ESG Integration in Fixed Income

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How to Define ESG? Two Key Dimensions:

Financial Risk

- Mainstream investor / ‘Universal Owner’
- Integrate key ESG issues and risk factors
- Integrated ESG rating

Values

- Values investor
- Reflect values “Bill of Health”
- Ethical screens

Portfolio Construction

ESG Risk Assessment | Reputational Risk Assessment | Business Activity Screening
Key Challenges to ESG Integration in Fixed Income

- How to define ESG?
  - We lack a *common language* to define ESG objectives
  - Need a common framework to drive policy, manager selection, engagement

- How to measure ESG integration?
  - Current mandates focus on process, no standard measure of ESG performance
  - How to measure, benchmark, and *communicate success*?

- What does ESG mean for non-equity asset classes?
  - What does ESG mean for *non-corporate bonds*? Sovereign? Agency? Securitized?
  - What are acceptable ESG strategies for alternatives? Short positions? Derivatives?
  - Growing interest but limited offerings in this space creates *opportunity for first movers*
Barclays Global Aggregate Index – Credit Quality vs. ESG Quality

Barclays MSCI Global Aggregate Sustainability Index → eligibility based on credit and ESG criteria

Index Exposure to ESG Risk
The ESG Case for Fixed Income

- ESG risks can pose unanticipated liabilities to issuers:
  - Financial penalties and liabilities
  - Disruptions to operations / cash flows
  - Interruptions / cancelations of projects
  - Revaluation of reserves
  - Unexpected capital outlays
  - Product risk and impact on revenue

- ESG factors are not comprehensively understood by markets:

- ESG research helps investors anticipate extra-financial risks:
  - That could eventually lead to credit downgrades
  - That could affect the yield and price of an issuer’s bonds
  - That distinguish two materially different issuers with similar financial metrics

- Time horizon of fixed income investing conducive to considering ESG risk:
  - Most ESG risks materialize in the medium- to long-term
Assessing ESG Risk Exposure – Example: Water Stress

Water Stress by Basin

Water Intensity by Activity

Liters / $

Company
Risk
Exposure

Exposure to Water Stress

Portfolio Level

Industry/
Activity Data

Company
Segment
Data

mapped to

Country/
Basin Data

Company
Risk
Exposure

Gold
Copper
Etc
Etc

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We mapped country specific risk associated with carbon regulations and reduction commitments to company specific geographic distribution of reserves.
ESG Integration Trends in Fixed Income

**Corporates – Investment Grade**
Most common, similar integration strategies to equities, additional challenges around engagement; index solutions

**Corporates – High Yield**
Less common (lower coverage, information) but higher potential for ESG issues to become material

**Securitized and Asset-Backed Securities**
Limited ESG integration, less relevance

**Sovereign Debt**
Rapidly growing interest, esp. EM and EU – focus on governance and human rights, natural resource constraints

**Municipal and Agency Bonds**
Nascent interest in ESG strategies, broad universe, focus on geographic risk factors and positive impact

**Green Bonds and Social Impact Bonds**
Value proposition: Same financial characteristics but additional environmental value-add; Strategy: Targeted allocation
Compare portfolio’s ESG performance to standard benchmark and ESG benchmark

Informs manager selection, monitoring, reporting, ESG risk assessment
Barclays MSCI ESG Index Family: ESG Types

- **ESG Socially Responsible**
  - Credit/Corporate

- **ESG Sustainability**
  - Credit/Corporate
  - Aggregate

- **ESG Weighted**
  - Credit/Corporate
  - GovRelated/Tsy
  - Aggregate

**ESG Socially Responsible**
- Applies negative screens for issues such as alcohol, tobacco, gambling, weapons, firearms, GMOs, etc.
- Uses same SRI definition as MSCI SRI equity indices
- Excludes Impact Monitor “Red”
- Index Families
  - Ex Controversial Weapons
  - Religious Screens
  - Ex Sanctioned Countries
  - Ex Predatory Lending

**ESG Sustainability**
- Applies minimum ESG rating threshold
  - ≥ BBB for headline index
- Unrated issuers are excluded
- Sector drift allowed within corporate indices or can be preserved (weights normalized to parent index)

**ESG Weighted**
- Overweights ESG high-rated /positive momentum issuers and underweights low-rated/negative momentum
- Factor tilts based on the 7 ESG letter ratings and ratings momentum over past year
- Can be combined with other screens based on BISR or ratings
MSCI ESG Government Ratings

Our Government Ratings help investors assess the long-term competitiveness of national and sub-national economies

- Identifies **ESG risks** affecting a country’s value creation process – long-term sustainability of output and growth

- Identifies **countries with strong ESG fundamentals** that are likely to outperform in the long run

- **Differentiates** countries that are otherwise similar based on financial and fiscal characteristics

- **Emphasizes** quantifiable benchmarking of performance over qualitative assessment of policies, using a transparent methodology
Differentiating between the countries by quantifying ESG risks

Greece vs. Chile

In 2008, Greece’s ESG performance was characterized by:

- Relatively weak social and socio-economic performance
  - High unemployment
  - Weak economic environment
- High corruption
- Poor resource management and high resource consumption levels
- High environmental vulnerability
- Poor financial governance

In 2008, Chile’s ESG performance was characterized by:

- Low natural resource risk and moderately strong natural resource management
- Low environmental vulnerability
- Low corruption, compared to Greece
- Moderately strong social and socio-economic performance
  - Conducive economic environment
- Strong political and financial governance

Source: Credit Ratings (long-term foreign currency) from Fitch Sovereign Rating History (www.fitchratings.com)
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Over 600 clients with $15 trillion in assets globally

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