Federated Hermes Global Equity ESG Fund

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Federated Hermes
International

www.hermes-investment.com
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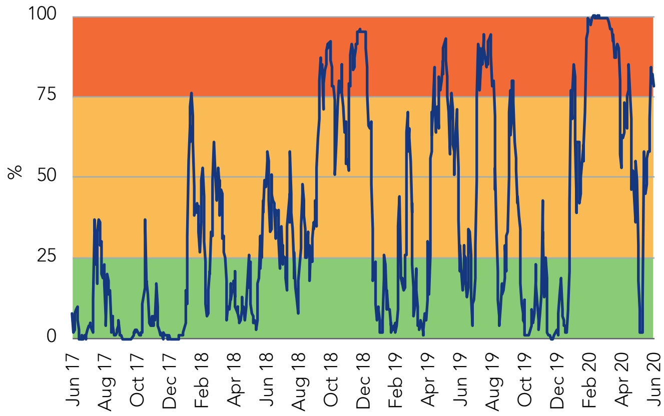
SECTION 1

Global Equity ESG: Review, H1 2020

It's easy to forget that just six months ago investors were broadly optimistic for 2020. At the time, US-China trade talks were progressing, while a positive Q4 2019 earnings season was still fresh in the minds of many.

But the world was about to change. The coronavirus, which first emerged in the Chinese city of Wuhan in late 2019, spread aggressively across the world. Turmoil, reminiscent of the global financial crisis, ensued in financial markets: volatility spiked, risk aversion jumped (see Figure 1) and markets plummeted.

Figure 1. Risk aversion spiked amid the rapid spread of the coronavirus globally



Source: Federated Hermes Global Equities, as at June 2020. Note: risk aversion measures investor confidence – when the risk aversion indicator is in the green zone investors tend to be more speculative and seek higher risk assets; when it is in the red zone investors are nervous and tend to seek safety.

As whole economies shut down, companies perceived to have the ability to survive the looming economic slump performed relatively well. This was reflected by a clear preference for balance sheet strength and operational efficiency.

Markets then rallied, fuelled by unprecedented government interventions and a massive loosening of monetary policy, but the preference for these qualities remained, with the exception of a couple of short and sharp rotations into value. Additionally, companies providing goods or services that helped mitigate the impact of the virus also performed well, resulting in a preference for positive earnings growth.

We have continued to focus on the long-term merits of a diverse range of companies with durable business models that look attractive from multiple perspectives and have good or improving environmental, social and governance (ESG) characteristics. This approach has been successful, both in the jaws of the crisis and as markets rebounded.

Looking ahead, we see growing awareness of sustainability across every sector. Embracing sustainability is not just about avoiding risks, it is also about finding business opportunities. In this environment, it is that type of thinking which enables businesses to thrive (or survive).

The transition to a more sustainable economy, therefore, represents an exceptional market opportunity. Companies playing an active role in adapting to and mitigating some of the greatest challenges that we see today in society are likely to be rewarded through future policy and legislation, promoting greater sustainable development. This crisis will perhaps hasten the speed of transition, and markets for obsolete, unsustainable products and services will decline.

While environmental concerns have gained exceptional mainstream attention over the last 12 months compared with previous years, the global pandemic and the tragic death of George Floyd brought the social aspects of businesses to the fore. In particular, how companies responded to the health concerns of their workforce and customers was seen as poignant evidence of stakeholders' rights gaining importance. The protests about the systemic racism that exists within our societies stirred companies into action on policies which had not previously been fully tested or held to account at such a level.

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

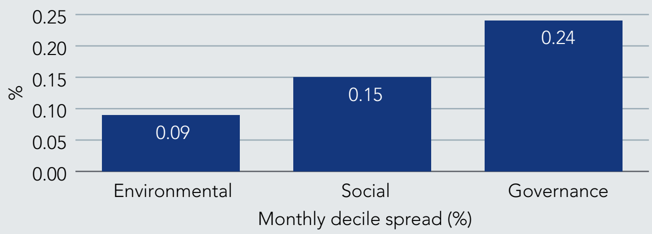
Responsibility: integration of ESG factors and active ownership minimises the probability of negative surprises and can unlock hidden value

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

Validating the philosophy

In our latest study, ESG investing: a social uprising, which analysed correlations between companies with high ESG scores and shareholder returns from 31 December 2008 to 30 June 2018, we found that companies with good or improving environmental, social or governance characteristics on average outperformed companies with negative characteristics. This was driven by the strength of their corporate governance and, for the first time since our investigation began in 2014, social metrics.

Figure 2. ESG investing: finding value in governance and social factors



Past performance is not a reliable indicator of future results.
Source: Federated Hermes, 30 June 2018. Note: Monthly decile spread is the average difference in monthly return between companies ranked in the top 10% and companies ranked in the worst 10%. Figures calculated using constituents of the MSCI World index assuming monthly rebalancing.

SECTION 3

Engagement overview, H1 2020

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 may take the following form: face-to-face meetings with board members, chairs, lead independent directors and chairs of board committees. Through our interactions with divisional heads and investor relations teams, 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.

Against the backdrop of the global coronavirus pandemic, we have seen an increased willingness from companies to discuss ESG issues with shareholders (see our commentary Stewardship during and after a pandemic for more information). In addition, in H1 2020, both EOS and the international business of Federated Hermes, as part of the Investor Alliance on Human Rights, signed a joint statement with other investors about how companies should respond to Covid-19.

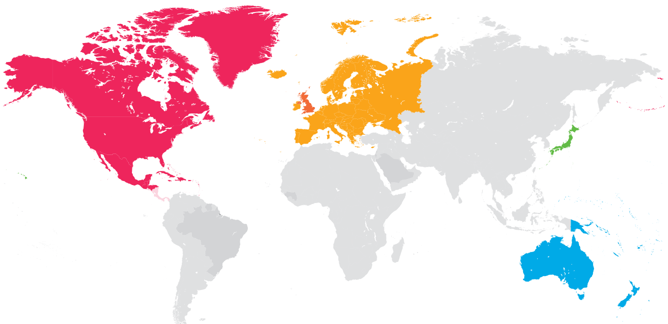
In these uncertain times, there is however one metric that can enable greater business resilience – and that is good board effectiveness. While company disclosures of board size, age, composition and tenure are improving in some markets, it provides a limited picture of a board's functionality. Simply ticking all of the 'good governance' boxes does not guarantee good governance, as demonstrated by large-scale corporate failures. A recent paper published by EOS outlined five principles that can be considered most important for board effectiveness. They include genuine independence, diversity and inclusion; the role of the chair; how the board allocates its time; the board's relationship with the CEO; and commitment to continuous improvement. These areas are best explored through dedicated engagement between investors and board directors. Within the investment process for our Global Equity ESG Fund, we use a combination of quantitative and qualitative lenses to evaluate companies.

Engagement progress, H1 2020

Total number of engagement issues and objectives **258**

Number of companies engaged **73**

Issues and objectives engaged by region



Australia and New Zealand **1**

Developed Asia **48**

Emerging and developing markets **23**

Europe **60**

United Kingdom **12**

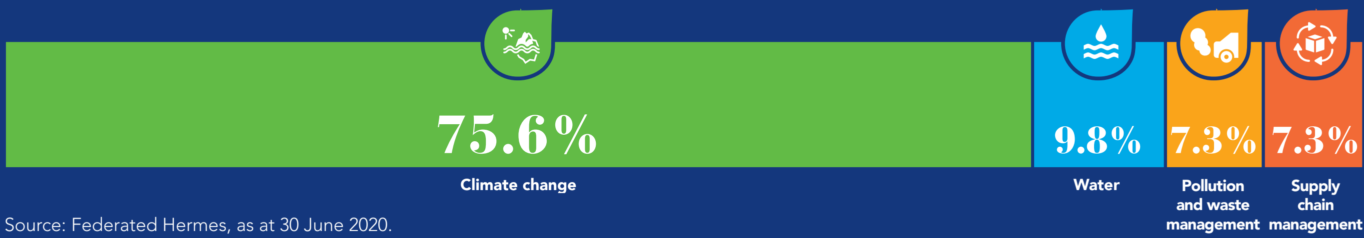
North America **114**

Source: Federated Hermes, as at 30 June 2020.

Engagement objectives by theme

Source: Federated Hermes, as at 30 June 2020.

Environmental: issues and objectives engaged



Source: Federated Hermes, as at 30 June 2020.

Social and ethical: issues and objectives engaged

Source: Federated Hermes, as at 30 June 2020.

Governance: issues and objectives engaged

Source: Federated Hermes, as at 30 June 2020.

Strategy, risk and communication: issues and objectives engaged

Source: Federated Hermes, as at 30 June 2020.

Milestone status of engagement

Source: Federated Hermes, as at 30 June 2020.

Voting, H1 2020

Voting is a key part of demonstrating active ownership and ensuring companies are meeting the needs of shareholders. This year we experienced a voting season like no other: AGMs went 'virtual' amid coronavirus lockdown measures, leading to different challenges for businesses. Remuneration, in particular, was a key focus as job uncertainty and swift changes in demand for products led to significant shifts in how certain individuals were rewarded.

We have also seen an increase in shareholder proposals which are also an important mechanism to hold management to account. We supported 52 shareholder proposals over the period.

> **This year we experienced a voting season like no other**

Voting breakdown

Meetings where we voted in favour:
25.8%

Meetings where we voted against, against and abstained, or with management by exception:
74.2%

Source: Federated Hermes, as at 30 June 2020.

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:

47%
lower than the benchmark index

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

Fund: **68**

Benchmark: **148**

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

Fund: **123**

Benchmark: **230**

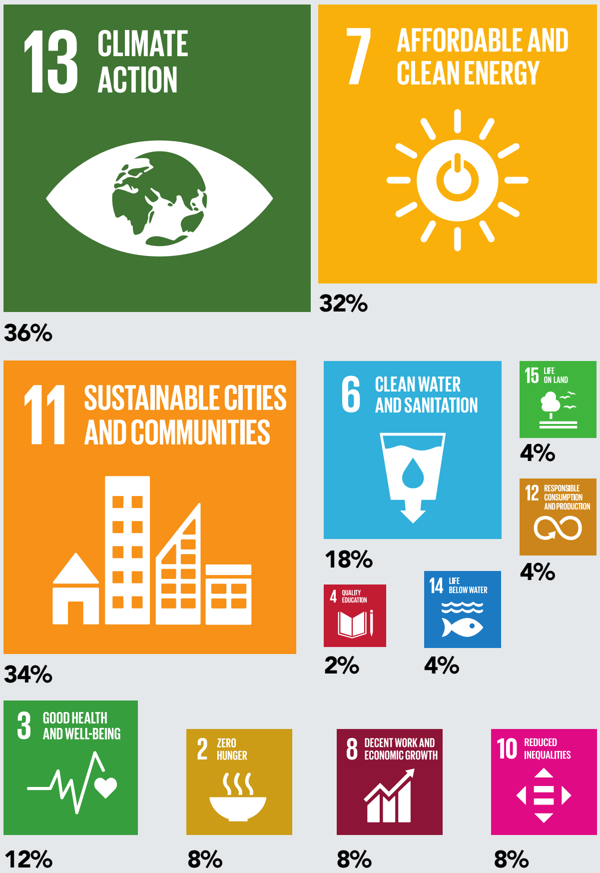
Environmental opportunities exposure[1]

39%

Source: Federated Hermes, as at June 2020.

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 2020.

[1] Scope 1 emissions are all direct GHG emissions by a company. It includes fuel combustion, company vehicles and fugitive emissions. Scope 2 emissions are indirect emissions from the generation of purchased electricity, heat and steam.

[2] Environmental opportunities exposure means companies where there is revenue exposure to green themes, such as energy efficiency, pollution prevention, green buildings or sustainable water for example.

SECTION 5

ESG CASE STUDY:

Nestlé

Nestlé is the world's largest food and beverage company

Employs over

300,000 people

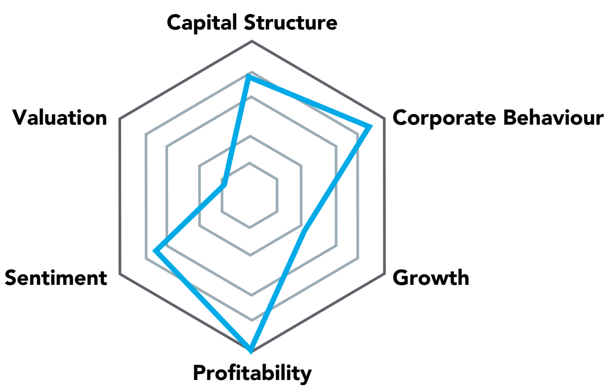
With over 2,000 brands, it operates in more than

190 countries

Identifying long term outperformers

We believe focusing on long term investing allows us to capture the companies which are able to realise the benefits of their diligent and market-leading approach to managing and operating their business and products. We target innovative companies that anticipate tomorrow's challenges today, thereby delivering a market need. Our proprietary system the Alpha Model allows us to assess the attractiveness of a company over the long term across a number of factors – profitability, growth, sentiment, valuation, corporate behaviour and capital structure. This combination of proven fundamental characteristics is crucial to our investment approach – and it can be demonstrated through our exposure to Nestlé. The Alpha Model tells us that Nestlé is a well-managed, high-quality company with impressive balance sheet strength, profitability and defensive earnings (see figure 1).

Figure 1. The Alpha Model provides a thorough analysis of Nestlé's long-term prospects



Source: Federated Hermes, as at 31 March 2020.

The company has remained resilient during the global coronavirus pandemic, owing to its diversified portfolio of products and presence across the world. In its Q1 2020 results, the group reported organic growth of 4.3% and maintained its full-year guidance amid expectations of continued improvements in organic sales growth and underlying operating profit margin[2].

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[2] Nestlé, as at 31 March 2020. See: https://www.nestle.com/media/pressreleases/allpressreleases/three-month-sales-2020.

Driving positive ESG momentum

Alongside an attractive combination of long-term fundamentals, we seek to invest in companies with positive ESG momentum. As one of the largest companies in the world, Nestlé has impacts throughout high, medium and low developed economies. With a diverse product range of over 2,000 brands, some of the raw materials that it uses for its products, including palm oil and cocoa, can have negative environmental and social impacts if not sourced responsibly. From an ESG perspective, we rank Nestlé favourably compared to its peers when the overall sustainability impact of the company is considered. It has also been demonstrating progress on a number of material issues, on which we have also engaged the company. These include:

Plastics: the company announced an industry-leading plastics strategy to develop sustainable packaging and shift towards recycled plastic.

Cocoa supply chain: it launched the Nestlé Cocoa Plan in 2009 to make cocoa farming more sustainable, improve the lives of farmers and enhance the quality of its products. A key part of its plan is to address the issue of child labour. Nestlé was the first company in the industry to introduce a comprehensive Child Labor Monitoring and Remediation System (CLMRS) in 2012 – and today, it covers 78,580 children, helping them stop partaking in unacceptable activities and, where needed, helps them access quality education. In 2019, Nestlé published a comprehensive and transparent cocoa report, which demonstrates the significant progress the company has made on the issue of child labour as well as its ambitions for the future. It aims to achieve 100% sustainable cocoa sourcing in its confectionery products by 2025. And plans to expand the reach of the CLMRS across its supply chain in West Africa.

Carbon neutral: the company is targeting net-zero emissions by 2050 and has publicly identified the need to lower the carbon footprint of its product portfolio by increasing the number of plant-based food and beverage options. In our engagements with Nestlé on its strategy for sustainable food, we have acknowledged its high-level commitment, but we would like to see time bound targets at brand and category level so as to increase the volume and sales of its plant-based food.

Gender diversity: Nestlé runs programmes internally to improve gender diversity. as a result of a new female board member being elected in April 2020, the company has now increased its board diversity to over 30% women.

We are encouraged by the positive progress that Nestlé has made in recent years – and we will continue to engage with the company on sustainability-related issues.

Responding to the coronavirus pandemic

Nestlé has focused on three key priorities during the pandemic – the health and wellbeing of its employees, ensuring business continuity to meet consumer needs and supporting communities with local relief efforts – as outlined in its Q1 2020 update[3]. For example, for out-of-home and food service customers, through its 'Always open for You' initiative, Nestlé is extending its payment terms, suspending rental fees for coffee machines and offering free products. Elsewhere, within its dairy supply chain, it is working with more than 200,000 dairy farmers globally, fulfilling its commitments to buy agreed volumes in order to sustain farmers' livelihoods.

In 2019, Nestlé published a comprehensive and transparent cocoa report, which demonstrates the significant progress the company has made on the issue of child labour as well as its ambitions for the future.

[3] Nestlé, as at 24 April 2020. See: https://www.nestle.com/media/pressreleases/allpressreleases/three-month-sales-2020

SECTION 6

ENGAGEMENT CASE STUDY:

Ping An

Ping An is second largest life insurance company in China

Employs over **372,000 people**

It serves **200.48m** retail customers and

516m internet users through its five ecosystems in financial services, healthcare, auto services, real estate services and Smart City solutions

As China's second largest property and casualty insurance company, Ping An focuses on finance technology and systems to provide customers and internet users with innovative and simple products and services. Using the Alpha Model to assess the company's fundamentals, Ping An is rated above its peers across all factor categories (namely, profitability, growth, sentiment, valuation, corporate behaviour and capital structure). Within a broader low-growth environment, the group's new and renewal business has proved resilient, while its customer development yielded strong results in Q1 2020. It acquired 8.71m new retailer customers in the first three months of the year, of whom 34.7% were sourced from internet users within its five ecosystems. It also launched its 'one-click claims service', which yielded strong engagement, enabling non-physical contact claim settlement anywhere at any time.

However, against the backdrop of the global coronavirus pandemic, Ping An is operating in a challenging business environment: we have seen changes to interest-rate regimes, a rise in credit risk and a deterioration in credit quality. In addition, offline operations have stalled due to constraints imposed on the business due to Covid-19 and respecting health awareness of staff and customers. Ping An has responded to the crisis by strengthening its credit risk management and developing additional online operational models. The virus has accelerated technological transformations which is favourable for the company's future prospects, given its strong technology driven platform and foundation.

An improving ESG profile

We use our proprietary QESG Score to rank a company's ESG characteristics and to demonstrate whether risks are increasing or decreasing. Ping An's QESG Score has improved year-on-year, particularly its environmental characteristics, due to improved disclosure. As well as the quantitative assessment, qualitatively we have also seen an improvement and robust structures that go beyond "box-ticking".

Alongside our colleagues at EOS at Federated Hermes (EOS), have been engaging with Ping An since 2017. At the time, the company did not have a systematic framework on responsible investment, despite its progress on inclusive finance and green finance. We suggested that as a first step, it become a signatory of the Principles for Responsible Investment (PRI) and shared our experience as a founding signatory. We also shared insights on areas for improvement to create more long-term sustainable value.

Since then we continued to build our relationship with the company, engaging on issues such as its communications and disclosures, the Task Force on Climate-related Financial Disclosure (TCFD) recommendations, artificial intelligence (AI) applications and data governance, and its sales incentivisation mechanism (see our engagement timeline below). In just three short years, Ping An became the first Chinese asset owner signatory of the PRI and published its first TCFD report, which set overall environmental objectives, strategies and governance structures.

It documented its strategy of climate change considerations and risk management for investment portfolios, insurance products, green finance innovation and research and management of Scope 1 and 2 emissions. In addition, It is committed to integrating ESG factors into its investment strategies and products, and has started implementing its own responsible investment policy framework. In April 2020, Ping An became the first Chinese company to join the UN Principles for Sustainable Insurance with a sustainable insured amount surpassing Rmb 121tn (US$17tn).

Meanwhile, on the issue of AI ethics and data governance, it became one of the first major financial institutions globally to publish a set of AI ethics principles. We continue to engage on the issue and hope to discuss how AI principles are being applied and implemented in different aspects of financial services offerings and operations.

Our engagements with the company occurred at a time when reform, driven by stewardship activities, was accelerating change in – and awareness of – sustainable investment in China. ESG integration is now an area of research and discussion in the region, supported by policy reforms developed since the 2016 Guidelines on Establishing the Green Financial System.

Other initiatives helped to promote the sustainable investment agenda in China too: in 2018, the China Securities Regulatory Commission (CSRC) revised the Corporate Governance Code to incorporate new language specifying public companies' responsibilities to disclose ESG information. In addition, an agreement to develop a mandatory environmental disclosure framework for listed companies is also in place.

In June, Ping An was named ESG Investor of the Year for Insurers, China at the industry-recognised Triple A Sustainable Investing Awards for Institutional Investor, ETF, and Asset Servicing Providers for a second consecutive year. The group's low carbon business and operation policy was also recognised at the awards, earning the prestigious Editor's Triple Star.

Engagement timeline

Engagement objectives:

We encouraged Ping An to:

- improve its communications and disclosure to meet expectations of global investors;
- report against the TCFD recommendations;
- publish ethical AI and data governance principles;
- become a PRI signatory; and
- improve its sales incentivisation mechanism to encourage a responsible and sustainable sales culture that suitably meets clients' long-term needs.

Q3 2017

- The company welcomes our constructive dialogue on best practice disclosures.
- We urge the company to become a signatory of the PRI and offer to share our experience as a founding member of the PRI.

Q2 2018

- We raise concerns about the company's recruitment and incentivisation mechanism of its sales agents.

Q4 2018

- The company acknowledges that its sales incentivisation mechanism can improve; it announces a change in strategy for the 2019 financial year to lead the market in changing the short-term behaviour of sales agents.

Q1 2019

- We push for emissions disclosure by absolute amount and recommended alignment with the TCFD reporting framework. We also share our public policy work on TCFD globally and invite the company to join the UK-China TCFD workshop as a way to build its knowledge.
- We discuss the ethical use of AI with the company; consideration will be given to constructing a framework to manage and disclose the principles that govern AI applications.

Q2 2019

- The company confirms that it is working towards becoming a PRI signatory.

Q3 2019

- The company joins the PRI as the first Chinese asset owner member and requests to co-lead engagements with us due to our ongoing engagement relationship.
- The company publishes its AI governance framework and ethical principles. It asks for our feedback on how they can be improved.

Q4 2019

- The company joins the China-UK TCFD pilot group. It presents for the first time at the PRI TCFD Forum in Beijing.
- The company posts a 49.7% increase in Q3 net profit on the back of steady growth in life products. It acknowledges that its strategy focusing on high-value, high protection life and health insurance products has paid off.

Q1 2020

- The company publishes its first TCFD report, which includes scope one to three emissions data, waste data, and sets targets for climate change.

Q1 2020

- We gain insights into the company's agency reform process, the tools that help support compliance, and its sales process. We share our recommendations on how to further improve transparency and disclosure.
- We urge the company to better harness its big data generated from its 100% digital screening for hiring and training processes.

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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