ESG in fixed income

Being skeptical about skepticism

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Wealth Management

While ESG is experiencing some growing pains, we think these concerns are relatively small and outweighed by the long- and short-term benefits of adding ESG criteria into fixed income investing.

Corporate bond issuers are increasingly focused on tapping demand for responsible investing (RI), with Moody's estimating $1 trillion in sustainability-linked debt sales for 2021. RI is an umbrella term that encompasses three main branches: (1) ESG integration, which focuses on supporting companies that perform well on environmental, social, and governance (ESG) metrics; (2) Impact investing, which looks for quantifiable impact on particular social or environmental goals; and (3) Socially responsible investing, which aligns personal values with investment choices by providing or withholding investment capital from specific industries or companies.

ESG integration relies on how a particular company ranks on material ESG factors. Third-party rating services are often used to rank companies relative to their peers. With more money flowing to investments with attractive ESG profiles, there has been increasing focus on the lack of consistency in determining the criteria for ESG ranking, alongside reports of so-called "greenwashing," or deceptive practices designed to artificially inflate an issuer's ESG score.

We believe these scoring concerns are overstated for both equities and fixed income. For fixed income in particular, the discussion in part reflects a misunderstanding of corporate bond issuance and the role of the corporate structure. We think it would be a mistake for investors to ignore ESG as an investment criteria due to these growing pains, which—even if true—carry relatively low impact to well-diversified portfolios.

Nothing new under the sun

ESG as an investment label is relatively new, but elements of the concept are long-standing in the fixed income world. For a corporate entity, governance is largely synonymous with "character" for an individual, one of the most basic credit lending standards. Environmental issues have also figured importantly in the credit analysis of issuers in certain industries. In the U.S. oil and gas sector, for example, investors routinely consider potential environmental impacts that could disrupt or block the permitting of expansionary projects, with possible financial consequences for the company.

We believe potential ESG bond investors should take comfort in the fact that credit markets have decades of experience in evaluating and pricing these types of risks. The variability of ESG scores between different providers does not mean that the analysis is arbitrary and unreliable; instead, these differences in part reflect how different raters weight the various ESG factors. For now, investors and advisors may have to dig a bit deeper into the ESG scoring and ranking to understand the weighting format, but we believe the benefits of further research warrant the additional time.

The devil—and the ESG score—is in the details

ESG has its roots in equity investing, and equity investors tend to take a holistic view of an enterprise; after all, the owner of a business is the owner of it all—good, bad, and ugly. Fixed income is different. Investors lend money to a specific legal entity—the so-called obligor. This legal entity is often an operating company that produces a company's goods and makes sales to the company's clients. In many cases, the obligor will be limited to selling one particular line of products or sell only to a particular geography. These limited-focus operating companies are generally not the well-known publicly traded equity; instead, companies often have a holding company that brings together all of the disparate operating companies into a publicly traded holding company.

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This distinction matters for ESG bond investors. Many of the criticisms of ESG-rated bonds conflate the borrower with the holding company. Some of the largest polluters have operating divisions focused on cleaner energy or cleaner products. Bonds sold out of these legal entities may carry a positive ESG score, which may seem incongruous with the larger company's environmental footprint. But this entity-specific ESG score is both appropriate and helpful.

By drawing in ESG investors, these operating divisions should have a lower cost of capital, which will lead the overall company to focus growth on these potentially higher return investments. By concentrating growth on cleaner product lines within an overall potentially problematic structure, ESG investing can effect real change, and it's entirely appropriate for ESG ratings to reflect these benefits.

Greenwashing by any other name

Prospective ESG investors will eventually encounter the "greenwashing" label, which refers to bonds or securities that are presented with inflated ESG metrics. We believe this label is significantly overused and the practice—to the extent it occurs—is no impediment to adding ESG considerations to an investor's portfolio.

As discussed, many of these greenwashing arguments conflate legal entities and ignore the benefits of lending to an ESG-positive division. But greenwashing complaints are also frequently levied against a project that was purported to have significant positive ESG characteristics, but in reality failed to deliver the promised benefits.

Failing to meet a goal, however, is not a sign of improper behavior. Companies frequently miss financial goals and that is an understood risk of making projections in an uncertain world. Since ESG can involve new technologies or novel engineering challenges, estimates can be especially difficult to meet. These failures to fully deliver do not constitute a reason to dismiss ESG criteria, any more than Enron's rapid decline from AAA to default proved that credit ratings are worthless.

Diversification and portfolio construction can also help minimize the impact of greenwashing on an investor. Even if some issuers in a portfolio have overstated ESG scoring metrics, the overall portfolio likely remains beneficial, in much the same way that the S&P 500 can rally even though prices drop for several constituent members. And since ESG supplements—and does not replace—traditional credit analysis, the financial impact should be similarly contained. In short, even if we accept the critics' view on the current state of ESG ratings, both the financial and the social investment cases remain intact, in our opinion.

Perfect is the enemy of the good

ESG is undoubtedly experiencing growing pains and there are legitimate questions on how environmental, social, and governance levels are calculated and then weighted. For investors considering incorporating ESG into their portfolios, we think these concerns are relatively small and outweighed by the long- and short-term benefits of adding ESG criteria.

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