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The world of bonds is put to the test by the challenge of ESG issues

For Banor Capital, sustainability analysis offers a set of essential techniques to address future risks which, in many cases, are linked with climate change

by Francesco Castelli*

Banor Capital Ltd is an independent asset management company that is authorized by the Financial Conduct Authority. Banor Capital was set up in London in 2011 on the initiative of a group of professionals who had worked together as a team since 2001. Banor Capital, which is part of the group that was formed together with twinned companies Banor SIM and Banor SICAV, is offering its services as a reference partner for private and institutional customers to manage, through Banor SICAV and Aristea SICAV, a range of high value added products that represent various investment strategies, markets and asset classes.
Assets Under Influence of the Banor group are above 8 billion EUR, of which 3.5 billion EUR in discretionary asset management.
Banor Capital is integrating issues related to responsible investments in an increasingly detailed and specific manner and it is one of the signatories of the PRI (the Principles for Responsible Investment supported by the United Nations) with the aim of contributing to the generation of a widespread culture of sustainability of investments.

Our experience with sustainable portfolios has a history spanning more than ten years. We started when an institutional customer, specifically a religious institution, asked us to apply ethical criteria to its investment portfolio. We set to work on its expectations, making it clear to the customer that constraints of an ethical/religious nature could reduce the expected return. That first experience had some unexpected developments; for example, we discovered that our customer's return on investment did not fare at all badly. The constraints that the customer imposed naturally reduced the volatility of the portfolio and, in the medium term, led to results that were in line with, or above those of portfolios that were managed in a traditional manner. Comforted by the results, we started to develop an organic research methodology that we can now apply to all client portfolios, not only to those with ethical requirements. This is a fundamental and non-trivial step. In a capitalist economy, does it make sense to offer customers specific moral values that are not directly based on maximising profit? Our answer, with data to support it, is affirmative and it is determined by way of the concept of materiality. When we request that our investments should be sustainable, we do so because we believe that, in the medium term, this approach guarantees higher returns and lower risks for our customers. Our first experience also prompted us to apply the same methodology on bond portfolios: a less obvious choice, which has only become established in recent times. Indeed, the sustainable finance phenomenon originated and grew in the stock market. Enlightened investors (often institutional investors, motivated not only by economic objectives but also by ethical ones) have brought their demands to bear on boards of directors of large companies, requesting improvements in the management of companies in relation to various aspects that are today grouped under the ESG (environmental, social, governance) banner.
Managing environmental risks proactively, reflecting on the social effects of the company's economic activity and maintaining good governance of the company are priorities for a good manager. They may perhaps increase costs in the short term but they guarantee company solidity in the long term.
Harvard University identified this approach with the term "materiality". The values that we ask companies to respect are values that good sense suggests, but they are also principles that generate higher economic returns in the medium term. To what extent can these principles be useful in the analysis of bonds? Do we really believe that ethically based qualitative considerations can be useful in credit analysis? Here again, our answer is affirmative and it is supported by a significant amount of quantitative research. As a bond asset manager, I even think that these principles can be more important for bond management than they are in the management of equity. Whoever buys a company bond, is in general more motivated by a buy and hold approach compared with whoever buys shares, if for no other reason because market liquidity is significantly lower. Granting credit to a company is often a long-term choice and it is only natural to prefer doing so with well-managed companies, giving due consideration to environmental risks and social impact. So much so that as bondholders we are interested in the return of the capital: a company that decides to take a short cut on environmental risks, for example, may derive some short term benefit (with an improvement of its profit).

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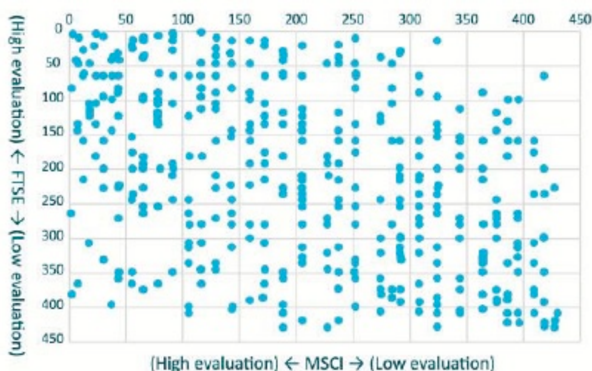
COMPARISON BETWEEN ESG RATINGS OFFERED BY TWO AGENCIES ON CLSA AND GPIF



Source: CLSA, GPIF. graph 1

Such improvement would remunerate shareholders, but not bondholders (whose return is fixed by the annual coupon flow). On the other hand, bad management exposes even bondholders to heavy risks (on the environmental front, just think of BP's disastrous oil spill in the Gulf of Mexico. On the social front, we recall the law suits which were a bankruptcy risk for the multinational tobacco companies). That is the reason why, as a bondholder I feel even more justified to insist on ESG criteria. In the field of bonds, as in the case of stocks, a shared standard still does not exist: this generates much confusion in the final investor but it gives active asset managers the opportunity to make a difference. Let us consider a relatively famous example: CLSA (a broker) and GPIF (in institutional investor) compared the ESG ratings offered by two different agencies. As can be seen in graph 1, the opinions of the two are not correlated. Agencies with an excellent rating (in one case) end up among the bottom of the class in the other case. This is a very different situation compared to credit ratings (where correlation is very high). This confusion must not discourage investors. It is true that today there is still no shared paradigm. But it is also true that ratings as such are not a magic recipe. Let us consider credit ratings: it has been demonstrated that buying upgrades and selling downgrades typically generates underperformance. And in the medium term it is likely that we will discover similar dynamics for ESG ratings. Ratings (ESG or credit) fulfil a certification role: the role of an active asset manager on the other hand is to anticipate the dynamics that lead to a certain rating. Active management cannot be based purely on a label but must analyse the underlying factors: the trick is to select the most relevant (most material) factors and extract the best investment signals. But the relevance of a factor changes radically from sector to sector. For an industrial company, CO_2 emissions or the consumption of energy are relevant factors in determining an ESG profile. But they are negligible or totally irrelevant in the case of a bank or an insurance company. In that case we will be more interested in finding out the indirect impact (for example, the industries to whom the bank offers financing). Water consumption is among the main environmental impact factors for the food, chemical and paper industries. But even in this case there are distinctions to be made. A few months ago, during an investors meeting, I witnessed an amusing exchange where an analyst complained to a listed company about its excessive consumption of water. The managing director of this well-known producer of spirits reminded him that reducing the amount of water used would improve the impact on the environment but it would raise the alcoholic content of its products thereby damaging its customers. In conclusion, sustainability analysis (or ESG analysis as I prefer to call it) imposes on us investors and analysts a considerable work load: we are required to analyse variables and dimensions that were once overlooked. We are now forced to look at longer investment time horizons and go into the merits of qualitative and not just quantitative considerations. But this analysis also offers a set of essential innovative techniques to face future risks which, in many cases, are linked with climate change.

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