BlueBay
Asset Management

CONTENTS

ESG investment review for the BlueBay Global High Yield ESG Bond Fund 1H 2019

Fund investment review

Market review and outlook

Global High Yield (HY) markets opened the year with renewed vigour quickly retracing all the drawdown experienced during Q4 2018. Although not quite displaying the exuberance of the first month of the quarter, gains were extended progressively throughout the period with the first quarter return of +7.10% ultimately the strongest quarterly performance since Q1 2012.

The markets received a boost from a variety of factors over the early part of the year. These included a productive and conciliatory tone around trade discussions, better than feared corporate earnings, stabilising energy markets, and an increasingly supportive central bank communique with a dovish tone and supportive actions from the Federal Reserve (Fed), European Central Bank (ECB) and Bank of China, all providing support to the wider market.

The positive tone continued into the second quarter although the return profile was far from a straight line. There was a noteworthy reversal in the middle of the period as a deterioration in global trade dynamics (following President Trump's somewhat surprising change in tack toward discussions with China), disappointing global growth data and a deterioration in the European political backdrop set a more bearish tone for risk markets generally. However, dovish and supportive rhetoric from both the ECB and the Fed (and some softening in trade related concerns) provided the catalyst for renewed optimism in HY markets during the latter part of the period however and resulted in a second quarter return of +2.62% and a first half return of +9.90%.

While risk market weakness – driven by growing global trade uncertainty and associated concerns over the prospects for global growth – appears for

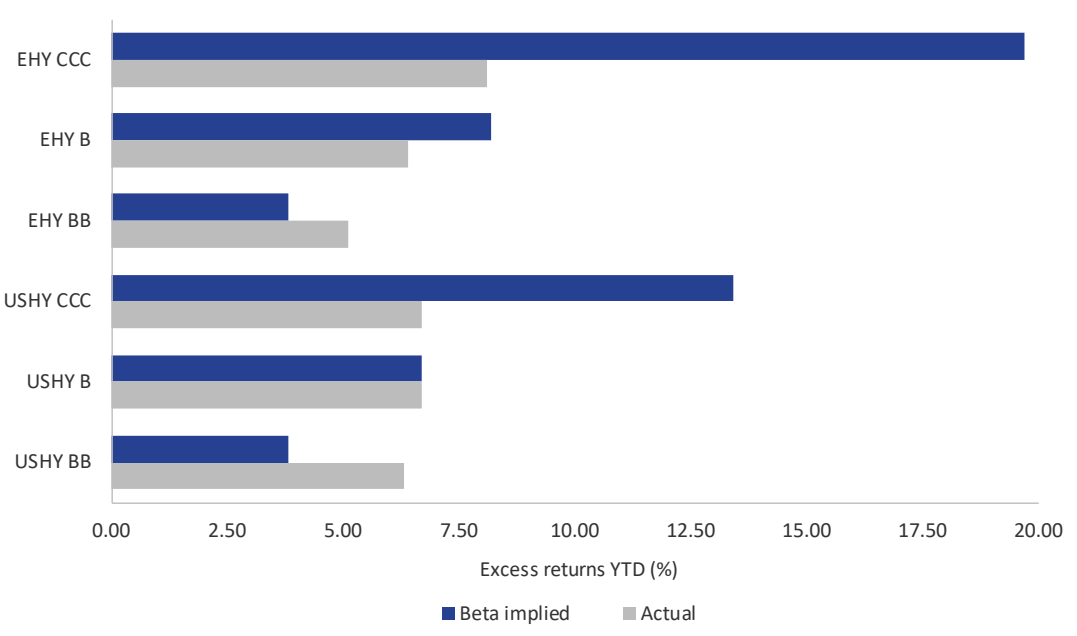
now at least to be a short-lived phenomenon, a degree of caution remains prudent. Although fundamentals for the wider corporate HY universe that we follow remain generally supportive, we prefer to express this view via traditionally less-cyclical sectors which are likely to prove more robust if recent concerns over trade and growth momentum do prove to be founded. As ever we remain cognizant of complacency and accordingly we remain focussed on credit selection and achieving the best risk adjusted returns in this slightly less certain environment while balancing appropriate levels of beta within our funds to capture current levels of central bank driven enthusiasm.

Fund performance

The Fund returned +9.37% gross of fees [1] over the first half of the year. It initially underperformed the benchmark in the first quarter where as a result of a slightly more defensive positioning coming into the year, we were caught slightly off-guard by the aggressive snap back in the market in the first 10 days of the year. There was also highly unusual outperformance of BB rated securities to which the Fund is underweight (relative to B and CCC rated issuers) which benefitted more from falling core rates (being more interest rate sensitive) and the markets apparent preference for "safe risk" (typically during periods of such significant positive market beta we would expect lower rated securities to outperform). However, the Fund subsequently outpaced the benchmark by around 40bps during the second half due to strong stock selection and an overweight in North American HY assets (which outperformed) underpinning returns.

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.

High Yield: Beta-implied vs. actual excess returns by rating [2]



Past performance is not indicative of future results.

2: Source: Bloomberg Barclays EU and US corporate credit indices and BlueBay calculations; latest data at 10 April 2019; Note: 1 In the chart above, the blue bar (and first column of numbers) shows by rating category the excess return year-to-date that ex ante would have been implied by the excess return YTD on the index as whole. The grey bar shows the actual YTD excess returns by rating category. If the grey bar (actual excess returns) is greater than the blue bar (the excess return ex ante implied by the return on the index), credit has out-performed on a beta-adjusted basis.

Fund Environment, Social & Governance (ESG) review

In our last Fund ESG newsletter we made some predictions about specific ESG related themes and developments where we expected to see activity and progress during 2019. The first six months of the year has already seen some of the environment related topics play out, specific climate change, natural resource use and public policy and regulation promoting more sustainable financial markets.

Firstly, on climate change, we observed heightened grassroots activism, spurred on by the 'school strike for the climate' protest outside the Swedish Parliament held by a lone Swedish girl, Greta Thunberg, in August 2018. The UK saw prolonged civil disruption by Extinction Rebellion activists that resulted in the government declaring an 'environment and climate emergency', making it the first national parliament to do so. The UK has since become the first G7 country to legislate a commitment to reach net zero carbon emissions by 2050. Such an ambitious target will require a complete low-carbon transition and reallocation of capital.

Keeping with the policy and regulation theme but expanding out the scope beyond the UK to Europe, June saw the European Commission launch a set of reports for consultation which covered a taxonomy for environmentally sustainable economic activities, Green Bond Standards and climate and ESG Benchmarks and disclosures guidelines by the Technical Expert Group on Sustainable Finance. It also published guidelines on how companies should report on climate-related risks. These documents are the latest developments in the EU's Sustainable Finance Action Plan, which commenced in March 2018 and seeks to clarify and standardise disclosure and definitions in the sustainable finance market and encourage progress towards a low-carbon, resilient and resource efficient economy. Such leadership by Europe has been taken up by Canada, which set up its own Expert Panel on Sustainable Finance in April 2018 and published its final report in June as well.

We very much welcome the ongoing efforts of the Commission to promote more sustainable fund markets. There are undoubtedly issues and challenges associated with the detail which will need to be worked through associated with the topics the reports cover, they provide useful starting framework to build on. There have been efforts to ensure social issues are not overlooked in the focus on climate and environment, such as in the green taxonomy guidelines. This is important as achieving the UN sustainable development goals (UN SDGs) requires action by policy makers across the ESG spectrum.

As we move into the second half of 2019, societal expectations around sustainable consumption are continuing to intensify with regulatory shifts responding to increased desire for change. The EU has voted to ban the top-10 single-use plastics from 2021 and is considering targets for increased recycling of plastic bottles, with Canada announcing plans to follow suit.

The 'Greta Thunberg effect'

Aged 15, Greta's personal activism calling for the need for immediate action to combat climate change began in August when her recurring and solitary protests outside the Swedish Parliament in Stockholm began attracting media coverage. It initiated the 'School strike for climate' movement that formed in November 2018, that grew materially after the UN climate change conference in December 2018. On two occasions, In March and May, we witnessed more than one million students each time in over 100 countries around the world join her call in striking and protesting for climate action.

She has now participated in numerous events and met with various government representatives and politicians where she has given her unique outspoken stance about how the inaction of those currently in charge of society are endangering the quality of life for her and future generations. Greta continues to campaign and advocate for climate action and her efforts continue to inspire those around her concerned about the lack of, and pace of change.

Photo: Anders Hellberg

Incorporating ESG factors within the Fund's investment process

In principle, companies which offer products or services to promote good human health align well with the Fund's ESG investment philosophy. However, we also recognize that the nature of the product and how a company makes them available can potentially raise ESG concerns and result in investment material legal, regulatory and reputational risks. This is something which the drug industry has experienced first-hand in recent years, as following numerous revelations of unethical or responsible business practices, we have seen regulators clamp down hard on poor practices and growing mistrust from the public at large.

In identifying potential investment opportunities in the drug sector, we take a considered view which encompasses potential sensitivities related to the therapeutic areas the company is active in as well as their ESG performance track record on key issues such as research ethics, quality & safety, talent management, access to medicines as well as general environmental operational compliance.

A company we recently reviewed for potential investment as in the market for a new issue was Endo International. This is an Irish-domiciled but primarily US focussed pharma company with meaningful exposure to opioid products, which offer pain relief to users. Usage of opioids is of increasing concern from a public health perspective as a result of growing misuse (see below graphic), which is leading to patients seeking stronger doses which not only adds to healthcare costs but heightens the risk of death from overdose. The drug industry has come under scrutiny with allegations of aggressive marketing that downplay addiction risks, promoting misuse of the product and lack sufficient product warnings. There are now legal proceedings in the US courts against drug companies as a result including Endo, and risks are high of the US government introducing legislation in response to growing concerns which would potentially materially impact players active in this product area. Our ESG analysis of Endo also considered the company's wider ESG practices. On this aspect, we feel that its practices were not sufficiently progressive given the high risk exposure it faces of being in the drug industry per se, but especially given its link to opioids.

As a result of both elements of the ESG analysis summarised above, we concluded the company was not a suitable investment for the Fund. Charlie Whinery, our HY Healthcare analyst believes the ESG risks are investment relevant and potentially material for Endo. *"The opioid exposure represents an unquantified liability which has a high risk of materialising"* explains Charlie, *"... and given its modest ESG efforts, there are concerns about the company's ability to manage this risk effectively."*

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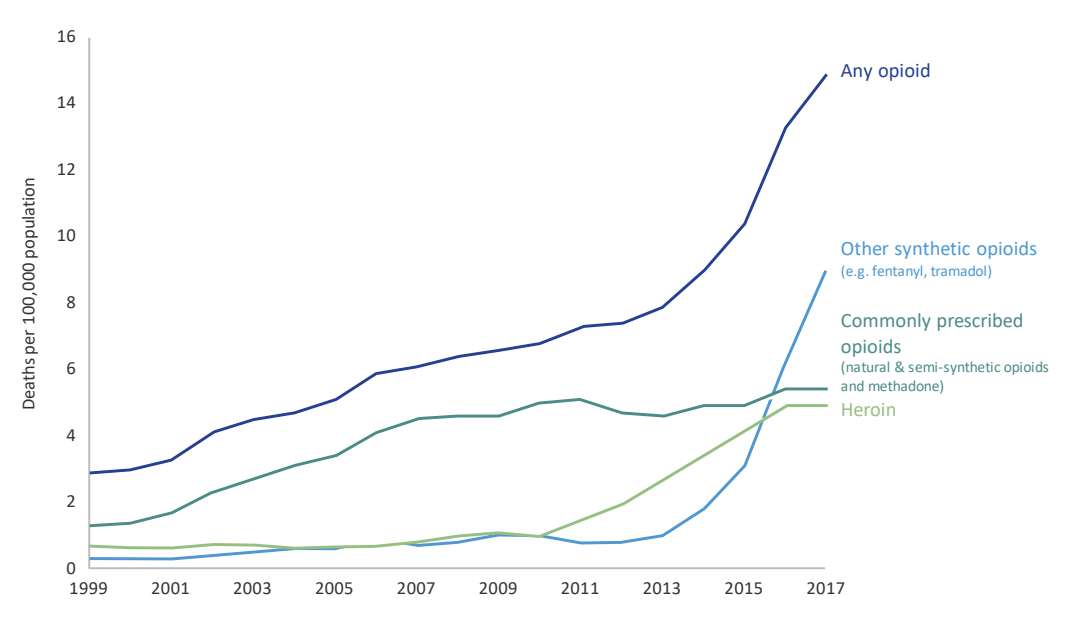
Overdose death rates involving opioids, by type, United States, 2000–2017



Source: Centers for Disease Control and Prevention; National Vital Statistics System Mortality File

BlueBay ESG investment news

Ensuring transparency in our ESG investment efforts

We published our third annual ESG investment report in June 2019, available here. The report highlights our activities, progress and accomplishments during the 2018 calendar year.

2018 was a pivotal year for BlueBay from an ESG perspective, both internally and externally. We made significant progress on our journey to more systematically integrate ESG into the credit research process across our public-debt investment strategies whilst also furthering our collaborative industry efforts to drive the sharing of knowledge and insights and advance industry ESG debt investing practices; some highlights relating to the latter are provided below.

Whilst we are proud of our achievements to date, there is still much to do given the criticality of ESG to our business and industry. ESG has been earmarked as one of two firm-wide strategic priorities for 2019, underpinning our commitment in this area, and as such we look forward to updating on our continued progress.

The results show that taking ESG factors into account can identify alpha generating opportunities for investors.

Collaborations to advance thinking and practice on ESG debt investing in sovereigns

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

Separately, we have collaborated with our sovereign ESG vendor, Verisk Maplecroft on a joint research project exploring the materiality of ESG factors for sovereign debt investing and their impact on investment performance. The research introduces an innovative way of quantifying the relationship between ESG and sovereigns.

The report was published in 2019 and is available here. Of the many key findings, the results show that taking ESG factors into account can identify alpha generating opportunities for investors. We welcome feedback on the research results.

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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