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H1 Report 2023

Federated Hermes Limited

www.hermes-investment.com
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SECTION 1

Review, H1 2023

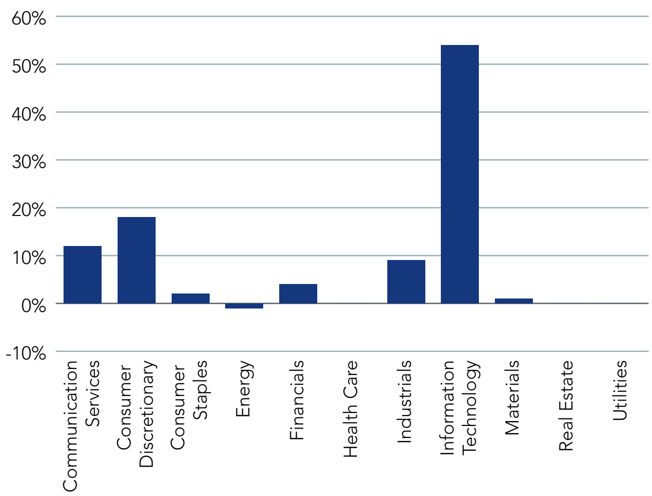
Global equities began the year positively, posting strong gains in January. Risk aversion declined sharply, with sentiment boosted by China's economic reopening and signs that inflation was receding from its autumn peaks – reflected in falling bond yields. The Information Technology sector performed particularly strongly – and would continue to do so for much of the period – driven by excitement around generative AI following the launch of ChatGPT in late 2022.

However, it wasn't long before the feel-good factor started to dissipate and risk appetite began to deteriorate. Ironically, the change in sentiment was largely triggered by positive economic data. This highlighted the resilience of the US economy, raising concerns that inflation would remain higher for longer. The collapse of Silicon Valley Bank (SVB) in March, closely followed by the bailout of Credit Suisse, confirmed investors' retreat into risk-off mode.

A key issue in H1 2023 has been a lack of market breadth, with performance being driven by a small number of mega cap tech-focused stocks. In fact, over 80% of returns from the MSCI All Country World Index (ACWI) during the period were driven by the Information Technology, Communication Services and Consumer Discretionary sectors (see Figure 1 below). Meanwhile, over 75% of the return of the S&P 500 could be attributed to just 10 stocks[1].

We believe the case for investing in sustainability has never been stronger.

Figure 1: Proportion of MSCI ACWI returns by sector, H1 2023



Source: Federated Hermes, as at 30 June 2023.

Past performance is not a reliable indicator of future performance.

Excitement around the practical potential of generative artificial intelligence (AI) drove much of this outperformance. However, beyond enthusiasm for a small group of stocks which are set to be the primary beneficiaries, investors have remained cautious. Inflationary pressures are proving more stubborn than anticipated, especially in Europe – with the UK the chief culprit. At the same time, hawkish central banks and recession fears kept our risk aversion indicator consistently in 'risk off' territory. Only in the past few weeks of the quarter did risk appetite increase, coinciding with a long-awaited improvement in market breadth.

From a factor perspective, Growth was most favoured overall (particularly in Q1), along with Profitability and Capital Structure. However, there has been little consistency in recent months; the tussle between Growth and Value has continued, while the preference (or not) for sentiment and quality factors has changed at regular intervals. This suggests investors continued to take a short-term view.

The lack of market breadth proved to be challenging for the Strategy over the period, although we remain confident that our investment philosophy and process can generate compelling excess returns over the long term.

Opportunities continue to favour key mega cap stocks, which provide the safety of strong balance sheets and protected market positions. These names continue to appeal to investors seeking growth, but also to those favouring quality. However, risk aversion has started to ease and there are tentative signs that market breadth is starting to improve, which should broaden the opportunity set.

Moreover, we believe the case for investing in sustainability has never been stronger. Even if anti-ESG sentiment continues, many sustainable businesses have compelling valuations. Sustainability increasingly impacts all facets of our lives; those businesses primed to deliver solutions to some of humanity's greatest challenges – as well as those positioning themselves to be most resilient to the effects of those challenges if they are not met – will be richly rewarded as we progress towards a more sustainable future.

[1] 'Federated Hermes, as at 30 June 2023.

SECTION 2

Engagement overview

Alongside our colleagues at our stewardship business, EOS at Federated Hermes ('EOS'), we seek to drive change through board and executive-level interactions. Our engagements with portfolio companies often include meetings with divisional heads, investor relations teams, board members, chairs, lead independent directors and chairs of board committees.

Through our interactions, we gain information relating to specific engagement objectives and issues. Our proprietary milestone system allows us to track our engagement progress. Furthermore, we benefit from the wider research universe covered by EOS, a diverse team with backgrounds including law, banking, sciences, academia, accountancy, climate change and corporate strategy, and the collective ability to speak fluently in over 10 languages. In turn, the team's skills, languages, connections and cultural understanding enable local language dialogues which are of great importance.

Figure 1: Measuring progress – Milestones

Engagement progress, H1 2023

Total engagements **68**

Engagement objectives by theme

Source: Federated Hermes, as at 30 June 2023.

Voting, H1 2023

Voting is a key part of demonstrating active ownership and ensuring companies are meeting the needs of shareholders.

Voting breakdown

Meetings where we voted in favour:	Meetings where we voted against, against and abstained, or with management by exception:
27.4%	**72.6%**

Source: Federated Hermes, as at 30 June 2023.

SECTION 3

ESG outcomes

We recognise that every company has both positive and negative impacts when it comes to its operations. Here we present a snapshot of the strategy's carbon metrics:

Carbon footprint (scope 1 and 2) per $m invested

Fund: **47.7**

Benchmark: **95.7**

50% lower than the benchmark index

Carbon intensity – tonnes per $m of sales (scope 1 and 2)

Fund: **85.0**

Benchmark: **187.3**

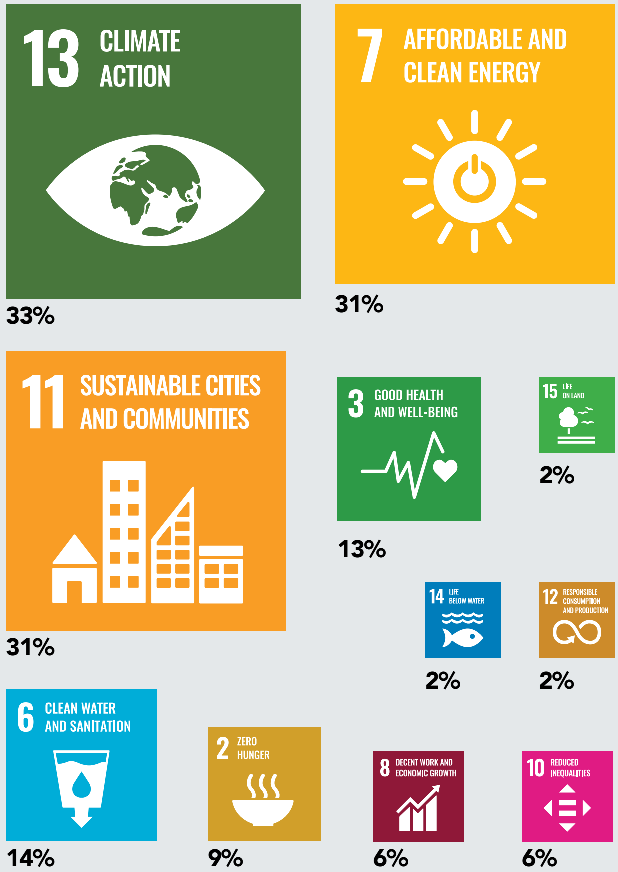
55% lower than the benchmark index

Environmental opportunities exposure **36%**

Source: Federated Hermes, as at 30 June 2023.

SDG exposure

Here we demonstrate our SDG exposure – that is, companies where there is revenue exposure to investable themes which are aligned to the UN Sustainable Development Goals (SDGs).



Source: Federated Hermes, as at 30 June 2023. Note that percentages shown add up to more than 100% as companies can be exposed to more than one SDG.

SECTION 4

In the spotlight: AI

Fast reading

- AI has dominated headlines in H1 2023, reflecting both fear around its accelerating evolution and, in the wake of the launch of ChatGPT, excitement about its potential
- Investor interest has been reflected in eye-watering returns for key tech stocks that have accounted for the lion's share of overall positive market performance
- We believe AI will be a disruptor in the truest sense, bringing both positive and negative impacts for society and the global economy

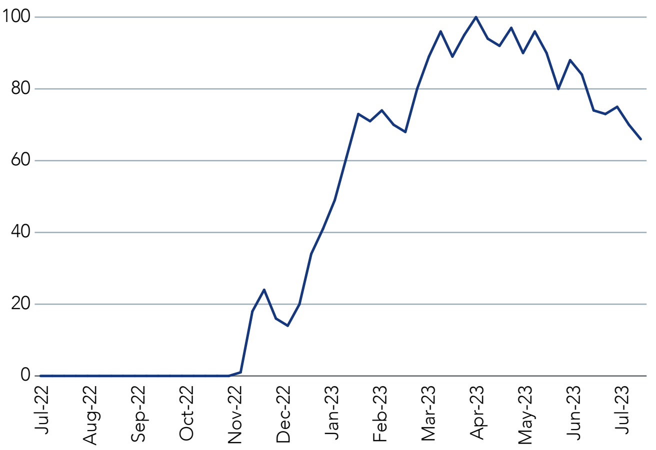
The concept of AI has been around since at least the mid-1950s, when, building on the work of British polymath Alan Turing, American computer scientist John McCarthy coined the phrase and founded AI as an academic discipline[2].

Since then, there have been a series of breakthroughs – or false dawns – in the development of AI. However, it is arguably only in the last year that AI has really exploded into the public consciousness. The release of generative AI chatbot ChatGPT in November 2022 generated a huge buzz of excitement around AI's potential – closely followed by rising concern regarding the risks if the technology is not effectively regulated.

Short-term hype, but a long-term opportunity

Recent data suggests that excitement around ChatGPT is starting to wane (see Figure 2 below). There are a number of possible reasons for this. Firstly, the novelty value may have worn off – both for the media and the public. Secondly, schools and universities have finished for the year (ChatGPT has quickly become popular as a study aid). The US$20 per month subscription charge for unrestricted access may also be having an impact, while Microsoft have integrated some of ChatGPT's functionality into its search engine, making it less necessary – and less visible – as a discrete offering.

Figure 2: Relative level of interest in ChatGPT over time



Source: Google Trends, as at 23 July 2023. 100 on the y-axis represents peak level of interest

Of course, the generative AI technology behind ChatGPT has the power to act as far more than just an intelligent search engine. By training neural networks and machine learning on the vast amounts of data increasingly available, AI can perform a wide range of tasks that would otherwise be prohibitively expensive and/or time consuming, if not impossible. With companies rapidly latching onto its practical potential, AI's impact on the global economy promises to be era defining.

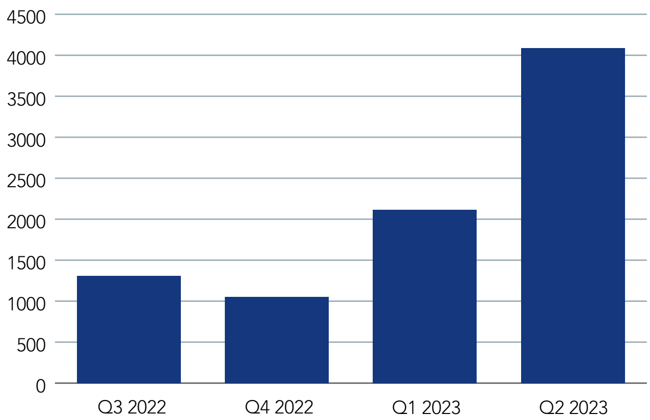
According to research by Accenture, 98% of global executives see AI foundation models playing an important role in their organisation's strategies within the next three-to-five years[3]. Little surprise, then, that mentions of AI in company earnings calls have spiked significantly over the past 12 months (see Figure 3).

According to research by Accenture,

98%

of global executives see AI foundation models playing an important role in their organisation's strategies within the next three-to-five years[4].

Figure 3: Mentions of AI in MSCI ACWI company earnings calls, Q3 2022 to Q2 2023



Source: Bloomberg, as at 30 June 2023

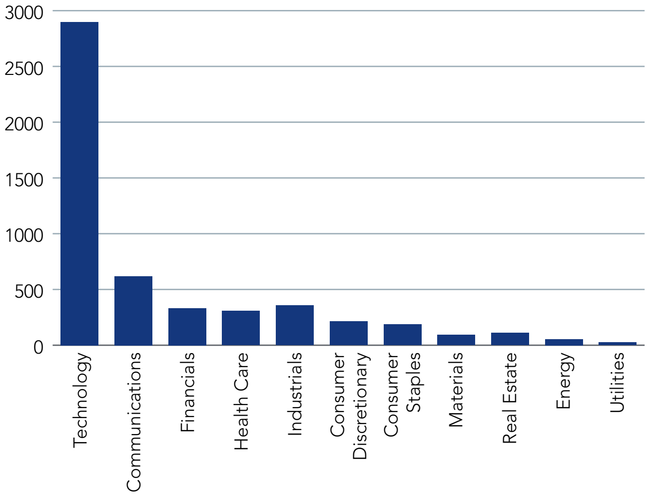
[2] 'The History of Artificial Intelligence', Rockwell Anyoha, Harvard University Graduate School of Arts and Science blog, 28 August 2017. https://sitn.hms.harvard.edu/flash/2017/history-artificial-intelligence/

[3] 'A new era of generative AI for everyone', published by Accenture, March 22, 2023. https://www.accenture.com/gb-en/insights/technology/generative-ai

[4] 'A new era of generative AI for everyone', published by Accenture, March 22, 2023. https://www.accenture.com/gb-en/insights/technology/generative-ai

While the tech sector dominates the conversation, AI provides opportunities in most, if not all, industries (See Figure 4 below). For example, generative AI can be used to optimise manufacturing processes, supply chain management, drug discovery, personalised customer service and delivery of healthcare.

Figure 4: AI mentions by sector in the MSCI ACWI, Q3 2022 to Q2 2023



Source: Bloomberg, as at 30 June 2023.

With great power, comes great responsibility

As well as delivering potential productivity gains and providing a competitive advantage, the disruptive power of AI also creates risk. A glance at the topics discussed in corporate earnings updates shows that companies have very real concerns around data governance, future regulation and ethics in particular (see Figure 5 below). Meanwhile, a recent survey by Forbes revealed that 75% of consumers were concerned about the potential for AI to generate misinformation, while only 5% of respondents stated they were unconcerned[5].

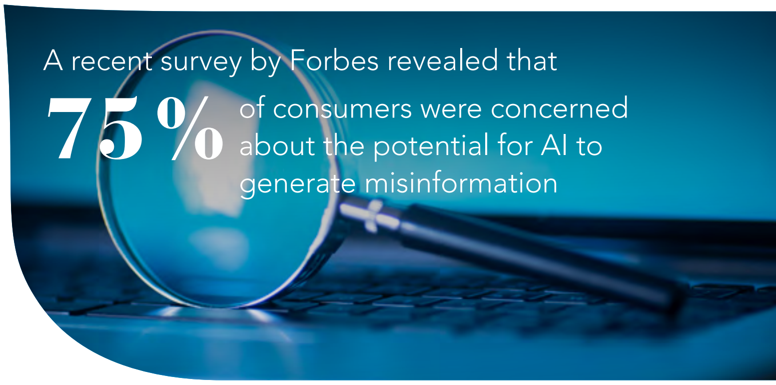
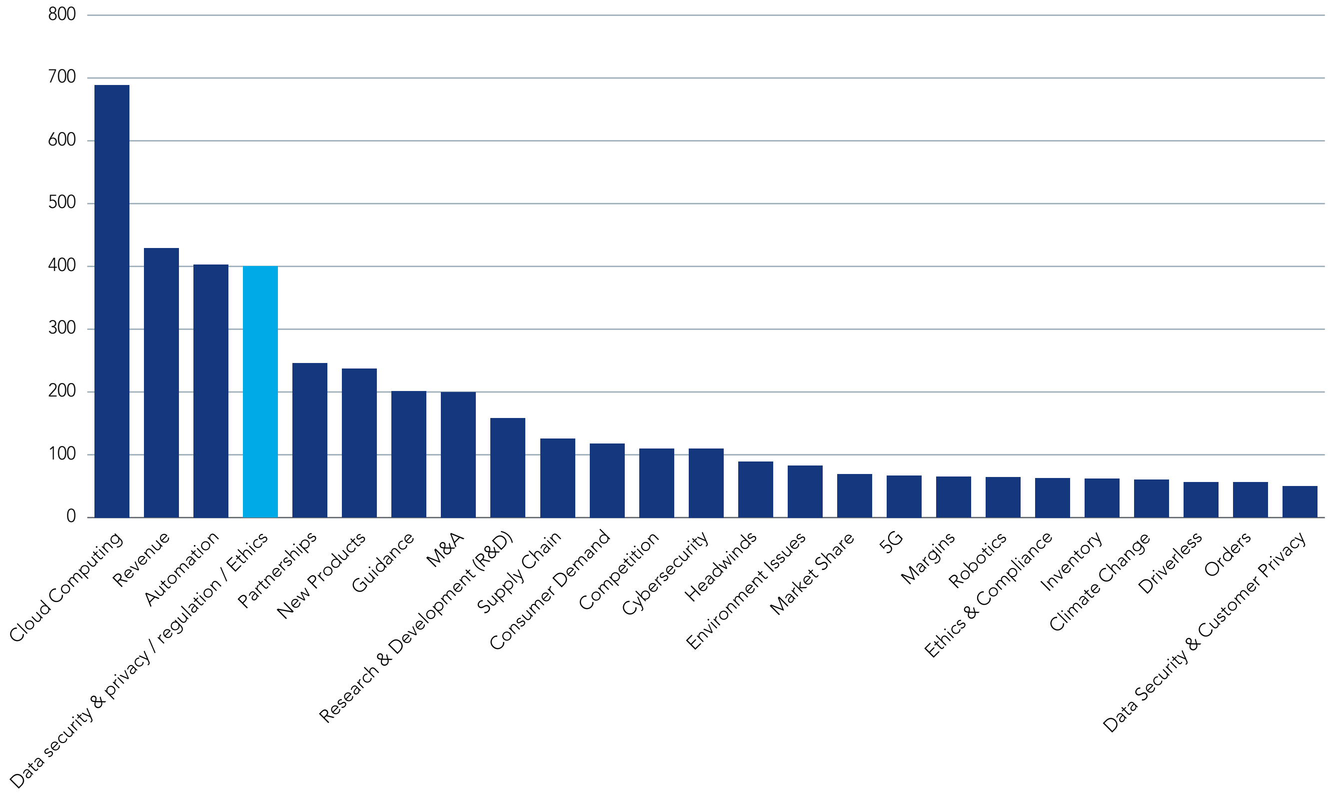


Figure 5: AI-related topics mentioned on company earnings calls, Q3 2022 to Q2 2023



Source: Bloomberg, as at 23 July 2023.

[5] 'Over 75% Of Consumers Are Concerned About Misinformation From Artificial Intelligence', published by Forbes Advisor, updated 20 July 2023. https://www.forbes.com/advisor/business/artificial-intelligence-consumer-sentiment/

While regulation has failed to keep pace with the digital revolution, legislators have started to crack down on the unfettered virtual world. Companies face fresh regulatory risk as a result, while reputational and financial risks are also likely to increase. In addition, companies employing AI will need to build trust with their end customers. Given these facts, we firmly believe that companies need to adopt robust controls and governance around the use of AI.

With this in mind, it's vital for investors to understand how companies are monitoring and managing these emerging risks. Our EOS stewardship team have been engaging with companies to encourage a responsible approach to AI and data governance since 2018. The team's Digital Rights Principles, which build on this work, are summarised in Figure 6.

Figure 6: Summary table of EOS at Federated Hermes' Digital Rights Principles

Topic	Investor Expectations
Negative societal impacts	• Ensure robust governance and policies over **artificial intelligence** • Prioritise **children and young people** in addressing negative societal impacts • Safeguard community and worker rights in **supply chains** • Take actions to close the **digital divide**
Freedom of expression	• Maintain processes for responding to laws and regulations that impose **censorship** • Implement transparent **content moderation** rules on social media • Maintain clear processes for responding to orders for **network disruptions or shutdowns** • Disclose public policy positions on **net neutrality**
Privacy rights	• Maintain processes for responding to **requests for information about users** • Maintain processes concerning **direct access agreements** • Responsible use of **facial recognition technology** • Ensure robust governance and policies over **cybersecurity** • Obtain **user consent** for their own collection, storage, and utilisation of data

Our expectations regarding AI (along with the context behind them) are set out in our whitepaper *Investor Expectations on Responsible AI and Data Governance* and are summarised below.

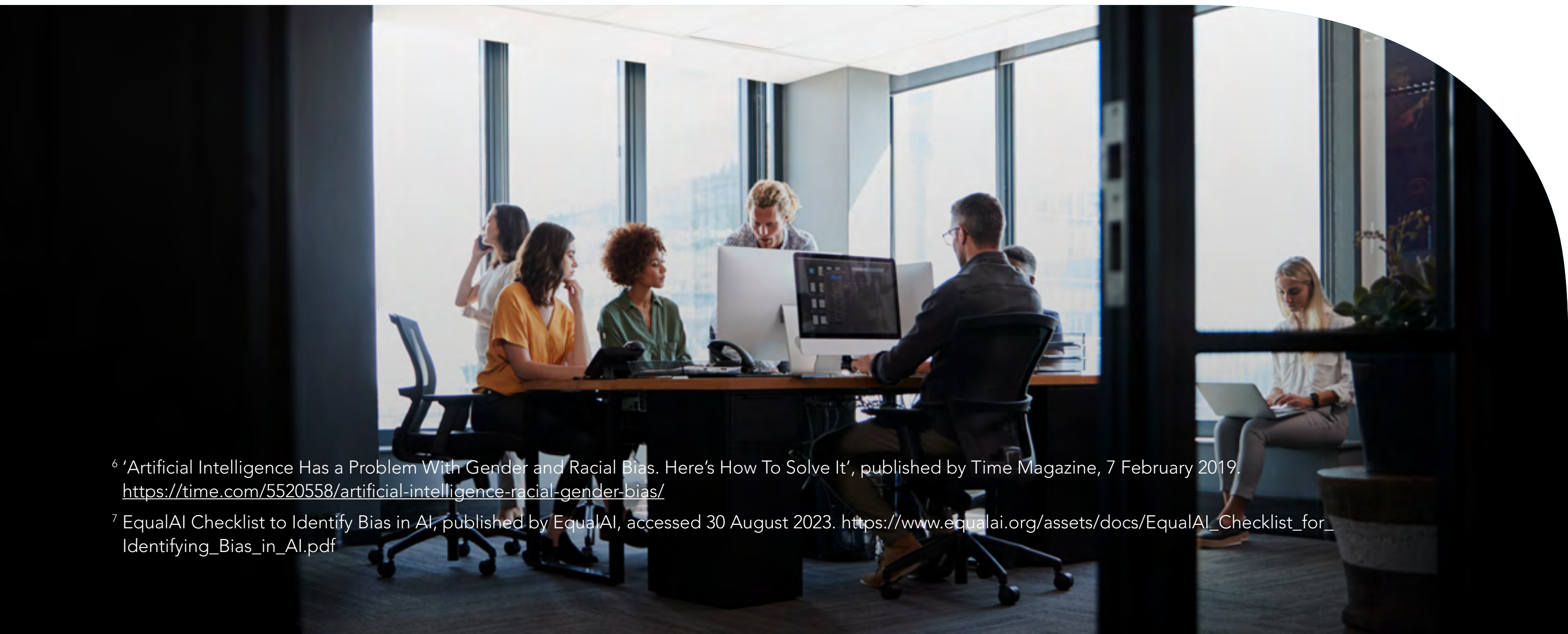
Companies should ensure robust governance and policies over artificial intelligence (AI). AI is used for numerous purposes, including by the Information, Communications and Technology (ICT) sector to curate, rank, and recommend online content, targeted advertising, search results, and political news. AI advances human development, but there is the potential for misuse. Companies could become powerful in influencing users' behaviour or contributing to social segmentation, while exerting significant control over media consumed[3]. Unintended racial, gender, and other biases have been identified within algorithms and can lead to inequitable outcomes[6].

Investor Expectations on Responsible AI and Data Governance provides a full engagement framework in relation to AI. Companies should disclose the range of purposes for which they use algorithmic systems; explain how they work, including what they optimise for and what variables they take into account; and enable users to decide whether to allow them to shape their experiences. Firms should also take actions to eliminate unintended racial, gender, and other biases in algorithms, including those recommended by the EqualAI Checklist to Identify Bias in AI[7].

In addition, there are a number of social issues that need to be considered. These include the potential for job displacement; protecting intellectual property; and what happens to the extensive human network that provides tagging and training services to build the AIs once they've been used. Engagement can give us a better understanding of how a company manages these risks.

Summary

How a company uses AI will be extremely important, not just from a productivity and efficiency standpoint, but also a reputational one. Our investment models will help identify interesting new ideas linked to AI's potential, while our long experience of engaging on AI and digital rights should mitigate the risks associated with this nascent technology.



[6] 'Artificial Intelligence Has a Problem With Gender and Racial Bias. Here's How To Solve It', published by Time Magazine, 7 February 2019. https://time.com/5520558/artificial-intelligence-racial-gender-bias/

[7] EqualAI Checklist to Identify Bias in AI, published by EqualAI, accessed 30 August 2023. https://www.equalai.org/assets/docs/EqualAI_Checklist_for_Identifying_Bias_in_AI.pdf

SECTION 5

CASE STUDY:

Microsoft

Microsoft Corporation is a diversified global technology platform company. Best known for its Windows operating system, the firm's products and services also include cloud computing, productivity software, videogame consoles, social networking and computer hardware.

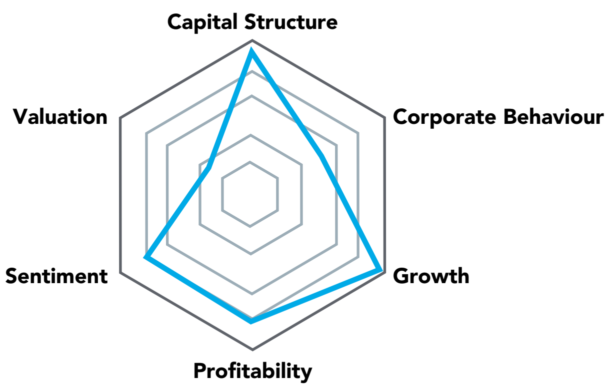
Microsoft's scale and reach give it a huge competitive advantage in a market with high barriers to entry, while its focus on productivity tools and cloud computing offers strong opportunities for long-term structural growth. It also enables the company to continue to innovate – as demonstrated by new products such as ChatGPT – which should deliver accelerating revenue growth.

> **Microsoft's focus on productivity tools and cloud computing offers strong opportunities for continuing long-term structural growth.**

Investment perspective

Our proprietary Alpha Model highlights a highly profitable company with an excellent capital structure, that delivers stellar growth and enjoys strong positive sentiment.

Alpha Model Assessment



The explosion in the number of Azure Open AI customers, from around 2,500 at the end of March to more than

11,000

at the end of June bodes well in this respect.

Management comments following recent earnings indicate monetising AI is likely to be a gradual process. The release framework – from initial beta testing through pricing to launch – will take several months for each new product. That said, Microsoft's AI infrastructure has been designed as a scalable platform, sowing the seeds of future revenue growth. The explosion in the number of Azure Open AI customers, from around 2,500 at the end of March to more than 11,000 at the end of June bodes well in this respect.

ESG profile

Microsoft is an outperformer on our proprietary Quantitative ESG (QESG) score, particularly pillars QE (Environment) and QG (Governance). The company has maintained MSCI's highest AAA rating since 2016, reflecting its class-leading yet continually improving governance (good board diversity and independence, no exposure to significant controversy).

On the social side, the firm has been involved in patent disputes, and there are questions over supply-chain standards and potentially anticompetitive practices. However, these issues are largely historic, and the company has reassured us of its commitment to human rights best practice, with a particular focus on the cobalt supply chain.

Additionally, a number of Microsoft's core businesses, online data centres and physical infrastructures have obtained ISO 27001 certifications, the leading international standard for information security management.

Engagement

We have found Microsoft generally receptive to engagement on a wide range of topics. These include social impacts relating to digital rights, on which we have made significant progress. Our objective was for the company to complete a human rights impact assessment for emerging digital products and services like AI, using this to identify risks and appropriate mitigation strategies in line with the UN Guiding Principles.

> **Our objective was for Microsoft to complete a human rights impact assessment for emerging digital products, to identify risks and appropriate mitigation strategies in line with the UN Guiding Principles.**

Engagement timeline:

June 2022

Raising concerns – We sent the company the EOS digital rights principles, which we had detailed in earlier conversations. We outlined our expectations and provided an engagement framework on human rights specific to digital products and services.

September 2022

Acknowledging concerns – We met the company's ESG Director to discuss our recommendations. We found the company's privacy policies and terms and conditions confusing for an average user and asked for them to be supplemented with images and videos. We also highlighted the lack of references to children and teenagers in the updated human rights report and asked Microsoft to become a leader in considering the best interests of underage users. We further argued that content moderation, along with standards for privacy rights, should be applied to apps listed on the Azure platform as well as on social media platforms such as LinkedIn. The company acknowledged that while some practices are in place, they are mostly reactive rather than proactive.

March 2023

Planning – We met the director of ESG engagement and learned Microsoft plans to complete a human rights impact assessment for emerging digital products and services. The company also offered the opportunity to engage with its digital safety team to discuss its overall approach and specific actions relating to children and other vulnerable groups.

SECTION 6

CASE STUDY:

Visa

Visa Inc. is a global payments technology company that connects consumers, businesses, banks, governments and territories to fast, secure and reliable electronic payments. The largest player in a thriving sector with high barriers to entry, it is well-positioned to benefit from the growth of digital payments.

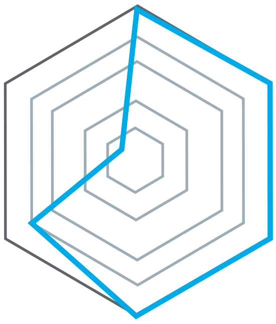
The transition towards digital payments provides Visa with a structural growth tailwind. The company also has a forward-looking approach to the integration of AI for a range of activities; these include fraud prevention, transaction authorisation, cybersecurity, and expanding access to credit, as well as analytics to improve efficiency and the customer experience.

> **The transition towards digital payments provides Visa with a structural growth tailwind; the company also has a forward-looking approach to the integration of AI for a range of activities.**

Investment perspective

Our proprietary Alpha Model highlights a high-quality company with an excellent capital structure and corporate behaviour score. The company also exhibits strong growth, is highly profitable and enjoys positive sentiment. Together, these attributes justify its premium valuation.

Alpha Model Assessment



ESG profile

The company ranks favourably against peers on our proprietary QE (Environmental) and QG (Governance) metrics. Though weaker than some of its peers on our QS (Social) metric, the company actually has an effective bribery and corruption policy, a strong diversity programme and healthy board diversity.

Overall, corporate governance is of a very high level. However, Visa has been involved in controversies involving anti-competitive behaviour, being accused of using its dominant market position to charge higher fees and impede competition in the industry. While these are historic issues, we continue to monitor the company closely for anti-trust issues, cyber risk and remuneration.

Engagement

Our engagement with Visa has touched on a wide range of issues, from remuneration to artificial intelligence, financial inclusion and cybersecurity. We started to engage with the company on artificial intelligence in early 2022. Our objective was to ensure disclosure of governance and policies for the responsible use of artificial intelligence, including how algorithmic systems are used, what they are optimised for and what variables are taken into account.

> **Our objective was to ensure disclosure of governance and policies for the responsible use of artificial intelligence, including how algorithmic systems are used, what they are optimised for and what variables are taken into account.**

Engagement timeline:

January 2022

Raising concerns – We raised our concerns during a meeting to discuss the company's 2022 proxy statement. We followed up later in the year by sending Visa our Digital Rights Principles and requesting a meeting to discuss its approach to managing these new and emerging risks, as its disclosure on digital rights risks lagged those of its peers.

September 2022

Acknowledging concerns – We met the chief sustainability officer, chief privacy officer and others to discuss the digital rights principles. The company understands it needs to manage data responsibly and believes consumers should be empowered to manage the use of their data. The chief privacy officer highlighted the large, diverse internal teams which support the firm's governance policies. The data governance team ensures they are integrated throughout the organisation.

> **The company understands it needs to manage data responsibly and believes consumers should be empowered to manage the use of their data.**

> **The CEO supports the responsible use of AI and takes part in employee training on the issue.**

Although Microsoft's current use of AI is limited, a recent increase in requests for information on responsible AI governance meant its disclosure in this area was evolving. The CEO supports the responsible use of AI and takes part in employee training on the issue. The company also understands the importance of diverse teams leading AI development.

Planning – We encouraged the company to consolidate its disclosures on governance, policies for responsible data use and guiding principles on responsible AI, to make them more accessible to investors and other stakeholders. We also encouraged alignment to the Global Network Initiative. Visa agreed to investigate further and requested examples of best practice.

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