M&G INSTITUTIONAL

Focus on sustainable allocation

Are government bonds compatible with an ESG approach?

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- Any government's revenue raising and spending is likely to cover a complex range of activities.
- The benefits of government spending and policies should be viewed alongside investors' concerns about participation in other activities.
- Government bonds and derivatives can play important roles in applying asset allocation views, using easily traded, liquid securities.

Maria Municchi
Fund manager

Positives can outweigh negatives in holding government bonds

We believe that government bonds, also referred to as sovereign bonds, merit full and fair consideration for inclusion in portfolios screened for environmental, social and governance (ESG) attributes. Accordingly, within the M&G sustainable allocation strategy we expect to hold investments in government bonds. They, and their derivatives, can form an essential and liquid building block to achieving the desired asset allocation position and play a crucial role in shaping the risk and return characteristics of an overall portfolio.

We understand that some ESG investors may prefer to avoid holdings of government bonds. Such exclusions are likely to be on the basis that a government may be actively involved in, or benefits from, one or other of the "sin" sectors, such as tobacco, alcohol, gambling and armaments. Material involvement, or sometimes any involvement at all, in these industries may disqualify a corporate entity from inclusion in some portfolios, but this is often for different reasons than those being scrutinised using an ESG screen.

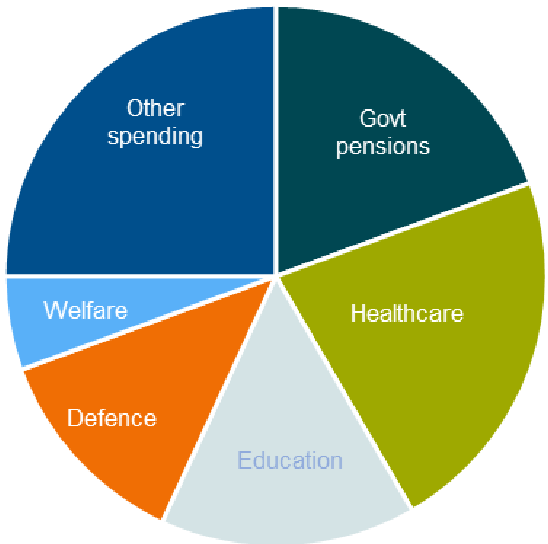
Our screening process excludes holdings in securities issued by companies meaningfully involved in the production and distribution of tobacco, alcohol, controversial weapons, thermal coal and gambling services. However, we believe that the complexities of government finances and expenditure justify applying a modified approach to government bonds.

We recognise that no government is likely to be beyond reproach if its policies and spending behaviour are considered against a standard corporate-level ESG screen. A company's activities are usually more focussed and less far-reaching than a government's, while the proceeds of sovereign bond issuance are expected to be used to serve an entire nation. Typically, the funds raised through such bond issuance are dwarfed by tax revenues and, in total, there will inevitably be significant spending for beneficial purposes, as well as activities that some investors may find less palatable.

US Treasuries are a good example because, although the US has the largest known defence spending among nations, most of US government expenditure is still on social care. If you consider US discretionary spending (i.e. the part of the US federal budget that Congress appropriates each year) more than half of it is dedicated to defence. However, approximately 60% of total federal spending is mandatory (source: thebalance.com), the largest portions being Social Security and Medicare.

Figure 1 considers US government spending for 2018. About 22% was on healthcare, 19% on pensions, 15% on education, with defence being the fourth largest component at just 12%.

Figure 1: Total US government spending for FY 2018



Source: www.usgovernmentspending.com as of 20 March 2019

When viewed through this lens, we believe that discounting investment in US Treasuries outright would not be justified. So, currently, we are comfortable holding US Treasuries in our portfolios, as most of the activities supported by that borrowing may be viewed as being essential for the functioning of US society.

It is important to note that investing in any particular government's bonds should not in any circumstance be seen as an endorsement of an incumbent political party or of its agenda, or as expressing a political view. The investment decision is merely a consequence of the financial assessment of the asset and its underlying characteristics, combined with an ESG assessment of the country relative to peers, as described below.

Investment analysis

Before investing in a government's bonds, we assess the fundamental characteristics of the country, including such items as fiscal and monetary policy, economic trends, and the political and social environment. All factors that we believe could affect the government's ability to service and repay the debt are analyzed, including a range of ESG factors.

ESG screening

Within our investment process, we screen the sovereign bond universe by ESG ratings and only select bonds that are rated BB or above by MSCI. MSCI ESG Government Ratings assess a country's ESG Risk Exposure, Risk Management Practices and Performance. They are not the same as, and should not be confused with, credit ratings provided by credit rating agencies.

The MSCI ESG risk exposure assessment recognizes that countries each have different quantities, qualities and mixes of resources to call on in their production processes, be they financial, human capital or natural materials. A country's ESG risk management and performance are measured by considering a number of factors. They include, the efficiency of its resource utilization, performance on socio-economic factors, financial management, the control of corruption and political stability, among others.

MSCI assesses the country ESG risk exposures and measures this against its ESG risk management practices and demonstrated ESG performance to form the basis of the ESG Government Rating.

We also carry out additional qualitative checks on ESG strengths and weaknesses, using research available from other institutions. Those include the World Bank, Freedom House, Financial Action Task Force and the United Nations Security Council for research relating to governance and social issues. When assessing environmental policies, we are also able to use research from other organisations such as Climate Change Performance Index, Climate Action Tracker, Climate Analytics and New Climate.

Investing sustainably in emerging market bonds

We may also invest in emerging market (EM) government bonds when opportunities arise and we apply the same rigorous ESG-screening approach when assessing these issuers as we do for developed governments. Although some of those markets might be more difficult to assess because of lack of transparency and deeper governance issues, we believe that investing in EM government bonds may be a proactive way of fostering greater sustainability in the long term. With the right incentives and structures in place, those growing economies can make significant progress both in terms of fighting climate change and generating additional benefits for their population. As an example, Colombia has been one of the key sustainability players in the international arena and supported the development of the UN Sustainable Development Goals.

Where would we not currently invest?

Some government bonds do not pass our ESG assessment and therefore we would not invest in them, even if the fundamental analysis looked appealing. Two examples would be Egypt and Indonesia in the current environment.

Egypt does not pass our initial screening, as it has an MSCI ESG rating of B. We also believe that the country does not exhibit sufficient political freedom that would allow it to clear the social and governance hurdles of our ESG assessment. Additionally, the country is not considered to be free, according to Freedom House, an independent organization that measures and reviews indicators of freedom around the world.

Despite Indonesia having an overall MSCI ESG rating of BB and attractive fundamentals, we do not consider the country to have sufficiently strong environmental policies regarding palm oil production and it lacks controls at both national and international levels. We therefore decided not to invest though we are closely monitoring further developments.

Using short positions in government bonds

We may use derivatives to generate short exposure to government bonds as part of the efficient portfolio management and asset allocation processes, in order to manage the duration characteristics of the portfolio. However, our portfolios cannot currently have negative duration at the overall level.

For example, we could have a long position on US Treasuries with 30 years to maturity and with 10 years to maturity and hold a short position in US Treasuries with two years to maturity. This position would express the view that the US yield curve is too steep and that two-year yields are likely to rise (and prices fall) relative to 10-year and 30-year yields. This position would be permitted as long as the aggregate duration level does not fall below zero.

We could also hold a short duration exposure in a specific currency to express an investment view, as long as there are long duration positions in other currencies to offset.

For example, we could hold a short position in UK gilt futures without having any other long exposure to UK government bonds or sterling corporates as long as there are aggregate offsetting long duration positions in other currencies. This position would express the view that UK interest rates are too low, given the economic fundamentals and could be a threat for long term economic stability.

Appendix: Assessments of countries we may have invested in

For some selected countries in which the strategy may hold government bond issues, we provide summary observations relating to individual Environmental (E), Governance (G) and Social (S) characteristics. Please note, this is not an exhaustive list of the countries in which the strategy may invest.

United States

E: Some inadequate policies at federal level, partly compensated for by stronger action at individual state level.

G / S: Strong democratic values with effective government and with extensive personal and political freedom. In 2017, according to The World Bank, the US had an average Worldwide Governance Indicators (WGI) percentile ranking of 85*.

Italy

E: Italy has managed to considerably reduce its energy use per capita over recent years. However targets for emission reductions, renewables and energy efficiency are not particularly ambitious.

G / S: Democratic government but with poor stability and effectiveness. Strong social security. Average WGI percentile ranking of 68.

Spain

E: Climate action policy is improving but needs to be more ambitious.

G / S: Democratic and effective government. Average WGI percentile ranking of 75.

Mexico

E: Mexico has been notably active in the international negotiations around climate change but national targets are not considered ambitious enough and have recently been diluted by government action.

G / S: Democratic government but with poor stability and effectiveness. Corruption is also an issue but the country is considered to have some measurable freedom. Average WGI percentile ranking of 38.

Colombia

E: Colombia has an ambitious and progressive position at the United Nations climate negotiations and it is on track with the process of ratifying the Paris agreement.

G / S: Colombia is transitioning into a more stable and efficient government structure. Average WGI percentile ranking of 45. The country actively promotes and aligns its initiatives to UN SDGs.

Chile

E: As part of the Paris Agreement, Chile is committed to both conditional and unconditional targets for reducing greenhouse gas (GHG) emissions**.

G / S: Effective government and rule of law. Average WGI percentile ranking of 79.

Peru

E: As part of the Paris Agreement, Peru is committed to both conditional and unconditional targets for reducing GHG emissions**.

G / S: Considered to be a free country by Freedom House, with freedom of expression and good accountability, though lacking in stable governments. Average WGI percentile ranking of 47.

South Africa

E: The new Integrated Resource Plan provides a new direction in energy sector planning, which includes a shift away from coal, increased adoption of renewables and gas, and an end to the expansion of nuclear power.

G / S: Government is effective though there some lack of stability and reliability. The country has considerable freedom according to Freedom House. Average WGI percentile ranking of 57.

Brazil

E: Brazil performs well when it is compared to other countries with the lowest energy use per capita and has very high share of renewables in the energy mix. Brazil played an active role in international negotiations in the past but national efforts have recently been more muted.

G / S: Free country with freedom of expression and accountability rating but unstable government and corruption issues. Average WGI percentile ranking of 44.

* Calculated as the average of the percentile rankings for six broad dimensions of governance: Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, Control of Corruption, ranging from 0 (lowest ranked) to 100 (highest ranked). Data provided by The World Bank.

** According to Climate Action Tracker.

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