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Building resilient portfolios while supporting positive climate outcomes

Introducing the Aviva Investors Climate Transition Global Credit strategy

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Tom manages the Climate Transition Credit Fund, the Fixed Income Stewardship Fund (Aviva's ESG Bond Fund), and co-manages the sterling investment grade strategies.

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Tom holds a BA (Hons) in Accounting and Law. He is also a CFA charterholder and a member of both the CFA Institute and the CFA Society of the UK.

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Justine is a Senior Portfolio Manager in the Global Credit team. Justine co-leads our Climate Transition Credit Fund and is lead portfolio manager on several buy-and-maintain credit mandates.

Justine previously worked at Pictet Asset Management as a Senior Investment Manager. She was lead Portfolio Manager on a number of credit investment grade and crossover strategies, including a global sustainable credit fund. She additionally contributed to the development of a proprietary ESG framework.

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Key takeaways

Climate risks are a real and ever-growing threat to companies. Yet these risks are often widely ignored, misunderstood or inconsistently addressed by credit markets.

We believe full integration of climate factors into an actively managed credit portfolio can enhance long-term returns and help create resilience for investors.

The Aviva Investors Climate Transition Global Credit strategy aims to deliver all the benefits of an investment-grade bond portfolio, including strong and consistent returns, while also supporting real-world climate mitigation and adaptation efforts.

As active investors, we engage directly with companies to encourage them to set science-based targets (SBTs), amongst other commitments. This enables us to go beyond portfolio-level climate objectives and make a positive difference across industry value chains.

Introduction

In March 2023, the Intergovernmental Panel on Climate Change (IPCC) published the final part of its sixth assessment report, setting out the devastation extreme weather is already causing across the world. The scientists who compiled it warned worse is to come if humanity fails to act decisively to tackle the climate crisis.

"This report is a clarion call to massively fast-track climate efforts by every country and every sector and on every timeframe. Our world needs climate action on all fronts: everything, everywhere, all at once," said António Guterres, secretary-general of the United Nations.[1]

As well as being the greatest threat the planet faces, climate change poses huge risks to investment portfolios and clients' financial wealth. The physical impacts of floods, wildfires and extreme temperatures create dangers for companies across a range of industries. New regulation, emerging technologies and shifting consumer and investor preferences will transform business models as the transition accelerates.

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The rise of climate-themed funds

Many investors recognise the need to act to address the long-term physical and financial risks emerging in a rapidly warming world.[2] This has caused climate-themed credit funds to grow in popularity, complemented by advances in climate-related data and regulatory developments.

The climate-themed fund sector houses a range of approaches aiming to satisfy different investor goals and preferences.[3] These may include:

- Fossil-fuel exclusions and climate-risk mitigation
- Decarbonised portfolios via Paris-aligned benchmarks (PABs)
- Climate-risk mitigation through investment in transition-oriented companies
- Investment in green bonds, with the proceeds supporting climate-aligned projects

In many cases, these approaches involve trade-offs. Take PABs: interest in funds tracking these benchmarks has grown in recent years, as investors seek to align their portfolios with the decarbonisation objectives set out in the historic 2015 Paris Agreement. While such alignment may help reduce the carbon intensity of a portfolio, it is a relatively blunt tool for achieving climate aims (see *Active investment: Engagement and SBTs*).

For example, while a Paris-aligned portfolio may lower the risk of exposure to stranded assets among energy-intensive businesses, it does nothing to affect the business models of other issuers; such a portfolio will therefore still bear indirect exposure to transition risk. In addition, PABs tend to leave out huge swathes of the market due to their low-carbon focus – for example, they exclude almost all of the active bond issuers within the European electricity sector.

> Paris-aligned benchmarks tend to leave out huge swathes of the market due to their low-carbon focus

From a credit investor's perspective, this both narrows the pool of investable securities and limits opportunities to support the transition efforts of companies whose products and services will be vital on the journey to a lower-carbon future.

Similarly, a fund that targets only green bonds – which comprise a relatively small investment universe, despite growth in this market over recent years – would significantly restrict the available opportunities for return and diversification and potentially introduce concentration risk.

A climate-focused alternative to global investment-grade credit

To support positive real-world change and deliver on financial objectives, we believe a more holistic approach is needed.

Launched in 2021, the Aviva Investors Climate Transition Global Credit strategy aims to help mitigate some of the key risks associated with climate change while delivering the benefits of a traditional investment-grade credit approach, including consistent long-term income and capital growth.

It also aims to achieve positive climate outcomes by supporting companies investing in the transition to a lower-carbon economy – even if they are not low emitters now – and those developing solutions to help the world tackle climate change and adapt to its effects. The strategy may appeal to investors who want to strike a balance between managing climate risk, fostering positive change within companies and benefiting from the green transition.

Our approach opens a much broader investment universe than is available to more specific funds – such as those investing only in green bonds – allowing the strategy to be a direct alternative or complementary to a core investment-grade credit portfolio. To offset some of the natural underweights coming with a climate lens, such as low exposure to the oil and gas sector, the strategy retains the flexibility to invest up to 15 per cent in high-quality high-yield names, essentially mid-to-high BB issuers (which may include "rising stars") whose volatility profile is conducive to maintaining the investment-grade profile of the overall portfolio.

At the same time, we look to take advantage of the untapped potential of bondholders to exert a positive influence on sustainability standards.[4] Unlike passive investors, we engage directly with issuers to encourage them to improve not only their own climate credentials, but also those of their suppliers, supporting change across industry value chains.

Risk mitigation and resilience

As climate-aware bond investors, our main focus is on resilience and managing downside risks. We aim to mitigate the growing climate threats facing issuers and bondholders, including stranded assets and physical and decarbonisation risks.

Climate risk is often ignored or underappreciated by credit investors. It encompasses the long-term effects of climate change on a company's operations and business model, and as such should play an important part in any assessment of an issuer's creditworthiness. It may include physical hazards from flooding, wildfires or extreme temperatures, as well as transition risks such as regulatory penalties, technological advances or changes in consumer preferences.

Climate change is already having a major impact on every large company around the globe. Many firms are expensing physical impacts and the effects of government actions, such as fines. Banks are facing increasing pressure on their loan books, and rating agencies are starting to adjust assessments depending on climate-transition performance. We expect these developments to result in price tiering between decarbonisation leaders and laggards, much as external pressure led to higher costs of capital for tobacco companies in the past.

A mispriced risk

Despite growing evidence of the materiality of climate-change factors, the market does not always adequately or consistently price them in. For example, balance sheets among companies in the auto industry are being challenged by the need to pivot to electric vehicles (EVs). Yet corporate bonds from carmakers that have failed to proactively make the shift towards EVs often trade broadly in line with those from climate-change leaders in the sector. We believe this is unsustainable.

We are alert to mispriced climate risk in all forms. Climate change represents an asymmetric investment risk. While it can improve the potential upside for bondholders where they are invested in solutions providers or transition leaders, the upside is usually far smaller than the potential downside dangers.

MSCI investigated how different climate scenarios could affect the five-year default probability of a large sample of US dollar and euro-based bond issuers. Its analysis showed 16 per cent of investment-grade issuers in its sample could be downgraded to high yield in a "net-zero 2050" scenario. Among dollar- and euro-denominated high-yield issuers, 26 per cent and 28 per cent respectively were at risk of downgrades.[5] A separate study from Fitch Ratings found 20 per cent of global companies could face downgrades by 2035 due to climate vulnerabilities (see Figure 1).

Climate laggards potentially face increased balance-sheet stress, which will likely result in a higher cost of capital and greater default risk. We have already seen companies such as Australian multinational mining firm BHP offload coal assets at significantly reduced levels versus their book value.[6] While this did not move spreads at the time, we expect this kind of balance-sheet risk to become more prevalent and meaningful as the transition continues.

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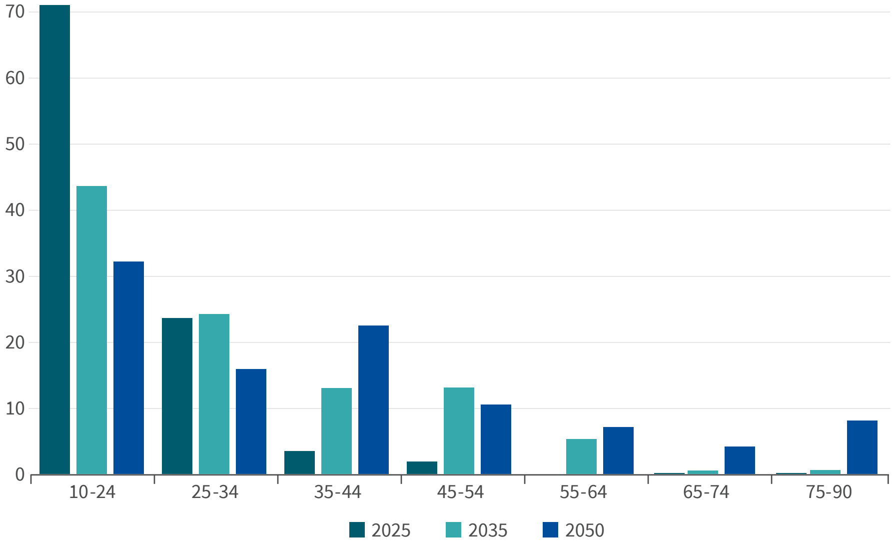
Figure 1. **Corporate issuers' vulnerability to climate risk (per cent)**



Note: The chart shows Climate Vulnerability Scores (Climate.VS); a Climate.VS score of 45 or above is considered "elevated". An elevated score could lead to material risk of a negative rating action in or before the year to which the score relates.

Source: "Climate risk-related downgrade may affect 20 per cent of global corporates by 2035," Fitch, March 8, 2023.

Many companies are ill-prepared for the coming disruption, and we expect more stranded-asset risk to manifest as tougher regulation is introduced. Some firms will have to make wholesale adjustments in a short period, which is likely to be more costly than long-planned, incremental change.

By contrast, climate-aware companies should be better equipped to adapt their business models, shift supply chains, accommodate physical risks and address regulatory issues. If they achieve this, their bondholders may benefit from smaller drawdowns, reduced volatility and lower risk of downgrades and defaults.

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Backing solutions providers and promoting the transition

We use a proprietary screen to exclude the worst carbon emitters from our portfolio, which reduces the kinds of risks discussed previously. We also invest in solutions providers and transition-oriented companies to further mitigate climate risk and actively support the shift to a lower-carbon economy.

Our focus on solutions and transition themes allows us to identify companies whose services and products deliver tangible climate outcomes. It also helps maximise the strategy's opportunity set and potential to deliver consistent, long-term outperformance.

As well as the issuer's climate credentials, several factors determine whether a corporate bond will be a good investment, which means active credit managers have a large toolkit to call upon (see *Boxing clever: Portfolio construction in investment-grade credit*).[7]

Among these factors, security selection is critical and necessitates a thorough understanding of the risks associated with many variable fundamentals – for example, an issuer's balance-sheet strength and quality of governance – and an assessment of whether a bond offers adequate compensation for these risks. This typically requires extensive research, usually conducted by well-resourced credit teams with the integration of broader environmental, social and governance (ESG) considerations alongside climate research.

Before identifying solutions providers and transition-oriented companies to add to the portfolio, we first apply our fossil-fuel filter. This helps protect capital by reducing the risk of stranded assets, particularly among coal-mining companies and oil and gas producers. Importantly, however, we do not apply a blanket low-carbon approach that excludes companies based on their carbon footprint without first considering whether they are helping to reduce overall emissions, or are on genuine transition pathways.

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We have the flexibility to allocate up to ten per cent of the portfolio in companies above our carbon threshold that play an active role in delivering substantial real-world change. A good example is Italian utility company Enel Group. Best-in-class utility companies will be as essential in the future as they are now, and their successful transition will be a critical milestone on the road to a lower-carbon world. Enel was one of the top-50 worst carbon emitters globally, but it has adopted an ambitious emissions reduction pathway compared to its peers, aiming to end its use of coal by 2027 and treble its renewable capacity. While its existing emissions are higher than our fossil-fuel threshold, it is on the right climate path.

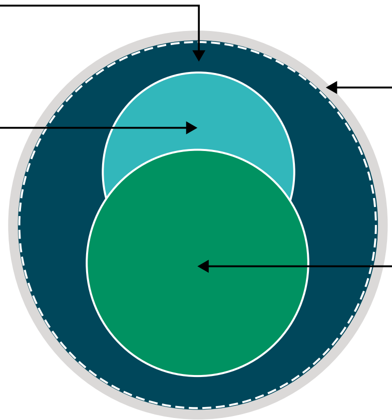
Figure 2. **A wider opportunity set**

Global IG credit universe
We start by looking at about 2000 issuers

Solutions providers
Companies offering goods and services providing solutions for climate change mitigation and adaptation

Mitigation
Examples:
- Sustainable transport
- Energy efficiency
- Renewable energy
- Low-carbon energy
- Electricity infrastructure

Adaptation
Examples:
- Water
- Health
- Oceans
- Urban areas
- Weather



Fossil fuel exclusion
We avoid most carbon-intense fossil fuels first

Transition oriented
Companies aligning business models for a warmer, low-carbon world, typically found across sectors based on our transition risk model

Example:
- Automotive company transitioning to EV technology

Source: Aviva Investors, 2022.

Transition-oriented companies

We cannot transition to a lower-carbon world if we simply rule out poor performers; all companies need to adjust. Transition-ready issuers are companies from all sectors that are managing their transition risks and improving their climate resilience. In doing so, they often use the services of solutions providers (see below). We think progressive transition-oriented companies are likely to retain a first-mover advantage and be more resilient over the medium term.

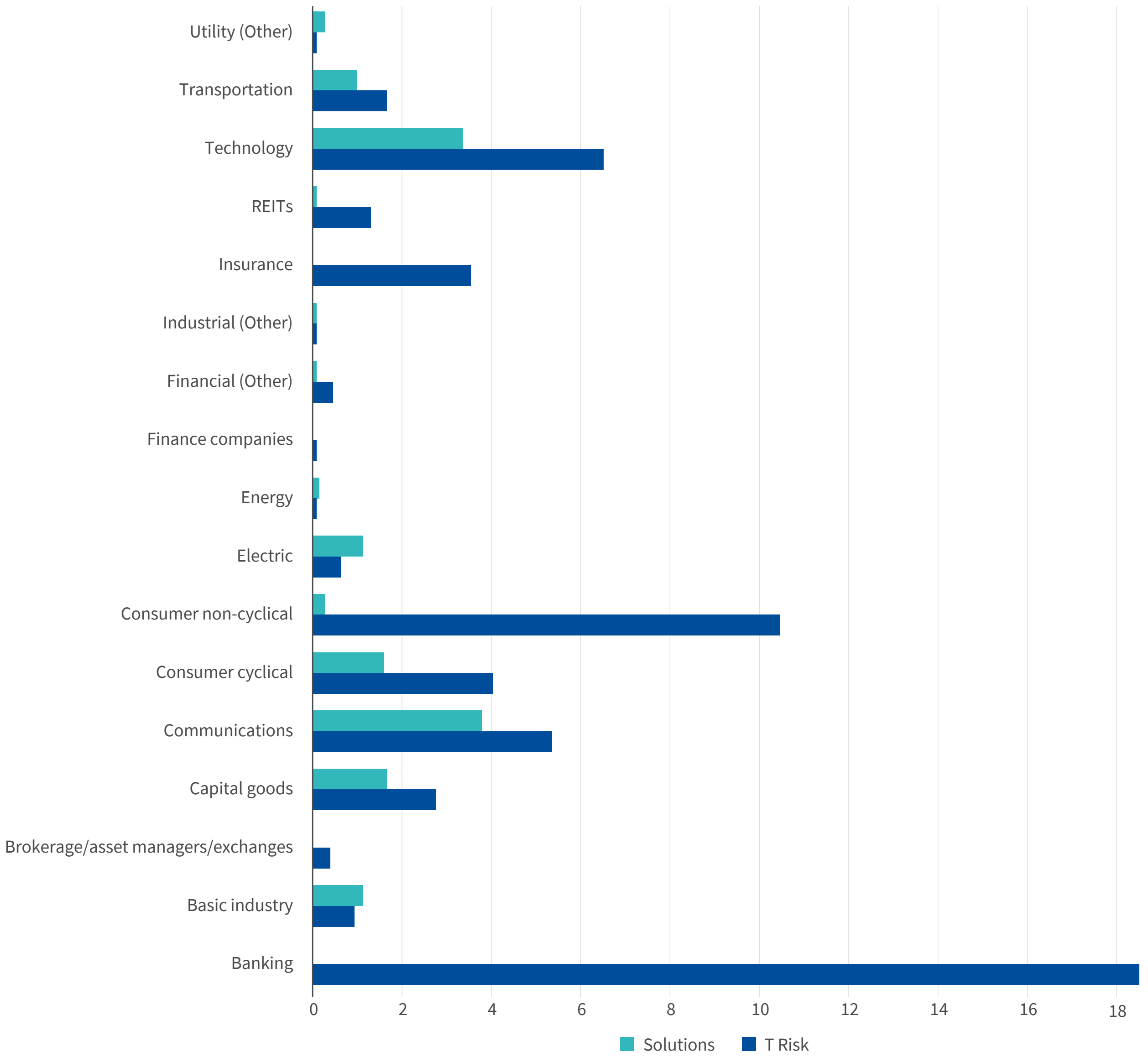
We assess issuers using our proprietary transition risk (T-risk) model. This model identifies climate-change risk at a granular sector or industry level, ranking the risk as high, medium or low. We combine this rating with a score that provides a measure of the quality of climate-risk management processes at individual companies.

The combination of these elements determines whether a company satisfies our transition criteria. For example, companies operating in high T-risk sub-industries will need market-leading approaches to climate change to be assessed as eligible for investment. The T-Risk model gives us a large eligible universe, spanning many more sectors than would be accessible in a solutions-only approach (see Figure 3).

We cannot transition to a lower-carbon world if we simply rule out poor performers; all companies need to adjust

On top of this quantitative assessment, we assess eligible companies from a qualitative standpoint. Our sizeable teams of credit and ESG investment professionals provide us with an additional edge.

Figure 3. **Our investable universe by sector: Transition and solutions (per cent)**



Source: Aviva Investors, 2023

Wireless network operator T-Mobile US is a good example of a transition-oriented company from a sector not associated with being progressive on climate matters. It is a large company driving material climate-friendly change in its operations. T-Mobile US was the first American wireless industry operator to set an SBT, and achieved its target of sourcing 100 per cent of its electricity from renewable sources by 2021. We purchased T-Mobile US's high-yield bonds in 2021 because of the company's appealing governance and climate focus. The company's debt was later upgraded to investment grade.[8]

Solutions providers

Solutions providers are companies whose products and services help mitigate the risk of climate change or enable communities to adapt to adverse physical impacts.

We initially assess companies as offering solutions depending on whether they derive at least 20 per cent of their revenue from these themes. Issuers that meet this threshold are then assessed using proprietary analysis. We further examine revenue sources by business segment to determine whether the issuer's business activities satisfy our solutions criteria and therefore whether it is eligible for investment.

In the credit universe, solutions providers are tilted towards more mature and large-cap companies. Many of the companies that meet the 20-per cent threshold enjoy growing and resilient sources of revenue and benefit from major government incentives.

These incentives are becoming more powerful. For example, the US Inflation Reduction Act (IRA) is reducing costs for clean-energy technology and could provide tailwinds to whole sectors: Swedish battery maker Northvolt has said if it built a factory in the US, IRA tax credits would amount to around $8 billion by the end of the decade and cover 30 per cent of its operating costs.[9] With Europe pressing ahead with its own subsidies for green technologies, large caps in sectors such as industrials, utilities and technology could be major beneficiaries and prove more resilient in downturns.

> The US Inflation Reduction Act is reducing costs for clean-energy technology and could provide tailwinds to whole sectors

The solutions sleeve of the portfolio is as much about long-term resilience as alpha generation. For that reason, and because it contributes to our positive climate-outcomes goal, we typically significantly overweight our exposure to solutions providers (we have a 30-40 per cent target exposure versus a c.20 per cent benchmark weighting).

As the solutions-provider universe is relatively small and concentrated on a narrow range of sectors, diversification is potentially an issue. However, the additional transition lens gives our portfolio the diversification and opportunity set needed for any global credit portfolio. This enables us to pursue our mandate and differentiates the strategy from narrower, more concentrated carbon-solutions strategies.

Portfolio construction

Our strategy aims to deliver the key benefits of investment-grade bond investing, chiefly downside protection and consistent returns. It is designed with similar portfolio characteristics and uses the same portfolio construction methodology as our flagship global investment-grade strategy.[10]

We believe our approach, combining solutions providers, transition-oriented companies and carbon-intensive companies implementing genuine green strategies, is unique among climate-focused credit strategies. As such, it may be of interest to clients looking for a strategy that offers the potential to achieve both positive climate outcomes and investment performance. The fact we have a larger investable universe than green-bond funds, for example, provides us with more arbitrage opportunities between sectors, seniority in the capital structure, maturities and currencies.

Active investment: Engagement and SBTs

The opportunity for engagement on the part of active investors in bond markets is considerable. Given companies will often issue bonds many times a year, investors can frequently apply influence through their capital-allocation decisions and dialogue with issuers. Additionally, many issuers are owned privately, meaning there is no pressure from public equity holders to improve governance. This gives bondholders a real opportunity to drive meaningful change in an important part of the capital markets beyond the reach of equity investors.

Focused dialogue with company management is essential to meet our climate objectives. A well-structured and targeted engagement programme can help shape investee company strategy and allow businesses to become more resilient to the impacts of climate change. Engagement can also provide an informational advantage by granting insight into a company's strategy.

> Bondholders have a real opportunity to drive meaningful change in an important part of the capital markets beyond reach of equity investors

Active fixed-income investors have a wide range of tools to enact meaningful engagement. The most effective engagement is ongoing and takes place on multiple fronts, from collaboration across credit and equity teams, to ESG analyst-led engagement with issuing companies, to engagement at a corporate level with industry bodies, governments and regulators to address market failures, a practice we call macro stewardship.[11]

Supporting real-world change

While some competitors have long-term net-zero targets, based on relative carbon-emissions reductions or a percentage of green revenues, we believe near-term science-based targets (SBTs) are currently the best way to align to the 1.5^{0}C global warming goal established by the 2015 Paris Agreement (see *Why we focus on science-based targets (SBTs) rather than net-zero objectives*) and drive concrete action. We target 90 per cent portfolio exposure to companies with SBTs by 2030.

Our focus on SBTs, together with our active engagement and macro-stewardship efforts, aims to ensure our approach has an influence in the real world, not just our portfolio. Engagement is a means by which we can encourage all the companies we meet — not just portfolio companies — to adopt more climate-friendly practices, thereby assisting in the construction of a more sustainable economy.

Estimates of the capital required to drive the climate transition vary from $3.5 trillion to $9.2 trillion a year.[12] Whatever the exact figure, much of this capital will be in the form of debt. Given the stress on government balance sheets, a lot of investment will come from exactly the kind of companies we invest in. Engagement is paramount to drive that change.

Why we focus on science-based targets (SBTs) rather than net-zero objectives

While 1,833 companies have announced their intention to reach net zero, few have target dates. This reflects a tendency to acknowledge climate ambitions without knowing how to achieve them. This is why we support the more practical orientation of near-term SBTs, which specify by how much, and how quickly, firms must reduce emissions.

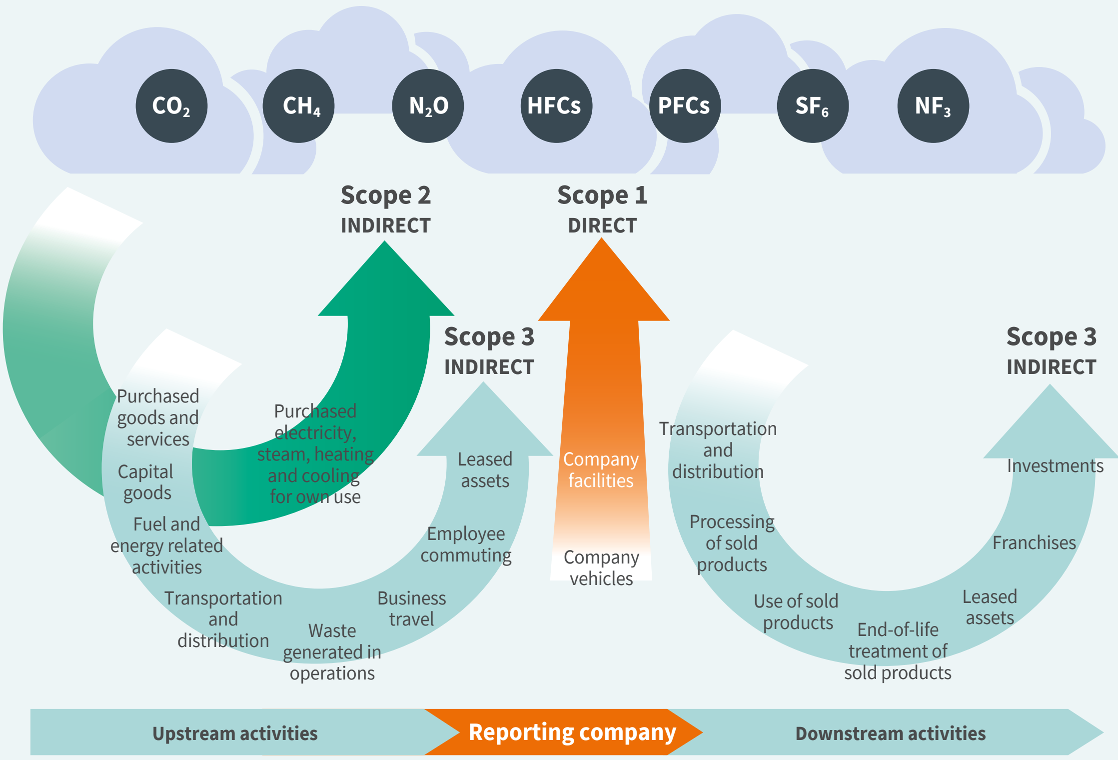
There are significant differences between SBTs and net-zero targets. For example, the latter allow residual emissions to be neutralised through carbon dioxide removal (CDR) mechanisms, like carbon offset schemes. CDRs can be used as a "fix" to align an emissions pathway with the desired net-zero outcome, but there are growing concerns about whether there will be enough capacity to deliver genuine carbon reductions, either through natural sequestration (forestry, soil carbon) or emerging technological solutions. SBTs do not allow abatement targets to be met through CDRs in any timeframe.

By setting SBTs, companies signal they are taking an active, forward-looking view. Those including Scope 3 emissions will encourage suppliers and users of their products to curb their own carbon footprints. Eventually, suppliers that fail to act may struggle to hold on to customers.

Furthermore, from a portfolio management perspective, cumulative emissions data offer little insight. Normalised carbon footprints (which measure emissions in tonnes of carbon dioxide per million dollars/euros invested, adjusted for equity ownership) or carbon intensity (measuring total carbon emissions relative to revenue) have their own challenges; for example, oil and gas producers will see carbon intensity fluctuate with energy prices, despite absolute emissions remaining largely unchanged.

In contrast, SBTs reveal how companies are managing risks and planning to develop climate resilience across their value chains. For investors, they can also mean allocation decisions have greater impact, because the impetus to decarbonise can trickle down the supply chain.

Figure 4. **Scope 1, 2 and 3 emissions**



Source: Aviva Investors, GHG Protocol, 2021.

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Key risks

Past performance is not a guide to future performance.

Investment/objective risk

The value and income from the strategy's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the strategy will achieve its objective and you may get back less than you originally invested.

Currency risk

The strategy is exposed to different currencies. Derivatives are used to minimise, but may not always eliminate, the impact of movements in currency exchange rates.

Credit and interest rate 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

Investments can be made in derivatives, which can be complex and highly volatile. Derivatives may not perform as expected, meaning significant losses may be incurred.

Derivatives are instruments that can be complex and highly volatile, have some degree of unpredictability (especially in unusual market conditions), and can create losses significantly greater than the cost of the derivative itself.

Illiquid securities risk

Some investments could 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 can be volatile.

Sustainability risk

The level of sustainability risk may fluctuate depending on which investment opportunities the Investment Manager identifies. This means that the fund is exposed to Sustainability Risk which may impact the value of investments over the long term.

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