Simple sustainable investing solutions may not work for bond investing

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Combining sustainable investing and fixed income has the potential to deliver attractive long-term returns while delivering positive change. However, there are risks with doing so in a naïve way.

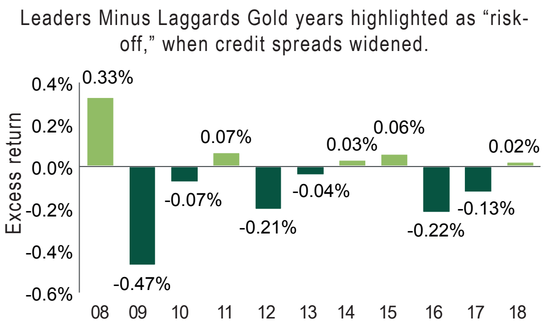
The ESG advantage in the bond market

Bonds issued by companies with favorable environmental, social and governance (ESG) ratings tend to trade at tighter credit spreads and have longer durations. Based on our research and as presented in Exhibit 1, we find that bonds with higher ESG ratings offered downside mitigation during periods of market turbulence despite their loose relationship[1] to traditional credit ratings.

This suggests that investing in companies with the highest ESG ratings may offer further downside mitigation above and beyond what their credit ratings would suggest. In other words, ESG considerations may provide an alternative long-term lens to evaluate credit. Credit ratings agencies are starting to take notice by exploring ways to incorporate environmental and climate change risks into their decisions.[2] That said, uncertainty remains around the timing, nature and magnitude of ESG risks. While keeping ESG in mind, investors should still focus on the primary drivers of fixed income returns such as duration, sector, issuer and option adjusted spread.

Exhibit 1: ESG characteristics and performance

ESG leaders tend to perform well during risk-off episodes



Source: Northern Trust Quantitative Research, MSCI, Bloomberg ICE Global Investment Grade corporate universe. Returns represent annualized average excess returns of equally weighted portfolios for the Bloomberg ICE Global Investment Grade corporate universe formed as follows. ESG Leaders represent MSCI ESG Ratings of AAA or AA; ESG Laggards represents MSCI ESG Rating of B or CCC. Returns are gross of dividend withholding tax. Returns include backtested performance. Performance December 31, 2007 through December 31, 2018. Past performance is no guarantee of future results, Returns of the indexes also do not typically reflect the deduction of investment management fees, trading costs or other expenses. It is not possible to invest directly in an index.

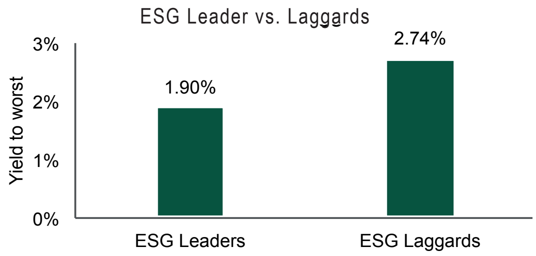
Watch for biases

Bond investors who explore the world of sustainable investing should perform their due diligence and have a strong understanding of both ESG factors and the drivers of long-run bond returns. Taking a naïve approach by simply investing in top-rated ESG companies or applying standard exclusions of some industries could be fraught with unintended yield, duration, sector, and country risks. Investors should take intentional risks, and ensure they are compensated for those risks, to achieve the outcomes they seek.

For example, ESG ratings are based on rankings within industries independent of country and sector. As Exhibit 2 illustrates, yields of ESG leaders tend to be lower, which may cause portfolio yield to fall short. Also, as shown in Exhibit 3, European companies are the most common ESG leaders while U.S. companies are often laggards. This could lead to too much emphasis on French companies and introduce sovereign risk. Standard exclusion practices may present problems as well. Screening for controversial weapons, fossil fuel reserves, and tobacco among others could introduce unintended sector weightings. Given these biases, combining ESG with fixed income means that investors should take appropriate risk controls for duration, spread, country and sector risks while favoring companies that are stronger than peers.

Exhibit 2: ESG yield bias

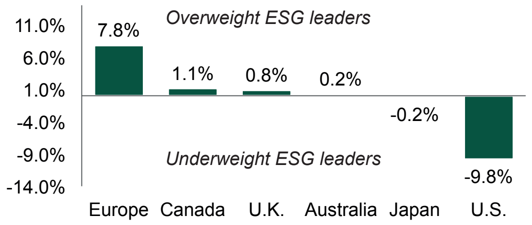
ESG leaders have lower yields than the laggards. Investors should be careful that applying ESG doesn't mean unintended lower yields.



Source: Northern Trust Asset Management, MSCI, Global IG corporate universe from October 31, 2019.ESG Leaders are companies with ratings A or above vs. laggards have ratings BBB or below.

Exhibit 3: ESG regional bias

Companies in Europe tend to be leaders while they lag in the U.S. Investors should be careful that an ESG focus doesn't create unintended country weights.



Source: Northern Trust Asset Management, MSCI, Global IG corporate universe as of Oct. 31, 2019.ESG Leaders are companies with ratings A or above. Laggards have ratings BBB or below.

Climate change: look forward, not back

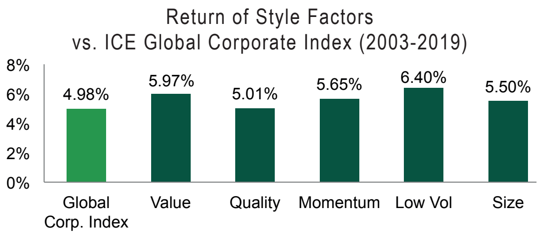
It is extremely difficult to model implications of climate-change to asset prices. But increasingly asset owners are lowering exposure to both fossil fuel reserves and carbon emissions as the first line of defense against the transition risks associated with climate change. In doing so, investors should not only focus on historical measures of carbon footprint. They should also favor companies that are taking steps to mitigate low carbon transition risks through renewable energy and clean-technology, in addition to other forward looking measures.

Avoiding the pitfalls: consider factor investing

In order to further bolster fixed income outcomes, our research shows that precisely targeting factors such as quality, value, size, momentum and low volatility has historically improved fixed income returns.[3] Exhibit 4 shows the performance of the top 20% (based on our proprietary fixed income score) of each of the factors relative to the global corporate credit benchmark. Combining factors with ESG can provide both positive risk and return outcomes while investing responsibly. So investors don't have to sacrifice performance to invest sustainably. In fact, combining high financial performers that also value sustainable business practices makes as much business sense as it makes good sense.

Exhibit 4: How factors work for bonds

Value, momentum and low volatility have outperformed the broad global bond market.



Source: Northern Trust Quantitative Research, January 31, 2003 to June 30, 2019. Past performance is no guarantee of future results; Returns of the indexes does not typically reflect the deduction of investment management fees, trading costs or other expenses. All returns of gross of fees. It is not possible to invest directly in an index. Returns for the quintile one portfolio sorted on Northern Trust Asset Management factor score and debt cap-weighted.

Guidelines to get started

As you consider sustainable investing for your bond allocation, keep in mind these key ideas:

- Sustainable investing may be used when seeking to improve performance and manage risk in a fixed income allocation.
- Be ready to control for duration, spread, country and sector biases that can manifest when adding ESG into the investment process.
- Consider ESG ratings as an additional factor to evaluate an issuer's long-term creditworthiness.
- Style factors such as quality and value may be combined with ESG factors to potentially improve risk-return outcomes.

FOOTNOTE

1 Alain Devalle, Simona Fiandrino and Valter Cantino. 2017 The Linkage between ESG Performance and Credit Ratings: A Firm-Level Perspective Analysis, International Journal of Business and Management

2 S&P Global highlights 717 rating actions during 2015-2017, where environmental and climate risks were an important factor and 106 where those risks were key to a rating action

3 Northern Trust Paper: Looking Beyond Term and Credit: Factors that Drive Performance of European Corporate Bonds