RESPONSIBLE INVESTING **IN SOUTH AFRICAN FIXED INCOME**

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The same, but different
Many investors think of ESG considerations as primarily relating to equity investments. However, these concerns are shared by bondholders and shareholders alike. The difference is that, while lenders (bondholders) are typically first in the queue when it comes to available payments after bankruptcy proceedings, in the normal day-to-day running of companies, they do not benefit from the same powers of ownership as shareholders. For example, bondholders cannot vote to remove directors. As such, it is understandable that fixed income fund managers will approach ESG matters somewhat differently to those dealing in equities. This is mostly an issue of practicality, though, as the underlying philosophical commitment is usually the same in both cases.

Another key difference is that the domestic bond market is dominated by public entities. More than half of the debt listed on the JSE is placed by the South African government. Other issuers include state-owned enterprises (SOEs) and municipalities. Corporates, banks and listed real estate investment trusts (REITs) make up the remaining issuers. Given the limited number of issuers, and the overlap with companies listed on the stock exchange, managers tend to engage with all issuers irrespective of whether they hold their debt or not.

Of course, the government is not just a major issuer, but also the regulator of the investment industry. In South Africa, fund managers play a constructive role by engaging with government on key matters through various channels, such as the Association for Savings and Investment South Africa (ASISA), or through direct engagement with policymakers on matters such as the fiscus, corporate governance and the environment.

In the case of corporates and SOEs, where investment managers are significant providers of capital, meetings with management and written communication with boards on specific issues are key forms of engagement.

Most of the corporates that issue bonds on the local market are listed entities. This means managers can draw on their equity research process to assess how ESG factors impact the creditworthiness of issuers.

Return of capital
Ultimately, investment in fixed income instruments is premised on the expectation that capital will be returned and that interest payments are made timeously to investors. Fixed income research is therefore focused on understanding the key drivers of default and permanent capital loss. When investing, managers need to ensure that credit spreads – the yield earned over and above the appropriate risk-free rate – adequately compensates the investor for any such risks. An ESG focus can help identify such risks, along with a rigorous interrogation of company and sector-specific factors.

Engagement with companies helps to identify material ESG risks or opportunities, and the potential impact of these risks on an issuer's cash flow and balance sheet. Further, managers also factor in an issuer's willingness to engage on, and address, such concerns where they are identified. This helps to determine an appropriate risk-adjusted fair value for the instrument.

For any new issuance, managers carefully evaluate the terms of potential transactions by drawing on in-house legal expertise as well as external opinions. Legal scrutiny is arguably a much bigger feature of fixed income investing than it is in equity investing. It can play a constructive role in helping shape some of the contractual agreements by ensuring that covenants include the appropriate metrics and disclosure obligations. The main point of engagement is therefore when the instrument is issued and covenants are agreed, but of course ongoing monitoring and engagement remain important.

After issuance, companies frequently need to refinance their debt, or an issuer may seek consent to make amendments to contractual terms of existing bonds. Managers therefore actively seek ongoing direct dialogue with boards and management to better understand the ESG concerns and disclosures and the management and mitigation of financial risks. This should ultimately improve sustainability outcomes.

Dealing with asymmetries
Given the asymmetric return profile of investing in fixed income assets, credit selection is primarily focused on mitigating downside risk. As noted above, ESG engagement efforts can play a role in identifying and reducing these risks.

As the ability of fixed income investors to effect material changes is limited by the lack of voting rights, limiting the horizon of the investment is one avenue of risk management. The other, more extreme, form is simply exiting the investment when underlying risks appear to have materially increased. Finally, diversification remains a powerful tool in fixed income portfolio construction, limiting exposures to individual issuers.

The importance of engagement

As responsible investors, investment managers recognise the potential impact of ESG issues on the long-term performance of fixed income portfolios. Engagement with debt issuers on ESG practices is critical to gain additional understanding or, where necessary, to seek change that will protect and enhance the value of investments.

In some instances, engagement efforts will be exhausted without meaningful progress. If deemed appropriate, disinvestment would then be a serious consideration. In the event of an ESG/sustainability-related corporate action from an issuer, managers revert to their responsible investing policies for guidelines and clarity.

Engagement is not only about forcing change within the underlying businesses; it is also about gaining a deeper understanding of the businesses to enrich the investment decision-making process. Even when dealing with instruments with a short maturity, ongoing ESG scrutiny is important, since managers are likely to roll-over maturing debt or reinvest with the same borrower at some later stage. Addressing concerns in the short term is part of ensuring long-term sustainability. In addition, even though many sustainability factors are long term in nature, not dealing with them decisively may still reduce access to markets and funding in the short term, which will impact on fixed income investments. Therefore, active engagement with borrowers is required regardless of the term-to-maturity of the investment.

The developing market for Green Bonds in South Africa

A green bond is an instrument specifically designed to raise money for environmental- or climate-related projects While globally, green bond sales reached $575 billion in 2023 according to Bloomberg, the market for green bonds in South African has been largely untested for corporate issuers, although this is gradually changing. One of our fixed income managers was instrumental in structuring the first green bond in this country, issued by property company Growthpoint. The success of green bonds depends on their ability to help meet sustainable development objectives without compromising on credit risk and introducing significant complexity. The manager helped Growthpoint to define how the proceeds should be used, obtained the required assurances from the Green Building Council of South Africa and the auditors for the required property management system, and set the annual reporting commitments on the various green components of the buildings for which the proceeds were to be used.

In the case of the Growthpoint bond, the structure reduced the need to have the buildings transferred to a separate entity and have another green rating provider involved in the process. This ultimately reduced the cost and complexity of the issue, while providing sufficient comfort for capital markets participants. This offered particular value given the underlying credit risk and additional sustainable development benefits.