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## GROWING THE SUSTAINABLE PIE THE RIGHT WAY



### Key trends that will help to shape the growth of the sustainable fixed-income market in 2021 and beyond.

- We anticipate an increased focus on management incentives being tied to ESG-related key performance indicators (KPIs), and not just at senior management level.
- We believe 2021 will see the continued evolution of regulatory plans which will challenge investors, assets owners, companies and governments to improve their sustainable disclosure and reporting.
- We predict the robust growth of corporate and sovereign green, social and sustainable bond issuance, both by region and sector. Credibility is key to its continued growth.
- By asking more of issuers, ranging from the bare minimum of whether they have an ESG plan, to specific topics on how sustainability affects their businesses, fixed-income investors can push issuers to improve their practices, transparency and reporting for the benefit of all stakeholders.
- In our view, shareholders and bondholders working together will create the maximum opportunity to improve environmental and societal outcomes, as well as share best practices.

With environmental, social and governance (ESG) considerations now high on the agenda for the majority of stakeholders, the integration of ESG factors within the fixed-income investment process is fast catching up with equities.

We believe much can be achieved in fixed income in terms of improving environmental and societal outcomes, through both sovereign and corporate issuers. Policies, regulations and the development of new investing and reporting standards all aim

to provide guide rails for bond investors and to improve the consistency and credibility of innovations in the bond market to further enhance sustainability.

In this article, we highlight some themes that we believe will be important for ESG in fixed income in 2021. There is a long way to go, but ultimately, we hope that much of what we discuss here becomes business as usual in the years to come.

## Management incentives and KPIs

We anticipate an increased focus on management incentives being tied to ESG-related key performance indicators (KPIs). This should not just be focused on senior management, and we expect to see a greater alignment between a wider range of stakeholders in issuers where this dynamic exists or is being enhanced.

An important question to also ask companies is where their board ESG oversight and expertise sits, and whether the drivers of the strategy have the necessary skills and accountability in place. We frequently ask these questions during engagement with management teams as it helps demonstrate whether the company is living and breathing a responsible strategy.

## Increased regulations around ESG investing

Plenty of new regulations and policies have been announced by authorities during 2020, including the 'greening' of the European Central Bank's (ECB) purchase programmes and the development of the European Union (EU) taxonomy, which has helped to define what can be considered 'green', 'social' or 'sustainable'.

We believe 2021 will see the continued evolution of regulatory plans which will challenge investors, asset owners, companies and governments to improve their sustainable disclosure and reporting.

We are closely monitoring the potential implications for certain pools of capital that run the risk of either becoming stuck invested in stranded assets, or chasing too few assets and becoming expensive. There will also be opportunities for those issuers who can transition and those who develop long-term strategies with ESG considerations in mind.

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## Investor demand growing for fixed-income ESG solutions

Demand for fixed-income ESG-integrated solutions continues to grow and catch up with equities, not least in the area of sustainable bonds. There are many different types of sustainable bonds available, along with a long runway for growth, given the relative size of the markets.

Some parts of the market are constructed purely with sustainability in mind – for example, the use of 'proceeds' bonds, development agencies and not-for-profit organisations, which have the benefit of linking investor capital to physical outcomes.

## Growth in government-issued green, social and sustainable bonds

European governments represent the majority of issuance in this sub-sector today. We expect to see further growth not only from these European government issuers, but also from other countries around the world. Funding the recovery from the combined health-care and economic crisis of Covid-19 has accelerated the widening of the use of proceeds from these bonds to include social factors too. Examples include

the recently-issued EU SURE bonds, while in the UK, Green+ Gilts are expected to launch in 2021, with the proceeds going towards both environmental and social purposes. We will continue to analyse the purpose of proceeds of government bonds and selectively invest.

Reporting on the outcomes of the use of proceeds bonds is as important for governments as it is for the corporate sector. In fact, we believe governments should be leading by example; robust and transparent reporting by governments can encourage companies to follow suit.

We have already been investing in development agencies' bond securities for a while, and sometimes in their specific use of proceeds bonds. Often, by their very nature, development agencies have a mission to improve environmental and societal outcomes, and at times, we choose to allocate capital to development agencies in lieu of conventional government bonds. Credit quality is often similar or stronger, and we can allocate clients' capital in favour of more sustainable purposes.

## Increased engagement – bond investors asking more of government and corporate issuers

We expect investors to ask more of fixed-income issuers when it comes to ESG factors. Although fixed-income investors do not get a vote, they can and do engage. However, even today, in many of the meetings we have with issuers, we do not see peers asking important ESG questions. By asking more of issuers, ranging from the bare minimum of whether they have an ESG plan, to specific topics on how sustainability affects their businesses, fixed-income investors can push issuers to improve their practices, transparency and reporting for the benefit of all stakeholders. We have noticed ESG-related slides appearing in some issuers' presentations in some of the most carbon-intensive sectors, but ESG should not just be about ticking boxes, which is why fundamental credit analysis is critical.

Although environmental factors have been a primary focus for investors for a few years now, they have sometimes still been eclipsed by time spent analysing social and governance issues, especially as climate risks have often been regarded as very long-term in nature. As the narrative around climate risk is becoming ever more urgent, we expect governments to increasingly address it, which should also lead to the broadening of green government-bond issuance.

## Growth in green, social and sustainable bonds from US issuers

The US has lagged other parts of the world, especially Europe, in the issuance of use of proceeds bonds. With the impending change in administration and the country planning to rejoin the Paris Climate Accord, it appears that new government policies will ultimately lead to a greater focus on improving both environmental and social outcomes domestically. This is encouraging news as we often see that when governments lead by example, either through policies, support mechanisms or 'use-of-proceeds' sovereign issuance, it encourages domestic issuers to follow suit.

We do have exposure to use-of-proceeds bonds, but are aware that the green-bond market, for example, is skewed to certain sectors (such as financials and utilities), geographic areas and credit quality, and we see very little representation from high-yield issuers. Although the green-bond market has grown materially, it is still small compared to mainstream bond markets, and sees more deal oversubscriptions than non-green issuance. While this 'greenium' exists, green bonds have tended to outperform in risk-off periods owing to having fewer sellers.

We anticipate that further growth driven by US issuers, for example, can enhance the size, diversification and liquidity of the market.

Over time, even the best of the green-bond issuers will run out of projects to parcel into the green-bond framework, which may lead them down the road of sustainability-linked bonds as they continue to raise capital with the objective of providing positive environmental or social outcomes.

### Sustainability-linked bond growth

We believe that the growth in social bonds could follow the path of the growth in green bonds, especially when trying to deal with the effects of Covid-19, but we also expect significant growth in the newest area of the sustainable bond market – sustainability-linked bonds.

The first sustainability-linked bond was issued by Italian utility company Enel in September 2019. Since then, nine other issuers have come to the market with sustainability-linked bonds. The slow pace demonstrates that the market is still finding its feet (the structure upon which investors and issuers can agree is robust), but we believe this relatively innovative area of financing has legs and will ultimately see material growth.

The International Capital Market Association (ICMA) released its guidelines on sustainability-linked bonds in June 2020, and is currently considering the concept of transition financing. As bond investors, we always prefer to have greater and stronger credit protections; owing to the global chase for yield, much of this has been eroded – both in number and quality. We have always taken issue with the fact that there is no penalty for a green-bond issuer if bond proceeds are not allocated as promised or if reporting is not as it should be.

### Avoiding greenwashing

Sustainability-linked bonds are one step further back in that they fund general corporate purposes rather than specific environmental or social projects, but one step forward in that there exists a covenant tied to a key ESG KPI. So far, these bonds have focused on environmental KPIs such as emission-intensity targets, with a coupon step-up as a penalty for missing

the targets, but we anticipate that bonds with social KPI targets may soon also materialise.

For us, having a target that links back to the broader strategy of the issuer can sometimes be more powerful for achieving positive outcomes than a narrow focus on a specific project, but that target needs to be credible.

The risk of ‘greenwashing’ becomes a real possibility when an issuer which scores poorly on ESG factors issues use of proceeds bonds linked to specific environmental projects. Also, some issuers are attracted to the prospect of raising cheaper capital by using a label. In our view, this is where active management and fundamental analysis can make a material difference by identifying the most suitable issuers.

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### Pools of capital creating more distance between the ESG winners and losers

The downside of the new regulations, policies and taxonomies being developed is the risk of investors trading methodologies. This risks pools of capital chasing too few assets but also failing to provide capital to issuers perceived as falling outside eligibility for certain labels, such as those which are not compliant with EU taxonomy.

We assess each issuer on a case-by-case basis. While we are not mandated to accept a lower return, for example for an issuer’s labelled bond versus its non-labelled bond, we do factor in whether the stated sustainable outcomes are achievable as well as how we expect the security to perform though the economic cycle.



## Improving ESG data quality, transparency and disclosure

ESG data quality in fixed income is inherently inferior to equities in certain areas, owing to there being many smaller and private issuers. Data providers have been making decent headway on closing the gap, but relatively poor disclosure remains widespread, especially in the area of leveraged finance markets.

Also, much of the data gathered is backward looking and, frequently, the quality of the data is only as good as the disclosures provided by the issuers. While there has been a recent flood of new ESG data providers claiming to have superior insight into material ESG issues, investors are still learning how to process the data, and, once again, standards and consistency are required to act as guide rails.

At Newton, we have developed robust proprietary tools which incorporate a significant amount of ESG data. The tools are a critical input to our investment process, but are only an input, and the added value is the forward-looking, fundamental analysis.

The hope is that the more we see countries and companies run in a responsible manner, the better ESG disclosures and data quality will become. This trend will be accelerated by regulators and stakeholders, who will increasingly demand more from the issuers. Even though task forces have been established to standardise reporting frameworks, the current lack of standardisation of reporting means much is still left up to the issuers' discretion.

## Bond and equity investors working together

Finally, there is a need for improved communication not only between bondholders and issuers, but also between bondholders and shareholders on ESG topics. When it comes to purely financial returns, what is good for a bondholder is not necessarily good for a shareholder and vice versa. However, when it comes to ESG factors, we believe both sets of investors should be fully aligned.

We believe that an issuer considering ESG factors should be more likely to have a resilient and effective business model, which can also lead to both societal and financial positive outcomes.

Today, there are more shareholder-focused industry bodies than fixed-income ones. The bodies exist in recognition of the work to be done and how investors working together have more chance of effecting positive change. That is even more important for fixed-income investors, who can engage, but cannot hold management teams to account through voting. Bondholders, however, do have the ability to deny capital to issuers. In our view, shareholders and bondholders working together will create the maximum opportunity to improve environmental and societal outcomes, as well as share best practices.

We have worked with our colleagues across asset classes for a number of years. This, we believe, has enabled us to better put management teams on the spot, and has ensured that we receive a greater consistency of responses to both financial and ESG-related factors.

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