Does sustainable investing belong in fixed income?

Sustainable investing is traditionally an equity concept. Its history is largely devoid of fixed income. Yet that appears to be changing. The growing desire from clients for products that embed ethical values, alongside growing evidence that sustainable approaches do not compromise financial performance, has led to a surge in enthusiasm for sustainable approaches to investing across all asset classes. But is this all hype? Does it truly belong in the world of credit?

Before attempting to tackle this question, it is worth laying out what we mean by sustainable investing, since there is no universally agreed definition. We consider it to be the practice of investing in companies that will deliver a net benefit to society. The companies must provide products or services that make the world better, while at the same time exhibiting sector-leading environmental, social and governance (ESG) standards.

Fixed income considerations

Financial considerations are obviously of great importance to us as investors. From a fixed income perspective, we want to know (among many considerations) how robust the balance sheet is, whether the debt can be serviced and how volatile the business model is. We essentially want a comprehensive understanding of the risks that we face as lenders, and will then consider whether these risks are sufficiently compensated for by the price.

This is where there are abundant benefits in incorporating ESG considerations in our analysis. Forecasting how robust our investments will be in 10, 20 or 40 years is an extremely difficult task. One thing which is clear is that companies with serious ESG red flags almost always spell trouble for long-term lenders, despite the higher credit spreads they might offer. Consequently, the 'sector-leading ESG' requirement for sustainable funds does not seem too burdensome to us as credit investors.

Consider the recent drive to decarbonise the UK. Heating domestic houses constitutes a large proportion of carbon emissions, and so the government is committed to removing gas as a source of energy over a very short period of time. This will be a major challenge for our gas infrastructure, and so any related bonds due to mature in 30 or 40 years are going to be impacted. Stringent ESG requirements help shield against such risks.

Values or returns?

The other key feature of sustainable investing is the embedding of ethical values. The benefits of this are by nature subjective, since different people hold different values. A common concern, however, is that there is a trade-off between values and returns. This makes intuitive sense, since ethical investing necessitates that certain bonds become un-investable regardless of the financial returns that they might theoretically offer.

Counterintuitively, then, we find that the long-term performance of our sustainable credit funds, as well as our ethical fund (which has fewer requirements), is comparable to that of our unconstrained funds. The reason for this is that, despite their different purposes, they share a great deal in common. They all rely upon the same investment philosophy, they all have an integrated ESG approach, and they all feature investments that lie outside benchmarks.

Diversification benefits

So there certainly seem to be a number of points in favour of the sustainable approach in fixed income. But does it make sense investing in a fixed income sustainable fund if you are already invested in an equity one? Won't there be a lot of overlap that concentrates your risks?

In fact, it is quite the opposite. Fixed income portfolios are highly complementary to equity approaches owing to the different factors they value and the different indices they look at. A lot of the bonds we own do not have equity equivalents. Social and affordable housing is a major part of our portfolios, and credit markets provide a level of access to it that equity markets cannot match. Likewise, we can invest in roads, airports, hospitals, universities, even the BBC.

So yes, we unequivocally believe that sustainable investing has a place in fixed income. Its ESG considerations provide a level of portfolio 'future proofing', it suits our proven investment philosophy such that we find little evidence of a trade-off between values and long-term returns, and it provides a great deal of diversification from the stocks found in sustainable equities' portfolios. All told, we think it is a great addition to the world of credit investing.

Investment risks

The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Sustainable investing: The investment strategy will result in certain industries being excluded as a result of our ethical and sustainable investment policy. As a consequence, there may be increased risk due to reduced diversification opportunities.

Contact us

For more information about our range of products and services, please contact us.

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