Global Sustainable Credit – our best of both approach

It scarcely needs stating that the Covid-19 pandemic has been incredibly challenging for investors. National lockdowns, negative oil prices and gilt yields, record-breaking economic collapses quickly followed by unmatched growth. The crisis has triggered all kinds of events that were recently unimaginable. The swing in market sentiment, driven by the unprecedented actions from central banks, has likewise been remarkable.

The Covid-19 pandemic has been a true black swan event that has proved a great test for risk management strategies. It is too soon to declare the long-term winners and losers, given that we are not yet through the crisis and there are many market distortions that have yet to unwind. Nevertheless, based on their performance during both the downturn and the recovery, it appears likely that 'sustainable' investment strategies will emerge particularly strongly.

Sustainable investing has become something of a buzzword of late, often associated with the rise of millennials, yet we have been managing sustainable funds at Royal London Asset Management (RLAM) since 2003. We have proved over that timeframe that embedding values into investing does not need to come at the expense of financial returns. Our sustainable funds have achieved significant long-term outperformance against their benchmarks, including during the troubled markets of 2020.

We have two requirements for all of the companies in which our sustainable funds invest. First, they must provide products or services that benefit society. Second, they must be sector leading from an environmental, social and governance (ESG) perspective. By integrating these criteria with fundamental financial analysis, we seek to 'future proof' our portfolios against, among many factors, climate change, technological innovation, regulatory changes and default risks.

Historically, sustainable investing has been closely associated with equity investing, yet we think it suits credit just as well. The risk profile of bonds is asymmetric: the upside is capped, whereas the downside is everything. That renders effective risk management critical. This is where the sustainable approach is especially valuable, since it limits the investment universe to companies with relatively low ESG risks that tend to be well regarded by society due to their 'do good' credentials.

We have therefore developed a new strategy, the RL Global Sustainable Credit Fund, which integrates the expertise of our sustainable and fixed income investment teams. It builds upon our experience running such a strategy on a segregated basis over the past two years, and we want to bring that proposition to a wider client base.

How will it work in practice?

The first part of our process is sustainability screening as shown in figure 1 overleaf. We have an in-house team of nine 'responsible investment' analysts with different areas of specialism. Following their analysis, the team takes a democratic vote to decide whether an issuer passes our sustainability screen. If no decisive conclusion is agreed, we put the matter to our external and independent advisory committee, composed of leading experts across different disciplines relevant to sustainability.

We have now screened over 900 companies, giving us an eligible investment universe of around 650. That means we have a highly diversified global universe of credits from which to select. Indeed this is an obvious benefit of creating a global fund, it counteracts one of the main drawbacks of sustainable investing – that it must inevitably shrink the investment universe.

While some sectors and issuers are well represented globally, such as banks and insurance, others are essentially specific to certain markets (for example, social housing in the UK and technology in the US). As can be seen in figure 2, going global allows us to diversify across more themes, more sectors and more issuers, thereby reducing the idiosyncratic risks that we would otherwise face. It also brings additional opportunities like being able to take advantage of cross-currency inefficiencies to pick up yield.

Figure 1: Our sustainability screening

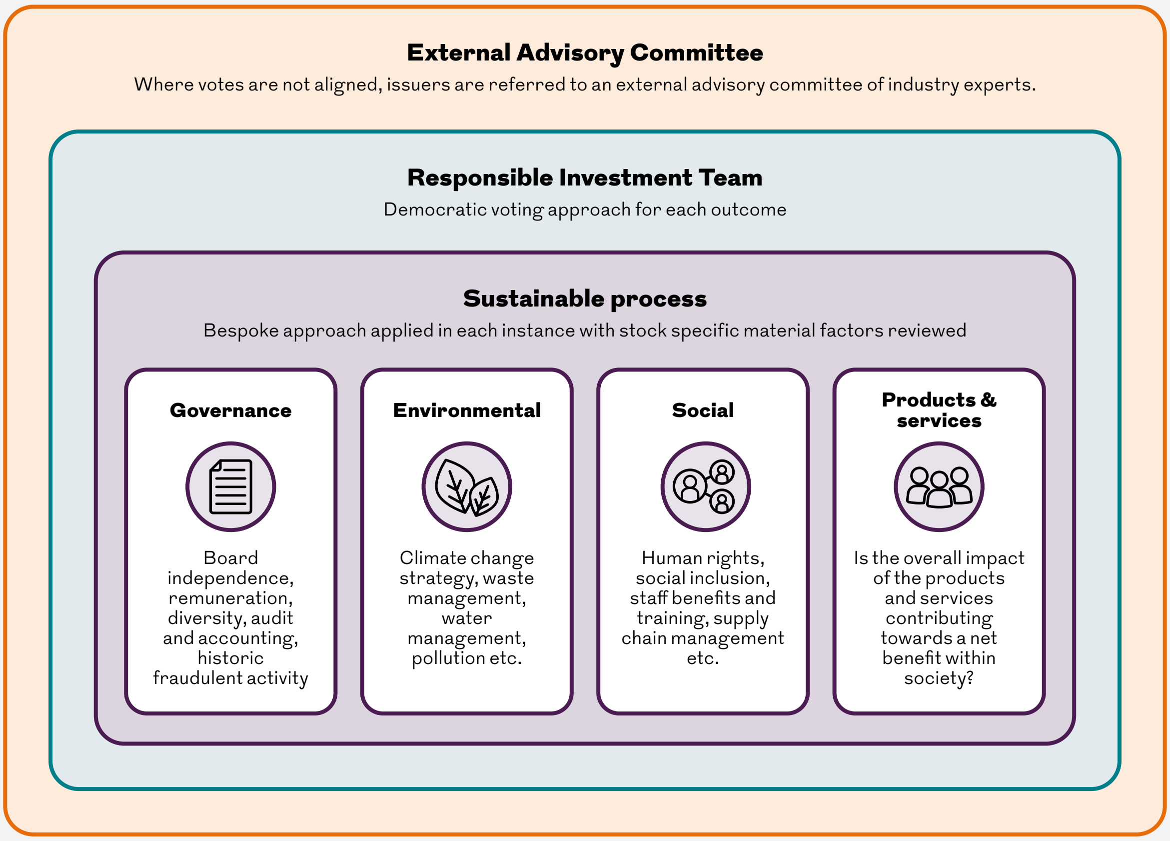
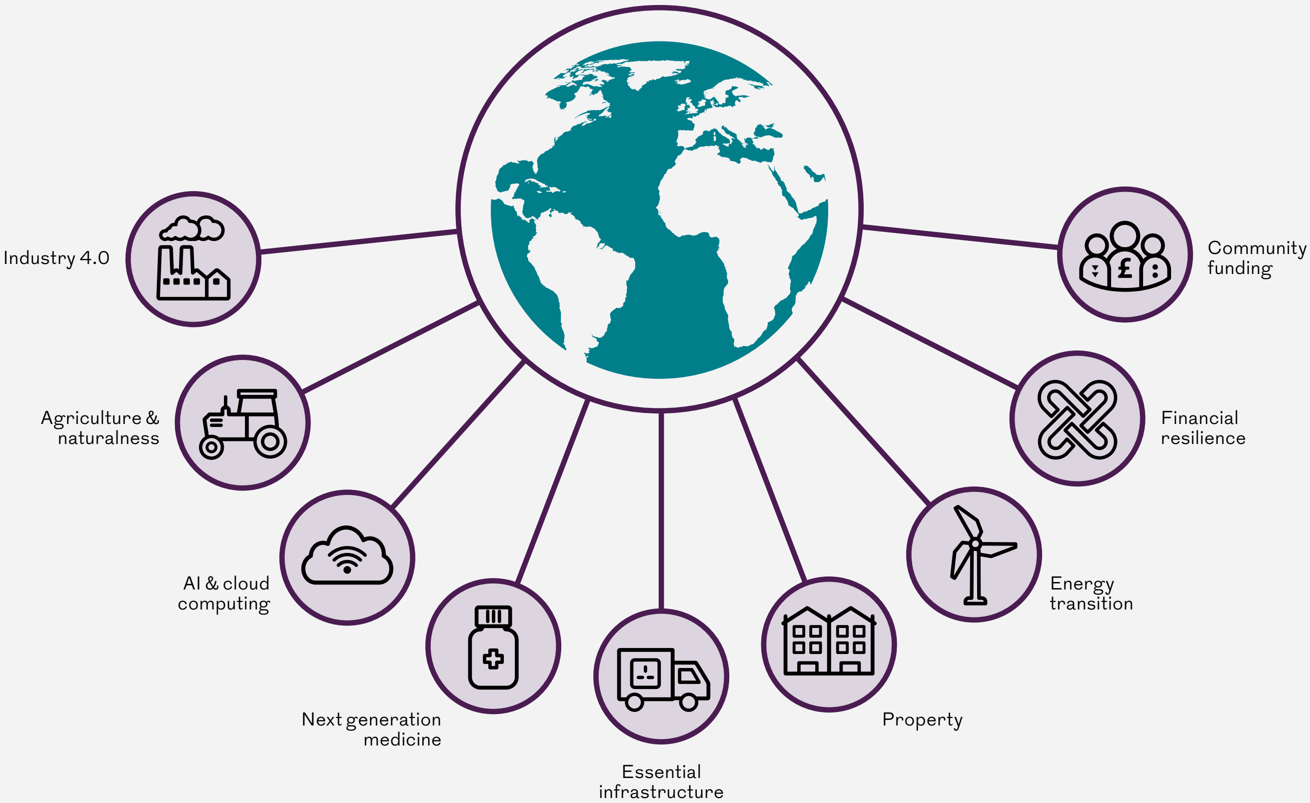


Figure 2: Access to a diverse array of critical themes



In the final phase of our process we apply our credit philosophy. This is based on the premise that there are exploitable inefficiencies in corporate bond markets. By conducting our own research, centred on exploiting these systematic inefficiencies, we believe we can achieve higher and more consistent returns to meet our clients' objectives.

What are the challenges?

Nothing can replace doing your own research and there are rarely black and white answers. Symptomatic of the pitfalls of trying to outsource difficult work is the dramatic rise in the popularity of 'green bonds'; bonds for which the proceeds must be earmarked for green projects. By their very designation, they might seem like obvious candidates for sustainable investors. Unfortunately, however, we find that the reality is much more complicated.

In theory, issuers of green bonds are compelled to comply with International Capital Market Association (ICMA) principles. These require that they monitor and report on how the proceeds from the green bonds are being used, to ensure that they are restricted to social and environmental projects. The issue with the principles is that they are voluntary, not having the same force as covenants or laws.

Of course, non-compliant companies risk huge reputational damage, but in situations of deep financial distress they may well judge a reputational hit to be a price worth paying. Most green bonds are unsecured, meaning that there is nothing to effectively prevent companies from divesting the green parts of their business, leaving the proceeds from the bonds in non-green parts of the business.

Another problem is that a company's ability to issue green bonds says very little about how green the company actually is. The green project may constitute only a miniscule part of its overall business. We think we can often do far more good investing in companies without any green bonds outstanding, but which derive 30-40% of their revenues from green projects. That brings the added benefit that we would avoid having to pay the premium that often comes with the 'green' label.

Consider, for examples, the issues from DTE Energy and Avista shown in figure 3. The bond from DTE Energy comes with a green label, whereas the Avista bond does not. Despite this, we believe the ESG and renewable energy credentials of Avista as a company are more attractive, and a lower proportion of its energy production comes from coal. Revealing the extent to which the 'green' label carries a considerable premium, the credit spread on the Avista bond is nevertheless much more attractive.

There must, of course, be a balance here, since we cannot expect companies to turn entirely green overnight. We must allow them a pathway to becoming greener, while remaining sufficiently sceptical that we do not take every green project as evidence that they are meaningfully on such a journey. The judgments are often very difficult to make, and that is why we consider our democratic approach to be so necessary.

Figure 3: The most attractive green opportunities often come without green labels

Company	**DTE Energy**	**Avista**
Issue	DTE 3.95% 2049 USD	AVA 4.35% 2048 USD
Credit rating	A	A
Secured	✓	✓
Market capitalisation	$23bn	$2.4bn
Green label	✓	✗
ESG leader	✓	✓
Share of renewable energy	13%	>50%
Coal generation	15%	8%
Spread	1.15%	1.45%

Portfolio characteristics and holdings are subject to change without notice. This does not constitute an investment recommendation. For information purposes only.

Source: RLAM as at 9 September 2020.

A new product, not a new strategy

We think the RL Global Sustainable Credit Fund is a great step forward for our business and are excited to deliver a new product that addresses the needs of many of our clients. The fund builds directly upon our existing sustainable and fixed income funds, utilising the same philosophies, collaboration and deep research capabilities that have made them so successful. We are confident that we have the resources and experience to make this a truly exciting addition to our range.

Investment risks

Past performance is not a guide to future performance.

The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Derivative risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both fund losses and gains. The impact to the fund can be greater where they are used in an extensive or complex manner, where the fund could lose significantly more than the amount invested in derivatives.

Efficient portfolio management (EPM) techniques: The fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the fund to increased price volatility.

Exchange rate risk: Changes in currency exchange rates may affect the value of this investment.

Interest rate risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Liquidity risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Contact us

For more information about our range of products and services, please contact us.

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