UK Equities
What does ESG mean to us?

For Professional Clients, Qualified Investors and Qualified Clients/Sophisticated Investors only.

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Henley Investment Centre

- Investing in stocks which have the right ESG momentum behind them can be a positive way for our funds to potentially generate alpha
- We draw upon ESGintel, Invesco's proprietary tool, which helps us to better understand how companies are addressing ESG issues
- Engaging with companies to understand corporate strategy today in order to assess how this could evolve in the future
- Monitoring how companies are performing from an ESG perspective and if the valuations fairly reflect the progress being made

Our focus as active fund managers is always on finding mispriced stocks and ESG integration underpins our investment process at every stage.

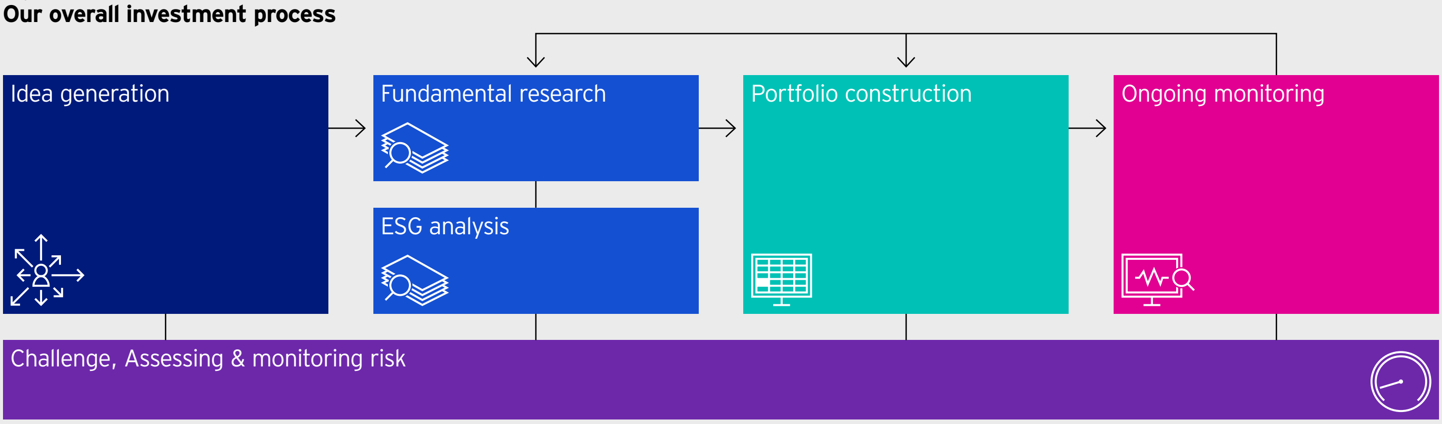
The incorporation of ESG into our investment process considers ESG factors as inputs into the wider investment process as part of a holistic consideration of the investment risk and opportunity, from valuation through investment process to engagement and monitoring. The core aspects of our ESG philosophy include: materiality; ESG momentum; and engagement.

- Materiality refers to the consideration of ESG issues that are financially material to the corporate or issuer we are analysing.
- The concept of ESG Momentum, or improving ESG performance over time, indicates the degree of improvement of various ESG metrics and factors and help fund managers identify upside in the future. We find that companies which are improving in terms of their ESG practices may enjoy favourable financial performance in the longer term.
- Engagement is part of our responsibility as active owners which we take very seriously, and we see engagement with companies as an opportunity to encourage continual improvement. Dialogue with portfolio companies is a core part of the investment process for our investment team. As such, we often participate in board level dialogue and are instrumental in giving shareholder views on management, corporate strategy, transparency, and capital allocation as well as wider ESG aspects.

ESG integration is an ongoing strategic effort to systematically incorporate ESG Factors into fundamental analysis. The aim is to provide a 360 degree valuation of financial and non-financial materially relevant considerations and to help guide the portfolio strategy.

Our investment process has four stages. In this note we go through in detail how ESG is integrated into each stage of our process.

Figure 1
Our overall investment process



For illustrative purposes only.

Idea Generation

Ideas come from many sources – our experienced FMs, other team members or investment floor colleagues, various company meetings, and by exploiting the intellectual capital of our sell side contacts. We see it as important to spread our nets as wide as possible when trying to come up with stock ideas which may find their way into our portfolios. We remain open minded as to the type of companies we will consider. This means not ruling out companies just because they happen to be unpopular at that time and vice versa.

ESG can create opportunities too – for example, the benefits of moving towards more sustainable sources of energy like wind, solar and hydroelectric power generation. This was one of the reasons we became interested in some of our utility holdings which are held across several portfolios. This highlights the importance of opportunities brought about by ESG and not just the risks. ESG can also influence the timing and scale of a mispricing being corrected in the market.

To be clear, at this early stage of the investment process we typically would not rule out companies with a sub-optimal ESG score. Investing in stocks which have the right ESG momentum behind them – by focussing on fundamentals and the broader investment landscape – can be a unique way for our funds to potentially generate alpha.

Fundamental Research & ESG Analysis

Research is at the core of what we do and is what the investment team spends most of its time doing. The key is to filter out those ideas which aren't aligned with our investment philosophy and concentrating on those where we see the strongest investment case. Our fundamental analysis covers many drivers, for example, corporate strategy, market positioning, competitive dynamics, top-down fundamentals, financials, regulation, valuation, and, of course, ESG considerations, which guide our analysis throughout. The key drivers will differ according to each stock.

We use a variety of tools from different providers to measure ESG factors. In addition, at Invesco, we have developed ESGintel, Invesco's proprietary tool built by our Global ESG research team in collaboration with our Technology Strategy Innovation and Planning (SIP) team. ESGintel provides fund managers with environmental, social and governance insights, metrics, data points and direction of change. In addition, ESGintel offers fund managers an internal rating on a company, a rating trend, and a rank against sector peers. The approach ensures a targeted focus on the issues that matter most for sustainable value creation and risk management.

This provides a holistic view on how a company's value chain is impacted in different ways by various ESG topics, such as compensation and alignment, health and safety, and low carbon transition/ climate change.

We always try to meet with a company prior to investment. Based on our fundamental research, including any ESG findings, we focus on truly understanding the key drivers and, most importantly, the path to change. This helps us better understand corporate strategy today and how this could evolve in the future. Today, the subject of ESG is increasingly part of these discussions, led by us.

Portfolio Construction

We aim to create a well-diversified portfolio of active positions that reflect our assessment of the potential upside for each stock weighted against our assessment of the risks. Sustainability and ESG factors will be assessed alongside other fundamental drivers of valuation. The impact of any new purchases will need to be considered at a fund level. How will it affect the shape of the portfolio having regard to fund objectives, existing positions, overall size of the fund, liquidity and conviction?

We do not seek out stocks which score well on internal or third party research simply to reduce portfolio risk. We ask the question, "Why does the idea deserve a place in the portfolio?" We ask this because there is a competition for capital, a new idea will require something else to be sold or reduced so that it can be included.

Ongoing Monitoring

Our fund managers and analysts continuously monitor how the stocks are performing as well as considering possible replacements. Are the investment cases strengthening or weakening? Are their valuations reflecting the companies' prospects appropriately? Is the company performing from an ESG perspective and are the valuations fairly reflecting the progress being made or not? Are the anticipated key drivers playing out or not? These questions, and their answers, are all of equal importance to us.

How do we monitor our holdings from an ESG perspective? Again, the same resources used during the fundamental stage are available to us. Our regular meetings with the management teams of the companies we own provides an ideal platform to discuss key ESG issues, which will be researched in advance. We draw on our own knowledge as well as relevant analysis from our ESG team and data from our previously mentioned proprietary system ESGintel which allows us to monitor progress and improvement against sector peers. Outside of company management meetings we constantly discuss as a team all relevant ESG issues, either stimulated internally or from external sources.

Additional ESG analysis is carried out by the team, when warranted, on particular companies. Depending on the particular case this is often in conjunction with the ESG team. Such cases would be those that are more controversial, considered to be higher risk and viewed poorly by ESG providers, resulting in a valuation discount. We don't just look at the specific issue considered to be higher risk either, for example the environmental risk of an oil company, but all areas of ESG. This means undertaking extensive analysis of social and governance policies and actions at the same time. We would note that this analysis is an ongoing process, typically involving multiple engagements with the company over a long period of time. All ESG discussions and interactions are written up – including our views and thoughts – with a section solely dedicated to ESG. Likewise, research undertaken by the ESG team is available to the entire Henley investment floor, and wider business. Further analysis could be warranted as a result of these discussions.

Challenge, Assessing & Monitoring Risk

In addition to the above, there are two more formal ways in which our funds are monitored:

There is a rigorous semi-annual review process which includes a meeting led by the ESG team to assess how our various portfolios are performing from an ESG perspective. This ensures a circular process for identifying flags and monitoring of improvements over time. These meetings are important in capturing issues that have developed and evolved whilst we have been shareholders. It is our responsibility to decide if it is appropriate, or not, to investigate these issues in more detail. We may ask the ESG team to assist in undertaking more analysis or discuss such issues with the company themselves or external brokers.

There is also the 'CIO challenge', a formal review meeting held between the Henley Investment Centre's CIO and each fund manager. Prior to the meeting, the Investment Oversight Team prepare a detailed review of a portfolio managed by the fund manager. This review includes a full breakdown of the ESG performance using Sustainalytics and ISS data, such as the absolute ESG performance of the fund, relative performance to benchmarks, stocks exposed to severe controversies, top and bottom ESG performers, carbon intensity and trends. The ESG team review the ESG data and develop stock specific or thematic ESG questions. The ESG performance of the fund is discussed in the CIO challenge meeting, with the CIO using the data and the stock specific questions to analyse the fund manager's level of ESG integration. The aim of these meetings is not to prevent a fund manager from holding any specific stock: rather, what matters is that the fund manager can evidence understanding of ESG issues and show that they have been taken into consideration when building the investment case.

Company Specific Examples

In the selection below, we highlight some of the recent engagements that we have had with companies to give you a flavour of how active engagement can create positive outcomes.

International provider of equipment and rental services

Key ESG issues
Rated **Low Risk** by Sustainalytics.

E	Carbon - Own Operations
S	Human Capital Management
G	Corporate Governance and Business Ethics

Our assessment

- Key issues highlighted by Sustainalytics are that following acquisitions the company needs to be mindful of staff retention so as not to damage existing client relationships. They also indicate that the company's vehicle fleet are energy and fuel-intensive which opens them up to scrutiny from stakeholders in an environment where regulations are becoming increasingly more stringent.
- The company rents equipment to construction and other sectors, and while its vehicles do emit green house gases, they are typically better maintained than those owned by the industry. Furthermore, in renting equipment, customers are sharing the same capital asset, which means fewer need to be built in the first place, so reducing the carbon footprint of the construction industry. In addition, rental companies can ensure that equipment is maintained to the best standards to extend the asset's useful life.
- Decarbonisation is also a hugely important issue for the company, and they are looking into how they can decarbonise their fleet. The business highlights the role that rental companies can play in bringing newer environmentally friendly hydrogen or electricity powered technology to the market at speed.
- The company recognises the need to recruit and retain skilled employees and has a strong human capital development programme. The company engages in initiatives with various trade schools has initiatives such as employing ex-service men and women and assisting ex-prisoners back into the workforce.
- Sustainable value and growth are key tenets of the company's strategy, but they have not communicated their sustainability credentials before. We believe these to be quite strong and hence represent an opportunity. A new Managing Director of ESG has recently been appointed which we think a positive move.
- The company is noted as showing particular strength in its audit and financial performance systems, as well as its board structure, quality and integrity of its board/management and its ownership structure/shareholder rights by Sustainalytics.
- ESG factors have been part of the company investment case in the past and we are increasingly viewing these factors as key enablers to improve the carbon footprint of construction. Run by a sound management team the company is intent on doing the right thing for its people and the communities it operates in.

International transmission and distributer of electricity and gas

Key ESG issues
Rated **Medium Risk** by Sustainalytics.

E	Carbon Reduction
S	Occupational Health & Safety, Human Capital
G	Corporate Governance

Our assessment

- Sustainalytics highlight that as one of largest electricity and utility companies in the world it will need to play a central role in helping the UK achieve its aggressive greenhouse gas targets by promoting decarbonisation of the grid.
- The company engages in the transmission and distribution of electricity and gas. The company invited Invesco to attend their Oct 2020 ESG seminar, which was the launch event for their 2021 ESG programme. The event featured talks by multiple members of the executive team including the CEO and chairman.
- During the webinar the company outlined their ESG strategy, and the key role they will play in facilitating the electrification of high carbon emitting industries and products such as automobiles.
- They outlined their carbon reduction targets, which include a 2050 net-zero target as well announcing on the webinar an interim scope 3 reduction target for 2030.
- The company's business model means it is less exposed to carbon risk than utilities that have greater generation capacity (the company are distributers), but the company lags many peers in terms of supporting the transition to a less carbon-intensive grid according to Sustainalytics. We know from our conversations with the company, however, that they are trialling new products in order to promote transition.
- Following the webinar, Invesco provided feedback to the company that although the overall vision set out by the company is very strong, more clarity is needed about how their gas business can be decarbonised and the feasibility of proposed solutions such as renewable natural gas (RNG) or hydrogen blending.
- Traditionally a male dominated industry, the company is cognisant of the competition from other sectors for talent pool that will be attracted to other sectors. As such it has announced social objectives they are working on, including getting more women into STEM from a young age.
- The company has a board-level committee that oversees safety and environmental issues, and executive remuneration is tied to safety although specific metrics are not disclosed.
- The company is noted as showing particular strength in its ownership structure/shareholder rights, its remuneration systems and its stakeholder governance by Sustainalytics.

Voting Policy

We review AGM and EGM proposals taking into account our own knowledge of the companies in which our funds are invested, as well as the comments and recommendations of ISS, Glass Lewis and IVIS. In addition, Invesco provides proprietary proxy voting recommendations and publishes these recommendations via its PROXYintel platform. All voting decisions remain with the fund manager, however, where a fund manager votes against an Invesco voting recommendation, the rationale for such decision is recorded and available on the platform.

Where there are situations of controversy or differing views between the consultants mentioned above, we will draw on the expertise of our internal ESG team for advice. There will be times when we will follow the recommendations made by proxy research providers but times where we disagree with the stance being taken.

Voting in line with management recommendations should not be seen as evidence of a lack of engagement or challenge on our part, but rather that we believe that the governance of the companies in which we are invested is appropriate for the size of the company, robust and worthy of support. There may be instances where we vote in support of management, but the ESG performance of the company is not perfect and issues have been identified. In this situation we would have been engaged with the company leading up to the vote and if necessary, would have raised concerns and likely given a time horizon or measure for improvement which, if not met, could lead to a vote against in the future. In that respect, our approach to governance is one of engagement and improvement. We do not expect companies to change overnight but we do expect continual review of governance processes and continued improvement.

A recent example of voting engagement involved director remuneration at a large international distribution and outsourcing services group. We reviewed the company's director remuneration policy ahead of the AGM and noted that the group has formalised its policy on post-employment shareholdings for directors which was an issue we had raised previously. Given this, overall we were supportive of the policy. However, prior to voting at the AGM we continued to have an outstanding query on executive directors pension benefits, and whether the pension contribution would be aligned over time to those available to the wider workforce as this did not appear to be the case. This was also flagged by a third-party research provider. We engaged with the company on the matter and shortly after the company issued an announcement setting out how the CEO's remuneration would align with the pension contribution rate for the majority of the wider workforce in the UK. As a result we felt able to support all the resolutions at the AGM and had successfully discharged our stewardship duties.

Conclusion

The regulatory landscape is rapidly evolving, which increasingly compels organisations and investors alike to clearly demonstrate their awareness of ESG issues in their decisions. Landmark initiatives such as the European Union's new Sustainable Finance Disclosure Regulation (SFDR) are at the forefront of this shift.

We believe that our approach is honest, coherent and pragmatic. The principles behind ESG deserve to be embedded in an investment framework which encourages positive change. Coupling this with a focus on valuation is, to our minds, the best way to deliver strong investment outcomes for our clients' long term. This reinforces our fundamental belief that responsible investing demands a long-term view and that a stakeholder-centric culture of ownership and stewardship is at the heart of ESG integration.

Investment Risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Important information

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