



# Buy and Align— The Next-Generation of Buy and Maintain Portfolios

Introducing the Net Zero Transition Product Framework to help clients meet income and climate goals.

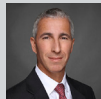
July 2023

## EXECUTIVE SUMMARY

Climate change and the transition toward net zero<sup>1</sup> represents a large systemic change in financial markets that will likely impact almost all securities and asset classes over time. To help clients navigate this complex and challenging transition, we have developed a Net Zero Transition Product Framework and applied it to a “buy and maintain” corporate bond strategy. The framework seeks to deliver financial returns and manage risk while promoting energy transition.



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*Head of Investment-Grade Credit,  
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*Portfolio Manager,  
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The large global investment-grade corporate bond market offers a plethora of opportunities. For some time now, a popular choice for those investing in this asset class has been a “buy and maintain” approach. We believe the environment for these strategies remains attractive. At the same time, climate considerations are becoming ever-more paramount for some investors—either because they recognize climate as a bigger risk factor to the delivery of financial performance or because they have a desire to direct investment capital toward decarbonization. The buy and maintain approach can be enhanced to account for certain climate targets—what we have termed a “buy and align” strategy.

## What Makes a Buy and Maintain Strategy Attractive?

### Attractive income opportunity

A standard buy and maintain strategy in investment-grade corporate bonds currently offers the potential to earn an attractive income. The sharp rise in government bond yields during 2022 has propelled yields in the asset class materially higher. At the end of June, the yield on offer in global investment-grade corporate bonds was over 5.2%<sup>2</sup>—a level rarely seen in the past decade.

<sup>1</sup> Net zero refers to a state where greenhouse gas emissions added to the atmosphere are balanced by removals (such as through forests or carbon capture and storage).

<sup>2</sup> Yield to maturity as of June 30, 2023, for the Bloomberg Global Investment Grade Corporate Bond Index. **Past performance is not a reliable indicator of future performance.**

## Finding the Maturity Sweet Spot in Corporate Bonds

(Fig. 1) Key metrics of investment-grade corporate bond markets

U.S Investment-Grade				Euro Investment-Grade			
Maturity Bands	Yield to Worst (%)	Duration (years)	Option-Adjusted Spread (bps)	Maturity Bands	Yield to Worst (%)	Duration (years)	Option-Adjusted Spread (bps)
1–3 years	5.72	1.85	72	1–3 years	4.54	1.99	135
3–5 years	5.43	3.56	106	3–5 years	4.41	3.75	169
5–7 years	5.31	5.22	121	5–7 years	4.32	5.44	184
7–10 years	5.42	6.88	152	7–10 years	4.22	7.44	182
10–20 years	5.50	10.39	159	10–20 years	4.08	10.82	164
>20 years	5.41	14.49	145	>20 years	3.93	19.56	157

As of June 30, 2023.

**Past performance is not a reliable indicator of future performance.**

The index used for U.S. investment grade is the Bloomberg U.S Corporate Bond Index and the index used for Euro investment grade is Bloomberg Euro Aggregate—Corporate Bond Index.

Source: Bloomberg Finance L.P.

### Potential for lower transaction costs

Bonds are typically held for a longer period in a buy and maintain approach, so there is less portfolio turnover or need to transact in the secondary market. This can help lower transaction costs compared with higher-turnover portfolios. This is particularly important as central banks continue to remove stimulus support from markets, which could impact liquidity conditions and make it more expensive to transact in the secondary market.

### Fundamentals strong heading into a downturn

Investment-grade companies are underpinned by strong fundamentals. This is particularly important given a slowdown in global economic growth, which could have knock-on implications for profits and balance sheets. This should, however, be partially mitigated given that many companies are entering the slowdown from a position of strength. We expect the majority of credits to be able to withstand this downturn, and rating downgrade risk appears limited. According to JP Morgan, only 1.6% of the euro corporate investment-grade universe was affected by an agency rating downgrade in the first five months of this year.

### Where Is the Sweet Spot?

Looking at the curve, the downward slope currently implies that the shorter end provides the higher yield, but we believe the sweet spot is in the five- to seven-year duration range. While the

yield might not be as high, we believe that the level is still attractive, and this part of the curve offers more diversification and ability to implement astute security selection. Importantly, there is also potentially lower reinvestment risk in this maturity range. This is driven by our expectations that central banks could start easing monetary policy from as early as next year as the lagged impact of the significant monetary policy tightening this past 18 months feeds through and puts pressure on economies.

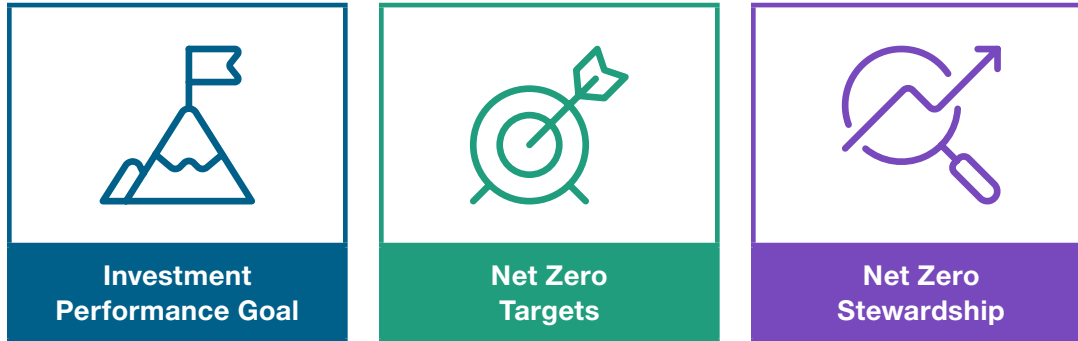
### Evolving “Buy and Maintain” to “Buy and Align”

With climate considerations growing in importance for many investors, we sought to evaluate how a traditional buy and maintain strategy could be adapted to directly address climate objectives. Companies face increased scrutiny and pressure from investors, regulators, customers, and other stakeholders to do more to address the pressing issue of climate change. There is significant pressure to set net zero targets to align to the goals of the Paris Climate Agreement, which aims to keep the global temperature rise to 1.5°C compared with preindustrial levels.

We expect the energy transition and associated carbon emissions reduction objectives to become a pivotal feature of many clients' investment goals. This is why we've built a buy and align approach—one that incorporates the traditional features of buy and hold, but with climate targets built in.

## T. Rowe Price Net Zero Transition Product Framework

(Fig. 2) Three key elements of the framework



As of June 30, 2023.

Environmental, social, and governance (ESG) considerations form part of our overall investment decision-making process alongside other factors to identify investment opportunities and manage investment risk. At T. Rowe Price, this is known as ESG integration. For certain types of investments, including, but not limited to, cash, currency positions, and particular types of derivatives, an ESG analysis may not be relevant or possible due to a lack of data. Where ESG considerations are integrated into the investment research process, we may conclude that other attributes of an investment outweigh ESG considerations when making investment decisions. As part of our wide range of investment products, we also offer products with specific ESG objectives and/or characteristics. Source: T. Rowe Price.

### What Is “Buy and Align”?

Buy and align evolves the buy and maintain corporate bond approach to target specific climate goals alongside its objective to seek a financial return. This approach is structured using the **T. Rowe Price Net Zero Transition Product Framework**, which has three elements:

Buy and align evolves the buy and maintain corporate bond approach to target specific climate goals alongside its objective to seek a financial return.

— Steven Boothe, CFA

Head of Investment-Grade Credit, Portfolio Manager

#### 1. Investment Performance Goal

The framework seeks to deliver financial returns and manage risk in line with the portfolio’s investment objective and investment philosophy while promoting energy transition.

#### 2. Net Zero Targets

Under the framework, distinct net zero status targets are set for 2030, 2040, and 2050, which align with a 1.5°C pathway.

#### 3. Net Zero Stewardship

To support the portfolio’s transition toward the net zero status targets, we seek to engage with companies within the investment universe that do not yet have Achieved or Aligned net zero status.<sup>3</sup>

Additionally, we will provide data transparency to clients with quarterly reporting that illustrates the portfolio’s climate profile across a broad set of metrics, including net zero status, carbon footprint, decarbonization pathway, alignment to climate solutions, engagement statistics, and examples of engagement insights. Additionally, the portfolio will provide reporting on alignment to sustainable investments and other relevant Principle Adverse Impact (PAI) indicators.

<sup>3</sup> **Achieved** status is when a company is already achieving the emissions intensity required by the sector and regional pathway for 2050 and whose ongoing investment plan or business model is expected to maintain this performance.

**Aligned** status is when a company has a 2050 net zero target that is supported by 1.5°C aligned short- and medium-term targets, exhibits GHG emissions intensity performance in line with its targets and has credible decarbonization plan and capex alignment.

## Key Features of “Buy and Align”

### Seeks investments from broadest opportunity set

Our buy and align approach seeks investments from the broadest opportunity set. We do not simply exclude high-carbon-intensity sectors from the investment universe, but instead focus investments on issuers we believe are capable of transitioning to net zero. While excluding high emitters may be easier to implement and explain to investors, it forgoes the opportunity to engage with and influence the very companies that have the potential to make a material difference to climate targets going forward.

### Active engagement

Engagement is a key feature in the approach. We seek to partner with companies to better understand their transition plans by engaging with them on a regular basis on a variety of environmental subjects. Our research platform and proprietary Responsible Investing Indicator Model (RIIM) help us to analyze the progress of a company’s net zero pathway—those that are not currently aligned can be prioritized for engagement.

“We seek to partner with companies to better understand their transition plans by engaging with them on a regular basis on a variety of environmental subjects.

— Matt Lawton, CFA

Portfolio Manager, Global Impact Credit Strategy

### Medium- to long-term focus

The approach features a medium- and long-term focus with net zero targets set for specific dates. We believe this allows for a more forward-looking assessment of the net zero investment universe, rather than more traditional approaches of setting near-term portfolio greenhouse gas (GHG) emissions targets. By taking this approach, the portfolio will have the opportunity to provide capital to the companies that are driving the biggest shift in decarbonization, as opposed to being reconciled to a low-emitters universe.

## Assessing Company Climate-Related Action

(Fig. 3) Four-part framework we utilize



### ASSESS

Level of Disclosure



### IDENTIFY

Emissions Targets



### EVALUATE

Climate Strategy



### CONSIDER

Engagement Activity

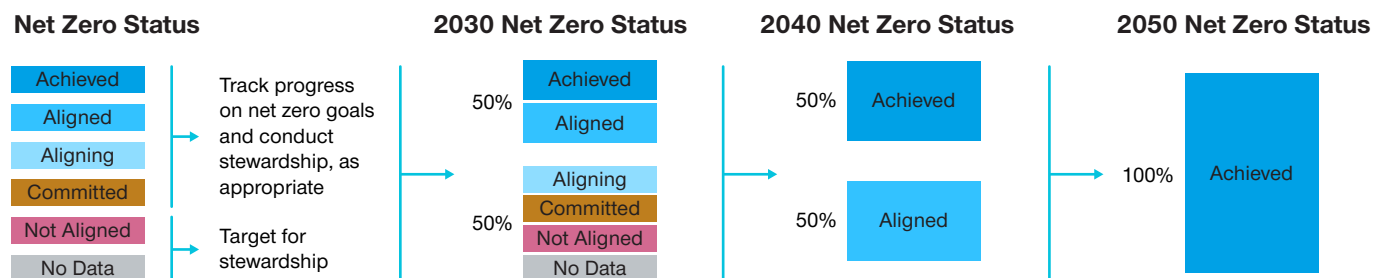
As of June 30, 2023.

Source: T. Rowe Price.



## T. Rowe Price Net Zero Transition Product Framework

(Fig. 4) Breakdown of net zero targets



As of June 30, 2023.

For illustrative purposes only.

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Source: T. Rowe Price.

### Evaluating ESG bonds

Environmental, social, and governance (ESG)-labeled debt may form part of the investment universe for the portfolio; however, the GHG emissions profile will be attributed to the ultimate issuer. Investing in ESG-labeled debt gives the opportunity to provide capital that directly contributes to decarbonization as well as other sustainable objectives. This will be reflected in the portfolio's overall climate solutions and/or sustainable investment alignment.

We evaluate the quality and credentials of each issue brought to the market through our proprietary ESG bond framework. While issuer practices have been improving, this fast-growing market has proven vulnerable to greenwashing—where some issuers provide misleading information about the environmental credentials of an organization's products, services, and investments. Therefore, research is vital and the ESG bond framework helps us do this by providing robust analysis and ongoing monitoring of bonds in this category.

### Portfolio Construction

In constructing the portfolio, the starting point is **fundamental bottom-up research**. How companies are positioned to navigate climate change—both energy transition and physical adaptation—is considered by our analysts during the research process. We believe it is part of our fiduciary duty to understand how our investee companies are assessing their exposure to climate change and building environmental sustainability into their long-term strategic planning. Over time, climate change will likely impact almost all securities.

Analysis is supported by our dedicated **responsible investing** (RI) team and our proprietary **RIIM** tool, which helps to proactively and systematically analyze ESG factors that could impact our investments. The independent assessment of an issuer's net zero targets is an important component, and our RI team has designed a bespoke framework to assess a company's progress in that regard. This process ensures that an issuer's target is indeed in line with a science-based net zero trajectory and takes into account different aspects such as the short- and medium-term GHG reduction targets, the credibility of each target, and whether or not the company has obtained validation from the Science Based Targets initiative. Our evaluation and measurement of ongoing progress on performance against these targets is supplemented by company engagements where we are given an opportunity to provide feedback and advocate for best practices.

From here, we combine this bottom-up research with the Net Zero Transition Framework and top-down considerations, such as the macroeconomic outlook and relative value across sectors. We then construct the portfolio of around 90–100 holdings, while managing risk exposure at both the individual issuer and portfolio level.

Our role is to help clients determine how climate impacts their portfolios and provide solutions that meet their needs. The development of the T. Rowe Price Net Zero Transition Product Framework and our buy and align corporate bond approach can help clients who seek to simultaneously address climate transition targets alongside financial objectives as part of their investment strategy.

## INVEST WITH CONFIDENCE<sup>SM</sup>

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

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