# An asset class at a crossroads: reshaping credit through ESG

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Federated Hermes International

www.hermes-investment.com
For professional investors only

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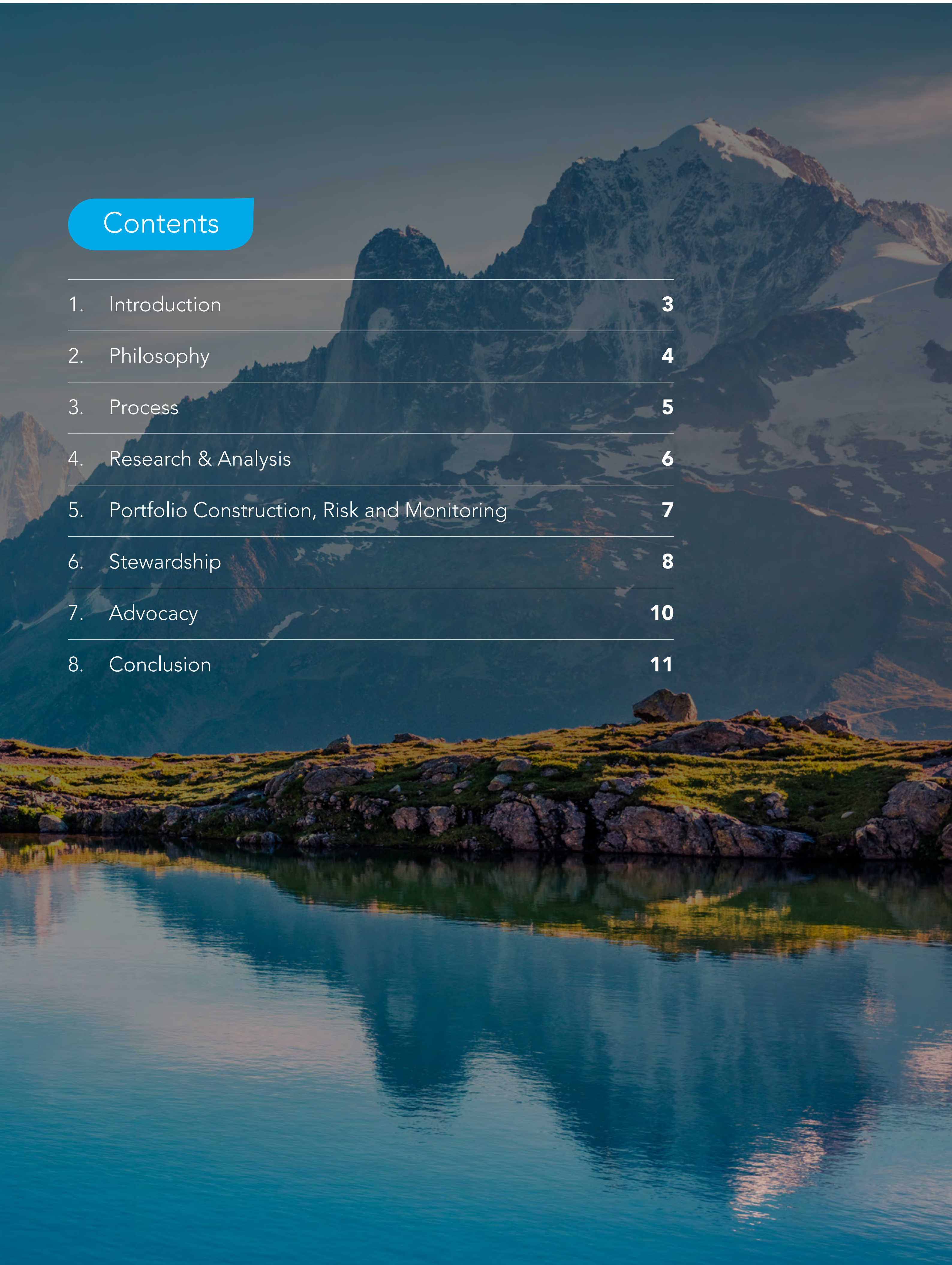

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## Foreword

In the year of the introduction of Sustainable Finance Disclosure Regulation (SFDR) and COP26, it is an opportune time to consider what a best-in-class ESG and Sustainability Credit proposition looks like. In this report, we offer an example of what can be achieved when investment teams collaborate with a centralised Responsibility Office, like the one we have at Federated Hermes International.

Financial markets have seldom been more interested in ESG, sustainability and stewardship than they are today. While this is fundamentally a positive trend that we believe will come to define financial markets in the future, it also makes it difficult for prospects and existing clients to distinguish asset managers who integrate ESG, sustainability and stewardship in a genuine fashion from those who consider it to be a box-ticking exercise that makes for good marketing.

In this paper, we outline our credit team's ESG and engagement integration philosophy, and how the team is working to authentically integrate ESG into every step of its investment process.

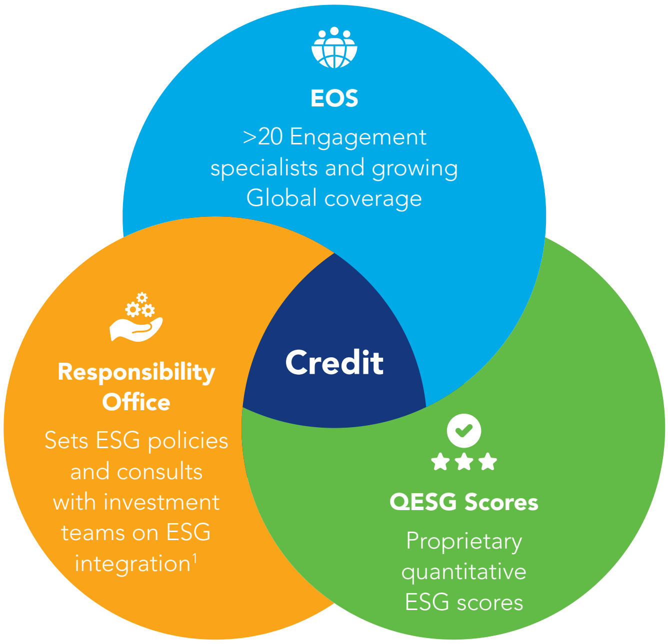
**Fraser Lundie CFA,**
Head of Credit

**Dr Michael Viehs,**
Head of ESG Integration

## Our philosophy

At Federated Hermes, we are committed to delivering superior risk-adjusted investment returns to our clients within the terms of our mandate. We understand, however, that the way we achieve our investment objectives will have implications that are far beyond financial, affecting the environment and society at large. As such, we seek to invest for both a better financial future for our ultimate stakeholders, and for a better, more sustainable, society. We achieve this through a holistic approach to investing that incorporates environmental, social and governance (ESG) considerations into all of our investment products. Our ability to mitigate ESG risks and capture investment opportunities arising from these considerations is essential to achieving consistent investment outperformance for our clients.

**Figure 1:** Substantial ESG resources under one roof




The Federated Hermes Credit team has spent many years refining what we consider to be a best-in-class ESG-integrated investment process, which is standard across our suite of products. We believe there is a direct link between ESG risk and credit risk, and see no separation between ESG-integrated investing and more traditional investing based purely on financial metrics. Our approach not only relies on inputs from various external data providers (such as, amongst others, Sustainalytics, Trucost and MSCI), but also builds on the extensive experience of our EOS engagement platform and the bottom-up work of individual analysts. Our methodology aims to capture the positive movement in a company's ESG characteristics and not rest on annual data inputs. The insight we gain from engaging with companies is an important ongoing additional input into our fund managers' investment considerations as we place a strong focus on driving positive change within investee companies. We believe that there is an opportunity to add alpha by investing in companies that may score poorly in ESG behaviours as measured by the traditional data providers, but show an earnest desire to improve those ESG behaviours. This can be achieved by investing and engaging with the company prior to its ESG risk reduction being priced into market consensus.

In addition to active ESG, which is standard across our range of products, there are mandates that go a step further and incorporate an objective on sustainability alongside a traditional financial objective. We define sustainable investment as:

**Predicated on the principle of preserving the right of future generations to enjoy the economic, social and environmental benefits of today, sustainable investing is becoming a financial stakeholder in companies or assets that seek to substantially mitigate or reverse stress on society and the environment whilst also creating economic value and financial performance.**

**– Federated Hermes.**

We have identified three pillars for achieving client investment goals,  which can be accommodated, tailored, and managed within our dynamic and scalable process.

## The three pillars are:

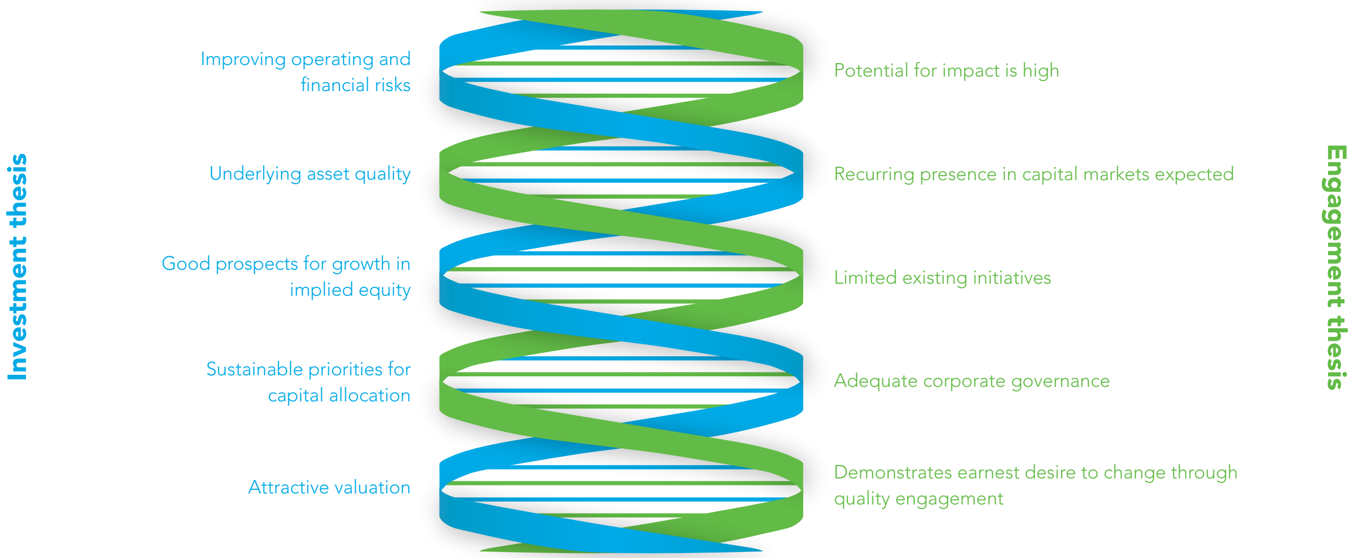
**1.** Active ESG: Assess ESG risks within the investment process, including engaging with companies to improve against these metrics.

**2.** Sustainable: Fund the most sustainable companies, whilst excluding harmful businesses and engaging all to improve.

**3.** Impact: Generate positive impact to society and the environment by investing and engaging with companies in transition.

While objectives on sustainability are independent of the financial objective of the fund, we believe there is a collinear and self-enforcing nature to both goals which can benefit investors and society over the long term.

**Figure 2:** Profitability and positive change: two halves of the whole




# Process: from idea to advocacy

## A holistic approach to ESG integration in credit investment

Our holistic approach to ESG integration considers ESG factors within all stages of the investment process, from initial universe screening through to stewardship and advocacy. Our process begins when screening global credit markets to create our core investible universe (the universe from which portfolio managers can select securities). We are able to 'screen in' securities on which we have high conviction from a sustainability perspective (as indicated by our proprietary sustainability scores) but which are not already captured by other criteria. This means we are able to include securities that would not necessarily screen highly if considered from the purely financial angle of our investment process.

In addition to this, the team operates a minimum ESG threshold for investment. Using our proprietary and forward-looking ESG scoring system (detailed below), the lowest scoring issuers from an ESG perspective are excluded from portfolios. Finally, Federated Hermes has a firm-wide exclusions policy that is incorporated into the credit funds.

For investment solutions governed by a sustainable investment objective alongside a financial investment objective, the engagers takes the lead in the development and maintenance of sustainable investment processes and proprietary sustainability scores (detailed below). For the purposes of these solutions, the sustainability scores act as a further lens to review and screen the investible universe to ensure the portfolio is constructed in a way that feeds into the sustainable objective of the strategy.

### Our suite of proprietary ESG and Sustainability scores:

- ESG score (from one to five) – assesses the potential forward-looking impact of non-fundamental factors on a company's enterprise value. The scores are assigned by credit analysts as part of their bottom-up assessment of each issuer, alongside more traditional financial scores of credit and value. Within their assessment, the analysts will consider the Federated Hermes QESG[1] score, as well as the sustainability scores assigned by the engagers, which are considered in the ESG score for each issuer as part of our holistic approach.
- Sustainable Development Goals (SDG) Score (from one to five) – determines the ex-ante potential for a company to effect positive change on society and environment. SDG scores assess a company's willingness and ability to manage its operating process and/or the products it produces in a purposeful way for the benefit of society and or the environment.
- Climate Change Impact (CCI) Score (from one to five) – assesses the climate change credentials of a company along two dimensions: 1) how credible is the company's process and progress in decarbonisation compared to its own goals — if any — and compared to its sector peers (i.e. scope and ambition of decarbonisation plans; near-term and mid-term goals innovation; capital expenditure; reporting, etc.) and 2) the impact of decarbonisation on the company and on the wider economy (i.e. materiality; time frame; avoided emissions; value change contribution).
- Sustainable Leaders (SL) Scores (from one to five) – a sector-weighted, ordinal assessment of the sustainability leadership of companies, derived from the sector-weighted average combination of our proprietary scores overlaid by views from credit analysts and engagers.

**The main criteria for the governance category is the earnestness with which a company seeks to improve all of its behaviours.**

# Research and Analysis

## If a company advances through the initial screening, then the Credit team can include that company in its investment universe.

Once in the universe, the credit research analysts will assess various factors to understand how much the company's behaviours jeopardise or enhance its enterprise value. The criteria do not differ across jurisdictions or sectors, however, the team recognises that certain sectors are more vulnerable to ESG behaviours which can lead to sudden degradation in firm value. To that end – while the team looks at the relative standing of a company within its sector for each of the three components of ESG – for each sector they might emphasise one ESG factor more than others. For example, this may be environmental behaviours for Basic Materials and Energy companies, governance for Financial Services and Banking, or social for Consumer and Retail.

The main criteria for the governance category is the earnestness with which a company seeks to improve all of its behaviours. The analyst assesses management's desire and ability to build a sustainable business that will support and perpetuate firm value. This is assessed in the context of factors such as quality of management, board structure and independence, remuneration and succession planning. From that, the team can gain an understanding of whether the controls in place to prevent fraud, environmental damage and employee injuries are genuine. For the social category, the team seeks to determine whether controls are sufficient to prevent the production of faulty or dangerous products. The analyst will also want to know that a

[1] Our proprietary QESG scores are our proxy for the ESG performance of issuers. These scores combine specialist ESG research with fundamental insights gained through in-depth engagements with companies. Each company is given a proprietary score for its exposure to the three ESG subcategories – environmental, social and governance – from which we generated an overall QESG score.

company is treating its employees fairly and doing what it can for employee safety. Finally, for the environmental category, the team will focus on a company's efforts to reduce its impact on the environment as a sign of its desire to build a company for the long term. The team will focus acutely on a company's susceptibility to sudden damage to the environment and the extent to which it could lead to a sudden loss of firm value.

Just as the team scores credit risk and valuations, ESG risks of individual companies are scored on a suite of information. While certain data points such as QESG scores or carbon emissions may provide a quantitative input to the score, assessment also relies heavily on the analyst's judgement of qualitative factors, guided by insights from direct engagement with the company. This enables the analyst to build a picture of the degree to which ESG behaviours pose a risk to overall enterprise value. The credit research analysts and engagers discuss the ESG and sustainability scores in detail at the credit committee when evaluating credit selection. Engagers work closely with the credit research analysts throughout the process and take ownership of evaluating each issuer for the sustainability scores.

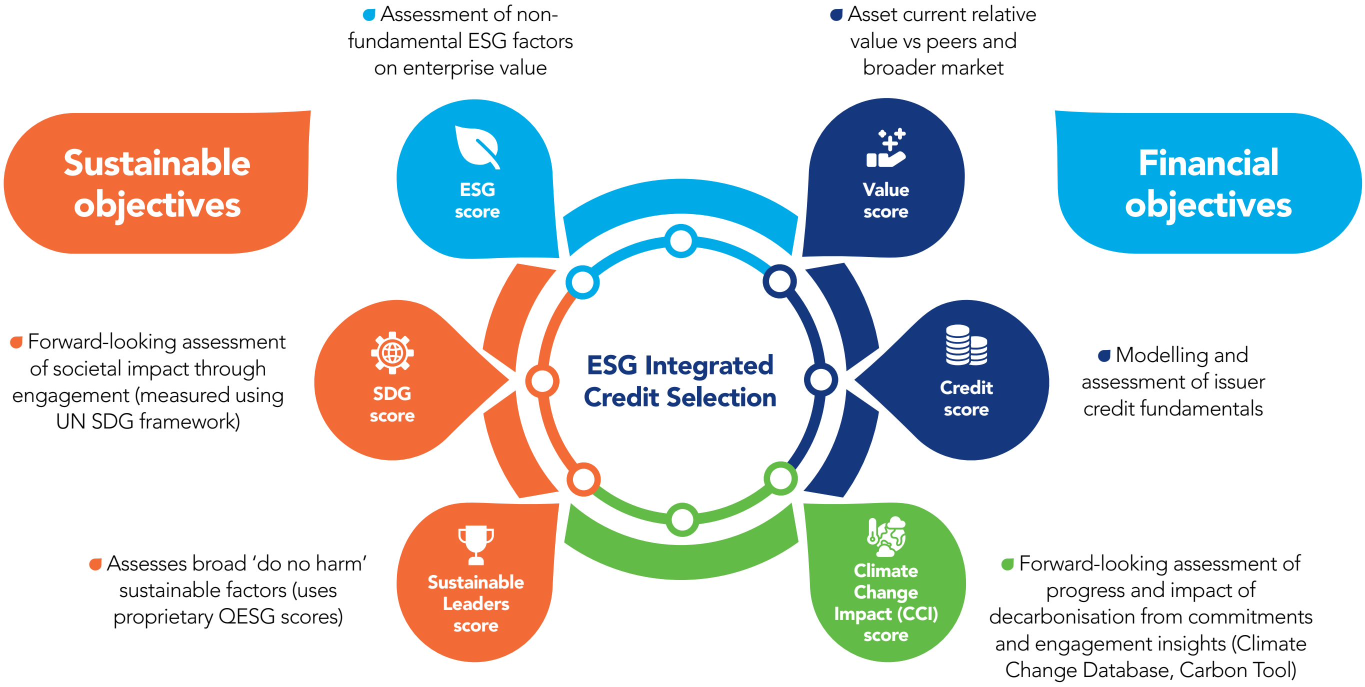
## Key features of our ESG scores:

**1.** Proprietary: Our scoring system is not pulled off the shelf, but is the result of over 15 years of intellectual and structural investment.

**2.** Independent: To maintain the integrity of the sustainable sores, they are generated in a value-vacuum and, as a result, are not influenced by how attractive a security is.

**3.** Ex-ante: As with scoring for financial objectives, we want to assess and score a company based on where it is going, not on where it is today. We must be forward looking and aspirational. It is through engagement and analyst insight that we convert historical, ex-post data into forward-looking scores for investment purposes. We invest in where a company is going, not where it has been.

The research analyst's final score for each issuer, which measures the overall likelihood for outperformance, is made up of the ESG, credit and value scores. ESG behaviours, therefore, are considered to be equally as important as more traditional financial metrics in determining the final view on an issuer.

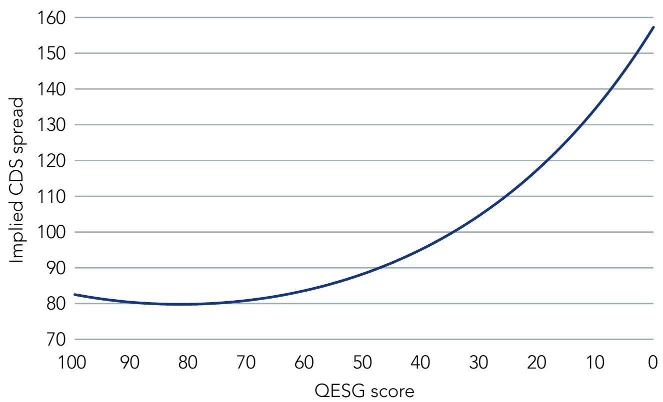



### Arriving at a shared view

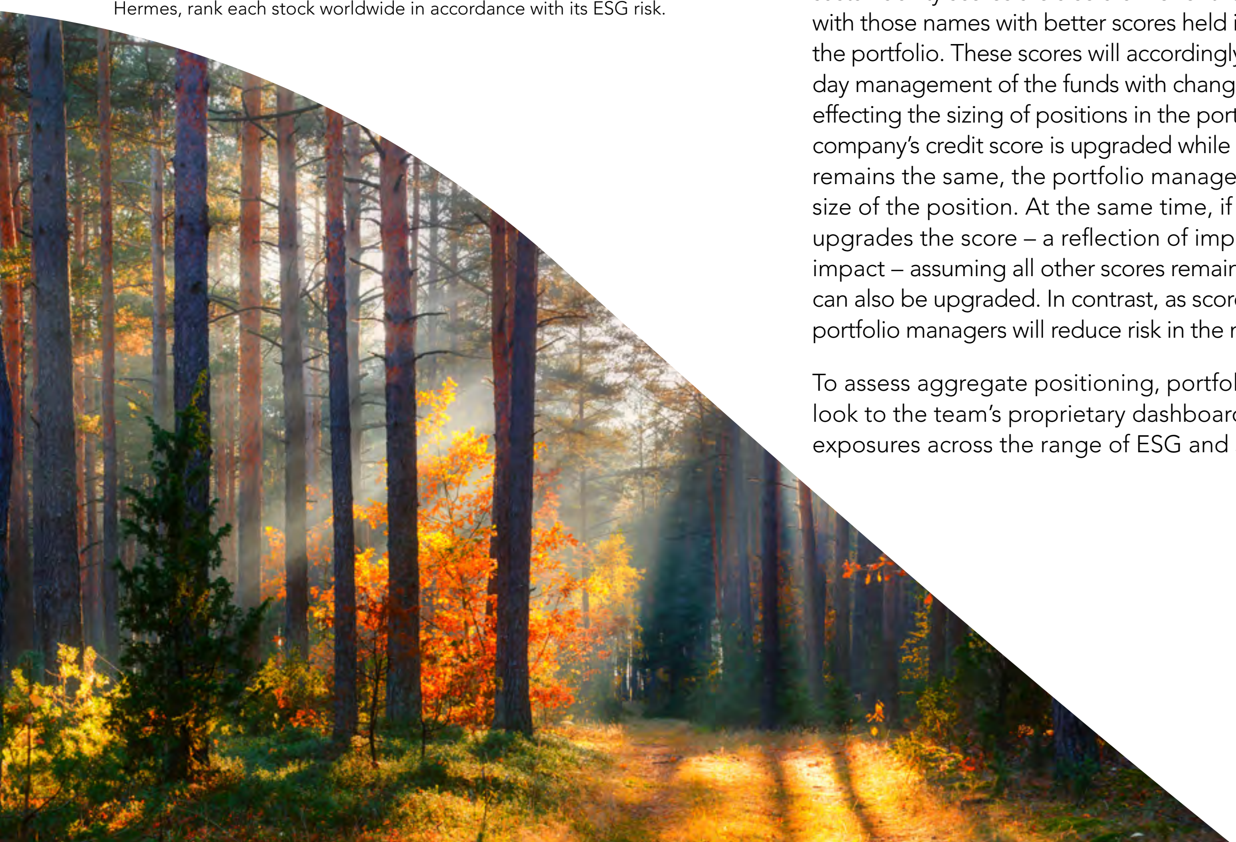
There is an entire section devoted to the discussion of ESG factors in the team's corporate summaries. This comprehensive section includes an analysis of how that company behaves versus its peers in various ESG factors, including our own proprietary QESG scores mentioned above. It also captures how that company scores on a historical basis, so that for each of the Q scores across E, S and G, the team can follow the company's behavioural trajectory.

Once the analyst and the credit committee have an understanding of the ESG risks and trends, the team will price those ESG risks to ensure that our clients would be compensated for the risk were we to invest. In a collaboration between the engagers and the Responsibility Office, we have developed a proprietary pricing model, as shown in the QESG credit curve. This model allows the team to 1) understand if the ESG risks are appropriately priced and whether any mispricing exists relative to peers, and 2) estimate spread changes that could materialise should the ESG characteristics change in the future.

**Figure 3:** Implied CDS spreads and corresponding QESG scores, 2012-2020:




Source: Federated Hermes, as at 31 December 2020. Note: The QESG Scores, generated by our Global Equities at the international business of Federated Hermes, rank each stock worldwide in accordance with its ESG risk.



## Portfolio construction and monitoring

Once issuers have gone through our screening and bottom-up research process, they are available for selection by portfolio managers across our range of credit funds. Our suite of ESG and sustainability scores have a direct effect on the sizing and selection of securities, depending on the fund's objective.

For active ESG portfolios, the ESG score is most relevant to portfolio construction as an indicator of ESG risk within a certain name. All else equal, we would be more comfortable owning a larger portion of the debt of a company with a better ESG score. Although funds may occasionally invest in companies with a 'level four' rating (the lowest ESG score permitted in the portfolio), they will be sized appropriately for the additional risk they represent. The company also needs to be engaged with to ensure it is moving in the right direction. In general, we expect companies with an ESG score of four to be a very small portion of our portfolios and would only be suitable if they have potential to improve. The team believe that this flexibility enables it to benefit from the alpha opportunity that exists from driving improved ESG behaviours through corporate engagement.

**For active ESG portfolios, the ESG score is most relevant to portfolio construction as an indicator of ESG risk within a certain name.**

Within sustainable and impact mandates, the team's proprietary sustainability scores are also a driver of the portfolio construction, with those names with better scores held in greater weight within the portfolio. These scores will accordingly feed into the day-to-day management of the funds with changes in the scores effecting the sizing of positions in the portfolio. For example, if a company's credit score is upgraded while its sustainability score remains the same, the portfolio managers will increase the size of the position. At the same time, if the engager upgrades the score – a reflection of improving sustainability/impact – assuming all other scores remain the same, the position can also be upgraded. In contrast, as scores are downgraded, portfolio managers will reduce risk in the name.

To assess aggregate positioning, portfolio managers can look to the team's proprietary dashboard to view portfolio exposures across the range of ESG and sustainability scores.

# Stewardship

## Our policy is to pursue engagements with companies that either have weaker ESG scores but reflect good relative value, or score well but in which we have a sizeable position and demonstrate a willingness to engage with us.

Generally, engagements are carried out in collaboration with our engagement platform, EOS at Federated Hermes (EOS), and the EOS analyst will lead the engagement relationship. The Credit team, however, also benefits from having a dedicated engagement team, who are responsible for developing engagement strategies and working with our portfolio companies from a credit perspective. Wherever possible, the relevant credit analyst will attend joint engagement meetings. In both instances, credit analysts will sit with EOS analysts before and after meetings to share knowledge, perspectives and ideas.

EOS engages with companies on behalf of, and in collaboration with, our investment teams on environmental, social, strategic and governance issues. Its goal is to drive beneficial change with respect to risk management, value creation and fund reputation. All corporate engagement work is sought to be complementary to, and integrated with, public policy and best practice engagement and voting (where applicable).

For sustainable and impact portfolios, which include a sustainable investment objective alongside a financial investment objective, the dedicated Engagement team will play a greater role in setting the engagement strategy and objectives, along with the requirements of the mandate. For example, within our SDG Engagement High Yield strategy, the team owns the engagement programme, which seeks to generate social and environment impact in line with the UN SDG framework.

### Advocacy

Outside of the team's direct investment work, they are also active in a number of industry wide initiatives, committees and task forces seeking to drive change in the wider market and bring true ESG and sustainable investment to the forefront of investing. These include the Ratings Advisory Committee at the Principles for Responsible Investment (PRI); CFO Taskforce for the United Nations Global Compact (UNGC); Target Setting workstream at the Institutional Investors Group on Climate Change (IIGCC); Technical Working Group (Communications and Technology) for the US-based Sustainability Accounting Standards Board (SASB); CFA UK Sustainability steering committee and CFA UK ESG Working group; as well as charitable organisations such as the EIRIS foundation.

For a deeper exploration of stewardship in fixed income, please refer to our following publications: Can we all get along - Part I and Can we all get along - Part II.

# Conclusions

At Federated Hermes, we aim to go a step further in the integration of environmental, social and governance factors into our investment processes. We avoid traditional, backward-looking box-ticking and, instead, considering ESG within our holistic investment process. Investing remains about looking toward the future and making decisions that make sense over the long term. With the uncertain world we are faced with, we feel that placing ESG and sustainability at the core of what we do is not only essential to delivering long-term value for our clients, but also necessary to deliver benefit for society as a whole.

Federated Hermes
International

## Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes now form the international business of Federated Hermes. Our brand has evolved, but we still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important new strategies from the entire group.

## Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy



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