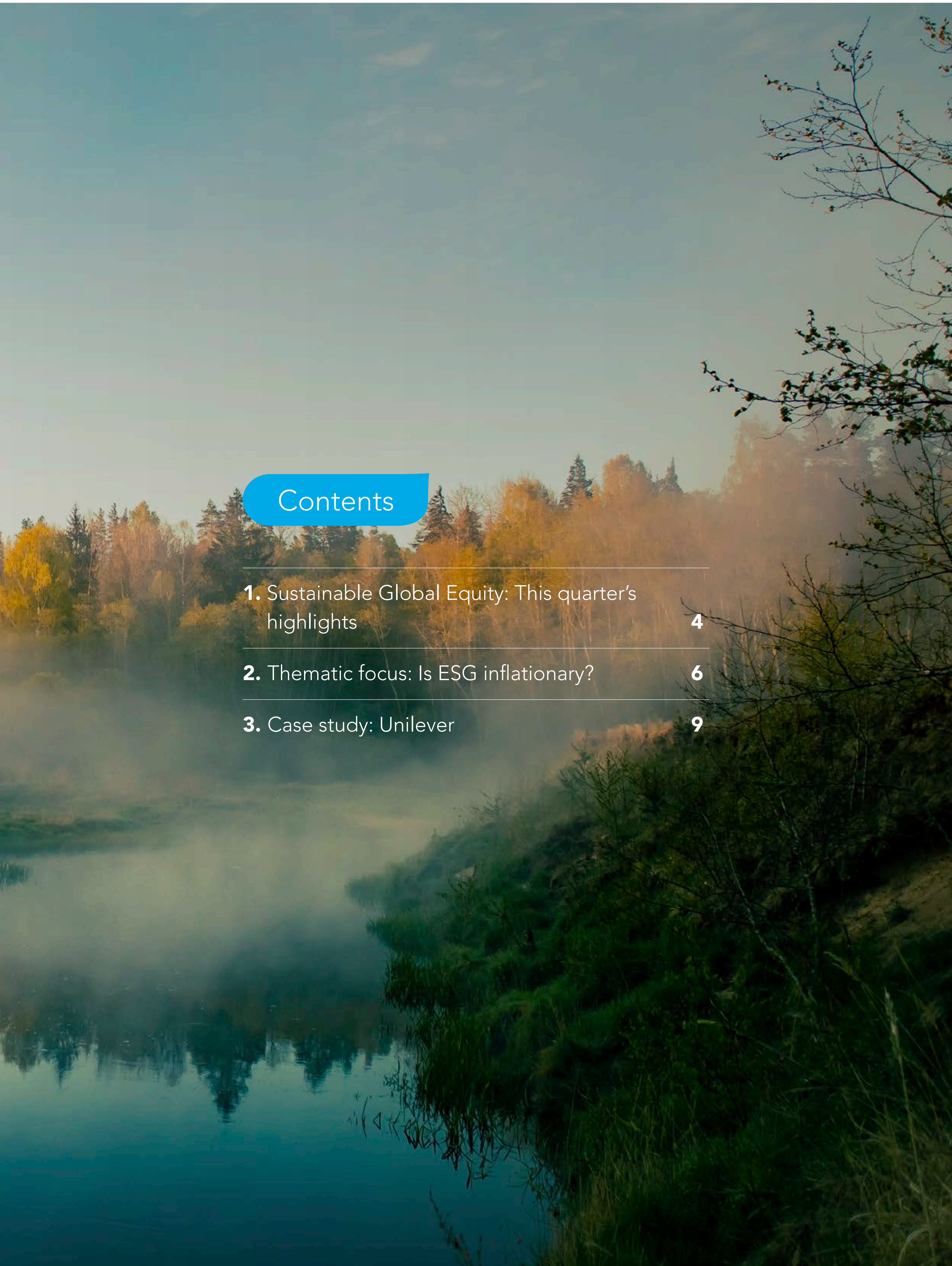
Federated Hermes Sustainable Global Equity Fund

Quarterly Report
Q1 2022

Federated Hermes Limited

www.hermes-investment.com
For professional investors only

Federated Hermes Sustainable Global Equity is a high conviction, fundamental strategy targeting sustainable companies: profitable businesses whose products, operations and activities help create a more sustainable future. Our ability to identify these investment opportunities – and engage companies to sustain and strengthen their positive actions – is reinforced by best-in-class ESG and stewardship integration. Through this approach, we seek long-term transformative change and financial outperformance.



Contents

SECTION 1

Sustainable Global Equity: This quarter's highlights

Exposure to sustainability themes

All portfolio holdings fit into one or more of our four investible themes, each of which consists of a number of sub-verticals.

As at 31 December 2021, exposure to these themes was as follows:

Environmental preservation

Sub themes include:

- Energy transition
- Electrification
- Biodiversity
- Future mobility
- Decarbonisation

Portfolio weighting: **25%**

Health and wellbeing

Sub themes include:

- Medical equipment
- Life sciences
- Pharmaceutical innovation
- Healthy and active lifestyles
- Health & Safety

Portfolio weighting: **23%**

Efficient production and resource usage

Sub themes include:

- Water preservation
- Circular economy
- Better and faster decision-making
- Supply chain efficiency
- Green materials

Portfolio weighting: **23%**

Social inclusion

Sub themes include:

- Democratising access to goods and services
- Financial inclusion
- Access to education
- Digitalisation

Portfolio weighting: **27%**

Source: Federated Hermes as at 31 December 2021

Environmental footprint

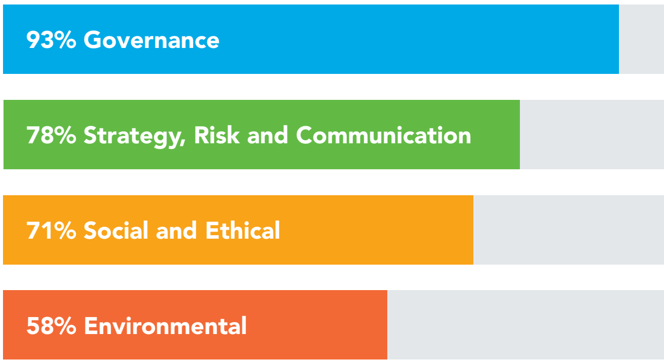
The strategy aims to have a smaller environmental footprint than the benchmark, the MSCI All Country World Index.
As at 31 December 2021, the portfolio's CO2, water and waste footprint measured as follows:

	Fund portfolio (tonnes per $m invested)	Benchmark (tonnes per $m invested)
CO_2 footprint (scope 1, 2 & 3)	63.1	154.6
Waste footprint	2.1	15.4
	Fund portfolio (m3 per $m invested)	**Benchmark (m3 per $m invested)**
Water footprint	4,539.4	56,965.0

Source: TruCost, Federated Hermes as at 31 December 2021

Engagement themes

As a percentage of the strategy's AUM, the team's engagement efforts for the last 12 months breakdown as follows:



Source: Federated Hermes 31 December 2022

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Portfolio positioning

As at 31 December 2022, the portfolio's top 10 active positions were as follows:

Holding	Portfolio active weight (%)*
Costco	3.50
Nvidia	3.40
Microsoft	3.33
Trane Technologies	3.12
Novo-Nordisk	3.09
ASML	3.02
Epiroc	3.01
Mastercard	2.94
Fortune Brands Home & Security	2.77
Lonza	2.73

Source: Federated Hermes

*The portfolio active weight is calculated as the fund weight minus the benchmark weight.

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SECTION 2

Thematic focus ESG and inflation: An inconvenient truth?

When it comes to ESG investing, we need to talk about the inflationary elephant in the room says Martin Todd, Portfolio Manager for Global Equity ESG.

ESG investing continues to march into the mainstream, but COP26 exposed a landscape of fragmented opinions and simmering discord on a global scale. Here, we argue that if sustainability is to win over its sceptics and reach escape velocity, investors, governments, corporates and consumers can no longer ignore what we believe to be the most important elephant in the room.

Against the backdrop of this shift towards a more sustainable way of living, the world is grappling with rising prices. As a result, the two biggest market themes for the year ahead are, right now, on a collision course.

Markets have mostly tiptoed around discussions linking ESG and inflation, largely because the topic is as polarising as it is inconvenient. It polarises because there are two schools of thought at play: the first suggests that adopting ESG or sustainable practices in business is a fundamentally inflationary act. The second school of thought argues that doing nothing to address issues such as climate change is, ultimately, even more inflationary.

The inconvenient part of the situation lies in the fact that – in truth – both schools of thought are correct.

Let's take carbon emissions as our first example. Decarbonisation can be inflationary in two ways and both, ultimately, boil down to a question of supply:

1 In many countries the cost of renewable energy is coming down quickly, yet a lack of supply has limited its deflation in comparison to fossil fuels – and this has been exacerbated by new levels of demand created by widespread electrification in areas such as EVs.

2 As governments place more restrictions on both fossil fuel development and nuclear power – thus constraining energy supply – pricing for fossil fuels and for the renewable sources poised to replace them inevitably moves higher.

In a real-world example of this dynamic, in early December 2021, Shell announced its withdrawal from the development of a new oilfield in the North Sea.[1] The move, hailed as positive for the climate, will reduce fossil fuel supply and so drive up costs. Meanwhile, demand for renewable alternatives will also rise, triggering an inflationary double whammy.

This is a relatively simple energy-related example, but the same issues are bubbling under the surface of the whole corporate sector. A clothing manufacturer may be under societal and regulatory pressure to use more sustainably sourced material – but to do so comes at a cost. Converting a piece of agricultural land from producing traditional cotton to producing organic (i.e. more sustainable) cotton is resource-intensive and takes time. It's hard to incentivise a farmer to do this without providing financial support. Put bluntly, if the world wants producers to transition to more ESG-aware practices, then the world must pay for it: yes, hello inflation!

In the sentence above, transition is the key word. At the heart of the equation is the time horizon: Now and in the short-term we can expect inflationary pressures to increase. But as innovation and economies of scale come into play, ongoing costs will gradually come down and the cost of green solutions will fall. In other words, short-term investment must be weighed against more-enduring, long-term gain.

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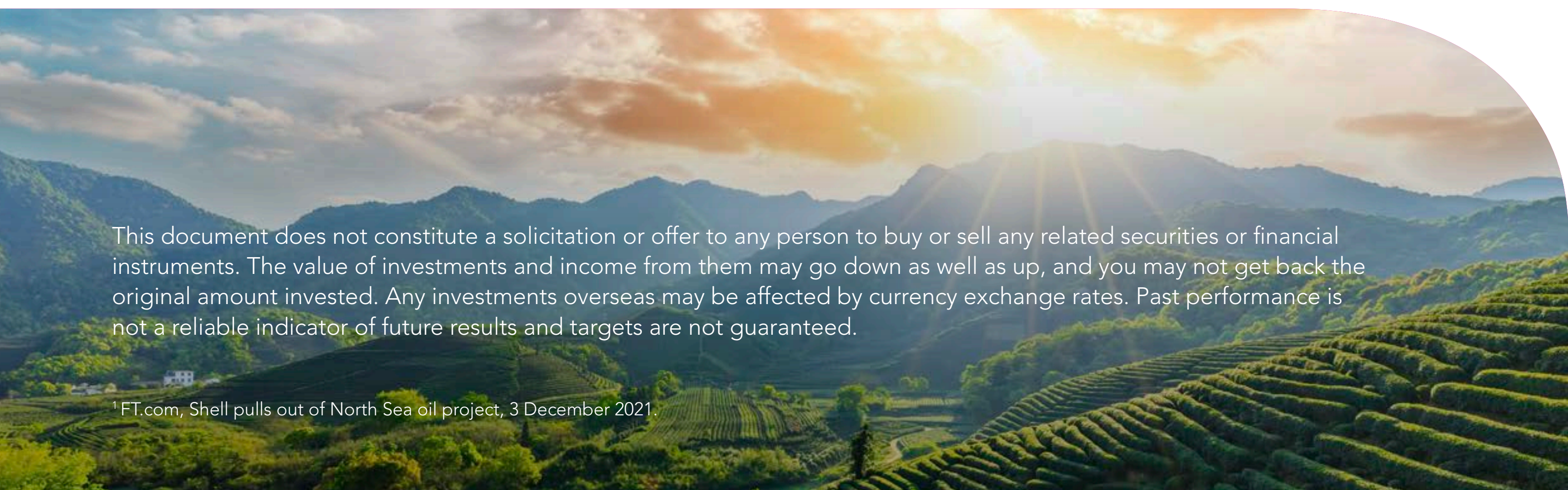
Still, asking corporates to incur costs in the short-term to reap benefits in an unknowable future remains somewhat tricky. Fossil fuels and plastics are simply cheaper and more efficient right now. Change, in any direction, creates resistance and costs money; and those costs will ultimately land with the end consumer.

The recent rise in energy bills globally, for example, is not solely a symptom of Covid and supply chain disruptions but also the ramification of changing sources of energy and reduced availability of natural gas and oil.



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[1] FT.com, Shell pulls out of North Sea oil project, 3 December 2021.

Another widely felt impact will be on the aviation industry. Higher taxes and the possible requirement for airlines in some countries to use a percentage of sustainable aviation fuel will likely drive up costs across the sector. As these are passed onto the consumers, a sharp rise in the cost of air travel could price out the average family who may find foreign holidays less affordable than before.

Such cost increases will not impact the world's wealthy, but middle to lower income households. As more governments introduce these kinds of industry-specific regulations, questions about patterns of consumer impact and the pricing-out of the less-well off will need to be addressed globally.

Those who advocate for a more sustainable way of living have a responsibility to bear this in mind – and to ensure that families and individuals are part of the conversation about the short-term impact on living costs.

Moving beyond a focus on purely environmental considerations, the social element of ESG also has an important role to play. Here, companies are under growing pressure to go beyond paying a minimum wage and instead provide a living wage, provide decent working conditions and appropriate benefits to employees. 'Gig' economy workers, for instance, are in some countries afforded rights to holiday pay and benefits.

On the face of it, this might appear inflationary as companies seek to pass these costs on to consumers – but there is clear evidence to suggest that a company that treats its employees well is more likely to see lower turnover and have a more motivated workforce. As a result, what a company may invest to maintain higher wages and benefits is offset by lower costs associated with rehiring, retraining and plugging inefficiencies.

In our own portfolio we can point to retailer Costco as an example of a company that treats its employees well, and thus benefits from a more engaged, experienced, happy workforce.

The dream of global coordination

As we look to the future, the complexity of the landscape and lack of governmental coordination makes it difficult to map which groups are likely to be most adversely impacted and when that impact will be felt. What we do know is that government incentives and support, along with infrastructure investment, are key to making the sustainability transition as pain-free as possible.

Here, supply- and demand-side policies both have a role in addressing sustainability issues. While much current policy targets the demand side through levies and taxes – which means a higher cost for consumers – policy also needs to promote supply with appropriate incentives for private sector innovation.

This is where we come in. As investors, our job is to take the long view. With essential government support, corporate investment in infrastructure, R&D, new technology and sustainable production will allow companies to reap significant medium- and long-term benefits. The efficiencies this creates will help those companies grow their consumer base and, in turn, their market share. We see this as part of a virtuous circle that will benefit the government and the society in which the company operates. These efficiencies will also help to bring costs down to a point where the new, more sustainable approach is financially comparable to the old.

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There is no denying, however, that there will be a period of time when the costs will not be comparable: the old ways will be cheaper and more efficient. It's at this point that governments must bridge the gap and provide a financial defence that shields consumers, as much as possible, from the onslaught of higher prices.

Some governments will be more willing to do this than others. Investors, consumers and corporates are challenged by the fact that no two governments are approaching ESG with the same urgency, no two are focused on the same themes, or introducing the same incentives or regulations. The EU is widely deemed to be ahead of the US on climate change, while the US has placed a greater emphasis on Diversity, Equity and Inclusion (DE&I).

It would help if governments were clearer about the potential short-term costs of a move to more sustainable living. Yet, as things stand, there is an absence of straight talk about the essential trade-off that may be needed. (NB: This is despite survey data suggesting that an increasing proportion of people, especially younger people, are willing to pay more for 'green' products.)

In an ideal world, governments would step up to the plate and prepare their citizens for the future by clearly communicating the message: that we need to pay more now, for better long-term outcomes. If governments continue to duck this obligation, the risk is of a backlash, and many well-intended measures may be rejected by the populace and progress may stall.

In the meantime, we may assume that consumers in jurisdictions where governments are trying to move fastest on themes that matter to them are potentially more at risk of cost inflation in the short term. But, on the ground, the truth is less linear; climate change may, for example, cause a company to raise prices for a range of reasons quite apart from government action, particularly in the developing world.

Amid such a kaleidoscope of drivers, we believe global government-level cooperation is vital to understanding and limiting the adverse impact of this transition on some consumers over others.

ESG and the long-term investor

Within our funds, a key investment criterion involves assessing how a company treats its employees. Many of the companies we hold pay their people more than average and we, on a long-term investment horizon, believe the benefits of this far outweigh the costs.

One such holding is Unilever. As our case study below demonstrates, the company takes a positive long-term view on the benefits of embedding ESG into the fabric of its global corporate and market activity.

CASE STUDY

Unilever

We invest in global consumer brand Unilever. The company is a pioneer in sustainability across many aspects of its business and often ranks highly among the world's best employers. It's also leading the field with an initiative to pay a living wage to all tier-1 and tier-2 suppliers.

The company is a pioneer in sustainability across many aspects of its business and often ranks highly among the world's best employers.

In our regular meetings with the company, we have spoken in-depth about the long- and short-term impact of an ESG policy that goes over and above that of any of its peers. Unilever acknowledges that these commitments are costing it more than it earns in terms of customer loyalty and near-term profits – but it also believes there are more profound business benefits to be reaped over the longer term, including:

- An ability to attract the best talent in its industry
- Having a strong and influential relationship with leading partners and suppliers
- Strengthening its standing among global governments and regulators.
- Rising demand for its products particularly from younger and more ESG-aware cohorts.

Unilever enjoys a strong level of supplier retention and loyalty that allows it to maintain operations by virtue of being at the front of the queue where suppliers are concerned.

Overall, we share Unilever's view that there is much to be gained from being an ESG leader in one's industry and building the kind of reputation and relationships that pay dividends in difficult times. For example, Unilever enjoys a strong level of supplier retention and loyalty that allows it to maintain operations by virtue of being at the front of the queue where suppliers are concerned.

Conclusion

Unlike the costs, the benefits of a strong ESG policy can be difficult to quantify. That said, it's no excuse for not having this most difficult of conversations. We believe this is the next frontier of the challenge of embedding ESG into the fabric of global corporate and market activity. It's clear from discussions at COP26, that few people are fundamentally opposed to doing business in a more ESG-aware way. But, we all, as part of a community committed to living in a more sustainable society, must take the lead in the conversation about what this new way of life will cost us.

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The fund has environmental and/or social characteristics and so may perform differently to other funds, as its exposures reflect its sustainability criteria.

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Federated Hermes

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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 Investment Management are now undertaken by Federated Hermes Limited (or one of its subsidiaries). We still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important 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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