Janus Henderson INVESTORS

ESG IN CREDIT INVESTING: THEMES, CONSIDERATIONS AND IMPLEMENTATION

Adrienn Sarandi
Director of Fixed Income ESG

As the focus on Environmental, Social and Governance (ESG) investing globally continues to sharpen, Adrienn Sarandi, Director of Fixed Income ESG, answers some of the most frequently asked questions. She explains why the Janus Henderson Global Corporate Credit Team believes ESG considerations are best integrated in core credit analysis rather than carried out by standalone specialists, explores whether COVID-19 has altered the evolution of ESG and outlines some current trends and areas of interest for investors.

Why is ESG a vital part of the value proposition in all of Janus Henderson's credit portfolios?

The Global Corporate Credit Team at Janus Henderson seeks to enhance value for clients through active management and ESG considerations are key elements of our approach. We believe that excelling at ESG research and actively engaging with investee companies will lead to better-informed investment decisions by reducing risks and uncovering 'ESG alpha' opportunities.

At the heart of ESG is the simple idea that companies are more likely to succeed and deliver strong returns if they create value for all their stakeholders - be that employees, customers and suppliers - as well as society more widely and the environment. Consequently, ESG analysis focuses on how companies are serving stakeholders, the strength of their 'social licence' to operate and how this impacts their current and future performance. Hence ESG analysis is a key ingredient in our analysis that seeks to identify companies with business models that are 'future proofed' and able to deliver sustainable cash flows. At the same time, it helps us seek to avoid borrowers that cannot or will not mitigate their material ESG risks, which may ultimately lead to meaningful underperformance or capital impairment.

In the past, asset owners and investment managers focused on 'why' they should integrate ESG factors into their investment processes more systematically. ESG investing has markedly matured in recent times and now the conversation has moved to the 'how'. How is it best to leverage ESG insights to enhance risk adjusted returns? How can disclosure standards be improved? How can ESG performance and outcomes be measured? In terms of the why, we believe the question is comprehensively answered and there is no trade-off between performance and ESG integration*. We believe that integrating ESG considerations into investment decisions can improve performance. It is now the 'how' questions that are pertinent.

Is ESG now an inseparable part of credit investing?

Absolutely. In our view, a process that fails to integrate ESG factors properly, misses some important dimensions in investment decision-making. Bond investors have always been focused on governance factors, but in recent years broader ESG considerations have become a more systematic and formalised part of the investment process. Environmental and social considerations therefore now vie for importance. Many of the environmental and social risks have also been increasing and some are now prominent across industries and regions.

More recently, it was consensus to expect the 2020s to be the decade of transition and transformation from an E, S and G perspective. While the heavy focus on climate change lost some momentum in the first half of the year due to the pandemic, there has been an uptick in focus on other 'S' and 'G' issues, with companies taking a greater interest in employee wellness, inequalities and supply chain management. Crises also typically expose governance issues and COVID is no exception with several scandals erupting in recent months that left some corporates paying a heavy price.

It is therefore clear to us that investors ignore material ESG factors at their peril.

ESG investing is a broad concept. How do you apply ESG?

ESG is integrated in all of Janus Henderson's corporate credit strategies as a core component. We aim to identify and evaluate the most material ESG risks of each issuer we invest in and use these insights to improve returns.

Firstly, it is important to differentiate between 'integrated' ESG strategies – which apply responsible investing principles – compared to 'values' and 'impact' based strategies that apply Socially Responsible Investing (SRI) principles.

In our 'integrated' ESG strategies, the primary purpose of the ESG lens is to maximise risk-adjusted returns. Since there are no specific ESG performance objectives within these strategies, in the vast majority of cases, we do not have blanket sector exclusions. The integrated ESG approach looks at credit markets holistically and aims to evaluate on a case-by-case basis how relevant factors may lead to credit improvement or deterioration, and the resultant impact on credit spreads and the issuer's cost of capital.

For clients in our 'values'-based strategies, we apply the same approach but with the addition of a negative screening overlay to remove controversial sectors/issuers in accordance with clients' beliefs.

For those clients who want to go a step further with 'impact' investing – an approach that seeks to deliver a measurable positive impact for society and the environment alongside positive returns – we are currently building out capabilities that allow us to design tailored solutions with measurable positive outcomes.

Why do you include some 'sin' sectors in your strategies that integrate ESG within their investment approach?

Excluding some controversial sectors outright makes sense for 'values' based ethical investors. In 'integrated' ESG strategies we do not apply blanket exclusions based on industry classifications alone because we do not believe this is the best way to enhance risk-adjusted returns.

This does not, however, mean we invest in challenged sectors and issuers. When approaching areas of the market that have an inherent material ESG risk profile, we take each sub-sector and issuer on its own merit and actively engage to better understand whether and how ESG risks are addressed. In keeping with this approach, we avoid investing in companies – in any sector – where the materiality of the ESG risk and deteriorating trajectory of that risk lead us to believe we could see a marked worsening in credit strength or capital impairment. Examples include structurally challenged businesses (such as certain coal miners where the risk of stranded assets – which are now worth less than expected due to the transition to cleaner energy – are high) or those that are negligent in terms of their conduct towards workers, customer safety and the communities they operate in, or those with other serious governance issues.

Conversely, we aim to reward those – and benefit from – issuers that may not have a very strong ESG profile but are taking meaningful initiatives to make improvements. This is dependent on the associated risks not being material enough to pose a serious risk of capital impairment. For example, Volkswagen faced the fallout from its emissions scandal, but management change led to serious steps being taken to redeem itself and significantly improve its ESG profile. Another example is an issuer in a high emission industry that has a credible strategy to transition to a low carbon economy and can evidence its progress. We want to benefit from ESG-led credit improvements that translate into tighter credit spreads. Ultimately, we believe improving ESG profiles will benefit society as well as increasing the potential for bondholder gains.

How do you integrate ESG considerations into your credit research?

Our credit analysts aim to identify the most material ESG considerations for each issuer we invest in, to make sure we can understand and price the risks and then aim to detect credit improvement or deterioration before the market prices in this change. To do this, we need to conduct our own forward-looking ESG analysis rather than using external ESG data providers, which tend to base their scores on backward-looking disclosures.

We do not have dedicated ESG analysts in the credit research team because we consider ESG analysis a core part of credit analysis. We believe no one is more qualified to integrate the most material ESG considerations into our credit recommendations than our credit analysts who are experts in their sectors. To authentically integrate ESG, we consider credit analysts to be best placed to incorporate it within the research, rather than have a small number of ESG analysts providing an 'overlay' and engaging on their behalf. We do, however, leverage our centralised specialist ESG resources to support us with research and engagement.

What are the benefits to having proprietary ESG ratings as well as using external ESG data providers?

We believe both add value – but in different ways. While we subscribe to several third party ESG data providers, we believe it is imperative to carry out our own analysis, in line with the reasons noted previously, and set a proprietary ESG rating for every issuer we hold.

The biggest difference between external providers and our own ESG ratings is the focus on what we consider most material for each issuer. We also put a greater emphasis on the forward-looking factors and the direction of travel rather than just backward-looking historical data. We are also cognisant of some biases inherent in external ESG scores given that large companies from certain regions tend to provide better disclosures and score more highly. While we acknowledge there are data challenges, where we do make extensive use of external data providers is in relation to climate change. We use various sources of climate data to inform our assessments and measure and manage climate change risks in our portfolios.

What are the biggest challenges you are currently facing in ESG investing?

The biggest challenges remain the lack of standardisation in disclosures as well as the depth and quality of the disclosures that we need for better visibility into how companies are run, particularly around some harder to quantify 'S' metrics. This is why we believe company engagement is so important. Whether it is encouraging companies to improve their carbon disclosures or trying to better understand their policies around supply chain management, diversity or financial inclusion, a proactive dialogue with companies is necessary until we have more standardised metrics and better reporting from companies. This is important because encouraging companies to improve in these areas should ultimately help drive stronger corporate sustainability and enhance investment returns.

Hence, we are strong advocates of active engagement and industry-wide collaboration with our peers to help steer improvement and make progress on corporate disclosure. Our efforts in this area include helping to frame questionnaires that seek to standardise minimum disclosure from issuers. We recognise they are inundated with questions from investors and not always sure what they should be disclosing. We also take part in working groups and events that bring together issuers, asset managers and credit rating agencies, as well as being a Task Force on Climate Related Financial Disclosures (TCFD) supporter and actively engaging with issuers on their alignment with TCFD recommendations. In addition, we are a member of the SASB Alliance, that helps businesses around the world to identify, manage and report on the sustainability topics that matter most to investors.

What are institutional investors currently focusing on related to ESG?

Different regions tend to focus on different areas and use different ESG approaches. For example, many of our Australian clients do not want to have exposure to tobacco, while in Asia tilting ESG portfolios towards 'Best in Class' ESG profiles in addition to some exclusion criteria is gaining prominence. In the US, if you manage a pension fund in a US State where the coal industry is an important employer, the remit would probably have a different perspective than in Europe. Certain states would likely also exhibit very different views on guns and gambling too. In Europe, in addition to controversial weapons, more and more of our clients are asking to exclude companies that generate a certain percentage of revenues from thermal coal without turning their Integrated ESG mandates into an SRI strategy. But full divestment from controversial sectors is also becoming very common, for example, from French, Dutch or German clients. Climate risk measurement and management is one of the top concerns on clients' minds and we partner with them to implement their climate objectives, whether in an Ethical or Integrated ESG strategy. European clients are also allocating more to impact strategies. What we as an asset management industry need to provide to our clients is choice. Investment options and solutions that align with their values and help achieve financial as well as ESG performance objectives.

How do you implement climate aware solutions?

We work with our clients to tailor their mandates according to their risk-return and ESG objectives. For climate-aware strategies we can explore a range of different approaches, for example carbon reduction targets, two degrees alignment, actively financing the transition via green and brown industries, active engagement, targeted exclusions or full sector divestments, or a combination of these. As a result of increasing focus on climate risk measurement and management, an emerging trend among European and UK institutional investors is to implement specific and targeted climate objectives within an Integrated ESG strategy. Rather than just applying blanket exclusions of controversial 'sin' sectors, some asset owners are now asking for a more holistic way of including specific and more granular exclusion criteria into their mandates while also allocating more capital to those 'transitioning' companies that have a credible climate strategy and science-based targets. For example, we have been working with some clients to include targeted exclusion criteria, particularly around companies that derive a certain percentage of their revenues from thermal coal extraction or power generation, rather than excluding fossil fuels altogether from their mandates.

When it comes to negative screening, however, there can be obstacles based on the level of detail on which ESG data providers can screen. When screening for coal, for example, ESG data vendors do not take a company's climate strategy and recent progress in moving away from coal into consideration and data can be a year out of date. Also, they may not be able to ascertain the percentage of revenues generated from thermal coal and metallurgical coal. The latter is still necessary for steel production – a vital part of the future economy – and is very hard to decarbonise. Or in the mining sector, for example, for some companies thermal coal as a percentage of earnings, as opposed to revenues, is a more appropriate benchmark given the nature of their business, but this is not readily available. Hence, in our view it is vital that investment decisions include proprietary ESG research and active engagement with issuers as opposed to just relying on third party vendors' data. This, to us, demonstrates there is no substitute for analysing the numbers in-house to derive the most accurate and relevant information for those asset owners who are implementing a more complex but perhaps more effective approach to divesting.

Also, what is becoming more necessary and apparent, is an in-depth understanding of every issuer in terms of their climate strategy, where they are on their decarbonisation path, or in the case of coal, what type of coal is extracted, for what use, if there's a viable alternative for it and whether the company has a credible strategy to exit thermal coal. Targeted exclusions are more complicated but ultimately should lead to much better outcomes to actively finance the energy transition and help position portfolios and investors away from unwanted financial risks.

Why do you believe ESG is best implemented using an active strategy rather than passive?

In our view, it comes down to extracting the maximum benefit from identifying and driving change. ESG analysis is ultimately about being on the right side of change. As active managers our goal is to be proactive and spot improving trends in the economy, sectors and bond issuers that can boost returns and equally avoid deterioration that could damage returns. We believe there are clear benefits to accessing this larger toolbox that active management can offer to help mitigate risks, drive change by proactive company engagement and seek out stronger risk-adjusted returns.

Do you think the importance of ESG will continue to grow?

Definitely. We think 2020 has proven that ESG analysis is not just a bull market luxury but very much a bear market necessity, and its importance will only grow. In the past, ESG was integrated mostly on the back of client demand. Upcoming regulations, however, especially in Europe, will require that ESG is systematically integrated within investment management. This momentum seems certain to increase globally as governments, policy makers and regulators push for meaningful progress on addressing climate change and social issues. In fact, the COVID-19 crisis has shown us what a global systemic emergency looks like and reinforces to us the importance of accelerating the fight against other globally relevant threats, such as global warming, loss of biodiversity, inequalities and build a greener, resilient and more inclusive global economy in the interest of everyone, including investors and asset owners.

In terms of climate change, there is a pressing need to reallocate capital to speed up the transition to a low carbon and circular economy if we are to limit global warming to well below two degrees. More public and private sector investments will need to be channelled into clean energy and new technologies as well as helping high-emission and hard to abate sectors, that are vital to economic growth, to decarbonise and align with the Paris Agreement. We as an asset management industry need to provide to our clients a range of investment options and solutions that align with their values and help achieve their financial as well as ESG related objectives. We expect to see more innovative, well designed and purpose led strategies to address real issues and achieve real outcomes. For example, in our view, Transition Finance will have a big role to play and recent developments around sustainability-linked instruments were well received by the market. Demand is rising for companies that are able to transition to a more sustainable world and they should provide better risk-adjusted returns over the long term.

We believe good ESG analysis will be key to identifying and supporting companies that are driving, and benefitting from, change and in turn allowing us to deliver good quality and consistent risk-adjusted returns for the clients we serve.

References made to individual securities should not constitute or form part of any offer or solicitation to issue, sell, subscribe or purchase the security.

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Glossary

Bear market: a financial market in which the prices of securities are falling. A generally accepted definition is a fall of 20% or more in an index over at least a two-month period. The opposite of a bull market.

Bull market: a financial market in which the prices of securities are rising, especially over a long time. The opposite of a bear market.

About the author

Adrienn Sarandi
Director of Fixed Income ESG
Adrienn Sarandi is Director of Fixed Income ESG at Janus Henderson Investors. Prior to joining the firm, Adrienn was a fixed income investment director at Schroders, London, where she covered active credit and other fixed income solutions. Before that, she was a fixed income product specialist at Legal & General Investment Management, London, a fixed income investment analyst at Colonial First State GAM, Sydney, and a senior associate at PIMCO Europe Ltd. She started her career in 1999 in investment banking, working in research roles at ABN Amro Bank and Merrill Lynch.

Adrienn received her MSc in economics from the University of London, Birkbeck College. She has 21 years of financial industry experience.

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