Why fixed income investors are applying ESG across bond portfolios

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Investors are increasingly integrating ESG into their fixed income portfolios, but the sovereign bond sector still presents challenges.

“ESG considerations in fixed income have been changing and changing very quickly,” Nam Tran, Senior Consultant, Frontier Advisors, said at the annual conference.

“We’re seeing changing investor demand. We're seeing changing and growing sophistication of the ESG approaches used by managers. We’re seeing it increasing the amount of ESG-aligned issuance in the market.”

Matthew Clunies-Ross, Chief Investment Officer, Artesian, said the US and Europe were leading development and progress across the sector.

“In Europe now, if you don't have a labelled green bond fund, you just won't actually be allocated any bonds – it's gotten to that point,” he said.

The success of US company Verizon’s green bonds, which helped fund Power Purchase Agreements (PPAs), prompted Artesian to approach some Australian telcos with a similar proposition.

NBN Co was receptive to the idea, Clunies-Ross said. Artesian brought some of its institutional investors, Future Super and the Clean Energy Finance Corporation, to an initial meeting and three months later, NBN issued its first green bond.

“Everyone's learning,” Clunies-Ross said. “We all need to help each other and provide information – that's more collaboration than engagement. You’ve got to go one step beyond if you're going to be credible in this space.”

He said when Artesian began in the field it could initially measure the impact of about 25% of its funds but that had now risen to about 45-50%.

Sovereign bond challenges

While the industry had shifted from basic negative screens (avoiding issuers in areas such as tobacco or weapons) to explicitly evaluate ESG considerations, the degree of integration still varied by sub-sector, Jill Guan, Consultant, Frontier Advisors, said.

“With corporate credit there's a high degree of integration because the data is easier to obtain and there's a better ability for managers to talk to issuers or engage.”

However, it was still proving difficult to integrate ESG factors into sovereign credit despite rising investor expectations over the past 18-24 months. Managers found it difficult to access ESG data while influencing governments was challenging.

“Clients want you to drive change in areas that perhaps only can be done in the government fixed income space and the important role that governments play with respect to regulation, and so on,” Tamar Hamlyn, Principal, Ardea Investment Management, said.

The approximate $US40 trillion sovereign credit sector represents about one-quarter of the bond universe.

Some Australian state governments have issued green bonds to finance specific clean infrastructure projects, allowing them to precisely calculate carbon emissions, but other government bond issues are more difficult to quantify.

“If you ask a state government or even the Federal Government here in Australia, what's your Scope 1 and 2 emissions, a lot of them are still struggling to answer that because if you're the Federal Government, you've got enormous departments spread across this entire portfolio of bureaucracy that you operate.”