Royal London Asset Management

Considering ESG factors in cash and government bonds

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The effective integration of ESG factors in government bond markets is still in its infancy relative to other fixed income markets. A 'green bond' market is starting to develop in government bonds, which is likely to become more prevalent. We will monitor these developments carefully, although such bonds might fall foul of some of the problems with corporate green bonds, including a lack of visibility over both the use of proceeds and the source of cash which services coupon repayments - both of which should be green.

Otherwise, we use our market position to engage with issuers. We have regular contact with senior figures at the UK Debt Management Office (DMO) to address potential issues and concerns. We also hold occasional one-to-one meetings with representatives from other DMO entities for countries including Australia, New Zealand, Canada and Sweden.

We are also increasingly considering ESG factors when evaluating our exposure to financial counterparties. Applying high standards of corporate governance to banks aligns closely with the interests of clients. For example, we have concerns about Chinese banks as many are ultimately owned and controlled by the Chinese government, which is less transparent and investor-friendly than other ownership and regulatory regimes. While we do lend to Chinese banks, we restrict the maturity and hold much smaller percentages than similarly-rated financial institutions.

Considering ESG factors in cash funds

Many of our cash fund clients have strong beliefs about how their funds are invested. This can be for a variety of reasons, from strong ethical beliefs at an institutional level to concern about reputational risk and bad publicity. As a result, this sector of the market is more advanced in considering ESG factors.

Charities, in particular, have been subjected to media scrutiny about their investments. In the past, this sometimes seemed rather unfair, given the investments were often managed by institutions on an arms-length basis. However, with greatly increased awareness about ESG factors, it is incumbent on trustees and treasurers to be more aware of how their funds are invested.

The RLAM Responsible Investment team gives ESG guidance and specialist input across our funds, including our cash funds. This is an important differentiator compared to some of our competitors.

Ethical cash

For the cash range, in the first instance, we apply screens that can be broadly seen as 'ethical'. Companies that generate over 10% of their turnover from either one or a combination of the following categories are excluded as standard:

- fossil fuel extraction
- armaments
- tobacco

While the exclusion of fossil fuels was previously offered to clients with segregated portfolios, we introduced it as standard across our pooled funds earlier this year.

Governance

Governance is arguably the element of ESG investing that has been mainstream for longest. It came to prominence following the global financial crisis in 2008 as investors started to appreciate that good financial and corporate practices depended on shareholders exercising their responsibilities. Initially driven by risk aversion, it has since developed to be a more positive process: well-managed companies are less likely to hit problems but, if they do, they tend to react better to a crisis.

In cash funds, applying high standards of corporate governance to banks aligns closely with the interests of clients. Most treasury investors aim to strike the right balance between liquidity and security, with investment return (yield) an important, but secondary, consideration. Yet, there are well-known examples of compelling returns exerting a hypnotic effect.

We prefer to identify such risks in advance. Very few clients, we imagine, would be attracted to the yield pick-up offered by Cyprus-based banks with strong Russian connections. However, prior to the financial crisis, the risks of Icelandic banks were less obvious, yet had dire consequences for clients that were attracted to yields that were 'too good to be true'. Of course, it's easy to be wise after the event. As I've said, an example of our current thinking is our approach to lending to Chinese banks.

Our investment process

The investment process across our range of cash and ultra-short duration bond solutions utilises our strength in credit research overlaid with a macro bias and ESG integration. In addition to screening out companies that generate over 10% of revenues from tobacco, armaments and fossil fuel extraction, we also apply ESG scores to all our investments and, on an ongoing basis, we engage with organisations to enhance corporate performance to the benefit of investors.

The investment process across our range of cash solutions mirrors the approach we take within our credit and rates portfolios. Although the cash suite generally focuses on short-dated instruments this is not a reason to ignore the structure, covenants, ESG principles and longer-term financials of the institutions in which we invest.

This structured analysis creates a well-diversified portfolio that should benefit from a lower probability of default and downgrade. The combination of assets backed by security and the role that ESG plays in strong financials helps to ensure less portfolio price volatility and greater liquidity in times of market stress.

Furthermore, we use other factors to mitigate risk while optimising returns for our clients:

1. **Low volatility**
   Our bottom-up investment process means we build our portfolios security by security, and have an in-depth understanding of each and every bond. This, combined with long-term thinking, means that we are committed to the instruments we buy; and, independent of day-to-day fluctuations, we are confident that the yield at which each is bought will be realised.

2. **Bank Recovery and Resolution Directive (BRRD)**
   During the financial crisis, in the UK alone, £1 trillion of taxpayers' money was used to bail out ailing banks. To protect taxpayers from a repeat of these events and promote the stability of the financial system, the BRRD was passed in the UK in January 2016. This ensured that in the event of a future bank failure, bond holders rather than taxpayers would stand as guarantor; the bank would be 'bailed in'. 'Bail ins' represent significant risks for bond holders investing in banks unless precautions are taken. One of the benefits of RLAM cash portfolios is the allocation to covered bonds. Covered bonds offer protection to bail-in risk as these bond promises are ring-fenced and cannot be used if a bank were to run into difficulty.

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Summary

Many clients overlook the 'ethical' considerations of cash investing, but there is no longer any excuse not to consider ESG factors. We firmly believe that in-depth credit research focusing on security and investing in firms with a strong ESG ethos is fundamental to delivering strong returns for our clients.

(An earlier version of this article was published in *The evolution of responsible investing: Integrating ESG into fixed income portfolios* in November 2020. You can read the full report here)

Investment risks

The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

The views expressed are the authors' own and do not constitute investment advice.

Contact us

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