The growing role of ESG in fixed income

With environmental, social and governance (ESG) issues becoming more important across the globe, Mahesh Jayakumar explains how MFS incorporates ESG factors into fixed income research, and looks at the opportunities and challenges facing investors

ESG has been a theme in equities for many years. Why has it been a growing trend in fixed income?
Fixed income has traditionally been used for its ability to manage downside risk while generating income and, in general, it continues to play a diversification role in asset allocation. The fixed income investor base is growing as both institutional investors, such as pension plans, and an increasing number of retail investors, such as retirees and everyday savers, perceive greater volatility within equity markets and allocate more of their capital to fixed income.

At the same time, market participants such as asset managers, asset owners, regulatory agencies and policymakers are increasingly thinking about ESG issues beyond just the implications for equity shareholders. In addition, more investors are seeking to use their capital to have a positive social or environmental impact, which involves a greater degree of ESG integration.

In light of this, and given that fixed income markets are significantly larger than equity markets, it is clear why ESG is becoming an increasingly important part of fixed income investing.

How do you approach incorporating ESG issues into fixed income analysis?
Our investment approach has always focused on identifying companies and issuers with sustainable, long-term competitive advantages. As investors, we need to take into account all factors that can affect the viability of our investments through multi-year business cycles and ever-evolving macro environments. We believe that the integration of ESG factors into our research is essential, as these issues often affect the long-term sustainability of cashflows for issuers.

When evaluating corporate bonds, integrating ESG issues into our fundamental analysis of the issuer's credit and leverage profile is critical. ESG analysis involves understanding issues that are typically nonfinancial in nature, such as environmental impacts, employee well-being, supply chain management, product safety and workforce diversity. In the short term, shocks to these factors can affect cashflows and the ability to pay interest to debt holders. In the long term, they can harm corporate culture and impact operating models, which can lead to the erosion of revenue generation and, ultimately, profitability.

While governance is widely considered the most prominent ESG factor affecting various fixed income sectors, environmental and social factors must also be considered. For instance, the deterioration of social or environmental factors can influence the political stability or business climate of a particular country. Therefore, we evaluate social factors, such as inequality, and environmental considerations, such as air quality and water stress, along with a country's governance practices.

Which elements are most important in this integrated approach?
ESG factors are assessed within the context of overall credit risk. Traditional credit analysis involves understanding the ability and willingness of the borrower to service their debt. An integrated approach must consider how ESG factors could affect the ability of the borrower to pay back the lender.

Emphasis is placed on materiality and time horizon, ie, the maturity of a bond. Materiality measures the likelihood that a particular ESG issue will affect a borrower's revenues, costs, long-term financial condition and, ultimately, ability to repay debt. Time horizon determines materiality. ESG factors can become increasingly impactful over time, so the maturity of a bond is a critical lens for any ESG analysis.

Finally, high-quality ESG data sources are crucial to truly understanding an investment's material ESG risks and opportunities. Market data, such as ESG ratings, are important to consider as one of many inputs into the fixed income research process. However, more holistic and relevant insights require assessing these topics deeply and independently.

Do you see any challenges in applying ESG factors to fixed income?
The quality of ESG data has come a long way, but it continues to vary in terms of coverage and availability. For example, there is still not enough disclosure of ESG information from private and emerging market companies. As awareness of ESG issues increases, the demand for relevant data also increases, which means a greater number of market data providers are stepping in to fill this void.

Another challenge relates to engagement between investors and issuers. Unlike equity shareholders, bondholders do not have formal engagement mechanisms such as the ability to vote proxies or raise shareholder resolutions.

The relationship between credit ratings and ESG ratings is also a challenge specific to fixed income investors. High credit ratings do not necessarily imply high ESG scores and vice versa. The impact of a given ESG factor on credit spreads can be uncertain and change over time. Therefore, it is important to assess whether ESG factors are fully reflected in the credit rating.

What are the opportunities for fixed income investors?

The rise of thematic investing, such as green bonds, is providing fixed income investors the means to directly finance projects that address specific issues, such as climate change mitigation and adaptation, renewable energy production and increased energy efficiency. Growth in green bonds has led issuers to structure bonds with similar use-of-proceeds and project selection frameworks, such as social and blue bonds. Social bonds fund projects in such areas as education and health while blue bonds focus on oceans and marine life.

The United Nations' Sustainable Development Goals (SDGs) are increasing awareness among both investors and companies about the role we can all play in developing a more sustainable society and economy. Fixed income investors can help tackle larger issues such as climate change by unlocking much needed capital. Bond markets are deep enough to provide required financing, and the structure of fixed income investments lends itself very well to project financing. Investors provide capital up front to a borrower who uses the proceeds to complete or accelerate a project. The borrower can then use the cash flows generated by the project to pay the lenders back over time.

Like equity investors, fixed income investors can employ screening and tilting strategies to reflect ethical values and include bond issuers with better sustainability profiles. They also have the opportunity to increase engagement with borrowers on sustainability and related ESG issues since increased disclosure benefits all participants in the capital structure, including bondholders.

How is the thematic bond space developing and has Covid-19 had any impact?

The sustainable debt market showed resilience amid the health and economic shocks of the first half of 2020, which saw a fall in green bond issuance and a surge in social bond supply.1 The increase in social bond issuance has been significant this year; these securities are dedicated to funding social projects and/or activities that have a positive impact on health. Covid-19 has pressured societies and economies to support care systems and the populations that are the most affected by the crisis, and this aligns with the mission of governments and supranationals that have always been the biggest issuers of social bonds. The total issuance in the first half of the year was more than twice as large as last year's total volume.

We believe that thematic bonds could provide an attractive investment opportunity that can be held within traditional fixed income portfolios, not just in a standalone thematic fund.

If you are interested in learning more about how sustainable investing works at MFS, please visit us at mfs.com/sustainability or contact MFS head of UK institutional sales, James Lindsay, at jlindsay@mfs.com

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[1] Source: Bloomberg 2H2020 Sustainable Finance Market Outlook, as of 29 July 2020.

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