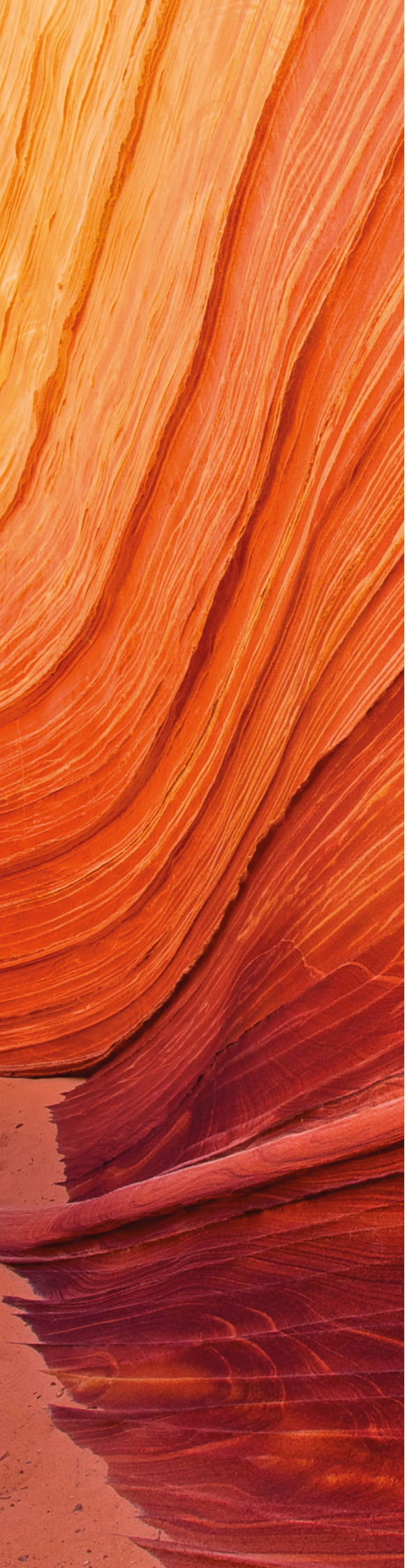
BlueBay
Asset Management

Annual ESG Investment Report 2018

RBC Global Asset Management

Signatory of:
PRI Principles for Responsible Investment
CDP DISCLOSURE INSIGHT ACTION



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BlueBay Asset Management LLP is a leading European-headquartered, active fixed income manager, entrusted by clients with over US$60.1 billion in AuM in corporate and sovereign debt, rates and FX (as of 31st December 2018). We focus on offering a compelling investment proposition to clients through relevant products with the objective of delivering superior performance. BlueBay has an established track record of innovation across a broad range of specialist strategies, including relative return, total return and alternative investment portfolios in both public and private debt markets. For more information about BlueBay as well as our ESG activities, visit our website: www.BlueBay.com and www.BlueBay.com/ESG

CEO message

Welcome to our third annual environmental, social and governance (ESG) investment report, which highlights our activities, progress and accomplishments during 2018.

Taking ESG considerations into account has been an important aspect of our investment activities for many years. 2018 saw substantial growth in client demand for investors to be more ESG-aware. Such a message has reached the highest level of management as illustrated, at a dinner I attended of CEOs in late 2018, where there was a clear sense that investors now expect their managers to integrate ESG as standard practice across all managed assets, and not just restrict this to niche funds. Today, clients expect to be shown tangible evidence of how ESG principles are embedded in the investment process. Such a message was not new to us as we have long anticipated these shifting expectations.

ESG touches each part of the organisation: it's where our clients, and our employees, want us to go, and we believe it is the right thing to do. Furthermore, it is also an invaluable investment tool. Comprehensive ESG risk analysis allows our investment professionals to holistically assess the value of investee entities, improves risk oversight, enhances transparency and stimulates engagement.

I am pleased to report that in 2018, we made substantial progress on our journey to more systematically integrate ESG into the credit research process across our investment strategies. We established an issuer ESG evaluation process, which generates proprietary ESG Ratings and Scores for all investee organisations, allowing us to more clearly define ESG investment risks and opportunities, promote transparency to our clients, and increase accountability of our investment professionals in applying ESG risk analysis alongside conventional investment criterion. The process has already facilitated greater engagement and collaboration between our ESG specialists and investment teams and resulted in an innovative ESG assessment framework that is built on a solid understanding of the fixed income asset class. 2018 was also a year where we stepped up our collaborative industry efforts such as working with the UN-supported Principles for Responsible Investment (PRI) to share knowledge and insights and further advance industry ESG debt investing practices. This report provides more details on these and many more achievements made.

While we are proud of the advances we have made so far, we believe there is still much to do given how critical ESG is for our business and the industry. I believe that everybody in our organisation should be able to discuss and express how ESG principles are incorporated within our investment processes in a succinct and uncomplicated fashion. This is our ultimate goal. Evidence of our ongoing commitment is the fact that BlueBay's management committee have earmarked ESG as one of only two strategic priority business areas for 2019 (the other being Brexit). As part of this, we will conduct a strategic, firm-wide review of our ESG approach, looking at both the investment, and corporate responsibility aspects. We will also be reviewing our newly implemented issuer ESG evaluation process, to ensure we glean the maximum possible value from this proprietary approach to deliver strong investment performance and help our clients meet their ESG requirements. So, for 2019, we look forward to showing our investors the positive benefits of our forward-thinking and thorough efforts in this area.

Erich Gerth
Chief Executive Officer

> Today, clients expect to be shown tangible evidence of how ESG principles are embedded in the investment process

Our ESG investment approach

Philosophy

In 2013, BlueBay committed to take a more strategic and systematic approach to incorporating ESG factors into our investment practices. This decision to roll out a firm-wide ESG investment risk management framework was in response to growing client demand for a formal structure and evaluation process for our conventional investment strategies, as well as recognising the potential investment value this could bring.

Our work in this area has been built on a solid understanding of fixed income and ESG, as well as our evolving insights on how the two interact. Whilst we believe there is much we can learn from how ESG has been applied in the equity asset class, there are some key differences in the fixed income universe. Specifically, how bond prices and spreads are impacted, and therefore, how ESG dynamics can play out. As such, our ESG integration framework needs to be workable across the sub-asset classes of Investment Grade (IG), Leveraged Finance (which includes High Yield- HY), Emerging Markets (EM), Convertibles (CB), and Private Debt; as well as across a range of issuer types beyond corporates.

> The decision to roll out a firm-wide ESG investment risk management framework offer was in response to growing client demand for a formal structure and framework

ESG investment strategies employed

We employ a range of ESG investment strategies for our managed assets:

- ESG integration forms the core of our efforts and is applied across all our managed assets, supplemented by engagement where appropriate;
- ESG negative screening (product based) on controversial weapons is applied to all pooled funds;
- ESG norms-based screening (conduct-based) and ESG tilting is applied for a few specific, more ESG orientated pooled funds offerings; and
- Proxy voting is applied in more limited instances to our convertibles and leveraged bond strategies.

The ESG investment strategies BlueBay employs

	ESG integration	ESG engagement	Ethical (negative/ exclusions) screening	Norms-based screening	ESG tilting	ESG best in class	ESG (positive/ thematic) investing[3]
Pooled funds – ex Global High Yield ESG Bond Fund / Global Income Fund [1]	✓	✓	✓				
Pooled fund - Global High Yield ESG Bond Fund	✓	✓	✓	✓			
Pooled fund – Global Income Fund	✓	✓	✓		✓		
Segregated accounts	✓	✓	✓ [2]				

Source: BlueBay Asset Management

Notes: 1 This refers to the BlueBay Luxembourg, Cayman Island, and Dublin domiciled funds; 2 This is a discretionary service available for clients where this is requested; 3 For example; climate change investing, social impact investing, microfinance, green bonds.

Our ESG investment policies

We have adopted a number of ESG investment related policies.

ESG Investment Risk Policy

Controversial Weapons Investment Policy

Proxy Voting Policy on Corporate Governance &

Corporate Responsibility

Statement on UK Stewardship Code

Statement on UK Modern Slavery Act

Investing in debt compared to equities – some key differences

The fixed income investment universe is smaller than that of equities when viewed in terms of the number of unique issuers. However, the range of instruments (bonds) available for investors is broader (given in equities there is typically only one share class) and there is greater variability in their terms (e.g. yield, maturity etc.). It is also possible to invest in non-corporate issuers (e.g. sovereign bonds).

In equities, company share prices are more volatile and susceptible to being influenced by sentiment and views about potential future earnings. However, in fixed income, spreads and bond prices are less sensitive to such movements, as they are more intrinsically linked to financial strength and the risk of default. BlueBay recognises ESG investment risk in fixed income is inherently multidimensional. We understand that not all corporate issuers will necessarily react in the same way to a given factor or change, particularly when taking into account their credit strength (e.g. HY issuers tend to be more sensitive to changes in financial circumstances than those in the IG asset class as they carry more debt). Different issuer types may also not behave in the same way (e.g. stated owned enterprises may be less sensitive to external market shocks than private companies as they have government protection). Even different securities for the same issuer may react differently to the same external factor, be they ESG related or otherwise. Such differences add to the complexity in developing an ESG framework that is applicable across the entire fixed income spectrum and can adapt to the various nuances.

Resourcing & oversight

BlueBay's ESG Investment Risk team (ESG team) is comprised of four individuals dedicated to ESG, and is part of the Investment Risk department, reporting into the Head of that function.

Team members as at 31 December 2018:

Jean-Philippe Blua
Head of Investment Risk, Performance and Attribution

My-Linh Ngo
Head of ESG Investment Risk

Lucy Byrne
ESG Analyst

Camille Lancesseur
Junior ESG Analyst

Dillon Neale
ESG Intern

Source: BlueBay Asset Management, as at 31 December 2018

ESG related industry memberships

Signatory of:

PRI Principles for Responsible Investment

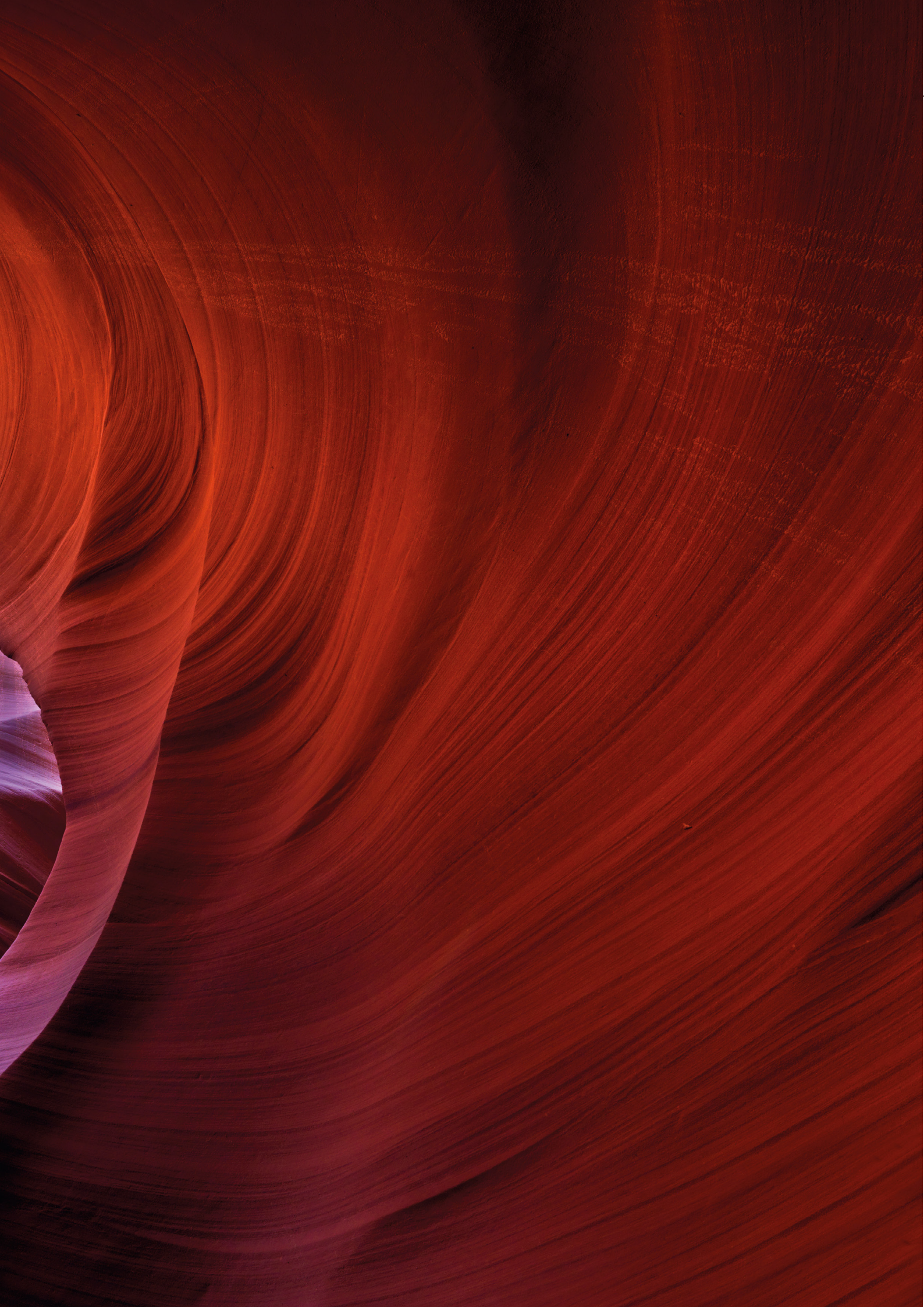
BlueBay has been a member of the UN-supported Principles for Responsible Investment (PRI) since July 2013. The PRI is an independent membership-based organisation for stakeholders active in the investment value chain seeking to work to support members to incorporate ESG factors into their investment and ownership decisions.

CDP DISCLOSURE INSIGHT ACTION

BlueBay has been a signatory to the CDP, formerly the Carbon Disclosure Project, since 2016. The CDP is an International, not-for-profit organisation providing a global reporting framework for companies to measure, disclose, manage and share critical environmental information. This includes material on climate change, water and natural resource usage which is consulted by a range of stakeholders (including investors) to inform decision making.

AIMA

The Alternative Investment Management Association (AIMA), of which BlueBay is a member, has been expanding its work on responsible investment in the hedge fund industry. In August 2018, BlueBay joined the Responsible Investment Working Group AIMA has set up dedicated to this area. AIMA leverages off the insights and guidance from the group to inform its work in the areas of regulation, investor education and communications.



Review of 2018

Reflections on ESG market developments

Interest in financial implications stemming from ESG factors grew significantly in 2018, driven partly by the wider adoption of mandatory ESG reporting requirements globally, and by asset owners and investors making proactive stewardship commitments. In Europe, the European Commission has continued to explore the potential of 'hard coding' ESG to ensure the future of European finance is sustainable. Whilst final decisions are yet to be made, it is new regulatory frameworks such as these that have the potential to reset and transform how global financial markets incorporate ESG / sustainability considerations into investment activities.

Throughout the year, the world's media dedicated increasing scrutiny to the negative environmental and social implications of climate change and single-use plastics. Social unrest was a prominent theme that punctuated the news cycle, driven by widespread social inequalities and concerns relating to corruption, cyber security, and the implications that new technologies may have on human workforces. Global headlines also featured numerous stories on public health concerns linked to products viewed as having a negative impact on society such as tobacco. In BlueBay's 2017 ESG Investment Annual Report, we predicted that the UN Sustainable Development Goals (UN SDGs) would continue to increase in popularity, both as a framework for directing asset allocation and for reporting evidence of contribution to societal goals. Our predictions did indeed play out during the year.

In the context of fixed income, we have observed increased attention from investors on how ESG factors are taken into account we expect this trend to continue, one data point being the global ESG investment study BlueBay and its parent company RBC GAM, commissioned during 2018. Whilst more ESG orientated approaches are gaining traction, our view remains that investors want to see an integrated ESG approach as standard.

New regulatory frameworks have the potential to reset and transform how global markets incorporate ESG and sustainability considerations into investment decisions

Performance against our 2018 ESG priorities

Overall, 2018 was a transformational year for BlueBay in relation to ESG. We are pleased to say we have made progress on all our 2018 ESG priorities. Having committed to working towards a more strategic approach to ESG integration and 2018 saw a meaningful scaling up of ESG integration efforts across the firm including the launch of our formal issuer ESG evaluation process across all public debt investment teams (see the text box for more details on how this works). We adopted an ambitious target to ensure all 'provisional' issuer ESG evaluations were completed by year end (i.e. the initial ESG assessment is completed solely by the credit analysts, it is subsequently 'finalised' after being reviewed by the ESG team). Consequently, a significant portion of 2018 was dedicated to developing the evaluation framework, enhancing the knowledge of credit analysts to better understand ESG risks in their respective sectors and embedding the process into fundamental credit research.

Simultaneously, the ESG team continued to develop and enhance the company-wide ESG data infrastructure and further develop partnerships with organisations outside of the business, including being a member of many PRI working groups.

Summary performance against our 2018 ESG investment work programme

Focus Area	Progress	Comments
Enhance investment choice *ESG integration is offered as standard in our conventional investment offerings. However, we recognise that some investors seek dedicated value-driven ESG strategies and will continue to review the potential to develop these as appropriate*	Achieved	Throughout 2018, we engaged with asset owners, investors and consultants to ensure BlueBay's product offering remains appropriate. The majority of our stakeholders have underscored their preference for ESG factors to be considered within our existing range of investment strategies. This aligns with our strategic focus on ESG integration. Whilst there is interest in more ESG orientated product offerings, the scope and nature of interest is variable, although it is clear there is growing interest in incorporating ESG considerations in sovereigns, and emerging markets.
Embed ESG in credit research *Roll out a formal, systematic process to evaluate issuers on ESG*	Achieved	The process and content for the issuer ESG evaluation was finalised in the first half of 2018 for both corporate and sovereign issuers. By August, the evaluation process was formally rolled out across all public debt teams. The analysts were set an ambitious target of conducting a 'provisional' issuer ESG evaluation for all held investments by the end of 2018. Over 90% 'provisional' issuer evaluations were completed for both sovereign and corporate issuers, which totalled over 1,000 unique issuers – a significant achievement. The ESG team were able to finalise over 25% of these 'provisional' ESG evaluations for sovereigns, and 15% for corporates. Outstanding issuer ESG evaluations will be carried over to 2019, with credit and ESG analysts required to conduct and finalise these as well as maintain the process for future qualifying investments.
Develop ESG tools, enhance investment team support *Work to build consensus, knowledge and understanding of investment material ESG sector risks throughout the business*	Partially Achieved	In 2018, we updated an existing ESG briefing paper for the Energy & Mining sector to enhance the knowledge of our credit analysts and help their understanding of ESG dynamics across the sector. Drafts for the majority of the other sector groupings were developed and we hope to finalise these during 2019.
Strengthen the ESG data infrastructure *Establish an integrated system combining ESG and investment data to monitor, report and inform on ESG investment risks and performance.*	Partially Achieved	In 2018, we completed the first phase of our ESG IT/data infrastructure project. This involved the creation of a new ESG data platform, which more robustly captures ESG data from BlueBay's ESG vendors and combines it with our investment exposure to enhance investment reporting and monitoring. In 2019, we will continue to work on developing and enhancing our ESG investment reporting solution and further expand the array of ESG data points we input into our systems for in-house monitoring, analysis and reporting purposes. Additionally, with the roll out of the issuer ESG evaluation process, we were also able to initiate work to incorporate our proprietary ESG metrics resulting into our internal investment decision platform (the Alpha Decision Tool).
Embrace wider industry engagement *Work with key investment stakeholders to advance thinking and practice in ESG fixed income*	Achieved	BlueBay continued to build on its collaborative efforts with external organisations active on ESG investing again in 2018. We played active roles within initiatives convened and coordinated by the UN-backed PRI. This included continuing to chair the Advisory Committee on Credit Ratings, and participating in the ESG Bondholder Engagement Working Group and that on Cybersecurity. When the PRI launched the Sovereign ESG Working Group in 2018, BlueBay was selected to be a member. We also participated in the PRI project looking at ESG in Private Debt.

Source: BlueBay Asset Management

Our issuer ESG evaluation framework

BlueBay has been developing a formal issuer ESG evaluation framework for use by credit analysts as part of their fundamental research process to facilitate ESG integration. Whilst we already source ESG data on issuers from external providers, we believe it is critical for us to formulate our own independent views, particularly given that third-party analysis tends to be more relevant to equity investment than fixed income, and in some cases, there is a lack of ESG coverage across issuers.

Our evaluation framework generates two proprietary ESG metrics:

- a Fundamental ESG Rating, which indicates our absolute view of the ESG risks faced by the issuer. This Rating is co-owned by the credit analyst and ESG investment team. There can only be one Fundamental ESG Rating per issuer across BlueBay, and;
- an Investment ESG Score, which reflects a relative view on the extent to which ESG factors are considered relevant to valuations. This Score is solely owed by the credit analyst.

We have purposely disaggregated our view of the ESG risks and how an issuer manages these from their investment materiality. Doing so enables us to better understand the extent to which ESG risks are indeed investment material, and in which circumstances. This level of transparency is especially important for fixed income, where the asset class operates differently to equity, and ESG factors play our in different ways for various reasons. We believe that the relationship between our proprietary metrics will provide us with further insights that will inform our wider knowledge and understanding of ESG fixed income dynamics, and ultimately our investment decisions.

The issuer ESG evaluation process requires credit analysts to complete the initial ESG assessment (i.e. the 'provisional' evaluation) which is subsequently reviewed and finalised by the ESG team (i.e. the 'finalised' evaluation).

The ESG outputs from the issuer ESG evaluation process

Fundamental ESG (Risk) Rating [Issuer level] [co-owned by credit & ESG analysts]
Very high ESG risks
High ESG risks
Medium ESG risks
Low ESG risks
Very low ESG risks

Investment ESG Score (indicative) [Long position at security / instrument level] [owned by investment professional(s)]	Description
-3	Very high ESG investment related risks
-2	High ESG investment related risks
-1	Some ESG investment related risks
0	ESG considerations are unlikely to have an impact
+1	Some investment opportunities as a result of ESG considerations
+2	High investment opportunities as a result of ESG considerations
+3	Very high investment opportunities as a result of ESG considerations

Source: BlueBay Asset Management

UN-supported PRI's external assessment of BlueBay's ESG investment efforts

The PRI independently assesses its members ESG investment efforts each year, based on the member's annual transparency report submissions. For the 2018 reporting cycle (covering performance for 2017), BlueBay continued to outperform the median score in every category.

Module / Assessment results	Score (pre 2015: A being highest and D being lowest possible); post 2015: A+ being highest and E being lowest)									
	2014 reporting cycle (2013 calendar year)		2015 reporting cycle (2014 calendar year)		2016 reporting cycle (2015 calendar year)		2017 reporting cycle (2016 calendar year)		2018 reporting cycle (2017 calendar year)	
	BlueBay	Median	BlueBay	Median	BlueBay	Median	BlueBay	Median	BlueBay	Median
Strategy & Governance	A	B	A	B	A+	B	A+	A	**A+**	**A**
Fixed income – SSA	A (fixed income – government)	D	A	E	A	C	A+	B	**A+**	**B**
Fixed income – corporate financials	B (fixed income – corporates)	D	A	C	A	C	A	B	**A**	**B**
Fixed income – corporate non-financials					A	C	A	B	**A**	**B**

Source: BlueBay Asset Management

ESG in action – integration highlights

Some refections from our Chief Investment Officer (CIO)

Q Where has BlueBay focussed its ESG efforts in 2018?

Our analysts have always taken ESG into account when assessing the credit worthiness of countries or corporates. In 2018, we moved to formalise this process, making it far more structured and transparent.

As part of this new framework, whilst we continue to have an in-house ESG investment team which has responsibility for guiding and overseeing our ESG analysis and engagement efforts internally with our investment professionals, we expanded the responsibility for ESG more directly to the credit analysts, to ensure that ESG is a core part of the analytical research process. Responsibility for ESG now sits just as much with the investment professionals as it does with the ESG team.

Q Why is this latest development of having issuer ESG evaluations, such a milestone for the business? What will be the benefit for clients?

We have now committed to ensuring we have a formal ESG evaluation for every single qualifying issuer we invest in, whether that be a sovereign, corporation or quasi-governmental institution. We have started by focusing on all held issuers and will expand this to be standard practice for future investments.

To illustrate the business priority attached to this, we set an ambitious target of having credit analysts complete an initial assessment by the end of 2018 – we have over 1,000 issuers and had only launched the initiative in August of 2018. We achieved over 90% at end year in terms of inital analysis conducted. The ESG team have been working to review and finalise the provisional ESG Ratings and Scores assigned from this process, which will be completed in 2019.

Such data will also be stored in our in-house investment platform and ensure ESG data metrics are available alongside conventional investment metrics to inform on investment decisions. During 2019, clients will start to see such ESG Ratings and Scores being discussed and reported at the portfolio level, promoting greater transparency and accountability of our ESG integration process.

Q How have clients informed the enhancements to BlueBay's ESG process?

It is as much a journey for clients as it is for us. However, both BlueBay and our clients believe in the importance of having a best-in-class investment process. To do that, we believe you need to have ESG embedded at the core.

We could have opted to only apply our new ESG process to ESG funds, but we believe it is fundamentally important to always take ESG into account across all funds. Yes, dedicated ESG funds will have a process where the very worst ESG Ratings will systematically stop us from investing, but ESG should be an input into all our funds. In the wider fund range, we may still decide to buy issuers with weaker ESG Ratings if we believe the ESG risk is reflected in the price, but we will have the confidence that we have the best possible view of that risk.

Q What is the next phase of development for BlueBay's ESG approach?

2019 will be the year that we begin reviewing the findings of our assigned ESG Ratings and Scores on issuers. We would like to ensure we have analytics to identify the influence that ESG is having on investment decisions and performance.

It is also about making this analysis part of standard practice. Every time we make a new investment, we will need to ensure we establish an ESG Rating and Score for each company.

We are also developing a proprietary research tool for investment analysts and we want to ensure that our current issuer ESG evaluation is incorporated.

Raphael Robelin, partner, CIO

Responsibility for ESG now sits just as much with the investment professionals as it does with the ESG investment team.

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Views from our investment team on incorporating ESG into debt investing

Engaging with our investment professionals on ESG highlighted some of the many opportunities and challenges of working to incorporate ESG into investment practices, including acknowledging the multi-dimensional aspects of some factors, which can be particularly acute in the debt asset class as compared with equity investing. Here we share some of the thoughts and insights from individuals across our different investment desks on two areas of discussion.

Our new issuer ESG evaluation process and some of the challenges involved

BlueBay's newly integrated issuer ESG evaluation approach has aimed to formalise and standardise components of fundamental analysis across our teams. Investment professionals have commented that with the new ESG framework they can now systematically identify and evaluate material ESG risk factors in terms of their relevance and materiality to credit risk.

"It has moved me from a reactive approach to a proactive approach," explains Oliver Grace, a senior credit analyst covering the energy sector within BlueBay's Leveraged Finance team.

"Through this new, analytical approach, I consider who is at risk, who is best equipped to handle controversies, who is doing the bare minimum and who could be vulnerable. I also get a much better sense of those companies that are able to navigate idiosyncratic shocks and headwinds from the regulatory environment."

It has also provided a framework from which analysts can more explicitly document the basis for an investment decision on ESG grounds. For instance, during 2018, Vanessa Scarbonchi a financials and consumer analyst in the Convertibles team was revisiting the credentials of a global supermarket group. Historically, the team had never invested in the company because of reservations about the group's corporate governance practices.

"We found the company had a very complex corporate and capital structure, and we felt it was poorly serving shareholders," she explains. "*These complex structures later translated into decision making and reporting issues."*

"Our assessment of the company's weak ESG would later translate into investment performance. It performed poorly, and our decision not to invest resulted in a lot of alpha generation. We also avoided a name which became vulnerable from a headline perspective and carried reputational risk."

Commenting from a portfolio management perspective on the value of the new process to his team's investment activities, HY senior portfolio manager Justin Jewel states that:

"When there is an ESG risk that we have identified of some materiality to a business, we ask, how serious is the risk? Does it materially affect the investment outlook? And is it a near-term or long dated potential risk that we can't easily price?". This process, he says, sets a *"higher bar"* for the strategy.

Jana Velebova, a senior portfolio manager in our Emerging Markets (EM) desk, responsible for sovereign and blended strategies, explains how she sees our approach as compared with peers.

"*Speaking to others in the industry, most houses are looking at ESG as something that is quite quant focussed, using simple rankings off the back of an external ratings framework. Our approach is unique. The huge amount of resources that we have allocated internally, coupled with our knowledge of sovereign risk, allows us to be bespoke about how we incorporate ESG risks into our investment decisions. This is far superior to being solely reliant on rankings from external providers, which can be very backward-looking, or are a simplification of the situation which we are dealing with."*

The extent to which it is possible to conduct quality ESG assessments is a function of the availability, consistency and reliability of data. Our analysts researching EM and HY companies highlighted this is a particular challenge, where they are having to work with inconsistent or non-existent corporate disclosures, which can mean additional time being dedicated to researching one company or its issuers.

"It can be very disparate," says Alex Collins, our EM extractives analyst. *"You will have examples where companies only report annually but they will not publish their financials online. And, if there are no financials, you can guarantee there will not be an ESG report."*

Collins explains that additional efforts are made to research all ESG factors that may impact an emerging issuer's risk, but stresses that instances where insufficient information is available it will almost always result in companies being excluded from the investment process as it may be more reflective of broader limited financial transparency which can be a red flag.

Encouragingly, our analysts feel the data situation is improving. "In the natural resources sector, there is a greater focus on sustainability," observes Esther Krukowski, a senior corporate analyst for the Convertibles desk, leading the extractives and TMT sectors. *"There*

Alex Collins
Corporate Analyst - Emerging Markets

Esther Krukowski
Senior Corporate Analyst - Convertibles

Graham Stock
Partner, EM Senior Sovereign Strategist - Emerging Markets

James Macdonald
Partner, Senior Corporate Analyst - Investment Grade

has been a tilt towards investment in renewables by the integrated majors. Investor presentations now feature dedicated updates on ESG related projects and policies."

On determining ESG investment materiality

In terms of the relative importance of E, S and G risks to debt investing, there is broad consensus across our investment teams that governance is key and particularly critical in some instances. Typically, the governance part of credit analysis has the quickest feed through into price action in the market, so this requires the most detailed review.

James Macdonald, a senior credit analyst in the Investment Grade (IG) team covering financials explains that his team has dedicated significant time to looking at governance issues within the sector, having identified risks relating to management, product and technological failings.

"We have spent a lot of time understanding governance by looking at the composition of boards, the independence of risk and audit committees, compliance teams and studying corporate reporting lines. It is about trying to identify where there is any weakness. You are dealing with large, complex organisations which means it can be difficult to spot individual issues, but if you can identify weaknesses at the top end, it can be symptomatic of an institution that is likely to have weaknesses throughout its organisation."

Macdonald says the financial services sector – and banks, in particular – can present a particularly difficult challenge because they are highly regulated institutions, so his focus is not on regulatory failings, but more on what could eventually lead to a regulatory failure.

"Understanding governance and culture is extremely important," he says. *"Most banks are regulated and many of them are listed, so you might assume that the governance would be consistent. Actually, there can be considerable differences."*

Whilst governance is also important to sovereign issuer analysis, political factors, are also an extremely important part of the governance element for sovereign issuers as Graham Stock, a senior sovereign strategist and partner within BlueBay's EM team explains.

"In corporates, the governance element can mean looking at management, but it is a little more nuanced when it comes to sovereigns because governments change at elections, in a democracy, Some governments may be lacking in some areas, but this may not have an impact on their credit prospects. For example, minority rights might be weaker than we would like, but it might be difficult to draw a link with the issuer's ability to repay."

Governance has particular relevance depending on the sub-asset class, and in thinking about credit quality. *"For High Yield, governance is number one,"* says senior portfolio manager Justin Jewell.

"Investment Grade companies are typically, large, well run, professional companies with a clear (or reasonable) alignment between equity holders and creditors. In High Yield debt, that alignment can be questionable and the quality and time horizon, of both the management and the owners, can be a little different."

Beyond governance, the materiality of social and environmental issues may take on a sectoral and regional dimension. A good illustration of that comes from the points our HY energy analyst Oliver Grace makes. He states that alongside governance, corporate safety records are also key for his companies, as a poor track record throws up the potential for costly litigation and negative regulatory consequences. Grace explains that while the investor community have been less concentrated on the carbon footprints of smaller energy companies in the HY space, they have still been keenly focussed on other environmental issues, which they consider to be material to the financial performance of these businesses.

In the US, certain states such as California and New York take a dim view of energy companies that do not appropriately manage safety and environmental risks related to the extraction and distribution of natural resources. One regional oil and gas producer has taken steps to manage its water use, placating the tough regional authorities in the state in which it operates.

"We like companies like this, which have taken a proactive approach to recycle the water it uses, by treating and distributing it back to the local agricultural community," Grace explains.

The significance of context is also a point to bear in mind, and the fact that ESG trends are dynamic. EM extractives analyst Alex Collins states that for his sectors, there is a general perception that ESG standards and practices are lower in such regions as compared with developed markets. He argues that the situation is changing.

"Previously, the environmental standards have been lower. But what we are now seeing is a trend in these markets to try and bridge the gap with their developed market peers."

The nature of the sub-asset class is also something which

Jana Velebova
Senior Portfolio Manager - Emerging Markets

Justin Jewell
Partner, Senior Portfolio Manager - High Yield

Oliver Grace
Senior Corporate Analyst - High Yield

Vanessa Scarbonchi
Senior Corporate Analyst - Convertibles

impact potential sensitivity of an issuer to ESG or indeed any other risks. Unlike the other fixed income desks within BlueBay, the Convertibles team uses instruments which are sensitive to equity prices, making them unique within the business.

"A convertible bond provides fixed income protection and equity optionality, so investor sentiment is important", explains Esther Krukowski.

Factoring time horizons also influences the assessment of investment materiality of ESG factors. Collins explains that analysts must consider both short and long-term ESG investment implications, which can have a positive as well as negative influence on decision-making.

"You want to keep an eye as far ahead as you possibly can. But If there is a short-term trade which has a three- to six-month time horizon, a longer term ESG regulatory risk may not matter so much as in these instances, this is less significant in the short-term. But if this was to form a core holding, then it becomes more of an investment issue."

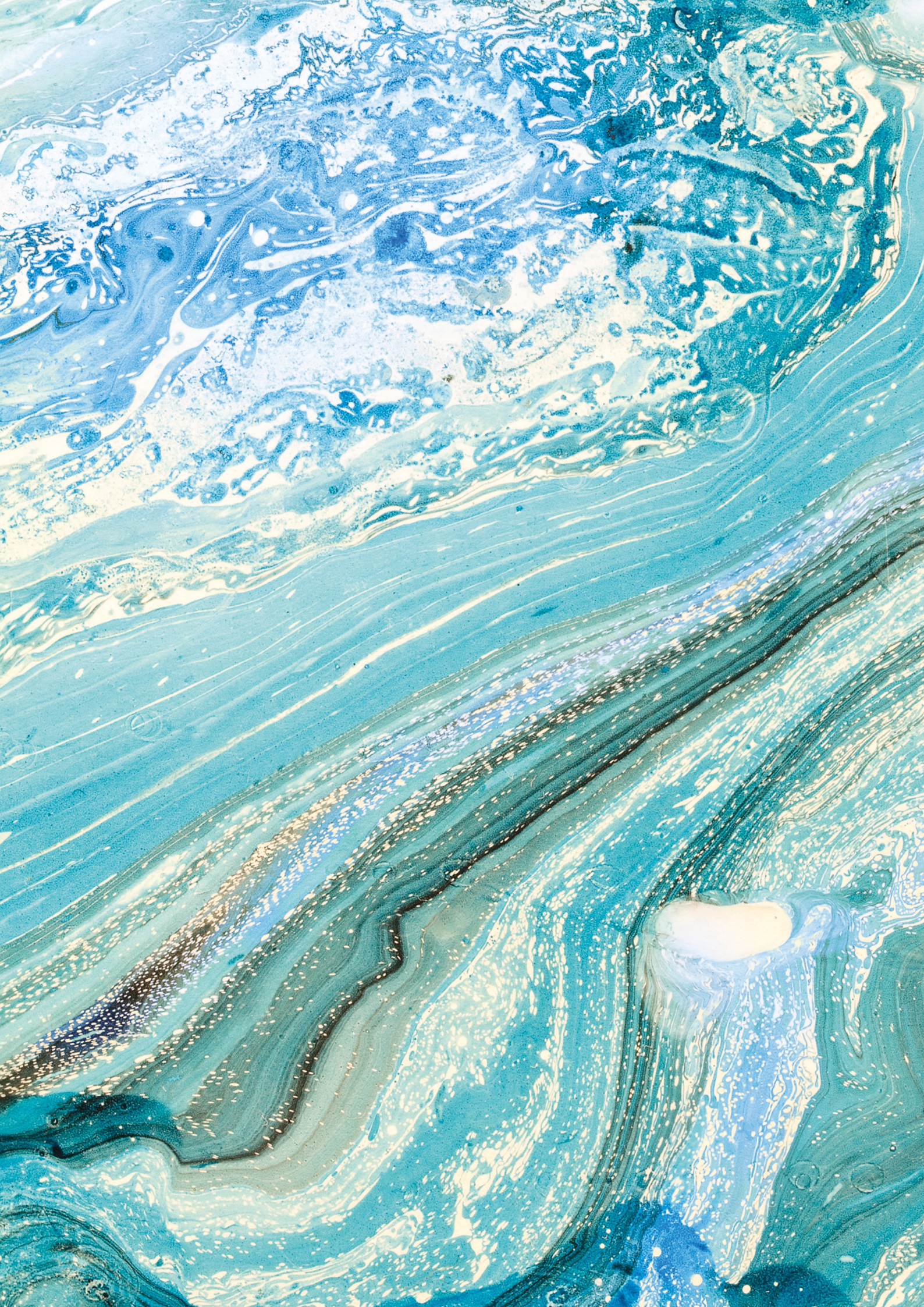
The nature of the issuer type may also come into play here. For instance, our sovereign investment teams also work to ensure that social and environmental metrics are considered, but with a longer-term view. These are usually considered along with the macro analysis, although they are not always assessed within the same timescale as the investment horizon, which can be shorter in nature.

"In terms of environmental issues, governments can influence the environmental framework in a way that companies cannot. So, we assess the quality of regulations and the implementation. On the social side, we look for indications of social strengths and weaknesses in a country." explains Jana Velebova, our EM sovereign senior portfolio manager.

While it could be argued that environmental and social factors only emerge gradually, BlueBay believes it is important to study these metrics, as a build-up of these factors can lead to one small problem acting as a trigger point for an issue that has taken many years to emerge.

"Often, you have a confluence of several factors that lead the country to a tipping point," explains Velebova.

"When the investment world has had enough, it reacts to a key event that, normally, it would not have. This can be due to a sum of the weaknesses on the ESG front, so it is important to keep track. The Arab Spring was triggered by an ESG factor, a single event that woke up entire populations and investors alike, and which was quickly reflected in price action."



ESG in action – stewardship highlights

Engagement

In 2018, most of our ESG engagement efforts were focussed on gaining a better understanding of how material ESG risks were being managed at the investee entities. This occurred at an issuer, sectoral or thematic level, and were conducted directly by BlueBay, or through working collaboratively with other investors and key stakeholders, both reactively and more strategically. In many of these instances, as part of the engagement process, the aim was also to influence issuers and other stakeholders on how to better manage and/or report on investment material ESG issues such as culture and ethics, cybersecurity and climate change.

CASE STUDY 1

Company profile

A state-owned integrated electricity company in the Emerging Markets universe.

Background

Towards the end of the year, we met with representatives of his quasi-government entity to discuss a range of ESG matters. The company had only recently become aware of the growing significance of having positive G credentials, and its representatives were keen to learn more about how the company was perceived by the investor community in terms of managing key ESG risks.

Action and outcome

During the meeting, it became apparent that there was a gap between the company's perception of the quality of its ESG practices and reporting, and that of investors. This resulted from a difference in understanding of what investors consider to be the most material ESG risks facing the company is. Management stated that whilst there were some structural issues (such as its energy mix, which has a high carbon footprint given its electricity is currently sourced from a combination of gas and coal assets), which were more challenging to address in the near term, they could identify clear practical steps to better reflect their practices in other ESG areas, and that our feedback had been valuable in determining these. We expect to see meaningful improvement in the company's ESG practices and reporting in the future.

Investment view

We continued to have exposure to the issuer pre and post the meeting and believe this is one of the better managed company's within the peer group. As a result of our meeting we expect to see improvements in ESG practices and disclosure and view that good ESG momentum could be positive from a credit perspective.

CASE STUDY 2

Issue & sector

Cybersecurity management by a range of companies in a range of sectors (such as healthcare, retail, telecommunications, media and technology (TMTs) and financials) and geographies (UK, Europe and North America), across the IG and HY universe.

Background

As well as co-leading the engagement with a global financials company as part of the PRI coordinated investor initiative on cyber security, we participated in meetings convened by other investors to improve our knowledge and understanding of how companies are approaching the issue of data security and privacy. Given this is an emerging and growing risk, such discussions inform on our views on good practice.

Action and outcome

Participating in meetings with a range of companies in different sectors and geographies helped enhance our knowledge and understanding of data security and privacy risks as emerging risk issues. During the discussions, it became apparent there is not necessarily a clear consensus on what good practice looks like. However, the involvement of the board in providing oversight and socialisation of the issue, beyond its technical aspects are considered key, particularly in light of the potential scale of impacts on businesses.

Investment view

Whilst cybersecurity is relevant to many sectors, we believe it has more significance from an investment perspective to retailers, financials and TMT who are handling large volumes of personal and financial data and are consumer facing. Those with presence in Europe also face more regulatory risk. We continue to be involved in the PRI cybersecurity working group and will apply our learning proactively to engage with issuers we meet where we feel this is a potentially investment relevant issue.

CASE STUDY 3

Sovereign profile

A European sovereign issuer in Developed Markets.

Background

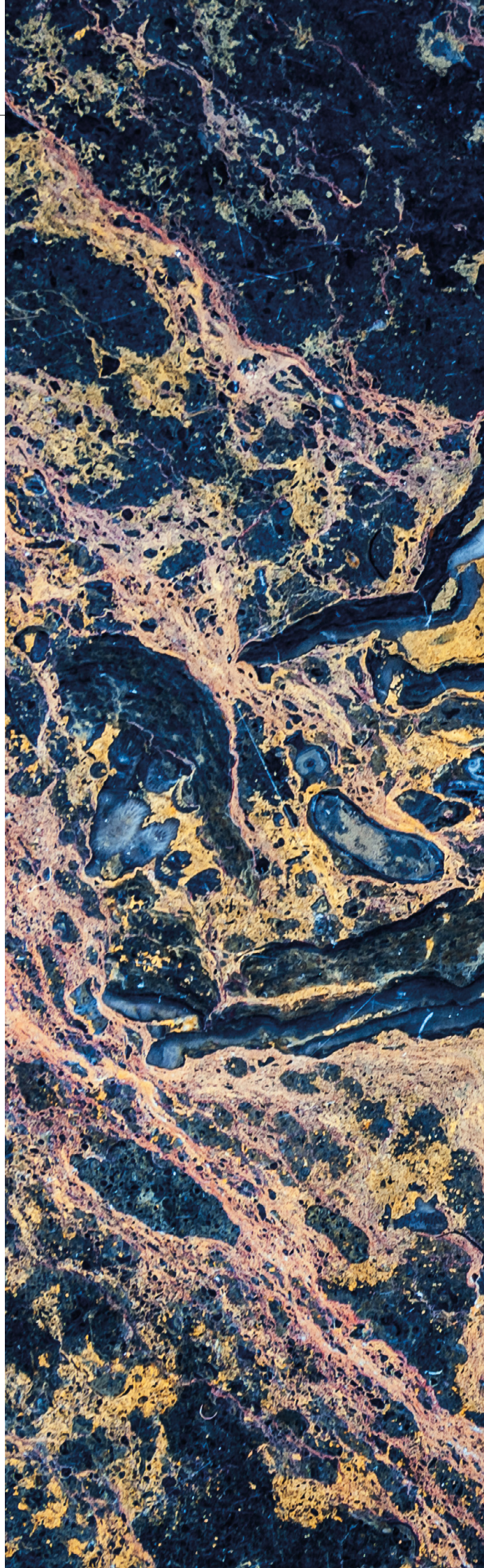
The government of this European municipality has long expressed a strong desire for increased regional autonomy from another sovereign, which is it's constitutional monarchy. In 2017, an unlawful independence referendum was held, which led to increased investor uncertainty about the risks to outstanding debt commitments linked with the entity involved.

Action and outcome

BlueBay has long been in dialogue with each of the respective government entities about the need to better understand their respective positions and look for compromise. Since the 2017 event, we have continued to engage with both issuers, arguing for greater dialogue to negotiate differences and reach a solution. Understandably, the situation is complex, and dialogue remains ongoing.

Investment view

We have continued to have exposure to either one or both entities within our developed market sovereign strategies over the course of 2018 and are actively monitoring developments. We believe a potential solution that would be positive from an investment perspective would be if both parties could agree on an approach where the other was able to gain greater autonomy without requiring independence, an approach we have seen work in other instances.



Collaborations to advancing thinking and practice on ESG debt investing

ESG in credit risks and ratings
Chaired by BlueBay, this PRI co-ordinated group seeks to promote awareness, understanding and knowledge about how ESG factors impact credit risk analysis and credit ratings.

During 2018, the group published it's second report summarising the outcomes of the various events convened in Europe and North America for investors and credit rating agencies (CRAs). From the work to date, it is clear that ESG incorporation is still largely seen as a tool to mitigate downside risk, and whilst there is consensus on the importance of the 'G', more work is needed on the 'S' and 'E'. Furthermore, there is increasing organisational resourcing and transparency on how ESG factors are being integrated into debt analysis, which are both welcomed. The initiative convened further events across Asia towards the end of 2018. A final report of the current phase of the project is scheduled for release in 2019.

ESG bondholder engagement
The aim of this PRI-co-ordinated group is to advance thinking and practice among debt investors on ESG engagement. In April, the group published a report intended to provide an overview of current market practice and draw together a guide on good/best practice, which BlueBay contributed to. Overall, there was a clear consensus within the group that engagement is an important tool for ESG investors. We found this positive trend particularly encouraging given our belief that while we are not owners of companies we invest in, as lenders of capital, bondholders still have potential to influence business practices through engagement.

ESG in private debt
BlueBay was also part of the PRI investor group tasked with publishing a briefing paper on ESG in Private Debt. We participated in discussions and interviews that informed the content of the report, which will be available in 2019.

Sovereign ESG investing
In late 2018, the PRI established a working group on sovereigns to explore good practice in terms of ESG integration and engagement. BlueBay is a member of this group, which is due to publish its findings during 2019.

Separately, we have been collaborating with our sovereign ESG vendor, Verisk Maplecroft on a joint research project exploring ESG and investment performance. The findings will also be published in 2019.

Proxy voting

BlueBay employed proxy voting 20 times in 2018, relating to 15 separate companies.

These votes were in relation to investments in our Convertibles, HY and EM strategies. In all instances, decisions were related to corporate governance matters.

BlueBay voted in line with management recommendations in most cases. In two instances, we voted against the management team and in another two, we abstained from some of the resolutions. The abstentions and votes cast against management were in relation to two separate companies, one in the EM strategy and another in the HY strategy.

Looking ahead to 2019

Thoughts on ESG market trends

Thinking ahead to 2019, we believe ESG change will continue apace. Coupled with volatile and challenging investment environments, this makes taking a proactive and holistic approach to investing critical in our efforts to protect and enhance client assets.

On the policy front, we believe at the European level we may start to see more details on 'what' and 'how' the European Commission intends to embed ESG into financial markets. As China continues to advance its green finance agenda and mandates environmental action, we also expect this will increasingly motivate other governments and regions to act.

The increasingly active role of banks, central banks and regulators globally in promoting sustainable finance to manage systematic ESG risks in recent years is most welcomed. We expect this to continue into 2019 but believe such efforts must be coordinated to ensure there is global alignment of policy and practice.

Looking at the environmental pillar, we expect climate change to remain a strategic focus area given the growing sense of urgency around the approaching 'tipping point' for global temperature increases, after which material negative physical consequences will result if inadequate action is taken. Our view is that the scope of focus will continue to broaden in 2019 to more explicitly encompass agriculture and land use, industrial processes and transport, as well as the social dimension of a 'just' transition, which is gathering momentum. We expect reporting requirements on and quantifying risk exposure and resilience to climate risk will intensify.

Alongside climate, is the wider challenge of ensuring sustainable natural resource management to avoid environmental degradation. We would like to see concepts such as the circular economy gain greater traction to address issues such as waste, pollution and ecosystem diversity. Corporate supply chains will increasingly be an area of focus. We predict attention will expand to including packaging material as well as clothing and other household goods.

We believe that wider social and governance elements will remain important. Corruption and income inequalities at a societal level, and the social side of development, will increasingly fuel debates and discussions about what sort of development and progress we want and need. Lastly, we believe the ongoing implications of the digitalization trend will continue to emerge in 2019. This is also likely to materially change the shape of critical societal infrastructure and some services.

2019 ESG priorities

ESG as business priority for BlueBay has never been stronger. This is is most clearly illustrated by our Management Committee's adoption of ESG as one of two strategic priorities for 2019. Specifically, the aim is to ensure there is full integration of ESG into all aspects of our business.

We have summarised the main focus areas within our 2019 ESG work programme. With strong firm-wide support and commitment from the firm's senior management, 2019 promises to be another exciting year for BlueBay's ESG investment journey.

ESG has been adopted by BlueBay as one of two strategic priorities for 2019. Specifically, the aim is to ensure there is full integration of ESG into all aspects of BlueBay's business

2019 ESG work priorities

Focus Area	Description
Strategy	• Conduct a strategic firm-wide review of how BlueBay approaches ESG from both an investment and corporate responsibility perspective in order to define specific 2019 priorities, associated actions and ensure appropriate implementation and monitoring of progress. As part of this review we will establish appropriate governance structures to provide oversight of such efforts.
Enhance investment choice	• Continue to engage with key stakeholders to ensure BlueBay has compelling product offerings to meet investor needs and explore expanding our current ESG orientated offering opportunities where appropriate to do so.
ESG investment related policies	• Update the ESG investment related policies which are due for review and explore the potential to expand their scope where necessary.
Embed ESG into credit research	• Conduct analysis over the initial results of the completed ESG evaluations for all held public debt investments to identify potential insights that will inform our understanding of how ESG dynamics play out in the debt market. • The ESG team will work with analysts to facilitate the completion of issuer ESG evaluations as standard practice. • Finalise and roll out refinements to the Private Debt team's existing ESG investment risk management process, aligning it to the ESG evaluation process conducted by the public debt teams, where appropriate to do so. • Initiate work with the structured credit team to explore how best to integrate ESG into its investment process.
Develop ESG tools, enhance investment team support	• On the corporate side, we will aid investment teams in the analysis of sector-level ESG risks by completing sector ESG briefings. • Continue to provide support to investment professionals (both credit analysts and portfolio managers) to build awareness, knowledge and understanding of ESG investment matters.
Strengthen the ESG I.T / data infrastructure	• Continue to drive the establishment and enhancement of our internal ESG infrastructure to support investment teams in leveraging ESG data to inform and report on ESG investment risks.
Embrace wider industry collaborations and engagement	• Maintain active participation in external ESG investment industry related initiatives and collaborations and step up engagement on ESG investment public policy related matters.

Source: BlueBay Asset Management

Feedback and Contact Us

We hope you have found our annual ESG investment report useful.
To ensure we continue to meet our key stakeholder needs and interests,
we welcome feedback on how we can improve our future efforts.

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