News & Views

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What does ESG mean for fixed income markets?

Investors should not ignore the potential benefits of sustainable bond investing as environmental, social and governance (ESG) - related concerns rise rapidly up the fixed income agenda, says Newton portfolio manager Scott Freedman.

While ESG factors were once seen as the preserve of equity investors, they are increasingly taking centre stage across swathes of the global fixed income market.

In Europe, recent growth in this area has seen a particularly strong focus on social bonds with the market growing by an estimated 43 per cent to €66 billion in the three months to June 30[1].

While much of this growth came as agencies and supranational issuers sought to ease the economic and social impacts of the Covid-19 Coronavirus pandemic, other areas of ESG fixed income investing also continue to see healthy growth. Issuance of impact bonds alone surged to US$300bn last year[2] and interest in ESG across other areas of fixed income investment continues to grow steadily.

Newton portfolio manager Scott Freedman believes recent growth in structured ESG-focused fixed income investment has been driven partly by growing regulation and a greater public awareness of ESG and risk-related factors among investors.

Yet he also points to increasingly compelling academic research that suggests ESG can make a difference at both an issuer level and in terms of positive performance and greater market engagement from global credit agencies on ESG and sustainability in fixed income.

“Now ESG is going mainstream and the link between ESG and bond performance appears to be firming up - especially as credit-rating agencies consider related factors in their fixed income risk assessments,” he adds.

Doing the right thing

Commenting on rising awareness of responsible investment and the need for good stewardship across the global investment industry, Freedman says companies and investment managers can no longer afford to ignore ESG considerations.

“Regulatory change means both companies and investors will increasingly need to take ESG into account. In many cases, ignoring environmental, social or governance issues is simply no longer an option. When ESG risks come to the forefront they really can have a material impact on bond performance.

“Issuers who ignore their stakeholders on specific ESG concerns can and do have their credit ratings downgraded and can quickly become investments to avoid. In fixed income investment, avoiding the losers is often equally as important for investors as picking the winners,” he adds.

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[1] Institutional asset manager. Social bond and sovereign green bond issuance surges. 30 June 2020.

[2] Worth.com. How to Keep Impact Investing Impactful. 27 July 2020.

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While equity investors can vote on the shares they hold, the potential influence of bondholders might appear less obvious. Yet Freedman insists fixed income investors can have considerable influence over issuers, particularly if they engage with them in a constructive way.

“While bondholders cannot vote shares they do not hold, they can and do engage with companies in other ways and can really influence issuers in order to make a positive difference. Investors can discuss relevant and material issues with companies and encourage them to improve in specific areas.”

Perhaps the most serious sanction bond holders can apply, he adds, is to restrict debt finance to companies which prompt more serious ESG concerns.

“In more serious cases, the denial of debt finance to companies falling short on E, S or G factors is a very powerful sanction in terms of corporate behaviour, especially for companies with weaker finances or less opportunities to raise capital in markets. Overall, though, we are seeing greater opportunity for investors to engage in bond markets and are noticing a change in corporate behaviour in areas like the energy sector.”

While corporate bond holdings offer opportunities to influence the behaviour of companies, Freedman also points to opportunities in the sovereign-bond sector and in issuance from supranational organisations whose bonds finance sustainable development in emerging economies.

“Investing in supranational organisations is one area of investment which is only available to fixed income investors. In some cases, it can provide a low risk way of investing in highly stable names while knowing their entire capital is helping to drive positive ESG outcomes,” he adds.

Pandemic legacy

While ESG rises rapidly up the investment agenda, Freedman believes the Covid-19 pandemic and its aftermath will leave a lasting legacy for global markets and could strengthen the need to adopt a fair and sustainable investment approach.

“The Covid-19 crisis has made social and economic concerns much more pressing than they were before the pandemic, and has really kick started some of the more recent green initiatives and perspectives we are seeing today. The pandemic has become a societal issue as governments and companies are asked to build a fairer economy.

“Going forward, issuers are likely to face increased scrutiny over how they dealt with the pandemic at its height, but also on whether they can sustain appropriate performance while supporting a broad range of stakeholders in what could prove to be a long, slow recovery,” he concludes.

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