The Value of ESG Analysis in Fixed Income Investing

Introduction

Responsible investing, which is the process of taking into consideration sustainable and ethical practices when deploying capital, has grown meaningfully over the past 15 years. According to the Forum for Sustainable and Responsible Investment, approximately $3.3 trillion of investment dollars were screened for environmental, social or governance (ESG) factors in some capacity at year-end 2011, up from $2 trillion in 2001. However, a preponderance of this growth has occurred within equity investments, leaving out a substantial proportion of the investment universe.[1] As investors continue to demand responsible investment options and to advocate for more sustainable practices at corporations, it will be increasingly important to incorporate ESG analysis into fixed income investing.

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The two most commonly used terms to describe these investment objectives are Socially Responsible Investing (SRI) and Environmental, Social and Governance (ESG). While the terms are occasionally used interchangeably, it can be argued that ESG is more specific than SRI investing. According to The Forum for Sustainable and Responsible Investment, a wide variety of investments can be considered SRI, including community and impact investing, green investing, ethical investing, mission investing and investments in the public markets.[2] By contrast, ESG investing requires a review for positive and negative qualities within all three tenets (environmental, social and governance) and focuses on investments in public securities.

Many investment vehicles conduct basic socially responsible exclusionary screens, but this does not adequately protect investors from the risk of an ESG-related event. For example, a screen against investing in companies that produce nuclear energy would have prevented losses from an investment in Toyota Electric Power Company (TEPCO), the owner of the Fukushima nuclear facility that was damaged in the 2011 earthquake and tsunami. However, a basic prohibition against nuclear energy would not have prevented an investment in BP, the responsible party in another environmental disaster. There are dozens of examples of companies that would have passed exclusionary screens but still had known risks associated with their ESG-related practices, and those risks eventually damaged the value of their publicly-traded securities. Therefore, ESG principals should not only be applied to fixed income investing, but the process of doing so should be robust and multi-dimensional.

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ESG as Risk Management

The United Nations-supported Principles for Responsible Investment (UN PRI) effectively demonstrated the ability of ESG reviews to diminish risk in their 2013 publication "Corporate Bonds: Spotlight on ESG Risks". Within the paper, the UN PRI research team highlighted examples of inferior bond performance from TEPCO, referencing the above-mentioned Fukushima disaster; from BP, as a result of the Deepwater Horizon oil spill; and, from Lonmin, a producer of platinum, whose facilities were targeted by strikes and where local police subsequently killed protestors. In each case, the value of publicly-traded or privately-held debt was substantially impacted by an incident that violated ESG principles. Perhaps most importantly, each company had a history of either safety lapses or poor labor-relations that would have alerted potential investors to the possibility of escalating problems. Therefore, a comprehensive ESG review of each could have prevented exposure to these companies and reduced volatility in fixed income portfolios.[3]

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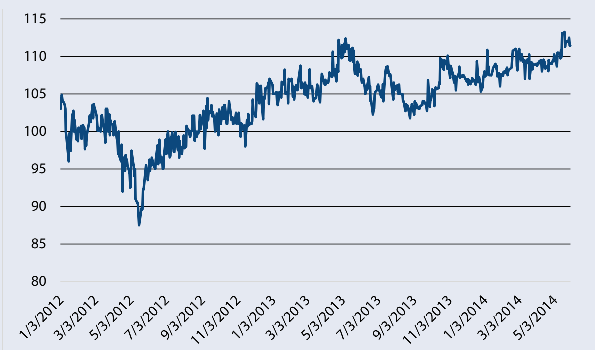
Chesapeake Energy 1/8% Due 02/15/2021



Source: Bloomberg L.P.[5]
Past performance is not necessarily indicative of future results.

While an abundance of examples exist, this paper will highlight two additional examples: Governance, through a review of Chesapeake Energy; and, Social, through a review of Wal-Mart Stores.

Chesapeake Energy* received poor grades on governance for years due to the influence and compensation of former CEO and Chairman Aubrey McClendon. The issues came to a head in April 2012, when the Securities and Exchange Commission (SEC) announced that it was investigating conflicts of interest at the company. Specifically, the company had a program that allowed Mr. McClendon to purchase a 2.5% ownership share in each of the company's oil wells, and Chesapeake supported these purchases through company-backed financing. Under this arrangement, McClendon reportedly borrowed up to $1.1 billion to finance the ownership positions.[4]

In January 2012, prior to the news of the SEC investigation, the company's BB+ rated 6.125% bond due 2/15/2021 traded at $104.875. In May 2012, after the investigation and other conflicts of interest became public, the bond's price fell to $87.5, producing a mark-to-market loss of 16.6%. During that time, prices on similarly structured securities also fell, but to a lesser degree. By comparison, Concho Resources'* BB+ rated 7% bond due 1/15/2021 traded at $113.17 in the winter of 2012 before dropping to $107.438 by the end May 2012, a decline of only 5.1%.[5] The increased volatility of Chesapeake's debt was due to the possibility of fines, losses and restructuring as a result of the SEC investigations and revelations that followed.

The value of Chesapeake's bond did recover and eventually traded closer to peers, but that recovery was a slow process and, again, tied to the company's resolution of its governance problems. McClendon relinquished his title as chairman of the Board in May of 2012, but did not step down as CEO until April of 2013, a full year after the scandal was publicized.[4]

With regard to Social factors, Wal-Mart* provides an example of a company that has made improvements in its domestic environmental practices through supply chain efficiency, but is still burdened by its poor labor relations. In 2012 alone, the company experienced strikes at 1,000 stores in 46 states, as well as in Argentina, Canada, South Africa and the United Kingdom.[6] Moreover, due to a practice of chronically underpaying its employees, it is estimated that the company's workers consume an incredible $6.2 billion in government resources a year, from food stamps to Medicaid benefits.[7] Therefore, it can be argued that taxpayers are artificially supporting the company's financials by the $6.2 billion that it is not providing to employees by way of benefits. In addition to being a poor ethical practice, this leaves the company vulnerable to changes in government policy. In fact, the company faced revenue headwinds in the first quarter due to the reduction in the federal food stamp program.

Providing a foil to Wal-Mart's labor practices is Costco Wholesale.* The company pays employees a living wage of approximately $21 an hour, and 88% of its employees have company-sponsored healthcare insurance. According to the CEO, Craig Jelinek, the company believes "it's a lot more profitable in the long-term to minimize employee turnover and maximize employee productivity, commitment and loyalty."[8]

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Wal-Mart's poor labor relations and, therefore, its dependence on government subsidies, has arguably impacted the performance of its bonds. After the changes to the national food stamp program were announced, the value of Wal-Mart's AA rated 1.5% bond due 10/25/2015 fell from $102.1 on October 28, 2013 to $101.6 on May 30, 2013.[5] During this time, yields declined overall, driving prices higher, and corporate bonds performed well. By contrast, the value of Costco's 1.125% bond due 12/15/2017 improved from $99.5 to $99.8 over the same period of time.[5] While not as dramatic of a movement as the Chesapeake Energy bonds suffered, the very highly-rated nature of the bonds, as well as their short durations, make these bonds substantially less impacted by interest rate fluctuations. Furthermore, the impact of food stamp reductions is at its infancy—reductions were passed in January of this year and will continue for the next 10 years.[9]

How to Implement ESG Screens in Fixed Income

There are several different asset types in a traditional fixed income fund: corporate bonds, Treasury bonds and securitized bonds, which can include agency mortgages (Fannie Mae and Freddie Mac), Commercial Mortgage-Backed Securities (CMBS), and other securitized bonds, like those backed by student or auto loans. While the process to review each asset class from an ESG perspective varies, the outcome must still provide insight into the underlying risks and benefits of each asset.

With regard to corporate bond investments, the review should be a multilayered process, starting with exclusionary screens. The next step is to look more deeply at each component of ESG. For environmental matters, topics of importance can include, but are not limited to: the percentage of facilities with International Organization for Standardization (ISO) certifications; a history of safety lapses or accidents that have environmental ramifications; and, its use of newer technology to reduce fossil fuel or water consumption. Pioneering companies at the forefront of environmental innovation are not only more likely to have lower energy costs, but also benefit from a wide range of other economic benefits.[10]

With regard to social factors, the first essential element is a review of the company's workplace relations. A company may make improvements in other categories or even receive accolades, but deficiencies in the treatment or management of employees should lead to an ESG review failure. Those issues are not only unnecessary, but have a multitude of potential costs to investors. One example is Rock-Tenn,* a paper products company that made substantial progress on their environmental practices and forest management. However, the company has received violations from the United States Equal Employment Opportunity Commission due to allegations of racism at certain locations.[11] The company was not willing to elaborate on these problems or any potential remedies, meaning that ESG investors cannot be confident that the issues were properly addressed.[12] Caustic work environments are known to reduce productivity and employee engagement, leading to higher turnover (and therefore costs).[13]

Finally, as highlighted in the review of Chesapeake Energy, a company's governance structure is the third critical pillar of a comprehensive ESG review. Understanding management's compensation and incentive structure, as well as that of the board of directors, deepens the investor's understanding of the leadership team, their philosophy and the resulting risks to the firm.

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While there has been an increasing awareness of the behaviors of companies, and therefore of the importance of an ESG review in the selection of corporate bonds, it is similarly important to conduct a thorough ESG analysis for CMBS facilities. There is an implicit separation of responsibilities between tenant and landlord, but the fact remains that the performance of a mortgage is ultimately dependent upon its tenants. For example, an investment in UBSBB 2012-C4, a mortgage with 11.90% exposure to two defense contractors, Kellogg, Brown and Root and Boeing, is clearly impacted by their ability to retain government contracts and to do so profitably.[14] Neither company would pass a stand-alone ESG screen, so it would be inappropriate to invest in a CMBS tranche so heavily reliant upon their success. Similarly, large concentrations of companies with poor governance or labor relations, such as Sears Holdings, increase the risk profile of the pool overall.

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As a result, it's necessary to screen CMBS for the following issues: 1) retail and office tenants that would have otherwise been screened out of a corporate bond review process; 2) industrial tenants with environmentally unfriendly practices; 3) hotels that include gambling or have a high risk of human trafficking; and, 4) a significant presence of mobile home parks, particularly those with poor reputations. Mobile home parks without features like community centers, clean spaces and crime deterrents have higher rates of vacancy and delinquency.[15]

After a review has been completed on the tenants, the next step is to aggregate the known or estimated exposures to the various exclusionary screens. This provides investors with insight into the aggregate concentration of businesses engaged in activities that would have normally failed a stand-alone exlusionary screen. This process serves to de-risk the pool and increases investor familiarity with the properties and tenants, both of which should allow for a more informed investment, and improved assurances that the pool meshes well with existing investments, and the portfolio's objectives.

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A similar process is required for asset-backed securities, particularly those prone to predatory lending practices. During the 2000s housing bubble, there was an increased number of privately-issued residential mortgage-backed securities. Many of securities contained very low quality mortgages that were written by unscrupulous lenders. From an ESG perspective, these questionable lending practices arguably led to the collapse of the financial markets in 2008, resulting in more severe financial hardship during the downturn and, consequently, the decline of neighborhoods and communities.

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Once again, there is a relationship between the ESG performance of the asset category and its economic performance. From a valuation standpoint, these securities proved to be volatile and, therefore, inappropriate for most fixed income investors seeking the preservation of principal. As an example, a mortgage pool issued by First Horizon Alternative Mortgage Securities* in 2004 (FHAMS 2004-FA2 1A1) traded near par through the first part of 2008. However, once the magnitude of the financial crisis became clear, the bond's value declined to $67.33 by December 2008. While it has since recovered, the premium is not as high as mortgages with a similar coupon, and the security has become very illiquid. At a minimum, investors experienced substantial mark-to-market losses in 2008 and, at best, now hold a bond that has underperformed the market while being difficult to divest.[16]

Price History of FHAMS 2004-FA2 1A1

Source: International Data Corporation[16]

Past performance is not necessarily indicative of future results.

Implications of ESG Investing in Fixed Income

When considering fixed income investments in particular, the benefits of an ESG screen are clear. The foundation of a balanced portfolio is a fixed income vehicle, due to the stability and income that traditional fixed income investing provides. As outlined in "A Return to Traditional Asset Allocation,"[17] an unlevered fixed income portfolio minimizes the impact of market fluctuations, and a portfolio with ESG-screens perfectly complements that objective by further reducing risk. This foundation frees investors to seek alpha through equity investments, where there is an opportunity to reap the full rewards of business improvements and earnings growth.

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Finally, ESG-screened investment opportunities allow investors to conscientiously invest in funds and support businesses that "do good by doing well." The investments can have a positive impact on communities and the economy, as companies are rewarded for sustainable or admirable practices. Investors that value ESG from an equity perspective, either as a risk-management tool or a vehicle for change, should therefore apply the same values to fixed income investing.

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Portfolio Manager

Footnotes

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[*] As of 6/30/2014, the Parnassus Funds do not hold these securities.

About Parnassus Investments

Parnassus Investments is an independent and employee-owned investment management company based in San Francisco, California. The firm seeks to invest in good businesses that have increasingly relevant products or services, sustainable competitive advantages, quality management teams and ethical business practices. We believe the most attractive opportunities for investments arise when companies with good business fundamentals become temporarily undervalued. Our goal is to provide value to our shareholders by generating attractive risk-adjusted returns over the long-term. The firm was founded in 1984, and currently manages five fundamental, U.S., core equity strategies across multiple market capitalizations, one Asia Pacific equity strategy and one U.S., fixed income strategy.

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