BlueBay
Asset Management

Active ESG investing
The smart choice for bond investors

The benefits of incorporating ESG factors into an active investment approach are becoming increasingly apparent.

Market Insight

by
My-Linh Ngo

Senior ESG Analyst

Published November 2016

Environmental, social and governance (ESG) investing involves investment strategies that proactively incorporate ESG or sustainability factors within the investment process.

In our view, incorporating ESG is the right and smart approach for investors to consider. Robust ESG management by companies can be taken as a proxy for overall management quality. Taking ESG into account can thus help identify companies most likely to be financially successful as they have a greater probability of having effective and enduring business models. In this way ESG investing should help portfolios deliver performance over the long term as well as lower their volatility in the interim.

We believe ESG is generally fits well with an active management approach as many ESG risks are currently not adequately priced in by the market. Active management is particularly critical for ESG fixed income investing given some of the unique technical characteristics of the asset class.

Fixed income investing is generally well suited to active management

In recent times, passive or index investing has become an increasingly popular strategy for many investors as part of their asset allocation decisions. Most common in the equity asset class, it has started to spread into others, including fixed income.

While the arguments about the broad advantages and disadvantages of active versus passive management are well known, the main attractiveness of a passive approach is the perceived lower costs. However, in our view, a passive approach is likely to be a false economy over time and in some fund offerings (e.g. fixed income), may not hold true. We see many drawbacks to passive investing in the fixed income context which are summarised in the Figure 1.

RBC Global Asset Management

Figure 1: Comparing the advantages and disadvantages of passive and active investing in the fixed income context

Fixed income investing strategies/factor	Default avoidance	Diversification benefits	Application of fundamental research	Access to liquidity	Costs / fees
Passive	LOW (own most of the market, so own the defaults in it)	MEDIUM (high for some funds, but low in others e.g. EMD/HY indexes capture limited portion/most tradable issuers)	LOW (largest weights/highest allocations made up of most indebted issuers; highly heterogeneous asset class esp. EMD sovereigns, idiosyncratic risk profiles as countries are at different stages of economic development)	MEDIUM (financial crisis has led to regulation which has reduced market liquidity, resulted in trade size and access to brokers challenges)	LOW (lower manager transaction costs can be passed on in terms of lower fee)
Active	HIGH (only own part of the market)	MEDIUM (allocation independent of country indebtedness, tradability, can pick from any part of the market)	HIGH (expert analysis possible of issuers taking into account unique conditions to identify alpha opportunities)	MEDIUM (ability to size trades appropriately and access brokers with scale)	MEDIUM (higher manager transaction costs some of which are passed on in fees)

Active ESG investing particularly relevant for fixed income

ESG investing lends itself well to active management; currently ESG risks are not widely known in the market and therefore risks as well as opportunities, are not necessarily fully priced. Active management enables investors to explicitly, proactively and systematically take these into account.

Alongside financial credit analysis, active managers can use ESG as an additional filter; used as a proxy for management quality, it can be argued that a low- ESG rated issuer is likely to be riskier, more volatile and less liquid in some cases which the credit rating does not sufficient reflect.

The reason for poor ESG performance could be related to inadequate governance, weak employee relations or ineffective internal compliance measures. An active manager is able to evaluate these nuances and make a decision whether to avoid or limit exposure to such an issuer.

The fixed income universe is larger and more complex than equity markets which may mean a passive investment approach could be too simplistic in terms of generating alpha. There is more variation in credit quality, the number of investible instruments from a single issuer and a range of bond maturities. This, alongside the reduction in the willingness of banks to warehouse risk, can further reduce the level of liquidity in the market for some bonds and potentially increase associated transactional costs and complexity.

Due to the multi-dimensional nature of fixed income assets, different bond types (duration, rating etc.) for a single issuer may exhibit multiple credit and ESG risk profiles. An active management approach can identify and more effectively disaggregate the investment risks and rewards. Applying a binary 'in or out' decision on exposure that investors would get with an ESG fixed income index offering would not allow for this fundamental dynamic and could mean investors lose out on opportunities for attractive return generation.

Increasing the potential for attractive returns with active ESG fixed income investing

We believe ESG is fast becoming an increasingly important and dynamic influence for investors when looking at their investment objectives and the way in which they select an asset manager. An increased awareness of ESG factors and an active approach can potentially have a material impact on an issuer's long-term financial performance. In our view there are numerous benefits from incorporating ESG into an active management approach, especially for debt investors.

In the current environment of low average yields across many asset classes, and the increasing belief that we are approaching the latter stages of the credit cycle, we believe benchmark returns could be challenged and the benefits of active investing will become all too apparent. Incorporating additional analysis which can provide further insight into the creditworthiness of a company or sovereign should surely be viewed as a valuable tool for enhancing long-term investor returns.

This document is issued in the United Kingdom (UK) by BlueBay Asset Management LLP (BlueBay), which is authorised and regulated by the UK Financial Conduct Authority (FCA). BlueBay is also registered as an investment adviser with the US Securities and Exchange Commission (SEC), and as a commodity pool operator and commodity trading advisor with the National Futures Association (NFA) as authorised by the US Commodity Futures Trading Commission (CFTC). To the extent this document is accessible outside of the UK, it is issued by the following respective Bluebay entities or affiliates. In the United States, by BlueBay Asset Management USA LLC, which is registered as an investment adviser with the SEC and as an introducing broker with the NFA. In Japan, by BlueBay Asset Management International Limited which is registered with the Kanto Local Finance Bureau of Ministry of Finance, Japan. In Hong Kong, by BlueBay Hong Kong Limited which is registered by the Securities and Futures Commission. In Switzerland by BlueBay Asset Management AG where the Representative and Paying Agent is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich, Switzerland. In Australia, BlueBay is exempt from the requirement to hold an Australian financial services licence under the Corporations Act in respect of financial services as it is regulated by the FCA under the laws of the UK which differ from Australian laws. In Canada, BlueBay is not registered under securities laws and is relying on the international dealer exemption under applicable provincial securities legislation, which permit BlueBay to carry out certain specified dealer activities for those Canadian residents that qualify as "a Canadian permitted client", as such term is defined under applicable securities legislation. The registrations and memberships noted should not be interpreted as an endorsement or approval of any of the BlueBay entities identified by the respective licensing or registering authorities.The document is provided for informational purposes only. It is not intended, nor should it be interpreted as investment, tax or legal advice. This document does not constitute an offer to sell nor is it a solicitation of an offer to purchase any security or investment product in any jurisdiction. This document is not available for distribution in any jurisdiction where such distribution would be prohibited and is not aimed at such persons in those jurisdictions. **Past performance is not indicative of future results.** BlueBay makes no express or implied warranties or representations with respect to the information contained in this document and hereby expressly disclaim all warranties of accuracy, completeness or fitness for a particular purpose. BlueBay is under no obligation to update the information in this document to reflect changes after the publication date. The information contained in this document is believed to be reliable, but BlueBay cannot and does not guarantee its accuracy, timeliness or completeness.No part of this document may be reproduced in any manner without the prior written permission of BlueBay. In the United States, this document may be provided by RBC Global Asset Management (U.S.) Inc. ("RBC GAM-US"), an SEC registered investment adviser. RBC Global Asset Management (RBC GAM) is the asset management division of Royal Bank of Canada (RBC) which includes BlueBay, RBC GAM-US, RBC Alternative Asset Management Inc., and RBC Global Asset Management Inc., which are separate, but affiliated corporate entities. Copyright 2016 © BlueBay, is a wholly-owned subsidiary of RBC and BlueBay may be considered to be related and/or connected to RBC and its other affiliates. ® Registered trademark of RBC. RBC GAM is a trademark of RBC. BlueBay Asset Management LLP, registered office 77 Grosvenor Street, London W1K 3JR, partnership registered in England and Wales number OC370085. All rights reserved. Published February 2016.

Contact us

Marketing and Client Relations Department
77 Grosvenor Street
London W1K 3JR

Tel: +44 (0)20 7389 3775
marketing@bluebay.com

www.bluebay.com