MFS® White Paper

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Sustainability in Credit Under the Spotlight

Environmental, social and governance investing in fixed income

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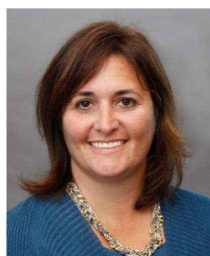

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In brief

- **Integrated approach** — incorporating environmental, social and governance (ESG) factors into the fixed income investment process is best done by embedding ESG analysis into the credit analysts' and portfolio managers' research process, rather than relying on exclusions or investment decisions based on external providers of ESG ratings.
- **Materiality and time horizon** — the complexity of markets requires that investors determine the potential materiality of ESG risks and opportunities as well as the time-frame within which they are expected to have an impact on borrowers' credit quality.
- **Active management** — Due to the changing nature of ESG factors and their effect on investee companies, we believe that active managers are well suited to assess ESG risks and opportunities. Incorporating ESG factors allows for an understanding of borrowers from the viewpoint of various stakeholders and provides a means of engaging with management.

Fixed income investors are increasingly incorporating material ESG factors into the assessment of credit risk. ESG is now also more likely to be integrated into the mainstream investment process, as opposed to a specialist, segregated activity, confined to green bonds or appended onto the investment process.

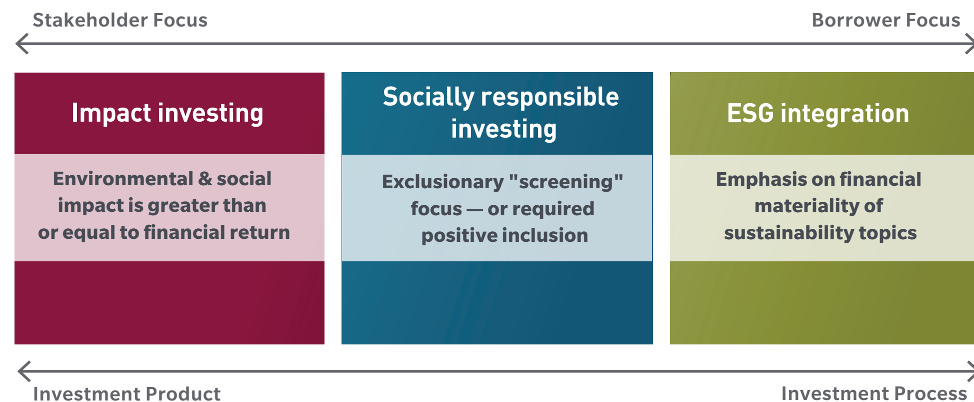
ESG investing has its origins in the equity markets beginning with religious, values-based or thematic — largely environmental — investors. With the founding of the UN Principles of Responsible Investment (UN PRI) in 2006, the movement to encourage equity owners to influence the behavior of companies in relation to ESG issues gained further impetus.

Importantly, these measures helped to shift sustainable investing beyond purely norms-based ethical approaches (*e.g.*, negative screening for tobacco or gambling stocks) and toward mainstream integration in the investment process. This led to further adoption of ESG investing by the investment community, primarily in three forms: socially responsible investing (SRI), impact investing and ESG integration (shown in Exhibit 1).

In a US context, socially responsible investing (SRI) generally refers to a normative approach, *i.e.*, eliminating or selecting investments according to specific guidelines. Impact investing aims to generate a measurable, beneficial social or environmental result alongside a financial return.[1] An integrated ESG approach involves assessing ESG risks and opportunities in the course of fundamental investment analysis, portfolio construction and risk management.

The integrated ESG model is gaining traction in the investment community according to a survey of more than a 100 fixed income managers conducted by Russell in 2016.[2] The study revealed that 68% of fixed income managers who participated have an investment policy that covers how ESG considerations are integrated into the investment process.

Exhibit 1: Sustainable Investing Paradigms



Creditworthiness and cash flow generation

Fixed income analysis, at its heart, is concerned with the creditworthiness of a borrower — how likely they are to pay interest when it is due and the probability of receiving the principal in full and on time. Analysts assess the sustainability of cash flows and the willingness of the borrower to repay the debt when it falls due.

The distribution of fixed income returns has a fat-tail, meaning that the vast majority of fixed income securities pay their coupons and principal on time and in full, however, a small minority default or need to restructure their debt obligations. In other words, fixed income investors face a high probability of getting their money back and earning a small return, as well as a small probability of suffering major losses. This is the main reason fixed income analysis focuses first and foremost on downside risks. This is a key difference from equity investing where returns tend to have a more normal distribution.

While ESG integration is currently in the spotlight, it is helpful to remember that fixed income analysts have been implicitly incorporating ESG risks and opportunities into their traditional investment process for a long time even though it may not have had an explicit ESG label. However, we believe a formal ESG integration process can help identify additional risks and opportunities by looking at an investment from a unique perspective.

ESG integration considers a number of factors in the course of analyzing, selecting and managing investments, including, for example:

- **Environmental:** climate change, pollution, carbon emissions, biodiversity, water stress, resource efficiency, sustainability;
- **Social:** labor practices, human rights, income inequality, community relations, diversity policies, human capital employee health and safety, education;
- **Governance:** corruption, strength of institutions, transparency of decision-making, corporate governance, rule of law.

When asked which ESG factor is the most important in investment decision-making, governance is cited by the majority of respondents in a couple of recent surveys.[3] This may be because governance considerations are relevant for all securities, while the materiality of environmental or social topics will vary based on the industry and issuers.

> Integrating ESG considerations into the credit analysis process is just as important as trying to determine whether the leverage of a company is likely to increase over the next two to three years.

ESG in fixed income

Even though fixed income analysts have been taking account of ESG factors, whether implicitly or explicitly, for some time now, it remains challenging to assess the impact of ESG-related factors in fixed income for a couple of reasons. Firstly, the time it takes for these factors to affect borrowers can often be lengthy and, secondly, the materiality of these factors needs to be determined in the context of the overall credit analysis.

For example, given decades-long trends in regulatory developments, it has been clear that cars would need to evolve to reduce emissions. However, the risk of failure to do so has only become material for credit quality since the middle of the current decade when the combination of tougher regulation (environmental), a change in consumer preferences (social), and companies employing questionable methods to meet emission standards (governance) combined to have a material and immediate effect on companies' credit quality.

In a similar vein, it is widely known that many multinationals, including some popular household names, employ legal structures to minimize corporate tax payments. There have been several instances where increased media attention and changes in regulations have impacted corporate tax payments, and aggressive tax practices have provided an important signal regarding a high risk tolerance on the part of a board and management team. However, to this point, tax issues have not appeared to impact demand for their products and services. It remains to be seen if this happens in the future. Minimizing tax payments is not in and of itself a negative for credit, but this topic could prove to have additional adverse effects on these companies' business models in the future, especially as tax-related disclosure increases.

For these reasons, ESG factors need to be reviewed consistently as part of the ongoing security monitoring process to access materiality and the timeframe in which they are likely to have an effect — positive or negative — on credit quality. Integrating ESG considerations into the credit analysis process is just as important as trying to determine whether the leverage of a company is likely to increase over the next two to three years.

The wide variety of potential ESG factors combined with the enormous diversity of entities that issue fixed income securities, along with the range of securities each entity can issue can pose challenges when integrating ESG factors into fixed income analysis. Investors need to develop a clear strategy and a framework that can assist analysts in identifying and quantifying the risks and opportunities. We believe that the approach must be dynamic, however; over-reliance on a static list of criteria and decision-trees will likely result in suboptimal investment outcomes.

In our experience, most ESG factors represent potential downside risks. Likewise, fixed income research generally emphasizes downside risk management over upside potential. From this perspective, integrating ESG factors into the fixed income analysis process can be relatively seamless. Another similarity is that credit quality deterioration is most often a gradual process in the case of both ESG and more classic fixed income risks. Pressures build within the debt structure, which at first may appear immaterial and can remain that way if the borrower takes remedial action. However, sometimes the pressures build gradually over time until the debt burden becomes unsustainable and the structure collapses.

In classic fixed income investment analysis, investors look at financial variables to determine whether pressures are building in the debt structure, but it remains nearly impossible to predict the precise factors and timing that will drive an issuer to bankruptcy. Similarly, when looking at ESG factors, pressures can develop gradually over time and become material, *e.g.*, an independent board of directors can become less independent, benign products used in the production process can be replaced with harmful products, and tax avoidance schemes can be put in place.

The pressures from ESG factors can sometimes be mitigated with actions, but sometimes they build within an issuer and become so great or coincide with a change in the operating or regulatory environment, and a confluence of events then leads to severe deterioration in the sustainability of the borrower.

Determining the effect of the timing and materiality of ESG factors on an issuer's credit quality is extremely difficult and very complex to model. The interplay between various factors can be relatively straightforward until a sudden change occurs, similar to catastrophe theory. It's like trying to model how high ocean waves can rise before they crash.

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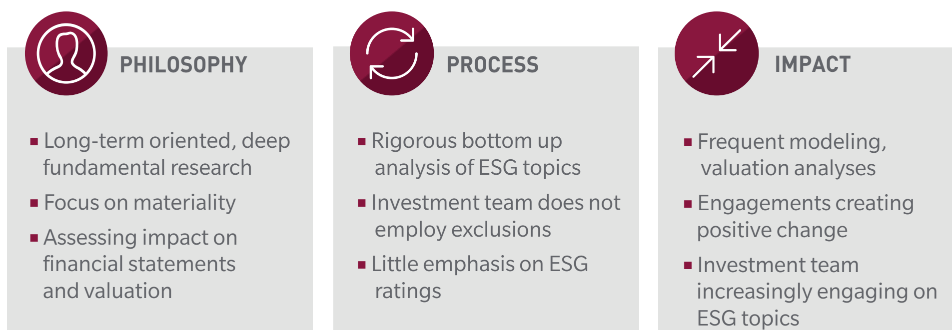
ESG ratings

ESG scores supplied by third-party providers are one tool available to assist investors in the analysis of ESG risks and opportunities. While these ESG ratings are widely used by fixed income investors, many managers are focusing more intently on their own in-house proprietary ESG analysis. The Russell study published in 2017 mentioned above found that 52% of the respondent fixed income managers use third-party ESG providers exclusively; 35% use external providers with an in-house ESG analysis overlay and 15% only use internal analysis.[4]

MFS' approach to sustainable investing

MFS is focused on fundamental research with a long-term time horizon, an investment philosophy and approach that easily lends itself to integrating material ESG risks and opportunities. In fact, while we receive ESG ratings and research from many third-party providers, we have found that MFS' ESG analyses are sometimes at odds with third-party ratings. This is discussed in one of the case studies on pages 7 and 8. Exhibit 2 provides an overview of MFS' approach to ESG Integration.

Exhibit 2: ESG Integration at MFS



ESG information on borrowers can provide the possibility of valuable new and differentiated topics for risk consideration, *e.g.*, water risk in certain regions of the globe. Along with the interest in sustainability, more ESG data is now available to supplement traditional fixed income research, *e.g.*, employee safety data. These insights and data points help analysts understand the long-term sustainability of cash flows, the crux of credit analysis.

Active management

Investors seeking to integrate ESG factors into fixed income analysis need to consider the range of factors that determine the valuation of a fixed income security using the classic investment approach, and simultaneously assess whether ESG factors pose material and timely risks, tail risks or whether they are of no relevance to the security being analyzed.

The range of different types of ESG risks and opportunities, and the impossibility of quantifying their effects in a hands-off objective fashion, means that incorporating ESG factors into fixed income investment analysis is best accomplished via active management. An active approach provides the necessary flexibility. Tracking an index or using a screening approach based on a fixed set of parameters risks a suboptimal investment selection over time because of the changing nature of ESG factors and their effect on cash flow sustainability.

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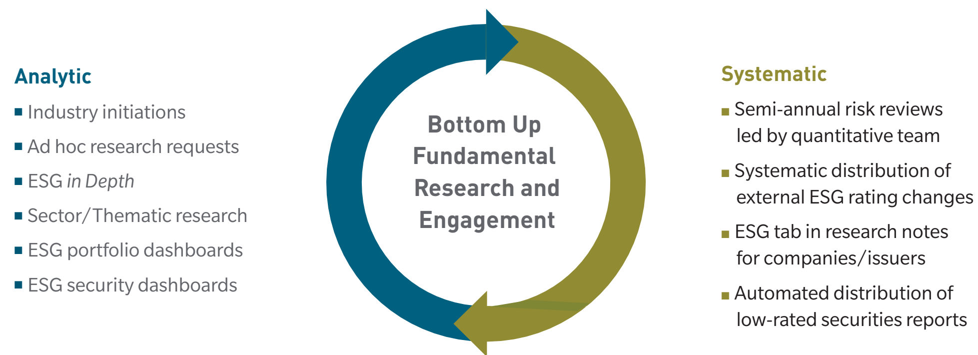
Exhibit 3 shows the analytic and systematic elements of our ESG integration framework, which is designed to facilitate the effective assessment of ESG factors by all of our investment professionals.

Exhibit 3: MFS Sustainable Investing Strategy



Conclusion

There is a high level of ESG awareness and increasing ESG factor integration among fixed income managers. Increasingly, ESG integration is being driven by the rationale that, as a part of credit analysis, it should provide a more comprehensive picture of a company's outlook and long-run sustainability.

Assessing ESG in the context of overall credit risk is complex, requiring investors understand the array of potentially material ESG factors, as well as the time-frame within which they are expected to factor into a borrower's credit quality. The changing nature of ESG factors makes a formulaic approach with set criteria suboptimal. Incorporating ESG criteria into the analysis process can be a point of differentiation among managers, often leading to more appropriate compensation for existing risks.

The dynamic nature of ESG factors and their effect on borrowers' risk profile and opportunity set point to the benefits of active management. An active approach allows fixed income investors to develop an understanding of borrowers from the viewpoint of various stakeholders, and provides a means of accessing and engaging with management. In our view, the result is a better informed investment decision.

In addition, clients in all regions are asking for greater transparency and accountability vis-à-vis ESG factors. There is a strong investment case for the integration of ESG into the credit evaluation process — and a client-driven business case, which is likely to continue to propel the industry forward in this regard.

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Case Studies

These case studies illustrate how ESG analysis is integrated into the fundamental investment process at MFS.

US corporate bond issuance

As part of our analysis of an American automobile manufacturer in advance of a bond issuance, we incorporated a broad view of its ESG performance. From an environmental perspective, we considered the company's commitment to electric vehicles as a positive. However, we also noted several concerning social issues, including accusations of union-busting activities, employee discrimination, above-average worker injury rates and product safety issues alongside a generally concerning governance profile. These factors contributed to our view that the company faced a high probability of operational challenges. In light of this, and factoring in the company's negative cash flow, we believed investors were not being adequately compensated for the risk they were taking.

As mentioned, we often find third-party ratings do not align with our views regarding the materiality of particular ESG factors. In this case, we noted the company's strong third-party ESG ratings, which were a function of environmental considerations, such as the extremely low point-of-use carbon footprint of electric vehicles. Other factors on the ESG continuum, such as those outlined above, carried far less weight in the third-party rating assessment.

Outcome

Since we conducted this analysis in 2017, the company has experienced labor and management issues, as well as accelerated cash burn. These issues ultimately also resulted in a third-party ESG rating downgrade in early 2018, well after our investment process had identified the risks in the investment.

Emerging market sovereign debt – South Africa

For the past several years, as a result of governance concerns related to deep political divisions within the ruling African National Congress (ANC) as well as fiscal mismanagement, our hard currency (US dollar) emerging markets debt portfolios have been structurally underweight South African debt. This underweight was increased in 2017 when then-president Zuma replaced his well-regarded finance minister, Pravin Gordhan.

We perceived Gordhan's ouster as a downgrading of the leadership of the national Treasury and anticipated a steady erosion of South Africa's credit metrics. These dynamics were underscored in November 2017 by Standard & Poor's downgrade of the country from BB+ to BB on political turmoil as well as a disappointing medium-term budget policy statement.

Throughout 2017, market observers watched preparations for December's 54th National Conference of the ANC with great anticipation. The conference's choice of successor to Jacob Zuma in the role of party president would bear significantly on the future stability of the government and its fiscal policy. The selection of Vice President Cyril Ramaphosa would introduce the prospect of improved governance and political change, while a win by President Zuma's ex-wife, Nkosazana Dlamini-Zuma, would likely have meant continued fundamental deterioration. In a market-friendly outcome, Ramaphosa was chosen and efforts to force Zuma to resign from the presidency accelerated following the conference—culminating in Zuma's February 2018 resignation and replacement by Ramaphosa.

Outcome

Ramaphosa consolidated power faster than expected, and has surprised positively by delivering a credible budget (*e.g.*, raising the VAT), stepping up investigations into corruption, implementing governance changes at state-owned enterprises (including Eskom), and conducting an extensive cabinet reshuffle where the three important ministries of finance, mining, and public sector enterprises were given to reform-minded ministers. These are, in our view, positive outcomes that offer better prospects for meaningful reform, including improvements in governance and fiscal management. They have led us to reevaluate our underweight position.

Nordic telecom company

Following a period under private equity ownership, a Nordic telecom company was publicly listed in 2010, regaining an investment grade rating. The original owners had completely exited by 2013, however, by 2016 there was persistent media speculation about renewed private equity interest. The company also screened well as a potential target given its stable earnings profile, strong cash generation and relatively low leverage.

The ESG analysis conducted by MFS' telecom analyst focused on governance issues relevant for bondholders — factors such as clauses in the bond documents (*e.g.*, coupon step-up following credit rating downgrades and change of control put options) and management remuneration metrics. In addition, MFS' fixed income analysts attended regular meetings with the company management alongside their equity research colleagues and benefited from their perspective on the company.

The assessment was made that management was mostly focused on shareholder remuneration and much less on balance sheet strength and bondholders' interests. The likelihood of another leveraged buyout during the life of the bonds was judged to be high and the effect material, thus meeting the material and timeliness test.

Outcome

The company was bought by a private equity consortium in February 2018 and yields widened to reflect the more highly leveraged balance sheet. Its credit rating was also cut multiple notches by three rating agencies.

European bank

ESG policies can also be a differentiating factor, highlighting a relative strength. This particular European bank has a robust ESG strategy that includes exclusionary criteria encompassing human rights, business ethics, protection of the environment and sensitive or controversial societal issues.

For example, companies involved in controversial weapons systems or labeled as “worst offenders” under the UN Global Compact Principles are blacklisted from doing business with the group. The bank also has specific policies for social and environmentally sensitive sectors, such as gambling, fur, palm oil, soy, intoxicated crops, deforestation, mining, tobacco, etc. It also has a human rights policy and a Modern Slavery Act Statement.

Each business unit is required to present a sustainable solution at least once a year and 15% to 20% of the variable compensation of the executive committee members is based on their sustainability efforts. The bank's ESG policies also extends to its product portfolio. It has an established SRI fund and launched an SRI pension fund this year.

Outcome

These factors reduce the risks of the bank being embroiled in financing activities that expose it to regulatory fines, sanctions and public criticism — and its ESG product range seeks to capitalize on ESG opportunities in the market. These considerations support a strong and sustainable business model.

Endnotes

[1] Inderst, G. and Stewart, F., Incorporating Environmental, Social and Governance (ESG) Factors into Fixed Income. Investment. World Bank Group publication, April 2018.

[2] Russell (2017), Fixed Income ESG Survey Results, Russell Investments.

[3] Russell (2017), Fixed Income ESG Survey Results, Russell Investments; Callan Institute 2018 ESG Survey.

[4] Russell (2017), Fixed Income ESG Survey Results, Russell Investments.

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