ESG
Fixed Income
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CAPITAL GROUP®

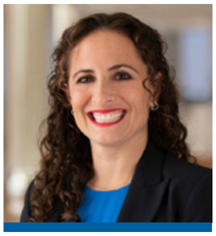
Five quick takes on ESG in bond investing: Views from our global bond investment team

Shining a light on ESG in bond investing

Equity investors often take the spotlight when it comes to discussing and considering environmental, social and governance-related (ESG) developments. An ownership stake often fuels interest in the company's strategic plans, while proxy voting confers the opportunity to vote on key decisions.

What is not so widely discussed is that, as lenders, bond investors can also have distinctive and insightful perspectives on ESG. Furthermore, bond investors operate in an investment universe that includes types of issuers that don't exist for investors in public equities, such as privately held firms and governments.

Against this backdrop, five of our fixed income investment professionals share their experiences of considering and discussing material ESG matters with issuers. From emissions disclosures to employee safety and the potential financial benefits of good governance, these quick takes shine a light on how ESG integration can shape long-term investment thinking.



Sarah Leshner Carvalho
Latin American Corporates
Investment Analyst

1. Looking beyond the headlines is crucial

Conversations on material ESG matters with company management can sometimes help us dig deeper for answers. For instance, Capital Group's ESG team recently spotted a news story on a chemical leak at a food processing plant. As we were bondholders, the senior management at the company that owned the facility were keen to reassure the Capital Group analysts covering them that they were taking the leak seriously and had sought to limit the health impact on employees.

"They had responded to the problem much more rigorously than media reports suggested," says New York-based fixed income investment analyst, Sarah Leshner Carvalho. "Employee health was being tracked, and they were considering enhancements to safety protocols. These were developments that could be financially consequential for their business, so we've kept a close eye on progress."

Engagement also offers the opportunity for meaningful dialogue on major plans. Leshner Carvalho recalls another firm that was considering bringing an ESG-labeled bond deal to the market. "As one of their largest investors, they wanted to hear our thoughts on their plans and funding strategy," explains Leshner Carvalho, who met with senior management alongside one of Capital's ESG specialists. "We thought their key performance indicators could be more explicit, and that their coupon structure could better compensate bond investors if they were to miss their targets. They were receptive to our views."

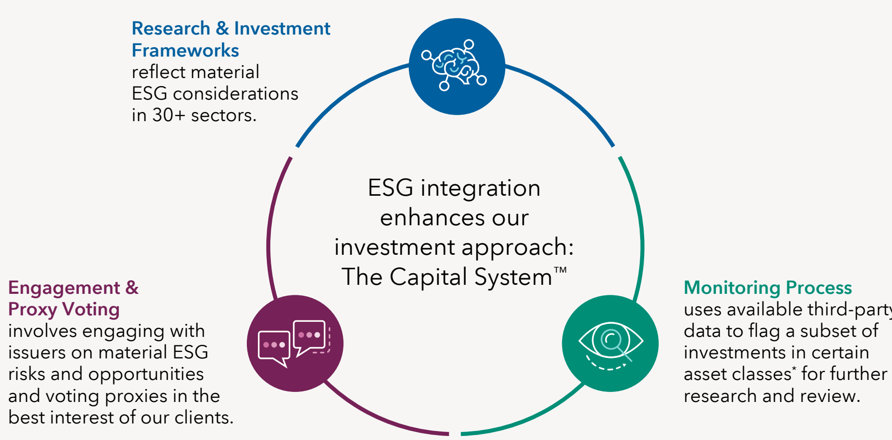
Efforts around ESG vary widely across industries and regions. Engagements can, therefore, be more about getting the conversation started. Leshner Carvalho points to a recent discussion on board composition as an example. Investor roadshow materials portrayed a distinct lack of gender and ethnic representation at a holding company. She talked with executives there about Capital Group's fundamental research on human capital. Numerous studies suggest diversity encourages greater innovation, corporate resilience, productivity, and better functioning teams. Furthermore, our experience tells us that strong diversity, equity and inclusion practices can enhance investment outcomes.

Leshner Carvalho also noted that, with so many larger bond investors paying more attention to governance structure, meaningful improvements around diversity could encourage demand for bonds and ultimately lower borrowing costs for the company.

Our three-part ESG integration process focuses on matters that could be financially material

Bond and equity investors may sometimes be looking for different things from an issuer. For instance, a bond investor might favor very strong capitalization and funding, whereas an equity investor might prefer more efficient use of capital.

At Capital Group, we consider ESG-related risks and opportunities that could have a material effect on investment outcomes – for issuers of bonds and equities.



*As of December 31, 2022, monitoring applies to corporate and sovereign holdings.

Denis Tolkachev

High-yield Fixed Income Investment Analyst

2. Sharing thoughts on best practices with high-yield issuers in the energy sector

ESG in the energy industry isn't just about the shift to renewables. Managing the environmental impact from the production and transportation of carbon-based fuels can also have varied material financial consequences. Exploration and pipeline operations are often constrained by environmental regulations that can carry financial penalties when violated.

Engagement on ESG is, therefore, a critically important input for fundamental research into exploration, production and oil field services companies. New York-based high-yield fixed income investment analyst, Denis Tolkachev, says his ESG engagements have covered varied topics: "In partnership with our ESG team, I've encouraged companies to develop robust disclosures around emissions metrics. I've also shared certain industry best practices, including examples of how firms can potentially reap financial benefits from minimizing gas flaring and deploying carbon capture."

Kirstie Spence

Fixed Income Portfolio Manager

3. Rounding out emerging markets discussions and fine-tuning valuations

Bond investors in emerging markets play a crucial role in the reallocation of global capital from savers in the developed world to the investment needs of the developing world.

When our investment professionals engage with governments via meetings and roadshows, they will often emphasize the importance of transparency, good governance and adopting international standards, explains Kirstie Spence, London-based fixed income portfolio manager. "Putting to one side potential political and economic gains, governments that pursue best practices can improve their access to financing and lower their cost of capital," she adds.

"Having an ESG monitoring process for sovereigns helps us identify and analyze financially material ESG considerations. That encourages well-rounded discussions and can also help us fine-tune valuations," says Spence. "Clearly, sovereign issuers can choose to ignore us. That said, for the many governments that want and need capital, the views of bond investors are likely to matter to them."

Our Sovereigns ESG monitoring process leverages data (where available) from large multinational institutions

Notre Dame Global Adaptation Initiative Vulnerability Index	Summarizes a country's vulnerability to climate change and other global challenges in combination with its readiness to improve resilience.
United Nations Human Development Index	Summarizes average achievement in key dimensions of human development: a long and healthy life, being knowledgeable and having a decent standard of living.
World Bank Worldwide Governance Indicators	Indicators for over 200 countries and territories across six dimensions of governance: voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, rule of law and control of corruption.

Danny Jacobs

Fixed Income Investment Analyst

4. Finding opportunities in autos beyond electric-only vehicles

"Whilst the broader market tends to be overwhelmingly focused on electric vehicle production, there has been less attention on other ESG-related opportunities and risks in autos," says Danny Jacobs, London-based fixed income investment analyst. "We have been able to take a more nuanced, holistic view on electric vehicles, as well as incorporating other potentially financial material ESG issues within our fundamental research."

Jacobs points to older, established car manufacturers as an area where Capital Group's ESG investment frameworks and research have encouraged differentiated insights. "We've seen certain legacy autos with a smaller manufacturing footprint lead the way when it comes to sustainability in supply chains," Jacobs says. "Sourcing of cobalt and nickel and broader supply chain transparency, for example, are ESG considerations that can have financial consequences due to repercussions on operations and emissions."

Mandeep Saini

Fixed Income Investment Analyst

5. Transparency across industries varies widely

While ESG-related transparency is improving overall, New York-based fixed income investment analyst, Mandeep Saini, has seen wide variation in how ESG issues are addressed by firms. "In some industries we've sought to encourage greater transparency. A recent example involved a defense company where, mindful of legal risks, we requested clarity on their supply chain and export controls."

At the other end of the spectrum, Saini recalls a life sciences company with products that help improve crop yields – including in developing countries. The firm has put great focus on ESG transparency. Reducing litigation risk and shifting regulatory and consumer attitudes to genetically modified crops are recurring topics in these engagements.

The firm has attempted to address concerns around ecological damage to non-genetically modified crops by tightening labels and being more specific with usage instructions around pesticides and seed planting. "We continue to interact with management on a variety of financially material ESG issues, including how they're managing the broader biodiversity impact of their products," Saini adds.

Learn more about our ESG approach, explore our latest research →