Insight INVESTMENT

INVESTING RESPONSIBLY IN CREDIT AND BEYOND

INSIGHT EXPERTS DISCUSS THE CHALLENGES FACING SOVEREIGN DEBT, ASSET-BACKED SECURITIES, LDI AND SUSTAINABLE CREDIT PORTFOLIOS

MAY 2022

BNY MELLON | INVESTMENT MANAGEMENT

DR. BEN CALDECOTT

Dr Ben Caldecott is the founding director of the Oxford Sustainable Finance Group at the University of Oxford's Smith School of Enterprise and the Environment. He is also a founding director and principal investigator of the UK Centre for Greening Finance & Investment (CGFI), the national centre to accelerate the adoption and use of climate and environmental data and analytics by financial institutions internationally. Dr Caldecott is also founder and co-chair of the Global Research Alliance for Sustainable Finance and Investment (GRASFI), an alliance of global research universities promoting rigorous and impactful academic research on sustainable finance.

GARETH COLESMITH

Gareth is Insight's Head of Global Rates and Macro Research and oversees global, UK and inflation-linked government bond portfolios. He also has direct responsibility for managing absolute return bond portfolios.

ROBERT SAWBRIDGE

Robert is Insight's Head of Responsible Investment. He oversees the responsible investment programme at Insight across all asset classes and investment teams.

PRITESH SOLANKI

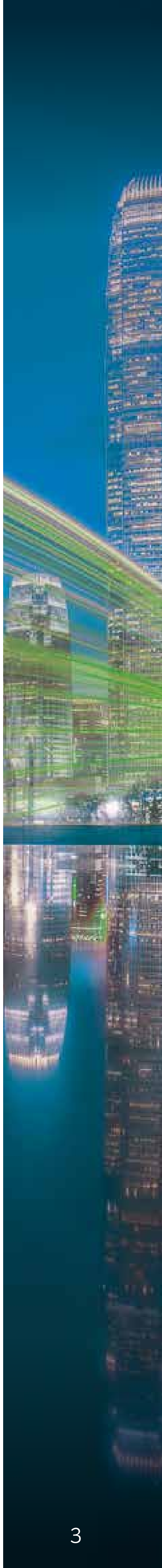
Pritesh is a Portfolio Manager within Insight's Secured Finance Team, having originally joined the team as an analyst in May 2015. Prior to Insight, Pritesh spent two years at MKP Capital Europe as an associate portfolio manager.

EMILY TANN

Emily is a Solution Designer in the Client Solutions Group who joined Insight in July 2019. She works on the design and delivery of investment solutions tailored to address the specific risk and return objectives of Insight's clients.

GREATER AWARENESS OF SUSTAINABILITY AMONG INSTITUTIONAL INVESTORS MEANS THEY ARE DEMANDING MORE FROM THEIR ASSET MANAGER PARTNERS, PARTICULARLY WHEN IT COMES TO THEIR CREDIT ALLOCATIONS. DR. BEN CALDECOTT SPEAKS WITH FOUR INSIGHT COLLEAGUES ABOUT THE ESG CHALLENGES THEY FACE IN A RANGE OF MARKETS.

CONTENTS



THE DATA CHALLENGE FOR INVESTING RESPONSIBLY IN SOVEREIGN BONDS

Ben Caldecott: How do you use data to assess the resilience of public finances to ESG risks and uncertainty? What lessons have been learned?

Gareth Colesmith: One thing everybody needs to bear in mind with sovereign risk is that climate change is likely to negatively impact the creditworthiness of all countries over the long term, whether from physical damage, mitigation costs, or decarbonisation costs. Or, most likely, all three. Following the global financial crisis and the COVID-19 pandemic, countries everywhere have a lot of debt and climate change will only increase that burden. And that will increase the probability of credit rating downgrades and fiscal crises.

We have had sovereign ESG assessment frameworks for four or five years. A key differentiator for us is that we split those into risk and impact ratings. The risk ratings look at ESG risks that could affect a country's ability or willingness to repay debt over the next 30 years or so, and we incorporate that analysis into how we think about government bonds across all portfolios. The impact ratings reflect a country's success in meeting the UN's Sustainable Development Goals, which is appropriate for clients that want to take those issues into account in their portfolios.

There are a lot of ESG regulations coming on stream, and they are usually driven by the very best of intentions. But regulators are not ESG experts, and their regulations often do not make a huge amount of sense.

For example, national sources for greenhouse gas emission intensity – the volume of emissions per unit of GDP – are typically more up to date but less independent than multinational sources that rank countries on an equivalent basis. There is also the question of whether to measure the greenhouse gases produced by a country or those that are ultimately consumed by it. Western service-based economies tend to look much better when they ignore the emissions created in the production of imported goods, which is permitted by regulators.

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Following the global financial crisis and the COVID-19 pandemic, countries everywhere have a lot of debt and climate change will only increase that burden, increasing the probability of credit rating downgrades and fiscal crises.

So, how do we avoid potential greenwashing when sometimes even the regulators appear to be complicit? We can make our analysis public when it shows deficiencies in a country's policies, actions, or even regulatory framework. We can engage with and lobby governments, as well as regulators and debt management agencies. And finally, we can lead by example.

At Insight, we continue to develop the tools to help clients navigate the complexities of fast-changing ESG regulations. We also think beyond regulations to reach the ESG outcomes that clients want for their investments.

Ben Caldecott: What is Insight doing to deal with ESG data deficiencies and unavailability concerning sovereign credit?

Gareth Colesmith: There are various things we can do. The most obvious is to look for better data sources. In building our sovereign ESG frameworks, we reviewed around 6,000 data series from various sources, and we have exhausted the open-source, freely available sources out there. But we must acknowledge some issues with the timeliness, quality, and coverage of that data. It is now a matter of judging and assessing the data sources you pay for and working out which do not add any value – and that involves a lot of work.

On timeliness, we lobby data providers to try and bring their data up to date more quickly. Many of those data providers, such as the World Bank, are keen to work with us and are very keen to improve the data they provide.

One way of tackling issues around the timeliness of data is by using a system of flags to alert portfolio managers to potential changes. So, we have green, red, and black flags for the risk framework. And for the impact framework, we have a controversy flag. For example, we are currently debating whether to apply controversy flags to the UK around the government's proposal to send migrants to Rwanda and to the US about the potential overturning of Roe versus Wade.

The Russian invasion of Ukraine is another example. None of the data has yet caught up with events. We added a controversy flag and a black flag to Russia in February. The latter advised our portfolio managers that they should avoid investing in this country. But that was taken out of our hands because of the sanctions regime, which restricted trade in Russian securities.

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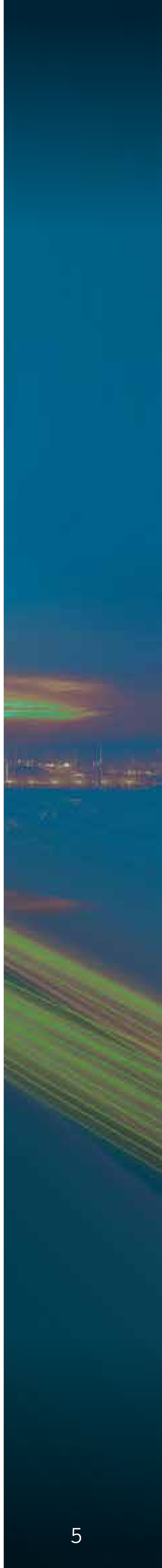
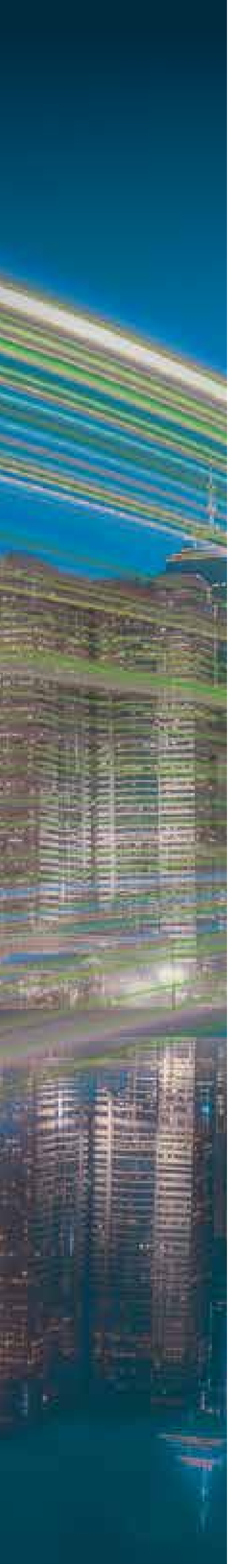
Two ways we are tackling the issue of ESG data deficiencies and unavailability concerning sovereign credit is to look for better data sources and lobbying data providers to try and bring their data up to date more quickly.

For more information on the Prime sovereign ESG ratings, please see here.





KEY DEVELOPMENTS IN RESPONSIBLE INVESTMENT WITHIN LDI PORTFOLIOS

Ben Caldecott: What does responsible investment mean for LDI portfolios?

Emily Tann: We think of three pillars when it comes to responsible investment in LDI. The first pillar is the assessment of ESG factors in all the assets we buy and all the derivative counterparties we trade with. The second pillar is engagement with issuers and derivative counterparties. And the third pillar is exercising our stewardship role more broadly to support sustainable markets through engagement with policymakers, regulators, and other industry bodies. Engagement is therefore not just limited to counterparties but operates on a much broader scale. In combination, the activities across the three pillars seek to protect clients' interests.

Two major developments over the past year in LDI have offered clear points of action: one is the first UK issuances of green gilts and the other is the introduction of requirements for pension schemes to report on the carbon emissions associated with their portfolio.

The recent issuances of green gilts were driven by the UK government's commitment to achieving net zero emissions by 2050, with the proceeds of the gilts hypothecated to projects with clear alignment to UN Social Development Goals (SDGs). It was interesting to note the wide range of views from clients and consultants in the lead up to the issuance on the appropriateness of the green gilts from a risk-return perspective, as they were more expensive than the non-green equivalents for identical credit risk. Despite this, they were very popular at issuance and issued at attractive levels (in our opinion), and as such we participated in the issuance on behalf of a number of clients. While green gilts offer more than just a prospect for engagement, we did take the opportunity to engage with the Debt Management Office on their green financing framework and the issuance, and we rated these gilts highly from a green bond perspective.

On carbon emissions reporting for LDI portfolios, we looked at how to apply DWP guidance to the most material exposures of our clients' LDI portfolios – UK gilts. Reported emissions for sovereigns are based on the total emissions of the country of the issuer, and so we take total UK emissions as the initial data point.

There are currently certain limitations with the data and some discretion around how to calculate the metrics, which could lead to inconsistencies in reporting and perhaps even unintended consequences in the name of improving emissions reporting.

However, the introduction of these requirements, and the use of a sovereign's total emissions, has sharpened the focus of schemes on the UK's climate policy and progress regarding climate change. Ultimately, we expect that as pension schemes report on the climate risks in line with new guidelines, this increased transparency will help to educate and inform members about the UK's progress towards its net-zero goals. And, like with the broader engagement we have carried out around RPI reform and green gilts, there is the potential to engage widely with the government and other interested parties on climate and carbon.

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Ben Caldecott: Why is counterparty engagement so important to Insight, and what do you think it helps achieve?

Emily Tann: On engagement with counterparties specifically, it is an integral part of our stewardship responsibilities to do so, and we think it is the right thing to do. Given our scale and the scale of derivatives we trade, we have good, strong relationships with our counterparty banks. So, we believe we can use that to effect positive change.

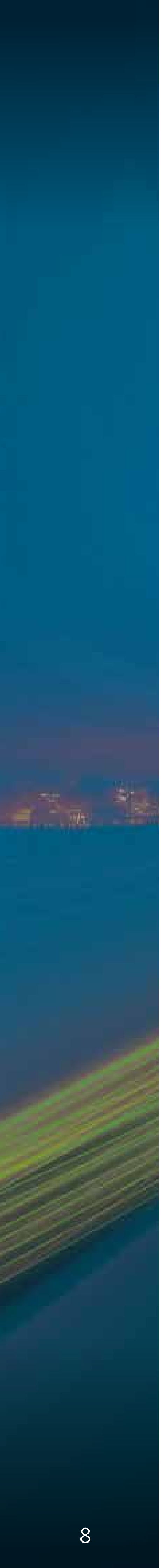
We focus on those counterparties that we perceive to be laggards and talk to them about what their competitors are doing in the areas where we see they are weaker. We set them targets in line with what their competitors are doing so they can reach that level. And we have been prioritising key engagement themes of environment, cybersecurity, remuneration, and diversity.

Engagement is not limited to counterparties. One recent example of engagement in our stewardship role concerned the UK government's decision to replace the RPI measure of inflation with the lower CPIH from 2030 onwards. The change is expected to lead to lower coupon payments on index-linked gilts and lower pension increases for pensioners, and is effectively a vast wealth transfer of around £100bn from pensioners to the UK government. It was clearly a social issue, and initially there was not much awareness. So, we lobbied hard against the change and worked to raise awareness with our clients and the press. As a result, a group of pension schemes have been granted a judicial review of the government's decision. If it is successful, it could see the consultation process rerun.

Ben Caldecott: If engagement does not work, have you ever excluded a counterparty based on ESG failings?

Emily Tann: We consider the exclusion of a bank from a counterparty panel to be a last resort. It is not something we have had to do in the past. But we do have a clearly defined six-step process of increasing severity if we find the counterparty is not responding to engagement. We are always trying to ensure there is sufficient market access for clients and a wide-enough panel to execute trades well.

> We focus on those counterparties that we perceive to be laggards and talk to them about what their competitors are doing in the areas where we see they are weaker. We have been prioritising some key engagement themes – climate change, cybersecurity, water management, and diversity and inclusion.



HOW A FOCUS ON ESG FACTORS IS CHANGING THE ABS MARKET

Ben Caldecott: How does the ABS market reflect ESG factors – both in terms of risks, and in terms of values?

Pritesh Solanki: Our industry has done quite poorly advocating for ESG within the ABS market – we have spent more time talking about the integration process. Ultimately, there are obstacles to the integration of ESG within ABS, such as limited access to holistic data, the complexity of the structures, the need to analyse each security in turn, and the lack of industry standardisation. But I do think we are heading in the right direction.

ABS is ring-fenced in nature, which means the loans originated by the issuer are directly financed by investors such as us. Every dollar of our capital finances one dollar of those assets; there is complete transparency, and we have direct recourse to those assets over time. This transparency is the pillar for good governance, in terms of understanding the underlying risks.

Also, the ABS market is not 'sinful' in nature. We have very few revenue streams or assets backed by fossil fuels, weapons, or tobacco. That is primarily because the end borrower is a consumer like me or you, whether the loan is for a residential mortgage, a commercial real estate, or a car loan.

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Since the global financial crisis, the banking sector has been curtailed quite materially when it comes to regulation; only prime borrowers have had access to credit. That is why we believe the ABS market serves a huge social function, whether it be a hire-purchase loan for a person to buy a car to get to work, a first-time property buyer to get on the ladder, or for a business entrepreneur to get a loan. ABS provide a social function in that sense.

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We are engaging with issuers to make sure they incorporate what we consider best practice at a business level, to make sure it is sustainable and responsible from an industry standpoint.

Governance typically falls on us as credit investors when it comes to the underwriting process, but little is talked about from a regulatory standpoint. After the financial crisis, European regulators forced issuers to hold what we call 'skin in the game' or risk retention, which makes sure there is an alignment of interest between investors and issuers. It is one of the main reasons why, since the financial crisis, we are yet to see a default in the ABS market in Europe.

Data is in the DNA of secured finance strategies. And I believe that good data – which is what we are trying to develop at Insight – is really what is going to unlock ABS's potential within an ESG principles framework. The lack of holistic data is something that Insight is tackling.

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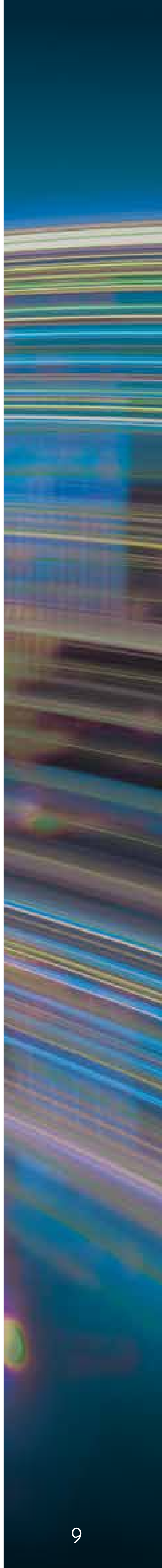
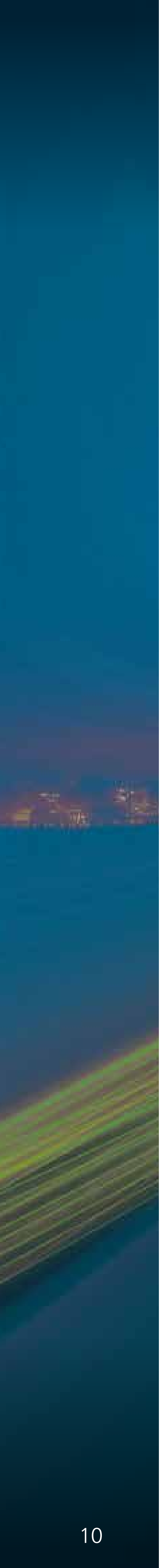
Every dollar of our capital finances one dollar of those assets; there is complete transparency."

We send issuers and originators questionnaires to gather information, which we turn into a usable ESG metric that feeds into the investment process: not to exclude issuers, but to engage with them. We are encouraging these issuers to incorporate what we consider best practice and ensure their business is sustainable and responsible from an industry standpoint. We have also worked with the International Capital Markets Association to create a working group with the largest asset managers to think about the most important key performance indicators (KPIs) across ABS sectors. Once these KPIs are agreed, we could be in a situation where we get data directly from issuers, and we will be able to do an ESG underwrite with those metrics.

For more information how Insight invests responsibly in secured finance assets, please see here.





TRENDS IN RESPONSIBLE INVESTMENT IN CREDIT

Ben Caldecott: What sustainable investment trends do you see in credit markets and what do institutional investors need to know about them?

Robert Sawbridge: There are currently three key market trends in credit markets, and underlying each of these is effectively one single dynamic: an investment landscape shifting towards a greater level of sustainability.

The first trend manifesting in our client credit portfolios is that they are becoming much more customised. This may take the form of basic exclusionary criteria, but we are also starting to see much more sophisticated credit solutions to achieve sustainable outcomes.

The second trend is the evolution of the broader credit market in this space. It is particularly noticeable in the development of the sustainable bond market, which stood at $1.1trn last year[1]. It is genuinely a big market now, and green bonds represent 50% of it.

However, the most interesting part of that market is the growth in new instrument types. One of the most prominent examples of this is the sustainability-linked market – where bonds are linked to predefined environmental or social KPIs – which has grown by 10 times over the past year[1].

But the market is innovating even further. We have recently seen the first outcome-driven investment opportunity after the World Bank issued its 'rhino bond' – where the proceeds are being used to fund black rhino conservation in South Africa. Investors lend to the World Bank and then get a rate of return that depends on the success of black rhino conservation efforts.

And the third trend we have seen in the credit market is how innovation leads to greater regulation, such as the EU's SFDR (Sustainable Finance Disclosure Regulation) and the UK equivalent that will be coming in the next year or so.

All this regulation has its heart in the right place and is trying to do the right things to improve transparency and unmask greenwashing, but it is incredibly complex. Also, there is a genuine risk that it leads to unintended outcomes in terms of capital allocation, not least because of how it is being brought in.

For example, in Europe, portfolio managers are asked to build portfolios and report on data points that companies have not yet disclosed because the sequencing for company disclosure is later. So, there are a lot of portfolios being built on estimated data, and there is a concern that this might lead to unintended outcomes.

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[1] Source: Bloomberg. As at 31 December 2021.

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, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and certain charges, such as currency conversion charges may depend on the individual situation of each investor and are subject to change in future.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. 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.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialize or vary significantly from the actual results. Accordingly, the projections are only an estimate.

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

ASSOCIATED INVESTMENT RISKS

Fixed income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

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 emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

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.

Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

While efforts will be made to eliminate potential inequalities between shareholders in a pooled fund through the performance fee calculation methodology, there may be occasions where a shareholder may pay a performance fee for which they have not received a commensurate benefit.

FIND OUT MORE

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