Market Perspectives

PRIVATE CLIENT SOLUTIONS

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Using ESG in Fixed Income Investing

In light of the COVID-19 pandemic, Environment, Social and Governance (ESG) issues have increasingly become key considerations for equity investors, but what about fixed income investors? The income and generally safe disposition of investment grade corporate bonds makes them an integral part of almost any portfolio's asset allocation. Furthermore, structural tailwinds should continue to bolster demand for "safe" assets. Yet despite its vast popularity and proven results, ESG is not widely discussed in conjunction with fixed income investing. Morningstar estimated there are US$1.8 trillion in open-ended sustainable investment funds around the global, with roughly one fifth of distinct strategies and total assets belonging to fixed-income funds. Here we'll discuss how some portfolio managers are already integrating ESG into their fixed income investment process as well as the benefits and challenges of doing so. This discussion will pertain predominantly to investment grade corporate bonds instead of sovereign or high yield bonds, which may utilize ESG data in slightly different ways.

ESG in Equities and Fixed Income – one in the same?

Both equity and fixed income investors can use ESG analysis for top-down research, such as gauging regulatory or industry trends, or for bottom-up research to select the best issues or issuers. However, when it comes to integrating ESG into equity analysis the process is more straightforward, which has increased adoption compared to other asset classes. When valuing equities, the focus is on determining price and ESG data can be used by practitioners in order to generate upside return or protect with downside risk mitigation. Meanwhile, investment analysis for fixed income is multi-layered with different investors focusing on factors such as payment structure, duration, seniority and credit risk. This makes ESG analysis a suitable tool for reducing downside risk by avoiding potential defaults or laggards and to a lesser extent, finding alpha generating opportunities.

Considerations when Incorporation ESG: Equities vs. Fixed Income

	Equities	Fixed Income
Types of Issuers	Public Corporation	Public Corporation, Sovereign State
Valuation Considerations	Price	Price, Payment structure, Duration, Credit Risk, Seniority
Relationship with Issuers	Owner with voting rights	Lender with credit terms
Traded	Exchange	Over-the-counter
Priority of ESG Analysis	1. Alpha Generation 2. Downside Risk Mitigation	1. Downside Risk Mitigation 2. Upside return potential
Ability to Engage with Management	-Proxy voting -Discussions when issuing equity	-Discussions before issuing debt (new or refinancing)

Source: Raymond James Ltd.

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Examples of ESG issues in Fixed Income

There are plenty of ways in which ESG factors can be incorporated into fixed income investing and transmit to more thoughtful estimations of a bond's value. Analysis at the issuer level allows for a detailed understanding of the idiosyncratic factors that relate to a company's cost of financing, bond/issuer ratings, or probability of financial distress. Research supports the idea that negative scores in environmental or social factors can translate into higher levels of potential risk in fixed income securities. As an example, United Nations Principles for Responsible Investment (UN PRI) found that companies with good employee relations are better positioned to endure financial distress given that they may be more likely to gain concessions from employees during times of financial instability. Corporate governance is often perceived as the strongest credit risk contributor within the realm of ESG. Governance issues, such as the structure and degree of independence of a corporate board, have long been used as inputs to pricing bonds, particularly in the primary market, showing that ESG principles have been utilized successfully in fixed income already. By having a solid understanding of an issuer's governance risks an investor can limit surprises such as sudden changes to financial policy, management structure or incentive plans.

Examples of ESG Criteria for Corporate Issuers

ENVIRONMENTAL	SOCIAL	GOVERNANCE
Environmental	Demographics	Business integrity
Climate change	Human rights	Shareholder rights
Biodiversity	Employee relations	Incentive structure
Energy resources and management	Health and safety	Audit practices
Biocapacity and ecosystem quality	Diversity	Board independence & expertise
Air pollution	Customer relations	Fiduciary duty
Water scarcity and pollution	Product responsibility	Transparency/accountability

Source: United Nations Principles for Responsible Investment (UN PRI)

It is important to note that investors should focus on the materiality of ESG factors, or how they can be used to quantitatively help determine valuation. As discussed in previous PCS publications related to ESG, frameworks outlined by globally-recognized institutions such SASB (Sustainability Accounting Standards Board) are important to consider. Just as with valuing equities, how we quantify ESG factors is dependent on industry/sector. For example, social issues might be more of a concern when valuing the bonds of companies in the consumer discretionary or IT sectors while environmental factors may be significant when considering the energy, materials or utility sectors.

Given that fixed income analysis is multi-layered, ESG risks should be considered in a similar approach. Take duration for example. When evaluating carbon risks on an issuer one could consider whether changes to regulation might impact 3-year bonds the same as 10-year bonds. Capital structure is also of prime importance given that any impact from ESG risks would likely be reflected more in the price of bonds that are lower down in a company's the capital structure.

Incorporating ESG into the Fixed Income Portfolio Construction Process

At the portfolio level it may be easier to bolster the ESG profile of a diversified fixed income portfolio relative to an equity portfolio. This is because the bulk of total risk in

fixed income investments are macro risks, such as interest rate risk. Therefore factors such as yield, duration, or diversification need not be sacrificed in order to bolster the ESG profile of a fixed income portfolio.

Implementing ESG factors into a fixed income portfolio is not too dissimilar from equities. Regardless of how ESG is utilized within the investment analysis and portfolio construction process, investors must develop robust and streamlined processes to help identify and manage ESG risks effectively. Various asset managers and research firms have different names for similar approaches, but we find the UN PRI classifications the most widely used and easy to identify. They note that ESG factors can be utilized within existing portfolio construction processes using a combination of three approaches: integration, screening, and thematic. There is no one-size fits all approach when it comes to incorporating ESG into the fixed income portfolio construction process so investors should do their due diligence to find the method the aligns with them best.

Characteristics of ESG Incorporation Approaches in Fixed Income

	INTEGRATION	SCREENING	THEMATIC
Gives a more complete picture of the risks and opportunities faced by an issuer	●		
Is applicable to investors that have no interest in considerations outside of their risk-return profile	●		
Largely about managing downside risk	●		
Can fit within existing investment processes	●	●	●
Restricts investment in certain industrial sectors, geographic regions or individual issuers, typically for ethical reasons		●	●
Non-financially material ESG factors or ethical considerations are incorporated into investment decisions		●	●
Directs capital towards issuers or securities that contribute to environmental or social outcomes			●
Largely about identifying opportunities			●

Source: United Nations Principles for Responsible Investment (UN PRI)

Some may assume that utilizing ESG to invest in fixed income is taking a **thematic** approach. This would entail combining specific types of bonds, such as green bonds or social bonds, in order to build a portfolio that has the intention of contributing to a specific ESG outcome. In our opinion this is more of a niche approach, suited for those inclined with investing consistently with goals beyond returns.

Meanwhile, integration and screening approaches are better suited incorporation into an existing investment processes which result in better outcomes. **Integration** involves explicitly and systematically using ESG factors in credit research, forecasts of financial statements and relative value/spread analysis. In this approach material ESG factors are used alongside traditional factors to form investment decisions. As such, ESG integration can look very different from one portfolio manager to another.

In **screening,** the goal is to apply filters to one's investment universe based on ESG factors the investor believes are material for uncovering potential bond issues or issuers to invest in. Screens can be positive, starting from a blank slate and including names that meeting certain ESG criteria, or they can be negative, which begins with an investment universe and then excludes names that don't meet certain ESG criteria. ESG screens can be built around a plethora of factors, such as propriety or third-party ESG ratings, carbon emission levels, or even board structure composition. An important consideration is that just like any other financial or accounting metric, ESG

factors should not just be viewed as static figures but analysis should also be considered to changes in a company's ESG factors over time to determine whether they are addressing issues or letting them falter.

Other than being able to perform ESG analysis to better inform your investment decisions, most institutional investors use their bond holdings to engage with companies to drive change at the source. Engaging as a tool can be used to source more ESG data from a company, help identify and measure credit risks that may be otherwise difficult to evaluate or influence how a company manages its exposure to various risks. Large investors often get a seat at the table with company management, particularly when issuers are coming to market with new debt or refinancing existing debt. In practice we often see large-integrated institutional investment firms have their fixed income and equity teams coordinate efforts in engaging with company management teams about ESG issues. When the conversation is on ESG factors that influence cash flows, and therefore enterprise value, engagement can improve long-term performance of an issuer's debt instruments and foster sustainable outcomes.

Benefits of Using ESG in Fixed Income Investing

When investors utilize ESG data in fixed income analysis the primary objective is typically to **reduce tail risk**. This is because ESG analysis can help build corporate bond portfolios that over time are less impacted by negative risk events, such as defaults or credit rating downgrades. This is of prime importance as the regulations drive corporations to transition to be more environmentally and socially friendly citizens.

Fixed income investors may also use ESG analysis for **alpha generation** by looking at trends in ESG ratings or risk factors pertaining to a given sector or issuer. For example, positive ESG momentum strategies see investors focus on bonds issued by companies that are seeing improvements to their ESG profile that the market has not yet priced in. Studies have shown that higher ESG scoring companies typically realize a modestly higher long-term return versus conventional peers and in the fixed income landscape, where each basis point carries weight, this is extremely valuable over the long-term.

Challenges remain but the tide is turning

The ability for fixed income investors to adopt of ESG analysis is not without its challenges but work is being done to address them. For example, many investors believe it is **difficult to measure and translate environmental or other goals into valuation drivers**. In reality, ratings companies such as Sustainalytics, FTSE and MSCI have been exponentially increasing their ESG data availability on not only the breadth of data but also the issuers and sectors covered. For example, as of 2018 MSCI's ESG data covered 93% of the issuers in the Bloomberg Barclays US Credit Index compared to just 75% coverage five years earlier. Investors should refrain from taking ratings at face level and instead need to pay close attention to ratings methodologies. ESG ratings agencies are not the only players increasing the availability of ESG data. Credit ratings agencies, such as S&P, Moody's, DBRS and Fitch, have also begun to incorporate ESG data into their ratings. Many global ratings agencies have been increasing their commitments to incorporating ESG by becoming signatories of the UN PRI statement on "ESG in Credit Ratings".

Despite the market having more readily available ESG data, there are many **differences between how a given company is rated among ESG rating agencies**, so investors must be cautious using ESG ratings without understanding the process of how that rating was achieved. In fact, many academic studies have found that there is low correlation between the ESG ratings of different ratings agencies.

Given that the widespread prevalence of ESG is fairly new most **ESG data is not required to be disclosed by regulatory bodies** so the availability of much of the ESG data investors rely on is dependent on companies readily divulging that data. Most large-cap corporations now employ sustainability teams to help fill this void however it may be harder for smaller cap companies to do. In fact, a recent survey by global management consulting firm McKinsey found that the biggest challenges investors have with companies' sustainability reporting practices are inconsistency, incomparability, and lack of alignment in standards.

Another challenge with ESG investing in fixed income is that there is **no global standard taxonomy**, which could open the door for greenwashing whereby companies mislead the degree to which their products are environmentally sound. Even the term "ESG" itself is subjective and can have slightly different definitions among asset managers or analysts. In order to overcome this hurdle investors should focus on widely used definitions from reputable organizations, such as UN PRI.

Using Managed Money Products

For those that want to include ESG in their practice but perhaps lack the resources to effectively conduct ESG analysis on fixed income securities, managed money products such as mutual funds and ETFs should be considered. These products allow any investor to gain access to institutional fixed income portfolio managers that utilize ESG analysis. Earlier we outlined that integration, screening and thematic are the three primary approaches to incorporating ESG into the fixed income portfolio construction process. Having an understanding of these approaches when considering various managed money products is extremely helpful in gaining insight into how a portfolio manager runs their mandate. Understanding a portfolio manager's process can help ascertain whether ESG analysis is a simple consideration within the broader process or the prime focus. There is no one size fits all approach so investors should first determine how they believe ESG analysis is best utilized and align themselves with managers that have similar philosophies.