Letter to investors

Capital Constrained

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Lead Portfolio Manager

Asia ex-Japan Equity
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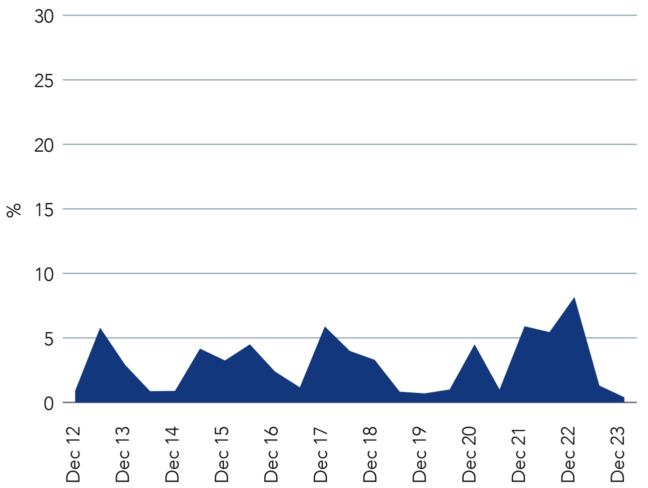
Federated Hermes Limited

www.hermes-investment.com
For professional investors only

In our latest Letter to Investors, Jonathan Pines, Lead Portfolio Manager, Asia ex-Japan Equity, looks at the remarkably attractive valuations on offer at the present time, and the implications for long-term investors.

We are long-only investors and are, therefore, always near-fully invested. Nonetheless, there have been periods where cash levels have crept up – to as high as mid-single digits, and on one occasion, high single digits

Figure 1: Cash holdings as a percentage of the Fund



Source: Federated Hermes Limited, Northern Trust. Cash holdings shown for a representative Fund in our Strategy.

Reasons for non-zero cash balances vary. Sometimes, they are technical. For example, there may be a temporary cash balance following a large inflow, in anticipation of a large outflow, or because of a partially or unexecuted buy order resulting from a price rise or percentage-of-volume trading constraints.

Occasionally though, a small cash balance is tactical. Even when valuations are attractive, we might take a view that factors such as especially negative news or sentiment may cause prices to fall in the short term, and as a result we might decide to hold a small cash balance. Essentially, these are bets on a greater-than-even likelihood of short-term market weakness.

These are, however, tough bets to win. Sentiment can change rapidly and unpredictably. Over the long term, not being fully invested for any significant period is almost certainly a losing strategy because markets tend to rise over time. Take the US stock market. Over the last decade the S&P 500 Index has almost tripled[1]. Any fund manager trying to beat that benchmark will have found any cash holding for all but a few short discrete periods to have been a significant performance detractor. Since inception, our own negative contribution from cash has been 0.2% per annum, a not-insignificant performance drag[2].

Some clients, understandably, frown upon any non-trivial cash balance held by fund managers. After all, by investing in the Strategy, they might contend, they have already decided to go long and don't want their carefully considered decision to be undone. "Your role is to outperform the benchmark, not to second guess our view on the asset class itself," they might say.

They are right of course. And yet.

We believe that an important part of the DNA of successful fund managers is to be able to hold (at least) two ideas in their heads simultaneously. An optimism about a stock's price-to-value proposition should be twinned with a sense of foreboding about what could go wrong. Long-term conviction should be strong, but never absolute. The line between confidence and over-confidence is fine. There are many variables, including top-down ones, which could sabotage the best investment thesis. Conviction needs to be accompanied by a humbling recognition that even if the investment thesis is sound (and top-down factors don't negatively interfere), especially in the short term, anything is possible. We deal in probabilities – a challenge of chance where we believe we have the house's edge.

At the portfolio level, even when valuations are attractive (as we believe they have been for our asset class for a long time) the tension between opportunity and uncertainty is ever present. And creditable paranoia, even in the context of cheap valuations, can rightly or (normally) wrongly find its expression in the form of a temporary, small cash balance.

So, even with the knowledge that *any* cash balance will likely hurt long-term performance, given that most thoughtful fund managers are programmed to check their optimism, it can be psychologically difficult to always be 100% long[3].

[1] Bloomberg as at 16 January

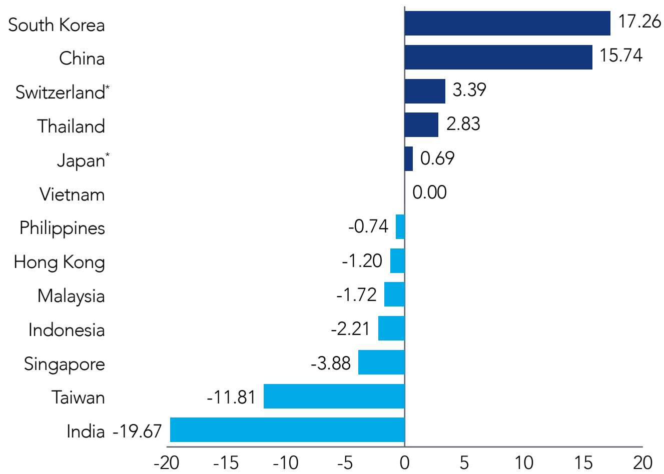
[2] Source: Federated Hermes Limited, Northern Trust as at 16 January 2024

[3] Some mandates address this inherent tension by specifying tight maximum levels of cash. One segregated account we manage allows us to have no more than 0.5% of our fund in cash at any time – which, of course, is an easier ask for an account with infrequent flows than for an open-ended fund.

We admit to being afflicted with this "small occasional cash balance" condition too. At the portfolio level, cash holdings (other than when resulting from technical factors) tend to reflect the tension between the valuation opportunity on the one hand and short-term uncertainty on the other.

Geographical tensions have risen (following from Hamas's October 7 attack on Israel, and Taiwan's election results, which might exacerbate tensions with China). But from an unusually depressed starting point on 31 December 2023, China's HSCEI benchmark has fallen a further 7% and South Korea's Kospi 9% in the first two weeks of January[4]. These two geographies comprise the lion's share of our holdings.

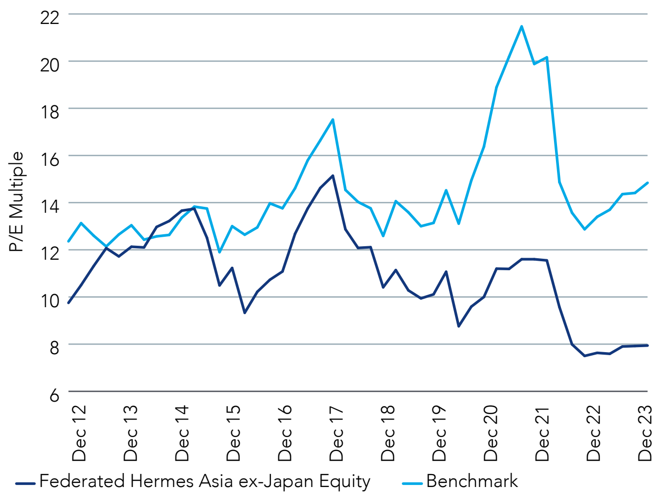
Figure 2: Active country weightings



Source: Federated Hermes Limited, Northern Trust as at 31 December 2023. Cash position is 0.5%. *Stocks not listed on Asia ex Japan stock markets may be bought if the companies generate most revenue or earnings or have most net assets or value from Asia ex-Japan.

Our cash holdings have fallen to essentially zero[5]. This is because, despite macroeconomic uncertainty, we find valuations to be overwhelmingly compelling. Our conviction has grown as short-term uncertainties (while real) have faded in importance relative to the rarity of the long-term opportunity.

Figure 3: Price-to-earnings (P/E) multiple



Source: Style Research Analysis as at 31 December 2023. Data is for a representative portfolio of the Strategy.

To be sure, risks are ever-present. Global tensions might continue to escalate. China's economic funk might be longer or deeper than we anticipate. But it seems to us that key geographical and sector segments within our Asia ex-Japan benchmark are now in the capitulation phase, and large 'on sale' signs mark the entrances to South Korea's and China's bourses.

Being capital constrained has its advantages. Stocks need to compete more fiercely for a place in our portfolio. It is not good enough for us to find a stock that we believe has a high probability of outperforming our benchmark or cash. New stocks need to outperform the worst idea in the portfolio, or be equally as good as the worst idea, while reducing risk. Being capital constrained introduces a healthy competitive dynamic and tension.

Stock picking is difficult. Indeed, if an investor can easily find stocks they believe are likely to outperform, it probably means that they are missing something.

[4] As at 16 January 2004.

[5] As at 16 January 2004, cash for a representative portfolio of our strategy was approximately 0.5%, a level we consider to be necessary to account for trading friction.

Household names are rarely mispriced. We typically need to look further afield and tend to find our best ideas in the corners of the market where others are not looking.

For example, we own stocks like China Bluechemical, a fertiliser company with access to fuel stock cheaper (and cleaner) than that available to most of its competitors. China Bluechemical trades on a P/E multiple of 5 times (excluding disposal gains) and dividend yield of 15%. Moreover, 137% of its market capitalisation is held in net cash. We own Youngone Corporation, a South Korean apparel maker for North Face (among other brands) that trades on a P/E multiple of 4 times, and despite a stingy 10% pay-out ratio, on a dividend yield of 4%. We hold Brilliance China, owner of the BMW China joint venture, that has close to 100% of its market capitalisation in net cash, a P/E multiple of under 3, and if it is able to sell its stake in the joint venture (rumored but currently denied), will likely have close to 200% of its market capitalisation in net cash. Brilliance China has made recent large dividend distributions.[6]

But nowadays, even the well-known names within our benchmark are cheap. Because of investor familiarity and high benchmark weightings, such stocks could be earlier beneficiaries of a hoped-for surge in stock prices. Samsung Electronics, the leading memory maker (and making inroads into 'logic') trades at 1.2 times book, with 20% of its market capitalisation in net cash. Chinese e-commerce leaders Alibaba and JD.com trade on P/E multiples of 8 and 9 times, respectively. Baidu, China's Google, trades on a P/E multiple of under 3 times core earnings. KB Financial, South Korea's leading bank, trades at 0.4 times book value and on a dividend yield of 6% while being the subject of a credible local activist campaign that could see that dividend yield doubling. Samsung Fire & Marine, South Korea's largest general insurance company, trades at 0.7 times book value and on a P/E multiple of 5 times. Its stock price might also benefit from the recent adoption by the company of the relevant international accounting policy for insurers that will result in more predictable earnings and, therefore, dividends, allowing it to attract a new class of investor. Hyundai Motor (preferred[7]) stock trades on a P/E multiple of 2.2 times earnings, a price-to-book multiple of 0.2 times and a dividend yield above11%[8].

Given the remarkably attractive valuations on offer, we are unusually optimistic that investors will enjoy a pleasing prospective performance over any reasonable long-term horizon, despite near-term uncertainties.

Jonathan Pines
Portfolio Manager
Federated Hermes Asia ex-Japan Equities

[6] Stocks are for a representative portfolio within our Strategy. Stocks mentioned might be traded by us prior to, or shortly after the dissemination of this note. We are not making recommendations to buy or sell any of the stocks mentioned.

[7] Preferred stock in South Korea has near-identical economics to the common stock and is thus better assessed as non-voting common stock than traditional preference shares which typically pay a fixed interest-like dividend expressed as a percentage of par value.

[8] Stocks are for a representative portfolio within our Strategy. Stocks mentioned might be traded by us prior to, or shortly after the dissemination of this note. We are not making recommendations to buy or sell any of the stocks mentioned.

Rolling year performance (%)

	31/12/22 to 31/12/23	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
Strategy	10.01	-10.05	7.85	11.91	13.88

Source: Federated Hermes as at 31 December 2023. 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.**

Schedule of Rates of Return and Statistics

Composite: **Federated Hermes Emerging Markets Asia IMI Equity**
Index: **MSCI AC Asia ex Japan IMI (net)**
Periods Ending: **31 Dec 23**

	Returns (%)		
	Composite Gross Return	Benchmark	Composite Net Return
Q4 23	5.78	6.74	5.49
1 Year	10.01	8.01	8.80
3 Years (Annlzd)	2.19	(5.32)	1.07
5 Years (Annlzd)	6.34	4.43	5.17
10 Years (Annlzd)	7.40	4.00	6.25
Jan-10 – Dec-23 (Annlzd)^^	10.42	4.31	9.40

	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)
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
2023	10.01	8.80	8.01	18.22	18.11	8	1.41	4,956.3	720.0

^^ 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. Standard deviation is not applicable (N/A) for any period if fewer than five accounts are in the composite for that period. (See footnote 5)

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 December 31, 2023. 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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