BlueBay
Asset Management

Do ESG factors reduce portfolio risk?

To date, investor interest in ESG has been largely focused on ethics ('values') and less on generating returns ('value'), which has led to flows into sustainable and ethical investments. However, we have seen increasing acceptance that incorporating ESG analysis can play a significant role in addressing portfolio risk.

In its report, *'Shifting perceptions: ESG, credit risk and ratings'*, the UN PRI points to evidence showing a clear link between ESG factors and the credit risk of a borrower[1]. In addition, there are links between governance and corporate failures, particularly in the investment grade space.

Investors are clearly taking note. In the RBC Global Asset Management 2018 Responsible Investment Survey, 67.3% of respondents said that they believed ESG factors can help mitigate risk in investment portfolios. Notably, this figure was up 19.4 percentage points on the previous year's survey.

Given that ESG analysis is heavily focused on measuring an investment's downside risks, it stands to reason that it should play a vitally important role in fixed income strategies.

"We have seen increasing acceptance that incorporating ESG analysis can play a significant role in addressing portfolio risk."

RBC Global Asset Management

[1] UN PRI, 'Shifting perceptions: ESG, credit risk and ratings, Part 1', July 2017, https://www.unpri.org/credit-ratings/esg-credit-risk-and-ratings-part-1-the-state-of-play/78.article

ESG and creditworthiness

A key consideration for bond investors is the relationship between ESG factors and an issuer's creditworthiness. These factors can exist at the issuer, industry or geographic level.

For instance, an issuer's credit rating or bond price can be affected by matters such as its corporate governance, regulatory compliance, the strength of its balance sheet and its brand reputation. At a higher level, issuers can be affected by risks such as regulation, technological change or disruption, supply chains, climate change or geopolitical tensions, depending on the industry and/or geographical presence.

Each of these risks has the potential to affect a bond's price performance or, in more serious circumstances, an issuer's creditworthiness.

Corporate risks

In the recent RBC Global Asset Management survey, investors were asked to identify the type of fixed income issuer to which they considered ESG issues most material. In mainland Europe (50%), the UK (43.3%), Asia (34.5%) and Canada (31.7%), investors believed that ESG issues had the largest bearing on corporate mandates.

Historically, it was assumed that ESG engagement for fixed income may be less effective because bond investors do not own the companies, so do not enjoy the same voting rights as those who are shareholders. More recently, companies have recognised the need to also acknowledge the concerns of fixed income investors. Doing so ensures they continue to have access to a broad pool of available debt, at attractive costs.

According to the UN PRI, corporate governance plays the most critical role in credit analysis[2]. This is because a company's corporate governance influences management decisions that then cascade down to other areas of the business, such as environmental and labour policies, competitive positioning, financial policy and so on. Meanwhile, a company's position on environmental and social factors can be considered indicators of future risks and opportunity potential that could affect its ability to repay debt.

For these reasons, Jean-Philippe Blua, Partner, Head of Investment Risk, Performance & Attribution at BlueBay, says it is important to think holistically when considering risk factors for issuers: *"For us, ESG constitutes an additional bottom-up risk factor to be considered alongside other more traditional metrics typically employed in risk management. It also provides a more medium-term perspective on the risks relevant to the issuer."*

"ESG constitutes an additional bottom-up risk factor to be considered alongside other more traditional metrics typically employed in risk management."

[2] UN PRI, 'Shifting perceptions: ESG, credit risk and ratings, Part 2', July 2017, https://www.unpri.org/credit-ratings/esg-credit-risk-and-ratings-part-2-exploring-the-disconnects/3250.article

"We have the most influence at primary issuance," says My-Linh Ngo, Head of ESG Investment Risk at BlueBay, *"At this point, companies are going to be more open to investor requests and may incorporate these into the terms of a bond. Legally, as soon as it is issued, the terms are fixed. But that doesn't mean that engagement has to end there."*

As companies have ongoing financing needs they are careful to maintain relationships with a loyal base of lenders, and this gives fixed income investors an opportunity for ongoing engagement, Ms Ngo says.

"Furthermore, at some point, a company may need to refinance existing debt," she explains. *"So, can they really afford to say, 'I know you want this, but we're not interested'?"*

Sovereign assessments

Fixed income risks, relating to ESG issues, are not limited to corporate bonds of course.

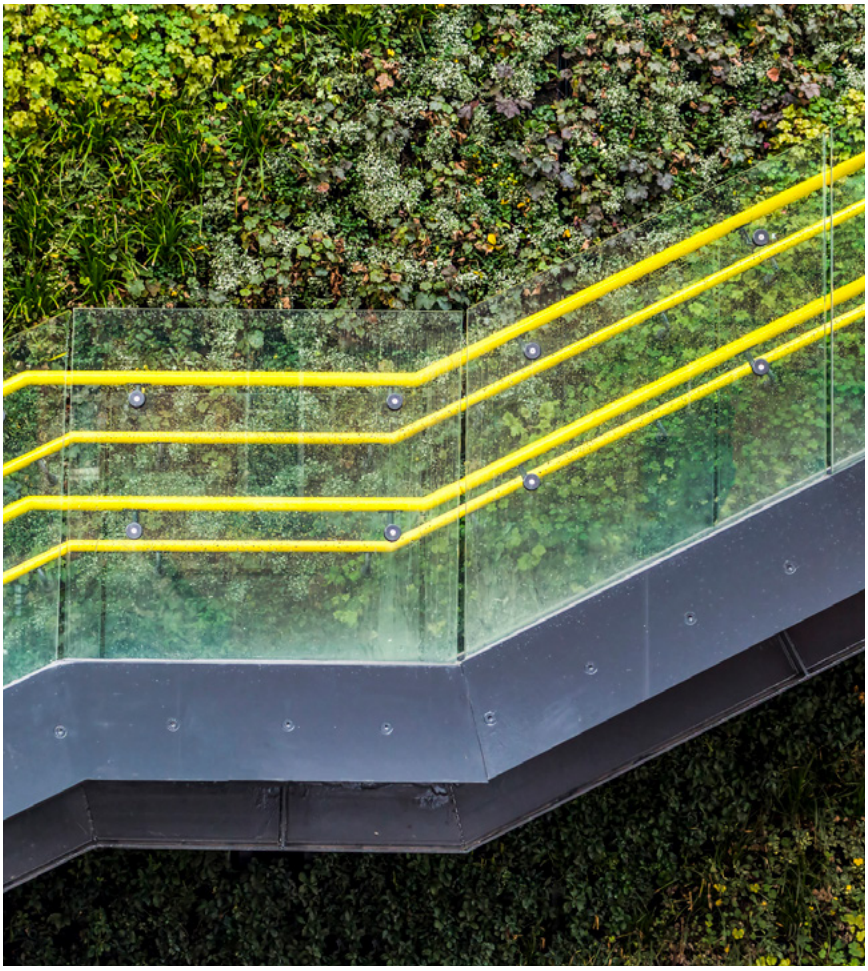
In certain geographies around the world, ESG issues were considered equally material to both sovereigns and corporates, in those polled for the RBC survey. More than 43% of UK investors voted this way, for example, as did 37.5% of US investors and 31% of Canadians.

For those interested in sovereign risk assessment, there is potentially some good news on the horizon, according to BlueBay's Head of ESG Investment Risk. She anticipates greater levels of engagement between sovereigns and investors in the years to come.

"The adoption of the UN's Sustainable Development Goals (SDGs) and the Paris Climate Agreement has placed governments under the spotlight in terms of the role they play and enables them to evidence their commitment," she explains.

Ms Ngo says that the market has already witnessed increased issuances of green bonds and she explains that there is still room for further growth in this and the SDG market from countries that have yet to tap global investors to fund their sustainability agenda, which can be positive for sovereign economic development.

"In particular, ESG offers an opportunity for emerging market sovereign issuers to tap into a more international investor base," she says. *"They want to position themselves as attractive and recognise that many global investors see the importance of ESG. Ultimately, it will mean that they have to be more transparent in these areas."*



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