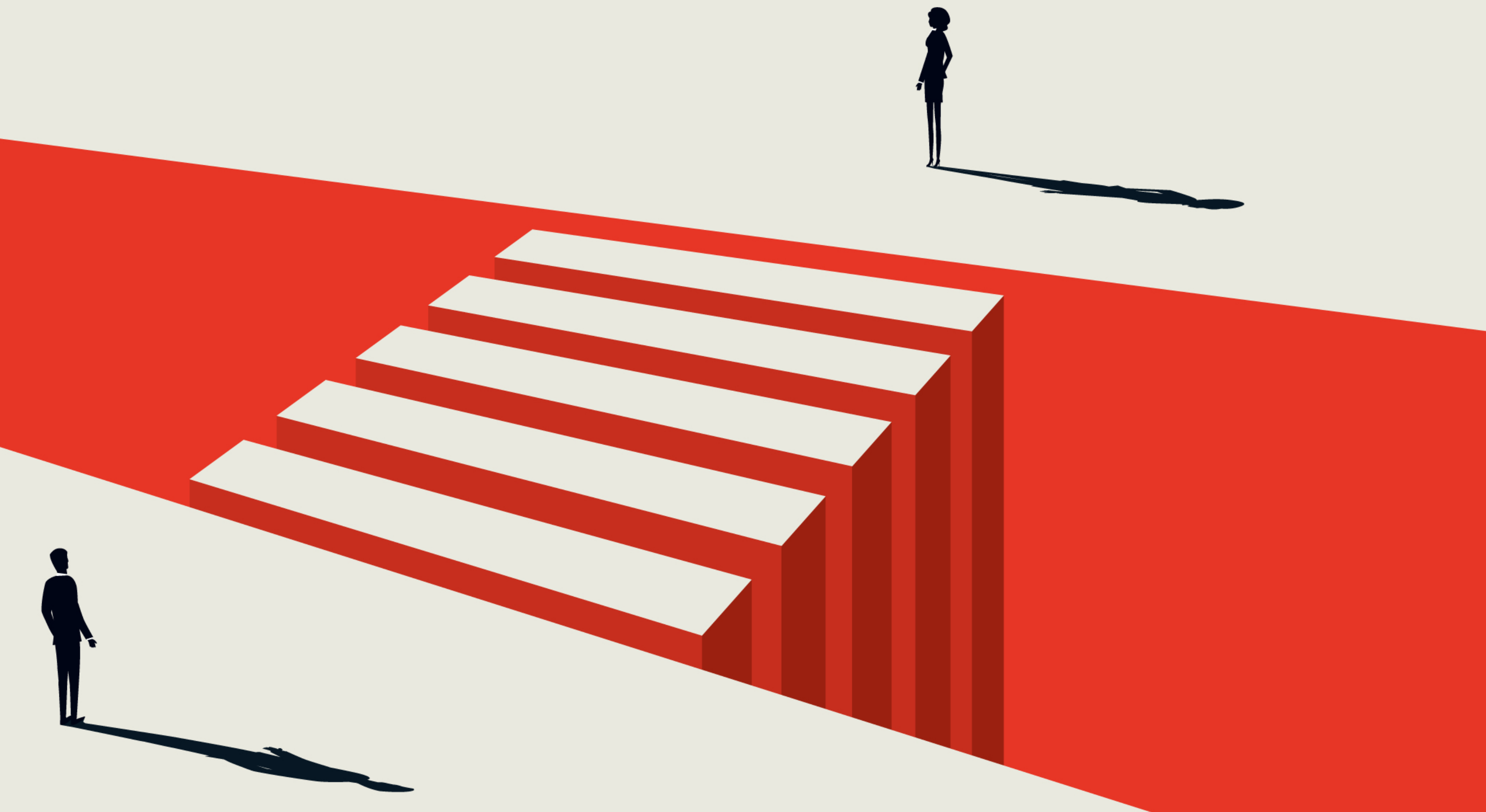
NORDSIP
NORDIC SUSTAINABLE INVESTMENTS

Round Table Discussion
March 2020

insights

THEMATIC STRATEGIES



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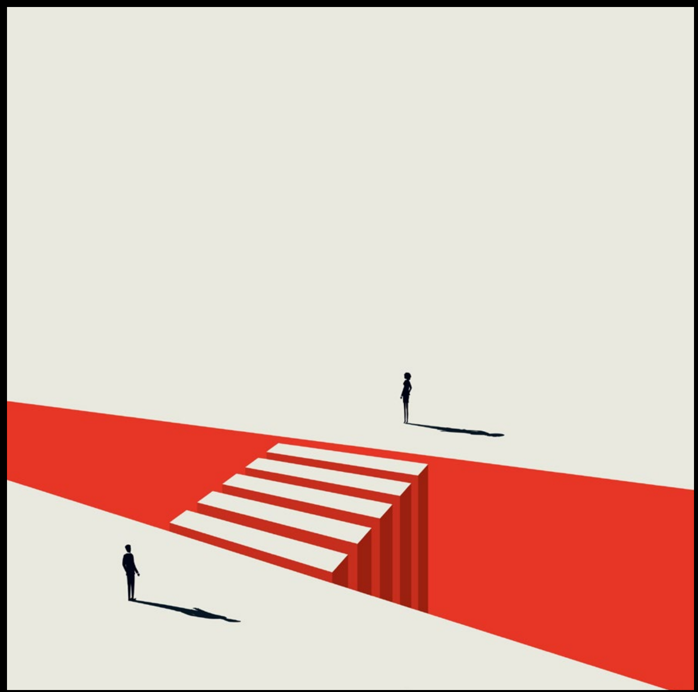

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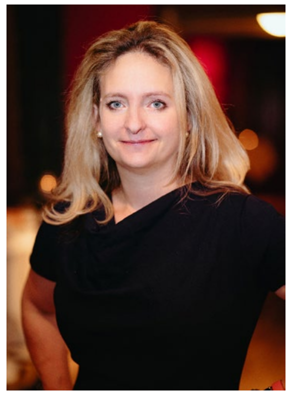


Aline Reichenberg Gustafsson, CFA
Editor-in-Chief
NordSIP

After the burst of the tech bubble at the beginnin of the naugthies, sector funds lost some of their popularity. The hyped TMT mega-funds that lost 90% of their NAV within less than 12 months showed investors how risky sector concentration had been in hindsight. Healthcare and biotech remained in favour for a while, but investor interest for sector funds seems to have dried out for good after the sub-prime crisis.

Thematic strategies fared better in the past decade. Investors view the concentration of the portfolio as more justified given a higher degree of opportunity offer by the theme in question. For investors who can take the risk, investing in strategies focused on megatrends can be more attractive than following the market.

As far as sustainable investments are concerned, thematic investments have a special role to play as well. While negative screening and ESG integration are hygiene factors, nowadays, many institutions, and most individual savers, have yet to dip their toe in the world of impact investing. Those opportunities that typically belong to the impact world, nonetheless, rely on mega-trends and "themes".

More often than before, however, the thematic approach proposed in the context of sustainable investment strategies have a wider scope than purely thematic strategies, such as those targeting water or cybersecurity, for example.

Those multi-thematic funds propose to investors a new approach that presents a double advantage compared to typical thematic funds. First, the focus is not on one but on several potential growth trends, increasing the manager's chances of getting it right in the long term. Or in other words, diversifying the risks and increasing accessibility to a larger pool of investors. Second, the sustainability angle of these multi-thematic approaches includes de-facto ESG integration and norm-based exclusions.

With those thoughts in mind, we convened a round table on the topic of thematic investments to discover what these strategies aim to deliver, while getting a better understanding of how they fit the needs of institutional investors or fund selectors. The topic took us along a journey from listed impact to the sustainable development goals.

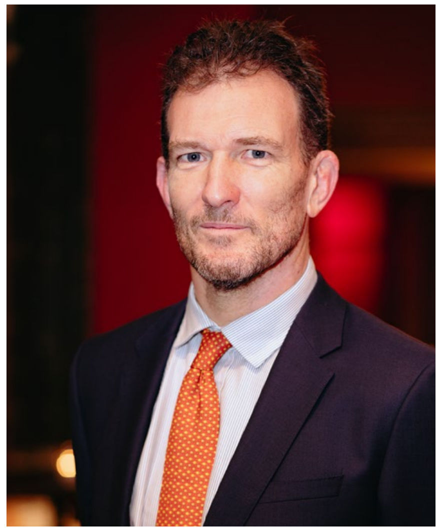
who is who?

Lingyi Lu
Head of Sustainability
Söderberg & Partners

Lingyi is Head of ESG and Deputy Head of Sustainability at Söderberg & Partners – a fast-growing company mostly active in financial advisory and asset management. As Head of ESG, Lingyi is responsible for the sustainability analysis and ratings of funds, life-insurance companies, unit-linked insurance companies and non-life insurance companies, distributed to clients, advisors and asset managers who integrate ESG aspects in their decision processes in various ways.

Since the summer of 2019, Lingyi is also member of the board of Swesif.

Prior to joining Söderberg & Partners, Lingyi worked with the United Nations Development Program (UNDP). She holds an MSc in Applied Economics & Finance from Copenhagen Business School and a BSc from Uppsala University.



Simon Pickard
Chair, Impact Investment Committee
Union Bancaire Privée

After starting a career in shipping, Simon spent the past 20 years in the investment management industry, including at Jupiter, Carmignac, Man Group and Argos Investment Managers, where he primarily specialised in emerging markets.

Simon joined UBP in 2019, to support the existing impact equity strategy and new sustainable products launches. Simon is the chairman of the impact investment committee, together with six of the fund managers. He is also a member of the Impact advisory board, which is composed of primarily nonfinancial Impact specialists. In parallel, Simon chairs the ESG committee for the Emerging Markets Investors Alliance, a nonprofit organization based in New York, which looks to improve governance throughout emerging markets.

Susanne Bolin Gärtner
Head of Fund Selection
Danske Bank

Susanne joined Danske Bank as Head of Manager and Fund Selection in January 2020. At the time of the event, Susanne was on gardening leave.

Prior to joining Danske Bank, Susanne headed up Fund Seelction and Fund Trading at Folksam from 2009. Before that, she held several senior positions within finance, banking and insurance institutions such as Alecta, Max Mat¬thiessen and SEB.

Bolin Gärtner graduated in Business Administration and Economics from Uppsala University as a Civilekonom (MSc).

Susanne is also a board member of Swesif as well as a member of the Fi¬nance Committee of Barncancerfond¬en (the Swedish Childhood Cancer Foundation).

Johan Florén
Head of Communication and ESG
AP7

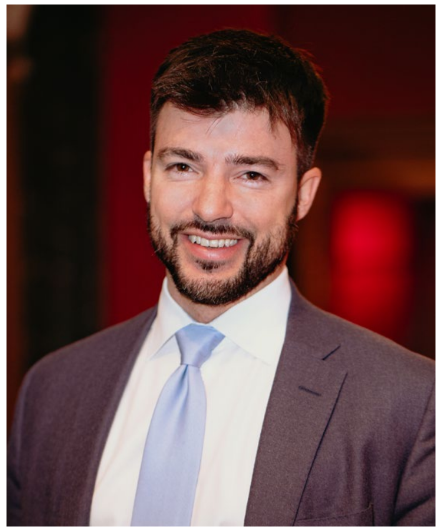
Johan is the head of communication and ESG at AP7, the default alternative within the premium pension systems theme, which he joined 11 years ago. After joining AP7 in 2009, Johan was elected to the Board of Swesif in 2011, first as director and then as Chairman for three consecutive years.

Prior to joining AP7, Johan held various positions within communications and worked as a teacher for instance at the Berghs School of Communication. He was also a member of the Amnesty Business Group or Amnesty International Sweden for seven years, of which three as Chairman. Johan completed the Communications Executive program at the Stockholm School of Economics and studied Theoretical Philosophy at Uppsala University and StockholmUniversity.

Jonathan Wallace
Environmental & Responsible Investment analyst
Jupiter

Jon started at Jupiter in 2009 as a Sustainable Investment and Governance Analyst and since 2014 focused entirely on the firm's Ecology Strategy, a fund launched already in 1988 when sustainability challenges were very different from today's.

Jon holds a MSc in Environmental Technology from Imperial College London and a BA in Economics & History from the University of Oxford.



Tim Crockford
Impact Investing Portfolio Manager

Tim Crockford previously spent ten years of his career at Hermes Investment Management. He became lead portfolio manager of the Hermes Europe ex-UK Equity Fund in 2015 and formed the Impact team in August 2016, which launched the Hermes Impact Opportunities Fund in December 2017.

Prior to joining Hermes, Tim worked at Execution Limited and then joined Sourcecap. He graduated from the University of Malta in 2006 with a Bachelor of Accountancy (Hons) degree, as well as a Bachelor of Commerce degree.

Tim Crockford left Hermes Investment Management at the end of 2019.

Hermes Investment Management and Federated Investors have rebranded as Federated Hermes.

From left to right: Simon Pickard, Kim Ohman, Jon Wallace, Kim Hansson, Magnus Kristensen, Susanne Bolin Gärtner, Aline Reichenberg Gustafsson, Johan Florén, Lingyi Lu, Jean-Luc Eyssautier, Magnus Jahnke, Tim Crockford

Thematic Strategies

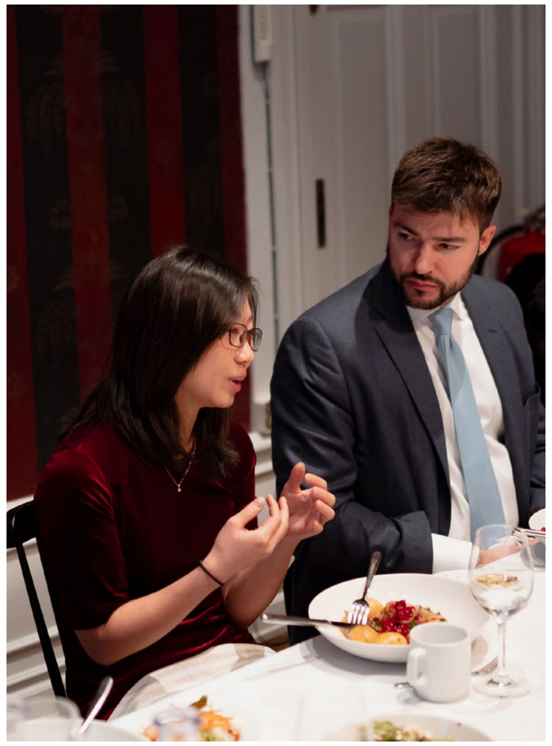
Nalen
Stockholm

28 November 2019

Thematic impact... or the impact theme?

While many investors can be seduced by the opportunity to invest in growth opportunities that also generate positive impact for the planet and society, not everyone is on board with the idea of impact investing using listed equities. To look at opportunities from a thematic perspective, however, is nothing new. Can listed impact be considered just another theme?

The link between thematic strategies and sustainability surprises **Lingyi Lu**. "This is the first event I have attended that combines impact and thematic investing," she explains. "Thematic investments often refer to a specific sector or a theme, whereas impact investments are related to a stated objective and they aim to produce a measurable social or environmental benefit as well as a financial return. A fund that has invested in companies active in the defence industry is a perfect example of a thematic approach. Even though one might argue that security is a human right, the defence sector is not typically associated with what we call impact. To me, those two approaches are separate. To look at impact as a way to conduct thematic investing is a new point of view that I look forward to explore further today."



From Thematic to Impact

"Thematic doesn't always mean sustainable, at Jupiter, we have a financial innovation fund, for example," says **Jupiter**'s **Jon Wallace**. "It is a thematic fund focused on allocation to stocks that we think will outgrow the market and it is not necessarily related to a sustainability theme. However, focusing on the thematic aspect in the sustainable investment space helps to distinguish between funds that might be sustainable in terms of broad mind-set and those that are specifically looking for the solutions to global challenges as their theme."

"The challenges in terminology are certainly not close to being resolved yet, but we can still try and map the different investment approaches. The Global Sustainable Investment Alliance's definition of sustainable investment, for example, has its pros and cons but it does provide a map in the context of impact and thematic investments. This organisation's definition of impact also relies on the notion of additionality, meaning that a project with positive impact would not have happened had it not been for the investment under consideration. The classification also makes a distinction between sustainability-themed investments – which is the description we are comfortable with – and impact. However, these sustainability-themed investments are not necessarily in the same category as financial innovation or other themes such as cybersecurity, which is a popular theme at the moment."

Introducing Additionality, Materiality & Intentionality

Simon Pickard highlights how **UBP**'s internal impact framework functions to guide investments in the team's publicly listed impact strategy. "The IMAP framework helps us focus on the Intentionality, Materiality, Additionality and Potentiality of a project. Thematic investments tend to be more about materiality. A water-themed fund for instance may invest in companies for which water materially contributes to the bottom line, without necessarily insisting on the intentionality of these businesses.

"Materiality is vital for impact too. However, unlike in thematic investments, intentionality is essential, particularly intentionality to change. It doesn't matter where we are today. The company must have the intention to drive change. Additionality, for us, is about whether that company is doing something which another company or solution would not easily replicate."

Changing Mindsets

"Although it is tough to measure, we also feel that one of the most significant impacts that we can make is to contribute to reframing and changing the argument. One of our goals is to shift from the paradigm of creating shareholder value to create what Nobel Prize winner Oliver Hart called 'shareholder welfare', a few years ago."

"The power of this reframing of the conversation around impact was clear in a recent survey conducted by a sustainability institute in Switzerland. They asked over 500 companies why they did not do more to combat climate change or to advance the SDGs. Respondents answered that this was because investors were pressuring them in the opposite direction. As investors, we should agree that part of our mission is to reverse that argument."

"Impact represents a small part of public markets at the moment. We need to be spokespeople for that change of concept in the business world. The investment community can do more to change and stop putting short-term pressure on companies."

Impacting Through Owning

"Active ownership is not getting the attention it should," **Johan Florén**, argues, echoing Pickard's point. "This is the best chance we have, as investors, to make a real contribution and to drive change. It may even be part of the notion of 'impact investing'. However, whether the concept of impact investing is going to be successful within listed equity is still open for debate. Impact comes from the world of development banks and churches. I have often discussed the idea of listed impact with people who come from the 'old school' impact investing crowd. They worry that it is only a marketing feature, almost akin to 'impact washing'. They don't like it at all."

Lifting Impact from its Niche

"That being said, we do believe that there is a great deal of potential in listed impact," Florén adds. "Had impact investing remained the exclusive remit of development banks, its size would remain very limited. I used to be active in the SweSIF and EuroSIF world, and they produce a biannual survey in which impact was insignificant until only recently. The report counted impact as one out of seven strategies, which represented a very small fraction of the sustainable strategies. And then, around five years ago, suddenly MSCI, Goldman Sachs, UBS and other such large financial institutions started talking

about impact. It was an important change. It was evident at the time that a significant development was taking place."

"This new popularity has great potential if we can galvanise the interest into actual investments because there's a lot of money in public markets," Florén explains. "The development sector could never channel such a large amount of capital on its own. We have also started looking into impact, but we stay very honest about all the challenges associated with this notion and I am not entirely sure if we will ever solve those challenges on day. Ultimately, it might be just another idea that didn't gain traction within global equities. We don't know. We have to be part of the journey and try to develop methodologies, measures, and indicators. We ought to contribute to the discussion."

Scale or Nothing

"The demand and the necessity are such that impact investing has to find some way to penetrate public markets," **Pickard** adds. "Of course, it is far more difficult for a provider of secondary capital to demand change in a company, but difference in scale of one market compared to the other is such that we have no choice. While global aggregate listed investments are estimated to be at around $80 trillion, unlisted investments total no more than $5 trillion. However, the relationship is the opposite in the impact segment. Unlisted impact is five times smaller than listed impact. We don't have a choice but to expand into public markets, even if we have to watch out for the risk of impact-washing. The experience in the expansion of ESG has already taught us to be wary of 'greenwashing' and that a nascent movement may be derailed because people are misusing a concept."

Aligning Directions

For **Susanne Bolin Gärtner**, what matters is that investors pursue the same sustainable goal, rather than to get bogged down in definitions. "It's easy to overanalyse these issues," she says. "People can focus a lot on whether a particular approach is the right way to calculate some minute factor. We may use different measurements, and different concerns and beliefs may motivate us. But at the end of the day, we all have the same goal. We have to allow for diversity in approaches. Impact funds will engage in different ways from traditional funds."

"Performance-wise, sometimes we hear that it is possible to get more alpha in certain strategies, while we focus more on the risk-level. If we can obtain more alpha for a given level of risk, it is good news, but it is not a necessity. Historically, investing in ethical funds was associated with giving up returns. Nowadays, however, impact funds are associated with themes that represent strong economic trends and important opportunities. On average, if they benefit from their exposure, they should perform well."

For Bolin Gärtner, engaging with fund managers is key as it can amplify the sustainability concerns of one institution and impact greater amount of capital. "Folksam has €16 billion in open and UCITs funds," she explains. "When we engage with the managers of all these funds, we indirectly engage with all the companies beyond our holdings in those funds. This means that the managers that we mandate to engage with their own holding will do it for us, but also for their other unit holders. As such we can leverage this engagement effort at least ten folds."

Building the Case for Listed Impact

The Quest for Additionality

At **Federated Hermes**, the team behind the Impact Opportunities Equity strategy first investigated whether it was possible to design an impact strategy, as defined by the Global Impact Investing Network (GIIN) while investing in publicly listed equities. Addressing the issues of intentionality and additionality was challenging at first. The strategy was of an inherently complex thematic nature and the portfolio managers had to communicate how the investee companies were driving positive and measurable impact. The idea was to clearly demonstrate to investors how companies are contributing to solving sustainability problems. The UN Sustainable Development Goals (SDGs) became a good reference for what those problems are.

Additionality in Context

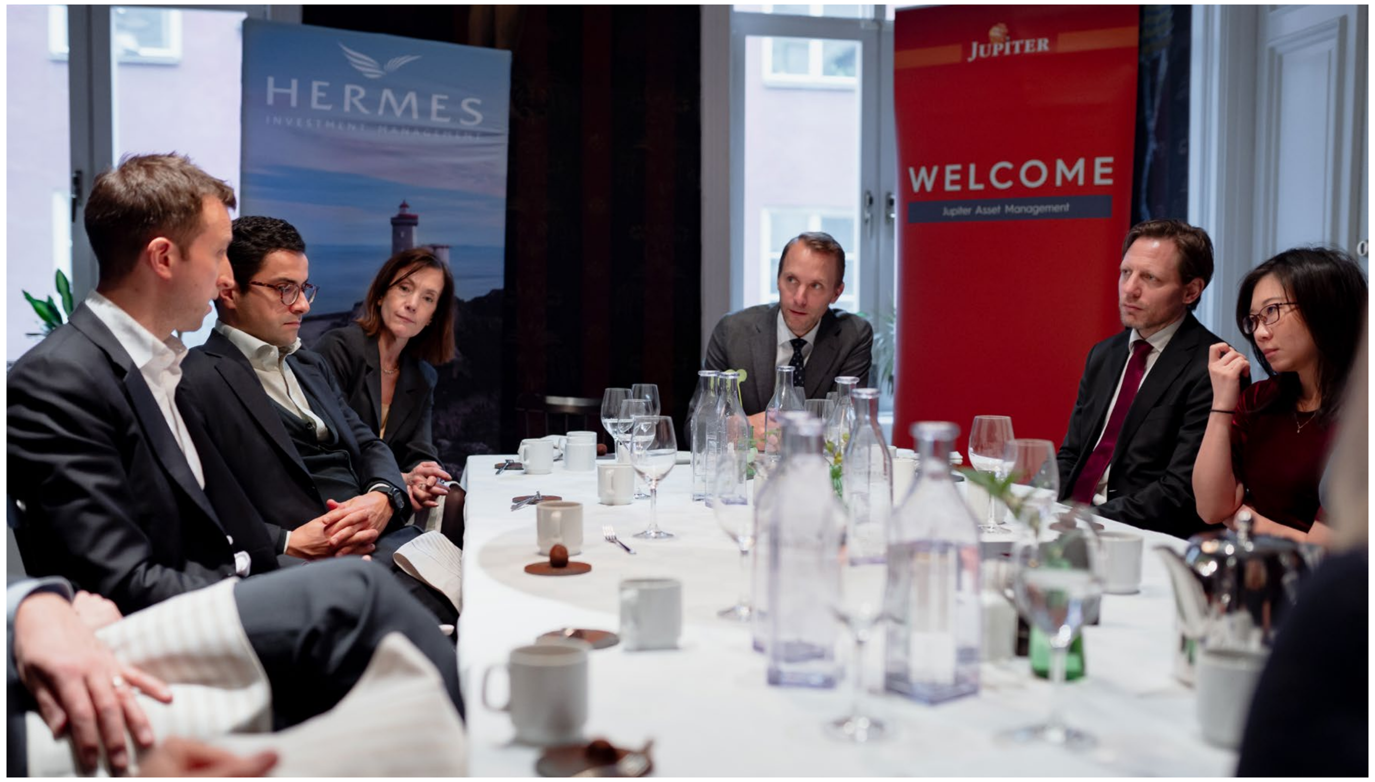
"I find this conversation about additionality fascinating," says **Wallace**. "This issue was not part of the mainstream market three years ago. It was a distant concept that came from the Clean Development Mechanism, which was part of the original attempt by the United Nations to try and combat climate change. The term emerged as developed countries sought to ensure that their financial contributions to Clean Development Mechanism projects targeted ventures that would not otherwise have received financing."

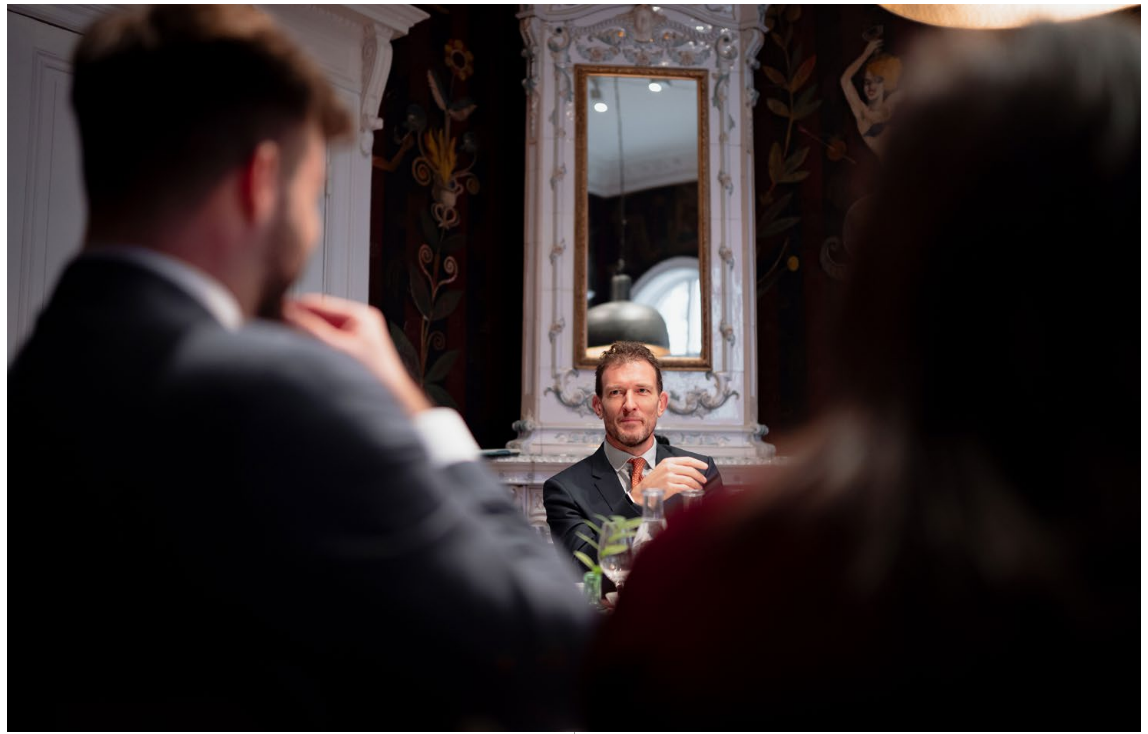
"The same challenge is emerging in public markets at the moment. We need to try and keep working through that debate. It is difficult to make the case for additionality in equity markets, given that it is impossible to prove that the company would not have been sheltered or bought by another investor or that the company wouldn't have found other means of investing by relying on alternative sources of capital."

"In fixed income markets, however, the dynamic is slightly different. Green bonds are designed in a way where capital is ringfenced to relevant project, because the bonds' documentation specifically lists these projects. There may more capacity for the fixed income bond market to show additionality than equities. However, the fact that this conversation is even happening is crucial. These points allow asset managers to talk about how capital represents an opportunity for clients to make a difference. When we talk about impact, we talk about how our investments help investee companies to drive positive change. It may not be our impact or our clients' impact, but the companies that we invest in have a positive impact."

The Additionality of SDG-targeting

The concept of additionality raises an interesting paradox. If more capital is needed to reach the SDGs by 2030, then any or all of that capital should qualify as additional, regardless of whether it is listed or not. Federated





Hermes's Impact Opportunities Equity managers focus on the additionality driven by the products the companies we invest in sell. Their aim is to invest only in companies that provides a unique solution to an unmet need. Solar companies, for example, are not typical target investments. Solar does provide a positive impact, but within the listed solar space, it is difficult to identify a single company that lies behind the reduction in the levelized cost of solar energy. That argument is different when it comes to offshore wind, for example. There are at least two companies in that industry that have proved to be a real catalyst for a significant reduction in the levelized cost of wind power in the past two years.

"Impact and the use of the SDGs were also a great leap forward from previous attempts to address sustainability issues, such as carbon foot-printing, which is an approach that has proved overly simplistic," adds **Florén**. With the SDGs, we can tackle global challenges in all their complexity, rather than focusing on one variable."

When Seeking Scale is Crucial

The issue of scale also matters for additionality as some of the targets underlying the SDGs have rather high implicit sunk costs. SDG 3 (Good Health and Well-being) provides a vivid case. Target 3.4 aims at a one-third reduction in premature death due to non-communicable diseases (NCDs). NCDs such as cancers are the leading cause of death in the world accounting for 7 out of 10 deaths. It would be difficult to achieve that goal with small scale private financing in small private companies. Typically, healthcare companies seek a listing on a public exchange at an early stage as they require a vast amount of capital to conduct the necessary R&D, most of which has to be spent in researching treatments that will never emerge. In biotech, only one molecule in a thousand makes it through to a commercial drug. Regardless, vast amounts of capital are required to fuel healthcare research and the public markets are well designed to provide it. This is also part of the reasoning that allows Federated Hermes's managers to target impact through their listed strategy.

For the team behind the Impact Opportunities Equity strategy, to focus on the product as opposed to the provider of capital makes sense. Targeting companies that drive change is what matters. An impact strategy should help achieve its goal, whether it is one of the SDGs or another sustainability target. Engagement is also a key element of this process. A wind turbine manufacturer, for instance, uses aluminium and the conventional aluminium production method is extremely carbon intensive. The role of a manager like Federated Hermes is to help the wind turbine manufacturers put pressure on their suppliers to produce lower carbon aluminium, for example.

Capital Structure & Cost of Capital

Impact and Capital Structure

"It is interesting to discuss impact in the light of additionality," comments **Lu**. "However, we may need to go further in defining impact and look at the capital structure behind a company. I recently tried to explain the concept of social entrepreneurship to a friend, and I found that it can be difficult. We were talking about the question in relation to a local foundation targeting investments in different projects or companies that are for social entrepreneurship."

"However, just looking at the companies they fund wouldn't provide an obvious definition of social entrepreneurship. It can be quite tricky to see what these projects have in common that allows them to qualify for that term and we discussed how far the limits stretch. How do we define social entrepreneurship? Today, many companies communicate their purpose by focusing on the benefits they bring to society more so than on profit maximisation. Hence, if benefitting society is the purpose of social entrepreneurship, should large corporations be included, as long as they formulate their mission as having such a purpose?"

"Is capital structure a criterion to determine what makes for impact or social enterprise? Should a company cap dividends for example, in order to qualify? How should impact investors consider and distinguish opportunities with the capital structure in mind?" Lu wonders.

Federated Hermes's team has examined the question of the capital structure when deciding which companies to target. The managers decided against owning large multinational corporations, which represent businesses that have amassed vast amounts of capital over time and are now in a stage in their lifecycle where they are redistributing it in the shape of dividends. In fact, they decided to own shares in companies which show a positive operating cash flow but a negative free cash flow. These companies have a proven concept towards delivering a measurable impact. But because of their mission to answer unmet needs, they have to grow and scale up their business as fast as possible. Typically, they are able to re-invest the cash they generate at an expected rate of return that is higher than their cost of capital. This means that the team decided not to count as impact companies that are no longer re-investing capital into new projects.

Influencing the Cost of Capital

For **Pickard**, the two banner IPOs of 2019 - Beyond Meat and ARAMCO – are an illustration of the positive influence sustainable investing is exerting on the market. "The cost of capital of Beyond Meats has been reduced significantly, while ARAMCO's was much higher than they would have been able to count on, two years ago. We have evidence that capital markets are changing. It would be more difficult for Brazilian meat companies to IPO today because they are seen to be contributing to the burning of vast swathes of the Amazon rain forest."

In other words, a project's additionality may be reflected in its cost of capital. The markets may have become more efficient at identifying companies whose product uniquely meet some unmet needs. If they are indeed providing such a unique solution, then by definition, one would expect those companies to provide a return substantially higher than the market rate.

The Profitability of Impact

Profit draws a line between impact and philanthropy and defines financial sustainability. Impact is about making a profit through an intentional mission to have a positive impact on society or the environment. Philanthropy is purely focused around that mission and does not target profit, which leads to a crucial difference in terms of how charities get their funding. They have to seek funding continuously as their projects are, by design, financially unsustainable. To the contrary, impact businesses are improving financially because they are providing a solution which is having a positive impact, not in spite of providing it.

However, the strong profitability that allows successful impact-generating companies to outperform market returns may in turn be put into question. Should asset owners indeed require companies, in general, to capture abnormally high profits at the cost of risk and negative externalities? Consider a company like Nestle, which is taking on a lot of dutiful missions around the world to supply emerging market countries with bottled water. The company also causes pollution because they do not follow through on what people do with used bottles afterwards. Instead of expecting such companies to maximise profits, shouldn't investors set a bar for returns beyond which companies would be explicitly mandated to focus on minimising externalities or generating positive impact?

Mapping Profitable Businesses to Impact

"Capping the returns of a company would be very strange," **Florén** believes. "When the SDGs were launched, we were very enthusiastic, because we thought that the framework was a proxy for sustainable development. All the problems were identified and sorted in 17 boxes which investors could start investing in. It wasn't as easy as we thought at first and, after a while, we realised that the SDGs were overwhelming. It is impossible to achieve all of the goals at once. They often contradict each other. Pursuing positive impact in one dimension is often done at the detriment of negatively impacting another. Starting with the hope of having found a proxy for all the problems we should address, we realised that the complexity would be impossible to deal with in a practical manner. As a result, we decided to simplify our objectives and narrow down to single goals, or even indicators, to be able to work with the SDGs. We also found that not all SDGs are investible."

Keeping an eye on the Goal of Impact

However, this hurdle should not undermine the twofold mission of impact investors, according to Florén. "According to EuroSIF impact investors have two goals: a financial return and a social or environmental impact," he adds.

"Without an impact goal, one could question whether it is worth calling it impact. It remains a challenge, but we have to achieve both types of returns."

"For us and for most mainstream investors, impact investing should start with a negotiation around investment terms. Start by stating: 'We are not allowed to, so we can never do such an investment.' It would be rather strange for a normal investor to accept to pay for a fund and obtain really poor returns. This would be a very niche type of products. Managers definitely have to provide both return and positive impact in parallel."

Considering Influence Across the Ecosystem

Wallace is keen to contextualise the role of asset managers and investors in the broader economic environment in which companies operate. "For multinational corporations such as Nestlé, the largest driver of change is not the behaviour of large asset owners. Competitors on the other hand can impose pressure on these companies and trigger a response from shareholders, allowing them to start asking excellent long-term questions."

"We would not think of Nestlé as being in our investment universe. However, we would never ignore the activities of the company as we would, instead, invest in companies directly linked to its activities, such as packaging companies. While we don't invest in Tesla, it is a good example of how competitors can drive change in an industry. It is forcing large companies in the automotive space to change their working plans completely. Volkswagen and Audi would not be reallocating their workforce, even having to make people redundant, and rehiring in other areas, without Tesla building a car plant on their doorstep. The case is made even more interesting by the fact that Tesla is partially funding itself through the sale of zero-emissions credits to competitors like Fiat, Chrysler and GM. The longer its competitors fail to join Tesla in the electric car segment, the longer they will contribute to their competitor's success."

"The offshore wind sector is fascinating, just like the automotive industry. We can't explain the change by focusing only on what they achieved last year, as it has been a while in the making. The likes of Ørsted have been developing offshore wind markets in the US, Japan and Taiwan for the last decade," Wallace adds. "At the same time, Ørsted was building a supply chain that allowed the cost of energy to come down. It takes long-term investment to grow in this market. Over several years, the impact of that company on its industry and supply chain is remarkable."

"These are hugely impactful companies, whether they are listed or not. The incumbents, as large and powerful as their position is at the onset, wouldn't have budged if it hadn't been for Tesla or Ørsted. So, as Tim said, whether as a secondary market investor or as another type of market participant, you may credibly claim to have been part of the solution."

"The conversation about additionality is taking the right direction. Whether we call it impact or not, we're thinking about the solutions we need. Who are the real change makers? Who is pushing industries in the right direction? For me offshore wind, in particular, amongst a couple of other sectors related to the circular economy, is where we find the most credible case where public markets participants can make a difference, even if it is difficult to recognise this on just an annual basis."

Using the SDGs as a Blueprint

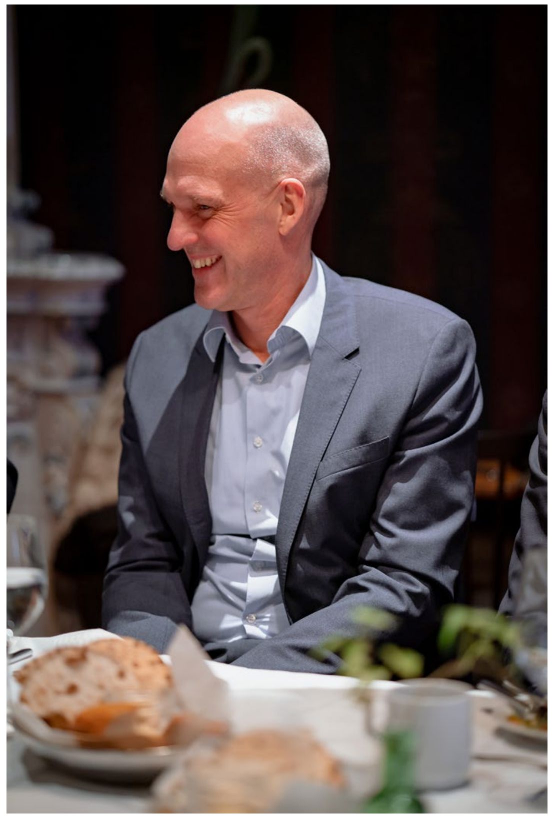
"The SDGs may be one of the closest tools mankind has to a blueprint or master plan for the next 11 or even 50 years," **Pickard** advances. "There's an extent to which trying to pick them all apart goes against what they were meant to do."

"Take the example of a micro-finance organisation in Brazil focused on lending to women and reducing poverty. What if the client base is also composed of farmers who may be destroying the rain forest? Biodiversity and climate action are targets that can't be set aside to improve on poverty. The act of balancing different SDGs is also consistent with well-diversified and well-rounded portfolios. We wouldn't want to have an impact fund which is an education fund or an off-shore wind fund in disguise. We should be trying to advance the blueprint and push the master plan on as many different fronts as possible. We do that by diversifying our portfolio, but also by making sure that our companies don't focus narrowly on a single perspective."

The SDG Taxonomy

Federated Hermes has built a 'SDG investing taxonomy'. The team went through all of the 169 targets that sit under the 17 SDGs and mapped how each publicly listed company contributes towards the achievement of those specific targets. By doing so, the team stands between focusing exclusively on some SDGs and taking a more thematic approach. On the one hand, the goal is to offer a diversified global strategy with nine themes inspired by the SDGs rather than a single-theme fund. At the same time, the managers found that the companies they took into account would only contribute to 25% - that is 44 - of the 169 SDG targets. The work is open for consultation on the firm's website.

An interesting founding is that there are some areas, particularly within public markets, which are naturally the preserve of highly intentional, mission-driven businesses, providing unique solutions, like small or mid-cap healthcare businesses. In this sector, in particular, large amounts of capital are necessary at a much earlier stage in the life cycle of those businesses, which contrasts with the dynamics characterising a microfinance business, for example.



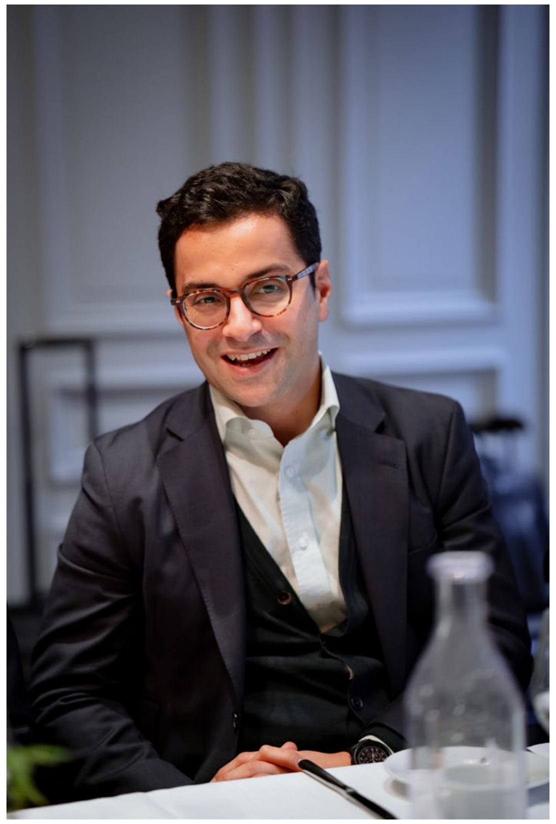
Among the nine themes that form Federated Hermes's thematic framework, education and financial inclusions are the areas where typical impact target companies can be found. Healthcare is another area where the team identified a long list of exciting businesses to invest in, but that is perhaps not traditionally associated with impact.

The Hurdles of the SDG Framework

One of the critical choices facing thematic impact investors is the tension between short term benchmarking and the long-term perspective inherent to sustainability. "When we started, we hoped to be able to work with all the SDGs. This however proved to be a challenge," **Florén** says. "After discussing this with our managers, we had to admit it was a challenge, and we needed to take a more practical approach. As a result, we decided to do the opposite and focus on diving deep into specific themes instead of trying to cover everything."

"The result was a two-pronged focus. One part is clean water and sanitation (SDG 6). The other part is climate action (SDG 13), which to some extent includes water as well. We have integrated this strategy within alternatives as a part of our diversified portfolio. Regarding performance, we need to wait and see, but we have recently solved the problem by setting a performance target to outperform the MSCI ACWI and it is part of our alternative strategies which is one way of diversifying our portfolio. 70% of the overall portfolio is beta, and the rest is set on diversifying assets. That is a fairly practical and realistic way to approach the allocation. It will have consequences on the portfolio which we will assess together with the other parts of the allocation but as long as we are beating the overall benchmark, that is fine. It is still too early to tell whether this focus will spread into a more significant part of our assets."

"We had a public procurement a couple of years ago which clearly showed that there is an enormous interest in the area and much creativity. However, track record is still lacking. Not many managers that have been pursuing such strategies for a long enough time. This problem is made more challenging when managers want to cover everything. It takes time to develop this set of skills, and it is not very convincing for managers to argue that they are skilled at everything. That they can outperform in every area and asset class. Since this is a new and developing field, we'd prefer to look at a particular and narrow type of management competence. In the long run, we might even get a full house of different SDGs specialists. But we're not there yet."



"Nevertheless, given the interdependence of the goals, investors may have a positive impact even when focusing on only a couple of the SDGs. That speaks to your point," **Bolin Gärtner** tells Florén. "When analysing the whole portfolio, you may see the effect on the other goals."

Opening the Door to Opportunities

"I believe that we can approach impact by trying to tackle all the SDGs," interjects **Jean Luc Eyssautier**. "There are a lot of companies in the small mid-cap area which will help tackle at least the first 15 goals. Hopefully, the mindset of investors joining the conversation on thematic strategies will evolve. They should focus less on the fact that they are investing in an impact fund. Instead, they should concentrate on the fact that it is a global fund that is investing in various interesting business and industries. But this should also raise an important question regarding how we benchmark performance. Does it make sense to benchmark against the MSCI ACWI or MSCI Europe when we are trying to tackle all the SDGs?"

Benchmarking Impact

It may be possible to build a global portfolio, benchmarked against the MSCI ACWI with an ambitious target of 5% annual outperformance, such as **Federated Hermes**'s Impact Opportunities strategy. However, as the impact theme outperforms, the benchmark may progressively shift to reflect this move. It is likely that the energy sector will no longer be dominated by oil majors but will be replaced by those that take part in the energy transition successfully. In the transport sector, the internal combustion engine manufacturers will likely give way to battery electric and potentially hydrogen fuel cell.

"There are a set of attributes that are key to succeed in an impact investing approach," **Pickard** argues. "For one, we need to be 99% active share managers. We have to leave behind any desire to benchmark. It might be obvious, but it may be difficult for the vast majority of managers to adopt a real active style, as it is different from how they have been educated and trained."

Measures that Drive a Long-term Mindset

"It seems also crucial," Wallace adds, "to design impact reporting to take several years under consideration, even scenario-type reporting. If Ørsted wants to grow and change the market it operates in, it will take several years. For an investment case to connect with the impact case and obtain a win-win it should also be considered over the same time period. Ørsted couldn't be expected to generate the type of above-market returns they are able to show now, as a result of pioneering in their market, had they not taken those actions over the period of six or seven years."

Lessons from History

Working for a strategy that has been around for a long time, Wallace can provide some context regarding the recent changes in the industry. "We are happy for people to associate us, in a public market context, with the investment we are making as having an impact," says Wallace. There is a subtle difference, but we are not too concerned with branding ourselves as an impact fund."

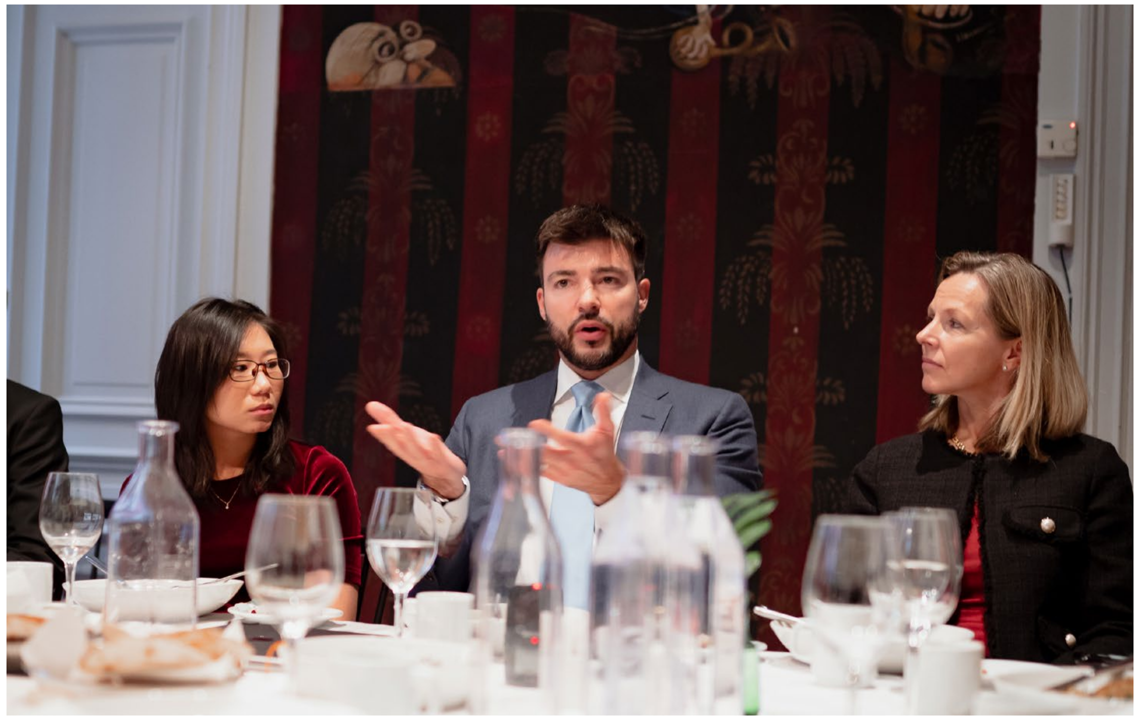
"Terminology comes to mind when thinking about the changes that have taken place over the years," Wallace adds. "We are on the cusp of a significant change, of which terminology is an important part. Going forward, the main distinction is between good investment practices like ESG integration and engagement - which investors should do as active stewards of applied capital - and choosing to invest in companies that are providing solutions."

"Although benchmarking is less relevant for this paradigm shift, my view is not necessarily shared by everyone. The regulator definitely thinks that it is important," Wallace says. "European regulators are concerned that there is a benchmarking problem. That is why they're introducing new ideas of what a Paris-aligned benchmark might be. They know that some investors are very concerned that they might make a decision which directs capital to projects that might underperform a generic benchmark in a different market environment."

"There may be a risk of overregulation, especially from the European Commission. But at least it's also a recognition by the regulator that capital markets have a significant role to play."

"There are also more funds in the public equity and bond spaces than there used to be, as well as an increasing number of multi-asset approaches thinking about what companies are doing, what their core operation are, and how they address certain challenges. That is the most important change we have seen."

"This increased popularity is not trivial and it is not new," Wallace remembers. "Then, sustainability was very much in vogue and focused on what companies were doing rather than sustainability in terms of ESG integration. However, that came and went. It didn't survive the end



of that market cycle. This time is different. I'm confident it will survive this time. Sustainability will endure because now we have several voices around the table all in agreement, investing resources and time into this endeavour. "

"From a pure investment perspective, the quality of the companies has increased. I joined in 2009, after the crisis, so I have never invested in a true bear market. Charlie Thomas, the fund manager who took over the strategy in 2000, is much more measured in his observations of the market. However, even he feels that have never had as many opportunities in so many of our investment themes at the same time as we do now. The quality of the companies that we are investing in today is entirely different from what it was between 2006 and 2008," Wallace recalls.

"In certain key themes, drivers have changed over time. In the clean energy for instance, we divested from solar entirely for a while. Regulation was the main driver behind those industries during the hype part of the cycle in the mid-¬-2000s. Nowadays, technology has become the main driver, and it is driving regulation in some cases. The price of energy motivated Senators from the North-eastern USA to get onboard with offshore wind. They didn't have to introduce subsidies. Technology what is driving change and that is the catalyst we are most excited about. The same change exists in spaces like mobility and the circular economy."

"I had the misfortune of starting in the industry on the buy side, at least about five weeks before Lehman went bankrupt," Crockford remembers. "My first sector was clean energy, and the market back then was trading at around 47 times earnings. Without being derogatory - particularly because survivor bias means that successful companies in this industry are thriving - I remember wondering why a windmill company traded at such a premium. One of the differences between then and now is that at the time, we only had the Millenium Development Goals (MDGs), which were much more focused on eradicating extreme poverty. They were much more general than the SDGs. There were only eight goals, if memory serves me right, with 17 targets in total. Now there are 17 SDGs with 169 targets. It's a complete framework."

"So the need for sustainable investment has grown and has been defined through the SDGs. They don't tell us how to solve the problem or how to invest. They're not exclusively for investors, but they do exist as a definition of what the problem is," Crockford concludes.

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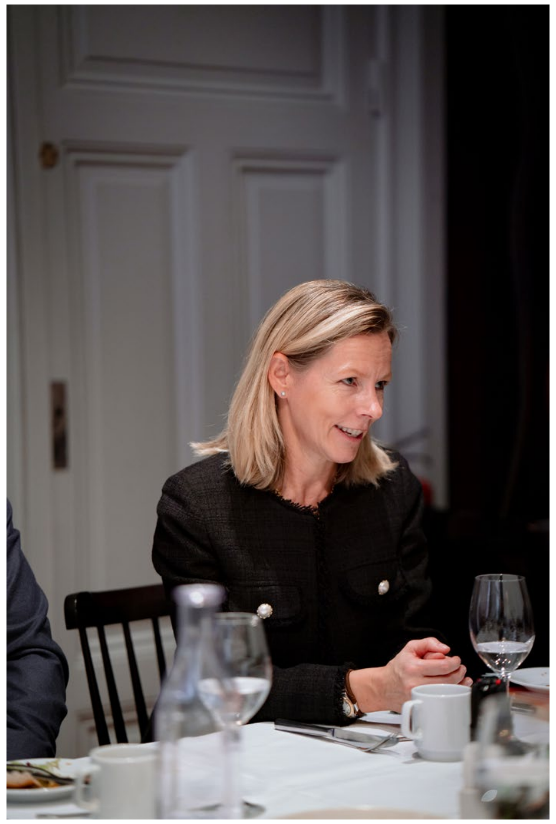
Selecting Thematic Funds

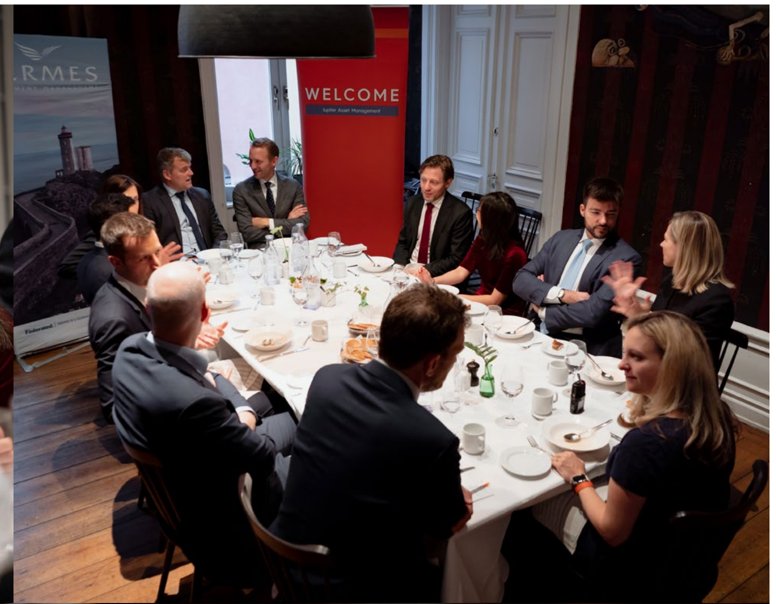


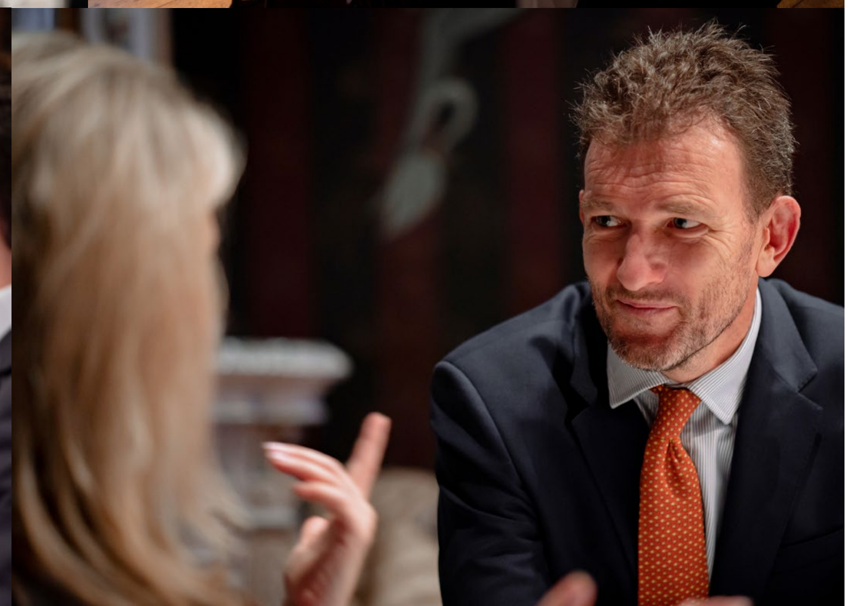
Having established the feasibility and desirability of liquid impact strategies, investors may have the option to choose thematic strategies that focus on one theme in particular. Multi-thematic strategies are an alternative and propose an overarching purpose, such as impact, while autonomously allocating to the themes they find most attractive.

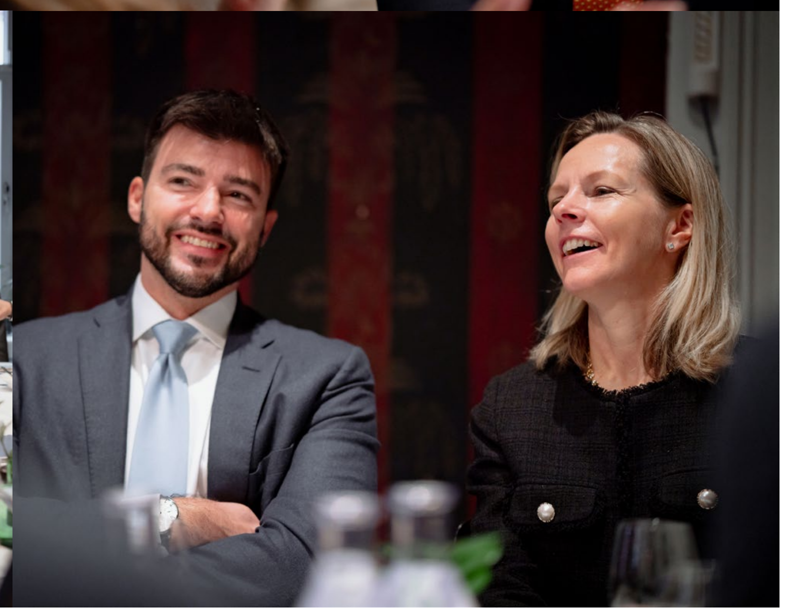
For a fund selector like Bolin Gärtner, it may be easier to consider multi-thematic strategies even though single theme funds are easier to explain. "When think of the end client, it may be easier to communicate and explain single themes. Water-themed or renewable-energy funds, for instance, have been quite popular. However, by investing in such products, the end client come into concentrated portfolios which may carry higher risks. We typically look at sector funds as being less diversified. Hence, I would argue that multi-themed global funds are more appropriate from a risk perspective. These considerations are less important for someone like me, when I am evaluating a fund, but it matters in terms of product offering for the end client."

Lu talks about what the defining factors in the process of evaluating the sustainability of an investment strategy. "We consider two aspects: ESG integration and active ownership," she explains. "It can be problematic for some thematic funds that only invest in best of class when working with ESG integration because they feel they can overlook engagement with those companies. However, because the rating combines the two perspectives, there's a penalty to missing one of these elements. Even when investing only in the best, we still need to have some engagement with them. It is necessary to ensure that these companies are keeping up with evolving standards in what is a very fast-paced investment space. Engagement is crucial," Lu states.

"Managers also have to be entirely committed to engagement. Active ownership has to go further than outsourcing votes to a consultant. Engagement involves hard work, having a plan, discussing it, looking at KPIs and measuring the changes that the company makes over time. It is a quasi-Private Equity skill which is something many listed-equity managers still need to learn," **Pickard** concludes.







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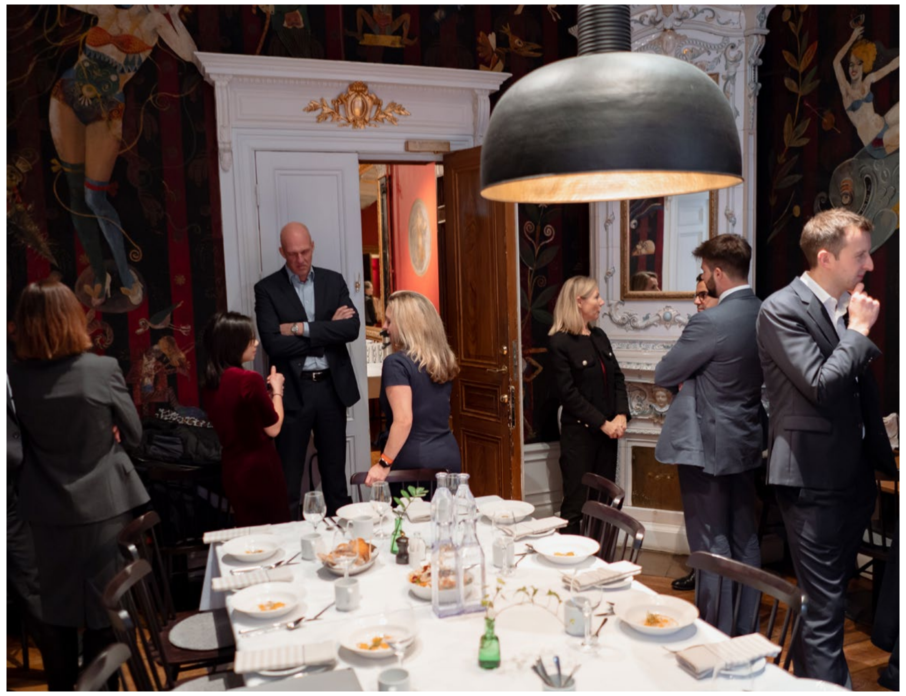

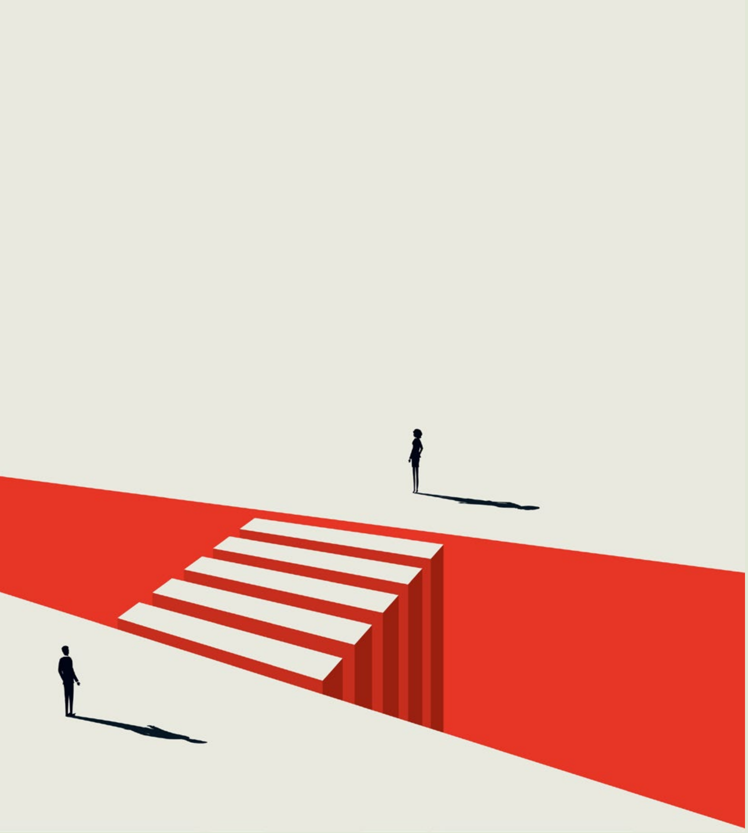

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