RBC BlueBay
Asset Management

Incorporating ESG into fixed income approaches:

Capturing the positive impact in fixed income

For sophisticated investors

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Learning objectives

After reading this guide, advisers will be able to:

- Describe key differentiators and similarities between ESG in bonds and equity
- Outline key global regulatory factors currently impacting fixed income investments
- Answer the most frequently asked questions regarding ESG in fixed income investing
- Evaluate the current market opportunity and drivers
- Identify some of the practical aspects of navigating ESG in fixed income investing

Foreword

by Julia Dreblow

Founding Director, SRI Services

This guide considers the incorporation of ESG into fixed income approaches. It is specifically targeted at financial advisers, in whose hands, so much control of the destination of UK investment sits.

Yet, while bonds are an important component of most of their client portfolios, there is a common misconception among advisers that all fixed income encompassing ESG elements is difficult, limited and compromised by under-performance.

Nevertheless, the UK retail and wholesale market is expected to rise to £2.9tn AUM by 2025 (Alpha FMC); 84% of which is expected to be advised.

Despite some recent maligning of the traditional 60/40 portfolio, that suggests a huge current and future allocation of private cash to bonds. It also leaves advisers with some serious issues to consider:

Bonds without an eye towards ESG are riskier: ESG is actually a risk management strategy in fixed income as poorly managed ESG risks may impact an issuer's ability to meet their financial obligations.

Regulatory imperatives: The Consumer Duty requires all of those in the value chain of an investment to seek the best outcomes for investors. Despite some recently reported UK investor fatigue around ESG issues, a 2023 Charles Schwab survey shows that almost half continue to prioritise sustainability over returns. For them, the likelihood is that, however their portfolio is balanced, that prioritisation applies to all of their investments. So, outcomes that don't include considering ESG and sustainability probably don't represent success in the context of the Consumer Duty.

Commercial imperatives: According to the government's 'Mobilising Green Investment, 2023 Green Finance Strategy,' "the global transition to a resilient, nature-positive, net zero economy will see trillions of pounds reallocated and invested into new technologies, services and infrastructure. There are huge opportunities for the UK's financial and professional services industry in this transition."

Societal relevance: ESG is no longer a niche area. With individuals across society now wanting to include their personal values within their financial plans, IFAs can no longer treat ethical and sustainability concerns as the preserve of specialists. To remain relevant they need to become ESG-literate across the full scope of options.

Political pressure: Private investment will be crucial to delivering net zero and the government stated that it will, "use government and other public levers to mobilise private investment" and that it is pursuing, "its ambition to become the world's first Net Zero-aligned Financial Centre." SDR (Sustainability Disclosure Requirements) is part of this process, having emerged from COP26 and the UK government's Net Zero target.

Bonding with ESG

The good news is that there are bond funds placing significant focus on ESG and sustainability solutions within fixed income investments. There are certainly opportunities that don't imply sacrificing Alpha for impact, although it's important to note that the bond and equity universes are very different and what works in equity doesn't necessarily work in fixed income, and visa versa.

That said, even without the voting rights that equity can provide, bonds can still offer options that allow investors to have an influence on bond issuers through their sheer financial clout - and usefulness to companies. The fixed income universe totals around USD122.6 trillion (SIFMA, May 2023), close to four times the size of the equity market.

That also suggests that the increasing momentum of ESG in fixed income is starting to present opportunities for planning and solutions that will only grow in number and importance which advisers absolutely need to be aware of.

Driving sustainable investment outside equities

by James Alexander

Chief Executive, UKSIF

James Alexander joined UKSIF as Chief Executive in October 2020. He has a background in international climate finance and infrastructure finance as well as many years' experience in leadership roles in membership organisations.

James has worked on international climate finance issues at the UN level and supported cities across the world to invest their pensions and reserves more sustainably.

James is Chair of the Global Sustainable Investment Alliance, Treasurer of Eurosif, the European Sustainable Investment Forum, a member of the Green Technical Advisory Group (GTAG) providing advice to the UK Government on implementing a UK green taxonomy and a member of the Disclosures and Labels Advisory Group (DLAG) providing advice to the FCA on the UK's SDR and fund labelling regime.

The UK Sustainable Investment and Finance Association (UKSIF) aims to empower the financial services industry to move further and faster to ensure a more sustainable and responsible financial system. For our 300+ members, this goes hand in hand with the huge economic opportunity that transitioning to net zero offers.

But the Prime Minister's recent U-turn on some climate policies is damaging investor confidence in the transition to net zero. Those actions risk deterring investment away from the UK and putting at risk the jobs and growth that come with it.

We drive the agenda to create a clear and consistent policy environment in many ways, including as members of various advisory taskforces to policymakers, providing input towards a number of sustainable finance initiatives in the UK. For example, UKSIF sits on the expert, independent Disclosures and Labels Advisory Group ('DLAG'), advising the FCA.

Of course, the range of investment products available in the market makes this a challenging task, and taking into account the variations in asset classes, how they function and the consequences in ESG terms, is crucial. Where the FCA's upcoming Sustainability Disclosure Requirements (SDR) and investment labels are concerned, there are certainly some specific Fixed Income considerations we see.

For example, the proposed 'Sustainable Focus' label in the FCA's consultation is for products that must have a minimum percentage (70%) of assets which can meet a credible environmental and/or social standard. While we support the proposed, high 70% threshold in place for funds' assets to attain the 'Sustainable Focus' label, we see potential pitfalls with the 70% threshold figure for certain asset classes beyond listed equities, such as sovereign debt.

Government bonds will often be a key part of a lower to medium risk portfolio, and it will often be difficult to classify these as 'sustainable' investments. Collectively, we need to avoid disproportionately excluding those savers who may want to invest in a sustainable way in a broad range of asset types, from fixed-income products to multi-asset strategies.

The most critical element of the FCA's labelling initiative is that it makes the market more transparent, while the movement of more private investment in the direction of sustainable propositions, is also dependent on the awareness, understanding and engagement of financial advisers and consumers. Currently, though, this is not a given. In UKSIF polling recently carried out, 39% of people reported not having an employer or adviser who provides financial advice, and 43% reported their adviser or employer did not offer them advice on environmentally sustainable financial products. It's no surprise, then, that well over half of respondents said they do not know if their investments are environmentally sustainable or not.

We clearly need ongoing educational initiatives to push up the number of advisers and wealth managers really committing to discovering and advising on their clients' ESG preferences - something the Consumer Duty is also likely to spotlight. In addition, my feeling is that the new labelling regime must effectively encompass a full and diverse spectrum of assets classes, beyond listed equities alone, to give investors and their advisers a clear understanding of the ESG credentials of products that might usefully form part of their portfolio.

ESG Regulation and Fixed Income Markets

by Sonali Siriwardena

Partner, Global Head of ESG, Simmons & Simmons LLP

Sonali has significant experience in the complex legal and policy landscape governing ESG. She advises on ESG matters in a multi-jurisdictional setting assessing the application of ESG regulations to global companies. Having worked within industry, she has a good understanding of how clients can apply ESG-focused regulatory and policy developments to mitigate risks and leverage business opportunities in a proactive and productive manner.

Sonali holds leadership positions in several ESG-focused industry bodies and is an active contributor to ESG-policy discussions. Amongst other commitments, she is a member of the ESG Advisory Committee convened by the UK FCA, a member of the City of London Law Society ESG Committee and a Board member of UK Sustainable Investment and Finance Association (UKSIF).

Disclosure has been the dominant focus of global ESG regulations impacting financial markets to date. The European Union (EU) has been a first mover in this space, introducing a flurry of sustainability-focused legislation over recent years, including the EU Taxonomy and the Sustainable Finance Disclosure Regulation (SFDR). While greater transparency has been a key policy driver, this has also impacted investment flows. For example, SFDR has been a game changer with article 8 and 9 funds combined market share growing to 57%[1] in Q1 2023. However, it is not a perfect science as the equity and public-markets centric nature of these regulations have created challenges, one namely being the hurdles SFDR creates for fixed income (FI) strategies to be classified as a "sustainable investment".

While pioneers take the arrows, others stand to benefit from a second-mover advantage. For example, given the industry response to SFDR, the UK FCA's proposed Sustainability Disclosure Requirements (SDR) takes a decidedly different approach to be cast as a labelling regime (as opposed to the disclosure route of the EU). While this shows that regulators are keen to improve and evolve the policy response, it also highlights that industry can play an influential role to help shape this evolution.

Readdressing the asset class bias could well represent the next evolutionary phase for sustainability regulation.

There is a common critique that regulations don't allow for the complexity of FI financial instruments, particularly when defining a "sustainable investment". An easy to conceptualise challenge, is the data and standardisation gap when it comes to adopting non-corporate investment strategies. For example, FI sovereign strategies cannot often use mainstream ESG data providers and need to assess unique data points such as whether a sovereign is party to international conventions or subject to international sanctions.

Another bone of contention for FI strategies is stewardship. SDR has included an active investor stewardship strategy as a baseline requirement to qualify for any of the three sustainability labels. Under SFDR, the European Commission recently clarified that when "considering" principle adverse impacts (PAIs) on sustainability factors, there must be a proactive plan to mitigate PAIs beyond just gathering and reporting data[2]. For FI strategies, there are fewer avenues for stewardship and engagement than for equity. For example FI doesn't have the same AGM voting rights, therefore there are fewer windows for engagement. Moreover, there are also nuances with sovereign strategies where engagement with state entities is not as straightforward as with corporates.

The debt markets have an unique and useful role to play in the sustainability agenda. Therefore FI investors and regulators must join forces to ensure that the fast-evolving regulatory landscape actively accounts for the FI sector and recognises the varied yet vital contribution it can make to channel finance towards sustainability.

[1] Morningstar SFDR Q1 2023 Report
[2] https://www.esma.europa.eu/sites/default/files/2023-04/Answers_to_questions_on_the_interpretation_of_Regulation_%28EU%29_20192088.PDF

What advisers want to know

Q&A with My-Linh Ngo

Senior Director & Impact-Aligned Strategist, Responsible Investment at RBC Bluebay Asset Management

My-Linh joined BlueBay Asset Management (which is now part of RBC Global Asset Management) in July 2014. She represents BlueBay in interactions with the UN-supported Principles for Responsible Investment (PRI), participates in two working groups, one on ESG Bondholder Engagement, and Advisory Committee on Credit Ratings (as chair). She has also served as a non-executive board director of UKSIF (2008-2014) and was a member of the Expert Committee for the Access to Medicines Index (2009-2013).

She previously held positions at Schroders as an ESG Analyst and at Henderson Global Investors as an Associate Director – SRI Research in the Sustainable and Responsible Investment team. My-Linh holds a Masters in Leadership for Sustainable Development from Middlesex University/ Forum for the Future, a Masters in Environmental Management Systems & Auditing, and a degree in Environmental Sciences, both from the University of East Anglia.

Q: Is it possible to consider ESG/Responsible Investment in asset classes beyond equities, like fixed income?

ESG/RI investing has evolved from the equity asset class, and there are many fund solutions available. However, the opportunities are not limited to equities, and more and more funds in the fixed income space are incorporating ESG/ RI. Whilst some approaches which exist in equities can be readily applied to bond funds, there are some important nuances and differences in how the fixed income asset class works that investors need to understand, to determine what ESG approaches are most appropriate. Given the debt asset class is larger than equities by size, the fact that companies would rather access funds by issuing debt as opposed to giving up equity, the potential to invest in countries as well as companies, and the emergence of new debt instruments like green or social bonds, there are some great opportunities available.

Q: Does ESG/RI mean sacrificing financial returns given it seems to be all about the negative screening of companies?

Not necessarily. There is a common misconception that all ESG funds do is apply exclusions. But, the reality is that approaches to help realise the ESG objective can range from taking a positive approach (screening 'in' specific investments) or an inclusive approach which centers on encouraging improved practices or negative (screening out) exclusionary one that takes account of either economic activities and/or business conduct. A combination of these approaches may be utilised within the same fund.

Whether applying ESG/RI can negatively impact performance depends on a number of factors, some related to ESG, but others are more about the broader investment strategy. For instance, ESG related factors include what the stated ESG objective is, and what the scope and volume of resulting ESG issues are that are being applied, and whether the fund's performance is being measured against a benchmark. For example, if a fund is applying exclusions, it may be that such issues may not necessarily have a financial impact on how companies perform so excluding them could not make a difference or actually disadvantage the fund at least in the short term. If the fund is being compared to a benchmark, and the ESG framework means it is unable to invest in a large part of the universe, then its ability to outperform could be constrained.

Q: Are there any particular challenges when it comes to ESG/RI in fixed income?

Yes, there are a few related to data and analytical tools. Some bond funds invest in small, private companies which may have little public ESG disclosure for investors to accurately assess their performance. It may also be that ESG rating agencies who assess company ESG practices more commonly focus on equity companies so there is not always sufficient coverage for fund managers to utilise. This is particularly true in the case of bond funds which invest in countries rather than companies. With the growth of the green bond market, an increase is needed on the ESG performance of the projects being funded rather than of the company itself. But, the situation is improving and we are starting to see more availability and quality in ESG information, which will support more informed investment analysis and decision-making.

Fixed income and equity:
key differences for ESG investing

Fixed Income	Equity
RELATIVE MARKET SIZE	
The FI market is close to 4 times the size of the equity market.	Around a quarter of the size of the bond market.
PRIMARY FOCUS	
Risk mitigation/risks to the downside – the upside is capped.	Alpha generation/risks to the upside.
INVESTMENT ANALYSIS	
Multi layered – quantitative. ESG analysis can sit alongside financial credit analysis as a proxy for management quality.	Single dimension and generally a more direct relationship between ESG and credit risk.
DRIVERS OF ISSUER PERFORMANCE	
Focused on financial strength (creditworthiness); ESG impacts may be delayed and limited.	Sentiment can be important; focuses on future earning potential; ESG impacts can be more immediate and big.
LEGAL STATUS OF RELATIONSHIP/VOTING	
Lenders – can't vote, accountability limited to terms in Covenants. But market size gives bondholder influence.	Owners – can vote at AGMs, good accountability to shareholders.
ACCESS TO MANAGEMENT/EASE TO ENGAGE	
Limited (greatest at pre issuance), relatively infrequent	High level of engagement with good frequency.
INFORMATION AVAILABILITY	
Limited (as traded OTC – where weaker reporting regulations apply)	High as traded on stock markets with minimum requirements.
ESG RISK IMPACT	
Focus is on fundamentals with bond prices influenced by changes to expectations such as financial strength of the issuer/risk of credit losses, i.e. credit worthiness.	Sensitivity to news flow and investor sentiment means more likely to be direct and immediate sensitivity to ESG factors.
PASSIVE/ACTIVE APPROACH	
Many ESG risks are not widely known in the market, so mispricing opportunities can naturally occur. Active management can take advantage.	Perceived lower cost of passive approach makes it popular.
ESG STRATEGIES	
ESG integration and ESG tilting most likely to be best fit although there is some scope in other strategies.	All ESG strategies likely to be a good fit (ESG strategies were designed with equity in mind).

SPECTRUM OF ESG APPROACHES

	Financial-only	Responsible	Sustainable	Impact			Impact-only
	Delivering competititve financial returns						
		Mitigating Environmental, Social and Governance (ESG) risks					
			Pursuing Environmental, Social and Governance opportunities				
				Focusing on measurable high-impact solutions			
Focus	Limited or no regard for environmental social or governance (ESG) practices	Mitigate risky ESG practices in order to enhance value	Adapt progressive ESG practices that may enhance value	Address societal challenges that generate competititive financial return for investors	Address societal challenges where returns are as yet unproven	Address societal challenges that require a below market financial return for investors	Address societal challenges that cannot generate a financial return for investors

94 fixed income funds with an ESG slant

by Julia Dreblow

Founding Director, SRI Services

Julia has spent 25 years specialising in retail sustainable, responsible, ESG and ethical investment. She has run her own business, SRI Services offering adviser friendly 'SRI' tools, since 2010, helping to upskill and equip others. Julia is also on the FCA's Disclosure and Labels Advisory Group, BSI sustainable funds steering group and is the technical author of the PIMFA ESG Academy. Current additional activity includes working with Parmenion, interactive investor, PFS, BSI and others.

Prior to this, Julia was Friends Provident SRI Marketing Manager for 12 years. She was also previously a director of UKSIF for seven years.

For as long as I can remember bonds have been a somewhat 'Cinderella' asset class in retail sustainable investments. Largely overlooked and most definitely underestimated. It is hard to say why this might be, but the fact the first ethical and sustainable funds held equities - and the profile of equity-oriented stewardship activities - notably shareholder voting - won't have helped.

However, with increased urgency and public interest this has started to change. Potential asset allocation benefits aside, bonds have an important part to play in financing corporate 'shifts' - including the transition to net zero and a circular economy. Put simply, bonds 'pull different levers' from equities.

That said, as with equities trust is an issue for bond investors. Too often investors look for the perfect, 'one size fits all' solution and are disappointed when they do not find it.

Our database tool, Fund EcoMarket, which is designed for advisers but open to all, helps users to recognise strategy differences and match them to client aims. Currently, we list 94 fixed interest/bond 'primary' (OEIC and SICAV) funds, and there are bond funds in each of our 'styles'.

They include those classified as 'Sustainability focused', 'Environmentally focused', and 'Socially focused', with funds that are likely to invest in assets clients may regard as controversial classed as 'ESG Plus' and 'Sustainability Tilted'. These are likely to compliment the anticipated FCA labels.

The Ethical and Faith classifications are probably self-explanatory – indicating a focus on values – some have strong sustainability policies, others may fall outside the SDR. The funds we list as having 'Limited Exclusions' are less likely to meet labelling requirements but may nonetheless suit some clients.

No matter what the final labels look like, disclosure – and therefore the need for additional information – will remain a key feature of this area. Understanding the specific aims, issues and approaches the manager applies, both at fund and fund manager level will doubtless be under the spotlight. Fund EcoMarket can help with this too.

However change is continual – for example 'Biodiversity' was rarely mentioned a few years ago – and articulating a clear focus on 'impact' is increasingly popular. We have also added filter options relating to 'Mental Health' (see 'Engagement Approach' area), 'LGBTQ+' (See 'Human Rights' area) and 'Intended for vegetarians/ vegans' (see Intended Clients area) this year, for example.

Some of these will appeal to more people than others, but from the perspective of advisers and wealth managers what matters is knowing where to start as such strategies are not common. Not all may relate to bond options today – but they could at some point.

The rate of innovation in sustainable investment has been phenomenal in recent years, and the cost of transitioning is clearly in the trillions. So, whilst we may not yet know exactly where SDR will land, we can be confident bond funds will have a growing part to play in both reflecting client needs and solving problems. There is much to finance, so watch this space.

IFA to IFA: practical pointers on fixed income and ESG

by Julian Parrot

Partner and Financial Planner, Ethical Futures

Julian founded Ethical Futures in 2005. It specialises in values based financial planning advice to private clients from all walks of life. During that time, he has been Chair of the Ethical Investment Association and a Director of UKSIF. He is also currently a Director of the Ethical Finance Hub in Edinburgh. In addition to this, he provides consultancy advice to two investment companies, EdenTree & Parmenion. Both roles involve providing feedback from a retail client perspective on issues around ethical and sustainable investment.

On a professional adviser basis, he has over 25 years advisory experience in financial services and holds the international standard in Financial Planning ISO 22222, which is subject to annual external validation.

94% of fixed income investors plan to increase their allocation to ESG bonds over the next two years.

The Continued Maturation of Fixed-Income ESG Investing, Coalition Greenwich, a division of CRISIL, April 2023

I've been focusing my financial planning firm on helping clients to use their money to meet their personal goals, while investing in things they believe in, for over 20 years. During that time, the FI market for clients with aspirations beyond financial performance has, and continues to evolve. It's now a market with increasing nuance and choice. As a result, it's essential for financial planners and advisers to grow their understanding of this investment area so they are able to knowledgably assist clients with effectively fulfilling their ESG ambitions.

Risk mitigation and beyond

Applying some ESG principles is a common strategy among investment managers. For many, this is not specifically about good environmental or social outcomes, but about mitigating potentially negative effects on assets, the financial earnings situation, or the reputation of the fund.

Many investors with an ethical outlook are seeking much more intentionality placed on driving positive ESG outcomes and currently, it's not always easy to differentiate between ESG simply as a risk mitigation strategy and where it is also one of the main objectives.

This is where advisers need to dig into the details of the fund philosophy and purpose: Look for a joined-up narrative that runs through the fund and its documentation, including definitions of what assets are in or out, objectives beyond just returning an amount of income above a certain threshold, and some sort of qualitative and where possible, quantitative assessment of the goals. This should be reflected by the bonds that are held.

And beware of green wash and mission drift.

Difficulties of due diligence

This research is difficult because a bond portfolio has a high volume of turnover and holdings, making analysis of all the individual, underlying assets a resource-intensive process. In the absence of such analysis, it's important to engage with investment managers to understand and record their explanations of the fund's process and philosophy, taking into account the criteria applied to bond asset selection, whether they are largely negative or positive and if they have tolerances that would or would not be acceptable to your client. Finding out the investment risk apportioned to the ESG holdings can also be telling.

Asset classes in the grey areas

Historically, gilts have often been avoided by the ethical investor because they are basically lending to governments. While a large chunk of funds raised is used for positives such as paying pensions and healthcare costs, 6% or 7% is broadly allocated to armaments and defence. Consequently, clients may have objections. This is why you often don't see these assets in the deepest green investment portfolios.

Useful Resources

The leading membership organisation for sustainable and responsible finance in the UK. This website provides educational materials, a list of its members, events and insights into UKSIF's work to influence government and regulators in support of the planet and the UK's sustainable finance and investment community.

uksif.org

The SRI Services website helps UK financial advisers and wealth managers match client preferences to sustainable, responsible, ethical and ESG investment fund options. It also offers educational materials and a comprehensive database of the relevant investment offers.

sriservices.co.uk

Resources on sustainability and responsible investment including the Principles for Responsible Investment, a list of signatories and insights into Fixed Income investments.

unpri.org

A summary of the FCA's work on climate change and sustainable finance with links to the current and upcoming relevant regulation.

fca.org.uk/firms/climate-change-sustainable-finance

Offering a free online directory of ethical funds.

ethicalscreening.co.uk

A technical compliance firm specializing in investment preferences and objectives spanning across the full spectrum of capital.

esgaccord.co.uk

Providing ESG profiling, research and investments for financial advisers.

fefundinfo.com

RBC BlueBay
Asset Management

We are an active investment manager partnering with clients to deliver optimal outcomes across asset classes. Our investment expertise is characterised by our specialist fixed income credentials and broad-based equity capabilities, plus integrated ESG approach and impact investing strategies. We design investment strategies and provide investment insights to meet client needs and focus on partnership, transparency and engagement to make clients' lives easier.

To find out more visit **rbcbluebay.com**

How did you do?

Learning objectives

After reading this guide, advisers will be able to:

- Describe key differentiators and similarities between ESG in bonds and equity

covered on pages 6 & 7

- Outline key global regulatory factors currently impacting fixed income investments

covered on page 5

- Answer some of the most frequently asked questions regarding ESG in fixed income investing

covered on page 6

- Evaluate the current market opportunity and drivers

covered on pages 4 & 8

- Identify some of the practical aspects of navigating ESG in fixed income investing

covered on page 9

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For more details on claiming CPD, go to:
intelligent-partnership.com/cpd

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"The momentum of ESG as an influencer of investment options should not be under-estimated. Neither should the growing necessity for advisers to be knowledgeable about products available outside equities. Fixed Income is a massive market offering diversification, clout and, for some clients, potential routes to the best outcomes the Consumer Duty is seeking."

Guy Tolhurst, Managing Director, Intelligent Partnership

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