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SUSTAINABLE FIXED INCOME

For investment professionals only
Not for public distribution

the editor's word

Every little basis point...

Talking about sustainable investing, without looking at fixed income is akin to investing in global equities without considering emerging markets. Or perhaps more like practicing tango without caring about your left foot. Yes, equities make for a larger proportion of asset owners' portfolio, but fixed income isn't that far behind. And, I am proud to say, thanks to the articles in this report, you may find that it is indeed possible to integrate SRI into practically every aspect of fixed income management.

Sustainable investing is not one-size-fits-all. It is full of grey areas, half tones and compromises. Therefore, for many years, it stayed in the realm of 'communication' and 'governance' professionals. Meanwhile, most of the investments crowd remained at a safe distance, applying exclusion rules, sometimes half-heartedly, thinking that constraining the investment universe would necessarily reduce future returns. But since the end of 2015 in the wake of COP21, many woke up to a certain degree of urgency, not least as evidence emerged that returns did not suffer from integrating ESG, especially among equity investors.

Fixed income allocations are moving too, but very slowly. Too slowly. On one hand, it is easy to understand. Bond math appeals to the least 'fluffy' people of the investment world. They have to be meticulous, if they are to count basis points. Why would they care about ESG? Most credit pickers admit they have always took 'G' into account but they wouldn't call themselves sustainable. What about 'E' and 'S'? Eyeroll... no one has reliable data. Beyond analysis, bond investors usually add, we can't do anything to influence the company, - not like the shareholders, with their votes!

On the other hand, as bond holders are scraping every little basis point off the table, with spreads compressed to razor-thin levels, shouldn't it make sense to focus on doing the 'right thing' when there is so little to lose, in relative terms? If ESG isn't currently priced in the yields, it may not add value, but it may not cost much either (but a little more work, of course).

No matter why, it is crucial that asset owners move their fixed income allocation into sustainable waters, fast. The capital this allocation represents is needed to drive shifts in infrastructure, energy and technology. Green and social bonds are perhaps not the sole answer to the earth's problems, but fixed income allocations can certainly be deployed more responsibly. Lending to support future-oriented, environmentally friendly projects is inarguably more sustainable than leveraging up mature economies that borrow from future generations and encourage excessive consumption.

I sincerely hope that this report can provide some inspiration for fixed income folks looking to shift their gears. Come on! Make every little basis point count.

Aline Reichenberg
Gustafsson, CFA
Editor-in-Chief
NordSIP

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on the owners' mind

Fixing Sustainabiliy in Fixed Income

In Sweden, how long have asset owners come regarding fixed income integration? Three experts help us understand what they have achieved so far, where they are hoping to go, and what challenges they have encountered.

In general, all agree that integrating sustainable investment practices in fixed income makes sense. “We think better sustainability practices and products would enhance the quality of a company or project, and reduce the operational risks. That would also lower the financial risk for us, and create more value for the real economy and society at large,” Gunnela Hahn, Head of Sustainable and Responsible Investment at the Church of Sweden.

“We believe that integrating sustainability aspects into the investment decision will affect the risk-return profile of the investments,” says Tobias Fransson, Head of Strategy & Sustainability at AP4.

“We strive increasingly to identify attractive investment opportunities and avoid sustainability-related risks,” says Per Lindgren, Head of Manager Selection at Skandia. “Skandia initiated responsible investing in equities in the mid-1990’ies and invested in the first green bond issued by the World Bank in 2008,” he adds.

For Fransson, however, “integrating sustainability into fixed income portfolio management is less straightforward than doing so for an equity portfolio. Various types of issuers must be viewed differently from a sustainability perspective. For corporate bonds, the application is fairly clear. AP4 screens corporate bond issuers in the same way as we screen equities for violations of international conventions that Sweden has ratified as well as against tobacco companies in which we do not invest. We were also early investors in the green bond market in 2013, and we have supported the development of that market ever since.”

Gunnela adds: “As a responsible owner we have the view that all our holdings should adhere to our investment beliefs including sustainability and ethics. So we have outlined in our investment policy the same ESG requirements for fixed income as for equities. However, sometimes the ESG scores are not applicable or available, such as for Swedish government bonds or some corporate bonds.”

> *“Integrating sustainability into fixed income portfolio management is less straightforward than doing so for an equity portfolio.”*

Gunnela Hahn,
Church of Sweden

Per Lindgren
Skandia

Tobias Fransson,
AP4

“It is hard to measure the exact degree of sustainability of our fixed income holdings,” Hahn continues. “Since we mostly have Swedish exposure (apart from some clear climate impact funds) and screen all our holdings, I would dare say that all our fixed income assets have low ESG and sustainability risks.”

> *“We have seen a very limited supply of funds offering ESG and sustainability corporate bonds.”*

“The proportion of sustainable investments in our fixed income allocation is very difficult to assess,” Fransson concurs. “The AP-funds must invest at least 30 percent of the portfolio in liquid investment grade fixed income. This implies a significant portfolio allocation to government bonds, mortgage bonds and supra-nationals, all issues where we see difficulties assessing the sustainability aspects. We are continuously working to enhance the way we view sustainability in the portfolio, within fixed income as well as other asset classes and the portfolio as a whole.”

AP4, Fransson says, does not use any external managers within the fixed income allocation. However, even for those who do, the task of selecting the right strategies is not the most straightforward. “The financial markets pose challenges for fixed income strategies to balance sustainability risks and return opportunities,” says Lindgren.

For Hahn, the offering is not as good as it should be: “We have seen a very limited supply of funds offering ESG and sustainability corporate bonds. Moreover, the market should shed much more light to mainstream credit funds since they make a much stronger link between the owner and the company than listed equity. It should, in theory, be easier for an investor to have a real influence on corporates when they ask for money than when trading their stocks on a secondary market. So the total credit market needs to transform if we are to reach for instance a two-degree world. 99% of the bond market is not green! For other assets we hold in the fixed income spectrum, such as green bonds or microcredits, their whole rationale is sustainability, so the main challenge would be that these markets are still too small and the product diversity too limited.”

As per the latest report, out of the SEK 8.7 billion the Church of Sweden manages at the national level, the fixed income portion accounts for 25.1%. In addition, alternative investments, which account for 7.2% of total holdings, also include alternative sustainable fixed income products such as microfinance and other impact- or SDG-related credit strategies. At AP4, 31% of a total of SEK 367 billion in assets are classified as fixed income. At Skandia, out assets totaling SEK 456 billion, 43.7% is invested in bonds.

> *“We strive increasingly to identify attractive investment opportunities and avoid sustainability-related risks.”*

ESG Integration

Anyone Lost in Fixed Income?

by Magnus Kovacec, CFA
CFA Society Sweden

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Magnus Kovacec, CFA
Executive Director
CFA Society Sweden

Guiding portfolio managers and financial analysts in how to incorporate ESG factors into their investment analyses and processes, the CFA Institute and UN-supported Principles for Responsible Investment (PRI) published a report on best practices. The report is based on a survey of 1,100 predominantly CFA finance professionals from around the world and the PRI reporting framework data, which is the largest global database on investors' ESG practices. ESG integration is defined as "the explicit and systematic inclusion of ESG factors in investment analysis and investment decisions."

The report, Guidance and Case Studies for ESG Integration: Equities and Fixed Income[1], explains the ESG integration methods of leading practitioners across the world, and provides case studies in how ESG analysis can be integrated into investment decision making. In addition, the report introduces a useful ESG Integration Framework as a reference for comparison of ESG integration techniques at the: 1) Research, 2) Security valuation, and 3) the Portfolio levels.

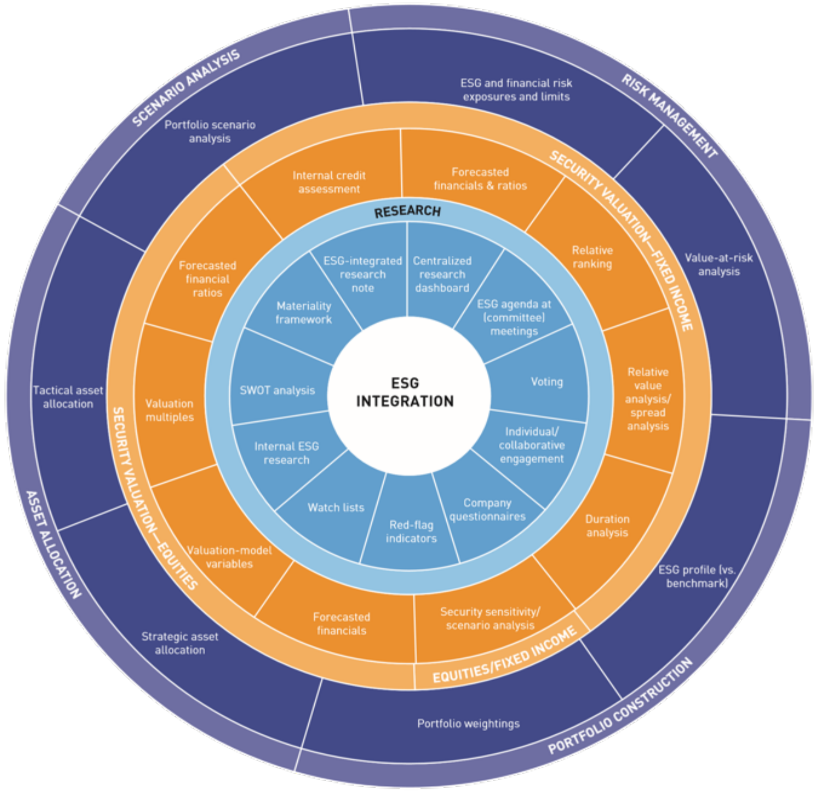

ESG INTEGRATION
RESEARCH
ESG-integrated research note
Centralized research dashboard
ESG agenda at (committee) meetings
Voting
Individual/ collaborative engagement
Company questionnaires
Red-flag indicators
Watch lists
Internal ESG research
SWOT analysis
Materiality framework
SECURITY VALUATION—FIXED INCOME
SECURITY VALUATION—EQUITIES
EQUITIES/FIXED INCOME
Internal credit assessment
Forecasted financials & ratios
Relative ranking
Relative value analysis/ spread analysis
Duration analysis
Security sensitivity/ scenario analysis
Forecasted financials
Valuation-model variables
Valuation multiples
Forecasted financial ratios
SCENARIO ANALYSIS
RISK MANAGEMENT
PORTFOLIO CONSTRUCTION
ASSET ALLOCATION
Portfolio scenario analysis
ESG and financial risk exposures and limits
Value-at-risk analysis
ESG profile (vs. benchmark)
Portfolio weightings
Strategic asset allocation
Tactical asset allocation

Figure 1: The ESG Integration Framework
(Source: CFA Institute)

Unsurprisingly there is no single best practice for ESG integration; it all depends on the individual firm, its resources and clients. ESG integration complements the practitioners' existing investment processes and practices, and no major changes may be needed. It combines fundamental analysis of both traditional financial and material ESG information in the security selection and portfolio construction processes. It does not reduce the investment universe by excluding a list of investments. Portfolio returns are not sacrificed, but ESG integration can be used to lower risk and/or enhance returns.

Fixed income is a later developer into adopting ESG integration compared to equities, but it's now expanding rapidly with its own integration techniques. Corporate credit analysis often uses the same ESG factors as equity analysis, e.g. corporate governance, or health & safety issues so important for mining companies. ESG factors can be used in credit analysis to help assess the ability of the issuer to pay its debt obligations and liabilities. Through fundamental credit analysis the key credit ratios can then be adjusted for ESG issues.

ESG integration is used to a lesser degree in sovereign debt analysis where macro-economic factors (interest rates, inflation) are more predominant. It's difficult to source ESG data on countries, especially environmental data. In addition, the environmental impact is seen as very long-term whereas social factors are more aligned with the investment horizon, and therefore analysed more. Here the perceived national level of corruption can be included to assess a country's willingness and ability to pay back its debt. Sovereign debt investors can use ESG factors at the portfolio construction level through country and regional allocation.

ESG integration in Municipal Credit Analysis includes assessing issuers' governance and management practices. Here practitioners can use credit rating agency research. In Structured Credit Analysis where Asset Backed Securities are collateralized by complex pools of underlying assets, ESG integration would involve analysing risk at several levels: transaction, servicer, collateral, and deal structure.

Drilling down on a regional basis, the follow-up report ESG Integration in the Americas: Markets, Practices and Data[2] indicates that only 13% of respondents in the U.S. state that material ESG issues are always/often included in credit analysis. An article by PRI[3] on the report observed that the U.S. is behind the rest of the world in adopting ESG integration. The reason is gaps in empirical research showing links between ESG and financial performance. Confidence in the value proposition of ESG is weaker in fixed income than equities analysis, which explains the lower adoption rate. In addition, lower demand from clients and materiality issues prevent consideration of ESG issues. Some also seem to confuse ESG integration with SRI and impact investing, with fears of excluding investment opportunities through exclusionary screening. The PRI concludes that more empirical research is needed to help U.S. investors integrate ESG and capitalize on opportunities uncovered by ESG analysis.

PRI admits that empirical studies on ESG benefits in fixed income are challenging because of the difficulty in comparing bonds with different characteristics such as: maturity dates, optionality features, interest rate duration risk, subordination levels, etc. They mention a study by Calvert Research and Management[4] from July 2015 where Reuters scores were used to back test ESG factors over the period 2003-13. The simulation used CDS spreads as a proxy for corporate bond returns (bullet maturity structure and isolation of credit risk). The results showed that the companies in the top half with higher aggregate ESG scores outperformed on a leverage and sector neutral basis, measured as the annual rate of change in CDS spreads over the 10-year period. Interestingly, the same back test now using individual E, S and G factors showed outperformance only for the companies with superior Environmental and Social scores. This indicates that Governance issues are already discounted in securities' prices, but analysis of the remaining Environmental and Social sustainability pillars offer greater alpha opportunities for investors. Perhaps most intriguingly, inclusion of ESG factors demonstrated varying degrees of efficacy across the credit quality spectrum. Lowly leveraged, high quality issuers showed no alpha generating advantage from high aggregate ESG factor scores. Instead simulation indicated that including ESG factors in consideration for highly leveraged, lower quality issuers resulted in outperformance.

The CFA Institute and PRI reports explain how ESG analysis can be integrated into investment decision making in ways which complement existing analyses and processes. In addition, a useful ESG Integration Framework is introduced as a reference for comparison of ESG integration techniques. ESG integration has a value proposition in that it can be used to lower risk and/or enhance returns. Portfolio returns are not sacrificed, since ESG integration does not reduce the investment universe by excluding a list of investments.

CFA Society Sweden[5] is one of 151 national member societies that support the global mission of the CFA Institute at a local level. Through the annual CFA Sweden ESG Awards, CFA Society Sweden recognizes the individuals, organizations or groups that have raised awareness of ESG considerations in the Swedish financial community. Last year's Award was presented to the Corporate Human Rights Benchmark (CHRB) which aims to measure the human rights performance of the world's 500 largest listed companies.

Figure 2: Examples of ESG Data Sources for Sovereign Credit Analysis

Freedom House–Freedom in the World survey
Reporters without Borders–World Press Freedom Index
Forum for a new World Governance–Worldwide Governance Index
Bündnis Entwicklung Hilft–The World Risk Index
Transparency International–Corruption Perceptions Index
World Bank–Ease of Doing Business Index
United Nations Development Program–Human Development Index
Fund for Peace–Fragile State Index
Organisation for Economic Co-operation and Development–Better Life Index
International Labour Organization–labor and health and safety statistics
Access Initiative and World Resources Institute–Environmental Democracy Index
Natural Resource Governance Institute–Resource Governance Index
Yale University–Environmental Performance Index
World Energy Council–Energy Trilemma Index
International Monetary Fund–country reports
EU–country reports

Source: CFA Institute

[1] Guidance and Case Studies for ESG Integration: Equities and Fixed Income, CFAI Institute and PRI, 2018.
[2] ESG Integration in the Americas: Markets, Practices and Data, CFAI Institute, 2018.
[3] The CFA Institute's ESG Survey, PRI, 2 March 2018, https://www.unpri.org/investor-tools/the-cfa-institutes-esg-survey/2739.article.
[4] Calvert Research and Management's ESG in fixed income investing, PRI, 2 March 2018, https://www.unpri.org/fixed-income/calvert-research-and-managements-esg-in-fixed-income-investing-study-/2741.article.
[5] https://www.cfasociety.org/sweden/Pages/AboutUs.aspx.

Global Sovereign Debt

About Machiavelli, Double Edged Swords and Virtuous Cycles

by Aline Reichenberg Gustafsson, CFA

Many investors believe that ESG is only relevant in the analysis of corporations. Templeton Global Macro, who manage Templeton Global Bond Fund*, think differently. ESG, believes Michael Hasenstab, Portfolio Manager and CIO, can have tremendous effects on macroeconomic performance, and therefore should influence his team's investment decision when selecting sovereign bonds. "ESG speaks to an economy's potential as an investment destination and the sustainability of that investment. Not only does industry research support the effectiveness of incorporating ESG analysis, but we have also found it to be a critical prong of our research process," he states in a recent white paper (Global Macro Shifts: Environmental, Social and Governance Factors in Global Macro Investing).

Economists and historians have for a long time recognised and debated the importance of environmental factors and social and political institutions for the long-term economic development of countries. Some of the early theories – going back all the way to Machiavelli in the sixteenth century – assigned great importance to the role of the environment, stressing that geography and climate determined the success of agriculture, the prevalence of diseases, and other determinants of economic growth. The purpose of environmental factors has been explored more recently by Jared Diamond in his 1997 best-seller Guns, Germs and Steel, and by Jeffrey Sachs in a 2001 paper (Tropical underdevelopment, National Bureau of Economic Research).

In short, robust governance at the sovereign level contributes to the quality, stability and predictability of the policy environment and is likely to lead to stronger growth and greater resilience. Social conditions influence the stability of a country as well as the ability of the government to enforce policies and affect national competitiveness and efficiency. Environmental factors may have a more long-term effect on the economy at the global level, but droughts and floods in emerging and frontier markets, for example, may have devastating human and economic costs.

Michael Hasenstab
CIO
Templeton Global Macro

"In the sovereign space, ESG analysis drives our evaluations of government institutions, policymaking and social cohesion – all of these are major factors in determining the quality of a country's macroeconomic environment. Fiscal policy and monetary policy can be run responsibly or they can run unsustainably – that difference can have a tremendous effect on the exchange rate, risk premiums, interest rates and inflation levels. We have seen those factors becoming even more critical in emerging and frontier markets where there's greater sensitivity to policy missteps, and greater potential impact to the macro environment. We've often seen those types of ESG factors directly influence asset prices and the exchange rate, so it's critical to get those assessments right in your research."

Labour and Demographics: Double Edged Swords

In the recent ranking of the current scores for the 44 countries analysed by the Templeton Global Macro team (Figure 1), Denmark and Switzerland appear to have the highest score at 9.2 and Venezuela, the lowest at only 2.2. One of the reasons no country received a perfect score is that labour and demographics can penalise highly developed countries. "Demographics can be double-edged; a growing population can both aid in growth potential as well as create challenges for governments to generate enough jobs or create risks to social instability. Demographics also affect a country's tendency to consume or save, which has effects on growth," the team explains. "Labour and wages are connected to complicated issues like competitiveness and productivity. Wage flexibility increases resilience to external shocks and protects export competitiveness, while rigid labour laws push labour into the informal market and reduce tax collection."

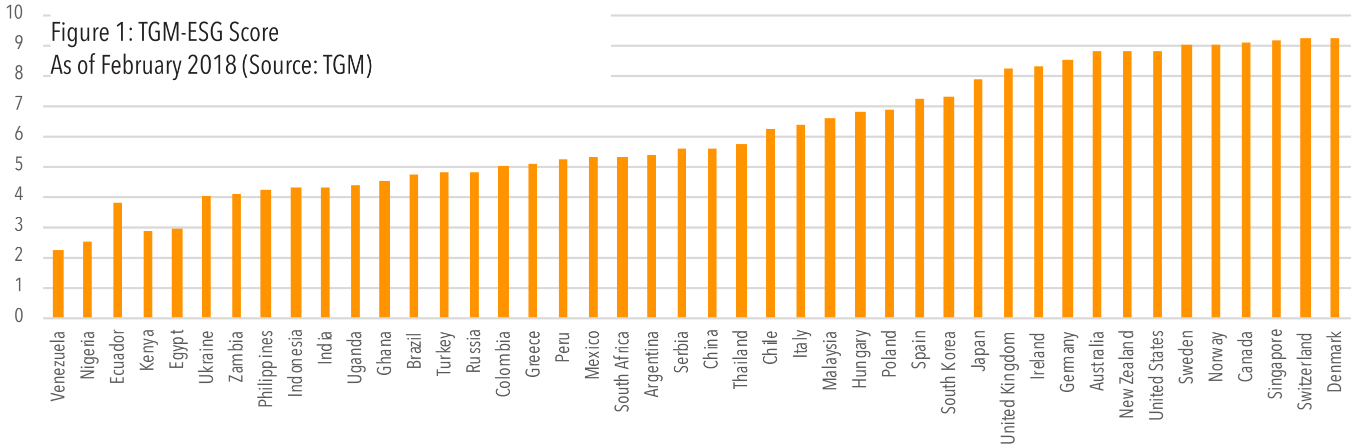


Figure 1: TGM-ESG Score
As of February 2018 (Source: TGM)

A Proprietary ESG Methodology

To adequately capture the E, S and G effects for each country, the Templeton Global Macro team has developed a methodology and proprietary index, the Templeton Global Macro ESG Index (TGM-ESGI), which allows a cross-comparison of 44 countries, thanks to two simple aggregate scores. The first corresponds to a current assessment of each country's ESG position, and relies on existing data from reputable sources such as the World Bank, the World Economic Forum and the United Nations. The other one is a projected score, which is based on the analysts' independent assessment of every criteria, and allows the team to express a subjective view of each country's expected future ESG developments. "We firmly believe it allows us to incorporate the insights of our research team and provides a rigorous method to assess underlying opportunities in a way that complements more traditional macroeconomic tools," Hasenstab explains.

Each ESG dimension is broken down into defined subcategories to help quantify the score. Governance accounts for 40% of the total score. It depends on the effectiveness of the government to carry out tasks and goals, its mix of policies, its attitude toward business activity and foreign investors, the level of corruption and the strength of its institutions. The Social score also weighs 40%. It is influenced by the level of social cohesion and stability, the quality of infrastructure, human capital (including education, healthcare and social programs), the balance of the labour market and demographics. The Environment score reflects unsustainable practices in the treatment of the environment, extreme weather risk and resource scarcity. It only weighs 20% in the end score, given that the more long-term nature of environmental consequences often exceeds fundamentally-driven investment strategies.

*A sub fund of Franklin Templeton Investment Funds, Luxembourg domiciled SICAV

Virtuous Cycles

The idea of virtuous ESG cycle emphasises the importance of the TGM-ESGI score evolution. As shown in Figure 2, Switzerland and Denmark, the best ranking countries in absolute ESG score, are not expected to change in the next three years (the medium term, for the Templeton Global Macro team). This is good news of course from an ESG point of view, but it may not provide investors with opportunities to generate above-average risk-adjusted returns by investing in these countries' sovereign debt. Conversely, countries who show the highest expected rating change represent a great opportunity.

"The most important distinction in our approach is that we take a forward-looking view. A lot of the ESG work out there takes a backward looking view, assessing just where a country stands today and where it's been, but not necessarily where it's headed. If you look at the traditional ESG indices they often align with a country's GDP, so the wealthy countries look good and the emerging and less rich countries look worse by comparison. But those types of measurements don't usually paint the full picture from an investment perspective.

For example, countries like Norway usually score high and are already wealthy, but lending to the Norwegian government is not going to provide a lot of yield. However, lending to countries that need capital and that are trying to move up the income path by implementing the right policies may often provide far greater opportunity for higher income and capital appreciation. Our participation in those markets often helps the countries get the capital they need while also providing our investors with a compelling return – those are the types of mutually beneficial opportunities that we look to identify in our ESG efforts.

A Tale of Two Countries

An interesting example from the Templeton Global Macro teams research is a comparison of how social factors has affected the development in Greece and Ireland.

The global financial crisis dealt a heavy blow to several eurozone countries. The sudden spike in unemployment and the need to implement austerity measures tested social cohesion and political consensus to an unprecedented degree. The strength of social factors became a crucial determinant of resilience and success. Greece and Ireland are arguably the two clearest, diametrically opposed examples, as illustrated by the graph in Figure 4.

Since its first bailout in 2010, Greece had to adopt a number of strict measures, including fiscal austerity and structural reforms. The fiscal adjustment was frontloaded and based more on permanent expenditure cuts than tax increases, and in total amounted to a staggering 20% of GDP between 2010 and 2014. Shortfalls in revenue collection and problems with spending control, however, were tensions that came in the way of budget implementation. Furthermore, the Greek population saw the program as an unfair diktat imposed by Europe and the IMF; the measures had little if any popular support. Eventually, the New Democracy party (ND) was voted out and replaced by the more radical left-wing Syriza party, which opposed the bailout terms and led to the suspension of the Troika program. Lack of social and political cohesion proved to be an insurmountable obstacle to the effective adoption of the severe changes needed to get the economy back on its feet. Economic performance remained weak, and debt sustainability at risk.

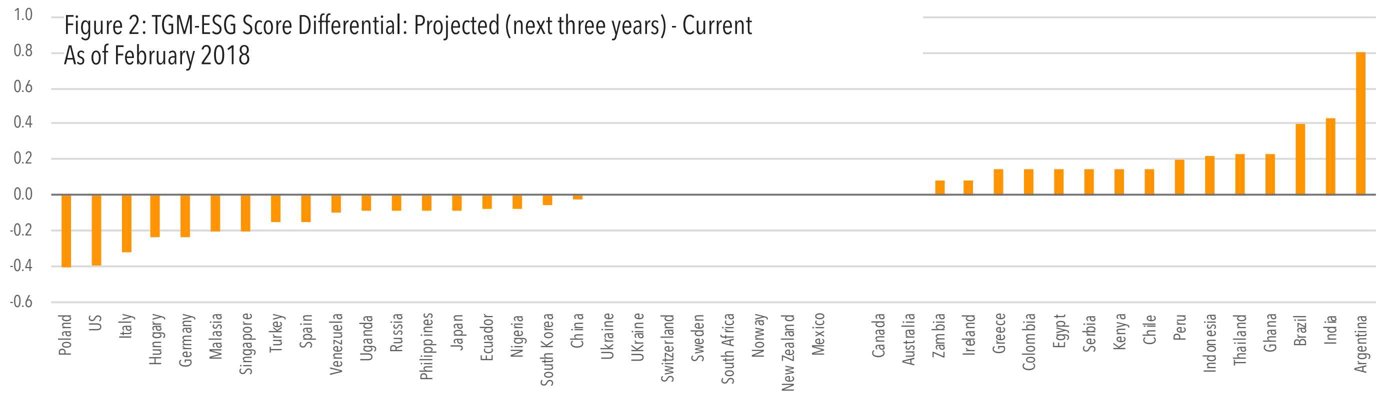


Figure 2: TGM-ESG Score Differential: Projected (next three years) - Current
As of February 2018

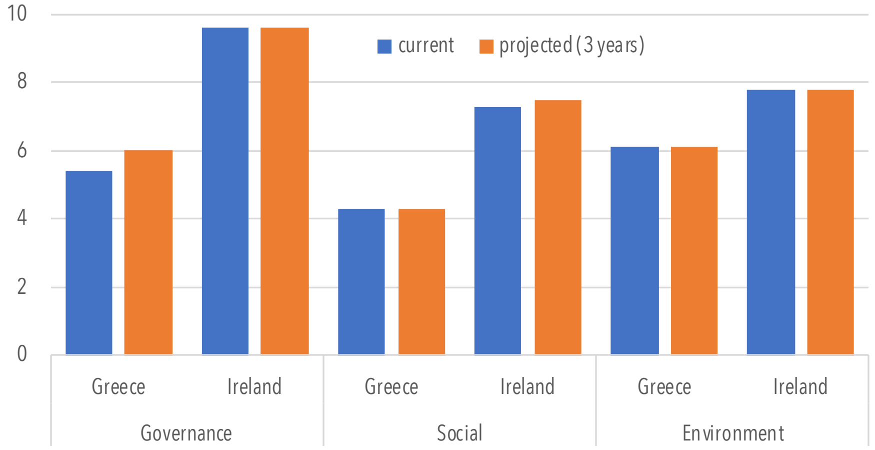


Figure 3: TGM's E, S and G Scores for Greece and Ireland,
As of February 2018

At the height of the same crisis, the Irish government announced the National Recovery Plan (2011–2014), which aimed to lower the deficit below 3% by 2014 and return to sustainable growth. The plan envisioned a total of €15 billion budget adjustment between 2011 and 2014. The adjustment was frontloaded, with €6 billion (or 40% of the total) implemented in 2011. Ireland's population understood the need for fiscal adjustment and supported the harsh and painful measures, allowing successive governments to keep the plan on track with the IMF and EC conditions. Ireland's economic fundamentals improved more quickly as a result, which also put the country in a stronger bargaining position; it was able to resist repeated calls by its EU partners to increase Ireland's corporate tax rate, a cornerstone of its pro-business stance and international competitiveness. Ireland's economy took off relatively quickly, enjoying one of the most robust recoveries in the EU.

Press reports over the last several years have often highlighted the hardship suffered by Greek citizens, so one might wonder if Greece faltered because it faced harsher conditions than Ireland. That, however, does not seem to be the case: a 2011 study comparing austerity measures across the UK, Spain, Portugal, Greece, Estonia and Ireland showed that the size of the adjustment undertaken by Ireland was substantially higher than that of any of the other countries. Ireland was one of the few European countries that experienced a decline in GDP per capita, in contrast to Greece where income grew between 2007 and 2010.

Among other factors, there could be two ESG-related reasons why the Irish public was willing to endure the painful austerity measures while the Greek population was not. For one, a study shows that the distributional impact of the policy changes in Ireland was among the most progressive, meaning the wealthy suffered disproportionately to the poor. This appears in Ireland's superior Gini index coefficient compared to Greece's—the more equitable distribution of the adjustment might have helped underpin social stability and cohesion within the former. A second potential factor was the perception of corruption. In a survey dated 2012 and published by the European Commission, 99% of respondents in Greece agreed to the statement, "corruption is a major problem in our country," versus 86% in Ireland.

"These differences in social factors can have long-lived economic consequences: at the end of its economic adjustment program, Ireland needed a modest 1.5% of GDP primary surplus to ensure debt sustainability, in contrast to Greece, which still needs a 6% primary surplus," concludes Hasenstab.

Source: Franklin Templeton Investments, Global Macro Shifts: Environmental, Social and Governance Factors in Global Macro Investing, February 2018

Investment Grade Credit

ESG Factors and Their Effect on Bond Prices

by Guy Cameron,
Cameron Hume

Guy Cameron,
Director, Cameron Hume

The term ESG factors means different things to different people, reflecting the many origins of the Responsible Investment movement. The PRI provide a broad, workable definition: "Responsible investment is an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns."

So, the PRI think it is about incorporating non-financial factors into investment decision making, with the intent of improving financial outcomes. The word "sustainable" signals the embedding of the UN Sustainable Development Goals. In 2015 Ban Ki-Moon described sustainability as: "At its essence, sustainability means ensuring prosperity and environmental protection without compromising the ability of future generations to meet their needs."

A significant omission from the PRI's definition of responsible investing given above is an explanation of what ESG factors are. The PRI's Fixed Income Investor Guide provides the following elaboration:

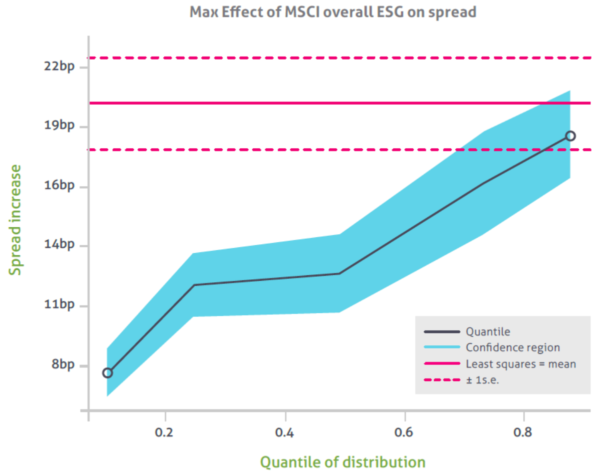
"…a key application for ESG information is to inform analysis of issuer creditworthiness. ESG issues, such as corruption or climate change, are potential risks to macro factors that may affect an issuer's ability to repay its debt. ….The fundamental elements of issuer analysis remain the same for all types of issuers."

This is the definition that we have adopted at Cameron Hume. An ESG factor is a non-financial measure that we consider likely to influence significantly an issuer's ability and willingness to service its financial obligations. Crucially, we believe the assessment should be ours, but the measurement should not be. A third party measure means that our clients are able independently to monitor the investment decisions we make on their behalf. Although there are many suppliers of ESG data and their definitions of ESG factors and their interpretation differ, we believe that investment managers will increasingly incorporate the measures of one or more of these suppliers into their investment process.

Naturally, individual investment managers will weigh the significance of ESG factors differently from the third party assessment and this will inform their views on the relative creditworthiness of an issuer. However, they will incorporate other factors into their investment views, such as the currency, maturity, credit quality and sector of the bonds as well as more traditional aspects of credit analysis such as the issuer's corporate structure, business strategy and competitive position.

It is reasonable to ask whether these third party ESG measures have a distinct influence on bond prices. That is, can we see an effect after taking into account the contribution that other more traditional credit factors make to bond spreads? In the following we look at one third party's, MSCI, overall ESG score and seek to assess its influence on the spreads of bonds from a cohort of issuers. This is a limited exercise, we consider only MSCI's overall score and not the subsidiary indicators they also publish; but if ESG factors are priced then we expect to see that the MSCI score influences spreads: a higher score leads to lower spreads all else being equal. Clearly this leaves open the question whether the extent of any influence on spreads is adequate, but that is beyond the scope of this exercise.

Figure 1



The factors that we expect to be important in determining spreads are the maturity of the bond, the credit rating, the sector, the currency of the bond and whether the issuer is a domestic or foreign issuer. In order to produce a balanced sample, we chose a cohort of investment grade corporate and supranational issuers that have bonds in both euros and US dollars. There were 4785 bonds in this cohort on the 13th February 2018, which we used as the valuation date for this exercise.

We were seeking to explain the influence of each of the factors on the spreads of the bonds. The data present a technical difficulty. As spreads are typically greater than zero, the spread data are not normally distributed, which means that ordinary least squares regression results can be biased. We have therefore used quantile regression[1] which is robust to these effects. Ordinary least squares regression estimates the mean effect of the explanatory variables and so is influenced by all the data in the sample. Quantile regression on the other hand estimates the effect at the specified quantile of the distribution and is most strongly influenced by the data at that point of the distribution.

In *Figure 1* we plot the estimated effect of the overall ESG score[2] for the quantile regression at the 10%, 25%, 50%, 75% and 90% quantiles and have also plotted the mean response from ordinary least squares[3]. The mean response says that an issuer with the poorest overall ESG rating pays 20 basis points (0.2 percentage points) more than a comparable bond from an issuer with the best overall ESG score. This number is small but not negligible – it is of the same scale as the difference in spread of AA- and A+ credits. We can also see the skewed nature of the response in the upward slope of the response with increasing quantile[4]. However, the most telling feature of the graph is that the mean response, is greater than the response at all of the measured quantiles. This means that the average response is driven by the responses in the tail of the distribution. Our interpretation of this result is that ESG factor exposures are only priced after the event, i.e. only after something 'bad' has happened do investors demand a significant risk premium for poor ESG risks.

In conclusion, we believe that it is best to use measures of ESG factors provided by a third party and we find evidence that they are modestly priced. Investors should make their own judgement of whether significant ESG factor risks are discounted by the market. There is evidence that issuers with poor ESG scores have modestly higher borrowing costs, but the distribution of responses is highly skewed. This suggests to us that ESG factor exposures are only priced after an 'event' and, therefore, there is value to our clients of incorporating consideration of ESG factors into issuer selection decisions.

[1] Quantile Regression, Roger Koenker, Cambridge University Press.
[2] In the regression model we rescaled the MSCI score to lie in the range 0 to 1.
[3] All the factors that we considered are statistically significantly different from zero and therefore influence the spreads of bonds.
[4] If the responses were equally distributed we would expect to see a flat line, like that of the mean, but instead the response increases with the quantile.

"We believe that it is best to use measures of ESG factors provided by a third party and we find evidence that they are modestly priced."

ESG Case Study

Our in-house suite of analytical tools, CaTo, enables ESG factors to be integrated into our investment process and the consistent delivery of our clients' ESG policies. By using CaTo we are able to value individual corporate bonds within sectors and use the MSCI ESG scores to grade the quality of over 3000 investment grade and high yield issuers. This process enables us both to identify the best rated ESG bonds within sectors and to construct our clients' portfolios in accordance with their ESG values and policies. The case study below illustrates how CaTo ESG tools were used to analyse the US dollar denominated, financial sector and inform a switch out of Wells Fargo Bank into Australian insurer, QBE Insurance Group, for material improvement in the MSCI ESG rating.

Credit analysis

Wells Fargo

Wells Fargo is rated A2. The ongoing retail accounts scandal is likely to adversely impact near-term revenue and underlying costs.

Whilst Moody's remain sanguine on the outlook for Wells Fargo, prolonged political and regulatory scrutiny of the executive supervision of practices during this time is likely to weigh on the rating outlook.

QBE Insurance Group

QBE is rated A3. Improving profitability, strong capitalisation and solid asset quality underpin the credit outlook.

ESG analysis

Within the cohort of US dollar denominated, A2 rated banks, we held the Wells Fargo 2023 maturity. The bond appears fair value against a CaTo interpolated curve (as shown in Figure 2).

Wells Fargo has had a low MSCI ESG rating of CCC since 2016, reflecting protracted problems with corporate governance, financial product safety and labour management.

Given the extent of the underlying governance problems within Wells Fargo we decided to investigate a switch into a peer financial institution.

ESG due diligence

CaTo quantitative tools were used to identify an appropriate alternative to Wells Fargo. Broadening our CaTo search across A-rated financials we identified QBE Insurance Group as an alternative issuer.

With an MSCI ESG rating of A, QBE is 4 notches higher than Wells Fargo (at CCC). QBE scores highly for corporate governance and responsible investing. We note the 2023 maturity bond trades +55bps cheap to the fair value fitted curve within the Insurance peer group (as shown in Figure 3).

Market analysis

Overall, QBE scores highly in its peer group for ESG criteria. QBE bonds trade cheap to the peer group (as shown in Figure 4), which we account for due to a lower weighting in global indices and investor 'home bias'. That is, US-based investors favour US-domiciled insurers in their portfolios.

Although Moody's rate QBE 1 notch below Wells Fargo, we are comfortable with the underlying credit metrics of the company and the liquidity that the 2023 bond demonstrates. The QBE 2023 maturity bond trades at an additional spread of +40bp to Wells Fargo 2023 bond. We are thus comfortable switching from Wells Fargo 2023 to the QBE Insurance Group 2023 bond, improving the ESG rating by 4 notches.

"At its essence, sustainability means ensuring prosperity and environmental protection without compromising the ability of future generations to meet their needs."
Ban Ki-Moon

Figure 2

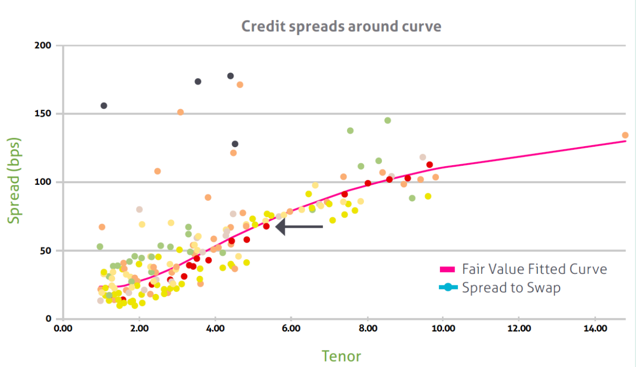


Figure 3

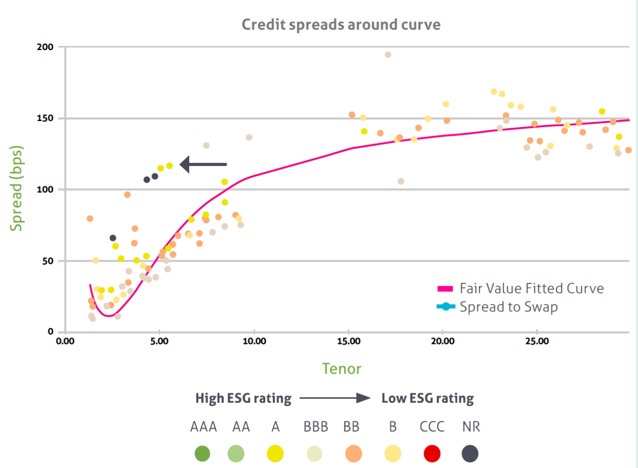
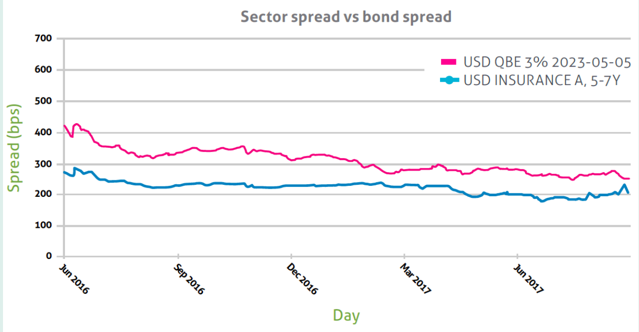


Figure 4



Global Corporate Bonds

Choosing a Label That Sticks

by Aline Reichenberg Gustafsson, CFA

Stefan Ericson,
Head of Fixed Income
Pareto Asset Management

Kaia Gaarud
Analyst
Pareto Asset Management

When ESG and SRI can take several directions depending on an investor's priorities, adopting a standard, receiving a rating or fitting into a label's requirements can have consequences on a strategy's outcome, financially but most importantly sustainability-wise.

Together with Stefan Ericson, Head of fixed income and Kaia Gaarud, analyst at Pareto Asset Management, we explored the journey that took them from starting a global corporate bond fund to obtaining the Nordic Swan Ecolabel approved by state-owned Miljömärkning Sverige. Along the way, we focused on why the same rules just cannot apply to every instrument and asset class.

At the onset, Pareto Asset Management decided to set up a credit fund explicitly aimed at limiting downside risk. "In credit, as everyone knows, the upside is capped, that is why our focus, in general, is on limiting the downside," starts Ericson. "For this new fund, we decided to design a strategy that would put this concern at the centre and eliminate at the onset the sectors that could hamper performance in a difficult market. With this in mind, we excluded boom-and-bust sectors such as fossil-based energies and commodities and reduced our target exposure to macro-driven sectors like real estate and financials."

Furthermore, the fixed income team had to adhere to Pareto's firm-wide SRI guidelines that take into account the Norwegian sovereign wealth fund's blacklist, including weapons and ammunition, coal, tobacco, pornography, etc. "We did not set out to build an ESG strategy from the beginning but, with our downside management in mind, we ended up with a set of guidelines within relatively strict ESG parameters," Ericson continues. "'G' has always had a strong weight in credit analysis. Our fossil-energy and commodities exclusions already gave us a heavy 'E' tilt. Beyond the exclusions that were imposed to us, the 'S' may seem less evident in credit, but we decided that it could make sense to examine that aspect as well and that it would improve our outcome in the long run."

For Pareto Asset Management's fixed income team, striking the right balance between the three ESG dimensions is crucial in achieving a sustainable outcome. "For us, focusing on one of the aspects, like the environment, will not effectively reduce our risk," explains Ericson. "Green bonds are a good example of an instrument that is tilted in one direction only. It is a great initiative, and we are happy that Sweden has been a pioneer in that market. That a bond is 'green' doesn't necessarily make it is sustainable. It means that a framework has been established to direct the proceeds of the bond to projects that are targeted at reducing emissions. The company wouldn't need to make any commitment outside of that project, let alone in the 'S' dimension, regarding labour practices for example."

At the time the team was building the strategy, Gaarud came in with a fresh pair of eyes and helped take the fund to the next level. "We were lucky to have Kaia join us as a young analyst in the spring," says Ericson. "She wasn't entrenched in daily tasks the way we all always are, and that allowed her to focus on the ESG aspects of this product truly. That's when we got in touch with the Nordic Ecolabeling, and thanks to her hard work and close collaboration with the Swan financials team, we managed to qualify for the certification."

Initially, it was a round table meeting with Per Sandell, Head of Financial Services Nordic Ecolabelling, that led Ericson's team to look into an ESG certification.. "We chose the Nordic Swan Ecolabel because we liked their approach more than what others proposed."

In fixed income, the challenge of finding an appropriate yardstick for a strategy is exacerbated by the predominance of equity-focused actors taking part in the development of new standards and regulations. "The largest providers of ESG data have developed models for equities," says Ericson. "It is quite common that corporate credit always comes like an afterthought. Take MiFID II for example. With equities, investors paid a higher commission to gain an informational advantage, and the regulators designed a regulation to remedy that. In fixed income, we don't pay any commission. The price we pay is embedded in the price we pay in a much less transparent way, but we can't just ask for a rebate because we decline to receive the broker's research. Fixed income and equities belong to two distinct asset classes and just can't be treated the same way."

One key difference between asset classes in the field of SRI is engagement. "We simply cannot engage in the same way shareholders can," adds Ericson. "We don't have a vote, and therefore do not have an opportunity to take a seat on the nomination committee to influence how the board should be composed. We can engage in a direct dialogue in certain cases, of course, but it may not count as 'shareholder engagement'. As bondholders, we are not claiming that we are working actively to change the world by targeting the 17 Sustainable Development Goals. However, we can promote the efforts of companies that are sustainable in the three ESG dimensions, by choosing to finance their activities instead of others."

While the Nordic Swan Ecolabel started by certifying equity funds, it has a set of requirements for fixed income products. Pareto's Global Corporate Bond fund is only the second fund to have received the label, and the only product currently registered for marketing in Sweden. Unlike other equity-focused and quantitative-based certifications, the Nordic Swan Ecolabel requires a deep involvement between the Swan financials team and the applying fund managers. One of the primary requirement is that all holdings of the fund are scrutinised using an ESG model, and the model has to be analysed and approved by the Nordic Swan Ecolabelling.

Another particularity of the eco-label is that part of the requirements are flexible to an extent. First, a set of minimum criteria guarantees that all Nordic Swan Ecolabelled funds qualify for the same essential elements. Also, the funds have to achieve at least 5 or 6 points out of 16 (for fixed income and equity respectively). "Investment strategies cannot focus on all sustainability aspects at the same time," explains Gaarud. "The 16 points have actually been designed so that it is not feasible for one product to qualify for all of them. Each manager needs to choose the points that are relevant to the product, and fulfil the criteria associated with those points."

"We really appreciated the fact that the Nordic Swan Ecolabel doesn't try to force a square peg into a round hole," says Ericson. "We were also impressed by the quality of the team, and their breadth of experience. Miljömärkning Sverige analyses and certifies thousands of consumer products, from detergents to baby clothes, but they also have attracted talented individuals from the financial sector to lead the analysis of financial products in a highly professional manner. In fact, the involvement of the team in the certification process is one of the elements that convinced us to apply. Once we started, we also gained tremendous inputs from our work with the Swan team."

For Gaarud, the experience was gratifying, and she will continue to be involved with the ESG aspect as a full-time analyst in the team. "I am working to ensure that we comply with the Nordic Swan Ecolabel in every aspect, even if it has almost no impact on the strategy itself, as it was already a good fit for the framework in its original shape," she comments. "The only adjustments we made had to do with the fact that all our holdings have to be screened by our ESG model. This means that we are staying away from ETFs for example, as we wouldn't be able to apply our internal model to all of the instrument's underlying positions. We had not used ETFs so far, even if we were allowed to under our fund rules."

Gaarud is also part of the dialogue the fund managers conduct with some of their bond issuers. Ericson mentions one, in particular, the unrated privately held Swiss-based manufacturer of non-woven fabric, Jacob Holm & Sons AG. "To separate fibres can be very polluting," he explains. "But we found out that thanks to an inter-generational management change at this family-owned company, the manufacturing process is evolving towards much better environmental practices. Competition is brutal in this field, but consumers are increasingly willing to pay the price for products that are less harmful to the environment. We saw that this company was starting to perform well, for the right reasons and decided to engage with management to find out more. We were surprised to see how willing they were to hear our opinion."

Private Debt

Scaling up Impact Investment

by Richard Sherry
M&G Investments

Richard Cherry,
Director, Alternative Credit
M&G Investments

Investment is required on a huge scale to address the world's biggest challenges, such as climate change, poverty and inequality. The UN Sustainable Development Goals (UN SDGs) and the series of targets underpinning the goals, have provided a powerful global framework for all public and private stakeholders, including governments, regulators, civil society (the 'third sector') and the private sector, for tackling social and environmental issues.

With an estimated funding gap of up to US$6 trillion annually needed to meet SDG targets, more needs to be done to mobilise capital on the scale required.

Whether investing to fund the construction of a solar park or wind farm, or new affordable housing, impact investing has a clear role in supporting the aims of the SDGs by putting capital to work in investments and projects with positive real-world impact. The Global Impact Investment Network's (GIIN) 2018 Survey suggests there are $228 billion of impact investing assets under management[1] – a figure the GIIN notes serves as the latest best-available 'floor' for the size of the impact investing market.

Impact funds are often small and concentrated, such as microfinance funds, and in many cases focus primarily on the impact of the investments, with financial returns a secondary consideration i.e. 'impact first'. Although surveys signal a diverse and dynamic impact investing market, there is still some way to go before it reaches critical mass. So, how can impact investing be scaled up so that it makes a real difference?

Increase access to impact investing opportunities

The 'use of proceeds' bond format has been the result of innovation in traditional fixed income markets and there has been a strong take up from institutional investors. The market for green bonds is fast growing albeit still in the early stages of development – the global green bond universe is estimated at around $389 billion[2] and is forecast to reach $1 trillion of annual issuance by 2020 – but arguably offers an imperfect 'solution' for impact investors.

The breadth and depth of the market currently does not easily allow the construction of a well-diversified, institutional-scale portfolio, while the lack of global green bond standards which issuers must adhere to, has led to some concerns about 'greenwashing'. This places the onus on investors to perform the due diligence needed to ensure the most impactful projects receive the necessary financing. New thematic bonds are starting to appear in the market, including social bonds, sustainability bonds, ESG-bonds and SDG-bonds, and even 'blue bonds', but issuance volume remains a fraction of the overall bond market.

Impact investing typically does not take place in large-cap public markets as there tends to be less 'pure-play' impact opportunities available. However, as the GIIN 2018 survey finds, an allocation of 14% of capital through public equity demonstrates a growing practice (and acceptance) of impact investing through publicly-listed equities. By adding a third dimension – 'impact' – to traditional risk-return analysis, it is possible to invest in companies that will have some positive impact, particularly compared to peers.

Catalyse collective action

Together with the UN's call to action with the SDGs, there are several key global and public-sector sustainable finance initiatives that look set to promote the growth and development of the impact investment market, including:

The PRI's Sustainable Development Goals (SDGs) agenda:

The UN-supported Principles for Responsible Investment (PRI) have included the SDGs and impact investing as part of their aim to bring responsible investors together over the next 10 years to work towards sustainable markets that contribute to a more prosperous world for all. This includes setting out steps and developing tools for investors to align their investment activities with the SDGs and introducing the SDGs into the PRI Reporting Framework.

The Global Impact Investing Network (GIIN):

There is positive momentum behind impact investment, yet impact investing is still a relatively small, niche area of broader investment practice. In its report, "The Roadmap for the Future of Impact Investing: Reshaping Financial Markets", published in March 2018, the GIIN presents a vision for more inclusive and sustainable financial markets and articulates a plan for impact investing to lead progress toward this future.

European Commission's Action Plan on Financing Sustainable Growth:

The High-Level Expert Group (HLEG) on sustainable finance appointed by the European Commission (EC) to help develop an overarching and comprehensive EU roadmap on sustainable finance, is one public sector initiative that is helping to steer private and public capital towards sustainable and impact investments. The Commission adopted a package of measures in May as a follow-up to the recommendations announced in its Action Plan, with all actions, including the development of an EU taxonomy on sustainable finance, set to be rolled out by Q2 2019.

A mulit-theme approach

As policymakers, regulators and international organisations continue to push the sustainable finance agenda forward and look for ways to mobilise private capital on the scale required, the current impact investment market offers a ready supply of diverse and viable opportunities that can help to tackle the world's most pressing social and environmental issues.

Pension funds, insurance companies and other institutional investors can already put their capital to work in multi-theme private debt impact strategies that target positive impact and offer attractive returns in excess of public markets for equivalent risk – often referred to as an illiquidity premium.

Private debt investments that generate clear environmental or social impact can be across a range of maturities and different asset types, for example this could be in the form of a private loan to finance the construction of a solar park or wind farm, or new affordable housing, hospitals or university facilities.

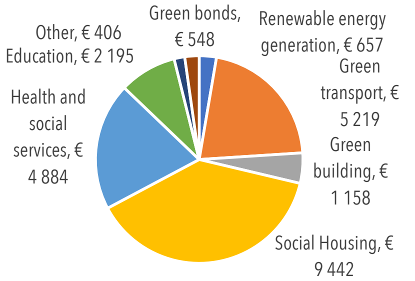
Why private debt for impact investing?

- More 'pure-play' impact investment opportunities than public markets
- Ability to directly negotiate covenants and other investor protections
- Potential for attractive returns given relative illiquidity and complexity
- Close dialogue with borrowers that could help:
  - » ensure the investment delivers a positive impact and preserves capital
  - » foster engagement to address ESG issues, improve impact reporting and mitigate risks

Having access to a broad range of asset types from which to source opportunities is essential to be able to build diversified portfolios and remain selective about which assets make it into a portfolio. Investing in sustainable private assets also requires detailed knowledge of environmental and social standards, as well as the resources and expertise in asset sourcing that an experienced active manager can help deliver. Bespoke private assets are often held to maturity, so they require careful analysis, documentation and monitoring to ensure high credit quality and positive impact generation throughout the life of the investment.

We assess an impact asset as we would any other asset in the private debt universe, with rigorous and detailed credit analysis and making investment decisions on a relative value basis. The only difference is that we carry out an impact assessment at the same time, using criteria we have developed in conjunction with a leading sustainability advisor. Impact can be measured through tangible outcomes such as the megawatt-hours of electricity a solar park generates or the reduction in carbon dioxide emissions as a result of the construction of a new renewable energy project. Assessing and quantifying impacts such as these are integral to our analysis and due diligence prior to making an investment.

M&G impact assets across fixed income: c.€25 billion AUM, by sector (€ million)



Source: M&G, as at 30 April 2018. Not all data labels are shown in the chart

[1] Source: "Annual Impact Investor Survey 2018". The GIIN. Total reported AUM based on collective data from 229 survey respondents.

[2] Source: $389 billion refers to outstanding labelled green bond volume. Climate Bonds Initiative: "Bonds and climate change. The state of the market 2018", as at September 2018

[3] Source: M&G, as at 30 June 2018

European High Yield

How to Handle the Lack of Data

by Carl Berthold
JAR Capital

Bond investors lend countries or companies money for a limited period of time for a specific interest rate that is acceptable to both parties at issue. Unlike equity investors, they acquire no ownership. Typically, these investors have no voting rights, do not attend shareholder meetings and have much less influence on business decisions. This has led to the perception that bond holders have no influence on companies. The truth is rather different, especially in the high yield bond market. Lower rated high yield companies have, generally speaking, one thing in common – a need for continued external financing to pursue their business plan. As such, management of these companies must actively attract investors and so bond investors have the opportunity to engage with companies at management level and pursue their investment goals according to their chosen method.

Increasingly, these methods factor in ESG criteria, a fact that seems to be unknown to many bond issuing companies in the high yield market. For example, over 1,900 signatories representing around USD 80 trillion of assets have signed up to abide by the United Nations' Principles for Responsible Investment (UNPRI). It should be in the vital interest of any borrower which depends on capital from global investors such as these signatories to ensure that no avoidable obstacles exist precluding investment.

"ESG criteria have always been part of the due diligence process but we have now 'professionalised' them by employing ESG experts to be involved with the analysis allowing us to continue to focus on the quantitative and qualitative analysis of companies."

Increasingly often, investors have the mandate or fiduciary duty to invest taking ESG criteria into account. This might arise out of ethical and/or economic considerations. In addition, a growing number of countries are introducing regulation requiring public pension funds to take ESG criteria in their investment making decisions into account. For example, the EU commission's legislative proposals on sustainable finance will require disclosure requirements on how institutional investors integrate ESG factors in their risk processes. At the moment, companies often seem to be unaware of the new EU Accounting Directive (2014/95/EU) requiring them to disclose non-financial and diversity information in their annual reports from 2018 onwards. Regardless of bondholders' or equity holders' requests companies will have to deal with ESG criteria, especially if they are publicly traded or wish to IPO at some point in the future.

Carl Berthold
Partner, Portfolio Manager
JAR Capital

Kerrin Tansley
Partner, Senior Portfolio Manager
JAR Capital

As a portfolio manager, JAR Capital has always considered sustainability criteria to be an additional and indispensable risk management tool which helps us to analyse companies and to better understand their full risk profile. In our opinion these criteria naturally have to include, among other factors, transparency, corporate governance, reputational, environmental and litigation risks. In fact, these criteria have always been part of the due diligence process but we have now 'professionalised' them by employing ESG experts to be involved with the analysis allowing us to continue to focus on the quantitative and qualitative analysis of companies. As such, ESG assessment represents a natural extension of the risk management process. We believe credit investing is all about minimising downside risk and, therefore, any tool that helps us in achieving this is welcome.

"To date, no sustainability rating agency has rated the high yield universe."

To date, no sustainability rating agency has rated the high yield universe. It is thus impossible to differentiate and manage according to best-in-class criteria which is available to equity or investment grade investors. JAR Capital, together with its co-operation partners, is pioneering the concept by building up a rated universe and working together with the companies to improve their ESG rating over time. For the rating analysis we chose ISS-oekom, one of the largest independent rating agencies in the sustainable space, which has been operating since 1993 and employs more than 1,200 highly qualified experts. On behalf of JAR Capital ISS-oekom analyses and rates JAR Capital's investment universe periodically on the basis of up to 100 rating criteria. Analysts gather information through media and other public sources, conduct interviews with stakeholders, and collect information on company policies and practices. Extensive company and stakeholder dialogue, coupled with strict verification, ensures objective and in-depth research.

Given the novelty of ESG analysis for many companies in the high yield market, the initial ISS-oekom rating is rarely in, or close to, the prime or best-in-class category. Information is simply not available or presented. JAR Capital's solution is to work additionally with an engagement specialist which addresses the identified weaknesses from the initial ISS-oekom rating report at management level.

Where required, JAR Capital functions as the door opener to the companies and facilitates the dialogue with the engagement company. The engagement with every single portfolio company enables us to be closer to management and enhance transparency at many different levels. It defines the change objective clearly, not only to resolve the immediate problem, but to improve ESG preparedness of the company. Furthermore, it defines the strategy for change, establishes a constructive relationship and a two-way engagement dialogue with a clear time frame. A range of appropriate tools is applied including mail dialogue, calls, meetings, conference calls and site visits. Where possible, we seek to work on a collaborative basis to leverage the power of influence. We truly believe the engagement dialogue substantially benefits the analysed companies as well as us and provides them clear incentive to improve their ESG credentials over time.

Ideally, integrating sustainability criteria into our investment process will help us achieve our paramount objectives: fulfilling our fiduciary mandate toward our investors and maintaining our track record of no defaults in any of our funds.

Credit Risk Analysis

ESG Credentials
Climb the Ranks

by Carmen Nuzzo
PRI

F

Carmen Nuzzo,
Senior Consultant
PRI,
ESG in Credit Ratings Inititative

Fixed income is catching up with equities

The consideration of environmental, social and governance (ESG) factors in fixed income (FI) markets is gathering pace. Once the exclusive focus of equity investors, the ESG lens is beginning to feature in bond evaluation, starting with credit risk analysis.

Several obstacles have delayed ESG consideration across this asset class until recently. One is linked to its complexity. There are multiple issuers in equity markets, most of which only have one type of share. In contrast, in FI markets, there are fewer issuers - including sovereigns – but a multitude of issues with different maturity, duration and structures.

Another obstacle stems from the lack of engagement culture. Unlike equities, the absence of voting rights in FI markets is often viewed as a reason to evade dialogue with issuers. This is particularly the case with sovereign issuers.

Additionally, research in this field is limited, as academic and market research tends to focus on the impact of ESG factors on equity performance. With little evidence of a clear link between ESG factors and FI valuations, bond investors have shunned the ESG business case.

However, things are changing rapidly. Appreciation of ESG consideration as a tool to better manage downside risks is growing; client demand is on the rise; and the frequency of environmental incidents are making climate change no longer a distant, intangible threat. Finally, regulatory pressures have also been building up, notably in Europe.

It is also becoming increasingly clear that better and more systematic ESG integration in credit risk is crucial for investors that buy bonds for capital preservation – particularly insurers and pension funds which own considerable amounts of long-term FI securities for asset-liability management.

Admittedly, many ESG factors have traditionally featured in credit risk analysis; but they have not been labelled as such. They may have been considered as part of the industry or business risk of a corporate issuer, or part of geopolitical risks in the case of a sovereign issuer. Other risks that were once perceived as long term are also now moving sharply into focus. Others are nascent or viewed as potential at this stage.

Perhaps most importantly, the practice of credit risk analysis is evolving. Market participants are more mindful that the lack of proper oversight, transparency and accountability of an issuer (including sovereigns) can negatively affect FI market pricing, volatility and, ultimately, financial stability. Furthermore, they are beginning to price risks differently, including those linked to non-financial variables such as pollution, once treated as negative externalities.

For example, when assessing a polluting company, investors may now not only focus on how much CO_2 the company emits but also on the material impact – including financial, regulatory and legal factors – of those CO_2 emissions.

ESG in Credit Ratings Initiative

The Principles for Responsible Investment (PRI) was among the first organisations to recognise the importance of engaging with credit rating agencies (CRAs) as well as investors to advance understanding of the impact of ESG factors on credit risk assessment, improve risk-adjusted capital allocation and promote sustainable investing. In May 2016, it launched the ESG in Credit Ratings Initiative, currently supported by 138 institutional investors globally (with over $27 trillion of assets under management) and 18 CRAs. The latter include large players such as Fitch Group, Moody's Investors Service and S&P Global Ratings, as well smaller regional players, with specialty products or a more explicit ESG reference in their methodologies.

Through the initiative, investors and CRAs have been engaging during 15 roundtables organised by the PRI across the globe on topics such as the materiality of ESG factors that can affect the relative probability an issuer default; the credit-relevant time horizons to consider; and whether ESG consideration should take an "add-on" approach – keeping ESG analysis separate but complementing traditional credit risk analysis – or a "built-in" approach which is more integrated but inevitably harder to demonstrate. Another important issue raised is the challenge of bolstering capacity and resources for credit analysts to have the adequate skills to assess new and emerging risks. This dialogue is documented in two reports of a three-part series: Shifting perceptions, ESG, credit risk and ratings – part 1: the state of play and part 2: exploring the disconnects.

Key takeaways

One of the resounding outcomes of the PRI roundtables is that building a more quantitative ESG framework is currently the biggest challenge faced by practitioners on both sides. They cite insufficient comparable data, too much non-material information and a plurality of reporting requirements as a barrier to data standardisation and cause of inconsistencies. Additionally, because some ESG factors are new (such as cybersecurity or the effects of disruptive technologies), time series analysis and back-testing may be redundant. Modelling often-intangible non-financial risks and capturing data interdependency is an added complication.

There is also no silver bullet when it comes to choosing relevant time horizons, as considerations vary based on investment objectives and whether the credit risk of a bond issuer or a single issue is assessed. Time horizons also depend on the visibility of future risks and the probability that they will materialise, the likelihood of them reoccurring and whether they impact a bond issuer's cash flow and balance sheet, as well as its ability and preparedness to adjust business models in line with changing ESG risks (see Figure 1).

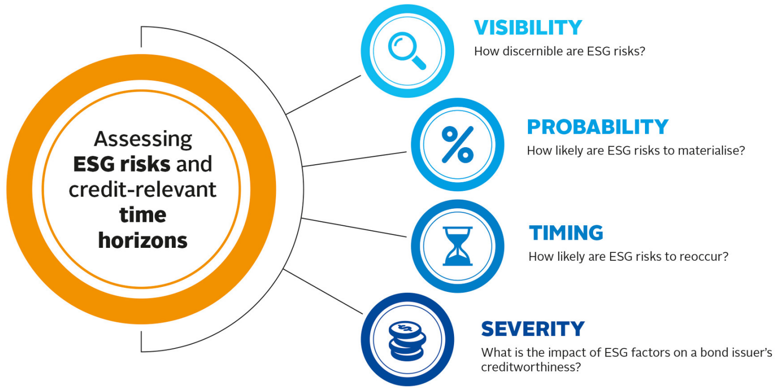

Assessing
ESG risks and
credit-relevant
time
horizons
VISIBILITY
How discernible are ESG risks?
PROBABILITY
How likely are ESG risks to materialise?
TIMING
How likely are ESG risks to reoccur?
SEVERITY
What is the impact of ESG factors on a bond issuer's creditworthiness?

Figure 1. Assessing ESG risks and credit-relevant time horizons (Source: PRI)

While it is too early to identify clear solutions to the problems encountered by investors and CRAs when incorporating ESG factors in credit risk analysis, ideas are beginning to come to the table. They will form the base of part three of the PRI's series of reports on the subject, which is in the pipeline.

Meanwhile, capacity is building among some of the trailblazing investors and larger CRAs, with organisational changes and expanding resources, including intellectual capital. On the CRA side, examples of rating changes following more systematic and insightful consideration of ESG factors – particularly environmental ones – are emerging. Indeed, Moody's Investors Service recently warned that widening inequality will weigh on US credit[i]. It also downgraded twice this year Pacific Gas & Electric Company on concerns related to governance and for its substantial exposure to the 2017 Northern California wildfires[ii]. And S&P Global Ratings, through back-testing, has analysed how environmental and social factors have affected past changes in ratings or rating outlooks[iii].

Although far from being mainstream, ESG consideration in credit risk analysis has turned the corner – and is here to stay.

To access more information on the ESG in Credit Ratings Initiative, visit www.unpri.org/credit-ratings.

[i] See Moody's Investors Service, press release, 8 October 2018.

[ii] See Moody's Investors Service, press release, 19 March 2018and press release, 6 September 2018.

[iii] See S&P Global Ratings, 'How environmental and climate risks and opportunities factor into global corporate ratings – an update', 9 November 2017 and 'How social risks and opportunities factor into global corporate ratings', 11 April 2018.

SDG Bonds

Creating a World of Opportunity for Issuers and Investors

by Mike Amey
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A quiet but profound pivot is underway in sustainable investing, with fixed income emerging as a crucial component in global efforts to make the planet healthier and more productive. The United Nations has already provided the framework with the 2015 Sustainable Development Goals (SDGs), and investors like PIMCO stand ready to provide much needed financing to support these targets, which include bolstering infrastructure, ending poverty and making the planet greener. But to achieve these ambitious goals, we believe bond issuers, whether they are governments or companies, have an essential part to play by aligning debt issuance to specifically support the SDGs.

We believe that formally integrating sustainability analysis across the investment community will be critical in the years ahead. This effort should help strengthen investors' assessment of risk and return, and also help the investment community become an active participant in creating positive societal change. However, to really achieve this, we will need investors and issuers to work together to deepen and broaden the market beyond green bonds to fully support the UN Sustainable Development Goals.

At PIMCO, we have been working hard at formalizing our sustainability analysis across the fixed income asset classes. These efforts help to improve the depth and rigor of our investment analysis, but as we deepen this research we also want to be able to track the impact of our efforts over time. We believe the SDGs give us the framework to do that.

A framework for measuring impact: the UN Sustainable Development Goals

The 17 SDGs (see Figure 1) cover a wide range of sustainability issues, across poverty, inequality, access to health and education as well as dealing with the impact of climate change.

These goals are deliberately broad, which is both a strength and a potential weakness. The strength is that the SDGs encompass not just climate risks but also other key areas where progress needs to be made to create a more inclusive, sustainable society. However, by being so broad they also create a challenge – how do investors and issuers grapple with measuring such a broad array of metrics?

This is where we believe the investment community needs to come together to align solution-focused approaches. Just as we at PIMCO are embedding our impact measurement efforts under the umbrella of the SDGs, so we would look for issuers to do the same thing. One approach could be a greater focus on issuance of debt where the use of proceeds is formally aligned to one or more of the SDGs.

Just as the green bond market has made great strides in raising awareness of climate risk, so we think that the nascent SDG bond market can work to raise awareness across the broad investment community of the societal challenges we currently face – and actively address those challenges.

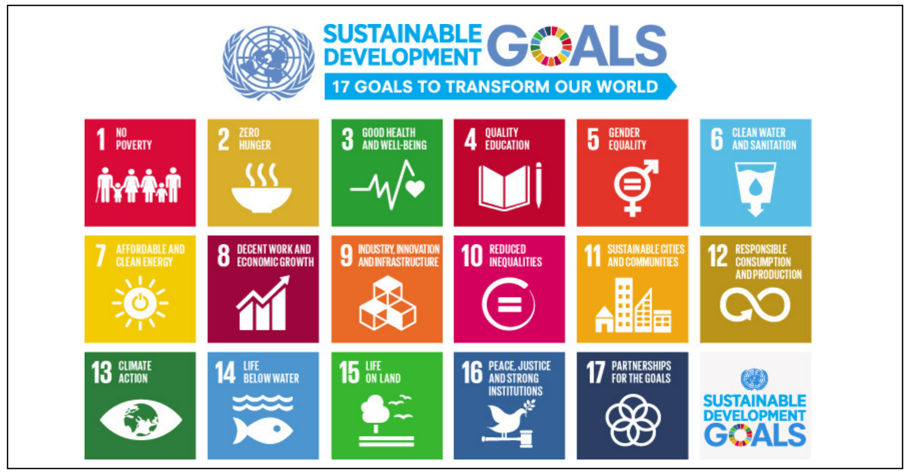
SUSTAINABLE DEVELOPMENT GOALS
17 GOALS TO TRANSFORM OUR WORLD
1 NO POVERTY
2 ZERO HUNGER
3 GOOD HEALTH AND WELL-BEING
4 QUALITY EDUCATION
5 GENDER EQUALITY
6 CLEAN WATER AND SANITATION
7 AFFORDABLE AND CLEAN ENERGY
8 DECENT WORK AND ECONOMIC GROWTH
9 INDUSTRY, INNOVATION AND INFRASTRUCTURE
10 REDUCED INEQUALITIES
11 SUSTAINABLE CITIES AND COMMUNITIES
12 RESPONSIBLE CONSUMPTION AND PRODUCTION
13 CLIMATE ACTION
14 LIFE BELOW WATER
15 LIFE ON LAND
16 PEACE, JUSTICE AND STRONG INSTITUTIONS
17 PARTNERSHIPS FOR THE GOALS
SUSTAINABLE DEVELOPMENT GOALS

Figure 1: the 17 Sustainable Development Goals (Source: UN)

SDG bonds: building on the green bond framework

We fully support the development of the green bond market and are delighted to see how issuance and interest in the sector continue to rise. According to Bloomberg data, green bond issuance hit a record high of $173 billion in 2017, with $200 billion in issuance forecast for 2018.

These are impressive sums; however, the UN estimates annual financing of $3 trillion to $5 trillion will be needed to meet the SDGs, the bulk of which is to come from the private sector. It is in this context that the breadth of the SDGs becomes one of their strengths: The vast array of SDG initiatives provides issuers with many opportunities to link so-called use of proceeds bonds to a number of sustainability efforts. Different industries will find themselves more closely aligned with different initiatives, and it will undoubtedly take time for issuers to understand under which of the SDGs they can most closely align their business (and hence their issuance). The fact that this takes time should not deter the effort. Indeed, we have already seen issuance both from development banks and commercial banks under the SDGs linked to gender diversity, health and well-being, education, climate, and sustainable communities. We fully support this effort, and encourage others to follow suit.

We also believe that the banking sector is uniquely suited to leading issuance efforts under the SDGs. Development banks often work in less developed parts of the world, and it is in the developing nations where sustainability efforts can have the greatest impact. We see significant scope for collaborative efforts between the development banks and the private sector to provide sustainable finance at mutually attractive interest rates.

The commercial banking industry, with its diversified loan books, should have unrivalled capacity to take the lead in SDG-linked debt issuance. The industry also has the strength and scope to overcome barriers to SDG issuance, such as the difficulty of defining what loans fall under which specific SDG, how investors can track the use of those proceeds, and even the fundamental question of why issuers should undertake the complexity of issuing dedicated use of proceeds bonds rather than demonstrating their commitment to sustainability by other methods.

Tackling these challenges in order: With a broad loan book, there is ample scope for banks to identify sectors most closely aligned to individual SDGs, and the fact that we have seen banks issue SDG bonds is testament to this view. We also believe that the green bond market provides a framework for tracking the use of proceeds, including an external review at the time the bond is issued, and then an annual third-party review confirming that the proceeds are being used in an appropriate manner. We believe this framework can work equally well for bonds issued under any of the SDGs. We also expect the UN Global Compact to publish its own "Blueprint for SDG Bonds" to further help issuers and investors with this important initiative.

Finally, there is the question of why issuers should follow the path of SDG issuance rather than demonstrate in other ways that they are embedding a sustainability focus across the business. Here we do not believe that it needs to be an "either/or" world. Rather we believe that issuers focused on sustainability can further cement their credibility by issuing debt under the SDG framework, thereby committing themselves to a greater degree of scrutiny. Just as PIMCO has embedded our sustainability efforts across the firm as well as launched dedicated ESG strategies, we believe issuers can embed sustainability as a firmwide initiative as well as issue dedicated securities. In due course, when sustainability efforts are fully mainstreamed, the need to issue specific use of proceeds bonds may fade, but we are not at that point yet.

One more potential benefit for banks that issue under the SDGs is that by going through the process themselves, they should be in a much stronger position to support clients who want to follow suit. In this way the banks can begin a virtuous circle where the first-mover advantage could be considerable.

Key takeaways

We believe the UN Sustainable Development Goals provide the investment community with a well-structured framework for tackling long-term sustainability challenges. The breadth of the goals should not be a barrier, but instead a fantastic opportunity for investors and issuers alike to come together and address long-term issues in a clear and coherent manner. As investors we believe that bonds issued under the SDGs will be a key part of the fixed income market in the years ahead, and we call on issuers to be at the forefront of this exciting opportunity.

about our partners

Cameron Hume was founded in 2011 by Guy Cameron and Chris Torkington; two highly-experienced industry professionals with a vision to deliver an investment business that places clients first.

Guy and Chris bring a combined 50+ years' experience with Baillie Gifford, Standard Life, Scottish Widows and Barclays, together with a fresh approach to risk and returns to the market. Cameron Hume now has a team of 12 and USD750m in funds under management.

Focusing exclusively on the active management of fixed-income investments, with full integration of ESG factors for institutional clients, this passionate and knowledgeable business offers the ability for clients to explore the opportunities to integrate ESG factors into their fixed-income portfolios in a way that works for them.

Cameron Hume has recently taken the confident step of launching the Cameron Hume Global Fixed Income ESG Fund, which offers a transparent and measurable approach for clients looking to incorporate ESG into their fixed-income portfolios.

JAR Capital is an Asset Management boutique headquartered in London with offices in Geneva and Gibraltar. The company specialises in the European corporate high yield market and the senior portfolio manager, Kerrin Tansley, has a track record dating back to 1996.

The management focuses on the preservation of capital and portfolios are constructed conservatively. To date, the management team has suffered no defaults. JAR Capital is believed to be the only manager in the high yield space that actively incorporates Socially Responsible Investment criteria in its investment process via an exclusion and engagement process.

JAR Capital is a signatory of the UN Principles of Responsible Investing (UN PRI). In recognition of our sustainability strategy we were the first, and remain the only, manager in the high yield space to have received the highly regarded FNG-certificate by the Forum of Sustainable Investments in Germany, Austria, Lichtenstein and Switzerland. In addition, the fund received an ÖGUT rating of "well suitable (gut tauglich)" from the Austrian Society for Environment and Technology.

Franklin Templeton Investments is one of the world's largest asset management groups with over US$717bn in assets under management on behalf of private, professional and institutional investors in over 170 countries. The firm offers investors a range of over 80 funds, which invest across different market sectors, geographies, asset classes and investment styles.

Templeton Global Macro has been a pioneer in unconstrained global fixed income investing for almost three decades, beginning with the launch of its flagship Templeton Global Bond Fund in 1986. The team conducts in-depth global macroeconomic analysis covering thematic topics, regional and country analysis, and interest rate, currency and sovereign credit market outlooks.

The team applies a fundamental, research-driven investment approach that focuses on identifying potential sources of high current income worldwide and seeks to capitalize on duration, currency, and sovereign credit opportunities to provide the best potential for solid risk-adjusted returns. Research into specific Environmental, Social and Governance (ESG) factors, combined with the fundamental macroeconomic analysis, is integral to the decision-making process.

The PRI is the world's leading proponent of responsible investment.

It works to understand the investment implications of environmental, social and governance (ESG) factors and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole. The PRI is truly independent. It encourages investors to use responsible investment to enhance returns and better manage risks, but does not operate for its own profit; it engages with global policymakers but is not associated with any government; it is supported by, but not part of, the United Nations.

M&G is one of the largest investment managers in Europe with approximately €200 billion in fixed income, €78 billion in equities and €30 billion in real estate3.

M&G naturally allocate long-term capital to responsibly-managed businesses and has been financing impact investments on behalf of its clients since the 1930s.

Today, M&G has approximately €25 billion invested in impact assets across public and private fixed income, with a proven track record of consistent returns, and a measurable social and/or environmental impact.

Pareto Asset Management is a boutique fund manager, with a narrow and focused management. Since the inception in 1995, Pareto Asset Management has managed funds for municipalities, foundations, investment firms and private investors. Employees as well as owners of the Pareto Group are heavily invested in the firm's funds, and together, companies and employees in the Pareto Group constitute its largest customer.

The company is based in Oslo, with branches in Stockholm and Frankfurt. Pareto Asset Management is part of the Pareto group – a solid firm with experience and a track record dating back to 1985.

Pareto Global Corporate Bond is the first fixed income fund in Norway to receive the Nordic Swan Ecolabel. Pareto Asset Management AS works systematically with ethical considerations in the management of funds and discretionary mandates. We are pleased to announce that our global fund Pareto Global Corporate Bond has taken the next step towards a more sustainable tomorrow by becoming the first fixed income fund in Norway to receive the Nordic Swan Ecolabel.

PIMCO is one of the world's premier fixed income investment managers.

With the launch in 1971 in Newport Beach, California, PIMCO introduced investors to a total return approach to fixed income investing. In the 45+ years since, PIMCO has continued to bring innovation and expertise to their partnership with clients seeking the best investment solutions. Today PIMCO has offices across the globe and 2,400 professionals united by a single purpose: creating opportunities for investors in every environment.

PIMCO partners with a wide range of institutions, including corporations, central banks, universities, endowments and foundations, and public and private pension and retirement plans. In addition PIMCO works with financial advisors and millions of individual investors pursuing personal financial goals, from preparing for retirement to funding higher education. Investing our clients' assets is a tremendous responsibility, and for that reason there can be no shortcuts.

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