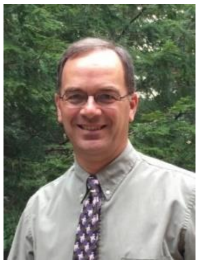
IEN Q&A: Making an Environmental, Social, and Governance (ESG) Impact through Public Fixed-Income

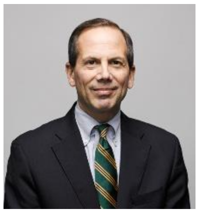
Equities have largely been the darling asset class when it comes to public ESG dollars. Of the nearly 1,900 ESG funds tracked by Bloomberg, about 62% invest in public equities versus 15% that focus on public fixed-income assets, according to reports in late 2018. This greater focus on equities supports the notion that the potential investment opportunities and value add within fixed-income ESG investments have yet to be fully tapped.

Given the benefits in investing in public FI with an ESG lens, **Intentional Endowments Network** (IEN) approached industry experts to gain insight on opportunities and trends within the sector and how managers and asset owners measure the impact of their investments. The specialists included:



Erik Gross, Treasurer, University of New Hampshire Foundation, $387 million in AUM

Mary Gregory, Sustainable Investing Specialist, Brown Advisory, $71.6 billion in client assets



Tim Coffin, Senior Vice President, Breckinridge Capital Advisors, $37 billion in AUM

Sarah Wilson, Senior Director, Responsible Investing Nuveen, a TIAA company, $977 billion in AUM

IEN: WHY INCORPORATE ESG WITHIN YOUR INVESTMENT PROCESS?

Gross: The first part of the answer reflects on us and the context we exist in. That is, the UNH Foundation seeks to align its investment methodologies with the longstanding and deep sustainability ethic of the University of New Hampshire. UNH constituencies are asking for this, and the Foundation has spent considerable time identifying the approach that will be the best for the investments and for UNH.

The second part of the answer is more holistic and outward facing. The Foundation recognizes that its investments are long-term and have impacts (at varying levels) that we can affect. Certain historically less quantifiable aspects of risk analysis were not fully reflected in the decision-making process, and so the ESG lens was determined to be a reasonable approach to enhance the fund analysis process. Right now that directly informs the management of our ESG portfolio, but we continue to evaluate and discuss expanding this approach across additional portions of the endowment.

Gregory: Integrating ESG into our investment process can add value to a fixed-income research process and to fixed income portfolio construction. Fixed income lends itself well to the incorporation of ESG factors for two reasons: 1) the focus on downside risk and 2) the ability to identify clear and tangible impact. Long-term thinking is a critical feature of ESG investing. This aligns well with our process as it focuses on identifying and evaluating investment opportunities that will perform over the long-term.

Incorporating ESG analysis into fixed-income portfolios has the potential to deliver attractive long-term performance while having a positive and measurable impact. The market is becoming more aware that a choice between returns and positive impact is no longer significant.

Coffin: The market can at times underprice certain longer-term and idiosyncratic risks, such as those posed by material ESG issues. As an investment grade fixed-income manager with an emphasis on capital preservation and risk mitigation, it is our obligation to gain the most comprehensive view of an investment. By broadening the scope of traditional analysis and examining ESG, we aim to identify bond issuers that are operating in a sustainable manner today and are preparing for the material issues that may affect them in the future.

Wilson: ESG integration is a primary way in which we implement responsible investing across asset classes and strategies. This approach reflects our conviction that incorporating ESG factors into fundamental investment analysis and portfolio construction enhances long-term performance and helps manage risk.

In our experience, fixed-income investments subject to ESG scrutiny have delivered competitive risk-adjusted performance, in part by helping avoid exposure to issuers involved in major ESG scandals.

IEN: WHAT TRAITS DO YOU LOOK FOR IN FIXED-INCOME ESG MANAGERS?

Gross: We look for a manager who can articulate a compelling case for the value of fixed-income in the portfolio, and for our ESG portfolio, also the compelling case for the benefits of incorporating ESG factors into their investment selection and monitoring process. We seek managers who are passionate about their investment space, about the value of ESG, and who can be clear about what makes them stand out above the other opportunities. Of course, demonstrated positive returns against the benchmark over several timeframes is critical.

Gregory: We look for a manager who takes a comprehensive approach to sustainability and identifies opportunities that equally weight impact and investment performance, across all sectors. The materiality of ESG to credit risk is supported by a growing body of evidence demonstrating that companies that integrate sustainability into their management process realize a range of competitive benefits: resource and cost efficiencies, productivity gains, new revenue and product opportunities, and reputation benefits.

IEN: WHAT ARE SOME OF THE CHALLENGES?

Gross: The first challenge is finding FI managers who actually are committed to and effective with ESG in their investment approach – in other words, having an adequate selection set to pick from. Correlated to that is another hurdle that the investment committee struggles with: short track records in the ESG space. With each passing year we expect to see more ESG FI managers, and short track records will become less of an issue. There has been great progress recently on this account.

Gregory: The lack of transparency and coverage in ESG research presents a challenge to finding opportunities in the bond market. A second challenge can be for a manager who relies on labeled green bonds only to fulfill a mandate – this is a significant constraint to their investment opportunities. A comprehensive, broad approach that incorporates ESG analysis into fundamental analysis while focusing on impact and sustainability drivers, leads to a larger investable universe across sectors with a greater opportunity for total return.

Coffin: One of the challenges of integrating ESG is the availability and standardization of ESG factors that are broadly reported by bond issuers. To help address this Breckinridge supports and participates as a member of the Sustainability Accounting Standards Board's (SASB) Investor Advisory Group (IAG). The group is composed of asset owners and managers who are committed to improving sustainability-related investor disclosures.

Wilson: Nuveen recognizes that there are limitations to third-party ESG ratings. These ratings are typically available for corporate and government-related bonds. For corporate bonds, the ratings use an industry specific approach. Companies are evaluated on the issues most relevant to their industry, balancing their strengths and weaknesses in ESG performance. For some key fixed-income sectors — including municipal bonds, mortgage-backed securities, commercial mortgage-backed securities and asset-backed securities — third-party ESG ratings are currently not available. Nuveen's fixed-income investment teams have developed quantitative and qualitative approaches to assessing these types of issuers on ESG performance in a fixed-income context, which is integrated into their independent credit analysis.

IEN: HOW ARE ESG FACTORS INCORPORATED WHEN ASSESSING FIXED-INCOME INVESTMENTS?

Coffin: When analyzing a corporate bond for investment, Breckinridge analysts first evaluate a bond issuer's business profile, market position, and competitive profile, as well as fundamental credit measures (such as margins, leverage, and cash flow).

The analysis then turns to an evaluation of management and sector-specific material ESG indicators, such as carbon emissions, workplace injury rates, and the composition of the board of directors. Further, important takeaways from any engagement calls with the issuing company are integrated into the analysis. The research is captured in an overall credit recommendation that includes an internal rating, a sustainability rating, and the analyst's bond valuation view. The recommendation is distributed to the investment team and helps to drive security selection.

Wilson: ESG integration at Nuveen involves close collaboration between responsible investing (RI) staff and investment teams. These two groups have distinct yet complementary roles: the RI staff helps refine ESG criteria and frameworks and uphold product standards, while the investment teams apply ESG data to security analysis, portfolio construction and other facets of investment decision making in actively managed strategies. This level of systematic coordination improves upon what Principles for Responsible Investment (PRI) surveys found to be the predominant (and suboptimal) approach among global practitioners, whereby isolated ESG analysts evaluate securities against ESG criteria and hand off the results to investment teams.

Each team's processes may emphasize or de-emphasize various ESG factors, depending on the stated intention of the specific strategy. A common area of examination is a company's role in major ESG controversies (e.g., toxic emissions, safety related product recalls, lawsuits or protests over negative events, and human rights concerns) as a potential indicator for credit risk. Integrating ESG information into the overall investment analysis also provides opportunities for investment teams to engage with issuers on material ESG factors and risks.

IEN: HOW DO YOU MEASURE IMPACT/SUCCESSFUL INVESTMENT? WHAT CRITERIA ARE USED GOING INTO AN INVESTMENT?

Gross: We evaluate each manager candidate on its own merits, and this includes how they implement ESG. Our consultant's extensive research team and knowledge of our portfolio's needs result in recommendations of funds that are best melding returns with the thoughtful manifestation of an ESG overlay. Therefore, as we monitor fund performance going forward, we will judge success on two outcomes: returns, and how the fund has met its goals for ESG impact against what it originally professed in the selection process. Material deviations from any aspect of an investment approach or result will subject the investment to serious review for continued inclusion in the portfolio.

Gregory: We look for a variety of factors but most importantly we want to see issuers who are using sustainability as a way to improve their company, country or municipality, and are also integrating it within their business lines to provide sustainable products and/or resources to their customers or population. Each bond under consideration for investment goes through rigorous ESG analysis. We start with a proprietary ESG risk assessment to identify risk and determine how it is being managed by the issuer. We also perform an ESG opportunity assessment to identify the sustainable impact and drivers that support our investment thesis. Our analysis of green and social labeled bonds directly examines the use of proceeds as a measurement of impact.

Coffin: We believe the impact of ESG investing should be measured on the intentionality of the investment approach, and its scalability. On request Breckinridge will provide additional reporting on the Sustainable Development Goals (SDGs). While we do not manage portfolios to explicitly conform to the SDGs, we believe there are some general areas of alignment and can map portfolio holdings to the SDGs.

Beyond that, measuring impact is in the eyes of the beholder. What a faith-based investor considers impactful may be quite different from what an environmental foundation considers impactful. As such, Breckinridge works with investors to customize bond portfolios to align with *their* values.

Wilson: Measuring the results of our RI strategies enables us to validate their success versus intended outcomes. Such outcomes may include higher ESG quality relative to benchmarks or positive impacts on society and the environment. As a general practice, we aim to publicly report outcomes on an annual basis, or more frequently if the data permits.

Our approaches to impact measurement differ and are developed based on the RI objective of the specific strategy. For example, when measuring ESG leadership, we seek to achieve a higher ESG quality score versus a benchmark. We can measure our relative ESG quality by calculating market value weighted average ESG scores for our portfolios and comparing them against the benchmark's. A higher score for a portfolio can be understood as the measurable impact of our comprehensive ESG criteria.

We partner with leading third-party research providers such as MSCI and Sustainalytics to help quantify ESG quality across corporate bonds, foreign government securities, private companies, development banks and agencies. Working with established, well-known global providers helps to standardize and validate our reporting, which our investors value. Moreover, as ESG measurement tools and analytics continue to evolve — an area in which Nuveen constantly seeks to innovate — they will provide a deeper understanding of how issuers' ESG quality contributes to the achievement of ESG and financial goals.