

ESG is a Natural Fit for Fixed Income

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ESG¹ factors should be more important in fixed income investment decisions than in equities. However, there certainly seems to be much more focus in the ESG literature about its impact and use in the equity markets.

Fixed income investing, and especially in the leveraged debt markets, has asymmetrical risks. Therefore, the first step in successful credit selection is to select issuers that will preserve one's capital and will pay their interest obligations over the life of the debt. Then one can concentrate on credits that have momentum to see improving fundamentals and potential spread tightening.

A disciplined credit approval process needs to carefully review potential risks. It needs to incorporate risks specific to the industry, the company, the financial statements, management, and the securities. Almost all of these segments involve ESG factors. In a systematized approach, all of the critical ESG factors can be segregated and examined separately.

Exploring these risks before investing in a credit is either in a firm's investment DNA or it is not. This responsibility cannot be an overlay that gets factored into investment risks only some of the time. With a framework in place, a client can see some metrics regarding the ESG risks that were evaluated in their portfolio. Additionally, in a separately managed account, it is possible to accommodate an investor that requires more customization regarding ESG factors. For example, if a client wants a portfolio concentrated in credits that face a lower level of ESG risks – that can be done.

Compared to ESG, SRI² is much more dependent on one's definitions. For many years, Shenkman Capital has worked with clients that want to limit or exclude investment exposures in certain industries or in specific lines of business. Experience has shown that there are many different views as to which industries or businesses should be part of such exclusions.

We have identified the most common factors that we have seen over time and are aware of the typical tolerance levels. This makes it easier to customize investment solutions for clients that want to have SRI related screens in their portfolios. Many investors utilize their own internal teams or third parties to develop their own lists, which can easily be incorporated into portfolio construction. However, we have seen that some of the larger third-party organizations are heavily focused on equities, and their work has incomplete overlap with the leveraged finance market.

SRI factors usually overlap with ESG issues. The major difference is that when examining these factors from an ESG perspective, it is explored as part of the risk assessment for making investment decisions. In SRI, it is part of an activist decision as to what type of businesses an investor is willing to help fund.

While negative screens are one way of pursuing SRI, concentrating on companies or businesses that are actively engaged in areas an investor supports is also possible, a.k.a. a positive screen. There are many companies that are actively pursuing their business goals that we believe would be considered positive by most people interested in SRI. For example, we have seen a company that is helping to reduce cost of books for college education through rental and electronic platforms come to the convert market. In our Fallen Angels & Rising Stars strategy, we have invested in a Scandinavian packaging company that has a large sustainability effort with a focus on recycled products and also requires many of its suppliers to report the use of renewable fuels in their transportation of supplies.

To assess and systematize ESG factors in fixed income requires a well-resourced, dedicated and disciplined approach, as third party information is incomplete. Good data and analysis on ESG factors is critical in proper risk assessment before making the decision to lend capital to a company. Similarly, SRI investing is possible using both negative and positive screening approaches when research analysts know it is a critical part of the analysis. This analysis requires a firm-wide investment approach that includes these issues in the regular decision process.

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¹ Environmental, Social and Governance.

² Socially Responsible Investing.

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