INTEGRATING THE SDGS INTO INVESTMENT STRATEGIES

OUTCOME #16
Investing in a global wind turbine company, providing benefits for investors as well as the wider world.

July 2018
For institutional investors only.
Our approach to holistic returns means we are committed to delivering excellent long-term investment performance and stewardship, while improving the lives of many
A world in transition

The Four Riders of the Apocalypse?

Globalisation
Demographics
Technology

Climate change

Or Sources of Opportunity?
Disasters are increasing in cost and frequency

Estimated by Moody's Analytics. Estimates from NOAA are not yet available. All figures are in 2017 dollars. An earlier version of this graphic was published in the September 2012 issue of National Geographic magazine.

John Tomasko and Riley D. Champine, NG staff
Sources: Adam Smith, National Climatic Data Center, Jeff Masters, Weather Underground, National Climatic Data Center

Hermes Investment Management | Integrating SDGs | July 2018 | CalPERS Board Offsite | 3
A complex, interconnected system

A system-level perspective

- Long-term vision
- Clear objectives
- Collaborative
- Sustainable
- Prosperous society
- Technology enabled
The UN Sustainable Development Goals

Ambitious, complex & detailed

169 Targets
Each of the 17 goals has a set of specific targets, which identify the focus areas per goal.

232 Indicators
Each of the 169 targets has at least one indicator, which help to tangibly measure progress towards the SDGs.

“The Sustainable Development Goals (SDGs):
A universal call to action to end poverty, protect the planet and ensure that all people enjoy peace and prosperity.”

Source: UN.
A US$93 trillion opportunity

A source of future growth, not just risk mitigation

The United Nations Conference on Trade and Development (UNCTAD), estimates that the SDGs will require annual investments of US$4-5 trillion. This is US$2-3 trillion above current levels.

This represents a significant opportunity still largely misunderstood, if not completely overlooked, by financial markets.

<table>
<thead>
<tr>
<th>Theme</th>
<th>Value of incremental opportunities in 2030 US$ billions: 2015 values</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mobility systems</td>
<td>2,620</td>
</tr>
<tr>
<td>Near healthcare solutions</td>
<td>1,650</td>
</tr>
<tr>
<td>Energy efficiency</td>
<td>1,345</td>
</tr>
<tr>
<td>Clean energy</td>
<td>1,200</td>
</tr>
<tr>
<td>Affordable housing</td>
<td>1,080</td>
</tr>
<tr>
<td>Circular economy manufacturing</td>
<td>1,015</td>
</tr>
<tr>
<td>Healthy lifestyles</td>
<td>835</td>
</tr>
<tr>
<td>Food loss &amp; waste</td>
<td>665</td>
</tr>
<tr>
<td>Agricultural solutions</td>
<td>665</td>
</tr>
<tr>
<td>Forest ecosystem services</td>
<td>365</td>
</tr>
<tr>
<td>Urban infrastructure</td>
<td>355</td>
</tr>
<tr>
<td>Buildings solutions</td>
<td>345</td>
</tr>
<tr>
<td>Other</td>
<td>740</td>
</tr>
</tbody>
</table>

The SDG investment case
An untapped opportunity – Beta of future growth

Mega trends
- e.g. rising consumer awareness on healthier and more sustainable foods

Emerging growth opportunities
- e.g. precision agriculture

Systemic risk
- e.g. climate change effects on supply chain, physical assets and mass migration

Operational ESG risks
- e.g. water scarcity in certain companies’ locations

Avoiding the pitfalls

Beyond the temptation of simple data tagging of SDGs

An investment approach that truly integrates SDGs should:

1. **Be forward looking**, targeting the goals and indicators
2. Have a clearly articulated **theory of change**
3. Mobilise **fresh capital**
4. Leverage the **power of engagement**
# How companies manage impact

<table>
<thead>
<tr>
<th>Intention</th>
<th>What</th>
<th>How much</th>
<th>Who</th>
<th>Contribution</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Don’t consider</strong></td>
<td>Important negative outcomes</td>
<td>Various</td>
<td>Underserved</td>
<td>Likely same or worse</td>
<td>Various</td>
</tr>
<tr>
<td>“I am aware of potential negative impact but do not try to mitigate it”</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Avoid harm</strong></td>
<td>Important negative outcomes</td>
<td>Marginal and for few</td>
<td>Underserved</td>
<td>Likely same or better</td>
<td>Various</td>
</tr>
<tr>
<td>“I have regulatory requirements to meet (e.g., I have to cut my carbon emissions)”</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>“I want to behave responsibly”</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>“I want to mitigate risk”</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Benefit people and the planet</strong></td>
<td>Important positive outcomes</td>
<td>Various</td>
<td>Various</td>
<td>Likely same or better</td>
<td>Various</td>
</tr>
<tr>
<td>“I want to support businesses that have a positive effect on the world to sustain long-term financial performance”</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>“I want a world where all businesses try to have a positive effect on society”</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Contribute to solutions</strong></td>
<td>Specific important position outcome(s)</td>
<td>Various</td>
<td>Various</td>
<td>Likely better</td>
<td>Various</td>
</tr>
<tr>
<td>“I want to help tackle climate change”</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>“I want to help tackle the education gap”</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| May have significant effects on important negative outcomes for underserved people and the planet | Try to prevent significant effects on important negative outcomes for underserved people and the planet | Have various effects on important positive outcomes for various people and the planet | Have a significant effect on specific important positive outcome(s) for underserved people or the planet |

Source: The Impact Management Project.
How the goals play a differing role across Hermes

Hermes EOS Stewardship Service
► Engagement with publicly listed companies, US$463bn+ of assets under advice both external and internal¹

Hermes SDG Engagement Strategy
► Impact through SDG-led engagement with portfolio holdings in publicly listed small & mid-cap companies

Hermes Impact Opportunities Strategy
► Investing in unconstrained publicly listed impactful companies globally for emerging growth

Hermes Global ESG Strategy
► “Best in class” approach to investing in companies with improving environment, social and governance factors

Hermes Real Estate
► Direct investment in real estate based “Place Making” for urban renewal

¹ Source: Hermes as at 31 March 2018.
The investment case for both sustainable investing and engagement is compelling

Extensive research shows that both drive enhanced returns

‘High Sustainability’ firms generate higher returns over the long term

2014 study by Eccles, Ioannou, and Serafeim investigated the effect of corporate sustainability on organizational processes and performance using a matched sample of 180 US companies.

High sustainability companies = those that voluntarily adopted sustainability policies by 1993. Low sustainability companies = those that adopted almost none of these policies.

Past performance is not a reliable indicator of future results.

Engagement drives enhanced financial performance

2012 study by Elroy Dimsona, Oğuzhan Karakaşb, and Xi Lic analyses an extensive database of corporate social responsibility engagements with US public companies over 1999–2009 addressing environmental, social, and governance concerns.

Engagements are followed by a one-year abnormal return that averages +1.8%, comprising +4.4% for successful and zero for unsuccessful engagements.
A thematic approach to idea generation

Source: Hermes.
Investing through an SDG lens

Context based approach

The SDGs can act as a lens for reappraising investment opportunities:

► **Growth:** US$3-4tn of incremental capital investment represents the beta of future growth

► **Risk:** Identifying stranded assets (systemic) and stranded Business models (specific)

► **Advocacy:** Corporate engagement, public policy engagement & education

► **Reporting:** Transparent disclosure of positive and negative impacts

Improving your Sharpe Ratio?
We are all impact investors

The SDG lens

Risk
► Identification of systemic and interconnected threats e.g. climate change and mass migration
► Focus on scenario analysis for specific challenges e.g. growing water scarcity
► Take a cross-sectional (regional and sectoral) and a longitudinal (risks emerging over time) approach
► Awareness of stranded assets and business models inherent in market cap weighted indices

Return
► Underserved or unmet needs of the global economy represent the beta of future growth
► Business model transformation is inevitable and will require a more open approach to assessing opportunities
► Support the generation of positive societal development through investing in innovation (SDG 9)

Impact
► Collaborative public policy and corporate engagement to eliminate or mitigate negative behaviours and outcomes
► Report on how your asset portfolio is exposed to the SDGs and measure (where possible) the net impact achieved
► Provide an annual strategy level impact statement that covers the enterprise and investor level impacts achieved

Going beyond the theory of change to practical action
The UN Sustainable Development Goals for 2030 are an opportunity to take a fresh look at how we look at investment risk, assess growth opportunities and recognise our complex impact on the world around us.

There are no easy answers and care needs to be taken to avoid “SDG-wishing” at the expense of delivering demonstrable change.

First and foremost we have to be good investors – asset managers and owners alike – and the SDGs should be a lens through which to view the world to make us better at our jobs.

The complex, interconnected nature of the SDGs calls for a system-level approach that involves the way that we invest and the manner with which we engage with our investments.

Going beyond the theory of change to practical action.
Impact measurement: challenges and opportunities

ESG
- More backward-looking
- Risk mitigation-oriented metrics
- Measures how sustainably the company operates
- Focused on the company-level
- ESG data provided by several rating houses
- Increasingly standardised
- Mainly quantitative

Impact Measurement

Opportunities
- More forward-looking
- Performance/outcome-oriented metrics
- Measures what impact the company creates
- Focused on broader, systemic impacts

Challenges
- Lack of available data
- Lacking standardisation
- Overwhelmingly qualitative and proprietary
- Valuation of impact unrealistic
Impact measurement: Investor-level

Categorising impact sought

<table>
<thead>
<tr>
<th>WHAT</th>
<th>WHO</th>
</tr>
</thead>
<tbody>
<tr>
<td>What outcomes do we target through engagement with the company?</td>
<td>Who is the prime beneficiary from the successful conclusion of the engagement?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>HOW MUCH</th>
<th>CONTRIBUTION</th>
<th>RISK</th>
</tr>
</thead>
<tbody>
<tr>
<td>How significant is the change sought?</td>
<td>Would this change have occurred without our engagement? Are other stakeholders already engaging?</td>
<td>What is the risk of the investor impact not being created?</td>
</tr>
<tr>
<td>Depth</td>
<td>Other investors</td>
<td>Lack of access to decision makers</td>
</tr>
<tr>
<td>Scale</td>
<td>The wider public and the media</td>
<td>Lack of engagement resource</td>
</tr>
<tr>
<td>Longevity</td>
<td>Local communities</td>
<td>Lack of company willingness to engage</td>
</tr>
<tr>
<td></td>
<td>NGOs/public bodies</td>
<td></td>
</tr>
</tbody>
</table>

Tracking engagement progress

Milestone Progress

1. Raise concern at appropriate level
2. Concern acknowledged by company
3. Company commits to credible change
4. Change implemented

Engagement objectives by theme

- Environmental
- Social and Ethical
- Governance
- Strategy, Risk and Communication
- Health and well-being
-Impact investors
-Future mobility
-Economic inclusion
-Education
-Water
-Circular economy
-Energy transition

Impact measurement: Enterprise-level

Qualitative elements
► Theory of Change (ToC) details how the company’s products or services spur positive, systemic change for people and planet
► Links the company’s inputs, outputs and positive impact
► Dynamic and forward-looking

Quantitative elements
► Theme-specific metrics provide consistency: We use standardised IRIS metrics across our eight investment themes
► Company-specific metrics provide flexibility: The metrics are specific to individual companies, enabling the capture of idiosyncratic impacts

Engagement
► Regular, constructive dialogue with portfolio companies provides feedback-loop
► Vital for encouraging disclosure of impact data, necessary for meaningful impact measurement
► Focuses on mitigation of negative impacts

Example: Brazilian educational organisation
One of the largest private educational organisations in Brazil and worldwide.

Theory of change
Inputs
Teachers, students, job portal

Outcomes
Student obtains employability-focused higher education degree

Impact
Student experiences substantial income growth

Theme-specific metrics
School Enrolment: Total
Teachers Employed

Company-specific metrics
Higher education: income effect
Indicator of Differences (IDD)
Many investment managers recognise the opportunity and now claim to integrate ESG

But what sets apart the market leaders?

► A large number of managers are now taking steps to integrate ESG factors into their investment process and some are combining it with a form of stewardship or active governance.

► However there is a clear gap between the mainstream and the market leaders demonstrating that while it is straightforward easy to cosmetically integrate ESG, it is difficult to do it well:

<table>
<thead>
<tr>
<th>Mainstream</th>
<th>Market Leaders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stand-alone engagement and / or ESG integrated investment functions</td>
<td>Insight from engagement programme a key input into portfolio construction</td>
</tr>
<tr>
<td>Engagement is largely reactive and letter-based with no dedicated resource</td>
<td>Board-level, face-to-face engagement. Setting and measuring progress against SMART objectives</td>
</tr>
<tr>
<td>Use of ESG as an indicator of risk</td>
<td>Focus on opportunities as well as risk. Enhanced ability to extract value from ESG data</td>
</tr>
<tr>
<td>Use of backward looking / static quantitative and absolute ESG metrics</td>
<td>Quantitative ESG factors overlaid with qualitative data from engagement activity. Ability to forecast the future trajectory of ESG characteristics</td>
</tr>
<tr>
<td>Utilise solely market providers of ESG data</td>
<td>Anticipate the market on ESG factors. Integrate public data with engagement insight</td>
</tr>
</tbody>
</table>
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Hermes Investment Management

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

**Private markets**
Infrastructure, private debt, private equity, commercial and residential real estate

**High active share equities**
Asia, global emerging markets, Europe, US, global, and small and mid-cap

**Credit**
Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

**Multi asset**
Multi asset inflation

**Stewardship**
Active engagement, advocacy, intelligent voting and sustainable development

**Offices**
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