ESG in liquidity and short-term fixed income investing

Craig Inches, Head of Rates and Cash, looks at the importance and possible ways of bringing responsible investing to liquidity and short-term fixed income management.

Why incorporate ESG into short-term liquid investment management?

Environmental, Social, and Governance (ESG) factors have, in recent years, become increasingly important to investors looking for consistency of returns combined with better ESG outcomes. Consideration of these non-financial factors and metrics often play a critical role in cash and short-term fixed income investing, along with liquidity, preservation of capital and providing diversification. We believe well governed companies that are both socially and environmentally responsible are better positioned to anticipate future risks and opportunities and have greater long-term potential.

History has shown that firms with poor ESG credentials are likely to suffer larger losses in times of stress and may be at a greater risk of downgrade, as ratings agencies are increasingly incorporating governance considerations into their own assessment of companies and issuers. Additionally, we believe that poor ESG will lead to a poor reputation, which leaves investors questioning whether that company is a viable investment.

However, incorporating ESG into a liquidity or short duration fund is not without its challenges. There are various data providers such as Sustainalytics, MSCI, and FTSE ESG who assess a company's ESG performance, and score them based on their findings. However, since ESG disclosures are immature and often not consistent, data from these data providers can be passed on their subjective criteria which may be often inconsistent with one another.

The Royal London Asset Management approach – a transparent scoring system.

At Royal London Asset Management, we have developed a unique and transparent approach to ESG integration. We are committed to investing responsibly on behalf of our investors and will consider companies ESG credentials whilst making investment decisions as part of our investment philosophy and portfolio construction process. Royal London Asset Management's RL Sterling Liquidity Money Market Fund (Irish domiciled) is now classified as Article 8 under EU's Sustainable Finance Disclosure Regulation (SFDR) (the "Regulation").

The Regulation aims to improve transparency around the ESG features of funds which promote environmental and social characteristics or have a sustainable objective. We also run our other liquidity / short duration funds, RL Short Term Money Market Fund, RL Short Term Fixed Income and RL Short Term Fixed Income Enhanced to these standards, and will look to seek somewhat related labels in SDR (Sustainable Disclosure Regulation) when it is introduced in the UK. The Sustainable Disclosure Regulation aims at providing investors with comprehensive and comparable sustainability information, in response to the UK Governments strategy to use the finance sector as a driver for the green transition.

How does Royal London Asset Management's framework to incorporate ESG into Liquidity / Short Duration Funds set us apart from our peers?

Our Four Pillar approach combines a quantitative and qualitative assessment of each company or issuer. This enables us to construct a balanced portfolio with a detailed understanding of each companies ESG risks.

1. Exclusion Policy

We operate a screening process where we will not consider issuers, bonds or securities of companies or other organisations that generate more than 10% of their turnover from either:

i) armaments
ii) tobacco or
iii) fossil fuels (or any combination of these exclusions).

2. Quantitative framework

Our unique scoring system utilises MSCI data which we overlay with an internal analysis and framework for assessing ESG risks. We understand the importance of not solely relying on third party data providers. Individual ESG security risks and scores are then aggregated to reach a portfolio-wide score. For companies with lower ESG credentials, we will typically limit exposure to that company or issuer and keep the duration of that investment short(er). This ensures we can maintain a highly diversified portfolio, whilst managing associated ESG risks.

3. Qualitative assessment

We regularly collaborate with our Responsible Investment teams adding an important overlay to our quantitative framework. In addition, we perform in-depth credit analysis and regularly meet with credit analysts to discuss each companies' financials, ESG themes, risks and challenges.

4. Ongoing engagement

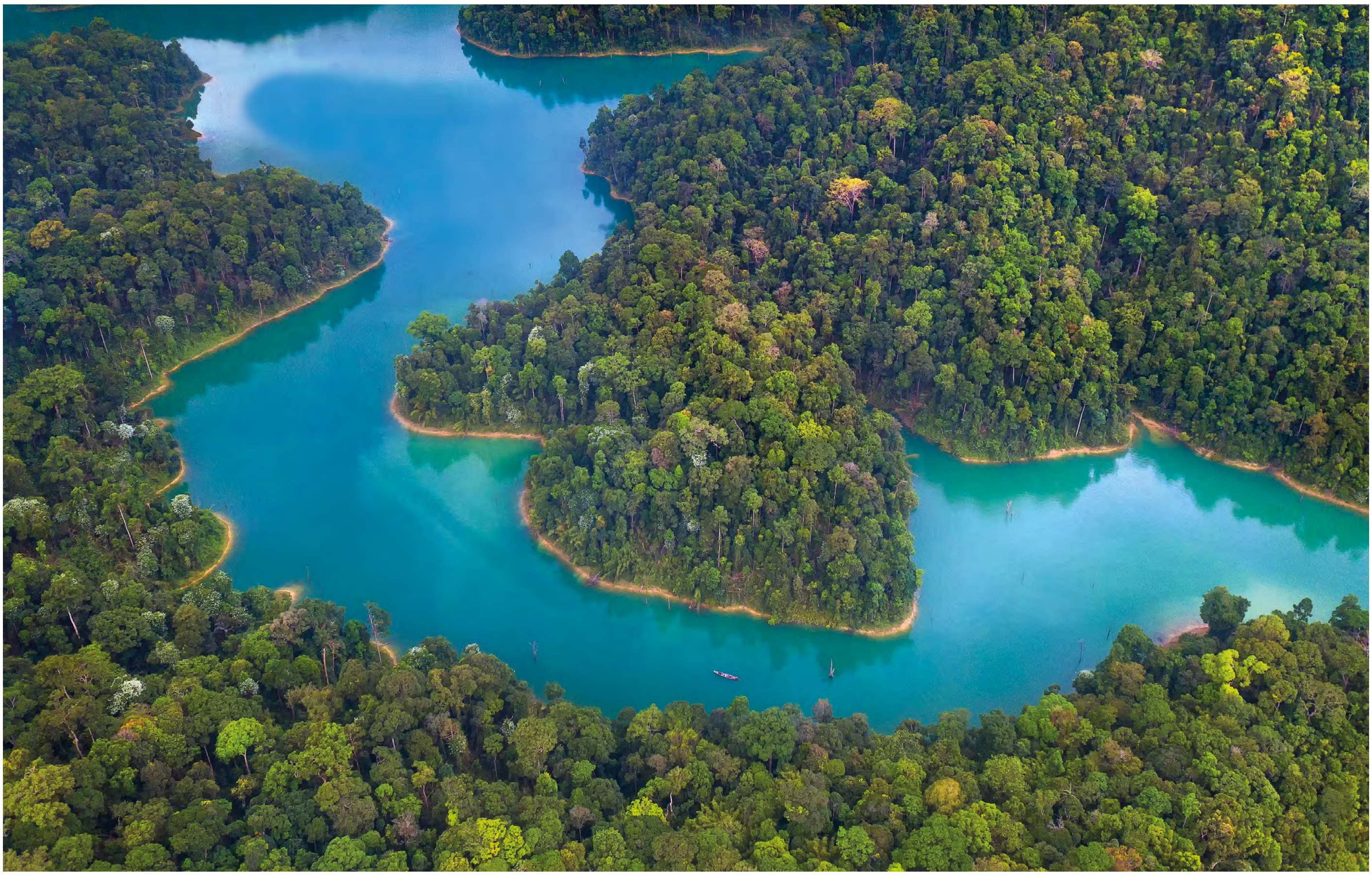
We believe that companies or issuers with poorer ESG credentials should not be overlooked. Instead, we aim to engage with those companies to challenge and help them address any issues they have with regards to market practices. Engagement themes include climate change, corporate culture and cyber security. As a result, we have been able to include previously excluded firms into our Funds following improvements in their ESG practices.

Our approach to ESG integration enables us to allocate a higher weighting to companies and issuers with stronger ESG and governance practices. However, we are aware that the risk of a downgrade does exist, which we need to manage. We undertake monthly stress testing to assess the effects of an ESG downgrade on each company or issuer in our funds. This helps us to understand how our portfolio will look in a worst-case scenario, so we can manage our ESG risks effectively. We also perform a stress test by downgrading the top 3 and top 5 holdings, which helps us to understand how we may need to rebalance our portfolios in the event of our largest holdings being downgraded from an ESG perspective.

At Royal London Asset Management, we understand the benefits of including companies with high ESG credentials in portfolio construction – which in our view provides increased liquidity in times of stress and greater potential for consistent returns, both of which result in better outcomes for our investors. We believe our approach allows us to understand and manage and monitor ESG risks effectively, and to construct highly diversified portfolios with responsible investing at the centre of what we do.

A case study – engagement for a better governance outcome.

Following a governance review with our Responsible Investment team, First Abu Dhabi Bank (FAB) was seen to have issues with independence, board oversight and diversity. An all-male board, along with a lack of clarity on which non-executive directors (NEDs) actually served on the board resulted in a poor governance score. We advised FAB via our broker that its governance scores were too low, and this made it difficult for us to invest with them. We were informed that FAB's senior management would look to make improvements, and we monitored progress carefully. We noted that the banks governance scoring subsequently improved, which allowed us to include them within our funds.



Investment risks

The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit Risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Interest Rate Risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

EPM Techniques: The fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the fund to increased price volatility.

Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the fund to financial loss.

Stable NAV Risk: The fund is not the same as a bank deposit account. It is designed such that it will seek, for the Distribution Classes, to maintain the Net Asset Value per Share at a fixed value by distributing income from the fund as it arises. However, whilst the fund's investments are reasonably believed by the Investment Manager to be of high quality, there is always a risk that an underlying issuer could default or otherwise fall in value, resulting in the fund being unable to maintain the Net Asset Value per Share at a fixed value and therefore a loss of capital will occur. The risk of loss is to be borne by the investor. There is no representation or warranty that the fund will be able to maintain a stable Net Asset Value per Share.

Inflation risk: Where the income yield is lower than the rate of inflation, the real value of your investment will reduce over time.

Money Market Fund Risks: A Money Market Fund is not a guaranteed investment, and is different from an investment in deposits. The principal invested in the fund is capable of fluctuation and the risk of loss of the principal is to be borne by the investor. The fund does not rely on external support for guaranteeing the liquidity of the fund or stabilising the NAV per share.

Royal London Sterling Liquidity Money Market Fund has been authorised as a Low Volatility Net Asset Value (LVNAF) MMF and is a short-term money market fund in accordance with MMF Regulation which seeks to maintain a stable NAV under the condition that the stable NAV does not deviate from the Net Asset Value per share by more than 20 basis points. In case of a deviation of more than 20 basis points between the stable NAV and the Net Asset Value per share, the following redemption or issue of Shares will be undertaken at a price that is equal to the Net Asset Value per Share.

Royal London Short Term Money Market Fund has been authorised as a Variable Net Asset Value (VNAV) MMF and is a short-term money market fund in accordance with MMF Regulation. The NAV is calculated using mark to market prices where possible otherwise mark to model prices are used.

The redemption or issue of Shares will be undertaken at a price that is equal to the Net Asset Value per Share. Following the implementation of the Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on Money Market Funds ("MMFs"), the fund is subject to the following risks:

No guarantee: The funds are not a guaranteed investment.

Principal fluctuation: An investment in the funds are different from an investment in deposits. The principal invested in the fund is capable of fluctuation in value.

No external support: The funds do not rely on external support for guaranteeing the liquidity of the fund or stabilising the NAV per unit or share. Risk of loss Any risk of loss of the principal is to be borne by the investor.

Government and Public Securities Risk: The fund can invest more than 35% of net assets in different Transferable Securities and Money Market Instruments issued or guaranteed by any EEA State, its local authorities, a third country or public international bodies of which one or more EEA States are members.

Contact us

For more information about our range of products and services, please contact us.

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