

# Federated Hermes Sustainable Global Equity



**Quarterly Report**  
Q3 2022

**Federated  
Hermes**   
**Limited**

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## Introduction

Welcome to our Sustainable Global Equity quarterly update.

In this issue we look at the state of global supply chains and their impact on sustainably focused businesses.

Lingering supply chain constraints have been a drag on the recovery of many sectors as they have emerged from the pandemic. A lack of sufficient raw materials has kept input costs high, while bottlenecks have inflated the cost of transport & logistics. China's ongoing zero-Covid policy has been partly to blame, given its vital role in many global supply chains, while the conflict in Ukraine exacerbated the problems just as pressures were starting to ease.

However, there are encouraging signs that the situation is improving. Costs for container shipping are beginning to recede, while tailbacks at ports, a recurring issue since the Ever Given blocked the Suez Canal in March 2021, are less in evidence. In the short-term, the pace of improvement will vary by sector, but in the longer term, more resilient supply should allow companies with sustainable business models positioned for secular growth to prosper.

As always, we provide an overview of the strategy's environmental and engagement data.

We complete this issue with a pair of case studies illustrating how improving supply chain conditions could benefit two of the portfolio holdings.

### **Our vision for sustainable long-term investing in global equities**

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

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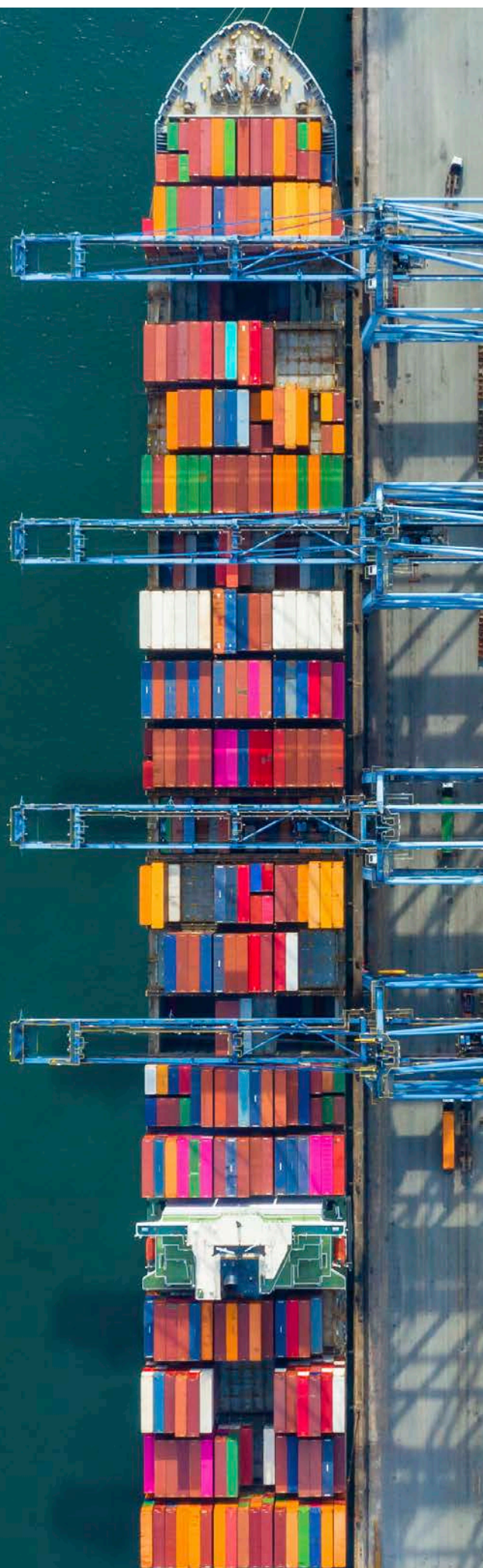
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SECTION 1

# Sustainable Global Equity: This quarter's highlights

## Exposure to sustainability themes

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

As at 30 June 2022, exposure to these themes was as follows:



**Environmental preservation**

**Sub themes include:**

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

Portfolio weighting: **22%**

**Health and wellbeing**

**Sub themes include:**

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

Portfolio weighting: **23%**

**Efficient production and resource usage**

**Sub themes include:**

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

Portfolio weighting: **28%**

**Social inclusion**

**Sub themes include:**

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

Portfolio weighting: **24%**

Source: Federated Hermes, as at 30 June 2022. The sub-themes listed above are not an exhaustive list. The portfolio weightings are subject to change.

## Environmental footprint

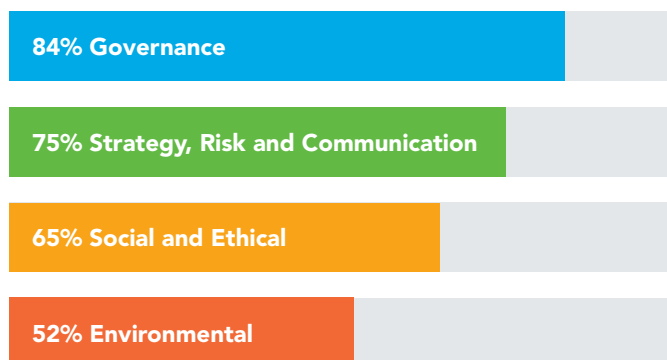
The strategy aims to have a smaller environmental footprint than the benchmark, the MSCI All Country World Index. As at 30 June 2022, the portfolio's carbon, waste and water footprints measured as follows:

	<b>Portfolio (tonnes per \$m invested)</b>	<b>Benchmark (tonnes per \$m invested)</b>
<b>CO<sub>2</sub> footprint (scope 1, 2 &amp; 3)</b>	78.7	158.6
<b>Waste footprint</b>	4.2	13.1
	<b>Portfolio (m<sup>3</sup> per \$m invested)</b>	<b>Benchmark (m<sup>3</sup> per \$m invested)</b>
<b>Water footprint</b>	9.3k	23.3k

Source: TruCost, Federated Hermes, as at 30 June 2022.

### Engagement themes

The team’s engagement efforts over the last 12 months covered 93% of the strategy’s AUM. The breakdown by theme was as follows:



Source: Federated Hermes, as at 30 June 2022.

**The strategy aims to have a smaller environmental footprint than the benchmark, the MSCI All Country World Index.**



### Portfolio positioning

As at 30 June 2022, the portfolio’s top-10 active positions were as follows:

Holding	Portfolio active weight (%)*
Microsoft	3.6
Mastercard	3.4
Thermo Fisher	3.4
Novo-Nordisk	3.2
Wex	3.0
RELX	2.9
Costco Wholesale	2.9
Adobe	2.8
AIA Group	2.8
PTC Inc	2.7

Source: Federated Hermes as at 30 June 2022.

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

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## SECTION 2 - THEMATIC FOCUS

## Are supply chain pressures starting to ease?

Ongoing supply chain constraints have been a significant contributor to the growing inflationary pressures we have witnessed in the wake of the pandemic, says Martin Todd, Lead Portfolio Manager. But new data offers encouraging evidence that the situation is starting to improve.

### Fast reading:

- In the wake of the pandemic, global supply chains have struggled to catch up with recovering demand. China's zero-Covid policy and the Ukraine conflict have contributed to recurring bottlenecks which have kept the cost of raw materials and shipping high.
- There are encouraging signs that supply chain pressures are easing. The issues are not uniform for all sectors, so the pace of improvement for different companies will vary, but the long-term outlook is good for sustainable companies positioned for secular growth.

In recent decades, lean international supply chains have become so accepted as the most efficient model for a wide range of businesses as to be almost unquestioned. Despite their length and complexity, the benefits in terms of productivity and cost-efficiency have historically far outweighed any risks. As companies increasingly internationalised their operations, world trade volumes have soared, reached around 40 times their 1950 level by 2020<sup>1</sup>. In the wake of the Covid pandemic, however, a range of issues have combined to create major headaches for companies relying on global supply chains, which have proved brittle in the face of unprecedented disruption.

### What caused the supply chain crisis?

As the threat from the pandemic began to recede and economies reopened, a huge amount of pent-up demand was suddenly unleashed. This put significant pressure on global supply chains which had been largely dormant for an extended period. With raw materials and labour in short supply, manufacturing was unable to ramp up to the required level, and as a result product shortages soon emerged. Meanwhile, a shortage of truck drivers and port staff, coupled with the impact of ongoing regulations to combat Covid, delayed the unloading of merchant ships and clogged up ports across the globe.

These issues were compounded by the knock-on effect of the Suez Canal obstruction in March 2021, when the 400-metre-long container ship *Ever Given* became stuck, blocking this vital waterway for six days. By the time the ship and its cargo of



18,300 containers was freed, nearly 400 other commercial vessels were waiting to pass through the canal, among them other container ships of a similar size<sup>2</sup>. One consequence was a global shortage of containers, which further exacerbated the ongoing situation. By September 2021 Drewry's World Container Index, which tracks representative costs for a standard 40ft container on eight major trade routes, had peaked at \$10,377 – more than six times the average rate through 2019 and early 2020<sup>3</sup>.

Given China's pivotal role in many global supply chains, the country's continued pursuit of its strict 'zero-Covid' policy only made matters worse. With lockdowns paralysing industry, delays in supplies of valuable components and raw materials grew from weeks into months. For many companies, alternative sources were simply unavailable, creating lasting production bottlenecks.

The conflict in Ukraine once again raised the stakes, increasing raw materials costs and adding the need to navigate sanctions (including secondary sanctions on countries like China and India who maintain relations with Russia) to the list of issues facing companies.

In the face of lasting disruption, as well as increasing protectionism and wage inflation, a large number of companies have made moves to reimagine and transform their supply chains. Clearly, businesses were unable to relocate production overnight. But as time has worn on, a key consequence of the crisis has been the increasing trend towards onshoring. In an EY survey conducted in Q1 2022, 53% of companies said they had already near- or re-shored some of their operations in the previous two years, while 44% said they were planning new or additional near-shoring activities in the following two years<sup>4</sup>.

### Problem contained: Indices show shipping costs falling

Happily, recent data from several key sources suggests that while we are not totally out of the woods, things are moving in the right direction.

The Federal Reserve Bank of New York's Supply Chain Pressure Index integrates transportation cost data with manufacturing indicators, such as supply-chain related components from Purchasing Manager Index (PMI) surveys of the major economies across the globe. This provides a useful indicator of the relative level of stress on supply chains over time. As the chart illustrates, while pressures remain significantly elevated, they have generally been easing since the end of 2021.

<sup>1</sup> 'Evolution of trade under the WTO: handy statistics. Published by the World Trade Organization. Retrieved 31 August, 2022. [https://www.wto.org/english/res\\_e/statis\\_e/trade\\_evolution\\_e/evolution\\_trade\\_wto\\_e.htm](https://www.wto.org/english/res_e/statis_e/trade_evolution_e/evolution_trade_wto_e.htm)

<sup>2</sup> 'The cost of the Suez Canal blockage', BBC News website, 29 March 2021, retrieved 30 August 2022. <https://www.bbc.co.uk/news/business-56559073>

<sup>3</sup> Drewry's World Container Index. Drewry website. Retrieved 31 August 2022. <https://www.drewry.co.uk/supply-chain-advisors/supply-chain-expertise/world-container-index-assessed-by-drewry>

<sup>4</sup> 'Why global industry supply chains are decoupling.' Published by EY as at 13 June 2022. [https://www.ey.com/en\\_cn/automotive-transportation/why-global-industrial-supply-chains-are-decoupling](https://www.ey.com/en_cn/automotive-transportation/why-global-industrial-supply-chains-are-decoupling)

**Federal Reserve Bank of New York Global Supply Chain Pressure Index (GSCPI), 2012-2022**



Source: Bloomberg as at 31 July 2022.

A further source of data is the FBX Global Container Index, which is part of a series of indices compiled by Freightos and the Baltic Exchange. It tracks the weighted average price of containers across 12 regional routes. The chart illustrates how rates climbed rapidly through the summer of 2021, following vaccine rollout and the subsequent economic reopening. While they are still higher than pre-pandemic levels, they have dropped sharply since March, indicating that the supply-demand imbalance is starting to correct.

**FBX Global Container Index, August 2017 – May 2022**



Source: Bloomberg as at 7 August 2022.

**Plain sailing from here?**

Another encouraging signal for supply chain logistics is the easing of congestion at key ports. At the height of the issues in January 2022, the container ship backlog outside the port of Los Angeles stood at a record 109 vessels, with vessels waiting between 18 and 24 days to dock on average. As of 29 August 2022, a mere eight ships were queued<sup>5</sup>.

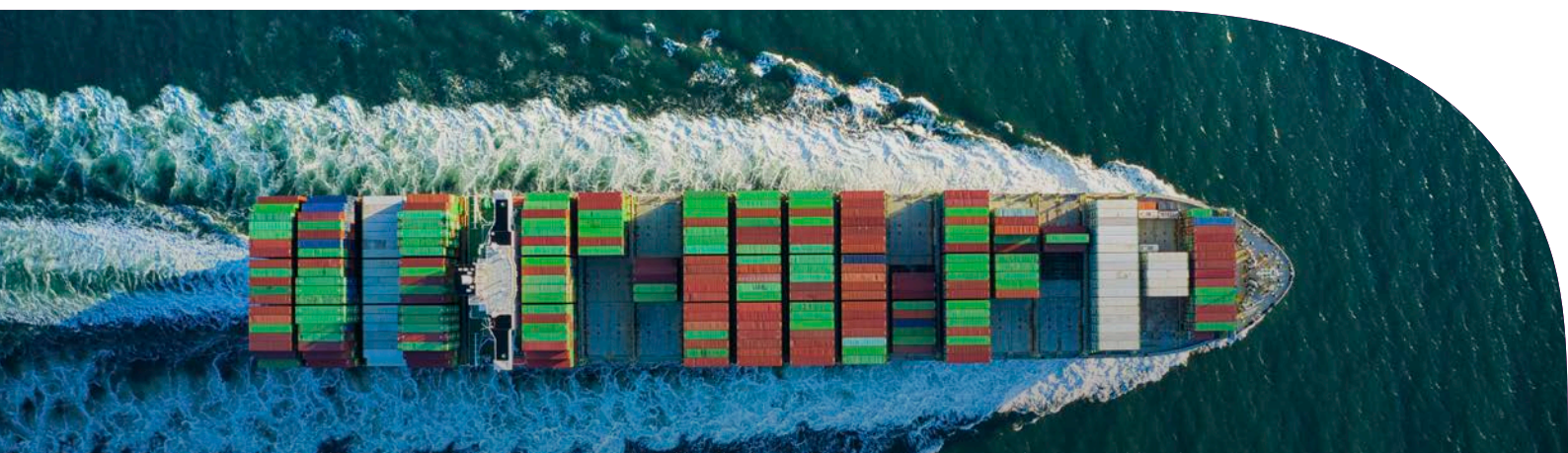
Meanwhile in the UK, potential supply chain disruption hit the news recently due to an eight-day strike at Felixstowe, which handles nearly half of the country's container traffic. However, both the British Ports Authority and the British International Freight Association played down the likelihood of any serious repercussions, pointing to improved supply chain resilience and available capacity elsewhere<sup>6</sup>.

**Zero risk: China's stringent Covid policy is still the big unknown**

China's zero-Covid policy continues to be a risk to supply chain recovery. However, there are signs that the government's approach is starting to soften. The Covid outbreak in Shanghai which started in late February 2022 was met with strict measures, including a two-month citywide lockdown in April and May. This had repercussions throughout China and beyond, causing significant economic disruption to semiconductor, electronics and car manufacturing, as well as to shipping<sup>7</sup>. In comparison, the more recent outbreak in Beijing was treated with a relatively light touch, perhaps reflecting a desire to control the economic impact. Having said that, fresh outbreaks saw millions of residents in provinces around the capital put under lockdown at the end of August.

**Investment implications**

In summary, while issues remain, there are encouraging signs that supply chains are bouncing back again. This is likely to benefit manufacturers positioned for secular growth, particularly those with business models focused on climate-related challenges. We have included case studies for two of our relevant portfolio holdings below.



<sup>5</sup> 'The Container Ship Backlog Outside Los Angeles Ports Is Almost Cleared'. Bloomberg. As at 30 August 2022. <https://www.bloomberg.com/news/articles/2022-08-30/flood-of-los-angeles-bound-container-ships-slows-to-a-trickle#xj4y7vzkg>

<sup>6</sup> 'Why the Felixstowe port strike won't cause 'huge disruption''. Published by the Chartered Institute of Procurement & Supply, as at 22 August 2022. <https://www.cips.org/supply-management/news/2022/august/what-impact-will-felixstowe-strikes-have-on-ports-globally/>

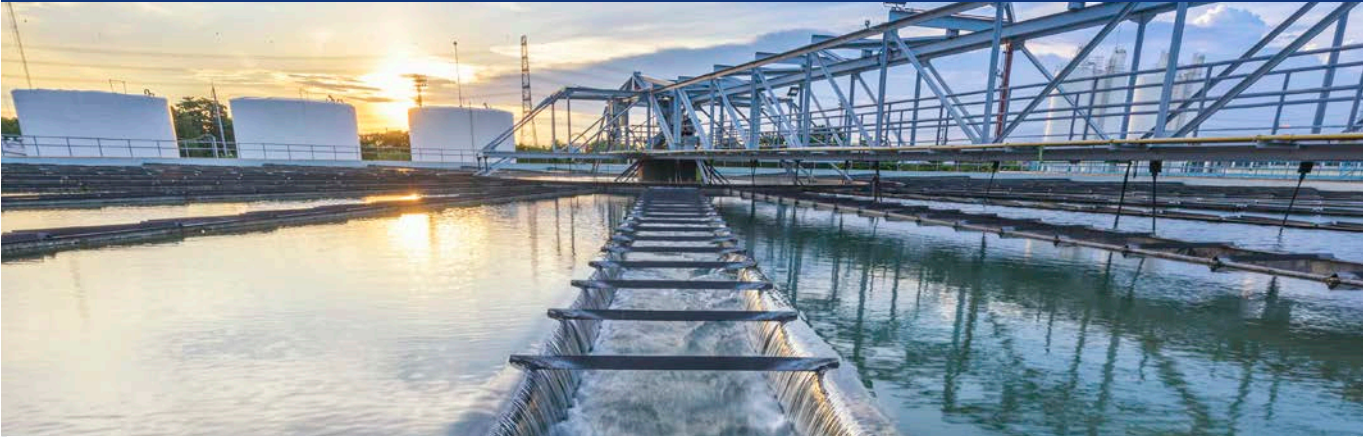
<sup>7</sup> 'Shanghai lockdown: Economy shaken by zero-Covid measures'. Published by BBC News as at 4 April, 2022, retrieved 31 August 2022. <https://www.bbc.co.uk/news/business-60950507>

 CASE STUDY

## Xylem Inc.

**A global leader in water technology, providing solutions to utilities, industry and agriculture**

Investible theme and sub-theme: Efficient production and resource usage; Water preservation



Xylem enjoys a strong position in the global water technology and solutions market and is active in more than 150 countries. Its investments in analytics and software have the potential to boost margins and increase the already high share of recurring revenues.

The firm's products and services address customer needs across the water cycle, covering three key value propositions:

- **Better affordability**, through efficiencies in the delivery, use and treatment of water
- **Improved resilience**, through the management of water-related risks and infrastructure
- **Addressing water scarcity** by managing limited water supplies which are the result of climate change, overpopulation and pollution

Efficient water management is a critical issue with wide-ranging consequences:

One in three people experience water scarcity at least one month per year



Over one third of the world's population will live in areas without adequate water supply by 2025.



**440m**

days of school are missed by children worldwide each year due to water-related illnesses.



**A crucial part of its offering is technology that enables its public utility, residential, commercial, agricultural and industrial clients to measure, monitor and control water usage.**

Particularly in developing countries, the burden of acquiring water falls disproportionately to women and children, exacerbating gender inequality and further preventing children from attending school. Better water management, particularly in areas affected by limited supply, is key to effectively addressing these issues.

Xylem is benefiting from secular demand growth driven by the increasing severity of water and climate-related challenges. A crucial part of its offering is technology that enables its public utility, residential, commercial, agricultural and industrial clients to measure, monitor and control water usage. These digital solutions reduce water loss and improve efficiency, thereby reducing costs.

The supply chain crisis has had an impact on Xylem most directly in the form of semiconductor shortages, which have slowed production and limited sales. However, in the company's most recent earnings update management pointed to gradual improvements in supply, as well as shorter lead times for product delivery. Meanwhile, demand remains robust, particularly for its digital products. These offer higher margins and provide enviable earnings visibility for the next couple of years.

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 CASE STUDY

## Vestas Wind Systems

Provider of wind turbine design, sales, manufacturing, installation and servicing to 80+ countries

Investible theme and sub-theme: Environmental preservation; Energy transition



Supply chain issues vary across different sectors and industries, impacting businesses in different ways. Vestas Wind Systems is an example of a company which is being open and realistic about the timescales for a return to normality.

Despite rapid growth and healthy prospects, the wind energy market is currently impacted by the poor availability and higher cost of raw materials and parts. In its recent earnings update, Vestas' CEO was frank in stating that the situation has neither improved nor worsened for the company. Supply chain issues are likely to continue until the end of the year, and while Vestas is hoping for improvements on the transport and logistics side, the company is not yet confident enough to build this into its forecasts. However, despite these short-term challenges, several factors contribute to our continued confidence in the company's long-term prospects.

According to the United Nations, there were 6,681 climate-related disasters between 2000 and 2019, almost double the figure for the previous 20 years<sup>8</sup>. With apocalyptic images of severe climate events flooding our media feeds, pressure is building on nation states to take more urgent action. Although somewhat compromised, US President Joe Biden's \$369bn Inflation Reduction Act<sup>9</sup>, which aims to use tax incentives to boost the renewables sector, is an important step in the right direction.

# \$94.26bn:

The expected value of the global wind turbine market in 2022<sup>10</sup>



# 5.97%:

Forecasted CAGR for the global wind turbine market, 2022-26



# 88:

The number of countries where Vestas have installed turbines



# 157GW:

Capacity installed by Vestas worldwide



Meanwhile, the fallout from Russia's invasion of Ukraine has pushed energy security high up the agenda for governments and driven a new focus on self-sufficiency. For most countries this means renewable energy solutions, including wind, have a vital role to play.

**Despite rapid growth and healthy prospects, the wind energy market is currently impacted by the poor availability and higher cost of raw materials and parts.**

When added to existing tailwinds for renewables in terms of governments' net zero targets, these factors provide companies such as Vestas with a strong opportunity for long-term, sustainable growth.

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<sup>8</sup> 'The human cost of disasters: an overview of the last 20 years (2000-2019)'. Published by the United Nations Office for Disaster Risk Reduction as at 13 October 2020. Retrieved 31 August 2022. <https://www.undrr.org/publication/human-cost-disasters-overview-last-20-years-2000-2019>

<sup>9</sup> US Senate passes Joe Biden's flagship economic package | Financial Times (ft.com)

<sup>10</sup> 'Research and Markets Global Wind Turbine Market Report 2022'. Published 11 August 2022. <https://www.globenewswire.com/news-release/2022/08/11/2496483/0/en/Global-Wind-Turbine-Market-Report-2022-Market-is-Expected-to-be-Worth-94-26-Billion-in-2026-from-70-54-Billion-in-2021.html>

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