BlueBay Asset Management

ESG investment review for the BlueBay Global High Yield ESG Bond Fund 1H 2020

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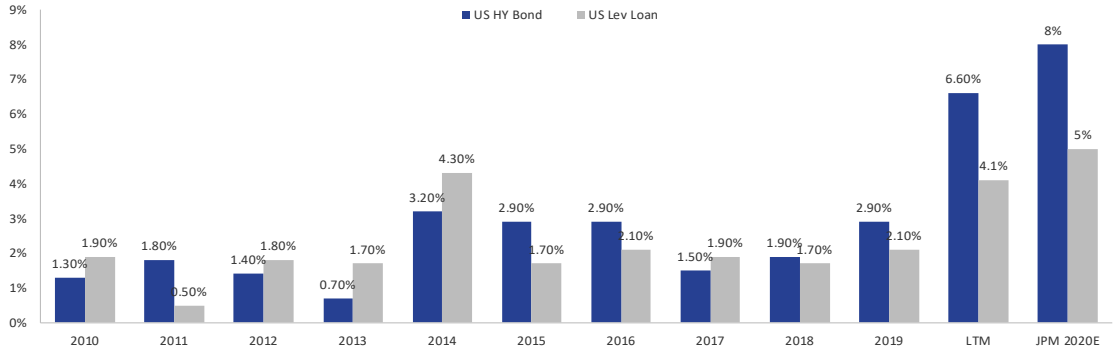
Market review and outlook

Although the year opened tentatively tighter, continuing the strong tone witnessed in the final quarter of 2019, this positive sentiment was short-lived as global risk markets began to respond to the COVID-19 outbreak. With global high yield (GHY) spreads troughing at a low of 350bps in January, the proximity and potential impact of COVID-19 quickly took hold causing spreads to more than triple, peaking in the latter half of March at almost 1100bps.

The unprecedented quantum of fiscal and monetary support to combat the economic impact of the virus quickly took effect, however, and in stark contrast to the first quarter of 2020, GHY markets rebounded with vigour during the second quarter of the year. Having registered losses of -13.5% in Q1, second only in magnitude to the declines experienced in the final quarter of 2008 when the GHY market recorded losses in excess of -18%, the second quarter recovery (with gains of almost 11%) meant returns for the first half of 2020 came in at -4% (ICE BofAML GHY Investment Grade Country Index). Despite the second-quarter strength, spreads stand around 250bps wider than where they began the year, but some 450bps tighter than the peak stress experienced toward the end of the first quarter (and now stand at 640bps).

Although much has been done to address the short-term liquidity requirements of much of the HY corporate universe, downgrades and defaults continue apace. In the US HY market, the trailing 12-month default rate closed the period at 6.2% (a 10-year high). Much of this stress has been prevalent in the energy market, which in addition to wider market stresses also had to contend with the breakdown in OPEC+ talks in the early part of the period contributing to losses in the region of -40% within the US HY energy sector during Q1.

Defaults & distressed exchanges have occurred quickly



Source: JPMorgan, as at 30 June 2020

Despite the turbulent backdrop, the HY asset class remains supported by a variety of factors. Notably, the quantum of global monetary and fiscal responses to the current economic and corporate stress is potent and has been highly effective at addressing liquidity concerns. Additionally, valuations and the income-generating nature of the asset class are suggestive of a positive return profile over the medium term, resulting in a supportive technical backdrop fuelling record-breaking flows into the US portion of the HY asset class.

As ever, despite this somewhat positive backdrop, credit selection remains paramount with still limited visibility over earnings normalisation. While recent fiscal support and capital raisings have been helpful in addressing liquidity shortfalls, this doesn't necessarily translate directly into long-term solvency for the HY issuer cohort. Accordingly, the medium-term robustness of a company's balance sheet remains key.

As noted, we are already witnessing a significant rise in defaults and restructuring activity (particularly in the US), and a growing distinction between what we would describe as winners and losers. While ensuring we capture recent market strength with appropriate market beta within our portfolios, our efforts continue to be focused on rigorous fundamental credit analysis and stock selection during this more challenged period.

Fund performance

The fund returned -3.58% over the first half of the year, outpacing the benchmark return of -4.03% by 44bps. Performance was particularly strong during the first part of the year with the fund's ESG foundations driving an underweight position in energy and extractive sectors more generally. As noted, the energy sector was particularly hard hit during the opening months of the year as OPEC discussions broke down resulting in an unprecedented slide in the price of oil and commensurately negative returns for companies operating in the sector.

With de minimis exposure to the energy sector and a preference for more defensive industries, such as media and telecoms, this positioning underpinned outperformance relative to benchmark during the opening quarter (albeit in the context of still noteworthy drawdowns in keeping with wider risk markets). Despite being underweight cyclicals sectors more generally, the fund came into the year with a constructive view on the US consumer. Accordingly, this pro-risk positioning in sectors such as leisure & entertainment and consumer goods necessitated significant reduction in exposure as the impact of the virus spread became evident.

Conversely, the sources of fund outperformance in the first quarter were then drivers of underperformance during the second quarter. Despite adding exposure in some of the more cyclical sectors, such as autos, the scale and pace of the rebound in the energy sector in particular meant the fund lagged its benchmark during the second half of the period.

Note: While gross of fee figures would reflect the reinvestment of all dividends and earnings, it would not reflect the deduction of investment management and performance fees. An investor's return will be reduced by the deduction of applicable fees which will vary with the rate of return on the fund. For example, if there was an annualised return of 10% over a 5-year period then the compounding effect of a 0.60% management fee and a 0.20% performance fee would reduce the annualised return to 9.32% (figures used are only to demonstrate the effect of charges and are not an indicator of future performance). In addition, the typical fees and expenses charged to a fund will offset the fund's trading profits. A description of the specific fee structure for each BlueBay strategy is contained in the fund's prospectus.

Fund Environment, Social & Governance (ESG) review

COVID-19 and the 'new normal'

Our prediction for 2020 was that it was set to be 'THE' year for ESG action, with the view that the primary focus would remain on the 'E' – the environment – and climate change specifically.

Very few would have disagreed with this: the physical impacts of climate change have become more visible than ever and we were beginning to see a clear direction of travel from politicians on climate change policy and regulation. Among the general public, plastics (and their impacts on biodiversity) became a headline topic, leading people to take personal action. Social unrest and rising populism stemming from concerns about human rights also became topical issues influencing investors, raising the 'S' profile.

Then came COVID-19. The pandemic has caused unprecedented levels of economic and societal harm across the world. Unsurprisingly, we have seen significant disruption to pre-agreed ESG plans and priorities as governments, companies, individuals and society as a whole work to respond and adapt to the new operating environment.

While there is a danger that ESG momentum will slow as the crisis-management mentality continues to take precedent, we believe the pandemic also presents the opportunity for action to be accelerated. We would argue that COVID-19 provides the perfect illustration of why we need to tackle climate change – its disruptive impacts will be world-changing if not addressed – and how quickly governments and society can act in the face of a true public emergency.

So rather than COVID-19 bringing ESG progress to a stop, we believe it should be viewed as a temporary delay, after which efforts should resume and accelerate to rebuild a world that is based on greener, more resilient and inclusive practices. Certainly, there is already evidence of that refocus, with data we have seen so far only pointing to an acceleration of the transition (see box below).

In terms of how we see the balance of emphasis going forward with regards to E, S and G, we predict focus will expand to become more balanced in terms of bringing social issues into sharper focus, illustrating the interconnectedness of people, the planet and prosperity.

Evidence COVID-19 will accelerate the sustainability transition

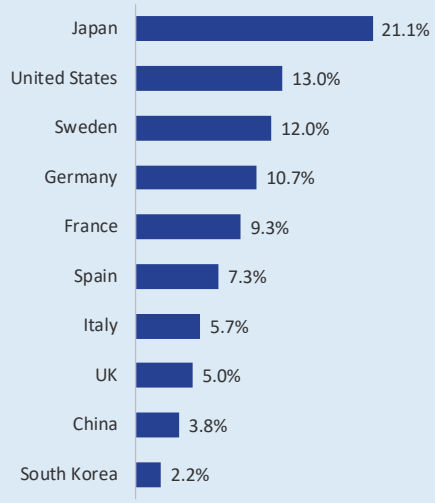
Two data points that indicate the pandemic is already leading to greater focus on ESG-related matters and investing are:

- **ESG fund flows and performance:** flows into ESG funds are at a record high for 2020 to-date, gathering over USD15bn in the first six months of the year[1]. We have also seen compelling statistics[2] showing ESG funds outperforming non-ESG funds and benchmarks.

- **Government policy and action:** policy-wise, as governments and institutions around the world are responding to the pandemic with the largest stimulus packages seen since the Great Depression, in Europe for instance there has been a growing call from a range of stakeholders for the European Green Deal[3] to be at the heart of the COVID-19 recovery package. Given that enormous support measures will shape national and regional economies and societies for decades to come, it is hard to argue with the need to adopt a framework for tackling short-term economic needs with long-term sustainability goals. Furthermore, it seems policymakers are listening and in agreement, embedding in their proposal the Green Deal as the EU's recovery strategy.

Global Coronavirus Stimulus Packages Compared

Financial response to the COVID-19 pandemic as a share of GDP (selected countries)



Source: Ceyhun Elgin, Forbes Statista, as of 10 May 2020

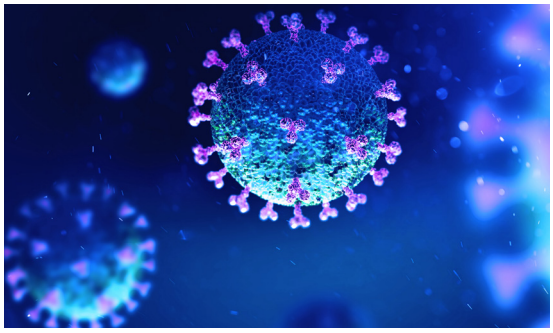
Notes:

1 Data according to ETF Flows, as stated in marketwatch.com article: https://www.marketwatch.com/story/sustainable-investing-flows-have-smashed-all-records-in-2020-whats-going-on-2020-07-07

2 For example, see: https://www.morningstar.com/articles/991091/sustainable-stock-funds-held-their-own-in-second-quarter-rally

3 The European Green Deal, launched by the European Commission in December 2019, outlines a comprehensive framework of regulations and legislation aimed at achieving the EU's targets of net-zero carbon emissions by 2050, and a 50% to 55% curb in emissions from 1990 levels by 2030. More information can be found at: https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en

Incorporating ESG factors within the Fund's investment process



Responding to the global COVID-19 pandemic

The current COVID-19 pandemic has led to many countries and sectors of the economy facing material reductions in commercial activity and/or significant disruptions to operations resulting from changes in supply and demand dynamics, as well as to supply chains. There is a need for all stakeholders – including investors – to play their role to assist in a coordinated economy-wide response and recovery.

Industry-level collaborations: in terms of collective action across the industry and with other stakeholders to ensure a robust and coordinated response, one area of activity has been our participation in the PRI efforts to facilitate signatory thinking and practice as a result of COVID-19 and develop a global response.

Sector-level engagement: the pandemic has raised the profile of social risks, such as worker safety across all companies, but this has particular significance for some sectors such as the meatpacking industry, which are proving to be hotspots for the virus globally. BlueBay has signed a public investor statement, in which there was a call for increased protections for workers in US facilities due to the heightened risks of COVID-19. At launch, it was signed by 118 investors with USD2.3 trillion in combined assets under management. BlueBay was a signatory of the statement shortly after the launch, in early June.

Issuer-level engagement: as investors, we understand these are extremely difficult times for many companies, particularly those in the HY market, and there is a critical need to prioritise and focus efforts to ensure near-term financial sustainability. However, it is critical that issuers and borrowers maintain open channels of communication with investors. By better understanding how companies are approaching the situation, investors are potentially in a better place to respond constructively and provide financial support to them. Whilst it may appear to issuers that they face the challenge of a trade-off between economic wellbeing and the health of their key stakeholders, as well as the overall health of society, it may be possible to strike an appropriate balance. It is also important to recognise that the COVID-19 pandemic represents an opportunity and not just a risk for countries and companies to do things differently in future. We believe issuers which demonstrate purposeful leadership by acting with intent now will be best placed to rebuild and restart in a new normal. Our efforts at this level have included developing a set of COVID-19-related questions for corporate engagement and we have been engaging with companies on this issue. Some examples of these efforts are as follows:

- We attended a call with the management of **Clearway Energy**, a renewable energy producer active in solar and wind energy, where worker safety and their ability to operate in a pandemic environment was discussed. The company has been active in providing local COVID-19 relief efforts to communities and is focused on ensuring worker safety to maintain the ability to operate in a pandemic environment.
- **Onemain Financial**, a provider of secured lending and consumer finance in the US, outlined in an investor call how it was responding to the pandemic by providing customer assistance and helping enact borrower assistance programmes to allow forbearance of up to 120 days for customers impacted by the crisis. In addition, the company is also offering loans in the communities that they operate, helping to connect people with resources online and providing access to financial literacy education for elementary, middle and high school students free of charge.

Promoting issuer ESG disclosure in the HY market

June saw the launch of a set of draft ESG disclosure guidelines for companies in the leveraged finance market by the European Leveraged Finance Association (ELFA), an industry trade body that BlueBay is a member of. We are representatives on their ESG Committee, which has led on developing this resource.

Released for public consultation before being finalised, the aim is to promote standardised high-quality ESG disclosure by borrowers in light of the growing investor demand for such information.

The intention is for companies and other market participants to apply these to their disclosures when coming to the market with new issuance, and for wider corporate communications.

Whilst there exist many public initiatives on ESG disclosure, the aim is to focus on a smaller core set of ESG disclosures given the smaller size and private nature of many leveraged finance companies.

Whilst it was directed at borrowers in the European market, clearly the applications are global in nature. The initiative is being supported by the Loans Market Association (LMA).

The draft ESG guidelines will be finalised following formal stakeholder consultations, conducted in partnership with the PRI over the course of 2020.

BlueBay ESG investment news

Annual 2019 ESG investment report now available

BlueBay has published its fourth annual ESG investment report, which highlights our continued efforts regarding the incorporation of ESG practices within our investment process over the 2019 calendar year. You can read the full report here.

We remain committed to making progress on this important area, which this year has transitioned from being a strategic priority to one of our strategic pillars for how BlueBay does business. We are grateful for the feedback we continue to receive from our clients on how we can continue to evolve our efforts.

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.

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