Sustainable income from sustainable sources

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IN BRIEF

- Investors tend to believe that sustainable investing comes at the cost of income.
- However, by investing across asset classes, investors can generate the income they need while achieving their sustainability objectives.
- We demonstrate that investors can reduce their carbon footprint meaningfully without sacrificing yield.
- Focusing on companies that take sustainability seriously typically means investing in higher quality businesses, leading to higher income sustainability.
- Taking a medium- to long-term view is key to materialising the benefits of sustainable investing.

ESG CHALLENGES DIFFER ACROSS ASSET CLASSES AND REQUIRE INNOVATIVE SOLUTIONS TO DELIVER A DIVERSIFIED STREAM OF INCOME FROM SUSTAINABLE SOURCES

Sustainable investing is front and centre of investors' minds – and while many investors began their journey to more sustainable portfolios by looking at their equity investments, the focus has now broadened to include other asset classes, as well as sustainable multi-asset investing.

Sustainable investing across the capital structure offers a broad range of opportunities for investors. However, it also requires innovative solutions to overcome ESG data availability issues and enable materiality assessments across asset classes.

Income-oriented investors focused on sustainability have to face the reality that the sectors of the fixed income universe with the highest environmental, social and governance (ESG) scores – namely, government bonds – deliver close to 0% yield. On the other hand, high yield credit, an asset class that has historically delivered strong risk-adjusted income, is often considered less sustainable when assessed on an index level. To complicate the picture, fixed income instruments such as securitised investments are often not covered at all by prominent ESG data providers.

Equities can provide income in a low-yield environment, but also require specialist analysis, particularly in emerging markets, where third-party data is more limited and governance issues, in particular, need to be assessed carefully.

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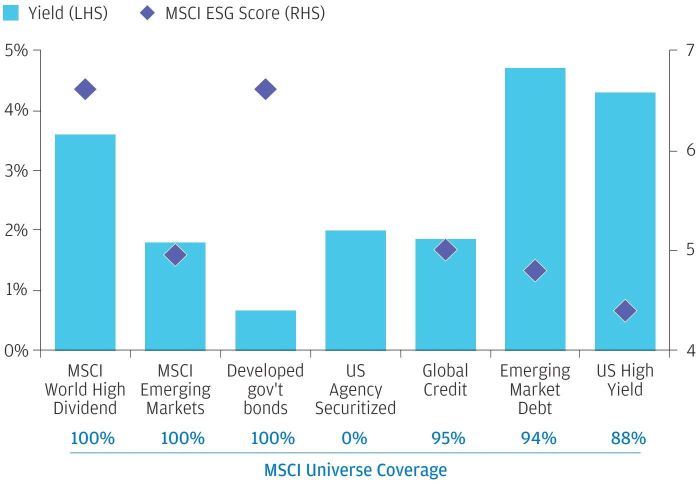
All of this underlines the importance of an innovative approach, with focus on engagement and a research process that evaluates sustainability across multiple dimensions. This includes detailed bottom-up analysis to identify sustainable income-generating securities, as well as a comprehensive sustainability and materiality framework across each of the multi-asset income asset classes.

With such a nuanced approach, can investors build a sustainable multi-asset income portfolio without sacrificing yield – a particularly pressing concern in the ongoing low-yield environment? Below, we examine the evidence for both equities and fixed income.

EXHIBIT 1: DIFFERENT ASSET CLASSES POSE DIFFERENT ESG CHALLENGES



Yield is not guaranteed and may change over time.
Source: J.P. Morgan Asset Management, J.P. Morgan, Bloomberg, Bank of America Merrill Lynch, MSCI. Yield and MSCI ESG score as at 31 January 2021. MSCI universe coverage as at January 2021. EM: Emerging markets. Positive yields do not imply positive results. Yields are not guaranteed. MSCI WORLD HIGH DIVIDEND YIELD, MSCI EM (EMERGING MARKETS) Index, JP Morgan GBI BROAD - ALL MATURITIES, Bloomberg Barclays Global Credit Index, JP Morgan EMBI Global Diversified Index, Bloomberg Barclays U.S. High Yield - 2% Issuer Cap Index.

SUSTAINABLE EQUITIES CAN BE AN ATTRACTIVE SOURCE OF YIELD ACROSS DEVELOPED AND EMERGING MARKETS

While considering ESG aspects for shareholders is nothing new, little work has been published so far on ESG factors in conjunction with dividend yield. Our findings show that income-seeking investors who choose companies with high ESG scores don't have to sacrifice dividend yield. The same holds true for dividend growth. In fact, we can observe that nominal dividend yield and dividend growth are highest for companies with high ESG scores (**EXHIBIT 2**).

EXHIBIT 2: DIVIDEND YIELD AND DIVIDEND GROWTH ARE HIGHEST FOR COMPANIES WITH HIGH ESG SCORES

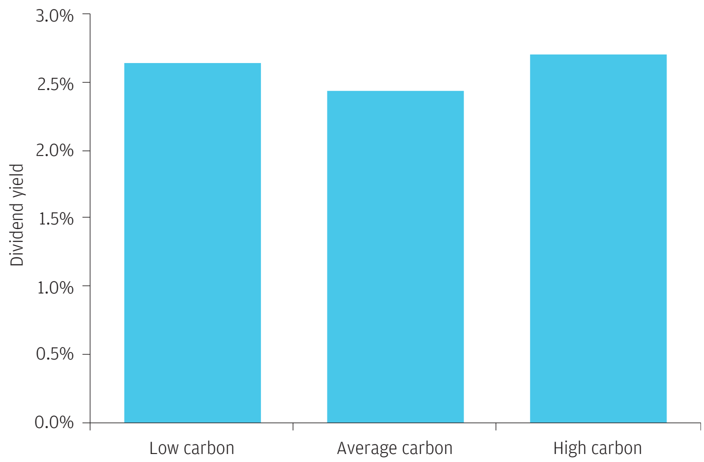
COMPANIES BY ESG BUCKETS	LOW	MEDIUM	HIGH
Yield	2.5%	2.6%	2.7%
Dividend growth	8.9%	8.3%	9.9%
ROE normalised	20.2%	20.6%	22.2%
(%) Premium/quality business	22.9%	25.7%	33.9%
Normalised payout ratio	43.5%	44.8%	52.3%

Yield is not guaranteed and may change over time.
Source: J.P. Morgan Asset Management, as of 31st of December 2020. MSCI ESG.

A similar observation can be made for the carbon footprint: companies with a low carbon footprint deliver, on average, a similar dividend yield to their competitors with higher carbon emissions (**EXHIBIT 3**). This supports our suggestion that income-seeking investors can combine their objective with sustainable investing, to source income from sustainable sources.

EXHIBIT 3: INVESTORS DON'T HAVE TO GIVE UP DIVIDEND YIELD WHEN INVESTING IN COMPANIES WITH LOW CARBON EMISSIONS

Dividend yield vs. carbon intensity



Source: J.P. Morgan Asset Management, as of 31st of December 2020. MSCI carbon data.

In emerging markets, we underline the importance of governance and sustainability considerations when evaluating dividend stocks. Our proprietary analysis shows that investors can construct a portfolio with a higher dividend yield from higher-quality businesses than the broad index, while promoting sustainability (**EXHIBIT 4**). We emphasise our proprietary red flag sustainability framework, which helps us identify premium businesses and is historically correlated with outperformance[1] and reduced governance issues.

[1] Reference - Exhibit 4, J.P. Morgan Asset Management, Fundamentaly speaking: Sustainable investing article, January 2020.

EXHIBIT 4: IT IS POSSIBLE TO BUILD A SUSTAINABLE EMERGING MARKET PORTFOLIO THAT IS HIGHER YIELDING THAN THE BROADER MARKET

EMERGING MARKET EQUITY	JPM EM INCOME – SUSTAINABLE	BROAD INDEX
Dividend yield	4%	2%
Ref flags – sustainable risk indicator	11	17
(%) Premium/quality business	83	46
Carbon footprint CO2e/$M sales	87	407

Yield is not guaranteed and may change over time.
Source: J.P. Morgan Asset Management, as of 31st of December 2020. MSCI Emerging Market Index.

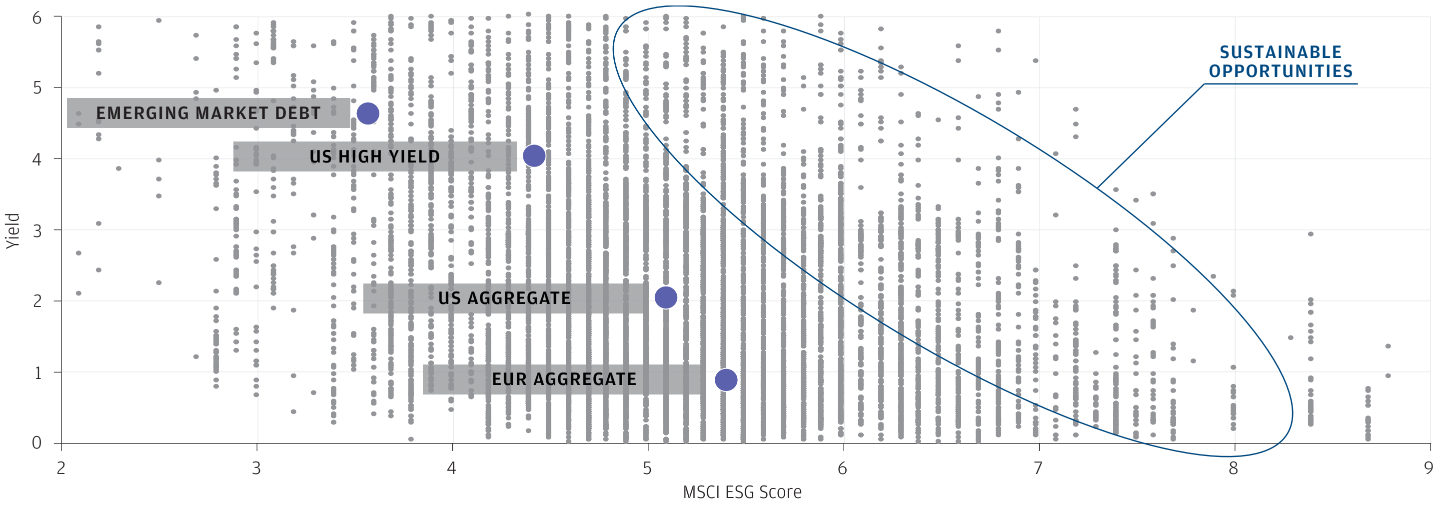
AN ESG FOCUS IN BONDS CAN ENHANCE PORTFOLIO OUTCOMES VIA LOWER DRAWDOWNS AND INCREASED RISK-ADJUSTED RETURNS

Beyond equities, our research shows that an ESG focus can help to improve the risk/return characteristics of bond portfolios. As highlighted above, ESG data coverage (for example, MSCI) tends to vary across the fixed income universe and is sometimes limited. Investment grade credit and sovereign issuers tend to be well covered, but as investors move further into sub-investment grade credit and into the emerging markets, data can become scarce. In addition, large fixed income markets such as securitised assets are not covered at all by providers such as MSCI. This highlights the importance of proprietary fundamental sustainability assessments to enable investors to access the entire fixed income universe.

While investors tend to think higher sustainability inevitably comes at the cost of yield and returns, we would argue that sustainable opportunities can be found within the fixed income investment universe without compromising on yield. **EXHIBIT 5** shows book yield in relation to MSCI ESG score, and illustrates why headline index metrics can lead investors to believe that certain fixed income markets only offer inferior opportunities for sustainable investors. However, we believe the distribution of data shows that, with an active approach, there are ample opportunities for investors to find attractive investments from a yield and sustainability perspective.

Similarly, we can show that focusing on sustainability doesn't have to come at the cost of risk-adjusted returns. As with equities, we would argue that for bond issuers, stronger ESG approaches are correlated to higher-quality businesses, making ESG factors a valuable additional input in the security selection process for all investors, not only those with a sustainable focus. We observe that this is especially true during periods of market stress, as illustrated by the relative performance chart in **EXHIBIT 6**. The analysis compares broad market bond indices with ESG-tilted benchmarks. The results of the backtest show that, across the fixed income sectors, introducing ESG tilts can lead to improved excess return, risk/return ratios and drawdowns **EXHIBIT 7**.

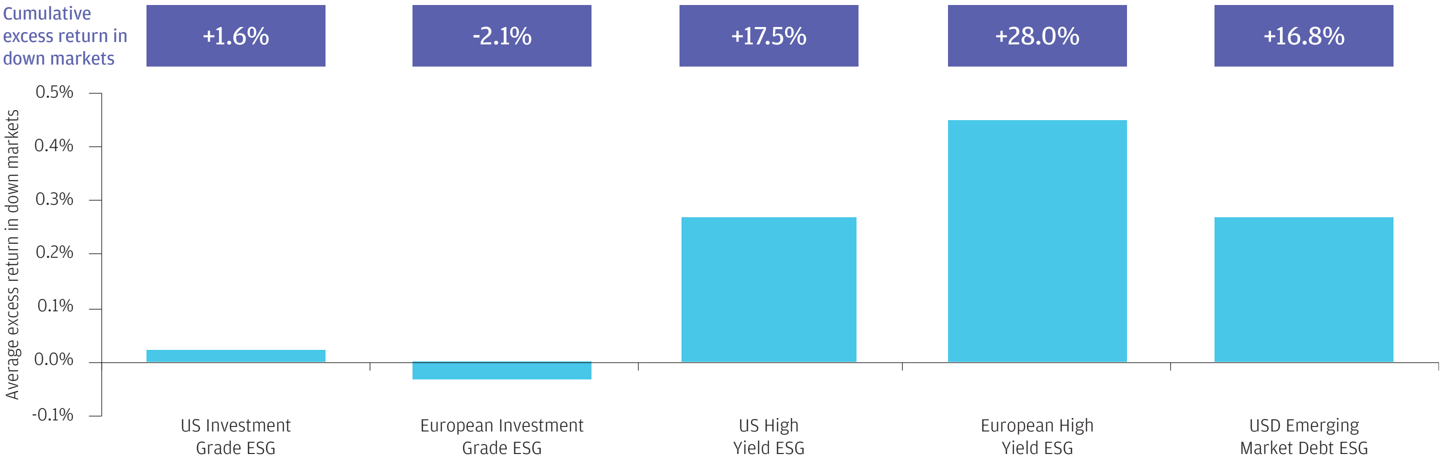
EXHIBIT 5: THERE ARE AMPLE OPPORTUNITIES FOR ACTIVE INVESTORS TO FIND SUSTAINABLE INCOME IN FIXED INCOME



Source: J.P. Morgan Asset Management, J.P. Morgan, Bloomberg, Bank of America Merrill Lynch, MSCI. Yield and MSCI ESG score as at 31 December 2020. Bloomberg Barclays US Aggregate Index, Bloomberg Barclays Euro Aggregate Index, JP Morgan EMBI Global Diversified Index, Bloomberg Barclays U.S. High Yield - 2% Issuer Cap Index.

EXHIBIT 6: COMPANIES WITH STRONGER ESG APPROACHES PROVE MORE RESILIENT IN DOWNTURNS

Excess return of ESG indices vs. the broad index during down markets



Source: ICE BofAML, MSCI ESG Research, J.P. Morgan Asset Management Global Fixed Income, Currency & Commodities Quantitative Research Group; data as of January 31, 2021.
Past performance is not a reliable indicator of current and future results.

EXHIBIT 7: INTRODUCING ESG TILTS CAN IMPROVE EXCESS RETURN, RISK/RETURN RATIOS AND DRAWDOWNS

(31/12/2006 to 31/01/2021)

	US IG	US IG ESG	EUR IG	EUR IG ESG	US HY	US HY ESG	EUR HY	EUR HY ESG	USD EM	USD EM ESG
Returns	1.23%	1.29%	1.11%	1.21%	3.84%	4.49%	4.60%	5.50%	2.58%	2.92%
Volatility	6.09%	5.99%	4.04%	4.26%	11.43%	10.68%	12.37%	10.89%	9.02%	7.96%
Information Ratio	0.20	0.22	0.27	0.28	0.34	0.42	0.37	0.51	0.29	0.37
Max drawdown	24.06%	22.88%	17.28%	17.09%	44.31%	38.71%	45.83%	37.04%	32.96%	26.46%
Rating	A3	A3	A2	A3	B1	BB3	BB3	BB2	BBB2	BBB2
Duration	6.6	6.6	4.7	4.7	4.2	4.4	3.5	3.6	5.0	5.1
Yield to worst	3.9	3.9	2.5	2.5	7.9	6.8	6.6	5.6	5.8	5.1
OAS	177	169	149	150	595	482	551	455	384	310

Source: ICE BofAML, MSCI ESG Research, J.P. Morgan Asset Management Global Fixed Income, Currency & Commodities Quantitative Research Group; data as of January 31, 2021. All reweighting to construct the ESG benchmarks is based on pro rata market value weights. OAS: option-adjusted spread.
Past performance is not a reliable indicator of current and future results.

CONCLUSION

Our analysis has shown that income-seeking investors can generate attractive income across a range of sustainable sources. Focusing on sustainability leads to higher-quality portfolios with more stable income. This makes sense: more sustainable businesses tend to take a long-term view, and what's good for the environment and for society often makes economic sense in the long term.

Utilising an active approach is key to investing sustainably across the capital structure. Sustainability has to be assessed holistically, and taking a medium- to long-term view is crucial, because the risks sometimes materialise over years.

We have shown that achieving the twin objectives of income and sustainability is possible with an active approach across multiple asset classes. Taking a multi-asset approach gives investors the ability to access sustainable companies across the capital structure to gather attractive, consistent income from sustainable sources.

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