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Investment insight

ESG in global high yield and emerging market corporates

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- High yield and emerging market corporate debt markets can help institutional investors achieve attractive yield from liquid assets in a low yield world.
- These two sectors remain under-researched areas of the fixed income market, which we believe leaves a wealth of opportunities for active credit selectors.
- Incorporating ESG analysis is becoming an essential element to security decision making in global high yield and emerging market corporate strategies.

Accessible and attractive yield in growing markets

The high yield (HY) bond market is very different to the emerging markets (EM) corporate bond equivalent in many respects , but the two do share some virtuous similarities. They both offer opportunities for investors who have been increasingly starved of yield and both are readily accessible in liquid markets. In addition to the yield and liquidity they offer, they have become substantial markets in terms of size and diversification in recent years.

Global HY markets have a market value of $2 trillion, measured by the market capitalisation of the ICE BofAML Global High Yield index as at 31st July 2019. The two markets are also substantially unrelated to each other as more than 75% of HY issues are still from developed markets, despite EM issuance growing within HY. The EM hard-currency corporate bond market (including quasi-sovereign bonds) was worth US$2.3 trillion as at

Figure 1: Comparisons with mainstream markets

	Global High Yield	EM Corporates	Global Inv Grade Corporates	Global Broad Market	Global Govts
Representative Index	ICE BAML Global HY	JPM CEMBI Broad Diversified	ICE BAML Global Corporates	ICE BAML Global Broad Market	ICE BAML Global Government
Yield to worst (%)	5.62	4.75	2.39	1.41	0.82
Spread to worst (basis points)	413	276	110	47	14
Effective duration (years)	3.37	4.73	6.67	7.18	8.35
Average credit rating	B+	BB+	A-	AA	AA

Source: Bloomberg, as at 31 July 2019

the end of July 2019. This compares to US$0.6 trillion a decade ago. This growth is largely attributable to the strong economic expansion across developing economies.

Yield, scale and liquidity represent attractive qualities to institutional investors, particularly pension funds facing intensifying challenges in delivering income to their members. HY (also known as sub-investment grade) markets are able to offer all three of those features and can be particularly attractive in an environment when many government and investment-grade bonds yield virtually nothing or even have negative yields.

Credit selection should continue to be the driving force behind returns, but the Global HY and EM corporates universes each offer significantly higher yields than the investment grade corporate and government bonds markets. That increased level of yield and yield spread is a reflection of the lower average credit ratings. However, they are also less sensitive to underlying interest rates or government bond yields, as the effective duration measures show. With bond yields currently at extremely low levels, being less sensitive to the negative effects of rising yields could be a welcome feature.

ESG characteristics are becoming core considerations

Institutional investors, in common with many individuals, also want to ensure that entities, whose bond issues they hold, uphold good practice in environmental, social and governance (ESG) factors. Not only does this approach reflect the burgeoning investment ethic of seeking more than simply financial return, but it can help influence market pricing and the volatility of those returns.

The high yield and EM corporates asset classes are generally regarded as relatively high beta in nature. Any positive or negative ESG developments can have a significant impact on asset prices making the ESG assessment an essential part of the credit analysis process. Understanding the full range of non-financial risks companies face, from such things as regulatory action to consumer boycotts, can help reduce negative effects on their financial performance, and thus allow investors to better value the security.

Eligibility screens

To be eligible for investment in our strategies, issuers must conform to certain requirements regarding their reputation and activities and then clear distinct thresholds with respect to their ESG credentials. We apply a three stage screening process to identify an investable universe from which the fund managers are able to select the most compelling candidates for inclusion in the portfolio on valuation grounds.

Two initial screens aim to remove unwanted issuers from consideration for the permitted universe. For both the Global high yield and EM corporate bond strategies we apply a common screen to both of the respective universes. First we exclude issuers that are in breach of the UN Global Compact principles on human rights, labour, environment and anti-corruption. We then screen out material participants in certain industry sectors, based on the proportion of their revenues derived from production or distribution in specific sectors. Again, these are common across each strategy, with companies deriving more than 5% of revenue for producers and 10% of revenue for distributors, from some specific sectors. Those sectors or sub-sectors are tobacco, alcohol, gambling, adult entertainment, thermal coal or nuclear energy. Further, we also exclude

Key ESG analytics providers

MSCI: Fundamental ESG research provider with extensive coverage of the global high yield universe. Launched in 2010, the company employs more than 155 ESG analysts and covers more than 9,000 issuers or 350,000 securities. Analysis attributes an ESG score to a company, up to 10 with those rated 7.2-10 considered to be ESG leaders. Those rated 2.9 or lower are considered to be ESG laggards.

Sustainalytics: Fundamental ESG research provider with leading EM debt coverage. The largest pure-play investment research provider dedicated to responsible investing and ESG research with a 25 year track record and coverage of more than 7,000 issuers. Sustainalytics scores companies from 0-100 (100 is being the best).

RepRisk: Event-driven signals to quantify reputational risk exposures. A niche ESG research provider specializing in quantifying reputational risk exposures, from 0-100 with 0 being the lowest reputational risk. It does this by leveraging big data techniques on a real-time basis. RepRisk screens over 500,000 news items each day, across 20 languages.

companies that achieve any revenues from defence and weapons.

A third screen relates to the ESG integration that companies apply to the way they operate. It is based on independent expert analysis provided by MSCI and proprietary ESG research. We exclude ESG laggards, those with scores of 2.9 or lower, from consideration in ESG HY strategies. For an EM corporates strategy we add ESG ratings provided by Sustainalytics and RepRisk. These three providers combine to provide cover for 99% of the investable EM corporate universe. Our EM process will exclude a company if it is considered to be a laggard by two of the three data providers.

Industry adjusting allows for companies that are demonstrating the best ESG practices within their industry to achieve the appropriate relative ESG score, regardless of the overall profile of the industry itself. This process recognises that certain industries or sectors may, by their nature, be prone to higher or lower ESG scores. It allows the ESG attributes of each issuer to be assessed against those of their industry peers. It also guards against skewing the consistency of the resultant eligible universe that may result from producing ESG scores on an absolute basis. This process rewards and encourages the leaders in industries that might still have much work to do to be as sustainable or responsible as other industries.

These three screens currently exclude approximately a quarter to a third of the underlying market universes as the figure below illustrates. The resulting qualifying investable universes continue to offer more than sufficient diversification and value opportunities for the fund managers to access for their respective strategies.

The exclusion of some unwanted issuers from the initial universes does not materially impact the key features of these respective indices.

ESG engagement in action

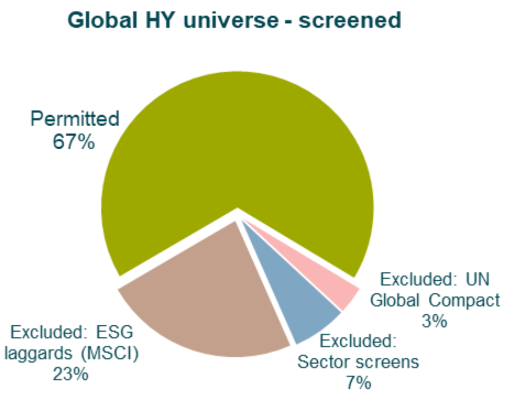
Iceland, the UK supermarket chain has long positioned itself as a sustainable retailer. It was the first UK supermarket to remove artificial colourings and flavourings from its own brand products in the 1980s, and the first to remove GM ingredients in 1999.

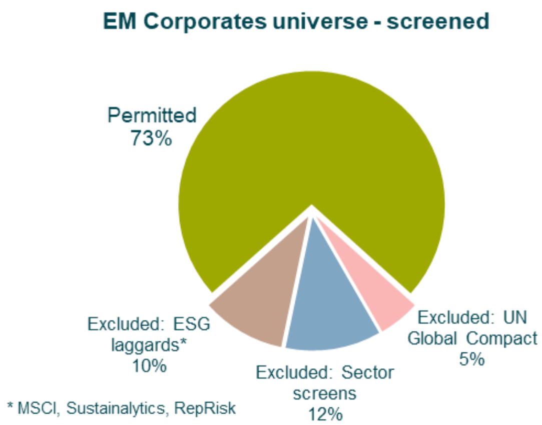
Iceland also caught the public's attention through its well-publicised initiatives to ban palm oil in its own brand products by the end of 2018. This followed on from its earlier pledge to eliminate plastic packaging from its own label food range by 2023.

An emphasis on frozen food means it tends to be less wasteful than other food retailers, with less than 1% of food unsold. It does not send food to landfill, instead giving it to the community, or using it for animal feed or to produce electricity.

M&G has historically had strong engagement with company management. To ensure a comprehensive ESG assessment, and to encourage further progress on a number of initiatives, we initiated an in-depth engagement on a wide range of topics.

Figure 2: ESG screens leave ample scope for security selection





Sources: M&G, Bloomberg, ICE Bank of America Merrill Lynch indices, MSCI Research, % market capitalisation as at 31 July 2019

ESG engagement is more than a filter

Importantly, ESG assessment also complements the rigorous credit risk analysis we already undertake. Given the high beta nature of the asset classes, it can be more important to look beyond the standard financial statements when assessing an issuer's valuation position. As with almost all credit investing, given the asymmetric profile of returns from individual bonds, it is important to minimise the scope for disruptive defaults or impairments in portfolios. Bond returns have limited upside but unlimited downside. ESG analysis can highlight non-financial factors that may not otherwise be adequately scrutinised or interpreted.

For high yield issuers and EM corporates, borrowing through bond issuance typically represents a major source of their funding requirements. This means that, as major bond investors, M&G can gain more extensive access to corporate management than other types of investors may be able. It allows us to achieve deeper and more robust fundamental analysis to take place and facilitates easier to engagement and collaboration with companies over their internal strategies for tackling ESG concerns and fulfilment. For corporate issuers, both EM and HY, ESG factors, and particularly the good governance (G) pillar, make a significant contribution to the investment decision.

Solutions for the challenges facing institutional investors

For institutional investors such as pension funds, looking beyond the mainstream of developed market investment grade bonds, the high yield and emerging markets may provide some attractive solutions to the immediate challenges many face. Yield and spread levels in these asset classes can offer superior outcomes relative to investment grade credit or government bond strategies and with less sensitivity to changes in underlying government bond yields that are, in many cases, negative. M&G is successfully bringing together these credit strategies and enhancing them by incorporating ESG considerations not only into the security filtering process but fully into the analytical assessments of each issuer and the potential value their issues represent.

ESG research in the investment process

Millicom, is a provider of mobile and cable services across Latin America and Africa. We believe, Millicom displays positive ESG credentials across a range of criteria. The company plays an important role in connecting communities and driving social and economic progress in some of the less developed parts of the world, by building the infrastructure for digital communications. The company has also implemented a wide range of social programs, including initiatives to help protect children online and promote digital literacy among vulnerable populations.

Millicom has recently developed a Sustainability Bond Framework under which the company intends to issue sustainability bonds. The proceeds will be used to finance a range of energy efficiency projects and social programs. The Framework has been independently assessed by ESG research agency Sustainalytics, who considered it to be credible, impactful and aligned with the Sustainability Bond Guidelines 2018.

Through its efforts to bring digital connectivity to some of the least connected parts of the world, we believe the company has helped drive positive social and economic change in the countries where it operates. The company is categorised as an ESG industry leader, or equivalent, by each of our three external ESG research providers.

We consider the significant ownership stake of Kinnevik AB and the pedigree of the experienced management team as positive indicators for governance and supportive of the underlying financial analysis.

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