Federated Hermes Climate Change High Yield Credit strategy

Fraser Lundie, CFA
Head of fixed income – public markets and co-portfolio manager

Nachu Chockalingam, CFA
Co-portfolio manager

Mitch Reznick, CFA
Head of Sustainable Fixed Income

Interim report
May 2022

Federated Hermes
Limited

www.hermes-investment.com

Authors

Fraser Lundie, CFA
Head of fixed income – public markets and co-portfolio manager

Nachu Chockalingam, CFA
Co-portfolio manager

Mitch Reznick, CFA
Head of sustainable fixed income

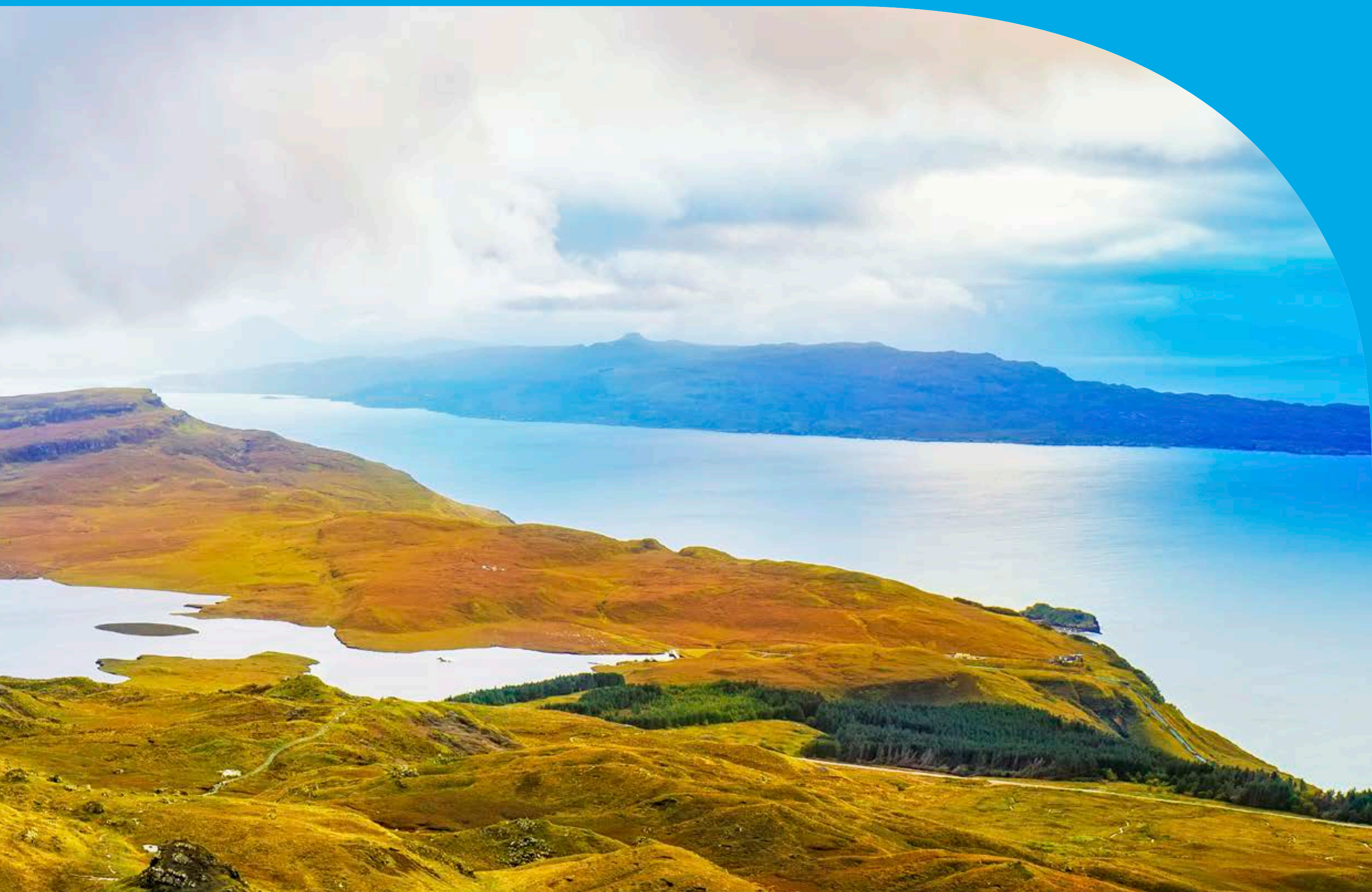
Bertie Nicholson*
ESG and engagement associate

Sophie Demare
Engagement & ESG associate

Kimberley Howlett
Fixed income investment specialist

*CFA UK Level 4 Certificate in Climate and Investing

Contents



SECTION 1

Introducing the Federated Hermes Climate Change High Yield strategy

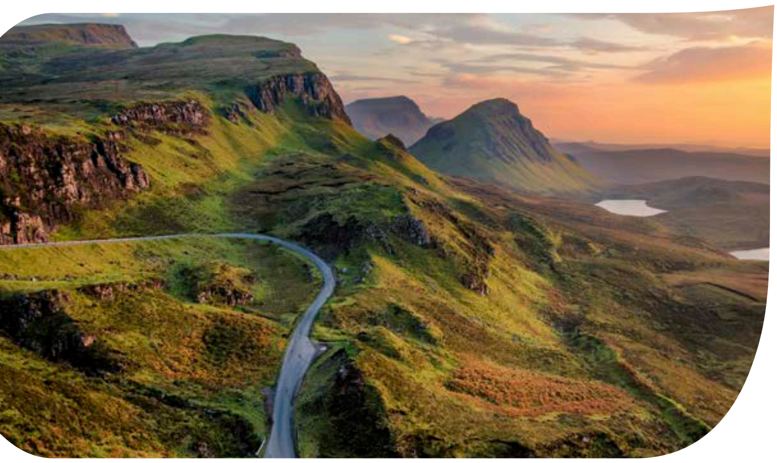
Seeking to deliver a positive climate impact

The world is currently facing significant challenges as a result of structural transitions in climate, technology, demographics, and geopolitics, all of which could dramatically change the way we live. To successfully manage these transitions, there is a growing imperative to deliver more resilient and sustainable outcomes. Investors, we believe, have an important role to play.

Launched in September 2021, the Federated Hermes Climate Change High Yield strategy aims to outperform the global high yield market by investing with conviction in companies with strong fundamentals, and the potential to decarbonise and transition to a low-carbon world.

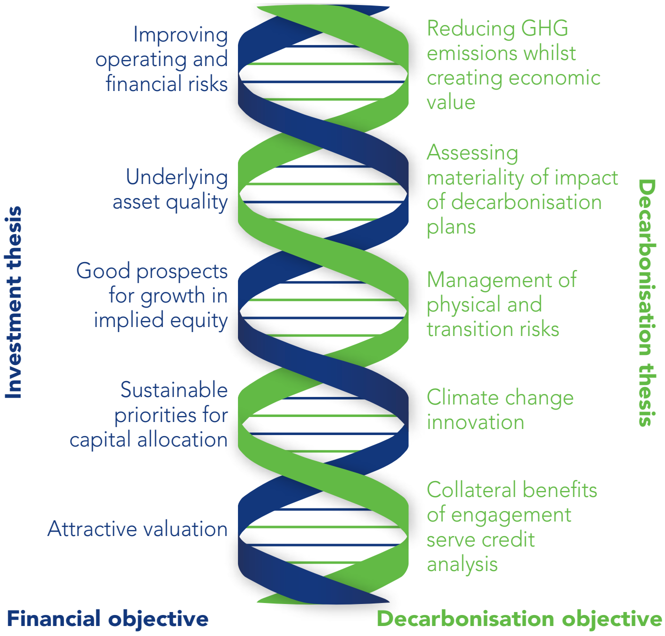
> **The world is currently facing significant challenges as a result of structural transitions in climate, technology, demographics, and geopolitics, all of which could dramatically change the way we live.**

The global high yield market offers opportunities to identify attractive companies with the willingness to change their operations, products or services to generate a positive environmental impact for the planet. We use our proprietary framework – the Climate Change Impact (CCI) Score – to reflect the ambition and expected impact companies have made and will make towards global decarbonisation. We will not hold companies where engagement on the climate change transition has failed, and we exclude controversial sectors and heavy greenhouse gas (GHG) emitting issuers that have no desire to change.



- Benefitting people and the planet: we seek to deliver into two self-reinforcing objectives – strong financial performance for investors and positive climate impacts, through decarbonisation, that contribute to the low carbon transition.
- Investment expertise: since 2004, our team's principal members have delivered attractive high yield credit returns through relative value investing across the capital structures of companies worldwide.
- Engagement strength: our dedicated engagers, supported by EOS at Federated Hermes, a leading global stewardship team, seek positive climate action.
- Measuring climate impact: our proprietary scoring framework (outlined in more detail in a later section of this report) allows us to assess a company's current and expected contribution to decarbonisation and the transition to net zero by 2050.

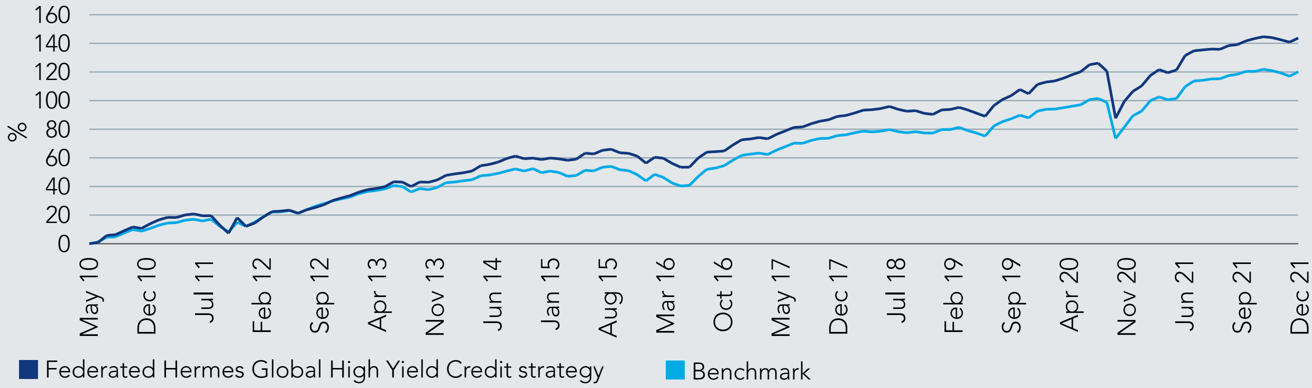
Figure 1. Interwoven and self-reinforcing decarbonisation and investment theses



Investment team experience

Federated Hermes Global High Yield Credit Strategy

Note: this is the track record of the Federated Hermes Global High Yield Credit strategy and is illustrative of the team's investment ability and not the expected returns of the Federated Hermes Climate Change High Yield Credit strategy. This is not the official GIPS Strategy and is based on synthetic returns. Management fees are not included and will have the effect of reducing returns.



Rolling-year performance (%)

	31/12/20 to 31/12/21	31/12/19 to 31/12/20	31/12/18 to 31/12/19	31/12/17 to 31/12/18	31/12/16 to 31/12/17
Composite gross of fees management fees are not included and will have the effect of reducing returns	3.81	4.31	19.08	-2.79	10.24
Composite net of fees	3.14	3.63	18.31	-3.42	9.52

Strategy information:

- Objectives: To achieve a positive financial return and to deliver a lower carbon footprint than the benchmark index
- Benchmark: ICE BoA Global High Yield Constrained Index, hedged to US dollars
- Instruments: Primarily high yield corporate bonds and derivatives
- Exclusions: Among others, fossil fuels, tobacco, controversial weapons, companies in contravention of the UN Global Compact, companies scored CCI 5 and companies where engagement on climate change transition has failed.
- Number of issuers: Approximately 150-200
- Base currency: US dollars, hedged
- Liquidity: Daily
- SFDR classification[1]: Article 9

Investment philosophy and process

The strategy aims to generate long-term, risk-adjusted outperformance by investing in attractive high yield credit instruments, while delivering a positive impact that supports a low carbon future.

To achieve this, we overlay our dynamic investment process – developed by our Credit team in 2004 and continuously enhanced – with a process that determines the climate change credentials of companies for portfolio construction and position sizing purposes. This involves converting climate-related data into forward-looking scores using inputs from our credit analysts and engagement professionals. Through our disciplined, bottom-up research, we aim to identify issuers with an attractive investment profile that contribute to the decarbonisation of the wider economy. We exclude climate change laggards[2] that show no desire to change, along with those companies exposed to controversial sectors, including fossil fuels. By investing flexibly, we target opportunities to generate strong returns and income across geographies, instrument types and credit curves.

> By investing in and engaging with material emitters that demonstrate a genuine willingness to change, investors can make a real difference for current and future generations.

[1] The Sustainable Finance Disclosure Regulation (SFDR) is a European regulation introduced to improve transparency in the market for sustainable investment products, to prevent greenwashing and to increase transparency around sustainability claims made by financial market participants. SFDR classification is subject to a contractual agreement with the client and is subject to change depending upon client requirements.

[2] Companies that are behind sector peers in their approach to dealing with the risks and opportunities presented by climate change.

SECTION 2

Investment review

Since inception, the strategy's benchmark spreads have been range-bound between mid-300bps and 500bps – a stark contrast to the preceding year, when they reached a peak of 1,100bps at the height of the pandemic (March 2020).

In its short lifetime, the strategy has seen its fair share of volatility, as the result of:

- The Omicron Covid-19 variant, which threatened to derail the global economic recovery;
- Sharp retracements in US treasury yields, as markets priced in the likelihood of a more rapid hike in rates;
- High inflation, and the possibility that this inflationary environment could be less than transitory;
- The conflict in Ukraine, with its many political and financial ramifications.

Figure 2: Historical global high yield spread (option-adjusted spread (OAS) from September 2021 – March 2022)

Source: Bloomberg, using ICE BofA Global High Yield Constrained Index. Accessed 31 March 2022.

We use negative and positive screening techniques to identify those issuers that can help the strategy best achieve its dual objective

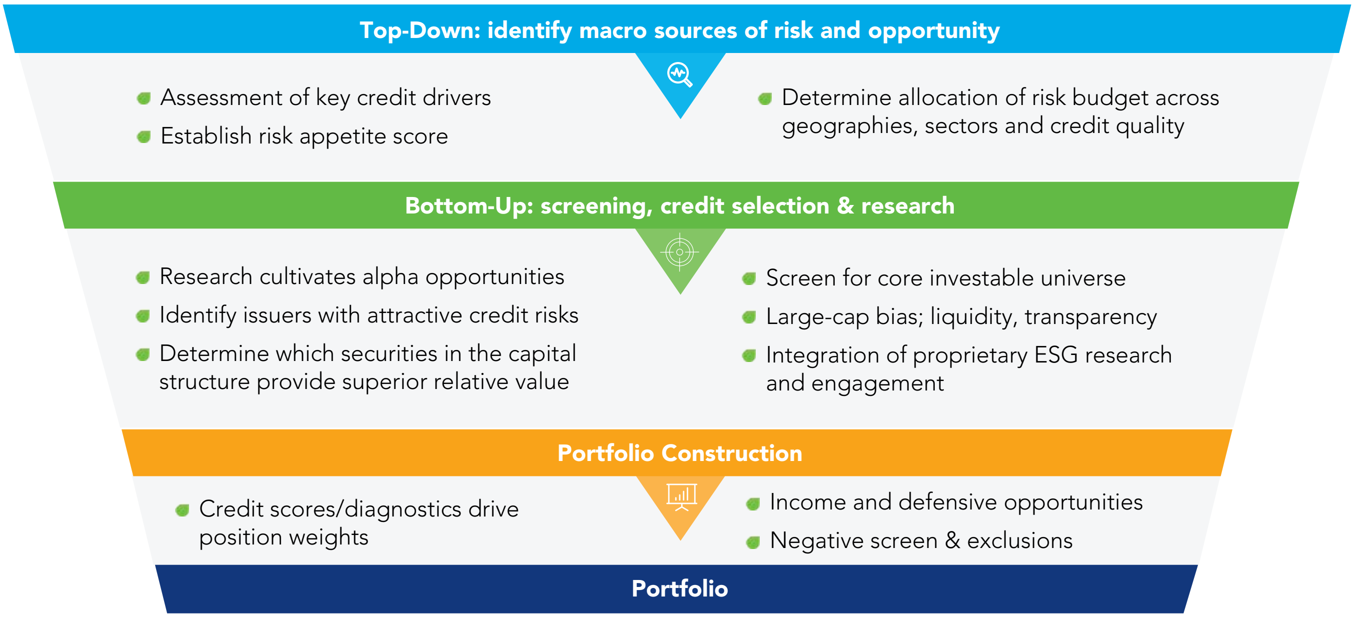
Through top-down analysis, we determine our risk appetite and the return prospects of different regions, sectors and ratings categories. Through our disciplined, bottom-up research, we then aim to identify high yield corporate issuers that not only have strong credit profiles, but demonstrable potential to decarbonise and transition their operations to a low carbon world. We use negative and positive screening techniques to identify those issuers that can help the strategy best achieve its dual objective:

- The strategy negatively screens companies by excluding those that engage in, or derive revenues from specified activities, including fossil fuels, tobacco and weapons[3].
- Positive screening is achieved through our proprietary climate change impact scoring methodology – the 'CCI score'. All else being equal, companies that have higher CCI scores should have a higher weighting in this strategy, to maximise the decarbonisation and engagement potential of the strategy.

Positive screening is achieved through our proprietary climate change impact scoring methodology – the 'CCI score'.

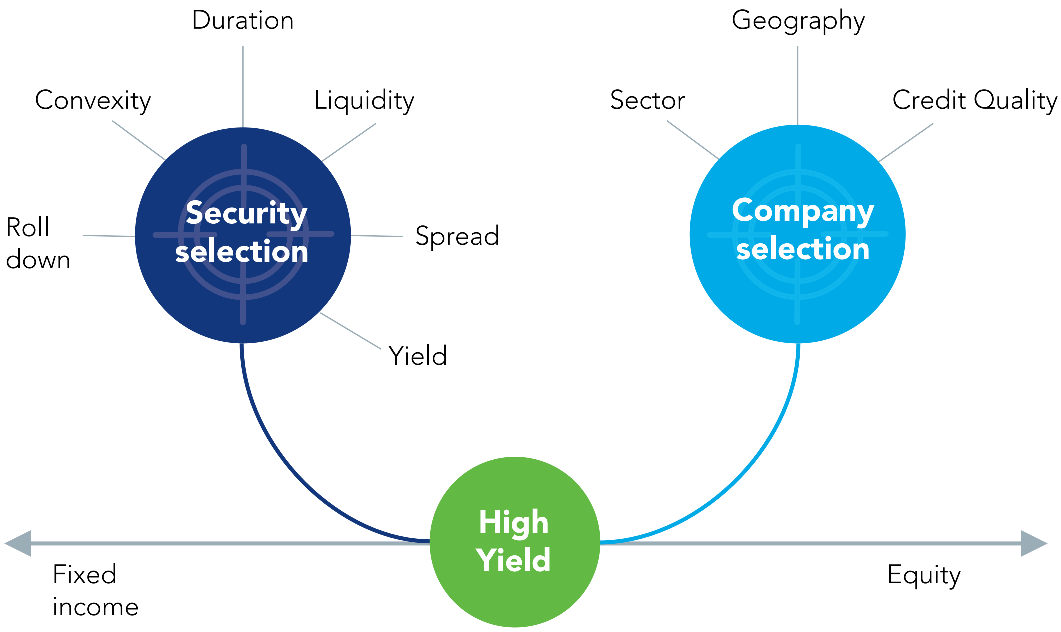
[3] We exclude companies that: derive over 5% of their revenues from the extraction or exploration of fossil fuels (or from the use of fossil fuels for electricity generation); generate revenues from the production of tobacco products (or receive over 10% of their revenues from tobacco distribution); generate revenue from the production of controversial weapons (or over 5% of their revenues from the production of conventional weapons). For full exclusions, please see the fund supplement (the Federated Hermes Climate Change High Yield Credit Fund is the representative account of the strategy).

Figure 3. The team's disciplined credit selection process is guided by macroeconomic analysis



We aim to outperform through the cycle by 1) identifying issuers that have an attractive credit risk/decarbonisation profile, and 2) determining which securities in their capital structures provide superior relative value. We make use of an issuer's full capital structure to manage risk and performance – we are mindful that there is risk to be managed and alpha to be made in areas like duration and convexity. As such, we tend to prefer larger capital structures, more global issuers and national champions, particularly in emerging markets.

Figure 4. The team exploit differences in relative value throughout issuers' capital structures

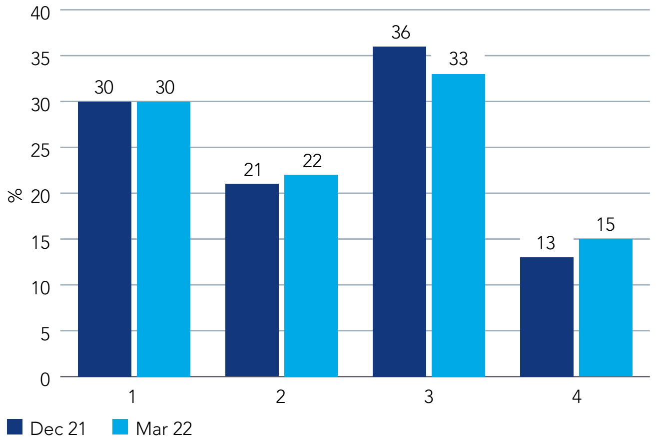


Since inception to the end of Q1 2022, the strategy's underweight in the Real Estate, Energy, and Consumer Goods sectors has contributed most to overall performance on a relative basis. In contrast, its overweight in the Banking, Capital Goods and Insurance sectors has been the biggest detractor.

From a ratings perspective, the strategy's underweight in B, CCC and lower-rated issues has had a positive impact on performance since inception, while its overweight in BB and higher-rated issues has detracted the most.

At a regional level, the strategy's underweight in Emerging Asia, Eastern Europe and Latin America has contributed most to relative performance, while its overweight in Western Europe and the Americas has been the greatest detractor.

Figure 5. below, illustrates the CCI score dispersion within the portfolio



Sector	1	2	3	4	Total
Automotive	2.6%	0.0%	3.3%	0.8%	**6.8%**
Banking	5.4%	4.9%	3.9%	0.5%	**14.7%**
Basic Industry	1.0%	3.2%	4.5%	1.1%	**9.8%**
Capital Goods	2.6%	4.9%	3.4%	1.0%	**12.0%**
Consumer Goods	0.2%	0.0%	1.1%	0.9%	**2.2%**
Financial Services	0.0%	1.0%	1.4%	1.0%	**3.3%**
Healthcare	0.0%	0.0%	2.0%	3.3%	**5.3%**
Insurance	1.6%	3.5%	1.7%	1.0%	**7.8%**
Media	0.8%	0.0%	0.7%	2.0%	**3.5%**
Real Estate	2.2%	0.0%	0.7%	0.5%	**3.4%**
Retail	2.8%	0.5%	2.6%	0.4%	**6.3%**
Services	0.0%	0.6%	1.5%	0.3%	**2.4%**
Technology & Electronics	3.6%	2.2%	1.4%	0.5%	**7.7%**
Telecommunications	3.9%	0.7%	4.0%	2.2%	**10.8%**
Utility	2.7%	0.6%	0.7%	0.0%	**4.0%**
Total	**21.4%**	**17.2%**	**25.6%**	**14.2%**	**100.0%**

Source: Federated Hermes, Sustainability Hub, 31 March 2022.

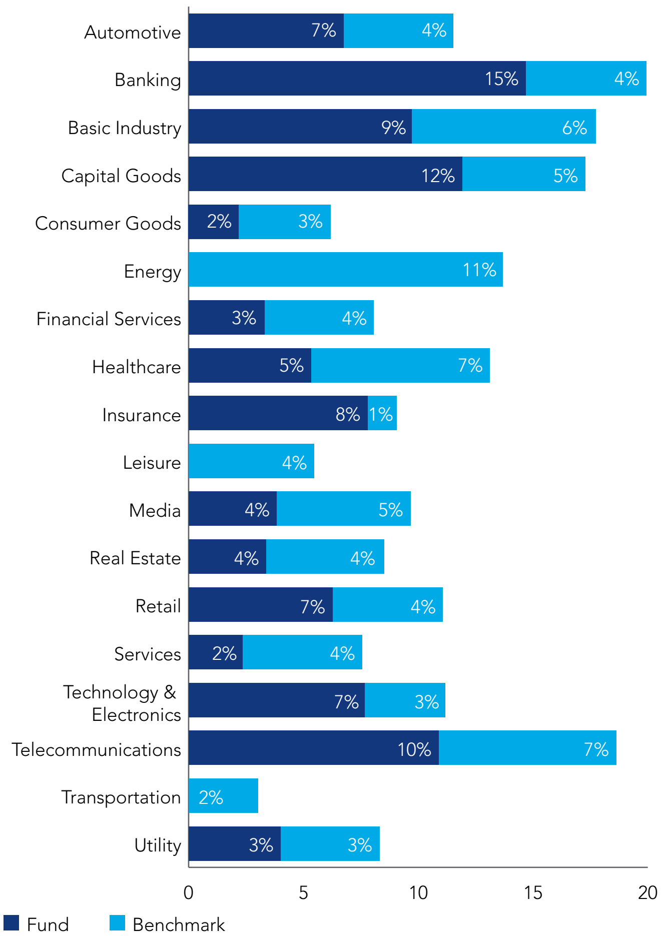
Carbon emissions vary significantly by sector

As active managers, we are aware that a portfolio's carbon intensity can be driven by both sector and security selection – in this context, allocations to high emitting sectors and low emitting sectors can have an outsized impact.

> **At a regional level, the strategy's underweight in Emerging Asia, Eastern Europe and Latin America has contributed most to relative performance, while its overweight in Western Europe and the Americas has been the greatest detractor.**

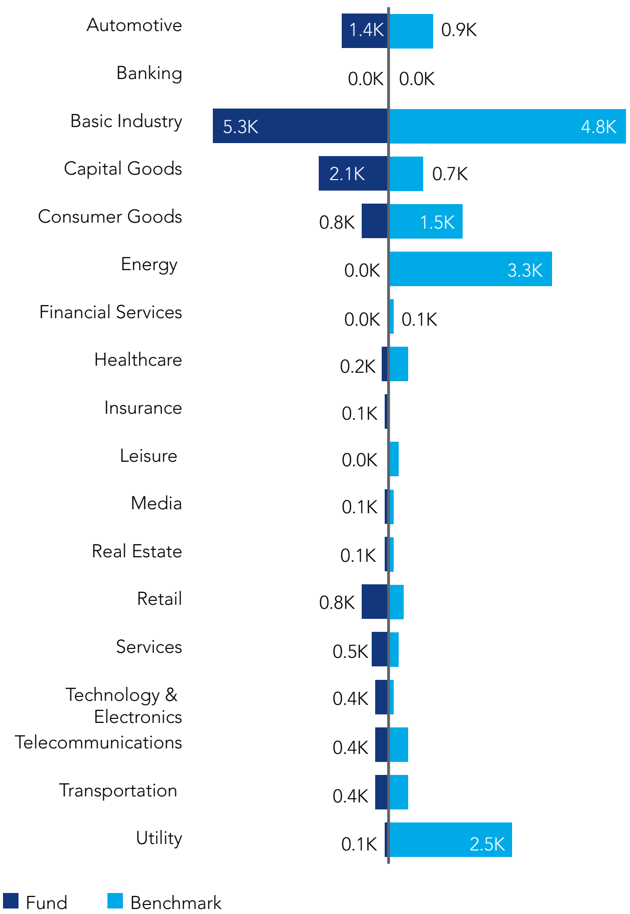
That said, a sector with a wide range of emissions, such as Basic Industries, presents a significant opportunity to optimise our carbon profile through individual security selection.

Figure 6. Strategy sector exposures in relation to the benchmark



Source: Federated Hermes, Environmental Tool, 31 March 2022. The benchmark used is the ICE BofA Global High Yield Constrained Index, hedged to US dollars.

Figure 7. Strategy Scope 1/2/3 emissions by sector in relation to the benchmark



Source: Federated Hermes, Environmental Tool, 31 March 2021. The benchmark used is the ICE BoA Global High Yield Constrained Index, hedged to US dollars.

By including carbon foot printing as a component of our environmental analysis, we can determine which companies are most exposed to emission levels.

Carbon Metrics

By including carbon foot printing as a component of our environmental analysis, we can determine which companies are most exposed to emission levels.

Indeed, our carbon intensity analysis is an extension of our overall environmental due diligence; we monitor the portfolio's carbon intensity and carbon footprint using a variety of tools, company data and third-party research, when available. The data provided below is sourced using Trucost, as of 31 March 22.

Sustainability Statistics

	Dec-21	Mar-22	% Change	BM Dec 21
Carbon footprint (Scope 1/2/3 – tonnes CO_2 per $m investment)	117.4	120.4	2.6	151.4
Carbon Intensity	309.1	289.8	-6.2	570.4

Engagement Statistics

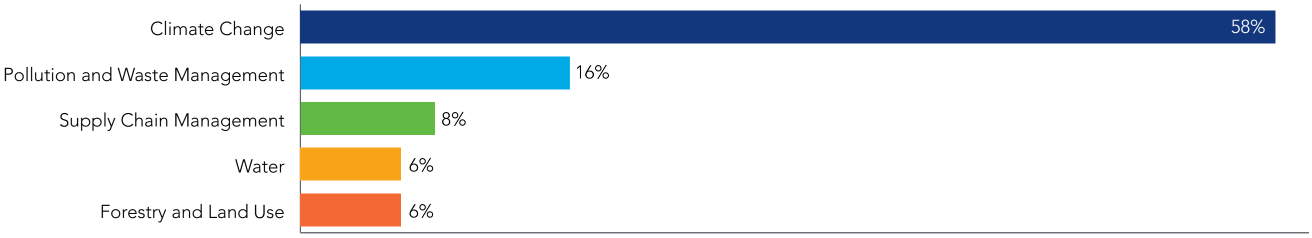
	Dec-21	Mar-22
Environment Engaged % AUM	65	63
Climate Change Engagement	62	58
Climate Change Emissions % Engaged	88	84

Source: Environmental Tool 31 March 2022. All environmental performance data has been calculated using available data from the below mentioned sources. For the credit strategies, many of the benchmarks have low data coverage in comparison to the strategy, which can lead to understating of the benchmark's environmental performance.

Carbon footprint measures carbon emissions generated by companies within the portfolio for every million units of currency invested. The calculation accounts for both direct and indirect greenhouse gas emissions, which are covered in industry-standard definitions for Scope 1, 2 and 3 emissions. Therefore, a smaller carbon footprint figure than the benchmark's is evidence that the strategy's emissions, adjusted for the market value held in the portfolio, are lower than those of the benchmark.

The Federated Hermes Climate Change High Yield Credit Fund is the representative account of the strategy.

Figure 8. Environment topics engaged as at 31 March 2022



Source: Federated Hermes as at 31 March 2021.

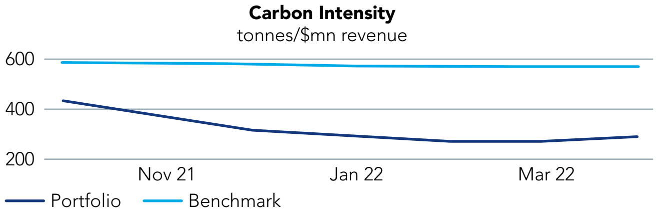
Decarbonisation over time

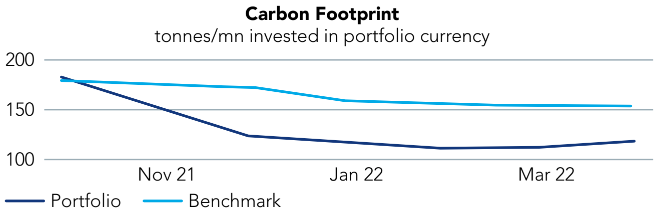
Over time, we expect the global economy to decarbonise; however, progress will not be uniform. The strategy will need to be dynamically adjusted to manage risk and allocate to companies and sectors that are believed to be strong contributors to performance over various time horizons.

The Federated Hermes Climate Change High Yield strategy looks at names that are leading the way in the decarbonisation transition, as well as companies that already have low baseline carbon emissions and the potential to make other companies more sustainable by virtue of their products and services. For investors, this provides the means to invest in the decarbonisation effort from two different angles.

Ultimately, we believe we should encourage companies to 'do the right thing'. As such, we continuously engage with portfolio companies, helping them commit to various milestones and deliver on their decarbonisation objectives.

While we believe our efforts will result in steadily falling emissions, this decline will be slower than if we were to divest from companies with high emissions today. There will also be some industries or companies where engagement will prove futile. Still, we prefer active engagement over divestment; engaging with companies to engender positive change ensures our capital has a voice.





Source: Federated Hermes, Environmental Tool, as at 31 March 2022.

The Federated Hermes Climate Change High Yield strategy looks at names that are leading the way in the decarbonisation transition, as well as companies that already have low baseline carbon emissions and the potential to make other companies more sustainable by virtue of their products and services.

SECTION 3

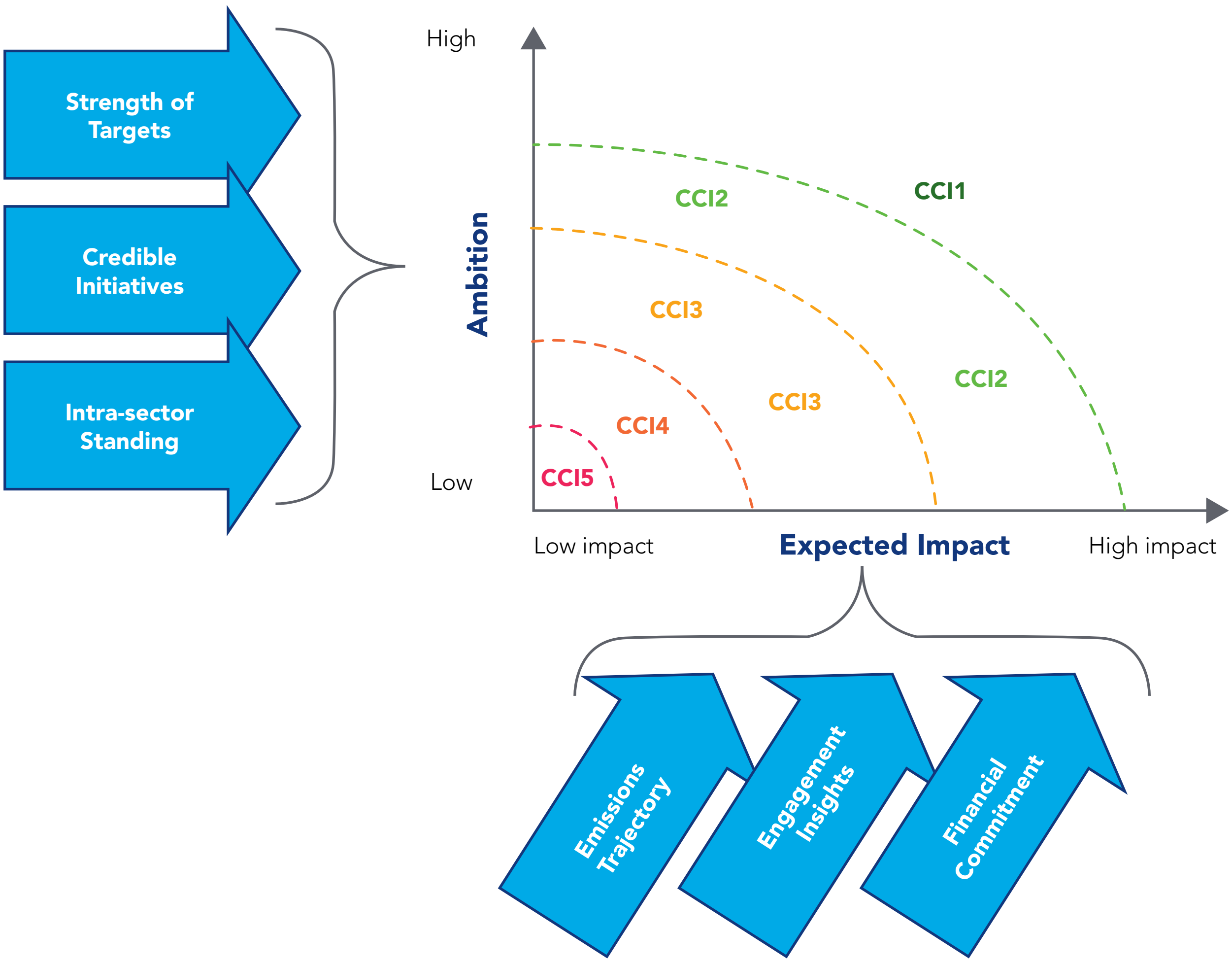
Our Climate Change Impact (CCI) score: An overview

The existential threat of climate change presents both risks and opportunities across the global economy. To create a credit portfolio that can withstand the turbulent years ahead, and make a positive contribution to mitigating climate change, an investor needs to assess a company's decarbonisation strategy in a sophisticated manner. Any credible investment process supporting this objective must be proprietary, independent and forward-looking.

Federated Hermes' Climate Change Impact (CCI) scores grade companies on a scale of one to five, based on:

1) The ***ambition*** demonstrated by a company's decarbonisation strategy

2) The ***expected impact*** of those decarbonisation plans



Source: Federated Hermes. For illustrative purposes only.

The ***ambition*** dimension assesses the quality of the decarbonisation strategies communicated by a company. To analyse this dimension, we evaluate a company's public disclosures, with particular focus given to the:

- Timeframe, detail and temperature alignment of the decarbonisation targets set
- Credibility of initiatives to support such targets
- Intra-sector standing of these ambitions

Sector-by-sector analysis is used to avoid sector bias. This is because each sector is at a different stage in addressing the issue of climate change, with sector-specific solutions required to mitigate and adapt to the risks present. Therefore, we apply a nuanced, sector-specific approach.

The second dimension, materiality of ***expected impact***, is essential if we are to understand the expected delta of decarbonisation resulting from the ***ambition*** of a company's strategy.

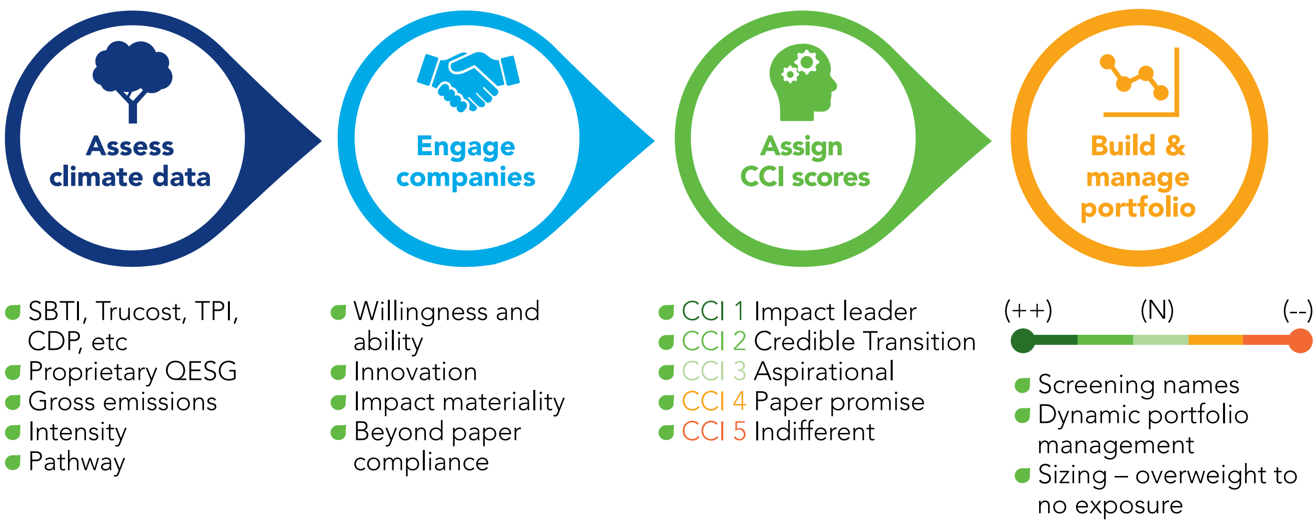
There is no guarantee that a company's stated decarbonisation commitments will be fulfilled. To understand a company's emissions trajectory – and generate a level of confidence in a company's potential, ex-ante emissions impact – it is therefore important to assess a company's current performance and historic track record in emissions management.

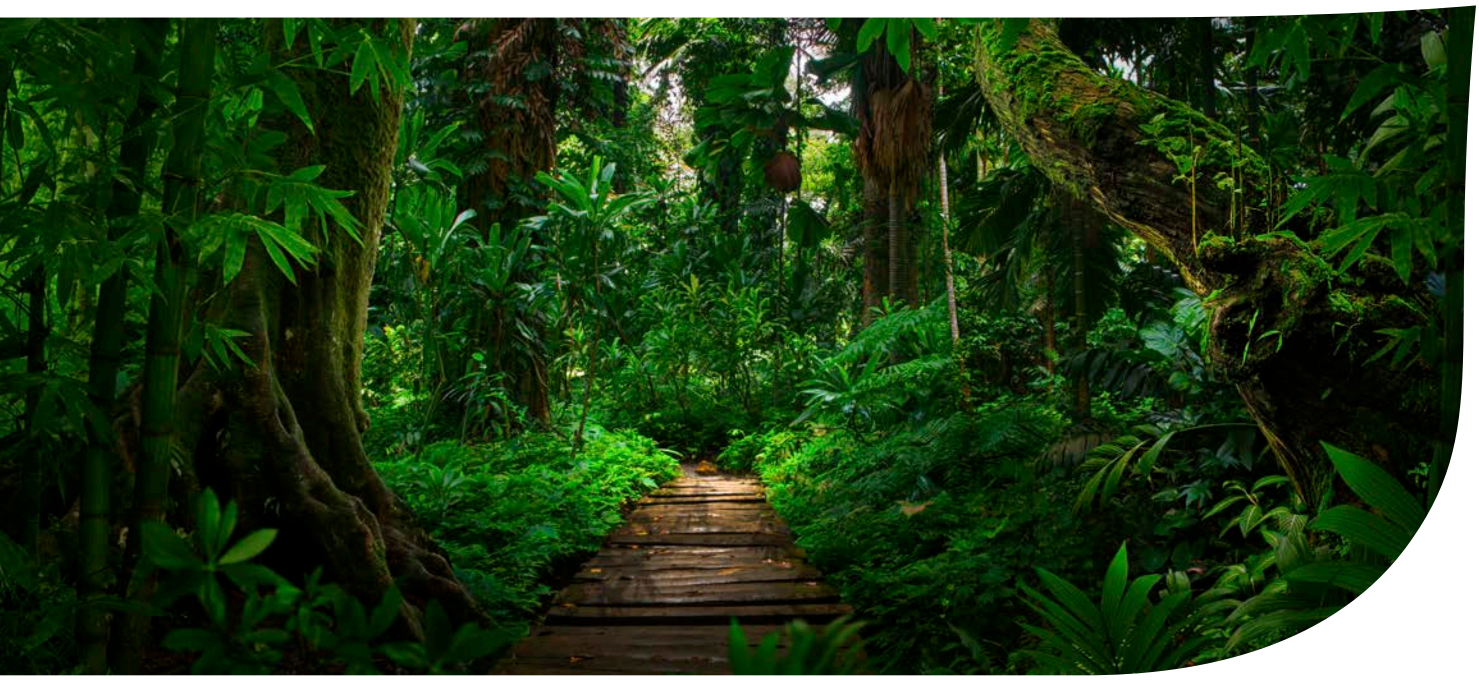
The data used to assess expected impact includes historic and current Scope 1, Scope 2 and, where significant, Scope 3 emissions, in both absolute and intensity-based terms. Where applicable, a company's financial commitments will be considered, specifically capital expenditure investments in climate-related initiatives. We also recognise the impact of companies with pioneering technology that directly or indirectly reduces emissions, such as renewable energy or zero carbon building materials.

Combined with engagement feedback, the above provides an informed picture of the likelihood of any stated decarbonisation thesis being delivered, as well as the 1.5°C scenario alignment being achieved.

Informing our analysis is a range of leading resources, including the Carbon Disclosure Project (CDP), Science Based Targets initiative (SBTi), Trucost, MSCI and Sustainalytics. Data from these resources is collated using our proprietary Carbon Tool and Climate Change Database, where it is cross-referenced with our engagement insights and public disclosure analysis to form individual CCI scores. Ultimately, a high CCI score recognises a leader who is both ambitious and expected to deliver on their potential – the latter is crucial in avoiding the influence of greenwashing. Applying this score in the construction and management of both mainstream and climate-themed portfolios offers greater exposure to companies who are leaders in the transition to a future of clean, efficient economies.

Figure 9. Engagement converts static data to a forward-looking score for portfolio construction





SECTION 4

Science-Based Targets – The 'North Star' of Climate Change Impact

When scoring a company in line with our CCI framework, we analyse a range of sources to assess both the ambition of a company's decarbonisation strategy, and the likelihood it will achieve its aims and align with a 1.5°C temperature scenario.

Sources include Carbon Disclosure Project (CDP) questionnaires and ratings, raw emissions data and/or estimates from Trucost, scores from third-party ESG data vendors, and our own proprietary ESG assessments, engagement input and other research.

A strong indicator of success on both fronts – and something on which we place great emphasis in our assessments – is company alignment to the Science-Based Targets initiative (SBTi). Brought about by the Paris Agreement in 2015, the initiative enables companies to set emissions reduction targets, with a view to limiting global warming to 1.5 °C. Since the initiative's inception, over 1,000 companies have set targets aligned to its most ambitious pathway of limiting global warming to 1.5°C, representing over $23tn in market capitalisation.[4]

To achieve SBTi alignment, companies must disclose their emissions in full and set targets in line with a series of requirements outlined by the initiative. Companies must target reduced Scope 3 emissions (if these account for over 40% of a company's total carbon footprint), use a base year no earlier than 2015, and review targets every five years. A company's efforts to offset carbon must only be considered for 'residual emissions', where no decarbonisation options exist in the run up to the target deadline.

Announcing a target in line with the SBTi is not only a public commitment to which a company can be held accountable; SBTi targets drive real-world decarbonisation. In a progress report published by SBTi in 2020, the initiative found that following the announcement of a SBTi-aligned target, companies achieved an average linear decarbonisation rate of 6.4% per annum[5]. By having companies set science-based targets, then, we are assured that a) a company's decarbonisation strategy is sufficiently ambitious, and b) it is reasonably likely to follow through on its promises. Both considerations help us decide whether a company will contribute to the decarbonisation of the global economy and take action to mitigate the risks to long-term value posed by climate change.

With the 2030 deadline fast approaching, the standards for achieving target alignment are also becoming more stringent. As of June 2022, companies will have to set targets in line with a 1.5°C scenario to receive the SBTi stamp of approval. Moreover, a framework for companies striving to achieve net zero by 2050 has been announced – companies must set additional, short-term targets within the next 10 years to qualify.

Over half of the companies in our portfolio have either announced targets in line with SBTi or committed to setting such targets in the next two years (Figure 10)[6]. Just short of 70% of 'CCI 1' companies have already achieved verification for their targets (Figure 1).

Figure 10: SBTi-Aligned Companies, By Commitment Level

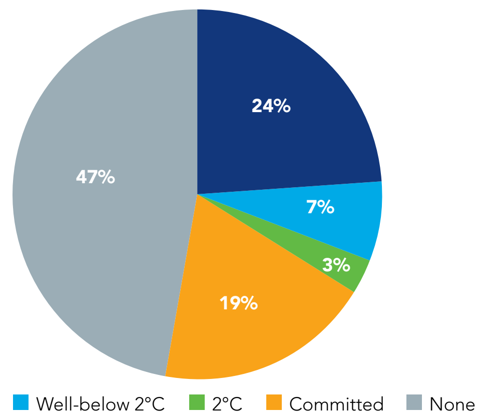
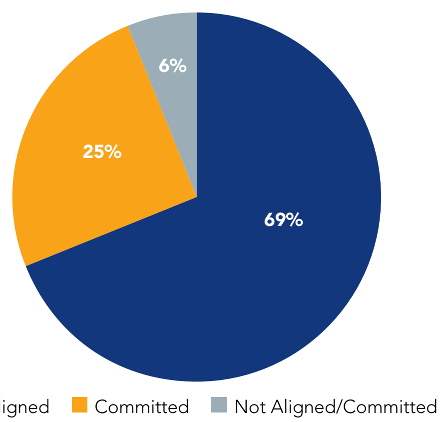


Figure 11: CCI 1 Companies, by Verification Status

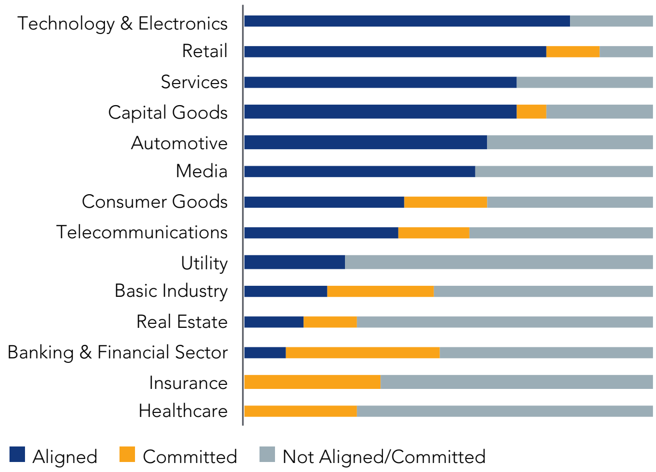


However, our analysis is not as simple as merely screening for SBTi-aligned companies. Our view on SBTi-alignment is sector-dependent, as some sectors are currently more capable of meeting the SBTi's requirements than others.

Figure 12 demonstrates that the technology/electronics and retail names in our portfolio lead in terms of SBTi-alignment. Both industries[7] benefit from the sector-specific guidance provided by the SBTi on how to measure and set targets for emissions. Meanwhile, our healthcare and financial holdings lag other sectors when it comes to achieving verification. For the healthcare sector, this is reflected in our scoring – no healthcare company in the strategy has been scored higher than CCI3.

[4] SBTi, Nov 2021.
[5] SBTi Progress Report 2020.
[6] Data for all charts accessed as at 31 January 2022.
[7] Here, we refer to the guidance for Apparel and Footwear- note that the majority of our Retail names fall within this category.

Figure 12: SBTi-Alignment Status (%), by Sector



On the other hand, out of the 25% of CC1 companies that have committed but not achieved SBTi verification, the majority are banks. Due to the complexity of calculating the carbon impact of a bank's portfolios, target-setting for this sector has lagged others. However, this is expected to improve rapidly, with the SBTi releasing specific guidance on target-setting for financial institutions in February 2022. We will continue to monitor this space, and potentially downgrade banks which fail to catch this momentum. For more detail on our scoring process for the banking sector, see our banking case studies in Section 5.

As sector capabilities evolve, we continuously assess the progress our holdings are making with respect to setting science-based targets.

As sector capabilities evolve, we continuously assess the progress our holdings are making with respect to setting science-based targets. We also prioritise SBTi alignment as a key objective throughout our engagement activities, especially for companies in the most carbon-intensive industries.

This said, we recognise that there is more to a company's decarbonisation strategy than SBTi alignment. We assess a company's disclosure on the initiatives it has in place to achieve its emissions-reduction goals. This is especially relevant for companies in sectors where SBTi verification is not yet widespread, and when differentiating among the lower-scoring issuers.

Finally, as verification becomes more commonplace within sectors, we will turn towards monitoring the progress of companies against their targets, as well as considering how a company's products and services contribute to the decarbonisation of the global economy.

We assess a company's disclosure on the initiatives it has in place to achieve its emissions-reduction goals.

SECTION 5

Sector case studies: Our CCI scoring system in practice

To illustrate how our scoring system works in practice, we have provided industry-specific case studies.

Industrials

Cement manufacturing accounts for about 8% of global emissions[8]. The International Energy Agency (IEA) estimates that if the sector is to align with the 'Net Zero Emissions by 2050' scenario, then annual emissions must fall by at least 3% each year to 2030[9].

Although the sector can switch to lower-carbon fuels and improve energy efficiency, these measures alone will not be enough. Reducing the clinker[10]-to-cement ratio, dampening the overall demand for cement and introducing technological innovations, such as carbon capture and storage (CCS), will contribute the most with respect to emissions reduction.

Our process for assigning industrial companies a CCI score considers each of these emissions reduction initiatives, with leaders identified as those who are pioneering the new technologies required to alter the decarbonisation trajectory.

Cement manufacturing accounts for about **8%** of global emissions

SECTOR CASE STUDY

Cemex is scored as a CCI 1

Cemex, the second largest ready-mix concrete company in the world, has committed to reaching net zero by 2050 – a highly ambitious target, given that the technology needed for the building materials sector to become carbon-free is still in its infancy.

Cemex's clear roadmap to 2050 positions the company as a leading developer of these technologies, which are revolutionising hard-to-decarbonise elements of the cement production process[11]. Further initiatives include developing carbon capture, utilisation and storage (CCUS) capabilities, and natural carbon sinks to offset residual emissions that cannot otherwise be reduced. These initiatives support medium and long-term reduction targets which, crucially, look beyond operational emissions to consider the emissions of sold products. This will have a wider impact by helping decarbonise the carbon-intensive construction sector.

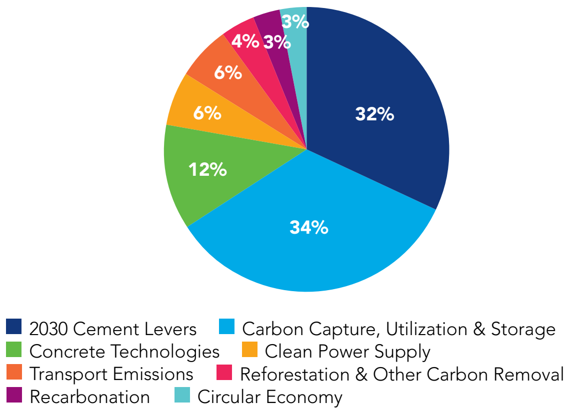
Cemex has also responded positively to engagement, with the CEO acknowledging our recommendations, and subsequently achieving SBTi verification for the company's emissions targets.

Ultimately Cemex's aim is to provide zero-carbon concrete, which it is well on its way to delivering with the introduction of the UK's first zero-carbon concrete block.

Positive progress is also reflected in the company's emissions performance, with operational emissions trending downwards both on an absolute and intensity basis.

These are strong signs the company will continue optimising its operations, delivering into the credible targets it has set. The company is therefore recognised for both its high ambition and expected impact through a score of CCI1.

CO_2 Reduction Levers for Cemex 2050 Ambition

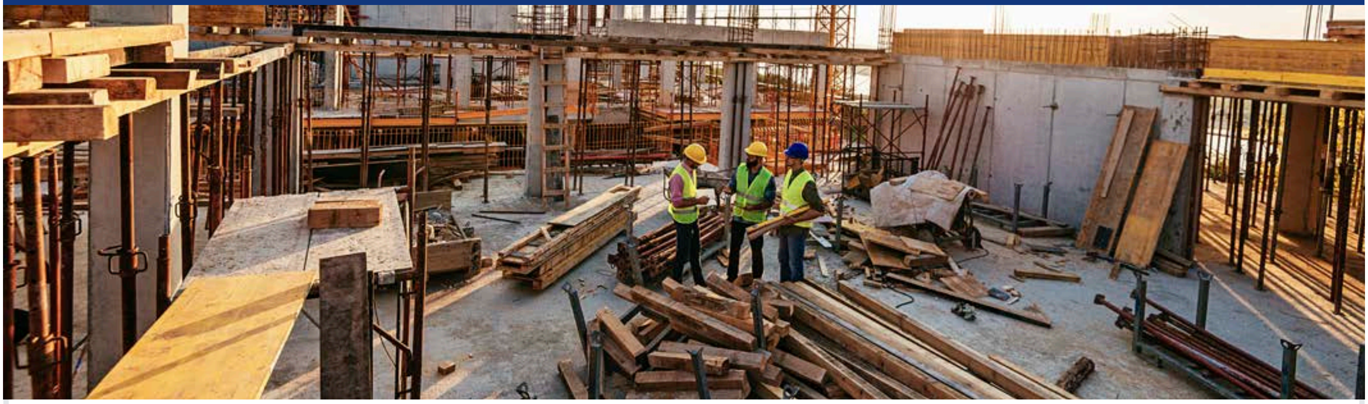


Source: Cemex, 2020 Integrated Report, p.36.

[8] Climate change: The massive CO2 emitter you may not know about, BBC News.
[9] Cement, IEA.
[10] Clinker is a binding agent in cement made from carbon-intensive processes.
[11] 2020 Integrated Report, Cemex.

SECTOR CASE STUDY

Vulcan Materials is scored as a CCI 4



While US construction materials company, Vulcan, has an environmental strategy, this strategy lacks credibility insofar as it does not disclose a decarbonisation pathway, or any emissions reduction initiatives with specific actions. By implementing various environmental programmes, the company clearly considers its carbon footprint, however, these programmes are limited to emissions monitoring, and unspecific energy efficiency and land protection initiatives.

There is also a lack of value chain emissions data beyond Scope 1 and 2, and reporting fails to include analysis of the material climate risks facing the company's operations. Furthermore, little progress was achieved with respect to Vulcan's emissions performance in 2020, with Scope 1 emissions intensity per tons shipped still above 2018 levels, and absolute operational emissions down only 2.7% versus the company's 2015 baseline.

Our analysis is complemented by engagement insights – through engagement, we have encouraged management to set specific emissions-reduction targets. The company followed our advice, stating that it would announce targets in 2021, but these are yet to be completed.

Ultimately, the combination of a strategy that lacks real ambition, with no evidence of significant progress being made, receives a score of CCI 4. As a result, the company is unlikely to contribute to the sustainability goals of the strategy, and is therefore not included in the portfolio.

Our analysis is complemented by engagement insights – through engagement, we have encouraged management to set specific emissions-reduction targets.

Banks & Financial Services

The banking sector is under increasing pressure from investors and the wider public due to its continued financing of the world's most polluting industries. For example, Rainforest Action Network's 'Banking on Climate Chaos' report, published in 2022, named the financiers channelling $4.6tn into fossil fuel industries six years after the Paris Agreement.[12]

Some banks have since stepped up, setting ambitious targets to phase out their exposures to carbon-intensive industries – including coal, oil and gas – in the hope of achieving Paris-alignment for their portfolios.

The banking sector is under increasing pressure from investors and the wider public due to its continued financing of the world's most polluting industries.

However, this is no easy feat. As a first step, banks face the task of calculating the emissions generated by the activities they finance, known as their 'financed emissions'. While this may be easier for smaller banks financing a smaller range of activities, larger, more universal banks will have to dedicate significant resource to measuring their footprint. Luckily for them, initiatives such as the Partnership for Carbon Accounting Financials (PCAF) have provided widely accepted guidance.

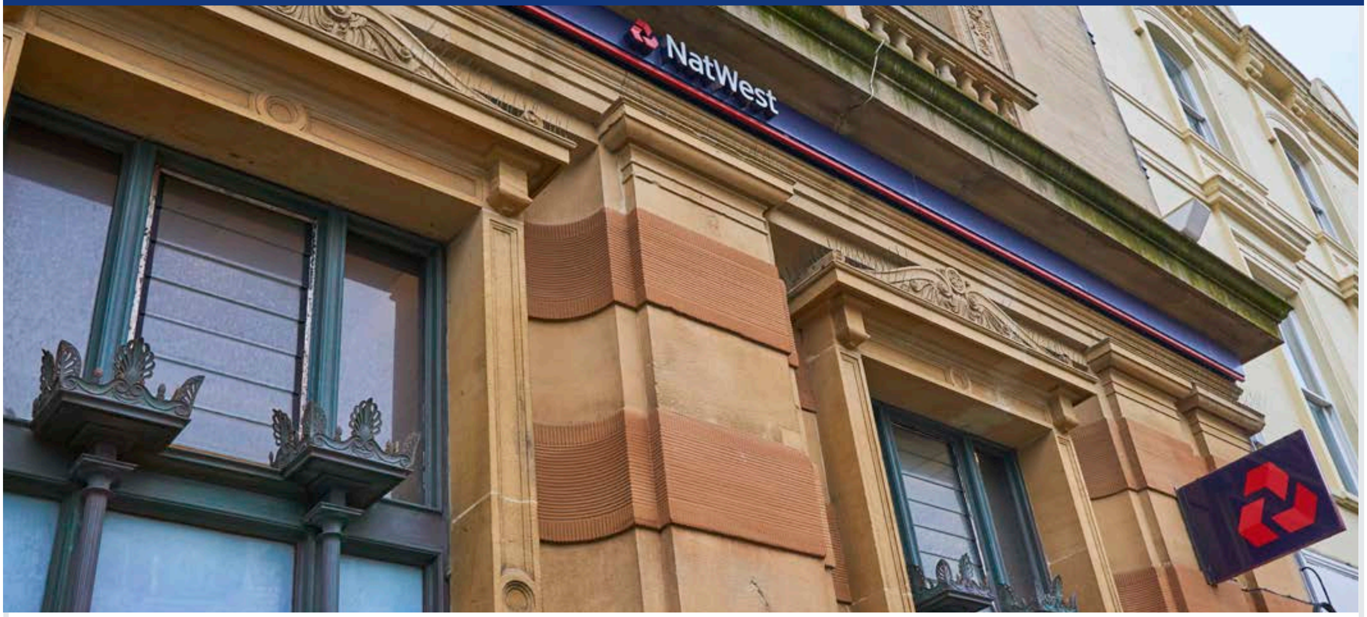
With multiple banks already up to the task, we believe that no bank can achieve CCI 'leadership' status without accounting for the most material portion of their emissions, as well as setting meaningful targets to reduce them. And, with 15 banks more recently achieving SBTi-alignment for their targets[13], we are raising our expectations.

European banks are noticeable leaders in this space, with many banks in other geographies only recently realising the true materiality of climate to their core activities.

[12] 'Banking on Climate Chaos: Fossil Fuel Finance Report 2022,' published by Rainforest Action Network in 2022.
[13] As of 28 February 2022.

SECTOR CASE STUDY

NatWest is scored as a CCI 1



NatWest achieved CCI 'leadership' status in February 2022, following news that the bank was cutting close to £970m in funding to coal and oil and gas companies that failed to align with its expectations on climate. This move was in keeping with the bank's commitment to cut its exposure to major oil and gas producers, as well as companies with more than 15% of activities related to coal, by the end of 2021[14].

Ultimately, the bank plans to fully phase out coal from its portfolio by 2030, and will only continue to finance primarily UK-based oil and gas companies under strict conditions related to emissions disclosure. These strong commitments will support the bank in its ambition to halve its portfolio emissions by 2030 and achieve net zero by 2050. The bank is expected to build on these targets with sector-specific portfolio emissions targets this year, following its commitment to SBTi. It has also committed to providing £100bn in climate and sustainable finance by 2025, which will include funding for the renewable energy sector, clean transportation, green mortgages, and more.

NatWest achieved CCI 'leadership' status in February 2022, following news that the bank was cutting close to

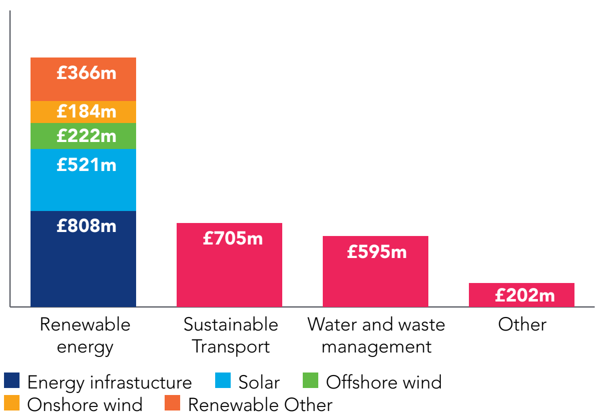
£970m

in funding to coal and oil and gas companies that failed to align with its expectations on climate.

Ultimately, the bank plans to fully phase out coal from its portfolio by 2030, and will only continue to finance primarily UK-based oil and gas companies under strict conditions related to emissions disclosure.

We will continue to follow the bank's progress as it calculates its financed emissions by sector, having covered over half of its portfolio so far, and seeks verification for its targets. For now, though, we identify NatWest as a clear industry leader, not only due to the strength of its commitments, but also because the bank has followed through on its promises.

Figure 13. NatWest's sustainable wholesale lending in 2021, by category



Source: NatWest 2021 Climate-Related Disclosures Report, p. 63.

[14] Unless said companies present a strategy in line with the bank's "Credible Transition Plan" assessments.

SECTOR CASE STUDY

Ally Financial is scored as a CCI 4

Until recently, Ally Financial was scored a CCI 5, as the bank had failed to disclose any material climate-related data, including its emissions profile and any emissions reduction targets or initiatives.

However, in 2021, the bank published data on its operational emissions for the first time. It established a Sustainability Office to coordinate the implementation of a climate change strategy – which it said will involve formulating an approach to climate risk – calculating the remainder of its emissions, and setting emissions reduction targets.

At the end of 2021, the bank announced it had achieved carbon neutrality for its operational emissions using carbon offsets. However, given that the bank does not have any brick-and-mortar branches, this action is limited to the emissions of its offices, and thus has limited materiality.

Furthermore, we prefer actions taken to directly reduce operational emissions, rather than the purchase of offsets. Though the bank has a target of achieving 30% Leadership in Energy and Environmental Design (LEED) certification of its office buildings by 2030, this initiative is rather weak compared to progress being made by peers in areas such as energy efficiency and renewable energy sourcing for operations.

The most material portion of the bank's emissions is, of course, its portfolio emissions. The bank explained that over the course of 2021 and beyond, it plans to calculate the climate impact of its portfolios, guided by the World Resources Institute's methodology. Progress on this initiative, as well as the setting of targets for the Paris-alignment of its portfolios, will be crucial for achieving future score upgrades. This would likely require the development of a detailed climate risk management strategy, as well as initiatives to phase out the most polluting assets and sectors.

Through continuous engagement with the company on climate matters, we have gauged its genuine commitment to developing a strategy for climate risk integration and management in line with TCFD recommendations.

Though the bank has a target of achieving **30%** Leadership in Energy and Environmental Design (LEED) certification of its office buildings by 2030, this initiative is rather weak compared to progress being made by peers in areas such as energy efficiency and renewable energy sourcing for operations.

We will continue to observe the bank's progress in these areas and update its score accordingly. Our engagement team will also continue to encourage the bank to improve its ESG disclosures, with a special emphasis on climate, as a key objective. However, our conviction gained through engagement, combined with the bank's recent positive momentum achieved on climate matters has given us sufficient confidence in the bank's future decarbonisation pathway to warrant an upgrade to CCI 4.

Consumer Goods – Fashion

The scale of the fashion sector's negative impact on the environment is immense and poorly understood by the public. Apparel is responsible for 10% of annual global carbon emissions, more than all international flights and maritime shipping combined; at its current rate, this is set to increase 50% by 2030[15].

Cultivation, deforestation, soil degradation from agricultural practices involving virgin fibre, energy use in production, transportation emissions and the apparel consumer's carbon footprint – which is associated with the washing, cleaning and disposing of products – all contribute to the sector's carbon footprint. As such, all are considered when we assign a CCI score.

At the heart of the sector's environmental challenges is the use of virgin fibres to meet the consumption habits driving fast fashion. With demand projected to increase, the sector has an obligation to transition to a more sustainable model of production that emphasises circularity at all points – from how chemicals are used, to how textiles can be reintegrated into 'closed loop' production cycles. This can directly address the sector's overreliance on virgin fibres.

On the consumer end, large apparel companies have an opportunity to drive initiatives that improve textile re-use and recycling rates.

SECTOR CASE STUDY

Levi Strauss & Co is scored as a CCI 1

Levi Strauss is considered a leader among sector peers for its approach to reducing emissions and preparing for a low-carbon future. The company has demonstrated a credible decarbonisation and circular economy strategy, which includes highly ambitious emissions-reduction targets, verified by the SBTi and covering both Levi's operations and supply chain. These targets are supported by innovative energy efficiency and circular economy initiatives, including a textile dye re-use scheme and initial pilots recycling materials for use in apparel.

Issues that lack attention from the sector, such as the sustainable sourcing of materials, are also addressed – the company sources 100% of its cotton sustainably through the Better Cotton initiative.

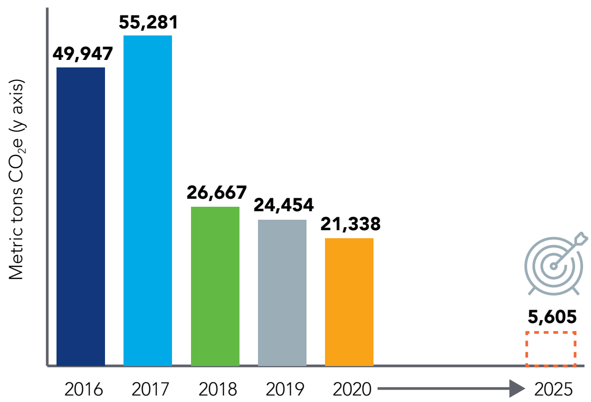
Issues that lack attention from the sector, such as the sustainable sourcing of materials, are also addressed – the company sources

100%

of its cotton sustainably through the Better Cotton initiative.

Our engagement with the company supports these initiatives. What's more, Levi's decarbonisation performance to-date has been strong, demonstrating the company's ability to successfully follow through on its strategy and remain in-line with a 1.5°C scenario.

Progress on 2025 Science-Based Greenhouse Gas Emissions Reduction Targets (from a 2016 baseline)



Source: Levi Strauss & Co., 2020 Sustainability report.

[15] How Much Do Our Wardrobes Cost to the Environment? (worldbank.org).

SECTOR CASE STUDY

Hanesbrands is scored as a CCI 3

Hanesbrands is addressing its carbon footprint by setting a decarbonisation target to reduce operational emissions by 25% come 2030, from a 2020 baseline. This is supported by operational initiatives to increase the use of renewable energy in electricity generation to 100% by 2030. The company also has plans to reduce operational waste and achieve sustainable cotton sourcing across all products by 2025.

Crucially, these targets fail to include the company's Scope 3 emissions, which are the most material across Hanesbrand's value chain. The targets in place are also comparatively weaker than leading names in the sector, and are yet to be independently verified as aligned to the temperature scenarios set out within the Paris Agreement.

Despite the company's lacklustre strategy and ambitions, the outlook and expected impact is positive, with the company being receptive to feedback on its sustainability strategy over the course of our engagement. Moreover, SBTi-approved targets are expected to be released in 2022.

Hanesbrand's current aspirations receive a CCI 3. We will reassess the company following expected updates to its strategy.

> **The company also has plans to reduce operational waste and achieve sustainable cotton sourcing across all products by 2025.**

BD009771 0012983 05/22

Federated Hermes
Limited

Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes now form the international business of Federated Hermes. Our brand has evolved, but we still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important new strategies from the entire group.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

For more information, visit **www.hermes-investment.com** or connect with us on social media: