Insight INVESTMENT

RESPONSIBLE INVESTMENT IN PRACTICE

THE GROWING IMPORTANCE OF CORPORATE ENGAGEMENT BY FIXED INCOME INVESTORS

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Part of BNY MELLON

SUMMARY

- Historically, fixed income investors have been less focused on corporate engagement than equity investors
- At Insight, we believe that fixed income investors have a responsibility to engage with companies
- Corporate engagement is another way to measure and manage credit risk, and so primary responsibility for engagement lies with Insight's credit analysts
- Insight conducts proprietary environmental, social and governance (ESG) research that supports direct engagement with companies

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THE GROWING IMPORTANCE OF FIXED INCOME INVESTORS IN CORPORATE ENGAGEMENT

Engagement has traditionally been lacking

Fixed income investors have traditionally been less focused on corporate engagement than equity investors. Unlike bondholders, equity investors can use their votes to guide corporate behaviour and show dissatisfaction with management/the board. Major shareholders may also have more access to the CEO and senior management, while fixed income investors will typically interact with the CFO or corporate treasurer. These limitations mean that fixed income investors typically do not have the opportunity to discuss ESG risks with corporate influencers, while some fixed income investors might outright dismiss the importance of engagement.

Fixed income investors have an important role to play

At Insight, we believe that fixed income investors can and should play a more active role in corporate engagement. While lacking a shareholder's vote, bondholders still have several avenues of access to senior management through which they can undertake impactful engagement. Capital-raising events provide one such avenue. While equity capital tends to be raised infrequently, companies regularly tap bondholders for financing, providing a clear incentive to address bondholders' concerns. Investor roadshows that usually accompany new bond issuance provide an opportunity for investors to hold companies to account. Another avenue is via regular dialogue with senior management apart from capital raising. Insight had approximately 1,600 meetings with senior management of issuers in 2017.

CORPORATE ENGAGEMENT IN THE FIXED INCOME PROCESS

How Insight integrates engagement

Insight believes that corporate engagement starts with the credit analyst. We believe that engagement is just another way to measure and manage credit risks, and has material financial implications for our investments. On this basis it is best understood within the context of the wider investment process.

Our credit analysts meet all companies ahead of investing in any bonds or loans that they have issued, or are about to issue. We have regular contact with companies through a variety of methods, including face-to-face meetings, investor conferences, conference calls, emails and letters. The frequency of our communication with issuers depends on the risks identified during our research process.

Escalating engagement activities will occur on a case-by-case basis. From a risk perspective, if we are not satisfied with a company's management of risk (including ESG-related risks), we are prepared to sell holdings, withhold investment or move to an underweight position. Over 2017, our analysts undertook 448 company engagement meetings concerning ESG matters (Figure 1).

Figure 1: Dialogue with issuer management on ESG matters in 2017[1]

[1] Source: Insight Investment, as at December 2017.

© Image: *'Mauna Kea Moonset'* by Sean Goebel (USA)
Insight Astronomy Photographer of the Year competition 2017

Insight's proprietary ESG scorecard

Insight uses a research provider for data, analysis and ratings for most corporate issuers in our investable universe. On a weighted basis approximately 98% of investment grade (IG) issuers, 80-85% of high yield (HY) issuers and 80% of emerging market (EM) issuers are covered by this data, with many privately controlled companies accounting for the gaps. As ESG factors are integral to our risk-management process, we cannot ignore ESG data gaps.

To mitigate the lack of coverage we engage directly with corporate issuers. Insight's credit analysts send a questionnaire to companies which is used to generate an internal ESG score. Through this scoring mechanism, we can identify issues that we can talk to the company about – whether it is poor environmental performance, or, as we will explore in one of the case studies later, issues such as the quality of the board. The ESG questionnaire has been completed by 30 companies over the last three years, across all industries and credit quality.

Insight categorises its corporate engagement activity into two types: **engagement for information** and **engagement for change**. For the vast majority of companies (c.95%), we engage for information, and for the remainder we engage for change.

Engagement for information

This form of engagement involves the credit analyst asking questions directly to company management in order to ascertain whether material risks exist that should be included in the credit assessment. Often this information may not be available through reading research reports.

Examples of such questions include:

- Is there potential for material costs to the company?
  - Is there potential that they will lose a license?
  - Is there a risk of a fine?
  - Are products under threat because of health and safety issues?
- Is the company vulnerable to future regulation?
  - Is this company's asset mix at risk?

Engagement for change

Engagement for change is where Insight wants to see an active change in a company's behaviour. Here the credit analyst will often work alongside the ESG team to identify the risk factors and a suitable strategy to help determine the engagement aims. Often our focus is on improving disclosure because this is a more achievable aim and aligns with a general focus on risk management.

We believe managing systemic ESG risks and more complex engagements are important to do collaboratively with other investors and industry initiatives. This includes organisations like the Principles for Responsible Investment (PRI) and the Institutional Investor Group on Climate Change (IIGCC). We have been supporters of both investor initiatives for more than 10 years and sign the annual IIGCC investor statement to governments on climate change. We have also signed up to a PRI Climate Action 100+ collaborative investor effort where Insight targets the largest corporate issuers to enhance their performance on climate change issues.

CASE STUDIES

Our approach to ESG engagement applies to both emerging market (EM) and developed market (DM) companies. In this section we provide some case studies illustrating this approach.

1 Case study: ESG factors driving an investment decision

Mid-size Latin American bank (emerging market)

Context

We bought this mid-sized Latin American bank at new issue on the basis of its fundamentals – it had stronger financials than its peers – and attractive valuations. As is common for a significant portion of the EM HY universe, our external research provider did not provide any ESG analysis on the bank.

Action

We engaged directly with management to understand how the bank handled ESG risks, and in particular with respect to family ownership of the bank. As part of this process, we asked the bank to complete our proprietary ESG questionnaire. The resulting score showed good social and governance risk management, with a weaker environmental score. The bank's environmental impact, however, is low, in our opinion.

In late 2017, rumours began circulating implicating the bank's chairman in a political scandal. Following this, we exited the position with a view to buying back on the expectation that the bonds would weaken. Subsequently, the bond price fell as the market became concerned that the bank could be in trouble. Having gained clarity on the ESG risks through our engagement with the company, we then bought back the bonds.

Outcome

Through our ESG analysis and engagement with management, we established that although the chairman had been implicated, the credit risk to the bank was low. By engaging with the bank, we were able to understand the ESG risks and how the policies and procedures in place mitigated those risks.

It later emerged that the case initially started because the bank itself had reported suspicious deposits to the government's money laundering unit. The chairman left the board while the investigation was ongoing. The bonds subsequently recovered.

2 Case study: Engagement for change

European Real Estate Company (high yield)

Context

This company is a fast-growing European real estate company with strong fundamentals. There have, however, been long-standing corporate governance concerns that Insight considered may limit ratings improvement.

Action

We met with the largest shareholder to discuss our concerns with the board, both in terms of independence and undersize. We outlined the need for governance improvements and enhanced disclosure. Following this we undertook a review of governance changes, including further board enhancements. We asked the company to complete an ESG self-assessment survey, which resulted in average scores for corporate governance, but highlighted the board weaknesses.

Outcome

Within a few months, after engaging with the company, new board members were appointed and ESG disclosures became a standard part of its regular update to investors. Within 12 months of the governance improvements one of the credit rating agencies upgraded the credit ratings on the issuer from junk to investment-grade, indicating a lower risk and higher-quality issuer.

In 2018 the company completed a new ESG questionnaire and its ESG score is now best-in-class.

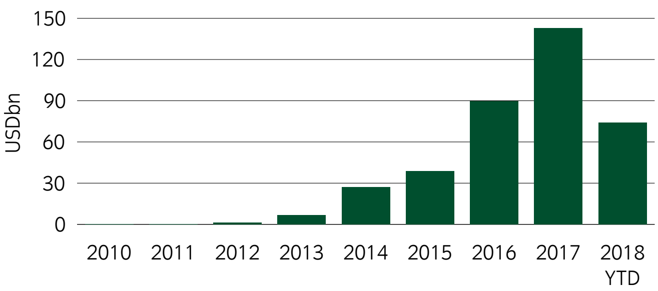
3 Case study: Determining the carbon impact of biomass energy production

European Energy Company (investment grade)

Context

This company is a major player in offshore wind energy. In order to reduce its carbon footprint, the company is phasing out the use of coal, with a target to end it fully from 2020s. The company currently operates several coal plants which it plans to convert to biomass. It believes biomass is a sustainable way of generating energy. They argue that the biomass generation is CO2 neutral as forests continuously capture and store CO2 emitted from the incineration of wood pellets and wood chips. The company reports it is on target to meet its targets through issuing green bonds (these are ordinary bonds where the proceeds are used for environment-focus corporate activities – see Figure 3 for green bond issuance trends).

Figure 3: Global green bond issuance[2]



Action

While the share of coal as a fuel in thermal power and heat generation remains high at 46% versus 27% for both biomass and gas respectively (year end 2016), at the time we engaged with the company, several of the coal plants had been converted to biomass, with more planned. However, in our view the CO2 neutrality and sustainability of biomass generation was not convincing. Levels of carbon release through the burning of wood pellets in one of its converted plants reached levels comparable to that of its coal plants. The level of carbon is also significantly higher than that of natural gas.

Unfortunately, and despite our engagement with management, the company's response was weak. Additionally, while CO2 emissions from transportation are lower, they continue. The wood pellets used in the converted plants are imported from abroad. The company argued that biomass would prove CO2 neutral assuming that, through a sustainable biomass partnership, their biomass suppliers continuously replant trees and that forest ecosystems and biodiversity are protected. However, even with this process in place, the company admitted that only 61% of its sourced biomass has been certified as sustainable.

Outcome

Ultimately, we concluded that despite good intentions we would not advocate investing in bonds which would finance new biomass projects in the sector.

The company's disclosure around CO2 emissions and carbon mitigation needs improvement, in our view. The quantitative data and assumptions around CO2 neutrality are insufficient. We continue our dialogue with the company.

CONCLUSION

While historically fixed income investors have tended to be less focused on corporate engagement than equity investors, at Insight we believe that fixed income investors have a responsibility to engage with companies. We believe that corporate engagement is just another way to measure and manage credit risks, with material financial implications for our investments. On this basis it is best understood in the context of the wider investment process. As our case studies highlight, corporate engagement has helped us make more informed fixed income investment decisions.

[2] Source: Insight Investment, Bloomberg, as at September 2018.

IMPORTANT INFORMATION

RISK DISCLOSURES

Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

FIND OUT MORE

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