

ESG INVESTING IN FIXED INCOME

Having initially focused on equities, investors are increasingly looking to extend ESG (Environmental, Social and Governance) practices across other assets classes, including fixed income. This is the first of a series of papers that will explore ESG in a fixed income context. This edition takes a high level look at the different approaches that can be employed and some related implementation considerations.

ESG APPROACHES FOR FIXED INCOME

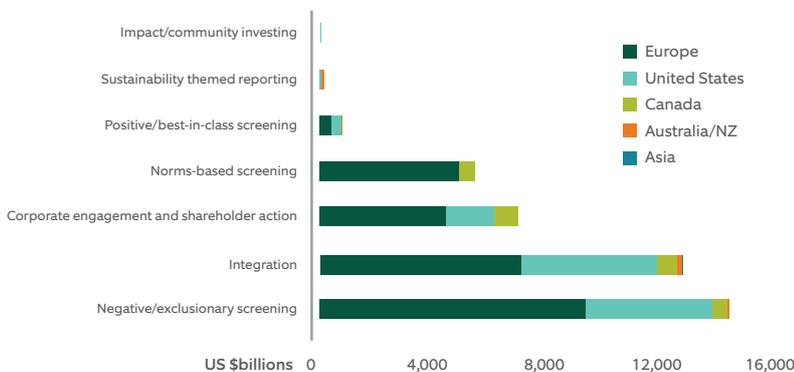
ESG may be viewed as a natural fit for fixed income portfolios, because the assessments required for ESG investing are already embedded into the risk process performed by many fixed income investors. However, the pace of ESG innovation in fixed income has been slow, perhaps due to the complexity in bond issuance and the lack of a recognized platform for engagement.

Figure 1 shows the range of ESG approaches that have developed across asset classes, the most prevalent being negative screening and ESG integration. In addition, green bonds is an ESG opportunity that is specific to fixed income. In the sections below we discuss green bonds, as well as negative screening and ESG integration.

Investor appetite has grown substantially for fixed income ESG investing, and various investment opportunities have been developed to cater to this demand.

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FIGURE 1: SUSTAINABLE INVESTMENT APPROACHES TO ESG INVESTING



Source: GSIA, 'Global Sustainable Investment Review,' 2014

1. GREEN BONDS

When investors think about ESG in a fixed income context, green bonds often come to mind. Momentum has been high in green bonds, primarily because they specifically finance activities that offer social and environmental benefits, presenting a unique opportunity for investors interested in sustainability.

Green bonds are mostly issued as vanilla securities offering similar yields and ranking equally to senior unsecured bonds from the same issuer. For this reason, green bonds have drawn interest from both dedicated socially responsible investors and mainstream fixed income investors alike. However, investing in green bonds is not without its challenges, the most notable of which are:

- Size: A relatively small market with total issuance of labelled green bonds still below \$100bln¹. This is especially relevant in terms of liquidity.
- Market concentration: Modest typical deal sizes and the limited range of issuers and currencies impact accessibility and appeal for mainstream investors.
- Transparency: Reporting standards vary, making comparisons of “green” credentials difficult.

While there has been an increase in the number of green bond indices since 2014, it is not clear that this has simplified the opportunity set. As illustrated in figures 2 & 3 key benchmark characteristics can be considerably different for green bond benchmarks versus traditional benchmarks.

These challenges mean that investors may need to look beyond just green bonds in terms of implementing ESG in their fixed income portfolios. Many green bonds form part of the universe of broad fixed income strategies and investors may prefer to focus on the broader opportunity set and utilize approaches shown in figure 1 to achieve their ESG goals.

When investors think about ESG in a fixed income context, green bonds often come to mind.

< 100bln

TOTAL ISSUANCE OF LABELLED GREEN BONDS STILL BELOW \$100BLN

¹31 December 2015

FIGURE 2: INDEX CHARACTERISTICS

	Barclays Global Aggregate Index	Barclays MSCI Green Bonds Index
No of issues	17165	91
Duration	6.6	5.48
Yield (%)	1.77	1.64
1yr Return (%)	-3.15	-5.71

Source: Barclays, 31 December 2015

FIGURE 3: SECTOR WEIGHTS (%) CREDIT QUALITY DISTRIBUTION (%)



Source: Barclays, 31 December 2015

2. SCREENING

Screening is the most widely used and simplest approach to ESG, requiring managers to filter portfolios based on specific ESG considerations or themes. Filters can be applied either on a negative or positive basis, the latter being relevant for investors seeking to optimize ESG credentials. The appeal of screening is often the ability to customize strategies to reflect the specific needs of the investor. We have also seen a growing number of screened fixed income indices that can assist the development of low cost ESG strategies. These include the Barclays MSCI Socially Responsible Index (negative screening) and Barclays MSCI Sustainability Index (positive screening, which focuses on best in class).

3. ESG INTEGRATION

Rather than start with a market capitalization weighted benchmark that may limit the application of ESG themes, investors are increasingly considering integrating ESG factors (through a scoring mechanism) into the core construction of the index or portfolio. Again we are seeing the development of a variety of ESG weighted benchmarks reflecting strong demand. It is important that investors are aware of the significant differences in the underlying composition that can result from the prioritization of ESG ratings. For example, figure 4 shows the clear differences in country concentrations between the Barclays MSCI Euro Treasury ESG Weighted Index and the standard Barclays Euro Treasury Index. It's imperative that investors who are interested in ESG integration understand the consequences of this approach compared with standard benchmarks and how these could affect their overall portfolio composition.

FIGURE 4: COUNTRY WEIGHTED DIFFERENCES BETWEEN BARCLAYS EUROTREASURY INDEX & BARCLAYS MSCI EURO TREASURY ESG WEIGHTED INDEX

Barclays Euro Treasury Index	Country	Barclays MSCI Euro Treasury ESG Weighted Index
23.4	France	26.3
18.3	Germany	20.8
6.2	Netherlands	6.9
13.3	Spain	10.0
24.3	Italy	18.5

Source: Barclays, 31 December 2015

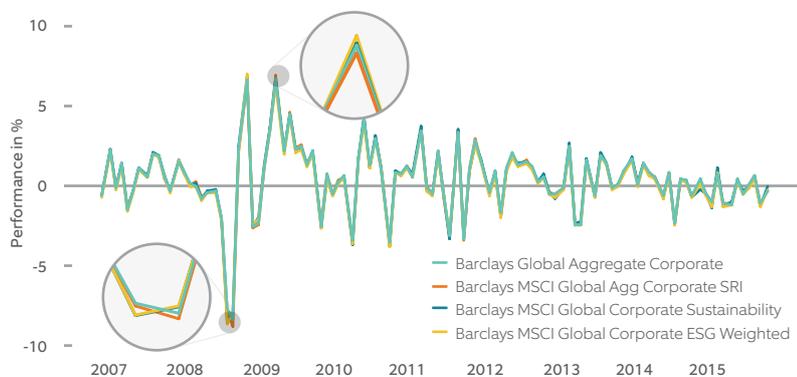
PERFORMANCE ACROSS ESG APPROACHES

A question that investors often ask around ESG implementation is that of performance. What is the impact of ESG prioritization? The answers are likely to vary depending on the ESG variables considered and the time periods evaluated. However, in overall terms when comparing the performance of various ESG benchmarks to traditional indices, evidence is thus far inconclusive. Some investors fear that they may have to choose between performance and investing according to their social and environmental beliefs, but this does not seem to have generally been the case. Figure 5 shows there have been minor return differences between the various ESG benchmarks and standard market-cap broad benchmarks. Of course performance divergences could be higher in the future and a careful consideration of the underlying benchmark characteristics is important.

There is an argument that over time issuers with higher ESG ratings, much like credit ratings, should attract greater demand and therefore lower issuance premiums and that they may exhibit superior performance. This would suggest that over time there may be an opportunity for an ESG approach to generate superior investment performance.

FIGURE 5: PERFORMANCE OF THE BARCLAYS/ MSCI FI ESG INDICES

Even during times of market strain and recovery the ESG focused indices effectively tracks the industry benchmark.



Sources: Northern Trust Quantitative Research, MSCI. January 2007 - December 31, 2015.

LOOKING AHEAD

Investors considering ESG approaches in fixed income may find little difference in the historical risk and return profile versus traditional strategies, which may appear to simplify the consideration of a responsible investing approach. However, it’s vital that investors carefully examine the implications of ESG choices, including changes to the investment universe and investment concentrations. This will ensure their fixed income strategy is not unduly constrained and continues to meet their overall objectives. Investors should not feel compelled to choose between investment performance and responding to their environmental, social and governance principles. Rather there is a growing range of solutions available which allow investors to optimize against multiple objectives.

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A Combined Approach

It’s possible to devise investment solutions that bring together Green Bonds, Screening, and ESG Integration with other relevant fixed income considerations (e.g. liquidity) to develop a robust approach. A combined approach allows investors to more precisely target specific outcomes to match investment objectives. The ability to customize can be combined with a focus on low-cost tradeable solutions. If you are an investor looking to integrate ESG into your fixed income portfolio talk to us about the variety of options available.

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