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Sustainability in Fixed Income

Key Developments and Investment Considerations

Authors

Pilar Gomez-Bravo, CFA
Director of Fixed Income - Europe

Mahesh Jayakumar, CFA, FRM
Fixed Income Research Analyst

In brief

- Material developments signify the growing importance of sustainability and environmental, social and governance (ESG) factors for fixed income investors. These developments include significant interest in climate change and thematic bonds and an increased focus on regulation, data and investor engagement.
- Green bond issuance has seen very strong growth, especially sustainability-linked bonds and social bonds given the pandemic.
- Our approach integrates sustainability into the various facets of the investment process, including fundamental research and the required data, along with prudent risk management and issuer engagement.

Sustainability and environmental, social and governance (ESG) factors are increasingly center stage for fixed income investors. Much is postulated and debated in this arena as investment frameworks can vary significantly due to fast evolving standards, data transparency and regulation. In our view, the art here lies in distinguishing the practice of greenwashing — window dressing — from authentic viable approaches to sustainability

Below we discuss current developments and key investment considerations when implementing ESG factors in the fixed income research process. The important developments include the explosion of interest in climate change and thematic bonds such as green bonds, as well as a greater focus on regulation, data and investor engagement (see Exhibit 1).

Policymakers continue to be extremely active in developing mandatory ESG, sustainability and climate-related disclosures at both the issuer and investor level. While this has been the case in Europe for some time and Europeans continue to be at the forefront of these discussions, we are increasingly seeing the same policy pressures in Asia and in the United States, particularly with the current administration. Investors are entering the fray more readily as the topic gains importance in the investment context from the vantage point of both risks and opportunities.

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Exhibit 1: Key Developments

Climate action

Climate change is undoubtedly a major challenge for the world. For both companies and countries, there is urgent focus on reducing emissions, while discussions continue apace on carbon pricing, carbon offsets and the timeframe for achieving net-zero targets. Many companies are responding by not only disclosing their emissions but also setting reduction targets. While central banks are discussing climate risks, regulators are requesting more reporting and investors are signaling a greater commitment to climate action.

The landmark 2015 Paris Agreement set the stage for global action to reduce emissions to ensure the temperature rise remains below the two-degree-centigrade threshold. The Paris Agreement constituted a bottom-up approach with countries deciding individually on emission reduction targets and timelines. These were communicated in the form of National Determined Contributions (NDCs). Six years later, the COP26 summit in Glasgow is the most important climate talks since the Paris Agreement. Amid a greater sense of urgency, countries have adopted a ratcheted-up approach, submitting revised and new NDCs to meet carbon reduction targets.

The imperative to address climate change is expected to become increasingly important for investors as the risks of rising temperatures emerge in very tangible forms and the opportunities inherent in the switch to renewables and other forms of carbon reduction comes into sharper focus.

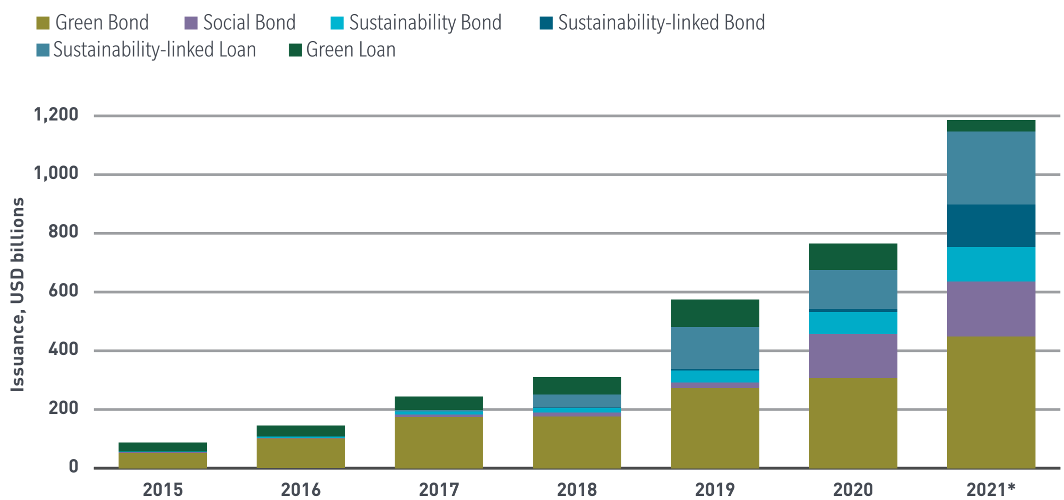
Thematic bonds

In fixed income, thematic bonds continue to play an important role in the implementation of ESG factors in investment portfolio decisions. Green bond issuance has seen robust growth, with more interest in sustainability-linked and social bonds due to the pandemic. In our view, various types of thematic bonds can be considered for inclusion in portfolios provided the fundamental credit characteristics of the issuer and the use of proceeds are well understood (see Exhibit 2).

Last year was already a banner year for the bonds, with close to US$550 billion in bond issuance across the four thematic categories. By the third quarter of 2021, this amount was exceeded; issuance now stands at close to US$850 billion. Green bonds alone account for more than half of the value of bonds issued in 2021 (US$450 billion) while social bonds account for close to US$190 billion and sustainability-linked bond issuance accounts for more than US$70 billion. [Note that the chart below includes both bond issuance and green loans.]

Sustainability-linked bond issuance has grown 500% in the past year. The typical issuers for these types of instruments are companies in carbon-intensive sectors, such as energy, materials and utilities, that use this funding for decarbonization projects and to incentivize investors by providing a step-up in bond coupons if they fail to meet the environmental KPIs established at the time the bonds are issued.[1]

Exhibit 2: Green and Other Thematic Bonds



Framework	Outlook
▪ Three main rules for issues; eligibility of projects; selection process of qualified projects; and ring-fencing of proceeds	▪ Broader focus on sustainability leading to increase in issuance as well as diversification in types of issuers
▪ Second party opinion confirms issuer framework and Green Bond Principles compliance	▪ Continued convergence of standards for issuance
▪ Optional green rating that considers the environmental aspects of the investments	▪ Increasing focus on understanding impact as part of improved reporting
▪ Post issuance reporting confirms funds were allocated to the appropriate projects	▪ Evolving regulatory framework and increasing government support for issuance
▪ Disclosure of impacts from ongoing projects	▪ Growth in dedicated investor and themed investment products

Source: Bloomberg and Bank of America, as of 30 September 2021. *Issuance for 2021 reflects 9 months as of 30 September 2021. Green bonds are specifically earmarked to raise money for climate and environmental projects. Social bonds are dedicated to fund social projects and/or activities that have a positive impact on individuals, communities or society. Sustainability bonds are bonds where the proceeds will be exclusively applied to finance or re-finance a combination of both Green and Social Projects. SDGs refers to the UN Sustainable Development Goals. Please keep in mind that a sustainable investing approach does not guarantee positive results and all investments, including those that integrate ESG considerations into the investment process, carry a certain amount of risk including the possible loss of the principal amount invested.

Regulation

Regulators in various regions are developing mandatory ESG and climate-related disclosure requirements, while encouraging the creation of green/sustainable taxonomies. Green and sustainability-linked bond issuance has the support of regulatory authorities and central banks that are also part of the dialogue in a fast-evolving environment.

The most significant new regulation is the European Union's SFDR (Sustainable Finance Disclosure Regulation) that calls for classifying funds based on their sustainability criteria. An Article Eight classification is assigned to funds that integrate ESG factors; Article Nine funds are those that target impact. The United Kingdom is examining mandatory reporting based on the Task Force for Climate Disclosures (TCFD) by 2025. In the United States, the Securities and Exchange Commission (SEC) and the Department of Labor are actively pursuing numerous ESG-related initiatives. In Asia, both Singapore and Hong Kong have proposed guidelines on climate and environmental risk management.[2]

Data

The proliferation of ESG data and rating providers, coupled with increasing voluntary company disclosure, provides investors with greater visibility into ESG risks and opportunities. This nonfinancial data is an important complement to credit ratings and the financial profile.

More providers of ESG ratings and their accompanying data are available than ever. The large incumbents, index providers and rating agencies continue to acquire smaller players while an increasing number of think tanks, nongovernmental organizations and investor consortiums focus on specialized data disclosure on a particular theme or topic, obtaining the data either directly from the issuer, through questionnaires or through publicly available sources.

ESG data sources vary in terms of coverage and quality. ESG data is more readily available for the corporate bond market than it is for other parts of the asset class. Corporate bond issuers are disclosing more ESG information, and an increasing number of ESG third party vendors are aggregating this data to create summary ESG scores.

Sovereign bond issuers have increased their disclosure related to green and thematic bond frameworks to enable investors to understand how proceeds from this issuance will be used for sustainable development and other projects. ESG sovereign data can also be obtained from other sources, such as think tanks and large multilateral organizations like the IMF, the World Bank and the OECD, but unfortunately disclosure is not as ample in other parts of the fixed income marketplace such as in securitized or municipal bonds.

Bond investors need to take time horizon as well as materiality into account when understanding the risks associated with ESG factors. ESG factors are typically long-term in nature and can have a limited impact on shorter-maturity bond instruments despite them being material to the sector, industry or issuer.

Engagement

Issuer engagement has taken on more importance because of investors' desire for more dialogue around ESG to better understand the sustainability profiles of issuers. Fixed income creditors are not owners of shares and thus don't have voting rights. However, fixed-income investors can engage in both formal and informal dialogue with issuers on ESG factors despite not being shareholders and have an important role to play in encouraging a sustainable agenda as key providers of financing.

Engagement can be undertaken collectively in addition to on a one-on-one basis. At MFS, we participate in various collective forums, such as the CA-100 Plus. We also engage in one-on-one dialogue with issuers.

The imperative to address climate change is expected to become increasingly important for investors as the risks of rising temperatures emerge in very tangible forms and the opportunities inherent in the switch to renewables and other forms of carbon reduction comes into sharper focus.

Investment considerations

At MFS, sustainability is at the heart of our long-term active investment approach and our purpose of allocating investment capital responsibly. Our robust framework of integrating sustainability into various facets of the investment process encompasses fundamental research and the data required along with prudent risk management and issuer engagement. We have a set of working groups and committees that guide the formulation and implementation of ESG factors across the firm's investment platform. Three key guideposts are considered in this regard: integration, data and risk management.

The most critical element is the *integration* of sustainability/ESG factors into the bottoms-up fundamental analysis that characterizes our investment approach. Research is the engine of portfolio construction; we populate portfolios with the analysts' best ideas. Each analyst, both in fixed income and in equities, is responsible for incorporating the consideration of ESG factors into his or her recommendations, working closely with the portfolio managers and with other dedicated ESG resources that focus on thematic analysis and materiality. At the end of the day, each sector analyst is charged with integrating ESG factors along with all other investment considerations. This is not a responsibility delegated to a separate team. The analyst engages directly with the issuer and those who define the strategic direction of the company to advance important sustainability agendas.

Second, *data* continues to remain a significant point of discussion. It is important at MFS that all investors have equal access to the relevant ESG data to make informed decisions. This continues to evolve as more disclosures and new standards emerge. While we use third-party ESG ratings in our analysis as we do with credit ratings, we do not rely solely on these to define or constrain our exposures.

Finally, *risk management* and risk analyses are critical. We look at ESG as a risk but also as an opportunity. We analyze ESG risk from the perspective of the overall portfolio and the portfolio construction process, as well as regarding individual securities. This enables us to assess the material risks associated with the portfolio — and make decisions about issuers that may be more at risk.

The most critical element is the integration of sustainability/ESG factors into the bottoms-up fundamental analysis that characterizes our investment approach.

Conclusion

Several key developments point to the growing importance of sustainability and ESG for fixed income investors. We are strong proponents of integrating these considerations into the investment process, a process supported by the relevant data and prudent risk management.

While climate change and ESG more broadly undoubtedly pose risks for many issuers, they also present opportunities as the world shifts to producing and consuming goods and services in a more sustainable way. We believe this theme will be a part of the investment landscape for decades to come.

Endnotes

[1] KPI = key performance indicators.

[2] Article 6: Integrates sustainability risks into the investment process. Article 8: Systematically promotes a stated environmental or social characteristic and provides enhanced disclosure accordingly. Article 9: Typically for "impact" funds, which have a dual objective of financial return and specific environmental or social outcomes.