Understanding sustainable credit

Shalin Shah – Senior Fund Manager

Shalin Shah explains Royal London Asset Management's long-established approach to sustainable credit and how he manages its sustainable credit portfolios.

Environmental, social and governance (ESG) investing started in equities and much of the data and analysis used today is still centred there. Sustainable investing in fixed income is less established and best practice is still evolving. It is clear, however, that simply replicating the approach taken by equity investors is sub-optimal.

Our 10-year-plus head start in sustainable credit over many of our competitors has given us time to develop a differentiated investment process based not just on data-driven models. We've learned to be flexible and understand the differences between equity and debt when considering sustainable criteria: what works for one often isn't relevant or important for the other.

Our approach to ESG in credit is built on the longstanding investment philosophy that credit markets do not accurately price idiosyncratic risk. We use ESG analysis in the same way as any other form of credit research – to uncover information that rating agencies and other market participants might be missing, helping us with our aim to make better investment decisions and deliver excess returns.

ESG rating limitations

It is extremely difficult to outsource the analysis of credit ESG risks to third parties. As well as the limited scope of equity-based platforms – only c. 40% of the bonds in the sterling credit index have a public equity profile – the apparent convenience of a single 'ESG score' often fails to capture the idiosyncrasies of credit. We know this inefficiency from credit ratings: while broadly helpful, the over-distillation of information into one rating creates distortions that we believe active investors can exploit.

Likewise, while issuance of so-called 'green bonds' has grown exponentially, they have clear limitations. They can trade above fair value as investors overvalue both the label and the 'easy win' it provides for client reporting.

In our view, the only credible solution is thorough, bottom-up fundamental research and an investment process that acknowledges the false distinction between traditional credit and ESG analysis. However, while ESG analysis needs to be intrinsic to the process, achieving this in practice is not easy and requires active collaboration between our Responsible Investment and Credit teams.

Our sustainable credit funds

All issuers within our sustainable holdings offer a net benefit to society or show ESG leadership. Unlike equities, credit risks are asymmetric: upside returns are capped, while a deterioration can lead to full capital loss. Therefore, alongside sustainable considerations, we value bondholder protection and diversification. We focus on bonds with strong security and covenants. Our portfolios are also highly diversified to reduce stock-specific risk.

As well as reducing risk, we seek out opportunities that are under-researched e.g. bonds that do not fall into mainstream indices or benchmarks and/or are unrated by ratings agencies. Importantly, the sustainable credit proposition provides access to critical sectors that most investors can't access via equity markets. Key themes that are deployed in the funds include social housing, the decarbonised economy, vital infrastructure, financial resilience (such as insurance products to support individuals through shocks), and community funding (banks focused on SME and retail lending). The remainder meet one of the overarching criteria. The themes deployed are not a requirement, they are an outcome of our rigorous selection.

Shalin Shah manages the credit portfolios of RLAM's sustainable funds, including the RL Sustainable Managed Growth Trust and the credit-only RL Sustainable Managed Income Trust.

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The views expressed are the author's own and do not constitute investment advice.

For more information on the fund or the risks of investing, please refer to the fund factsheet, Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Information page on www.rlam.co.uk

All information is correct at September 2020 unless otherwise stated.

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