BlueBay
Asset Management

Annual ESG Investment Report 2017

Global Asset Management

Signatory of:

PRI Principles for Responsible Investment

CDP

Contents

Erich Gerth
Chief Executive Officer

"Our culture and approach means that we have the skills and expertise to analyse and understand ESG considerations in the investment process."

Foreword

Welcome to this our second annual environmental, social and governance (ESG) investment report, detailing our performance over 2017. As you will see from the contents, we continue to make progress in embedding ESG thinking into our investment practices.

Some personal highlights include:

- Seeing the ESG Investment Risk team engage more closely with our investment teams, and in doing so, helping raise credit analysts' awareness, understanding and knowledge of ESG investment relevant risks and developments.
- As well as focusing internally, we have also begun to widen our efforts externally. In particular I am proud of the work we are doing with the UN-supported Principles for Responsible Investment (PRI) on ESG considerations in credit analysis and ESG bond holder engagement – not only will these inform on our own thinking at BlueBay, they will also help move the industry forward as a whole.
- The exciting launch of our first ESG labelled pooled fund, which is in the global high yield space, where we go beyond an ESG investment risk overlay, to encompass a more values-driven investment strategy, in recognition of the demand from investors for more choice.

As market and client dynamics shift, BlueBay as an organisation, strives to ensure that we remain at the forefront of investor needs in fixed income. ESG is emerging as an increasingly important investment consideration for many investors globally across all asset classes including fixed income. An ESG investment survey conducted by our parent company, the Royal Bank of Canada (RBC) Global Asset Management, during 2017 highlighted that over two-thirds of participants use ESG principles as part of their investment practices and decision making. Our culture and approach means that we have the skills and expertise to analyse and understand ESG considerations in the investment process.

We hope you enjoy reading about our efforts and look forward to engaging with you as we continue our journey.

About BlueBay

US$59.6bn AuM

5 sub-asset classes

16 strategies

117 investment professionals

380 employees and partners

7 offices globally (UK, US, Japan, Luxembourg, Switzerland, Germany, Australia)

- BlueBay is one of Europe's largest specialist active managers of fixed income, entrusted by clients with over US$59.6 billion in assets under management (AUM) in corporate and sovereign debt, rates and FX.
- Investment philosophy and approach focused on delivering absolute-style returns, with an emphasis on capital preservation.
- Established track record of innovation and performance, providing a broad range of relative return, total return and alternative investment portfolios in both public and private debt markets.
- BlueBay is a wholly-owned subsidiary of RBC with full investment autonomy and substantial operational independence.

AuM by strategy (US$m)

US$59,681m in total

29,802	12,401	9,711	5,603	2,163
Investment Grade	Emerging Market	Leveraged Finance	Multi-Asset Credit	Convertibles

Source: BlueBay Asset Management, as at 31 December 2017
Notes: Leveraged Finance consists of High Yield, Leveraged Loans, Distressed and Direct Lending (drawn capital); Multi-Asset Credit AuM includes US$2.4 billion of Leveraged Finance assets

July 2001

BlueBay is established at the inception of the euro to capitalise on inefficiencies in the growing pan-European corporate bond market, and in response to evolving opportunities in emerging market debt

2002

Launched flagship European credit long-short hedge fund strategy and the first long-only emerging market debt fund in UCITS format

2003

With a focus on capital preservation BlueBay pioneered the use of credit default swaps in traditional benchmark funds, applying short positions and other hedge fund investment techniques in both long-only and long-short strategies

2008

BlueBay launched a global convertible bond strategy to offer equity-style returns with bond-like volatility; this is followed by a VAG compliant investment grade convertible bond fund in 2012

2010

BlueBay is bought by RBC and launches a sovereign debt strategy to capitalise on new total return opportunities as a result of European peripheral stress

2012

Established a European private debt platform in response to European banks deleveraging and their retreat from corporate lending. Launch of BlueBay convertibles fund in Canada.

2015

BlueBay launched a financial capital bond strategy to capitalise on the new sub-asset class of bank contingent capital debt instruments

2017

Launch of a unique environmental, social and governance ("ESG") high yield strategy to meet the growing demand for ethical investment strategies

For further information about BlueBay, please visit: www.BlueBay.com

Our ESG investment management

"ESG factors can have a material impact on an issuer's long-term financial performance ... These may impact an issuer's ability to meet its financial responsibilities."

Our approach

We believe ESG factors can have a material impact on an issuer's long-term financial performance. Poorly managed ESG risks can lead to inefficiencies, operational disruption, litigation and reputational damage. These may impact an issuer's ability to meet its financial responsibilities. Supplementing traditional financial analysis with ESG analysis is prudent and in-line with our fiduciary duty to optimise investor returns.

We employ a range of complementary ESG investment strategies for our managed assets, varying in scope and relevance:

- ESG integration forms the core of our efforts and is applied across all our assets, supplemented by engagement where appropriate.
- ESG negative screening (product based) on controversial weapons is applied to our pooled funds, and
- Proxy voting is applied in more limited instances to our convertibles and global leveraged bond strategies.
- During 2017 we added ESG norms based screening (conduct-based) and ESG tilting to our approaches with the launch of new pooled fund offerings.

BlueBay is committed to being transparent and accountable about our ESG investment efforts. Visit our website to access our communications as well as our ESG investment related reports.

Our ESG investment policies

- ESG Investment Risk Policy
- Controversial Weapons Investment Policy
- Proxy Voting Policy on Corporate Governance & Corporate Responsibility
- Statement on UK Stewardship Code
- Statement on UK Modern Slavery Act

Our ESG investment strategies

	ESG integration	ESG engagement	Ethical (negative/ exclusions) screening	Noms-based screening	ESG titling	ESG best in class	ESG (positive/ thematic) investing[3]
Pooled fund - ex Global High Yield ESG Bond Fund/Global Income Fund[1]	✓	✓	✓				
Pooled fund - Global High Yield ESG Bond Fund	✓	✓	✓	✓			
Pooled funds - Global Income Fund	✓	✓	✓		✓		
Segregated accounts	✓	✓	✓ [2]				

Notes: **1** This refers to the BlueBay Luxembourg, Cayman Island and Dublin domiciled funds; **2** This is a discretionary service available for clients where this is requested; **3** For example; climate change, social investing, microfinance, green bonds.

Resourcing & oversight

At the end of 2017 the ESG Investment Risk team totalled three dedicated employees, residing within the Investment Risk department, which is located on the investment floor, but acts an independent support function.

Our Head of ESG Investment Risk is responsible for the ESG investment risk strategy, policies and processes, reporting directly to the Head of Investment Risk & Performance – Attribution. The ESG Investment Risk function provides regular progress and performance updates to the Market Risk Committee.

We have access to a range of fee-based and open-access resources. We source ESG data at the corporate and sovereign issuer level and at the sector level from specialist independent ESG and political risk research providers.

We also utilise ESG-related investment insights from sell-side brokers and other stakeholder groups and leverage off the in-house issuer, sector and country expertise of our investment professionals.

Jean-Philippe Blua
Head of Investment Risk, Performance and Attribution

My-Linh Ngo
Head of ESG Investment Risk

Susana Coutinho
ESG Analyst

Camille Lancesseur
ESG Intern

as at 31 December 2017

For further information on BlueBay's ESG investment risk management, please visit: www.bluebay.com/en/environmental-social-and-governance/overview/

Industry memberships

Signatory of:

PRI Principles for Responsible Investment

BlueBay has been a member of the UN-supported Principles for Responsible Investment (PRI) since July 2013. The PRI is an independent membership-based organisation for stakeholders active in the investment value chain seeking to work to support members to incorporate ESG factors into their investment and ownership decisions.

CDP DISCLOSURE INSIGHT ACTION

BlueBay has been a signatory to the CDP, formerly the Carbon Disclosure Project, since 2016.

The CDP is an international, not-for-profit organisation providing a global reporting framework for companies to measure, disclose, manage and share critical environmental information. This includes material on climate change, water and natural resource usage which is consulted by a range of stakeholders (including investors) to inform decision making.

My-Linh Ngo
Head of ESG Investment Risk

"I have noticed a marked shift in the framing of discussions, with ESG starting to be seriously talked about and linked with concepts such as systematic financial risk... this is evidence of a 'crossing of the line' in terms of ESG matters starting to enter more mainstream consciousness."

Review of the year

ESG market trends & developments

From an ESG perspective, when I think of 2017, I would sum it up as being the year that I have noticed a marked shift in the framing of discussions, with ESG starting to be seriously discussed and linked with concepts such as systematic financial risk. For me, this is evidence of a 'crossing of the line' in terms of ESG matters starting to enter more mainstream consciousness.

More specifically, in terms of industry developments, the year started with Donald Trump being sworn in as the 45th President of the United States, an individual who has publicly denounced the occurrence of climate change and stated his intention to withdraw the US from the Paris Climate Agreement (which he formally did in June). But from this not very encouraging start, we witnessed growing commitment and action on climate change which is evidence of the unstoppable momentum. This ranges from governments convening to agree the rule book to implement the Paris Agreement, to the FSB's Taskforce on Climate related Financial Disclosures (TCFD) framework gaining traction as a best practice tool for reporting on climate risks, and to the private sector recognising the commercial and societal imperative.

Reflecting on social developments, 2017 has seen the continued deterioration in social cohesion as evidenced by growing populism in western countries and broader trends in social unrest. Yet, encouragingly, we have witnessed increasing engagement by stakeholders across the board on the UN's Sustainable Development Goals (UN SDGs) in a way which never occurred with the Millennium Development Goals, which if successful would reverse the former trends. So overall, a mixed performance.

BlueBay's ESG investment performance

In terms of BlueBay's own ESG investment efforts, overall it has been a successful year as we have achieved the majority of the goals we had set ourselves, especially in the context of what was an ambitious work programme. The table overleaf provides a summary assessment of our performance against the 2016 plan. We have expanded on some of these activities within this report to provide highlights of our efforts in the next section.

External assessment of our efforts

PRI's assessment of BlueBay's ESG investment performance based on the annual Transparency Report submissions.

Module	Score (pre 2015: A being highest and D being lowest possible); post 2015: A+ being highest and E being lowest)							
	2014 reporting cycle (2013 calendar year)		2015 reporting cycle (2014 calendar year)		2016 reporting cycle (2015 calendar year)		2017 reporting cycle (2016 calendar year)	
	BlueBay	Median	BlueBay	Median	BlueBay	Median	BlueBay	Median
Strategy & Governance	A	B	A	B	A+	B	A+	A
Fixed income – SSA	A (fixed income – government)	D	A	E	A	C	A+	B
Fixed income – corporate financials	B (fixed income – corporates)	D	A	C	A	C	A	B
Fixed income – corporate non-financials					A	C	A	B

2017 ESG investment performance summary

Focus Area	Progress	Comments
Enhancing our ESG investment offering *Whilst we believe the majority of our investors are looking for reassurance we have a robust ESG investment risk management framework applied across all managed assets as standard, we have also seen a growing segment looking for investment solutions which go beyond this to be explicitly values-driven*	Achieved	We launched our first ESG labelled pooled fund in February 2017 with the BlueBay Global High Yield ESG Bond Fund. This is differentiated from our standard ESG investment risk overlay for our pooled fund range in having an explicit values-driven investment strategy which employs more extensive ESG negative screening on products, and a new norms based screen based on conduct. Whilst not a values-driven ESG labelled fund, in November 2017, we launched the BlueBay Global Income Fund, a multi-asset credit pooled fund which introduces ESG tilting as an ESG investment approach. The ESG data has been utilised to provide a filter to select securities, whereby the portfolio is tilted towards investments in better ESG scoring issuers.
Strengthening our ESG investment team resourcing *Whilst our operational model remains to empower our investment team members to be accountable on ESG, we recognise the need to ensure our in-house ESG staffing resource is sufficient to support our efforts*	Achieved	In June 2017, BlueBay added to its ESG dedicated team resource with a new ESG analyst, bringing the total headcount to three. This has enabled the team to better divide up sector and issue responsibilities as well as increase the overall support provided to investment teams.
Embedding ESG into fundamental credit research – issuer ESG checklist *Establishing a formal and systematic approach to incorporate ESG in credit research*	Achieved	Having launched the BlueBay Global High Yield ESG Bond Fund in February 2017, we piloted a corporate issuer ESG checklist as a way to formalise the ESG evaluation process. Towards the end of 2017, we expanded the pilot of the checklist to other teams, and initiated a formal review process. An updated version of the checklist will be produced, with the plan to roll this out in 2018. In late 2017 we also commenced work on a sovereign issuer ESG checklist which we plan to finalise and pilot in 2018.
Developing ESG tools to support our investment teams – sector ESG briefings *Working to build consensus and knowledge of investment material ESG sector risks*	Partially Achieved	Unfortunately whilst the ESG investment risk team were able to produce drafts for the majority of the outstanding sector ESG briefings, none were finalised during the year. This was mainly due to a combination of other unplanned priorities emerging during the course of the year, as well as other activities taking up more time and resourcing than anticipated. We will carry this task over to 2018 to complete.
Strengthening our ESG data infrastructure *Leveraging off ESG metrics to inform, monitor and report on risks and performance*	Partially Achieved	Resources were secured to get business analyst and I.T. support to redesign our internal framework. The scoping phase of the project was particularly time consuming such that work to identify a new solution did not happen. However, this remains a priority and will be carried into 2018.
Incorporating ESG into our private debt business *Having introduced a new ESG investment process into our Private Debt investment activities in late 2016, 2017 was the first full year of it operating in practice*	Achieved	Overall we have made good progress embedding ESG within the team's investment process. Implementation was relatively straight forward given the existing framework in place. The due diligence ESG phase has worked particularly well. Whilst ESG risks are clearly being considered by the team, there remains scope to enhance our documentation practices, as well as ways to strengthen measures covering the post-investment phase.
More active external industry collaborations *Working with key stakeholders within the investment value chain to advance thinking and practice on ESG in fixed income investing*	Achieved	We committed considerable resources to support the external collaborative initiatives we had signed up to – particularly those coordinated by the PRI. We believe we have generated valuable insights and have been pleased with the outputs from these to date. We co-chaired the Advisory Committee on Credit Risks and Ratings which in July 2017 published a report on the state of market practice, and saw the number of signatories to the Statement on ESG in credit risks and ratings increase meaningfully. Our participation in the ESG Bondholder Engagement Working Group led to our role in moderating the annual PRI conference panel session on this topic in September, and will result in the publication of a report in early 2018. We have also stepped up our usage of the PRI collaborative engagement platform, joining some initiatives such as that on cybersecurity. Outside of the PRI, we have been more active in participating in conferences, panels and media discussions to share our learning and thinking on ESG in fixed income.

ESG in action: highlights from 2017

"More than ever, as markets become more globalised and prove to be ever more volatile and challenging to predict, the case for active investment management strengthens."

Some reflections from our Chief Investment Officer (CIO)

Q: How would you summarise BlueBay's ESG efforts over the past year? What have been the main highlights for you?
As CIO, my aim is to support our ESG investment function to embed ESG insights into the firm's investment activities so that we start to see more tangible evidence of this adding value to the investment process. Clearly this will not happen over night, but there have been two developments I have observed this year which have been very encouraging to see.

One refers to the sector analyst forums, an initiative we set in 2015, which is proving to be a valuable mechanism for our credit analysts to have ongoing, dynamic interactions with our ESG investment team members. It has been heartening to see proactive, integrated credit and ESG presentations in some of these sector meetings during the course of the year such as the Industrial groups on electric vehicles (EVs), the Consumer group on cybersecurity and Energy & Mining group on energy infrastructure projects. It has also acted as a catalyst for analysts to proactively engage the ESG team more generally outside of these sessions.

The other area relates to the development of a formal issuer ESG checklist process. This will materially move us forward in terms of ESG integration as it embeds ESG in our credit analysis process and promotes greater accountability.

Q: What have you observed in terms of ESG trends and developments over the course of 2017, and how do you see this evolving and impacting financial markets?
Within the last year we have seen first-hand a material increase in the number and nature of ESG-related enquiries from investors and investment consultants. Clearly ESG thinking is moving more firmly into the debt asset class, and investors want to see ESG integration within conventional strategies not just in ESG dedicated ones.

In terms of how I see ESG impacting markets? Regulatory risk driven by ESG risks is an obvious one, whereby policy makers and regulators are intervening not just due to ESG concerns but as they worry about how ESG developments could negatively impact financial markets. Outside of these interventions, in some industries and/or regions we are also beginning to see pure economics and market forces come into play – take developments in the power utilities sector and renewables as an example.

Also, the more investors take ESG into account in the way they invest, the more ESG market participants will influence prices.

Q: What do you see as the challenges and opportunities of incorporating ESG?
There is clearly a need for more investment relevant ESG data from issuers, more useful ESG analysis and tools which focus on material investment factors, as well as more research which improves knowledge and understanding of how ESG factors impact fixed income dynamics.

As markets become more globalised and prove to be ever more volatile and challenging to predict, the case for active investment management strengthens. Overlay that with the particular nuances of the fixed income asset class in terms of its diversity and complexity, and we believe the case for an active approach is even more compelling for ESG fixed income investing.

How ESG insights add value

– some thoughts from our credit analysts

Q: To what extent do you see ESG analysis adding value to your work as a credit analyst?

Rob Lambert, Senior credit analyst, Investment Grade: I think adding ESG analysis has forced us to put some structure around an area that we were already doing. Specifically it has highlighted the potential value of non-financial disclosures as a source of additional insight into management, although there are challenges to being able to use this to meaningfully benchmark companies given this can be inconsistent, noisy and selective. Specific to my coverage - oil & gas and utilities - managing regulatory, technological and reputational risks associated with environmental impacts in particular has become a very important element of business strategy and investor perception, and it has become very clear that the first-movers are now outperforming. In summary, I firmly believe that ESG issues are not widely understood nor quickly incorporated into bond prices, creating the clear potential for alpha generation.

Amanda Gray, Senior credit analyst, Emerging Markets: I'm always open to considering new data sources that help broaden my perspective on corporate credit, especially as I cover emerging markets. My experience in helping to pilot a new ESG assessment method that systematically captures ESG risk factors has proved really helpful in this regard. A lot of the ESG risks I focus on are discussed in our credit meetings but for the first time I am now being asked to explicitly quantify these risks via an ESG score. This has resulted in me having to think in an entirely new way. For example, I would have previously made a portfolio manager aware of governance concerns on a credit. But now I can convey the materiality of those concerns numerically with an ESG score, and the extent to which I think we should be compensated for the risk in a bond's pricing. This has proved a helpful tool for integrating ESG factors into my credit analysis and communicating ESG risk to my Portfolio Managers.

Q: How do you interact with the ESG function and what has proved useful?

Vanessa Scarbonchi, Senior credit analyst, Convertibles: We collaborate with the ESG team on a regular basis as part of our pre and post investment due-diligence process. Their input is highly valuable especially on names that feature lower ratings or controversies and help us refine how we frame general risks associated with our investments. ESG analysts are also included in the sector analyst forums during which they can alert the investment teams on cross-cutting developments as well as flagging any controversies or red flags on current holding which can then be investigated by the respective analysts. Collaboration has extended to identifying and presenting on common themes, for instance cybersecurity risk in the consumer and the telecoms space. I would expect interactions to only increase further as analysts continue to integrate ESG as a potential differentiator in their recommendations.

Duncan Farley, Senior credit analyst, High Yield: Over the past few years ESG factors have emerged as a key driver in all investment decisions. Beyond direct ESG company assessment it is vitally important analysts also understand how ESG related factors will impact the current and future investment universe. Whether this is from ESG related regulatory and policy changes or from customer led reactions to ESG driven preferences; as analysts we need to be on top of these trends. This often requires specialist insight and in the High Yield team we have used our in-house ESG team to access this expertise. As an example we recently commissioned a study of Electric Vehicles (EV) and related Battery technology to better understand the predicted industry evolution and trends and to identify which platforms and materials are most likely to feature heavily in EV production. The resulting report provided insights that we would not have easily sourced through our traditional channels and provided excellent support for our ongoing investment decisions.

Q: ESG analysis is usually discussed in the context of corporates. How are ESG factors taken into account for sovereign investing?

Graham Stock, EM senior sovereign Strategist: The planned introduction of an ESG evaluation framework to sovereign investing is an exciting opportunity to formalise a process that has always influenced our work. The core of sovereign fixed income analysis is an assessment of the sustainability of the government's willingness and ability to pay. Governance therefore plays a central role, but willingness and ability to pay can also be challenged by environmental and social stress. We have always taken these factors into account, for example by considering the risk that social unrest might bring down a particular government. Going forward, the intention is to begin explicitly scoring countries more rigorously on their performance in areas such as income inequality or vulnerability to water stress such that these are not overlooked.

Integration

Incorporating ESG into credit research

2017 saw the ESG team work on the development of a formal issuer ESG evaluation framework for use pre-investment by credit analysts as part of their fundamental research process. Such a step will help progress our efforts to systematically incorporate ESG into the investment process of our teams. Whilst we already source ESG data on issuers from external providers, we believe it is critical we are able to formulate our own independent views, particularly given that third party analysis tends to be more relevant to equity investment than fixed income, and in some cases, there is a lack of ESG coverage of the issuers.

There are two important ESG metrics resulting from the process for each issuer: a Fundamental ESG Rating, which indicates our absolute view of the ESG risks/opportunities faced by the issuer, and an Investment ESG Score which reflects a relative view on the extent to which ESG factors are considered relevant to valuations, (which can be a security/instrument specific decision). The launch of the Global High Yield ESG Bond Fund was an opportunity to work with the High Yield team to pilot the evaluation tool. Following a good period of usage, the template has been further refined to incorporate feedback from the team as well as those from other desks in the firm, with the aim of rolling this out across all desks during 2018.

Interacting with our investment teams

Our focus on identifying ESG factors which are most investment relevant, involves the ESG investment function continually monitoring and reviewing ESG trends and developments on a number of different levels: sectoral, geographical, thematic/issue or issuer specific basis. These are prioritised in terms of the materiality of the investment exposure and then shared with investment teams as appropriate. The team's interactions with the investment teams also go the other way, with individuals approaching the team to seek targeted guidance and insights.

Outside of the dynamic interactions, since 2015, BlueBay has operated a cross-desk sector analysts initiative, where credit analysts covering the same sector, meet regularly to discuss key sector developments, including ESG-related ones, which have financial implications. During the course of the year, the ESG Investment Risk team collaborated with some analysts to jointly research and present on topics such as electric vehicles (EVs) and shared autonomy in the automotive sector; cyber risk in the consumer sector, as well as ESG risks associated with energy pipeline activities. In all instances, a practical output of the work was the creation of an internal framework for analysts to utilise in thinking about the extent to which their investments were materially exposed to these trends as a risk, and assess the quality of the management response.

Proxy voting

Proxy voting occurred in a total of 11 instances during 2017, relating to nine separate companies (with voting occurring twice for two of the companies).

In all instances, decisions were related to standard corporate governance matters.

For all instance, BlueBay voted in-line with management recommendations.

Engagement

The majority of our engagement efforts at an issuer level seeks to gain insights into how an issuer manages investment material ESG risks. Often alongside this we find we are also sharing thoughts on how a company can improve its efforts in regard to ESG in terms of ESG disclosure or overall ESG management.

Engagement case studies

Case study 1 – a leading European automotive manufacturing company in the Investment Grade universe

Background: The company has faced a high profile scandal within the last few years related to violations of environmental regulations on vehicle emission in a key end market, the USA.

Action & outcome: We had exposure to the company's bonds in some of our strategies before the event as we felt fundamentally it is was a strong company. Following news of the allegations and ever since, we have been in ongoing communications with senior management to better understand the issues and measures being taken, which have informed on our investment view.

Investment view: Whilst the scandal has not materially changed our investment view, it has informed on our thinking in terms of governance quality, since it indicates that critical questions were probably not asked at the right stage of engine/product development and an accumulation of failures went unchecked. Ultimately, we view the emission scandal cost as a one-off payment issue and do not expect any tangible damage to its brand value. Furthermore, our discussions with senior management and the actions that have been taken since the allegations make us believe that there has been a very tangible shift in the company's corporate culture. The company has massively overhauled its compliance structure and empowered middle management to be more vocal. We continue to monitor developments and will reassess our investment rationale accordingly.

Case study 2 – European banks in the Investment Grade or High Yield universe

Background: The banking sector represents a meaningful proportion of the fixed income universe and plays a critical gatekeeper role in the economy. However, the global financial crisis, and events since, have highlighted the fact that the risk management and business conduct practices of many companies in the sector were not as robust as they could have been, resulting in increasing regulatory, operational and reputational risks.

Action & outcome: We have continued to engage with a number of leading UK, French, and German banks on how they are addressing culture and conduct, their approach to social and environmental lending risk, as well as technological risks. We have also participated in external events and initiatives convened by key stakeholders to hear from other experts to inform on our thinking. These include engaging with the Banking Standards Board (BSB) in the UK, as well as the BankingFutures project.

Investment view: No one can deny that ESG related drivers which resulted in the financial crisis have materially impacted the operating environment of the sector. We have seen increased regulation, large scale industry restructuring and a significant increase in litigation risk across a wide spectrum of subject matters. The follow through of ESG impacts on other industries requires meaningful consideration given the risk underwriting role that banks take. For example, lending to companies engaged in fossil fuels may no longer be a viable business model, which can feed through into credit risk.

Case study 3 – a Latin American central bank

Background: This Latin American central bank has lagged behind other monetary authorities in its communication strategy around monetary policy decisions. Specifically, we believe the public reporting explaining decisions after each meeting to be insufficient, lacking transparency about which members of the monetary policy committee voted in which way. This made it difficult to subsequently follow the evolution of the central bank's thinking, since it was hard to match the public statements of committee members to their stance in previous meetings - colloquially speaking their identity as 'hawks' or 'doves' with regard to monetary policy.

Action & outcome: Over the course of 2017, and in prior years, we have taken advantage of meetings with committee and staff members both in country and abroad to make the case that greater transparency would boost the efficiency of their communications, and the efficiency of the market in pricing in the future path of monetary policy. We had several meetings with existing and newly appointed senior individuals in 2017 and in early 2018, both privately and in public settings. In April 2018 the monetary authority announced that it would shortly start to include the names and decisions of voters in the statement after monetary policy meetings, and identify them where appropriate in the more detailed minutes.

Investment view: Our view on the monetary authority's governance has meaningfully improved with the commitment to greater transparency, and we look forward to reviewing the enhanced disclosure. From an investment standpoint this gives us greater confidence in our ability to interpret future monetary policy decisions, and at the margin, could lead to an increase in exposure to local rates in particular, either paying or receiving depending on the circumstances.

ESG engagement with sovereigns – a view from our sovereigns desks

ESG has always been part of our thinking in the developed market sovereign world since we are assessing governments' policy agenda as an intrinsic part of our analysis. We believe the emphasis placed on bottom-up, as well as, ongoing access to key decision makers is a key strength of the sovereign efforts at BlueBay. In terms of those we interact with, these can range across central bankers, regulators, finance ministries, bank CEOs, trade unionists and civil servants in many markets.

A consistent message we have actively pushed is that better governance, strong and well enforced regulation, alignment of economic incentives and respect for ownership of assets are all key to a successful economy and general economic welfare. As such, we have sought to promote transparency and integrity, and sought to educate how borrowing costs will fall to the benefit of domestic tax payers, where reforms can be delivered. Members of the team do contribute actively in terms of thought pieces which play into public policy discussions (e.g. Mark Bathgate has a regular blog for *The Spectator* magazine, and Mark Dowding writes a regular Macro commentary sent to BlueBay clients).

However the extent to which we can be transparent about our specific sovereign engagement activities is limited as most discussions are private and off the record. Furthermore just as with corporate engagement, but potentially even more so for sovereigns, it can be challenging to attribute outcomes to specific efforts on our part given the scale of the factors at play, the stakeholders involved, the political dimension and so forth. That said, we believe it would be fair to say, and we have been informed privately, that our discussions have been helpful in informing on policy development in a number of instances.

Mark Dowding (Co-head of Developed Markets), **Mark Bathgate** (Portfolio Manager, IG), **Graham Stock** (EM Snr Sovereign Strategist)

The bigger picture

Collaborative initiatives at industry level

Our PRI membership has enabled our active participation in the investor work streams focused on ESG in fixed income investing.

PRI report:

- ***ESG in credit risk and ratings analysis:*** We believe it is important to work collaboratively with investors and key stakeholders to bring about positive change within the industry. Chaired by BlueBay's My-Linh Ngo, the Advisory Committee on Credit Risks and Ratings is a working group focused on advancing efforts to integrate ESG considerations into credit risk analysis and ratings. During early July 2017, the group published a report, *Shifting perceptions: ESG, credit risk and ratings*, on thinking and practice in the market regarding how investors and credit rating agencies (CRAs) are looking at ESG in credit analysis, as well as outlining some of the main challenges and opportunities.

- ***ESG bondholder engagement:*** We are also represented on the ESG Bondholder Engagement Working Group which is looking to advancing practices in terms of fixed income investors engaging with issuers on ESG related matters. Whilst we are not owners, we are lenders and as such still have certain rights and responsibilities.

  BlueBay contributed to interviews held for inclusion in, and feedback to, a forthcoming report into the subject to be published in 2018. We also moderated an expert panel discussion on this topic at the annual PRI conference in September 2017 held in Berlin.

Promoting sustainable finance in Europe

HLEG report:

In October 2016, the European Commission established the High Level Expert Group (HLEG) to develop a comprehensive European strategy on sustainable finance. The group is composed of 20 experts from 'civil society', the business community and other non-public sector institutions. HLEG has been active since January 2017.

The HLEG's interim report was published in July 2017 for public consultation and contained early recommendations and key policy areas for further discussion. A final HLEG report will be produced in early January 2018, with the European Commission then tasked with reviewing how to take their proposals forward.

BlueBay has provided responses to the public consultation which closed in late September 2017. Overall, we are broadly supportive of the recommendations and policy areas identified to be addressed in order to ensure Europe balances better finance with sustainable development. We look forward to the publication of the final HLEG report, and continuing to play our part in enabling a sustainable European financial market whereby sustainability is a guiding thread in Europe's financial system.

Looking ahead

"We do not see any ease off in rising investor and societal expectations in terms of ESG investing – if anything – it will only increase."

So what are our thoughts going into 2018? At an industry level, we do not see any ease off in rising investor and societal expectations on ESG investing – if anything – it will only increase. We anticipate four particular themes are likely to come through more meaningfully in 2018:

- One is the regulatory threat – if investors cannot show sufficient commitment and credible efforts – bodies such as the European Commission have indicated (through their formation of the High Level Expert Group) that they will not hesitate to consider legislative measures to force capital markets to follow a more sustainable path.

- The second challenge relates to carbon – we are fast approaching a period where if we do not take meaningful corrective action on climate change – we will be locking in irreversible temperature rises, which will potentially have profound consequences.

- The third – climate related also – is regarding the likelihood of there being material technological breakthroughs coming in some critical industries such as automotives (in the content of EVs) and utilities (in terms of renewables) which make sustainable solutions more commercially viable.

- Finally the fourth, is a renewed focus on the 'people' element of sustainability – for instance in terms of social capital more generally or as part of the inclusion and diversity agenda.

Whilst these can be viewed as ongoing risks and challenges, the themes can also be viewed as opportunities by those investors proactively engaging on this agenda.

Given the scale of the sustainability challenge and potential market risk, it is not surprising many stakeholders have predicted 2018 will be the year the fixed income market will have to get serious about ESG. As the largest market by assets under management, and given the critical role the debt market can play in financing not only the low carbon transition, but realisation of the UN SDGs, we anticipate greater scrutiny of fixed income investors.

Thinking about how we will continue to progress our internal ESG investment risk efforts in 2018, BlueBay has identified the following priority focus areas:

- The roll out and embedding of the issuer ESG evaluation process for both corporates and sovereigns will be a critical mechanism for involving and integrating ESG awareness in our investment thinking.

- To support the credit analysts' ability to operate independently and develop their thinking on ESG, we will work to finalise the sector ESG briefings.

- Critical to enabling investment teams and the ESG Investment Risk team to monitor and evaluate ESG risks within our portfolios, as well as enable improved client ESG reporting, we will continue to enhance our internal ESG data infrastructure so as to be more efficient and effective.

- We will work to evidence in more tangible ways, our progress on incorporating ESG within our investment risk practices.

- Having introduced more pooled funds in 2017 where the ESG component is more pronounced, during 2018 we will continue to review the extent to which additional solutions are needed.

- We will ensure we maintain an active role in the external collaborative initiatives we are already involved in or sign up to during 2018, and where possible continue to share our learning and insights on ESG in fixed income.

It is clear we have another challenging year ahead of us. Yet, there is a real sense that 2018 could be another critical milestone for us on our ESG investment journey in terms of further incorporating ESG investment risk thinking into our culture and processes.

Feedback and Contact Us

We hope you have found our annual ESG investment risk report useful. To ensure we continue to meet our key stakeholder needs and interests, we welcome feedback on how we can improve our future efforts.

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