ESG integration for fixed income: sound stewardship and social responsibility

By Paul English

In brief
We are convinced that ESG integration not only makes the world more sustainable, but can also lead to better risk-adjusted investment results. We describe some aspects of the Invesco Fixed Income ESG process – data collection, calculation of proprietary ESG scores and engagement – that supplement our traditional credit research, thus helping ensure that our clients achieve their goals.

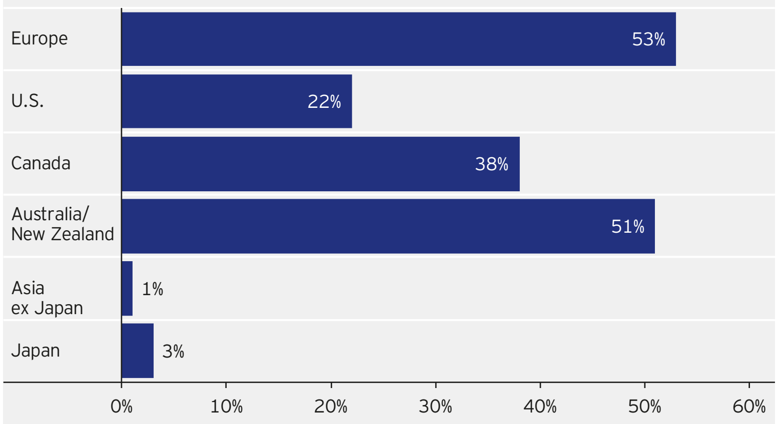
At Invesco Fixed Income, we are convinced that sound environmental, social and governance (ESG) practices can lead to better value for our clients. We view integrating ESG factors into our long-term investment framework as an additional layer of due diligence in the best interest of clients and markets. In this article, we describe our approach in detail.

Asset owners are increasingly interested in investment approaches that better align with their views on ESG issues. Moving beyond basic ESG screening techniques, we believe they will ultimately demand evidence that their investments are making a positive impact on our collective futures.

The increase in demand for sustainable investment solutions has been most prominent among financial institutions and corporate sponsored funds. Insurance companies have recognized the need to align underwriting and investment practices, for example, ensuring assets (e.g. tobacco bonds) are not undermining their assumed insurance liabilities (e.g. life insurance). Corporations have also moved to express corporate vision and sustainability policies through directed investments.

Though it's true that ESG first reached scale in Europe (figure 1), ESG investing is no longer a purely European phenomenon. We have seen increased ESG interest in Japan, the United States and, most recently, China. Invesco Fixed Income's approach to ESG investing takes account of this growing interest.

Figure 1
Socially responsible investing as a percent of total managed assets
SRI 26% of total managed assets globally



Source: GSIA's 2016 Global Sustainable Investment Review. Data as at 31 December 2015, except for Japan which is as at 31 March 2016.

We believe full ESG integration can improve long-term risk-adjusted returns
At Invesco Fixed Income, we believe that ESG-oriented investment can lead to better long-term risk-adjusted returns, driven by improved profitability (due to lower funding costs) and lower asset price volatility.[1] Consequently, we have fully integrated ESG risk factors into our fundamental credit research.

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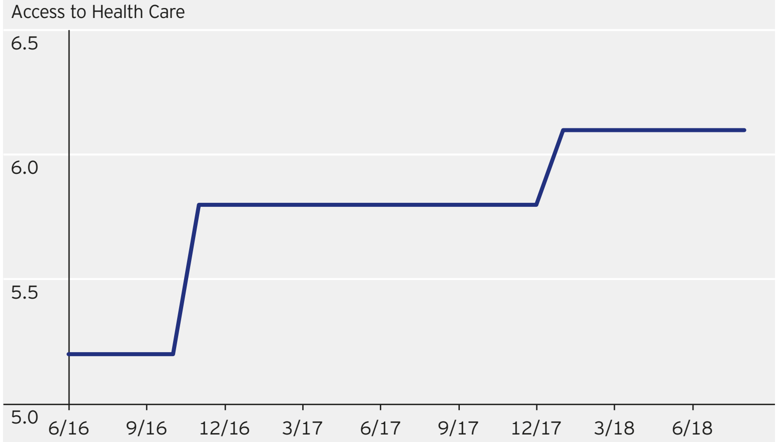
Our starting point is data collection. With robust historical data, we can analyze multiple ESG risk factors against market pricing and credit ratings. Data is collected from multiple sources, including issuing companies, Corporate Sustainability Reports (CSR) and external research providers. Our database contains time series of various ESG indicators for the issuers in our investment universe.

Such time series may be derived from: the corporate governance section of financial reports, the size of the board, its proportion of independent directors and its share of women, to name a few. In addition, we use scores for particular ESG themes provided by MSCI – figure 2 shows the historical development of the MSCI Access to Health Care score – as well as data from Sustainalytics and smaller research boutiques. This all supplements the information provided by Invesco's Global Responsible Investment Office, a central function that supports Invesco's investment teams with tools, research, education and client support.

Figure 2
Example of a company's MSCI key historical score – Access to Health Care



Source: MSCI, data from 1 June 2016 to 1 August 2018. Key issue scores are assigned by MSCI on a scale of 0 to 10, with 10 being the best. The Access to Health Care score evaluates the extent to which companies take advantage of opportunities for growth and protecting their license to operate through efforts to improve access to health care in developing countries and underserved markets. Scores are based on exposure to underserved geographies, access to health care strategy and programmes in areas such as R&D, pricing and licensing. For illustrative purposes only.

ESG analysis: interwoven into fundamental credit analysis
Based on this data, we have recently established a proprietary ESG rating process (figure 3). It brings together both quantitative and qualitative factors, ensuring alignment with our existing fundamental credit research process.

To obtain our proprietary ratings, ESG data is reviewed in absolute terms and by peer percentile rankings, guiding the establishment of independent E, S and G risk factor scores. These scores are evaluated along with analysts' assessments of issuers' policies and management engagement, providing the foundation for an overall ESG rating

Figure 3
Invesco Fixed Income's credit research
Proprietary ESG ratings process

Invesco Fixed Income's proprietary ESG ratings process is rooted in data collection, historical and peer analysis, issuer engagement and awareness of external resources, providing meaningful insights into ESG factor risks.

Data
- Bloomberg
- Sustainability report
- MSCI pillar scores

Analysis
- Everest
  - Sector ranking
  - Historical trend
  - Disclosure
  - Leading/lagging
  - Policy review
  - Engagement prioritization

Resources
- MSCI / sustainalytics
  - Identify key issues
  - Controversies
  - Business involvement screens
  - Methodologies
  - Index eligibility

ESG scorecards:

E, S & G factor scores	1	2	3	4	5
Overall ESG score	A	B	C	D	E

Source: Invesco. Quantitative ESG factor risk reviews are supported by detailed "ESG Monitors," which aggregate multiple datasets across ESG pillars. For illustrative purposes only.

and trend relative to sector peers. To avoid high absolute risk scores specific to one industry, an additional industry screening takes place at portfolio level. We also offer negative/exclusionary screening on a customized mandate basis as well as inclusion based on positive/best-in-class.

The output of our ESG analysis is integrated into our "Issuer Scorecards", which consolidate our fundamental credit opinions on each issuer. The addition of a ESG risk lens to our fundamental credit process has led to differentiated views of companies within the same sector. For example, we credited a US-based exploration and production company with providing quarterly disclosures to investors on positive safety and environmental performance, which may lead to better operating performance with fewer risks. On the other hand, we penalized a US-based pipeline company due to its lack of basic safety monitoring metrics and poor peer rankings. This highlights how issuer-level ESG risks and fundamental credit views are often interwoven.

Full ESG process integration ensures that all portfolios benefit from the evaluation of environmental, social and governance risks at issuer level through our proprietary ESG ratings process, as well as its influence on our internal fundamental credit rating and trend analysis. In the end, ESG risk assessments may be the decisive factor when similar opportunities exist in

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credit markets. With a uniform process across fixed income asset classes, portfolio managers can compare risks and opportunities.

Engagement: next frontier of ESG investing

Issuer engagement in the fixed income asset class is thought to be more challenging relative to equities. While this is due largely to the lack of voting rights as fixed income investors, we have found that most companies welcome engagement on ESG, recognizing that investors ultimately decide their cost of funding.

To make the most of limited time with management teams, we utilize peer analysis and key issue relevance to prioritize engagement opportunities. In other words, our engagement strategy is directed by the relevance and level of ESG risk factors. Lower-risk

Invesco awarded top grades for ESG two years in a row

As a signatory to the Principles for Responsible Investment (PRI), Invesco has reported, was assessed and is honored to have been awarded an A+ rating in 2018 for its overall approach to responsible investment (Strategy and Governance) for the second consecutive year.

The PRI carries out the annual assessment based on a signatory's progress year-over-year and relative to peers. The investment categories are evaluated using six performance bands (A+, A, B, C, D, and E), where A+ distinguishes the top scoring signatories, representing a score of 95% or above.

Invesco is committed to adopting and implementing responsible investment principles in a manner that is consistent with our fiduciary responsibilities to clients. Invesco supports the PRI and recognizes the importance of considering environmental, social and governance (ESG) issues as part of a robust investment process.

Any reference to a ranking, a rating or an award provides no guarantee for future performance results and is not constant over time.

items can be handled via written communication with investor relations departments. Higher risk factors provide opportunities for direct contact with senior management. We recognize that industry engagement practices are in the early stages and we are committed to finding practical ways to promote ESG awareness among company managements.

Conclusion

ESG integration is evolving: companies are expanding ESG factor reporting and working to enhance the overall quality of their corporate disclosures. Data providers have developed new products and end-investors are demanding more ESG-related product options. Asset owners are increasingly committed to aligning with the United Nations Climate Change Conference, which advocates limiting the rise in global temperatures to two degrees Celsius. Clients are also becoming interested in mapping corporate policies to the United Nations Sustainable Development Goals (SDG), which span several societal priorities, including eliminating poverty, reducing inequality and climate action. The SDGs represent a universally recognized agenda in this space.

Invesco Fixed Income continues to promote the integration of ESG capabilities across multiple fixed income asset classes to help clients meet these objectives and to deliver on our dual goals of maximizing risk-adjusted returns and contributing to a more sustainable future.

About the author

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Paul English's primary responsibilities include the management and coordination of the investment grade research function, credit strategy, resource requirements and standards of practice. His coverage responsibilities are focused on the analysis of financial institutions. In addition, Paul acts as Director of ESG Research for Invesco Fixed Income, responsible for research process integration.

Note

1 The strategic direction of our responsible investment practices is governed by the Corporate Responsibility Committee, chaired by Invesco's CEO Marty Flanagan.

About risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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