



# Fixed Income and the Transition to Net-Zero

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## The Challenges and Opportunities Around Net-Zero Are Different for Fixed Income Investors

At first blush, it may seem that bondholders have limited ability to help with the transition to net-zero. After all, bond issuers are generally mature, blue-chip companies rather than high-growth disrupters. Unlike shareholders in an enterprise, bondholders do not have the power to vote. Finally, many bond issuers are private companies, for whom less data is available versus public companies. However, despite these facts, bondholders can still play an important role for two reasons.

1

Companies often need to issue debt repeatedly, which gives bondholders repeated opportunities for engagement.

2

In recent years, new types of debt instruments have emerged – Sustainability-Linked Bonds (“SLBs”), which align incentives between bondholders and issuers.

### We Believe Its Better to Focus on Transition Rather Than Divestment

There can be a temptation for plans to pursue a divestment approach by eliminating certain industries – such as Oil & Gas – from the portfolio. This approach is quick to implement and easy to explain to stakeholders. However, we believe this is a suboptimal approach, and we prefer an approach informed by the **“Tragedy of the Horizon.”** This phrase refers to the incompatibility of rapid portfolio decarbonization with the longer-term transition of the real economy to net-zero. While portfolio managers can claim a “quick win” by divesting, this approach has zero impact on the amount of carbon being emitted in the real economy.

It is sometimes argued that if enough investors divest simultaneously, then the cost of capital will rise for these companies and pressure companies to change. However, we believe that this mechanism would only function over a long timeframe and will only put pressure on issuers that are capital constrained and sensitive to financing costs. Finally, if there remain enough investors who are willing to hold these securities, then all that may happen is securities change hands from investors that care about climate change to those that care less about climate change. This paradox has been observed in the thermal coal sector.

By divesting, you give up your seat at the table when the real work needs to begin for transition. The approach also does not help inform how you should approach the rest of the portfolio. After all, almost all sectors have a carbon footprint, so the transition to net-zero requires action when it comes to these industries.

**Tragedy of the Horizon:** Climate change is a long-term issue that will have a disproportionate impact on young people and future generations. Yet, the group charged with addressing climate change is primarily composed of current leaders in government and business whose time horizons both in terms of career and life expectancy are much shorter.

# Case Study: Corporate Bond Strategy That Meets Decarbonization Goals Without Compromising on Performance

We believe a better approach is Reduction and Alignment. Initially, you analyze the investments in your portfolio and make changes to demonstrate a headline reduction in carbon intensity as a statement of intent. Longer-term, you tilt towards companies that have credible decarbonization pledges. You commit to engaging with companies to improve disclosure and validate these assessments over time.

We developed a corporate bond strategy RP Broad Corporate Bond (BBB, Carbon Reduced) (“RP BBB”) in January 2020 that uses this approach. It was designed for an institutional client looking to reduce portfolio carbon immediately with a plan to further reduce overtime. Carbon emissions were defined as the sum of **scope 1** and **scope 2 emissions** as a percentage of revenue, and the strategy aims to have 70% or less of the carbon intensity on day 1. We additionally made a commitment to have alignment through ongoing assessment of carbon pledges and a policy of engagement. This strategy has been very successful both from a returns and a decarbonization perspective.

*Please contact us if you would be like to discuss this solution in more detail.*

- Scope 1:** Covers the Green House Gas (GHG) emissions that a company makes directly — for example while running its boilers and vehicles.
- Scope 2:** These are the emissions it makes indirectly – like when the electricity or energy it buys for heating and cooling buildings, is being produced on its behalf.

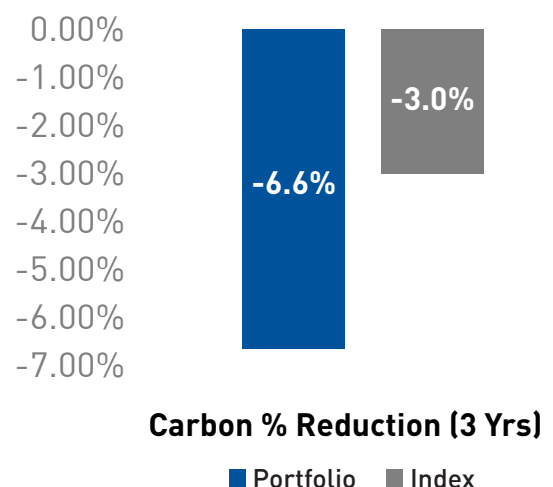
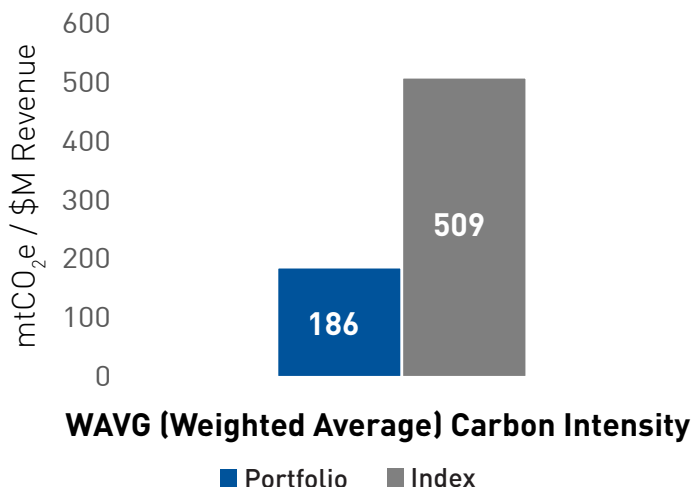
## RP BBB Has Less Carbon Intensity, More Carbon Reduction Than The Index

40%

Portfolio has less than 40% of the carbon intensity of the benchmark

2x

Portfolio exposures are reducing carbon at twice the rate of the benchmark exposures



## Case Study – How We as a Bondholder Can Engage an Issuer to Effect Change | Enbridge

In Europe, energy companies have used SLBs to credibly demonstrate their commitment to sustainability. Consider that nearly 15% of year-to-date bond issuance in European Energy and Utility companies has come in the form of SLBs despite Energy/Utilities relatively low contribution to Europe's economy (the Energy sector represents approximately 4% of European non-financial GDP)<sup>1</sup>. SLBs are bonds that tie investor compensation (coupon) to ESG deliverables. As such, they are a great way of ensuring alignment of interest between companies and investors. Canadian companies have been slow to embrace SLBs to raise capital. However, considering the outsized role energy companies play in the Canadian economy, we think SLBs can play a vital role in helping these companies transition to more sustainable long-term business models in this country.



### Background

Sustainability Linked Bonds (SLBs) ensure genuine alignment of interest between issuers and investors.



### Actions

Engaged Enbridge to discuss the company's position across the ESG pillars, its ESG-related ambitions, and ways to align the company's funding plans with sustainability goals.

Provided investor's perspective on how to structure sustainability-linked funding to align the stakeholder interests, highlighting key KPIs and appropriate guidelines and penalties.



### Outcome

Earlier this year, Enbridge became the first North American energy company to issue a bond in the USD SLB space, incorporating feedback from our discussions.

Enbridge included not just environmental KPIs in its framework, but social and governance KPIs as well

We believe fixed-income investors have a critical role to play in the transition to net-zero. While the ability for bondholders to influence corporate decision-making may appear less obvious, in our experience, bond investors have the ability – both in theory and in practice – to impact outcomes.

***Please contact us if you would like to discuss our approach to ESG and Impact Investing in more detail.***

<sup>1</sup>EU Commission – “Energy Sector Economic Analysis” (As of 2020)

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As Head of Client Portfolio Management, Liam leads the team responsible for developing client relationships and developing new investment solutions. Prior to this role, Liam spent several years managing corporate bond portfolios for the firm, with a focus on the Canadian corporate bond market.



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Zack joined RPIA in 2020 and is responsible for developing relationships with institutional investors and their consultants. In this role, he supports the Client Portfolio Management Team's sales efforts through market insights, investment strategy, and portfolio solutions.

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ESG factors that may be considered as part of our investment process include matters relating to climate change, energy use, energy efficiency, emissions, waste, pollution, matters related to human rights, impact on local communities, labour practices, employee working conditions, health and safety of the employees and affiliates, employee relations and diversity, executive compensation, bribery and corruption, board independence, board composition and diversity, alignment of interest between the shareholders and the executives, shareholder rights, and companies’ policies relating to ESG.

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The consideration of ESG factors in the investment process for RP Strategic Income Plus Fund and RP Alternative Global Bond Fund is weighted less than the core financial and credit analysis employed in the management of these funds. Please see the [simplified prospectus](#) for additional information.



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