



Global Fixed Income

How stronger incentives are changing ESG behavior

How do you think of ESG factors within your investment process?

Our investment process relies on bottom-up analysis, which develops into security selection. The analyst weighs environmental, social, and governance factors in determining the quality potential for a particular investment. We do this systematically and consistently, applying our methodology across all the securities that we look at, in order to construct a portfolio of securities that we believe will reflect broader social concerns.

This method not only helps us to compare opportunities, it also makes us very conscious of the idiosyncratic risks we may be taking on, and where they might be concentrated. Just because an individual security screens poorly on one criterion, that does not mean that it is automatically screened out of our universe. We're very interested in discovering opportunities where weaknesses are being addressed and there is scope for improvement as that can lead to improved valuations.

Our Responsible Investing Indicator Model analysis enables us to be systematic in the way we go about incorporating ESG factors into our investment decisions. It provides us with a very broad and detailed picture of the ESG profile of a particular investment proposition, which can then be compared with other investment propositions. The ability to put two assets side by side and objectively compare their ESG qualities is very powerful.

How important are ESG factors in the global bond market?

They have become very important. As the markets have begun to understand the range of ESG criteria—and that it goes beyond just pollution or bad management—these criteria are becoming more clearly reflected in asset valuations. Simply put, ESG is something that cannot be ignored. Analysts must consider the ESG factors of every investment they look at because those factors are going to play a role in determining the value of that investment.

We believe ESG is only going to become more important over time. We can already see that there are going to be many competing external standards, which means that any global fixed income strategy is likely to be increasingly measured with its shadow rating (an unofficial rating) under those different approaches.

What are the ESG trends to watch in global fixed income?

I think the proliferation of external standards is going to be key. I believe agencies such as Moody's and S&P are going to increasingly incorporate ESG into the ratings they award. National governments and economic jurisdictions such as the European Union will likely be able to send strong price signals by committing to much more ambitious targets in areas such as lowering carbon emissions. It will also be worth monitoring whether central banks make a mark by steering asset purchase programs toward ESG criteria and ensuring that the capital costs of "bad" companies are higher than the companies that meet that criteria.



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Fixed Income



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Stronger incentives would ultimately change behavior, but they would not necessarily make things easy or simple. Some companies and governments will score well on certain criteria and not others, which is why it is important to be as systematic as possible.

What is an example of ESG factors directly influencing your investment decision?

A recent example involved a bond offer by a North American oil company, where our analysis highlighted a number of elevated ESG risks. Principally, these included (i) meaningful exposure to energy transition risks, with an oil-heavy production mix and no clear path to lower carbon activities; (ii) a weak record on safety, with elevated worker fatality rates; and (iii) evidence of corruption reaching up to executive level. We believed the company would struggle to address these ESG challenges, particularly given its notable financial challenges and a low priority attached to sustainability. As a result, we decided not to participate in the bond offer.

On the corporate side, based on our analysis of a German auto manufacturer, we believe the company is trading below its underlying credit quality owing to perceived concerns over business ethics and corporate governance practices. We believe these ESG considerations, which are embedded in our

holistic, bottom-up credit assessment, are improving and reflected in ongoing ethical reforms, increased compliance oversight, and moves to integrate ESG criteria into top executives' compensation. We believe that improving governance and the company's strong environmental credentials—reflected in its leadership in developing electric vehicles and its aggressive decarbonization strategy—can help enhance its overall ESG standing among investors and ultimately support its bond valuations.

This is an illustrative example of how ESG factors may be incorporated into the investment process by Portfolio Managers. The views expressed may differ from those of other Investment Professionals at T. Rowe Price.



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