Look forward, not back

Scott Freedman considers how ESG factors play a key role in credit analysis

When it comes to assessing the risks around fixed-income investments, environmental, social and governance (ESG) factors have traditionally been viewed through the rear-view mirror, when something has already gone wrong. This article explains why we believe it makes sense to employ a forward-looking assessment of ESG-related credit risks, to help reduce the chances of potential future hazards.

The rating agencies and a growing number of investment managers are more explicitly factoring ESG issues into broader credit assessment. However, we need to ask whether these ESG-related risks are being fully priced in by the market. Anecdotally, it appears that such factors may only be fully priced in where there has been a more severe credit event, and in the past this has tended to be related to a governance failing. Issues here may include bribery and corruption, civil unrest, accounting misstatements, or the conduct of senior management.

In some cases, environmental and social issues may be influential, and certain sectors have seen a more fundamental change in credit risk perception, such as the US shale-drilling in relation to concerns about the banning of fracking.

Environment to the fore: A litany of problems

Over the past few months, there has been a variety of newsflow demonstrating how ESG factors can affect business risk (and therefore credit risk), and, at times, bond performance. Much of it has tended to focus on environmental concerns, and we list just four recent examples below:

- *September 2019: Rating agency Moody's said one of the reasons for it downgrading Ford's credit rating to sub-investment grade was because Ford's "current portfolio leaves it vulnerable to large emissions penalties in 2020 and 2021".*

- *November 2019: The European Investment Bank (EIB) said it would "end financing for fossil-fuel energy projects from the end of 2021. Future financing will accelerate clean-energy innovation, energy efficiency and renewables".*

- *November 2019: California's state government announced it would halt all purchases of new vehicles from GM, Toyota, Fiat Chrysler and other automakers that backed stripping the state of its authority to regulate emissions.*

- *December 2019: Spanish oil company Repsol pledged to eliminate emissions from its business by 2050. The company revised the value of oil and gas assets in a decarbonising world, resulting in a €4.8 billion impairment charge.*

Rating agencies have included some ESG factors in their scoring methodology for a while, but these factors are now becoming more explicit in their assessments, helping investors to understand their materiality to the ratings. The relationship between ESG factors and issuer ratings is not altogether consistent, but blow-ups have tended to occur in those with lower ESG ratings. This suggests more attention needs to be paid to this area of the market; opportunities can exist where risks have not been priced in.

All about the 'E'

It is perhaps unsurprising that many of the conversations we are having with clients and prospects now concern the environment, with the Paris Agreement four years ago mobilising a global call to action to protect against climate change. Today, even the European Union's sustainability taxonomy focuses solely on whether an economic activity is environmentally sustainable.

Having integrated ESG considerations into credit analysis for a long time, we have always been of the view that considering the materiality and impact of ESG factors on companies and countries is a crucial part of credit analysis. In our view, it results in better decision making, and can also lead to superior risk-adjusted returns.

Fixed income and equity: How the approach differs

Another question that often arises in client meetings is whether there are differences between integrating ESG in fixed income and in equities, given the fact that bondholders do not get to vote on a company's corporate agenda as they are not shareholders in its equity.

Given the risk asymmetry between bonds and equities, downside risk mitigation is more important for fixed income (bonds have limited upside but similar downside risk to equities). Generally speaking, a company with a strong ESG profile should benefit both shareholders and bondholders.

Differences will be driven by management's financial policies and their decision as to whether it decides to prioritise debt holders or shareholders. Another difference is that bondholders have a variety of relevant ESG-themed areas available for investment that are not available to equity investors. These include green financing, universities, development agencies and social housing.

Debt investors also have the opportunity to invest in private companies – one of the most powerful engagement areas for fixed income. We find engaging with issuers that have weaker credit ratings and/or are private, especially in high yield, where often bondholders are the company's only access to capital, means that our questions, views and recommendations on ESG issues are increasingly being heard. This gives us a greater chance of effecting positive change. Put simply, companies are having to answer more bondholder questions related to their respective ESG strategies, and investors are taking an increasingly dim view of those that are ill-prepared.

Opportunities

Of course, credit investing with an ESG lens is not just about risk mitigation; it is also about looking for opportunities. Identifying issuers we expect to adopt an improved ESG profile over time, often through engagement, can result in capital appreciation as the transition is reflected in rating upgrades and a lower cost of capital.

We have for many years worked with both our in-house equity analysts and specialist responsible-investment colleagues when analysing and engaging with companies from a fixed-income perspective. Situations where we own both the equity and debt of an issuer can provide us with a powerful tool with which to focus a management team.

We expect ESG to be priced into credit risk to a greater degree in the future

There are a growing number of ESG research providers and, while their data is useful, it is just one of the inputs into our proprietary analysis and investment process. The data can provide a basis for comparability, and market participants may begin to view the ESG scores as a type of consensus rating. Indeed, MSCI recently announced that it has made ESG ratings of over 2,800 companies publicly available; greater ESG data availability should cause companies and countries to take a greater interest in how they score. We are already seeing some of the better-rated companies today using their ESG rating to their advantage in that their ESG score drives the level of their bank-loan margin.

Conclusion

We believe that undertaking ESG research as a key part of our fixed-income investment approach is not just about reducing risks, and seeking to enhance returns to investors, but also about helping to influence corporate responsible behaviour. Asset managers and asset owners can no longer afford to focus solely on maximising short-term returns if it comes at the expense of other stakeholders, with the associated bad publicity and longer-term negative consequences.

It is still undetermined whether ESG is properly factored into credit pricing, but as ESG concerns rise up the agenda of society, governments and investors, we believe we are likely to see a growing bifurcation of pricing between the strong and weak ESG performers.

Having integrated ESG considerations into credit analysis for a number of years, we have always believed that considering the materiality and impact of ESG factors on companies and countries is crucial to risk assessment. In our view, it results in better decision making, and should, if done with diligence and consistency, result in superior risk-adjusted returns because ESG factors can have a material impact on credit risk, and therefore performance.

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