

Responsible *fixed-income* Investing

How Calvert delivers for asset owners

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Summary

- 2020 was a pivotal year for responsible investing, especially in fixed income, as the pandemic underscored the vital roles companies play in creating a sustainable global economy.
- Sustainable fixed-income issuance reached new records, spurred by growing demand, with increased allocation to environmental, social and governance (ESG) strategies, new funds and an improving regulatory climate.
- Green bonds played a major role in the investor adoption of ESG-focused strategies. Calvert is one of the largest green bond managers in the U.S. and has been a leader in green bonds since their inception in 2010. Then, as now, proprietary research — like Calvert's — is especially vital with so many new issuers and projects that need specialized analysis.
- In active, multisector, fixed-income strategies, an investment process that fully integrates ESG research with traditional analysis, founded on complete sector-based research of specialized teams, is critical to success.



2020 was a pivotal year for responsible investing, especially in fixed income. For more than three decades, Calvert has viewed responsible investing as a positive force for influencing corporations. During the COVID-19 pandemic, the contributions companies make — or could make — toward a sustainable world never loomed larger, whether producing vaccines, restocking food shelves or managing global supply chains disrupted by the global economic slowdown.

The pandemic heightened the awareness of environmental, social and governance (ESG) factors as drivers of financial performance — a trend that has been growing for the past several years. Along the same lines, we believe COVID-19 has fostered a broader understanding of how valuable ESG factors can be in linking corporate activity to the health and well-being of society and the global economy.

Our earlier Responsible *fixed-income* Investing paper established the value ESG can contribute to bond analysis; Here we focus on its remarkable growth and Calvert's continuing efforts to deliver that value to clients.

The 2020 green bond blitz, and more

Perhaps most ESG fixed-income headlines focused on the growth in “green” bonds, which the US SIF: Forum for Sustainable and Responsible Investment (US SIF) defines as “impact investing... aimed at solving social or environmental problems.” Indeed, green bonds are the largest component of sustainable issuances tracked by the Climate Bonds Initiative (CBI), and have surpassed \$1 trillion in outstanding market value — roughly the size of the U.S. high-yield market.

Green bonds further gained global significance, with issuance in all major regions (developed and emerging) and principal fixed-income sectors — they led the sustainable bond category in issuance in 2020 (Exhibit A) with \$375 billion, and are projected to grow sharply in coming years.

But green bonds are just part of the growth of the broader sustainable fixed-income trend, which can also be seen in its increased adoption by asset managers:

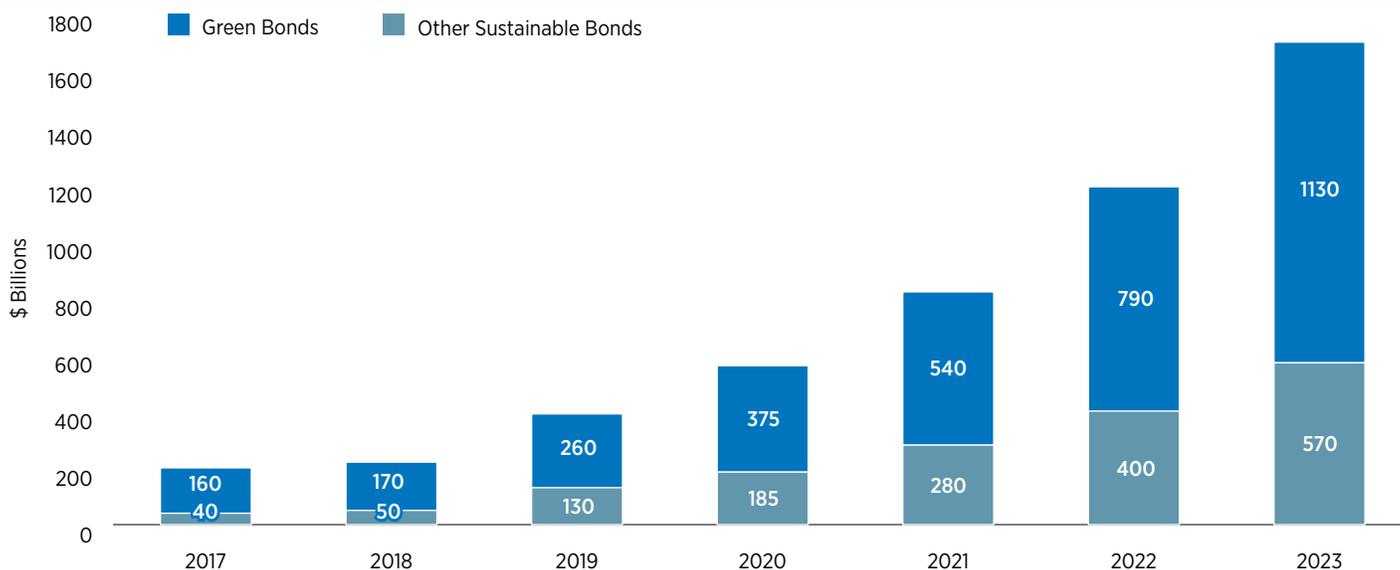
- The number of taxable, sustainable open-end and exchange-traded funds in the Morningstar universe increased by 33% to 64 in 2020. Two new sustainable municipal bond funds brought the number in that sector to 10, according to Morningstar, Inc.
- Fixed-income departments are devoting increasing resources to ESG-related research.
- ESG focus has expanded beyond investment-grade corporate credit to include other sectors such as municipal, high yield, emerging markets, securitized and floating-rate loans.

A number of policy and regulatory developments in 2020 also contributed to the growing acceptance of responsible fixed income:

- The European Central Bank (ECB) directed bond purchase programs to account for climate risks and buy green bonds.
- The U.S. Federal Reserve took steps to formally declare climate risks to be systemic, which need to be monitored and addressed by banks.

Exhibit A

Sustainable issues, including green bonds, surged in 2020





- The EU issued milestone regulations on sustainable finance disclosure regulation (SFDR) and taxonomy — a classification system that establishes a list of environmentally sustainable economic activities. (See sidebar on p. 7.)
- New green deals captured headlines in the U.S. and Europe — climate change featured prominently in U.S. elections and the European Climate Pact of December was the first big initiative of the European Green Deal. Many countries are pledging to achieve net zero emissions, and a large part of the associated investment will be funded by debt.
- The Biden administration indicated its support for “effective carbon pricing,” according to Treasury Secretary Janet Yellen, in January testimony before Congress.
- The U.S. Dept. of Labor in March 2021 said it would not enforce restrictive ESG fiduciary standards adopted by the Trump administration in the face of overwhelming opposition from commenters.

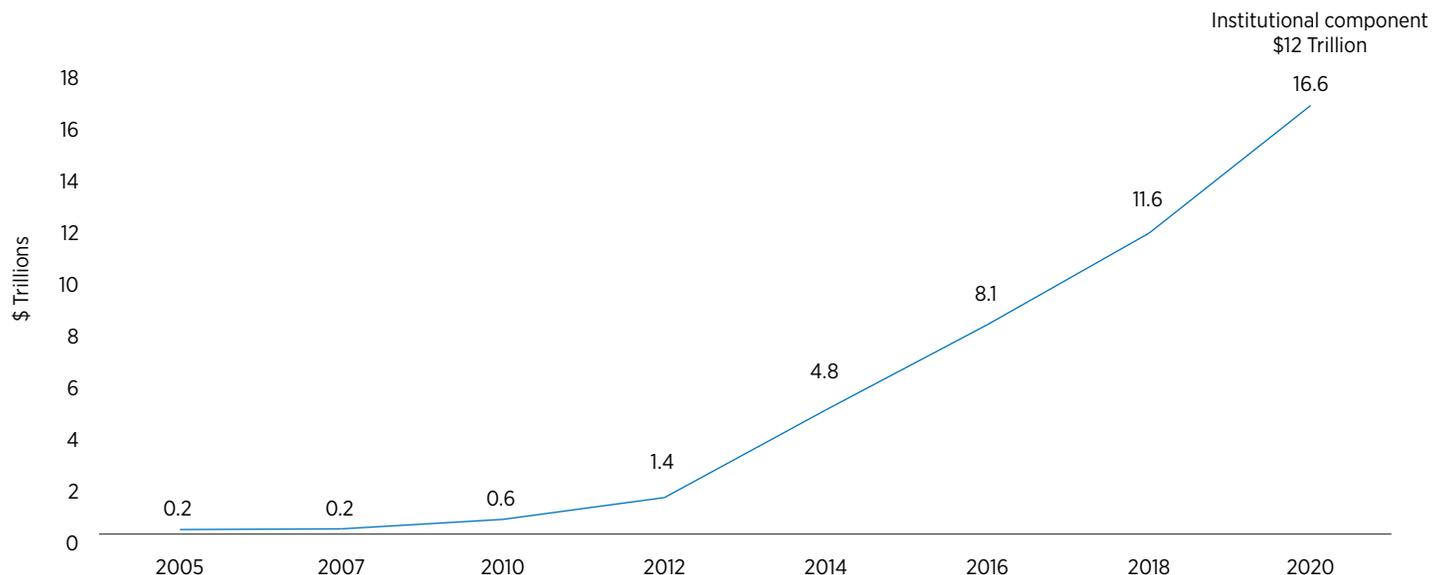
The big picture

Exhibit B shows that responsible investing continues to make large inroads among both individual and institutional investors, jumping 43% to \$16.6 trillion between 2018 (the last reporting period) and 2020, according to US SIF. Consistent with the U.N.’s Principles for Responsible Investment (PRI), which calls for strategies that “benefit the environment and society as a whole,” institutions comprise \$12 trillion, or 72%, of the US SIF total.

Exhibit B

Institutions own 72%, or \$12 trillion, of sustainable strategy assets

ESG incorporation by individual and institutional investors



Source: “2020 Report on US Sustainable, Responsible and Impact Investing Trends,” US SIF, 2020, based on money manager responses. Includes \$1.5 trillion in overlapping institutional and individual strategies.

¹The allocations cited here are based on 57 responses from institutions in a US SIF survey. It is a subset of the \$12 trillion in institutional holdings cited as part of Exhibit B, which is based on money manager responses.

Asset owners in the U.S. are largely following Europe’s path, where concerns over climate change have been a big driver for integrating ESG with traditional investing. This is true across all investor types, but the size of institutional investors was particularly notable.

Public fixed-income ESG allocations in institutional portfolios

Public ESG fixed income comprised \$113 billion, or 13% of the \$868 billion of ESG allocations incorporated in institutional portfolios, as reported to SIF in 2020, compared with 23% for publicly traded equity.¹ Two-thirds was in real estate, cash and private assets. We can only speculate on the composition of private assets and intended targets for the cash, but clearly fixed-income ESG is growing in importance to institutions.

In a thematic breakdown of the holdings, Exhibit C shows the ESG allocation for institutions overall, including equity. Note that “impact investing” comprises just \$13 billion, or 1.4% of \$913 billion of portfolio holdings, but 48 of 60 responding institutions reported incorporating such strategies. Given the interest green bonds have attracted, it will not be surprising to see their weightings grow substantially.

ESG fixed income and performance

One of the foundational beliefs of responsible investing is that all companies must address a range of ESG factors that can materially affect business outcomes. As a corollary, companies that most successfully manage ESG factors can gain an edge in long-term financial performance and create positive societal change — these are, in our view, mutually reinforcing efforts.



While most research has been on equities, the potential for ESG factors to enhance performance in fixed income has increasingly been the focus of study in recent years. A 2018 survey analysis by the World Bank observes:

A growing body of research shows that ESG factors are material credit risk for fixed income investors. The evidence suggests that incorporating ESG into fixed income investing should be part of the overall credit risk analysis and should contribute to more stable financial returns. It also dispels the myth that incorporating ESG means having to sacrifice financial returns. ESG investing is increasingly becoming part of the mainstream investment process for fixed income investors.²

A recent study by BofA Global Research bears out the World Bank’s assertion that incorporating ESG does not mean “having to sacrifice financial returns.”³

A 2019 study in the Journal of Applied Corporate Finance examined the mechanisms that link ESG performance to credit risk.⁴ It found that companies with strong ESG performance experienced fewer surprises – and lower volatility – in response to both good and bad events. As examples, in the transportation sector, firms with high ESG performance endured fewer labor problems, unexpected strikes and layoffs. In the oil and gas sector there were fewer industrial accidents. In technology/ media/telecommunications companies there were fewer terminated business contracts.

The ESG data deluge

The studies establish that ESG factors can add significant value to traditional fixed-income analysis. But developing methods to incorporate those factors within bond portfolios on an ongoing basis faces numerous challenges, especially as responsible investing has moved from a niche sector to mainstream acceptance.

The most fundamental issue is that ESG factors are only as good as the data used to evaluate them. As the interest in responsible investing surges, investors must cope with an array of data-related issues – its disclosure, integrity, proliferation and consistency. For example:

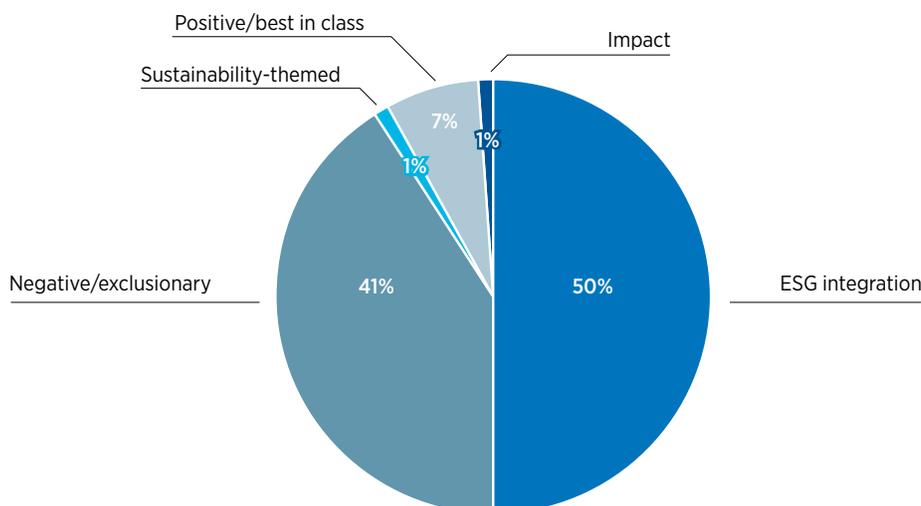
- **Corporate disclosure deficiencies.** Nine years ago, just 20% of the S&P 500 provided any type of reporting on material ESG risks; today, 90% do. Corporate ESG data disclosure has increased significantly in recent years, but gaps and inconsistencies still remain. This is especially true for fixed income, which has a large universe of issuers that still do not have fully available quantitative information.

Disclosure is now sufficient for all investment-grade corporate issuers to be assigned quantitative scores, but that is true for only slightly more than half of the high-yield corporate sector. Information is also scarce and/or uneven for private or smaller-capitalization companies and for other niche sectors like securitized bonds and bank loans.

- **Vendor data variations.** There are more than a dozen suppliers of public ESG data, produced with differing methodologies and rating scales. As a result, there is often low correlation between the ratings and contradictory investment signals. Therefore, it is not always clear which ratings best measure a firm’s performance on ESG issues that can affect its long-term value creation. Moreover, the universe of rated companies often differs among data providers.

Exhibit C

“ESG integration” strategies comprise half of institutional portfolios



Source: “2020 Report on US Sustainable, Responsible and Impact Investing Trends,” US SIF, 2020.

²G. Inderst and F. Stewart, “Incorporating Environmental, Social and Governance Factors into Fixed Income Investment,” World Bank, (2018). ³BofA Global Research, “ESG in fixed income – taking credit,” May 5, 2020 ⁴W. Henisz and J. McGlinch, “ESG, Material Credit Events, and Credit Risk,” Journal of Applied Corporate Finance, spring 2019, Vol. 31, No. 2.



Ahead of the data curve

As a leader in Responsible Investing over several decades, Calvert has long been ahead of the curve in addressing fundamental data issues, because ESG factors have always been our exclusive focus. Calvert’s philosophy and process were developed over many years when there was limited publicly available ESG data. So most analysis was conducted qualitatively on a company-by-company basis, based on the proprietary work of our dedicated research teams — as it continues today.

We view the recent profusion of ESG data as a source of both peril and promise. When investors and managers rely on one or two information vendors, as is common practice, building portfolios from the same data sets and top-line scores, similarities tend to emerge — it is a recipe for groupthink. It also represents outsourcing to vendors of a substantial chunk of fundamental analysis.

But Calvert also sees great promise in the new wealth of data and the potential for enhanced alpha generation. Our experience and expertise in Responsible Investing allows us to vet, sort and synthesize the reams of newly available information, and integrate it into our fundamental research process (discussed in the next section).

For example, public ESG data supplied by vendors is most readily available for highly rated benchmark credits. Issues with lower credit ratings often have good ESG scores, undisclosed to the public, along with attractive spreads. But, by definition, those companies exhibit some combination of weaker credit metrics, higher leverage and underlying fundamental challenges.

Calvert seeks to exploit the broadest range of issuers for financially material ESG factors, including the large and small, and the higher and lower quality. Achieving this Responsible Investing capability stems from Calvert’s particular combination of focus, philosophy, resources and experience.

We turn to Calvert’s ESG research process next, including exciting new research in the development of custom composite indicators.

Calvert’s ESG research process

The heart of the research process is *materiality* — determining which ESG factors are most germane to a particular industry and weighting them appropriately. The front end of the Calvert process is a custom model that rates and ranks companies by proprietary structural ESG scores.

The process starts with the construction of approximately 200 custom peer group models culled from subindustries, which facilitate relative comparison between companies that face similar ESG risks and opportunities (Exhibit D). For example, environmental factors have a larger material impact on a plastic bag manufacturer than, say, an accounting firm, for which social and governance factors would weigh more.

For each peer group, analysts identify key performance indicators (KPIs) — ESG factors that we believe have the biggest impact on performance. KPIs are developed by Calvert, but are also sourced from external vendors such as MSCI, Asset4, ISS, Sustainalytics and nongovernmental organizations (NGOs). Calvert selects about 300 KPIs from the thousands available.

As examples, climate and energy KPIs have the strongest relationship to financial performance in industries facing the most pressure to manage environmental impacts, such as oil and gas production, and machinery and truck manufacturing. Human capital management KPIs are common to most industries, but the indicator is especially strong for companies that must attract and retain technical workforces.

Recently, we have developed custom composite indicators (CCIs), which capitalize on the ongoing expansion of ESG information, while avoiding the data incompatibilities discussed earlier. Calvert’s CCIs aggregate ESG data from a variety of third-party data vendors to maximize the available data set. After independent testing for materiality, we then assign weight to indicators most highly associated with financial performance, and determine a proprietary ESG score for a given issuer and ESG theme. CCIs serve as a significant complement to our traditional KPI research.

Exhibit D

Calvert’s structural process focuses on key performance indicators



Source: Calvert Research and Management, March 2021.



The companies are then weighted by overall structural ESG scores — so called because they are designed to establish a baseline for how well issuers have the potential to manage ESG risks and opportunities. The scores help determine the preliminary investable universe and serve as inputs into the research team’s security selection analysis and portfolio construction, which we turn to next. In active, multisector, fixed-income strategies, an investment process that fully integrates ESG research with traditional analysis, founded on complete sector-based research of specialized teams, is critical to success.

Integrating ESG research and traditional analysis

Ongoing monitoring and performance assessment guide our understanding of how well the company measures up to the potential flagged by the structural scores, including circumstances likely to result in notable ESG performance impact. This process, which is largely qualitative, can be especially effective for issuers that lack a complete data set for ESG factors, and/or where the data is contradictory.

Exhibit E illustrates how this process is structured at Calvert — a structure that adheres to the strengths of a traditional fixed-income team, while incorporating the advanced benefits of ESG factors.

The top bullets in Exhibit E show how ESG analysis applies to securitized bonds, green bonds, floating-rate loans and municipal bonds; sector preference is driven by the team’s top-down view (Exhibit E, bottom). The opportunity set defined by the ESG analysis is integrated with traditional credit analysis, technical analysis and structural analysis, resulting in security selection. Optimal, risk-adjusted portfolios are constructed in keeping with the team’s top-down view.

ESG-focused investors expect a responsible allocation of capital that will provide competitive performance. At Calvert, we seek to tilt portfolios to overweight those issuers with favorable impact, when doing so does not impair our overall portfolio risk-reward objectives. We believe the best opportunities for successful long-term impact are in those programs that deliver competitive returns and are scalable.

Exhibit E

Portfolio construction integrates strengths of traditional and ESG analysis

ESG evaluation approaches for specific asset classes

Securitized

Asset-backed issuances are differentiated by two criteria:

- Characteristics of the sponsoring entity and securitized assets; and
- Where the ESG risk lies, between the sponsor and/or assets

Green Bonds

Traditional “labeled” green bonds as well as nontraditional issuances are evaluated under three categories:

- Green projects
- Solution providers
- Environmental leaders

Floating-Rate Loans

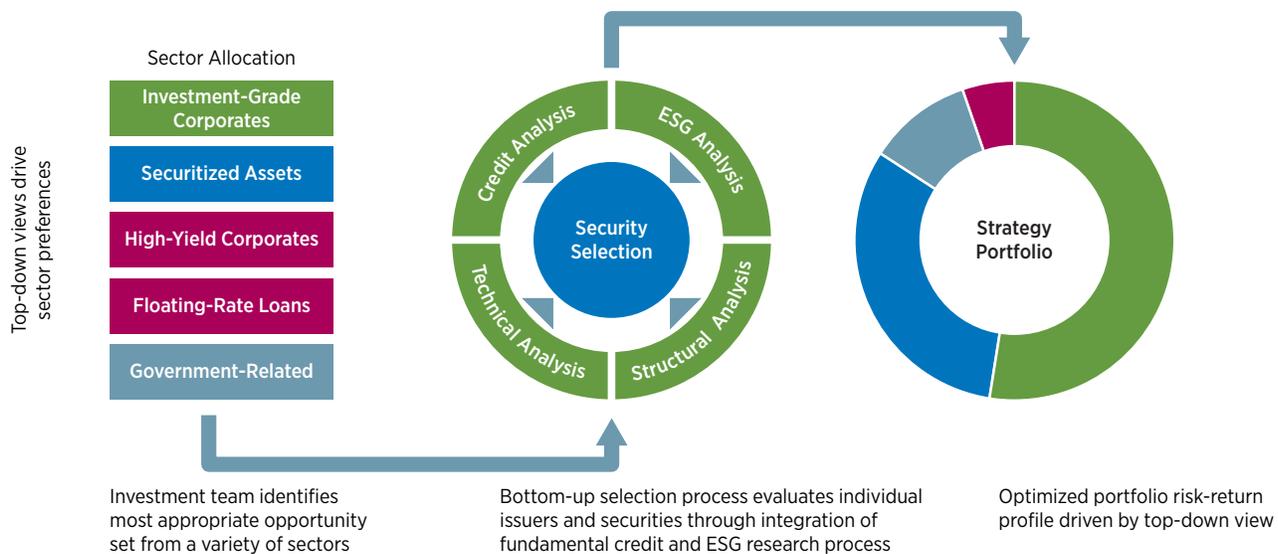
Loans are evaluated through five assessment modules:

- Business risk
- Operational performance
- Governance
- Product impact
- Circumstantial

Municipal Bonds

U.S. municipal bonds are reviewed through a four-step process to assess whether they meet ESG investment criteria:

- Credit review
- Sector rating
- Obligor rating
- Use-of-proceeds rating



Source: Calvert Research and Management, March 2021.



Engagement

Active engagement with issuers has long been central to Calvert's approach to Responsible Investing, as much for fixed income as for equities. Calvert's ongoing engagement efforts began in the mid-1980's, and in 1986 we were the first manager to file an ESG proposal.

Calvert believes that fixed-income investors have an important role to play in engaging with issuers on material E, S and G issues – a process that is mutually beneficial to investors and issuers. Our dedicated ESG team of seven professionals engages in dialogue on a wide range of issues, which helps us better assess ESG performance, and can improve the long-term value of our investments.

Engagement on the fixed-income side extends to private issuers and those with limited disclosure. This interaction is critical both for making investment decisions and with assisting issuers in identifying areas for improvement. We have periodic dialogues with management teams and actively participate in deal road shows. These forums provide for productive dialogue in discussing how issuers are managing their material ESG risks and opportunities.

At Calvert, we also advise issuers who provide direct impact investment opportunities for our clients, as we discuss next. The demand for impact in public fixed income will likely continue to grow significantly. We believe having this kind of voice is necessary to encourage the overall growth in the opportunity set while ensuring its integrity is supported by structure and scalability.

Impact: The issue-level perspective

"Impact" is widely associated with green bonds, although categorization and definitions remain very fluid, and sometimes lacking clarity. The nearby sidebar highlights recent moves to bring greater standardization to sustainability issues. Calvert's traditional working categories for "green bonds" are:

- **Green projects** — Where proceeds are directed to meeting green challenges, such as providing renewable energy resources or electric cars.
- **Solutions providers** — General obligation bonds from corporate issuers who derive a majority of revenue from clean technology or environmentally beneficial technology, products or services, such as renewables or water efficiency technologies.
- **Environmental leaders** — Issuers who demonstrate leadership in material environmental issues and, thereby, elevate industry norms.

As the market has evolved, sustainability and social bonds have emerged as new categories. Regardless of how a bond is labeled, all are not the same quality, and issuer commitment to overall ESG concerns varies widely. This underscores the need for granular understanding at the project and issue level, through the kind of independent, proprietary research Calvert has conducted for decades.

The push for sustainable bond issuance standards

As sustainable bond issuance has grown, so have questions on the part of investors, issuers and managers. For example, some issuers remain doubtful about whether their issues have sufficient impact to qualify as a green bond. Investors worry about whether they have adequate, standardized information to make well-informed decisions. In 2020, we saw some notable advances in Europe and China to address such concerns.

- **Europe.** In November 2020, the European Commission published drafts of final criteria for classifying economic activities as sustainable for climate change mitigation and climate adaptation. Criteria for other environmental objectives is slated for later in 2021. When finalized, the EU taxonomy will provide significant guidance to investors and issuers worldwide on sustainable finance classifications.

- **China.** As a dominant player among emerging markets in green bond issuance, China has made significant headway in raising its green bond qualification standards. In May 2020, the People's Bank of China proposed plans to remove "clean utilization of fossil fuel" from its list of eligible green programs. The Bank also plans to impose uniform standards for issuers across China's disparate jurisdictions.

Investors also have a role to play in telling issuers what information they deem most critical and what they regard as market best practices. As such engagement grows, we expect to see greater market growth and comprehensive standards formalized for sustainable issuance.



Impact: The broad perspective

All investors have a right to know whether responsible investing is contributing to the broad goal of substantive progress toward a sustainable economy. To achieve that, we firmly believe that broad impact must be material, measurable and reportable.

To that end, Calvert is developing a range of scores and grades for areas such as clean tech, human rights and workplace diversity, greenhouse gas (GHG) intensity and water stress. As an example, as of December 31, 2020, relative to the Russell 1000 Index, the Calvert US Large-Cap Core Responsible Index has⁵:

- 88% lower fossil fuel reserves
- 41% lower carbon emissions
- 83% lower toxic emissions

Impact reporting is an exciting development at Calvert — one we feel has major significance. Beyond the specific metrics, the broader perspective of impact reporting is sparking important discussions between

investors and managers about the specific process used to allocate capital responsibly. This sort of transparency is guiding the decisions of a growing number of investors, which in turn scales up the impact. Issuers, too, respond to such signals by modifying their culture and operations — initiatives that are further encouraged through engagement with managers and investors.

For such reasons, we believe that impact reporting eventually will take its place alongside total return, Sharpe ratios, tracking error and other key evaluation measures.

A sustained commitment

Calvert is committed to the belief that lending should be a positive force for social change and a source of long-term value. We are in the early days of fully exploiting the power of ESG factors to enhance portfolio returns, and we believe that institutions increasingly share our view. We encourage you to take advantage of our unique responsible fixed income-investment approach to help you achieve your investment objectives.

⁵Methodology - Impact metrics are based significantly on data self-reported by companies. Due to limitations in uniform reporting standards and inconsistent participation by companies, impact data coverage will vary, in some cases significantly. MSCI data is from fiscal year 2016 and applied to holdings information as of Fourth Quarter 2020. CARBON EMISSIONS (Source: MSCI, Factset): MSCI data is compiled using a company's most recently reported or estimated Scope 1 + Scope 2 greenhouse gas emissions (if available). Scope 1 emissions are those from sources owned or controlled by the company, typically direct combustion of fuel as in a furnace or vehicle. Scope 2 emissions are those caused by the generation of electricity purchased by the company. Factset data is used to calculate fund weights and overall exposure. LANDFILL WASTE (Source: Trucost): Quantity of waste that is generated by the company and is disposed to landfill. Waste is defined as direct hazardous and nonhazardous landfill and waste quantity. WATER USAGE (Source: Trucost): The sum of the volume of water used in a manufacturing or treatment process or in the actual product manufactured.



Responsible Investing

Investing primarily in responsible investments carries the risk that, under certain market conditions, the Fund may underperform funds that do not utilize a responsible investment strategy. In evaluating a company, the Advisor is dependent upon information and data that may be incomplete, inaccurate or unavailable, which could cause the Advisor to incorrectly assess a company's ESG performance.

Investments rated below investment grade (sometimes referred to as junk) are typically subject to greater price volatility and illiquidity than higher rated investments. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. In emerging countries, these risks may be more significant. As interest rates rise, the value of certain income investments is likely to decline. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. Convertible securities may react to changes in the value of the common stock into which they convert, and are thus subject to the risks of investing in equities, as well as, to the risks of investing in income securities. When interest rates rise, the value of preferred stocks will generally decline. The value of equity securities is sensitive to stock market volatility.

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Calvert Research and Management (Calvert) is a global leader in Responsible Investing. Calvert sponsors one of the largest and most diversified families of responsibly invested mutual funds, encompassing active and passively managed equity, income, alternative and multi-asset strategies. With roots in Responsible Investing back to 1982, the firm seeks to generate favorable investment returns for clients by allocating capital consistent with environmental, social and governance best practices and through structured engagement with portfolio companies. Headquartered in Washington, D.C., Calvert manages assets on behalf of funds, individual and institutional separate account clients, and their advisors. For more information, visit calvert.com.

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