Driving Value in Fixed Income Through ESG

When creating solutions for our fixed income clients that integrate environmental, social and governance (ESG) factors, there is no one-size-fits-all approach. ESG goals vary by end investor.

However, there is one question we are asked regularly: “Can I incorporate ESG into my portfolio without giving up yield?” We believe the answer is a resounding yes.

ESG considerations have always been implicit in our credit investment analysis. Given the asymmetric nature of price moves in fixed income,1 minimising defaults is crucial—and we find that more responsible companies tend to have fewer defaults. We believe that ESG factors have the ability to impact the fundamental credit risk of a company and, in turn, a company’s bond price.

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1 When a bond issuer experiences negative events (i.e.: a payment default, credit rating downgrade, negative headlines, etc.) bonds issued by this issuer are likely to experience a greater change in price (price decrease) than if there had been a positive event (price increase) for the issuer. This makes the price movements of bonds asymmetric.
Controversies and negative ESG-related headlines can hinder investors’ ability to transact in a bond over the short term.

However, ESG research is not typically designed for fixed income investors. As a result, the MSIM Fixed Income team has created a proprietary ESG-scoring methodology that explicitly considers the risks and opportunities ESG factors pose to corporate bonds.

Although fixed income investors are slightly behind equity investors in recognizing how ESG factors can provide unique insights into long-term risks and opportunities, as we see in Display 1, there is no shortage of examples where a sector-related ESG factor has led to sharp downward bond price movements, restructuring or default:

- **ENVIRONMENTAL**: Litigation and fines resulting from environmental disasters in the energy space

- **SOCIAL**: Business model disruptions as a result of additional regulation to better protect the vulnerable in consumer finance

- **GOVERNANCE**: Excessive financial engineering, partially as a result of poor governance, in the construction sector

We aim to capture the potential for these risks in our proprietary sector risk analysis (MSIM ESG Credit Scoring Analysis, Display 2).

### DISPLAY 1
Examples of Company ESG Incidents

<table>
<thead>
<tr>
<th>ESG Incident</th>
<th>Bond Price High Before the Incident</th>
<th>Bond Price Low Following the Incident</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental Disaster</td>
<td>107.54</td>
<td>97.33</td>
<td>-9.5%</td>
</tr>
<tr>
<td>Social Responsibility</td>
<td>96.15</td>
<td>57.30</td>
<td>-40.4%</td>
</tr>
<tr>
<td>Governance Misstep</td>
<td>104.14</td>
<td>2.28</td>
<td>-97.8%</td>
</tr>
</tbody>
</table>

Source: Bloomberg. Each row of data represents one company, as an example, that experienced the ESG incident described. The bond price before and following the incident represents one individual bond that was issued by the respective company taken at the peak bond price right before the incident was made public and at the trough bond price following the incident.

For illustrative purposes only and should not be construed as how each security have moved, or will move, before and after an incident.

### Proprietary Sector Risk Analysis...

Built on their deep knowledge as sector specialists, our credit analysts complement their investment experience with ESG-focused research from a wide array of leading third-party sources to derive sector risk weightings of high, medium or low across 47 sub-sectors. As seen in Display 3, these risk weightings reflect our view of how likely the ESG factor is to have a negative effect on a bond’s price movement.

**...Combined With Third-Party Company ESG Data**

We use this sector risk analysis to assign weights to raw ESG data provided by leading third-party experts. Risk weightings will vary from low to high for environmental and social factors, but will always be high for governance. We find that governance is the strongest ESG driver of portfolio risk and return, and as fixed income investors, we rely heavily on management teams’ controls to avoid involvement in fraud or corruption, and to execute on commitments to repay debt.

**Adjustment #1: Momentum**

While we offer our clients the option of using negative screening and sector exclusion lists for segregated mandates, our view is that companies should be rewarded for demonstrating a willingness to change and adopt stronger ESG principles. Sustainability experts have recently raised questions about the effectiveness of negative screens, preferring instead a more holistic view of a company’s approach.

To account for momentum in our scoring methodology, we make numerical adjustments to third-party data in favour of companies that demonstrate positive ESG momentum and against companies that demonstrate negative momentum.

**Adjustment #2: Controversy**

Negative ESG-related headlines can impact our ability to transact in a company’s bonds. Not only can a company’s controversy change its credit fundamentals, but it tends to increase public focus on ESG topics. Portfolio managers may move to avoid the most obviously controversial names.

To account for controversy, we make a numerical adjustment against companies that have been featured in the headlines for negative reasons. Our adjustment for controversy has less impact than our adjustment for momentum in our final score—we prefer to bias our score towards the future rather than the past.
DISPLAY 2
MSIM’s ESG Credit Scoring Analysis

Sector Risk (MSIM) + Third-Party Data

Company Risk (Third-Party Experts)
Quantitative Environmental, Social and Governance Scores

- Controversy Adjustment
- Momentum Adjustment

MSIM ESG COMPANY CREDIT SCORE

DISPLAY 3
Sector Risk Factor Weightings

Low Risk
ESG FACTOR IS UNLIKELY TO HAVE A NEGATIVE IMPACT ON PERFORMANCE

Medium Risk
ESG FACTOR HAS THE POTENTIAL TO DRIVE DOWNWARD PRICE MOVEMENT

High Risk
ESG FACTOR COULD SEND A BOND INTO DEFAULT DISTRESS

For illustrative purposes only. This represents how the portfolio management team generally implements its investment process under normal market conditions.
MSIM ESG Credit Scoring Analysis

The final output is a numerical score that is comparable across sectors and used as one of many inputs into the final investment decision on a security-by-security basis. We also use these scores to calculate the weighted-average MSIM ESG Credit Scoring Analysis of a portfolio and its corresponding benchmark. We use this score to better understand the ESG quality of our portfolios.

In Display 4 we demonstrate how our ESG Credit Score can differ from third-party ratings. In this example we compare two U.S. retail companies, which for simplicity we will refer to as Retailer A and Retailer B. As you can see, using MSCI data the companies appear to have similar ESG risk profiles. However, when we look a bit deeper we notice several factors that we believe differentiate the credits, impacting their ESG risks and possibly their bond prices in the future.

First, we have already discussed the importance of explicitly considering momentum and controversy factors. In this example, Retailer A and Retailer B couldn’t be more different. Retailer A has been involved in some significant controversies and has had downward ESG ratings momentum. Retailer B has been involved in fewer material controversies and more importantly has demonstrated positive ESG momentum.

When we look at the two companies’ quantitative E, S and G scores we see that the environmental and social scores of these companies are similar but the governance ratings are quite far apart. As we see governance being the ESG risk that most drives credit performance, it becomes imperative in our model to differentiate between Retailer A and Retailer B.

Taken in aggregate, our MSIM ESG Credit Score model incorporates the divergent momentum, controversy and governance scores to come up with a proprietary ESG Credit Score that is not only more applicable to fixed income investors, but we believe also properly differentiates these two credits.

ESG Engagement

The credit research team is focused on being active owners and implementing processes that incorporate ESG issues into investment decisions. We believe targeted engagement practices create healthy dynamics between investors and companies. These practices include increased transparency, diffusion of new ESG knowledge and the accumulation of political capital for investors and companies alike to affect change.

Specifically in the second quarter of 2019, the MSIM Global Fixed Income team rolled out a formal corporate engagement strategy that emphasizes coordination at the MSIM level with the Global Stewardship team. Engagements are both thematic and targeted with additional focus on low ESG scoring companies. The team also added new technology features that enable analysts to document and track the impact of engagements.

Thematic Engagement Case Studies

Drug Pricing (Fixed Income)

In 2019, MSIM’s Credit Research and Global Stewardship teams launched an engagement series with healthcare companies to discuss regulatory and reputational risks associated with drug pricing. The objective of the thematic engagement series is to identify companies best positioned to navigate regulatory and market changes around drug pricing.

Per capita pharmaceutical spending in the U.S. is 54%-209% higher than in other high-income countries and is continuing to increase. Many pharmaceutical companies have stated in their 10-K reports that they face financial risks associated with looming regulatory interventions to control drug pricing in addition to reputational risks as consumers grow weary of high drug

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Display 4

Case Study: Retailer A vs. Retailer B

<table>
<thead>
<tr>
<th></th>
<th>RETAILER A</th>
<th>RETAILER B</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI Score</td>
<td>3.8</td>
<td>3.7</td>
</tr>
<tr>
<td>MSCI Rating</td>
<td>BB</td>
<td>BB</td>
</tr>
<tr>
<td>MSCI Controversy Flag</td>
<td>Red</td>
<td>Yellow</td>
</tr>
<tr>
<td>Environmental</td>
<td>7.7</td>
<td>7.9</td>
</tr>
<tr>
<td>Social</td>
<td>2.5</td>
<td>2.3</td>
</tr>
<tr>
<td>Governance</td>
<td>3.3</td>
<td>7.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Environmental: Medium</th>
<th>Social: Medium</th>
<th>Governance: High</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSIM ESG Credit Score</td>
<td>4.1</td>
<td>7.1</td>
</tr>
<tr>
<td>MSCI ESG Scores</td>
<td>3.8</td>
<td>3.7</td>
</tr>
</tbody>
</table>

Source: Morgan Stanley Investment Management, MSCI. June 2018. Information is subject to change and provided for illustrative purposes only. Scale: 1–10, 0 worse, 10 best. This represents how the portfolio management team generally implements its investment process under normal market conditions. Ratings are relative and subjective and are not absolute standards of quality. Ratings apply only to portfolio holdings and do not remove the risk of loss.

2 JAMA Network Open (31 May 2019) *Trends in prices of popular brand-name prescription drugs in the United States*
costs. The 2020 U.S.-election cycle may catalyze drug price reform as it is an important voter issue so the team wanted to preemptively engage issuers on the topic. As investors, the team believes drug pricing is a material issue for the economy as a whole given the proven linkages between health, wellness and economic productivity.3

In engaging with pharmaceutical companies, the team found that drug price increases are highly discretionary choices made by management teams and that in the current climate, companies are making divergent decisions on how to set drug pricing. For example, one company has set a goal for low, single digit net price declines in 2020. Another company decided to increase prices on just 10% of its drug portfolio and another has committed to keeping list-price increases below 6%.

These divergent approaches underline the need for greater transparency on drug pricing as the landscape is varied and confusing for stakeholders. Companies agreed that increased transparency on drug pricing was important, but tended to believe that it was lacking in parts of the value chain other than their own. As MSIM continues this engagement series, it will promote the importance of transparency across all parts of the drug pricing value chain and explore ways in which companies can integrate affordability into their overall strategies.

Risk Considerations
There is no assurance that a Portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the Portfolio will decline and may therefore be less than what you paid for them. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio may be subject to certain additional risks.

Fixed income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income.

Longer-term securities may be more sensitive to interest rate changes. ESG strategies that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance. Mortgage- and asset-backed securities are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. Certain U.S. government securities purchased by the Strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future.

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CRC 2929252 Exp 03/31/2021 9774627_CH 022

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