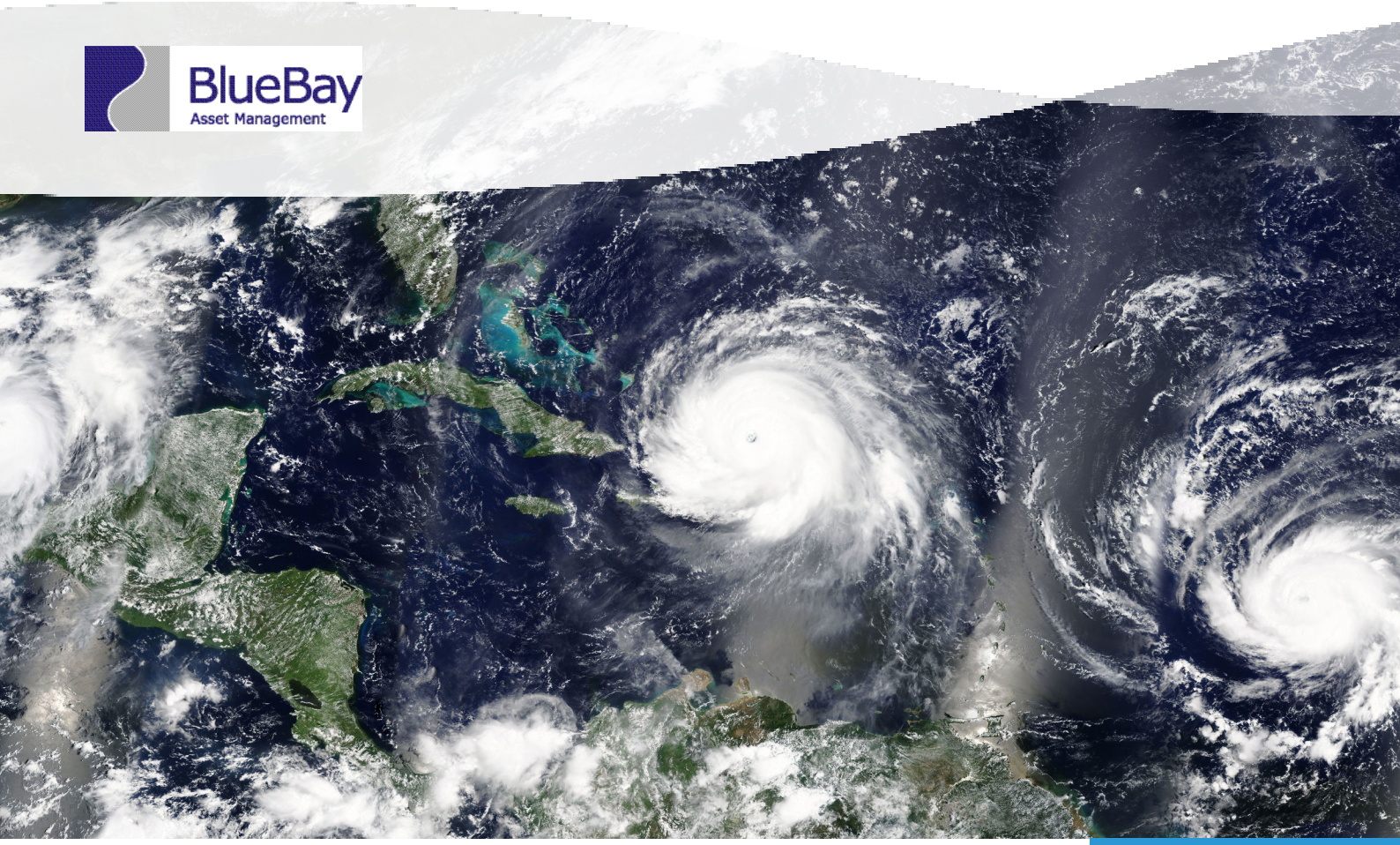
BlueBay Asset Management



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Market review and outlook

In comparison to the first half of the year, global high yield (HY) markets began the second half in a slightly more muted fashion with spreads oscillating in keeping with revolving sentiment around economic growth, trade, politics and central bank communique. Posting coupon-like returns for much of the period, global HY markets accelerated during the final month of the year recording gains of +1.81%, taking final quarter returns to +2.81% – in stark contrast to the fourth quarter of 2018 in which losses of -3.80% were recorded. Risk markets in general were underpinned over the latter part of the period as a phase-one trade deal between the US and China was sealed and a stabilisation in a selection of global growth statistics boosted cyclical sectors more generally. More specifically, energy markets rebounded aggressively in the closing weeks of the year, reversing the weak backdrop for the sector that had been experienced for much of the period. Over the course of the second half of the year, global HY markets returned 4.10%, taking full-year returns to +14.40%. Over the course of the full year, HY spreads contracted by 170bps to 370bps – essentially at the lows of the year.

As far as outlook is concerned, the backdrop of a somewhat accommodative Federal Reserve (and a relatively high bar for interest hikes during 2020); renewed bond buying from the European Central Bank (ECB); agreement on phase one of a US/China deal alongside a growing band of negative-yielding assets across global risk markets, in theory, extends the runway for global corporates and credit markets more generally over the medium term. While growth may only be "tepid", we believe this is more than adequate for leveraged finance assets to perform well.

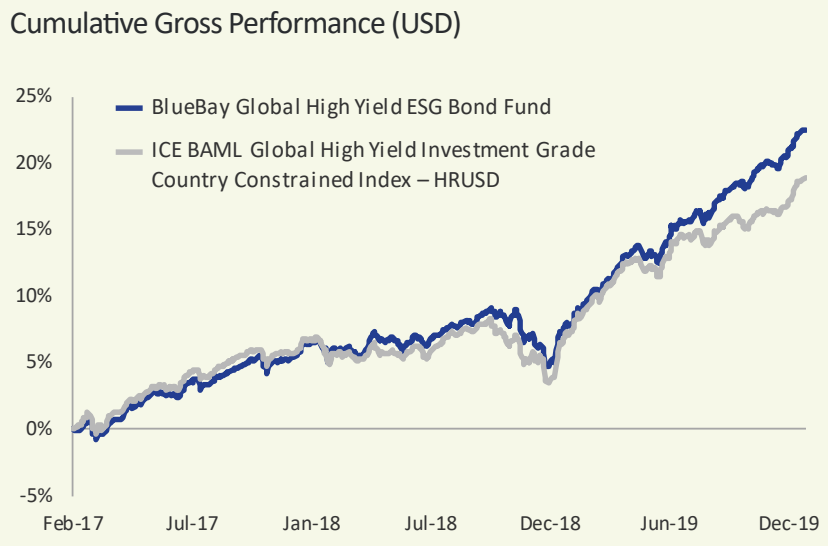
It is important to caveat, however, that this is an increasingly widely held view and is reflected in valuations within the market, which naturally leads us to pause for thought in assessing whether we are currently being appropriately compensated for the risks inherent in the HY bond market.

For now, at least we would say the answer is yes. However, we acknowledge that the potential for political, economic and trade-related volatility remains and that the apparent safety net from monetary policy cannot be viewed in isolation. Indeed, the variance in corporate results across sectors and individual issuers and the recent volatility in the energy sector (in particular) underline that a degree of caution remains prudent. As ever, we remain cognisant of complacency and accordingly, we remain focussed on credit selection and managing beta dynamically.

Fund performance

The fund returned +6.40% gross of fees [1] over the course of the second half of the year, notably outpacing the benchmark return of +4.10%. Over the course of the full year, the fund generated gains of +16.37% (gross), almost 200bps ahead of the benchmark return of 14.40%.

The fund maintained an overweight bias over the course of the period, helping to drive outperformance in a still-positive environment for risk assets. As has been the case throughout the year, positive name selection within this overweight positioning has been responsible for a significant amount of the outperformance relative to the benchmark. With less exposure to more resource-orientated sectors, such as mining, energy and electric utilities (given the fund's ESG investment criteria), the fund naturally lagged during periods of trade-related strength. However, this was more than made up for by sector allocations elsewhere with financials and more defensive sectors driving notable gains. From a rating perspective, a normalisation of performance in the latter part of the period (i.e. lower-rated securities outperforming reversing the trend seen earlier in the year) helped as the fund remains underweight BB-rated securities.



Source: BlueBay Asset Management, as at 31 December 2019.

Gross of fees. Past performance is not indicative of future results.
Fund inception date: 08 February 2017; Gross Returns calculated adjusting for cash flows using the Modified Dietz method.

Note: **1** 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

Reflections on 2019

For many, 2019 will be remembered as a year in which sustainability and ESG investing moved into mainstream consciousness, driven by major environmental and social events that highlighted the need to act.

Climate change was a dominant force throughout the year, with concerns regarding global temperature rises driving significant activism among the younger generation, with multiple #ClimateStrikes. Greta Thunberg continued to epitomise growing frustration about the lack of decisive action, whilst bushfires, floods and other natural disasters provided stark evidence that the physical consequences of climate change are already happening.

We saw the UN Sustainable Development Goals (UN SDGs) move from the sidelines and become core in discussions. Companies, sovereigns and investors all began to view these ambitions as an integral part of their operational strategies and key to overarching ESG reporting frameworks that demonstrate the impact of their efforts on the environment and wider society.

Lastly, with regards to progress in the private sector, a key highlight occurred during August when the CEOs of leading US corporations (a region where companies have largely lacked progress in terms of corporate responsibility), publicly stated that they have a purpose beyond profit and that shareholders do not have supremacy. Whilst it is easy to be cynical and actions need to follow, we believe this marks the start of what could be a material shift in thinking and practice from leading corporations as they recognise the need to ensure a social license to operate and consider their long-term impacts.

2020 ESG themes and developments to watch

Whilst 2019 proved to be a pivotal year for societal and financial market change regarding ESG, we believe 2020 will signal the time for action and set the tone for the decade to come. Our predictions for the key themes to watch are summarised below. What is clear is that climate change is likely to remain a key thematic issue throughout 2020.

Developments to watch in 2020

#ClimateEmergency, #GlobalGoals, #DecadeToAct: we are moving into the start of a decade where critical, accelerated and strategic action is needed to maintain global temperature rise below dangerous levels. We expect to see accelerated growth and capital reallocation shifting towards more sustainable economic activities and assets as the focus on impact increases.

Sustainable (resource) consumption: the issue of plastics – and waste more generally – and its environmental (e.g. biodiversity) and social impacts (e.g. human health) are likely to gain further traction. For this to be tackled effectively, we expect to see more coordinated and collaborative action from investors and other stakeholders around the concept of a circular economy.

Regulation, regulation, regulation: 2019 was a year of significant policy development, particularly within Europe. 2020 will mark the start of implementation efforts with the EU working to hardwire sustainability into the functionality of the finance industry, ultimately seeking to protect investors from concerns of mis-selling, mis-marketing and 'greenwashing'. We expect this may also prompt other regions and jurisdictions to follow suit.

Stewardship 2.0: as stakeholders increasingly demand investors move from 'tell me' to 'show me' regarding how they are discharging their fiduciary duty, managers will face greater scrutiny to exercise and demonstrate effective stewardship. The European Shareholder Rights Directive coming into force, and the revised 2020 UK Stewardship Code are clear examples of the direction of travel. In order to respond effectively, managers will require more and better data (including from issuers and borrowers) and tools to effectively and efficiently educate, evaluate and engage.

Human rights: we expect greater focus on sustainable and responsible management of human capital during 2020. As action on climate change accelerates, we will hopefully start to see attention move to ensuring that the low-carbon transition occurs in a just and fair way from a people perspective, as old industries go into decline and new ones emerge. Looking beyond climate change, issues of modern slavery and human trafficking remain to be tackled strategically, and questions regarding how technological advances will reshape the future of work need to be addressed.

Annual average temperatures for globe from 1850–2018 using data from UK Met Office. Graphics and lead scientist: Ed Hawkins, National Centre for Atmospheric Science, University of Reading. Data: Berkeley Earth, NOAA, UK Met Office, MeteoSwiss, DWD.

Incorporating ESG factors within the Fund's investment process – spotlight on the subprime lending market

Our investment and ESG teams have worked together to undertake an in-depth assessment of the subprime investment landscape. Given the inherent social risks surrounding subprime lending, there was a critical need for us to develop a framework through which we can better reflect the nuances of this sector and assess practices and conduct that should ultimately allow us to identify issuers considered suitable for the fund.

Facilitating financial inclusion

Large swathes of the global population continue to lack access to mainstream financial services. As Lucy Byrne, our ESG analyst explains: *"Typically, these groups tend to be low-income, vulnerable individuals facing barriers to financial inclusion, such as poor credit history or financial illiteracy. Providing financial services to such groups, which is often termed 'subprime', can be positive from an ESG perspective, as arguably these providers are helping serve individuals who would otherwise be neglected."* However, due to the vulnerability of such groups, how a company carries out these activities is critical as inappropriate marketing, mis-selling, and/or 'predatory' lending can undermine its social license to operate.

Understanding the market

Subprime lending refers to a portion of the mainstream (or 'non-prime') financial market where borrowers are not assessed to be completely ineligible for lending, and financing is permissible in certain situations, albeit with elevated risks on both the borrower and lenders side.

Globally, it is a highly fragmented market, with a range of different players of varying sizes.

Within the subprime market there is an inherent risk of poor practice given the imbalance of power between the lender (i.e. those providing finance) and the borrower (i.e. those in need of finance). Typically, a borrower of subprime lending has an immediate need for financing that leaves them with little/no leverage and ultimately susceptible to unethical practices and predatory lending, given that the more typical mainstream financing routes are not available to them. Often there is also a lack of financial literacy from the borrower and limited transparency from the lender around their practices, which further compounds the issues and risks therein. Given the vulnerability of the customers, it is not surprising the industry is highly regulated. Companies operating in this space face heightened financial, legal and reputational risks and need to demonstrate robust and ethical practices.

Establishing an ESG framework for evaluating subprime lenders

Our starting position is that subprime lenders can potentially have a place in the fund given their potential to facilitate financial inclusion for certain groups. However, our challenge was to understand which aspects of subprime lending would not qualify (e.g. predatory lending) and what does responsible practice look like in order to help differentiate companies from one another.

> "Providing financial services to such groups, which is often termed 'subprime', can be positive from an ESG perspective, as arguably these providers are helping serve individuals who would otherwise be neglected."
>
> Lucy Byrne
> ESG Analyst

Subprime lending ESG framework

We have identified the below elements which form the basis for our ESG framework for assessing companies.

- **Avoiding predatory lending** – we would seek to avoid companies deemed to be engaged in predatory lending practices, two useful 'red flag' metrics to identify these are:
  - Rate of return on capital (ROC) – where, after accounting for expected defaults and expenses, an issuer generates a ROC that is disproportionate to its business risk, we believe this could signal potential 'predatory' lending practices.
  - Lending term – longer-duration lending is less likely to signal predatory lending practices when compared to loans with a shorter duration (e.g. less than 30 days and 'payday' lending).
- **A responsible approach to charging interest** – whilst the annual percentage rate (or APR) can be a useful metric to track, it must also be considered within context. For example, a high APR tends to gain headline attention because of what it implies. However, as subprime borrowers carry a greater risk of default, it is reasonable that the lender needs to be compensated for that increased risk and the costs of assessing such borrowers, which can be higher given the duty of the lender to take extra care in this lending segment. In addition, as loan balances tend to be smaller, there is also a higher cost of making a loan which needs to be recovered either via a fee or interest rate, both of which would be part of the APR. As such, the focus on APR should be on *if* and *when* a borrower increases interest rates, as it could make it impossible for the borrower to pay back the loan and break the lending cycle, which is ultimately one of the biggest risks for borrowers.
- **Ethical and responsible practices** – given the inherent risks of subprime lending, there is a need for issuers to ensure ethical and responsible lending practices (and transparency of these), particularly regarding the recovery process in the event of missed payments and due diligence performed when providing lending in the first place. Practices such as commission targets based on sales would be something we would view as negative, compared with service-based ones, as well as inadequate credit checks.
- **Regulatory compliance** – adherence to regulations is necessary but not sufficient. Rather, customer complaints and feedback regarding practices, as well as any breaches or regulatory fines, all provide useful performance indicators.

Applying the ESG framework in practice – Examples

OneMain Financial is a provider of secured lending and consumer finance in the US, offering financial services to its customer base including subprime consumers. As such it is inherently exposed to subprime-related ESG risks such as predatory lending practices and consumer data security concerns. However, the company is not a payday lender with its lending products considerably longer in duration and lower in interest rate relative to the payday lending industry. Thus the company lacks significant controversies with an overall positive track record that lowers our concern levels.

John Guarnera, our senior corporate analyst covering financials, says: "*The company is not an aggressive or predatory lender and its product offering via longer-term secured lending is not something that qualifies as predatory lending in our view*". As such, even though we are cognisant of its fundamental risk exposure, we view it to be a suitable investment for the fund.

Another company we have evaluated but ultimately concluded was not a suitable investment for the fund is **Navient**, which provides and collects student loans in the US. Whilst this company is not solely focused on subprime lending per se (as it is a broader provider of student finance), its servicing practices can be aligned to that of predatory lending. Therefore, we have viewed this issuer through the same cautious lens.

The company has faced significant scrutiny over its performance with allegations of predatory lending, failure to act in its customers' best interests and unaffordable payment plans. Multiple lawsuits remain ongoing regarding these allegations, although Navient itself has maintained it has serviced loans to the best of its ability and rebutted the claims.

In our view, the scale and size of Navient's controversies and the significance of the reputational and regulatory risks associated with the multiple lawsuits resulted in us being wary of it currently. John Guarnera believes that: *"Whilst the company has made modifications to its loan programme and has product safety procedures, with the lawsuits yet to reach a conclusion, we continue to remain cautious and lack comfort over the effectiveness of its processes."*

"Whilst the company [Navient] has made modifications to its loan programme and has product safety procedures, with the lawsuits yet to reach a conclusion, we continue to remain cautious and lack comfort over the effectiveness of its processes."

John Guarnera
Senior Corporate Analyst

BlueBay ESG investment news

BlueBay 2019 PRI Assessment Results

BlueBay has been a signatory of the UN-supported Principles for Responsible Investment (PRI) since 2013. We participated in the 2019 annual PRI reporting and assessment process (covering the 2018 calendar year) and have received the PRI's independent assessment of our performance in terms of environmental, social and governance (ESG) integration within our investment process.

Overall, the assessment from the PRI continues to acknowledge our continued efforts in ESG investment risk management and progress. Below we outline BlueBay's PRI assessment results for the last three years.

	Score (A+ being highest and E being lowest)					
	2017 reporting cycle (2016 calendar year)		**2018 reporting cycle** (2017 calendar year)		**2019 reporting cycle** (2018 calendar year)	
Module/ Assessment results	**BlueBay**	**Median**	**BlueBay**	**Median**	**BlueBay**	**Median**
Strategy & Governance	A+	A	A+	A	A+	A
Fixed income – SSA	A+	B	A+	B	A+	B
Fixed income – corporate financials	A	B	A	B	A+	B
Fixed income – corporate non-financials	A	B	A	B	A+	B

Source: BlueBay Asset Management, as at September 2019

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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