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Strengthening ESG risk assessment through dynamic credit analysis

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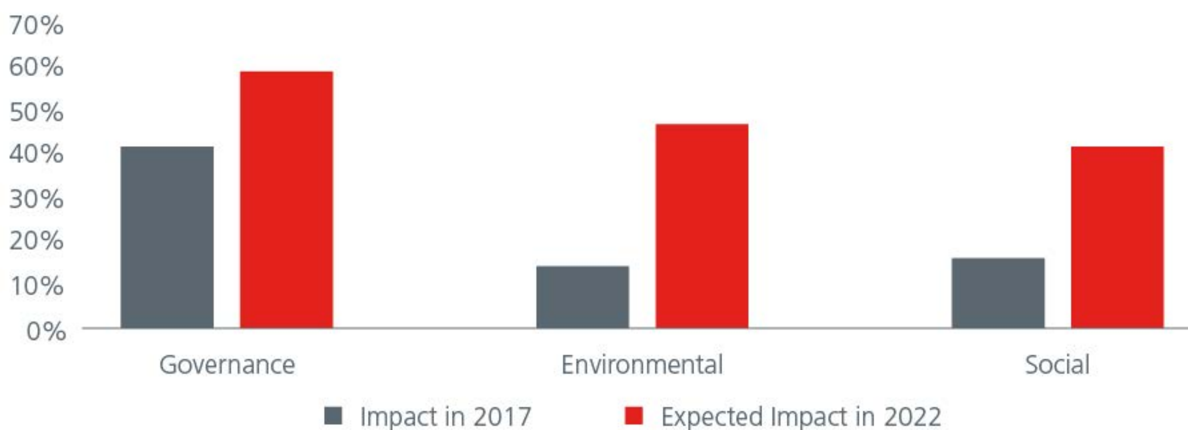
Investors increasingly recognise the benefits of ESG risk analysis in protecting the long-term value of their investments. As investment managers look to assess ESG risks, inadequate ESG disclosures, inconsistent definitions, diverse and often subjective interpretations imply that there are no short cuts to this process. We cannot merely rely on external ESG evaluation; active fixed income managers with significant credit research capabilities would be able to better understand the ESG risks of issuers and add value to investors.

Investors are starting to appreciate that focusing on Environmental, Social and Governance (ESG) factors help reduce their exposure to long term risks. Increasingly, regulations, such as more stringent emission standards and heavier penalties for violations of environmental standards have raised the materiality of ESG risks to issuers.

According to a survey conducted by the CFA Institute, investors expect environmental and social factors to have a greater impact on credit spreads and government bond yields going forward. See Fig. 1.

Fig 1: % of respondents who answered "often" or "always" to the question – "How often do ESG issues affect corporate bond and sovereign debt yields?"



Source: ESG integration in Asia Pacific: Markets, Practices and data, CFA institute, 2019.

Fig 2: Annualised return and volatility (Since December 2012)

	Since Dec 2012	
	Annualised Returns	Annualised Volatility
JACI Index	4.24%	4.20%
JACI ESG Index	4.20%	4.17%
JACI High Yield Index	4.64%	6.71%
JACI High Yield ESG Index	4.25%	6.27%

Source: Eastspring Investments. As of end May 2020.

Research has shown that higher ESG ratings correlate with lower credit spreads, and issuers with good ESG track records tend to benefit during periods of flight to quality. A study by Bank of America Merrill Lynch shows that 73% of Asia Pacific companies which were downgraded[1] between December 2009 – 2018 had below median ESG scores. Higher ESG scores, however, did not correlate with upgrades. This suggests that the consideration of ESG factors can help mitigate credit risks.

The lower long-term risks resulting from an ESG-focused investment approach can be seen from Fig. 2. The JACI ESG indexes, especially the JACI ESG high yield index, have lower volatility while delivering returns that are comparable to the broader bond indexes. MSCI also found that companies with high or upgraded ESG ratings generally experienced lower volatility[2].

ESG RISK ASSESSMENT – IT'S COMPLICATED

ESG risks may not be immediately apparent and could gestate over a longer time period. Research by MSCI suggests that governance factors tend to have a greater impact on profitability, idiosyncratic and systemic risks in the short term (1 year) as they are most directly linked to short term events and incident risks. Environmental and social factors, on the other hand, are more important over longer periods. Not only do time horizons impact ESG factors, there are also sectoral differences to consider. Governance factors, for example, may matter more for the financial sector while environmental factors may be more critical for the materials and energy sectors[3].

As such, careful analysis is required to identify companies that are undergoing structural changes and assess their ability as well as readiness to adapt to such changes. By understanding the long-term viability of an issuer's business model, active managers like ourselves can potentially avoid downside risks and protect the value of the portfolio's underlying investments over the long run.

ESG risk evaluation often goes beyond assessing a set of numbers but instead requires evaluating a myriad of "soft" and sometimes subjective factors. ESG factors are expansive and diverse, which makes them almost impossible to distill into a single number or rating that indicates "good" or "bad". For example, how should one assess the environmental impact of a nuclear power plant or a

Source: [1]By Standard & Poor. [2]BMSCI. Foundations of ESG Investing. How ESG Affects Equity Valuation, Risk, and Performance. Guido Giese, Linda-Eling Lee, Dimitris Melas, Zoltán Nagy, and Laura Nishikawa. July 2019. [3]MSCI. Deconstructing ESG Ratings Performance. Risk and Return for E, S and G by Time Horizon, Sector and Weighting. Guido Giese, Zoltan Nagy, Linda-Eling Lee. June 2020.

hydro-electric dam? Such grey areas have led us to devise innovative ways to assess the corresponding risks and apply them in a consistent manner across our investment framework.

The challenge in evaluating ESG risks can be seen from the fact that even ESG rating providers have different ESG ratings for the same company. Fig. 3 shows that while really "good" and "bad" ESG performers may be obvious, there is often greater subjectivity in rating companies that fall in-between.

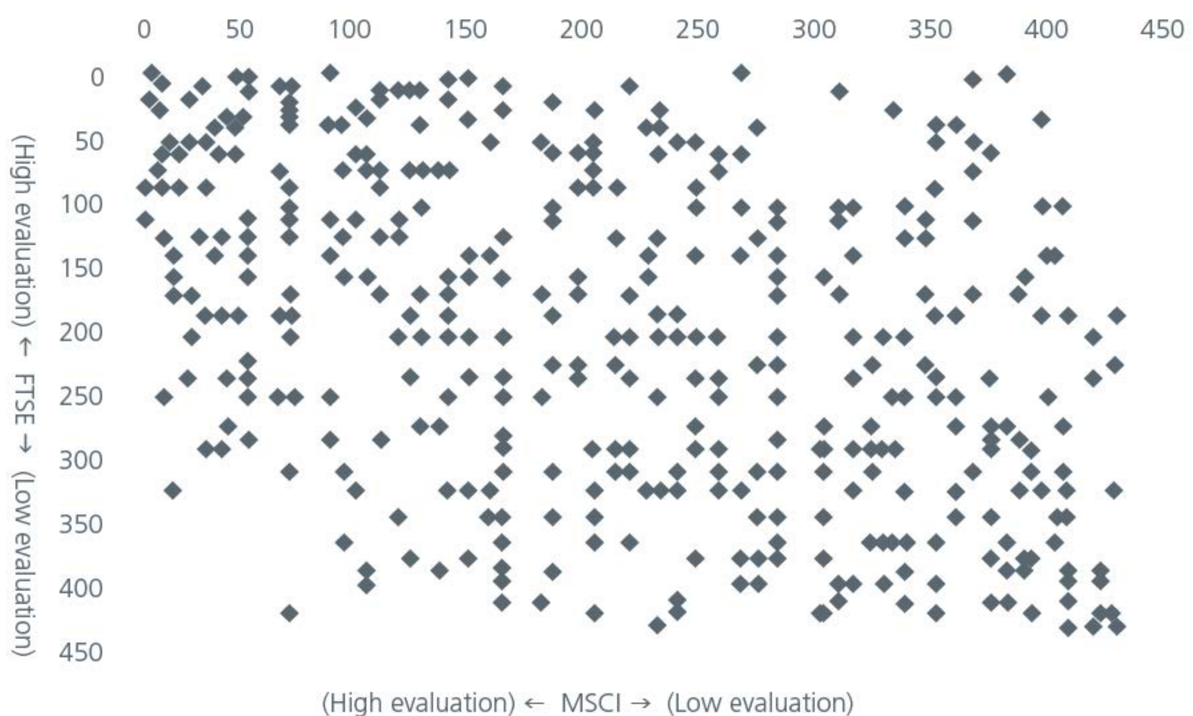
NO SHORT CUTS

As such, we believe that there are no short cuts in ESG evaluation. This is particularly so in Asia with its inconsistent ESG standards and inadequate ESG disclosures. See Fig. 4. In fact, China only recently removed clean coal projects from its list of green bond financing targets, in order to bring some of its ESG parameters up to par with global standards. The lack of alignment between disclosure regimes across different jurisdictions also makes cross-country comparisons difficult. While many governments and institutions have pushed for greater ESG-related disclosures, Bloomberg's ESG Disclosure Score Index (which ranks the usefulness of a firm's disclosure information) gives the median company across 17 countries[4] a score below 50%.

We believe that active fixed income managers add significant value through their in-depth research of companies and understanding of ESG issues.

At Eastspring, we do not simply rely on external ratings and assessments but draw on the strengths of our large credit research team. Their experience and depth of knowledge of the issuers help us make more informed decisions. While credit

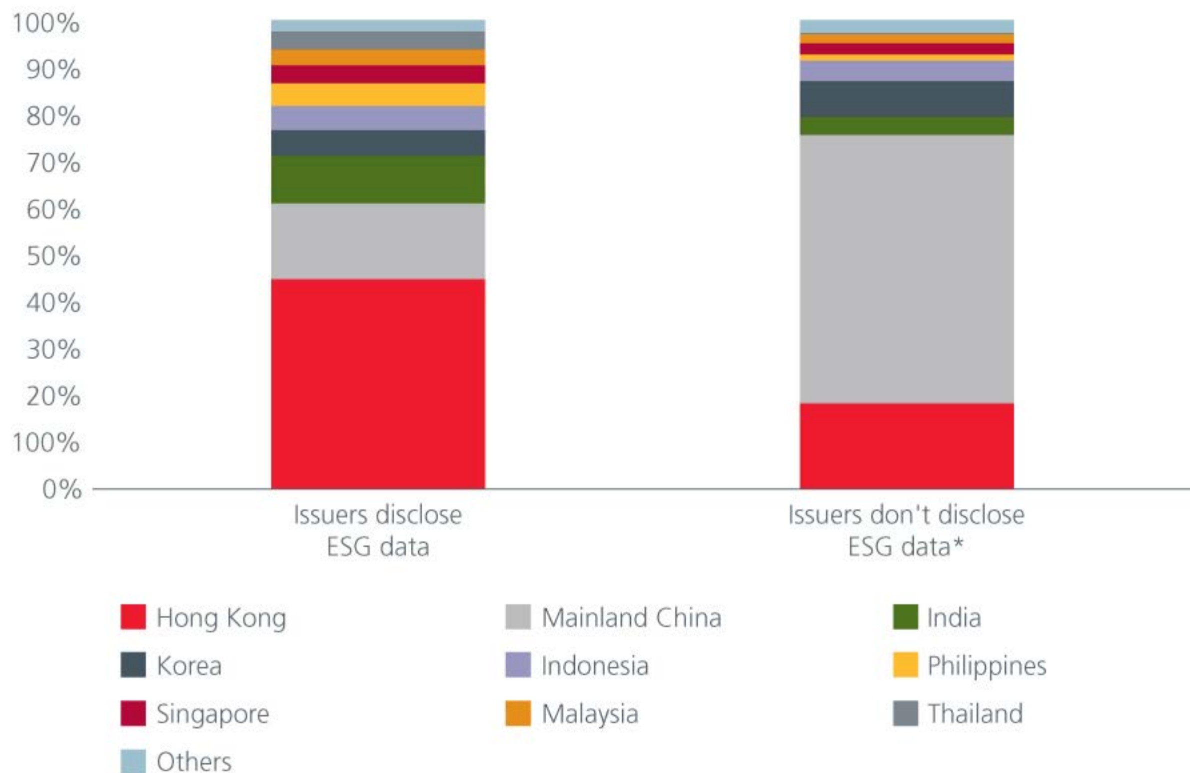
Fig 3: Comparison of ESG scores between two rating providers



Source: Asian investment bank CLSA and the Asian Corporate Governance Association.

Source: [4]Bloomberg. IIF. Includes companies listed in the benchmark stock exchanges in Indonesia, Thailand, Turkey, Korea, Brazil, US, Canada, South Africa, Europe, Hong Kong, Mexico, Singapore, India, Malaysia, Australia, China, Japan.

Fig 4: ESG disclosure breakdown by exchanges



Source: Bloomberg, company data, HSBC, November 2019; *No ESG data available on Bloomberg; **Market of origin for non-listed companies.

worthiness is a key pre-requisite, all securities and issuers are subject to an additional set of ESG risk evaluation criteria. We have formally incorporated corporate governance, historically an important factor in evaluating issuer risks, into our proprietary ESG evaluation framework.

We also do not automatically exclude issuers in controversial industries. Instead we prefer to assess the effort that such companies are making to remain relevant and whether they may be effecting positive changes within their industries during the process. Some coal-powered operators, for example, are transiting to renewable sources of energy. We acknowledge these positive initiatives and may keep such issuers within our portfolios. We believe that active engagement with investee companies goes a long way to improve ESG practice and management.

AN EVOLVING JOURNEY

A comprehensive ESG risk assessment will remain challenging until we achieve better quality ESG disclosures and greater consensus within the industry of what ESG means (ie a common taxonomy). While companies are already making progress on this front, thanks to the numerous international, regional and national initiatives, active fixed income managers that have significant credit research capabilities would be able to better understand the ESG risks of issuers and add value to investors.

As the market evolves, we continue to refine our ESG framework with our learnings. We aim to embed our ESG framework across all our fixed income strategies as we seek to deliver sustainable long-term performance for investors.

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