The importance of ESG risk in Global Credit

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At First Sentier Investors, we believe responsible investment is an essential component of asset stewardship and that embedding responsible practices into the core of our investment activities is in the best long-term interests of investors.

A focus on Environmental, Social and Governance (ESG) issues can be particularly important when investing in credit markets. Companies' management of ESG-related issues has a direct impact on their risk profile and, in turn, the probability of default. A full assessment of ESG-related risk has therefore been embedded in the Global Credit investment process for more than 15 years, since we became a signatory to the PRI.

In this paper we outline how ESG factors affect decision making in the Global Credit strategy, to mitigate risk and to help preserve investor capital over the long term. We describe what we do, what we don't – and why.

What we do

We believe investing in credit is as much about risk management as it is about return management. Unlike shares, which theoretically have unlimited upside potential, credit market returns are asymmetric. Corporate bond investors either receive regular scheduled coupons and the repayment of the principal upon maturity, or the bond defaults and they receive something less. With such binary investment outcomes, it's critical to understand a company's overall risk profile through ongoing credit research.

From a credit investor's perspective, 'risk' primarily means default and the potential for permanent capital impairment. Risks that might appear non-financial today can become financial risks in the future, potentially jeopardising issuers' ability to service their debt repayment obligations.

Our research therefore focuses on assessing overall credit risk, as well as the early identification of deteriorating issuers. The analysis considers a variety of risk dimensions, including an emphasis on ESG factors that can affect the creditworthiness of companies over time. Ultimately, if a company manages ESG risks poorly, it's difficult to have confidence that other risks are being managed appropriately.

Credit analysts relentlessly monitor every holding to ensure any changes in risk are captured as early as possible – for example where the cash flow outlook jeopardises a company's ability to fulfil its debt repayment commitments. As risk changes, we act, with the intention of removing deteriorating issuers from portfolios before default risk starts to materially affect valuations, and before capital is impaired.

The process begins with each credit being assigned to a specialist analyst. These research professionals are allocated specific industry and regional coverage, as separate risks can affect companies in different industry sectors and geographic regions. This specialisation helps analysts understand and quantify the key risks present in particular areas of the market, and the effectiveness of companies' management of these risks relative to peers.

Analysts determine whether material risks stem from Environmental, Social or Governance factors and assess how well the company is managing these material risks. All of this is critical, as corporate collapses generally occur as a direct result of poor corporate governance.

A recap: what exactly are E, S and G factors?

We consider a range of factors for each ESG pillar. These include but are not limited to the following:

Environmental: emissions and pollution; energy and fuel management; water intensity; wastewater and hazardous material management.

Social: supply chains; human rights; community relations; customer welfare; data security and privacy; human capital; labour relations; and health and safety.

Governance: strong corporate governance structure, processes and systems including independence and composition of the Board; separate roles of the Chair and CEO; independent Pay and Audit committees, appropriate incentives for executives, including claw back provisions and the inclusion of ESG KPIs for executive remuneration; business ethics; management effectiveness; corruption; transparency and quality of disclosure; diversity and inclusion; and employee retention.

All of these factors can affect a company's success and license to operate over the long term.

Analysts utilise sustainability reports published by companies and third party research providers to help inform their views, although there's no substitute for engaging with companies directly. An ability to quiz executives on ESG risk management can be particularly insightful in the assessment of overall ESG risk. Some companies are able to explain clearly how ESG issues are incorporated into management's key performance indicators and compensation plans. Others have no formal improvement targets in place and can be vague when questioned.

All companies are assigned a formal ESG Risk rating on a five point scale, ranging from 'very low' to 'very high'. The assessment is forward-looking, considering ESG-related risks and impact on credit quality in the next one to three years[1]. Analysts are also required to indicate whether ESG Risk is on an 'improving', 'steady' or 'deteriorating' trajectory. This is an important element of the process; it is possible for our Global Credit portfolios to invest in companies with poor ESG Risk ratings, as long as the firm's management of sustainability-related issues is improving, or where the valuation appropriately compensates investors for the risk profile.

That said, controls are in place that limit the funds' exposure to securities with the highest ESG Risk ratings. Issuers can also be rated 'uninvestable' from an ESG perspective, typically due to very weak corporate governance, repeatedly poor corporate behaviour, and/or weak disclosure – all of which can impair the analyst's ability to assess the true credit risk of the company. All of our Global Credit strategies are prohibited from investing in these entities.

Red flags for a potentially uninvestable issuer include high levels of controversy, or an unwillingness in management to change. If they won't improve processes, behaviour and culture to better manage material environmental and social risks, we know that it could lead to future material financial impact through litigation, fines and loss of reputation. This can have a meaningful impact on the creditworthiness of issuers, particularly if a deterioration in their financial position affects the company's ability to service its debt repayment obligations.

An example of an 'uninvestable' company

A large Australian financial services company is currently on our uninvestable list, reflecting concerns over culture and questionable governance corporate practices. This was highlighted during the Banking Royal Commission, which detailed a list of misconduct charges against the firm. Management has flagged that remediation action by the company could take as long as nine years, and cost more than A$1 billion. Avoiding these kinds of potential risks is critical in the mitigation of default risk and to help preserve unitholders' capital.

The formal determination of ESG Risk ratings for every security held in the portfolio is an integral part of the investment process, as it influences the assignment of Internal Credit Ratings. In turn, these Internal Credit Ratings drive security selection and position sizing decisions. This ensures a link between ESG risk and portfolio positioning is maintained at all times. It also tends to result in our Global Credit strategies being oriented towards companies that are managing ESG risks most effectively. In our experience, this helps minimise investment risk.

Once ESG Risk ratings and Internal Credit Ratings have been assigned, we consider overall risk at the portfolio level. The role of our portfolio managers is to ensure, insofar as possible, an even spread of credit risk in the portfolio. Too much risk coming from one industry sector or country can result in a clustering of defaults, which can have an outsized impact on performance. A high level of diversification is therefore desirable and we aim to diversify portfolios at every level (i.e. country, quality and sector) to avoid correlation and concentration risk.

Specialist support

We employ the services of specialist ESG data vendors to augment our own research into issuing companies. We use Sustainalytics to help inform Environmental and Social risk assessments and MSCI for Governance assessments. We also utilise RepRisk to track the number and scale of controversies for companies over a one- to three-year period. The number and severity of controversies can be a reasonable indicator of how well companies are managing key ESG risks, and where there is slippage between policy and implementation. Information gained from these third party vendors can be helpful, but ultimately it is up to our credit analysts to determine which risks are most relevant through their understanding and analysis of individual companies.

Our credit analysts are also able to call upon the experience and expertise of a specialist, in-house Responsible Investment team. This group engages with all investment teams in the firm, sourcing relevant research, helping to refine internal processes, coordinating collaborative engagements with companies, and providing advice on technical issues.

What we don't do

With the exception of tobacco and controversial weapons companies – which are excluded from all of First Sentier Investors' debt and equity products – no sector screening is carried out across all of our Global Credit strategies. We have considered implementing additional sector screens – such as gambling, alcohol and fossil fuels – but rather than applying blanket exclusions across all of our Global Credit strategies, we believe our credit analysts are best placed to assess which companies in these areas are investable and which are not.

Nor do we have stated portfolio objectives that target specific goals from the published list of Sustainable Development Goals (SDGs). Supported by the United Nations, these are a collection of 17 social, environmental and economic development objectives designed to be a "blueprint to achieve a better and more sustainable future for all". Rather than selecting individual SDGs to focus on, we favour a more holistic approach. By encouraging all companies in which we invest to pursue best practice – and being willing to divest holdings where we do not believe adequate improvements are being made – we believe we can influence companies to improve their behaviour over time, for the benefit of society as a whole. If managed properly, effective management of ESG considerations can generate material benefits for society and the environment over the long term.

Defaults erode capital, and make it much more difficult to achieve stated performance objectives. Our funds have experienced very few defaults over time, affirming the effectiveness of our approach to responsible investment and our focus on ESG risks. In the three years ending 31 December 2021, for example, we experienced no defaults at all. In that same period, according to Moody's there were more than 350 defaults globally[2]. This cannot be due to good fortune; an unrelenting focus on companies' management of evolving ESG-related risks has undoubtedly helped us avoid defaults over time. In our view, that is the primary purpose of active management in this asset class.

1. In line with the horizon period of the Internal Credit Rating. We have a separate process for the assessment of Stranded Assets from ESG factors that consider risks beyond the 1-3 year time horizon of the Internal Credit Rating.
2. Moody's Investors Service Annual Default Study: 2021

The process in action

We engage directly with companies whenever and wherever we have the opportunity to do so, encouraging management teams to sharpen their focus on ESG considerations and help guide their thinking around evolving ESG-related risks. No two companies are exactly alike and different firms can face different issues. The focus is therefore on materiality – which issues are most likely to affect individual issuers, and to what extent?

Importantly, changes in a firm's ESG Risk rating often affect the Internal Credit Rating and, in turn, portfolio positioning. This was the case with US energy utility FirstEnergy, in late-2020 for example, where we became increasing concerned about corporate governance during a bribery scandal. The ESG Risk rating on the issuer was raised to 'very high' from 'moderate', resulting in the Internal Credit Rating being downgraded. The company was subsequently removed from our Global Credit portfolios.

The process works exactly the same on the positive side. In 2021, for example, our ESG Risk rating on US-based agricultural machinery manufacturer Deere & Co was lowered to 'moderate' from 'high'. This reflected the company's increasing use of renewable energy sources in the manufacturing process, steady progress on greenhouse gas emission targets and a reduction in product safety recalls. The improved ESG Risk rating resulted in an upgrade to the Internal Credit Outlook, which provided portfolio managers with additional confidence investing in the company.

In some cases, it can be relatively straightforward to estimate the potential financial impact of a particular issue. If a company has a higher carbon intensity than its peers, for example, it is possible to assess the potential impact of a carbon tax on its earnings and balance sheet. Other issues can be trickier to quantify in financial terms, but are equally important. Exposure to modern slavery, for example – or other controversies in a company's supply chain – can erode the firm's financial position. Formal reviews and audits of existing policies and practices can incur meaningful costs, divert management attention, and damage a company's brand name and reputation.

Independent recognition

Our commitment to assessing all elements of ESG risk as part of the investment process has been recognised by independent experts, including the Principles for Responsible Investment (PRI).

Supported by the United Nations, PRI is the world's leading advocate for responsible investment. With most large asset managers now signatories, it can be challenging for investors to differentiate between the innovators and the laggards. Usefully, the annual ratings awarded by the PRI can help investors recognise which firms have incorporated responsible investment considerations into their investment processes most effectively. In the most recent PRI survey 2021, First Sentier Investors was awarded a '5-star' rating for our analysis of corporate debt – the maximum possible rating. This score compares favourably with the peer group of more than 2,000 asset managers globally [3].

Want to know more?

If you're considering an allocation to Global Credit and understand the importance of ESG risk management in this asset class, speak to your account manager to find out more about our Global Credit strategies.

We've been investing in corporate bonds for more than 25 years and our investment team has the experience and know-how to manage credit portfolios through the full market cycle. The over-arching investment philosophy has been largely unchanged during that period and has stood the test of time. Our Global Credit strategies have performed broadly in line with expectations over full credit cycles, capturing the credit premium available whilst avoiding permanent capital impairment, i.e. defaults.

The Global Credit strategies offer:

A proven and differentiated investment philosophy: Since credit market returns are asymmetric, we focus on 'avoiding the losers' through rigorous credit analysis, combined with sophisticated portfolio construction that's focused on diversification.

Consistent long-term performance track record: Favourable risk-adjusted returns generated over multi-year time horizons*.

Multi-dimensional credit research: A proven credit research process focusing on assessing credit risk and identifying deteriorating issuers early.

Best-in-class ESG integration: ESG risk factors are an important consideration in the assignment of credit ratings on individual issuers, which in turn drive portfolio construction decisions.

3. PRI Assessment Report, 2021

*Past performance is not indicative of future performance.