Fixed Income

Our primary goal is to deliver on client return objectives with a focus on the risk taken to achieve those objectives. To the extent that ESG factors can be properly assessed, and where we believe they will influence returns and risk, the Australian Fixed Income team systematically incorporates these factors in its investment framework and the proprietary fundamental analysis that sits within it.

Sustainability is integrated throughout the beliefs that underpin our philosophy:

- Countries and companies with better (or improving) ESG factors should have more sustainable cash flows (as they are more willing and able to service their debt) and make better long-term investments.
- Integration of ESG factors into our investment process will lead to better investment decisions.
- ESG risk factors need to be integrated across all levels of the portfolio: asset allocation, stock selection, implementation and measurement.
- While more sustainable is preferable to less, it's more than just the metrics. Active Fixed Income investors need to engage with the borrowers they lend to.

Our investment process incorporates ESG assessment at each stage.

At the asset allocation stage, we include modelled impacts of climate change in our country-level long run growth and inflation estimates. These include both the impact of rising temperatures on an economy's potential growth rate and the transition impacts of economy-wide decarbonisation and the shift to renewables. These adjustments then feed into our assessment of the medium term valuations of assets and the risks around them, a key input into our asset allocation process.

Additionally, we complement the ESG factors captured in our valuation framework with further analysis through our strategy research work. The impact of ESG factors on our assessment of the opportunities and risks associated with different sovereigns is particularly important, and these can influence decisions across duration, yield curve, country-relative rates and currency dimensions.

At the security selection stage, our credit analysts integrate ESG factors within their analysis of the creditworthiness of an issuer. Exposures to various ESG risk factors are analysed along with the effectiveness of a company's policies, procedures and corporate culture in addressing them. This assessment then directly feeds into our internal rating formulation, either through the adjustment of financial forecasts for the impact of the factors, or by adjusting our qualitative risk assessments.

We follow a similar approach with sub-sovereign issuers, where issuers are assessed on a relative basis on a list of relevant factors which are aggregated into an issuer ESG score. This ESG score is then a key variable, alongside macroeconomics, fiscal strategy and debt position, in determining our overall relative assessment of quality of each of the issuers.

Finally at the portfolio construction stage, we combine, implement and manage all of the exposures achieved through our asset allocation and security selection. This includes measurement and risk assessment of aggregated ESG exposures.

The Australian Fixed Income team is an integrated part of a global team of experienced investors and we leverage company-wide research and analysis into ESG risk factors. In addition, Schroders has a dedicated Sustainable Investment team which provides investment process and policy guidance with respect to ESG risk factors and assessment, as well as overseeing the development of our proprietary tools and updated ESG risk factors at a company and country level.

Our approach will continue to evolve along with research, data and technology and implementation options.

CASE STUDY

Within our Fixed Income team, our credit analysts integrate ESG factors within their analysis of the creditworthiness of an issuer. This case study illustrates one example of their assessments made at a company level against ESG criteria.

Westpac Banking Corporation: Governance insights uncover buying opportunity

All the major banks – including Westpac – have been under pressure due to the revelations of poor banking practices that were exposed in the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. More recently Westpac was the subject of legal action by Austrac, the financial transactions regulator, over non-reporting of 23 million suspect client transactions. In response to these issues we increased our forecast cost-to-income ratio to factor in increased compliance costs and IT costs to improve systems. We had also factored in a one-off fine for the failure to report suspect transactions to Austrac. These issues were offset somewhat by other measures the bank had taken over the past few years regarding increased capital and improved liquidity along with the simplification of their business. This meant there was no change in our internal rating meaning the spread widening in Westpac bonds compared to the other major banks represented a buying opportunity.

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