

ESG Factors in Fixed Income Investing

The Fiera Capital Approach to Municipal Bonds



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Fiera Capital has a deep and long-standing commitment to the \$3.7 trillion US municipal bond market, an important source of financing for infrastructure, hospitals, education, and other public purpose capital projects. We also have a deep commitment to the \$5 trillion US investment grade corporate bond market and its wide range of utilities, industrial, and financial companies. Our investment process emphasizes a thorough and intensive credit analysis of every issuer and borrower whose bonds we purchase on behalf of our clients. We have found that the integration of environmental, social and governance factors (ESG) can be a valuable and informative part of the investment process. It is our thesis that a consistent and formal examination of ESG factors, in conjunction with traditional financial metrics, can measure risk more broadly. Fiera Capital's portfolio managers may use this additional tool to select securities for their clients.

Judy Wesalo Temel
Senior Vice President,
Director of Credit Research

As this field has evolved, it is important to understand the language that defines the spectrum of ESG investing in the municipal bond market. One of the challenges that we have encountered is that ESG terms are not standard throughout the corporate industry, let alone the municipal side of the world. We view this an opportunity to shape the discussion and criteria as it evolves, utilizing our investment experience.

What are Environmental, Social and Governance Factors for Municipal Bonds?

At this point there is no specific guidance on assessing American state and local governments or the other range of borrowers in the municipal market in the UN PRI. While we believe that publicly financed infrastructure as a whole can benefit the greater good, our municipal ESG analysis seeks to identify attractive issuers from an ESG perspective. So, we constructed analogous municipal factors to the established corporate factors by assessing specific, material ESG issues on a sector by sector basis. We consider that governance drives the organization's values and culture, be it corporate or government, and sets the tone for management oversight of activities, including social and environment standards. Because of this, our proprietary model assigns the highest weights to governance factors, including disclosure, purpose and essentiality of the project being financed, legal security and debt and pension levels.

Fiera Capital's value add and analytical focus is on the systematic and explicit integration of ESG factors into the financial analysis of an issue, coupled with stakeholder action and corporate engagement. This is what we are committed to looking at, over time, across all our holdings. In addition, in partnership with our clients, we can customize portfolios to reflect a client's values, including sustainability themed and impact investing.

We developed specific metrics relevant to municipal issuers and weighted and scored each against a national range. For each municipal sector-state GO, local GO, water and sewer, electric utility, higher education, transportation and health care- we gave governance the same weight in our proprietary model, but we weighted the environmental and social factors differently, based on what the issuers in the sector do. For example, an important environmental metric for water issuers is the percentage of specific elements in the water used to determine water quality. For transportation issuers, the metric may be an airport and its surrounding areas' air quality.

Social factors can include the taxation impact, demographics, distribution of services and affordability. Based on the municipal sector we may use anywhere from four to ten sub measurements for each of the environmental, social and governance factors. A final score is calculated for the issuer. Because our core credit research is thorough and broad, most of the state and local governments we have approved should also score high on our ESG scale. Municipal issuers that score lower tend to have well-known, specific and identifiable problems. However, when viewed through an ESG screen, which places a greater emphasis on governance and policy priorities and objectives, some issuers may have lower ESG scores as the analysis reveals issues not captured by standard credit analysis based on financials.

For example, a highly rated electric utility security which passed through our robust credit analysis of financials, would score lower on an ESG basis due to a heavy reliance on coal as an energy source. And a state GO which we might deem at little risk from a default perspective, would score lower on an ESG basis due to a declining population and poor investment in health care. Material ESG factors can provide insight into challenges an issuer may face that could have important ramifications for the community supported by the issue or the security's long term performance.

Executing Impact Investment within Municipal Portfolios

In addition to developing our ESG factor analysis framework, we have created a methodology to execute impact investment within municipal portfolios based on our investors' preferences and values.

The Impact Strategy incorporates ESG factors for the initial credit analysis and selection, but goes a step further to examine the impact the issue may have on the world. Municipal bonds can impact communities from both the input side (via taxation impact) and the output side (due to use of proceeds). We believe this holistic approach is important because while the achievements and benefits from a bond financing may take time to develop, the taxation burden is immediate.

Our baseline Impact Strategy is focused on promoting social well-being and equality by investing in bonds with purposes including but not limited to education, health care, affordable housing, mass transit, clean water and others. Additionally, we analyze the extent of the tax burden. Is it progressive (e.g. income tax) or regressive (e.g. sales tax)? Does it encourage energy conservation (e.g. gas tax) or healthy lifestyle choices (e.g. cigarette tax)? The answers to these questions are an important measure of the immediate impact of a municipal issue on the population paying the taxes to fund it; an impact we believe is equally important to the use of proceeds for a portfolio with a goal of promoting equality.

ESG Examination of Municipals is a New Frontier, Driven by Increasing Investor Demand

While ESG investment has come a long way in other asset classes, there is more work to be done in the municipal bonds market. As ESG investment is more widely embraced in municipals, the factors may become increasingly important in the valuation of securities. Our ESG framework allows us to stay ahead of this developing trend and provides our portfolio managers with an additional tool to identify risk and opportunity in the municipal bond market.

The building of our ESG and Impact analysis frameworks, and the continuing expansion of our database of ESG and Impact examined issues, expands our ability to deliver customized portfolios seeking to meet a more inclusive set of investor goals.

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