Growing the sustainable pie the right way

Scott Freedman highlights themes that should help to grow the sustainable fixed-income market

As investor interest in environmental, social and governance (ESG) considerations continues to grow, the integration of ESG factors within the fixed-income investment process is fast catching up with equities. This article highlights themes that we believe will help shape and grow the sustainable fixed-income market in 2021 and beyond.

Management incentives and KPIs

We anticipate an increased focus on management incentives being tied to ESG-related key performance indicators (KPIs). This should extend beyond senior management, and we expect a growing alignment between a wider range of stakeholders in issuers where this dynamic exists or is being enhanced.

An important question to also ask companies is where their board ESG oversight and expertise sits, and whether the drivers of the strategy have the necessary skills and accountability in place. We frequently ask these questions during engagement with management teams as it helps demonstrate whether the company is living and breathing a responsible strategy.

Further regulation

Plenty of new regulations and policies were announced by authorities during 2020, including the 'greening' of the European Central Bank's (ECB) purchase programmes and the development of the European Union (EU) taxonomy, which has helped to define what can be considered 'green', 'social' or 'sustainable'.

We believe 2021 will see the continued evolution of regulatory plans which will challenge investors, asset owners, companies and governments to improve their sustainable disclosure and reporting.

We are closely monitoring the potential implications for certain pools of capital that run the risk of either becoming stuck invested in stranded assets, or chasing too few assets and becoming expensive. There will also be opportunities for those issuers who can transition and those who develop long-term strategies with ESG considerations in mind.

Green, social and sustainable bonds growth

European governments represent the majority of issuance in this sub-sector today. We expect to see further growth from these European government issuers, and globally. Funding the recovery from the combined health-care and economic crisis of Covid-19 has accelerated the widening of the use of proceeds from these bonds to include social factors too. Examples include the recently-issued EU SURE bonds, while in the UK, Green+ Gilts are expected to launch in 2021, with the proceeds going towards both environmental and social purposes.

Reporting on the outcomes of the 'use of proceeds' bonds is as important for governments as it is for the corporate sector. In fact, we believe governments should be leading by example; robust and transparent reporting by governments can encourage companies to follow suit.

Investors asking more of issuers

Investors are starting to ask more of fixed-income issuers on ESG factors. Although fixed-income investors do not get a vote, they can and do engage. However, even today, in many of the meetings we have with issuers, we do not see peers asking important ESG questions. By asking more of issuers, ranging from the bare minimum of whether they have an ESG plan, to specific topics on how sustainability affects their businesses, fixed-income investors can push issuers to improve their practices, transparency and reporting for the benefit of all stakeholders. We have noticed ESG-related slides appearing in some issuers' presentations in some of the most carbon-intensive sectors, but ESG should not just be about ticking boxes, which is why fundamental credit analysis remains critical.

Although environmental factors have been a primary focus for investors for a few years now, they have sometimes still been eclipsed by time spent analysing social and governance issues. As the narrative around climate risk is becoming ever more urgent, we expect governments to increasingly address it, which should also lead to the broadening of green government-bond issuance globally.

US growth

The US has lagged other parts of the world in the issuance of 'use of proceeds' bonds. Following the change in administration and the country rejoining the Paris Climate Accord, new US government policies should ultimately lead to a greater focus on improving both environmental and social outcomes domestically. This is encouraging news as we often see that where governments lead by example, either through policies, support mechanisms or 'use-of-proceeds' sovereign issuance, it encourages domestic issuers to follow suit.

We anticipate that further growth driven by US issuers, for example, can enhance the size, diversification and liquidity of the market. Over time, even the best of the green-bond issuers will run out of projects to parcel into the green-bond framework, which may lead them down the road of sustainability-linked bonds as they continue to raise capital with the objective of providing positive environmental or social outcomes.

Sustainability-linked bond growth

We also expect significant growth in the newest area of the sustainable bond market – sustainability-linked bonds. The first sustainability-linked bond was issued by Italian utility company Enel in September 2019 and since then, just a handful of other issuers have come to the market with sustainability-linked bonds. The slow pace demonstrates that the market is still finding its feet, but we believe this relatively innovative area of financing has legs and will ultimately see material growth.

The International Capital Market Association (ICMA) released its guidelines on sustainability-linked bonds in June 2020, and is currently considering the concept of transition financing. As bond investors, we always prefer to have greater and stronger credit protections; owing to the global chase for yield, much of this has been eroded – both in number and quality. We have always voiced our concerns over the lack of penalties for green-bond issuers that do not allocate bond proceeds as promised or if reporting is not accurate.

Avoiding 'greenwashing'

The risk of 'greenwashing' becomes a real possibility when an issuer which scores poorly on ESG factors issues 'use-of-proceeds' bonds linked to specific environmental projects. Also, some issuers are attracted to the prospect of raising cheaper capital by using a label.

For us, having an ESG KPI target that links back to the broader strategy of the issuer can sometimes be more powerful for achieving positive outcomes than a narrow focus on a specific project, but that target needs to be credible. In our view, this is where active management and fundamental analysis can make a material difference by identifying the most suitable issuers.

Improving ESG data quality

ESG data quality in fixed income is inherently inferior to equities in certain areas, owing to there being many smaller and private issuers. Data providers have been making decent headway on closing the gap, but relatively poor disclosure remains widespread, especially in the area of leveraged finance markets.

While there has been a recent flood of new ESG data providers claiming to have superior insight into material ESG issues, investors are still learning how to process the data, and, once again, standards and consistency are required to act as guide rails.

Working together

Finally, when it comes to purely financial returns, what is good for a bondholder is not necessarily good for a shareholder and vice versa. However, when it comes to ESG factors, we believe both sets of investors should be fully aligned.

We think issuers considering ESG factors should be more likely to have resilient and effective business models, which can also lead to societal and financial positive outcomes.

While bond investors can engage, they cannot hold management teams to account through voting as shareholders can. They do, however, have the ability to deny capital to issuers. In our view, shareholders and bondholders working together will create the best opportunity to improve environmental and societal outcomes, as well as share best practices.

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