BEUTEL GOODMAN FIRESIDE CHAT SERIES

How ESG is Evolving in Fixed Income: Fireside Chat with Sue McNamara

Asset managers and investors continue to embrace responsible investing, particularly ESG. EY recently described ESG as representing "a fundamental change in investment," in a report which also showed ESG-branded mutual funds continue to see record inflows. We recently sat down with Sue McNamara, Senior Vice President, Fixed Income to discuss ESG investing in the world of bonds, as well as some of the major themes in the space right now.

The recording took place on May 14, 2021. The following transcript has been edited for clarity.

Linda Watts : Thanks for joining us. My name is Linda Watts, I'm Vice President of Client Service and Business Development at Beutel Goodman. Today, I'm speaking with Sue McNamara, Senior Vice President, Fixed Income, one of the portfolio managers responsible for executing our ESG integration within our fixed-income portfolios. We're talking about ESG today, or the environmental social and governance factors that have become increasingly in focus as we look at investments. Sue, thanks for taking the time to discuss the topic with me.

Sue McNamara : It's my pleasure. I'm looking forward to it.

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Investment Counsel

LW : Great! Historically, there's been more focus on ESG within the equity market than the bond market and I think that, for many people, it's almost easier to understand ESG on the equity side. Can you elaborate on this and provide some detail on how this has evolved?

SM : Sure. I think the focus — why it's been more on equities first — if you think of it in terms of governance and the ability to vote on proxies and to engage with management. From that front, that is really something that is unique to equities. [With] fixed income, we can't vote proxies on say on pay or on other types of AGM issues [Ed. note: say on pay is a term used in corporate law whereby a firm's shareholders have the right to vote on the compensation of executives.]. We can only vote proxies on covenant change. It's just very narrow in scope and doesn't happen very often. Yet, when you think of it, debt investors have really an important role to play on two fronts.

First, companies tend to issue more debt than equity. Therefore, management teams are in front of their debt holders a lot more often than they are in front of their equity holders. It gives us a unique opportunity to engage on ESG issues with management when we meet with them. In the future, there's some possibility that we might start embedding ESG-type of performance targets in bond covenants, which would mean that if a company doesn't achieve a target, they could be possibly in violation of their covenants.

Second, in the debt market, companies can issue bonds that directly finance certain ESG issues. The first ones you can think of are green bonds. These are companies that can finance renewable power generation projects or green buildings. We had [the world's] first green bond in 2013, [which] was issued by the Électricité de France and since then, the global market has grown exponentially. Almost US$1.6 trillion in ESG-labeled debt is outstanding, currently.

I think this is driven by two sides, both on the demand and the supply side. On the demand side, there's been a proliferation of funds that have an ESG focus, both passive and active. These funds continue to attract significant flows. Then, on the supply side, companies are transitioning to the lower-carbon world and many of these companies have made commitments to net-zero [greenhouse gas (GHG)] emissions by 2050. So, in order for those companies to meet those emission standards, there's a tremendous amount of investment that is going to be required to facilitate that transition and a lot of that money will be funded within the debt markets.

LW : Yeah, we're definitely seeing real evolution in the bond market and we see that in bonds that are issued to fund ESG-related projects. I think most of us are familiar with green bonds, but it's really grown well beyond that now. Could you expand on the broader offerings and explain the differences between them?

SM : Green bonds were the first sustainable financing product, as I mentioned before. The use of proceeds from green bonds have traditionally been [for] renewable energy, energy efficiency, clean transportation, waste and water management, green buildings and other climate change adaptation-type technologies. But not all of ES&G is E. So, what we've seen lately is the emergence of social bonds.

These are bonds that are issued where the use of proceeds is to fund social projects, such as affordable housing, access to essential services [and more]. In Canada, CIBC issued the first social bond in September 2018. The proceeds from this $1 billion offering, which were called Women

In Leadership bonds, supported the bank's corporate lending to companies where women make up at least 30% of top executives or board members, or who were signatories to the Catalyst Accord 2022, which is a movement that aims to advance women in business.

That's one example on the social side and now we're moving to the concept of sustainability-linked bonds and loans. They provide incentive for issuers and borrowers to set and achieve predetermined sustainability performance targets. In this, it's kind of a unique structure in that the bond coupon actually can go up or down contingent on the issuer's ESG performance in meeting the goals that are set up in the covenants for those bonds. So, for example, issuers that meet their targets will see the lower interest rate versus a failure to meet those targets means that they're going to have to pay a higher interest rate.

We haven't necessarily seen any sustainability-linked bonds in Canada yet. But, the first step is on the loan side. For example, in April 2021, Gibson Energy [Inc.] fully transitioned its $750 million syndicated revolving credit facility, which includes terms that reduce or increase the company's borrowing costs based on whether its ESG targets are met. These targets include the reduction of scope one and two GHG emissions intensity, [an] increase of females in the workforce and an increase in racial and ethnic minority employees in the workforce. The company also has additional targets, including an increase in women on the board and having at least one member of the board that identifies as a racial or ethnic minority and/or Indigenous, by 2025.

LW : It's certainly a growing market and colourful list of options. It seems the colours don't just apply to the bonds themselves, though. We've seen some issues in the green bond market and some pushback relating to brown companies issuing green bonds [Ed. note: while there is no formal definition of brown companies, in its research, MSCI defines them as those with at least 50% revenue from thermal coal mining, generation of power from fossil fuels and/or extraction and production of conventional and unconventional oil and gas.]. Can you discuss this and maybe share your thoughts on carbon risk more generally? What do you think would be will be required to meet the Paris agreement climate change goals?

SM : It's an interesting dilemma that the bond market's been grappling with. That is, if you have a bond issued by a company that's not green, i.e. a mining company, but the proceeds from that project or that bond are going to reduce GHG emissions, is it really green bond? I think that's where the market starts talking about greenwashing and that if you're company is not really green can you really issue green bonds? [Ed. note: Oxford Languages defines greenwashing as disinformation disseminated by an organization so as to present an environmentally responsible public image.]. I think that's what is paving the way for this new concept that we have called a transition bond. I think this is going to be really important for Canada and where we can be a leader going forward.

In order to meet the Paris agreement climate change goals, a significant amount of financing is going to be required for non-green companies to meet their GHG reduction targets. These are companies that are already on the road to this by committing to having net-zero GHG emissions from 2050 [onwards]. If you just think about it, we currently are running about 20-30% of our grids off renewable power. We want to increase that to possibly 70-100%.

So, think of all the new projects that would have to be financed to get that way. You envision a future where we're all driving electric vehicles and the infrastructure that would have to be put in place. To do that, we're going to transition from the so-called dirty fuels like coal and diesel to other alternatives. [Think about] how you would have to completely alter the transportation network to do that. You are converting buildings to be greener and that's not even getting into the concept of hydrogen, which could completely replace crude oil in the future and change the way that we use and consume and produce energy.

When you think of all of these projects, they have to be financed and these are mostly going to be brown companies doing this, but converting to green-type projects to meet [the] Paris accord [goals]. That's where the concept of a transition bond comes in. They provide potential solution by enabling carbon-intensive companies to raise capital and use the proceeds for activities that will help them reduce their carbon footprint. For example, a power company can issue a transition bond to fund its projects that are converting coal-fired generation to natural gas.

LW : It will be interesting to see how that market evolves and certainly there seems to be a need for these transition bonds. Let's now drill down on putting all of this into action. To what extent do your portfolios currently have exposure to green bonds or sustainability-linked bonds?

SM : We currently own or have owned green bonds in the past from renewable-power companies such as Ontario Power Generation [Inc.], Algonquin Power and Brookfield Renewable [Partners L.P.]. We've bought green bonds issued by the provinces, such as the governments of Ontario and Quebec, as well as some of the municipalities, like Toronto. We've also bought social bonds that have been issued by the Canadian banks.

We purchased our first sustainability-linked bond for our fixed-income portfolio in March 2021. This was in the U.S., as I said before that Canada has yet to issue one. We bought U.S. poultry producer Pilgrim's Pride [Corporation] initial 10-year bond that provides a direct link to the company's sustainability performance target of achieving a 30% reduction in scope one and two GHG emissions. As I said, we've yet to see a sustainability-linked bond in Canada, but we're very hopeful in that BCE [Inc.] has just launched a sustainability-linked bond framework and is having meetings next week with investors.

LW : It's great to hear that we are investing in some of these alternatives within the funds and [it] certainly sounds like there's a lot of options. But, how does this work in terms of your investment process? How do you integrate with respect to these bonds versus your traditional debt, and as your fundamental analysis and relative value metrics differ?

SM : Yeah, that's a great question. At Beutel Goodman, we're value investors, we're not values investors. So, we don't buy any issue simply because it's just labeled green or as part of the sustainable-finance spectrum.

First, it has to go through the whole process that any corporate bond at Beutel Goodman goes through. There has to be thorough diligence on the issuer, which must be performed by the relevant credit analyst, and the issuer must be approved by the team to be put on our approved list.

Second, if it is a bond that has a sustainability-linked or ESG-type of colour to it, the due diligence must be performed on the use of proceeds in the framework from which the bond was issued. This is a way to avoid instances of greenwashing. The sustainable-finance bonds we buy must be issued out of a framework, in line with what the International Capital Market Association (ICMA) recommends. So, that means there's a process for continuous review, continuous reporting and an audit of the use of the proceeds. Sometimes, these bonds come with a third-party opinion so that the user proceeds have been audited by ESG data providers, such as MSCI and Sustainalytics.

Third, and probably most important, is that the relative value proposition has to be there. We look at the bond and if it is trading attractively and we see the opportunity for spread tightening, then we buy it. If that is not there, it doesn't matter what colour the bond is, we won't buy it.

LW : Thanks, Sue. I'm going to switch gears here. Earlier, you mentioned social bonds and when I speak to clients and consultants, that's what I often get asked about – the S in ESG. How are we engaging with companies in that respect and could you provide us with example?

SM : Engaging on the S can mean many different topics, including safety, relationships with First Nations, diversity, inclusion, cyber security [and so on]. So, to provide a few examples, a few years ago Husky Energy [Inc.] had some very high-profile safety incidents. In one incident, it actually broke their own internal safety protocols. So, we had a few meetings with management where they dug into what they learned from these incidents, what type of new operations and new procedures are they going to put in place to prevent that from happening again.

Another example would be on TC Energy [Corporation]. We've had several conversations with management over the years on First Nations involvement and engagement, especially in view of the opposition to the Coastal GasLink pipeline. In fact, we just spoke with them this week on cybersecurity. It's very topical now with Colonial Pipeline being cyberattacked and the concept of how do you prevent malware from coming in and possibly shutting down a vital pipeline network?

LW : Yeah, so tying into that and stepping back and looking at the international view, how do you think Canada is faring in all of this?

SM : Yeah, I would say right now that Europe is far ahead of North America when it comes to ESG. In fact, it's not only in the way that investors embrace and asset managers react to ESG, but it's also their regulations. There's a European taxonomy in place that provides a common framework on which economic activities can be called environmentally sustainable. The taxonomy also requires large companies to provide more detailed ESG disclosure.

This is really one of the things that we struggle with as ESG investors. Not all companies are reporting ESG-type of metrics. Not all are reporting in the same type of framework. We really need this kind of collective need to report ESG metrics that can be comparable across countries and companies.

I would say that Canada arguably has embraced ESG integration a little sooner than the U.S. has but the U.S. is catching up very quickly. As I said before in our discussion, we've seen sustainable bonds issued in the U.S. but not yet here. Both countries are working on the regulatory front.

Canada has a carbon tax program and the U.S. has the Biden green plan. This is where maybe I think the U.S. could be edging ahead of us. The U.S. Securities Exchange Commission (SEC) may become involved in mandating ESG disclosure. I think that is something that the Canadian regulatory agencies or securities regulators have to look at so we don't fall behind.

Really, it comes back to this concept of transition. Due to our natural-resource-intensive base, Canada has got to play a leading role in transition bonds. If you look at a real world example, this is why Brookfield Asset Management [Inc.] plans to raise at least $7.5 billion for a new global transitions fund. This is under the purview of [former Bank of Canada and Bank of England governor] Mark Carney. This fund is not just going to focus on renewable power and other green-type of investments. It's really to facilitate that transition from brown to green that I spoke about before. And this is really why Mark Carney has returned Canada, to lead this type of transition back in his home country.

LW : Thanks, Sue. It's such an interesting topic and I think one that continues to develop. I agree that Canada needs to continue to move forward and make sure that they say ahead or at least keep up with the U.S. I think we could probably spend hours talking about this but, unfortunately, that's all the time we have for today. So, thank you, Sue, for sharing all your thoughts today.

SM : Thank you. As you know, I love this topic and could talk about it for hours but thanks for taking your time.

LW : Thanks Sue. And to those listening in, please feel free to reach out to your relationship manager to provide any feedback or for additional questions you may have. Thanks again and have a great day.