

Federated Hermes Unconstrained Credit Fund

Celebrating three years



During a turbulent three years we have navigated global credit markets to deliver strong risk-adjusted returns for our clients.

A new era of fixed income investing

The fixed income investment landscape has changed. The profound shift in debt capital markets over recent years means that investors can no longer rely on the standard long-only approach to deliver the same strong returns that have typically been associated with the asset class.

Three years ago, we launched the Federated Hermes Unconstrained Credit Fund with the aim of generating capital growth and a high level of income over the long term. To achieve this, we adopted an approach that was not constrained by traditional benchmarks or traditional ways of investing, and sought to give investors access to the global liquid credit spectrum. This approach has allowed us to capture superior relative value, amid changing investment conditions, by using the full spectrum of credit instruments.

Performance

We sought to maximise long-term total returns by combining unconstrained, high-conviction credit selection with a hedge against adverse market conditions. By investing on a 'through-the-cycle' basis, and maintaining an element of dynamism and nimbleness, we have delivered on this objective for our clients.

Figure 1. Delivering strong risk-adjusted returns since inception

Annualised performance (%)	Three years	One year
Federated Hermes Unconstrained Credit Fund	8.66%	10.94%
Morningstar peer group median for Global Flexible Bond (USD hedged)	5.31%	7.89%

Rolling year performance, net (%)

	31/05/20 to 31/05/21	31/05/19 to 31/05/20	31/05/18 to 31/05/19	31/05/17 to 31/05/18	31/05/16 to 31/05/17
Federated Hermes Unconstrained Credit Fund	10.94	8.84	6.25	-	-

Past performance is not an indicator of future returns. Performance shown is the F share class US Dollar Accumulating net of all costs and management fees since seeding on 30 May 2018. Subscription and redemption fees are not included in the performance figures. Source: Federated Hermes as at 31 May 2021. Morningstar Peer Group Median for Global Flexible Bond is sourced from Morningstar as at 31 May 2021.

By managing risk and company and security selection, we achieved these returns during the volatility of the last three years: from the market sell off triggered by US-China tensions in the fourth quarter of 2018 to the Covid-19 lockdown of 2020. The flexibility of the fund's mandate allowed us to exploit valuation anomalies during these periods while also avoiding the riskiest parts of the market.

Protecting capital in challenging times

The fund's derivative overlay comes to bear during the most meaningful periods of market stress. The overlay seeks to provide a level of downside protection to the fund and gives our managers the confidence to go into a dislocated marketplace and buy opportunities at their most attractive prices.

Here's how this flexibility benefited us during the most turbulent period in the last three years.

Q1 2020 – Pandemic shock (Lockdown)

The coronavirus outbreak forced governments across the world to lockdown their economies, and the inevitability of recession wiped billions of dollars off global market in the most alarming sell-off since 2008.

Against the looming crisis, the economic shock was compounded by a collapsing oil price and a mass offloading of risk assets. Fixed income markets were subject to considerable volatility as investors sought to reverse any risk-on positioning within the asset class.

In the US, investment grade credit spreads hit the widest level since 2008, rising from 99bps to 373bps in just 22 days.

How we responded

“ We actively adjusted the derivatives overlay as the market moved downwards, taking profit on positions and ensuring the strategy had a degree of protection should the market continue to sell off. As spreads widened and derivatives moved into the money, we took profit and rolled positions into a longer dated, bigger notional, further out of the money contracts. Active management of the derivatives book allowed us to crystallise profits. Total contribution of the hedge overlay to the Unconstrained Credit Fund over the period was 9.35% on a gross of fees basis, whilst the Global High Yield index fell -14.38%, gross of fees. ”

Andrew Jackson, Head of Fixed Income

¹ Source of market data: Bloomberg

² Source: Federated Hermes, 31 March 2020

Overview of investment process

With a combined experience of over 40 years, the strategy's portfolio managers Andrew Jackson, Head of Fixed Income, and Fraser Lundie, Head of Credit, have managed a spectrum of funds during downturns and crises. Together, their vast experience alongside the diversity of our fixed income team acts as a key differentiator, enabling us to offer investors a dynamic credit-allocation solution that captures value from credit markets as investment conditions change.

Our investment process is designed to harness the increasingly globalised and diverse nature of the asset class as it continues to evolve.

We employ a rigorous and repeatable relative-value investment process that is driven by security selection across the entire capital structure of a business. Through top-down analysis, we determine the fundamentals and return expectations of the different regions and sectors. We also look at which parts of the market are interesting or less interesting on a risk-reward basis in terms of sectors, geographies, and sub-asset classes across the spectrum. And we will look to allocate capital accordingly. These findings form the foundations of our disciplined, bottom-up research which involves identifying issuers with attractive credit risks and which securities provide superior relative value.

From a bottom-up perspective, our process has been 17 years in the making. It involves a credit picking process, in which we take names through the Credit Committee and score them on their credit, value, sustainability, and related credentials, to come to an overall view on the credit. By focusing on the broad spectrum of debt instruments across the global investment universe, we uncover more stock-picking opportunities outside of the two largest markets of Europe and the US. We believe that our broader, more global approach allows us to deliver superior returns throughout the key phases of the cycle.

As well as deciding on the best credit segments and individual securities to invest in, the team also decide how much credit risk to take on through the strategy's derivative overlay. Overall risk appetite is governed by the monthly Multi Asset Credit Investment Committee (MACIC), chaired by Andrew Jackson. The MACIC seeks to garner input from all aspects of the fixed income universe and outside fixed income with the aim of delivering an appetite for risk that is in tune with risks in the economy and markets at large.

ESG – An investment imperative

Because we believe that non-fundamental factors are inexorably linked to credit risk, we are committed to integrating and pricing ESG risks in our investment decisions. To this end, analysts assign ESG scores to all credits covered. Our ESG assessment focuses on the impact that issuers' ESG policies and behaviours have on cash flows and, consequently enterprise value. Our ability to assess and price ESG risks is enhanced by the significant resources within the broader Federated Hermes International business including the engagement and stewardship teams within EOS and our own, specialist fixed income engagement team. We believe that ESG integration is critical to our ability to achieve sustainable long-term outperformance at an acceptable level of risk.

Along with our experience, other notable differentiators include:



Looking ahead

Looking towards the future, we continue to see plenty of opportunities for alpha beneath the surface of credit markets, and we stand by our conviction that a dynamic, unconstrained approach to credit investing is the best way for investors deal with the challenges on the horizon. With low volatility in markets, we will continue to make use of attractively priced credit options within our derivative overlay to provide a level of protection should the unexpected occur. The combination of these factors leaves us confident in our ability to deliver on our investment objective, despite low market yields.

Risk profile

- Past performance is not a reliable indicator of future results.
- 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.
- Targets cannot be guaranteed.
- It should be noted that any investments overseas may be affected by currency exchange rates.
- This information does not constitute a solicitation or offer to any person to buy or sell any related securities or financial instruments.
- Where the strategy invests in debt instruments (such as bonds) there is a risk that the entity who issues the contract will not be able to repay the debt or to pay the interest on the debt. If this happens then the value of the strategy may vary sharply and may result in loss. The strategy makes extensive use of Financial Derivative Instruments (FDIs), the value of which depends on the performance of an underlying asset. Small changes in the price of that asset may cause larger changes in the value of the FDIs, increasing either potential gain or loss.

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Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes now form the international business of Federated Hermes. Our brand has evolved, but we still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important new strategies from the entire group.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

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