

## Q&A: ESG and Fixed Income



Mahesh Jayakumar,  
Fixed Income Research Analyst

Mahesh Jayakumar joined MFS in the Boston office in 2019 as a fixed income research analyst focusing on environmental, social and governance issues.

Across the globe, fixed income investors are increasingly interested in environmental, social and governance (ESG) issues. MFS Research Analyst Mahesh Jayakumar explains how MFS® incorporates ESG factors into fixed income research and looks at the opportunities and challenges facing investors.

### **ESG has been a theme in equities for many years. Why is it now a growing trend in fixed income?**

Fixed income has traditionally been used for its ability to manage downside risk while generating income and, in general, it continues to play a diversification role in asset allocation. The fixed income investor base is growing as both institutional investors, such as pension plans, and an increasing number of retail investors, such as retirees and everyday savers, perceive greater volatility within equity markets and allocate more of their capital to fixed income.

At the same time, market participants such as asset managers, asset owners, regulatory agencies and policymakers are increasingly thinking about ESG issues beyond just the implications for equity shareholders. In addition, more investors are seeking to use their capital to have a positive social or environmental impact, which involves a greater degree of ESG integration.

In light of this, and given that fixed income markets are significantly larger than equity markets, it is clear why ESG is becoming an increasingly important part of fixed income investing.

### **How do you approach incorporating ESG issues into fixed income analysis?**

Our investment approach has always focused on identifying companies and issuers with sustainable, long-term competitive advantages. As investors, we need to take into account all factors that can affect the viability of our investments through multi-year business cycles and ever-evolving macro environments. As such, we believe that the integration of ESG factors into our research is essential, as these issues often affect the long-term sustainability of cash flows for corporations and other issuers.

When evaluating corporate bonds, integrating ESG issues into our fundamental analysis of the issuer's credit and leverage profile is critical. ESG analysis involves understanding issues that are typically nonfinancial in nature, such as environmental impacts, employee well-being, supply chain management, product safety and workforce diversity. In the short term, shocks to these factors can affect cash flows and the ability to pay interest to debt holders. In the long term, they can harm corporate culture and impact operating models, which can lead to the erosion of revenue generation and, ultimately, profitability.

While governance is widely considered the most prominent ESG factor affecting various fixed income sectors including corporate, sovereign and municipal bonds; environmental and social factors must also be considered in any analysis. For instance, the deterioration of social or environmental factors can influence the political stability or business climate of a particular country. Therefore, we evaluate social factors, such as inequality, and environmental considerations, such as air quality and water stress, along with a country's governance practices, such as the independence of institutions, rule of law and enforcement of contracts.

### **Which elements are most important in this integrated approach?**

In fixed income, ESG factors are assessed within the context of overall credit risk. Traditional credit analysis involves understanding the ability and willingness of the borrower to service their debt, which means making periodic interest payments and repaying principal. An integrated approach must consider how ESG factors could affect the ability of the borrower to pay back the lender.



Emphasis is placed on materiality and time horizon, *i.e.*, the maturity of a bond. Materiality is a measure of the likelihood that a particular ESG issue will affect a borrower's revenues, costs, long-term financial condition and, ultimately, ability to repay debt. Time horizon determines materiality. ESG factors can become increasingly impactful over time, so the maturity of a bond, whether it is a short-, intermediate- or long-term obligation, is a critical lens for any ESG analysis.

Finally, high-quality ESG data sources are crucial to truly understanding an investment's material ESG risks and opportunities. Market data, such as ESG ratings, are important to consider as one of many inputs into the fixed income research process. However, they only represent one perspective. More holistic and relevant insights require assessing these topics deeply and independently.

### **Do you see any challenges in applying ESG factors to fixed income?**

The quality of ESG data has come a long way, but it continues to vary in terms of coverage and availability. For example, there is still not enough disclosure of ESG information from private and emerging market companies. As awareness of ESG issues increases, the demand for relevant data also increases, which means a greater number of market data providers are stepping in to fill this void. It is a cycle whereby investors are driving the demand for data and bond issuers have to step up to provide this information amid competing standards and disclosure frameworks that may complicate the process for both parties.

Another challenge relates to engagement between investors and issuers. Unlike equity shareholders, bondholders do not have formal engagement mechanisms such as the ability to vote proxies or raise shareholder resolutions.

The relationship between credit ratings and ESG ratings is also a challenge specific to fixed income investors. High credit ratings do not necessarily imply high ESG scores and vice versa. The impact of a given ESG factor on credit spreads can be uncertain and change over time. Therefore, it is important to assess whether ESG factors are fully reflected in the credit rating.

### **What are the opportunities for fixed income investors?**

The rise of thematic investing, such as green bonds, is providing fixed income investors the means to directly finance projects that address specific issues, such as climate change mitigation and adaptation, renewable energy production and increased energy efficiency. Growth in green bonds has led issuers to structure bonds with similar use-of-proceeds and project selection frameworks, such as social and blue bonds. Social bonds fund projects in such areas as education and health while blue bonds focus on oceans and marine life.

The United Nations' Sustainable Development Goals (SDGs) are increasing awareness among both investors and companies about the role we can all play in developing a more sustainable society and economy. Fixed income investors can help tackle larger issues such as climate change by unlocking badly needed capital. Mitigating the environmental impacts of climate change will require an investment of more than \$1 trillion annually by many estimates.<sup>1</sup> Bond markets are deep enough to be able to provide this financing, and the structure of fixed income investments lends itself very well to project financing. Investors provide capital up front to a borrower who uses the proceeds to complete or accelerate a project. The borrower can then use the cash flows generated by the project to pay the lenders back over time.

Like equity investors, fixed income investors can employ screening and tilting strategies to reflect ethical values and include bond issuers with better sustainability profiles. They also have the opportunity to increase engagement with borrowers on sustainability and related ESG issues since increased disclosure benefits all participants in the capital structure, including bondholders. ▲

**If you are interested in learning more about how Sustainable Investing works at MFS, please visit us at [mfs.com/sustainability](https://www.mfs.com/sustainability).**

<sup>1</sup> Climate Bonds Initiative, 'Bonds and Climate Change', September 2018.



**Bond:** Investments in debt instruments may decline in value as the result of, or perception of, declines in the credit quality of the issuer, borrower, counterparty, or other entity responsible for payment, underlying collateral, or changes in economic, political, issuer-specific, or other conditions. Certain types of debt instruments can be more sensitive to these factors and therefore more volatile. In addition, debt instruments entail interest rate risk (as interest rates rise, prices usually fall). Therefore, the portfolio's value may decline during rising rates. Portfolios that consist of debt instruments with longer durations are generally more sensitive to a rise in interest rates than those with shorter durations. At times, and particularly during periods of market turmoil, all or a large portion of segments of the market may not have an active trading market. As a result, it may be difficult to value these investments and it may not be possible to sell a particular investment or type of investment at any particular time or at an acceptable price. The price of an instrument trading at a negative interest rate responds to interest rate changes like other debt instruments; however, an instrument purchased at a negative interest rate is expected to produce a negative return if held to maturity.

Please keep in mind that a sustainable investing approach does not guarantee positive results.

The views expressed are those of the author(s) and are subject to change at any time. These views are for informational purposes only and should not be relied upon as a recommendation to purchase any security or as a solicitation or investment advice from the Advisor.

Unless otherwise indicated, logos and product and service names are trademarks of MFS® and its affiliates and may be registered in certain countries.

Distributed by:

**U.S.** - MFS Investment Management; **Latin America** - MFS International Ltd.; **Canada** - MFS Investment Management Canada Limited. No securities commission or similar regulatory authority in Canada has reviewed this communication.

**Please note that in Europe and Asia Pacific, this document is intended for distribution to investment professionals and institutional clients only.**

**U.K.** - MFS International (U.K.) Limited ("MIL UK"), a private limited company registered in England and Wales with the company number 03062718, and authorized and regulated in the conduct of investment business by the U.K. Financial Conduct Authority. MIL UK, One Carter Lane, London, EC4V 5ER UK provides products and investment services to institutional investors. This material shall not be circulated or distributed to any person other than to professional investors (as permitted by local regulations) and should not be relied upon or distributed to persons where such reliance or distribution would be contrary to local regulation; **Singapore** - MFS International Singapore Pte. Ltd. (CRN 201228809M); **Australia/New Zealand** - MFS International Australia Pty Ltd ("MFS Australia") holds an Australian financial services licence number 485343. MFS Australia is regulated by the Australian Securities and Investments Commission.; **Hong Kong** - MFS International (Hong Kong) Limited ("MIL HK"), a private limited company licensed and regulated by the Hong Kong Securities and Futures Commission (the "SFC"). MIL HK is approved to engage in dealing in securities and asset management regulated activities and may provide certain investment services to "professional investors" as defined in the Securities and Futures Ordinance ("SFO"). **Japan** - MFS Investment Management K.K., is registered as a Financial Instruments Business Operator, Kanto Local Finance Bureau (FBO) No.312, a member of the Investment Trust Association, Japan and the Japan Investment Advisers Association. As fees to be borne by investors vary depending upon circumstances such as products, services, investment period and market conditions, the total amount nor the calculation methods cannot be disclosed in advance. All investments involve risks, including market fluctuation and investors may lose the principal amount invested. Investors should obtain and read the prospectus and/or document set forth in Article 37-3 of Financial Instruments and Exchange Act carefully before making the investments.