Responsible investing within fixed income

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The meaning of responsible investment has evolved over time. Originally, responsible investment meant excluding companies or countries according to pre-set criteria. Today, responsible investment is a form of investing that considers a broader range of risks over both the short and long-term.

This means that responsible investment isn't simply about avoiding certain investments, or divesting from particular sectors or issuers, though it may involve doing so. Nor does responsible investment mean sacrificing performance. We believe investing responsibly over the long term has the potential to increase the likelihood of achieving your performance objectives. When you view responsible investment this way it should not be seen as a niche approach relevant to only a few investors or just a token part of a portfolio, but a mainstream approach to investing.

Key drivers of responsible investment

The focus on responsible investing has seen a dramatic upswing in the past two to three years. Regulatory change has encouraged this shift and some of the recent drivers include:

- The Paris Agreement: this set a legally-enforceable goal of limiting global average temperature increases to well-below two degrees Celsius above pre-industrial levels. The ratification of the Paris Agreement has signalled a step change in policy action.
- The Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD): this has explicitly called on asset owners, investment managers, corporations and other key stakeholders to report on how they are managing climate change-related risks and opportunities.
- European Commission Action Plan for Sustainable Growth: this plan has several objectives including driving capital flows towards sustainable investment, managing financial risks stemming from climate change, environmental degradation and social issues, and fostering transparency and long-termism in financial and economic activity.

Responsible investment within fixed income

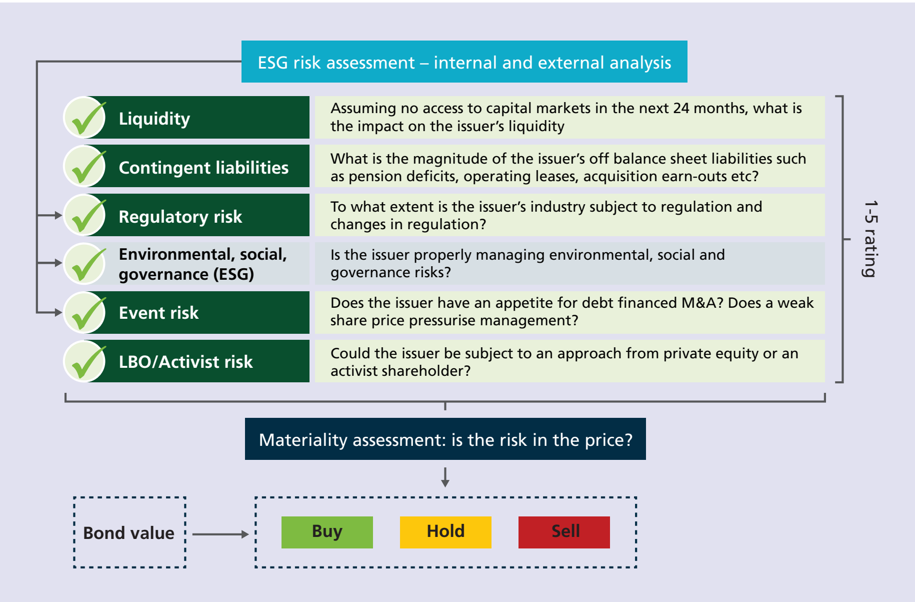
Environment, social and governance (ESG) factors can have an important impact on a company's credit quality and hence investment performance. Failing to include a proper analysis of these factors could potentially lead to incorrect investment decisions being made. ESG research can help fixed income investors potentially improve returns by identifying long-term value in companies, while at the same time anticipating financial risks, which could lead to credit downgrades, price volatility and widening credit spreads. We believe that strong performance and sustainable investing can often go hand in hand.

Integrating ESG factors into credit risk analysis

Our analysts conduct a fundamental review of a company's financial risk, in particular its cash flow, revenue and profitability. We pay particular attention to the scoring of key business risks using a checklist that identifies important sources of risk which can lead to a sudden deterioration in credit quality and high-profile business events that may not be readily apparent from an examination of a company's financial performance (see Figure 1).

ESG factors are embedded into Insight's fundamental credit research. Default risk is the prism through which our analysts

Figure 1: Insight's risk checklist



Source: Insight Investment

consider every issue. A full investment analysis is required to inform an investment decision, and ESG risk scores are a necessary element in assigning a credit rating that indicates the relative risk of default loss. Insight's credit analyst team is charged with determining the materiality of issues on the checklist, defined as the contribution these make to the default likelihood of a potential investment.

Governance factors important to fixed income include a company's board structure, in particular its shareholder-bondholder relationships. Social factors are broad, with a number of risks including labour management, health and safety and most recently data security and privacy. Environment factors go beyond simply climate change and include water risks, biodiversity and energy diversity.

It is through the combination of ESG risk screening and financial analysis that Insight's extended credit risk appraisal process brings together an assessment of the financial risks associated with a company's performance with a clearly defined set of key business risks, including ESG considerations, as a part of the mainstream investment process.

Insight carbon risk model

Insight has also developed a climate risk model focusing on corporate debt issuers to help better understand the risks and opportunities of climate change. Our model ranks investment grade and high-yield fixed income corporate credit issuers by how they manage their climate change-related risks and opportunities, and how are they are positioning themselves for the transition to a low-carbon economy. This model is an integral part of our investment process as it helps to inform our credit analysis as well as highlighting companies to consider for engagement.

Engaging with companies

Engagement or active ownership can be an integral part of incorporating ESG into fixed income investing. In many ways, equity investors are ahead of fixed income investors – the ability of equity investors to vote means they bear a specific responsibility with regard to how companies operate, and they can have a direct say in matters that affect long-term performance. However, fixed income investors have become increasingly aware of the influence they can have. Companies need finance, and in that context, bondholders' engagement with issuers is important. They can play an important role in encouraging companies to better manage their ESG-related risks and opportunities.

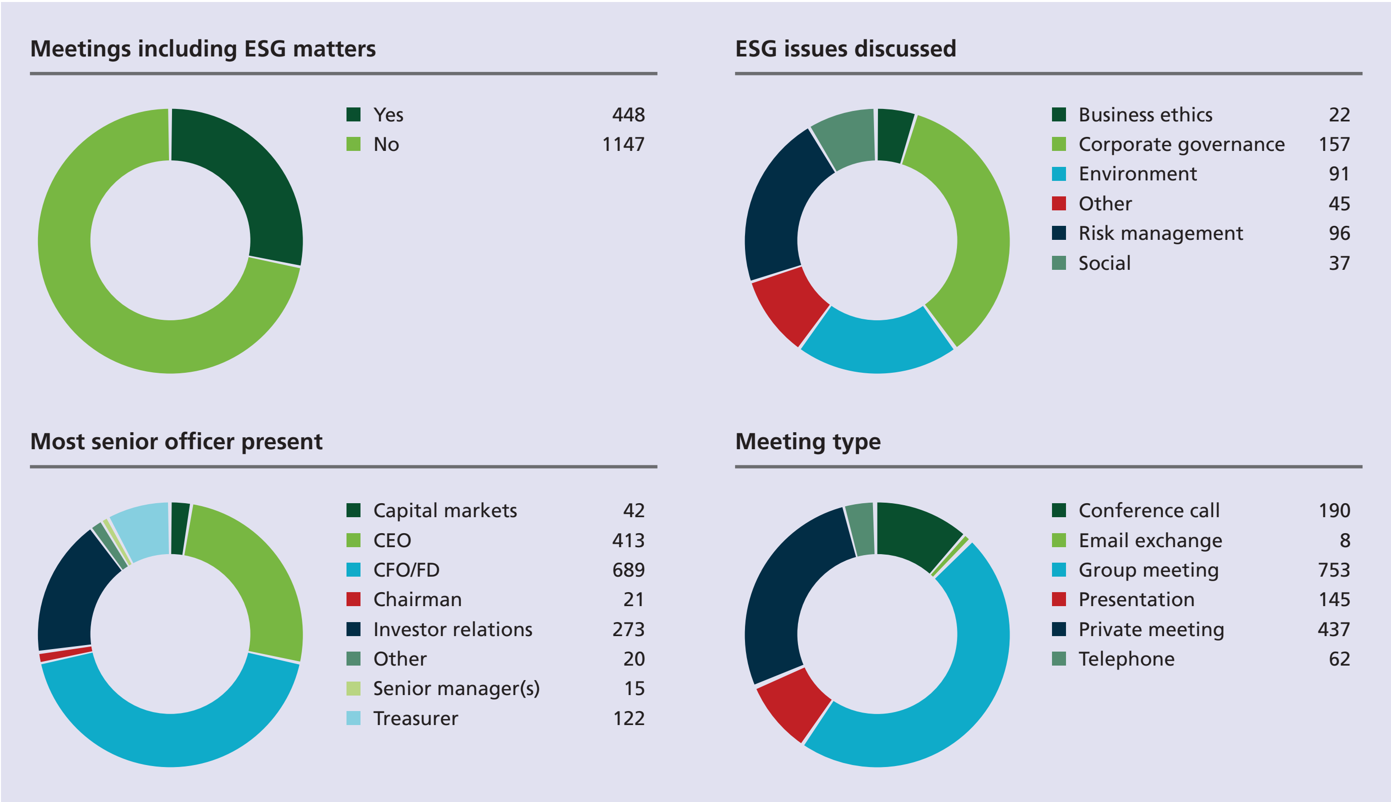
At Insight, company engagement is an integral part of our credit process. All our analysts regularly meet with issuers to discuss a range of factors including ESG. When the strategy identifies deteriorating ESG performance in one of its holdings, our analysts will engage with the company to establish the reasons and enquire about remedial actions. Our ESG engagement activities in 2017 are shown in Figure 2.

Adding overlays to enhance the ESG strategy

Applying an overlay to the investment process is an increasingly common method clients use to reflect their investment styles and philosophies within portfolio construction. Some of the typical overlays we apply for clients include:

- **Exclusion screens:** Using criteria provided by clients to prevent investments in certain business

Figure 2: Dialogue with issuer management in 2017



Source: Insight Investment

activities, such as tobacco, weapons and alcohol.

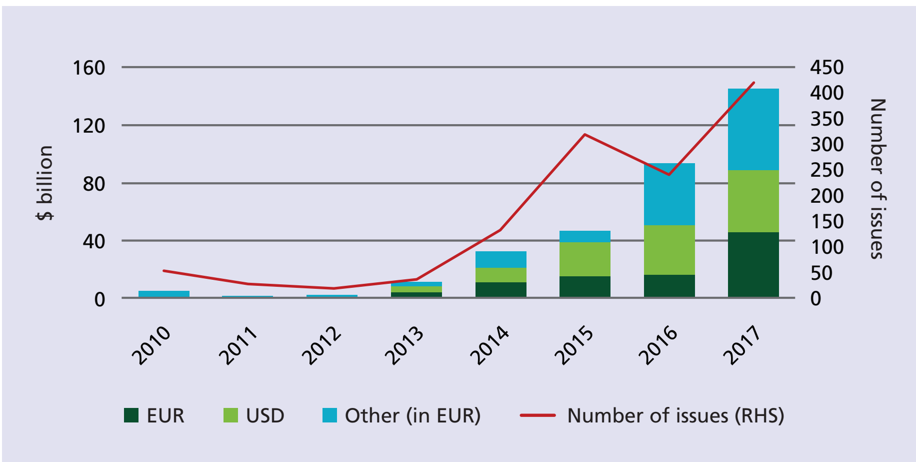
- **Norms screens:** Managing (reducing or eliminating) exposure to companies with past high-profile events that suggest they do not meet globally respected standards such as the UN Global Compact and those set out by the International Labour Organisation.
- **"Best in class":** Using ESG ratings to rank companies on their ESG performance, which can be used to identify leaders and tilt portfolios away from companies with the worst ESG performance and/or the highest ESG risks, and towards companies with the best ESG performance/the lowest ESG risks.
- **Low carbon:** Identifying companies with poor carbon emissions performance or those demonstrating greater environmental risk, and using this information to reduce the carbon footprint of portfolios.
- **Positive impact:** Tilting portfolios in favour of either individual bonds or corporate issuers that have a sustainability element. This includes green bonds and the UN Sustainable Development Goals (SDGs).

Investing in the environment

Green bonds are another way for fixed income investors to incorporate responsible investing in their portfolios. These are ordinary fixed income instruments but with the proceeds used for environment-focused activities, such as renewable energy, energy efficiency, green buildings and green loans.

This market has grown significantly, with over USD140 billion of new issuance recorded in 2017 and even more expected this year. Not only are corporates issuing green bonds, but there is a steady increase in sovereign issuance too, with Poland,

Figure 3: Growth of the global green bond market



Source:Bloomberg, as at 31 December 2017

Belgium and France all issuing green bonds.

However, not all green bonds may be "green". With a rapidly expanding market, Insight believes that a process to evaluate sustainable bonds is required to help guide decisions to buy or avoid some credits. We saw, for example, some controversial green bond issuance in some sectors and we considered these bonds inappropriate for portfolios, even though they were deemed appropriate by third parties. We believe that the need for an internal process is important as more impact-themed bonds come to market.

Conclusion

Responsible investing is about investing in a way which takes all material risks into account. Within fixed income portfolios, responsible investing can be integrated in several ways, including through overlays, investing in green bonds, through integration and engagement. We believe that integrating ESG factors into fixed income analysis can also offer a range of benefits to investors. For example, it can potentially reduce idiosyncratic and portfolio risk and improve portfolio performance, as it helps investors anticipate and avoid investments that may be prone to credit downgrades, price volatility and widening credit spreads.