Downside protection and bond holder engagement

In mid-September, **Tell Media Group**, in co-operation with **Aegon Asset Management**, **BlackRock** and **Danske Bank Asset Management**, invited four Norwegian institutional investors and manager selectors to discuss ESG-integration in fixed income. Tell Media Group founder Niklas Tell and Nordic Fund Selection Journal editor Caroline Liinanki moderated the roundtable.

By: **Niklas Tell** Photo: **Christer Salling**

The discussion, which was held at The Thief Hotel in Oslo, kicked off with Caroline Liinanki asking the investors about how their responsible investment policies for fixed income have changed over the years.

JEANETT BERGAN: "From a broad perspective, KLP has always looked at fixed income in the same way as equities when it comes to ESG. We're a global, mostly passive, investor in 6000 companies in 50 countries. We have strict guidelines and many exclusion criteria and the same criteria apply to both equities and fixed income. That said, over the last three to four years, we've done more work on ESG integration and are trying to be more aware of ESG risk upfront. We think that it's sometimes even more important in fixed income than in equities, due to less liquidity."

LARS TRONSGAARD: "It has been a long journey for Folketrygdfondet. We started to be an active owner in the 1990s, focusing a lot on the corporate governance side. From that starting point, we've tried to find a structure on the equity side on how to do responsible investments. The work on the fixed income side started some three to four years ago and by that time, we had a lot of experience from the work we had done in equities. Contrary to KLP, we don't have any exclusions and our approach to responsible investments is completely financial, which means integrating ESG-related topics to the credit analysis and to the investment decision. It's not an ethical question – it's a financial question. We believe that the companies that run their businesses in a sustainable way will give the best return over time and we're a long-term investor, so that fits our approach."

KRISTIAN RYLAND: "Responsible investments have been high on the agenda in Norway for a long time, starting with the work done by Norges Bank and the Council on Ethics. That developed into ESG integration as part of that overall responsible investing toolbox. At Grieg, we have our own framework of 'Do no harm – do good to make it happen' where we, among other things, look at ESG factors. That's both from a risk perspective but also as a set of opportunities."

NIKLAS TELL: "DO YOU HAVE THE SAME TOOLBOX FOR FIXED INCOME AS EQUITIES?"

KRISTIAN RYLAND: "Today, we try to do the same on both sides. That said, fixed income has been lagging equities when it comes to ESG and I think there's still a gap on how much we do on the fixed income side compared to equities. It's, however, a gap that's beginning to close."

KATRINE LINDBEKK: "At Gjensidige, we have, as many Norwegian investors, used negative screening for both fixed income and equities but in recent years, we've stepped up the work we do on the fixed income side. For our Norwegian bond portfolio, we've spent a lot of time on the "G" in ESG and we have governance ratings on all holdings, which feeds into our credit analysis. Going forward, we will spend more time on the "E". We've also had much more dialogue with our external managers over the last couple of years on ESG-related factors. That's something that's always part of our manager selection process today. The basis is having an ESG policy in place but we also look at their credit analysis work to understand how it works in practise."

CAROLINE LIINANKI: "SO WHY SHOULD YOU INTEGRATE ESG IN FIXED INCOME? WHAT'S THE OBJECTIVE AND WHY IS IT IMPORTANT?"

KRISTIAN RYLAND: "The simple answer is that it makes business sense to integrate ESG, regardless if you look at it as risk factors or a set of opportunities."

NIKLAS TELL: "SPECIFICALLY FOR FIXED INCOME, WOULD YOU SAY THAT IT'S THE ESG RISK OR THE OPPORTUNITIES THAT ARE THE MOST IMPORTANT?"

KATRINE LINDBEKK: "The risk management aspect is essential of course. With equities, you have unlimited upside but in fixed income, it's mostly a risk on the downside. Bad governance and not keeping up with current standards are risks that you would like to keep out of your portfolio."

ANDREAS DANKEL: "I very much agree on the asset class specific aspects that has been discussed and from my point of view, it has been a process of identifying factors that make a change. Personally, I think it's interesting to talk about ESG also from an ethical perspective but in practice, the materiality aspect is crucial. Unless an ESG factor has a material impact on the asset class, it really isn't relevant for what we're doing. That's both about identifying factors that will help us protect the downside but it's also about building conviction when it comes to opportunities."

BRUNNO MARADEI: "I would echo my colleagues around the table. Our approach has always been to focus on materiality first and foremost. The reason for integrating ESG is that it improves investment decision-making. It

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  Head of credit, Danske Bank Asset Management
- **BRUNNO MARADEI**
  Global head of ESG, Aegon Asset Management
- **GIULIA PELLEGRINI**
  Head of EMD sustainable investing, BlackRock

LARS TRONSGAARD
Folketrygdfondet
Fixed income portfolio manager at Folketrygdfondet, the manager of the Government Pension Fund Norway, but previously its deputy CEO and head of fixed income. Before joining the fund in 1992, he was the CFO of Realkreditt, a company that merged with DNB. He started his career as a financial analyst at Den norske Creditbank, now part of DNB.

JEANETT BERGAN
KLP
Head of responsible investments at the pension company KLP. She previously held the job between 2007 and 2017 but rejoined at the start of this year after about two years as director of sustainability at PwC Norway. She started her career as a sustainable investments analyst at Storebrand in 1998 and has also worked as a CSR advisor at KPMG.

> "Now that we're also focusing on ESG on the fixed income side to a larger extent, it's clear that it makes a lot of sense and that engagement here can prove just as fruitful"
>
> *– Jeanett Bergan, KLP*

improves the holistic understanding of risks but it all depends on the asset class and on the time horizon. You can't talk about ESG being as material for a three-year bond as it would be for a 15-year bond."

CAROLINE LIINANKI: "LARS, WHAT ARE YOUR THOUGHTS ON THE OBJECTIVES AND THE IMPORTANCE OF INTEGRATING ESG IN FIXED INCOME?"

LARS TRONSGAARD: "We have, as I said earlier, a financial approach to this and it's about reducing the risks of the portfolio. Integrating ESG is even more important on the fixed income side as the downside is bigger than your upside."

GIULIA PELLEGRINI: "I can only echo that, especially working in the emerging market debt space. It's the most relevant on the corporate side as we can't capture the upside to the same extent as an equity investor, so protecting the downside becomes very important. You want to avoid major credit events, which could be related to the environment and could hit the profitability and even the existence of a company. The same applies to sovereigns, even if we've been working more on the governance and social aspects of ESG there. For specific cases, however, it's also relevant to look at environmental factors. Ecuador is one example where we've done a lot of work in understanding the country's ability to repay its debt when a big earthquake took place. What we found is that its public financial management system was strong enough to face that catastrophe."

ANDREAS DANKEL: "I don't fully agree that ESG integration is more important in fixed income due to the downside risk. Equity markets are more volatile and even if you have unlimited upside, you also have a lot of downside."

CAROLINE LIINANKI: "WHY DO YOU THINK ESG-INTEGRATION WITHIN FIXED INCOME HAS BEEN SLOWER TO TAKE OFF THAN IN EQUITIES?"

JEANETT BERGAN: "I think it's been lagging because a lot of focus early on was on reputational risks. As a holder of equity in a company – as an owner – you're under more scrutiny from media and others if something goes wrong. You haven't seen that to the same extent on the fixed income side, where bondholder registers are not public. Neither do bondholders have voting power, so they don't have the same responsibility to ensure good corporate governance through owner stewardship. However, now that we're also focusing on ESG on the fixed income side to a larger extent, it's clear that it makes a lot of sense and that engagement here can prove just as fruitful. It's clear that the future will look very different and climate-related risks, for example, will have a big impact on sovereigns as well as on corporates going forward."

NIKLAS TELL: "AS AN EQUITY INVESTOR, YOU COULD BE AN OWNER FOREVER, AS LONG AS THE COMPANY YOU INVEST IN STILL EXISTS. BONDS, HOWEVER, HAVE A LIMITED TIME SPAN. WHAT DOES THAT MEAN IN TERMS OF ESG INTEGRATION?"

KATRINE LINDBEKK: "I would actually disagree with that. Our time horizon is very long and we expect to stay with companies for a long time, also on the fixed income side."

JEANETT BERGAN: "Absolutely. The companies typically need continued financing and if you have one bond maturing, you would typically continue to invest when the company issues a new one. It's a rolling kind of business. We don't really look at the maturity of a single bond as our total investment horizon.

ANDREAS DANKEL: "When it comes to how different maturities impact our ESG integration, we decided four years ago that we don't want to own part of the balance sheet of a company where we see material risks. Then, it doesn't matter if we think the ESG event will happen at a date when our bond has already matured. If we already own a bond in a company where we see a potential future ESG risk, we will engage with the company every six months even if we don't see a risk to our holding."

JEANETT BERGAN: "What is ESG integration really? A very good company from an ESG perspective can be very expensive. Are you ok with buying expensive companies or are you happy to buy less expensive companies, which are less good from an ESG perspective and then you work to improve it? Saying you're taking ESG factors into consideration in your investment decisions is easy but how you do it can be very different and there's potentially a conflict between ESG and financial impact."

BRUNNO MARADEI: "This is a very real concern in fixed income portfolios. You do sometimes see spreads in green bonds that do not reflect the risks. There's so much money chasing the same green deals. That's becoming a real trade off that you must make. Do you follow your fiduciary duty to make money for your clients or do you follow your clients' green preferences? This trade off is not as apparent in equities."

LARS TRONSGAARD: "I agree and for us it's easy because our mandate states that we must strive to achieve the highest possible return. It's therefore a question of whether we get compensated for the ESG risks that we see. On the question of time horizons, I think problems related to ESG will be remembered by the market for longer than the duration of a specific bond. If something has happened and a company wants to refinance at a later stage, they might not be able to do it or it will be more expensive."

GIULIA PELLEGRINI: "I think what's really important is to be transparent with your clients. You select a philosophy and make sure that it's understood by the clients. For us, we're active investors and we first and foremost need to deliver alpha. We reach that by integrating ESG factors and, as long as they are included in our benchmark indexes, we consider investing even in bonds with a poor ESG score because what we focus on is improving credits: bonds that on an absolute level score badly but where we can demonstrate clear improvements. Here, we've been helped by improving ESG data that help us map those improvements."

ROUNDTABLE – ESG IN FIXED INCOME, OSLO

KRISTIAN RYLAND
Grieg Investor
Head of fixed income at Grieg Investor, the Norwegian institutional investment consultancy firm. Prior to taking on the role as head of fixed income in 2013, he was an analyst at the firm, where he has worked his whole career.

KATRINE LINDBEKK
Gjensidige
Senior portfolio manager at the insurance company Gjensidige for the past nine years. Prior to that, she was a head of Statnett pension fund and has also worked at Kaupthing Asset Management and Morgan Stanley Investment Management. Until 2007, she spent seven years as a portfolio manager at KLP Kapitalforvaltning.

ANDREAS DANKEL: "I agree. Making sure your clients understand what you do and how you do it is very important. I would like to come back to the question of green bonds and whether they're overvalued. We, of course, never argue about the returns of an investment. We know if we get 3 or 5 per cent. What I think is very interesting and important is that ESG risks are subjective and one could argue therefore that the risk-adjusted returns on an investment are also subjective. One investor could view an ESG risk as minor while another investor could view that same ESG risk as huge. That makes it exciting but also difficult."

NIKLAS TELL: "AS EVALUATORS OF EXTERNAL MANAGER, DO YOU AGREE AND HOW WOULD YOU HANDLE THE FACT THAT THE ESG RISK COULD BE DEBATABLE? I GUESS THAT WOULD MAKE IT MORE DIFFICULT TO COMPARE MANAGER A TO MANAGER B."

KRISTIAN RYLAND: "That's part of our job. ESG means different things to different managers and we, of course, need to understand how they view it. We need to understand if they focus mostly on the risk aspects or if they use ESG factors to find investment opportunities. However, for us the first priority is that every product we invest in should be good investments."

KATRINE LINDBEKK: "When we select external managers, we have certain minimum standards that must be met. Previously, it was more a case of us hoping that an external manager would meet those targets but today it's not negotiable. It's an absolute demand. When that minimum standard is fulfilled, the process becomes more subjective where we look at the risks in the portfolio and where we try to understand how the manager works. That could be questions on how managers engage with companies they hold. Do we see proof of meetings etc? It's an evolving area."

KRISTIAN RYLAND: "I would say also that there's a lot of 'ESG-washing' when it comes to manager meetings and you must be aware of that. Managers will typically say that they've always integrated ESG in their investment process but often what they mean is that they've looked at governance issues. They have not looked at ESG factors from a holistic point of view. It's a lot of work to get a complete picture of how they work and we need to see examples from the portfolio to understand how ESG factors influence the selection of specific holdings."

LARS TRONSGAARD: "In terms of quantifying ESG risk into financial risk, it's still early days on the fixed income side."

BRUNNO MARADEI: "It's tricky to compare and it's the same when we buy research from external providers. Relying on only one is not really enough as there are different opinions out there. You need to have your inhouse credit analysts building their own ESG views, which is why we developed our own proprietary ESG risk categorisation system for corporate and sovereign credits. The absolute standard should be on the process and as selectors, you need to make sure that the manager has a process and a structured way to look at these factors. To say that one portfolio is 'greener' than another is far more difficult as it's subjective."

JEANETT BERGAN: "Maybe it's easier to integrate ESG if you have an objective not only to maximise financial returns but also a mandate to 'do good'. If you invest in a corporate bond of a company that has a very bad ESG but then actively engage with the company, then that's very good for society and it's probably a good investment as well. Is it more difficult to take that approach if your only objective is to maximise financial returns?"

GIULIA PELLEGRINI: "This is why we have two objectives where the first one is to deliver alpha to our clients. The second is to have an ESG score that is in line or above that of the index. There are, of course, issues with data from external providers that we rely on to say how 'ESG' we are and how 'ESG' the index is. So we use our own proprietary ESG tools overlaid with qualitative analysis to make investment decisions. I would also argue that we're in emerging markets to see these countries and companies improve over time. If we only invest in the best ones, then we fail on the aim to support that positive change."

JEANETT BERGAN: "I have worked on ESG research for some 20 years and I think getting a good ESG score from one of the big providers today is impossible if you don't have good processes in place. It does say something about the quality of a company."

ANDREAS DANKEL: "I agree very much with all of what has been said and I especially agree with you, Brunno, that you need internal processes and internal capacity to do this research. A lot of companies, also in the Nordic region, are not covered by external providers."

BRUNNO MARADEI: "I would also like to highlight the importance of active ownership and engagement in fixed income. Just because we're not owners of the company, we can still have an impact. At Aegon, we don't even tell companies if we hold equities or fixed income when we set up meetings with them. We generally find companies equally receptive to engagement – most companies don't ask us what class of investor we are."

LARS TRONSGAARD: "At Folketrygdfondet, being investors in both equities and fixed income, we've started to cooperate on engagement, especially for investment grade companies. As was mentioned earlier, there are, however, a lot of privately held companies and many of those are not really used to being approached by fixed income investors on these topics. We've started to do more in that space but it's still on a small scale. But so far it has been a positive experience."

NIKLAS TELL: "BRUNNO, YOU MENTIONED THAT YOU DON'T SEPARATE ENGAGEMENT BETWEEN EQUITIES AND FIXED INCOME BUT IS ENGAGEMENT IN FIXED INCOME DIFFERENT?"

JEANETT BERGAN: "No, we have the exact same approach. However, as Lars said, some privately held companies are not that used to being engaged."

CAROLINE LIINANKI: "IS IT MORE DIFFICULT TO GET A MEETING WITH A COMPANY AS A BOND HOLDER COMPARED TO BEING AN EQUITY HOLDER?"

ANDREAS DANKEL: "My impression is that if it's a good company, they will be interested in taking the meeting regardless if you're an equity or a bond holder. They're interested in the discussion and in learning about the issues that someone else have identified. That said, it obviously helps if you're a big player in a specific market."

GIULIA PELLEGRINI: "I agree, size helps. Also, our stewardship team will interact with companies on behalf of all internal teams, regardless if it's equity or fixed income."

NIKLAS TELL: "BUT I GUESS THAT YOUR WISH LIST AS FIXED INCOME INVESTORS COULD DIFFER FROM AN EQUITY HOLDER, WHICH WOULD LIKE A BIGGER DIVIDEND FOR EXAMPLE?"

ANDREAS DANKEL
Danske Bank Asset Management
Head of credit at Danske Bank Asset Management. He was also responsible for developing the firm's European corporate sustainable bond fund, launched in 2016. He has previously worked as a portfolio manager at BankInvest.

BRUNNO MARADEI
Aegon Asset Management
Global head of ESG at Aegon Asset Management. Prior to that, he was a senior investment officer at the European Investment Bank and a senior manager at EIRIS. He has also spent eight years at the World Bank Group.

GIULIA PELLEGRINI
BlackRock
Portfolio manager, head of EMD sustainable investing and deputy head of EM economic research for the fundamental EMD team within BlackRock's global fixed income group. Prior to that, she was chief economist for Sub-Saharan Africa in JPMorgan's emerging market research team.

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> *– Andreas Dankel, Danske Bank Asset Management*

KATRINE LINDBEKK: "That could be an issue."

BRUNNO MARADEI: "I agree but if we look specifically at engagement from an ESG perspective, I don't think there are any differences. A material ESG event will hit equity investors as well as fixed income investors."

CAROLINE LIINANKI: "DOES ANYONE HAVE ANY GOOD EXAMPLES OF SUCCESSFUL ENGAGEMENT AS A BOND HOLDER?"

LARS TRONSGAARD: "I think it's still early days but one of the most important areas is improved reporting from companies on ESG and I think that is happening thanks to engagement from investors."

CAROLINE LIINANKI: "BEFORE WE END THE DISCUSSION, I'D LIKE TO HEAR WHAT YOU SEE AS THE NEXT STEPS WHEN IT COMES TO ESG INTEGRATION IN THE FIXED INCOME SPACE."

JEANETT BERGAN: "I think the EU taxonomy will be important going forward. The EU is really serious in wanting to shift investments from fossil fuel to renewables and the taxonomy will come with clear limits. All investors that are using words like 'sustainable' or similar will have to comply. We don't know exactly what it will mean but it could possibly shake up the industry."

NIKLAS TELL: "IN A GOOD OR A BAD WAY?"

JEANETT BERGAN: "From a financial return point of view, it could have implications for certain companies and certain investors. For society and for financial markets over time, I think it's good."

KATRINE LINDBEKK: "How the environment will impact your portfolio will become an increasingly important topic. For us, it's early days but we have ongoing projects to assess the climate risks of our portfolios."

LARS TRONSGAARD: "I think a key step forward is getting more transparency in the corporate market, on companies that are not rated by external data providers. When we have that in place, the next step would be to have more differences in pricing where companies being transparent on ESG issues will be able to finance themselves at a better price."

ANDREAS DANKEL: "I think regulation, where the EU taxonomy will be the trigger, will have an impact. However, I'm not sure that will move quicker or be ahead of the general movement in the markets. Regardless of where we live on this earth, we can all see the changes to the environment and I think institutional investors as well as retail investors will start to question how their assets are invested to an even larger extent. And that will change the landscape. The sustainable, or green, part of the fixed income market is still a small part of the total market, which creates opportunities going forward." ●