Why active?

Active is: Integrating ESG into fixed-income investing

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ESG factors have historically been more commonly associated with equity investments, but the past year has seen a significant change with fixed-income investors pushing for ESG factors to be appropriately and demonstrably integrated into investment analysis and risk decisions.

Sustainable investing – which incorporates environmental, social and governance (ESG) factors into investment decisions and targeted investment outcomes – has transitioned from a trend to the mainstream over the past several years. It has become a core consideration for investors as they seek ways to enhance performance and manage risk, while increasingly targeting non-financial goals.

By considering ESG factors, investors can achieve a more expansive analysis of the risks to which companies may be subject. At the forefront of this analysis is climate change, but there is rising pressure on companies to disclose and demonstrate a consideration of broader ESG factors.

In the past, engaging with companies and formally incorporating these factors was perceived as the preserve of equity investments. But the surge in bond issuance in recent years has coincided with heightening investor focus on sustainability, and fixed-income investors are engaging more fully with issuers and adapting investment processes in line. One outcome of this evolution has been the increase in issuance – and issuers – of green bonds.

Key takeaways

- Integrated ESG means the inclusion of environmental, social and governance factors in all investment processes and risk decisions
- The ESG focus relating to fixed-income investments has mostly concentrated on downside mitigation, but there is an opportunity to generate positive alpha from companies with improving and transitioning ESG profiles
- A fully integrated ESG process draws on individual and collaborative expertise from diverse research teams covering ESG, equity and fixed income
- The market has yet to adopt a common approach, with a debate around the merits of exclusion strategies compared with integrated ESG's ability to invest and engage with issuers on a transitional path.

The primary ESG approaches

At Allianz Global Investors we employ three primary approaches under the umbrella of sustainable investing: integrated ESG, SRI (sustainable and responsible investing) and impact.

Integrated ESG portfolios have no restrictions on their initial investable universe, but there is a formal infrastructure to ensure investment decisions include ESG considerations. Further, portfolio managers must provide explanations for any holdings that are either rated low, or not rated at all by global index provider MSCI .

SRI involves the application of preliminary screening filters to remove issuers exposed to non-sustainable activities, creating a smaller investable universe. That universe will be analysed using a proprietary model to rate each issuer from worst to best in class; selection is then skewed towards the best rated.

Impact involves investment in companies generating an intentional and identifiable social or environmental impact along with financial returns – this strategy includes the likes of green, SDG and transition bonds.

All three strategies involve the collaboration and leveraging of asset class-specific research teams (for example, equity or fixed income) with the specialist ESG analysts, coupled with an active approach to engagement and stewardship. This multi-stakeholder process allows for a more informed approach to sector and company investing.

Increased disclosure supported by research

The asset management industry as a whole has embraced sustainability. By year-end 2018, over 2,000 asset owners with total assets under management of around USD 90 trillion had signed up to the United Nations Principles of Responsible Investing (UNPRI), which promotes six guiding principles[1] for the incorporation of ESG issuers into investment analysis. These cover ownership policies and practices, engagement to seek improved disclosure and actively promoting the implementation of these principles. In addition, there is growing focus on the adoption of other UN initiatives, like the Global Compact[2] and the 17 Sustainable Development Goals[3]. This shift has helped drive the momentum of ESG within fixed-income investing.

While the potential upside of a bond is limited, the downside can be significant in cases of default, so identifying potential risks is key, and many of these have ESG factors at their core

This momentum has also affected practices among issuers. Investors now have greater expectations around how issuers should disclose ESG factors, along with transparent and actionable KPIs (key performance indicators). As greater transparency becomes commonplace, formal incorporation of these factors becomes more granular, and those failing to meet investor demands risk either more limited or more expensive access to capital markets.

An integrated ESG approach means issuers' own disclosure is backed up by comprehensive proprietary research. Fixed-income assets are characterised by an "asymmetric" return profile – while the potential upside of a bond is limited, the downside can be significant in cases of default. As a result, identifying the relevance of potential risks is key, and many of these have ESG factors at their core.

This progress has been achieved despite the broader adoption of ESG being complicated by the impact of quantitative easing (QE) on asset valuations. Central banks' large scale purchases of bonds have not incorporated the same stringency on ESG factors, allowing some companies with less sustainable policies to achieve lower costs of financing, and heightening potential conflicts of interest between stakeholders. However, over the longer term, companies with a clear and credible approach to sustainability are more likely to be able to retain smooth and efficient access to funding.

Investors should question the available investable universe, the nature and breadth of any exclusions, and the active management element of any index

The benefits of moving away from an index

The growth in ESG-themed investment has understandably led to the development of ESG-related indices. However, investors need to be mindful of the construction of these indices and the extent to which they are appropriately matched to their investment goals. For example, investors should question the available investable universe, the nature and breadth of any exclusions, and the active management element of any index.

Active asset management is well suited to sustainable financing, not only because of the level of potential engagement on ESG topics, but also because it means investors can use financing as a lever of change. An integrated ESG approach enables engagement with managers with the goal of influencing issuers to transition to an improved profile.

Identifying and engaging with "turnaround" stories can be a key generator of positive alpha in fixed-income portfolios

Identifying these potential "turnaround" stories can be a key generator of positive alpha in fixed-income portfolios. Passive strategies on the other hand may be constrained by their index allocations from buying certain bonds until their ESG rating has reached a certain threshold.

Meeting evolving investor demand

Public and private focus on sustainable investing is expected to continue to grow, so proactive issuers who can meet rising investor demands on disclosure and transparency should benefit.

Proprietary research to identify material factors and areas for potential improvement will also be highly important. Thorough research will provide the bedrock for investors to be able to engage with company management and influence business practices, potentially unlocking value. The integration of ESG is therefore equally as important in fixed-income investing as it is in equities. This is especially true given the growth in debt in recent years, which has helped sustain the equity growth story.

ESG is no longer a "nice-to-have" but an increasingly important and necessary cornerstone to any fixed-income investment strategy. Investors are more and more likely to expect asset owners to be accountable to the same ESG standards as those companies in which they invest.

[1] https://www.unpri.org/pri/an-introduction-to-responsible-investment/what-are-the-principles-for-responsible-investment

[2] https://www.unglobalcompact.org/

[3] https://www.un.org/sustainabledevelopment/sustainable-development-goals/