



Global Impact Credit— One Year On

Reflecting on a year of impact investing and what's next.

January 2023

KEY INSIGHTS

- The past year has once again underlined the importance of and need for impact investing.
- We continue to see encouraging developments and innovations in impact investing but also a need for increased regulation to help tackle greenwashing.
- We have been extremely humbled by how open companies are to engagement and, at the same time, energized by how much more there is to learn and do.

With one year having passed since the launch of the strategy, Portfolio Manager, Matt Lawton, answers questions about the evolution of impact investing over the past 12 months, activity within the strategy, successes and challenges, and what he is watching in 2023.

Q. Matt, it's been one year since the strategy's launch, how has impact investing evolved in 2022?

First and foremost, the need for impact investing has palpably increased. In 2022 alone, we have seen record-high temperatures in numerous countries, including the UK; increased severity of hurricanes (Ian in Florida); and truly disastrous flooding that has affected almost one-third of Pakistan, with countries such as Australia also affected. Meanwhile, coal consumption and greenhouse gas emissions have risen.

From a regulatory perspective, awareness, challenges, and scrutiny

around greenwashing and maintaining credibility in public impact investing continue to grow. Several asset managers downgraded environmental, social, and governance (ESG) fund classifications, citing uncertainty around more stringent regulatory requirements from the European Union's Sustainable Finance Disclosure Regulation.

In the U.S., we've seen tremendous advancement of sustainability initiatives, most recently through the Inflation Reduction Act. While on the other hand, a number of U.S. states have actually pulled funds from asset managers that simply integrate ESG into their investment process, on the grounds that this means incorporating unwarranted concerns over climate change and that reducing exposure to oil and gas companies can hurt performance. Florida's chief financial officer attributed one divestment to the investment manager having "other goals than producing returns."



Matt Lawton
*Portfolio Manager,
Global Impact Credit Strategy*

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Amid this turbulence, we have evolved and advanced our impact capabilities here at T. Rowe Price. We've sought to enhance our corporate ESG bond evaluation models, as well as introduced new ESG bond models covering the securitized, municipal, and sovereign sectors. Likewise, we added to our impact sub-pillar taxonomy as new and compelling impact investment themes continue to arise, such as biodiversity and enabling small and medium-sized enterprises.

While growth in ESG bond issuance decreased in 2022 versus the prior year, the market for ESG and impact investing has continued to expand. ESG-labeled bonds account for a growing proportion of the overall market: new ESG issuance totaling just over USD 1.5 trillion for 2022, according to Bloomberg data. This has been driven by the ever-increasing universe of companies mobilizing capital toward environmental and social projects. We believe the opportunity set for potential impact investments will continue to grow across new companies and new sectors, potentially allowing us to create a broader, diversified range of impact outcomes for investors.

Q. Talking of opportunities, where have you unearthed innovative impact investment ideas in 2022?

As we have explored both broader and deeper across the impact investment market in 2022, one notable investment worth highlighting would be our “Rhino bond,” a Wildlife Conservation Bond issued by the International Bank for Reconstruction and Development, linked to the preservation of the critically endangered black rhinoceros in South Africa. This bond is financing conservation efforts that will hopefully not only yield benefits in terms of biodiversity, but also create

additional social benefits such as employment generation. At maturity, this AAA rated bond¹ carries an outcomes-based framework; in addition to principal repayment, investors may receive a conservation success payment, which will be linked to the black rhino population growth rate over the life of the bond. We believe that this exemplifies how capital can be a channel for impact additionality.

We have also widened our impact lens to new fixed income sectors beyond traditional corporates, including, most recently, securitized credit. For us, this is a new but certainly compelling market that we will continue to watch closely as it develops and as impact opportunities present. In a similar vein, we are closely monitoring the ESG-labeled sovereign bond market as another potential avenue for impact investment, given both the impact and portfolio diversification benefits these bonds could potentially offer. Currently, we believe it is still a little too early, but the time is edging nearer. Our Responsible Investment team has been testing an increasing number of ESG sovereign bonds through our proprietary model while also carrying out numerous and fruitful sovereign engagements.

In line with one of the strategy's key tenets, we continued to look beyond labeled bonds for impact in 2022. We have been able to provide a deeper, more diversified range of impact investments for clients, along with creating what we view as compelling alpha opportunities. Our dedicated Impact Investment team, alongside our Responsible Investment team, helps to measure and engage with our investment companies in aiming to ensure that we stay closely aligned to the impact theses as well as capture the impact outcomes as they are realized.

¹ The International Bank for Reconstruction and Development is an arm of the World Bank, and is AAA rated (using Standard & Poor's nomenclature) by ratings agencies Fitch Ratings, as of January 25, 2022, Moody's as of February 11, 2022, and Standard & Poor's, as of February 22, 2022. Subject to change. Ratings of other ratings agencies might differ. This information is provided for illustrative purposes only and does not represent the representative portfolio's average credit quality, which may differ significantly. The credit analysts for the strategy focus on identifying good investment value versus credit quality.

Q. How have you found engaging with companies since the launch of the strategy?

In a word, humbling. Some of the objectives and goals of the companies we have met with, their innovations, and the scope of what they are trying to achieve are inspiring. At the same time, it has become apparent how much more there is to learn.

It has been encouraging to see how companies have listened to and embraced our ideas and suggestions, affirming that we can help spur change and create potential additionality through engagement. Engagement is integral to our impact process, helping ensure that our impact theses play out as intended. The scale and prominence that T. Rowe Price carries have certainly helped us open new doors, providing access to management and that opportunity to potentially influence corporate behavior. It is a privilege we don't take lightly.

Perhaps one of the more humbling engagements that occurred in 2022 was when Banco Santander Chile approached us for our views on a framework for an inaugural benchmark-sized social bond. The bond aims to enable greater social equity in Chile by financing affordable housing mortgages, thereby promoting financial inclusion. We suggested that the company report on core social impact metrics related to affordable housing, as defined by the International Capital Markets Association, among other issues.

Engagement allows us to inform and investigate the impact thesis we have for each investment, which can yield positive insights and help identify greenwashed bonds.

Q. What have you found not so easy since the launch?

Sadly, greenwashing is ever present, and, at times, we need to question the level of

discernment on the part of investors. We have developed a suite of robust ESG bond evaluation models that helps directly address these challenges.

Even with this, some corners of the market are leaving much to be desired, notably sustainability-linked bonds (SLBs). While companies are pushing these types of labels, the structures can still lack additionality. For example, in one case we identified in 2022, an SLB was inexplicably issued where the company could repurchase the bond prior to any potential penalties taking effect. This exemplifies how SLB targets can either be too weak or not enforceable.

Finally, the proportion of social bond issuance remains relatively low compared with green bonds, which unfortunately constrains us as we seek new social impact investment opportunities.

Q. And lastly, when looking forward, what do you think the next 12 months hold in store for impact investing?

Greater emphasis on social impact is needed, including more social bond issuance. Broadly, we are optimistic that we'll see new sectors and companies issue inaugural ESG-labeled bonds, which would help grow and diversify the impact bond market.

From an investor standpoint, there is little doubt the impact investment market will continue to grow, in terms of both private and public. Consequently, we expect and hope to see more fund launches. This would be beneficial for the impact market as a whole, in terms of both closing the funding gap and driving best practice.

Further regulation, scrutiny, and standardization will remain a persistent theme with greater disclosure requirements on ESG funds marketed in Europe taking effect at the beginning of the year.

We certainly hope that we'll see fewer instances of greenwashing but lucidly we won't hold our breath. However, more importantly we are well prepared to tackle this issue through our proprietary frameworks.

In 2023, we look forward to continuing to work alongside companies that produce credible and ambitious ESG bond frameworks and doing everything we can to drive additionality, while also providing alpha opportunities for our clients.

Conclusion

It has been a fruitful first year for the strategy against a backdrop of continued development and innovation in the field of impact investing. We have been particularly heartened by the progress on company engagements and are increasingly excited by the potential we see for impact investing. As we look forward to 2023, we remain, above all, deeply committed to pushing for the highest possible impact standards and for additionality in all our investment decisions.

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