Herald Investment Management Limited Approach to ESG Integration

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Herald’s approach to ESG integration & engagement

Introduction

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

Herald’s approach to responsible investing and ESG

We believe that good ESG practices can be consistent with delivering better financial performance when effectively implemented. 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 and wider society, 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 objective is 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 responsible, long-term investors, an assessment of ESG risks and opportunities is an inherent part of our investment process. Gaining a robust understanding of these issues is a key part of assessing the outlook for future cash flow generation and the risks to an investment.

As long-term owners we aim to act as responsible stewards of our clients’ capital 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;
- To act as responsible owners by engaging with portfolio companies where a material ESG issue exists and exercising our proxy voting rights where appropriate; and
- To identify portfolio companies with high CO2 emission risk and encourage reporting and reduction in line with TCFD guidance through engagement.

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 flows.

As bottom-up fundamental investors, we consider ESG effectiveness alongside other risks faced by companies we own and investigate. ESG analysis is integrated into 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, customers, and competitors 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
- Reinvestment 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 range of issues that affect the economic sustainability, 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. Herald's investment team will make a determination about the ESG risks that are material for each company. We look for companies with strong staff and customer retention, which generally denotes a strong social and governance environment. We do this by directly interacting with management and by reviewing available quantitative and qualitative data on an annual basis as well as ad-hoc for any extraordinary ESG incidents. Any material risks identified may warrant further engagement where necessary.

Guidelines On Exclusions

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.

Guidelines On Environmental Factors

HIML recognises the growing importance that environmental issues play in our global economy. The scale of these factors will differ by company, sector, or region. Companies within the TMT sectors tend to be enablers of environmental efficiency rather than contributors to substantial environmental damage. Nevertheless, climate change and its effects will continue to pose ever changing systemic risks. We understand these risks vary by industry and as such should be managed using the principle of materiality in accordance with TCFD guidelines, so as not to put undue burden onto smaller companies which do not have a large environmental impact.

As a result, we have developed a more focused emissions related risk methodology to help identify investee companies which may be high emitters and encourage them to improve climate related disclosures and reduce emissions. We realise there is an additional cost to this. Many of the companies in our small cap portfolio are in the early stages of establishing their businesses and have far more limited resources for providing comprehensive ESG reports than larger, more established companies. However, we believe there can be benefits to being environmentally responsible as it keeps staff loyalty and retention high as well as ensuring the ever-increasing requirements of high-quality customers and consumers are met.

Our climate change risk matrix highlights the highest emitting companies in our portfolio based upon their Bloomberg BICS Level 3 Sectors and allocates them a risk factor from 1-6 with 1 being the lowest risk and 6 being the highest. Companies which have a risk factor of 3 and above based on their sector are then identified for further analysis. We own no companies in the highest risk category and a large proportion of HIT are at the lowest risk. The majority of companies in the medium-high exposure are in the semiconductor and technology hardware sectors, which are ranked as 4 out of 6 in terms of environmental risk. We review the companies which emerge and check if the nature of their business model and likely emissions profile is in line with their risk classification. In several instances, the generic category classifications do not reflect the emissions of the specific company. Where relevant, a further assessment of the materiality of the environmental risks posed by the operations of the highlighted business is carried out. If the company is likely to be a higher emitter, we check their reporting of emissions and if they have a reduction plan. If either are absent, an engagement process with the company will be initiated with the intention to encourage both reporting and the enactment of a reduction or abatement plan. By identifying these riskier sectors and analysing their ESG credentials we are mitigating the climate risk posed by these companies.

Where applicable, HIML will use our proxy votes for shareholder resolutions relating to these environmental issues. HIML also track to see if our investee companies have other key policies related to the environment, such as those relating to water usage and hazardous waste. This helps ensure responsible production and consumption of vital resources.

Guidelines On Social Factors

Herald tracks a range of social factors which affect businesses and employees, many of which are indicators of the quality of governance within the company. Many of these factors are assessed through our engagement with the businesses, and include employee turnover or diversity. Other factors are evaluated using Bloomberg data. Tracking if the company has policies on key issues such as human rights, anti-bribery, I.P protection and child labour. The business models of investee companies typically involve the employment of highly skilled, well-paid staff. They are typically paid above national average wages and their employee welfare standards are generally good. There is internal judgement and subjectivity applied to this section to determine their relevance in the context of the geographies in which the companies operate. We are supportive of global norms on human rights, labour, environmental and anti-corruption standards. These guidelines are encapsulated in numerous frameworks which are being progressively adopted by the small companies in which Herald typically invests. Many of the larger companies in the technology sector such as Apple and Microsoft lead in the adoption of such frameworks.

Guidelines On Governance Factors

Assessing a company's corporate governance practices has always been a crucial aspect of Herald's investment process. We recognize that there is no 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. However, the majority of our interactions relate to board composition and compensation to ensure the appropriate skills and independence are available to oversee accounting risk and other governance functions. Using engagement and our proxy votes to ensure appropriate oversight. As such, we believe governance cannot be easily encapsulated using numerical metrics but requires a more holistic approach. Therefore, our approach to corporate governance may change according to a company's local laws, regulations, established guidelines and the size and maturity of the company, and will be informed by our interactions with the company's management team and Board.

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. We assess company proxy proposals on a case-by-case basis and consider whether the resolution will enhance the certainty of long-term cash flow generation that we expect from the company. As previously mentioned in the preceding sections, where a company fails to address the concerns raised by Herald on ESG factors discussed, we will consider escalation through the use of our proxy votes to encourage improvement.

Engagement at Herald

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, 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 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, or any changes or initiatives a company has made throughout the year and provide 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, the Senior Independent Director and/or the 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.