Future First℠ Insights

Why Fixed Income Is Relevant for Responsible Investing

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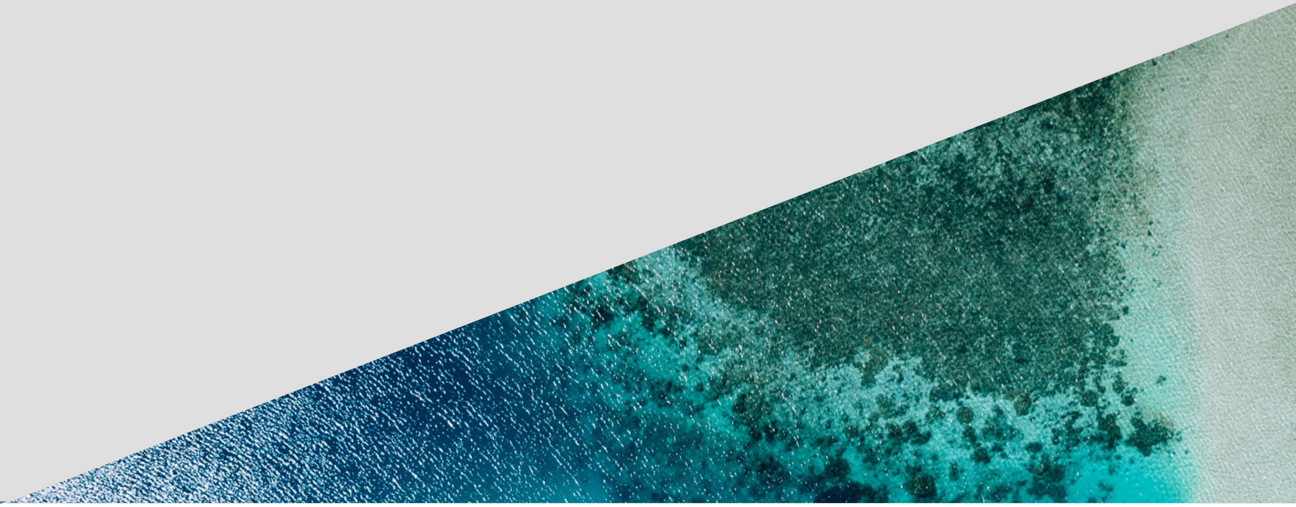
Consider Everything

Responsible investing has traditionally focused on equities, given shareholders' ability to influence management decisions. But as responsible investing evolves, some global institutional investors are widening their focus to fixed income. Bondholders can also have far-reaching influence over governments and companies, and fixed-income investors may seek to engage with debt issuers to better understand the ESG risks they face, evaluate how they manage them and encourage them to improve their practices.



The Power of the Bond Market

Famously, when describing the power and influence of debt markets on the global financial system, Clinton-era Democratic adviser James Carville said: “I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody.”

Fixed-income assets are a core allocation within many, if not most, investors’ portfolios. Institutional investors including insurance companies, pension funds, sovereign wealth funds and central banks have historically allocated significant assets to fixed-income strategies. Whether the focus is long-duration bonds to align with liability-conscious objectives, or credit strategies to seek additional alpha, fixed-income assets continue to form a crucial part of global investment programs.

The centrality of fixed income is illustrated by the amount of global issuance, which is many times larger than the equity market. The role of these assets in investor portfolios, and their dominance across global markets, mean these assets cannot be ignored as investors seek to invest responsibly in pursuit of their goals.

Assessing Debt Issuers' Sustainability Is Vital

Sustainability considerations form a part of fundamental investment analysis, in addition to increasing examples of explicit responsibility objectives. A 2020 joint survey conducted by the Official Monetary and Financial Institutions Forum (OMFIF) and BNY Mellon indicated that a majority of the central banks, sovereign funds and pension funds that responded integrate ESG criteria into their investment program to seek superior risk-adjusted returns.[1]

The potential materiality of ESG risks is widely acknowledged. There are many examples of such risks having a material impact on the pricing of a bond, or leading issuers to default. The core focus for fixed income investors is the risk of an impairment to their coupons or return of principal. Any material risk that could affect whether an issuer fulfills these obligations – including ESG risks – will be relevant to investors' analysis.

This is a central pillar of a responsible investment approach, and reflects a fixed-income investor's natural focus on the sustainability of an issuer's operations and its ability to afford financial obligations.

For example, for investors seeking to achieve a specific outcome, such as pension plans with defined obligations, maximizing the certainty of achieving this specific outcome is key. Investing with precision, including analysis of ESG risks to help ensure accurate valuations and effective risk management, is crucial.

[1] OMFIF, "Global Public Investor 2020: Sustainable Investment"

The PRI has established the ESG in Credit Risk and Ratings Initiative to "enhance the transparent and systematic integration of ESG factors in credit risk analysis,"[2] and global credit ratings agencies now incorporate ESG evaluation within their analysis.[3]

When it comes to engagement, headlines typically focus on shareholders who have voting powers that enable them to influence, and if necessary replace, company executives. The reality, however, is that fixed-income investors' influence can far outstrip that of equity investors, primarily due to a range of institutions dependent on debt capital markets for financing.

Debt markets provide finance to a wide range of entities, including sovereigns, supranationals and agencies, as well as many companies, some of which prefer to raise finance using the debt rather than equity markets. This means that fixed-income investors can have influence on entities and market sectors that are inaccessible to other investors.

Opportunities for dialogue are often regular. For many institutions, access to finance from the bond market is an ongoing necessity, either to fund new projects or roll over existing debt. This stands in contrast to the equity market, where issuance is comparatively rare.

While for major debt issuers, a single investor or asset manager can sometimes have little effect, collaborative initiatives – where investors work together to achieve a common goal – can have a meaningful impact.

This power means fixed-income markets can play a central role for investors seeking to influence governments and corporates, whether that is to achieve their financial or sustainability objectives.

[2] https://www.unpri.org/investment-tools/fixed-income/credit-risk-and-ratings

[3] For example, credit ratings agencies Moody's (https://esg.moodys.io/), Standard & Poor's (https://www.spglobal.com/ratings/en/products-benefits/products/esg-in-credit-ratings) and Fitch Ratings (https://www.fitchsolutions.com/products/fitch-ratings-esgrelevance-scores-data) offer ESG-specific analysis.

Bondholders Can Pursue Precise Sustainability Targets

When debt is issued, fixed-income investors can influence the structure and terms of the issuance. A bond with unattractive terms could lead to financing on less favorable terms for an issuer. In rare cases, an issuer may withdraw an issue if there is not enough demand and sometimes change terms or documentation language to comply with investors' requirements.

The regularity of debt issuance, combined with investors' ability to influence the terms and structure, mean fixed-income assets offer the potential for meaningful influence.

Investors can target sustainability outcomes in a way that other asset classes – such as equities – cannot offer.

In the now mainstream "use-of-proceeds" bond market, issuance can be linked directly to specific projects with a positive environmental and/or social impact (the most common are "green bonds," where bond proceeds are used to support environmental projects), or wider goals – such as the UN Sustainable Development Goals (SDGs). Some bonds also build in targets at the broader institutional level, such that if sustainability targets are met, the issuer benefits from more attractive financing terms; and similarly, if targets are missed, the investor receives compensation for this failure.

The growth of the so-called "impact bond" market means that debt issuers across a wide range of markets and sectors, including sovereigns and private companies, are being encouraged to pursue explicit sustainability objectives.

It also means that, through fixed-income markets, investors are able to tailor their portfolios and objectives to reflect both financial and sustainability targets in new, innovative ways – more than other financial instruments. According to the OMFIF and BNY Mellon survey mentioned earlier, green bonds are the most popular and growing sustainable asset class, but there is not enough supply to meet the demand: "There aren't many green bond issues that conform to our investment guidelines, and the ones that do are small."[4]

[4] OMFIF, "Global Public Investor 2020: Sustainable Investment"

New Opportunities Are Yet to Emerge

A responsible approach to fixed income, taking ESG risks and factors into account, can support an investor's financial and sustainability objectives. This is now widely appreciated by investors, but there is still work to be done to refine what this means in practice.

Fixed-income markets encompass a wide range of issuers and instrument types. While the basic principles of a responsible investment approach will remain consistent across them, the practical implications will be different. For example, most analysis of ESG and sustainability risks has focused on corporate debt, with research into their impact on sovereign debt still in a developmental phase. Much of this is down to the availability of good-quality data, which is still more accessible at a corporate level. Similarly, in secured finance, managing the impact of ESG risks on a residential mortgage-backed security will be very different than a commercial real estate loan, for example.

Overall, investors are at the beginning rather than end of their journey with respect to integrating a responsible investment approach into their fixed-income portfolios. However, as investor practices evolve, the focus on ESG risks and sustainability factors could provide investors with further opportunities to build portfolios that can target both financial and sustainability targets with greater precision, creating better outcomes for all stakeholders.