ESG opens doors into EM Corporate Debt

Stockholm (HedgeNordic) – While responsible investment has grown fast over the past couple of years, the proportion of assets in fixed income portfolios that follow a sustainable investment strategy is still much lower than in equities. In the arena of emerging market corporate debt, the concept of ESG integration becomes downright niche. Yet several academic studies show a positive relationship between ESG and financial performance. More remarkably, the favourable effect is stronger in fixed income and in emerging markets than in equities and developed markets. This year, the Emerging Market Fixed Income team at Union Bancaire Privée (UBP) launched a product in that exact place. HedgeNordic spoke to Karine Jesiolowski, Senior Investment Specialist – Emerging Fixed Income and Member of UBP ESG Committee to discuss the rationale behind this strategy.

"The idea of launching the Emerging Market Sustainable High-Grade Corporate Bond fund was born last year, in conjunction with the wider re-thinking of our overall responsible investing policy at UBP," starts Jesiolowski. "We decided to embed responsible investment more deeply throughout the organisation, including our asset management and private banking franchises. We set up an exclusion list that would apply to all our clients across platforms, and set up a watch list for companies involved in deep controversy, to ensure that all portfolio managers are aware of potential issues. We also wanted to gain everyone's buy-in to come up with an inclusion list containing ESG champions or companies that have a positive impact in line with the United Nations' 17 Sustainable Development Goals (SDGs). The new UBP policy was implemented as of the beginning of January this year."

For the Emerging Market fixed income team, integrating ESG was a no-brainer. Unlike other organisations where sustainability starts within the equity team and spreads across the capital structure progressively, at UBP, the buy-in was strong on the bond side from the onset. "Here, our strongest expertise resides in emerging corporates and in this area, governance, and environmental issues can often generate large drawdowns in single names," Jesiolowski continues. "It made sense to combine ESG with our own credit fundamental and relative value analysis. However, beyond the idea of using ESG to manage risk, we thought that it would be interesting to launch a fund dedicated to sustainable EM credits, as there are simply not many products available in that space."

The first step consisted in defining a wide enough investment universe. "We needed to determine whether the market would be investable and diversified enough to create a portfolio that makes sense," explains Jesiolowski. "It turns out that we do. We teamed up with MSCI ESG Research and integrated our own analysts' input. Combining both, we cover enough companies, even within the investment grade universe, which is our focus, as many investors we identified impose rating constraints on the funds they can invest in. Ex-ante, we can pick from a universe of approximately 200 issuers, which correspond to roughly 60-65 percent of the overall IG EM corporate universe."

Exclusions are not the sole criteria for universe selection. "We didn't think that focusing only on exclusions would make sense," Jesiolowski says, "because want to be able to invest in the best companies and therefore we need to have as broad a universe as possible, within a few obvious constraints." The team chose to exclude controversial weapon manufacturers (including nuclear weapons), tobacco companies, and issuers with substantial involvement in coal extraction or coal-based electricity generation. International sanctions as well as breaching the UN Global compact also trigger an exclusion. In addition to these negative screens, the selection process focuses on the companies that are mindful of ESG and are outperforming their peers in one of several dimensions. UBP uses MSCI ratings to this effect in combination with proprietary research.

“To select among the 200 issuers in our universe we apply our own credit and ESG analysis, and the main driver is bottom-up selection, then we also apply relative value and top-down fundamental tools to help us,” adds Jesiolowski. “It is important to be precise in the terminology, however. We are not an impact fund, and we rely primarily on ESG screening. At the same time, we may select some companies that have a positive impact on SDGs, and it is part of our analysts’ job to look at SDGs as positive factors for inclusion. This type of analysis helps us chose among two names that have a similar rating for example. We also have the opportunity to invest in green bonds. In fact, the framework green bonds provide is handy to us, as we can invest up to five percent of the portfolio in issuers that are not ESG-rated by MSCI, but we need a strong base to justify our choice.”

For Jesiolowski, the end portfolio looks very good indeed. “We end up with a much higher ESG score than the underlying index, as rated by MSCI ESG Research LLC. We reach an average of 5.6 versus only 4 for the index, and we achieve better levels in all three dimensions.” In addition to the ESG-oriented selection process, the team also believes in engaging with issuers. “Many people ask if it does make sense to engage even if you are not a shareholder. In reality, you make yourself heard as an investor, whether you own shares of bonds. An increasing number of people speak up, and it has a tangible effect. As a bondholder, the influence may be indirect, but companies increasingly take on board the risk of seeing their cost of financing increase if they don’t pay more attention to their bondholders’ concerns. This is true in both emerging and developed markets.”

“Engagement should always be part of the investment process as well, and not just an afterthought. While opening a dialogue with a company on ESG issues, a credit analyst can observe the company’s reaction. Are they listening? Are they prepared? Sometimes, the process will highlight differences of opinion between our analyst and the rating. We don’t use external data bluntly, but it helps get the conversation started. We also use GES as engagement manager, especially in the case of more important controversies or when we find it useful to pull together many investors, including those on the equity side.”

The fund, which launched at the end of February, currently counts USD 37.5 million of assets under management, which is deployed over 48 different issuers, both corporates and quasi-sovereign. “Fundraising has been a gratifying process. The strategy is truly niche, not only in one dimension but two. First, investors need to come onboard the idea of Emerging Market corporate debt and then consider the ESG aspect, but so far we have received very positive feedback. One of the banks offering our product to its clients has given us a high internal ESG rating. As it turns out, sustainability is what helps us open prospective investors’ mind to this very focused fixed income area, and not the opposite,” concludes Jesiolowski.