

Municipal Bonds and ESG: Natural Synergies, Growing Focus

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Environmental, social and governance (ESG) factors have long been an integral part of the analysis of municipal securities. Municipal bonds are issued to finance the construction and maintenance of critical public infrastructure. Funded projects include water and sewer systems, electric utilities, hospitals, schools and affordable housing, providing benefits that align with the interests of ESG-oriented investors and many of the United Nations (UN) Sustainable Development Goals (SDG). However, alongside these plentiful opportunities in the municipal space, ESG-related risks may also arise. The active management of municipal portfolios can help ensure that opportunities are assessed and that potential risks to cash flows are properly evaluated and compensated with adequate levels of spreads.

The UN SDGs (Exhibit 1) outline key global sustainability issues where public entities and private corporations have a role to play in financing the advancement of the goals. The SDGs provide a useful framework to illustrate the alignment of the municipal asset class with sustainability goals.



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Exhibit 1: Sustainable Development Goals



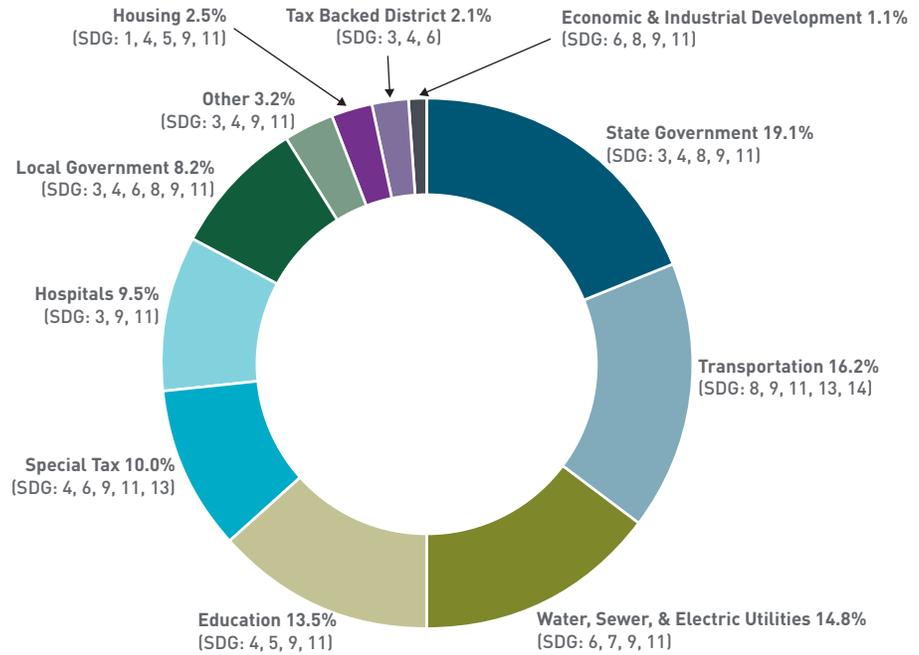
Source: United Nations. Sep 16, 2021
www.un.org/sustainabledevelopment/sustainable-development-goals/



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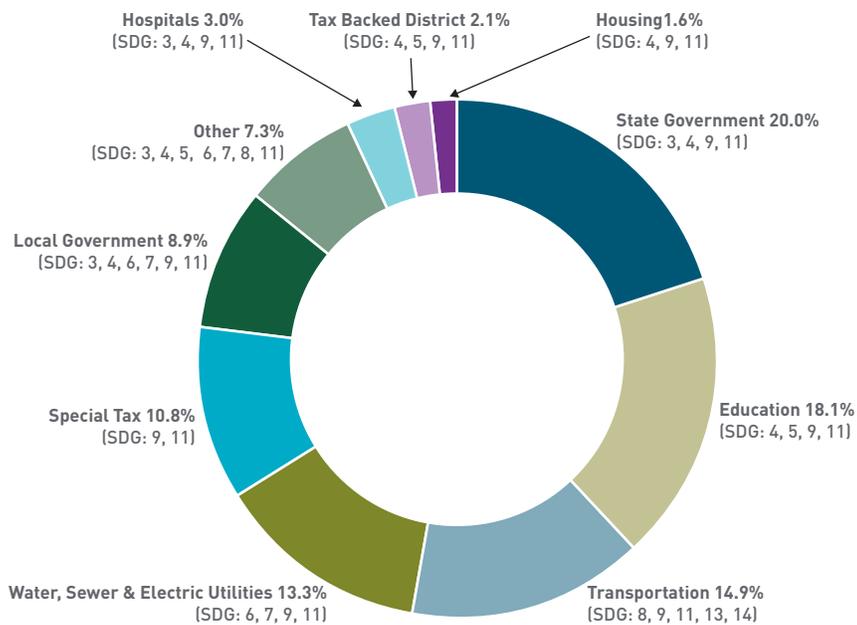
On the next page, we have linked SDGs to municipal bond sectors in the federally tax-exempt and taxable municipal indices. In most cases, sectors in these indices contribute to the goals of multiple SDGs.

Exhibit 2: Tax-Exempt Municipal Index. Largest Sectors, Weight, and Relevant SDGs



Source: Bloomberg Municipal Bond Index; MFS assigned the relevant SDGs based on the United Nations list.

Exhibit 3: Taxable Municipal Index. Largest Sectors, Weight, and Relevant SDGs



Source: Bloomberg Municipal Bond Index; MFS assigned the relevant SDGs based on the United Nations list.

Below we discuss MFS's integrated approach to ESG analysis and provide examples of how ESG factors may impact investment decision-making for municipal securities.

An integrated framework

At MFS, an ESG factor assessment is embedded in the analysis of municipal securities. The firm's municipal analysts perform an assessment to determine whether environmental, social, and governance concerns may impact the credit quality of the borrower, to what degree, and the time frame involved. The team formulates an ESG assessment based on the knowledge of our dedicated Fixed Income ESG team, as well as specialized data that maps and quantifies the environmental and social risks by borrower location. The investment team does not perform exclusionary screening of investments based on ESG factors but instead integrates these considerations into our risk/reward assessment to determine the extent to which the security's valuation reflects all identified risks. Below are some examples of ESG factors considered.

SAMPLE LIST OF FACTORS		
Environmental	Social	Governance
Climate Change Impact	Economic Indicators	Disclosure Policies
Natural Resource Access	Education	Management Practices
Emissions	Health/Safety	Board Composition
Energy Sources	Clear Air/Water	Political Environment

Case studies

The following examples highlight the integration of ESG factors in our bottom-up investment approach to municipal bond analysis.

Gulf coast general obligation bonds

This southeastern County's general obligation (GO) bonds, secured by its full faith and credit, benefit from strong governance, evidenced by high cash balances in governmental accounts, manageable pension and other long-term liabilities, and conservative budgeting practices. However, below-average-wealth indicators point to moderate social risk. Environmental risk is also elevated due to the county's location along the US Gulf Coast, placing it in the 95th percentile nationally for exposure to flooding from extreme weather events.

Ultimately, we determined that the county's cash position and the tax and population base from which it can draw revenue exceeded similarly rated peers, providing more than adequate cushion for potential financial erosion due to social and environmental spending. In this example, the county's GO bonds support public infrastructure in line with SDG 9, Industry, Innovation and Infrastructure, while strong governance presents a favorable ESG opportunity, in our view.

State jail construction project

After an evaluation found that correctional facilities were in dire need of upgrading, a US state entered into partnership with a private, for-profit jail enterprise to construct brand new facilities to address this social need. The partnership offered bonds backed ultimately by the state's payments for the construction and maintenance services provided by this private sector firm pursuant to the contract. The contract structure was viewed as sound and protective for bondholders, pointing to strong governance.

However, a consultation with MFS' corporate analyst covering the company revealed serious concerns about the correctional practices of the for-profit partner. Though the municipal bonds carried an investment-grade rating and an opportunity for excess risk compensation, we did not believe the benefit to the state outweighed the risk presented by the for-profit company's practices.

In this example, the state is seeking to fulfill SDG 16, Peace, Justice and Strong Institutions; however, the practices of the for-profit company presented heightened ESG risk, in our opinion.

Well-managed midwestern health care system

We participated in the low-investment-grade bond offering of a health care provider spanning two midwestern states, based on our view of credit upside as the management team executed on a series of strategic initiatives. This strong governance factor reflected the management's swift decisions to divest of unprofitable facilities and service lines and focus on building a diversified, integrated health care business to further the social mission of providing high-quality health care.

While social risks related to the not-for-profit's commitment to providing access to care to patients spanning the ability-to-pay spectrum were also identified, service line and geographic diversification were viewed as adequate offsets that have served the system well during the COVID-19 pandemic. The management's governance of strategic initiatives has proved effective, evidenced by improved financial metrics and rating outlooks.

In this example, the hospital is helping deliver SDG 3, Good Health and Well Being, and represents strong Governance and Social ESG opportunities, in our view.

Conclusion

We believe the municipal asset class is well aligned with the interests of ESG-oriented investors and the UN SDGs. However, ESG risks can vary meaningfully across sectors and issuers. We believe that our rigorous bottom-up municipal research process enhanced by access to MFS' global research platform enables investors to potentially capture the many environmental, social, and governance benefits of municipal bond ownership while seeking to avoid credits with unsustainable attributes. ▲

Bloomberg Municipal Bond Index measures the municipal bond market.

Bloomberg Municipal Taxable Bonds Index measures the taxable municipal bond market.

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