Our focus as active fund managers is on finding mispriced stocks. We are open to buying companies whose qualities and future potential are not properly reflected in their share prices. Equally, we look for companies whose willingness and efforts to change have yet to be recognised by the market. Correctly anticipating change for the good and the scope for market perceptions to catch up with reality can generate strong investment returns. The key is identifying the issues and focusing on the path to improvement.

The same principles apply to how we see ESG: many of its key aims and principles are well aligned with our long-term investment focus and engagement with the companies we own. Investment opportunities can arise from market dislocation related to ESG, as they can from other share price drivers. For example, a better investment outcome and greater progress towards achieving ESG’s basic aims may well be achieved by backing companies which have improving ESG momentum.

We do not automatically exclude companies where we see ESG risks. We try to be forward looking rather than backward looking. If there are material ESG risks, then we take those into consideration as part of our overall analysis and in determining the risk/reward for a particular stock.

Getting to the right answer involves more than just focusing on information provided by the ESG rating agencies. They provide some useful insights and information as to what the key ESG issues are and how they are viewed today. We will consider such research but the proprietary research and analysis we carry out, to try to anticipate how a company’s ESG strategy evolves in the future, will be more important to us.

Our overall investment process composes of five major components. In this note we go through in detail how ESG is integrated in our process.

Figure 1
Our overall investment process composes of five major components

Idea generation → Fundamental research → Portfolio construction → Valuation monitoring

Assessing and monitoring risk

For illustrative purposes only.
Component 01  
Idea Generation

We try to 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. 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.

ESG can create opportunities too – for example, the benefits of moving towards more sustainable sources of energy like wind generation. This was one of the reasons we became interested in a Danish wind turbine designer and manufacturer back in 2018. More important was our view that earnings downgrades were starting to stabilise with the valuation depressed versus its history. 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 generate alpha.

Component 02  
Fundamental Research

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. The key drivers will differ according to each stock.

With regards to ESG, we have a lot of resources available to us when we want to analyse an issue (or opportunity) further – the individual FMs, the team’s own knowledge, our own in-house ESG team and third-party research. This leaves the team well placed to decide what the key ESG issues are and, if they are significant or not. If material, and key to the long-term outlook of a company, we will undertake further investigation at this stage.

Our awareness and analysis of specific ESG issues has stopped us from initiating a position. For example, we were interested in a German company in the utilities sector exposed to several positive drivers, amongst which included management plans to transition towards a renewables company. However, the interim stage of heavy dependency on lignite (one of the most harmful types of coal) was too big an obstacle for us to get comfortable with, especially as there were similarly valued alternatives with cleaner transition stories within the sector.

We will always try to meet with the company. Based on our fundamental research, including any ESG findings, we will 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.

Likewise, with any sales ESG plays a role in various ways as it influences not only the potential upside, but also the risks to this upside being realised. To be clear we do not seek out stocks to reduce benchmark risk nor companies which score well on ESG screens. In the next section we discuss how we monitor our holdings from an ESG perspective, which will also influence the weightings of individual stocks.

Component 03  
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. The impact of any new purchases will need to be considered at a fund level and how it would affect the shape of the portfolio.

Likewise, with any sales ESG plays a role in various ways as it influences not only the potential upside, but also the risks to this upside being realised. To be clear we do not seek out stocks to reduce benchmark risk nor companies which score well on ESG screens. In the next section we discuss how we monitor our holdings from an ESG perspective, which will also influence the weightings of individual stocks.
Component 04
Valuation 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? Are the anticipated key drivers playing out or not? Likewise, we'll monitor how companies are performing from an ESG perspective and if the valuations are fairly reflecting the progress being made or not.

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 managements of the companies we own provides an ideal platform to discuss key ESG issues, which will be researched in advance. We will draw on our own knowledge as well as relevant analysis from our ESG team and data from our recently developed proprietary system, called ESGintel. This system includes an internal ESG rating, a rating trend and an intra-sector rank. There is also a score for materiality - targeting issues that matter most for sustainable value creation and risk management. 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 will be carried out by the team, when warranted, on particular companies. Depending on the particular case this will often be in conjunction with the ESG team. Such cases will likely 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.

Component 05
Assessing and 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 we hadn't considered to be material enough earlier in the investment process. It is our responsibility to decide if it is appropriate, or not, to investigate these issues in more detail. We could well ask the ESG team to undertake more analysis or discuss this 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.

In addition to the above, the team also produces a quarterly ESG report which highlights, for clients, the ESG-related activities over the quarter: engagement with management, stock specific examples, voting policy and statistics, ESG team key events and publications, etc.
Making Better Decisions
In the previous sections we’ve detailed how ESG is integrated at every stage of our investment process. In the chart below we highlight ESG in isolation and how it helps us as fund managers to make better informed decisions for our investors.

**Inputs to fund managers**

**Invesco ESG team**
- Regular formal ESG review meetings at portfolio level
- Information on latest ESG industry trends
- Support/discussion on AGM voting best practice
- Internal in depth ESG notes
- Ongoing interaction on stocks with particular ESG challenges
- ESGintel – proprietary ESG rating tool

**Fellow fund managers**
- Knowledge of management teams, corporate backgrounds & sector and country specific factors

**Third party ESG research**
- Access to external notes/ratings as inputs for stock research & company meeting preparation

**Impact**
- Improve fund managers’ awareness of ESG issues as others see them
- Improve rigour of stock analysis & meeting preparation
- Better able to assess the magnitude or significance of ESG issues
- Improve quality of dialogue/meetings with company management

**Result**
To give fund managers the tools needed to make better informed decisions

**Outputs from fund managers**

**Portfolios**
ESG issues are assessed by fund managers as part of our stock analysis alongside other criteria, but are not the sole investment driver
- We are ESG rating aware not ESG rating driven
- Bad/improving/good ESG as an influence on appropriate valuation?
- Bad/improving/good ESG as an influence on appropriate weighting?

**Analysis**
Relevant ESG issues raised in investment team’s internal notes to improve team efficiency

**Voting/Influencing managements**
- Final say on voting remains with the fund manager, but ESG team’s deep knowledge of best practice is taken fully into consideration
- Joint action by ESG and investment teams facilitates better corporate practice

**Our aims**
- Through ‘Engagement’ rather than ‘Exclusion’ identify potential for positive ESG momentum which may influence share prices, rather than ESG perfection which may already be priced in
- Better communicate to clients our ESG interactions

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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.

### Austrian energy company

**Key ESG issues**
- Rated **High Risk** by Sustainalytics. Corporate Governance and Emissions, Effluents and Waste rated as **Medium Risks**.

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<th>S</th>
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<tbody>
<tr>
<td>Energy Transition</td>
<td>Just Transition</td>
<td>Renumeration policy linked to carbon targets</td>
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**Our assessment**
- Of the specific risks highlighted by Sustainalytics “emissions, effluents and waste” is considered to be one of the most serious ones.
- The Climate Action 100+ group, of which Invesco is a member, is made up of 500 investors with over $45 trillion of AUM. This initiative aims to ensure various companies align with the Paris goals, for example achieving net zero emissions by 2050 or sooner.
- Invesco, in combination with an Austrian bank, are the two co-lead investors working directly with the energy company, in the pursuit of the key Climate Action 100+ group targets.
- Building on previous 1:1 interactions with the Chairman in 2019 – in which the company has responded positively by introducing various measures - the ESG team have been proactive in ensuring the company’s climate strategy continues to evolve further.
- In Q3, the Invesco ESG team provided detailed feedback to the company on their first lobbying report and held two constructive engagement meetings where Invesco was able to ask clarifying questions but also state the ESG evolutions Invesco are looking for. The aim is to build on the carbon targets already implemented by the company to ensure they will be compatible with Paris goals i.e. longer term net zero emissions.
- Aligning management remuneration to longer term net zero carbon emission targets was another topic discussed.
- As co-lead investors we expect further constructive discussions with management on the above topics as well as other relevant ESG issues.

### German polymer manufacturer

**Key ESG issues**
- Rated **Medium Risk** by Sustainalytics. E&S Impact of Products and Services rated as a **Medium Risk**.

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<tr>
<td>Environmental impact</td>
<td>Human Capital Management</td>
<td>Management reaction to Coronavirus</td>
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**Our assessment**
- Sustainalytics highlights the harmful impact of the company’s Products and Services on Society and the Environment. These include input materials, the impact during use, disposal and recycling.
- Our 1 to1 meeting with management in August gave us an opportunity to scrutinise their plans - presented at the H1 results - to become “fully circular” and assess their 2025 ESG targets.
- A number of projects have already been implemented with various other initiatives due to be rolled out. These involve:
  - Using alternative raw materials e.g. biomass
  - Adopting more energy efficient technologies e.g. recycled polycarbonates
  - Greater use of wind and solar energy
- To date many of the implemented projects are making good progress. Other positive steps include the new contract to provide 100 MW of electricity for 10 years from 2025.
- Other developments include board members taking a bigger proportional salary cut than those imposed on employees. The vacant SRI board position has now been filled.
- Overall we are encouraged by the progress management are making in addressing the environmental impact of its products and services. We are confident this will continue moving forward.

### Dutch manufacturer of LED and connected lighting solutions

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

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<tbody>
<tr>
<td>Energy efficient lighting solutions</td>
<td>Market dominance could lead to anti-competitive practices</td>
<td>Strong corporate governance performance</td>
</tr>
</tbody>
</table>

**Our assessment**
- The company became an independent company in 2016.
- The shares sold off aggressively during the first quarter of 2020 due to the company’s exposure to construction end markets which were greatly affected by Covid-19 lockdowns.
- Its suffering was compounded by a recent US acquisition involving leverage which was unfortunately timed.
- However, one of the key attractions for us is that sustainability is a core component of the corporate culture which is in turn a source of competitive advantage.
- This simply wasn’t captured in its valuation.
- Some examples of its sustainability credentials include: a relentless commitment to reducing energy consumption; its provision of hygiene solutions through UV-C Light solutions preventing the spread of Covid-19; smart farming light solutions allowing more local farming at better crop yields and; its goal of doubling its revenues from circular products, systems and services by 2025.
- This commitment to change has presented the company with the chance to build new revenue streams, lower its costs and reduce its cost of capital, as highlighted above.
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 and Glass Lewis.

Especially 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 ISS and Glass Lewis 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 challenge on our part, but rather that we believe that the governance of the companies in which we are invested is already good and worthy of support. There may be instances where we vote in support of management, but the governance is not perfect. 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, might lead to a vote against in the future.

Conclusion

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.
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.

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