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NEWTON

Investment Management

SUSTAINABLE BOND INVESTING AT NEWTON

April 2018

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The significant growth in sustainable and responsible investing over the last few years has until recently been focused on equity portfolios. However, investors are now starting to appreciate how such an approach can also be applied to fixed income. In this article, Scott Freedman and Victoria Barron review some of the developments in this area and explain how we integrate responsible investment in our fixed-income investment process.

Sustainable and responsible investing has emerged from the investment shallows and into the mainstream. Recent surveys suggest that investor appetite for sustainable investment products and strategies continues to grow and now accounts for over $8.72 trillion of assets managed in the US and $22.89 trillion globally.[1]

Most investors are familiar with the idea of integrating environmental, social and governance (ESG) research and analysis into an equity investment process to give a 360-degree view of a stock's investment risk and return. Backed up with active ownership through engagement and voting, this is increasingly seen as sound investment practice.

Investors may be less familiar with how ESG integration can be effective in fixed income and how it can add value. However, that lack of awareness is changing fast as investors begin to appreciate how rigorous ESG analysis can help to avoid default risk and as investment managers begin to offer a range of approaches to address a growing investor requirement for sustainable and responsible fixed-income investment solutions.

Ethical screening

One established approach is ethical screening or exclusion. Ethical investing can be applied to a fixed-income portfolio in exactly the same way as to an equity portfolio. Sectors and industries that conflict with an investor's mission or purpose can be removed from a portfolio or, alternatively, a threshold approach can be applied to limit an investor's exposure to certain business activities. Examples would be removing tobacco from the portfolio, or limiting exposure to thermal coal to say 10% of a company's business activity.

“Investors are beginning to appreciate how rigorous ESG analysis can help to avoid default risk.”

1 Source: Global Sustainable Investment Review 2016. Global Sustainable Investment Association (GSIA), March 2017

The growth in 'green' bonds

A more recent approach has been the emergence of 'impact' fixed-income investing through 'green' bonds. Green bonds are essentially traditional bonds in terms of structure and maturity, but the use of proceeds is tied to projects with clearly defined environmental benefits (such as energy efficiency, renewable energies and clean water). Disclosure is mandatory around the use of proceeds and the impact of the financing during the lifetime of the issue. Indeed, investment banks acting as underwriters have clubbed together to draft a set of Green Bond Principles which act as voluntary guidelines and encourage increased transparency and disclosure.

The appeal of green bonds is that they are backed by the full credit rating of the issuer, so that the underlying investor is not exposed to specific project risk. The challenge for green bonds is that there is no precise definition of 'green', and investors may prefer to own the underlying issuer in the belief that a company issuing in the green bond market is more likely to have a robust approach to its broader environmental challenges. Another constraint is liquidity. While the green bond market has grown significantly to amount to $194 billion in issuance, it remains a very small part of the $22.8 trillion global corporate bond market, and issuance is limited largely to supranational and multilateral issuers.[2]

The green bond market is set to grow further as covenants become more standardised, and issuance from other types of borrowers, notably municipalities and local government, increases (issuers have included the cities of Gothenburg and Stockholm, California and the state of New York). However, it is unlikely ever to represent more than a market niche, particularly if green bonds continue often to be priced at less attractive spreads than regular bonds of the same underlying issuer.

Integrating ESG research into fixed-income investment

A more broad-based approach to sustainable and responsible fixed-income investing is to integrate ESG research actively into an investment process. As a sustainable bond investor, we analyse ESG issues in our fixed-income portfolios as part of our core credit analysis. We consider ESG issues when looking at sovereign and corporate risk and across the credit spectrum from investment grade to high yield.

Our starting point for ESG integration in fixed income is different from our approach in equities because creditors occupy a different place in the capital structure from shareholders; stockholders own a piece of the company and participate in its success, while bondholders lend the company money and expect it to pay them back.

Shareholders have a higher risk tolerance because equities have significant upside potential. Bonds are generally seen as lower-risk instruments, but risk levels will vary depending on the type of debt instrument – for example, corporate bonds versus government debt or investment grade versus high yield. Furthermore, risk is asymmetrical for bondholders. A bondholder may have limited upside compared to an equity investor, but is still exposed to the downside risk of default. Similarly, a bondholder owning an oil and gas company may not see an improvement in credit quality if the company has robust health and safety policies in place, but the absence of a robust policy that leads to a safety breach or an environmental spillage can cause a collapse in credit quality and lead to material credit downgrades.

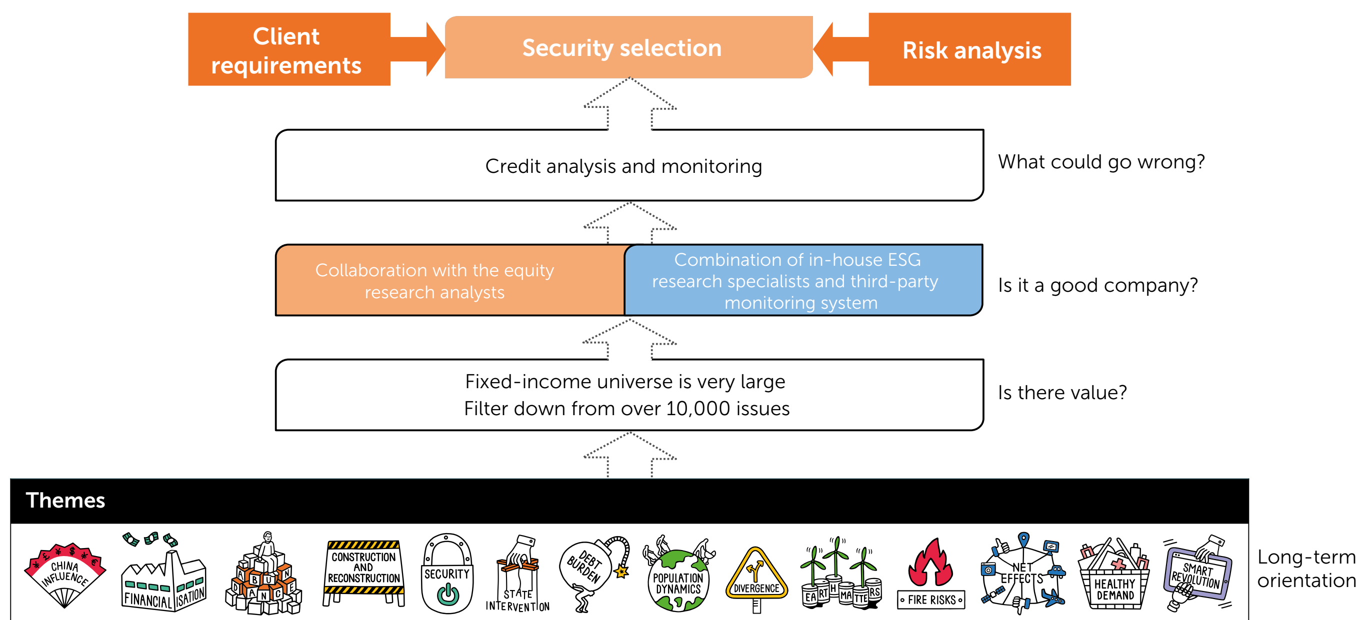
A bondholder is thus more vulnerable to downside risk, which means that avoiding losers is much more important than picking winners.

Our investment process

To address this risk of asymmetry in bond investing, we have adopted a proprietary fixed-income investment process that integrates ESG research and analysis across the credit spectrum. We carry out an initial screen of all our bond holdings to determine those with material ESG risks; we then make an in-depth assessment of bonds that carry a high probability of default so that we can exclude them from the investment universe if we deem the default risk too high. We also monitor credit portfolios actively to keep the ESG-creditworthiness of the issuer under review.

We use our proprietary ESG quality review framework to help identify material issues for a company, and we are able to cross-check our global voting and engagement records for companies in which we are also a shareholder. Where such issues are identified by the credit research analyst, our responsible investment team will then carry out a thorough bottom-up analysis of the ESG risks.

Our bottom-up investment approach incorporating ESG research



2 Source: Bank of America Merrill Lynch, April 2018

We also screen for controversies to identify if an issuer has been accused of any breaches of international norms and conventions. We consider international conventions on human rights, labour rights, climate change and biodiversity. In addition, we consider whether issuers have signed the United Nations (UN) Global Compact as well as how they are implementing the UN Guiding Principles on Business and Human Rights in company policies and processes.

The UN Guiding Principles on Business and Human Rights (2011) has a focus on the rights and responsibilities of companies, and also covers the role of governments when considering the impact of companies on human rights. The UN's 2008 Protect, Respect and Remedy framework, which informed the 2011 Principles, maintains that it is a state's duty to protect human rights.[3]

Assessing sovereign risk

A complex interplay therefore exists between macroeconomic and ESG issues when looking at sovereign risk, as well as when assessing corporate credit risk. To help us to understand the potential for sovereign default risk we aim to identify and analyse the relationship between these sets of issues. We look at a number of World Bank governance indices in our sovereign risk assessment, including those relating to accountability and voice, regulatory quality, rule of law, ease of doing business and control of corruption.[4]

We also take into account other sources, including the United Nations Human Development Index and Transparency International's Corruption Perceptions Index.

The primary responsibility for peace, security and the development of a country lies with its government, but sustainable economic competitiveness is dependent on the availability and quality of natural, human, social and political capital. In our sovereign risk analysis, we therefore evaluate issues such as natural resource depletion, social cohesion, conflict and political change in order to understand if the returns on offer from sovereign bonds are appropriate given the risks attached.

> “Sustainable economic competitiveness is dependent on the availability and quality of natural, human, social and political capital.”

Countries that govern their capital resources effectively are, we believe, more likely to experience stable long-term growth and have greater economic resilience. Sovereigns with limited political rights and civil liberties, and those with high unemployment rates, are more likely to experience greater civilian unrest. Strengthening the social contract between a government and its citizens should reduce the risk of corruption, which improves in turn the fiscal accountability of the economy, increasing tax revenues and improving the affordability of debt. A government's ability to plan economic policy owing to the greater level of certainty over the data that it feeds into its forecasting should in turn reduce policy error and enable a virtuous circle of self-improvement.

Climate change

Some ESG risks will unfold over the very long term, which makes the risk difficult to price accurately. Climate change is one such area where risk is significantly different when measured over longer or shorter time periods. As climate policy and regulation ratchets up as the effects of a changing climate become more visible, credit spreads are likely to widen for climate-exposed issuers, making borrowing more expensive. The same is likely for sovereign borrowers that are energy and resource-intensive and that fail to implement robust climate mitigation and adaptation measures to protect their natural capital.

Conclusion

ESG factors are key issues that should be incorporated in fixed-income analysis, given their clear influence on the credit quality of issuers. As we move into the latter stages of the business cycle, and global credit markets become less accommodative, ESG analysis can help investors to use creditworthiness as a differentiating factor between issuers.

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At Newton, we have always integrated ESG research in our fixed-income investment process. Our global thematic approach and close collaboration between our credit analysts, equity analysts and specialist ESG research analysts help us in our efforts to invest responsibly across the capital structure. Although bondholders do not get a vote, it is still possible to engage with issuers, and we take an active role in proxy voting and equity stewardship, to help us protect and try to enhance the value of our clients' investments across all asset classes.

3 http://business-humanrights.org/en/implementation-of-un-guiding-principles-governments
4 http://info.worldbank.org/governance/wgi/index.aspx

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