Global Asset Management

BlueBay Asset Management

ESG Beyond Equities

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With over 70% of global investors now using ESG principles as part of their investment process, according to data from the 2018 RBC Responsible Investing Survey, the approach has clearly marked the shift from niche to mainstream. From its roots in equities, we believe fixed income is the next asset set to benefit from the performance enhancing, risk reducing attributes of ESG principles.

ESG has carved out a solid position alongside other fundamental investment approaches, with nearly a third (31%) of investors surveyed in the 2018 RBC survey commenting that they believe ESG-integrated portfolios are likely to perform better than non-ESG integrated portfolios (up from 18% in 2017).

The numbers look positive on the flipside too – against return we must always balance risk, and most survey respondents, by a wide margin, think ESG can help mitigate risk in a portfolio. Overall, 67% of respondents view ESG as a risk mitigator.

When combining risk and return, the data shows strengthening confidence in ESG analysis as a tool for improving overall portfolio performance.

This trend is based on an increased level of acceptance about the investment merits of responsible investing and an interest in applying its principles to more diverse asset classes.

Equities have long been the primary asset class for road-testing ESG principles, with nearly 85% of those who incorporate ESG factors into their process doing so in equities, according to survey data. However, the survey also indicated that ESG analysis is moving beyond equities, as 60% of respondents incorporate it into their fixed income portfolios.

We believe fixed income is next asset class set to become the focus of ESG principles. But what are the benefits for bond investors?

The key is the potential to protect against downside risk.

While both asset classes can benefit from taking account of ESG factors for risk mitigation purposes, for debt investing this is critical as the growth potential of a bond is capped, but the possible downside is significant.

Like for like, ESG has been proven more beneficial in reducing downside risk versus aiding upside, making it a logical consideration for fixed income investors.

The ESG key

When combining fixed income and ESG, the key is an active investment approach.

The primary argument for passive investing is its perceived lower cost, but when applied to bonds this can prove a false economy.

With many ESG risks not widely known in the market, mispricing opportunities can naturally occur. Active management enables investors capable of identifying mispricings to proactively trade around these in an effort to generate returns. Lower-cost passive strategies follow a broad-brush 'hold the index' approach, hence do not take mispriced opportunities into account, which curtails their potential to generate alpha.

Comparing Advantages and Disadvantages of Passive and Active Investing in Fixed Income

Fixed income investing strategies/ factor attractiveness	Default avoidance	Diversification benefits	Application of fundamental research	Access to liquidity	Costs / fees
Passive	LOW (Own most of the market, so own the defaults in it)	MEDIUM (High for some funds, but low in others e.g. EM debt/HY indexes capture limited portion/most tradable issuers)	LOW (Largest weights/highest allocations made up of most indebted issuers; highly heterogeneous asset class esp. EM debt sovereigns, idiosyncratic risk profiles as countries are at different stages of economic development)	MEDIUM (Financial crisis has led to regulation which has reduced market liquidity, resulted in trade size and access to brokers challenges)	LOW (Lower manager transaction costs can be passed on in terms of lower fee)
Active	HIGH (Only own part of the market)	MEDIUM (Allocation independent of country indebtedness, tradability, can pick from any part of the market)	HIGH (Expert analysis possible of issuers taking into account unique conditions to identify alpha opportunities)	MEDIUM (Ability to size trades appropriately and access brokers with scale)	MEDIUM (Higher manager transaction costs, some of which are passed on in fees)

Source: BlueBay Asset Management

Alongside financial credit analysis, active managers can use ESG as an additional filter. As a proxy for management quality, it can be argued that a low-ESG rated issuer is likely to be riskier and less liquid in some cases, which the credit rating does not sufficiently reflect.

Smart application

Given that ESG strategies were first developed for equities, a 'one size fits all' view doesn't do the approach justice as it expands into bond markets – some nuancing is required. For example, 'best in class' strategies offer significant scope for equity ESG investing, but have a limited application in bond markets.

But one strategy that efficiently spans both asset classes is ESG integration.

The approach refers to the systematic consideration of material ESG factors as part of the investment process. The approach best caters for the different characteristics of bonds and their individual credit risk profiles.

ESG and the debt market duty

While a clear business case is likely to be the primary draw for many investors, applying ESG considerations to fixed income can also have societal outcomes.

As we face greater geopolitical instability and the escalating impacts of climate change, the long-term positive impacts of ESG strategies are gaining resonance.

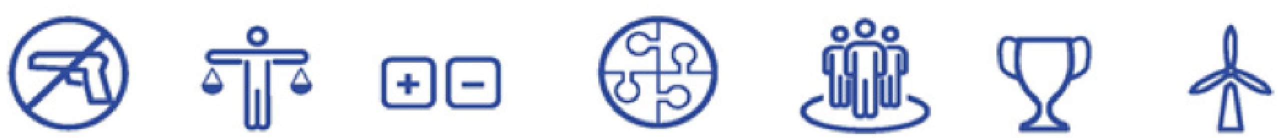
The fixed income market is significantly larger than the equity universe (two thirds vs a third), and includes sovereign and state-owned (SOEs) issuers, adding the potential to influence government efforts.

While equity holders might be known for their influence at board meetings, bond holders also have power. There is a legal contractual relationship between lenders and issuers, presenting an opportunity for ESG considerations to be written into issuance agreements.

As debt is a financially efficient fundraising source for issuers (opposed to raising capital via equity markets), many continually return to bond markets, and seek to do this with as low a cost of capital as possible. They are only able to do this if investors trust in the ability and willingness of the issuer to meet their obligations, giving lenders the potential power to work societal and environment improvements into issuance contracts over time.

The survey data confirms that the investment community sees the value in expanding ESG strategies out beyond equities and into fixed income to improve societal factors alongside enhancing long-term portfolio performance. It also raises a new issue for the management community – the market needs more fixed income offerings with an ESG angle. Investors should prepare for the ESG debt shift: We say watch this space...

Some Equity ESG Investment Strategies Are Better Suited to Fixed Income Than Others



ESG investment strategies/asset class	Ethical (negative/ exclusions) screening	Norms-based screening	ESG tilting	ESG integration	ESG engagement/ activism	ESG best in class	ESG (positive/ thematic) investing
Equities	Significant scope	Significant scope	Significant scope	Significant scope	Significant scope	Significant/ some scope	Significant/ some scope
Fixed income: Corporates	Some scope	Some scope	Significant scope	Significant scope	Some/limited scope	Limited scope	Significant/ some scope
Fixed income: Sovereigns	Limited scope	Some scope	Significant scope	Significant scope	Some/limited scope	Limited scope	Some/limited scope

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RBC Global Asset Management (U.S.) Inc.
Minneapolis | Boston | Chicago
800.553.2143 | **us.rbcgam.com**