

OUTCOMES  
BEYOND  
PERFORMANCE }

# INTEGRATING THE SDGS INTO INVESTMENT STRATEGIES

## CalPERS Board Offsite

### } 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.

  
**HERMES**  
INVESTMENT MANAGEMENT

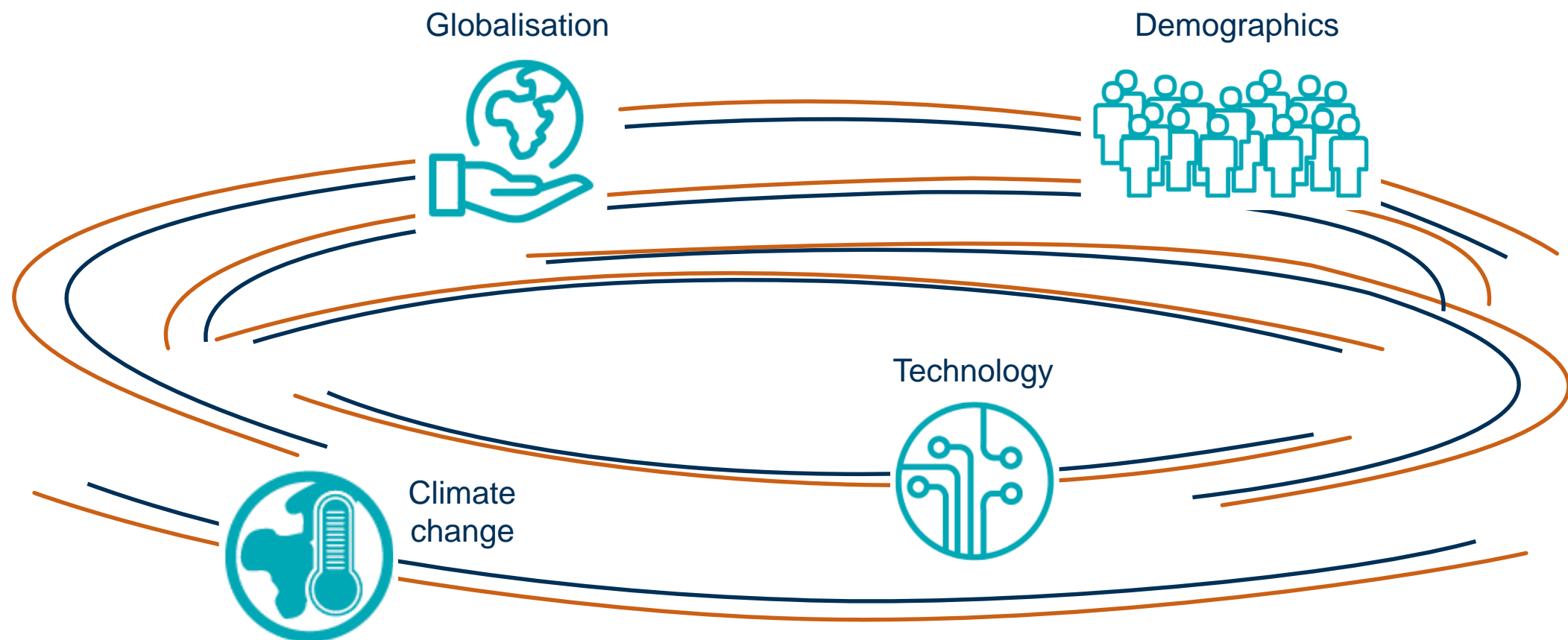
# OUTCOMES BEYOND PERFORMANCE



**Our approach to holistic returns means we are committed to delivering excellent long-term investment performance and stewardship, while improving the lives of many**

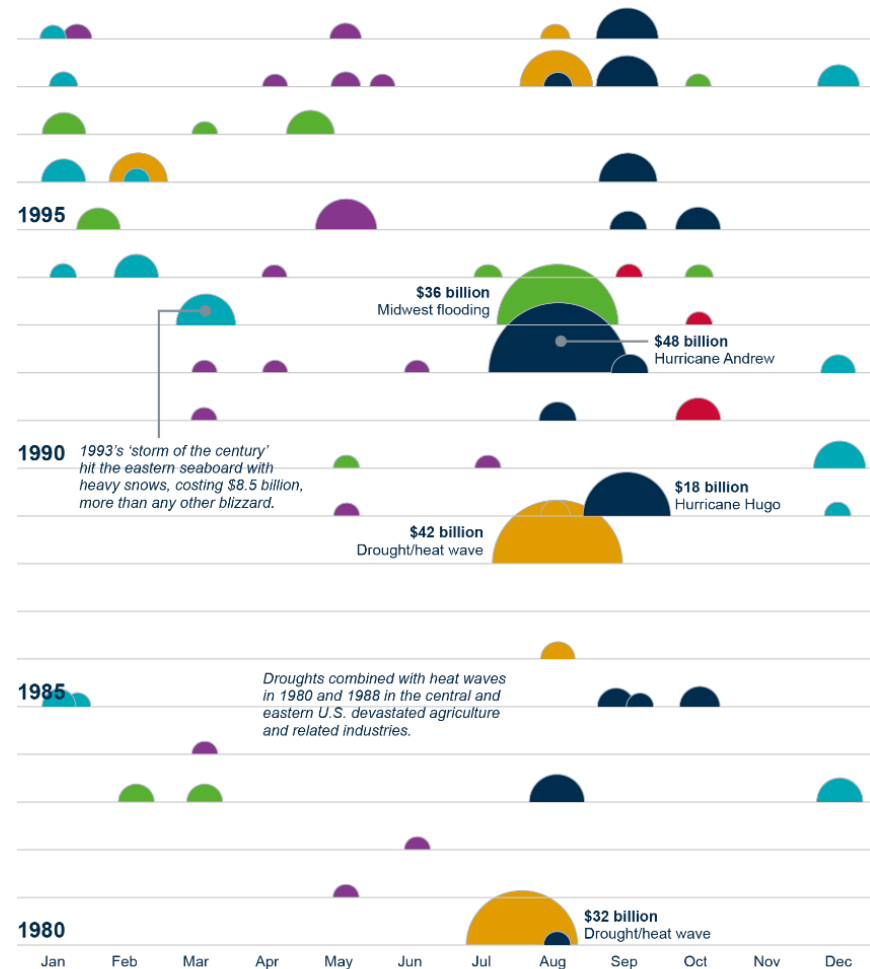
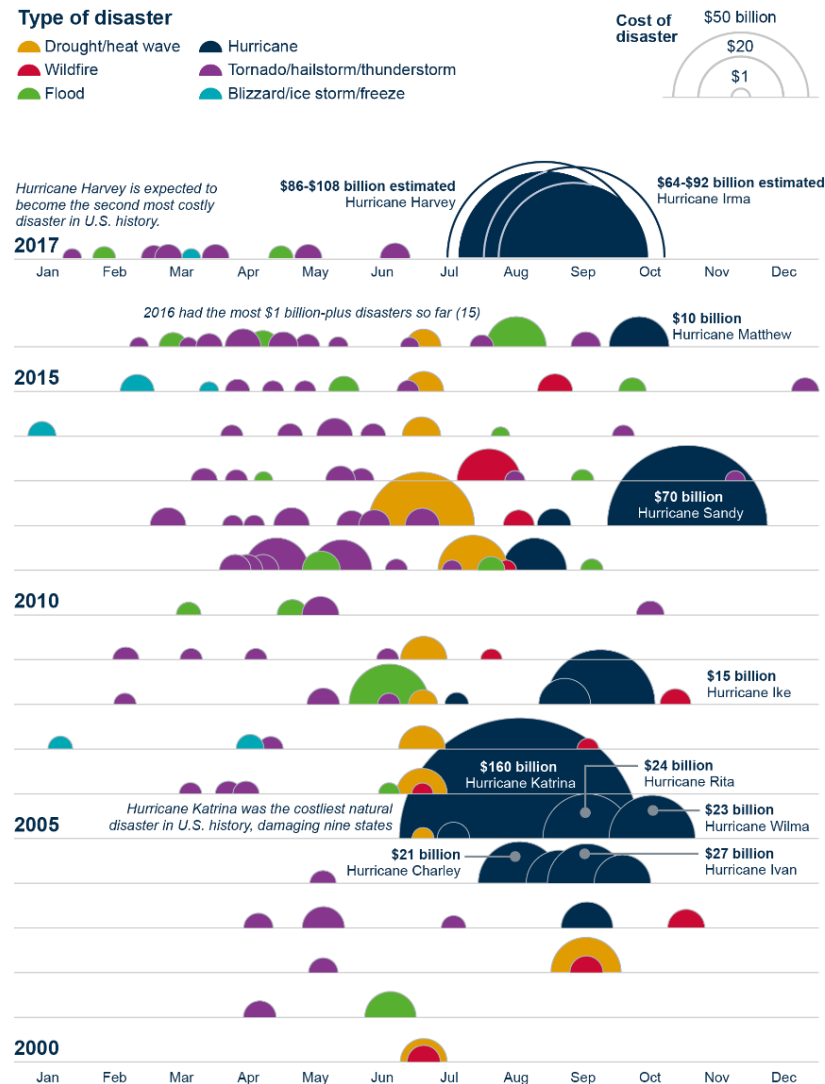
# A world in transition

## The Four Riders of the Apocalypse?



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.

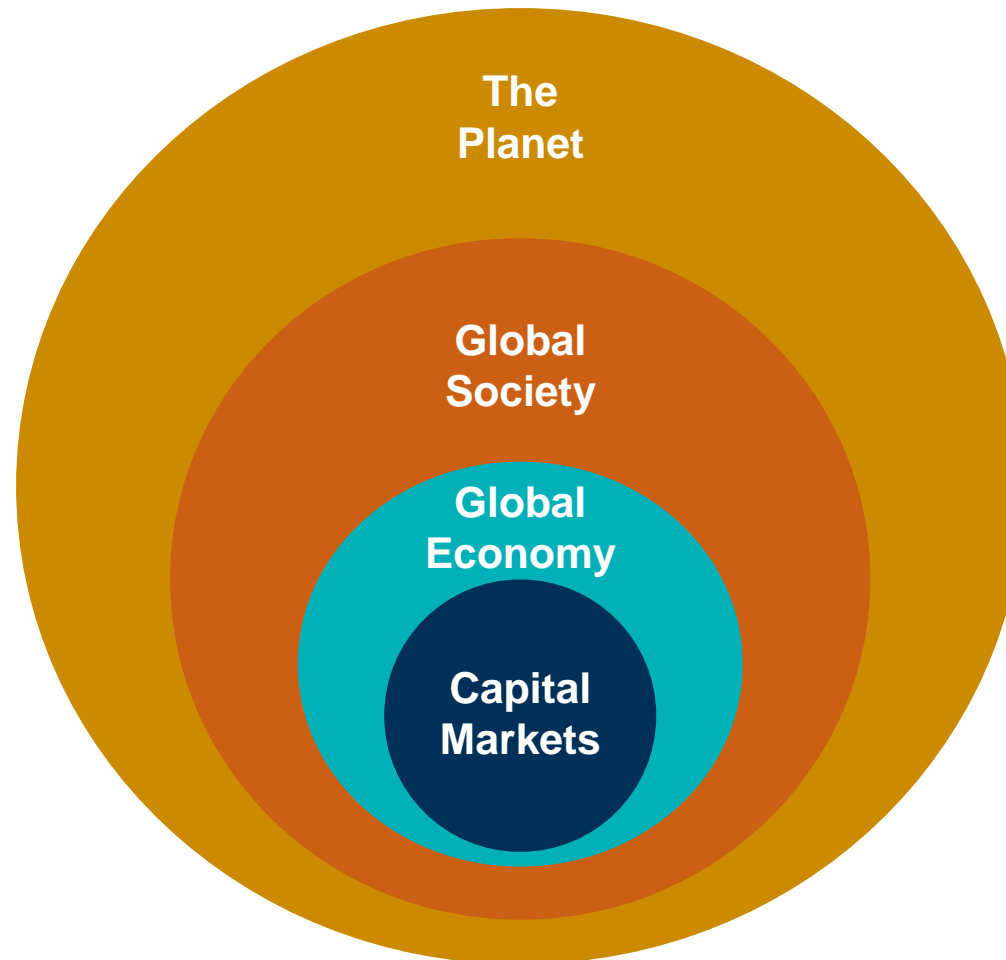
John Tomanio and Riley D. Champine, NG staff  
Sources: Adam Smith, National Climatic Data Center, Jeff Masters, Weather Underground, National Climatic Data Center

# A complex, interconnected system

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## 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.”**

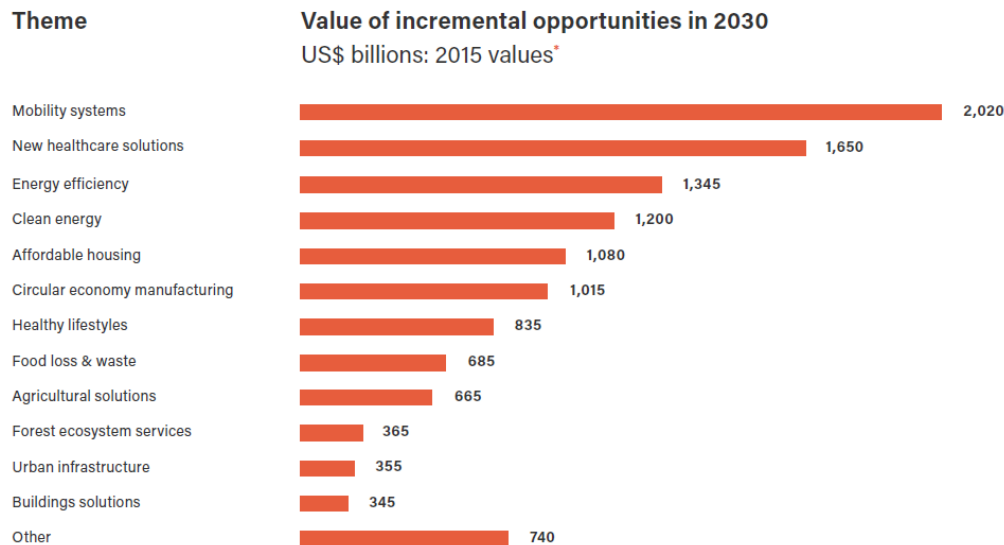
Source: UN.

# A US\$93 trillion opportunity

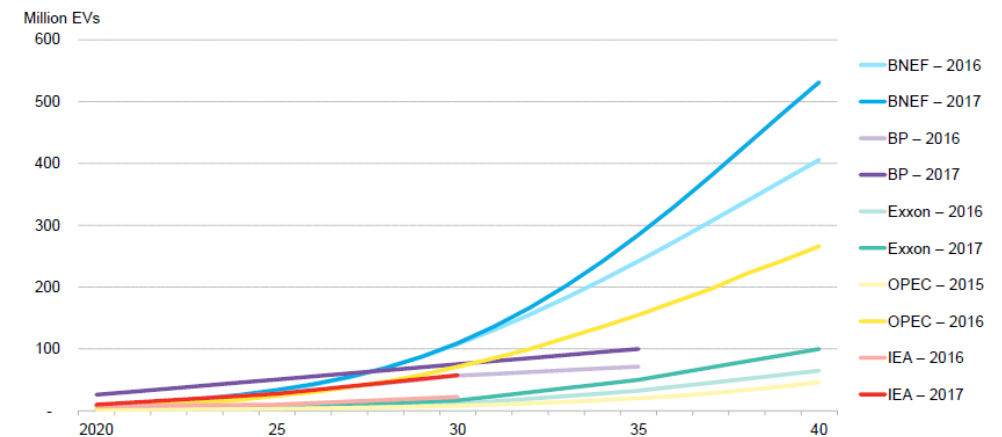
## A source of future growth, not just risk mitigation

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.



EV fleet size, 2020-40

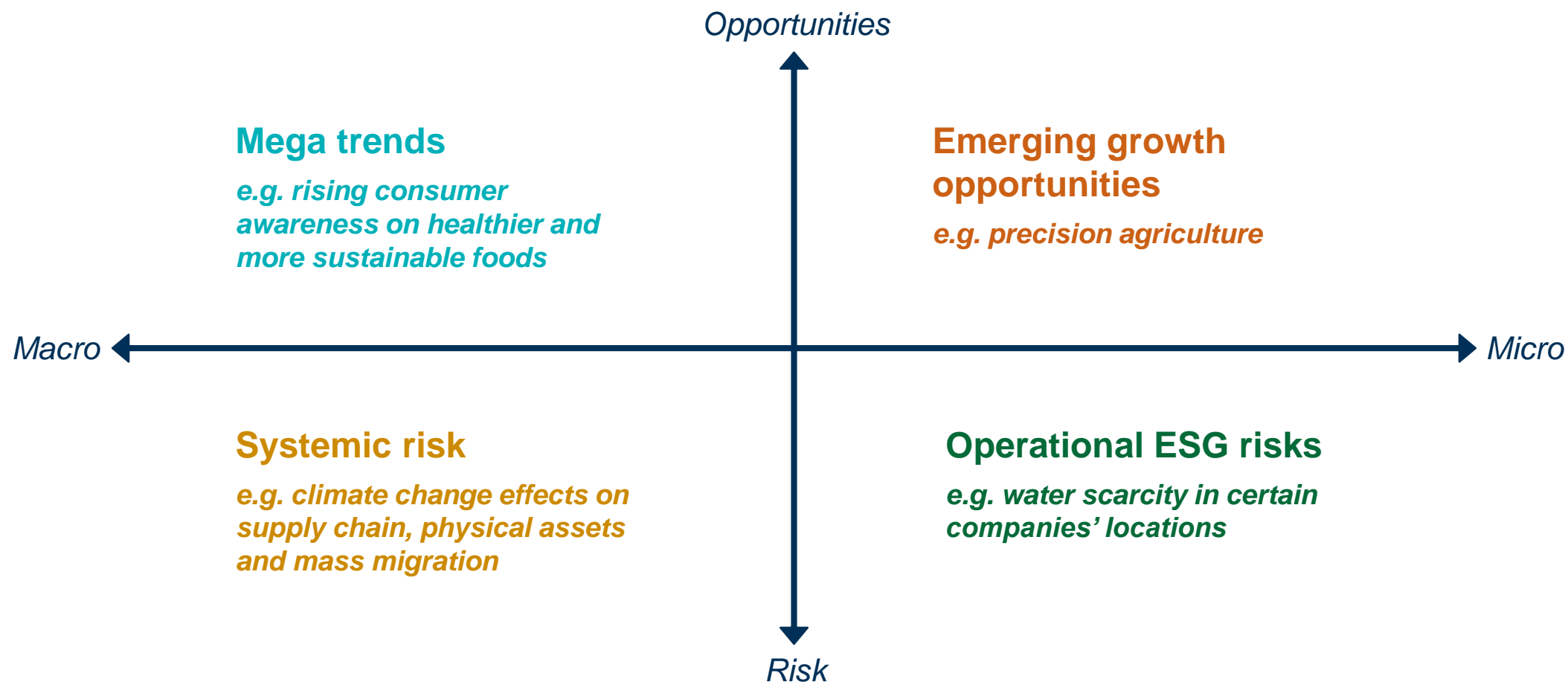


Source: Bloomberg New Energy Finance, organization websites. Notes: IEA forecasts to 2030 and BP forecasts to 2035. OPEC has not yet published its 2017 Oil Outlook. Only BNEF and OPEC provide annual data points for EV fleet size. Some data points for BP, ExxonMobil, OPEC and the IEA are estimated based on organization charts, reports and data. BNEF, BP and OPEC forecasts include just BEVs and PHEVs. ExxonMobil and IEA forecasts include BEVs, PHEVs and fuel cell vehicles. For more on the changes between BNEF's 2016 and 2017 long-term EV forecasts, see our July 6, 2017 Research Note "Global EV Sales Outlook to 2040" ([web](#) | [terminal](#)).

Sources: "Better Business, Better World", Business & Sustainable Development Commission, January 2017; Bloomberg New Energy Finance, July 2017.

# The SDG investment case

An untapped opportunity – Beta of future growth



Source: adapted from UNPRI, "The SDG Investment Case", 2017.



# Avoiding the pitfalls

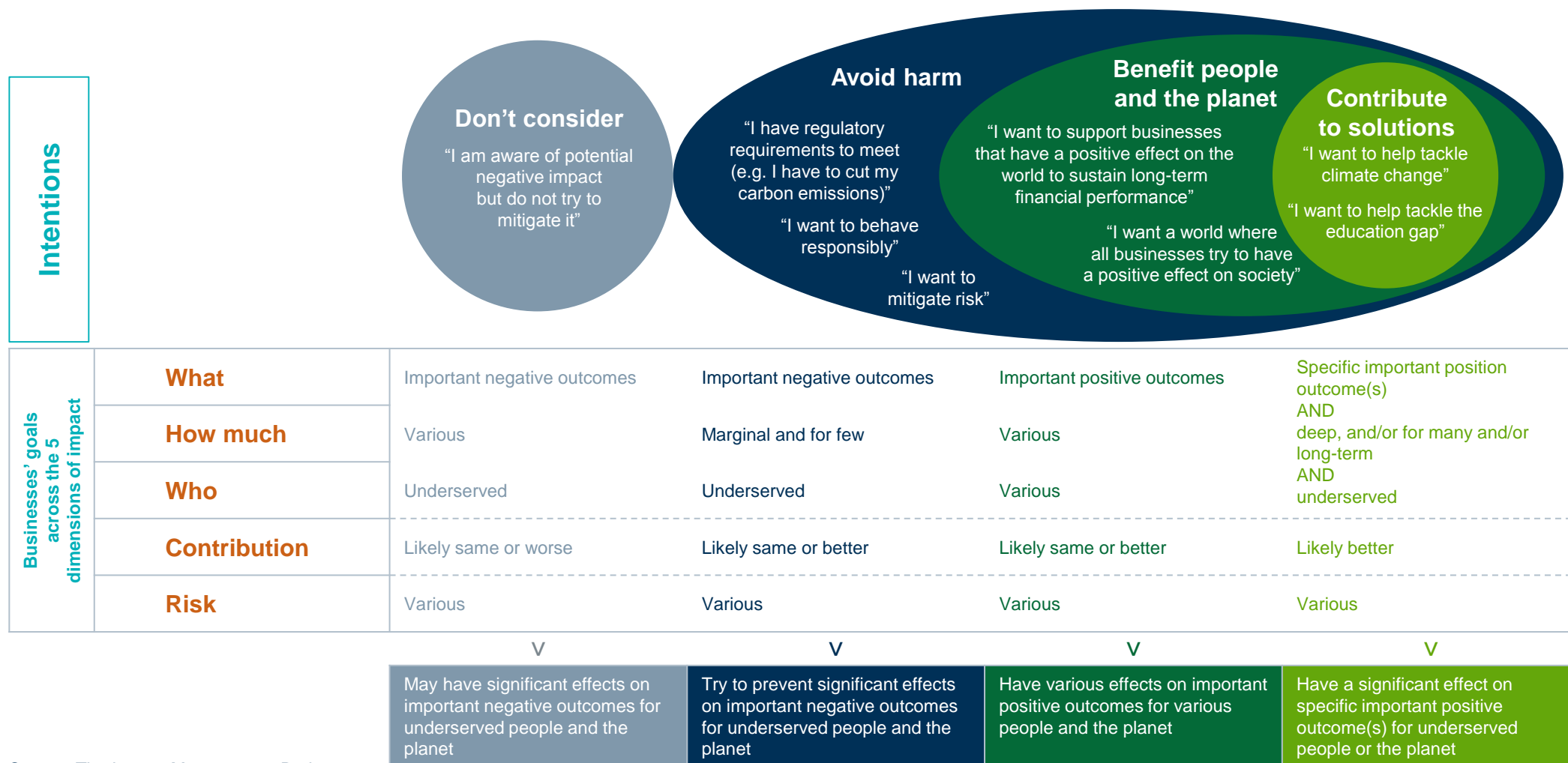
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## Beyond the temptation of simple data tagging of SDGs

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



Source: The Impact Management Project.

# How the goals play a differing role across Hermes

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## Hermes EOS Stewardship Service

- ▶ Engagement with publicly listed companies, US\$463bn+ of assets under advice both external and internal<sup>1</sup>

## 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

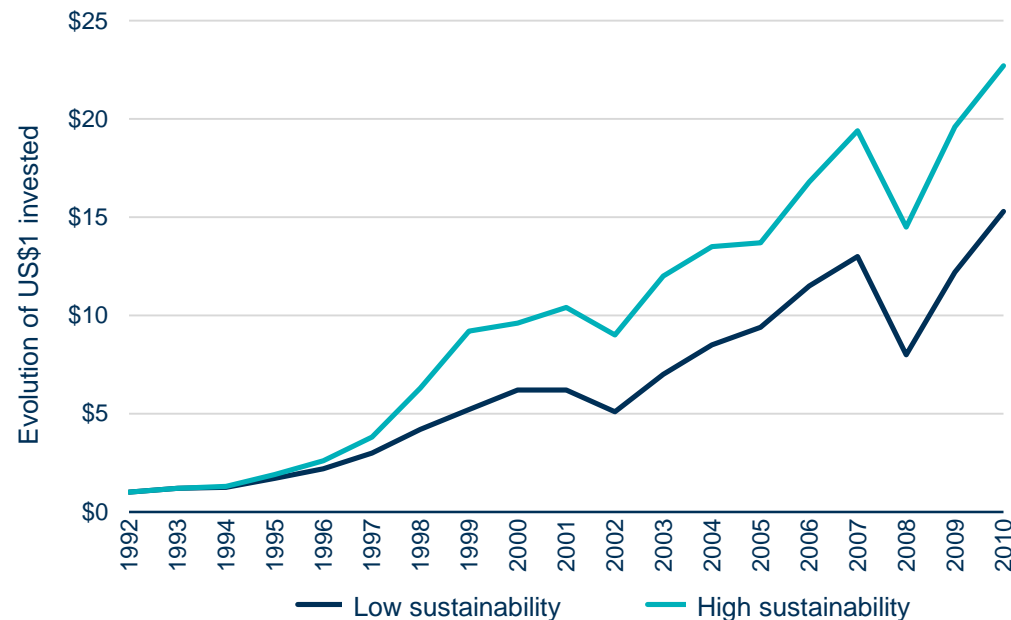
- ▶ Direct investment in real estate based “Place Making” for urban renewal

<sup>1</sup> 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

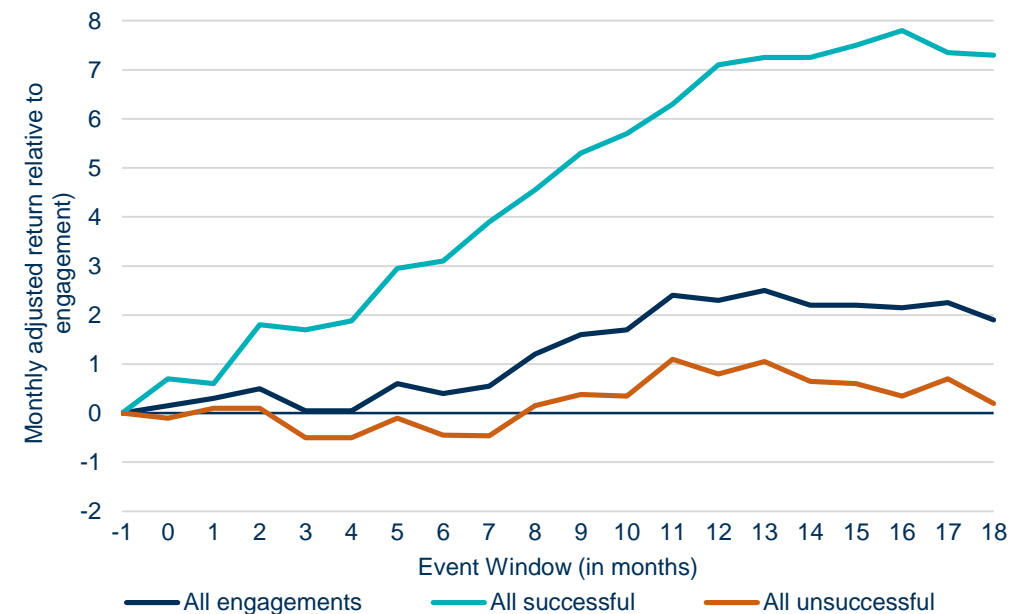


2014 study by Eccles, Ioannou, and Serafeim investigated the effect of corporate sustainability on organizational processes and performance using a matched sample of 180 US companies.

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.

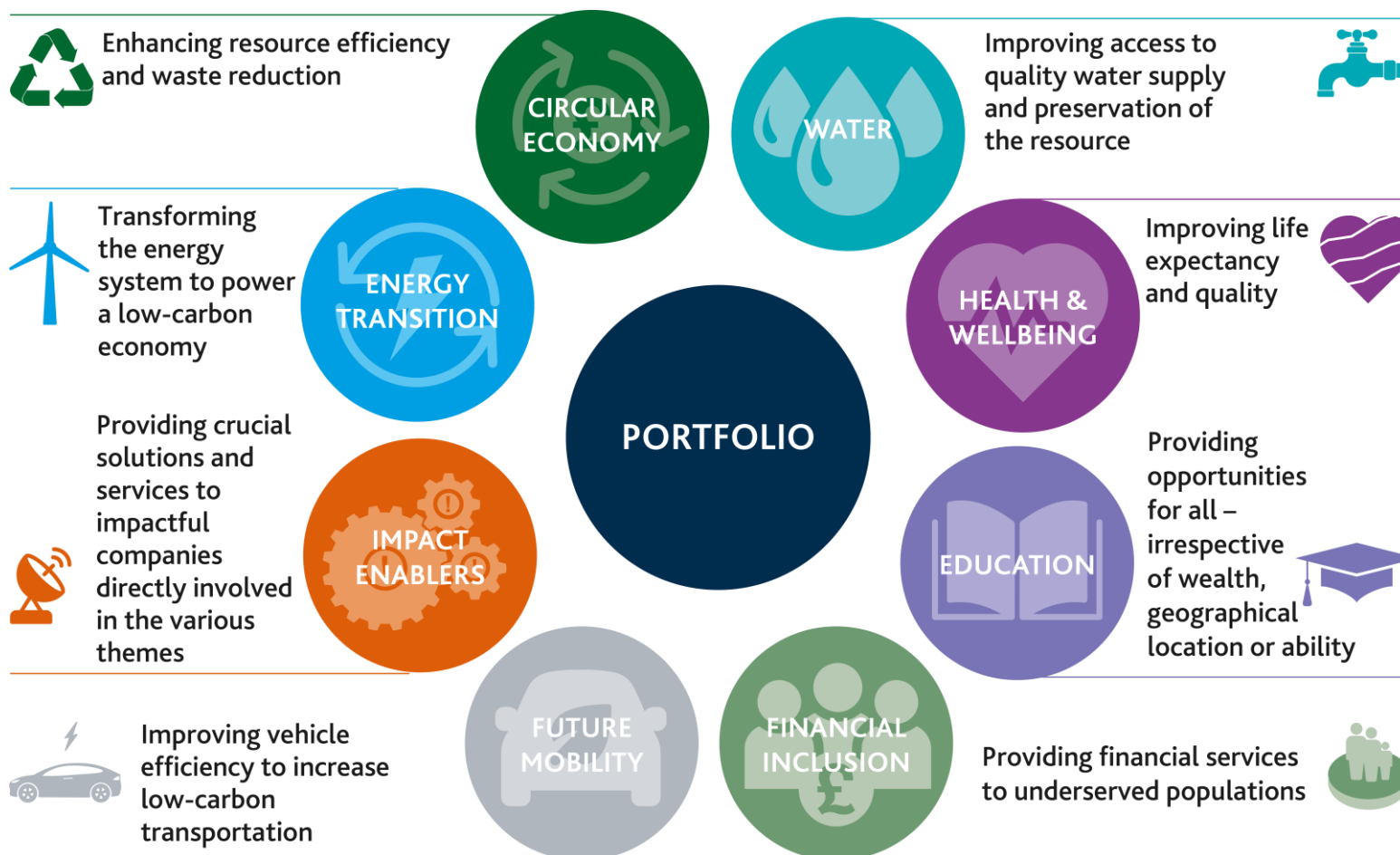
## Engagement drives enhanced financial performance



2012 study by Elroy Dimson, Oğuzhan Karakaş, 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

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## Context based approach

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

- ▶ **Growth:** US\$3-4trn 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

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## 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

# Conclusion

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- ▶ 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

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# APPENDIX

# 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

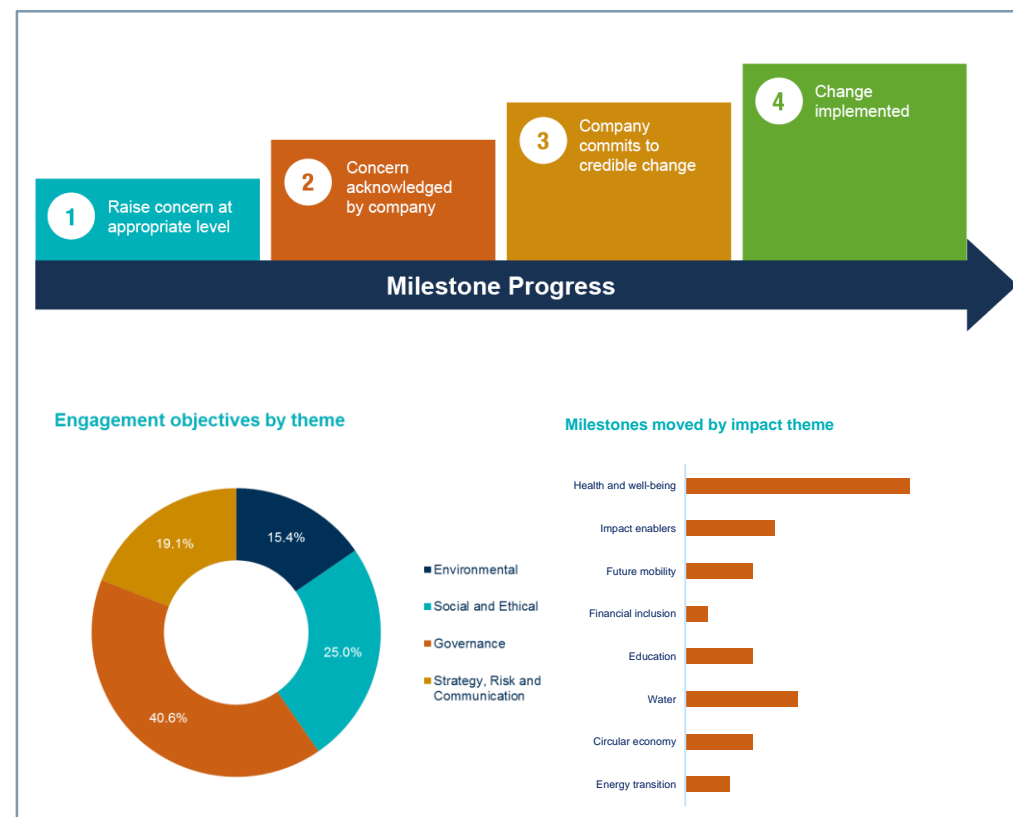
# Impact measurement: Investor-level

## Categorising impact sought

WHAT		WHO
What outcomes do we target through engagement with the company?		Who is the prime beneficiary from the successful conclusion of the engagement?
HOW MUCH	CONTRIBUTION	RISK
How significant is the change sought?	Would this change have occurred without our engagement? Are other stakeholders already engaging?	What is the risk of the investor impact not being created?
Depth		Lack of access to decision makers
Scale	Other investors	Lack of engagement resource
Longevity	The wider public and the media	Lack of company willingness to engage
	Local communities	
	NGOs/public bodies	

Source: Hermes, The Impact Management Project.

## Tracking engagement progress



# 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

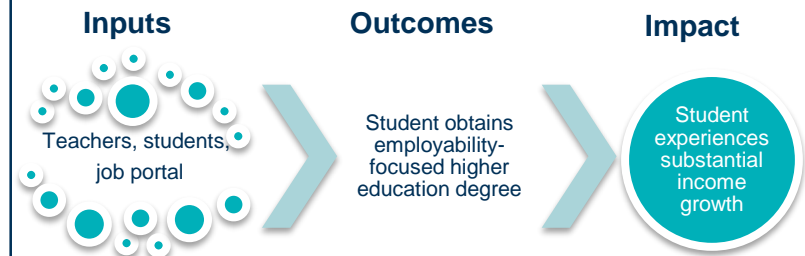
## Engagement

- ▶ 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



#### 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

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## 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:

### Mainstream

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Stand-alone engagement and / or ESG integrated investment functions

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Engagement is largely reactive and letter-based with no dedicated resource

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Use of ESG as an indicator of risk

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Use of backward looking / static quantitative and absolute ESG metrics

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Utilise solely market providers of ESG data

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### Market Leaders

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Insight from engagement programme a key input into portfolio construction

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Board-level, face-to-face engagement. Setting and measuring progress against SMART objectives

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Focus on opportunities as well as risk. Enhanced ability to extract value from ESG data

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Quantitative ESG factors overlaid with qualitative data from engagement activity. Ability to forecast the future trajectory of ESG characteristics

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Anticipate the market on ESG factors. Integrate public data with engagement insight

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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

London | New York | Singapore

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