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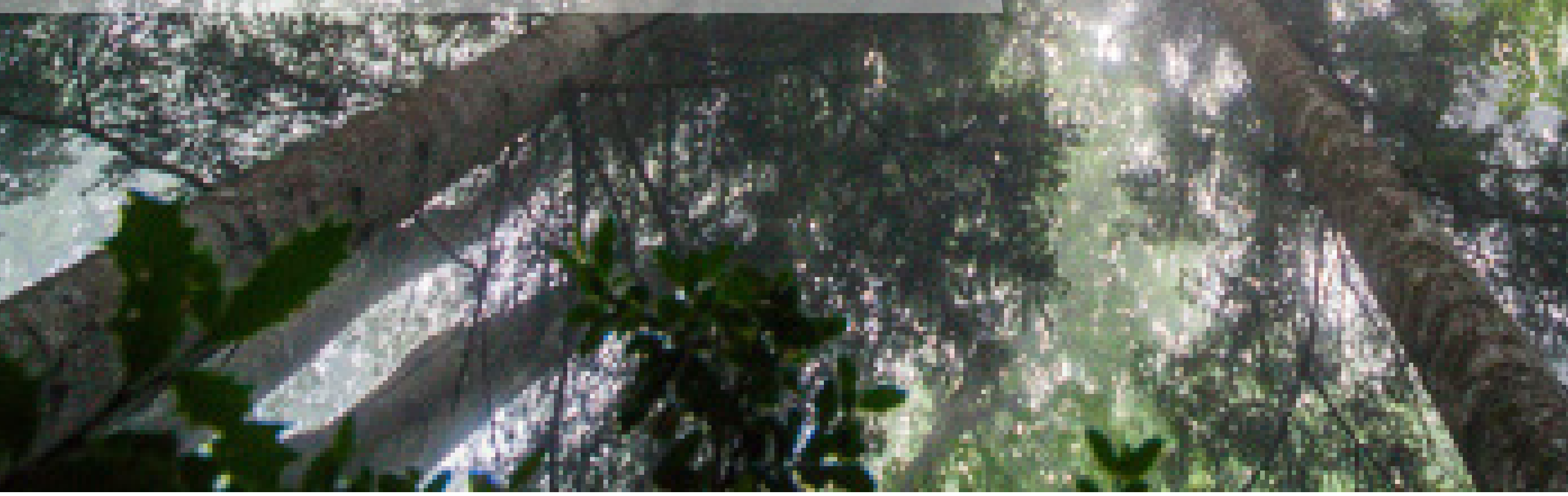
# DEMYSTIFYING SUSTAINABILITY-THEMED INVESTING

Responsible investing is one of the most prominent trends within the asset management industry today. Forces such as climate awareness and consumer preferences have contributed to an increased focus on sustainability that spans business, governments and society. The growth in demand for dedicated responsible investment solutions, coupled with the broader shift toward sustainability, has spurred a frenzy of new product launches, including the advent of sustainability-themed fixed income solutions.

As we've partnered with clients to identify solutions, we encountered a variety of sustainability-themed fixed income strategies with interesting differences and similarities. In this paper, we present our view of the shifting marketplace and our findings from working with clients to identify and develop sustainable fixed income solutions. The subsequent pages outline what we believe are key considerations that can help institutional investors, asset owners and consultants compare sustainability-themed fixed income strategies.



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The responsible investing marketplace has evolved dramatically in recent years. An exponential rise in demand for dedicated responsible investment (RI) solutions has spurred a frenzy of new product launches. According to US SIF, as of December 2018 approximately $11.6 trillion, or one-fourth of the professional assets under management in the US, incorporate environmental, social and governance (ESG) considerations.

Further, forces such as a climate awareness and consumer preferences have contributed to an increased focus on sustainability that spans business, governments and society. The shift toward sustainability affects a broad array of industries, presenting opportunities to invest alongside various sustainable megatrends. But while opportunities persist, few sustainability-themed fixed income solutions exist.

As we assessed the landscape, we realized that sustainable solutions come in many varieties. Sustainability-themed products may have materially different approaches to defining investment objectives, assessing sustainability, defining the investment universe, selecting securities and measuring impact. The heterogeneity presents challenges for asset owners and allocators as they are left to their own devices to develop frameworks to evaluate sustainability-themed solutions.

In our pursuit of developing a sustainability-themed client solution, we identified a few key considerations that can help investors compare and contrast sustainable fixed income strategies.

AEGON Asset Management

# DEFINING SUSTAINABILITY: PRODUCTS, SERVICES & PRACTICES

Just as there is no universal framework to categorizing responsible investment approaches and strategies, we've found there is no agreed-upon convention for defining sustainability. The European Commission's Technical Expert Group on Sustainable Finance, for example, attempted to tackle this challenge by developing a taxonomy for evaluating investments' environmental sustainability. While this is a good first step, a sustainability-themed strategy could use positive screening to identify investments aligned with a broader array of predetermined sustainability themes. Examples of sustainable themes may include: climate change initiatives, like green buildings and recycling services; health and well-being initiatives, such as adequate food supplies and educational services; and sustainable growth projects centered on mass transit or affordable housing.

Sustainability-themed strategies typically pursue their objectives through two primary channels: investment decisions and active ownership. Contrary to pure impact investments that seek to generate measurable impact, a sustainability-themed strategy typically prioritizes alpha generation over impact considerations (Exhibit 1). Contribution to return objectives may come from both traditional portfolio management techniques as well as alignment with sustainability themes. The strategy's contribution to a more sustainable environment, society and economy is a secondary but still important consideration.

## Sustainability defined

At Aegon AM US, we define sustainability as a global economic state that meets the needs and aspirations of people today and in the future, while protecting and improving the environment and preserving the quality of life for all.

## Exhibit 1: Examples of dedicated responsible investment solutions

| | Exclusions | Best-in-class | Sustainability-themed | Impact investing |
|---|---|---|---|---|
| Description | Utilize negative screening to avoid certain sectors, companies or practices based on specific criteria | Seeks to outperform by emphasizing positive selection of issuers with better or improving ESG profiles | Focus on sustainability themes in an effort to generate competitive returns over the long term | Pursue financial returns alongside positive social and/or environmental impact |
| Responsible Investment Approach | Negative screening | Positive screening | Positive screening<br>Thematic investing | Thematic investing |
| Primary Objectives | Risk management | Alpha generation<br>Risk management | Alpha generation<br>Environmental & social objectives | Environmental or social impact<br>Alpha generation |

## Exhibit 2: Examples of sustainability themes

# DEFINING SUSTAINABILITY: PRODUCTS, SERVICES & PRACTICES

We've found that there are two elements to defining sustainability and identifying investment candidates (Exhibit 3):

1. Sustainable products and services
2. Sustainable business practices

Exhibit 3: Examples of sustainable products, services and business practices

| Sustainable products | Sustainable services | Sustainable business practices |
|---|---|---|
| Improving access to education | Cloud computing services that facilitate virtualization | Operations 100% powered by renewable electricity |
| Smart meters used to optimize electricity demand | Recycling services that reduce adverse environmental impact | Robust health and well-being programs for all employees |
| Renewable energy generation | Financial services for small and medium enterprises | Science-based carbon reduction targets that enable the business to aligned itself with 2 degree scenario |

The structure and depth of the research framework utilized can greatly affect whether the strategy focuses on sustainable products and services, business practices or both. Historically, vendors have assessed sustainability by focusing on material ESG factors relevant to business practices with issuer policies and ESG disclosures as the starting point for the analysis.

Focusing on products and services, we've found that investment analysts can develop identifiable and measurable criteria to assess the issuer's alignment with sustainable themes. The sustainability review process may be customized by issuer type to accommodate key sustainability considerations that differ materially across sectors and asset classes.

# SUSTAINABILITY SCOPE: OBJECTIVES & INVESTMENT UNIVERSE

The scope of the sustainable investment universe can differ across strategies. Some may emphasize more narrow impact themes like affordable housing, renewable energy or community development. Other strategies may seek to align with sustainability more broadly in areas such as resource efficiency, public health and sustainable economic growth.

The sample investment objectives and universes in Exhibit 4 help demonstrate the variability across strategies marketed as 'sustainable' fixed income products. Based on objectives alone, it can be challenging to decipher if a strategy primarily employs a sustainability-themed, best-in-class or impact approach. Further, strategies' sustainability research scope can vary from partial coverage of fixed income sectors, such as applying sustainability analysis and ESG integration only to specific sectors like investment grade credit, or comprehensive wherein coverage is extended to all major sectors (i.e., governments, corporates and securitized products). For example, deeper analysis may reveal that a strategy positioned as sustainability-themed is using a best-in-class approach that tilts holdings toward sustainable themes, but may not be fully allocated to sustainable investments.

Exhibit 4: Sample objectives and investment universes

| Sustainable Strategy | Sample objective | Sample investment universe or focus areas |
|---|---|---|
| Strategy A | Favorable long-term total return through income and capital appreciation while giving special consideration to certain ESG criteria | Primarily invests in fixed income securities subject to ESG criteria. May also include proactive social investments. Focuses on four key investment themes; 1) affordable housing, 2) community and economic development, 3) renewable energy, 4) natural resources. |
| Strategy B | Provides market returns on fixed income investments while also producing measurable positive impacts on communities and the environment. | Primarily invests in investment grade securities that support social impact criteria. |
| Strategy C | Generate high levels of income by investing in securities aligned with the firm's responsible investment policy. | Focused on investment grade companies that operate in a manner consistent with environmental sustainability, resources efficiency, equitable societies and respect for human rights, accountable governance and transparent operations. |
| Strategy D | Deliver attractive risk-adjusted returns by incorporating ESG factors that the firm believes have a clear and tangible impact on performance. | Invests in fixed income securities selected on fundamental credit and ESG merits. |
| Strategy E | Seeks maximum total return, consistent with preservation of capital and prudent investment management | Includes intermediate-term fixed income securities with a concentration on socially conscious companies. |
| Strategy F | Generate competitive returns over the long term by investing in fixed income securities with a favorable sustainability profile | Invests in a broad range of fixed income securities and issuers that have favorable sustainability profiles and are aligned with sustainable megatrends |

Sample for illustrative purposes only.

When assessing a sustainability-themed strategy, it is important to identify the level of alignment with sustainability themes and the scope of the investment universe to ensure the strategy's intended outcomes align with the investor's objectives. In our view, a sustainability-themed investment strategy should seek to maximize the contribution from sustainability-related investment returns by selecting from an investment universe fully aligned with sustainable trends. For asset owners seeking a sustainability allocation for their fixed income holdings, this investment universe should cover all fixed income sectors to support return profiles that are broadly consistent with conventional fixed income strategies while aligning investments with potential sustainability-driven alpha.

# INVESTMENT PROCESS: SUSTAINABILITY RESEARCH

Beyond different objectives and investment universes, asset managers may also use varying processes to research and select sustainable investments. Key considerations may include:

- How are sustainability assessments integrated into the research process?
- Does the manager rely solely on third-party ESG/sustainablility research? Or are they conducting their own sustainability research?
- Is the sustainability research process customized for various fixed income sectors and issuer types?
- How does the manager consider sustainability-focused debt issuance including green, social impact, sustainable development bonds? Are green bond issues critically evaluated to eliminate any potential 'light green' or 'greenwashing' transactions?

Identifying investment candidates can employ top-down (sector/industry) or bottom-up (issuer level) components. In our experience, sustainability must be determined on a bottom-up issuer-by-issuer basis. Intensive bottom-up research is imperative for ensuring that a sustainability-themed investment thesis can be supported at the issuer level, as issuer-specific considerations may limit the ability to generalize sustainability to an entire sector or industry.

Additionally, a proprietary bottom-up view on sustainability is useful for reducing sustainability alignment risks presented by reliance on third-party research. In general, third-party ESG providers may evaluate issuers against criteria that may not fully capture sustainability considerations. Meanwhile, a more intensive research assessment with an emphasis on products and services can be more relevant to a sustainability analysis. As highlighted below, this difference in approaches may mean that investments that score favorably relative to narrow ESG standards may not be suitable for a sustainability-themed strategy. This also implies that sustainability-themed strategies may not fare well under fund ratings established and/or powered by ESG research providers.

### Case Study: Divergent third-party ESG research assessment and proprietary sustainability analysis

US Consumer Staple Example: AAA ESG Rating vs. Aegon AM US' Impact Neutral

A consumer staples company with a diversified product range and best-in-class business operations within its peer group earned an AAA ESG rating from a well-respected third-party research firm. While the AAA rating might suggest the company is supporting sustainable initiatives, a deeper review of the company's products and services reveals that close to 60% of firm revenue is derived from processed food products with extremely high sugar content. The World Health Organization has cited excess sugar intake as a leading contributor to unhealthy weight gain and poor dental health. As a result, a company believed to be sustainable according to a third-party ESG rating provider is not aligned at all from a products and services perspective.

Variation in sustainability research approaches should be carefully considered in the context of the investor's stated objectives. For example, a research process focused on business practices could allow for exposure to areas such as fossil fuel extraction and production or to franchise fast food restaurant operators that may have adverse impact on sustainability objectives such as climate change mitigation, resource efficiency and human health impact. Additionally, investors should consider managers' processes for assessing potential negative externalities associated with the pursuit of sustainability objectives.

### Sustainability in practice: sector-specific examples and considerations

| Sector/industry | Positive Impact | Negative Impact |
|---|---|---|
| Consumer finance | Providing critical access to credit to underserved consumers | Creating negative debt cycle for borrowers through predatory lending practices |
| Utilities | Renewable energy transition | Existing fossil fuel generation capacity |
| Pharma/healthcare | Positive health impacts such as access to affordable medicine and healthcare | Product safety, business practices, drug price inflation, and addiction |
| Food/agriculture | Ending global hunger and improving the quality of the food supply | Detrimental environmental, labor and product marketing practices |
| Homebuilders | Affordability | Environmental degradation from urban sprawl |

# SUSTAINABILITY THESIS: TIME HORIZON & MATERIALITY CONSIDERATIONS

Another way to evaluate strategies is to assess the time horizon of the manager's sustainability thesis as well as materiality considerations that may guide the security selection process. Questions to consider may include:

- Do they require investment candidates to be leaders in sustainable products/services and practices today?
- Do they allocate to companies with strategic plans in place to deliver new sustainable solutions as part of their medium- or long-term vision?
- How do they categorize sustainable issuers? Are there varying levels of sustainability alignment?
- How do they define materiality and how does that determination affect the security selection process?

Consider a company with environmentally harmful business operations. Despite the current anti-sustainability posture, the company has a compelling strategic plan to overhaul their business model and disrupt the industry with a solution to climate change. In this case, if the strategy solely allocates to companies with sustainable practices today, it could inadvertently overlook opportunities to contribute to positive change in the future. It's crucial to evaluate where the issuer is today and how it executes its strategy for long-term growth.

At Aegon AM, we believe sustainability is a long-term secular shift. To meet the world's sustainability ambitions, we believe the entire global economy will go through major systemic changes in the coming decades. Companies will need to evolve to deliver on consumers' demands and maintain a competitive advantage. As such, our sustainability thesis for most issuers is predicated on a long-term investment horizon.

> In pursuit of sustainable alpha, we believe there is merit in allocating capital to issuers identified as leaders as well as issuers that are influencing change and improving their business models.

While sustainable leaders exist today, we believe the companies that are investing in their businesses to make them more sustainable in the future shouldn't be overlooked. In pursuit of sustainable alpha, we believe there is merit in allocating capital to issuers identified as leaders as well as issuers that are influencing change and improving their business models. To do this, we segment issuers into five levels of sustainability based on materiality thresholds that determine the level of alignment with sustainable trends.

# SUSTAINABILITY RISKS: MANAGING INFORMATION GAPS & ACTIVE OWNERSHIP

Information gaps have been a persistent challenge for many responsible investment strategies. Managers with sustainability-themed strategies may have to overcome limited disclosure related to products, market segments and business practices when making sustainability determinations. Disclosure has improved markedly over the past decade as investors have demanded greater transparency from issuers. Additionally, the product evolution from third-party research providers and the advent of standards such as the Sustainable Accounting Standards Board Materiality Matrix have provided new tools that can be used to evaluate sustainability considerations.

While these developments represent progress toward reducing information gaps, the lack of standards and benchmarking create an issue that investment managers have to solve for their clients. At Aegon AM, we have managed information gaps by investing sizable resources in developing a robust research framework that includes proprietary sustainability research and targeted engagement efforts. Proprietary research assessments that incorporate analysts' insights on industry- and company-specific factors into the sustainability assessment while engagement with issuers through active ownership (outlined below) can be used to encourage additional disclosure related to sustainability topics.

Engagement with issuers on topics such as business plans, operational improvements and corporate social responsibility policies can present opportunities to enhance sustainability disclosure and develop a broader investment universe. It is less common for managers to undertake proprietary sustainability research assessments. This increases reliance on possibly incomplete or inaccurate sustainability data as well as potentially restricting their investment universe based on third-party data coverage.

## Case Study: Greenwashing

Consider a mid-sized oil and gas tanker operator who issues a green bond to fund more energy efficient oil tankers. The proceeds from the issuance are designated to reduce the tanker operator's fleet environmental footprint and support an overarching industry goal to reduce emissions by 2050.

A reputable second-party opinion provider classifies the bond as climate friendly. However, a sustainability analysis of the company's products and services may conclude that fuel transportation does not benefit the environment and is detrimental to achieving greenhouse gas emission objectives. While this issuance might improve the tanker operator's fleet energy efficiency, green bond issuance proceeds will not contribute to transforming the business away from environmentally detrimental activities.

## Evaluating the Role of Active Ownership in Fixed Income Strategies

Active ownership is a key component of many responsible investing strategies. Within fixed income, active ownership is implemented via engagement – the practice of entering into active dialogue with issuers on responsible investing topics.

A manager may engage with issuers to:

- Promote long-term financial performance improvements;
- Monitor, manage, and mitigate investment risks;
- Better understand business models and set management expectations;
- Set goals and timeframes to meet sustainability objectives;
- Improve disclosures that facilitate a more informed investment outlook;
- Maximize positive sustainability outcomes, including those related to the SDGs;
- Encourage the issuance of green, social and sustainable bonds that finance sustainable business activities.

# PORTFOLIO CONSTRUCTION: ECONOMICS, DECISION-MAKING AUTHORITY & OVERSIGHT

The roles and responsibilities for conducting research on alignment with sustainability themes, determining the sustainable investment universe and constructing portfolios can vary across managers. Important considerations include:

- Is the sustainability research determination being made independently from portfolio management decisions?
- What are the controls and/or committee structures in place to ensure the consistency and validity of the sustainability determination?
- Who has final decision-making authority?

In Aegon AM US' approach, research analysts provide sustainability and economic recommendations, a committee determines the sustainable investment universe and portfolio managers select securities from the eligible universe. Our Sustainable Investment Committee reviews and scrutinizes analysts' sustainability recommendations and determines the eligible universe. Having an investment committee for determining eligibility can help ensure the sustainability review process's consistency and integrity. The oversight body requires core investment competence and sustainability expertise to provide credible oversight for the sustainability-themed strategy. At Aegon AM, the committee determines sustainability eligibility for all potential investments prior to any portfolio management decision.

Furthermore, aligning a portfolio around sustainability themes such as resource efficiency, improved healthcare outcomes and climate change can result in different sector concentrations, relative to a traditional benchmark. Investible universe composition can also impact security selection and management decisions around portfolio risk characteristics that may differ from a traditional approach. Solar ABS, for example, are typically longer duration instruments that will contribute higher spread duration exposure relative to the benchmark. Investors should review the effect of these differences in the context of their return, liquidity, diversification and risk objectives.

In Aegon AM US' approach, research analysts provide sustainability and economic recommendations, a committee determines the sustainable investment universe and portfolio managers select securities from the eligible universe.

Impact reporting seeks to measure a strategy's contribution to non-economic outcomes such as positive environmental or social change. Reporting methodologies are ever-evolving and an industry-wide standard is yet to be developed.

While measuring impact can be challenging, asset managers should be able to report alignment with pre-defined sustainability objectives such as alignment with the UN Sustainable Development Goals or capital contributed to themes. Reporting can encompass environmental considerations such as carbon intensity. Additionally, engagement activity reporting can provide insight into the strategy's ability to further advance positive change.

Despite impact reporting challenges, investors considering a sustainability-themed strategy can evaluate a manager's available reporting relative to organizational needs. At Aegon AM, we are working to develop meaningful measurement tools to assess contribution to sustainability goals, evaluate potential environmental and social impact and measure active ownership outcomes.

## Conclusion

Rising demand for responsible investment solutions has led to rapid growth in sustainability-themed fixed income strategies. Despite the growth, challenges remain. Sustainability-themed strategies may have materially different approaches to defining the sustainability and identifying the investment universe and well as various methods to pursuing sustainability goals.

As the secular sustainability shift evolves, we expect forces such as climate awareness and consumer preferences to continue to drive demand for sustainability-themed fixed income strategies. Looking ahead, we expect product proliferation of sustainability-themed investment strategies will accelerate, exacerbating current barriers to adoption such as inconsistent terminology. The growing pains will likely diminish as the industry evolves toward a common taxonomy and industry groups develop frameworks to define sustainability. Until then, we believe an understanding of the various approaches and a thorough assessment can help asset owners and allocators identify the sustainability-themed fixed income strategy that best aligns with their objectives.

# OUR APPROACH TO SUSTAINABLE FIXED INCOME

## Mobilizing capital to pursue sustainable alpha and drive change

We believe sustainability is a long-term, secular shift: consumers are demanding more sustainable products, investors are increasingly interested in contributing to the greater good, companies view sustainability as a potential source of competitive advantage and governments are rallying to address the world's most pressing environmental and social issues. Sustainability is no longer a nice-to-have, but an imperative. This shift presents compelling opportunities for investors seeking to participate in and contribute to the shift toward sustainability.

Leveraging our time-tested fixed income platform, Aegon AM developed the Sustainable Fixed Income strategy that seeks to provide investors with the opportunity to participate in this transformation toward a more sustainable world. The strategy uses Aegon AM's fixed income investment expertise to pursue competitive financial returns while selecting investments from a wide range of fixed income issuers that we believe contribute to enhancing the sustainability of the global economy and society. Investment candidates span five Sustainability Pillars: Climate Change, Eco Solutions, Resource Efficiency, Health and Well-being and Sustainable Growth.

As an overlay to our traditional investment process, the Sustainable Fixed Income strategy incorporates a proprietary sustainability assessment and committee-based sustainability determination to establish the investable universe. Sustainable investment candidates are selected from all major fixed income sectors including corporate bonds, sovereign debt, structured securities and municipal bonds. Our proprietary research methodology combines internal expertise alongside external data to analyze the investments' sustainability profile in conjunction with their economic potential. This rigorous bottom-up sustainability assessment is conducted by sector specialist research analysts on all investments included in the strategy and is tailored to the specific sector and issuer type.

Prior to including investments in the sustainable universe, a Sustainable Investment Committee scrutinizes each analyst recommendation's sustainability thesis to establish the scope of alignment with the Sustainability Pillars as measured by contribution toward the United Nations' Sustainable Development Goals. Additionally, a dedicated Responsible Investment team supports Sustainable Fixed Income by proactively engaging with issuers to encourage sustainable practices, educate company management teams on sustainability issues and encourage growth of sustainable businesses. To affect positive change on a larger scale, our Responsible Investment team engages with issuers individually and collaboratively to encourage sustainable practices and growth of sustainable businesses. By aligning with sustainability themes and engaging with companies, we believe our Sustainable Fixed Income strategy can help clients pursue better long-term outcomes.

# AUTHORS

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Jose Pluto, CFA, is a portfolio manager for the Sustainable Fixed Income strategy and is a member of the Sustainable Investment Committee. Jose also serves as a senior structured finance analyst and has developed a deep research-based knowledge of asset backed securities and mortgage-related credit. For Sustainable Fixed Income, Jose contributes to portfolio positioning and relative value trading discussions, particularly with respect to structured securities. As a member of the Sustainable Investment Committee, Jose also scrutinizes research analysts' sustainability theses and helps determine the sustainable investment universe for the strategy. He has 20 years of industry experience and has been with the firm since 2017. Jose received his BA from Dartmouth College and his MBA from the Kellogg School of Management at Northwestern University. He is a CFA® charterholder.

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Julius Huttunen is a responsible investment manager in Aegon AM's global Responsible Investment team. Julius is also a member of the Sustainable Investment Committee. Leveraging his ESG and investment research background, Julius helps the organization enhance ESG integration processes across asset classes, product development and contributes to ex-post reporting initiatives. Julius also engages with companies to encourage more sustainable business practices. Julius received his BA from Ritsumeikan Asia Pacific University and an MSc in International Strategy and Economics from University of St. Andrews.