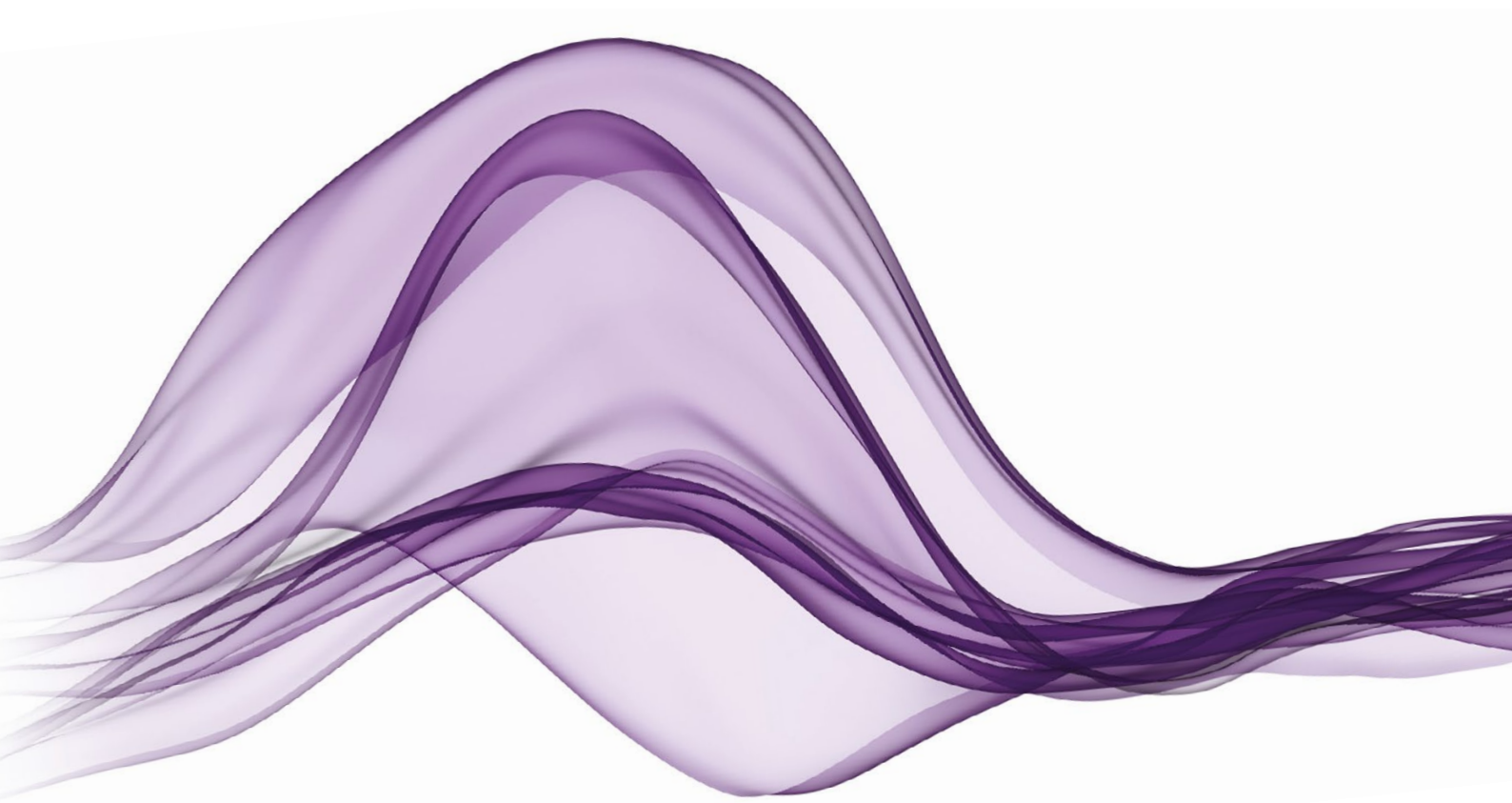


For professional clients only, not suitable for retail investors.

The evolution of responsible investing

**Integrating ESG
into fixed income portfolios**





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KEY POINTS

- Royal London Asset Management (RLAM) is a leader in responsible investing and it is a core part of our firm-wide investment philosophy. We believe that this will enhance returns, reduce risk and improve outcomes for clients over the long term.
- Understanding the terminology of responsible investment and how the different elements fit together is crucial. Using energy transition as an example, we explain how asset owners can identify clear and coherent ESG goals to inform their investment approach.
- Responsible investing is constantly evolving, however, so asset owners must keep up with new developments in regulation and across different asset classes.
- We consider the challenges and opportunities of applying environmental, social and governance (ESG) analysis to fixed income investing. In particular, we explain why the impact of ESG risks on credit is different from equities.
- Risk is integral to investment returns. Active managers are well placed to exploit the inefficiencies that good ESG analysis can highlight – the key is identification, measurement and mitigation.



Piers Hillier

Chief Investment Officer

Piers joined RLAM in January 2015 as Chief Investment Officer, with responsibility for managing and developing RLAM's investment capabilities. He has over 25 years of investment experience, including roles as Head of International Equities and a member of the Strategic Policy Group responsible for setting Asset Allocation for multi asset portfolios at Kames Capital. Prior to this, he was CIO and Head of Asset Allocation for LV= Asset Management and previously CIO European Equities for WestLB Asset Management. He also previously held the position of Head of European Equities at Deutsche Bank and Schroders. In his current role, Piers is a director of Royal London Asset Management Ltd, a member of the RLAM Executive Committee, and chairs the RLAM Investment Committee. He holds a Bachelor's degree from the University of Bristol and Masters degree from the University of Oxford.

“Asset owners need to understand why responsible investment is different for equities and credit.”

Introduction

Responsible investing has moved very firmly into the mainstream over recent years. There are many reasons for this, including increased awareness of climate change, environmental damage from plastics, societal awareness of inequalities, the importance of good corporate governance, and the power of the internet to influence and mobilise consumer action.

From an investment perspective, it has also become increasingly clear that responsible investment can boost returns, by giving managers an ‘informational advantage’ over traditional funds. Then there is stakeholder interest and legislation: asset owners are under increasing pressure to ensure that their assets are managed ‘responsibly’.

RLAM is a leader in responsible investing. Through our acquisition of The Co-operative Asset Management (TCAM) in 2013, we took on its responsible investment team and range of sustainable funds, including the Sustainable Leaders Fund (launched in 1990) and the Sustainable Diversified and Sustainable World Funds, which celebrated their 10th anniversaries last year. TCAM had blazed a trail in responsible investment, and was a market leader in mixed-asset sustainable funds, combining equities and credit.

RLAM took up this torch and we have been increasingly integrating responsible investing factors into our investment thinking over the last seven years. The direction of travel is clear and we are pleased that more asset owners are considering ESG factors. However, we're a little frustrated by some of the more questionable marketing it has

generated as asset managers with limited credentials have launched ‘me too’ funds.

We are wary of ‘greenwashing’, whether cynical or resulting from the naivety of enthusiastic latecomers. Both are unhelpful to asset owners and the asset management industry alike, particularly those of us that have invested over many years to build specialist teams, and develop and integrate coherent processes. The key, however, is to continue to develop our expertise in responsible investing and to help our current and prospective clients to understand the landscape, so they can make informed decisions.

We are confident that our high-quality approach will be recognised by asset owners following our excellent results in the 2020 PRI – Principles for Responsible Investment assessment report, which highlight that we are best-in-class for our strategy and governance around responsible investing, and for ESG integration into listed equities and fixed income. This is testament to the fact that being good stewards of our clients’ capital is incorporated into everything we do.

Demystifying the terminology

You could be forgiven for struggling with all the different terminology, not least as the newly-fashionable status of responsible investing has led to some blurring of definitions. Distinct investment approaches have been stretched and blended to appeal to a wider investor base. Even without this, asset management companies consider the sector differently: there is limited consistency in approach and terminology.

The aims of this report are to:

- clarify our use of this terminology and explain the relationship between the different elements
- help asset owners to understand how to develop a responsible investing approach by appreciating the key issues
- explain why fixed income (and investment grade credit, in particular) is a very different asset class from equities from a responsible investing perspective.

This last aim is particularly important at this time. While there is still some way to go, responsible investing is more established in equities: investment processes and data have improved significantly. Fixed income lags some way behind, however, largely because of poor/non-existent data and far less understanding of how ESG factors might affect issuers and individual bonds.

While responsible credit investing is still relatively immature, our strength in credit markets means we have been looking at it for some years, not least through our mixed-asset sustainable funds. It is the biggest area of potential development. Asset owners need to

understand why responsible investment is different for equities and credit, and how managers can't simply read across from equity ESG analysis when investing in credit markets.

An evolving process

I should say up front, however, that while we have been considering these issues for many years and have integrated many of the ideas into the investment processes for our various asset classes, we don't presume that we've got responsible investing perfectly right.

There are still areas that we are wrestling with and expect this to go on for some time

yet as definitions, data and the industry's understanding continue to evolve. While we would ideally wish to resolve all these challenges before talking to you, this is unrealistic. Besides, we believe that your perspectives are crucial and the synthesis of our experience with your insight is more likely to produce the best outcome in the long run.

Wherever you are on the responsible investing journey, we hope that you find this report helpful in informing your approach and identifying how best to achieve your investment goals. To hear more about our approach or to discuss your specific challenges, please speak to your contact at RLAM.





Ashley Hamilton-Caxton
Head of Responsible Investment

Ashley joined RLAM in November 2013 following the acquisition of The Co-operative Asset Management (TCAM) by the Royal London Group. She is responsible for coordinating and overseeing RLAM's approach to responsible investing across all of our asset classes. She has management responsibility for our company engagement, corporate governance analysis, and proxy voting. She is RLAM's spokesperson on responsible investing and corporate governance, and provides regular press commentary. Before joining RLAM, she was a Shareholder Engagement Executive at PIRC where she conducted corporate engagement and ESG analysis for the Local Authority Pension Fund Forum (LAPFF). Prior to that she was a research analyst and corporate engagement consultant for SHARE, a proxy voting and shareholder engagement consultancy based in Vancouver, Canada. She has a Master of Arts degree (Political Science) and a Bachelor of Arts degree (Political Science and Sociology) from the University of British Columbia.

“ We believe that being a responsible investor will enhance returns, reduce risk and improve outcomes for clients over the long term. ”

The responsible investment landscape

The challenge for asset owners who are relatively unfamiliar with responsible investing is the apparent complexity of the terminology. It seems that there are endless definitions, many of which sound very similar, that have to be understood before sense can be made of the whole picture.

Unhelpfully, asset managers and commentators each define these terms differently, or wrongly use them interchangeably. The lack of a common language and framework to describe different approaches has been a key barrier to the development and promotion of responsible investment in the UK. This is why the UK Investment Association's (IA) consultation on responsible investment resulted in the publication in November 2019 of its Responsible Investment Framework Report (figure 1).

The IA Framework has introduced a degree of consistency between asset managers that is beneficial to pension funds and other asset owners. However, it is now at risk of being usurped by an unrelated parallel initiative. Asset managers are now trying to understand how the EU's Sustainable Finance Disclosure Regulation (SFDR) might affect us, particularly given Brexit, and how it dovetails with or contradicts the IA's framework (see article 'Regulation is coming' – page 10).

As Piers Hillier says in the introduction, one of the aims of this report is to clarify from our perspective the terminology of responsible investing, and to explain why the different elements matter. This will necessarily involve some definitions,

although I will try to keep these to a minimum and confine the details to an appendix (see Appendix III – page 36).

The key is not to be blinded by the terminology and to understand how the terms interact to support the overall approach. However, whether addressing complex financial concepts or responsible investing, the onus is on us to be clear and speak plainly. We hope this report meets this standard.

Where it started

One way to understand responsible investment is to consider its origins. Ethical investing has its roots in religious beliefs, with Quakers and Methodists believing that investment should be aligned with a person's moral and ethical beliefs.

Modern ethical investing grew meaningfully in the late 1980s during apartheid when some investors led a campaign to stop investing in companies with ties to South Africa. During this time we also saw the rise of so-called 'green funds', driven by the growing environmental movement, and funds based on exclusions, i.e. screening out companies with a high environmental impact (e.g. oil and mining companies) or social harm (tobacco companies, arms manufacturers).

Ethical investors are interested in investing according to their own values. It is often believed that there is a trade-off between financial returns and achieving a social or moral benefit, and that by limiting your investment universe you are limiting your return potential. This is why

ethical investing and its various derivations have struggled to gain mainstream acceptance in the last 30 years.

Into the present

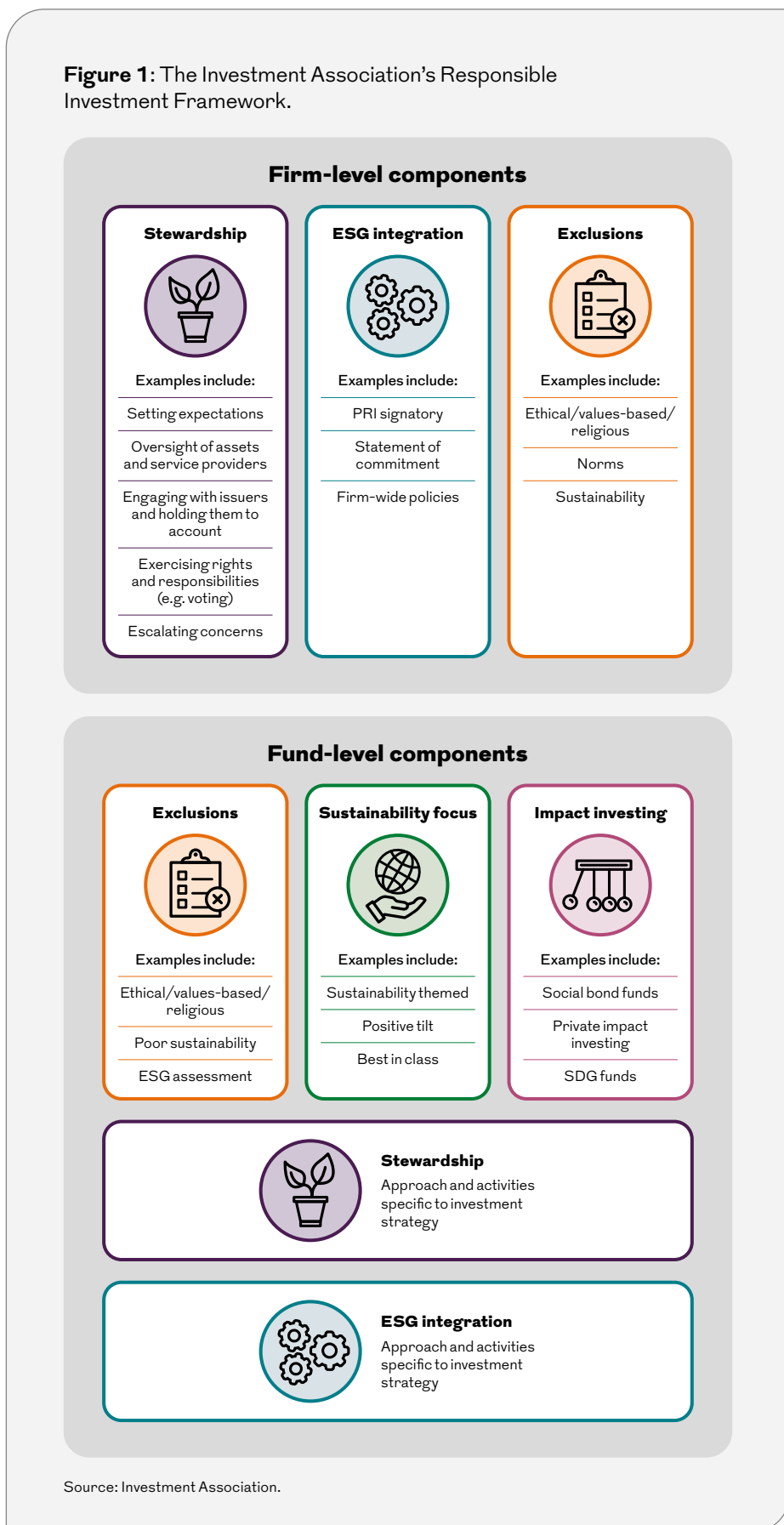
While today’s concept of responsible investment grew out of the ethical investment movement, it is substantially different. Responsible investing is arguably more sophisticated and focused on investment risk in addition to social and environmental harm. It is less about making moral or ethical judgements, and more about channelling capital to companies that manage their businesses better. There is a fundamental belief that returns from funds that implement responsible investment are at least as good, if not better, than funds where responsible investment factors are not considered. Finally, there is a significant emphasis on being good stewards of clients’ capital and using our power as investors to advocate for change to company behaviour. This means engaging with company management on a regular basis on environmental, social and governance (ESG) issues, and exercising our voting rights as either shareholders or bondholders.

RLAM’s approach

At RLAM, responsible investment is a core part of our firm-wide investment philosophy. It is applied to all funds, strategies and approaches (figure 2). We believe that being a responsible investor will enhance returns, reduce risk and improve outcomes for clients over the long term. It involves two central commitments to our clients that:

- we are trustworthy and will act in their best interests
- our investment teams consider and incorporate material ESG issues into their investment process

Figure 1: The Investment Association’s Responsible Investment Framework.



Crucially, it does not require all RLAM funds to adopt the same approach. While we have a single clear philosophy, in practice there is no magic formula that works across all strategies. Each asset class has distinctly different qualities and risk and return profiles, so it would not be realistic or sensible to seek to create a blanket approach.

We have several tools that we use to implement our approach to responsible investment. The first is stewardship – our commitment to engage with companies, regulators and standard-setters, and to review governance and vote at shareholder and bondholder meetings. It is our fiduciary duty to be good stewards of our clients' capital, and that means ongoing monitoring of companies and issuers before and after we invest. However, we also believe that active engagement and advocacy will produce positive outcomes for shareholders, society and the environment.

The second tool set is ESG integration – how we consider and incorporate ESG issues into our investment processes and our decision to buy, hold, sell or over/underweight a security. For RLAM, this involves a firm-level commitment to integrate ESG considerations into investment decisions, including both risks and opportunities.

Responsible investment

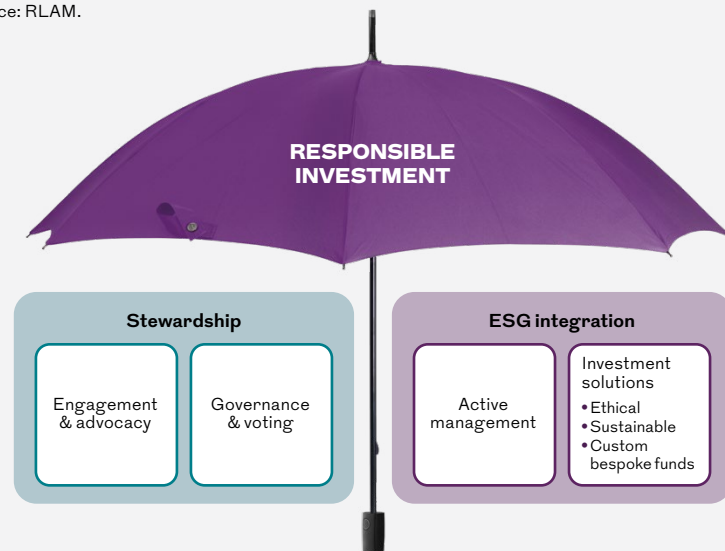
Investing clients' money in a responsible way, taking account of material environmental, social and governance (ESG) risks, and implementing our stewardship responsibilities.

ESG integration

The systematic and explicit inclusion of ESG factors into investment analysis and investment decisions.

Figure 2: RLAM's approach – 'responsible investment' is the umbrella term for our approach to ESG integration and stewardship, which covers all of our investment teams, strategies and funds.

Source: RLAM.



ESG integration must be fund- or strategy-specific to be effective. For example, fund managers may make adjustments to their discounted cash flow models, include an ESG factor within their quantitative security scoring methodology, adjust their bull/bear scenarios, or make qualitative judgements on balance sheet sustainability, management quality or investment risk.

We are pleased that our work to establish an effective company-wide responsible investment philosophy has been recognised in the 2020 PRI – Principles for Responsible Investment assessment report. This is the largest global reporting project on responsible investment, which evaluates practices and compares peers across a number of modules. This year, we've moved up from A to an A+ in strategy and governance, listed equity incorporation and fixed income corporate non-financial. We received A scores across the other five modules and our score was higher than the median across all categories.

This is very strong external recognition of our efforts to manage investments in a responsible way for the benefit of our clients.

Choosing the best approach

With so many different terms, definitions and approaches to responsible investing, it is important to have a clear framework for understanding which approach is best. We find the framework opposite (table 1) helps clients to assess their options, and ensure they find a fund and fund manager that is aligned with their core priorities.

RLAM's approach is to offer a variety of funds and strategies to meet different clients' responsible investing needs. We also work closely with our clients to design custom solutions. For example, we are currently considering how we can achieve a 'net-zero carbon' sterling credit portfolio, designing ESG-tilted equity funds and catering for client-specific exclusion criteria.

Table 1: RLAM’s approach to responsible investment solutions

Investment strategy	Ethical/exclusions	Responsible	Sustainable
Client goal	To avoid investing in companies or activities that are not aligned with certain beliefs or values (i.e. weapons, tobacco)	To consider ESG risks and opportunities in the investment process, and use company engagement and voting to reduce risk and improve investment outcomes	To align investments with long-term sustainability trends, i.e. to build an inclusive, sustainable and resilient future for people and the planet
RLAM definition	Explicitly prohibits investing in a particular company, sector, business activity, country or region	Investing client’s money in a responsible way, taking account of material ESG risks, and implementing our stewardship responsibilities	Seeks to invest in companies that meet sustainability criteria or deliver sustainable outcomes through the products and services they provide and/or their business conduct
RLAM example	Ethical Bond Fund Cash funds	Sterling credit Global credit UK equities Global equities Passive equities	Sustainable funds (equity, credit and mixed-asset funds)
	Bespoke client solutions		

Summary

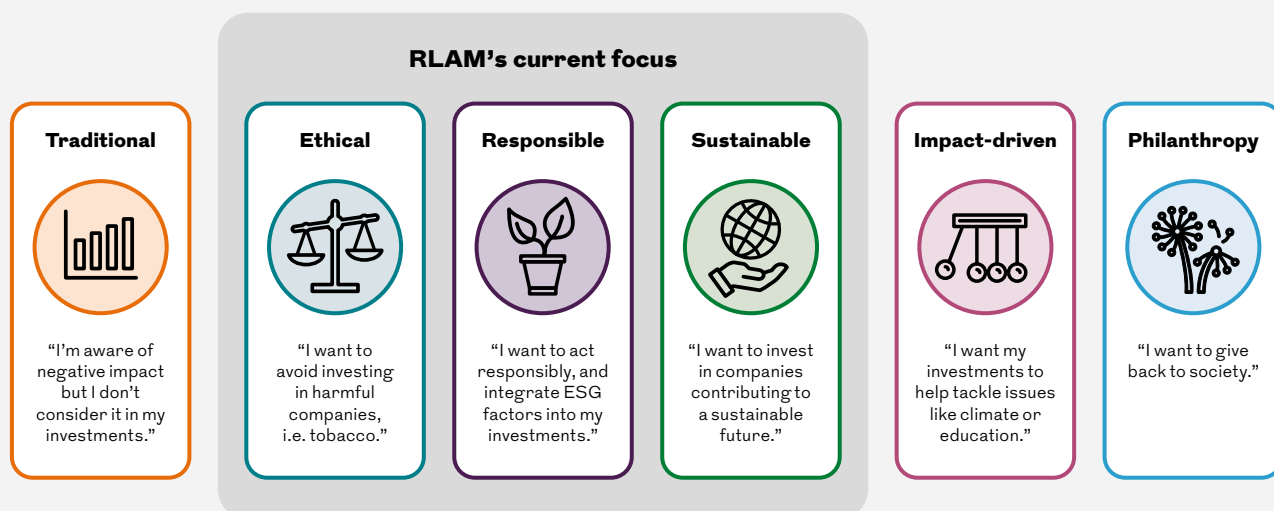
Responsible investment trends are evolving rapidly. We have been pleased to see our clients asking more and more detailed questions about responsible investment, ESG integration, engagement and voting. They are also demanding sophisticated funds, analytics and client reports. We are working hard to make sure we continue to have the capability to meet these demands, and very much view our clients as our partners on this journey.

I hope I have demystified some of the terminology and set out a clear framework for understanding responsible investment and its various components. We know that this can be confusing for clients.

The rest of this report will explain how asset owners navigate tricky stakeholder and regulatory requirements, and discuss in detail how ESG integration can be applied in fixed income – an area of growing interest.

Figure 3: Values-based investing – a spectrum of approaches.

Source: RLAM.



For definitions and examples, please see Appendix III (pages 36-37).

Regulation is coming

Greenwashing

Creating a false impression that a product is environmentally sound or exaggerating claims that a product has superior environmental qualities. Investors can be accused of greenwashing if they are selling investment products labelled as 'green', 'sustainable' or 'responsible' without being able to substantiate their claims or demonstrate how their investment process is truly differentiated from 'non-sustainable' or 'non-green' funds.

Investor confusion around responsible investing and the growth of 'greenwashing' has sparked calls for greater oversight and regulation. The IA has responded to help clear up terms and definitions in the UK by launching its Responsible Investment Framework. The framework was built on Global Sustainable Investment Alliance (GSIA) definitions which have been established for over a decade. RLAM has modelled its terminology on the IA Framework.

However, new regulation coming from the European Union (EU) is likely to rewrite the rule book. In recent years, the EU has made a clear commitment to transition to a sustainable economy. As part of this, a key objective is to channel private investment into projects that will aid the transition to a low-carbon economy. To incentivise this, the European Commission put together a Sustainable Action Plan that consists of several different regulatory streams relating to ESG issues.

Two major pieces of legislation, the EU Taxonomy and the Sustainable Finance Disclosure Regulation (SFDR), have emerged out of the Action Plan and will have significant implications for the investment industry.

The **Sustainable Finance Taxonomy Regulation** set out criteria for determining whether an economic activity is environmentally sustainable or not. The taxonomy is intended to provide businesses and investors with a common language to identify

economic activities that can be considered environmentally sustainable (or 'green'). It obliges financial market participants and large public-interest entities to make statements about how their financial products and activities align with the taxonomy. Standardising the concept of green or sustainable investment across the EU is intended to facilitate greater investment in environmentally sustainable economic activities, furthering the aims of the EU Sustainable Action Plan.

An activity will be deemed to be environmentally sustainable if it meets the following four criteria:

- It contributes substantially to one or more environmental objectives or is an 'enabling' activity
- It does not significantly harm any environmental objectives
- It is carried out in compliance with minimum safeguards
- It complies with technical screening criteria

The Sustainable Finance Disclosure Regulation (SFDR) is a related regulation which seeks to promote the integration of sustainability risks into investment processes and the disclosure of such risks to investors. The new regulation applies to fund managers, pension providers, MiFID investment firms and credit institutions, collectively referred to as 'financial market participants'. It also applies to financial advisers with three or more employees, including certain insurance

intermediaries and those involved in the provision of investment advice. Details were first published in December 2019 and most of the new obligations are due to come into force in March 2021.

The regulations will oblige financial market participants to publish information about the following:

- the integration of 'sustainability risks' in managers' investment decision-making processes
- a due diligence policy explaining the principal adverse impacts of its investment decisions on sustainability factors, or explaining why it does not consider such adverse impacts or when it intends to do so
- a remuneration policy detailing how the policy is consistent with the integration of sustainability risks
- assessing the likely impacts of sustainability risks on the return of each financial product, including how any benchmark index referenced is impacted; or explain why sustainability risks are not deemed to be relevant to a particular product.

The Taxonomy Regulation has already entered into force, and the SFDR is still under consultation with implementation planned for early 2021. As the new requirements are both very specific and far-reaching, asset managers are still trying to understand the impact of these new requirements on their investment products and client disclosures. In the UK, Brexit provides an additional layer of complexity that investors must navigate.







Carlota Garcia-Manas
Senior Responsible
Investment Analyst

Carlota joined RLAM from the Church of England National Investing Bodies, where she spent three years running high-profile corporate engagements focused on climate change, international corporate tax and board diversity (among others). Before this, she was the Director of Products and Services at a tech start-up (Datamaran, formerly eRevalue) where she led the research team to develop software for sustainability benchmarking. Prior to that, she spent 10 years and was Head of Research at EIRIS (now Moody's following its merger with Vigeo) where she led global ESG research and product development. Carlota has a deep interest in analytics and the integration of externalities (environmental and social) in corporate assessment. She uses techniques learned during her business development and sales role at eRevalue in her company engagements. Carlota is a Civil Engineer with an MSc in Environmental Economics.

“ [If you sell] fossil fuel assets at a discount and invest in renewables at a premium, are you acting in your beneficiaries' best interests? ”

Setting informed and coherent ESG goals in energy transition

Beyond investment beliefs, asset owners face further challenges in identifying clear and coherent ESG goals to inform their investment approaches. There are no straightforward answers: these are subjective and can involve balancing competing requirements, some of which are fiduciary. Notable challenges can include ambiguous goals and the pressure that can be exerted on decision-makers by stakeholders with different agendas.

At RLAM, we are used to navigating these various challenges, and helping clients to understand which questions to ask and what the various answers might involve. While asset owners must ultimately make the best decision for their specific circumstances, a coherent framework is helpful to inform this process.

In this article, I will focus on **energy transition**, although the same process can be applied to other ESG goals. Clients can express an interest in becoming carbon neutral, net zero or divesting fossil fuels – understandable aims, but very different. It can be necessary to have a detailed discussion to understand the thinking behind an apparently straightforward goal.

Which problem are we trying to solve by divesting fossil fuels?

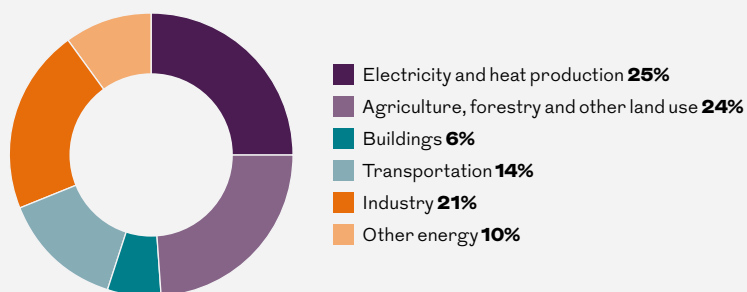
In the first instance, it is useful to understand the issues raised by fossil fuels. They are necessarily finite and will eventually run out, which would have huge societal implications. Over the decades,

this has led to increasingly ambitious exploration and production techniques, which pose significant environmental risks. Then there is the direct environmental impact of burning fossil fuels, namely the production of greenhouse gases that is contributing to climate change.

Net zero or carbon neutral?

These terms are often used interchangeably, but while similar, they are not the same. In Article 4 of the Paris Agreement, in order to achieve the long-term temperature goal set out in Article 2, parties aim to reach global peaking of greenhouse gas emissions as soon as possible, recognising that peaking will take longer for developing countries, and to undertake rapid reductions thereafter in accordance with best available science, so as to achieve a balance between anthropogenic emissions by sources and removals by sinks of greenhouse gases in the second half of this century. 'Carbon neutral' is a less precise term that permits offsets and is not necessarily aligned with Paris as defined in the PAS 2060 Standard:

- PAS 2060 allows offsets, while 'net zero' only allows certain forms of Greenhouse Gases Removals (GGR) in certain instances.
- PAS 2060 requires a carbon reduction plan (though no specific level of ambition is prescribed), while net zero requires a reduction target aligned to a 1.5°C science-based target.

Figure 4: Greenhouse gas emissions by economic sector.

Source: IPCC (2018).

Figure 4 shows that there are four major sources of greenhouse gas emissions: energy production, industrial processes (particularly steel and concrete production), transport, and agriculture and forestry. Buildings are a small, but distinct, category. Attention tends to fall on what governments and regulators can influence, hence the focus on the energy production, industrial and transport sectors. There is very little discussion at a policy-making level on agriculture and forestry.

Government policies have largely focused on reducing emissions from energy generation and industry, and transport. These have been reasonably successful. In May 2019, the UK recorded its first coal-free week of electricity generation since the 1880s; three weeks later, it recorded its first coal-free fortnight. The government intends to phase out coal-fired power plants by 2025 – a target that would have seemed impossible just a few decades ago.

For the most part, the switch away from coal has been possible because of gas-fired power stations. These produce just over half the amount of greenhouse gases as coal – a considerable improvement, but still not

enough. Otherwise, nuclear, wind and other alternatives (such as biomass, solar and hydro) make up the rest of the mix. Encouragingly, recent tenders for offshore wind generation required government guarantees of c. £50/megawatt hour, compared to £90 for nuclear and £60 for coal and gas if built today. The arguments for renewables are now as much financial as emotive. Beyond 2025 when coal generation ends, gas generation is set to decline, albeit slowly, while renewables grow.

It may appear that the argument against solid fossil fuels has already been won in some markets, but that is far from the case. This brings us back to what asset owners might aim for around fossil fuels and decarbonisation. As examples, excluding extraction is straightforward and excluding oil and gas producers or mining companies is easy. In an environment where electrification supports multi-sectoral decarbonisation, utilities can present more of a problem – questions here might include:

- Do you want to exclude companies that are industry leaders in shifting to renewables from fossil fuels, but may still have legacy assets?
- What do you do about gas pipelines¹ and electricity transmission wires?

- If you adopt a black-and-white approach, selling fossil fuel assets at a discount and investing in renewables builders or operators at a premium, are you acting in your beneficiaries' best interests? Furthermore, is this the optimal solution for the environment?

Further challenges arise in considering companies that generate a material share of their revenue from supplying oil and gas producers, mining companies or carbon utilities. As I've said, there are no straightforward answers to these questions. However, understanding the regulatory framework, drawing on academic studies and considering the societal impact of transition will help to identify a solution that is realistic, measurable and actually addresses your specific goals.

Net zero – the framework

The endgame for global emissions initiatives is to reach global peaking of greenhouse gases as soon as possible and to undertake rapid reductions thereafter to balance anthropogenic emissions with greenhouse sinks.

The basis for the current global approach is the Paris Agreement that was signed in 2016 within the UN Framework Convention on Climate Change. Its central goal is to keep the increase in global average temperature to well below 2°C above pre-industrial levels; and to try to limit the increase to 1.5°C to reduce the impact of climate change. While the US will leave it in November 2020, in practice it has already changed policy in some areas contrary to the Paris Agreement.

Despite its central role in getting climate change on the global policy map, however, the goals of the Paris Agreement were further accelerated by

the 2018 Intergovernmental Panel on Climate Change (IPCC) Special Report. Where the Paris Agreement set the goal of being net zero in the second half of this century, additional research suggested that the only way to avoid irreversible damage to the planet is to be 'net zero by 2050'. Around 80 countries, including the EU member states and Canada, have committed to this more demanding target: in the UK, it falls under the government's Green Finance Strategy.

Some see 2050 as unambitious and call for accelerated targets that aim for net zero in 2040 or even 2035. As things stand at present, without unforeseen technological developments, I believe 'net zero by 2050' is a stretch target that sensibly balances urgency against cost and an orderly transition, particularly in developed economies. Shifting this balance could have unintended negative consequences for society, which could fall disproportionately on the most vulnerable.

In addition, with any target, the devil is in the detail – it may be possible for a company, city or asset owner to be 'net zero by 2035', but this may involve real-world decisions that are negative for the planet. An example could be divestment: if the practical action is to sell an asset and transfer it to a less responsible owner or operator, is this really a positive outcome?

The power of engagement

In considering an effective responsible investment approach, it's crucial to consider not just integrating ESG factors into investment decisions, but also stewardship – namely active engagement and voting. While asset owners will ultimately set the direction of travel as they are closer to the

fiduciary responsibilities owed to their beneficiaries, at RLAM, engagement is a core aspect of our responsible investment approach. Engagement strongly supports energy transition: our approach has three key elements:

- 1 We focus on aligning companies' strategies with the 'net zero by 2050' goals.
- 2 Transition means gradual change, balancing different factors such as cost and urgency.
- 3 'Close, not sale' – avoiding just making these someone else's problem

'Close, not sale' is crucial to achieving the goals for the economy as a whole – we prefer to work with a company to realise the value of Paris-consistent assets and/or to shift over time to different resources or methods, as opposed to divesting and shifting the problem elsewhere. For example, pressuring a company where we hold shares to sell energy assets to a company where we don't (and hence cannot influence how those assets are managed) is not, in our view, effective responsible investment. Better to hold the assets and encourage the company to manage them better and then, at the right time, close them safely and responsibly.

Academic studies confirm that engagement can be effective, across the range of ESG issues, not just energy and climate change. In the Oxford University Press's (OUP) Review of Financial Studies² it has been shown that strong engagement works in terms of information discovery and influence. Its success, however, is influenced by holding size among other factors, so collaboration between investors is important.

While asset managers can be guilty of listing their responsible investment 'credentials', such as signing the UN Principles for Responsible Investment, including Sustainable Development Goals, or their membership of Climate Action 100+ (CA100+)³, these initiatives are genuinely important in setting goals and achieving change through collaboration. However, these are mainly focused on equity ownership as company law and corporate governance give shareholders primacy over bondholders.

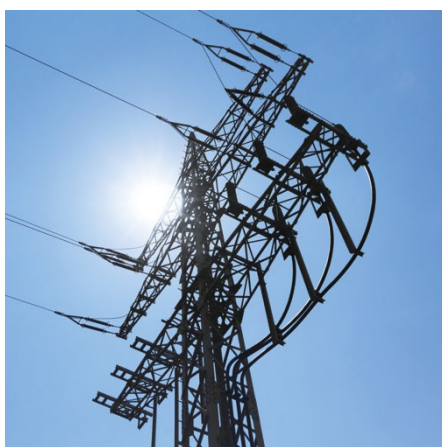
At RLAM, we look at our total holding across all asset classes when engaging with companies. We believe that engagement is a key enabler for the aspirations of the Paris Agreement and the IPCC 1.5°C 2018 Special Report, and consider the regulatory requirements from governments, the interests of asset owners and their stakeholders, and the actions of companies that comprise the global economy. Done well, it can also mitigate negative unforeseen consequences, as identified by the Just Transition initiative. This advocates a fair and thoughtful transition that addresses social impacts, such as employment re-skilling needs and the impact on vulnerable communities.

We are encouraged that more and more companies are committing to be 'net zero by 2050', including global energy companies. Meanwhile, Microsoft has pledged not only to be carbon neutral by 2030, but also to remove all of its historical carbon emissions by 2050 – this is not only eye-catching marketing, but these corporate efforts can mobilise the technological changes required to make the UK economy net zero as a whole by 2050.

Ongoing challenges

Any investment approach around energy transition must acknowledge that there are two sides to the issue – supply and demand. Selling mining or power generation assets will not alone meet the decarbonisation goals without changes on the demand side. At RLAM, we have considered downstream energy impact from electricity and gas transmission networks to the energy efficiency of buildings, engaging with utility infrastructure owners and property companies.

Without the major technological changes, such as those implied by Microsoft's pledges, however, we must accept that there will be practical limitations to carbon reduction – some industries, such as cement and steel production, airlines and shipping, will continue to have considerable carbon footprints for the foreseeable future. The only way to accommodate these 'hard-to-abate' sectors, in a decarbonisation pathway, is to increase negative emissions in planting trees or forestry management, or to improve carbon capture, utilisation or storage. These are still very expensive, but are expected to become more competitive over time, for example through subsidies until they're



commercially viable. To focus minds on efficiencies, governments have at their disposal a number of tools including carbon taxes, regulations, licences to operate and fines for breaches.

Without such measures and the changes they can enable, asset owners will have to decide whether to invest in inherently carbon-producing sectors or companies, or whether to focus only on 'cleaner' sectors. Again, this will depend on their fiduciary duties – not a straightforward issue if some are financial and others are rooted in societal considerations.

Externalities have historically proved difficult for companies, asset managers and asset owners to assess, but identifying and integrating ESG considerations into investment decisions should help to address this. We suggest that asset owners can protect themselves and their beneficiaries by keeping ahead of regulatory changes and the scientific evidence by being informed, but also to be proportionate in their decisions – again, this reminds us that engagement is likely to produce better outcomes than divestment.

In our view, despite the progress of the Paris Agreement and its subsequent refinement by the IPCC 1.5°C 2018 Special Report, the biggest challenge facing society, in the absence of technological alternatives, is the lack of political traction in the UK and globally. Policy remains piecemeal and often incoherent, with subsidies being changed for financial reasons. The financial costs of the Covid-19 pandemic might exacerbate these pressures, combining with a push for economic recovery that is driven by deregulation. The lack of an international framework is particularly challenging for global companies.



Summary

Hopefully this article has explained some of the challenges that asset owners can face in setting goals to inform their investment strategy. In considering just decarbonisation, we have considered some crucial questions. There are many others, across the different facets of responsible investing and environmental and social impacts.

Asset owners could feel alarmed that there are so many factors to consider and apparently straightforward solutions, such as divestment, could make matters worse, not better. If so, at RLAM we have been considering these issues for years, and have the resources and expertise to help to identify the best solution to meet fiduciary responsibilities and to serve the interests of beneficiaries.



Martin Foden
Head of Credit Research

Martin joined RLAM at the start of 1998. He initially joined RLAM's UK Equity Team, with responsibility for analysing the transport, business services and construction sectors, as well as managing balanced pension funds. This experience greatly enhanced RLAM's credit research capabilities when he joined the Fixed Income Team at the beginning of 2003. Since moving to the Fixed Income Team, he has been instrumental in developing RLAM's analytical process through the advancement of the team's cashflow forecasting and evaluation of issuer structures. Martin has a degree in Industrial Economics from Nottingham University.

“Credit risk and return is asymmetric, and it is the impact rather than the origin of risk that matters.”

Applying ESG analysis to sterling credit: challenges and opportunities

Our approach to ESG in credit has always been built on a longstanding investment philosophy that credit markets do not accurately price idiosyncratic risk. We use ESG analysis in the same way as any other form of credit research – to uncover information that credit rating agencies and other market participants might be missing, helping us to make better investment decisions for our clients and deliver excess returns.

From this origin, it can be unhelpful to contrive a false distinction between ESG and credit analysis. The former is not an adjunct to the latter and we firmly believe that our best research is undertaken through interaction and collaboration. It feels artificial and counter-productive to be territorial about the source of the risk, when all that really matters is its identification and impact. Anything matters that is likely to impair expected returns for clients. And if it can be observed, it should be mitigated.

Practically, ESG integration into our credit analysis framework reflects our primary role as long-term lenders of our clients' money, in the first instance, rather than short-term traders of bonds. Given the asymmetric nature of credit risk and return, the sustainability of our lending position is therefore most critical. As active investors of our clients' assets, we target our risk identification and engagement most intensively on those sectors where we feel there is most ESG risk and, as is often the case, there is limited third-party ESG research.

We find this turns the real challenge of poor and unfocused ESG data available in the market into the real opportunity of enhanced information discovery.

Consider long-tenor and high impact sectors like utilities, where there is not a lot of third-party research due to typical ownership structures. With limited differentiation in terms of the price of debt, not least due to the influence of rating agencies, whose processes require them to fixate on the most immediate credit risks, truly targeted ESG analysis is critical in terms of reducing risk without compromising portfolio returns.

Bonds are different from equities

The separate articulation of ESG investing started as an equity construct and much of the data and analysis used today is still centred in equities. Discussion around ESG integration in fixed income is less established and perceived best practice is continually evolving. What is clear to us, however, is that simply replicating the approach taken by equity investors, while convenient for the manager, is sub-optimal.

On the one hand, it ignores the fact that in credit markets we can lend to the same company in many different ways, such as lending to a ring-fenced part of the company or its subsidiaries, or secured over specific assets. This idiosyncrasy

is one of the most exciting attributes of corporate bonds for active investors and should be embraced, rather than ignored as an unhelpful inconvenience. On the other hand, third-party data coverage is constrained, as only around 40% of the bonds in the sterling credit index have a public equity profile. Not only does a focus on companies with a public equity listing greatly reduce the opportunity set, it is also the very area of the market where information dissemination is already most efficient.

Our response to this is straightforward. Based around an understanding that, unlike with equities, credit risk and return is asymmetric, and it is the impact rather than the origin of risk that matters, there is, arguably, no asset class to which sustainability is more important than credit. We address poor quality third-party data provision by having an in-house Responsible Investing team, and embrace idiosyncrasy through bespoke and bottom-up credit and ESG analysis. A common ethos and

complementary experience across the teams ensures risk identification is never territorial and is effectively enhanced through collaboration.

The importance of a research-based investment and engagement process

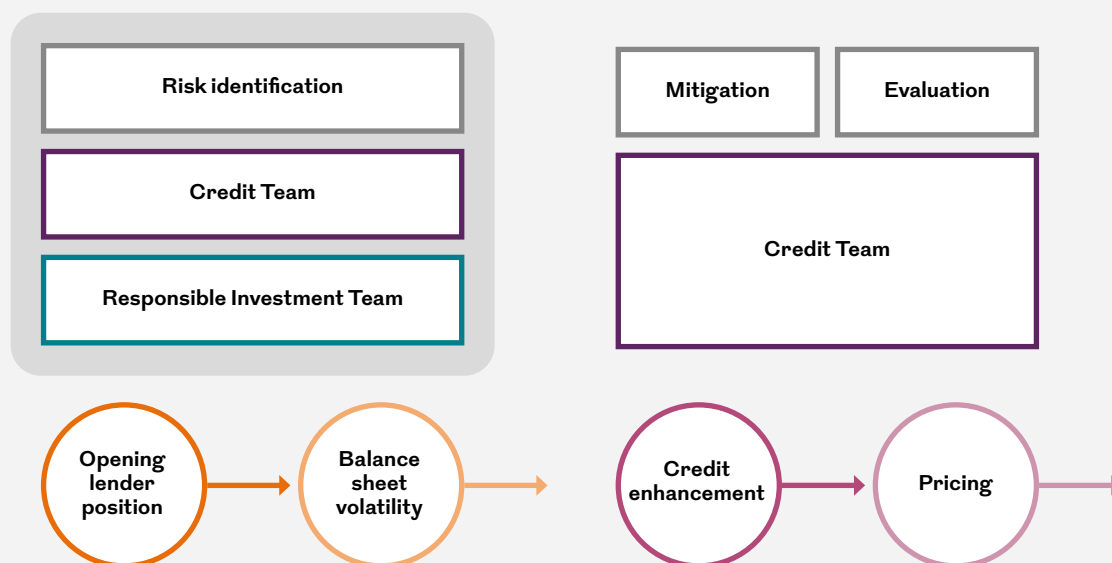
As credit investors, we believe it is extremely difficult to outsource effectively the analysis of ESG risks to third parties. As well as the limited scope of equity-based platforms, the apparent simplicity and convenience of a spoon-fed ‘ESG score’ often fails to capture the vagaries of the real world and the sheer idiosyncrasies of credit. We know this inefficiency well from the role of credit ratings in the market: while broadly helpful, the over-distillation of information into one rating creates distortions that active investors can exploit. Ratings agencies give an opinion at a point in time, but active managers have to assess an issuer’s progress.

The only credible solution is thorough, bottom-up fundamental research and an investment process that acknowledges the false distinction between traditional credit and ESG analysis. However, while ESG analysis needs to be intrinsic to the process to be credible, achieving this in practice is not easy.

At RLAM, effective collaboration between our Responsible Investment and Credit teams is a vital component of our initial and ongoing risk identification, which then allows our Credit team to evaluate and mitigate the credit risk (see figure 5). Our approach allows each team to feed in to the research process based on their particular expertise and experience; our Responsible Investment team will provide an assessment of the quality and credibility of an issuer’s ESG impact, to understand where the risks and opportunities may lie within a business model prior to investment, and follow this up as information changes.

Figure 5: Honing the integrity of lending decisions.

Source: RLAM.



Our Credit team will then incorporate this analysis into their ongoing assessment of the relative value of the credit, including how the materiality of these factors may be mitigated by our lending position in a company's capital structure and the price we need to be paid for the overall credit risk. The collaboration between these two teams improves information discovery and dissemination, but getting the right decision-making sequence is key. Ultimately, the final decisions to buy or sell and portfolio positioning are still made by fixed income specialists, given their experience of evaluating and mitigating credit risk.

Our long-established credit philosophy is to focus on the sustainability of our issuers' balance sheets given the skewed nature of credit risk and return. We believe that our core philosophy and considerable experience of credit investing provides an excellent

framework for administering a truly bond-centric ESG approach.

From an engagement perspective, our collaborative approach to research provides the perfect bedrock for appropriate issuer engagement. At a general level, we find it instructive to understand the unavoidable subordination of our control compared to the equity holders of a business. Often, the most significant influence we have is during the initial structuring and pricing of new bond issues. The reality is that unless you have pre-emptive rights in the legal contract, then a major point of influence has passed. More than 50% of our typical credit portfolios have such pre-emptive controls, through strong covenants and security.

From this base, which reflects the economic realities of being creditors rather than owners, we are able to target our issuer and thematic engagement

following an established framework where the impact is greatest and the scope for influence is genuine. Our most successful and informative recent engagement projects (for example, see Appendix II 'Gas utilities in a net-zero economy' page 34) have all shared some key characteristics, being debt-centric, high impact and truly additive to portfolio decision making.

ESG and ABS

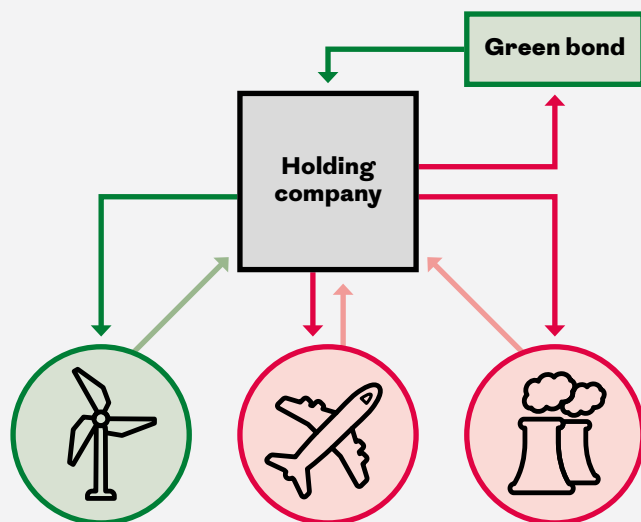
Our particular approach is specific to us and ensures the integration is not discordant with the way we have managed credit portfolios over many cycles. For instance, we have invested in secured bonds and asset-backed securities (ABS) for decades, valuing the additional credit protection provided and sheer diversity of mispriced opportunity; and this is another reason why our focus needs to extend beyond the narrow confines of unsecured corporates with publicly-listed parent companies. If third-party ESG data is limited across corporate bonds, it is virtually non-existent for ABS, further motivating us to make our integration bespoke and bottom-up.

In practice, this means that for a residential mortgage backed security (RMBS) we may examine the underlying lending policies and practices of the bank writing the mortgages, including the processes for dealing with arrears and default events. We also consider how this relates to the specific make-up of the pool, such as placing greater scrutiny over a lender's governance and oversight framework if the pool contained a greater proportion of interest-only or high loan-to-value lending.



Figure 6: Typical structure of a green bond – arrows indicate cash flows.

Source: RLAM.



Similarly, for a commercial mortgage backed security (CMBS), we consider the ESG performance of the underlying assets. These assets can vary from City office buildings to retail parks or industrial units. We also now regularly engage with new issuers prior to investing to understand how they are managing their environmental impact. In particular, we are interested to understand how they are preparing their assets to cope with climate change and its potential impact on asset life and sustainability of cash flow.

We are also encouraged that certain issuers are now building explicit ESG-related covenants (such as on cladding on student and hotel properties) into bond documentation. Our Credit Research team is expert at understanding the strength of these covenants and whether they can protect our clients' capital against potential risks or minimise financial losses in the case of a default.

Are green bonds a silver bullet?

Perhaps the area of fixed income ESG that has garnered greatest acceptance is the issuance of labelled bonds; encapsulating green, social, sustainable and, even, transition bonds. At one level, the concept is beyond reproach. As a bridgehead to get investors and issuers considering and elevating critical societal issues, they have undoubtedly been a success and the market has delivered exponential growth in issuance. Equally, as the most convenient and widespread way for managers to demonstrate their ESG credentials to asset owners, our credit analyst DNA forces us to be sceptical.

Given the vast majority of labelled issuance is unsecured, our principal concern is the lack of direct control and visibility over specific use of proceeds and then, in return, the cash flows servicing the debt. As cash is fungible,

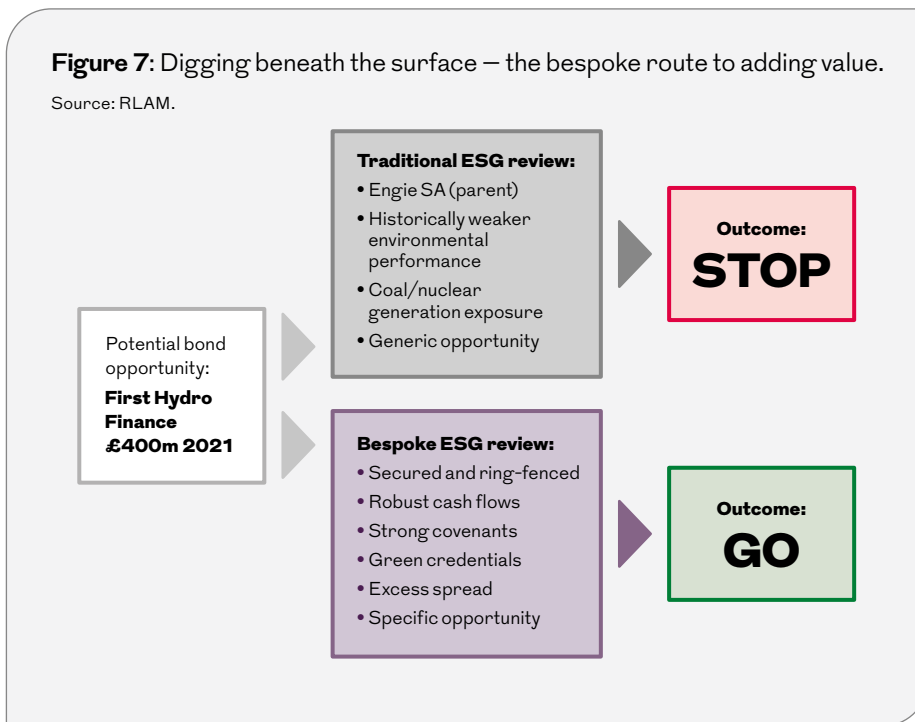
limiting your assessment to the individual bond and taking the label at face value precludes the very real risk that the buyer is simply freeing up resources to finance other, potentially less wholesome, assets and businesses. In extremis, the green bond you purchased to finance a new, environmentally-friendly asset simply becomes a 'bond' if that issuer underperforms and loses control of the asset to other preferential creditors.

Sub-optimal by design, possibly even more challenging is the notion that these bonds can trade through intrinsic fair value as investors overvalue both the label and the easy win it provides for client reporting. Being cynical, it's hard not to conclude that the European property company, with questionable governance practices, issuing a green bond to purchase a portfolio of existing but 'green' properties, or the gas distribution company that issues a transition bond to fund expenditure that is a near-term requirement of the regulatory license to operate, have realised the funding cost benefit of the label.

“ The apparent simplicity and convenience of a spoon-fed 'ESG score' often fails to capture... the sheer idiosyncrasies of credit. ”

Figure 7: Digging beneath the surface – the bespoke route to adding value.

Source: RLAM.



“ The only credible solution is thorough, bottom-up fundamental research and an investment process that acknowledges the false distinction between traditional credit and ESG analysis. ”

Equating a portfolio’s ESG efficacy to its weightings in labelled bonds feels like a distraction and we prefer to focus on the overall ESG performance of our bonds beyond any spoon-fed prescription. Indeed, the credit market provides real opportunities for end investors to access critical and socially strategic sectors and issuers that are not accessible to equity investors. We think it is much more compelling, for instance, to focus on our ability to directly fund affordable housing and environmental infrastructure, and earn appropriate economic returns for our clients.

Positively, the market’s preference for convenience generates opportunities for active managers who are prepared to put in the hard work to understand a company’s overarching sustainability, or search for bonds secured on specific green assets to embed these bonds into portfolios without compromising achievable yields.

An example of one such bond is First Hydro Finance 9% 2021, which is an unrated, off-benchmark bond issued by a subsidiary of French company, Engie (see figure 7). As an electricity generator with some non-renewable capacity, the parent company may have a poor ESG rating. However, its subsidiary, First Hydro, generates hydro-electric power in Snowdonia and has a far better sustainability assessment. In addition, the bonds are secured, with strong covenants and ring-fenced assets and cash flows. The attractions of a bond that may fail a traditional ESG credit screen only become apparent under our more bespoke and integrated credit and ESG approach.

The emergence of presentational contrivance and ESG gimmicks as easily-accessible tools for investment managers to convince the world of their ESG credentials, risks distracting from the fundamental reasons that make

responsible investment so important. Ultimately, it is vital that ill thought-through and clumsy integration of ESG analysis does not constrain opportunity in a misguided attempt to diminish risk. By contrast, effective and authentic integration can only be beneficial in improving the integrity of lending decisions and, as a consequence, the sustainability of clients’ portfolios.

Integrating ESG into credit analysis – the hidden costs of the path of least resistance

Such is the regulatory-sponsored clamour for asset managers to demonstrate their ESG credentials to their clients, a range of new and accessible tools and processes are emerging in credit markets with remarkable alacrity. While capital markets have an unerring ability to deliver ‘solutions’ to meet investor need, history suggests that they often favour convenience and near-term scalability over authenticity.

Credit, when done right, is the most idiosyncratic of asset classes, making ESG integration, and its articulation, more challenging. And with things accelerating so fast, it seems sensible to us to pause momentarily and check that the path the industry is mapping out means we will arrive at the right destination – ensuring more responsible and sustainable outcomes for asset owners.

Labelled bond issuance (i.e. ‘green bonds’) is mushrooming and yet does not necessarily provide effective control and visibility for investors over proceeds. It is also observable that in a number of cases, investors are paying up for the privilege – lower return for worse outcomes doesn’t sound like responsible active management.

Equally, it is easy for investors to digest and report ultra-distilled ESG scores from a wide range of third-party data providers – yet coverage of bond indices is limited and centred on the highest profile issuers. Not only does this ignore the necessity for bespoke ESG analysis to get to the heart of bond specificity, but also risks anchoring investors to the most expensive and commoditised parts of the credit universe.

Meanwhile, the bond rating agencies are finally coming to the party by formally encapsulating ESG analysis into their ratings. Yet, as ever, they remain constrained by their methodologies and focus on short-term credit impacts. Clearly, the potential impact of poor governance is most immediate, but

can a credit rating that purports to distil credit worthiness for the next 12 months really be an effective way to capture the nuance and tenor of social and environmental risks? With the development of these handy tools for investors a purpose has definitely been served; but is it the right one?

At RLAM, what we will not do is compromise on the key cornerstones of our integration because it may be harder to enact and explain. Quite simply, if not necessarily conveniently, we favour a ‘business as usual’ and non-territorial focus on risk identification by our credit analysts and Responsible Investment team working in unison, with an undiluted focus on bond structure and specific bond obligors. Any material risk that can be observed and can impact sustainable cash flow generation and asset life, irrespective of origin, has to be evaluated and mitigated, for our lending decisions to have integrity.

We emphasise pre-emptive control in our portfolios, but need to supplement this with targeted engagement where the impact is greatest and the scope for influence is genuine. We may buy labelled bonds, but if we are paying for ESG ‘additionality’ it has to be tangible and demonstrable.

In addition, recognising the need for our clients to discharge their obligations on the assets they own, we provide a reporting package that blends quantification with context. We can offer more-tailored carbon foot-printing than is currently achievable from third-party providers, but always urge clients to review our quarterly ‘Fixed income & ESG integration’ reports that allow us to delve into the nitty gritty of our bond-specific analysis and engagement.

The clamour for ESG product and outputs will continue to intensify. With managers currently engaged in an ESG arms race to demonstrate their credentials, unless we define and plot the right path, focusing on the authenticity of any integration, the industry runs the real risk of losing sight of the right destination.



Azhar Hussain
Head of Global Credit

Azhar has 24 years of direct experience of investing in an array of strategies across the Global Fixed Income and Leveraged Finance arenas. He trained as a chartered accountant with Deloitte before starting his investment career as a high yield credit analyst at Gulf International Bank. He subsequently became Head of Corporate Debt being responsible for IG & HY absolute and relative return strategies. He left to join Insight as Head of HY & Leveraged Loans before joining RLAM, initially as Head of Global High Yield, where he has successfully launched funds across the Global HY & Multi Asset credit strategies. Azhar holds a BA in Economics & Law from SOAS, University of London and recently obtained an MSc in Behavioural Science from LSE.

“ Tailored research is far superior to ‘off-the-shelf’ data or reports as it can address whether ESG progress is real or cosmetic. ”

ESG and global credit

Our Global Credit team covers the euro and dollar investment grade credit and global high yield markets, and our multi asset credit (MAC) strategy. The emphasis has been to create a team of diverse experience and expertise, as this brings a better challenge. However, we all share an overarching belief that you have to research and understand every bond or loan that you are going to add to a portfolio. To do this properly, there are no shortcuts. We have recently added significant resources to the team’s research capabilities.

A tailored view

The high yield market is less homogenous than the investment grade universe. A lot of high yield bonds and loans originate from companies that are not listed on equity markets. So the ‘off-the-shelf’ research that is available for many listed companies isn’t an option and research has to be bespoke. This applies to ESG analysis as much as traditional financial analysis. While our team is comfortable with some aspects of ESG research, changes in this area make having a specialised team essential.

As a result, we work closely with the Responsible Investment team to integrate ESG analysis into our research and investment processes. Considering ESG risks ensures strong corporate citizenship and integrity, and provides longer-term sustainability of cashflows from the companies in which we invest. We place a particular emphasis on governance. For unquoted companies, we have to have a degree of trust in the reported numbers, and the importance of the quality and integrity of management and owners cannot be overstated.

Two core principles have guided the integration of ESG factors into our research and investment processes:

1 Engagement, not avoidance

Our preference is to engage with companies with poorer ESG practices. We don’t use exclusions because they tend to avoid weaker ESG-ranked companies, often with no consideration of the financial trade-off. Collaboration between the Responsible Investment team and credit analysts enhances information discovery and analysis, and supplements third-party data where quality and coverage is often low.

2 Rigorous financial impact assessment

ESG analysis gives us an additional perspective on our traditional credit analysis. We recognise that governance issues may pose the greatest near-term financial risk to companies in global credit and particularly high yield markets, while environmental and social issues may have longer-term regulatory impacts.

Our rigorous credit research process leads to an overall internal score, which incorporates nine fundamental factors (e.g. free cash flow, growth prospects, etc.). As one of our nine factors, ESG issues can move the rating in our internal model up or down one notch. We work closely with the Responsible Investment team to investigate and understand any significant ESG risks, but the final investment decision resides with the fund manager and takes into account relative valuation.

Collaboration in action

Our Responsible Investment team has reviewed all of our bond holdings in the energy and chemical sectors. The difference between the best and worst ESG performers is marked. For instance, when looking at oil exploration companies, some are trying to reduce the environmental impact of their operations by running their rigs on renewables where possible, and are transparent about boardroom pay and the like. Others are trying to drill in more controversial areas such as the Arctic and are less willing to discuss governance with investors.

This sectoral research demonstrates how ESG factors are a key element in our investment process. It highlights the differences in how companies are addressing ESG factors and hence the relative risks that bond holders are taking. As investors, we want to make sure we are properly rewarded for these risks in each investment.

Tailored research is far superior to ‘off-the-shelf’ data or reports as it can address whether ESG progress is real or cosmetic. ‘Green washing’ – where PR and marketing can suggest that a company’s ESG credentials are stronger than is the case – is not widespread, but is something to look out for. As integrated ESG analysis becomes increasingly prevalent, the pressure on laggards to green wash could well increase.

Some companies are now issuing green bonds, which state that the proceeds raised will be used for green activities, such as the generation of renewable power. But, however convenient, a label cannot replace fundamental bottom-up ESG analysis. We are also cautious about the financial attractiveness of some green bonds given that there is high demand and low supply. This is why we like to use our in-house Responsible Investment team to search out other green opportunities that may not have the ‘green’ label.

More to come

ESG factors are still not universally looked at or talked about. Companies are generally offering more information and clarity – both on what they are currently doing and what their plans are for the future – but there is more to come.

When I’m asked why we have integrated ESG analysis into our investment process, my answer is always: “Why wouldn’t you?” ESG analysis is clearly not a fad and its potential contribution to performance is significant. An oil company with lax health and safety protocols is at greater risk of an accident that could cost billions of dollars to clean up and with subsequent fines and damages. A consumer products company or retailer reliant on low-paid or child labour could see demand for their products collapse overnight. The power of social media to organise consumer action cannot be underestimated – better to head off such problems in advance with thorough research.

As a bond investor, the upside is almost always less than the downside – if a company goes under, we lose everything, but if a company does really well, we still only get the coupons and repayment of principal as promised. So looking for those risks that can really hurt a company makes sound financial sense.





Craig Inches
Head of Rates and Cash

Craig is Head of Rates and Cash at RLAM, responsible for the management and oversight of RLAM's Rates and Cash business. He works closely with Paul Rayner (Head of Alpha Strategies Rates) and the Rates team to manage a suite of solutions ranging from enhanced cash through sovereign and global bonds culminating in absolute return. Prior to RLAM, Craig was an investment director with Scottish Widows Investment Partnership, where he gained extensive cash and fixed income experience. Craig has an MSc in Investment Analysis from Stirling University, a BSc (Hons) in Actuarial Mathematics and Statistics from Heriot-Watt University and is an associate of the UK Society of Investment Professionals (CFA UK).

“ 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. ”

Considering ESG factors in cash and government bonds

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 highlighted by Martin Foden (see page 19).

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.

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.

As well as applying ESG factors to our portfolios, we can help clients to optimise their treasury portfolios by assessing treasury needs against different time and risk considerations. We call this process 'laddering' – its considerations and merits are described in the article from July 2019, *Making treasury cash work harder* (see rlam.co.uk).



Tom Johnson
Responsible Investment Analyst

Tom joined the team as a Responsible Investment Analyst in May 2018, to work on the implementation of RLAM's responsible investment strategy and to provide support on company screening and corporate governance. Prior to this, Tom spent nearly three years working in Royal London's group press office, focusing in particular on the asset management business. Tom holds a BA in Politics and Philosophy from Cardiff University.

“ Arguably, the key long-term environmental risk for any physical asset is how it might be affected by climate change. ”

ESG integration: what's that coming over the hill?

At RLAM, we've long understood that integrating ESG analysis into fixed income comes with nuances not seen in equity markets. As Martin Foden describes (see page 16), where and how you lend to a company means the top-down, equity-led approach of third-party data providers has significant flaws. This has informed our bespoke, credit-specific approach to ESG factors, complementing our 'regular' credit analysis. However, as fixed income markets begin to adapt to ESG, we're considering what ESG integration in credit might look like in future.

Know the score

We have resisted assigning to a credit issue a simple score or rating for ESG factors. Just as with credit ratings, ESG ratings would not be a panacea and would necessarily involve compromise and inefficiencies.

Taking corporate governance as an example, each company might have to comply with one or more national corporate governance code, the disclosures required by listing rules in markets where they print, investor expectations and their owner's preferences. Boiling that down to a number or letter that applies regardless of your position as a creditor in a capital structure is overly reductive, particularly if comparing the bonds against industry peers operating in other jurisdictions.

Despite this, with the mainstream credit rating agencies, third-party data providers, index providers and

consultants all seeking to impose frameworks, there is likely to be more standardised data to meet these needs. Issuers overwhelmed by the array of different frameworks will look for common standards, as we are already seeing in the UK's social housing sector. The more astute issuers and their advisers now routinely publish key data points and information.

The scope and trajectory of such data, however, particularly in areas such as carbon emissions, environmental management and safety, will demand further scrutiny. For social factors, better assessment of transparent industry-specific datasets such as complaints will need to be supplemented by a more nuanced understanding of each issuer's approach. The deluge of additional data will require credit investors to ask more searching questions of issuers.

A related development will be enhanced ESG reporting, for example on the carbon footprint of a portfolio. This is only feasible for equity funds at present because of the lack of reliable data for fixed income assets, but as data improve, asset owners will be able to see how their portfolios compare to the market. The wider availability of these data will drive further changes in asset owners' expectations and requirements.

Look who's talking

Our experience in engaging with fixed income issuers has tended to fall into one of three camps. For companies whose shares are publicly traded, the experience of engaging to get more information and insight is no different from that of shareholders. Secondly, some privately-owned businesses used to credit investors only asking them about leverage, costs and cashflows have been very eager to discuss ESG factors. This has applied to both leaders and laggards, who have been keen to understand our approach and the information that we use.

A small third group, however, has tended to be less willing to engage with bondholders about pay, independent oversight or their environmental or social policies. We expect this to change as engagement becomes an increasingly vital tool in integrating ESG into fixed income. Who we're engaging with will also change.

Traditionally, bond roadshows have been fronted by finance teams, occasionally supplemented in recent years by the 'sustainability expert', brought in to talk through those slides. We expect that leading management teams will be able to explain how their sustainability agenda is genuinely integrated into their business model, turning to a specialist only for more detailed questions.

A renewed interest in corporate governance might also see bond investors demanding more from independent directors usually used to dealing with shareholders. However, where governance is weak, engagement achieves limited results or (as is the case for plenty of securitised bonds) where there is no traditional board to speak

of, investors will continue to need other ways to ensure that they can mitigate these risks.

Let's get physical

One of the core tenets of RLAM's credit analysis has always been an assessment not just of who is repaying us, but protections we might have if they do not. Secured and securitised bonds come with a claim, either directly or through a loan over assets owned by the borrower. Whether it's a portfolio of telephone exchanges, hydroelectric dams in North Wales, a luxury London hotel or UK residential mortgage loans, the collateral often ties back to physical properties. Therefore, understanding the environmental risks and opportunities for those assets is vital.

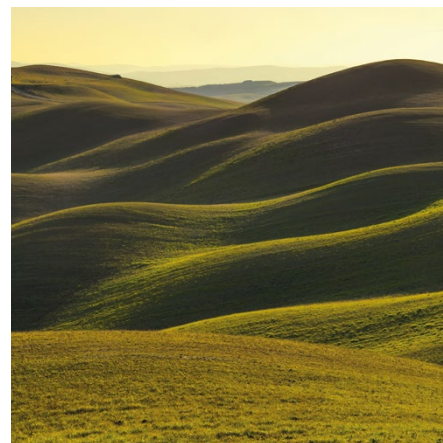
We already assess the environmental profiles of a range of bonds tied to commercial property, where Minimum Energy Efficiency Standard (MEES) legislation means that less energy efficient properties need to be upgraded or may no longer be suitable for rent. In light of the Grenfell Tower tragedy, we routinely ask issuers focused on social housing, student accommodation and other residential properties to highlight any potential cladding risks and ensure that these are properly mitigated.

Arguably, the key long-term environmental risk for any physical asset is how it might be affected by climate change. Extreme weather events don't discriminate against the properties they might damage. So, for commercial mortgage-backed securities (CMBS) deals, which tend to be focused on a smaller number of properties, our Responsible Investment team already uses public flooding

information to scrutinise new CMBS portfolios and challenge issuers where risks are elevated. Last year, we reassessed a bond secured against port infrastructure, including how it was planning for rising sea levels.

The current challenge is how to assess areas such as residential mortgage backed securities (RMBS) where we might be exposed to thousands of loans secured against different properties. Manually checking each of these is obviously impractical, so our Responsible Investment team is working with some of RLAM's quantitative analysts to devise an effective solution.

We are exploring the broader impacts of climate change on credit. Investors are generally aware of the polluting impact of fossil fuels. However a 'net-zero' economy means that energy networks and transport assets will have to go through major transformations, and we are continuing to focus on this space.



Summary

It is now clear to most investors that responsible investment isn't a fad that will drop out of favour in the next bear market. Indeed, as a bellwether, the RLAM sustainable funds performed particularly well in the recent market weakness that resulted from the Covid-19 lockdowns and the subsequent recovery.

A combination of the clear performance benefits from the informational advantage that it has over traditional investing, and pressure from stakeholders and regulators alike to ensure that assets are managed responsibly to meet climate change targets and other ESG goals, means that responsible investment will continue to gain traction.

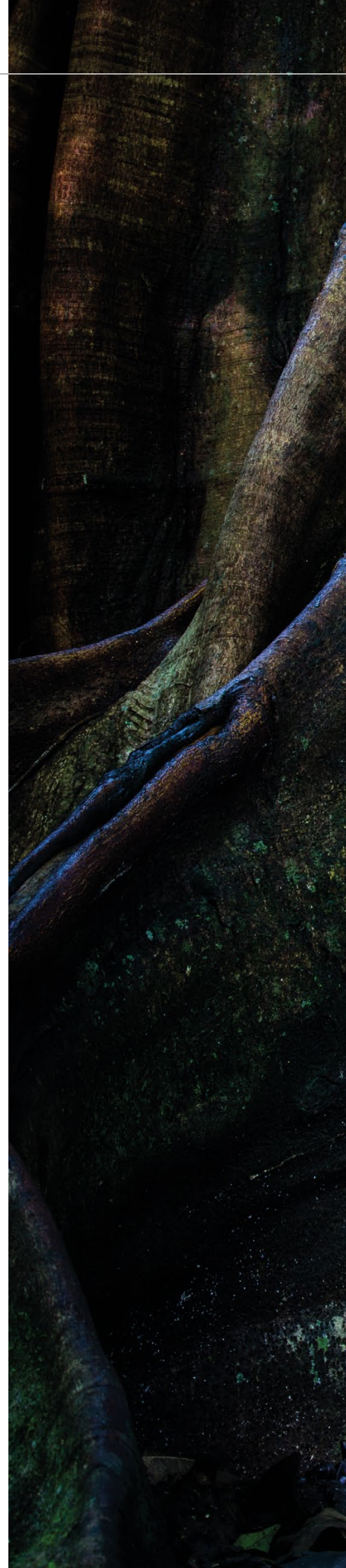
There is still a long way to go, however, and we urge asset owners not to switch off feeling that you have 'ticked the ESG box'. The responsible investment landscape is evolving quickly and will have an impact on investment strategies well beyond the original starting point in equities.

To understand the potential scope of responsible investment and make informed investment decisions, it is first necessary to understand the terminology of responsible investment. We hope that we have clearly explained our use of this terminology and the relationship between the different elements.

Beyond this, we hope that we have helped you to understand how to develop a responsible investing approach by appreciating the key issues and how top-down global climate change commitments can dovetail with your responsible investment goals.

Lastly, we have sought to explain why investment grade credit is a very different asset class from equities from a responsible investing perspective. We believe that fixed income is the new area of evolution for ESG integration and asset owners need to understand the detailed implications of this.

To hear more about our approach to responsible investing, particularly in fixed income, or to discuss your specific challenges, please speak to your contact at RLAM.





APPENDIX I

Go with the flow: does ESG matter when investing in water?

This is a summary of a report produced jointly by our Responsible Investment and Credit Research teams on potential ESG risks in the water utilities sector. It was published in October 2019 prior to the UK General Election.

The water sector is largely unquoted. There are a dozen water companies supplying England and Wales, but only three of these are listed on the London Stock Exchange – the rest are generally privately owned through entities such as pension funds, sovereign wealth vehicles and private equity. However, this sector does have significant investment needs – and it regularly uses credit markets to help finance its infrastructure spending. The long-dated nature of the sector's assets means it is looking for long-dated lending – a perfect match for fixed income investors with long-term investment horizons.

If any sector was an obvious candidate for ESG analysis, it is water. However, the 'off-the-shelf' research that is readily available on listed companies doesn't exist for bond investors; it needs to be done in-house. This presents a number of questions – not least, what are the factors that matter, and how do we assess them?

While the water industry is highly regulated in the UK, there is differentiation between firms and across capital structures. To this end, in 2015 and 2018, we produced a comprehensive ESG analysis of the

water sector, looking at a variety of measures impacting water companies. In 2019, we revisited our evaluation of the sector due to a number of developments, including criticism of overall company performance, the handing out of multi-million pound leakage-related fines by the regulator, and the increasing risk of nationalisation under a potential future Labour government.

Does it matter?

It is valid to ask whether ESG analysis matters. After all, for a bond investor, the risk of a borrower deteriorating after funds have been lent is what matters. Our view is that if you are not looking at ESG in assessing credit risk, you are not assessing credit risk properly, and are simply ignoring some of the risks that can cause borrowers to deteriorate.

In the case of the water sector, it is a mixture of short-term and long-term influences. In the short term, issues such as leakages matter because regulators fine companies that fail to address this. In the long term, ESG factors are part of the sector's social licence to operate. Failures in this area could lead to fundamental changes to the regulatory framework, which water companies have used to underpin lending to the sector.

In perhaps the most high-profile recent example, Southern Water was hit with a record £126m fine, including £123m of customer redress, as a punishment for spills of wastewater from its sewage plants, as well as for deliberately

misreporting leakage performance. As a result of the fines, Moody's and S&P downgraded its credit ratings for Southern.

In addition, the Environment Agency is currently undertaking a criminal investigation into the case to determine whether permit breaches occurred at a number of sites and whether any damage was done to the natural environment. Southern also raised the incidents to the attention of the Serious Fraud Office, although no further investigation was undertaken.

How do we do this?

We looked at a selection of material ESG issues for each borrower with public debt outstanding. To ensure we targeted the most material issues, we used the Sustainability Accounting Standards Board's Materiality Map for guidance, supplemented with metrics that are more significant for the UK market. This led us to look at a number of areas:

- **Energy management:** the presence of energy recovery processes, the kind of energy being used, and the amount of sludge (treated residual sewage) that is transformed into valuable outputs on site.
- **Scenario analysis:** companies now have to plan for alternative potential scenarios based on different patterns of rainfall, which are likely to become more extreme as the impacts of climate change increase.

- **Water scarcity strategy:** we used the level of customer metering as a proxy for a water scarcity strategy as this is the most effective means to moderate usage. Fitting a water meter reduces usage by 10%-15%, a figure that rises to 17% when smart meters are fitted.
- **Water stress:** an assessment to determine which regions are most at risk from water scarcity, and the severity of potential climate change impacts and water consumption demand.
- **Environmental performance:** the Environment Agency's Environmental Performance Assessment is a basket of seven measures that assess how well a company protects the environment. Measures include the number of times there were unexpected contaminants released, whether companies are meeting their environmental permit conditions and whether sludge is disposed of safely.
- **Leakage:** leakage targets are set using the sustainable economic level of leakage. In practical terms, Ofwat requires water companies to fix leaks, as long as the cost of fixing the leak is less than the cost of not fixing the leak. Water companies maintain that leakage has been at economic levels since roughly 2000.
- **Access and affordability:** we looked at 'bad debts' in order to measure the extent to which water companies were successfully working with customers to ensure bills are paid.
- **Customer satisfaction:** as water companies operate as regional monopolies, there is limited pressure on companies from a competition perspective. However, customer satisfaction will have financial incentives

in the next regulatory period, and as a result, has the ability to directly impact a company's financial performance and the credit quality.

- **Governance:** water companies operate within a highly regulated industry, dampening the transition of operating volatility to credit risk. However, this does not remove the benefits that bondholders derive from good corporate governance.

Results

Our analysis found a significant variation between companies' ESG scores, yet with 55% of factors assessed being rated as poor, severe or medium; we considered the overall ESG performance of the sector as weak. However, this weak performance needs to be viewed in the context of the underpinning of the regulatory framework, which significantly dampens the impact of most measures from a lender's perspective in the short and medium term.

In this light, the ESG factor that we deem to have the most direct link to short-term company performance is leakage, as financial implications associated with leakage fines directly impact performance through the regulatory framework.

Leakage

Since privatisation, water companies have spent approximately £150bn on improving services overall and are continuing to invest, however there is criticism that based on current leakage targets, many leaks will not be fixed as it is not economic for water companies to repair. Clearly, as water stress and

scarcity becomes worse, the wastage of water from leaks will become more impactful and water companies will have to invest further to reduce these.

This is particularly the case for water companies that are located in regions experiencing severe water stress. Therefore, as the impacts of climate change become more extreme, the correlation between metering, leakage and water stress will likely intensify.

Governance

Some bonds are issued outside the operating company entity, and are therefore not covered in the Ofwat regulatory protection, making good governance more of a concern. But following the increase in leakage and pressure from the opposition Labour Party over renationalisation, there is increasing focus on the influence of shareholders on the balance between paying dividends and maintaining a sustainable network, making strong governance even more vital. Companies are regularly criticised for paying too much to shareholders while performance is worsening.

To understand the impact of governance, we reviewed a number of governance factors for each company and compared them against what we consider to be good practice, referencing the UK Governance Code as appropriate. As illustrated in the table (page 32), there appears to be a trend in the factors between governance and overall company performance. No companies that have good governance practices feature amongst the worst environmental performers.

Borrower	Access and affordability	Energy use	Leakage	Metering	Water stress management	Customer satisfaction	Governance	ESG score	2018 ESG score
Company A	Good	Good	Good	Poor	Medium	Good	Good	5	3
Company B	Good	Good	Good	Good	Severe	Medium	Average	4	5
Company C	Good	Good	Good	Good	Severe	Medium	Average	4	4
Company D	Good	Good	Good	Good	Medium	Medium	Poor	4	4
Company E	Good	Good	Medium	Good	Medium	Good	Poor	4	5
Company F	Good	Good	Good	Poor	Medium	Good	Poor	4	3
Company G	Good	Good	Medium	Poor	Medium	Medium	Good	3	3
Company H	Poor	Good	Medium	Poor	Medium	Good	Good	3	2
Company I	Good	Good	Medium	Good	Severe	Poor	Poor	3	3
Company J	Good	Poor	Good	Poor	Severe	Poor	Average	2	4
Company K	Poor	Good	Poor	Poor	Severe	Poor	Poor	1	1
Company L	Poor	Poor	Medium	Poor	Medium	Medium	Poor	0	2

Source: RLAM internal research, as at June 2019. Companies have been anonymised as these are subjective.

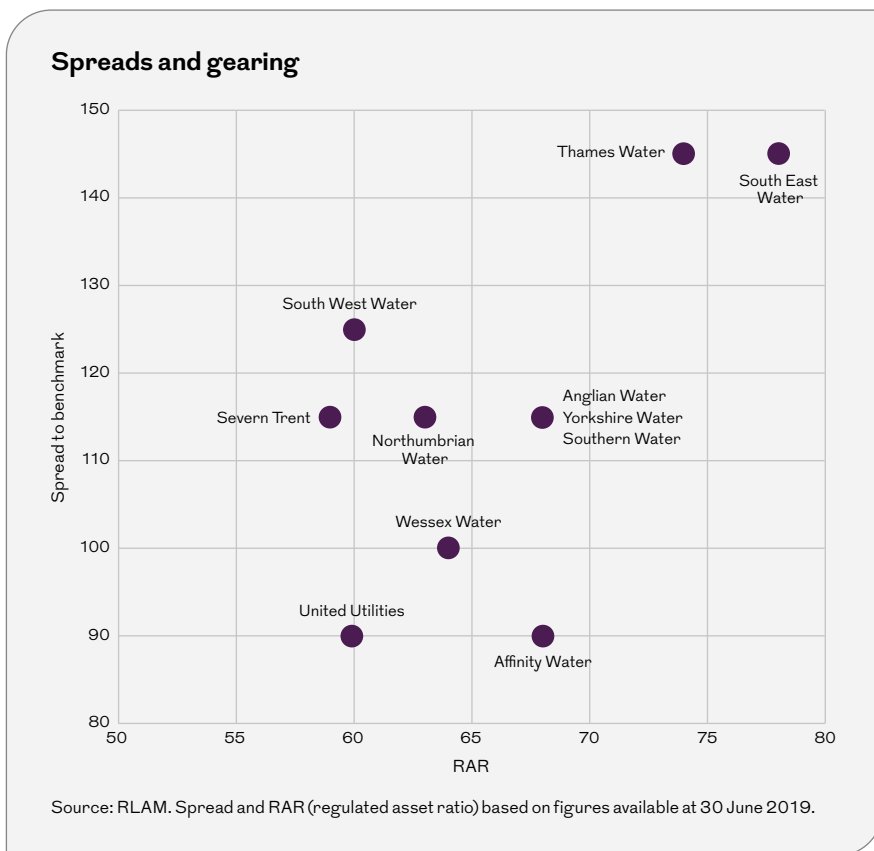
How does RLAM use this?

This ESG analysis has been integrated into our existing credit analysis of the sector. For example, we look at credit spread and gearing with the Class A part of the capital structure. This gives a simple valuation perspective on which bonds are attractive – generally speaking higher gearing translates into a higher spread available. But with our ESG ratings, we can see where we believe the market is pricing risk incorrectly – for instance, offering high spreads on companies that we believe have better ESG credentials, and this is indeed the case for South East Water.

Conclusion

We believe that sound ESG management leads to less volatility and marginally higher profitability, stronger long-term climate resilience and greater social performance. In the short term, upcoming changes to the regulatory framework will make these factors more relevant, as a higher proportion of company revenue will come from operational performance incentives.

More importantly, from a long-term investor perspective, ESG management is essential to ensuring companies maintain their social licence to operate and build positive customer perception. Governance and metering appear to be indicators of a company’s overall ESG performance and therefore are good leading indicators of general ESG performance. Effective ESG management can also bolster a water company’s social licence to operate, something that should be a priority to all the water companies in the UK in the face of possible future nationalisation.





APPENDIX II

Gas utilities in a net-zero economy

This is a summary of a report produced jointly by our Responsible Investment and Credit Research teams on potential ESG risks in the gas utilities sector. It is valid as of December 2019.

In June 2019, the UK committed to a legally-binding target of net zero carbon emissions by 2050; an ambitious aim that will impact every sector of the economy, as well as closer to home.

In 2018, for the first time UK households emitted more carbon dioxide into the atmosphere than power stations, according to provisional government figures. Much of this comes from burning gas in order to heat our homes, water and food. A relatively small number of companies are involved in moving this gas through the nationwide transmission network, into the local distribution networks and, finally, into our homes.

To understand the sector better and what future (if any) it has in a net zero environment, in October and November 2019, RLAM engaged with the companies that transport this gas in local areas, SGN, Wales & West, Cadent and Northern Gas Networks. We also met National Grid, which operates the transmission network, and Ofgem, the regulator. Conventionally, the bonds issued by the UK gas networks are seen as relatively low-risk investments by the credit market, underpinned by a stable regulatory framework and an expectation that the pipes on which they earn their returns are here to stay.

We wanted to challenge whether, in a world of net zero, this established thinking still held true.

Getting to net zero

Burning natural gas might produce less CO₂ than coal or oil, but the contribution it makes to emissions is still substantial. Across homes, businesses and power stations, it represents half of all emissions in the UK today. Reducing these emissions enough that the remainder can be offset on a sustainable basis, while maintaining warm homes and secure energy supplies, is a huge challenge.

Our discussions with these different stakeholders raised a number of common themes which the UK will have to overcome in order to get to net zero. The networks felt that regulatory pressure was preventing them from effectively investing in the new technologies that would be needed; most companies recognised the significant ultimate cost of carbon capture and storage (CCUS), that cleaner fuels were not a panacea and, whatever happened, any broader transition would have to take place against forecast declines in overall gas demand.

Following our discussions and analysis, we've assessed the implications of three potential scenarios:

Fully electrify

With gas demand already reducing, in this scenario the gas networks are fully phased out or maintained for emergencies. Key trends, including more cost-effective renewable energy sources, are supportive of this position.

However, a fully-electrified network would require a huge increase in the amount of generation required to meet peak energy

demand for heating, particularly in cold winter months. Ofgem estimated back in 2016 that aggregate peak demand for heat is roughly five times that of electricity.

Other costs of this transition would also be significant: as more consumers moved to electric heating, the costs of the gas networks would rise for the remaining gas customers, further incentivising individuals to switch to electricity, perpetuating, in Ofgem's words, a 'death spiral' that could leave the gas networks redundant.

Burn something cleaner

The gas networks are already investigating the potential of hydrogen as an alternate fuel source. Unlike natural gas, the only by-product of burning hydrogen is water vapour, with the energy being released as the hydrogen combines with oxygen in the atmosphere.

While hydrogen is prone to leakage in steel pipes, up to 75% of distribution networks can already carry hydrogen, as distribution companies are already replacing all metal pipes close to residential areas with plastic ones for safety reasons. However, the cost of producing this hydrogen (which would rely on costly electrolysis or on commercially-viable CCUS) would still lead to higher costs for consumers. This switch would also lead to new boilers and other appliances being required in every home.

A blended option

Most of the gas companies envisaged a future in which networks used a variety of methods to meet their decarbonisation targets. These included more use of bio-gas, which has no net impact on the



total stock of carbon in the atmosphere and is thus considered a green fuel, partial injection of hydrogen up to levels which existing appliances can tolerate, introducing regional hydrogen grids, some carbon capture, plus alternate technologies, such as hybrid heat pumps.

Each of these partial technologies faces their own risks, from a lack of supply (for green gas), the difficulty in cleanly producing hydrogen at scale without CCUS, and the inefficiency of UK housing stock. Overall gas demand would still be expected to decline materially under this scenario.

The broader risk to the system as a whole and security of supply is that these localised solutions prevent nationwide solutions in the case of extreme weather events in one or all parts of the country, and make it harder to balance national energy supply and demand.

Implications for RLAM

There are clear investment implications and conclusions to be drawn from this engagement and analysis. No single scenario offers a perfect solution and, with the clock ticking towards 2050, it is still not clear which strategy the gas networks will adopt. However, whichever

strategy is chosen, the inherent conflict between the short-term nature of regulatory cycles and the long-term infrastructure investment required to decarbonise the UK's energy system is a continued source of tension. In our engagement with the regulator we highlighted this potential disconnect. We expect future regulatory price controls, which set the returns these networks can earn, to begin to reflect the need for a longer-term view.

As providers of long-term financing to the gas network, understanding the potentially enormous impacts of decarbonisation is vital, particularly in a sector which, due to a perception of long-term stability, is seen as relatively low risk by the credit market. More specifically, our analysis of these developments, and their potential impact on asset life and the sustainability of cashflows, helps us to evaluate the degree of yield compensation we require as lenders into the sector. This encapsulates portfolio exposures to individual issuers, the wider utility sectors, as well as different lending structures and bond maturities. In addition to incorporating this targeted analysis into our overall credit analysis of the sector, it also builds an established framework for further engagement and analysis.

This project is another example of how effectively integrating ESG and credit analysis better informs evaluation of credit risk, providing our Credit team with information to build more sustainable portfolios for our clients.

APPENDIX III

Responsible investment definitions and examples

Please note: other than the umbrella term of ‘responsible investment’, these definitions are listed alphabetically. However, as described in Ashley Hamilton-Caxton’s article (see page 6), they have a clear taxonomy and apply to different strata of our approach to responsible investment. For example, engagement is a process within stewardship.

Responsible investment

“Investing client’s money in a responsible way, taking account of material environmental, social and governance (ESG) risks, and implementing our stewardship responsibilities.”⁴

This includes

- a firm-wide investment philosophy, applied to all RLAM funds, strategies and approaches
- a commitment to clients that we are trustworthy and will act in their best interests
- a belief that being a responsible investor will enhance returns, reduce risk and improve outcomes for our clients over the long term
- a commitment by investment teams to consider and incorporate material ESG issues into their investment process for the purpose of meeting client requirements

From RLAM’s perspective

- we are a signatory to the UN PRI and the UK Stewardship Code, responsible investment is a core competency and commitment, and we report annually on our activities and progress

Engagement

“Purposeful dialogue between investors and companies (potential or future investments) on ESG issues with the intention to influence (or identify the need to influence) company behaviour or improve disclosure.”⁵

This includes

- collective and one-to-one interactions between investors and companies
- ESG information discovery that is intended to inform future engagement or investment decision-making

From RLAM’s perspective

- we met a water utility as a bondholder to seek changes to how the company is implementing its risk controls, following a pollution fraud incident
- we provided feedback to the remuneration committee of Euromoney Institutional Investor PLC, proposing the company should reconsider certain aspects of its remuneration structure, and the company subsequently changed its pay scheme proposals at the AGM

Exclusions (ethical investment)

“Explicitly prohibits investing in a particular company, sector, business activity, country or region.”⁶

This includes

- prohibition of investment on the basis of religious or ethical considerations
- not investing in companies because they make or provide unacceptable products and services
- excluding companies on the basis that they violate certain international norms, such as the UN Human Rights Declaration or the UN Global Compact
- prohibiting investment in companies that don’t meet minimum ESG standards (internal or external)

From RLAM’s perspective

- the RL Ethical Bond Fund prohibits investment in companies that generate more than 10% of their revenue from tobacco, weapons, pornography, gambling or animal testing. It also prohibits investment in companies that engage in human rights abuse or display poor environmental practices
- the RL Cash Funds prohibit investment in companies that generate more than 10% of their revenues from tobacco, fossil fuel extraction or weapons

Impact investment

“Investments made with the intention to generate positive, measurable social and environmental impact alongside financial return.”

This includes

- social or ‘green bond’ funds where ring-fenced proceeds are intended for use in generating positive social or environmental impact
- private markets – investing directly in unlisted equity, debt or project finance with the intention to generate positive impact
- funds whose purpose is to explicitly invest in companies contributing to one of the UN Sustainable Development Goals (SDGs) and where outcomes are measurable

From RLAM’s perspective

- we currently do not offer impact funds, as our preference is to offer sustainable funds, which we believe provide a better customer outcome
- we will quantify the environmental and social impact of its investments only when the impact is objectively and transparently measurable

Stewardship

“The responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to long-term benefits for the economy, the environment and society. It is our fiduciary duty to be good stewards of our clients’ capital.”⁷

This includes

- company engagement and holding companies to account through discussion and dialogue
- exercising voting rights (proxy voting)
- oversight of assets and service providers, thought leadership and advocacy with regulators
- escalation activities where companies fail to meet expectations or respond to engagement

From RLAM’s perspective

- we vote at annual meetings across all of our active funds and send letters to companies to explain our rationale for opposing a management resolution
- we engaged with 178 companies in 2019 on 260 different issues (an increase of 55% from 2018), including executive remuneration, pensions, climate change, environmental management, health & safety, succession planning and diversity
- we publish an annual Stewardship Statement that outlines how we meet our stewardship commitments and act in the best interests of our clients

Sustainability

“Meeting the needs of the present without compromising the ability of future generations to meet their needs.”

- The most widely recognised definition, defined in 1987 by the UN Brundtland Commission. Promoted by the UN Sustainable Development Goals as part of the 2030 Agenda for Sustainable Development, which:
 - aims to build an inclusive, sustainable and resilient future for people and planet

- includes three core elements: economic growth, social inclusion, and environmental protection
- The intention is to promote sustainable, inclusive and equitable economic growth, creating greater opportunities for all, reducing inequalities, raising basic standards of living, fostering equitable social development and inclusion, and promoting integrated and sustainable management of natural resources and ecosystems

Sustainable investment

“An investment strategy that seeks to invest in companies that meet sustainability criteria or deliver sustainable outcomes through the products and services they provide and/or their business conduct.”⁸

This includes

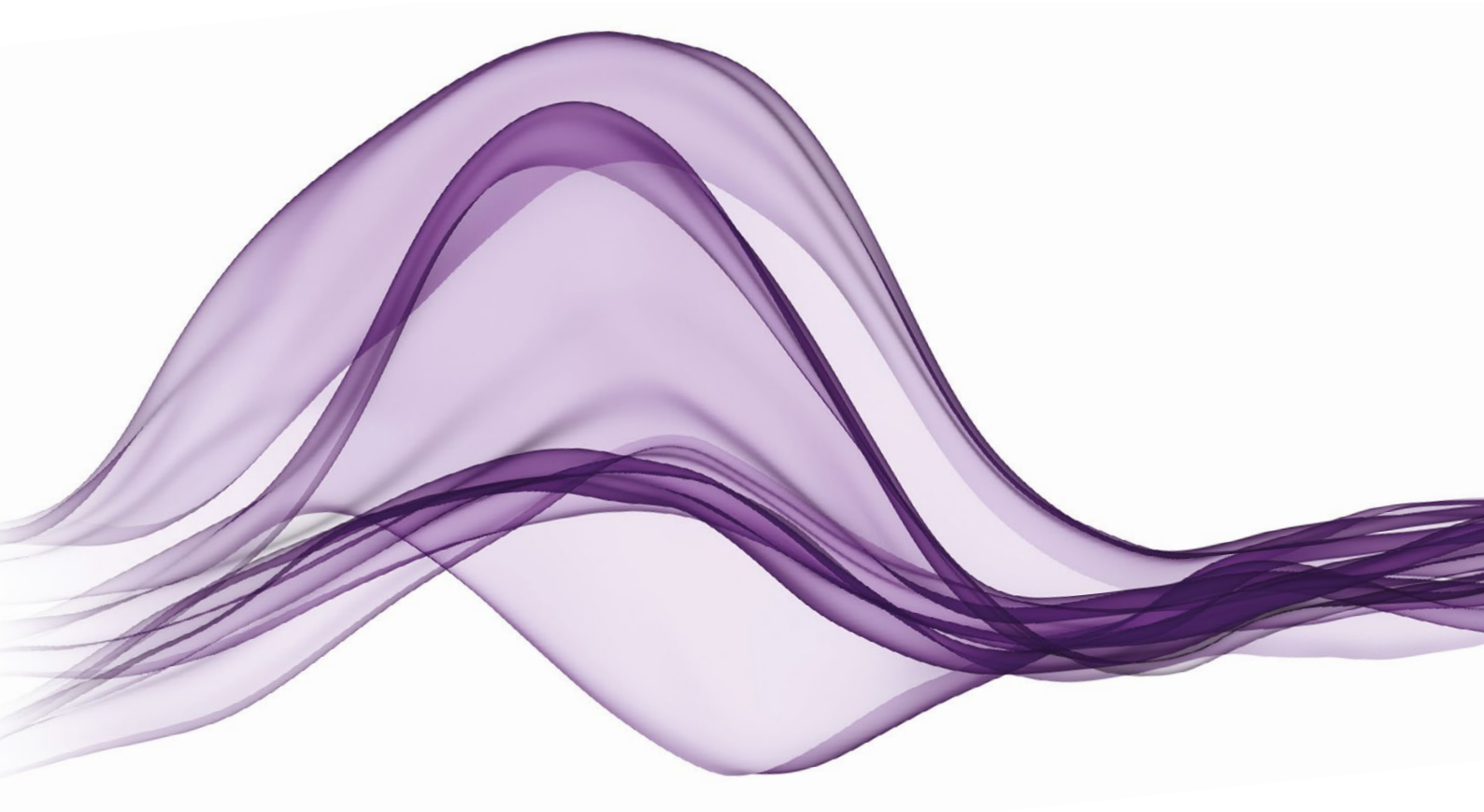
- sustainable-themed funds – where the explicit purpose of the funds is to invest in companies that contribute capital to particular sustainable themes including climate change mitigation, pollution prevention, or the UN Sustainable Development Goals
- ‘best in class’ – approaches that select the best-performing companies or exclude the worst-performing companies based on sustainability criteria

From RLAM’s perspective

- our sustainable funds range – aims to invest in companies that have products and services contributing to the transition to a more sustainable society, or are considered ‘ESG leaders’

Notes

- 1 We consider the challenges involved in gas distribution networks for credit investors in Appendix II (see page 34).
- 2 Review of Financial Studies, Vol 28, Number 12, December 2015 – Professors Dimson, Karakas and Li.
- 3 CA100+ is an investor initiative to engage with the largest corporate GHG emitters that gathers more than 450 investors with over \$40 trillion in assets.
- 4 Adapted from the UN PRI definition of ‘responsible investment’.
- 5 Modified from the UN PRI definition of ‘engagement’ as described in the PRI Reporting Framework.
- 6 Summarised from the Investment Association RI Framework definition of ‘exclusions’.
- 7 Adapted from the 2020 UK Stewardship Code and the ICGN Global Stewardship Principles.
- 8 Summarised from the Investment Association RI Framework definition of ‘sustainability focus’ and the Global Sustainable Investment Association (GSIA) definition of ‘sustainable investing’.



For professional clients only

Past performance is not a reliable indicator of future results. 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.

All information is correct at November 2020 unless otherwise stated.

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