SPONSORED COMMENTARY

Incorporating ESG While Maintaining Yield

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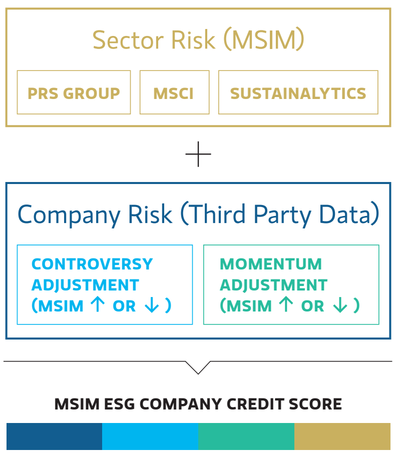
When creating ESG solutions for our fixed income clients, there is no one-size-fits-all approach. ESG goals vary by end investor. But there is one question we are asked regularly: "Can I incorporate ESG into my portfolio without giving up yield?" We believe the answer is a resounding yes.

ESG considerations have always been implicit in our credit investment process. Given the asymmetric nature of price moves in fixed income, minimising defaults is crucial – and more responsible companies tend to have lower defaults. We believe that ESG factors have the ability to impact the fundamental credit risk of a company and, in turn, a company's bond price. Controversies and negative ESG-related headlines can hinder investors' ability to transact in a bond over the short term.

Because available ESG research is not typically designed for fixed income investors, the MSIM Fixed Income team has created an ESG-scoring methodology that explicitly considers the risks that ESG factors pose to bonds.

Display 1: MSIM's ESG Scoring Process



Proprietary Sector Risk Analysis...

Built on their deep knowledge as sector specialists, our credit analysts complement their investment experience with ESG-focused research from a wide array of leading third-party sources to derive sector risk weightings of *high, medium or low* across 47 sub-sectors.

Display 2: Sector Risk Factor Weightings

Although the debt markets are slightly behind the equity markets in recognising how ESG factors can provide unique insights into long-term risks and opportunities that might not be captured by traditional financial factors, there is no shortage of examples where a sector-related ESG factor has led to sharp downward bond price movements, restructuring or default:

- Litigation and fines resulting from environmental disasters in the energy space
- Business model disruptions as a result of additional regulation to better protect the vulnerable in consumer finance
- Excessive financial engineering, partially as a result of poor governance, in the construction sector

We aim to capture the potential for these risks in our proprietary sector risk analysis.

Display 3: Examples of Company ESG Incidents

	BOND PRICE BEFORE THE INCIDENT	BOND PRICE LOW FOLLOWING THE INCIDENT	% CHANGE
Environmental Disaster	107.54	97.33	-9.5%
Social Irresponsibility	96.15	57.30	-40.4%
Governance Misstep	104.14	2.28	-97.8%

Source: Bloomberg.

....Combined With Third Party Company ESG Data

We use this sector risk analysis to assign weight to raw data provided by leading ESG data providers, including MSCI and Sustainalytics. Risk weightings will vary from *low to high* for environmental and social factors, but will always be *high* for governance. Governance is the strongest ESG driver of portfolio risk and return. As fixed income investors, we rely heavily on management teams' controls to avoid involvement in fraud or corruption, and to execute on their promises.

Adjustment #1: Momentum

While we do offer our clients the option of using negative screening and sector exclusion lists for segregated mandates, our view is that companies should be rewarded for demonstrating a willingness to change and adopt ESG-friendly principles. Many sustainability experts have recently raised questions about the effectiveness of negative screens, preferring instead a more holistic view of a company's approach.

To account for momentum in our scoring methodology, we make numerical adjustments using third party data in favour of companies that demonstrate positive ESG momentum and against companies that demonstrate negative momentum.

Adjustment #2: Controversy

Negative ESG-related headlines can impact our ability to transact in a company's bonds. Not only can a company's controversy change its credit fundamentals, but it tends to increase public focus on ESG. Portfolio managers may move to avoid the most obviously controversial names.

To account for controversy, we make a numerical adjustment against companies that have been featured in the headlines for negative reasons. Our adjustment for controversy has less impact than our adjustment for momentum in our final score – we prefer to bias our score towards the future rather than the past.

MSIM ESG Company Credit Score

The final output is a numerical score that is comparable across sectors and used as one of many inputs into the final investment decision on a security-by-security basis. We also use these scores to calculate the weighted-average MSIM ESG Company Credit Score of a portfolio and its corresponding benchmark. We use this score to better understand how ESG friendly our portfolios are.

The Fixed Income ESG Strategy team continually re-evaluates our equations and data inputs based on the latest research and studies available. Our objective is to avoid "goodwashing" and approach ESG in a thoughtful and practical way rather than as a box-ticking exercise.

By embedding ESG within the investment team and process, we aim to optimise a portfolio's ESG profile in a way that not only minimises any yield discount, but aims to turn ESG considerations into insights that can mitigate risk and contribute to higher potential returns.