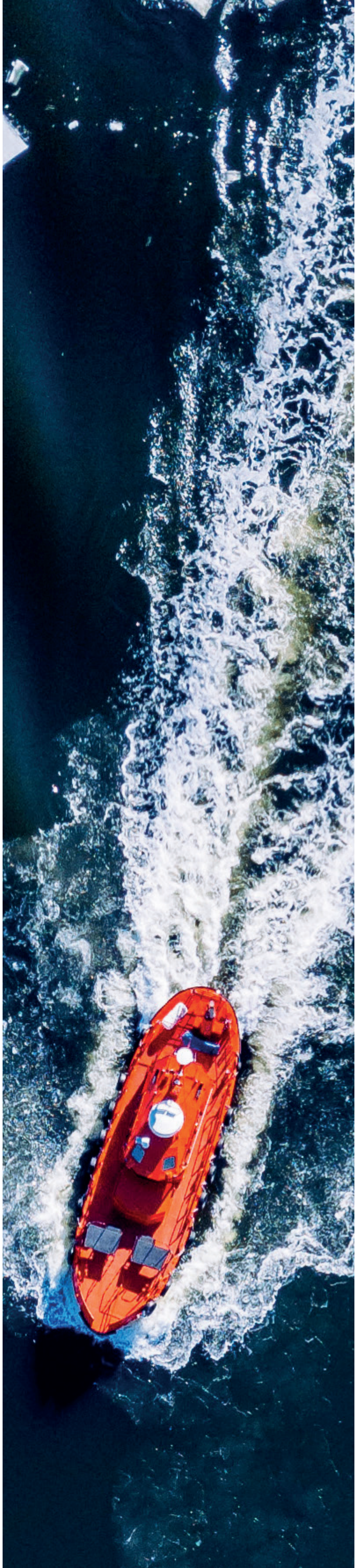

Climate change: an integral consideration in fixed income strategies

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Throughout history, humans have risen to address challenges to the health and safety of their communities. Scientific consensus has certainly outpaced political consensus on how to tackle the significant physical and economic impacts of climate change, but the global political will for increased regulation is strengthening. Therefore, it is our goal at LGIM to understand how regulation will manifest itself and impact our clients' assets. While it is very difficult to determine the exact regulatory mechanisms and timing, it is reasonable to assume that companies that are more aligned with the trajectory of these regulations face lower risk and higher opportunity than those who are not.

Valuation

Valuing the impact of climate change in fixed income securities is fundamentally different than in other asset classes such as equities. Fixed income securities lack homogeneity due to, among other things, coupon, maturity and specific covenant protections. Therefore, the impacts of climate change will not impact the probability of default of each security in the same manner. For example, climate change is not as large a consideration for evaluating the probability of default for overnight commercial paper as it would be for 30-year debt securities. As such, a broad exclusion policy may not be a reasonable investment approach to climate change in the fixed income world. Rather our fixed income investment approach to climate change considers the impact to an issuer's long-term credit quality, security specific features, and risk mitigation techniques.

Climate change is a major existential risk to all asset classes. While isolating the financial impact to a specific security's performance is beyond the scope of this article, it is our contention that certain long-term climate risks are beginning to be reflected in certain securities' valuations. At LGIM, we utilize proprietary analytics in tandem with an engagement approach designed with the aim of providing superior investment returns while creating positive change with capital-seeking organizations.

The carbon blame game

As with most problems, the initial response is "who's to blame?" As it relates to climate change, the global conversation focused on the man-made contributions of carbon emissions. The investment community coalesced around the idea of Scope 1, Scope 2 and Scope 3 carbon emissions to allocate the "blame" across the corporate entities. This yielded results that were predictably focused on producers of energy and the major consumers of energy in their manufacturing processes. Thus, the low-hanging fruit for most energy transition strategies is simply to underweight sectors that fall in the aforementioned categories.

The fault of this "blame allocation" is that it ignores the potential social good of the ultimate product or service that produces the carbon emission. In the case where a company can prove a social good and the lack of outsized profits, it is reasonable to assume the company can navigate the energy transition. Understanding a company's relationship with a regulator, such as with a utility, is critically important to evaluating a company's ability to navigate the energy transition.

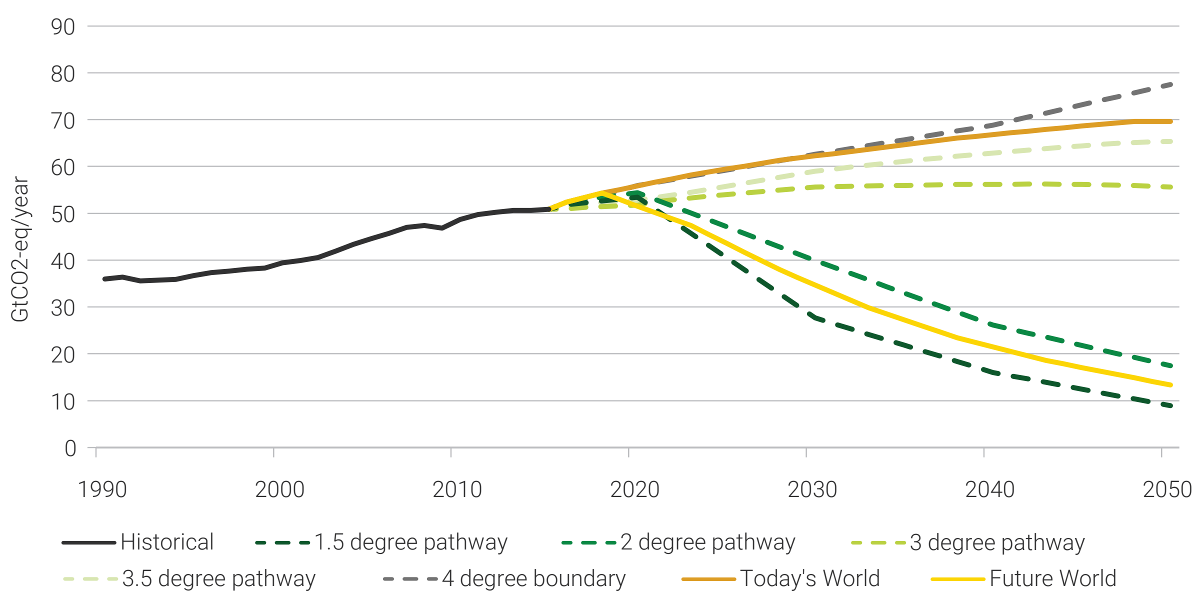
In addition, while carbon emissions are heavily weighted in the environmental analysis component of a broader ESG framework, there are other factors that expose companies to regulatory risks. In our analysis, we specifically reference factors such as water usage, product safety and supply chain management policies.

At LGIM, we have a more nuanced approach that relies heavily on proprietary analytics. Specifically, we have developed a framework for evaluating alignment to standards set by the Paris Climate Accord. This is a highly scalable approach that can easily be adjusted as the regulatory environment evolves.

Evaluation alignment strategies

We have concluded an extensive review of the global energy system in partnership with a global management consultancy. We have created a bespoke, detailed and investor-focused model to facilitate construction of fully independent energy scenarios. The model 'Destination' will inform subsequent, long-term investment decisions and develop dynamic pathways for the future energy system. As shown below, a significant reduction in greenhouse gas emissions is required to comply with a 2-degree world.

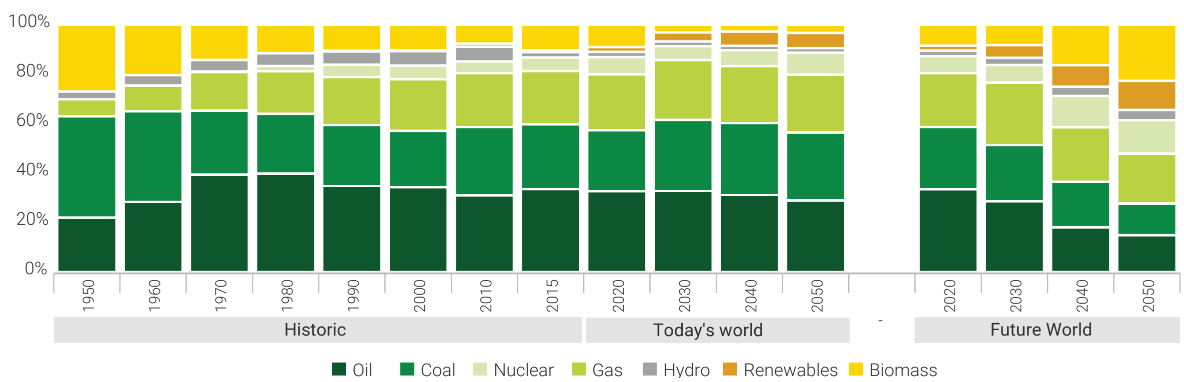
Figure 21: A significant reduction in greenhouse gas emissions is required to comply with a 2-degree world



Source: LGIM and Destination@Risk, September 2020. There is no guarantee that any forecasts made will come to pass.

We expect the future world of energy to look radically different from today. As shown in the chart below, there is likely to be meaningful changes in the energy mix in the future. Identifying where exposure may be more concentrated in carbon intensive sectors or regions allows us to make incremental changes to portfolio allocations across asset classes.

Figure 22: We expect the future world of energy to look radically different from today



Source: LGIM and Destination@Risk, September 2020. There is no guarantee that any forecasts made will come to pass.

Our Destination model helps estimate the physical and market risks associated with various energy transition scenarios. Moreover, the next iteration of Destination will measure alignment with a 2-degree world. This becomes an integral launch point for our analysts to determine whether a company's strategic plan for dealing with the energy transition is viable or not.

From a fixed income perspective, analysts' assessment of a company's strategic plan will be an important input into our internal probability of default rating. This, in turn, helps determine whether a security has attractive value versus comparable fixed income securities. In addition, higher climate change risk may prompt risk mitigation actions such as selling certain securities, changing maturity exposures, or demanding increased covenant protection in new issue transactions. Separately, we believe alignment data provide important transparency to clients' portfolios. In the near future, we plan to measure the climate alignment of issuers, securities and entire portfolios.

Engagement as a tool for all capital providers

We value our role in aiming to provide superior investment returns to our clients as well as creating positive change to the entities we provide capital. We do not limit our engagement to those with public equity. In our view, all stakeholders have an influence. On the fixed income side we do not necessarily have traditional influence through a proxy vote. Nonetheless, we believe influential relationships can occur through dialogue with credit investors and other non-equity capital providers.

Importantly, engagement works both ways. When our analysts receive important information about a company, it is critically important to share this data across asset classes, subject to any confidentiality or regulatory limitations. A hallmark of our investment process is collaboration across asset classes. This collaboration manifests itself through six sector-based Engagement Groups. These groups comprise research analysts across asset classes as well as their colleagues in the Investment Stewardship team. These groups bring together the sector expertise across the firm to determine the most critical topics on which to engage companies. Climate change is one such topic. Engagement data is collated and shared across asset classes. Importantly, we track engagement to hold management teams accountable for progress on their energy transition plans.

Client portfolios: harnessing the energy transition

Climate change is a meaningful component of our fixed income investment process. Importantly, our global network of investment professionals is well down the path to envisioning the course of this transition. We have used a combination of external research with our own proprietary research to develop a process for evaluating climate-related risks and opportunities within each asset class. Energy transition risk is explicitly included in our security analysis and portfolio construction.

We remain committed to aiming to produce superior returns for our clients as well as engaging with capital seekers who could benefit from a more thoughtful approach to the energy transition. In every transition, there are winners and losers, and the great energy transition will be no different. We are prepared to help our clients' portfolios capitalize from the upcoming changes.

Contact us

For further information about LGIM America, please visit lgima.com or contact your usual LGIM America representative

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