Link to Article on website

How does ESG and Sustainability play out in the Asian Fixed Income & Credit Markets?

On March 23, Hubbis held a virtual thought leadership event to delve into the growing influence that ESG and Sustainability have in the Asian fixed income and credit markets. Principal Global Investors, LLC was the sole sponsor, and was represented by Howe Chung Wan, managing director and head of Asian fixed income at the firm. We invited an exclusive group of private bankers and independent wealth managers from leading banks and firms in the region to help set the scene and to probe Howe for his expert views. All of their comments have been treated off-the-record for this summary report, while any comments from Howe are presented on-the-record below. Principal Global Investors, LLC is the global asset management arm of Principal Financial Group, a 143-year-old insurance and retirement firm headquartered in the US, and with an approximate total global AUM of USD590.6 billion, as of 31 December 2021.

GET IN TOUCH
View Howe Chung Wan's LinkedIn Profile
Find out more about Principal Global Investor

Exclusive Partner

THESE ARE SOME OF THE DISCUSSION POINTS, ALL CENTRED ON ASIA'S FIXED INCOME/CREDIT MARKETS:

- How should investors approach ESG investing in Asia/EM?
- Are ESG criteria different in EM vs DM?
- How can we find reliable and trustworthy data for Asia and emerging markets?
- What are some of the ESG trends in Asia's bond markets?
- How does ESG impact performance? Does it reduce risk or improve returns, or both?
- How should investors construct ESG portfolios? Should we just think about ESG leaders?
- What about geopolitics and ESG?

Key Observations & Insights

Setting the scene in Asia - private banks and wealth managers in Asia have been pushing the ESG and Sustainability agendas increasingly vigorously in recent times but this effort has been targeted mostly to equities/funds

A leader at one of the larger international private banks operating in Asia reported how much effort his European bank had been putting into communicating and expanding ESG-driven investing worldwide wherever they operate for some years already, leveraging their major commitment in the bank and their sister asset management business in Europe.

"Well before the whole ESG trends really set in, we have been committed to this effort, including for example reporting ESG scores at the individual security level in our client statements, so that clients can also see at the portfolio level what their average scores are in our monthly statements," he explained. "We have done this for seven years already."

ESG mostly expressed through equities/funds

He said that it was easier on the equity side to assess and incorporate these values and metrics into portfolios curation than on the fixed income side, although for more obvious segments such as 'Green' bonds, in which his bank is a notable leader in, the equations are easier to formulate and adherence easier to track.

"But in all fairness, the conversations we have with clients are more around funds and equities rather than fixed income and credit, where the main focus remains on coupon and yield," he reported. Accordingly, their focus remains largely on equities and on funds rather than debt or specific bond issuances.

Putting order to the mass of ESG information

Another expert from a global US bank agreed, noting that most of their initiatives centre on funds rather than single stocks. "What we find is that in the asset management industry, everyone seems to be an expert on ESG and have been doing this for quite some years, and what we find is an overload of information. From a private investor perspective, a lot of our efforts are in trying to put some order and structure around the curation of products, especially funds, that we can comfortably say fit the right levels of sustainability or ESG."

On the fixed income side, but not specific to Asian fixed income, they see some marginal interest in Green bonds and Social bonds, but so far, the demand is relatively thin amongst their clients in Asia, he reported, adding that most of the engagement in ESG and sustainability in general tended to come through fund selection, being the easiest to discern and monitor.

ESG and fixed income – of interest but early days as yet

Another banker at a leading US global bank agreed, noting that investors primarily focus on the thematic side for ESG mostly through equities and less so on the fixed income or credit sides.

"There is interest in learning more, however," he reported. "For example, would the investors need to give up yield, are risks lower and so forth. These are questions to be addressed, but right now, people are not really voting for this with their ESG money in the fixed income space."

Accurate data and proper disclosure are vital

A guest pointed to data and disclosure as key hurdles relating to fixed income and ESG. "I think at the end of the day, ESG is a function of disclosure. If proper disclosure is not there, the whole exercise doesn't have any meaning. Until or unless investors really see a meaningful difference in yields, then it's not going to swing the needle (to better data and disclosure). At the end of the day, it's the yield that would drive the investors in the bond market, unless, of course, yes, you have the regulators coming in, and demand that everybody adhere to ESG parameters. That would be a different story. But either way, until that, I think it's more of a risk management exercise that one would conduct anyways in the fixed income market."

ESG has been around for some time, but predominantly centred on equities and less prevalent with regard to fixed income/credit

"Governance is in fact at the heart of predictability of coupon payments and principal repayments. Investors expect to get paid and it is at the heart of what we do, day in day out, as credit investors, and particularly in the high yield market, which many of you will be involved in. In short, governance is already very much embedded in the way how fixed-income investors think.

There are key areas that are unique for fixed income compared to equity. If an issuer makes issues of bonds that are specifically designed to be ESG, you can look at them from both the security level as well as the issuer level, whereas in the equity space, you don't really have that kind of concept. This is why, in fact, fixed income investors tend to drill down to what that ESG element of any particular issuance is about.

Asia, especially China, is a prime ESG mover

For example, under ICMA, which is the International Capital Market Association, they have a definition of, for example, that no more than 5% to 10% of the proceeds can be used for non-ESG purposes when you issue ESG related bonds. So, in short, investors need to look in detail at the specific instrument first, and the issuer as well.

Asia might seem well behind the developed markets, but it is not. Actually, Asia will soon become the second-largest regional market for ESG issuance, driven by the regulators and authorities within the region and predominantly led by China. For those of us working out of Singapore or Hong Kong, we can see that there is a clear motivation and activity amongst the authorities to promote green finance. So, Asia is increasingly becoming a very important part of this landscape in the ESG space.

Fixed income actually offers investors a reasonably direct route to sustainability and ESG impact

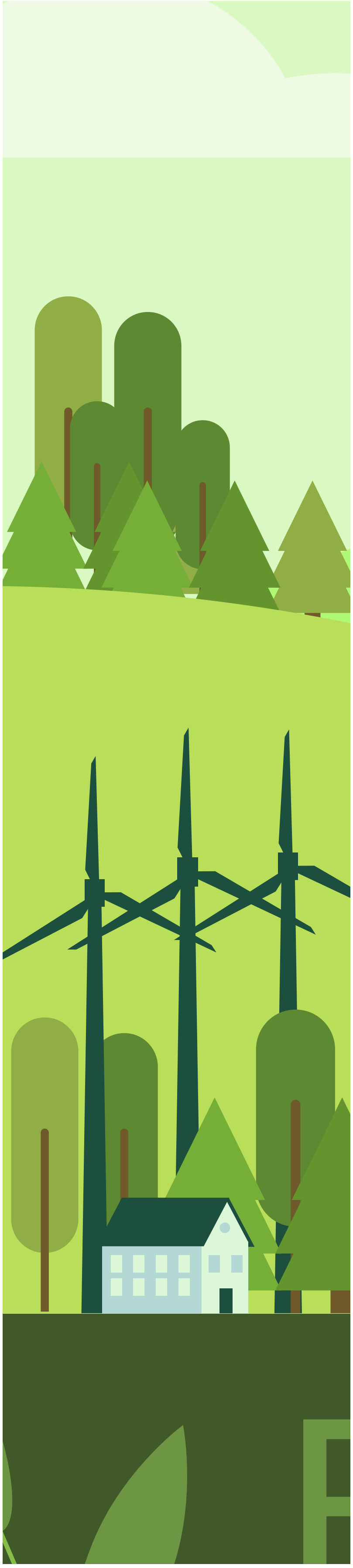
Additionally, remember that the fixed income markets offer direct access to impact, as they must use the proceeds into the system and into real projects. So, fixed income is a very important avenue for many of these issuers to use to advance some of these sustainable goals.

I would like to now point to three core changes and realities we see in the fixed income world in relation to ESG and sustainability.

Materiality moves centre stage and impacts funding costs

The first is materiality. In the past, as credit investors, we have thought directly about ESG factors, for example if an iron ore company has a dam that's broken and there are floods as a result that cause environmental and social distress. Or perhaps there are fraud or accounting issues that arise at another company. So, we look at the bottom line of the company, and then work backwards to the leverage and see if it all makes sense or not from a credit point of view.

But things have changed. We are now seeing companies



either obtain a discount or pay a premium for funding because of certain issues. So, the materiality aspect has changed considerably. It's not now only about the credit fundamentals, but the ESG elements now come through in the cost of funding, either negatively or positively.

Downside protection offered through ESG-centricity is now more evidently allied to upside potential and alpha

The second element to consider is that we not only want to make sure we get the money back, that there are no landmines ahead, but we need to now consider the possibly asymmetric related up-side and downside potential. On the downside, it is all about risk and credit fundamentals. On the upside, companies are shifting or pivoting away from how they used to operate to a model that's going to be more sustainable, meaning that the market then shifts to the belief that in the long run, those companies are better vehicles to ride.

This creates the opportunity for alpha potential, especially in markets that tend to be less ef-ficient, like in emerging markets. We therefore find this actually an excellent way to identify com-panies to see companies that might have this opportunity to pivot away from brown to green, or in the social aspect to move away from some of their former practices, for example along their supply chain, to a far more sustainable situation. So, we can now look at this from the upside perspective, and not only from the downside risk of not getting repaid viewpoint.

Asia's long-term economic and social potential ideally match the drive to ESG and sustainability

We operate in the emerging markets in Asia, and we certainly think sustainable investing ideally suits the type of long-term capital these markets need. In EM, for example, the companies need the long-term capital that supports these transitions. So, the region is a very good fit in terms of thinking long-term from both the company and the investor perspective. There is a very clear match in terms of sustainable investing and EM Asia investing.

The gradually evolving evidence of linkages between ESG, risk management and fixed income returns

We are asked many questions in the normal course of our activities, and I would like to run you through some of those.

The first question is the relationship between returns and ESG. It is harder for us in fixed income than equities, because in fixed income it is the coupon and the repayment. But then there is the question as to whether the fixed income investor believes that there is a longer run outcome, an upside in the future.

Well, the way we see this is that as a fixed-income investor we must protect ourselves from any downside, such as the company not existing in the future, or taking a different form. That is possible for example due to geopolitical tensions, or market turmoil, for example in property. But with ESG, there is an important element of risk mitigation, that helps us focus on companies that will survive and, as they are there for the longer-term, are more likely to grow larger in their space. Which means you may benefit from being invested in those types of companies.

No definitive answers as yet, but the ESG/ fixed income compass needle is pointing in the right direction

But as I said, there is no definitive reply to this question, I can only frame it to you. That is how we think about it. If you go look, for example, at the JACI ESG indices, or you look at any of the Barclays ESG indices versus the normal Asia credit or EM credit indices, in the long run, you're probably not going to see a massive outperformance or underperformance.

But as to picking the names to include, we like to think about it over the much longer-term perspective, and helped by ESG, rather than over the short-term type of view and returns. We are deliberately managing and curating a portfolio that's of a specific ESG nature, choosing companies that we feel make the cut in our view in terms of ESG.

The ESG fixed income universe is smaller, and investors are more loyal to the paper and issuers, resulting in lower volatility

These bonds have 'stickier' investors, which means less volatility. When the universe that you can buy is smaller, you tend to hold on to those because they're clearly names or bonds that meet the hurdle requirements set and that meet the due diligence. So, they tend to do much better from a volatility point of view.

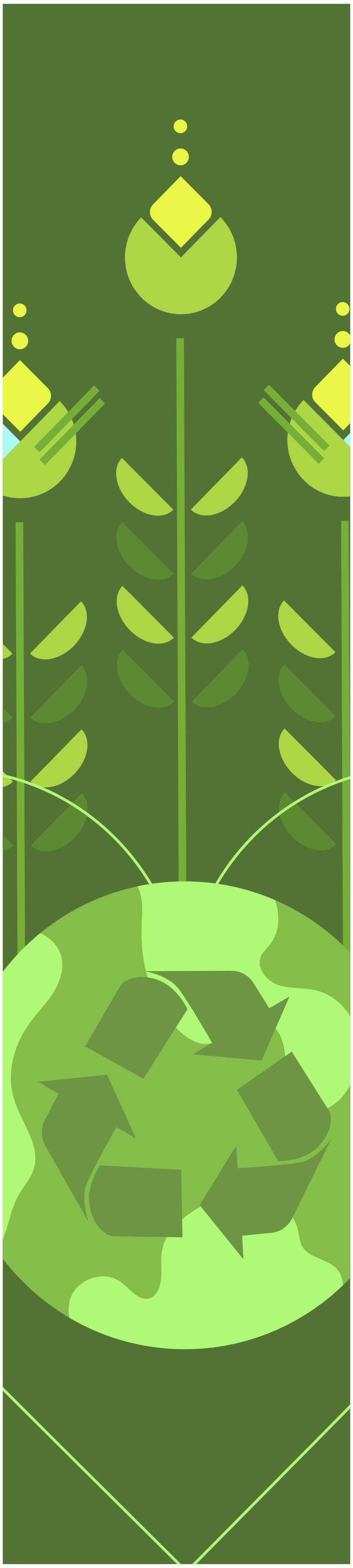
We are also careful about the flow of money that kind of goes into this space. Basically, we assess the mismatch between how the market is pricing it versus its credit fundamentals and its ESG credentials. There is an element of too much money flowing into an area whereby the market pricing doesn't sort of make sense.

So, we must be careful. We are obviously invested in this sector, and it's a sector that we like, fundamentally, and it is a sector that's growing, and the regulatory environment is supportive of this as well. But we must be careful about where market pricing has gone vis-à-vis where the credit fundamentals are.

And I think you've seen this during the sell-off just right before what happened in Russia, when there were worries about much higher inflation and the actions of the Federal Reserve. And actually, ESG paper, or the green securities, were the ones that underperformed. Why? Because the money that flew in became indiscriminate in the type of names in which they were invested.

There is significant and widespread progress and considerable optimism, but the reality is that ESG data and metrics are still evolving, meaning that there is more upside potential that will become clearer

As to the evaluation of the ESG criteria of the target issuers, the market is still very much in the evolutionary stage. Just sharing



our own experiences, even in the data that we have, our process is triangulating various data sources, which can be different. Moreover, we need to assess how the company reports as well. In brief, we need to drive towards consistency by using several sources, and we anticipate the future will hold greater disclosure and greater transparency.

Standardisation and some form of more globally adopted taxonomy remain way in the future

The question is often raised regarding standardisation and standardised taxonomy. Europe has the Sustainable Finance Disclosure Regulation (SFDR) standards, but many other jurisdictions are following up, for example Hong Kong or Singapore. We expect similar disclosures in the future, so that eventually, Chinese companies listing in Hong Kong, and in-bound companies listing or issuing in Singapore will later have similar disclosures. But that is not yet the case, improvements are ahead.

Engagement and ongoing rapport with the companies that issued the debt is vital

The next level centres on engagement. Actually, many companies that we invest in are private, so they have no exchange or other requirements to disclose, so we need to engage and to monitor how they approach and commit to a host of ESG factors. For example, regarding environmental factors, we need to engage in order to really understand the way they account for carbon intensity and greenhouse gas emissions. As we engage with them, we learn how they are producing their numbers and determine if they are consistent with the way we look at things.

Expert Opinion

HOWE CHUNG WAN

In Europe where you have ESG specific type of flows, the greenium or negative spreads emanating for ESG leaders has been present to the tune of anywhere between 10-15bp for higher quality names. This has been so far less apparent in Asia but we think as the ESG story evolves and as dedicated ESG assets grow, in our view, the increased flows biasing towards the better ESG performers may lead to increased differentiation between ESG outperformers and underperformers. Already one thing we have seen is some sell side being less willing to trade names with ESG issues meaning a lower liquidity for these names. We have also seen a neighborhood effect whereby an issuer printing a green bond or ESG bond tends to have some benefit of helping the rest of the curve compared to other like for like names.

Curating the investible universe requires lenses with many different angles of refraction to see ESG/ sustainability in all its dimensions

We split our investment universe into around fourteen business sectors. From a social perspective, for example, we do not compare how a tech or financial company behaves relative to a mining, we stick within sectors and rank within those sectors. In strategies where we take a ESG leaders approach, we select only from the first two quartiles in each sector. We arrive at what we consider our ESG leaders, followed by what we call transition enablers and then the opportunities.

PGI's Transition Enablers

The transition enablers are companies that are on the verge of doing the pivot between what we don't see in the current backward-looking data, and what they will become. We track their commitment levels to some of the key factors. It is in this transition segment where we see there is value from a market investor point of view, so this is where the alpha opportunity comes.

And PGI's Opportunity Set

The opportunity set comprises new industries in the green sector, such as electric vehicle companies, battery companies, and others that fit the economic sustainability model ahead. They also have the support of regulators and policymakers behind them, for example perhaps an affordable housing solutions company or other 'new' economy vehicles.

The art and science of determining illusion versus reality

I will also address the issue of substance and reality. For example, someone might ask if Chinese companies adequately disclose in line with the broader 'Green' movement or agenda that policymakers in China are so visibly pushing.

I can answer the question by referring broadly to what we obtain in Asia. In the Asia credit space, disclosures around some of the top fields such as the environment-related sector, or the supply chain related sector, show a coverage of about 65% to 70%. This means a 30% to 35% gap and some of that is in China, but more in the state-owned rather than private sector.

Play ball, and we will play ball – and if ESG and fixed income align globally, then the cost of borrowing for ESG leaders should fall

Another area that creates the 30% to 35% gap is the private companies that are not listed, and that comes back to the heavy lifting I mentioned earlier around engagement. Our methodology is such that companies that do not disclose their ESG related information will have their scores penalised.

Finally, in the sovereign space, we use an entirely different methodology, because when we look at sovereigns, we tend to use some of the United Nations Principles for Responsible Investing (UNPRI or PRI) type of indices in terms of looking through what some of these factors are, rather than through a corporate lens. And within the sovereign lens, they tend to paint a very different picture for us.

For example, it is not uniform across commodity producing countries. We consider natural gas to be somewhat less exposed to environment risks compared to say coal because gas is less polluting when burnt for power generation.

On the subject of sovereign actions that can destabilise geopolitics and unsettle investors, few issues loom larger than Russia

I would like to share some views relating to Russia and Asia credit. There is a clear connection between energy shortages as a result of supplies and due to future European abstinence from Russian sourcing, both of which will drive clean energy faster and further. But, in the very near term, there is a rush for energy security, driving commodity prices higher, and that impacts commodity and energy prices in Asia.

The Fed and the major central banks all have key roles to play in the face of inflation - sabre rattling alone won't do it, action must be taken, but an excessive response is just as dangerous as too minimal a response

In our view, we think that the market pricing in terms of the total number of hikes within the entire cycle is getting very much priced in. The key is how much the curve has been inverting. And we see that as a sign of possible markets thinking about recession, and there's only so much the Fed can keep pushing, a limit to how aggressive they can go.

The market likes it for now, or at least believes in it because they believe in a Fed that's going to calm inflation and not having to double up and become even more aggressive at the later stage. So, they see it as a good thing that Powell is speaking aggressively.

We agree. If they are actually going to stem inflation, but there's only so much they can do before pushing the economy too hard, and we do not see the US economy going in that direction anytime soon this year but are monitoring it carefully.

Expanding on that view, we still see many of the indicators doing really well. There are a couple of indicators with respect to consumer spending, and small businesses sentiment - both have been falling - but many other indicators, including the housing market, the household balance sheet, are all in fairly good shape.

China's major impact on Asian credit and spreads – the cloud is lifting

What surprises us the most in terms of the way rates are being priced is how Asia credit has behaved in the whole scheme of things, how much it has underperformed the rest of the emerging market space. And the reason to us is China, which in 2021 was impacted by many adverse stories around technology, property, regulatory tightening and so forth.

But since that phase, things have improved, sentiment has improved, it looks more coordinated, and as things improve Asia credit may turn and has the potential to do really well from here. So, its certainly a very interesting time looking at where spreads are versus the rest of the world in Asia credit.

Further, I expect the decarbonisation drive is going to take a bit of a backseat in China in the very near term, as the priorities in terms of China policymakers shift more to the growth angle, and thinking about regulations, for example to promote debt deleveraging, especially in the property market, and to help drive common prosperity.

I don't mean that their goals of reducing carbon by 60% in 2030 have disappeared, but before they get there, they will prefer to prioritise growth, we believe. So, we are seeing that some of the coal and cement companies in China are able to step up the amount of production again to pre-2019 levels, as China drives itself out of any economic downdraft." ■

The Final Word – the outlook for ESG/sustainability in Asia's fixed income markets

ESG in Asia fixed income will increasingly become mainstream. Policy impetus to grow the Asia ESG universe. Policy and regulatory landscape supporting ESG growth will lead to a larger opportunity set with more issuance, more diversification in the asset class and build the ecosystem of issuers, debt capital markets and investors.

One prediction could be that non-ESG funds may underperform going forward. As ESG become table stakes and a basic hygiene factor for investors, flows will continue to go into ESG strategies bypassing non-ESG funds.