T. Rowe Price

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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.

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 side of secular change that aligns with our impact goals— 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.

> "Fixed Income Impact porfolios can be flexibly managed to clients' objectives.
>
> – Matt Lawton
> Portfolio Manager, Fixed Income

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"

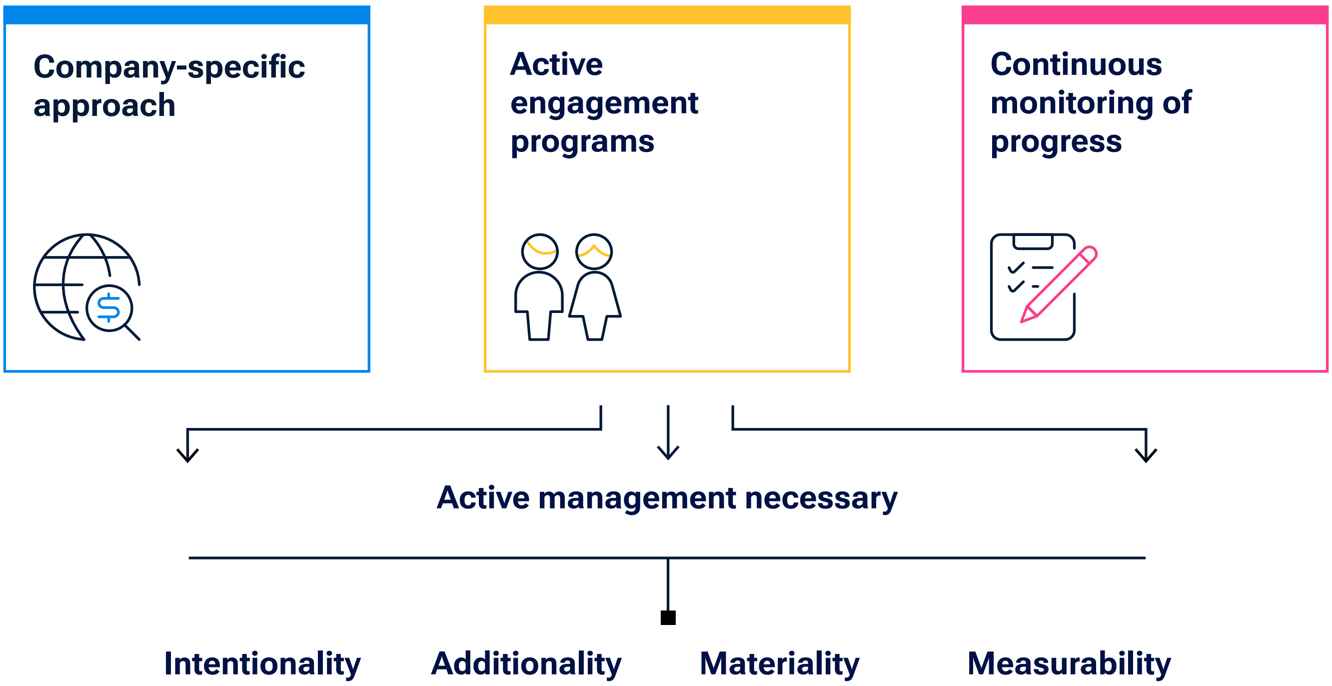
Myth 4

"An impact approach necessitates higher tracking error"

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.

Engagement

Company engagement aims to assess how our capital is being used toward achieving the desired impact investment. We don’t invest passively in corporate debt; we seek to ensure that our clients achieve their desired impact investment goals.

We believe company 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-orientated 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, materiality and measurability 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 ESG-labelled bonds, our Global Impact Credit Strategy also seeks impact investments outside the ESG-labelled bonds 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 environmental and/or social impact. Many of these companies choose to finance their activities through conventional, as opposed to ESG-labelled, bonds. We define these issuers as those where at least 50% of current revenues are aligned to our proprietary pillars, subpillars, and at least one UN Sustainable Development Goal (SDG).

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 December 2024, approximately 40% of our Global Impact Credit representative portfolio[1] was made up of high-impact, non-labelled bonds. Rady Children’s Hospital[2], a non-profit healthcare system located in San Diego, falls into this category. As the largest children’s hospital in California, the issuer creates impact through high quality care to underserved and vulnerable communities, many of whom rely on government-sponsored health insurance programs and would otherwise be unable to afford medical care. Further impact is provided through ongoing research and development into innovative drugs. 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 proprietary impact pillars, subpillars and at least one UN Sustainable Development Goal (SDG).

After identifying the pillar and subpillar 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.

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 in reduced diversification and higher systemic risk. The so-called ‘greenium’—a valuation premium for bonds that are labelled as green—although decreasing, can also compromise the relative value of labelled-bonds and reduce the alpha opportunities for investors.

[1] 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.
[2] 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.

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 strategies position, which make up the majority of the portfolio, alongside a combination of higher-beta bets and defensive offsets, whose weights will be adjusted depending on the market environment and our willingness to take on credit risk.

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).

Impact screening is the starting point of portfolio construction

Top-Down Considerations

Relative Value

- Across region, sector, currency, and curve
- Tactical vs structural

Credit Cycle

- Macroeconomic outlook
- Global views for growth, policy, and inflation
- Regional variances and dislocations

Risk Management

- Tracking error volatility
- Scenario analysis
- Correlation and common factors

Identify the objective for each security in the portfolio

Core Strategic Positions

- Long-term positions driving the portfolio
- Strong underlying credit fundamentals
- Primarily coupon and yield driven

Tactical Ideas

- High conviction ideas
- Bottom-up analysis and market dislocations
- Higher potential return, but larger risk contributors

Defensive Offsets

- Positions designed to remove portfolio imbalances
- Benefit from risk-averse environments
- Focusing on limiting downside risks

Impact and Fundamental Screening

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.

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.

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T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.