

# Toolkit for responsible investors



The pressure for funds to behave as responsible owners continues to mount. The financial crisis brought to the fore the need for pension funds and other institutional investors to be aware of the ESG risks within their portfolios. The crisis, which wiped billions off the global financial markets and from pension funds' investments, served to exemplify the need for investors to be active owners of the companies in which they hold shares. The development of the UK stewardship code, which impels fund managers and encourages pension funds to act as good owners of companies looks set to be replicated in other regions with an EU-wide stewardship code being acknowledged as all-but inevitable and anticipated with varying levels of warmth and caution.

As responsible investment and engagement with both companies and the investment industry becomes an increasingly accepted and necessary practice for pension funds, so the tools available to investors in fulfilling their fiduciary duty as responsible investors have developed in response. For funds that lack the time, knowledge and resource to respond to this challenge, behaving as a responsible investor can be a difficult charge to meet. The challenge lies in developing an integrated approach that reflects the values of the fund and its beneficiaries. There are an increasing number of SRI service providers that can help to provide support for this challenge and in providing solutions which vary in scope, impact and approach.

In line with pension funds increasing allocation to a broader mix of asset classes, corporate bonds, private equity, hedge funds, real estate, infrastructure and commodities have all been added to the responsible investment agenda. Even where investment strategies focus on short term results, for pension funds, the need to apply a long-term view to their investments still holds. Alongside proxy voting and engagement with public companies, funds are now moving to apply stewardship and responsible ownership policies across the range of traditional and alternative investments.

A consistent and active approach to monitoring ESG risks across the portfolio is critical to the successful implementation of responsible ownership policies which effectively span different asset classes. ESG risks may arise within the investment process or by virtue of ownership of the underlying asset. The diversity and secrecy surrounding some investment strategy make engaging with the underlying instruments or assets seem impossible.

However, responsible long-term owners and investors, particularly those with a fiduciary obligation to maximise value for beneficiaries need to understand how their investments are managed in a transparent and sustainable way. This transparency will open the door to enabling asset owners to ensure that investment is also carried out in a sustainable way.

The parameters of responsible ownership have thus been extended from focusing solely on corporate ESG risks to addressing risks inherent in fund governance and portfolio management. The impact of the Madoff and Galleon hedge fund scandals have underscored the need for investors to be as responsible in their approach to alternative investments as they are to more obvious asset classes such as listed equity and corporate bonds. Whilst the application of responsible ownership policies to hedge funds and private equity are relatively newer concepts, the momentum from groups such as the UN Principles for Responsible Investment (UN PRI) in this area will ensure that this quickly becomes a necessary feature of fund's stewardship activities.

Hermes Equity Ownership Services (EOS) assists pension funds and other institutional investors all over the world to implement responsible investment policies across their portfolios. Hermes has been at the forefront of developments in responsible investment since its inception 27 years ago. Its EOS team represents the interests of its clients in voting, engagement and public policy in relation to listed equities, corporate bonds and alternative investments.

## Policies, processes and priorities

Constructing an approach to responsible ownership that reflects the interests and concerns of pension funds, their trustees and beneficiaries can be a perplexing experience. EOS works with investors to draft and implement responsible ownership policies which crystallise the interests of funds' beneficiaries in terms of both the value of assets and ethical values. These bespoke voting, engagement and stewardship policies form the basis on which all voting and engagement work is carried out. Geography and local law and corporate governance best practice, as well as international norms and treaties are often a starting point from which policies are determined.

## Voting

Exercising voting rights on all applicable securities is one of the basic tenets of being an active owner and is core to fulfilling Principle 2 of the UN PRI. Hermes EOS goes further than the basic voting execution offered by some of the larger proxy voting providers. Our 'intelligent' voting approach combines voting and engagement and is designed to bring about change at companies which our clients own. We see the vote not just as a mechanism for registering our approval or otherwise, but as an opportunity to address our concerns at the company through dialogue with its management.

## Engagement

Engagement with the objective of changing the course of company behaviour in the longer-term has become a key activity for responsible investors. Effective engagement is an iterative process with predefined, realistic and measurable objectives. Rather than simply voicing a concern, or gathering information, engagement activity should have measurable outcomes and yet should be sufficiently flexible in its approach to take into account the specific circumstances of the company. The majority of funds do not have the resource, experience or time to carry out an effective corporate engagement programme alone and a collaborative approach with other investors is often favoured. Hermes EOS represents a standing coalition of investors, and leverages the weight of pension funds' combined holdings to engender positive behaviour at companies and to encourage them to address relevant ESG risks and issues, enhancing or protecting shareholder value over the longer-term. EOS has the largest engagement resource of any fund manager or pension fund in the world. Our international team of experts engage with companies across the globe in native language and with the benefit of a deep understanding of the local culture and business practices.

## Screening and monitoring

Knowing which issues to engage on is one of the key skills of effective engagement. Hermes EOS operates a proprietary screening process which combines a wide range of different sources, analysis and practical considerations to identify critical ESG risks in portfolios. The output of our screening process is then further analysed for breaches of clients' SRI policies and to identify those companies that violate their guidelines. The results of these screens, combined with a practical consideration of where resource is best applied on behalf of clients, is then used to inform EOS' engagement programmes. We monitor companies in our clients portfolios on an ongoing basis for ESG risks, violations of international norms and contravention of clients' SRI policies.

## Exclusions

Excluding a company from its investment universe limits the ability that investors have to influence company behaviour for the better and presents the possibility that those that purchase shares following divestment by another investor may not engage in

company dialogue. However, for many funds, the threat of exclusion may serve as both a 'last resort' where engagement is not effective in a given time period in bringing about change, and also mitigates the reputational risk to the fund of investing in companies involved in negative ESG activities. EOS provides support for the decision-making of funds which make the choice to take this route, using the screening process described above to identify companies which breach clients' SRI guidelines.

## Other asset classes

The majority of pension funds and other large investors begin their stewardship activities with listed equities, though engagement with issuers of corporate bonds on ESG matters is now an accepted, if more recent, element of company dialogue. However, the concept of responsible investment and ownership extends to all asset classes, including hedge funds, private equity and property. The PRI applies all investments, including assets beyond traditional shares, and investors are beginning to apply the same energy to ensuring a sustainable approach to alternatives as to their shareholdings. It is widely accepted that fund trustees' fiduciary duties include a consideration of ESG factors due to their potential material impact on financial performance. This responsibility spans all investments.

Hermes EOS' pioneering responsible ownership services have developed in response to this need to ensure sustainability is addressed across all of its clients' assets. Its team apply their expertise in sustainability issues to private equity investments, hedge funds and real estate. EOS engages with both General Partners and hedge fund managers to ensure that sustainability is given consideration in terms of both the underlying assets – companies – and the structure and governance of the fund. Property is one area in which environmental best practice can have a direct and tangible economic impact. Hermes' expertise and experience in sustainable real estate enables us to identify and address financial and environmental risks in relation to funds' listed and unlisted real estate investments.

## A combined approach

For institutions to act collectively to try to avoid future financial crises and safeguard the value of assets will mean taking an active approach to ownership of all assets in their portfolios. Whilst the approach may vary between different asset classes, the underlying principle is the same: to probe and question those who manage assets and put capital to work to ensure the long-term sustainability of investments. Consistently at the forefront of developments responsible ownership, Hermes EOS provides a complete solution for investors who want take a holistic approach to management of ESG risks across their portfolios.

**Helena Mahoney, Head of Client Relations**

**Hermes Equity Ownership Services**

**A market leading organisation**

Hermes Equity Ownership Services (EOS), a boutique within Hermes Fund Managers (Hermes), has pioneered comprehensive and unified responsible investment and corporate governance advisory services to institutional investors across the globe. With a team of 34 EOS leads the field in promoting stewardship activities among pension funds and the benefits of shareholder engagement; responding to the increased demand for shareholders to meet their fiduciary responsibilities and act as an active owner of companies. Owned by the BT Pension Scheme, one of Europe’s largest Pension Schemes, EOS has a strong commonality of interests with all institutional funds.

**A pioneering service**

EOS uses a proprietary screening process to determine which companies will benefit from intensive engagement. The first element of this screen looks at the companies’ ability to create shareholder value by comparing the weighted average cost of capital with cash returns to investors. The second element assesses the prospects for engagement success. We escalate the intensity of our involvement with companies over time depending on the nature of the challenges they face and the attitude of the board towards our intervention.

We aim to be honest and open with companies about the nature of our discussions and will seek to keep such discussions private. Not only has this proved the most effective way to bring about change, it also acts as a protection to our clients, so that their position will not be misrepresented in the media. While we are robust in our dealings with companies, the aim is to deliver value to clients, not to seek headlines through campaigns.

**Application across a diversified portfolio**

EOS provides comprehensive ESG overlay services across public equity, corporate bonds and private equity:

EOS Activity	Public Equity	Corporate Bonds	Private Equity
Intelligent voting	●		
Corporate Engagement	●	●	●
Public Policy Engagement	●	●	
UN PRI	●	●	●

To learn more about our pioneering responsible investment advisory services please contact us on the details below or visit [www.hermesfundmanagers.com](http://www.hermesfundmanagers.com)

**Contacts**

**Hermes Equity Ownership Services**

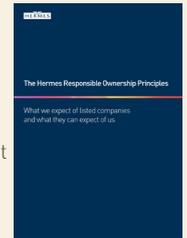
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**Hermes Responsible Ownership Principles**

The Hermes Responsible Ownership Principles (available from [www.hermesfundmanagers.com](http://www.hermesfundmanagers.com)) set out our basic expectations of companies in which our clients invest. These cover business strategy, communications, financial structure, governance and management of social, ethical and environmental risks. The Principles and their regional iterations guide our intervention with companies throughout the world. Our approach is pragmatic and company and market specific, taking into account individual company circumstances.



**About Hermes Fund Managers**

Hermes Fund Managers (Hermes) is an Institutional long-term asset manager, targeting sustainable alpha-generation. With 30 years of heritage, Hermes is a growing investment manager with global presence. Head-quartered in London, with European coverage, we have offices in Boston, New York and Sydney. Built on a solid foundation, Hermes has years of experience managing assets for the BT Pension Scheme, one of the largest European and Global schemes, pioneering services in ESG and stewardship our specialist boutiques cover equities, fixed income and a range of alternative asset classes.

Hermes continues to take a pioneering role in developments in the responsible asset management arena. Our approach to responsible asset management is twofold: we take a “good fiduciary” approach to relationships with our clients and act as a “good owner” when representing client stakeholder interests. This forms the core principle of our business which ensures we fully understand the needs of our clients not only today but over the long-term.

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