

Expanding ESG Coverage

MORE INVESTORS ARE APPLYING ESG SCREENS FOR FIXED-INCOME SECURITIES

By Lori Pizzani

Whether the approach is dubbed sustainable investing, impact investing, or screening for environmental, social, and governance (ESG) practices, the trend of applying these approaches for investing has definitely gone mainstream. Until recently, the focus has been on equity investing, but the practice of applying ESG screens for fixed-income analysis is growing.

According to the Global Sustainable Investment Alliance, the global sustainable investment market (including equity and fixed income) climbed to \$21.4 trillion at the beginning of 2014, encompassing 30.2% of professionally managed assets in the regions of Europe, the US, Canada, Asia, Japan, Australasia, and Africa. The number is up 61% from \$13.3 trillion at the start of 2012. The US, Canada, and Europe now account for nearly 99% of these sustainable investments, but growth has been trickling into the Asian markets of Malaysia, Hong Kong, South Korea, and Japan.

In August, CFA Institute announced the results of a global survey of 1,325 CFA Institute members. The survey, conducted jointly with the Investor Responsibility Research Center Institute during May and June 2015, found that 73% of investment professionals worldwide consider ESG factors in their investment analysis and decisions, with 63% using it to

manage risk. A significant 61% of respondents believe that companies should be required to annually disclose ESG sustainability indicators within the most up-to-date reporting framework, with 69% agreeing that disclosures should be independently verified and 44% supporting high-level audits.

Although the survey didn't distinguish equity from fixed-income securities, the findings reflect a broader movement that is changing the way investment managers look at ESG issues. "We're seeing a cultural change as to how investment analysis is done," says Matt Orsagh, CFA, CIPM, director of Capital Markets Policy at CFA Institute. "Investors are using ESG factors to build the whole mosaic needed to see the complete picture, going beyond the numbers and taking a holistic approach."

Approaches to ESG screening, both inclusionary and exclusionary, vary; however, more and more investment professionals are taking an integrated approach to ESG analysis across equity, fixed-income, and even private investment markets.

"A comprehensive ESG screen helps to minimize excessive risk and allows us to find high-quality companies and securities," says Samantha Palm, portfolio manager of the Parnassus Fixed Income Fund. "Securities that do well on ESG screens tend to be better-run companies. Companies that cut costs on safety, for example, typically have more accidents that impact a company." Parnassus Investments, based in San Francisco, has built its reputation on deploying socially responsible screens and analysis across equity securities since its inception 31 years ago. In 1992, with the beginning of the Parnassus Fixed Income Fund, it adapted its approach for fixed-income sectors by incorporating corporate bonds and convertible bonds and, in 2013, commercial mortgage-backed securities and residential mortgage-backed securities.

ESG screens are more narrowly defined, whereas socially responsible investing covers a wider swath, explains Palm. Not only does Parnassus use the same exclusionary screens for fixed-income securities that it uses for equities (e.g., nixing companies with ties to weapons, alcohol, tobacco, gambling, and direct investments in Sudan, with some minor allowances), but it also evaluates for positive performance attributes of environmental impacts, products, employee benefits and corporate culture, and corporate governance and business ethics. "We can apply ESG to either asset class," she says. "The most important thing is to have a robust and repeatable process toward that end goal."

The trend has two main drivers: aging investors with diversified portfolios and enlightened investment managers, according to David Kathman, CFA, a senior analyst with Morningstar in Chicago. Although Morningstar hasn't historically broken out ESG-screened fixed-income mutual funds, Kathman has been following several, some with rapidly growing assets under management. "Today there is much more of a focus on positive screening," he says. Savvy managers "generally have a percentage of fixed-income securities that support renewable energy, community and economic development, plus green bonds to support green projects."

By year-end 2015, Morningstar will launch ESG scores for all of its 200,000 tracked global mutual funds and exchange-traded funds, to be based on each fund's ESG footprint as determined by portfolio holdings. To develop its scoring system, Morningstar partnered with Amsterdam-based Sustainalytics, which provides ESG research and analysis and assigns companies 70 scores related to ESG policies and practices.

RISKS AND REWARDS

Fixed-income investors have been asking, "What are the ESG risks and opportunities facing an issuer?," according to Laura Nishikawa, CFA, executive director, head of ESG

KEY POINTS

ESG screening is going mainstream across fixed-income sectors/securities.

The ESG trend has two main drivers: aging investors with diversified portfolios and "a cultural change as to how investment analysis is done."

Green bonds are an emerging growth area for fixed-income investments.

research at MSCI. In 2012, MSCI expanded its equity ESG research to include several fixed-income sectors: corporates, sovereigns, supnationals, agencies, and covered bonds. It became the first to provide ESG analysis tools to help fixed-income investors integrate ESG factors into their processes. This past May, MSCI launched the next generation of ESG research, which includes expanded governance data, director profiles, and deeper assessments of key risks.

Nishikawa says that all three pillars of ESG are integral, but governance is the most universally recognized. “Every corporate default has everything to do with governance,” she adds. “I don’t think there’s any part of the fixed-income market that ESG can’t apply to.”

In 2012, MSCI worked with Barclays to launch a family of fixed-income benchmark indexes incorporating ESG risk and participation measures. According to a June 2013 Barclays report, ESG as an investment theme is growing because more ESG information is available. Evidence shows that ESG factors are becoming more important to companies. Moreover, ESG “market norms” are emerging, although they are still far from being standardized.

Investors are incorporating ESG screening in recognition of the material impact ESG factors can have on financial risks and returns, as the Barclays report explains. ESG approaches are being deployed for security selection, asset allocation, risk estimation/performance attribution, monitoring, and sometimes proactive engagement with management.

ESG reviews of fixed-income investments continue to be evaluated with a wider lens and have reached critical mass, according to Gregg Sgambati, managing director of S-Network Global Indexes’ ESG Solutions in New York City. Investors are looking for ESG-aware bond issuers, who are expected to have lower funding costs in the future. “It’s about bond investors looking at risks and ways to mitigate portfolio risks,” he says.

S-Network, a developer of proprietary and custom indexes, partnered with Thomson Reuters in April 2013 to develop an objective ESG scoring system and benchmarks for 4,600 public companies worldwide to showcase those with superior ESG practices. “This space is growing, and there continues to be a broad spectrum of people interested,” notes Joseph LaCorte, CFA, co-founder and CEO of S-Network.

“People are starting to jump on the [ESG] bandwagon, but they want statistical and empirical evidence that incorporating ESG helps control risk and helps create opportunity for alpha,” says Kim Nguyen-Taylor, director of credit analysis at Calvert Investments in Bethesda, Maryland, and co-author of the recent white paper “The ESG Advantage in Fixed Income Investing: An Empirical Analysis.” For the white paper, Calvert back-tested using six simulations to validate the efficacy of ESG performance (using the annual rate of change for credit default swap [CDS] spreads as a proxy for performance) for investment-grade

and high-yield companies based upon annual ESG scores. The analysis was done for two periods: 31 December 2002 through 31 December 2012 and 31 March 2003 through 31 March 2014.

Although individual results varied, all six simulations provided evidence that incorporating ESG factors into the analysis of fixed-income securities may add value by controlling risk and generating alpha opportunities. It also showed how specific ESG factors contributed to outperformance and by what magnitude. However, Nguyen-Taylor cautions about data limitations, which include limited sample sizes, infrequent CDS quotes early in the sample periods, and survivorship bias caused by recession-related bankruptcies, mergers, and acquisitions.

Interestingly, although the “governance” pillar of ESG has gotten more attention than the other environmental or social aspects, Calvert’s research suggests that it has less positive effect overall than do environmental and social factors. “While governance is deeply watched, it did not have as much of an impact,” explains Ivan Naranjo, CFA, associate portfolio manager at Calvert and co-author of the simulation project report. “It all adds up to wanting the best risk-adjusted returns.”

GOING GREEN

The green bond market, still in its infancy, is another ESG-related phenomenon. Green bonds specify uses of proceeds and were created to expand the investor base for worldwide climate-friendly projects, such as developing renewable energy and sustainable transportation, funding forest and watershed projects, and building infrastructure to prevent flood damage. Since 2008, the World Bank has issued \$8.5 billion in green bonds and the International Finance Corporation has issued \$3.8 billion in such bonds.

Everence Capital Management, investment adviser to the faith-based, socially responsible, and ESG-aware Praxis Mutual Funds (based in Goshen, Indiana), was an early investor in green bonds and still supports them, according to Benjamin J. Bailey, CFA, senior fixed-income investment manager at Everence. Explaining his foray into green bonds, he says, “We knew we wanted to do this, so we asked, ‘Why don’t we actively look for securities doing good?’”

This past April, Praxis invested \$1 million in the first-ever US-dollar Asian Development Bank green bond, and in July, it invested another \$1 million in the first green bond issued by a European export credit body, Swedish Export Credit Corporation.

As the co-portfolio manager at Everence, Delmar King, explains, “The real issue for us was we wanted to outperform the benchmark, and we felt we weren’t giving up anything from a yield perspective and not taking on more risk.”

Lori Pizzani is a freelance financial and business reporter based in Brewster, New York.

KEEP GOING

Find full survey results and ESG educational content provided by CFA Institute at cfa.is/1FGXakq

“How Can Fixed-Income Investors Address ESG Considerations?” *Enterprising Investor* (17 June 2014) [blogs.cfainstitute.org/investor]

“Diversification of a Different Kind,” *CFA Institute Magazine* (March/April 2015) [www.cfapubs.org]

“Using ESG Factors for Equity Valuation,” *CFA Institute Magazine* (November/December 2014) [www.cfapubs.org]