GLOBAL CORPORATE CREDIT

Our ‘integrated ESG’ approach to credit investing

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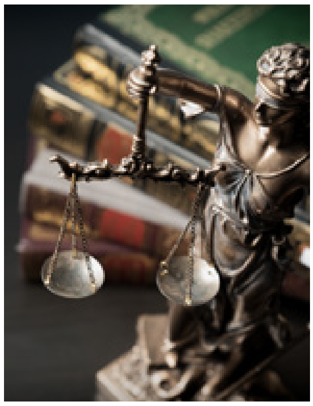
> “Companies need to be on the right side of change or risk becoming obsolete. As long-term credit investors and fiduciaries of clients’ money we want to make sure we lend to companies with a sustainable future.”
>
> Jim Cielinski, Global Head of Fixed Income

Evolving our ESG integration

At Janus Henderson Investors we seek to enhance value for clients through active management and our Environmental, Social and Governance (ESG) process is based on the belief that rigorous application of ESG principles can improve risk-adjusted returns. This document outlines the approach of the Global Corporate Credit Team. Back in 2017 we explained how, as part of this active approach, we considered ESG factors within our credit investing. Since then we have evolved our integrated ESG capabilities, whereby we incorporated a top-down thematic element to complement our bottom-up credit analysis and assigned a proprietary ESG rating to every issuer we cover.

At all times we integrate ESG into investment decision-making and company engagement in order to generate superior risk-adjusted returns while investing responsibly and aspiring to achieve better outcomes for society and the environment.



Our ESG philosophy

We believe that rigorous application of ESG principles can improve risk-adjusted returns and that company engagement is an integral part of successful investing.

As an active credit manager we take into account all material risks, of which ESG is a key component. The premise being that as with other risk metrics, improving ESG risk profiles lead to a lower cost of capital. Being positioned in companies that actively pursue ESG improvement should allow us to outperform as their credit spreads tighten and their cost of capital declines. While companies with weaker ESG risk profiles are not automatically excluded from our credit portfolios, we do avoid or disinvest from companies where the level of ESG risk is material and they are not willing or able to mitigate these risks, hence remain on a deteriorating trajectory. Engagement with management teams is an integral part of our ESG process and our global credit research analysts ensure companies are aware that ESG issues are a significant factor in our fundamental company analysis and, therefore, our appetite to invest.

Janus Henderson
—KNOWLEDGE. SHARED—

Our 'integrated ESG' approach to credit investing

Our integrated ESG process

ESG analysis is integrated into our credit research and built on a top-down thematic approach combined with bottom-up ESG assessment of each issuer we cover.

Top-down thematic ESG research

Looking at the credit market holistically, we aim to identify themes that significantly impact the industries and issuers we invest in. Deep dives into these themes help us to analyse disruptions and innovations and how companies' business models and cash flow profiles will be impacted, which in turn will drive long-term financial performance. Each theme is part of one or more of five megatrends that we believe are or will be shaping the world.

MEGATRENDS

CLIMATE CHANGE | RESOURCE CONSTRAINTS | CHANGING CONSUMER PREFERENCES | DEMOGRAPHIC CHANGES | TECHNOLOGICAL ADVANCES

ENVIRONMENTAL

- Plastic waste
- Sustainable transport
- Water management
- Sustainable housing/finance
- Cleaner energy
- Energy efficiency
- Food waste

SOCIAL

- Artificial intelligence
- Cyber security
- Social media
- Ageing population
- Population growth
- Sharing economy
- Health and wellness

GOVERNANCE

- Regulatory changes (diesel, sugar, plastic, food waste, data privacy)
- Diversity and inclusion
- Bribery, ethics and culture
- Ethical use of technology

Note: These are some of our current and potential future deep dive topics.

Process in practice

Recent examples include a deep dive into plastic waste and sustainable transport where we looked across industries to identify winners and losers from these themes. Researching these themes can also help us with company engagement. As part of our energy transition research, we have been talking to issuers that are facing regulatory headwinds to transition to a lower carbon world. For example, the shipping industry is seeing an increase in regulation related to the environment which requires them to reduce sulphur emissions. We engaged with one of the shipping companies we owned in high yield portfolios regarding their level of readiness and the potential cost implications of these regulatory changes and drew the conclusion that there was a significant risk to their business model, with an increase of +50% to their fuel costs. We subsequently sold down our exposure to the issuer and shorted the name via CDS and increased our underweight to the shipping sector. We are also talking to oil & gas companies to understand their readiness and willingness to align with Task Force on Climate-related Financial Disclosures (TCFD) reporting and we made some adjustments to our positioning.

Looking at the global credit market through the lens of these themes can also help uncover under-researched opportunities that might not be obvious when looking at industries or regions in isolation. Hence it can aid the cross-pollination of ideas as analysts work together to relate themes across sectors and regions. For example, discussions on the topic of electrification bring together the energy, utilities and autos analysts while the autos analyst works with the wider team to understand how the sharing economy could impact car ownership and in turn distributors and auto parts manufacturers. This collaborative approach accentuates our analyst and portfolio manager structure, where analysts also make relative value recommendations looking across industries.

We believe that building up a wealth of research on key themes will provide a valuable input for longer-term positioning and engagement and help identify issuers with sustainable and unsustainable business models and cash flows.

Bottom-up ESG research

ESG analysis is an integral part of the global credit team's fundamental bottom-up credit research. ESG is one of many factors we consider in our credit analysis; however, if we deem an issuer un-investable on ESG grounds then it will override our overall credit recommendation. Examples can include industries and issuers where we expect disruptions and material ESG risks to pose a significant risk to their existence, such as the thermal coal industry.

In terms of ESG considerations, we look for materiality and whether the ESG risks identified for each issuer are improving or deteriorating. A key question is whether a company is willing or able to manage and mitigate material ESG risks and whether we can see actual evidence of it.

It is important to emphasise that our integrated ESG approach is not about ethics or negative screening, rather it is about enhancing returns and reducing risks.

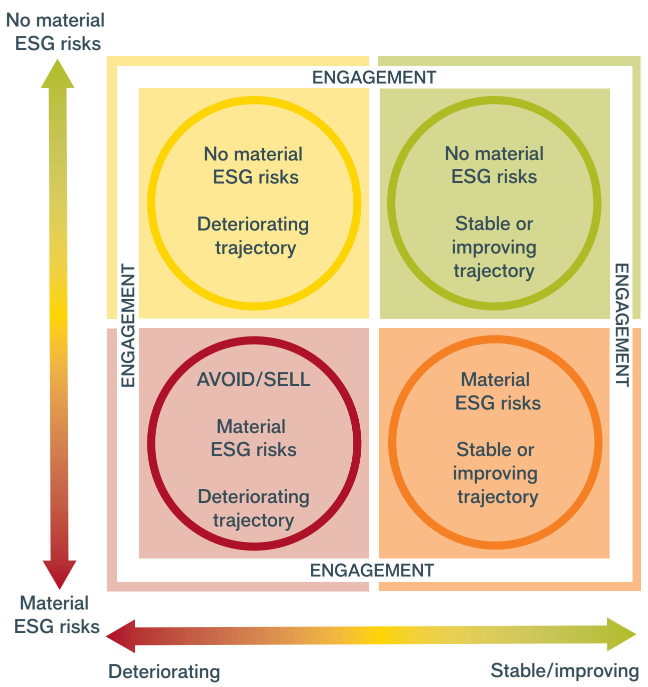
Our ‘integrated ESG’ approach to credit investing

Recognising improving ESG risk profiles
While exclusion-based strategies adopt a negative approach to investing, our integrated ESG approach takes a more positive stance and looks for opportunities where companies are actively improving their ESG profiles (the orange and green quadrants on the diagram below). Just as with other credit metrics, we look for improvement in ESG profiles that is not yet reflected in the price in order to maximise risk-adjusted returns. Positions in companies with weaker ESG risk profiles making strides to mitigate their risks (orange quadrant) can be the most profitable ones if we can recognise these opportunities before the market catches on and prices in the reduction in risk.

We are also happy to allocate to issuers who are ESG leaders (green quadrant) if we find them attractively priced. It is important to note however that ESG considerations do not indicate the overall creditworthiness of an issuer. For example, a company with no material ESG risks could still have a weak overall credit profile from other financial standpoints.

Reducing risks
If a company has material ESG risks and is ignoring them or is not able to actively mitigate them, it is very likely that its bond prices will suffer in the future. We aim to avoid issuers where we think significant risks exist (red quadrant) hence we do not buy bonds from these issuers or if we own them we will systematically sell down exposures across all our credit portfolios.

For issuers with a relatively strong ESG profile, where some emerging ESG issues are not currently addressed (yellow quadrant), we try to evaluate whether a deteriorating trajectory will lead to underperformance and whether there are better opportunities elsewhere.



In our view this approach offers three benefits:

- The prospect of generating higher risk-adjusted returns from buying credit improvement that is not yet reflected in the price.
- A greater positive impact on society by rewarding and encouraging positive ESG outcomes.
- Engaging with imperfect sectors or companies to influence and speed up positive change in industries where a lack of alternatives supports their continued operation.

Excluding entire industries for non-financial reasons that may be a big part of a strategy’s investment universe can have a large impact on the strategy’s volatility and risk-return profile. Unless a strategy’s objectives explicitly include ethical considerations and/or positive impact, negative screen-based exclusions may not be appropriate for investors who expect to maximise risk-adjusted returns in an integrated ESG fashion.

Engagement – making a difference

Engagement with management teams is an important part of our fundamental credit analysis. We meet with the management of all issuers in which we invest and take advantage of any opportunities thereafter to maintain a dialogue with them. This can provide a forum for engagement about strategy, future plans and any specific ESG issues. We engage on specific ESG issues to better understand the company, how they plan to mitigate risks and aim to positively influence outcomes.

As credit investors, we may not hold voting rights to be able to directly shape the direction of a company, but we believe we can still have influence over companies, particularly those in which we are a large creditor. We engage with companies not only through company meetings but also surveys, emails and calls with an ultimate objective of achieving positive outcomes in the issues we raise. Should we not see a meaningful improvement in mitigating a material ESG concern and the company remains on a negative trajectory, we will divest and/or avoid the issuer until we see evidence that the issues have been addressed.

We also collaborate with our equity colleagues and attend company meetings together, engaging with issuers on ESG issues at the wider firm level rather than just the credit team. Furthermore, the Governance & Responsible Investment Team also supports us on specific ESG issues as well as representing us through industry-wide initiatives, such as the Climate Action 100+ initiative.

Proprietary ESG ratings

Our proprietary ESG analysis and ESG ratings are generated by our credit analysts and are built into our internal research tool, Quantum, which is shared globally. An Avoid ESG rating would result in an overall avoidance of the credit or if a company that we own has deteriorated on ESG grounds that makes the issuer deemed no longer investible (ie gains an Avoid ESG rating), we systematically sell down all our exposures across all portfolios.

Issuer	Industry	Overall credit recommendation	ESG rating
Company A	Banking	✔ M/W	● No material risks/stable or improving trajectory
Company B	Technology	▬ U/W	● No material risks/deteriorating trajectory
Company C	Chemicals	▬ U/W	● No material risks/stable or improving trajectory
Company D	Automotive	✔ M/W	● Material risks/stable or improving trajectory
Company E	Pharmaceuticals	✔ M/W	● No material risks/stable or improving trajectory
Company F	Apartment REITs	✚ O/W	● No material risks/stable or improving trajectory
Company G	Mining	✖ Avoid	A Avoid

Overall credit recommendation	ESG rating
✚ O/W	● No material risks/stable or improving trajectory
✔ M/W	● No material risks/deteriorating trajectory
▬ U/W	● Material risks/stable or improving trajectory
✖ Avoid	A Avoid

Note: Sample screen of Quantum tool for illustrative purposes.

Our ‘integrated ESG’ approach to credit investing

Tools and resources

We use a wide range of tools and information to aid our ESG analysis. We are empowered by firm-wide ESG collaboration, including the dedicated in-house Governance and Responsible Investment Team, shared research with equity colleagues, and the dedicated Fixed Income ESG Working Group. This in-house research strength is complemented by subscription to third-party data and research providers.

GLOBAL CREDIT RESEARCH TEAM	GOVERNANCE & RESPONSIBLE INVESTMENT TEAM	FIXED INCOME ESG WORKING GROUP	EXTERNAL ESG RESEARCH & TOOLS
• A global team of credit research analysts • Proprietary ESG research and thematic sector deep dives • Company engagement • Proprietary ESG ratings	• An independent team of dedicated specialists • Provides ESG research and thematic deep dives • Provides support with company engagement • Information and external research sharing	• FI investment professionals responsible for ESG integration and process enhancements • Identifies ESG megatrends and themes for deep dive analysis • Implements process enhancements • Represents the voice of the asset owners with respect to ESG	• Sustainalytics • RepRisk • MSCI • ISS • Vigeo EIRIS • Rating agencies (ESG scores/research) • Broker research

ESG research documentation and reporting

Our credit analysts have been logging industry-wide or issuer specific ESG issues within their coverage since 2013 and we have been reporting these in quarterly investment reports since 2016. As of 2019, credit analysts explicitly document ESG issues in all substantive written research produced globally and record factors that are material to each company in our proprietary global research database. This enables us to report on specific ESG issues and to track the evolution of each company’s ESG profile over time.

The complete picture

Ultimately, we believe that good credit investing involves understanding risks and opportunities so credit analysis that fails to incorporate ESG factors is, in our view, incomplete. There are so many parallels between credit analysis and ESG that they are fast becoming inseparable.

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Janus Henderson
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Important Information

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