

# The Pillars of impact investing

By Andrew Parry, Head of Sustainable Investing

**The concept of ESG-aware investing** is now well understood, although it is delivered in varying forms. The investment industry is now taking this one step further and embracing impact investing, an approach that is well established in the world of philanthropy, family offices, non-governmental organisations and social enterprises, but is less well understood in the mainstream.

Existing social investors understand this concept well, but they also operate in a world in which social returns generally rank higher in importance than financial ones. So, how readily can the philosophy of impact investing be applied more broadly?

The three key concepts which distinguish impact investing from conventional investing are:

- 1. INTENTIONALITY:** the intention of an investor to exert a positive social or environmental impact;
- 2. ADDITIONALITY:** fulfilling a good cause beyond the provision of private capital; and
- 3. MEASUREMENT:** being accountable and transparent in reporting on the financial, social and environmental performance of investments.

These ideas can bring significant benefits compared to the way traditional investors approach investing. Analytical thinking, along with a proactive approach to understanding and measuring the impacts (both positive and negative) that all businesses have on society and the environment, is fundamental to long-term investment success.

## ENCOURAGING PROSPERITY ACROSS SOCIETY

The concept of additionality, often seen as too idealistic for mainstream investors, is worth exploring as it can be argued that it forms the very purpose of capital markets. The accusations of short-termism and over-intermediation levelled at the investment industry reflect the loss of a connection between capital and its commercial and societal purpose. Through additionality, impact investing can help restore that bond.

Investors can encourage companies to invest capital, funded by shareholders if required, in long-term, sustainable opportu-

nities that address unmet societal needs in innovative ways. Doing so has the potential to deliver attractive returns for all stakeholders. This is a lofty ambition which takes impact investing in public markets beyond ESG investing, with the aim of constructing a concentrated portfolio of companies which demonstrate a commitment to long-term sustainable returns that bring real societal benefits.

Such companies will not only have a clear mission but should also embody strong cultural values, embracing diversity, employee development and environmental awareness, and ensuring that their mission is enforced throughout their supply chains. These are features that are increasingly recognised as hallmarks of successful and resilient businesses. As such, additionality should underwrite behaviours which establish a holistic and long-term perspective that perceives short-term maximisation of profits to the detriment of longer-term sustainability as failure. The true goal of additionality is to encourage prosperity across society rather than to create pockets of isolated wealth.

## THE CASE FOR IMPACT INVESTING

① Investors have to live in the societies shaped by their investments, therefore environmentally/socially positive investing is inherently in their interests.

② In the long term, businesses can only thrive if the wider economy/society does as well, so investors should prioritise investments that enable a more resilient economy, environment and society.

Therefore, there is a strong argument that impact investment delivers the best holistic outcomes for beneficiaries and is the most sustainable approach to long-term investing.

## HERMES' ESG STRATEGIES

We believe that a responsible approach to investing is appropriate across all asset classes and for all investment strategies. Investors can mitigate ESG risks and capture opportunities through five distinct ESG strategies. Our aim is to help investors practically understand these strategies, regardless of the ESG methodology they adopt.

### Exclusionary screening >

**DEFINITION:** Excluding entire sectors, companies or countries from a fund or portfolio based on ESG criteria, moral or ethical views, or religious beliefs.

**OBJECTIVES:** Align investors' money with their perception of ESG risk or broader beliefs, and to mitigate ESG risks as investors exit 'sin' stocks, such as tobacco or gambling companies.

**HERMES' APPLICATION:** Our proprietary exclusion list – or screen – is updated on a quarterly basis, and incorporates investors' bespoke ESG preferences. The exclusion list includes companies:

- Identified by Hermes EOS, our in-house stewardship team, as being involved in providing controversial weapons;
- With a High Severity rating for environmental and social risks in the Hermes EOS Controversial Companies report;
- Generating more than 10% of their revenue from the gambling, tobacco, logging, nuclear energy or armaments industries.

**HERMES PRODUCT:** Hermes Global Equity Screened ESG.

### Positive screening >

**DEFINITION:** Investing in companies demonstrating positive ESG performance relative to peers.

**OBJECTIVES:** Achieve superior capital appreciation by mitigating ESG risks and acting on opportunities provided by companies demonstrating good ESG behaviours.

**HERMES' APPLICATION:** We invest in companies with a good or improving ESG track records, robust financial statements, competitive strengths and a proven ability to consistently beat revenue and earnings expectations.

Our proprietary tool, the ESG Dashboard, alerts us to stock-specific ESG risks not specifically covered in fundamental analyses of companies.

**HERMES PRODUCT:** Hermes Global Equity ESG.

### ESG integration >

**DEFINITION:** The inclusion of ESG factors alongside financial analysis of assets by investment managers.

**OBJECTIVES:** Improve long-term risk-adjusted returns, mitigate ESG risks and identify investment opportunities created or supported by positive ESG change.

**HERMES' APPLICATION:** ESG factors are integrated into the investment analysis performed in all of our strategies across public and private markets.

We combine company-specific ESG data captured by our proprietary analytical tool, the ESG Dashboard, with qualitative assessments of ESG risks and opportunities. These views are considered alongside the research and insights of our in-house stewardship and engagement team, Hermes EOS.

**HERMES PRODUCT:** All Hermes strategies integrate ESG, notably Global Emerging Markets.

### Impact investing >

**DEFINITION:** Investing in companies, organisations and funds which have the commercial purpose of solving social or environmental problems.

**OBJECTIVES:** Generate strong investment returns by allocating to companies creating tangible benefits for society and the environment that will endure over time.

**HERMES' APPLICATION:** We invest for the long term in companies intending to make a positive and sustainable impact on society, and which are succeeding commercially by doing so.

Our impact strategies are also linked, explicitly or implicitly, to the specific targets detailed within each of the UN Sustainable Development Goals (SDGs).

**HERMES PRODUCT:** Hermes Impact Opportunities.

### Active ownership >

**DEFINITION:** Engaging with companies on ESG concerns that affect their long-term growth, and using shareholder power to positively influence corporate behaviour.

**OBJECTIVES:** Promote positive change within companies that strengthens their financial performance, and provide a forward-looking view of ESG performance than can reveal opportunities.

**HERMES' APPLICATION:** On behalf of investors worldwide and for our own portfolios, we advise businesses on strategic and ESG concerns. We engage companies as active stewards of capital in face-to-face dialogues at the executive and board levels, and vote at corporate annual general meetings and other shareholder gatherings to help investors perform their fiduciary duty as active owners. We also engage on companies that issue debt and not equity.

Going beyond companies, we advocate shareholders' interests to legislators, regulators and industry bodies to help shape the policies governing global capital markets and transparency and reporting standards for companies.

**HERMES PRODUCT:** Hermes EOS.

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