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

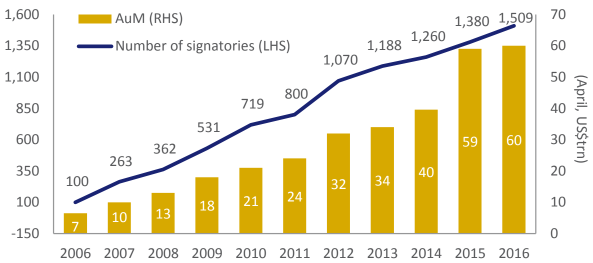
Global SRI assets by region (US$bn)

		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.

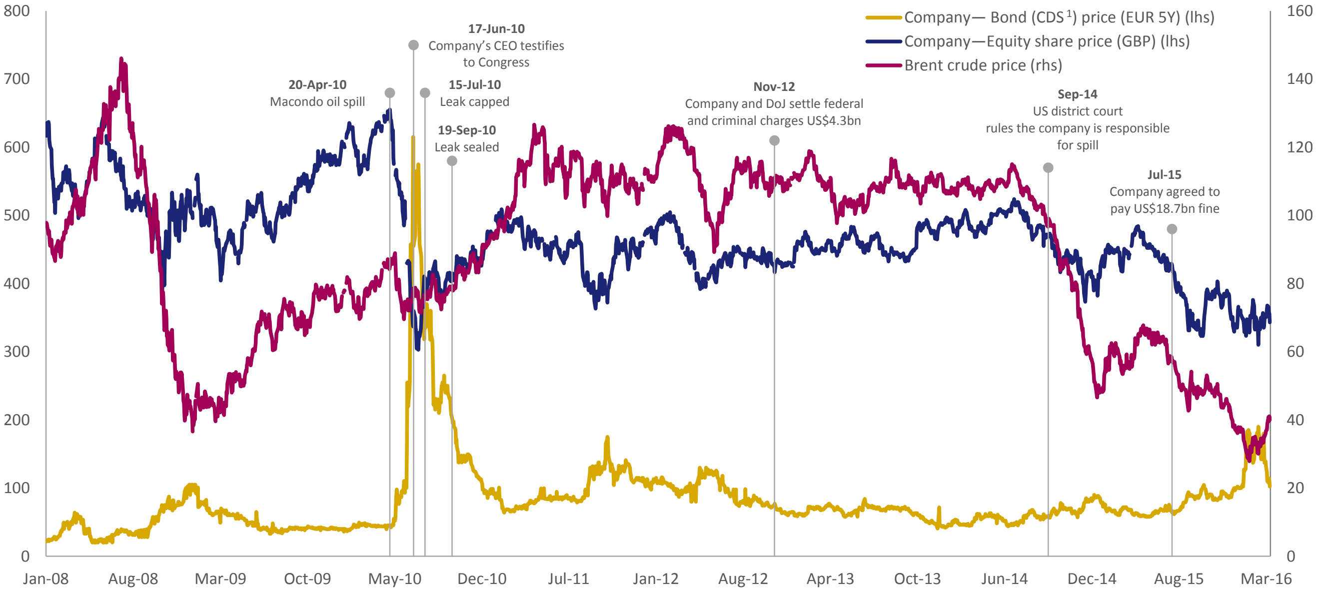
It is also noteworthy, that due to the asset class' complexity, different debt instrument types and specific bond maturities, the relevance of ESG risks may vary. This means that for the same issuer, the ESG risk of holding its bond may vary depending on where it fits in the capital structure and quality 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*.

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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 EGS 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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