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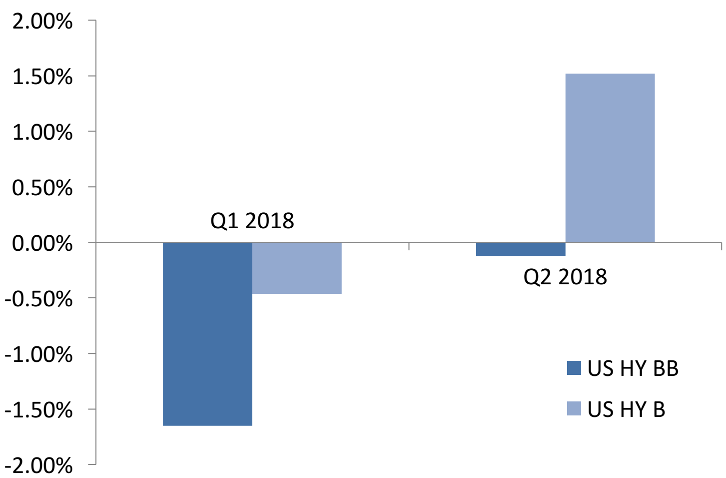
ESG investment review for the BlueBay Global High Yield ESG Fund 1H 2018

Fund investment review

Market review and outlook

Despite strong corporate earnings providing what in theory should have been a supportive environment for high yield (HY) bonds, a series of macro events proved to be destabilising over the first half of the year resulting in a negative return at the benchmark level of -0.40% (gross of fees). Ironically, robust US corporate revenue growth contributed to something of a reappraisal of inflationary prospects in the US and in turn a sharp repricing of treasury yields, which weighed especially on the better quality (more interest rate sensitive) component of the HY market market. Emerging Market (EM) stresses and a re-emergence of European political instability similarly weighed over the second half of the period, with the latter aspect leading to a particularly sharp underperformance of European HY. Meanwhile the US HY component recovered some poise as an underwhelming new issue market proved technically supportive.

Performance of US high yield BB v B rated issuers



Source ICE BofAML 30 June 2018

Signatory of:

Fund performance

The Fund returned +0.67% over the first 6 months of the year outperforming the benchmark return of -0.40% by 107bps. Instrumental over the course of the period was strong single name selection which was responsible for approximately 2/3 of the outperformance over the period. Likewise, of significance, was the Fund's rating allocation with a heavy skew toward single B rated securities, which outperformed higher rated BB securities meaningfully over the period. B's are more levered to the strong corporate fundamentals that we noted during the period and are of course less sensitive to interest normalisation, which weighed on BB rated securities over the period. The Fund also generated notable alpha from its underweight position in EM corporates, which underperformed during the period. On the flipside, the Fund's allocation to European HY weighed somewhat as US HY notably outperformed Europe in general. Specifically our allocation to European subordinate financials weighed as political volatility resumed in the region and accounted for the vast majority of the underperformance from the region. Accordingly, we reduced our positioning within this sector significantly during the period believing the increase in European and in particular Italian political uncertainty was likely to prevail for some time.

Overall, we maintain a positive view on the wider Global HY market as strong revenue and earnings growth coupled with positive supply technicals (significantly lower US HY supply than expected in particular) is likely to dominate in the short to medium term.

Fund environmental, social & governance (ESG) review

The first half of 2018 delivered cause for optimism as the momentum around balancing the need for sustained growth with environmental and societal considerations gathered pace. We saw the early signs of a shift to include climate and sustainability factors in financial policy and regulation.

While it is still early days, the potential hard coding of ESG factors into how markets work could facilitate the transformational change needed, in light of the many societal and environmental challenges we face.

Ongoing efforts to promote a sustainable financial market in Europe

We reported in the last ESG investment review that the European Commission would be outlining its response to the recommendations of the High Level Expert Group (HLEG). In March, the Commission endorsed some of the recommendations, which cover issues of taxonomies, duties, preferences, disclosures, benchmarks and risks. Working Groups have been commissioned to review and evaluate different areas before outlining firm plans.

Some of the investment related developments include:

- Its intention to legislate an explicit requirement for institutional investors and asset managers to integrate sustainability considerations in the investment decision-making process.

- Commitment to promote increased transparency towards end-investors, allowing them to make informed investment decisions and enabling the comparison of sustainable and long-term investment performance.

- Plans to advance efforts to establish a sustainability classification/taxonomy in the EU to aid consistency and develop clarity regarding what constitutes a sustainable investment through the creation of a technical group.

- Creating standards and labels for sustainable financial products, such as green bonds, to promote transparency and facilitate informed choice.

The Commission also outlined its position on the incorporation of ESG/sustainability factors into investment risk management and how such factors are taken into account in relation to data/ research providers.

In the context of fixed income investing, it recognised the role of credit rating agencies (CRAs) and set out plans to:

- Engage with stakeholders to explore whether regulation needs to be amended to mandate the CRAs to explicitly integrate ESG into their analysis.

- Work with the industry regulator to review the extent to which current practices by the agencies already take ESG factors explicitly into account and invite suggestions on solutions to advance such practice.

- Intention to carry out a comprehensive study on ESG / sustainability ratings and research.

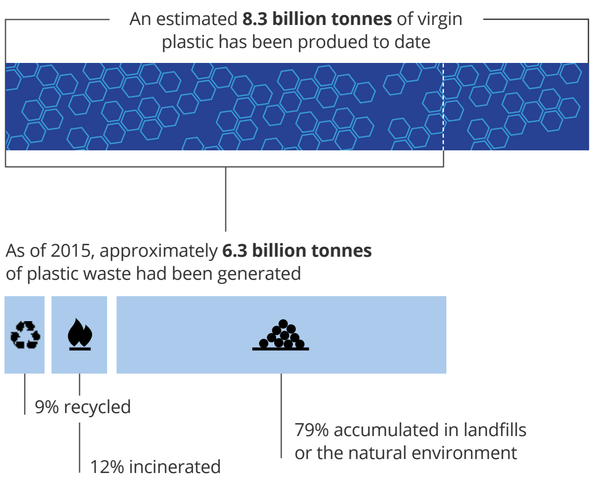
The war on plastics

Last year we observed that as result of the ecological and health impacts, the issue of plastics has been gaining increasing attention.

The scale and speed of action we have seen from corporates and governments around the world has been unprecedented.

Whilst it could be argued that some of the steps taken (e.g. banning single use plastics and promoting more environmentally sustainable substitutions) may appear tokenistic, it highlights what is possible when there is collective and decisive action. Such rapid action would be welcomed in a host of other ESG related issues.

How much plastic is there?



Source: https://www.bbc.co.uk/news/science-environment-42652937 (10.12.2017)

Incorporating ESG Factors within the Fund's investment process

Beyond the formal ESG exclusionary screens, we actively consider how ESG factors are being managed in companies as part of our ESG integration and engagement process. An example of this in action is the review we conducted in February of Flora Food Group (FFG), for which the private equity firm, KKR was in a competitive bidding process to buy from the publicly listed food producer Unilever. KKR intended to finance the acquisition through equity and debt (involving a combination of bonds and loans). KKR won the bid and officially took ownership on 1st July 2018.

FFG is a global spreads business (primarily margarine), present in c. 70 countries with top three positions in most of these, and owning a portfolio of strong brand names. Under a new management team brought in 2016, the business has seen improving sales trends under a new strategy, repositioning it as a plant-based alternative, dairy and gluten free spread option for more health conscious consumers.

Whilst under Unilever's management (with Unilever itself considered a leading ESG company), the broader division under which the spreads business fits within has taken an active and progressive approach to sustainable sourcing of agricultural products, such as palm oil from countries like Indonesia and Malaysia where there are concerns about human rights, deforestation and biodiversity issues.

Considered to have industry leading practices, one of the potential ESG concerns we had when reviewing the deal was whether, given FFG was going private and be under private equity ownership, KKR as the new owners, would commit to maintaining those practices. Claire Nicoll, our HY Consumer analyst raised this issue at the bank meeting with KKR and management, and gained some reassurances. KKR has stated that they were committed to following Unilever's responsible sourcing policies, and specifically would work towards 100% sustainable palm oil sourcing by 2019. They stated that whilst they were looking to make cost savings within the business, these would not come at the expense of sourcing cheaper, unsustainable palm oil.

A further comfort for us was that more generally private equity firms are becoming increasingly active at incorporating ESG factors within their investment activities, and KKR in particularly has been proactive on this front. However, despite these positives, Claire states that she ".. *continues to have some residual concerns about the extent to which sustainable agricultural practices will continue under the new private ownership structure, as this does represent a meaningful reputational and regulatory risk for a consumer facing company like FFG given KKR is not a household name like Unilever*."

Ultimately, the team participated in the sterling denominated loan, which we thought offered the best combination of value and downside protection in the capital structure, but was not considered for this Fund as it typically invests in bonds rather than loans. But FFG would be potentially eligible for investment from an ESG perspective, as whilst we recognise the valid concerns about sustainable agricultural sourcing, we feel the evidence to date shows this issue is being proactively and effectively managed. However, we will continue to track activities and raise issues with management as appropriate.

Engaging companies on cyber risks

Whilst digitialisation brings opportunities which can promote sustainable environmental and social practices, it can also present some ethical and operational challenges for companies around data privacy and security.

BlueBay is working collaboratively with peers via the UN-supported Principles for Responsible Investment (PRI) to advance our knowledge and understanding of best practice in this area.

As a member of the project, which has the support of more than 50 investors with collective asset of over USD 10 trn, BlueBay has been participating in a number of meetings with management from companies across a range of sectors (including food and beverage, online retail, telecoms and healthcare companies) and from a range of geographies (including the UK, continental Europe and North America).

Whilst the initiative is intended to run through to 2019, the PRI will share its initial findings from the first phase later in the year, with a final report due at the end of the project. The insights gained to date have already been valuable in enabling us to have a more strategic perspective on the issue and highlighted some of the nuances and challenges involved.

Promoting best practice fixed income ESG investing

ESG investment practices have primarily emerged from the equity asset class. Whilst there may be some areas of similarity between equity and fixed income investing, there are also areas of difference due to varying structure and dynamics of the asset classes. These can have some important implications for how debt investors approach ESG investing.

To ensure BlueBay develops credible ESG fixed income practices and deliver, on strong performance, in addition to the work we do in-house, we work collaboratively with other key stakeholders, via the PRI, including taking active role, in two fixed income working groups:

Advisory Committee on ESG credit risks and ratings

Chaired by BlueBay, this group seeks to promote awareness, understanding and knowledge about how ESG factors impact credit risk analysis and credit ratings.

The group recently published its' second report summarising the outcomes of the various events convened in Europe and North America for investors and CRAs.

From these reports, it was 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 increasingly more 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 later in 2018.

ESG Bondholder Engagement working group

The aim of this 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 as well as draw together a guide on good/best practice on this topic.

Overall, there was a clear consensus view that engagement is an important tool for ESG investors. While we are not owners of companies we invest in, as lenders of capital, bondholders still have potential to influence business practices. It was encouraging to see a trend in increasing ESG bondholder engagement amongst investors.

We hope you have found this ESG briefing useful. To ensure we continue to meet our investors need, we welcome feedback on how we can improve our future efforts.

+44 (0)20 7389 3775
esg@bluebay.com
www.bluebay.com

KEY FEATURES

Strategy	Global High Yield corporate bonds (with a focus on the US and Europe)
Benchmark	BAML Global High Yield Investment Grade Country Constrained Index (HWIC)
Investment policy/ strategy constraints	• Minimum 2/3rds sub-investment grade • Minimum 50% US-domiciled issuers
Objective	Excess returns over the course of the cycle with a focus on capital preservation
Leverage	Not permitted
Target return (over the cycle)	2% above benchmark, gross of fees
Target tracking error	0–6% relative to benchmark
Liquidity	Daily
Fund structure/domicile	UCITS IV fund, domiciled in Luxembourg
Base currency	US$ (US$, €, GBP, CHF, CAD, NOK, SEK and other share classes available)
Typical number of issuers	80–120 (majority held in core positions, remainder on opportunistic basis)

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