THE PRINCIPLES FOR RESPONSIBLE INVESTMENT PODCAST TRANSCRIPT

THEMATIC ESG INVESTING IN THE US MUNICIPAL BOND MARKET.

WITH JASPER COX, INVESTMENT PRACTICES ANALYST, PRI, CHRISTIAN LEVEQUE, MUNICIPAL PORTFOLIO MANAGER AND STRATEGIST AT PAYDEN & RYGEL AND RUTH DUCRET, SENIOR ANALYST, MUNICIPAL RESEARCH AT BRECKINRIDGE CAPITAL ADVISORS.

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Jasper Cox

Hello, and welcome to the PRI podcast. I'm Jasper Cox, a Fixed Income Analyst in the investment practices team at the PRI. States and local governments in the US have a critical role to play in many of the environmental and social challenges we face, from reducing carbon emissions to addressing poverty. In turn, the investors who lend to these administrations through buying their bonds can contribute to the solutions. But how can this be factored into investment decisions? Those bonds are part of the US municipal bonds markets, which encompasses local administrations, government enterprises, and agencies non-profits and some private entities. It's the most prominent sub sovereign debt market in the world. Some issuers in this market have started selling labelled green or social bonds, it's earmarked proceeds for green or social projects. By their nature, municipal bonds or muni bonds for short often fund these types of projects anyway. So, what's the use of this label? To discuss these questions, I'm very pleased to be joined by Christian Leveque, who is Municipal Portfolio Manager and Strategist at Payden & Rygel. He is also a member of the PRI's sub sovereign debt advisory committee and Ruth Ducret, Senior Analyst at Municipal research at Breckinridge Capital Advisors.

Ruth Ducret

Thanks for having us.

Christian Leveque

Thanks for having us Japer.

Jasper Cox

No problem, it's great you could both be here. Some investors want to contribute to specific environmental or social outcomes alongside achieving attractive risk adjusted returns. This is what we at the PRI call a thematic approach to ESG investing. Christian, how do you go about doing this for muni bond funds?

Christian Leveque

From a philosophical perspective, we start with the assumption that, you know, total return and social impact are not mutually exclusive goals. So, we still employ an active management approach that would take many of the traditional performance and risk metrics into consideration while also providing a thematic overlay and a lens through which we view and evaluate our investment universe.

Jasper Cox

So how do you go about measuring outcomes?

Christian Leveque

Given some of the data that's available in the varying sectors and of course the fragmented nature of the market that does continue to be a challenge, but of course there are certain metrics that you look at, which would be a bit different from sector to sector. So, say for healthcare, for instance, you may look at access to hospitals within your specific area. Look at the payer mix to get an idea of the demographic breakdown of what that looks like and what type of communities you're ultimately serving. Similarly, a community college district, you look at immediate income levels and compare it to say the state-wide could be an area where demographically you're serving a community that's socially and economically underserved. Water and sewer you can look at, that's a bit more generic, but you can look at the operational efficiency and, you know, kind of the quality of their operations and the water or transportation. It will vary a bit from sector to sector. We'd probably all agree that looking at metrics that you can solidify in a quantifiable sense is really the desirable outcome. And I think as the data adaptation becomes better, you'll start to see the market follow.

Jasper Cox

So, trying to add some sort of quantifiable measurement of these outcomes. So, Ruth I'd like to turn to you now, we've just been speaking about what I defined as the thematic approach to ESG investment. How does this differ from what some people, including the PRI would call the integration approach? Because there's still a lot of confusion here.

Ruth Ducret

Thematic or outcomes based or really impact approaches are quite different from ESG integration or the risk return approach. The two concepts get often very confused both by the media, by politicians and really by people in the industry itself. When you're looking at impact, risk and reward might be secondary to impact it really depends on the investor. The key message I'd love to get across is a lot of when you're talking about ESG investing, it really depends on understanding who the investor is, and what are their objectives. Label bonds, which again means green social or sustainable bonds can be helpful in identifying bonds that align with impact investors, for example, but ESG integration on the other hand is not a product. It helps to identify long-term risks and rewards. When you're looking at ESG, you're thinking about non-financial and historically non-traditional data and information that can be used in helping and assisting more traditional credit analysis. When you're looking at an issuer there's places where the two overlap, but they really are two different concepts.

Jasper Cox

Thanks Ruth that's a very helpful explanation. Going back to the thematic approach, how does the muni bond market lend itself to this type of ESG investing?

Ruth Ducret

I would say arguably pretty much anything that is issued by a muni, you could argue, could lend itself to the thematic investing approach because what our government entities and sub sovereign entities looking to do, they're looking to benefit society as a whole, right? It really fits and aligns nicely with your environmental and your social impact approaches, but I'll let Christian probably apply more on this topic.

Christian Leveque

Sure. I would really just echo that same sentiment. We tongue in cheek refer to municipals as the original impact investment, which of course sounds good, but I think there's a lot of truth in it as well. Ultimately, the projects, regardless of which sector you're looking at, it really, the end user is the public, right? The taxpayers, the voter base, all of these projects are targeted in a sense to some measurable net benefit to society, whether it be providing clean water or access to healthcare or public education, you know, reducing the carbon footprint through encouraging mass transit and things like that. If you look at just the broad investment universe or the broad municipal index, you know, the sectors align really well with these types of projects. As Ruth mentioned, really a lot of these projects just naturally lend themselves to impactful investments in projects.

Ruth Ducret

The one caveat I would say is that what we've seen can sometimes not align well with what an impact investor might want. With municipal bonds they're generally very high credit quality. The municipalities that can issue for large projects, which are well received on a traditional credit basis are typically wealthier municipalities, wealthier cities, towns, school districts. And that might not be particularly where some impact investors want to lend their money. They want to lend their money to where they can make a greater social impact. So that's just one area where the two don't necessarily align. If you're looking at a project basis and the use of proceeds when you're determining impact on the whole, it, it aligns quite well.

Jasper Cox

So, Munis are the original impact investments of sorts, interesting point there, Ruth, where you have Munis that are quite wealthy, well positioned, but some investors looking to achieve certain outcomes may want to choose a different type of investment there. I wanted to go back to something you mentioned earlier, Christian, you gave some interesting examples of the types of investments you might look at as a thematic investor. It made me wonder how you go about balancing different types of themes or different types of outcomes, or even if that's possible at all, for example, the social in the environmental, can you sort of trade them off or do you just pick one and go for that?

Christian Leveque

It's very realistic to incorporate multiple ESG related and impact outcomes. In my opinion, the real appeal of impact investing is we do this, and I know a lot of other investors do it as well, but we start from an inclusionary perspective as opposed to say some other strategies, especially say like, think of on the corporate side, where they may start with an exclusionary basis and automatically exclude complete sectors. It provides us with an opportunity to deploy capital in a targeted way to, you know, variety of sectors and projects, each of which will differ in kind of the nature and intensity of impact. And I also think from both a product perspective in terms of, again, I manage a mutual fund to pooled vehicle, but from the investor's perspective, who's ultimately the lender. You know, it makes a lot of sense in terms of the portfolio construction as well. But I think this is a preferable approach given it allows you to more prudently diversify the portfolio to look like a traditional municipal investment portfolio would look like as opposed to potentially coming out with something that looks like a very concentrated and defined portfolio. And I do think it's possible to balance both.

Ruth Ducret

Yeah, I think it can get a little tricky in some instances, but I'd say on the whole given just how the muni market is structured and that the use of proceeds is generally used for projects like hospital bonds or capital projects on a hospital and you can generally see exactly what the use of proceeds will be used for, in terms of where they're allocating their capital and water sewers another good example, based on what the investors values are and how those align it could get a little bit tricky. I always come back to this example in Colorado county that issued debt to fund the decarbonization or really energy efficiency on a jail. In examples like that, where you have two outcomes that don't align very well with an investor's values. You could have an issue when you're solely looking at the use of proceeds. Which is why we at Breckinridge are focused on the underlying issuer and the sustainability profile of the underlying issuer.

Jasper Cox

One topic that always comes up when I speak to investors about this. And I'm surprised actually, neither of you have mentioned it yet is tobacco bonds, which is where states securitize settlement payments, they receive from tobacco companies. There's a big debate about whether these can be sustainable or not because the money is essentially coming from tobacco, but the states can do what they want with it. So quickfire question for both of you can tobacco bonds be sustainable? Christian, you first.

Christian Leveque

I love this example. We debate this often, and I'll say, you know, here at Payden and Rygel, we have a firm wide, no tobacco policy. So, we don't really invest in tobacco regardless. I think it's a fair question. And I think I could make a strong argument for a positive net benefit for tobacco bonds. Just given that yes, the revenue stream is coming from smokers, but the use of proceeds again, what it's ultimately going for is for healthcare initiative. So clearly, I think there's, you know, identifiable and measurable impact that's coming from that. Yeah, I do think that there's a, a strong argument to make that it looks obviously a bit different than say if you were buying, you know, Philip Morris corporate bond, there're two very, very different vehicles with different purposes. One thing I would just mention too, I think it's important to highlight for, you know, some listeners who may not be quite as familiar with the municipal bond market is one thing that's very advantageous to the asset class, the use of proceeds and the project and the source of funds. Everything is statutorily identified and segregated on an issuance level. So, unlike say a corporate issuer who issues a sustainability link bond that cash just still goes to their general corporate balance sheet. Contrast that with the municipal market where in a large profile issuer may have, you know, many issues that don't necessarily identify with a social or environmental benefit, but some more recent projects maybe do. And again, that's easily identifiable in their offering documents.

Jasper Cox

Good point there about the transparency of the asset class. And I think that was a tentative yes to my question on tobacco bonds.

Christian Leveque

Short answer is yes.

Ruth Ducret

I would say we have similar debates. We don't buy tobacco bonds, but one subject that we have debated is lottery bonds. It's another example where the bonds are backed by people purchasing lottery tickets or betting, which is gambling a vice, but it's funding education, which is, you could put it squarely in the S category, which again, as a ESG integration shop, we find it easier to reconcile.

Jasper Cox

Turning away from the sin sectors, as fun as that is to discuss. We've alluded to, or well mentioned labelled bonds, but we haven't gone into them in much detail yet. What's the role of labelled bonds in this market? Given, as you say, the use of proceeds is fairly well defined and often very thematic anyway.

Ruth Ducret

The label bond market is growing extremely rapidly, S and P put out a report in February of this year. They said that they expected labelled municipal bond issuance to be up to 60 billion in 2022. And that's up from 46 billion in 2021. So, it's really growing. And I think that the sky's the limit in the municipal bond market, because so much of the use of proceeds fits so nicely into either the E and the S and frankly the G, but mainly E and S things that maybe in the past hadn't been labelled are getting labelled now. Massachusetts recently, I don't actually think that they brought the bonds to market in the end, maybe I think they put them on hold, but these unemployment bonds where they labelled them as social or you'll see school districts now labelling their bonds as social, where they might just have been building a school in the past. There's a lot of runway for these kind of labelling, they're important because they allow you know, for easier identification and a wider investor base that can participate in these labelled bonds. Oftentimes there's a third party or a second party that's verifying that these bonds meet what's called these IKMA principles.

Jasper Cox

IKMA is clearly a key player here. How do they define what's a green or social bond is?

Ruth Ducret

The market has really coalesced around IKMA as the standard of what's going to be labelled green, social or sustainable. Therefore, pillars are centred around the use of proceeds than the process for project evaluation and selection. And I think this is sort of more aligned with ESG integration. This is where you might see more holistically what an issuer is doing, not just on a project-by-project basis, but their overall ESG approach and philosophy. And then they talk about the management of proceeds, which is easier in the municipal market. As Christian was discussing earlier, the proceeds are rank fenced around a particular project, and then ongoing reporting is also another pillar providing ongoing reporting of the project and how the proceeds have been used.

Christian Leveque

I would just jump in real quick and just add a couple things. As Ruth mentioned, the growth and label bonds has been pretty prolific. I mean, you've seen over the last five to seven years, a tremendous amount of growth there. One caveat to that I would say is a little over half of that issuance tends to be concentrated to some of the very largest issuers in the marketplace. I don't say that in a negative light either. I mean, I think if you think about say governance and disclosure, right, I mean the largest issuers have over the same timeframe have also pushed better practices in governance and disclosure practices as well. So, I think it's common to see the largest issuers leading with best practices, which of course trickles down to, you know, some of the smaller sectors in the market, which is only a benefit to investors and analysts as you get, you know, more and better information.

Christian Leveque

Identification is a big deal and especially as the municipal market becomes more of an international market, I mean traditionally it has been a bit of a sleepy market. And prior to the global financial crisis, most bonds were insured it was looked at as, almost more of just kind of a tax advantage rates product as opposed to a credit product. But now it is looked at as more of a credit product. And you've seen a lot of European interest in municipal issuance, especially on the taxable side one because they get favourable risk waiting on investing in infrastructure projects. And then again, the labelled bonds are very beneficial to the European investors because they, at this point, they're required to kind of explicitly define how they take ESG considerations into their investment process. So again, I think as you see the depth and the breadth of the market increase, the label, bonds are clearly advantageous to some of the investor base who traditionally may not have been quite as involved with the product.

Jasper Cox

And Ruth, you mentioned that third party reviewers come in sometimes and assess these bonds on behalf of the issuer, but that's not always the case. And actually, the muni bond market, they quite a lot of bonds, which are self-labelled where essentially the issuer is you could say almost marking their own homework. Is that a problem? How do you think about the self-labelled bonds?

Ruth Ducret

The municipal market is developing, we're still sort of at the beginning stages of the labelling and it hasn't all been flushed out yet as compared to the corporate market, which is certainly more advanced, I would say, just in terms of how long they've been labelling and how stringent the market expectations are. So, for the municipal market, I've seen some Munis issue bonds where they literally have the word green in their title of their offering statement. And that's the only time the word green is mentioned. And then there's others where they are explicit, and they label themselves or self-labelled as green. But then they're closely following all the IKMA guidelines and giving a really large breadth of underlying disclosure, which is extremely helpful as an investor. And then there's a growing segment of the market that is relying on third party verification.

Ruth Ducret

As a ESG integration analyst, not someone that's looking at impact necessarily, what I want to see that if they're self-labelling that they're giving a nice amount of disclosure. The third party verification helps and, you know, they write a lot and have a nice summary, but for me, you know, I'm doing my own credit research and so it's not essential that I see the bonds labelled. The municipal market as a whole is moving more and more toward the labelling and also the third party. Although a lot of people say second party verification because it, it just gives a, you know, it's an easy stamp of approval. It's cleanly shows that someone else has looked at it, verifying that you don't have to rely just on the issuer.

Jasper Cox

I like the idea of an issuer writing green on the first page, and then hoping that no one will go beyond that. That's why we are the, PRI always tell investors to do their due diligence on these labelled bonds. Christian, do you have anything to add on the topic of self-labelling.

Christian Leveque

Ruth, you know, really covered a lot of it. I mean, I would say at this point, again, as she mentioned, the market is still developing and in kind of the way that they're going to treat this, I've seen kind of both ends of the spectrum. I've seen some projects where in talking to the issuers, leading up to it and the, and the bankers and so forth, they've considered getting to the second- or third-party designation. We're really essentially told that they would qualify for, but ultimately decided one, not to choose a third-party labelling, but two just decided not to label it as green bonds at all. And then as Ruth mentioned, you have the, the opposite end where, you know, they put green in the title and then they have pretty much nothing else. It does still span the spectrum. And I think there isn't one consistent set of standards that everyone has adopted just yet.

Christian Leveque

Some issuers remain cautious of how they want to go about doing this, but clearly the market is, is trending in that direction. Again, the, the labelled one makes it easily identifiable. And two, it does give that stamp of approval, especially for people who don't necessarily have as deep credit research bench, you know, maybe doing some individual investing or things like that. I mean, the municipal market is unique in the sense that individual investors still dominate the market, which of course is unique to the asset class. We'll still see things trend in that direction, but the label to us is less crucial. We're doing our own work, as Ruth said, she is. And, for us, it's more about disclosure practices, the information we're getting and, and not only at issuance, but the continuing disclosure and development of best practices that we see from the issuer going forward.

Ruth Ducret

And I think that's the struggle for the issuer is these third party or second party verifiers. It costs a lot of money and is the juice worth the squeeze? You know, is it really worth it? If they're going to sell their bonds at pretty much the same rate as they would, if the bonds weren't labelled, because right now there's not widespread agreement as to whether or not there's any pricing differential between a labelled bond and a non-label mini bond, the greenium.

Jasper Cox

Yes, the greenium to throw another definition in the mix.

Ruth Ducret

Yes!

Jasper Cox

I think we are just about out of time. It's been a great discussion. Thank you for joining Christian and Ruth.

Christian Leveque

Thank you. Japer we appreciate you having us on the podcast today.

Ruth Ducret

It's a pleasure to be here. Thank you.

Jasper Cox

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