Allspring

AUGUST 2023

PM Perspectives: Climate Buy and Maintain

Addressing climate, credit, and cash flow

PM Perspectives is a series of profiles highlighting the current views of senior investment leaders across Allspring. This issue profiles four of Allspring's experts on our Climate Transition Buy and Maintain Credit strategy. The strategy was designed to provide a long-term investment approach that seeks to invest in companies leading decarbonization efforts while offering strong investment potential.

Tom Lyons (head of Climate, Sustainable Investments), **Catherine McLaughlin** (head of Institutional Sales for U.K. and Ireland), **Alex Temple** (head of Credit), and **Martijn de Vree** (head of Fixed Income Solutions) share their views on the challenges facing portfolio managers and the opportunities available to investors.

Q: HOW DOES ALLSPRING'S CLIMATE TRANSITION BUY AND MAINTAIN CREDIT STRATEGY ADDRESS CLIMATE, CREDIT, AND CASH FLOW?

Tom: We designed the strategy to do three things: align with the Paris Agreement,[1] decarbonize the real economy by channeling capital to companies with the best solutions across industries, and generate alpha. Getting this right at the outset is paramount, as we invest in companies with a view of holding them in principle until maturity.

Catherine: Many of our investors care a lot about decarbonizing their portfolios to net-zero emissions by 2050, which aligns with the Paris Agreement. The Climate Transition Buy and Maintain strategy combines this climate objective with investors' financial objectives of paying benefits to their members through bond cash flows. Following the recent rise in bond yields, some investors are also considering their portfolio risk and return objectives and using credit as an alternative to their equity allocations.

Q: DO THE OBJECTIVES OF THE STRATEGY EVER CONFLICT OR ARE THERE SYNERGIES?

Alex: This comes down to the dual aims that we have in the Climate Transition Framework and then in the strategy in particular—that is, we aim to decarbonize and tilt the portfolio toward credits that are going to outperform from both a climate and a financial perspective.

We're also looking for companies whose valuations aren't vulnerable to climate change as well as those that stand to benefit from society's response to it, which, we believe, have the potential to generate superior returns. Our Climate Transition Framework provides the structure, and our insights into climate risks and opportunities put us in position to pursue higher financial returns.

1. The Paris Agreement is a **legally binding international treaty on climate change.** It was adopted by 196 parties at the U.N. Climate Change Conference (COP21) in Paris on December 12, 2015. It entered into force on November 4, 2016. Its overarching goal is to hold "the increase in the global average temperature to well below 2°C above pre-industrial levels" and pursue efforts "to limit the temperature increase to 1.5°C above pre-industrial levels."

Source: https://unfccc.int/process-and-meetings/the-paris-agreement

Q: WHAT ASPECTS OF THE STRATEGY ARE INTERESTING TO INVESTORS?

Martijn: This is very much a long-term investment philosophy, intended to pursue low turnover, low transaction costs, and consistent cash flow with strong credit performance.

We talk to many investors who want to be on the right side of change and not just decarbonize their portfolios but also support decarbonization of the real economy. Typically, when investors have a buy and maintain mindset, they want to avoid investing in stranded assets. Therefore, we see a lot of synergies between the buy and maintain investment approach and the climate transition approach, as we believe that the long-term success of a company is materially impacted by how it operates in a decarbonizing world.

Q: ARE THERE CHALLENGES TO OVERCOME WHEN BUILDING THIS TYPE OF STRATEGY—PARTICULARLY FROM A FIXED INCOME PERSPECTIVE?

Tom: I think a key challenge is applying a value-based analytical methodology, aiming to find companies that are decarbonizing and generating value in the process, and trying to apply that to the work of our 49 credit analysts globally. Each analyst has their own approach to identifying and verifying what they think it takes to create value in their respective industries. Constructing a way to do this in a consistent manner took time. We continuously work with the analysts to make sure we maintain that consistency in how we measure value.

Alex: I agree with Tom, and one thing that has helped in this process is the increasing availability of data, with climate data now available from Trucost, MSCI, and Bloomberg as well as the companies themselves. Pressure from governments and investors for transparency has helped speed up progress here. For credits in our portfolio, we want to make sure we know the company inside and out and that we have the essential data to both measure our climate impact and help our clients with their own climate reporting requirements.

Q: WHY IS IT IMPORTANT TO USE A GLOBAL BENCHMARK RATHER THAN A PARIS-ALIGNED AND EXCLUSIONS-BASED BENCHMARK?

Martijn: We prefer to be inclusive and have a wide opportunity set. From there, we look for companies we think will have a positive impact on climate change and make a strong investment case. We're looking to pick transition winners and invest on the right side of change.

Paris-aligned and low-carbon indexes focus quite specifically on historical carbon emissions. The downside of focusing too much on one specific metric, especially when using a passive or index-based strategy, is that it doesn't say anything about what companies are contributing or will contribute in the future. If you look at decarbonization over time, it's actually the high emitters that can make outsized contributions to decarbonizing the real economy, and they need sufficient capital to do so. Our preference is to invest with companies that will make a meaningful impact and, importantly, to engage with them.

> "This is very much a long-term investment philosophy, intended to pursue low turnover, low transaction costs, and consistent cash flow with strong credit performance.

Q: GIVEN THE IMPORTANCE OF ENGAGEMENT THROUGHOUT THE TRANSITION, HOW DO YOU IMPROVE EACH ENGAGEMENT AND THE INVESTMENTS?

Alex: Engagement happens at many different levels, which is well suited to the credit asset class. While engagement is formally led by the Stewardship team, as they incorporate views and holdings across the firm, our credit analysts are in regular dialogue with leadership at corporates, including treasurers and chief financial officers. This can be at one-on-one meetings, on investor calls, or increasingly at new deal road shows and days on which they are in the primary markets with new deals. That's often where we give our feedback on ways in which we see the company leading or lagging and how it could be doing things differently. We not only look to identify opportunities for companies to help improve their climate transition credentials, we also reflect on the broader goals of our engagements, track progress, and incorporate insights for future engagements.

Q: IS THERE A PARTICULAR REASON WHY BUY AND MAINTAIN WORKS WELL WITHIN THE CREDIT SPACE?

Catherine: Many investors are looking for an investment option with low turnover plus cash flow. I think this strategy resonates because of the additional climate element. For example, in the U.K., pension schemes split their portfolio between liability-driven investing and growth assets. As funding levels have improved, many have begun to look at de-risking plans, including insurance solutions.

But that is a multiyear process and, during this time, it's important to align assets to liabilities as much as possible and to generate cash flows to continue to pay member benefits. A buy and maintain credit solution can help with that.

Q: THE CREDIT RESEARCH IN INDIVIDUAL NAMES IS DIFFERENT FROM THAT OF A TRADITIONAL ACTIVE FIXED INCOME STRATEGY. HOW DO YOU ALLOW FOR THAT IN THE CLIMATE TRANSITION FRAMEWORK AND PORTFOLIO CONSTRUCTION?

Alex: We have a more conservative approach to security selection in buy and maintain portfolios. That means we're looking for credits that are improving and we're looking to avoid names that could have their credit rating downgraded. This is a longer-term view, so turnover and transaction costs are expected to be lower. It's important for us to get the right credits the first time around, as our philosophy is, in principle, to hold bonds until maturity, calling for a deep understanding of companies and insights in how their business models may be affected by climate change. We want to help investors achieve their financial and climate objectives while facilitating investment in the climate transition that the planet will need for years to come.

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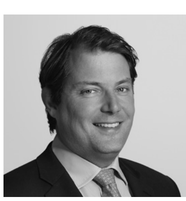

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For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

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