ESG in **Fixed Income**

BMO Global Asset Management

Contents

"We believe that responsible investment is a mindset: as asset managers, we have a privileged and trusted position as stewards of capital, which gives us both influence and responsibility."

Introducing our **integration approach**

BMO Global Asset Management believes in the importance of taking a responsible approach to investment. This document describes why and how we integrate ESG factors into corporate fixed income investing.

The relevance of fixed income instruments from a responsible investment perspective has long been identified and hardcoded in the UN Principles for Responsible Investment, originally launched in 2006. Despite this, the spotlight in responsible investment has been on equities, and the impact of Environmental, Social and Governance (ESG) factors on shareholder value.

The ESG implications on fixed income investments, as well as the role of creditors and bondholders in a sustainable financial market, have received comparably little attention. In this report we highlight how ESG factors and stewardship activities are integrated into BMO Global Asset Management's corporate fixed income investments and engagement approach. We also look at how the growing Sustainable Bonds market is enabling fixed income investors to align investments with sustainability goals.

Thomas Hassl
Vice President, Analyst, Responsible Investment

Andrew Brown
Director, Portfolio Manager, Fixed Income

Paul Allen
Director, Head of Credit Research (London)

Ronald Salinas
Director, Portfolio Manager, Head of Research (Miami)

The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

Changes in interest rates can reduce the value of your investment.

Why ESG issues **are relevant to bondholders**

Financial, operational and reputational risks linked to ESG factors can materially affect a company's ability to generate stable cash flows to honour its financial obligations.

A company's creditors are key financial stakeholders and share a common interest with shareholders, namely robust risk management.

Compared to equity investors, creditors have limited upside potential in investment returns, and tend to be more focused on the downside risks. In this regard, the identification and management of material ESG risks is a form of enterprise risk management, protecting long-term credit quality. That being said, companies cannot, and should not, avoid taking well-calculated risks to generate adequate returns for equity investors. Establishing a balance of risk and reward that is needed to attract both creditors and shareholders to generate a sustainable capital mix is in the interests of both types of investor.

The relevance of ESG issues to credit quality is now acknowledged by the major credit rating agencies, with Moody's and S&P Global both expanding their ESG capabilities to better integrate ESG factors in their credit rating methodologies.

Key ESG issues for bondholders

Our credit approach includes ESG issues with a fundamental belief that that these are part of a company's risk profile. On the right are examples of ESG risks that could affect the credit risk of companies:

Environmental risks

Issues including:

- Litigation, clean-up, and reputational risks associated with environmental pollution
- Risk of stranded assets for oil and gas, utilities, and coal mining companies, potentially impacting a company's ability to service or repay its debt
- Monetary costs associated with environmental risk management, such as R&D and capital expenditure needed to address changing consumer and regulatory trends. Examples include expenditures relating to the electrification of transport or the global energy transition

Social risks

Harmful social practices, such as:

- Poor labour practices
- Involvement in human rights violations
- Data breaches

Governance

Good practices we look for include:

- Effectiveness of board oversight of company management, providing appropriate checks and balances to prevent abuse
- Robust audit process, including an independent audit, appropriate accounting policies, and high standards of transparency and disclosure
- Compensation metrics that reflect a company's financial strength and stability, and also include material ESG issues where appropriate
- Clarity on financial policy

BMO Global Asset Management's approach:

We factor these ESG issues into the credit investment process through a dual approach:

1. **ESG Integration**: incorporate ESG risk assessment into the credit research process
2. **Engagement**: active dialogue with companies on behalf of bondholders

Our global credit teams and Responsible Investment team work in close collaboration

Integration of ESG issues in our **investment processes**

ESG integration is the consideration of financially material ESG issues in the course of investment analysis and decision-making, with a view to gaining a more comprehensive understanding of risk and long-term opportunity.

For credit investments, this translates into assessing the impact ESG issues have on the ability and willingness of an issuer to service and repay its debt. As such, ESG is an integral part of our proprietary credit scoring methodology.

For non-financial companies for example, ESG factors form part of an issuer's "Business risk assessment", which next to Financial Risk and Sovereign Risk contributes to our overall view of credit quality.

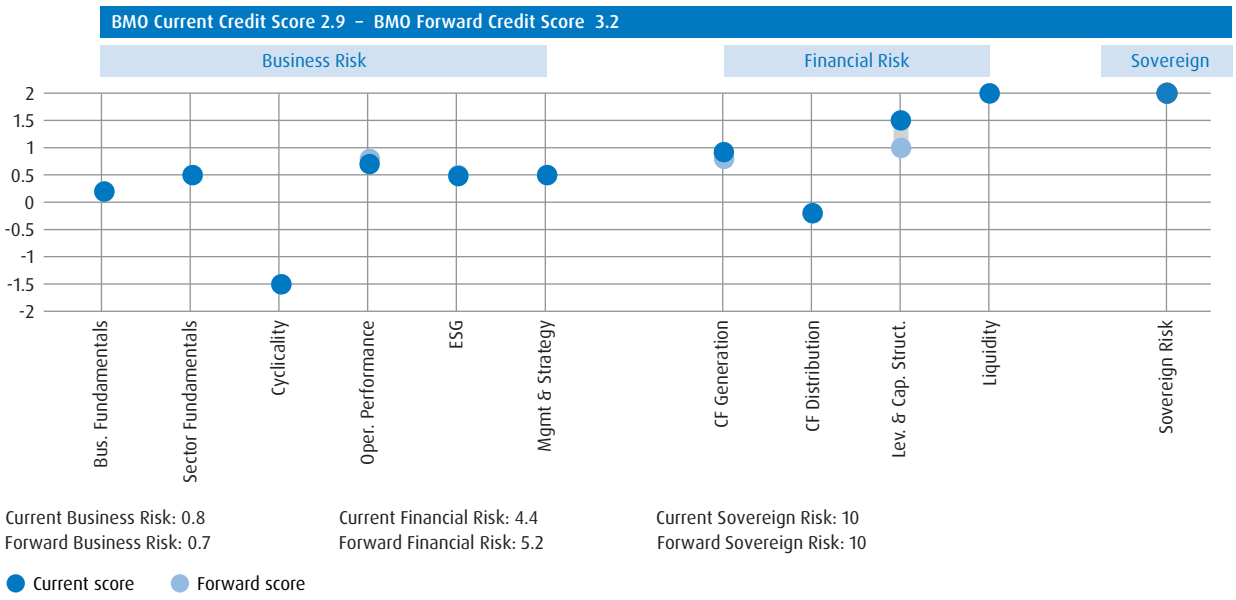
The analyst assigns a credit-specific ESG score of between -2 and +2 based on the analyst's view of how the company's ESG profile impacts its overall credit profile (0 being neutral). The ESG score combines the rigor of our credit scoring process with proprietary input from our Responsible Investment team's risk analysis framework.

This is incorporated into the wider scoring scheme, which results in an aggregate credit score for each company. For each credit metric we also assign a future score, based on forecasted financial and non-financial metrics, in order to identify the likely direction of credit quality.

A commitment by the company to improve the environmental, social or governance profile, perhaps as a result of engagement, can lead to a higher future ESG credit score.

The credit score is then used in our assessment of relative value. Put simply, for companies with lower credit scores, we require a higher yield, or spread, to compensate for the additional perceived risk.

Excerpt from our credit scoring model showing integration of ESG research



*BMO Credit Score for Corporates is weighted Business Risk Score: Financial Risk Score: Sovereign Risk Score 50:45:5.

Source: BMO Global Asset Management as at Sep-2019

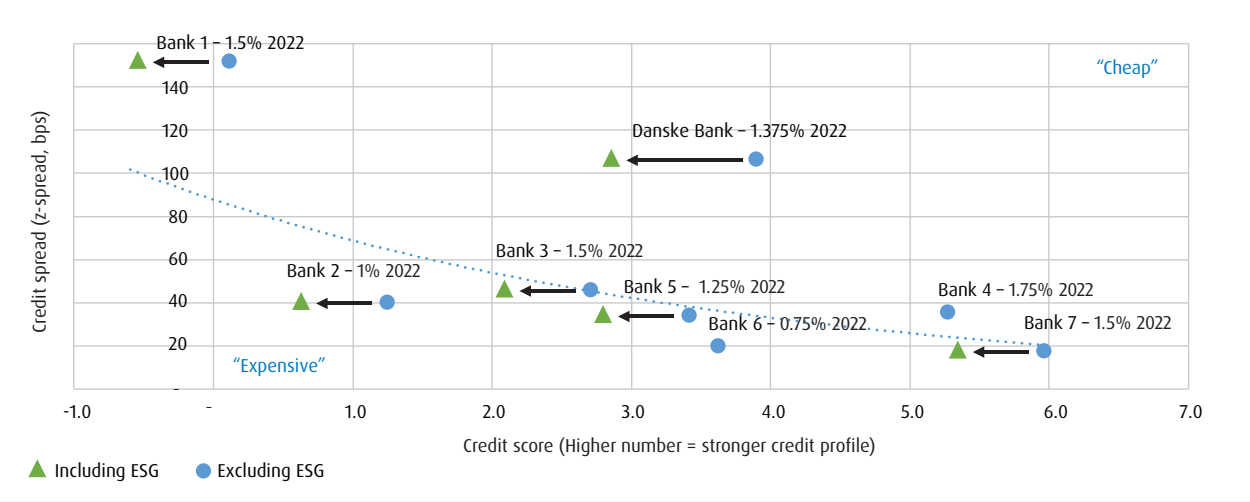
ESG integration in practice: Assessing bank credit risks

The chart below shows the impact of our ESG score on the overall credit score of selected bank bonds in May 2019. The chart plots credit spread against credit scores and shows how a change in ESG score affects the latter. For example, Danske Bank's 1.375% 2022 bond would, without ESG considerations, trade relatively close to the preferred top-right corner, where bonds have high credit scores and spreads.

Adding ESG to the mix, however, and the fact that Danske had at the time the lowest ESG score (-2) as a result of the money laundering scandal involving its Estonian operations, the attractiveness of the bond diminishes and moves towards the left, away from "cheap" towards "expensive".

Of course, not all companies are assigned negative ESG scores. The Swedish mortgage lender, SBAB is an example of a bank with positive ESG scoring, contributing to the relative fundamental attractiveness of the issuer. It has solid corporate governance practices as well as strong environmental credentials, which include stress tests of the loan book based on climate related risks.

Example of the impact of ESG score on overall credit scores and relative value



Arrows indicate impact of ESG considerations on overall credit score. This is embedded in our view of relative value. Credit spread is the extra yield, over and above a government bond or swap rate, that compensates an investor for credit risk.

Source: BMO Global Asset Management, for illustration purposes only. Data as at 01-May-2019

Engagement – active ownership **to drive positive change**

The second pillar of our credit ESG approach is issuer engagement.

2019 saw us engage with 765 companies across a range of **environmental, social and governance issues**

Having identified the ESG issues we consider material to the creation and protection of long-term investor value, we use in-depth dialogue to encourage the companies we invest in to improve performance and move towards best practice in managing those issues. Our engagement encompasses a spectrum of ESG issues, across a range of sectors and geographies, covering BMO Global Asset Management's assets as well as those of the clients of our engagement service, ***reo***®. We monitor the outcomes of our engagement and report on our progress.[1]

Compared to equity investments, where engagement is considered an established responsible investment strategy, bondholder engagement is a relatively new concept that has only recently gained widespread acceptance. A major hurdle for early adoption was the question of whether investor stewardship should span beyond equities to also include other asset classes that don't grant the investor formal ownership rights. It was also unclear how issuers would respond to creditors requesting engagement meetings to discuss the management of ESG issues.

Our experience in engaging fixed income issuers clearly contradicts the above argument, and we have generally had little difficulty in securing meetings. A key factor is the need for continuous refinancing. Whereas companies only very rarely come to the market to issue additional equity, bond issues are much more frequent. The desire for these issues to be successful, we have found, is a strong reason for bond issuers to accept engagement meetings and to discuss ESG issues. Moreover, the impressive growth of the Green, Social and Sustainability bond issuances has further improved investor access to traditional bond-only issuers and, as a result, they have added ESG to their agenda.

Our global engagement programme is structured around seven themes:

- Environmental standards
- Climate change
- Human rights
- Labour standards
- Business conduct
- Public health
- Corporate governance

[1] A more detailed description of our engagement programme can be found in our Responsible Investment Approach

Issuer Case Study: Glencore

Metals and mining company Glencore is an example of an issuer to which we assigned a negative ESG Credit Score of -1.5 on both a current and a forward-looking basis. This reflected increased legal risk linked to activities in markets in which it operates, such as Nigeria, the Democratic Republic of Congo and Venezuela, as well as the impact of environmentally damaging mining practices.

36

Our Responsible Investment team developed an engagement programme and have engaged the company 36 times since 2011.

To address these issues and gain a better understanding of Glencore's ESG profile, our Responsible Investment team developed an engagement programme and have engaged the company 36 times since 2011.

While progress has been made with the publication of various ESG policies on human rights, climate change and water management, our Responsible Investment team maintains the view that more needs to be done to fully restore investor trust in the company's ESG practices. Steps should include clearer responsibility and accountability from top to site-level management, and more stringent monitoring and compliance audits by Glencore's headquarters on all its subsidiaries and joint ventures on material ESG issues. More investments into dealing with environmental remediation, improving working conditions and improving the operational impact on local communities are necessary as well.

Issuer Case Study: Volkswagen

In 2015 auto-manufacturer VW admitted to the existence of software designed to defeat emission testing. Over the following months, our Responsible Investment team engaged multiple times with company representatives including the chairman and Head of Group Strategy. The focus of our engagement since the diesel scandal has been on governance reforms, the strengthening of internal controls as well as long term emissions strategy. We are also co-leading engagement with VW under the Climate Action 100+ initiative. As a result of this engagement, we felt that the company was actively seeking to improve its ESG credentials and that significant steps had been made to improve transparency and corporate culture. This subsequently led us to increase our forward ESG score from -1.5 to -1, and led to us identify opportunities within VW's suite of bonds.

"Over the two decades we have run an ESG engagement programme, we have seen more and more companies come to the realisation that if they work together with investors, both sides can reap the benefits in terms of long-term performance."

Juan Salazar, Director, Analyst, Responsible Investment

Green, Social and Sustainability Bonds **– seeking returns and impact**

The Sustainable Bond market has grown rapidly in recent years, and Green Bonds have emerged as an effective investment tool to finance the transition to a low-carbon economy.

We consider Green, Social and Sustainability Bonds (collectively called "Sustainable Bonds" from here onwards), whose proceeds are earmarked to finance environmental and/or social projects, as an effective tool to channel capital towards sustainable solutions, designed to tackle some of the most pressing societal and enviromental challenges of our time.

The strong link between the use of proceeds of Sustainable Bonds with the Sustainable Development Goals (SDGs) makes this "asset class" an interesting tool for investors who are seeking both returns and positive impact.

The popularity of Sustainable Bonds among investors, who place these bonds in conventional, ESG and impact funds, can be considered both a blessing and a curse. Whilst the strong demand for Sustainable Bonds sends a clear signal to issuers to participate in this "asset class" and encourages them to identify eligible[2] green and/or social projects to be earmarked to Sustainable Bonds, it also opens the door for greenwashing. An issuer might use the popularity of sustainable bonds in an attempt to get better credit terms on their bond issuances or to create an unsubstantiated or misleading perception of its Sustainability profile.

Case study: Sustainable Bonds as an effective sustainable development financing instrument

The Sustainable Bond market has grown rapidly in recent years, The OECD estimates that around USD 6.3 trillion of infrastructure investment is needed each year to 2030 to meet development goals, increasing to USD 6.9 trillion a year to make this investment compatible with the goals of the Paris Agreement[3].

As bank loans and government funding alone will not be sufficient to provide all the necessary financing, Sustainable Bonds are developing into a critical sustainable development financing instrument.

[2] ICMA defines voluntary process guidelines for issuing Green, Social and Sustainability bonds, which provide a list of eligible project categories.
[3] Source: OECD, 2017

The strong link between the use of proceeds of Sustainable Bonds with the Sustainable Development Goals (SDGs) makes this "asset class" an interesting tool for investors who are seeking both returns and positive impact.

To manage the risk of greenwashing, our green bond analysts in the Responsible Investment team screen every bond eligible for our responsible investment strategies to ensure sound ESG practices and adherence to the Green Bond Principles.

Leveraging our position as an established responsible investor, we have also been engaging a wide range of market participants since 2015 on the issues facing the green, social and sustainability bonds market. Discussions have focused on the nature of the projects financed, project assessment, the quality of reporting and general quality standards in the market.

We have found these meetings to be a valuable opportunity to access bond-only issuers, allowing us to assess not only their labelled (e.g. "green") bond strategies, but also their broader approach to managing ESG risks and opportunities. We have also held discussions with the investment banks, who have played an important role in developing the market and service providers.

"Our aim is to maximize positive impact and avoid greenwashing."

Catherine McCabe, Responsible Investment

We provide investors access to Sustainable Bonds through the following fixed income strategies:

Strategy	Focus
Standard bond strategies	• Sustainable Bonds held as a part of a portfolio alongside regular bonds
Responsible bonds strategies	• Socially responsible investment strategies holding Sustainable Bonds alongside regular bonds of issuers which meet the sustainability-related screening criteria
Pure-play Sustainable Bonds strategies	• A portfolio focused solely on Green, Social and Sustainability Bonds. Every issuer and issuance is evaluated and monitored as part of a dedicated process

Source: BMO Global Asset Management

Where next for **fixed income and ESG?**

Data quality and availability, regulation and changing investor preferences are set to shape the near-term future of ESG in fixed income.

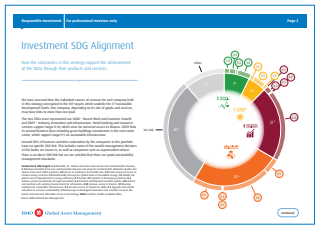
While the integration of ESG factors in fixed income strategies has come a long way and the understanding of the implications of ESG factors on a company`s creditworthiness has improved immensely, we strongly believe that more is to come. ESG data is constantly improving and we expect investors, ESG research providers and traditional credit rating agencies to continue to invest in this area and develop new, innovative tools designed to improve the identification and management of ESG issues relevant to fixed income investors.

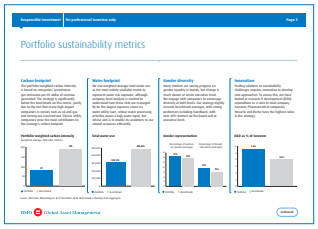
Supportive of this development are improvements in company reporting, with an increasing number of issuers producing sustainability reports and using international reference frameworks such as GRI, SASB, the Task Force on Climate-related Financial Disclosures (TCFD) or the Green Bond Principles (GBP) to increasingly streamline ESG reporting.

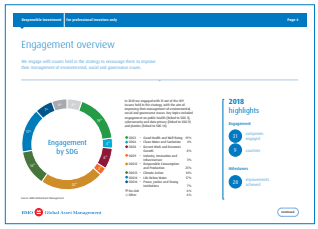
Finally, as investors, we are constantly looking at new ways on how to improve communication to our clients, and have developed methodologies to use the SDGs to analyse our investment choices and undertake company engagement[4]. In our view, this helps to both support the long-term financial performance our clients want and promote positive change.

Example of our impact summary

BMO Responsible Euro Corporate Bond Fund







[4] SDG Framework Viewpoint (2019), Impact Summary for Responsible Euro Bond (2019)

"Risk analysis is central to fixed income investment. It's clear to us that ESG issues can pose threats to credit quality equivalent to, and sometimes greater than, traditional financial issues. We believe definitive ESG investment process inclusion enhances the outcomes we deliver to our clients."

Janelle Woodward, Head of Fixed Income

Viewpoints

We regularly produce research on responsible investment and engagement throughout the year, with past topics ranging from ocean plastics to modern slavery. Please visit our website to learn more.

A selection of our viewpoints

How BMO Global Asset Management can help you

BMO Global Asset Management incorporates material ESG issues into its investment processes across asset classes. We also offer our Responsible Funds range, which invests in companies operating sustainably and excludes those not meeting our ethical and ESG criteria, and our ***reo***® engagement service, through which we provide engagement and voting services covering global equities and credit.

reo® is a registered trademark of BMO Asset Management (Holdings) PLC.

BMO Global Asset Management

We believe that responsible investment is a mindset: as asset managers, we have a privileged and trusted position as stewards of capital, which gives us both influence and responsibility.

We take this responsibility seriously. We consider the impact of our investments on society and the environment, and the extent to which it affects long-term value creation. We work closely with the companies we invest in as active owners, to improve the management of environmental, social and governance (ESG) issues. We support this work with the thoughtful exercise of our voting rights. We strive to be thought leaders on these issues and their relevance to us as investors.

- **Thought leadership** – promoting and encouraging the development of responsible investment across the broader marketplace and industries
- **Active ownership** – using our position as an asset owner to drive positive change through engagement and proxy voting
- **Integration** – ensuring financially material ESG issues are considered within our active investment processes
- **Products** – offering a range of ESG orientated investment solutions built around a clear sustainability philosophy

Risks to consider

The value of your investments and any income from them can go down as well as up and you may not get back the original amount invested. Changes in rates of exchange may also reduce the value of your investment.

Screening out sectors or companies may result in less diversification and hence more volatility in investment values.

Views and opinions have been arrived at by BMO Global Asset Management and should not be considered to be a recommendation or solicitation to buy or sell any companies that may be mentioned.

The information, opinions, estimates or forecasts contained in this document were obtained from sources reasonably believed to be reliable and are subject to change at any time.

Leaders in **responsible investment**

From the launch of Europe's first ethically screened fund in 1984 and our position as a founding signatory of the UN PRI, to the comprehensive suite of ESG specialist funds and services available today, we have a strong heritage in responsible investment.

A history of innovation

A growing range of ESG orientated client focused solutions

- **17-strong** Responsible Investment team
- **A+ Rated** for strategy and governance by UN Principles for Responsible Investment
- **30+ years** of investing responsibly
- **£3.6bn*** under management in ESG specialist funds

*As at 30-Nov-2019

- 1984 – **Launch** of BMO Responsible UK Equity Fund
- 1987 – **Launch** of BMO Responsible UK Income Fund, BMO Responsible Global Equity Fund
- 2000 – **Launch** of Responsible Engagement Overlay (***reo***®)
- 2006 – **Founding signatory** to Principles for Responsible Investment (PRI)
- 2007 – **Launch** of BMO Responsible Sterling Corporate Bond Fund
- 2010 – **Launch** of BMO Responsible Global Emerging Markets Equity Fund
- 2015 – **Launch** of BMO Sustainable Opportunities Global Equity Fund
- 2016 – **Launch** of Green Bond Strategy
- 2018 – **Launch** of BMO Responsible Euro Credit portfolio
- 2019 – **Launch** of BMO SDG Engagement Global Equity Fund

Award winning

Environmental Finance – Sustainable Investment Awards 2019 Winner – Best ESG reporting by an asset or fund manager: large

Investment Week – Sustainable & ESG Investment Awards 2019 – Winner – Best ESG/SRI/Impact Research Team

Investment Week – Sustainable & ESG Investment Awards 2018 – Winner – Best ESG Research Team

Contact us

bmogam.com

Follow us on LinkedIn

BMO Global Asset Management