Climate Dominates Headlines and Commentary on ESG Rating Agencies

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Summary

This Shenkman ESG Quarterly Newsletter focuses on two topics. The first is the continued press coverage and news releases on climate change and investing. The second is the third party ESG rating agencies and some anecdotes involving recent discussions regarding the same.

Climate Changes Headlines

Climate change has continued to receive heightened focus in the business media, stemming in part from major events like the United Nations meetings on the topic and the Davos World Economic Forum. Time.com wrote that Davos had become the "climate change conference".

The continually expanding coverage and discussion on climate is likely to meaningfully impact investment flows over time. An estimated $20 billion flowed into funds in the U.S. that were labeled "sustainable" during 2019 and the green bond market reached $1 trillion in size. There are probably many more subtle impacts on investment flows as well. Institutional portfolio managers, for example, may try to underweight fossil fuel companies to help get a better rating from third party ESG rating entities and to show a climate-conscious tilt to investors – a trend that is likely to grow. Shenkman's ESG checklist highlights when an operator is a bad environmental citizen and this could impact the sizing, relative value and the overall decision to buy a credit at our firm. We also recognize that if a debt issuing company is a bad operator within the ESG framework it will likely negatively impact their business over time and potentially raise their cost of capital. Additionally, such a company (assuming other investors are taking similar steps or will over time) could see a more limited universe of buyers for its debt instruments, which could reduce liquidity and heighten refinancing concerns.

Regulators are increasingly focused on both climate and sustainability issues in investing and reporting. In 2019, the European Commission came out with recommendations on sustainable and environmental reporting for companies. It has also been working on developing a taxonomy on ESG factors and may review how labeling of ESG and sustainability is used in investments. The European Commission also last year agreed on the first steps of a law that would require investment companies, like asset managers and insurers, to disclose environmental risks in their investments. Additionally, in December the U.S. Securities and Exchange Commission sent out examination letters to some investment firms asking questions to those that have products with ESG and sustainable labels. The letters asked about methodologies and record keeping as they relate to these products. These moves appear to be an effort to ensure that investment firms are not "greenwashing," which is when companies claim to be more environmentally friendly or claim to be doing more than normal but are not. For example, an investment firm would be considered "greenwashing" if it were simply labeling a fund ESG or Sustainable but were doing little different than it had done in the past and it had not developed a framework for this analysis. Shenkman Capital's approach to using ESG factors in our investment process is to embed it in the credit approval and monitoring process throughout the firm as a risk mitigation tool. In a previous ESG Quarterly and in previous policy papers, we outlined our approach, which are available by request or on our website.

Regulators appear to be taking an increased interest in the development of ESG investing and specifically where it involves environmental or sustainability issues. We applaud the increased passion and attention that is being centered on this aspect of investing; however, we do worry that regulators will reach too far and make didactic and/or poor definitions in a field that requires more subtlety and subjectivity. The other concern is that ESG considerations can evolve very rapidly in a world with constant technological change. Regulators and legislatures tend to put something in place (e.g., a law or a rule) and act as if a problem has been solved. As a result, they may not make adequate resources available to monitor the situation carefully or be able to make changes after a rule is in place. Lastly, while environmental concerns represent a huge risk factor for the planet and deserve attention, we believe they should not steam-roll investors or regulators and should not divert attention away from the equally pressing investment and societal risks from social and governance issues. Even if investors have been able to establish a great framework for managing a portfolio around carbon footprints, they should not be excused from considering governance or social issues as well.

Third Party ESG Ratings

A lack of agreement over clear ESG analysis protocols, definitions, and even goals makes it very difficult for "independent" third party ESG or sustainability rating agencies to be consistent. However, it has not stopped the rapid proliferation of new agencies in the field nor their efforts to expand ratings. These for-profit entities appear to take very different approaches which can increase confusion. An MIT study found that approximately 40% of the ESG rating protocols do not align across the various ratings firms; this compares to about 90%-plus alignment on financial ratings. Additionally, the goal of ratings for different investors may be much more varied

in ESG than in pure credit. With definitions very dependent on subjectivity, rating agency "scores" and "ratings" can sometimes create a false sense of objectivity and precision that does not yet exist in this field.

Many of these ratings agencies appear to be biased toward companies that have the resources to put in additional public reporting on ESG issues, which makes word search technology and other broad methods easier to use. We favor transparency, but we recognize that smaller companies, such as those in the leveraged debt arena, may not have the same resources to do all the reporting that a larger company might. Additionally, one company may choose to report something that the agencies favor, and another does nothing different operationally but gets penalized for having chosen not to report on it because it did not view it as anything exceptional. For example, there could be two telecommunications companies that do the same employee training about privacy issues and have instituted similar systems and policies to protect customer data, but Telecom A reports all of these efforts in its annual report and much smaller company Telecom B does not report it but if asked would take an analyst through all their systems and procedures. An agency may penalize the rating of Telecom B versus Telecom A simply because of their dependence on only "reported/searchable" data.

In the last few months, some clients have asked us about several credits that were in their portfolios that had received poor grades from some third-party agencies on ESG. In responding to these requests, we found that several of the concerns raised by the agencies either had been aggressively addressed by the companies or were in the process of being addressed through changes in management, changes in policy and/or closures/asset sales. However, these companies were still being penalized by the ratings agencies for these missteps. We also followed up by engaging with the management teams to confirm some of these changes and get updates. If our view was that these companies were being penalized in the market due to an ESG rating and that our fundamental ESG research and company engagement showed that the company was aggressively moving to solving these issues, this could result in an investment opportunity with upside if the ESG ratings eventually caught up to the corporate changes.

One must be cautious not just to use some type of word search or reporting methodology to eliminate investments on ESG grounds. This broad stroke approach might be like an investment in equities being based only on technical analysis without any fundamental review. One of the major issues in trying to be too quantitative in ESG is that there is a lack of defined protocols and terms within ESG. There are efforts to define a taxonomy, such as the one being contemplated by the European Commission, yet these still may prove to be too subjective. Additionally, there are questions of whether thorough cost-benefit analysis has been conducted or whether the responses are simply based on emotional ESG appeals. Broad elimination of an industry or a sector as an investment might be the right decision from an ESG perspective, but doing it based on a metric such as key words or a GICS category, without analyzing and meeting with managements to understand their businesses, may lead to a missed opportunity. A broad exclusion also largely removes the ability to engage with the issuers and possibly effectuate some changes for the better.

Conclusion

Climate change is an ESG factor that appears to be receiving most of the business media. However, we believe that one should not focus on this topic to the detriment of other factors. Our ESG Checklist focuses on E, S as well as G issues. As ESG concerns and issues rapidly evolve, we believe investors can be hamstrung if they are too confining in their definitions and areas of focus. A flexible approach that involves company engagement requires an open-minded commitment from the investment team by evaluating how companies operate within society.

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