RUSSELL RESEARCH

Russell Investments Bond Manager ESG Survey 2015

Summary of Findings

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EXECUTIVE SUMMARY

Russell Investments recently conducted a survey of 79 fixed income asset managers from around the globe to assess their attitudes to Responsible Investment and how they integrated Environmental, Social and Governance (ESG) issues into their investment processes. The survey consisted of 10 questions addressing the respondents' attitudes to ESG and its importance in their decision-making processes, including the level of their firms' participation in the United Nations Principles for Responsible Investment (UNPRI) and National Association of Pension Funds (NAPF[1]) Stewardship Disclosure Framework.

From the survey responses, we observed a high level of ESG awareness and a widespread willingness to participate in the UNPRI and NAPF Stewardship Disclosure Framework initiatives.

We also observed a significant difference in the way that the respondents understood and defined ESG investing. Whilst a majority viewed ESG factors as a subset of fundamental investment analysis, a significant minority understood ESG factors to be primarily concerned with moral value judgements, and therefore to be determined by their clients' individual preferences.

This difference of interpretation appeared in particular to influence the respondents' willingness to adopt a firm-wide Responsible Investment Policy.

In the following sections we set out the questions and summarise the balance of responses. We include some direct quotations from the managers themselves, in order to illustrate their views. We also add some further commentary based on our own views and perspectives.

[1] The NAPF has now re-branded to the 'Pensions and Lifetime Savings Association'.

INTRODUCTION

Environmental, Social and Governance (ESG) factors are a hot topic for equity investors. But for bond investors, there is some uncertainty over how much efficacy ESG factors really have, and whether there is a good way to integrate them. The core mission of the bond manager research team at Russell Investments is to ensure that the investment management firms on our research ‘buy’ list employ robust investment processes and intelligent execution, and so have a high probability of generating superior investment returns in the future. That means we need to understand how a manager incorporates ESG into their strategy and understand whether this will positively impact performance going forward. That’s why we have incorporated ESG factors into our regular bond manager evaluation process, and why we have initiated a dedicated ESG bond manager survey. Russell Investments Bond Manager ESG Survey 2015 was based on a representative sample of 79 fixed income managers from around the globe, and was intended to assess how far those managers have formally integrated ESG factors into their methodology.

Russell Investments Bond Manager ESG Survey 2015 was intended to assess how far managers integrate ESG into their methodology

ESG in fixed income may appear to be a relatively new concept, but in reality many fixed income strategies already incorporate elements of ESG factors. In particular, analysis of governance is frequently very developed. Bond issuers have contractual obligations, and so this analysis can address not only ability, but also willingness, to pay. Assessing the quality of company’s management is also a critical part of credit analysis which has a direct tie to governance. In an Emerging Market (EM) context, the strength of a country’s institutions, its political stability and its status in the global community can help an EM debt investor determine whether there is adequate governance to believe that a country will be willing to pay back its debts.

Similarly, bond investors bear the risk of litigation and catastrophic reputational damage overtaking a company, but enjoy none of the profits upside that may attach to socially risky behaviour. That’s why social factors can be important to bond investors too. Increasingly, technology is creating new risks – in terms for instance of climate risk and stranded carbon assets – that will likely be more worrisome to bond investors in future. So environmental factors have garnered further attention also.

It is in this context that we commissioned our survey of 79 fixed income managers. We wanted to understand better how important ESG was to their investment process, how well integrated ESG was within their process and how effective it was.

We expected to find that formal ESG integration would be most important and most clearly apparent in higher-risk areas such as EM and high-yield corporate credits because those markets incur greater credit and country risk, and much less so in areas such as Developed Markets (DM) government bonds and municipal bonds. We recognised that there would be some exceptional cases – for instance, managers with 100% pure quantitative processes focused on DM government bonds – where formal ESG policies would not necessarily be applicable.

Most importantly, we were very aware that, while ESG awareness may be correlated with good performance, there is not necessarily a causal link, i.e. a good investment may have some level of correlation with strong ESG scores, but achieving strong ESG scores may not be the reason for it being a good investment. The available evidence in Fixed Income is not conclusive to support ESG factor investing as an effective approach in its own right. Consequently, managers that tick all the ESG boxes may still not have all the skills necessary to generate superior performance. That’s why, although we meaningfully engage with managers about their approach to ESG factors and why we continue to develop our research into the subject, we do not link positive expected performance to more developed ESG processes, nor do we expect that our survey will be a silver bullet for picking outperforming managers.

We found a high level of ESG awareness, particularly in the higher-risk segments of bond markets

What we found was largely consistent with our expectations. First, we found a high level of ESG awareness. In their responses, 63% of the respondent managers claimed that both social and environmental factors were already integrated into their investment processes. However only 49% had a formal Responsible Investment Policy that covers how ESG considerations are actually integrated into their investment process. A similar number (48%) said that an ESG factor had overridden an otherwise attractive investment in their investment process. Perhaps unsurprisingly given the variety of managers and methodologies, there was no consensus on how best to implement ESG factors into a decision process. Second, we found ESG awareness to be most pronounced in the higher-risk areas, and to be much less evident in strategies based on interest rate or global macro themes. Third, there were many interesting insights, however because the participants often had different perspectives on and definitions of ESG, these insights were not perfectly captured by yes/no answers, which typically understated the true level of ESG awareness in the respondent universe. In particular, a number of respondents appeared to understand the specific terms 'ESG' and 'Responsible Investment' primarily in terms of their clients' ethical value judgements, rather than in terms of investment fundamentals ("values" rather than "value"). These managers indicated that a formal ESG or Responsible Investment policy was the prerogative of their clients, and that their own management role was to work to implement their clients' briefs; for that reason they had declined to adopt a formal ESG policy themselves. Nonetheless these respondent managers are highly capable firms and in fact evaluate many ESG factors as a matter of course. Other respondent managers specifically stressed that they understood ESG primarily in terms of investment fundamentals and as central to their investment judgements. The sections below are intended to provide a fuller understanding of the managers' mind-sets. They include direct quotations from some of the respondent managers and some supplementary comments in which we endeavour to 'read between the lines' of their answers. We hope you find it interesting reading.

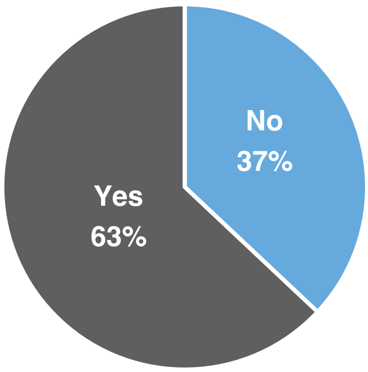
A number of respondents appeared to understand the specific terms 'ESG' and 'Responsible Investment' primarily in terms of their clients' ethical value judgements, rather than in terms of investment fundamentals

It is clear from our survey findings that ESG in fixed income markets is an evolving concept. We look forward to working with the bond manager community in future, to further develop our understanding of ESG implementation in bond market investing.

THE SURVEY RESPONSES

In the following sections, we review each of the 10 questions in our bond manager 2015 ESG survey. In the sections, we show a pie chart that analyses the responses from the 79 respondent managers. Next we show a selection of direct quotations from the managers, chosen as examples to represent the principal viewpoints and opinions. Lastly we add some further comments and analysis, based on Russell Investments' understanding of the participants and their actual situations.

Question 1 – Are environment (e.g. environmental practices, fracking, carbon emissions, climate change and stranded assets risks) considerations integrated into your investment process?



YES

'ESG analysis is an intrinsic part of stock and bond analysis as opposed to being a separate exercise and every member of the investment function has a responsibility to consider ESG issues related to their investment decisions.'

'The decision is not necessarily an ethical decision but more around the sustainability of the [issuer's] business model.'

'We understand that environmental, social, and corporate governance practices may present risks that need to be evaluated, and we analyse these risks as part of our fundamental research process. The focus of our process is to determine the extent to which ESG issues pose a significant risk to creditworthiness.'

'Pollution concerns are the most important environmental consideration that directly impacts our credit investment decision. The Deepwater Horizon oil spill in the Gulf of Mexico in April 2010 is perhaps the most notable example of how an environmental disaster can impact a company through production disruptions, reputational risk, litigation and liabilities.'

NO

'Environmental considerations are not integrated into [our] investment process, however can be incorporated if requested by the client.'

'While we do not have a formal ESG company policy statement, we do work closely with many of our clients to meet their ESG requirements.'

'The firm does not explicitly exclude investments based on environmental or social considerations, unless directed to by a segregated or separate account client. However, when assessing opportunities we look to gain an understanding of all the risks and issues that a company faces. These other issues may include environmental, social, human rights and governance policies… the governance issue is particularly important as we place a high level of importance on effective management, strong transparency, and favourable governmental operating environment and regulated market conditions. In addition, part of our process involves monitoring a country's economic freedoms and assessing changes at the margin to determine positive or negative developments that may impact companies that are located in or have exposure to these countries.'

'While no specific environmental considerations are integrated into the investment process of our Emerging Local Currency Debt fund, we have implemented a company-wide ESG integration programme aimed at sharing critical ESG information with all investment teams. Our ESG integration programme also entails the systematic exercise of voting rights, and the exclusions of companies involved in the production of mines and cluster munitions.'

'Our investments and securities focus on the largest four sovereign fixed income markets and their securities, so we do not find the need to apply such environmental considerations to these highly developed countries and markets at this time.'

This opening question immediately revealed a difference in perception on the part of the respondent managers. While the majority saw ESG factors principally as important risk drivers that would naturally form part of fundamental credit analysis, a significant minority understood ESG factors to be primarily concerned with moral value judgments, which they perceived might be non-economic and which they believed to be the prerogative of their clients. One manager in this latter category specifically referred to US regulation as the basis for this view:

'DOL regulations have made clear that…ERISA responsibility generally does not permit a money manager to make investment decisions for a plan based on non-economic factors such as furthering social goals (i.e. ESG/SRI factors) or to make investments that are targeted for other such related non-economic reasons…Accordingly,…we do not incorporate ESG/SRI considerations in making investment decisions that are inconsistent with or contravene current law… For separate mandates, the Company has the capability to restrict securities by issuer or industry based on a client-provided list if that is so desired. Our pre-trade compliance order generation tool as well as our post-trade compliance application can be custom-coded for client-defined guidelines and constraints. Full audit trails and security access controls are maintained at each step of our electronic straight-through processing system to ensure client requirements are consistently met. In short, while the Company itself does not adopt a formal ESG/SRI policy, the Company respects and welcomes such policies adopted by client-investors and can accommodate those constraints through custom-coding.'

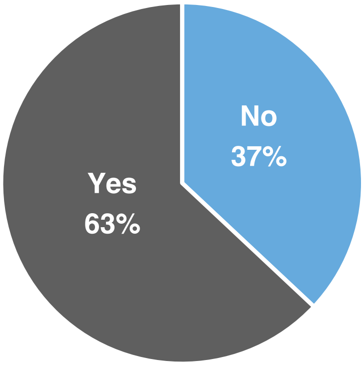
While the majority saw ESG factors as important risk drivers, a significant minority understood ESG factors to be primarily concerned with moral value judgements

By contrast, a number of managers responding 'yes' provided extensive details of their investment process combined with cogent arguments for viewing ESG factors as intrinsic to an analysis of fundamental value. Irrespective of this difference of view, the majority of responses from managers in the 'no' camp indicated a high level of awareness of the importance of ESG factors as actual or potential risk factors. While their ESG approach was typically to have procedures in place to manage portfolios in line with the specific requirement of clients, their investment processes did actually take account of many ESG factors. On this basis it appears that, whether or not the respondent managers had formally integrated ESG factors into their investment processes, as a group they have a high level of ESG awareness. We also observed that the respondent bond managers who were organised globally, or were based in Europe, were more likely to integrate environmental factors into their investment processes than the respondents who were focused exclusively on the US market. (This finding is consistent with the data from our standard manager research process, in which we allocate an ESG score alongside our rank for each manager, and where we find higher ESG scores among the global and European-based managers.) Naturally we observed a similar pattern of responses to question 2, concerning social factors.

Bond managers who were organised globally, or were based in Europe, were more likely to integrate environmental factors into their investment processes than those focused exclusively on the US market

Specifically regarding the environmental risk factors themselves, manager responses included a very wide range of potential risks and issues, including biodiversity, climate risk and carbon emissions, water stress and waste management/pollution. One response mentioned the rate of natural resource depletion as a risk factor for the sovereign bonds of countries with mineral-dependent economies.

Question 2 – Are social (e.g. human rights, animal welfare, diversity and equal opportunity employment) considerations integrated into your investment process?



YES

'Yes. Various social considerations are integrated into our investment process and our engagement efforts. Social topics typically include working conditions, supply chain management and anti-corruption. Issues such as human rights and diversity often factor into these social indicators for ESG integration.'

'When evaluating a credit investment, we believe that labor management practices, health/safety concerns and internal policies on anti-corruption are the most important considerations related to the social aspect of ESG. Companies with inadequate employee retention and engagement programs are a concern as productivity is likely limited as a result. Certainly, those engaging in human rights violations and child labor practices are avoided due to both legal and reputational risks. Companies that face high exposure to risks of product safety issues or workplace accidents are also a concern as these can lead to production disruptions, litigation and liabilities. Lastly, we look for strong policies related to corruption and bribery in industries that are more prone to these types of practices.'

'The management of a company is often challenged when major corporate events such as large mergers and acquisitions are pursued. In these cases, our analysts evaluate a variety of factors including the longer-term impact of this type of transaction on the company, and the ability of management to successfully integrate the operations (facilities and employees) of the companies.'

'Our review processes cover both the current state and understanding of social issues, including workforce and labor issues; health and safety compliance; product safety; consumer relations; supply chain; community involvement.'

'Our norms-based analysis determines if a company observes the ten principles of the United Nations Global Compact. After identifying any breaches of the Global Compact principles, the analysis uses several parameters to evaluate the severity and magnitude of the breaches. Emphasis is also placed on a company's response when an incident occurs. A company that takes positive, responsible measures to ensure that such a breach does not happen again is considered more favourably than a company that does not acknowledge its responsibility and/or does not take any corrective measures. If the SRI analysts identify any breaches with respect to the principles of the Global Compact, and depending on their magnitude, a colour code (green, orange, red) is assigned to each company for each of the main categories: Human Rights (HR), Labour (L), Environment (ENV) and Anti-Corruption (COR).'

NO

'The High Yield Bond strategy does not incorporate social considerations into their investment process and security selection... [But] can be managed with social considerations at the client's request.'

'These tend not to be major considerations when investing in municipal bonds. Government entities tend to practice such social welfare practices.'

'To date, we have not noted positive results through our back tests regarding environmental or social factors.'

'As it relates to our EMD strategies, holdings are generally concentrated in government bonds. For government bonds, ESG factors are not applicable to the investment decision process.'

'The investment teams attempt to avoid investments that have known but un-quantifiable risks attached, including environmental and human rights problems…the investment teams are focused primarily on analysing the economic merits of an investment opportunity. However, the team's analysis includes potential risk factors that may adversely impact a company, which many times include environmental and labor issues, and the team will avoid investments with significant risks that are difficult to quantify.'

'Currently, we do not apply a separate ESG assessment in our EMD investment process. Many ESG factors, however, are important in our evaluation of EM sovereign and corporate credits. Our Country Credit model uses many ESG factors, such as social developments, corruption, and political governance, in determining the overall creditworthiness of each country.'

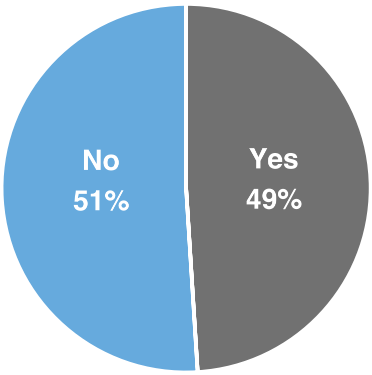
The respondent answers of 'yes' and 'no' to question 2 were identical to the answers given to question 1. This was unsurprising, considering that the same differences of perception regarding "values" versus "value" applied equally to both environmental and social factors. In fact, many managers simply repeated or restated their answer to question 1 in responding to question 2.

Those responding 'yes', and including more detailed replies, identified a very wide range of social risk factors. These responses frequently featured an emphasis on employment law and labour relations. This makes sense as most corporates face both an immediate threat to cash flows arising from industrial action, and reputational damage from litigation and adverse publicity. By contrast animal rights were mentioned infrequently, and without making a direct link to any economic impact of breaches.

A number of replies evidenced a strong awareness of the potential impact of ESG factors, irrespective of the lack of a formal ESG integration approach

Those responding 'no' typically cited the primacy of their clients' views, and their willingness to manage specific portfolios in accordance with those views. Several managers also asserted that their research indicated social factors had an immaterial impact on the parts of the fixed income markets where they were managing portfolios. As in question 1, a number of replies evidenced a strong awareness of the potential impact of ESG factors irrespective of the lack of a formal ESG integration approach.

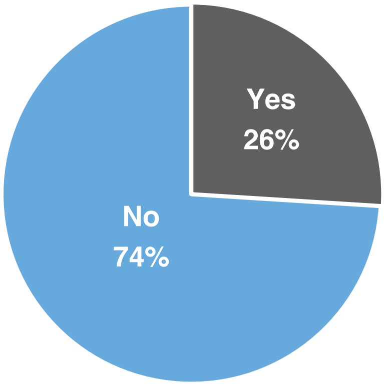
Question 3.1 – Does your firm have a Responsible Investment Policy that covers how ESG considerations are integrated into the investment process?



On the face of it, the responses to questions 3.1 above and 3.2 (below) might appear to have elicited rather disappointing responses. However, bearing in mind the strong differences in view regarding the primacy of "value" or "values" in ESG investing, we see these responses rather as consistent with the responses to questions 1 and 2. Regarding question 3.1, of the 50 respondents who had integrated ESG into their investment process, 34 (68%) already had a formal Responsible Investment Policy. Of the remaining 16, 6 intended to develop a policy in the next 12 months, taking the prospective number of respondents with both ESG integration and a Responsible Investment Policy to 40 (80%).

80% of the respondents who had integrated ESG into their investment process also had – or intended to develop – a Responsible Investment Policy

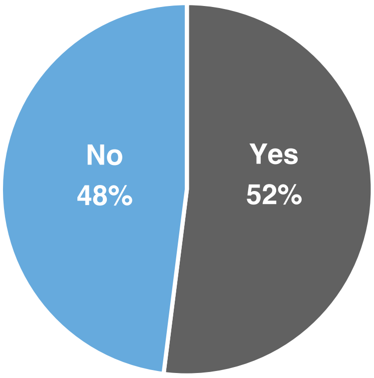
Question 3.2 – [For those answering 'no' to 3.1 and responding to question 3.2]. Does your firm intend to develop a Responsible Investment Policy in the next 12 months?



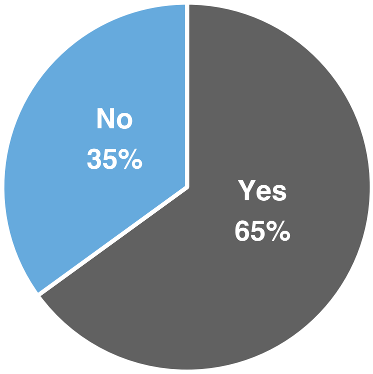
Similarly, a 74% 'no' ratio from the 38 respondents to this question might appear disappointing. However, those who saw ESG factors as primarily "values"- based, or as having no material economic impact in their own specialist parts of the bond markets, would not have an immediate incentive to adopt a Responsible Investment policy. Focusing on the group of 24 respondents who had neither integrated environmental or social factors into their investment process nor had developed a Responsible Investment Policy, 18 did not intend to develop such a Policy in the next 12 months, 4 did intend to develop a Policy and 2 did not reply. From this group therefore, 17% intend to develop a Responsible Investment Policy in the next 12 months even though ESG factors are not integrated into their investment process. This appears to support our view of ESG as an evolving concept, where bond managers are embracing the philosophy of responsible investing in a variety of different ways, according to their particular perspective and investment process.

We view ESG as an evolving concept, where bond managers are embracing the philosophy of responsible investing in a variety of different ways, according to their particular perspective and investment process

Question 4.1 – Does your firm actively participate in any engagement activities (either with issuers directly or collectively with other shareholders)?



Question 4.2 – [For those answering 'yes' to 4.1 and responding to question 4.2]. Does your firm provide a report on your engagement activities?



YES

'Engagement, which is and has been core to our rigorous investment research process, includes meeting with regulators, company management and rating agencies to discuss matters that help educate and inform us, as well as influence rules, strategies, and behavior, that will benefit the investments we own in our client portfolios. This includes ESG matters.'

'We engage with companies on these matters; this engagement can include discussions with management, increasing or decreasing our position in the company, or voting proxies in a certain way.'

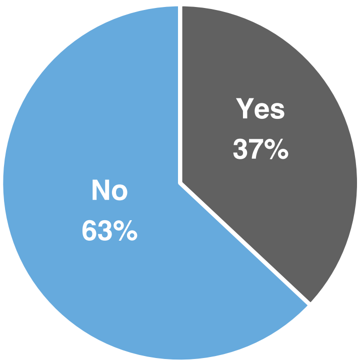
'We interview company managements when evaluating strategy and management quality. When appropriate, we engage companies to discuss issues that may include environmental and social policies and practices, particularly in regions that are deemed high risk.'

Like question 3, we believe these responses are reasonable and consistent when viewed in context. Certain types of manager – for instance those with quantitative processes – would be unlikely to engage with company management on any topic, as this type of dialogue would not form part of their investment process. Similarly, both traditional and quant managers who look to diversify their portfolios across a very wide range of holdings in order to reduce idiosyncratic risk would likely be unable to engage in any material way. Similarly, managers focused on DM government bond markets would be unlikely to have an engagement programme. Allowing for these factors, a positive response of >50% appears reasonable and consistent with previous responses.

In terms of reporting on engagement, 43 managers (54% of the survey universe) replied to this question. 68% of those respondents operating an engagement programme also provide reports on their activities. We expect this already high percentage to increase over time.

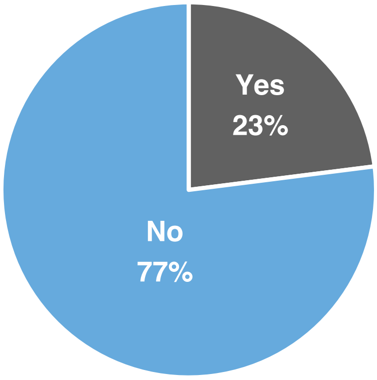
We expect the already high percentage of respondents that provide reports on their engagement activities to increase over time

Question 5 – Is your firm domiciled in the United Kingdom?

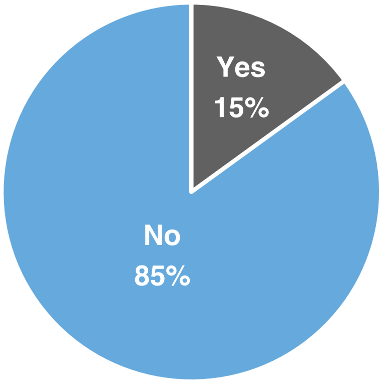


The majority of the respondents are international asset managers. A number of those with UK subsidiaries registered in the UK replied 'yes'. The purpose of the question was to assess how far the respondents had a UK focus or awareness.

Question 6.1 – Has your firm completed the National Association of Pension Funds (NAPF[2]) Stewardship Disclosure Framework?



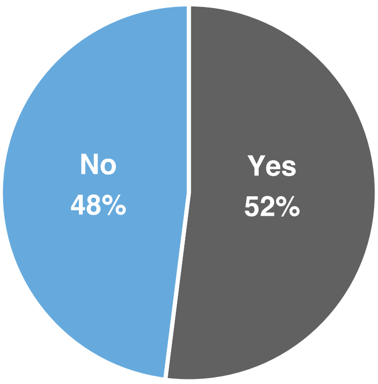
Question 6.2 – [For those answering 'no' to 6.1 and responding to question 6.2]. Does your firm intend to complete the Framework in the next 12 months?



Viewed in isolation, the take-up of the NAPF Stewardship Disclosure Framework, both current and prospective, might appear disappointing. However, allowing for the fact that the NAPF is a UK-based body and most of the respondents are international organisations, it appears very reasonable. Focusing purely on the UK-domiciled respondents, which represent 29 out of the 79 total respondents, we see a more encouraging picture. 15 out of 29 (52%) of the UK-domiciled managers responded 'yes'. With a further 6 out of 29 (21%) of the UK-domiciled managers intending to complete the Stewardship Disclosure Framework in the next 12 months, that suggests a prospective 73% completion rate by the UK respondents.

73% of the UK-domiciled respondent firms have completed or intend to complete the NAPF Stewardship Disclosure Framework

Question 7.1 – Is your firm a signatory to the United Nations Principles for Responsible Investment (UNPRI)?



[2] The NAPF has now re-branded to the 'Pensions and Lifetime Savings Association'.

This response appears straightforward but in fact requires some analysis and interpretation.

Firstly, in terms of support for Responsible Investment initiatives, 18 managers (23% of the survey universe) were both signatories to the UNPRI and had completed the NAPF Stewardship Disclosure Framework. By contrast 38 respondents (48%) were neither signatories to the UNPRI nor had completed the NAPF Stewardship Disclosure Framework.

The majority of truly global respondent bond management firms are existing signatories of the UNPRI

Secondly, in terms of geography, 16 of the 50 non-UK respondents were signatories to the UNPRI (32% of the non-UK sample). By contrast, 25 of the 29 UK-domiciled managers (86%) were signatories. As most of these UK-domiciled respondents have parent companies that are global organisations, we can infer that the majority of truly global bond management firms are existing signatories of the UNPRI, whereas other firms are more likely to support either local ESG initiatives or no ESG initiatives. This is consistent with the findings from our standard manager research process. We allocate an ESG score to bond managers alongside our formal rank for each manager. We find higher ESG scores among the global and European-based managers (or those with a footprint in the UK/Europe) than for managers focused exclusively on the US. In particular, smaller US managers are much less likely to have high ESG scores.

Question 7.2 – Please describe briefly how your firm considers the UNPRI principles within your investment process?

'Our SRI investment policy:

- *excludes G-rated issuers from all of its active investment activities (excluding index-linked UCITS and ETFs, which are constrained by their benchmark indexes), notably companies involved in making or selling anti-personal mines (APM) or cluster bombs (CB); companies involved in the production or sale of chemical, biological and depleted uranium weapons; companies that violate, repeatedly and seriously, one or more of the principles of the Global Compact.*
- *is highly committed to issuers, and notably by exercising shareholder voting rights (incorporating E- and S-criteria to Ai voting policy) and through shareholder dialogue.'*

'We aim to systematically integrate ESG factors into both our top-down (i.e. longer term macroeconomic view) and bottom-up (sector and security selection) investment processes.'

'Our ESG integration programme entails the systematic exercise of voting rights, and the exclusions of companies involved in the production of mines and cluster munitions.'

'We created the Responsible Investing Committee to oversee incorporation of ESG factors into our investment process and ownership practices. We have also hired a dedicated ESG analyst who is helping the investment staff to better understand how ESG issues can impact their management engagement efforts and investment decision-making process.'

'Our firm also acts as an active owner and promotes best ESG practices in our engagement activities. Those activities can take different forms: dialoguing with companies, joining collaborative engagement initiatives, elaborating an active proxy voting policy and promoting sustainable development.'

'All of our managers…are unconstrained in their investment management processes…as a result; SRI issues are fully delegated to the managers.'

This open-ended question elicited a wide variety of responses. Some managers attached copies of their policy documents setting out in detail how they integrated the UNPRI principles into their processes. Others provided briefer and less specific responses, with some focusing more narrowly on exclusion policy and/or voting policy. The respondent managers referred variously to the date they signed up to UNPRI (or in some cases, how their own ESG initiatives pre-dated it), to other initiatives that they supported (e.g. the Green Bond Principles), or to their progress to date in meeting the standards required by the Principles. All of the respondents who were signatories to the UNPRI also provided a response to this follow-up question. Overall, the depth and considered nature of the replies indicates that these firms are true supporters of the initiative rather than viewing it as a mere box-ticking exercise.

The depth and considered nature of the replies from signatories indicates that these firms are truly committed supporters of the UNPRI

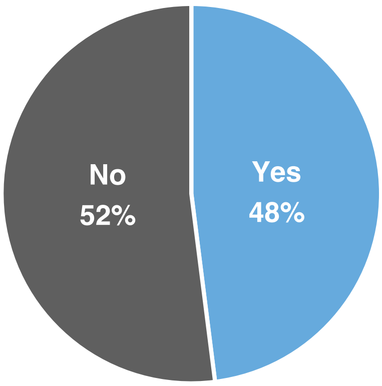
Question 7.3 – In what year did your firm become a signatory to the UNPRI?

YEAR	NUMBER OF RESPONDENTS	PERCENTAGE RESPONDENTS PER YEAR
2006	8	20%
2007	5	12%
2008	1	2%
2009	2	5%
2010	4	10%
2011	3	7%
2012	7	17%
2013	7	17%
2014	4	10%
	41	**100%**

As shown in the table above, there were a substantial number of signatories in the inception year 2006 and in the year following, 2007. 2008 and 2009 saw fewer new signatories from our sample; however the following years saw a continuing stream of new signatories, with 44% of the respondents signing in the last 3 years. We believe that this trend will continue and expect to see significant numbers of new signatories in future.

We expect to see significant numbers of new UNPRI signatories in future

Question 8 – Does your firm have any ESG factors as decision-making factors in your investment process?



YES

'We have a series of ESG questions included in the Investment Committee guidance deck that all investment teams consider when assessing a company. In addition, we have developed a number of sector-specific guides that help our teams identify and assess material issues for the industry that they are considering.'

'We believe that by analysing sustainability risk factors alongside traditional risk factors, the firm will have a more complete picture of the risk and return opportunities that will ultimately allow us to deliver better outcomes for its clients.'

'ESG plays a key part in our investment decisions given that companies which are identified as non-compliant with broad ESG principles are likely to have a higher risk of not being able to access refinancing.'

NO

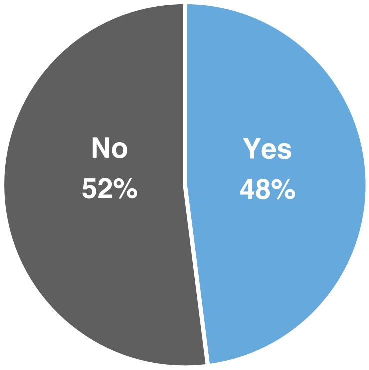
'Each investment team within the company is responsible for their own research and analysis.'

'Any ESG-related research is obtained at the discretion of the respective Investment Analyst.'

On the face of it, the overall percentage responses do not indicate a strong conviction in the efficacy of ESG factors. However, bearing in mind the difference in opinions regarding “values” versus “value”, this response is we believe highly congruent with the previous findings. In particular, the response percentages for question 8 are comparable to those for question 3.1, ‘Does your firm have a Responsible Investment policy’? Of the 40 respondents who had no Responsible Investment policy, only 8 had any ESG factors as decision-making factors in their investment process. This seems consistent with our finding that many of these respondents believed that views on Responsible Investment were the preserve of their clients, and that their own function was to execute on the ESG preferences instructed by clients.

Of the 40 respondents who had no Responsible Investment policy, only 8 had any ESG factors as decision-making factors in their investment process

Question 9 – Has an ESG factor ever overridden an otherwise attractive investment in your investment process?



‘As explained above, all factors apply to our process.’

‘The goal of our ESG initiative is to embed the analysis of ESG risks across the investment process. For this reason, we do not look to separate out the impact of ESG research/analysis from mainstream financial analysis.’

The responses to this question were strongly correlated with the adoption of a Responsible Investment Policy. Of the 40 respondents who had no Responsible Investment Policy, only 9 reported that an ESG factor had overridden an otherwise attractive investment in their investment process. Of the 39 who already had a Responsible Investment policy, 30 reported that there had been an ESG override. Otherwise, it is difficult to draw further strong conclusions from the responses, given the variety of different views and policies across the respondent universe. For instance, some respondents that already had a Responsible Investment policy and had already comprehensively integrated ESG into their investment process might arguably perceive they had no need of an additional ESG override.

Question 10 – If you were to assess the realistic impacts, which parts of ESG, if any, apply more to your fixed income process? Please explain the magnitude of the ESG factor impacting your process

'We do not see the application of the ESG factor as relevant to our fixed income decision, if for no other reason than we see ourselves focusing on only the largest, most liquid and highly scalable sovereign fixed income markets in the world at this time. If we were to begin to apply our investment philosophy to the fixed income markets of the developing countries, the ESG factor might be more relevant.'

'We find ESG analysis to be most relevant in our High Yield and Emerging Market Debt strategies, but less relevant in other strategies. The factors we find most relevant are related to transparency, management quality and a company's management of HES risks (health, environment and safety).'

'ESG is a complement to our fundamental credit underwriting process. Through a system developed by our Governance unit, analysts can screen a company and sector through an Excel template that pulls together data that may impact a company's overall ESG rating. An analyst will consider these factors when providing a recommendation on a security. While a decision has not been "overridden" by the ESG process, the factors are one of many that are considered.'

'While all credit research analysts include ESG considerations in their issuer analysis as a matter of course, it is not a strict evaluation or ranking process, for different issuers or situations will require greater emphasis on "E" or "S" factors. On the other hand "G" is always considered to be the most important factor as good governance should be a fundamental of every business. All ESG factors are important and play a role in our investment process; however the G has a greater impact. Governance is the oldest factor; good governance has a strong link to good risk management.'

'As regulation is the primary driver of spreads of financials (which are approximately half of the investment grade universe), utilities and telecoms (which are the two largest non-financial sector issuers), that would mean that Social (due to regulation) is the single biggest systematic driver of credit spreads across sectors. Governance, however, is a cause of numerous company specific issues, and is the largest cause of unique or non-systematic risk amongst issuers.'

'When assessing the impacts of ESG risks on portfolio performance, we have found that the most acute risk is poor governance. This is due to it having the most immediate and severe impact on trading values in a company, e.g. Phones4U, Tesco.'

'We view ESG as having a powerful dual purpose: it helps mitigate a range of business risks and fosters value creation. While assuming a multitude of forms, what ESG risks share is the potential to damage a company's operations to the degree that the company is unable to meet its financial obligations to its creditors. We take a broad view of ESG factors, which vary by company and industry. Importantly, we understand that materiality and relevance will vary across sectors and geographies.'

The consensus amongst respondents to this question was that ES and G factors can all be relevant to appraising fixed income investments, and their importance can vary according to circumstances

This lengthy selection of quotations highlights a broad consensus amongst the respondent managers, namely:

- ES and G factors can all be relevant to appraising fixed income investments, and their importance can vary according to circumstances. However generally speaking G has primacy as the underlying factor most relevant to ability and willingness to repay debt.
- ESG factors are the most relevant in company-specific and higher-risk situations. They tend to apply less in DM Government Bonds and in processes relying on quantitative analysis of macro factors.

Behind the consensus, we observed a variety of different approaches, both through the detailed survey responses and through our own in-depth manager research capability. For instance, we noted:

- One quant manager who tested for efficacy of ESG factors and allocated E,S and G weights accordingly
- A second quant manager who tested for ESG factors and found no material correlation of ESG factors with superior performance
- A manager who researched ESG starting with top-down Capital Markets work first and proceeding to integration afterwards
- Managers who opted for full-scale ESG integration as intrinsic to fundamental bottom-up research
- Managers who allocated ESG scores as a factor to consider alongside their standard fundamental research process
- Managers who made use of ESG insights on an ad hoc basis driven by individual in-house analysts, and with no formal over-arching process

These observations are consistent with our view of ESG as an evolving concept, where bond managers are embracing the philosophy of responsible investing in a variety of different ways, according to their particular perspective and investment process.

The observations are consistent with our view of ESG as an evolving concept

SUMMARY AND CONCLUSIONS

- Russell Investments Bond Manager Survey 2015 found a high level of ESG awareness amongst the respondent managers and willingness on the part of their firms to participate in the UNPRI and NAPF Stewardship Disclosure Framework, as appropriate. (Fully global managers tended to focus on the UNPRI, exclusively UK-domiciled firms were focused to a greater extent on UK-based initiatives).
- Whilst the majority of managers viewed ESG factors first and foremost as central to an appraisal of value in bond investments, a significant minority viewed ESG factors as primarily an issue of moral value judgments and therefore the prerogative of their clients. This difference of view tended to drive responses across a number of questions, in particular those related to integrating ESG factors into the investment process and adopting a formal Responsible Investment policy. Managers who viewed ESG factors primarily through the lens of clients' moral value judgments were much less likely to adopt a Responsible Investment policy of their own.
- Irrespective of formal policies and integration of ESG, the universe of respondent managers showed a high level of awareness of ESG issues. Global managers, and those based in the UK/Europe, typically evidenced higher levels of awareness and integration than the managers operating exclusively in the US. This is consistent with Russell Investments' own experience, gained through our standard manager research process including our ESG scoring approach.
- Those respondents with a primarily 'values' focus stated a high level of willingness to work with clients to implement their ESG views.
- Similarly, the respondents had different perspectives driven by their different bond market specialism, nonetheless demonstrated an underlying consensus on the importance of ESG and in particular the primacy of governance as a factor.

Irrespective of formal policies and integration of ESG, the universe of respondent managers showed a high level of awareness of ESG issues

Russell Investments would like to thank all the respondent managers for their participation. We look forward to working with them in future, to further develop our understanding of ESG implementation in bond market investing as this evolves over time.

FOR MORE INFORMATION:

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visit **www.russell.com**

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