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ESG: Three Challenges High Yield Managers are Tackling Today

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BARINGS INSIGHTS

From influencing company behavior to seeking better data disclosure, high yield managers are pushing the envelope when it comes to ESG.

The integration and thinking around environmental, social and governance (ESG) factors is ever-evolving. While ESG unquestionably plays a pivotal role in investment decisions across the markets—from equities and fixed income to alternatives and real estate—each industry and asset class is characterized by its own nuances and unique challenges.

High yield is no exception. While the industry has made tremendous strides in recent years, there is progress still to be made—particularly given the growing interest in, and attention on, ESG and sustainability around the globe. Encouragingly, investors and managers are facing up to these ESG challenges in a variety of ways, from focused engagement with companies to collaboration with industry players to the development of innovative analytical models. In this piece, we focus on **three ESG challenges** high yield managers are trying to solve, and shed light on how we are tackling them and where we think the industry is headed.

1. Influencing ESG Practices (as Debt vs. Equity Holders)

High yield issuers carry a heightened risk of default, a strong consideration when factoring in any potential risks, including ESG. Whether looking at a company's safety and labor standards or its CEO succession plan, any one risk has the potential to generate negative headlines and impact the price of a bond or loan. One challenge for high yield investors, as debt rather than equity holders, is that by definition they do not own shares, or sit on the boards, of companies, and therefore cannot vote to influence company behavior the same way equity investors can. But investors and managers are increasingly pushing the envelope. For many investors, for instance, it's not enough for managers to claim ESG analysis is part of the investment process—most want tangible examples of how managers are making an impact despite their position in the capital structure.

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The thinking around engagement and influence has certainly evolved, and while it is true that high yield investors are not voting shareholders, their ability to influence and engage with companies has become increasingly clear—and significant. At a high level, the global credit market provides the bulk of financing to companies, meaning fixed income investors have a very real ability, and arguably responsibility, to hold issuers accountable on ESG. In many of our high yield investments, for example, we hold material positions in the company's capital structure. Our position as a sizeable lender to an issuer gives us access to decision makers at the company and therefore the ability to encourage improvements in ESG behaviors and promote better ESG reporting and disclosure.

Indeed, we believe engagement—rather than relying solely on exclusion—is the most effective way of uncovering value and mitigating risks, and thus in the best interest of our investors. Engagement can include rigorous due diligence and conversations with company management, with the intention of gathering better information and promoting both transparency and accountability. At Barings, our analysts, in many cases, have close and longstanding relationships with the companies we lend to, engaging directly with senior management teams and financial sponsors to try and effect positive change and potentially help pave the way for stronger performance over time. While it involves rigorous due diligence and can be a long-term process, engagement ultimately allows us not only to build credibility with issuers, but also to better gauge how ESG factors may affect the performance of investments over time.

2. Carbon Emissions Reporting

Carbon emissions reporting is top of mind for many, particularly as policymakers around the globe enact various measures to reduce greenhouse gas emissions and move toward low-carbon or carbon neutral economies. Investors, too, are putting increasing pressure on managers to reduce the carbon footprint of their portfolios.

However, there are a few inherent challenges to carbon emissions reporting when it comes to high yield. For one, relative to the more technology-focused, asset-light companies in the large-cap equities market, companies in the high yield universe tend to be more asset-heavy—which increases the overall carbon intensity of the asset class. At the same time, data around companies' carbon emissions can be fairly opaque. This is particularly true in the European loan market, where the majority of issuers are private, sponsor-owned companies, sometimes lacking the resources to produce comprehensive carbon emissions reporting. In fact, in the European loan sector, only about 20% of companies are transparent with their carbon data.[1] Disclosure levels are slightly higher when it comes to bonds, particularly in the U.S., given the greater prevalence of larger, publicly listed companies.

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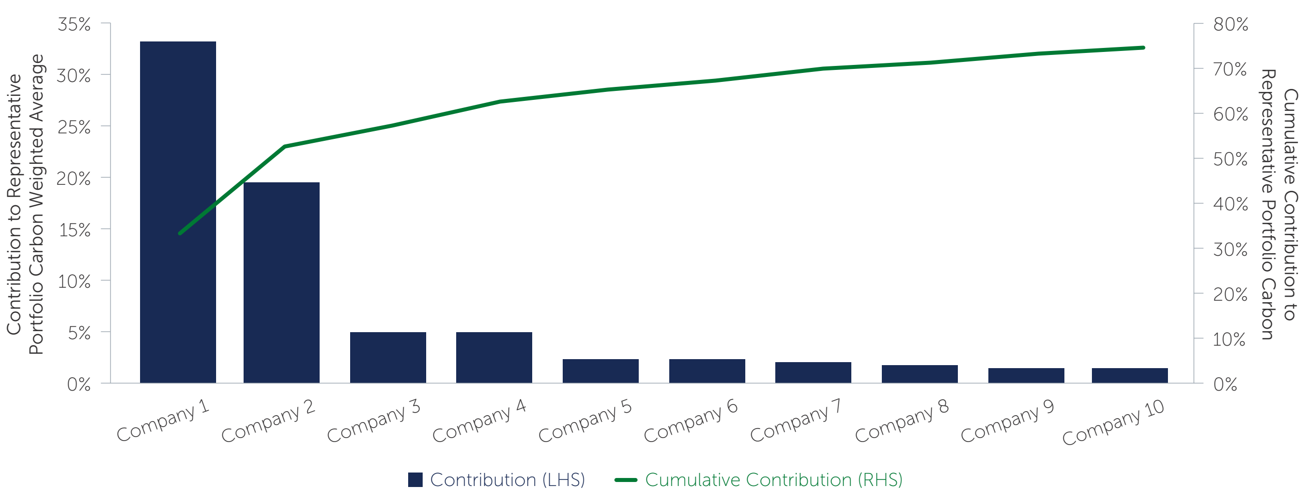
The exposure of the high yield market to asset-heavy industries like energy, coupled with ongoing regulation, underscores the importance of carbon reporting. While we expect to see improvements in these disclosures going forward, there are varying ways managers are seeking to overcome the reporting shortage today, some more effective than others. At Barings, we have developed a carbon footprint model to help us and our clients better understand the carbon impact of our portfolios. As part of our process, we use carbon data where it exists, and if it doesn't, we estimate the total carbon emissions that companies generate based on a set of comparable companies. For one of our European loan portfolios, for example, only 16.8% of carbon emissions data was officially available. Our model was able to estimate the data for another 76.6% of the portfolio, which meant our total data coverage reached 93.4% of the overall portfolio.

FIGURE 1: Issuer Contribution to Weighted Average Carbon Emissions

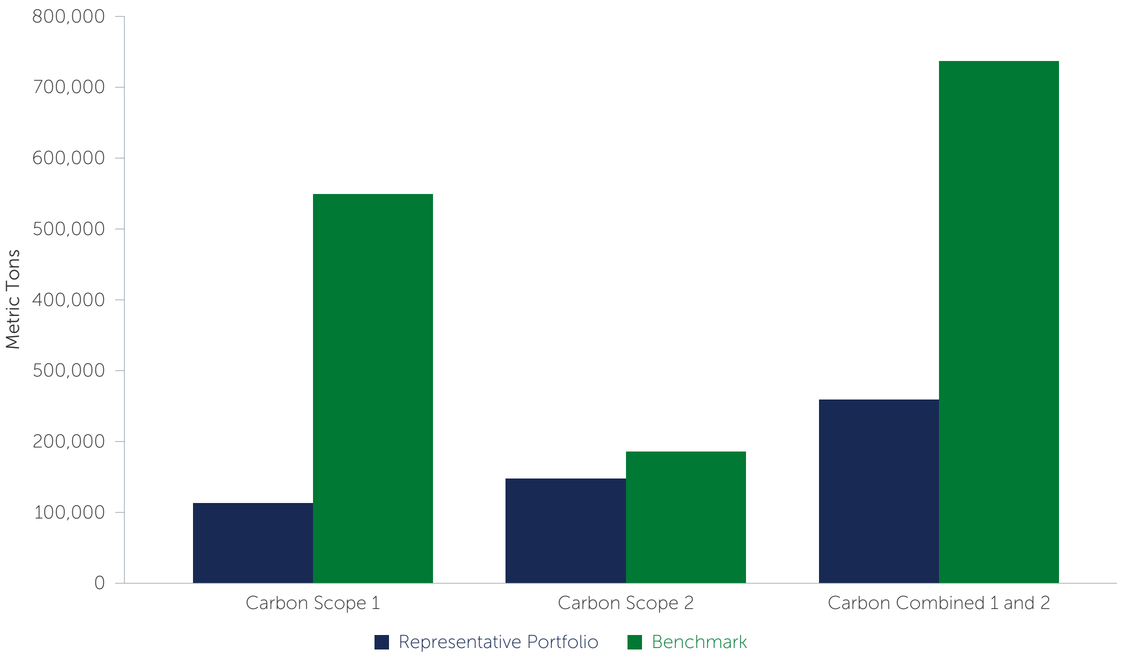


SOURCE: Barings. As of February 26, 2021.

1. Source: Based on Barings' market observations. As of December 31, 2020.

In helping us measure the carbon levels in our portfolios, this model also allows us to isolate those companies with the highest expected carbon emissions in the portfolio and target our engagement activity on those companies. Typically, we have found that a large portion of the carbon in a portfolio is centered on a handful of names. For example, in one of our portfolios, we found that two issuers accounted for more than 60% of the portfolio's total carbon emissions. In addition to helping us consider carbon emissions in portfolio construction, this data allowed us to focus our engagement on the companies where we thought it would be most impactful.

FIGURE 2: Weighted Average Carbon Emissions of Representative Portfolio vs. Benchmark



SOURCE: Barings. As of February 26, 2021. Carbon Scope 1 refers to direct emissions from the activities of a company, while Scope 2 refers to indirect emissions.

We believe this deliberate and targeted approach to engagement is more effective in the short term than trying to uncover data for, and influence the practices of, the hundreds of companies within the high yield universe—and longer-term, should help promote better practices more broadly. The model also allows us to look at future expected returns and carbon emissions side-by-side, to help gauge relative value and whether investors are being compensated in return for higher levels of carbon emissions.

3. Data Limitations

Disclosures and data can be quite limited in the high yield market, as already touched on, and what does exist rarely gives a comprehensive view of how a company is addressing ESG considerations. Coverage by third party providers is also relatively limited—and what is available from third party data feeds may not be the most reliable, as often these providers themselves do not have the full information or have not met with the companies they are analyzing.

This lack of data can make comparing or scoring companies more difficult. It has also created challenges around producing credible ESG benchmarks and indexes—although that is certainly the way the industry is heading given the push from regulators, companies, sponsors and investors alike. It is also worth noting that while the industry as a whole is advancing in these areas, different asset classes will inevitably evolve and progress at varying paces. We have already seen that to an extent, with ESG indexes available for high yield bonds but not yet for loans.

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Industry-wide, there are a number of ongoing initiatives seeking to improve the data that is available to high yield investors. For example, through our involvement in the European Leveraged Finance Association's ESG committee, as well as the London-based Loan Market Association, we are collaborating with our industry peers to identify ways to improve data disclosure in the high yield bond and loan markets. Along with a number of market participants, we are also involved in a project regarding the development of ESG loan indexes. In addition to bringing about better loan market disclosure—as companies with better disclosure would presumably receive higher ratings—initiatives in this area may ultimately bring about a more consistent methodology for rating companies.

While these efforts and initiatives will continue to push the industry forward, there are also certain measures managers can take today to help overcome the data deficiency in the market. At Barings, our large team of global high yield analysts performs rigorous, bottom-up ESG analysis on each new investment we consider, and also monitors ESG developments across our existing portfolio companies. Our analysts generally have a close relationship with the companies they cover, enabling them to better engage and interact directly with management teams to gather data. This capacity and breadth means we do not need to solely depend on third party providers, which may not have the same level of knowledge or interaction with company management.

Our in-depth approach to ESG helps us analyze risk—and improves our ability to gauge whether we're being compensated for the risk we are taking—as we incorporate ESG into our internal credit grades. For each company we analyze, we conduct a 'current state' risk analysis. As part of that, environmental, social and governance factors are rated on a scale of one to five, with a higher number assigned to companies with weaker ESG profiles. The final ESG rating assigned to a company is an average of the three scores, which is weighted differently by sector. We also place as much or more credence in an issuer's ESG outlook, and prioritize the direction in which a company is evolving over its starting point. In providing a way for us to gauge whether an issuer's profile is deteriorating, stable or improving, the outlook component of our analysis is critical in helping us uncover opportunities and avoid risks. Ultimately, a company's ESG profile—a combination of its current state and outlook—can affect its overall credit grade, both positively and negatively. And this in turn can influence our relative value recommendations and feed into portfolio construction.

Progress Over Perfection

High yield is making significant progress when it comes to ESG, and we expect the momentum to continue, particularly given the potential for ESG factors to materially influence the price of a bond or loan. At Barings, as we strive to be responsible corporate citizens, we strongly believe that integrating ESG into our fundamental, bottom-up investment process and engaging directly with companies to improve their ESG stance are crucial to delivering value to our investors.

The effective integration of ESG comes from considering a wide range of inputs across industries, companies and geographies, as well as from challenging our analysts and portfolio managers to think broadly and engage with companies in different ways. We are also continually developing and improving our approach to ESG, ensuring our practices and processes remain effective. In our view, this gives us a more holistic understanding of complex risks and value drivers, ultimately putting us in a position to seek better risk-adjusted returns over time.

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**As of December 31, 2020*

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