# Executive Summary

The scarcity of resources makes commodity trading both an attractive but also sensitive issue for institutional investors as well as responsible private investors. The growing demand in commodity products is generally due to portfolio diversification. Products such as derivatives do not serve merely as hedging instruments, but to benefit from rising or falling price levels. Trading commodity products is hence, mainly not subject to interest in buying the physical underlying commodity, but to make financial benefits. The contemporary view in finance is that speculation is per se positive. However, this is not been shared in this thesis because only a small amount of the society benefits from commodity trading and negative impacts on the real economy as well as on poor people should not be underestimated.

Rising prices of precious metals used in the industry and of base metals, in general, harm the real economy, as industry needs in the procurement of raw material become more and more expensive. The increasing prices arising partly from speculation results in actually avoidable higher prices for states investing in infrastructure, for instance, or end consumers. Consequently, speculation and the corresponding rising prices impact the investment activity of nations and companies contributing wealth to the real economy.

Getting exposure to agriculture products is even more sensitive as trading these products can impact the survival of the poorest directly. Investors in agriculture markets are mainly blamed for contributing to rapid price rises as well as rising volatility. This is especially controversial since rising food prices can have significant impacts on poor people which has been seen in the past food crisis. Foodwatch, for instance, a politically active organization, launched a campaign against unethical bets on the soft commodity market, in order to abandon commodity trading in financial institutions, such as Deutsche Bank (Foodwatch (2011)). Hence, Deutsche Bank investigates whether its business with trading commodities is decoupled from the general law of demand and supply and examines if its activities have impacts on the growing amount of people that live below the poverty line (Teevs (2011)). Consequently, investments in, particularly, agriculture products need to be eyed with suspicion as rising prices directly impact the survival of the poorest in an economy. That is why investors need to take a critical view of these investments and balance the different impacts from a societal, social and ethical perspective.

The aim of this paper is to show how responsible investment is implemented in commodity trading. Therefore, not only environmental, social and governance (ESG) issues and the corresponding issues on responsible investment, but also its implications on commodity trading need to be analyzed in detail. The analysis will be implemented on the basis of a case study with Hermes Fund Managers, London (HFM). The goal of this case study is to identify responsible investment practices in commodities at HFM, analyze it and derive suggestions for other private or institutional investors. The information is gained through in-depth web research, internal information provided by HFM and an interview in order to get a deeper understanding of the internal processes that are linked to the ESG issues in their investment process. Hence, the following research question shall be answered:

*How is responsible investment in commodities identified and how are environmental, social and governance criteria integrated in Hermes Fund Managers' investment analysis and ownership practices?*

There are four types of possible investments in commodities that are subject to this thesis, namely, commodity derivatives, physical commodities, real productive assets and equity investments in the commodity sphere. The impact of ESG issues on commodity investments can be influenced by getting exposure to real productive assets and public companies that are active in the commodity sector. In contrast, the possibility to mitigate ESG issues into trading derivatives or physical commodities is very low. This is because these contracts are standardized and by holding a physical commodity investors do not have the incentive to actively contribute to a sustainable development of the commodity supply chain process.

Although there are already best practice guidelines across commodity-exposed asset classes that are supported by the Principles for Responsible Investment Initiative (PRI), these are still too broad. The guidelines should be more binding and more precise on their recommendations. Investors with a long-term horizon should only invest in real productive assets and commodity equities and keep away from investments in commodity derivatives or in physical commodities. As investments in real productive assets require more information that is mostly costly and difficult to access, a good alternative to get exposure in the commodity market are equities of public companies. Consequently, investors can use their shareholders rights to integrate ESG issues into the companies' decision making and governance.

The implementation of responsible investment in commodities at HFM seems to be ahead of those of other fund managers and private investors. Its direct investments in equities as well as the service they provide – Hermes Equity Ownership Services – is an excellent example of implementing responsible investment practices. Equity investment decisions are based on quantitative as well as qualitative research concerning ESG issues. This approach is also embedded in the service HFM provide because their aim is to pool shareholders' interests in order to get a big stake in the companies, so that it can influence the companies' decisions and governance according to financial as well as ESG issues.
However, HFM policies leave room for improvement, as HFM's commodity department only invests into standardized contracts like futures. Hence, they cannot contribute to a sustainable investment process in this regard. Although this is a problem with the nature of the type of the investment process, exposure to commodity derivatives was not reduced and replaced by investments in real productive assets or companies operating in the commodity sector.

Nevertheless, it would be short-sighted to conclude that HFM is not doing enough for promoting responsible investment, but it shows that there is further room for improvement on HFM's investment approach. At the same time, the PRI has shown weaknesses in case of investments in derivatives and physical commodities which calls for adjustments of these recommendations as well.