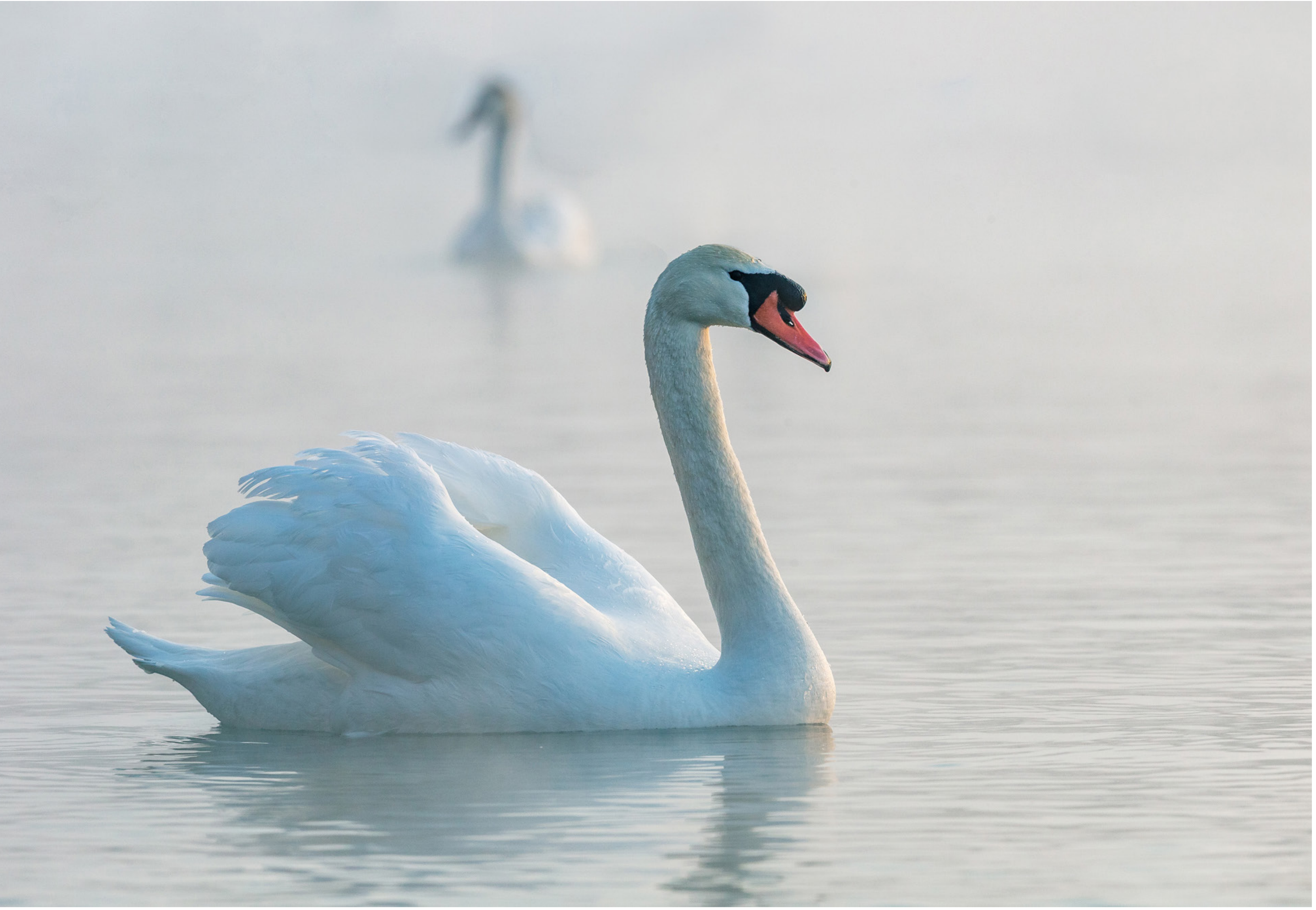
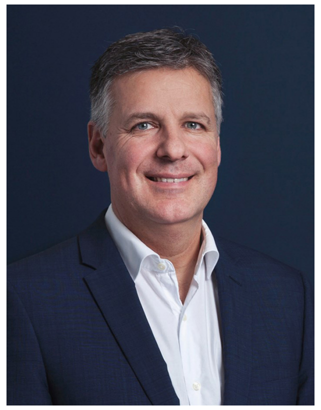


Global Corporate Bonds

Choosing a Label That Sticks

by Aline Reichenberg Gustafsson, CFA



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When ESG and SRI can take several directions depending on an investor's priorities, adopting a standard, receiving a rating or fitting into a label's requirements can have consequences on a strategy's outcome, financially but most importantly sustainability-wise.

Together with Stefan Ericson, Head of fixed income and Kaia Gaarud, analyst at Pareto Asset Management, we explored the journey that took them from starting a global corporate bond fund to obtaining the Nordic Swan Ecolabel approved by state-owned Miljömärkning Sverige. Along the way, we focused on why the same rules just cannot apply to every instrument and asset class.

At the onset, Pareto Asset Management decided to set up a credit fund explicitly aimed at limiting downside risk. "In credit, as everyone knows, the upside is capped, that is why our focus, in general, is on limiting the downside," starts Ericson. "For this new fund, we decided to design a strategy that would put this concern at the centre and eliminate at the onset the sectors that could hamper performance in a difficult market. With this in mind, we excluded boom-and-bust sectors such as fossil-based energies and commodities and reduced our target exposure to macro-driven sectors like real estate and financials."

Furthermore, the fixed income team had to adhere to Pareto's firm-wide SRI guidelines that take into account the Norwegian sovereign wealth fund's blacklist, including weapons and ammunition, coal, tobacco, pornography, etc. "We did not set out to build an ESG strategy from the beginning but, with our downside management in mind, we ended up with a set of guidelines within relatively strict ESG parameters," Ericson continues. "'G' has always had a strong weight in credit analysis. Our fossil-energy and commodities exclusions already gave us a heavy 'E' tilt. Beyond the exclusions that were imposed to us, the 'S' may seem less evident in credit, but we decided that it could make sense to examine that aspect as well and that it would improve our outcome in the long run."

For Pareto Asset Management's fixed income team, striking the right balance between the three ESG dimensions is crucial in achieving a sustainable outcome. "For us, focusing on one of the aspects, like the environment, will not effectively reduce our risk," explains Ericson. "Green bonds are a good example of an instrument that is tilted in one direction only. It is a great initiative, and we are happy that Sweden has been a pioneer in that market. That a bond is 'green' doesn't necessarily make it is sustainable. It means that a framework has been established to direct the proceeds of the bond to projects that are targeted at reducing emissions. The company wouldn't need to make any commitment outside of that project, let alone in the 'S' dimension, regarding labour practices for example."

At the time the team was building the strategy, Gaarud came in with a fresh pair of eyes and helped take the fund to the next level. "We were lucky to have Kaia join us as a young analyst in the spring," says Ericson. "She wasn't entrenched in daily tasks the way we all always are, and that allowed her to focus on the ESG aspects of this product truly. That's when we got in touch with the Nordic Ecolabeling, and thanks to her hard work and close collaboration with the Swan financials team, we managed to qualify for the certification."

Initially, it was a round table meeting with Per Sandell, Head of Financial Services Nordic Ecolabelling, that led Ericson's team to look into an ESG certification.. "We chose the Nordic Swan Ecolabel because we liked their approach more than what others proposed."

In fixed income, the challenge of finding an appropriate yardstick for a strategy is exacerbated by the predominance of equity-focused actors taking part in the development of new standards and regulations. "The largest providers of ESG data have developed models for equities," says Ericson. "It is quite common that corporate credit always comes like an afterthought. Take MiFID II for example. With equities, investors paid a higher commission to gain an informational advantage, and the regulators designed a regulation to remedy that. In fixed income, we don't pay any commission. The price we pay is embedded in the price we pay in a much less transparent way, but we can't just ask for a rebate because we decline to receive the broker's research. Fixed income and equities belong to two distinct asset classes and just can't be treated the same way."

One key difference between asset classes in the field of SRI is engagement. "We simply cannot engage in the same way shareholders can," adds Ericson. "We don't have a vote, and therefore do not have an opportunity to take a seat on the nomination committee to influence how the board should be composed. We can engage in a direct dialogue in certain cases, of course, but it may not count as 'shareholder engagement'. As bondholders, we are not claiming that we are working actively to change the world by targeting the 17 Sustainable Development Goals. However, we can promote the efforts of companies that are sustainable in the three ESG dimensions, by choosing to finance their activities instead of others."

While the Nordic Swan Ecolabel started by certifying equity funds, it has a set of requirements for fixed income products. Pareto's Global Corporate Bond fund is only the second fund to have received the label, and the only product currently registered for marketing in Sweden. Unlike other equity-focused and quantitative-based certifications, the Nordic Swan Ecolabel requires a deep involvement between the Swan financials team and the applying fund managers. One of the primary requirement is that all holdings of the fund are scrutinised using an ESG model, and the model has to be analysed and approved by the Nordic Swan Ecolabelling.

Another particularity of the eco-label is that part of the requirements are flexible to an extent. First, a set of minimum criteria guarantees that all Nordic Swan Ecolabelled funds qualify for the same essential elements. Also, the funds have to achieve at least 5 or 6 points out of 16 (for fixed income and equity respectively). "Investment strategies cannot focus on all sustainability aspects at the same time," explains Gaarud. "The 16 points have actually been designed so that it is not feasible for one product to qualify for all of them. Each manager needs to choose the points that are relevant to the product, and fulfil the criteria associated with those points."

"We really appreciated the fact that the Nordic Swan Ecolabel doesn't try to force a square peg into a round hole," says Ericson. "We were also impressed by the quality of the team, and their breadth of experience. Miljömärkning Sverige analyses and certifies thousands of consumer products, from detergents to baby clothes, but they also have attracted talented individuals from the financial sector to lead the analysis of financial products in a highly professional manner. In fact, the involvement of the team in the certification process is one of the elements that convinced us to apply. Once we started, we also gained tremendous inputs from our work with the Swan team."

For Gaarud, the experience was gratifying, and she will continue to be involved with the ESG aspect as a full-time analyst in the team. "I am working to ensure that we comply with the Nordic Swan Ecolabel in every aspect, even if it has almost no impact on the strategy itself, as it was already a good fit for the framework in its original shape," she comments. "The only adjustments we made had to do with the fact that all our holdings have to be screened by our ESG model. This means that we are staying away from ETFs for example, as we wouldn't be able to apply our internal model to all of the instrument's underlying positions. We had not used ETFs so far, even if we were allowed to under our fund rules."

Gaarud is also part of the dialogue the fund managers conduct with some of their bond issuers. Ericson mentions one, in particular, the unrated privately held Swiss-based manufacturer of non-woven fabric, Jacob Holm & Sons AG. "To separate fibres can be very polluting," he explains. "But we found out that thanks to an inter-generational management change at this family-owned company, the manufacturing process is evolving towards much better environmental practices. Competition is brutal in this field, but consumers are increasingly willing to pay the price for products that are less harmful to the environment. We saw that this company was starting to perform well, for the right reasons and decided to engage with management to find out more. We were surprised to see how willing they were to hear our opinion."