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Buy-and-maintain credit

The long road to net zero

Iain Forrester

It takes Aviva Investors

AVIVA INVESTORS

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Main responsibilities

Iain is responsible for Aviva Investors' Global Buy-and-Maintain team within our Credit function, delivering tailored client outcomes through portfolio construction, an active investment approach, and ESG integration.

Experience and qualifications

He was previously Head of Insurance and Pension Solutions, delivering outcome-oriented investment strategies for global insurance companies and pension funds. Prior to joining Aviva Investors, Iain was an Investment Director in the Insurance Solutions team at Standard Life Investments and held senior leadership roles focused on investment strategy and asset-liability management at Standard Life. Iain is a Fellow of the Institute & Faculty of Actuaries and has a degree in Mathematics from the University of Cambridge.

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Introduction

The goal of buy-and-maintain credit investing is to provide clients with long-term excess returns over government bonds while remaining within a defined credit risk budget. But over the timespans involved, environmental, social and governance (ESG) risks presented by secular shifts can impact managers' ability to deliver those returns. Climate change is an example of such a seismic physical, regulatory, and reputational risk and requires foresight and strategic planning.

The more effectively buy-and-maintain portfolio managers can identify and understand such long-term ESG dynamics, the better they should be able to meet clients' desired net-zero and investment outcomes.

The challenge is ensuring the corporate issuers of longer-dated debt held in portfolios are aligned to what the future – both societal and environmental – is likely to be. But while managers need to keep their clients' long-term net-zero target in mind, they also need to define and deliver interim objectives along the way.

> Asset owners are increasingly looking to incorporate sustainability goals into their investment mandates

In this paper, we consider the importance of ESG integration and impact; the benefits of forward-looking and 'point-in-time' approaches to measure progress; data challenges; and explain why uncertainty about the future trajectory of investee companies is not an excuse for inaction.

Setting the scene

Every investor is different, but for the purposes of this paper, we will assume the client is a UK defined-benefit pension scheme, with an existing buy-and-maintain portfolio containing long-dated investments. We assume the portfolio is still in its reinvestment phase, with a stable target duration, as the scheme contains long-dated liabilities. While we also assume the scheme has a run-off strategy, determining long-term sustainability objectives is still likely to make sense for schemes targeting a buy-out, to drive activity in the period prior to that eventuality.

In this context, the portfolio will comprise investments across global fixed-income markets, with an investment-grade and local-currency (sterling) bias. The portfolio will be invested in bonds issued by traditional financial institutions and companies, other entities such as universities, foundations and housing associations, property-backed transactions, sovereign-linked and supranational entities, and developed and emerging-market sovereigns. This means the investor cannot take a one-size-fits-all approach; in particular, they will need to leverage both corporate and sovereign approaches.

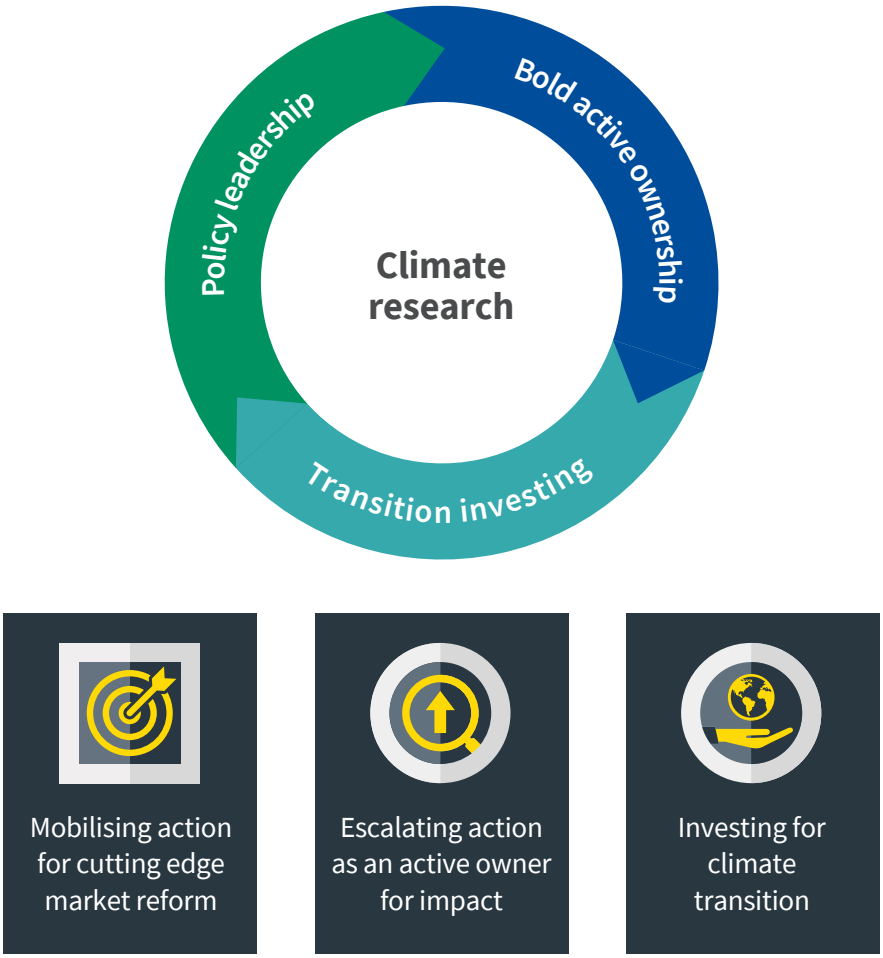
Defining a sustainability objective

The first step is for investors to decide whether they want to introduce explicit sustainability objectives into their investment mandate: is the goal to take an integrated approach, where the investment outcome is the sole objective, albeit acknowledging the importance of ESG as an integral component of the investment process? Or is it to achieve a specific environmental and/or social impact in addition to the investment outcome?

Investing for impact will require investors to set explicit targets, as well as a pathway to achieve them – for example, having interim targets for the portfolio in 2030 before reaching net zero in 2050. That said, an integration-led approach can still support sustainability objectives and the climate transition, including by driving policy change and through active stewardship.

> Investing for impact will require investors to set explicit targets

Figure 1. **Integration and impact for net zero**



Source: Aviva Investors, as of May 16, 2022.

ESG integration and net zero

Integration involves incorporating ESG considerations into the investment and risk-management processes. It can also include stewardship activities to improve portfolio companies' ESG profiles by encouraging them to adopt best practices.

For the buy-and-maintain portfolio manager, the focus is on ensuring the corporate issuers of longer-dated debt held in their portfolios are sustainable over the investment time horizon. Where asset managers have signed up to the Net Zero Asset Managers Initiative, this assessment includes a commitment to support investing aligned with net-zero emissions by 2050 or sooner.[1]

By integrating ESG risks into its investment views – bottom-up credit views and sector allocations in particular – the manager will reduce the portfolio's exposure to firms with poor outlooks and exclude holdings that don't align to its core investment beliefs.

> By integrating ESG risks into its investment views the manager will reduce the portfolio's exposure to firms with poor outlooks

Where an asset manager has a net-zero objective and associated engagement and divestment and exclusion policies in place, over time its portfolio holdings will comprise a growing number of firms that support the transition.

The complexity arises from the fact corporate issuers are often engaged in multiple activities with different investment and ESG considerations. Where debt is issued at the holding company level, the firm must decide whether to support firms that may be developing necessary technology on one side (such as carbon capture and storage) while conducting carbon-intensive operations elsewhere.

In some cases, debt may be issued at the individual operating entity level, so investors can direct capital at entities supporting the transition. For instance, our baseline exclusion policy permits debt investments from suitable operating companies of excluded holding companies.[2]

There can also be sovereign considerations, particularly for utilities and energy firms: the impact of implicit or explicit government support on operations and profitability, the political risk arising from a country's energy transition, whether nationally defined contributions (NDCs) of the sovereign are aligned to the investor's targets, or the prospect of nationalisation. Energy providers can also be affected by the evolving geopolitical environment, views on nuclear power, or the broader impact of windfall taxes. These considerations are important as, over the long term, utilities and energy providers will play a central role in the transition, as well as providing portfolio diversification today.

> Energy providers can be affected by the evolving geopolitical environment

Given this complexity, some clients may choose to avoid investment in certain sectors, for example to exclude firms undertaking oil and gas exploration. The alternative is to engage with these firms and push them towards a sustainable transition.

1. 'The Net Zero Asset Managers Commitment', The Net Zero Asset Managers initiative, as of June 21, 2022.
2. See Our baseline exclusions on page 4 of: 'Summary of the Aviva Investors ESG Baseline Exclusions Policy', Aviva Investors, May 2022.

The power of engagement

Engagement is a key component of integration, driving change through portfolio exposures as the asset manager engages with firms across a range of ESG issues through bilateral meetings, coordination with equity portfolio managers to vote at AGMs, letters setting out specific asks and through joint engagement in collaboration with other investors (as with Climate Action 100+).

For example, this year we used the weight of our £253 billion in assets under management (as of March 31, 2022)[3] by setting out expectations to firms and governments in letters to CEOs and to 27 countries' central banks and finance ministers.[4, 5]

Engagement is often presented as an equity story, but that is not what it could or should be. Buy-and-maintain investors provide long-term funding to businesses (sometimes up to 30 years or more); if this support is withheld, it can have a material impact on the cost of capital for businesses. Long-term credit investors have a particularly strong voice when engaging in those areas of the market without access to equity funding, like housing associations, charitable foundations and universities.

Engagement is often presented as an equity story, but that is not what it could or should be

As discussed in a recent article, *Now for the hard part… The challenge of delivering net zero*,[6] at the peak of the pandemic, companies came to the debt market more than twice as often as to the equity market, and even more so companies with challenging decarbonisation pathways like utilities, transport and banks. This gives long-term credit investors real weight, and they need to use their voice to encourage those firms to adopt science-based targets (SBTs) for net zero.[7] They can engage through their asset manager, directly and through joint initiatives like the Net Zero Asset Owners' Alliance.

3. 'About us', Aviva Investors, as of June 21, 2022.
4. Mark Versey, 'Our annual letter to company chairpersons', Aviva Investors, January 24, 2022.
5. 'Responsible Investment annual review 2021', page 118, Aviva Investors, as of July 2022
6. Mirza Baig, 'Now for the hard part….. The challenge of delivering net zero', Aviva Investors, March 29, 2022.
7. Mirza Baig, 'Now for the hard part….. The challenge of delivering net zero', Aviva Investors, March 29, 2022.

Divestment considerations

If companies fail to adopt net-zero targets and set clear strategies despite engagement, divestment may be the final option, even though the buy-and-maintain portfolio manager's initial expectation was to hold the bonds to maturity.

This means investors must think carefully about the implications of investing in organisations that don't yet meet their net-zero expectations. They must be aware any engagement can fail, and plan accordingly.

One approach to managing this risk is to limit the term of any investment in such issuers (for example, limiting investment to bonds with maturity dates prior to 2030), reducing the likelihood and portfolio impact of any potential divestment. If the company responds to the engagement asks, the portfolio manager can look to extend the term of the investment.

Delivering impact

Investors who want to drive change through their holdings can adopt an impact approach, employing a combination of engagement to change firms' behaviour and investment in those organisations that will make a difference.

The first step is to decide what aspect of sustainability or ESG to target: this could be progress towards one or more of the Sustainable Development Goals (SDGs), people, biodiversity and natural capital, or climate change. Impact portfolios generally focus on specific metrics like an increase in the proportion of UK workers earning a living wage or a rise in the number of species present in a protected area.

The first step is to decide what aspect of sustainability or ESG to target

If the focus is climate change, in addition to specific net-zero targets, an impact portfolio could include a target on the proportion of investments that support the transition and/or adaptation solutions. The portfolio could also apply additional exclusions, prohibiting investment in firms that score poorly on the relevant metric, or firms whose business models are viewed to be contrary to delivering the relevant objective.

Given the nature of buy-and-maintain portfolios, and the typical credit risk appetite of clients who invest in them, it can be harder to support pure-play providers of nascent technologies, as these are often rated below investment grade. As a result, investment in solution providers is often linked to larger multinational firms, who have themselves chosen to back such technologies.

Buy-and-maintain portfolio managers will seek to understand the long-term themes and evolution of new technologies and identify potential investment opportunities as they approach investment grade (provided they remain within the investor's risk appetite).

How to assess progress

Investors also need to decide on their primary measure of net-zero progress, the main options available today being an assessment of point-in-time portfolio metrics (with target levels for those metrics in future) or the percentage of the portfolio invested in companies with forward-looking, science-based commitments.

Over time, the difference between these two approaches is likely to reduce as more granular, and robust, projection scenarios and forward-looking models are developed (see Data is never perfect), and as data becomes increasingly available.[8] For now, investors can monitor their portfolio using both approaches.

Using portfolio metrics

A standard approach consists in focusing on a specific portfolio metric, generally one adopted by a number of businesses, such as the targets set by the Net Zero Asset Owners' Alliance (see Figure 3, on next page). It provides a simple measure to report externally, allowing the demonstration of progress annually and comparability with peers.

> A standard approach consists in focusing on a specific portfolio metric

The chosen metric could be the weighted-average carbon intensity of a bond portfolio, which measures CO_2-equivalent emissions per dollar of revenue at the companies held, or other portfolio-level measures such as absolute emissions. There may then be a goal to reduce the measure progressively, or to achieve defined reductions by specific dates, until net zero is reached by or before 2050. Alternative metrics may allow for better comparisons within sectors, for example considering emissions per kWh instead of revenue within the electricity generation sector, but these can't be applied at a portfolio level.

It is important to understand the nature of these metrics – for example, those based on emissions per dollar of revenue for oil and gas producers may, in the short term, be driven more by energy price volatility (which is particularly relevant today) than changing emissions.

There may also be a focus on Scope 1 and Scope 2 emissions, given the more limited data available on Scope 3 – the distribution of firms' emissions between Scope 1, 2, and 3 can be very different, so different investment decisions may be taken based on the defined target. More widely, investors will need to determine how they want their manager to allow for incomplete data coverage – an issue that can be more material for buy-and-maintain portfolios given their allocations to unlisted issuers.

Figure 2. **Scope 1, 2, and 3 definitions**

Scope 1	Scope 2	Scope 3
Direct emissions from owned or controlled sources	Indirect emissions from the generation of purchased electricity, steam, heating and cooling	All other indirect emissions that occur in a company's value chain

Source: Carbon Trust, as of July 5, 2022.

8. Mirza Baig, 'Now for the hard part... The challenge of delivering net zero', Aviva Investors, March 29, 2022.

The chosen metric will necessarily influence investment decisions. If carbon intensity is the primary goal, the portfolio manager may have to exit certain positions (or restrict future investment in them) should the number become too high relative to its stated trajectory. This could mean the manager does not invest in corporate entities he or she considers core to the transition simply because they currently have a high carbon intensity.

For example, industrial gas producers such as Linde and Air Liquide have relatively high Scope 1 and 2 emission intensity and may be excluded. However, among other gases, they produce hydrogen, which could be key to the transition (and does not produce further carbon emissions when used by their customers).

Figure 3. **Net Zero Asset Owners' Alliance four-part target setting approach**

Source: 'Target setting protocol second edition', Net Zero Asset Owners Alliance, May 2022.

Using investee firms' commitments

A more qualitative approach would be to consider the portfolio's holdings in debt issued by investee firms with forward-looking, science-based commitments – such as SBTs or alignment to sector decarbonisation pathways.

The asset manager can consider multiple factors, such as principal adverse impacts (which are the key areas to assess businesses on risks and exposures), robust transition plans with quantifiable and verifiable performance indicators, and the integration of climate accounting (see *Our annual letter to company chairpersons*).[9]

Integrating qualitative assessments of organisations' commitment and plans to achieve net zero are particularly important for buy-and-maintain portfolios. Given how difficult it is to know where margins will be in 30 years' time, investors should give more weight to qualitative assessments of how the business will adapt to long-term trends. Sustainability is a critical part of making the investment case (see *Credit: The long and short of ESG investing*).[10]

> Investors should give more weight to qualitative assessments of how the business will adapt to long-term trends

An example of a qualitative approach would be to set a target to hold a proportion of the portfolio in firms with SBTs that contribute to limiting global warming to 1.5 or well below two degrees Celsius – for example, setting a minimum percentage for such holdings by 2030. Investors should be mindful to future-proof their targets, as other standards may emerge to replace SBTs or cover sectors that do not yet have them, such as the Energy Transitions Commissions' roadmaps for net zero for hard-to-decarbonise sectors.[11] Just because a sector isn't covered, that shouldn't make it un-investable.

It is also important to consider whether equivalent targets should be permitted. For example, sovereign-owned entities may be integral to supporting a country's NDCs but unwilling to sign up to SBTs as a standalone entity. Alternatively, their primary target may be expressed in different terms. In the UK housing association sector, for example, the primary objective is to improve the energy performance certificate ratings of the underlying housing stock.

9. Mark Versey, 'Our annual letter to company chairpersons', Aviva Investors, January 24, 2022.
10. 'Credit: The long and short of ESG investing', Aviva Investors, November 25, 2021.
11. 'Publications', Energy Transitions Commission, as of July 2022.

How do science-based targets work?

Adopting science-based targets (SBTs) is a means of ensuring organisations have greenhouse-gas reduction strategies aligned to specific climate objectives.

SBTs specify by how much and how quickly companies need to reduce emissions and provide a clearly defined path to achieve this. The process analyses each sector's contribution to current emissions before determining what that sector's pathway will look like out to 2050. That in turn makes it possible to set each company within a sector an emissions pathway.

For example, when setting SBTs, firms must include Scope 3 emissions where they account for more than 40 per cent of the total. This means firms are also putting pressure on suppliers and users of their products to curb their carbon footprint.

For more detail, see *Investing for climate action: Easy as SBTs?*[12]

The question of how investee firms choose to decarbonise is also relevant. The approach of a company like Italian energy giant Enel to close its coal power stations or convert them to gas directly contributes to global emissions reduction. In contrast, an oil major selling its stake in arctic oil fields to a private equity business doesn't reduce and may even increase global emissions.

Whether using portfolio metrics or investee firms' commitments, asset managers can provide clients with complementary data, including a variety of further ESG measures such as principal adverse impacts. Whatever the approach, metrics are needed. Setting a target requires data, assumptions and projections, which remains fraught, despite recent progress.

Setting a target requires data, assumptions and projections

12. Rick Stathers, 'Investing for climate action: Easy as SBTs?', Aviva Investors, January 11, 2022.

Data is never perfect

The finance industry needs to jointly agree on a better way to build forward-looking carbon models, with assumptions that reflect the way corporate behaviour will change over time. As Mirza Baig, global head of ESG investments at Aviva Investors, recently explained:

> "Trends in regulation, technology, and supply and demand dynamics are all vital. These assumptions need to include realistic assessments about how likely it is companies can deliver what they say they will. There is also a lot of work to be done to project decarbonisation pathways for companies who currently make no formal disclosures."[13]

Data coverage

In terms of data, coverage will never be 100 per cent. Where there is no data for a position from a given data provider, investors must decide whether to use alternative providers, exclude it from the calculation or use an estimate. Where there is no published data, the manager would also typically engage with the issuer to improve disclosure.

In addition, different parts of a business may all have the same reported carbon-intensity score as data may only be provided for the holding company. This can be very different from the true carbon-intensity of the operating company in which the portfolio is invested, and investors should push for added disclosure.

Metrics limitations

Metrics are imperfect, and investors must pay attention to detail. Do the metrics consistently include Scope 3 emissions, for instance, or just Scope 1 and 2?

The relative impact of measures can have material implications for the attractiveness of a sector compared to others. For example, electricity distribution grid companies (whose Scope 2 emissions include those required to generate electricity lost through the network transmission process) can have higher carbon-intensity metrics than oil majors.

To reiterate, different parts of a business can have the same carbon-intensity score – that of the parent company – despite having different individual carbon footprints.

Again, these limitations can result in unintended exclusions, whereby an investor may be unable to incorporate an allocation to high-carbon segments that are essential to the transition, even where these have very small Scope 3 emissions, as in our earlier example of industrial-gas producers.

13. Mirza Baig, 'Now for the hard part….. The challenge of delivering net zero', Aviva Investors, March 29, 2022.

We can’t wait for perfection

We need to transition our economies to net zero over time. Simply shutting down all fossil fuels today is not viable, as this would have a dramatic impact on jobs, economies and societies – as shown by the current energy crisis driven by sanctions placed on Russia – but it must happen as fast as possible to meet the Paris goal of limiting temperature rises to 1.5 degrees.

Investors need to push companies to set clear decarbonisation pathways and be willing to divest from those that do not. However, the primary focus must be on engaging with companies to help them reduce emissions where they can. If investors engage and those industries are needed until a replacement fuel or technology exists, their bonds don’t have to be phased out – unless the companies don’t move fast enough.

The investment industry is making rapid progress on what needs to be measured and how to set and implement net-zero pathways, but much uncertainty remains as the entire economy needs to step up and align to the Paris goals. While targets, metrics and strategies will continue to evolve as these approaches mature and ambitions grow, we are running out of time to limit global warming. The time to act is now.

Much uncertainty remains as the entire economy needs to step up and align to the Paris goals

Further reading

MSCI and the Paris-Aligned Investment Initiative have both published detailed guides on setting and implementing net-zero targets for investors:

Net-Zero Alignment: Objectives and Strategic Approaches for Investors by MSCI.[14]

Net Zero Investment Framework 1.5°C Implementation Guide by the Paris Aligned Investment Initiative.[15]

Key risks

Investment risk

The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Investors may not get back the original amount invested.

Credit risk

Bond values are affected by changes in interest rates and the bond issuer's creditworthiness. Bonds that offer the potential for a higher income typically have a greater risk of default.

Derivatives risk

The fund uses derivatives; these can be complex and highly volatile. Derivatives may not perform as expected, which means the fund may suffer significant losses.

Illiquid securities risk

Certain assets held in the fund could, by nature, be hard to value or to sell at a desired time or at a price considered to be fair (especially in large quantities), and as a result their prices could be very volatile.

14. Guido Giese, et al., 'Net-zero alignment: objectives and strategic approaches for investors', MSCI ESG Research LLC, September 2021.
15. 'Summary of the Aviva Investors ESG Baseline Exclusions Policy', Aviva Investors, May 2022.

Important Information

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