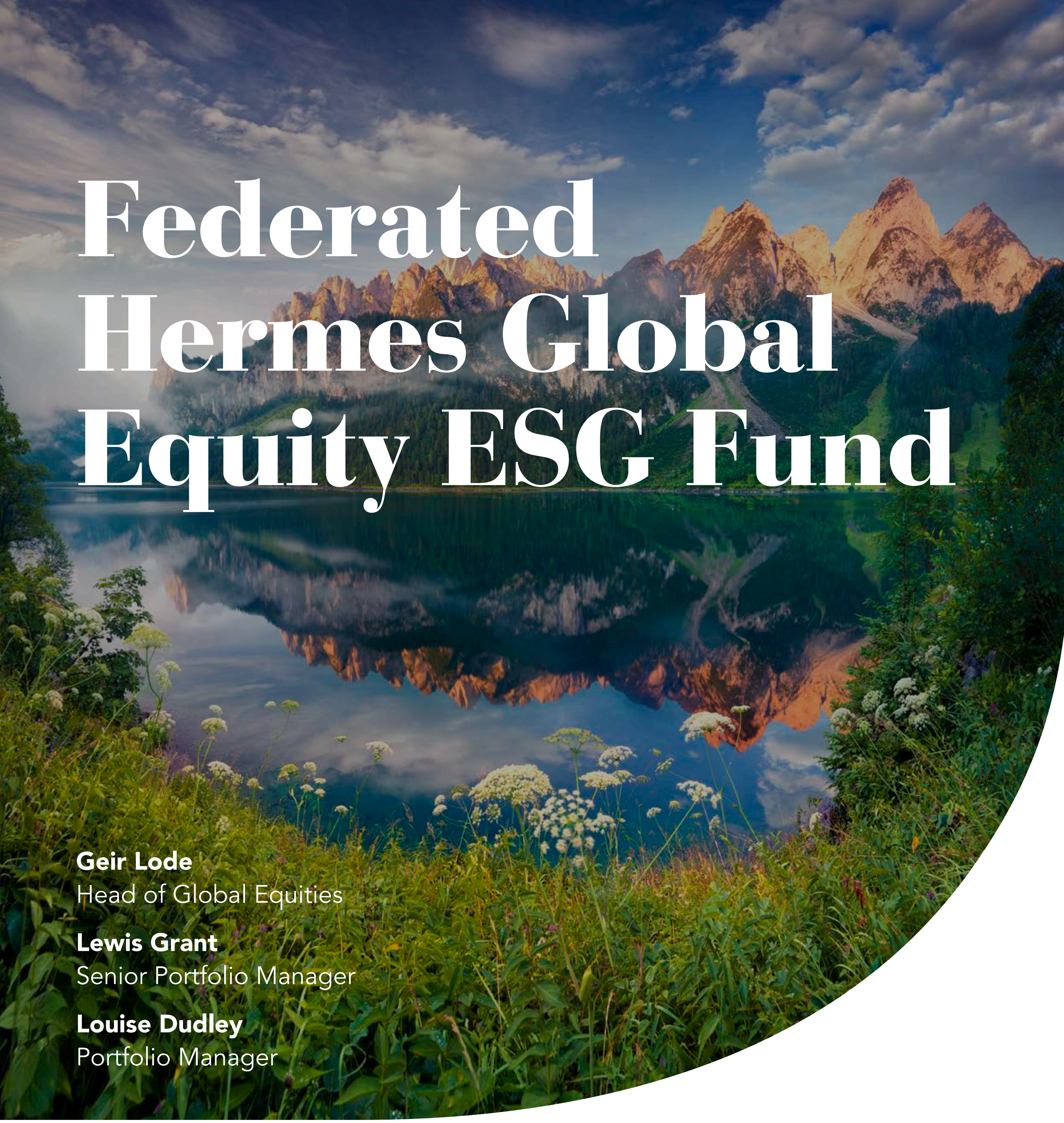

Federated Hermes Global Equity ESG Fund

Geir Lode
Head of Global Equities

Lewis Grant
Senior Portfolio Manager

Louise Dudley
Portfolio Manager

Annual Report 2022

Federated Hermes Limited

www.hermes-investment.com

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SECTION 1

Investment review

After almost two years of unparalleled disruption, investors entered 2022 in a relatively sanguine mood, expecting modestly positive returns ahead as the world pivoted from pandemic to prosaic normality.

But the 2022 storyline took a radically different twist: by year-end, global equity markets had fallen about 20%, forming a rare double-negative with bonds that ended the annual period roughly 13% in the red.

Instead of an easy ride through Covid-free times, fear-infected investors faced multiple challenges during the year from the shock Russian invasion of Ukraine (triggering concerns of a European energy crisis) to the flare-up of non-transitory inflation followed by the inevitable treatment of rising interest rates.

Even prior to the Ukraine crisis, the US Federal Reserve had set the tone for 2022 by signalling rates would likely have to jump higher and faster than markets had previously anticipated to keep inflation in check.

As the Fed slammed on the brakes, equity markets tumbled while also reversing the decade-long investor preference for growth companies over value. In fact, value experienced the strongest swing in its favour since the global financial crisis some 14 years earlier.

Even prior to the Ukraine crisis, the US Federal Reserve had set the tone for 2022 by signalling rates would likely have to jump higher and faster than markets had previously anticipated to keep inflation in check.

Value ruled for most of the first six months of 2022, bar a few brief interludes such as a shift to defensive sectors in the immediate wake of the Russian attack on Ukraine late in February.

Unfortunately, spiking energy costs caused by the war in Ukraine threw further fuel on the inflationary fire, which in turn saw the expected trajectory of interest rate rises steepen and recession talk dominate market conversations.

By the 2022 halfway mark, companies with well-stocked balanced sheets and positive sentiment were in favour.

The gloom cleared a little in the third quarter as investors placed bets that inflation was at, or near, its peak in a mood-shift that saw bond yields slide and stock markets rotate back into growth mode.

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Optimism, however, had a short shelf-life with subsequent higher-than-expected inflation prints pushing yields up again while investors braced for more Fed rate hikes: the growth rally fizzled and markets resumed their downward trajectory.

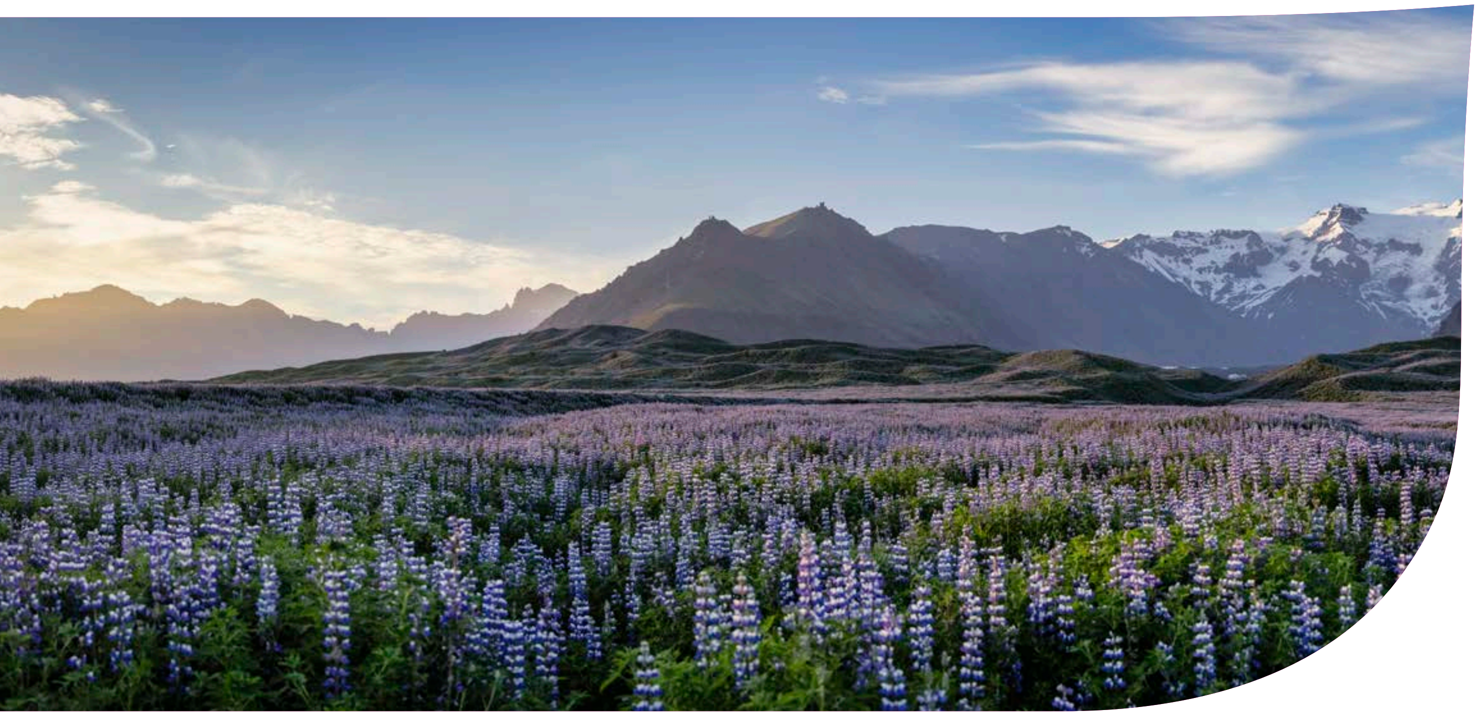
Highlighting the macro-driven topsy-turvyness of 2022, hopes bloomed anew as December dawned amid the Chinese retreat from its restrictive zero-Covid policy and softer inflationary signals.

Overall, the Global Equity ESG Strategy is designed to be broadly neutral from a sector and regional viewpoint with controls for top-down macro and style exposures.

Despite incipient signs of weakening price pressures, the Fed (and other central banks) stayed on-message – as long as inflation remained substantially above-target, the monetary authorities would 'keep at it'.

And so the year ended as it had begun with the inflation debate drowning out all other market small-talk and investors turning to value, once more, for solace.

Overall, the Global Equity ESG Strategy is designed to be broadly neutral from a sector and regional viewpoint with controls for top-down macro and style exposures.



At the same time, diversification ensures that the strategy invests in companies with good or improving ESG characteristics across the style spectrum, which should help negotiate the uncertain market environment.

However, the stellar performance of energy stocks in 2022 – the only sector to produce positive returns over the year – provided a headwind that was too strong for strategies with a sustainable bias such as the Federated Hermes Global Equity ESG Strategy.

In 2023 so far, the market has already oscillated between extreme highs and new lows in tandem with fluctuating inflation data, contrary central bank musings and other big-picture concerns.

This volatility is likely to continue for some time as investors battle still-unresolved issues such as the course of inflation and interest rates, recession probabilities and ongoing geopolitical tension.

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In 2023 so far, the market has already oscillated between extreme highs and new lows in tandem with fluctuating inflation data, contrary central bank musings and other big-picture concerns.

Without a doubt, investors must stay attuned to the continuing macro uncertainties and likely direction of travel: even if inflation and central bank-hiking are easing (as many observers suspect), the world is facing a period of higher-for-longer interest rates.

The phase-change is important as share prices have historically adjusted 12-18 months ahead of rates, which could provide a boost for stocks with both high expected earnings-growth and a sustainable focus.

Federated Hermes' ESG research has consistently shown the importance of identifying not just the current leaders, but also the improvers.

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Indeed, our view is that companies able to negotiate through difficult times with strong business momentum centred on sustainability offer the best long-term opportunities for investors right now – at least those with a clear eye on the future.

SECTION 2

Our investment philosophy

We believe in:

Pragmatism: a combination of time-tested fundamental and ESG characteristics that are attractively priced

Sustainability: companies with a competitive advantage and sustainable business models are more likely to offer visibility of earnings growth

Responsibility: integration of ESG factors and active ownership minimises the probability of negative surprises and can unlock hidden value

Long-term focus: investing over the long term allows companies to reach their true potential

The role of ESG factors

As investors, there are certain fundamental qualities we look for in any potential portfolio stock including robust financials, competitive strength, and a consistent record in beating revenue and earnings expectations.

Ideally, investable companies should also feature impressive management teams, an attractive price relative to peers and a focus on mitigating ESG risks.

But given few, if any, stocks fit this perfect profile, our process hinges on finding those with the most attractive combinations of these desired characteristics in any market environment.

And ESG factors play an increasingly important role in identifying portfolio contenders. For example, our latest research found ESG remained a key performance indicator even during the recent market volatility and energy sector surge.

Furthermore, the most recent study shows the E-factor is now a performance-influencer on a par with the S and G metrics as confirmed in our previous analysis[1].

The 2020 research reaffirmed that governance and social factors were a statistically meaningful driver of shareholder returns. In particular, the study found more socially responsible companies tended to outperform[2] during the Covid-19 period – suggesting the pandemic had revealed the importance of social factors in business success.

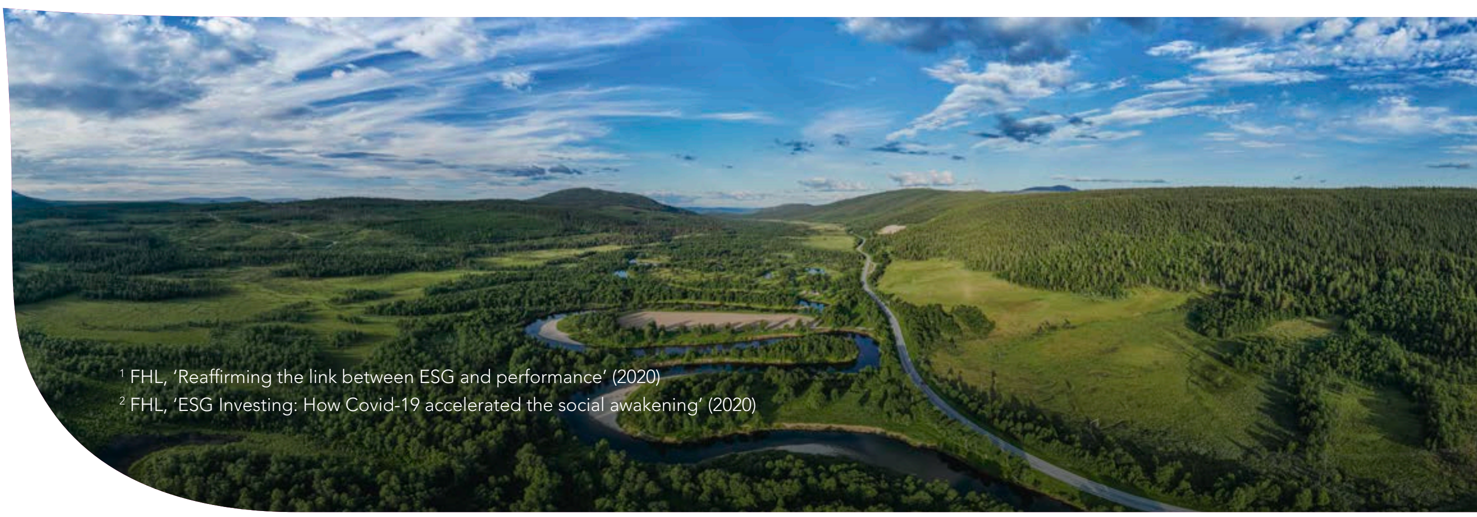
While both governance and social metrics have long shown statistically significant relationships with stock performance, the link between corporate environmental gauges and investment returns has historically been weaker and more volatile.

However, our new research clearly identifies that companies with strong environmental ratings tend to perform better, or in line, with peers while poorly ranked firms generally underperform by a significant margin.

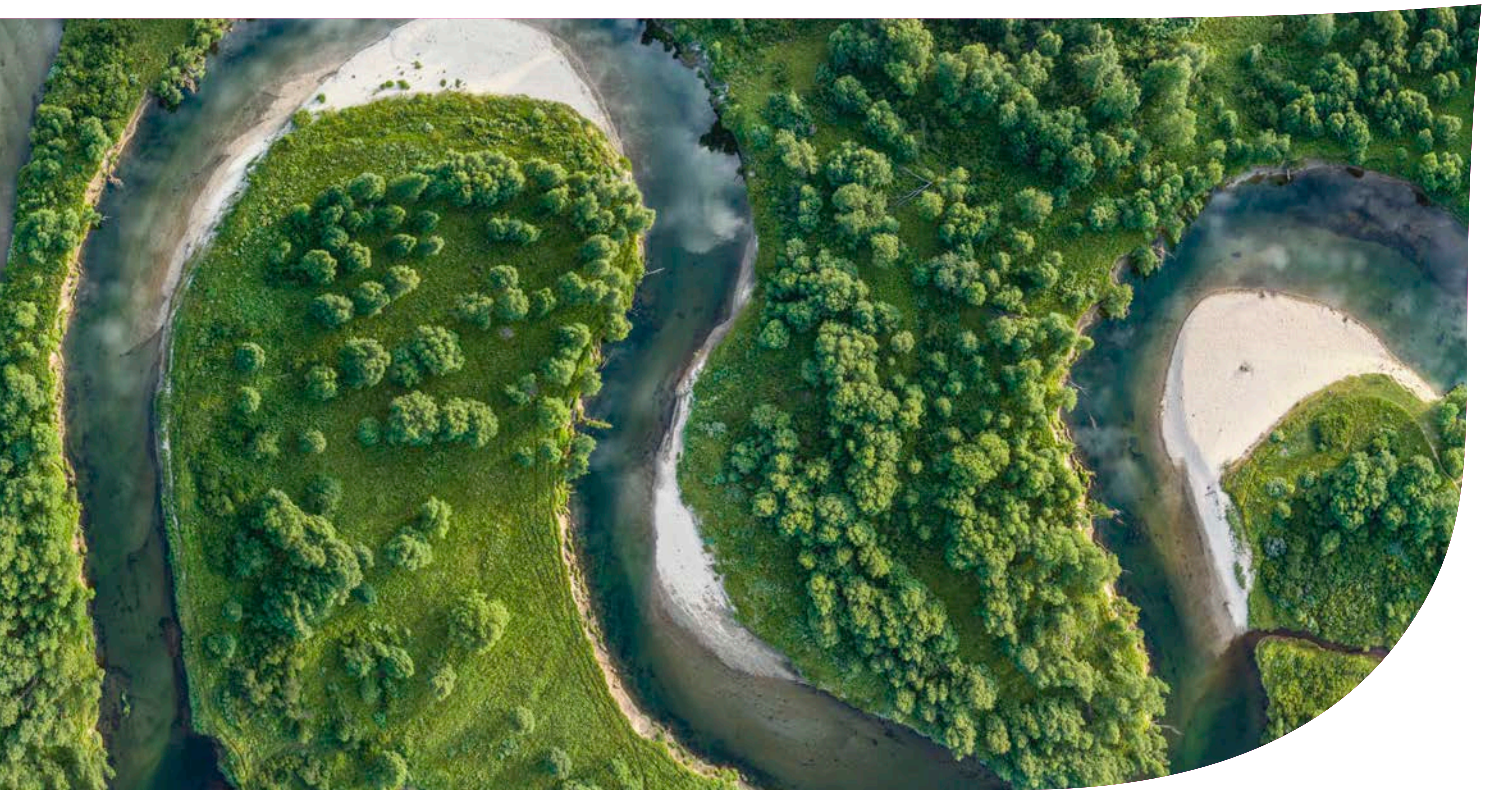
While this effect persisted in 2022, the differences between peer groups – the outperformance of US Energy compared to European Energy companies, or of companies producing weapons relative to other industrial companies – overwhelmed the positive rewards to ESG within each local peer group. Further, within the Energy sector in 2022 the effect was reversed, such that the companies with the less favourable environmental characteristics tended to outperform.

While the research overall adds to the growing body of evidence that long-term investors should pay attention to all ESG qualities, it also serves as a reminder that the transition to a cleaner economy will not be straightforward.

The 2020 research reaffirmed that governance and social factors were a statistically meaningful driver of shareholder returns.



[1] FHL, 'Reaffirming the link between ESG and performance' (2020)
[2] FHL, 'ESG Investing: How Covid-19 accelerated the social awakening' (2020)



The non-linear shape of ESG

Our inaugural 2014 ESG analysis also demonstrated a striking non-linear relationship between the governance factor and shareholder returns in a conclusion often overlooked by other studies.

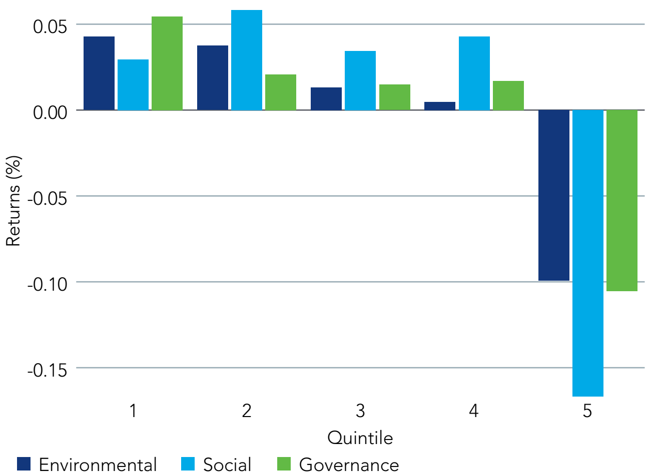
> **Importantly, the outsize influence of low G-scores on performance is also replicated in both the social and environmental factors, delivering a crucial lesson for investors: avoiding the worst-in-show offers an effective way to capture the ESG premium.**

The research found that while companies with strong or improving corporate governance scores outperformed, the result was skewed almost entirely by the impact of peers with poor or worsening standards.

In short, underperforming laggards drive the governance premium rather than high-scoring industry leaders.

Importantly, the outsize influence of low G-scores on performance is also replicated in both the social and environmental factors, delivering a crucial lesson for investors: avoiding the worst-in-show offers an effective way to capture the ESG premium.

Figure 1. Companies with poor ESG practices have historically underperformed over the long term



For illustrative purposes only. Average monthly total relative returns of companies in each quintile, based on environmental, social and governance scores, from 31 December 2008 to 30 June 2022. Figures are calculated using constituents of the MSCI World Index, assuming monthly rebalancing. Source: MSCI, Federated Hermes, as at 30 June 2022.

SECTION 3

Engagement overview

Alongside our stewardship colleagues in EOS at Federated Hermes (EOS), we seek to drive positive change through board and executive-level interactions. Our engagements with portfolio companies take the form of face-to-face meetings with board members, chairs, lead independent directors and chairs of board committees. We also gather information relating to specific engagement objectives and issues through our interactions with divisional heads and investor relations teams. Our proprietary milestone system allows us to track our engagement progress through four key stages from initial raising of concerns through acknowledgement of the issue and commitment to change, to implementation.

We benefit from the wider research universe covered by EOS. The diverse team have backgrounds in law, banking, sciences, academia, accountancy, climate change and corporate strategy, and collectively they are fluent in 10 different languages. This expertise, combined with their cultural understanding and connections, enables local language dialogues which are of great importance.

As ever, voting and engagement is a good way to hold companies to account and is an important factor in our assessment of governance. We view it as a key part of demonstrating active ownership and ensuring companies are meeting the needs of shareholders.

The most frequently discussed issues on the social side were human rights and diversity. Both issues have moved up the ESG agenda for companies. On human rights, new regulation encouraging greater due diligence has pushed companies to be more transparent in their approaches, giving us the opportunity to probe further on company actions including auditing and remediation. On diversity, investor expectations continue to ramp up. Again, greater data being released from companies, allows for more targeted questions for how companies are implementing targets and strategies to improve representation. Climate change continues to be the dominant environmental topic. TCFD reporting, net zero commitments and more ambitious greenhouse gas emissions targets are areas that prompt meaningful dialogues with companies and are gaining significant traction in the market.

Within Governance, remuneration continues to be the most highly covered area. Though we have seen improvements with additional metrics linking pay and performance, quantum is frequently an issue and remuneration committees are typically not effectively addressing long-term investor concerns on this topic. A common current issue is a lack of adequate stock ownership by CEOs and although this is progressing slowly, it takes a number of years for remuneration changes to feed into executive packages. At the largest companies, we expect executives to hold 8 to 10 times their base salary in shares for at least two years past their departure. Our updated 2022, US Corporate Governance Principles are available here.

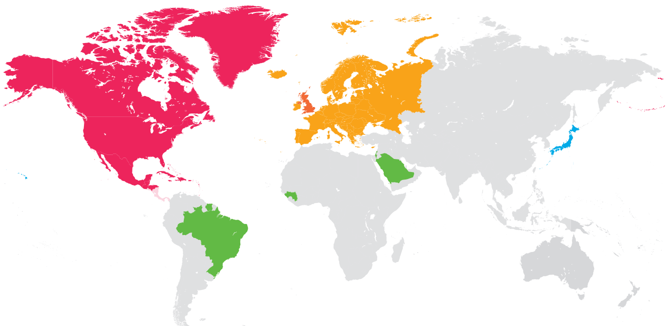
Two portfolio holdings where we have seen recent progress are Unicredit and IBM – and we outline that progress in our two engagement case studies later in this report.

Engagement progress, 2022

Total number of engagement objectives: **145**

Number of companies engaged: **76**

Issues and objectives engaged by region



North America **67** | United Kingdom **3** | Europe **26**

Emerging and developing markets **6** | Developed Asia **20**

Voting breakdown

Meetings where we voted in favour:	Meetings where we voted against, against and abstained, or with management by exception:
29.8%	**70.2%**

Source: Federated Hermes, as at 31 December 2022.

Engagement objectives by theme

Source: Federated Hermes, as at 31 December 2022.

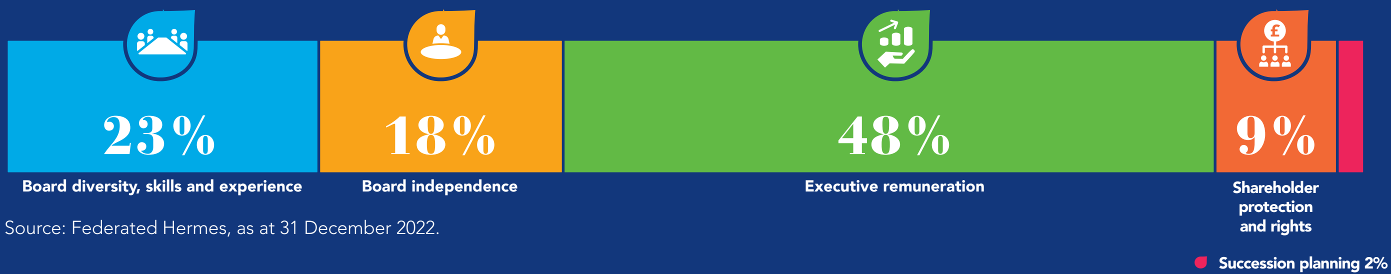
Environmental: issues and objectives engaged

Source: Federated Hermes, as at 31 December 2022.

Social and ethical: issues and objectives engaged

Source: Federated Hermes, as at 31 December 2022.

Governance: issues and objectives engaged

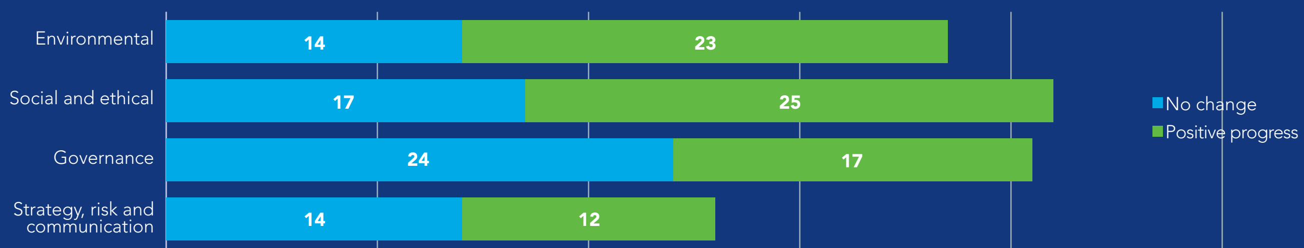


Source: Federated Hermes, as at 31 December 2022.

Strategy, risk and communication: issues and objectives engaged

Source: Federated Hermes, as at 31 December 2022.

Milestone status of engagement



Source: Federated Hermes, as at 31 December 2022.

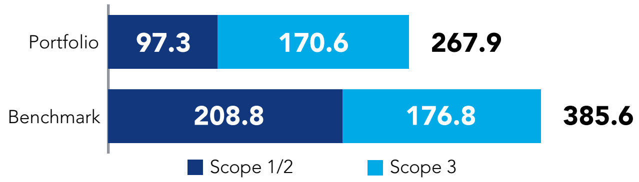
SECTION 4

ESG outcomes

We are cognisant that every company has both positive and negative impacts when it comes to its operations. Here we present a snapshot of our Fund's carbon metrics:

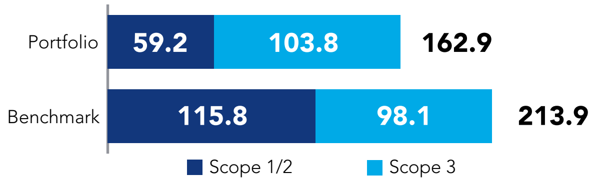
39% lower than the benchmark index per US$m invested (Scope 1 and 2)

Carbon intensity – tonnes per $m of sales



Source: Federated Hermes, as at 31 December 2022.

Carbon footprint per $m invested



Source: Federated Hermes, as at 31 December 2022.

Environmental opportunities exposure

35%

SDG exposure

Here we demonstrate our SDG exposure – that is, companies where there is revenue exposure to investable themes which are aligned to the UN Sustainable Development Goals (SDGs).

Source: Federated Hermes, as at 31 December 2022.

Science-based targets

We continue to see increased momentum behind climate action and carbon risk management, in line with the rollout of the TCFD framework. The fact that more of our portfolio companies are committing to TCFD reporting – and to net zero or science-based decarbonisation targets – is evidence of this trend:

Globally, in total over **1,600** companies are taking science-based climate action and over **800** companies have approved science-based targets, up from **687** only 12 months ago.

7 companies in the portfolio have committed to action within two years of setting science-based targets for scope 1 and 2 emissions, which are classified as 2°C, well-below 2°C or 1.5°C.

Another **37** companies already have these commitments in place.

In total, this accounts for **45%** of the portfolio as at the end of December 2022.

Source: Federated Hermes, as at 31 December 2022.

SECTION 5

In the spotlight: Get well soon: how ESG makes healthcare investing better

ESG investing in the healthcare sector comes with a unique set of challenges. But with the right framework in place it can be rewarding too

Fast reading

- Healthcare represents almost 14% of global share markets[3] with growth underpinned by demographics and technology in a sector characterised by unique regulatory risks and diverse ESG components;
- We focus on quantitative and qualitative analysis of both positive and negative ESG factors to build a diversified portfolio of the best-performing companies;
- Stewardship is yielding concrete results in the healthcare sector as engagement with companies brings material changes in line with sustainability goals.

First. Do no harm.

Set down at least 1,800 years ago, the Hippocratic Oath, paraphrased above, set the mould for ethical codes of practice.

Medicine has come a long way since ancient Greek times, spawning a huge global industry but the principles of limiting harm while maximising health remain at its core.

Healthcare is now one of the largest sectors, accounting for approximately 14% of the MSCI All Country World Index across a globally diverse set of investment opportunities. The largest of these subsectors are pharmaceuticals (or pharma); and, biotechnology, where innovations – notably, in diagnostics and genetics – underpin rapid growth.

The pharma-biotech categories mirror divisions between incumbents and 'growthy' innovative companies in other industries (think banks versus 'fintechs', for example).

Aside from the ingrained general human demand for health services, the sector is also buoyed by significant demographic tailwinds in both developed and emerging markets.

Rapidly ageing populations in developed countries are pushing healthcare costs per GDP to ever-higher levels. Meanwhile, citizens in fast-growing emerging market economies are spending more money on health and increasingly expecting access to the same modern medical services available in the developed world.

Yet despite the apparently universal drivers of healthcare, investors in the sector must carefully assess the highly nuanced risk-and-reward characteristics of different firms involved in the business.

For instance, companies entering emerging markets in search of the attractive growth opportunities on offer also have to negotiate complex legal and regulatory barriers as well as the vagaries of early-stage healthcare systems.

Healthcare is now one of the largest sectors, accounting for approximately **14%** of the MSCI All Country World Index across a globally diverse set of investment opportunities.

To be fair, regulation is a common risk for health-sector businesses in all jurisdictions given the, understandably, tight government focus on preventing potentially deadly errors.

Companies that fall foul of stringent health regulations can face steep fines and, perhaps, even more costly reputational damage.

In addition to safety-oriented rules, the healthcare sector has more recently been threatened by tougher anti-competitive legal challenges, especially in emerging markets.

Legally enforced competition restraints, however, are not exclusive to emerging economies: the new Inflation Reduction Act introduced by the Biden administration, for instance, will create winners and losers in areas such as biologics (medicines derived from living organisms) with a bias to US-based manufacturers.

[3] Source: Factset, 30 December 2022

Given the complicated regulatory landscape across the entire sector, corporate governance is a high-priority due-diligence factor for healthcare investors and a clear case where specialist ESG knowledge can reap rewards.

Prognosis positive: factors for good

As detailed elsewhere in this report, ESG metrics can provide a boost to investment performance by identifying the lowest-rated firms in any industry measured against a range of well-documented factors.

And while all industries contribute one way or another to human development, the healthcare sector is more broadly aligned with the public good than most: saving lives, treating diseases, and, as the Covid-19 crisis showed, preventing or easing pandemics, inarguably highlight the real-life positive impact of the industry – some of which is captured in the influential 'Access to Medicine Index'.

> **As detailed elsewhere in this report, ESG metrics can provide a boost to investment performance by identifying the lowest-rated firms in any industry measured against a range of well-documented factors.**

Established in 2008, the Access to Medicine charity has published the annual industry index for eight years with the 2022 edition analysing 20 healthcare companies on 'products and R&D projects for 83 diseases, conditions and pathogens that have been identified as the most critical priorities regarding access to medicine'.

"These 20 companies are assessed, scored and ranked based on 31 metrics spanning R&D, governance, pricing and supply," the Access to Medicine website says.

To a certain extent, the index serves as a proxy for a key measure of healthcare company alignment with the 'access to basic services' target included in the UN Sustainable Development Goal (SDG) 3 of ensuring 'healthy lives and promote well-being for all at all ages'.

> **The Access to Medicine index is an invaluable resource for ESG investors, providing a transparent comparison of healthcare firms against a standard set of variables as well as raw data and scoring methodologies to drive direct engagement with companies over best-practice compliance or improvement.**

Federated Hermes holds several of the top-rated Access to Medicine Index stocks in its Global Equity ESG Strategy including AstraZeneca, Pfizer and Roche.

The Access to Medicine index is an invaluable resource for ESG investors, providing a transparent comparison of healthcare firms against a standard set of variables as well as raw data and scoring methodologies to drive direct engagement with companies over best-practice compliance or improvement.

Our investment remedies

However, the index is just one source of information – and one limited to only 20 companies (there are 140 in the MSCI world healthcare sector) – in the Federated Hermes ESG research toolbox used to analyse a wide spectrum of risks.

We use both qualitative and quantitative techniques to assess healthcare stocks across ESG factors such as:

- **SDG alignment** – as discussed earlier, healthcare firms in general deliver on many of the UN sustainable goals but deeper analysis can reveal how companies are progressing on issues such as women's sexual and reproductive health rights;
- **Human capital** – staff retention, training, health and safety, executive remuneration (with links to ESG outcomes) all need careful attention from investors. Wage costs represent about a quarter of healthcare sales revenue – a proportion that may increase with inflation and cut into profitability;
- **Political risks** – covering regulation, drug-pricing controls, and potential reputational damage from rule breaches;
- **Product pipelines, innovation and leadership** – including patents;
- **Business ethics** – evidence of bribery, corruption or – on the plus side – responsible marketing policies. Measures include compliance and progress against the UN Global Compact Principles;
- **Diversity, equity and inclusion** – multiple data points are available (board gender representation, for example) while external gauges such as the Bloomberg Gender-Equality Score are also useful references for investors – healthcare firms score above average on this metric;
- **Climate change** – the healthcare industry is generally considered a relatively low-risk for carbon exposure but net-zero commitments and TCFD reporting add value; and,
- **Environment** – the sector faces some specific environmental issues such as antibiotic pollution, a subject for engagement with two of our portfolio holdings, Roche and Zoetis.

Importantly, the Federated Hermes ESG Dashboard enables our analysts and portfolio managers to bring together a vast amount of data to assess the positive and negative trends on a per-company basis. Our proprietary Sustainable Opportunities Score is also useful for healthcare companies, which in general rank favourably overall given the sector's weighting to positive health and wellbeing goals and strict regulatory controls around potential negative outcomes.

Engaging professionals: why stewardship can cure industry ills

As significant owners of many healthcare companies we treat our asset stewardship role with particular care.

Currently, our engagement objectives tilt towards long-term social and governance objectives as these two factors weigh more heavily on the sector with issues such as diversity, access to medicine and executive remuneration on the agenda.

Discussions about executive pay, for example, now focus on tying remuneration to long-term objectives and reforming shareholder structures to enable more equitable outcomes.

We have also introduced new issues into the dialogue based on our research – notably with queries on the pricing of 'biosimilars' – or drugs that closely match others – on the back of a recent analysis by our partner stewardship advisory division, EOS.

Other engagement highlights in the healthcare sector include ensuring companies:

- have robust drug promotion and marketing policies in place; and,
- follow the 'WHO Ethical Criteria for Medicinal Drug Promotion'.

Improving human health is undoubtedly a public good, which is now largely delivered by listed public companies in an industry valued at about US$7tn (as per the MSCI healthcare index).

Through thoughtful stewardship programs, institutional investors can help healthcare firms balance profit and principles to create long-term sustainable returns. Incidentally, EU investment regulations now define 'sustainable' as including the standard of 'do no significant harm' – something medical pioneers understood eons ago

Table 1: GICS Industries: Healthcare Equipment and services, Pharma, Biotech & life sciences

Health Care (weight in MSCI All country world index).	13.37%
Pharmaceuticals	5.42
Biotechnology	1.97
Life Sciences Tools & Services	1.41
Health Care Technology	0.06
Health Care Providers & Services	2.29
Health Care Equipment & Supplies	2.22

Source Factset as at 30 December 2022

Improving human health is undoubtedly a public good, which is now largely delivered by listed public companies in an industry valued at about

US$7tn (as per the MSCI healthcare index).

SECTION 6

ESG CASE STUDY: IBM

Iconic IT firm IBM has been in business for more than 100 years in various guises, delivering regular profits in an industry more recently obsessed with disruptive start-ups. To its credit, IBM is trying to keep up with the times in ethics as well as tech…

Founded in 1911 as the Computer-Tabulating Recording Company in Endicott, New York, the technology giant now known as IBM has more claim than many in understanding sustainability.

Morphing into the International Business Machines company in 1924 before adopting the now-famous three-letter-initial brand, IBM has been at the forefront of many computing technology revolutions through its history – and also at times a notable laggard.

Today, the company is built around four key business units - software, consulting, infrastructure and financing – and remains one of the world's largest companies.

Investment perspective

IBM is a profitable company offering investors stable growth, an attractive dividend profile and a solid value opportunity based on current trading price of about 14-times forward earnings.

The firm has been battling a slight credit-rating headwind over the last couple of years following a significant debt issuance that triggered a downgrade from some agencies.

IBM is a profitable company offering investors stable growth, an attractive dividend profile and a solid value opportunity based on current trading price of about **14**-times forward earnings.

In its 2022 fourth-quarter results delivered this January, IBM reported steady growth across all business segments, particularly in its hybrid cloud computing service. For the 12 months to the end of December, 2022, the company booked revenue of US$60.5bn and free cash-flow of US$9.3bn.

We believe the group's capital allocation strategies will support ongoing revenue growth while the business should also deliver higher margins and improved free cash-flow.

Against the positive outlook, we expect the company to deliver ongoing stable revenue and operating income growth, which should in turn lead to a re-rating of the stock.

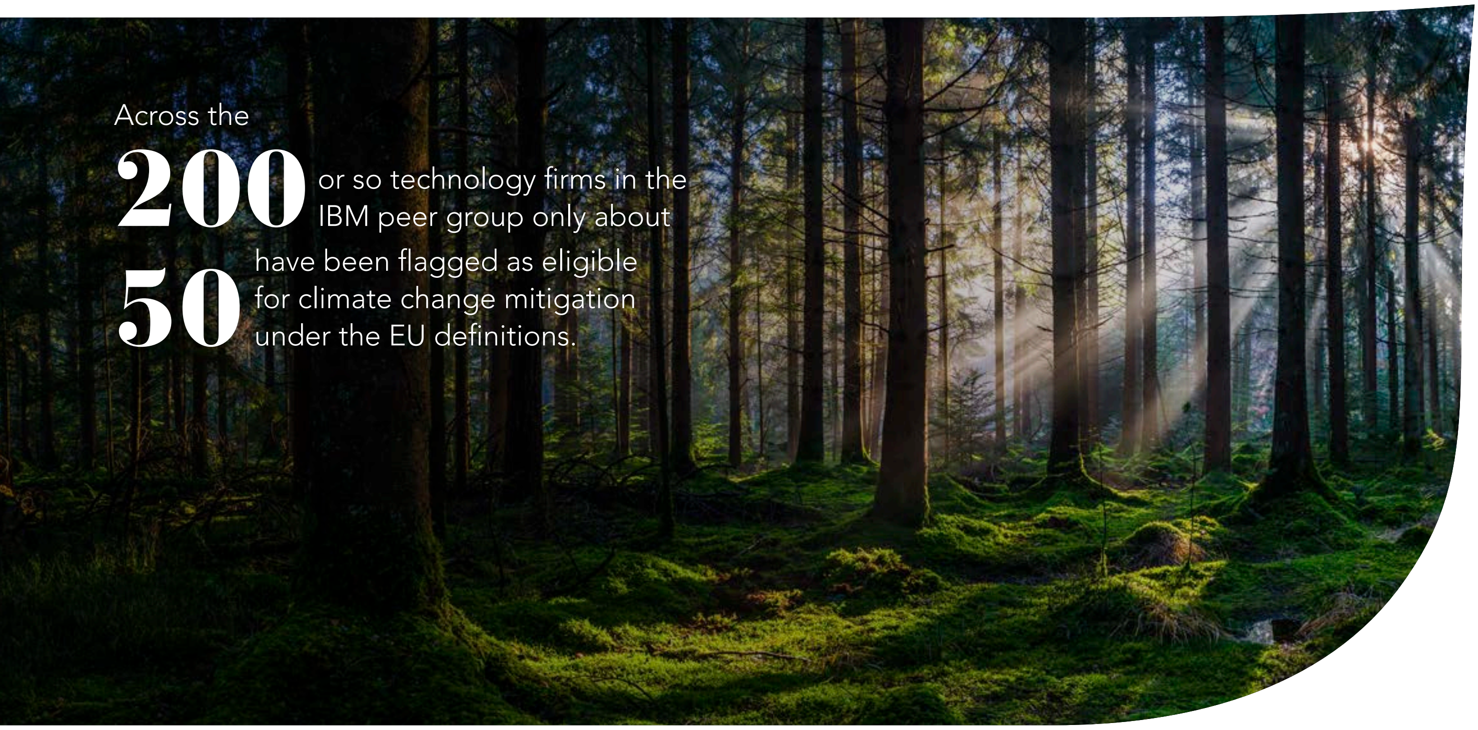
ESG profile

As we have shown multiple studies (including our latest 2022 research), investing in companies with above-average or improving ESG scores is correlated with outperformance.

IBM sits squarely in the improver camp across all three ESG factors with particular gains in social and governance scores.

For example, the company is a signatory of the long-established Electronic Industry Citizenship Coalition (EICC), which holds members to ensure safe supply chain conditions and "that workers are treated with respect and dignity, and that business operations are environmentally responsible and conducted ethically".

As well as using independent parties to conduct periodic supply chain inspections (with audits now expanding across more suppliers), IBM also has strict requirements for corrective action if EICC compliance breaches occur.



Other ESG strong points include detailed bribery and anti-corruption policies, reinforced through employee training and strong whistle-blower protections.

Globally, IBM has a staff-count of almost 300,000 with the business recently picking up many 'employer of choice' accolades such as third place in the Forbes 2022 World's Best Employer list.

While the company's environmental score lags social and governance performance, it has made gains on that front too, boasting some form of carbon emissions target dating back to 1995.

Based on EU taxonomy, IBM also rates well on carbon metrics with more than half of its revenue and almost 70% of capital expenditure eligible for climate change mitigation status.

Across the 200 or so technology firms in the IBM peer group only about 50 have been flagged as eligible for climate change mitigation under the EU definitions.

Furthermore, the company is poised for growth in a number of green sectors with its integrated systems design and enterprise software services increasingly used in renewables, power management and industrial automation.

Engagement

Despite IBM making substantial progress on ESG, there is always further to go – and investors have a big role to play in setting the direction and pace of travel.

Globally, IBM has a staff-count of almost

300,000

with the business recently picking up many 'employer of choice' accolades such as third place in the Forbes 2022 World's Best Employer list.

We have a long history of engagement with IBM, dating back to 2012 when we engaged with the firm to separate the chair and chief executive roles. While that original goal has yet to be achieved, our dialogue with the company has produced success on issues such as board engagement with shareholders, changes to leadership structures, transparency on lobbying, shareholder rights, and climate targets.

Following investor pressure, for example, IBM bolstered the powers of its independent directors. Generally, the business scores well on governance factors but we are pushing for further improvements on diversity, 'overboarding' – or using directors who sit on many other boards, and the inclusion of ESG expertise as board criteria.

We have a long history of engagement with IBM, dating back to 2012 when we engaged with the firm to separate the chair and chief executive roles.

Our governance engagement extends as well to the IBM audit function, which has been carried out by PwC for more than 50 years. PwC does change the IBM lead auditor every five years but more regular rotation across the entire auditing team would be appropriate. We would also like to see more ESG input from PwC, which is weak on climate and sustainability.

On social factors, IBM has been receptive to investor discussions, even proactively engaging over racial equity issues with an internal audit: a new racial equity employment policy is due to come out this April with hiring practices and employee protection clauses.

In talks over human rights, IBM has emphasised its membership of the Responsible Business Alliance and adherence to the US code of conduct – although we would prefer the company adopts UK standards.

Over the last four years the company has faced some minor controversies over staff age discrimination but we believe the impact is immaterial. In 2021, IBM also committed to helping reskill 30 million people by 2030.

As detailed earlier, IBM has made some gains on environmental measures – notably, supply-chain emissions targets in addition to establishing an environment intelligence unit and working with the 'Raise Green' fund to support direct action over renewable energy.

Over the last four years the company has faced some minor controversies over staff age discrimination but we believe the impact is immaterial.

But on the downside, the company does not support Scope 3 carbon emissions targets, arguing the metric is impractical for the software industry. IBM also rejects the Science-Based Targets initiative (SBTi) in favour of research produced by its internal climate team.

Our near-term IBM engagement objectives include:

- Incorporating ESG performance in board and executive compensation – a proposal that may be put to a shareholder vote this year;
- Pay-gap reporting put in place by 2024;
- Human rights due diligence – a new initiative; and,
- Scope 3 emissions targets – a move likely to meet the most resistance from the company.

Table 2: external recognition

Year	Awarding authority	Award title
2021	Forbes	America's Best Employers 2021
	Forbes	Canada's Best Employers 2021
	Forbes	Best Management Consulting Firms 2021
	The Human Rights Campaign Foundation	Best Place to Work for LGBTQ+ Equality
	Forbes	Best Employers for New Graduates 2021
	Fortune	2021 World's Most Admired Companies
	Forbes and Statista	IBM as one of America's Best Employers for Diversity 2021
	PEOPLE	Great Place to Work 50 Companies That Care 2021
	Forbesand Statista	IBM as one of America's Best Emploiyers for New Grads 2021
	Human Rights Campaign 2021	Best Places to Work for LGBTQ+ Equality
	Fortune	Best Big Companies to Work For 2021
	Fortune	100 Best Companies to Work For 2021

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SECTION 7

ENGAGEMENT CASE STUDY: Unicredit

With roots in banking dating back to the 15th century, Milan-headquartered Unicredit is designated as Italy's only systemically important bank. In more recent times, the European financial powerhouse has identified digitisation and ESG as key components in its business growth plan

Pan-European commercial banking giant Unicredit was formed in the early 1990s as a conglomerate of seven Italian banks, later adding institutions based in Poland, Germany and Austria to the group. Today the business incorporates 13 underlying banks.

Despite its relative youth as a combined entity, many of the banks now wrapped up in the organisation embody centuries of history, such as Rolo Banca, which can trace its antecedents back to 1473.

With more than 15 million customers globally, the bank is organised around four regional divisions and two business units: corporate and individual solutions, respectively.

In a new overarching 'Unicredit Unlocked' strategy laid out in 2021, the bank said sustainability "will be embedded in our culture".

With more than **15** million customers globally, the bank is organised around four regional divisions and two business units: corporate and individual solutions, respectively.

"We will first hold ourselves accountable, striving to reach the same standard we ask of our clients and we will invest in and support the communities within which we operate," Unicredit said at the time.

Investment perspective

Unicredit beat consensus expectations in its 2022 annual and December quarter results delivered in Q1 2023 as net interest income and profits rose on the back of higher rates.

Loan growth also held up over 2022, sparking positive re-ratings of growth expectations in bank analyst models.

Meanwhile, cash distribution is tracking as per guidance in good news for risk-off investors seeking yield amid rising concerns about recession in inflation-hit Europe.

The share price trades at attractive valuations while the company maintains robust quality metrics such as balance sheet strength and high dividend levels.

> **Like many European banks, Unicredit was hit by exposure to Russian businesses in the wake of the Ukraine invasion but our analysis suggests the investor reaction has been overdone.**

Like many European banks, Unicredit was hit by exposure to Russian businesses in the wake of the Ukraine invasion but our analysis suggests the investor reaction has been overdone.

Following a restructure several years ago, some management changes and a new strategic focus, we believe Unicredit is well-placed for growth and increased profitability.

ESG profile

Unicredit ranks roughly in line with peers based on our proprietary ESG factors.

However, the financial institution has suffered a little on governance due to an ongoing controversy related to the use of alternative investments.

Encouragingly, Unicredit has responded in a positive way to our governance expectations during recent discussions. In another positive development, the firm has appointed an ESG expert at the executive committee level.

While governance is the most important ESG attribute for banks, climate change risk is also an area of increasing concern for the sector.

We consider that the Taskforce for Climate-related Financial Disclosures (TCFD) provides an excellent framework to assess how banks are managing against these looming risks. In particular, we expect to see bank TCFD-reporting to reveal emission targets in both investments and loan books.

Since 2020, Unicredit has published an annual stand-alone TCFD report in recognition of the best-practice approach. The bank has also committed to fully exit lending to the thermal coal-mining sector by 2023.

Among other environmental-focused targets, Unicredit is aiming to:

- remove all single-use plastic from its buildings by this year;
- reduce paper usage across the business; and,
- be a top-five issuer of green bonds and sustainability-linked loans in the Europe, Middle East and African region banking sector.

On the social side of the ledger, Unicredit has signed up to several international agreements including the Principles of Responsible Banking and the UN Global Compact.

The business has also emerged as a leading campaigner for gender equality in the European finance sector, setting an internal target for 2023 of 30% of women in senior leadership roles.

Against a troubled backdrop for the Italian banking sector, Unicredit has impressed by putting in place multiple publicly available policies and detailed operating guidelines addressing business ethics subjects such as bribery, anti-discrimination and diversity. It is also one of only three financial institutions to disclose artificial intelligence risk factors.

In another 2023 goal, the company has committed €1bn to support positive social impact initiatives.

We are reviewing bank's latest ESG targets, which focus on environmental and social impact and supporting customers in the shift to a low-carbon economy.

Engagement

From 2014 onwards we have clocked up a number of successful engagements with Unicredit over issues including board composition, size and excessive number of vice-chairs. In particular, the bank removed its executive chair from the remuneration committee following discussions with investors.

Along with many other investors we have voted against Unicredit remuneration plans but the company has made improvements on executive pay practices in line with global standards.

For example, the bank has changed share-conversion price calculations to better-align with long-term value; implemented a clear method for deferred cash compensation and performance-based equity rewards; and, linked sustainable finance results to the sustainability component of the remuneration framework.

Our discussions with Unicredit on executive pay continue – along with other ongoing topics such as climate change, product strategy, Russia/Eastern Europe risks and environmental concerns.

As discussed previously, in a welcome development the bank adopted the TCFD reporting standards for the 2020 year (published in the first half of 2021) but our engagement has helped Unicredit develop a systematic approach to climate risk across the entire business.

Unveiling its new ESG focus in 2021, Unicredit noted that "a successful ESG strategy must be just that: strategic".

"This process is already ongoing, and we want to ensure we get it right," the 2021 statement says.

We agree. And ongoing feedback from engaged investors will help keep Unicredit on the right ESG path.

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Glossary

Active management: refers to a portfolio management strategy where the manager makes specific investments with the goal of outperforming an investment benchmark index or target return.

Active ownership: Means to actively exercising your rights as a shareholder. The two main ways to do this are voting at shareholder meetings and engaging – having an active dialogue – with investee companies.

Alpha model: Our proprietary model assesses a company's long-term prospects, by identifying those with the most attractive combination of fundamental characteristics or "factors". It is then used to create a portfolio that aims to generate consistent, positive relative returns regardless of market direction or the wider geopolitical environment.

Capital structure: the mix of various forms of external funds, known as capital, used to finance a business. It consists of shareholders' equity, debt (borrowed funds), and preferred stock, and is detailed in the company's balance sheet.

Carbon emissions: Scope 1 – All direct emissions from the activities of an organisation or under their control. Scope 2 – Indirect emissions from electricity purchased and used by the organisation. Scope 3 – All other indirect emissions from activities of the organisation, occurring from sources that they do not own or control.

CDP: an international non-profit organisation based in the United Kingdom, Japan, India, China, Germany and the US that helps companies and cities disclose their environmental impact.

Cyclical: Companies that follow the trends in the overall economy, which can make their stock prices volatile. When the economy grows, prices for cyclical stocks go up. When the economy turns down, their stock prices will drop.

Defensive stocks: a stock that provides consistent dividends and stable earnings regardless of the state of the overall stock market. With constant demand for their products, defensive stocks tend to be more stable during the various phases of the business cycle.

ESG: Environmental, social, and governance (ESG) criteria are a set of standards for a company's operations that socially conscious investors use to screen potential investments.

ESG Dashboard/ESG Portfolio Monitor/QESG Score: Proprietary tools used by our Global Equities team to capture a company's ESG profile

EU taxonomy: A classification system, providing companies, investors and policymakers with appropriate definitions for which economic activities can be considered environmentally sustainable.

Factors: Fundamental characteristics which we analyse to assess the attractiveness of each company within our investible universe.

Generally Accepted Accounting Principles (GAAP): a set of accounting principles that US companies must follow when putting together financial statements.

Growth: An investment style focusing on shares in companies whose earnings are expected to rise at an above average rate, for which investors are usually prepared to pay a premium.

Human capital: The skills, knowledge, and experience possessed by an individual or population, viewed in terms of their value or cost to an organization or country.

Investment style: The method and philosophy followed by an investor or fund manager in selecting investments for a portfolio.

Macroeconomic: a branch of the economics field that studies how the aggregate economy behaves.

Monetary policy: action that a country's central bank or government can take to influence how much money is in the economy and how much it costs to borrow.

Multiples: Investors use multiples to quantify a company's growth, productivity, and efficiency. For example, a multiple can be used to show how much investors are willing to pay per dollar of earnings, as computed by the price-to-earnings (P/E) ratio.

Net Leverage: A measure of a business' net debt relative to EBITDA (earnings before interest, taxes, depreciation and amortisation). It reflects how long it would take a business to pay back its debt if debt and EBITDA were constant.

Net zero carbon emissions: This means any emissions would be balanced by schemes to offset an equivalent amount of greenhouse gases from the atmosphere, such as planting trees or using technology like carbon capture and storage.

Operating Income: Operating income is a measurement that shows how much of a company's revenue will eventually become profits. Operating income is similar to a company's earnings before interest and taxes (EBIT).

Profitability: a business's ability to produce a return on an investment based on its resources in comparison with an alternative investment.

Quality: defined by low debt, stable earnings, consistent asset growth, and strong corporate governance. Investors can identify quality stocks by using common financial metrics like a return to equity, debt to equity and earnings variability.

Rising yields: Yield refers to the earnings generated and realised on an investment over a period of time. Higher yields are perceived to be an indicator of lower risk and higher income.

Risk on and risk off: An investment setting in which price behaviour responds to and is driven by changes in investor risk tolerance. Risk on risk off refers to changes in investment activity in response to global economic patterns.

Science-based targets: Science-based targets provide companies with a clearly-defined path to reduce emissions in line with the Paris Agreement goals.

Sentiment: The general prevailing attitude of investors as to anticipated price development in a market. This attitude is the accumulation of a variety of fundamental and technical factors.

Solvency II: a Directive in European Union law that codifies and harmonises the EU insurance regulation. Primarily this concerns the amount of capital that EU insurance companies must hold to reduce the risk of insolvency.

Stewardship: The role in which investment managers use the rights – if not the obligation – of financial stakeholders to engage with companies or assets to pursue the objective of sustainable wealth creation for investors.

Supply chain: A network between a company and its suppliers to produce and distribute a specific product to the consumer.

Sustainable Finance Disclosure Regulation (SFDR): imposes new EU transparency and sustainability-related disclosure requirements on financial market participants – the aim is to direct capital away from harmful activities and towards activities that are more sustainable.

Task Force on Climate Related Financial Disclosures (TCFD): an organization that was established in December 2015 with the goal of developing a set of voluntary climate-related financial risk disclosures. These disclosures would ideally be adopted by companies to help inform investors and members of the public about the risks they face related to climate change.

Value: An investment style that focuses on shares where the investment manager considers the market price to be less than its real value.

Voting: Exercising the rights given to equity holders in companies to vote on business matters and director elections during annual and extraordinary general meetings.

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