# ESG risks, sustainable opportunities and bondholder engagement

In mid-June, Tell Media Group, in cooperation with **Barings**, **Payden & Rygel** and **PGIM Fixed Income**, organised a roundtable discussion at Nobis Hotel in Stockholm, focusing on sustainability in fixed income. Tell Media Group founder Niklas Tell and Nordic Fund Selection Journal editor Caroline Liinanki moderated the discussion.

By: Niklas Tell Photo: Christer Salling


The discussion started out with Caroline Liinanki asking the investors how they approach sustainability in the fixed income portfolio, both from an ESG integration perspective as well as from a more sustainable opportunity perspective.

**TORBJÖRN KRONBLAD:** "To address sustainability risk in fixed income, we work with two different portfolios. We have one SSA portfolio (supranational, sub-sovereigns and agency bonds) that invests into sustainability and one credit portfolio where sustainability is integrated into the investments process. In the SSA portfolio, we have narrow benchmarks, which reduces ESG risks. Here, we also invest opportunistically in green and social bonds. In the credit portfolio, we can go underweight and divest from sectors with significant ESG risks."

**FREDRIK TYCHE:** "We primarily invest in funds with only a few direct holdings. When we do research on investments, we have the same approach across asset classes so our ESG assessment would be the same for a fixed income and an equity fund. We do an ESG assessment on the firm where there are a number of boxes that needs to be ticked and then we of course also look at the product. It could be that the product fits but that the manager fails our assessment. We need to tick both boxes in order to invest."

**LINDA SUNDBERG:** "We have a similar structure to Nordea in this regard. However, at least historically, we've had a stricter policy than most other investors and that's why we have two funds specifically made for us when it comes to fixed income where we're the only investor. We're a small team and that solution has made it easier for us."

**NIKLAS TELL: IS THIS SET-UP SOMETHING YOU HAVE DISCUSSED CHANGING?**

**LINDA SUNDBERG:** "There has been discussions to do more impact investments and to focus more on being part of the transition, also when it comes to fixed income. Then we might need to look at other things as well."

**NIKLAS TELL: WHEN YOU LISTEN TO THE INVESTORS HERE, IS THIS SIMILAR TO WHAT YOUR HEAR FROM OTHER INVESTORS YOU INTERACT WITH?**

**LAURA LAKE:** "I think what's clear is that investors generally have both similar and different takes on ESG and sustainability – not only here in the Nordics, but across our global client base. The way we approach ESG and sustainability in fixed income is to focus on time horizon. In the short term, we look at the ESG factors and risks that could impact credit spreads in the next 12 months. However, many of the ESG factors that our clients care about are unlikely to impact credit spreads in such a short time-period, which is why we have developed frameworks and tools in order to include these client-directed factors in portfolios as well. In this regard, we're well positioned as the majority of our assets are in customised client mandates where we can create solutions for clients that have similar but different views on these issues."

**JOHN PLOEG:** "We have a similar setup in a way as we see ESG integration and sustainability as two different things. When it comes to ESG integration, we think it's important to include the factors that are material, similar to what Laura was saying. Also, we don't separate between ESG and other risks because we think that can become a bit arbitrary. You could have a company with higher ESG risks but where the balance sheet is very strong, and another with lower ESG risks but with a shakier balance sheet. We think you must ultimately come up with one overall credit risk view of issuer that includes ESG and non-ESG factors. On top of that, we've developed tools and frameworks in order to look at longer term sustainability factors that are more important to some clients."

**GARETH HALL:** "Our approach is somewhat similar to what we have already heard. We score all issuers based on ESG factors. These ESG scores are then integrated into our overall fundamental credit risk scores through upgrade or downgrade adjustments. Views on how to approach topics such as exclusions and climate transition will differ across mandates. Having a systematic process in place enables us to construct appropriate portfolios for different clients."

**FREDRIK TYCHE:** "Would you say that you view ESG from a risk/reward point of view in that you're willing to invest if you're rewarded for the risk you are taking? I think in the Nordics, ESG risks are simply risks that we're not willing to take."

**GARETH HALL:** "I think it's a two-stage process. There are initial red line decisions on what should not be approved for investment by investment committees. That could be specific sectors that you're not willing to support due to elevated ESG risk or it could be specific governance issues that you're not willing to take on. When that screening is done, you then consider relative value and ensure that you're being compensated in total return for the risks you do take, be that ESG risks or credit risks."

**JOHN PLOEG:** "Normally when we talk about managing risks, it's not about excluding the risks because then all portfolios would be full of AAA bonds. It's about understanding those risks and making sure we're paid enough to take them. That said, it can be a little different when it comes to ESG risks because sometimes it's not only about investment risk, but more about reputational risk for investors."

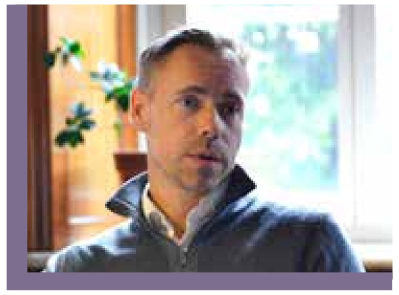
**LAURA LAKE:** "We're a US domiciled manager with a global client base. There are a lot of different views on ESG between our clients in certain US states and clients in Europe. For example, we have some clients in Europe that have reduced their investable universe by some 50 per cent because of their view on ESG. For these clients, we've created customised benchmarks to ensure that their financial and ESG goals are in-line and to ensure that their tracking error is in line with their investable universe. Customisation and structuring solutions for clients are key in this environment."

**LINDA SUNDBERG:** "Can I just ask, what's a no-go from an ESG perspective for your clients in certain US states?"

**LAURA LAKE:** "I think it all comes down to how you define your role as a fiduciary. For some clients, it's purely about

### PARTICIPANTS

- **TORBJÖRN KRONBLAD**
  *Co-head of fixed income & FX at AP4*
- **LINDA SUNDBERG**
  *Head of sustainable investing at Svenska Kyrkan*
- **FREDRIK TYCHE**
  *Portfolio manager/sustainability strategist at Nordea Life & Pensions*
- **LAURA LAKE**
  *Head of ESG at Payden & Rygel*
- **JOHN PLOEG**
  *Co-head of ESG research at PGIM Fixed Income*
- **GARETH HALL**
  *Managing director, global high yield at Barings*



TORBJÖRN KRONBLAD
Co-head of fixed income & FX at AP4. Prior to joining AP4 as a senior portfolio manager in 2012, he worked for more than five years as a senior portfolio manager at Nordea Investment Management in Copenhagen. He has previously also worked at EON Energihandel and as a trading analyst at Moore Capital Management in London.

LINDA SUNDBERG
Head of sustainable investing at Svenska Kyrkan. Before joining Svenska Kyrkan, she spent some eight years as an investment director at the Swedish Ministry of Enterprise. She has previously also worked as a financial supervisor at Finansinspektionen, a senior analyst at Ernst & Young and at SEB Merchant Banking.

maximising returns and not including the consideration of non-financial factors into the management of portfolio's that are unlikely to impact spreads in the near term. For others, being a fiduciary means not only focusing on delivering a return to stakeholders but also delivering for people and the planet, while having a positive impact through the investments. This is why we have structured our operations to be able to deliver customised solutions."

**GARETH HALL:** "I agree on the importance of being able to customise solutions. For example, we have a client that has an exclusion policy on tobacco and not only manufacturing but also on any retail or services related to the tobacco industry. In order to fulfil that mandate, you really need to have the systems and processes in place in order to screen investments. You also need to understand how potential exclusions will impact the overall portfolio in terms of investable universe from a risk and potential return point of view."

CAROLINE LIINANKI: TORBJÖRN, AS AN AP FUND YOU HAVE A MANDATE TO CONSIDER SUSTAINABILITY WITHOUT COMPROMISING ON RETURNS. HOW DO YOU DO THAT WITHIN FIXED INCOME?

**TORBJÖRN KRONBLAD:** "Yes, we have the AP fund law with a clear statement to incorporate ESG factors in our investment process. In the credit portfolio, we do underweight certain sectors and we also divest from certain sectors based on ESG risks. But we also take on the ESG risk in sectors that we think are well positioned for the transition. Also, our portfolio managers assess the ESG risks of each issuer that we buy into and hold over time."

NIKLAS TELL: WHAT WOULD YOU SAY ARE SOME OF THE SPECIFIC CHALLENGES WHEN IT COMES TO FIXED INCOME AND SUSTAINABILITY?

**LAURA LAKE:** "One example would be residential mortgages, which are an important component in the US bond market. The data shows that there are higher emissions from the parts of the country that are less well off from a socio-economic point of view. Now, if clients want to de-carbonise their mortgage portfolio, we have the tools to do that, but this may increase the borrowing costs for the parts of the country that are less economically advantaged. So, there's potentially a greater trade-off between the 'E' and the 'S' when it comes to implementation in the fixed income universe compared to equities."

**JOHN PLOEG:** "There's just a greater variety in terms of what you can invest in when it comes to fixed income compared to equities. And, I do agree with you Laura on the home owners. They can't control who's supplying electricity to their grid, so why should we penalise them. Also, it seems that there's this push to make everything fit the equity model in terms of ESG. That we should be able to show one number for carbon emissions, for example. I think we need different tools when it comes to fixed income because it's simply different."

NIKLAS TELL: I GUESS IT'S A CHALLENGE FOR YOU AS INVESTORS AS WELL BECAUSE I ASSUME YOU WANT TO OR ARE REQUIRED TO REPORT ON YOUR COMPLETE PORTFOLIO?

**FREDRIK TYCHE:** "We have committed to net zero by 2050 but we also want to finance the transition. By investing in more carbon intense companies that we think are in a good position to transition, that will penalise us on the net zero at least short term. Sometimes it's difficult to balance this, especially in fixed income."

CAROLINE LIINANKI: HOW SHOULD YOU APPROACH NET ZERO IN FIXED INCOME?

> "Just the fact that we're reaching out and are able to explain what ESG factors investors care about helps advance a sustainable dialogue"
>
> *– Laura Lake, Payden & Rygel*

**JOHN PLOEG:** "Before answering that I just want to say something about net zero goals. Aligning your portfolio with a net zero target assumes that the world will absolutely reach the 1.5 degrees target but all evidence suggest that we are not reaching that. Even 2 degrees is starting to look unlikely, even if all countries keep their pledges. This isn't my opinion, it's what all the experts are saying, whether it's the UN, the IEA, academics, or various NGOs. What we're moving towards is a very different world from a 1.5 degrees world and that has important ramifications for what is commercially viable for companies. Coming back to your question, I think it's important to not only look at one number when it comes to carbon emissions because then we end up with the problem that Fredrik was mentioning. We will need energy intensive companies in order for the transition to happen and if you're managing your portfolio to a portfolio-level carbon footprint, you will be incentivised to sell out of companies that can contribute most to real world decarbonisation – like steel companies – and buy into those whose contributions will be limited – like many software companies. Instead of only looking at a carbon footprint number, I would prefer a ratings approach where you look at the quality and credibility of the targets that different issuers set and then bucket them into different alignment categories. Then you can do the same across all different asset classes but you would do it with a methodology appropriate for each asset class."

**GARETH HALL:** "We have a current state ESG scoring methodology applying one to five scores but importantly we also have a momentum score where we are assessing an issuer's outlook compared to the market. That helps us to understand which companies are trending better when it comes to transition. We have an ESG quantitative analytics team that are doing a lot of carbon attribution work and can provide forecasts for portfolio decarbonisation. Having these tools in-house is beneficial but we must acknowledge that data availability can be patchy in fixed income."

**LAURA LAKE:** "We agree that data availability is absolutely a challenge. Given this, one of the things we've focused on is engagement with issuers. Engagement is important, even if we're not able to vote proxies as a bondholder. Just the fact that we're reaching out and are able to explain what ESG factors investors care about helps advance a sustainable dialogue. Many of the European companies that we invest in have corporate sustainability reports, they have great answers to our ESG questions and they want to be part of the dialogue. When we talk to companies in the US, some express concern as to why we're reaching out. Sometimes even their legal teams are involved. We need

**FREDRIK TYCHE**
Portfolio manager/sustainability strategist at Nordea Life & Pensions. Before joining Nordea Life & Pensions in 2023, he spent about seven years as a fixed income product manager at Nordea Asset Management. He has also worked as a private banker at Nordea and a financial advisor at Swedbank.

**LAURA LAKE**
Head of ESG at Payden & Rygel where she is responsible for sustainable investing across the organisation. Prior to that, she was chief investment officer of Breckinridge Capital Advisors and before that, a senior portfolio manager at Mellon (Standish) responsible for managing multi-sector portfolios for insurance companies.

> "One concern here is that liquidity can sometimes be an issue and they are also issued less frequently compared to other bonds"
>
> *– Torbjörn Kronblad, AP4*

to explain that we want to have a dialogue and we want to partner with them in their transition, share what we're hearing from others on best practices to help move the transition forward."

NIKLAS TELL: HOW DO YOU VIEW ENGAGEMENT ON THE FIXED INCOME SIDE AT AP4?

**TORBJÖRN KRONBLAD:** "Data is improving all the time but it still lags the data for listed equities. We currently have a data coverage of some 80 per cent and that can be compared with some 35 per cent a couple of years ago. I would say that engagement on the fixed income side is still developing."

CAROLINE LIINANKI: WHAT IMPACT CAN YOU HAVE AS A FIXED INCOME INVESTOR?

**LINDA SUNDBERG:** "Recently we've had a lot of discussions with our managers on divestments of challenging areas of the business because that's not something that we're positive on. Divestments is typically seen as an easy solution but the problem is that it's probably sold to someone with less strict views on sustainability. We understand that our fixed income managers can't have the same level of engagement as our equity managers but we have discussions with our managers to explain what we actually want to invest in when it comes to fixed income because we want to be part of the transition."

**GARETH HALL:** "The perception that a fixed income manager can't engage is a myth. If you are a large debtholder, you may have better access to management than a small equity holder. We generally find that we can get access to senior management or dedicated sustainability professionals at companies to discuss engagement topics."

**JOHN PLOEG:** "As an active manager, engagement is absolutely a core part of our process. It's true that we're not allowed to vote at the AGMs, but companies very much want to hear what their bond holders care about because if bond holders are unhappy, their cost of capital will increase. I think how you approach engagement is very important. It's about being constructive and thoughtful to keep a dialogue going. It shouldn't be cookie cutter where you ask for the same, high-level thing to every company without linking it to their business and circumstances."

**LINDA SUNDBERG:** "However, engagement also takes time. How do you decide which companies you want to engage with?"

**JOHN PLOEG:** "If you know that the issuer is not going to be interested in discussing the concerns you have, it's not the best use of your resources. In that case, it may be better to just not continue to hold that issuer. It's also not worth spending too much time with the companies that are already good, so we tend to focus on the middle part – finding the companies that are receptive to change and where we have genuine concerns and insights to share."





**LAURA LAKE:** "I agree. I think prioritisation of issuers is really important and building those long-term relationships. If there's a big headline event that affects a specific industry, it can open a dialog as companies are usually more willing to engage. It might not be the most important topic for us at that point in time, but it gives us access and an opportunity to build a relationship with the issuer. We have a lot of clients that care about very specific ESG factors and want us to engage and report on specific topics, so we need to build those in-depth relationships with issuers."

NIKLAS TELL: HOW DO YOU VIEW SUSTAINABILITY LINKED BONDS – SO GREEN OR SOCIAL BONDS – VERSUS WORKING MORE BROADLY WITH SUSTAINABILITY IN YOUR FIXED INCOME PORTFOLIO?

**TORBJÖRN KRONBLAD:** "As a starting point, we have a fairly concentrated benchmark for our credit portfolio so our ESG risk small to begin with. We, of course, also screen for violations against international conventions such as human rights and we also avoid controversial weapons. On top of that, the individual portfolio manager have a thoughtful process where we select sectors that we think will do well in a transition environment. When it comes to green and social bonds, that's something we look at for the SSA portfolio. One concern here is that liquidity can sometimes be an issue and they are also issued less frequently compared to other bonds."

**GARETH HALL:** "I think there's a fascinating debate when it comes to the topic whether it is most beneficial to hold a green bond or a vanilla bond from same issuer. Ultimately, as a fixed income investor, you're usually faced with the same credit risk and the overall sustainability risks would also be similar because it's the same company issuing the bonds. I think it's important to think about risks from at the company level and not only look at the individual issue label."

CAROLINE LIINANKI: SO WHAT ARE THE BENEFITS OF INVESTING IN A GREEN BOND?

**FREDRIK TYCHE:** "I think the fact that you can target a specific project with a green bond is positive. As mentioned before, we invest mostly via funds and what we've done is telling our managers that we would like them to invest a certain amount into green bonds. It's not a fixed target, however."

**JOHN PLOEG:** "I think there are some challenges with green bonds because even if you invest in a green bond, you're still economically very tied to brown assets. One example would be if the brown assets outperform and the company is upgraded. Then, even if I'm only invested in the green bonds, I would also still benefit. And if the company defaults, my collateral would be brown assets as well as green, so I wouldn't really want to see them lose value. Aside from the fact that it has a green label on it, a green bond is essentially the same as a vanilla bond because it's the same underlying credit risk. The main benefit of a green bond, as it's essentially a marketing activity, is that it creates more of a reputational risk for the company if they don't deliver on the plans. However, a company needs to have a good transition plan to begin with for that to be a meaningful benefit. Issuing a green bond is not enough."

NIKLAS TELL: WHAT WOULD YOU SAY ARE SOME OF THE MAIN CHALLENGES WHEN IT COMES TO CONSIDERING SUSTAINABILITY WITHIN FIXED INCOME?

**TORBJÖRN KRONBLAD:** "For me, it's a mix of several things


**JOHN PLOEG**
Co-head of ESG research at PGIM Fixed Income. His team is responsible for the frameworks and research used for strategic integration of ESG research across all elements of the firm, including investment decision-making, and internal and external education and engagement. He also serves as a member of the ESG Policy and ESG Ratings Sub-Committees.

**GARETH HALL**
Member of Barings' global high yield investments group and is responsible for the portfolio management of various European, global and ESG-focused strategies. Additionally, he is also leading the development of ESG investment capabilities for the global high yield team.

> "If we had clear standards, that should also help reduce reputational risks because then everyone would understand and agree what sustainability means"
>
> *– Fredrik Tyche, Nordea Life & Pensions*

that create challenges. If we return to green bonds, one challenge is that the demand is higher than the supply. That means that when you have a maturing bond, it can be challenging to find the next issue as they're less frequent than vanilla bonds. If you have a dedicated pool of assets that needs to be invested in green bonds, that can be a challenge. Also, as we've already touched on, data is a challenge even if it's improving."

**LAURA LAKE:** "One of the big challenges we face is the fact that ESG means something different to everybody. As a firm, we've defined how we view ESG investing through our Article 8 funds. However, when we talk to clients, they have a lot of different definitions for what ESG and impact means to them. We have views and definitions regarding impact as an asset manager, but nonetheless each client will sit within a specific regulatory environment and within a cultural environment that informs their own definitions which may be different from ours. We respect that and are able to deliver solutions that meet their needs. The challenge is that bespoke views on impact are more difficult to scale as an asset manager."

**FREDRIK TYCHE:** "One challenge is when you don't have customised benchmarks and you exclude certain sectors. If you've excluded, for example, the energy sector and that sector performed really well, it can be difficult to explain to clients."

**GARETH HALL:** "This is something we spend time talking about with clients. If you use a wider benchmark, you need to be aware of tracking error."

**JOHN PLOEG:** "I think we also need to acknowledge that sustainability is a very complex area and even if the investment community can do a lot, I don't think we can solve all the issues without clear policies from elected officials. Many of these questions don't have a clear answer, and often the choices involve trade-offs. For instance, should we limit how much people fly to cut aviation emissions? These trickier questions should be answered by elected leaders, not private investors."

**CAROLINE LIINANKI: LOOKING AHEAD, WHAT WOULD YOU SAY ARE SOME OF YOUR HOPES AND FEARS IN THIS AREA?**

**GARETH HALL:** "There's a lot to be debated on the topic of regulation but I do hope and believe it should provide improved ESG data to the markets over time."

**LAURA LAKE:** "I think SFDR regulation has been a positive in some ways but it hasn't provided the industry with clear sustainability definitions. The other challenge is that regulation is not harmonised across regions. In Europe, we have a lot of regulation but not much teeth to the regulation. In the US, it's the other way around. A hope going forward would be greater consistency."

**FREDRIK TYCHE:** "I agree. We absolutely need more standardisation in this area. Also, if we had clear standards, that should also help reduce reputational risks because then everyone would understand and agree what sustainability means."