Insight INVESTMENT

April 2020

# RESPONSIBLE INVESTMENT IN FIXED INCOME UPDATE: Q1 2020

## HIGHLIGHTS

- Insight has released a letter following the PRI's recent call for a "robust response" from its members to the COVID-19 crisis.
- Social and sustainability bond issuance surges in Q1, spurred by the pandemic.
- Global pension fund leaders call for investment community to focus on sustainability, with EU regulations at the fore.

## REGULATORY AND INDUSTRY NEWS

- **Insight has released a letter outlining our actions in navigating the pandemic, including our response to the PRI's suggestions**: Insight's own letter, signed by our CIO, is available **here**. The Principles for Responsible Investment (PRI) stated that "an immediate, robust response to the COVID-19 crisis is needed across the global economy", and outlined seven actions for investors to take **here**.
- **Pandemic spurs surge in social and sustainability bond issuance**: Such issuance was up 69% compared to the first three months of 2019, to US$6.7bn, driven in part by issuers seeking to provide emergency funding in response to the pandemic, according to HSBC Global Research. This included a US$3bn social bond from the African Development Bank to provide financing to countries and businesses, and to support African communities, seeking to overcome the virus and its implications. A range of other bonds seeking to finance pandemic responses were also issued.[1]
- **The EU's technical expert group on sustainable finance (TEG) published its final report on the EU taxonomy**: The final report[2] includes extensive details and recommendations regarding the taxonomy, which defines which economic activities can be considered as environmentally sustainable, and will be used under the proposed EU Green Bond Standard to define which projects count as 'green'.[3] This marks the next step towards the implementation of legislation that will render it essential for major companies to report on non-financial matters, including environmental measures. The first reporting is due for December 2021 and buy-side, sell-side and corporates are all in scope for the new regulation.
- **Global pension fund leaders issue statement calling for investment community to focus on sustainability:** Declaring that "meaningful and decision-useful ESG-related disclosure and analysis remains the exception rather than the rule", leaders from the California State Teachers' Retirement System, Japan's Government Pension Investment Fund, and the UK's Universities Superannuation Scheme issued a joint letter calling for companies and asset managers to "rethink their strategy and enhance their disclosures".[4]
- **Four in five companies not on track for 2°C world, warns asset owner-led Transition Pathway Initiative (TPI)**: The TPI State of Transition Report 2020, which called on investors to hold companies to account on climate amid coronavirus-fuelled financial pressures, found "scant evidence" of corporate climate progress over the last year. A mere 43 companies (18%) out of 238 energy, industrial and transport companies emerged as having emissions trajectories aligned with the target of limiting climate change to 2°C.[5]

## INSIGHT INVESTMENT DECISIONS REFLECTING ESG FACTORS IN Q1 2020

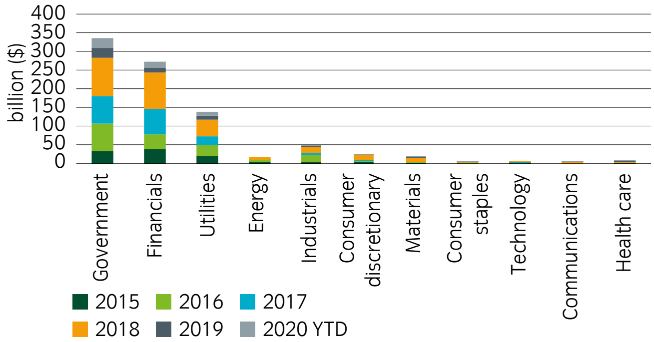
| Sector | Asset class | ESG risk factor | Comments | Investment decision | Insight ESG rating |
|---|---|---|---|---|---|
| Utilities | Buy and maintain | Governance | Following a worst-in-class rating for the governance pillar, the decision was made to engage with the issuer on key underlying issues such as issuer behaviour, workforce management and general corporate governance. | HOLD | 3 |
| Utilities | Active | Environmental | An attractively priced transition bond that targets a key environmental risk: mitigation and adaptation for a low carbon economy. | BUY | 2 |
| Technology | Active | Governance | Following a worst-in-class overall ESG rating and confirmation from the sector analyst of poor governance. | SOLD | 5 |
| Financials | Active | Environmental and Governance | An attractively priced green bond with strong green credentials and a best-in class ESG score. | BUY | 1 |

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] Source: HSBC Global Research. Green Bond Insights: Delayed but not denied, 15 April 2020. [2] For more information on the final report, see https://ec.europa.eu/info/publications/sustainable-finance-teg-taxonomy_en#200903 [3] For more information on the Green Bond Standard, see https://ec.europa.eu/info/publications/sustainable-finance-teg-green-bond-standard_en [4] https://www.uss.co.uk/~/media/document-libraries/uss/news/our-partnership-for-sustainable-capital-markets.pdf 5 https://www.transitionpathwayinitiative.org/tpi/publications/50.pdf

## IMPACT BOND ISSUANCE IN Q1 2020

Figure 1: Impact bond issuance by sector and year[6]



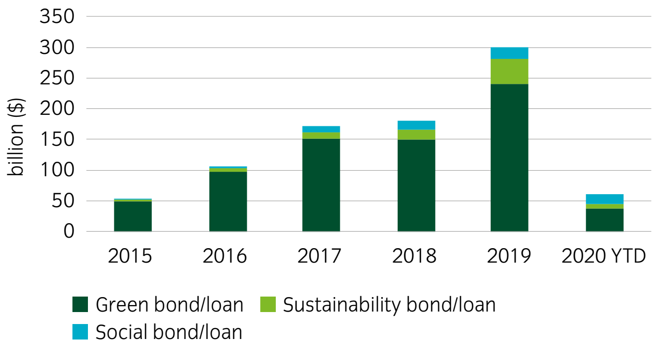




Figure 2: Largest impact bond issues in Q1 2020[7]

| Issuer | Issuer type | Size of issue | Bond type |
|---|---|---|---|
| African Development Bank | Government | US$3.00bn | Social |
| Societe Du Grand Paris EPIC | Government | €2.70bn | Green |
| International Bank for Reconstruction & Development | Government | £2.27bn | Sustainable |
| Chile Government International Bond | Government | €1.40bn | Green |
| Autonomous Community of Madrid Spain | Government | €1.37bn | 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 Q1 2020

Our analysis of 28 impact bonds issued in Q1 2020 resulted in the following ratings:

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

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

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

Sample of Insight Investment's impact bond analysis in Q1 2020[8]

| Name | Bond type | ESG performance met? | Bond framework criteria met? | Impact criteria met? | Traffic light score |
|---|---|---|---|---|---|
| Telia Company AB (communications) | Green | Yes | Yes | Yes | ▲ |

**Analyst assessment:** The bond's proceeds may be used for renewable energy (including wind and solar projects and green digital solutions to reduce GHG emissions), energy efficiency (technology improvements including fibre/high speed internet) and green buildings (improving overall building standard). Telia has committed to providing allocation and impact reporting and has state relevant KPIs for this. A green bond committee comprised of representatives from the company's Treasury, Strategy, Technology and Sustainability teams, will be responsible for selection and evaluation of eligible projects. Telia has committed to providing allocation (independently verified) and impact reporting including a list of relevant KPIs to monitor impact.

**Rated green:** The company has a clear framework and has set various business level targets on carbon emissions, waste management and 100% action amongst employees to be achieved by 2030. The company has sought partnership with various other companies, for example Finnish transport to develop smart bus traffic by implementing "Narrow Band IoT", a Nordic utility owner to install 900,000 smart meters and therefore aiming for a net positive impact across the business. There is clear commitment from the company to implement a sustainable strategy.

| Name | Bond type | ESG performance met? | Bond framework criteria met? | Impact criteria met? | Traffic light score |
|---|---|---|---|---|---|
| Cadent Finance Plc (utilities) | Transition | Yes | Yes | Yes | ▲ |

**Analyst assessment:** The bond's proceeds may be used for retrofit gas transmission & distribution networks (repair/replacement of pipelines), renewable energy (low carbon energy), clean transportation (infrastructure projects) and energy efficiency/green buildings (for buildings, offices and depots). A working group consisting of the treasury team, the CSR team and the project team will be responsible for selection and evaluation of eligible projects. Cadent have committed to providing allocation and impact reporting with verification of the allocation reporting.

**Rated amber:** Cadent will be using most of the proceeds to target reduction in methane leakages which is essentially correcting a negative impact associated with the network. However, we recognise that this will, in the medium-long run, contribute to the transition to a low carbon economy as hydrogen/low-carbon gas will be able to run through the network.

[6] Source: Insight Investment. Data as at 31 March 2020. [7] Source: Bloomberg. Selected by Insight according to absolute value of local currency. [8] The specific securities identified and described are subject to change, for information only to demonstrate our approach to ESG. No assumptions should be made that the securities identified were or will be profitable.

| Name | Bond type | ESG performance met? | Bond framework criteria met? | Impact criteria met? | Traffic light score |
|---|---|---|---|---|---|
| Prologis Euro Finance (Financials) | Green | Yes | No | No | ▲ |

**Analyst assessment:** The bond's proceeds may be used for green buildings (with several different organisations used for certification standards), renewable energy (for example solar panel installations) and energy efficiency (mainly targeting energy storage systems). Projects for the bond are to be selected by a green bond committee comprised of members of Prologis' ESG department and management, with proceeds to be tracked on a portfolio basis. Prologis has committed to provided allocation reporting.

**Rated red:** Part of the unallocated proceeds are intended to be used to repay existing debt rather than to fund the above projects, which has no clear connection to green projects. The impact of the bond is limited as the certification levels are not on par with what we've seen in the market. Prologis have also not formally committed to providing impact reporting and has not disclosed any relevant KPIs for monitoring the impact of the bond proceeds.

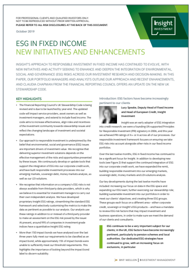
## FURTHER READING


### 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.

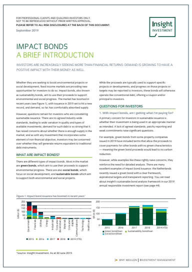

### Responsible investment in fixed income: a primer

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



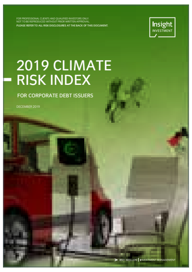

### ESG in fixed income: new initiatives and enhancements

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

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




### 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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