Federated Hermes Global Equity ESG

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Annual Report 2023

www.hermes-investment.com
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SECTION 1

Investment review

Global equities began the year in positive fashion. Risk aversion declined sharply with sentiment boosted by the reopening of the Chinese economy and signs that inflation was receding from its autumn peaks, reflected in falling bond yields. In addition, excitement around AI, following the launch of ChatGPT in late 2022, drove equity markets higher.

The excitement caused by AI was the main driver of global equity markets for much of 2023. The result was a distinct lack of market breadth, as a select few companies – the Magnificent Seven – had a huge influence on overall market returns. Indeed, as we entered Q4, over 90% of the MSCI ACWI return had been driven by Information Technology, Communication Services and Consumer Discretionary. Outside of the AI-generated excitement, investors remained cautious. Inflationary pressures proved to be more stubborn than anticipated, while hawkish central banks, fears of recession and geopolitical uncertainty ensured that investors remained firmly in 'risk-off' territory.

That was until Q4 when we witnessed a sudden change in investor sentiment. A more dovish-sounding Federal Reserve increased the likelihood that a soft-landing would be achieved and reignited the belief that we had reached peak interest rates. This led to a surge in global equity markets, coupled with a notable increase in market breadth and a more favourable environment for active managers.

The picture has been mixed from a factor perspective. We saw a sharp change in sentiment at the start of the year with growth the preferred factor. But for much of H1 investors switched between growth and value at regular intervals in response to policy makers' rhetoric around interest rates. In Q3, value led the way, especially in Europe and Japan. Understandably, given the investor uncertainty, quality factors such as capital structure, corporate behaviour and profitability have generally been favoured, although the recent market rally has seen growth come to the fore.

Performance review

The Global Equity ESG Strategy underperformed against this backdrop during 2023. Stock selection was the main influence on relative returns during the period with significant detractions in Information Technology and Communication Services. These detractions were largely due to our decision to switch our Nvidia exposure into Advanced Micro Devices in January, coupled with not owning Meta Platforms, which due to significant ESG concerns is not currently considered investable. In fact, Nvidia and Meta Platforms were responsible for almost the entire underperformance in the period. On the positive side, there were notable contributions from stock selection in Industrials, being overweight Information Technology and underweight Energy.

Performance contributors	
UniCredit	UniCredit has consistently reported strong quarterly results in 2023 with the company also raising guidance on higher net interest income, better profitability and higher trading income.
Advanced Micro Devices	The company has benefited from the AI trend in 2023. It is seeing accelerating demand, driven by a faster pace of AI Infrastructure across a variety of industries, while new product innovation provides further opportunities.
Royal Caribbean	The cruise line has consistently reported positive earnings. New bookings have outpaced 2019 levels by a 'very wide margin' and demand has continued to accelerate, reflected in strong bookings for 2024.
Performance detractors	
Nvidia	Nvidia benefited from its leading position in AI, but we had an underweight to the name having rotated into Advance Micro Devices (which looked more attractive in our model and also performed well) at the start of the year. We subsequently reopened the position in Q4 as the boost that the AI trend gave to Nvidia's outlook prompted the Alpha Model to classify the company as hyper-growth and as such the company's premium valuation is less of a headwind to the investment thesis.
Pfizer	The company was affected by poor sentiment towards companies that had benefited during the Covid-19 pandemic. Pfizer subsequently cut guidance for 2023, reflecting lower demand in its Covid franchise.
Alibaba	Alibaba has been affected by poor sentiment towards Chinese stocks due to concerns over sluggish economic growth. The company reported better-than-expected results, but there have been some concerns over the increased investment needed to maintain its competitiveness.
Meta Platforms	Not owning Meta had a significantly negative influence on performance.

Positioning

The Strategy is structured to be broadly neutral from a sector and regional viewpoint, while top-down macro and style exposures are controlled. Within these parameters, the team seeks to identify a diverse range of companies that look attractive from multiple perspectives and have no materially weak links. This diversification ensures that the Strategy is exposed to companies with good or improving ESG characteristics across the style spectrum.

Over the past few months, we have increased the Strategy's tilt towards growth and quality, with the latter reflecting the continued uncertainty in the market. The Strategy remains diversified: sector exposures continue to be within +/- 3% of the benchmark index weight. The largest overweight positions are in Health Care and Information Technology, while Energy and Utilities are the largest underweights, reflecting the lack of suitably sustainable investment candidates. Our regional exposures remain within this expected range, although the trading activity resulted in a reduction of the strategy's overweight to Europe and an increase in our exposure to North America.

> **The geopolitical landscape is fragile, and the avoidance of recession is not guaranteed, such that we continue to favour quality growth over more speculative names. In addition, sustainable companies are starting to be rewarded by investors after a challenging period.**

Outlook

A weak opening to equity markets in 2024 suggests that investors are experiencing a hangover after November and December's exuberance, waking up to the reality that the optimistic upturn may have been too much too soon. Macro sensitivity remains at the forefront of investors' minds as doubts over a soft landing in the US emerged. We continue to follow the data and don't believe the conditions have changed enough to warrant a halt in optimism, but much will be riding on the first few economic releases of 2024.

Interest rate decisions continue to be key. Policy makers continue to push the higher-for-longer mantra, but the market is not listening, and anticipation of a rate cut is set to bring about a market broadening. Small and mid-caps are ready to take advantage of more comfortable conditions as the burden of servicing debt eases.

Growth stocks should also benefit from the loosening of economic conditions. However, it will be important to be selective. The geopolitical landscape is fragile, and the avoidance of recession is not guaranteed, such that we continue to favour quality growth over more speculative names. In addition, sustainable companies are starting to be rewarded by investors after a challenging period. Yet the premium valuation that sustainability should command has not been restored, making 2024 a year when sustainability is likely to be rewarded by investors.

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SECTION 2

Engagement overview

Alongside our stewardship colleagues in EOS at Federated Hermes (EOS), we seek to drive positive change through board and executive-level interactions. Our engagements with portfolio companies take the form of face-to-face meetings with board members, chairs, lead independent directors and chairs of board committees. We also gather information relating to specific engagement objectives and issues through our interactions with divisional heads and investor relations teams. Our proprietary milestone system allows us to track our engagement progress through four key stages from initial raising of concerns through acknowledgement of the issue and commitment to change, to implementation.

Figure 1: Measuring progress – Milestones

Source: Federated Hermes Limited, as at 31 December 2023.

We benefit from the wider research universe covered by EOS. The diverse team have backgrounds in law, banking, sciences, academia, accountancy, climate change and corporate strategy, and collectively they are fluent in 10 different languages. This expertise, combined with their cultural understanding and connections, enables local language dialogues which are of great importance.

As ever, voting and engagement is a good way to hold companies to account and is an important factor in our assessment of governance. We view it as a key part of demonstrating active ownership and ensuring companies are meeting the needs of shareholders.

The most frequently discussed issues on the social side were human capital and human rights. Both issues have remained high on the ESG agenda for companies. On human capital, our focus on diversity, equity & inclusion continues, with focus on company strategy, including pay gap, workforce diversity and although disclosure has improved, we are looking for an expansion of disclosed metrics. In addition, employment terms and conditions and health & safety have remained important topics. On human rights, we continue to promote the application of the UN Guiding Principles on Business and Human Rights. Supply-chain rights remain an important discussion topic and, In the wake of the AI-generated excitement, focus on digital rights, such as data privacy and unfair bias, has also increased.

Climate change continues to be the dominant environmental topic. TCFD[1] reporting, net zero commitments and more ambitious greenhouse gas emissions targets are areas that prompt meaningful dialogues with companies and are gaining significant traction in the market. Natural resource stewardship has also risen up the engagement agenda in 2023, primarily in respect of biodiversity.

Within governance, remuneration continues to be the most highly covered area. Though we have seen improvements with additional metrics linking pay and performance, quantum is frequently an issue and remuneration committees are typically not effectively addressing long-term investor concerns on this topic. We, therefore, seek simpler, more transparent pay structures with a reduced variable-to-fixed pay ratio and a reduction in short-term performance metrics. Board effectiveness & structure also continues to be a significant area of interest. Having the requisite skills, diversity of perspectives (including ethnicity, gender, age, background, etc) and independence to drive the strategy and set the culture are all vital to the long-term success of a company.

[1] **TCFD**: The Taskforce on Climate-Related Financial Disclosures is an organisation that was established to develop a set of voluntary climate-related financial risk disclosures. These disclosures would ideally be adopted by companies which would help inform investors and other members of the public about the risks they face related to climate change.

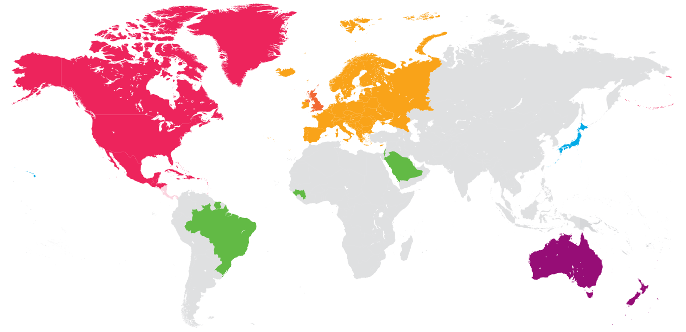
Engagement progress, 2023

Total number of engagement objectives: **109**

Number of companies engaged: **78**

On human capital, our focus on diversity, equity & inclusion continues, with focus on company strategy, including pay gap, workforce diversity and although disclosure has improved, we are looking for an expansion of disclosed metrics.

Objectives by region:



Voting, 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:
29.3%	**70.8%**

Source: Federated Hermes Limited, as at 31 December 2023.

Engagement objectives by theme

Source: Federated Hermes, as at 31 December 2023.

Environmental: issues and objectives engaged

Source: Federated Hermes, as at 31 December 2023.

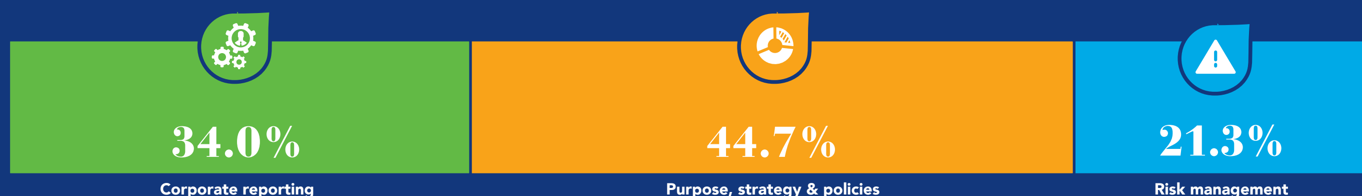
Social and ethical: issues and objectives engaged

Source: Federated Hermes, as at 31 December 2023.

Governance: issues and objectives engaged

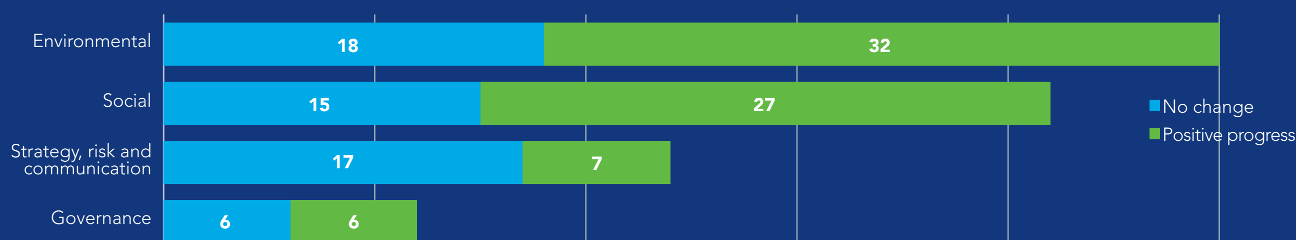
Source: Federated Hermes, as at 31 December 2023.

Strategy, risk and communication: issues and objectives engaged



Source: Federated Hermes, as at 31 December 2023.

Milestone status of engagement



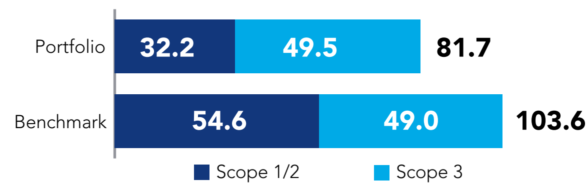
Source: Federated Hermes, as at 31 December 2023.

SECTION 3

ESG outcomes

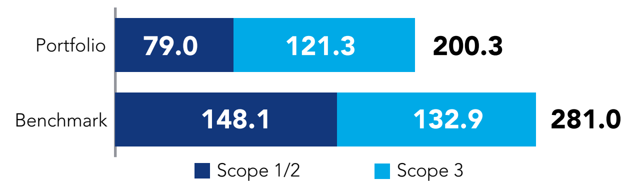
We recognise that every company has both positive and negative impacts when it comes to its operations. Here we present a snapshot of the strategy's carbon metrics:

Carbon footprint per US$m invested



Source: Federated Hermes Limited, as at 31 December 2023.

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



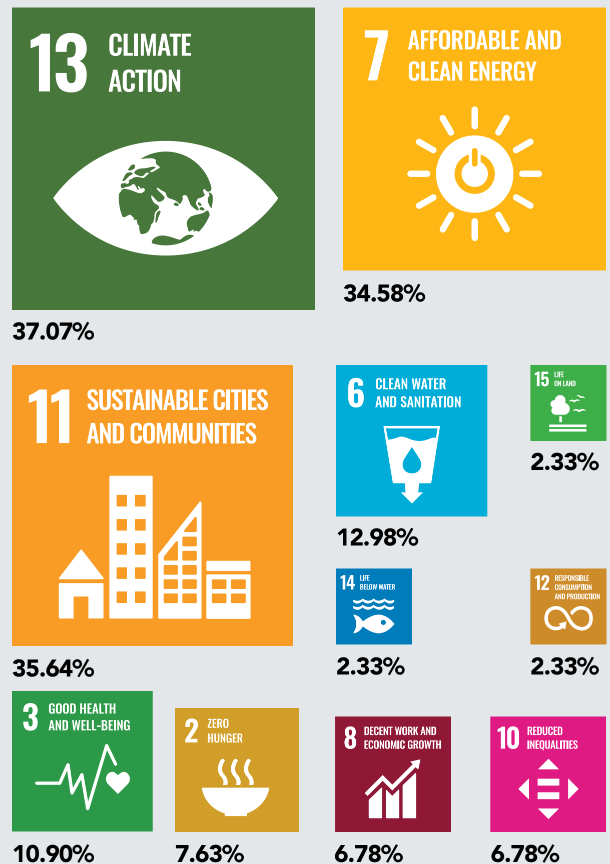
Source: Federated Hermes Limited, as at 31 December 2023.

Environmental opportunities exposure

39%

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 Limited, as at 31 December 2023. Note that percentages shown add up to more than 100% as companies can be exposed to more than one SDG.

Science-based targets

We continue to see increased momentum behind climate action and carbon risk management, in line with the rollout of the TCFD framework. The fact that more of our portfolio companies are committing to TCFD reporting – and to net zero or science-based decarbonisation targets – is evidence of this trend:

Globally, in total over

7,480 companies are taking science-based climate action and over

4,565 companies have approved science-based targets, up from

Source: Federated Hermes, as at 31 December 2023.

Within the Strategy

42 companies have validated science-based targets and another

7 have committed to setting them within the next two years.

This represents

51% of the strategy's holdings.

SECTION 4

Introducing the new QESG 3.0: the next generation

Philosophy and approach

A key part of our philosophy is that we favour companies with good or improving standards of ESG with the objective of delivering superior shareholder returns. That is, we integrate ESG into the process because we believe ESG can make you money.

We have a proprietary ESG assessment framework that uses the unique engagement insights generated by 'EOS' at Federated Hermes, market leaders in stewardship, allowing us to identify companies that we believe are improving their ESG behaviour – and hence unlocking value – ahead of the market.

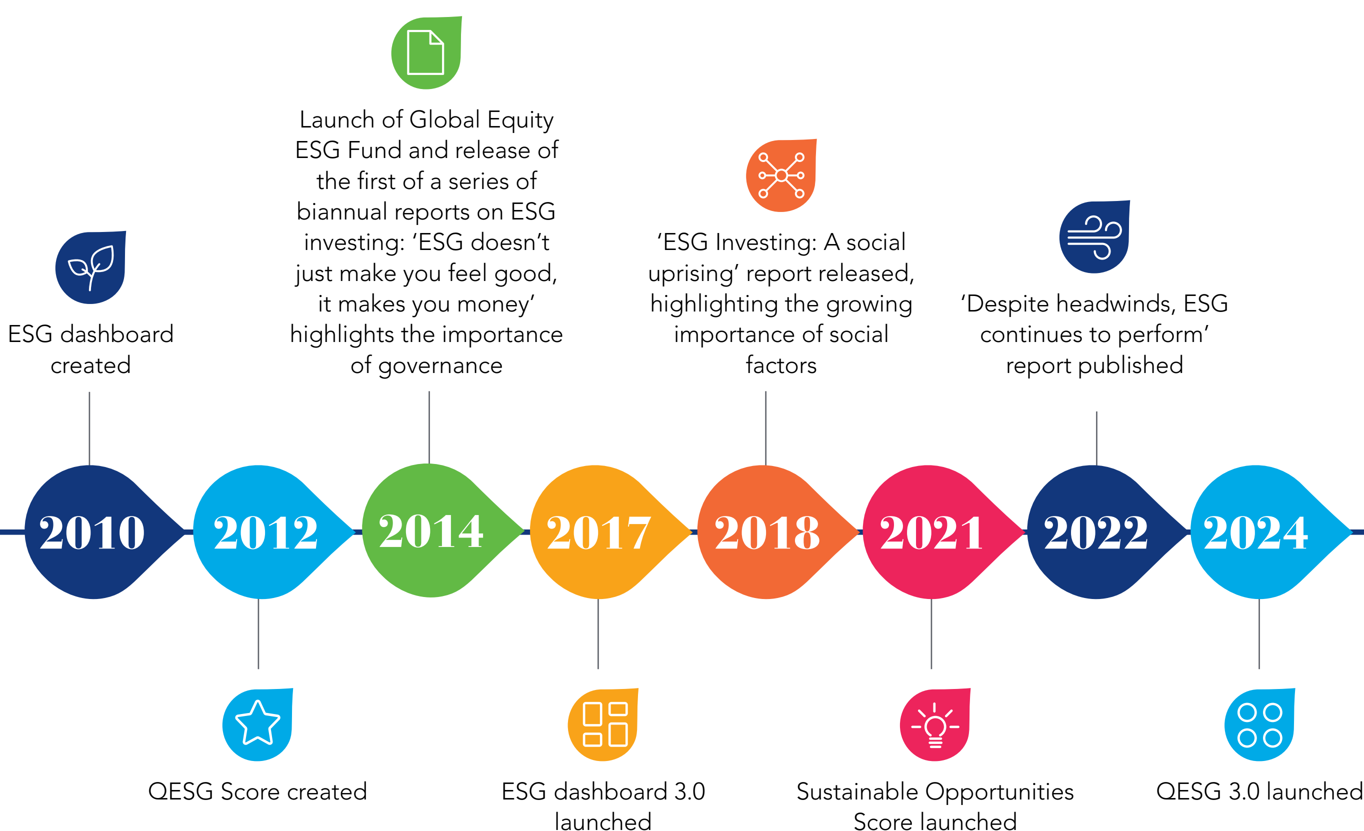
We supplement the EOS intelligence with a wide range of third-party ESG vendors – more than 10, including MSCI, Trucost and Sustainalytics – recognising the strengths and weaknesses of the various providers and the limitations of quantitative ESG data in general (For more on this, please read our evolution of ESG piece).

The resulting assessment of ESG – the QESG Score – is embedded directly within our stock selection model and is a crucial part of how we determine the expected return of investments.

QESG 3.0: Building on over a decade of research into ESG integration

The Global Equities team has a history of innovation, whether providing bespoke solutions that meet client-specific needs, the continuous improvements in the Alpha Model, or our pioneering research into ESG which provides a strong foundation for the new QESG Score to build on.

Figure 2: A history of innovation



What has changed?

The broader philosophy of the score remains the same, in that it remains vital to avoid the worst companies and identify those that are changing for the better. However, there are several key areas where improvements have been made.

New positive and negative indicators

- The philosophy and approach of the Sustainable Opportunities Score is now embedded directly into the QESG Score.
- Product involvement becomes more important when assessing the negatives. We consider a wider range of negative product exposures and apply differing levels of severity, with the penalty depending on both the severity of the issue and the proportion of revenue exposed. For example, involvement in coal mining would be more heavily penalised than involvement in natural gas. We consider a much wider range of company policies and practices.

More differentiation by industry

- We ensure that the assessment is relevant to the industry in which the company operates, such as considering exposure to palm oil for companies in the household products industry, or to timber for packaging companies.
- Dynamic selection of metrics based on relevance and coverage within industry. As the data availability improves or as third party providers increase coverage, the score will automatically pick up the metrics most relevant to an industry.
- There are a couple of key philosophical exemptions to this rule: controversies and product involvement. Both of these are important considerations regardless of industry and we would want to penalise for material controversies or unsustainable activities.

Separating the good, the bad, the ugly (and everything in between)

QESG 2.0 was good at separating the bad from the rest, but as the amount and quality of ESG disclosure has increased we are now able to produce more granular assessments of companies. In this new iteration, QESG 3.0, we favour continuous and multi-level categorical factors wherever possible, improving – or avoiding – some of the binary indicators used previously. For example, for many metrics the methodology assigns companies into one of five groups – quintiles which represent '**leaders**', '**above average**', '**average**', '**below average**' and '**laggards**'. This provides more interesting distribution for comparing companies, but also allows us to place more emphasis on where ESG change has most impact. The score that we assign to a company that has moved out of the bottom ('laggards') quintile is greater than for a company that has moved from quintile 3 ('average') to quintile 2 ('above average'). In other words, an improvement from a lower level is likely to reduce risk to a greater degree and potentially unlock more significant shareholder value than if an already good or safe company improves.

QESG 2.0 was good at separating the bad from the rest, but as the amount and quality of ESG disclosure has increased we are now able to produce more granular assessments of companies.

We have always used a similar approach with regard to controversies, which are considered on their severity and/or materiality. A severe controversy, for example, would prompt an exponential penalty on the QESG Score, while lower-level controversies would have a considerably smaller impact. The effect of these controversies has been increased within QESG 3.0 to reflect some companies which have exposures to some of the very worst environmental or social abuses balancing these material risks with a deluge of disclosure – this is not possible in the new scoring regime. Likewise, a company with a high number of low-level controversies would see an increased penalty based on the frequency of these issues.

A reworking of EOS-supplied information

The information provided by EOS is the most important and proprietary part of the QESG Score, and it is the information we rely on most heavily when considering a company's ESG trajectory.

In QESG 3.0 we have expanded the use of this data to include a shorter term 'engagement sentiment' assessment and a more granular assessment of the long-term progress a company is making against its engagement targets. As a result, we consider three distinct engagement signals within the score:

1. **Engaged indicator:** This indicates whether a company is engaged or not. Effectively, this demonstrates that EOS believe a company can make engagement progress, which would provide a small boost to the overall QESG Score.
2. **Engagement score:** This assesses a company's engagement milestone progress over the past three years. More emphasis is placed on the recent success and more significant milestones achieved (i.e. completing an engagement is more valuable than acknowledging the existence of an issue). The speed in which the milestones were completed is also considered, with reference to the target timeframe supplied by the engager (typically three years).
3. **Engagement sentiment:** This is a direct input into the score from the engagers. It is a measure of how long a firm is taking to make progress on current milestone objectives compared to expectations, and reflects the most recent meetings with a company (independent of whether there has been actual milestone progression).

New data sources: Drawing on a variety of new data sources to assess emerging ESG themes

We have been able to increase the amount of data from MSCI and Sustainalytics that offer additional insight into how a company is managing its ESG risks.

- **Theme-specific management scores:** These scores evaluate how well management prepare and deal with ESG risks, such as biodiversity land-use management.
- **Business risk exposure:** This is similar to product involvement, but offers additional information, such as packaging waste.
- **Greenhouse gas (GHG) emissions targets flag:** This indicates whether a company has set emissions reduction targets and evaluates Scope 1, 2 & 3 targets independently.

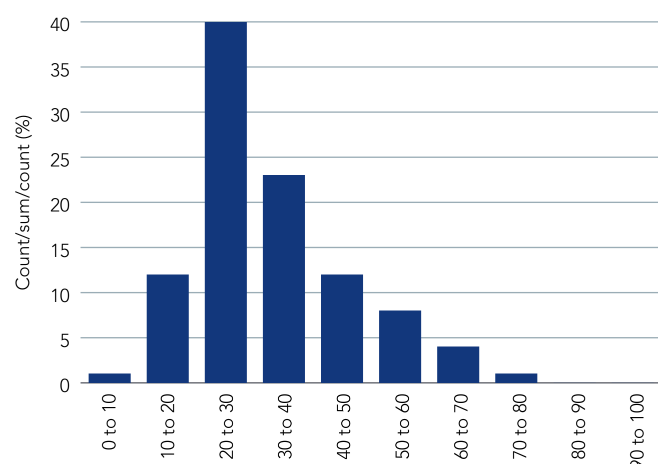
There are also a range of other metrics that we have included, covering forest and water stress ratings, gender equality, ownership type and board independence.

> **While the overall philosophy is not meaningfully changed, the new framework results in lower scores for most companies such that the new and old scores are not directly comparable.**

How have the changes influenced the QESG Score?

While the overall philosophy is not meaningfully changed, the new framework results in lower scores for most companies such that the new and old scores are not directly comparable. The changes result in a greater skew to the left, as seen in Figure 3. This is a result of the increased emphasis on penalising negative indicators, such as controversies and product involvement, among others.

Figure 3: The QESG Score (3.0)



Source: Federated Hermes Limited as at 2024.

> **We believe these companies have a structural growth advantage over peers and the higher QESG score for these names will help our portfolios to favour these more attractive opportunities.**

The change also means that our Sustainable Opportunities Score is 'baked into' the QESG Score. This enables the team to highlight companies that have good and improving ESG characteristics and also a favourable balance between the positive and negative influences a company has. This helps the team identify potential investment candidates that are driving the sustainable transition. We believe these companies have a structural growth advantage over peers and the higher QESG score for these names will help our portfolios to favour these more attractive opportunities.

Ultimately, QESG 3.0 offers a more robust, more dynamic assessment of ESG with more relevance for the industry in which a company operates. How a company manages its ESG risks continues to be of upmost importance, but it also gives more consideration to social and environmental opportunities that could help unearth a wider variety of potential investments.

> **In QESG 3.0 we have expanded the use of this data to include a shorter term 'engagement sentiment' assessment and a more granular assessment of the long-term progress a company is making against its engagement targets.**

SECTION 5

CASE STUDY:

Zoetis

Zoetis is an American drug company, developing and manufacturing animal health medicines and vaccines for livestock and pets across the globe. The company has a history of innovation, giving it a differentiated product portfolio in areas, such as, dermatology, parasiticides, pain and diagnostics, which provide a platform for consistent and sustainable growth.

Companion Animals, one of the company's products, represents 61% of revenues, with livestock accounting for the remainder. Demand for its companion animal products remains strong and is the key driver of growth. There are encouraging trends in vet visits, which are directly correlated to growth and the willingness to pay continues to grow, especially with younger pet owners who are more willing to pay whatever it takes.

Companion Animals, one of the company's products, represents

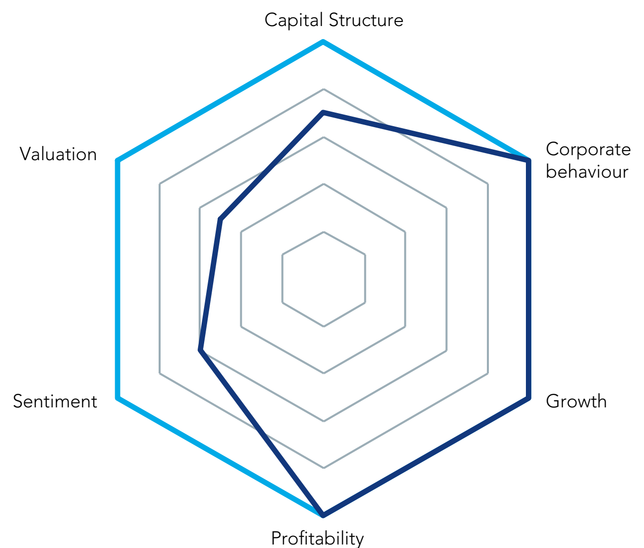
61%

of revenues, with livestock accounting for the remainder.

Investment perspective

The company looks attractive across most factor categories, especially corporate behaviour, growth and profitability, and it is an ESG improver that compares favourably to peers across each ESG pillar, particularly governance.

Alpha Model assessment



The improvement in its ESG profile is reflected in its receptiveness to engagement, coupled with recent progress on our engagement objectives. Recent discussions have included Taskforce on Nature-related Financial Disclosures (TNFD)[2], climate strategy and diversity. The company confirmed that it is working on TNFD disclosures and is conducting a materiality assessment, in which we expressed an interest.

Antimicrobial Resistance (AMR) is an important topic and the company stated that its antibiotics business had shrunk in absolute terms, partly driven by its focus on pets. In addition, the company's product development strategy has focused on alternatives to antibiotics. While this is reassuring, we have asked the company to include AMR in its annual reporting, which the company will consider.

Antimicrobial Resistance (AMR) is an important topic and the company stated that its antibiotics business had shrunk in absolute terms, partly driven by its focus on pets.

On its climate strategy, the company was receptive to our suggestion that it sought validation of its emissions reduction targets from the Science Based Targets Initiative (SBTi)[3]. We have also expressed concerns over the use of carbon offsets, although the company asserted that offsets were a tool of last resort. It also argued that it has a robust internal approach to managing climate risks, including Task Force on Climate-related Financial Disclosures (TCFD) analysis and regular meetings with the executive committee and the board.

On its climate strategy, the company was receptive to our suggestion that it sought validation of its emissions reduction targets from the Science Based Targets Initiative (SBTi).

On diversity, Zoetis plays a leadership role in several community initiatives to employ and promote diverse talent. The company was keen to receive feedback and we recommended analysing retention rates by demographic, suggesting that it could inform targeted measures. We also suggested conducting analysis on the productivity and innovation improvements yielded from community outreach, possibly measuring a return-on-investment.

The above does not represent all of the securities held in the portfolio and it should not be assumed that the above securities were or will be profitable. This document does not constitute a solicitation or offer to any person to buy or sell any related securities or financial instruments.

[2] **TNFD**: The Taskforce on Nature-related Financial Disclosures (TNFD) is a market-led, science-based, and government-backed initiative providing organizations with the tools to act on evolving nature-related issues.

[3] **The Science Based Targets initiative (SBTi)**: Established in 2015, the SBTi is designed to help companies to set greenhouse gas (GHG) emission reduction targets in line with climate science. The initiative defines and promotes best practices in emissions reductions and includes a team of experts to provide companies with independent assessment and validation of their targets.

CASE STUDY:

Prysmian

Prysmian is a multinational company, with headquarters in Milan, Italy. The company produces underground and submarine electrical cables for power transmission, infrastructure projects and telecoms transmission, with a strategy aimed at positioning itself as one of the main technological players in the energy transition. The vast majority of revenues are driven by this exposure, which is split into two areas: high voltage (renewable transmission) and power distribution (grid).

Its high voltage, renewable transmission business continues to see strong demand, reflected in an order backlog of approximately €20bn. Capacity utilisation is almost entirely full, and the company is selective in taking on new orders, providing insulation from cancellation risk, as existing orders can be brought forward. With a robust demand outlook for renewables, the company may look to add further capacity.

Its high voltage, renewable transmission business continues to see strong demand, reflected in an order backlog of approximately

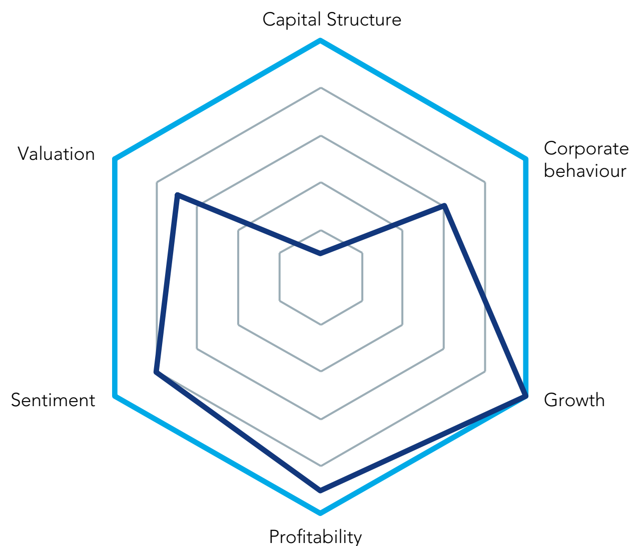
€20bn

The outlook for its power distribution (grid) segment also looks positive, with demand supported by the replacement cycle and renewable additions. Prysmian's ability to provide bespoke solutions with short lead times to utilities makes the company a trusted partner and gives it a high market share where it operates and a significant competitive moat.

Investment perspective

Our Alpha Model highlights a highly valued, profitable company that delivers strong growth and enjoy positive sentiment. It is also a strong and improving ESG performer, comparing favourably to peers across all ESG pillars.

Alpha Model assessment



The company has taken actions to address concerns regarding emissions as they have pledged to reach net-zero for its global operations between 2035 and 2040, and a net-zero global value chain by 2050.

Prysmian outperforms its peers on governance metrics, is in line for social metrics, however lags on environmental metrics. The company has taken actions to address concerns regarding emissions as they have pledged to reach net zero for its global operations between 2035 and 2040, and a net-zero global value chain by 2050. These targets have been verified by the Science Based Targets Initiative.

Moreover, the company's overall ESG-related disclosure follows best practice, signalling strong accountability to investors and the public. ESG-related issues are overseen by a Sustainability Steering Committee, chaired by the COO, suggesting that these are integrated into the core business strategy. We note the company also has a strong bribery and corruption policy, strong board diversity and a strong anti-discrimination policy.

With regard to its supply chain, the company has two main products that it uses: metals and plastic. Every supplier signs a comprehensive code of ethics, and its top suppliers are subject to audits. It has also been working in partnership with suppliers of plastic and copper to develop products from recycled materials.

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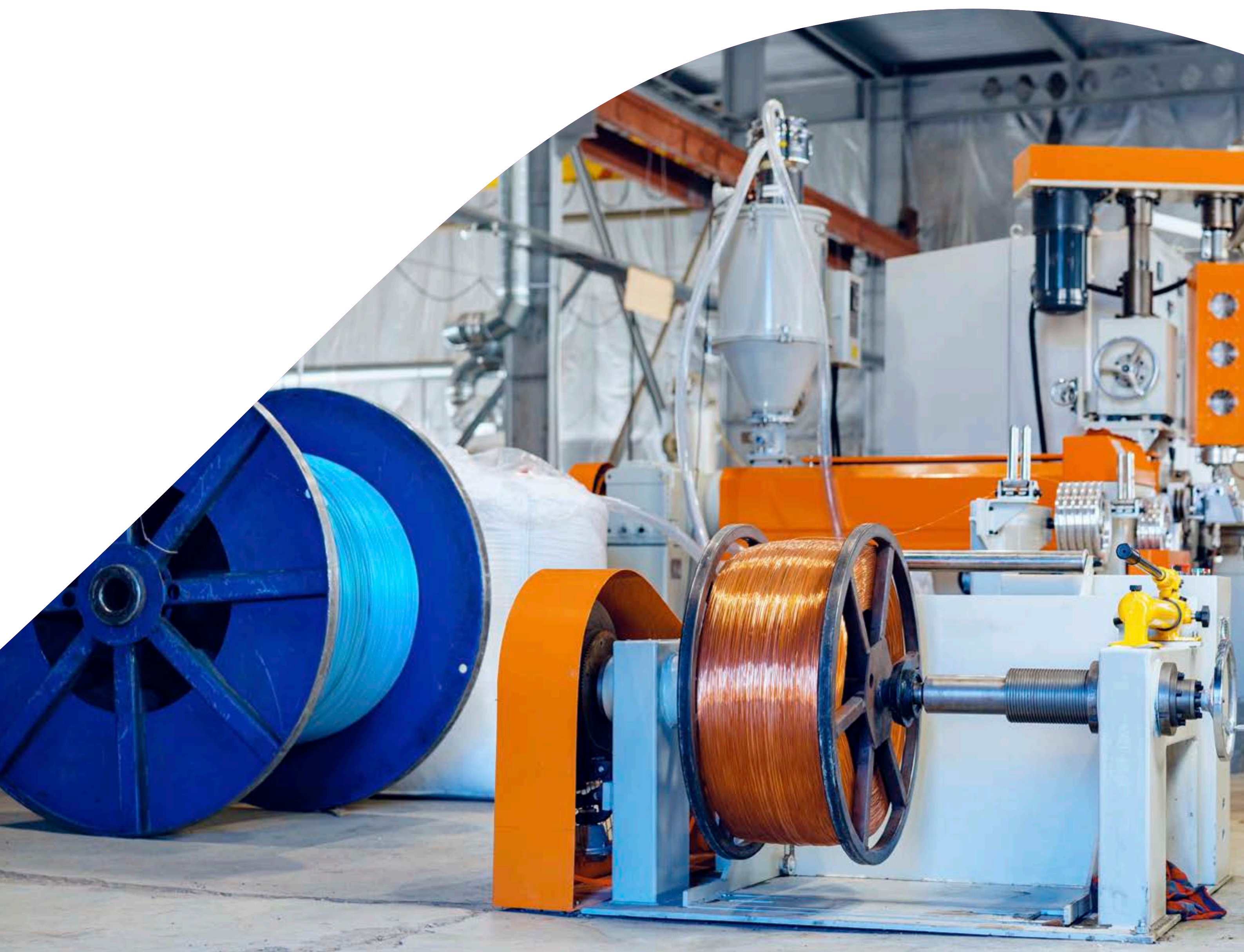

The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Any investments overseas may be affected by currency exchange rates. Past performance is not a reliable indicator of future results and targets are not guaranteed.

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