RICHMOND CAPITAL MANAGEMENT

Experience, Knowledge, Service

June, 2018

ESG Awakening in the Fixed Income Markets

The fixed income markets have long been the investment community's "forgotten child" when it comes to integrating ESG (Environmental, Social, and Governance) criteria in the investment process. This important segment of the capital markets, which provides trillions of dollars in much needed capital to publicly traded corporations around the globe, is awakening to the realization that they can and should apply ESG principles to their investment process.

The UN PRI (Principles for Responsible Investment) has recently published a collaborative document on "ESG Engagement for Fixed Income Investors."[1] In the document, PRI states their mission: "We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole." As a UN PRI signatory, Richmond Capital has incorporated ESG thinking into our management policies and investment practices. Institutional investors like Richmond Capital are now realizing the benefits of this ESG commitment in their investment process.

The UN PRI Six Principles

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

Source: PRI

Historically, fixed income asset managers have not sought to influence corporate issuers. Unlike equity investors who have a history of engaging with corporations through proxy voting, bond managers have been less likely to engage these same issuers. Of course, fixed income managers do not vote on corporate proxies and did not believe that they had particular leverage to institute changes within these companies. However, with the increased need of capital for R&D and/or merger activity, fixed income managers are recognizing that they can engage corporate bond issuers to improve important disclosures related to ESG issues. This is an important step in encouraging better corporate behavior and setting the foundation for many companies to include ESG principles in their day-to-day operations.

As part of our engagement process, Richmond Capital has recently contacted over 40 large U.S. corporations seeking additional information on their level of ESG disclosure. We were pleasantly surprised by the robust responses. In particular, a large telecommunications company contacted us to set up a conference call. The call included this company's treasury department which is responsible for the issuance of their debt which totals in excess of $115 billion. Our experience points out that issuers of this magnitude are keenly aware and sensitive to their ability to access the capital markets. This company has fairly extensive disclosures on ESG issues but was receptive to our questions specifically regarding governance and social issues. They had recently had a protracted strike of union workers resolved. By engaging this corporation, we obtained a more holistic view of the long-term credit worthiness of the company. In return, ESG engagement allows issuers to garner a better understanding of investor's expectations.

For most investors, investment performance ranks as their main "report card." Many bond investors have long felt that incorporating ESG thinking into their investment process hurts performance; however, many studies today have indicated the exact opposite. Some investors rely on third-party providers like MSCI and Sustainalytics for ESG scores and ratings. In 2016, Barclays Capital, using research provided by these two independent services, evaluated how bond portfolios tilted toward higher rated ESG securities performed. Their conclusion was that these "ESG positive" portfolios lead to small but steady outperformance.[2] This historical research from Barclays effectively debunked the long held notion that incorporating ESG criteria into the investment process leads to underperformance and does not fulfill investors' fiduciary responsibility. Indeed, it can be argued that the additional level of ESG scrutiny provides investors with a more complete profile of corporations and ultimately will lead to better long-term risk adjusted investment decisions and enhanced investors' fiduciary responsibility.

The ESG awakening by bond investors is just beginning here in the United States. As the trend toward active engagement with bond issuers continues, companies will feel the necessity to comprehensively address ESG on an ongoing basis. Ultimately, by allocating capital to those companies that incorporate ESG principles, bond investors are realizing that they can have a broad impact on the business practices of corporations globally.

[1] *ESG Engagement for Fixed Income Investors: Managing Risks, Enhancing Returns, UN PRI 2018.*
[2] *ESG Investing in Credit Markets, Lev Dynkin, Albert Desclee, Jay Hyman, Simon Polbennikov, November 17, 2106.*