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A With Intelligence Company

ESG in Fixed Income
Whitepaper

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Welcome to CAMRADATA's ESG in Fixed Income Whitepaper

There has been little let-up in the appetite for ESG-friendly strategies over the past few years, as investors have clamoured for new strategies in a growing range of different asset classes.

As this appetite has grown, there have been considerable flows into ESG-focused fixed income funds and the growing sophistication of managers in the space has allowed allocators to incorporate a range of different ESG-focused strategies into portfolios.

The growth of the ESG fixed income asset class has been strong. In 2022, for the first time on record, fixed-income funds commanded the lion's share of sustainable fund flows in the US, attracting $2.4bn, according to Morningstar.

Stewardship and engagement remain core features of ESG and a more effective lever in facilitating change due to the key role fixed income investors play in funding growth, innovation and other vital commercial activities. The impact of these efforts is creeping into valuations around cost of capital, but progress is glacial and inconsistent.

We continue to see innovation in the impact space also with new green, social impact and sustainability bonds coming to the fore.

Nevertheless, there are considerable challenges that ESG-focused managers need to overcome.

The longstanding issue of data quality and comparability remains an operational challenge for asset managers and a potential barrier to the efficient allocation of capital to the most ESG-friendly and effective strategies.

Meanwhile, the growing anti-ESG backlash in the US is leading to outflows for many strategies, mainly in the equity space. But could we start to see a similar trend and impact for fixed income funds?

For investors and their advisers, it is important to remain selective when investing in ESG fixed income and agile to address any new issues as they appear.

Meet the Team

Natasha Silva
Managing Director, Client Relations

Amy Richardson
Managing Director, Business Development

Sam Buttress
Associate, Business Development

Sarah Northwood
Marketing and Events Coordinator

Orin Ferguson
Associate, Business Development

ESG in Fixed Income Roundtable

The CAMRADATA ESG in Fixed Income Roundtable took place in London in September 2023

How are fixed income fund managers keeping up with the rapidly evolving regulatory environment and investors' increasing expectations?

ESG has been rapidly accelerating across the investment world in recent years and has become an increasingly important component of fixed income investing.

According to S&P Global Ratings, issuance of green, social, sustainable and sustainability-linked bonds (GSSSB) hit $4trn since these debt classes became formally recognised. Despite a global stagnation in bond issuance in general, GSSSB issuance is still expected to exceed $900bn in 2023.

This expansion is obviously providing investment managers with myriad new opportunities, but there are also challenges for the industry. CAMRADATA invited a panel of fixed income and ESG experts to discuss how the asset class is evolving in response to the rapid shifts in investor perception and demand.

One key challenge identified by our panellists was the role of regulation. Regulators around the world have been introducing new ESG rules and frameworks for investors. Intended to protect end-investors and bring greater rigour to markets, the speed of this regulatory overhaul is causing unintended consequences.

Keeping up with regulators

"If the intent of regulation is to drive productive behaviour, it may be going too far," reflected Stephen Porter, responsible investment lead at Scottish Widows.

He pointed to the time-consuming nature of compliance: "At the current rates of regulatory change, we could end up spending more time reporting than actually doing anything. I would like things to pause for a good 12-24 months, to stop and take stock. For instance, have the good intentions led to behaviours becoming sufficiently more desirable? Or are the goalposts just being moved?"

Regulatory developments have heightened the compliance burden on fixed income teams. Samantha Lamb, Head of Fixed Income at GIB Asset Management, noted that this cost was having to be met at a time when the industry is under pressure to reduce costs. However, workload grumbles aside, Lamb reflected that regulation was moving fixed income ESG investment in the right direction.

> *"At the current rates of regulatory change, we could end up spending more time reporting than actually doing anything. I would like things to pause for a good 12-24 months, to stop and take stock."*

"More regulation has to be a good thing – it was the Wild West in terms of terminology," said Lamb while conceding the additions did feel "overwhelming".

She highlighted the context of this regulatory shift. "To some extent, it is not dissimilar to creating a non-financial accounting language," she added. "It took 100 years to put accounting consistency into place and we are trying to do it on the non-financial side in the space of five years. It is frustrating, though, that different regulators are not listening to one another at all."

One major focus of fixed income ESG regulation has been on the use of proceeds. Despite how an ESG debt security is marketed to investors, the proceeds may ultimately finance a project not aligned with sustainability at all. Greenwashing has become a hot topic in the industry, with increasing scrutiny over how GSSSBs are structured and marketed.

This scrutiny means the reputational danger of greenwashing has become more pronounced, which is causing hesitation among some investors regarding how they incorporate fixed income into sustainable portfolios. Matthew Jarvis, investment consultant at XPS Pensions Group, explained that while he is encouraged by trustees' greater engagement with ESG investment, this was perhaps being held back by greenwashing-related fear.

"Trustees do care about sustainability but are very cautious, especially with anything that has ESG or sustainability in its name," explained Jarvis. "They are concerned about their own reporting and particularly whether those products are the real deal or not, but they especially don't want to take credit for things they have no particular control over."

Unfortunately, with ESG regulation still developing for the fixed income world – as fast as new securities are being designed and issued – the fear of greenwashing has become exacerbated. This is now having a paralytic effect in some corners of the industry with some firms wary to make any statements at all in their reporting – a term our panel coined as 'green-hushing'.

"As an industry, we are running scared to the point we are asking 'can we say anything at all?'" said Scottish Widow's Porter. "This has created green-hushing, where we choose to just keep our mouths closed. It takes the risk of greenwashing to the extreme."

Jonathon Ennis, VP of investment research in fixed income for Mackenzie Investments, told the panel he is seeing this trend in his native Canada: "A few years ago, there was a big concern about greenwashing as everyone was making big commitments without delivering. Yet, now we are moving into a green-hushing phase where everyone is working away, but not talking about it as much due to the backlash."

Who rates the rating agencies?

For fixed income managers, credit rating scores have long been a valuable resource for informing portfolio investment decisions. These ratings have traditionally been based on the creditworthiness of the issuer, which is dictated by its underlying financial metrics. But, with non-financial metrics to consider when creating ESG scores, greater scrutiny of agencies is required for how they score bonds.

Much like regulators, many of these credit agencies are still finding their way when making ESG-based assessments. The largest agencies have been active in the space – making acquisitions of sustainable data providers and launching their own ESG-based labels – but Mackenzie's Ennis still sees them as fringe offerings.

"It seems like it's a separate business for them and they don't want to combine the sustainability assessment within their actual credit ratings," said Ennis. "But, in our business, we are trying to combine them."

Lamb is critical of agencies and their motivations around ESG scores. Where they are being kept separate from mainstream credit ratings, Lamb dismissed these efforts as something agencies are more interested in commercialising than integrating.

"It is also important to remember that credit rating agencies have a time horizon of three to five years, which is why they often miss the long-term view," added Lamb. "That means they are also only looking at bonds through an ESG risk lens, and not from a sustainability perspective."

There is a lot of activity around ESG from credit agencies, which, in addition to the new regulations, means there is a lot of noise for investors to contend with. This is something that Alex Funk, CIO at Schroders Investment Solutions, said is complicating his work.

"The lack of ratings consistency is an issue," Funk said. "The broad spectrum we see in the sustainability scores is the opposite of what we see on the credit rating side of things. [Rating agencies] had an opportunity to create a standardised framework, to create more trust, but that hasn't been the result."

Jarvis explained he was seeing the same concerns with ESG-related data among his clients in the pension world.

"We see more and more queries from trustees about all manner of ESG-related information," he said. "They see a report and want to know why an ESG score has or hasn't improved, or why the scores across one portfolio differ to another. They may also ask why the emissions of a portfolio have increased compared to last year. It is causing a lot of interest and engagement, and it is moving trustee thinking forward, but I'm not sure how much real-world action has been created as a result."

Amid so much confusion, and against the backdrop of greenwashing concerns, investors are rationalising fixed income issuers into ESG and non-ESG buckets. However, this distinction is not binary and is rarely clearly defined. Scottish Widows' Porter has noted how rating agencies, and the wider market, negatively view issuers in the fossil fuel sector when using an ESG lens – but warned against the mindset of banishing such debt from portfolios.

"To help the real economy to transition – and thus decarbonise our investment portfolios – we need to support and provide finance to companies that want to change, including those that are currently 'big and dirty", Porter told the panel. "That is what I would really like to see in the credit space. Yes, it needs to be done within the right risk/return framework, but that is where we can really move the dial. That would theoretically feed through into financial returns for investors."

Financing the energy transition effectively may mean funding some of the world's biggest polluters – but this a nuance that is likely to struggle to register with ESG ratings agencies and regulators.

Panellist Sarita Gosrani, head of ESG at bfinance, was sceptical of the binary approach and explained she looks beyond fund labels as they "can be quite narrow".

"You get a lot of tunnel vision with people focusing on portfolio footprints, which means the ability to transition doesn't get a look in," said Gosrani. "Thinking about 'big and dirty' and moving this to 'big and clean' doesn't get into portfolios very often, as there are concerns around reputation."

This point was also put to David Katimbo Mugwanya, head of fixed income at EdenTree Investment Management, whose firm is an ESG pioneer and has operated in this space for three decades. Though he said he would not be able to buy bonds from 'big and dirty' names, instead favouring 'purer' sustainability plays in his portfolio, he pointed to how the conversation around ESG in fixed income was maturing and becoming more developed.

> ***We capture a lot of exclusion requirements, but after that, it is very much delegated to managers. We are still waiting to see stronger requirements relating to ESG integration."***

"The people who have asked the sharper questions around ESG are now moving onto the impact side of things," said Katimbo Mugwanya. "We are still evolving how we look at things."

"Having been active in the ESG space, 'big and dirty' is never going to find its way into our portfolio. But the ability to stratify in recent years has improved, with more thematic and impact funds launching. Regardless, we keep things pure – it would not cut it for us if a company were not deemed responsible even whilst able to evidence ringfencing or impact. Unless your client is looking for a transition mandate that includes dirtier elements, it can be hard to justify."

Mackenzie's Ennis gave his perspective on this theme, by sharing his firm's experience engaging with such companies: "We have lots of 'big and dirty' companies in Canada that want to change. We have been actively engaging with them through our commitments to the Net Zero Asset Managers initiative.

"Our key engagement program is a "Dear CEO" Letter followed by meetings and follow-ups to our Top 100 emitters across all our funds and a "Dear CFO" Letter specific to our fixed income team to encourage the issuance of green bonds and other labelled debt to help finance the energy transition."

ESG's fixed income journey

The headline statistics may show a significant surge in demand among investors for ESG fixed income products – and there is a frenzy of activity from product providers, rating agencies and regulators – but this is best described as evolution rather than revolution.

On the positive side, progress has been made with the market developing in recent years from the 'Wild West' GIB Asset Management's Lamb described when discussing the need for regulation. As with any asset class, greater demand from investors is stimulating innovation.

Schroders' Funk has seen a notable change: "Four years ago, you could not create a credible multi-asset portfolio with a well-thought-through sustainable fixed-income element. That has changed. Today, pure sovereign sustainability is the only missing piece – there's just not enough liquidity, but we are seeing some providers coming to the market.

"Better issuers keep coming to market and I have more choice now. It's definitely growing, and that is exciting."

Gosrani said investment managers have progressed well, but the lack of standardisation remains a challenge that needs to be overcome. This is something, she explained, that is potentially disadvantaging fixed income relative to other asset classes:

"Compared to other asset classes, it's probably less sophisticated in terms of investor demands and needs. We capture a lot of exclusion requirements, but after that, it is very much delegated to managers. We are still waiting to see stronger requirements relating to ESG integration."

One reason for this has been the general trend around fixed income from the product development side of the industry. GIB Asset Management's Lamb pointed out that many asset managers have been merging fixed income teams over the past decade, creating larger entities that are naturally constrained by more rigid processes. This, unfortunately, frustrates innovation, she said, which can be challenging when exploring new sustainability mandates.

"This makes it hard to revolutionise those strategies and think about sustainability in those teams," she said. "Sustainable fixed income products are not there yet."Another area where there remains room for improvement in fixed income ESG regards

> *"We've discussed regulation and the focus on current portfolio emissions, but we can't lose sight of the ultimate goal – to have a tangible, real-world impact. If we can showcase that to more investors, there will be a lot of uptake."*

engagement. This may be more commonly associated with equity investing, but influencing a company's financing can be just as significant. Porter pointed out: "ESG should have started with fixed income because, quite frankly, fixed income pulls at the purse strings."

Unfortunately, our panellists were quick to share their concerns about what they had experienced in the market, with a lack of engagement from fixed income managers. Gosrani and her team regularly assess fund managers on their abilities – but finds there is a lot to be desired with the majority.

"[Engagement in fixed income] is still underrated and investor expectations are not very well developed," she said. "People need to realise stewardship is a very important part of transitioning a company. A lot of managers have processes for selecting GSSSBs, but we have found that a lot of them do not have post-investment processes for escalation when issuers fall short of expectations. I would love to more managers with genuine escalation strategies."

At EdenTree, Katimbo Mugwanya explained he and his team have been able to directly engage with companies when they hold their debt, citing recent examples across the UK water sector. On occasion, they have found reason to divest where an issuer's direction of travel on material sustainability issues veered away from the desired path. He explained that greater mainstream attention on fixed income ESG was supporting collaborative efforts to conduct engagement.

"Collaboration is getting better, but I would say this is via specific groups," he reflected. "We are a member of such groups and increasingly bigger asset managers are joining them, whereas it used to just be us small boutiques. It helps that companies are also becoming more receptive to engagement. It is definitely moving forward."

It was clear from the discussion that momentum is building for integrating ESG into fixed income. No longer a niche factor in the eyes of investors, our panellists are facing more requests and are now being challenged to execute ESG integration policies across their portfolios.

This is not easy, due to a range of factors. But as ESG in fixed income matures, the asset class will be able to overcome the challenges of integrating new regulations, ratings inconsistency and the lack of formalised frameworks.

There is clearly an opportunity to build on the increasing investor demand, and XPS Pension Group's Jarvis highlighted it is important for the industry to step up and meet the ultimate goals of ESG. He wants to see the industry get better at publicising and reporting on ESG fixed income investing, which he believes would stimulate better engagement from investors and therefore, ultimately, help achieve the goals of ESG investment.

"The key risk is we lose sight of real-world impacts," said Jarvis. "We've discussed regulation and the focus on current portfolio emissions, but we can't lose sight of the ultimate goal – to have a tangible, real-world impact. If we can showcase that to more investors, there will be a lot of uptake."

Roundtable Participants

David Katimbo Mugwanya
Head of Fixed Income

Personal Profile

David leads on EdenTree's responsible and sustainable fixed income strategies, including the Sterling Bond Fund and the Short Dated Bond Fund.

David joined EdenTree in 2015 and possesses over a decade of investment expertise across sovereigns, corporate debt and money markets. David is also a member of the London Stock Exchange Primary Markets Advisory Group.

Company Profile

EdenTree is an asset manager with a difference. EdenTree has been leading the way in Responsible and Sustainable Investing for 35 years, launching its first responsible fund in 1988. All of it's £3.8bn of assets under management are invested responsibly, sustainably or ethically. Ultimately owned by a Charity, the Benefact Trust, all of EdenTree's distributable profits go back to our charitable parent, and out to good causes.

It is an active fund management business, specialising in delivering client outcomes through the careful selection of intensively screened businesses and assets, irrespective of asset class and market conditions, and at appropriate valuations.

EdenTree believes that responsible stewardship and active engagement with companies are critical to achieving superior performance over the long-term.

Samantha Lamb
Head of Fixed Income

Personal Profile

Samantha is the Head of Fixed Income at GIB Asset Management and has overall responsibility for GIB's Fixed Income capabilities.

Samantha joined from abrdn, where she was Head of Environmental, Social and Governance (ESG), Fixed Income. Part of a team responsible for £180bn of AUM, Samantha led the integration of ESG considerations into investment decisions and drove ESG innovation through, for example, launching one of the first SRI Corporate Bond funds. Samantha previously held the position of Investment Director, Fixed Income at Standard Life Aberdeen and over her more than 17 years of experience, has had roles at Aegon Asset Management, JP Morgan and Dresdner Kleinwort Wasserstein.

Samantha holds a BA in Economics and Philosophy from the University of Leeds and is a CFA Charterholder.

Company Profile

GIB Asset Management are a boutique institutional asset manager seeking to generate superior investment performance through deep integration of sustainability into investment decision-making and hence, scale capital in support of sustainable development.

Operating in London and New York, the company provides a focused set of differentiated, forward-thinking investment products for institutional investors. Each strategy is treated as its own boutique, with aligned entrepreneurial teams, focused on a high-conviction approach supported by an institutional-level infrastructure.

Roundtable Participants

Jonathon Ennis, MBA, CFA

VP, Investment Research, Fixed Income Team

Personal Profile

Jon Ennis, Vice President, Investment Research is responsible for leading Mackenzie's Credit Research Team. The team of eight analyst covering hundreds of corporate issuers and more than $20 billion of corporate debt holdings, provide bottom-up credit analysis, research, and recommendations for fixed income portfolios.

Jon joined Mackenzie Investments in 2008, working with the Portfolio Operations department before joining the Mackenzie Fixed Income Team in 2010 as an Associate Investment Analyst. His duties included developing research coverage across a range of sectors, helping to expand the credit research geographic footprint from North America to include Europe and Emerging Markets, and is also responsible for ESG integration across all corporate debt holdings.

Jon received a Bachelor of Commerce degree and MBA from the Smith School of Business at Queen's University. He is also a holder of the Chartered Financial Analyst designation.

Company Profile

Mackenzie Investments, founded in 1967, is a leading Canadian global asset manager, headquartered in Toronto with international investment teams in Boston, Dublin and Hong Kong. As part of IGM Financial Inc., a subsidiary of Power Corporation with a history dating back to 1925, Mackenzie benefits from the financial stability of a deep corporate structure while maintaining a boutique investment management profile.

Our distinct and experienced investment teams offer both fundamental and quantitative approaches with expertise across traditional and non-traditional asset classes, including equities, alternatives, currency and multi-asset strategies.

We provide investment management services to pension plans, consultants, foundations and other institutions, building trusting relationships that seek to understand client perspectives. We are committed to delivering strong investment performance and offering innovative, relevant solutions to our clients by drawing on the experience gained through over 50 years in the investment management business.

MACKENZIE Investments

Sarita Gosrani

Director of ESG & Responsible Investing

Personal Profile

Sarita leads bfinance's ESG advisory unit supporting investors globally on their RI/impact journey and providing expertise and support to internal research teams across asset classes on ESG, climate and impact.

Sarita was formerly Head of ESG Research at XPS Pensions Group and has more than a decade of experience in investments, financial services and pensions. Sarita leads the firm's sustainability initiatives, sits on the firm's Responsible Investment Committee and is Chair of the firm's Diversity and Inclusion Committee.

Sarita is a CFA Charterholder and holds a BSc with a double major in Economics & Human Geography, University of Toronto.

bfinance

Alex Funk

Chief Investment Officer, Schroders Investment Solutions

Personal Profile

Alex has many years of financial services experience which ranges from discretionary fund management, corporate finance, banking, capital raising, private equity to venture capital.

Alex started managing a discretionary fund management business in South Africa and Mauritius, where he designed and managed model portfolios for financial advisers and wealth management firms across the world. Alex has extensive experience in managing multi-asset portfolios in the UK and is responsible for a range of portfolios and funds.

Alex holds a Bcom Honours in Financial Analysis (Cum Laude) from the University of Stellenbosch, South Africa and is a CFA Charterholder.

Schroders

Roundtable Participants

Stephen Porter CFA, PhD

Responsible Investment Lead, Scottish Widows

Matthew Jarvis, CFA

Investment Consultant

Personal Profile

Dr Stephen Porter is the Responsible Investment Lead at Scottish Widows. He is a CFA charterholder and has over twenty years experience in investment management as well as a decade within academia. Stephen earned an MSc and PhD related to carbon and sustainable business at the University of Edinburgh, where he continues to guest lecture and supervise research on these topics as an Honorary Fellow.

Stephen is also a trustee of the Plan Vivo Foundation, a Scottish-registered charity that seeks to aid communities vulnerable to climate change build their resiliency through local, nature-based carbon projects.

Personal Profile

Matthew is a client-facing investment consultant and a member of XPS's ESG research team. In his role within the ESG team, Matthew conducts a range of research activities including undertaking comprehensive assessments of the ESG, climate change and stewardship practices of investment managers as well as supporting clients in understanding and improving their ESG credentials. In addition, Matthew also delivers ESG training to clients and has written several ESG-related thought pieces.

Outside of his research responsibilities, Matthew advises numerous UK DB trustee clients on a full range of investment related matters.

Matthew joined XPS in 2019 and is based in London. He graduated from the University of Nottingham with a BSc Hons in Economics and is also a CFA Charterholder.

SCOTTISH WIDOWS

XPS Pensions Group

Moderator

Elizabeth Pfeuti

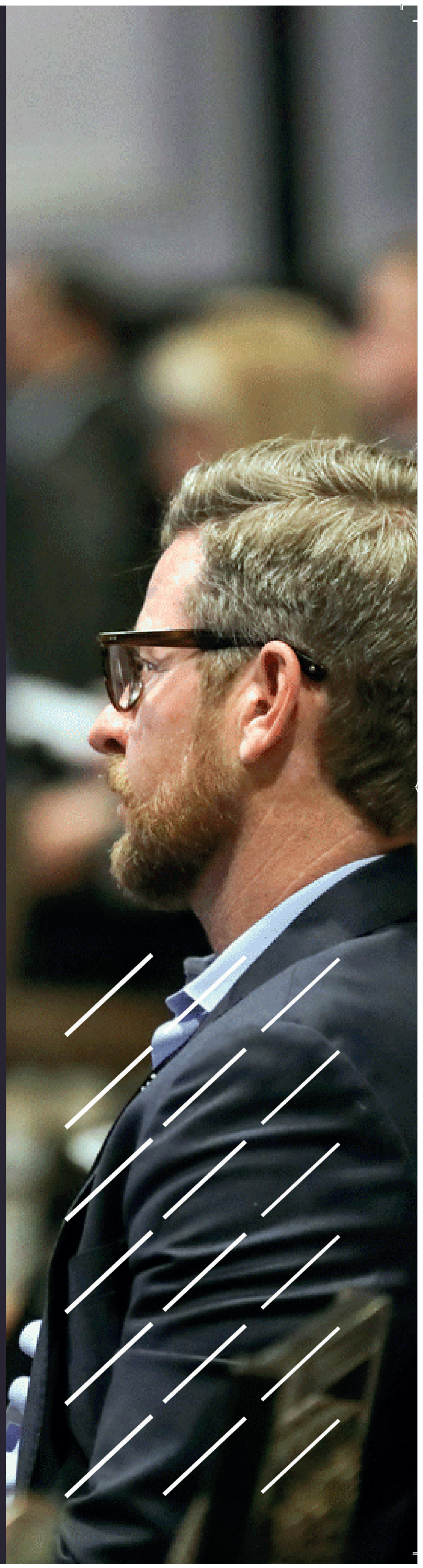
Chief Client Officer

Personal Profile

Former Dow Jones staffer Elizabeth Pfeuti is Rhotic's Chief Client Officer and a member of the Rhotic Media executive leadership team. A highly-decorated journalist, Elizabeth has been in financial journalism for around 15 years. At Dow Jones, she covered the asset management, investment banking and investor services beats for Financial News, where she also wrote on a wide range of regulatory themes

She was previously the European Editor for CIO Magazine and boasts an exceptional contact book of buy-side and in-house institutional CIOs and asset management executives. More recently she has worked on corporate briefs for pension consultants, investment banks and asset management groups.

RHOTIC



Investing Responsibly in Fixed Income

> *“For us, Responsible Investment is not a fad but a long-term dedication to performance with principles.”*

EdenTree Investment Management are pioneers in Responsible Investment, having launched one of the first ethical funds in the UK over 35 years ago, back in March 1988. For us, Responsible Investment is not a fad but a long-term dedication to performance with principles. We hold to the belief that such dual outcomes are more likely to be achieved by considering both financial and responsible research in detail, to form a holistic view of issuers that generate returns sustainably, without future detrimental impact. Investors increasingly want their investment portfolios to make a difference and have a positive impact on society and the environment around them.

At EdenTree, we applaud this alignment on investment with values and deliver this via three distinct Fixed income propositions that have capital preservation, income and positive impact as objectives.

EdenTree Fixed Income Funds

	Responsible & Sustainable Short-Dated Bond Fund	Responsible & Sustainable Sterling Bond Fund	Global Impact Bond Fund
Headline	Cash +	Income	Impact
Investment Objective	To preserve capital and generate income payable quarterly.	To generate a regular level of income payable quarterly.	To generate a regular income payable quarterly with positive societal impact
Summary Portfolio	High quality short dated bonds (90% exposure to Single-A rated or above)	Flexible & diversified mix of Corporate Bonds, PIBs and Preference Shares	Diversified mix of global corporate bonds (min. 80% exposure to impact instruments)
Distribution Yield*	3.00%	4.41%	3.13%
Income Frequency	Quarterly	Quarterly	Quarterly
Duration (years)*	2.1	6.2	5.7
Average Credit Rating	AA-	BBB+	A-
AMC*	0.35%	0.55%	0.55%

Source: EdenTree – data as at 31st August 2023

Author:

David Katimbo Mugwanya

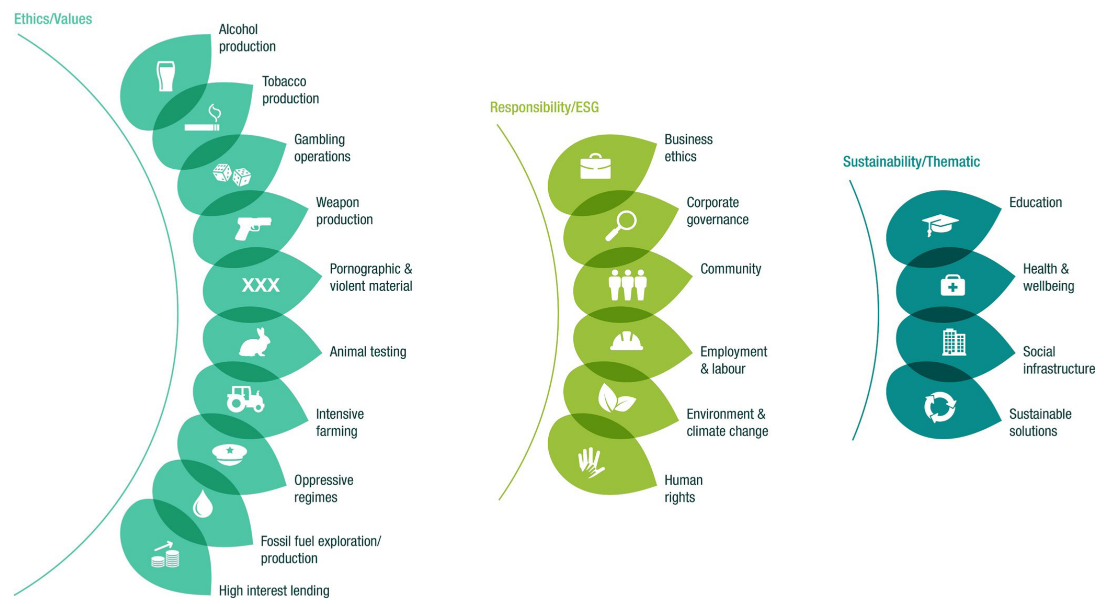
Head of Fixed Income

Investment process overview

EdenTree’s award-winning* responsible and sustainable investing approach fully integrates environmental, social and corporate governance factors into the investment management process, with our Fund Managers and Responsible Investment Team working side by side to generate ideas, analyse opportunities, create meaningful and diversified portfolios and undertake ongoing evaluation.

This is implemented across the core pillars of our overall investment process including research, screening and engagement in Fixed Income. As responsible stewards, EdenTree also votes at all meetings across all international markets for equities, except where these are share-blocked.

Screening – To be considered suitable for inclusion within our range of responsibly managed funds, an investment idea must meet the criteria laid out by our responsible and sustainable screening model. There are three parts to this: ethics and values, responsibility and ESG and sustainability and thematic. See infographic below for more information on these screens.



The ten negative screens which make up the ethics and values portion aim to avoid harmful activities that are a detriment to society. Issuers that derive more than 10% of their profits or turnover from these activities are excluded from our universe of investible issuers. Sovereign debt, government-backed issuers and or state-owned enterprises are assessed for suitability using the Oppressive Regimes screen.

We then have responsibility criteria, incorporating six different considerations which reflect ESG risk and our commitment to responsible investment. These are core to the way in which we consider issuers as being suitable for inclusion in our responsible and sustainable funds.

Finally, as we screen debt issuer ideas, we will consider the positive sustainability case in terms of products and solutions, and how issuers are referencing the Sustainable Development Goals as part of their business case.

Research – EdenTree’s thought-leadership research draws on an unrivalled depth of expertise that has built up over 30 years as pioneers in responsible and sustainable investing. Our team regularly publish Insights and expert opinion pieces, which help to inform our clients.

Three times a year we produce our flagship EdenTree Insight publications, which provide a sustainable perspective on some of the biggest challenges facing our world today and how we, as responsible and sustainable investors can be a part of the solution.

In-depth credit research is conducted in tandem with responsible screening from the outset to gauge the ability and willingness of borrowers to repay their debt obligations. We typically favour high quality issuers with analysis of fundamentals, management quality and debt covenants to gauge profitability, cashflow generation and leverage.

Engagement – We engage with businesses on a wide range of environmental, social and governance issues, both when we are considering investing and then as debtholders. This is an integral component to the investment process and put simply, entails a dialogue with companies that is carried out on asset-class 'agnostic' basis.

We undertake three key types of engagement: thematic; screening related, and reactive. As active fund managers, engaging with investee debt issuers is fundamental to understanding the risks and challenges they face from an environmental, social and governance (ESG) perspective. Engagement is usually prioritised according to risk factors we identify, and we actively monitor ethical and financial issues as part of our research into companies. We believe that the way we engage with businesses enables us to make sound, responsible investment decisions and to act as a force for change. We form constructive long-term relationships with the issuers we lend to and continue to engage with them after we have invested as part of an active, ongoing monitoring programme. Engagement commences at the investment ideas stage and is intended to either gain information or clarification on key risks, raise concerns and/or raise business standards over time.

We believe strongly that the exercise of investor stewardship via engagement has made a powerful difference in business behaviour and the raising of standards. One example is our ongoing engagement with water companies across the UK, a lot of which are private but still issue debt in the public markets, which has shone a light on river pollution and the water quality in the UK's rivers. We do not take lone credit for this; the hundreds and thousands of individual engagements made by investors across the world has catalysed significant change in recognising the importance of ESG factors to companies, and the need for it to be reported on and well managed.

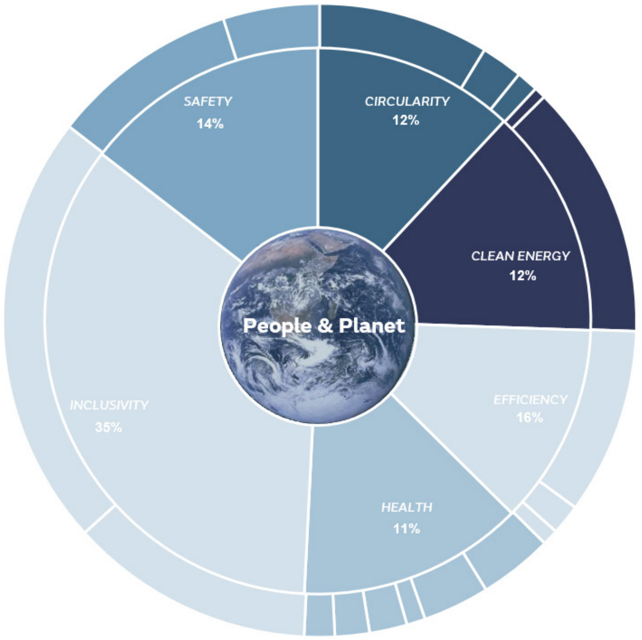
The value of any investment, and the income generated from it may fall as well as rise and will be affected by currently fluctuating changes in interest rates, general market conditions and other political, social and economic developments, as well as by specific matters relating to the assets in which it invests. Past performance should not be seen as an indication of future performance.

Sustainable World Corporate Bond Strategy

> *"Long-term success belongs to the companies who are solving our greatest challenges"*

The GIB AM Sustainable World Corporate Bond Strategy is a long-term global investment grade corporate bond strategy with strategic asset allocations to high yield and emerging markets. The strategy aims to outperform a custom benchmark* over the cycle by investing across a universe of sustainable companies.

The portfolio has a diversified thematic framework that aims to deliver compelling risk-adjusted returns whilst helping to solve the greatest challenges of our time.



Source: GIB AM Analysis as at 30.09.2023

Author:

Samantha Lamb, GIB AM Head of Fixed Income

*The custom benchmark is the Bloomberg Global Aggregate Investment Grade Corporate incl. High Yield and EM Custom Index (USD Hedged) [60% Global IG + 20% Global HY + 20% EM Corporates indices].

Thematic approach

GIB Asset Management has developed a thematic framework that identifies the biggest challenges over the medium to long term and the products and services needed to address these.

The thematic work draws on research from the UNDP, SDGs, academia and the private sector. The themes are split between challenges facing both People and Planet.

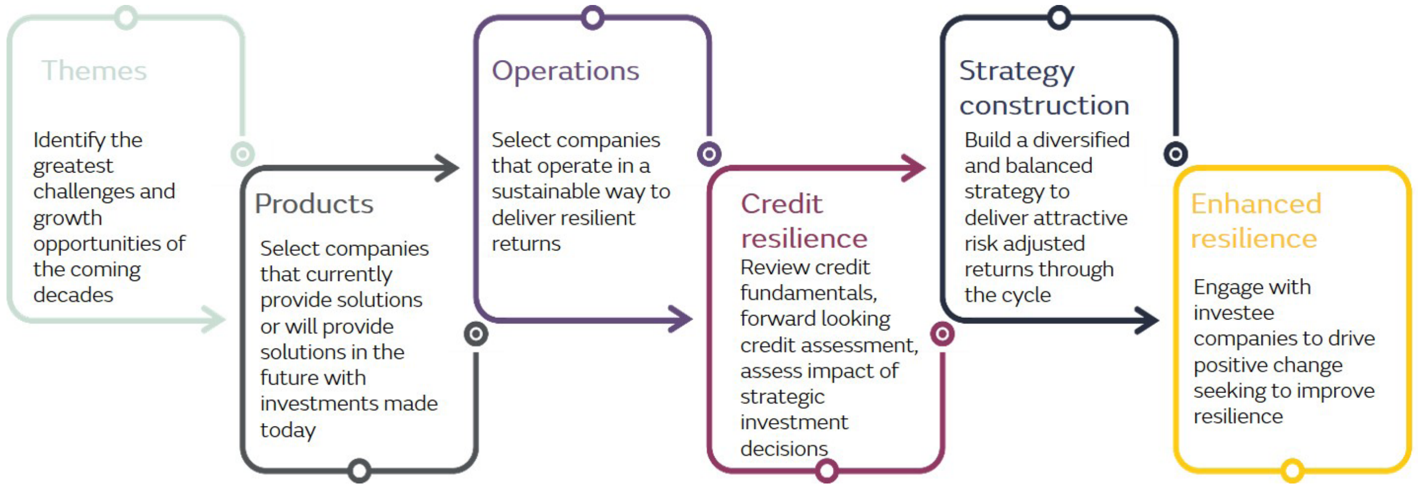
The integration of sustainability at the start of our process ensures that it guides every investment decision.

We believe companies whose business aligns with a GIB theme, have sustainable operations, and are led by forward looking management teams, will achieve long-term success.

From challenge to opportunity

At GIB Asset Management, we focus on resilient businesses offering products which help solve the world's biggest challenges, while ensuring we invest in some of the most compelling opportunities from a long-term credit perspective.

- Our process starts with building our long-term thematic framework – what are the biggest challenges facing people and planet?
- We identify a subset of companies, which through their products or services contribute to solving these challenges.
- We proceed to analyse the way they go about their operations – is the way they do business consistent with a sustainable approach and are we comfortable the underlying business will be around for the long term?
- Once we have established thematic and operational alignment, we carry out an in-depth credit analysis of the company with specific focus on integration of strategic future investment plans as well as establishing the general credit resilience of the issuer.
- Finally, we construct the portfolio reflecting long-term credit valuations and bottom-up opportunities in global sustainable credit with the aim to outperform the benchmark over cycle.
- On an on-going basis, we engage with the investee companies to drive positive change and improve resilience.



About GIB Asset Management

GIB Asset Management is a sustainability-led boutique asset manager. We focus on unlocking opportunities that others don't see in the relentless pursuit of superior investment performance for our clients.
Delivery of performance through purpose.

Operating in London and New York, we provide a focused set of differentiated, forward-thinking investment solutions for institutional investors. To find out more about our products and insights, scan below:

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Spotlight on sustainability-linked debt

The gradual increase of green bond issuance through the 2010s accelerated into a tidal wave of ESG-labelled debt issuance in the early 2020s. The original green bond concept has developed into a "use of proceeds" category that includes green, social and sustainability (GSS) bonds. This category works well for government issuers as well as corporate issuers in sectors such as power, utilities, financial and real estate that have specific green project categories that qualify under the International Capital Markets Association frameworks, and that can be verified by second-party opinion providers. Previous reports cover the description and differences between green, social and sustainability bonds.

> *"Companies have the choice to do nothing on sustainability and yet those that choose to do something are regularly criticized for not doing enough"*

The newer concept of sustainability-linked debt has a coupon structure that is linked to corporate ESG targets and specific ESG key performance indicators (KPIs) that are defined at issuance and go by the labels sustainability- linked bonds (SLBs) and sustainability-linked loans (SLLs). This category, known as sustainability-linked debt, is open to any issuer from any sector so long as they have relevant corporate ESG targets, along with consistent reporting for their ESG KPIs (Figure 1).

Companies are generally motivated to issue SLBs to align financing strategy with company strategy as it relates to sustainability. Critics argue that this is all greenwashing because companies can set their own KPIs and thus have an incentive to make them easy to achieve. Supporters argue that the entire concept of ESG targets is voluntary because they are not required by governments.

Companies have the choice to do nothing on sustainability and yet those who choose to do something are regularly criticized for not doing enough. Not all ESG targets and SLB KPIs are relevant or ambitious. There is a significant effort required from credit analysts and ESG analysts to sort out good SLBs from bad SLBs. A robust process is required to decide which SLBs are worthy of investment.

The more times that companies repeat and reinforce their sustainability strategy and their ESG targets, the more likely they will be achieved. What gets measured gets managed. Mechanisms such as ESG-labelled debt – including the growing category of sustainability-linked debt – as well as ESG-linked executive compensation ensure that words turn into action and that failures to achieve ESG targets will be high profile and result in significant reputational damage for both executives and the company. The current and evolving structure of SLBs includes coupon step ups if the issuer fails to achieve their stated ESG KPIs, so there is no additional downside to the bond investor – only additional upside in the form of that penalty payment. The benefit to the issuer is primarily as a boost to their reputation and their sustainability credentials. It is a way for them to affirm their commitment to their ESG targets.
In recent years, companies have set targets in their SLB frameworks ranging from the reduction of greenhouse gas emissions to the increased use of renewable energy or achieving specific targets related to gender equality

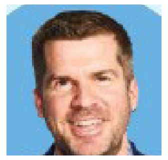
(Figure 2). An available universe of over 300 SLBs shows that half of issuers use one KPI and half use more than one KPI (Figure 3). By setting environmental and social KPIs in their SLBs, companies are sending a strong signal to their medium- and long-term commitments to positive socio- environmental impacts for the benefit of people and planet in line with the UN Sustainable Development goals (SDGs).

This paper will outline recommendations to corporate debt issuers about which ESG KPIs are most relevant and material for SLBs from the perspective of the Mackenzie Fixed Income Team.

ESG KPI #1:
Greenhouse gas (GHG) emissions reductions targets by 2025 and 2030

Corporations can follow government GHG emission reduction targets or select their own targets by 2030 as a key milestone towards their net-zero-by-2050 commitments. Within environmental KPIs, GHG emission reduction targets are the most popular, with over 50% (Figure 2) of SLBs having at least one target related to GHG emission reduction. Issuers prefer to use targets related to absolute emissions – only 26% of the targets are related to intensity measures. For this environmental KPI, companies are focused on Scope 1 and 2 emissions, with less than 20% of those SLBs targeting Scope 3 emissions 4). Scope 3 emissions are more difficult to estimate and generally outside of the companies' control because they represent the emissions of their customers and their supply chains. Companies that include Scope 1, 2 and 3 in their targets for their SLBs would be considered more ambitious.

Author:s



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(Figure 4). Scope 3 emissions are more difficult to estimate and generally outside of the companies' control because they represent the emissions of their customers and their supply chains. Companies that include Scope 1, 2 and 3 in their targets for their SLBs would be considered more ambitious.
Examples include the few SLBs issued to date in Canada. The three SLB issuers below represent the full set of SLB issuers in Canada, but many more are expected in the coming years. These few Canadian issuers add to a growing list of SLB issuers from the US, Europe, Latin America and Asia.

	GHG reduction target	Target date	Reference date	Coupon step-up
1st in CA – Telus	46% absolute emissions	2030	2019	+100 bps at maturity
2nd in CA – Enbridge	35% emissions intensity	2030	2018	+50 bps at maturity
3rd in CA – Tamarack Valley	39% emissions intensity	2025	2020	+75 bps at maturity

ESG KPI #2:
Increased production or consumption of renewable energy by 2025 and 2030 Companies can accelerate the energy transition by increasing their consumption and/or their production of renewable energy. The percentage of electricity from renewable sources and the percentage of renewable energy produced are the second most frequently used KPIs (Figure 2) by companies issuing SLBs – along with energy efficiency KPIs. Here are some examples:

	Renewable energy target	Target date	Reference date	Coupon step-up
Wesfarmers	100% use of renewables	2025	2020	+12.5 bps per year
Nobian	50% use of renewables	2025	2020	+12.5 bps per year
Enel	80% of installed capacity	2030	2020	
Enel	100% of installed capacity	2040	2020	

ESG KPI #3
Women in leadership (typically VP+) targets by 2025

There has been a significant shift towards gender diversity at the board level from 2015 through 2020 – especially for larger corporations. However, the expected trickle- down effect to executive teams has been slow over that same time frame. The inclusion of targets by 2025 signals that corporations are serious about moving quickly to develop diverse executive and management teams that will strengthen their diversity of thought and ability to be creative and innovative and responsive to all stakeholders.

	Women in leadership target	Target date	Reference date	Coupon step-up
Enbridge	40% of board	2025	N/A	+10 bps at maturity
Suzano	30% in leadership	2025	N/A	+25 bps per year

ESG KPI #4
Racial and ethnic diversity targets by 2025

The diversity conversation has expanded from mostly focused on gender to include racial and ethnic diversity. Specifically, the underrepresentation of Black and Indigenous people is most pronounced in corporations and deserves dedicated strategies and targets. Here are some early examples:

	Racial and ethnic diversity target	Target date	Reference date	Coupon step-up
Enbridge	28% racial & ethnic representation in workforce	2025	N/A	+10 bps at maturity
Tamarack Valley	6% indigenous employees	2025	N/A	+25 bps at maturity

Conclusions and recommendations

In 2022, the Mackenzie Fixed Income Team advanced its ESG engagement program by sending "Dear CFO" letters directly to company executives encouraging the issuance of green bonds and SLBs. The total amount of reverse interest was more than $1 billion (CAD) and the team intends to repeat this process on an annual basis. This program expands the team's pre-existing active engagement program, spanning over five years and defined by asking questions and making recommendations to corporations related to key ESG topics.

The recommendation from the team to corporate debt issuers is to focus on two or three ESG KPIs to be included in their SLB frameworks and issuance and reporting. We advise that they select their most important environmental KPI, their most important social KPI and any other KPI that is specific and material to their business. The list above provides context for generally material ESG KPIs; however, companies should select the metrics that are most material to their company and to their sector. This process should start at the top of the company with the development of corporate ESG strategy by the executive team and the board of directors. The corporate ESG strategy and any related targets should be important to and driven by the CEO and communicated as such to all stakeholders.

As it relates to financial policy, capital structure and debt issuance, the CFO then plays the key role in translating corporate ESG strategy into ESG-labelled debt issuance. This provides an essential signal to market participants that the targets are important and integrated into their broader corporate strategy. As mentioned, corporate finance teams have different types of ESG-labelled debt available to them. A certain amount of their projects can be financed with green, social and sustainable bonds. The rest of their debt financing and refinancing needs can be met with sustainability-linked bonds and loans. We are starting to see companies that are driving towards, or that have already achieved, 100% ESG-labelled debt by using a combination of green use-of-proceeds debt and sustainability-linked debt. One note on public companies versus private companies. SLBs are typically issued by public companies and SLLs are typically issued by private companies. For the latter, terms and KPIs typically remain private, so there is no theoretical greenwashing benefit. These private companies focus on sustainability-linked debt for the same reasons as public companies – to affirm their commitment to their ESG targets and their broader sustainability strategy to key stakeholders, including their owners and their lenders.

The Mackenzie Fixed Income Team looks forward to continuing to encourage the issuance of SLBs through the 2020s – while being selective and identifying good SLBs versus bad SLBs – to drive progress towards the UN Sustainability Development Goals by 2030.

FIGURE 1 – INDUSTRY CLASSIFICATION
Sustainability-linked structures

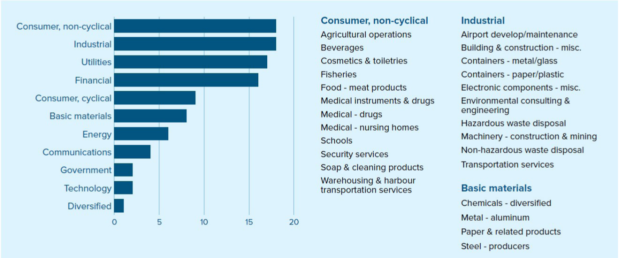


FIGURE 2 – KPI - KEY PERFORMANCE INDICATOR
SLB - ~96% data coverage

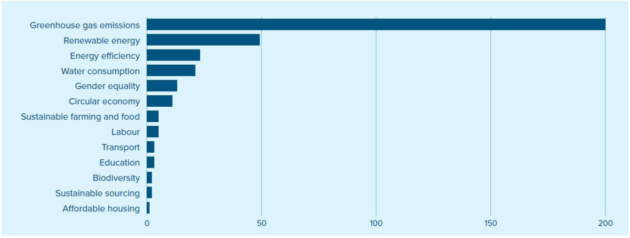
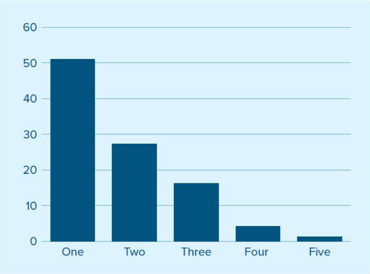
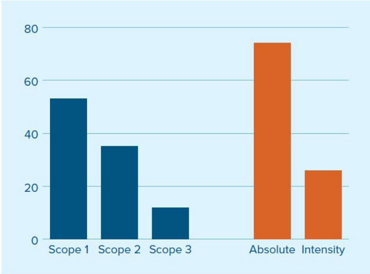


FIGURE 3 – NUMBER OF TARGETS - KPI
SLB universe



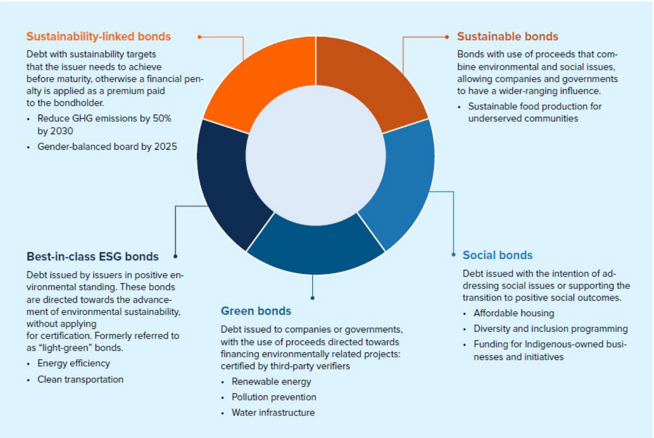
Source: Bloomberg, Environmental Finance Data, Mackenzie Research

FIGURE 4 – GHG EMISSION REDUCTION TARGETS - TYPE
(SLB - ~96% data coverage)



Source: Environmental Finance Data, Mackenzie Research. Historical data 2019 -2022 – 308 SLB assessed

FIGURE 5 – SUSTAINABLE DEBT 101



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