THE EVIDENCE IS COMING IN; ESG IS POSITIVE FOR FIXED INCOME RETURNS

KEY POINTS

- **ESG adoption transcends ethical motivations. It is a positive for fixed income returns, particularly credit returns.**
- **Strong ESG practice is about more than simply culling "bad" industries from investment portfolios. Just avoiding the undesirable is the antithesis of stewardship.**
- **Investors have to engage with companies to change and improve behaviour.**
- **Engagement, positive (as well as negative) screening of corporate issuers and integration with our well-defined investment process are hallmarks of our active approach.**
- **While fixed income has lagged equity markets in terms of ESG adoption, the tide is turning. Attention from regulators, the proven return benefits uncovered by academic work and our own experience to date are signposts of an encouraging shift.**

The United Nations-supported Principles for Responsible Investment (PRI) has come a long way since its April 2006 launch. In a little over a decade it has grown from 100 to over 1,700 signatories from more than 50 countries representing US$62 trillion of funds.[1]

Initially at least, the PRI and incorporating environmental, social and governance (ESG) factors into investment processes and decision-making may have been regarded as a fringe issue in some quarters, but today they are absolutely mainstream.

The widespread adoption of ESG[2] has been made possible by a subtle but important change in emphasis and understanding.[3] Early adopters were ethically motivated investors focused on environmental and social issues while many institutional investors observed for any signs of negative impacts on portfolio returns.

The key to gaining widespread traction has been in challenging the perceived effect on performance. Not only is it no longer assumed that "doing the right thing" will be a drag on portfolio returns; rather, it is seen as positive for returns.

At the same time, it is now seen as prudent to avoid investing in companies that have a detrimental impact on their local communities and the environment or which are poorly governed, because their business practices may not be allowed to remain unchanged[4] and resulting imposts to alter behaviour could further diminish companies' financial performance.

Said differently, investing in ESG transgressors creates a double-whammy possibility for investors. A first hit to performance as the errant company's deeds come to light and a second blow as it has to take corrective action.

See *Our approach to ESG* on the following page for a summation of the way our Global Liquid Strategies (GLS) team incorporates ESG into the investment process and comments on collaboration with key stakeholders to advance responsible investing in Australia. We also make the affirmative case for ESG in the same section under *ESG is positive investing, it's not just about exclusions*.

RESPONSIBLE INVESTING A "SHOULD DO" IN AUSTRALIA

In Australia, the increasing attention on responsible investing goes beyond the UN PRI charter and performance-related motivations. The ASX Corporate Governance Council Principles and Recommendations, first introduced in 2003, with the most recent update released in March 2014,[5] APRA's thinking[6,7] as well as legal opinion on directors' duties, mean that ESG-related practice is a "should do".

To be more specific; recommendation 7.4 of the ASX Corporate Governance Council Principles and Recommendations states that: "A listed entity should disclose whether it has any material exposure to economic, environmental and social sustainability risks and, if it does, how it manages or intends to manage those risks."[8]

As for those who may not want to follow recommendations; the document requires an "if not, why not" statement in a public company's corporate governance statement explaining its reasons for not following a recommendation.[9]

By the same token, APRA has made it clear "that the days of viewing climate change within a purely ethical, environmental or long-term frame have passed."[10] Instead, the Regulator is calling for entities that fall within its purview to develop comprehensive approaches on how they plan to deal with climate change across dimensions including reporting, monitoring, and managing physical as well transition risks.[11]

Excess returns can be generated by applying both positive and negative screening.

OUR APPROACH TO ESG

We believe that environmental, social and corporate governance (ESG) factors can have a material impact on the long-term returns of investment portfolios.

Each of QIC's five investment capabilities Global Liquid Strategies (GLS), Global Multi-Asset, Global Infrastructure, Global Real Estate and Global Private Capital integrate ESG factors into their respective investment decision-making processes.

The GLS team's ESG journey has benefitted from the fixed income-specific data that has started to become available in recent years. Until this emergence of fixed-income related insights, the work of academics was an important component of our responsible investment thinking.

ESG is integrated into each step of GLS' five-step investment approach **(Figure 1)**, feeds into security selection and is closely monitored by portfolio managers.

As significant stakeholders in credit markets, we believe that engagement with the management of underlying companies is a constructive way of raising responsible investment issues and encouraging improvement. We regularly meet issuers to address company-specific ESG issues as well as overarching themes such as climate change.

We have chosen not to invest in some corporate bonds on account of ESG issues while investing in others owing to their high responsible investment ratings. Returns from corporate bonds tend to reveal themselves slowly and so we cannot definitively say that ESG has materially added to our performance.

Nevertheless, we are encouraged by the direction of the ESG-influenced issues we recently bought including several green bonds. Given the market's nascent status in Australia, green and socially responsible bonds are a relatively recent addition to our portfolios and thus far have slightly outperformed non-green corporate bonds of a similar maturity **(Figure 2)**.

ESG IS POSITIVE INVESTING, IT'S NOT JUST ABOUT EXCLUSIONS

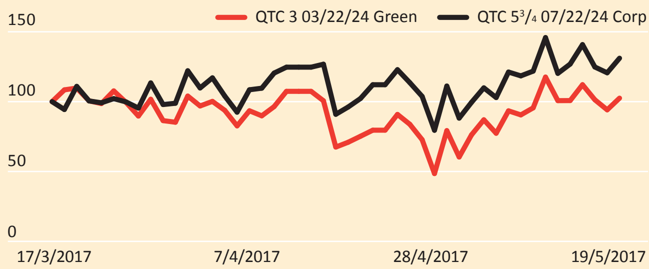
When ESG first emerged in its current form, some initially looked at it through an SRI-lens, narrowly interpreting it as requiring a trade-off between long-term investment outcomes and "doing good." Such thinking looks even more antiquated with the passage of time.

An exclusions-driven approach is consistent with SRI where an explicit "moral premium" is sought. It is not ESG, however.

We think of ESG as "positive screening." From our fixed income perspective, ESG is ultimately another way of interrogating a company's quality.

Figure 2: An example green bond's encouraging performance vs. bond of similar maturity

Comparison of spread moves (Normalised Asset Swap Spread, basis points)



As of 19 May 2017
Source: QIC and Bloomberg

QIC does not invest in munitions and landmine manufacturers or tobacco companies. Even so, aside from these three industries, we do not shut out entire industries and companies, including those that sometimes may be deemed socially or environmental contentious.

A dogmatic approach would hamper our ability to engage with companies that could be encouraged to improve their social and environmental conduct. It would also be at odds with our active management philosophy, where we value the ability to overweight and underweight industries and companies based on the economic cycle.

Quality companies will minimise their environmental footprint. They will be acutely mindful of the need for companies to operate with a social licence and will have robust corporate governance practices that eschew anything that smacks of conflicts of interest and lax supervision of management.

There is an abundance of academic literature making plain that integrating ESG into the investment process has a neutral impact on long-term investment performance, at worst, more likely it has a positive effect on investment returns.

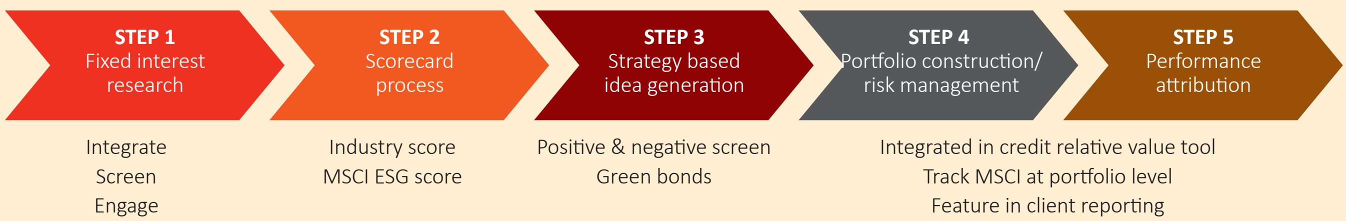
Data is especially strong in the equities arena and while fixed income related evidence is less statistically established due to its relative newness, it is nonetheless encouraging and we expect similarly decisive results, in time.

Our belief in the positive investment effects of ESG is exemplified by our integration of MSCI ESG Research and its ESG Ratings coverage of Australian securities into our investment process. MSCI ESG Research's coverage now extends to approximately 80 per cent of securities in our Australian portfolio, up from 50 per cent previously.

To our thinking, it's another form of engagement. It is different from company engagement, as it is usually understood, but nevertheless contributes to deepening the application of ESG in Australia.

Figure 1: How GLS approaches ESG

Integrated into each step of our five-stage process



Source: QIC, for illustrative purposes only

In that spirit, in November 2016, the Centre for Policy Development and the Future Business Council released an influential legal opinion on company directors' legal obligations to consider the impacts of climate change.

The opinion found that "company directors who fail to properly consider and disclose foreseeable climate-related risks to their business could be held personally liable for breaching their statutory duty of due care and diligence under the Corporations Act. The opinion's author, a Senior Counsel, warned it is "only a matter of time" before we see this sort of litigation against a director."[12]

All-in-all, the responsibilities carried by organisations and individuals with financial and investment management responsibilities are a far cry from just a generation ago. Consequently, the broader range of issues that fall under the umbrella of responsible investing/governance/ESG are considerations alongside other more traditional investment factors. At the very least, not taking ESG issues into account is becoming a challenging position to defend.

That's why ESG standings are now regarded as measures of risks facing companies stemming from good/poor behaviour in the environmental, social and governance spheres and the language used to describe these attributes has evolved towards terms that have positive connotations regarding long-term investment performance.[13]

NEED FOR FIXED INCOME SPECIFIC PERSPECTIVE

That said, up until recently, the relationship between responsible investing and investment performance has been largely equity market focused. Similar studies on the responsible investing/fixed income relationship have been rare.

This is unsatisfactory as fixed income is not a subset of equities. It requires specialised analysis. With that context, this paper owes a great debt to academics who have given attention to the ESG/fixed income relationship as well as the work of Barclays.[14]

It's a little surprising that the bond market/sustainable investing relationship has been under-examined as bond markets would seem to be eminently suitable for this kind of research.

The US corporate debt market, for instance, is a very large (around US$8.5 trillion outstanding market debt during the fourth quarter of 2016), very active (with an average daily investment grade trading volume of US$18.5 billion and US$11.5 billion in high yield for calendar year 2016) and dynamic (with new investment grade bond issuance reaching US$1.43 trillion and US$216 billion in high yield during 2016 vs. US$197.5 billion total equity issued in the same year).[15]

ESG ratings are one piece of the puzzle. Corporate analysis and the macro-economic outlook are essential to credit selection.

Furthermore, because, in general, companies need to refinance themselves in the debt market more frequently than in the equity market (due to the finite maturity of bonds), the former appears to be more suitable for active investors and other stakeholders to implicitly exercise stakeholder activism and companies would be inclined to meet their demands or suffer higher debt costs.[16]

Corporate bond markets are also more of an institutional investor's arena in comparison with the equity market. Around 93 per cent of US corporate bonds are institutionally owned while the equivalent percentage for US equity is about 59 per cent.[17]

The institutional investor view on ESG is especially important as institutional investors are generally believed to be better informed than private investors and because of this it is more likely that they will take into consideration complicated issues such as ESG when allocating the funds they manage.[18]

Second, high institutional participation decreases free float bonds (i.e., increases the concentration of bonds in the hands of a relatively small number of investors), and this should make it easier for bondholders to "discipline" company management when they need to by simply selling the respective corporate bonds, hence increasing the cost of debt for transgressing firms.[19]

Finally, corporate bonds are complex. They encompass interest rates, credit spreads, coupons and term structures and the multitude of issues within them requiring forensic precision. All this would seem to point towards an institutional perspective.

STAKEHOLDER THEORY AND VOLKSWAGEN EXAMPLE

Before providing evidence for the positive relationship between higher ESG ratings and superior fixed income performance, it's useful to touch on the abstract association between the two transmitted by the concept of "stakeholder theory."

Arguably, there are stakeholders who attempt to infer a firm's underlying corporate character according to its ESG record. If this perception of corporate character is deemed to be one of a trustworthy and cooperative entity, then it can result in a significant competitive advantage.[20]

It makes intuitive sense that a company that is responsible in its interactions with society, exhibits strong corporate governance practices and thoughtful in its treatment of the natural environment is more likely to enjoy greater customer loyalty, increased employee attraction and retention rates as well as productivity, and, finally, have superior access to capital compared with a firm that does not pay attention to its social posture.[21]

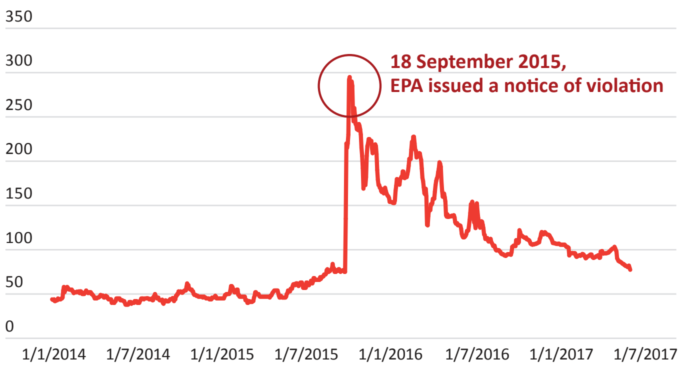
By contrast, a firm that is found to behave irresponsibly on ESG dimensions risks a higher probability of negative events occurring such as employees withholding best efforts, a decrease in social licence to operate, increased regulatory scrutiny, potentially government sanctions, and associated legal costs.[22]

Such events could lead to a higher cost of debt for the transgressing company. The example of the Volkswagen (VW) emissions scandal that erupted in September 2015 is a powerful case in point.

The German carmaker found itself in the firing line when the United States Environmental Protection Agency (EPA) charged it with violation of the Clean Air Act over 2009-2015 by installing software that deceived official emissions testing. Market reaction was swift and savage (**Figure 3** on following page).

VW credit default swaps blew out to more than 250 basis points versus mid-70s prior to the news, while the company's share price plunged more than 30 per cent overnight. MSCI's ESG rating for VW fell to CCC from BBB, ranking it among the worst in the industry.

Figure 3: Markets savaged Volkswagen after the EPA's charges
Volkswagen senior 5-year credit default swap spreads (Basis points)



As of 21 May 2017
Source: Citi Velocity and QIC

QIC GLS' flagship Australian fixed income portfolio had an underweight position in VW prior to the scandal coming to light. VW's below-peer MSCI ESG rating in the years prior to the transgression was a significant factor in our decision, as was the group's relatively tight credit spreads. The view that VW's spreads didn't adequately compensate investors for credit and ESG risks meant that our active underweight contributed positively to excess returns upon the dramatic widening in VW's spreads.

Once the spreads widened we evaluated the risk and management's commitment to rectifying the emissions issues. Our detailed assessment identified value in the bonds at wide spread levels and thus we purchased the bonds and benefited from the rally into mid-2016. We saw little further upside in the bonds at that point owing to ongoing litigation risk and consequently sold out of the position.

All this adds up to the contention that the default probability and loss severity of bondholders' investments in firms that expose themselves to ESG transgressions is higher than investments in companies with better practices.[23]

Two propositions naturally grow from all this. The first is that firms with more ESG strengths have lower credit spreads (lower cost of debt financing) and higher corporate bond ratings (lower default risk). Secondly, firms with more ESG-related concerns have higher credit spreads (higher cost of debt financing) and lower corporate bond ratings (higher default risk).[24]

FINDINGS FROM INDUSTRY AND ACADEMIC RESEARCH

Now it's time to go beyond assumptions to discover what industry and academic research actually reveals by starting with Barclays' work.

To examine the responsible investment/corporate bond performance relationship, they used as their universe the Bloomberg Barclays US Corporate Investment-Grade Index, a widely quoted benchmark for institutional asset managers investing in the US credit market.

In April 2016, around the time Barclays' study was carried out, this index included 5,675 bonds from 761 different issuers. Barclays' only considered bonds with ESG scores from both MSCI and Sustainalytics, which reduced the sample size by about 10 per cent.[25]

Key findings from Barclays were:

- Most portfolio pairs (high-ESG minus low-ESG portfolios) delivered a positive return, indicating a generally positive return premium for the "ESG factor" in corporate bond markets. The cumulative excess returns of the high-ESG over the low-ESG portfolio from August 2009 to April 2016 was almost 2 per cent.[26]
- Governance had the strongest link with performance and Social the weakest, being even associated with slightly negative returns. Environment is in between. So, the intuition of investment professionals that Governance is more important to portfolio risk and return than the other two dimensions of ESG is validated in the analysis.[27]

  The investment significance of Governance underscores our belief that negative screening is insufficient; it is at odds with our ESG principles. The exclusion of entire industries may be short-sighted and does not allow us to be agents of change.

The revelation that Governance had the strongest link with performance is especially important as it is a factor that bottom-up credit analysts have long valued. We firmly believe credit needs to be assessed and actively managed.

It's reassuring to know that even before the formal advent of ESG, fixed income and credit professionals were looking at the correct issues when analysing companies and issuers. Governance is a proxy for quality and risk while the inclusion of the Environment gauge provides another analytical lens.

See *Are E, S and G equal or are some more equal than others?* on the following page for a discussion on the investment performance influence of each of the ESG factors.

As active managers we know that neither credit ratings nor ESG ratings are the Holy Grail. Experience, understanding the macro outlook and getting your hands dirty in balance sheet analysis are vital. To this we add that incorporating an ESG tilt in a credit portfolio is not detrimental to returns, but can be beneficial.

ACADEMIC STUDIES SUPPORT CASE FOR RESPONSIBLE INVESTING

Findings from academic studies are broadly consistent with both our own experience and Barclays' research.

The Friede, Busch and Bassen study combined findings from about 2200 individual studies and found "…that the business case for ESG investing is empirically very well founded. More importantly, the large majority of studies reports positive findings. Promising results are obtained when differentiating for portfolio and non-portfolio studies, regions, and young asset classes for ESG investing such as emerging markets, corporate bonds, and green real estate."[30]

More than two-thirds of cases researched by Friede, Busch and Bassen uncovered significant positive performance relations to ESG criteria.[31]

Likewise, Feng Jui Hsu and Yu-Cheng Chen found "that social responsible firms have lower credit spreads and lower default risk."[32]

Additionally, Feng Jui Hsu and Yu-Cheng Chen's work "showed there is a negative and significant association between CSR[33] score and forward default probability. In addition, good CSR companies have very low short-term default probability and forward default probability."

"Using CSR performance information assembled by KLD[34], we find that better CSR performance scores appear to provide crucial information that can reduce financial risk. Furthermore, positive CSR performance scores appear to be associated with reduced financial risk while negative CSR performance scores lead to increased financial distress. In addition, analysis shows that positive CSR performance has a greater impact on rating score forecasts than does negative CSR performance. That is, firms with good CSR performance enjoy reduced credit risk, corporate bond spreads, and bankruptcy risk. This suggests that investors are more likely to respond to positive CSR information than negative CSR information."

THE OUTLOOK FOR ESG AND FIXED INCOME RETURNS

These findings thus far are all well and good, but it does raise the issue of the efficient markets hypothesis. Can corporate bond portfolios with high ESG scores (thus lower default risk) provide attractive returns?

"Yes" is the decisive answer.

Firstly, the market may not be efficient on ESG considerations yet. ESG ratings in the fixed income arena are relatively new and credit investors are not as attuned to ESG ratings as their equity peers, nor are they as familiar with ESG ratings as they are with corporate credit ratings.

This will change over time as ESG becomes more mainstream in the fixed income realm. We think excess returns can be generated for those with the skill to assess ESG criteria and apply both positive and negative screening across portfolios.

Secondly, let's assume the market was perfectly efficient. High ESG scoring companies have lower default and downgrade risk and thus they would exhibit tighter credit spreads than low ESG companies all else being equal. An investor observing this and not taking ESG considerations into account would therefore consider the safer names "too tight." Risk-adjusted returns should be the focus of attention and that requires comprehensive understandings of industries and companies, and not ignoring ESG considerations.

The efficient market hypothesis assumes that investors perfectly price all information that is currently available. A key advantage of a strong ESG rating is a company's ability to deal with new information. Strong governance and social conscience should make a firm more flexible and therefore better able to cope with unforeseen challenges. Strong environmental conscience should help a firm mitigate environmental issues and deal with new regulations.

It's important to note that like corporate credit ratings, ESG ratings are not a "be all and end all" for spreads and pricing. For us, this presents opportunity and the potential, with quality credit analysis and eyes on all three facets (environmental, social and governance) to reap extra return potential. Strong analysis of corporate balance sheets, the macro-economic outlook and industry health remain essential to credit selection.

Investors of all stripes intuitively know that companies that act responsibly are more likely to perform well financially as well as be supported by the communities they are part of. As fixed income investors, it's encouraging to be validated by academic research and the beginnings of investment industry analysis.

As ESG considerations reveal themselves over the long haul and become increasingly important in the investment management industry, they may also help to alleviate the pressure for short-term performance and by doing so foster a greater emphasis on value creation for assets owners and the world at large.

ARE E, S AND G EQUAL OR ARE SOME MORE EQUAL THAN OTHERS?

The values embedded in PRI give equal weight to environmental, social and environmental factors. However, investors and asset owners may assign different weights to each as they pertain to influences on investment performance.

Governance is an indication of how well-governed a company is and the extent to which the primacy of shareholder interest is ensured. It can be seen as a measure of management quality.

By contrast, the **Environment** and **Social** variables capture the risk and opportunities that are often specific to the industry and the activities of a company. The link between E and S and future performance is therefore indirect.[28]

While many investors agree that Governance has a link to performance, there is less agreement on the importance of Environment and Social attributes. The Barclays survey of large asset managers in 2016 found that investors often have different views on the importance of E, S and G than asset owners. The research showed that asset owners find Environment more important, while managers see Governance as more relevant to financial performance.

Disclosure of ESG-relevant information by issuers is mostly voluntary at this stage, but there is a strong appetite from investors for defining new, expanded, reporting standards that would be made mandatory and help investors form a more holistic view of corporate performance.[29]

As a lot of the analysis done by each provider is based on publicly accessible data sources, and on the information put forward by the rated companies, it would be reasonable to expect the qualitative rankings of different companies to be comparable.

In practice, MSCI and Sustainalytics ratings often disagree with each other. When measuring the relationship between ESG ratings of the two providers, we found positive but low correlations across all three dimensions as well as for the composite rating. This is not surprising, given the differences in methodology.

To sum up: Like corporate bond ratings, ESG ratings should not be considered as a simple commodity. Ratings from different providers carry different information and can potentially suggest different portfolio management decisions.

At the end of the day, investors and asset owners need to do their own work to reach their own conclusions rather than reflexively following the analysis of providers.

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