Insight INVESTMENT

January 2020

RESPONSIBLE INVESTMENT IN FIXED INCOME UPDATE: Q4 2019

HIGHLIGHTS

- Impact bond issuance surges more than 60% in 2019 to over $250bn
- Central banks increase focus on ESG issues as Federal Reserve considers climate risks and Bank of Japan joins green network
- Analysis suggests climate regulations could wipe $2.3trn off global company valuations within five years

REGULATORY AND INDUSTRY NEWS

- **Investors with $37trn in assets urge action at the UN Climate Change Conference (COP 25):** The 631 names, including high-profile investors such as the California Public Employees' Retirement System, want to end fossil fuel subsidies, phase out coal power and establish a "meaningful" price for carbon. Some predict an "apocalyptic future" for financial markets if the world does not step up its effort to combat climate change. Insight was a member of this group.
- **Climate regulations could wipe $2.3trn off global company valuations by 2025:** Tighter rules on climate change could have a sharp impact on asset valuations, according to research by the Principles for Responsible Investment (PRI). Analysis of sector and company-level climate forecasts based on factors including carbon prices, coal bans and support for renewable energy, suggested the worst-performing companies, such as those in the fossil fuel sector, would lose up to c.43% of their value, whereas the best-performing, such as agricultural companies related to biofuels and companies associated with electric vehicles, could gain up to c.33%.[1]
- **The Federal Reserve increased research into climate change:** Federal Reserve Chairman Jerome Powell said the US central bank is increasing work on climate change risks, but does not see them as a "near-term" threat. He said that climate change does not have any near-term implications on monetary policy, though he recognised that climate change could affect key policy over time.
- **Central bank green network expands as Bank of Japan enlists:** The Network for Greening the Financial System (NGFS), a group of central banks including the European Central Bank and People's Bank of China, focuses on developing climate risk management in the financial sector and supporting the transition towards a sustainable economy. It announced several central banks had joined its roster, including the Bank of Japan and Central Bank of the Russian Federation.
- **UK regulator announces new ESG rules for workplace pensions:** The Financial Conduct Authority (FCA) called for independent governance committees (IGCs), which have oversight of contract-based defined contribution pension schemes, to "report on their firm's policies on ESG issues, consumer concerns and stewardship for the products that IGCs oversee". The rules will apply from 6 April 2020, with reports issued in early 2021 to take account of the new regulations.[2]

INSIGHT INVESTMENT DECISIONS REFLECTING ESG FACTORS IN Q4 2019

Sector	Asset class	ESG risk factor	Comments	Investment decision	Insight ESG rating
Automotive	Active	Social and governance	Following a fall in the ESG rating, we engaged with the issuer to understand the steps being undertaken to improve product quality, governance and disclosure. There was an underwhelming response to our engagement and plans for improvements had no tangible commitment targets.	BUY ▶ SELL	5
Utilities	Active	Environment	The issuer committed to clear environmental targets, which were linked to the bond's coupon payments meaning the issuer would pay more by way of a coupon if it did not meet its overall target objectives.	BUY	1
Mining and materials	Buy and maintain	Environment, social, and governance	After a significant environmental incident, and recognising the potential for future environmental concerns, we moved to a hold rating, with a view to engaging with the issuer to understand future plans before considering a sale.	HOLD	3
Industrials	Buy and maintain	Governance	Following a whistleblower incident we decided to keep the issuer on a hold rating. Engagement activity is ongoing to understand the materiality of the issues and to assess the future plans to address these risks.	HOLD	4

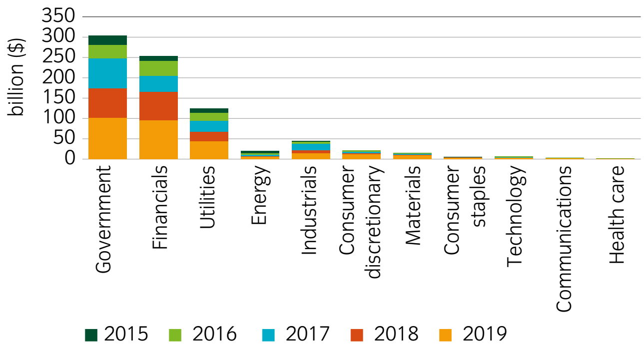
This is an illustrative list of investment decisions affected primarily by ESG factors, selected to demonstrate the role of ESG analysis in our research and decision-making.

[1] For more information, please read the article from PRI here.

[2] For more information, please see https://www.fca.org.uk/publications/policy-statements/ps19-30-independent-governance-committees.

IMPACT BOND ISSUANCE IN Q4 2019

Figure 1: Total issuance (USD) by sector and by year[1]



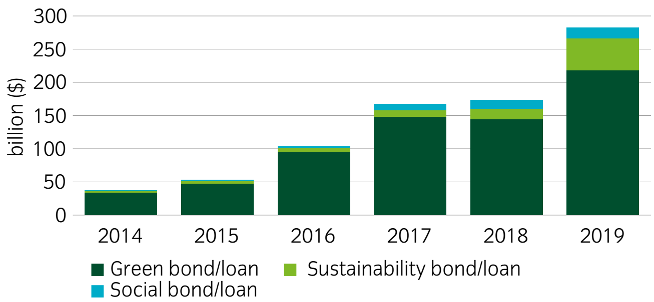


Figure 2: Largest impact bond issues in Q4 2019[2]

Issuer	Issuer type	Size of issue	Bond type
Bank of America Corporation	Diversified Banks	$2.0bn	Green
State of North Rhine-Westphalia Germany	Government Regional	€1.65 bn	Sustainable
China Development Bank	Government Development Banks	CNY1.42bn	Green
Credit Agricole	Consumer Finance	€1.38bn	Green
New South Wales Treasury Corporation	Government Regional	AUD1.22bn	Sustainable

A NOTE ON RESPONSIBLE INVESTMENT AND IMPACT BONDS

Investing responsibly means taking ESG risks into account across all portfolios. Impact bonds may bear similar ESG risks to traditional bonds. Investing in them does not mean you are necessarily taking a more responsible approach, but they can be an effective way to have a positive environmental or social impact with your investments.

INSIGHT IMPACT BOND RATINGS IN Q4 2019

Our analysis of 21 impact bonds issued in Q4 2019 resulted in the following ratings:

4 bonds were rated **green**, indicating the bond **meets** Insight's minimum sustainability requirements

9 bonds were rated **amber**, indicating there are **weaknesses** in the bond with regard to sustainability

8 bonds were rated **red**, indicating the bond **does not meet** Insight's minimum sustainability requirements

Sample of Insight Investment's impact bond analysis in Q4 2019

Name	Bond type	ESG performance met?	Bond framework criteria met?	Impact criteria met?	Traffic light score
Enel SpA (utilities)	SDG	Yes	Yes	Yes	▲

Analyst assessment: Enel SpA is aiming to reach targets of a 55% share of renewables by 2021 and 125g/kWh scope 1 GHG emissions by 2030. They have issued USD 5-year, EUR 4-year and 7-year bonds under the first target and a EUR 15-year under the second target. Both of these groups of issues are aligned with the Paris Agreement and the coupon has a one-off 25bp step-up if the company misses its targets. They are the first to issue a bond with this structure.

Rated green: The structure of the bonds allows the bonds' performance to be linked with the targets set, creating an outcomes-based framework for the bonds, which we view positively.

Name	Bond type	ESG performance met?	Bond framework criteria met?	Impact criteria met?	Traffic light score
PNC Bank NA (financials)	Green	Yes	Yes	Yes	▲

Analyst assessment: The bond's proceeds may be used only to finance (or refinance) projects focused on renewable energy (solar and wind), energy efficiency in owned properties (25% improvements), green buildings (Leadership in Energy and Environmental Design platinum and gold), completed at most three years ago. A Sustainable Finance Working Group and Green Bond Approval Committee will select projects. Net proceeds will be monitored internally with unallocated capital to be held in cash.

Rated amber: The categories targeted for the bond's proceeds were very broad, with limited information on how the cash would be allocated across each. Also, a second-party opinion on the bond's sustainability characteristics was not available when we assessed the bond.

Name	Bond type	ESG performance met?	Bond framework criteria met?	Impact criteria met?	Traffic light score
Ellaktor SA (industrials)	Green	No	Yes	No	▲

Analyst assessment: The bond's proceeds may be used to finance renewables (wind and solar), toll roads and environment (waste) operations. Projects for the bond are to be selected by the business division and treasury teams, with proceeds to be managed via a green bond register, which logs how proceeds are allocated and which projects are considered. Ellaktor has committed to providing allocation and impact reporting.

Rated red: Part of the proceeds were intended to be used to repay existing debt rather than to fund the above projects, which has no clear connection to green projects. Additionally, other operations such as toll roads are not considered to be green projects.

[1] Source: Insight Investment. Data as at 31 December 2019.
[2] Source: Bloomberg. Selected by Insight according to absolute value of local currency.

FURTHER READING

INSIGHT ESG FIXED INCOME RATINGS
CORPORATE METHODOLOGY SUMMARY

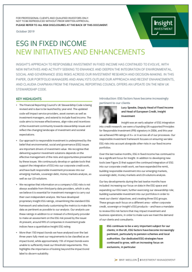
Insight ESG Fixed Income Ratings: corporate methodology summary

We believe environmental, social and governance (ESG) factors can have a material impact on investment risk and have created a risk-centric approach using advanced quantitative tools and avoiding subjective ethical biases.

RESPONSIBLE INVESTMENT IN FIXED INCOME
A PRIMER

Responsible investment in fixed income: a primer

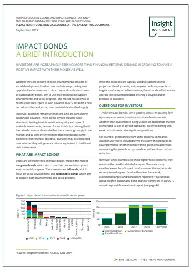
What is responsible investment and how does it differ from sustainable and impact investing? What does it mean to invest responsibly in fixed income?



ESG IN FIXED INCOME
NEW INITIATIVES AND ENHANCEMENTS

ESG in fixed income: new initiatives and enhancements

Insight's approach to responsible investment in fixed income has continued to evolve. In this paper, our portfolio managers and analysts outline our approach and recent enhancements.



IMPACT BONDS
A BRIEF INTRODUCTION

Impact bonds: a brief introduction

What are impact bonds, do you get what you pay for, is there sufficient capacity and how does performance compare to traditional bonds?

2019 CLIMATE RISK INDEX
FOR CORPORATE DEBT ISSUERS

Climate Risk Index 2019 for corporate debt issuers

The Climate Risk Index provides an annual assessment of 1,846 corporate fixed income issuers and analyses how they are managing the risks and opportunities presented by climate change. In this paper we outline our methodology and results from our 2019 climate risk index.

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.

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.

FIND OUT MORE

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