10 YEARS of responsible investment

Considering ESG and climate change within Environment Agency Pension Fund's fixed income portfolios

Kate Brett – Principal, Responsible Investment, Mercer

Introduction

Many of Environment Agency Pension Fund's (EAPF) responsible investment activities focus on EAPF's position as active owners of shares in companies; in other words, with respect to the Fund's equity holdings. However, the Fund also invests in debt, including company debt and government (or sovereign) debt – these investments are also known as bond investments or fixed income investments and make up over 35% of the Fund's assets. This chapter profiles how EAPF applies its responsible investment and climate change policies to its fixed income investments.

An evolving landscape

Looking back over the last 10 years, there has been a substantial shift with respect to considering Environmental, Social and Corporate Governance (ESG) issues in fixed income investments. 10 years ago, responsible investment was not really on the agenda for fixed income investors and responsible investors were typically focused on what they could do within their equity portfolios, with a particular focus on company engagement.

Today, the picture is very different: many of the World's largest fixed income investment managers are PRI signatories, including all of EAPF's fixed income managers. On top of progress in ESG integration within the investment process, new investment instruments are being developed, such as green bonds and social impact bonds, to enable investors, such as EAPF, to apply responsible investment principles to their fixed income investments.

Despite this, fixed income is still the 'baby of the family' when it comes to ESG integration relative to other asset classes, such as equities and property, where standards, processes and monitoring tools have been 'tried and tested' and are much more established.

EAPF intends to play a leading role in encouraging the adoption of improved RI practices within fixed income, as it has done in other areas over the past decade. With that in mind, this chapter sets out the Fund's current approach, how it has evolved, potential investment opportunities and what the next 10 years may hold for the Fund's fixed income investments.

How can ESG be integrated into fixed income investments?

When investing in bonds, the Fund's investment managers consider several features of a bond, including:

- The creditworthiness of the underlying issuer, indicated by a bond's credit rating
- The risk of a credit rating downgrade
- The risk of default (when the issuer is not able to repay the debt)
- The maturity of the bond, i.e. the length of the payback period of the bond, which can range from 1 month to over 35 years

ESG factors, including risks posed by climate change, are increasingly being embedded into credit ratings for bonds.

Integrating ESG issues in credit ratings for bonds

Credit ratings are assigned by independent credit rating agencies (for example Standard & Poor's or Moody's) and are used by investors to help determine the creditworthiness of a bond.

Similar to personal credit checks and scores, credit ratings are used to describe how likely it is that the debt will be repaid in full – the better the rating, the better the chance that the debt will be repaid and the lower the investment risk. Credit ratings are assigned to both company issued bonds and to sovereign bonds. The majority of the Fund's fixed income assets are held in relatively low risk assets, including UK government bonds (known as gilts) and 'investment grade credit' – company bonds achieving high credit ratings.

When considering ESG issues for company issued debt, the credit rating agencies and the Fund's investment managers may consider company issues such as:

- Exposure to assets that are at risk of becoming 'stranded' in the shift to a low carbon economy (e.g. coal reserves)
- Governance, accounting transparency and corruption related issues
- Employee labour practices and relations
- Reputational and litigation risks

When considering ESG issues for sovereign issued debt, the credit rating agencies and the Fund's investment managers may consider country-specific issues such as:

- Transparency and corruption
- Public health and education standards
- The vulnerability of a nation to the physical impacts of climate change (such as rising sea levels) and its ability to adapt to climate change

The credit rating of bonds may be downgraded for various reasons, including ESG issues, if the creditworthiness of the issuer is called into question. For example, as well as the widely publicised fall in the share price of Volkswagen following 2015's emissions scandal, the credit ratings of Volkswagen's bonds were downgraded by the credit ratings agencies, indicating the company's reduced creditworthiness as a borrower due to concerns over the environmental, governance and litigation risks associated with the scandal.

EAPF's approach

The Fund's fixed income investments are currently divided into the following broad areas:

- UK Corporate Bonds – largely comprising of listed (i.e. traded on an exchange) debt of UK companies.
- 'Buy & Maintain' Corporate Bonds – comprising of listed debt of global companies and managed with the intention, subject to ongoing monitoring, of holding the debt until maturity (holding the bonds for their whole life rather than trading the bonds).
- UK Index-linked Gilts – comprising of inflation-linked UK government bonds.
- Global Fixed Income – comprising of listed global debt.
- Private debt – comprising of the debt of privately held companies.

When developing a new mandate or appointing a new fixed income manager, EAPF considers the level of ESG integration within the strategy and also the investment manager's commitment to responsible investment, in order to ensure alignment of interest between the manager and EAPF. The ESG capabilities of the managers are monitored on an ongoing basis both by EAPF and through the use of Mercer's ESG ratings.

In 2012, EAPF introduced carbon footprinting for its corporate bond portfolios, following the introduction of carbon footprinting for equity portfolios in 2008. The Fund's investment managers are able to consider the carbon footprint and the environmental footprint of their portfolios relative to a relevant fixed income benchmark, as well as the exposure to assets that may be at risk of becoming stranded in a shift towards a low carbon economy.

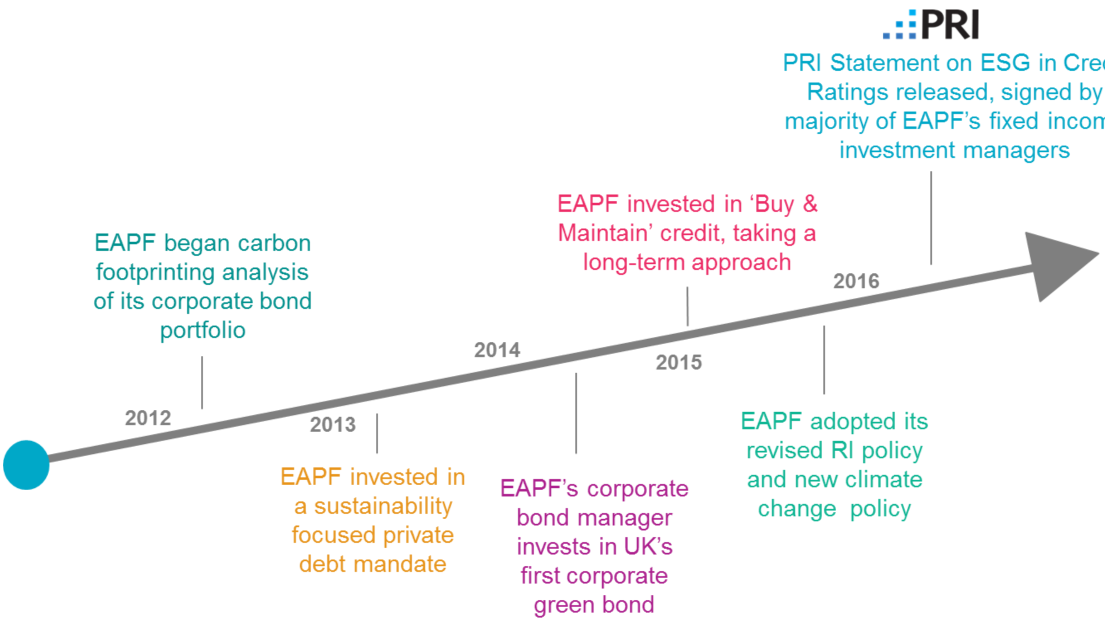
The Fund's 'Buy & Maintain' bond mandate, which was introduced in 2015, takes a long-term approach to fixed income investing. The nature of the mandate means that EAPF does not want to be holding positions that it needs to liquidate (sell) because they later become unacceptably risky. So the mandate includes RI guidelines designed to ensure the manager fully considers long-term ESG risks and only holds bonds where any such risks are being compensated. The focus is particularly on climate risk and corporate governance. The portfolio has a lower carbon footprint and lower environmental footprint than a typical corporate bond benchmark given its investment approach. In addition, while company engagement has historically been associated with shareholders (given the voting rights attached to being a shareholder), companies are increasingly becoming open to engagement by long-term debt holders.

The EAPF's private debt allocation is a new investment area for the Fund and one which creates particular risks and opportunities. Private debt involves lending directly to companies, rather than through the bond markets. By providing growth capital to small and medium-sized privately owned enterprises, EAPF can help these companies expand, employ more people and support economic growth. It tends not to involve lending to environmentally high risk areas such as resource extraction, and so overall EAPF feels it has generally positive aspects. Nonetheless EAPF expects managers to conduct detailed due diligence on possible investments, particularly on governance and environmental risks. One aspect EAPF focuses on is when companies are struggling to repay the debt and debt investors need to take action: here EAPF seeks to ensure that any action taken is as responsible as possible, with the aim of preserving the long-term value of the company as well as jobs.

Private debt is an area where EAPF felt there was a strong case for investing in a specialist sustainable mandate, where the investment strategy applies a sustainability lens in determining which companies to lend to. This mandate provides a complement to EAPF's other investments in sustainable businesses, which tend to focus more on equity investment.

The chart below highlights the evolution of ESG integration in the Fund's fixed income holdings over the last five years:

EAPF: Developments in ESG integration in fixed income



Opportunities – where next?

Mercer anticipates that the increased focus on ESG issues in fixed income investing will continue, particularly with respect to the integration of ESG issues into the credit ratings process. In May 2016, 100 fixed income investors (together representing assets of over $16 trillion) including several of the Fund's fixed income investment managers, signed the PRI's Statement on ESG in Credit Ratings, with the aim of enhancing the systematic and transparent consideration of ESG factors in the assessment of creditworthiness. As an active PRI signatory, EAPF will continue to support market-wide developments in ESG integration for fixed income investments.

In addition to increased ESG integration within its fixed income portfolios, EAPF actively seeks to support new, developing opportunities aligned with its responsible investment and climate change policies. One of the areas of opportunity that EAPF and its investment advisor, Mercer, are actively monitoring is the growth of the green bond market.

Green Bonds

Green bonds are bonds where the money raised through the issuance of the bond is ring-fenced to be used to support projects or activities that have a positive environmental impact, such as those focused on renewable energy or energy efficiency. Green bonds can be issued by either companies or by government related entities such as the World Bank Group and regional development banks.

The recent Paris Agreement on climate change has highlighted that the period to 2020 will be crucial for investment in green infrastructure as part of the transition to a low carbon economy, given the ambitious aim of global governments to limit global warming to less than 2˚C. It is anticipated that green bonds will play an important role in supporting low carbon infrastructure projects, such as low carbon transport systems and low carbon buildings, particularly in developing markets.

Whilst still small in the context of global fixed income markets, the green bond market is growing rapidly; with issuance reaching over $40bn in 2015 and surpassing $90bn last year, based on data collated by the Climate Bonds Initiative. It is anticipated that this growth trend will persist (albeit the rate of growth may slow) as the barriers that have historically made it difficult for institutional investors, such as EAPF, to allocate capital to this area continue to be overcome. The Green Bond Principles, self-regulatory guidelines that provide a framework for the development of the green bond market based on transparency and disclosure, were established in 2014 and have recently been updated to include best practice guidance on reporting and external reviews, a development that is expected to benefit the ongoing growth of the green bond opportunity set.

Given the emerging nature of this opportunity, the Fund does not have an explicit benchmark allocation to green bonds, but within the Fund's existing bond mandates the investment managers actively review and invest in green bonds as part of the wider portfolio. These investment decisions are made at the discretion of the Fund's investment managers. For example, within the UK Corporate Bond portfolio, the Fund's investment manager has invested in a green bond issued by the company Unilever, which has a strong reputation for sustainable business practice.

Similarly, social impact bonds have been developed such that the funds raised by the debt issuance are targeted on areas such as education or social welfare. The social impact bonds market in the UK is very much in its infancy and these bonds have typically been very small in scale. As such, these bonds have not generally been suitable investments for the Fund given its size and investment requirements but EAPF, along with its investment advisor Mercer, will continue to watch this area for growth.

Overall, EAPF believes there will be attractive opportunities arising in the fixed income space and while the last 10 years of responsible investment may have been dominated by progress in other asset classes, ESG integration and opportunities in fixed income will certainly be at the forefront of the next 10 years.

If you have any questions about the approach of the EAPF, please contact either Faith Ward - Chief Responsible Investment and Risk Officer, or Mark Mansley – Chief Investment Officer, Environment Agency Pension Fund.

By: Kate Brett – Principal, Responsible Investment, Mercer

Kate Brett is a senior investment consultant in Mercer's Responsible Investment (RI) team, based in London. Kate is responsible for advising institutional investors on sustainable investment strategies and provides advice to a broad range of clients, including pension funds, endowments and insurers on integrating Environmental, Social and Corporate Governance (ESG) issues throughout their investment processes. In addition, Kate is responsible for developing intellectual capital across a range of responsible investment topics and has been the author and co-author of a number of recent reports and papers, including 'Investing in a Time of Climate Change' (2015), a collaborative study between Mercer and 18 industry partners, 'Fossil Fuel Investments Under the Spotlight' (2015) and 'How Low Can You Go? An Introduction to Low Carbon and Fossil Free Passive Equity' (2016). Kate holds a Master's degree in Theoretical Physics & Mathematics from the University of St Andrews and is a CFA Charter holder