# Time to focus on ESG

**Summary**
• There are indications that a growing number of pension funds are considering fixed-income allocations as part of their ESG efforts.
• Motivations include increased awareness of ESG factors that pension funds can influence, regulatory changes, perceived investment opportunities and rising pressure from activist groups.
• A wide range of tools are available to fixed-income investors to allocate capital targeting better ESG outcomes.
• It has been suggested that a clear framework, with consistent standards across regions of the world, would help investors to compare and contrast issuers and bonds and better hold them to account.

**Abigail Williams considers how ESG considerations are being incorporated into pension funds' fixed-income allocations**

In the drive to improve sustainability performance, a growing number of pension funds are considering fixed income allocations as part of their ESG efforts. So, what types of strategies and approaches can pension funds consider to adopt a more organised and holistic treatment of fixed-income allocations in such efforts?

**Stewardship role**

According to Capital Cranfield professional trustee, Mark Hedges, all pension funds will consider ESG within their fixed-income allocations because they are required by the regulator to consider non-financial factors and risks when considering their investments.

This does not mean that they necessarily change their allocations to focus on sustainability or ESG investments but "when they reach decisions, they take account of those factors".

That said, he also observes that more recent requirements relating to the implementation of TCFD mean that pension funds will have to set metrics around carbon in their portfolios, and a forthcoming change will require a metric demonstrating how pension funds are aligning to the Paris Accord on limiting temperature rises to 1.5 per cent above pre-industrial levels.

"Increasingly this is seeing pension funds adopting investment strategies that more specifically address ESG. Whilst the initial focus has been on equities, this is now also being addressed in fixed-income portfolios," he says.

For Hedges, this development is motivated by a number of drivers, including increased awareness of ESG factors that pension funds can influence changes via their stewardship role, and regulatory changes such as TCFD, as well as from the investment opportunities identified and marketed to pension funds by asset managers and increased pressure from activist groups.

Elsewhere, Newton Investment Management portfolio manager, Scott Freedman, observes that, in the past, fixed income lagged equities in terms of being more explicit on how investors consider ESG factors.

"The assumption was that 'how can you engage when you're not a shareholder?' But this was a wrong assumption and, at Newton, we have been engaging with issuers and considering ESG factors as part of our credit analysis for many years," he says.

Freedman believes the role fixed-income markets have in funding the transition away from carbon-intensive economies, as well as for improved social outcomes, will become "increasingly critical" – and also that "most pension funds understand this and absolutely consider their fixed-income allocations within sustainability efforts".

"Often fixed-income investors are the largest providers of capital, and on an ongoing basis when debt is refinanced. Asset owners and investors are realising that within their fixed-income allocations they are able to more directly allocate capital towards better environmental and social outcomes," he says.

Amundi head of euro aggregate and lead portfolio manager, Isabelle Vic-Philippe, agrees that most pension funds have begun their journey towards responsible investing and are considering ESG in their fixed-income allocations. Even though the investment objectives of pension funds can vary significantly, she

points out that they all tend to include ESG consideration in their fixed-income investments, as they constitute by nature a large part of their assets.

"This progress has been fostered by the increased availability of data, from a few hundred companies included in equity universes, to thousands in a corporate bond world," she says.

"Pension providers are progressively being commanded by their different stakeholders to do their fair share in the global fight against climate change, calling for greater integration of climate change considerations in their investments," she adds.

**Strategies**

Given the fact that pension funds cannot ignore these strong pressures coming from multiple directions, Vic-Philippe says they may consider several options to translate the ESG dimension in their fixed-income allocations and portfolios, according to the weight of assets allocated to this ESG/sustainability space.

"Some pension providers may choose to change their traditional fixed-income approach to integrate ESG policy and sustainability objectives. Historically, it has often started by excluding sectors or a list of issuers, then by integrating ESG criteria in the management of their fixed-income portfolios," she says.

In terms of concrete strategies, Freedman points out that there are a growing number of tools available to fixed-income investors to allocate capital targeting better ESG outcomes – and that there can exist a higher level of accountability in place between the investor and issuer, which is so important.

These improvements can be achieved with 'labelled bonds' – bonds with specific ESG or sustainability objectives, such as green, social, sustainable and sustainability-linked bonds – as well as through 'vanilla' bonds. When selecting such approaches, Freedman also warns that greenwashing risks remain, which is why is it "crucial to consider each issuer and instrument on a case-by-case basis".

"Given we experience ESG integration across all fixed-income asset classes, it is possible for pension funds to allocate their fixed-income assets towards sustainability efforts. Their ESG philosophy will be an important driver of where they allocate to, as the way their underlying investments are managed needs to resonate with that," he says.

Although it is possible to allocate to one area, such as a net-zero focus, Freedman also believes that it "makes good sense to consider investing with broad improved ESG outcomes in mind, as it is hard to separate the E, S and G".

"For example, we must remember that there are social consequences to funding the climate transition, such as a change in the profile of skills demanded from the workforce required and the robustness of ethics within new supply chains – that is, ensuring that the environmental focus does not cause any significant harm to any social factors," he adds.

For Federated Hermes' head of sustainable fixed income, Mitch Reznick, any approach to the fixed-income allocations "should also respect that matters of ESG and sustainability are capital structure-agnostic, meaning that they are corporate-level factors that affect all financial stakeholders one way or another".

"The benefit of fixed income is that, as an investor, there are multiple access points to invest in a name, such as terms, structure, secured, senior, subordinated, loan, bond and so on. As such you can more precisely allocate risk based on your ESG-informed view of the name, he says.

**Continued growth**

Looking ahead, Barnett Waddingham's principal and senior investment consultant, Pete Smith, predicts that the identification and acquisition of relevant ESG data relating to unlisted companies and issuers will continue to be a key challenge.

"It's a growing area of consideration, because it's a growing part of pension scheme portfolios generally. In time, as sustainability feeds its way through to annuity pricing a greater focus on sustainability in bond management is likely to develop," he says.

Moreover, although it remains a small market in the context of the global bond market, Freedman anticipates continued growth in ESG-labelled bond issuance after 2021 to set new records.

"We expect to see a continued broadening out of sectors as labelled issuance is still quite concentrated in the finance, utility and real-estate sectors.

Freedman also warns of a risk that fragmentation and tiering will begin to appear in some labelled bonds, such as new-format green bonds, with environmental targets within some sustainability-linked bonds starting to reference science-based targets.

His view is that the market needs a clear framework with consistent standards across regions of the world, which would help investors to compare and contrast issuers and bonds and better hold them to account.

"New labels may also be developed, but we believe that this could run the danger of creating 'label fatigue' and increasing the risk of greenwashing. Over the next few years, we think there will be less need for bond issuance to be in labelled-bond form. The increasing accountability of all stakeholders, including governments, companies, investors and asset owners, should mean less need for labels but more emphasis on differences in the cost of capital between issuers," Freedman says.

**Written by Abigail Williams, a freelance journalist**

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