WELLS FARGO Asset Management

Income Generator

Innovations in sustainable fixed income investing

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Sustainable investing is a top priority for many today. We can see that interest across the investment spectrum—from investors, to companies that issue new securities, to asset managers that are creating new products and to regulators that are formalising guidelines regarding sustainability. Further, the COVID-19 pandemic has likely accelerated the trend towards sustainability, as we focus more closely on the vulnerability and resilience of not just society, but also of our planet.

With this mounting focus on environmental, social and governance (ESG) issues, the number of ESG-related product launches has increased substantially over the last three years. Broadridge calculated that more than half of all global long-term fund inflows went into ESG-type mandates during the first three quarters of 2020.[1]

Historically, investors turned to their equity managers for their ESG needs. Yet, given the importance of the fixed income component within an overall portfolio, investors are increasingly looking at their fixed income investments to meet their sustainable investment requirements. Since March 2018, equity ESG strategies have received over $90 billion of cumulative net inflows whilst, over the same period, fixed income ESG strategies have had inflows of $33 billion.[1] The overwhelming majority of inflows into fixed income ESG were into active rather than passive ESG mandates.

Europe leads the green charge

Looking across the globe, growth and innovation in fixed income sustainable investing has been most evident in Europe. One reason for this is that a meaningful shift in European regulation following the 2015 Paris Agreement helped Europe take the lead in "greening" fixed income investments.

Regulators, seeing huge growth in interest, have focused on ensuring that asset owners, the companies that issue securities and asset managers alike disclose and describe these investments correctly. Below are examples of two recent regulations that have focused the minds of both asset owners and asset managers on sustainable investments.

1. Broadridge, "Through the Global Product Lens—All Eyes on ESG", February 2021.

The EU's Sustainable Finance Disclosure Regulation (SFDR)

This regulation came into effect on 10 March 2021 with the goal of making it easier for investors to compare and understand the sustainability profile of funds. Under the SFDR, products have to be categorised into specific types and include metrics for assessing the adverse ESG impacts of the investment process for each fund. The most visible and impactful aspect of SFDR is the classification of funds and investment mandates into four categories, as laid out by Articles 6, 7, 8 and 9 of the SFDR:

- **Article 6** focuses on whether or not sustainability risks will be taken into account by the fund or product manager when making investment decisions and the rationale behind them. Products in this category do not have binding or material sustainability controls in the investment process. They can include tobacco companies or thermal coal producers and they are not promoted as ESG funds.
- **Article 7** focuses on if and how products take into account the impact of their investment decision-making process on ESG factors.
- **Article 8** covers products that promote environmental or social characteristics, or a combination of those characteristics (among others), provided the companies in which investments are made follow good governance practices. This can include negative screening criteria of certain sectors, if done in a material and binding way, such as arctic-drilling companies.
- **Article 9** covers products targeting bespoke sustainable investments and those that have sustainable investment as their objective.

Disclosure rules for UK pension schemes[2]

New disclosure rules relating to UK pension funds' consideration of ESG factors and engagement with investee companies came into effect on 1 October 2019. Trustees of pension schemes are obliged to outline their approach to engagement with and voting of their shares in investee companies and how they take account of financially material factors, including ESG and climate change considerations, in investment decision-making. Again, we see regulation creating greater transparency and focus on sustainable investing.

Innovation in green, social, sustainable and sustainability-linked (GSSS) bonds

The GSSS bond market has grown exponentially and has diversified into many different sectors and types of bond structures. Most exciting, the market has evolved from the initial issuers of green bonds, namely utilities and financials, to include companies from many other sectors as they seek to help build a more sustainable future.

The innovation we're talking about can be seen in the table below. The companies shown have issued bonds with sustainability performance targets (SPTs) appropriate for their industry, which they've done largely to meet increased demand from investors for sustainable business targets. These sustainability-linked bonds (SLBs) focus on outcomes, with coupon step-up provisions that penalise issuers who do not meet pre-agreed SPTs. By their very nature, these are forward-looking instruments with concrete targets, in contrast to green bonds where goals are less defined.

2. From October 2019, the UK Department of Work and Pensions incorporated ESG into pension fund regulations. Pension trustees must update their scheme's statement of investment principles to set out their policies on ESG, climate change and stewardship activities. There are additional requirements from 2020 to trust based DC schemes.

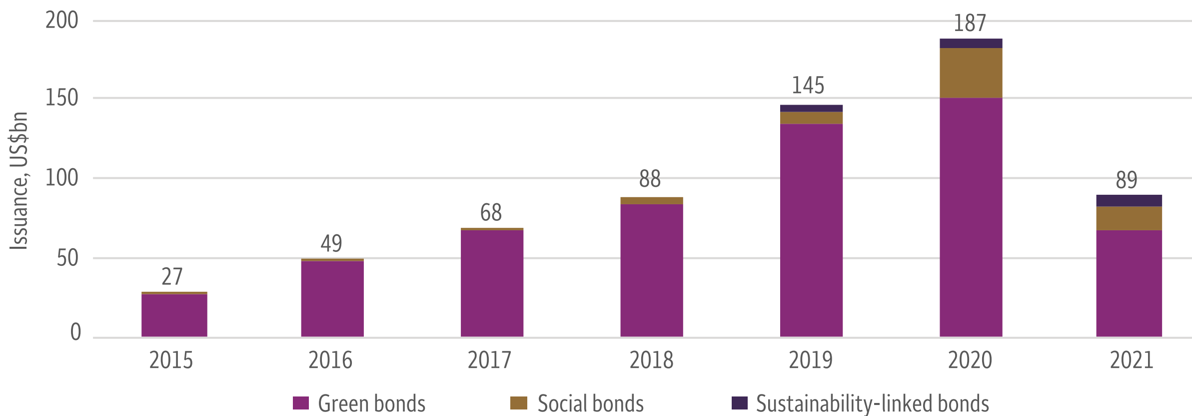
Figure 1. New bonds have been issued that are tied to sustainability outcomes

Issuer	Issue date	Currency	Sector	Tenor (years)	Step-up (bps)	Sustainability performance targets*
Novartis	Sept. 2020	EUR	Pharmaceuticals	8	25	2025 patient access targets
Enel	Oct. 2020	GBP	Utilities	7	25	2022 renewables installed capacity
Lafarge Holcim	Nov. 2020	EUR	Building materials	11	75	2030 CO^2 emissions
NRG Energy Inc.	Nov. 2020	USD	Utilities	7	25	Scope 1–3 greenhouse gases
Tesco	Jan. 2021	EUR	Supermarkets	8	25	2025/26 CO^2 emissions

Sources: WFAM and Bloomberg. Named companies are for illustrative purposes only and are not a recommendation to trade.
*Company-designated targets per bond offering document.

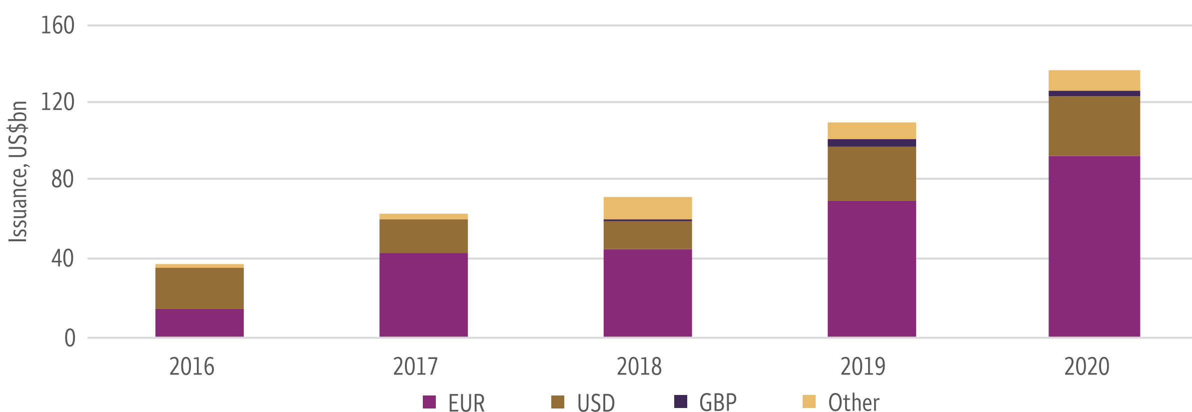
To see how we've arrived at this point, let's consider recent history. Over the last three years, the total notional value of the ICE BofA Green Bond Index increased by almost four-fold, with GSSS issuance accounting for 9.3% of corporate bonds issued in Europe in 2020, according to PWC.[3] You can see the acceleration of GSSS bond issuance in Figure 2. Figures 3 and 4 show the availability by currency and issuance across the credit spectrum, respectively.

Figure 2. GSSS bonds are a new way for investors to pursue their goals



Sources: WFAM, Barclays and Bloomberg; data as of 12 April 2021

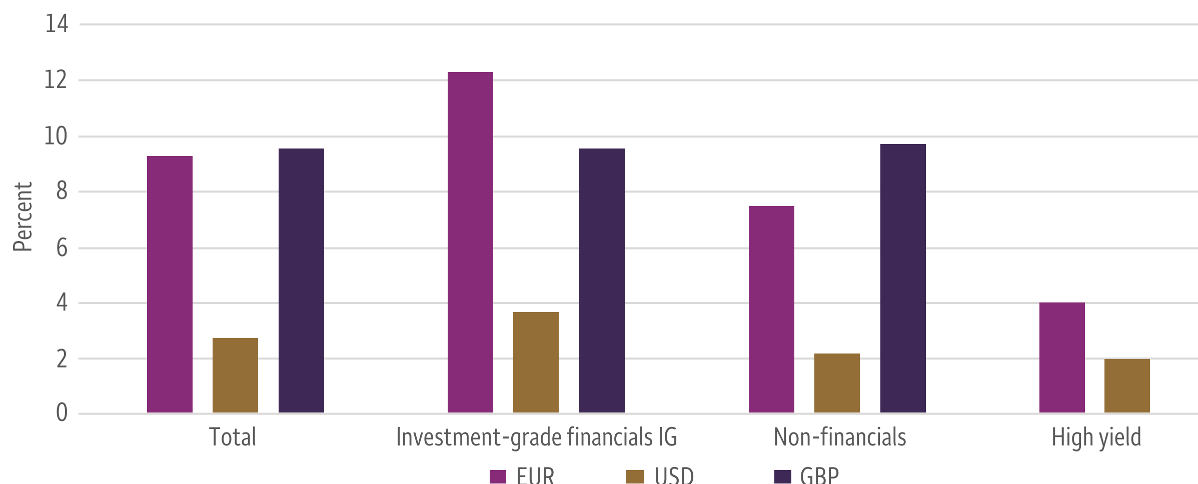
Figure 3. European issuers have led the green charge but the US is gaining ground



Corporate issuers only. Developed market hard currency bonds only. Excludes covered bonds.
Sources: WFAM and Bloomberg

3. PWC "Debt Watch Europe. 2020 Annual Review", January 2021.

Figure 4. ESG-labelled issuance as % of total corporate bond issuance in 2020



Includes both use-of-proceeds bonds and SLBs. Developed market hard currency bonds only. Corporate includes covered bonds.
Sources: Dealogic and Barclays Research. As of December 2020.

Investing sustainably in sub-investment-grade

Just as in the investment-grade markets, both investor demand and sustainability-focused regulation are transforming the ability to invest sustainably in sub-investment-grade assets. The SFDR regulation, which makes it easier for investors to compare and understand the sustainability profile of funds, has given leveraged finance market participants better access to ESG data from borrowers and, in turn, they can produce the analysis required by the new regulation. For example, earlier this year the European Leveraged Finance Association, alongside the Principles for Responsible Investment, launched a number of sector-specific questionnaires covering ESG that can be sent out to prospective borrowers to help investors compile the information required.

Most leveraged finance buy-side companies, including WFAM, have for years worked with ESG-inspired exclusion lists. These lists tend to exclude investments in sectors of the economy such as thermal coal, oil sands or UN Global Compact violators. But that approach is evolving.

Moving beyond exclusion lists, asset managers with better ESG analysis can tilt portfolios away from underperformers within a sector and towards outperformers. Products are also being developed that encourage faster transition towards low- and zero-carbon economies. Lastly, due to improved information and analysis, asset managers are better able to report on sustainability in a more detailed and comprehensive fashion.

Product innovation in the high yield bond market has included bonds with pricing linked to ESG criteria and that help move an entire company towards more sustainable operations rather than just a specific project, like green bonds do. In March 2021, the Greek power generation company Public Power Corp. (PPC) was the first company to issue this kind of bond in the European high yield market. This PPC bond shows us a glimpse of what the future might look like, linking a 50-basis-point (bp; 100 bps equal 1.00%) coupon step-up provision directly to specific key performance indicators, namely a 40% reduction in the company's Scope 1 CO^2 emissions by December 2022. The deal went well, with demand sufficiently strong to merit a 150-million-euro increase in the issue to 650 million euros. Pricing subsequently tightened, too, to a final yield of 3.875% for this BB-/B rated credit.

Innovation in leveraged loans has come in the form of borrowers tying the interest rate they will pay on their loan to how well they meet their sustainability goals. Take Klöckner Pentaplast, for example. This German plastic packaging maker promised to increase the share of women in senior roles by two percentage points to 27%, increase the proportion of recycled material in its packaging by four points to 26% and cut its emissions. The company can trim 7.5 bps off its interest margin—currently 475 bps—if it meets these three goals.

Our approach to investing in climate transition

Climate is one of the leading issues in the ESG agenda. Up until 2019, few investors put climate change at the centre of their investment policy. European asset owners and asset managers have been at the forefront because investors in Europe are more likely to have already adopted a net-zero carbon emissions target or plan to do so in the next three to five years, compared with investors in other regions. Now other regions are increasingly interested in becoming part of the solution as well.

Fixed income investors play a vital role in this process. Debt finance is essential to today's fossil-based economy, and debt finance will be an important source of capital for helping put carbon emitters—utilities, transport and construction, for instance—on a path to sustainability. In fact, sustainability bonds and SLBs are by their nature designed to help companies develop sustainable business operations.

With this in mind, we have designed a Climate Transition Credit approach that comprises multiple decarbonisation mechanisms. Therefore, our approach implements a proprietary framework to channel capital to those companies with the most compelling societal climate strategies, both capturing transition opportunities across sectors and managing climate risk. Our approach builds on our experience of rigorously integrating and actively managing ESG risks across our credit strategies, which we believe delivers the best risk-adjusted returns.

Our approach aims to achieve both the climate and financial objectives of our clients. Further, it is designed to have a carbon-intensity advantage from the start. With that in mind, we design portfolios with an initial cap of carbon intensity of 30% below that of the portfolio's benchmark. Then in subsequent years, we strive to decarbonise the portfolio over time with the objective of achieving carbon neutrality by 2050. To do this successfully, we actively engage with the companies that we invest in to improve their climate disclosure, for instance, and also hold them accountable for their carbon targets.

Figure 5. Our approach focuses on both climate and financial results

Step 1. Actively manage security selection within WFAM Transition Framework

Step 2. Use targeted exclusions to maximise climate benefits

Step 3. Reduce weighted average carbon intensity at least 30% lower than the benchmark

Step 4. Decarbonise portfolio by 2050

Step 5. Engage with issuers to enhance climate and financial performance

To sum up

Across our credit strategies, we integrate ESG risk analysis into our investment process using proprietary and third-party information. Our portfolio managers, working alongside our experienced Credit Research and Sustainable Investing teams, work diligently to ensure that client goals—including ESG and climate goals—are met. We are also at the forefront of the discussion on sustainable finance, playing an active role in key forums such as the International Capital Market Association's Advisory Council of the Green Bond Principles and Social Bond Principles Executive Committee.

To date, Europe has taken the lead in sustainable investing both in the investment-grade and sub-investment-grade markets, and we see the issuance of GSSS bonds and loans increasing significantly from here. However, the Biden administration in the US has showcased a plethora of commitments and developments in recent months, including a new climate finance plan announced on Earth Day, 22 April 2021. With the US on board, we believe that ESG and climate-focused investing will now enjoy policy and regulatory tailwinds in an unprecedented way.

Like the environment, the climate of finance is changing. We're fully committed to helping investors achieve both their financial goals and their ESG and climate goals.

We want to help clients build for successful outcomes, defend portfolios against uncertainty and create long-term financial well-being. To learn more, investment professionals can contact us:

- To reach our US-based investment professionals, contact your existing client relations director, or contact us at WFAMInstitutional@wellsfargo.com.
- To reach our US-based intermediary sales professionals, contact your dedicated regional director, or call us at 1-888-877-9275.
- To reach our US-based retirement professionals, contact Nathaniel Miles, head of Retirement at Wells Fargo Asset Management, at nathaniel.s.miles@wellsfargo.com.
- To discuss sustainable investing solutions, contact Hannah Skeates or Christopher McKnett, co-heads of Sustainable Investing at Wells Fargo Asset Management, at hannah.skeates@wellsfargo.com or christopher.mcknett@wellsfargo.com.

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