BlueBay
Asset Management

Responsible investment

David Riley
Chief Investment Strategist, BlueBay Asset Management

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Ignoring ESG factors is a risk investors can no longer afford to take. Our future must be sustainable. Those who embrace change and marry return objectives with ethical principles look set to be rewarded with improved performance profiles over the long term.

Summary

- Considering ESG factors has become mainstream for investors around the world, led by Europe.
- The Covid-19 pandemic has placed even greater importance on the consideration of societal risks to the economy.
- ESG investment 'tilts' take a long-term view that favour companies and countries with greater resilience and benefit from the transition to a zero-carbon economy.
- ESG strategies generally experienced smaller drawdowns than broad market indices, reflecting the typically greater resilience of companies with higher ESG ratings.
- In our view, effectively incorporating ESG considerations into an investment process can enhance risk-adjusted returns by capturing a broader range of risk factors and exploiting mispricings.

Responsible investment and sustainable finance have become hot topics across the industry. Both approaches incorporate environmental, social and governance (ESG) principles into business decisions and investment strategies, marrying return objectives with ethical principles. The issues covered range from climate change and pollution to labour standards, cybersecurity and corporate behaviour.

According to the latest RBC Global Asset Management 2020 Responsible Investment Survey, 75% of investors integrate ESG principles into their investment approach and decision making, although US investors lag well behind their global counterparts in ESG adoption (65% compared with 94% of respondents in Europe and 72% in Asia).

The Covid-19 pandemic is reinforcing the importance of responsible investment with greater investor focus on supply-chain risk and workplace culture, including the safety of employees. The pandemic is also prompting investors to

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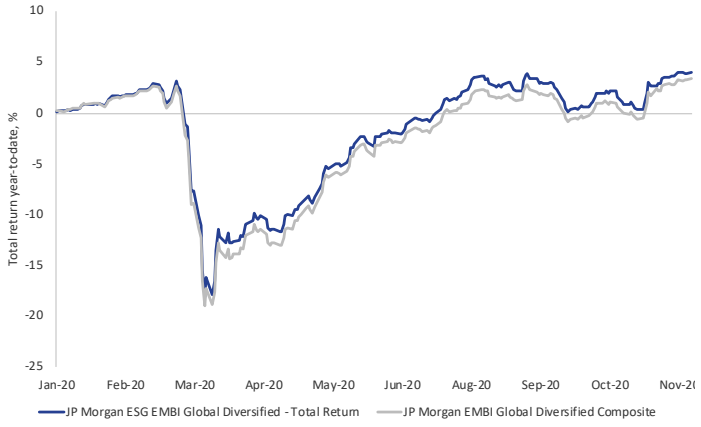
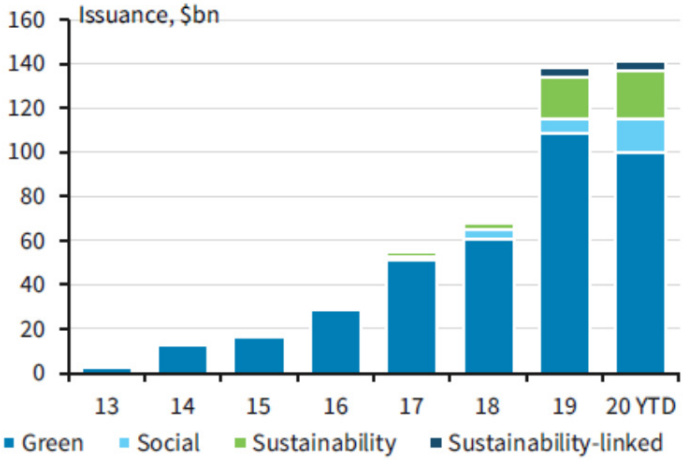
Chart 1: ESG versus conventional emerging market debt index in 2020



Source: JP Morgan, 27 November 2020

Chart 2: Corporate ESG bond issuance by type



Note: Corporate issuers only. Developed-market hard-currency bonds only.
Source: Dealogic, Barclays Research, November 2020.

pay closer attention to climate change, which according to the World Health Organisation, threatens the health of the global population, including from greater vulnerability to infectious diseases.

Many investors worry that responsible investment implies lower returns because 'brown industries' and other sectors associated with harm, such as tobacco and munitions, are excluded from the opportunity set. But this could be considered a short-sighted view.

The incorporation of ESG factors allows investors to identify companies with potentially higher long-term value creation, avoid assets with mispriced costs from climate change, and reduce portfolio exposure to social and governance risks.

There is evidence that investment strategies that have a 'tilt' towards positioning overweight highly scoring ESG securities and those with improving ESG ratings outperform their conventional counterparts. According to Morningstar data, during episodes of market volatility, including the Covid-related sell-off in the first quarter of 2020, ESG strategies generally experienced smaller drawdowns than broad market indices, reflecting the typically greater resilience of companies with higher ESG ratings.

In our view, effectively incorporating ESG considerations into an investment process can enhance risk-adjusted returns by capturing a broader range of risk factors and exploiting the mispricing of ESG risks. Market pricing of ESG risks is imperfect and highly non-linear, making markets prone to sharp repricing risks when factors reach tipping points.

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We also believe it is important for investors to engage with companies and governments to encourage greater transparency and sustainable policies. For example, at BlueBay, we co-chair the Investors' Policy Dialogue on Deforestation to support active dialogue with the Brazilian authorities. The aim is to promote the message that investors are concerned about sustainability and that it impacts investment decisions.

Increasingly, asset-owners are demanding that investment managers go beyond negative ESG-screening and actively engage with issuers to demonstrate a beneficial social and environmental impact, alongside positive investment returns.

Governments, central banks and asset-owners are all promoting sustainable investment, reflecting the key role

finance can play in addressing the profound economic, social and environmental challenges facing the world. Greater demand has been met by the rising supply of ESG and green bonds, but the lack of widely accepted and enforced standards are raising justified concerns around 'green' and 'social washing'. We believe these concerns underscore the importance of proprietary research, engagement with management and active investment as the most effective ways to incorporate ESG and reflect asset-owner demand for responsible investments.

We anticipate the transition to a net zero-carbon emission economy over the coming decades will have a profound impact on the investment landscape. Investors able to identify the companies, sectors and countries that will benefit from a shift to a low-carbon economy and that are resilient to the physical and transition risks associated with climate change should be rewarded. Neither investors nor businesses can continue to ignore both the risks and opportunities that stem from the secular trend towards sustainable investment.

DISCLAIMER

Disclosure