

FIXED INCOME THE 'NEGLECTED CHILD' OF RESPONSIBLE INVESTMENT

4 February 2014, London – Fixed income has historically been the ‘neglected child’ of responsible investment, taking a backseat to equities and other asset classes, according to a panel of investors discussing the rationale for integrating environmental, social and governance (ESG) factors into bond portfolios at an event arranged by the Principles for Responsible Investment (PRI).

Hosted at the London offices of AXA Investment Managers, a signatory to the PRI, the event brought together more than 100 institutional investors with an interest in, or exposure to, the fixed income asset class.

Moderating the first panel, Helene Winch, the PRI’s Director of Policy and Research, highlighted several ESG risks that had been material for fixed income investors in recent decades.

Florian Sommer, Senior Strategist, Union Investment, said corruption, a key indicator of governance failings, proved to be one of the most important factors of the Eurozone debt crisis. Citing research from Transparency International’s Corruption Perception Index, which measures perceived levels of public sector corruption in 176 countries, he noted that since 1970 there had been 38 cases of sovereign default, 33 of which occurred in countries with high instances of corruption.

The link between corruption and sovereign credit risk is explored further in [Sovereign Bonds: Spotlight on ESG Risks, published by the PRI in 2013.](#)

Andreas Hoepner, the PRI’s Senior Academic Fellow and Associate Professor of Finance, ICMA Centre, Henley, said until recently, investors have mostly focused on ESG issues related to corporate stocks and bonds but much less for sovereign debt. However, since the Eurozone crisis, investors have had to reevaluate sovereign debt as a defensive holding. “ESG issues are increasingly considered as key to economic analysis for assessing the sustainability of sovereign debt,” he noted.

Till Jung, Director of Business Development at Oekom Research, said Oekom’s ESG sovereign ratings were able to sense deterioration in Greece’s sovereign risk profile much earlier than Standard & Poor’s, Moody’s and Fitch, through an approach that included ESG factors.

The ‘unburnable carbon’ thesis of the Carbon Tracker Initiative is also gaining interest from fixed income investors. The NGO points out that if the world is to avoid significant impacts relating to climate change, up to 80 percent of proven coal, oil and gas reserves will have to remain unexploited. If governments maintain or intensify their emission reduction targets, fossil fuels will become less viable as an energy source and demand is likely to fall, making it uneconomic to extract higher-cost reserves and potentially stranding fossil fuel assets already capitalised and valued on corporate balance sheets.

Responding to a question on the potential for “stranded assets” to impact fixed income investments Lise Moret, Senior Responsible Investment Analyst, AXA Investment Managers, discussed carbon risk and the way it is taken into account in the assessment of countries’ ESG profile by AXA.

Integrating responsible investment in fixed income

Pension funds, insurers and other asset owners allocate a significant proportion of their funds to fixed income. For the average pension fund, this is roughly a third of all assets according to Towers Watson. Diandra Soobiah, Responsible Investment Manager, National Employment Savings Trust (NEST), stated “within pensions funds, allocations to the fixed income asset class have doubled over the last five years”.

In the second panel, Ebba Schmidt, Investment Manager, Pension Protection Fund (PPF) and Chair of the PRI's fixed income work stream, said that 70% of the PPF's assets sit in fixed income, logically making a case for the incorporation of ESG issues into the portfolio.

“It's not always a black and white numbers game and sometimes we need to be explicit with managers about what we are looking for,” according to Schmidt. “A lot of the debate is on belief rather than data” in terms of measuring the ESG outcomes and performance of managers.

Bondholder engagement: should lenders be better stewards?

As lenders of capital and not owners of shares, bondholders generally have fewer opportunities to formally engage with companies, for example by exercising voting rights or speaking at AGMs. The third and final panel questioned how bondholders could be active owners, in line with Principle 2 of the PRI, and whether they should engage individually or in collaboration with other investors during roadshows and debt reissuance to drive improvements in ESG disclosure, management and performance.

Colin Melvin, CEO, Hermes EOS and a member of the PRI's Advisory Council, said engagement with bond issuers was possible and that his firm had been successful in doing so, but questioned whether additional regulation was required to make this more effective.

According to Mark Gull, Co-Head of Asset and Liability Management, Pension Insurance Corporation, good credit analysts have always looked at ESG issues, they just haven't defined it as such. “As bond holders don't vote, it can be quite difficult to engage on ESG issues. All the work goes in upfront when the bond is issued. This is the point you can engage with a company. You have the ability to say ‘I want certain terms in there’.”

Tamara Box, Global Head of Structured Finance, Reed Smith LLP, added: “Bond holders are not owners, they are lenders. Whatever you want needs to be put in a contract. With more illiquid bonds, your ability is much more difficult, but you can vote with your feet”.

From why to how?

The PRI will build upon recent guidance for signatories outlining *why* ESG factors are relevant for fixed income investors by publishing examples of *how* investors are putting the Principles into practice in this asset class. This will be based on interviews with a number of pension funds and investment managers, as well as brokers and other stakeholders in the investment chain.

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Additional reading and resources

- [Sovereign Bonds: Spotlight on ESG risks \[PRI\]](#)
- [Corporate Bonds: Spotlight on ESG risks \[PRI\]](#)
- [Unburnable Carbon 2013: Wasted capital and stranded assets](#) [Carbon Tracker Initiative]
- [Fixed Income: ESG in the world's largest asset class](#)

