Why we believe ESG could outperform in China fixed income

January 2024

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Executive Summary
Driven by global sustainability mega-trends, investing dynamics have evolved away from the adoption of conventional strategies toward more sustainable investment approaches. Some investors are still hesitant to make the transition due to longstanding misperceptions that returns might be sacrificed by investing sustainably as compared to conventional strategies. We argue that sustainable investing could enhance risk adjusted return in China fixed income strategies.

In this paper, we delve into why we believe environmental, social and governance (ESG) is a driver of value in fixed income investments in Asia and particularly China, not only from a risk management and technical perspective, but also in terms of credit selection.

Risk management: ESG metrics are leading indicators of potential operational and financial difficulty
Risks related to ESG issues could have a measurable effect on both a company's operations and reputation. Common ESG incidents that could disrupt daily operations and revenue generation include product safety incidents, waste or pollution spills, weather-related supply chain disruptions, unusual management alternation, etc. With the topic of ESG becoming more popular globally, any company in the spotlight due to ESG accidents faces reputational risk which unavoidably hurts enterprise value. Evaluating issuers from an ESG angle, particularly the governance angle, helps investors minimize tail and drawdown risk by excluding issuers that are particularly vulnerable in terms of operational sustainability and financial stability.

Let's take the China property sector as an example to demonstrate how ESG integration helped us reduce the scope of single name drawdowns amid the recent downturn.

The internal process of Invesco Fixed Income (IFI) requires the analyst to assign ESG ratings alongside fundamental ratings for each issuer. For the China real estate sector, we recognize that some property issuers have done a solid job in achieving environmental KPIs and constructing green buildings, while also managing social risks such as maintaining a strong safety track record. However, governance is a key factor in forming a holistic assessment. Evaluating the governance pillar requires an understanding of the relative interests of the stakeholders involved from homeowners, local governments, local suppliers, management team, investors, etc. We favor higher quality issuers who are in a better position to balance stakeholder interests. Most importantly, governance is a key factor in assessing the company's willingness to repay debts.

Under the proprietary ESG rating framework of IFI, each issuer is assigned an ESG rating from A to E (A is best, C is average, and E is worst), and each pillar of E, S and G is also scored from 1 to 5 (1 is best). An ESG trend is also assigned with Improving, Stable, or Weakening, all relative to the sector's pace. This is based on the materiality of ESG risks and opportunities for each sector and issuer, reflecting the output and progress from engagement as well.

In the case of a leading China property developer, the issuer runs a standardized business model that comprises property development, construction, management and investment as well as hotel development and management, with a focus on property development in lower-tier cities. Given its industry status, business size, and large debt outstanding, the issuer was a big benchmark name in the Bloomberg Asia Ex-Japan USD China Credit index and was the largest China property name in the benchmark in mid-2021, before China's property woes began. Based on our proprietary ESG rating framework and on-going monitoring of the issuer's ESG momentum, we had assigned the issuer an ESG rating of D since 2018, and the ESG trend was downgraded from "Improving" to "Stable" in the middle of 2023. The issuer ended up being downgraded to the high yield bucket in the middle of 2022 and then went into default in the second half of 2023, the bond now trades at single digits compared to the historical high of 90s.

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Given our concerns about this issuer from an ESG perspective, we hadn't taken positions in the name since inception (despite it being a big benchmark name). By assessing governance risk, we were able to identify and avoid issuers that are vulnerable to default risk and large drawdowns in price. Since our model portfolio was incepted in early 2021, we have also remained underweight in other China property names which later went into default. Undergoing credit selection with an additional lens on governance allows us to better understand risks that are not captured by traditional accounting metrics. This is more salient amid the current backdrop where issuers are faced with tightened refinancing conditions. Exclusion criteria and negative screening could be used to avoid issuers that fail to meet certain ESG criteria. In this way, ESG could help with risk management by negative screening and contribute to the active return of the fixed income investment.

Credit selection: Higher ESG rated issuers demonstrate higher excess return
Adopting a positive tilt toward issuers with above-median ESG ratings based on IFI's proprietary ESG rating system is also an effective tool to enhance return as it identifies issuers that meet sufficient ESG practices and standards for sustainable development (as measured by their ratings relative to their peers). An issuer's ESG inputs can usually be measured by better performance, driven by stronger employee motivation, cost savings due to a more sustainable business model or future savings in pollution taxes, or a positive response from consumers and other market players. [1]

Invesco Fixed Income research has a coverage ratio of approximately 90% of the China and Hong Kong offshore USD bonds investment universe [2], as of 27 December 2023, with ESG ratings ranging from B to D. By rescaling the excess return contribution, we could estimate the YTD excess return of each ESG rating bucket. For example, B rated issuers in the index achieved a 235bps excess return YTD, compared to 52 bps for C-rated names and -951bps for D rated names (Table 1). Therefore, we could conclude that issuers with higher ESG ratings demonstrated higher excess return .[3]

Companies with above-median ESG ratings are usually characterized by proactive consideration of ESG factors such as environmental commitment, sustainable products or processes, human capital management, privacy and data security, business ethics and board engagement, etc. We believe these commitments contribute to solid fundamental metrics of issuers and stronger conviction from investors.

Meanwhile, issuers rated as below average could be more vulnerable to price erosion under systematic or idiosyncratic risk events.

In the long run, we believe that issuers that are geared towards ESG megatrends will also benefit from stronger business profiles as their revenue base grows and they obtain a higher composition of green revenues. A stronger business profile allied with appropriate financial policy and metrics can translate into improving credit ratings over time. This is an opportunity for investors to generate excess return on the upside.

Table 1 - Invesco Fixed Income ESG rating breakdown and YTD excess return of J. P. Morgan Asia Credit China and Hong Kong Index

ESG rating bucket	Market Value %	YTD Excess return contribution (bp)	YTD Excess return (bp)
B	13.9%	33	235
C	66.6%	35	52
D	10.5%	-99	-951

Source: Aladdin, J. P. Morgan, Invesco, data as of 27 December 2023.

Hence, we believe that a positive tilt towards issuers with above-median ESG ratings is likely to bring excess return to the portfolio, which serves as an important pillar of our credit selection process.

1 PwC 2021 Global Investor Survey.
2 J. P. Morgan Asia Credit China and Hong Kong Index is used as representative.
3 Excess return is the amount of return after subtracting specific factors that are not typically within direct portfolio management control such as interest rate, carry, FX, and trade return.

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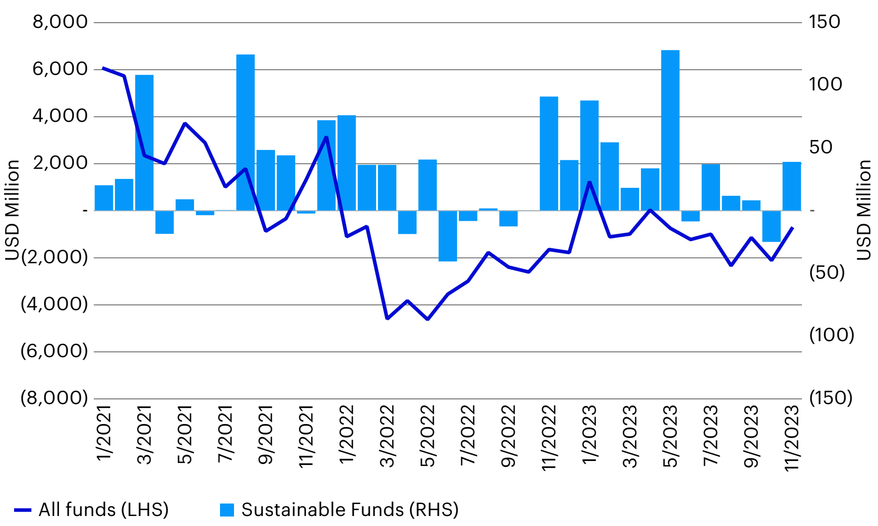
Technical support: Flows of sustainable funds show resilience amid gloomy Asia credit markets

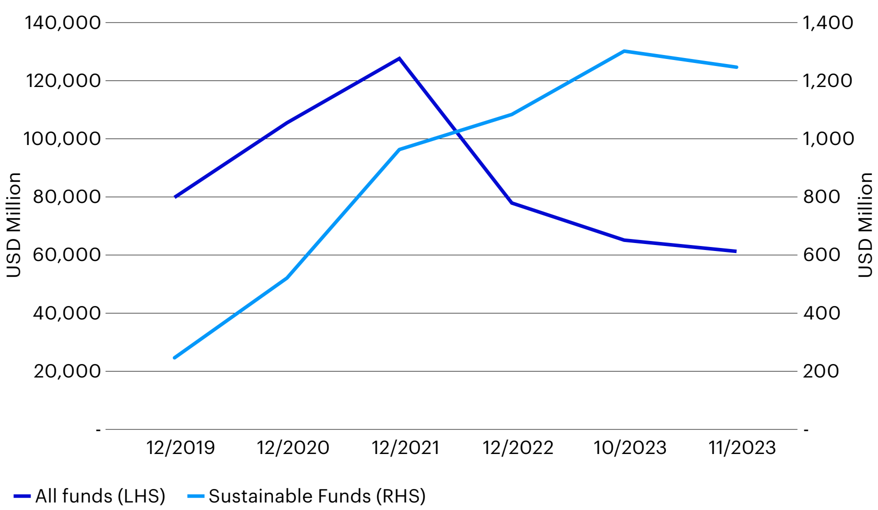
Despite the challenging macro backdrop, sustainable fixed income funds in Asia remained resilient and generated net new money for most months through 2022 and 2023. Based on Morningstar data ,[4] during the period from September 2021 to November 2023, Asian fixed income funds in total suffered net outflows for 24 months out of the 27, while the sustainable funds [5] had net inflows for 19 months out of the 27 (Figure 1). Looking at assets under management (AUM), despite the AUM shrinkage of the broad Asia bond fund universe amid the bearish market environment since late 2021 to 2023, the AUM of sustainable funds has seen an uptrend up since 2019 (Figure 2). Therefore, we believe that ESG bond funds can benefit from more resilient technical support with rising awareness and increasing asset reallocation into ESG investing.

Figure 1 – Fund flows of Asia fixed income funds (January 2021- November 2023)



Source: Morningstar, Invesco, data as of 30 November 2023.

Figure 2 – Assets under management (AUM) of Asia fixed income funds (December 2019 – November 2023)



Source: Morningstar, Invesco, data as of 30 November 2023.

4 EAA OE Asia Bond, EAA OE SGD Bond, EAA OE Asia High Yield Bond, EAA OE Asia Bond - Local Currency, EAA OE RMB Bond – Onshore, EAA OE HKD Bond, EAA OE China Bond, EAA OE Greater China High Yield Bond, EAA OE Other Bond

5 Definition of sustainable funds as defined by Morningstar.

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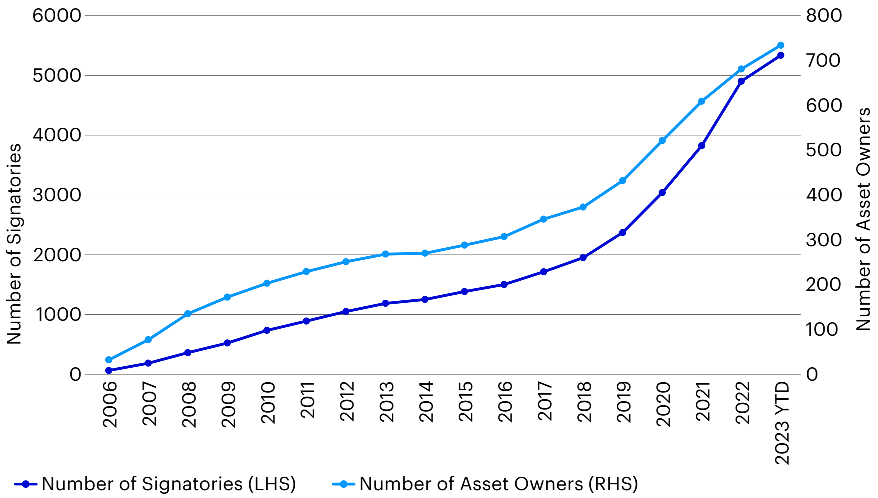
We have also seen that both the number of signatories to the Principles for Responsible Investment (PRI) and the number of asset owners within these signatories have been growing in a rapid way in recent years. Under the Principles for Responsible Investment (PRI) framework, signatories are required to understand the investment implications of environmental, social and governance (ESG) factors and incorporate these factors into their investment and ownership decisions. This suggests that many asset owners recognize that ESG factors are financially material, while a significant portion try to align their investments with their values and with broader environmental and social objectives. Undoubtedly, they would in turn expect and require their investment managers and service providers to do the same. This again underscores that we can expect stronger technical support in the sustainable investing space.

Figure 3 - Principles for Responsible Investment (PRI) signatory growth



Source: Principles for Responsible Investment (PRI), Invesco, as of 30 September 2023. The annual year ends on 31 March of each year as per PRI definition.

Investment implications

In our view, sustainable investing could serve not only as a risk management tool, but also as a pathway to enhancing long-term financial gains. Given the positive impact on risk management, credit selection and technical support, sustainable investing could bring better risk adjusted returns in the long term. The use of proprietary ESG analysis is key to add active views and lens to investments. We believe Asian fixed income investors should adopt these key thematic investment opportunities as a core part of their portfolios.

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