Going Green in Fixed Income

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Environmental, social, and governance (ESG) investing has historically been more associated with equities. But if you're a fixed-income investor and you're not thinking about sustainability themes, you may be overlooking a valuable source of alpha.

We believe that fixed-income investing—because of its focus on long-term cash flows and the sustainability of the business—may actually lend itself even better to ESG and sustainable investment themes than equity investing. After all, ESG initiatives often strengthen a company's bottom line and reduce volatility, and as lenders, our top concern is always the borrower's ability to generate enough cash and income over the long term to service the debt.

Driving Alpha Through Lower Volatility

While some investors may fear that focusing on ESG factors may serve as a headwind to the performance of a fixed-income portfolio, recent data show the opposite to be true. Bloomberg Barclays published a survey in 2017 to identify whether there's an alpha advantage or performance degradation caused by including ESG themes in a bond portfolio.

To conduct its research, Bloomberg Barclays constructed pairs of portfolios that differed drastically in their ESG scores, but were nearly identical across all important dimensions of risk for corporate bonds.

The model was run once to find the portfolio with the highest possible average ESG score that meets these constraints and once to find the one with the lowest ESG score. Bloomberg Barclays then measured and compared the performance of these portfolios from August 2009 through April 2016.

The key question is whether substantial differences would arise over time between the average returns of the two portfolios—and the research found that incorporating ESG factors created a significant alpha advantage.

- In one data set (which showed the return difference between portfolios with high and low ESG scores for one ESG provider), Bloomberg Barclays found a 29-basis-point advantage on an annual basis (combined E, S, and G scores).
- In another data set (which showed the return difference between portfolios with high and low ESG scores for another ESG provider), Bloomberg Barclays found a 42-basis-point improvement in performance (combined E, S, and G scores).
- The return difference for G (governance) scores were 0.29% and 0.82%, respectively, highlighting the importance of governance in potential outperformance.

In analyzing these results, Bloomberg Barclays found that much of the alpha is driven by the reduced frequency of downgrades for companies that focus on ESG.

To an equity investor, this magnitude of alpha might not seem like a lot, but to a bond investor with a high-grade portfolio, that significantly moves the needle in terms of performance. We're always striving to make marginal improvements to our investment process to enhance performance, so anything that improves performance by this magnitude is worth looking into.

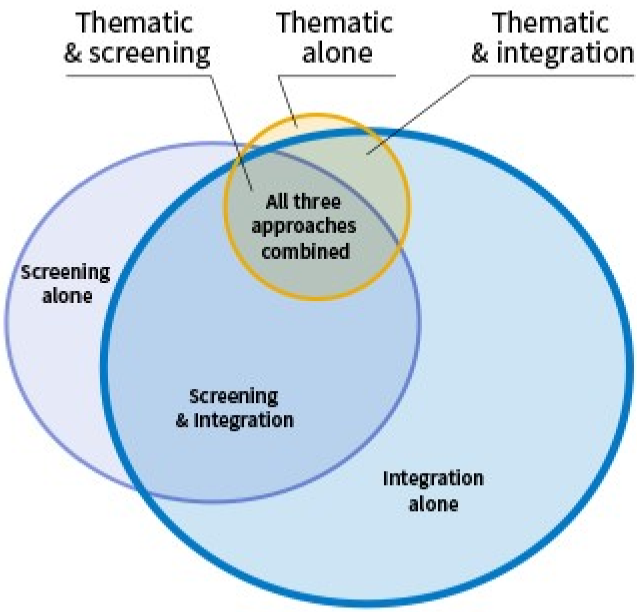
Evolution of ESG Investing

We see fixed income as one of the highest-growth areas of the sustainable investing universe. More than 2,000 institutional investors have signed on to the United Nations-supported Principles for Responsible Investment, pledging to incorporate ESG into their investment process. Today, those 2,000 U.N. signatories control about $90 trillion in assets, about a third of which are in fixed-income assets.

ESG has evolved from rules-based "socially responsible investing," in which investors would exclude certain types of companies—often omitting tobacco, alcohol, or firearms—from the portfolio. But as ESG has evolved to include sustainability-themed investing and integration approaches, this creates further alignment with how we view companies as fixed-income investors.

Strategies for Incorporating ESG into Investment Decisions by Total Volume of Directly Managed Fixed Income Assets

Combined FI approaches in US $trn.	
Screening alone	$2.3
Thematic alone	$0.1
Integration alone	$9.6
Screening + integration strategies	$5.8
Thematic + integration strategies	$0.1
Screening + Thematic strategies	$0.4
All three strategies combined	$1.4
No incorporation strategies applied	$2.3
Grand total (actively managed)	$21.9



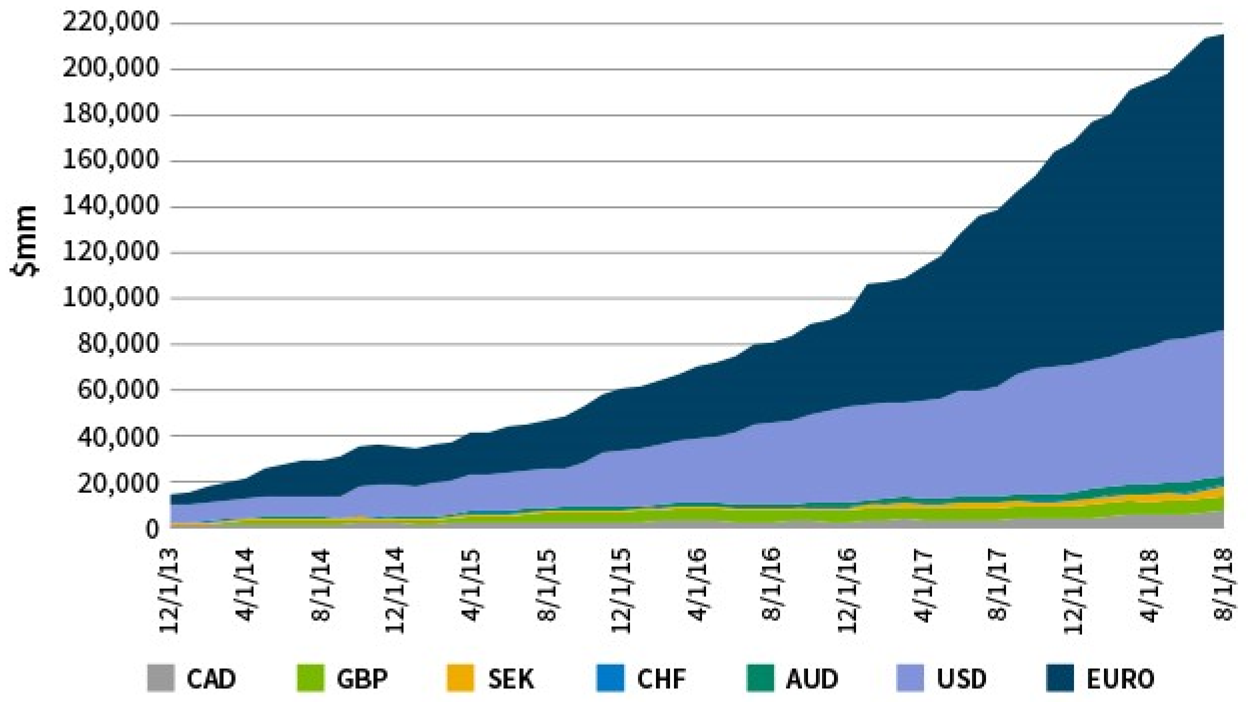
Source: PRI 2017.

Green and Sustainability Bonds Emerge

One of the most significant developments in fixed-income ESG investing has been the creation of green bonds. These are bonds issued by a company or municipality that uses the proceeds for environmental purposes.

Two of the most common uses for green bond proceeds have been energy-related—renewable energy and energy efficiency. But increasingly, we're seeing broader applications including sustainable forestry, climate change mitigation, and more.

Barclays Green Bond Index Issuance by Country



Source: Bloomberg, Barclays Green Bond Index. The Bloomberg Barclays MSCI Green Bond Index measures the global market for fixed-income securities issued to fund projects with direct environmental benefits.

We're also seeing companies issuing sustainability bonds. Starbucks was one of the pioneers in this field, issuing a five-year bond in 2016 that used its proceeds to source coffee from farmers who followed a specific set of sustainable practices. Following this success, the company came out with another sustainable bond committed to sustainable practices within its supply chain.

Last year, HSBC followed suit by issuing its own sustainable bond dedicated to lending in areas such as healthcare, education initiatives, and sustainable infrastructure. This is a notable trend because banks are among the biggest issuers of bonds.

Now that these bonds are out in the market, they can be compared with general corporate bonds. We're finding that there's no performance degradation to the issuer; there isn't necessarily a higher cost to the issuer, either.

Similar to what we found when analyzing the results of the Bloomberg Barclays research, when we look at individual green or sustainability bonds, the alpha is usually driven by lower volatility. There's a more dedicated investor base for these securities, so that means the issuer is going to see less volatility in its cost of funds.

As fixed-income investors, we are always looking at company management, cash flow, the balance sheet, and a company's overall business strength. ESG integration gives us a valuable additional lens through which to make these evaluations. Most important, we believe companies can use sustainable practices to reduce their operating risk, enhancing the risk-adjusted returns of their bonds.

To access more insights about how William Blair is reaching beyond traditional investment analysis to think about the white space between asset classes, sectors, geographic regions, and investment teams, we invite you to explore other posts about sessions at our 2018 CONNECTIVITY conference.

Todd Kurisu, CFA, is a portfolio manager on William Blair's Fixed Income team.

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