Issuers, Impact and ESG: Calvert's Fixed Income Research Process

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Boston - In our experience, considering environmental, social and governance (ESG) factors, along with traditional fundamental research, is critical in evaluating the quality of an issuer and the risk-versus-opportunity profile of a bond.

Overall, we believe an issuer's long-term outlook is incomplete unless a company reveals how financially material ESG factors are recognized and controlled by management — something Calvert's research process addresses, along with societal impact.

In our view, the Calvert Research System sets us apart in its depth of coverage, focus on materiality and inclusion of comprehensive, diverse data sets. Integral to this process is a commitment to working with issuers to evaluate, identify and move the bar toward better ESG outcomes.

Our Initial Assessment

The nature of Calvert's communications with debt issuers is typically specific to a bond being issued and usually takes place at the time of issuance. We focus on the project, deal structure and assessing and potentially influencing project eligibility criteria for sustainable debt securities and ESG commitment level. This type of interaction often flows from — or is conducted in tandem with — our research process and extends most often to issuers with limited disclosure. It serves the critical, dual purpose of helping us make investment decisions and assisting issuers with identifying areas for improvement.

We also advise certain green bond issuers who provide direct impact investment opportunities, and believe the demand for sustainable fixed-income securities will accelerate in the public sector. In our view, having this kind of voice is necessary to encourage the overall growth of impact bonds among issuers while also ensuring their integrity is supported by structure and scalability.

Direct Impact or Green Bonds

In the debt market, direct impact investing is often associated with green bonds, which fund projects in areas such as climate change mitigation, adaptation and resilience. Calvert's traditional working categories for green bonds are:

- Green projects — Where proceeds are directed to meeting green challenges, such as providing renewable energy resources or facilitating low-carbon transportation. Labeled green bonds fall under this category.
- Solution providers — General obligation bonds from corporate issuers who derive a majority of revenue from clean or environmentally beneficial technologies, products or services, such as renewables or water-efficiency technologies.
- Environmental leaders — General obligation bonds from issuers who demonstrate leadership in material environmental issues and, thereby, elevate industry norms.

As the market has evolved, social, sustainability and sustainability-linked bonds have emerged as supplementary sustainable debt mechanisms. Regardless of how a bond is labeled, all are not the same quality, and issuer commitment to overall ESG concerns varies widely.

This underscores the need for granular understanding at the project and issuer level, achieved through the kind of independent, proprietary research Calvert has conducted for years. We believe this depth of assessment is critical, as it uncovers areas for discovery or improvement and fosters effective, targeted communication of our perspectives with bond issuers, as illustrated in the following examples.

Example 1: Issuance criteria outside the norm

We often provide feedback or request additional information from an issuer whose eligible project criteria fall outside standard market practices. For example, one real estate issuer's green financing framework differed from its peers in its guidance for the time required to allocate the bond's proceeds. The issuer also had set minimum energy efficiency criteria for project eligibility that deviated slightly from those set by other real estate issuers that operated different property types. Discussions revealed the issuer's project eligibility criteria were based on "best results" seen from previous energy efficiency projects — outcomes they were seeking to replicate more broadly. We also learned they desired a longer time frame so the bond's proceeds could be directed to future, large-scale green projects, rather than refinancing existing assets. In our view, issuer intention around use of proceeds and a project's overall impact on a company's ESG profile are key issues when evaluating a bond for investment.

Example 2: Addressing controversies

Calvert routinely monitors issuers across several criteria, including evidence of substandard reporting, existing controversies related to eligible green assets or the issuer's overall environmental performance. In one instance, a securitized, residential solar-bond issuer faced controversy over how it was reporting its contracts to credit bureaus. We asked the company for its perspectives on the issue, and what it was doing to mitigate the problem. The issuer relayed reporting constraints that led to the controversy and how it had changed its business model in a manner likely to avoid future occurrences. This discussion provided Calvert with a better understanding of the scope of the controversy, as well as insight into the risks of similar disputes going forward.

Example 3: Guidance on best reporting practices

Often Calvert will engage with both green bond issuers as well as related underwriters to improve the general quality and information available to the market. Recently, Calvert expressed concern to an automotive issuer over its project eligibility criteria and provided guidance on defining low-carbon transportation assets in line with 2050 net-zero targets. We outlined the information investors need to calculate the estimated impact of green notes. An improved understanding of the issuer's limited optionality with regard to eligible project categories helped Calvert better determine portfolio eligibility.

Bottom line: Regardless of the ultimate decision on a particular security, Calvert utilizes its rigorous research processes to capture materially relevant data and gain greater insight into a bond, as well as advise issuers on project structure, financing and impact. We believe these efforts also encourage the ongoing growth of the green bond market.

The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. As interest rates rise, the value of certain income investments is likely to decline. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. Investments rated below investment grade (sometimes referred to as "junk") are typically subject to greater price volatility and illiquidity than higher rated investments.

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