



ESG engagement: Unlocking the bondholder's voice

When it comes to ESG, engagement is no longer the sole preserve of equity holders. Bond investors are finding ways to gain insight, drive change and make their voices heard.

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As environmental and geopolitical risks continue to rise, threatening economic stability, ESG considerations have become as important for fixed income investors as they are for equity holders. They're shaping the way we all invest, shifting the focus from pure upside potential to a broader outlook that factors in long-term sustainability for people and the planet.

For bondholders, this has led to a big shift in the area of investor engagement. Equity buyers have traditionally been the ones to engage with the companies they invest in. As shareholders – and therefore part owners of the business in question – they enjoy proxy voting rights, which give them the opportunity to influence corporate governance and directly engage with management teams on how the company is run.

“Digging into a company's values, culture and ESG practices requires a hands-on approach”

Bondholders are lenders, not owners, and do not have a direct legal mechanism of influence. But the importance of ESG in the investment community has changed this dynamic, unlocking the bondholder's voice.

What bondholders lack in voting rights, they make up for in size and therefore potential ability to influence. The fixed income universe totals approximately USD128.3 trillion, dwarfing the equity market at approximately USD34.8 trillion.

As individuals or a collective, bondholders have the power to financially back or withdraw support for new issuance, with the associated ability to drive up borrowing costs.

In the past, if one bond investor skipped an issue on ESG concerns, another would likely buy the bonds, maintaining demand. But as ESG factors become central to clients' mandates, the industry as a whole is shifting towards a more scrupulous operating model. Poor ESG practices are becoming less tolerated. A company with little regard for ESG considerations could be met by a lukewarm appetite for its issuance, with those who are willing to buy the debt pushing up the cost of borrowing to compensate for heightened ESG risks.

How to engage

Bondholder engagement requires an active management approach. Index tracking and passive algorithms do not factor in all the nuances associated with engagement. Digging into a company's values, culture and ESG practices requires a hands-on approach.

Withholding capital by not buying a company's bonds provides a blunt way of expressing a negative ESG view, but it won't necessarily lead to change. Without a voting option, bondholder engagement typically takes the form of dialogue – through meetings, calls and letters. Asset managers can engage as individuals or work together to harness some of the collective clout of the bondholder universe. Press exposure can also assist in driving up the power of a bond investor's message.

Understanding engagement across fixed income

Driving change is rarely easy, meaning bond and equity holders alike face challenges in getting their voices heard. Within fixed income, there are many nuances that can shape how effective engagement methods are – some represent potential roadblocks, others opportunities.

Corporates vs sovereigns	<ul style="list-style-type: none"> Barriers to engagement with sovereigns are more common than corporates, with concerns regarding political sensitivity, investment position size, market location and the inclusion of the sovereign in passive indices potentially limiting factors. The focus of sovereign engagement is typically to generate insights, but there can be opportunities to engage for influence, such as improving fiscal transparency and ensuring an operating environment that gives investors confidence.
Sub-asset class differences, i.e. high yield (HY) vs. investment grade (IG)	<ul style="list-style-type: none"> It can be easier to engage with IG issuers more so than HY, due to the typically large size and resources of the issuer and its ability/need to engage on topics such as results. HY issuers can be particularly helpful in terms of generating insights and better understanding ESG practices and risk management, particularly when there is a lack of third-party data available.
Emerging vs developed markets	<ul style="list-style-type: none"> Gaining access to emerging market (EM) issuers can be an engagement challenge, both for corporates and sovereigns. Engagement with EM issuers can be particularly useful in understanding ESG practices where disclosure is weak, as well as to drive positive change and best practices. There are occasions where developed market (DM) engagement, particularly with sovereigns, is less relevant than efforts in EM, given the typically more advanced standard practices of DM issuers.
Conventional public debt vs structured credit	<ul style="list-style-type: none"> Engagement is possible in structured credit, but the nuances of the asset class mean careful consideration must be applied to the methods used, the level at which engagement is possible and the degree to which there can be engagement for influence purposes (opposed to purely for insight).

What we do at BlueBay

Engagement activities

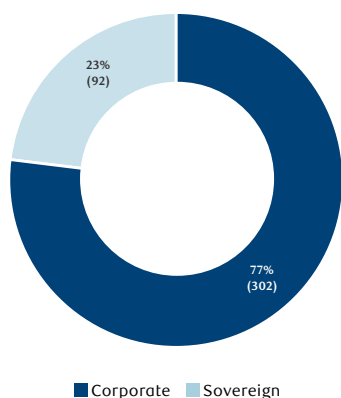
At BlueBay, ESG engagement isn't limited to one business area. Depending on the nature of the initiative, our dedicated ESG team might lead efforts or work in tandem with specific investment teams. Issuer and sector-level collaborative engagement usually involves investment and ESG team members, while issue or industry level efforts are primarily fronted by the ESG team.

Engagement reporting

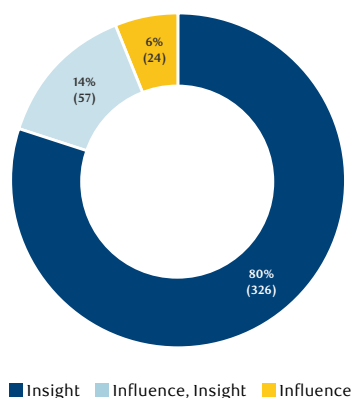
In 2020, we rolled out a centralised engagement log on our proprietary research platform. The system documents instances of engagement, logging methods used, topics raised and views post-engagement. We are constantly developing this technology to capture more granular outcomes, including systematically monitoring progress against objectives and timelines.

Our 2020 engagement summary

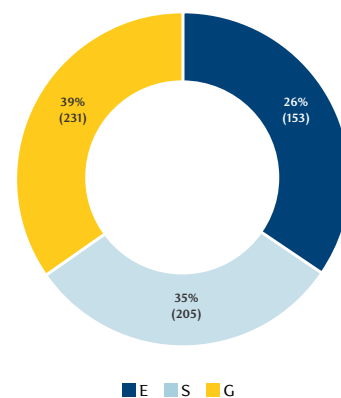
Breakdown by Issuer type – % of total (& number of)



Breakdown of engagement by driver – % of total (& number of)



Breakdown of engagement focused on 'risk' by E, S and G pillars – % of total (& number of)



Source: BlueBay Asset Management LLP, as at December 2020. Some engagements have been multiple risk opportunity pillars and so totals may not add up to 100%.

Engagement in action – case studies

Leading global meat producer

Region: Emerging markets

Engagement aim: Improve ESG practices and gain assurances around the strategy to mitigate future incidents following negative newsflow.

Status: Engagement remains ongoing. We will work with the company via collaborative initiatives and individually to drive progress.

Engagement overview:

The company has a poor ESG track record relating to financial accounting irregularities and bribery.

- We signed up to a collaborative engagement approach in 2017, led by the PRI, to seek assurance on management strategies to mitigate future incidents.
- As part of phase II, we sought to increase dialogue around water management risk and opportunities in food processing.
- In 2020, we increased proactive dialogue regarding worker health & safety in light of Covid-19.

European video game company

Region: Europe

Aim: Gain insight into governance changes and steps taken following harassment allegations.

Status: Ongoing. The company demonstrated material steps towards positive governance and cultural change. We will continue to monitor progress as these steps will take some time to fully embed.

Engagement overview:

- Management call to understand governance changes being put in place following allegations relating to culture and behaviour.
- Discussed what we could expect regarding investor communications and a possible roadmap of milestones demonstrating change.

Sovereign

Region: Emerging markets

Engagement aim: Gain insight into government efficacy and Russian relations.

Status: Closed – we were not reassured by the responses to questions around Russian relations. We felt tensions had risen and the country's response to Covid-19 had been poor. We passed on new issuance opportunities.

Engagement overview:

- The country operates an authoritarian regime. Our concerns became elevated during the 2020 election, where action was taken against opposition candidates, prompting the EU to consider imposing sanctions on the country.
- During a new issuance call, the nature of the country's relationship with Russia was discussed.

Collaborative ESG engagement

Collaborative engagement can offer a powerful mechanism for debt investors to influence issuers on improved ESG practices. These can be broad or specific, with a collective often having more sway than individual efforts.

We are committed to playing our role in collaborative engagement and driving ESG best practice forward through stewardship activities. Collaborative approaches can sometimes yield change that may not be possible as an individual, or which would have taken much longer to achieve alone.

In some circumstances, we may undertake individual and collaborative action on an issuer for maximum impact.

We are members of numerous industry bodies and initiatives in order to inform and develop our internal ESG practices and to advance ESG thinking across the fixed income investment universe.



Collaboration in action

Investor engagement on deforestation

Region: Emerging markets

Engagement aim: Influence to improve practices around Amazon deforestation.

Status: Ongoing – [click here to read more details on the project.](#)

Engagement overview:

- Investors' Policy Dialogue on Deforestation was formed in 2020, marking the start of long-term engagement with Brazilian authorities on the sustainable management of the Amazon rainforest.
- It currently has support from 34 investor groups with over USD4.6 trillion in assets under management.
- The investor group co-signed an open letter expressing concern over escalating rates of deforestation. Dialogue was secured with Brazilian central bank representatives and members of the Amazon council.
- A 2-year engagement programme was formalised, with BlueBay as co-chair.

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