How Active Investment in Traditional Corporate Bonds Can Deliver Significant Social Change

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There is no question that society expects the investment industry and capital markets to responsibly allocate capital to help solve some of our biggest challenges. While equity investors may have the higher profile due to their ability to influence company behaviour through engagement and proxy voting, the corporate bond market is critically important to both raising capital and impacting strategy.

Generally, corporations tend to issue corporate bonds as a form of borrowing more often than equity issuance. As a result, corporate management teams are frequently reaching out to credit investors to convince them to buy their bonds. Although credit investors don't vote proxies, they can be a key driver of positive change.

We've recently seen the rise of different forms of 'responsible' bonds – Green, Social, Sustainability-Linked and others – which would appear to fulfill that need to make a positive difference. Responsible bonds certainly do drive positive change, but there is a strong argument that there is a significantly higher potential impact from traditional bond buyers who actively engage with companies and push for change.

Responsible bonds – a quick primer

With ESG considerations gaining more and more prominence in global capital markets, institutional investors, together with their clients and beneficiaries, continue to demand more corporate action to address those issues. One key development has been the creation of corporate bonds with covenants requiring certain favourable ESG-linked behaviours.

Original forms of responsible bonds, such as Green and Social bonds, include covenants setting out a specific set of investments that the bond proceeds must be used for. This helps ensure investors that they have driven change as the raised capital will be used for beneficial projects. Green and Social bond issuance continues to grow globally, a trend that will hopefully continue.

Taking a broader perspective on influencing corporate strategy

The influence of Green or Social bonds only extends to the specific proceeds from their issuance, which can limit their impact on corporate behaviour. For example, a coal-fired power producer with $20bn of overall debt might issue a $500m green bond to invest in one small wind turbine, driving a relatively small improvement within its overall business. Meanwhile, the proceeds from its larger, traditional bonds help maintain "business as usual."

If active fundamental credit investors in that $20bn of traditional debt elect to engage with company management they have a powerful platform to promote responsible change to overall corporate strategy.

Though perhaps an extreme example, in reality most one-off Green or Social bond issues tend to be a small part of the issuer's overall financial profile. While green and social bonds can be a source of positive change, the potential impact from engaged buyers of traditional bonds can be far greater.

Sustainability-Linked Bonds – an innovative solution

Recently we've seen the rise of Sustainability-Linked Bonds (SLBs), which include covenants that create an incentive for a company to meet defined corporate level performance metrics, by including a step-up in the cost of the debt if the performance metric is not achieved. With Green or Social bonds, the impact is limited to the proceeds from the one bond issue; in comparison, SLBs have the potential to directly impact overall corporate behaviour and targets. Although SLBs are relatively new and there has been limited SLB issuance to date, they represent an exciting innovation that provides credit investors with another important tool to enact change.

With more issuance we'll see just how committed companies are to setting and meeting demanding targets for performance improvement. Ultimately, as the SLB market grows, it will be important for active investors to continue to engage with companies to hold them accountable and ensure that any performance metrics are both tangible and relevant. Allotting outsized importance to one or two metrics may provide an incomplete picture of overall corporate behaviour and direction.

Metrics can also be gamed. Using our coal-fired power producer example, the company could issue an SLB and commit to reducing the carbon emissions intensity of its revenue, accomplishing that by buying another wind power company. Its emissions intensity will decrease, but society is no better off with overall emissions staying the same.

However, if a renewable power company buys a coal-fired power plant with plans to convert the facility to a more sustainable form of power generation, their overall carbon emission intensity may increase in the short run, but society actually benefits from lower overall carbon emissions over time. In this instance, providing debt funding through a traditional bond would reduce more carbon emissions for society than buying the SLB of the coal-fired power company that just used M&A to game its metric.

Active investors that look beyond SLBs and just one or two metrics will have the ability to provide capital funding for a wider variety of solutions to society's challenges.

Looking towards the future

The various forms of responsible bonds will likely continue to evolve and their issuance will remain a growing source of positive influence in society. However, realizing the full potential of the corporate bond market to drive change will require active fundamental credit investors that engage with companies and use their buying power in traditional bonds to influence corporate strategy.

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Daniel joined Dynamic Fund's Fixed Income team in 2009, following his role as an analyst with a boutique asset manager, where he was responsible for risk management and investment portfolio oversight. Promoted to Portfolio Manager in 2012, Daniel's focus was on credit investing across a variety of mandates. The Credit Research Team was created in 2016, with Daniel appointed its inaugural Head, responsible for fundamental credit research and analysis across the 1832 Asset Management fixed income teams, followed by his promotion to Vice President & Head of Research in 2019.

Prior to joining the industry in 2005, Daniel was a Commonwealth Scholar and earned a Master of Arts in Global Political Economy from the University of Sussex, where his graduate research focused on the risks that credit default swaps and other financial derivatives presented for the global financial system. He also earned a Master of Laws degree from the University of Toronto, with a specialization in Innovation and Technology law.