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Climate and credit – solving the conflict with no compromise?

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At Royal London Asset Management, we have long understood the conflict at the heart of delivering effective ESG and climate integration into analysis. On the one hand, anything that can undermine the sustainability of issuers' balance sheets demands mitigation as an intrinsic part of any credible research process. On the other, delivering this authentically is not straightforward, and, far too often, purported integration amounts to little more than the adoption of seductively convenient shortcuts.

In an asset class that exhibits welcome idiosyncrasy - how and where you lend can be just as important as who you lend to - blunt ESG label and ratings, and generalised third-party data, do not handle nuance well.

And this risks the most invidious outcome of all – bad lending decisions and inappropriate allocation in the face of some of the most existential credit risks of all. Ultimately, in our view, if your ESG integration is proving easy, you're probably not doing it right. In this paper we outline our solution for effectively integrating climate considerations using a Climate Conviction approach.

Challenges to integrating climate

With increased regulatory onus on asset owners and managers to demonstrate being reliable stewards of capital – it has become more important than ever to manage this conflict, particularly when it comes to climate. But first, to help ensure any solution is pointing in the right direction, enhancing our investment decisions whilst providing clients with the right insights to meet their responsibilities, it is worth looking briefly at the challenges to effective climate integration.

The original user of the majority of third-party ESG data was the equity market. This has created a structural data coverage issue for fixed income, exacerbated by issuer and subsidiary mis-mapping. With significant skews between higher and lower impact issuers, this is particularly impactful when it comes to portfolio emissions data. Outputs which are being used to assess the relative net zero progress of asset managers, can become disproportionately distorted at relatively small levels of coverage or mapping deficiency. Consider that a typical bond benchmark may have less than 50% of issuers with a public equity listing, and the potential for climate misinformation is material.

Furthermore, relying on third parties results in anchoring to the 'most efficient' parts of the market – which can only damage your risk adjusted returns, and is the antithesis of active management. The key to any credit fund is effective diversification – especially in investment grade where the risk and returns can be asymmetric – and failing on this will ensure your returns will never be sustainable.

As credit analysts, whilst we are trained to identify risks and challenges, we do need to change our emphasis here and help to find useful solutions, rather than being paralysed by the pursuit of perfection. In fact, as technology, regulations and the political backdrop are moving at breakneck speeds, we can be liberated as being too prescriptive too early is counterproductive and heightens the risk of setting off in the wrong direction.

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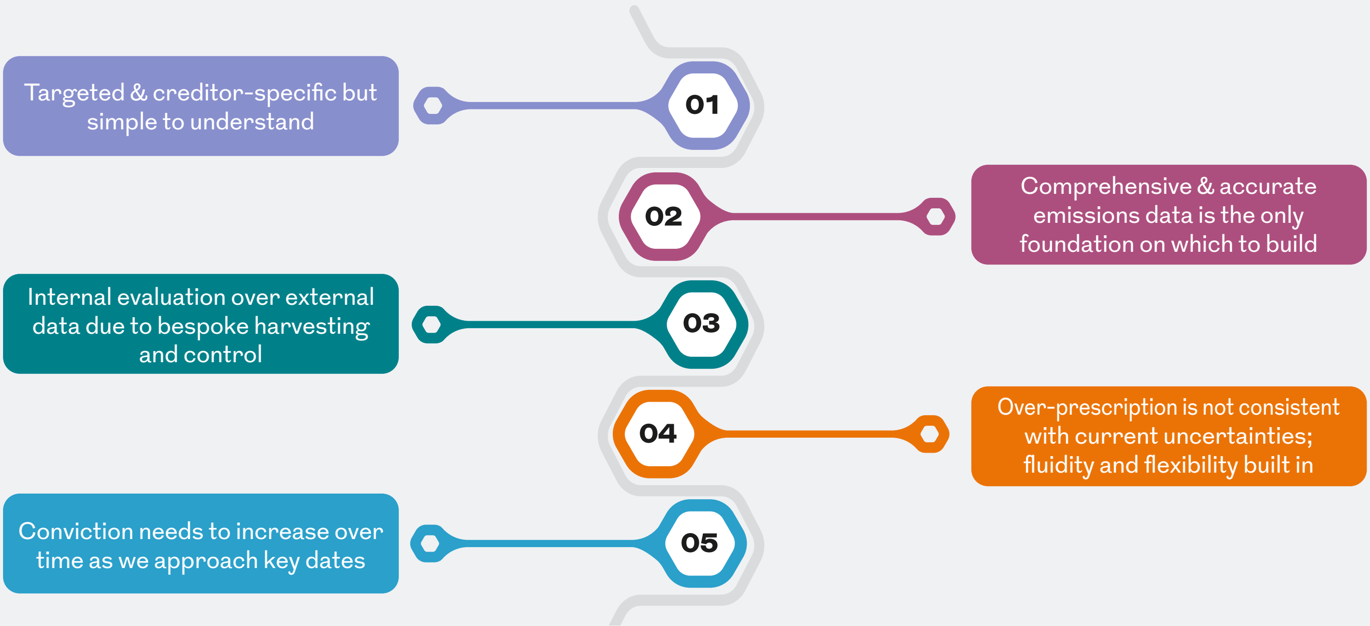
In-house analysis and collaboration are key

Our solution? It became clear to us very early, through our work with climate conscious clients over a decade ago, that to gain the most useful insights there must be no shortcuts. We need bespoke bottom-up environmental analysis and emissions data that maps to the precise entities that we are lending to.

To this end we have spent the past five years developing an in-house carbon emissions database that means our investment decisions, resource allocation and client reports are built on a foundation of high coverage and accuracy. This is then cemented by our fundamental non-negotiables when it comes to building credit portfolios: diversification, looking wider than convention to exploit enduring market inefficiencies; effective collaboration across our teams of industry experts to enhance our risk identification; and an unwavering belief that our own harvested and controlled data and insights must take precedence over the mechanical use of blunt external data.

Figure 1: Climate conviction philosophy



Source: Royal London Asset Management. For illustrative purposes only.

More specifically, our practical solution to evaluating issuer and portfolio transition credentials and enabling our clients to meet their reporting responsibilities is centred on Alignment Conviction – put simply, what is our level of conviction of an effective transition based on the available information and issuer specifics. We apply an Alignment Conviction score to each of our issuers based on a blended approach encapsulating both comprehensive transition analysis and engagement, and enhanced third party data, all built on the knowledge we have garnered from our in-house climate database.

Critically, reflecting the primacy we give to our own harvested and controlled information and assessments, our greatest Alignment Conviction comes from where we apply our own proprietary analysis (see figure 2). With this work as a foundation, we can utilise Science Based Targets Initiative (SBTi) and Implied Temperature Rise (ITR) data to expand our insights, having enhanced the dataset with improved issuer mapping, whilst acknowledging our conviction over alignment in these areas will not be as high.

Creating tailored hurdles and reporting around climate conviction

Whilst all of our portfolios benefit from our underlying analysis, should clients find it useful, we can aggregate each issuer Alignment Conviction into a portfolio score to give visibility on progress, reflecting our conviction over the portfolio's transition credentials (see figure 3).

For context, a score of 50 out of 100 would represent a fully aligning portfolio where the data is solely third-party derived – in truth an entirely theoretical situation given the relatively low coverage of credit indices from third-party providers. A typical Royal London Asset Management credit portfolio would benefit from the enhancements we have made through our proprietary analysis – creating the potential for conviction levels that go beyond what can be achieved through reliance on the most convenient tools.

Figure 2: Climate conviction strategy - Increasing Alignment Conviction over time

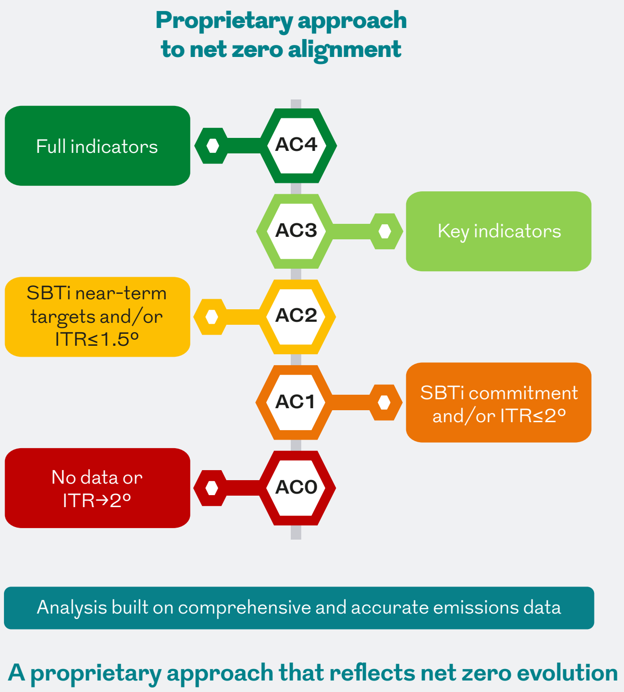
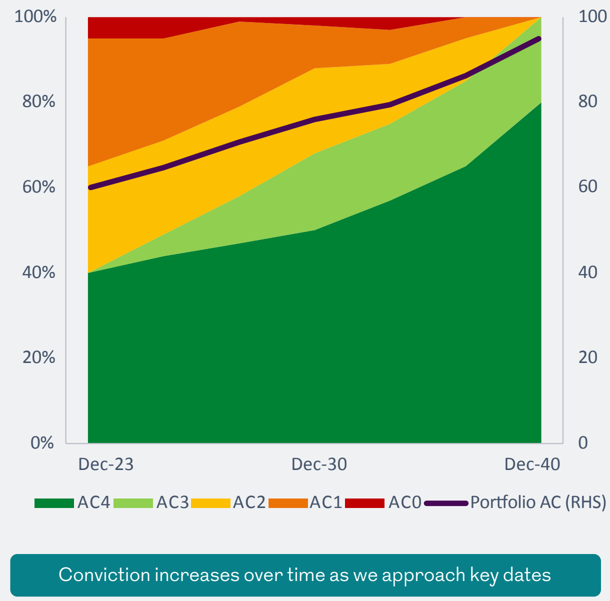


Figure 3: Increasing conviction on portfolio transition credentials



Source: Royal London Asset Management. For illustrative purposes only.

A practical solution

From here, it is also possible to work with clients to build in more mandated limits on lower conviction exposures, with increasing hurdles over time, as we move towards key dates, potentially requiring explicit investment actions if targets are not met. We believe that any mandatory targets would, however, require clear asset owner involvement – recognising the potential tensions that may build between investment performance, portfolio risk and level of alignment.

This practical solution allows clients to discharge their reporting requirements, enabling them to assess and monitor the preparedness of their credit portfolio for net zero, and progress over time against their key milestone dates.

When combined with our differentiated approach to building credit portfolios, with an emphasis on exploiting enduring market inefficiencies by a team with huge experience and stability, we believe that our Climate Conviction framework fundamentally solves the credit climate conflict with no compromise.

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