Environmental, Social & Governance (ESG) and fixed income investing—Part 1

In the first of a two part series, ESG specialist My-Linh Ngo explores the concept of incorporating ESG into fixed income investing

There is a growing consensus that environmental, social and governance (ESG) related investment strategies can help in delivering financial performance over the long term.

We believe ESG investing will increasingly feature in client mandates. As well as delivering financial performance, ESG related investment strategies (which are defined broadly as those which proactively and explicitly incorporate ESG factors within the investment process) may also facilitate a more socially responsible, as well as environmentally and economically sustainable society.

As such, we believe that what was once a niche market led by values based investors is becoming much bigger, driven by value investors (see Figure 1).

Figure 1: Data summarising the market size and growth of the ESG market

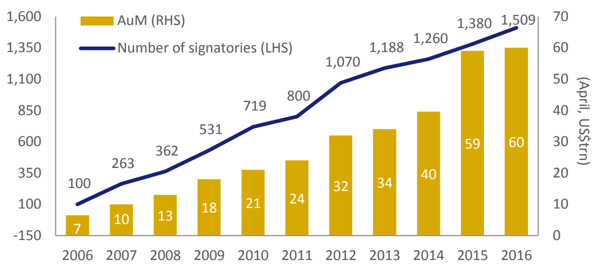
Global SRI assets by region (US$bn)

	US$bn
1 USA (SIF)	6,572
2 Canada (RIA)	945
3 Europe (EUROSIF)	13,608
4 Asia ex Japan (ASRIA)	53
5 Australasia (RIAA)	180
Total global SRI assets	**21,358**

Proportion of SRI relative to total managed assets

	2012	2014
Europe	49.0%	58.8% [1]
Canada	20.2%	31.3%
United States	11.2%	17.9%
Australia	12.5%	16.6%
Asia	0.6%	0.8%
Global	**21.5%**	**30.2%**

Growth of the UN-supported PRI initiative



Source: GSIA, 2014 Global Sustainable Investment Review, February 2015; UN PRI as of May 2016

Note:

1 This figure is based on the aggregation of all SRI strategies reported in the European SRI Study 2014 without double counting, and is presented in order to be consistent with the methodology of this global report. Please note, however, that this figure is not used in the European study as there is no single European definition for sustainable investing.

An additional investment risk filter

BlueBay believes that ESG factors can potentially have a material impact on an issuer's long-term financial performance. Poorly managed ESG risks can lead to inefficiencies, operational disruption, litigation and reputational damage, which may ultimately impact an issuer's ability to meet their financial responsibilities.

When considering the rationale for incorporating ESG into investment analysis and the potential impact on performance, it is clear that the long-term financial success of a company is often influenced by the nature and quality of its relationship with its stakeholders. More direct, explicit and proactive analysis of different stakeholder relationships (which is part of the ESG analysis) is helpful in providing additional insight into the business' outlook, and in identifying potential areas of conflicting trends or emerging ESG risks and concerns.

Supplementing traditional financial analysis with ESG analysis is therefore prudent and in line with BlueBay's fiduciary duty to optimize investor returns.

Incorporation ESG in fixed income

Whilst ESG investing has traditionally been discussed in the context of equities, we believe it is equally important in fixed income investing.

Indeed, many academic studies have shown that incorporating ESG is most beneficial in terms of managing downside risks. In fixed income, it is all about mitigating downside risk as the upside is capped.

Whilst a default may be the worst scenario, there are also intervening risks to investors, including downgrades in the quality of the debt, which can impact investor returns.

The business case further supported by the fact that the risks for fixed income investors of investing in the wrong bond can be greater than those associated with investing in the wrong equity asset. Equities are most commonly traded on an exchange, making them more liquid and, generally, more clearly defined.

In fixed income, the investment universe is larger, more complex, and there is more variation in quality and number of investible instruments. This reduces the level of liquidity in the market for some bonds and potentially increases associated transactional costs and complexity.

ESG risks may impact bonds differently to equities

For equities, share prices are often driven by news flow and sentiment about growth prospects (e.g. in earnings, profits), rather than just fundamentals. As such there is more likely to be direct and immediate sensitivity to ESG factors.

For fixed income, the emphasis is focused on fundamentals (e.g. cash flows) with the bond prices influenced by changes to expectations such as financial strength of the issuer/risk of credit losses, i.e. credit worthiness. This means there is potentially less direct and immediate sensitivity to ESG risks as the creditworthiness of the issuer can act as a buffer to the ESG risk. So whilst an ESG risk may be considered significant in terms of a business risk, it may not necessarily be an impactful financial risk that results in a change in credit rating or impact bond prices or spreads materially.

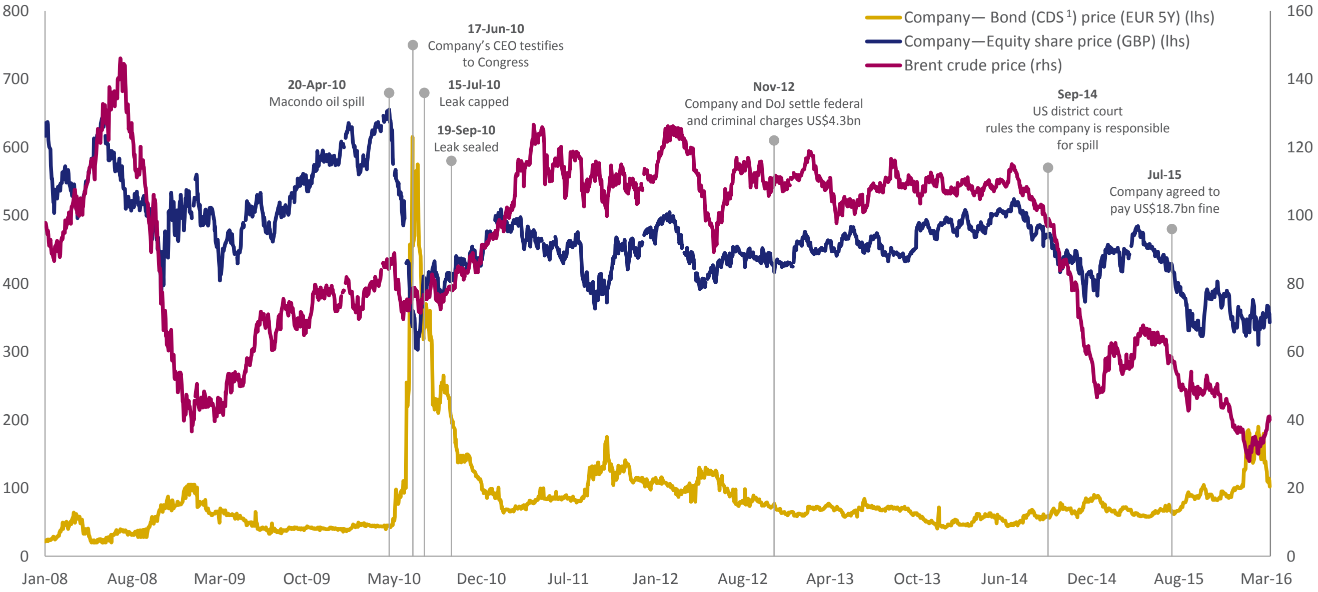
It is also noteworthy, that due to the asset class' complexity, different debt instrument types and specific bond maturities, the relevance of ESG risks may vary. This means that for the same issuer, the ESG risk of holding its bond may vary depending on where it fits in the capital structure and quality spectrum, and its maturity term and the planned holding period. This makes ESG risks relating to fixed income particularly multi-dimensional.

Clearly, what has just been outlined above is a very simplistic explanation of how and why equity and bond prices may react in different ways to business risks (including ESG ones). In reality, price reactions will most likely be quite idiosyncratic, reflecting company specific circumstances.

Nonetheless, whilst the response may vary in their timings and quantum, it would be true to say, both equity and bond prices will react in some way (given they do interact with each other) – as illustrated by the price performance of a leading global oil & gas company, following a major oil spill in 2010 (Figure 2).

Figure 2: Equity and bond CDS price movements for a leading global oil & gas company post a major oil spill in the Gulf of Mexico in 2010

Comparison of Equity and Bond CDS price movements



Source: Bloomberg, as at 10 March 2016

Note:

1 A credit default swap is bought as insurance against non-payment. The more the holder of a security thinks its issuer is likely to default, the more desirable a CDS is and the more the premium is worth it.

ESG risks can, and do, impact credit worthiness

Credit rating agencies themselves have acknowledged that ESG can – and does – impact an issuer's credit ratings.

In terms of corporate credit, Standard & Poor's states environmental and climate risks are material to business risks in oil refining and marketing, regulated utilities and unregulated power and gas industries, where environmental regulations and weather events tend to have a more direct impact on credit quality than in other sectors[1].

Moody's efforts in developing a sector environmental heat map to illustrate how they see ESG risk impacting different sectors, yields similar conclusions[2]. They have also conducted analysis and also shown that the risk of carbon reduction policies on non-financial corporates can have three primary credit effects; direct costs, disruptive technological shocks and policy uncertainty/regulatory risk.

In conclusion Standard & Poor's (October 2015) believes that environmental and climate risks will likely grow and "could lead to a more widespread weakening of corporate credit profiles and subsequently more downgrades than in the past."[3]

ESG risks are not limited to corporate credit. Standard & Poor's have also noted climate change as a global mega trend will impact sovereigns. In most in most cases, this will be negatively in terms of economic growth, external performance and public finances, with poorer and lower rated sovereigns being hit hardest.[4]

In summary, whilst ESG has not been a considerable factor in fixed income investing to date, it is clear it is an increasingly important and dynamic influence that fixed income investors should understand.

In part 2 of this series, My-Linh will review the appropriateness of current ESG investment strategies for fixed income investing, and outline her thoughts on the way forward.

Notes:

1 As detailed in: Standard & Poor’s, October 2015, *How environmental and climate risks factor into global corporate ratings*.
2 Moody’s Investors Service, November 2015, *Heat map shows wide variations in credit impact across sectors*.
3 Standard & Poor’s Rating Services, October 2015, *How environmental and climate risks factor into global corporate ratings*.
4 Standard & Poor’s Rating Services, May 2014, *Climate change is a global mega-trend for sovereign risk*.