Breckinridge CAPITAL ADVISORS

ESG BEST PRACTICES: APPRECIATE, INTEGRATE, COLLABORATE, DEMONSTRATE

(For a glossary of ESG-related terms, please click this link.)

Best practices can be working standards intended to achieve preferred outcomes. In developing best practices, companies, regulators, or governing bodies—which are among the groups seeking to develop best practices for a specific procedure, business, or industry—can balance the unique qualities of an organization with practices that it has in common with others.

While a specific best practice may be applicable or appropriate for one organization, it may not apply or be suitable for another organization. In our experience, implementing a best practices approach in environmental, social, and governance (ESG) research begins with a clear understanding of ESG basics and how they may expand the investment process. This article explores best practices that, at Breckinridge, guide our ESG investment research efforts.

In brief, a systematic approach to ESG research in combination with fundamental security analysis and issuer engagement is intended to widen an analyst's view and lengthen an analyst's focus.

In the case of fixed income investing, we view ESG analysis as an additional lever for a research analyst to pull through an in-depth review of material non-financial indicators to complement a traditional credit analysis.

Industrywide, ESG-labelled strategies continue to grow rapidly. In 2020, ESG assets managed by registered investment companies totaled $3.10 trillion, up 19 percent from $2.61 trillion in 2018, according to the U.S. SIF Foundation.

Application of ESG approaches has developed and broadened over time

Breckinridge integrated an ESG approach in its research process more than a decade ago. More recently, credit ratings agencies have added ESG factors to help assess the creditworthiness of issuers. (See *Bond Rating Agencies Upgrade Their Municipal ESG Capabilities* and *Credit rating agencies turn attention to ESG risk*.[1])

Broader recognition of ESG materiality and wider availability of ESG assessments from rating agencies may also highlight the value of independent ESG analysis developed through a proprietary investment approach.

Complementary Views in the Security Research Process

Fundamental analysis is key to a bottom-up, active, fixed-income investment management approach. Balance sheet strength, valuations, and exposure to quantifiable risks, such as interest rate risk and credit risk, are also essential in evaluating a potential investment.

We believe that a detailed ESG analysis can enhance our credit research process through facets of sector-based materiality, risk identification, and direct issuer engagement.

- **Sector Materiality Matters.** Material factors are those that have enough significance or relevance as to make a tangible impact on an investment. Understandably, various ESG factors may express greater or lesser materiality in different sectors. For instance, high carbon emissions and environmental liabilities potentially can be more material in the energy sector, while access to healthcare and product quality and safety may be more pertinent in the pharmaceuticals sector.
- **Risk Management is Critical.** An area where we believe ESG integration can make a meaningful contribution is through bottom-up analysis that can identify dormant liabilities that could negatively impact creditworthiness, bond spreads or in an extreme case affect the ability of a bond issuer to repay bondholders and meet other financial obligations. For example:
  - » A corporation might be infringing on human rights through exploitative labor practices in its supply chain and could face reputational damage.
  - » A city that addresses the differing needs of local neighborhoods inequitably may experience population declines, with negative implications for future tax revenues.
  - » A manufacturer might be negligent in its handling of harmful wastewater and could face regulatory fines.
  - » A public utility that falls behind on transitioning to a low-carbon future may end up with a less diverse energy mix to meet customer demand. They may also face increased regulatory risk resulting in potential fines.
  - » A mortgage pool that includes a disproportionate amount of mortgages on properties in flood- or drought-prone regions may experience disruptions in cash flows from more frequent or intense storm events.

  By incorporating thoughtful ESG risk analysis that may point to strengths and weaknesses in areas such as those listed above, an experienced analyst can utilize this information to help assess long-term creditworthiness and by extension the relative value or attractiveness of an issuer's bonds.

- **Engagement with bond issuers**. An important part of active fixed income investing is engaging in dialogues with the issuers of bonds on material credit and ESG factors. Engagement is an opportunity to ask questions and develop a better understanding of what the management of the company or government entity is doing to address ESG issues.

  A thorough preparation for an ESG issuer engagement should arguably integrate data from respected third parties as well as an organization's own analysis of financial and non-financial factors. Leading organizations such as the Sustainability Accounting Standards Board can provide relevant research that helps to shape internal analysis.

Issuer engagement can help to uncover context around ESG issues. It can shine a light on the way that management thinks, acts, reacts, and plans around various sustainability issues. In the end, all of that can influence decisions to invest in, avoid, or either overweight or underweight exposure to a certain security, industry, or sector.

For security issuers, the engagement process can help management stay in touch with and better understand investor concerns and preferences for standardized reporting methods. All in all, engagement between investors and issuers can be part of a healthy ongoing dialogue that can lead to an improved understanding of material ESG issues.

Finally, engaging subject matter experts can add context to issues and factors that can help inform ESG analysis. Collaborating and sharing knowledge and insights with peers, academics, and non-governmental organizations can build shared goals for mutual benefit.

Walking the Talk Adds Credibility and Demonstrates Commitment

Investing in a manner that integrates ESG analysis is based on our conviction that the best organizations from a sustainability perspective integrate ESG into the firm's culture, identity, and operating practices.

At Breckinridge, we view our B Corp status as a statement in support of our pursuit of long-term positive impact for our clients, employees, and the communities in which we live, work and invest. Being a certified B Corp is an important signal that can attract employees and help to foster socially responsible practices by holding the organization accountable and demonstrating its ongoing commitment to sustainability.

Part of that is our commitment to make ongoing charitable donations of 1% of gross revenues and to support our employees' volunteer time with three paid volunteer days per year.

Another measure of an organization's commitment to walking the talk with regard to ESG performance is the regular publication of a Corporate Sustainability Report (CSR: See the 2021 Breckinridge CSR here: *Persistence Towards Progress*). A CSR is an accounting of the organization's progress on the path to more sustainable operations as well as a sign of its commitment to continuous improvement.

Investors seeking an ESG-focused fixed income investment manager may want to consider the manager's approach to many of the issues reviewed in this article when making their selection.

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FOOTNOTES:
1. *Credit rating agencies turn attention to ESG risk*, *Financial Times*, February 23, 2019.

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All investments involve risk, including loss of principal. Diversification cannot assure a profit or protect against loss. Fixed income investments have varying degrees of credit risk, interest rate risk, default risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer-term securities. Income from municipal bonds can be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the IRS or state tax authorities, or noncompliant conduct of a bond issuer.

Breckinridge believes that the assessment of ESG risks, including those associated with climate change, can improve overall risk analysis. When integrating ESG analysis with traditional financial analysis, Breckinridge's investment team will consider ESG factors but may conclude that other attributes outweigh the ESG considerations when making investment decisions.

There is no guarantee that integrating ESG analysis will improve risk-adjusted returns, lower portfolio volatility over any specific time period, or outperform the broader market or other strategies that do not utilize ESG analysis when selecting investments. The consideration of ESG factors may limit investment opportunities available to a portfolio. In addition, ESG data often lacks standardization, consistency and transparency and for certain companies such data may not be available, complete or accurate.

Breckinridge's ESG analysis is based on third party data and Breckinridge analysts' internal analysis. Analysts will review a variety of sources such as corporate sustainability reports, data subscriptions, and research reports to obtain available metrics for internally developed ESG frameworks. Qualitative ESG information is obtained from corporate sustainability reports, engagement discussion with corporate management teams, among others. A high sustainability rating does not mean it will be included in a portfolio, nor does it mean that a bond will provide profits or avoid losses.

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