Viewpoint

ESG in Corporate Credit – Creating Better Outcomes

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Can socially responsible investing enhance returns in corporate credit?

Environmental, Social and Governance (ESG) investing is a relatively new, but fast-growing feature of fixed income investing. Investors are becoming more aware of the possible benefits of applying ESG factors into their portfolios, as well as their own social responsibilities.

As a result, we are seeing a rapid increase in demand for more ESG-oriented strategies from institutional investors. In our view, including ESG considerations in portfolio construction does not (as many might think) result in sub-optimal financial returns.

In our experience, companies with good governance structures, strong employee and community relations and responsible environmental policies can deliver long-term investment performance.

Creating Positive Outcomes

ESG investing is less established in fixed income than equities and assets under management remain lower in fixed income.

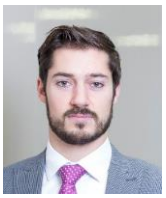
However, whilst shareholder activism and voting may appear to make ESG factors easier to implement from an equity perspective, we believe bondholders can also be effective advocates of change. Bondholders are often sizable lenders on a corporate's balance sheet (for example we can own up to 10-15% of a bond issue), which can give them considerable influence.

Companies that require regular bond market funding are also more likely to adhere to bondholder demands, especially when made by increasing numbers of investors. Thus it is important investors make their views known and clear to companies to initiate positive change.

Issuers are also incentivised to lower their funding costs by aligning their needs with investors; if investors want more ESG awareness in a firm, a company is more likely to incorporate ESG considerations into its business practices.

Tatjana Greil-Castro, Ph.D
Portfolio Manager

Tatjana joined Muzinich in 2007 and has over 20 years' corporate credit experience. Tatjana came to Muzinich from Metlife Investments, where she served as an Associate Director of the Higher Return Unit. Prior to that she worked as a Senior Portfolio Manager in European High Yield for Fortis Investments and as a portfolio manager and credit analyst at Legal & General Investment Management. She has a Ph.D. from the London School of Economics, a Masters from the Kiel Institute of World Economics in Germany and an M.Sc/B.S. in Economics from the University of Vienna.



Ian Horn, CFA
Credit Analyst

Ian joined Muzinich in 2013. He is a Senior Credit Analyst focusing on the utilities, steel, real estate and transportation industries. Prior to joining Muzinich, Ian spent 2 years at the Royal Bank of Canada in their Wealth and Investment Management division, and previously worked at Lazard and JP Morgan. Ian earned a Masters in Engineering from the University of Oxford, where he received academic awards including a scholarship from the Institution of Mechanical Engineers. Ian holds the Chartered Financial Analyst designation.

Investor engagement can therefore directly benefit client portfolios if the performance of their investments is enhanced by positive change from an ESG standpoint.

A Market Standard?

While it is a desirable concept, there is not yet a common standard of ESG investing in fixed income. Nevertheless, as the demand for ESG considerations has grown, so too have the ways of implementing it in portfolios.

Exclusion lists are becoming widely adopted, such as that developed by *Norges Bank Investment Management*, as well zero tolerance screens (to exclude companies affiliated with controversial weapons, child labour, animal testing etc.) or - more broadly - non-compliance with the business standards set by the *UN Global Compact*.

Investors typically have specific views they wish to express through their investments. Examples of **negative screens** often implemented, frequently with a maximum involvement threshold in such end markets, can include alcohol, tobacco, weapons, fur and leather.

These screens could be considered a passive approach to ESG investing, eliminating companies with practices or operations that do not fit investor ESG frameworks. Involvement **in controversial events** of a certain scale (e.g. environmental damage, bribery or health and safety) could also be a threshold.

ESG scores take a broader view of ESG topics and allow investors to consider the relative performance of companies based on these metrics. These are typically accompanied by research which can show companies how they score, which investors can use to encourage companies to improve, although they are largely reliant on a company's disclosure to do so.

Green and social bonds, where issue proceeds are ringfenced for specific approved purposes, are also worth considering. Their growth has been notable in recent years and we believe looks set to continue.

Carbon foot-printing, where the carbon emissions of a portfolio are measured based on its underlying constituents and weights, is relatively new. Its gaining popularity in Europe where it has become a regulatory requirement in some countries, however its accuracy depends on the quality of data published by portfolio companies.

Engagement with companies and management teams is a more active approach. It's the manager's responsibility to identify metrics or themes important to them, and use their influence to encourage change; managers may opt to monitor improvement or set a maximum period where it must be achieved.

Lastly managers may consider **fully integrating ESG** into their credit analysis and bond pricing, which considers ESG strengths and weaknesses. Lenders would generally demand a higher return from a company that displayed weak ESG qualities, on top of the pricing suggested from pure credit analysis.

From this brief overview of a bond manager's ESG implementation toolkit, there are many credible options for managers to deploy in an ESG strategy. Whilst not perfect and subject to investor views, they provide managers with the opportunity to develop their own proprietary approach.

We believe any ESG strategy must balance manageable constraints on the investable universe whilst allowing a manager enough decision-making capacity to demonstrate their skill in pricing credit risk.

Our Approach

At Muzinich, we have a number of strategies with different ESG profiles. We are able to customise the level of ESG requirements to suit client needs, using the approaches outlined herein.

In each of these strategies, our ESG approach is combined with deep and thorough credit research, as is applied across the firm.

More broadly, we are keen to contribute to the development of the ESG movement, encouraging greater transparency from portfolio companies, and fund independent research of companies previously not examined from an ESG perspective.

The Future of Responsible Investing

Looking ahead, we see continued growth and demand for ESG investing in fixed income, both geographically and by investor type, especially in Europe which is at the forefront of this trend.

ESG investing can encourage a higher standard of corporate responsibility whilst seeking to offer attractive financial performance; criteria that should suit investors and companies alike.

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