AEGON Asset Management

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September 2024

AEGON **INSIGHTS**

Responsible investing integration across core fixed income solutions

Integrating RI as part of investment analyses is no longer an option. In addition to meeting regulatory and stakeholder expectations, it allows for better management of financial risks and uncovering underlying opportunities. This paper elaborates on opportunities to integrate RI across core fixed income.

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Executive summary

- Core fixed income plays an important role in portfolio diversification and with the growing attention on responsible investment considerations, there is a need to actively consider these factors along core fixed income strategies.
- When compared to equities, integration of responsible investment considerations within core fixed income is less straightforward due to inherent characteristics of the asset class.
- Engagement within core fixed income can be useful to understand how issuers approach responsible investment as well as to influence behavior towards addressing responsible investment risks.
- While the process for integration of responsible investment is similar across sovereign bonds, supranational, sub-sovereign and agency (SSA) bonds and corporate credits, there are some important differences to note.
- Despite its setbacks, emerging market debt is fast gaining popularity amongst investors. Through the synergy of public and private partnerships, there is potential to bring real impact.

Core fixed income is an important part of institutional investors' portfolios, such as pension funds and insurance companies. Core fixed income encompasses various sub asset classes, sovereign bonds and corporate credits being the most commonly known. Relative to more modern and complex asset classes, investors are rather familiar with the risk – return profile of core fixed income. However, more recently, investors have been looking for ways in which they can assess and integrate responsible investing in their core fixed income portfolios.

Responsible investing strategies vary across different asset classes. This is largely owing to the different strategies employed as well as the underlying availability of data. For core fixed income in particular, the most commonly used strategies involve integration, screening, active ownership or thematic. These strategies can be employed individually or as a combination to match investment goals. Integration predominantly involves including ESG considerations to investment analyses to limit downside risk. Screening involves introducing pre-determined criterions to filter investments based on investors' preferences. Thematic strategies on the other hand, are more directed to support specific environmental or social outcomes.[1]

Responsible investment is being integrated in more innovative ways over time. This can be evidenced through the different sustainable fixed income solutions made available in the market. These solutions are well positioned to drive real change in the world, and fund projects or outcomes that directly contribute towards a sustainable future. Such solutions are generally hybrid in nature whereby it pursues sustainability alongside a thematic strategy.

For core fixed income, the most commonly used responsible investing strategies involve integration, screening, active ownership or thematic.

Responsible investment strategies

To perform an analysis on common ground, it is important to define a responsible investment framework. Although numerous organizations, networks and regulatory bodies offer industry-accepted frameworks and definitions (e.g., PRI), we will perform our analysis based on our Aegon Asset Management framework.

Aegon Asset Management: Responsible Investment Framework

The ESG approach at Aegon AM is guided by three ESG pillars namely ESG integration, active ownership and solutions. As part of ESG integration, ESG factors are included in the research framework of analyses for fixed income and equity issuers. By considering ESG factors alongside traditional financially material factors, a longer-term view on investments is achieved. Engaging in dialogues or active ownership act as an important pillar because they provide an opportunity to highlight concerns or expectations. Lastly, Aegon AM's capabilities are categorized into five groups. A combination of solutions could be utilized across liquid traditional fixed income strategies such as sovereign, sub-sovereign and credits.

ESG solutions are categorized as follows:

Exclusions and ethical	Best-in-class ESG	Climate transition	Sustainable	Impact investing
Identify issuers to exclude usually based on their activities and associated adverse impacts.	Select issuers with superior ESG profiles based on financially material ESG issues.	Select issuers better prepared to manage climate risks.	Select issuers better aligned to sustainable economic activities or the Sustainable Development Goals.	Select projects, borrowers or issuers able to demonstrate measurable social or environmental impact.

Having defined our framework, we will now analyze how strategies within core fixed income can integrate responsible investing.

[1] UNPRI, 2019. Available at: An introduction to responsible investment: fixed income | Introductory guide | PRI (unpri.org)

Sovereign bonds

Historically the process of ESG integration within the sovereign sub-asset class began with excluding countries that were poor performers and this was mostly driven by the reputational risks arising from such association. Since then, ESG integration within sovereigns has evolved into a more encompassing approach. At present, non-financial factors such as ESG are integrated within investment research or by applying specific filters that are related to the environment or ethical considerations. Examples of filters include a country's environmental practice and policy, or involvement in human rights abuses or controversial industries. Thematic sovereign bonds that typically include green, blue or SDG bonds are also gaining traction in the sovereign bond market. Proceeds from these instruments are earmarked for projects that directly contribute to the specified theme.

Materiality of ESG factors	While environmental factors are important, other pillars such as governance or social have taken the front seat owing to their greater relevance for sovereigns. But this is fast changing since it has been widely accepted by investors that impacts of climate change are universal and not restricted to a single geographical location. Further, environmental factors are often intertwined with social factors such as demography or standard of living, raising the relevance of environmental factors moving forward. Apart from the above, environmental factors become highly relevant in sovereign thematic strategies. Traditionally, governance for sovereigns has been seen as a highly important factor since it directly impacts environmental and social factors as well a country's ability to repay loan obligations. Examples of governance factors that are more material to sovereigns are the strength of institution, levels of corruption, rule of law or freedom of speech.[2]
Engagement & Stewardship	Engaging in dialogue within sovereigns is less straightforward as compared to equity investors or corporate issuer engagements, since the focus of discussions could be different, and nature of engagement can also be misinterpreted. Typically, engagement with sovereign issuers is oriented to gather more information or understand macroeconomic data, whereas corporate issuer engagement is geared towards influencing strategies or policies.[3]

For sovereign bonds, non-financial factors such as ESG are now integrated within investment research or by applying specific filters that are related to the environment or ethical considerations.

Supranational, sub-sovereign and agency bonds

Green, social, sustainability and sustainability-linked bonds (GSSS) make up a large part of the supranational, sub-sovereign and agency (SSA) market. Since a majority of the SSA bonds including GSSS bonds are issued to finance specific outcomes or projects this means that ESG analyses can lean towards assesment on the use-of-proceeds rather than solely on the issuer's profile.[4] Further, in order to qualify as labelled debt, they are usually expected to meet relevant principles or certifications such as the ones set out by the International Capital Market Association (ICMA), which further reduces the 'emphasis' on broad ESG assessment. That said, this does not suggest that the issuer's profile would take a backseat in the investment analysis. It still remains as a key deciding factor.

[2]UNPRI, 2019. Available at: https://www.unpri.org/fixed-income/a-practical-guide-to-esg-integration-in-sovereign-debt/4781.article
[3]UNPRI, 2019. Available at: https://www.unpri.org/fixed-income/a-practical-guide-to-esg-integration-in-sovereign-debt/4781.article
[4]World Bank, 2018. Available at: http://documents.worldbank.org/curated/en/913961524150628959/Incorporating-environmental-social-and-governance-factors-into-fixed-income-investment

Materiality of ESG factors	Labelled debts within the sub-sovereign space are becoming highly popular and they often support either an environmental or social outcome. It is possible that the bond supports both outcomes at the same time. Materiality of ESG factors for labelled debt or earmarked proceeds are clear and do not entail extensive assessments. However, the risk of greenwashing cannot be discounted entirely. In order to manage this risk, investors should monitor the reporting and disclosure of the issuer as well as through regular engagements to improve transparency.
Engagement & Stewardship	Nature of dialogue in the GSSS space is like sovereign bonds. Given that the debts are issued to fund specific projects or outcome, the outcome of engagements may be geared towards understanding how the proceeds will be utilized or keeping abreast with the progress of funded projects. Unlike corporate issuer engagements, engagements within GSSS do not aim to improve areas within a company that do not perform well from a responsible investment lens.

This means that ESG analyses can lean towards assessment on the use-of-proceeds rather than solely on the issuer's profile.

Corporate credits

Assessment of responsible investment factors are highly crucial for corporate credits as an issuer's ability to repay debts go beyond the financial profile of the company. Regardless of the sector that they operate in, companies are exposed to a multitude of risks including climate change, labour controversies and governance. ESG ratings from external data providers or internal rating frameworks that delve into these areas provide a good starting point to assess a company's operations and position. While utilising external ESG providers' inputs is a useful starting point, third-party data alone doesn't fully address bond investor needs. For example, our Aegon Asset Management internal framework provide an independent ESG view as part of a well-rounded fundamental assessment. We are focused on an issuer's ability and willingness to meet debt obligations. For that reason, we believe it is critical to consider any and all factors that may impact companies' creditworthiness, including ESG considerations.

Within corporate credits, assessment of responsible investment considerations for investment grade credits can be conducted more thoroughly given that there is higher availiability of data. But the same is not true for high yield credits. Navigating through the lack of adequate disclosures and data within the space of high yield credits is challenging but integration of responsible investment within this realm has since evolved from where it initially began. Typically, this involves thorough analyses of various ESG factors on top of the issuer's liquidity and financial positions. It is also worth noting that these underlying responsible investment risks could very well differ by business and sector.

Materiality of ESG factors	Traditionally, governance factors within corporate credits have been viewed as most important. While the importance of governance has not diminished, attention on social factors such as safety and gender diversity and environmental considerations are becoming more prominent. Depending on the sector in which a company operates in, weightage for environmental and social pillars may differ. In most cases, the governance pillar would have equal weighting across sectors.

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Engagement & Stewardship	Engagement for corporate credits can be initiated post downgrades in ratings resulting from a controversy or lack of adequate improvement from a responsible investment lens. Generally, these engagements are aimed towards improving the performance of issuers since there are no voting rights within the fixed income asset class. That said, engagements could also be held to understand how an issuer approaches responsible investment issues. This is typically done during the due diligence process or before an investment is undertaken.

Emerging market debt

Emerging market debt (EMD) are fast gaining popularity amongst fixed income investors which is largely driven by the higher risk-return profiles associated with the debt group. But it does not come without its challenges. Due to relatively less developed capital markets in emerging economies, they lack the specialisation can cater for responsible investment solutions on a large scale, all of which contribute to the undersupply of the opportunities. This scarcity for credible responsible investing projects coupled with poor data disclosure heavily impedes the growth of the market for responsible investment.

Regardless, emerging market debt present many opportunities for investors who are willing to overlook the challenges that are omnipresent within the asset group. Emerging countries often face limited access to grants and concessional finance[5] as a result of the challenges above, all of which result in a causal relationship that only delays the response of these economies towards some of the biggest global challenges; climate change or biodiversity loss. The chain reaction continues as now investments from emerging countries might seem less attractive due to higher ESG risks as compared to a similar opportunity in a developed country. Through the harmony of public and private solutions particularly through labelled EMD, there is potential to spur real change in emerging economies and across the globe. In 2018, Indonesia issued the first sovereign Islamic bond (sukuk) amounting to $1.25 billion. This bond was aimed at supporting the nation's goal in reducing its GHG emissions whereby the use of proceeds were directed to projects within renewable energy, energy efficiency, sustainable transport, sustainable agriculture and climate resilience[6]. Taking Indonesia as an example, by subscribing to this debt, investors are well poised to make real impact in the world.

Conclusion

Investors consider factors that can affect the long-term returns of their investments. This includes considering responsible investment factors as part of their investment decision making process. This article aims to showcase the adoption of responsible investment across core fixed income strategies. While there are broad similarities amongst the different fixed income strategies, there are also important differences between them that investors should be aware of.

> ***While utilizing external ESG providers' inputs for investment grade credits is a useful starting point, third-party data alone doesn't fully address investor needs.***

[5]World Economic Forum, 2023. Available at: https://www.weforum.org/agenda/2023/01/tackling-sovereign-debt-climate-finance-davos23/
[6]Ministry of Finance, Indonesia. Available at: https://api-djppr.kemenkeu.go.id/web/api/v1/media/B51F74A2-F8BF-47C7-A77F-DA48C2D33067

Core fixed income strategies	Materiality	Engagement
Sovereign debt	• Governance pillar traditionally viewed as most relevant • More recent view: three pillars; environmental, social and governance are intertwined in a country's economy	• Limited scope for engagement given complications and possible misinterpretation of nature of engagements
Supranational, sub-sovereign and agencies (SSA) bonds	• Depended on the type of debt issued • Most cases environmental or social pillar, on top of existing requirements for governance pillar	• Mainly aimed at understanding how the proceeds will be utilized
Corporate credits	• All pillars can be of importance • Dependent on the sector in which a company operates in	• Engagements are aimed at improving the performance of issuers

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AdTrax: 6951872.1.
Expiry Date: 26 August 2025