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ESG AND CREDIT INVESTING

What does the future hold?

Introduction

In recent years, most investment managers have analysed how they will incorporate and implement Environmental, Social and Governance (ESG) considerations into their credit investment processes.

For experienced credit analysts and portfolio managers, especially those who have been working in credit markets for a decade or more, the recent push for ESG may come as a surprise. Many of them would believe that these factors have always been part of a thorough credit research process, well before the now-famous 'ESG' acronym was invented.

It is even more surprising to see that this recent ESG push has come from asset owners, like pension plans and sovereign wealth funds, rather than asset managers. As a result, these institutional investors will be required to increasingly align their performance goals with the priorities and values of their beneficiaries.

The rise of ESG

When Nikko AM became a signatory to the United Nation Principles for Responsible Investment (UN PRI) in 2007, an international network of investors focused on sustainable investing, less than 300 investment managers had signed up. There are now 1,600 signatories representing US$62 trillion assets under management.

Back in 2002, WorldCom was the poster child for corporate governance failure, a situation that should have stressed the importance of ESG factors. Years of experience in credit investing also helps to distinguish between good and bad corporate governance, as seen previously during the crises in 2001/02 and 2007/8, which provided analysts with a steep learning curve. It is clearly positive that our industry is finally implementing these factors into their investment processes in a structured way.

However, it is important to note that ESG is by no means a 'new topic', and having a team of skilled and experienced credit analysts is still the key for success. A lot of asset managers that entered into sustainable investing did so by structuring separate ESG teams, which in turn advised the investment teams. More and more buy-side firms are now realising that this type of separation is not necessarily the most efficient way to invest with ESG in mind. As a result, many have started to integrate these ESG teams into their investment platforms, and we agree that this is the best approach.

The value of better transparency

The increasing focus on sustainable investing has made the work for credit researchers somewhat easier than even ten years ago, as a great amount of ESG-related information is now readily available.

In the past, corporates were reluctant (or perhaps unprepared) to provide detailed ESG reports, however a failure to do so today will ensure the company receives a bad ESG report score before the research process has even started.

Disclosing ESG information is still not, however, a standardized procedure, and so is often not comparable across companies and sectors. If companies and investment managers cannot find a common ground, both sides face the risk of more regulation in this area. The good news is that many corporates have embraced the move to sustainable investing, which shifts the focus away from short-term thinking. As a result, shareholders are now more interested in the long-term goals of a company, rather than the next round of quarterly results.

The challenges of incorporating ESG

We believe that one of the biggest challenges for sustainable investing in the future will be the incorporation of the 'newer factors', E and S, into asset managers' research approach. While most experienced analysts work with a best-practice list for corporate governance, built on the back of many years of experience in credit investing, it is often more difficult to form an opinion on the environmental and social aspects of a business. Often credit analysts rely on third-party research, such as MSCI, to cover these areas.

While corporate governance assesses mostly general management quality, which has a direct impact on the company's performance, E and S tend to capture risk and opportunities linked to a specific industry or region. Understanding environmental aspects, for example, is more important when analysing utility companies, rather than banks. The connection between performance and behaviour is also more indirect and longer-term for social and environmental factors, than it is for corporate governance.

In a recent research paper, Barclays Bank analysed the impact that ESG has on the performance of companies by constructing corporate bond portfolios, and then applying an ESG tilt in security selection. To isolate the ESG performance effect from other performance drivers, the portfolios' main risk parameters (such as sector allocation, maturity, credit quality) were equalized.

ESG ratings from MSCI and Sustainalytics were then used to construct portfolio pairs, one with a high ESG score, and one with a low ESG score. The same was done for each of the individual factors – E, S and G – to help isolate their performance impact. To measure the impact of sustainability, the performance of the low ESG scores was always deducted from the high ESG score portfolios.

Barclays found, using data from August 2009-April 2016, that the results were positive, which confirmed that incorporating ESG ratings into portfolio construction can help to influence performance. The contribution to performance was also interesting with the results revealing that the highest performance was generated by portfolios focused on companies with a high Corporate Governance rating. Still positive, but lower, were the results for Environment, while the contribution from Social was negative.

Should then a credit manager apply a lower weighting to E and S factors when constructing portfolios? Probably not, even though the performance advantage for both is rather minor. A recent survey from Barclays Bank revealed that these two factors are far more important for asset owners than corporate governance. The direct impact on performance might be marginal, indirect and long-term; however, they ensure that the investments correspond with the ethical and social values of an increasing number of institutional clients. European asset owners, in particular, require that their values are reflected in their portfolios, alongside their performance goals. This presents a challenge for credit portfolio managers, as they strive to outperform, while at the same time reflecting the increasing importance of sustainability into portfolio construction.

A more positive approach to ESG

The focus on responsible investing has traditionally been around excluding companies from controversial sectors, such as tobacco. More recently, however, the attention has shifted toward investing in companies with positive ESG credentials. Even companies from controversial sectors can actively manage ESG factors, and so make it worthwhile to consider them as an investment.

This more positive approach is also changing the perception of ESG's performance impact. In the past, the exclusion of controversial companies was viewed as a potential drag on performance; however, the current focus on companies with a positive attitude toward sustainability means an active ESG approach is now regarded as a catalyst for outperformance. For some clients, these newer ESG investment approaches are not far reaching enough, with the latest developments seeing asset owners now looking to allocate money to 'impact investing'.

Impact investing involves investing in companies, organizations and funds that not only generate a financial return, but also a social and environmental return too. The majority of impact investors are currently private equity or venture capital firms, rather than fixed income investors, as loans made to sustainable projects are often illiquid, unrated and long-term.

Green bonds might strike the middle ground for investors that are not yet prepared to loan money to a wind park project in Mongolia, but still want exposure to ESG investments. Green bonds are issued by organizations and corporates, with the proceeds solely dedicated to funding qualifying green investments.

Maybe it is not fully clear yet which ESG path that asset owners' will ask their credit manager to follow. However, we expect that the importance of ESG investing will grow one way or the other over the coming years, with asset managers having to adapt to client demands, even when it no longer purely focuses on financial goals, but also on long-term values.

Holger Mertens biography

Holger joined Nikko Asset Management in July 2015 to manage the development of the firm's Global Credit capabilities.

Prior to Nikko AM, Holger worked at Lazard Asset Management and held a variety of roles based in both Frankfurt and London and was Lead Portfolio Manager for their European Corporate Bond Portfolio. Before Lazard, he worked for Deka Investment Management where he was a Fund Manager/Analyst in Corporate Bonds.

Holger began his career at DG Bank as a Fixed Income Trade and Sales assistant. He holds a Masters in Business Management and Economics from the Frankfurt School of Finance & Management and is a CFA® Charterholder.

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