ESG investing and fixed income: The next new normal?

We believe the bond market is uniquely suited to both benefit from and provide finance for ESG-related (environmental, social and governance) efforts.

A quiet but profound pivot is underway in the sustainable investing space – a pivot that, in our view, will reshape markets and elevate fixed income to a place of prominence within the environmental, social and governance (ESG) field.

When the United Nations Global Compact launched its concept of ESG investing in 2004, the focus was decidedly on the action and tactics that international investors (especially asset management firms) could undertake as equity owners to influence the behavior of corporations in relation to sustainability issues.

This critical framing, with a related emphasis on the financial materiality of a range of ESG issues, delivered its intended consequence – moving sustainable investing beyond purely norms-based ethical approaches (i.e., negative screening and potentially sacrificing returns) and toward mainstream understanding and adoption.

To date, however, equities have received the lion's share of attention and engagement from investors. The reasons, when comparing equities with other assets, include a much larger body of ESG research, numerous benchmarks and indexes, and clearer connections to corporate engagement.

We believe this is about to change, ushering in a possible "ESG New Normal" with fixed income at the core of the sustainable investing universe that could eventually expand ESG-related borrowing from billions of dollars annually to the trillions needed to safeguard a country or company's creditworthiness over the long term.

So, what leads us to this conclusion?

First, we witness the growing recognition by many in the market that **ESG issues present material credit risk – with respect to both corporate and sovereign debt**. Certainly, PIMCO's integration of ESG credit analysis across the entire investment universe reflects the understanding that investors, like any lender, cannot ignore sustainability and governance issues that may affect a borrower's ability to repay its debt.

The materiality of ESG issues in relation to credit risk follows naturally from the growing body of evidence demonstrating, for example, that companies that effectively manage and integrate sustainability issues realise a range of competitive benefits – including resource and cost efficiencies, productivity gains, new revenue and product opportunities, and reputation benefits.

Second, on both the product innovation and sourcing side, **fixed income ESG is accelerating**. Numerous ESG bond funds have been launched – or are in the works – by both mainstream institutions and boutique houses.

And in the green bond space, supply is expected to increase more than 60% this year to $250 billion, surpassing 2017's record $155 billion, according to Bloomberg. It is worth noting that corporate, government and asset-backed c ategories all saw nearly equal issuance growth in 2017. Of course, these encouraging growth estimates must be understood vis-à-vis the size of the world's total bond market – nearly $100 trillion.

Meanwhile, PIMCO engagement and discussions with both corporates and sovereigns suggest we are on the cusp of a sea change in social bond securities related to issues such as water access, sanitation, gender, health and other social-related infrastructure areas (e.g., food distribution, transport). In this regard it's also worth noting the recent interest declared by development banks and agencies in working with private finance and institutional investors – often for the first time – to source deals and co-invest.

Third, and closely related to the previous point, **the U.N. Sustainable Development Goals (SDGs) are exciting interest and passion as an overarching ESG framework** that can guide investments to achieve returns while delivering positive societal impact. To be sure, the 17 SDGs – adopted unanimously by all 193 U.N. member states in 2016 – can be seen as a comprehensive and thorough elaboration of ESG, with the added benefit of targets and even indicators.

Moreover, and crucially, the U.N. estimates that in order to achieve the SDGs by 2030, between $3 trillion to $5 trillion annually will be required, with the majority of this investment needing to come from the private sector. The long-term nature of the SDGs – with its arc to 2030 – and the fact that much of the financing, especially on the sovereign side (but not only), will need to relate to long-horizon social and environmental projects and investment means that debt instruments could be ideally suited.

Thus, we see the prospect of a blossoming market in "SDG bonds" by sovereigns, development banks and companies – either general in nature, or thematically targeting a specific goal or goals.

The bottom line

In many ways, the fixed income market is uniquely suited to both benefit from and provide finance for ESG-related efforts. Issuers often return to the bond market – unlike the stock market – when they refinance old debt or seek new funding. This gives bond investors a unique opportunity to identify risks, engage issuers and build relationships that can influence change. We believe that ESG investing is not only about partnering with issuers who already demonstrate a deeply integrated approach to ESG, but also engaging with those who want to improve their own initiatives and are willing to work with lenders to achieve their goals.

Moreover, long-term thinking is a critical feature of ESG and is well-aligned with bond investors, specifically at PIMCO where the cornerstone of our investment process is to identify risks and opportunities in markets over a three- to five-year period.

We believe that incorporating ESG analysis into fixed income portfolios has the potential to deliver attractive long-term returns while also having a positive impact. It doesn't need to be an "either/or" proposition, and the market is waking up to that reality.

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PIMCO

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