Federated Hermes Global Equity ESG Fund

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SECTION 1

Review, H1 2021

Investors were in optimistic mood at the start of the year as the roll-out of vaccines across the globe provided a genuine path out of the pandemic. This optimism was reflected by rising yields and higher commodity prices, which provided additional impetus to the 'value' rotation that started last November and drove the outperformance of cyclical areas of the market.

By the end of Q1, however, investors had started to become more cautious as yields and commodity prices paused. Our measure of investor risk aversion was no longer indicating an optimistic outlook, and investor sentiment was finely balanced between risk on and risk off.

This didn't stop global equity markets from rising however, but Q2 was volatile as market leadership swung between 'growth' and 'value'. Against this backdrop, inflation expectations fluctuated, yields drifted lower and the new delta variant of the Covid-19 virus started to spread, taking some of the shine off the progress of the vaccination programme. Understandably, our risk aversion measure also highlighted an uncertain environment.

The Alpha model highlighted a preference for valuation. But, as investors became more cautious, they favoured valuation alongside quality factors, such as capital structure, corporate behaviour and profitability. This was interspersed with brief periods in Q2 when growth came back into favour and that is how the period ended.

In many ways, the market environment was the mirror image of the recovery period from mid-March 2020 as many of the so-called Covid-19 winners found themselves languishing near the bottom of the performance charts, replaced by companies positively disposed to the reopening of economies and the expected economic rebound. Among the most notable victims were companies or industries with strong sustainability credentials, such as companies exposed to the energy transition. Meanwhile, oil companies and miners, which are highly geared towards the recovery – and where the fund has little exposure – performed extremely well.

Despite this clear headwind, our investment approach, which seeks a diverse range of companies that look attractive from multiple perspectives, ensured that the fund kept pace with the benchmark index. This diversification results in a fund that avoids excessive factor or macro exposures, is broadly neutral from a sector and regional perspective, and is populated by companies with good or improving ESG characteristics across the style spectrum.

Furthermore, it provides a degree of protection from short-term swings in sentiment. Tangible evidence of this is demonstrated by the fund's performance over the past 18 months. It outperformed its benchmark in Q1 2020 as fear gripped markets when the pandemic took hold; it outperformed in the subsequent recovery between March and November and has held its own in the subsequent vaccine-boosted value rally.

Going forward, investors are looking through any dampening of activity caused by the delta variant and are focused on the seemingly irreversible trend towards reopening. Global earnings are still being upgraded and, while multiples may be peaking, earnings growth can lead markets higher.

As such, we remain bullish towards equities. However, at these valuation levels, risk appetite is more fragile and future gains are likely to be more conservative. We are also mindful that the narrative can quickly change, creating scope for bouts of short-term volatility. These periods are notoriously difficult to predict so we continue to take a long-term view and remain broadly diversified, while using moments of turbulence to invest in long-term opportunities.

With the initial euphoria of the reopening behind us, the easy wins for value investors are also behind us. As such, we are focused on finding value opportunities within sectors, rather than simply focusing on the traditional value sectors. We also continue to focus on the transition to a more sustainable economy, which we view as an exceptional market opportunity as awareness grows of sustainability issues and opportunities across sectors.

SECTION 2
Our investment philosophy

We believe in:

Pragmatism: a combination of time-tested fundamental and ESG characteristics that are attractively priced

Sustainability: companies with a competitive advantage and sustainable business models are more likely to offer visibility of earnings growth

Responsibility: integration of ESG factors and active ownership minimises the probability of negative surprises and can unlock hidden value

Long-term focus: investing over the long term allows companies to reach their true potential

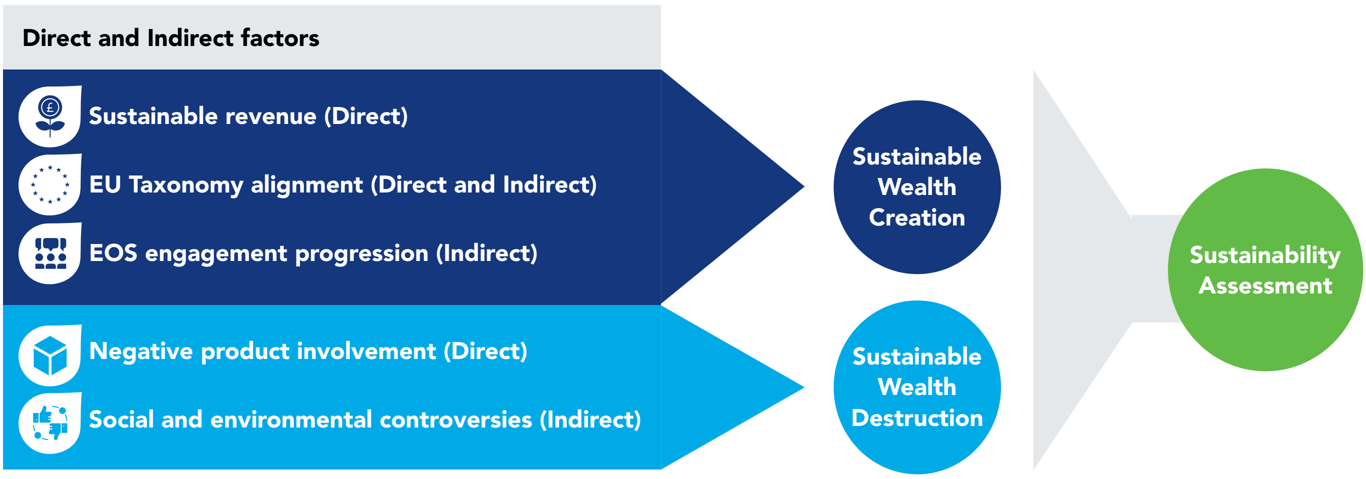
Validating the philosophy

We like stocks with robust financial statements, competitive strength and a proven ability to consistently beat revenue and earnings expectations. Ideally, these companies should also be guided by impressive management teams, mitigate ESG risks and appear cheap relative to peers. But very few stocks embody such an ideal investment, so we identify those with the most attractive combinations of characteristics in every market environment.

We identify companies using a systematic approach based on solid time-tested fundamentals. The process also applies a proprietary risk management framework. Further details on how we integrate ESG considerations in the process is included in our recent paper 'A truly integrated approach'. During H1 2021 as part of our research we identified an opportunity to measure how a company contributes to sustainability. We set out further details in our research paper 'Introducing our sustainability assessment framework'.

We are currently using the score to inform our analysis while we learn more about the companies that the score positively identifies and in time we will determine how we will use the score in our investment process based on these observed outcomes. One key aspect to the score, continues to support our existing philosophy, focussing on evaluating both the level and change of how a company is addressing sustainability.

Figure 1. The Federated Hermes Global Equities Sustainability Assessment



Source: Federated Hermes, as at April 2021.

SECTION 3

Engagement overview

Alongside our colleagues at our stewardship business, EOS at Federated Hermes ('EOS'), we seek to drive change through board and executive-level interactions. Our engagements with portfolio companies often include meetings with divisional heads, investor relations teams, board members, chairs, lead independent directors and chairs of board committees.

Through our interactions, we gain information related to specific engagement objectives and issues. Our proprietary milestone system allows us to track our engagement progress.

Furthermore, we benefit from the wider research universe covered by EOS, a diverse team with backgrounds including law, banking, sciences, academia, accountancy, climate change and corporate strategy, and the collective ability to speak fluently in over 10 languages. In turn, the team's skills, languages, connections and cultural understanding enable local language dialogues which are of great importance.

Engagement progress, H1 2021

Total engagements **162**

Engagement objectives by theme

Environmental	Social and Ethical	Governance	Strategy, Risk and Communication
25.0%	27.3%	32.6%	15.2%

Source: Federated Hermes, as at 30 June 2021.

Voting, H1 2021

Voting is a key part of demonstrating active ownership and ensuring companies are meeting the needs of shareholders.

Voting breakdown

Meetings where we voted in favour:	Meetings where we voted against, against and abstained, or with management by exception:
30%	70%

Source: Federated Hermes, as at 30 June 2021.

SECTION 4
ESG outcomes

We are cognisant that every company has both positive and negative impacts when it comes to its operations. Here we present a snapshot of our fund's carbon metrics:

Carbon footprint (scope 1 and 2) per $m invested

Fund:	Benchmark:
49.9	104.0

52% lower than the benchmark index

Carbon intensity – tonnes per $m of sales (scope 1 and 2)

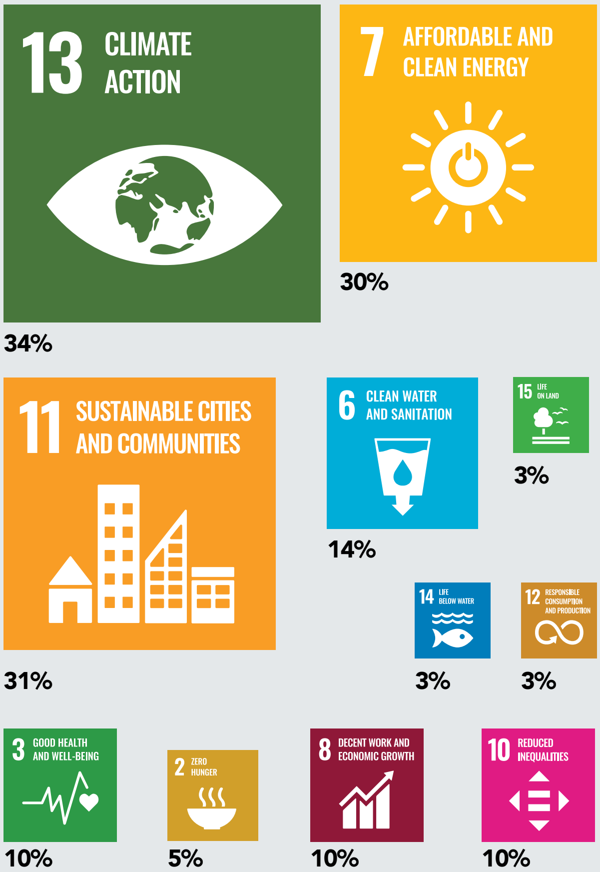
Fund:	Benchmark:
131.8	236.0

44% lower than the benchmark index

Environmental opportunities exposure **37%**

SDG exposure

Here we demonstrate our SDG exposure – that is, companies where there is revenue exposure to investable themes which are aligned to the UN Sustainable Development Goals (SDGs).



Source: Federated Hermes, as at 30 June 2021. Note percentages shown add up to more than 100% as companies can be exposed to more than one SDG.

SECTION 5

In the spotlight: ESG in US tech

Technology makes up the largest segment in the global investment universe, accounting for more than 20% of the MSCI All Country World Index (see Figure 2). The sector's dominance of the equity market mirrors its increasingly central role in our everyday lives. From phones to computers to microchips, the pervasive nature of the sector's output and its role in our society, particularly during the lockdowns of the last year, pay testament to the exceptional returns that investors in the sector have enjoyed.

Figure 2. Sector weighting

Information Technology	Benchmark weight
Communications Equipment	0.58
Electronic Equipment Instruments & Components	1.15
IT Services	4.20
Semiconductors & Semiconductor Equipment	5.18
Software	6.21
Technology Hardware Storage & Peripherals	4.57
Total market capitalisation	21.89

Source Factset, as at 30 June 2021.

Within the fund, technology is the sector to which we hold the largest overweight. This is predominantly the result of a strong exposure to semiconductors & semiconductor equipment, and technology hardware storage & peripherals.

On account of the increasingly important role that this sector plays in our lives, governments across the world continue to update regulation surrounding how the sector operates. In most cases, the technology companies have been ahead of the curve on regulatory matters and in the cases where companies have found themselves on the wrong side of emerging laws, they tend to address the issues quickly and any fines incurred have been insignificant relative to the ongoing cash generation that has been achieved. This evolving regulatory landscape is a challenge that the technology companies must embrace to ensure their long-term survival.

The sector has lagged more mature industries in the implementation of ESG-related practices as their fast pace of growth has, in some cases, overtaken the requirement to build long-term considerations into their evolving business models. Many companies are now reporting standardised ESG metrics and, as a result, we see that technology companies fare above average on our QESG[1] score.

Mineral sourcing, crucial for companies using a range of resources within their products historically received a lot of societal focus and industry groups were created to tackle the issues around conflict minerals, and policies were implemented to improve minimum standards and transparency. The mineral sourcing challenge led companies to think more deeply about both their supply chains and end of use, leading to more circular thinking being adopted by companies as part of the drive to reduce absolute consumption with scrap metals being re-introduced into new components, and more products being sold as a service. The additional legislation on human rights due diligence globally, in particular the EU Mandatory due diligence law which was passed in April 2021 has also increased investor focus to this area of human capital supply chain management. Frameworks such as the Workforce Disclosure Initiative and Know the Chain are useful for companies and investors to source comparable industry data in this area.

More recently cyber security, data governance, the ethics in AI and market competition have attracted attention from the media and the market. The sector has begun to improve its processes on these issues and regulation is being implemented, particularly in the EU with the ePrivacy and Cybersecurity Act due to be implemented this year.

The final issue hanging over the sector is tax and tax policy. Amid continued criticism that the tech giants are failing to pay their fair share of tax, governments across the world are joining the conversation about corporate taxation. As a result, it is likely that a global tax agreement will be reached at some point in the medium term.

Our investment approach

We draw on our proprietary QESG model, along with quantitative and qualitative analysis to guide our investment decisions. We look for companies with good practices and processes, robust implementation and evidence that the company is on a positive trajectory in tackling ESG issues.

Technology companies, being largely US domiciled, have historically faced less top-down scrutiny of their ESG reporting. This has, however, begun to change with the Biden administration. That said, the sector still poses a problem for responsible investors as the size of these businesses and their exceptional returns mean there are significant investment risks associated with not holding them.

As mega caps and consumer-focused businesses, technology companies are often the target of conflicting newsflow. It can be difficult for investors to pinpoint what is meaningful amid the huge amounts of content that references these companies and their goods, employees and operations.

In 2020, markets saw an influx of retail investors who have a tendency to trade more frequently and use sentiment indicators. This has contributed to the very strong performance of technology names over the period. But the larger the retail investor base that a company has, the more important it is for the company to manage its reputation. For example, we have seen several companies in the sector launch advertising campaigns to highlight their work on issues such as working conditions, recyclability and data privacy.

[1] Note: QESG scores, generated by our Global Equities team at the international business of Federated Hermes, rank each stock worldwide in accordance with its ESG risk.

How big is too big?

In our view, the technology companies are ahead of the global average on addressing environmental and social issues. Their management and innovative business models mean they have been able to build their businesses in tandem with the maturing debate around ESG and sustainability. This is why our approach – which incorporates identifying companies that are adopting improved practices – is crucially important.

As these companies grow to be more systemically important businesses, the expectations and the responsibility placed upon them becomes greater. As investors, we look for names with attractive financial characteristics, meaningful revenue growth, a willingness to foster innovation and produce products that can command an ever-increasing price. The technology ecosystem continues to expand, and the dominant market players are well placed to build out broader ranges of products and services. With such strong cash-generating businesses, what companies decide to do with that cash will influence investor enthusiasm. On momentum, investor expectations are high, particularly given that the companies have weathered the Covid-19 slowdown so well. The high expectations may be a source of weakness if the companies cannot continue to deliver in a world of constrained longer-term growth.

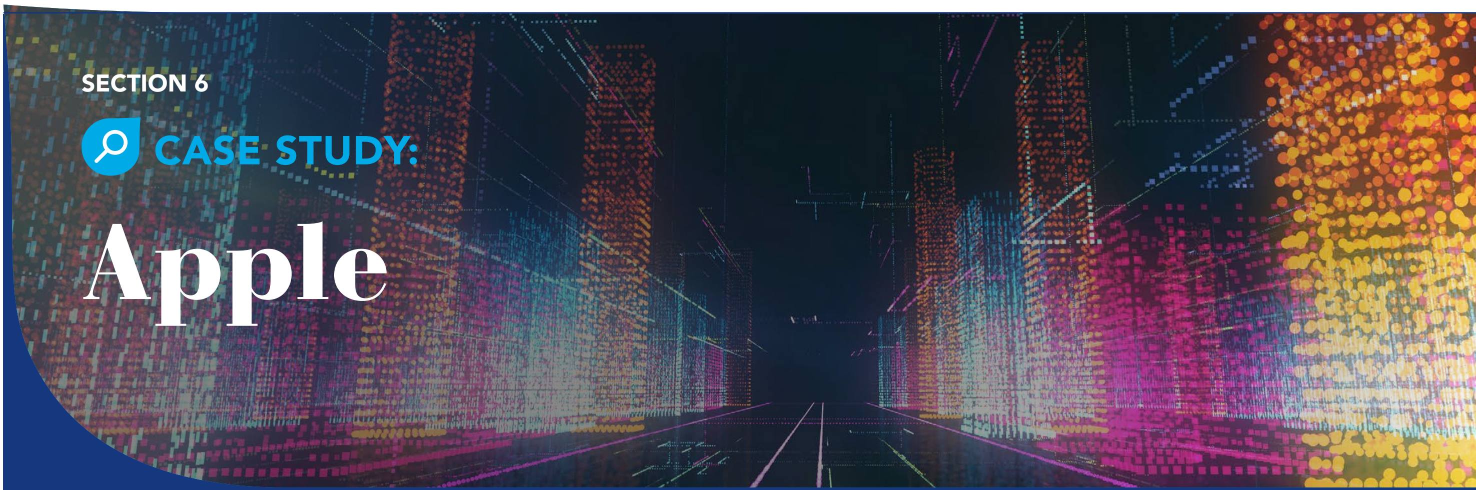
> **The technology ecosystem continues to expand, and the dominant market players are well placed to build out broader ranges of products and services.**

Engaging with big tech

Engaging with big technology companies can be a challenge given the influence and scale that these businesses have. Getting access to leadership can also prove difficult given the governance and shareholders structures. We have, however, seen this improve over recent years as companies have welcomed greater interaction from investors. As a result, we've had significant success with technology companies on environmental and social topics rather than governance, although product responsibility (a governance topic) is often cited as the most meaningful. Through our engagement on this topic, we look for more transparency and often propose greater accountability through committees and dedicated expertise. Other broader conversations with technology companies encompass market concentration and culture. This is in addition to the most frequently discussed items of climate change, human capital and data privacy. While a significant proportion of the sector offers earnings and revenue growth, engaging on sustainable business practices remains an integral part of mitigating the ESG risks the companies are exposed to.

Stewardship outcomes:

- Apple – announced its commitment on carbon neutrality.
- Alphabet – establishment of human rights executive council and creation of processes and tools to enable the responsible use of AI.
- FujiFilm – improved board structure and published AI policy.
- SK Hynix – company joined industry committee and declared ambition to achieve net zero carbon emissions.



SECTION 6

CASE STUDY:

Apple

Apple Inc. is a US company that develops and sells mobile and media devices, personal computers, portable digital music players and related digital content services and applications. First listed in 1980, it has risen to become the world's largest listed company with a market cap of around $2.5 trillion.

Over several years, Apple has moved from being a focal point of several social and human rights controversies to becoming a leader in tackling environmental issues across the technology space. The company continues to invest in innovation around green energy, electric vehicles and autonomous vehicles. It is also focused on reducing its carbon footprint by working with suppliers, supporting the development of green energy and using production processes and products that have less environmental impact, such as recycled and alternative aluminium.

> **Over several years, Apple has moved from being a focal point of several social and human rights controversies to becoming a leader in tackling environmental issues across the technology space.**

Our outlook on Apple

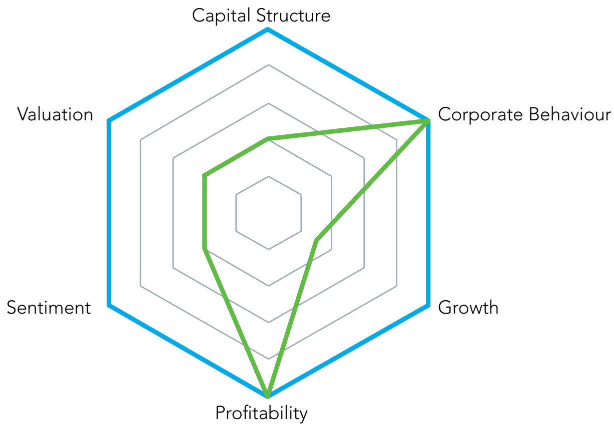
From an investment perspective, there are three factors driving our positive outlook on the company. These are sentiment, profitability and corporate behaviour. The company has attractive earnings and margin growth relative to its peers. Along with strong cash flow and competitive strength, Apple established robust governance and environmentally aware practices.

In its last Q2 earnings statement, Apple demonstrated exceptional revenue growth across key segments, including iPhone, Mac, iPad and wearables. We expect the company to continue to grow, particularly in wearables and services across key markets including China.

Looking ahead, Apple is positively exposed to discretionary spending trends. The 5G upgrade cycle is continuing to support iPhone sales, while increasingly robust privacy and data controls ensure that the products maintain a competitive advantage.

Apple's management of its key ESG risks is adequate and the company provides extensive visibility into policies and programmes. For example, Apple integrates privacy principles into the development of its hardware, software and services, including iCloud and Apple Pay. Similarly, Apple protects user data using encryption, tokenisation, and data segmentation to prevent connecting user behaviour with an identity.

Figure 3. The Alpha Model provides a thorough analysis of Apple's long-term prospects



Apple in our portfolio

The company has been held in the portfolio for a number of years and has many appealing investment characteristics, including a favourable valuation and strong cashflow generation. However, growth rates have reduced somewhat as iPhone sales have slowed. Apple has strong privacy commitments and practices, and its confrontation with the US government on data requests helped to boost its reputation – the company actively promotes its brand as having better privacy standards than peers. EOS has engaged positively with Apple, most notably in relation to device addiction, Scope 3 emissions and freedom of expression, citing the company's removal of mapping apps in Hong Kong. Apple outperforms across the 'environment' and 'governance' metrics, but lags behind slightly in 'social', which is evidenced by level 3 controversies relating to labour relations in the supply chain according to Sustainalytics. The company was the first US technology companies to issue a green bond in 2016.

Engagement issues

- Risks: most are related to the technology hardware industry and its impact on climate change, human rights and risk management. We are also monitoring the company on the issue of diversity and board independence; two issues which Apple currently scores very well on.
- Supply chain constraints could be an issue although the company has proactively ensured its distribution arrangements are solid across the world (and diversified) mitigating this risk. Apple positively works with supply chain partners.
- US tax rises: Apple is better positioned on this issue than many other large global tech players and already has transparent policies in place. The company received attention for its tax strategy, and while its tax optimisation strategy is in line with other multinationals, the company paid back taxes to Ireland as of September 2020.

> **Growth in sustainable revenues, however small, must be considered as well as a company's ability to execute on strategies linked to Sustainable Wealth Creation or the mitigation of Sustainable Wealth Destruction.**

SECTION 7

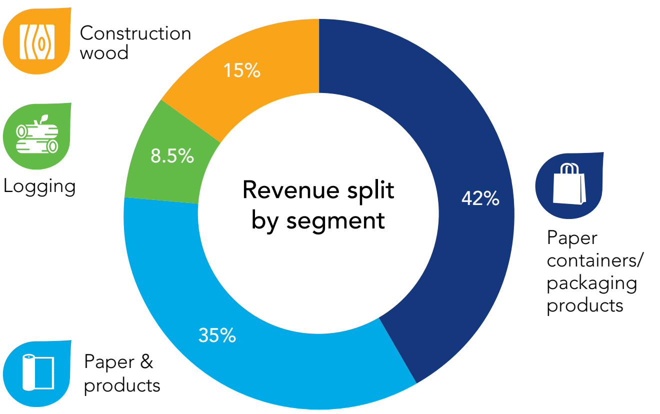
ENGAGEMENT CASE STUDY:

Stora Enso

Stora Enso is a sustainable food-packaging specialist that describes itself as ‘the renewable materials company’. The company produces a quarter of all food containers in the world, and has a broad footprint, operating in more than 40 countries.

With wood and fibre as the main raw materials in its production processes, the company is exposed to pulp and packaging prices as well as paper. Stora Enso is the largest company in its peer group by sales.

Figure 4. Stora Enso revenue split by segment



Source: Factset RBICS, June 2021.

The business seeks to contribute to the attainment of the UN’s Sustainable Development Goals by focusing its sustainability activities in nine key areas, including sustainable forestry, materials, water and energy, and business ethics, with human rights integrated into all.

In 2018, the company introduced its own green bond framework and has committed to reduce greenhouse gas emissions from its operations by 31% per tonne of pulp, paper and board produced by 2030. CDP consistently ranks the company favourably on Forests, Timber and Climate Change.

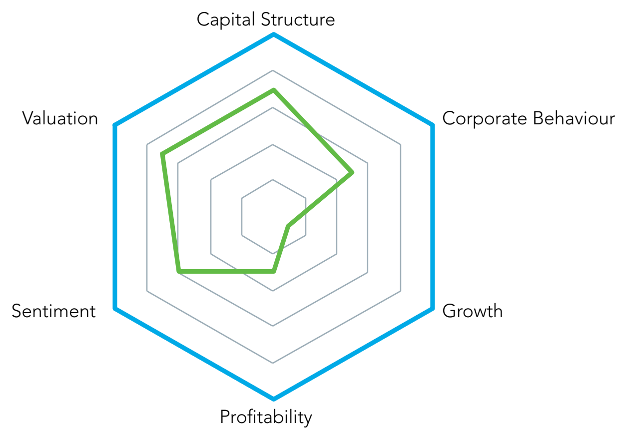
Where Stora stands on key ESG risks

As well as offering solid investment characteristics such as favourable sentiment and a strong capital structure at an attractive valuation, the company scores very highly based on our assessment of the pertinent ESG risks that it faces. The management of environmental issues is strong including around water stress which is a prominent risk, particularly in China where scarcity is of increasing concern. Operational efficiency is a key measurement metric and Stora is average among its peers on energy intensity, but sources 79% from “low carbon” energy (including biomass). On diversity, which can be a challenge to achieve for the industry, the company leads on both gender balance and gender equality.

Sustainability is a company focus: addressing material sourcing and product recycling and re-use. Stora demonstrates best practice supplier management and auditing, however, land disputes in some territories are ongoing. The issue of chemical safety is evolving based on increased regulation and safety standards, particularly within emerging markets.

Despite the company establishing strong oversight programmes of its joint ventures and supply chain, these exposures are key risks as it expands. Following a meeting in May 2017, we were pleased with the implementation of the human rights action plan but concerns remain about joint ventures in emerging markets. We asked the company about the progress of the implementation of the human rights action plans that resulted from a comprehensive assessment. We were satisfied that all issues raised in the assessment have been addressed and almost all action plans have been implemented. As some plans are permanent in nature, the company does not report them as completed. We commended the company for publishing its sustainability indicators targets, but challenged the carbon footprint target, which does not seem to be stretching.

Figure 5. The Alpha Model provides a thorough analysis of Stora Enso’s long-term prospects



Land and labour

The company has certified the land holdings that supply most of its fibre. Nevertheless, its land management in both China and Brazil continues to garner criticism, despite efforts to rectify historical problems. The company faces increased regulation and safety standards, particularly in emerging markets, and this is an area where we continue to push for improvements. We raised our concerns with the company about the reputational risk of the joint ventures in Brazil, China and Pakistan, as all of them have been involved in controversies relating to land ownership and labour rights. We discussed how each local operation is dealing with the controversies and were encouraged with the actions taken to improve relationships with communities. More broadly, we challenged how Stora Enso oversees its joint ventures. The head of investor relations outlined the framework in place to mitigate reputational risk. A dedicated team at the head office oversees the joint ventures and members of staff sit as non-executive directors on local boards. We were reassured by the company's progress on human rights and sustainability, and will follow up on the revised carbon footprint target.

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

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