



# Impact Investing in Credit: Debunking Four Common Misconceptions

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Increasingly, companies are being measured not only by their earnings and cash flow, but according to the effect their activities have on the environment and society. As a result, credit investors no longer judge those companies solely on their risk and return characteristics, but increasingly by their external impact as well.

So-called impact investing is not a new asset class: it is a natural extension of environmental-, social- and governance-focused ('ESG') investment approaches in credit. The idea is to identify debt issuers on the right side of change—those that are seeking to deliver a

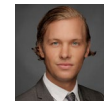
beneficial environmental and social impact, as well as positive financial returns.

Impact investing has grown considerably in the past few years. But a lack of knowledge and several commonly shared misconceptions may discourage investors from considering this way of investing in credit.

In this article, we attempt to debunk four popular myths about impact investing, as well as showing how T. Rowe Price's Global Impact Credit Strategy addresses them.



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## Four impact investing myths

**Myth 1**  
"Impact investing doesn't work in the secondary market"

**Myth 2**  
"Only ESG-labelled bonds can create a positive impact"

**Myth 3**  
"Achieving impact requires an overhaul in the portfolio construction process"

**Myth 4**  
"An Impact approach necessitates higher tracking error"

Fixed Income  
Impact portfolios  
can be flexibly  
managed to client  
objectives.

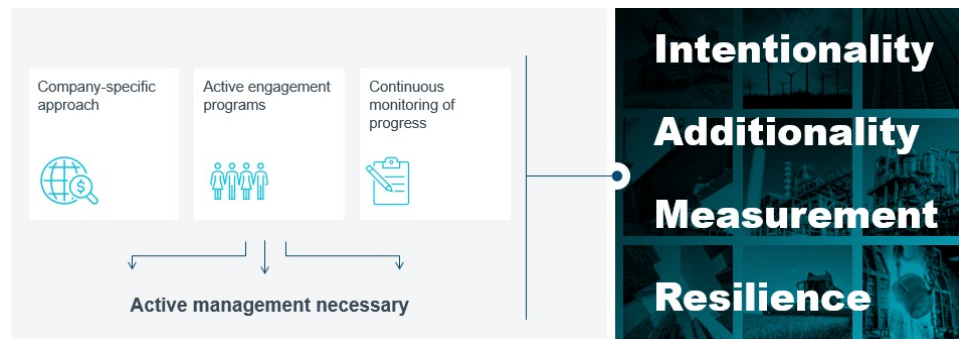
— Matt Lawton  
*Portfolio Manager, Fixed Income*

### Myth 1: “Impact investing doesn’t work in the secondary market”

In theory, impact investing is simple, but in practice it is not easy. Active management is crucial in making a real difference in the secondary

market for corporate credit, for three reasons: the need to take a company-specific approach; the requirement for active engagement; and the need for continuous monitoring.

### Three reasons for active management in impact investing



#### Company-specific approach

Any analysis of impact investments in the secondary credit market requires a company-specific, bottom-up approach. We use our proprietary research models to help identify and screen impact opportunities, ensuring that all investment decisions are based on a clearly defined, positive impact thesis that is both material and measurable. With every impact investment, we identify a Key Performance Indicator (KPI) that we record, track and report over time.

#### Active engagement

Active engagement aims to ensure our capital is being used for the desired impact investment. We don’t invest passively in corporate debt; we seek to influence companies’ decisions to ensure that our clients achieve their desired impact investment goals. We believe active engagement is a prerequisite to achieving these objectives.

#### Continuous monitoring

Continuous monitoring of a company’s progress towards its impact goals is vital. On a regular basis, we revisit the thesis of our impact investment, alongside the company’s post-issuance reporting, to ensure it remains on track with the portfolio’s desired goals. This outcome-oriented approach also helps us track our KPIs, meaning we can report our annual impact metrics to clients comprehensively and transparently, helping them assess the impact their investments have made.

These three tenets rely on a diligent and methodological impact investing philosophy. We embed the principles of intentionality, additionality, measurement and resilience into our everyday impact investment process. For more on our philosophy, please view our [impact charter](#), which delves deeper into these principles.

## Myth 2: “Only ESG-labelled bonds can create a positive impact”

We disagree with this assertion: impact investing, in our view, can and should go beyond bonds labelled as having a positive environmental, social or governance impact. While we do invest in labelled-bonds, our Global Impact Credit Strategy also seeks impact investments outside the ESG labelled-bond market. We believe this approach offers us greater depth and diversity, as well as presenting additional alpha generation opportunities.

There is an abundance of issuers whose products, solutions, and activities create a positive ESG impact. Many of these companies choose to finance their activities through conventional, as opposed to ESG-labelled bonds.

For example, renewable energy developers help reduce carbon emissions through solar and wind projects. Emerging market banks drive financial inclusion through microfinance. And not-for-profit paediatric hospitals provide healthcare solutions in an inclusive and affordable manner.

As at the end of October 2022, approximately 42% of our Global Impact Credit representative portfolio was made up of high-impact, non-labelled bonds.

NextEra Energy Partners falls into this category: it operates an industry-leading portfolio of wind, solar, and battery storage assets. 100% of the company’s power generation comes from clean

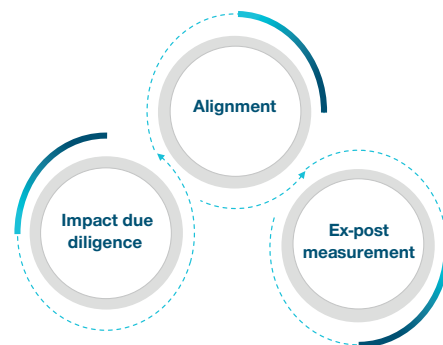
or renewable resources, which will accelerate global decarbonisation by supporting the transition of energy production away from fossil fuels. Ignoring such investments on the basis of the absence of an ESG label could be a missed opportunity.

However, accepting a non-labelled bond in an impact credit portfolio is more challenging than relying on a bond issue whose use of proceeds is clearly earmarked. In our Global Impact Credit Strategy, we therefore ensure that every investment is aligned to one of our 3 proprietary impact pillars, 8 sub-pillars and at least one UN Sustainable Development Goal (SDG).

After identifying this alignment and quantifying its extent, we carry out an in-depth due diligence process on every impact investment. We then commit to monitoring and measuring the progression of impact KPIs. In the diagram below, we show how we qualify a non-labelled bond as impact in our Global Impact Credit Strategy.

Finally, there are risks associated with investing only in ESG-labelled bonds. The labelled bond market is dominated by a small number of sectors, which may result into reduced diversification and higher systemic risk. The so-called ‘greenium’—a valuation premium for bonds that are labelled as green—can also compromise the relative value of labelled-bonds and reduce the alpha opportunities for investors.

## Qualifying a non-labelled bond



### Alignment

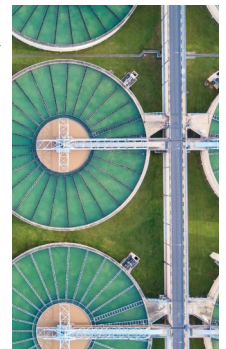
- Aligning all investments to a framework such as the UN’s SDGs<sup>1</sup> or proprietary impact pillars, guides prudent impact decision making

### Impact due diligence

- Five dimensions of impact, and fundamental analysis help identify impact opportunities

### Importance of ex-post measurement

- Monitoring progression of impact KPIs



<sup>1</sup>United Nation’s Sustainable Development Goals

**Myth 3: “Achieving impact requires an overhaul of the portfolio construction process”**

Again, we don't believe this to be true. The traditional portfolio construction process forms the foundation for impact investing, but just requires an additional step: screening potential investments for their impact characteristics.

The risk management of an impact portfolio is also consistent with that of a traditional bond portfolio. We manage the portfolio in a similar way to our

Investment Grade Credit Strategy, which combines three types of market 'beta': core strategic positions (around 70% of the representative portfolio), tactical, higher-beta bets (around 15%) and defensive offsets (also around 15%).\*

Top-down considerations, such as global relative value and macro-economic variables, also influence the sources of portfolio risk and their desired level. However, our bottom-up impact screening process is the starting point of portfolio construction (see the diagram).

\*as of 30 September 2022

**Impact screening is the starting point of portfolio construction**



#### Myth 4: “An impact approach causes higher tracking error”

Any actively managed portfolio whose bond weights differ from those of the benchmark will inevitably have some tracking error. But an impact credit portfolio will not necessarily have higher tracking error than a traditional bond portfolio, despite the more limited investment universe.

Like any actively managed strategy, impact credit portfolios can be managed flexibly to suit different client objectives, such as demands for specific duration, credit quality and beta. And just as in a

mainstream credit portfolio, an impact portfolio manager can deliberately target the level and sources of risk, based on market views and client objectives.

For example, we recently ran four model impact credit portfolios to demonstrate how flexible budgeting for duration, yield curve, sector, quality, and tracking error can achieve a desired level of risk, whilst still capturing impact. The below demonstrates this by showing how each portfolio’s tracking error stays in check despite the range of differing mandates (conservative to income):

#### Flexible budgeting across duration, curve, sector, and quality to achieve desired risk

	Bloomberg Global Aggregate Credit	Impact – Conservative	Impact – Income	Impact – Aggressive
Quality	A2/A3	A3/Baa1	Baa1/Baa2	Baa2/Baa3
Option Adjusted Spread (OAS) (bps)	144	185	206	252
USD Hedged Yield	5.08%	5.54%	5.72%	6.23%
Option Adjusted Duration (OAD)	6.35	6.25	4.15	6.21
Duration Times Spread (DTS)	9.57	11.46	9.29	15.05
<b>Tracking Error Volatility (TEV) (bps)</b>	<b>N/A</b>	<b>113</b>	<b>160</b>	<b>240</b>

For illustrative purposes only.

The impact models shown are based on the Global Impact Credit representative portfolio and customized to reflect different holdings and security weights to demonstrate the potential outcome of different risk scenarios across the risk spectrum. The conservative portfolio is adjusted to hold a high percentage (>30%) to defensive securities, such as Supranationals, as these generally have lower spreads, beta, and credit risk compared to the benchmark. The aggressive portfolio has larger exposure to securities with higher spreads, beta and credit risk, such as emerging markets. The income portfolio has greater emphasis on income generating securities versus beta.

**Model Results:** The results shown above are based on the application of a model and do not represent the actual returns of any T. Rowe Price product or strategy. Model results are hypothetical, do not reflect actual investment results, and are not a guarantee of future results. Model results were developed with the benefit of hindsight and have inherent limitations. Model results do not reflect actual trading or the effect of material economic and market factors on the decision-making process. Certain assumptions have been made for modeling purposes that may not be realized. Management fees, transaction costs, taxes, potential expenses, and the effects of inflation have not been considered and would reduce returns. Results have not been adjusted to reflect the reinvestment of dividend and capital gains. Actual results experienced by clients may vary significantly from the results shown.

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## **Conclusion**

At T. Rowe Price, we believe that impact investing is a vital tool for credit investors wishing to incorporate a positive environmental, social or governance impact into their fixed income portfolios. In this article, we showed that impact investing in credit can go hand-in-hand with the traditional investment process,

but requires a clear, methodical impact philosophy and an active approach.

By bringing together deep fundamental and impact research capabilities with an active approach that goes beyond ESG-labelled bonds, we believe we can consistently deliver both impact and outperformance relative to the portfolio's benchmark.

**Material Risks—The following risks are materially relevant to the portfolio:**

**ABS and MBS risk**—Asset-Backed Securities (ABS) and Mortgage-Backed Securities (MBS) may be subject to greater liquidity, credit, default and interest rate risk compared to other bonds. They are often exposed to extension and prepayment risk.

**Contingent convertible Bonds risk**—Contingent Convertible Bonds may be subject to additional risks linked to: capital structure inversion, trigger levels, coupon cancellations, call extensions, yield/valuation, conversions, write downs, industry concentration and liquidity, among others.

**Convertible bonds risk**—Convertible bonds contain an embedded equity option which exposes them to risks linked to equity as well as fixed income. They may be subject to higher market and liquidity risk.

**Credit risk**—Credit risk arises when an issuer's financial health deteriorates and/or it fails to fulfill its financial obligations to the portfolio.

**Distressed or defaulted debt risk**—Distressed or defaulted debt securities may bear substantially higher degree of risks linked to recovery, liquidity and valuation.

**Default risk**—Default risk may occur if the issuers of certain bonds become unable or unwilling to make payments on their bonds.

**Derivatives risk**—Derivatives may be used to create leverage which could expose the portfolio to higher volatility and/or losses that are significantly greater than the cost of the derivative.

**Emerging markets risk**—Emerging markets are less established than developed markets and therefore involve higher risks.

**High yield debt risk**—High yield debt securities are generally subject to greater risk of issuer debt restructuring or default, higher liquidity risk and greater sensitivity to market conditions.

**Interest rate risk**—Interest rate risk is the potential for losses in fixed-income investments as a result of unexpected changes in interest rates.

**Liquidity risk**—Liquidity risk may result in securities becoming hard to value or trade within a desired timeframe at a fair price.

**Prepayment and extension risk**—Mortgage and asset-backed securities could increase the portfolio's sensitivity to unexpected changes in interest rates.

**General Portfolio Risks**

**Capital risk**—the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

**ESG and Sustainability risk**—may result in a material negative impact on the value of an investment and performance of the portfolio.

**Counterparty risk**—an entity with which the portfolio transacts may not meet its obligations to the portfolio.

**Geographic concentration risk**—to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

**Hedging risk**—a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

**Investment portfolio risk**—investing in portfolios involves certain risks an investor would not face if investing in markets directly.

**Management risk**—the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

**Operational risk**—operational failures could lead to disruptions of portfolio operations or financial losses.

The representative portfolio is an account we believe most closely reflects current portfolio management style for the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio shown may differ from those of other accounts in the strategy. Information regarding the representative portfolio and the other accounts in the strategy is available upon request.

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for the portfolio, and no assumptions should be made that the securities identified and discussed were or will be profitable.

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