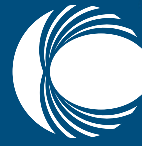

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Insurance CIO Whitepaper

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Welcome to CAMRADATA's Insurance CIO Whitepaper

Insurance asset management is defined by two primary challenges: solvency-based capital charges and bond yields.

Capital charges under Europe's solvency regulations have long-since driven insurers into lower returning assets, namely government bonds which carry lower capital charges – but which also deliver lower returns compared to other asset classes.

Higher capital charges for equities and other growth assets do, in fact, virtually punish insurers who seek growth rather than just liability management through their investments.

Although solvency-based capital charges are a well-known structural problem, the restrictions they cause have come into sharp focus again in tandem with the second of those challenges: low bond yields.

Covid-19 has seen the return of an economic environment – and response to it by central banks – that is not dissimilar from the financial crisis of 2008. Low policy bank interest rates have seen government bond yields fall once more to historically low levels and in some parts of Europe even become negative.

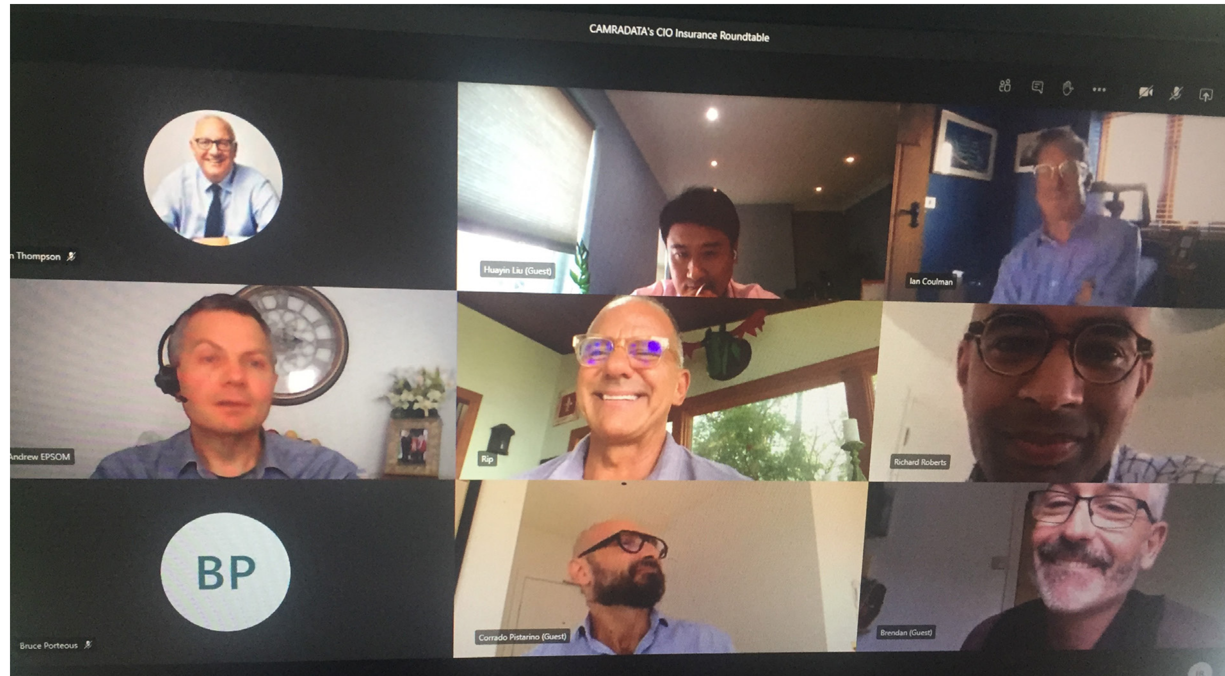
To confront this yield problem, insurers are under pressure to move up the bond risk spectrum, into corporate bonds, high yield and emerging markets. Higher capital charges will apply, but yields should improve.

Unfortunately, so too does risk - and it is now important to assess risk in light of the pandemic and contrast it with the days following the 2008 crash when the corporate bond market was a buoyant place to be.

Assets managed on behalf of insurers represent around €10 trillion in Europe. Historically, much of these assets have been managed by firms affiliated with insurance companies. They are still big players – but many non-affiliated asset managers have entered the space in recent years. This will increase competition and could help insurers confront the above problems.

Insurance CIO Roundtable

The latest CAMRADATA Insurance CIO roundtable took place virtually in London on 29 September 2020.



CAMRADATA's 2020 Insurance CIO roundtable found panellists curtailing investments into riskier assets. The tactical reduction will switch when prices move back into line with value.

Meanwhile, there is an ongoing strategic shift of capital into private debt and other forms of alternative credit. Security of income is a major issue here.

All panellists are getting to grips with the incorporation of ESG metrics into their portfolios. Most seek greater standardisation of these metrics. There was an acknowledgement that regulation is currently based on short-term historic volatility. The challenge is whether to even attempt to model ESG on such a basis.

"Markets have recovered but uncertainty is still there." This is how Ian Coulman, CIO of Pool Re, summarised the financial outlook going into the fourth quarter of 2020. The £6.5bn state-backed

> *" Our reasoning has been that as nominal yields approach zero, the chances of picking winners decreases. So we focus on downside because the upside is diminishing "*

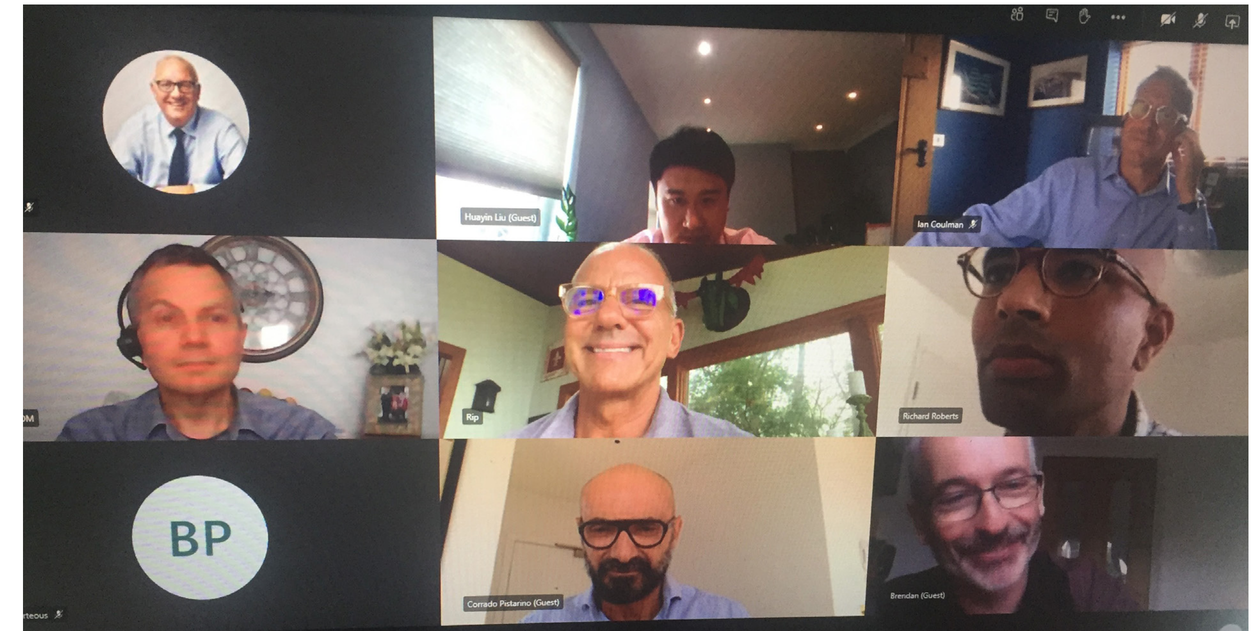
reinsurer of terrorist damage to commercial property cut allocations to riskier assets in August, including credit, Multi-Asset Credit and equities. The money has been tactically redirected to sovereign debt until the economic outlook improves.

Rip Reeves, CIO of US-based AEGIS, which insures much of North America's energy complex, was in a similarly cautious mode. AEGIS froze its allocation to private debt earlier this year and has put spare capital to work not in its investment portfolio but other parts of the business.

Reeves told the CAMRADATA Insurance CIO roundtable that AEGIS has been steering its portfolio away from riskier securities for the past couple of years. "Our reasoning has been that as nominal yields approach zero, the chances of picking winners decreases. So we focus on downside because the upside is diminishing."

He added that unlike investment teams in other types of organisations such as pension funds, AEGIS does not have a mandated performance return: "Instead we have a maximum risk budget which gets backfilled into the most efficient investment portfolio."

Richard Roberts, a global insurance investment director at Aberdeen Standard Investments, agreed that clients' focus right now is on portfolio resilience, moving



up in terms of quality to avoid bad situations. One tactic Aberdeen Standard has employed for clients involves switching the domicile of similar credits to earn a pick-up. "It is a move away from weaker names rather than reducing exposure. We have moved over to US credit, hedged back to sterling," said Roberts. Although not a significant uplift in credit quality rating, these switches meant clients were more comfortable with issuer names whilst securing a yield increase.

Roberts said that Aberdeen Standard was also seeing steady march by clients into private markets. He gave the example of fund financing, an ASI offering whereby investors lend to private market fund managers ahead of them drawing money from their vehicles' own Limited Partners. Roberts described the offering as fairly low risk, A/AA rating, with duration of between one to four years whilst offering a spread in the region of 150bps. He emphasised that the security derived primarily from the Limited Partners (typically pension funds and other insurers), not the acquisitions of the private market fund vehicle.

And so, if some insurers such as Pool Re and AEGIS are tactically reducing their exposure to riskier securities, the other, more

> *" With the ECB buying every month, there is little value in Investment Grade at the current spread. So we are looking to private placements for security - of covenants, not ratings. We want to see and analyse individual covenants "*

strategic trend evident from Roberts and other panellists was this growing appetite for exposure to real assets.

Corrado Pistarino is CIO of the £240m investment portfolio of Foresters Friendly Society, a UK mutual. Foresters has just gone into an infrastructure equity fund, the latest in a series targeting illiquity premiums, including private corporate debt and long-lease real estate. For Pistarino, these moves are part of the mutual's broader diversification away from public markets and towards enhanced focus around the theme of liquidity.

Huayin Liu is CIO of UNA Seguros, a multi-line Portuguese insurer with approximately E500m in investments. UNA Seguros currently has no private-asset exposure but Liu is hoping to buy into private debt soon.

"We have been talking to managers this year. Since April we are starting to see more deals in Europe and the US, but not the UK. Compared to pre-COVID, deals are 100-300 bps more attractive and managers are able to negotiate better covenant terms," he said.

Liu gave an indication of how the two big trends of cautiousness and private assets relate. "With the ECB buying every month, there is little value in Investment Grade at the current spread. So we are looking to private placements for security - of covenants, not ratings. We want to see and analyse individual covenants."

Andrew Epsom, Insurance Client Solutions Director at Royal London Asset Management, said that seeking increased security was a hallmark of RLAM's investment strategy in debt. Due to the current environment of uncertainty together with a potential yield pick-up, a strategy focusing on secured bonds was currently being explored by a number of insurers. He gave examples of the benefits of this relative to two issuers in sectors that have been

investments. He added that he was also modifying the cultural norm among the in-house Portuguese actuaries for evaluating expected asset returns.

Pistarino described illiquids such as infrastructure equity as high-governance assets. This means that not only does his team have to conduct a thorough due diligence and evaluate the merits of each deal, but there should also be a shared understanding across the various functions of the Society, up to the board level, of the implications of holding an asset for probably a number of years without the ability to de-risk during turbulent times.

Such communication is all part of the changes accompanying

" Such communication is all part of the changes accompanying insurers' shift to long-term portfolios of riskier holdings, which is increasingly a focus for regulators "

materially affected by the COVID environment - Mitchells & Butlers, a bar and restaurants owner, and Carnival, the cruise operator. Both companies had had to obtain new financing to manage the current environment.

RLAM was happy to participate in the former through its secured bonds – which is an exposure that has recourse to Mitchells & Butlers' properties in extremis. Carnival, on the other hand, had previously only offered unsecured debt. The unsecured bondholders in Carnival had been subordinated in the structure, with a material fall in credit rating and a large mark-to-market loss. The secured bondholders in Mitchells & Butlers had fared much better, retaining the previous credit rating.

Tactical Pessimism

It is the parlous predicament of companies like Carnival, struggling to salvage revenue during a pandemic with no end in sight, that caused Pool Re to derisk this summer. "Unless there is a vaccine, this is a global problem," said Coulman. "The indications from Central Banks suggest they are willing to let inflation run ahead of its normal pace to try to inflate their way out of the problem – not that there is much inflation coming through yet."

In the meantime, Pool Re expects more insolvencies and defaults. Coulman is clear that the move to sovereign debt was a tactical allocation, following the markets' recovery in early spring. He expects Pool Re to buy more credit next year when market prices better reflect underlying economic reality.

At this point, the CIOs of both large and small portfolios related that they have a big communications job explaining to shareholders what to expect from markets in current conditions. This matters in the context of the overall enterprise plan; where best to deploy risk and capital. Liu explained that it was a learning process for his Chinese shareholder – which runs a conglomerate and not just insurance - to adapt to a more realistic expected revenue from underwriting versus insurers' shift to long-term portfolios of riskier holdings, which is increasingly a focus for regulators. In March 2019, the European Commission announced modifications to the capital charge under Solvency II on equities held for more than five years. The carrot for more patient capital is a reduced charge of 22% versus 39% for equities.

Liu said he was advocating for more guidance to be provided to insurance companies on the classification of long-term and strategic equity investments. The debate then naturally progressed to Environmental, Social and Governance (ESG) criteria, which is related to long-termism and another aspect of capital management for which the European Union is developing more rules.

Pistarino named the transition to a low-carbon economy as one of his top themes for strategic asset allocation this decade. "The next ten years are crucial if we are to follow a 1.5 degrees trajectory," he said. Although Foresters is not obliged to conduct a stress test for climate change-related risks – the UK regulator expects only large insurers to do that – Pistarino said it is important for all insurers to build expertise and internal capabilities before it becomes mandatory. Foresters is a PRI signatory and equities have been managed in a sustainable fund since 2018.

Epsom said that there had been three key but potentially conflicting demands from insurers allocating to equities: lower fees, outperformance over a benchmark and effective integration of ESG criteria. In response, RLAM has developed a new systematic strategy for implementing equity portfolios to meet these demands. This utilises the global equity universe considered part of RLAM's active equity process, but then uses a cost-effective systematic approach to implement a sub-set of this universe including integrating ESG criteria and any other bespoke requirements.

Coulman said he personally believed that the 'E' and 'S' ought to be baked into the governance structure of a company. In terms of market offerings, he said this sector still suffered from a lack of common standards. "There are so many requirements from regulators and industry bodies to grapple with. What is the right approach?"

He said that morally we should be protecting the planet, but having had conversations for years with all ten external managers for Pool Re, there was not an industry standard

or common methodology by which ESG could be measured.

Reeves said the variety of ESG approaches reminded him of Enterprise Risk Management in its early days. He added that AEGIS's investment portfolio looked environmentally-friendly today more by chance than design. The team generally prohibits investments in any of its policyholders, which means it avoids carbon-intensive utilities and suppliers. He added, however, that AEGIS has a thorough assessment of the ESG risks carried in its credit portfolio.

Liu added his to the voices seeking some kind of regulatory harmonisation of ESG metrics. "There are scores for managers and strategies but I don't rely on them too much because of the lack of standardisation," he said. In terms of morality, he distinguished Socially-Responsible Investing from ESG. Unlike Coulman, he did not see a grander ethos defining ESG. Instead, he wanted to be able to price risk sensibly. He saw this as a duty to policyholders. He noted here the potential conflict between undervalued stocks and ESG criteria and even the capital charges related to long-termism. How do investors assess how fast and far capital-intensive energy providers transition to a low-carbon path? Can they be a source of profit at various times along the way?

" Three key but potentially conflicting demands from insurers allocating to equities: lower fees, outperformance over a benchmark and effective integration of ESG criteria "

Pistarino warned that capital adequacy in Solvency II is constructed based on a one-year Value-at-Risk and a fair valuation of assets and liabilities. As a result, the one-year horizon is at variance with the long-term dynamic over which climate change-related risks would emerge. Here the CAMRADATA panel saw tension between the direction of ESG policy within the EU and current risk management. "The incentive to position a portfolio along a prudent temperature pathway needs to recognise that the expected performance of those assets may act as a constraint, in the absence of decisive policy interventions," observed Pistarino.

EIOPA, the EU's regulatory agency for pensions and insurers, has already surveyed the industry about

incorporating ESG into underwriting and commercial activities. But as with incorporation of ESG into customary market-risk measures, policy development is nascent.

"We are at the beginning of this process," said Pistarino.

Some might argue that any mismatches are a boon for active managers, i.e. those investors more far-sighted than regulation directs in their vision of where future economic growth lies. So many managers now claim – ahead of regulation – to be ESG-aware.

"ESG analysis is fully integrated into both credit and equity analysis at Aberdeen Standard already," said Roberts. He nevertheless would like to see regulators give more guidance. "I believe in risk-based capital charges but some acknowledgment of the transition to net-zero carbon within the solvency capital framework would spur movement in our industry," he said.

The panel closed with one more niggardly risk to be managed: the UK's withdrawal from the EU. The mood was realistically optimistic. "I don't believe the EU and the UK will fail to reach an agreement," said Pistarino. "London is a major financial centre on the doorstep of the EU. Too many European

" I believe in risk-based capital charges but some acknowledgment of the transition to net-zero carbon within the solvency capital framework would spur movement in our industry "

companies rely on it. I don't think it is in anyone's interest to unravel that."

He noted that whereas there was a lot of complacency in the markets four years ago at the time of the Brexit referendum, markets had time to prepare for a 'no deal' scenario. He predicted that the maximum fall for sterling would be 8-10% should such an event occur.

Even this would be a short-lived reaction, however. Strategically, Epsom noted that most UK insurers have far less dependence on domestic investments than ten years ago – in particular the proportion of equities allocated to UK issuers was now much lower.

Roberts added that to really understand the impact of Brexit was a "line-by-line" assessment through the portfolio.

From the other side of the Atlantic, Reeves – whose company owns a Lloyds syndicate – said that AEGIS was prepared for the UK's withdrawal and it continues to be a geopolitical issue of significance.

On the investment outlook he said: "For regulatory purposes, we are required to own sterling-denominated assets which we keep at the minimum."

Roundtable Sponsor

Richard Roberts, Global Insurance Investment Director

Personal Profile

Richard Roberts is a Global Insurance Investment Director developing Aberdeen Standard Investment's global insurance business. Prior to joining Aberdeen Standard Investments in August 2020 he was Head of Balance Sheet Investments for Zurich Insurance Group's UK business responsible for Balance Sheet Investment Strategy, Unit Linked Discretionary Relationships and Treasury. Richard also spent a number of years working as an Investment Accountant within Zurich's UK business. He is a Chartered Accountant and a CFA charterholder.

Aberdeen Standard Investments

Company Profile

Aberdeen Standard Investments is a leading global asset manager dedicated to helping investors around the world reach their desired investment goals and broaden their financial horizons. We provide access to a wide range of strategies and asset classes that target to help enhance the risk-adjusted return on a portfolio. Plus we provide a complete service to meet reporting and fiduciary requirements, including complete investment outsourcing where required.

Roundtable Sponsor

Andrew Epsom, Insurance Client Solutions Director

Personal Profile

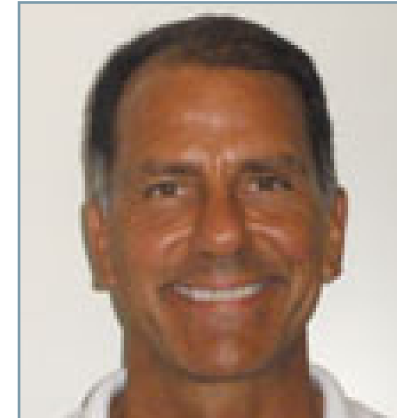
Andrew Epsom is an insurance investment specialist with 25 years of experience. Prior to joining Royal London in 2020, Andrew was a principal in the Mercer Insurance Investment Team, where he was responsible for leading several strategic relationships with global insurers as well as introducing the Mercer investment platform to insurers across Europe. Prior to this, Andrew spent 13 years at Willis Towers Watson, including being Co-Lead of the Insurance Investment Advisory Group in the UK. Andrew is a qualified actuary and has a BSc(Hons) in Mathematical Statistics and Operational Research from the University of Exeter. He has also completed the Investment Management Evening Programme at the London Business School.

Royal London Asset Management

Company Profile

Royal London Asset Management (RLAM) is part of the Royal London Group, the UK's largest mutual insurer. In line with our mutual ownership, we invest for the long-term and put our clients at the centre of all that we do. Our understanding of the unique needs of insurance companies makes us well placed to help other insurers manage their assets. We provide tailored investment solutions that recognise an insurer's specific needs around areas such as risk appetite, liquidity, liability matching and sustainability. We leverage RLAM's award-winning asset management capabilities across fixed income, cash, equities, multi-asset, property and sustainable strategies.

Roundtable Participants



Rip Reeves

Chief Investment Officer and Treasurer

Rip Reeves is Chief Investment Officer and Treasurer for AEGIS Insurance Services -- a global, commercial P&C Insurer with offices in East Rutherford, NJ and London, England. Prior to joining AEGIS Insurance Services in 2011, Mr. Reeves was CIO for Argo Group. For 20 years Mr. Reeves was a bond portfolio manager and asset allocation specialist for Standish, Ayer & Wood, Scudder Stevens & Clark and JP Morgan Investment Management. Mr. Reeves started his financial career on the trading floor at Salomon Brothers in 1985, in mortgage derivatives. He has a BS and an MBA from Louisiana State University.

Corrado Pistarino

Chief Investment Officer

Corrado Pistarino has more than 20 years experience in capital markets. He is Chief Investment Officer at Foresters Friendly Society. Previously to his current positions, he was Head of Insurance LDI at Aviva Investors, responsible for over £10bn of insurance funds and £30bn of derivatives exposure.
His previous employers include Deutsche Bank, Dresden Kleinwort and ABN AMRO Bank. He worked in structuring/trading and client coverage, with a focus on ALM and capital management solutions.
Corrado has a degree in Physics from Turin University and a Master in Finance from London Business School.

Roundtable Participants

Ian Coulman

Chief Investment Officer

Ian is an experienced investment professional with international experience and strong leadership and management skills. He possesses extensive investment knowledge of all major asset classes and a wide variety of investment products and styles in fixed income, conventional equities and alternative asset classes. As Pool Re's Chief Investment Officer, Ian is responsible for the development and implementation of investment strategy, strategic asset allocation and the monitoring of managers. Prior to joining Pool Re as CIO, Ian was Managing Director of Butterfield Asset Management, a wholly owned subsidiary of Butterfield Bank.
The asset management subsidiary provided investment management services to high net worth individuals, institutions and retail clients. Before joining Butterfield in 1998, Ian fulfilled a number of senior investment roles with AIG in London, Boston and Tokyo. Ian began his investment career with the private Swiss bank Lombard Odier.

Huayin Liu

Chief Investment Officer

Huayin Liu is the Chief Investment Officer of UNA Seguros, a Portugal based insurance group. Before joining UNA, Huayin was a Portfolio Manager at Reinsurance Group of America (RGA), responsible for managing RGA's assets in the EMEA region across five different currencies: GBP, Euro, USD, SGD and South African Rand. Huayin started his career working in various roles in both ALM and Investment Manager Research departments at Redington, advising UK Pension Schemes and Insurance Companies on asset allocation, manager selection and hedging strategies.

Moderator

Brendan Maton

Freelance Jounalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.
Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles. Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.
Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

Embedding ESG considerations into Strategic Asset Allocation - an impactful evolution for insurers

Introduction

Environmental, Social and Governance (ESG) considerations have been very high on the agenda of insurers for a number of years – and given the magnitude of the challenges society is faced with, they will undoubtedly remain a key priority.

Indeed, for insurers, the impact of ESG related themes can be significant and wide ranging. On the liability side of the balance sheet for example, increases in claims arising from extreme weather events will be a consideration for P&C insurers. On the asset side, the transition to a low carbon economy brings with it the risk of leaving some investments stranded and opportunities for those who position themselves for this change.

At the same time, the policyholders that insurers serve will have expectations that their premiums are being invested in a manner that both delivers financially and generates some benefit to wider society; whilst the shareholders of insurers will have their own demands again. Add in regulatory change for good measure – in the UK for example, the PRA have required banks and insurers to enhance their approach to managing the financial risks from climate change[1] - and the case for such themes remaining high priority is clear and compelling.

On the asset side, insurers should look to their asset managers for assistance. At Aberdeen Standard Investments (ASI), our aim is to invest for a better future. ESG considerations have been an integral part of our decision-making process for almost 30 years.

" A key feature of our process is the specification and utilisation of sophisticated climate scenarios to estimate the impact of the climate transition on the expected returns of different asset classes "

From bottom up - to top down

ESG considerations are best looked at holistically. We believe the importance of bottom up ESG analysis cannot be underestimated; considering how the companies which you own or lend to might be exposed to ESG related risks and opportunities, and how those considerations factor in to your assessment of value is an essential element of a robust investment process. Likewise, over time we believe significant good will come from pro-active ongoing engagement with companies on ESG related issues.

Further detail on our approach to integrating ESG across asset classes can be found at https://www.aberdeenstandard.com/en/uk/institutional/responsible-investing

We also believe consideration of ESG from a top down perspective is important. Strategic Asset Allocation (SAA) is the process of making long term decisions about where to allocate your capital. Such decisions will be informed by the expected risks and expected returns of the assets classes available for investment. Such expected risks and returns are in turn and over time impacted by environmental and social changes – the consideration of how ESG factors can affect long term returns should therefore be embedded in any robust capital market assumption process that forms an input to the SAA. For this reason, a key feature of our process is the specification and utilisation of sophisticated climate scenarios to estimate the impact of the climate transition on the expected returns of different asset classes.

Here however we demonstrate how the embedding of ESG considerations into SAA can be taken a step further still, describing how an insurer might use the process to assist them in maximising the alignment to their ESG philosophy, without compromising their investment risk and return objectives.

Embedding climate impact in to SAA

SAA decisions can shape the ESG impact of an insurer's portfolio.

Investors typically think about asset allocation from the perspective of expected risk and returns. We frequently add a third and important lens of solvency capital optimisation for our circa. 150 insurance clients.

Below we go a step further to demonstrate the important role that capital allocation decisions can play in aligning investment to an insurers ESG philosophy and helping to achieve their ESG objectives.

Perhaps the area in most significant need of increased capital allocation is that of climate change, in particular to support the transition to a low carbon economy. To achieve the climate goals agreed by the world's governments, an additional US$1.5 trillion a year is needed to finance the transition to a low-carbon economy[2].

We outline within the table below how three portfolios with similar risk and return objectives can each have a significantly different contribution towards supporting the transition to a low carbon economy.

Traditional balanced Target return 5%			Modern diversified Target return 5%			Climate-aligned Target return 5%		
Asset classes	% asset class weight	% of portfolio allocated to climate opportunity	Asset classes	% asset class weight	% of portfolio allocated to climate opportunity	Asset classes	% asset class weight	% of portfolio allocated to climate opportunity
Equities	55	1.7	Equities	30	0.9	Equities	25	0.8
						Climate opportunity equity	5	5
Rates	10	0	Rates	10	0	Rates	10	0
Credit	35	1.1	Credit	40	1.2	Credit	30	0.9
						Green/ infrastructure bonds	5	3.5
			Infrastructure	10	4.5	Other infrastructure	7	0
						Renewable energy infrastructure	8	8
			Real estate	10	1	Climate enhanced real estate	10	3
Portfolio expected return	Portfolio volatility	Climate solutions allocation	Portfolio expected return	Portfolio volatility	Climate solutions allocation	Portfolio expected return	Portfolio volatility	Climate solutions allocation
5%	7.9%	2.8%	5%	5.8%	7.6%	5%	5.8%	21.2%

Securities selected for the model portfolio are for illustrative purposes only. This is offered as opinion and are not reflective of potential performance. Target returns are not guaranteed and actual events or results may differ materially.

We use the metric of "climate solutions allocation" within this exercise. By climate solutions we mean companies and projects that provide low-carbon energy and transport solutions that will allow societies to reduce global carbon emissions. Utilities that generate power using renewable energy, battery technologies and electric vehicles, other decarbonisation technology companies, and energy efficient buildings would all fall into this category. We use MSCI ESG data to quantify the share of the MSCI World Equity Index that is allocated to climate solutions and make our own estimate elsewhere using fairly strict definitions.

We demonstrate that even relative to a modern diversified portfolio, which here allocates 7.6% of the portfolio to climate solutions (primarily through allocation to infrastructure), much greater allocations to climate solutions can be made without sacrificing expected return or increasing expected risk; 21.2% of the climate aligned portfolio.

To achieve this, insurers may have to consider a broader investment universe than they are exposed to at present, climate enhanced benchmarks, sustainable index funds and exposure to private asset classes such infrastructure amongst the primary candidates.

Richard Roberts
Global Insurance Investment Director

Conclusion

The traditional process of choosing where to allocate capital has long been dominated by considerations of expected risk and return, both in discrete terms and relative to insurance liabilities. For insurers, the advent of risk based capital regulatory frameworks has in recent years added a third lens of solvency capital efficiency to the mix. These are and will remain essential components of a robust SAA process for insurers.

To date, achieving one's ESG objectives has had a tilt towards how you assess, engage with and manage the investments you have already decided to allocate to. Going forward, we believe that additional focus should and will be given to bringing ESG considerations forward into SAA decisions. We have demonstrated above one way in which our SAA process can assist our clients in supporting the transition to a low carbon economy without losing sight of risk, return and capital efficiency.

This article utilises analysis published within the Aberdeen Standard Investments thought leadership paper "Strategic Asset Allocation: ESG's New Frontier", authored by Craig Mackenzie, Head of Strategic Asset Allocation, Global Strategy.

1 – PRA Policy Statement PS11/19; April 2019

2 - McCollum, D et al (2018) Energy Investment Needs for Fulfilling the Paris Agreement and Achieving the Sustainable Development Goals. Nature Energy.

Important information

Investment involves risk. The value of investments, and the income from them, can go down as well as up and an I investor may get back less than the amount invested. Past performance is not a guide to future results.

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ESG integration in fixed income – preserving good intentions but delivering superior outcomes

Environmental, Social and Governance (ESG) considerations have been a hot topic for many investors over recent years. This is especially the case for insurers, with increased regulatory pressures emerging around recognising climate related asset risk in investment and capital management approaches. For many insurers, climate risks are a balance sheet rather than just an investment issue.

Having said that, we observe that the insurance industry as a whole is still struggling to effectively integrate ESG into the investment approach, with the increased risk management, stress testing and disclosure requirements, and particularly in harvesting the return benefits of a robust ESG framework. This is even more challenging within fixed income, where the majority of insurers' assets are invested, but where ESG practices are much less evolved than in equities. In this paper we consider an appropriate framework for ESG integration within credit, as well as sharing our views on how outcomes from investing in sustainable green bonds can be improved.

Is ESG integration really that different?

Our approach at RLAM to ESG in credit has always been built on a longstanding investment philosophy that credit markets do not accurately price idiosyncratic risk. We use ESG analysis in the same way as any other form of credit research – to uncover information that credit rating agencies and other market participants might have missed, helping us to make better investment decisions and potentially deliver excess returns.

We believe it is unhelpful to contrive a false distinction between ESG and credit analysis, when all that really matters is risk identification and its ability to impair expected returns for investors. Given the asymmetric nature of credit risk and return, the sustainability of our lending position is therefore most critical. We target risk identification and engagement most intensively on those sectors where we feel there is most ESG risk and, as is often the case, there is limited third-party ESG research. However, we find this turns the real challenge of poor and unfocused ESG data available in the market into the real opportunity of enhanced information discovery.

> *" We target risk identification and engagement most intensively on those sectors where we feel there is most ESG risk "*

Comparing apples with oranges, bonds with equities

ESG investing started as an equity construct and much of the data and analysis used today is still centred on this. Discussion around ESG integration in fixed income is less established and best practice is continually evolving. However, simply replicating the approach taken by equities ignores that in credit markets we can lend to the same company in many different ways, such as lending to a ring-fenced part of the company, or secured over specific assets. In addition, third-party data coverage is constrained; for example only around 40% of the bonds in the sterling credit index have a public equity profile. Not only does a focus on companies with a public equity listing greatly reduce the opportunity set, it is also the very area of the market where information dissemination is already most efficient.

Unlike with equities, credit risk and return is asymmetric, and it is the impact rather than the origin of risk that matters. There is, arguably, no asset class to which sustainability is more important than credit.

ESG scores - convenient but costly?

We believe it is extremely difficult to outsource effectively the analysis of ESG risks to third parties. The apparent simplicity and convenience of a simple 'ESG score' often fails to capture the vagaries of the real world and the sheer idiosyncrasies of credit.

We know this inefficiency well from the role of credit ratings in the market: while broadly helpful, summarising information into one rating creates distortions that active investors can exploit. The only credible solution is thorough, bottom-up fundamental research and an investment process that acknowledges the false distinction between traditional credit and ESG analysis. While ESG analysis needs to be intrinsic to the process to be credible, achieving this in practice is not easy, but we have developed integrated and robust processes within RLAM to overcome these challenges.

For bonds, we are able to target our issuer and thematic engagement following an established framework where the impact is greatest and the scope for influence is genuine. Often, the most significant influence we have is during the initial structuring and pricing of new bond issues. The reality is that unless you have pre-emptive rights in the legal contract, then a major point of influence has passed. More than 50% of our typical credit portfolios have such pre-emptive controls, through strong covenants and security.

You're only paying for the label

Perhaps the area of fixed income ESG that has garnered greatest acceptance is the issuance of labelled bonds; encapsulating green, social, sustainable and, even, transition bonds. As a mechanism to get investors and issuers considering and elevating critical societal issues, they have undoubtedly been a success. However, as the most convenient and widespread way for managers to demonstrate ESG credentials to asset owners, we are often sceptical around their value.

Given the vast majority of labelled issuance is unsecured, our principal concern is the lack of direct control and visibility over specific use of proceeds and then, in return, the cash flows servicing the debt. As cash is fungible, limiting the assessment to the individual bond and taking the label at face value precludes the very real risk that the buyer is simply freeing up resources to finance other, potentially less wholesome, assets and businesses. Possibly even more challenging is the notion that these bonds can trade through intrinsic fair value as investors overvalue both the label and the ease of reporting. Being cynical, it's hard not to conclude that the European property company, with questionable governance practices, issuing a green bond to purchase a portfolio of existing but 'green' properties has realised the funding cost benefit of the label.

Positively, the market's preference for convenience generates opportunities for active managers who are prepared to put in the hard work to understand a company's overarching sustainability, or search for bonds secured on specific green assets to embed these bonds into portfolios without compromising achievable yields.

An example of one such bond is First Hydro Finance 9% 2021, which is an unrated, off-benchmark bond issued by a subsidiary of French company, Engie. As an electricity generator with some non-renewable capacity, the parent company may have a poor ESG rating. However, its subsidiary, First Hydro, generates hydro-electric power in Snowdonia and has a far better sustainability assessment. In addition, the bonds are secured, with strong covenants and ring-fenced assets and cash flows. The attractions of a bond that may fail a traditional ESG credit screen only become apparent under our more bespoke and integrated credit and ESG approach.

ESG in fixed income – delivering superior outcomes

The significant additional investment already made into ESG-focused fixed income is a positive affirmation that insurers are taking their responsibilities in this area seriously. However, we believe that many of the mechanisms used to implement ESG are sub-optimal – be it through not integrating ESG risks coherently into the wider credit risk framework, or through an over-reliance on ESG ratings and green labelling.

By contrast, effective and authentic integration can only be beneficial in improving the integrity of lending decisions and, as a consequence, the sustainability of insurance company asset portfolios.

Andrew Epsom
Insurance Client Solutions Director

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Insurance-aware investment solutions

The current investment environment produces acute challenges for insurance companies needing to generate sufficient yield under the ultra-low rate environment, with increased volatility and tail risk remaining, whilst staying within risk and capital budgets. This is exacerbated by increasing regulatory responsibilities emerging especially around sustainability.

Royal London Asset Management has developed a number of solutions to help our insurance clients meet these challenges. These include:

- **Yield enhancing but secure fixed income** – our core approach within fixed income is to overweight allocations to secured bonds – this has the attraction of both increasing yield as well as providing extra security against default and downgrade risks.
- **Cost-effective active equity investing** – using the global security universe developed for our successful active equity approach, but implementing this in a systematic manner to reduce costs and also implement investor-specific filtering criteria across areas such as ESG.
- **Extensive sustainability range** – we have developed a range of sustainable funds (from 100% equities to 100% fixed income with multi-asset solutions within) that invest in companies that we believe are well positioned to benefit from products and services that help solve major environmental and social challenges, and positively manage their ESG risks. These funds also have much lower carbon intensity than equivalent market benchmarks.

To find out more, please contact **andrew.epsom@rlam.co.uk** call **+44 (0)203 272 5594** or visit **www.rlam.co.uk**

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Portfolio Manager, Global Asset Manager

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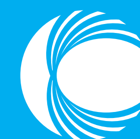
Business Development Manager, UK Asset Manager



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To find out more - **Natasha Silva** (Natasha.silva@camradata.com) would be delighted to speak to you.

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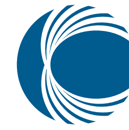

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