Incorporating ESG trends into IG credit strategies

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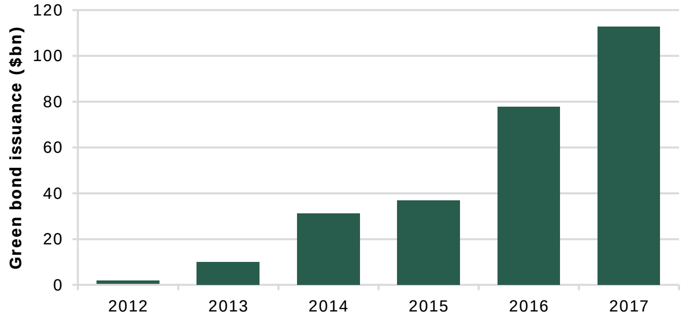
Environmental, social and governance (ESG) investing has reached a number of significant milestones, particularly in the area of fixed-income investment-grade (IG) credit strategies. The good news for investors who want socially responsible investing is that the amount of green-bond supply, benchmarks, and performance tracking tools are more robust than ever. Below we highlight recent developments for credit–related impact investing.

- Green-bond issuance reached record levels in 2017 and included a broader spectrum of issuers, intended uses, and geographies.
- A largely unified reaction against President Trump's decision to withdraw from the Paris Agreement affirmed the overwhelming dedication to combating climate change.
- ESG integration in fixed-income portfolios continues to gain popularity, especially as new tools allow a variety of investors to achieve varying levels of portfolio ESG integration.

Green bonds are an increasingly important market segment
2017 marked the 10-year anniversary of the first green-bond issuance, when the European Investment Bank came to market with what it dubbed a "unique opportunity to participate in the financing of renewable energy and energy efficiency." This issuance marked the inaugural deal in what would become a globally-recognized financial instrument that has continued to evolve. Green-bond issuance ended 2017 with $112 billion in new supply, which was an increase of nearly 200% from just two years earlier. Both supply and demand for these bonds have increased sharply since they were first introduced.

Green-bond issuance has increased sharply



Source: Bloomberg League Tables

The diversity of green-bond issuers, uses, and geographies has also expanded. Taking a look at issuers, the French government broke two records with its inaugural green bond issuance in January 2017. It became the first country to issue a sovereign green bond and it issued the largest (7 billion euro) green bond ever. The government stated that the proceeds from the issuance would "fund central government expenditure under the 'Invest for the Future' programme to fight climate change, adapt to climate change, protect biodiversity, and fight pollution." The issue was more than three times oversubscribed as demand exceeded 23 billion euro.

Another trend is the emergence of China as an upcoming leader in climate-change management. Notably, Chinese companies accounted for nearly a quarter of non-supranational green-bond issuance in 2017. In addition, the Chinese government has announced plans to develop green manufacturing in the Yangtze River Economic Belt, where the total industrial output of green manufacturing in the region is expected to reach 5 trillion yuan ($742 billion) by 2020. This region includes heavily polluted cities, such as Shanghai, as well as some of the highest concentrations of industrial facilities in the world. The Chinese government has also announced plans to create hundreds of green manufacturing facilities and upgrade existing ones in an effort to curb pollution. Accordingly, the China Development Bank has been a prominent regional issuer of green bonds. As other developing nations make the decision to consciously balance industrialization and development with environmental responsibility, we expect the list of emerging market green- bond issuers to grow.

Largest emerging market green-bond issuers

Developing issuers: Domicile	Inaugural green bond issuance	2017 green bond issuance ($ billion)
China	2015	$25.4bn
Mexico	2016	$4.0bn
India	2015	$1.5bn
Brazil	2015	$1.0bn
Argentina	2014	$0.5bn

Source: Bloomberg League Tables

Within corporate issuers of green bonds, a prevalent trend is the shift of funding needs from one-off projects to longer-term sustainable investments aligned with a company's business objectives. Apple Inc.'s 2017 green-bond issuance highlights this trend. When Apple issued green bonds in 2016, the use of proceeds contained a vague list of green projects, such as "finance renewable energy, energy storage and energy efficiency projects, green buildings and resource conservation efforts." By 2017, however, Apple had introduced the firm-wide goal of a "closed-loop supply chain" where "products are built using only renewable resources or recycled material." The company's $1 billion green-bond issue in June 2017 had a "focus on advancing Apple's goal of a closed-loop supply chain." This alignment of long-term corporate goals with the availability of funding through the credit market highlights a success of the maturing green-bond market through the alignment of investor and borrower goals. Apple's transparency with the use of green bond proceeds—through both auditor-mandated reporting as well as its voluntarily-published Annual Environmental Responsibility Report—provides green-bond investors with confidence that their investment is creating a positive environmental impact.

Widespread support for Paris Accord on Climate Change
The unified progress toward the goals of the 2015 Paris Agreement, even as U.S. President Trump announced in June 2017 that the United States would be withdrawing from the Paris Accord, is a testament to the widespread belief in the principles outlined in the agreement. Below we discuss the broad commitment to combating climate change, which draws attention to the fact that many ESG-related financing decisions are made at the local and corporate rather than national levels. As a result, bottom-up security selection has become more important for ESG investors.

A broad coalition of businesses, investors, cities, states, tribes, educational institutions, and faith organizations from around the country arose as the "We Are Still In" movement to pledge support for the goals of the Paris Agreement. From this movement came what is being referred to as the Chicago Charter—an agreement and commitment to cutting the nation's greenhouse emissions at the municipal level. Provisions of this deal, which has been signed by dozens of mayors, show the unwavering and independent local support for the Paris Agreement to:

- Achieve a percentage reduction in greenhouse gas emissions equal to or greater than our nations' Nationally Determined Contributions to the Paris Agreement,
- Advocate alongside other mayors for greater local authority and flexibility to develop policies and local laws that empower cities to take aggressive action on climate, and
- Incorporate the realities of climate change and its impacts into local infrastructure and emergency planning through strategies of adaptation and resilience.

We've seen this affirmation of commitment translate directly into policy at the corporate level, much like Apple's closed-loop supply chain pledge. Several companies are industry leaders in long-term environmental stewardship:

- Anheuser-Busch InBev announced in 2017 its commitment to secure 100% of the company's purchased electricity from renewable sources by 2025 (6 terawatt-hours).
- Qualcomm Inc. set a similar goal, which aligns with the Paris Agreement, to "reduce absolute Scope 1 and Scope 2 greenhouse gas (GHG) emissions from global operations by 30% compared to a 2014 baseline, by 2025."
- Dell Inc. reaffirmed its commitment to combating climate change in a statement released the day after Trump's decision to withdraw from the Paris Accord, saying "as political landscapes change, our point of view does not. We remain committed to our policies and the targets we've outlined as part of our 2020 Legacy of Good Plan."

Like these issuers, Wells Fargo has continued to work toward achieving its environmental goals, including those outlined in our 2020 Environmental Sustainability goals to:

1. Develop and deliver products and services that advance clean technology and environmental solutions,
2. Enhance the environmental performance of our operations, and
3. Provide $65 million in support to critical environmental needs.

Developments in ESG integration in investment-grade credit The increased interest in ESG-conscious credit products has led to the rapid evolution of the management tools and approaches for portfolio managers. These new tools include research vendors and ESG-related benchmarks. New approaches include more and better ways to blend impact investing with traditional fixed-income investing.

1. ESG research
Similar to the way credit-rating agencies provide independent research and assessment of credit metrics, several ESG rating services have emerged that provide research into the environmental, social, and governance footprints of credit issuers. For example, the MSCI ESG research service rates a universe of 17,686 companies on 14 environmental issues, 15 social issues, 5 governance issues, and 8 country-specific issues, to provide an aggregate ESG score. As demand for this sort of specialized research has increased, several other companies have entered the ESG research space, including Bloomberg L.P., Dow Jones, Thomson Reuters, and Sustainalytics. We supplement our fundamental research process with these research tools to assess credit risks from a different perspective, which adds a new dimension to our research process and provides further opportunities to generate alpha through security selection.

2. ESG fixed-income performance tracking

Perhaps one of the most telling signs of the growth of socially responsible credit tools is the vast availability of uncorrelated ESG-related benchmarks. Not only does this highlight the strong demand for this kind of product, but also the different approaches an investor could take in constructing a socially responsible investment portfolio.

The table below shows a small subset of available ESG-related fixed-income indices.

Examples of ESG-related fixed-income indices

Index	4Q 2017 total return	Inception	Holdings
Bloomberg Barclays MSCI US Corporate ESG Focus Index	1.16%	Jan 2013	Corporate
Sage ESG Intermediate Credit Index	0.17%	Mar 2017	Corporate
Bloomberg Barclays MSCI Global Green Bond Index	1.45%	Dec 2013	Aggregate
Bloomberg Barclays MSCI US Aggregate ESG Select Index	0.34%	Sep 2017	Aggregate
S&P ESG Pan-Europe Developed Sovereign Bond Index	0.38%	May 2008	Sovereign

Sources: Bloomberg Barclays MSCI, Sage Advisory Services, and Standard & Poor's
Past performance is no guarantee of future results.

3. Rapid development in ESG credit strategies
Interest in the field has come from a variety of investors, including both foreign and domestic entities, pension funds, banks and insurance companies, and from investors of varying sizes. We've also seen a vast assortment of the level of ESG integration into discretionary portfolios. We view the levels of integration as a fluid scale between traditional investing and impact investing.

Impact Investing: Investing in companies with the intention of generating positive, measurable social and/or environmental impact alongside a financial return

Positive screening: Actively seeking companies deemed well-performing on certain ESG measures

ESG integration: Integrating consideration of environmental, social, and governance issues into due diligence and financial analysis

Exclusionary screening: Avoid investing in countries or sectors that do not align with values or meet other standards

Traditional investment: An investment made solely with financial purposes, such as profit or capital preservation.

The development of tools for evaluating corporate ESG makes customized levels of integration increasingly feasible. As a result, the dialogue between managers and investors has evolved from being simply risk and returns focused to a conversation that includes the impact of the investments. These are all welcome developments for both investors and investment managers because they provide additional tools to align investments with ESG goals, measure the reach of those investments, and gauge their performance against a comparable benchmark.

Outlook for responsible investing through credit
Based on the developments in the responsible credit investing space in 2017, it is hard to envision any sort of deceleration. Green-bond issuance will almost certainly increase in 2018, and it is on pace to reach the $1 trillion cumulative green-bond issuance milestone by 2020—a goal proposed by climate management nonprofit Mission 2020.

Despite the U.S.'s decision to leave the Paris Agreement, we expect global collaboration between governments (both local and national), corporations, and individuals to continue to drive advancements in combating climate change. Developing nations, such as China and India, will likely play an increasingly large part in the global effort.

We also expect regulation to continue to drive social change. For example, this year the United Kingdom will require companies to disclose gender pay-gap data. Similarly, the Hong Kong Exchange will implement rules requiring listed companies to report on environmental issues.

Demand for socially responsible investment vehicles will likely continue to grow, as we've seen the world's largest pension funds place more focus on the impact of their investments. While the Norwegian Pension Fund has been the leader in this space, Japan's Government Pension Investment Fund is expected to shift 1 trillion yen into ESG indices.

Specific to investment management, we expect client interest in socially responsible investment credit portfolios to increase. We remain optimistic that the momentum that drove development in the ESG credit space so far will persist and continue to drive change. We welcome these developments and intend to be an active participant in ways that are relevant and meaningful for our clients.

For more information

For more general information about green bonds, the proceeds of which are used for projects that benefit the environment, see the WFAM Market Insight article, "Green Bonds: Socially responsible investment trend" dated March 2017.

For more on the growing case for security selection within an ESG strategy following the U.S. decision to withdraw from the Paris Accord, see the WFAM Market Insight, "Audio, Paris Agreement" dated August 2017.

Benchmark definitions

The Bloomberg Barclays Morgan Stanley Capital International (MSCI) U.S. Corporate ESG Focus Index measures investment grade, fixed-rate, taxable corporate bonds, and is optimized to maximize exposure to positive environmental, social and governance (ESG) factors. The index aims to preserve the overall risk characteristics of the Bloomberg Barclays US Corporate Index, while targeting issuers with the highest MSCI ESG Ratings in each sector. You cannot invest directly in an index.

The Sage ESG Intermediate Credit Index SM designed by Sage Advisory Services, Ltd. Co., measures an investment strategy that aims to maximize exposure to positive Environmental, Social and Governance (ESG) characteristics, while maintaining high liquidity. Created in August 2017, the Sage ESG Intermediate Credit Index uses a proprietary selection process to identify securities from the Bloomberg Barclays US Intermediate Credit Index with optimal ESG ratings, while closely aligning duration and risk characteristics to the Bloomberg Barclays US Intermediate Credit Index. You cannot invest directly in an index.

The Bloomberg Barclays MSCI Global Green Bond Index offers investors an objective and robust measure of the global market for fixed income securities issued to fund projects with direct environmental benefits. An independent research-driven methodology is used to evaluate index-eligible green bonds to ensure they adhere to established Green Bond Principles and to classify bonds by their environmental use of proceeds. You cannot invest directly in an index.

The Bloomberg Barclays MSCI US Aggregate ESG Select Index is a fixed-rate, investment grade bond benchmark that follows the rules of the Bloomberg Barclays US Aggregate Index and applies additional sector and ESG criteria for security eligibility. In addition, treasury, securitized, and class 2 government-related (agency, local authority, sovereign, supranational) and corporate (industrial, utility, and financial) sectors are weighted to match the individual sector exposures of the Bloomberg Barclays US Aggregate Index. You cannot invest directly in an index.

The S&P ESG Pan-Europe Developed Sovereign Bond Index, a rules based alternately weighted index, is the first in the family of sustainability sovereign bond indices. Alternate weights for the countries are derived by RobecoSAM's environment, social and governance (ESG) scores of the countries. You cannot invest directly in an index.

Mutual fund investing involves risks, including the possible loss of principal, and may not be appropriate for all investors. Consult a fund's prospectus for additional information on these and other risks.

Stock values fluctuate in response to the activities of individual companies and general market and economic conditions. Bond values fluctuate in response to the financial condition of individual issuers, general market and economic conditions, and changes in interest rates. Changes in market conditions and government policies may lead to periods of heightened volatility in the bond market and reduced liquidity for certain bonds held by the fund. In general, when interest rates rise, bond values fall and investors may lose principal value. Interest-rate changes and their impact on the fund and its share price can be sudden and unpredictable. Investing in environmental, social and governance (ESG) carries the risk that, under certain market conditions, the investments may underperform products that invest in a broader array of investments. In addition, some ESG investments may be dependent on government tax incentives and subsidies, and on political support for certain environmental technologies and companies. The ESG sector may also have challenges such as a limited number of issuers and liquidity in the market, including a robust secondary market. Investing primarily in responsible investments carries the risk that, under certain market conditions, an investment may underperform funds that do not utilize a responsible investment strategy.

Carefully consider a fund's investment objectives, risks, charges, and expenses before investing. For a current prospectus and, if available, a summary prospectus, containing this and other information, visit wellsfargofunds.com. Read it carefully before investing.

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