BlueBay Asset Management

**As attention increases for investors to take action on climate change, bondholders are taking active steps to influence issuers, while pension funds have the investment scale to meaningfully drive ESG progress.**

# Climate impact

## Think beyond stocks


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With most countries lagging behind their Paris Agreement goals, combined with an absence of government leadership, attention on climate action has shifted to the investment community. Investors are increasingly looking for the industry to throw some of its sizable weight behind driving the agenda forward.

### Pension allocations are material

One of the larger cohorts within the industry are the pension providers, which represent more than USD33 trillion in assets.

Many pension funds are getting a better grasp of incorporating ESG considerations into their investment practices, but equities have typically led in this arena, with the pick-up in fixed income somewhat slower. But with bonds typically accounting for the core allocation of pension funds – 54% in the average UK defined benefit pension, according to 2019 Mercer data – it's an area that requires more attention.

### Focusing on primary capital could be most impactful

One approach that appears to be gaining momentum is to 'deny the debt'. In essence, not providing capital funding to companies or sovereigns deemed to be fundamentally 'failing' on climate change.

The shift to include fixed income in the fight against climate change is logical for many reasons. One is materiality – the fact that the absolute size of the debt market trumps the equity universe means that if you want to make an impact, you need to think beyond stocks.

Another angle is the thinking that investors' impact will be greater if efforts are focused on primary markets (as opposed to secondary ones), in both equity and fixed income.

In secondary markets, trading occurs between investors rather than directly with the issuer. In short, there is not much opportunity to directly signal your concern about climate change or influence change over a company when it's not present.

By targeting new bond issuance and bank lending in fixed income markets (i.e. primary capital), investors can affect supply/demand dynamics more directly. You can not only potentially impact an issuer's access to capital, you could drive up their cost of capital.

Issuers that find they are struggling to get access to capital or having to pay more for that access because they are unattractive to investors due to their lack of ESG efforts may then start to take action.

### Green bonds

The 'deny the debt' concept is about signalling to issuers matters which concern investors. Another concept gaining interest takes the opposite approach, allowing issuers to signal their interest in areas that investors want to allocate funding to, namely tackling climate change.

The green bond market has emerged to do just that. In their purest form, green bonds are designed for investors to direct issuers on how their capital will be used. Their name would suggest that these issuances provide a vehicle to immediately stimulate better climate outcomes. In reality, they are still in their infancy and have some way to go.

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While intentions are positive, it is important to avoid the charge of 'green washing' by ensuring a robust assessment of each green bond issuance on a case-by-case basis – 'brown' assets may be being funded alongside 'green' ones.

### Sustainability linked bonds

Among the other ESG-labelled issuances that are emerging are 'sustainability linked bonds'. These do not adopt the 'use of proceeds' model, rather they are 'outcomes' linked, which creates a clear economic incentive for issuers to change their behaviour, as their coupon payments are linked to the achievement of a specific ESG metric. Issuers have full flexibility on the use of proceeds, so investors cannot allocate for the impact they would like to see their capital directly go to, beyond seeing an overall positive ESG outcome.

In our minds, both models have their merits, both for issuers and for investors, each solving for different requirements. It is great to see such innovation occurring in the fixed income industry and expanding the investor toolkit.

### Being active is key

All these approaches have a role to play in fighting climate change. Indeed, we need all asset classes to participate. But given the scale and urgency of the climate issue and the lack of international governmental leadership, we expect to see more on the 'deny the debt' concept, especially from asset owners such as pension funds that have set ambitious net-zero climate goals. The emphasis on primary capital in either case is logical and necessary – focusing solely on the secondary capital market is not going to get us where we need to be.

This will be part of a broader emphasis on fixed income markets, where lenders and bondholders play a unique and critical role. The challenge will be whether they seize the opportunity to act as enablers of the low-carbon transition or act as a barrier to it. Either way, taking an active approach will be key.

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