A Special Report from

SAVVY INVESTOR

Fixed Income: Are the rules changing?

Targeting the dual goal of financial performance and net-zero objectives

Authored by Savvy Investor

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Special Report

Fixed Income: Are the rules changing?

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Fixed Income: Are the rules changing?

DAVID BRANNON
HEAD OF RESEARCH
SAVVY INVESTOR

David has over 15 years of investment industry experience. Working for a top-tier investment bank, he spent the majority of his career in investment analysis, most recently managing fixed income investment performance and attribution within the asset management division.

"FIXED INCOME INVESTING WITH A DECARBONISATION GOAL IS ADMIRABLE BUT TRICKY – THE GAME IS DIFFERENT TO EQUITIES, AND IT REQUIRES A CAREFUL APPROACH."

The late Queen Elizabeth II famously referred to 1992 as an 'annus horribilis'. Thirty years on, fixed income investors could probably use the same term for the last 12 months; with an inverse price/yield relationship, a central bank-driven rate climb has seen returns plummeting.

Regardless of this year's investment performance, the road to net zero has remained top of mind. Fixed income investing with a decarbonisation goal is admirable but tricky – the game is different to equities and it requires a careful approach.

LGIM's paper 'Reaching for net-zero within Active Fixed Income' discusses the decarbonisation challenge in credit investing. This year's geopolitical tumult has reinforced the need for energy security. Asset managers can help make a difference here, through astute strategies and company engagement.

In our 'Ask the Expert' interview we dig deeper – asking how to achieve meaningful engagement as a fixed income investor, and whether exclusion can ever be effective. We also discuss the importance of good climate data and other key challenges that exist.

DAVID BRANNON
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Report Sponsor

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We are Legal & General Investment Management (LGIM), the asset management business of Legal & General Group. Our purpose is to create a better future through responsible investing. We strive to achieve this through a strong sense of partnership with our clients, working together to achieve positive long-term outcomes. We draw on industry-leading expertise to innovate constantly across public and private assets, index and active strategies. And we are a responsible investor, rising to the challenges of a rapidly changing world. On behalf of savers, retirees and institutions worldwide, we manage £1.29 trillion in assets*.

* Source: LGIM internal data as at 30 June 2022. The AUM disclosed aggregates the assets managed by LGIM in the UK, LGIMA in the US and LGIM Asia in Hong Kong. The AUM includes the value of securities and derivatives positions.

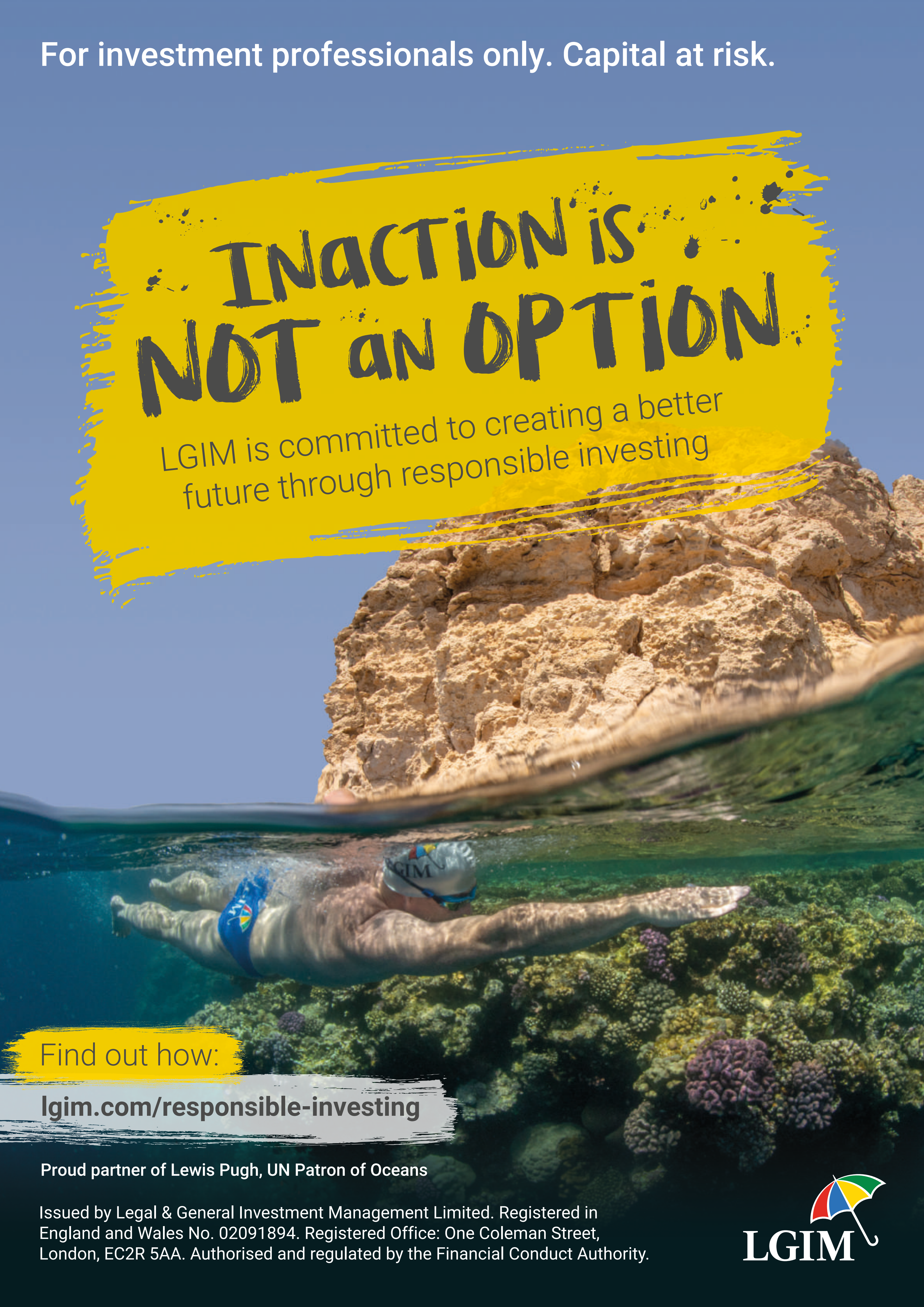
LGIM's Investment Experts

Toby Orpin
Head of Fixed Income Distribution, LGIM

Toby is responsible for the distribution of LGIM's global fixed income capabilities to pension funds and institutional investors, and its consultants. Prior to joining LGIM in April 2014, Toby was at LCP Investment Consultancy, working with clients on investment strategy and researching fund managers in the alternatives investment space. Toby has a Master's degree in Mechanical Engineering from the University of Exeter.

Amélie Chowna
Fixed Income Investment Specialist, LGIM

Amélie is a Fixed Income Investment Specialist within the Global Fixed Income team covering Global Credit and Absolute Return Portfolios. Prior to this, she was a Portfolio Manager for the Global Bond Strategies team, which she joined in 2014 as a Quantitative Analyst. She joined LGIM in 2011 from AXA IM holding a variety of roles within LGIM before joining the Global Fixed Income team. Amelie graduated from ESSEC Business School and holds an MBA. She has been a CFA Charterholder since 2015.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Featured Paper from LGIM:

Reaching for Net-zero with Active Fixed Income

CLICK TO VIEW FULL REPORT

LGIM is committed to achieving net-zero greenhouse gas emissions by 2050 across all assets under management. Here, Amélie Chowna breaks down how the Active Fixed Income team is targeting this goal.

2022 has been characterised by geopolitical and market upheaval. It has also demonstrated the importance of energy to the global economy. We believe the most effective way to achieve energy security over the long term and avoid a climate catastrophe, is by achieving net-zero emissions.

In December 2020, LGIM was a founding signatory to the Net Zero Asset Managers Initiative, which is committed to supporting the goal of net-zero greenhouse gas emissions by 2050, or sooner, and investing that aligns with net zero.

To this end, we have set concrete targets: Our ESG strategies are increasingly incorporating net-zero considerations; we continue to engage with investee companies (with consequences, should they fail to act); and we are investing in 'green' opportunities.

We also incorporate net-zero considerations into some of our strategies alongside broader ESG components, such as LGIM's Active ESG View, UN SDG assessment, Climate Impact Pledge, and more.

"MANAGING A CREDIT PORTFOLIO WITH A DUAL TARGET OF FINANCIAL PERFORMANCE AND NET-ZERO OBJECTIVES REQUIRES A THOUGHTFUL OPTIMISATION EXERCISE BETWEEN YIELD- AND CLIMATE-RELATED CONSIDERATIONS."

Climate Metrics for Credit

Managing a credit portfolio with a dual target of financial performance and net-zero objectives requires a thoughtful optimisation exercise between yield- and climate-related considerations.

Our net-zero portfolios are aimed at achieving relative and measurable decarbonisation, while also investing in issuers on the pathway to net zero by 2050. LGIM's net-zero framework is applied to these portfolios, with emphasis on the reduction of emissions versus the reference benchmark and an improvement in temperature alignment over time.

Our targets capture past and future improvements in climate-related metrics. This means active managers can look for alpha opportunities in sectors with high carbon emission intensity, rather than excluding them entirely. As these sectors will continue to require capital to transition towards net zero, we believe

issuers transitioning adequately should eventually benefit from a lower risk premium. This is because market participants are likely to start repricing climate-related risks and model their impact on credit ratings.

At the outset, we also establish targets for our net-zero portfolios – and make them more stringent over time – engage with laggards and closely monitor the progress made by issuers.

"UNILATERALLY DIVESTING HOLDINGS IS, THEREFORE, NOT GUARANTEED TO LEAD TO THE DECARBONISATION OF THE REAL ECONOMY AND INDEED COULD IMPEDE NECESSARY INVESTMENT IN CLIMATE SOLUTIONS."

How Does LGIM Apply Exclusions?

In a sentence; we seek to engage, rather than simply exclude.

The net-zero challenge is broader than merely excluding high-emitting sectors, as all companies generate some emissions – either directly through their operations (Scope 1 and 2) or through their value chain (Scope 3). Some high emitters, such as mining companies, will have an important role in developing and investing in solutions. Unilaterally divesting holdings is, therefore, not guaranteed to lead to the decarbonisation of the real economy and indeed could impede necessary investment in climate solutions.

Our exclusions that relate to new thermal coal and new oil sands target some of the highest-carbon sectors of the global economy, which are structurally misaligned to the direction of travel, and for which cleaner, cheaper alternatives are increasingly available. These exclusions are also designed pragmatically, in order not to immediately and substantially to reduce diversification – and increase turnover and costs – for some of the existing portfolios that are committing to net zero.

Over the next decade, issuers that are not making substantial progress in reducing their own emissions – regardless of their sector – are likely to find themselves at risk of exclusions from the growing share of LGIM assets managed in line with net zero. Where relevant, we may also seek to apply further sanctions – for example, under our Climate Impact Pledge, or more stringent temperature alignment requirements.

"THE MOMENTUM BEHIND THE NET-ZERO TRANSITION IS UNMISTAKABLE: THE PERCENTAGE OF COMPANIES SETTING AMBITIOUS DECARBONISATION TARGETS HAS ALMOST DOUBLED IN A YEAR."

Looking Forward

The momentum behind the net-zero transition is unmistakable: The percentage of companies setting ambitious decarbonisation targets has almost doubled in a year[1]. Even where companies have yet to put net-zero-aligned transition plans in place, practices are improving. The number of companies sanctioned for not meeting our minimum expectations has decreased by over 35% since 2021. In 2021, we sanctioned 130 companies for failing to meet minimum standards: In 2022 that number has decreased to 80.

We believe the most significant question for most diversified investors is not whether a portfolio is net-zero today, but how to devise strategies that affect long-term change in the market.

We are further evolving our product range aligned with net zero and will continue to monitor and review our funds in light of the progress made in the real economy. At the same time, we will ratchet up our engagement with corporates and governments to help accelerate this progress.

While asset managers have made material progress in setting climate targets and making innovations to meet client needs, we recognise that there is much further to go. That's why at LGIM, in addition to the steps outlined above, we continue to collaborate with policymakers and other stakeholders to make a net-zero future not just possible, but probable.

Click here to download the full report

[1] Source: LGIM Climate Impact Pledge as at 14th June 2022

Ask the Expert with LGIM:

Fixed Income in an ESG World

Toby Orpin is responsible for the distribution of LGIM's global fixed income capabilities to pension funds and institutional investors, and its consultants. Prior to joining LGIM in April 2014, Toby worked at LCP Investment Consultancy. Amélie Chowna is a Fixed Income Investment Specialist within the Global Fixed Income team covering Global Credit and Absolute Return Portfolios. Prior to this, she was a Portfolio Manager for the Global Bond Strategies team, which she joined in 2014 as a Quantitative Analyst. She has been a CFA Charterholder since 2015.

Toby Orpin
Head of Fixed Income Distribution, LGIM

Amélie Chowna
Fixed Income Investment Specialist
LGIM

David Brannon
Head of Research
Savvy Investor

David Brannon: Are fixed income investors as open to incorporating sustainability as equity investors?

Toby Orpin: This is a good question because equity has traditionally been the main driver: If you own the equity, you have a vote. What's changing is corporates are increasingly focused and concerned about the cost of funding their debt – so there is much more awareness of ESG issues from the corporate side. ESG investors have clocked onto this and now realise how powerful ESG in fixed income can be.

> **"It's very important for us as investors to also be mindful of the 'G', or governance portion of 'ESG' because it impacts the way the company is run and could ultimately impact the company's ability to pay coupons and repay the capital on its bonds."**

Amélie Chowna: In addition, our clients are increasingly considering ESG factors due to regulatory requirements. As fixed income portfolio managers, when we choose issuers and sectors to invest in, we also need to take into consideration the financial materiality of these ESG factors. And for some issuers or sectors, those ESG considerations are financially material.

It's very important for us as investors to also be mindful of the 'G', or governance portion of 'ESG' because it impacts the way the company is run and could ultimately impact the company's ability to pay coupons and repay the capital on its bonds. So it's both driven by clients who want ESG factored into their portfolios, and by us as investors because we want to understand the ESG risks in the companies that we purchase.

David: How has the availability of sustainability-related strategies grown in the fixed income space?

Toby: This has been a huge focus over recent years. Historically, the main way ESG was considered was in exclusion-only strategies, and of course, governance has always been a big focus of fixed income investing. Today, though, I think we're seeing a much greater focus on the 'E' and 'S' as well.

There's a whole host of strategies based on factors ranging from impact to climate transition to the UN's Sustainable Development Goals (SDGs), that look at all ends of the investable universe, both positive and negative. I think the big shift has been to focus on a balanced portfolio and look at ESG across the range of investments.

David: How difficult is it to integrate ESG factors into fixed income investing and how much of a challenge is good data in implementing and assessing climate impact?

Amélie: It's become a lot easier – which paradoxically can also become a problem because now you have myriad different frameworks and providers and clients can become overwhelmed by how much ESG data they have access to.

For example, at LGIM we have developed our own proprietary methodology for the integration of ESG factors into our investment process. Providers are sharing an increasing amount of raw data as they become more aware of disclosure requirements. We are pleased to have observed better data disclosures in listed securities, but there are still asset classes where coverage can be lacking; for example in emerging markets debt. We seek to overcome this by sourcing information from multiple data sources and engaging via our Global Research & Engagement Groups (GREGs), which we'll come back to later.

"Our core view is that exclusions have to be part of a net-zero investing framework because we want to have minimum standards."

David: Can exclusion ever be an effective approach to net-zero investing?

Amélie: Our core view is that exclusions have to be part of a net-zero investing framework because we want to have minimum standards. We do, of course, exclude some activities, for example, new coal or oil sands. It's about not financing new projects, rather than a backwards-looking approach.

However, we want to make sure that we can still provide capital to companies and sectors that may be carbon-intensive now but are on the right track towards decarbonisation. Divestment can just mean that someone else is buying the problem, and this investor may not be as focused on real-world change as we are.

As an example of minimum standards, we will not take exposure to issuers who are operating in carbon-intensive sectors and not disclosing carbon data. This is the forward-looking aspect of our framework: What is the issuer's pathway towards decarbonisation? And are we comfortable with their pathway?

We also want to integrate other factors into our exclusion framework. It's great if an issuer is decarbonising, but we don't want to forget about the 'S' and the 'G'.

To attend to this, we have added another layer to our assessment of issuers: our SDG framework, based on the UN SDGs. This is intended to guard against having exposure to low-carbon companies who may, for instance, have bad track records in their business practices, who are persistent UNGC (United Nations Global Compact) violators, or who have poor track records in handling social issues and governance issues. We have designed the framework to ensure that our clients are comfortable with all the issuers we have exposure to in the portfolio.

David: What challenges remain for net zero fixed income investing?

Toby: Data disclosure is typically better in developed markets, but other regions are improving and growing in their understanding of its importance.

There is still a range of opinions on impact versus transition strategies. We've seen various ways of adopting a net-zero fixed income offering across the marketplace; some use, perhaps a slightly blunter approach that only looks at WACI (weighted average carbon intensity) and excludes certain sectors almost entirely.

This is a consequence of only looking at carbon emissions, without that forward-looking piece. If you do take that kind of approach, diversification becomes a huge issue. There are simply not enough companies decarbonising fast enough to move straight to net zero today. This means we need to allow capital to flow to the companies to move towards that transition. If we were to construct a portfolio that was fully net-zero-aligned and in line with a global temperature rise of 1.5 degrees, you would only be able to invest in 20 to 25% of the investable universe.

"IF WE WERE TO CONSTRUCT A PORTFOLIO THAT WAS FULLY NET-ZERO-ALIGNED AND IN LINE WITH A GLOBAL TEMPERATURE RISE OF 1.5 DEGREES, YOU WOULD ONLY BE ABLE TO INVEST IN 20 TO 25% OF THE INVESTABLE UNIVERSE."

Amélie: The diversification element is very important. If you wanted to design a portfolio today with a very low intensity of carbon emissions, you would end up with a higher exposure to, for example, banks, technology, media and telecoms firms, and a very low exposure to industrials and utilities. In my view, this is not a desirable approach because sectoral diversification is important in a bond fund. Added to this, we know that assessments of banks are imperfect because, while they may not have very high Scope 1 and 2 emissions, we get very poor data on their Scope 3 emissions. We don't want to have a portfolio investing in a handful of sectors that only appear to be of a very low carbon emission intensity on the surface: We want a truly diversified portfolio.

Toby: It's about picking the best-in-class names in each sector.

Amélie: It comes back to integrating forward-looking factors, such as temperature alignment. This is a classification we assign to issuers as part of the LGIM Destination@Risk model developed by our climate solutions team. It looks at companies' past emissions, and the ambition and credibility of climate targets, and works out the likelihood of a company reaching zero emissions by 2050. For example, if a company is aligned to 1.5 degrees, that means that they have a very high likelihood of reaching net zero by 2050. If a company is aligned to a six-degree rise in temperatures, that means they're not on the right track.

> **“...that's why our framework and philosophy that we need to continue providing capital to companies which will be part of that transition is very important.”**

David: Have you adjusted your approach in light of this year's geopolitical developments?

Amélie: If anything, the events of this year have reminded us that the whole philosophy behind our framework is the right way forward. It has highlighted that we do need to transition faster than ever. We've had entire countries and continents realised they were over-reliant on some channels for their energy supplies, and that that was a problem. Germany had to reactivate coal power stations because they hadn't sufficiently invested in renewables. Energy independence is an ever more central consideration: that's why our philosophy that we need to continue providing capital to companies which will be part of that transition is very important.

David: How do you see net zero fixed income investing evolving in the coming years?

> **“...TO UNCOVER ADDITIONAL VALUE AND INSIGHTS. IT WILL BECOME INCREASINGLY IMPORTANT TO INVEST IN YOUR OWN PROPRIETARY ANALYSIS TO GAIN AN ADVANTAGE IN INFORMATION.”**

Toby: I believe there will be more consensus among investors on the names who are performing well regarding the climate transition, and as such, they will become increasingly expensive. Many investors are using external data providers to assess climate factors, so to uncover additional value and insights. It will become increasingly important to invest in your own proprietary analysis to gain an advantage in information.

That's certainly what we've focused our energy on – to get that forward-looking assessment, you can't just rely on data alone. You do need that qualitative review. You need to meet the companies, assess the credibility of their plans, their track records of meeting their targets, and so on. It takes a lot of investment in people to assess these factors. I think going forward there will be more of a focus on in-house investment from investment managers to achieve that.

On top of that, engagement will become key. It's not just enough to invest in the companies and governments that are already green – that will certainly not help the world transition and meet the net-zero challenge. We need the whole tide to rise.

Amélie: Not everybody can do that in the asset management industry. If you want to engage meaningfully and have an impact, you need to be a big asset manager and LGIM is a powerhouse in terms of managing assets. We're predominantly an index business, and through this index business, we have voting power that we can exercise on behalf of our clients. It's this voting power that has given us access to boards, CEOs, and CFOs.

Toby: I think one thing we've noticed is the willingness from some of the emerging markets to engage now, and that the engagement is a two-way thing. In some of these regions, it's more of a consultative approach to what best-in-class ESG looks like.

> **"It's quite a new and innovative framework around engagement because in our industry the investment stewardship or corporate governance teams are very separate from the investment departments – but we've purposely joined them together."**

David: How do you achieve meaningful engagement as a fixed income investor?

Amélie: In 2019, we created our Global Research & Engagement Groups (GREGs). These groups combine credit research analysts, equity research analysts and investment stewardship colleagues. We have nine groups with a focus on individual industries. There is a utilities group, a financials group, and so on. They allow us to have a better understanding of the key challenges that companies face from the ESG and sustainability perspective.

We achieve this by having credit research analysts and investment stewardship colleagues in the same group. This means we do have a voice with companies we can influence. And it makes sure that when a credit research analyst speaks to a company, the message will be the same compared to when a conversation takes place with an investment stewardship colleague only, or with an equity research analyst. If you have these three teams engaging separately, with three different messages, that's not helpful. We've brought them together to make sure we engage with one voice and amplify the impact.

It's quite a new and innovative framework around engagement because in our industry the investment stewardship or corporate governance teams are very separate from the investment departments – but we've purposely joined them together.

Savvy Investor's Top Fixed Income Papers

The following table features 25 of the top fixed income papers uploaded to the Savvy Investor site.

Papers from S&P Dow Jones Indices and VoxEU discuss the crossover between fixed income and sustainability. S&P Dow Jones Indices remark that investors' focus on sustainable investing has shown no signs of abating this year, despite the magnitude and speed of rate hikes. VoxEU meanwhile looks at the effectiveness of central bank green quantitative easing versus a carbon tax.

Finomial and Review of Finance analyse fixed income return dynamics. Finomial challenges the widely held view of bonds as safe investments by exploring how much investors can lose. The Review of Finance paper focuses on long bond returns, and what part classic bond pricing plays in investor decision-making.

A number of other papers discuss fixed income portfolio construction, green bonds, and strategic asset allocation options.

SAVVY INVESTOR'S TOP FIXED INCOME PAPERS (BY DATE)

PAPER TITLE	DATE PUBLISHED
Reaching for Net-zero within Active Fixed Income (LGIM)	23/11/2022
Collateral Damage From Higher Interest Rates (INET)	15/11/2022
Green versus Sustainable Loans: The Impact on Firms' ESG Performance (Vox EU)	08/11/2022
European High Yield - Planning for Yields to Peak Soon (PGIM Fixed Income)	01/11/2022
Impactful Short Duration: Green Bonds and Yield Curve Strategies (S&P Dow Jones Indices)	31/10/2022
Have Central Banks Permanently Repriced Corporate Credit? (MacKay Shields)	26/10/2022
ESG Investing In EM Debt: Enhancing Sustainable Development Outcomes (Nuveen)	25/10/2022
Fixed Income Investing: The Active Advantage (Nuveen)	18/10/2022
All-asset Volatility And The Opportunities In Convertible Bond Arbitrage (Man Group)	14/10/2022
Green QE and Carbon Pricing: Looking at potential tools to fight climate change (VoxEU, 2022)	11/10/2022
The Hidden Costs of Corporate Bond ETFs (Quantpedia, 2022)	11/10/2022
Accessing CLOs: Risk, Return And Liquidity Considerations (Nuveen)	10/10/2022
How To Bring Paris Agreement Goals To Fixed Income Indices (S&P Dow Jones Indices)	28/09/2022
How Much Can You Lose with Bonds? (Finomial, 2022)	27/09/2022
Portfolio Construction In Practice: Tracking A High-yield Index (Qontigo)	21/09/2022
There Is An Alternative: Hedged Convertible Bonds (Lazard AM)	21/09/2022
How The Complexity Of ABS Can Help Institutional Investors (NN IP)	21/09/2022
Evolution of ABS (DoubleLine, 2022)	20/09/2022
How Project Finance Can Advance the Clean Energy Transition in Developing Countries (OIES, 2022)	13/09/2022
The Relationship between Central Bank Auctions and Bill Market Liquidity (ECB, 2022)	30/08/2022
Climate Change Mitigation: How effective is green quantitative easing? (ECB, 2022)	30/08/2022
A New Perspective on the Corporate Bond Liquidity Factor (2022)	30/08/2022
Inflation Expectations and Interest Rate Swap Returns (SRSV, 2022)	30/08/2022
Treasury Bonds: Buy and hold or trend follow? (Alpha Architect, 2022)	23/08/2022
Decomposing Long Bond Returns: A decentralised theory (Review of Finance, 2022)	16/08/2022

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Savvy Investor is the world's leading knowledge network for institutional investors. Membership is free, providing pension funds and other investors with access to over 10,000 white papers and market commentaries, covering a wide range of pensions and investment topics. Savvy Investor provides each member with a personalised experience, presenting them with the latest white papers and thought leadership content based on their topic preferences. Membership is restricted to institutional investors and their service providers, and member engagement is high.

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Breakdown of Savvy Investor Membership

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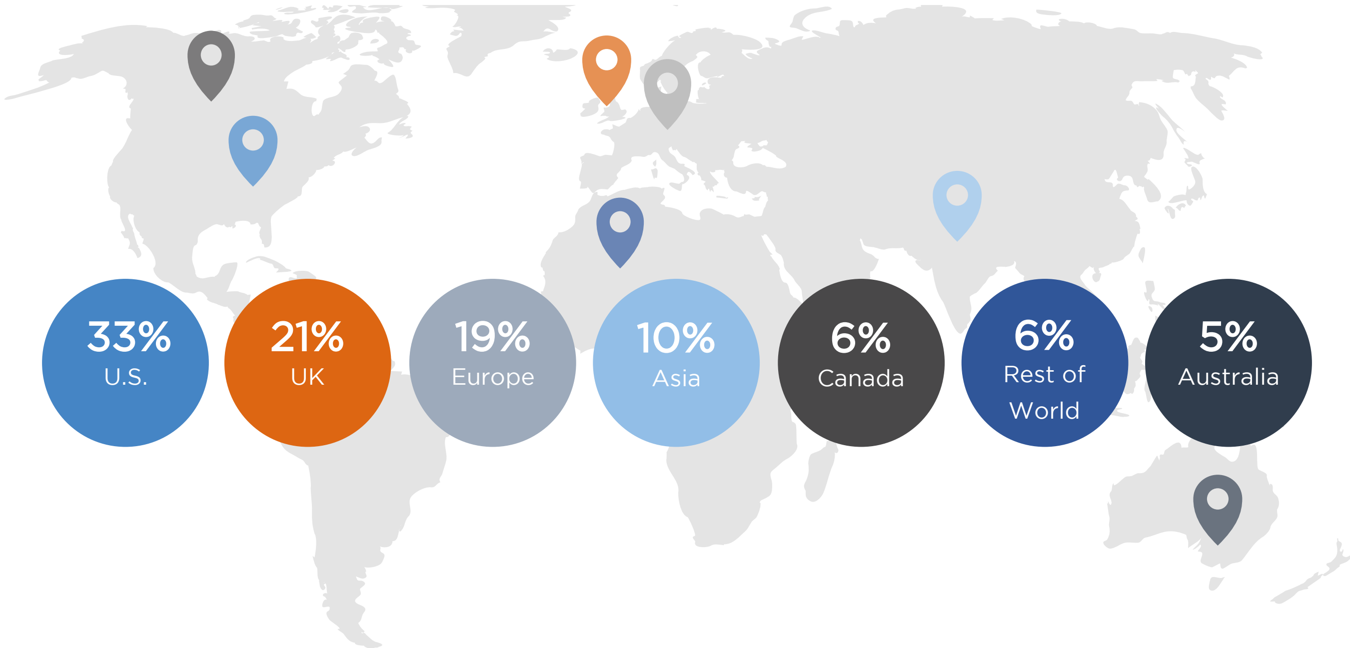

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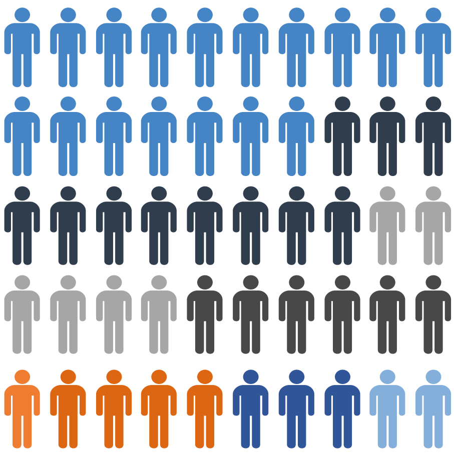

- 33% Investment Managers & Analysts
- 11% Wealth Managers & Advisors
- 21% Pensions, Asset Owners & Allocators
- 8% Others
- 12% Investment Consultants & Professionals
- 4% Investment Banks
- 11% Sales, Marketing & Client Service

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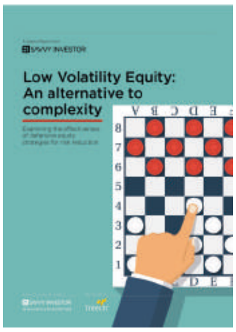

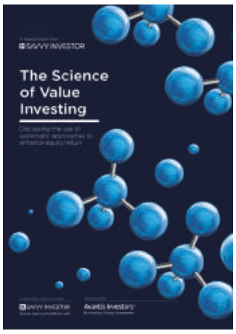

December 2022

Fixed Income

Multi Assets

January 2023

Sovereign Sustainability

Investment Outlook 2023

February 2023

Real Assets

FX/Currency Investing

March 2023

Pensions Focus

Emerging Markets

Subject to demand (at any time)

The Business of Asset Management

Insurance Asset Management

Asset Allocation Quarterly

Fund Management Technology

Quant Strategies

Other topics upon request...

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