Aegon Asset Management

ENHANCING ESG INTEGRATION: THE VALUE OF AN INDEPENDENT RESEARCH ASSESSMENT

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Key takeaways

- *The availability of environmental, social and governance (ESG) research and data continues to improve, providing fixed income managers additional information to support ESG integration practices.*
- *While external ESG research is an important input, the data has limitations as the methodologies vary across providers, ESG scores can be inconsistent and challenging to compare, the analysis could omit important financial considerations and the time horizon may not align with bondholders' interests.*
- *A proprietary ESG integration approach may add value by combining external ESG research with internal insights to form an independent credit assessment of ESG-related opportunities and risks.*

In recent years, the availability of environmental, social and governance (ESG) research from industry-recognized providers has improved tremendously. This has provided bond managers better access to ESG-related research to support integration practices and meet rising investor demand for responsible investment solutions.

While integrating ESG factors helps to uncover and mitigate risk, we believe the value in ESG integration is in accurately parsing out what really matters. ESG-specific information available to investors today—from ESG research firms, credit rating agencies, consultants and issuers themselves—is vast, complex and often contradictory. To sort through it all and make better-informed investment decisions, we believe it is crucial to conduct an independent assessment of ESG factors in conjunction with traditional financial metrics.

As part of Aegon Asset Management's ESG Next initiative, our Credit Research team has enhanced the ESG integration process to include an independent viewpoint of the potential materiality of ESG issues on an issuer's credit fundamentals. The result is a proprietary categorization approach to measure the ESG materiality and effect on a corporate issuer's credit profile.

Limitations of external ESG research

ESG data from external providers are an important input into our corporate credit research process. External research firms provide in-depth research, ratings, analysis of key ESG business practices and controversy history on thousands of companies worldwide. However, similar to our views on the traditional credit rating providers, we believe there are limitations to the externally sourced ESG data. Four key limitations include:

1. ESG scoring methodologies are complex and vary across providers
    - **Contradictory risk weightings.** Emphasis on certain environmental, social and governance factors used to evaluate a company differs by provider. For example, providers assign differing weights for the bribery and corruption risk factor to arrive at their respective scores for a metals/mining company.
    - **Varying risk scales.** Providers score companies on different risk scales. As an example, one assigns a company to one of seven risk categories while another uses only five risk categories.
    - **Inconsistent ESG risk factors.** Providers use different building blocks, or factors, for assessing ESG risk. For example, one provider utilizes a universe of 37 key ESG risk factors while another uses 20.
    - **Different risk evaluation approaches.** Providers incorporate exposure to ESG risk and the ability to manage the ESG risk in different ways when arriving at their respective scores.
2. ESG scores are inconsistent and not easily comparable
    - **Letter rating.** Many market participants tend to focus on the letter rating (AAA to CCC) from one provider. These letter ratings are relative to the standards and performance of the company's industry peers and do not provide a broad, absolute rating that is comparable across industries. For example, ESG risk for a BBB-rated company in the metals/mining industry is not equivalent to the ESG risk of a BBB-rated technology company.
    - **Numeric score.** Another provider publishes its ESG Risk Rating, which is a quantitative score from 0 (best) to 100 (worst); this score is absolute and comparable across industries.
3. ESG data providers' research omits important financial considerations
    - ESG data providers specialize in ESG analysis, which leads to a breakdown of the link between ESG risk and what it means for an issuer's ability and willingness to meet debt obligations.
4. Time horizon of ESG data providers' research more aligned with equity investors
    - Risk from certain ESG factors may not materialize over the holding period of a corporate bond.

Integrating ESG factors to improve decision-making

ESG integration can be used as a tool to help manage risk and identify potential opportunities. Furthermore, we believe the assessment of ESG elements may contribute to alpha, particularly over the long term. As outlined in our paper, "How We Integrate ESG," our Credit Research team integrates analysis of ESG issues into its investment process as part of fundamental, bottom-up research. Simply put, we believe ESG integration is part of a comprehensive fundamental research framework. ESG integration provides an additional set of data points to consider during the investment decision making process, which is why we believe it is one of three key reasons to invest responsibly. Although ESG integration is typically thought of as a risk mitigation tool, it may also provide upside opportunity for investors. As depicted in Exhibit 1, companies across various industries can exhibit ESG related opportunities and risks.

Exhibit 1: Examples of ESG-related risks and opportunities

	Risks	Opportunities
Environmental	An independent energy company with a history of flaring/venting a relatively high proportion of associated gas in its Permian Basin operations.	A technology company utilizing renewable energy to power its data centers.
Social	A mining company involved in controversies related to human rights violations over the proper treatment of local indigenous peoples.	A financial services company with a high rate of lending to underbanked communities as well as small and medium enterprises.
Governance	A protein producer with executives and/or controlling owners that are involved in numerous bribery and corruption scandals.	A metals company with a board that has an independent majority, has split the roles of CEO and chair and has a fully independent chairman.

A proprietary approach to categorizing ESG opportunities and risks

Varied methodologies and ESG scoring outputs from external providers, as well as the omission of financial metrics and a time horizon more consistent with equity investing, led us to develop a proprietary, standardized process to categorize ESG-related opportunities and risks for corporate credit. This process combines external ESG information with our own internal ESG assessment, alongside traditional financial metrics.

The external ESG information serves as a starting point, but ultimately we rely heavily on the industry, company and country expertise of our research team. Our credit research analysts can provide perspective on industry-related ESG topics, historical perspective on governance-related factors for companies and countries, and context around any historical impacts to valuation or credit quality as it relates to ESG factors. Ultimately, our credit research analysts arrive at an independent view of a company's ESG profile. Focus is given to the potential economic effect ESG issues may have on the issuer's ability and willingness to meet debt obligations. The level of credit impact is based on five levels with increasing magnitude (Exhibit 2).

Exhibit 2: Aegon AM US' ESG categories for corporate credit

	Category	Description
1	Responsible Leader	A leader in sustainable business practices or positive ESG practices are combined with the pursuit of Sustainable Development Goals as established by the United Nations.
2	Minimal Risk	Fundamentally low exposure to ESG risks or policies in place that mitigate most ESG risks.
3	Event Risk Potential	ESG risk exposures could negatively affect the company but the effect is not measurable and timing is uncertain; the company's response is likely to influence the severity of such risk.
4	Credit Outlook Impact	ESG risks are resulting in pressure on the company's credit fundamentals, but there is still an ability to address these risks and limit the impact on the credit rating.
5	Internal Rating Override	ESG factors have resulted in a material effect on the company's credit quality that is not reflected in its credit rating.

Although ESG factors are identified and assessed individually, the firm takes a holistic approach to integrating ESG-specific factors along with more traditional credit analysis to understand the overall credit profile and how it affects the investment opportunity as a whole. Our ESG integration process seeks to answer three key questions as outlined in Exhibit 3.

Exhibit 3: Our ESG integration process seeks to answer three key questions

Evaluate economic impact and effect on creditworthiness	What is the potential economic impact and the associated effect on the issuer's creditworthiness?
Assess impact on valuation	Are ESG risks and opportunities accurately reflected in credit spreads?
Identify engagement opportunities	Could engagement be beneficial in an effort to generate long-term economic value?

ESG corporate credit case studies

To illustrate the process in action, the following exhibits provide brief case studies of companies that fall within ESG categories one, three and five. The categories are shown in Exhibit 2.

Exhibit 4: ESG corporate credit case studies

Case Study #1 – Responsible leader	
Company description	Downstream aluminum producer
ESG-related opportunity or risk	Environmental • Small environmental footprint for a metals/mining company with limited risk related to tailings (earth-filled) dams, biodiversity and land use • Uses recycled aluminum for a portion of substrate, which is ~90% less energy intensive than primary aluminum • Supplies aluminum to the auto/transport industries for light weighting, which increases fuel efficiency/reduces greenhouse gas emissions Social • Lack of mining operations limits local opposition risk Governance • New management team that was put in place has greatly reduced our past concerns around governance
Aegon AM US ESG category	Responsible leader (category #1)

Case Study #2 – Event risk potential	
Company description	Technology company offering hardware, software and storage solutions
ESG-related opportunity or risk	Environmental • 80% ownership of a company that provides software that allows datacenters to generate scale efficiencies and reduce energy needs Social • Supply chain risks with respect to sourcing cobalt from mines in the Democratic Republic of Congo Governance • Unique board structure raises serious questions regarding board independence • Multiple share classes and unequal voting power increases risk related to lawsuits and management distraction • History of controversies with minority public shareholders regarding valuation
Aegon AM US ESG category	Event risk potential (category #3)

Case Study #3 – Internal rating override	
Company description	Protein producer
ESG-related opportunity or risk	Environmental • Sourcing of cattle from deforested areas as well as areas subject to water stress raises environmental concerns Social • A history of controversies involving labor and product quality point to an inability to manage relevant risk Governance • Bad corporate behavior and corruption is rampant with executives/controlling owners involved in numerous bribery and corruption scandals
Aegon AM US ESG category	Internal rating override (category #5)

Related literature

Electric Power Sector to Drive Success of Electric Vehicles

Global Emissions Standards Driving Hybrid and Electric Vehicle Growth

A Solution to the Plastic Problem Presents Risks to the Chemical Industry

How we Incorporate ESG

Three Reasons to Invest Responsibly

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