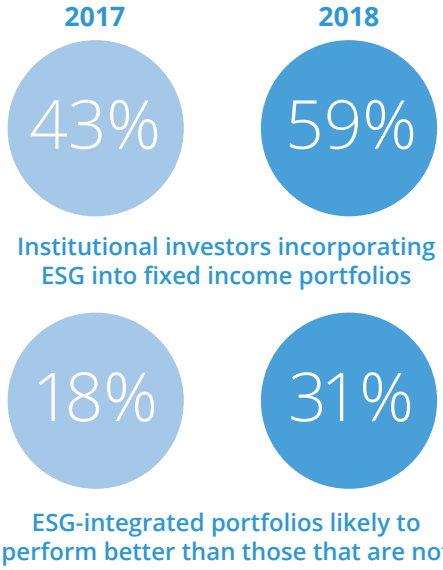
BlueBay
Asset Management

ESG and fixed income: The time is now?

Bond investors have lagged their equity counterparts in integrating ESG considerations into portfolios. But with ESG occupying a bigger role in credit ratings, and investors showing more willingness to engage with issuers, the fixed income sector may soon catch up.

The movement towards investing in line with environmental, social and governance (ESG) considerations appeared to have bypassed fixed income.

While equity investors have benefited from a wide body of research and performance benchmarks aligned to ESG factors, it has been a slower burn for bond investors. There is evidence to suggest the tide is now turning.



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In addition to investor appetite, there are indications that ESG can make a material difference to financial returns in all asset classes, including fixed income. In its 2018 report, 'ESG engagement for fixed income investors,' the UN Principles for Responsible Investment (PRI) stated "*ESG factors can affect the investment performance of bonds, both negatively and positively, at the issuer, sector, geographic and system levels*."[1]

So how do fixed income approaches to ESG engagement differ from equities and how they are being integrated into an investment strategy?

Understanding risk contribution in bond prices

ESG achieved earlier success in equities compared to other asset classes because the process of integrating it is less complex.

Share prices are driven by news flow and sentiment towards a company's growth prospects, revenue generation and expected profit margins. Positive or negative news relating to sustainability or governance factors will likely manifest itself in a company's share price - making the risk contribution of ESG factors simple to understand.

For bond investors, matters are more complex. The key challenge is isolating the contribution of ESG risk in bond prices given that coupon, term structure, call structure and rates all influence credit spreads.

Bond investors work in a larger investment universe, where there is significant variation in the quality and number of instruments, as well as lower levels of liquidity than equity markets.

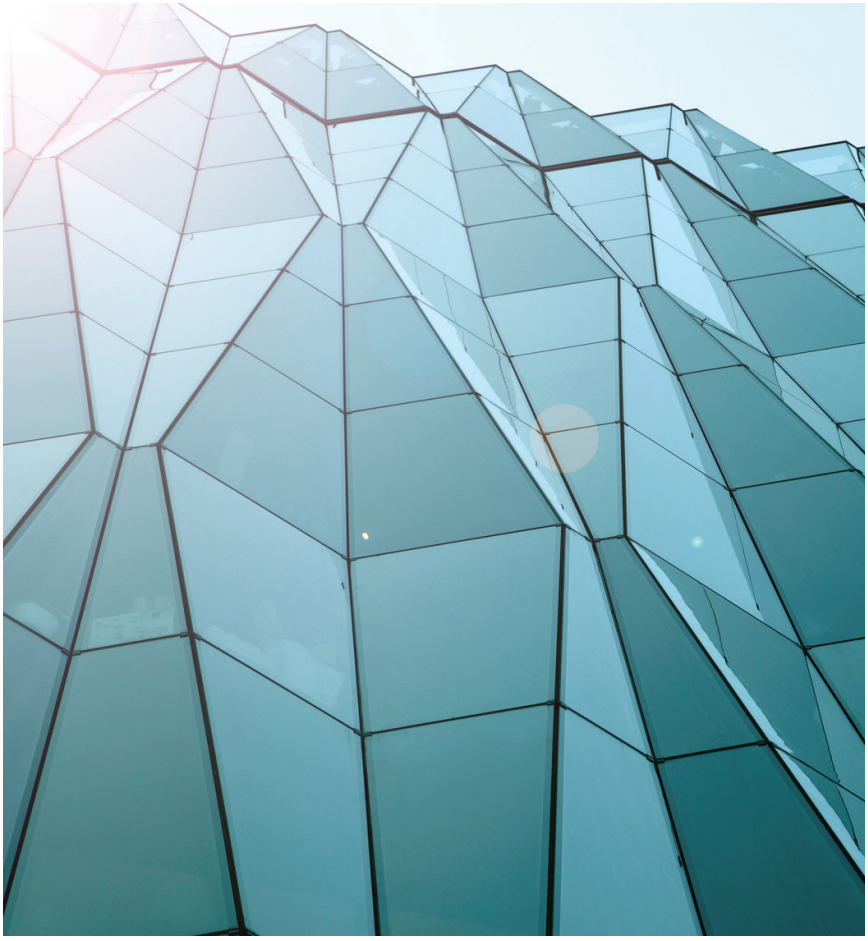
My-Linh Ngo, Head of ESG Investment Risk at BlueBay Asset Management, says a major difference that sets fixed income investors apart is that the primary emphasis is on downside risk - whereas with equity investors it is on the upside.

"*With fixed income, the credit rating is what moves spreads. Bond prices are pegged to the credit rating and the risk of default, so there is less volatility.*" Ngo says.

This is not the only difference. Fixed income investors also need to consider:

- Finite duration/maturity of fixed income securities vs equities being held in perpetuity
- Position of fixed income instruments in corporate capital structure
- Different rights compared to shareholders, particularly in terms of voting and engagement
- Sovereign, supranational, agency issuers and asset-backed securities that do not exist in equity markets.

If a company is considered to have the asset base and the balance sheet to absorb business shocks – ESG or not – it will be these factors that have a material impact on the price or the volatility.



[1] UN PRI, ESG engagement for fixed income investors, April 2018.
https://www.unpri.org/fixed-income/esg-engagement-for-fixed-income-investors-managing-risks-enhancing-returns-/2922.article

There is also the complication that, for any given issuer, the ESG risk of holding a bond may vary depending on which bond is held, for how long it is held, and its maturity term.

Solving the integration puzzle

As the number of ESG-integrated market benchmarks rises and adoption of ESG ratings increases, utilising an investment process which embeds ESG factors for fixed income has become more important.

However, determining the appropriate ESG strategy to apply is not necessarily clear cut. Although an obvious option, screening potential investments on an ESG positive or negative basis may not work with the structural nature of a sub-asset class, depending on size and sector bias issues.

According to My-Linh Ngo, expectations on the ability to engage is another area to consider more carefully. While bond investors, as creditors, do not have the same rights as equity investors, owners of a company, they still have rights and responsibilities, therefore it is important to find ways to engage with issuers.

She explains that fixed income investors have the most influence during the primary issuance cycle, where an issuer is more likely to be open to what investors want and therefore will be willing to incorporate that into the terms of the debt instrument.

Furthermore, the influence of the debt asset class should not be underestimated. Stephen Thariyan, Co-Head of Developed Markets at BlueBay Asset Management argues that, *"For most companies, raising funds in the debt market is more efficient and effective than giving up equity. Hence the size of the asset class is significantly larger than the equity market. In this respect, we have noted that companies are beginning to understand the increasing relevance and importance of good ESG practices to attract bond investors"*.

While the debt asset class presents some unique challenges for incorporating ESG factors, fixed income investors also have the opportunity to play a significant role by engaging with bond issuers and shaping a more sustainable future, whilst maximising the potential for superior long-term risk adjusted returns.

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