ESG & SRI NEWSLETTER: *August 14, 2020*

PROPOSED PENSION RULES STIR CONTROVERSY AND HIGHLIGHT OTHER ESG DIFFICULTIES

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INTRODUCTION

In this newsletter, we discuss the controversy surrounding the recent U.S. Department of Labor (DOL) rule proposal on ESG investing. We also explore what we see as the broader issues for ESG investing that this debate brings to light. In particular, we highlight the danger of trying to force quantitative measures onto subjective factors. We also note how this proposal is especially problematic in an evolving field where definitions and priorities may vary from investor to investor and where labelling a product as ESG may mean different things to different people. We also outline some of our processes and highlight the potential for the increased use of our SRI tool. Finally, we provide an update on our assessment report from the Principles of Responsible Investing (PRI).

Mark R. Shenkman
President & Founder

Justin W. Slatky
Chief Investment Officer

Bob S. Kricheff
Portfolio Manager & Global Strategist

Amy L. Levine, CFA
Director of ESG

For more information, please contact:

Nicholas G. Keyes, CFA, CAIA
Director of Client Solutions
(212) 867 – 9090

ClientSolutions@shenkmancapital.com

PROPOSED ESG RULES FOR ESG INVESTING

In late June, the DOL put out new rule proposals to provide "clear regulatory guideposts" to pension and 401k retirement plans about investing in "ESG vehicles."[1]

- The DOL stated that it is an attempt to make clear that fiduciaries for these plans cannot invest in ESG vehicles when they understand an underlying investment strategy could "… subordinate return or increase risk for purpose of non-financial objectives."
- The Secretary of Labor was quoted as emphasizing that the focus of these plans is in "… providing for the retirement security of American workers."[2]
- The rules proposal acknowledges "… that ESG factors can be pecuniary factors, but only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories."
- The proposed rule also lays out how 401k type plans must offer alternatives for funds that pursue ESG objectives in their investment mandate or name.
- The rule also requires fiduciaries of these plans to document why an ESG related investment was selected and rationalize it versus other similar investments.

[1] https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/financial-factors-in-selecting-plan-investments

[2] https://www.dol.gov/newsroom/releases/ebsa/ebsa20200623

This DOL proposal comes on the heels of releases from the U.S. Security and Exchange Commission (SEC) and Europe and the UK. In May, an SEC subcommittee released recommendations for vastly improved ESG disclosure by companies, in part to level the playing field of information and improve the ability for investors to examine ESG factors. In Europe and the UK they have already taken steps with an initiative that requires investment managers to disclose how they integrate sustainability risks into their investment decision-making processes by early 2021 and a push for more corporate disclosure as the European Commission (EC) is reviewing the Non-Financial Reporting Directive.[3]

There has been considerable backlash in letters to the DOL and in the press from investment firms about this proposed rule. Some have made statements that the rule implied that the DOL was trying to restrict or eliminate ESG investing and others have stated that it would hold ESG to a higher standard than other investment decisions.[4] [5]

This proposal could put more onus on plan managers to "prove out" the economic benefits of investing in a strategy that defines itself specifically as an ESG investment vehicle or in which social goals are designated as part of its mandate. It becomes a difficult task to periodically determine if this latter priority conflicts with pecuniary issues. The proposal also appears to hold the performance of a fund with ESG "objectives" to a higher standard.

We certainly understand and agree with some of the concerns about the implication of these rules for allocators and fiduciaries. We also understand the commercial concerns of firms which have invested in developing products with defined ESG labels. However, in our view these proposed rules highlight the bigger struggles for regulators, allocators, and investment related businesses when they try to apply narrow definitions to an evolving, highly subjective area and try to quantify investment risks that do not always fit in to a figure. This lack of consistent definitions creates issues for regulators and allocators.

ACCEPT THE SUBJECTIVITY

In many cases, perhaps with a push from their legal departments, firms are hoping to have third parties define ESG issues for them. This has led to a proliferation of for-profit companies trying to define ESG investing with ratings and indices. However, the efforts to try to codify ESG ratings has appeared to be very inconsistent. A study from Massachusetts Institute of Technology (MIT) in 2019 and then updated in May 2020 highlights these weaknesses.[6] The study states that "ESG ratings from different providers disagree substantially." It follows to state, "This means that the information that decision-makers receive from ESG rating agencies is relatively noisy." One of the reasons it cites for the poor correlation is rater bias, "Hence, measurement divergence is not

[3] https://www.forbes.com/sites/bhaktimirchandani/2020/05/29/what-to-make-of-the-secs-warnings-on-esg-ratings-and-recommendations-for-esg-disclosures/#1d5ce13c3184

[4] https://www.ft.com/content/abfa7a6f-79e3-4abd-9aee-93d99384ef36

[5] https://www.morningstar.com/articles/990580/the-department-of-labor-attempts-to-throttle-esg-investing

[6] "Aggregate Confusion: The Divergence of ESG Ratings"; Florian Berg, Julian F. Koelbel, Roberto Rigobon; MIT Sloan, University of Zurich; May 17, 2020; https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533

only due to random measurement error, but is partly driven by some form of rater-specific bias." This implies that there can be considerable subjectivity within the field.

The difficulty in trying to apply precise ratings and scores on these factors was also addressed by Jay Clayton, the Chairman of the SEC. In May, he was quoted as saying, "I have not seen circumstances where combining an analysis of E, S and G together, across a broad range of companies, for example with a 'rating' or 'score', particularly a single rating or score, would facilitate meaningful investment analysis that was not significantly over-inclusive and imprecise."[7]

We believe that an effort to quantify ESG factors can lead to unbalanced attention on certain risks while ignoring others. Some ESG factors lend themselves to easy measurement (e.g. carbon footprints and board composition). We have seen ratings systems that we believe appear to overweight these measurable factors at the risk of not properly considering less measurable issues and that also fail to penalize or instead reward companies that simply don't report these metrics. Recent events have highlighted how quickly some more unmeasurable risks can arise. For example, the recent COVID crisis and concerns over racial injustice have clearly elevated social issues in the hierarchy of ESG risks. With COVID impacting the global economy, companies could face business and financial backlash for how they manage the safety of their employees and customers. The public perception of companies could also be shaken if they choose to take government aid. In a similar vein, events in the US and around the globe have elevated the discussion on how firms approach the issue of race and gender equality, a social issue that if mismanaged could have significant economic risks for companies.

As a prudent investor, we believe a disciplined approach is needed that incorporates analysis, discussion, and monitoring of ESG risks and opportunities throughout the entire investment process. A defined ESG or socially responsible investment product can be customized but will not necessarily meet everyone's requirements or definitions. The variety of ways in which investors view ESG is highlighted by some product development in the marketplace. As an illustration, one for-profit index company points out on their website that they have over 1,500 ESG indices.[8] In our opinion, the plethora of indices shows how differentiated the definitions and goals are in the market and the ability to customize various solutions is vital.

OUR APPROACH & THE EVOLUTION OF SRI DATA

Our ESG checklist and ESG Tier assignment is not meant to be an absolute score but an assessment tool to help assess risks and compare investment opportunities. We utilize these items at the credit approval and portfolio level. The overall process, any outliers, and issuer engagement (for companies that rank poorly) are overseen by our Investment Risk Committee which also functions as our ESG Committee.

Our SRI process and tools are evolving into what we believe will be an increasingly valuable investment tool. Our research team reviews every credit on our Approved List (both prior and subsequent to approval) for revenue

[7] https://www.forbes.com/sites/bhaktimirchandani/2020/05/29/what-to-make-of-the-secs-warnings-on-esg-ratings-and-recommendations-for-esg-disclosures/#19bf48923184

[8] https://www.msci.com/esg-investing

exposure to 17 different common SRI screens. We assess exposure to each of these revenue streams to the best of our ability from public primary and secondary sources, including discussions with management teams. For each category, we record if each company has 0% exposure to the category, up to 50% of revenue from the category, or more than 50% of their revenue from the category.

We can easily customize a portfolio for an investor who wants to exclude certain exposures from their portfolios. We can also use it as a risk analysis tool by examining portfolio exposures to these factors and determining the average spread that the portfolio is receiving for investing in these potentially higher risk segments.

We have found that, in aggregate, there is a meaningfully higher spread on those issues that have SRI risks flagged in our system than those without SRI flags. We are not naïve enough to think that this alone is causation. However, as we continue to analyze the data on SRI flagged credits, we believe this proprietary tool could become an increasingly valuable risk assessment tool that provides additional insights into how the market is pricing these risks.

We believe in the value of ESG; however, we believe it needs to be embedded throughout the investment decision process and portfolio construction. We will continue to quantify, monitor, track, and assess ESG risks and benefits, while being cautious not to create a false level of precision in areas where quantification is not practical. We understand there are different views on ESG and SRI. Therefore, we assess and track ESG consideration throughout our core investment process and have developed tools that allow for a high level of customization.

PRI ASSESMENT

As part of our involvement in ESG, Shenkman Capital is a signatory of the Principles for Responsible Investing (a global non-profit organization). Our 2020 assessment report has been released, and we are pleased to have maintained our ‘A’ rating in all categories from last year, which is above the median in most categories. Our PRI scores are a testament to our ongoing commitment to ESG and recognition of our efforts to integrate ESG factors into our investment process. Please see our website https://www.shenkmancapital.com/responsible_investing for more information.

MODULE NAME	SHENKMAN SCORE	MEDIAN SCORE
Strategy & Governance	A	A
Fixed Income – Corporate Financial	A	B
Fixed Income – Corporate Non-Financial	A	B
Fixed Income – Securitized	A	B

OFFICES

SHENKMAN CAPITAL MANAGEMENT, INC.

461 Fifth Avenue
New York, NY 10017
(212) 867 – 9090

262 Harbor Drive
Stamford, CT 06902
(203) 348 – 3500

SHENKMAN CAPITAL MANAGEMENT LTD

49 St. James's Street
London, UK SW1A 1JT
+44 (0) 207 268 2300

Website: www.shenkmancapital.com

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