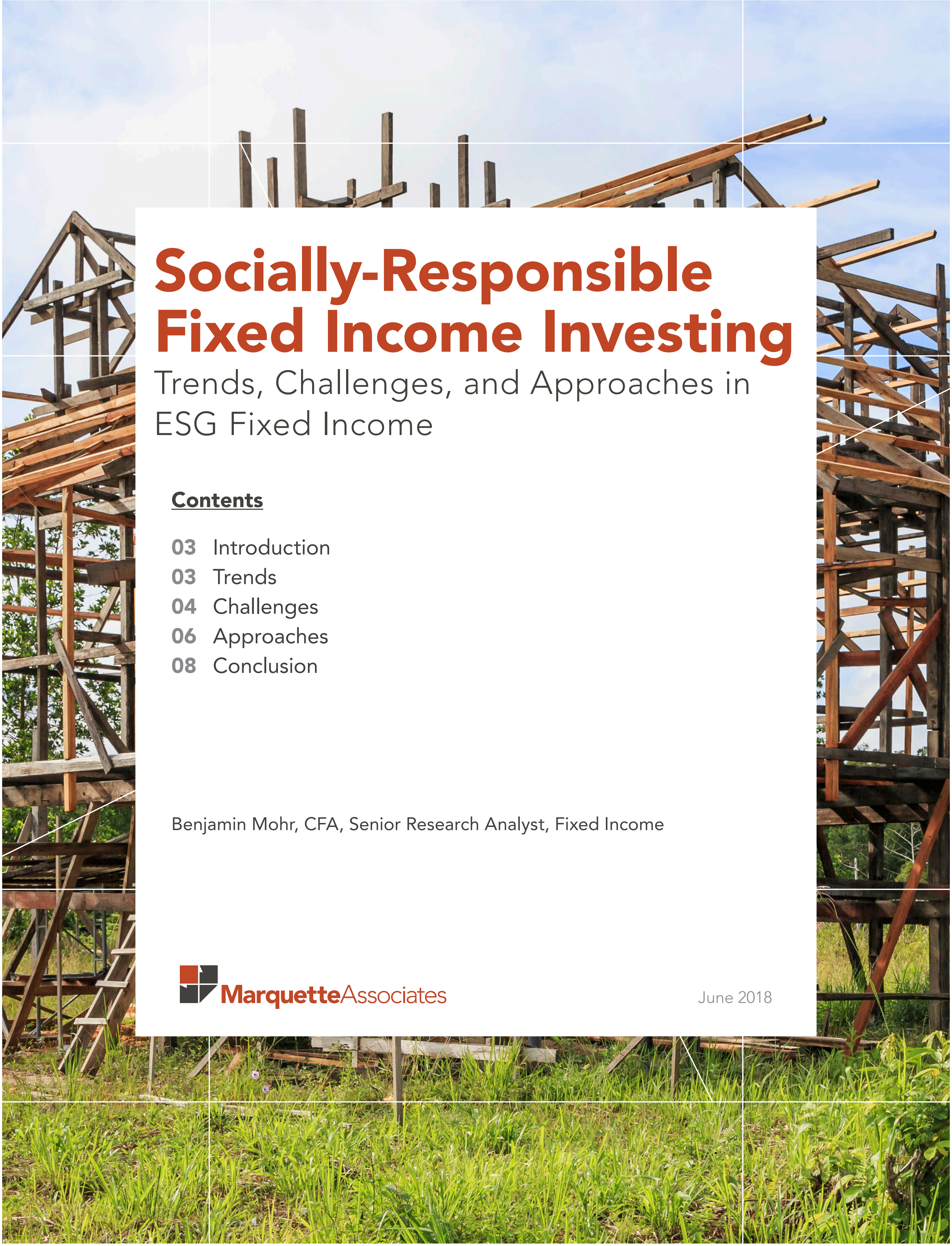
Socially-Responsible Fixed Income Investing

Trends, Challenges, and Approaches in ESG Fixed Income



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INTRODUCTION

Socially-responsible investing (SRI) is one of the fastest-developing segments of investing and we see a ballooning trend of true action taken by investors. Specifically for fixed income, socially-responsible investing is growing and a great deal is evolving in the recent landscape, particularly in terms of philosophical changes as well as the development of new products where "the rubber meets the road."

This white paper explores trends in socially-responsible fixed income investing and assesses the challenges. In addition, we examine the prevalence of Environmental, Social, Governance (ESG) issues and compare their uses in fixed income versus equities. Finally, we evaluate methods to invest in fixed income for the responsibly-minded investor.

Before we explore the trends, we first define SRI, ESG and impact investing. SRI is the use of negative screens to avoid investing in sectors that are socially or environmentally harmful. ESG strategies screen investments based on environmental, social and governance standards. Examples of each standard are shown in Exhibit 1. Lastly, impact investments target issuers that bring about positive social or environmental change without sacrificing returns for investors.

Exhibit 1: ESG Issues

Environmental	Social	Governance
Climate change and carbon emissions	Human rights infringement	Workplace health and safety
Air and water pollution	Consumer health and safety	Executive pay
Water scarcity	Community relations	Conflicts of interest
Sustainable transportation	Fair marketing and advertising	Board diversity
Waste management	Labor relations and supply chain management	Audit committee structure
Supply chain management	Data protection and privacy	Bribery and corruption
Risk of environmental litigation	Employee engagement and satisfaction	Lobbying and political contributions
Biodiversity harm		Whistleblower protections
Energy efficient facilities		

TRENDS

What is driving the growth of SRI/ESG? One reason is the proliferation of millennials in the workforce, who are having more of an influence on investment decisions within the institutional space. Being more ESG-aware than previous generations, they want additional value — such as positive social impact — from investments, and not just returns.

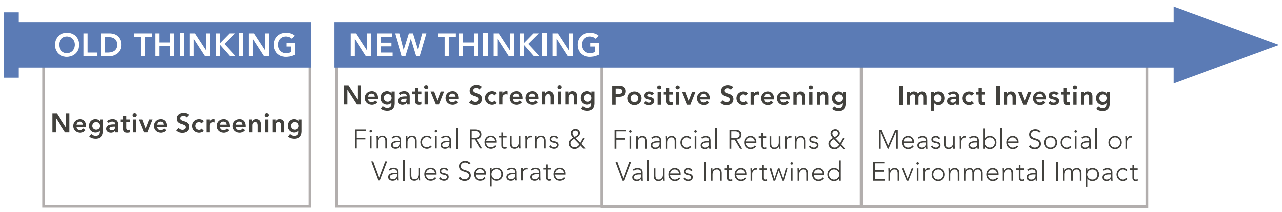
There is growing empirical proof of the benefits — not just social, but also returns-wise — of SRI and ESG, and the Department of Labor recently provided public guidance that ESG adds value to investments.[1] Furthermore, a Barclays study published in October 2016 showed that ESG improves performance in corporate bonds: bonds with higher ESG scores were shown to outperform those with lower ESG scores for the period of 2009 to 2016 by 2%.[2] The supposition was that ESG would hurt returns, since an issuer has to expend additional resources to pay attention to ESG, but the data showed the opposite. While this is a revelation for the broader bond markets, it is nothing new to emerging market debt (EMD) teams, who have already embraced ESG to a certain extent as part of their risk analysis of emerging sovereign and corporate issuers. However, the ESG framework utilized by EMD teams thus far is more focused on the social and governance factors and how they drive returns, rather than environmental factors.

The SRI/ESG trend is now global. In the U.S., for example, CalPERS is integrating ESG into its manager selection process. Pensions worldwide, especially in Europe and Asia, are incorporating ESG into their investment decisions.[3] This trend is part of a greater push by institutions towards optimal positive social impact. As an example, the state of Illinois is developing a program advocating board diversity, going hand-in-hand with their advances in ESG investing. For fixed income, the trend is gradual, as most institutions are only focusing on fixed income ESG now that they have their equity

ESG systems and procedures in place.

A final trend is a shift in the way we think about SRI and ESG. The old thinking focused exclusively on negative screening for security selection. The new thinking focuses on the paradigm that negative screening arises from separating financial returns and values, while positive screening arises from intertwining financial returns and values. As this space continues to evolve, we now have further distinction on how this new thinking applies to SRI/ESG/impact investing terminology. The broad market consensus today defines SRI as "not investing in issuers with a negative social impact," while ESG is defined as "seeking out better risk-adjusted returns through issuers with better environmental, social and governance management." As a further extension, SRI is applied through negative screening, while ESG is applied through positive screening. Finally, there is impact investing, defined as "measurable social or environmental impact along with financial returns." Based on the mission of the investing organization, the target returns from impact investing may be set higher or lower than standard non-impact investing returns.

Exhibit 2: ESG Thinking Has Evolved



CHALLENGES

The history of SRI for equities can be traced all the way back to the 1800s, with the Quaker movement. However, SRI for fixed income is relatively new to the game. Theoretically, SRI for the two could be quite similar from an overall perspective. They are both concerned with impact (i.e. positive screening) as well as risk mitigation (i.e. negative screening). Looking at an issuer's track record for SRI would be important whether we are investing in the bonds or the stock of that issuer. However, SRI fixed income faces some unique challenges.

First, creditors and long-term owners are not the same. Bonds mature while equity ownership can be perpetual. The time horizon between a bond investor and a stock investor can therefore be vastly different. As an example, the ESG trends, projects and/or impact for an issuer could be 20 to 30 years out, so an investor in that issuer's bonds, which might mature within that timeframe, may have too short of a time horizon to have any meaningful ESG influence.

Second, there may be a limited ability for creditors to engage with management or the board because they are not equity owners. Creditors, for example, have no proxy votes and cannot file shareholder proposals. However, the creditor does have a seat at the table to influence the issuer on ESG during bankruptcy restructurings. Certain asset managers have been shown to do so by strengthening balance sheets and instituting better governance policies for the re-emerging company.

The concept of creditor advocacy has gained momentum over the last five years. The United Nations Principles for Responsibility Investment[4] group, the world's leading proponent for responsible investing, organized a working group of asset managers and institutional investors that has produced a guide on corporate bond engagement, "ESG Engagement for Fixed Income Investors – Managing Risks, Enhancing Returns," released in April 2018. The guide includes best practices and case studies, along with surveys on what asset managers and institutional investors are doing in fixed income and equity SRI/ESG investing.

One key focus is on what the industry should experiment with in terms of corporate bond engagement. The following areas are where conversations are most active, which may lead to further opportunities:

- Adding environmental — such as water impact — terms in debt offering documents
- Setting SRI/ESG debt covenants where payment is accelerated if certain metrics are triggered — such as environmental or corruption metrics
- Casting votes on SRI/ESG issues at bondholder meetings
- Moving divisions or business lines across states or countries due to labor/environmental reasons

The industry is making a major push in corporate creditor advocacy, with sovereign and municipal creditor advocacy to follow. Human rights issues, terrorism, and government transparency are key sovereign and municipal creditor advocacy topics that the industry is currently exploring.

The third challenge is the size and complexity of fixed income markets. While common stock is fungible (meaning that one common stock can be replaced with another), bonds can come in an infinite variety of types with an infinite variety of terms. A large bank, for example, may issue only one class of common stock, but have hundreds of different bond issuances outstanding, each with different coupons, maturities and covenants. Moreover, government bond issuers are very different from corporate bond issuers, which are very different from securitized bond issuers.

Exhibit 3: Challenges of ESG for Bonds

	Stocks	Bonds
Timeframe	Perpetual ownership	Bonds mature
Influence	Higher with greater ownership	Lower, unless issuer is distressed
Complexity	Fungible	Infinite types and terms

Meeting the Challenges

In this latest wave of ESG development, the focus is on investment-grade corporate bonds — the recent Volkswagen emissions scandal focused a lot of investors' attention on the need for ESG in this sector — while it is still relatively nascent in the high yield, developed markets sovereign and securitized bond sectors.

Exhibit 4: ESG Framework Development

More Established ESG		Next Frontier
Emerging Markets Debt	→	High Yield Bonds
Municipal Bonds	→	Developed Markets Sovereign Bonds
Investment Grade Corporate Bonds	→	Securitized Bonds

Thus, ESG for investment grade corporate bonds and emerging markets sovereigns are leading the way, with municipal bonds following closely behind. However, as mentioned earlier, the ESG framework utilized by EMD teams thus far is more focused on the social and governance factors and how they drive returns, rather than environmental factors. In municipal bonds, water projects obviously have an intrinsic ESG component to them. Furthermore, the issuance of green bonds in the municipal (quasi-sovereign/quasi-corporate) space continues to grow. While there are few strategies dedicated to green bonds, the asset class is expanding and bears watching.

Another key focus is how to apply ESG factors to non-corporate bonds. The current approach for ESG fixed income outside of corporate bonds — particularly as it pertains to developed markets sovereign bonds — targets three key topics. The first is natural resource depletion, which could serve as a key metric. The second is the impact of populism.[5] MSCI recently published a paper on this topic. Last, the government's fight against corruption could be an insightful indicator. Currently, a corruption index is being developed by ESG analytics providers such as MSCI and Sustainalytics. Surprisingly, some of the most corrupt nations are the most stable, which has a counterintuitive effect on sovereign fixed income investments.

Lastly, there is a correlation between the ESG factors. For example, correlation is high between positive governance factors and positive environmental and social factors. Typically, if an issuer's governance ratings are high, its environmental and social factors are similarly high. This is because the issuer's management is thinking of broader issues that affect the issuer. Conversely, if an issuer's governance ratings are low, then typically its environmental and social factors are similarly low as well. Thus, strong management of any one ESG factor reinforces the overall ESG strength of that issuer.

How to Implement? *MSCI and Sustainalytics Off-the-Shelf SRI/ESG Lists*

Currently, asset managers and institutional investors can utilize off-the-shelf SRI/ESG lists maintained by the two leading analytics providers in this space: MSCI and Sustainalytics. MSCI, for example, rates over 6,000 issuers on a scale from AAA to CCC and provides these to institutional investor subscribers. AAA represents a best-in-class SRI/ESG rating, while CCC represents a worst-in-class rating. These SRI/ESG ratings are updated at least annually. Available analytics range from ESG metrics on specific securities to overall portfolio exposure of investment strategies.

APPROACHES

Despite the aforementioned challenges to SRI/ESG fixed income investing, the asset management industry is making notable strides for this space.

We are seeing the adoption of various SRI/ESG approaches by a growing number of fixed income managers, whether for dedicated SRI/ESG strategies or for their standard strategies. In general, the fixed income research analyst will compare ESG factors across peers and focus on best practices. For example, within a particular industry, nine out of ten companies might abide by a particular benchmark, such as maternity leave of at least six months. When encountering an industry participant that does not live up to best practices, the analyst might ask of management: "Why not you?" The fixed income investor has both the "carrot" and the "stick" as tools at his or her disposal: Issuers are cognizant and incentivized knowing that, by meeting ESG standards, they would be rewarded with the confidence of creditors. On the other hand, if ESG benchmarks are not met by the issuer, the fixed income investor can let it be known that he or she will divest.

There currently exist three dedicated, specific investment strategy types within SRI fixed income investing that are gaining momentum as each build a strong investor base: community impact/reinvestment, religious advocacy, and labor-friendly construction. These three form the key focus areas as to how an investor could incorporate SRI/ESG into actual allocations — the arrows in the quiver.

Exhibit 5: The Three Key SRI/ESG Fixed Income Strategy Types

Community Impact/Reinvestment

Community impact/reinvestment features a dedicated bond investment strategy that typically fits within the core fixed income asset class, with the Bloomberg Barclays U.S. Aggregate as its benchmark. These strategies focus on securitized bonds — mortgage-backed securities (MBS) and asset-backed securities (ABS) —as well as taxable municipal bonds that reinvest in the community and target a positive social impact.

These securities might include residential MBS backed by mortgages on single family homes for which the borrower has an income that is 80% or less of the region's median income, ABS backed by small business loans, or highly rated (AA or better) taxable municipal bonds issued by a low-income community. Asset managers in this space can typically customize portfolios to pick bonds in specific parts of the country to meet the investor's objective.

Religious Advocacy

Historically focused on negative screening, religious investing is gradually moving towards impact/positive screening. There are a number of core bond managers and a few high yield bond managers who can invest abiding by the United States Conference of Catholic Bishops (USCCB) guidelines or the Evangelical Lutheran Church of America's Corporate Social Responsibility Screens, for example. The manager will typically notify the client of any borderline trades that require the client's express approval pre-trade. Despite the ongoing shift from negative screening to positive screening, developments in negative screening are still occurring. The latest development in such negative screening is a USCCB-screened private credit direct lending fund. This strategy is a joint venture between a private credit-focused asset manager and a USCCB-focused asset manager. The strategy holds first and second lien loans issued primarily by private-equity backed borrowers, and screens out USCCB-violating credits both at the time of origination as well as add-on acquisitions.

Often the manager's ESG screening list overlaps with MSCI's ESG screening list by a significant amount, and the manager is not that much more exclusionary. For example, if a biotech company creates a technology that can be used for stem cell research but does not market it as such, both the manager and MSCI would typically not exclude this biotech company.

For long-term assessment purposes, a manager in this space might manage a real portfolio using its ESG process, and also maintain a paper tracking portfolio that is managed without considering ESG. Certain managers in this space have track records of this, which, while short thus far, are showing that the ESG portfolio is providing an excess return over the non-ESG portfolio. Over time, we would expect an ESG portfolio to benefit the investor in a myriad of ways, given that ESG has empirically been shown — as mentioned earlier from the Barclays study — to produce not just a positive social impact, but an accretive return impact as well.

Asset managers that perform impact/positive screening and religious advocacy for equities have made a commitment to roll out similar processes for fixed income as well. The top priority is to familiarize themselves with issuers that they are not familiar with, and the starting point is to use the equity ESG scorecard as the base on which to build the fixed income ESG scorecard.

Labor-Friendly Construction

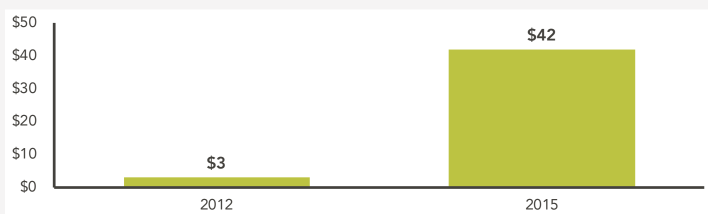
Labor-friendly construction loans comprise a fixed income asset class that has a long track record. Such strategies focus on the "S" of ESG and help provide jobs to communities by investing in construction loans that require union labor. These strategies usually have core fixed income as their comparables because the rest of their portfolios are in U.S. Treasury, agency, corporate and securitized bonds that have the risk-return profile of a core bond portfolio. They would typically invest between 5% to 50% of their portfolio in union labor-friendly construction loans. One added benefit from such strategies — in addition to their ESG benefits — is their strong protection in rising rate market environments. This is because construction loans typically have floating rates, and their yields rise as market interest rates rise.

Green Bonds

Green bonds (Qualified Green Building and Sustainable Design Project Bonds) comprise a fast-growing segment of ESG that focuses on the "E" of ESG. Green bonds are tax-exempt bonds issued by municipalities or quasi-sovereign/quasi-corporate organizations, such as the World Bank, for the development of land with a positive environmental and social impact. Such land could include abandoned buildings or generally be underdeveloped or underutilized. These developments typically feature low pollution/pollution prevention or energy efficiency, and may focus on cultivating environmentally-friendly technologies, sustainable water management, clean transportation, protection of terrestrial or aquatic ecosystems, or sustainable forestry/fishery/agriculture. Apple, for example, issued $1.5 billion of green bonds in 2016 to finance green buildings, energy efficiency projects, renewable energy and energy storage.

Green bonds have become well-defined over the years and interest has ballooned. In 2012, there was only $3 billion of green bond issuance. In 2015, it grew to $42 billion. However, what is driving the interest in green bonds is still SRI values, not ESG values. The incremental impact of green bonds may be circumspect because often, projects would have gone through even if they were not labeled green bonds.

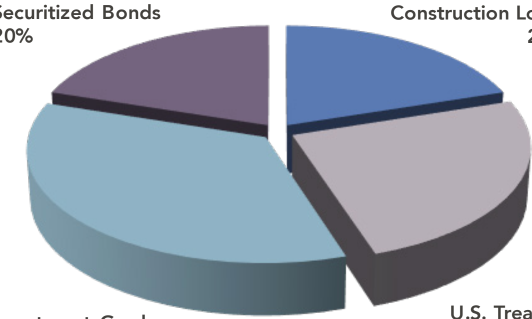
Exhibit 6: Growth in Green Bond Issuance ($B)



Source: World Bank

There are a small handful of dedicated green bond strategies today, and certain core bond separate accounts managed by ESG-experienced managers may have clients who have requested green bonds in their portfolios. In such cases, the clients typically do not provide numerical guidelines on green bond usage and usually 4-5% of the portfolio is allocated to green bonds at the portfolio manager's discretion.

Exhibit 7: Typical Labor-Friendly Construction Portfolio



Incorporating ESG into Existing Bond Agency Ratings

There is an ongoing dialogue about incorporating ESG ratings into the standard bond ratings. The industry is exploring how to incorporate or supplement the current analyses being done by the rating agencies such as S&P, Moody's and Fitch. One idea is ESG-related downgrades, as currently the bond rating agencies make downgrades based only on investment return factors. Dual ratings are another possibility, with the bond rating agencies maintaining an ESG-conscious rating along with their standard rating for all credits.

Critically, incorporating ESG into existing bond ratings requires the agencies to reexamine their methods and they may have to adjust their models to incorporate climate change risk, for example. To do so, the rating agencies could begin by examining the outliers. For example, who is in the bottom quartile for each of the environmental, social and governance factors? Additionally, the rating agencies need to keep in mind that the materiality of each of these factors is industry-dependent. The rating agencies have to look at the sector and industry that the issuer is in and how material, for example, governance is. Governance is most material for banks and financials, and less for utilities where environmental risk is most material.

Currently, the biggest question is how to analyze governance in a comparable way across the various issuer sectors ranging from sovereigns, quasi-sovereigns and state-owned enterprise agencies, to local authorities, corporates and securitized bonds. The current thinking groups governance factors into four broad categories — the larger the red flag here, the more susceptible is the issuer to event risk:

1. Board composition as it relates to independence and diversity.
2. Ownership and potential conflict of interest.
3. Pay for executives and alignment to long term performance.
4. Lapses in accounting, which have been shown to have high correlation with incidents of fraud.

As we can see, there are a variety of ways in which a strategy could approach SRI/ESG, whether it be through low-income communities, religious screening, environmental impact or job creation, and a key current frontier is how to incorporate ESG ratings into existing bond ratings.

CONCLUSION

In conclusion, SRI/ESG fixed income investing is gaining momentum, driven by the growing interest not just in a positive societal impact from investments, but from the objective of stronger returns through investing in issuers with better ESG management. We see empirical proof that strong ESG management actually does positively impact investment performance, and we see a global trend of the integration of ESG into the asset allocation and manager selection process. However, although recent Barclays research has shown that bonds with higher ESG scores outperform those with lower ESG scores, it is important for investors to keep in mind that investing in an ESG manner necessarily entails constraining the investment opportunity set. This constraint may potentially limit the upside or introduce greater volatility depending on the time period and market environment.

There are several ways by which the responsibly-minded investor could benefit from existing approaches. Community impact represents a strong, growing kind of strategy to reinvest in society. Religious advocacy is the future and much groundwork already exists to benefit from both the negative and positive screening in this space. Green bond investing is growing in leaps and bounds. And labor-friendly construction helps create jobs while protecting investors from rising rates. Finally, bond rating agencies are exploring ways to incorporate ESG into their ratings, representing a major next step in the evolution of SRI/ESG fixed income that will broaden and make this segment even more accessible to investors.

There exist challenges, though, especially in laying out a framework for the newest frontiers in fixed income SRI/ESG such as high yield bonds, developed markets sovereigns and securitized bonds, but a foundation for SRI/ESG in investment grade corporate bonds, municipal bonds and emerging markets debt already exists. In addition, there are now over one thousand asset manager signatories, as of the time of this writing, to the United Nations Principles for Responsible Investment. This attests to the strong commitment made by firms worldwide in furthering SRI/ESG investing. The large amount of these signatories means more data than ever before on SRI/ESG investing and will help bring us through future milestones in SRI/ESG development.

We have seen substantial strides in SRI/ESG fixed income over the last few years. Marquette continues to be involved in the development and monitoring of SRI/ESG strategies as we assist our clients in selecting the SRI/ESG strategies that are the best fit for their unique situations.

NOTES

[1] The DOL Interpretive Bulletin 2015-01 states that when ESG factors have a causal relationship to the financial value of an investment, "these factors are more than just tiebreakers."

[2] Figure 11, "Sustainable Investing and Bond Returns," Barclays, 2016

[3] "European Pensions Go Green for Social, and Bottom-Line, Benefits," Institutional Investor, 2015, and "Japan's GPIF Expects to Raise ESG Allocations to 10 Percent," Reuters, 2017

[4] UNPRI is a United Nations-supported network of international institutional investors, asset managers and financial intermediaries that meets regularly and publishes guidelines towards better understanding responsible investing and assisting signatories in incorporating guidelines into their investment practices.

[5] Populism is a political movement that focuses on support for the concerns of ordinary people as opposed to the business elite or special interest groups.

[6] "The Relationship between Environmental Social Governance Factors and Stock Returns," J. Evans & D. Peiris, 2010

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