BlueBay Asset Management

Active vs passive for ESG investors

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AUTHORS
Mark Dowding
Chief Investment Officer, Senior Portfolio Manager

The growing popularity of ESG investing is resulting in some issuers 'greening' a portion of their debt stock to gain inclusion in dedicated ESG benchmarks. While passive investors lack discrimination over the underlying positions they have exposure to through these dedicated indices, their active counterparts have the chance to take a much more forward-looking approach, which brings with it the potential for superior ESG returns.

Reflecting a broader shift in society, the investment industry is showing increased interest in ESG strategies. These approaches seek to allocate capital towards issuers which demonstrate superior performance with respect to environmental, social and governance factors, at the expense of those which perform poorly on these criteria.

This has led to the birth of new ESG-related benchmarks, which have been designed along these lines, either by eliminating issuers and certain sectors or by focusing on opportunities in areas such as green bonds. Over time, it is easy to see how changes in the relative demand for the securities of some issuers demonstrating robust ESG performance could increase to the detriment of those which do not.

At the same time, we would note a concern that canny bond issuers (or their advisory banks), which understand benchmark construction, may find ways of lowering borrowing costs by undergoing a 'greening' of part of an issuer's debt stock.

In this way, we believe some ESG-oriented investors who pursue a passive approach in fixed income could find themselves at the mercy of the rules that benchmark providers articulate and bond issuers may seek to exploit.

In a truly active ESG-oriented fixed income strategy it is possible to apply ESG criteria in a much more forward-looking manner than benchmark providers will be able to do, in order to improve the potential for vastly superior ESG outcomes.

For example, we find it counter-intuitive to look at many ESG benchmarks in emerging markets because of the high weightings given to countries such as Saudi Arabia, which has the third-largest country weight in the iShares JP Morgan ESG EM Bond ETF.

This is also pertinent with respect to ESG engagement of issuers. Active investors may seek to educate and lobby issuers to modify their behaviours in order to achieve stronger ESG scores – essentially dangling the carrot of investment linked to improved ESG performance.

Similarly, the ability to take short positions in issuers which ignore ESG-related failings provides an example of how active managers can seek to deliver superior outcomes for those investors aiming to prioritise ESG factors in the context of a sustainable investment strategy.

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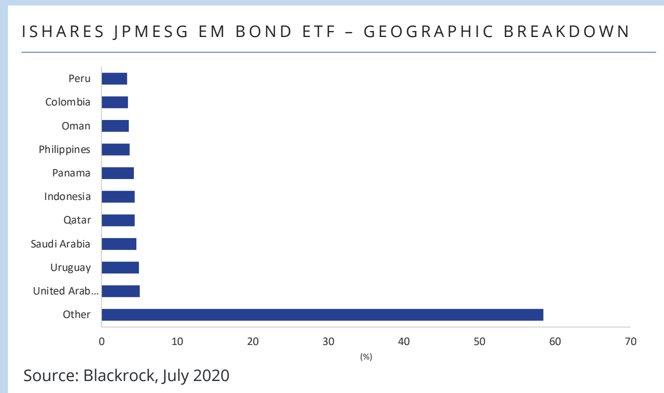
Passive ESG approaches – an opportunity for active managers to step up

- **Passive investing is gaining grounds within ESG. This can be seen with the likes of the iShares ETF and the L&G index fund which track the JPM ESG EMHC index developed in 2018. Both funds have raised USD2bn+ in aggregate in less than two years.**
- **However, the ESG methodology used by the index provider entirely relies on third-party ESG scores (Sustainalytics & RepRisk) and results in some questionable outputs. For example, with Saudi Arabia as the fourth-largest country exposure.**



Source: Blackrock, July 2020

- **Despite its flaws, this ESG approach provides an improvement when compared to non-ESG emerging market hard currency funds (based on MSCI ESG fund ratings) for any ESG investor looking for EM debt exposure**
- **This offers active managers an opportunity to develop more sophisticated ESG emerging market debt solutions in a space which is currently lacking in ESG products.**

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