Measuring To Manage: Evaluating ESG Risk In Corporate Debt

- Increased investor interest in sustainability issues is being met with increased disclosure by bond issuers and others of information about environmental, social and governance risks.
- Standish Mellon Asset Management Company LLC (“Standish”) has developed a proprietary risk scoring system that uses that information to objectively assess the ESG exposure of individual issuers, sectors and portfolios.

A familiar cliché holds that “you can only manage what you can measure”, and fixed income managers have long based investment decisions on quantitative measurements of risk factors. Chief among these are the so-called five c’s of credit—character, capacity, capital, collateral and conditions. But while these factors, combined with balance sheet and cash flow analysis, provide valuable insight into potential downside risks, they give an incomplete picture of an issuer’s environmental, social and governance (ESG) risk exposure.

Fortunately, the increasing interest in investment strategies that consider ESG factors is being met with increasing disclosure by corporate bond issuers about their exposures, goals and policies relating to those sources of potential risk. The Governance and Accountability Institute reports that 81% of S&P 500 companies published a corporate sustainability report in 2015, up from fewer than 20% in 2011. Meanwhile, organizations including Ceres, the Sustainability Accounting Standards Board and the Carbon Disclosure Project are encouraging companies to increase disclosure and are advocating for the standardization of the information that is disclosed. Also helping to increase the amount and quality of ESG-related information are data aggregators and rating services such as MSCI, Sustainalytics and Oekom who cover an increasingly vast universe of issuers.

The Standish ESG risk score

While increased data and transparency provide tools for managers to better understand ESG risk, the way in which the data is put to work matters even more. Identifying data that could materially affect the market’s perception of an issuer’s creditworthiness within the investment horizon is critically important. With this goal in mind, Standish has developed the Standish ESG risk score system, which provides absolute assessments of ESG risk that can be compared across issuers and sectors. It combines, with relative weights set by Standish’s investment team, the exposure and management scores that MSCI gives each issuer for up to 32 ESG-related issues. Issuer- and Portfolio-level ESG Analytics are available to portfolio managers and credit analysts, providing meaning and understanding beyond raw data.

No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.
Successfully portfolio management requires measuring and prioritizing the many factors likely to impact financial performance. Some of these metrics such as contribution to duration, contribution to spread duration and option-adjusted spreads are commonly understood industry standards. They are imperfect, but they provide a basis for communication, identifying trading opportunities and allocation changes. Their relevance and comparability across issuers and sectors makes them valuable. To incorporate ESG risk factors into this common language and the risk/reward assessment process, the Standish investment team created an ESG risk metric. It includes not just information that could materially affect the market’s perception of an issuer’s creditworthiness, but information that is specific to fixed income assets. For example, an issuer’s investments in promising—but unproven—green technologies may provide upside for shareholders, but those may be irrelevant to its Standish ESG risk score because they do not benefit fixed income investors more concerned about downside protection than with upside potential. With this principle in mind, the Standish investment team focuses primarily on four issues within each of the three pillars of environmental, social and governance risk:

- **Environmental Pillar**: MSCI Key Issue
  - Carbon Emissions
  - Energy Efficiency
  - Product Carbon Footprint
  - Water Stress

- **Social Pillar**: MSCI Key Issue
  - Labor Management
  - Supply Chain Labor Standards
  - Product Safety & Quality
  - Privacy & Data Security

- **Governance Pillar**: MSCI Key Issue
  - Corruption & Instability
  - Business Ethics & Fraud Management
  - Anticompetitive Practices
  - Board, Pay, Ownership, Accounting

At the beginning of the investment process, team members compile information on an issuer including ratings, balance sheet structure, revenue and cost/investment trends, cash flows/liquidity and credit spreads. All of these measures vary among issuers and industries but must be comparable. While these metrics don’t always provide a complete picture of an issuer’s creditworthiness, they provide a commonly understood body of knowledge for discussions between strategists, credit analysts, portfolio managers and traders.

Some of the ESG data and ratings providers’ methods are less relevant and comparable than our scoring system requires. For instance, some focus on “best in class” approaches, where issuers are compared to their peers. These approaches create potential blind spots when ESG risks are assessed across sectors. Other data providers focus on narratives which help provide context, but may reflect values or concerns that the provider views as important, but that we may not.

The results of this additive, issue-by-issue process are ESG risk scores that are fully transparent and allow credit analysts or portfolio managers to challenge the underlying data; for example, by subtracting risks that are largely priced in or mostly already addressed. This chart shows the average Standish ESG risk scores in each sector of the Barclays US Credit Corporate Index.

### Contribution to Standish ESG Risk Score by Sector

<table>
<thead>
<tr>
<th>Industry</th>
<th>Climate Change</th>
<th>Natural Capital</th>
<th>Pollution/Waste</th>
<th>Human Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking</td>
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<td>1</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Finance</td>
<td>3</td>
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<tr>
<td>Utilities</td>
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<tr>
<td>Energy</td>
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<tr>
<td>Technology</td>
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<td>3</td>
<td>1</td>
<td>2</td>
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<tr>
<td>Capital Goods</td>
<td>2</td>
<td>1</td>
<td>3</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Barclays, MSCI, Standish as of 3/31/16
Corporate behavior and corporate governance (red colors in the charts) are governance factors and are considered material across sectors—as would be expected for a pillar that is closely related to “character,” one of the five c’s of credit.

The contribution of environmental (green colors) and social (blue) factors to ESG risk varies greatly from sector to sector. The energy and utility sectors have high exposure to environmental risks. Less obviously, the entire transportation sector—not just airlines—also has exposure to climate change, a risk not necessarily captured by “carbon intensity” metrics.

The technology sector has relatively high social risk exposure in the areas of keeping a highly skilled and competitive workforce engaged (human capital) and exposure to privacy and security risks (product liability). Financials also have significant exposure to social factors especially in the banking, insurance, and brokerage subsectors where trust is a cornerstone of the business model.

**The Standish ESG score versus best-in-class scoring**

The Standish ESG risk score is an absolute measure of risk and as such is different from the “best-in-class” approaches to evaluating ESG risk exposure which we view as complementary types of ratings. The chart below shows how individual issuers in the Barclays US credit corporate index rank both on the MSCI weighted average ESG Score and the Standish ESG risk score. The MSCI scores use a best-in-class approach and are plotted along a vertical axis where 0 is worst in class and 10 is best. The Standish ESG risk scores are plotted on the horizontal axis with 0 having the least exposure to ESG risk and 10 the most. While there is a correlation between both ratings because best-in-class issuers tend to have less absolute ESG risk, the Standish ESG risk score clearly provides additional information about which issuers have, in our view, significant exposure to ESG risks.

Combining these two complementary measures may provide useful, objective metrics for investors who are wary of relying solely on a single approach to risk assessment. For example, investors concerned about climate change may not want to divest from all fossil fuel-related issuers because they believe that the more forward-thinking companies may play roles in promoting renewable energy. Those with this perspective would prefer to invest only in best-in-class energy companies while divesting from the worst and investing instead in sectors with less environmental risk exposure.

The increasing abundance and transparency of information regarding ESG risk has many implications for both fixed income investors and issuers alike. As consumers, regulators and investors increasingly consider ESG factors in their purchasing, rulemaking, and capital allocation decisions, the distinctions between best- and worst-in-class companies are likely to become more pronounced. We believe the Standish ESG risk score provides a useful, objective assessment of ESG externalities than may be internalized and eventually may become one of the many drivers of an issuer’s credit performance.
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