Manulife Investment Management

ESG investing in Asia - an invisible evolution

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Sustainable and responsible investing is fast becoming one of the most important investment criteria globally, and in Asia, while the uptake has been slower, this trend is growing. Moreover, sustainability is now also seen as an important economic driver for investment performance. Murray Collis, Deputy CIO Fixed Income Asia ex-Japan, and lead portfolio manager of the Sustainable Asia Bond strategy, discusses the drivers behind this movement and how the COVID-19 outbreak may have influenced developments. Murray also explains the role of active management when investing in, and engaging with, companies in Asia's growing sustainable investments market.

How is the Asian bond market evolving towards increased sustainability awareness and integration? Also, what are the main drivers behind this growth?

Asia has developed a lot in terms of sustainability over the past decade. In fact, they have actively been embracing the concept of ESG. We have seen a few different drivers behind the growth of sustainability in Asia, and we have slowly been incorporating these drivers into our portfolios over time. Asian Governments are continuing to affirm their commitments to ESG issues in the region. For instance, within the last week China has announced that it wants to become carbon neutral by 2060.

What we have seen over the last decade is that governments in the region are recognising ESG issues and starting to put frameworks in place to deal with them. This has led to the initial growth that we have seen in the Asian sustainability market. Once an issue becomes part of the government's agenda, regulators then start to take notice. Asian countries are now starting to build and develop best practice principles for ESG investing, and the corporations within these countries are also starting to adopt stewardship codes. Governance regulations such as the separation of duties between CEO and Chairman have now become mandatory requirements for listed companies in a growing number of countries in the region.

Central Banks in the region are also putting measures in place to support the growth of the ESG market within Asia. A good example of this is the Monetary Authority of Singapore setting aside around $2 billion to support the development of sustainable finance in Singapore. While the People's Bank of China has introduced a series of significant measures in recent years which include accepting green bonds as collateral for its medium-term lending facility programme. There are a number of different ways in which governments and regulators can help to support the growth of the sustainability market and it is positive to see Asian nations starting to embrace them.

From an investor's perspective, there is a growing recognition within Asia of the benefits to be gained from investing in sustainable fixed income products. It is evident historically that sustainable investments tend to outperform over the medium to longer term and this is something that investors are starting to factor in when considering ESG investments.

On another positive note, the economic and corporate data originating from Asia has consistently improved over the last few years. Our belief is that having access to better quality data enables investors to make more informed investment decisions. As a result, the increasing quality of the data has also resulted in market growth.

If you look at companies within Asia, the language around ESG and sustainability has improved over time. That's partly to do with engagement and partly to do with the regulatory environment and the government's approach to this topic. As previously mentioned, we are starting to see Asian corporations adopting best practices, which then creates opportunities for sustainable investment products. A good example of this is the green bond market in Asia. There were very few green bonds being issued four to five years ago, but since 2016 Bloomberg estimates that China represents around 17% of global green bond issuance.

Looking at the J.P. Morgan Asian Credit Index (JACI), which is one of the most commonly used indices for Asian credit in this region, sustainability bonds issued in the Asia Pacific region made up almost 4% of the index in July 2020. This is impressive considering that this segment represented less than 1% of the index a few years ago.

When you put all of this together, it is evident that there are a number of factors that are helping to drive the market. Regulators and governments are supporting and incentivising the growth of sustainable investment, plus you have investors demanding the adoption and implementation of ethical practices from corporations.

As with most themes in Asia, is China leading the way in the field of sustainable investment?

It is probably fair to say that the more developed countries in Asia have been moving ahead. For example, we are starting to see a lot of green bond issuance from both Hong Kong and Singapore. China is (and always has been) one of the biggest markets in the region, and if you look at China's weight within the Asian credit market it has increased dramatically in the last decade.

We're also seeing big developments within India, although they still have a lot more work to do in this space. Overall, there should be some great opportunities in the near-term pipeline, as we're seeing a lot more issuance from renewable energy companies in India, China, and even in parts of South Asia.

How has COVID-19 changed your investment views with regards to ESG fixed income?

It is not something that we have necessarily changed, it has just reinforced our views. We have been integrating ESG into our investment processes for many years and when investing in Asia, governance has always been a really important factor, particularly when looking at the high yield universe.

If we look at COVID-19 and what has happened over the course of the year, it has helped to reinforce the broader social and environmental issues. Investors are really taking note and starting to consider these broader issues, and this is starting to be reflected by the market in terms of social bond issuance. Over the first half of this year, we have seen more than double the amount of issuance that occurred in 2019 and that does create more opportunities in the market.

During the pandemic we have seen a lot of ESG equity funds outperforming markets, have you experienced the same in the ESG fixed income market in Asia?

We have seen this to some degree, especially during the volatility experienced in March and April, although markets have recovered reasonably well since then.

Earlier I mentioned the JACI, and last year an ESG version, the J.P. Morgan ESG Asia Credit Index, was launched. As investors, this enables us to look at the two indices and see how they are performing relative to each other. During March 2020, the ESG index had a lower drawdown than its non-ESG peer but when you look at their performances year to date, it is roughly the same, albeit that the ESG index has lower volatility. So, when looking at them from a risk-adjusted return basis, the ESG index has produced a better risk-adjusted return.

Has COVID-19 pushed ESG to the bottom of the list of investor priorities?

I'd argue that the opposite has occurred. We have seen investors worldwide inject more than $70 billion into ESG funds in the second quarter of 2020. We think that there are a few reasons for this, one being that investors have seen the effects of COVID and it has highlighted some key sustainability issues that need addressing. Secondly, when you look at the wild fluctuations that we witnessed in March and April, investors have probably looked at the economic risks that are playing out and are wanting to invest in businesses that are robust and that have sustainable business models.

How do you engage with fixed income issuers on ESG related factors?

We take a multi-faceted approach. When people think about engagement, they commonly think about the equity market. However, engagement is also really important in the fixed income space, particularly in Asia.

We see engagement as an opportunity to build long term relationships with issuers that we engage with. When we engage with issuers, we discuss a number of topics with them, which gives us greater insight into their business models and the strategies that the businesses adopt. We can also leverage the knowledge that we gain from dealing with regulators and governments to identify strong opportunities within the region. Ultimately, engagement can create better outcomes for us and our investors.

What we want to do is to share what we believe are the best sustainability practices. For us, it is not just about the number of engagements, but the positive outcomes resulting from those engagements.

Are fixed income issuers ever hesitant to adopt ESG or do they all seem to embrace ESG as part of their processes?

Yes they very much embrace it. As I have previously mentioned, we have had ESG integrated within our processes for a long time.

Over the past decade, our processes have developed as the markets have developed. Historically, there was a lot of discussion around corporate governance, but now it has gone one step further and we're seeing environmental issues consistently being brought up in the discussion. Most issuers are now very open to hear what you have to say on the matter, however when we do find an issuer that is reluctant to listen to us, then this does raise a red flag.

Is it time for Asian Fixed Income to be seen as a standalone asset class rather than a small subset of a larger fixed income allocation?

Definitely. I have been based in Singapore for over a decade and during this time I have seen significant growth in the Asian fixed income market. Over the past 5 to 10 years, Asia has produced some really strong returns as an asset class, but the market has also grown substantially. Coming out of the global financial crisis, Asian credit markets were roughly around $250 billion in value, whereas now the market is worth well over $1 trillion.

Asia is a huge market as it is made up of 17 countries, spanning from investment grade to high yield. The overall quality of the market is really high. When you look at the performance of Asian bonds compared to more developed bond markets, it has very compelling risk-adjusted returns. So the Asian bond market is not only attractive for investors who are looking for a pickup in yield compared to developed markets, but also on a pure risk-adjusted return basis.

Have the yields in the Asian fixed income space been hit as badly as across more developed markets across the world?

There are two parts to this question. We have recently launched a fund that focuses on the Asian dollar bond market, and it is priced off the US Treasury curve, which means that we do currently have lower yields due to the low interest rate environment. But we also have a spread cushion, because when investing in Asia, an emerging market yield premium exists, even for investment grade bonds. Currently investing in an average investment grade bond portfolio within Asia will get you around a 4% yield to maturity, which is pretty compelling when compared to global yields.

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Looking ahead, where do you see the key opportunities for this asset class?

Asian countries are currently some of the largest emitters of carbon dioxide in the world. Over time we see that there will be a transition to a low carbon economy, which will create opportunities for sustainable investors. There is now a greater emphasis on climate change and the risks associated with climate change, so it is going to be a long-term investment trend.

Another important point is that governance is an issue that most investors raise. Investors are concerned about the independence of firms boards and the stance on board diversity, so these are topics that are on our agenda when speaking to companies in Asia.

We are also seeing a surge in green bond issuance from property developers in China, which we think is really interesting. To us, this signals recognition by the government of what is going on in the domestic market and trying to encourage the adoption of best practices. A lot of this new issuance is going towards renovating and revamping existing properties up to a green standard, which we think is a great outcome. The positive side of this for investors is that they are being rewarded with a substantial yield.

Renewable energy is expected to be another area of growth within Asian economies, so we are continuing to watch this space. We have also identified some excellent opportunities within India and other Southeast Asian countries.

What are some of the risks that you foresee over the next 12 months?

This will be driven more by what is happening globally. Obviously we are in an era of low interest rates and central banks across the globe are making it clear that this low interest rate environment is here to stay for an extended period of time.

The biggest factor on determining global economic growth is how quickly a vaccine for COVID is found and then how quickly it is mass produced and distributed to the global population. In the meantime, the other factor will be how governments and central banks will continue to support economies until a vaccine is found.

Do you see any risks for Asian bond markets arising from the US Presidential election?

That's an interesting question. At the moment, nobody really knows how this election is going to play out. Both parties are certainly looking at China, albeit with different takes on how to manage that situation. I think it goes without saying that the party that focuses on putting trade tariffs in place will be less favourable for the Asian economies.

At the moment we see very little correlation between these external factors and ESG scores, so we think it is really important for investors to do their own bottom up research. From a sustainability point of view, that is one way in which we can mitigate those risks.

Asia is very well placed at the moment. China is focused on increasing domestic growth, the financial sector is growing in Asia, and there is renewable energy in India. It is a pretty diverse market with a lot of opportunity for investors to diversify their portfolios, so we're not as concerned about the outcome of the election as we previously may have been. From an ESG viewpoint, we want to see the quality of data coming out of Asia to continue to develop and improve as this is what allows investors to make good, well-rounded decisions.

Why take an active approach to sustainable investing in Asian fixed income?

The issue with adopting a passive approach within Asia or indexing is that it is reliant on data that is not yet complete. We currently have over 20 credit analysts spread across 11 countries in the region. Having presence in every major country allows us to benefit from local knowledge that we gain from having people on the ground and in our view, this is better than pursuing a passive approach.

There are some methodological issues that investors should consider when they look at adopting an indexing versus an active approach. We think that having an active approach allows you to research and choose the best quality or best-performing names, and then make the appropriate allocations to those companies. For us this is the best way to generate better returns over the long term.

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