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NEWTON

Investment Management

WHY A SUSTAINABLE APPROACH TO BOND INVESTING COULD BOOST RETURNS AND REDUCE RISK

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At a time when monetary policy is undergoing a transition and global growth is slowing, this article looks at how a flexible and sustainable approach to bond investing could help investors protect returns and reduce the risk of defaults over the months ahead.

The current market environment for bond investors is characterised by prevailing low yields after years of loose central-bank and government fiscal policy. Against a backdrop on which government asset-buying programmes and unprecedented money printing has increased inequality between the rich and the poor over the decade since the global financial crisis, mainstream politicians have broadly borne the brunt of growing dissatisfaction among electorates, which has fuelled a rise in populism on both sides of the political divide.

The upshot of all this has been to heap pressure on government and monetary policymakers to consider a pivot away from quantitative easing towards fiscal easing, which, if executed over time, is likely to increase government and public spending deficits.

Less correlated returns; higher default rates

It is our contention that, given the new uncertain market phase we are heading towards, asset-class returns are likely to be less correlated than over the last few years, and more unpredictable. We also expect a cyclical economic downturn to gather pace over the next two years, which is likely to increase the rate of defaults in the credit sector. We believe that, if bond investors are to reduce the chances of capital losses, they would be prudent to look beyond passive index-tracking and benchmark strategies that are over-reliant on narrow parts of the bond market, where liquidity may become an issue.

At a time of significant economic and political uncertainty in which we anticipate that growing government debt levels will crowd out other capital requirements, we believe that a dynamic and unconstrained investment approach is a sensible and effective one for fixed-income investors. Such an approach can take advantage of a broad bond universe, and be allied with a disciplined focus on capital preservation and the positive sustainable credentials of potential investments.

There are two key ways in which bond investors can lose money: through rising interest rates and through bond defaults. As we have discussed previously, we believe there are plenty of indicators that the economic outlook is deteriorating, and as a result, the threat of rising US-led interest rates has reduced for now. However, given the lower economic growth we anticipate over the next couple of years, we would expect to see both default rates and the cost of debt rise. In our view, this environment heightens the importance of taking an active and sustainable fixed-income approach.

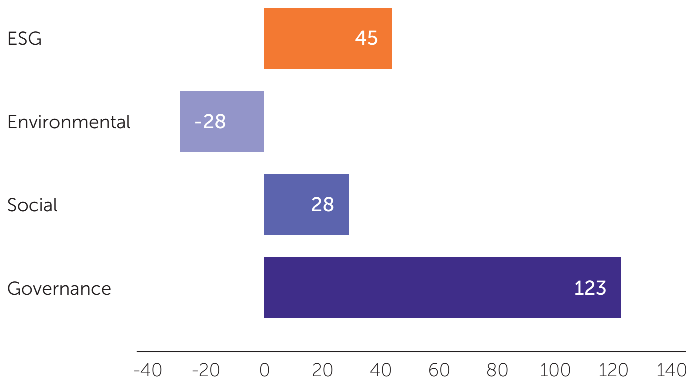
Effectiveness of an ESG approach

It is broadly accepted that a higher credit rating is beneficial in that it reduces the perceived risks surrounding a company or a country, and allows a would-be investor to make an educated judgement on the risks and opportunities around the investment case. Consequently, the higher the credit rating, the lower the rate at which a company or country is able to borrow at, as it is considered a less risky investment.

There is a growing body of evidence that proves that the performance of a fixed-income portfolio can be enhanced by applying a rigorous sustainable lens to the bond-selection process – employing environmental, social and governance (ESG) analysis alongside conventional financial metrics. We expect that over time, as with conventional credit ratings today, an issuer's cost of borrowing will increasingly be influenced by its ESG quality score.

In its 2018 fixed-income study, Barclays found that tilting a credit portfolio in favour of bonds with strong ESG credentials tended to lead to better performance versus those portfolios that had a low MSCI ESG rating. Indeed, as exhibit 1 shows, a high MSCI ESG portfolio score led to a 45 basis point overall increase in bond performance, with governance factors proving to be the biggest contributor, adding 123 basis points of outperformance. Social factors also scored well, while we expect environmental factors, which are lagging behind currently, to boost performance over time, given the ever-growing interest in climate change and other environment-related issues.

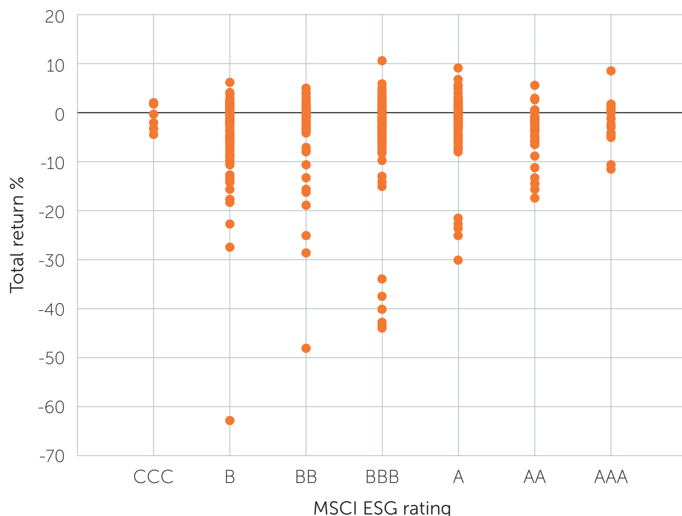
Exhibit 1: **The benefit of integrating ESG analysis into fixed income – average outperformance of portfolio with high MSCI ESG rating over portfolio with low rating, in basis points/year (US high yield 2012-2018)**



Source: Bloomberg Barclays Indices, MSCI ESG Research, Barclays Research October 2018.

If we turn specifically to the European high-yield bond sector as an example, a sector which may bear the brunt of a rise in default rates as the economic cycle worsens, it is no coincidence that the weaker the MSCI ESG rating, the worse or more volatile the bond's return. It is especially true in a fixed-income context that avoiding the losers is at least as important as picking the winners. Exhibit 2, which shows total return data for 2018 covering 433 bond issues within the European high-yield index, bears this out.

Exhibit 2: **MSCI ESG rating against 2018 total return (European high-yield index)**



Source: ICE Bank of America Merrill Lynch Indices, MSCI ESG Research, Newton April 2019.

As well as seeking to access improved performance and avoid defaults, in our view sustainable-bond investing can provide investors with the opportunity to direct their fixed-income investments towards a range of positive impacts. ESG factors have already been proven to have a positive material impact on a company's financial profile, and we believe in-depth analysis of ESG considerations, alongside issuer engagement where appropriate, can help to enhance long-term investment opportunities in this growing sector.[1]

Finally, for those still concerned that taking a rigorous responsible approach to bond investing might impair potential performance, we believe there are at least six compelling factors as to why bond investors should consider such an approach to bond investing. They are listed below:

Positive impact

Bond investors have the ability to provide financing for a range of socially and environmentally beneficial investments that are not available to equity investors. Examples include supranational development agencies, green bonds, social housing, and other not-for-profit organisations.

Engagement

Bondholders can still engage even though they do not get a vote. They may hold less influence with large public companies than equity investors do, but they represent the only external investor influence that can be brought to bear on private companies, who are often more reliant on debt-capital markets to sustain and grow their businesses. Better assessment of (and sometimes influence on) a company's management of ESG risks and opportunities should, in our view, provide the potential to deliver a more rewarding investment for clients. Investing across the capital structure means that as bondholders, we can also harness the engagement activity of our equity colleagues where we own both the bonds and equity of an issuer, and where companies may be less receptive to bondholder engagement given their wider capital-market access.

The inclusion of ESG factors within credit analysis enhances risk mitigation, which is particularly important given the asymmetric nature of bond returns. ”

Risk mitigation

ESG factors can have a material impact on a company's financial profile and, as mentioned earlier, there is a growing body of academic research supporting this view. The inclusion of ESG factors within credit analysis enhances risk mitigation, which is particularly important given the asymmetric nature of bond returns. We believe responsibly managed companies are best placed to achieve a sustainable competitive advantage and provide strong long-term investment opportunities.

1 *ESG and Financial Performance: Aggregated evidence from more than 2,000 empirical studies*, Journal of Sustainable Finance & Investment (Friede, Busch & Bassen), 2015.

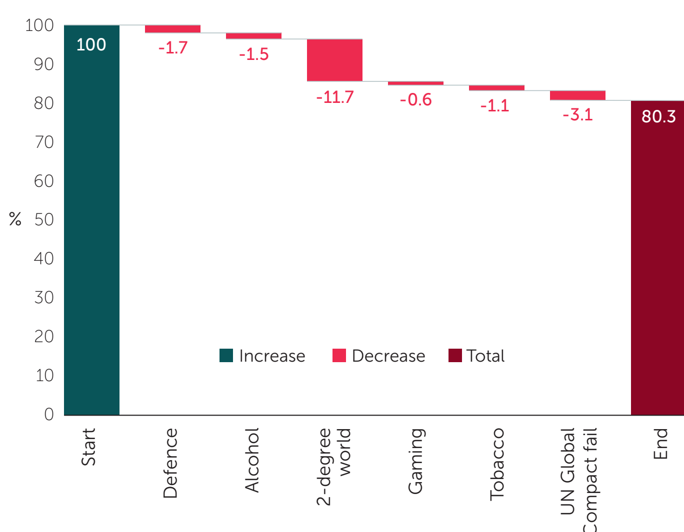
No detriment to financial returns from lower sector weightings

Owing to the nature of sustainability-focused investing, some sectors are likely to have an inherently lower portfolio weighting in some responsible fixed-income strategies.

At Newton for example, our sustainable equity and fixed-income strategies have adopted a 'red lines' approach of excluding investments in violators of the UN Global Compact, and in issuers which are incompatible with a '2-degree world', which means that we have little or no exposure to some sectors such as energy, defence and tobacco. However, the opportunity cost of this is limited in a fixed-income context, given lower sector concentrations and the lesser upside potential of bonds compared to equities.

The global investment-grade and high-yield corporate bond indices total $12.3 trillion in size before exclusions. Exhibit 3 shows that a soft exclusion of defence, alcohol and gaming companies, along with our proprietary 'red lines', reduces the available investments by just under 20%, leaving a still sizeable universe totalling $9.9 trillion.

Exhibit 3: **Approximate eligible corporate bond universe**
ICE BofAML Global Investment Grade & Global High-Yield Corporate Bond indices



Source: Newton, ICE BAML Bond Indices, 5 April 2019.

Robust sustainable fixed-income investment process

We believe investors should consider fixed-income investors that are experienced in in-depth ESG analysis on all corporate and sovereign-bond holdings, and that have the support of an established responsible-investment team with a longstanding ESG heritage.

Transparent

We believe it is important to select a bond investor which is as transparent with its clients as it would wish its investee issuers to be with it, so publishing detailed quarterly reports of all fixed-income engagement activities should be an important priority.

CONCLUSION

We are entering a market phase of considerable economic and political uncertainty, in which we believe the returns derived from fixed income are likely to become less correlated with other asset classes – and thus less predictable – as we see a gradual shift away from quantitative easing to fiscal easing.

We anticipate that, under such an economic and monetary-policy shift, government debt levels are likely to grow at a time when economic growth is likely to slow. In this environment, we would expect default rates to rise and access to cheap debt to become more restricted. To us, this is when a dynamic and unconstrained investment approach which accesses a broad bond universe can come into its own, especially when combined with the added rigour of a disciplined focus on capital preservation and the positive sustainable credentials of potential investments.

Companies with higher ESG ratings have been shown to outperform their lower-scoring peers, so in our view an active, responsible bond strategy should be better placed to weather the changing market backdrop when compared to a more passive option, which could be locked into a narrow index and may run the risk of incurring a capital loss.

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