Saturna White Paper: Sustainability Series

ESG Tilts

Active managers of fixed-income portfolios who seek to reduce risk exposure and achieve favorable positioning with regard to an industry, company, or particular issue may want to increase their consideration of environment, social responsibility, and governance (ESG) factors. We like to call this type of integrated finance "ESG Tilts" because it helps the portfolio lean in the direction of sustainable businesses with low ESG risks. ESG tilts can also promote expression of investment conviction or an ESG view through the intentional structuring of the fixed-income portfolio. To illustrate how ESG tilts, in practice, can contribute resiliency to a portfolio, we examine BP's Deepwater Horizon environmental disaster as a case study example.

SATURNA
SUSTAINABLE FUNDS

Introduction

Integrated finance, which examines a firm's environmental, social, and governance (ESG) record alongside its financial data, can help uncover risks left in the shadows by traditional bond rating methodologies. But if we adopt a practice of fully analyzing and incorporating a firm's overall ESG attributes, are we implying that ESG risks are constant across a firm's entire capital structure? Another way this may be considered is this: are equity shareholder considerations the same as, or even in harmony with, bondholders' interests when it comes to ESG considerations? And if ESG considerations for fixed-income investors do differ, what additional factors should fixed-income managers consider in their investment process?

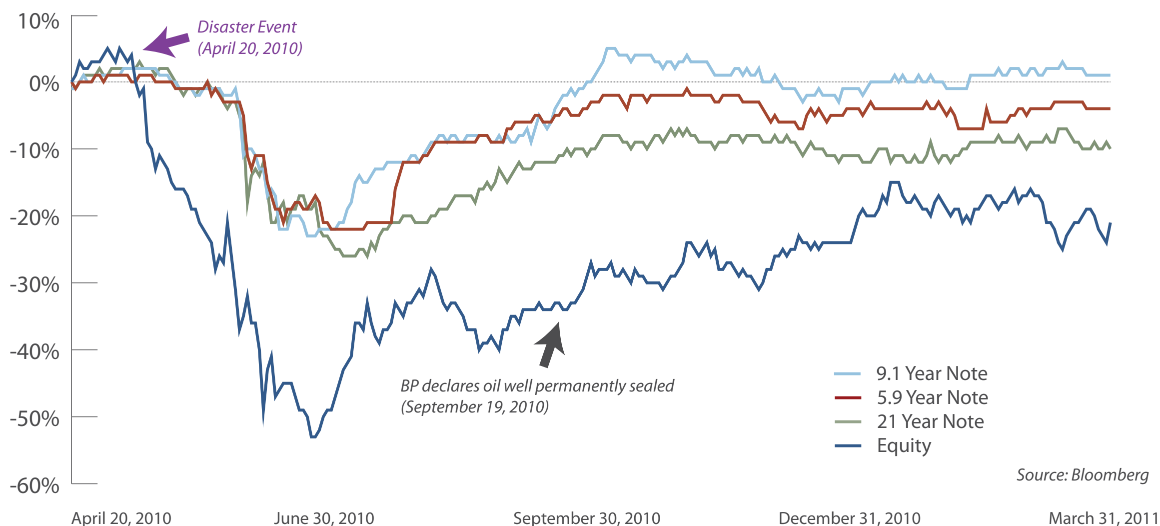
From an ESG risk perspective, we find that equity shareholders and creditors have more shared interests than differences. Long-term investors seek enterprises that demonstrate favorable performance; and favorable fiscal and operational performance is predicated on good stewardship characteristics in matters of corporate governance and broad stakeholder engagement. While these shared interests serve similar degrees of self-preservation, it doesn't mean that shareholders and creditors are looking at the same side of the balance sheet. Instead, it is important to acknowledge that economic benefits accrue differently to each asset class, and lend themselves to inherently different risks and rewards.

ESG Events

The 2010 explosion of BP's Deepwater Horizon offshore oil well and subsequent oil spill exemplifies a substantive "ESG event" offering evidence that bondholders and equity shareholders need to proactively consider ESG factors collectively while also considering how each asset class can be affected individually.

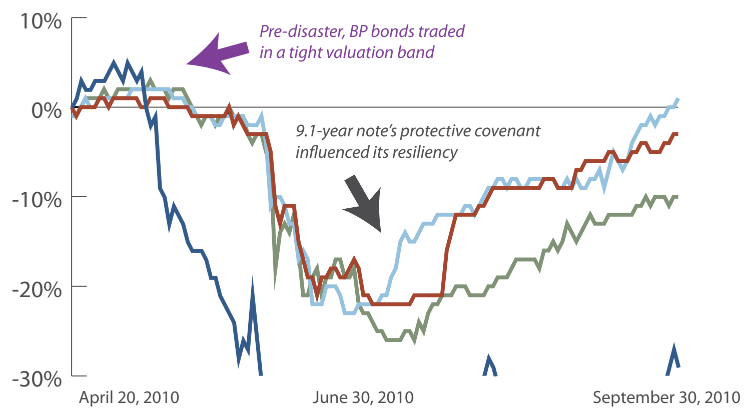
Following the event, BP's equity valuation progressed on a rapid, perilous descent – its value declining in excess of 50% – as questions surrounding the company's legal and environmental obligations grew. The public's shock soon reached political center stage, prompting President Barack Obama's administration to order a hold on the issuance of new offshore drilling leases[1] and to authorize teams to investigate 29 oil rigs in the Gulf of Mexico to determine the cause of the disaster.[2] The question of BP's ability to retain any claim on future drilling lease rights emerged as a legitimate concern for investors. BP's equity value bottomed out and eventually began a slow, upward rise after BP officials declared the oil well "completely and permanently sealed" some months later on September 19, 2010.[3]

British Petroleum: Securities Valuation Change During Deepwater Horizon Disaster



While BP's debt securities track a similar pattern – declining steeply in value and later rebounding – the bonds offer important cues for fixed-income portfolio managers to proactively integrate ESG considerations in their security selection. Attention to these matters may not only make a substantial difference in reducing risk, but more importantly, may improve "investment resiliency" to external, material ESG factors that can inhibit performance. On April 2, 2010, 18 days before the disaster, BP's fixed-income securities traded in a relatively tight valuation band – that is, slightly above each security's market value – but then bottomed out in late June. At this point each of the fixed-income securities began to break away from the tight valuation band, creating a disaggregated return profile that reflected their underlying governing covenants.

A fixed-income security's price recovery progression is not driven solely by its duration to maturity, as most tend to expect, but rather by the security's individual and unique covenant features. The 9.1-year note experienced the most pronounced price rebound, followed by the equity securities, and then the remaining bond issues, sequenced by their respective durations. It is interesting to note that the 9.1-year note later traded at a premium after the formal announcement of the oil well's being permanently sealed.

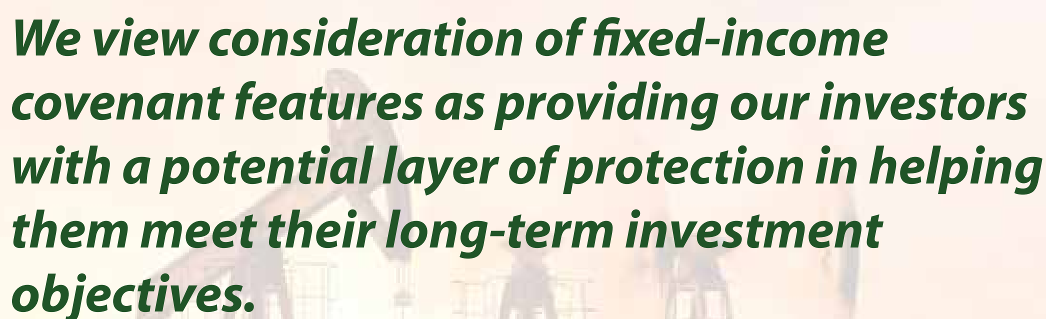


The Devil is in the Details

Charles P. Normandin and Robert E. Scott's article *The Changing Nature of Debt and Equity: A Legal Perspective of How Shareholders and Creditors Interests Are Served From a Corporate Governance Perspective* establishes an important framework for how to think about the legal regulation of debt and equity and discusses how creditors form contractual relationships with debtors by establishing "contract rules" – that is, by forming specific covenants embodying the tenure of the engagement.[4]

Why the 9.1-year note's price recovered rapidly while BP's other debt issues followed a more traditional duration-linked trajectory requires a detailed examination of their respective covenant features. The old adage that, "the devil is in the details" bears a good deal of weight and merit when it comes to fixed-income security analysis. Covenant features can differ by security, even from the same issuer, in part to reflect legal evolution and market lessons learned.

Of the four notes outstanding at the time of the accident, only one was issued directly by BP (in May of 2009), while the other securities were issued by Atlantic Richfield Company (ARCO) and later acquired via BP's purchase of ARCO in 1999.[5] Due to the different sponsoring issuers, different covenant features exist between the bonds. Embedded in the securities' prospectuses, investors who perform their due diligence find the 9.1-year note contains a distinguishing restricted payment covenant feature governing how the company may deploy its cash proceeds. Typically, a restricted payment covenant aims to prohibit disbursement of cash payments until the bondholder is paid first. This ensures the bondholder's claim priority to cash that may otherwise be allocated to a subsidiary, corporate treasury activities, early debt redemption, or stock dividends to equity shareholders. The restricted payment feature can help clarify first priority within a company's capital structure and in the company's "waterfall" of cash disbursements. The tight valuation band in which BP's debt securities traded before the Deepwater Horizon's explosion essentially masked the intrinsic value of the restricted payment covenant. Expressed in another way, before April 2010, the market appears to have placed no extraordinary or meaningful additional value to the 9.1-year note's distinguishing covenant, a feature that ultimately provided resiliency and a significant valuation premium benefiting astute investors after the onset of the environmental disaster.



We view consideration of fixed-income covenant features as providing our investors with a potential layer of protection in helping them meet their long-term investment objectives.

This key covenant feature became an important performance driver along the note's valuation path throughout BP's Gulf disaster. Each asset class responded in a manner consistent with its respective governing regulation. Equity securities are more sensitive to sudden, unexpected, and material ESG impairments as they reflect a company's going concern, while debt valuation moves in muted sympathy, reflecting the securities' senior status claim to equity shareholders.

ESG Tilts

Our analysis begs another question: can or should debt covenant features be viewed as material ESG factors from an investment perspective? The answer to this question is: absolutely.

Broader consideration of ESG factors in fixed-income portfolio construction offers portfolio managers the opportunity to incorporate ESG tilts. **"Tilting a portfolio" can be seen, for example, when a portfolio manager attempts to insulate a portfolio from duration risk in a rising interest rate environment by emphasizing the selection of short duration securities or increasing the convexity profile of the portfolio.** Through these tilts, the manager expresses an ESG view regarding a particular issue, industry, or company.

ESG tilts may also signal a manager's strong conviction. For example, a fixed-income manager may indicate strong conviction that corporate credit defaults will decline over the upcoming short-to-intermediate time horizon, foretelling a more favorable market risk/return profile and helping to rationalize the inclusion of below-investment-grade securities in an attempt to optimize the portfolio's performance. The manner in which fixed-income managers can express their views or biases through these portfolio tilts is truly limitless – adding to the creativity and value that active, fixed-income portfolio managers can offer investors.

Saturna Capital's responsible fixed income investing philosophy includes close scrutiny of material, non-financial ESG factors during our portfolio construction process as a means of improving a fixed-income portfolio's resiliency. We view consideration of covenant features as providing our investors with a potential layer of protection in helping them meet their long-term investment objectives. Volkswagen's recent emissions manipulation scandal offers another case in point. Attention to covenant features may provide value, particularly in industries that may be more susceptible to material environmental or governance events.

Conclusion

Examining the market's response to extraordinary and external ESG factors reveals important lessons for all investors. Ultimately, equity shareholders' and bondholders' interests are like the strands of a braid – intertwined yet distinct. Fixed-income instruments are governed differently than equities, resulting in different risk and return characteristics that require further consideration. We find merit in encouraging collaboration between fixed-income investors and equity shareholders to address material ESG factors that can impair fiscal performance, such as water usage and carbon emissions. Neither fixed-income nor equity investors benefit when corporate leadership or governance practices are silent on material ESG issues.

Consideration of material ESG factors in the investment process continues to evolve, and perhaps more so for fixed-income investors given the regulation of equity securities. The more important message offered in this analysis is that ESG considerations within the portfolio construction process extend beyond a feel-good story to offer a comprehensive exercise in due diligence while serving investors with enhanced portfolio resiliency.

About The Author

Patrick Drum MBA, CFA, CFP®
Sustainable Bond Fund Portfolio Manager
Amana Participation Fund Portfolio Manager

Patrick T. Drum, Research Analyst and Portfolio Manager, joined Saturna Capital in October 2014.

He is a select member of the United Nation's Principles for Investment (UNPRI) Fixed Income Outreach Subcommittee and an adjunct professor of finance at Pinchot University, formerly known as Bainbridge Graduate Institute (BGI). Mr. Drum has nearly ten years of experience integrating ESG considerations into fixed income portfolio management.

He holds a BA in economics from Western Washington University and an MBA from Seattle University Albers School of Business. He is a Chartered Financial Analyst Charterholder (CFA) and a Certified Financial Planner®. Mr. Drum has nearly twenty years of investment experience in serving institutions and private clients.

Footnotes

[1] *Johnston, N., Nichols, H. Obama Says New Oil Leases Must Have More Safeguards, Bloomberg Business, May 1, 2010. http://www.bloomberg.com/news/articles/2010-04-30/new-offshore-oil-drilling-must-have-safeguards-obama-says*

[2] *Oil Spill Reaches Mississippi River, CBS News, April 29, 2010. http://www.cbsnews.com/news/oil-spill-reaches-mississippi-river/*

[3] *Blown-out BP oil well finally killed, WWLTV.com, September 19, 2010. http://www.wwltv.com/story/news/2014/08/27/14343816/*

[4] *Normandin, Charles P., with discussion by Scott, R. The Changing Nature of Debt and Equity: A Legal Perspective. Federal Reserve Bank of Boston, 1989. https://www.bostonfed.org/economic/conf/conf33/conf33c.pdf*

[5] *Cooper, C., Liesman, S. BP Amoco Reaches Deal to Buy Altlantic Richfield for $26.8 Billion, The Wall Street Journal, April 2, 1999. http://www.wsj.com/articles/SB922957318416361129*

www.saturnasustainable.com

This publication should not be considered investment, legal, accounting, or tax advice or a representation that any investment or strategy is suitable or appropriate to a particular investor's circumstances or otherwise constitutes a personal recommendation to any investor. This material does not form an adequate basis for any investment decision by any reader and Saturna may not have taken any steps to ensure that the securities referred to in this publication are suitable for any particular investor. Saturna will not treat recipients as its customers by virtue of their reading or receiving the publication.

The information in this publication was obtained from sources Saturna believes to be reliable and accurate at the time of publication.

All material presented in this publication, unless specifically indicated otherwise, is under copyright to Saturna. No part of this publication may be altered in any way, copied, or distributed without the prior express written permission of Saturna.

As of December 31, 2015, no Saturna Fund owned any securities of the companies mentioned.

Please consider an investment's objectives, risks, charges, and expenses carefully before investing. To obtain this and other important information about the Saturna Sustainable Funds in a current prospectus or summary prospectus, please visit www.saturna.com/sustainable or call toll free 1-800-728-8762. Please read the prospectus or summary prospectus carefully before investing.

Investing involves risk, including possible loss of principal. Generally, an investment that offers a higher potential return will have a higher risk of loss. Stock prices fluctuate, sometimes quickly and significantly, for a broad range of reasons that may affect individual companies, industries, or sectors. When interest rates rise, bond prices fall. When interest rates fall, bond prices go up. A bond fund's price will typically follow the same pattern. Investments in high-yield securities can be speculative in nature. High-yield bonds may have low or no ratings, and may be considered "junk bonds." Investing in foreign securities involves risks not typically associated directly with investing in US securities. These risks include currency and market fluctuations, and political or social instability. The risks of foreign investing are generally magnified in the smaller and more volatile securities markets of the developing world.

In addition to the fixed-income market risks above, the Amana Participation Fund entails risks specific to investing in sukuk. Sukuk structures may be significantly more complicated than conventional bonds and often include a series of entities created specifically to support the sukuk structure. In addition, sukuk are largely created in or otherwise subject to the risks of developing economies, many of which have weak or inconsistent accounting, legal, and financial infrastructure. The structural complexity of sukuk, along with the weak infrastructure of the sukuk market, increases risks of investing in sukuk, including operational, legal, and investment risks.

The Saturna Sustainable Funds limit the securities they purchase to those consistent with sustainable principles. This limits opportunities and may affect performance.

Performance data quoted represents past performance which is no guarantee of future results.

© 2016 Saturna Capital Corporation and/or its affiliates. All rights reserved.

Distributed by Saturna Brokerage Services, member FINRA / SIPC. Saturna Brokerage Services is a wholly-owned subsidiary of Saturna Capital Corporation, adviser to the Saturna Sustainable Funds.

1300 N. State Street
Bellingham, WA 98225-4730
www.saturna.com