Integrating ESG Analysis into Fixed Income Investing
Executive Summary

- Because yield is the primary driver of fixed income returns, capital impairment and downside risk avoidance have always been central tenets for bond investors. ESG risk assessment would appear to be a natural component of this approach.

- Unlike equity investors, fixed income investors encounter several complicating factors that can affect the assessment of an ESG risk’s impact on a credit. These include factors related to maturity, credit quality, liquidity and unrated securities.

- Amundi Pioneer’s fixed income investment team has adopted a holistic, multidimensional approach to analyzing ESG risks and opportunities, integrating the work of our US-based credit analysts with the extensive ESG tools and resources of Amundi.

- We believe integrating ESG factors into a fixed income investment process can offer significant advantages, including enhanced risk assessment and a path toward optimizing return potential and social responsibility.
Responsible Investing is the Subject of Intense Debate

In previous papers, we’ve discussed Amundi Pioneer’s framework for approaching and incorporating environmental, social and governance (ESG) analysis in our equity investment process. We now turn to fixed income which, as highlighted by a 2018 CFA Institute1 survey, is “less far along than equity,” in the adoption of ESG principles.

On the surface, this appears perplexing. Bond market investing has always been an asymmetric experience—one where the downside risk to the price of an instrument is greater than the upside potential. Because yield is the primary driver of fixed income returns, capital impairment and downside risk avoidance have always been central tenets for bond investors. ESG risk assessment would appear to be a natural component of this approach. Like equities, integrating ESG analysis into a fixed income process poses the challenge of inconsistent definitions and standards, social distortions and data profusion. However, fixed income investors also face some unique challenges.

The Complexity of Maturity and Credit Quality

After identifying and quantifying an ESG risk, equity investors have a relatively straightforward process of assessing its impact on share price. They typically employ a discounted cash flow (DCF) analysis. While there are many assumptions that go into any discounted cash flow model, the key elements that influence a DCF model’s output include: 1) The discount rate reflecting the time value of money and 2) The event probability (i.e., events in the distant future will have lower probable outcomes due to uncertainty). In the case of a debt investor, however, several complicating factors can affect the assessment of an ESG risk’s impact on a credit.

**Maturity:** Because bonds have defined maturities (equities are essentially perpetual), the impact of ESG factors can vary in importance even for the same creditor. For example, many ESG factors take time to come to fruition. What might appear to be a negligible risk over the next 3-5 years could evolve into a significant impact over a longer time horizon. Consider, for example, the potential for stranded investment2 in the oil and gas industry. Investors are now anticipating an accelerating shift to alternative energy and electric vehicles. However, even the most aggressive assumption regarding the adoption of both technologies does not anticipate a material dent in oil or natural gas demand over the short-term. Thus, an investor in a 5-year bond might conclude that the risk of significant cash flow or asset value impairment is negligible. However, over the life of a 30-year bond, the potential for a significant shift in carbon energy demand and the resulting deterioration in the oil and gas industry’s profitability and cash flow generating ability could translate into a significant steepening of credit curves (widening of the gap between the yields on short-term and long-term bonds). If the trends accelerate even faster, there is a potential for smaller industry participants to seek bankruptcy protection, materially impacting security prices along the entire credit curve.

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2 Stranded investments are those that have suffered from unanticipated or premature write-downs, devaluations or conversions to liabilities.
An Example of ESG Complexity in Credit Analysis

The inter-related nature of ESG and other fundamental risks also magnifies the complexity.

A recent bankruptcy in the utilities industry provides a stark example. The utility, a high credit quality issuer, suffered cascading losses due to a confluence of drought-heightened fire threat (E), an unsupportive regulator and diminishing societal tolerance for corporate bailouts (S) and management/board mistakes (G) that drove the company to seek protection from its creditors.

Credit Quality:

A higher quality credit should be less sensitive to ESG risks. To illustrate, compare the sensitivity of credit quality to changes in operating fundamentals. For instance, a 10% decline in operating cash flow will have a greater impact on a lower quality (more highly levered) credit than it will on a higher quality credit’s security price. The reason relates to the size (in terms of multiple) of the higher quality credit’s equity “cushion” (the market’s assessment of the value of an enterprise, above and beyond the amount of debt on its corporate balance sheet). The size of this cushion literally dampens the impact to credit quality from a drop in cash flow. In the same way, an ESG risk that affects cash flow generation equally among high and low quality credits in the same industry will have an outsized impact on the lower credit quality issuer.

There is an additional layer of complexity for below-investment grade credit. Many high yield issuers have multiple layers in their debt capital structure (senior secured or subordinated). For instance, investors in the senior secured part of a company’s capital structure may be relatively unaffected by a governance issue that creates a risk for management stability. For this class of investors, as long as management instability does not jeopardize the long-term value of the business, a governance risk may be perceived to be a transitory concern. For subordinated investors, if the governance issue causes the firm to lose access to the capital markets at a critical time, the risk could have a substantial impact on the value of their security if it forces the firm to seek bankruptcy protection. Thus, the same ESG risk may affect different parts of the capital structure of the same credit, in completely different ways.

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3 The terms senior secured and subordinated refer to the priority in which the debt claims are paid by a firm in bankruptcy or liquidation. Senior debt is often secured and is paid back before the subordinated debt. Once the senior debt is completely paid back, the company then repays the subordinated debt.
**Liquidity:** Liquidity, itself a complex risk to assess for fixed income securities, complicates any attempt to quantify an ESG risk factor. We believe a high bid/ask differential (the difference between the prices at which an investor can buy and sell a security), a consequence of poor liquidity, can dampen the discounting effect of an ESG risk in the short-term. High transaction costs may mask subtle shifts in value resulting from a deteriorating ESG trend until it is material enough. Then, illiquidity magnifies the impact as investors rush for the exits, but may find no bid for their security until the ESG risk is clearly defined. For higher quality bonds, transaction costs tend to be lower. This reduces the friction costs of any ESG risk discount, suggesting a higher sensitivity to subtle shifts in ESG risk – in contrast to the previous assertion that higher quality companies will be less sensitive to ESG risk in general.

**Unrated Fixed Income:** Many fixed income subsectors have either rudimentary ESG assessments from the traditional ESG rating providers (MSCI, Sustainalytics, etc.) or none at all. Below-investment grade corporate credit, particularly private debt, can be very problematic. While financial metrics and operating data are required for any public equity or debt issuer, private debt issuers have no such obligation. This is doubly challenging when it comes to ESG data. Even to those investors who choose to “go private,” ESG data is virtually impossible to collect, because third-party data providers rarely have access to private company reports. As a result, private debt investors would need to gather this information on their own.

Structured fixed income (asset-backed securities, mortgages, etc.) is another challenging area. ESG assessment is in unchartered territory, given the difficulty of rating a legal entity with no employees, no management team and no business activity. Like private debt issuers, the entities that finance their activities via securitizations typically lack the transparency that has enabled ESG scoring. Thus, like the private debt markets, there are no third-party providers of ESG scores for securitized assets. Amundi Pioneer’s solution is to look towards the underlying use of capital and assess the societal value (either positive or negative) of that capital’s purpose.

**Amundi Pioneer’s Holistic Approach**

Despite these challenges of integrating ESG risk in fixed income, our investment team has adopted a holistic approach, analyzing ESG risks and opportunities in connection with traditional financial data. Our approach begins by assessing the risks and opportunities within a four step, or quadrant, process. This approach is supported by the insights and resources of Amundi, a leading player in global ESG investing.
An Integrated, Multi-Dimensional Framework

Quadrant 1: Proprietary ESG Risk Scores
Amundi analyzes over 5,000 companies, utilizing a proprietary risk assessment framework that weighs and scales ESG risk factors from all major rating providers to develop a comprehensive assessment of ESG risks. Amundi Pioneer credit analysts use these proprietary risk scores in conjunction with independent commentary from our dedicated ESG analysts to highlight and evaluate key ESG exposures.

Quadrant 2: Sector and Trend Analysis
Over the years, our credit analysis framework has evolved to incorporate a long-term assessment of competitive and technological disruption. This framework provides a strong platform for the assessment of ESG risks that exhibit similar disruptive characteristics: seemingly inconsequential and benign forces that rise to an exponential nexus at some “tipping point.” Using this platform, our analysts determine the level of systematic (or sectoral) ESG risk versus idiosyncratic (company specific) risk. We can then compare systematic risks across sectors, develop relative ESG risk rankings and identify companies with “best ESG practices” to aid in sector relative value analysis. To assess potential outcomes, we gather a historical perspective, and then consult with management and industry experts to identify company and industry level trends.

Quadrant 3: Relevance, Materiality and Time Horizon
Here we weigh the relevance and possible impact of an ESG risk on an issuer’s future credit quality against multiple time horizons over which the ESG risk will materialize, to determine the appropriate discount. It’s critical to define relevance of a risk because there may be a myriad of ESG factors to consider. By our count, the ESG ratings providers have identified over 200 ESG risks. Clearly, some risks are more relevant to specific sectors.

Quadrant 4: Engagement
A key pillar of our investment process is interaction with management on strategic issues and prospective issuance. ESG engagement is a critical extension of this. Historically, fixed income investor engagement with companies on ESG issues was viewed as having limited value. The belief was that equity investors had more leverage because of management’s focus on their company’s share price. This is changing. Fixed income investors are increasingly voicing concerns about ESG risks. Working in concert with our equity colleagues, we are now more frequently relaying concerns about ESG risks to management teams.
Example: Materiality Analysis

For a steel manufacturer, social risks are less relevant than an assessment of environmental risk factors. While there may be concerns regarding working conditions, safety issues etc., there is no brand or franchise at risk if a social issue surfaces. On the other hand, the company’s poor waste remediation could result in significant fines, materially impairing firm value. The opposite may be true for a consumer brand company. Thus, materiality is linked to relevance. However, even if an ESG factor is relevant to a specific industry, if we determine the risk will not materially affect a company’s ability to generate cash flow in the future, impair value or threaten capital, it does not make sense to spend time analyzing it. Our analysts thus determine:

- How the level of risk and its trend is embedded in the price of the security
- If a more significant discount is warranted because the risk is being ignored or underappreciated
- Whether an opportunity exists because the risk is overly discounted, or there is a positive trend that the market has missed or underappreciates

Conclusion

We believe integrating ESG factors into a fixed income investment process can offer significant advantages. Different maturities, uncertain liquidity conditions and the complexity of the credit quality dimension provide a host of opportunities for competitive advantage over traditional credit risk assessment. We believe that by intentionally incorporating these factors into a robust credit research process, we can help identify short and long-term risks and can help avoid capital impairment and pursue relative value opportunities for our investors. Finally, a process that balances both opportunities and risks and integrates insights gleaned into a fundamental framework that encompasses a long-term disruption perspective, will help investors identify a path toward optimizing return potential and social responsibility.
When interest rates rise, the prices of fixed income securities will generally fall. Conversely, when interest rates fall, the prices of fixed-income securities in the will generally rise. Investments are subject to possible loss due to the financial failure of issuers of underlying securities and their inability to meet their debt obligations. Investments in high yield or lower rated securities are subject to greater-than-average price volatility, illiquidity and possibility of default.

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