

The background of the slide is a photograph of a coastal area at sunset. Several wind turbines are visible in the distance, their silhouettes against the bright orange and yellow sky. In the foreground, a group of four people are walking along a wet, reflective beach, their figures also silhouetted. The water reflects the warm colors of the sunset.

OUTCOMES
BEYOND
PERFORMANCE }

INTEGRATING SUSTAINABLE INVESTING INTO PENSION PLANS

SAN JOSE FEDERATED CITY EMPLOYEES' RETIREMENT SYSTEM
SAN JOSE POLICE AND FIRE DEPARTMENT RETIREMENT PLAN
INVESTMENT COMMITTEES

OUTCOME #16

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


Andrew Parry, Head of Sustainable Investing
May 2019

For professional investors only.



HERMES
INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE



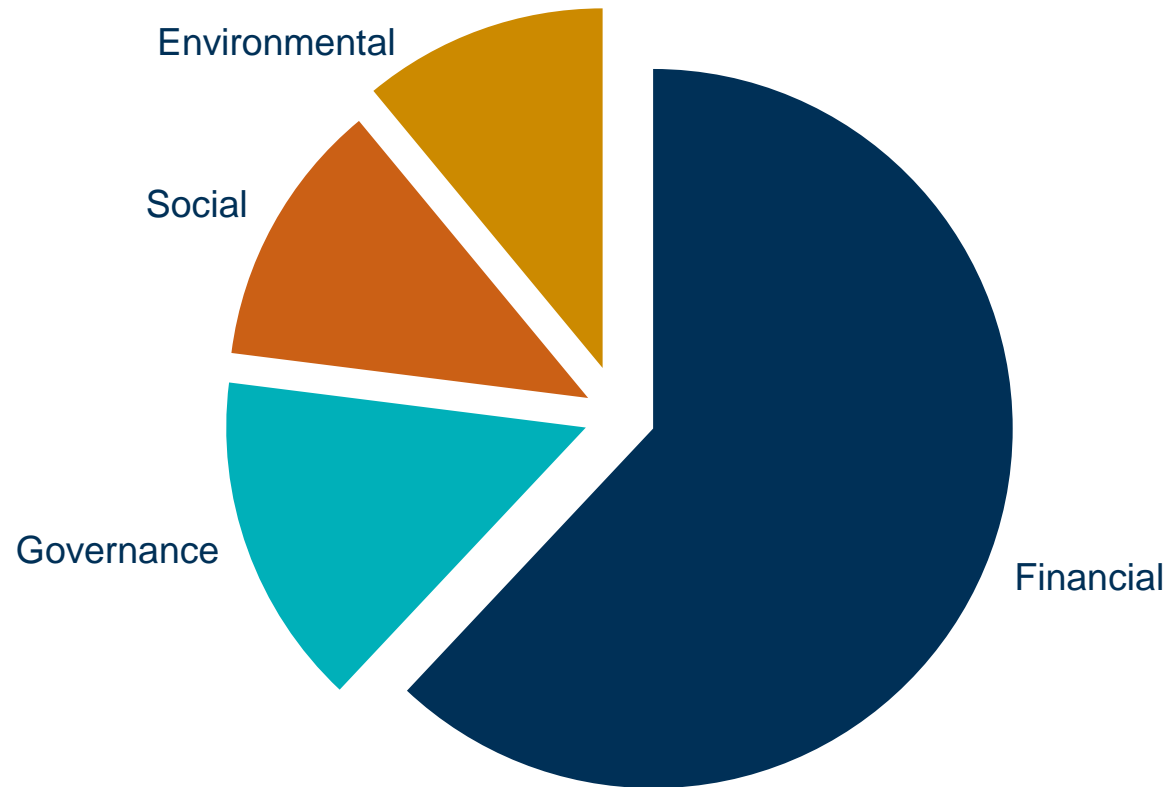
Our approach to holistic returns means we are committed to delivering excellent long-term investment performance and stewardship, while improving the lives of many

Going beyond the alphabet soup



ESG: Finance 101?

Getting the complete picture



For illustrative purposes only.

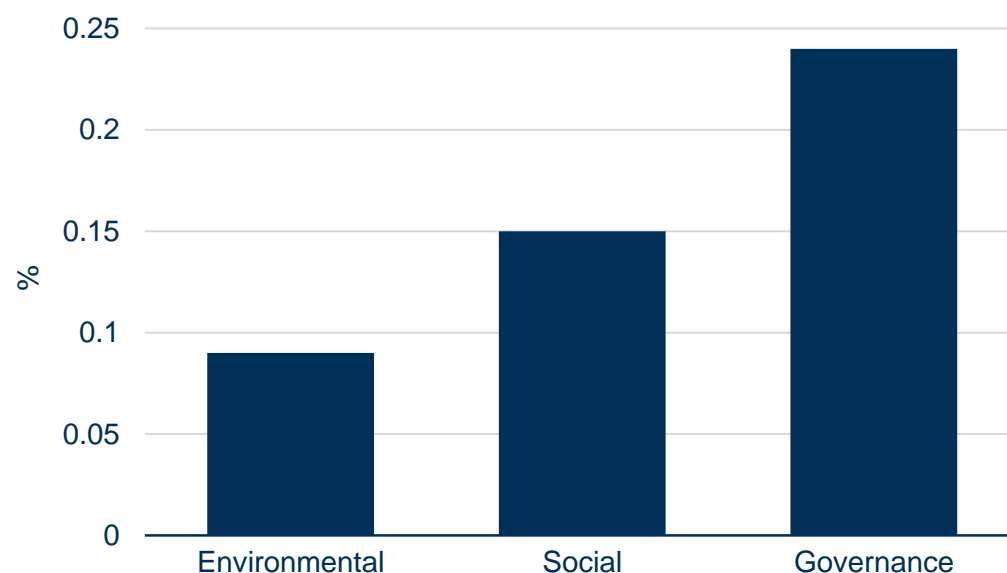
Performance benefits of integrating ESG factors

In 2014, our seminal paper showed statistically significant link between the quality of corporate governance and shareholder returns: companies with strong corporate oversight have tended to outperform their poorly governed competitors by an average of 30bps per month from 31 December 2008 to 31 December 2013.

In 2018, we revisited our study, updating our results to better understand how ESG factors have impacted shareholder returns in the past 24 months. Contrary to our earlier analysis, we find that the governance premium has weakened and, for the first time, social factors now qualify as statistically significant.

ESG value is driven by corporate governance and social characteristics

Average monthly dispersion in total returns between companies in top decile and lowest decile on environmental, social and governance scores from 31 December 2008 to 30 June 2018.



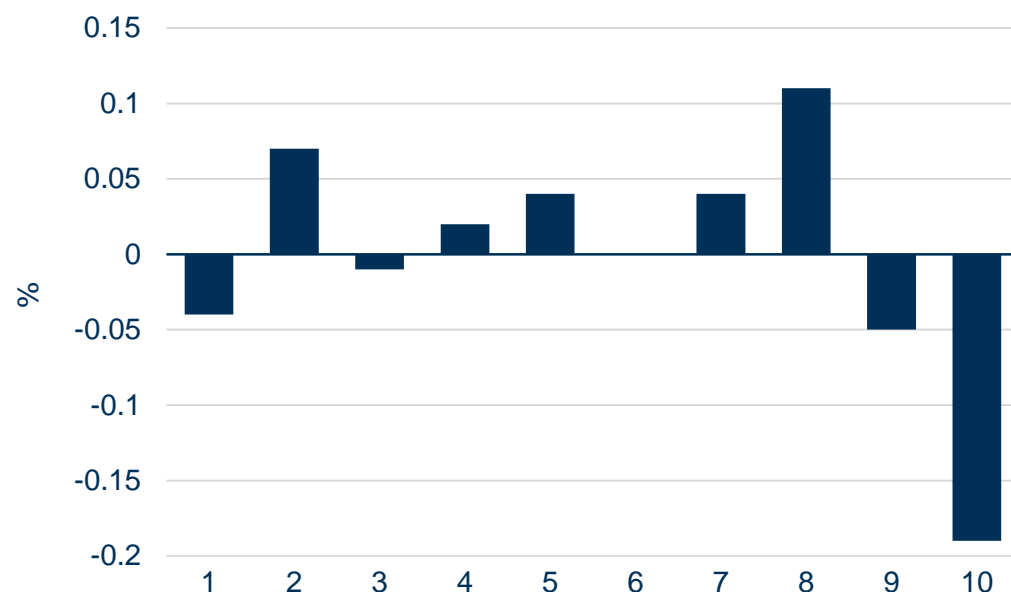
Source: Hermes Investment Management as at 30 June 2018.

Source: ESG investing: does it just make you feel good, or is it actually good for your portfolio? (Hermes Investment, 2018).

Performance benefits of integrating ESG factors

Companies with the lowest ranked social scores tend to underperform

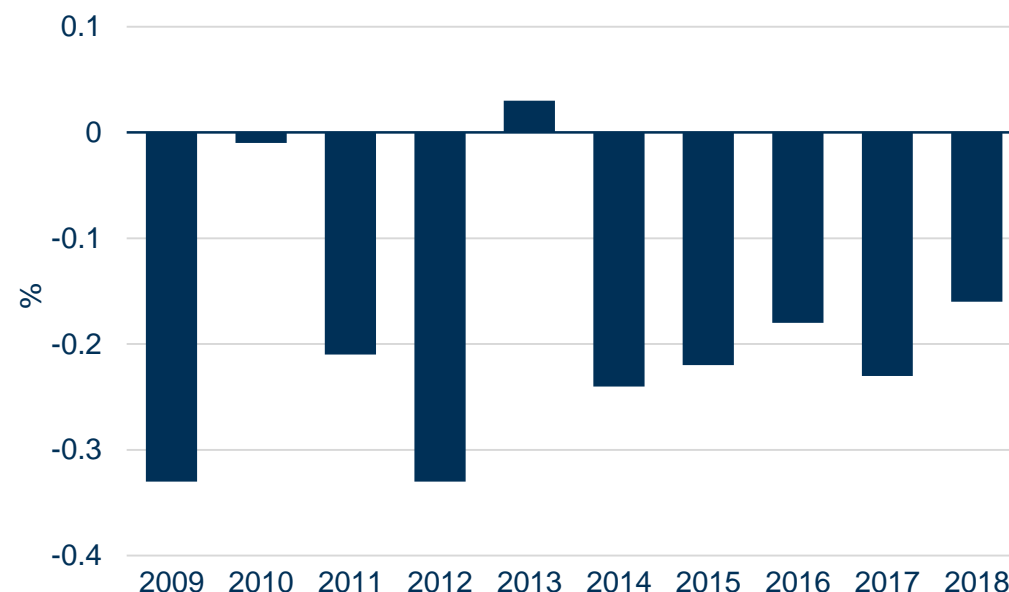
Average monthly total returns for companies in each decile based on social factors, from 31 December 2008 to 30 June 2018.



Source: Hermes Investment Management as at 30 June 2018.

Relative returns of companies with the poorest social practices compared to the average company

Average monthly dispersion in total returns between the average company and companies in the lowest decile on social factors for each calendar year from 31 December 2008 to 30 June 2018.



Source: Hermes Investment Management as at 30 June 2018.

Source: ESG investing: does it just make you feel good, or is it actually good for your portfolio? (Hermes Investment, 2018).

The investment case for sustainable investing

Extensive research shows sustainability drives enhanced returns

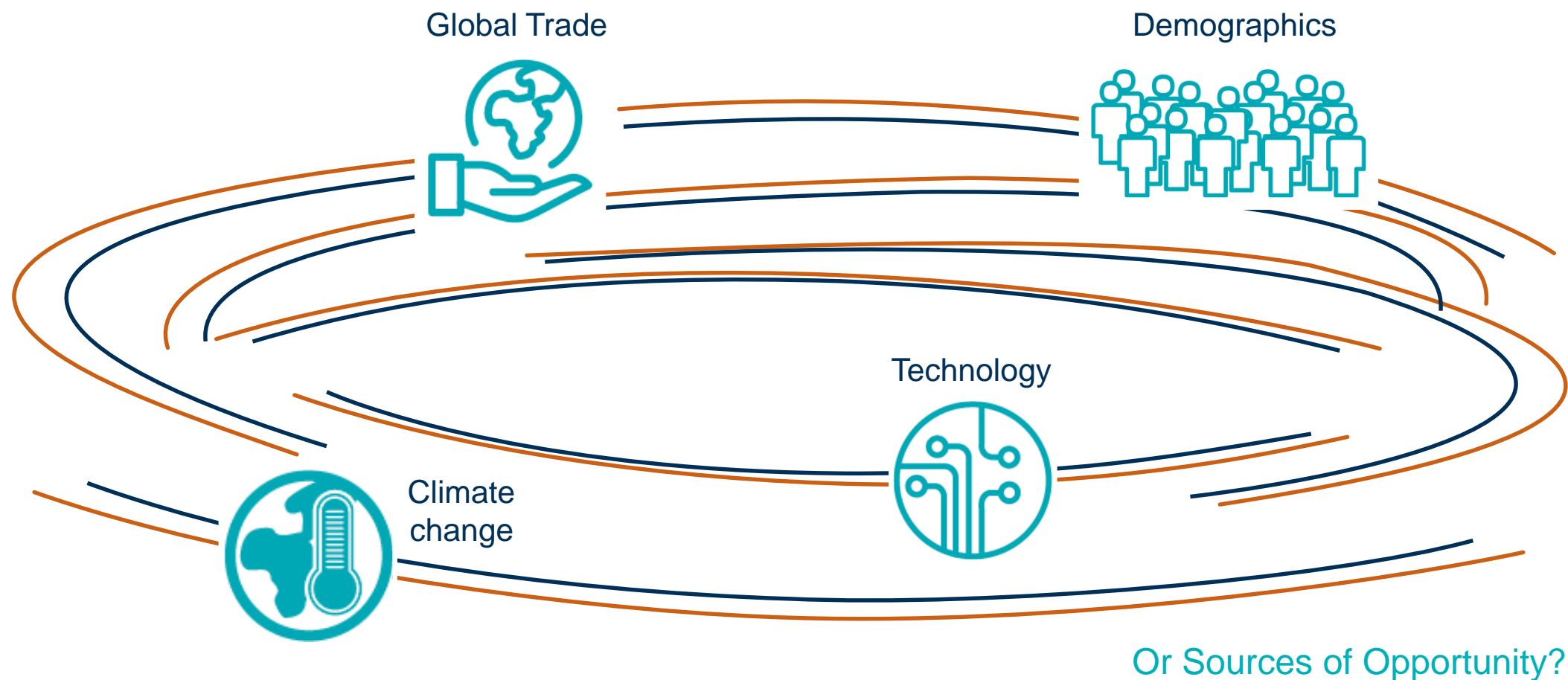
‘High Sustainability’ firms generate higher returns over the long term



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.

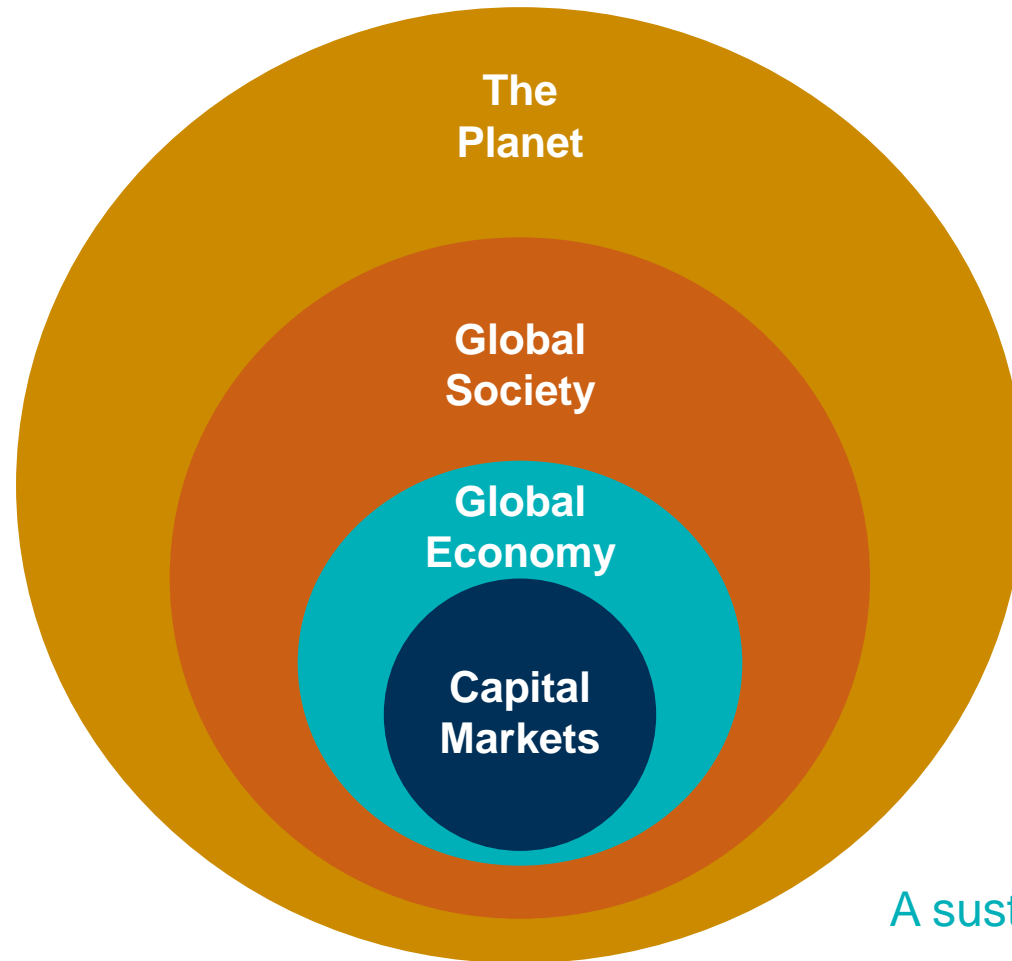
A world in transition

The Four Riders of the Apocalypse?



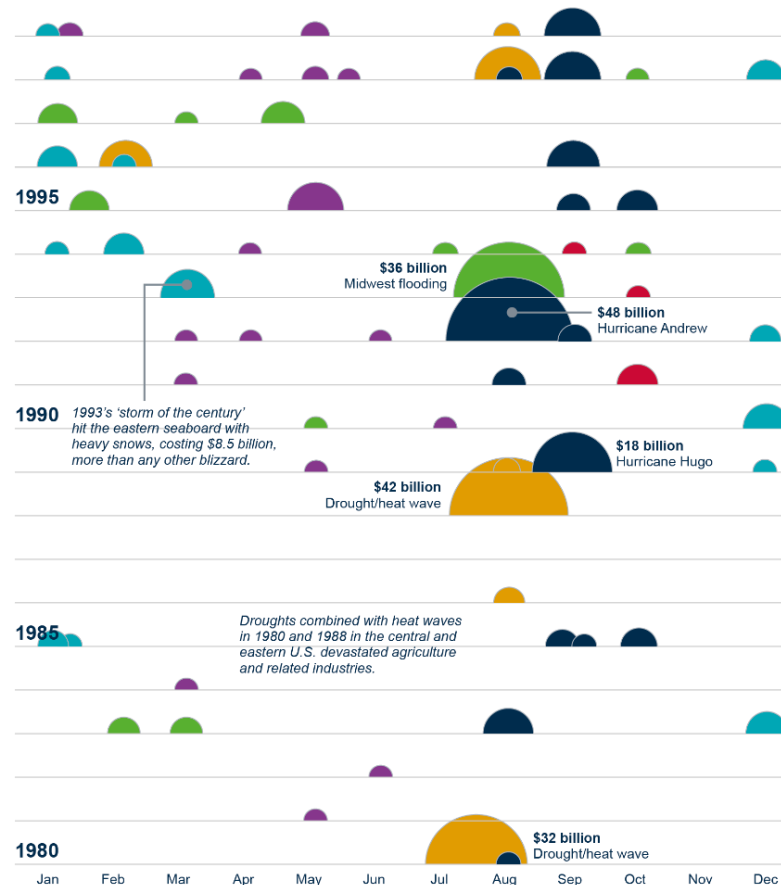
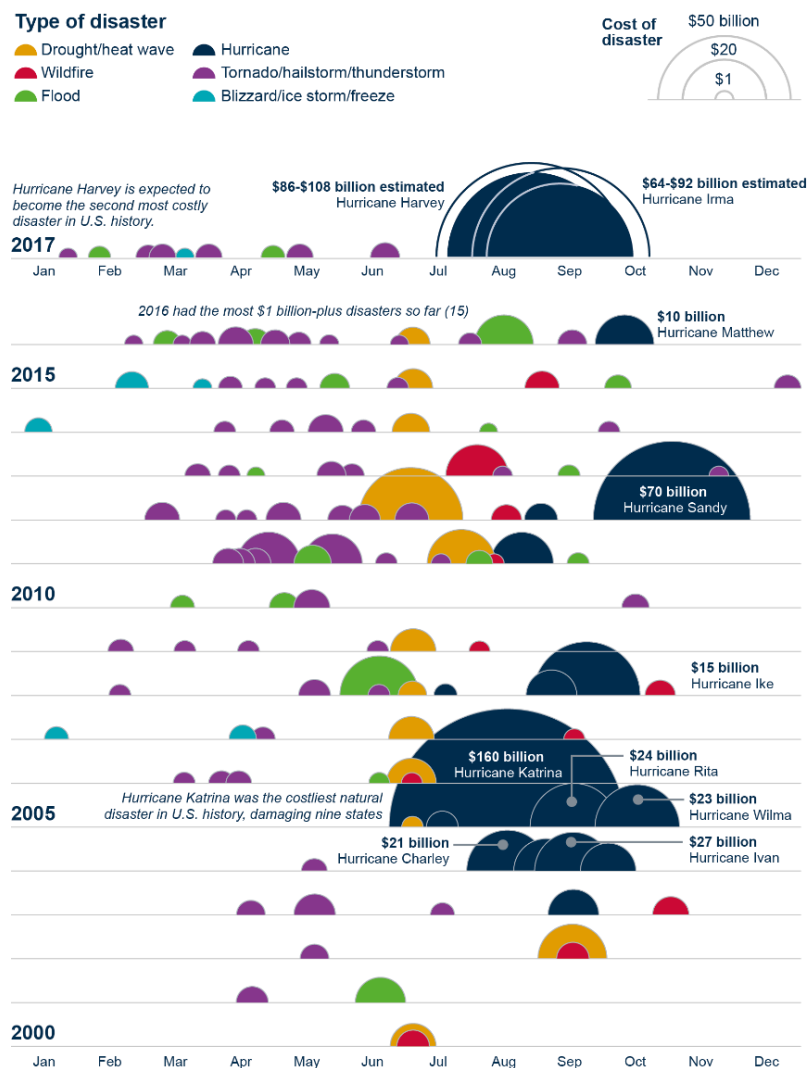
A complex, interconnected system

We are all in it together



A sustainable & resilient system

Disasters are increasing in cost and frequency

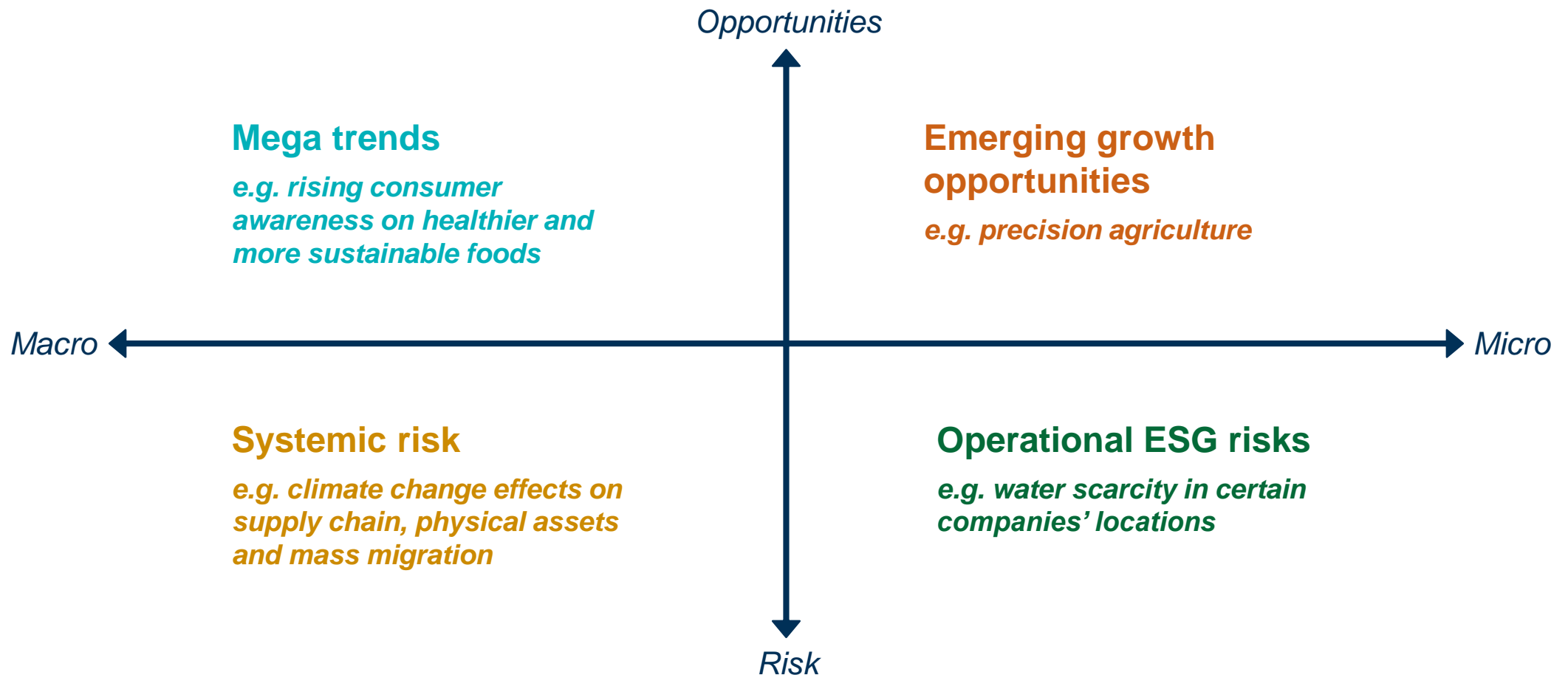


Estimated by Moody's Analytics. Estimates from NOAA are not yet available. All figures are in 2017 dollars. An earlier version of this graphic was published in the September 2012 issue of National Geographic magazine.

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

Sustainable investing investment case

An untapped opportunity – Beta of future growth



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

Responsible Investment Continuum



Responsible Investment

Socially Responsible Investing (SRI)

- ▶ Ethical Investing
- ▶ Based on stock exclusions
- ▶ Expected investors willing to give up some return

ESG Investing (ESG)

- ▶ Environmental, social and government focus
- ▶ Best in class company selection
- ▶ Usually conducted using quantitative screening to identify companies delivering above average ESG performance

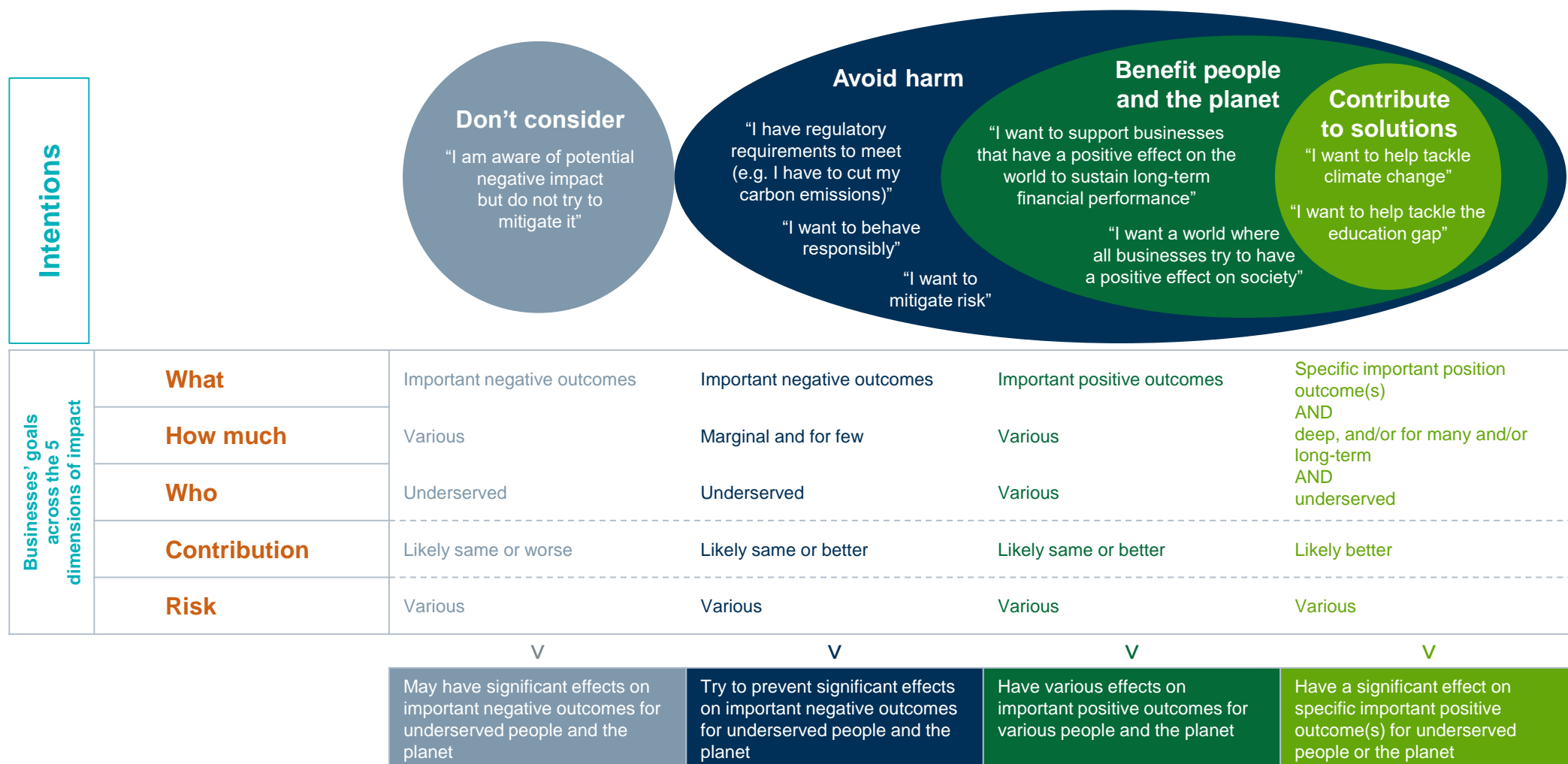
Impact Investing

- ▶ Seeking to achieve above market returns
- ▶ Investing in companies making a positive impact on people and the planet
- ▶ Forward looking focus, companies that address new growth areas

Targets cannot be guaranteed.

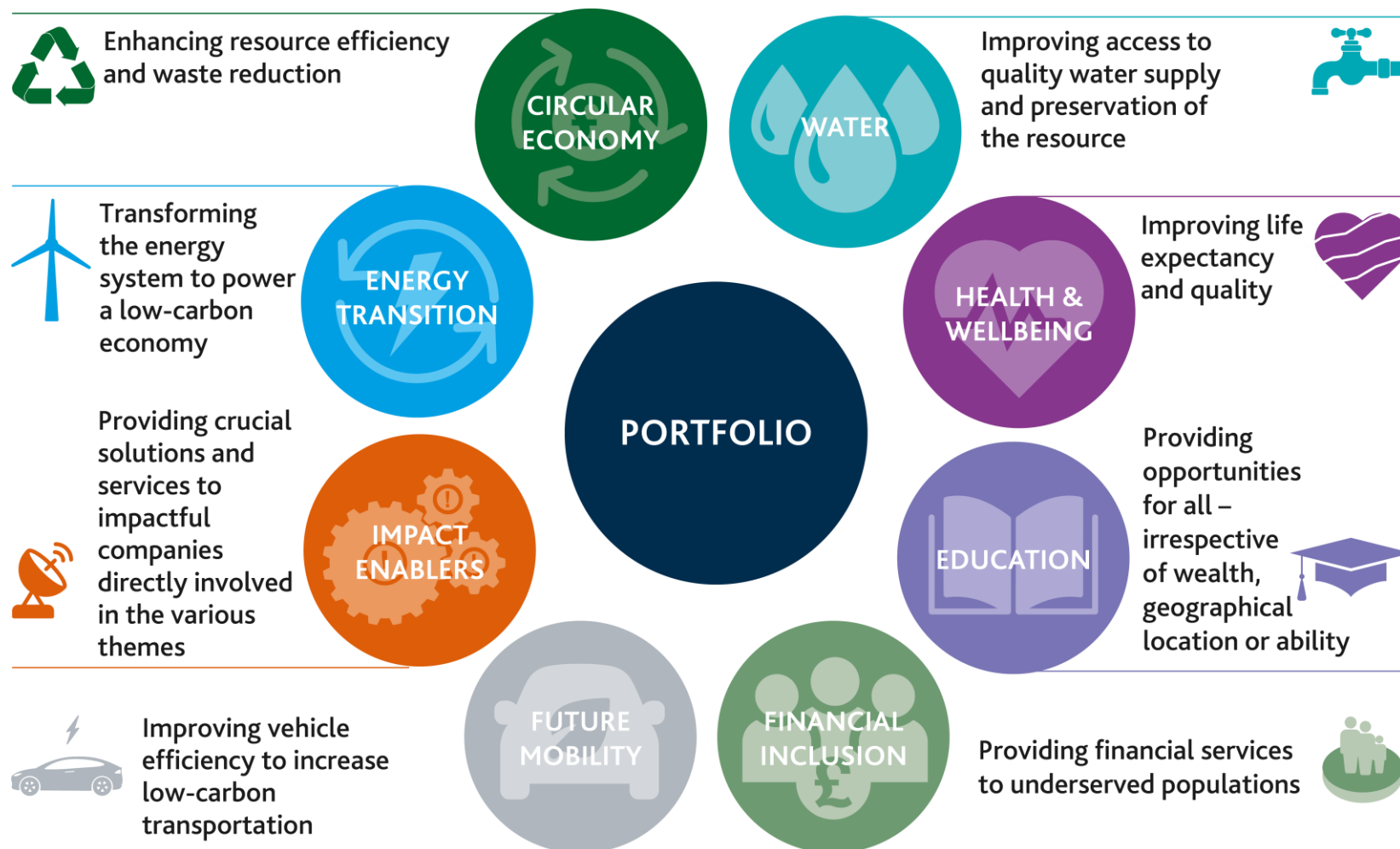
Guide to ESG Investing <https://www.hermes-investment.com/wp-content/uploads/2018/11/guide-to-esg-investing-final.pdf>

The impact investing spectrum



Source: The Impact Management Project.

A thematic approach to idea generation?



Source: Hermes.

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.

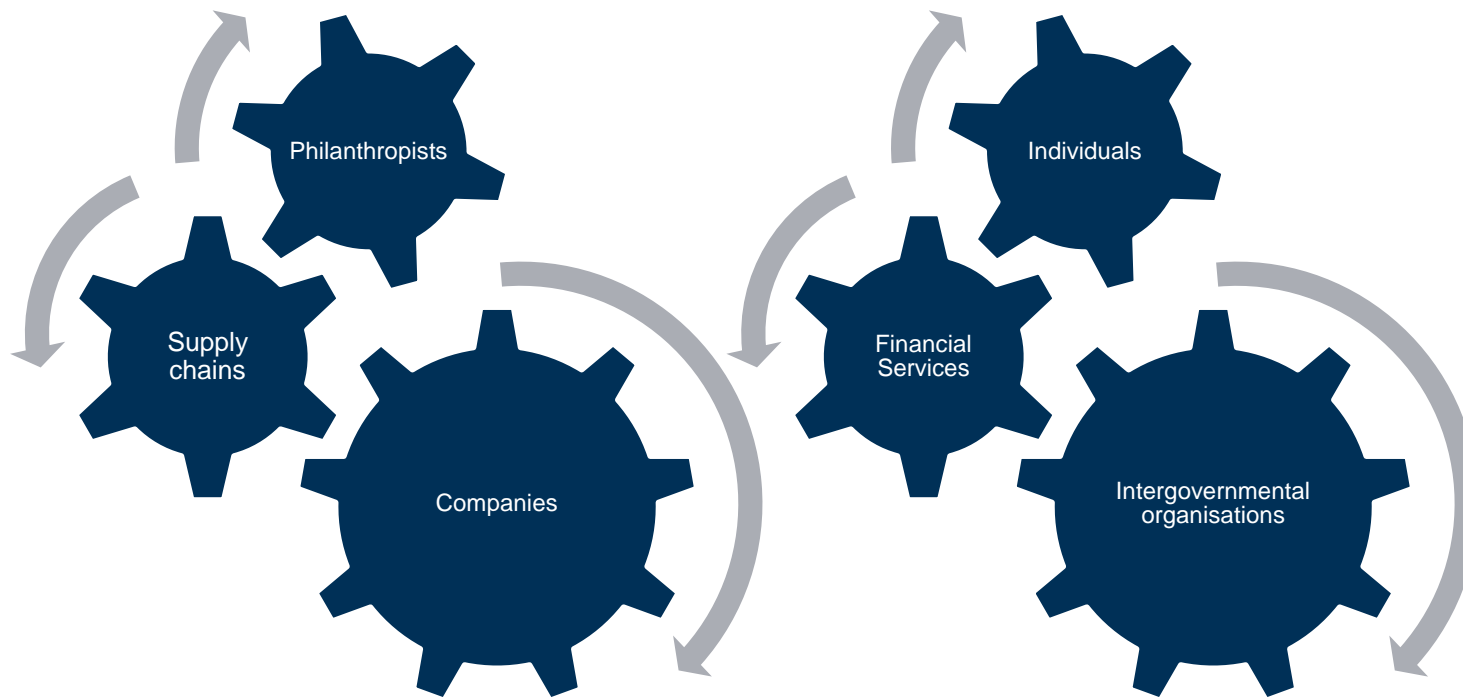
“The Sustainable Development Goals (SDGs):

A universal call to action to end poverty, protect the planet and ensure that all people enjoy peace and prosperity.”

Source: UN.

Achieving the SDGs requires partnerships

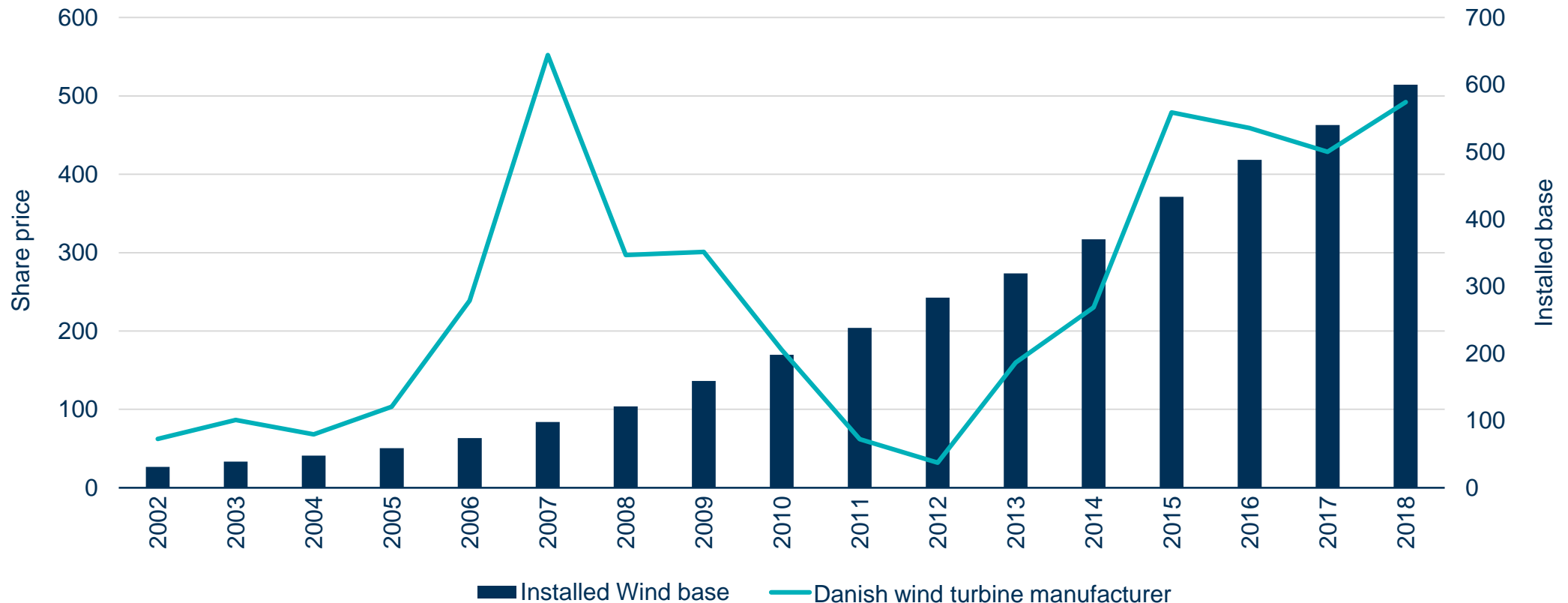
- ▶ Achieving the overarching goals of the SDGs cannot be done through investment alone, but rather through a systemic change across multiple actors
- ▶ The United Nations Conference on Trade and Development (UNCTAD), estimates that the SDGs will require annual investments of US\$4-5 trillion. This is US\$2-3 trillion above current levels
- ▶ The SDGs recognise the need for a strong commitment to global partnerships and cooperation, given how the world today is more interconnected than ever before



Financial returns/investment considerations come first

Knowing when to invest just as important as what you invest in

Installed Wind base vs Danish wind turbine manufacturer share price



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

New tools & insights inform sustainable investing

Standard setting

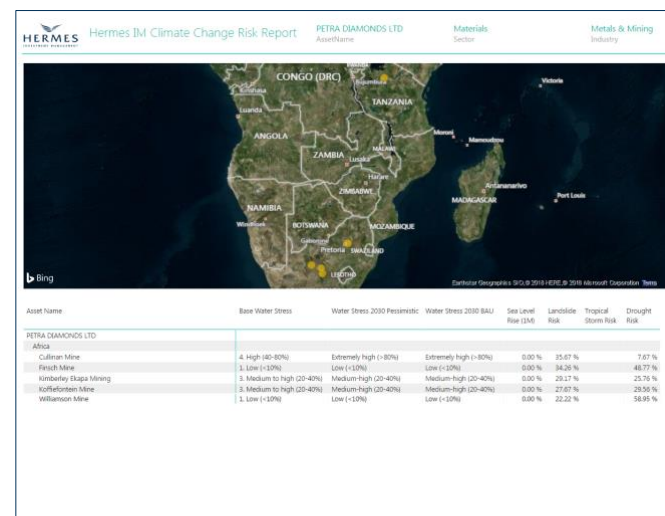
Example: Impact Management Project & PGGM

	IMPACT GOALS									
	AVOID HARM			BENEFIT STAKEHOLDERS			CONTRIBUTE TO SOLUTIONS			
	Materiality in %	Score	Weight	Materiality in %	Score	Weight	Materiality in %	Score	Weight	Materiality in %
Signal that impact matters										
+ Engage activity										
+ Grow new or undersupplied capital markets										
+ Provide flexible capital										
Private Real Estate	12	5.6%	Mortgages*	1.7	0.8%	Private Real Estate - BIO Climate	0.3	0.1%		
Private Real Estate	12	5.6%	Private Real Estate - BIO	0.1	0.0%	Private Equity - BIO Climate	0.2	0.1%		
Private Equity	9.9	4.8%	Other Equities - BIO	0.5	0.2%	Other Equities - BIO Climate	0.3	0.1%		
Government Bonds	39	18.9%				Cash BIO**	0.1	0.0%		
Other Equities	4.2	2.0%								
Alternative Equities Strategies	18	8.7%								
High Yield Developed Markets	4.8	2.3%								
Insurance Linked Investments	3.7	1.8%								
Total	103	50.0%	Total	2.3	1.1%	Total	0.9	0.4%		
Developed Market Equities	25	12.0%	Investing in Solutions Equities - BIO	6.4	3.1%	Investing in Solutions Equities - BIO Climate	1.5	0.7%		
Emerging Market Equities	8	3.9%								
Developed Market Credits	0.7	0.3%								
Emerging Market Credits	8.5	4.1%								
Emerging Market Debt Local Currency	8.5	4.1%								
Total	51	24.9%	Total	6.4	3.1%	Total	1.5	0.7%		
Structured Credit	5.4	2.6%	Developed Market Credits - BIO	0.4	0.2%	Developed Market Credits - BIO Climate	0.1	0.0%		
			Emerging Market Credits - BIO	0.1	0.0%	Emerging Market Credits - BIO Climate	0.1	0.0%		
			Government Bonds - BIO Climate	0.7	0.3%					
			Semi-sovereign, Sub-sovereign and Agency bonds - BIO Climate	0.1	0.0%					
Total	5.4	2.6%	Total	0.5	0.2%	Total	1	0.5%		
Infrastructure	6.5	3.2%	Infrastructure - BIO	0.1	0.0%	Infrastructure - BIO Climate	1.1	0.5%		
			Private Real Estate - Healthcare	0.1	0.0%	Private Equity - Microfinance	0	0.0%		
			Private Equity - Healthcare - BIO	1	0.5%					
Total	6.5	3.2%	Total	1.2	0.6%	Total	1.1	0.5%		
Total	0	0.0%	Total	0	0.0%	Total	0	0.0%		

* PGGM Mortgages portfolio qualifies as 'Benefit Stakeholders' because PGGM solely invests in specific mortgages aimed at providing healthcare workers with affordable housing
 ** A part of PGGM's Cash portfolio is invested in climate solutions by the cash provider (Rabobank Duurzaam Deposito)

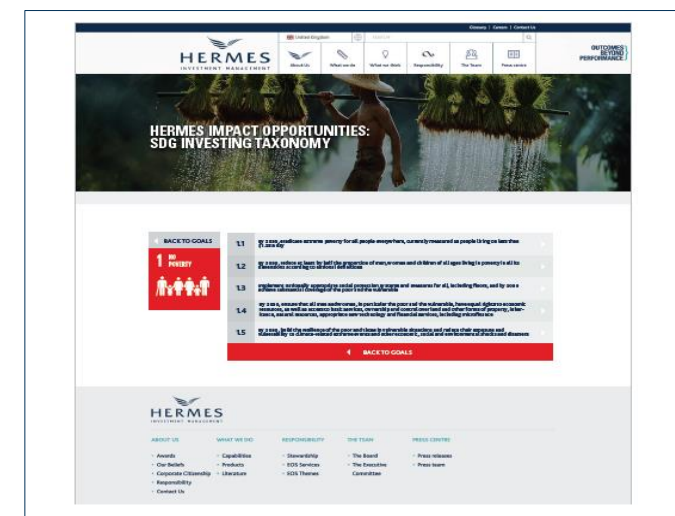
Internal R&D

Example: Hermes Climate Change Risk Report



SDG Taxonomy

Example: Hermes SDG Taxonomy



For illustrative purposes. Sources: Publicly available reports from PGGM, The Impact Management Project, BASF & Hermes.

A European perspective

Tightening regulatory & legal requirements

UK DWP Investment Regulations

- ▶ From October 2019, pension trustees must update their scheme's SIP to set out their policies on ESG, climate change and stewardship activities
- ▶ From 2020, additional requirements apply from 2020 to trust based DC schemes. Similar changes are anticipated for contract based schemes and their IGC's¹ following an FCA consultation, expected in the first quarter of 2019

European regulations

- ▶ New governance regulations came into force on 13 January 2019 designed to implement the second European Pensions Directive (IORP II) with potentially further reaching implications in terms of integration of ESG into trustee risk control processes
- ▶ Changes are also expected to flow from amendments to Shareholder Rights Directive, to be incorporated into national law by 10 June 2019
- ▶ EC Action Plan on Sustainable Finance looks to bring new rules on ESG to all financial market participants

UN PRI

- ▶ TCFD²-based reporting is to become mandatory for PRI signatories in 2020. While reporting will become mandatory, disclosure will be voluntary

¹ Independent Governance Committee. ² Taskforce on Climate-related Financial Disclosure.
Source: Sackers.

US fiduciary purpose

ESG: permissible but never mandatory

From SRI to ESG

- ▶ Transformation of SRI (exclusions based) to ESG (integrated financial analysis)
- ▶ Collateral benefits ESG versus risk-return ESG

Duty of loyalty

- ▶ Sole interest rule (Trusts) and ERISA¹: solely in the interest of beneficiaries
- ▶ Motive matters: avoid conflicts of interests with the needs of the beneficiary
- ▶ Policy value: prior approval required for mixed objectives – “sole interest” is the default setting

Duty of care – the “prudent person”

- ▶ Prudent investor rule: consistent with both passive and active investing – with clear risk & return objectives
- ▶ Active investing: diversifying, documented and with a net-value added intent that can be modified
- ▶ Engagement: supportive of improved risk-adjusted returns

¹ Employee Retirement Income Security Act (1974).

Source: *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing* by a Trustee Schanzenbach & Sitkoff.

Four pillars of sustainable investing

Context based approach

A lens for assessing investment opportunities:

- ▶ **Growth:** US\$3-4trn of incremental SDG 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?

Turning Sustainability-led investing into reality

A long term project

Develop your own taxonomy

- ▶ As a pension scheme, market rate of return investing is a prerequisite and requires pragmatism
- ▶ Investment potential of sustainability can be split into four categories:
 - **Growth:** contributing to societal needs responsibly and sustainably at or above market rates
 - **Stewardship:** engage to change behaviours to mitigate risk through reducing negative outcomes
 - **Leadership:** advocate to encourage an overall system shift with a clear economic rationale
 - **Measurement:** report on negative impacts avoided and positive impact delivered

Challenges to address

- ▶ No commonly agreed framework or mapping of sustainability to existing activities or strategies
- ▶ Any approach will need to be adaptive and flexible
- ▶ Be mindful of the danger of scoring, ranking or labelling
- ▶ Limited data as sustainability as much about future outcomes as current activities

Many investment managers 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:

Mainstream

Stand-alone engagement and / or ESG integrated investment functions

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

Use of ESG as an indicator of risk

Use of backward looking / static quantitative and absolute ESG metrics

Utilise solely market providers of ESG data

Market Leaders

Insight from engagement programme a key input into portfolio construction

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

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

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

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

Practical Steps for Trustee Boards

Getting ahead of the curve

Establish clear investment principles

- ▶ Going beyond mere compliance
- ▶ Provide trustee training on ESG & systemic risks
- ▶ Annual review & scenario testing

Review existing strategy & managers

- ▶ Establish strategic opportunities versus funding status & resources
- ▶ Differentiate between active & passive approaches
- ▶ Approach to engagement & stewardship

Member considerations

- ▶ Identify appropriate strategy for DB & DC (where applicable) within a risk-return framework
- ▶ Develop a clear communication strategy to members of the benefits of ESG integration into investment principles
- ▶ Annual reporting of the environmental & social footprint of the schemes assets including engagement

Conclusion

- ▶ Not all schemes are equal, need to take a context based approach taking into consideration resources and situation, in the context of changing legal and regulatory requirements
- ▶ Sustainable investing as 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 ESG/Sustainability washing at the expense of delivering demonstrable benefits to scheme members
- ▶ First and foremost we have to be good investors – asset managers and owners alike – and sustainability should be a lens through which to view the world to make us better at our jobs
- ▶ The complex, interconnected nature of the sustainability 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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Hermes Investment Management

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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, small and mid-cap and impact

Credit

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

Stewardship

Active engagement, advocacy, intelligent voting and sustainable development

Offices

London | Denmark | Dublin | Frankfurt | New York | Singapore

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