Federated Hermes Sustainable Global Equity

Quarterly Report
Q4 2022

Federated Hermes Limited

www.hermes-investment.com
For professional investors only

Introduction

Welcome to our Sustainable Global Equity quarterly update

In this issue, we consider whether, after two decades of lower for longer, inflation has now become the 'new normal' for investors. If so, how should we adapt to this new environment, what factors are likely to drive inflation over the medium term, and what does this mean for sustainability?

The reawakening of inflation in 2020, following the Covid-19 pandemic, brought with it new challenges but also new opportunities. As ESG enters this demanding new phase, we consider how inflation and sustainable investing can best exist side-by-side.

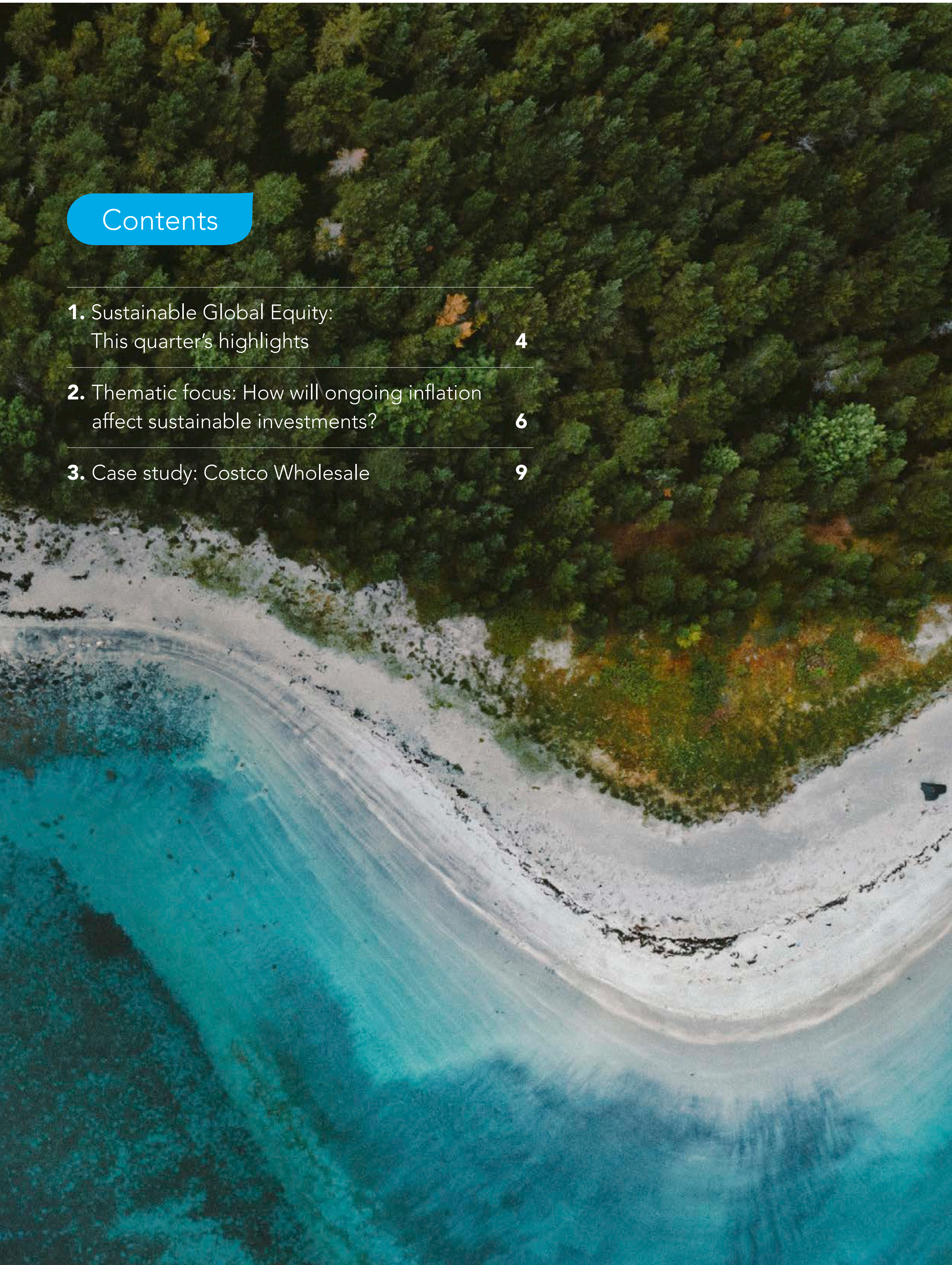
The headwinds of the past year – the Russia/Ukraine conflict, the energy crisis, the looming threat of a global recession – are competing for the spotlight on the stage of economic uncertainty. How then, can investors address inflation – and, more importantly, how can they do so *responsibly*?

As with every edition of the Sustainable Global Equity quarterly update, we have included an overview of the strategy's environmental and engagement data.

To conclude this issue, we take a deeper look at one of our portfolio holdings, Costco Wholesale, and consider why working with steadfast companies is now more important than ever, as the retail sector tackles inflationary pressures head-on.

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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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 September 2022, exposure to these themes was as follows:

Environmental preservation

Sub themes include:

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

Portfolio weighting: **21%**

Health and wellbeing

Sub themes include:

- Life sciences
- Pharmaceutical innovation
- Healthy and active lifestyles
- Medical equipment

Portfolio weighting: **22%**

Efficient production and resource usage

Sub themes include:

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

Portfolio weighting: **29%**

Social inclusion

Sub themes include:

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

Portfolio weighting: **27%**

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

Environmental footprint

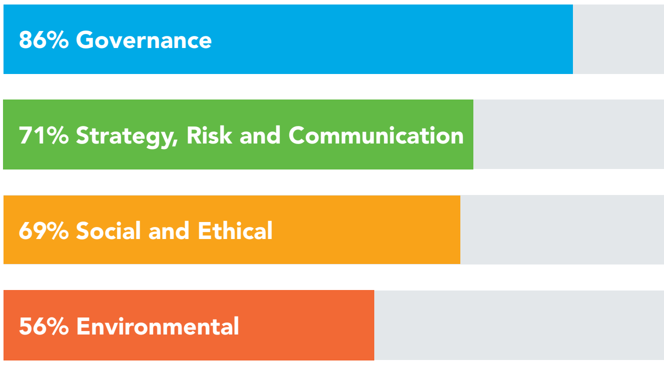
The strategy aims to have a smaller environmental footprint than the benchmark, the MSCI All Country World Index. As at 30 September 2022, the portfolio's carbon, waste and water footprints measured as follows:

	Portfolio (tonnes per $m invested)	Benchmark (tonnes per $m invested)
CO_2 footprint (scope 1, 2 & 3)	98.3	176.7
Waste footprint	1.2 (landfill only)	7.8 (landfill only)
	Portfolio (m³ per $m invested)	**Benchmark (m³ per $m invested)**
Water footprint	8.3k	22.3k

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

Engagement themes

The team's engagement efforts over the last 12 months covered 86% of the strategy's AUM. The breakdown by theme was as follows:



Source: Federated Hermes, as at 30 September 2022.

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

Portfolio positioning

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

Holding	Portfolio active weight (%)*
Mastercard	3.5
Thermo Fisher	3.4
Costco Wholesale	3.3
Gartner	3.2
Deere & Co	3.2
Novo-Nordisk	3.2
Bank Rakyat Indonesia	3.1
PTC	3.1
Microsoft	3.1
RELX	3.0

Source: Federated Hermes as at 30 September 2022.

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

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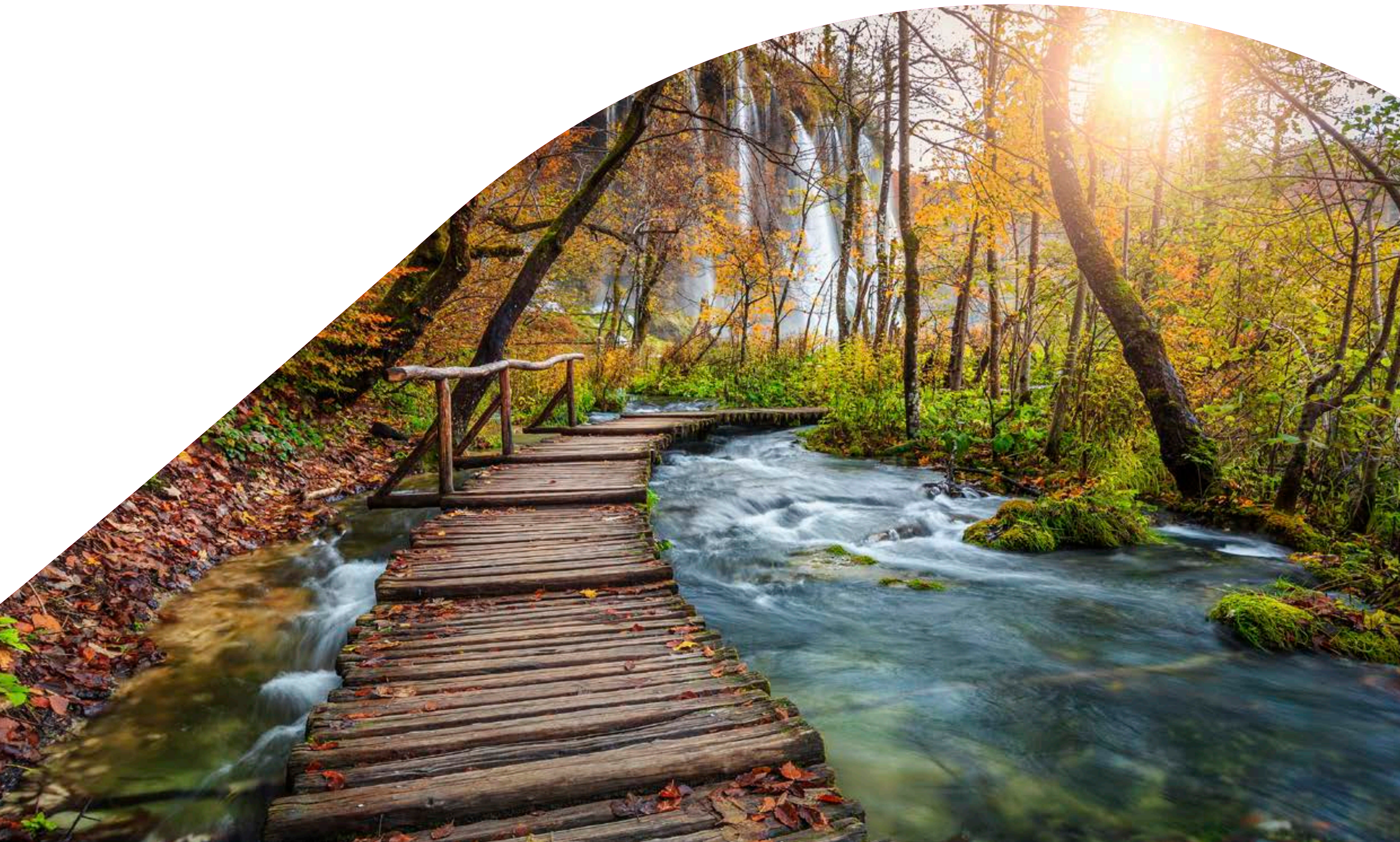


SECTION 2 - THEMATIC FOCUS

How will ongoing inflation affect sustainable investments?

With structural pressures driving a higher base level of inflation over the medium term, the need to focus on high-quality, sustainable businesses is stronger than ever, says Martin Todd, Portfolio Manager of the Federated Hermes Sustainable Global Equity strategy.

Fast reading:

- While the most acute impacts of the Ukraine conflict on energy and food supplies are temporary, we believe deglobalisation and greenflation will result in a higher base level of inflation over the medium term than that seen in the past decade.
- In this more challenging macroeconomic environment, growth stocks and sectors reliant on discretionary spending will suffer. However, high-quality companies built around a sustainable model in sectors such as consumer staples will be well-positioned to outperform.

Back at the beginning of the year, our first **Quarterly Report of 2022** talked about the 'inflationary elephant in the room' in relation to ESG investing. As the year draws to a close, that elephant has made itself extremely comfortable and look set to be an uninvited houseguest for some time to come. In this report we offer our view on the key underlying forces that will drive inflation over the medium term, the regions and sectors likely to be most affected, and what this means for investing with sustainability in mind.

Get used to structural inflation

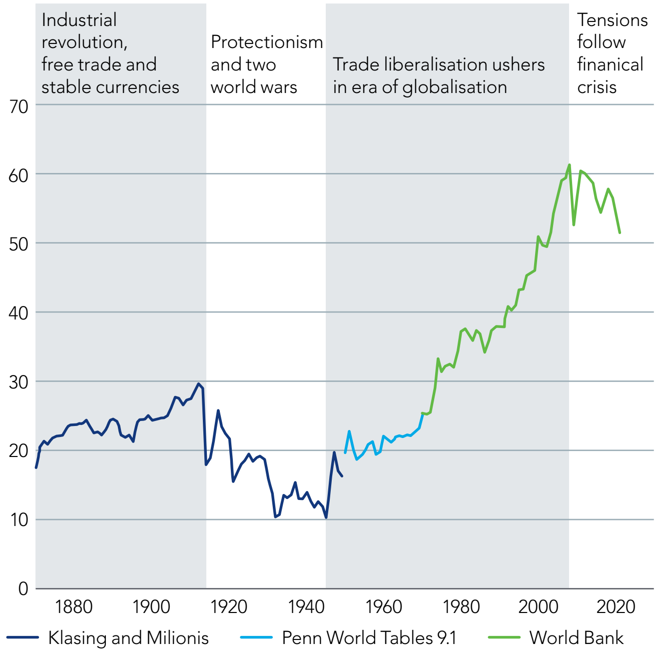
Our base case is that even once the most acute impacts of the Ukraine conflict on energy and food supplies have abated, we should expect a higher base level of inflation. While this will not be in the high single digits as it is currently in many countries, it will certainly be higher than it has been over the past 15 years. This paradigm shift will be particularly challenging in developed-market countries, where both businesses and individuals have become conditioned to a near-zero rate environment for so long.

This more structural inflation has two key elements:

Deglobalisation

A key outcome of the Covid-19 pandemic has been the setting-in-motion of a reversal of the globalisation experienced over many decades; the significant disruption to global trade caused by lockdowns and other precautionary measures has led many companies to onshore, re-shore or near-shore their supply chains. This process is inflationary at a structural level, as it usually involves moving the source of production to an environment where costs for everything from labour to energy and construction will be higher.

Figure 1: Global trade openness index: sum of imports and exports as a share of GDP (%)



Source: Financial Times, 'Deglobalisation: will backlash against Russia lead to downturn in open trade?', as at April 2022.

Greenflation

As discussed in our Q1 2022 report, the transition to a more sustainable economic model requires investment and therefore inevitably increases costs in the short term. The energy crisis driven by the conflict in Ukraine has made the imperative to move away from fossil fuels more pressing than ever. However, it will take time and money to secure the necessary technological advancements that will allow renewables and lower carbon energy to completely replace fossil fuels. In the meantime, costs will remain elevated both for these products and for their more polluting alternatives.

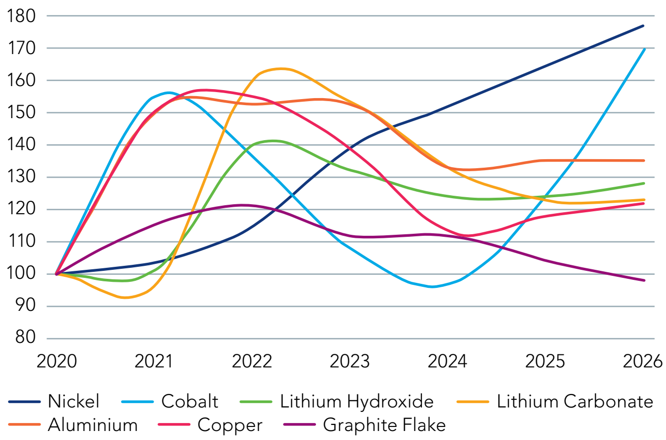
A good example of the inflationary impact of deglobalisation is in the semiconductor industry. With semiconductor chips so vital for much of the technology we nowadays take for granted, from mobile phones to cars, countries have strong political reasons for wanting more control over supply. However, building out chip production in the US, for example, will incur vastly higher costs than for current supply, which comes mainly from Taiwan.

Turning to greenflation, energy security has come sharply into focus over the course of the year. European countries in are being forced into a reckoning with their reliance on foreign sources of oil and gas. This has been exacerbated by OPEC's recent decision to cut production, despite requests from the US to do the opposite. However, the limited predictability of many renewable sources of energy means that even countries with strong potential for increased wind, solar and hydro capacity will be unable to rely on these sources of energy unless there is significant innovation in battery storage technology.

Part of the problem is that policy has focused on trying to reduce demand through levies and higher prices, rather than on how to increase supply. Going forward, coordinated frameworks and incentives will be needed to encourage inward investment and drive more rapid innovation.

The energy transition is also acting as an inflationary force in other, less obvious ways. For example, increased uptake of electric vehicles is driving ever-stronger demand for battery raw materials including lithium, cobalt, and nickel. Unfortunately, barriers to investment and long lead times mean mining capacity is struggling to expand quickly enough to cope with increased demand. This results in lower availability and higher input costs for electric vehicle (EV) makers, which in turn both reduces the supply of EVs in the market and keeps costs well above that of equivalent petrol vehicles.

Figure 2: Indexed key EV raw materials prices, 2020 = 100

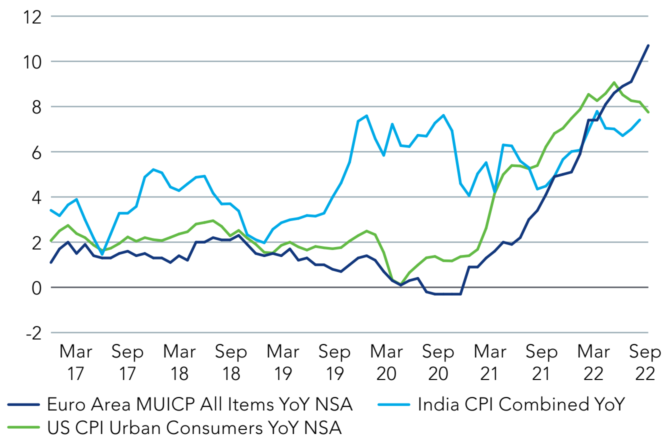


Source: Wood Mackenzie, 'Could 'greenflation' stall the electric vehicle revolution?,'' as at January 2022.

Differences by region

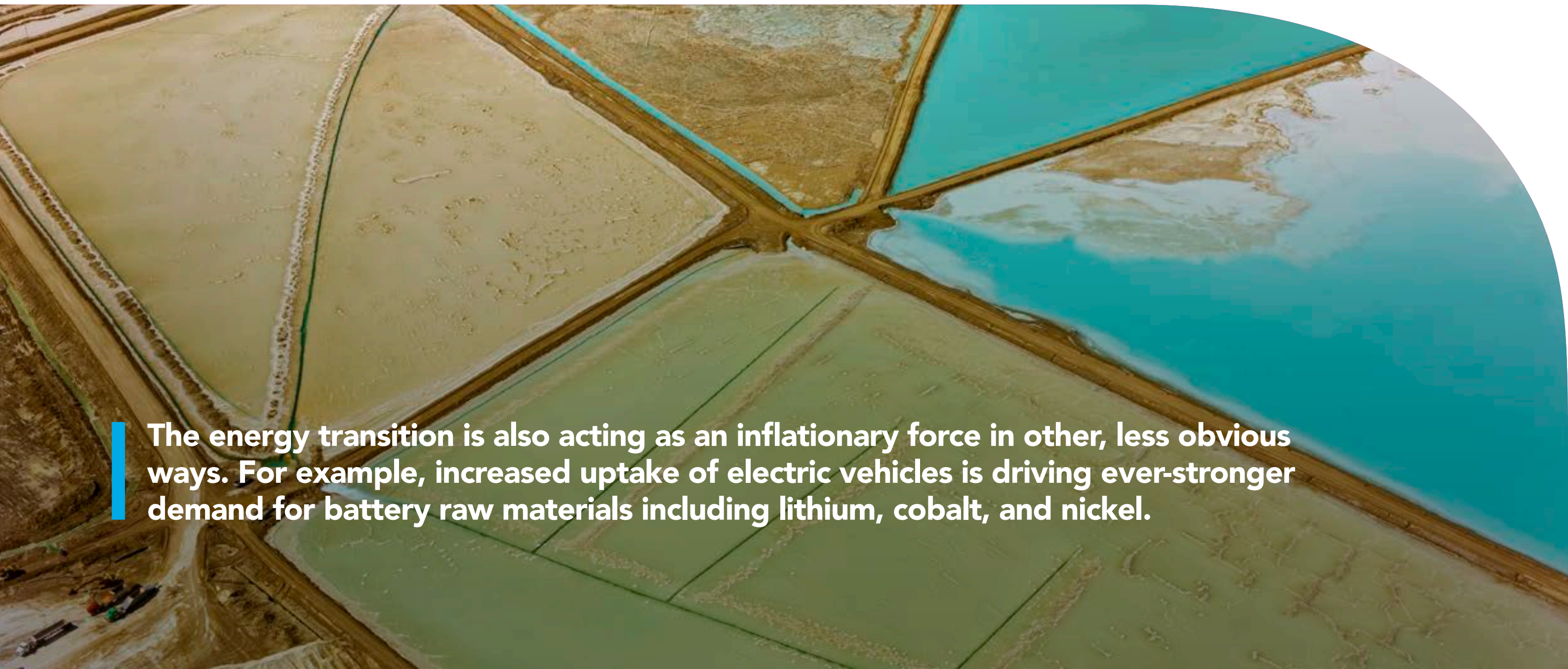
In what amounts to something of a role reversal, emerging market countries are tending to suffer less than developed markets in the current macro environment. In India, where we have a holding in a banking business, inflation is running at 6-7%, but this compares to a 'normal' inflation rate for the country of around 5%. The change in rate is therefore minimal and much easier for businesses and individuals to swallow.

Figure 3: Emerging markets suffering less than developed markets



Source: Bloomberg as at September 2022.

One probable reason for the lower inflation in emerging markets is that through necessity, most EM countries did not indulge in quantitative easing in the wake of the global financial crisis, nor did they implement costly lockdowns and furlough schemes during the pandemic. In contrast, developed market countries are going through the pain of needing to normalise from artificially low rates at the same time as having to deal with the additional inflationary pressures from deglobalisation and greenflation.



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Beware growth stocks and cyclical businesses

As inflation has risen this year, many of the stocks that had performed well during the near-zero interest rate environment of the last decade have suffered. With central bank rates still climbing, growth companies that tend not to make a profit will continue to find themselves under considerable pressure.

Most sustainable investment funds avoid investing in traditional energy firms, and have therefore missed out on the boost from the surging value of energy stocks. They also over-index to growth in the form of tech stocks, which are popular with ESG-focused funds due to their generally lower-than average carbon footprints. As a result, many (though not all) sustainable investment funds have underperformed the market this year.

At the same time, a potential collapse in demand caused by the cost-of-living squeeze could mean more cyclical businesses will start to come under pressure as well. With more of people's income going on mortgage or rent and energy bills, appetite for non-essential goods and services will inevitably drop.

We have taken these factors into account in the fund's portfolio, which indexes underweight for high-growth companies as well as consumer discretionary businesses. In fact, we sold the fund's shares in its only discretionary retail holding, Adidas, earlier this year, due to the twin impacts of faltering consumer demand, and slower economic growth in China, where Adidas was expanding quickly.

Trust in quality

We believe that in this challenging environment the companies most likely to do well are those that can demonstrate genuine quality under fundamental analysis. For us, there are several factors which tend to characterise a high-quality business. These can include:

- **Robust demand:** Quality companies tend to enjoy strong and stable demand, with sales holding up even in recession – usually thanks to a product or service which represents a must-have for their consumers.
- **Strong fundamentals:** Firms that historically have demonstrated strong returns on investment of capital, as well as enjoying reliable revenue through steadier sales and margin trends.
- **Purchasing power:** Businesses boasting strong relationships and a high degree of influence with suppliers, giving them the ability to push back on rising input costs and keep pricing tight.
- **Solid customer base:** Companies whose client base is over-indexed towards older and more affluent consumers, as these customers are likely to benefit from greater income stability in a downturn.
- **Volume focus:** Businesses focused on increasing profitability through volume growth rather than increasing their margins are also likely to perform better.

Given these factors, certain themes and sectors are better positioned to weather the current inflationary environment. While consumer discretionary faces challenges, demand for consumer staples are far less susceptible to late-cycle dynamics, especially when it comes to established brand names.

To take just one example, consumers tend to buy Hellman's mayonnaise regardless of the state of the economy; its makers, Unilever, are therefore able to pass through costs in the form of double-digit price increases without significantly impacting demand. Similarly, the fund's portfolio includes Yaoko, a grocery retailer which is little known outside its native Japan, but which is a high-quality defensive business well-positioned to perform as conditions become more challenging.

Meanwhile, a firm like Costco not only has the purchasing power to keep costs down, but it also gains from people seeking value in the face of rising costs. The company's straightforward business model of selling quality consumer durables at a lower price than anyone else is allowing it to win more customers and open new stores even as recession starts to bite. You can read more about how Costco is thriving in an inflationary environment in the case study which forms part of this report.

Our view is that quality stocks like these were unfairly hit at the same time as growth and cyclical stocks during the recent market rotation. Whether the coming recession proves to be mild or more serious, we believe that in such an environment, high-quality, defensive businesses are well-placed to outperform. In the coming quarters, as higher inflation persists, rate rises continue and pressures on consumers increase, quality will come to the fore. We believe we have positioned the fund's portfolio well to deliver strong performance for clients under this expected tightening of economic conditions.

CASE STUDY

Costco Wholesale

Investible theme: Social inclusion
Sub-theme: Low-cost consumer goods/staples & human capital

The strong inflationary pressures affecting the global economy have, unsurprisingly, hit the retail sector particularly hard. That is why, in this volatile environment, we believe in working with steadfast companies such as Costco.

The ESG story

Our engagement case for Costco focuses on the company's clear philosophy and commitment to its offering and people. We believe that its philosophy is not broadcast enough in the wider market; we view Costco as an under-appreciated leader, particularly when it comes to both ESG metrics and the sustainability of its business model. There is certainly room for the company to be more vocal in promoting its strengths, and there is also increasingly a case for product impact too, given its policy of passing on savings to members. We believe that Costco can also affect change in the retail space by continuing its expansion internationally and replicating its approach in these markets. This, in turn, could drive competitors to re-think their own philosophies. These factors contribute to our ongoing confidence in the company, and in its long-term prospects.

As a global business, Costco has over

118.9 million

members worldwide

And it pays its workers an industry leading average of

$24 per hour

plus benefits

Costco has an industry-leading approach to how it treats employees. The business philosophy is simple: **pay staff proper living wages, provide healthcare insurance and training and, in return, receive loyalty and productivity**.

The company believes that genuinely happy employees will drive higher member spend and result in increased retail footfall. As a result, its employee turnover is half the industry standard, which is even more valuable in a market environment increasingly dominated by e-commerce. This makes Costco an exemplar of employers across industries, and not just in the retail space.

> **Looking to the future, we welcome the opportunity to continue engaging with Costco, and will be encouraging the company to promote its strengths as an industry-leader in the ESG space.**

Light at the end of the tunnel

With regards to the current state of markets, and inflation in particular, Costco is seeing the evidence of lower commodity prices as the light at the end of an otherwise dark tunnel. The road ahead is a long one and it is likely that it will take some time for customers to notice a considerable drop in prices but, nonetheless, these developments bode well for the company and the entire retail sector.

A sustainable business model

The key aspects of the Costco business model include customer retention, preservation of high-quality products, and using scale to drive down prices for the end-customer. On a per-SKU[1] basis, the company has more purchasing power than its competitors, Amazon, or Walmart. This drives incredible value for customers, and creates a moat for the business.

In the aftermath of the Covid-19 pandemic, the e-commerce risk remains high for retailers, but among its peers, Costco stands out in its resilience to the Amazon threat. Its philosophy of 'high quality, great value' offers a different proposition to Amazon, where it is one of convenience and variety. The company is not tempted to raise prices to drive short-term profitability.

[1] SKU: Stock-Keeping Unit, a unique alphanumeric code a retailer assigns to each of its products to distinguish them from each other and manage inventory.

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