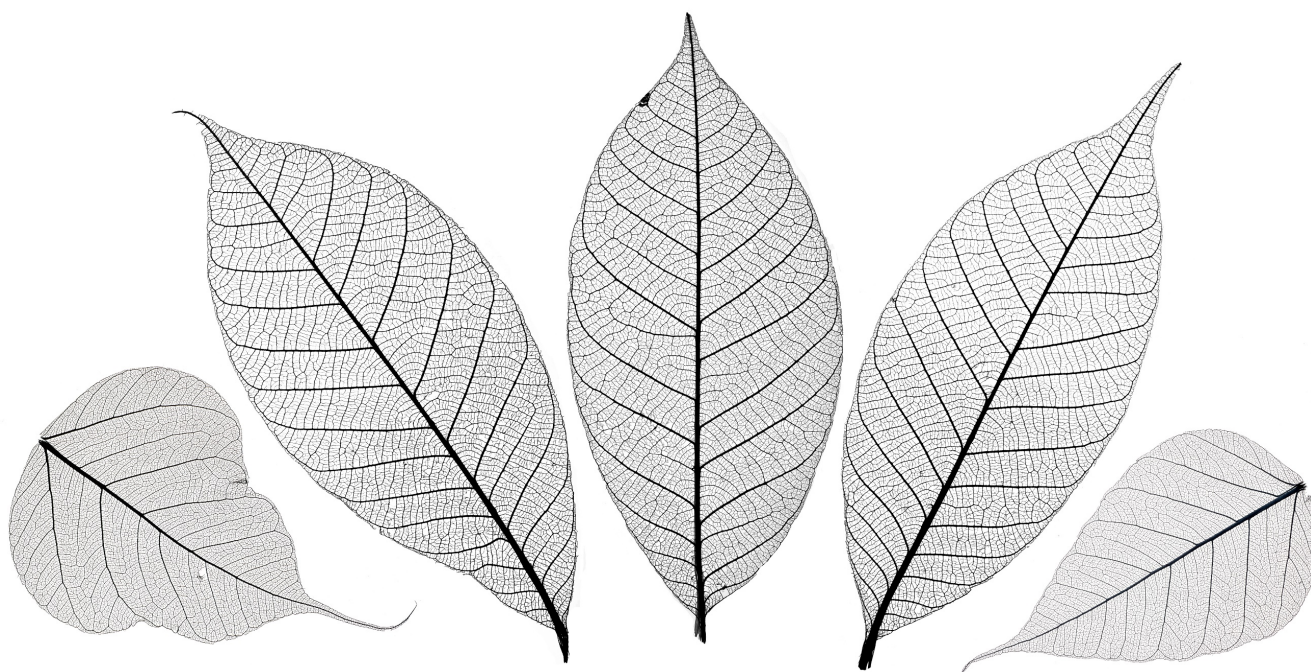




ESG considerations in fixed income



Observation of 10 ESG integration trends



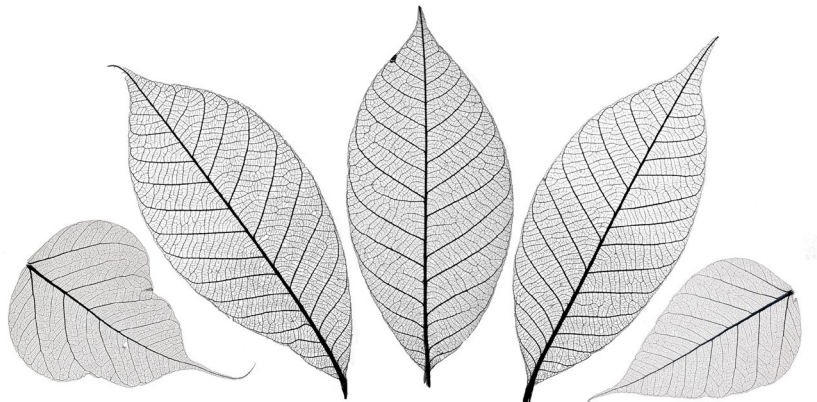
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ESG considerations in fixed income

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Since 2014, Russell Investments has formally incorporated environmental, social and governance (ESG) factors into our investment process, including fixed income research. As a component of our manager research process, manager research analysts assign an ESG rank to individual strategies. Our observations of market trends assist us in identifying leading market practitioners around ESG considerations and implementations in their investment processes.

ESG criteria have become important considerations across the global investment community. While ESG was initially a hot topic for equity investors, fixed income market investors are taking notice and practitioners are quickly catching up. Russell Investments has observed the rapid expansion in ESG integration practice among fixed income asset managers in recent years. We have observed that fixed income market practitioners are embracing the ESG integration with a sense of urgency.

In this paper, we aim to share some key ESG integration trends we see among the fixed income market practitioners. Our observations derived from the findings from our 2019 Annual ESG Manager Survey and discussions with a number of fixed income market practitioners. The topics are:

- | | |
|--|--------------------------------------|
| 1. ESG for fixed income investing | 6. ESG data integration |
| 2. Sense of urgency | 7. Reporting |
| 3. ESG data coverage availability | 8. Climate-related reporting |
| 4. Engagement in fixed income | 9. Product offerings |
| 5. ESG team vs. integrated investment team | 10. Impact investing in fixed income |

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 “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 some indications that fixed income managers are finding their way into 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 note.


 *The primary difference [with fixed income investing] is the fiduciary duty associated with proxy voting and shareholder engagement...*

Exhibit 1 highlights some key differences between ESG integration for equities and fixed income instruments. Because fixed income investing is primarily about diversifying from and moderating the risks associated with equity investing - and this is true even for the more risky securities such as high yield bonds and emerging market bonds - downside protection is the key to a successful bond investment program. It is not surprising, then, that ESG considerations are mainly considered a risk mitigation exercise in fixed income investing. ESG factors tend to have a long-term outcome that corresponds well for fixed income investing where the investment horizon also tends to be long-term.

Exhibit 1: Key differences between ESG integration for equities and fixed income instruments

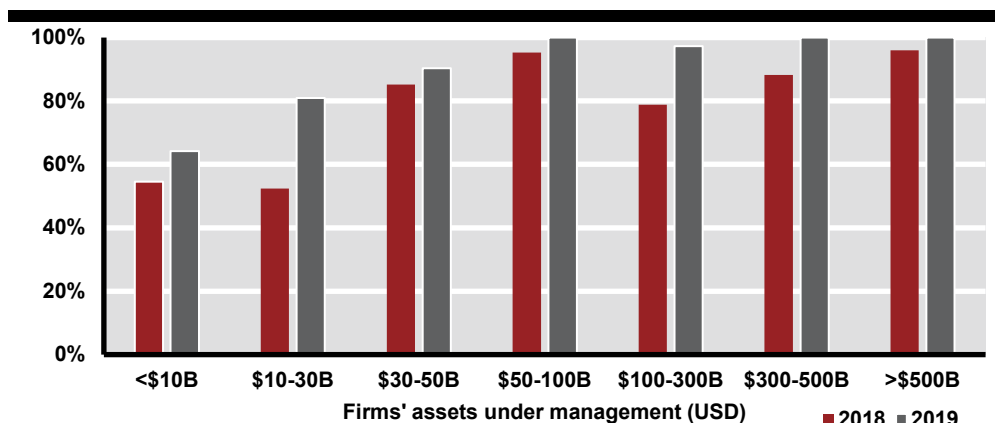
ESG INTEGRATION	EQUITIES	FIXED INCOME
Entities	Public corporation	Public or private corporation, Sovereign
Investment analysis	Fundamental (i.e., one stock price)	Multi-layered (i.e., fundamental, maturity, yield, capital structure)
Status	Owner with voting rights	Lender with credit terms
Trading	Exchange	OTC & exchange
Performance	Upside return potential & downside risk mitigation	Downside risk mitigation
Engagement	Explicit	Implicit

“ Because fixed income investing is primarily about diversifying from and moderating the risks associated with equity investing...down side protection is the key to a successful bond investment program.

2. Sense of urgency

Over the past couple of years, we saw a rapid expansion in fixed income practitioners embracing ESG integration. The degree of their progress varies, as do the starting points. Following the Russell Investments 2019 ESG Manager Survey, we continue to observe a clear pattern of ESG integration across regions and the level of assets under management. The market practitioners based in the United States have progressed the least when compared to practitioners based in continental Europe, the United Kingdom, Australia and New Zealand. Firms with a smaller asset base also lagged those with larger assets in general. However, we're seeing more U.S.-based firms and/or smaller asset base managers playing catch up in establishing their responsible investment policy implementation and process in more recent years (see Exhibit 2). The sense of urgency has heightened this past year among fixed income market practitioners. The playing field has evolved and the bar of ESG integration has risen.

Exhibit 2: Firms with responsible investment policies



Source: Russell Investments 2019 Annual ESG Manager Survey.

3. ESG data coverage availability

Within the fixed income market, we've observed that ESG integration has been more broadly adapted in the corporate credit market at first. This is understandable, given corporate bonds are the closest to equities, which allow equity coverage in ESG considerations to be transported into the corporate credit market. Many credit market practitioners try to incorporate ESG considerations into their companies' credit analyses. Third-party ESG data providers, such as MSCI and Sustainalytics, also had greater ESG coverage for corporate bonds than for the rest of the fixed income markets.

Within the corporate bond world, investment grade rated corporate bonds have wider ESG data coverage than high yield bonds. This is mainly because there are more privately-held companies that are rated below investment grades where the disclosure requirements are less than those that are publicly traded. We have observed increased efforts to analyse ESG aspects in sovereign debts, followed by municipal and securitised markets over the past year.

ESG considerations in corporate credit differ from sovereign bonds because the first is associated with companies while the second is associated with governments that become even more complex. Furthermore, change is slower at the country level than at the company level, so investors need to be mindful of the timeline associated with ESG considerations in sovereign levels compared to corporate levels. While there are not set standards in how market practitioners apply ESG considerations in corporate credit analyses, Sustainability Accounting Standard Board's (SASB) standards to assess materiality of ESG considerations are assisting the market practitioners in establishing the ESG integration framework. On the other hand, sovereign debt analyses lack such well-established guidelines.

“ Within the fixed income market, we've observed that ESG integration has been more broadly adapted in the corporate credit market at first.

4. Engagement in fixed income

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 direct dialogue between an investor and the company in which the asset owner or market practitioners are invested. Active ownership often uses engagement to seek its desirable outcomes, so the term “engagement” has

been a mainstream investment concept in equity investing. However, we have observed a trend where many fixed income market practitioners have started to use the engagement terminology as a part of their ESG integration efforts. So, we'd like to take a moment to discuss the engagement implications in fixed income investing.

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 management. For instance, the global bond market consists of over \$60 trillion¹ in market capitalisation. In our [2019 Annual ESG Manager Survey](#), we asked market practitioners to state how often they engage with underlying companies related to ESG issues.² We saw 89% of market practitioners with both equity and bond offerings and 71% of market practitioners with bond-only offerings claim they often or always discuss ESG topics when they interface with companies they are invested in³. The heightened market interest in ESG considerations has led many underlying companies to be more amenable to proactively discussing ESG related topics.

That said, the explicit limitation exists for bondholders who are without proxy voting. We believe that when market practitioners simply raise an ESG topic to the underlying companies, it is not necessarily sufficient to call it "engagement". The reality is that bondholders can only express ESG topics in the underwriting process by putting some ESG provisions in the credit agreement at pre-new issuance, which occurs infrequently. What we have observed is that the fixed income market practitioners with equity offerings leverage their equity counterparts to increase influence when engaging with the underlying companies. And 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 investors⁴.

5. ESG team vs. integrated investment team


Many market practitioners have an ESG or responsible investing team that is distinct from their investment team. Many firms are ramping up dedicated efforts in ESG initiatives and are adding resources to the ESG team, especially those firms with a larger asset base. The whole industry is moving towards embracing ESG awareness as part of a broader investment analysis. Therefore, boosting ESG resources makes sense in order to achieve scale and expertise.

In the past, we saw many dedicated ESG professionals coming from the business side, as opposed to the investment side. In addition, we saw many market practitioners treating the information from the ESG team as an additional screening overlay onto the investment practice. In another words, a separation of responsibilities meant that the ESG team covered ESG specific considerations while the investment team focused on traditional aspects in analysing companies.

Investment practitioners with a large asset base more often have a separate ESG team, whilst smaller asset-based firms tend to leverage an existing investment team for conducting ESG-related investment analysis. This makes sense as larger firms might be able to better afford such resources. However, we have also seen a greater segregation between the ESG and investment team on many occasions. We acknowledge the merits of having a dedicated ESG team because it allows such asset firms to better digest a vast range of ESG-related information. However, the benefit of having a separate ESG team really depends on how well the ESG team integrates with the investment team and how ESG information gets translated into one's investment decision-making.



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Now we are seeing increased collaboration between ESG teams and investment teams for many firms. The portfolio managers and analysts are increasingly aware of ESG risks and opportunities when considering investment decisions. This evolution is due to the awareness that ESG considerations are important to investment practice and risk management. ESG considerations often infrequently “make or break” a security selection, unless materiality assessments are high, but the influence of that information is becoming more apparent. At the same time, the level of ESG integration among investment decision-makers still varies, mainly because the level of conviction in how ESG impacts investment propositions differs. This conviction variance contributes to how well the separate ESG team working well with the investment team.

For the larger firms with separate ESG teams, we look for evidence that the separate team is influential in security selection and portfolio construction, while assuring that the importance of investment value is still the top consideration. For smaller firms adopting the integrated approach, the challenge is to demonstrate that the investment team is digesting those broader ESG considerations in an identifiable way.

6. ESG data integration

Market practitioners are increasingly incorporating quantitative or metric-driven ESG data into their investment processes. We’ve observed that more fixed income market practitioners are subscribing to third-party ESG data providers. The most common external quantitative ESG data providers are MSCI, Sustainalytics, Bloomberg and ISS-oekom. In addition, credit rating agencies, such as Moody’s and S&P, are increasing their efforts to identify ESG risks as a supplemental information in their credit analysis. ESG specific data is increasingly available in the marketplace, and our [Annual ESG Manager Survey](#) showed that market practitioners are primarily using a combination of internally produced and externally provided ESG data⁵ when making investment decisions. The survey also found that only a small portion of market practitioners rely solely on third-part data. In other words, many asset managers use third-party data as inputs and form their own ESG insights.

7. Reporting

Demand for metrics-driven reporting is generally two-fold: one for ESG criteria broadly and the other for climate-change related metrics such as carbon footprint. Asset owners are increasingly demanding greater transparency around ESG considerations in their portfolios through reporting. As such, market practitioners are faced with a scaling challenge, because reporting formats often vary according to each asset owner’s content preferences. There is no standard in ESG reporting.

This non-consensus is understandable as ESG means different things to different people. From a value-based difference standpoint, some investors might care more about social issues, such as labour practices and data security, while others care more about governance issues, such as executive compensation, internal controls and shareholder rights. At the same time, there is a mounting interest in environmental issues, especially around climate change. Furthermore, many market practitioners measure ESG criteria in their portfolios differently. Some practitioners incorporate third-party ESG data provider to help form their ESG insights. Many market practitioners reference the vendor inputs then augment them within their own assessments, which might result in different observations from the vendor’s conclusion. Because vendors and market practitioners express ESG outputs

In other words, many asset managers utilise third-party data as inputs and form their own ESG insights.

Asset owners are increasingly demanding greater transparency around ESG considerations in their portfolios through reporting.

differently, it is understandable that investors request their own 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 own interpretation of ESG. The stated rationale for this being that it facilitates easier comparison from market practitioner A to practitioner B. Reporting ESG criteria is a major topic in ESG investing and will certainly continue to evolve.

8. Climate-related reporting

As for reporting the linkage between portfolios and climate change specifically, a clear standard format is lacking. Many market practitioners report relative carbon footprint, such as tons of CO₂-equivalent emission per revenue dollar. Some practitioners report projected annual CO₂ emissions savings. Third-party data providers continue to expand their reporting capabilities around measuring greenhouse gas (GHG) emissions, particularly connecting to the global transition pathway required to limit global warming to below two degrees Celsius.

According to our 2019 [ESG survey](#), climate reporting efforts have expanded in the last year. Financial Stability Board (FSB) introduced the industry-led Task Force on climate-related Financial Disclosures (TCFD)⁶ to encourage climate-related financial disclosures. As of December 2019, there were over 930 organisations around the globe supporting the TCFD, which represents over \$11 trillion in market capitalisation.⁷ For PRI signatories, a continuously expanding portion of investment practitioners, TCFD-based reporting becomes mandatory in 2020. In 2017, the TCFD released recommendations, specifying how asset owners and asset managers should report climate-related financial disclosures. At the same time, market practitioners are digesting and evaluating how to address the TCFD reporting, in many cases realising that additional resourcing will be required to meet the reporting requirements. We expect climate-related reporting to receive a fair degree of attention in 2020.

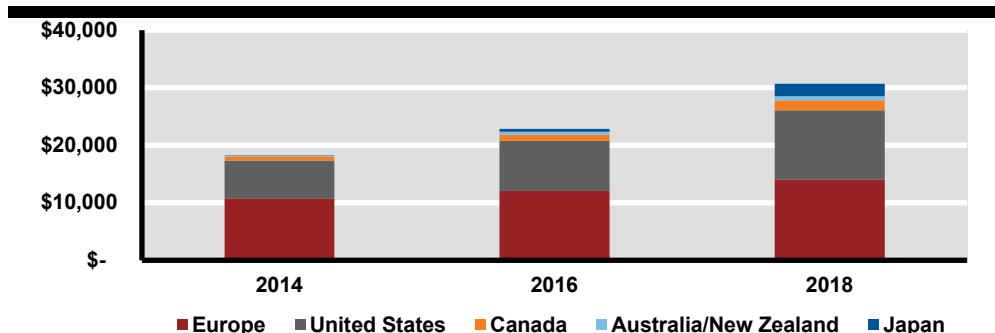


We expect climate-related reporting to receive a fair degree of attention in 2020.

9. Product offerings

Responsible investing product offerings continue to expand around the globe. Exhibit 3 shows that sustainable investing assets have seen tremendous growth over the past several years. The scale of sustainable investments notably increased from 2016 to 2018. In 2016, European investments accounted for more than half of the total. Subsequently, however, sustainable investments in the U.S. and Japan grew. Active sustainable investments have turned into a global trend.

Exhibit 3: Global sustainable investing assets

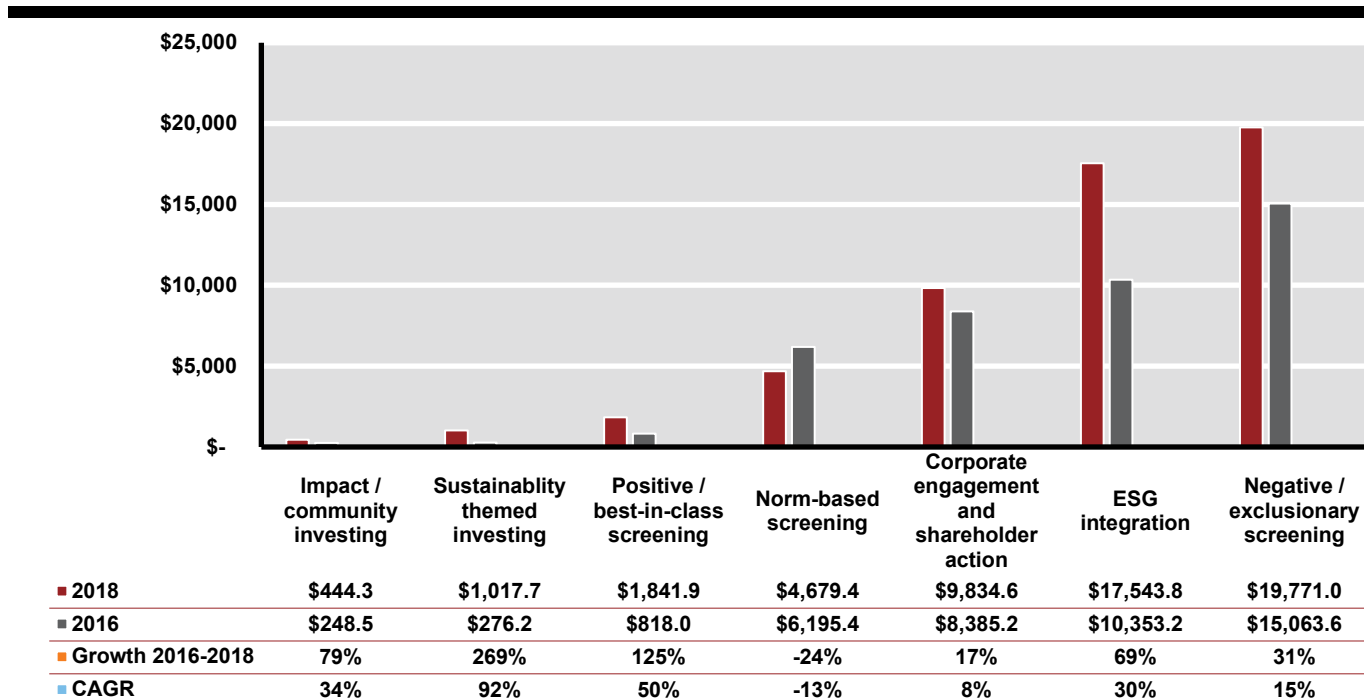


Source: Global Sustainable Investment Alliance, "Global Sustainable Investment Review" (2016 and 2018). All assets are converted to U.S. dollars at the exchange rates at each previous year-end.

Exhibit 3 shows that sustainable investing assets have seen tremendous growth over the past several years.

To dig deeper into the sustainable investing strategy offerings, Exhibit 4 shows the types of sustainable investing strategies offered. The largest category for the sustainable investing strategies is negative/exclusionary screening. At the same time, the ESG integration category has seen a much greater growth rate than screen-based offerings in recent years. Furthermore, themed investing has seen the highest growth, exceeding both screen-based and ESG integration categories. This is in-line with our observation that market practitioners are launching responsible investing strategies that have targeted sustainable goals, such as following Sustainable Development Goals (SDGs). We expect to see this growth trend for products with sustainable goals continue.

Exhibit 4: Global growth of sustainable investing strategies (2016-2018)



Source: Global Sustainable Investment Alliance, "Global Sustainable Investment Review" (2016 and 2018). All assets are converted to U.S. dollars at the exchange rates at each previous year-end.

10. Impact investing in fixed income

Impact investing in the fixed income market has been relatively small but is growing across three primary categories: green bonds, social bonds and sustainability bonds.

1. **Green bonds** aim to focus on transition toward a low carbon economy and is a leading impact solution within the fixed income market. Green bonds are bonds issued by countries or companies with the proceeds targeting environmental projects and opportunities.
2. **Social bonds** focus on non-environmental impact, including affordable housing, access to finance, and/or supporting small businesses.
3. **Sustainability bonds** are quickly evolving and 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 SDGs.

The key features in impact 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 aim to provide guideline for the use of proceed definition. 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 programs. Audit firms often get involved in verifying 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, how much GHG was reduced, etc). Having a well-defined investment framework of one's investment opportunity set, infrastructure to exploit the market and reporting are important considerations in impact investing.



The key features in impact investing are to understand how the proceeds are used and to monitor the actual versus stated objectives.

Summary and conclusions


The integration of ESG into investment practice is rapidly evolving for fixed income investors, and many market practitioners are embracing the agenda as a key initiative. While the starting point varies for each market practitioner, the whole market is adjusting. Key areas of advancement we've noted are through additional resources, data availability and establishing, or further enhancing, investment frameworks around ESG considerations. Because of this rapid evolution, the bar has risen for all practitioners.

ESG specific information is increasingly available in the marketplace. Getting access to ESG related data and digesting such information into one's investment process are an evolving investment practice. Along with increased scrutiny, asset owners are demanding greater transparency around ESG considerations in their portfolios through reporting. Ultimately, asset owners want greater transparency regarding the linkage between the portfolios and climate change; yet how to respond to this aspirational goal is not yet clear and a standard format does not currently exist. Reporting ESG criteria is a major topic in ESG investing and will certainly continue to evolve.

Responsible investing product offerings continue to expand around the globe. Impact investing in the fixed income market has been relatively small but is growing across three primary categories: green bonds, social bonds and sustainability bonds. The portfolio transparency ask is greater for such impact investing. Definitional challenge continues to exist for impact investing.

Since 2014, Russell Investments has formally been covering ESG considerations as a part of our strategy evaluation process. Our 2019 Annual ESG Manager Survey found a high level of ESG awareness and an increase of ESG factors integration among the respondents. The concept of ESG integration is evolving to provide a more comprehensive pictures in analysing underlying companies, in addition to traditional security analyses. The ESG survey results provide more in-depth understanding of asset managers' ESG integration framework for our manager strategy evaluation.

ESG 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 and 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.



ESG has now reached the stage of universal recognition in terms of its importance to asset owners and the investment management community.

¹ Bloomberg Barclays Multiverse as of 31 December 2019.

² Phillips, Y. (2019). "2019 Annual ESG Manager Survey", *Russell Investments Research*. Available at: <https://russellinvestments.com/uk/insights/esg-survey>

³ See endnote 2.

⁴ Russell Investments is a Climate Action 100+ signatory since 2020. <http://www.climateaction100.org>

⁵ See endnote 2.

⁶ Russell Investments is a PRI signatory since 2009 and a supporter of TCFD since 2019.

⁷ Financial Stability Board.

About Russell Investments

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For more information

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