

# M&G Public Fixed Income

## Our approach to ESG integration in fixed income funds

FOR INVESTMENT PROFESSIONALS ONLY

November 2020



- ESG factors are integrated across the investment analysis and decision-making of all fixed income, equity and property funds at M&G, regardless of whether they are managed with specific environmental, social and governance (ESG) objectives or with minimum ESG criteria in mind. This note will focus on the process used to integrate ESG factors into our fixed income funds that do not have an explicit ESG objective.
- Investment risks are not only centred on corporate and sovereign financial metrics, but increasingly extend into areas such as reputation, regulation, digital and climate change, making it essential that we integrate ESG analysis into our investment process.
- Considering ESG factors not only brings an additional dimension to identifying investment risks, it also has the potential to help us uncover investment opportunities not yet reflected in bond prices.

*The value and income from a fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise and you may get back less than you originally invested.*

## ESG Integrated funds: explaining the integration process

M&G is a large and influential asset manager and globally recognised brand, meaning that we take our commitment to responsible investing very seriously. An essential part of a responsible investment strategy is the awareness of financially material ESG factors – environmental, social and governance factors, that have the potential to move bond prices. As a signatory of the United Nations Principles for Responsible Investment (UNPRI)<sup>1</sup> since 2013, we have chosen to apply our ESG commitment throughout the investment range. M&G operates a system of company-wide exclusions whereby all funds must exclude any securities issued by companies directly involved in the manufacture, development or trade of cluster munitions and anti-personnel landmines. Bonds caught up in these exclusions are highlighted in internal investment systems, which then restrict portfolio managers from selecting them for funds.

Not only is the integration of financially material ESG factors into credit analysis and investment decisions central to our approach as responsible investors, it has always been an important component of the successful outcome to many fixed income investments.

By far the most significant ESG work is carried out as part of the fundamental analysis done by our analysts. All of M&G's funds in the fixed income range rely on the fundamental analysis of bond issuers in order to seek out the best investment ideas, work that is undertaken by a large team of dedicated sector-specialised in-house analysts. In order to incorporate ESG factors into this research, analysts must ensure that ESG issues are embedded into their credit views. Our analysts are in a powerful position to understand the relevance and materiality of ESG factors for the credit profile of the companies they cover, something which is underpinned by a good level of corporate access. Therefore, financially material ESG considerations feed directly into our credit research and overall in-

### M&G 'ESG Plus' vs M&G 'ESG Integrated' funds

ESG factors are taken into consideration as part of our investment processes across all public and private fixed income portfolios. We have taken this one step further in recent years and have been actively expanding our range of investment strategies that take a more explicit approach to ESG factors, namely our **ESG Plus** fund range.

These particular funds seek to deliver an ESG-related investment objective or are managed in accordance with ESG criteria applied within the investment strategy.

However, In this note we focus on the process of ESG integration within our **ESG Integrated** fund range (ie all remaining fixed income funds on our platform).

house credit ratings. These ratings are then made available to M&G fund managers through internal platforms. This can have an impact on their views on the extent ESG-related risks are being priced in by the market as part of an overall assessment of all credit risks. Ultimately, this assessment could influence a decision on whether or not to invest in a particular issuer.

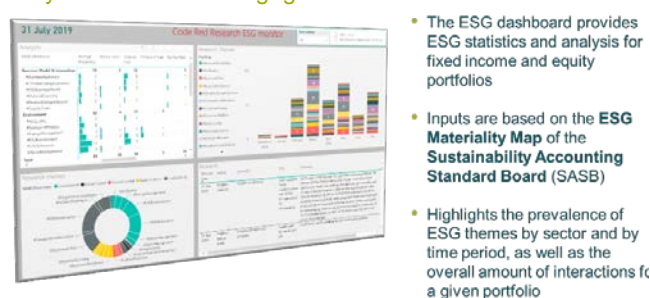
This approach does not exclude companies from investment per se, but it does ensure the fund manager is aware of the heightened risk associated with any poor performance around key ESG issues. As bond investors, we would require a higher level of credit spread to compensate for such risks, compared to a similar investment in a company which manages ESG risks better. In other words, ESG Integrated funds can still have exposure to securities with weak ESG credentials, if we believe the company or government will improve its ESG quality going forward and/or the risks are fully reflected in the bond price.

<sup>1</sup> M&G's UNPRI transparency report and our UNPRI assessment scores can be found on the M&G responsible investment webpages: <https://www.mandgplc.com/our-business/mandg-investments/responsible-investing-at-mandg-investments>.

We have several tools and methods at our disposal to assist with the ESG integration process:

- The **ESG Dashboard** (Figure 1) is M&G's main ESG platform that is used for driving ESG interaction across investment teams, enabling users to quickly view and digest the Credit Research team's ESG interactions with investee companies. Users can screen portfolios for any ESG interactions, engagement activities or themes.
- Closely linked to the ESG Dashboard is our **Code Red** system, one of M&G's main investment research database that allows the fixed income investment team to access internal credit analysis and credit ratings. Within the tool, analysts use a series of ESG hashtags based on the Sustainability Accounting Standards Board (SASB) framework to flag ESG content to the fund management teams, ensuring ESG risks can be captured within a fund manager's investment case.

Figure 1. ESG Dashboard – monitoring ESG themes within analyst research and engagement



Source: M&G

- The ESG dashboard provides ESG statistics and analysis for fixed income and equity portfolios
  - Inputs are based on the **ESG Materiality Map of the Sustainability Accounting Standard Board (SASB)**
  - Highlights the prevalence of ESG themes by sector and by time period, as well as the overall amount of interactions for a given portfolio
- Investment teams have access to and work alongside a dedicated **Stewardship & Sustainability Team** of ESG/responsible investment specialists. This nine-strong team coordinates M&G's ESG engagement efforts with target companies, provides thought leadership around thematic issues and provides deep-dive analysis on key sustainability themes. They also undertake a periodic ESG review on all fixed income funds.
  - An important way we enhance our research into ESG-related factors is through **issuer engagement**. M&G engages with corporations regarding material ESG issues in order to gain a better understanding of ESG risks, and to encourage improvement in ESG practices. The additional insight often gained through ESG engagement also better informs our credit views and investment decisions. We hold fortnightly meetings to discuss and coordinate the programme of ongoing ESG engagements. These meetings are attended by members of the Stewardship & Sustainability Team, as well as credit analysts and fund managers, who each contribute valuable engagement angles. M&G's scale and influence in the fixed income markets means we will typically get access to senior management teams in order to carry out this work. We also regularly engage with regulators, policymakers and government bodies, both collaboratively and individually, in order to protect and promote our clients' interests.
  - **ESG databank** is an internal tool used to identify specific ESG factors across industries, allowing for better-targeted engagements that focus on the issues that are really material for each of those industries.

There are 3 sources of company engagement initiation:

1. **Credit analysts:** typically have the most access to corporate management and will take the lead on ESG issues that are linked to credit risk.

**Recent example:** *M&G credit analysts instigated a review of the telecom sector following increasing international concerns around the viability of Huawei as a supplier of telecom equipment. Through an active engagement process, they sought to establish the extent of Huawei exposure across the sector to gain a clearer picture of Huawei-related risks around supply chains, governance and company disclosure.*

2. **Stewardship & Sustainability:** this team provides inputs around thematic risks (cybersecurity, plastic use, deforestation, climate risk). Holdings that exhibit potential elements of thematic risks will often trigger engagement action.

**Recent example:** *following the Amazon Rainforest fires in 2019, the team instigated a study into the region's commodity-intensive industries to examine company compliance with local zero-deforestation policies. As a result of our analysis we relinquished our holding in one issuer.*

3. **Fund managers:** fund managers often initiate engagement to better understand sizeable issuers or sectors in order to optimise the risk/reward payoff in their portfolios.

**Recent example:** *An existing holding and sizeable bond issuer in the agricultural meat-processing business was selected for engagement following growing investor attention on practices and standards within the global food industry. After a lengthy communication process with the company, we found it to be acting responsibly around areas such as animal welfare, board oversight and upholding international standards. Despite identifying some areas for improvement, we were satisfied the company was managing its ESG risks effectively.*

- M&G is in the process of developing a proprietary '**ESG Scorecard**' – a system that quantifies a variety of ESG factors and indicates whether they are materially contributing or detracting from an analyst's credit rating. As opposed to many third-party ESG data providers who base their methodology on data processing and algorithms, we choose a more nuanced approach because we think that ESG is a largely qualitative domain. Hence, the M&G ESG Scorecard will emphasise the qualitative aspects of ESG risks while aiming for a forward-looking and timely output. This tool will be used in conjunction with investment research and the views of the fund manager to get a bigger picture of the investment case, and will help to systematically assess the risk/reward payoff of a fixed income security.
- Finally, M&G works with various independent **ESG research providers**, such as MSCI, Sustainalytics, RepRisk and ISS to complement our own ESG research and ratings, enabling us to make better-informed investment decisions around ESG factors.

Identifying and understanding non-balance sheet risks can impact the value of an investment and, we believe, is an essential part of the fundamental research process for corporate and sovereign bonds alike. Using the above-listed tools and methodologies to help us better consider ESG factors not only brings an additional dimension to identifying investment risks, it also has the potential to help us uncover investment opportunities not yet reflected in bond prices. We believe it is only by truly understanding both financial and non-financial elements of an investment case that we can make

fully informed investment decisions. This is how we seek to achieve long-term, sustained performance for our clients.

Investors should note that investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by a fund.

**M&G**  
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