MARKETING COMMUNICATION

Climate change in Fixed Income: The important role of credit on the path to net zero

By WFAM's Global Investment Grade Credit and Global Fixed Income Research teams

FOR PROFESSIONAL/QUALIFIED INVESTORS ONLY

Executive summary

There is an established consensus that society must decarbonise the economy to manage climate change in a responsible way.

At Wells Fargo Asset Management (WFAM) we believe we can invest deliberately to advance this profound transition.

Fixed income investors play a vital role in this process. Debt finance is essential to today's fossil-based economy, and it will be equally essential to decarbonise the economy of the future and fortify its infrastructure to handle climate change's increasingly severe physical effects.

With this in mind, we believe a more deliberate and structured approach to investing in credit can achieve climate goals, such as reducing portfolio carbon intensity and alignment with the Paris agreement, even more efficiently. We have designed a Climate Transition Credit approach that comprises multiple decarbonisation mechanisms, but does not simply exclude the highest emitters. Our approach instead implements a proprietary framework to channel capital to those firms with the most compelling societal climate strategies, therefore capturing transition opportunities across sectors while managing climate risk. This approach builds on our experience of rigorously integrating and actively managing environmental, social and governance risks in our investment grade strategies, which we believe delivers the best risk-adjusted returns.

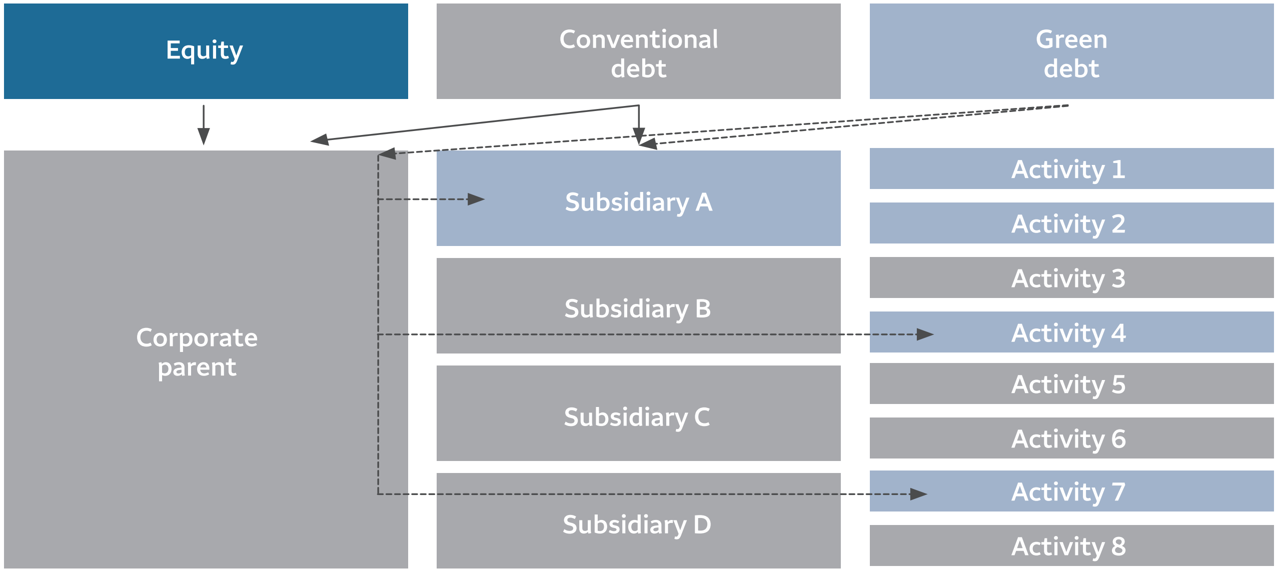
Decarbonising fixed-income portfolios, why now?

Fixed income has a vital role in decarbonisation. As the second largest asset class in the world, it is essential to funding the transition to a sustainable economy. This is supported by the fact engagement levels with creditors have increased as companies appreciate the vital role of the debt capital markets.

The structure of many credit securities allows for targeting of desired green activities more efficiently than parent equity and conventional debt by directing proceeds to green subsidiaries or green activities within diversified issuers (see Figure 1).

Moreover, as climate data has been improving, available now at a level that can be factored into fundamental driven research, the opportunity for fixed income investors to impact sustainability has never been greater.

Figure 1: Credit allows targeted investment



We believe climate change creates the need for a profound transition

Our Climate Transition Credit approach is grounded in an investment philosophy that we must move expeditiously to decarbonise the economy while ensuring our infrastructure is climate-resilient. We also believe a broad range of firms will lead this transition, not only smaller firms that concentrate solely on the 'greenest' activities, but also larger, more diversified firms with the most adaptive climate strategies. Lastly, we think these firms will outperform over the long term.

To enable these firms' success, investors must go beyond decarbonising portfolios through divestment and tilting, and instead efficiently mobilise trillions of dollars of capital and channel it to the most promising initiatives.

We harness both traditional and new security structures to actively manage transition exposure. Unlike public equities, proceeds can be linked to specific activities. Green and sustainability bonds, as well as traditional bonds issued by transition-focused firms, provide this advantage.

However, to achieve this transition, fundamental analysis and a focused security selection are key. We therefore leverage our strong credit track record and a deep, fundamental understanding of sectors, industries, and corporations—including their business models—to take advantage of market opportunities and drive positive climate outcomes.

Climate Transition Credit: Delivering climate and financial objectives

We have designed an investment process that embeds five key features to deliver on investors' financial goals, such as achieving expected investment grade credit return and risk exposure, and climate goals, including reducing portfolio carbon intensity, allocating to transition opportunities and alignment with global initiatives such as the Paris Agreement.

The chart (Figure 2) below summarises this design by identifying primary financial and climate goals then mapping them to the design's main structural features.

Figure 2: Climate Transition Credit: key features

	1 Apply WFAM Transition Framework	2 Use targeted exclusions to maximize climate benefit	3 Preserve ongoing CO2 advantage vs. benchwork	4 Decarbonise portfolio over time	5 Engage
Financial goals					
Typical IG credit performance & risk metrics		★	★		★
Diversification to avoid overconcentration		★	★		★
Climate goals					
Capture transition opportunities across sectors	★	★	★		★
Contain exposure to negative climate risks	★	★	★	★	★
Deliver carbon intensity well below market	★		★		★
Decarbonise portfolio over time			★	★	★
Align with Paris Agreement (COP 21)			★	★	★

Focusing on the solution

1 Actively manage security selection with WFAM Transition Framework

Our Transition Framework is designed to identify those firms that are best prepared to perform through the transition as well as those that are likely to be less prepared. We draw on our breadth and experience in fundamental credit research, to identify and deploy capital to transition outperformers across industry sectors.

Our approach is to use new data and new insights grounded in traditional fundamental analysis (including established credit and equity asset pricing models). Transition leaders will typically provide 'yes' answers to key questions evidencing alignment with Task Force on Climate-related Financial Disclosures (TCFD) recommendations, net zero emissions, and profitability in a <2 degrees world. Key areas of questioning include: competitive strategy, asset positioning (competitive risks, decarbonisation risks: scopes 1, 2 and 3, regulatory risk, technology risk, physical risk), operational expertise, stakeholder relations and risk and financial strength and flexibility.

2 Use targeted exclusions to maximise climate and financial benefits

We do not believe in automatically excluding industries with high historical carbon emissions. Instead, we focus on firms' forward transition performance. While some approaches exclude fossil fuels on the view that historical carbon intensity will continue indefinitely, we believe it is necessary to take a forward view on firms' climate and financial performance as some of today's heaviest emitters will be tomorrow's decarbonisation outperformers. The opposite can also be true; many renewables-tilted strategies were overweight The Pacific Gas & Electric Company (PG&E) despite its extreme exposure to physical risks (see Figure 3).

We will typically guide positioning away from industries like thermal coal and upstream hydrocarbons, except where we have confidence in a combination of climate and financial outperformance.

Figure 3: Many renewables-tilted strategies were overweight PG&E despite its extreme exposure to physical risks

Note: For illustrative purposes only. This information is stale to demonstrate past performance. Named companies are not a recommendation to trade. Past performance is not a reliable indicator of future results.

Source: WFAM, Bloomberg as of 30th June, 2020.

Focusing on the solution

3 Reduce weighted average carbon intensity at least 30% lower than benchmark

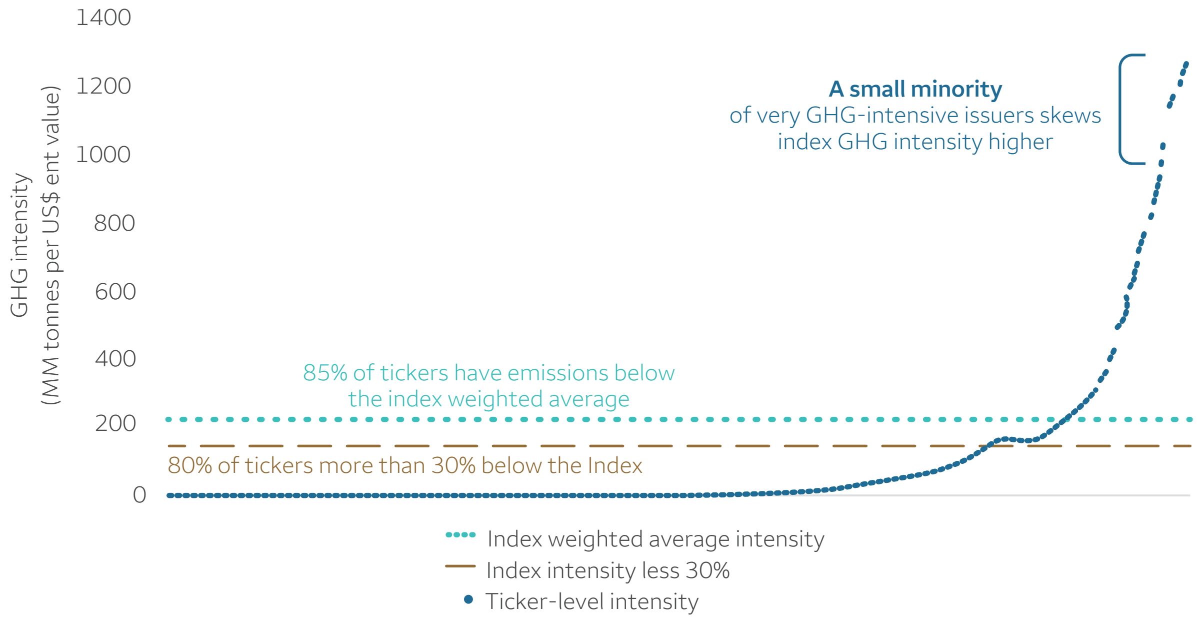
We believe a 30% cap on portfolio emissions intensity can deliver three benefits simultaneously:

First, it provides rigor by ensuring carbon reduction vs. benchmark until that time net zero is reached.

Second, it affords flexibility to balance positioning across sectors while focusing on the most compelling transition value propositions in all cases (see Figure 4).

Last, it facilitates high quality risk management through diversification while channeling funds to the transition activities most in need.

Figure 4: Intensity cap provides decarbonisation rigor while preserving flexibility



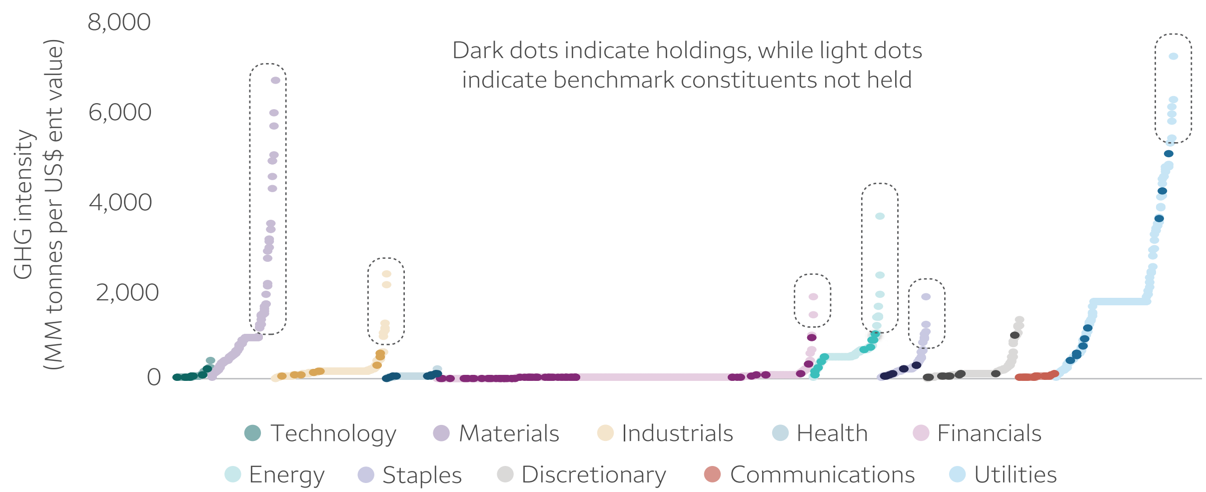
Source: Wells Fargo Asset Management, Bloomberg Company Materials, Bloomberg Barclays Global Aggregate Corporate Index as of 30 Sept 2020. For illustrative purposes only.

4 Decarbonise portfolios by 2050

Beyond delivering lower carbon intensity than the benchmark, we believe decarbonising portfolios over time is essential to aligning with the Paris Agreement. Further, we believe our approach can simultaneously deliver financial performance comparable to that of customary investment grade credit strategies. For example, using today's global investment grade universe, we evaluated a broad range of hypothetical portfolios that achieve intensities 25%, 50% and 75% below benchmark (see Figure 5 for a 50% reduction scenario). We found that, in today's market, the opportunity set narrows at higher levels of emissions reduction. However, our analysis also suggests it is possible to maintain ample opportunity sets by beginning with substantial decarbonisation today (e.g. 30%) and increasing this percentage over time as industries adapt.

It's important to stress that to reach net zero emissions, while also achieving investors' financial goals, the economy's carbon-free opportunity set would need to expand. However, by 2050, we are optimistic that decarbonisation of the economy and technological innovation in carbon capture will provide the means to achieve a portfolio with net zero emissions. This optimism appears to be shared by a growing number of investors.

Figure 5: We invest across sectors with focus on firms poised to outperform in a decarbonising economy



Notes: For illustrative purposes only. Dark dots indicate portfolio holdings, light dots indicate benchmark constituents not held.

Source: Wells Fargo Asset Management, Bloomberg Barclays Global Aggregate Corporate Index, Bloomberg Company Materials, Bloomberg Barclays Indices as of 30th June, 2020.

Focusing on the solution

5 Engage with issuers to enhance climate and financial performance

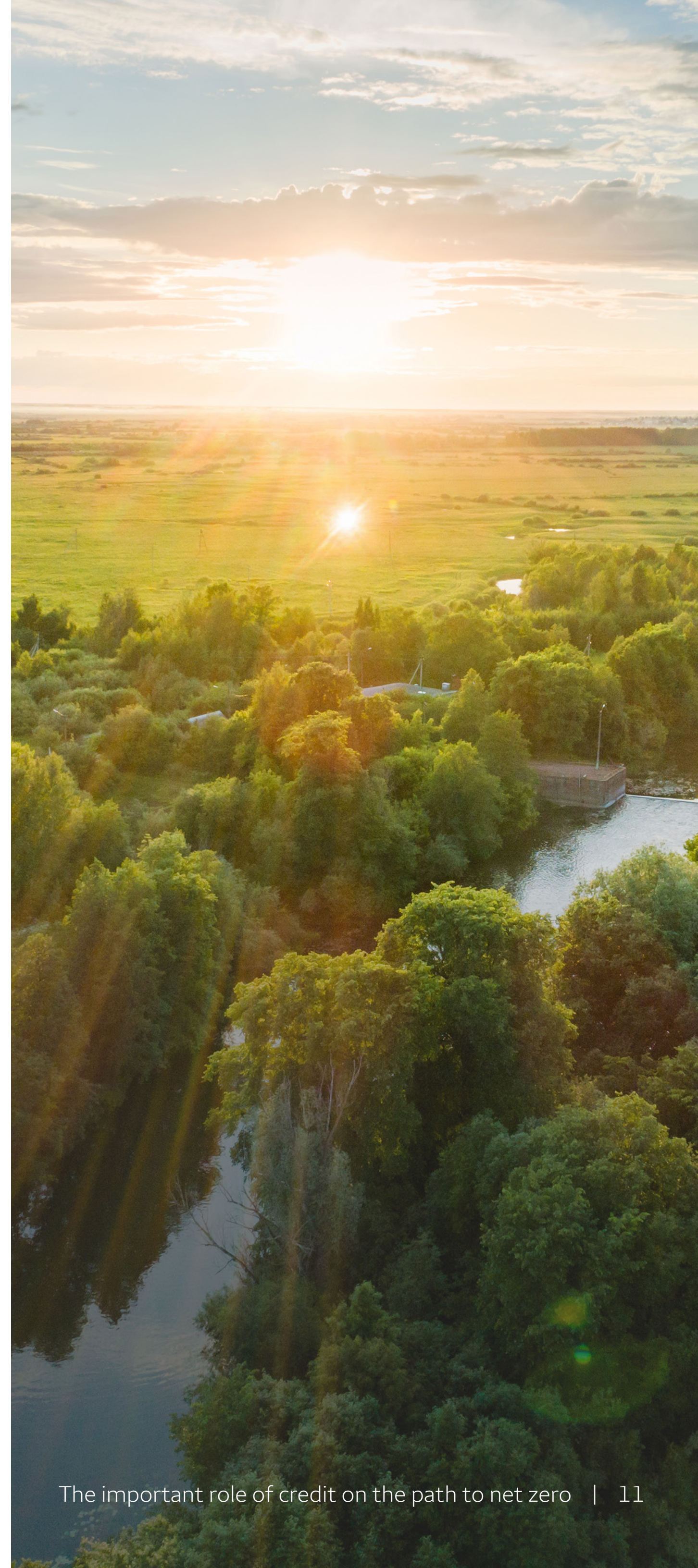
Engagement is core to WFAM's investment processes. We view engagement as active management in action with a goal of maximising the long-term value of our clients' capital. Engagement deepens our knowledge of investee firms and provides a platform to impel companies to improve performance on material ESG issues. Annually, WFAM sets a strategic plan for engagement by sectors, industries and material issues. Investee companies are prioritised by impact potential (systemic importance, aggregate exposure, and strategy-level exposure) and relative performance. We believe it is important to engage independently as well as through our participation in industry groups such as Climate Action 100+.

Implementation of climate transition credit

Our Climate Transition Credit approach can be implemented across credit mandates, globally and regionally, and with various investment approaches. The table (Figure 6 below) demonstrates how the approach can be applied to both global investment credit and buy and maintain portfolios, with differing financial goals but the same climate goals.

Figure 6: Climate Transition Credit's versatile approach works well across credit mandates

	Global Investment Grade Credit	Buy and Maintain Credit
Financial goals and objective	• Provide performance and risk metric similar to a typical investment grade credit strategy • Consistent outperformance over multi-year horizons • A benchmark-aware approach provides flexibility to focus on less efficient sectors of the market to generate alps • Facilitate diversification, avoid unwanted concentrations • Target return: Benchmark +75bps over a market cycle • Target turnover: 75% +/- 25%	• Provide cash flow and risk characteristics similar to a typical investment grade buy and maintain portfolio • Predictable cash flows over time with limited credit migration • A cash flow-driven approach provides tailoring to client requirements • Facilitate diversification, avoid unwanted concentrations • Investment style: buy & maintain • Target return: gilts + 100bps over a market cycle • Target turnover: 15–20%
Climate goals and objectives	• Capture transition opportunities across sectors • Contain exposure to negative climate risks • Deliver carbon intensity well below market >=30% • Decarbonise portfolio by 2050 • Align with consensus agreements e.g. COP 21, UN Global Compact	



WFAM Climate Transition Credit helps investors achieve climate and financial goals

Across its credit strategies, WFAM integrates ESG risk analysis into its investment process. By doing this, we take account of firms' climate business strategies and exposure to physical climate risks. However, many investors—large institutions as well as individuals—are committed to taking a more deliberate approach to transitioning to a sustainable economy.

WFAM shares this objective. In this note, we outlined our climate transition credit framework. Grounded in the same fundamentally driven process used across our credit strategies, our climate transition credit process harnesses a suite of key features to help investors achieve both their financial goals and climate goals, including:

- Channeling capital to firms with the most compelling climate strategies and best value propositions across sectors
- Containing exposure to negative climate risks
- Delivering carbon intensity well below market
- Decarbonising by 2050
- Aligning with the Paris Agreement (COP 21)

WFAM Investment grade credit expertise and proven track record

Our fixed income platform has one of the world's largest global research teams and manages over $507bn in fixed income AUM globally. We believe that fixed income markets are inefficient by virtue of their complexity, structure and investor base, meaning that opportunity to generate alpha is prevalent. WFAM has a strong credit culture with integrated sustainable investing and climate research. Our global credit research platform is the foundation for our focus on bottom up security selection, relative value assessment and risk management. We focus on generating consistent, repeatable risk-adjusted returns while achieving the desired outcome of our clients.

Our Global Investment Grade Credit team have been managing USD- and EUR- denominated strategies since their inception in 1999 and 2003, respectively. Their long term performance features in the top decile of their peer groups, ranking second and third in their respective peer group over 10 years. This proven and sustainable active investment process has been refined over more than a decade of investment-grade portfolio management. A stable team with no turnover in the past 5 years, they are further strengthened by independent risk oversight by a dedicated risk management team. Their established track record of success in investment-grade markets has facilitated their growth in AUM, which today stands at $50bn, with $19bn in ESG-sensitive mandates, across a global investor base.

Source: As at 30 Sept 2020 including our affiliate Galliard Capital Management (Galliard)

We want to help clients build for successful outcomes, defend portfolios against uncertainty and create long-term financial well-being.

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