October 2018

FIXED INCOME AND ESG CONSULTANT ROUNDTABLE

INSIGHT WAS DELIGHTED TO WELCOME INVESTMENT CONSULTANTS ON 27 SEPTEMBER 2018 TO DISCUSS ITS APPROACH TO FIXED INCOME AND ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) ISSUES. HERE WE OFFER HIGHLIGHTS OF THE DISCUSSION, ALONGSIDE SELECTED QUESTIONS AND ANSWERS FROM THE DAY.

INTRODUCTION: RESPONSIBLE INVESTMENT IS NOW A 'MUST HAVE'

Lucy Speake,
Head of European Fixed Income,
Insight Investment

Our responsible investment framework focuses on ensuring we take ESG risks into account alongside other risks in our fixed income portfolios.

Our clients expect us to integrate ESG issues into our investment analysis, and we have been doing so for well over a decade in our credit portfolios. All of our credit analysts include details on ESG in their research notes, rather than delegate this to a separate team. We also aim to engage with issuers when we believe ESG risks may be material. For example, in 2017, we logged c.450 meetings which included discussions of ESG matters.

It seems clear that responsible investment is no longer just 'nice to have' but a 'must have'. The vast majority of European clients we interact with have an interest in responsible investment – their awareness of the long-term risk factors is rising, and a strengthening regulatory framework is also leading more to take action. There is also a growing body of research suggesting that while a responsible approach might have an impact on alpha in the very short term, it can help potentially improve longer-term performance by helping to identify and manage long-term risks.

HOW S&P GLOBAL RATINGS INCORPORATES ESG ANALYSIS

Michael Wilkins,
Managing Director, Sustainable Finance,
S&P Global Ratings

S&P's credit ratings aim to reflect an issuer's ability and willingness to meet its financial commitments as they come due. In recent years, due to both regulatory developments and interest from stakeholders, we have become more open about the role of ESG analysis within our credit-rating methodologies.

Whether a factor is relevant for credit risk comes down to its probability, potential impact, and the time horizon over which it is expected to take effect.

Environmental and climate, and social, factors have had a material impact on some of our credit ratings in recent years (see Figure 1).

For example, we improved the outlook on a Scandinavian power company, to stable from negative[2]. The company sold some assets in late 2016, and we believed this reduced its exposure to potentially negative political intervention, merchant power prices and carbon-dioxide emissions, and transferred a large amount of asset-retirement obligations (as dictated by regulatory policy).

Figure 1: Environmental and climate factors have had a mixed impact on S&P rating actions, while social factors have been mostly negative[1]

	ENVIRONMENTAL AND CLIMATE		SOCIAL	
	Positive actions	Negative actions	Positive actions	Negative actions
Placed on CreditWatch	5	4	1	2
Change to outlook	22	12	4	12
Upgrade/downgrade	20	43	5	17
Total	47	59	10	31
% total actions in positive/negative direction	44%	56%	24%	74%

[1] Source: S&P Global Ratings. Covers the period from end June 2015 to end July 2017. Ratings are placed under CreditWatch when the agency believes a rating change could be needed in the short term following an event or deviation from an expected trend, a material change in issue or issuer performance, or a change in rating criteria. A positive or negative rating outlook signifies a one-third probability that a rating may be upgraded or downgraded respectively within the next two years. Note: 2% of the rating actions for social factors were neutral (placed on CreditWatch, without a positive or negative view). [2] The mention of a specific security is not a recommendation to buy or sell such security. The specific securities identified are not representative of all the securities purchased, sold or recommended for advisory clients. It should not be assumed that an investment in the securities identified will be profitable. Actual holdings will vary for each client and there is no guarantee that a particular client's account will hold any or all of the securities listed.

Another example was our decision to revise the outlook for a UK travel operator[3] to positive in early 2017. Terrorist attacks are a significant risk for international tour operators, classified as a social risk in our framework. We believe the company managed the impact of this risk on its business effectively. Despite terrorist attacks disrupting some of its markets, it redirected its capacity to safer destinations at short notice. Alongside other factors, this contributed to our improved view on the company.

There has also been growing interest from clients in an ESG evaluation that goes beyond a credit rating or the financial materiality of related risks.

RESPONSIBLE INVESTMENT IN CREDIT

Joshua Kendall,
Senior ESG Analyst, Fixed Income
Insight Investment

We define responsible investment as an approach that aims to incorporate ESG factors into investment decisions to better manage risk and help to generate sustainable, long-term returns (see Figure 2). This is in line with the definition of the UN-supported Principles for Responsible Investment (PRI) and means that ESG analysis touches on everything we do.

For our credit analysis we have integrated ESG data and research within our existing research process. We use a third-party provider for some ESG data, and supplement this with internal research where information is lacking – there is typically less data available for high yield or emerging market debt issuers. This includes a questionnaire that we send to selected issuers to assess their exposure to and management of ESG risks.

Our climate risk model, the first of its kind, was developed to help identify climate-change-related risks faced by corporate issuers. It ranks over 1,800 issuers according to their exposure and how they manage these risks. Our main focus, with each credit we analyse, is whether these risks are material for that investment. We believe engagement with issuers is a key part of credit analysis.

Finally, we note that clients and regulators increasingly require more transparency, and so we have prioritised offering clients reports on their portfolios' ESG performance, carbon footprint and impact on ESG issues.

Figure 2: What does responsible investment mean in fixed income?

Robert Sawbridge,
Portfolio Manager, Fixed Income
Insight Investment

Our credit analyst notes on different issuers will include an assessment of ESG factors. These will often be material in our buy-and-maintain portfolios, which are long-term in nature.

For example, one client's buy-and-maintain portfolio transitioned to us from another investment manager. In the portfolio was an issue from a mining company. Our analysts conducted a review of the company's fundamentals, such as its EBITDA, capital expenditure and leverage, and these looked reasonable, but it scored badly on ESG risks, even within the mining sector – which is more exposed than others to some material ESG risks. Our analyst assigned a 'hold' rating to the issue, pending further information. However, the company did not respond to requests to engage on these issues. Given historical examples of mines failing due to environmental issues, and their owners struggling to repay their debt, we decided to sell the holding.

This demonstrates that we analyse ESG factors to support risk management, rather than simply apply them to exclude issuers on the basis of their ESG performance. If a company is exposed to material ESG risks but is managing them well, we may not exclude them from our portfolios.

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Separately, we have noted an evolution in what our clients are looking for from their investment strategies. Many have moved beyond exclusions to expect their strategies to adhere to global norms, such as the UN Global Compact; explicitly take ESG risks into account; seek to skew portfolios towards, or away from, sectors or issuers according to their ESG performance; and to incorporate positive impact objectives alongside financial targets.

This led us to convert a euro-denominated corporate bond strategy in late 2017 to incorporate sustainability objectives. It excludes 'worst-in-class' issuers and favours issuers with strong ESG scores, while aiming to align investments with positive impact themes.

If the ESG performance of an issuer in the portfolio worsens to the extent that it might be excluded, the portfolio manager will seek to engage with the issuer to improve its performance. If it fails to do so within 12 months, we aim to sell the holding. For example, one of our holdings made an acquisition that led its ESG score to drop. We are expecting to engage with the company to discuss how the situation might be improved.

Overall, we aim to incorporate ESG factors in our analysis to enhance our focus on potential downside risks, and we believe this should not – in principle – lead to underperformance relative to a standard credit index. We also aim to engage actively with companies on relevant issues, and to work closely with our clients to help them achieve their objectives and so they can better understand how their strategies are performing on ESG matters (see Figure 3).

Figure 3: Managing ESG credit portfolios in practice – Insight's approach

MATERIAL FOR RISK

Incorporate ESG analysis into investment process for corporate and government issuers with a focus on managing downside risk

DESIGNED NOT TO UNDERPERFORM

Incorporating ESG factors in investment decisions should not lead to underperformance vs conventional index

ACTIVE STEWARDSHIP

Responsibility to engage with companies on a variety of key issues and work with others to address systemic risk factors

CUSTOMISATION

We work closely with individual clients to deliver portfolios according to their specific requirements

TRANSPARENT REPORTING

We are committed to delivering enhanced reporting to help clients to better understand their portfolios' ESG profiles

RESPONSIBLE INVESTMENT IN EMERGING MARKET DEBT

Colm McDonagh,
Head of Emerging Market Fixed Income,
Insight Investment

When people think of emerging market debt (EMD), they usually think of risk and lack of transparency. And when it comes to ESG, they think the information doesn't exist and standards are universally poor – so ultimately, ESG isn't a material driver of performance.

In fact, there is substantial ESG data available for emerging-market corporates, though there is some variation: better-rated companies generally disclose more information, and sectors with more established debt issuers – such as financials, or oil and gas – tend to perform on ESG issues in line with developed-market peers. There is also variance depending on the domicile of a particular issuer, with c. 80% of the worst ESG performers concentrated in just c. 20% of emerging markets. While there is more ESG data than might be expected, we conduct our own research to help fill in the gaps. Issuers are surprisingly responsive to our questions. They perceive that increased transparency and willingness to engage make them more attractive borrowers for fixed-income investors, and could ultimately lower their cost of borrowing.

This analysis can help investors in different ways. For example, a Guatemalan telecoms company self-reported potentially improper payments made on its behalf in 2015, and its bond price fell. Investors who knew the company's management and understood how it managed its ESG risks might, on this basis, have decided to buy the bond after it fell. If they did so, they would have benefited after the bond recovered its losses. In this case, assessment of the ESG risks could have helped investors to take advantage of the market's apparent mispricing of the debt. Another example is that of a Croatian food and beverage company where analysis of ESG factors could have highlighted concerns over its governance well before the company defaulted on its debt in May 2017[4].

Overall, we have found that European investors are growing more interested in ESG factors within EMD portfolios, though there is wide variation in the criteria on which investors focus. There is some interest in Asia, but less in the US. Clients are also increasingly customising investment guidelines and expect reporting on ESG issues.

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RESPONSIBLE INVESTMENT IN SOVEREIGN DEBT

Gareth Colesmith,
Head of Global Rates and Macro Research, Insight Investment

We include ESG factors in our long-term risk assessment for sovereign debt. For clients that request it, we exclude some issuers on the basis of bad ESG performance, or bias allocations towards better performers.

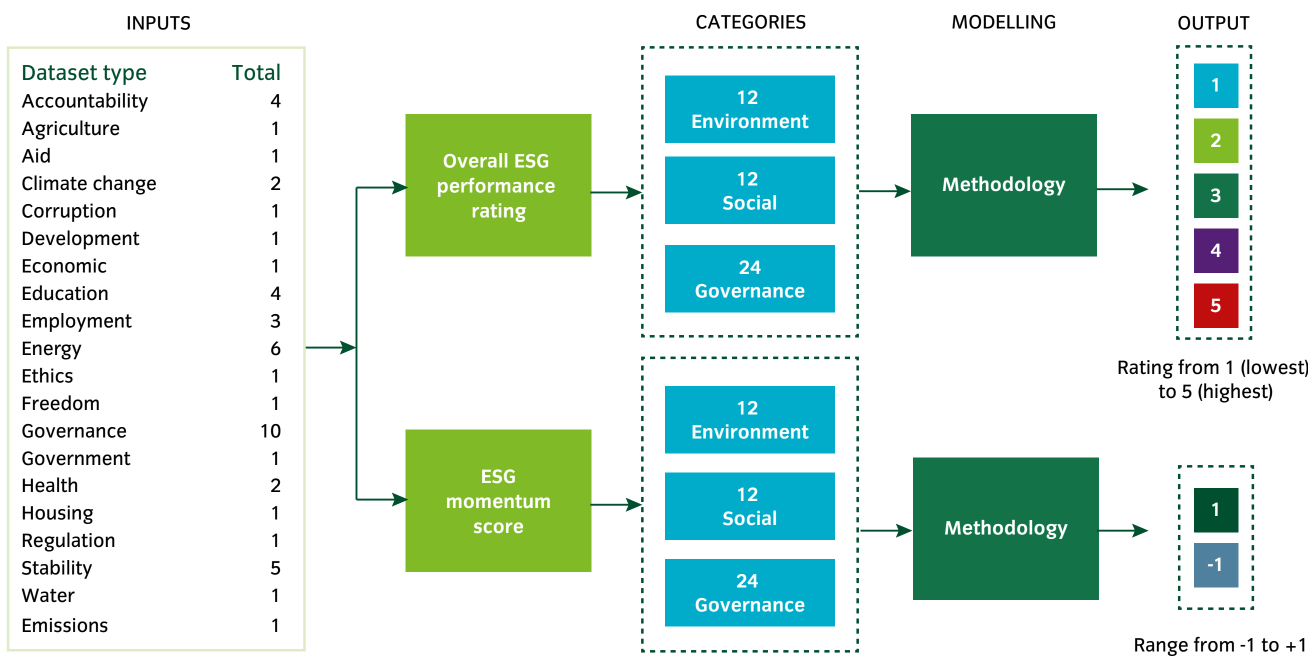
There is very limited scope for engagement with sovereign issuers, but one area in which there may be scope for dialogue is green bond issuance, where sovereign issuance is increasing.

To support our efforts we have developed a country sustainability risk model that generates two scores for each country: an overall ESG score, and an ESG momentum score that reflects whether its ESG performance has improved or deteriorated over the last six years (see Figure 4). The model is weighted slightly towards governance factors, which typically have a more immediate impact on a sovereign's ability and/or willingness to repay its debt.

The results show few surprises in terms of which countries perform well or badly overall, but there are some unexpected results among the momentum scores. For example, the model indicates that Ivory Coast has the highest ESG momentum score in the world. We believe that highlighting how a country's ESG performance has changed over time can help to highlight potential problems in the future that could become material for debt investors.

Traditionally, sovereign debt investors will look at the economic and political picture. ESG factors sit alongside these, and will typically reflect longer-term risks.

Figure 4: How we assess ESG factors for sovereign investments



QUESTIONS AND ANSWERS

Q. Fixed income investors have less influence over corporates than equity investors. Can you give an example of how you have encouraged a company to change despite this?

A. Equity investors are able to vote and they can have a direct say in matters that affect long-term performance. But fixed income investors can have significant influence. Companies need finance, and in that context, bondholders' engagement with issuers is important.

Insight is big enough to have an influence on issuers. A recent example is our dialogue with a German property development and management company. We had concerns over its governance and met with the largest shareholder to discuss the independence of the board and the need for more board members, along with improved disclosure. Within a few months, more board members were appointed and ESG disclosures were incorporated within regular investor updates. In September 2017, the company was upgraded to investment grade.

Q. Research has found there are very low correlations between ESG data from different providers. How do you manage this issue?

A. For Insight, ESG factors are a core part of risk management, so we prefer to use data that aims to reflect whether ESG issues might be material for a company's business and its creditworthiness.

One factor behind this low correlation could be that ESG data depends on relatively noisy, publicly available information. This means it can be helpful to engage directly with a company and reach a qualitative judgement on the risks, rather than depending solely on quantitative data.

Q. Do you use the same analytical models for ESG in both developed and emerging markets?

A. Yes. We think it's important to assess the markets on a comparable basis, not least because we expect the yield pick-up available from emerging market debt relative to developed market debt to compress over time.

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Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

FIND OUT MORE

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