Letter to investors

Outperforming us over the long term

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Federated Hermes Limited

www.hermes-investment.com
For professional investors only

In our annual Letter to Investors, Jonathan Pines, Lead Portfolio Manager, Asia ex-Japan Equity, discusses the Strategy's performance since inception in 2010. As long-only investors, the team's key objective is to outperform the benchmark. However, a close secondary objective is that our clients have an excellent experience investing in the Strategy; for us to outperform the benchmark in and of itself is not enough to ensure this is always the case.

All investors know – whether they are active like us or passive – that most funds do not outperform their benchmark, mainly because of fees. If the average fund performs in line before fees, which assuming broad professional market participation mathematically must be true, it follows that the average fund must underperform after fees (which are, of course, above zero)[1].

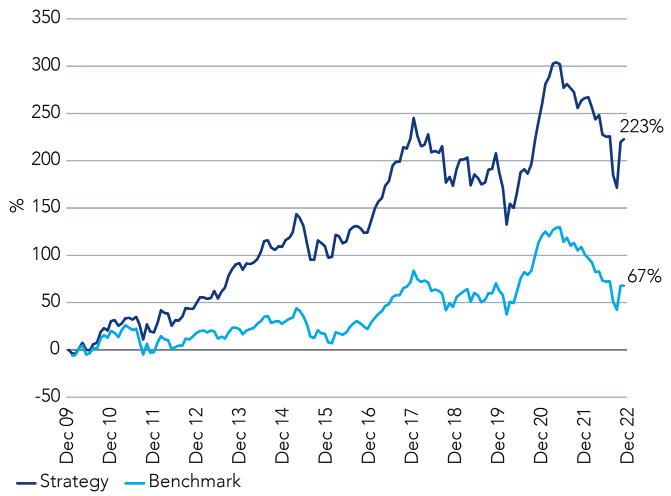
And, while it's hard to beat our benchmark[2], we're happy to say that, thus far, it's been even harder to beat us – and we're hoping this remains the case.

We launched our Asia ex-Japan Equity Strategy in January 2010 with a small amount of seed funding generously provided by our then owner, the BT Pension Scheme. We launched different legal versions of pooled funds soon thereafter.

Since our Strategy's launch our benchmark has performed poorly – returning a mere 4.25% per annum. However, those that have invested with us have done better. Our longer-term investors have beaten our benchmark considerably. And because we are now at our highest cumulative relative performance since inception, any investor still invested has fared better than our benchmark irrespective of when they initially invested with us[3].

Figure 1: Federated Hermes Asia ex-Japan Equity Strategy – performance since inception

Strategy vs. benchmark performance (%, US dollars, net of fees)



Source: Federated Hermes Limited, Northern Trust, as at 31 December 2022. Inception Date 1 January 2010. Strategy returns in US dollars net of 75 basis points in fees per annum. Benchmark is the MSCI AC Asia ex Japan IMI Net Total Return USD Index. **Past performance is no guarantee of future performance.**

As long-only investors, our key objective is to outperform our benchmark. However, a close secondary objective is that our clients have an excellent experience investing with us. For us to outperform our benchmark is a necessary but in and of itself insufficient factor to ensure such a client experience.

Two scenarios that could result in an unsatisfactory client experience, even if we outperform our benchmark, come to mind. First, the benchmark's performance might be so poor and outperformance so marginal that despite outperformance, a satisfactory absolute performance might not be realised by a client. Second, a client's experience might be substandard if the timing of their investment coincides with the start or continuation of a period of our Fund's underperformance with divestment occurring before we have made good on such underperformance.

To deal with the first scenario, it is of course extremely difficult to identify a situation in advance when both the benchmark performance is likely to be weak and gains from stock picking are unlikely to be able to make up for this. A theoretical scenario for such a setup to be reasonably predictable in advance would be if the entire universe were unambiguously and uniformly overvalued. But given the broad geographical remit of our Asia ex-Japan benchmark and the cheap valuations that have been on offer in at least some countries, we have never considered our benchmark to be unambiguously and uniformly overvalued since the Strategy's inception in January 2010. It has not even come close. That said, the potential for an entire universe to be overvalued has helped inform our team's hesitancy about launching thematic funds. This is because, the narrower the focus or universe of a fund (for example an income-, consumer- or defensive-themed fund), the more likely it is that the components of such a narrowly-focused universe or fund will be periodically obviously and uniformly overvalued. We have also sought to mitigate against the occurrence, at least in the short-to-medium term, of the first scenario by timing the recent launch of a new fund – China Equity – to coincide with a period of unusually cheap valuations rather than elevated investor demand[4]. Indeed, the launch coincided with a period of noticeably lower investor appetite towards China equities.

In terms of the second potential cause of a substandard client experience, when the timing of a client's investment and divestment results in their realised performance lagging that of the Strategy, we have debated internally how best to help our

[1] In rare circumstances, the average portfolio manager normally outperforms the benchmark, such as on China's mainland (China A shares) because in that market individuals (rather than professionals) dominate trading activity.

[2] The benchmark is the MSCI AC Asia ex-Japan Investable Market Index.

[3] As at 4 January 2023.

[4] Our China Equity fund was launched in July 2022 – the first new substantive Strategy launch by the team since January 2010. A single country fund admittedly has a higher chance of occasional uniform overvaluation. However, we consider the MSCI All Shares China Benchmark to be a sufficiently broad and inefficient benchmark to significantly reduce this likelihood. In addition, components are traded in three different market settings (China, Hong Kong and the US). These qualities collectively mitigate against the likelihood of an unambiguous and broad overvaluation, particularly given the near record low valuation for that fund's benchmark at the time of launch.

clients not lag the performance of our Strategy. Indeed, our 'stretch objective' would be for most of our clients to *beat* our Strategy's performance.

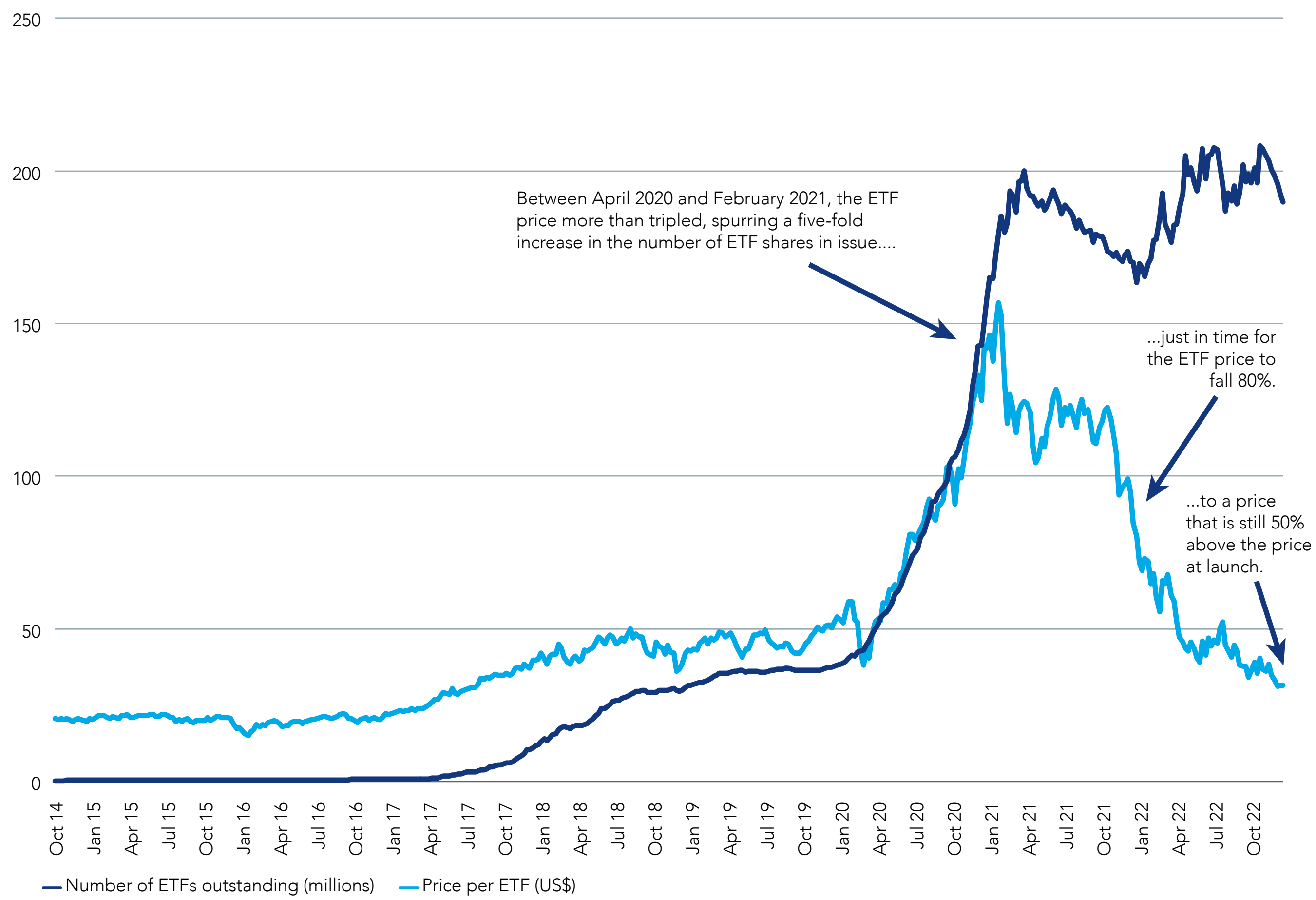
This, of course, would be no mean feat. Most investors in funds do not get the timing of their investment and divestment right, and as a result the performance they realise for themselves lags the longer-term performance of the fund that they invest in.

One only need look at the experience of investors in a well-known US innovative technology Exchange Traded Fund (ETF) in order to understand why. This particular ETF, which was previously very popular with investors, has recently attracted significant media attention on account of its volatility and poor performance. However, an investor who invested on day one (31 October 2014) is up 50%. Of course, one would have to look very hard to find an (or perhaps *the*) investor who is up 50%. Most are down, and down substantially.

For ETFs, new shares are created when investors are net buyers and cancelled when investors are net sellers. One can therefore calculate the approximate experience of the average investor by examining the number of shares in issue at any time and comparing that with the price performance of the ETF. The results of the analysis of the ETF in question can make for depressing reading.

Figure 2: Maximising pain – Return chasing can result in divergent returns

Performance of a well-known innovative technology ETF and number of ETFs outstanding (millions) and price per ETF (USD)



Source: Bloomberg as at 31 December 2022.

As shown in Figure 2, the ETF shares in issue started rising sharply (indicating net new investment), quintupling between April 2020 and February 2021, with shares in issue remaining approximately constant thereafter. However, the price of the ETF since the number of ETF shares peaked has fallen by approximately 80%. So, while the fund is still up 50% since inception (after being up as much as 500%), most investors are down far more than 50% having bought far nearer the peak than the trough. Using Bloomberg data, we calculate a cumulative aggregate investor loss exceeding \$10bn[5].

Divergence between fund performance and fund investor performance is a frequent occurrence, albeit normally less dramatic than in the example above.

[5] As at 31 December 2022. Source Bloomberg, Federated Hermes Limited.

This is because investors understandably tend to invest in funds that have already outperformed. Selectors are in the unenviable position of having to choose among the thousands of different available funds, and it is logical that strong past performance should be at least one criterion for judging the quality of a fund manager or the potential for likely future success.

Of course, strong performance of many funds might be because they are skilfully managed, and such funds might therefore be expected to continue to outperform over the long term.

But strong performance might also be fleeting. Perhaps the investment manager got lucky, or their style was in vogue. Perhaps unjustifiable risks were taken to achieve the performance. Perhaps key team members behind the fund's performance have moved on. Perhaps the reason the client invested in the fund in the first place was because the prolific fund house whose fund they bought ran ten funds with the same benchmark and marketed their best performer. If you run enough funds with the same benchmark, then one is always likely to beat it over the preceding relevant period. If you flip a coin enough times, you will eventually flip five heads in a row. All you then need do is then label your 'five-coin toss winning streak' fund your New Flagship Asia ex-Japan fund.

Likewise, underperformance might have resulted from temporary factors such as stylistic headwinds. Underperformance, of course, might also have resulted from investments that suffered a permanent loss of capital, making recovery far less likely.

Examples of underperformance resulting from a permanent loss of capital would include a missed fraud, a bankruptcy or other financial distress resulting in dilution or other impairment; an unexpected loss from being 'overweight' a geopolitical event that plays out negatively – for example, being overweight Ukrainian or Russian stocks prior to the recent invasion; or from simply paying too much for a stock that, having been marked down, is (absent hyperinflation) unlikely to ever achieve its former heights – such as buying Peloton, Coinbase or (dare we say) Tesla stock in 2021.

We believe that:

1. Our past performance has not been flattered by us being particularly lucky, stylistic tailwinds, or from taking excessively risky bets.
2. We are likely to continue to outperform over the long term.
3. We will continue to have a reasonably long average stock holding period (two and half years or longer).
4. As we have in the past, we are certain to experience future periods of underperformance.
5. We will be able to identify whether a bout of underperformance results mainly from a permanent loss of capital or from more temporary factors, including a valuation dislocation or anomaly.

While we cannot provide financial advice, these set of beliefs imply by deductive reasoning, that we anticipate that we are more likely to outperform when we have suffered a period of underperformance that does not include a significant permanent loss component. This is because, when we underperform, the price-to-value proposition of our non-permanently impaired bets becomes more compelling.

Our experience, however, has been that when we underperform, we see net outflows rather than inflows. This is understandable; indeed predictable. But for us to achieve our objective of most of our clients outperforming the Fund, we would need to see inflows in such periods. This would enable us to add to our increasingly compelling holdings during such periods.

And as tough as it might be to attract inflows when we are underperforming, we believe we have – more than most fund managers – a fighting chance of achieving this stretch objective.

We are contrarian investors, which we emphasise almost every time we communicate with our clients.

We seek to buy companies that are out of favour for reasons that we adjudge to be temporary. Often when we happen to be at an investor conference, we are the only investors who show up to meet management of unpopular companies. Gone are the days when this made us nervous. Nowadays our loneliness tends to increase our conviction. Our favourite situation is when we turn positive on a company even before the company's own management can see light at the end of the tunnel.

For fund investors to beat the performance of funds that they expect to outperform over the long term, it follows (deductively) that they need to add to their investments when such funds are underperforming but have not suffered a permanent capital loss. To buy more of a fund when it, like the companies we seek to invest in, is down but not out.

Of course, as we know only too well, this is a psychologically difficult thing to do. But it is an approach that, in our experience, we have found to be very rewarding. Because they are invested in a contrarian fund like ours, we are hopeful that some of our clients have a greater-than-average inclination to apply that same spirit of contrarianism in the timing to at least some of their own allocations.

Two questions emerge from the above:

1. Will this approach (of buying good funds that are down but without significant permanent impairment) work with all funds, including non-contrarian funds? We believe that it *will* tend to work with all funds that are skilfully run, liquid, have a long-term track record of outperformance and have not benefited disproportionately from luck, stylistic tailwinds or taking excessive risks, and have not had recent key management changes. Indeed, one of our preliminary screens for potential new ideas is to identify the holdings of such funds that have gone through a period of recent underperformance.

2 Does this mean that our clients should sell us when we are *outperforming*? No. (Although we would say that, wouldn't we.) In all seriousness, while we cannot give financial advice, we would give pause to such a trading strategy in our fund for four reasons. First, the simplest way to achieve a return similar to an underlying fund that one expects to outperform over the long term is to stay invested for the long term. Second, there are other measures of the prospective opportunity that are often even more relevant than the extent of recent relative performance – mainly the conclusions we can reach from bottom-up analysis of our stock picks or even blunt aggregate portfolio measurement tools such as quantitative analyses. For example, despite recent outperformance, a quantitative 'style analysis' of our portfolio (which tracks key measures of quality and value against our benchmark) shows a compelling potential outperformance opportunity now. Our portfolio has both near-record high quality and cheap valuation relative to its own history versus the benchmark[6]. Third, we are free to change the composition of our portfolio and, being active investors, do so daily. We can move quickly and when ideas mature, aggressively switch into new ones. Finally, there are negative tax implications for many investors associated with frequent trading.

In some ways, we believe our stock picking approach – perhaps by luck rather than design – encourages our clients to add to their holdings (or at least avoid being shaken out) when we have recently underperformed; and not allocate excessively high allocations to us when we have recently outperformed. This is because (in the past at least) we have tended to outperform most consistently when the benchmark has fallen, as shown in Figure 3.

Figure 3: Benchmark and Strategy performance – more consistent winners in benchmark down years

Absolute returns (US dollars, %, net of fees), with benchmark negative years shown in bold

	Benchmark	Strategy
2010	20%	30%
2011	**-19%**	**-10%**
2012	21%	26%
2013	4%	29%
2014	4%	9%
2015	**-8%**	**1%**
2016	4%	7%
2017	41%	45%
2018	**-15%**	**-15%**
2019	17%	13%
2020	25%	11%
2021	**-2%**	**7%**
2022	**-20%**	**-11%**

Source: Federated Hermes Limited, Northern Trust, as at 31 December 2022. Inception Date 1 January 2010. Strategy returns in US dollars net of 75 basis points in fees. **Past performance is not a guarantee of future performance.**

We believe that this tendency (to outperform more consistently in benchmark down years) makes it psychologically easier for clients to at least stick with us when we are doing relatively badly. Most clients would not be shaken out if we achieve a +10% return when the market is +15%. Some might even add to their holding, betting on a catch up. Similarly, most clients would not feel an irresistible urge to double down in down years even when we are doing relatively well. After all, no one is offering high fives and whooping with delight when the fund they are invested in is down 11%, even when the market is down 20%.

Many of our outperformance years – 2022 being a case in point – have more often been greeted with yawns (or even disappointment) than applause. But we are willing to take a market-beating negative return any day. After all, we know that outperformance in down years is likely to eventually lead to satisfactory absolute returns over the long term. We are delighted to be -11% when the benchmark is -20% if we can approximately match the benchmark's +14% the following year. We are tortoises, not hares.

Contrast this with a fund that might be up 40% when the market is up 20%, electrifying investors, stirring animal spirits and attracting huge allocations, only to be down 40% the next year when the market is down 20%. Being down 40% would of course test the staying power of even the toughest-minded investor (who would perhaps only have invested after the previous year's +40% return had already been achieved).

This 'return chasing followed by deep disappointment' phenomenon is not a theoretical construct or the exception to the rule. It is the rule. All one needs to do is examine the timing of the progression of the size of the aforementioned US innovative technology ETF shown in Figure 2, or (closer to home), the timing of net inflows into the hottest growth-oriented "valuation agnostic" Asia ex-Japan funds.

As is all too often the case, these funds grew big just in time to maximise investor pain in the drawdowns that immediately followed with the receding of the tide. And even for those glamour funds that are still holding on to good long-term performance, like in the example provided in Figure 2, we believe that the performance experienced by their average investor has been dismal – even relative to our benchmark's lost decade.

Jonathan Pines
Portfolio Manager
Federated Hermes Asia ex-Japan Equities

[6] Source: StyleAnalytics, Federated Hermes Limited as at 31 December 2022.

Rolling year performance (%)

	31/12/21 to 31/12/22	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
Strategy	-10.05	7.85	11.91	13.88	-14.45

Source: Federated Hermes as at 31 December 2022. Composite inception date: 1 January 2010. Returns are in USD gross of fees. The information shown is supplemental to the GIPS® compliant composite report provided in the Appendix. **Past performance is not a reliable indicator of future results.**

GIPS® Composite

Composite: **Federated Hermes Int'l Emerging Markets Asia IMI Equity**
Index: **MSCI AC Asia Pacific ex Japan (net)**
Periods Ending: **31 Dec 22**

Annualised Returns (%)			
	Composite Gross Return	Index	Composite Net Return (Assuming Maximum Fee)
Q4 22	13.88	10.99	13.57
1 Year	(10.05)	(19.76)	(11.04)
3 Years (Annlzd)	2.78	(0.56)	1.65
5 Years (Annlzd)	1.13	(0.44)	0.02
10 Years (Annlzd)	9.19	3.57	8.05
Jan 10 – Dec 22 (Annlzd)^^	10.46	4.04	9.44

Annualised Returns (%)									
	Composite Gross Return	Composite Net Return	Benchmark Return	*Composite 3-Yr Std Dev	*Benchmark 3-Yr Std Dev	Number of Portfolios	**Dispersion	Composite Assets (mil)	Firm Assets (bil)
2013	29.75	28.63	3.59	18.03	18.35	<5	N/A	476.6	39.4
2014	9.74	8.85	4.41	13.39	13.03	<5	N/A	1,550.0	38.9
2015	1.41	0.29	(8.35)	14.14	13.00	5	N/A	2,066.3	28.0
2016	8.25	7.06	4.21	14.91	14.62	5	N/A	2,944.3	28.9
2017	45.74	44.13	40.54	15.23	14.66	5	4.52	4,807.8	34.5
2018	(14.45)	(15.39)	(14.93)	15.02	14.43	7	0.34	4,391.7	32.0
2019	13.88	12.62	16.91	15.00	14.36	7	2.15	4,338.3	40.2
2020	11.91	10.68	25.13	19.52	18.81	6	0.98	3,220.7	585.7
2021	7.85	6.67	(2.05)	17.86	17.16	7	0.45	3,713.0	634.2
2022	(10.05)	(11.04)	(19.76)	20.94	20.52	7	0.54	3,738.5	627.4

^^ Represents composite inception period. See below for additional notes to the schedule of rates of return and statistics.
* Represents the 3-year annualized standard deviation for both the gross composite and the index returns. Statistic is used to measure the volatility of composite returns.
** Standard deviation is calculated using gross returns. Dispersion is not applicable (N/A) for any period if fewer than five accounts are in the composite for that period.

The composite includes all discretionary portfolios following the Emerging Markets Asia Equity strategy run by the Federated Hermes Asia ex Japan Equity team (London Office) and has an inception date of 1 January 2010. The objective of the strategy is to achieve long-term capital appreciation. From February 2016, the investment process evolved to allow the use of partial hedging where allowed by the investment mandate. The benchmark is the MSCI AC Asia ex Japan IMI (net) Index, which is designed to measure the equity market performance of developing and emerging market countries in Asia excluding Japan and covers all investable market capitalization securities. Prior to December 2012 the benchmark was the MSCI Emerging Asia IMI Index. The benchmark is market-cap weighted and rebalanced on a quarterly basis. The return is calculated on a total return basis net of withholding tax. This composite was created in March 2010. Federated Hermes claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Federated Hermes has been independently verified for the period of January 1, 1992, through September 30, 2022. The verification report is available upon request. A firm that claims compliance with the GIPS® standards must establish policies and procedures for complying with all the applicable requirements of the GIPS® standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS® standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report. Since inception the management fee schedule for this strategy was 1% per annum for the first USD 25mln, 0.90% per annum for the next USD 50mln, 0.88% per annum for the next USD 25mln, 0.86% per annum for the next USD 50mln, 0.82% per annum for the next USD 50mln and 0.73% per annum thereafter. As of 1 January 2014, the management fee schedule for this strategy was 0.75% per annum. As of 1 November 2014, the management fee schedule for this strategy is 1.10% per annum. Gross of fees returns have been calculated gross of management/custodial fees and net of reclaimable withholding taxes, but after all trading commissions.

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