NEWTON

Investment Management

BNY MELLON | INVESTMENT MANAGEMENT

January 2020

HOW ESG FACTORS CAN HELP REDUCE CREDIT RISK AND ENHANCE RETURNS

Why we believe integrating ESG considerations into credit analysis is not only crucial to risk assessment, but can result in superior risk-adjusted returns and better environmental outcomes.

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INTRODUCTION

HOW ESG FACTORS CAN HELP REDUCE CREDIT RISK AND ENHANCE RETURNS

Why we believe integrating ESG considerations into credit analysis is not only crucial to risk assessment, but can result in superior risk-adjusted returns and better environmental outcomes.

When it comes to assessing the risks around fixed-income investments, environmental, social and governance (ESG) factors have traditionally been viewed through the rear-view mirror, when something has already gone wrong.

This article explains why we believe it makes sense to employ a forward-looking assessment of ESG-related credit risks, to help reduce the chances of potential future hazards.

The rating agencies and a growing number of investment managers are more explicitly factoring ESG issues into broader credit assessment. However, we need to ask whether these ESG-related risks are being fully priced in by the market.

Anecdotally, it appears that such factors may only be fully priced in where there has been a more severe credit event, and in the past this has tended to be related to a governance failing. Issues here may include bribery and corruption, civil unrest, accounting misstatements, or the conduct of senior management. In some cases, environmental and social issues may be influential, and certain sectors have seen a more fundamental change in credit risk perception, such as the US shale-drilling in relation to concerns about the banning of fracking.

ENVIRONMENT TO THE FORE: A LITANY OF PROBLEMS

Over the last few months, there has been a variety of news flow demonstrating how ESG factors can affect business risk (and therefore credit risk), and, at times, bond performance. Much of it has tended to focus on environmental concerns. We list a few examples below:

SEPTEMBER 2019

Moody's – rating agency:

Cited that one of the reasons for it downgrading Ford's credit rating to sub-investment grade was Ford's *"current portfolio leaves it vulnerable to large emissions penalties in 2020 and 2021."*

NOVEMBER 2019

Fitch – rating agency:

Issued a warning for the Brazilian agricultural sector, saying that the backlash over the Amazon wildfires could spark boycotts of the country's beef exports, and threaten the approval by each member state of the European Union/Mercosur trade deal.

European Investment Bank (EIB):

Said it will *"end financing for fossil-fuel energy projects from the end of 2021. Future financing will accelerate clean-energy innovation, energy efficiency and renewables."*

California's state government:

Announced it will halt all purchases of new vehicles from GM, Toyota, Fiat Chrysler and other automakers that backed stripping the state of its authority to regulate emissions.

DECEMBER 2019

Repsol – Spanish oil company:

Announced it will eliminate emissions from its business by 2050. The company revised the value of oil and gas assets in a decarbonising world, resulting in a €4.8 billion impairment charge.

S&P – rating agency:

Warned on current global warming trends which suggest that the materiality of climate risk for ratings is only likely to increase in the future. S&P said: *"The longer the delays in addressing current trends in climate change, the more likely we could see economic and social disruptions, due both to higher physical risks, and the need to transition to a low-carbon economy at a faster pace."*

Rating agencies have included some ESG factors in their scoring methodology for a while, but these factors are now becoming more explicit in their assessments, helping investors to understand their materiality to the ratings.

ESG RISKS AFFECTING BOND PERFORMANCE

The relationship between ESG factors and issuer ratings is not altogether consistent, but blow-ups have tended to occur in those with lower ESG ratings. This suggests more attention needs to be paid to this area of the market; opportunities can exist where risks have not been priced in.

Analysis of the European high-yield index for 2018, which was a lower-return year for credit, shows that material underperforming issues tended to have the weaker ESG ratings.

Data for the 11 months to 30 November 2019 – a better-return period for credit as a result of a more favourable backdrop with lower volatility – shows there were fewer blow-ups, but the ones that did occur were again concentrated in the weaker ESG ratings.

Exhibit 1:
MSCI ESG rating against 2018 total return (European high-yield index)

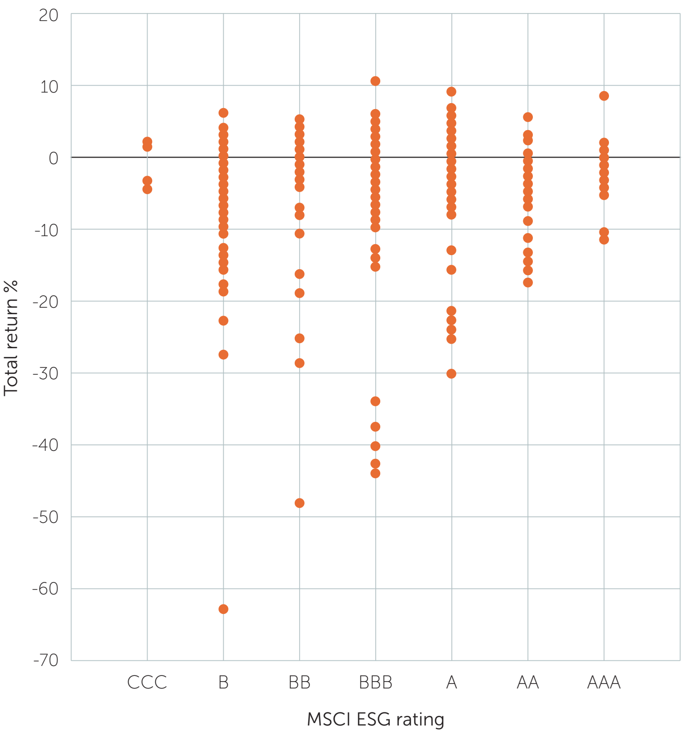
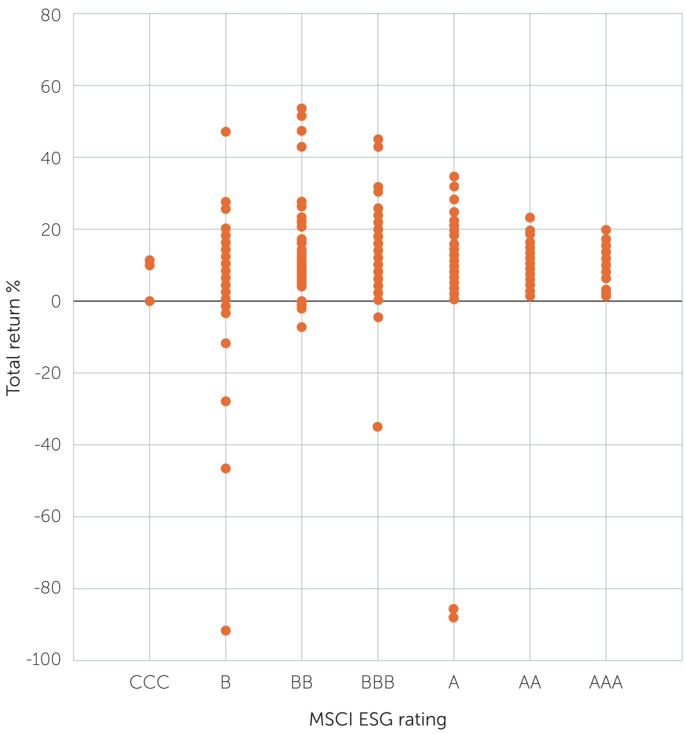


Exhibit 2:
MSCI ESG rating against 2019 total return (European high-yield index)



Source: ICE BofAML Indices, Newton, December 2019.

All about the 'E'

It is perhaps unsurprising that many of the conversations we are having with clients and prospects now concern the environment, with the Paris Agreement four years ago mobilising a global call to action to protect against climate change. Today, even the European Union's sustainability taxonomy focuses solely on whether an economic activity is environmentally sustainable.

We have demonstrated above that environmental factors are perhaps the most tangible of ESG factors to perceive and quantify, but that is not to say that measurement is easy. While consideration of social and governance factors is also an important part of our ESG assessment of companies and countries, in time it may also be possible to consider these issues in a more explicit manner.

WHY FACTORING ESG CONSIDERATIONS INTO CREDIT ANALYSIS IS IMPORTANT...

Having integrated ESG considerations into credit analysis for a long time, we have always been of the view that considering the materiality and impact of ESG factors on companies and countries is a crucial part of credit analysis. In our view, it results in better decision-making, and can also lead to superior risk-adjusted returns, as we have shown above how ESG factors can have a material impact on credit risk and therefore performance.

Exhibit 3 shows how good ESG practices can create value for companies, as well as highlighting some of the negative factors considered when we undertake our ESG analysis. Good ESG practices can reduce both business and financial risk, resulting in a more profitable business, stronger credit metrics and, therefore, a lower cost of capital.

Exhibit 3:
How integrating ESG considerations can create value for companies

	GOOD ESG	POOR ESG
REVENUE GROWTH	• Demand for next-generation products and services. • Trusted companies more likely to be awarded licences to operate.	• Reputational risk – products that are not safe or sustainable. • Resource access problems (asset closures, community-relations issues).
COST OF SALES	• More efficient use of resources, e.g. energy, water.	• Elevated costs from higher resource-intensity, higher waste-disposal costs.
REGULATORY / LEGAL RELATIONS	• Fewer regulatory constraints. • Government support/subsidies. • Paying fair tax reduces negative publicity.	• Advertising or sales bans. • Fines, penalties and enforcement actions.
HUMAN CAPITAL	• Improved employee satisfaction, motivation, innovation. • Accountability leading to improved performance. • Easier to attract high-quality talent.	• Poor reputation makes it hard to attract quality talent. • High employee turnover. • Human rights issues in the supply chain.
CAPITAL ALLOCATION	• Longer-term perspective on investment, improved business resiliency. • Reduced exposure to future environmental regulation.	• Stranded-asset risk, impairments. • Reduced competitive advantage.

...AND HOW IT AFFECTS SOVEREIGN BONDS

Exhibit 4 shows a similar approach for sovereign bonds, giving a sense of what we consider to be good and poor ESG practices. We have for a long time used a variety of publicly available data to assess sovereign risk, and this incorporates certain ESG-linked criteria.

Exhibit 4:
How integrating ESG considerations can create value for countries

	GOOD ESG	POOR ESG
ECONOMIC GROWTH	• Well thought-out infrastructure improvements reduce supply-side and import/export bottlenecks. • Education provides young people with appropriate skills to enter workforce. • Investment is encouraged by adequate property rights and legal framework.	• Bureaucracy, especially rent-seeking bureaucracy, becomes a cost to doing business, and a drag on growth and investment. This impedes the velocity of money in the economy.
MULTILATERAL ASSISTANCE	• Idiosyncratic risks or left-field economic events are more likely to garner sympathetic multilateral assistance if ESG criteria have been on an improving trend.	• Likely to be dependent on opaque bilateral assistance with higher borrowing costs and more restrictive conditionality. • More tied lending likely to benefit citizens of lenders over borrowers.
WORST-CASE SCENARIO	• External economic events affect economic fundamentals, and weigh on debt coverage ratios and debt metrics.	• Endemic corruption, leading to scenarios where bribes and payments no longer yield results; the fabric of fragile society can break down, leading to civil war.
HUMAN CAPITAL	• Greater meritocracy and social mobility. • Better individual rights, less police oppression, better personal security. • Easier to attract high-quality talent.	• Weak social contract promotes widespread tax evasion and greater levels of economic informality. • 'Brain drain' migration.
CAPITAL ALLOCATION	• Considered infrastructure investment can mean meaningful improvements to the lives of citizens. • Longer-term perspective on investment. Projects which can be supported through multiple political cycles. • Sound environmental management, e.g. a focus on water management and energy efficiency.	• Infrastructure reliant on incomplete or underdeveloped ancillary infrastructure. • Consistent budgetary overspend and opaque bidding processes. • Vanity projects. • Poor environmental management and preparedness.

Fixed income and equity: how the ESG approach differs

Another question that often arises in client meetings is whether there are differences between integrating ESG in fixed income and in equities, given the fact that bondholders do not get to vote on a company's corporate agenda as they are not shareholders in its equity.

Given the risk asymmetry between bonds and equities, downside risk mitigation is more important for fixed income (bonds have limited upside but similar downside risk to equities). Generally speaking, a company with a strong ESG profile, as shown in the 'Good ESG' example in Exhibit 3, should benefit both shareholders and bondholders.

Differences will be driven by management's financial policies and their decision as to whether it decides to prioritise debt holders or shareholders. Another difference is that bondholders have a variety of relevant ESG-themed areas available for investment that are not available to equity investors. These include green financing, universities, development agencies and social housing.

Fixed-income engagement an important driver of positive change

Debt investors also have the opportunity to invest in private companies – one of the most powerful engagement areas for fixed income. We find engaging with issuers that have weaker credit ratings and/or are private, especially in high yield where often bondholders are the company's only access to capital, means that our questions, views and recommendations on ESG issues are increasingly being heard. This gives us a greater chance of effecting positive change.

Put simply, companies are having to answer more bondholder questions related to their respective ESG strategies, and investors are taking an increasingly dim view of those that are ill-prepared.

Evidence to support this, and the powerful role bondholders can play in driving greener climate change policies, was cited by Knut Kjaer, the founding chief executive of Norway's sovereign wealth fund. He told investors at a recent investment conference in London that investors could have more of an impact on the world's biggest carbon emitters through the debt markets than through equity markets:

> *"If you take the 100 most fossil-fuel intensive companies, it's only 40 or 41 of them that have listed equities. All of them are in the debt markets.[1]"*

Knut Kjaer
Founding chief executive of Norway's sovereign wealth fund

Opportunities

Of course, as we mentioned earlier, credit investing with an ESG lens is not just about risk mitigation; it is also about looking for opportunities.

Identifying issuers we expect to adopt an improved ESG profile over time, often through engagement, can result in capital appreciation as the transition is reflected in rating upgrades and a lower cost of capital.

We have for many years worked with both our in-house equity analysts and specialist responsible-investment colleagues when analysing and engaging with companies from a fixed-income perspective. Situations where we own both the equity and debt of an issuer can provide us with a powerful tool with which to focus a management team.

> *"Identifying issuers we expect to adopt an improved ESG profile over time, often through engagement, can result in capital appreciation as the transition is reflected in rating upgrades and a lower cost of capital."*

We expect ESG to be priced into credit risk to a greater degree in the future

There are a growing number of ESG research providers and, while their data is useful, it is just one of the inputs into our proprietary analysis and investment process.

The data can provide a basis for comparability, and market participants may begin to view the ESG scores as a type of consensus rating.

Indeed, MSCI last month announced that it has made ESG ratings of over 2,800 companies publicly available; greater ESG data availability should cause companies and countries to take a greater interest in how they score. We are already seeing some of the better-rated companies today using their ESG rating to their advantage in that their ESG score drives the level of their bank-loan margin.

1 Source: https://www.ipe.com/news/esg/use-bond-markets-to-challenge-heavy-emitters-says-nbim-founder-kjaer/10033794.article

CONCLUSION

We believe that undertaking ESG research as a key part of our fixed-income investment approach is not just about reducing risks, and seeking to enhance returns to investors, but also about helping to influence corporate responsible behaviour.

Asset managers and asset owners can no longer afford to focus solely on maximising short-term returns if it comes at the expense of other stakeholders, with the associated bad publicity and longer-term negative consequences.

It is still undetermined whether ESG is properly factored into credit pricing, but as ESG concerns rise up the agenda of society, governments and investors, we believe we are likely to see a growing bifurcation of pricing between the strong and weak ESG performers.

Having integrated ESG considerations into credit analysis for a number of years, we have always believed that considering the materiality and impact of ESG factors on companies and countries is crucial to risk assessment. In our view, it results in better decision-making, and should, if done with diligence and consistency, result in superior risk-adjusted returns because ESG factors can have a material impact on credit risk, and therefore performance.

"Asset managers and asset owners can no longer afford to focus solely on maximising short-term returns if it comes at the expense of other stakeholders, with the associated bad publicity and longer-term negative consequences."

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