Morgan Stanley

INVESTMENT MANAGEMENT

Key Fixed Income ESG Considerations for 2023

FIXED INCOME TEAM | INVESTMENT INSIGHT | 2023

The year 2022 undoubtedly tested the durability of the sustainable-labelled debt market. The Russia-Ukraine conflict, the resulting energy crisis and rising inflation led to market volatility and higher interest rates, which deterred issuers of Green and other labelled Sustainable Bonds, albeit to a lesser degree than traditional bond supply.

While we expect some of the macro headwinds will continue to impact the market in 2023, a rebounding sustainable bond market can continue feeding opportunities for fixed income investors to mobilise capital towards ESG-related projects and targets, as client focus on sustainability objectives such as the net-zero transition expands to their debt holdings.

As the integration of sustainability within fixed income portfolios grows, pressure on investors to actively engage with bond issuers is also mounting, while sustainability disclosure frameworks could benefit from a more focused consideration of the complexities and ESG data challenges of non-corporate investments.

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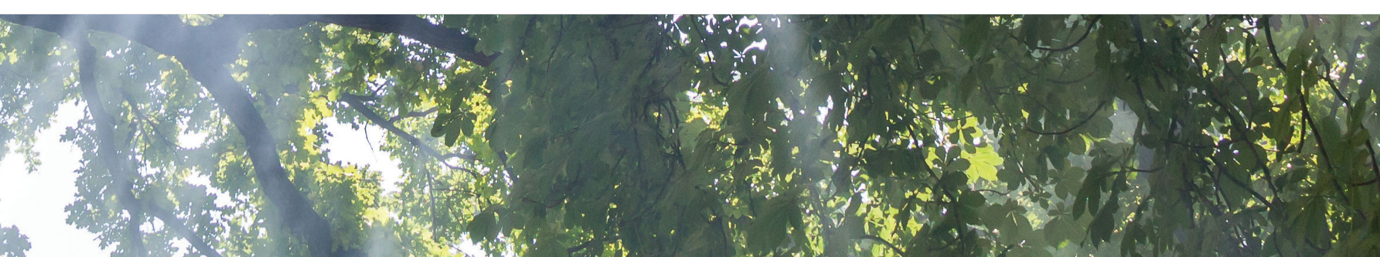
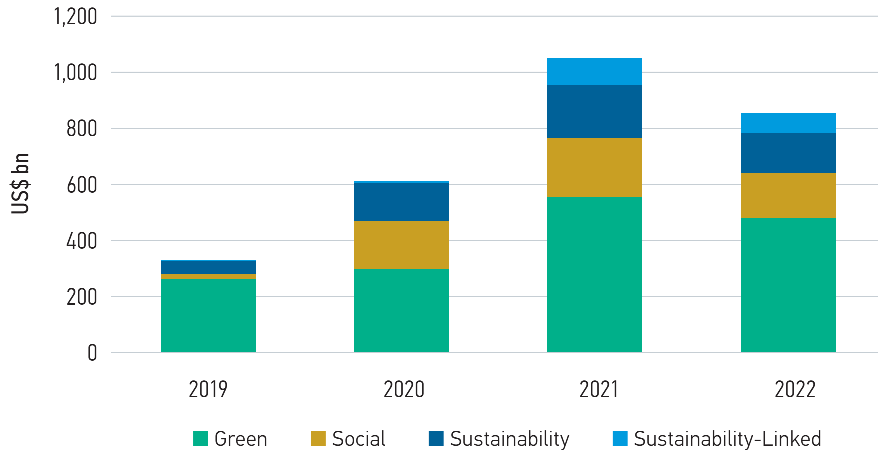


1. Labelled supply rebound in 2023: Sustainable Bonds will continue to provide opportunities to invest in real-world outcomes, however subject to growing scrutiny on their integrity

2022 has been an exceptionally tumultuous year for the bond market. Absolute global supply of Green, Social, Sustainability and Sustainability-Linked bonds ("Sustainable Bonds") fell victim of the broader market trend, stopping short of $850 billion in new issuance, almost a fourth below 2021 levels. Still, in relative terms, labelled bonds continued their march toward becoming mainstream, reaching approximatively 30% of total new issuance for EUR IG and EUR HY.[1]

DISPLAY 1

Labelled Sustainable Bond Issuance, 2019-2022



Source: Environmental Finance Data

With a forecasted 2023 rebound to ~$1 trillion labelled issuance, we believe sustainable Bonds continue to represent an effective tool for fixed income portfolios to invest in sustainability objectives such as climate change mitigation and adaptation, equality, and job creation. This is further incentivised by policy measures such as the US Inflation Reduction Act, the EU Taxonomy and Carbon Border Adjustment Mechanism (CBAM), and the UK Transition Plan, among others.

Evolving regulation, especially in Europe, has, however, also introduced a greater degree of scrutiny on bond labels, with a skew of investor preference towards use of proceeds structures (characterising Green, Social and Sustainability Bonds) with an identified pool of environmental and/or social projects, which can more easily fit the definition of a "sustainable investment" under the EU Sustainable Finance Disclosure Regulation (SFDR). Greater regulation-driven demand to buy those bonds could drive "greeniums" up again.[2]

Sustainability-Linked Bonds (SLBs), with their general corporate purpose nature, have on the other hand triggered increasing scepticism around their integrity. This is partially due to their appeal to companies from more carbon-intensive sectors. In addition, targets often lack credibility: for example, lack of consistent external assurance of the science-aligned nature of carbon reduction target used in a transaction. Credibility is further called into question when issuers look to revise their initial targets to be less ambitious, as was seen during the energy crisis in 2022. The first failure by one company to achieve its SLB target, which triggered the bond coupon step-up, was met with a largely neutral impact on the bond price, raising further questions about these instruments' credibility and effectiveness.

We think SLBs remain a potentially effective alternative to use of proceeds bonds for less capex-intensive issuers, if structured in line with best practice. They could, for instance, be used to support specific biodiversity objectives for which it is challenging to find sufficient volumes of proceeds. In addition, sustainability-linked financing can be a powerful instrument to keep governments accountable on their climate-related and sustainable development pledges, including through changing administrations. 2022 saw the debut of SLBs in the sovereign space, with Chile and Uruguay issuing the first two bonds in this format. SLBs could be a viable route to facilitate the access of smaller, emerging market economies to debt markets, while providing investors with greater transparency associated with the reporting and external verification requirements of labelled transactions.

Moving into 2023, we believe the following considerations will be pivotal to the maturing and further mainstreaming of Sustainable Bonds:

- **ENHANCED IMPACT REPORTING:** impact data for Sustainable Bonds has been, to date, hard to track and aggregate for portfolio-level reporting. This is due to issuer impact reporting not being necessarily aligned with financial reporting timeframes, the use of bespoke metrics and methodologies that make aggregation challenging, and difficulties around the attribution of impact to a specific bond and,

[1] Note: a large portion of EUR HY debt was issued in Sustainability-Linked format, versus predominantly Green/Social/Sustainability use of proceeds format for EUR IG. Source: Morgan Stanley Research, HSBC Research, Bloomberg.

[2] Sustainability in 2023: Outlook and Key Trends, Morgan Stanley Research.

even more granularly, the portion of financing allocated to projects generating that impact. We expect this to improve in 2023, as issuers face more pressure to enhance sustainability and impact-related disclosure, and as a number of data providers work on impact datasets that can facilitate investor use of this information.

- **ESTABLISHMENT OF A MARKET-WIDE CARBON ACCOUNTING METHODOLOGY FOR GREEN BONDS:** for diversified sustainable fixed income strategies, which invest in a combination of labelled and non-labelled bonds, one of the key portfolio carbon reporting challenges lays in demonstrating the environmental benefits of holding a bond in green versus vanilla format. The finalisation of the Green Bond methodology by the Partnership for Carbon Accounting Financials (PCAF), and broad-based agreement amongst market players on how to account for issuer-level versus security-level emissions for labelled bond holdings, could add to the demand for these instruments and help investors manage their portfolio decarbonisation more accurately.

- **GREATER STANDARDISATION AND TRANSPARENCY ON SLBS:** ongoing work by the International Capital Market Association (ICMA), of which MSIM is a member, in relation to their Sustainability-Linked Bond Principles and related Working Groups, will contribute to raising the bar, as well as individual and collaborative engagement from investors with SLB issuers. Key areas for improvement include clarifying what an "ambitious" target means, establishing the relevance and materiality of penalty mechanisms, developing processes for amending indicators and target values, and defining minimum requirements for considering SLBs sustainable investment, including under SFDR.

2. Levelling up engagement with debt issuers: aiming for enhanced collaboration and long-term influence

As the implementation of ESG factors within Fixed Income portfolios continues to rise globally, from 42% of investors doing it in 2021 to 76% in 2022,[3] and requirements for stewardship codes compliance and climate reporting toughen (e.g., UK Financial Conduct Authority requiring large financial institutions to report in line with the Task Force on Climate-related Financial Disclosures, or "TCFD", by June 2023), bondholders are called to collaborate with equity holders to align their sustainability expectations when engaging in company dialogue, aiming to exert long-term influence on management. The Investment Association recently published guidelines on improving fixed income stewardship, recommending more intentional ESG-focused engagement to complement the more traditional information-gathering credit meetings.

We anticipate the following engagement priorities for fixed income investors during this year:

- **A THEMATIC FOCUS AROUND SUSTAINABILITY ISSUES THAT NEED SIGNIFICANT DEBT FINANCING TO BE ADDRESSED, INCLUDING THROUGH EXTERNAL COLLABORATIONS:** key themes include human rights to support a "just" transition, net zero alignment, and biodiversity, targeting, in particular, the automotive, mining, utility and energy sectors, through scrutiny on the deployment of their financing plans. Credit teams will play an increasingly active role as part of investors' participation to collaborative platforms: for example, MSIM has joined the PRI Advance initiative on human rights stewardship, with the Fixed Income team leading the dialogue with selected companies, in coordination with the Global Stewardship team.

- **DEEPER ENGAGEMENT ON SUSTAINABILITY-LINKED FINANCING TERMS, PARTICULARLY WITHIN HIGH YIELD:** to drive the above-mentioned improved credibility in this type of issuance, fixed income investors should engage with issuers to help develop more robust sustainability-linked financing frameworks. This is especially relevant within the high yield market, which has shown the greatest appetite for this format. This includes early discussions on what sustainability indicators or underlying targets are appropriate in the context of an SLB, where investor consent should be sought for amendments to any of the bond terms, and the appropriateness of penalties. To this end, investors should also establish a constructive dialogue with standard setting bodies, industry associations, such as ICMA, as mentioned above, and third-party verification providers.

- **LEVERAGING UNIQUE ACCESS TO SOVEREIGN BOND ISSUERS:** despite a new higher-rates status quo, debt markets will continue playing a key role in financing the ambitious projects needed across the global economy to meet the Paris Agreement objectives and the UN Sustainable Development Goals. The universe of sovereign bond issuers is also significantly smaller—in terms of total number of countries—compared to the thousands of corporate bond issuers, making it potentially more costly for investors to substitute an investment if a country presents sustainability concerns. Fixed income investors should therefore contribute to keeping governments accountable for their pledges, while taking into consideration the specific priorities of developed and emerging markets.

As presented in our 2022 Engagement Report, the MSIM Fixed Income team[4] conducted almost 150 ESG-focused

[3] Source: Index Industry Association.

[4] + MSIM Fixed Income refers to legacy MSIM, excluding Calvert and Eaton Vance.

engagement meetings in the past year, with almost one-third influencing our investment strategy. We continue to make targeted, constructive engagement a priority, collaborating with the Global Stewardship team and other investment teams to leverage our exposure across the capital structure and across organisations to make more informed investment decisions, ensure accountability around sustainability issues, and help drive positive change.

3. Sustainability disclosure—the tip of the iceberg for fixed income: bespoke guidance on non-corporate investments and more security-level data can drive higher quality disclosure across asset classes

The regulatory push on sustainability-related disclosures, through SFDR in the EU and analogous ongoing efforts in the UK, the US, and several Asia-Pacific countries, is contributing to ensuring greater transparency in the sustainable investing market and a more responsible use of sustainability-related terminology in product names.

Most disclosure frameworks are largely focused on corporate investments, suitable to equity investors but leaving multiple challenges for fixed income to grapple with, given the diversity of asset classes within this universe.

As such frameworks evolve, we think greater standardisation on the following aspects can help catalyse more sustainable investing allocations to fixed income:

- **ACCOUNTING FOR SOVEREIGN INVESTMENTS:** the dependency of country-level sustainability outcomes on corporate activity in their jurisdiction represents a measurement hurdle. Finding sustainability, and especially carbon-related metrics, suitable to both developed and emerging countries, which can be aggregated at the portfolio level, is also challenging, and may introduce some bias. For example, the link between sovereign indebtedness and carbon in the calculation of financed emissions is, at best, very tenuous in our view. In addition, government bond portfolios can be characterised by significant derivative holdings, including in currencies. We believe it is important for investors to be aware of this exposure, albeit indirect, when assessing portfolios through a sustainability lens, and to develop thoughtful approaches to track the sustainability-related progress of their portfolios.
- **SUSTAINABILITY ALIGNMENT OF SECURITISATIONS:** the elephant in the room is the lack of consistent access to data for many mortgage- and asset-based securities, which can hinder investors' ability to assess the positive or negative sustainability impacts of these investments. This currently requires the deployment of extensive research capabilities and resources. Enhanced disclosure by originators and servicers on the underlying loans and collateral can facilitate the due diligence and regular monitoring of their environmental and/or social alignment.
- **ISSUER- VERSUS SECURITY-LEVEL SCREENING:** while most positive and negative screening is usually conducted at the issuer-level, we believe there is merit for assessing at least certain sustainability characteristics at the security level; for example in the case of Sustainable Bonds and securitisations, given the greater transparency on their use of proceeds. Affirming this process could further incentivise demand for these products.

We recognise the regulatory and standards-setting landscapes are progressing fast, and we expect some of these aspects to be tackled in more detail in the course of the year. Data availability and quality will play a major role in determining fixed income investors' ability to expand the spectrum of investments that they can analyse and potentially classify according to varying degrees of sustainability criteria. At MSIM, we have developed methodologies to assess sovereign, securitised, and labelled Sustainable Bond investments.

As more jurisdictions design their own approaches to sustainability disclosures, they should build on the EU experience and aim to take some of these issues into account from the outset.

2023: Time to Stop, Collaborate and Listen

After the exceptional uncertainty of 2022, this is the year in which investors' attention turns to a more promising fixed income outlook. We expect it will be a crucial year to consolidate the credibility of the labelled Sustainable Bond market. This could mean temporarily putting on hold the supply-side push on innovation and be more thoughtful about the role these instruments play, including within the new regulatory regimes taking shape across Europe, North America, and Asia. Labelled debt, when robustly structured, can represent (at least temporarily) a safe harbour from the risk of greenwashing that is embedded in otherwise vaguely defined sustainable investments.

We believe that engagement should start bearing fruit, with concrete evidence of action—both from issuers to implement recommendations, and from investors to reflect that in their investment strategy. Fixed income investors will likely be more empowered and have a stronger voice at the table to utilise their holdings to influence issuers and drive forward key sustainability themes.

Finally, as regulators across geographies learn from the experiences of SFDR to establish new disclosure frameworks, it is critical that they take into consideration the complexities of fixed income investments, in order to ensure a level playing field in the offering of sustainable products and a more comprehensive application of enhanced transparency requirements across the market.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to **market risk**, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in a portfolio. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. Certain **U.S. government securities** purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **Public bank loans** are subject to liquidity risk and the credit risks of lower-rated securities. **High-yield securities (junk bonds)** are lower-rated securities that may have a higher degree of credit and liquidity risk. **Sovereign debt securities** are subject to default risk. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (**liquidity risk**). They are also subject to credit, market and interest rate risks. The **currency market** is highly volatile. Prices in these markets are influenced by, among other things, changing supply and demand for a particular currency; trade; fiscal, money and domestic or foreign exchange control programs and policies; and changes in domestic and foreign interest rates. Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with foreign investments. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, and correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations (CMOs)**, it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

ESG Strategies that incorporate impact investing and/or **Environmental, Social and Governance (ESG)** factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance

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