Active ownership of passive Exchange Traded Funds (ETFs)

HSBC
Asset Management

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Foreword

At HSBC, we are active stewards for our ETF clients

ETFs are an efficient way to invest in a range of markets without having to spend time choosing individual stocks. These funds aim to replicate the investment returns and characteristics of an index. Managers of passive ETFs do not have discretion to reduce exposure to, or divest from, the companies in the relevant index.

Precisely because they cannot sell the companies in an index, ETF investors are the ultimate long-term owners. How well companies manage the environmental, social and governance (ESG) issues that impact company returns over time therefore is of crucial importance to ETF investors. In the same manner ETF managers who undertake detailed stewardship of the companies in their funds are working to protect and enhance the returns of their ETF investors. That's why at HSBC we are passionate about the stewardship of our ETF assets.

We are large, long-term owners with the scale, reach and depth of knowledge to be effective in exercising our fiduciary duties to engage with the companies we hold on behalf of our clients.

Our ETFs are part of our global asset management business, with over USD74bn[1] of assets under management in our passive and systematic equity strategies.

Our active ownership, aiming to support and encourage companies to follow principles of good governance, and environmental sustainability, means we can positively impact the long-term value of our client's investments.

Effective stewardship is widely regarded as a driver of enhanced operational and financial performance. It helps to reduce risks and maximise returns at the individual investment level, as well as enhance overall market stability and deliver positive impacts for society and the environment more generally.[2]

At HSBC, we are able to use our significant influence as investors to encourage corporate behaviour that enhances value, through company engagement, proxy voting, and as signatories to investor stewardship codes as the Principles for Responsible Investment, the UK Stewardship Code and the Hong Kong Principles of Responsible Ownership.

This paper provides a brief summary of our proactive engagement, voting, public policy and advocacy activity as active stewards for our passive ETFs, and gives an insight into how we leverage our extensive experience and depth of resources in these areas for the benefit of our ETF clients.

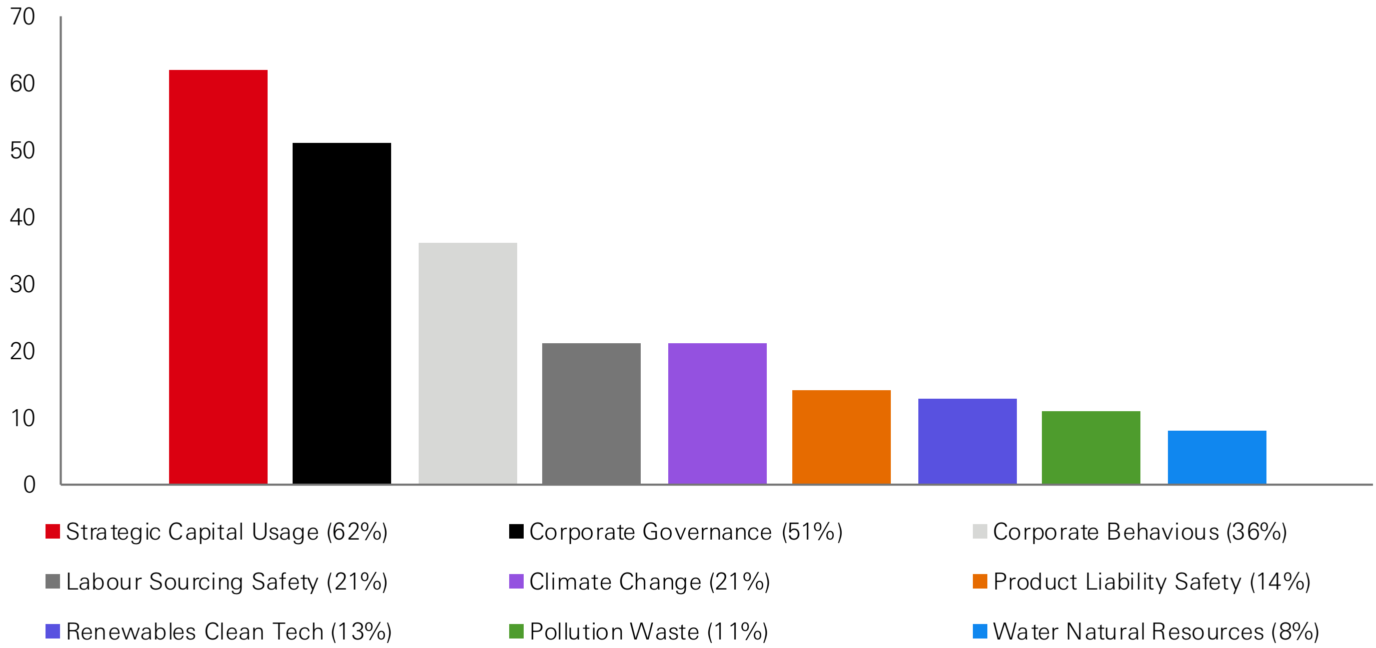
[1] Source: HSBC Asset Management, as at end December 2020
[2] Source: ShareAction 'Point of no Returns' report, March 2020

Active ownership – engagement

At HSBC, we prefer to engage with companies to inspire change rather than exclude them, whilst for many of our ETFs exclusion is not an option for funds which hold shares in all the companies in their index. Our stewardship has been recognised as market leading, with A+ ratings from the global Principles for Responsible Investment and a Tier 1 ranking under the UK Stewardship Code[3].

We engage with fund constituent companies to improve company practices, across a range of environmental, social and governance issues, as shown below:

Themes discussed during company engagements[4]



Given the typically diverse make up of passive portfolios, smaller players may lack the depth of research resources and depth of knowledge needed to engage constructively with constituent companies, but we engage across equity and fixed income holdings globally, leveraging our extensive research capabilities across both asset classes.

In 2020, we carried out 2,300+ issuer engagements globally. Through our engagement with companies held within our ETFs, we aim to convey investor concerns and look for these to be addressed, recognising that sometimes a number of engagements is required for change to be brought about. We prioritise engagements based on our holding, issue and exposure, not necessarily whether we expect change, although we can demonstrate positive outcomes in many instances.

More details of HSBC's engagement activities can be found in our annual Responsible Investment Review, which provides investors with key information about our active ownership undertakings and illustrates the importance we place on stewardship.

[3] Source: Annual PRI (Principles for Responsible Investment) assessment, 2020; UK Stewardship Code, 2016
[4] Source: HSBC Asset Management, as at 31 December 2020

Examples of our engagement include:

Tesco – constituent of the HSBC FTSE 100 UCITS ETF and HSBC MSCI Europe UCITS ETF

Issue	Engagement	Change
We conducted a thematic engagement project into post-consumer packaging waste risks faced by consumer staples companies. Our research suggested Tesco was highly exposed to the risks of packaging waste but was also a leader in managing the issue. However, we felt there were a number of aspects of their packaging waste practices and policies that we wanted to understand better and influence.	First we wrote to the company and outlined our research, views, and questions. Tesco offered us a written response as well as a formal engagement meeting with one of their managers for packaging reduction. We learned about Tesco's plans for refillable packaging, reverse vending, and setting appropriate waste reduction targets. We encouraged the company to make absolute waste reduction by weight explicit in its goal setting.	We were encouraged that the Tesco team agreed with our assessment of the risks and opportunities presented by post-consumer waste, and are implicitly focused on absolute waste reduction. In early 2021, the company announced it had removed 1bn pieces of plastic from its packaging in the past year. We hope to see the company expand the target and give investors more granular detail on the absolute packaging weight reduced. We are considering how we can support this work further via our engagement, voting and advocacy.

Samsung Electronics – constituent of the HSBC MSCI AC Far East ex Japan UCITS ETF

Issue	Engagement	Change
We had concerns regarding Samsung's approach to working conditions, health and safety standards and related disclosure. There have been serious allegations of human rights and labour rights violations including health and safety practices linked to worker deaths, poor wages, unpaid overtime, obligatory overtime and extended work hours, no time off work, exploitation, intimidation and union busting at the company's factories.	We have met with the company regularly over a number of years to raise our concerns and seek company commitments that they will be addressed.	We were already engaging with the company when the Chair and several other Executives of the company were sentenced to time in prison for undermining labour union activities in South Korea. We will continue to engage with the company on labour standards, including Freedom of Association across all geographies where they operate.

Facebook, Alphabet and Twitter – constituents of the HSBC S&P 500 UCITS ETF and HSBC MSCI World UCITS ETF

Issue	Engagement	Change
Engaging with the social media companies on the issue of live-streaming and distribution of content that promotes or supports – or tends to promote or support – acts of torture, terrorism or the infliction of extreme violence or extreme cruelty.	Following the transmission of the violent attacks in New Zealand, we joined a collective engagement initiative with Facebook, Alphabet and Twitter to encourage the companies to establish robust policies and procedures to manage these risks. This engagement is led by NZ SuperFund.	We were signatory to letters raising our concerns to the companies. Subsequent meetings with Facebook and Twitter have provided greater clarity on the different company approaches, although it is not clear whether changes implemented are proportional to the scale of the issue and risk. Alphabet have improved disclosure of their controls over content, although do not engage in open dialogue on ESG issues.

Source: HSBC Asset Management, 2021.
For illustrative purposes only and does not constitute any investment recommendation in the above mentioned companies.
This example is historic and contains information that is not current and should not be construed as an offer to sell or a solicitation of an offer to purchase or subscribe to any investment, and does not constitute any investment recommendation in the above mentioned companies. The views expressed were held at the time of preparation and are subject to change without notice. Any forecast, projection or target when provided is indicative only and is not guaranteed in anyway.

Active ownership – collaborative engagement

We actively engage in investor-led collaborative engagement initiatives. These may form part of a broad initiative to address systemic issues or may reflect an escalation of company-specific concerns shared by investors.

Collective engagement helps companies by allowing a focused dialogue with a number of investors on issues of concern. Collective effort can be more efficient and lead to better results, because companies get a chance to hear the same view from more than one investor. At the same time, it allows investors, whether in passive or active strategies, to share resources and insight, allowing them to engage more effectively with each company they approach.

As our ETF clients would expect, we are fully transparent in our reporting of our engagement and voting activity, publishing our voting on a quarterly basis and summary information about our engagement activity annually.

An example of where HSBC has helped to lead collaborative engagement is Climate Action 100+, the largest ever global collaborative investor engagement initiative, seeking alignment with the Paris Agreement. There are over 540 investor signatories under the initiative with USD52 trillion in AUM[5] – this scale provides us significant ability to influence companies on the critical issue of climate change, on behalf of our clients in both our active and passive investment strategies.

Shareholder resolutions have been used under the Climate Action 100+ initiative as a means of promoting better management of climate risks. As at March 2021, we have participated in 11 collaborative engagements led through Climate Action 100+.

These include our work in 2020 leading engagement as part of Climate Action 100+ with BHP Group[6], a global resource mining company and constituent of the HSBC FTSE 100 UCITS ETF:

Issue

BHP is one of the world's largest producers of iron ore, mining a range of other minerals, including metallurgical and thermal coal, as well as maintaining oil & gas production. The company had been a leader in its sector in addressing the challenges of carbon transition but needed to make new commitments to meet rising investor expectations.

Action Taken

We are the European lead investor with the company and met the company more than a dozen times over the course of the year, providing feedback on various aspects of its climate strategy, as well as co-ordinating support investors and engaging with other listed members of the controversial Minerals Council of Australia lobby group.

Outcome

The company added to its existing net zero operational emissions commitment with a 2030 target to reduce operational emissions by 30%, announced work to explore reductions in scope 3 emissions in its use of shipping and in steel production, strengthened the link between executive remuneration and the climate plan and improved its analysis of the impact of a 1.5-degree scenario on its portfolio. It also committed to sell its thermal coal business.

[5] Source: www.climateaction100.org, as at January 2021

[6] Source: HSBC Asset Management. For illustrative purposes only and does not constitute any investment recommendation in the above mentioned companies. This example is historic and contains information that is not current and should not be construed as an offer to sell or a solicitation of an offer to purchase or subscribe to any investment, and does not constitute any investment recommendation in the above mentioned companies. The views expressed were held at the time of preparation and are subject to change without notice. Any forecast, projection or target when provided is indicative only and is not guaranteed in anyway.

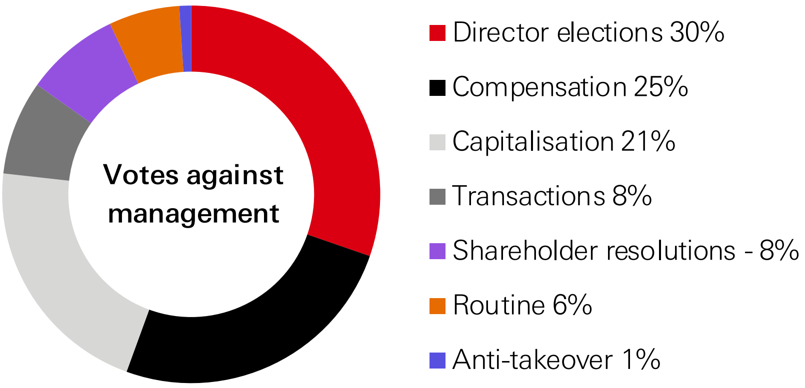
Active ownership - voting

Exercising voting rights is an important expression of our stewardship and broader responsible investment approach, and we vote on all equities held within our ETFs except in very few cases where the process of cost undermines investor interests.

Our global voting guidelines aim to protect investor interests, foster good practice and enhance long term value. We expect companies to apply governance good practice for their market of listing and, for larger companies, to meet globally-recognised good practice standards.

In 2020, we voted on over 82,500 resolutions at around 8,000 company meetings across 70 markets, representing 96% of the ballots which we were entitled to vote. We supported management on 90% of resolutions, abstaining or voting against on 10%.

The issue we most frequently opposed was director re-election (30% of votes against management) predominantly for reasons of lack of independence, followed by executive pay – either because it was too high or not linked to performance (25%), and capitalisation issues (21%). We voted against at least one resolution at 43% of all company meetings:



Our votes differed from the proxy voting standard policy recommendation on more than 7,000 resolutions (8%). More than half of our votes on these resolutions were against management, with capitalisation and director elections in China, and executive pay in the US the main areas where we had voted against management more often.

Shareholder dissent has been shown to be an important precursor to leadership and governance changes in firms[7], and in 2020, we engaged with 310 companies to discuss our voting decisions on resolutions where we felt unable to support management. These companies were prioritised based on our largest holdings and markets and represented circa 38% of our total HSBC ETF assets under management[8].

One key area of voting-related engagement focus for us is board composition. The conduct and composition of a company's board are important to a company's performance, and independent representation on boards is an important element in advancing the interests of all shareholders. We have focused in particular on Japan, one market which has some of the lowest levels of independent board representation seen in developed markets.

[7] Source: Proxy Advisors and Shareholder Dissent: A Cross-Country Comparative Study, Sauerwald, et al., Journal of Management, 2016

[8] Source: HSBC Asset Management, as at 31 December, 2020

Issue

Many Japanese companies have very few independent directors. The market requirement is for only two outside directors who need not be independent. We believe that larger companies with international investors can be held to a higher standard and seek at least one-third board independence.

Action Taken

We write every year to companies in the local TOPIX100 index with independent directors making up fewer than one-third of their board, asking them to indicate if they will improve their balance. We escalated this issue two years ago for companies which still did not meet the one third standard by voting against all non-independent directors, other than the CEO and Founder/President.

Outcome

There has been a steady increase in the number of companies meeting the one-third independence standard. Out of 71 companies we have written to since 2017, 27 now have at least one-third independent directors on the board.

Our engagement with Japanese companies on this issue is ongoing and we hope to see increased levels of independent representation on boards, accompanied by increased transparency around the nomination process for directors.

This should be of benefit to our clients invested in the HSBC MSCI Japan UCITS ETF, which aims to track as closely as possible the returns of the MSCI Japan Index, made up of large and mid-sized Japanese listed companies. Some of the companies that we engage with on this issue are found in the top five weighted constituents of the index[9] - Toyota Motor Corp, SoftBank Group Corp and Keyence Corp. These Japanese companies are also significant in developed world funds, such as the HSBC MSCI World UCITS ETF.

[9] Source: MSCI, as at 31 December 2020

Active ownership – public policy and advocacy

We meet with regulators and policymakers, both indirectly and through industry networks, to advocate for progressive public policy action on a range of themes which help safeguard our ETF investors' long-term interests.

One such theme is improving market standards and transparency on sustainability; we recognise that standards and transparency are central to providing the appropriate information for us as investors, as well as for our clients. Companies that measure their ESG impacts are more likely to manage them; those that publish the data can be held to account.

HKEX – listing requirements

Response to public consultation	Outcome
We responded to the public consultation on the ESG reporting guide and related listing rules by the Hong Kong Exchanges and Clearing Limited (HKEX), where we expressed support for enhanced disclosures of board responsibilities over material ESG issues, and their assessment and management of climate-related issues, amongst others.	This contributed to HKEX's revision of ESG requirements for Hong Kong listed companies, where most of the proposals were adopted, effective for financial years commencing 1 July 2020.

SEC – shareholder proposals rules & proxy voting regulations

Collective investor letter	Outcome
The proposals put forward by the SEC to amend shareholder proposals rules and the regulations governing proxy voting advice, prompted us to sign a collective investor letter, co-ordinated through the PRI, raising our concerns that the changes may compromise shareholder rights in the US and cautioning that these changes were likely to cause unintended consequences that could harm the governance of issuers and ultimately the value of investments.	Although the changes were largely adopted, the strength of shareholder opposition may incentivise the new US administration to amend them.

Active ownership for our HSBC ETFs – looking forward

Our established active ownership approach including voting, engagement, public policy and advocacy drives positive behaviour, promotes high standards and ensures the interests of all stakeholders are considered. We use our influence as global, large investors, to try to enhance the companies in which our ETFs invest.

HSBC's ETF solutions are built on our strong index tracking heritage, with over 30 years' experience managing passive equity portfolios. Active ownership is central to our philosophy, beliefs and processes and as such is an important part of how we maximise long-term value for our ETF clients.

Looking ahead, we recognise the responsibility we have towards continuing to improve market standards and drive positive corporate practices, including in the areas of board composition and executive remuneration. Our engagements will also continue to focus particularly on supporting the transition to a low-carbon economy – reducing the role of coal and other fossil fuels – as well as protecting biodiversity.

Consideration of these important stewardship issues while investing efficiently through our established and disciplined processes is critical to delivering sustainable value for our ETF clients.

Important information

Key risks

The value of an investment in the portfolios and any income from them can go down as well as up and as with any investment you may not receive back the amount originally invested.

- **Concentration risk:** The Fund may be concentrated in a limited number of securities, economic sectors and/or countries. As a result, it may be more volatile and have a greater risk of loss than more broadly diversified funds
- **Counterparty risk:** The possibility that the counterparty to a transaction may be unwilling or unable to meet its obligations
- **Derivatives risk:** Derivatives can behave unexpectedly. The pricing and volatility of many derivatives may diverge from strictly reflecting the pricing or volatility of their underlying reference(s), instrument or asset
- **Emerging Markets risk:** Emerging markets are less established, and often more volatile, than developed markets and involve higher risks, particularly market, liquidity and currency risks
- **Exchange rate risk:** Changes in currency exchange rates could reduce or increase investment gains or investment losses, in some cases significantly
- **Index tracking risk:** To the extent that the Fund seeks to replicate index performance by holding individual securities, there is no guarantee that its composition or performance will exactly match that of the target index at any given time ("tracking error")
- **Investment leverage risk:** Investment Leverage occurs when the economic exposure is greater than the amount invested, such as when derivatives are used. A Fund that employs leverage may experience greater gains and/or losses due to the amplification effect from a movement in the price of the reference source
- **Liquidity risk:** Liquidity Risk is the risk that a Fund may encounter difficulties meeting its obligations in respect of financial liabilities that are settled by delivering cash or other financial assets, thereby compromising existing or remaining investors
- **Operational risk:** Operational risks may subject the Fund to errors affecting transactions, valuation, accounting, and financial reporting, among other things

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