THE Frontier Line

Thought leadership and insights from Frontier Advisors

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ESG Integration in Debt Markets

FRONTIER ADVISORS

Frontier Advisors

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $260B in assets across the superannuation, charity, public sector and higher education sectors.

Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

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ESG integration in debt markets

Consideration of environmental, social and governance (ESG) factors continues to gain momentum across the institutional investor base, with the focus spanning beyond equities across to other asset classes, including fixed income.

Frontier is supportive of this trend as we view ESG integration across the debt manager universe as a significant investment consideration given the size of the asset class and the core allocation within investor portfolios. Additionally, assessing all aspects of risk in the debt market is critical in the current environment given the asymmetry in the return potential for the sector, where the risk of capital loss outweighs the likelihood of more capital gains. We also believe that the assessment of ESG related risks should not only be applied to part of an investor's portfolio, but rather a holistic approach should be adopted that considers both risk and return factors related to ESG at the total portfolio level.

The debt universe encompasses a large number of sub-strategies with a broad range of risk/return profiles and the extent to which ESG is incorporated into the investment process will differ across strategies. In this edition of the Frontier Line, we explore best practice in terms of integrating ESG into fixed income investing, highlighting various considerations across the different sub-sectors.

Frontier and ESG

Frontier considers ESG issues from both an organisational perspective and in our research and advice. We are a signatory of the Principles for Responsible Investing (PRI) and The Paris Pledge. We are continually working to embed the assessment of key ESG risks and opportunities into our investment and manager research and actively engage with managers on these issues.

The following set of beliefs underpins our approach with regards to ESG:

- Frontier believes that ESG issues, and the management of them, can have an impact on investment risk and return;
- we believe there are particular ESG themes that require attention given they will be potentially significant as drivers of value creation and destruction;
- we understand and accept individual client desires to exclude or tilt away from certain exposures based on ESG grounds;
- we believe that our own investment research should consider and explore ESG issues and examine new and existing investment opportunities in light of this; and
- we note that many ESG issues are being covered in depth by dedicated researchers. We draw on this research as appropriate but also undertake our own analysis into the implications for client portfolios.

Frontier's efforts to date have been focused around drawing attention to ESG and emphasising its importance, at both the firm and investment levels with the managers that we assess, as well as assessing the strength of the manager's ESG culture and the manner in which ESG is integrated into the process.

ESG fixed income considerations

Organisational/management

Below we discuss a number of ESG specific considerations from an organisational/management perspective that by no means are exclusive to the fixed income manager universe.

- One of the first considerations is whether the manager has a formal ESG policy in place. Whilst this is an important first step, we note that a manager's ESG policy should not be taken on face value and simply being a PRI signatory is not considered sufficient or even a material factor. The manager's actual motivations and level of adherence to the policy needs to be tested – that is, does the manager genuinely believe that ESG integration is important?
- A manager with an overarching ESG policy should consistently apply (where practical) integration of ESG factors across the range of strategies it offers, acknowledging that relevant ESG considerations will vary across asset classes, sub-sectors and industries.
- The level of ESG integration will also largely depend on whether the manager has the appropriate level of resourcing, expertise and access to data to make informed ESG related investment decisions and whether there is a dedicated ESG team conducting the analysis or if it is being done within the investment team.

Passive fixed income

Passive fixed income comprises a core allocation in institutional investor debt portfolios. Given these are benchmark driven strategies, ESG considerations are not typically considered unless explicitly instructed by investors via specific exclusions or ESG aware benchmarks. We do, however, believe that there is some scope to consider ESG at the margin, for example, as part of the manager's sampling approach or opportunities to engage with issuers.

Sovereign bonds

Historically, investors considered sovereign debt, particularly for developed nations, a low risk investment that delivered predictable returns. The evolution of ESG from a sovereign debt perspective has gained traction over recent years, particularly in light of the Eurozone crisis and ongoing geopolitical risks. We believe that the analysis of ESG related issues can provide useful insight into the fundamental characteristics and creditworthiness of a country over the medium and long term, identifying both country specific investment risks and potential opportunities at an early stage. The following diagram, developed by the PRI Sovereign Fixed Income Working Group, summarises some of the key ESG criteria for sovereign issuers and the links between these factors and sovereign creditworthiness and investment performance.

Frontier believes that incorporating ESG country risk metrics, for both developed and emerging nations, can help the manager better understand and potentially reduce risk in sovereign bond portfolios. When assessing ESG risk from a sovereign perspective, it's not only important to have an understanding of what impact environmental and social factors will have on an economy, but also what framework the government has in place to identify and mitigate such risks. Additionally, from a governance perspective, a manager should also be assessing how a country's institutional strength and governance standards may impact the sovereign's ability to service its debt obligations. We expect that formal ESG integration should most clearly be apparent in the assessment of emerging market sovereigns, given the greater country risk apparent relative to developed markets. While we acknowledge that there are challenges around assessing ESG risk in developed market sovereign bonds, we note that developed economies are not immune, with governance related factors being cited as a contributing factor that led to the downgrading of the US and UK by S&P Global Ratings.

Figure 1: SFIWG framework for exploring the links between ESG factors and sovereign fixed income investment performance.

Environmental
- Climate Change
- Water resources & pollution
- Biodiversity
- Energy resources & management
- Biocapacity & ecosystem quality
- Air pollution
- Natural disasters
- Natural resources

Social
- Human rights
- Education & human capital
- Health levels
- Political freedoms
- Demographic change
- Employment levels
- Social exclusion & poverty
- Trust in society/institutions
- Crime & safety
- Food security

Governance
- Institutional strength
- Corruption
- Regime stability
- Political rights & civil liberties
- Rule of law
- Regulatory effectiveness & quality
- Accounting standards
- Government finances

Economic factors influencing creditworthiness
- Economic strength
- Economic growth prospects
- Balance of trade
- Fiscal performance
- External debt
- Foreign liquidity
- Cash reserves
- Monetary flexibility

Credit risk indicators
- Credit ratings
- CDS spreads
- Bond yields
- Bond prices

Source: PRI Corporate Fixed Income Working Group

Sovereign bonds—case study (Venezuela)

Venezuela is suffering the worst economic crisis in its history. The Government has drastically cut imports of essential goods in order to conserve the cash needed to pay bondholders to the detriment of the Venezuelan people. Venezuela comprises around 5% of the hard currency emerging market debt index (JPMorgan EMBI Plus Index), with many managers continuing to hold the debt despite the issues. In fact, an overweight allocation to Venezuela has been a recent significant positive contributor for those managers holding overweight positions.

The argument from some managers is that the ESG risks are adequately accounted for in the price. However, we think it is very difficult to reasonably price this risk.

The counter view is that the country poses a potential significant moral and reputational risk to investors which ultimately may be reflected in capital markets withdrawing support and negatively impacting the price of the bonds.

Venezuela highlights the challenges around assessing the level of integration of ESG risks and the fact that managers may assess this risk differently resulting in different portfolio outcomes. Ultimately, a manager will have its own philosophy and approach to ESG integration and investors need to assess whether a manager's approach is sufficiently aligned with their own approach.

Corporate bonds

The traditional investment approach to fixed income links the credit risk of a security to the analysis of a company's financial metrics. We believe that integrating ESG metrics into the assessment provides a more complete view of the risk and return characteristics of a security. ESG considerations are an important element and contributing factor to a corporate's credit quality, with the potential for poor management of ESG related risks to lead to corporate default, rating downgrades, widening of credit default swap (CDS) spreads and breaches of covenants.

The following diagram developed by the PRI Corporate Fixed Income Working Group summarises some of the key ESG criteria for corporate bond issuers and the links between these factors and a corporate's creditworthiness and investment performance.

The materiality of ESG factors in the assessment of a corporate's debt largely depends on the industry and region of the business' operations. The manager should therefore be aware how various ESG factors affect different industries/ companies and weight these accordingly. For instance, from an environmental perspective, certain factors such as climate change or carbon emission regulations are considered more of an industry specific risk that will impact issuers in some sectors more than others, while the impact of governance factors such as board composition and practices, transparency and the quality of management are important regardless of the sector or issuer being assessed.

Figure 2: The relationship between ESG factors, credit factors and measures of creditworthiness

Environmental
- Climate Change
- Biodiversity
- Energy resources & management
- Biocapacity & ecosystem quality
- Air/water/physical pollution
- Renewable & non-renewable natural resources

Social
- Employee relations
- Human rights
- Community/stakeholder relations
- Product responsibility
- Health & safety
- Diversity
- Consumer relations
- Access to skilled labour

Governance
- Shareholder rights
- Incentives structure
- Audit practices
- Board expertise
- Independent directors
- Transparency/disclosure
- Financial policy
- Business integrity
- Transparency & accountability

Factors influencing corporate creditworthiness
- Profitability
- Employee productivity
- Competitive advantage
- Cost of capital
- Leverage

Credit risk indicators
- Credit ratings
- Breach of covenants
- Volatility
- Bond yield
- Default
- CDS spreads

Source: PRI Corporate Fixed Income Working Group

ESG integration

In assessing the level of ESG integration in a manager's process, Frontier considers a range of factors:

- Does the manager's ESG assessment form part of its overall sovereign/credit debt score or are they only considered on ad hoc basis?
  - Having a single internal credit rating score/research report that includes an ESG assessment that combines fundamental and ESG analysis will ensure that key ESG considerations are not ignored and investors are better positioned to assess risks.
- How is the manager ranking the individual ESG factors, what weighting is placed on the various sub-factors considered and how does the resulting ranking for the sovereign/credit influence an investment decision?
  - Ideally, managers should be considering what impact each of the ESG factors has on an issuer's credit-worthiness and also making necessary adjustments for any country or industry specific nuances.
- Does the manager exclude certain countries/sectors from the investment universe due to a poor ESG score or is an ESG overlay applied where it over or underweights securities relative to the benchmark based on the ESG score?
  - If the manager excludes a particular country/sector, what are the practicalities of doing so, particularly if it comprises a significant allocation within the index (i.e. impact on tracking error)?
  - Given that ESG analysis identifies both risks and opportunities, an approach that excludes particular countries/sectors runs the risk of neglecting any potential improvements or opportunities. However, there may be cases where negative screening makes sense (i.e. reputational risks or mandated by the client).

ESG engagement

ESG best practice in debt markets goes beyond the assessment and integration of ESG factors into the investment process and should also include engagement with issuers where practical. Whilst engagement is common practice amongst shareholders, the lack of voting power of fixed income investors has meant that engaging with issuers has historically been less common practise.

We believe that engagement from a fixed income perspective has the potential to be beneficial to investors as it can build on relationships through time creating more effective dialogue going forward. It allows investors to gain insight into how a company is positioned to mitigate risks or leverage opportunities. Additionally, engagement is useful as a means to accessing and sourcing relevant ESG data for research purposes, which may not otherwise be publicly available. This is particularly relevant on the sovereign side, where a country's ESG strengths and weaknesses are not as readily covered by rating agencies compared to equity or corporate debt ESG analysis, and therefore utilising a combination of internal and external ESG research will provide a more comprehensive assessment of ESG considerations, and provide a broader view in understanding a country's strengths and weaknesses.

On the corporate side, engaging with issuers is arguably a more effective exercise. In the case of high yield and unlisted debt, which tend to be more prone to ESG risks, and where external research may not be available, engaging with issuers is considered necessary and provides greater opportunities to promote and influence change.

Frontier ESG ratings

Frontier adopts a five star rating process (one, three or five stars) when assessing the level of ESG integration within a manger's investment process. The lowest rating is assigned to those managers that display limited evidence of considering ESG or only do so on an ad hoc basis. The next two levels of ratings are assigned to managers that are consistently assessing ESG risks within the process, however the distinguishing feature between the mid-and top-tier rated managers relates to whether the level of ESG integration within the investment decision making process consistently flows through to portfolio construction. We also rate managers more highly if they display a high level of active engagement with issuers and undertake their own ESG research as a cross-check against external data.

Next steps…

The fixed income universe includes a range of debt sub-sectors and the extent to which ESG is integrated into the investment process will vary across strategies. Where ESG research and integration is reasonably expected, in our assessment of a manager, we consider the strength of the firm's ESG culture and the manner in which ESG is integrated into the process. To date, the vast majority of debt managers that Frontier has met with are cognisant of ESG, however the level of actual integration is mixed. Our efforts going forward will continue to be focused upon drawing attention to ESG and emphasising its importance at both the firm and investment levels with the managers that we assess.

Additionally, we view ESG in debt markets as an important and evolving area of our own research and we will continue to enhance our approach for integrating the identification and assessment of ESG risks and opportunities within our fixed income manager research process.

Investors that are also looking at ways to better manage ESG risks within their fixed interest portfolio could consider the steps on the table below.

Table 1: ESG initiatives and timeframes

Shorter term	Medium term	Longer term
Frontier believes some ESG enhancements within passive fixed income is achievable and could be implemented relatively quickly. Areas for consideration could include: • consider the merits of negative screening aligned with an investor's philosophy (i.e. removal of certain sub-sectors); • process to reduce carbon footprint; and • consider ESG focused benchmarks (with similar risk/return characteristics of existing benchmark). Consider the various approaches of other passive managers in terms of ESG integration.	Adopt a set of standards as a minimum requirement for the level of ESG integration that would be reasonably expected across the fixed income sector and conduct a review of existing debt managers. Engage with existing managers on the ESG review findings, providing feedback on potential areas for improvements. Assess whether there is ESG risk concentration across the fixed income portfolio.	Ongoing annual ESG health check of managers, following up on any suggested areas of improvements. Benchmarking of existing managers versus broader managers to ensure best practice is maintained over time. Engage on specific ESG related issues (various over time) with existing managers. Engage with issuers directly, alongside managers, or encourage collaborative engagement between existing managers on specific ESG related issues.

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