Global Asset Management

BlueBay Asset Management

ESG for Bonds? The New Way Forward for Fixed Income Investing

Special topic – My-Linh Ngo, Head of ESG Risk

Consideration of ESG factors has become a familiar feature of equity investing. With meaningful data now available, evidence is emerging of a positive relationship between progressive ESG practices and long-term investment performance. As momentum continues to build, the ESG spotlight is increasingly turning towards fixed income markets.

Why could it be so beneficial for bond investors? The key is the potential to protect against downside risk.

While both asset classes can benefit from taking account of ESG factors for risk mitigation purposes, for debt investing this is critical as the growth potential of a bond is capped, but the possible downside is significant.

Like for like, ESG has been proven more beneficial in reducing downside risk versus aiding upside, making it a logical consideration for fixed income investors.

Active management bedfellows

A natural kinship between ESG and bond markets is the need for an active investment approach. While the arguments around active versus passive are well known, the main draw of a passive approach is the perceived lower costs. But this could prove a fixed income false economy.

Figure 1: Comparing advantages and disadvantages of passive and active investing in fixed income

Fixed income investing strategies/ factor attractiveness	Default avoidance	Diversification benefits	Application of fundamental research	Access to liquidity	Cost/fees
Passive	LOW (Own most of the market, so own the defaults in it)	MEDIUM (High for some funds, but low in others e.g. EM debt/HY indexes capture limited portion/most tradable issuers)	LOW (Largest weights/highest allocations made up of most indebted issuers; highly heterogeneous asset class esp. EM debt sovereigns, idiosyncratic risk profiles as countries are at different stages of economic development)	MEDIUM (Financial crisis has led to regulation which has reduced market liquidity, resulted in trade size and access to brokers challenges)	LOW (Lower manager transaction costs can be passed on in terms of lower fee)
Active	HIGH (Only own part of the market)	MEDIUM (Allocation independent of country indebtedness, tradability, can pick from any part of the market)	HIGH (Expert analysis possible of issuers taking into account unique conditions to identify alpha opportunities)	MEDIUM (Ability to size trades appropriately and access brokers with scale)	MEDIUM (Higher manager transaction costs, some of which are passed on in fees)

Source: BlueBay Asset Management

Adding an ESG slant brings the possibility of additional alpha screens to a fixed income strategy. Many ESG risks are not widely known in the market, creating the potential for mispricing opportunities. Active management enables investors capable of identifying mispricings to proactively take these into account in an effort to generate returns.

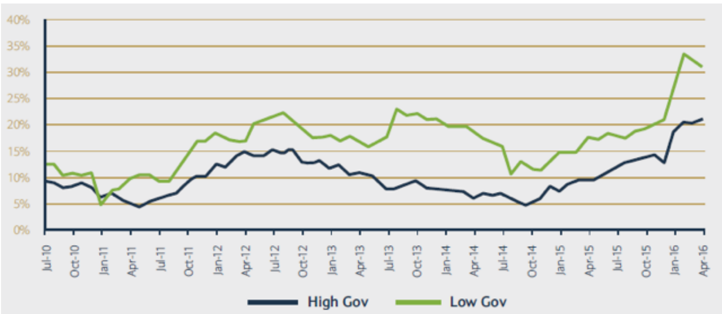
Alongside financial credit analysis, active managers can use ESG as an additional filter. As a proxy for management quality, it can be argued that a low-ESG rated issuer is likely to be riskier and less liquid in some cases, which the credit rating does not sufficiently reflect.

Figure 2: How ESG scores relate to credit spreads and credit ratings

	Bonds with low ESG scores	Bonds with high ESG scores
Average ESG score (0 to 10)	2.6	7.7
Average spread (bps)	172	134
Average credit quality	A3	A2

Source: MSCI ESG Research; Barclays Research, 2016

Figure 3: Bonds with high MSCI governance scores have experienced fewer credit ratings downgrades
12-month rolling downgrade notch rates for bonds with high and low governance



Source: MSCI ESG Research; Barclays Research, 2016

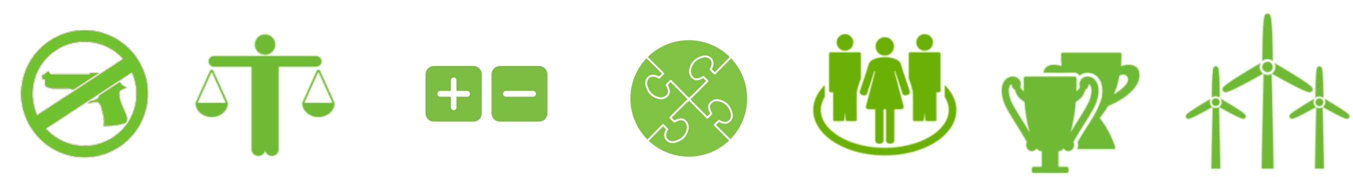
Smart application – ESG integration

While the positive impact is clear, consideration must be given to how it is applied, bearing in mind that the majority of ESG strategies were first developed for equity investing.

One strategy that efficiently spans both asset classes is ESG integration.

This refers to the systematic consideration of material ESG factors as part of the investment process. The approach best allows for the different characteristics of bonds and their potentially different credit risk profiles.

Figure 4: Some equity ESG investment strategies are better suited to fixed income than others



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

Source: BlueBay Asset Management

Why care? Debt markets' influence and duty

While a clear business case is likely to be the primary draw for many investors, applying ESG considerations to fixed income investment strategies can also make a difference in terms of societal outcomes.

As we face greater geopolitical instability and the escalating impacts of climate change, these long-term ESG impacts are gaining resonance.

The fixed income market is significantly larger than the equity universe (two thirds vs a third), and includes sovereign and state-owned (SOEs) issuers, adding the potential to influence government efforts.

While equity holders might be known for their influence at board meetings, bond holders also hold power. There is a legal contractual relationship between lenders and issuers, presenting an opportunity for ESG considerations to be written into issuance agreements.

As debt is a financially efficient fundraising source for issuers (opposed to raising capital via equity markets), many continually return to bond markets, and seek to do this with as low a cost of capital as possible. They are only able to do this if investors trust in the ability and willingness of the issuer to meet their obligations, giving lenders the potential power to work societal and environment improvements into issuance contracts over time.

While there is still some way to go before it receives the same level of attention as it does for equity investors, ESG is moving up the fixed income agenda. An increased awareness of ESG factors and an active approach can potentially have a material impact on an issuer's long-term financial performance. In our view, the benefits of incorporating ESG into fixed income strategies are becoming hard to ignore. Investors should prepare for the ESG debt shift.

Global Asset Management

RBC Global Asset Management (U.S.) Inc.
Minneapolis | Boston | Chicago
800.553.2143 | **us.rbcgam.com**