Key Findings | CROSS ASSET Investment Strategy

ESG Investing & Bonds: Key Findings

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Amundi ASSET MANAGEMENT

Responsible Investing & Performance: The Bond Frontier

As investors gradually integrate ESG into their stock and bond portfolios, it becomes crucial for Amundi, as a leading responsible investor, to gain a deep understanding of the various facets of ESG and its impacts on different asset classes. Therefore, ESG has been a top priority for Amundi research teams.

In 2018, we published a seminal paper exploring the impact of ESG investing on asset pricing in stock markets for the periods 2010 to 2017. We recently published an update of this paper, extending the analysis to June 2019. We found that, while ESG investing tended to penalize both active and passive ESG investors between 2010 and 2013, ESG investing was a source of outperformance from 2014 onwards, even becoming a beta strategy in the Eurozone.

We now turn to the question of the impact of ESG investing in the fixed income space, a domain that has yet to be fully explored by academics and professionals. Our new study shows that the performance of ESG investing has improved over time in corporate bond markets between 2010 and 2019.

"As a responsible asset manager, it is our duty to constantly take the pulse of ESG investing dynamics, to ensure that we remain at the forefront of responsible investing. Last year, we focused on equities. This year, we update this study and consider the case of corporate bonds. Ultimately, we plan to cover all the traditional asset classes."

Thierry Roncalli, Head of Quantitative Research

Since 2014, the credit return of the long/short strategy between best-in-class (or 20% best-ranked) bonds and worst-in-class (or 20% worst-rated) bonds is positive in Euro-denominated Investment Grade (IG) bonds for the ESG global score, but also for its three pillars (Environmental, Social and Governance). If we control the tracking error risk with respect to the benchmark, we obtain a similar story. The performance of ESG optimized portfolios was penalized before 2014, whereas ESG integration has created alpha since 2014.

In the case of Dollar-denominated IG bonds, the results are more disappointing in absolute value, but the trend between ESG and performance is positive. Indeed, ESG investing was a source of underperformance from 2010 to 2019 if we consider both long/short best-in-class versus worst-in-class strategies and benchmark-controlled optimized portfolios. Nevertheless, we noticed that the large underperformance during the 2010-2013 period has been dramatically reduced these recent years.

The study also demonstrates the positive impact of ESG on the cost of capital of issuers. For instance, after controlling for the credit quality, we estimate that the theoretical cost-of-capital difference is equal to 31 bps between a worst-in-class corporate and a best-in-class corporate in the case of EUR IG corporate bonds. In the case of USD IG corporate bonds, it is lower but remains significant at 15 bps. These results are important because ESG investing and ESG financing are two sides of the same coin. In order to tackle environmental and social issues, ESG must be a winning bet for both investors and issuers.

ESG in Fixed Income: Not as Straightforward

In the stock market, integrating ESG is a natural strategy for investors seeking lower extra-financial risks than the average, completing and enhancing traditional security analysis and stock picking processes. For instance, governance scoring can be a useful tool to reduce reputational risks. This is particularly relevant for long-term investors, who are at the cutting edge when it comes to implementing ESG in equity markets. For fixed income, the picture is slightly more complicated. Indeed, investors seem less advanced when managing their bond portfolios.

In the sovereign space for instance, ESG filters can lead to significant exclusions or underweighting, pressuring liquidity. There are a few reasons why bond investors may be less prone to integrating ESG:

- Credit agencies increasingly announce that they already integrate ESG risks as one of their metrics.
- Bond scoring systems are mainly driven by three factors: duration, credit spread, and liquidity. Playing ESG in a fully diversified investment grade bond portfolio leaves little room for taking on idiosyncratic risks.
- Liquidity issues are more prevalent in the fixed income space, making it difficult to rebalance actively managed portfolios using ESG signals.
- The objectives and time horizon of the bond holder differs from a stockholder: given the fact that he knows the return on the debt, his main objective is to minimize the risk of default within the maturity of the instrument. Therefore, a stock holder will be more sensitive to ESG risks than a bond holder.

For these reasons, we notice that ESG integration in fixed income is not so much about portfolio *management*, but more about portfolio *completion* with green, social or sustainability (GSS) bonds. In order to observe real disruption of ESG on bond investing, we would need to see supply/demand imbalances on the traditional fixed income market, and not only on GSS bonds.

Main finding: A Real Transatlantic Divide

Using the same methods as for our previous research on stock markets, we consider the impact of ESG screening on the investment grade universe:

- For euro-denominated IG corporate bonds, the results closely echo findings on the stock market:
  - Between 2010 and 2019, best-in-class bonds have outperformed worst-in-class bonds, with the 2014-2019 period even more favorable than the 2010-2013 period. For example, buying the best-in-class (or 20% best ranked) bonds and selling the worst-in-class (or 20% worst ranked) bonds would have generated an annualized performance of 37 bps between 2014 and 2019.
  - Optimizing a bond index with an ESG tilt generated negative excess return for 2010-2013, but positive excess return during the 2014-2019 period. For example, an optimized portfolio with 25 bps tracking error would have generated an annualized excess return of 3 bps between 2014 and 2019.
  - Social was the winning pillar over 2014-2019.

Annualized excess credit return in bps
(IG, 2014-2019)

	Long/short strategy				Optimized strategy (TE = 25 bps)			
	ESG	E	S	G	ESG	E	S	G
EUR IG	37	4	42	15	3	4	9	-3
USD IG	-32	-36	-12	-19	-9	-10	0	-12

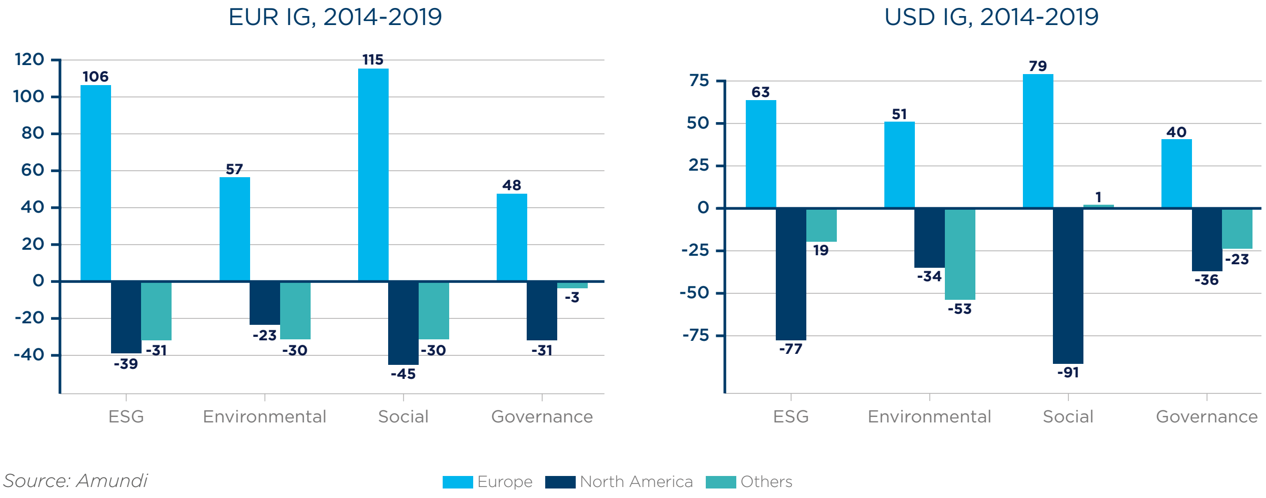
- For USD-denominated IG corporate bonds, we notice that the results are more negative for both the long/short strategy and the benchmark-controlled optimized strategy: we do not observe a positive relationship between ESG scoring and performance. For instance, the previous figures become -32 bps and -9 bps in the case of USD IG bonds whereas they were +37 bps and +3 bps in the case of EUR IG bonds. However, we notice an improvement of ESG investing between 2014 and 2019 compared to the previous 2010-2013 period.

"Contrary to common ideas, ESG investing may generate performance in EUR IG bonds. In the case of USD IG bonds, ESG investing is penalized. But we are beginning to see the light, as the cost of ESG investing has been dramatically reduced these recent years."

Alban de Faÿ, Head of SRI Fixed Income Processes

These results seem to indicate that the currency (EUR versus USD) is an important factor when implementing ESG investing. However, we may wonder if this divide really concerns the currency of issued bonds or if it is more a regional issue. For instance, a EUR-denominated bond can be issued by a European corporate, but also by a firm which is located outside Europe. In fact, if we consider the long/short strategy between best-in-class and worst-in-class bonds, our study shows that Europe had a systematic positive contribution whereas North America has a systematic negative contribution, whatever the currency (EUR and USD). If we consider optimized portfolios, results are similar. Therefore, this transatlantic divide shows that ESG investing is a source of outperformance when it concerns IG bonds of European issuers, but a source of underperformance when it concerns IG bonds of American issuers.

Contribution in bps to the long/short strategy



Source: Amundi

ESG Investing & ESG Financing: Two Sides of the Same Coin

The study shows that ESG and credit ratings are positively correlated. In order to identify the marginal effects of ESG, we have developed an integrated ESG-credit pricing model. We found some evidence that ESG affects the cost of capital in a positive way: issuers with higher ESG scores have lower cost of capital than issuers with lower ESG scores for the same credit rating. At the equilibrium, the yield spread difference between a best-in-class and worst-in-class corporation is equal to 31 bps and 15 bps for Euro- and Dollar-denominated IG bonds for the 2014-2019 period, whereas the impact of ESG was not significant between 2010 and 2013.

If we consider a less theoretically extreme example, for instance for a diversified credit portfolio mainstreaming ESG criteria, the yield spread difference is between 3 and 8 bps in EUR IG and half in USD IG. These results are important because they show that ESG does not only concern the investment side, but also the financing side. Bond issuers must take into account these stylized facts all the more since ESG investing will continue to spread in the fixed-income space.

ESG Investing & Fixed-Income: What is Next?

As a responsible investor, Amundi continually monitors ESG investing dynamics in order to understand how ESG investing impacts the pricing of financial assets and how to be positioned to meet the needs of our clients. This study gives a direct reading of the market behavior in the past. Looking forward, it can help to anticipate future trends, although a simple extrapolation of past results is not satisfactory.

Key Takeaways

As investors navigate these new waters, they will need to have a clear sense of the directions they want to take. Looking beyond this study, these are some of the takeaways and convictions we hold for the future:

1. We have crossed the Rubicon: the positive relationship between ESG and performance in the 2014-2019 period shows that ESG is materializing to the point that it has become a factor. Therefore, ESG must be regarded as a key investment decision driver.

2. More and more ESG criteria are integrated in Credit Rating methodologies. As a consequence, ESG criteria have more and more impact on the valuation of fixed income instruments and there are some correlation patterns between ESG and credit ratings.

3. Highlighting the value provided by research throughout the investment life cycle, the integration of ESG means (a) being able to clearly explain ESG rating methodologies, (b) articulating ESG ratings within credit analysis, (c) elaborating impact assessments of ESG on credit quality and (d) sharing all these elements with investors.

4. ESG integration has gone mainstream and is now assessed by investors as both a financial performance driver and for its impact on each of the three pillars (E, S and G). Therefore, ESG integration should not limit itself to credit analysis. Investment policies must integrate ESG rating objective underpinned by a comprehensive approach on E, S and G. The most obvious objective in this regard is a better ESG portfolio score than the benchmark, complemented by an exclusion policy in each of the three pillars.

5. When selecting asset managers, investors increasingly scrutinize the capacity to generate financial performance and to prove a positive impact of ESG. Thus, the integration of ESG is now a matter of fiduciary duty for both asset managers and investors.

"On ESG, there is no turning back. The integration of ESG is now a matter of fiduciary duty for both asset managers and investors."

Eric Brard, Global Head of Fixed Income

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