ESG considerations in fixed income

Rapid expansion trend continues

Yoshie Phillips, CFA, Director of Investment Research

Fixed income market practitioners are evolving to integrate environmental, social and governance (ESG) factors and, at Russell Investments, we are witnessing a rapid expansion in the techniques used to further embed ESG into day-to-day practices. In this paper, we share some key ESG integration trends we are observing amongst these practitioners. These are derived through a combination of findings from our annual ESG Manager Survey as well as up-to-date discussions with some of the leading fixed income managers in the market. The topics covered here are:

1. ESG for fixed income investing
2. Sense of urgency / ESG journey
3. Data coverage availability
4. Engagement
5. Materiality
6. Regulation
7. Reporting
8. Climate-risk measures
9. Product offerings
10. Surge of labelled bond issuance

1. ESG for fixed income investing

Before diving into our observations, we believe it's helpful to compare the history of ESG considerations in fixed income investing to equity investing. The primary difference is the fiduciary duty associated with proxy voting and shareholder engagement (proxy and engagement) for equity investment managers.

The role of proxy and engagement has emerged as a major part of responsible investment practices. The idea that investors can influence the activity of their holdings had a slower uptake among many bond investors, where proxy voting isn't an option. Fixed income investment managers distanced themselves from the notion of engagement at first, while focusing more on integration. However, we have seen rapid shifts where fixed income managers are embracing an engagement practice that leverages some of the unique features of fixed income investing in a more implicit manner. We review this recent development later in this paper.

Fixed income investing is primarily focused on diversifying from and moderating the risks associated with equity investing - and this is true even for riskier securities such as high yield bonds and emerging market bonds. Downside protection is key to a successful bond investment programme. It is not surprising, then, that ESG considerations are mainly considered a risk mitigation exercise in fixed income investing. Furthermore, ESG issues and opportunities tend to have long-term effects that bode well for fixed income investing where the investment horizon is likely to be long-term.

2. ESG journey: A sense of urgency

Over the past couple of years, we have witnessed a rapid expansion in fixed income practitioners embracing ESG integration. Investor demands and regulatory requirements are rapidly shifting, and bond managers are being held to a rising standard. The degree of their progress varies, as do the starting points.

Market participants in Europe are leading in the integration of ESG practices, but other regions are trying to close the gap. Whilst ESG application is more advanced in the corporate credit market, in other fixed income market segments, including sovereign, securitised credit and municipal bond market, market practitioners are adopting the investment processes to better incorporate ESG inputs in those areas. The embracing of ESG integration has contributed to the expansion of ESG or sustainable fixed income product offerings. ESG integration and sustainable strategies are positioning themselves as mainstream offerings with similar risk and return objectives as the conventional bond strategies. ESG integration tries to incorporate ESG criteria into investment processes as an enhanced investment practice in the investment approach to identify risks and return opportunities. A sustainable approach typically seeks holistic ESG outcomes with additional sustainable criteria, such as better climate risk management, engagement focus and/or allocating a portion in environmentally and socially minded investment opportunity sets. Both ESG Integration and Sustainable strategies are seen in mainstream product offerings. Thematic/impact investing tries to capture measurable positive impacts to improve sustainable goals while seeking financial returns. The financial landscape has evolved and the bar for ESG integration continues to rise.

Exclusionary Screening	**ESG Integration**	**Sustainable**	**Thematic / Impact Investing**
Avoidance of companies in controversial sectors (e.g. weapons, tobacco, thermal coal). • Traditional Socially Responsible Investing (SRI)	ESG related inputs deeply embedded into the investment approach designed to improve the portfolio's potential risk and return profile in mainstream offerings. • Corporate Bond • Core Bond • Global Bond • High Yield Bond • Emerging Market Debt	ESG outcome is managed with the investment approach designed to improve the portfolio's potential risk and return profile in mainstream offerings. • Corporate Bond • Core Bond • Global Bond • High Yield Bond • Emerging Market Debt	Desire to capture measurable positive ESG impact which is central to the investment objective. • Green Bond • Impact Bond • Low Carbon Credit • Climate Transition Credit • Impact Municipal

Source: Russell Investments.

3. Data coverage availability

In the fixed income market, we have observed that the corporate credit market has been the first to broadly adopt ESG integration. This is understandable, given that corporate bonds are the closest to equities, allowing equity coverage in ESG considerations to be transferred over to the corporate credit market. Many credit market practitioners try to incorporate ESG considerations into their companies' credit analysis. Third-party ESG data providers such as MSCI and Sustainalytics also have greater ESG coverage for corporate bonds than for other debt markets. It is important to note that within the corporate bond world**, investment-grade-rated corporate bonds have wider ESG data coverage** than high yield bonds. The reason for this is that there are more privately held companies that are rated below investment-grade, where the disclosure requirements are less than those that are publicly traded. That is even more true in the leveraged loan market where privately held companies account for greater market share.

We have observed increased efforts to analyse ESG aspects of sovereign debt, followed by municipal and securitised markets over the past year. ESG considerations in corporate credit differ from sovereign bonds - the first is associated with companies, while the second is associated with governments that are more complex. The source of ESG-related information in sovereign debt is typically different from corporate credit. Furthermore, the consideration of ESG criteria to analyse countries is often different for developed market countries than emerging market countries.

Fixed income market practitioners continue to be challenged by data coverage and methodology for climate-related metrics outside of corporate credit. When compared to sovereign debt, corporate credit has a slower rate of change at the country level than at the company level, investors need to be mindful of the timeline associated with ESG considerations in sovereign bonds, compared to corporate bonds. Additionally, ESG application in securitised products lag other fixed income sub-asset classes. The lack of adequate data to analyse ESG-related information at the security level is the key challenge among securitised products market practitioners. However, there is strong momentum in establishing a robust framework for applying ESG considerations in the non-corporate credit market, including securitised products and municipal bond markets.

4. Engagement

For equity investors, active ownership is the use of shareholder rights to advocate for good corporate governance and to improve the long-term value of a company. Corporate engagement is a form of direct dialogue between an investor and the company in which they are invested. Active ownership often utilises engagement to seek its desired outcomes, so the term engagement has been a mainstream investment concept in equity investing for some time. We have now observed a rapidly growing trend of many fixed income market practitioners utilising the engagement terminology as a part of their ESG integration efforts.

While bondholders do not have voting rights per se, as capital providers to corporations, they do have a direct line of access and communication to company management. For example, the global bond market consists of over $70 trillion[i] of issuance; therefore, bond investors are substantial capital providers. Furthermore, many bond issuers are repeat issuers, meaning they come back to the capital market regularly - an incentive for companies to engage with bond investors. In our 2020 Annual ESG Manager Survey, we asked market practitioners to state how often they engage with underlying companies in relation to ESG issues.[ii] Our findings show that 92% of market practitioners who invest in bond offerings claim that they often or always discuss ESG topics, when they interface with companies they are invested in[iii]. The heightened market interest in ESG considerations has led many underlying companies to be more amenable to proactively discussing ESG related topics. While the explicit limitation exists for bondholders who are without proxy voting, the influential power of bondholders appears to be expanding. Bond investors often report their engagement activities with case studies. Successful bondholder engagement case studies include encouraging label bond issuance, greater transparency and disclosure, especially among privately held companies, pressuring board membership composition for privately held companies and/or encouraging net zero initiatives. In order to demonstrate effective bondholder engagement practices, it is important to establish a framework on how to prioritise the objectives of specific engagement activities and be able to monitor and report such activity outcomes.

We have observed that those investors who also have equity offerings leverage their equity counterparts to increase influence when engaging with the underlying companies. Some bond managers who have limited or no equity offering try to partner with other bond managers to increase influence. Climate Action 100+, an investor-led climate engagement coalition launched in 2017, helps facilitate such bond managers to coordinate the engagement activities with other investors[iv] - referred to as collaborative engagement. As the importance of active ownership continues to increase, so will the consensus among investors to incorporate active management across all asset classes.

Market practitioners have a pivotal and vital role to play in the quality of active management taking place - ensuring value-adding conversations are happening between investment practitioners and the companies in which they are invested. As we move forward, standout approaches will be able to demonstrate clear methodologies, articulate a best practice and demonstrate effective engagement practices.

[i] Bloomberg Barclays Multiverse as of 30 April 2021.

[ii] Phillips, Y. (2020). “2020 Annual ESG Manager Survey”, Russell Investments Research. Available at: https://russellinvestments.com/-/media/files/au/about-us/responsible-investing/esg-manager-survey-results-2019-aus.pdf

[iii] See endnote ii.

[iv] Russell Investments is a Climate Action 100+ signatory since 2020. http://www.climateaction100.org

5. Materiality

Market practitioners are increasingly incorporating quantitative or metric-driven ESG data into their investment processes, with materiality assessments being the key focus. We have observed that an increased number of fixed income market practitioners are subscribing to third-party ESG data providers. The common external quantitative ESG data providers include MSCI, Sustainalytics, RepRisk, Verisk Maplecroft and Trucost. In addition, credit rating agencies, such as Moody's and S&P, are increasing their efforts to identify ESG risks as supplemental information to their credit analysis. We've observed that many bond managers utilise this third-party data as inputs, using their fundamental analysis to form their own ESG insights. In doing so, materiality assessments on ESG issues continue to play an essential role when incorporating ESG considerations into their security level analysis. The Sustainability Accounting Standard Board (SASB) framework remains the most widely accepted standard in industry-specific materiality mapping, as the materiality of ESG factors vary by sector. For instance, carbon intense sectors, (i.e., utility, mining, steel, cement and energy sectors) have greater environmental considerations, while social concerns (i.e., data privacy and security) are more material for banks and technology companies. That said, many fixed income asset managers are modifying the SASB framework to focus on fixed income specific considerations to assess the financial materiality of ESG-related issues with forward-looking views.

Outside of the corporate credit market, well-established materiality guidelines remain absent for sectors such as sovereign debt, securitised credit and municipal bonds. Despite ESG application being embraced within fixed income, consistency in the approach still has a long way to go.

6. Regulation

Regulators around the globe are playing a vital role in how the investment industry is incorporating ESG practices. European regulators have introduced the Sustainable Finance Disclosure Regulation (SFDR) in an attempt to increase the transparency and accountability of investments that claim to have ESG or sustainability objectives. The SFDR requires asset managers in Europe to disclose how sustainability risks are incorporated into their investment decision-making process. Additionally, the European regulator has established a classification framework - EU Taxonomy - to determine whether economic activity is an Environmentally Sustainable Investment. In order to be deemed an Environmentally Sustainable Investment, economic activity must meet four criteria. Find out more about SFDR and Taxonomy here.

There is ever-growing global support to tackle climate risk and while Europe has led the way in regulations to tackle ESG measures, there are signs that other regions, like the U.S., are following a similar path towards developing taxonomies and standards. Increased regulations which focus on transparency, disclosure and use of common language in sustainable investing assist in the global standardisation of the ever-evolving ESG practices. At the same time, reportable data gaps exist in the fixed income market around ESG considerations. Bond investors are trying to comply with regulations, despite the data not being readily available for certain fixed income segments.

7. Reporting

The increased regulation on ESG disclosure obligations is accelerating the demand for metrics-driven portfolio transparency and reporting. Reporting is generally two-fold: one for ESG criteria more broadly and the other for climate-risk measures such as carbon footprint and preparedness, for the transition to a low-carbon economy. Both regulators and asset owners are demanding greater transparency around ESG considerations in portfolios through reporting. The forms of ESG reporting continue to evolve and still vary by asset managers. Furthermore, each asset owner can have varying preferences in the ESG reporting content, adding further to the complexity. Today, there is no standardisation in ESG reporting, whereas many asset managers are trying to build infrastructure to offer customisation.

The consideration of ESG factors varies amongst individuals. As an example, from a value-based standpoint, investors might prioritise social issues (i.e., labour practices and data security) - whilst others might prioritise governance issues (i.e., executive compensation, internal controls and shareholder rights). Some investors prioritise diversity and inclusion aspects. We are currently witnessing a vast interest in environmental issues, especially around climate risk measures.

Furthermore, the measurement of ESG criteria within a portfolio varies. A number of market practitioners reference external vendor (data provider) inputs, which often take snapshot views, then augment them within their forward-looking assessments, which might result in varying observations from the vendor's conclusion. Since vendors and market practitioners express ESG outputs differently, it is understandable that investors request their criteria in order to facilitate comparison. Some market practitioners even appear to support this effort themselves: providing ESG scores from an external vendor, such as MSCI, even though they have their interpretation of ESG outputs. The stated rationale for this being that it facilitates easier comparison from market practitioner A to B. Reporting ESG criteria is a major topic in ESG investing and will continue to evolve.

8. Climate risk measures

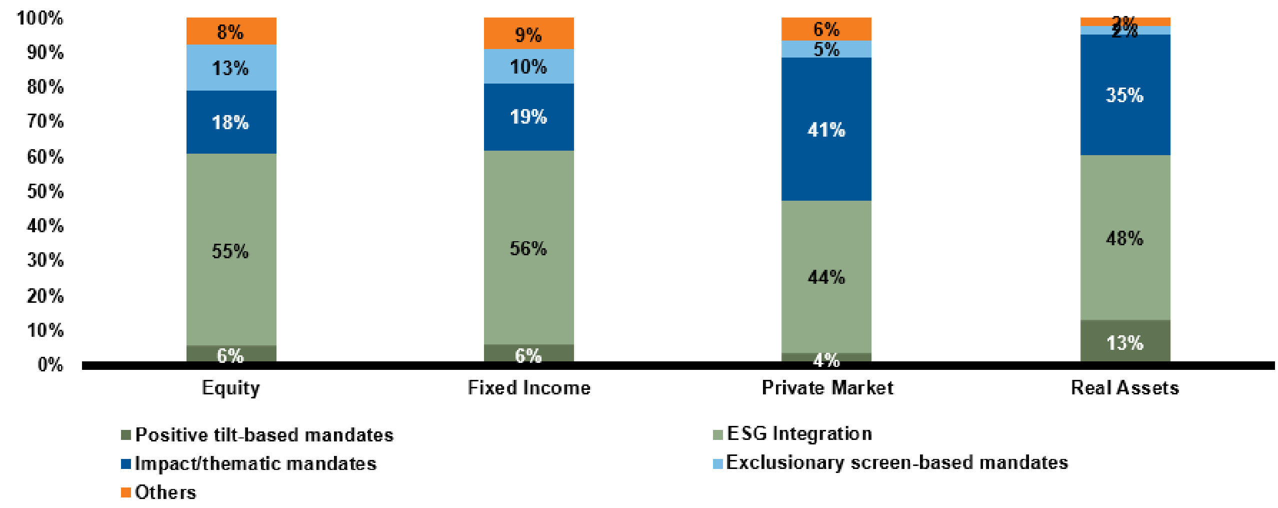
The increased pressure to tackle climate risk through climate risk disclosures is resulting in the climate-related reporting format generating a lot of attention. Third-party data providers continue to expand their reporting capabilities around the measurement of greenhouse gas (GHG) emissions – specifically where it connects to the global transition pathway required to limit global warming to below two degrees Celsius (signed under the Paris Agreement). Climate risk can be segregated into physical risk – referring to climate-related damage that impacts asset prices - and transition risk – referring to those arising from the shift toward a low-carbon economy. The Task Force on Climate-Related Financial Disclosures (TCFD) guidelines detail how to disaggregate the transition and physical risks, yet some of these risks are challenging to quantify. At Russell Investments, we have committed to the Net Zero Initiative to support the goal of net zero greenhouse gas emissions by 2050. The net zero initiative encourages all financial market participants to evaluate the current status of their existing portfolio offerings, their engagement activities toward net zero, and forward-looking climate transition plans. Asset owners are increasingly interested in the transparency of how the portfolios they invest in are aligned with the Paris Agreement to address climate risk. Climate risk measures continue to expand and evolve. This is expected to be the key evolution in sustainable investing.

9. Product offerings

Our 2020 ESG Manager Survey results show ESG-related product expansion across asset classes, with an increased number of assets being deployed into ESG and responsible investing specific strategy offerings. In order to gain a deeper understanding of these strategy offerings, we asked asset managers to identify the types of ESG or sustainability-labelled strategies they currently offer (including exclusionary screen-based, ESG integration, best-in-class/positive tilt-based and impact/thematic strategies) in our annual ESG survey across asset classes. We also asked which type of strategies asset managers are seeing the most interest and asset growth in over the past 12 months. The results show proportionally more demand in ESG integration strategies, which are often mainstream strategies that are benchmarked against traditional indices, such as the Bloomberg Barclays Global Aggregate and U.S. Aggregate Indices. This suggests investors are looking to substitute existing core allocations with ESG approachable strategies.

Additionally, the interest for impact/thematic strategies in fixed income offerings also increased, as shown below in exhibit 3. Among impact strategies, green bonds, United Nations Sustainable Developments Goals (SDGs) and low carbon solutions are the most popular impact strategies that we have seen in the fixed income strategy expansion. We expect to see this growth trend for products with sustainable goals continue.

Exhibit 1: Types of ESG / responsible investing products with the most interest and/or asset growth over the past 12 months



Source: Russell Investments 2020 Annual ESG Manager Survey.

10. A surge of labelled bond issuance

Bonds with specific environmental and/or social objectives are referred to as impact bonds or labelled bonds. The labelled bond market has seen explosive growth in issuance over the past two years. In the first four months of 2021, labelled bond issuance reached over $340 billion, compared to roughly $500 billion in the 2020 full year issuance volume. The labelled bond market has four primary categories: green bonds, social bonds, sustainability bonds and sustainability-linked bonds.

1. **Green bonds** aim to focus on the transition toward a low carbon economy and are the largest component of the labelled bond market. Green bonds are bonds issued by countries or companies with the proceeds targeting specific environmental projects and opportunities.
2. **Social bonds** focus on social impact, including affordable housing, access to finance, and/or supporting small businesses. Social bond issuance has surged since the COVID-19 crisis, as the pandemic brought heightened attention to the importance of social issues.
3. **Sustainability bonds** target a combination of green and social goals. We have observed that such sustainability bond offerings tend to link their investment opportunities with the United Nation's Sustainable Development Goals (SDGs).
4. **Sustainability-linked bonds** have their coupons linked to the issuers reaching specific environmental or social targets or Key Performance Indicators (KPIs). If an issuer fails to reach these targets by a given date, the coupon steps up or additional payment is due at maturity.

The key features in green bond, social bond or sustainable bond investing are to understand how the proceeds are used and to monitor the actual versus stated objectives. In the case of green bonds, the International Capital Market Association Green Bond Principles aims to provide a guideline for the use of the proceed definitions. However, there is much subjectivity in the definition of what qualifies as green bonds in the marketplace. In order to address this challenge, there is a growing number of independent opinion providers, such as Vigeo Eiris and Cicero, to evaluate such green bond programmes. Audit firms are often involved in verifying the traceability of funds to the specified projects. Regular reporting is also required to list green projects and disclose certain impact measures (e.g., energy savings and how much GHG was reduced). Having a well-defined investment framework, infrastructure to exploit the market and reporting are important considerations in impact investing. The need for portfolio transparency is greater for such impact investing.

The sustainability-linked bonds, on the other hand, are not tied to specific projects and can be used for general corporate purposes. Sustainability-linked bonds are new instruments in the impact bond market and remain relatively small in volume, compared to other impact categories. Such bond issuers favour sustainability-linked bonds due to flexibility – they do not have to tie to specific projects and are not rigid in how the proceeds are used, while still showing their commitments to specific environmental or social outcomes. It is important to watch out for self-labelling, in terms of establishing KPIs. Some KPIs might not make much difference in the company becoming more sustainable as the KPIs might not have material impacts. Green bonds offer greater transparency in how the use of proceeds is applied. The sustainability-linked bonds offer scientific-based measures for bond issuers. Each offers its own merits, and we will likely see the evolution of impact bond features.

Additionally, the valuation of the labelled bond is worth highlighting. The surge in labelled bond issuance was driven by strong demand. In fact, the demand has been so strong that the spreads between labelled and unlabelled bonds for the same company are showing a clear trend. Labelled bonds are often slightly more expensive than unlabelled bonds – referred to in the market as the *greenium*. This is likely due to the proliferation of ESG product offerings that prefer to invest in labelled bonds, creating a supply/demand imbalance that influences price. Therefore, the labelled bond market is expected to continue to grow.

Summary and conclusions

The incorporation of ESG into investment practice continues to expand, and many fixed income market practitioners are embracing the ESG journey as a key initiative. While the starting point varies, engagement is becoming a key information source to analyse investment opportunities. The impact bond market is exploding with the supply/demand imbalance – due to the rapid expansion in ESG considerations, the bar has risen for all practitioners. We believe that regulation is driving much of the adoption of ESG practices, with Europe leading.

ESG specific information is increasingly available in the overall marketplace, yet this is scarcer in some areas of fixed income markets. The access to ESG related data and the means to digest such information into an investment process continues to evolve. Alongside the lack of ESG related data, asset owners are demanding greater transparency around ESG considerations in their portfolios through reporting. Ultimately, asset owners want greater transparency regarding the link between portfolios and climate risk; yet how to respond to this aspirational goal continues to evolve. Reporting ESG and climate risk criteria is a major topic in ESG investing and will continue to develop.

Responsible investing product offerings continue to expand around the globe into the mainstream. The labelled bond market has seen explosive growth in issuance across four primary categories: green bonds, social bonds, sustainability bonds and sustainability-linked bonds. Green bonds offer greater transparency in regard to how the use of proceeds are applied. Sustainability-linked bonds offer scientific-based measures for bond issuers. Yet, each offers its own merits and challenges. The proliferation of ESG product offerings is creating a supply/demand imbalance with *greenium*.

Since 2014, Russell Investments has formally been covering ESG considerations as a part of our strategy evaluation process. Our 2020 Annual ESG Manager Survey found a high level of ESG awareness and an increase of ESG factor integration among the respondents. The concept of ESG integration is to provide a more comprehensive picture in analysing underlying companies, as a part of enhanced security analyses. The 2020 ESG Manager Survey results provide a more in-depth understanding of asset managers' ESG integration framework for our manager strategy evaluation.

To conclude, the incorporation of ESG factors has now reached the stage of universal recognition in terms of its importance to asset owners and the investment management community. The role of engagement is gaining ground among bondholders in an attempt to seek outcomes with sustainable goals. The methods of implementation continue to vary, a clear best practice is dependent upon the asset type and practitioner, whilst identifying a common reporting mechanism has a long way to go. As we move forward, standout approaches will be able to demonstrate leading implementation methodologies, articulate a best practice and define useful and informative metrics that are broadly recognised by investors as effective implementations of ESG considerations.

Russell Investments' commitment to responsible investing

As a global investment solutions provider, we believe that transparency and investing responsibly can help deliver attractive investment returns and meet client objectives in the long-term. We collaborate with organisations that establish and drive responsible investment practices.

KEY STATISTICS

7 Years of ESG integration	**37** Global ESG specialists[v]	**$47 billion** Global assets in ESG approach	**85** Years in business	**ESG Score** For all formally ranked products	**Stewardship codes** Global application of and commitment to the UK and Japan Stewardship Codes

Since 2009 UN-PRI signatory	**400** Global asset managers participated in our 2020 ESG Manager Survey	**94,598 Proxy votes** Made at 9,547 meeting in 2020[vi]	**Proprietary** Investment tools and frameworks	**52** Years in institutional investment consulting / manager research	**10,810** Votes against management	**6** Years of the Russell Investments Annual ESG Manager Survey

Signatory of:

Source: Russell Investments as at 31 March 2021.

[v] Includes proxy voting and engagement committee, as at 31 March 2021.
[vi] Russell Investments' 2020 Proxy and Engagement Report.

For more information

Call Russell Investments at **612 9229 5111** or

visit **russellinvestments.com.au**

Important information