Federated Hermes Global Equity ESG Fund

Geir Lode
Head of Global Equities

Lewis Grant
Senior Portfolio Manager

Louise Dudley
Portfolio Manager

Annual Report 2021

Federated Hermes International

www.hermes-investment.com
For professional investors only

Contents

SECTION 1

Annual review, 2021

While not quite matching its predecessor for drama, 2021 proved to be another eventful year for markets. In the first quarter, the roll-out of vaccines saw an unusually strong and sustained surge in investor optimism. This was reflected in rising yields and higher commodity prices, and provided additional impetus to the cyclical value rally. However, as the year progressed, fears around inflation and new Covid-19 variants led to fluctuating investor confidence and ongoing volatility.

By the end of Q1, yields had stopped rising and investors were becoming more cautious. As a result, quality factors such as capital structure, profitability and corporate behaviour rose in popularity alongside valuation.

Despite the underlying caution, equity markets continued to rise largely unabated until the start of September. Beneath the surface, however, markets were volatile, particularly in Q2. Fluctuating inflation expectations led to regular switches between growth and value, while the emergence of the Delta variant towards the end of Q2 raised fears further. This led to heightened risk aversion and a preference for quality at the start of the summer.

> **Fluctuating inflation expectations led to regular switches between growth and value, while the emergence of the Delta variant towards the end of Q2 raised fears further.**

A positive earnings season in Q3 brought some apparent calm to the markets, reflected in the smaller magnitude of factor returns. However, as the summer ended, volatility returned. Inflation concerns resurfaced and, with markets at or near all-time highs, indices fell. High-multiple names were the major casualties, as investors switched preference to value.

Yet this preference was short-lived, and growth and sentiment again drove a market recovery. This time it lasted until the end of November, when the emergence of the Omicron variant saw risk appetite plunge and investors flock to more defensive areas of the market.

> **A positive earnings season in Q3 brought some apparent calm to the markets, reflected in the smaller magnitude of factor returns.**

News of the new variant fed into concerns that inflation was no longer 'transitory', as Federal Reserve (the Fed) Chair Jerome Powell had previously insisted. Powell acknowledged during testimony to the Senate Banking Committee on 30 November that "it is probably a good time to retire that word".[1] Following its December meeting, the Federal Open Markets Committee announced faster-than-expected tapering, along with plans for three interest rate rises in 2022, and up to three more in 2023.[2] With these issues weighing on investor sentiment though the final weeks of the year, preferences shifted towards valuation and quality.

The absence of a consistent market driver is reflected in the list of best and worst performers over the year. These have little in common, with high quality semiconductor equipment manufacturers and healthcare names rubbing shoulders with cyclical energy names and the banking sector.

> **The diverse nature, and active management, of the portfolio helped the Fund keep pace with the market despite the difficult environment for sustainability-focused stocks.**

The list of laggards, meanwhile, highlights one of the more interesting outcomes of 2021: assets associated with sustainability tended to underperform. After a strong year in 2020, the valuations of some of the more obviously sustainable investments detached from their underlying fundamentals as naïve flows into 'ESG assets' chased similar opportunities. Given our clear ESG focus this might have led to the Fund struggling against the benchmark. In fact, the diverse nature, and active management, of the portfolio helped the Fund keep pace with the market despite the difficult environment for sustainability-focused stocks.

[1] 'Jerome Powell Ditches "Transitory" Inflation Tag, Paves Way for Rate Hike', Bloomberg, 30 November 2021.

[2] 'Fed officials expect three rate rises next year in hawkish pivot on inflation', Financial Times, 15 December 2021.

Diversification is a cornerstone of our investment approach. We invest in a range of companies across the style spectrum which not only have a good or improving ESG profile but that look attractive from multiple perspectives. The Fund focuses on quality characteristics alongside attractive valuations, growth and ESG characteristics, thereby providing exposure to solid, sustainable companies that are well-positioned for the future. We also seek to minimise macroeconomic factor exposures, ensuring that stock selection is the main driver of relative risk and returns. As a result, the portfolio should generate consistent outperformance whatever the market environment, and should be well-protected from the sort of short-term sentiment swings seen over the past year.

Despite a volatile, factor-driven market environment, we have been able to ensure the Fund has retained exposure across the style spectrum. As markets reached all-time highs, the team became mindful that higher-multiple names looked increasingly vulnerable to disappointment. Meanwhile, with high inflation expected to persist we increased the Fund's exposure to value; this has provided protection during the recent style shift, which looks set to continue.

The Fund focuses on quality characteristics alongside attractive valuations, growth and ESG characteristics, thereby providing exposure to solid, sustainable companies that are well-positioned for the future.

With high inflation expected to persist we increased the Fund's exposure to value; this has provided protection during the recent style shift, which looks set to continue.

The Fed's recent hawkish pivot signalled a sea-change from the super-accommodative monetary policy seen over the past decade. But it was ultimately a show of confidence in the strength of the expected US economic recovery and the weakening of the link between Covid-19 cases and hospitalisations. Rising interest rates typically result in lower valuation multiples for all equities. However, we should see a period in which value stocks, particularly those sensitive to interest rate rises, outperform growth. In the meantime, for growth stocks being selective will be of paramount importance; we prefer stocks with defendable growth and a competitive advantage that are more likely to avoid disappointment.

The transition to value is vulnerable to disappointing economic datapoints and new variants, so we should expect higher-than-usual volatility.

The transition to value is vulnerable to disappointing economic datapoints and new variants, so we should expect higher-than-usual volatility. In such an environment, the ability to actively manage risk will play a vital role, ensuring the portfolio remains invested in a diverse range of stocks with a combination of attractive fundamentals, while keeping our usual strong focus on ESG factors.

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 2020 study, ESG investing: How Covid-19 accelerated the social awakening, we analysed the correlation between a company's ESG score and shareholder returns since 2009. The findings reinforced what we already know: a robust link exists between underperforming firms and poor social and governance metrics. The study found that the governance premium was 24bps per month on average, while the social premium was 17bps over the same period. Companies are now thinking beyond their shareholders – they are thinking about their employees, customers and suppliers.

Latest figures show that the link between a company's ESG score and shareholder returns remain strong, although the former's influence has declined somewhat. From 31 December 2008-2021, the governance premium was 20bps per month on average, while the social premium fell to 14bps per month. This echoes our observations in Section 1 of this report, concerning the underperformance of names associated with sustainability in 2021, and our Sustainable Opportunities Score, which was weak in February, March and December, alongside the Growth factor.

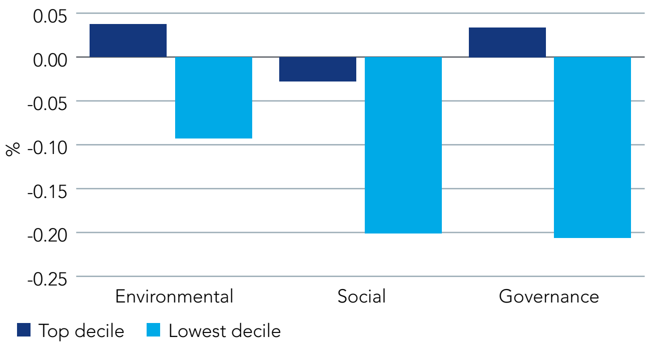
The study found that the governance premium was

24bps per month on average, while the social premium was

17bps over the same period.

Latest figures show that the link between a company's ESG score and shareholder returns remain strong, although the former's influence has declined somewhat.

Figure 1. Companies with poor ESG practices have historically underperformed over the long term



Source: Federated Hermes, as at 30 June 2020.

SECTION 3

Engagement overview

Alongside our stewardship colleagues in EOS at Federated Hermes (EOS), we seek to drive positive change through board and executive-level interactions. Our engagements with portfolio companies take the form of face-to-face meetings with board members, chairs, lead independent directors and chairs of board committees. We also gather information relating to specific engagement objectives and issues through our interactions with divisional heads and investor relations teams. Our proprietary milestone system allows us to track our engagement progress through four key stages from initial raising of concerns through acknowledgement of the issue and commitment to change, to implementation.

We benefit from the wider research universe covered by EOS. The diverse team have backgrounds in law, banking, sciences, academia, accountancy, climate change and corporate strategy, and collectively they are fluent in ten different languages. This expertise, combined with their cultural understanding and connections, enables local language dialogues which are of great importance.

As was the case in 2020, we conducted our stewardship activities almost entirely online, which led to a greater number of interactions with companies. We continued to achieve progress at the company-level – the greatest headway was achieved on environmental objectives. Climate change was an issue that drew greater attention from society and financial services in 2021, with extreme weather events now increasingly commonplace. We have set out our expectations of companies and regulators through our public policy advocacy work, including Climate Action 100+ and the 26th United Nations Climate Change conference (COP26) in Glasgow. We also provided feedback to a voting provider on the consideration of climate within their voting recommendations.

Elsewhere, we welcomed the creation of the Net Zero Banking Alliance by the largest 30 lenders in the US, Canada and Europe. The alliance now has a membership of over 100 institutions, including portfolio holding, Citi Group, with whom we have been engaging since 2016. Over the course of 2021, we also saw many companies make net zero commitments and issue Task Force on Climate Related Financial Disclosures (TCFD) reports. Disclosing company targets is one of the first steps towards setting out a strategy to reduce emissions and consider climate impacts strategically. The increased robustness of scenario analysis produced by companies, the International Energy Agency (IEA) and the Intergovernmental Panel on Climate Change (IPCC) allows for improved assessment of resilience by investors.

The most frequently discussed issues on the social side were human rights and human capital management. Many of these discussions had a pandemic-focussed tilt, as we challenged companies to re-think their policies, processes and practices in the wake of the global slowdown. The involvement of companies in the Uighur region of China attracted discussion, as well as broader human rights due diligence in supply chains. For the technology sector, where the violation of human rights is harder to trace, we challenged companies to interrogate their business models, addressing risks including content moderation, algorithmic use and content curation, advertising content and targeting, and censorship.

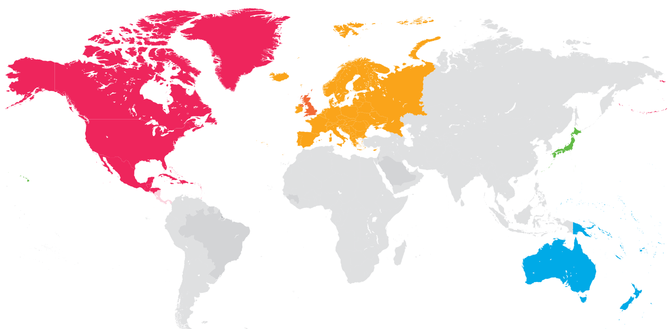
Of the governance issues we engaged on, remuneration was a common area of discussion. Though we have seen improvements, with additional metrics linking pay and performance, quantum is frequently an issue. Remuneration committees are not typically effective at addressing the concerns of long-term investors on this topic.

Engagement progress, 2021

Total number of engagement issues and objectives: **341**

Number of companies engaged: **75**

Issues and objectives engaged by region



Australia and New Zealand **1**

Developed Asia **39**

Emerging and developing markets **25**

Europe **80**

United Kingdom **20**

North America **176**

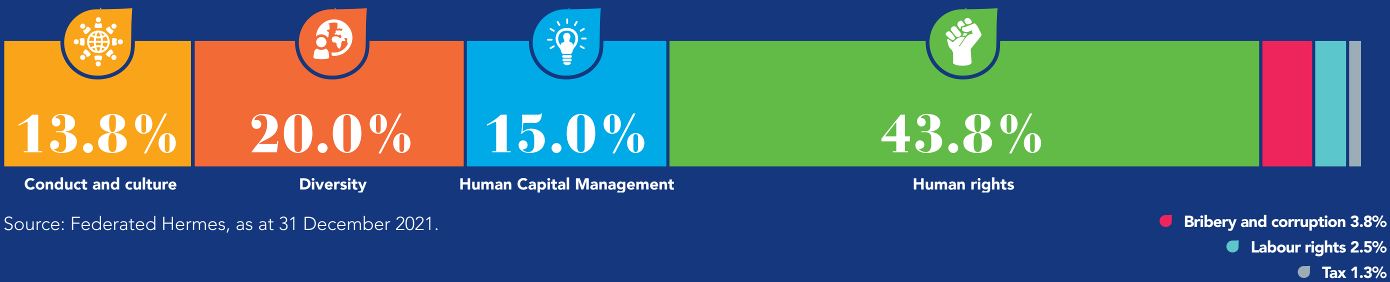
Engagement objectives by theme

Source: Federated Hermes, as at 31 December 2021.

Environmental: issues and objectives engaged

Source: Federated Hermes, as at 31 December 2021.

Social and ethical: issues and objectives engaged

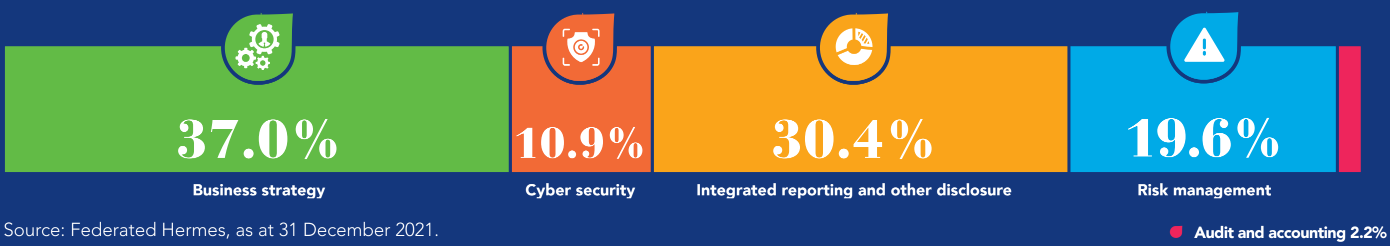


Source: Federated Hermes, as at 31 December 2021.

Governance: issues and objectives engaged

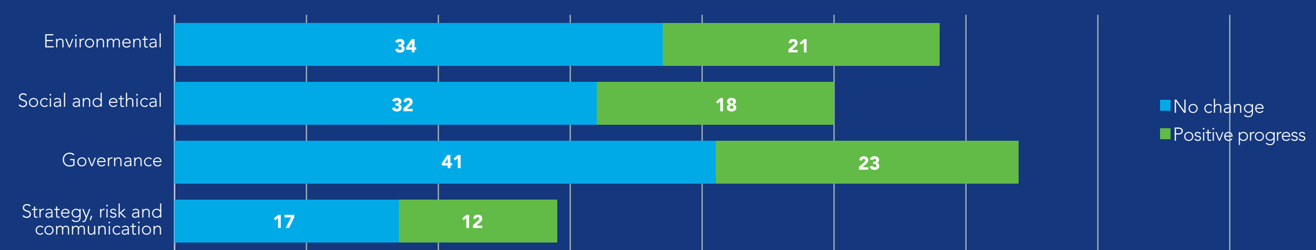
Source: Federated Hermes, as at 31 December 2021.

Strategy, risk and communication: issues and objectives engaged



Source: Federated Hermes, as at 31 December 2021.

Milestone status of engagement



Source: Federated Hermes, as at 31 December 2021.

Voting, 2021

Voting is a key part of demonstrating active ownership and ensuring companies are meeting the needs of shareholders. Voting received greater focus in 2021 as the prominence of ESG, responsible investing and stewardship became further embedded across financial services. More investors than ever were employing their vote to send a message of change to companies. With the majority of company AGMs being held online for a second year, we saw many of the same challenges as 2020 – such as timing, access difficulties, and online presentations. The two voting issues that received greatest attention were not dissimilar from the key engagement topics for 2021: diversity and climate change.

On climate change, we saw the world's highest emitting companies impacted by the Climate Action 100+ investor initiative, with greater disclosure around carbon metrics and plans to address climate risk. For the first time, we saw companies commit to net zero ahead of AGMs, in an effort to avert shareholder proposals, as well as 'Say on Climate' votes. One example is Delta Air Lines – for this portfolio holding, we supported a shareholder proposal on climate lobbying in 2021, as we did in 2020. We see an opportunity for the company to reduce reputational risk by disclosing its direct and indirect lobbying efforts, while ensuring actions match commitment when it comes to carbon neutrality.

On the topic of diversity, we voted against more boards on this issue for 2021, as we toughened our expectations across a number of markets. Though we saw significant progress at AGMs in 2020 on gender and race, greater representation at board and executive level is needed. This is an area where we continue to push for greater change, as the companies we invest in are aware. Full voting guidelines are available here: Global Voting Policy (hermes-investment.com)

Voting is a good way to hold companies to account and is an important factor in our assessment of governance. One of the reasons that we have been able to purchase a company like Hong Kong Exchanges & Clearing, for example, is because it compares favourably with peers on governance. We have voted in favour of the vast majority of board resolutions: our only concern is that one of the company's directors has too many other commitments. Aside from that issue, the company has an exceedingly good governance structure, which is reflected in the board's independent majority and the split between CEO and Chair. The company also has a fully independent audit committee, good board diversity, good business ethics policies, good disclosures and no meaningful controversies.

Voting breakdown

Meetings where we voted in favour:	Meetings where we voted against, against and abstained, or with management by exception:
31.5%	**68.5%**

Source: Federated Hermes, as at 31 December 2021.

On climate change, we saw the world's highest emitting companies impacted by the Climate Action 100+ investor initiative, with greater disclosure around carbon metrics and plans to address climate risk.

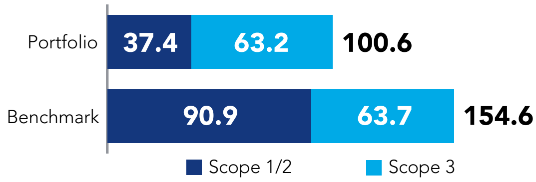
SECTION 4

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:

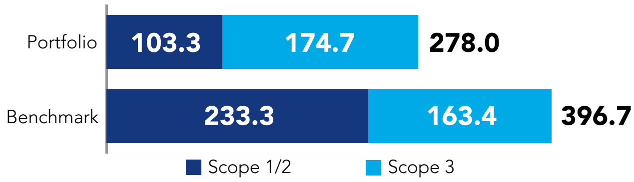
59% lower than the benchmark index per $m invested (Scope 1 and 2)

Carbon footprint per $m invested



Source: Federated Hermes, as at 31 December 2021.

Carbon intensity – tonnes per $m of sales



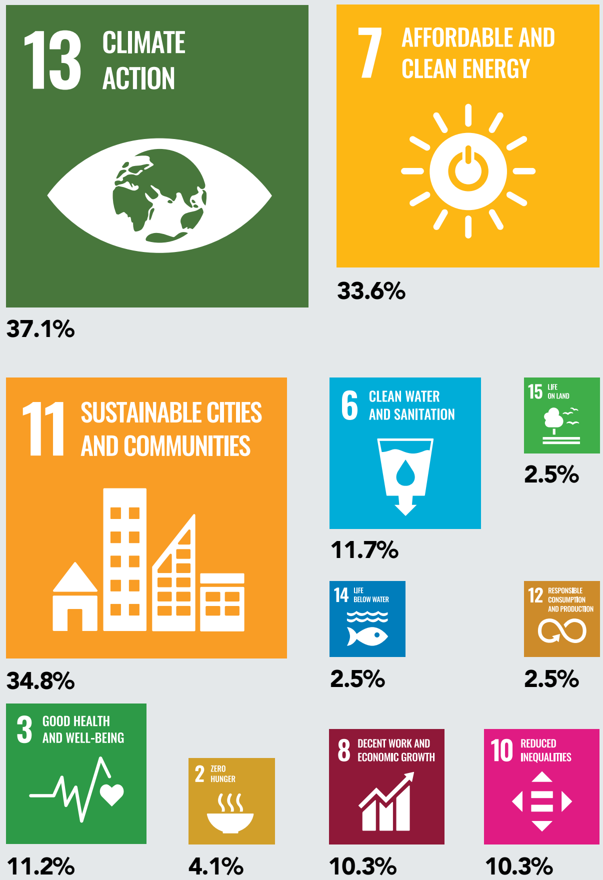
Source: Federated Hermes, as at 31 December 2021.

Environmental opportunities exposure

39%

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).



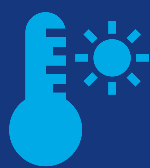
Source: Federated Hermes, as at 31 December 2021.

Science-based targets

We continue to see increased momentum behind climate action and carbon risk management, in line with the rollout of the TCFD framework. The fact that more of our portfolio companies are committing to TCFD reporting – and to net zero or science-based decarbonisation targets – is evidence of this trend:

Globally, in total over **1,300** companies are taking science-based climate action and over **650+** companies have approved science-based targets, up from **350** only 12 months ago.

8 companies in the portfolio have committed to action within two years of setting science-based targets for scope 1 and 2 emissions, which are classified as 2°C, well-below 2°C or 1.5°C.



Another **29** companies already have these commitments in place.

In total, this accounts for **34%** of the portfolio as at the end of December 2021.

SECTION 5

In the spotlight: Sustainable Finance Disclosure Regulation (SFDR)

Full disclosure: sustainability is here to stay

If 2021 is to be remembered for anything, it may well be as the year when sustainability finally went mainstream. The weight of expectation — along with a last-minute climbdown over coal — may have resulted in a lukewarm media reception for COP26, but less newsworthy events pointed to a sea change. From accelerating electric vehicle (EV) adoption to proliferating net zero pledges and science-based targets, signs that sustainability had risen up the social, political and corporate agenda were there for those who wished to see them. Not least among these was the entry into effect of the European Union's Sustainable Finance Disclosure Regulation (SFDR).

What is SFDR?

SFDR has been described as an 'industry game-changer' by Sustainalytics. Introduced in 2019 and brought into effect in March 2021, the regulation is integral to the EU Sustainable Finance Action Plan. It imposes new transparency and sustainability-related disclosure requirements on financial market participants; the aim is to direct capital away from harmful activities and towards activities that are more sustainable. SFDR will help organisations focus on ESG risks during the investment process, as well as addressing an existing gap in mandatory rules for ESG disclosure.

SFDR has been described as an 'industry game-changer' by Sustainalytics. Introduced in 2019 and brought into effect in March 2021, the regulation is integral to the EU Sustainable Finance Action Plan.

Along with the EU Taxonomy for sustainable activities, SFDR is intended to support the European Green Deal. This envisions an economy that is both climate neutral by 2050 and positive for biodiversity. The regulation aims to:

1. Improve and standardise financial firms' sustainability-related disclosures so that institutional asset owners and retail clients can understand, compare, and monitor the sustainability characteristics of their products and services.

2. Create a level playing field on sustainability for firms operating in the EU so that European firms will not suffer unfair competition from non-European competitors.

3. To prevent 'greenwashing' i.e., the provision of misleading information regarding the sustainability characteristics of products and services.

Under SFDR, disclosure obligations are split into three categories:

1. The Principal Adverse Impacts (PAI) of investment decisions on sustainability factors

2. Considering sustainability (ESG) risk

3. Product-specific obligations

The regulation itself is backed up by a set of rules which create a template for how sustainability-related information should be presented. These are known as the regulatory technical standards (RTS).[4] They are currently still at advanced draft stage and are expected to be finalised later in 2022.

Where did SFDR come from?

Sept 2015

The UN 2030 Agenda sets out 17 Sustainable Development Goals (SDGs)

The SDGs are an urgent call for action by all in a global partnership

Dec 2015

The Paris Agreement is adopted by 196 parties at the COP21 summit in Paris

Its goal is to limit global warming to well below two degrees Celsius

Mar 2018

The European Commission releases its Sustainable Finance Action Plan [SFAP]

The SFAP aims to address the UN 2030 Agenda and the SDGs by proposing an EU-wide strategy for sustainable finance.

Dec 2019

The European Commission presents the European Green Deal

This builds on the SFAP to create a broader roadmap for making the EU's economy sustainable

2019 - 2020

The SFAP results in three new regulations

These are the Benchmark Regulation, the Taxonomy Regulation and SFDR

[3] 'Sustainable Finance Disclosure Regulation: An Industry Game-changer', Sustainalytics website, November 4, 2020.

[4] The RTS have been developed by the three European Supervisory Authorities: the European Banking Authority, the European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority.

1 **March 10, 2021**
First reference period starts. Effective date of the SFDR regulation. Financial Market Participants (FMPs) and Financial Advisers (FAs) can start considering principal adverse impacts.

June 30, 2021
Latest date by which FMPs and FAs (with more than 500 employees on group level) must start considering principal adverse impacts.

2 **January 1, 2022**
Second reference period starts in relation to the indicators of various disclosures, whereas the Adverse Sustainability Impacts Statement.

3 **January 1, 2023**
Third reference period starts

June 30, 2023
The final date on which FMPs and FAs need to report for the first time, through the Adverse Sustainability Impacts Statement and other forms of disclosures under SFDR, their performance on entity level on various ESG indicators accompanied with textual explanations and commentaries.

June 30, 2024
The final date by which FMPs and FAs need to report for the second time with a historical, year on year comparison between the first and second reference period.

Source: Avieco, 'What is SFDR and what does it aim to achieve?'

SDR: the UK version of SFDR

Having been introduced post-Brexit, SFDR will not apply in the UK. Instead, the UK will have its own framework, developed by HM Treasury, the Department for Business and the Department for Work and Pensions. Known as the Sustainability Disclosure Requirements (SDR). SDR was announced by UK Chancellor Rishi Sunak at his Mansion House speech in July 2021. In October 2021 the government published 'Greening Finance: A Roadmap to Sustainable Investing'[5], which provides further details on SDR.

What will SFDR measure?

One of the key elements of SFDR is the requirement for firms to report on Principal Adverse Impact (PAI) indicators. These indicators are a predefined list of ESG-related metrics that are considered to have an impact. They are divided into two main categories:

- Climate and other environment-related indicators
- Social and employee, respect for human rights, anti-corruption and anti-bribery matters

'Financial market participants' (FMPs) are required to provide clients with pre-contractual disclosures, as well as periodic disclosures on an ongoing basis. They will have to report on 18 mandatory indicators (see Table 1 for the full list), plus at least one from a list of 22 optional environmental indicators and one from 24 optional social indicators. The final report on the draft RTS[6] provides templates for both the pre-contractual and periodic disclosures.

[5] 'Greening Finance: A Roadmap to Sustainable Investing', published by HM Government, October 2021

[6] 'Final Report on draft Regulatory Technical Standards', Joint Committee of the European Supervisory Authorities, 2 February 2021.

Table 1: List of mandatory disclosures under SFDR

Climate and other environment-related indicators	
Greenhouse gas emissions	1. Greenhouse gas (GHG) emissions
	2. Carbon footprint
	3. GHG intensity of investee companies
	4. Exposure to companies active in the fossil fuel sector
	5. Share of non-renewable energy consumption and production
	6. Energy consumption intensity per high impact climate sector
Biodiversity	7. Activities negatively affecting biodiversity-sensitive areas
Water	8. Emissions to water
Waste	9. Hazardous waste ratio

Social and employee, respect for human rights, anti-corruption and anti-bribery matters	
Social and employee matters	10. Violations of UN Global Compact principles and OECD (OECD) Guidelines for Multinational Enterprises
	11. Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines for Multinational Enterprises
	12. Unadjusted gender pay gap
	13. Board gender diversity
	14. Exposure to controversial weapons

Indicators applicable to investments in sovereigns and supranationals	
Environmental	15. GHG intensity
Social	16. Investee countries subject to social violations
Fossil Fuels	17. Exposure to fossil fuels through real estate assets
Energy efficiency	18. Exposure to energy-inefficient real estate assets

Our response to Principal Adverse Impacts (PAI)

Having been founding members of the Principles for Responsible Investing (PRI) in 2006, we have long sought consistent, publicly available data on ESG from companies. We set out our view on PAI in March 2021 in our Statement on Principal Adverse Impacts. In the Global Equities team, we have been reporting on ESG and carbon metrics since 2012, and have also championed improved performance on ESG metrics through engagement and public policy advocacy work.

We support ongoing reform of sustainable finance and agree that having further standards should help reduce greenwashing and limit the overstating of green credentials. We expect other regulatory regimes around the world to learn from the EU's approach and improve their own guidelines on responsible investing in the near future. While there has been criticism that the regulation has been rolled out too quickly, it has effectively and rapidly moved the dialogue forward. We see this accelerated approach as necessary given the systemic challenges that the world faces. As global investors we acknowledge that European firms going forward will be subject to these additional disclosures, however many of the global companies in which we invest sell their products and services into the EU, so will therefore also be subject to disclosure requirements.

The challenges of complying with SFDR

While we welcome SFDR, as with any new regulation, complying with its terms presents some challenges. These include:

- Obtaining and selecting the necessary data to fulfil disclosure requirements for all mandatory PAI indicators
- Finding data sources that cover a broad, extensive universe of public companies, worldwide
- Streamlining the process of aggregating and reporting PAI indicators up to the product and entity level.

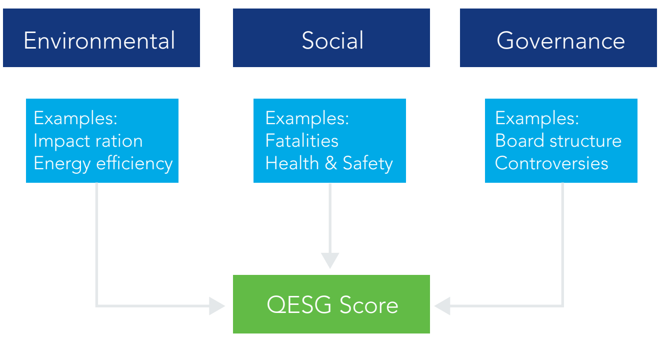
SFDR also requires firms to make strategic decisions about their approach to sustainability. For example, to communicate how a product impacts sustainability providers will need to decide how to measure that impact.

What are we doing to address SFDR?

As a company founded on the principle of doing business the right way, monitoring and incorporating international norms has long been part of our investment process. To this end, we use MSCI, Sustainalytics and our proprietary EOS engagement team to identify potential breaches of the UN Guiding Principles. EOS also conducts controversy research and provides us with a Controversy Indicator to highlight companies exposed to acute or potential ESG risks relating to supply chains, customer use of products and regulatory at-risk areas.

We incorporate this information into our proprietary Quantitative ESG (QESG) Score, which captures not only how well a company manages ESG risks but also whether this is improving or not (see Figure 2). This is because we have observed that changes in a company's approach to ESG risk can be as important to its share price performance as its current exposure.

Figure 2: QESG score



More detailed information is presented in our ESG Dashboard and our ESG Portfolio Monitor (see Figures 2 and 3).

Figure 2: ESG Dashboard

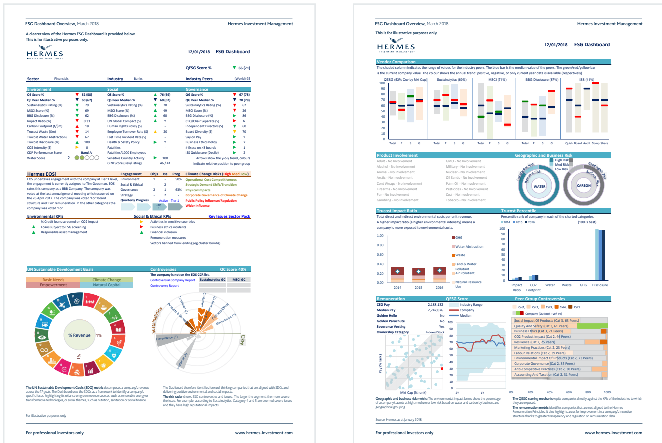
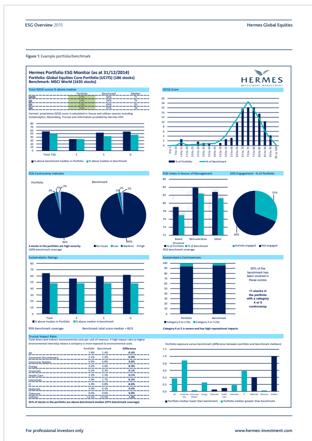


Figure 3: ESG Portfolio Monitor



This data is carefully analysed and verified ahead of investment. Where issues are identified, EOS play an important role in identifying where companies have remedied these sufficiently. They also indicate the next steps expected at companies where there have historically been problems.

As already highlighted, meeting the requirements of SFDR requires data which is often reported in a non-standardised way by companies. However, we are working to create a consistent template for our own reporting. At the same time, we are working with clients to ensure we can meet the expectations of the frameworks they are creating to amalgamate the data from across their investment partners.

Meeting the SFDR challenge 1: Board gender diversity

One of the challenges in providing accurate disclosure for SFDR is that information from data providers can be inconsistent. As an example, Table 2 shows statistics for the number of female board members as a percentage of the total for various firms, as sourced from a range of data providers (these are figures for real companies and providers which have been anonymised). As you can see, while most of the data is consistent there are some notable variations.

When it comes to a number of the metrics required to comply with SFDR, the time period for reporting will be important. Typically, many governance factors are updated annually at a company's AGM. For a global portfolio this will mean that at a particular point in time, some companies' data will be for the current year while others' will be for the preceding year. What's more, this information does not necessarily match the financial data reporting period. This all adds to the measuring and reporting challenge.

No excuses should be made where companies do not measure up. However, an appreciation of the wider context in terms of a firm's size, sector and the country or region where it operates can be useful in assessing its situation and prospects. It is important to understand how a company is meeting investor expectations and the targets and programmes it has in place to advance systemic change. An understanding of these aspects can also be useful at a portfolio level: for example, being overweight to emerging economies, where the overall representation of women at board level is lower, may lead to lower gender equity within a portfolio. This means for the end investor, it is important to be able to view these numbers in the context of the investable universe and the representative benchmark.

Table 2:

	Provider A	Provider B	Provider C	Provider D	Provider E
Company A	36.36	36.36	36.36	27.27	36.36
Company B	37.50	37.50	37.50	37.50	28.57
Company C	33.33	33.33	33.33	33.33	33.33
Company D	37.50	37.50	37.50	37.50	30.00
Company E	30.00	20.00	30.00	30.00	30.00

[7] For more information visit https://tnfd.global

Meeting the SFDR challenge 2: Biodiversity

Biodiversity is another area covered by SFDR that presents challenges in terms of accurate reporting. The requirement set out as part of the regulation is prescriptive. Specifically, it mandates the disclosure of the 'share of investments in investee companies with operational sites owned, leased or managed in, or adjacent to, protected areas and areas of high biodiversity value outside protected areas.'

This impacts a relatively narrow proportion of the investible universe directly. What's more, it's hard to assess and in particular to apply monetary values and credibility to the available data. Companies in sectors with exposure to natural capital such as consumer goods and materials typically have policies and targets on sourcing and managing products. But generally, they are not acknowledging the impact of their business on biodiversity. Historically it has therefore not been a focus for data vendors, and currently we view it as one of the hardest in the regulation to comply with. However, there are positive signs of change.

> **Biodiversity is another area covered by SFDR that presents challenges in terms of accurate reporting. The requirement set out as part of the regulation is prescriptive.**

As a firm, we have signed up to the Zero Deforestation Pledge that was launched at the recent COP26 summit. We are also contributing to the creation of the Taskforce on Nature-related Financial Disclosures (TNFD).[7] This coalition of financial institutions, corporates and market service providers will create a risk management and disclosure framework for organisations to report and act on nature-related risks. Together with the new EU regulations, we expect this to drive the generation of more robust data over the next couple of years, which in turn will force companies to take stronger action in this important area.

As a firm, we have signed up to the Zero Deforestation Pledge that was launched at the recent COP26 summit. We are also contributing to the creation of the Taskforce on Nature-related Financial Disclosures (TNFD).

Sustaining momentum: Beyond SFDR

We support the deep market impact SFDR will have on promoting enhanced disclosure and increasing investor duties around ESG metrics. It will clearly aid investors in assessing the suitability of products for their needs and help them make informed decisions.

As the disclosure requirements were implemented after the Brexit implementation period, the UK will not adopt SFDR. However, the UK is currently working on its own framework which is likely to be informed by the EU's approach. One area in which the EU framework is perhaps lacking is on stewardship, where we see the UK Stewardship Code bridging some of the gaps. Singapore is also developing a framework, which is currently in consultation. The EU Taxonomy is also being developed which will bring greater focus from companies on assessing their economic, environmental and social impact.

One area in which the EU framework is perhaps lacking is on stewardship, where we see the UK Stewardship Code bridging some of the gaps.

At Federated Hermes we will continue to pursue the enhancement of responsible investing via the UN Principles for Responsible Investing, our EOS stewardship business and through our broader public policy advocacy work. Within our portfolios, we will be doing more to highlight assets linked to the development of sustainability. At the same time, we will work to reduce adverse sustainability impacts through company and industry engagement.

At Federated Hermes we will continue to pursue the enhancement of responsible investing via the UN Principles for Responsible Investing, our EOS stewardship business and through our broader public policy advocacy work.

We take a holistic approach to assessing companies, using data and qualitative information from multiple sources to enhance our ability to inform our investment decisions. We take a long-term constructive view on companies and their ambition towards balancing their impact in the real world. Our strategies, which are data led but not data-constrained (for example, where quantitative information is not reliable or available) will benefit as confidence in companies' disclosures can be better assured. We will avoid additional complexity where it is not material but will seek out information that supports the evolving needs of our clients at the forefront of responsible investing. We therefore welcome SFDR and the global roll-out of sustainability-related regulations globally which are sure to follow its lead.

SECTION 6

ESG CASE STUDY:

Fortune Brands Home & Security, Inc.

Fortune Brands Home & Security Inc. is a Fortune 500 company with a range of industry-leading consumer brands selling products for kitchens, bathrooms, entryways, outdoor living spaces, and for protection and security

30+ brands managed

$6.1bn in 2020 sales

22% 2016-2020 sales growth

Table 3: Company financials 2020-21

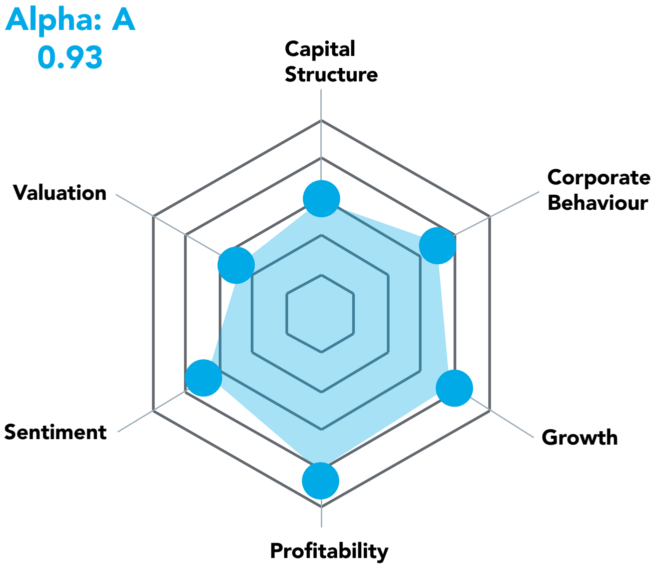
Operating Income (Loss)	30 December 2021 ($m)	30 December 2020 ($m)	Change (%)
Plumbing Operating Income:	629.7	467.9	35%
Outdoors and Security Operating Income:	291.9	201.3	45%
Cabinets Operating Income:	279.3	235.7	18%
Corporate Expense:	-110.5	-103.5	7%
Total Company Operating Income (GAAP):	1,090.4	801.4	36%

Source: Fortune Brands.

Fortune Brands Home & Security ('Fortune Brands') earns a place in our Global Equities strategies thanks to its portfolio of leading home product brands. These are exposed to attractive longer term housing dynamics. Its products are sold to both the DIY and professional markets, which alongside its diverse product range provides some resilience. The company has a well-respected management team who have proven adept at identifying changing consumer preferences. This has helped drive sustained growth and market share gains across a diverse range of products across its four divisions: cabinets, plumbing, doors and security. It is well-liked by our proprietary Alpha Model, ranking above its peers in four out of six categories: Corporate Behaviour, Profitability, Growth and Sentiment. Its profitability characteristics are particularly strong, driven chiefly by its plumbing division. It is experiencing strong growth in this area and has maintained pricing power and high margins despite inflationary headwinds.

From an ESG perspective, the company scores particularly well on governance but ranks below peers on environmental and social metrics, primarily due to a lack of disclosure. However, the company's management is open to engagement, and it is improving across environmental, social and governance metrics. Our interactions have focused on sustainability issues such as diversity, water conservation, sourcing of sustainable timber, the company's climate change mitigation approach, and improving its sustainability disclosures.

Figure 3: Federated Hermes' Alpha Model provides a thorough analysis of Fortune Brands' long-term prospects



Source: Federated Hermes, as at 31 December 2021.

The company ranks favourably against peers when viewed through a long-term sustainability lens as captured by our Sustainability Assessment (further details available here). It has significant sustainable revenue exposure and is also well aligned to specific UN Sustainable Development Goals including SDG 6: Clean Water and Sanitation and SDG 11: Sustainable Cities and Communities. The firm has reduced the waterflow rate for all its kitchen faucets to 1.5 gallons per minute; its internal analysis suggests that just 10-20% of products offered by principal competitors have made a similar shift. This puts Fortune Brands in a good position to capitalise on an increasingly environmentally aware consumer, as well as making it well-prepared for potential future regulation.

> **From an ESG perspective, the company scores particularly well on governance but ranks below peers on environmental and social metrics, primarily due to a lack of disclosure.**

Market risks and the potential for growth

As a US-domiciled business sourcing materials from around the world, the company is exposed to foreign currency exchange rates and commodity prices. In the current rising interest rate environment, it faces headwinds in terms of increased debt payments.

Supply chain issues are another current source of concern for companies with global operations. Management have stated that they continue to develop and deploy their unifying operating model, Fortune Brands Advantage, across all its businesses. This should further reduce complexity and increase efficiencies in the firm's global sourcing, minimising the potential risk.

In terms of its own Scope 1 and 2 operational greenhouse gas emissions, the company has a relatively average exposure and is moderately below the average for its subsector. Sustainability reporting has been a weak point for the firm as it lacks initiatives to address greenhouse gas reduction targets and deadlines. Our EOS team have been engaging with the company to improve this aspect of the business; the management team welcomed our suggestions and will look to incorporate them into their future sustainability reporting.

Engagement

We started our engagement with Fortune Brands in May 2018 by addressing problems relating to household water efficiency. As the owner of the number one faucet brand in North America, the company has significant power to support household water efficiency. This engagement was completed with the establishment of an eco-friendly product strategy, with management KPIs for measurement of the water saved through the adoption of the firm's products.

A second issue of concern for us was the company's limited sustainability reporting. We therefore proposed the company introduce focused and quantified group-level reporting to drive progress on several social and environmental issues. Following discussions in 2018, the company welcomed our suggestions and incorporated sustainability disclosures covering at least three areas of focus – along with associated KPIs – into its second report in 2020.

> **Following discussions in 2018, the company incorporated sustainability disclosures covering at least three areas of focus – along with associated KPIs – into its second report in 2020.**

We have also established two plans with Fortune Brands covering environmental themes related to climate change and land and forestry use. These plans are already bearing fruit, as the company has confirmed it is working on better environmental data collection. We've also engaged with the Chair on the benefits of sustainable sourcing. The company is making positive steps on this issue, pivoting away from China and towards North America for much of their sourcing.

Overall, Fortune Brands is an industry-leading company that demonstrates great performance and is moving proactively towards a sustainable approach to their business activities. We therefore view it as an excellent investment opportunity within our Global Equity strategies.

Engagement objectives and timeline

We've encouraged Fortune Brands to:

- Measure and report on its scope 1 and 2 emissions, and establish forward-looking targets to move towards carbon neutral operations
- Establish a sustainable timber policy with targets for certified wood sourcing and recycled timber (and aspire towards a restorative approach - protecting forest and timber supplier by creating more forest than used)

2018

- We had meetings with the CFO, investor relations (IR) and sustainability team in Q2.

2019

- Introductions and further information shared in Q4

2020

- We had a call with IR and exchanged more emails

2021

- We had a call with the chair, and sent a letter regarding the inclusion of sustainability metrics in executive pay

SECTION 7

ENGAGEMENT CASE STUDY:

Prudential plc

Prudential plc ('Prudential') is a UK-listed multinational business providing life and health insurance, and asset management services. In recent years it has restructured to create a strong focus on the growing Asian and African markets.

Targeting
50M customers by 2025[8]

Network of
560,000
agents across Asia and Africa[9]

Digital app 'Pulse' downloaded
30M times in Asia and Africa since launch[10]

Prudential's roots are in the UK, where it was founded in 1848. It has long been admired by investors for its exposure to rapidly expanding Asian markets, where an emerging middle class has driven increased structural demand for health and wealth products.

In recent years, Prudential has restructured significantly to create a more growth-focused business proposition. In the UK, where regulatory changes such as the introduction of the Solvency II capital rules have made traditional products (i.e. annuities) more difficult to sell, the company spun off M&G (its UK asset management and life insurance arm). This was followed by the demerger and listing of Jackson, its US variable annuity provider, in September 2021.

Financial performance and potential for growth

Prudential has formed part of our portfolio since the fund's inception in 2014, with our investment thesis based on Asia exposure with UK quality. Using our proprietary Alpha Model, the firm scores strongly on Sentiment and Capital Structure, and respectably on Growth. In terms of Valuation, it is slightly expensive, and Profitability is weaker than other factors.

> **Prudential has formed part of our portfolio since the fund's inception in 2014, with our investment thesis based on Asia exposure with UK quality.**

The company is very well placed as a market leader in Asia, where increasing affluence continues to support a growing need for pensions and medical insurance (something the Chinese government itself is promoting). It is also expanding into Africa, and is targeting 50 million customers globally by 2025. We expect a steady growth in earnings, with dividends remaining consistent. Recent operating profit has been beating market expectations while new business profit was up 25% in H1 2021. This was largely thanks to the huge success of Pulse, Prudential's innovative digital platform. Pulse is available in 11 languages across 17 Asian and African markets[11], enabling improved profitability through direct consumer access.

ESG and purpose

In general, Prudential is doing a good job of managing its ESG material risks, although we continue to push for greater market leadership. The company's purpose is established and clearly stated, namely: "To help people get the most out of life. We make healthcare affordable and accessible, we protect people's wealth and grow their assets, and we empower our customers to save for their goals."[12] Meanwhile, it is positioning its Eastspring Investment division as an ESG investor in Asia, capitalising on growing interest in responsible investment in the region.

Having gone through significant change over the past few years, Prudential is not the top ESG performer it once was and has been B-rated by CDP since 2018.[13] Despite this, it still receives a good QESG Score[14] and is slightly ahead of peers on E, S and G metrics. Strengths include its commitment to sustainable investment and its human capital development programme. However, disclosure requirements continue to increase, and Prudential is keeping up rather than pushing ahead. We would like to see more specifics, particularly on sustainability.

[8, 9] Prudential, Press release and half year results (30 June 2021).
[10] Prudential, Pulse by Prudential Wins Mobile App of the Year Award at Insurance Asia Awards 2021.
[11] Prudential, 'Pulse – transforming Prudential'.
[12] Prudential, 'Our purpose'.
[13] See CDP, 'Prudential – Climate Change'.
[14] Our proprietary quantitative, environmental, social and governance score captures how well a company manages ESG risk versus its peers and monitors ESG-rating momentum, showing the trajectory of progress in managing those risks.

Engagement

Our long history of engagement with Prudential stretches back to 2010, four years before the fund first invested in the company. We originally engaged on the lack of synergy and alignment between the businesses which then comprised Prudential, an issue which was resolved by the M&G and Jackson demergers. We later highlighted problems around shareholder communication and gender equality. Prudential have since made good progress on these issues, including improving female representation in senior management to 30%, roughly in line with the 33% target recommended by the Hampton-Alexander Review.[15] We are also pleased the company uses a sustainability scorecard as part of remuneration, which accounts for 20% of long-term incentives.

Although the company has no immediate ESG risks or concerns, we maintain a strong ongoing dialogue and believe Prudential should strive to regain its status as a leader. Our current discussions focus on corporate structure, sustainability strategy, use of artificial intelligence (AI) and alignment of remuneration.

Engagement objectives

We've worked with Prudential to:

- Address issues relating to business structure
- Improve gender diversity at senior and board level

We're encouraging Prudential to:

- Make its sustainability strategy even better
- Align remuneration
- Increase use of AI

Key engagement activity

2010
- Met separately with chair and senior independent director to discuss issues around aborted acquisition of AIA

2011
- Opposed re-election of the chair at AGM due to concerns over failure in duty to shareholders

2012
- Met with new chair to discuss issues including board composition and executive remuneration

2013
- Met chair and discussed future strategy, regulation, shareholder communication, board composition and company structure
- Met with new senior independent director and challenged the structure of the group

2014
- Met chair with other investors and discussed board culture, talent retention and remuneration; followed up with letters and further dialogue
- Voted against remuneration policy at the AGM

2015
- Met chair and discussed succession planning, company structure and remuneration
- Met incoming and outgoing remuneration committee chairs

2016
- Met remuneration committee chair to discuss improvements to director's remuneration policy

2017
- Opposed the firm's remuneration policy at the AGM

2018
- Call with chair to discuss M&G demerger and board diversity

2019
- Wrote to request further discussion on gender diversity
- Voted against re-election of nomination and governance committee chair

2020
- Challenged the robustness of the sustainability strategy, which predated the M&G demerger
- Voted against the firm's remuneration policy at the AGM
- Met with chair-elect to discuss company structure, impact of Covid-19, ethical risks around AI and the company's sustainability strategy
- Call with head of artificial intelligence to discuss the rise of AI at the firm

2021
- Met lead independent director to discuss board effectiveness
- Met head of sustainability to discuss the firm's new sustainability strategy
- Met current and incoming remuneration committee chair to discuss proposals for 2022

[15] The Hampton-Alexander Review set a target of 33% representation of women on FTSE 350 boards and in executive committee and direct reports, with this goal to be achieved by 2020. For more information see FTSE Women Leaders.

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

BD009387. 0012493 02/21