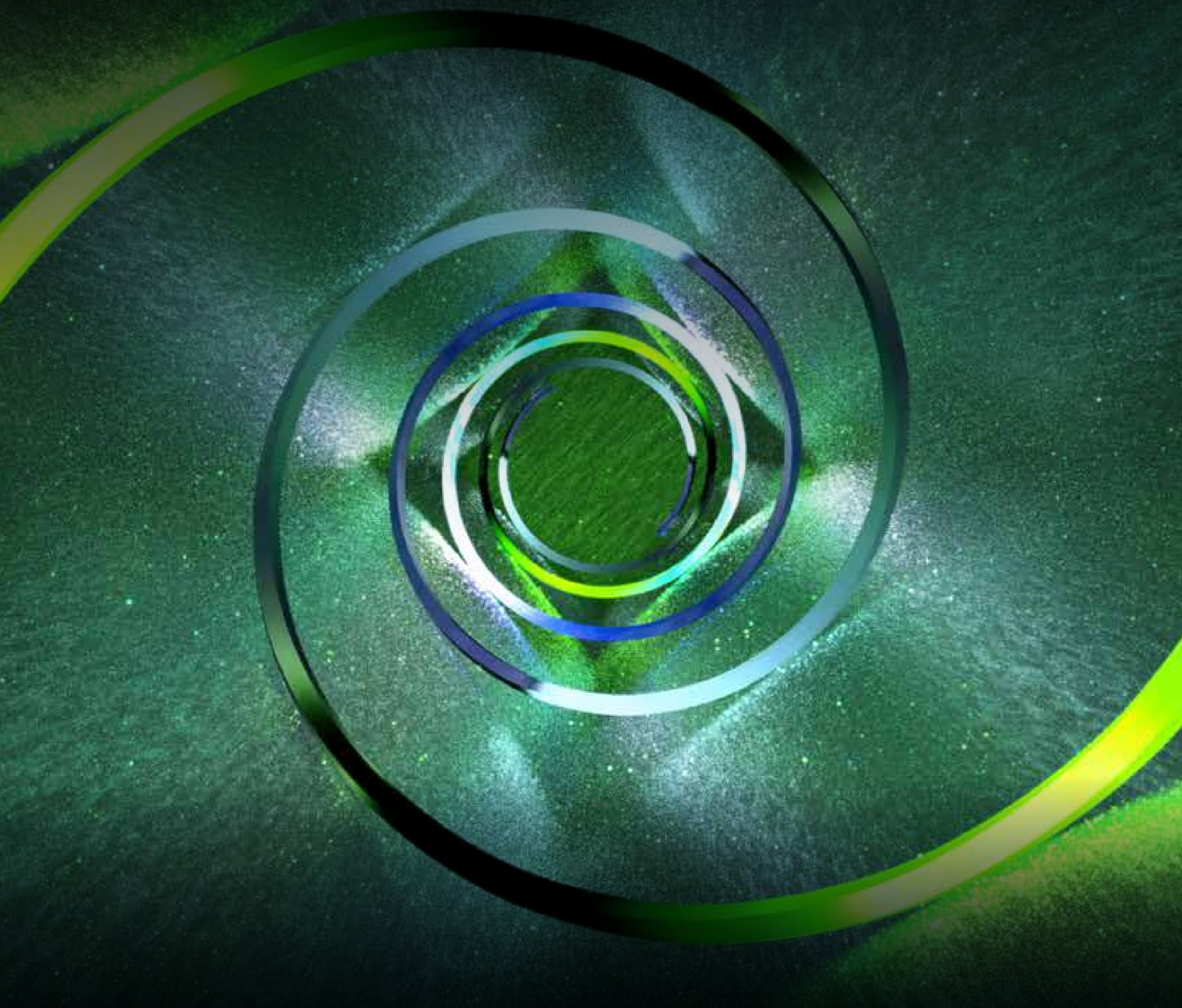
DRAFT. PENDING APPROVAL.

INSIGHT INVESTMENT
THOUGHTS FOR 2025

NOVEMBER 2024



BNY | INVESTMENTS

EXECUTIVE SUMMARY

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- Global rates – time for a reality check: Real policy rates have moved from deep negative territory to the highest levels since before the global financial crisis, providing central banks with the flexibility to start easing. Although prudent rate cuts are necessary to underpin growth and ensure a soft landing, the exuberance of rate markets is questionable. Markets are now pricing in a faster easing cycle than previous crises, which seems at odds with an economy that is still growing and an equity market close to record highs. Unless economic data deteriorates significantly, markets may need to reassess expectations for both how rapidly rates will decline and the terminal level of rates.
- Global inflation – the best news is behind us: The outlook for global inflation remains uncertain despite the gravitation of headline rates towards central bank targets. We believe factors such as the shift from globalisation to deglobalisation will keep inflation structurally high in the coming years. In the US, sticky inflation, monitored by the Atlanta Fed, is declining at a slower rate than the headline consumer price index and has stabilised at around 3%. Stickier inflation is just one of the challenges facing central banks, with food prices and money supply turning upwards once again.
- Multi-asset – a simple approach is unlikely to work in 2025: Our regime-based framework became more neutral in the summer, and we adjusted our cyclical exposures downwards. However, we are conscious that easier monetary policy should support economic activity, potentially shifting us into a more positive growth regime in 2025. One concern we have is the lofty valuation of US equity markets, as history suggests valuations do matter. This may mean a more targeted approach to risk-asset allocations may be necessary in the year ahead.
- Investment grade credit – time for active managers to shine: Robust investor demand has compressed spreads to below long-term average levels. Despite this, absolute yields remain high relative to the past decade. This environment presents a unique opportunity for active managers to enhance returns beyond yield alone. In a striking contrast with research focused on active equity managers, data from Mercer indicates that median managers in global credit and aggregate strategies have historically outperformed their benchmarks. High levels of issuance should provide ample opportunities for stock selectors to capitalise on new issue premiums and unique investment stories in 2025.
- US municipal bonds – prudently enhancing yield: Taxable municipal bonds offer a higher yield compared to US Treasuries and can periodically even offer higher yields than US investment grade corporates. These issues are backed by tax revenue streams, and generally have a low likelihood of default. In our view this puts taxable municipal bonds in a sweet spot between Treasuries and investment grade credit, offering a prudent way to enhance yields while minimising credit risk.
- High yield credit – maximising exposure to the higher rates environment: High yield credit is particularly suited to compounding returns over time, with market yields high enough to amplify the power of compounding. High yield corporates have weathered the sharp increase in interest rates over recent years, and defaults in the current cycle are at relatively low levels. We believe a focus on shorter-dated strategies and larger corporate issuers that have been downgraded from investment grade can help reduce default risk.
- Secured finance – choose your risks wisely: With central banks easing rates, it may seem counterintuitive to invest in instruments with coupons linked to short-term rates. However, we believe that the high level of spreads offers the potential for still attractive levels of income, especially if easing cycles are shallower than expected. These structurally high spreads are a result of complexity premium, with the potential for illiquidity premium in less liquid assets. Such premia are available despite the fact that these issues are secured and have experienced low levels of defaults historically.
- Global currencies – check your hedge: Managing currency risk can reduce the volatility of an international portfolio and improve overall returns. However, currency-hedged share classes are often inefficient. We outline five reasons why we believe investors should rethink the use of hedged share classes – including the potential for significant performance drag over time. We believe a dedicated currency manager can offer transparency and achieve lower transaction costs compared to fund structures.

INVESTING RESPONSIBLY // 15

- Why nature risks matter, and how to integrate them within a portfolio: Nature-related financial risks are diverse, including supply-chain disruptions, commodity-price impacts, regulatory compliance costs, environmental litigation, and insurability risks. These risks can significantly impact the financial performance of investments. Some risks are idiosyncratic and specific to companies and locations, while others are systemic. Considering both types of risks is crucial for investors. Enhanced investment risk screening for nature risks is now possible, and engaging with companies on nature risks and opportunities is increasingly viable as asset-level data improves.
- Applying the TNFD framework in practice to a corporate bond portfolio: Insight conducted a case study to look at the practical implications of implementing TNFD recommendations at a portfolio level. The study concluded that enhanced investment risk screening for nature risks is possible, integrating nature risk into investment risk screening. This includes company-level analysis and portfolio-level analysis of systemic nature risks. Risk mitigation can be achieved through denial of capital, ongoing engagement with companies, and considering the duration of bonds versus the tenor of nature risks in portfolio construction.
- Access to water – a growing risk: Water risks are material and diverse, with significant implications for corporate bond portfolios. These risks include market-based transition risks, such as tightening regulations and water prices, and physical risks, such as aquifer depletion and degraded water quality. Global water risks are rising due to demographic growth and climate change, leading to increased agricultural demand, pollution, and groundwater depletion. Insight's research highlights water risk as the most material source of nature risk to corporate bond holdings.
- Impact bond rating efficacy: Impact bond analysis is essential for investors to maximise environmental and social outcomes transparently and measurably. Use-of-proceeds bonds provide a unique opportunity for fixed income investors to achieve positive impacts. Insight analyses impact bonds using a proprietary assessment framework to mitigate the risk of 'impact washing.' Since 2017, Insight has rated over 1,000 impact bonds, with 77% meeting the criteria to be classified as impact bonds. The quality of impact bonds has improved, reflecting developments in sustainability standards.

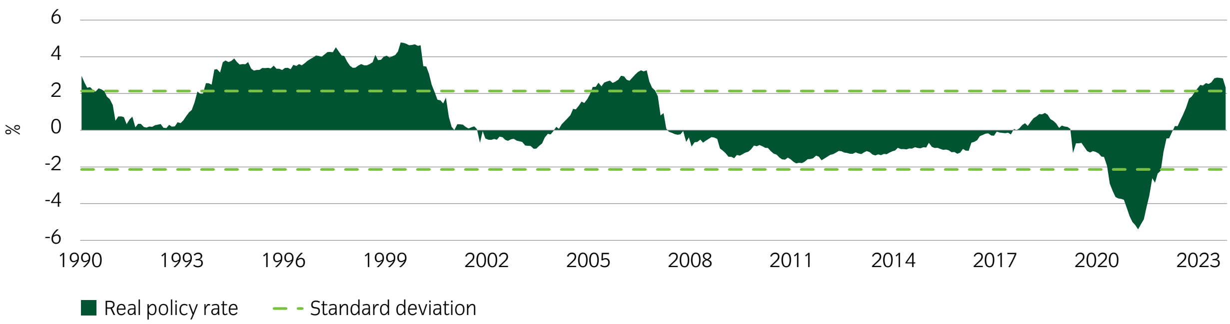
INVESTMENT

TIME FOR A REALITY CHECK

High real policy rates provide flexibility to cut

With inflation having declined significantly from peak levels, real policy rates have moved from deep negative territory to the highest levels seen since before the global financial crisis (see Figure 1). It is difficult to justify policy rates being at such restrictive levels given softer economic data, and this has provided central banks with the flexibility to start easing, despite ongoing inflation concerns.

Figure 1: Real policy rates moved to overly restrictive levels[1]



Did we miss the crisis?

Although we agree that prudent rate cuts are necessary at this stage of the cycle to underpin growth and ensure that central banks can engineer a soft landing or mid-cycle slowdown, we question the exuberance of rate markets. Looking back at history, markets are now pricing in a faster easing cycle than the tech bust, global financial crisis and pandemic (see Figure 2). This seems at odds with an economy that is still growing, and an equity market close to record highs.

Figure 2: The spread between overnight rates and 2-year Treasury yields is at crisis levels[2]

Steeper yield curves ahead

Unless data meaningfully deteriorates in the months ahead, we believe markets are likely to be forced to reassess expectations for both how rapidly rates will decline and the terminal level of rates. We believe this is likely to put a floor under yields in the intermediate are of the curve and that yields at the very long end of the curve could even drift upwards, resulting in steeper yield curves.

[1,2] Source: Insight and Bloomberg. Data as at 30 September 2024.

THE BEST NEWS IS BEHIND US

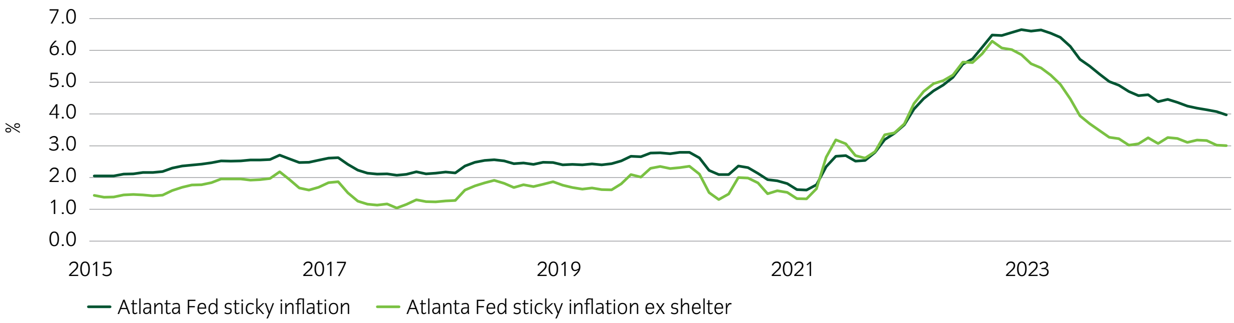
Gravitating to central bank targets

With the post-pandemic inflation spike still fresh in investors' minds, we believe many are underestimating the medium-term inflation risks. Although headline rates of inflation have moderated and are gravitating to central bank targets in the short term, the longer-term outlook for inflation remains highly uncertain. In our view, factors such as the shift from globalisation to deglobalisation will keep inflation structurally high in the years ahead.

Inflation remains stubbornly sticky behind the headline numbers

In the US, the Atlanta Fed monitors 'sticky inflation', which is a basket of goods that normally change price relatively slowly. This index is declining at a far slower rate than the headline consumer price index and excluding shelter it has stabilised and started to trend sideways at around 3%.

Figure 3: Sticky inflation has started to stabilise at a higher level[3]



Central banks have a lot to worry about

There are other worrying signs for policymakers. September saw the fastest increase in global food prices since 2022, with sugar prices spiking by 10.4% due to drought and wildfires impacting Brazil. Food prices, and commodities more broadly, appear to have bottomed and are now slowly trending upwards again, along with the broader commodity complex (see Figure 4).

Money supply is another data series that some central bankers will be carefully watching. A surge in money supply was arguably one driver of the post pandemic inflation spike, and a contraction in money supply likely proved helpful in bringing inflation back down to earth. But money supply growth is now firmly in positive territory and tending upwards once again (see Figure 5).

Figure 4: Commodities are trending upwards again[4]

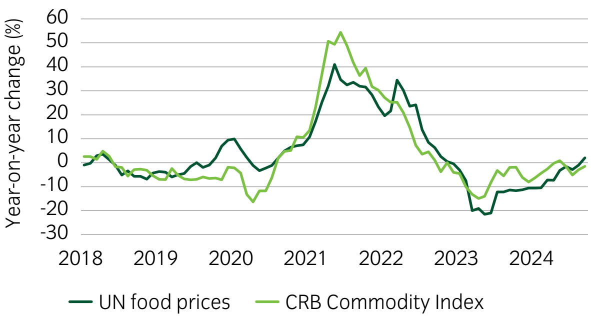
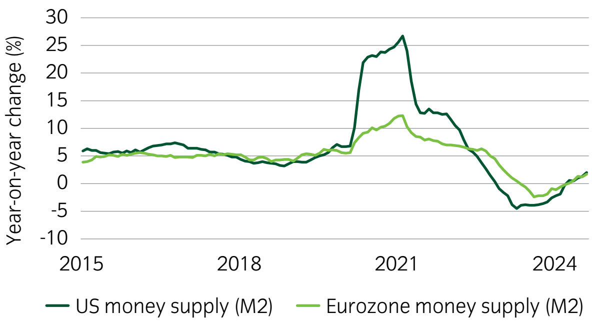


Figure 5: Money supply is turning upwards[5]



[3, 4, 5] Source: Insight and Bloomberg. Data as at 30 September 2024.

A SIMPLE APPROACH IS UNLIKELY TO WORK IN 2025

Waiting for growth to stabilise

In August 2024, our regime-based framework shifted into a falling growth regime, with inflation falling but above target and real rates falling. Normally a falling growth regime would be a negative environment for risk assets, but when combined with falling real rates and inflation, returns have historically been acceptable. With this in mind, we reduced our cyclical exposures towards long-term average levels in the summer, a level which still provides us with meaningful participation in risk markets, without leaving us overly exposed should data more meaningfully slow.

As we look forward to 2025, we are conscious that the recent weakness in growth could be short lived. Easier monetary policy should support economic activity, and this would potentially shift us back to a ‘stabilising’ growth regime. As long as the outlook for inflation and real rates remains stable, stabilising growth regimes have historically been a much more positive backdrop for risk assets. It is also often followed by a shift to an accelerating growth regime, which has historically been the most positive regime of all.

Although this suggests that 2025 could end up being another good year for asset returns, one concern we have is how much US equity markets can rally from already lofty valuations. This is an important question given US dominance of global equity indices.

When assessing the outlook, equity valuations do matter

From an equity market perspective, US outperformance, high valuations, and the dominance of the Magnificent-7 (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla) all complicate historical comparisons. In recent years, US economic outperformance has translated into better corporate performance and earnings per share (EPS) growth and, in turn, US equity outperformance. Nevertheless, the S&P 500 Index is currently trading on a 24.5 times (historical) P/E ratio. Even excluding the Magnificent-7 the Index is trading on a 21 times ratio which, in a historical context, appears expensive.

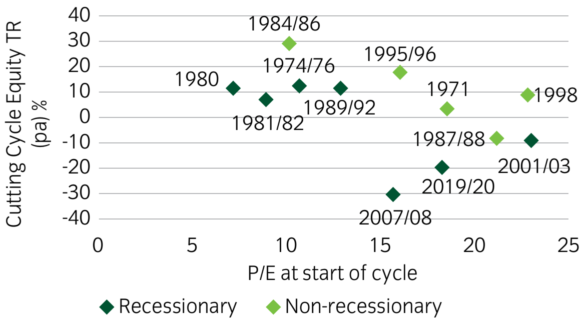
Does valuation matter, in the context of rate-cutting cycles? Figure 6 looks at US equity returns based on the P/E (trailing) at the start of a Fed easing cycle compared to the forward return (over that easing cycle). The results are not clear-cut, but lofty valuations are tricky starting points for equities, with a P/E over 15 time showing mixed results historically. As is usually the case with valuations, there are historical instances (1998) when an expensive starting point hasn’t stopped further gains. Moreover, for the two worst experiences shown – the global financial crisis (2007/08) and Covid (2019/20) – it is hard to argue that high equity valuation was the main cause of the subsequent period of distress. Perhaps the main example where that reasoning applies is 1987/88.

A more targeted approach is likely to be necessary in the years ahead

Should a broader reacceleration in growth occur in 2025, there may be an increasing appeal in expanding risk asset exposures. But we are conscious that simply increasing allocations to global equities may not be the best way to benefit from this environment given the dominance of US markets in that index. However, there is plenty of value in equity markets outside of the US, and targeted exposures to those markets with strong earnings outlooks may be one way to capture an upswing in global growth.

Another way to play this view is of course in the alternatives space. Option-based strategies allow tactical equity-based exposures to be taken that would benefit if markets moved higher, but with limited risk and the ability to build downside buffers into positions to generate a degree of asymmetry.

Figure 6: Starting P/E vs return during Fed cutting cycle[6]



[6] Source: Insight and Bloomberg. Data for S&P 500 Index as at 30 September 2024.

INVESTMENT GRADE CREDIT

TIME FOR ACTIVE MANAGERS TO SHINE

A combination of high absolute yields and tight credit spreads

Robust investor demand through 2024 has caused spreads in investment grade credit to compress (see Figure 7). Absolute yields have declined from their peaks, in part due to the compression in spreads, but remain high relative to the last decade (see Figure 8). This combination of tight spreads but high absolute yields mean some investors are waiting for spreads to widen before increasing allocations. We believe this overlooks the potential for active managers to enhance returns in fixed income markets beyond yield alone.

Figure 7: Spreads have tightened significantly[7]

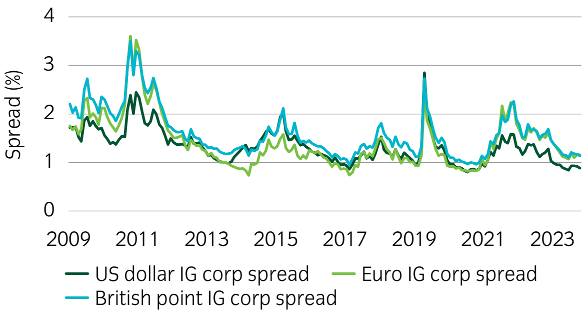
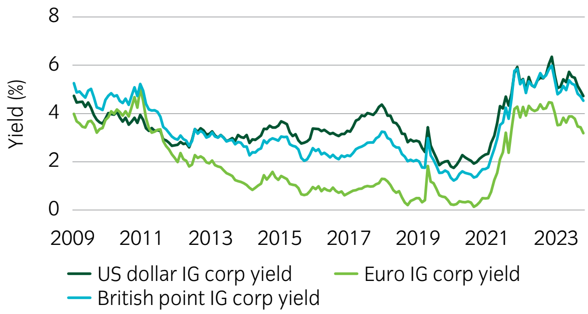


Figure 8: Absolute yields remain attractive[8]



Active managers have real potential to add value in fixed income

Many investors believe that active managers struggle to outperform or even match their benchmarks and extrapolate this idea across all investment assets. But this isn't true in fixed income markets, which are far less efficient and transparent than equity markets, presenting inefficiencies that can be exploited by active managers. The rise of passive investment in fixed income has, if anything, exacerbated these inefficiencies.

As we can see in Figure 9, data from Mercer shows that the median manager for both global credit and global aggregate strategies have historically generated long-term returns well above benchmark. For managers able to consistently achieve top quartile performance, there is an even greater potential to add value. This means that it is important not to view fixed income investment via the view of yields alone, but to also ensure that careful thought is given to manager selection, focusing on their history of generating consistent performance in excess of market returns.

JP Morgan forecast that gross US investment grade issuance will reach $1.5 trillion in 2024, with elevated levels of issuance expected to continue into 2025 as corporates seek to refinance debt issued around the pandemic (see Figure 10). Euro-denominated markets are following a similar trend. This should create an environment with significant opportunities for stock selectors, who can exploit new issue premiums and home in on idiosyncratic investment stories.

Figure 9: Median managers have outperformed in fixed income markets[9]

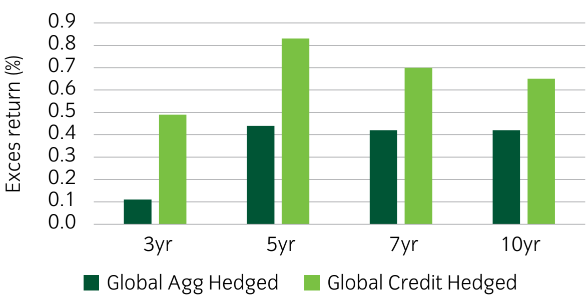
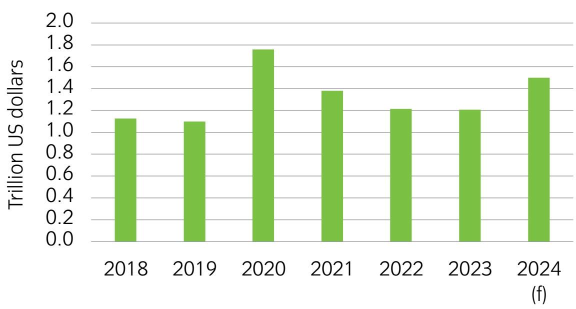


Figure 10: High levels of issuance should provide plentiful opportunity[10]



[7,8] Source: Insight and Bloomberg. Data as at 30 September 2024.
[9] Source: Mercer survey data, as at 30 June 2024.
[10] Source: JP Morgan research published October 2024.

US MUNICIPAL BONDS

PRUDENTLY ENHANCING YIELD

Yield enhancement

For those looking to enhance yields, but unable to take outright credit risk, we think taxable munis sit in a sweet spot between Treasuries and investment grade credit. Taxable municipal bonds offer a higher yield compared to US Treasuries (see Figure 11) and can periodically even offer higher yields than US investment grade corporates (see Figure 12).

Figure 11: Taxable muni versus US Treasury 30yr yield[11]

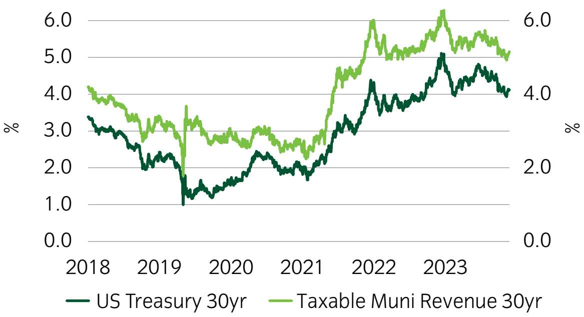
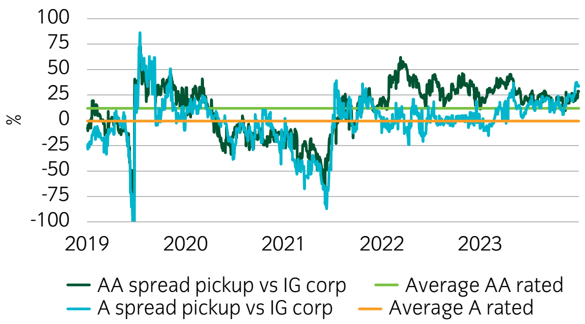


Figure 12: Taxable muni revenue bonds versus US IG corporate spread (bp)[12]



Diversification benefits

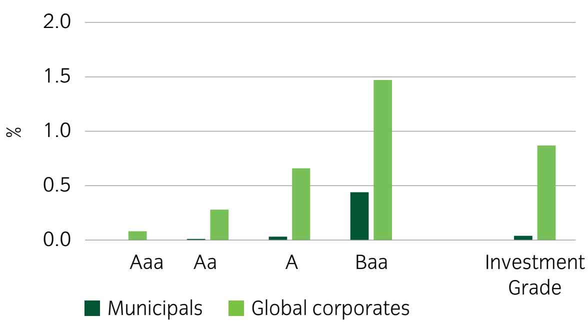
Municipal bonds can help diversify a portfolio as taxable municipal bonds have historically exhibited a more stable volatility profile than US investment grade corporate credit, while offering a comparable spread over US Treasuries. For example, the 360-day spread volatility of the US Bloomberg Taxable Index is 21.7%, significantly lower than the 360-day volatility of the Bloomberg US Corporate Agg at 30.4%.[13] There are also considerably more long-duration issues available than for global corporates.

A low risk of default

Municipal bonds typically have a high credit quality with low default risk:

- **High credit quality:** Taxable municipal bonds are backed by tax revenue streams, with many state issuers having built sizeable rainy-day funds over recent years. The credit quality of the muni universe is on a gradual improving trend despite a deterioration of the Federal governments credit rating.
- **Low default risk:** Municipal bonds generally have a low likelihood of default (see Figure 13) and when defaults do happen, recovery rates have been significantly higher than for global corporate issues.

Figure 13: Municipal bonds have a superior track record for defaults[14]



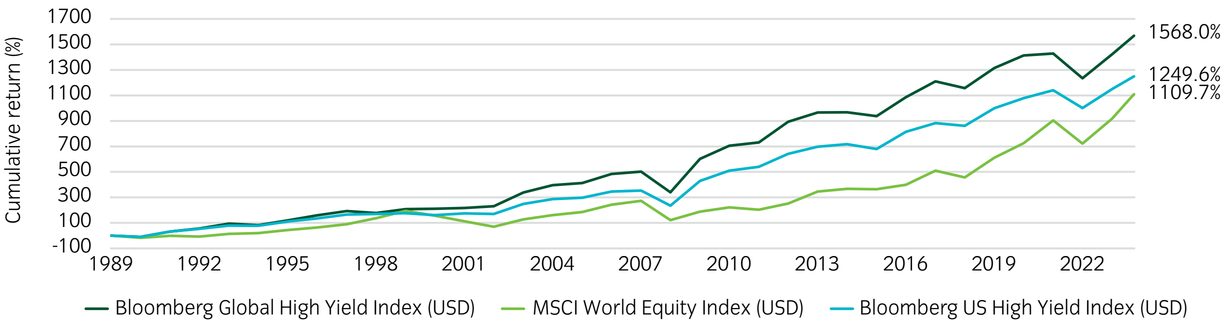
[11] Source: Bloomberg US Taxable Municipal Revenue AA 30yr, as of September 30, 2024.
[12] Source: Bloomberg US Government 30yr, Bloomberg US Corporate AA 30yr, as of September 30, 2024.
[13] Source: Bloomberg and Insight, June 2024.
[14] Source: Moody's US municipal bond defaults and recoveries 1970-2022 (published July 2023).

MAXIMISING EXPOSURE TO THE HIGHER RATES ENVIRONMENT

Harnessing the power of compound returns

One of the most powerful tools for investors is the concept of compound returns. This is where returns earned on investments increase the capital of the investor, resulting in the exponential growth of their investments over time. The higher the returns that can be generated, the greater the power of compounding. We believe high yield credit is an asset class that is particularly suited to compounding returns over time. With market yields sufficient high to amplify the power of compounding, the potential for long term growth is especially compelling. As we can see in Figure 14, over the long term, investors in global high yield have even outperformed global equity markets.

Figure 14: Global high yield has generated impressive returns over time[15]



Minimising defaults maximises returns

Defaults are an important factor for high yield investors. Although the impressive long-term returns in Figure 14 include the impact of defaults, the potential returns could be even greater if defaults can be avoided.

High yield corporates have weathered the sharp increase in interest rates over recent years and defaults in the current cycle are at relatively low levels (see Figure 15). There has been a structural change within high yield markets which should help make high yield more resilient to defaults than it has been in the past. Between 2007 and 2023, the proportion of US high yield issuers rated BB, the best rating category for high yield, increased from 37% to 47%, while the proportion rated CCC declined from 21% to just 13%. In European high yield, just 5% of the market is now rated CCC. Private credit investors have increasingly provided a bespoke financing solution to more stressed companies, which also improves the overall credit health of the HY market.

In our experience, a focus on shorter-dated strategies where there is greater visibility of cashflows and business models can also help to reduce default risk. The Bloomberg 1-5 year Global HY Index has a very similar return profile to the broader Bloomberg Global HY index but with lower volatility, providing better risk adjusted returns (see Figure 16). Strategies that focus on larger corporate issuers that have been downgraded from investment grade is another method.

Figure 15: Global high yield defaults remain low[16]

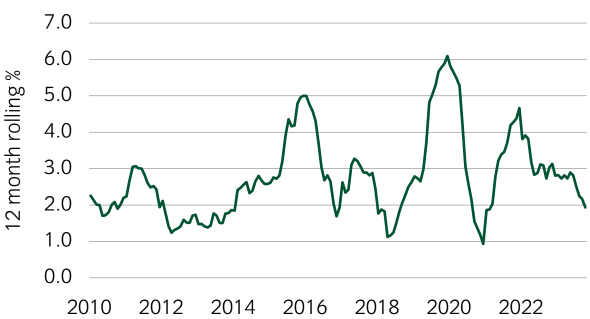
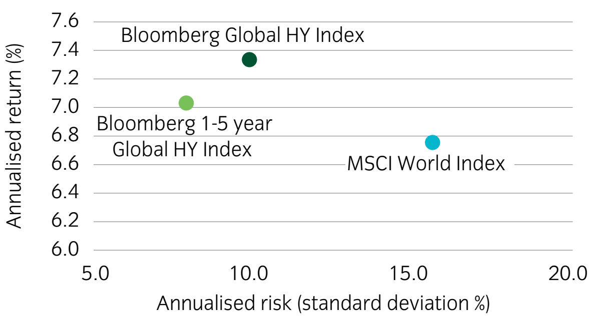


Figure 16: Reducing volatility without sacrificing returns[17]



[15, 17] Source: Insight and Bloomberg. Data as at 30 September 2024. [16] Source: Bank of America. Data as at 30 September 2024.

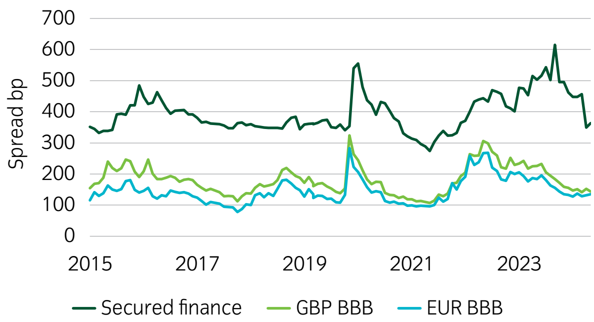
SECURED FINANCE

CHOOSE YOUR RISKS WISELY

Potential for high income even as central banks ease

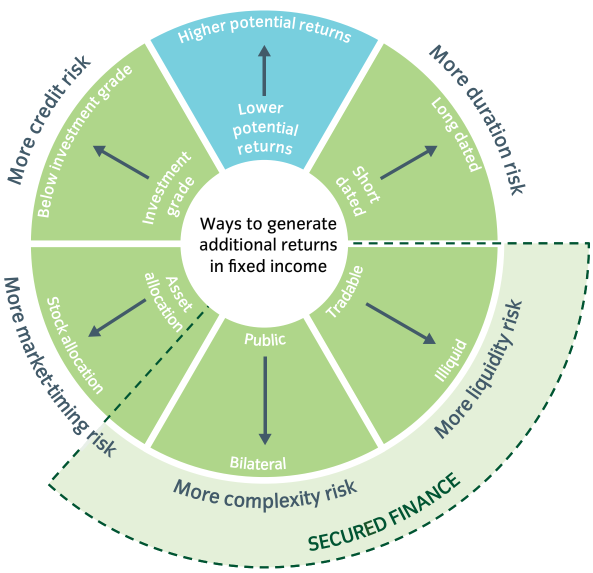
With central banks easing rates, it may seem counterintuitive to invest in instruments with coupons linked to short-term rates. However, in our view, markets have become too optimistic about how much central banks will ease rates as we expect inflation to prove stubbornly sticky in the years ahead. In our view, the terminal level of rates is likely to prove higher than many expect which, combined with the level of spreads available in the asset class (see Figure 17), should result in still-attractive levels of income in the years ahead despite central bank easing. This is in an asset class that is secured by underlying assets and where limited duration risk results in far lower price volatility than similarly rated corporate credits.

Figure 17: Secured finance spread[18]



Why secured finance offers a yield premium

Figure 18: Secured finance seeks to exploit complexity and liquidity risk[19]



1. **Structural yield premium in ABS:** Post-global financial crisis, ABS markets have consistently offered a yield premium over corporate bonds, driven by factors such as regulatory considerations, complexity, and negative sentiment.
   - **Regulatory considerations:** Regulatory changes post-crisis have made ABS less attractive for certain investors, but recent consultations may improve this environment, potentially increasing the investor base and reducing regulatory premiums.
   - **Complexity and negative sentiment:** The complexity of ABS deals and lingering negative sentiment post-crisis contribute to reduced demand and higher returns for those willing to invest in the asset class.
2. **Potential for additional illiquidity premium:** Including less liquid ABS or collateralised loans in a portfolio can further enhance returns, reduce volatility, and offers the investor more control over lending terms.

[18] Source: Insight. Shows the spread of Insight's secured finance strategy. Data as at 31 August 2024.
[19] For illustrative purposes only.

The safety of structures

ABS have an excellent historical track record, largely due to unique features such as the use of dedicated special purpose vehicles (SPVs), the use of subordinated tranches that absorb defaults, and secured underlying loan pools.

SPVs are legally distinct entities created to isolate financial risk. They are bankruptcy-remote from the originator of the underlying loans, meaning that the financial health of the originator does not affect the SPV.

This structure provides additional protection through features such as subordinated tranches and reserve funds within the SPV capital structure, which absorb defaults. The underlying loans within these structures are secured against either physical assets such as residential or commercial property, or identifiable cashflows such as consumer or corporate loans.

Since the global financial crisis, lending and underwriting standards, and therefore secured transactions structures, have been under intense regulatory scrutiny. This has led to even higher quality deals in terms of protection and understanding borrower defaults, so it stands to reason that forward-looking losses may be even lower than history suggests.

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CHECK YOUR HEDGE

Currency-hedged share classes are often inefficient

Investing in international assets can improve portfolio diversification and broaden the pool of available opportunities. One of the unintentional by-products of an international portfolio is the introduction of currency risk. There are two key features of currency exposure: the first is that, given the volatility of the asset class, currency risk can meaningfully impact overall portfolio returns; and the second is that currency exposure stemming from international assets is expected to generate zero returns. As such, managing currency risk can both reduce the volatility of an international portfolio as well as improve overall returns.

For investors gaining exposure to international assets via publicly traded funds, a common way to manage currency risk is to subscribe to a currency-hedged share class of the fund. Although this may seem an efficient and cost-effective option, our analysis shows that they are often neither.

Five reasons to rethink using hedged share classes

1. **Hedged share classes often only hedge the US dollar (USD) risk in the portfolio and leave other, smaller currency risks unmanaged.** This leaves investors with a residual currency risk that can be significant, depending on the allocation of assets and the volatility of the unmanaged currency component.

2. **If investors hold several funds with international asset exposures, holding numerous hedged share classes can lead to implementation inefficiencies and higher transaction costs, as the investors would not benefit from any netting across different currency exposure positions.** This is a particular issue if the assets in the various funds have a low, or negative, correlation.

3. **Currency risk is typically managed using derivatives, such as FX forwards, which require periodic funding of profits and losses at regular settlement intervals.** An equity manager would need to maintain a cash buffer to meet any losses that arise, which leads to a structural reduction in exposure to the underlying equity index. This has two direct implications: firstly, cashflows or collateral requirements managed at the individual investment level are not optimal and create additional drag; secondly, the fund manager of the hedged share class would be consistently under-investing in the underlying asset in order to maintain appropriate cash buffers for the FX hedges.

4. **The overall fees charged by currency-hedged share classes can be high and not transparent.** A currency-hedged share class can be both expensive and opaque. Indeed, we have observed that these types of structures can charge 1bp to 2bp more than currency managers typically charge. Furthermore, as neither management fees nor trading costs are clearly monitored, there is a notable risk of non-competitive trading costs.

5. **Most importantly, currency-hedged share classes can often experience significant performance drag relative to benchmark.** Our analysis suggests that share classes that undertake a currency hedge can persistently underperform an unhedged share class using a dedicated currency manager simply taking a passive hedging approach. This can be by close to 100bp per annum in some cases.

A simple approach may not be the best approach

In a nutshell, investing in a currency-hedged share class can be both less efficient and more costly than managing currency risk via a dedicated currency manager. Our experience is that a dedicated currency manager can offer transparency and achieve lower transaction costs through curated trading relationships when compared to fund structures.

A significant additional benefit of using a dedicated currency manager is that they can be responsible for managing all currency risk at the overall portfolio level, after working out the net currency exposures from the full underlying list of international asset exposures. This type of approach should be expected to lead to more comprehensive and efficient currency hedging as well as more efficient management of the collateral pool.

INVESTING RESPONSIBLY

THE TASKFORCE ON NATURE-RELATED FINANCIAL DISCLOSURES

While it is becoming common for investors and asset owners to act on reducing climate change risk in their portfolios, natural-capital risk has received less scrutiny. The Taskforce on Nature-related Financial Disclosures (TNFD) is a market-led disclosure framework which was finalised in late 2023 for measuring the impact of companies on nature, and their dependence on nature, building on the work of the Task Force on Climate-related Financial Disclosures (TCFD).

The TNFD is a voluntary framework, but one which is shaping regulations and investment practices. Its adoption and influence have accelerated through 2024, and this is likely to continue in the years ahead.

Despite growing investor demand for biodiversity and nature-focused investments, the supply of credible use-of-proceeds bonds (also known as impact bonds) focused on these areas remains low. It will be some time before TNFD investing can be a reality.

We expect such issuance to grow as the TNFD framework is adopted. Some issuers are in the early stages of setting nature-related targets, which could lead to new issuance.

WHY NATURE RISKS MATTER – AND HOW TO INTEGRATE THEM WITHIN A PORTFOLIO

Sources of nature-related financial risk are diverse, ranging from supply-chain disruptions, commodity-price impacts and regulatory compliance costs to rising environmental litigation and insurability risks (see Figure 19 below). Any of these could have a substantial impact on the financial performance of an investment. Whilst some nature-related risks are idiosyncratic and company and location-specific, others are systemic risks that will increasingly impact at the market level. Considering both transmission mechanisms from nature loss into financial risk is key for investors. In practice, these risks are interlinked and often mutually reinforcing; analysis by the Network for Greening the Financial System (NGFS) has highlighted the links between idiosyncratic and systemic risks within capital markets.

Figure 19: Why nature risks matter for investment portfolios[20]

Sources of nature risk	Economic risk	Financial risk
Physical risks **Decline of natural capital and ecosystem services** (e.g., water scarcity and drought)	Micro (issuer level) risks - Damage to assets - Stranded assets - Operational disruption - Increased cost of goods and services - Reduced productivity	Credit risk - Increase in defaults - Collateral depreciation Market risk - Repricing of assets - Fire sales
Transition risks **Misalignment with actions to protect and restore nature** (e.g., shifting regulation and consumer preferences)	Macro (system level) risks - Price volatility - Shifting capital and trade flows - Changes in fiscal balances - Reduced productivity	Underwriting risk - Insured losses - Widening insurance protection gap Liquidity risk - Shortages of liquid assets - Refinancing risk

[20] Adapted from: Nature-related Financial Risks: a Conceptual Framework to guide Action by Central Banks and Supervisors (PDF), September 2023, NGFS.

APPLYING THE TNFD FRAMEWORK IN PRACTICE TO A CORPORATE BOND PORTFOLIO

Insight conducted a case study to look at the practical implications of implementing TNFD at a portfolio level which can be read in our paper: Nature-related financial risks in corporate bonds: Testing the TNFD framework. We drew the following conclusions:

1 **Enhanced investment risk screening by portfolio managers for nature risks, including risks related to companies' value chains and geographical exposures, is possible**

Investment risk screening can now integrate nature risk to some extent, as the nature data landscape has evolved significantly over the past 24 months given the impetus of TNFD. In particular, the enhanced materiality assessment tools provided by TNFD and emerging corporate disclosures (e.g., under the EU Corporate Sustainability Reporting Directive) should allow for more granular assessment of material nature risks within investment risk screening. Investment risk screening should encompass both company-level analysis of nature risks as well as portfolio and market-level analysis of non-diversifiable, systemic nature risks. We can also begin to consider the tenor of nature risks and where and when these are likely to materialise within portfolios. Risk mitigation can be undertaken through denial of capital, ongoing engagement with companies and considering the duration of bonds versus the tenor of nature risks in portfolio construction – for example, we may consider holding shorter-dated bonds from issuers with an elevated natural-capital risk profile and use the point of refinancing to drive improvement in target-setting and disclosure.

2 **Engaging on company-specific nature risks and opportunities is increasingly viable as asset-level data improves**

As information improves on asset-level and geography-specific nature risks, deeper and more meaningful dialogues with investee company management on nature-related risks will be possible. The Science Based Targets Network and TNFD highlight that companies can and should be setting nature targets relating to land-use change, freshwater impacts and GHG emissions. Other important areas such as soil quality, which underpin biodiversity and other important areas of nature, can be monitored in terms of baseline condition and reported on an ongoing basis. Data gaps remain a significant issue, and a fundamental challenge remains that nature impacts and dependencies cannot be normalised into a single footprint metric to monitor and report progress – but more data is being disclosed. We note that science-based targets are emerging for important drivers of nature risk such as deforestation, and we can begin to set normative targets across portfolios and monitor performance relative to these over time.

3 **The next step will be portfolios targeting impact allocations focused on nature**

Looking beyond the consideration of nature impact and dependencies in a conventional corporate bond portfolio, we note the growing interest in use-of-proceeds instruments targeting nature and biodiversity related issues. While issuance is growing, these remain relatively scarce, small in size and relatively illiquid. There is evidence of the TFND giving impetus to new use-of-proceeds structures, as well as highlighting the range of activities and ways in which issuers can influence nature outcomes. As this pool grows, alongside improving data, we expect portfolio-level targets for a positive impact allocation to become increasingly viable.

ACCESS TO WATER: A GROWING RISK

Water risks are material and diverse

Insight's research analysing nature risks across corporate bond portfolios using the Taskforce on Nature Related Financial Disclosure (TNFD) framework pointed to water risk as the most material source of nature risk to these holdings.

From an investor perspective, water-related risks have a range of transmission mechanisms into financial impacts at both the issuer and portfolio level. Sources of risk can be broadly defined as market-based transition risks (e.g., tightening regulations, permitting restrictions and water prices) as well as physical risks (e.g., aquifer depletion leading to localised shortages for industrial users, or degraded water quality leading to operational disruption).

Historically, water prices have been very low for most users, which fails to incentivise consumers to use and discharge water efficiently given the marginal impact of water on financial performance.

Figure 20: Summary of water-related financial risks[21]

Sources of water risk	Micro (issuer level) impacts	Macro (system level) impacts	Financial impacts
Transition risks Misalignment with actions aimed at protecting water resources (e.g., tightening regulation and permitting as competition for water increases)	Stranded assets Higher operating costs Disruption to revenue streams		Credit risk – increase in defaults, collateral depreciation Market risk – repricing of assets, fire sales
Physical risks Decline in ecosystems and services derived from them (e.g., water scarcity, rising seasonal variability)	Rising insurance costs	Falling insurability of specific assets or activities	Underwriting risks – increased uninsured losses, insurance coverage gaps
		Changes in trade and capital flows, fiscal balances	Liquidity risk – shortages of liquid assets/ refinancing risk
	Disruption to operational processes	Changes in raw material input costs	Credit risk – increase in defaults, collateral depreciation

Water risks are set to grow

Global water risks are rising due to demographic growth and climate change, which in turn will lead to increased agricultural demand, pollution and groundwater depletion. The impact of such factors is already becoming clear: groundwater levels are declining in 71% of aquifer systems[22], and overall, there could be a 40% shortfall in water supply by 2030[23].

To read more on this topic, and how it could impact corporate risk, see our paper: Nature-related risks in corporate bonds – Access to water: A growing risk.

IMPACT BOND RATING EFFICACY

Insight has rated over 1,000 impact bonds from more than 500 issuers since 2017 to the end of 2023. Out of these bonds 77% have met our requirements to be classified as an impact bond. Conversely, 23% received a red score meaning they did not pass the criteria in our impact assessment framework. While we have typically seen an improvement in the quality of impact bonds, iterations of our impact bond assessment framework have reflected developments in sustainability standards to remain best in class.

Impact bond analysis is essential, in our view, for investors to maximise their environmental and social outcomes in a way that is transparent and measurable.

Use-of-proceeds bonds (also known as impact bonds) provide a unique opportunity for fixed income investors to achieve positive impacts. These debt instruments specify their proceeds will be used to have a positive environmental or social impact.

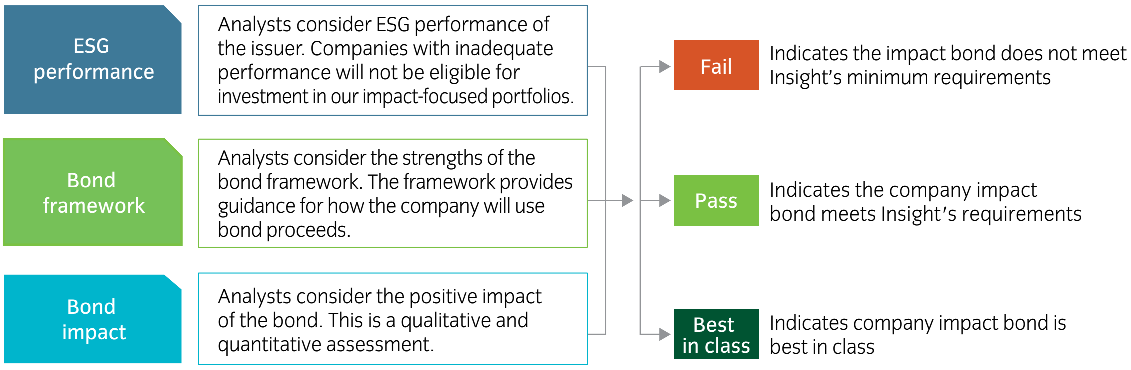
To help deliver sustainability objectives for our clients, Insight analyses impact bonds using its proprietary impact bond assessment framework to mitigate the risk of 'impact washing' of sustainable investments. Impact washing is a phenomenon whereby an issuer falsely claims an investment is impact focused with potentially little or superficial demonstration of impact. The risk of impact washing is enabled by multiple factors including:

- a lack of disclosure,
- a lack of regulation,
- the ability of impact bonds to help articulate and strengthen an issuer's sustainability credentials and strategy, and
- strong demand from investors for impact bonds.

Insight utilises an impact bond assessment framework, giving each a rating which will determine its eligibility and suitability for investment in impact strategies.

[21] Source: Insight.
[22] Rapid groundwater decline and some cases of recovery in aquifers globally, January 2024, Nature.
[23] Water Resources Management, October 2022, The World Bank.

Figure 21: Insight's impact bond assessment framework[24]



To read more on this topic see our paper: Maximising sustainability outcomes: impact bond rating efficacy.

[24] Source: Insight. For illustrative purposes only.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and costs incurred when purchasing, holding, converting or selling any investment, will impact returns. Costs may increase or decrease as a result of certain currency conversions, such as currency hedging, investment exposure to international markets, and exchange rate fluctuations.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialize or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed Income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Exposure to international markets means exposure to changes in currency rates which could affect the value of the portfolio.

Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

Currency risk management

Currency hedging techniques aim to eliminate the effects of changes in the exchange rate between the currency of the underlying investments and the base currency (i.e. the reporting currency) of the portfolio. These techniques may not eliminate all the currency risk.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

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ESG

- **Investment type:** The application and overall influence of ESG approaches may differ, potentially materially, across asset classes, geographies, sectors, specific investments or portfolios due to the nature of the specific securities and instruments available, the wide range of ESG factors which may be applied and ESG industry practices applicable in a particular investable universe.
- **Integration:** The integration of ESG factors refers to the inclusion of ESG risk factors alongside financial risk factors in investment analysis and research to judge the fair value of a particular investment and may also include the monitoring and reporting of such risks within a portfolio. Integrating ESG factors in this way will not typically restrict the potential investable universe, but rather aims to ensure that what we believe to be relevant and material ESG risks are taken into account by analysts and/or portfolio managers in their decision-making, alongside other relevant and material financial risks.

- **Ratings:** The use and influence of our ESG ratings in specific investment strategies will vary, potentially significantly, depending on a number of factors including the nature of the asset class and the structure of the investment mandate involved. For an investment portfolio with a financial objective, and without specific ESG or sustainability objectives, a high or low ESG rating may not automatically lead to a buy or sell decision: the rating will be one factor among others that may help a portfolio manager in evaluating potential investments consistently.
- **Engagement activity:** The applicability of Insight firm level ESG engagement activity and the outcomes of this activity relating to buy, hold and sell decisions made within specific investment strategies will vary, potentially significantly, depending on the nature of the asset class and the structure of the investment mandate involved.
- **Reporting:** The ESG approach shown is indicative and there is no guarantee that the specific approach will be applied across the whole portfolio.

  Performance/quality: The influence of ESG criteria on the overall risk and return characteristics of a portfolio is likely to vary over time depending on the investment universe, investment strategy and objective and the influence of ESG factors directly applicable on valuations which will vary over time.
- **Costs**: The costs described will have an impact on the amount of the investment and expected returns.
- **Forward looking commitments and related targets:** Where we are required to provide details of forward-looking targets in line with commitments to external organizations, e.g. Net Zero Asset Managers Initiative, these goals are aspirational and defined to the extent that we are able and in accordance with the third party guidance provided. As such we do not guarantee that we will meet them in whole or in part or that the guidance will not evolve over time. Assumptions will vary, but include whether the investable universe evolves to make suitable investments available to us over time and the approval of our clients to allow us to align their assets with goals in the context of the implications for their investments and issues such as their fiduciary duty to beneficiaries.

Insight applies a wide range of customized ESG criteria to mandates which are tailored to reflect individual client requirements. Individual investor experience will vary depending on the investment strategy, investment objectives and the specific ESG criteria applicable to a Fund or portfolio. Please refer to the investment management agreement or offering documents such as the prospectus, Key Investor Information Document (KIID/KID) or the latest Report and Accounts which can be found at www.insightinvestment.com and where applicable information in the following link for mandates in scope of certain EU sustainability regulations https://www.insightinvestment.com/regulatory-home/sustainability-regulations/; alternatively, speak to your main point of contact in order to obtain details of specific ESG parameters applicable to your investment.

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