



## **Herald's approach to ESG integration**

### **Introduction**

This paper outlines how Herald Investment Management Limited (“Herald”) integrates the consideration of environmental, social and governance (“ESG”) risks into the investment process.

### **Herald's approach to responsible investing and ESG**

We believe that good ESG practices are consistent with delivering better financial performance. The UK Stewardship Code and the UN-supported Principles for Responsible Investment (PRI) recognise that institutional investors have a duty to act in the best long-term interests of their beneficiaries.

Herald shares the belief underlying the Principles, namely that ESG issues affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time).

At Herald, we believe that successful investing is about identifying, and owning for the long-term, companies that can sustainably generate excess returns on capital for years to come. Our objectives are to achieve attractive returns over the medium-to-long term whilst minimising the risk of permanent capital loss for our clients. To achieve this, we seek to identify and invest in high quality companies that are trading below our assessment of their value.

It is within our assessment of a company's quality that ESG factors play an important role. As long-term investors, an assessment of ESG risks and opportunities are an inherent part of our investment process as gaining a robust understanding of these issues is a key part of assessing the outlook for future cash flow generation and risks of an investment.

As long-term owners we aim to act as responsible stewards of our clients' investment by exercising our proxy voting rights and having open dialogue with portfolio companies on a broad range of issues, including ESG-related issues.

Over the years, we have taken steps that highlight our commitment to responsible investing, and we will continue to review and evolve our approach to responsible investment. We have been abiding by the UK stewardship Code since 2010 and in January 2020, we became signatories of the United Nations-sponsored Principles of Responsible Investment (PRI), the globally recognised accord for responsible investment,

### **Objectives**

Herald's ongoing Responsible Investment objectives are:

- To assess material ESG risks as part of the investment process; and
- To act as responsible owners by engaging with portfolio companies where a material ESG issue exists and exercising our proxy voting rights where appropriate



## Integration of ESG into the investment process

For Herald's actively managed portfolios and investments, Herald's Investment team undertakes in-depth, company research, seeking to identify sustainable competitive advantages that enable businesses to generate excess returns on capital and predictable cash flow.

As bottom-up fundamental investors, we consider ESG risk alongside other risks faced by companies we own and investigate. ESG risk analysis is integrated in our investment process and is not a separate function. We are active investors who interact closely with the management of the companies in which we invest as well as their suppliers and customers where possible.

We recognize that ESG considerations, such as a company's board structure, environmental practices, or labour policies, can affect a company's valuation and financial performance. Therefore, our investment professionals incorporate ESG issues into their research and decision-making process. Investment research includes an assessment of a company's inherent quality based on the following quality criteria:

- Economic Moat – Assessment of the sustainability of a company's competitive advantage(s)
- Agency Risk – Assessment of the extent that management will act in the best interest of shareholders
- Business Risk – Assessment of the predictability and reliability of future cash flows and earnings
- Re-Investment Potential – Assessment of a company's ability to reinvest profits back into its business at high incremental rates of return.

Analysis of ESG factors forms part of the suite of issues that affect the Agency and Business Risk of companies. Gaining a robust understanding of these issues is a key element in the assessment of the outlook for, and risks to, the sustainability of future cash flow generation. Importantly, Herald is focused on materiality. Herald's Investment team will make a determination about the ESG risks that are material for each company.

Assessing a company's corporate governance practices is, and has always been, an important aspect of Herald's investment processes. We recognize that there is no one single indicator with global application that identifies when companies are failing to adopt best corporate governance practices, and that different markets may adopt different practices and structures of corporate governance. Therefore, our approach to corporate governance may change according to a company's local laws, regulations, and established guidelines.

Specifically, as it relates to environmental issues, we recognize the growing importance that these factors play in our global economy. While the importance of these factors will differ by company, sector, or region, as our investments are focused in the technology, media, and telecommunications sectors, these companies tend to be enablers of environmental efficiency rather than contributors to environmental risks.



Although, no industrial sectors are currently explicitly excluded from the remit, the nature of the Technology, Media and Telecommunications (TMT) sectors that Herald focuses on implicitly, limits investment in a number of the most environmentally damaging sectors, such as coal mining or generating energy by burning fossil fuels. The fund's focus on TMT sectors, to some extent inherently limits exposure to some key environmental risks

## Proxy Voting

Herald considers that proxy voting rights are an important power, which if exercised diligently can enhance client returns and should be managed with the same care as any other asset managed on behalf of its clients.

Herald will assess shareholder proposals on a case-by-case basis and consider whether the shareholder proposal will enhance the certainty of long-term cash flow generation that we expect from the company.

## Engagement

As a long-term investor, Herald is committed to engaging with all portfolio companies on a broad range of issues. Matters of strategy, capital structure, performance and risk, etc are the responsibility of the Portfolio Manager and Investment team and are the subject of regular engagement.

Herald focuses its engagement on material issues, particularly those which could affect future cash flows. We are also focused on safeguarding against short term actions by either companies or their shareholders which may not be in the best interests of our clients. The level of engagement on ESG issues is also considered in the context of the relative size of Herald's shareholding.

Engagement in relation to ESG issues can take a number of forms and does not necessarily involve Herald seeking to effect change. For example, many companies conduct annual shareholder outreach programs as a forum to discuss general corporate governance, sustainability, executive compensation, any changes or initiatives a company has made throughout the year and provides the opportunity for a company to solicit shareholder feedback and discuss views provided by other shareholders.

Herald may also seek engagement to achieve a better understanding of the management of material ESG issues or to seek clarity in relation to a specific proxy proposal.

In many cases, engagement is a result of proxy voting. For example, depending on the materiality of the issue and the size of Herald's holding, where Herald has determined to vote against management's recommendation, Herald may engage with a company outlining its rationale for the vote and providing advice on what the company should do to remedy the issue.

When seeking change, Herald will typically begin engagement with company management, or through investor relations. Herald may seek to escalate engagement from management to committee Chairs,



Senior Independent Directors and/or Chair of the Board. Herald is cautious of collaborating with other shareholders due to concerns about breaking concert party rules or insider trading regulations but on occasion may do so when it is believed to be in the clients' interests.

Herald also recognizes the limitations of our influence as a minority shareholder and in cases of strong disagreement our ultimate action may well be to sell the investments.