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Why does ESG matter in fixed income and what are we doing about it?

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Why is it important to consider environmental, social and governance (ESG) factors when making fixed income investments?

In short, for four important reasons:
1. It's our legal duty to consider ESG factors, as stated in Regulation 28 of the Pension Fund Act.
2. The world is heating up – and investors know this.
3. We ignore ESG factors at our peril.
4. As asset managers, we have the power to make a real difference.

1. We have no option (it's our legal duty to consider ESG factors as stated in Regulation 28 of the Pension Fund Act)

Our legal duty, as stated in Regulation 28, is to "... give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund's assets, including factors of an environmental, social or governance character. This concept applies across all assets and categories of assets and should promote the interests of a fund in a stable and transparent environment."

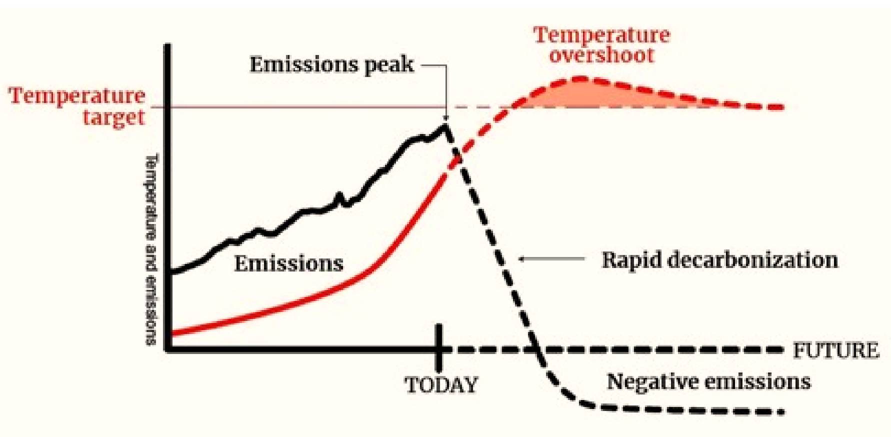
The Act urges further "… before making an investment in and while invested in an asset consider any factor which may materially affect the sustainable long term performance of the asset including, but not limited to, those of an environmental, social and governance character."

Therefore, as fiduciaries and custodians of our clients' funds, we have no option but to consider ESG factors when both assessing and managing investments - to ensure that we identify risks that could potentially erode value, and to price for these risks so as to earn sustainable risk-adjusted returns on behalf of our clients.

2. Too hot to handle (the world is heating up – and investors know this)

Global warming could actually be approaching the point of no return – with visibly rising temperatures, melting ice, and altered climates. The ability to plan for the future has dropped from decades to mere years. Time for consideration of the necessary changes in humanity's behaviour is running out.

Apart from the extreme weather realities experienced on every continent, scientific evidence for climate change has multiplied and become more accessible and sophisticated. Demand for urgent change in the behaviour of governments and other institutions has become the clarion call of millennials around the world. This is a signal of things to come, in terms of the demands and expectations of investors of the future.



Source: Bioenergy International, courtesy WMO & UNEP

For a more in-depth analysis, see Climate risk is a reality – investors take note article.

3. If you are aware of a problem and do nothing, you become part of the problem (we ignore ESG factors at our peril)

We cannot continue to ignore ESG factors; there is no shortage of examples of a lack of governance – and the impact this has - particularly amongst South Africa's State-Owned Enterprises (SOEs). In his 2020 State of the Nation Address, President Cyril Ramaphosa referred to "years of state capture, corruption and mismanagement"; "Eskom's inability over many years – due to debt, lack of capacity and state capture – to service its power plants"; and that "the extent of capture, corruption and mismanagement in SOEs is best demonstrated at South Africans Airways, which was placed in business rescue late last year" – amongst others.

Governance issues are not limited to SOEs, as evidenced in governance failures in African Bank and Steinhoff locally, and high-profile Volkswagen and Enron debacles in the past, to name a few. These have wiped out share values and, in some cases, destroyed lives.

ESG risks cannot be underestimated, and can certainly not be ignored. A proactive stance from fixed income investors (and all investors) is called for. This can take many forms (as will be seen below) from mindful deal selection and due diligence, to unequivocal demands and monitoring of the ESG compliance of investee companies.

(For some case studies on dealing with governance in the SOEs, see Guidance and Case Studies for ESG Integration: Equities and Fixed Income article.)

4. Reforming the "status quo" (as asset managers, we have the power to make a real difference)

ESG crises can create political risk, such as the populist backlash against "the status quo". Capital providers (investors) invariably represent the "status quo", and thus face risks of uncertainty, expropriation, taxation, and protectionism. Channelling capital with this in mind is both responsible and defensive.

Managers therefore have no excuse when it comes to applying due care and diligence in the ESG risk analysis of their investments. As stated above, this forms part of our fiduciary duty towards our clients.

Asset managers are beginning to realise that ESG aspects can become an additional set of analytical risk tools on which to build sustainable and competitive investment processes. If viewed through a **risk-avoidance and return-seeking** lens, there should be no compromise of investment returns.

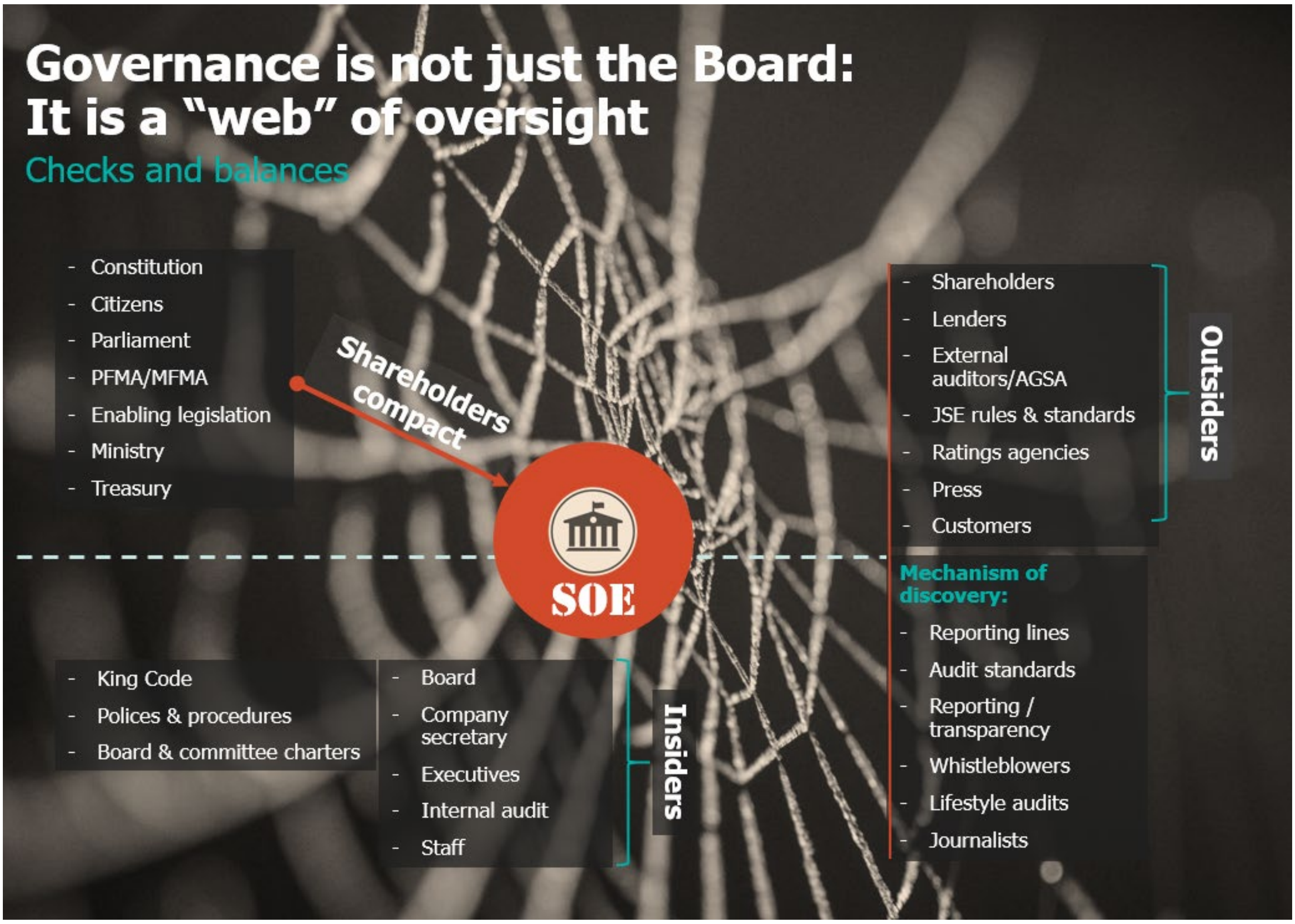
A plethora of guidance principles, frameworks and codes are available to the investment universe, such as the:

- King IV Code
- Code for Responsible Investment in South Africa (CRISA)
- UN Principles for Responsible Investment (PRI)
- UN Sustainable Development Goals (SDGs) – to name a few.

There is a growing trend in the industry to move beyond the simplistic goal of "making money" toward "making money **and** being a positive force in the world". This implies a wider role and duty by participants, that demands more varied analyses and better decision processes. Culture is a competitive advantage in building robust decision processes, but also in attracting clients and employees. It is worth noting that by 2025, Millennials will make up 75% of our workforce. The shift towards seeking a sense of purpose in our work has already started.

What are we doing about it (the Futuregrowth example)?
Futuregrowth's approach is to integrate sustainable ESG best practices when assessing companies and engaging them on their practices – understanding that these are key components in managing investment risk and that ignoring ESG issues can have a negative impact on risks and rewards, ultimately affecting client returns. As such, ESG screening and analysis forms part of our fundamental credit analysis process across our wide range of fixed income sectors. We use a variety of tools and inputs for this purpose, and these are constantly modified as new learnings arise.

ESG scorecard: screening and analysis
Subjectivity in assessing each issuer - judgement is required, no one size fits all!



The fixed income asset class is complex due to the wide variety of issuers, and therefore there is no 'one-size-fits-all' solution to analysing companies on ESG issues. Analysts have to apply their acumen and judgement, and there will be variances in our approach to, for example, issuers in the listed sector versus those in private (unlisted) debt.

We also recognise that companies are at different stages in their business lifecycles and we have to be realistic in our requests regarding specific ESG recommendations. We therefore engage with companies to reach a mutually agreed outcome that will benefit both parties, with the goal of improving the sustainability of their business.

How do we protect our clients' funds?
An integral part of our process is to embed strong protections for our clients wherever possible.

Through our large skilled credit team, we are able to negotiate specific terms in loan agreements, such as requiring borrowers to report timeously on any material events that could affect the credit quality of the loan. On these occasions, we engage with the borrowers to ensure that the risk is minimised as far as possible, and, importantly, that long-term, proactive strategies are devised and implemented to manage the risk and the impact on future revenues. Learnings from these events are shared internally and applied across all our investments, where applicable, to the benefit of all our clients in the end.
In the case of private (unlisted) debt, we stay involved throughout the term of the loan, often receiving monthly management accounts and attending quarterly meetings where we have the opportunity to engage with management on an ongoing basis. Where appropriate, we participate in various committee meetings conducted by the company (e.g. lenders' committees, boards) where we engage with senior management on any issues of concern.

Through our collaboration with the Association for Savings and Investment South Africa (ASISA) and other industry and public forums, we also seek to raise standards in the domestic bond market by advocating reform that improves protections for our clients.

Our primary objective is to earn sustainable, risk-adjusted returns for our clients. We believe that our focussed and dynamic approach has set us apart in this field. We take pride in adding value to our clients' portfolios by integrating ESG analysis into our investment processes, assessing and pricing for related risks, and actively engaging with borrowers to ensure the sustainability of their businesses and the environment.

The power of capital to effect change – we have an important role to play
It is clear that the days of ESG veneering and tick-box reporting are over. Investors need a comprehensive set of ESG risk measures to avoid or price for these risks, so as to reduce portfolio risk over the long-term.

It is easy for fixed interest managers to assume that the "the Board is watching" these matters. Instead, we need to constantly apply critical thinking and judgement to our investments. We have the capacity to assess and strengthen corporate governance standards far beyond the Board of Directors.

Our choices about capital deployment have real-world consequences. We can make a positive difference if we choose to do so and we should not underestimate the power of capital to effect meaningful change.

Futuregrowth is a proud signatory of the UN Principles for Responsible Investment (PRI) and endorses the Code for Responsible Investment in South Africa (CRISA).

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