



# Materiality and Engagement

ESG integration in Federated Hermes  
high-yield fixed-income strategies

From our US-based high yield team

We believe analysis of environmental, social and governance factors (ESG) can complement classic fundamental analysis to help identify material business risks. When it comes to the high-yield asset class, a thorough understanding of operational, including ESG, risks is an especially critical consideration given high yield's exposure to companies with higher financial risk.

For more than four decades, Federated Hermes' high-yield strategies have focused on generating superior, risk-adjusted returns. Our investment philosophy is rooted in the conviction that—first and foremost—high-yield fixed-income investing must focus on bottom-up fundamental analysis.

Federated Hermes' high-yield team, led by Mark Durbiano, has developed a proprietary framework for incorporating ESG factors into its investment process. Used alongside our intensive, research-driven, fundamental analysis, ESG integration is part and parcel of what we do every day to uncover the risks and opportunities that translate to the potential for strong long-term performance for our clients.

## ESG and risk

**"ESG integration is part and parcel of what we do every day to uncover the risks and opportunities that translate to the potential for strong long-term performance for our clients."**

Understanding and evaluating ESG risks as part of high-yield credit research provides additional insight to uncovering potential sources of tail risk. Integrated analysis of these factors is an extension of our primary research and offers a complementary stream of information to identify risks and opportunities in addition to those sourced through traditional fundamental analysis.

Tail risks are events that have a small probability of occurring, but can incite large moves in security prices, especially to the downside—as demonstrated by the tragic consequences of the coronavirus pandemic. Oil spills, data breaches, safety violations (or identifying companies that may have a higher probability of these occurring) are all examples of tail risks that would not be uncovered by traditional fundamental analysis. While analysis of ESG factors

may not predict specific events like these, it can provide insights into the likelihood of these events and a company's internal controls to mitigate these risks. That may lead a portfolio manager to reconsider a particular investment or avoid a new potential investment on the basis of a weak ESG profile.

At Federated Hermes, we focus our analysis on materiality. Analysts identify the ESG-related risk factors that are most material and financially relevant to their industries and companies, then determine to what extent the risk can be mitigated by management and the board. They use this analysis to generate a proprietary ESG score for every company owned. Establishing proprietary ratings based on direct engagement with companies allows for a forward-looking, proactive view.

## Our DESG rating system

Each issuer under coverage receives an ESG rating from 1 (above average on mitigating ESG issues) to 3 (below average on mitigating ESG issues) based on the following:

- **Federated Hermes high-yield team's proprietary ESG research process**, which includes discussions with the company and identifying the most material ESG-related factors specific to the company and its industry
- **Consult with EOS engagers** for a deeper dive into the nuances of key ESG-related implications for the companies and industries in which we invest
- **Review of all pertinent third-party data and standards** on a given company or industry where available
- **The "D" in our DESG score stands for Debtholder Stewardship**, an additional layer to our in-house ESG scoring framework for high-yield strategies.

### Mitigating ESG Issues



Federated Hermes is one of the largest active managers with a dedicated engagement and stewardship division. EOS at Federated Hermes is a pioneer in the engagement space with a 15-year database providing a competitive advantage for the high-yield strategy and our firm. Engagers are ESG subject-matter experts on topics such as climate change, human capital management, sustainable supply chains and corporate governance ([Learn more about EOS at Federated Hermes here.](#)) and are uniquely positioned to assess the ESG progress and momentum of a corporate issuer. Federated Hermes portfolio managers and analysts directly interact with EOS engagers in a consultative manner, regularly participating in engagement calls. When combined with bottom-up fundamental analysis, EOS sector-specific insights provide a more comprehensive view of the ESG risks and opportunities for issuers under coverage.

## Federated Hermes high yield: four pillars of ESG integration

### 1 ESG as a risk-mitigation tool

The high-yield team utilizes a proprietary ESG assessment to uncover potential sources of tail risk. Assessing ESG factors gives our analysts and portfolio managers another dimension to evaluate the quality of an issuer's underlying business. For example, how do governance practices compare to others in their industry; what are their human capital management policies; and what is their past track record on environmental issues?

### 2 ESG as a management evaluation tool

Thoughtful consideration of ESG risks is likely indicative of thoughtful consideration of overall business risks. We believe management is a crucial component of a high-yield issuer's success. Management that is proactively identifying and mitigating ESG risks is most likely managing other risks to their business. More importantly, managements that are not proactively identifying and mitigating ESG risks may also be lax in dealing with other longer-term business risks.

### 3 ESG risk in the context of relative valuation

We utilize our proprietary effective spread analysis to identify companies that have poor ESG practices that may not be reflected in their bond valuation. The goal is to identify companies with high ESG risk and low credit spreads. While unrecognized ESG risks may be present in bonds at all spread levels, the probability of the "big surprise" causing a substantial widening of credit spreads is more likely to impact bonds in our low effective spread category. The key question is, "Are you being fairly compensated for ESG risk?"

### 4 ESG as it relates to debtholder stewardship

In addition to E, S & G considerations, the high-yield team also focuses on "Debtholder Stewardship" also referred to as its DESG rating. Traditional ESG analysis is more shareholder-oriented. Given the complex leveraged capital structures of high-yield companies and the potential for managements to try and circumvent covenants or other investor protections, we consider analysis of how management and boards treat bondholders as another piece of the ESG mosaic.

## Hurdles with integrating ESG factors in high-yield analysis

The high-yield market presents a unique set of challenges for ESG as issuers may be smaller in size with a number even being private. This limits disclosure versus large-cap companies in the public markets. The resulting lack of transparency around a business's operations makes stringent first-hand research and analysis a critical component of our investment process. That same lack of transparency applies to sourcing credible data related to ESG factors. Even though demand from investors around ESG issues has been rapidly increasing, the response from issuers typically found in the high-yield universe is not currently robust. The lack of disclosure in our market segment means third-party ESG ratings may not accurately reflect the ESG profile of a given company and are of minimal value to credit analysts. Further, third-party ESG data is by design backward looking, reactive in nature and often inconsistent across various sources.

## The power of engagement

Given limited disclosure on ESG metrics and policies from high-yield issuers, we believe engagement with companies is paramount to fully understanding and evaluating their material ESG risks. Federated Hermes has deep resources to pursue company engagement. In addition to the high-yield team's broad interaction with issuers, our investment team uniquely benefits from direct access to EOS at Federated Hermes, a pioneer and global leader in active engagement. Our fleet of EOS engagers are ESG subject-matter and policy specialists who directly interact with corporate boards and management, providing unique ESG insights that complement our fundamental primary research. Because the engagement process is proactive, forward-looking and goes right to the source, we believe there is no better way to understand a company's risks and opportunities and to advocate for stronger compliance systems, better governance and improved sustainability efforts.

Our experienced high-yield management team, including sector-specialist research analysts, work with engagers to evaluate and continuously monitor companies on material ESG issues. EOS engagers are subject matter experts in ESG focus areas, with many holding degrees in the field or years of corporate experience in ESG or sustainability practices. These professionals are an excellent source of information relating to background, industry standards and best practices. Engagement, combined with our intensive focus on each company's business and financial fundamentals, is a key informational advantage and, ultimately, enhances our risk management.

### Example of an investment decision based on ESG considerations

In June of 2019, a combination of high ESG risk and low credit spread were determining factors in our decision to pass on an issuance by a waste disposal company for the health care industry. Although this industry-leading company provided an essential, high-demand service, a combination of poor board oversight and accounting controls, environmental concerns with the company's medical waste incinerator business and lagging peers on certain certifications resulted in multiple controversies. These controversies included discharging mercury into wastewater and a legal settlement over an alleged pricing fraud where the company had overpriced and/or suddenly increased its prices in a deceptive manner over many years.

## The ESG journey continues

Demographic shifts, governance trends and growing concern over social inequality and environmental risks are accelerating widespread awareness of ESG factors and their relationship to investment performance. We believe the voices asking for ESG principles to be implemented across industries and companies will only grow louder.

From our perspective, analysis of high-yield companies has always required an intensive, "kick the tires" approach, and incorporating ESG factors is no different. Over time, our investment analysis also will benefit from increased EOS engagement of high-yield issuers. As more engagers are interacting with high-yield issuers on ESG topics, we will get a more comprehensive view of long-term structural ESG risks impacting our issuers.

By their very definition, high-yield issuers carry more financial risk. The Federated Hermes high-yield investment team is focused on fully evaluating all operational risk factors, including material ESG factors. The additional resources we can garner through interactions with EOS subject matter experts and learnings we can glean from their engagements give us further evaluative opportunities we feel are unrivaled among high-yield managers.

### **The value of investments and income from them may go down as well as up, and you may not get back the original amount invested.**

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