

Developing appropriate Environmental, Social & Governance (ESG) fixed income strategies—Part 2

In the second piece of a two part series, ESG specialist, My-Linh Ngo, discusses the range of ESG investment strategies available to fixed income investors

In the first part of this ESG in fixed income investing series, we focused on the natural fit of ESG analysis with fixed income investing given both best add value through a focus on mitigating downside risk.







But it is also important to note that incorporating ESG factors into fixed income also has great potential to make a difference in terms of beneficial societal outcomes. Specifically:

- **Relative size of the market**
 - The size of the fixed income market is much larger than the equity market (two thirds vs. a third) with a longer term outlook and potentially less volatility
- **Type of financing needed**
 - In the context of global environmental challenges such as climate change, it has been stated that significant future investment is required, the majority of which is needed in infrastructure. The equity market alone is unlikely to be able to meet this need. Here green bonds/climate aligned bonds may play a critical role in the transition to a low carbon economy.
- **Direct influence**
 - In areas such as climate, fixed income investors may have more influence over companies such the state-owned-enterprises who are more likely to issue debt than equity

Appropriateness of different ESG investment strategies depends on asset class

Whilst the majority of ESG strategies have been developed with equity investing in mind, it has become apparent that some work better than others for fixed income investing as illustrated in Figure 1.

Figure 1: Contrasting the suitability of common ESG investment strategies for equity and fixed income investing

ESG investment strategies/ asset class	 Ethical (negative/ exclusions) screening	 Norms-based screening	 ESG integration	 ESG engagement/ activism	 ESG best in class	 ESG (positive/ thematic) investing
Equities	Significant scope	Significant scope	Significant scope	Significant scope	Significant/ some scope	Significant/ some scope
Fixed income: Corporates	Some scope	Some scope	Significant scope	Some/limited scope	Limited scope	Significant/ some scope
Fixed income: Sovereigns	Limited scope	Some scope	Significant scope	Limited scope	Limited scope	Limited scope







Source: BlueBay Asset Management, 2016

From the graphic above it is worth noting the following points:

- **Negative screening strategies**
 - Approaches that exclude whole sectors may work in some sub-asset class strategies but not others, depending on the size of the sector as a proportion of the investment universe (e.g. prominence of extractives issuers in emerging market debt strategies)
- **Best in class strategies**
 - The separation of investment grade (IG) and high yield (HY) issuers within the same sector as is common in fixed income strategies can mean that the whole universe is not being viewed in its entirety
- **Engagement strategies**
 - Whilst an engagement strategy is still possible for corporate bond strategies, it may be more difficult to implement without formal legal rights. In addition, managing a sovereign fund with ESG engagement could be a further challenge. However, there is still scope for engagement, as issuers need to come to the debt market to access new capital as issuing equity is not always the most cost effective or efficient option. As such, fixed income investors have a degree of influence, especially at the primary issuance stage, and this should be utilised responsibly and constructively. There is a need for fixed income investors to be more pragmatic in terms of their ESG expectations, particularly with high yield and emerging market debt issuers, where awareness and availability of resourcing may be limited, in addition to the reality that ESG related standards and regulation may not be as advanced as in developed markets. But engagement is possible where investors are realistic, resourceful and creative in their approach.
- **Thematic strategies**
 - This approach can work, as stated above. For example, the scale of investments needed to tackle climate change means 'green infrastructure' is urgently needed and fixed income investors can tap into this via the green bond market.

In our view, the most compelling strategy for fixed income is ESG integration, as it best allows for the different characteristics of bonds and their potentially differentiated ESSG risk profile. Indeed this is the primarily approach we have implemented across all BlueBay's investment strategies (Figure 2).

Figure 2: BlueBay and the ESG investment strategies we employ

	 ESG integration	 ESG engagement	 Ethical (negative/ exclusions) screening	 Norms-based screening	 ESG best in class	 ESG (positive/ thematic) investing ³
Pooled funds ¹	✓	✓	✓	✗	✗	✗
Segregated accounts	✓	✓	✓ ²	✗	✗	✗

- BlueBay does not manage any explicitly labelled ESG investment strategies/products
- BlueBay primarily employs an ESG Integration investment strategy across all our managed funds
- ESG engagement may occur as part of the ESG integration process but such activities are currently limited
- Ethical screening currently relates to exclusions on investments in manufacturers of cluster munitions and landmines, for pooled products with bespoke screening possible for segregated accounts
- BlueBay can develop customised ESG investment strategies for clients with segregated accounts

Source: BlueBay Asset Management, 2016

Notes:

- 1 This refers to BlueBay Luxembourg and Cayman Island domiciled funds
- 2 This is a discretionary service available for clients where this is requested
- 3 For example; climate change investing, social impact investing, microfinance, green bonds

Advancing ESG efforts in fixed income

While it is clear ESG is moving up the agenda for investors in fixed income, there is still some way to go before it receives the same level of attention as it does for equity investors. Given the scale of interest in ESG fixed income investing, we are confident this will come.

Making progress requires action from all the key stakeholders in the investment value chain, including from issuers and investors. In our view, some key areas for considerations are highlighted below:

- **Availability of issuer level ESG data**
 - This comes from improved disclosure about ESG factors that impact an issuer's long-term sustainability. The UN supported Principles for Responsible Investment (PRI) network, of which BlueBay has been a member since 2013, as well as other networks to promote public ESG transparency are considered important bodies supporting this effort. BlueBay is working with such organisations and stakeholders in the belief improved data will provide more holistic investor understanding of an issuer's credit risk profile.
- **High quality ESG credit analysis**
 - This relates to the work of specialist ESG research providers (such as the MSCI ESG Research, Sustainalytics and Vigeo EIRIS), sell side investment brokers, as well as credit rating agencies (CRAs) such as Standard & Poor's and Moody's). BlueBay has been playing its part in encouraging these groups to enhance their ESG credit analysis. For instance, since early 2015, we have been an active member of the PRI's Fixed Income Engagement Sub-Committee, which has initiated dialogue with the CRAs on ESG credit analysis. During May this year, the project published a joint investor and CRA statement (in which BlueBay is a signatory) thus demonstrating a clear commitment from both groups to work on this going forward in a collaborative manner.
- **Develop fixed income specific ESG investment strategies:**
 - Whilst it is helpful to consider strategies which have originated from equity investing and build on these, it is also important that the fixed income industry also works on innovating with investment strategies which are more tailored to fixed income, such as ESG tilting strategies based on ESG performance. With BlueBay's strong track record of innovation in fixed income investing, we will continue to consider ways to best incorporate ESG dynamics into our investment products and processes.
- **Public transparency & accountability**
 - It is important that investors communicate externally to their key stakeholders about their position and approach to ESG in their investment activities. Not only does this ensure accountability with clients and others, it can also be an important driver in promoting change more widely in the investment industry. BlueBay is committed to reporting on our efforts as evidenced by the launch of our ESG investment risk website in 2015.

As a progressive fixed income manager, BlueBay is committed to helping our clients meet their ESG commitments and we believe our ongoing ESG investment risk management efforts will put us in a strong position to factor ESG into our investments activities.

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