Opinion **Markets Insight**

ESG playbook for bond investors needs a rewrite

It will take an evolution of fixed-income managers' approach to make a difference to corporate behaviour

ELLEN CARR

Unlike credit ratings, ESG rankings are thus far inconclusive, and at times contradictory, in their ability to identify good corporate practices © Maurice Schuckart/Dreamstime

Ellen Carr YESTERDAY

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Not to be left out of the ESG gold rush, a growing number of bond firms now offer environmental, social and governance funds. ESG integration has become a standard box to be checked (or not) on bond clients' Requests for Proposals. Investment banks have created tools to help fixed income managers ESG-ify their portfolios.

Yet the structure of the corporate bond market and the nature of creditors' relationships with managements suggest that the ESG playbook needs a rewrite if bondholders want to make a difference in corporate behaviour.

For the avoidance of doubt — I believe that good E, S and G practices can correspond with superior returns. As the co-author of a book about the importance of gender diversity in investment management and a shareholder and employee of a majority women-owned firm, I am an observably passionate "S" and "G" advocate.

Despite our commitment to diversity and frequent inquiries about ESG strategies, the firm I work for is, explicitly, not an ESG manager. We do not tell our clients what should be in a socially responsible portfolio. Our firm must balance client requests with the resources needed to create a relevant, marketable, compliance-blessed ESG framework.

These resources are not necessarily resident at smaller firms, because company research is only one of several tools for outperformance. In equities, alpha — or the ability to beat the market — is about picking good stocks. In fixed income, alpha also includes management of a portfolio's sensitivity to interest rates, sector allocation and picking the best bond in the capital structure.

To analyse whether Apple is a good stock, a firm might employ an analyst who is only responsible for covering the tech sector. But making a call on Apple bonds might fall to an analyst overseeing several large sectors, or a corporate bond specialist who looks across all industries to determine relative value.

The structure of the investment-grade research process has led some bond shops to create rankings using the ESG ratings available on Bloomberg, from various sources. But unlike credit ratings, these are thus far inconclusive, and at times contradictory, in their ability to identify good corporate practices.

Bond investors don't take the credit rating agencies at their word on the quality of a company's financial health. Telling a prospective client that credit ratings drive portfolio construction would not help it win any client mandate selections. But this approach has worked for some managers when using ESG ratings.

One argument for ESG investing is that sustainability-minded investors can influence a company to make positive changes. But fixed-income managers don't vote shares, and engagement with management is typically limited to a new issue "roadshow".

Creditors have two (thus far underused) tools to influence corporate strategy. We could boycott new bond issues. But our new-issue habit would be hard to break. Portfolios must regularly reinvest cash thanks to coupon payments and maturities of bonds. The new-issue calendar doesn't always align with an ESG buy list.

Our second tool would be covenants that require adherence to, or progress towards, specified ESG goals. This would require a fundamental change in bond contracts. Investment-grade bonds have minimal covenants, while high yield covenants focus on balance sheet metrics.

Companies have given us a weak version of this with “ESG bonds”. But unlike a traditional bond covenant, which requires compliance at a corporate level, an ESG bond only requires its issuer to invest the proceeds towards the covenanted use. And even that is somewhat discretionary.

Where does fixed income go from here? In the optimistic case, we work with our equity counterparts to present a united front in dealing with companies while engaging more with the ESG rating agencies. This approach requires more resources, against a backdrop of fee pressure and increasing technology expenses. And it ignores the potential for conflict between bond and equity perspectives and priorities.

I’m hopeful that thoughtful discussion of ESG in bond portfolios that avoids easy box-ticking will lead to meaningful evolution of our investment process. But I’m sceptical over whether what has happened in fixed income to date has made much difference in the world. Bond portfolio managers must change their approach to ESG principles if they want to influence corporate behaviour.