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.

Q3 2021

For professional investors only.

Federated Hermes

www.hermes-investment.com

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 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.

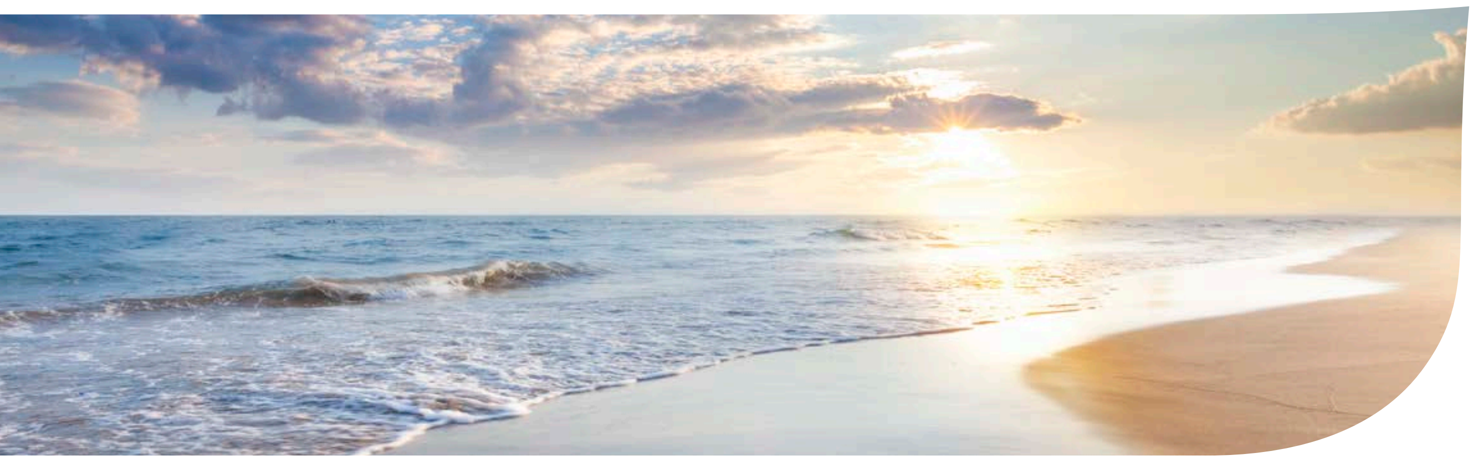
Full spectrum: unrestricted by security type or geographical silos, we seek to exploit opportunities in developed and emerging markets for investment grade and high-yield corporate bonds, credit default swaps, loans, asset-backed securities and government securities.

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 derivative overlay that aims to protect 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.

> **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, CFA, Head of Credit. As well as deciding on the best credit segments and individual securities to invest in, they also decide how much credit risk to take on through both the strategy's best long ideas and the derivative 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 dynamic solution for investors seeking to outsource their full credit exposure or enhance their traditional fixed income allocations. The strategy necessitates increasing or decreasing risk appetite within the prevailing market environment as Jackson and Lundie have demonstrated by delivering annualised returns of 9.83% since the strategy's inception[2].

Overall risk appetite is governed by the monthly Multi Asset Credit Investment Committee (MACIC), chaired by Andrew Jackson. The MACIC seeks to garner input from all aspects of the fixed income universe and outside fixed income with the aim of delivering an appetite for risk that is in tune with risks in the economy and markets at large.

The primary outputs of MACIC are:

1) to overall assess risk appetite (both gross and net);

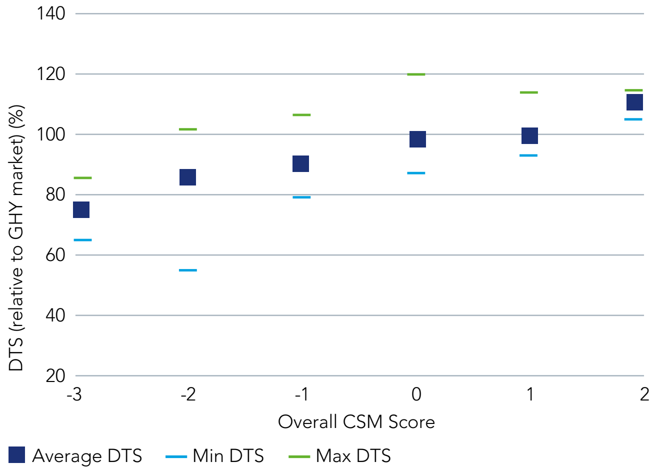
2) determine the need for (and value of) tail risk hedges;

3) provide top-down guidance on asset allocation primarily validating overall risk positioning.

A key input into this meeting is the bi-monthly Credit Strategy Meeting (CSM) which provides a forward-looking overall score for credit risk appetite (through a numeric and documented consistent process that evaluates macro, fundamentals, credit quality, sentiment, technical and tail risk). In addition, the 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.

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 index 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 some of the most turbulent periods of the last three years, including the coronavirus crisis (see question three and four for more information about how we fared during these periods).

Figure 1. Historical Strategy Duration Times Spread (DTS) by Overall CSM Score



Source: Federated Hermes.

Figure 2. Unconstrained Credit Strategy: Net rolling performance (%)

	30/06/20-30/06/21	30/06/19-30/06/20	30/06/18-30/0/19	30/05/17-30/06/18	30/06/16-30/06/17
Composite[1]	11.0	10.3	10.4	–	–

Past performance is not a reliable indicator of future returns.

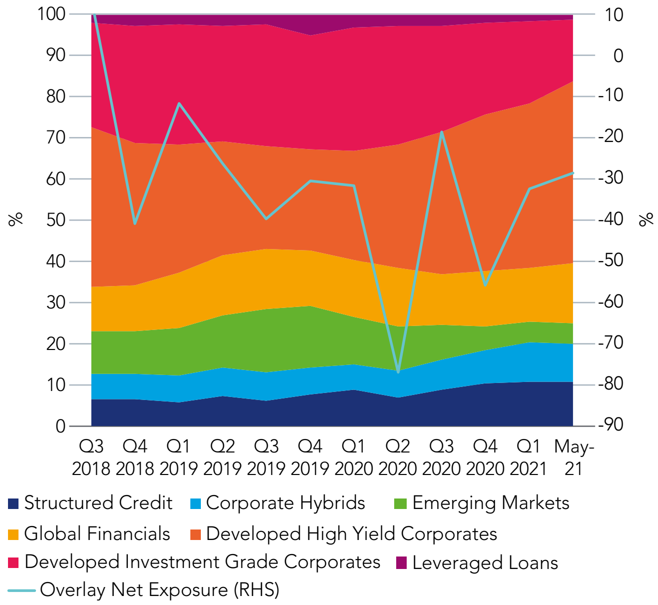
Performance shown is the strategy in USD gross of fees. Subscription and redemption fees are not included in the performance figures. Data is supplementary to GIPS® compliant information at the end of the document. Source: Federated Hermes, as at 30 June 2021.

[2] Source: Federated Hermes, as at 30 June 2021. Performance shown is the strategy in USD gross of fees.

3 How do you manage the derivative overlay to provide downside protection for the long book?

We make use of a dynamic derivative overlay made up of credit default swap (CDS) index and options that enables us to tactically adjust the risk profile of the portfolio for the prevailing market environment. In term of options, we buy out-of-the-money payer options in order to profit if credit spreads widen significantly from a market sell-off. The size and composition of the hedges employed will vary depending on the team's risk appetite and the risk exposure of the long book. This provides us with an effective hedge, with losses limited to the upfront cost of the option.

Figure 3. Portfolio allocation: exposures since inception



Source: Federated Hermes, as at May 2021.

Some key benefits of options include:

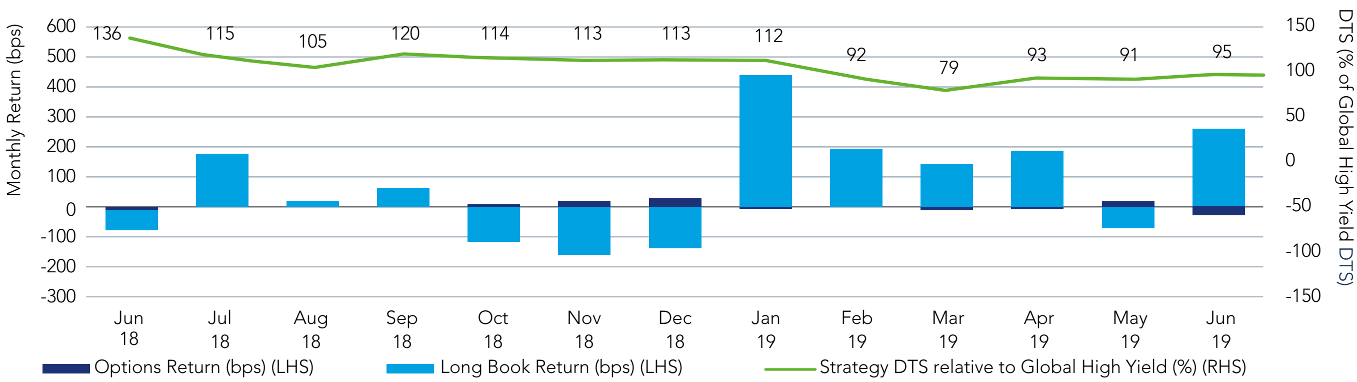
- **Cost effective:** when volatility is low, options can provide a cost-effective way of hedging the portfolio. Typically, we budget 0.75% per annum for hedging cost.
- **Convexity:** as the market sells off further, our options hedges become more powerful, making them an effective hedge against significant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

We believe that this process of incorporating options into the Unconstrained Credit strategy is essential to outperforming in both bull and bear markets.

Since the strategy's inception, the use of options within the derivative overlay has helped provide a level of downside protection and enabled us to have higher conviction in our credit selection and maintain risk during market sell-offs. This means we can participate in rebounds as markets rally, and avoid having to sell bonds at the worst time. This was well demonstrated during the Q4 2018 sell-off, when our options protection gave us the confidence to maintain a higher DTS exposure[3] and, in turn, benefited us in Q1 2019 when a v-shaped recovery occurred (see Figure 4).

The team's view at the time was that the sell-off in Q4 2018 did not reflect the fundamentals in the market, and a sharp recovery in spreads would likely occur once sentiment turned. Here the inclusion of the options in the portfolio gave the portfolio managers comfort in materially increasing the risk on the long side into the sell-off, 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.

Figure 4. The options overlay was instrumental in the success of the strategy during the Q4 2018 sell-off



Source: Federated Hermes, as at 30 June 2019.

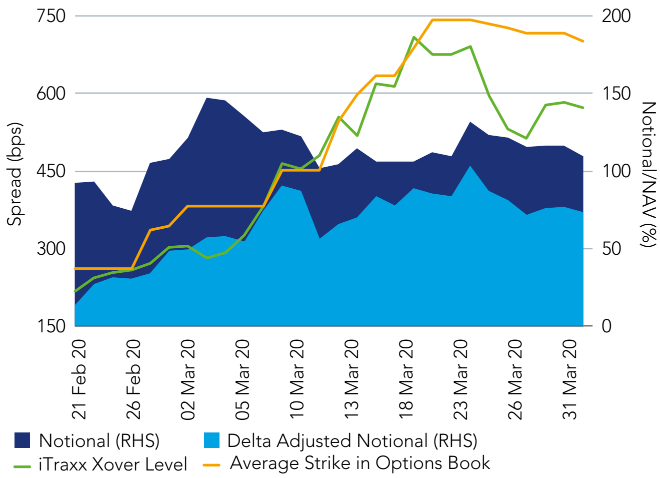
[3] Duration times spread (DTS): recognises that bonds with a longer duration or wider spread –or both –have a higher beta and therefore greater contribution to index returns.

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 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 net asset value (NAV) in notional terms on 3 March 2020.

Figure 5. Scaling-up our options exposure in response to Covid-19



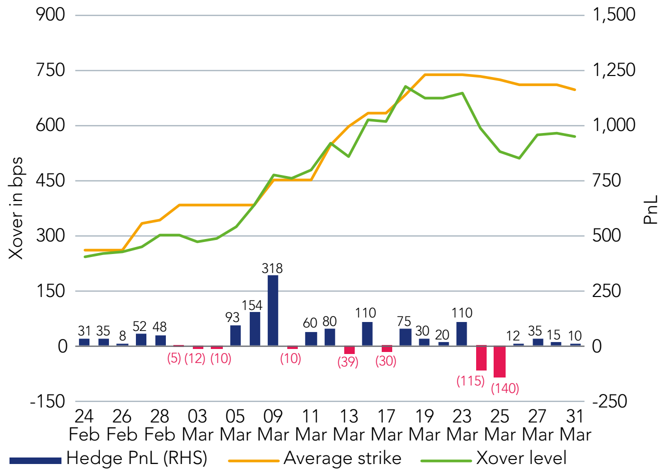
Source: Federated Hermes, Bloomberg, as at 31 March 2020.

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 (as indicated by the increase in the average strike price of the options book in Figure 5). Figure 6 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.

[4] Performance of HW00 Index in USD.

Figure 6. Options overlay: seeking downside protection through the sell off

Average strike of European options v iTraxx Crossover level

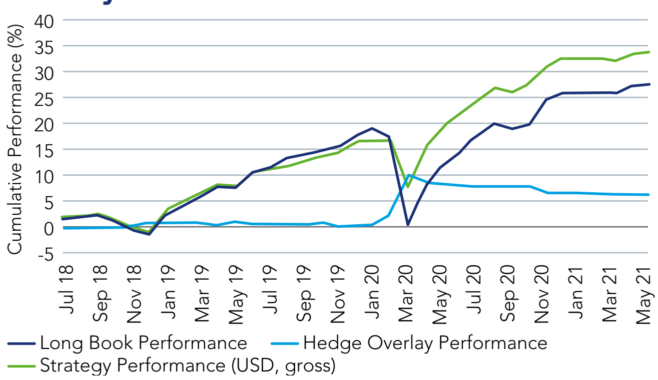


Past performance is not a reliable indicator of future returns.

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 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%[4] (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).

Figure 7. Cumulative performance of Long book v overlay



Source: Federated Hermes, Bloomberg, as at 31 May 2021.

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5 How do you manage duration and inflation risks within the portfolio?

With bonds having enjoyed a significant bull run over the last few decades, leaving global interest rates near record lows, duration risks plus the spectre of rising inflation are at the top of many investors' minds. Our unconstrained approach to credit investing means we have many levers we can pull to manage these risks within the portfolio, and generally we look to manage duration to within 2 to 6 years, depending on our view.

Firstly, our freedom to allocate between high yield and investment grade gives us the ability to look to more spread driven parts of the market when we see fit. From a sector perspective we can look for opportunities in areas of the market that may benefit from rising interest rates or inflation, such as financials and metals and mining. We also have the ability to look to floating rate instruments such as bank loans or Asset Backed Securities where we have a specialist team searching for the best opportunities in European structured finance. In terms of security selection, where it makes sense to do so, we are also able to hold Credit Default Swaps instead of cash bonds, further reducing the portfolio's exposure to interest rates given CDS only represent pure credit risk.

Finally, on a macro level we manage the overall fund duration using interest rate futures.

6 How liquid is the portfolio?

Figure 8 documents the liquidity profile of the portfolio. For example, 33.70% can be liquidated in one day, 56.24% on day two and 98.11% by day 10.

Figure 8. The liquidity profile of the portfolio

Days	Trade to cash (%)
1	33.70%
2	56.24%
3	69.42%
4	79.08%
5	86.16%
10	98.11%

Source: Federated Hermes, as at May 2021. 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.

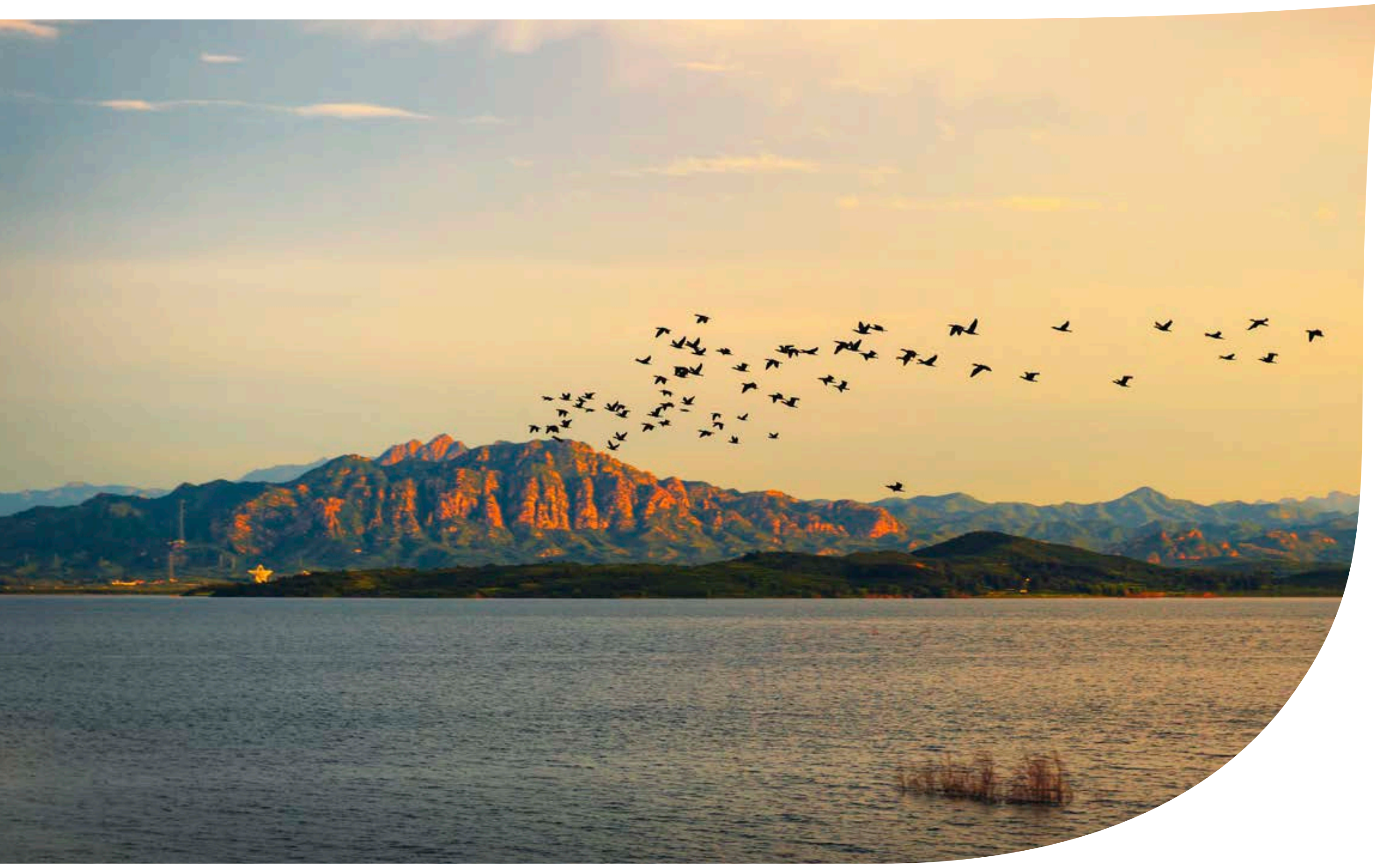
7 What makes Unconstrained Credit a high-conviction strategy?

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.**

Based on the top down views of the desk, the team dynamically assess how much and what type of risk to take. In managing this, the strategy also incorporates a dynamic derivative 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. The team's diversity in terms of specialist portfolio managers (such as emerging markets, 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?

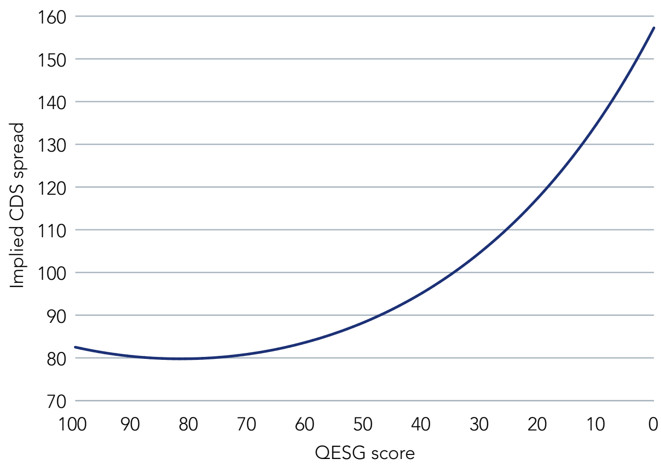
Because we believe that non-fundamental factors are inexorably linked to credit risk, we integrate ESG factors into our investment decisions and analysts assign ESG scores to all credits covered. Our ESG assessment focuses on the impact that issuers' ESG policies and behaviours have on cash flows and, thus, enterprise value. To generate our ESG scores of 1-5, our analysis draws upon both internal and external sources. Our ability to assess and price ESG risks is enhanced by the significant resources within the broader Federated Hermes International business. In addition to the team's ESG score, issuers that are taken through credit committee are reviewed against the criteria of the team's proprietary sustainability scores, including sustainable development goals, Climate Change Impact and Sustainability Leaders. These scores are owned by the Sustainable Fixed Income team (SFI) and can provide further insight to the portfolio managers about the sustainable characteristics of a company when making investment decisions.

Engagement efforts led by our in-house stewardship team EOS and SFI engagers are a critical element of the team's integration of ESG considerations into our investment process. Credit analysts work closely with engagers; share views and opinions; and attend company meetings together with engagers. This allows the analysts to develop a much better real-time understanding of management's thinking, culture and processes around sustainable business practices as well provides an opportunity to encourage further progress, improvements and pursuit of best practices. The credit team believes that improved ESG behaviours ultimately lead to lower risks and volatility and thus better investment decisions.

The credit team also uses Federated Hermes International proprietary quantitative ESG (QESG) scores as one of several inputs into our analysis. The QESG scores combine internal analysis with external sources, such as Sustainalytics, MSCI and Trucost to score company's behaviours on a scale from 1 to a 100. FHI's firmwide proprietary ESG dashboard is also integrated into our ESG assessments. In addition, analysts have access to proprietary firmwide Carbon Tool allowing them to assess company's carbon footprint and Climate Change Database developed by the SFI team, allowing access to climate and sustainability-related information of the credit universe. These proprietary tools allow for sophisticated comparison of companies against peers and sectors with respect to a range of ESG considerations.

Drawing on the QESG scores, we developed our own pricing model to capture the influence of ESG factors on credit spreads – 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 9). 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 9. ESG risk pricing model: implied CDS spreads and corresponding QESG scores, 2012-2020



Source: Federated Hermes, as at 31 December 2020. Note: The QESG Scores, generated by our Global Equities at the international business of Federated Hermes, rank each stock worldwide in accordance with its ESG risk.

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 offers investors a dynamic, high conviction exposure to global credit alpha, that aim to protect in down markets whilst also outperforming in a market rally.

Unlike other strategic bond funds, we use credit index options to provide a level of downside protection rather than government bonds. The incorporation of options within our dynamic derivative overlay acts like a form of insurance, helping mitigate risks within the prevailing market environment by providing cover for our bottom-up, high-conviction positions against adverse market moves. We see this as being a highly effective tool for providing downside protection for our portfolio, especially considering the current market environment of low government bond yields.

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.

10 What should we expect in terms of performance?

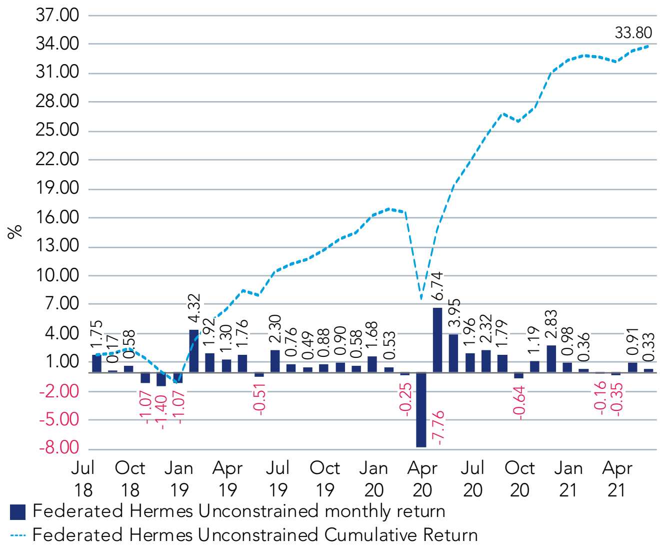
We launched our strategy in July 2018, communicating our aim to deliver a gross return target of the risk-free rate plus 5-6% per annum through the cycle. Unsurprisingly, many investors were keen to hear how our strategy would be able to achieve this target return considering how tight spreads were at 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, since we launched our strategy, markets have experienced two of the most volatile periods in the last decade and the strategy has comfortably delivered its return target.

Targets cannot be guaranteed.

In 2020 we were able to take profits on our options positions as markets sold off in Q1, leaving us in a strong position to generate returns as the market recovered.

We continue to see plenty of opportunities for alpha within credit markets and have options in place to provide a level of protection should the unexpected occur. Because of this we remain confident in our ability to deliver on our objective going forward, despite low market yields. Indeed, our strategy has outperformed the average performance for the global unconstrained fixed income universe (see figure 11).

Figure 10. Our Unconstrained Credit Strategy has generated annualised returns of 9.8% since inception

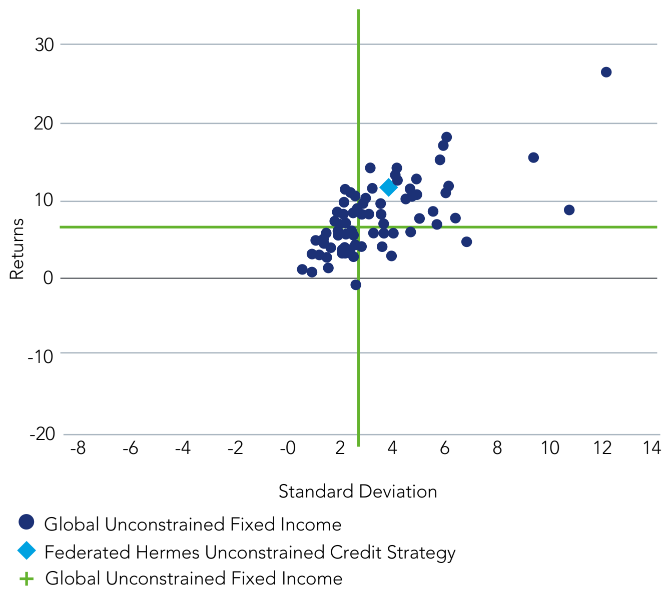


Past performance is not a reliable indicator of future returns.

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 30 April 2021 in USD, gross of fees.
Source: Northern Trust.

Figure 11. 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 2021. Performance shown is the composite, gross of fees and in USD. The blue dots represent peers in the Global Unconstrained Fixed Income universe. The green cross represents the average for the Global Unconstrained Fixed Income universe.

Risk profile

- Past performance is not a reliable indicator of future results.
- 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.
- Targets cannot be guaranteed.
- It should be noted that any investments overseas may be affected by currency exchange rates.
- This information does not constitute a solicitation or offer to any person to buy or sell any related securities or financial instruments.
- Where the strategy invests in debt instruments (such as bonds) there is a risk that the entity who issues the contract will not be able to repay the debt or to pay the interest on the debt. If this happens then the value of the strategy may vary sharply and may result in loss. The strategy makes extensive use of Financial Derivative Instruments (FDIs), the value of which depends on the performance of an underlying asset. Small changes in the price of that asset may cause larger changes in the value of the FDIs, increasing either potential gain or loss.

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	Composite Gross Return	Composite Net Return	Benchmark Return	*Composite 3-Year Std. Dev.	*Benchmark 3 Years Std. Dev.	Number of Portfolios	**Dispersion	Composite Assets (million)	Firm Assets (billion)
2018	-1.06	-1.38	–	–	–	<5	–	357.5	32.0
2019	17.58	16.81	–	–	–	<5	–	511.9	40.2
2020	13.76	13.02	–	–	–	<5	–	805.2	585.7

*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: