ROYAL LONDON
ASSET MANAGEMENT

Climate and credit – if it's easy, you're not doing it right

Martin Foden, Head of Credit Research and Luca Giacalone, Senior ESG Credit Analyst, discuss the challenges of integrating climate conviction within credit portfolios and how in-house analysis and collaboration are key.

At Royal London Asset Management, we have long understood the conflict at the heart of delivering effective ESG integration into credit funds. On the one hand, anything that can undermine the sustainability of issuers' balance sheets demands mitigation as an intrinsic part of any credible research process. On the other, delivering this authentically is not straightforward, and, far too often, purported integration amounts to little more than the adoption of seductively convenient shortcuts.

In an asset class that exhibits welcome idiosyncrasy, how and where you lend can be just as important as who you lend to. Blunt ESG label and ratings, and generalised third-party data, do not handle this nuance well. And this risks the most invidious outcome of all: bad lending decisions and inappropriate allocation in the face of some of the most existential credit risks of all. Ultimately, in our view, if your ESG integration is proving easy, you're probably not doing it right.

Challenges to integrating climate

With increased regulatory onus on asset owners and managers to demonstrate being reliable stewards of capital, it has become more important than ever to manage this conflict, particularly when it comes to climate. But first, to help ensure any solution is pointing in the right direction, enhancing our investment decisions whilst providing clients with the right insights to meet their responsibilities, it is worth looking briefly at the challenges to effective climate integration.

The original user of the majority of third-party data was the equity market. This has created a structural data coverage issue for fixed income, exacerbated by issuer and subsidiary mis-mapping. With significant skews between higher and lower impact issuers, this is particularly impactful when it comes to portfolio emissions data. Outputs which are being used to assess the relative net zero progress of asset managers can become disproportionately distorted at relatively small levels of coverage or mapping deficiency. Consider that a typical bond benchmark may have less than 50% of issuers with a public equity listing, and the potential for climate misinformation is material.

Furthermore, relying on third parties will result in anchoring to the 'most efficient' parts of the market – the antithesis of active management – and is likely to undermine effective diversification, which is so critical for well invested credit funds.

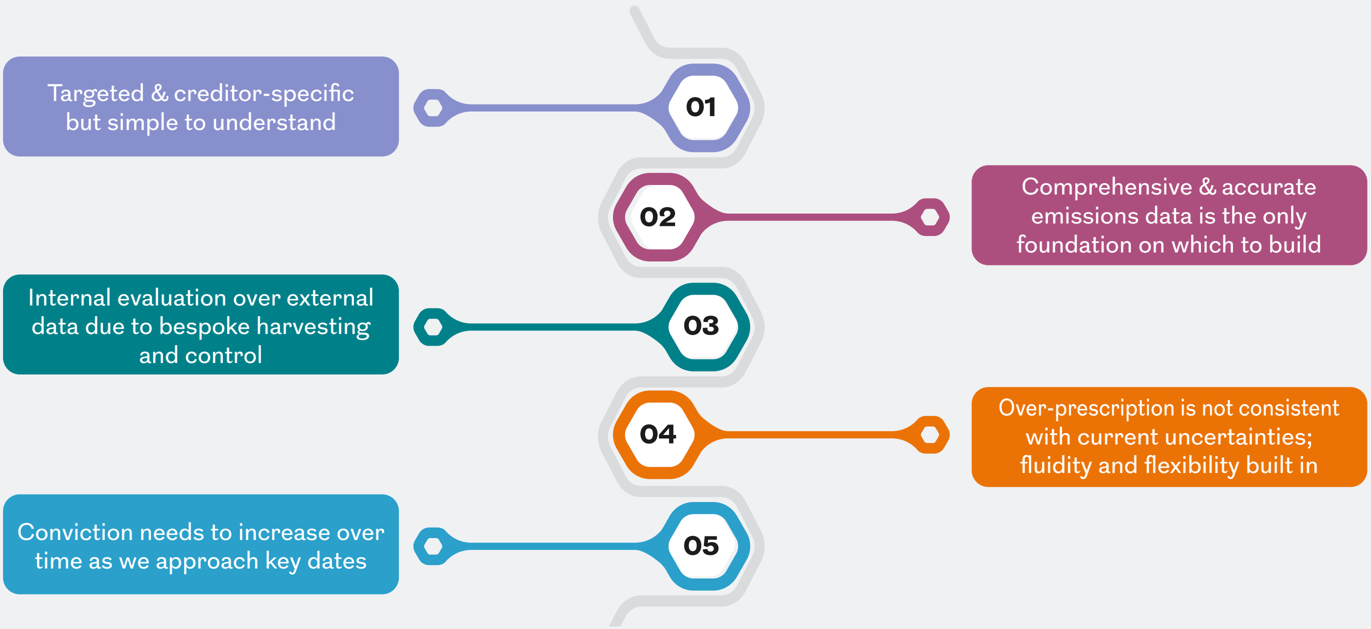
As credit analysts, while we are trained to identify risks and challenges, we need to change our emphasis here and help to find useful solutions, rather than being paralysed by the pursuit of perfection. In fact, as technology, regulations and the political backdrop are moving at breakneck speeds, we can be liberated, as being too prescriptive too early may be counterproductive, heightening the risk of setting off in the wrong direction.

> To gain the most useful insights there must be no superficial shortcuts. We need bespoke bottom-up environmental analysis and emissions data that maps to the precise entities that we are lending to.

In-house analysis and collaboration are key

Our solution? It became clear to us very early, through our work with climate conscious clients over a decade ago, that to gain the most useful insights there must be no superficial shortcuts. We need bespoke bottom-up environmental analysis and emissions data that maps to the precise entities that we are lending to. To this end we have spent the past five years developing an in-house emissions database that means our investment decisions, resource allocation and client reports are built on a foundation of high coverage and accuracy. This is further cemented by fundamental non-negotiables when it comes to building credit portfolios: diversification, looking wider than convention to exploit enduring market inefficiencies; effective collaboration across our teams of industry experts (both credit and ESG) to enhance our risk identification; and an unwavering belief that our own harvested and controlled data and insights must take precedence over the mechanical use of blunt external data.

Figure 1: Our Climate Conviction philosophy

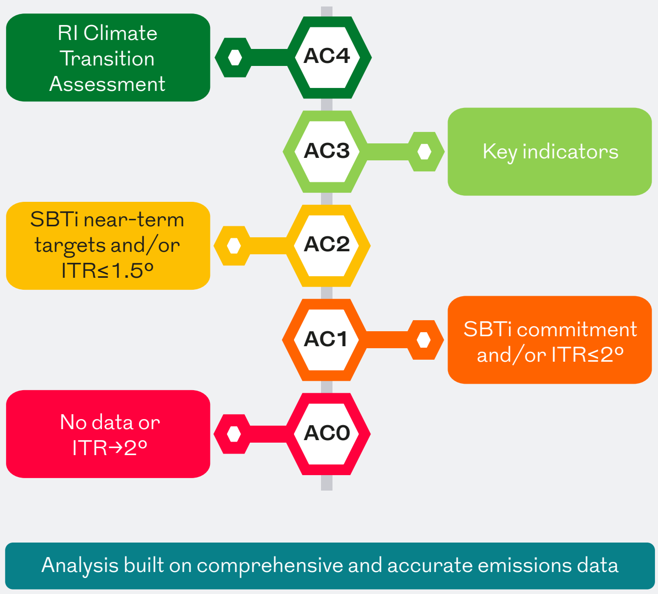


A practical solution - Climate Conviction

More specifically, our practical solution to evaluating issuer and portfolio transition credentials, and enabling our clients to meet their reporting and regulatory responsibilities, is centred on Alignment Conviction (AC) as the key building block of our Climate Conviction framework. Put simply, what is our level of conviction of an issuer's effective transition. We apply an AC score to each of our issuers based on a blended approach encapsulating both comprehensive transition analysis and engagement, and enhanced third-party data, all built on the insights we have garnered from our in-house climate database.

Critically, reflecting the primacy we give to our own climate analysis, our greatest conviction comes from the climate transition assessments we carry out in-house (see figure 2). With this analysis as a cornerstone, we can then supplement coverage with selected and enhanced third-party data points to expand our insights, whilst acknowledging our conviction over alignment in these areas will not be as high.

Figure 2: Proprietary approach to Net Zero Alignment Conviction



Source: Royal London Asset Management. For illustrative purposes only.

At a portfolio level, this blending of in-house and enhanced third-party insights enables us to obtain a much greater level of coverage and conviction of a fund's overall transition credentials than would be possible from using third-party metrics in isolation. For example, only one-third of the Royal London Asset Management Climate Aware Buy & Maintain Credit Fund is invested in issuers with third party verification of emission reduction targets – reflecting the fund's targeting of credit opportunities in lower profile issuers with credit enhanced characteristics. Usefully, through the application of our Climate Conviction framework, we actually know that close to half of the fund's exposure, and two-thirds of the fund's carbon intensity, is in issuers with the highest alignment conviction scores of AC3 and AC4, and can use these more comprehensive insights to ensure progress over time. Integration that complements rather than conflicts, means we don't have to compromise our long-standing and proven approach to credit investment.

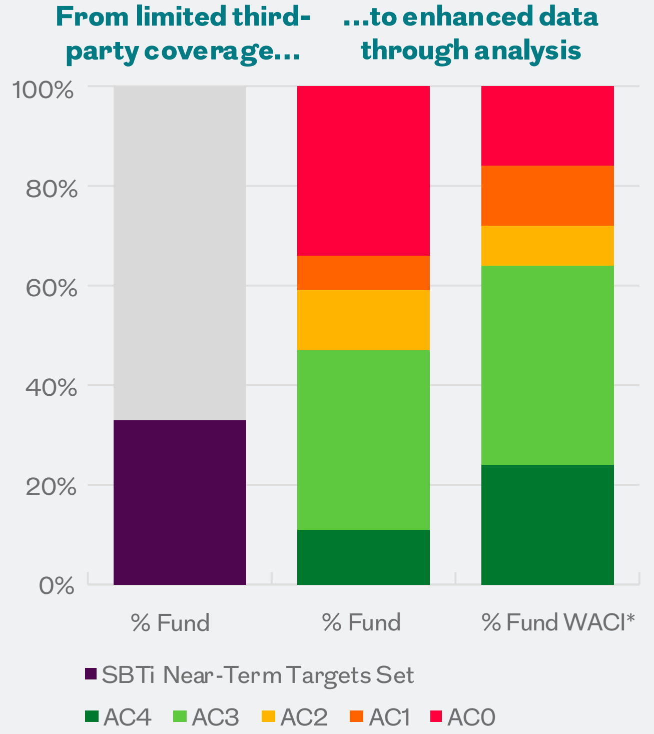
Further aiding client reporting and monitoring, it is also possible to aggregate issuer AC scores into an overall portfolio score to give enhanced visibility on portfolios' transition progress over time.

Creating tailored hurdles and solutions

We have a number of funds that embed specific thresholds built around our Climate Conviction framework, with increasing hurdles over time as we move towards key dates, including the RL Climate Aware Buy & Maintain Credit Fund. We can also work with clients to harmonise targets with their specific climate policies, more fully cognisant of potential trade-offs between the scope and timing of key milestones and portfolio impacts.

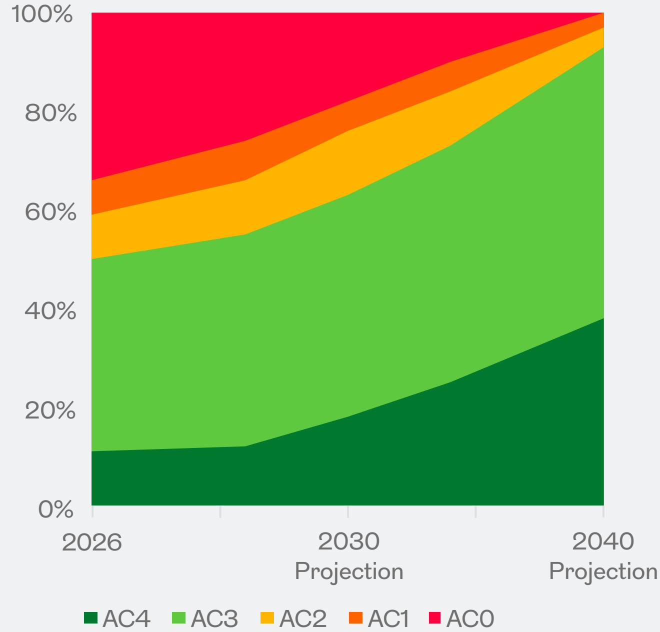
As well as informing our lending decisions and portfolio construction, this practical approach helps support clients' reporting requirements, enabling them to assess and monitor the preparedness of their credit portfolio for net zero, and progress over time. When combined with our differentiated approach to building credit portfolios, with an emphasis on exploiting enduring market inefficiencies, we believe that Climate Conviction helps solve the credit climate conflict with significantly less compromise.

Figure 3: Increasing conviction on portfolio transition credentials



*WACI: Weighted Average Carbon Intensity (Scope 1 and 2).
Source: SBTi, MSCI, and RLAM as at 31 December 2025.

Figure 4: Enhanced insights to monitor progress over time



Source: Royal London Asset Management. For illustrative purposes only. Projections are not guaranteed.

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.

ESG is integrated across some of our funds. ESG integration refers to the consideration of ESG risk as part of the investment process. It does not mean the fund is trying to achieve a particular positive ESG outcome. Please check prospectus documentation for details on specific fund-level objectives.

Credit risk: The value of a fixed interest security will fall in the event of the default or reduced credit rating of the issuer. Generally, the higher the rate of interest, the higher the perceived credit risk of the issuer. This fund may invest a percentage of it's assets in sub-investment grade bonds. Such bonds have characteristics which may result in higher probability of default than investment grade bonds and therefore higher risk.

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Overseas market risk: Funds investing in overseas securities are exposed to, and can hold, currencies other than Sterling. As a result, overseas investments may be affected by the rise and fall in exchange rates.

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