



FIXED INCOME

ESG: The Intent Beyond the Income

BARINGS INSIGHTS



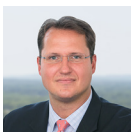
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ESG is playing an increasingly meaningful role in fixed income investing. At Barings, we formally integrate ESG across our corporate credit asset classes—but the way we apply our analysis is necessarily different due to the nuances of each market.

Environmental, social and governance (ESG) themes have risen in prominence across many investment strategies over the last decade. Shaped by the influence of investors, regulators and society—as well as by global issues that have and will continue to impact financial markets—sustainable investing is becoming ever more ingrained in the investment process.

The pace of this change is apparent in the growth of assets managed under sustainable strategies, which, globally, expanded to \$31 trillion at the start of 2018, up more than 30% from \$23 trillion in 2016.¹ Europe has the largest share, with roughly \$14 trillion of sustainable assets under management, followed by the U.S. (\$12 trillion), Japan and Canada.

That said, the rate of ESG adoption across asset classes has not been uniform, with equity leading the way in terms of formal adoption, and fixed income—by some measures—lagging behind. A key reason for this was the perception that fixed income investors, as debt rather than equity holders, were limited in their ability to meaningfully engage with companies. In addition, the data and disclosures available to fixed income investors have traditionally been less comprehensive.

But the tide is turning—or arguably has turned—for fixed income. 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. At the same time, companies are realizing that engaging with debt investors can have tangible benefits when it comes to navigating an ever-changing world, particularly to the extent that ESG can influence a company's cost of capital.

At Barings, we believe integrating ESG into fixed income investing can help mitigate risks, uncover new opportunities and provide long-term value to investors. The way we integrate ESG across our corporate credit asset classes is authentic to our overall investment philosophy, and an extension of the way we factor in any type of risk—in essence, we analyze ESG data alongside other fundamental factors in order to better understand each investment. While our formal integration of ESG is consistent across these asset classes, the way we apply our analysis is necessarily different due to the nuances of each market.

In this piece, we describe our approach to ESG across our corporate credit asset classes, highlighting firsthand examples of our own experience in high yield, investment grade credit, emerging markets corporate debt, and private credit.

Public Corporate Credit: A Formal Framework

Across our public fixed income strategies, we incorporate ESG into our internal credit grades. In helping us to quantify and track ESG risk, this formal framework helps us determine whether any extra risk we believe we are taking is reflected in the price of a security. For each company we analyze, we conduct a 'current state' risk analysis. As part of that, environmental, social and governance are rated on a scale of one to five, with a higher number assigned to companies with poor ESG profiles. The final ESG rating assigned to a company is an average of the three scores.

While our 'current state' analysis is critical to our process, we 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.

1. Source: Global Sustainable Investment Alliance (2018 Global Sustainable Investment Review).



As it has become increasingly clear that ESG can materially impact investment returns, both positively and negatively, active engagement—rather than applying blanket exclusions on entire sectors—has emerged as an effective means of **identifying improving credit stories, uncovering relative value** and, of course, **mitigating risks**.

Engagement, to us, is a means of influencing—or identifying the need to influence—an improvement in ESG principles or behavior. Engagement can include rigorous due diligence and conversations with company management, with the intention of gathering better information and promoting both transparency and accountability. It can be a long-term process, certainly, but through the engagement process, investors and managers have an opportunity not only to build credibility with issuers, but also to better gauge how ESG factors may affect the performance of investments over time.

IDENTIFYING IMPROVING CREDIT STORIES

The thinking and standards around ESG vary tremendously across the corporate credit universe. While some companies and countries have barely begun to consider improving their ESG performance, others maintain robust governance standards and adhere to strict environmental and social regulations. But one thing many have in common is the intention to grow and evolve in a sustainable way.

Indeed, the potential to identify and capitalize on improving credit stories is one of the most compelling arguments for active management and engagement when it comes to ESG. **Emerging markets corporate debt** is one area where this opportunity is particularly evident. At Barings, our EM corporate debt team invests primarily in hard currency bonds issued by EM companies. Emerging market companies tend to be closely tied to the country in which they are domiciled, meaning they can be more exposed to top-down risks. This is particularly true with state-owned businesses, but also extends to private companies, like banks, in industries heavily influenced by a country's macro climate.

Many emerging market companies are also in industries with high built-in ESG risks—metals & mining, oil & gas and power generation, for instance—and sometimes could be subject to less stringent governance and environmental regulations versus the developed world, depending on jurisdiction. Compounding the risks in this space, third party data and research is relatively scarce, and what does exist rarely gives a comprehensive view of how a company is addressing ESG considerations.

In our view, this presents a significant opportunity for value creation. More specifically, as active managers engage with both companies and countries to gain a better understanding of ESG concerns—as well as any steps being taken to address them—there is an opportunity to effect positive change, and potentially help pave the way for stronger performance over time.

To the extent that sovereign factors come into play, we also prioritize the direction of change over an issuer’s starting point. As we [discuss in detail here](#), a focus on identifying countries that are improving their ESG standards has tended to correlate well with strong future performance.



Case Study

EM CORPORATE DEBT: INDIAN MINING COMPANY

A mining company we owned had one of its facilities closed by the government following protests from local environmental groups. In response, we engaged with the company’s management team to get a sense of its strategy and plan for addressing these concerns. As part of those conversations, we requested additional disclosures and follow-up regarding the closed facility and any remedial actions required by the local community.

Overall, we felt the company’s management team was taking these concerns seriously, and has since provided additional information on the steps it is taking to mitigate its environmental impact. The company also appeared committed to upholding its disclosure standards. While some concerns remained, we were generally satisfied with the way the company addressed these ESG issues and, as a result, we remained invested.

The case studies included in this paper are being shown for illustrative purposes only. They should only be considered as a reflection of Barings’ investment process, and references to particular portfolio companies should not be considered a recommendation of any particular security, investment, or portfolio company. The information provided about particular portfolio companies is intended to be illustrative, and is not intended to be used as an indication of an investment’s current or future performance.

We have seen similar opportunities for value creation in **global high yield**, where we invest primarily in bonds and loans across the U.S. and Europe. Relative to emerging markets, there is typically more third party research available, particularly on bond issuers, though it tends to differ by region and company.

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. However, not all risks are likely to lead to significant downgrades or defaults.

In fact, periods of weaker performance and spread widening can often lead to opportunities, particularly in companies that are being penalized for past or current actions despite having taken steps toward enacting positive change. For this reason, we prefer to actively engage with companies to more thoroughly understand their approach and thinking around ESG—and where possible, to reward responsibility and progress. In our view, this can present opportunities to invest in companies with improving credit stories at very attractive prices—that often go on to outperform.



Case Study

HIGH YIELD: U.S. PHARMACEUTICAL COMPANY

A large pharmaceutical company in the U.S. made headlines several years ago due to allegations of price gouging and other governance risks—and as a result received a poor governance rating from third party agencies. Upon conducting our own internal analysis, we found that the company was taking material steps to improve its practices, including changing its board and firing its CEO. We interpreted this as evidence that the ESG risk may not have been as material as initially perceived. In other words, though the risks were certainly severe and worth flagging, we were able to make a case, based on our own analysis, that the company was headed in a positive and constructive direction.

Based on our analysis, we saw an opportunity to invest in this company at very inexpensive levels that were more indicative of its past transgressions than its forward momentum. Over the subsequent three years, the company went on to outperform significantly—and our investors, by extension, benefitted.

UNCOVERING RELATIVE VALUE

ESG analysis—in contributing to a more holistic understanding of a company’s risk-return profile—can also help managers differentiate among credits with similar financial profiles. This is perhaps most evident in the **investment grade space**, where many companies are highly rated and pose very little default risk. Relative to high yield and emerging markets debt, investment grade companies tend to have more internal data and commentary, as well as third party research, available—from quarterly and annual reports to ad hoc analysis based on news flow and market movements.

Many of the companies in this space have robust governance structures in place, and often are subject to stringent environmental protections and other regulations. To this end, we believe ESG analysis is one way to differentiate those companies that look most attractive from a relative value perspective—and through active management, we can adjust our portfolios accordingly.



Case Study

INVESTMENT GRADE: A PORTFOLIO’S CARBON FOOTPRINT

A European investor asked us to determine the carbon footprint of a portfolio we manage, relative to the index. We used third party data to conduct the analysis, and ultimately determined that the carbon footprint of the portfolio was much higher than the index.

However, upon analyzing the data more closely, we determined that the worst offenders were concentrated in two industries—airlines and utilities. We also determined that four of the individual companies in those industries were contributing only minimally to the portfolio’s return. As a result, we traded out of those names and by doing so improved the portfolio’s carbon footprint by 40%.

This isn’t to say that investment grade companies don’t pose ESG risks. In fact, many of these companies comprise multiple lines of business, sometimes in many different countries—and maintaining good governance across the spectrum is no easy task. It is also almost inevitable that certain segments of a business will pose some degree of ESG risk, due to a controversial product it manufactures, for instance, or the country where it’s based. Even if these factors are unlikely to significantly add to, or detract from, performance over time, they are critical inputs in a company’s overall risk-return profile—and thus to evaluating the relative attractiveness of any one issuer compared to its peers.

MITIGATING RISKS

As fixed income managers, it is not necessarily within our remit to determine what is morally right or wrong when considering ESG factors—after all, we are acting as stewards of our clients’ capital. But it is our responsibility to take a deep dive into the companies we analyze—whether in investment grade, high yield or emerging markets debt—to try to gauge whether, and to what extent, certain ESG risks threaten the performance of an investment. High carbon footprints and human rights violations, for instance, may have direct negative repercussions not only on a company’s reputation, but also on its operating costs and cash flows. Indirectly, these factors can lead to poor performance, downgrades and even defaults.

If, based on our analysis, we believe ESG risks are high enough to pose a material threat to investment performance, we may choose to reduce our exposure, particularly if we don’t believe a company is willing to improve its practices. We have also declined deals outright. Ultimately, we will not invest in companies or credits we are uncomfortable with, and have turned down opportunities where we felt, based on our internal analysis and active engagement with companies, that ESG risks were too high.



Case Studies

INVESTMENT GRADE: U.S. ENERGY COMPANY



A large exploration and production company in the U.S. recently went through a multi-billion dollar merger—the largest in the company’s history. The company and board arranged the merger in a way that allowed them to circumvent a shareholder vote, raising a significant governance concern.

When we engaged company management, we emphasized the importance of good governance and diversification of the board. We saw no immediate change in the company’s behavior, and as a result reduced our exposure. Going forward, we will continue to monitor and engage with the company, and adjust our exposure in accordance with the steps it takes toward ensuring good governance.



EM CORPORATE DEBT: NON-BANK FINANCIAL COMPANY

An emerging market non-bank financial company was preparing to issue a debut three-year deal. Upon closer analysis—including a meeting with the company’s CEO—we had serious social and governance concerns. For one, there had been repeated instances of the CEO engaging in questionable behavior; we also uncovered a track record of insider trading and fraud. The company has also been flagged in the past for failing to pay taxes.

In addition, the company came to investors with a transaction that was marketed as capital-raising for their stable, more visible business lines, but in fact, a closer look revealed that the proceeds could be used to support an earlier-stage, and highly cyclical division. In this case, we declined the investment given our strong ESG concerns.

ESG in An Illiquid Market

The role of ESG in the **private credit market** is no less significant, albeit our process for analyzing ESG factors is (intentionally) different given the nature of the asset class. Private credit is illiquid, meaning there is limited to no ability to trade out of an investment over the course of what is typically a five to seven-year contractual term. Another challenge is that there is very little third party data available—the companies in this space are private, and typically smaller than their broadly syndicated counterparts, and in some cases lack the resources to produce in-depth sustainability reports.

As a result, when it comes to ESG, private credit requires a high degree of selectivity up front. For us, this means considering a wide range of potential ESG factors as part of our initial due diligence—for instance, whether a company is in a sector or industry that may be a significant contributor to climate change, or whether a portion of its revenue comes from more controversial areas like weapons manufacturing or alcohol.

Ultimately, if we believe there is a high likelihood that ESG risks will materially impact an investment over the course of its lifecycle—either directly or indirectly through litigation, regulation or reputational damage, for instance—we turn down the deal.



Case Study

PRIVATE CREDIT: OUTPATIENT HEALTH CARE PROVIDER

We recently evaluated an opportunity with a U.S. company that provides interventional procedures—such as injections and spinal stimulations—to help manage chronic back pain. There is a large and growing market for these procedures, as they tend to cost less than traditional back surgeries and often have shorter recovery periods.

As we conducted due diligence on the company, we discovered that it prescribes opioids as part of its ongoing care and monitors patient adherence to the prescriptions through an

in-house toxicology lab. While interventional pain management is often viewed as an alternative to opioids, we felt this course of treatment could incentivize the company to create additional revenue by both providing patients with opioids and testing them on an ongoing basis.

In light of the ongoing opioid crisis in the U.S., we also felt there may be future regulatory changes that could potentially alter the company's business model. Given all of these concerns, we declined the opportunity.



That said, there is also an opportunity for engagement in private credit—and we believe it is our responsibility to address ESG issues with investors, sponsors and companies. In private credit, engagement often consists of identifying the need to influence rather than directly effecting change. Often, this happens through conversations with management teams or private equity sponsors, in which we have an opportunity to ask questions or provide our views on the way ESG factors may impact certain industries or companies. It also gives us a chance to evaluate management teams and gauge whether their views and thinking are similar to ours when it comes to ESG—if we aren't on the same page or think a business may move in a direction that we're uncomfortable with, we are likely to decline the opportunity. Ultimately, we believe this form of engagement can go a long way in informing the thinking around ESG considerations and shifting the dialogue toward more sustainable practices.

Progress Over Perfection

The integration and thinking around ESG is ever-evolving, and there certainly isn't a one-size-fits-all approach to incorporating it into investment strategies. At Barings, as we strive to be responsible corporate citizens and a prudent fiduciary for all of our clients, we strongly believe that integrating ESG into our fundamental, bottom-up investment process is crucial to delivering value to our investors.

When it comes to ESG, we believe effective investment management comes from considering a wide range of inputs across industries, companies and geographies—and from challenging our analysts and portfolio managers to think broadly and engage with companies in different ways. Whether investing in private or broadly syndicated markets, emerging or developed, we are also continually developing and improving our approach to ESG, ensuring our practices and processes remain relevant and effective.

Our ultimate goal is to drive sustainable practices in our business, in our communities and in our world. We believe sustainability has a place in every aspect of our organization, and as such have taken concrete steps to formally integrate ESG into our investment strategies. 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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