

The next frontier

UBS Asset Management | ESG integration in fixed income



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Historically, the integration of sustainability considerations within finance has been more prevalent in listed equities than in fixed income strategies. This lag in investors implementing ESG within their fixed income investment processes has been due to a variety of reasons. These include the role of ESG in credit ratings, the shortage of sustainability indices against which to benchmark performance, and the challenges to engage with issuers. At UBS Asset Management we observe that this is now quickly changing.

Investor interest in ESG investing broadly has been rising steadily over the past three decades. This is now being underpinned by the clear support of policy makers via initiatives such as the European Commission's High-Level Expert Group on Sustainable Finance.

In a recent report published by the World Bank in conjunction with the Government Pension Investment Fund (GPIF) of Japan, "Incorporating Environmental, Social and Governance (ESG) Factors into Fixed Income Investment", the authors chart the spread of ESG investing beyond its traditional domain of the equity markets to other asset classes, including fixed income.¹ As the report highlights, given the fact that bonds comprise a key constituent of institutional investors' portfolios, investor interest in applying ESG principles to fixed income investments is hardly surprising, particularly as regulatory and fiduciary pressures increase.

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Greater levels of corporate disclosure, as well as the expansion of corresponding coverage by ESG data providers, have also provided a starting point for integrating ESG into fixed income. ESG data and ratings are now available for almost all investment grade credit issuers as well as a large proportion of high yield issuers. At the same time there have been several important innovations in the fixed income space, including the rise of green bonds, the emergence of social bonds, and unique collaborations such as between the World Bank and UBS to provide low risk sustainable investment alternatives to high grade fixed income investments. These innovations give investors the ability to allocate more private capital to sustainable fixed income instruments.

In our opinion, the next significant step is the integration of sustainability considerations into the overall credit assessment. This moves sustainability beyond a niche investing activity with significant implications for mainstream investors who are looking to apply sustainability in their credit portfolios.

At UBS Asset Management (UBS-AM) our aim is to achieve the systematic integration of ESG into our proprietary credit research process. This paper will explain our approach, as well as illustrating some of the newer developments within fixed income ESG integration. We will demonstrate the unique methodology adopted by the UBS-AM credit research analysts in applying sustainability considerations to the credit research process.

¹ "Incorporating Environmental, Social, and Governance (ESG) Factors Into Fixed Income Investments," April 2018. <http://www.worldbank.org/en/news/feature/2018/04/19/incorporating-environment-social-and-governance-esg-factors-into-fixed-income-investment>.

Integrating ESG: The limitations of ESG ratings

The UN Principles for Responsible Investment (PRI) defines integration as “the analysis of all material factors in investment analysis and investment decisions, including environmental, social, and governance (ESG) factors.”² Unfortunately, the concept of “integration” of sustainability is, in our view, often used too broadly in the industry to refer merely to the application of sustainability data or ratings into the investment process. In our view, this is due to three misunderstandings regarding the nature of third party sustainability ratings that are widely used in the industry and their place in the integration of sustainability.

Firstly, there is often a belief within the field of Responsible Investment (RI) that simply applying ESG Ratings based on some form of screening represents sustainability integration. In our opinion, what this view fails to recognize is the role of ESG research providers as providers of information and data rather than investment analysis. Without question, the data sets created by large ESG providers such as MSCI, ThomsonReuters and Sustainalytics represent an essential and invaluable service for the industry. The task of collecting ESG information and providing it in a consistent and usable format should not be underestimated given the challenges posed by inconsistent and often voluntary sustainability reporting by companies around the world.

However, while this data access represents an essential first step, the ratings that often accompany this data do not constitute forward looking recommendations but rather screenings based on historical information. Such ratings are derived from publicly reported information by companies, as well as news controversies available in the public domain. By their very nature, they are historical in orientation, generally providing an assessment of what has happened, rather than giving a viewpoint on progress and what is likely to occur in the future.

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Secondly, while the issue of financial “materiality” has been widely discussed, we view third party rating frameworks as too broad to be immediately applicable to an investment process. Given the wide range of parties that rating providers serve, the topics covered in their sustainability ratings address not only financially material information but also data and criteria that are employed for ethical screening. Furthermore, these ratings attempt to cover sustainability information that is applicable for both fixed income and equities. And while there is clearly overlap in terms of the information required, the ratings fail to address the specific needs of fixed income investors, in particular with respect to their greater focus on downside risk.

Thirdly, and most fundamentally in our view, sustainability ratings provide an assessment which is separate from the financial analysis of the company itself. By definition, this must be the case given that they come from third party ratings providers who work independently from the investment process. Consequently they do not cover the financial impact of material sustainability issues on the actual financial assessment, and can therefore only be useful from an investment standpoint when applied to the fundamental credit assessment. In short, while sustainability ratings play an important and crucial part in sustainability integration, incorporating this information within investment recommendations requires the additional and crucial application of this information by the credit analysts and portfolio managers themselves.

² Matt Orsagh, CFA (CFA Institute); Justin Sloggett, CFA (PRI); Anna Georgieva (PRI) “ESG in equity analysis and credit analysis PRI,” April 2018.

UBS-AM's approach to integration within credit research overcomes these limitations and therefore pursues integration at a higher level, beyond that of screening.

Unique challenges with addressing ESG issues in fixed income

Any analysis of the challenges inherent within addressing ESG issues in fixed income must start with the fundamental differences between the fixed income and equity asset classes and the reasons why equity approaches cannot simply be replicated within fixed income.

We have already alluded to the key difference in needs between fixed income and equity investors—the fixed income orientation towards managing downside default risk and the equity orientation toward upside appreciation. But at the more granular level of analysis, the range of considerations which must be incorporated and accounted for is wide. These were highlighted by the GPIF/World Bank Group report cited earlier. In addition to the factors noted above, we would particularly draw attention to:

- The duration / maturity of fixed income investments. Bonds can only be held for a pre-defined period, whereas an equity holding can potentially be held in perpetuity
- The place of fixed income instruments in the capital structure of the company. This differs from that of equity investments given differing layers, such as senior, subordinated debt, hybrid etc.
- Bondholders rights, which differ from those of shareholders especially with respect to voting and engagement
- Sovereigns, quasi-sovereigns, supranational, agency issuers and asset-backed are all important segments in fixed income

We believe that these challenges can only be overcome by pursuing sustainability integration at a more fundamental level than the application of third party scores that are widely available on the market today.

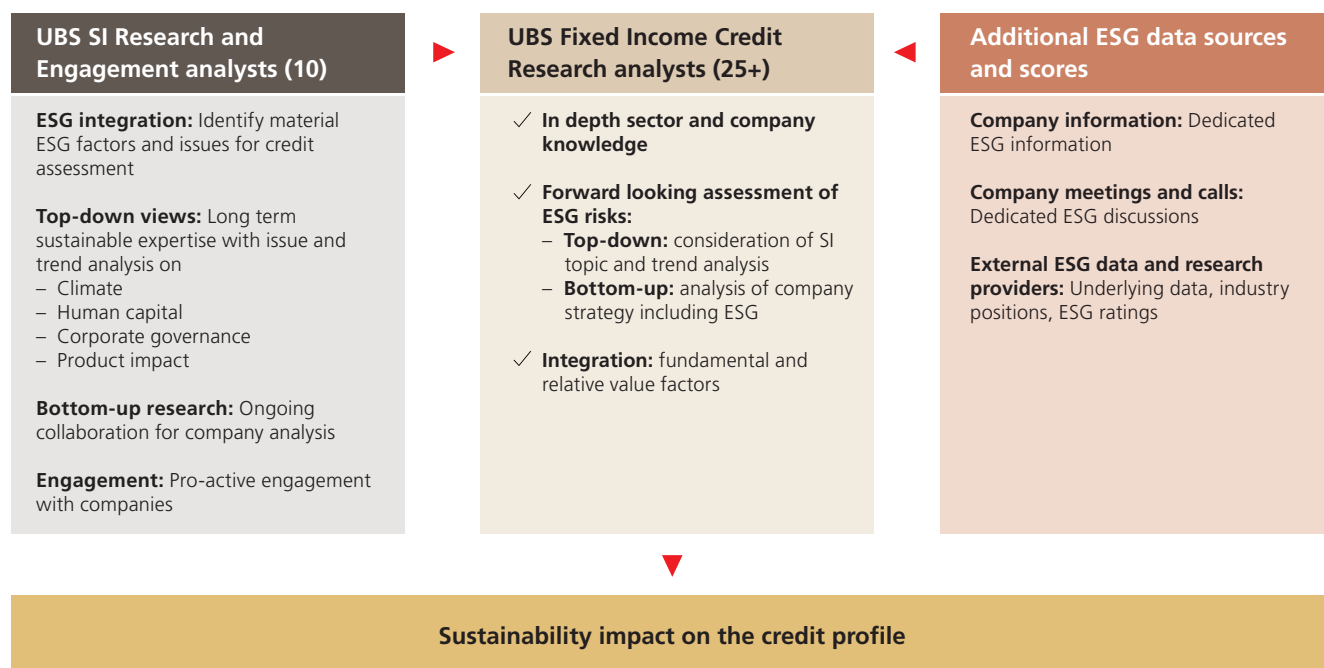
UBS solution: a proprietary, forward looking assessment

At UBS-AM we have taken the decision that ESG integration is strongest when the credit analysts sit at the heart of it. UBS-AM's fixed income team includes over 25 credit analysts with on average over 25 years of industry experience covering Investment Grade, Sovereigns, High Yield and Emerging Markets. This team is located in various centres including Chicago, Zurich, London, Singapore and Sydney.

Our credit analysts are at the centre of ESG integration in fixed income because we believe they are best placed to **make use of their in-depth knowledge of issuers and experience in fundamental analysis to provide the context in which to consider sustainability issues**. They aggregate quantitative and qualitative data, consider its relevance and materiality, put it into an appropriate recommendation framework, and then also make judgements based on sometimes incomplete and imperfect information. Analysing ESG issues requires the same skills, albeit from a different starting point, a different set of conditions and with sometimes divergent conclusions.

Crucially though, UBS-AM **credit analysts make forward looking** judgements. This judgement applies as much to ESG issues as it does to financial ones, and as such, distinguishes their work from purely ESG data gathering or scoring discussed earlier in this paper. While the current level of sustainability profile and performance of an issuer is an important starting point, dynamics of sustainability issues, timing, and expected responses by the issuer are all important forward looking aspects when it comes to assessing the credit. Finally, UBS-AM **analysts’ ownership of their understanding of sustainability issues is how we expect to further deepen ESG integration going forward.**

Collaboration is an important part of the assessment process. Credit analysts are supported in the development of their ESG analysis by UBS-AM’s sustainability investment research team. Through dialogue, they are able to address questions about the materiality of an issue, the quality of an issuer’s management of its risks, and how to balance different levels of materiality or the timing of how ESG issues are expected to develop. They also utilize various data sources to gather information.



Source: UBS Asset Management.

Two case studies below illustrate what might be considered as part of the analysis process

Case study A:

This is a European investment grade issuer in the construction materials sector. Key ESG issues are identified as climate, environment, and corporate governance. The issuer is an ESG industry sector leader, tackling almost all material factors better than peers and leading approaches in the most material ESG issues. The issuer's corporate governance is clean with an independent board, separate CEO & Chairman and no principal shareholder. The issuer also has a clean sheet in terms of controversies. On the weaker side, we see challenges around exposure to climate change, where a recent acquisition makes it more difficult for the issuer to meet its emissions reduction targets, but do not see the scale as having a material impact on the credit position. Given the overall leading ESG profile of the issuer and its highlighted strengths, we consider this to have a positive impact on our credit assessment which supports our overall favourable view on the issuer.

Case study B:

This North American high yield issuer is a private correctional/detention center operator for the Bureau of Prisons (BOP). The private prison industry fulfils a critical need for the US Government given significant overcrowding at BOP facilities. However studies indicate that contract prisons incur more safety and security incidents per capita than comparable institutions, and require additional oversight. In terms of these highly sensitive human rights issues, it is encouraging that the issuer maintains an inmate rights policy but implementation is not clear. Furthermore, the issuer is facing substantial criticism relating to serious allegations of human rights abuse and neglect of inmates in its facilities, encompassing inadequate healthcare, solitary confinement, and physical assaults. As a result it faces a number of suits and allegations. Given the high sensitivity of its core business activities, and evident weakness in managing material risks, we see risks skewed very much to the downside. The ESG analysis indicates the credit situation is more fragile than we had previously assessed.

UBS materiality analysis for sustainability integration into fixed income

The integration process is based on UBS-AM's materiality analysis, which has been developed by our sustainable investment research team working in collaboration with our credit analysts. The frameworks are based on the recommendations of the Sustainability Accounting Standards Board, the weighting methodologies of our data providers, and in discussion with individual credit and equity analysts.

This materiality analysis covers a variety of key issues across the range of sustainability factors, including corporate governance, products, business ethics, and labor. These issues are assessed for their overall credit impact, looking at the importance of a particular ESG issue, both on the credit worthiness of a debt instrument but also on its longer-term implications and impacts on the longer-term debt instruments of that issuer.

Fundamental analysis

Based on the materiality framework to focus on the most material issues, the credit analysts then assess a set of the key ESG strengths and weaknesses for each issuer. Crucially, analysts focus their research and analysis on whether and to what extent the most material sustainability issues impact the fundamental credit worthiness and risk profile of the issuer. Analysts also look at recent controversies for an additional check on the management ability, as well as for potential future liabilities for possible material impacts on credit worthiness.

The credit analysts determine whether the scale of the ESG issues is enough to impact the credit assessment. This leads them to provide an explicit assessment scored on a scale for each issue of whether and to what extent sustainability issues have an impact on the fundamental credit recommendation. The key test of this assessment is whether the scale of the ESG risks is significant enough to become one of the key considerations in the development of the issuer's credit worthiness going forward as well as the extent to which the ESG analysis leads to a change in credit opinion.

Macro trend analysis

While this bottom-up assessment of the material sustainability performance is conducted by the credit research analysts, UBS-AM's sustainable investment research team provides context for ESG issues that span different sectors. To do this, they look at the cross-sectoral topics from the point of view of relevance to credit decisions in order to understand: the overall scale of impact on credit worthiness, how the topic is expected to develop over time, and when it is expected to impact on issuers. This top-down view supports both credit analysts in their assessments, and portfolio managers who are looking to position their strategies appropriately.

Capturing outcomes

The ESG outcomes in our credit analysis are captured via our UBS ESG Score, which, put simply, requires analysts to make three key decisions for individual issuers:

- What is material impact on sustainability issues on the fundamental credit assessment?
- What is the likely future direction of the ESG Credit Score?
- Does the ESG analysis lead to a change in credit opinion?

Conclusion

By systematically integrating ESG factors across our fixed income platform we are moving a step closer to our stated ambition of broad SI integration across all our asset classes. The developments highlighted within this paper illustrate the extent to which Sustainable Investing integration within fixed income is already turning from a 'nice to have' to a 'must have' for asset owners. ESG data is more prevalent than in the past but this is only the starting point. We believe that ESG analysis by the credit analysts themselves provides an opportunity to pursue a deeper integration than has previously been done within the industry, one which is materially focused, forward looking and concentrated on the implications of sustainability for credit risks. UBS will remain at the forefront of this movement, developing innovative new strategies and solutions to answer the challenges our clients face.

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