Bonding responsibly

Bonds are common investments for pension funds, but the current environment has created a great opportunity for institutional investors to ensure that their credit market securities are helping the planet as much as possible

Bonds are one of the key investments for any pension fund, with fixed income assets often being used to balance volatile equity investments. With the world going through a pandemic crisis and markets remaining unpredictable, there has perhaps never been a better time to consider integration of environmental, social and governance (ESG) factors into credit market investment.

As this feature will demonstrate, this consideration is very much in vogue, can offer value and is undergoing an evolution as the coronavirus crisis rattles on.

Popularity

In an indication of the growth of ESG investment in the credit market, ratings agency Moody's has forecasted that debt based on environmental, social and governance principles could climb as high as $375 billion in 2020, up by almost a sixth on the year before.

Principles for Responsible (PRI) senior analyst, Felix Soellner, says: "Traditionally, the credit market has lagged behind the equities market in the ESG product offering but, with over $80 trillion of institutional monies on the credit side, this focus has been shifting towards managing credit relationships in alignment with ESG requirements."

T Rowe Price portfolio manager, Mike Della Vedova, states: "ESG has been part of our investing DNA for many years, even before it became known as ESG. The different factors that constitute ESG are important elements within our research process when determining valuations and long-term performance."

Soellner states that although in some cases "ESG risks have been incorporated on a fundamental level for a long time" there has been "material changes in how this analysis is being carried out through the increasing formalisation and systemisation" of integration.

MSCI executive director and factor strategist, Hitendra Varsani, also produces evidence of increasing demand, noting that MSCI has more than 320 fixed income indexes linked to ESG through its partnership with Bloomberg and Barclays, and "launched our own suite of ESG linked corporate bond indexes at the end of last year" due to client demands.

Varsani concludes: "In the context of ESG adoption in equities, the credit market is still in its infancy, but this is changing. We see increased demand from asset owners, asset managers, broker dealers, wealth segment, as well as pure credit index providers in either using the ESG ratings directly or index linked solutions."

Process

Now that we've seen how ESG integration is increasingly popular in the credit market, it's worth considering how it is actually achieved by investment professionals.

Della Vedova explains that, at investment management firm T Rowe Price, the multi-structured process consists of the ESG team evaluating individual companies and sharing their findings with credit research analysts, analysts incorporate ESG factors into their independent issuer valuations and ratings and a portfolio manager balances out ESG factor exposures at the portfolio level.

He adds that the company's ESG teams have created specialist tools to "systematically analyse the ESG factors that could impact our investments", stating that "the foundation of the analysis is a proprietary flagging tool called the Responsible Investing Indicator Model (RIIM)" which covers around 13,000 securities.

While he comments that the processes behind the asset manager's Global High Income Bond Strategy "naturally incorporate an analysis of each company's ESG factors and tend to yield an ESG-friendly portfolio", he adds that the investment team works closely with ESG specialists and screen the portfolio with the RIIM "at regular intervals".

Della Vedova notes: "This helps us understand the ESG characteristics of the portfolio and makes us aware of any exposures to specific ESG factors or how these ESG factors may impact a company's business operations and market performance."

ESG integration is one thing, but can how are returns influenced by taking these factors into account?

Value

Della Vedova is reassuring in the face of this query, commenting that integration "should have a positive impact on returns for investors as they will contribute to a more holistic view of the company", adding that companies that poor ESG factor scores "can have a significant detrimental impact on performance in both the short and longer term".

However, Soellner warns that incorporation "can create extra costs", although he adds that these can be mitigated by "the benefits of using ESG to support the bottom line and creating an opportunity set for the credit side".

He adds: "If investors are willing to accept lower coupons on their bond investments, then this judgement would most likely be based on a fundamental belief that the issuer is of higher credit quality than a comparable low ESG-performing peer.

"Applying a haircut to the interest paid is therefore a tool to appropriately valuing a bond and its credit risk. Increasingly, this type of mechanisms is utilised to monitor and reward ESG performance over time."

Varsani comments: "There is an increasing body of literature that demonstrates ESG factors have brought defensive characteristics, such as some positive correlation with credit ratings, tighter OAS, and low volatility."

In terms of a current examination of the value on offer from 'sustainable' investment in the credit market, MSCI's *Corporate Bonds Through a Factor and ESG Lens* blog post shows the finance company's ESG Leaders and ESG Universal indexes achieving marginally higher returns than its USD IG Corporate Bond Index over the first half of the year.

Varsani adds: "During the first quarter of this year, sustainable investing in corporate bonds showed defensive characteristics and helped mitigate drawdowns in both the investment-grade and high-yield universes."

Considering this apparent robustness in the face of a worldwide pandemic, its also worth considering how the extreme conditions of Covid-19 have affected factoring ESG into credit market investment.

Pandemic

Soellner argues that the 'social' aspect of ESG factors have been a particularly relevant consideration in the midst of the coronavirus crisis.

He explains: "Signatories spent significant time managing relationships and structuring payment holidays and effectively redirecting a majority of their engagement activities to crisis management. Those actions include providing additional liquidity to keep business operations afloat and staff employed and keeping their employees safe, to redirecting products and services to benefit public and private health care providers.

"The question around the licence to operate became a very human one as corporations started to see the need to support the communities they are operating in. Fundamentally, the current crisis will not reinvent the way investors are addressing ESG concerns in their investments but rather, sharpen their focus on crisis management, including a more granular assessment of ESG materiality."

Della Vedova agrees, pointing out that when businesses are struggling financially they "may look to cut costs in areas such as health and safety, jeopardising the safety of employees", which he adds "demonstrates the importance of thorough analysis on ESG factors, particularly through periods of uncertainty".

Della Vedova notes: "The underlying ESG factors are unchanged and should still be monitored in the same way and with the same mindset. However, the prevailing economic conditions mean it is worth placing an even greater emphasis on ESG within a company."

This is backed up by an assessment from ratings agency Moody's released in mid-August, which noted that a record $3 billion-worth of social bonds were sold to credit managers in the year's second quarter, while the issuance of green bonds slowed.

Approaching the issue from a slightly different angle, Varsani offers insight into how MSCI have rethought ESG factors in the wake of the pandemic, with the company's ESG Research team having created 10 charts considering the 'new normal' from various angles.

He comments: "These topical issues range from society to reconsider what a dangerous job looks like, seeking out green buildings, social inequalities as less educated workers face a choice between layoffs or working in close proximity to others.

"Perhaps one of the most critical issues is the increased focus on climate related issues and the potential signs of more disasters to come."

Written by Duncan Ferris