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ESG in fixed income – more of the same?

Interview with Jason Smith

As a fixed income specialist, do you look at ESG differently from other ETF providers?

ESG considerations are increasingly important whatever the asset class. However, in fixed income, there are some key differences compared with, say, equities. Like equities, you can look at a company and its ESG credentials. However, you can also look at a single bond and how that money is being used. For example, is it a green bond or a social bond, earmarked for specific environmental or social projects?

In fixed income, we also have to think differently about stewardship of the assets we own. We don't have voting rights but we can, for example, support collaborative initiatives. We also use credit and bond indices, so, while we don't have direct control over index constituents, we can actively engage with index providers and encourage them to consider ESG factors in their selection criteria.

Fixed income is a complex asset class, so it's no surprise that incorporating ESG considerations into fixed income is complex too. At Tabula, we're increasingly bringing ESG into our core product range, so the most important thing is to actively engage with investors and understand their needs.

Where are the gaps in the current fixed income ESG ETF offering?

In a survey of professional investors earlier this year, we found that respondents overwhelmingly wanted more innovation. Currently, many fixed income ESG ETFs are close copies of equity ESG ETFs, applying the same ESG ratings and methodologies to existing bond indices. The inflows to these ETFs reflect the demand for ESG in general, but the products themselves may not be exactly what investors want.

Many existing ETFs are also closely tied to traditional benchmarks, with similar regional and sector weightings. However, our survey found that, for many investors, tracking error is becoming less critical. There was also a demand for more transparency. With indices based on broad ESG ratings, it's difficult to understand why certain issuers are included or excluded. Taking a step back, it can also be hard to see a clear purpose in these ETFs apart from being "more ESG". We think that ETFs with specific environmental or social objectives, for example alignment with a 1.5C Paris climate scenario, could be more compelling.

Another insight from our survey was that parts of the fixed income market are underserved. As investors look to re-align their entire portfolios, we expect increased demand for ESG ETFs across every market segment.

What innovations do you expect in fixed income ETFs?

ESG is evolving rapidly and ETF providers need to be adapt. The best approach in a particular asset class today is unlikely to be the best solution in a few years' time. In the longer term, we see opportunities in the relationship between ESG risks and credit spreads. The major ratings agencies have signed up to the UN-supported PRI's "Statement on ESG in Credit Risk and Ratings" and we are starting to see excellent granular data from some agencies showing how different ESG factors influence ratings.

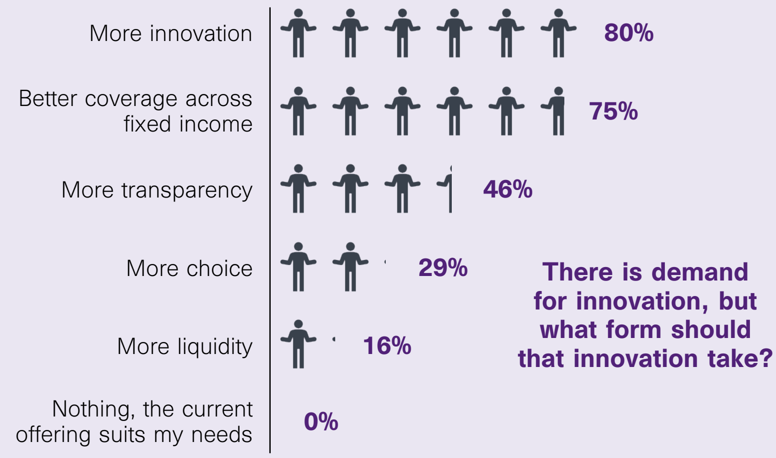
However, right now, the big focus is on climate change. This is arguably the defining challenge of our age and all investors, across all asset classes, have a part to play. The EU is taking a strong lead, formalising an EU Green Bond Standard and defining Paris-Aligned Benchmarks and Climate Transition Benchmarks to help investors allocate capital to more climate-friendly investments. Equity ETFs are already emerging and we expect bond ETFs to follow soon. Although there are criticisms of some of the detail of the EU's approach, there is no doubting their sense of urgency and their motivation in getting capital flowing in the right direction.

What are the choices for climate-conscious fixed income investors?

For fixed income ETF investors, there are two approaches. Green bonds are an obvious choice, providing funding for projects with environmental benefits. This market has grown rapidly but is not without challenges. In particular, it is not always clear that the proceeds of a bond labelled "green" are being used as expected. While the EU and other bodies are trying to address this, investors should also look carefully at the index methodology behind an ETF to ensure that there is sufficient scrutiny of individual bonds. For now, the green bond market is also concentrated in certain sectors and countries. Issuers are primarily sovereigns and supranationals, with a smattering of utility companies but few other corporates. As a result, green bond ETFs are currently quite specialised investments, although this should change as the market grows and diversifies.

For investors looking to shift their core bond allocations into more climate-conscious investments, the new EU Paris-Aligned and Climate Transition Benchmarks could be more interesting. These benchmarks allow investors to align their portfolios with the 1.5C Paris goal, while retaining diversification. They also have some minimum standards – for example, they exclude companies involved with controversial weapons or violating the UN Global Compact. So, while they are focused on climate, they don't ignore other critical ESG issues. It won't be long before there are bond ETFs tracking these benchmarks. ■

What could be improved in the current fixed income ESG ETF offering?



Based on 120 professional investors surveyed in May/June 2020 by Tabula Investment Management ("Tabula") or independent research company Pureprofile. Tabula commissioned Pureprofile to interview professional investors (institutional and wealth managers) across seven European countries.

Jason Smith
Chief Investment Officer, Tabula Investment Management

Jason Smith is CIO of Tabula and is responsible for designing and building new funds. For over 20 years he was a senior portfolio manager at several leading global asset managers. Prior to Tabula, Jason was most recently a senior portfolio manager at Goldman Sachs Asset Manaagement, where he focused on a variety of fixed income portfolios including rates, inflation, LDI and secured finance. Previously, he was head of portfolio management for the absolute return funds at Barclays Capital, receiving both a Citywire 'A' rating and Lipper leader award for performance. He has also managed a range of fixed income and absolute return portfolios at BlackRock, JP Morgan, Towers Perrin and IBM. Jason has a post-graduate diploma in Artificial Intelligence from the University of Westminster and a BA in Banking and Finance from the London Guildhall University.