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Sustaining interest

Outcomes of a Mistra workshop on environmental, social and governance (ESG) issues in fixed income investment

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Contents

Executive summary

This report summarises the outcomes of a workshop held in Stockholm on 2 June 2006 by Mistra, The Foundation for Strategic Environmental Research, on the integration of environmental, social and governance (ESG) issues into fixed income investment. The workshop was stimulated by the apparent mismatch between the research devoted to understanding the financial impacts of ESG issues in the fixed income domain and that in equities (in a climate of large and growing allocations to fixed income asset classes by institutional investors).

The key questions posed by the half-day workshop were as follows:

- What is the state of the art in the integration of ESG issues into investment research and asset management in corporate fixed income securities?
- What are the current approaches to ESG issues for investors in non-corporate debt?
- How can fixed income investors benefit from the 'head start' of equity investors in this domain? In which areas might their investment decisions differ?
- What possibilities exist for fixed income investors to engage with investee companies and other issuers of debt?
- How can academic research support the work of industry practitioners in this field?

Key outcomes included:

- Integration of ESG issues into asset management, credit ratings and investment research in corporate securities:
  - ➔ There is an industry-wide lack of sophistication in considering the financial impact of environmental, social and (to a lesser extent) governance issues on corporate fixed income investments. There is also a lack of transparency regarding the extent to which mainstream credit rating agencies, sell-side researchers and asset managers take into account ESG issues
  - ➔ Methodologies that do not systematically integrate ESG issues into financial analysis (i.e. quantify the issues) can only be viewed as a first step towards the satisfactory treatment of ESG issues in fixed income
  - ➔ A new generation of ESG-inclusive credit ratings could include cultural and management quality indicators that might allow agencies to detect conditions conducive to corporate fraud
- Current approaches to ESG issues for investors in non-corporate debt:
  - ➔ There is a need to differentiate between country ESG indicators that are likely to be leading indicators of economic performance and those that are based more on ethical or values judgements
  - ➔ There is a clear opportunity for the academic community to collaborate with specialist rating agencies to produce and test a set of indicators that would identify economically material ESG risks in sovereign bond issuers
  - ➔ In both instances indicators would need to be kept to a measurable and manageable number
- Benefiting from and contrasting with the equity domain:
  - ➔ The asymmetric return profile of fixed income investments means that the investor's interest in ESG issues is strongly focussed on downside risk. Interest in cash upside is limited to the extent that it improves interest cover, solvency, etc. in the lifetime of the instrument. The attractiveness of the upside follows a law of diminishing returns beyond a certain level of credit quality (in contrast to equity investors who have a direct participation in this upside)
  - ➔ Where a company makes expenditure in ESG improvement to mitigate risks and capitalise on opportunities we might expect long-term holders of equity and buyers of long-term fixed income investments to react in a similar fashion, which may differ from the decision reached from the same data by holders of short-term fixed-income investments
  - ➔ It may be that the clearest differences in opinion between different types of investors are exposed by governance issues in extraordinary events such as M&A and restructurings, where the best interests of equity and bond holders can be in direct conflict
- Possibilities for fixed income investors to engage with investees:
  - ➔ Fixed income investors (particularly large institutions) often have a direct conduit to the management and exhibit de facto ownership characteristics similar to those of long-term holders of equity
  - ➔ Engagement is often strongest with first-time issuers in emerging markets, where companies tend to be more debt-hungry and where ESG issues are often most acute
    - – Absolute levels of ESG performance are less important in emerging markets than positive momentum

The further steps proposed included:

- A suggestion that upcoming conferences discussing ESG issues for investors and corporations devote time to considering further the implications for fixed income investments
- Establishing minimum ESG corporate reporting standards for emerging markets, as a pragmatic first step in improving ESG reporting overall
- Encouraging the academic community to collaborate with specialist rating agencies to produce and test a set of indicators to identify financially material ESG risks in sovereign bond issuers. As with corporate reporting, the aim should be to produce a small number of indicators with comparable and up-to-date data

Background

Large and increasing allocations to long-dated fixed income

Fixed income investments (including loans and corporate and sovereign bonds) and hybrid instruments (such as mezzanine debt) have always received a substantial allocation of assets from institutional investors, particularly those with long-term liabilities such as insurance companies and defined-benefit pension schemes. Indeed, fixed income often accounts for more than 75% of the asset allocation for pensions in countries such as Austria, Germany and Japan[1].

Recently a number of fundamental changes in the investment industry have led to an increase in allocations to fixed income investments (and especially in the demand for long-dated fixed income products). These include:

- Regulatory changes (notably in Denmark, the Netherlands, Sweden, the UK and the US) to the disclosure and funding requirements for defined-benefit pension schemes have forced such schemes to recognise substantially higher liabilities than were previously accounted for and to institute rigorous plans for addressing pension deficits where they exist. The result has been a move towards pension funding through asset-liability matching / liability-driven investment. This approach favours prime long-term debt given its ability reduce the short-term mark-to-market disparity between fund assets and liabilities (potentially at the cost of long-term returns)
- Hard regulation for institutions has been accompanied by guidance from governments (stimulated by the same long-range demographic trends) that citizens should regard public and private pension savings essentially as a 'safety net' for their retirement income, to be supplemented by higher-risk savings made throughout the working life. This policy of transferring risk from government and employer to the individual is evidenced not least by the replacement of defined-benefit pension schemes by defined-contribution schemes and the encouragement of personal savings products through tax incentives. The result is that pensions are increasingly being viewed both by institutions and by plan members as insurance policies requiring low risk-return outlooks, rather than wealth accumulation vehicles

In addition to these essentially long-term trends, a number of shorter-term demographic and market trends also point towards a shift of assets from equities to fixed income:

- In developed economies the wealthy baby boomer generation is on the verge of retirement, which will necessitate a switch of their pensions and other savings products from capital growth investments to income-generating investments such as high-yield equity and fixed income
- A number of observers have suggested that, despite the market correction in the first half of 2006, equity valuations are historically high, with the result that many institutional investors are switching into fixed income in anticipation of a de-rating of large-cap equities

Substantial evidence exists for this systemic increase in the size and duration of fixed income allocations:

- In an effort to close defined-benefit pension funding gaps a number of large corporate pension funds have adopted asset-liability matching and switched essentially all their assets into fixed income. In many cases such plans are also using complex combinations of derivatives to minimise inflation and interest-rate risk, strengthening the notion of the pension fund as an insurance policy[2]
- A recent survey suggested that 42% of UK-based institutional investors plan to increase their bond allocations in the coming year[3]. Similarly, a survey of UK asset managers showed that the

[1] Organisation for Economic Co-operation and Development (OECD), 2003
[2] In the UK examples of pension fund sponsors choosing asset-liability matching include Boots, WH Smith and Schroders
[3] Financial Times, 24 April 2006

asset class undergoing most rapid growth is fixed income (at the end of 2005 fixed income funds accounted for 29% of assets under management, compared to 18% at the end of 2001)[4]

- Several recent public and private bond issuances have been heavily oversubscribed by pension funds seeking assets to match their liabilities, particularly in the cases where the bonds have maturities of 20 years and upwards. Indeed, recent estimates put the demand for additional prime long-term bonds at $2,000bn over the next three years[5]
- A survey of liability-driven investment (LDI) strategies among European pension funds found that 19% of respondents were currently using LDI and that a further 29% intended to make such a move[6]
- The supply / demand imbalance has made it historically cheap to raise long-term debt. Public issuers have benefited — the recent 50-year UK Government bond sold at the lowest yield for 50 years — and companies beyond the 'usual suspects' of utilities have engineered bonds that overcome the structural constraints to long-term corporate debt issuance. Indeed, so attractive is the cost of debt at the long end of the market that even foundations are raising debt on the capital markets — in July 2006 the Wellcome Trust announced that it planned to issue £500m of long-dated bonds, and in the US the outstanding debt issued by not-for-profits is estimated at $33bn

These changes represent a reversal of the long-term drift away from fixed income assets that has been witnessed in the UK and US since the 1950s.

Increasing attention on environmental, social and governance (ESG) issues

In recent years there has been a significant movement of institutional investors (particularly those with long-term and long-only investment styles) towards the notion that environmental, social and governance (ESG) issues can have a material impact on the financial performance of investments[7]. Although substantial strides have been made in past years towards integrating ESG issues and other non-traditional value drivers into investment decision-making and ownership practices, to date the research work done by asset owners, asset managers and investment analysts has largely concentrated on the corporate equity domain. Similarly the growing number of asset management products that integrate ESG issues into the investment process have largely been equity-based (notwithstanding innovative fixed income products provided by ABN AMRO, BNP Paribas, Dexia, HSBC, Robur, Sarasin and others).

Much of the academic and industry research that has been carried out into the impact of ESG issues on corporate and investment performance has considered creation and destruction of enterprise value (i.e. value that accrues to all providers of capital). Intuitively therefore the increasingly sophisticated understanding of the financial impact of ESG issues in the equity research domain is likely to be of interest to investors in corporate debt. However, little work has investigated the extent to which the conclusions of such research are also applicable to fixed income investors and the situations in which a fixed income investor would arrive at a different investment decision to an equity investor based on the same data.

In the case of public debt instruments (municipal, sovereign and supranational bonds) the discussions of ESG issues have tended to concentrate on ethical and normative approaches to environmental and social issues. That is to say that the discussions of the 'sustainability' of cities and nations have been somewhat detached from the direct financial impact of ESG issues on the debt sold by those cities and nations.

Likewise research into the financial impact of ESG issues at levels above individual assets (i.e. portfolio and strategic asset allocation effects) and research into the role of ESG issues in active ownership (notably

[4] Financial Times Fund Management, 8 May 2006
[5] Oddo Securities: The irresolvable $2,000bn pensions conundrum, February 2006
[6] JPMorgan Asset Management, June 2006
[7] See e.g. the Enhanced Analytics Initiative (http://www.enhanced-analytics.com/), the Principles for Responsible Investment (http://www.unpri.org/) and the Who Cares Wins initiative (http://www.unglobalcompact.org/Issues/financial_markets/)

direct engagement between investors and investees) has not yet been extended from the equity domain to fixed income. The mapping of ESG issues onto fixed income investments is an important step towards a stage where institutional asset owners and their service providers can truly integrate material ESG issues into the investment process in a holistic way, from investment principles, style and strategic asset allocation, to fund selection and portfolio construction, through to picking and taking active ownership decisions on individual investable assets.

A workshop on an area requiring increased attention

Given the large and increasing institutional asset allocations to fixed income, Mistra, The Foundation for Strategic Environmental Research, decided to convene a workshop of institutional investors with an interest in broadening the ESG investment debate to fixed income investments. Mistra's interest in this area is two-fold:

- As part of the Foundation's programme work Mistra sponsors a large academic research platform designed to improve the utility of academic research into the effect of ESG issues to the investment industry. This research 'bridge' between academia and industry is intended to cover work on all asset classes
- Mistra is committed to investing all the foundation's own assets according to a sustainability policy that reflects Mistra's mission to contribute to the solution of environmental problems and to work for sustainable development. Mistra's assets currently stand at approximately Swedish Krona 3.7 billion (~ US$520 million), of which approximately 35% (Swedish Krona 1.3 billion / ~ US$180 million) is invested in domestic fixed income products

As such an understanding of how ESG issues affect the performance of fixed income investments is a critical element of both the work that Mistra funds and the long-term financial viability of the Foundation. This report presents the discussions that took place during the Mistra fixed income workshop, and presents Mistra and onValues' conclusions and suggested next steps.

Workshop design and goals

The half-day workshop took place in Stockholm, Sweden on 2 June 2006, and featured investment professionals and representatives of government and academia from institutions in Scandinavia, France, Germany, Switzerland and the UK (see 'Participants' on page 15). The workshop was moderated by Ivo Knoepfel of onValues, and was held under the Chatham House Rule.

The key questions posed by the half-day workshop were as follows:

- What is the state of the art in the integration of ESG issues into investment research and asset management in corporate fixed income securities?
- What are the current approaches to ESG issues for investors in non-corporate debt?
- How can fixed income investors benefit from the 'head start' of equity investors in this domain? In which areas might their investment decisions differ?
- What possibilities exist for fixed income investors to engage with investee companies and other issuers of debt?
- How can academic research support the work of industry practitioners in this field?

Mistra's intention in convening the workshop was to catalyse further work in this field by academic and industry researchers, and to encourage collaboration between these two communities.

Workshop outcomes

Integration of ESG issues into asset management, credit ratings and investment research in corporate securities

A number of institutional asset managers presented insights into the approaches used to integrate ESG issues into existing fixed income funds. In summary:

- There is a focus on bonds issued by public entities, supplemented by corporate bonds and mortgage-backed securities
- Asset managers tend to favour a best-in-class approach to ESG issues
- When considering ESG issues in the context of fixed income investments, asset managers concentrate on how weak ESG performance could impair debt repayment, with less of an interest in how robust practices could enhance credit quality. The heightened sensitivity of the fixed income investor to downside risk was a recurrent theme in the workshop
- The managers generally adopt a classic two-screened approach — a best-in-class ESG buy list that is used by both equity and fixed income managers is married with a buy list for fixed income securities based on traditional financial criteria. There was some consensus in the room that if the fund is a classic SRI / ethical investment (i.e. one that aims to deliver a blend of financial, environmental and social return to investors) then this approach is satisfactory. If, however, the aims of the fund are purely financially focussed (with integration of ESG issues as a pathway to enhanced financial performance), then methodologies that do not systematically integrate ESG issues into financial analysis (i.e. quantify the issues) can only be viewed as a first step towards the satisfactory treatment of ESG issues in fixed income. This is an identical concern to that expressed by large institutional investors of the coverage of equity research of ESG issues
- ESG-inclusive fixed income products for institutional investors are commercially viable. One asset manager commented that although equities had attracted the bulk of ESG-inclusive assets under management to date, their experience has shown that "it is possible and profitable to develop fixed income products that integrate ESG considerations in and systematic, transparent and financially-focussed way"

Workshop participants highlighted the following key elements of the consideration of ESG issues in corporate fixed income securities:

- Mainstream credit rating agencies (Fitch Ratings, Moody's, Standard & Poor's, etc.) look at the ability of issuers to generate cash flow to cover their interest obligations (generally on a 3–5 year horizon). Corporate governance is clearly a critical element of that ability to generate cash flow and the risk in those cash flows. To this extent some ESG issues are integrated into corporate credit quality ratings[8]. Environmental and social issues are considered in corporate credit ratings, though not as explicitly as governance issues. It may be that credit rating agencies need to make clearer to issuers and research consumers how environmental and social issues affect ratings
- Anecdotal evidence from the asset managers present indicated a similar trend — that fixed income managers were increasingly accepting that governance can be financially material, but that there was much less knowledge concerning environmental and social issues. Nonetheless, conversations are beginning to take place between equity and fixed income teams and between ESG specialists and mainstream generalists on the possible impact of ESG issues on fixed income investments. Indeed, one ESG specialist asset manager noted that he found mainstream fixed income analysts to be more open to discussions of ESG issues than their equity colleagues. However, the manager noted that the fixed income analyst's perception of the issues was firmly geared towards detecting risk rather than opportunity
- A clear picture emerged of:

[8] Fitch Ratings, 2004

    - An industry-wide lack of sophistication in considering the financial impact of environmental, social and (to a lesser extent) governance issues on corporate fixed income investments
    - A lack of transparency regarding the extent to which mainstream credit rating agencies, sell-side researchers and asset managers take into account ESG issues
- It was pointed out that although the credit risk associated with criminal fraud (such as was observed at Enron, Parmalat, et al.) is considered 'force majeure' by most rating agencies, a new generation of ESG-inclusive credit ratings could include cultural and management quality indicators that might allow agencies to detect conditions conducive to corporate fraud
- It should also be noted that research into corporate fixed income securities is not restricted to the large credit rating agencies — a substantial amount of analysis of publicly-traded fixed income securities is produced by the sell-side teams of investment banks. In such research the critical concern, as with equity research, is the issues affecting the generation of cash flow and the risk associated with those cash flows. It is therefore not true to imagine that ESG issues are only material to fixed income investors if they could be expected to trigger a change in the credit rating — any issue forecast to have a cash or risk impact will change the yield and therefore the value of the investment
- Participants discussed two critical elements that must be addressed in moving towards integration of ESG issues into financial analysis of fixed income investments:
    - Timing — are positive and negative cash flows related to an ESG issue likely to occur within the lifetime of the fixed income instrument? What are the consequences of an issuer making expenditure in ESG improvement to mitigate risks and capitalise on opportunities (e.g. investment in clean technology, improvements in working conditions, splitting chairman and CEO roles)? Are positive cash flows related to new products likely to be generated in the bond's lifetime? What are the impacts on cash balances and cash generation from existing products? How do the cash flows relate to key events such as coupon payments and repayment of the principal?
    - Asymmetry of fixed income returns — clear distinctions must be made with the equity domain due to the limited upside presented by fixed income investments. This asymmetric return profile has important consequences for the psychology of fixed income investors and the bases for the decisions they make (see further discussion in 'Benefiting from and contrasting with the equity domain' on page 9)
- A possible catalyst for integration would be to add ESG into the corporate debt market at the point of issuance e.g. including ESG criteria in the bond covenants
- It was also noted that many large corporations actively measure and manage both normal operational risk and critical situations risk; the latter being both applicable to ESG issues and of particular interest to fixed income investors looking to price in risks that could place a sudden squeeze on the issuer's ability to service their debt

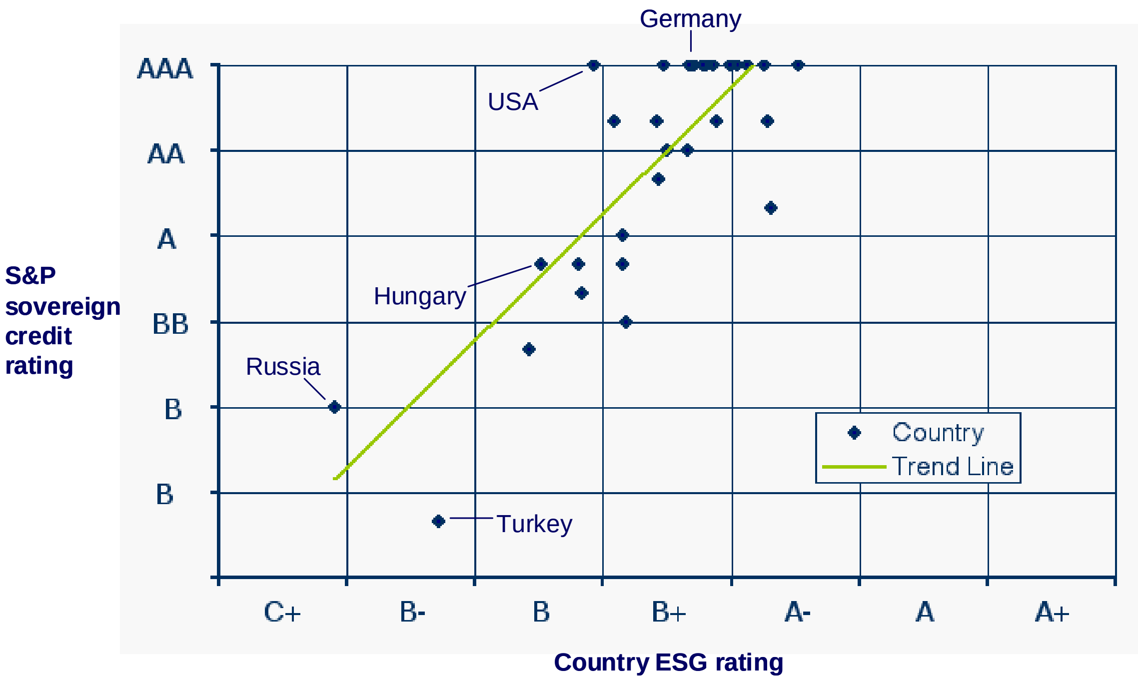
Current approaches to ESG issues for investors in non-corporate debt

A presentation was made to the workshop by a specialist rating agency on their work on ESG ratings of sovereign debt issuers. It should be noted that most of the clients for the research are 'mission-driven' investors that are looking for an investment return that is a blend of financial, environmental and social.

- Ratings are produced for many categories of non-sovereign public debt issuers:
    - National agencies e.g. Development Bank of Japan
    - Private financial institutions that provide financing for public-sector borrowers e.g. Eurohypo
    - Municipalities and other sub-sovereigns
    - Public financial institutions e.g. Caisse des Dépôts
    - Supranationals e.g. International Bank for Reconstruction and Development, EUROFIMA
- In producing ESG ratings for these types of institutions agencies often run into difficulties regarding the availability and quality of data. In Europe the public debt market tends to be

dominated by financial institutions that do not have publicly-listed equity. The level of disclosure of meaningful data is therefore low

- The rating agency looks at a number of environmental criteria for each issuer to determine an overall ES(G) rating, which is linked to the environmental and social quality of the issuing institution's own lending processes
- The rating agency has thus far found a weak correlation between issuers' environmental and social performance and their credit quality. They attribute this largely to poor data and lack of transparency. The rating agency noted that this data problem has stimulated some potential investors to engage with the institutions on their disclosure of ESG issues
- In contrast, the agency has observed a reasonably high correlation between their country ESG ratings and the S&P sovereign credit rating (see chart below)



Significance level: 1%
Correlation coefficient (Pearson) > 0.8

Source: oekom research

- This apparent correlation between the ESG performance of a nation and its creditworthiness was a point of substantial discussion in the workshop:
  - ➔ Some participants commented that this kind of ESG analysis could be an important tool for policy makers, given that it indicates that a nation's ability to raise debt and its overall investability (given that the sovereign credit risk is also the foundation for the cost of equity when considering investments in foreign countries) is directly dependent on its ability to manage ESG issues. It was suggested that investors should concentrate not the absolute country ratings but rather the change in ESG performance i.e. a low-rated country would fall off an investor's investable list if it did not demonstrate consistent improvement in its ESG rating
  - ➔ The notion of the interplay between institutional investors and the monetary policy of nations is underlined by the aforementioned trend towards liability-driven investment for defined-benefit pension funds. The solvency of such pensions is strongly geared to the interest rates set by the central banks in the countries where the fund's assets and liabilities are located
  - ➔ Others wondered if the correlation at the high credit-quality end of the scale meant that country ESG ratings were only a differentiating factor for investors for nations where the credit quality is lower e.g. emerging markets. However, with the re-emergence of ultra-long sovereign bonds and suggestions that the rising costs of social security in countries

such as France, Germany, Italy, Japan and the US could lead to a downgrade of those countries' prime bonds[9], it may be that ESG ratings could also provide added insight at the high end of the credit rating spectrum

➔ Participants also commented on the need to differentiate between country ESG metrics that are likely to be leading indicators of economic performance (e.g. levels of violence and corruption) and those that are based more on ethical or values judgements (with less clear financial implications e.g. the country's policy on whaling). There was a consensus that the former group of financially material indicators would need to be kept to a measurable and manageable number

➔ There was likewise discussion of what other indicators could be used to improve the identification political and economic risk at the country level (independence of central banks, women's literacy, etc.). This was cited as a clear opportunity for the academic community to collaborate with specialist rating agencies to produce and test a set of indicators that would identify economically material ESG risks in sovereign bond issuers. The emphasis should be on producing a small number of indicators with comparable and up-to-date data (that can capture e.g. the rapid environmental and social change taking place in China)

➔ Finally, some workshop participants commented that perhaps the most interesting insight came from the countries that are outliers to the S&P / ESG correlation. For example, what additional insight can be gleaned by investors from the fact that Turkey has a higher ESG rating than its S&P rating would predict, and from the fact that the US scores lower on ESG metrics than its AAA peers?

- An important outcome the workshop's treatment of non-corporate fixed income investments was to highlight that low-risk investment opportunities exist that are neither corporate nor sovereign. AAA mortgage-backed bond issuers are growing in number, and there are other significant opportunities to invest in the gap between corporates and sovereigns, such as through municipal debt issuers. Given that fixed income seeks low risk (for which sovereigns are suitable) but also non-correlated positions (for which sovereigns are poor, but corporate bonds better), the growing market in municipal and mortgage-backed securities provides an interesting opportunity to reduce the non-diversifiable risk in fixed income portfolios

Benefiting from and contrasting with the equity domain

As has been previously mentioned, the majority of sell-side equity research considering the financial impact of ESG issues[10] considers future operating (i.e. pre-interest) cash flows related to such issues and the cost of capital or risks inherent in those cash flows — broadly speaking, the creation of enterprise value. It therefore follows logically that ESG issues that are material to the equity investor may also have value impacts for the fixed income investor. Where can the fixed-income investor benefit from the work of equity researchers on ESG issues, and where are the points of departure?

There follows a comparison of some of the key characteristics of the valuation of fixed income and equity investments:

[9] Standard & Poor's, March 2005

[10] See e.g. the Enhanced Analytics Initiative (EAI). Although the substantial majority of the research evaluated by the EAI (173 single pieces of ESG-inclusive research were considered in the last 6-month period) analyses corporate equity, the Initiative is open to research covering other asset classes and to the use of equity research in other domains

	Fixed income	Equity
Valuation method	Spread based on credit risk calculation	Fair value based on DCF or comparative-value methods (e.g. EV / EBITDA multiples)
Time horizon of interest	Duration of bond	Perpetuity (in theory)
Key metrics	Solvency, pre-interest cash flows (for the duration of bond) — the ability and willingness of the borrower to repay the debt on time and in full	Earnings measures, dividends, free cash flows
Specific criteria	Cash flow 'disruptions', especially close to redemption: regulation, capital expenditures, fines, litigation, 'unexpected events'	Longer-term financial value drivers: revenues, costs, risk premia, tax levels, reinvestment rates, etc.

Source: onValues

- For the financially-focussed equity or fixed income investor, the value of investments is largely based on the magnitude and timing of cash generated by an asset and the risk in the generation of that cash
- Both fixed income and equity investors (and the shades of grey in between) are sensitive to the downside risk posed by a reduction in cash flow due to ESG issues
- Cash upside — 'opportunity' related to ESG issues:
    - ➔ The fixed income investor's interest in the asset's ability to generate additional cash flow is focussed on improving interest cover, solvency and other indicators of credit quality in the lifetime of the instrument. The attractiveness of cash upside follows a law of diminishing returns beyond a certain level of credit quality
    - ➔ Equity investors, in contrast, have a direct value participation in additional cash generation thanks to dividends, share buy-backs, reinvestment in the growth of the business, etc.
- Timing of cash flows:
    - ➔ The fixed income investor's key concern is how positive and negative cash flows related to ESG issues in the lifetime of the instrument coincide with regular interest payments and the redemption of the principal. A particular concern is the potential for extraordinary events to 'squeeze' the borrower's ability to make payments
    - ➔ Equity investors are concerned with distancing cash outflows and bringing forward cash inflows for present value reasons
- Workshop participants also commented that the notion that the equity investor was concerned with the cash flow profile in perpetuity often did not play out in reality, given oft-cited equity market preoccupation with the short term. As such the behaviour of short-term fixed income investors and equity investors may be similar in many cases

How, then, might we expect different types of investors to react to the intrinsic and extrinsic financial impacts of ESG issues? For example, an automobile manufacturer may decide that climate change and consumer environmental sensitivities present a significant opportunity for the company — that near-term expenditure on R&D, fixed assets, headcount, marketing, etc. will be net-present-value positive for holders of the company's equity. How would these ESG impacts affect short- and long-term fixed income investors and equity investors?

	Relevant impacts for different types of investor FY1	FY2–4	FY5 and beyond	Overall appraisal
Equity investor (long-only, long-term)	Cash downside + higher risk	Cash upside	Improved long-term growth potential and risk	Positive
Fixed-income investor (short duration, 1–2 y)	Cash downside + higher risk			Negative
Fixed-income investor (medium duration, 3–5 y)	Cash downside + higher risk	(Cash upside only if risk level is reduced)		Negative / neutral
Fixed-income investor (long duration)	Cash downside + higher risk	Cash upside	Improved long-term growth potential and risk	Positive

Source: onValues

From first principles we might therefore expect long-term holders of equity and buyers of long-term fixed income investments to 'process' information about expenditure to improve ESG performance in a similar fashion, which may differ from the decision reached from the same data by holders of short-term fixed-income investments. The significance of this parallel between equity and long-dated fixed income interests may grow in a climate where investors are looking to increase not only the size but also the duration of their fixed income allocations. It may be that the clearest differences in opinion between different types of investors are exposed by governance issues in extraordinary events such as M&A and restructurings, where the best interests of equity and the various creditors can be in direct conflict.

Finally, it is worth noting that some institutions who are holders of short- and medium-term fixed income investments make rolling investments in these instruments over long periods of time. In such cases it may be that maximising the credit quality of the current investment 'at all costs' is not the optimum investment decision over the long term.

Possibilities for fixed income investors to engage with investees

The workshop went on to consider the possibility for fixed income investors to engage with the issuers of the securities in general and specifically on ESG issues. Although fixed income investors do not enjoy the legally-enshrined voting rights of equity investors, there is clearly a sliding scale of engagement leverage from equity owners through preferred shareholders to holders of mezzanine and other hybrid instruments down to the bondholders (and their differing seniorities).

The ability of fixed income investors to engage with issuers may be particularly pronounced for regular buyers of a company or country's debt, given their ability to comment during the book-building phase on the attractiveness of the pricing (and how that attractiveness might be affected by changes in ESG performance). Similarly in the lifetime of an issue rating agencies could advise covered companies that governance and potentially environmental and social risk management might impact an upgrade / warning / downgrade.

With this is mind, workshop participants commented that:

- Fixed income investors (particularly large institutions) frequently have a direct conduit to the management of the companies they capitalise, and often exhibit de facto ownership characteristics similar to those of long-term holders of equity
- One asset manager described a direct engagement policy on its fixed income products. The manager mentioned that their engagement is strongest with first-time issuers in emerging markets, where companies tend to be more debt-hungry and more willing to engage with current and potential investors (and where ESG issues are often most acute). The manager, which uses specialist ESG research providers in parallel with its engagement, engages on environmental, labour, human rights and corporate governance issues, benefiting from the fact that they are generally also an investor in the company's equity. Mirroring the comments made regarding the opportunities for sovereign investors to demand positive change in ESG performance from

issuers, the manager commented that absolute levels of ESG performance are less important in emerging markets than positive momentum — the purpose of the engagement in emerging markets is not to insist on e.g. best-in-class corporate governance, but rather to help management to take steps in the right direction

- Despite the efficiency of engaging simultaneously with companies on the equity and fixed income sides, it may be that engagement must also reflect some of the aforementioned differences in the profile of equity and fixed income investors. For instance, it may be that fixed income engagement would focus on management's ability to limit the possibility of catastrophic financial events, whereas equity engagement may be more orientated to creating financial upside
- There is a potential problem with direct engagement by an investor where equity and fixed income investors have not differing priorities but rather best interests that are in direct conflict (see 'Benefiting from and contrasting with the equity domain'). In such cases it is likely that the responsibilities of large, diversified owners would guide them towards taking investment (including active ownership) decisions that are in the best interests of the fund as a whole, even when these decisions differ with the 'prudent' decisions on a per-asset or per-asset class basis
- Distressed debt and restructuring: recent corporate restructurings have provided ample evidence for the influence wielded by bondholder committees (given their liquidity preference and their status as likely post-restructuring shareholders). Such committees are typically an eclectic mix of speculative 'vulture' investors and legacy holders of the company's debt that were unable to divest before the debt became distressed. Although committee members are seldom interested in becoming long-term holders of the restructured entity's equity, they have a vested interest in shaping a strategy that will maximise value for future shareholders. The 'catharsis' of the restructuring process can therefore provide an opportunity to bring ESG issues onto the management agenda
- Outwith the corporate domain, ESG rating agencies present at the workshop described the engagement of fixed income investors with government financial institutions and sub-sovereign issuers to improve their disclosure of ESG-related data (having been frustrated by the lack of transparency in these non-listed institutions)
- Workshop participants also noted the smaller number of potential fixed income issuers available to investors relative to equities and the lower liquidity and transparency in their markets. Divestment is therefore a less viable option, increasing the attractiveness of engagement as a means to addressing ESG issues and other risks to the credit quality
    - ➔ An interesting corollary of this limited choice in fixed income issuers is that large institutions with sizeable fixed income allocations may more rapidly approach the characteristics of a 'universal investor', where the institution is essentially invested in all market participants and experiences investment performance more closely geared to the overall health of the market, rather than the returns on any one investment[11]. It is thought that universal investors are both more sensitive to the impact of ESG issues and inclined to use engagement rather than divestment as a response to negative ESG performance. This may also be true of defined-benefit pensions using a liability-driven investment strategy, whose performances are strongly geared to the monetary policy and overall health of the economies in which their assets and liabilities lie

Further steps

- Mistra's intention in convening the workshop was to encourage market participants to increase research into the impact of ESG issues on fixed income investments, and to foster links between industry and academic researchers
    - ➔ Recognising the learning opportunities available and exchange of ideas that took place even in the course of a half-day workshop, the participants expressed a desire to have more opportunities to discuss the extension of the ESG debate to the fixed income domain

[11] See the work of James Hawley and Andrew Williams at the Center for the Study of Fiduciary Capitalism (http://www.fidcap.org/)

- ➔ Mistra and the workshop participants therefore suggest that upcoming conferences discussing ESG issues for investors and corporations devote time to considering further the implications for fixed income investments

- The group showed a desire to demand a certain minimum level of corporate reporting on financially material ESG risks and how they are being managed. Given the importance of ESG risks in emerging markets, it was proposed to establish minimum ESG reporting standards for such countries, as a pragmatic first step in improving ESG reporting overall. It was stressed that a focus on a small number of indicators would benefit investors and investees alike
- The participants also highlighted a clear opportunity for the academic community to collaborate with specialist rating agencies to produce and test a set of indicators to identify financially material ESG risks in sovereign bond issuers, with an emphasis on producing a small number of indicators with comparable and up-to-date data

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About Mistra

Mistra, the Foundation for Strategic Environmental Research, aims to make a difference in the field of sustainable development. The Foundation achieves this by funding groups in the academic community that contribute to solving major environmental problems through applied research. Each year Mistra invests approximately Swedish Krona 200 million in the research programmes it supports.

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