Lower credit risk observed in sectors that are positively aligned with the SDGs

March 2020

The United Sustainable Credit Income Fund invests in the RobecoSAM SDG Credit Income, which is managed by Robeco Institutional Asset Management B.V., an investment specialist in sustainable investing and a subsidiary of ORIX Corporation Europe N.V. (formerly known as Robeco Group N.V.). The following paper "Lower Credit Risk observed in sectors that are positively aligned with Sustainable Development Goals" was contributed by Robeco and was first published in November 2019.

Robeco's analysis of historical performance data confirms that in practice: credit sectors with positive or neutral Sustainable Development Goal (SDG) scores have less downside credit risk than those with negative SDG scores.

Identifying the companies of the future

Our view is that incorporating the SDGs in an investment strategy creates awareness of the potential additional sources of risk for the portfolio. Launched in 2015 by the United Nations, the SDGs have become a widely adopted framework for assessing the ESG-related behaviour and sustainability characteristics of companies. Those companies and sectors that offer solutions to help achieve the SDGs may well be the winners of the future - as well as being attractive investment candidates. Conversely, those companies and sectors that do not work towards the SDGs could face severe operational and financial repercussions, including fines, license withdrawals and reputational risk that ultimately could detract from their investment appeal.

To capture these benefits and to help manage the risks, Robeco uses a proprietary SDG screening methodology based on the RobecoSAM SDG framework, which is the starting point for its credits selection process. It is a three-step methodology that looks at what the company produces, how it does so, and whether it is involved in any controversies. The use of SDG screening for credit issuers results in a set of SDG scores, ranging from -3 (for issuers with a high negative contribution to the SDGs) to +3 (a high positive contribution to the SDGs).

The SDG screening excludes individual issuers with a negative rating and only invests in issuers with a neutral to positive SDG rating. The outcome of this screening process is that 24% of the investible universe has a negative score, and is thus not eligible for SDG investing.

Matching SDG alignment to financial performance

To test the observation that bonds from companies that contribute positively to the SDGs tend to perform better than bonds from companies that make a negative contribution, Robeco looked at data on 50 credit sectors going back five years[1].

Using the SDG scores generated by the SDG screening methodology, Robeco mapped sector-wide SDG scores to the Barclays sector indices.

Sectors were then aggregated into three theoretical portfolios: one made up of sectors with positive SDG scores (from +1 to +3), one consisting of sectors with neutral (zero) SDG scores, and one with sectors that have negative SDG scores (-1 to -3).

Who's positive, then?

Of the 50 sectors analysed, 10 sectors received a negative SDG score (e.g. automotive, aerospace, defence, tobacco and gaming industries). A further 17 sectors received a positive SDG score (e.g. telecoms, banks, grid operators and healthcare/pharmaceutical companies). The remaining sectors received a neutral score.

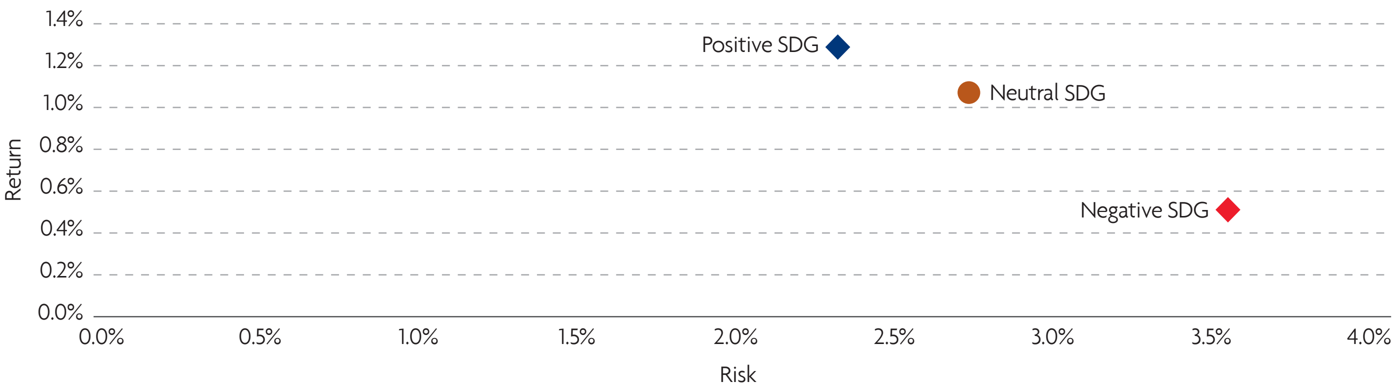
Sectors with a positive or neutral SDG rating had a superior risk-return relationship compared with sectors with negative SDG scores.

The findings show a striking difference in the performance of the SDG-positive sector relative to the SDG-negative sector.

Superior risk-return ratios, better default performance

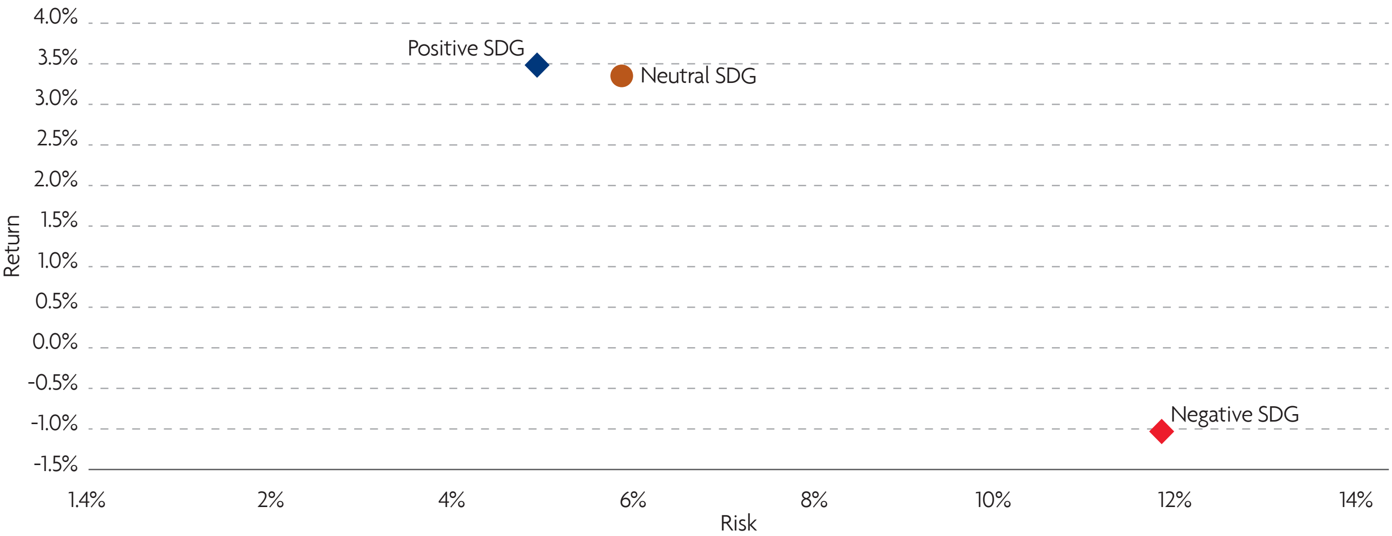
The data shows that, over the past five years, sectors with a positive or neutral SDG rating had a superior risk-return relationship compared with sectors with negative SDG scores. In other words, risk was lower without returns being diluted. This finding held for both investment grade and high yield credits. The difference between positive and neutral sectors on the one hand and negative sectors on the other was more pronounced for high yield credits.

Figure 1 | Investment grade credit: risk-return, five-year history, 30 September 2014 to 30 August 2019



Source: Barclays, and Robeco calculations based on the global IG universe. Data up to August 2019, five-year history. The above chart is for illustrative purposes and does not represent the performance of any specific investment strategy.

Figure 2 | High yield credit: risk-return, five-year history, 30 September 2014 to 30 August 2019

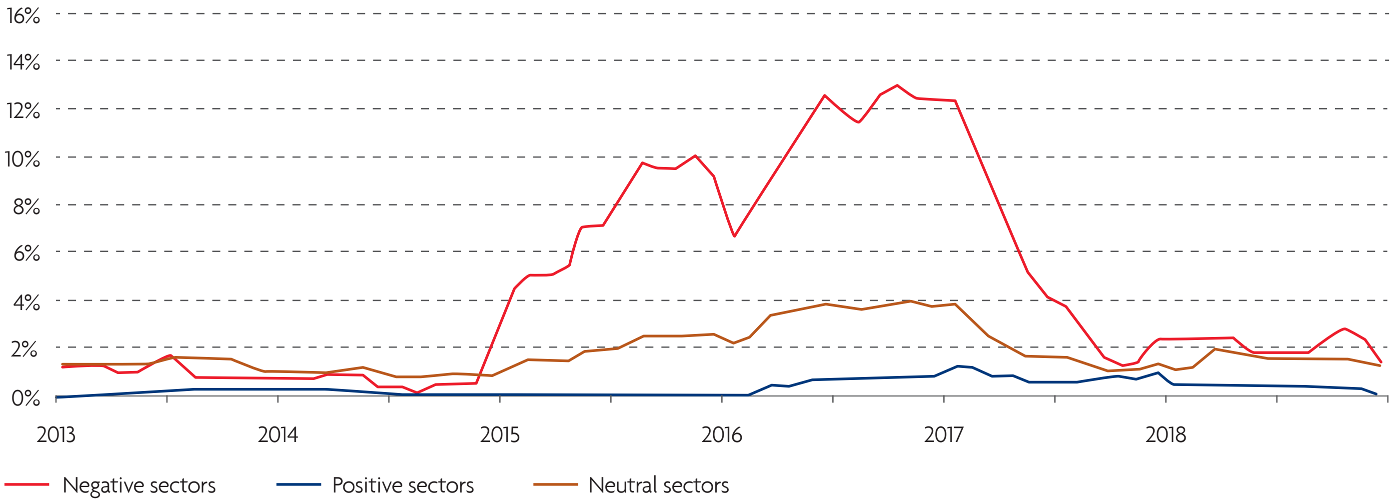


Source: Barclays, and Robeco calculations based on the global High Yield universe. Data up to August 2019, five-year history, 30 September 2014 to 30 August 2019. The above chart is for illustrative purposes and does not represent the performance of any specific investment strategy.

The finding of a better risk-return profile for positive and neutral SDG sectors is a result of lower credit risk compared with the sectors with negative SDG scores. And, importantly, this risk reduction is achieved without sacrificing returns.

Lower portfolio risk is also reflected in the relative default performance. Examining data for the past five years shows that, over time, sectors with a positive SDG score have lower default rates than neutral sectors. Furthermore, positive and neutral sectors have lower default rates than sectors with negative SDG scores.

Figure 3 | Rolling 12-month default rates



Source: Barclays, JPMorgan, Bank of America Merrill Lynch and Robeco calculations Data from 1 January 2014 to 1 December 2018, five-year history. The above chart is for illustrative purposes and does not represent the performance of any specific investment strategy.

Building more granularity: Looking at the detail and not only the sector

It is important to qualify that the above analysis focuses only on sector performance and not on the performance of individual credits. In the SDG measurement framework, a three-step screening process is applied to arrive at SDGs cores for the individual companies. If a sector has a negative SDG rating, the entire sector is not avoided. Instead, the sector score is the starting point, from where the issuing company is evaluated based on what it produces, how it does so, and whether it is involved in any controversies. This process could result in a changed score, based on how well the company is aligned with the SDGs.

Robeco's empirical analysis that maps sector-wide SDG scores to sector performances shows a positive link between healthier portfolio performance and neutral-to-positive scoring on sustainability. This relationship can be analysed further in future when there are more data points. In particular, it will be interesting to perform the analysis at company level, especially for those sectors in which there is a wide range of SDG scores for individual issuers. In the meantime, these findings reveal that incorporating sustainability criteria in the credit selection process can help build robust portfolios that perform well financially.

Notes:

[1] Robeco focused on a five-year research period as this overlaps with the period since the introduction of the SDGs in 2015.

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