Opportunities in ESG-oriented solutions

Sustainable fixed income research

MACKENZIE Investments | Fixed Income Team

A need for change, a time to act

The United Nations has declared climate change the greatest threat that modern humanity has ever faced.[1] Inequality continues to plague the world, ranging from the ongoing COVID-19 pandemic that has disproportionately ravaged under-served communities around the world, to long-standing concerns about racial injustice and inequitable treatment within the legal system. Effective solutions to these complex and multifaceted crises faced by the global community will consider the intersectionality of society's systemic barriers while requiring support from both public and private sectors. We aim to address these critical issues, among others, by investing into transformative initiatives and sustainability-oriented issuers. The Mackenzie Fixed Income Team has provided funding to leading issuers in the fight against climate change, transformational initiatives reshaping the scope of Canada's energy sector, and global credits aimed at advancing the United Nations' Sustainable Development Goals. We recognize that we must continue to use our presence to advocate for sustainability, equality and accountability of corporations and governments around the world.

This transition to sustainable investing has begun, illustrated through inflows of nearly US$350 billion throughout 2020 and US$325 billion in the first six months of 2021 alone.[2] We remain adamant in our belief that fixed income markets will continue to adapt to reflect ESG risks, as evidenced by widening spreads between the bonds of sustainability leaders and laggards. Our team believes that a forward-looking approach of analyzing material risks and transitional opportunities will provide value across all industries. We believe the Mackenzie Fixed Income Team is uniquely prepared to embrace and adapt to the future of financial markets through its holistic ESG-oriented methodology. Our team of ESG and core credit analysts remain committed to the continued education of our analysts and investors to promote awareness and engagement with sustainable investing principles.

We believe that, just as credit risk assessments vary between industries, our process of analyzing ESG positioning should be uniquely targeted to suit the characteristics of individual issuers.

Konstantin Boehmer
Senior Vice President, Portfolio Manager,
Head of Global Macro
and Quantitative Analytics
ESG Integration Leader,
Mackenzie Fixed Income Team

Andrew Vasila
Investment Analyst
ESG and Global Fixed Income,
Mackenzie Fixed Income Team

Mackenzie Fixed Income Team core ESG principles

Analyzing securities through a targeted ESG assessment process may provide a unique opportunity to uncover hidden financial, reputational and climate change risks.

As climate change continues to intensify, equity and credit markets will increasingly adapt to reflect the growing risk to the global economy.

Impact is achieved most effectively through a holistic and complementary approach that:

- Recognizes best-in-class performers
- Rewards issuers with positive ESG-linked momentum
- Supports credits with material sustainability-linked use of proceeds

Adopting a holistic ESG research and integration process provides investors with the ability to capitalize on emerging trends in sustainable debt issuance while avoiding the pitfalls of greenwashing and exposure to ESG laggards.

Proactive engagement with debt issuers demonstrates increased commitment to promoting sustainability versus divestment or exclusion.

Recognizing risk, realizing opportunities

We believe it is important for investors to understand that ESG risks encompass more than environmental investment strategies, mitigating the damages of climate change and reducing greenhouse gas emissions. While these metrics remain critical, the scope of ESG research and modelling includes an issuer's exposure to unstable governance, employee health and safety practices, and measures of diversity and inclusion. Each of these metrics carries unique forms of regulatory and reputational risk to an issuer's outlook and allows portfolio managers to consider each pillar of ESG (that is, environmental, social and governance), as well as a composite materiality-weighted ESG score. Our ESG and credit analyst teams are responsible for the assessment of these risks within the credit valuation process, providing our team with an integrated process in which it considers a weighted evaluation of all available data to construct a holistic investment thesis for each of our holdings.

As with all of the Mackenzie Fixed Income Team's funds, the primary objective of our sustainable solutions is to deliver outperformance in long-term risk-adjusted returns. As such, the ability to identify material risks to the issuer and invest in credits with the best perceived risk-return ratio is critical. Fundamentally, this has not changed, with ESG data and scoring serving as a newly integrated metric under which our team identifies risks to the reputation and financial stability of an issuer. Our team performs an intensive credit research process that considers the valuation of credits relative to their risk profile. Through the strategic integration of ESG research and modelling capabilities, our core credit analysts gain increased insight regarding the sustainable orientation of the issuer's future, as well as the exposure to controversy risks that may be increased owing to the role of climate change and increased regulation on corporate and sovereign issuers.

Figure 1 | An approach balancing exposure to labelled debt and best-in-class ESG issuers reduces volatility while maintaining returns.

Green bond index vs corporate AA/A bond indices

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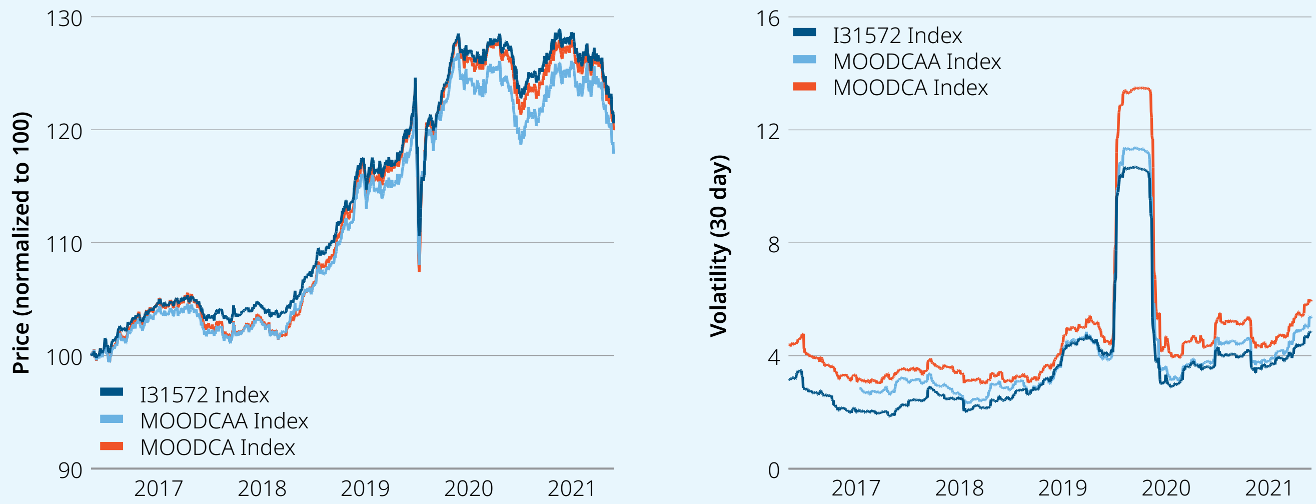


Bloomberg: MSCI Global Green Bond Index vs. corporate AA/A bond indices

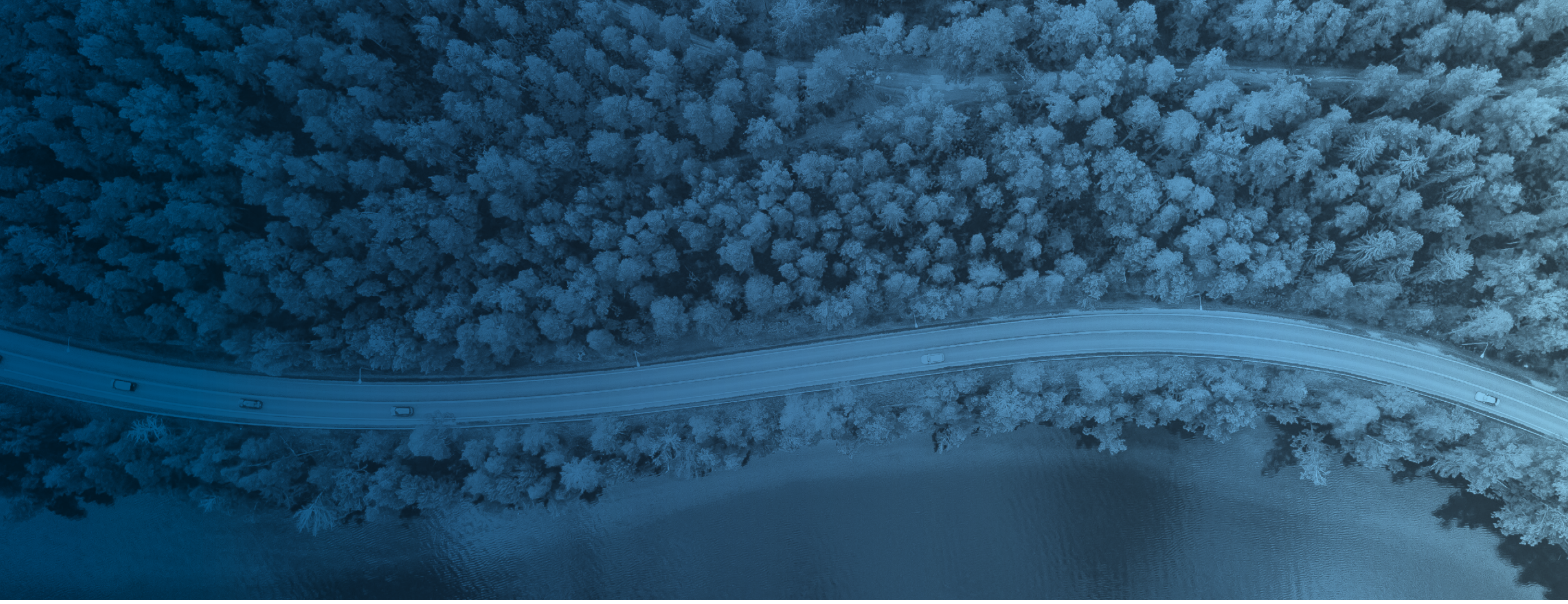
As shown above, exposure to green bonds provided high quality downside mitigation in periods of significant market disruption. Green bond exposure also experienced less volatility, and amplified the magnitude of the subsequent recovery, while maintaining a higher average credit quality. This positive deviation is largely the result of exposure to bond issuers in high emission sectors: with the green bond index favouring issuers that provided guidance on their transition to reduce emissions and support emission-reduction targets. The targeted selection process highlighted in green bond indices reduces exposure to volatility caused by unstable commodity prices and the wider adoption of clean technology.

We expect this transition to continue, improving the performance of ESG-oriented issuers, relative to the widening spreads and declining valuations faced by ESG laggards. We continue to believe in the outperformance of sustainable solutions, given the reduced exposure to material sources of risk and controversies, paired with the employment of progressive ESG-oriented management practices.

Having identified the merits of risk mitigation through ESG integration, the most critical concern of advisors, institutions and retail investors alike is the fear of sacrificing returns by taking a “martyr” stance against “unethical” or “unsustainable” investments. However, the transition to a sustainable economy provides significant opportunities that have produced impressive returns, often outperforming their respective benchmarks.[3]

Sustainable investments have seen continued growth, with 74% outperforming their respective universe despite the volatility of 2020[4]

As shown in “Morningstar’s Sustainable Investing Landscape; sustainable funds and ETFs,” 57% of recognized sustainable funds outperformed their respective benchmarks when assessed on a risk-adjusted basis, after fees, across the 2021 calendar year.[4] Additionally, 60% of the funds that received a five-globe sustainability designation outperformed their benchmarks by an average of 3.7% across 2020, with 2021 results expected by Q2 2022. This was lifted by the rise of sustainable investing themes amid a series of volatile years in the history of the modern market.[5] ESG oriented strategies benefit from improved risk management, reduced volatility and stabilized returns, enabling investors to enhance sustainability while optimizing the risk-return metric. We believe these characteristics make the strategy particularly attractive to fixed income investors.



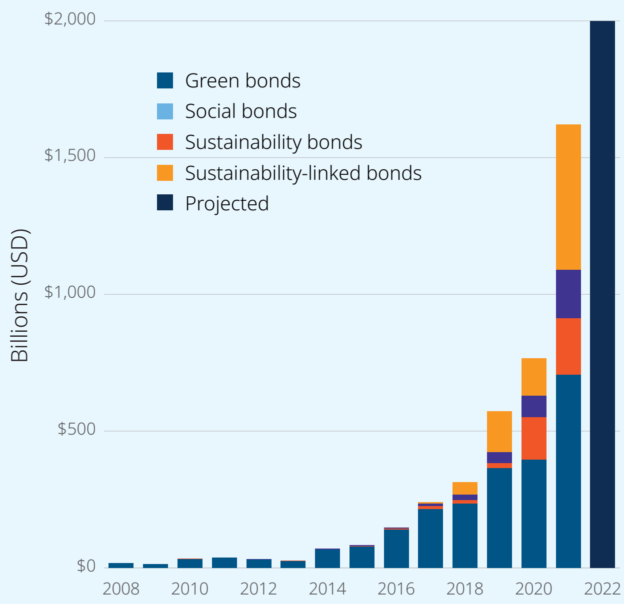
Opportunities in sustainability labelled debt

An instrument for change

Over the past several years, we have seen an exponential increase in new sustainable debt issuances, as shown in Figure 2,[6] leading to the creation of revolutionary new credit instruments, including sustainability-linked bonds and social bonds, to supplement the market's existing green bond framework. These new debt instruments support the unique structure of a credit's use of proceeds, often providing a green-premium, or "greenium," to issuers in order to support the advancement of sustainable objectives. Sustainable debt provides investors with reduced risk and increased transparency. Higher sustainability targets provide unique opportunities for amplified investor returns in the event that an issuer fails to deliver on their objectives. The significant market interest for labelled sustainable debt strengthens the role of socially responsible ESG-oriented investing strategies, empowering institutional and retail investors alike to directly contribute to reducing inequality and combatting climate change.

This dramatic increase in labelled debt has provided asset managers with the opportunity to develop unique strategies catering to the desire of investors to advance sustainability directives while capitalizing on a generational catalyst: ESG-oriented investing. With governments facing growing political pressures and corporations expected to adapt their business models, the transition to a sustainable economy will provide investment opportunities not seen since the launch of the Internet. Each sector of the economy will face unique challenges towards adapting to a sustainable future, not limited to significant technical innovation and dramatic infrastructure advancement. What is certain is that the transition to a net-zero economy will require ground-breaking innovation and significant investment. With access to uniquely labelled debt instruments and recognizing the present value of future innovation, governments and corporations have gained access to a financing tool that provides increasingly affordable funding for desperately needed change.

Figure 2 | Issuance of labelled debt has increased exponentially



Source: Bloomberg

The next generation

As baby boomers segue into retirement, younger generations have accelerated in their professional and financial journeys. The demographics of investors are changing, and this change isn't slowing down. Since 2020, millennials represent the largest generation in America, exceeding 72 million citizens, accounting for over one-third of the U.S. labour force and a significant portion of the voting population.[7] Millennials have been actively concerned about environmental sustainability, as shown by Deloitte's Global Millennial Survey series, which has placed climate change as a top concern for several years.[8] Also, amid mounting concerns relating to systemic racism and inequality within public and private sectors alike, two-thirds of millennials claim to have advocated for sustainability through their actions at the ballot box or through directing their spending and charitable donations.[9]

We believe that the demographic transition and eventual transfer of wealth will continue to support the exponential growth of sustainable investing.[10] Millennials and eventually Generation Z will soon account for the majority of investors and, with a proven history as active advocates, they will likely continue to let their votes, wallets and investments do the talking. [11]

Sustainable debt 101

Sustainability-linked bonds

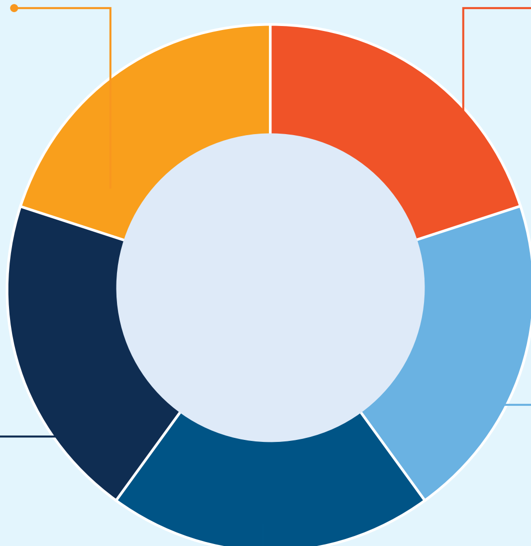
Debt with sustainability targets that the issuer needs to achieve before maturity, otherwise a financial penalty is applied as a premium paid to the bondholder.

- Reduce GHG emissions by 50% by 2030
- Gender-balanced board by 2025

Sustainable bonds

Bonds with use of proceeds that combine environmental and social issues, allowing companies and governments to have a wider-ranging influence.

- Sustainable food production for underserved communities



Best-in-class ESG bonds

Debt issued to issuers in positive environmental standing. These bonds are directed towards the advancement of environmental sustainability, without applying for certification. Formerly referred to as "light-green" bonds.

- Energy efficiency
- Clean transportation

Green bonds

Debt issued to companies or governments, with the use of proceeds directed towards financing environmentally related projects: certified by third-party verifiers

- Renewable energy
- Pollution prevention
- Water infrastructure

Social bonds

Debt issued with the intention of addressing social issues or supporting the transition to positive social outcomes.

- Affordable housing
- Diversity and inclusion programming
- Funding for Indigenous-owned businesses and initiatives

The future of sustainable investing

Sustainable investing aims to benefit all future generations of global citizens through investing in the transition of corporate practices and policies to sustainable countermeasures, while rewarding leaders in sustainable innovation and operation. Through increasing public engagement and disclosure standards, corporations that promote environmental sustainability will benefit through access to enhanced debt financing and preferred interest rates. Corporations that have been trailing with respect to environmental sustainability and reporting will be directly affected as they will be labelled as laggards when viewed through new lenses of disclosure and sustainability.

Whether intentional or otherwise, it is likely that the development of ESG disclosure standards, through measures such as those derived from the Taskforce for Climate-Related Financial Disclosures, will create a new-era asset classification system. We believe that following implementation, new debt issuance will be tied to ESG scores, comparable to credit ratings, which will affect the ability of corporations (and potentially municipal and sovereign governments) to affordably access debt. This transition, furthered by existing market perceptions, will in our view create a new scope of supply and demand concerns, as pricing is eventually derived from economic risk and environmental sustainability, segmenting asset classes and debt issuers, and from investors by ethical practices and sustainable values.

Mackenzie and other proactive asset managers have established the fundamental framework for responsible investing principles. Central banks have taken notice, as they have begun to draft policies and establish practices to support the transition to a sustainable future. In 2021, we witnessed proposed sustainability disclosure principles from the European Central Bank, climate stress-test proposals from the U.S. Federal Reserve and Bank of England, and the Bank of Japan's intention to finance sustainable initiatives through zero-interest loans.[12] It is evident that while the merits of ESG integration remain diminished by adoption laggards, the risks associated with environmental sustainability and ethical operations have been recognized by global institutions. The transition to sustainable solutions will not slow down. Although we have been early adopters, we remain firmly committed to our core principles, while continuing to evolve our thematic products and ESG integration methodologies to support the philosophies of our team and our investors.

1. Q4_2021_Canadian_Sustainable_Fund_Landscape.pdf (contentstack.io)
2. Global sustainable fund assets hit record $2.3 tln in Q2, says Morningstar | Reuters
3. Factbox: How central banks are responding to climate change | Reuters
4. Climate Change 'Biggest Threat Modern Humans Have Ever Faced', World-Renowned Naturalist Tells Security Council, Calls for Greater Global Cooperation | Meetings Coverage and Press Releases
5. Who Owns Stocks? Explaining the Rise in Inequality During the Pandemic - The New York Times (nytimes.com)
6. Sustainable debt issuance exceeds $730 billion in 2020 | Bloomberg Professional Services
7. Millennials outnumbered Boomers in 2019 | Pew Research Center
8. The Deloitte Global 2021 Millennial and Gen Z Survey
9. Sustainable debt issuance exceeds $730 billion in 2020 | Bloomberg Professional Services
10. Climate Change 'Biggest Threat Modern Humans Have Ever Faced', World-Renowned Naturalist Tells Security Council, Calls for Greater Global Cooperation | Meetings Coverage and Press Releases
11. Factbox: How central banks are responding to climate change | Reuters
12. Sustainable debt issuance exceeds $730 billion in 2020 | Bloomberg Professional Services

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