

# How can ESG integration work in fixed income?

## ✓ TwentyFour Asset Management explains its approach to ESG integration within its fixed-income portfolios

**A**t TwentyFour, ESG – environmental, social and governance – factors, are a critical component in our investment process.

We believe ESG can be essential in helping to minimise long-term risks to the value of our investments, improving risk-adjusted returns for our clients and ensuring their capital is invested responsibly.

As ESG investing has grown, it's become clear that across the asset management industry there are many different interpretations of what constitutes ESG investing, and how it

should be implemented. This can be confusing for investors trying to select a manager that matches their objectives.

### Integration

We follow an **integration** approach to ESG, which means ESG analysis is built into the regular investment process for all our portfolios; our portfolio managers evaluate the ESG risks associated with every company whose bonds they consider adding to a portfolio, and how these might impact the value of the asset over time.

For true ESG integration, we believe portfolio managers have to be accountable for this process and do their own ESG analysis. As an active asset manager, we wouldn't feel comfortable relying solely on an external ESG data provider, or even a standalone ESG team within the business. We want our whole team to know the ESG risks of the credits they track inside and out.

### **So how does this work in practice?**

Every day, TwentyFour portfolio managers use a purpose-built relative value tool called Observatory to scan the global universe of fixed income and select bonds, and the ESG scoring is built right into this software.

Designed in-house at TwentyFour, Observatory is like our very own search engine for the global universe of fixed income. Observatory stores key metrics on over 30,000 bonds from companies and governments around the world, allowing instant relative value comparison from issuer to issuer and from bond to bond.



**“We’ve never been shy in engaging with companies, regulators, central banks and governments when we feel it is in our clients’ interest. Our Observatory system allows us to document these interactions and be transparent with our clients about when, why and how we went about them.”**

*Chris Bowie, Partner and Portfolio Manager, TwentyFour Asset Management*

ESG factors are integral to this relative valuation process, and sit right alongside more familiar bond characteristics such as yield or maturity.

As a starting point, we populate Observatory's ESG fields with data from a third-party provider, which gives us information on more than 6,000 public companies across 400 ESG data points.

But as we've said, we don't want to rely solely on third-party data. All commercially-available ESG databases are drawn from publicly listed firms. But many corporate bonds are issued by private companies, meaning around 40 per cent of the most widely used global credit indices aren't covered.

Therefore, our external ESG database informs our ESG scoring, but the PMs'

**“TwentyFour’s growing presence in the pensions space has been achieved by understanding client needs and responding quickly to them. Our active approach to assessing ESG risks can be time-consuming, but we believe is essential for giving clients the clarity they need.”**

*Graeme Anderson, Chairman and Portfolio Manager, TwentyFour Asset Management*

own work is there to fill in the gaps, and to override the database if necessary, in response to new developments. This means we arrive at a combined ESG score for each bond issuer, which is heavily dependent on the portfolio managers' own ongoing credit work.

### How do we arrive at this combined score?

We start with the basic building blocks of ESG.

**Environmental** risks, for example, might include a company's level of emissions or its waste management policy. **Social** factors might include things like equal pay, human rights and ethics policies, while **Governance** risks typically relate to a company's treatment of its stakeholders; staff, customers and capital providers.

This initial assessment can give us a good idea of a company's ESG performance relative to its peers, but we think it's important to go further, which is why TwentyFour's integration model incorporates more qualitative ESG risks such as **Controversies** and **Momentum**.

**Controversies** tend to be related to specific events or actions that point to poor behaviour and might be a risk to investors in the future, such as a firm with a history of accidentally polluting the environment or being found guilty of predatory pricing.

In considering **Momentum**, meanwhile, we want to understand whether a company has a credible plan to improve any weaknesses we identify in its ESG credentials. For example, we have previously afforded positive momentum



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*Charlene Malik, Portfolio Management, TwentyFour Asset Management*

to an energy producer with a multi-year plan to dramatically reduce its use of coal.

We believe companies that can demonstrate a clear path to a better outcome should be supported by capital markets, and this is why TwentyFour's more active approach to ESG allows for more nuanced considerations like momentum.

It also places a greater importance on **Engagement** with issuers, which we believe is the most effective method by which bondholders can influence corporate behaviour on ESG issues.

We've never been shy in engaging with companies, regulators, central banks and governments when we feel it is in our clients' interest. Observatory allows us to document these interactions and be

transparent with our clients about when, why and how we went about them.

Finally, this ESG integration model gives us a platform for creating funds with explicit sustainability goals. With these mandates we move the bar higher, using a careful combination of positive and negative screening to positively reward the firms with the best combined ESG scores, while ruling out the companies or even entire industries that score poorly. We launched our first such sustainable fund in early 2020 and expect to launch more of these in the next few years.

We believe this more active approach to ESG integration is best suited to our culture as an active, high conviction and specialist fixed income asset manager.

We think it is the best way to help protect our clients from long-term risks to the value of their investments, while ensuring their capital is always deployed responsibly.

Our unique Observatory tool makes certain these risks are a part of the conversation at every step, making ESG a truly integral part of the investment process at TwentyFour Asset Management.

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