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Digging Deep Into Material Factors for ESG Investors

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When we published a paper outlining our approach to engaging with companies on Environmental, Social and Governance (ESG) issues, many investors asked how we determine what issues are "material." It wasn't just a technical question: In 2020, police shootings of civilians and the deaths of frontline workers during the pandemic pushed social justice concerns to the forefront for many investors.

Here's the short answer: We define material issues for ESG investors as nontraditional factors that are likely to have an impact on the risks and opportunities relevant to a company's business model value, by affecting the firm's cash flows, cost of capital and enterprise value.

This paper provides a longer answer. It explains how we identify which ESG factors are material, how we track factors that may become material, and how we incorporate the materiality of ESG factors into our credit research and investment processes.

As discussed in a recent research piece by MacKay Shields and Kirstein, "ESG & Fixed Income: Beyond Ratings and Labels", investors appear to be moving from excluding issuers with poor ESG scores to integrating ESG strategies. We believe that thoughtful ESG integration can help investors achieve both their financial and ESG goals, and that our research processes embody important principles for integrating ESG that investors should consider.

The Evolving Nature of Materiality

Global financial markets have come to agree on a definition of materiality through observation of financial outputs and impacts. For example, the Financial Accounting Standards Board (FASB) writes, "The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying on the report would have been changed or influenced by the inclusion or correction of the item."[1]

This definition of materiality is commonly applied to evaluations of companies using traditional financial metrics, such as earnings growth or leverage ratios. But ESG investors also evaluate companies using nontraditional metrics, particularly in Europe. Indeed, the European Commission's 2018 plan for financing sustainable growth—known as the EU Action Plan—requires companies to consider both the potential impact of sustainability factors on their businesses, and their businesses' potential impact on sustainability factors.

Time horizon is also an important component of the evolution of the discussion around materiality. Independent of security maturity, a forward-looking lens is important because cultural norms and related business practices change rapidly. Thus, what is material changes over time, as shown by the increased concern over police shootings of civilians in recent years.

We believe the accounting definition of materiality is an effective measuring stick when considering ESG factors. If excluding the ESG factor from analysis would fundamentally alter the outcome of our investment decision, we regard the factor as material. Since the definition of materiality will change over time with cultural norms, law and regulation, investors must be sensitive to early signs of such changes.

1. Source: Financial Accounting Standards Board (FASB), *For the Investor: Disclosure Effectiveness—How Materiality Fits In.* See link here to access.

Relevance Matters

But no factor matters much in isolation. For investors, it makes sense to weigh ESG factors against each other and against traditional financial metrics. Integrating ESG factors within the broader MacKay Shields credit research process allows our analysts to assess how material ESG factors are—given the circumstances of the sectors and companies they follow, and the likely time frame for the factors to become significant. Using established industry frameworks for materiality, we weight the importance of ESG factors along industry lines. Fifteen of the 35 factors in our credit analysis framework relate to ESG issues. This approach allows us to focus on those factors that are most pertinent to each industry and reduces the risk that less relevant ESG factors will distract our analysts.

For example, we deem workplace safety to be more relevant to the healthcare industry than to investment banking. Even before Covid-19, nursing assistants missed more workdays because of occupational illness and injury than workers in any other job category. Healthcare firms require healthy and stable faculty and staff to meet their legal obligation to provide a sufficient level of care. Thus, a company's success or failure in reducing missed employee workdays due to injury on the job is a material ESG factor.

Within industries, we judge the materiality of a factor to a company by comparing the company to its peers. When a company substantially deviates from the industry average, we adjust our ESG assessment according to the magnitude of the deviation, whether positive or negative. The output of our analysis is an ESG score for each issuer that informs our overall credit assessment of each issuer. The display at right, for instance, shows that several ESG factors are more material for banks than for unregulated financial institutions; related-party transactions are a noteworthy exception.

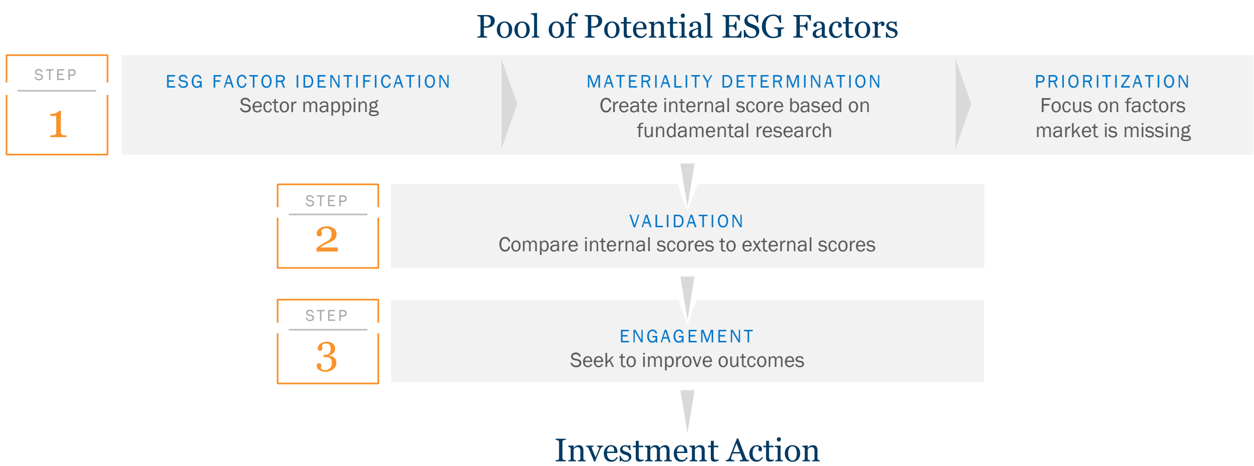
If we deem an issuer's ESG risk to be exceptionally high without commensurate return potential, we exclude the issuer from consideration for purchase. If an issuer is weaker than its peers on a single factor but close to the peer group average on others, the weakness on only one factor might lead us to exclude the issuer. On the other hand, if the issuer scores well overall, despite its weakness versus peers on an ESG factor, we will generally engage with the company to encourage it to improve its score on that factor. In the meantime, we would hold a position in line with our risk-adjusted return expectations. If the company succeeds in improving its score on the factor in question, we might increase our position. Our scoring process is iterative: We constantly refine our views as we assimilate new information and engage with issuers.

FIGURE 1: SCORING ESG FACTORS FOR BANKS VS. UNREGULATED FINANCIAL FIRMS

	Banks	Non-Regulated Financial Institutions
ENVIRONMENTAL	M	L
POLITICAL AND REGULATORY RISK	H	L
ENVIRONMENTAL POLICY/RISK	M	M
SOCIAL	M	L
TECHNOLOGICAL RISK	M	L
WORKPLACE POLICIES	L	L
HUMAN RESOURCE POLICIES	L	L
SUSTAINABLE BUSINESS PRACTICES	M	L
MANAGEMENT FOR ALL STAKEHOLDERS	M	L
GOVERNANCE	H	M
MANAGEMENT: REPUTATION, STABILITY, RISK APPETITE, DEBT POLICY, ACQUISITION RISK	M	M
OWNERSHIP/SPONSORSHIP/DIVIDEND RISK	M	M
CORPORATE STRUCTURE/COMPLEXITY	M	L
BUSINESS PLAN	L	L
BOARD COMPOSITION	L	L
CAPITAL STRUCTURE	M	M
RELATED PARTY TRANSACTIONS	L	H
MANAGEMENT ESG AWARENESS/ENGAGEMENT	H	L

High (H), Medium (M), Low (L)
Source: MacKay Shields

FIGURE 2: OUR ESG MATERIALITY DISCOVERY PROCESS



Source: MacKay Shields

ESG Material Assessment Process

Let's take a closer look at how we think about ESG materiality in our research and investment processes.

ESG FACTOR IDENTIFICATION

We begin our materiality assessment by looking at the relevance of various ESG factors at the industry level. Our approach is broadly in line with the materiality map for industries that other firms use, but we may deviate from it if we believe relevant factors are emerging that the market doesn't yet recognize sufficiently.

For example, regulators are seeking to incorporate climate-related risks into their stress tests for banks. The concept of double materiality in the EU Taxonomy and Sustainable Finance Disclosure Regulation is meaningful here. Climate change is a material issue for banks because it can adversely impact banks' loan books. At the same time, bank policies are material for climate change, because banks can increase or decrease capital flows to companies that produce greenhouse gases. The current industry materiality map does not yet incorporate this analysis, but we encourage our analysts to anticipate emerging material issues for industries and incorporate them into their fundamental analysis of companies.

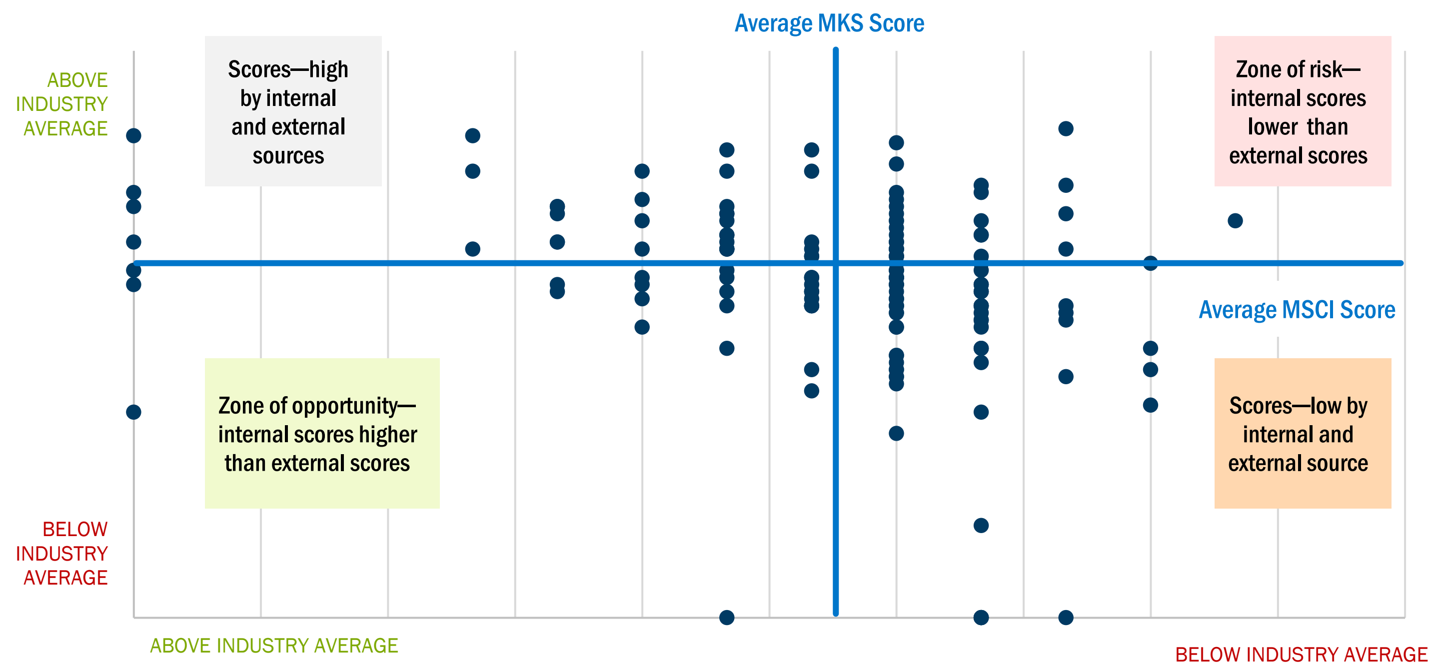
This is an iterative process. We periodically review how our approach may deviate from industry conventions and whether our approach may suffer from anchoring bias (a preference for what we have previously done). In such instances, we seek to validate our view analytically.

For example, we recently scored a large US bank below its industry peers. When we noticed that external sources scored the bank even lower, we checked whether we were being too optimistic: We tracked our scores over time to ensure they accurately reflected the progress the bank was making in addressing its governance and social issues. After completing this review, we concluded that our scores were justified and captured more relevant, forward-looking information than the scores the external sources produced.

PRIORITIZATION

We also refine our assessments by prioritizing factors we expect to have the greatest potential impact on bond returns. For example, if our score for a company is above external providers' scores, and we believe the market price is too low relative to our score, we will overweight the position to seek profit from an expected tightening in credit spreads as the market comes around to our point of view. One way to capture improving credit spreads is to engage with companies to boost their scores. We continually monitor whether our engagements are producing better investment outcomes.

FIGURE 3: BY LOOKING AT OUR INTERNAL SCORING AND MSCI, WE CAN BETTER ASSESS THOSE THAT ARE ABOVE AVERAGE AND CREATE POTENTIAL OPPORTUNITY



Source: MacKay Shields and MSCI

Figure 3 plots various bonds in two dimensions—by our internally produced scores and the sources produced by an external source, MSCI. We consider bonds that we score higher than the external source does exist in the zone of opportunity; we consider bonds we score lower than external sources to lie in the zone of risk.

VALIDATION

When we identify a material ESG factor, we ask whether it has or will substantially impact our investment decision on a particular company. If not, we exclude the factor from the investment thesis for that security.

If our ESG assessments differ from the market view on certain issuers, we review our own assessments. The greater the deviation of our scores from third-party scores, the more intensely we review our scores to ensure our viewpoint has a solid research basis. If we have strong research conviction and the pricing is attractive, we are likely to take a larger position in the issue. On the other hand, if we determine that we should incorporate additional information, which moves our internal score closer to the industry average, we might reduce our position size relative to the benchmark. We might also reduce our position size if we decide that our engagement efforts are unlikely to influence the company's actions enough to affect credit spreads.

Emerging Materiality Factors

With economies gradually reopening, we see several trends that are increasingly relevant for how we are positioning our portfolios. One is the race to carbon neutrality: We think the risk is growing that banks are underestimating the exposure to climate risk and carbon-intensive industries in their loan books and investment banking business.

Today, ESG materiality frameworks list few environmental issues as material to the banking industry. This makes sense, to some degree. Under the international Greenhouse Gas (GHG) Protocol, for example, banks have fewer material commitments than, say, utilities, to actively manage and reduce their Scope 1 emissions (emissions of greenhouse gases from their own operations) or Scope 2 emissions (indirect emissions from purchasing electricity, steam, heating and cooling). But banks do have material commitments to reduce their Scope 3 emissions (indirect emissions from funding carbon-intensive industries and from linking investors to those industries). Transparency about their Scope 3 emissions is material for individual banks and for the systemic risk of the financial system, and we expect to see increasing regulatory scrutiny of banks' exposure to carbon-intensive industries.

Some jurisdictions are already taking the first steps in this journey. In New Zealand, regulators want to require larger banks, insurers and asset managers to disclose by the end of 2023, the impact of climate change on their businesses. In the European Union, work is underway to expand materiality in accordance with the double materiality framework of the EU Taxonomy and Sustainable Finance Disclosure Regulation. In the U.S., the New York State Department of Financial Services is starting to require insurers operating in New York State to integrate climate-related financial risks into their governance frameworks, risk-management processes and business strategies.

Ultimately, we expect banks to see their cost of capital rise, if they do not proactively manage the carbon exposures in their loan books and publicly explain how they are moving toward lending to less carbon-intensive industries. Investors will apply a 'dirty-energy' premium to their bonds.

Conclusion

ESG investing may be relatively new, but in key respects, it's much like traditional investing, in our view. We think the criterion for ESG materiality should be the same as for other factors (potential impact on investment outcomes). We also think the magnitude of the potential impact is what makes an ESG factor—such as a traditional factor—relevant to investments in an industry or company. Within industries, what matters is how a company compares to its peers on material ESG factors, such as other factors; whether market pricing accurately reflects any differences; and whether any market mispricing is likely to correct. As a result, at MacKay Shields we embed ESG considerations into our overall credit research and investment process. We believe adopting a wider lens that includes all factors, traditional and untraditional, is necessary for reasonable investors today.

As we move forward, being able to identify factors with the potential to become material will be crucial. As the experiences of 2020 have revealed, factors deemed immaterial can rapidly become material. Investors who understand these matters should be able to react more quickly to avoid uncompensated risks.

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