BlueBay Asset Management

The ESG arms race

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Making an impact through active fixed income.

Delivering impact-led outcomes has been the preserve of equity funds...until now.

Times are changing and fixed income is starting to feature in the impact investment mix.

We believe this shift is critical for driving the ESG agenda because, ultimately, to create longstanding and holistic change, fixed income needs to play a leading role. Not least because this market dwarfs equities – fixed income totals some USD128.3 trillion versus the equity universe at approximately USD34.8 trillion.

Active vs. passive

For some time, ESG investing was limited to screening out the 'bad bits' of the investment universe. But any passive manager can do this, which begs the question – how can active managers add value within this space?

Something that passive managers do not do is participate in engagement. With fixed income, you have the chance to engage as a condition of ongoing issuance, which creates the opportunity for extended dialogue with the issuer. This means that while bondholders do not have the voting rights of their shareholder peers, they do have the ability to financially back or withdraw support from new issuance, with the associated ability to drive up borrowing costs.

Layer on top of this active managers with the ability to go long and short and you have both the carrot and the stick at your disposal to push for positive change.

Shorting brown debt

One such case study is Saudi Arabia. A sovereign that has always been asset-rich and historically has never needed to issue debt to raise funding. However, a couple

of years ago, it came to a point where reserves had depleted on the back of lower oil prices, requiring the sovereign to tap capital markets.

At the time, our ESG proprietary framework identified Saudi Arabia as our highest-risk sovereign in terms of ESG rating. During early investor meetings we flew the flag for ESG, but – still in its infancy then – much of our feedback was dismissed. We soon after took a sizable, active short position.

For the ensuing waves of issuance, Saudi Arabia was open to listening, wanted to engage and ultimately wanted to learn what it could do to pursue a more progressive ESG agenda.

Shorting for the sake of ESG can be a Catch-22

Ironically, shorting for the sake of positive impact is something we are often limited in taking advantage of through our conventional funds only, versus our ESG-focused ones. The reason being that ESG-focused investors tend to be more restrictive in their portfolio construction.

For example, most ESG-focused investors would express the need for a blanket ban on tobacco. However, it's an industry that we might like to short to push the ESG agenda forward. That said, we continue to see it as an approach where active managers can generate returns while offering the potential to drive positive change.

Buyers beware

According to a 2020 PwC report, ESG funds are projected to triple in size by 2025. Across the financial services industry, it's become something of an ESG arms race.

As this market grows, so too will the need for investors to be able to identify those managers that greenwash or see ESG as a 'tick box' exercise, versus those who are true champions for this agenda.

Within fixed income, green bonds are one such example of 'buyer beware'. While these securities certainly have a place, the waters are muddied.

They can prove a legitimate form of investment when the issuance of the green debt leads a project to take place that otherwise never would have seen the light of day. Unfortunately, it feels like a lot of green-bond issuance is being released by issuers looking to cash in on lower borrowing costs.

We see greater opportunity for positive change through fixed income via impact-aligned bond strategies, where issuers are individually selected and there is the transparency available to measure the impact they are having. This should be further supported by the introduction of the Sustainable Finance Disclosure Regulation, which went live in March this year, with the EU regulator aiming to help investors easily identify instances of greenwashing.

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