

AN INVESTMENT MAGAZINE INFOCUS REPORT, sponsored by PIMCO

ESG GAINS POPULARITY

in fixed income markets

For fixed income investors wanting to incorporate **ESG FACTORS**, it is **NOT ENOUGH to mimic the approach** equity managers take. **Demand** is emerging for **SPECIALIST PRODUCTS to meet the specific needs of fixed income investors.**

By Deborah Johnson

IN RECENT YEARS, it has become de rigueur for equity investors to incorporate environmental, social and governance (ESG) principles into their portfolios. Now, increasingly, fixed income investors are doing the same although, as analysis from the United Nations-supported Principles for Responsible Investment (PRI) shows, they have a lot of catching up to do.

As the world's leading proponent of responsible investment, the PRI encourages investors to use responsible investment to enhance returns and better manage risks. Each year, it scores how its signatories have performed in relation to implementation of the PRI's six principles across various asset classes, and provides a median figure to enable peer comparison.

The PRI's annual report card on how major asset classes are tracking on ESG, based on data provided by the group's 1750 global signatories, shows fixed income portfolios are lagging.

While median scores in the 2016 PRI assessments for equities were A's and B's, scores for the various fixed income categories ranged from C's to E's – an E denoting those not implementing responsible investment at all.

“ESG in fixed income is catching up quickly but it will take some time before it's as widely used as in the equity space,” PRI managing director Fiona Reynolds says. “Because it's a newer area, best practice is still emerging but scores will increase over time as practice and tools develop.”

PIMCO, a firm among the world's largest fixed income management houses, introduced one of the first socially responsible investment bond funds in 1991. However, it wasn't until April 2017 that its first dedicated ESG fund, the PIMCO ESG Global Bond Fund, was launched in Australasia. The fund is part of its global ESG investment framework, which was developed over six years by a firm-wide working group that included investment and client-facing teams and was led by Alex Struc, portfolio manager and head of ESG portfolio management at PIMCO.

Struc says the group drew on the PRI principles in formulating the framework, which has three pillars: exclusion, evaluation and engagement. These are applied in the most relevant and meaningful ways to the different asset classes the firm manages.

In its 2016 *Fixed Income Reporting Module*, the PRI cautions that although certain responsible investment activities can be carried out across both equities and fixed income, such as engagement and screening, the approaches are different.

This is necessary because the differences between fixed income and equities pose unique challenges for each, Reynolds says.

“Lenders have a contractual relationship with borrowers; they are not owners,” she explains. “Debt holders don't vote at AGMs,

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and access to management can be relatively infrequent. Fixed income investors also have to deal with issues such as multi-layered analysis (like yield spread and yield curve) and multiple issuer types (such as corporate, government, financial sector and supranational)."

Even within the broad fixed income asset class, Reynolds argues, there's a need for a specialist approach. "Widespread incorporation of ESG hinges on: a stronger consensus on which available ESG indicators give the most insights; more ESG research coverage for high-yield, emerging market and non-listed issuers; and a better understanding of how bondholders can manage ESG risks by engaging issuers."

The complexities of integrating ESG in fixed income and the related lack of available products have been cited as reasons for the relatively low take up among asset owners.

Locally, of 115 products approved by the Responsible Investment Association Australasia's (RIAA) certification program, only three are fixed income offerings.

RIAA chief executive Simon O'Connor agrees that incorporating responsible investment and ESG across the various types of fixed income investments is not just a matter of replicating the approach used for equities.

"ESG issues differ by sector, company and asset class," O'Connor says. "Just as market trends affect different companies in different ways, all investments are exposed to varying levels of ESG risk. This complexity means there is no single method for assessing ESG and ethical risks."

THE THREE E'S OF ESG

Struc says the process behind the PIMCO ESG Global Bond Fund is based on the "three E's of ESG": exclusion, evaluation and engagement.

Exclusion means corporate bonds issued

by companies with business practices that are misaligned with sustainability principles are excluded.

"We have a specialist group that meets monthly to discuss exclusions; these are split between a core list and a dynamic list," Struc says.

Evaluation means issuers are evaluated based on past and current behaviour. For every potential investment, PIMCO's ESG team independently scores E, S and G factors, looking at the materiality of the risk to the balance sheet of that particular sector or company before weighting to generate a numeric ESG score.

"For example, 'E' has a smaller relative contribution when assessing the ESG profile of banks compared to utilities," adds Struc. We also identify best-in-class ESG practices by evaluating how an issuer's ESG score compares with peers and whether it is improving over time."

Engagement, meanwhile, means interaction with companies.

"Engaging collaboratively with companies in relation to ESG can influence long-term change," Struc says. "Companies with above-average ESG scores can be further improved through proactive influence and companies with less stellar scores may offer us the opportunity to really move the needle."

Struc adds that, as an equity holder, PIMCO's ESG team takes quite a different approach.

"We think like a treasurer, so as to assess a company's ability to change, engage like a partner so as to unlock a company's willingness to deliver results, and hold to account as a lender, to ensure a company's progress," he says.

For sovereign bonds, PIMCO modifies its ESG framework.

Sovereign bonds issued by those countries in the bottom 15 per cent of the global transparency index are excluded.

Evaluation takes place with a primary focus on governance but also incorporates environmental and social indicators. PIMCO has found that serious ESG issues can usually be correlated with the financial health of a country, along with its investment credentials, thus ESG plays an integral role in assessment of the investment opportunity. There is no formal engagement.

Struc says: "With sovereigns, you are also investing in a global macro trade. US treasuries are not just about the US, they may be part of a 'flight to safety' trade in turbulent markets – a risk-off strategy."

The options available to fixed income investors have evolved from exclusionary screens through to specialist categories that are making a positive impact, such as green bonds.

There are also several diversified fixed income funds that incorporate ESG.

MORE THAN SCREENING OUT

PIMCO's ESG Global Bond Fund was designed to achieve returns consistent with other core bond strategies while also making a positive social impact. Its benchmark is the Bloomberg Barclays Global Aggregate Index hedged into Australian dollars, which reflects the aspiration to incorporate ESG without sacrificing performance. Struc describes it as "mobilising traditional fixed income capital for the purpose of change".

Reynolds calls PIMCO's ESG Global Bond Fund a good example of how ESG strategies can be used across the fixed income sector.

"For many investors, screening out undesirable investments does not go far enough," she says.

One such investor, the New Zealand Anglican Church Pension Board was a seed investor in the NZ PIMCO ESG fund. Its investment chief, Simon Brodie, explains: "It's rare to find a global bond fund that meets socially responsible investment criteria. What PIMCO offers aligns closely with our investment strategy and the principles of our ethical investment philosophy."

The launch of PIMCO's ESG fund is timely. The PRI states that fixed income is one of the fastest-growing areas of responsible investment activity for asset owners. It has already gathered more than \$1 billion from large institutional and smaller retail investors.

With more widely available ESG investment products, and greater interest from asset owners, a virtuous circle for responsible fixed income is formed. ✕