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In focus

ESG, Sustainable and Impact Investing – The future of credit

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Environmental, Social and Governance (ESG) has been part of the equity toolkit for decades. Over the last few years, credit investors have incorporated ESG into their investment processes, known as ESG Integration. In this article, we delve into how credit investors use ESG to improve their performance and to create Sustainable and Impact products.

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ESG and credit investing – Why and How

If everything goes as planned, debt investors get a modest premium above the risk-free rate and their money back at maturity. Given credit's asymmetry of risk and return compared to equity, focusing on downside risks is key to success. The investment horizon using traditional fundamental projections starts to get blurry beyond six months. Assessing and projecting ESG factors and their trajectory can increase confidence and extend the investment time-frame from months to years. In addition to managing downside risk, having a longer-term perspective generally improves returns by lowering trading costs.

Although credit investors do not have a vote on board decisions like equity investors, debt comprises a much bigger portion of corporate balance sheet capital[1]. Raising and lowering the cost of debt capital can meaningfully impact corporate cash flows, returns and executive compensation. The shorter duration of debt compared to equity compels management teams to more frequently engage in public offerings with credit investors.

For example, management must satisfy short-term credit investors' concerns every few months in the commercial paper market. Front-end market technicals of lender concentration[2] and a narrow pricing range (short-term credit investors are more focused on a return ***of*** capital and less ***on*** a return on capital) mean that if investors are unsatisfied with fundamental or ESG factors, it is ***not*** a question of just paying more. Investors may choose to not invest, which would ***eliminate access to the market***. ESG assessments also impact credit access and costs indirectly in private markets through financial intermediaries such as banks and insurance companies. This provides credit investors a variety of direct and indirect engagement opportunities to address ESG disclosure and pre-financial costs and benefits.

Fundamental versus ESG integrated

ESG integrated research refers to systematically assessing and incorporating non-traditional, governance factors and stakeholder costs and benefits derived from ESG data into the investment process. ESG assessments and outlooks focus on unaccounted externalities that will accrue and materialize on the financial statements, impacting the credit risk premium. While credit investors have always incorporated non-financial factors into their investment analysis, ESG integrated research is an enhancement to traditional fundamental research. There are studies showing a high correlation between ESG analysis and ratings and traditional fundamental research and credit ratings[3]. As with traditional research and investing, alpha production is not derived from assessing historical data; it relies on identifying current mispricing of future states.

ESG integrated investing is no longer rare. Incorporating ESG factor analysis into traditional fundamental research is becoming table stakes. A recent survey indicated that around 80% of credit investors use ESG integration either as their sole strategy or combined with one or more other strategies.

There are three key characteristics of ESG research and investing:

1. Anecdotes are replaced with data
2. Materiality is tailored to industries and markets
3. Engagement

Importantly, as with fundamental research and investing, ESG integrated research and investing does not make moral or ethical judgement on behalf of asset owners. The intention is simply to have more comprehensive information to drive better investment decisions.

1 Total outstanding fixed income stands at $70 trillion according to *Bloomberg Barclays Multiverse* as of April 30, 2021.

2 "Concentration Risk on the Buy-Side of Credit Markets: The Cause." ["…the world's top five asset management firms command more than 27% of global credit AUM…"] *Enterprising Investor*, 31 Aug. 2021, https://blogs.cfainstitute.org/investor/2021/08/31/concentration-risk-on-the-buy-side-of-credit-markets-the-causes/.

3 "ESG and Credit Rating Correlations." *Risk Control*, Feb 2022, https://www.riskcontrollimited.com/insights/esg-and-credit-rating-correlations/.

Doing your ESG homework

Just as with fundamental research, access to quality data and tools is critical for thorough ESG integration. However, while ESG rating agencies and third-party research and data providers can be helpful, their output often lacks consistency, nuance and investment value. Their coverage can often be limited outside of more traditional asset classes, like listed equities and credit. As noted above, simply assessing historical information is not enough to source alpha. Proprietary tools, resources and a seasoned research team with ESG accreditation are needed to project the trajectory of fundamental ESG factors. You have to do your own work with you own tools.

With more than two decades of experience and over forty researchers dedicated to ESG and sustainable finance, Schroders has developed several proprietary tools that help investors identify investment opportunities and risks, including:

1. **Context** – Schroders' proprietary ESG analysis tool gives our researchers and portfolio managers insight into the sustainability of a company's business model. It is based on the principle that the long-term health of a company relies on the strength of its relationships with stakeholders.
2. **SustainEx™** – Quantifies the impact that companies have on society by translating environmental and social impacts into financial costs and benefits. The tool is built on academic and industry studies that map, measure and quantify dozens of different positive and negative externalities. The tool has developed over the years to provide ever broader asset class coverage.
3. **MUSE** – A unique tool for assessing municipals investments that derives an overall sustainability score driven by more than forty ESG factors from a variety of sources, including several proprietary metrics. These metrics span a wide range of environmental, social, governance and "other" areas including air pollution, earthquake risk, adult obesity, violent crime, income inequality and motor vehicle deaths, to name a few. This score can then be calculated for counties, states or regions of the country. This is an example of a proprietary tool providing coverage of an asset class area for which third party data is not as readily available.

Exclusions versus "Best in Class"

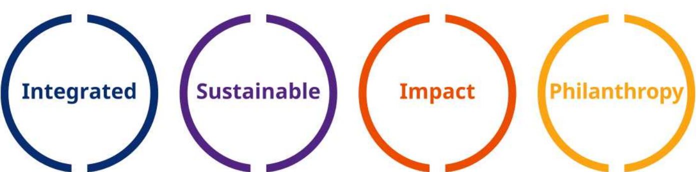
Asset ***owners*** have always excluded certain assets from their investment portfolios for a variety of credit and non-credit reasons such as "no High Yield," "no Emerging Market," "no Foreign Currency" or "no Financials." Before ESG data was available, asset owners relied on conjecture or simple exclusions to further their environmental and social objectives.

When asset ***managers*** integrate ESG factors into their investment process, we believe it does not increase or decrease investment opportunities. Rather, it seeks to maximize returns given risk by focusing on "best-in-class" investments regardless of market, asset class, sector, industry, and issuer. In our view, ESG integrated best in class investing is an enhancement to simple exclusion investing.

Transition Financing

Transition financing, which aims to offer capital to high-emitting companies or industries, in order to support their shift towards a climate-neutral or climate-positive future, is one of the most controversial topics of Sustainable investing. Some regulators[4] and asset owners require or choose to exclude such industries or issuers, thereby constraining a portion of the investible universe. While some exclusions are generally accepted[5] for sustainable investing, we believe regulation in the United States will focus on best in class instead of exclusions and allow for transition financing to encourage engagement with problematic industries or issuers to avoid surrendering influence.

ESG Integrated, Sustainable, Impact or Philanthropy?



There is a spectrum of approaches to ESG research and investing, according to asset owner priorities. This runs from, as has been discussed at length above, **taking ESG factors into consideration** (Integrated) to, going further along the spectrum, **promoting ESG characteristics** (Sustainable) to **trying to achieve positive sustainability outcomes alongside returns** (Impact), to "doing good," where return is not the primary motivation (Philanthropy). Sustainable funds offer asset owners the added opportunity to contribute to improving social and environmental factors while minimizing uncompensated ESG risks. The threshold for Impact investing is higher than for Sustainable investing. Impact funds promote the reduction of future environmental and social costs through positive inclusion of sustainable themes.

Sustainable and Impact Investing in the EU versus USA

The EU introduced the Sustainable Finance Disclosure Regulation (SFDR) to increase the transparency and accountability of investments that claim to have Sustainable or Impact objectives. Additionally, EU regulators have established an EU Taxonomy. Find here a good summary of ESG regulation around the globe.

In the USA, the Securities and Exchange Commission (SEC) and the Department of Labor (DOL) have begun to focus on Sustainable and Impact investing. While the SEC is very focused on creating standards[6], firms have started offering Sustainable and Impact funds with bespoke definitions and disclosures.

In 2020, the administration at the time issued a rule, that would have required managers to narrowly apply the fiduciary standard of prudence under the Employee Retirement Income Security Act (ERISA) that called into question whether managers could consider nonfinancial ESG factors.

In May of 2021, President Biden signed an executive order that directed the federal government to treat climate change as an investment factor. Subsequently, the DOL published a proposed rule, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, which would not only remove prior limitations but encourage and **maybe even require asset managers to consider ESG risk factors** while making investments

4 "EU Action Plan – Deep dive on Disclosure Regulation (SFDR)." ["…The French regulator AMF has taken a slightly different and stricter approach and asks for percentage limitations of the investment universe…"] *EY*, 9 Dec 2020, https://www.ey.com/en_ch/sustainability-financial-services/eu-action-plan-deep-dive-on-disclosure-regulation-sfdr

5 Note: United Nations Global Compact violators are corporations that have material ESG exposures and risk incidents related to the ten UNGC Principles. Source: "Delisted Participants." *United Nations Global Compact*, https://www.unglobalcompact.org/participation/report/cop/create-and-submit/expelled.

6 "SEC Response to Climate and ESG Risks and Opportunities." *U.S. Securities and Exchange Commission*, https://www.sec.gov/sec-response-climate-and-esg-risks-and-opportunities.

The proprietary ESG tools mentioned are designed to enhance the research process but do not guarantee favorable results or the abatement of all risk. There is no guarantee that Integrating ESG factors won't limit the investible universe or will lead to favorable investment opportunities.

and casting proxy votes. An idea underlying the proposal is that climate change and ESG factors can be financially material and that integrating them into the investment process would lead to better long-term risk-adjusted returns.

Sustainable and Impact investing: Cost or benefit?

There is little debate regarding the merits of ESG integration, which is defined as enhancing the traditional fundamental investing framework with an assessment and outlook on ESG factors[7]. However, there is a fierce debate regarding whether Sustainable or Impact investing provides a cost or benefit to investors.

A prudent investor should analyze all current direct and future indirect costs and benefits accruing to debt and equity capital providers. Ignoring unaccounted external ESG costs may expose credit investors to controversies and drawdowns. Likewise, understanding positive ESG externalities could allow for longer-term investing in structurally best in class bond issuers.

There are mostly equity studies showing that investing in companies with good ESG ratings leads to outperformance, as well as some studies showing underperformance, as seen in this journal report[8], research article[9] and fund fee study[10].

Comments in support of the DOL proposed rule can be found in this letter[11] and comments against integrating ESG factors in the SEC's request for comment can be found in this letter[12].

The issue is **that there are no generally accepted measurement standards for Sustainable or Impact investing, which makes it impossible to compare outcomes**. Efficient frontier theory assumes that constructing a portfolio that contributes to (Sustainable) or promotes (Impact) environmental or social objectives reduces the investable universe and thus lowers potential returns. However, there are offsetting and complicating factors;

1. Currently the opportunity loss is minimal as credit market spreads are tight even for sectors and issuers that score poorly on ESG metrics.
2. Another important factor is a favorable ESG technical as more capital is invested, driven by growing client demand for ESG products[13]. This technical will be positive for ESG-favorable sectors and issuers and negative for those that score poorly from an ESG perspective.
3. Lastly, as credit exposures range from a moment to perpetual, a Sustainable or Impact fund may out- or under-perform depending on duration even on debt issued from the same issuer.

As we do not have standard definitions and only a limited history in fixed income Sustainable or Impact investing, we cannot quantify the economic, environmental or social costs or benefits. **We can only say that we expect returns to Sustainable and Impact strategies will be different than to fundamental or ESG integrated funds.**

Conclusion

The future of credit investing

Asset owners want the best risk-adjusted returns. Integrating ESG factors into traditional fundamental research is key to understanding longer term pre-financial costs and benefits.

Until we have global standards, we believe Sustainable funds should have a better relative, and Impact-titled funds should have a better absolute, proprietary externality score than their corresponding benchmarks. Given the inconsistencies of third-party ESG assessments and ratings, proprietary tools, assessments and outlooks are essential. From our perspective, much like fundamental projections, credit issuers with negative ESG factors should be sold and those with positive ESG factors should be bought. We believe there should be opportunities for transitional investment in laggards.

Welcome to the future of credit investing.

7 *Barclays Live*, https://live.barcap.com/PRC/publication/FC_TEJ-bGJfMTYwNjc0MjgyNzc3NX4gfiB-IH4g_2614506.

8 "Should ESG Funds Be In Retirement Plans?" *Wall Street Journal,* 16 Sep 2021, https://www.wsj.com/articles/should-esg-funds-be-in-retirement-plans-11631729292?st=5qefupdt4x4tvat&reflink=desktopwebshare_permalink.

9 "Corporate Sustainability: First Evidence on Materiality." *American Accounting Association,* 01 Jan 2016, https://meridian.allenpress.com/accounting-review/article-abstract/91/6/1697/99330/Corporate-Sustainability-First-Evidence-on?redirectedFrom=fulltext.

10 "2020 U.S. Fund Fee Study." *Morningstar,* Aug 2021, https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/annual-us-fund-fee-study-updated.pdf.

11 Letter to DOL (Office of Regulations and Interpretations, Employee Benefits Security Administration) on behalf of State of California's Office of the Attorney General, Rob Bonta, 13 Dec 2021, https://www.napa-net.org/sites/napa-net.org/files/1448000-1448320-comment%20letter%20iso%20dol%20proposed%20rule.pdf.

12 Letter to SEC (Chairman, Gary Gensler and Commissioner, Allison Herren Lee) from Jean-Pierre Aubry, Associate Director of State and Local Research, CRR at Boston College, https://www.sec.gov/comments/climate-disclosure/cll12-8922481-245102.pdf.

13 *BofA Global Research*, https://rsch.baml.com/r?q=FJszJWQJw9!-elqK99YO6Q&e=David.Knutson%40Schroders.com&h=xExH8g.

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Schroders uses SustainEx™ to estimate the net impact of an investment portfolio having regard to certain sustainability measures in comparison to a product's benchmark where relevant. It does this using third party data as well as Schroders own estimates and assumptions and the outcome may differ from other sustainability tools and measures.

The success of any quantitative ESG research model depends largely upon the effectiveness of the investment team's quantitative model. A quantitative model, such as the risk and other models used by the investment team requires adherence to a systematic, disciplined process. The team's ability to monitor and, if necessary, adjust its quantitative model could be adversely affected by various factors including incorrect or outdated market and other data inputs. Factors that affect a security's value can change over time, and these changes may not be reflected in the quantitative model. In addition, factors used in quantitative analysis and the weight placed on those factors may not be predictive of a security's value. No investment strategy, technique or model can guarantee future results or eliminate the risk of loss of principal.

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