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Interview: Quintet on fixed-income ESG investing

Eurex spoke to James Purcell, Group Head of ESG Investment at Quintet Private Bank, on ESG investing in the fixed-income segment.

Quintet Private Bank is headquartered in Luxembourg and operates in 50 cities across Europe. Quintet serves wealthy individuals and their families, as well as a broad range of institutional and professional clients, including family offices, foundations and external asset managers.

1. What are the challenges that asset owners face when choosing to invest with ESG in fixed income?
The key challenge for everyone deploying ESG criteria when investing is data quality. When making an assessment of any aspect of an investment, you need to be able to compare like with like. The challenge in that regard when conducting ESG analysis is a lack of standardization.

Even if we take criteria that could be commonly measured across most sectors and geographies, such as gender diversity, companies report all kinds of different metrics. For example, a World Economic Forum review of the 15 largest US FMCG firms yielded 22 differently defined gender metrics. This is why sustainable accounting standards for corporates, such as Sustainable Accounting Standards Board (SASB), are so crucial to solving the ESG challenges asset owners face.

Fixed-income investors have an additional challenge when thinking about how to deploy ESG, which is financial materiality. Because debt ranks higher than equity in the capital structure, debt instruments are typically less volatile and less sensitive than are equity instruments to incremental good or bad news. Therefore, certain ESG factors may simply not matter to the fixed-income investor's returns. For example, if good labour practises are translating into increases in productivity and a percent or two of market share gain, this could significantly change the value of the firm's equity, but it may simply not be material enough to effect the firm's solvency and thus its bond price. The challenge asset owners face when investing with ESG in fixed income is thus of relevance and materiality. That's unique to fixed-income investors.

2. Do you feel there is still a lack of standardization in ESG regulation? Do you feel that Europe and its regulations is going to solve this issue (at least in part)?
The short answer is yes and yes. However, we need to dig a little deeper as there are some caveats and nuances. Many of us in the ESG industry see the wave of European regulations as attempting to "green" the real economy through financial transmission. While admirable, this is indirect and thus inefficient.

Going straight to the real economy, legislating the required green incentives by industry group – such as a carbon tax – and also legislating for common ESG corporate standards would be a far more effective route to achieving structural change. There is a counterpoint, of course, and that is whenever steps are taken in pursuit of ESG standardization – whether that's by investor groups such as the United Nations-supported Principles for Responsible Investment, to which Quintet is a signatory, or by legislators and regulators – we should broadly support them. Any action to move the industry closer to a common understanding and language for ESG is a good thing.

3. What else do you think may slow down ESG adoption in the fixed-income segment?
I think there's a cultural barrier to ESG adoption in fixed income, which isn't often discussed and will take time to break down. Typically, an equity investor proactively seeks out idiosyncratic risk. They are long the proverbial "call option" and thus are looking for the single stories, the trends, and the unique developments that will lead to outsized returns – often via a concentrated portfolio.

James Purcell serves as Group Head of ESG Investment at Quintet Private Bank, which operates in 50 cities spanning Europe – including Zurich, where Purcell is based. He previously served as Global Head of Sustainable and Impact Investing at UBS Wealth Man-agement. In that capacity, he oversaw the bank's investment policy and strategy for ESG integration, exclusion and impact investing solutions. Purcell graduated from the University of Oxford with a BA (honours) in Modern History and earned an MBA (high honours) from the University of Chicago Booth School of Business. He holds the CFA qualification.

In contrast, fixed-income investors typically seek to avoid systematic risk; they are "short puts" with each bond offering limited return with a large downside. A fixed-income investor would never want to be in a position where one or two issuer defaults would destroy their investment performance. So if your mindset is to harvest credit and duration premia, then that's best done through diversification at the macro level rather than micro-level analysis. I think ESG adoption comes more naturally to the equity stock picker because it's more about the single names, and less about aggregate factors such as credit and duration risk.

4. What do you think are the pros of ESG investing in the fixed-income segment?

The big "pro" for ESG investing in fixed income is access to what I would call "Dedicated Assets". With equity investing, ESG is merely a lens, a way of viewing information. Your ESG investor is using the same instrument universe as a conventional investor but is interpreting the data differently – just as how Growth and Value investors make differing decisions based on the same inputs.

When it comes to fixed income, the opportunity set is so much richer: you can create and invest in instruments and sub-asset classes that are constructed with sustainability specifically in mind. Green bonds are an obvious example; by ring-fencing the proceeds of the bond for green purposes, you connect an investor's capital to real-world outcomes and thus attract a whole new investor segment who wants their investments to create a richer life. Microcredit is another; there are clear cause-and-effect linkages between investment and use-of-proceeds. Innovations such as catastrophe bonds, pandemic bonds, and agricultural finance all expose the investor to different risk premia that diversifies their portfolio, and these investments simultaneously help achieve positive real-world outcomes. For investors who want to intentionally make a difference with their capital and be able to measure and verify the outcomes, fixed income makes for a fantastic set of investments.

5. ICMA has now published the first "official" definition of sustainable finance. Do you agree with it or do you think there may be things omitted from that definition?

As I said earlier, whenever a group of ESG investors puts aside their differences to agree on methodology and taxonomy, that's a cause for minor celebration. I believe ICMA's definition of sustainable finance has about a dozen sub-components, which feels a little complex if the aim is to crowd-in capital from non-professional investors.

I think the International Institute of Finance's attempt at something similar late last year was pretty good. They partnered with the world's largest asset manager (Blackrock) and the world's largest wealth manager (UBS) and condensed 80 different sustainable finance terms into just three categories. That's the kind of simplification that will be required to secure extensive adoption and fresh capital from the population at large.
(https://www.iif.com/Press/View/ID/3637/IIF-Proposes-Alignment-Around-Fewer-Simpler-Sustainable-Investment-Terms-to-Enhance-Transparency-and-Bolster-Confidence-in-the-Integrity-of-the-Market)

6. In your opinion, what is the most difficult strategy to adopt in fixed-income ESG investing? Exclusion/inclusion, integration, green bond-only, impact investing, SDG investing and why?

I'll take a counterpoint here, because I think green bond investing has a few (surmountable) hurdles. Let me explain. There are obvious issues around green bond labelling and definitions – though ICMA and now the EU have made solid attempts to clarify that area. However, the biggest challenge, to my mind, is the sector and credit-quality composition of green bonds.

If I'm a conventional fixed-income investor running classic investment-grade benchmarks and I choose to investment in green bonds, then I'm going to be running some significant sector biases that are going to skew my risk. The green bond market has been growing substantially, but it's still very focused on sectors such as financials and utilities – and EUR issuance dwarfs USD issuance. I feel like the green bond market is at a critical juncture: it's now big enough that investors can legitimately run large portfolios within its confines, but not quite of the size and diversification where large mainstream investors can move "all in".

At Quintet, we're nimble enough to take the plunge. We're making a sustainable investing instrument selection the default for our discretionary run portfolios, and green bonds will replace conventional investment-grade exposure. I think that our clients will be rewarded for that – both in terms of performance and experience.

7. In terms of liquidity in the bond market, do you feel green and ESG bonds are now more liquid than conventional / brown bonds?

On balance, no. Green bonds tend to attract a relatively sticky investor base and thus the bonds are tightly held. This makes it fairly easy to liquidate a green bond portfolio, but not so easy to build one – in size – quickly. In a falling market, it can be quite helpful to hold green bonds as their price may temporarily, and favourably, deviate from conventional bonds of the same issuer.

8. Can you make a projection/estimate for the dimension of the ESG fixed-income market in 3–5 years and tell us what do you think will drive this growth?

Given all that we've said, I think three things will happen. First, some of these "Dedicated Assets" – such as green bonds, microcredit and development bank debt – will become commonplace in investor portfolios. It surprises me how few investors – particularly private clients – are familiar with the AAA credit-rated bonds of the development banks, such as the World Bank and Asian Development Bank. For us at Quintet, they are fantastic portfolio substitutes for AAA credit-rated government debt.

Second, I'd like to think the fixed-income market will be used to solve real-world problems – and at scale. Tools such securitization have great potential to unlock capital because they can match investors to projects and tranches with the appropriate level of risk appetite and impact. Take the classic blended finance example, where there is a charity that can afford to build half of a sanitation plant and would like to preserve their financial capital. Then there is the investor who has the other half of the capital but requires a higher investment return than a sanitation plant typically provides. The two groups, by themselves, will not build any sanitation plants. But, together, and with some senior and junior tranches, the plant gets built and both can reach their financial and sustainable objectives. So I'm keen to see more of that kind of fixed-income-led innovation.

Third, I do think we'll see more ESG integration in mainstream liquid fixed-income funds, despite the challenges of data quality and materiality. As I said earlier, this will accelerate rapidly if we can align corporate disclosure through SASB guidelines.

With all these projections I'm almost certain that the critical driver will be private wealth. As individuals increasingly seek to express their values and lifestyle choices through their investments, it will create irresistible pressure on corporates and investors to release the data and offer the investment solutions private clients require. That will spread through wealth managers, asset managers, and pension funds.

At Quintet, we're committed to being at the forefront of that change, and helping our clients create a richer life, however they define it.

For more information please go to www.eurexchange.com or contact:

Eurex | Equity and Index Derivatives
Sales
Matthew Riley **T** +44-20-78 62-72 13
matthew.riley@eurexchange.com

11 Westferry Circus, 3nd Floor, Canary Wharf
London, E14 4HE