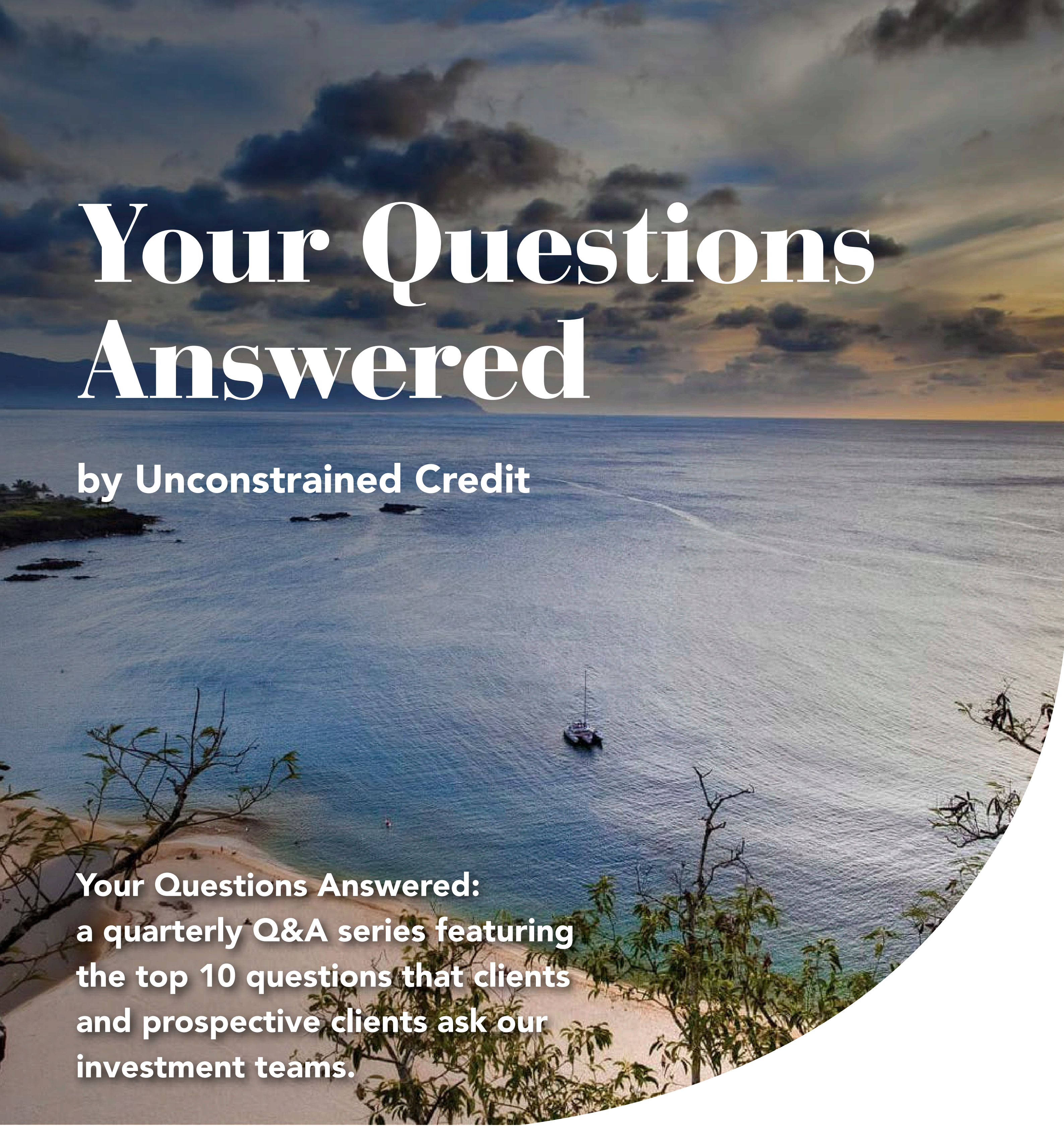


Your Questions Answered

by Unconstrained Credit

Your Questions Answered: a quarterly Q&A series featuring the top 10 questions that clients and prospective clients ask our investment teams.

July 2020

For professional investors only.

Federated Hermes

1 How is our Unconstrained Credit strategy different to other flexible credit solutions?

With a combined experience of over 40 years, the strategy's portfolio managers Andrew Jackson, Head of Fixed Income, and Fraser Lundie, Head of Credit, have managed a spectrum of funds during downturns and crises. Together, their vast experience alongside the diversity of our fixed income team acts as a key differentiator, enabling us to offer investors a dynamic credit-allocation solution that captures value from credit markets as investment conditions change and targets a gross return of the risk-free rate plus 5-6% per annum[1]. Although our specialist portfolio managers (such as EM, loans and ABS) and credit analysts provide views and trade ideas, final investment decisions and portfolio implementation are made by Lundie and Jackson.

Other notable differentiators include:

Bottom-up skill: through fundamental credit analysis, we identify issuers that drive returns in each credit market before searching their capital structures for the most attractive instruments.

Top-down oversight: we apply expertise from across the credit spectrum as well as insight from other asset classes. The Multi-Asset Credit Investment Committee (MACIC) drives our appetite for risk, steers the strategic asset allocation across credit classes based on their relative value, and determines what hedges are appropriate for the prevailing market environment.

Full spectrum: unrestricted by security type or geographical silos, we seek to exploit opportunities in developed and emerging markets for investment grade and high-yield corporate bonds, credit default swaps, loans, asset-backed securities and government securities.

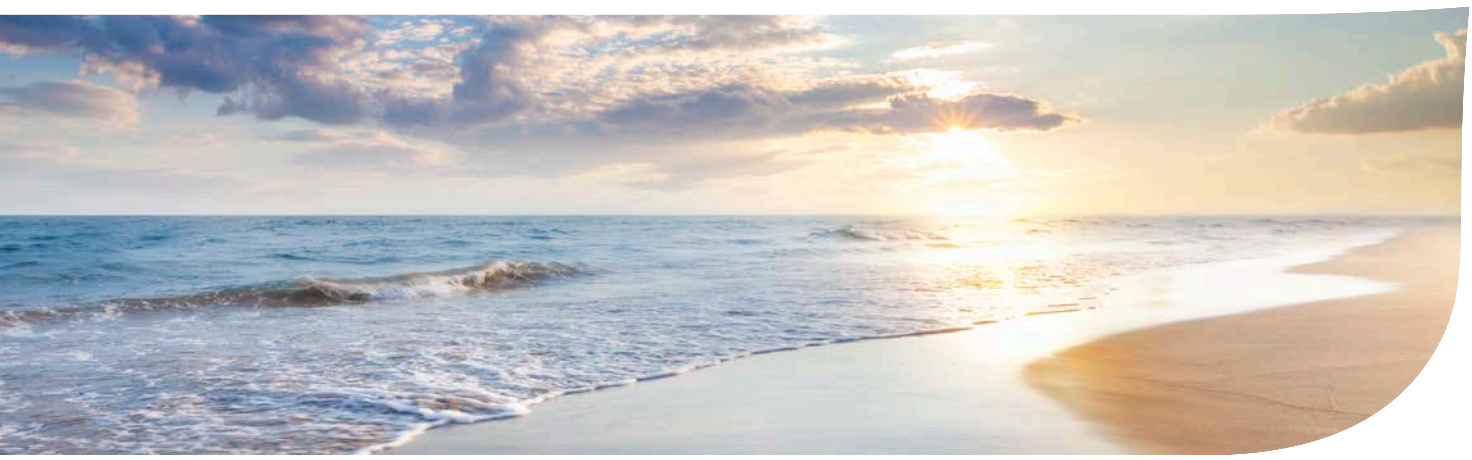
Our best ideas: the strategy selects from our team's best long-only credit ideas, which, combined with a dynamic asset allocation framework, offers the potential to enhance our team's ability to achieve positive absolute returns through the cycle.

Downside defence: optimal convexity is achieved by a dynamic options overlay that aims to provide a measure of protection against large market and macro risks and acts as a hedge for our high-conviction credit strategy in times of market disruption. There will be instances where this approach is complemented by very material increases or reductions in risk on the long side as dictated by our risk appetite. This combination enables the strategy to manage through periods of stress to capture opportunities and significantly dampen volatility and has been instrumental in driving performance to date.

ESG advantage: we price ESG risks within fundamental credit selection combined with market-leading company engagement alongside our stewardship services team, EOS at Federated Hermes.

Structured with independent risk management: we operate with the flexibility of a boutique, while enjoying the support and resources of a major asset management firm, including independent risk oversight provided by the Federated Hermes Investment Office.

Our vast experience and the diversity of our fixed income team acts as a key differentiator.



[1] Hermes Unconstrained Credit Strategy does not have a benchmark for performance purposes. The risk-free rate – currently Libor – is given for illustrative purposes only.

2 How much/little risk can you take?

Our Unconstrained Credit Strategy enables investors to outsource their credit allocation to our trusted and vastly experienced managers Andrew Jackson, Head of Fixed Income, and Fraser Lundie, Head of Credit. As well as deciding on the best credit segments and individual securities to invest in, they also decide on your behalf how much credit risk to take on through the strategy's option overlay. With over four decades of experience combined, Jackson and Lundie have managed credit risk in all its forms, having managed a spectrum of credit funds (including but not limited to absolute return and benchmark-tracking funds) through a number of crises. Together, their combined skillset and vast experience offers a solution for investors seeking to outsource their full credit exposure or enhance their traditional fixed income allocations. And our strategy necessitates increasing or decreasing risk appetite within the prevailing market environment as Jackson and Lundie have demonstrated by delivering annualised returns of 9.7% since the strategy's inception[2] (see Figure 1).

Lundie's detailed and rigorous security selection across the capital structures of issuers worldwide exploits differences in relative value among bonds, loans and derivatives, which in turn is imperative to generating positive returns. Meanwhile, Jackson chairs MACIC, the monthly committee which agrees the strategy's appetite for credit risk (defining the risk parameters for asset allocation and credit selection) and provides bottom-up views and analysis to assist in portfolio construction. In addition, our monthly Credit Strategy Meeting (CSM) drives the broad sector positioning of the portfolio's credit allocation (geography, credit quality and curve positioning) and, within these broad sectors, which specific industries the team favours. The team also holds relative-value meetings to affirm sector valuation views, which play an important role in issuer and security-selection decisions from a bottom-up perspective.

In essence, our risk appetite is defined by the quantum and shape of the long-only allocation to our portfolio management team's best ideas and by implementing ideas on the short side, which manage downside risk by dynamically hedging portfolio market risk and allow for greater conviction in our long-only book – decisions which rest with Lundie and Jackson.

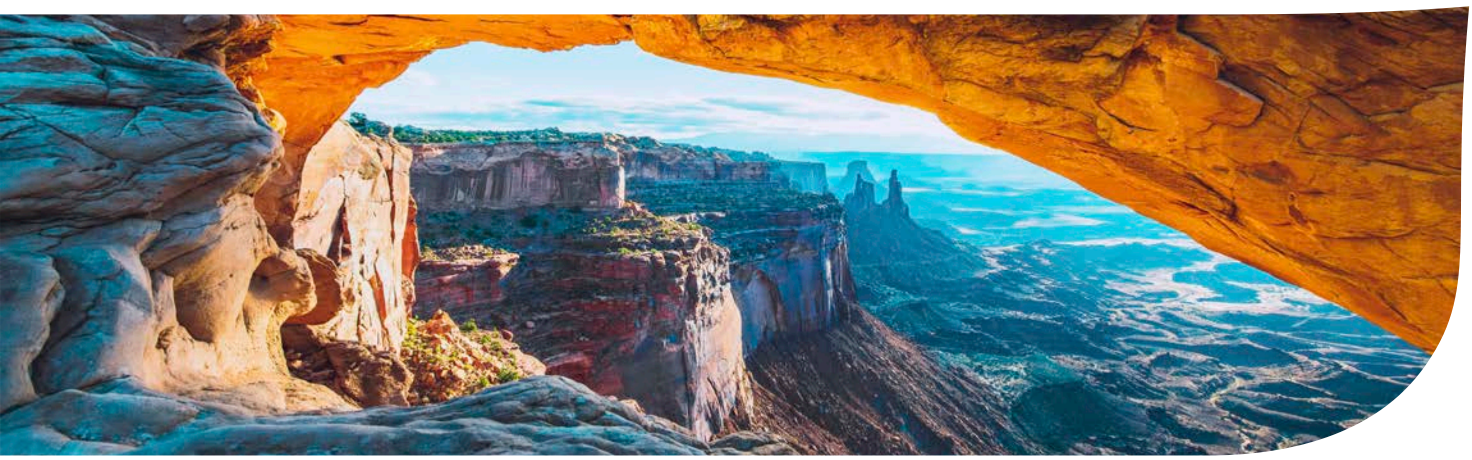
Since we launched our strategy, there have been times when we have taken more risk than would have been achieved through an investment into a Global High Yield benchmark and on other occasions significantly less. Our Unconstrained Credit offering is designed to capture value within markets and, as such, it is likely to take less risk during periods where spreads are very tight. This approach, along with the options overlay and the dynamic risk appetite management, have been the primary reasons for our strong performance through the Q4 2018 - Q1 2019 period as well as the ongoing coronavirus crisis (see question four and five for more information about how we fared during these periods).

Figure 1. Unconstrained Credit Strategy: Rolling performance (%)

	31/05/18-31/05/19	31/05/17-31/05/18	31/05/16-31/05/17	31/05/15-31/05/16	31/05/15-31/05/16
Unconstrained Credit Strategy[1]	10.66	–	–	–	–

Past performance is not a reliable indicator of future returns.

1 Performance shown is the strategy in USD gross of fees. Subscription and redemption fees are not included in the performance figures. Data is supplementary to GIPS® compliant information at the end of the document. Source: Federated Hermes, as at 31 May 2020.



[2] Source: Federated Hermes, as at 31 May 2020.

3 Why use options?

We buy out-of-the-money option payers in order to profit if credit spreads widen significantly from a market sell-off. This provides us with an effective hedge, with losses limited to the upfront cost of the option.

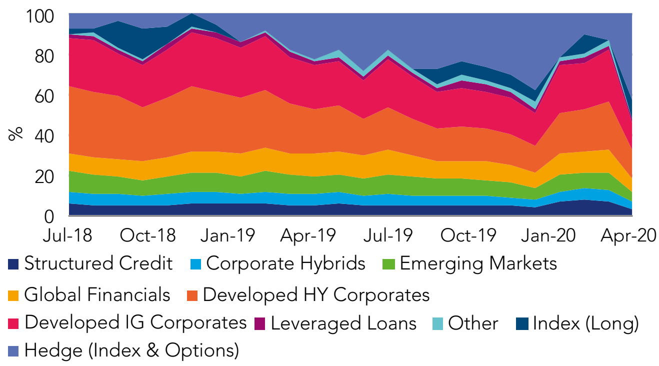
Some key benefits of this strategy include:

- **Cost effective:** when volatility is low options can provide a cost-effective way of hedging the portfolio. Typically, we budget 0.75% per annum for hedging cost.
- **Dynamic:** flexibility to tailor the exposure to changing market dynamics.
- **Convexity:** as the market sells off further, our option hedges become more powerful, making them an effective hedge against significant market shocks such as in Q1 2020 (see question four).

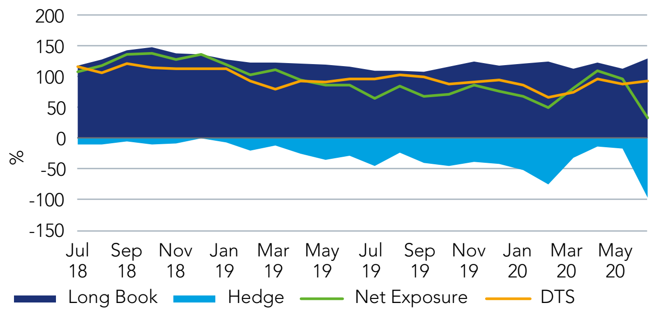
We believe that this process of incorporating options into the Unconstrained Credit Strategy is essential to outperforming in both bull and bear markets. Given the strong market rally through 2019, we had been increasing our hedge exposure during late 2019 and into Q1 2020 as we perceived there was a build-up of risk in the market which could result in a pull back.

Figure 2. Portfolio allocation: exposures since inception

2a. Historical gross exposure by strategy



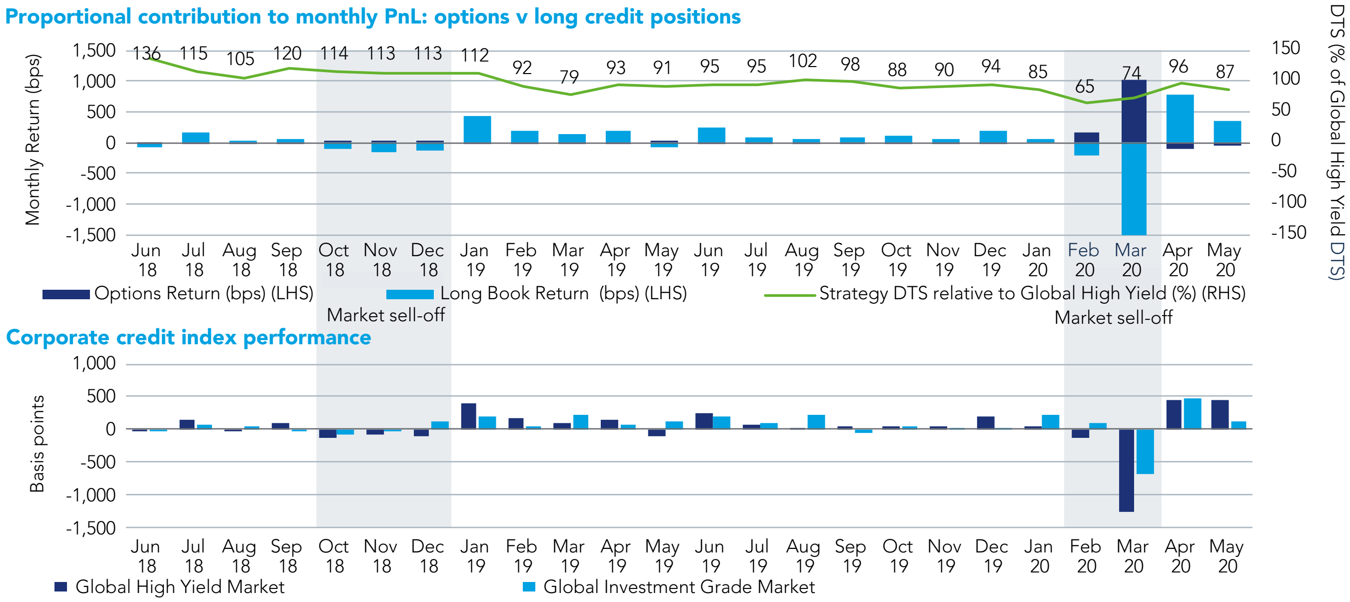
2b. Long book vs. hedge allocation



Source: Federated Hermes, as at 31 May 2020.

The reality was obviously much worse than anyone could have expected: in March 2020, markets sold off amid fears about the impact of the coronavirus on the global economy and a collapse in oil prices, the power of incorporating an options-based strategy was evident (see figure 3; see also question four for information on how the strategy performed during the coronavirus crisis).

Figure 3. Options overlay: portfolio benefits



Past performance is not a reliable indicator of future returns.

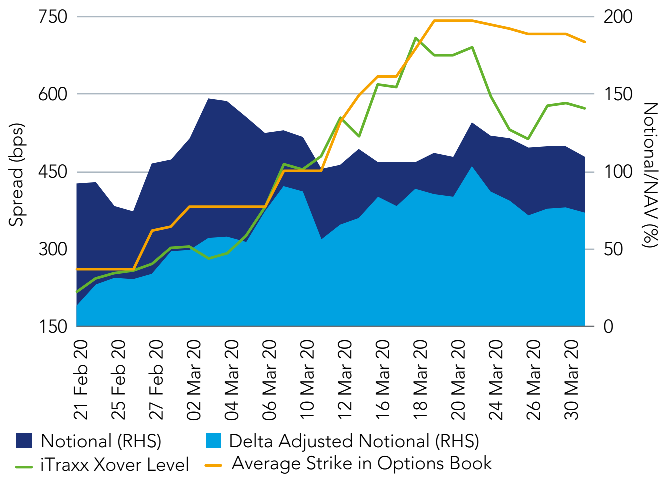
Source: Federated Hermes, as at 31 May 2020. High-yield market performance is that of the ICE BofA Merrill Lynch Global High Yield Constrained USD Hedged Index. Investment-grade market performance is that of the ICE BofA Merrill Lynch Global Broad Market Corporate USD Hedged Index.

4 How has the strategy performed during the coronavirus pandemic – and what role did options/hedges play?

In advance of the crisis our view had been that markets offered little value and, as a result, we entered the crisis with less risk than at any time since the launch of the strategy. From 24 February and into March 2020, credit markets sold off heavily as a dispute over oil production between Russia and Saudi Arabia rattled investors fearing a coronavirus-driven global recession. During this time, we actively adjusted the options overlay as the market moved downwards. This enabled us to take profit on positions and ensure that our Unconstrained Credit Strategy remained protected as much as possible should the market continue to sell off.

Having increased options positions going into the crisis, our portfolio management team actively adjusted the options overlay as the market moved downwards, taking profit on positions and ensuring the strategy remained protected as much as possible should the market continue to sell off. As risk increased at the end of February, our team quickly scaled up options exposure – reaching a peak of 147% of NAV in notional terms on 3 March.

Figure 4. Scaling-up our options exposure in response to Covid-19

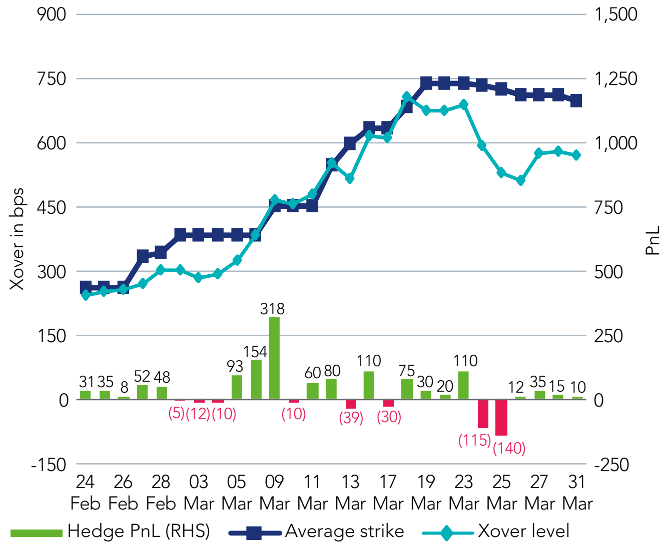


Source: Federated Hermes, Bloomberg, as at 31 March 2020.

As spreads widened and options moved into the money, we took profit and rolled positions into longer dated, bigger notional, further out of the money contracts. Figure 5 shows the increase in the average strike as the Crossover moved wider, demonstrating how a rapid widening of options positions has the potential to add considerable value. For further granularity, we also added smaller positions with the same maturity but different strikes.

Figure 5. Options overlay: seeking downside protection through the sell off

Average strike of European options v iTraxx Crossover level



Past performance is not a reliance indicator of future returns.

Source: Federated Hermes, Bloomberg, as at 31 March 2020. Performance shown of Hermes Unconstrained Credit Strategy in USD, gross of fees. Xover level represents the level of the IHS Markit iTraxx Crossover CDS index. Hedge PnL represents the aggregate performance of the options book and index hedges within the strategy, including but not limited to contracts on the iTraxx Crossover index. **Please refer to Figure 1 for the rolling performance of the Unconstrained Credit Strategy.**

By actively managing the options book during this period of tumult, this enabled us to crystallise option profit and loss, while at the same time maintaining convexity and a level of protection. The total contribution of options to the performance of our Unconstrained Credit Strategy from 24 February to 31 March was 9.35% – this compares to the Global High Yield index which fell by 14.38%[3]. (Note: the Unconstrained Credit Strategy does not have a benchmark; the comparison demonstrates the return that would have been achieved by investing into a Global High Yield benchmark during this time).

[3] Performance of HW00 Index in USD.

5 How does the downside protection from using options give us conviction to seek rise and do well in recovery?

Since the strategy's inception, the use of options to help provide a level of downside protection has enabled us to have higher conviction in our credit selection and maintain risk during market sell offs, enabling us to participate in rebounds as markets rally. This is well demonstrated during the Q4 2018 sell-off, when our options protection gave us the confidence to maintain a higher DTS exposure[4] and, in turn, benefited us in Q1 2019 when a v-shaped recovery occurred (see figure 6).

In Q4 2018, credit markets slumped. At this time, the strategy's options overlay fulfilled its role as a powerful hedge: it helped us manage the downside risk during the market sell-off and, by exhibiting lower volatility, we delivered a strong risk-adjusted return. In fact, the overlay posted a positive return on a standalone basis over 2018. But what was really important about the overlay was that it kicked in by significantly reducing the strategy's long positioning throughout November and December, helping to mitigate overall fund losses as well as making money itself.

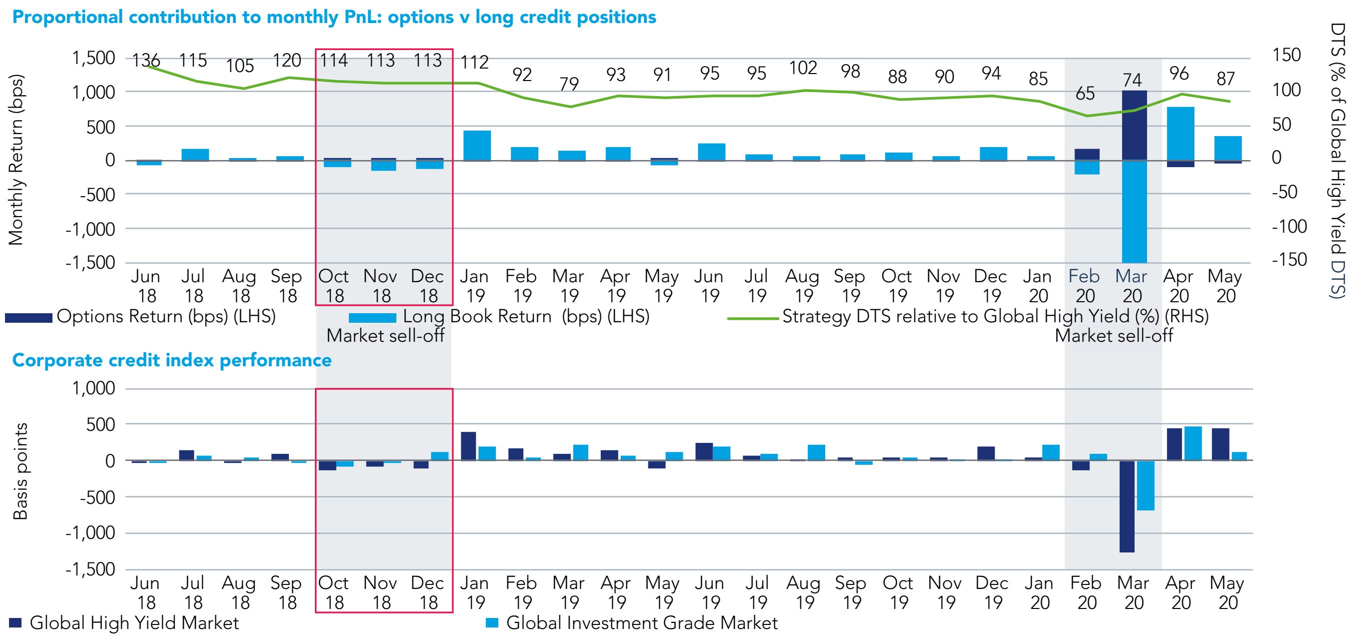
This was vital as it gave us the chance to spend December and early January buying severely dislocated bonds from around the world at a time when other funds were seeking to reduce risk. And there were lots of attractive opportunities to buy.

Around this time investment-grade credit in aggregate was trading below par cash price for the first time since the financial crisis. But it seemed like most other investors didn't recognise this as they were focusing their attention on spreads.

At the same time, much of the media attention was focused on the risk of several high-profile companies being downgraded to high-yield status. As a result, these firms' bonds were trading at deep discounts – in some cases, as if they already had a 'B' rating. Many other investors sold these companies at a loss. But we conducted in-depth fundamental analysis on these names that suggested there was little risk of them falling to junk-bond status. And, as a result, we invested in them.

The strategy fell in December 2018, largely due to our purchases of undervalued names, which went on to rise sharply in the first few months of 2019. If we hadn't bought them, the strategy would not have achieved a strong performance during the recovery in Q1 2019.

Figure 6. The options overlay was instrumental in the success of the strategy during the Q4 2018 sell-off



Source: Federated Hermes, as at 31 May 2020. High-yield market performance is that of the ICE BofA Merrill Lynch Global High Yield Constrained USD Hedged Index. Investment-grade market performance is that of the ICE BofA Merrill Lynch Global Broad Market Corporate USD Hedged Index.

[4] Duration times spread (DTS): recognises that bonds with a longer duration or wider spread –or both –have a higher beta and therefore greater contribution to index returns.

6 How liquid is the portfolio?

Figure 7 documents the liquidity profile of the portfolio. For example, 34.69% can be liquidated in one day, 57.73% on day two and 100% by day 10.

Figure 7. The liquidity profile of the portfolio

Days	Trade to cash (%)
1	34.69%
2	57.73%
3	72.58%
4	82.40%
5	88.78%
10	100.00%

Source: Federated Hermes, as at June 2020. Note: this analysis excludes the structured credit portion of the portfolio (circa 8%).

In addition, normal waterfall is based on mitigating any deviation from normal market impact when trading, and so assumes 25% of a security's average daily trading volume (ADTV). As such, the securities that take longer to sell are a result of our holding size rather than being illiquid in nature.

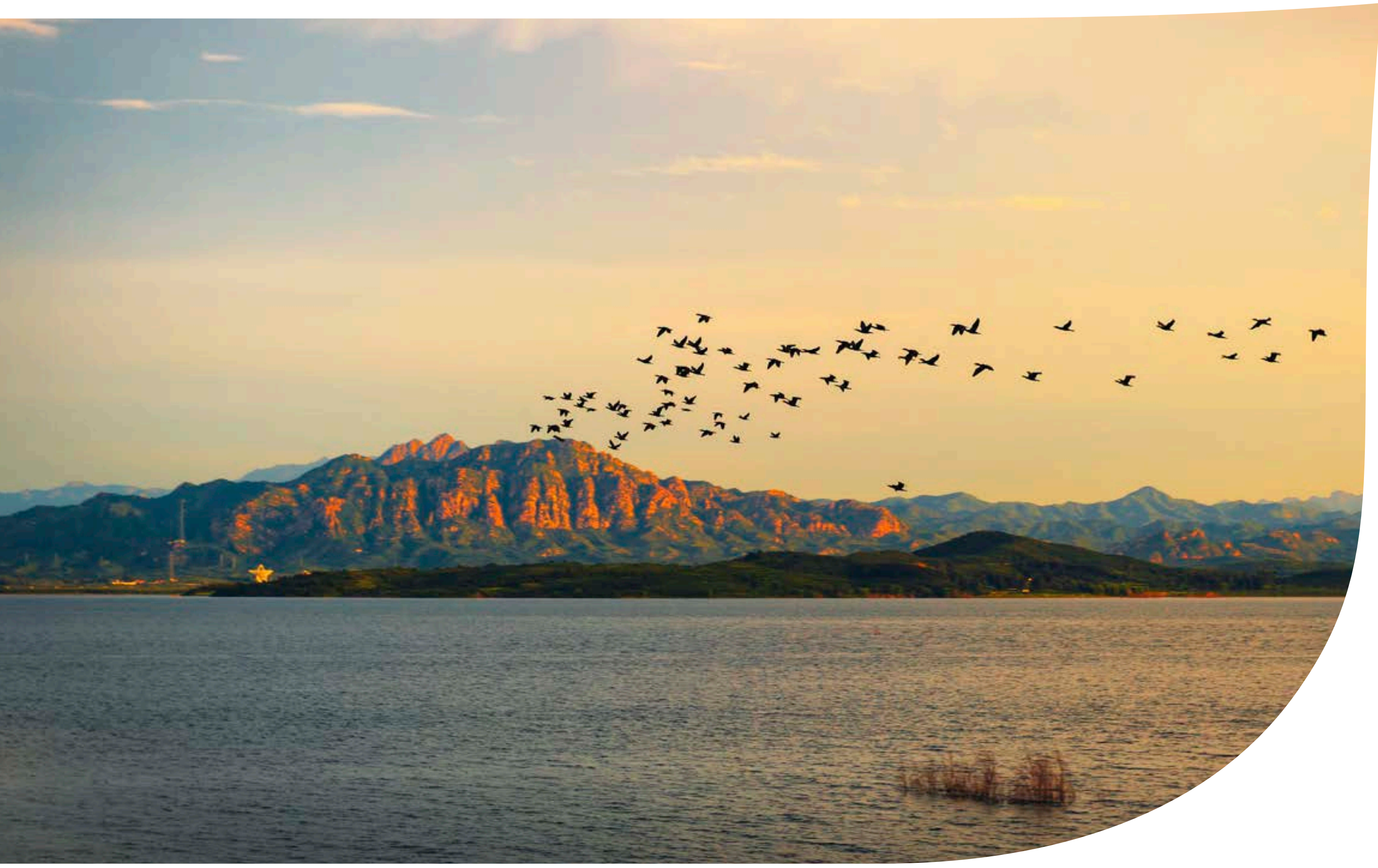
7 What makes Unconstrained Credit a high-conviction strategy?

Our Unconstrained Credit Strategy aims to generate capital growth and a high level of income over time. To achieve this, we adopt an unconstrained, high-conviction approach to investing across the global liquid credit spectrum, with the goal of capturing superior relative value as investment conditions change through instruments such as developed and emerging market investment grade and high yield corporate bonds, loans, government securities, asset-backed securities, convertible bonds, preferred stocks, credit default swaps, credit index options, interest rate instruments and other credit derivatives.

Our Unconstrained Credit Strategy aims to generate capital growth and a high level of income over time.

The strategy also incorporates a dynamic options overlay, which aims to provide a defensive hedge against down markets, while also performing rebalancing and risk management functions. We believe that this process is essential to outperforming in both bull and bear markets.

In addition, the prior experience of our team underlies its confidence in investing across traditional and alternative credit classes through the entire capital structure. In addition, the team's diversity in terms of specialist portfolio managers (such as EM, loans and ABS) and credit analysts provides the lead portfolio managers with views and trade ideas that can be leveraged across credit strategies and products.



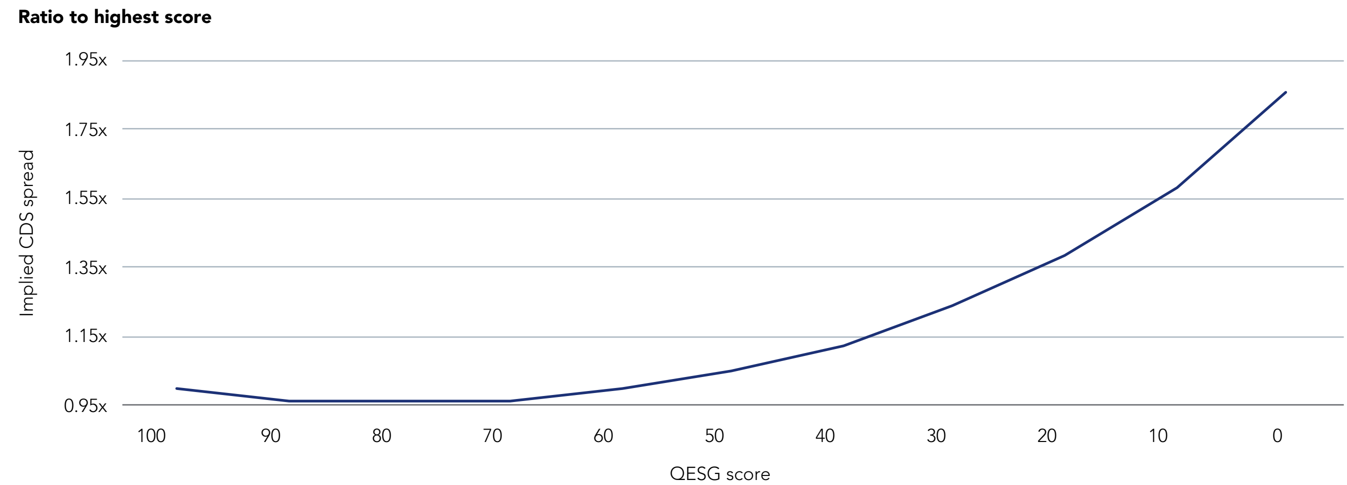
8 How does Uncontrained Credit express its ESG convictions?

Just as we score credit and operating risks and valuations, we also price the ESG risks of individual companies – after all, they impact enterprise value and valuations. This approach is consistent across our flexible credit range and builds upon the foundations of the Federated Hermes platform, known for its leadership in ESG integration.

We have a unique collection of ESG resources: the responsibility team consults us on policy and integration and develops tools for analysing ESG; we have a dedicated lead engager within the Fixed Income team who drives our team's engagement and impact agenda; we also collaborate with our stewardship business EOS at Federated Hermes – a large team skilled in face-to-face engagement with corporate executives and directors; and our internal, proprietary quantitative ESG (QESG) scores generated by Federated Hermes Global Equities, which rank each stock worldwide in accordance with its ESG risk.

We developed our own pricing model to capture the influence of ESG factors on credit spreads by using the QESG scores – as they provided a numeric value to represent ESG risks (for many years, we had assessed these qualitatively). By regressing these values against the spreads of credit default swaps (CDS) instruments – which provide the purest reflection of credit risk – we were able to determine the nature and strength of the relationship between the ESG risks captured by the QESG scores and credit spreads. Our analysis showed a convincing relationship between ESG risk and credit spreads, manifesting as an ESG-risk curve (see figure 8). This enables us to calculate the marginal price for ESG risks of companies and anticipate the change in valuations as a company moves along the ESG Credit Curve.

Figure 8. ESG risk pricing model: implied CDS spread v QESG Score



Source: Federated Hermes. For illustrative purposes only.

There is no doubt that our approach to sustainable investment within Fixed Income will continue to evolve, as will our approach within the strategy. Federated Hermes remains at the vanguard of engagement, ESG analysis and responsible investment. We expect that as companies and governments improve disclosure, measurement and awareness this will continue to grow as an input to our management approach.

9 Is the strategy a good complement to other flexible credit/bond strategies?

Having enjoyed one of the most successful launches that the international business of Federated Hermes has ever seen, we believe the strategy is a good complement to other flexible strategies because it has delivered very low drawdowns during big sell-offs and has not been dragged lower in terms of performance, in turn generating outperformance in market rallies.

Unlike other strategic bond funds, we use options to provide a level of downside protection rather than government bonds. The incorporation of a dynamic options overlay into our strategy mitigates risks within the prevailing market environment by providing cover for our bottom-up, high-conviction security positions against broad, adverse market moves. Simultaneously, the overlay can exploit risks so that our team can act on opportunities to buy out-of-the-money option payers (at higher strike prices) in order to profit if spreads widen significantly in the wake of a market correction.

What's more, we have managed to deliver our target return since inception (see question 10 for performance information) during which time markets have experienced two of the most volatile periods in the last decade.

Past performance is not a reliable indicator of future returns.

Unlike other strategic bond funds, we use options to provide a level of downside protection rather than government bonds.

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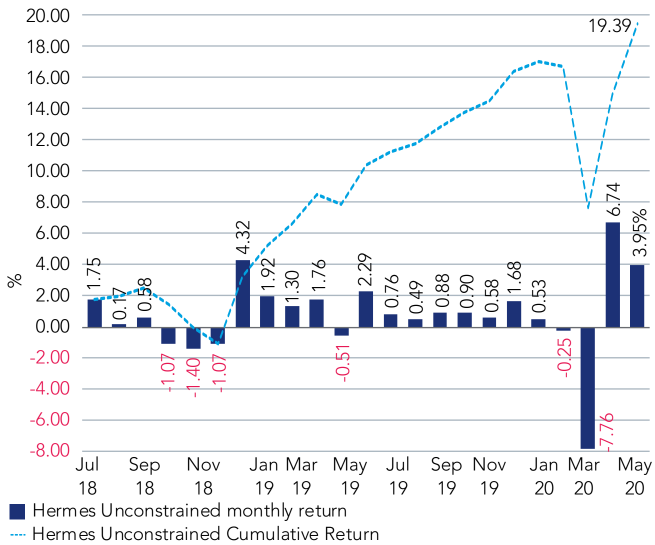
10 What should we expect in terms of performance?

In July 2018 we launched our strategy, communicating our aim to deliver a gross return target of the risk-free rate plus 5-6% per annum through the cycle. Unsurprisingly, many investors were keen to hear how our strategy would be able to achieve this target return considering how tight spreads were at the time and the potential cost of the options overlay that the strategy uses. Several of the potential scenarios that we used at the time as examples to show how the strategy could prosper in various conditions have in fact played out: indeed, we have experienced two of the most volatile periods in the last decade since we launched our strategy and it has comfortably delivered its return target.

Figure 9. Our Unconstrained Credit Strategy has generated annualised returns of 9.7% since inception

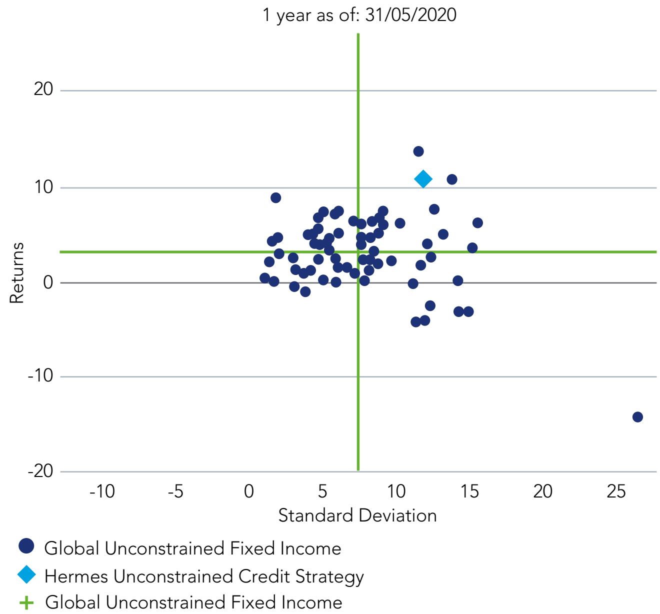


Past performance is not a reliable indicator of future returns.

Data is supplemental to the the GIPS® compliant information that follows. The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Any investment overseas may be affected by currency exchange rates. 1 Cumulative return since strategy's inception in USD. Inception date: 1 July 2018. Performance as at 31 May 2020 in USD, gross of fees. Source: Northern Trust.

Since the strategy's inception, we have delivered annualised returns of 9.7%, while in 2019, it generated returns of 17.6%[5] (see figure 9). During the March self-off, which occurred amid the global coronavirus pandemic and a collapse in oil prices, we were able to take profit on positions by actively adjusting the options overlay as the market moved downwards. This ensured that our Unconstrained Credit Strategy remained protected as much as possible should a further sell-off occur. As a result, our strategy recorded a gross return of 2.6% for the period of 1 January to 31 May 2020. Indeed, our strategy has outperformed the average performance for the global unconstrained fixed income universe (see figure 10).

Figure 10. Unconstrained Credit Strategy performance: one-year v peers



Past performance is not a reliable indicator of future returns.

Source: eVestment, as at end of May 2020. Performance shown is the composite, gross of fees and in USD. The black dots represent peers in the Global Unconstrained Fixed Income universe. The red cross represents the average for the Global Unconstrained Fixed Income universe.

[5] Source: Federated Hermes, as at 31 May 2020. Performance is in USD, gross of fees. Inception date: 01 July 2018. Please note: the Hermes Unconstrained Credit Strategy does not have a benchmark for performance purposes.

GIPS® Composite

Composite: **Hermes Unconstrained Credit Hedged to USD**

Creation date: **10 August 2018**

Inception date: **01 July 2018**

All information is quoted in USD

Year	Gross of Fees Return	Net of Fees Return	Benchmark Return	Std. Dev. 3 Years Composite	Std. Dev. 3 Years Benchmark	No of Portfolios	Composite Dispersion	USD Total Composite Assets (Million)	% Total Firm Assets
2019	17.6	16.8	–	–	–	<5	–	512	1.3
2018*	-1.1	-1.4	–	–	–	<5	–	358	1.1

*Partial Year Returns for Composites and Benchmark

Hermes Fund Managers Limited claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Hermes Fund Managers Limited has been independently verified for the periods 1 January 1998 through 31 December 2018. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS® standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS® standards. Verification does not ensure the accuracy of any specific composite presentation.

For the purposes of compliance with GIPS®, the firm is defined as Hermes Fund Managers Limited ('Hermes'), an asset management group consisting of a number of subsidiary or affiliate companies. As of 31 December 2009 the Hermes Fund Managers Limited firm definition was broadened to better represent the full range of investment strategies offered. Hermes Investment Management is the brand name for the Hermes group including Hermes Fund Managers Limited. Information about changes is available upon request. Gross of fees returns have been calculated gross of management, custodial fees and reclaimable withholding taxes, but after all trading commissions.

The composite includes all discretionary portfolios following the Unconstrained Credit Hedged to USD strategy run by the Hermes Global Credit team and has an inception date of 01 July 2018. The objective of the strategy is to generate capital growth and a high level of income over the long term. The strategy may invest in a broad range of assets, either directly or through the use of derivatives, (including, but not limited to, equities, equity-related securities, Eligible CIS and/or financial indices, futures, options, swaps, debt, fx and money markets). The strategy through its investments in FDIs may be leveraged. The composite does not have a benchmark. Performance is shown in USD. The composite base currency is USD.

The management fee schedule for this strategy is 0.65% per annum.

The standard fees are shown in Part 2A of its Form ADV. For historical fees, please contact Hermes. Net results reflect the above-mentioned fee schedules, actual results may vary for each individual portfolio.

Composite descriptions, along with additional information regarding policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Where appropriate, composite dispersion is calculated as the asset weighted standard deviation of the annual returns of the constituent portfolios. If a composite consists of less than five portfolios for the full year then no measure of dispersion is shown. The three year annualised standard deviation measures the variability of the composite and benchmark returns over the preceding 36 month period. Standard deviation measures are not shown where there are less than 36 monthly observations available. Standard deviation measures are not required for periods prior to 2011.

Federated Hermes
International

Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes now form the international business of Federated Hermes. Our brand has evolved, but we still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important new strategies from the entire group.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

For more information, visit **www.hermes-investment.com** or connect with us on social media: