

## TRANSCRIPT

### PENSIONS FOR PURPOSE PODCAST SERIES 2, EPISODE 9 ENGAGEMENT WITH US COMPANIES

**Laasya Shekaran:** Hello everyone, and welcome back to the Pensions for Purpose Podcast. I'm your host, Laasya Shekaran, and today we are joined by Will Pomroy, Head of Impact Engagement Equities at Federated Hermes. Will, it's great to have you here.

**Will Pomroy:** Good morning, Laasya.

**Laasya Shekaran:** My Pensions for Purpose Co-Host today is Richard Giles. So Richard, it's great to have you on the podcast as well today.

**Richard Giles:** Morning Laasya, morning Will.

**Laasya Shekaran:** One of the biggest questions that we've been getting from our members recently is about what they should make of the ESG backlash that we've been seeing, which has been particularly prominent in the US. So, in today's discussion, we want to get into this topic and find out more about how we got here, but also how we can move forward. So let's start at the beginning, Will: how did we actually get here? What's led to this ESG backlash that we're seeing, especially in the US?

**Will Pomroy:** It's a big question Laasya, and I think clearly an important one to try and unpack to understand what sustainable investment means today, and frankly, what it's going to mean in the years to come.

I think something from my reflection, having worked in the space for a long period of time now, is that some degree of backlash was almost inevitable. Clearly it's been heightened somewhat, and has certainly been more vigorous, and perhaps weaponised and politicised than one might have expected in the US this year, or certainly over the last 12 months or so, but I think if we unpack what the causes might be, it's in large part, because, frankly, there has always been, for 10 to 20 years or so, a confusion as to what sustainable investment is, and therefore, it's meant all different things to all people.

One tries to drill through and understand what it means from an investment perspective. There has been a lot of confusion in that space, and some very dark green purist thematic funds are seen as ESG, as are pretty traditional ESG integration, almost plain vanilla, global equity funds. Clearly, there's a world of difference between the two of them, and yet the same level of expectations have, in many cases, been laid onto both types of strategies.

Then, when we think about the regulatory and political shifts in more recent times, again, some of the elements of ESG that have become certainly polarised, and certainly weaponised in the United States are quite narrow in their focus. If we think about the decarbonisation agenda, they're really thinking about elements of that climate transition, which are impinging on commercial activity, or the perceived imposition of impinging on commercial activity in certain sectors, in particular, the energy sector, what we're thinking about in the social agenda are certain aspects of talent management, which are really around the breadth of a workforce, and in particular, the feelings in some parts of the population that certain populations are being discriminated in favour of, and therefore against others, when in reality, I don't think sustainable investment has ever been about that zero sum game of one coming at the expense of the other. It's always been about, in the latter case, companies investing in their workforce and maximising the talent available to them, and frankly, making sure they're deploying the

maximum talent that is available to them at all times, and not focusing on too narrow a population base, including on the former.

It's in trying to ensure that companies are actually capitalising on those commercial opportunities that are available to them, and not continuing to expend capital to explore opportunities that are diminishing and dwindling over time, and therefore coming at the expense of those commercial opportunities that will be growing in the years ahead. I think there's a point in time tension around a couple of those points. But actually, I think if we look ahead for the next five to 10 years, the energy transition and climate transition remain big tailwinds for investors of all types, and sustainable investors in particular.

Decent work, and companies providing and investing in their workforces, is more important today than it's ever been. So, all things social, speak to good quality companies maximising the talent available to them, ensuring that their employees are skilled up for the challenges ahead, and therefore they will be successful in the years ahead. So there's a bit of a political moment in time, but good quality companies recognised what was important 12 to 24 months ago. Those same said issues are important today, and will be more important in the year or two to come, so we'll still see those same themes being more important. But I think the language around how we talk about them, how we frame them with companies, and certainly for investors, how we identify the opportunities. There's a change of language that I think we're all slightly adapting to at this point in time, and regulation and politics has slightly confused and stirred things up, but we'll navigate our way through.

**Laasya Shekaran:** That's quite an optimistic take, which is quite nice to hear, because sometimes you see all the headlines and it just feels quite scary. But I think it's an important point that actually, a lot of this backlash is probably rooted in a lack of understanding or clarity about what we mean by different terms and what we're trying to get out of them, so focusing on that.

**Will Pomroy:** I think that's absolutely right, Laasya. Maybe I'll just reflect quickly back on some of the regulatory developments over the last two or three years, which the sole objective in many cases was to bring clarity to what was a confused space. I don't think at this stage they have brought that clarity, and therefore, if you're an end investor or an institutional investor or a retail investor trying to navigate your way through the breadth of sustained investment options available to you, it isn't clear what it is you're looking at, and it's certainly not clear, ultimately, what it is you may believe you're sacrificing, or leaning into on an ethical, moral or returns objective basis.

Therefore, that regulatory burden that's been imposed quite heavily on both the asset management industry and the corporate side over the last three to four years does need a bit of a rethink, both to get the cost benefits in a better balance, but also to reassess whether it's meeting that key objective of bringing transparency and clarity to help people understand what it is they're looking for, and where, ultimately, they're allocating their capital to, whether that be, as I said, on the corporate or the investor side. We haven't got to that level of certainly clarity today.

**Richard Giles:** Will, can I just widen the lens a little bit in terms of how you approach things at Federated Hermes? You've recently published a paper on equity engagement, which was very interesting to see. I wondered if you could summarise the core principles that you apply. We've got these political headwinds and tailwinds that move with the times, but what core principles do you apply in your work?

**Will Pomroy:** It's a welcome question, Richard. Maybe I'll just set the scene briefly. The core strategy that I spend most of my time on is the Global SMID Engagement Equity Strategy, which we launched eight years ago.

The core principles behind that strategy when we launched it, we think remain true today: if you're thinking about public equity markets, where and how, as an investor, can you have an impact with those companies which you're investing in? We believe that comes through engagement. In reaching that conclusion, we then also reached the second conclusion of where we in public equities can we maximise that impact? We came to the conclusion that was in the smaller mid-cap space, for the reason that you get greater access to management, and then the more immature in their developments of sustainability strategies. They're growing businesses and have a significant opportunity to mature their sustainability strategies alongside the growing business, and therefore have an outsized impact.

In recognition of that, the core principles we bring to bear are that we think engagement needs to be purposeful, that you need to actually identify the companies with that improvement potential at the outset, and therefore construct a portfolio around that opportunity set, and not simply overlay engagement on top of an existing portfolio. Engagement needs to be integrated through everything that one does, and that means it's actually factored into the portfolio management decisions and the portfolio manager, as well as the investment analysts, and the engagers own the engagement agenda with that company. It's a cohesive conversation we then have with the company. The company understands where we're coming from, and they understand our expectations, but most fundamentally, the agenda we have is not divorced from the investment case.

The engagement conversation we're having around the sustainability improvements we hope to see with the company are matters that we think will enhance the quality of the company, either for enhancing returns, enhancing revenue, reducing costs, or frankly just reinforcing the resilience of the business in the next, you know, five to 20 years as we look out over the short-, medium- and longer-term horizon, so that you know the two things are fully integrated from an investment and a sustainability perspective.

Finally, I think perhaps the most important factors to keep in mind from an engagement perspective are that one needs to be patient, and this too often is easily said, but quite easily forgotten, as we're in a 24/7 culture and expect to see immediate returns and immediate impacts, and stories being proliferated and evidence provided for the impact that investors have generated. We do need to remember that even the best engagements take a good few years to bear fruit. We tend to describe a model engagement in very simplistic terms of, it takes a year to build a relationship for the company to understand where you're coming from, and for you to understand more deeply what's happening within the company itself. It's maybe another 12 to 18 months for a plan to be developed to address whatever initiative one has identified as needing, and addressing, whether that be on energy transition, decent work, or human rights, or whatever else it might be and then it's another 12 months or so to begin to see some of the impacts of that initiative being put into place. That's a three to three-and-a-half year window, and that is almost certainly a best case scenario.

More realistically thinking, three to five years in a good case, is when we will begin to see the returns from all that engagement effort. It's only really going to work if you're a patient investor, willing to persevere with the conversations and the engagement with the management team through good times, and undoubtedly there will be trickier times within that engagement, too, to then bear the fruit in years three to five or maybe six to eight, and so long-term investors need to be patient.

Ultimately, by doing so, they then reap the rewards and the outcomes, and the annual report that you just alluded to, Richard, that we published for our Engagement Equity Strategy just last week, is, we think, full of stories that that begin to put some of the colour and flesh, and the bones of all that engagement activity we've been doing for eight years. It is full of some of those stories, and the names that we've held for all of the eight years of that strategy. Indeed, in some cases, there are names in that strategy that we've held within our sister funds here at Federated Hermes for two decades or more, and therefore the knowledge we have of those companies is deep.

Again, I think it's those companies that really do tell the full story of how, being a patient, but also a purposeful and focused engager with those companies, does bear fruit over that longer term.

**Richard Giles:** Thanks a lot, I just wanted to follow up, to forward focus to now, and the impact that the US political situation is having, and maybe for listeners to understand the nature of those conversations and how they might be changing given that situation in the US. Perhaps you could give an example of how your engagement with a US company might look today.

**Will Pomroy:** It's both different and the same, I suppose, which is not the greatest about us, but, as I said, for the US companies and our various funds here, and in particular, within our engagement fund, we have been engaging with them for a long period of time; engaging with the management team, the board of directors and folks below the management team to understand what it is they're doing, and hopefully influence their priorities and nudge them in a positive direction towards one that is both beneficial for wider stakeholders and beneficial to us as investors.

In terms of how that conversation has changed over the last few months, as we have a new administration in the US, and certain elements we have touched on around ESG have become weaponised and certainly highly politicised in the US. What has changed is we perhaps have to be more forthright in our framing of the topics that we're engaging with those companies on.

Where, certainly in Europe, it may be taken for granted that when we talk about the energy transition, we're talking about something that we think is good commercially as well as good for society, in the US, that maybe taken for granted framing is no longer sufficient. One needs to be much more specific in explaining why that agenda that you're discussing with the company is good from an investment perspective and why it is good for shareholder value for certain actions to be taken, as well as why it's good for stakeholders, and so the much more shareholder value-orientated framing of an engagement objective is now more important.

I would probably reflect this should have always been important in any case. We are not going to persuade a management team to do anything that they don't think is good for business. They are there to drive value for the business. That is their purpose, and unless we can explain and frame an objective as being good for business and good for society, it's never going to get that buy-in from the management team, and it's certainly never going to be sustainably embedded within the business which you're invested and engaging with; and so frankly, it was always a good thing to do.

We perhaps maybe took it for granted in certain cases, or certainly maybe didn't frame it as fulsomely as we should have done, and I think we are now all recognising that there was a greater need to do that, whether that be on the climate side, speaking to some of those climate opportunities and energy, resilience, etc, or even indeed on the social side, where, as I said,

some of those topics are now highly politicised in the US. But there is a need for businesses to create broad-based workforces that are engaged, motivated and productive, that are recognising that there are huge skills shortages in certain sectors, and huge needs to invest in and upskill those workforces. That's a more important agenda today than it was a few years ago, and will be increasingly important in the next few years. So we continue to engage on exactly the same topics. But the framing of that has become more explicit and certainly more framed around the value-enhancing opportunity for making some of those changes than it was maybe a year or two ago.

**Laasya Shekaran:** I guess one of the benefits that especially long-term investors, like pension schemes, or like yourselves, can have when they make those engagements is encouraging companies to think about value over the long-term, rather than just short-term profits, which is where a lot of sustainability issues come in.

**Will Pomroy:** Absolutely. It is very much a time horizon piece. Even within that, I think one needs to recognise that pension funds in particular, and certainly longer-term investors, are more interested in the medium-term than they are the short-term, but equally, we can't lazily frame everything as being of convergent self-interest in the long-term.

The long-term can be a very long way off for any management team of any publicly listed company, and so one does need to frame the risk and opportunity within a time horizon that is still relevant for the management teams and companies that we're engaging with. A three to five-year view is the ideal framing of addressing some of those risks pieces, as well as positioning business to realise the opportunities, as opposed to saying, 'We know in 2050 we need to be net zero, and therefore here, in 2025, we need to begin to take action.' That's always been an easy ask to make, but it's always been, in many cases, seen as the next CEO's problem rather than the current CEO's problem.

Repositioning it for the CEO to see why it's good for them today to make the changes that you're asking of them for their business, that will still in many cases incur costs, but will reap rewards within the time horizon that they are being paid for, is the way to get buy-in with companies, and therefore embed and make those changes sustainable within the companies that you're speaking to.

**Laasya Shekaran:** It sounds like you take quite a collaborative approach to engagement, and find that effective, but that's a little bit at odds with some of the messages we hear from civil society campaigners, who are often calling for immediate divestment, and from their perspective, they maybe think that these issues are too big and too worrying for them to continue over the next three to five years as you continue your ongoing engagement. They're still doing stuff that could be very damaging to the planet or to humanity in the longer term. But it's a tricky one, because obviously if you divest, then what happens? Somebody else just buys the company. How does divestment actually fit into your engagement approach?

**Will Pomroy:** Again, an important question. Certainly for us, as active investors, divestment clearly has to be a tool that we have in our toolbox, and frankly, probably quite an important one.

Every investment decision we make is an active decision to either buy or not buy a stock, and therefore almost de facto, we are excluding or divesting from stocks all the time, but for those that we invest in, we have a multi-year view, and we've got companies that we've held for 20-plus years. We're very willing to be patient, but absolutely, there is an urgency to making changes today that can't just be pushed off to 2030, or to a point in the future. And so we do

have an expectation to see companies making the necessary changes that are good for business and good for society.

We do, therefore, have to hold ourselves to a credibility test. Certainly for our approach, because, as you rightly said, it is deliberately collaborative, we do seek to work with the company, to sit on the same side of the table as the management team and try to work through some of those challenges they're facing, to bring about the change that they also, in most cases, recognise is a necessary one.

It's not going to be a linear journey. It's not a journey that's going to be clearly defined at the outset, where it's easy to say, if you haven't made X progress by point Y in the calendar, we're going to have to divest, because that may not take into account conditions outside of their control, or regulatory developments, or the pace of scaling up commercial technologies that will be necessary to allow them to take that big leap forward.

What we ultimately need is to be able to sit in front of our institutional clients and our retail clients, and say, 'This is our portfolio. These are all the reasons why we hold each company in our portfolio. This is the progress we have seen by each company in the portfolio', and we can sit comfortably in front of you and explain, in an authentic way, why we think that company continues to merit a place in an engagement strategy.

We think we can do that then, but I think, frankly, we've answered the question, 'Should that company remain in the portfolio?' I think transparency is ultimately the test of whether you can stand up the credibility of the case you're making. In our annual report for the engagement fund, we do exactly that. We have lots of conversations with clients around some of those names in the portfolios that do look dirtier, that do have high levels of emissions that do need to spend a lot of capital over the coming years to make that necessary transition to be net zero-aligned in the years to come, but for all of those, we are forcibly transparent to explain why we think, if you're going to bring about that necessary energy transition, you need to be invested in some of the dirtiest sectors: you need to get your hands dirty and you need to be patient. But you also need to be transparent about the progress that is being made, so you can defend that position to the clients who have allocated their capital to you.

**Richard Giles:** Well, I wonder if you might help bring that to life for the listeners, with an example of engagement that you've undertaken, that's had a successful outcome.

**Will Pomroy:** I'm happy to, Richard. To a huge degree, there's greenwashing, which is a fair challenge to throw at all of us at various points. Given I've talked a lot about being patient and also being willing to get your hands dirty, I think a couple of examples that spring to mind in response to your question, would be that our engagement strategy is particularly overweight to industrials, but also to materials, and in particular building materials. We have a couple of cement manufacturers in the portfolio, and they're the companies, frankly, that we get the most questions about from our investors in the strategy, because if you do a carbon footprinting of the portfolio, there's a big spike when you get to that cement manufacturer, that constitutes approximately half of the Scope 1 and 2 emissions to the portfolio.

Cement manufacturing, I think, has a pretty well laid out and documented transition pathway that it needs to progress along, but clearly, there are nuances as to whether that's a cement manufacturer in North America or in the UK, in Europe or further afield. There are particular building standards that need to be adhered to and particular permitting challenges to progress towards utilisation of alternative fuels, etc.

Fundamentally, the big lever that needs to be pulled will be the deployments of carbon capture technology in the years to come. That's some way off being commercially scalable today. So with that background, we've held a company in North America called Eagle Materials Inc., which is a North American cement manufacturer, the second largest domestic-only cement producer in the US.

When we initiated our engagement with them several years ago, frankly they hadn't published anything on sustainability for the best part of a decade. It wasn't something that they were shouting from the rooftop. They were certainly, in comparison to European international peers, some way behind, both in their acknowledgement, recognition, and maybe, indeed, investment in sustainability initiatives.

A number of years on now, the disclosure has improved; they're still behind those European peers. Its energy intensity has improved markedly; they're still behind European peers for the geographic nuances I just alluded to, but they're also investing hundreds of millions of dollars today in retrofitting their older kilns so that they are much more energy efficient. And you will see a 20% emissions intensity reduction in their older kiln as a result of some of that investment in the next couple of years.

They're investing in alternative cementitious materials, so they will be able to get some of that clinker substitution in the years ahead. They're investing significantly in alternative fuel utilisation, and they're piloting carbon capture technology at one of their sites, too, which myself and a colleague had the pleasure of going to visit late last year. So they're doing all the things, frankly, that one can ask of them.

They're not ticking all the boxes, because their disclosure absolutely still lags where some of the international peers are. But we are seeing year-on-year evidential and demonstrable progress towards a situation where that business is going to be net zero-aligned because, frankly, cement will remain integral in building out the infrastructure for all manner of things over the next few decades, including all the renewable projects that we clearly know we need, too. So we've seen very good progress there on a company that I think you need to be patient with, but also get your hands dirty, and understanding some of the nuances and developments needed.

On the flip side, just to give a quick counterexample, we have absolutely got examples that we can point to over the years, of names that we've divested from because we haven't seen the adequate progress that we would like to have seen. And again, a couple of those have probably been in the US. We've got a couple of industrial names there where, maybe initially, we invested on the case of being quite confident that we'd see the progress. We had a lot of conversations for a year or two with members of management, but we didn't get that progress that we hoped for.

We ultimately escalated our engagement to board members; that failed to unlock the bottleneck. Ultimately, we've documented in our annual reports that we've sold out of companies on that basis.

The other scenario one often sees is a change of management being a catalyst for progress, or in other cases it has the opposite effect. So again, in the early stages of this strategy, we had a company in the fund where the management team was wholly aligned with the philosophy that we had. The CEO had his own charity that was doing a lot of great work with refugees and refugee camps, in terms of some of the kind of parallel-aligned initiatives that were tied to the business itself.

However, 18 months to two years into the strategy, there was a change of management. Another high-quality management team came in, which was much more internally focused, and therefore much less receptive to engaging with us around some of these, perhaps non-financial, but nonetheless long-term value-enhancing initiatives that we were speaking with the previous management team about.

We exited that position, too. And again, we've got a handful of examples of that type. That, frankly, is the nature of investment. But things do change over time, and you can't predict what the future will throw up. Sometimes things don't quite work out, and we move on and reallocate our capital and our time towards those opportunities where we think we can make more positive progress.

**Laasya Shekaran:** Thanks for bringing that to life. It's quite clear that really every engagement is different, depending on how the discussions and how the work goes. I guess another thing that comes up in the topic of engagement is this idea of collaboration, and we have seen that some of the key investor collaborative initiatives have disbanded recently, or have at least paused their activities, like the Net Zero Asset Managers Initiative (NZAM). What does investor collaboration look like now?

**Will Pomroy:** It's a great, and very live and topical question, isn't it? Certainly from Federated Hermes' perspective, collaborative engagement has almost been the DNA of the firm for over 20 years. The Hermes EOS business that we run here, stewarding assets on behalf of several pension funds in the UK as well as those internationally, is all about like-minded investors coming together, and collaborating in a shared platform.

Therefore, as an organisation, we've always been very active participants in a huge range of different collaborative investor initiatives, whether that be CA100+ or NZAM; or roll off another list of different acronyms and Federated Hermes will likely be there. We continue to be there today, so there has been a lot of focus on the antitrust concerns around those initiatives in the US, and, as you rightly touched on, a number of those initiatives have either disbanded or paused their activities of late. We've obviously reviewed our own involvement in those initiatives. As I said, we've taken the decision to continue to commit to those collaborative investor engagements going forward.

We think collective engagement for sector-wide challenges is clearly critical to move a sector forward. In most cases, certainly when we think about the energy transition, it's not going to be one company alone that's going to be able to make that change. The industry as a whole needs to move in lockstep, and that's where collective engagement is really critical.

Secondly, I think it is important to reflect on maybe the lack of progress that's been made by some of those collective engagement initiatives over the last 10 years. There have been huge steps forward in terms of those initiatives driving acknowledgement of the issue, driving disclosure up, but the criticism would often be made, and I would have a degree of sympathy for the criticism, that the capital allocation decisions and the strategic shifts of those businesses and sectors has not matched the level of assets that have been proportionately pushing for the change that has been being sought.

I think that speaks to two things: one, that the collective engagement is not hundreds of billions or trillions of dollars, or speaking to one explicit ask of a company. What the collective initiative engagement initiatives are asking is for companies to explain better how they are managing the risk, and what they are doing to acknowledge and address the risk and opportunity for their



business in their sector, but the investors are not micromanaging the businesses. Perhaps that's a positive, in that it means they are not falling foul of antitrust, but it's also a negative in terms of the lack of progress that's maybe being seen. Because also, the other point is, there isn't - or hasn't been - a unified view amongst that investor coalition for the last 10 years.

I think, as we see some of those investors step away from those initiatives, that will indeed also speak volumes to the commitments of those other investors to the initiatives they've been part of for the last 10 years or so. I think we're seeing a bit of a reshaping of the industry. Those who remain committed continue to do so.

But I'll also make one final point, which is that for the engagement strategy that we run, we have tended to find that the most impactful engagement is bilateral. It is where the company management teams understand the views, in a deeply thoughtful way, of the investor base that they have, and they understand what the portfolio managers think of the company—what they expect to see the company doing in the years ahead that is going to be value-enhancing.

And I think those conversations that are most constructive and most thoughtful do tend to come bilaterally, rather than through collective bodies, just by the very nature of having a more open, honest, and perhaps at times forthright conversation that is more permissible in that bilateral environment.

**Laasya Shekaran:** Will, this has been an absolutely fascinating discussion, and I've learned a lot about what we can take from this ESG backlash, about how we got there, and how we can be clearer about what we're doing; but also the pragmatic, and even somewhat optimistic, approach that you are taking in light of all of this background. If there was one thing you wanted listeners to take away from this discussion, what would it be?

**Will Pomroy:** Maybe they can actually do two things. I think you've used the two words I would use, Laasya. I think there's a real need to be pragmatic. I think we do need to all be practicable in our asks of companies and not have unrealistic expectations.

But at the same time, be patient and continue to persevere with the initiatives and indeed the engagements with those companies, recognising that the urgency continues to remain. Frankly, the issues that were material yesterday continue to be material today, and that engagement really is still the most powerful tool that we have in the investor toolbox to bring about that change that we're all seeking.

**Laasya Shekaran:** Thank you so much, it's clear that engagement is more important now than ever. It's great to hear your approach to this, and I'm sure listeners can take a lot away from this.

Listeners, if you want to make sure that you never miss an episode, hit the follow button, and remember that you can find us wherever you get your podcasts. Thanks for listening, and we'll see you on the next one.