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AEGON Asset Management

Aligning financial and climate obligations within fixed income portfolios

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Iain Buckle
Head of Credit – UK

Rory Sandilands
Investment Manager

Regulatory, societal and investment pressures are driving greater awareness of climate-related risks. At the same time investors face many challenges, including a backdrop of negative real returns on cash which demand they consider alternative investment solutions.

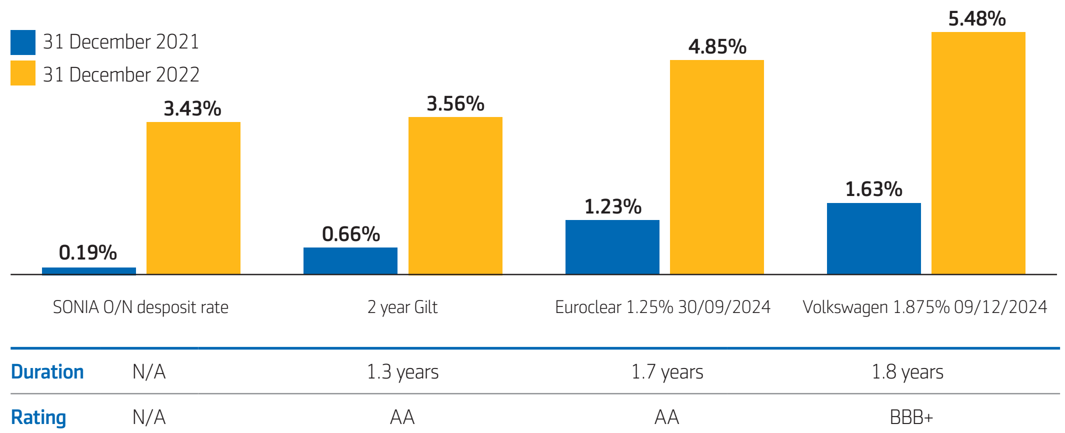
This article discusses why short-dated corporate bonds which are relatively close to maturity can help investors capture attractive yields with minimal interest-rate sensitivity, low portfolio volatility and good levels of liquidity – all while having a relatively low climate-related risk.

The appeal of short-dated investment grade bonds

The unique characteristics of short-dated bonds offer investors an opportunity to access a lower-volatility segment of the broader investment-grade fixed income market.

Short-dated investment grade bonds can offer attractive and relatively consistent returns against a market backdrop of negative real returns. Chart 1 below highlights that you can enhance your yield by taking modest risk through investing in short dated corporate bonds from good quality companies without taking on additional interest rate (duration) risk.

Short-dated investment grade bonds offer attractive yield and spread for low duration



	SONIA O/N desposit rate	2 year Gilt	Euroclear 1.25% 30/09/2024	Volkswagen 1.875% 09/12/2024
Duration	N/A	1.3 years	1.7 years	1.8 years
Rating	N/A	AA	AA	BBB+

Source: Aegon AM.

The appeal of short-dated bonds is based on a range of factors, including:

- A long-term record of generating attractive risk-adjusted returns.
- Capital-preservation qualities – higher resiliency to negative company-specific events than longer-dated bonds.
- Less susceptibility to fluctuating interest rates as returns derive from credit risk rather than duration risk.
- Steady cashflow generation paid-out as an income or reinvested to take advantage of further opportunities.
- Higher liquidity than longer-dated equivalents, due to the high frequency of bonds reaching maturity.

Furthermore, with short-dated bonds there is no material yield sacrifice for a reduction in climate risk which is a benefit that we now explore in more detail.

Today's ideal is to deliver a dual climate and return outcome

Assessing climate transition risk

Understanding the potential risks to company cash flows is vital to retain the conservative nature of short-dated bonds. Actively managing ESG risks, including climate related risks, should therefore play an important role in investment decision making.

To assess the materiality of climate change risks for bonds, research typically focuses on the potential impacts of transition and physical risks. This involves assessing a range of carbon emission metrics to help investors consider the carbon footprint of various investments.

When focusing on transition, the next stage in climate risk analysis is to assess a company's ambitions, performance, and management toward net-zero. This goes beyond backward-looking emissions to form a forward-looking view of a company's transition readiness and alignment with the energy transition.

Analysis can be conducted for issuers across a wide range of industry sectors and may consist of an examination of:

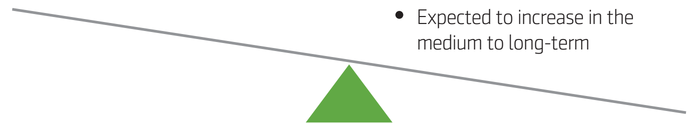
- Long-term ambition and associated targets
- Historical emissions trends and disclosure
- Climate / environmental management, governance and strategy

Transition Risk
Policy and market changes resulting from climate action and the energy transition

- Can be orderly (e.g. EU 'Fit for 55') or disorderly (e.g. covid-19 lockdowns
- Expected in the near to medium term

Physical Risk
Permanent environmental changes resulting from unconstrained climate change

- Can be acute (e.g. extreme weather events) and chronic (e.g. sea level rise)
- Expected to increase in the medium to long-term



More in-depth analysis should be considered for issuers in sectors deemed to have a stronger ability to influence the achievement of global climate goals. This influence can be direct as a result of their emissions or products, for example oil & gas or utilities; or indirect as a result of their ability to influence the activities of others, for example banks. In these sectors, it is important to understand the idiosyncratic considerations and issues faced by companies and tailor climate analysis accordingly.

Rather than simply exclude high influence sectors, this type of research can help to identify and support those companies that have robust and credible plans to transition towards a low carbon economy. Furthermore, the design of the research framework can be compatible with external climate initiatives such as the Net-Zero Asset Owner Alliance and the Paris Aligned Investment Initiative, while a complementary active engagement can play an important role in encouraging more aggressive climate-related targets and helping to improve the quality of disclosures.

Bond maturity and climate risks

The analysis and decisions made around climate risks can vary significantly depending on the maturity of an individual bond. With shorter-dated bonds investors are much less exposed to a climate-related deterioration in credit quality during their lifetime.

Although we can potentially identify climate risks now, they can take a long time to significantly impact a company's credit profile. In general, the longer you lend to a company that is potentially facing climate risks, the more you are exposed to those risks. So, for holders of longer-dated bonds, particularly through buy-and-hold strategies, it is vital to analyse and understand climate change risks.

When we compare a bond in the oil & gas sector with a similarly rated bond in the consumer sector, the latter will typically have a lower climate transition risk. At the short end of the market (less than four years), there is little difference in the yields of the two bonds, whereas for longer-dated bonds issued by the same companies, the differential increases significantly.

This means that the additional yield or premium that the oil & gas company must pay increases significantly as you move out the maturity spectrum, suggesting that the climate risk of that sector is more likely to be priced into the longer-dated bonds of those companies. But conversely, the small difference between these respective issuers at the short end suggests that transition risk is not priced in. So, a more focused approach to managing climate risk can be applied to a portfolio of short-dated bonds with little yield sacrifice

It's vital to analyse and understand climate change risks

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Summary

It is possible to construct a climate transition focused short-dated corporate bond portfolio that does not sacrifice expected yield. Rather than simply exclude companies based on higher carbon emissions, or from the higher influence sectors, portfolios can be constructed to invest in those companies that have robust and credible plans to transition towards a low carbon economy and therefore be better aligned to investors' net-zero goals. This is potentially attractive to investors as regulatory, societal and investment pressures lead to a greater awareness of climate-related risks.

To discuss aligning financial and climate obligations within your fixed income portfolios, please contact your usual Aegon AM representative or visit www.aegonam.com/gsdct

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