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ESG in credit portfolios: Insights from buy and maintain strategies

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Introduction

This article aims to explore the special relevance of environmental, social and governance (ESG) considerations in credit portfolios, particularly within the context of buy and maintain (B&M) credit mandates, where the long-term nature of the investments makes a sustainability perspective explicitly pertinent.[1] We provide insights into how leading ESG investment managers incorporate ESG across a range of topics: integration of ESG issues, climate change and stewardship.

We have seen considerable progress over recent years, particularly among our highly rated managers. However, despite some demonstrating market-leading practices, there is still a long way to go for the fixed income universe as a whole. Therefore, we also draw out how investors can engage with their fixed income managers to help improve their approach in this area.[2]

Climate change examples feature prominently throughout as we see both investment managers and investors exploring the materiality of this long-term risk. In this article, we do not focus heavily on social aspects or the growing number of green/social bond funds being launched, but recognize the growing momentum in these areas.

One of the most interesting aspects of B&M strategies is linked to their aim to capture the credit risk premium as efficiently as possible over the long term. It is precisely because of this focus on the long-term horizon that we believe these strategies provide some fascinating insights into why ESG issues should be integrated into all credit portfolios. It does this by leading us to portfolios with two distinct features:

1. Holdings that are longer term in nature.
2. Holdings that display asymmetry of returns.[3] This means investors care mainly about avoiding the downside and harvesting the income they are owed. Fixed income investors essentially win by not losing.

These features make ESG considerations, which can often be longer term in nature, highly relevant to a strategy's success.

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[1] Our starting position is that ESG issues impact credit risks, as supported by a growing body of literature. In a 2018 report commissioned by Japanese pension fund GPIF and the World Bank, the authors conducted a survey of studies and found that, on balance, ESG integration in fixed income does not entail a return sacrifice and ESG factors are indeed material to credit risk. See Inderst, G and Stewart, F, *Incorporating Environmental, Social and Governance (ESG) Factors Into Fixed Income Investment*, World Bank Group publication, April 2018, pp. 17–21.

[2] See also our February 2020 paper, *Responsible Investment in Fixed Income*, available at https://src.mercer.com/research/5e4fada884411b0024234e36/Mercer_Responsible_Investment_in_Fixed_Income.

[3] All else equal, a bond's upside is limited to its yield at purchase if it is held to maturity. If the bond defaults, losses can be materially more significant. This is in contrast to equities, where the upside of investment is essentially unlimited, although this also typically comes at higher risk.

Let's take a closer look at these two defining features and unpack the insights they have to offer:

1. Taking a long-term approach: B&M portfolios have long time horizons, ones that are longer than almost all other credit strategies. As the name suggests, managers "buy" a credit with the intention of holding the position to maturity, collecting all payments along the journey. This longer time horizon makes B&M more sensitive to secular ESG (for instance, climate change[4]) and tail risks to play out. By extension, it forces the manager to consider how they might impact creditworthiness over the duration of the investment.

   For example, imagine holding a 10-year bond of a car manufacturer that is making little progress in moving to electric vehicles. As that bond approaches maturity, will the continued evolution of the policy environment and technology landscape impact the issuer's ability to repay its liabilities? More to the point, are investors being properly compensated for that risk compared with investing in other market segments or even in competing auto manufacturers?

2. Avoiding downside and the asymmetry of return: In fixed income, investors "climb the ladder" to generate returns (that is, a little bit at a time) and "slide down the snake" (or chute) when they lose money (default is not a pleasant ride). B&M managers are focused (or hopefully obsessed!) with making sure they pick holdings that will pay them all the coupons and principal due over the lifetime of the security. Therefore, managers should have a laser focus on downside risk and pay less attention to shorter-term capital appreciation — there is no additional upside beyond pull-to-par to participate in if investors never intend to sell. This leads us back to the question of how, then, should ESG make its way into understanding risks that might take us by surprise or "blow up" and impair returns?

Buy and maintain (B&M) mandates explained

B&M is a style of management for credit portfolios that is common for investors with well-defined long-term liabilities, such as insurers and defined benefit pension schemes (with particular prevalence in the UK). Portfolios are constructed in a benchmark-agnostic manner to efficiently capture the credit premium. Mandates are often bespoke in nature, with the investment objectives being tied to liability, duration or cash flow-matching criteria rather than beating a benchmark.

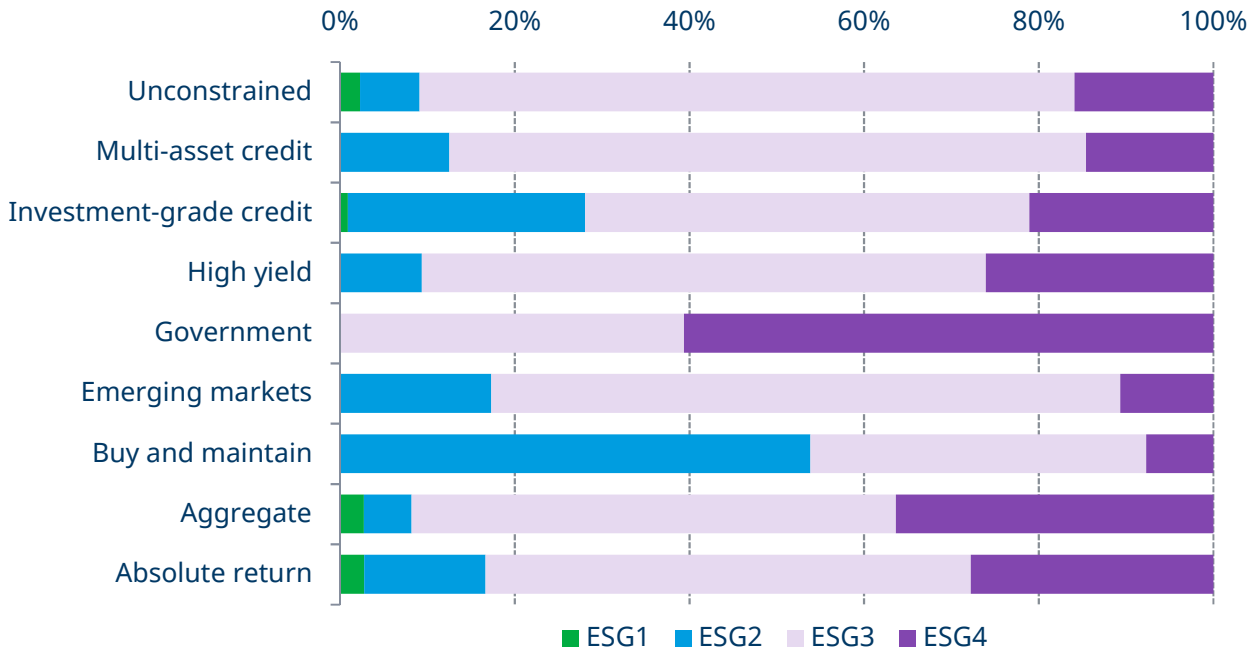
B&M mandates are designed to be low turnover in nature, with long-term holding periods, often with the intention of holding securities to maturity. However, there is an ongoing need for surveillance of the holdings, and managers will typically have the flexibility to sell in advance of credit deterioration and avoid payment impairment. Mandates may also have the flexibility for some limited turnover (for example, 10% per annum) to implement relative-value trades, with the objective of maintaining or improving the credit quality and/or yield of the portfolio.

[4] We are already seeing the physical damages from climate change, however our point is that the longer the time horizon an investor has, the more the physical and transition risks accelerate.

ESG ratings across sub-fixed income asset classes

Having started with these observations it should be unsurprising that of all the fixed income asset classes researched by Mercer, B&M has the highest proportion of highly rated (ESG1/ESG2) strategies. Furthermore, momentum is growing: Even over the space of 12 months, we have seen the proportion of highly rated managers from an ESG perspective grow across B&M and other fixed income asset classes.

Figure 1. ESG ratings across fixed income universes



Source: MercerInsight® data as at December 31, 2020.

Integrating ESG in B&M mandates

By their nature, B&M portfolios rely on a bottom-up fundamental assessment of an issuer's ability to service debt in order to generate returns. As part of this assessment, leading investment managers focus on integrating ESG considerations into their credit-ratings process as systematically and seamlessly as possible. This helps them ensure that for every new and existing investment, they have considered material ESG risks that might impair an issuer's ability to pay. Top-down sector views on the most pertinent ESG issues are also incredibly important.

Managers have developed proprietary approaches for these assessments that focus on the most material sector and company-specific issues, and have adapted their approach where there are limitations with third-party ESG data (for instance, lack of coverage, stale or estimated data). Leaders are not reliant on a single third-party ESG rating provider for this analysis but take an informed and proactive approach to understanding the credit implications of the various E, S and G issues most relevant to the different companies and sectors.

In practice, good managers spend considerable time thinking about the most risky holdings in their portfolio. They will continually monitor holdings and focus their attention on the most material ESG risks to ensure they are being sufficiently compensated. Others won't even consider investing in those with the worst ESG scores.

Engaging managers on ESG integration

Responsible investment leaders are asking their managers to monitor and explain material ESG risks:

1. *What are the most material ESG risks within my portfolio, and how am I being compensated for them?*
2. *Are they predominantly risks specific to that particular issuer or issue (idiosyncratic tail risks) or risks that will affect a whole sector or the bond market (systemic risks)?*
3. *How are they split by company-level or sector-level risks?*

Managing climate-change risk in B&M strategies

Integrating ESG considerations into the investment process helps identify and manage idiosyncratic risks to companies (for example, community opposition to a planned extension of a chemical plant). However, leading managers recognize that certain themes, such as climate change, will affect every single holding and sector in its own way.

Understanding climate change and its likely impact on investment portfolios is reliant on trying to gain insight into the future — across potential physical impacts as well as transitions risks, such as policy responses, and transition opportunities like technology developments. While we are already experiencing the impacts of climate change today (for example, increased frequency and intensity of destructive weather patterns), much of the investment pain and opportunity will play out in the future — and won't afford markets the luxury of advance notice. Companies not taking into account transition risks, such as the imposition of

a carbon tax, are at risk of being exposed to increased costs and the inability to pay back their debt.

According to the latest scientific research,[5] urgent action is required over the next decade to 2030 in order to limit global temperature rises to 1.5°C and avoid the worst physical impacts of climate change. B&M portfolios today have bonds spanning this entire period and beyond.

How well portfolios are positioned for a transition to a low-carbon economy is likely to be strongly tested. As a systemic risk, climate change will affect all sectors and companies in different ways, but the energy and utility sectors are likely to be impacted the most negatively if we see a swift and coordinated move to a low-carbon pathway, while sub-sectors such as renewable energy are likely to benefit.[6] For example, drought could limit hydropower's role in the energy mix going forward. Investors would want to assess the risk from drought over the period in question before investing in a hydroelectric project.[7]

Leading managers are using climate-transition ratings to assess holdings in climate-critical sectors. For example, these managers are seeking to understand companies' ability to navigate climate change, as well as their exposure to climate change — from physical damages and companies' emissions trajectories to temperature alignment — all to identify which companies are most likely to gain or lose in different climate change scenarios. Some are taking this a step further and launching climate-aligned strategies with key climate-change objectives and metrics built into portfolio design.

One interesting point that has come up in different conversations is managers with long-term horizons are finding that the market is sometimes not fully pricing between companies with markedly different climate change risk profiles. One manager likened these opportunities to cost-free options. Investors seeking to be ahead of the curve should explore this area with their managers.

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[5] *2018 IPCC Special Report: Global Warming of 1.5 ºC*, available at Global Warming of 1.5 ºC — (ipcc.ch).

[6] Mercer. Investing in a Time of Climate Change — The Sequel, 2019.

[7] Power-technology.com. "Why Drought Could Limit Hydropower's Role in the Energy Mix," June 25, 2018.

Understanding and engaging managers on climate change

Investors are becoming increasingly sophisticated in both understanding and mitigating climate-change risk within their portfolios. One of the most popular approaches is to measure the carbon footprint of the underlying companies to which they lend.

From a comparator index perspective, emissions are not distributed equally between issuers and industries, but rather are concentrated in specific sectors such as energy, metals and mining, and utilities. Below are two ways investors are managing this risk:

1. **Working with their managers to better understand and set carbon-footprint targets for the portfolio.** Some investors have the potential to reduce materially their carbon footprint by targeting outsized contributors without incurring significant turnover, and all within parameters that maintain the integrity of the portfolio's overall aim and objectives. Ideally, these discussions would take place at the mandate-design stage.
2. **Challenging managers on how they are managing climate-change risks for key companies and sectors.** As an example, the utilities sector will undoubtedly see profound change as we move towards a low-carbon economy. Managers need to be thinking about the competitive advantages of companies within this sector over the long term (for example, those that are successfully decarbonizing and moving into green solutions compared with those that are overly reliant on fossil fuels).

Stewardship

Good stewardship isn't limited to voting on listed equity holdings. Fixed income managers should use their influence to engage with companies and push for change where it is beneficial. At the core of engagement from a fixed income perspective is a desire to gain insight into ESG risks. It is important to understand whether investors are being compensated for these risks and understand how these risks may be mitigated by working collaboratively with the companies in question and holding them to account. In the context of B&M strategies, the argument for sound stewardship is only strengthened. Managers are lending to companies and operating within sectors where often the most effective way to manage long-term ESG and other risks is through engagement.

In the case of utilities once again, consider the importance of managers engaging with regulators and companies as they seek to understand the best entities to lend to in these heavily regulated markets. We are seeing huge pressure for energy-generation companies to shift from high carbon to lower carbon or renewable energy-generation models. Having meaningful discussions with companies can help managers form a view on whether these companies are taking a truly long-term approach and provide avenues to help them improve their strategy.

Leading managers are taking holistic approaches to stewardship on key themes such as diversity, climate change and governance. We believe the best approaches assess companies using a range of metrics to then prioritize engagement and provide a comprehensive baseline from which to track progress.

Engaging managers on stewardship

Leading investors are challenging their managers to demonstrate that not only are they identifying key risks, but also holding companies to account and seeking to achieve positive outcomes

Two key ways to potentially improve stewardship monitoring are to:

1. *Request engagement reporting specific to the portfolio.*
2. *Ask managers for evidence and case studies of positive outcomes (not just activity) across E, S and G issues.*

Conclusion

As long-term lenders, B&M portfolio managers have every incentive to make sure that ESG risks don't get in the way of generating long-term returns. This article has demonstrated why B&M portfolios may provide a great petri dish for material insights on the application of ESG that investors can learn from and apply to their own fixed income portfolios — from ESG integration's role in credit assessment, to climate change considerations, to stewardship.

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