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Interview with Nicolas Forest

Global Head of Fixed Income

The Journey of Integrating ESG in Fixed Income

CANDRIAM

A NEW YORK LIFE INVESTMENTS COMPANY

25 years of ESG

The Journey of Integrating ESG in Fixed Income

Nicolas Forest, Global Head of Fixed Income, answers our questions about integrating ESG factors in Fixed Income investments.

Nicolas Forest

Global Head of Fixed Income

Nicolas, With global standardization of definitions still incomplete, how should we define 'integration'?

To 'integrate' is 'to blend into a unified whole'. I think that broad definition of the word is really the point in ESG as well. ESG integration is not just compiling data, it is understanding how to interpret it. And staying ahead of the changes.

To me the most important point is that ESG integration is a ***process***, not a result. It is the embedding of Environmental, Social, and Governance risks and opportunities within the traditional Fixed Income business and financial analysis to determine investment decisions.

ESG integration is an ***education process*** as well, on the part of the investment managers and analysts as well as on the part of the asset owners. It is how we understand the analysis of a company or sovereign.

What results do you expect?

We expect to achieve better long-term risk-adjusted returns. And along the way, I expect that the integration of ESG factors into Fixed Income processes across the investment industry will help allocate capital in more efficient ways, resulting in better societal outcomes.

Is there a specific methodology investors should look for, to avoid ‘greenwashing’?

That is really two questions. As with other elements of investment analysis, there is not a single correct method. There is more than one effective approach. When choosing a strategy, asset owners must examine the particular investment process under consideration. The ESG integration approach must align with their own investment philosophy, and with their specific risk/return targets.

‘Greenwashing’ is a related question. The recent European regulations on Sustainable Finance Disclosure, or SFDR, are a big step. Investors in funds receive both greater transparency on ESG characteristics, sustainability goals as well as how the achievement (or not) of those characteristics and goals will be measured and reported. Again, it is a step on the path. Companies and countries do not always produce the non-financial data they promise, much less all the data investors wish. It is difficult to construct a meaningful reporting system for asset owners when the issuers have not generated comparable data.

With the tremendous demand for ESG products in recent years, not all investment managers have the training or experience to design or manage an investment process which truly integrates ESG factors.

How can one measure the result of integrating ESG?

Just as we measure the financial investment results against a benchmark, or the value of an index of securities, we can measure the ESG ‘success’. To do that, asset owners need to determine what they wish to achieve. That allows them to choose a measurement, or Key Performance Indicators. A common one for Greenhouse Gas/GHG reduction, for example, would be the carbon footprint of the portfolio, against the carbon footprint of the index used for financial performance measurement. Information, while increasing, is not always available, so we can use proxy indicators. For example, when overall diversity data is not available, the percentage of women Directors can provide an indication. KPIs can benchmarked against absolute instead of against the index; for example, that the carbon footprint of the portfolio decline by 5% per annum (just as financial performance targets and reporting can be either relative to a benchmark, or absolute). It is important to consider the KPIs chosen; them must use science-based data, and/or clearly articulated social goals.

How does Fixed Income differ from Equity in terms of ESG integration?

There is really no mystery. When integrating ESG factors, the same similarities and differences apply as in the rest of the analytical process. For example, because bonds are more asymmetrical than equities, once again the downside risk identification is enriched when additional elements, such as ESG factors, are included in the information mosaic.

Remember that some types of bonds may offer significant upside. Convertibles may become equity, and High Yield may be upgraded to Investment Grade. So a comprehensive analysis of the business model and future cash flows and opportunities requires understanding when fundamental factors, including ESG factors, indicate the balance of probabilities is on the upside.

More holistically, the notion of 'Responsible Investor' differs between holders of equity and holders of debt. Equity investors own the company -- one might say a Responsible equity investor aims to be a good steward. By contrast, bond investors finance the activities of a company or country. A Responsible debt investor aims to ensure that financing is allocated to companies to pursue sustainable activities.

Can you provide some examples of the key elements?

Governance is a good place to begin because many Fixed Income managers have been integrating, Governance factors for years, with the goal of reducing risk and enhancing returns.

Fixed income investors routinely examine quantifiable Governance elements such as Board independence and the number of outside directors, whether financial results have been restated, and the independence of the Compensation Committee. Fixed Income investors have also long included qualitative factors such as the alignment of interests of management and investors, and the complexity of the legal and financial structure.

With sustainability increasingly a requirement in certain businesses and jurisdictions, it seems only logical to expand the examination of long-term remuneration criteria to ensure they include sustainability targets. The key is understanding which types of sustainability targets are real, which may be well-meant wishful thinking, and which may even be misleading (ie, greenwashing by the issuer).

Social factors, by contrast, may be the most difficult of the ESG factors to integrate into Fixed Income. For one thing, the importance of a factor varies by sector. Health and Safety is obviously more important for manufacturing than for a software company, while Human Rights are more difficult to evaluate for industries with long supply chains where suppliers may not provide decent working conditions. To truly *integrate* Social factors into Fixed Income analysis requires more specialized knowledge on the part of the Fixed Income portfolio managers. While more difficult to integrate, the value of including Social considerations in a business, profit, and cash flow analysis is increasingly tangible the longer the Covid-19 economy continues.

Environmental factors are of course the current focus for many investors and the media. As an asymmetrical investment, Fixed Income can integrate business risks of climate change into fundamental analysis of issuers. Not to forget that some areas of Fixed Income do have more upside – convertible bonds, high yield – and may be able to take advantage of climate change opportunities, as well. And let's not forget that climate risks are becoming real economic and credit risks for both Emerging nations and *Developed* nations. This is an element to incorporate in both sovereign and corporate issuers.


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What about Sovereigns?

While an *explicit* integration of ESG factors mainly arose in recent years, from both academia and the industry, integration has been a critical part of sovereign analysis for decades. Governance indicators in sovereign analysis, for example, seek to capture the capacity and willingness of the authorities to mobilise resources to fund debt payments and the risk that this might be disrupted by political instability, civil unrest, corruption or ineffective government. For investors in Emerging Market sovereigns, history has shown that the integration of governance was a key factor for understanding and assessing credit risk.

In recent years, the integration of ESG factors in sovereign analysis has clearly expanded and improved. At Candriam we are convinced that Environmental, Social and Governance risks are important for sovereign analysis and will impact the ability of an issuer to meet its financial liabilities. Integrating extra-financial criteria in our fundamental analysis helps to identify risks that cannot be captured by financial figures.

We believe a nation's overall development, and therefore creditworthiness, arises not only from an interaction between economic and financial elements but also interaction of all the various natural, societal, and political elements of a nation. Environmental, Social and Governance elements are a part of the long-term economic picture. As material drivers of long-term economic growth for countries, they are therefore central to value creation for sovereign fixed income investment. A detailed use of factors such as water resources, education, working practices, and potential for corruption, will not only help us analyse a country, they can also help us price the credit but helping us identify and price future risks that might not be visible yet in the financial metrics.

Governance is no new idea in sovereigns -- political risk has an important bearing on a nation's ability, and willingness, to service its debt. Elements such as cohesiveness of a society and rule of law can affect a government's ability to approve or collect tax revenues. Further, it is not only the ability of a government to collect tax, but also appropriately allocate the revenues -- for example to fund education and healthcare -- that is enabled by governance. This has an important impact on the long-term growth potential and creditworthiness of the nation.

Social Factors such as education, health services, workplace regulation and worker's rights play an important role in sovereign creditworthiness. Again not a new idea, but the issue is the process of integrating these into the credit analysis.

Environmental Factors and their use in sovereign credit analysis demonstrate how the picture is changing, and underscore that integration of ESG is a *process*. Environmental factors, sometimes called Natural Capital, are a key building block when assessing the sustainability of a country, its economy, and its creditworthiness. Climate change is a significant and increasing source of disruption, particularly as critical issues such as water scarcity increasingly threaten agriculture, a sector which is an important contributor to the GDP of a large number of countries. Heat waves and pollution affect business activity and economic growth, by threatening health and life expectancy, and by affecting day-to-day lives through closure of schools and other public institutions. In June of 2021, Swiss Re warned that climate change is a systemic risk which could wipe 18% off GDP[1] in 30 years. Obviously the effect will vary dramatically among nations.

1 World Economic Forum. https://www.weforum.org/agenda/2021/06/impact-climate-change-global-gdp/#:~:text=The%20largest%20impact%20of%20climate,the%20Swiss%20Re%20Institute%20warns, accessed 14 September, 2021.

Here, too, it is well worth asking the question of what data an investment manager uses, and how the investment team integrates this information into the process.

Finally, ESG integration for sovereigns is also about engaging with countries to advance sustainable development. It is certainly a complex challenge. For example, we participate with other investors in engaging with Brazil on reversing deforestation.

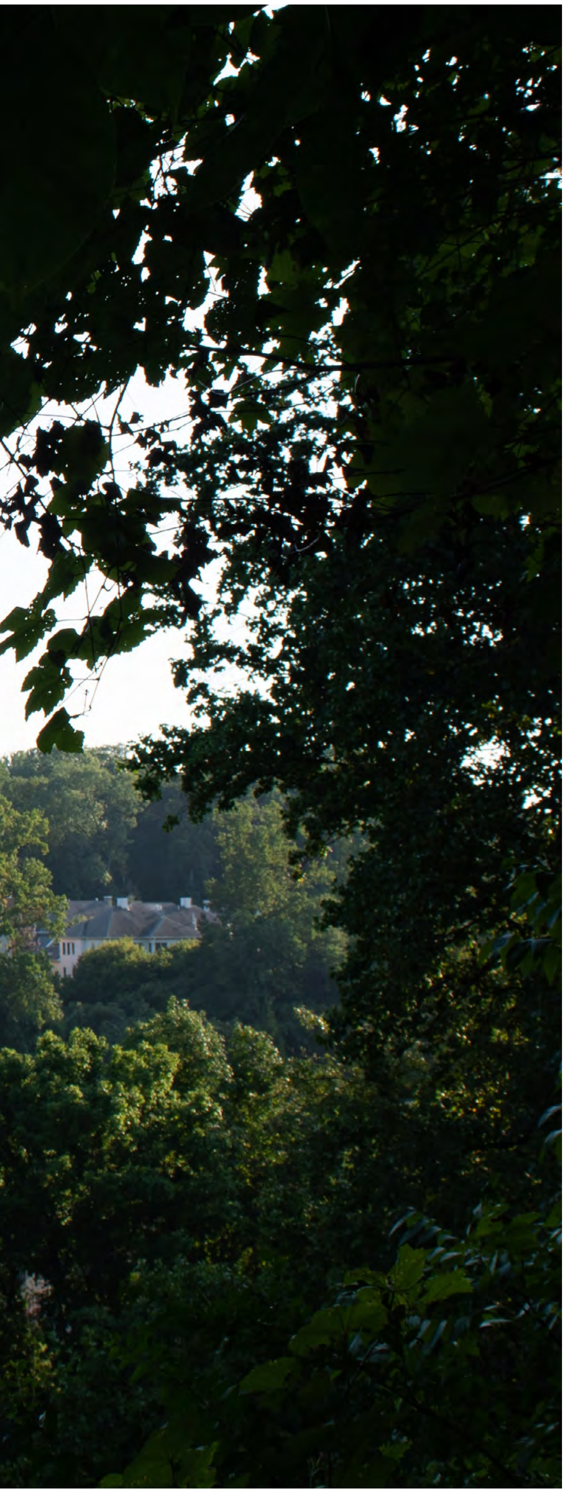
What are the nuts and bolts?

Again, there is not a single correct or effective method. So 'best' depends on both the performance generated and the philosophy of the asset owners.

At Candriam, we integrate ESG factors within the fundamental analysis of the issuer and, where appropriate, individual issues. For us, no issue may be added to a portfolio until an internal credit recommendation has been developed by the analyst and validated by the Credit Committee. These factors come in to the fundamental analysis in the same way as any other fundamental factors.

ESG integration is a process, not a result. Integration is not just adding data, it is not an ESG rating, it is not a 'yes' or 'no'. It is part of the credit analysis of an issuer. We need to incorporate extra-financial factors in our credit analysis and outlook. If an issuer's exposure to climate change physical or transition risks is not acknowledged and acted upon with a credible Greenhouse Gas/GHG reduction trajectory, there is a downgrade risk. In integration, screens are not a primary tool (although we do exclude cluster munitions and Financial Action Task Force/FATF Black List countries), among others. 'Integration' is not 'include' and 'exclude' decisions, it is nuances.

“ESG integration is an education process as well.”



Where do we go from here?

We are very focused on risk-adjusted returns. In simple form, all investing is identifying the risks, avoiding undesirable risks, selecting which risks to accept to generate a return, and pricing them. A central investment goal of ESG integration is ongoing improvement in the identification and pricing of risks.

Regulation is evolving continuously. Professionals need not only to stay on top of changes, but to anticipate them. The advantage of new ESG regulation is improved clarity for asset owners.

Business conditions are evolving, and issuer fundamentals are increasingly affected in very real ways by ESG factors. Covid-19 has shown the importance of Social factors on profits. The upcoming COP-26 is expected to put the economics of Climate Change under the microscope.

As issuers are subject to ever-more-precise analysis, new leaders and laggards will emerge. Fixed Income investors and asset owners will begin to engage with issuers operating below their potential, to share information on best practices and help this middle range of issuers improve their ESG metrics.

ESG integration is a *process*. So the process should evolve continuously. It is our Conviction that success in truly integrating ESG factors will be reflected in investment performance.

Case Study: ESG Integration in Candriam Credit Analysis

We cannot speak to how other investment managers 'integrate' ESG factors in their investment processes, but we can describe our process at Candriam as an example.

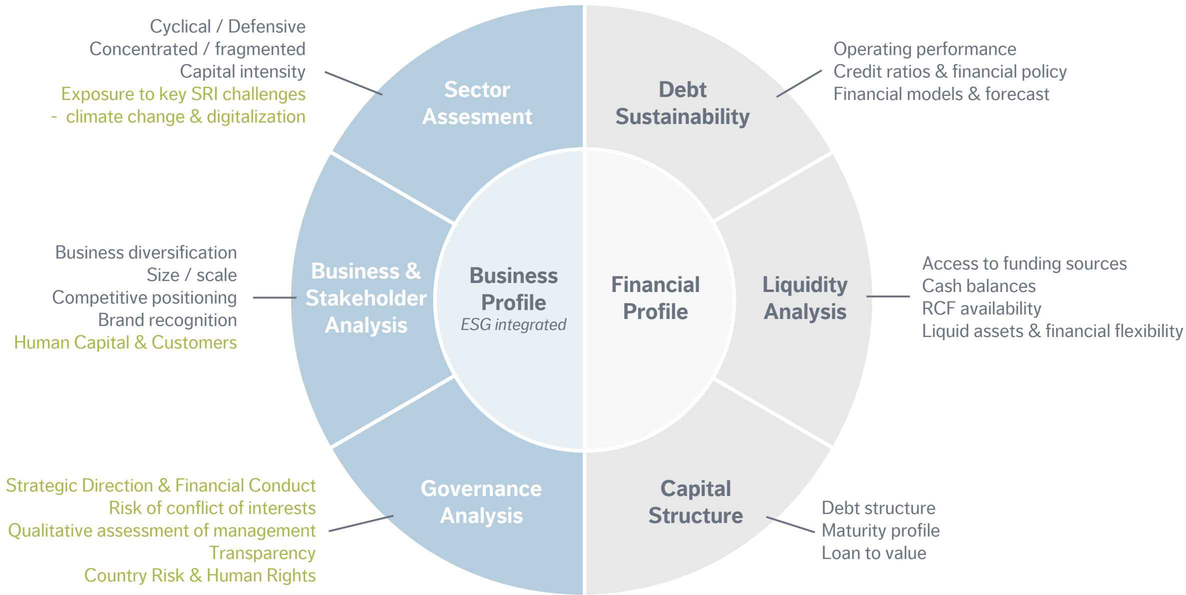
In all our strategies, both broad universe and Sustainable universe, we integrate ESG in every step of our fundamental and valuation analyses. As the graphic shows, our business analysis considers, among other elements, whether the company operates in a cyclical or defensive sector, whether is a market leader or follower, and equally, whether it is exposed to downside climate change risks or has business opportunities generated by climate change (for example, sales of insulation products).

In our Sustainable strategies, we limit our universe according to our internal ESG Team's score. In our broader strategies with full universes, we do not limit, but we do refer to our internal ESG Team's score. We do not eliminate names solely for a negative ESG rating, but a poor review from our colleagues would prevent us from applying a top credit rating. Therefore we would not exclude the issuer, but with a lower internal credit rating, we would demand a higher yield to compensate for the risks our colleagues have demonstrated.

In practice, Candriam's ESG integration is a process, not a yes/no vote or a score.

We also monitor closely the impact of ESG integration on portfolio's overall ESG rating and compare it to their benchmark's rating.

Figure 1: Fundamental Analysis with ESG Integration



Case Study: The History of a Responsible Investor

The resourcing of an investment manager's ESG skills and data should be of interest to asset owners. Some of the largest firms have considerable financial resources to on-board new staff and data systems, but may not yet have much experience coordinating as a team.

The difficulty with being a pioneer is less opportunity to learn from others – but the advantage is that ~~elusive concept of~~ irreplaceable asset, 'corporate memory'.

No investment manager or asset owner was 'born' as an ESG investor in the today's sense – although for decades many have integrated qualitative and/or extra-financial elements in credit analysis. After all, 'willingness' to repay debt can be an elusive quantity.

If ESG integration is a process both of analysis and of education, then working alongside ESG specialists, and using their scoring systems in ESG strategies, has provided an excellent foundation for full integration of ESG in all issuer analysis. Our history in Responsible Investing is what makes Candriam who we are.

Figure 2: Integrating ESG in Fixed Income: The Journey

€150 B
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