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Overcoming the Complexity of Sustainability in Fixed Income

Given the asymmetric return profile of fixed income, with limited upside and the potential to lose all your capital via default, understanding the durability of issuers is crucial. This is why understanding how a company is run, or its governance, has always factored into fixed income analysis.

More recently, investment theses for fixed income have evolved to factor in environmental and social aspects as the availability of data has increased significantly. Ultimately, the role of fixed income investors is to distil the noise from the essence of what is material to the ability of the issuer to service its debt obligations. That's because investors have the choice of how long to lend for, and whether to lend at all. The integration of nonfinancial factors into the analysis creates complexity, but there is a strong regulatory and social drive to include them.

Overcoming complexity through listening and collaboration

To overcome this complexity and distinguish the signal from the noise, asking the right questions of corporate management is crucial as fixed income investors have limited time to engage with issuers. This means the process of assessing sustainability is also about the process of listening and applying learnings to portfolio decisions. The investment thesis should include how the issuer responds to certain issues over time, which can involve a journey of asking better questions.

Fixed Income Sustainability Analysis in Action

The example below illustrates how MFS® seeks to understand the nuances and overcome the complexities of integrating sustainability factors into investment decisions and engagement activities.

Being ready when the tide turns

European defense has historically suffered because it has been grouped with tarnished sectors such as gambling and tobacco, given the consensus view of what constitutes harmful and socially unsustainable activities. In most cases, these concerns were merited, given weapons manufacturers' close links to governments — including supplying dictators and rebels — along with their dependence on outdated environmental technology against a backdrop of weak governance and omnipresent bribery and corruption. As a result, aerospace and defense predictably ended up in an exclusion bucket for many investment managers as well as financial institutions across Europe.

The European SRI Study 2018[1] found that for EU investors, 63.6% of European Union investors excluded "controversial weapons" and 45.7% excluded "all weapons." However, after the invasion of Ukraine, early indications highlight a renewed attitude on defense, with signs of a more accommodative backdrop and initiatives to realign the security and defense "strategic compass" by 2030. Now that multiple countries, particularly in Europe, have pledged to increase their defense and military spending, some investors are starting to rethink their exclusionary approach on the defense sector.

[1] Eurosif, European SRI Study 2018, page 23.

Additionally, the aerospace and defense sector will continue to play an important role in protecting people and promoting prosperity — with certain long-term projects important in stimulating economic growth across many countries. The evolution of social arguments within sustainability communities has most recently led to European defense manufacturers becoming associated with promotion of the UN sustainability goal of "Peace, Justice and Strong Institutions" because they help defend the values of liberal democracies and provide an important deterrent in the effort to preserve peace and stability. However, transformation of governments will require many years (if not decades) to implement strategic resets on defense spending (if that is even possible).

For bondholders focused on financial materiality, sustainability cannot be considered an indicator of right or wrong — and binary EU social taxonomy inclusion or exclusion does not validate moral concerns or conclusions — therefore bottom-up assessment of issuers will remain essential in determining risk/reward for bond valuations.

Consistent engagement changes thesis for European electronic systems and device manufacturer

As the Russian invasion of Ukraine gathered momentum in early April, one of our analysts reassessed our credit recommendations on a European electronic systems and device manufacturer for the defense sector alongside documenting a more nuanced, longer-dated view on ESG within the sector. The company took steps to improve its credentials, especially given longstanding governance concerns over boardroom appointments, quantified objectives and long-term targets. Bonds performed well in 2022, with a backdrop of war supplemented by a deleveraging of the balance sheet (via disposals) and an eventual credit rating upgrade.

The company has delivered on important milestones and appointments, including the appointment of a new chief sustainability officer and two new board members focusing on corporate development and social responsibility along with the implementation of new anticorruption practices. We believe management will help mitigate governance deficiencies, which, combined with strategic clarity, will improve decision making, so the company is no longer a concern from a sustainability standpoint. Given the economic changes for defense companies and improvements from a sustainability standpoint, we think the company can potentially perform well over the mid- to long-term.

To learn more about how sustainability works at MFS, please visit mfs.com/sustainability or contact your MFS representative.