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Insight INVESTMENT

May 2020

HOW DID EUROPEAN SUSTAINABLE BOND INVESTMENTS PERFORM DURING COVID-19 TURMOIL?

THE ECONOMIC IMPACT OF COVID-19 HAS BEEN UNPRECEDENTED IN SPEED AND SCOPE, WITH EARLY INDICATIONS SUGGESTING THE DISTRESS CAUSED MAY BE MORE SEVERE THAN THE GLOBAL FINANCIAL CRISIS OF 2008-2009. THIS PAPER EXPLORES HOW EUROPEAN CREDIT INVESTORS MIGHT HAVE BENEFITED OVER THE PERIOD OF VOLATILITY THROUGH MARCH AND APRIL FROM HAVING AN ADDITIONAL FOCUS ON ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) ISSUES IN THEIR PORTFOLIOS.

KEY FINDINGS[1]

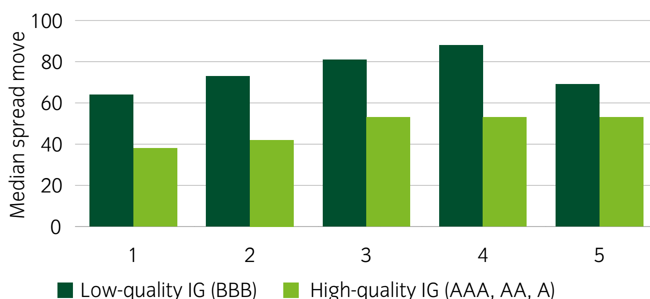
- Companies with better ESG[2] ratings were generally more resilient
- Green bonds did not outperform conventional bonds
- Sustainability-focused portfolio tilts and allocations are likely to have helped investment performance in this period

RESILIENCE OF COMPANIES WITH BETTER ESG PROFILES

Our analysis indicates that spreads generally widened more for issuers with worse ESG ratings.

In Chart 1, we consider the median spread movement within ESG rating 'buckets' over the period. We also split the underlying investment grade issuers out by credit quality to understand whether there is a bias to the results depending on the credit quality of the issuer.

Chart 1: Median spread move split by credit quality and ESG rating[3]



The spread-widening trend appears to be broadly consistent across both high-quality (AAA, AA, A) and low-quality investment grade credit (BBB), albeit somewhat more exaggerated for BBB credits. This may indicate that ESG performance plays a more important role in the pricing of lower-quality credits than for credits with a more robust credit risk profile.

A striking result was the relatively smaller median spread move of worst-in-class names (those with an Insight ESG rating of 5).

This anomaly was mainly due to compositional issues. Our proprietary ESG ratings looks at companies globally, and there are fewer worst-in-class companies in European investment grade indices. As such, the data set for such companies is relatively small, and is further skewed by the size of one or two issuers in that bucket: a German automaker, as a major benchmark constituent, is responsible for almost 50% of all bonds with an ESG score of 5. This skewed the results as the German automaker's bonds outperformed the peer group over the period due to resilient results and the European Central Bank's bond-buying programmes, which were extended and broadened over this period.

NO DIFFERENCE BETWEEN GREEN AND CONVENTIONAL BOND PERFORMANCE

There is a perception that green bonds should outperform non-green, or 'brown', counterparts during periods of volatility. This is because there are more price-insensitive buyers for green bonds, who value them as much for the impact they achieve as the spread they offer.

[1] We looked at performance during the period of heightened volatility, from 1 March 2020 to 30 April 2020. To categorise issuers by ESG performance we have used our internal ESG ratings methodology where we rank companies within a sector from best-in-class to worst-in-class (ESG ratings from 1 to 5 respectively, where 1 represents a high ESG rating). We used the Bloomberg Barclays Euro Aggregate Corporate Total Return Index (Unhedged) as our analysis universe for the purpose of this exercise. [2] References to ESG or responsible investment herein may include approaches that are both quantitative, qualitative and subjective. ESG and responsible investment approaches are subject to documentation setting out Insight's description of ESG and responsible investment, individual portfolio guidelines and portfolio objectives. [3] Source: Bloomberg, Insight Investment Management, Investment Universe: Bloomberg Barclays Euro Aggregate Corporate Total Return Index (Unhedged). Data as at 30 April 2020.

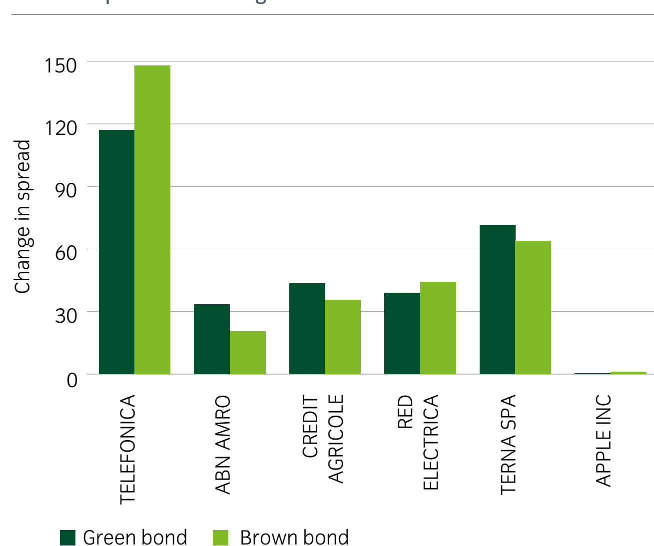
Some recent third-party analysis has used index performance to conclude green bonds have outperformed in recent market turmoil, but this does not consider the quality or sector differences which exist between such indices.

For our analysis, we looked for maturity-matched pairs of bonds issued by the same company – one green, one brown – to determine if there was any difference in their performance.

The data set is relatively small, but we believe it is notable that there was little evidence that green bonds systematically outperformed brown equivalents over the period in question (see Chart 2 for a sample of the pairs analysed). The clearest example of outperformance comes from Telefonica, a subordinated bond. This could be an instance of the green component of a bond becoming more 'valuable' for bonds with wider spreads. The number of green bonds with a high yield level is relatively limited and these instruments are a key way for green bond funds to generate additional carry over typically low-yielding benchmarks.

We believe there is not compelling evidence that green bonds are inherently more or less defensive for investors than their brown equivalents. However, as investors switch to more impact-focused metrics in their strategies, we may see a clearer premium (the so-called 'greenium') offered by green bonds.

Chart 2: Spread moves – green vs brown bonds[4]



SUSTAINABLE PORTFOLIOS MAY HAVE BENEFITED FROM A MORE DEFENSIVE PROFILE

We believe portfolio tilts in favour of companies with better ESG ratings, and sector allocations towards more sustainable industries, may have helped portfolios outperform through the recent turmoil.

This was the experience of the Insight Sustainable Euro Corporate Bond Fund, which aims to tilt its portfolio in favour of better-quality ESG issuers. It also has a higher hurdle to investing in climate-sensitive sectors including adopting an approach which excludes certain brown industries like coal mining and coal power generation. It holds an overweight position in positive impact bonds – both those that are explicitly labelled as such, and bonds issued by companies with a strong sustainability business profile.

The Fund outperformed its benchmark over the first four months of 2020 (see Table 1).

Table 1: Insight Sustainable Euro Corporate Bond Fund performance[5]

Period	Portfolio (%)	Benchmark (%)	Relative
YTD April	-1.87	-2.65	0.78
1 Year	1.09	-0.49	1.58
Since 30 September 2017	1.72	1.07	0.65

Our analysis suggests that, whilst there was little contribution to outperformance from the green bond holding in the portfolio, performance was supported by its sustainability focus in two ways:

1. **The Fund favours issuers with better ESG scores:** This would have created structural outperformance in the Fund, according to our analysis above
2. **The Fund excludes certain sectors, leading it to have a non-cyclical bias:** Exclusions, primarily related to carbon-sensitive sectors, mean the Fund invests less in more cyclical sectors such as mining and energy, and more in non-cyclical sectors (see Table 2). This would have helped Fund performance over the period. Spreads in more cyclical industries widened more than other sectors over the period (see Chart 3).

Table 2: Insight Sustainable Euro Corporate Bond Fund performance by sector[6]

Sector	Portfolio (%)	Benchmark (%)	Relative
Food and beverage	7.32	4.60	2.73
Telecoms	9.70	7.33	2.38
Senior banks	27.85	25.58	2.27
Capital goods	2.07	3.70	-1.63
Energy	2.29	3.92	-1.63
Autos	3.35	6.93	-3.58

[4] Source: Bloomberg, Insight Investment Management. Data as at 30 April 2020. Issuances with similar currencies and maturities selected to best reflect the green vs brown comparison. The specific securities identified and described are subject to change, for information only. No assumptions should be made that the securities identified and discussed were or will be profitable. [5] Past performance is not a guide to future performance. Insight as at 30 April 2020. Returns are gross of fees and in EUR. Benchmark: Barclays Capital Euro Aggregate Corporate Bond Index. The name of the fund and its benchmark were changed from Insight Euro Corporate Bond Fund and Markit iBoxx Euro Corporates Index on 29 September 2017, respectively, when the sustainable investment approach was adopted on the Fund. Since the publication of this article the Insight Sustainable Euro Corporate Bond Fund has been merged into the Responsible Horizons Euro Corporate Bond Fund. The latter Fund, managed by Insight, is part of the Ireland-domiciled BNY Mellon Global Funds, plc (BNY MGF) range and is classified as an Article 8 product under the EU Sustainable Finance Disclosure Regulation. [6] Insight as at 30 April 2020.

Chart 3: Sector spreads[7]

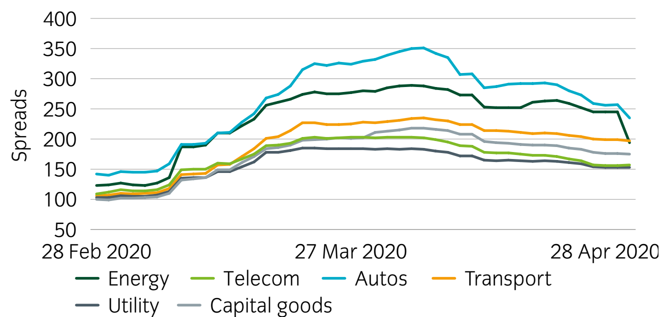
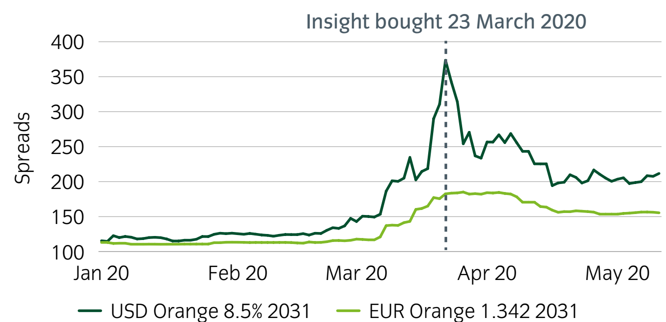


Chart 4: An example of cross-currency distortions[8]



However, whilst there was some structural benefit from the ESG tilt in the portfolio over the period, it is also clear that much of the alpha generation was created by traditional active management techniques. For example, the biggest underweight in the Fund, in the autos sector, is not de facto an ESG tilt but rather a view on the long-term prospects for that industry.

With the volatility creating opportunities, we were particularly dynamic in managing risk in the Fund, both taking advantage of cheap new issuance in sectors less affected by COVID-19, and looking at large cross-currency distortions when markets became dislocated. An example of this is illustrated in Chart 4, showing the purchase of an Orange SA bond iin US dollars versus where the same maturity bond traded in euros.

In short, it was a combination of active management and the ESG profile of the Fund which delivered outperformance over the period.

CONCLUSION

Our research suggests companies with stronger ESG profiles were indeed more resilient during the recent market turmoil. In contrast, we see limited evidence on a like-for-like basis that green bonds outperformed brown bonds during the recent period of volatility, though with the emergence of more impact-focused metrics in investor strategies a clearer premium for green bonds may be distinguished over time.

Overall, during this period we believe sustainability-focused portfolio tilts and allocations benefited portfolio performance, and support our long-held view that a focus on ESG factors should be accretive to performance and not detrimental. Combined with robust active management capabilities, there is the potential for such strategies to deliver meaningful alpha over the longer term.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

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Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

[7] Source: Bloomberg, Insight. Data as at 30 April 2020. [8] Source: Bloomberg, Insight. Data as at 12 May 2020.

Institutional Business Development
businessdevelopment@insightinvestment.com
+44 20 7321 1552

European Business Development
europe@insightinvestment.com
+49 69 12014 2650
+44 20 7321 1928

Consultant Relationship Management
consultantrelations@insightinvestment.com
+44 20 7321 1023

@InsightInvestIM

company/insight-investment

www.insightinvestment.com

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