the company acknowledged the low-pay nature of the hourly work and the challenges this poses for retention. We continue to prioritise living wage payment as a requirement for decent employment terms. The company indicated that it would provide further information on the composition of workers who are and who are not receiving a living wage.	Progressed to Milestone 2 
KB Home	Health & safety reporting and targets: Given the company's elevated risk exposure to construction and its role as a semi-skilled labour employer, we believe KB Home should provide standardised reporting on injuries, accidents and lost-time frequency for its workforce. As a next step, it should consider future-facing targets for improving these metrics.	In 2021, the company published its first year of health and safety data for its workforce and contractors. We understand some data is not available due to the nature of subcontracting in construction, but we believe this could be rectified so the company can monitor injury and accident patterns more precisely. However, we continue to engage with the company on this issue as we believe it could be improved by enhancing comparability to historical data and providing greater detail on performance and plans for improving worker safety.	Progressed to Milestone 2 
Veolia	Introduce living wage and disclose benefits: Veolia has a global workforce and presence in many developed and developing markets. Some of these markets may not have the same regulatory provisions for standards of pay and employment benefits, such as working time limits or healthcare. We believe the company should introduce a global living wage appropriate to each market, and disclose what proportion of the workforce receives at least basic healthcare benefits as part of their employment.	In 2021, the company was considering a global living wage and enhanced disclosures of benefits. We continue to engage on this issue and on the considerations that need to be made, given that the company does not have a living wage commitment or policy for its global workforce.	Progressed to Milestone 2 



SECTION 4

Telecommunications: connecting the SDGs

The telecommunications industry plays a pivotal role in helping the world to achieve those SDGs that are focused on broadening access to internet, digital and mobile services. Here, we explore three key related themes:

- combining the connectivity of telecommunications with emergent technologies for new solutions to social and environmental challenges;
- climate change mitigation through telecommunications infrastructure energy efficiency, renewables buildouts and demand generation; and

- the potential to foster highly circular value chains for electronic equipment to maximise the value and use of natural materials.

Several SDG indicators provide a direct measure of access to digital services, such as the proportion of populations who are able to use the internet or are covered by mobile networks. While the inclusion of these indicators in the SDGs is an acknowledgement of the vital role that connectivity plays in society and as a building block of many other goals, access alone is not the aim of sustainable socioeconomic development. Indirectly, we believe that a series of indicators relating to health, livelihoods, energy, consumption and cities are enabled by the sector.

Telecommunications as the innovation backbone in technological solutions for people and planet

3 GOOD HEALTH AND WELL-BEING	8 DECENT WORK AND ECONOMIC GROWTH	10 REDUCED INEQUALITIES	11 SUSTAINABLE CITIES AND COMMUNITIES
SDG 3.6 is about reducing the number of global deaths and injuries from road traffic accidents, mobile networks are offering advanced safety solutions to help with this.	Indicator 8.10.2 references "mobile-money-service providers" as a way to expand access to banking in emerging markets.	Target 10.c is to reduce the transaction costs of migrant remittances to less than 3% and eliminate remittance corridors with costs higher than 5%.	Indicator 11.6.2 measures air quality in cities which is often accomplished with remote monitoring stations that transmit live readings via mobile networks.

As speed, reliability, coverage and device connectivity increase, so does our ability to utilise these innovations. Many have substantial social and environmental value, and contribute to SDGs in new ways.

Digital cash, such as bitcoin and those being developed by some central banks, could enable people to transact without the need for fee-charging intermediaries and with greater privacy. However, this technology is likely to require an internet connection in order to function. In emerging markets, telecommunications companies are partnering with payment providers to create seamless digital payment and banking systems. It can also reduce the cost of remittances that place an unfair burden on citizens of developing economies. Remittance costs in 2021 averaged 6.3% globally⁹.

As speed, reliability, coverage and device connectivity increase, so does our ability to utilise these innovations.

Innovations are emerging to make transportation more sustainable, necessitating always-on digital connections – such as in highly responsive vehicle-to-vehicle networks that enable vehicles to exchange information with each other and surrounding infrastructure. For example, vehicles can communicate traffic information with each other, enabling dynamic route planning and reducing air pollution. Such innovations rely on cross-sector partnership with telecommunications providing the plumbing for innovations based on connectivity.

⁹ 'Remittance Prices Worldwide - Issue 38,' published by The World Bank in 2021

¹⁰ Management report 2021, Telefonica




CASE STUDY

Telefonica:
 innovative solutions to support sustainability



Between 2011 and 2021, Telefonica invested €190m in more than 1,000 start-ups through its open innovation platform.¹⁰ It also has a pilot project where its radio towers are equipped with sensors to detect wildfires. If an alert is triggered, a drone is automatically launched from the tower that uses internet-of-things technology to transmit real-time data back to a control centre. As one of the world's largest telecommunications companies, we expect the company to drive greater impact on key people and planet problems. Our engagement has focused on understanding the potential for SDG impact across a complex innovation portfolio, and whether this is measurable.

Ever-growing data demands comes with growth in energy requirements – telcos can help

	
<p>SDG 7.2 aims to increase the share of renewable energy in the global energy mix</p> <p>SDG 7.3 is about accelerating the rate of improvement in energy efficiency</p>	<p>Indicator 13.2.2 measures the total greenhouse gas emissions per year which can be partly achieved by increasing renewable electricity and energy efficiency.</p>

Data speeds are continually increasing, and 5G and fibre optic services are the latest incarnation. Such technology brings greater energy efficiency with speed, but outcomes in the efficiency and speed race are uneven. The volume of global data passing through data centres increased 600% between 2010 and 2018, while energy use rose modestly by 6%¹¹. Despite this, higher speeds enable use cases with prolific data demands (such as ultra-high resolution video and enterprise cloud computing), so the resulting increase in data throughput can offset energy efficiency gains and carbon intensity reductions. Remarkably, the telecommunications sector now consumes about 2% of the world's energy¹². By maximising the use of low and zero-carbon electricity in end-to-end network and data centre operations, the sector can decrease costs and emissions from its growing electricity demand. This is highly relevant for mobile networks, where 20-40% of operating costs is energy¹³.

5G is 90% more efficient than 4G in terms of energy per unit of data transmitted, but requires a higher density of antennas^{14,15}. Additionally, operators may need to continue to run legacy networks so, for the foreseeable future, 5G will operate alongside, not instead of, 4G. The picture for upgrading from copper to fibre for broadband is clearer as it generally displaces old equipment and is 85% more efficient than copper networks¹⁶.

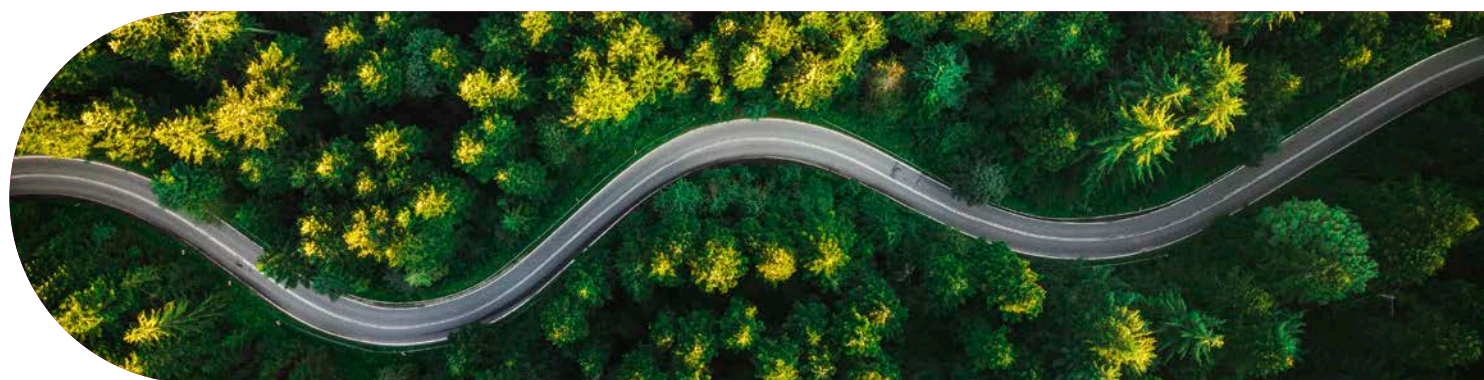
While efficiency gains can help reduce energy requirements, the remaining power demand can be switched to renewable sources to further reduce GHG emissions. Telecommunications firms generally source from local grids, so the ability to switch to renewables depends on availability in each country. Even when the grid has a high carbon intensity, a company can use power purchase agreements (PPA) to source renewable electricity directly. Some companies are also installing renewables onsite to power telecom towers, which is particularly useful for off-grid locations.

CASE STUDY

Millicom: tailoring its approach to renewable energy sourcing



In our engagement with Millicom, we discussed the company's opportunities and challenges in sourcing renewable electricity in Latin America. Paraguay and Costa Rica have a high proportion of renewable electricity from hydroelectric sources, and grid electricity has a low carbon footprint. In other countries, Millicom is using PPAs to source renewables. Its GHG emissions per unit of revenue has remained stable over the last three years and we want to see this decline. We have expressed our preference for the company to set a climate change target using the SBTi methodology because it provides external confidence that the target is aligned to the goals of the Paris Agreement.



¹¹ 'Recalibrating global data center energy-use estimates,' by Masanet et al (eds., published by Science in 2020)

^{12,13} 'Energy Efficiency: An Overview,' published by GSMA in 2019.

¹⁴ 'Nokia confirms 5G as 90 percent more energy efficient,' published by Nokia in 2020.

¹⁵ 'Leading 5G with Efficient Small Cell Densification,' published by Commscope in 2021.

¹⁶ 'Consolidated Management Report: 2019,' published by Telefonica in 2019.

Telecommunications firms, as hardware gatekeepers, have a unique role to play



SDG 12.2 is about the management and efficient use of natural resources measured in terms of the materials footprint per person at a global and domestic level.

Indicator 12.5.1 calls for a reduction in waste by increasing reuse, reduction and recycling of materials.

The world has a serious and growing electronic waste challenge: over the last decade, the amount of e-waste increased 38% globally, reaching 7.3kg per capita. Over the same timeframe the amount recycled only increased from 0.8 to 1.3kg per capita¹⁷. Telecommunications firms have a unique opportunity to enable solutions to this dispersed challenge. Unlike other sectors that sell electronics, they often maintain an ongoing or contractual relationship with customers due to the nature of many mobile, internet and corporate digital and data services. Telecommunications firms have shown little scaled-up innovation in enabling circular consumption, despite the potential in the business model. There are isolated, highly successful examples of initiatives, such as free takeback programmes and increasing recycled content used in devices, but we believe this is a sorely under-explored area of innovation.



CASE STUDY

Lumen:

potential to be the engine house of circular consumption



In 2020, Lumen (an American telecommunications and technology company) recycled 3,509 metric tonnes of electronic and communications equipment, including customer equipment and end-of-life infrastructure materials¹⁸. Customers are able to return old routers and modems which are then reused or recycled. We believe the company can do more to incentivise customer recycling and contextualise its reporting on circular economy initiatives, such as disclosing the percentage of devices returned and setting a target related to this.

¹⁷ 'Ensure sustainable consumption and production patterns,' published by United Nations in 2020.

¹⁸ Environmental, social and governance report for 2020, Lumen

SECTION 5

Appendix

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

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

Appendix B. Clarifying Our Approach

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

Objectives

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

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

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

Issues

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

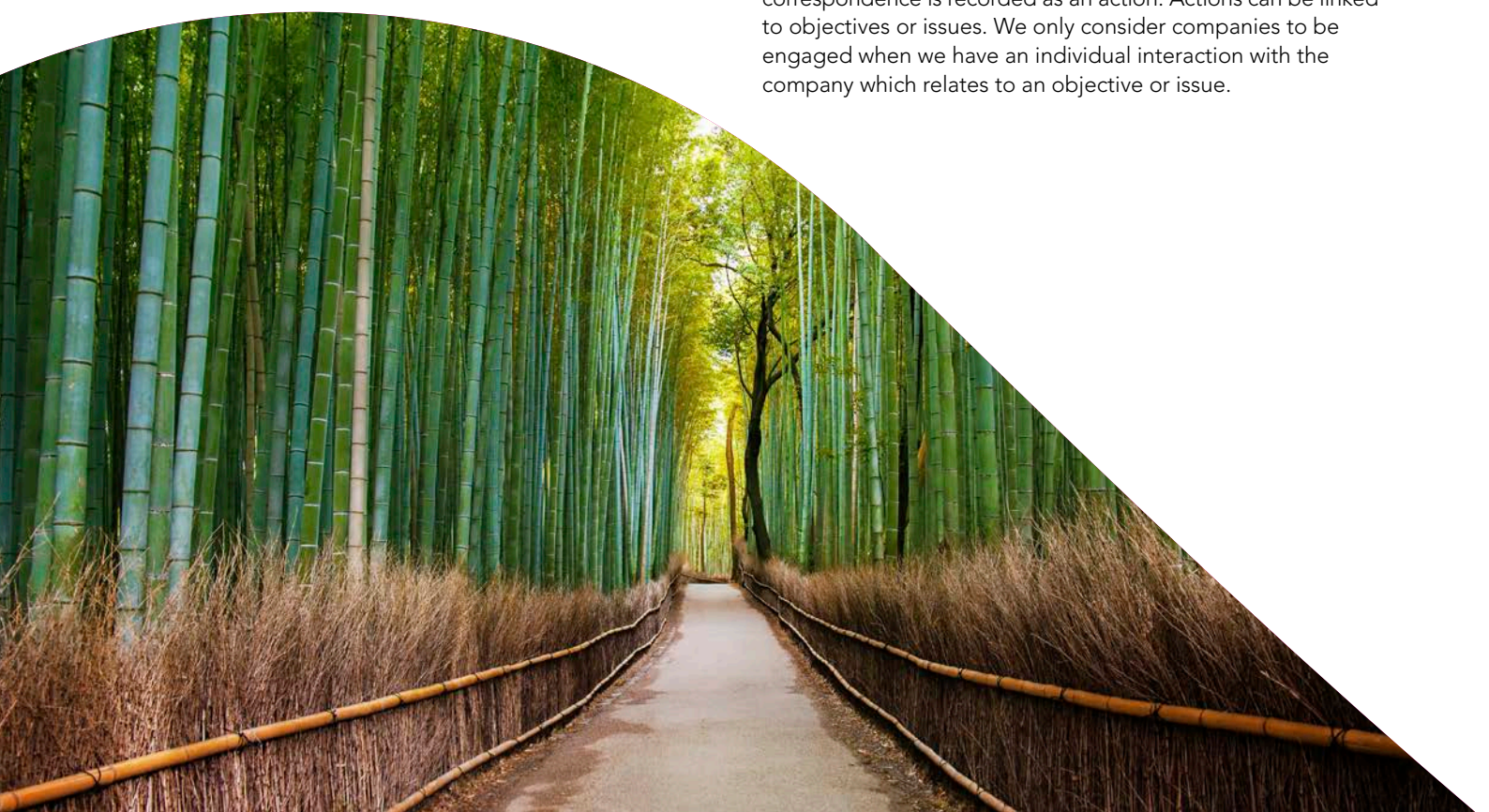
We set clear and specific objectives within our company engagements to ensure we achieve positive outcomes.

Milestones

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

Actions

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



Appendix C. Engagement outlooks

We publish two engagement stories from the SDGHY portfolio each quarter. Please find two included here on Italian banking group Intesa Sanpaolo (published in Q3 2021), and US aluminium producer Alcoa (published in Q4 2021).

ENGAGEMENT CASE STUDY:

For Professional Investors Only

Intesa Sanpaolo

Federated Hermes SDG Engagement High Yield Credit Strategy

The Intesa Sanpaolo Group (Intesa Sanpaolo) is Italy's leading financial institution. It serves 13.5 million domestic customers through its 4,300 Italian branches, as well as a further 7.2 million international customers via a further 1,015 branches in 12 countries. Domestically, the Group is a leader by market share in all key subsectors, including retail and corporate banking, insurance and wealth management. Its *Banca dei Territori* division, which delivers retail and small and medium enterprise (SME) banking services, accounted for nearly half of operating income in 2020. It also provides corporate and investment banking and wealth management across Europe, the Middle East and North Africa.



**Filippo
Alloatti, Head
of Financials
(Credit)**



**Aaron Hay,
Director,
Engagement
& Strategy,
Sustainable
Fixed
Income**

Investment case

Intesa Sanpaolo is among the best performing European financial groups. This said, the business has had to deal with three major challenges over the last decade or so. Firstly, the fact that it is based in Italy means its funding costs are higher than its peers in core European countries. Secondly, the global financial crisis – and the sovereign debt crisis that followed – had an impact on the country's SMEs, meaning the company faced higher risk-associated costs. And thirdly, it has had to cope with compressed and negative interest rates resulting from the expansionary monetary policy of the European Central Bank (ECB).

Considering this operating environment, Intesa Sanpaolo's good health is a credit to the bank's management. It is one of the best capitalised banks in Europe, with a Common Equity Tier 1 (CET1) ratio of 15.7%, after accruing for €2.1bn in dividends. This represents 710bps of capital buffer over and above the mandated minimal capital requirement set by the ECB's Supervisory Review and Evaluation Process (SREP). These figures bode well for a successful normalisation of the bank's equity-credit interests, particularly now that the ECB guardrails – which suspended dividends during the Covid-19 pandemic – have been removed.

The bank still has challenges ahead. These include continued de-risking of the loans book to improve the current 4.1% gross nonperforming loan (NPL) ratio; successfully integrating UBI

Banca (which it acquired in 2020); and further building out the insurance and wealth management operations, which are so important in a negative rates environment. In addition, the bank will need to deliver on its declared ESG ambitions. However, it looks well placed to address these issues.

Engagement context

The post-pandemic role of social impact lending for individuals and small businesses

After commencing engagement with Intesa Sanpaolo, we set out our engagement objectives and the UN Sustainable Development Goals (SDGs) we saw as focal points for the business in a Q1 2020 outlook. Shortly afterwards, the coronavirus pandemic ripped a hole in the Italian economy, changing the fiscal and socioeconomic landscape significantly. The country endured multiple lockdowns and suffered an 8.9% drop in GDP in 2020, although it has partly rebounded in 2021.¹⁹ Italy enjoyed the fastest monthly increase in the European Commission's economic sentiment index across all major eurozone economies in May 2021. Reduced restrictions have played their part, but the efforts of the Italian central bank and its banking sector have also been extremely important in this respect.²⁰

¹⁹ 'Italian economy shrinks 2.0% in Q4 2020, posts full-year GDP drop of 8.8%', published by Reuters as at 02 February 2021.

²⁰ 'Italian rebound helps eurozone's recovery from pandemic recession', published by the Financial Times as at 28 May 2021.

Indeed, social impact loans and funding played a significant role in preventing a deeper recession, assisting an overwhelmed national health system and aiding an economic recovery. Loans from the Italian financial sector funded vital equipment for the country's hospitals. At the same time, money from Italian banks, including Intesa Sanpaolo, helped fuel the rapid digitalisation of small businesses, something Prime Minister Draghi identified as "of utmost importance" to recover from the pandemic and narrow socioeconomic inequalities.²¹ This allowed Italian SMEs to maintain solvency when lockdowns and societal disruption caused revenues to dry to a trickle, and later recover as conditions eased.

Various types of lending fall under the umbrella of 'social impact loans'. These include microcredit, loans to SMEs and households, and impact lending for infrastructure and social projects. Some of these contribute to socially focused SDGs, for example, loans to households and SMEs contribute to SDG 10 (Reduced Inequalities). Specifically, such loans help to sustain income growth for the bottom 40% of the population at a rate higher than the national average.²² These bridges to safety and solvency for individuals and small businesses helped ensure Italy did not backslide on the improved social outcomes it had already achieved. To identify their contribution to such goals, banks are increasingly expected to measure and disclose social impact loans and the resultant social outcomes within their wider lending activity.

Addressing historic employment inequalities in financial services

We believe banks' efforts to support socioeconomic inclusion must be matched by similar efforts to develop workplace inclusion, which is representative of the societies they serve. Expectations for corporate action on equality and inclusion accelerated in 2020, gaining further momentum in 2021.²³ At annual general meetings we have observed a dramatic rise in shareholder resolutions and voting support for diversity initiatives such as reporting workforce inclusion efforts.²⁴ Having historically struggled to build diverse, inclusive workforces, financial services firms face acute pressure in this area. Ethnicity pay gaps are largest in the professional

and finance sectors²⁵ and only one-fifth of positions on the management boards of Europe's largest banks are held by women.²⁶ We have engaged Intesa Sanpaolo and many of its peers on the actions and strategies we believe are essential for effective human capital development. We hope this will help redress historic inequality challenges. These actions should also contribute to achieving targets within SDG 5 (Gender Equality) and SDG 10 (Reduced Inequalities) amongst others.

Scaling sustainable finance for confronting the climate crisis

Banks have no time to waste in assessing and mitigating the increasingly threatening impact of climate change on customers, loans and assets managed. Both the International Energy Agency and the Intergovernmental Panel on Climate Change have outlined the monumental changes required across sectors to decarbonise in line with the targets set out in the Paris Agreement.^{27,28} With governments introducing increasingly ambitious environmental policies to pursue these targets, banks, like all businesses, must act before it's too late.

Following the introduction of the European Green Deal at the end of 2019, the EU has continued to commit to various actions which help achieve this goal. These include a refreshed circular economy action plan to reduce pressure on natural resources, halt biodiversity loss and create sustainable growth and jobs. With both public and private investment needed to achieve this growth, European banks will play an important role in facilitating a sustainable transition. In mid-2021, the EU updated its sustainable finance strategy to strengthen existing rules for non-financial reporting.²⁹ These changes aim to increase the flow of sustainability information and provide greater transparency regarding corporate activity, helping to eliminate greenwashing. For banks, greater data availability and transparency can help improve the management of lending and financing risk. It can also redirect banking away from high-risk sectors — such as those with disproportionate exposure to legacy fossil fuel value chains — and towards more sustainable activities.

As these changes are introduced, European banks are working doggedly to improve extremely complex climate and environmental risk management approaches and resultant disclosures. Analysis by the European Central Bank (ECB) shows, however, that two in three banks are not adequately in line with supervisory expectations in this respect.³⁰ Greater depth and

speed of action is required to redress deficiencies, as these may result in considerable negative financial impacts if environmental risks materialise in unexpected ways.

More positively, better risk management can help direct investment towards commercial or consumer activity that is better aligned with the transition to a climate-neutral, climate-resilient economy.

We have engaged Intesa Sanpaolo and many of its peers on the actions and strategies we believe are essential for effective human capital development.

²¹ 'Italy's economy aided by businesses pushed online by pandemic', published by the Financial Times as at 04 June 2021.

²² 'Goal 10 - Reduced inequalities - U.K. Indicators For The Sustainable Development Goals', published by sdgdata.gov.uk, retrieved 09 September 2021.

^{23,24} 'Investors increase pressure on companies over racial issues', published by the Financial Times as at 20 June 2021.

²⁵ 'Understanding pay gaps', published by the Bank of England as at 03 June 2020.

²⁶ 'ECB Banking Supervision seeking greater diversity within banks', published by europa.eu as at 15 June 2021.

²⁷ 'Sixth Assessment Report', published by the Intergovernmental Panel on Climate Change as at 06 August 2021.

²⁸ 'Net Zero by 2050 - Analysis', published by the International Energy Agency as at 18 May 2021.

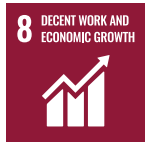
²⁹ 'Sustainable Finance and EU Taxonomy', published by europa.eu as at 21 April 2021.

³⁰ 'The clock is ticking for banks to manage climate and environmental risks', published by europa.eu as at 18 August 2021.

SDG-focused engagement



After the pandemic, aiding the Italian recovery SDG 1 & 8



The pandemic caused a financial crisis that impacted Italian businesses and households; around 30% of the population suffered a fall in household income and household spending fell 11.5% between the first two quarters of 2020.³¹ The Italian south was hit hardest as employment in this poorer, rural area declined more than elsewhere. With an overall domestic market share of 22.8%, and over 12% market share in most regions,³² Intesa Sanpaolo was well-positioned to maintain basic wellbeing through social impact loans for individuals and SMEs. This helped address the most severe negative impacts of the pandemic and contribute to SDGs 1 and 8.



Social impact through lending

Our engagement with Intesa Sanpaolo in Q2 2021 on its sustainable finance strategy helped build an understanding of the bank's breadth and depth of sustainable investing products. Since this engagement, the bank's high social impact loans, in particular, have been of vital importance in supporting the Italian economy. In 2020 alone, the bank disclosed €37.4bn of new loans for high social impact activities, a figure amounting to 43% of total loans. Of this money, €31.9bn went to supporting people affected by natural disasters (including Covid-19).³³ Further support was given through the suspension of up to €73bn worth of mortgages and loan payments. We are pleased with the progress the company has made in communicating this impact in its 2020 disclosures. However, in line with our objective to improve the communication of sustainable finance inputs and outcomes, we feel Intesa Sanpaolo can do far more to clarify and communicate its market-leading package of sustainable finance activity.



The role of banks in social diversity SDG 5 & 10



Diversity and inclusion has become highly material to financial services. Businesses are embracing the end-goal of achieving diversity in their workforce, to mirror the societies they serve. By developing strategies to enhance workforce diversity, companies are contributing to multiple SDGs. For example, SDG target 5.1 aims to end discrimination against women, while SDG target 5.5 seeks women's full participation at all levels of decision making, including equal opportunities for leadership. More broadly, SDG 10 is focused on social, economic and political inclusion for all, irrespective of age, sex, disability, race, ethnicity, origin, religion or economic or other status.³⁴



Delivering concrete improvements

Women comprise 54.3% of Intesa Sanpaolo's workforce and employee turnover was significantly lower for women than men in 2020.³⁵ Within the company hierarchy, women make up around 40% of middle management positions and 37% of the board, while in Italy women received more promotions than their male counterparts.³⁶ In our previous engagement outlook, we highlighted our objective for the bank to implement more specific workforce diversity targets for its human capital strategy. Progress has since been made; the bank acknowledged our concerns and has subsequently carried out a diversity and inclusion audit. The results from this will inform the next iteration of the bank's diversity strategy. In line with our objective, we have encouraged medium-to-long-term diversity targets for gender diversity at all levels of the workforce. We have also pushed Intesa Sanpaolo to increase its focus on ethnic and racial diversity, which should ultimately help the business reflect the society it is lending to.

³¹ "'There is no money left': southern Italy's poor pummelled by Covid', published by the Financial Times as at 16 November 2020.

³² Intesa Sanpaolo Annual report 2020.

³³ '2020 Consolidated Non-financial Statement', published by Intesa Sanpaolo as at 01 July 2021.

³⁴ '17 goals to transform our world — U.K. Indicators For The Sustainable Development Goals', published by sdgdata.gov.uk, retrieved 10 September 2021.

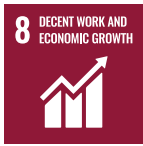
³⁵ '2020 Consolidated Non-financial Statement', published by Intesa Sanpaolo as at 01 July 2021.

³⁶ '2020 Consolidated Non-financial Statement', published by Intesa Sanpaolo as at 01 July 2021.

SDG-focused engagement



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



EU sustainable finance developments
SDG 8 & 13



The EU Green Deal aims to decouple economic growth from resource use and ensure the EU economy will have zero net greenhouse gas emissions by 2050. In addition to funding initiatives – such as the circular economy action plan and the EU hydrogen strategy – the EU continues to update its sustainable finance strategy to facilitate and maximise capital flows for climate action from the private sector. Banks are under serious pressure to develop credible and meaningful sustainable finance strategies. They are also expected to disclose the positive impact such funding activity has towards measures of decarbonisation and goals in SDGs such as SDG 8 (Decent Work and Economic Growth) and SDG 13 (Climate Action).



Financing the Italian economy's transition

Intesa Sanpaolo continued its record of financing climate action in 2020. The group granted more than €2.5bn in loans to the green or circular economy, disbursed €1.45bn from its €6bn Circular Economy Plafond project and allocated the proceeds of its €750m Circular Economy Green Bond to eliminate 255,000 tonnes of CO2 emissions.³⁷

These efforts have not abated in 2021, with €1.25bn being disbursed from the Circular Economy Plafond in the first quarter of the year alone. We have discussed Intesa Sanpaolo's circularity and climate finance strategy from our first engagement with the bank. We set an objective to improve the transparency of its disclosures and clarify and publish clear policies on its climate risk assessment approach to help manage downside risk. Intesa Sanpaolo acknowledged this objective and recognised our concerns for the need to develop and disclose a clear coal policy and 'net-zero in lending and investments' long-term strategy. The bank published oil, gas and coal lending restrictions policies in July 2021. We will review and provide feedback on these, enabling us to advance our objective in this risk area.

We set an objective to improve the transparency of its disclosures and clarify and publish clear policies on its climate risk assessment approach to help manage downside risk.

³⁷ '2020 Consolidated Non-financial Statement', published by Intesa Sanpaolo as at 01 July 2021.

For Professional Investors Only

ENGAGEMENT CASE STUDY:

Alcoa

Federated Hermes SDG Engagement High Yield Credit Strategy

Alcoa is a major global producer of bauxite, alumina and aluminium. Its operations encompass all major production steps in the aluminium value chain, including value-added cast products. It has access to bauxite reserves at seven mines in Australia, Brazil, Guinea and Saudi Arabia, and operates seven alumina refineries. Its aluminium segment includes smelting, casting, and energy assets. Alcoa has approximately 14,000 employees in 15 countries. Alcoa is held in the Federated Hermes SDG Engagement High Yield Credit Fund.



Anna Chong,
Senior Credit
Analyst



Jake Goodman,
Engagement
Manager –
Fixed Income

We commenced engagement with Alcoa in 2019, and published our hypothesis on key drivers of positive, future sustainable development goals (SDG) impact in a Q1 2020 engagement outlook; this provides an update on our engagement.

Investment case

Alcoa has a track record of balanced financial policies, which have emphasised strengthening the balance sheet while providing shareholder returns. The company has prioritised balance sheet repair, strong liquidity and investing in capital expenditure to sustain and improve operations. As a result, Alcoa has exceeded its net debt target, over \$1bn cash was generated through non-core asset sales, and net leverage is low and comfortable. Therefore, the company is in a position to return cash to shareholders and invest in expansions and/or breakthrough technology implementations without diminishing the credit profile. It is exposed to the aluminium commodity chain, with lower cost bauxite and alumina production providing vertical integration through the value chain. In terms of future growth, aluminium is expected to benefit from the shift to lightweight electric vehicle designs, and beverage cans continue to be supported by plastics substitution, among other trends.

Engagement context

The lightweight nature of aluminium and its recyclability with minimal degradation are of immense value to many sectors and end use cases which rely on durable, high-performing metals to function. For example, its lightweight properties help automakers increase fuel economy, and its

high recyclability and potential for lower-carbon production enable a wide range of manufacturers (such as in electronics and packaging) to increase circularity and decrease emissions intensity of their own production value chains.

Aluminium recycling rates are high; 75% of all aluminium ever produced is still in use.³⁸ However, the current quantity of recycled aluminium is only enough to meet 30% of annual production because of demand growth and the long life of some end-products. The remaining 70% of supply is via primary aluminium production, a carbon-intensive smelting and refining process accounting for 4% of global greenhouse gas (GHG) emissions.³⁹ Within this process there are several sources of emissions where coal often generates the electricity and creates immense heat required for primary production.

Unfortunately, the aggregate production capacity constructed since 2010 has a poorer emissions intensity than older facilities because much of it was built in China, which relies heavily on coal.⁴⁰ Pressure is mounting on the industry, stemming from regulatory, buyer and stakeholder expectations to

Alcoa has exceeded its net debt target, over \$1bn cash was generated through non-core asset sales, and net leverage is low and comfortable

decarbonise. For example, China has imposed controls on emissions, and Europe is planning for import taxes on high-carbon products, including aluminium, as early as 2023.⁴¹ Aluminium producers must find alternatives to coal throughout production to bring down emissions. A shift to renewable energy in smelting is, on its own, insufficient. The International Aluminium Institute (IAI) estimates that producers must cut GHG emissions intensity per tonne of primary aluminium 97% by 2050 to limit global warming to 1.5°C.⁴²

To its credit, the sector has continued to adapt to evolving sustainability expectations of its value chains. Innovative

Aluminium producers must find alternatives to coal throughout production to bring down emissions.

solutions, such as inert anode smelting, which mitigate key sources of emissions, are being rolled out. In response to the growing demand for 'green aluminium', the London Metal Exchange (LME) recently added sustainability information to its LME passport, enabling product batches to be tagged with environmental and social data. However, customer hesitancy to pay a premium for green aluminium's higher production costs is reflected in the LME's recent decision to delay plans to launch a separate market for low-carbon products.⁴³

In addition to the CO₂ challenges of production, there are significant environmental impacts which must be addressed. For example, mercury is contained in the bauxite ore from which alumina is extracted and can cause serious biological harm if released to the environment. The aluminium industry is also thought to be the largest anthropogenic source of perfluorocarbons, a GHG far more potent than CO₂. Another waste by-product is red mud, which is what remains after alumina is extracted from its ore and is highly caustic. Some of these are unavoidable, so it is essential for producers to minimise and carefully manage such pollutants.

Like many heavy industrial processes, the workforce faces significant occupational health and safety risks inherent to mechanised, high-temperature, high-risk production environments. The lost time injury rate (LTIR) for the sector has trended downwards since 2017 and the current rate is around 1.0 injuries per million hours worked, a 47% reduction.⁴⁴ Compared to the steel industry, the rate is higher, but has improved markedly since 2017.⁴⁵

70% of aluminium supply via primary production, accounts for **4%** of global CO₂ emissions.⁵

³⁸ The International Aluminium Institute. "Aluminium for future generations." *International Aluminium Institute*. Accessed November 30, 2021.

³⁹ Hacking, A. et al. (2020). "Green Aluminium: Equities & Commodities. Preparing for a Greener Future." *Citi Research Multi-Asset*.

⁴⁰ Alcoa, Turning Raw Potential into Real Progress, Investor Day presentation, November 2021.

⁴¹ European Commission. (2021). "Carbon Border Adjustment Mechanism." *European Commission*. Accessed November 12, 2021.

⁴² IAI. (2021). *1.5 Degrees Scenario: A Model to Drive Emissions Reduction*. International Aluminium Association.

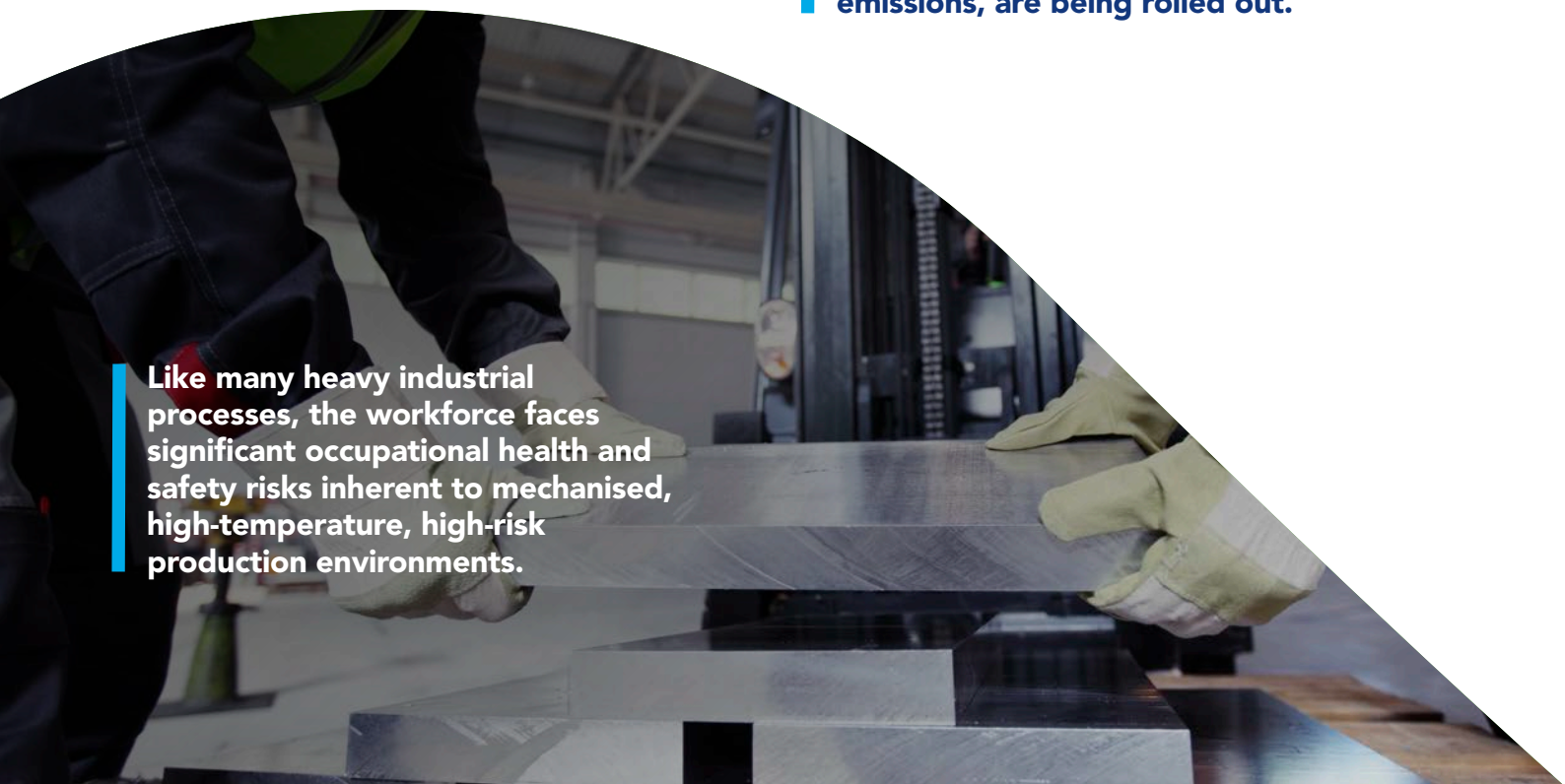
⁴³ Argus Media. (2021). "Low-carbon Al future needs government intervention." *Argus Media Group*. Accessed November 12, 2021.

⁴⁴ International Aluminium Institute. "Workplace Accidents." *International Aluminium Institute*. Accessed November 16, 2021.

⁴⁵ World Steel Association. "Safety and Health." *World Steel Association*. Accessed November 16, 2021.

Innovative solutions, such as inert anode smelting, which mitigate key sources of emissions, are being rolled out.

Like many heavy industrial processes, the workforce faces significant occupational health and safety risks inherent to mechanised, high-temperature, high-risk production environments.



SDG-focused engagement



Decarbonisation of a hard-to-abate sector SDG 7, 9 and 13

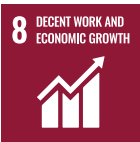


Decarbonisation cannot occur at a sufficient pace without significant change within the aluminium industry, alongside many other heavy industrial value chains. Industrial heat for refining, electricity for smelting, and gases produced by carbon anodes during electrolysis drive 90% of aluminium production emissions.⁴⁶ Each one requires a unique approach to decarbonisation that links to SDG 7.2 about increasing the use of renewable power, 9.4 about adopting clean technologies in industrial processes and indicator 13.2.2 which measures total GHG emissions. Indirect emissions from electricity consumption can be tackled through a shift to renewables. This, however, depends on availability of renewable energy close to smelting facilities and ensuring that a large, uninterrupted supply of energy for smelting is secured – a challenge for intermittent sources such as wind and solar.⁴⁷ Tackling emissions from the remaining processes requires further technological development and economies of scale for low-carbon production innovations.



Aiming to be the lowest global emitter

We have engaged with Alcoa since 2019 on its climate action strategy, driven by our objective for the company to set a science-based target (SBT). Insight gained from our subsequent engagements gave us confidence that Alcoa is heading in the right direction. We were therefore pleased, and unsurprised, by the company's increasing ambition since starting the conversation in 2019. In 2020, it set more aggressive GHG reduction targets of 30% by 2025, and 50% by 2030 from a 2015 baseline. It later announced, in October 2021, a sector-leading commitment to net-zero GHG emissions across global operations by 2050. Taken together, the three targets with three deadlines appear well-aligned with the requirements of the Paris Agreement. An important step is to validate the decarbonisation pathway; Alcoa is working with the IAI to define this methodology. These actions are in line with our expectations, and we continue to engage on the next milestone for our objective: validation of the scientific basis for a 1.5 degree-aligned emissions reduction pathway in the targets being set. Alcoa's progress on decarbonisation will continue to be limited by its remaining reliance on coal for around 36% of its energy needs. Phasing out coal-driven production assets will continue to be a key point in future engagement.



A hazardous working environment SDG 8

The aluminium industry is among the sectors with the highest risk exposure to occupational health and safety hazards, due to the industrial nature of the production process, its frequency of exposure to hazardous materials, and its reliance on heavy equipment and machinery requiring high-skilled operation. Work-related injuries and high-impact events are frequent within the sector, and companies must assume responsibility for the prevention of harm towards their employees to the fullest extent possible. This includes a frequent undertaking of best-practice risk assessments, elimination or mitigation of safety hazards wherever they are found, and regular health and safety training for employees. SDG 8.8 focuses on high quality, safe employment, and has an indicator specifically targeting a global reduction in workplace injury and fatality rates.



Continued focus on fatality prevention

Alcoa strives for zero fatalities and life-threatening or life-altering injuries and illnesses throughout its operations. It has identified its most critical risks across its activities as the operation of earth-moving equipment during mining, the incidence of chemical burns during refining, and handling molten metal during the smelting and casting processes. After updating its safety standards in 2018, the company analysed the extent of existing gaps between its current operations and the standards it strives for in 2019, after which it established a three-year plan to address shortcomings. All of its employees undergo regular environment, health and safety (EH&S) training, and any incidents are followed up using a detailed investigation process to identify areas for improvement. However, in 2020, Alcoa did not meet some of its EH&S targets, and sadly, experienced a fatality at a Brazilian facility. During engagement, we underscored the importance of meeting its ambitious targets when it comes to the safety of its workforce. Given the critical need to protect workforces, we continue to monitor this closely, and have set an objective to demonstrate a quantified pattern of improved health and safety performance outcomes over the next two years.

⁴⁶ EN+ Group, accessed 11/11/2021.

⁴⁷ Mustri, S. (2020). *The Quest for Green Aluminium: Profits and Perils*. BloombergNEF.

SDG-focused engagement



Protecting biodiversity through responsible waste management SDG 12, 15



SDG target 12.4 and 15.3 focus on pollution generated as part of production processes, responsible management of waste, and restoration of degraded land. This issue is especially relevant for aluminium producers, as poor management can lead to emissions and spills of materials which are highly toxic to the environment and human health. For example, 150 million tonnes of red mud, which can poison bodies of water and surrounding ecosystems if not contained, are generated every year from aluminium production. While it is possible to extract useful resources for construction materials from this waste, only 3% is recycled globally.⁴⁸ To prevent significant negative impacts to biodiversity and the health of communities surrounding operations, producers must ensure they are adequately identifying, assessing, and mitigating potential operational risks.



Room for improvement on pollution

Pollution and waste are of particular importance at a local level to the communities surrounding production sites and underpins Alcoa's license to operate. Toxic substance spills have been reported at various Alcoa sites and, although occasional incidents are to be expected, it could signal poor operational risk management. We will engage the company on actions taken in response to the incidents and how it intends to achieve zero pollution events. Associated with this are a range of other pollutants that are inherent to the aluminium production process, rather than a result of unplanned incidents. We intend to set an objective for pollution management to exceed sector best practice and engage on pollution intensity reductions over time. We believe the company will be amenable to next steps in this arena, as it has now published a biodiversity policy detailing its commitment to protecting and rehabilitating ecosystems impacted by operations. It is working with others in the industry to find ways to re-purpose red mud for cement production.

⁴⁸ Service, R.F. (2020). "Red mud is piling up. Can scientists figure out what to do with it?" *Science.com*. Accessed November 12, 2021.

Risk profile

- Past performance is not a reliable guide to future performance. The value of investments and income may go down as well as up and you may not get back the original amount invested.
- Where the Fund invests in debt instruments (such as bonds) there is a risk that the entity who issues the contract will not be able to repay the debt or to pay the interest on the debt. If this happens then the value of the Fund may vary sharply in value or result in loss. Also, the value of the debt instrument may go up or down with changing interest rates.
- The performance of the Fund will have some dependence on the economic environment of emerging markets which may negatively affect the value of the strategy.
- The Fund makes extensive use of Financial Derivative Instruments ("FDIs"), the value of which depends on the performance of an underlying asset. Small changes in the price of that asset may cause larger changes in the value of the FDIs, increasing either potential gain or loss. FDIs can be used to alter the exposure to underlying Investments. Depending on how they are used, FDIs may increase or decrease the overall volatility of the Fund and carry the risk of substantial loss in market conditions which are not expected by the Investment Manager at the time the FDIs are entered into.
- The use of leverage may result in large fluctuations in the net asset value of the Fund, amplifying both gains and losses.
- For more information on risks please refer to the Key Investor Information Document and Prospectus.

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

GIPS® Composite

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

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

Periods ending: **31 December 2021**

All information is quoted in USD

	Annualised Returns (%)		Composite Net Return (Assuming Maximum Fee)
	Composite Gross Return	Index	
Q4 21	-0.22	-0.33	-0.38
1 Year	2.87	3.04	2.20
Oct 19 - Dec 21 (Annualised) ^{^^}	6.62	5.54	5.93

Year	Annual Returns (%)						No of Portfolios	**Dispersion	Composite Assets (Million)	Firm Assets (billion)
	Composite Gross Return	Composite Net Return	Benchmark Return	*Composite 3-Yr St Dev	*Benchmark 3-Yr St Dev					
2019	4.04	3.87	2.90	N/A	N/A	<5	N/A	276.3	40.2	
2020	7.94	7.23	6.48	N/A	N/A	<5	N/A	680.6	585.7	
2021	2.87	2.20	3.04	N/A	N/A	<5	N/A	1,855.3	634.2	

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

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

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

The composite includes all discretionary portfolios following the SDG Engagement Global High Yield Credit Hedged to USD strategy run by the Federated Hermes Int'l Global Credit team and has an inception date of 1 October 2019. The objective of the strategy is to exceed the return of the benchmark over a rolling five-year period whilst delivering positive societal impact aligned to the United Nations Sustainable Development Goals ("UN SDGs"). The strategy may invest in a broad range of assets, either directly or through the use of derivatives, (including, but not limited to, equities, equity-related securities, Eligible CIS and/or financial indices, futures, options, swaps, debt, fx and money markets). The strategy through its investments in FDIs may be leveraged. The composite's benchmark is the ICE BofA Global High Yield Constrained Hedged to USD Index, which is designed to measure the debt market performance of global high yield debt. The benchmark contains primarily USD and EUR issues. The Index is rebalanced on the last calendar day of the month and the return is calculated on a total return basis. This composite was created in November 2019. Performance shown for 2019 is for a partial period starting 1 October 2019. Federated Hermes claims compliance with the Global Investment Performance Standards ("GIPS®") and has prepared and presented this report in compliance with the GIPS® standards. Federated Hermes has been independently verified for the period of January 1, 1992, through September 30, 2021. The verification report is available upon request. A firm that claims compliance with the GIPS® standards must establish policies and procedures for complying with all the applicable requirements of the GIPS® standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS® standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report. The management fee schedule for this strategy is 0.65% per annum. Gross of fees returns have been calculated gross of management, custodial fees and reclaimable withholding taxes, but after all trading commissions.

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