BlueBay
Asset Management

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ESG investment review for the BlueBay Global High Yield ESG Fund 2H 2017

Fund investment review

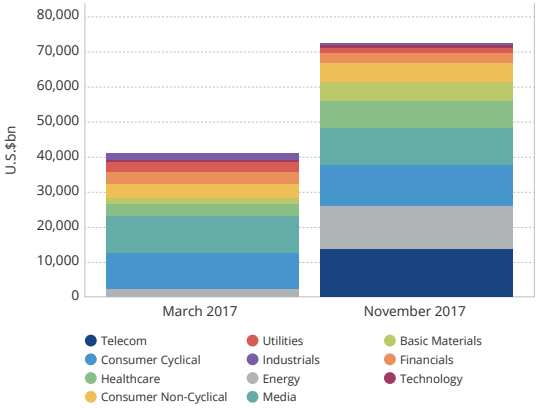
Following a pause toward the end of the second quarter, global leverage finance markets quickly resumed their upward momentum in the second half of 2017. The Bank of America Global High Yield Investment Grade Country Index returned +2.73%.

Market review and outlook

The wider backdrop remained supportive for the high yield market, with robust global growth, measured monetary policy normalisation, prudent corporate balance sheet management and generally strong corporate fundamentals. This positive tone was aided by optimism around the passage of the US tax reform bill and resulted in a negligible default rate, with the par-weighted US high yield default rate closing the year at 1.27% (down from 3.57% at the start of 2017).

Nevertheless, it remains important to highlight the notable rise in idiosyncratic risks both at sector and issuer level during the latter part of the year. This rise was in part responsible for market outflows, which weighed on performance.

RISING IDIOSYNCRATIC RISK AT A SECTOR LEVEL



Source: Morgan Stanley, 17 November 2017

We remain comfortable with the broader environment and are encouraged that corporates are not yet engaging in overly aggressive behaviour. Current stresses in the retail and telecoms sector are unlikely to have a meaningful impact on default rates in the foreseeable future, in our view. Simply 'owning the market' is not advisable at this stage of the credit cycle. Instead, our focus is on bottom-up credit selection and we seek alpha-generating opportunities through disciplined fundamental analysis.

Fund performance

The fund returned +2.98% gross of fees during the second half of the year, outperforming the benchmark. Since inception (8 February 2017) the fund returned +5.67%. Against a backdrop of strong risk markets but increasing dispersion, idiosyncratic risk performance was driven by single-name selection, with meaningful alpha generated both through concentrated overweight positions and by avoiding the worst performers at the benchmark level. Balance sheet repair positioning within the European banking sector was a noteworthy contributor. Likewise, selective positioning within the energy sector, which benefited from the improved demand / supply dynamic and the rising oil price, was a key driver of performance.

Fund environmental, social & governance (ESG) review

The second half of 2017 continued to be busy on the sustainable development and ESG investment front. Here we highlight a few events and developments which are particularly noteworthy.

- **International climate policy action:** efforts to scale up and coordinate international action on climate change continues. Government representatives convened in Bonn, Germany in November to translate the goals of the 2015 Paris agreement into concrete action. (see next page)
- **The ecological and health impacts of plastics in the environment is under the spotlight:** another environmental issue which is gaining increasing attention is the issue of plastics in our oceans. It has been estimated that eight million tonnes of plastic - bottles, packaging and other waste – end up in the ocean every year, harming marine life and entering the human food chain. Encouragingly in December, Britain joined nearly 200 countries in signing up to a UN resolution to eliminate plastic in the sea.
- **Promoting sustainable financials markets:** with increasing recognition that ESG factors can represent systematic market risks, governments and regulators are turning their attention to how they can proactively hardwire this into how markets operate. The European Commission has been visible in initiating efforts to inform on its action plans, with the setting up of a High Level Expert Group (HLEG) (we expand on this in a later section as BlueBay has participated in the HLEG public consultation).
- **Annual ESG investment conference evidences record interest by investors to integrate ESG:** encouragingly, the move of ESG into more mainstream thinking was apparent from the annual UN-supported Principles for Responsible Investment (PRI) event in Berlin, Germany in September. A meeting of professionals active in the ESG investing space, this year's event was oversubscribed, with approximately 1,000+ people meeting to discuss, debate, and strategize about moving the agenda forward. As well as moderating a panel on ESG bondholder engagement at the conference, BlueBay's ESG specialist, My-Linh Ngo found the event useful in identifying key themes for 2018 as well as updating knowledge on best practice.

My-Linh Ngo
ESG Specialist
Head of ESG
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THE BONN CLIMATE TALKS

Having agreed to self-determined carbon pledges (non-binding) to reduce emissions in the 2015 Paris agreement, this event was about governments developing the 'rule book' of the agreement.

On balance, the meeting closed with some progress having been made, but some ongoing challenges remained in terms of agreeing the politics and processes needed. The next international climate meeting will be in Poland in December this year, where the Paris rulebook should be decided and formally adopted.

Key take-aways

The science: there is increasing likelihood that the temperate rise will be more than two degree Celsius, although some analysis shows we are committed to 2.7-3.5 degree Celsius now, largely as result of assumption of withdrawal of commitment by USA.

Coal: there was continued pressure to push down coal consumption with a new 'Powering Past Coal' alliance announced by more than 20 countries and other sub-national actors including the UK, Canada, Denmark, New Zealand, and Mexico; as well as the US states of Washington and Oregon. The initiative focuses on unabated coal power generation, with members committing to setting coal phase out targets, to no further investments in unabated coal power generation domestically or internationally.

The US factor: following President Trump's announcement in June that America would withdraw from the Paris agreement by 2020, there were fears his administration would play an obstructive role in the talks. Fortunately that did not happen. It was apparent from the commitment of other countries including China, and the pledges of US States, cities and US private sector players, that federal USA is increasingly isolated on climate change. Significantly, the collective sum of the pledges of the 'We Are Still In' coalition of US cities, states, and companies add up to the equivalent of the original US pledge.

Carbon pricing & trading: plans for regulatory reform in Europe on carbon trading (aiming to increase carbon prices and make more ambitious climate goals achievable) were approved, this will increase costs for high carbon impact sectors.

Private sector action: numerous companies took the opportunity to announce collectively or individually new commitments and (science-based) targets on their own carbon footprints further demonstrating the growing proactive efforts of the private sector.

Looking to the US, Portfolio Manager Thomas Kreuzer is comfortable with our utilities positioning. We have no exposure to coal power, partly due to the fund's explicit screening, but also due to our investment view of the sector being challenged by costs, competition from renewables and increasing regulatory risk despite efforts by President Trump to roll back the Clean Power Plan. Oliver Grace, our energy sector corporate analyst, is conscious of the carbon profile of fossil fuels, favouring gas as a transitional fuel (given its lower carbon intensity).

Thomas and Justin Jewell believe we will soon start to see climate change risks impact markets from a top-down perspective. They believe idiosyncratic risks will rise as companies begin to differentiate themselves regarding how they respond to this challenge. A progressive approach to climate change is a proxy for management quality, especially for those in activities where this represents a material risk.

Incorporating ESG factors within the fund's investment process

Active consideration of a company's ESG efforts beyond formal negative screens

The fund has a formal set of negative screens that set a minimum standard, filtering out companies involved in certain business activities. These screens are benchmarked against international ESG standards. Additionally, we conduct in-house ESG assessments, where we may identify additional companies that are unsuitable for investment. As such, the fund benefits from the evolving knowledge and insights we have on ESG developments and best practices within BlueBay.

A good example is **PBF Energy**, a publicly traded US refining company. The investment rationale was positive as we viewed the company as benefiting from material operational improvements following extensive issues experienced during 2015 / 2016. Looking at third-party ESG data, the credit does not stand out as having particularly negative ESG performance issues; its low score is more due to a lack of progressive ESG efforts. But on further investigation and following dialogue with management, our energy analyst viewed the health and safety performance associated with its use of hydrofluoric acid as likely to become more of a concern, with reputational risks also increasing given that PBF operates in California. Despite the attractive valuation, given the high ESG risk exposure facing PBF and our view of insufficient mitigation efforts, we decided to divest from the company. There was no performance impact from exiting as the bonds were trading above par.

Oliver Grace
Senior Corporate Analyst

Engaging with companies on ESG risks

In late 2017, we attended a group investor meeting with representatives of **BNP Paribas** to get an updated overview of the company's sustainability strategy and performance.

The meeting reaffirmed our view of the company in terms of it having a holistic and credible approach to ESG, supported by broadly positive performance on key areas. BNP is one of the few banks to set a quantitative objective to measure its contribution to the UN sustainable development goals (SDGs).

We have witnessed an emerging trend within the last year whereby French institutions are looking to differentiate their ESG efforts by demonstrating leadership in areas such as climate change. We believe that France's political and regulatory positioning on climate change has been a major driver of this action. For BNP, efforts in this area include working to align its business practices with a two-degree Celsius temperature rise scenario. BNP is doing this by reducing its exposure to high-carbon industries, increasing its renewables exposure, developing methodologies to quantifying its carbon footprint and exploring ways to report credibly on its carbon impact.

To further improve, we would like to see BNP report more meaningfully on its management of cybersecurity, given the trend in digitalisation is set to fundamentally reshape the banking industry and forthcoming European legislation on data security and privacy.

"BNP is one of the leading banks in Europe and true globally systemically important financial institution. From a credit perspective, while capital ratios are robust, we see the key strength being the diversified and profitable business model, which allows for strong internal capital generation. This is underpinned by a clear strategic vision and a conservative approach to risk management."

James McDonald
Senior Corporate Analyst

Promoting best practice: ESG in fixed income investing

We believe it is important to work collaboratively with investors and key stakeholders to bring about positive change within the industry.

Chaired by BlueBay's My-Linh Ngo, the Advisory Committee on Credit Risks and Ratings is a working group focused on advancing efforts to integrate ESG considerations into credit risk analysis and ratings.

During early July, the group published a report, 'Shifting perceptions: ESG, credit risk and ratings', on thinking and practice in the market regarding how investors and credit rating agencies (CRAs) are looking at ESG in credit analysis, as well as outlining some of the main challenges and opportunities.

Key observations include:

- Investors and CRAs are both ramping up efforts to consider ESG factors in credit risk analysis, however, ESG integration is not yet systematic.
- Investors' and CRAs' views on the visibility and materiality of ESG factors vary, partly because they look at credit risk from different perspectives.
- Both parties need to improve the public reporting they do on ESG within their credit analysis.

The next step for the project will be the scheduling of a series of roundtables globally to explore the issues raised in the report and identify ways forward.

Further details on the group's work is available at: www.unpri.org/credit-ratings

My-Linh Ngo
ESG Specialist
Head of ESG
Investment Risk

Inputting into European public policy on sustainable financial markets

In October 2016, the European Commission established the High Level Expert Group (HLEG) to develop a comprehensive European strategy on sustainable finance. The group is composed of 20 experts from 'civil society', the business community and other non-public sector institutions. HLEG was established in has been active since January 2017.

The HLEG's interim report was published in July, containing early recommendations and key policy areas for further discussion. Based on the feedback from the public consultation, the HLEG will issue a final report in early January 2018, with the aim of the European Commission reviewing how to take these forward during the course of 2018.

BlueBay provided responses to the public consultation which closed in late September. Overall, we are broadly supportive of the recommendations and policy areas to be addressed in order to ensure Europe balances better finance with better development.

Specifically:

- We support efforts to establish a set of principles of fiduciary duty and related concepts of loyalty and prudence, which requires consideration of non-financial and longer term risks.
- We recognise the establishment of a classification system for assets and products that capture all acceptable definitions of 'sustainable' is critical to improving awareness and improve clarity to direct investment flows, although these need to be flexible and inclusive to acknowledge the different valid approaches which exist now and could exist in the future.
- We believe it is important to require public transparency about purpose, approach and performance on ESG related matters to build trust and confidence in the market.

We look forward to the publication of the final HLEG report, and continuing to play our part in establishing a sustainable European financial market whereby sustainability is a guiding thread in Europe's financial system, and continue to ensure Europe leads by example in the area of green and sustainable finance.

BlueBay ESG investment news

External recognition of our ongoing efforts on ESG

As a member of the UN-supported Principles for Responsible Investment (PRI) since July 2013, BlueBay has been submitting a self-completed questionnaire which details our efforts to incorporate ESG into our investment activities. Following this, each year the PRI provides a summary assessment report, benchmarking our efforts with peers.

We participated in the latest annual PRI Reporting & Assessment process covering the full year 2016 (read our 2017 Transparency report on our website) and during the second half of 2017, received our assessment report.

Overall, as in previous years, the PRI assessment has continued to recognise our ongoing progress in ESG investment risk management. In summary, the results of our PRI assessment are as follows:

- In the **Strategy and Governance** module we ranked A*, which was above the median score of A.
- In the three modules relating to specific fixed income sub-asset classes **(fixed income – SSA; fixed income –corporate financial; and fixed income – corporate non-financial)** we ranked A+, A and A respectively, which was above the median score of B for all.

SUMMARY SCORECARD

AUM	MODULE NAME	YOUR SCORE	YOUR SCORE / MEDIAN SCORE
	01. Strategy & Governance	A+	A
Direct & Active Ownership Modules			
10-50%	12. Fixed Income - SSA	A+	B
10-50%	13. Fixed Income - Corporate Financial	A	B
10-50%	14. Fixed Income - Corporate Non-Financial	A	B

Note: the top score possible is A+, the lowest is E.

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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