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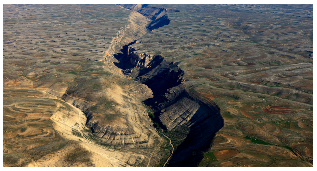

ESG: The UNPRI, Ratings Agencies and Opportunities in Credit Analysis

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Brandywine Global became a signatory of the UN-supported Principles for Responsible Investment (UNPRI) in 2016; in the nearly four years since we joined, we have taken a more active role within the organization by joining industry working groups such as the Credit Rating Advisory Committee. Whilst we have incorporated governance factors into our credit investment process, becoming a signatory formalized our methodology by including environmental, social, and governance (ESG) factors that allow us to more fully understand the price and information risk we are taking. The ESG process for credit plays to our strengths of combining top-down macroeconomic analysis with bottom-up fundamental research. Given my role in credit research and involvement with the PRI, I'd like to share some insight on my position on the Credit Rating Advisory Committee, its impact on third party data from ratings agencies and ESG vendors, and ultimately how this information influences how we integrate ESG factors when it comes to analysing corporate credit.

Benchmarking ESG Risks

We use external, third-party research to both benchmark a prospective or existing investment and to highlight potential areas of concern. The team uses this data in tandem with our own fundamental ESG analysis. A bond is, in essence, a contract between us (the lender) and the corporate (the borrower) to lend money in exchange for a stream of coupon payments and the return of the principal at the end of the contract. While we hope and expect to select bonds that offer value and the potential for capital appreciation *the most important factor is the return of that principal at the maturity of the bond.* Understanding any factor—E, S or G—that prevents that return due to the loss of capital is the principal aim of our research, to ensure that we are being adequately compensated for the level of risk we are taking and enable us to engage with company management if we are concerned either before purchase or while holding the bond.

The PRI Credit Risk and Ratings Initiative

However, one issue we found was the lack of ESG data from third party suppliers for private, mainly high yield companies. While this does not stop the fundamental bottom-up ESG analysis, it does mean that it is harder to benchmark the company against its peers in terms of ESG performance. To try and help in this area, we signed the PRI's Credit Risk and Ratings Initiative in 2017, in which I also sit on the advisory committee. Credit rating agencies (CRAs) play an important role by assessing credit risk and helping to guide bond pricing, while having enhanced access to companies that ESG rating agencies do not have as the former requires anything used in their scoring to be publicly disclosed. We believed that CRAs should more fully incorporate ESG into their credit ratings, especially in more opaque, lower-rated, higher-yielding private companies. We believe it is impossible to fully assess the credit risk without incorporating ESG, so engagement with the CRAs on how to best incorporate these factors in a clear and transparent framework is a key aim of this advisory committee—and one objective that could have the most impact on increasing the uptake of ESG analysis in credit.

To date the advisory committee has published three reports in conjunction with the CRAs:

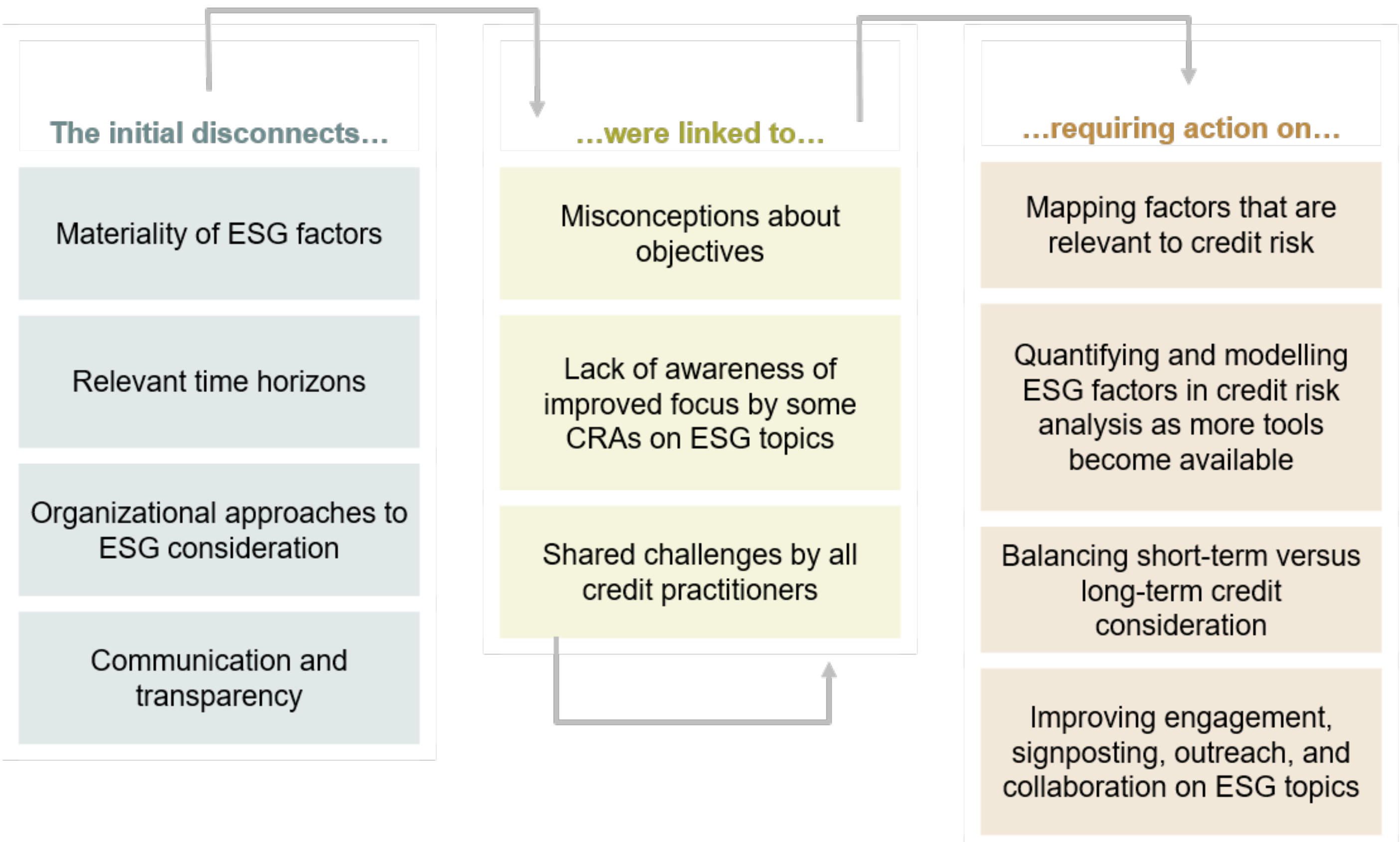
1. The first was to understand the current state of play in incorporating ESG into credit investing
2. The second was to explore the disconnects between what investors were expecting and CRAs were

providing

3. The third was how to move from these disconnects toward actionable areas.

Opportunities

While there is much work still to do, [the committee has helped advise and steer the CRAs]() into being more explicit when ESG factors have affected the credit rating of an entity—when it is relevant and material. The advisory committee's next stage is to engage with various stakeholders to raise awareness of the work that it has done with CRAs to increase adoption of the reports' findings. The streams are focused on investment consultants, ESG vendors, issuers, and regulators. By focusing attention on these tracks, the committee can ensure that the excellent work can be communicated to a wider audience and increase adoption and materiality. Chart 1 below outlines the disconnect, impact, and remedial action needed to improve ESG data within the CSR space:



Source: PRI

I believe the main disconnect has to do with the time horizons of ESG issues. Take for example, a coal company. For an equity or 30-year bond investor, the issue of stranded coal assets becomes a very real issue in relation to future asset impairment. For an investor in a two-year bond, it becomes less of an issue. It is therefore important that CRAs and investors distinguish between these different time horizons in their assessments of bonds with varying duration.

As a credit analyst, I believe addressing these disconnects in information will be incredibly helpful in our bottom-up fundamental research, particularly for corporate issuers with limited public data, ESG analysis, and peer review.

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