ESG and climate: When credit becomes sustainable

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The worsening health crisis currently spreading around the world has shown us just how extremely vulnerable our biological, environmental and social conditions are. Considerable efforts are being made to prevent the COVID-19 virus from spreading, but it is undoubtedly too soon to say how the epidemic will influence international opinions on global issues such as climate risk, personal protection and good governance.

Those investors who have opted to incorporate ESG and climate issues into their portfolios will emerge from the crisis with even greater faith in their convictions and all the keener to take more action for the future. New investors will undoubtedly soon join the movement to transform our economies in the name of sustainable development. Or at least we can hope so.

If the collective asset management industry is to meet the needs of these investors, it must strive to offer ESG and climate investment solutions covering a wide range of asset classes. Steering credit investments poses considerable challenges if we consider the growing share of corporate bonds in portfolio allocations as sovereign bond yields have shrivelled. The other challenge for asset management companies is to develop a range of services that are suitably tailored to the requirements of each individual client in terms of reporting, impact measurement and the construction of customised ESG and climate investment universes.

An investment universe extending beyond the green bonds market to target the very core of institutional investment portfolios

All of us here at CPR AM have taken on board the need to understand ESG and climate issues. All our staff members have now been made aware of ESG and climate risk issues so are better qualified to understand the needs and meet the expectations of our investors. CPR AM launched Climate Action, an international equity fund dedicated to the companies most committed to the energy transition, in December 2018; it is now going to roll out this theme for bonds. *"When it comes to bonds, we aim to incorporate the widest possible scope of issuers committed to tackle global warming and not consider the emerging green bonds market specifically, which currently accounts for less than 5% of euro investment grade bond indices and is not always synonymous with low carbon emissions"*, points out Noémie Hadjadj-Gomes, Head of Research at CPR AM.

Two quantitative approaches to incorporating ESG and climate criteria

CPR AM's new fund, Climate Bonds, will focused on the euro-denominated investment grade bond universe and will apply the same quantitative investment philosophy as the Smart Beta Credit ESG fund launched in late 2018. CPR AM's quantitative ESG and climate credit solutions are developed on the back of close collaboration between the research, fund management and credit analysis teams, with the support of the Amundi group's non-financial research (for ESG aspects) and specialist external providers (for specific climate data).

Systematic strategies are free of emotional bias and more transparent, and they offer the advantage of covering broad investment universes, which is particularly valuable given the growing size of the bond market. In addition, these quantitative approaches may easily be adapted into a dedicated format, for instance to adhere to a specific ESG investment charter, to comply with financial regulations restricting the eligible investment universe or with a given regulatory capital requirement (SCR), or to match a duration structure suited to the investor's liabilities (ALM), etc.

CPR AM's Smart Beta Credit ESG fund offers a defensive and ESG-based alternative to traditional euro investment grade bonds. *"We take the view that it is not by overweighting companies with the best ESG behaviours that we will generate performance but rather by excluding companies with poor ESG behaviours because they may damage the reputation and hence the performance of issuers in the portfolio. This argument is even more valid in the bond segment as specific incidents can take a heavy toll on performance"*, says Noémie Hadjadj-Gomes.

"Our guidelines for the Climate Bonds fund were to set up an investment strategy that would deliver returns similar to those of the bond asset class but with an investment universe focused on factoring in climate issues".

Liquidity risk controlled permanently

"The fund managers also monitor liquidity risk continually in order to diversify the portfolio and optimise transaction costs. They do so by factoring in a liquidity score calculated in-house for each name, managing turnover constraints depending on market conditions, and working on the number of portfolio lines", emphasises Noémie Hadjadj-Gomes.

Fund managers therefore do not follow a fully systematic approach. They incorporate the credit research team's opinions (vetoes / top pans / top picks) and may invest in the primary market in order to capture issuance premiums. *"It is a well-known phenomenon. A bond's price tends to rise in the days following its issuance, before being incorporated into the bond indices. By participating in the primary market, and provided the bonds pass through the filters used to build the ESG/climate universe and are approved by the credit research team, our fund managers are able to improve a portfolio's returns"*, points out Noémie Hadjadj-Gomes.

Close analysis of each company's climate policy and carbon footprint

When establishing its climate universe, whether for its equity fund or for its dedicated bond solutions, CPR AM applies a transparent methodology developed in partnership with CDP (Carbon Disclosure Project), a pioneering non-governmental organisation specialising in the disclosure of carbon data worldwide.

"Our approach is multi-sector and diversified, with the aim of promoting the transition to an economy that is globally compatible with the targets set out in the Paris Agreement. Our selection encourages companies that are in the best position to manage climate risk", explains Noémie Hadjadj-Gomes. CDP's scoring methodology is based on the climate policies published by companies rather than on econometric sector models.

CPR AM's climate investment universe includes companies that have received the best scores from CDP, as well as companies whose carbon emissions are consistent with the target to limit global warming to 2 degrees as per the Paris Agreement. This appraisal, referred to as SBT (Science-Based Targets), is the result of joint expert assessments carried out by the World Wildlife Fund (WWF), World Resources Institute (WRI), CDP and UN Global Compact. We then apply two other filters, one for ESG criteria and another to exclude companies involved in controversies.

Services to assess the impact of its investment decisions

Besides developing the investment building blocks from which to access the credit market with an ESG and climate dimension, CPR AM provides services to measure the impact of the strategies applied by its fund managers. Carbon reporting is thus widespread in CPR AM's range of funds, and its fund management teams are able to measure the impact of each investment decision directly using their front office tool before placing any orders.

Company temperature is another of the indicators we follow to monitor the official environmental targets set by companies on a long-term temperature trajectory. Aligning a portfolio with a 2°C trajectory (corresponding to the upper end of the global temperature range that the Paris Agreement recommends not exceeding) implies picking companies which have decarbonisation strategies that are consistent with the requirements of the ecological transition. Around 90% of MSCI Euro companies (in terms of capitalisation) replied to the CDP this year and will have their temperature measured. *"We are currently working on developing an aggregation method that is more effective than a simple weighted average of the temperatures of companies in our portfolio, as this will give us a more reliable gauge of the temperature of our investments"*, concludes Noémie Hadjadj-Gomes.