Social Responsibility Can Be a "Core" Fixed-Income Strategy

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ESG focuses on many areas that have the potential to negatively impact free cash flow generation and balance sheet integrity, which in turn have direct ramifications on long-term fixed-income performance.

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For many fixed-income investors, socially responsible investing (SRI) is thought to be incompatible with a core fixed income strategy. Misconceptions that SRI portfolios are niche products, attractive only to investors who are willing to sacrifice yield in order to achieve a mostly intangible social goal, are still common among both individual and institutional investors alike.

We believe, however, that SRI investing is well qualified to be a core fixed-income portfolio strategy that is benchmarked to the Barclays U.S. Aggregate Bond Index and managed for total return. Adding SRI criteria to the security selection process for a core fixed-income portfolio delivers something an increasing number of investors, particularly the key "millennial" demographic, want – a positive social impact – while retaining the potential for long-term outperformance.

Avoiding risk

As an additional benefit, using Environmental, Social and Governance (ESG) metrics to evaluate fixed-income securities can help to identify risks that are not fully captured in a credit rating, and thereby help portfolio managers to "avoid the losers" that get hit by low frequency but high impact events. ESG performance is a good indicator of how well an entity – be it a sovereign government or a corporate issuer – is managed and the long-term risks it faces. Given the composition and structure of the investment-grade fixed-income market, the key to long-term outperformance is to identify and avoid those entities that underperform. We believe using ESG criteria helps do that and provides a competitive advantage in our investment process.

ESG focuses on many areas that have the potential to negatively impact free cash flow generation and balance sheet integrity, which in turn have direct ramifications on long-term fixed-income performance. Relevant environmental factors include issues such as climate change, natural resource use, and waste management. Social evaluation categories include human capital and product safety. Assessment of governance criteria touches on corporate governance, business ethics, as well as government and public policies.

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These subjects form the basis of our analysis of an issuer's exposure to material risk and its ability to manage that risk. We seek to understand the possible financial implications of that exposure, and to determine whether a particular security is priced correctly given the full spectrum of risk. We use an ESG evaluation process to identify issuers that are leaders in their respective sectors on ESG performance. Strong performance on these criteria is likely to correlate highly with sustainable financial performance over the long term.

For corporate issuers, ESG analysis can identify risks that are not overtly apparent in their financial statements or credit rating. Governance issues form only a small component of a credit rating, but in certain instances, as in the case of accounting practices, can be enormously consequential. Social and environmental issues are also important; poor labor relations, accusations of human rights violations and product safety issues can have a meaningful impact on profitability and reputation. Likewise, exposure to climate change issues, air and water pollution, and the use of renewable versus non-renewable resources can also impact a company's financial performance and, over the long term, its ability to service its debt obligations.

ESG criteria can help with analysis of sovereign debt issuers as well. For many investors, sovereign debt is thought of as the least risky area of a portfolio, which magnifies the importance of the risks that sovereign issuers face given their market valuations. Poor governance at the sovereign level can have an important impact on economic activity and growth, which in turn can impact future ratings transitions. Social factors such as health and education standards, infrastructure access as well as political and press freedoms can be important determinants of government stability. Environmental factors such as water scarcity and climate change preparedness can also impact long-term sovereign creditworthiness.

While variations in any one area may not impact performance to a noticeable degree, an entity's collective ESG metrics can be the differentiating factor in forecasting long-run outperformance. As a result, we believe that rather than delivering reduced performance in order to attain stronger ESG metrics, issuers – both corporate and sovereign – that strive to obtain and maintain high ESG ratings are likely to outperform their competitors over the long term. In that way, social responsibility can strengthen, not weaken, a core portfolio. ■

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