Getting hands-on in fixed income ESG

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Debt market investors are getting to grips with applying ESG principles to their portfolios. But is there a potential performance cost for taking an ethical bias? We look at the most popular ways of integrating these principles and their impacts on the investible universe.

From its roots as a topical talking point, ESG has grown into a long-term investment theme that's here to stay.

Accepted across the industry as the thinking of the future, the question for investors has shifted from a philosophical 'should' we implement ESG factors to a practical 'how' do we implement them.

While taking an ESG approach is fairly well established for equity investments, it's a newer concept in the world of fixed income, making the 'how' largely uncharted territory.

Expressing the bondholder voice

Trailblazing bondholders have two main choices when it comes to portfolio implementation.

One of the easiest ways to take immediate action is through 'negative screening'. Excluding the bonds of issuers that do not meet investors' ESG criteria provides a quick way to clean up a portfolio. While this approach doesn't target short-term change in company behaviour, it can serve to remove debt funding sources from controversial names and industries.

The longer-term option is 'active ownership', whereby bondholders use their influence to promote positive change. Taking carbon as an example, while it may seem tempting to turn your back on the global industrials that are the world's biggest emitters, these companies are also the ones with the size and scale to make a significant long-term ESG difference.

As ESG-focused investing becomes more established in the fixed income universe, we anticipate active ownership strategies gaining momentum and the bondholder voice becoming more powerful. But right now, negative screening gives investors an immediate way to express an ESG view within their portfolios.

So far, so simple, right? Not necessarily...

Universal impacts

Removing companies from the investable universe might tick the ethics and values box, but what impact can it have on a portfolio's expected risk-adjusted return?

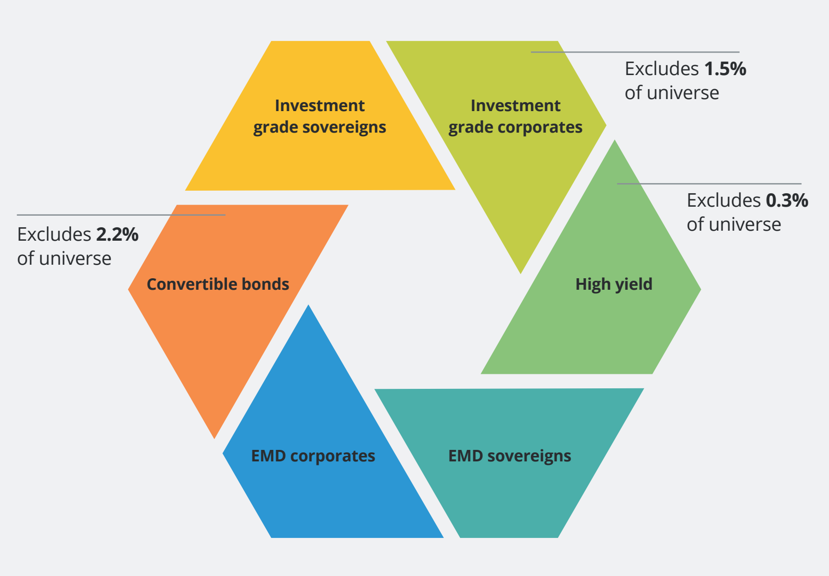
In theory, if it has an immaterial impact on your overall ability to hit your performance target, then you could implement the strategy immediately with few, if any, ramifications. But what's the reality?

We dig into the four most contentious industries to examine how the investment universe is altered by their exclusion through negative screening.

1. Controversial weapons
(cluster munitions, landmines, depleted uranium, chemical & biological weapons)

Some investors screen out these names as standard, but a blanket approach can introduce unexpected return complications.

CHART 1: NEGATIVE SCREENING OF CONTROVERSIAL WEAPONS – APPROXIMATE REDUCTION IN INVESTABLE UNIVERSE



Source: BlueBay Asset Management, as at 30 September 2019

Many of these manufacturers also produce non-controversial goods, such as aircraft and submarines, with only a small percentage of their revenues coming from controversial weapons. A simple screen such as setting weapon revenues at a maximum of 5% of a company's total might see all sector names making it through and in a portfolio's investable universe.

The big challenge is where to draw the line.

The investment decision becomes one not only based on numbers, but of ethics and tolerance too. Only the client can advise on exactly how stringently they want their ESG values implemented in this case.

Another point to consider is where power best lies. If you withdraw capital from certain names so they ultimately run out of funding and stop making controversial weapons, this doesn't mean that these weapons will disappear from the world. Someone will always manufacture them somewhere, so it is worth giving consideration to whether they are best produced in markets with stringent governance frameworks or in unregulated territories with less established manufacturing practices and safety oversight.

Each investor will have a different take on these questions, which will subtly shift the investment outcome, but our analysis shows that even when applying a stringent negative screen, the impact on the size of the investable universe is marginal.

As ESG-focused investing becomes more established in the fixed income universe, we anticipate active ownership strategies gaining momentum and the bondholder voice becoming more powerful.

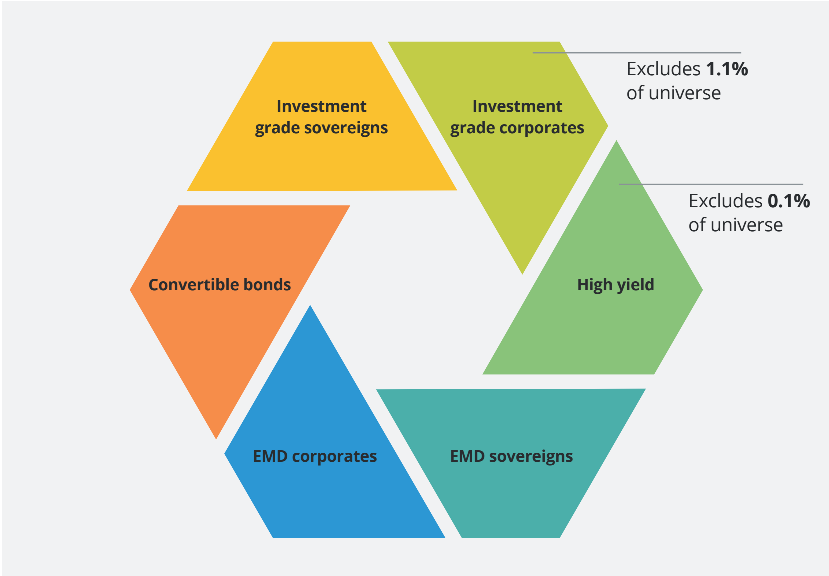
2. Tobacco

As a classic single-product industry, the exclusion of tobacco names seems more straightforward than controversial weapons.

The one notable potential complication is retailers – at what point, if at all, do you set revenue screens on companies linked to the sale of tobacco? While this is a question for client consideration, the reality is that cigarette sales make up such a small percentage of most retailers' revenues, and many don't disclose their revenue breakdowns in much detail, that even very stringent screens are unlikely to exclude retail names from investment consideration.

We found the overall impact of tobacco exclusion from the investable universe was marginal as these companies are typically found in the vast and highly diverse investment grade and high yield asset classes.

CHART 2: NEGATIVE SCREENING OF TOBACCO – APPROXIMATE REDUCTION IN INVESTABLE UNIVERSE



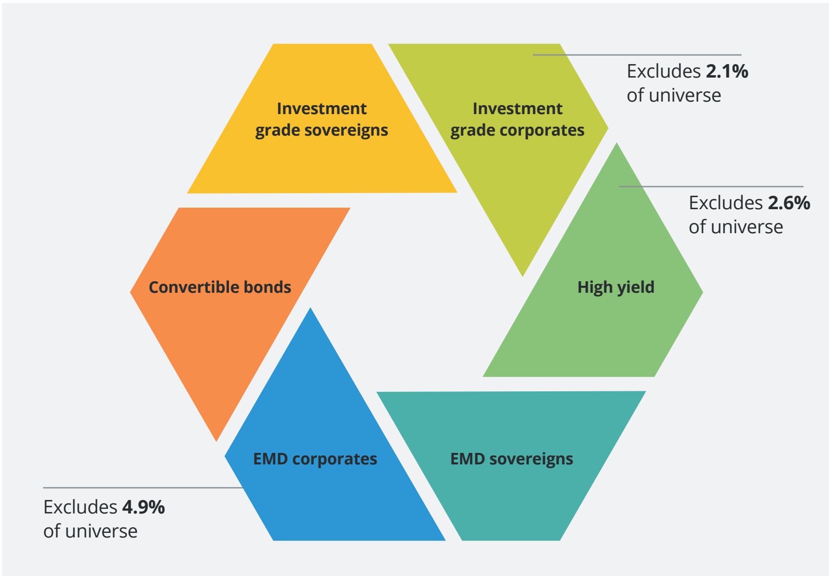
Source: BlueBay Asset Management, as at 30 September 2019

3. Gambling

The allocation complications around gambling exclusion are two-fold. Casinos are often found in regional pockets, such as Macau and Las Vegas, raising the question of the impact to geographic exposure. Additionally, they are often integrated within global hotel chains. These complications test investors when it comes to negative screening – do you apply a blanket screen and wipe out some of the world's biggest hotel groups, or a relative screen set at say 5% of revenues to allow some flex?

We found the exclusion of gambling names had a relatively modest impact on the investible universe, with the exception of emerging market corporates, where at 5% of the total universe, the sector size is not inconsequential.

CHART 3: NEGATIVE SCREENING OF GAMBLING – APPROXIMATE REDUCTION IN INVESTABLE UNIVERSE



Source: BlueBay Asset Management, as at 30 September 2019

4. Fossil fuels

Comprising a big part of the normal investable universe, fossil fuels raise lots of questions as to what to include/exclude and where to draw the revenue line regarding negative screening. The precise scope of how to optimally exclude is currently being explored by investors.

The proliferation of engagement lists such as the 'Climate Action 100+', the 'Coal 100 Underground' and the 'Tar Sands 20', which typically rank industry names by emission levels, can provide useful focal points but also mean there is no one universal approach to negative screening as each list has its own criteria.

There's also the issue of global supply chains. As carbon is a waste product of all supply chains, irrespective of the industry or sector, at some point you have to make a call on what you include, and this decision will be subjective to each investor.

As coal is the single-biggest contributor to climate change, this is the sub-industry that is most commonly screened out first. There are various approaches to doing this, but 'revenue threshold' is the most common.

The one notable potential complication is retailers – at what point, if at all, do you set revenue screens on companies linked to the sale of tobacco?

Overall, the size and scope of the fossil fuels market means it has a more notable impact on the size of the investable universe compared to the other three industries considered. Setting a revenue screen at say 30%, which is the level we apply at BlueBay for thermal coal, results in the exclusion of almost 10% of the emerging market corporates universe – creating a potential return implication that can be managed but should not be overlooked.

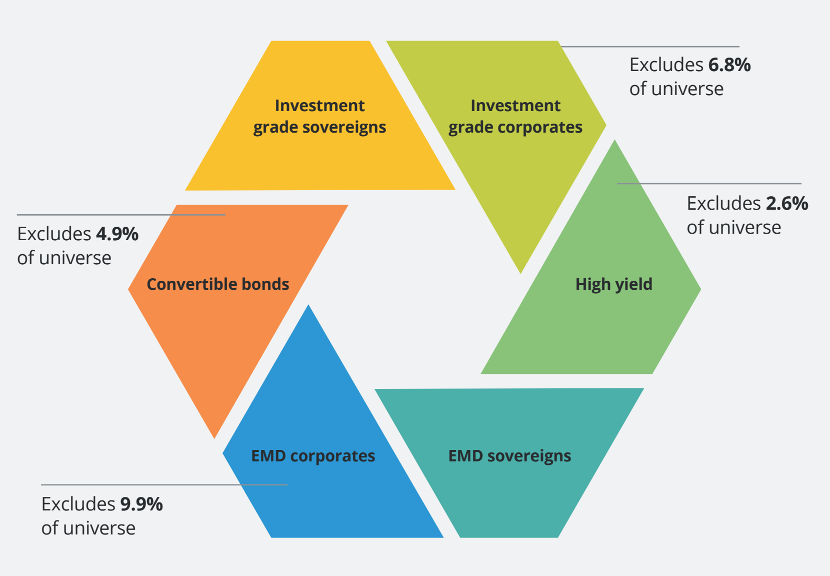
The bottom-line

We believe the size and scope of the fixed income market offers smart investors sufficient opportunities to restore any yield loss caused by restricting the investible universe, while respecting their clients' ESG preferences.

While bondholders might be at the beginning of their ESG journey, the direction of travel is clear and momentum is starting to build. As fixed income-specific ESG practices are developed, we expect bondholder influence to grow and for engagement to become both more common and more impactful. Working together should increase the power of the bondholder collective voice, and in time we could see engagement, rather than exclusion, become the first port of call for portfolio construction.

As for right now, the asset class's bountiful universe, combined with a flexible and thoughtful investment approach, should allow investors to implement a values-led portfolio construction approach avoiding the worst of the ESG names without negative performance ramifications.

CHART 4: NEGATIVE SCREENING OF FOSSIL FUELS – APPROXIMATE REDUCTION IN INVESTABLE UNIVERSE



Source: BlueBay Asset Management, as at 30 September 2019

TABLE 1: NEGATIVE SCREENING SUMMARY

	Overall impact of exclusion on investable universe	Most impacted asset class
Controversial weapons	Marginal	Convertibles bonds @ 2.2% of universe
Tobacco	Marginal	Investment grade corporates @ 1.1% of universe
Gambling	Modest	Emerging market corporates @ 4.9% of universe
Fossil fuels (coal)	Moderate	Emerging market corporates @ 9.9% of universe

Source: BlueBay Asset Management, as at 30 September 2019

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