

ESG investment review for the BlueBay Global High Yield ESG Bond Fund 2H 2018

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Market review and outlook

Performance of leveraged credit markets in the second half of 2018 was bifurcated to say the least. Q3 represented the first positive quarterly return of the year with gains driven by strong corporate earnings and a strong technical backdrop fuelled by limited primary market supply in US high yield bond markets in particular. Of note, a resumption of political volatility in Europe and a rise in idiosyncratic corporate risks weighed on the wider European region causing the spread differential between US and Europe to widen significantly.

The strength of the wider global high yield market in the third quarter was, however, completely reversed during the final quarter of the year as global growth prospects were reassessed and concerns grew over the complications of rising

trade tensions. In keeping with other risk markets, the ICE BofAML Global High Yield Investment Grade Index returned -3.90% in the final quarter, resulting in a full year return of -1.98%. Although our top-down views have clearly been challenged during the latter part of 2018 as risk markets across the board have been repriced, we do not believe this sell-off represents the end of the credit cycle.

Our core view remains that we are unlikely to experience a recessionary environment during 2019 – cycles rarely turn when underlying earnings growth remains in double digits irrespective of how long we have enjoyed the current phase of the cycle and indeed we believe recent widening in spreads provides a more compelling backdrop for the year ahead.

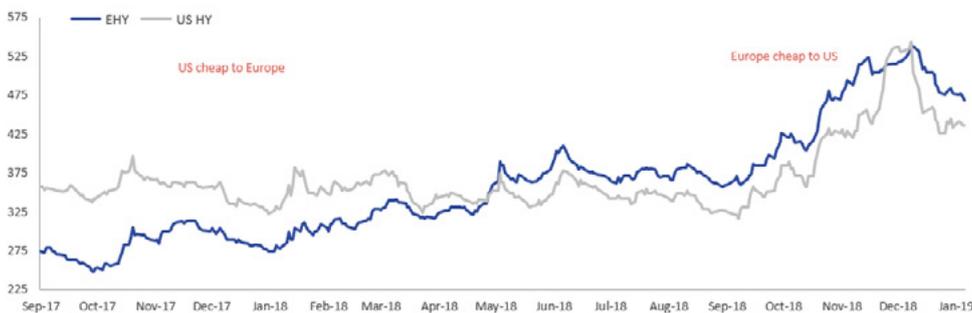
Fund performance

The Fund returned -1.05% gross of fees* over the second half of the year, outpacing the benchmark return by 53bps. Over the full year, the Fund returned -0.39% gross of fees, an outperformance versus benchmark of 158bps gross of fees. Keeping pace with the market strength during the third quarter, the outperformance during the second half was all in the final quarter as the Fund's focus on security selection and avoiding the key losses was

of particular importance. The Fund's preference for lower rate securities (and accordingly lower allocation to BB's) was a source of underperformance over the final part of the year – higher rated securities outperformed as core rates rallied amidst concerns over growth stability. That said, the Fund's preference for less cyclical sectors offset the drag from rating allocation as more growth sensitive securities underperformed.

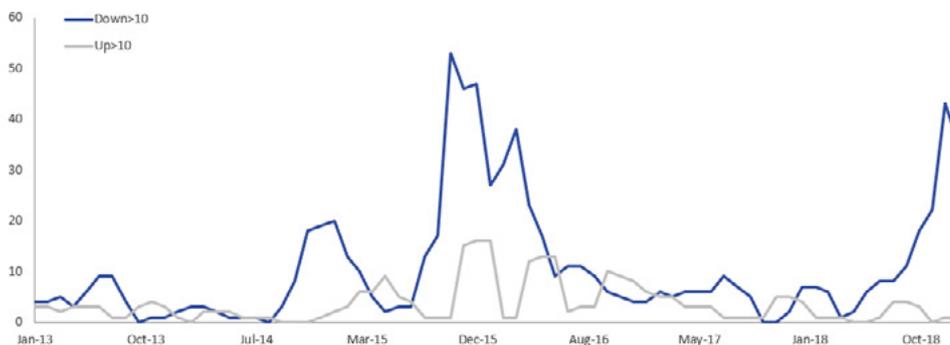
* While gross of fee figures would reflect the reinvestment of all dividends and earnings, it would not reflect the deduction of investment management and performance fees. An investor's return will be reduced by the deduction of applicable fees which will vary with the rate of return on the fund. For 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.

EUROPEAN VS US HY SPREADS (BPS)



Past performance is not indicative of future results.
Source: Bloomberg

NUMBER OF EUROPEAN HIGH YIELD BOND MOVING MORE THAN 10 POINTS PER MONTH



Source: JPMorgan

Fund ESG review

In this review, two observations are highlighted: increasing physical and scientific evidence that climate change is happening, and the results of our own survey illustrating 2018 represented the year when ESG meaningfully entered investment thinking and practice in the fixed income world. Lastly as the year closes, we outline our thoughts on how the ESG landscape will evolve in 2019.

But first to climate change. Throughout 2018, droughts, floods, fires, heatwaves, typhoons and hurricanes have been a feature of the news. Data was also published which suggested that 2018 is likely to be the fourth warmest on record with the planet's average temperature hovering close to 1°C above the levels recorded in 1850-1900¹. Beyond any human costs, such events are resulting in economic and financial costs in terms of insured losses, lost productivity and uninsured losses.²

¹ World Meteorological Organisation's (WMO)'s State of the Climate report, November 2018
http://ane4bf-datap1.s3-eu-west-1.amazonaws.com/wmoocms/s3fs-public/ckeditor/files/Draft_Statement_26_11_2018_v12_approved_jk_0.pdf?XUDp1UTyslkHog4_TTuiHszZ6A9D93

² Counting the Costs, Christian Aid, Dec 2018
<https://mediacentre.christianaid.org.uk/download?id=4170&pn=21e38f435ea050ce63ac6b7e52c58d72-pdf>

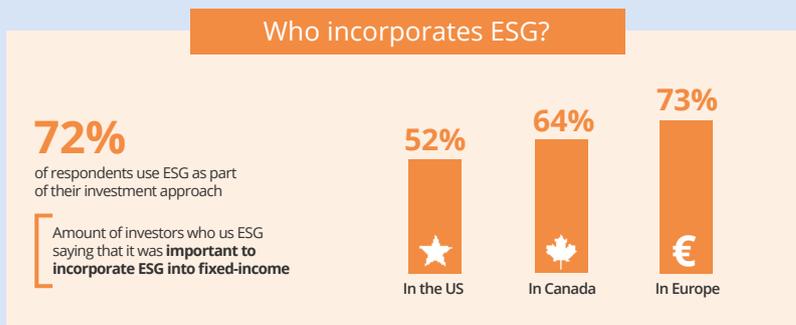
Survey reveals ESG incorporation is no longer an optional extra

Partnering with our parent company, RBC Global Asset Management, we conducted a survey of institutional investors and investment consultants to better understand evolving ESG investment trends. This was completed by investment professionals in Canada, Europe, Asia and the US. This year's survey included a detailed section on fixed income.

The results revealed that the adoption of ESG investing by asset owners is growing steadily as the focus moves from 'whether to' to 'how to' implement. A gap was also highlighted between what investors want and what is on offer regarding ESG-focused fixed income solutions.

ESG investing remains on a strong upward trend. The gaps that exist regarding information and resources illustrate that there is more to be done to build a fully functional market around ESG investing that meets the needs of investors and the consultants and managers that serve them.

Visit our website for more information about the survey and for a copy of the fixed income summary report can be accessed [here](#)



Source: BlueBay Asset Management LLP, October 2018

Looking ahead into 2019, we believe there will be activity and potential progress on the following ESG related areas and themes:

- **Investors step up demand on ESG incorporation:** as requirement grows for ESG integration across all investment strategies and a greater focus on the long-term, investors will step up their demands for credible evidence of this occurring, and this will increasingly be used as a manager selection filter. Against this trend, during 2018, BlueBay has been actively reviewing and refining its ESG investment progress, which we will report on in more detail next year.
- **Regulations and policies increasingly formalizing ESG expectations:** within Europe in particular, policy makers and regulators will further explore - and some start to implement - new measures to explicitly outline their ESG expectations of key players in the investment industry. BlueBay is supportive of the need to be transparent about our ESG investment efforts and performance outcomes and will continue to report on our thinking and progress. However, given how dynamic and broad approaches to ESG are, we believe it is important any measures avoid being overly prescriptive and narrow in scope.
- **A more strategic and holistic approach to sustainability continues to gain traction:** as governments and investors look beyond economic indicators for sustainable growth and wellbeing, those companies and investors that can demonstrate the extent to which they are investing *for* impact (e.g. contribute to the UN SDGs directly with targeted impacting investing such as through green and sustainability bonds), and/or investing *with* impact (e.g. being responsible stewards) will gain competitive advantage. BlueBay's fund offerings fall into the latter category, although in practice, where it makes sense to do so, we will invest in issuers which generate positive ESG impacts.
- **Key themes remain climate change, sustainable resource use and managing social capital:** we see climate change continuing to dominate the ESG agenda during 2019, along with sustainable use of natural resources and more equitable management of human capital (see box for more details).

2019 ESG themes to watch

- **Climate change:** reporting on and quantifying risk exposure and resilience to climate risk will intensify. Whilst BlueBay's ESG investment efforts already consider carbon risk where this is considered a material risk issue, we will further explore ways to detail how this is being done. When companies are high risk, there will be more scrutiny of their targets, how this aligns with the Paris Climate Agreement and how they mitigate and adapt to physical, regulatory, technological and liability risks.
- **Sustainable consumption and the circular economy:** as the war on plastics from this year shows, efforts to promote more sustainable consumption patterns (in terms of resource use, waste and pollution), are likely to be the start of a wider push in 2019 for society to move from a linear to a circular economy. Corporate supply chains will increasingly be an area of focus. We predict attention will expand to including packaging material as well as clothing and other household goods.
- **Digitalization risks and opportunities:** ongoing implications of the digitalization trend will continue to emerge in 2019. This is likely to materially change the shape of critical societal infrastructure and some services. As part of the PRI working group, we have been focusing on cybersecurity risks and opportunities. As such, we believe we are well placed to track developments in this sector and understand what emerging good practice looks like.
- **Enhancing social capital:** efforts to tackle discrimination, inequalities and social inclusion are likely to increase given their link to increasing social and political tensions and as well as global unrest.

Incorporating ESG factors within the Fund's investment process

Beyond specific business activities formally excluded by the Fund, we may potentially invest in companies in high ESG impact sectors. However, our ESG integration process is such that we place higher hurdles of what is considered acceptable as minimum ESG practices to effectively mitigate potentially heightened credit risks. A good example of this in action is the analysis we conducted of Baffinland Iron Mines Corporation (BIM), an open pit iron mine in the Mary River area of Baffin Island, Nunavut, Canada.

From the credit research, the investment team had a positive view on the corporate fundamentals of BIM, believing it to have a high quality asset (it has one of the highest grade of iron ore globally) with strong debt coverage, supported by a significant equity component and a growth trajectory that was expected to translate into materially higher earnings and future deleveraging. That being said, we were cognisant that the nature of the operations and its geographical footprint exposes BIM and its surrounding environment (both physical and in relation to local communities) to a range of ESG risks that cannot be understated and needed to be balanced against the investment fundamentals.

From our ESG analysis, it was apparent that from an environmental management perspective, BIM has been able to streamline its operations so as to reduce the amount of processing required on-site, including no need for on-site tailings management, hence positioning it well against peers particularly in light of recent industry events. The company is also planning to expand its rail logistics, replacing the current fleet of haul trucks, which will further enhance its efforts to reduce emissions and lower its overall environmental footprint.

In terms of the social perspective, an imperative consideration for us was disruption to the native Nunavut Inuit community where in the past there have been tensions over displacement and concerns over impacts associated with operations, both to the local population and biodiversity more generally. However, we believe that these tensions have largely been resolved, particularly in relation to the Qikiqtani Inuit Association (QIA) and North Baffin communities, where BIM has delivered long-term benefits including employment and training opportunities. BIM has spent approximately US\$5.3mn in environmental and regional sustainability development initiatives as recently as 2017.

Based on our research we view BIM as a company that has been proactive in managing its material ESG exposure, offsetting risks by moving away from the more traditional methods used by peers. Further comfort comes from the lack of significant controversies despite operating in a highly sensitive area, and the efforts made to strengthen working relationships with the local native Nunavut community. As such we feel it would qualify for inclusion in the fund.

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Ensuring transparency in our ESG investment efforts

We published our second annual ESG investment report [here](#); covering the 2017 calendar year period, it provides highlights on some of the activities conducted, as well as sharing some case study examples of ESG analysis and engagement in action.

External assessment of our ESG efforts continue to show above average practices

We have been a signatory of the UN-supported Principles for Responsible Investment (PRI) since 2013. The PRI's independent assessment of our efforts, conclude that BlueBay continues to have progressive industry ESG practices.

Module / Assessment results	Score (pre 2015: A being highest and D being lowest possible); post 2015: A+ being highest and E being lowest)									
	2014 reporting cycle (2013 calendar year)		2015 reporting cycle (2014 calendar year)		2016 reporting cycle (2015 calendar year)		2017 reporting cycle (2016 calendar year)		2018 reporting cycle (2017 calendar year)	
	BlueBay	Median	BlueBay	Median	BlueBay	Median	BlueBay	Median	BlueBay	Median
Strategy & Governance	A	B	A	B	A+	B	A+	A	A+	A
Fixed income - SSA <small>(fixed income - government)</small>	A	D	A	E	A	C	A+	B	A+	B
Fixed income - corporate financials <small>(fixed income - corporates)</small>	B	D	A	C	A	C	A	B	A	B
Fixed income - corporate non-financials					A	C	A	B	A	B

Source: BlueBay, July 2018

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

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