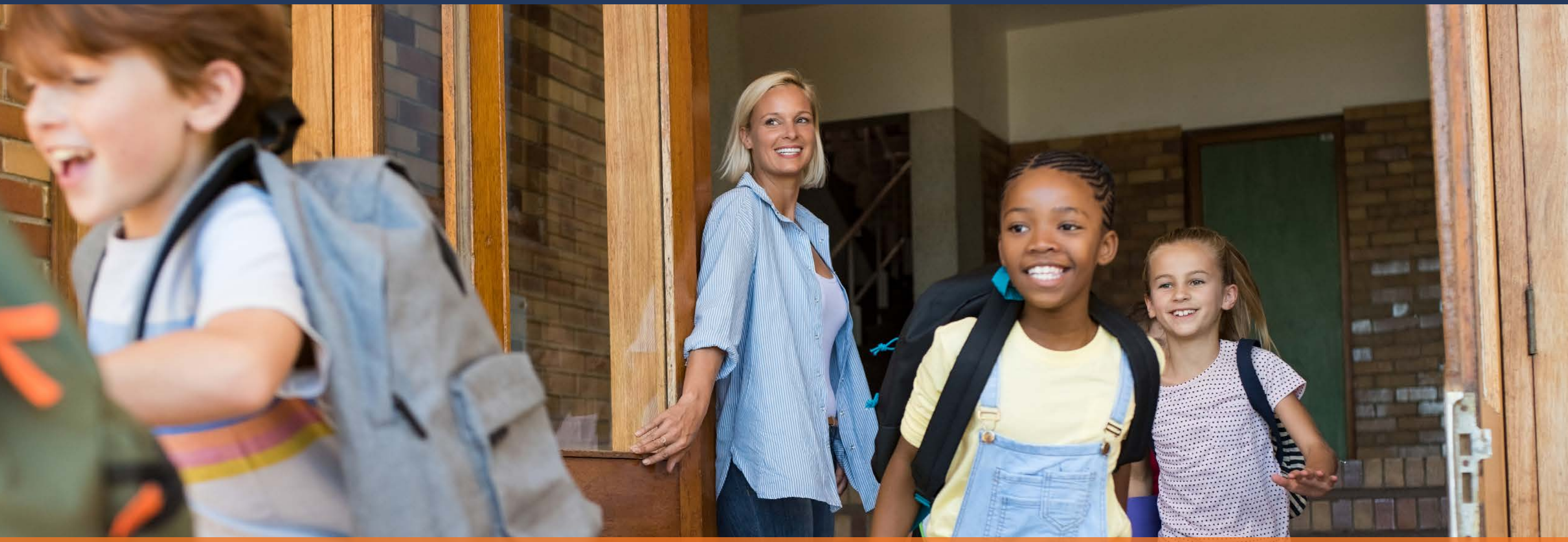

ESG IN MUNICIPAL BONDS: AN IMPACT STORY TAKES SHAPE

Specialization and experience are becoming prerequisites to uncover authentic, deep impact in the municipal bond market.

- Paul Hwang, *Portfolio Manager, IMPACT Community Capital*

The total issuance of "green" bonds eclipsed $500 billion last year, helping the total market surpass $1.5 trillion, according to [Climate Bonds Market Intelligence.](https://www.climatebonds.net) The growth of the social, sustainability and sustainability-linked bond market (SLBs) was nearly as impressive, growing by approximately 50% year over year to reach total issuance exceeding $646 billion as of the start of 2022[1]. Given the impressive growth, one might wonder where opportunities remain in a market that has grown so crowded almost overnight. Ironically, it's the unbridled race into sustainability and Environmental, Social, Governance (ESG) investing creating the opportunity for an active strategy that can separate not just the winners and losers, but the issuers able to produce material impact versus those looking to catch a "marketing" tailwind.

Municipal bonds on their own generally tend to be aligned with the public interest. Investments can help fund projects across a range of environmental or social themes, including clean water, mass transit, education, affordable housing, and economic and community development, in addition to other focus areas. However, unlike other asset classes, it can be difficult to categorize municipal bonds through a traditional ESG framework or quantify the extent to which issuers are delivering non-financial impacts because it takes industry expertise, coupled with deep research, to determine the depth of impact among municipal bond offerings. This challenge is particularly evident when analyzing smaller issuers who may lack the resources to track and report on ESG factors but are every bit committed to a specific initiative or public good. In fact, out of the approximately 56,000 municipal bonds outstanding in the municipal bond index, only about 3,000 bonds are designated with an ESG designation[2].

There's no shortage of issuers whose sustainability attributes are as compelling as their financial prospects. The challenge is that there is also a rapidly expanding group of issuers whose mission is not as clear as outlined in the issuer's prospectus. For instance, in one recent "green" bond sale, a packaging company sought to raise $100 million that would go to the construction of a recycling facility.

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OUT OF APPROXIMATELY **56,000** MUNICIPAL BONDS, ONLY ABOUT **3,000** BONDS HAVE AN ESG DESIGNATION.

[1] Source: https://www.climatebonds.net/2022/01/500bn-green-issuance-2021-social-and-sustainable-acceleration-annual-green-1tn-sight-market
[2] Figures based on bonds outstanding in the Bloomberg Municipal Bond Index with Green, Social or Sustainable self-designations as of 4/29/2022.

Bloomberg, however, reported that the company has been cited several times for emissions complaints that culminated into a class-action lawsuit that advanced in the courts this past February. In other cases, a city may seek funding for a series of projects through a general obligation bond and only through reading the fine print will investors discover that a portion of the funding may be dedicated to police-brutality settlements.

It's against this backdrop that an active, customized approach can target specific impact outcomes while accounting for the risks and opportunities under an ESG lens. Portfolio characteristics can be identified and mapped into individual clusters or samples. This helps to create a subset of bonds or bond-linked exposures to identify issuers with characteristics that correspond to the performance benchmark, while the positions within each cluster can be adjusted as the market conditions or economic picture dictate. Through an ESG or impact lens, this approach can be just as powerful to analyze the environmental or social attributes of an issuer, concentrating on the most impactful projects with the least amount of ESG risk and ensuring governance is adequate or reflects the constituencies being served.

The potential draw for institutions is that the strategy can provide either a "low friction" entry point for those new to ESG investing or can help more mature programs amplify their impact in an allocation that traditionally demands deeper analysis.

WATER TREATMENT PLANT

THE VALUE OF AN IMPACT LENS

As the volume of self-designated green or social bonds has grown considerably, the "noise" can be overwhelming to investors without experience in impact. Within the municipal bond space, however, issuers who are intentional about incorporating ESG considerations into their bond offerings remain a very small minority. According to the Bloomberg Municipal Bond Index, as of April 29, 2022, only a fraction of its total exposure was designated as green (4%), social bonds (1%) or sustainable bonds (less than 1%).

Still, experience provides an acute informational advantage to managers utilizing a top-down approach to target the most impactful areas -- think affordable housing, education, community development, or other segments that lend themselves to environmental or social strategies. When this is coupled with a bottom-up analysis -- at the security or issuer level and informed by fundamental research -- experienced managers can isolate the issuers offering the most attractive financial returns and meet strict ESG criteria. Through merging these approaches, investors can benefit from low-turnover, high-conviction strategies.

Moreover, it's often the case that financial analysis and sustainability attributes will overlap. For instance, in the municipal bond space, smaller issuers may not have the resources to track and maintain ESG reporting. Through deep, rigorous analysis, however, managers can determine whether this represents a risk to monitor or an opportunity to qualify the issuer as appropriate through a sustainability lens. Among corporate issuers, it's also the case that those who are more likely to encounter financial distress tend to correlate with poor governance scores and other adverse risks.

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PROPRIETARY ESG RESEARCH, TAILORED TO THE SECTOR

In-depth expertise in these markets is paramount to source and evaluate true impact among municipal bond issuers. This informs not just the analysis into financial and non-financial factors, but also the process through which managers select securities. For instance, at IMPACT Community Capital, each issuer is scored, one through five, based on ESG and thematic-sector criteria. These scores are then overlayed on top of a fundamental credit rating. Scoring is based on all three ESG factors – environmental, social and governance – with one being the lowest score and five representing the highest.

As of the mid-year, 2022, widely accepted standards defining "green" or "social" bonds had yet to form any kind of consensus. IMPACT, however, incorporates into its "scoring framework" internationally recognized standards and guidelines issued by the International Capital Markets Association's (ICMA) Green Bond Principles, Social Bond Principles, Sustainability Bond Guidelines, and the UN PRI's Sustainable Development Goals.

It may sound simple – and it is designed to be uncomplicated -- but each issuance is unique. ***In turn, credit analysis focuses on the specific issuers through an ESG framework that factors in materiality considerations and key indicators that vary by sector.*** Far from being passive, the strategy also entails direct engagement with issuers and demands accessibility of reporting, which can factor into governance scores.

The ESG rankings incorporate several other considerations. And while the analysis covers a wide breadth of different factors, the investment universe is narrowed through a fundamental credit analysis that filters out any securities or issuers that might pose financial risk. This creates a target-rich pool from which the portfolio management team analyzes: An issuer's historic ESG track record, be it positive or negative; the security's use of proceeds; the projected impact on underserved areas such as low socioeconomic communities or diverse populations; long-term projections around usage; and appropriate third-party ESG ratings for either an issuer or a specific security.

AT IMPACT COMMUNITY CAPITAL, EACH ISSUER IS SCORED, ONE THROUGH FIVE, based on ESG and thematic-sector criteria. These scores are then overlayed on top of a fundamental credit rating. ***Scoring is based on all three ESG factors – ENVIRONMENTAL, SOCIAL AND GOVERNANCE.***

ENVIRONMENTAL THEMATIC CRITERIA

To get a sense of how environmental considerations factor into securities selection, it's important to remember materiality can differ significantly from one sector to the next. The opportunity to have an environmental impact through funding new school projects or libraries is somewhat limited compared to water and sewer projects. However, with an understanding around what's material and what isn't, there is no shortage of considerations to determine which issuers would qualify for an investment through an ESG lens.

Opportunities in water and sewer development, for instance, can span from clean water-and-storage and wastewater-treatment projects to municipal efforts to reduce untreated water discharge, targeted removal of pollutants, or projects to extend capacity so communities with insufficient infrastructure are able to access clean water. Social considerations, too, have become more prominent in recent years, but through an environmental lens, several obviating factors could preclude a water and sewer project from being considered for an investment. Public water systems that fail to provide adequate safe water create obvious ESG risks in the form of potential fines and loss of customers. An over-reliance on imported water or single-source facilities are, likewise, susceptible to concentration risk. "Over sourcing" or excess depletion of local ground water can also create supply risks. Additionally, sewer systems with unaddressed spillage carry obvious headline risk as well as the prospect of potential fines.

Conversely, issuers with diverse and sustainable sources, affordable rates, appropriate levels of capital spending to offset depreciation and minimize future burdens, drought-prone water conservation efforts, and environmental leadership can collectively help an issuer stand out as an attractive candidate. In many ways, the focus on non-financial factors covers much of the same ground as fundamental analysis, exploring supply/demand characteristics and concentration risks. But on top of supply chain dynamics and input costs, ESG investors will focus on available natural resources and conservation discipline.

Environmental analysis can differ considerably across different sectors. And while materiality may vacillate from project to project, the “E’” factor remains an important consideration as part of securities selection. In the **education, housing and healthcare sectors,** for instance, several considerations guide this environmental analysis. New facility construction should meet energy-efficiency standards, incorporate certifiable green-building features and adhere to sustainable building standards. Issuers should also track and meter energy and water sources and be aligned to specified usage targets. Stormwater management, biodiversity protection, and greenspace preservation are also important to new construction, while carbon neutrality has become table stakes for most issuers.

The environmental analysis in areas such as the **utilities space,** however, can be even more cut and dry, favoring power production from renewable resources (wind, geothermal, solar or other alternatives) or issuers who expand access to clean-energy programs, zero-carbon grids, smart meters, or programs to reduce energy usage. Again, an ESG analysis will favor issuers who help to minimize reliance on fossil fuel or nuclear-generated fuel projects

Transportation also provides an example of the subtle ways ESG can incentivize better outcomes. For instance, transportation projects need to track and quantify reduction of carbon emissions, deliver transparency through a rigorous reporting process, put in place infrastructure upgrades, and facilitate the electrification of fleet vehicles and the use of alternative fuels. And again, greenhouse gas (GHG) offsets and meeting stormwater environmental footprint standards remain obligatory for new issuers. But the devil is in the details, as certain considerations will dictate whether transportation issuers qualify, be it an infrastructure project, special tax or revenue bonds (see sidebar).

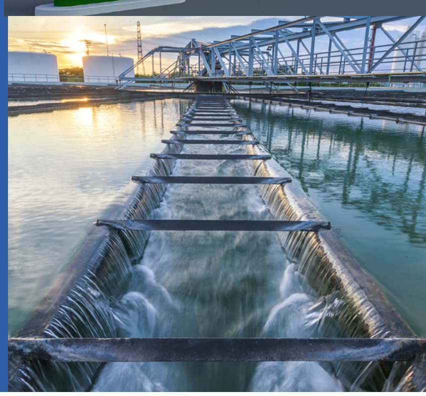
TRANSPORTATION “FACTOR” FOCUS : ENVIRONMENT

DISQUALIFYING PROJECTS

- Toll Bridges / Tunnels Expansion
- General Purpose Highway Lanes
- Dual Express Lanes (in each direction)
- Improvements to Bridges, Entries/Exits
- General Use Airport Bonds

QUALIFYING PROJECTS

- Clean Energy Transportation
- Net-Carbon Reducing Mass Transit
- Cost-reducing, Accessible Mass Transit
- Infrastructure that Supports Alternative Fuels
- Transparency / Carbon Reporting
- GHG Offset Statistics



SOCIAL THEMATIC CRITERIA

The environmental analysis may seem black and white when compared to the "social" factors that influence securities selection. The anticipated carbon footprint, for instance, provides a baseline from which to analyze environmental impact across most sectors or projects. Social considerations, however, can be far more nuanced. In some cases, it may be premised on providing basic infrastructure, such as clean drinking water, sanitation or transportation to large populations. In other cases, the goal may be focused on tackling discrete Diversity, Equity and Inclusion (DEI) issues affecting specific populations. These goals can include desired outcomes focused on socioeconomic advancement and empowerment or even access to essential services such as healthcare, education, and financial services.

GOALS CAN INCLUDE DESIRED OUTCOMES FOCUSED ON socioeconomic advancement and empowerment or even access to essential services such as HEALTHCARE, EDUCATION, and FINANCIAL SERVICES.

EDUCATION, for example, can be an area where deep, expert analysis is critical to channel resources toward areas and populations where it can have the biggest impact. To do so requires a dynamic process that factors in several different considerations.

Are proposed projects providing quality education to target populations? Are resources being made available to students living below the poverty line, such as free and reduced-price lunches or other services that can level the playing field? Are there programs available for English-as-a-Second-Language (ESL) students? How will policymakers and school leaders track KPIs, such as graduation rates, college matriculation or workforce preparedness? Are the projects located in districts where they will serve target populations? And what strategies are in place to guard against truancy or dropouts? **These are just a few of the types of questions ESG-oriented analysis will seek to answer.** Of course, environmental considerations will be part of the analysis as well – such as greenspace preservation or biodiversity protection – but for most education projects, the social considerations will be more material.

These and other questions don't just inform the "social" analysis, they speak to the quality of the issuer and indirectly support the financial case behind an investment.

EDUCATION "FACTOR" FOCUS : SOCIAL

DISQUALIFYING PROJECTS

Low Teacher Pay
Inadequate Academic Performance
High Truancy / Drop-out Rate
Low Graduation Rates
State-Takeover Risk

QUALIFYING PROJECTS

Appropriate Graduation Rates (relative to AMI averages)
Appropriate Teacher Pay (relative to cost of living)
Proficiency Test Scores
Assistance to Vulnerable Groups
Strategies to Lower Socioeconomic Achievement Gaps

AFFORDABLE HOUSING, another category that can directly address social issues, requires similar nuance to assess the most appealing issuers through a financial and impact lens. The objective in most cases is to create or rehabilitate quality affordable housing, but the opportunity set can vary considerably based on geography, the socioeconomic populations being served or even the specific community, be it projects to provide senior housing, family Low Income Housing Tax Credit (LIHTC) properties, workforce housing or any other demographic group.

For context, states and many cities have housing- and economic-development authorities created for the purpose of financing affordable multi- and single-family housing. These organizations, in addition to serving groups such as veterans or disabled individuals, typically serve low- to moderate-income individuals and families with household income at 80% or less on average than the Area Median Income (or AMI) of a specific market. Through providing low-interest loans for single-family homes, the development of economically disadvantaged areas, or directly financing new affordable-housing developments, these projects have become essential as housing costs and rents have climbed. The nation's largest local housing finance agency and leading issuer of mortgage revenue bonds for affordable housing has financed more than 184,000 housing units since 2003 and issued more than $24.2 billion in bonds and other debt obligations.

We understand the challenges to pursuing a double bottom line, delivering dependable financial returns to meet future obligations, while also helping drive systemic change in underserved populations.

These high-impact, affordable housing bonds make up about 17% of ESG designated bonds within the municipal universe. The social benefits speak for themselves. In many cases, however, the ESG expertise of managers is reflected in the financial analysis to understand which issuers offer the best risk-adjusted returns.

GOVERNANCE THEMATIC CRITERIA

While governance is every bit as important as the environmental and social lenses deployed – and often represents the foundation upon which change happens – it can also be more of a mosaic in terms of analyzing and assessing what's adequate or appropriate.

At the highest level, financial management, board diversity and independence, disclosure policies, pension plan management, cybersecurity and other risk-mitigation protocols represent key areas that will be scrutinized. Past controversies, alternatively, represent red flags, and ESG investors should avoid headline risks that can lead to financial and reputational losses.

These governance considerations share similar approaches to assessments and due diligence that traditional public fixed income and municipal bond investors will conduct into any traditional issuer from a fundamental credit rating perspective. Through an impact lens, how ever, local dependency – such as the taxable base, public spending or environmental changes – means certain ESG factors may affect an issuer's capacity to service debt. As a result, the quality of governance can be even more relevant in managing ESG risks. For instance, environmental changes may adversely affect property and land valuations, force businesses to relocate, or require increased expenditures to pay for infrastructure adaptations, among other risks.

This is where the "E," "S," and "G" lenses can overlap, as scrutiny into governance will also analyze an issuer's preparedness to address physical climate risk, the resilience of infrastructure, an issuer's financial position, or the degree of the project's insurance policy coverage.

Governance considerations are also critical to help identify areas where issuers might be exaggerating their environmental or social impact. To scrutinize these risks, we'll look for transparency and clarity around the use of proceeds, management's evaluation of the project's impact, audited management of proceeds going forward for the life of the bond outstanding, and timely and complete reporting, both from a financial perspective and around certain sustainability KPIs.

EXPERIENCE MATTERS

While ESG expertise is essential to contextualize the opportunities and the risks, it becomes even more important to cut through the noise caused by green or social washing. According to one study across the mutual fund universe, merely adding a "self-designated" ESG label allowed retail funds to generate a roughly fourfold increase in flows, whereas institutional funds experienced an even larger, ninefold increase. The research also noted that the "self-designations" of managers yielded significant increases whether or not third-party analytics providers contradicted the label through low sustainability scores.

To be sure, the furious land grab now characterizing the impact segment – in part fueled by the premiums available to issuers touting their environmental or social bona fides, actual or not – has more recently attracted the attention of regulators. Recent enforcement actions and high-profile probes help to underscore the extent of the problem. BNY Mellon, Goldman Sachs and Deutsche Bank's DWS unit are among the bigger names to have faced "greenwashing" allegations or been the subject of related investigations.

Given the names involved, it's likely regulators are looking to make an example out of a handful of high-profile managers, but it won't necessarily help those not steeped in impact discern the signals from the ESG "noise" in municipal bonds and public fixed income. For these reasons, an actively managed solution is required to identify issuers motivated to effect change and the bad actors looking to capitalize on the ESG movement.

At IMPACT Community Capital, we understand the challenges to pursuing a double bottom line, delivering dependable financial returns to meet future obligations, while also helping drive systemic change in underserved populations. This perspective, though, also gives us a unique lens to assess the extent to which other issuers and securities can deliver on their stated impact goals. In public fixed income and municipal bonds – where a large proportion of projects are premised on "doing good" – this translates into an attractive opportunity for our investors to uncover deep impact in our communities.

The focus on fundamental analysis, however, is no different than any other strategy that more exclusively applies a financial lens. In fact, the very same factors inform our securities selection process to maximize risk-adjusted returns on behalf of our investors. And given the nuances and complicating factors discussed above – in which most issuers may appear to be impact aligned at first blush – expertise coupled with a bespoke and rigorous process is fast becoming a prerequisite to uncover deep impact that allows institutions and insurance companies to meet their investment needs and at the same time move the needle and advance their ESG objectives.

ABOUT THE AUTHOR:

Paul Hwang is a Portfolio Manager at IMPACT Community Capital, focusing on investments with positive impact for IMPACT's investment programs and growth strategy. Paul has responsibility for investment research and financial modeling.

Paul started his career as an analyst and underwriter at The Vanguard Group and Zurich Financial Services and, most recently, six years at AllianceBernstein, where he served as Assistant Vice President and Associate Portfolio Manager, managing municipal bond portfolios and purchasing securities on AB's tax-exempt trading desk. At AB, he also helped to launch the firm's Municipal Impact strategy, a municipal bond strategy providing positive social and environmental impact.