# ESG Integration in Fixed Income

## Mercer Training Session

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- The value of investments can go down as well as up and investors may not get back the amount invested.
- This fund invests in overseas markets and the value of investments can be affected by changes in currency exchange rates.
- This fund invests in emerging markets which can be more volatile than other more developed markets.
- This fund uses financial derivative instruments for investment purposes, which may expose the fund to a higher degree of risk and can cause investments to experience larger than average price fluctuations.
- Reference to specific securities should not be construed as a recommendation to buy or sell these securities and is included for the purposes of illustration only.
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- Investors should note that the views expressed may no longer be current and may have already been acted upon.
- Past performance is not a reliable indicator of future returns.

# ESG in Fixed Income

# Evolution of ESG and Fixed Income

## We have entering the next generation of ESG investing

**Early 2000's Pre-ESG**

- Focus on Governance factors emphasised by high profile corporate scandals
- Name specific exclusions
- Aligning investments with beneficiary values (e.g. religious mandates)

**2008-2015 Early ESG**

- Reputational risk; new regulation, regulatory risk
- Emerging global social norms and social licence to operate (e.g. banks)
- High profile industrial accidents highlights the potential for monetisation of ESG risks e.g. Macondo

**2015-2020 Maturing ESG**

- Post-Paris Agreement rise in Green bond issuance
- Rise in popularity of broader exclusions (Tobacco, Coal, Weapons)
- Credit analysis; quant research

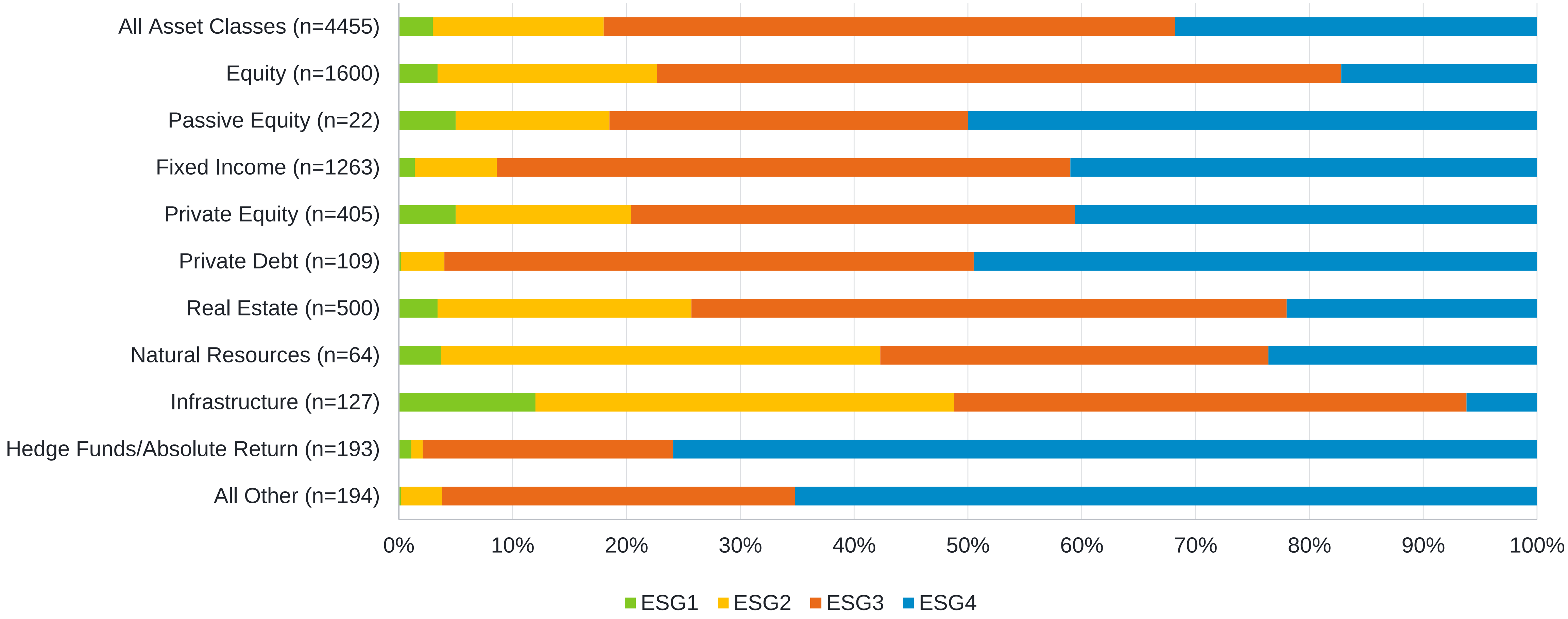
**Next Generation**

- Regulatory alignment (?)
- Macro societal influence; millennials
- Focus on climate transition
- Innovation in ESG instruments (Social, Sustainable, KPI-linked

Source: Fidelity International, Bloomberg "ESG Investment Insights: Investing in Fixed Income ESG" 2020

# ESG integration progress report

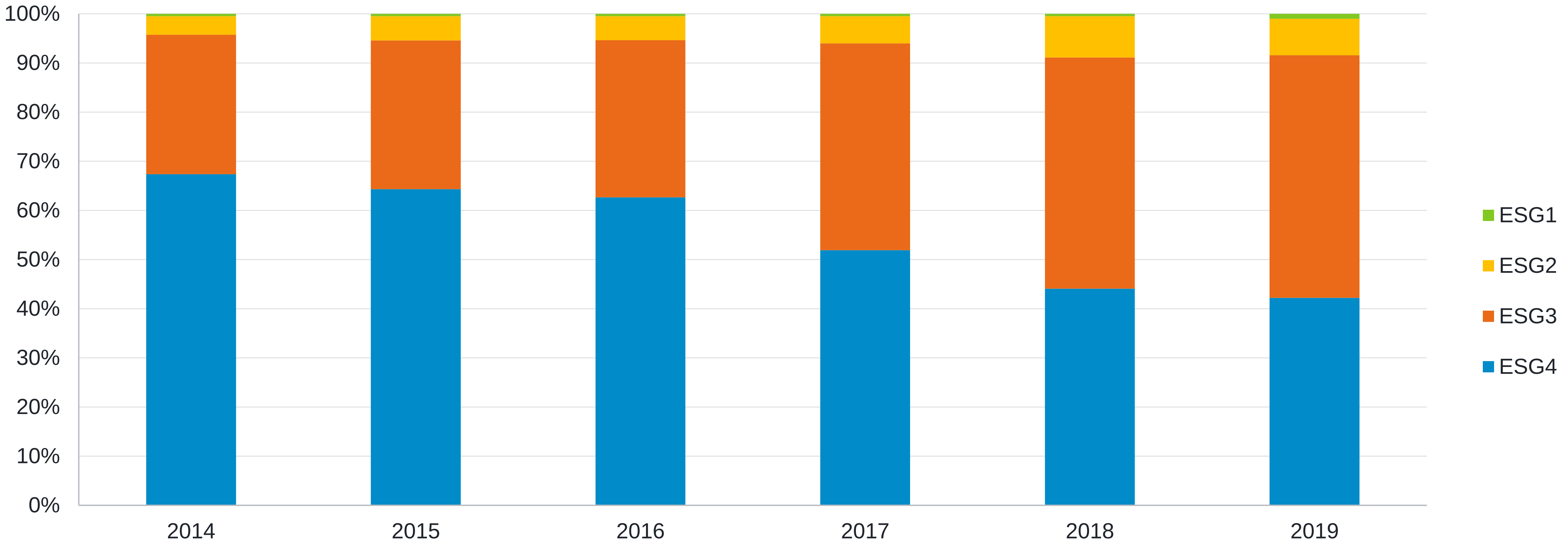
## Distribution of Mercer's ESG ratings (1=best)




Source: Mercer – 2020.

# Evolution of ESG integration in Fixed Income strategies

## Distribution of Mercer's ESG ratings in Fixed Income strategies (1=best)




Source: Mercer – Responsible Investment in Fixed Income report, 2019.

# Why are bonds different?

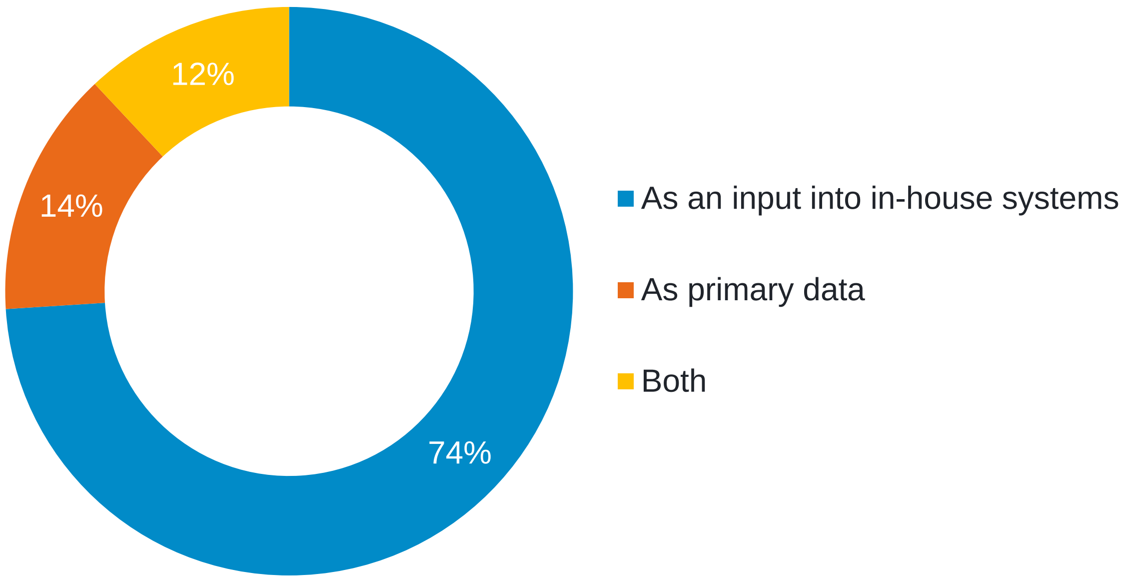
## Key differences between ESG integration for equities and fixed income instruments

| ESG Integration | Equities | Fixed Income | Implications |
|---|---|---|---|
| **Entities** | Publicly listed companies | Public and private companies, governments, supranationals, quasi-sovereigns | Data availability, mapping of corporate structure, bondholders as the only public source of capital (pressure) i.e. SOEs |
| **Performance** | Upside return potential & downside risk mitigation | Downside risk mitigation | Equities benefit to upside of secular trends (i.e. decarbonisation) vs focus on avoidance of risks for FI investors |
| **Access** | Broad access to management and Board, including CEO, Chairman, and CFO / Treasury | Typically more narrow access to CFO / Treasury teams and often during new issue more than routine | Equities can often have a bigger voice on sustainability. Integration of the Fixed Income team with the Equities ESG team can increase Fixed Income's impact |
| **Frequency and type of contact** | Regular around results. Often one-on-one for large investors | Can be frequent or infrequent depending on the importance of Fixed Income and the frequency and type of new issue. Often group meetings, limiting one-on-one interaction. | Equities often has an easier time engaging with companies than Fixed Income |
| **Voting** | Routine and well-established voting process at AGMs | No voting except in consent solicitations | Equities can explicitly make their opinions known in a way Fixed Income cannot |
| **Engagement** | Routine and explicit | Newer and may be explicit and implicit | Higher frequency and breadth of engagement increases touch points and leverage generally favouring Equities over Fixed Income |

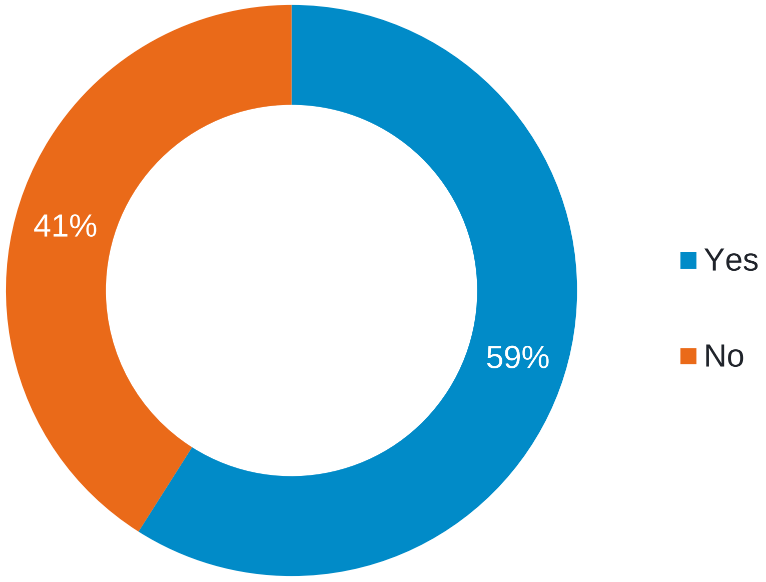
# ESG is Important for Fixed Income investors

But the data providers still struggle to match needs

### Fixed Income Investors Using ESG Data



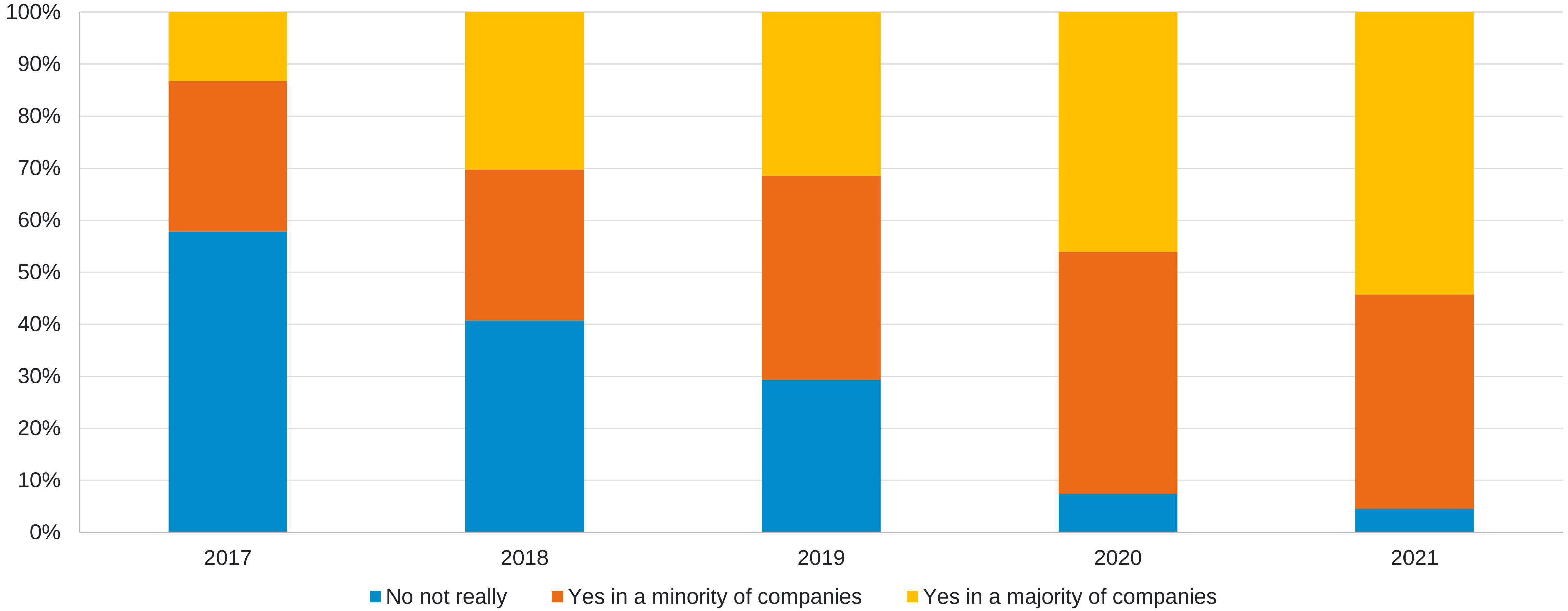

### But 59% say mandates limited by the ratings




Source: UNPRI Survey, 2020

# Fidelity Analyst Survey 2020 - ESG emphasis

## Growing emphasis among companies to implement and communicate ESG policies…




"Have you seen a growing emphasis among your companies to implement and communicate ESG policies in the last year?" Chart shows weighted average of responses.

# The impact of ESG investing in corporate bonds (1/2)

## In fixed income, good ESG companies outperform bad ESG companies

### Key findings:

- We conducted a detailed study of the corporate bond universe analysing the relationship between ESG ratings and a number of fundamental, valuation and technical statistics
- We find a monotonic relationship between the ESG score of a company and the 5-year cash bond spread. Companies with a **higher ESG** score are associated with a **lower credit spread**
- Moreover, we find that **higher ESG**-rated companies **perform better** on an excess return basis. Our results show that over the last 12 months credit spreads of the best ESG-rated companies have tightened on average by ~20%, compared to around 12% for the worst ESG companies

### Better ESG-rating – tighter spreads… (OAS in bps)



Source: Fidelity International, Sustainalytics, "The impact of ESG investing in corporate bonds" published July 2018. Full paper available under https://www.fidelityinstitutional.com/en/the-impact-of-esg-investing-on-corporate-bonds-cf89bb/

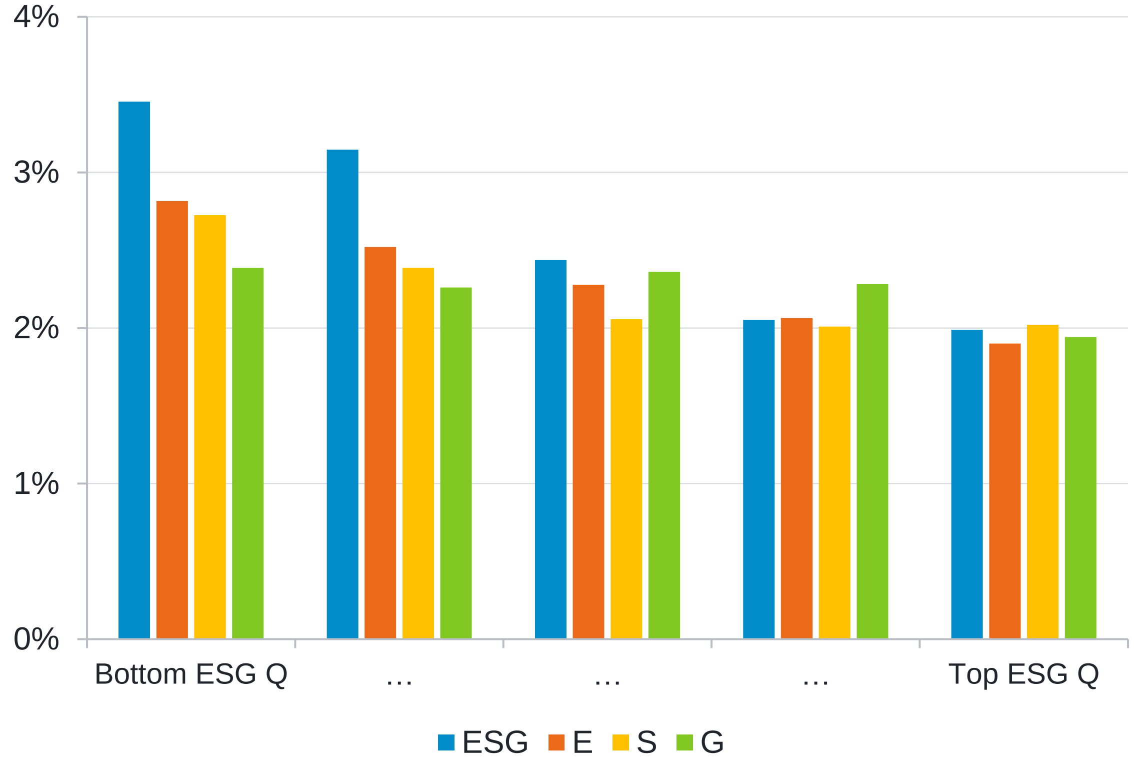
# The impact of ESG investing in corporate bonds (1/2)

## ESG screening can help to avoid meaningful losses

### Key findings:

- Our empirical results show that companies with **higher ESG** scores tend to have a **lower probability of default**
- This has immediate implications in portfolio construction, and highlights the benefit of incorporating ESG in credit portfolios.
- The relationship is non-linear, with the companies in the worst quintile having a significantly higher probability than those in the 4th quintile

### Environmental and Social ranks have been good signals of future bankruptcy risk

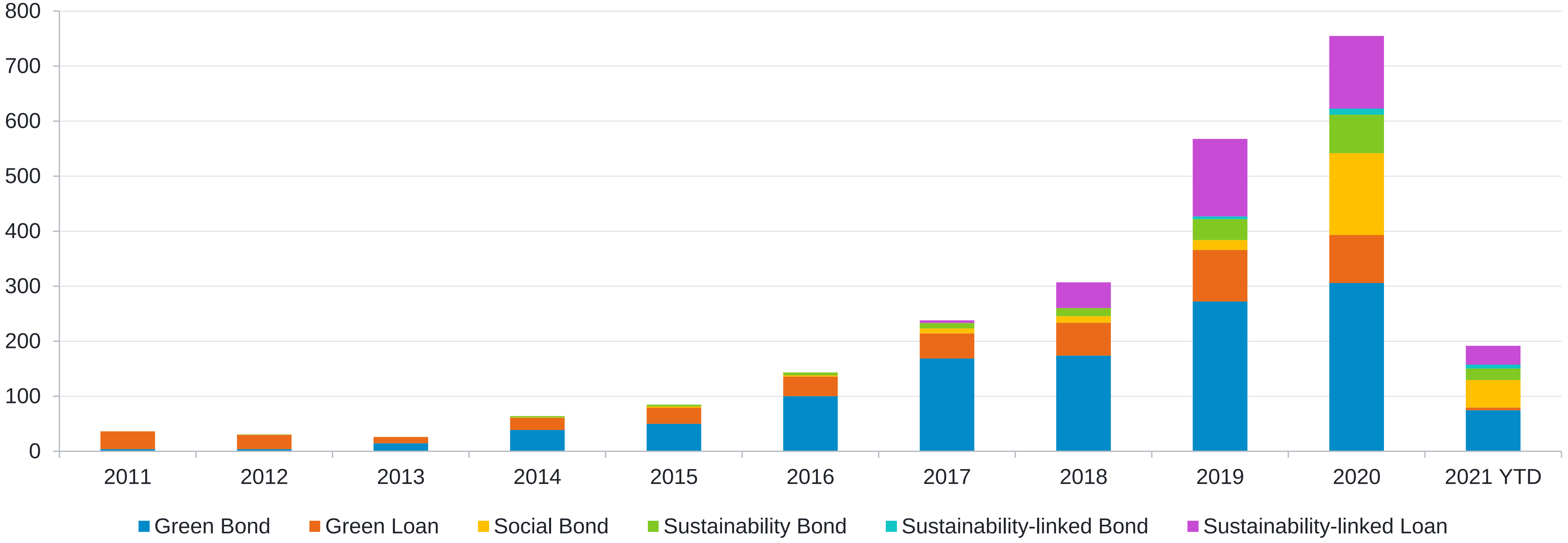



Source: Fidelity International, Sustainalytics, "The impact of ESG investing in corporate bonds" published July 2018. Full paper available under https://www.fidelityinstitutional.com/en/the-impact-of-esg-investing-on-corporate-bonds-cf89bb/

# Sustainable debt is a fast growing asset class

## There is more than just green bonds

### Global sustainable debt issuance ($billion)




Source: Bloomberg NEF, as at 17th March 2021.

# ESG at Fidelity

# The importance of Sustainable Investing

## Investment Horizon

- As long-term investors we need to have confidence in the sustainability of our investments
- Need confidence in firms' future cash flow, policies & engagement with their stakeholders
- Sustainable investing is the analysis of material factors driving long-term value creation.

## Integration

- ESG analysis cannot be disaggregated from financial analysis as ESG has a direct impact on fundamentals.
- ESG factors vary by industry and geography and are therefore best understood and applied in the context of local markets and business models.
- ESG considerations are fully integrated into the analysis conducted by our global research team

## Source of Value

- Investing in companies with strong ESG characteristics adds value and helps to protect against downside risk
- Sustainability factors are material to long-term investment outcomes; and these factors are not always correctly priced by markets.

## Engagement

- We take an active ownership approach and strongly believe that fostering change is the most effective way to positively influence corporate behaviour.
- It is important to execute ownership rights of engagement and voting, but also to ensure that our clients capital is appropriately allocated.

# Fidelity Proprietary Rating

Fidelity Proprietary Rating

## Why our own ratings?

- Does not solely rely on the same widely disseminated data sets
- More forward looking
- Fundamental analysis
- Allows fuller coverage - including more private companies and quasi-sovereign

## How we make them

- Collaborative input across 180 equity and fixed income analysts
- Rated relative to peer group on a standardised scale
- Forward looking assessment of a company's ESG trajectory
- Quantify impact on valuation

Source: Fidelity International, 2020

# In-house sustainability ratings

## How we create our sustainability ratings

- Collaborative input across 180 equity and fixed income analysts
- Rated relative to peer group on a standardized scale
- Forward looking assessment of a company's ESG trajectory
- Quantify impact on valuation e.g. discount to P/E or change of WACC projections

## ESG Ratings

| | |
|---|---|
| A | Acknowledges and under-stands the current and future level of risk. Limited probability of adverse risk |
| B | Acknowledges and understands current and future level of risk. Some probability of adverse risk |
| C | Acknowledges and understands current risk but not future |
| D | Acknowledges risks it may face however does not understand current and future level of risk |
| E | Not aware of any risk and has no management plan in place |

## ESG Trajectory

▲ ■ ▼

Source: Fidelity International, 2021.

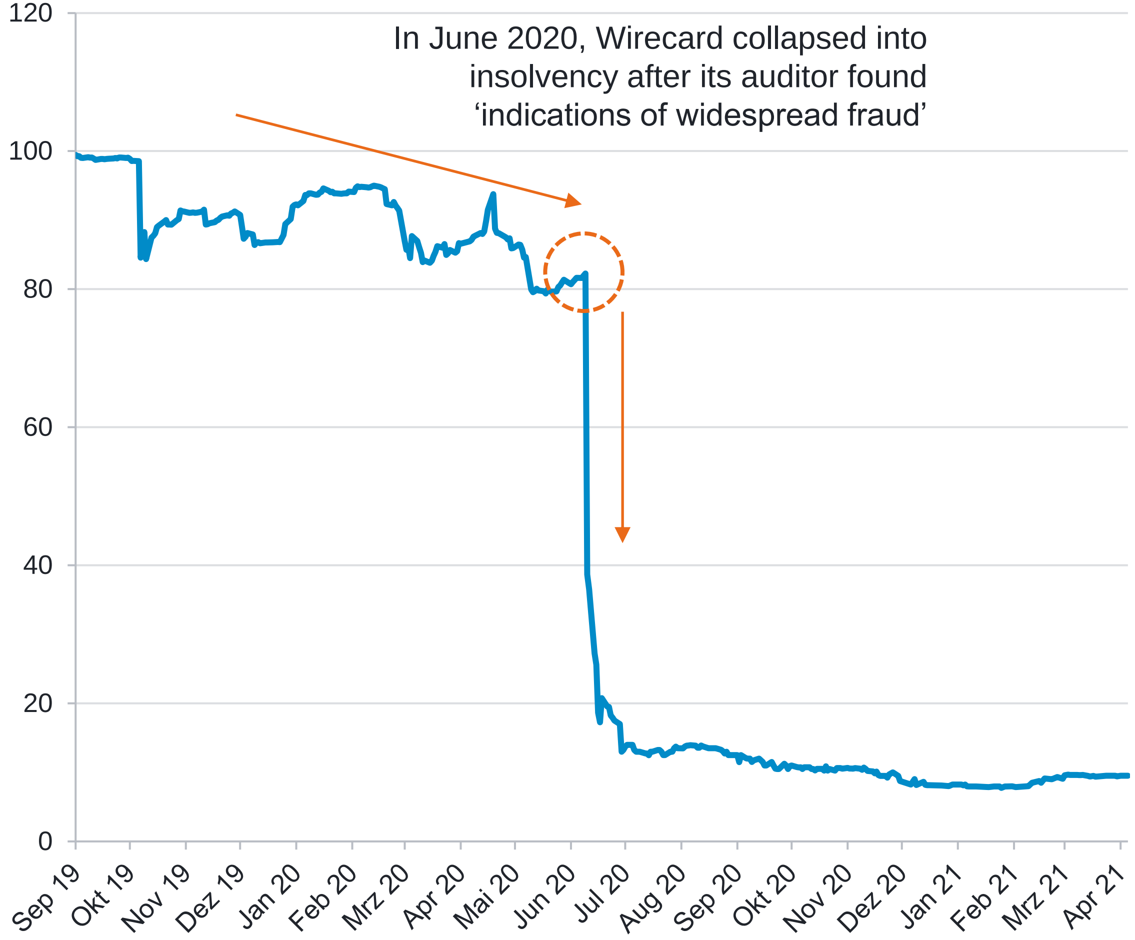
# The value of independent sustainability research

wirecard

Wirecard

(German payments company)

| | Fidelity ESG Rating: E | External research provider: Median rating |
|---|---|---|
| E | ▪ Lacking disclosures | ▪ No carbon reduction target |
| S | ▪ High 'Glassdoor' rating vs peers | ▪ Effective data protection measures |
| G | ▪ Aggressive acquisition strategy<br>▪ Poor accounting quality and evasive responses from management when challenged<br>▪ No evidence to support company's claims of a 'net cash' balance sheet<br>▪ Lack of effective compliance controls | ▪ Acknowledged allegations of accounting manipulation<br>▪ However strong financial performance cited as counter to allegations<br>▪ Rated governance above peer group average |




Source: Fidelity International. April 2021

# A Practical Application – Reduced Carbon Bond

# Challenges of environmentally sustainable investing options for Fixed Income

Main investment strategies currently available *in the market*

## Green Bonds

Any type of bond instruments where the proceeds will be exclusively applied to finance or re-finance in part or in full new and/or existing projects and activities that will promote progress on environmentally sustainable activities

**Challenge**: small, less liquid and delivers less yield than a global corporate bond universe

## Fossil Fuel Divestment

Removal of investment assets including stocks, bonds, and investment funds from companies involved in extracting fossil fuels, in an attempt to reduce climate change

**Challenge:** Divestment without engagement does not help climate change

## Low Carbon Indices

Aim to reduce the exposure to companies with high carbon emissions and high carbon reserve while trying to minimise the tracking error against the traditional benchmark

**Challenge:** Carbon data alone does not capture the full picture, a pure index based approach is incomplete

Source: Fidelity International, 2020. Low Carbon Indices may include but are not limited to the MSCI Low Carbon Indexes. Traditional Benchmarks are Global Corporate Indexes.
Divestment strategies refer to revenue-based or thematic exclusions

# Green Bonds: part of the Fixed Income investor toolkit

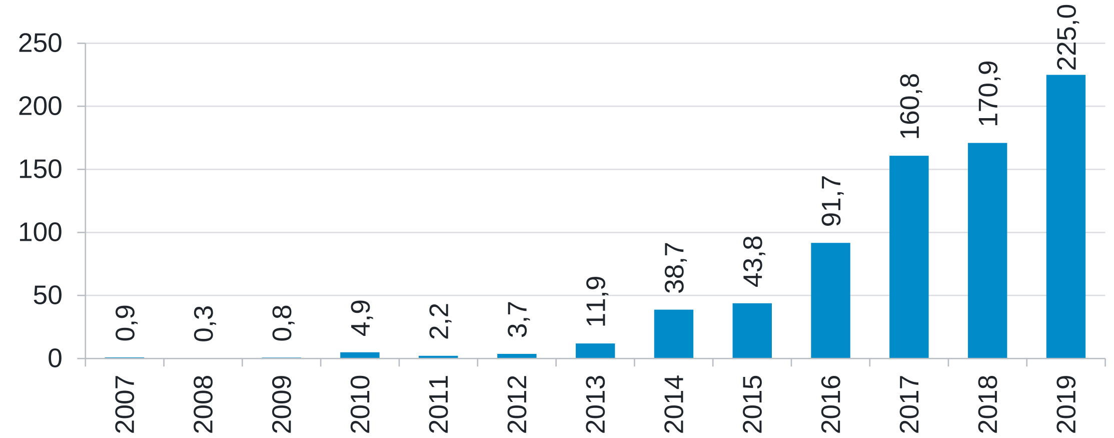
## Work well in complement to a Global Corporate allocation, not instead of

**Green bonds are part of the solution as they by design finance specific projects or activities that promote green investment**

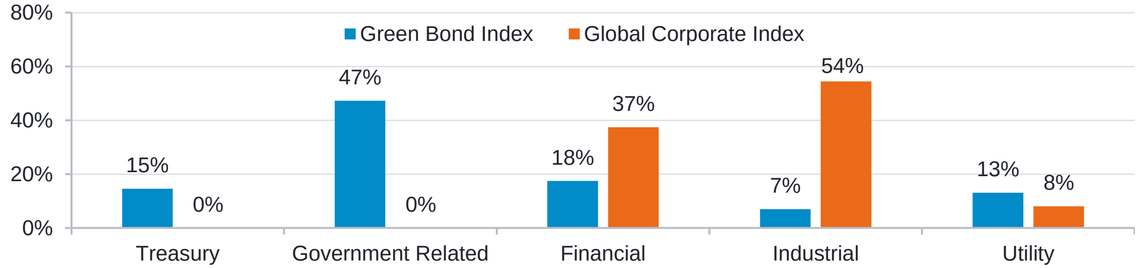
However, there are investment limitations to consider:

- Small universe, with lower level of yield compared to a standard global corporate universe
- Lack of standardisation in terms of definitions and impact measurement
- Secondary green bonds trade at a premium and liquidity is relatively low

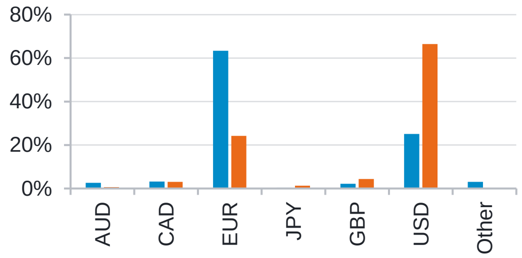
### Green bond issuance



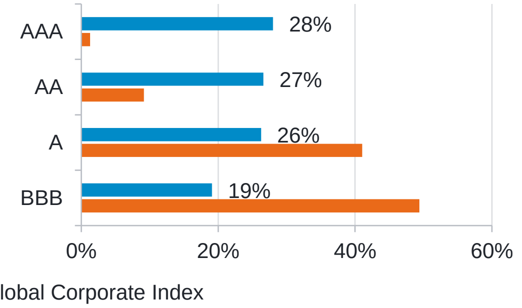

### Sector breakdown




### Currency breakdown




### Rating breakdown (Basel)




| | Yield | Spread | Average Rating | Duration (years) | # bonds | Index Market Value (US$ bn) |
|---|---|---|---|---|---|---|
| Green Bond Index | 1.17% | 131 | AA3 | 7.9 | 475 | 390 |
| Global Corporate Index | 3.03% | 266 | A3/BAA1 | 6.9 | 13,021 | 10,412 |
| Global Aggregate Index | 1.22% | 82 | AA2 | 7.0 | 25,360 | 57,943 |

Source: Fidelity International, ICE BofAML, Climate Bonds Initiative. Data as of 31 March 2020. Using Bloomberg Barclays indices.

# Is divestment part of the solution?

## High carbon intensity sectors represent a large portion of the investment universe

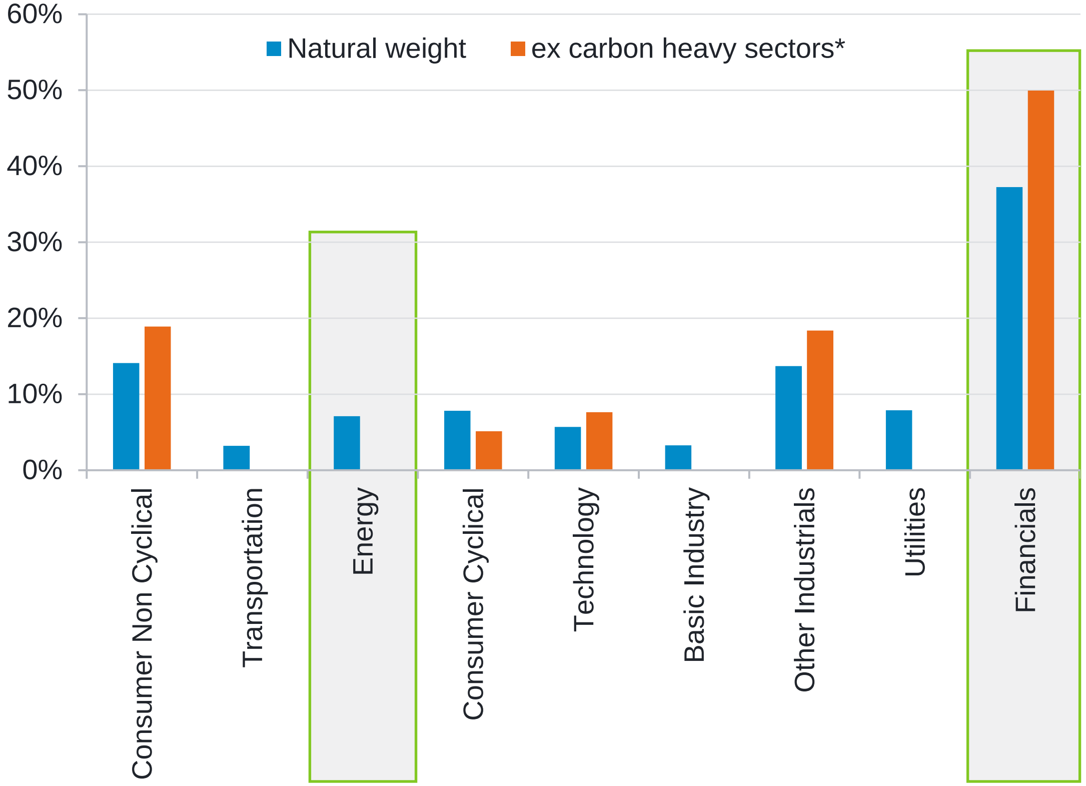
Divestment has significant drawbacks in isolation:

1. **Lower diversification:**
   - Few low carbon alternative to Energy and Utilities ($2trn FI markets)
   - Concentrations in Fins and Consumer sectors where emissions indirect
2. **Reduces alpha opportunities:**
   - Smaller opportunity set = reduced alpha opportunities,
   - Evidence that reformers and transition stories drive alpha
3. **Doubtful impact on carbon emissions:**
   i. Direct emissions vs indirect (Scope 1&2 vs 3)
   ii. Exclusion leaves capital provision to investors without a climate change mandate.
   iii. Fossil fuel companies can be drivers of change (Ørsted, Shell) with suitable scrutiny

The Climate Crisis is a complex problem that cannot be solved with simplistic solutions.

**=> Engagement is a better approach than divestment in our view**

### Comparison of full corporate bond universe vs excluding carbon heavy sectors




Source: Fidelity International, Bloomberg Barclays Global Credit indices, December 2019. * Excluding automotive, basic industry, energy, transportation and utility sectors.

# Active management and ownership is key

## Low carbon indices / optimised solutions: data does not give the full picture

- Most indices use tonnes of emissions per unit of revenue (carbon intensity)
- However, this measure can be distorted by different factors:

| Business activity mix | Local price regulation | Accounting Rules |
|---|---|---|

- Following Carbon indices does not work, you need to know your companies:
  - Narrow peer groups of comparable companies
  - Industry specific metrics e.g. emissions per unit of production
  - Normalising for accounting differences
  - Understanding business models and the outsourcing off emissions

### European utility example

| | Spanish Utility | Scandinavian Utility |
|---|---|---|
| Direct + First Tier Supply Chain Emissions (tonnes CO2) | 29,641,582 | 19,428,151 |
| Revenue (EUR mn) | 29,215 | 3,632 |
| Carbon intensity (tonnes CO2 / € million revenues) | 1,014.60 | 5,169.73 |
| Business activity mix | 60% generation / 40% distribution | 100% generation |
| Electricity prices (EUR/Mhw) | 59 | 45 |
| Power Generation (GWh) | 137,348 | 100,900 |
| Tonnes CO2 / GWh produced | 216 | 193 |

Source: Fidelity International, Bloomberg, S&P Trucost © Trucost 2018, data 2018. For illustration purposes only. All rights in the Trucost data and reports vest in Trucost and/or its licensors. Neither Trucost, nor its affiliates, not its licensors accept any liability for any errors, omissions or interruptions in the Trucost data and/or reports. No further distribution of the Data and/or Reports is permitted without Trucost's express written consent.

# Do’s and don’ts of incorporating climate change criteria in fixed income portfolios

- ✗ **Don’t rely solely on green bonds.**
  *This segment of the market does not provide a replacement for the main fixed income portion of an asset owner’s portfolio mix, because its liquidity and market exposure is different and on a stand-alone basis it does not solve for climate change.*
- ✗ **Don’t rely on divestment.**
  *Excluding certain sectors e.g. fossil fuels will not move the climate change dial and change the sector mix of the portfolio*
- ✗ **Don’t set yourself a hard carbon reduction target.**
  *By establishing a hard carbon reduction target there is a risk the portfolio composition will be skewed towards only issuers with already low carbon footprints, but portfolio diversification will suffer as a result - it is easy to build an optically low carbon portfolio with only banks!*
- ✗ **Don’t passively follow carbon data.**
  *It can be tempting to build a systematic data screen or even a low carbon index that would filter out those issuers with the lowest carbon footprints, yet it is important to incorporate a fundamental bottom up view into the analysis to truly understand the business models of the different companies and identify the right lens of analysis to understand the carbon picture.*
- ✗ **Don’t compromise on portfolio performance.**
  *Integrating climate risks into your portfolio does not mean you need to compromise on the quality of the performance of your portfolio.*
- ✓ **Do favour approaches that focus on engagement even in Fixed Income.**
  *Simply investing in companies that have low carbon emissions today is missing the opportunity to work together with those firms who can make a difference in terms of carbon transition in the future too. One individual bond manager will not move the dial but combined with the whole credit and equity research team, corporate stewardship, and following a thoughtful climate change agenda in cooperation with other asset managers, engagement can start to become a powerful tool.*

# Climate and ESG security selection

## Building a portfolio with genuine impact on emissions

**The investable universe is a combination of the following:**

### Low Carbon Issuers

Prioritise companies with lowest current emissions within their sector

### Issuers on improving path

Companies with aggressive Science Based Targets to decarbonise in line with a 2 degree (or better) pathway

### Green Bonds

Green Bonds from select issuers with either best or improving decarbonisation strategies. Selection subject to strict criteria

**Continual engagement to monitor decarbonisation path**

**ESG exclusions: tobacco, controversial weapons, semi-automatic weapons, UN Global Compact violators**

Source: Fidelity International, 2020

# Appendix

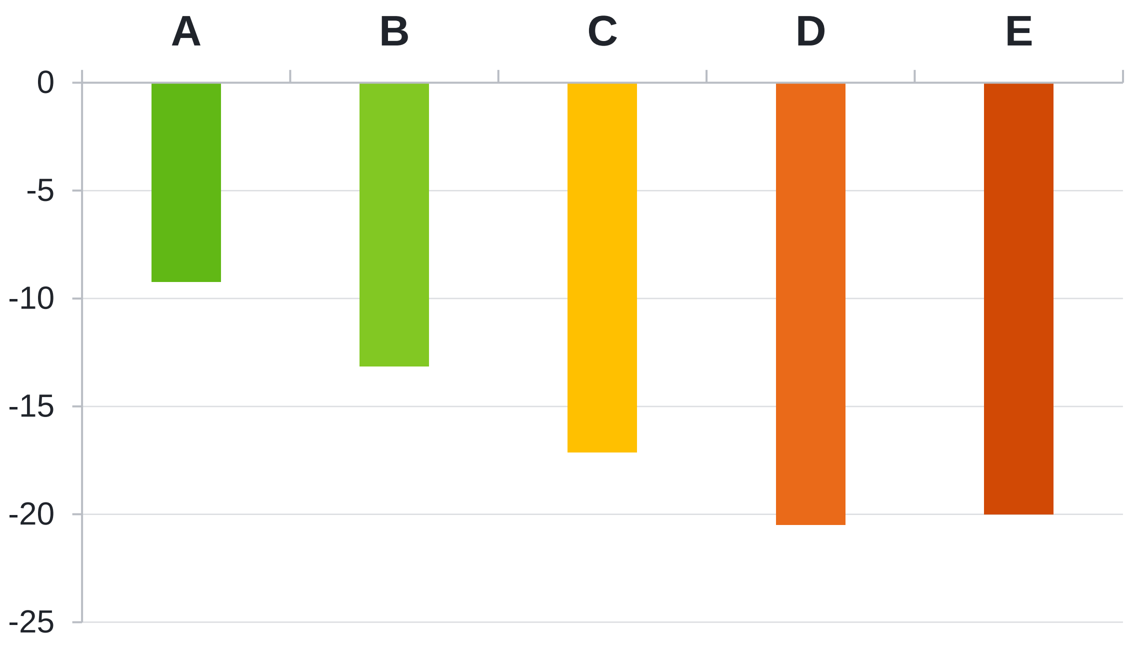
# Survival and sustainability in the 2020 market sell off

## Equity and credit performance by FIL proprietary during market selloff

### Equity issuer returns (%) by ESG rating

| Fidelity ESG Rating | % of total rated | Stock Return | Stock return vs S&P 500 |
|---|---|---|---|
| A | 12% | -23.1% | +3.8% |
| B | 39% | -25.7 | +1.2% |
| C | 33% | -27.7 | -0.8% |
| D | 14% | -30.7 | -3.8% |
| E | 2% | -34.3 | -7.4% |

### Credit issuer excess returns (%) by ESG rating

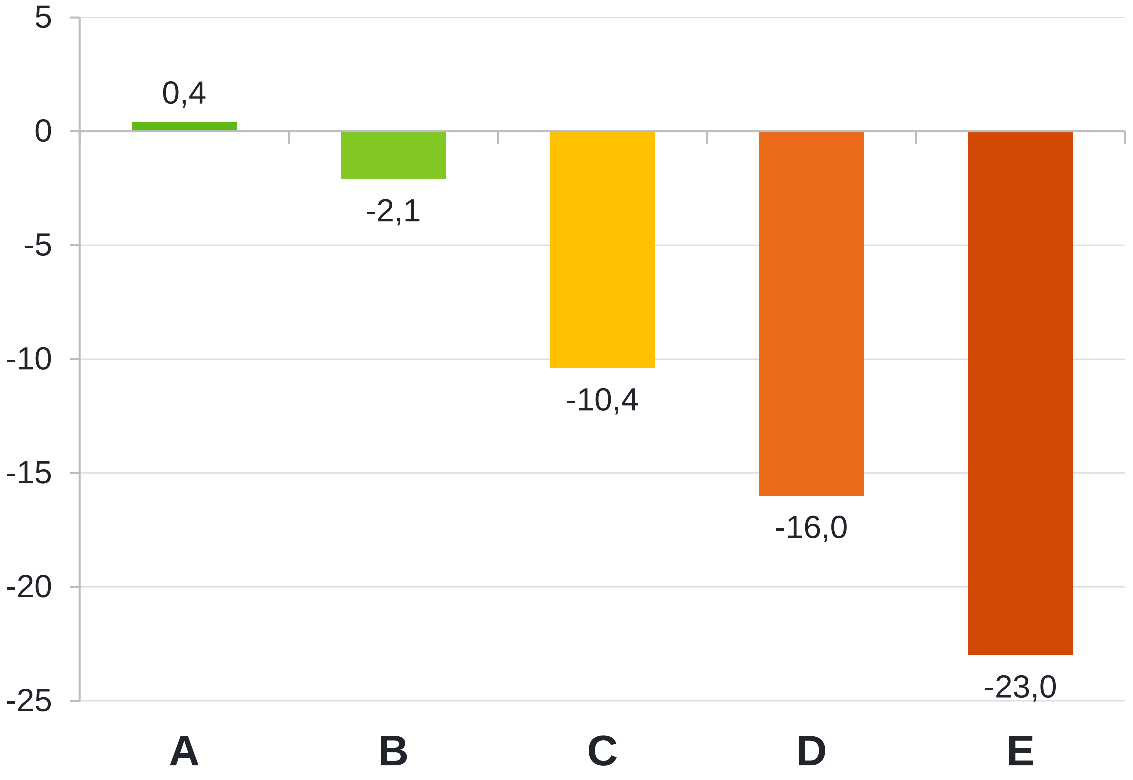



Source: Fidelity International, April 2020. Based on performance measured during the peak to through period for each market (Equity: 19th February – 26th March 2020; Credit: 2nd January – 23rd March 2020). Based on a sample of 2,689 equity issuers and 1398 bond issuers globally with proprietary ESG ratings.

# Performance of FIL ESG Ratings: Q1- Q3 2020

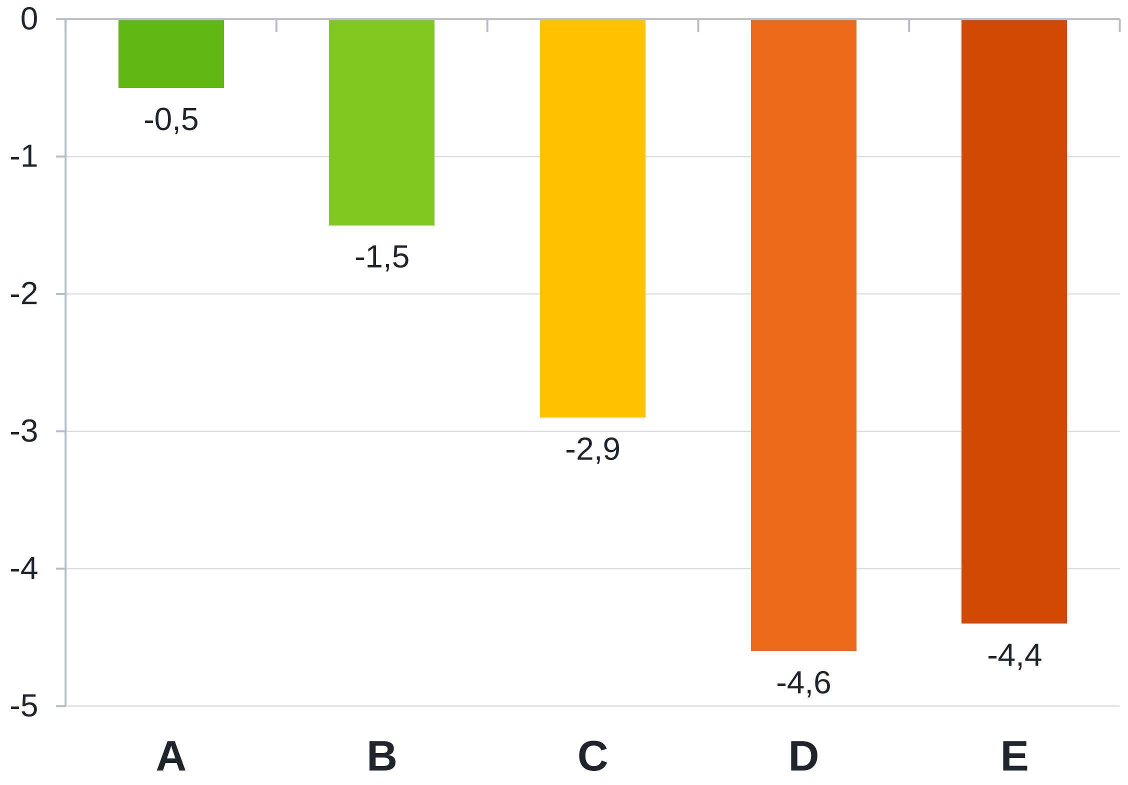
## Outperformance of better ESG rated names across asset classes

### Stock returns (%) by ESG rating




Source: Fidelity International, October 2020. Note: Chart displays equal weighted USD stock returns of A-E rated stocks vs MSCI AC World USD returns, from 1 January to 30 September 2020. Data from 2,659 company ratings.

### Credit issuer excess returns (%) by ESG rating




Source: Fidelity International, October 2020. Time period is 2 January to 30 September 2020. Data from 1,450 company ratings. Excess returns over government bonds in relevant currency. For example, German government bonds used for companies with EUR debt. Data from 1,450 company ratings

# Credit research performance outcomes

## Leveraging corporate access and industry expertise to deliver valuable research insight

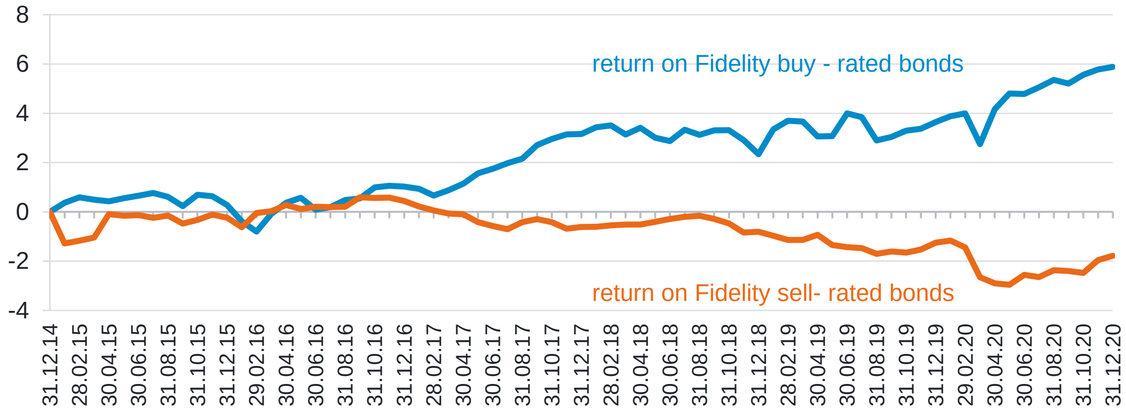
Strong buy ⟵⟶ Strong sell

| 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|

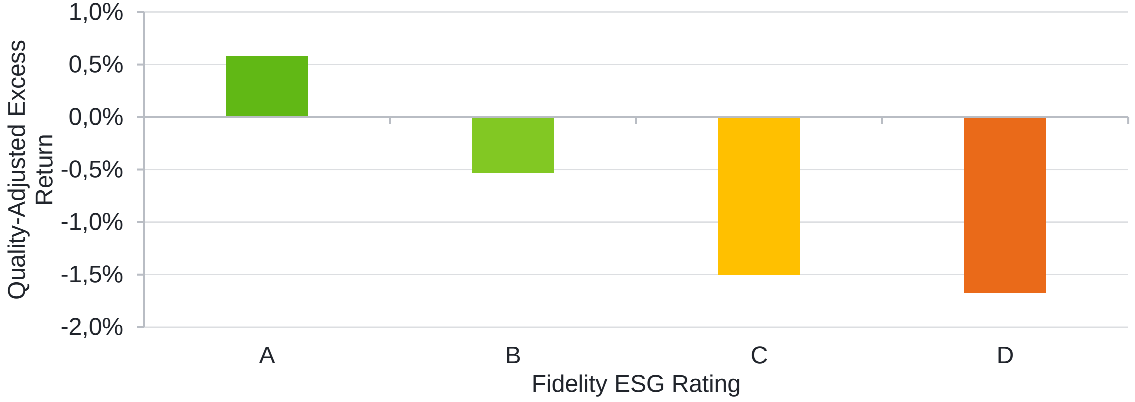
Leader ⟵⟶ Laggard — Trajectory

| A | B | C | D | E | Improving | Stable | Deteriorating |
|---|---|---|---|---|---|---|---|

**Fundamental research performance*** (global credit, %)




**Sustainability ratings performance**** (global credit, %)




- 1-5 ratings reflect analyst conviction in outlook for issuer, from 1 reflecting 'strong buy', to 5 'strong sell'
- Recommendation produced by in-depth fundamental analysis and valuation
- Portfolio managers are not obliged to follow analyst recommendation
- 'Buy rated' issuers have outperformed over the long term

- A-E ratings reflect company's ESG characteristics. Leaders are sustainable businesses which manage ESG risks and opportunities in a way which supports long-term shareholder value creation. Laggards are at higher risk of sustainability failings and value erosion
- Defining the trajectory indicates the direction of travel with respect to sustainability
- Short term performance data suggests leaders outperform laggards during volatile markets

Source: Fidelity International. Data as at 31 December 2020. *Performance is calculated in local terms and is measured in terms of excess returns over duration matched government bonds so is shown free of the impact of currency and duration. Each name is equally weighted within its relevant RV and sector bucket while bond weightings within each name are reflective of the size of the issue. Performance is shown relative to the equal weighted universe of names. The universe of names is taken to be all names that are covered, held in a portfolio or within a benchmark that is assigned to a portfolio. 1s and 2s (equivalent to strong buys and buys are combined with equal weighting). 5s are excluded from the performance summary due to their small sample size. **Performance period from Jan 20 to Dec 20. Analysis on performance based on FIL rating is done through our proprietary quantitative research team over 2020. Quality adjustment works by splitting up tickers in the universe into quintiles based on starting spread, calculating an average return for a given ESG-rating within each quintile and then averaging across quintiles (equal weight per quintile) to get a return for an ESG-rating.

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