Shifting sands

Summary
- The influence pension funds can have on a company's ESG aims has been largely limited to those holding equities.
- Bond-holding pension funds, however, are becoming increasingly influential.
- In order to succeed, early engagement and timing are essential.

Pete Carvill looks at how pension funds as investors can incorporate ESG/sustainability considerations into their bond portfolios. So far the focus has mainly been with incorporating ESG issues into equities, as shareholders are able to vote and therefore influence company issues, unlike bond holders. However, it seems bond holders' ESG concerns may start to be picked up by companies

Interest in environmental, social, and governance (ESG) investment issues has grown in recent years. Once in the background of investing, recent developments have seen it codified, and moved front and centre in the minds of trustees.

Increasing focus

Much of this has come following legislation such as the IORP II Directive. One year after it came into force in 2017, the proportion of pension funds considering the investment risk of climate change had risen from 5-17 per cent. And this was against a backdrop where many felt that opportunities for ESG investment were lacking – a joint industry report in January found that 29 per cent of pensions professionals felt this way.

All this is taking place in a shifting landscape of legislation, adjusting at a pace that seems as if it should be measured in miles per hour. Along with IORP II, there were the measures set out by the Department for Work and Pensions (DWP) in 2018 and 2019 around how funds disclose information on their investments.

In February, the DWP sent out a letter to The Pensions Regulator (TPR), setting out its expectations that the latter would take a more proactive approach on climate change and ESG. This followed an amendment to the Pension Schemes Bill earlier in the month, asking trustees to review climate change's impact on investment strategy. This was subsequently scaled back, with the government saying such a move would apply only to large schemes.

PLSA lead for investment and stewardship policy, Caroline Escott, says that these moves have come as no surprise. "We know that the DWP and the minister have been keen to encourage schemes to integrate and consider financially-material ESG factors. There's a feeling that we have a legislative framework in place, and after applying to deadlines last year, this year, and next year, it is up to the supervisory and enforcement approach of the regulator to hold schemes accountable in regards to their ESG strategies."

Bondholder influence

There is a lot of work to be done. But

one segment that has an increasing amount of influence in a company's ESG activities are bond-holding pension funds. However, traditional focus has been on share-holding pension funds, given that they have voting rights on a company's objectives and behaviours, while bondholders do not. But this is starting to shift.

Firstly, bondholders have plenty of chances to engage, says Willis Towers Watson senior investment consultant, Kate Hollis. "Bondholders have plenty of chances to engage. Some companies, such as Volkswagen, have a large chunk of their shares owned by the family or the government. This means that the free voting rights are limited. You could argue there that the bondholders have more influence than the shareholders."

There are many times, says Hollis, when private equity takes over a company, then leverages using bonds. This, she says, leads to bond investors having considerable engagement and influence.

Secondly, there is transparency and branding. While a bad public image may not directly affect the fund, it does affect the company and may limit its ability to pay once the bond matures.

Thirdly, there is matching. PTL client director, Clare James says: "If you are going to be holding bonds for the long term, you've effectively lent out the money and want it to come back. You need companies to act responsibly and be there in the long term to deliver their promises."

Quantum Advisory investment consultant, Jayna Bhullar, puts it more succinctly: "The consequences of poor ESG practises could impact a company's ability to re-pay its debt and should therefore be critical for bond holders."

Lastly, there is the fiduciary duty of trustees. "There are some studies," says James, "that show ESG factors will lead to superior returns and better, sustainable companies over the long term. That's what you want with a long-duration investment."

James is supported by a recent meta-study conducted by Friede & Busch. It found that ESG factors had a positive or neutral impact on financial returns in 90 per cent of 2,200 academic studies done over four decades. It was also reported that since 1990, the MSCI KLD 400 Social index, made up of companies with strong sustainability profiles and excluding laggards, has outperformed the S&P 500 with annualised returns of 11.2-10.7 per cent.

Action

This begs the question as to what funds as bondholders can do. "The start point," says Sackers partner, Stuart O'Brian, "is being realistic about how you invest and what is feasible in that. That does lead to the old myth that if you're passively invested, you can't do much. But there's an increasing focus on engagement not being the preserve of equity managers, but bond managers, too."

He continues: "Trustees shouldn't just resign themselves to the fact that they are in a passive pool mandate. They should look at whether it's the right fund to hold. And they need to look more critically at whether the policies align with their manager's policies. If a trustee states some fantastic ESG policy but selected a pulled fund mandate with a manager that doesn't match, that looks odd."

Timing is also key to engagement, says Hollis. "Large companies that borrow frequently tend to be permanently in the credit index. That means they are refinancing bonds with new issues frequently. They need people to buy those bonds. While you can raise equity once and the voters can vote on it, the bondholders can engage with companies at each new issue. Some of the largest, like General Electric, borrow multiple times a year. There's opportunity for engagement there."

Newton Investment Management fixed income portfolio manager, Scott Freedman, puts it succinctly: "The more that companies are reliant on you, the more they will listen to you. If that margin capital is not available, then it could be that those companies end up starved of capital."

Bhullar seconds this, saying: "The main opportunity for bondholders to influence ESG behaviour largely sits at the stage of new issuance and re-financing. It is more difficult to do this at other stages. A large proportion of approaches remain exclusionary. Active management of bonds could seek to incorporate this in a strategic manner, such as agreeing terms prior to investment, identifying company specific characteristics and factoring this into their decision making/positioning. This would help with managing ESG risks and could enhance returns."

Collaboration between departments within the fund and a coherent outlook, says Escott, can also have real benefits. "Getting bondholders together with the equity holders of a particular company on a particular issue. And that means the asset managers, different asset managers and different schemes as well can be a really powerful way of working together to achieve real change."

Freedman says that engagement in ESG is not just about allocating to green capital and projects. "I prefer," he says, "to think of it as mobilising capital because there will be gains made from companies not scoring well today that will transition to lower emissions, and profit from it, in the long term."

He summarises: "Engagement is a clear point in how you invested, but it's more much than just green bonds. There are sustainable bonds, climate awareness bonds, etc, all types of bonds. It's a market that will continue to grow."

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