Transcript

PGIM FIXED INCOME

>> [Background Music] You're listening to All The Credit, a monthly Podcast Series brought to you by PGIM Fixed Income, ad Active Global Fixed Income Investment Manager. And now, your host Senior Portfolio Manager, Mike Collins.

>> Hello, welcome to Episode 9 of All The Credit, PGIM Fixed Incomes monthly podcast. I'm Mike Collins, just one of the many investment professionals at PGIM Fixed Income and your host for All The Credit. Our regular listeners have probably noticed that we have touched on the topic of ESG. That's environmental, social, and governance, in most of our prior podcasts, as the consideration and integration of those factors are deeply ingrained in our fundamental research, our relative value analysis, and even our portfolio construction process. But we're really excited today that this episode is dedicated to the ESG topic, and our guest is an expert on the subject. She's one of our most recent hires, and his PGIM Fixed Incomes new head of ESG research, Eugenia Jackson. Eugenia and I will discuss the rapidly evolving trends in ESG and how PGIM Fixed Income is incorporating our proprietary ESG impact ratings into our investment process. Eugenia and I are here to give you all the credit. Welcome, Eugenia.

>> Hi, Mike. I'm really happy to be here.

>> Well, we're thrilled to have you. I think it's a testament to our commitment to ESG. You're not only our head of ESG research, you're also the co-chair of our ESG committee, which has been in place for four years now. Why don't you tell the listeners a little bit about yourself, and you've only been here, you know, not even a couple months, I think. And we would all like to learn about your career path. I know you've had a long and storied career in ESG and with regard to socially responsible investment. Tell us a little bit about your career path and how that -- those factors have evolved over the last decade or so.

>> Sure. Well, I've been in many ways doing ESG for over 20 years now, from my very first job when I started working for an engineering company on a large pipeline construction project, where we paid a lot of attention to environmental and social impact assessments. I also did -- I published the research on corruption for a US-based research center in my native country of Georgia. However, the last 15 years or over last 15 years I spent in the financial industry, focusing on ESG topics. First starting as a governance analyst, and then expanding my expertise into all three pillars of environmental, social and governance. So -- and at that time, I have to say it's been a tremendous evolution in the way that ESG has -- is being used in the financial industry. It's become a lot more mainstream, a lot faster than I would have ever expected. And maybe I'll give you an example like 10 years ago, for example, ESG community was a small, a tiny part of the financial industry. Very few asset managers had dedicated ESG analysts, most of ESG activities were really focused on corporate governance, on stewardship, such as active engagement with issuers. And really very few asset owners and retail investors were either aware of or interested in ESG focused strategies. And where -- they were interested, quite frankly, the ESG strategies available were either focused on negative or positive screening. You would find it hard to find many examples of full integration of environmental and social factors into investment analysis, governance has always been there. But environmental and social is really something that will only has really evolved in the last five, six years. So now, as the materiality of environmental and social factors for corporates, for businesses, for issuers, and therefore for us, as investment professionals have increased, now we are seeing a completely different picture. So, we're seeing a much more comprehensive integration of ESG factors into investment analysis and into investment processes just as you highlighted before. We have a lot more resources allocated by investment firms to analyzing ESG factors. And perhaps my higher is the

evidence of that. We have a lot more ESG data available. And I know there are really a lot of concerns about the quality and consistency of ESG data. But compared to what we had when I started my career in this industry, it's a huge enormous improvement. Also, we have as, you know, a much larger and fast-growing interest among clients in ESG-focused strategies. But as a result, we also have a much higher availability and variety of ESG strategies in the market that can help clients address the different requirements and investment objectives that they have. So there have been a huge, huge developments over the last 10 years

>> Tell us about the regional transition, right? I -- you're, you know, European office, you'll be presumably working in London. And I think of that as the home really of ESG to some extent with regard to the real incorporation and integration of these factors into the investment process, and it's a building portfolio. Are you seeing that those trends and that emphasis shift from Europe to the rest of the world and eventually to the US? And how is that progression working in your eyes?

>> Well, yeah, absolutely. I mean, ESG has become a truly global phenomenon. I mean, Europe, of course, there's a lot of attention being paid to the developments in ESG in Europe, and it's definitely, it's not just a trend, it's really already an established focus for its mainstream in Europe. It's very hard to call it a niche. But if you look at other regions, for example, I look at Asia Pacific, again, 10 years ago, if you ask me this question, 10 years ago, I could perhaps point to Australia as an example of an ESG friendly market. But now we have Japan as one of the leading markets in terms of focus on ESG and stewardship. We also see asset owners in Hong Kong, Taiwan, Korea, Singapore, putting a lot of effort in this area. So, Asia Pacific is coming up very, very fast. When it comes to the US, I think you're right, there is a common perception that US is sort of behind the curve when it comes to ESG. But I would really like to emphasize here that US is very large and a very diverse market, with many different types of investors. And it also has a very different regulatory environment compared to Europe at the moment. So, it shouldn't really come as a surprise that ESG accounts for a smaller share of US markets compared to what we see in Europe, for example. However, having said that, I also want to stress that there are many asset owners and many asset managers in the US who've really been the front runners and early adopters of ESG investing. If I use the example of public sector pension funds, they've been so strong in engaging with the boards and management of corporate issuers on ESG topics. Early on, they were advocating for integration of financially material ESG risks and issues into business strategy of a corporate issuers. They are very, very vocal in asking for better disclosures. And as an example -- another example is that US is the largest number of shareholder proposals related to environmental and social issues every year, larger than anywhere else in the world and larger than the rest of the world combined. So, it's -- to me, it's a real sign of an active responsible investing community in the US. And maybe the last point about the US is it has a lot of asset owners and individual investors who have a very sharp focus on impact investing. And, you know, as, you know, impact investing means that you invest not only for financial returns, but also you want to use in your investment to achieve measurable environmental and social objectives. So -- and this is still a very small proportion of the total investment market, but it's gaining speed very, very fast. And in the US, this is a very visible trend.

>> Right.

>> So, I think, you know, the whole world is coming up to speed with ESG.

>> And I really want to get into some of those, those trends, how they're being incorporated? What some of the newest versions of ESG and green bonds that we're seeing a lot of issuance in the market for? And how we're attacking ESG at PGIM Fixed Income? But, you know, folks like me, Eugenia, who've been here at PGIM Fixed Income our entire careers. Many of us have been here for decades, as you know, we're always really fascinated and curious to know what brings, you

know, somebody here, and you, like I said one of our newer additions to the team. We're thrilled to have you but why PGIM Fixed Income? What was it about our culture or style or approach that that attracted you to the organization?

>> Oh, there've been number of reasons. But first and foremost, PGIM is an active fixed income manager with, I think, stellar reputation in the market. It has a huge reputation for, you know, performance, for integrity, for its strong culture. And this is -- these are the attributes of any organization that are very, very important for me. Secondly, I think fixed income is -- has such a huge -- offer such a huge opportunity for ESG investing, and we'll talk about it a little bit later. But I really wanted to focus on fixed income as an asset class and see what can be done, you know, the push the boundaries may be in the fixed income of ESG in fixed income. And this is something that's PGIM Fixed Income has offered an -- me an opportunity to do And I think lastly, I was really impressed when talking to many now colleagues, during my interviews about the effort. The commitment and the resources that PGIM Fixed Income is -- has been willing to put behind ESG. I think it's very rare to see that the entire credit research platform is involved in producing ESG ratings doing ESG analysis, engaging actively with corporate issuers and with sovereign issuers. And I think this is such an enormous benefit to have for me in my role, and because my small team is not going to be able to do all of it, but having the support of the entire credit research platform gives us a very, very powerful way of addressing ESG issues.

>> Yeah, you know, I was a credit analyst decades ago at this shop, Eugenia. And as you mentioned in your earlier comments, the governance aspect of ESG has always been, you know, at the forefront. I remember, you know, we would have warning flags on individual credits, whether they're corporations or sovereign issuers. If there's a change in management, if there are problems with the management of the organization, the strategy, the general governance, the board practices, et cetera, so that's always been fully integrated into credit research. And it's the social and environmental things that are becoming increasingly important without a doubt, because they certainly are changing corporate behavior. They certainly are impacting performance and valuations on stocks and on bonds. So, I'd like to get into, you know, how the world is looking at those factors and what are some of the trends we're seeing in asset management with ESG for -- specifically for bond investors, as you put it?

>> Sure. I mean, there's a lot I can talk about. But I would like to specifically highlight three major trends that I see. Firstly, is an almost a universal demand these days for ESG integration across all strategies. So, it's not the select view anymore. It's not just the strategist with the ESG mandate was ESG focus. Every strategy is expected to fully integrate environmental, social and governance factors that are credit material into the credit analysis and into the investment decisions. That is big, because even three, four years ago, you couldn't really find the full integration of ESG into investment analysis. Secondly, I think we need -- the second trend, the big one is the focus on climate change-related risks and opportunities. And maybe this trend is more pronounced in Europe at the moment than in other parts of the world. But a growing number of investors, institutional and individual investors are realizing that both the physical risks arising from climate change, as well as the transition risks that arise from policy actions aimed at reducing greenhouse gas emissions can have a real material impact on investment performance. And this trend is only going to grow, particularly as the physical impacts of climate change are becoming more and more visible to a growing number of people and the growing, you know, segments of our society. The third impact, and I think it's the third trend, and this is a very important one is what I call a search for impact. And this is something that it started slowly. But in Europe, for example, you can see it growing very fast, as I mentioned before, it is also growing in the US. But it's no longer enough to exclude some select bad actors from portfolios. Many ESG minded investors are seeking much more. And this investors, and particularly young generation, are increasingly looking for investment

approaches that would make their money work to not only achieve financial returns, but also to achieve environmental and social good. And this is a real shift in mindset, because the positive impact of investments on the environment in society is now being sought alongside financial returns. And the equal importance is being given to both and I think this is a really big shift and big trend that we're going to see. And just on the fixed income side. Fixed income was a great space with -- for investing with environmental and social impacts in mind. And just not as a quick example, in the past five years as you refer to before, we've had such a significant growth in sustainable debt finance instruments. And these are green bonds, social bonds, sustainability bonds, the more recent one sustainability linked bonds, even blue bonds. I don't know if you've heard about the blue bonds. But we also have green loans, sustainability loans. And the purpose of this sustainable debt finance instruments is to create a much stronger link between investment and financial return, and the real world environmental and social impacts. So, maybe just to finish off that this sustainable debt instruments offer fixed income investors an opportunity to direct capital towards issuers and projects that deliver positive environmental and social impact. And we can see already that the green bond mandates from issuers with strong ESG frameworks with credible use of process commitments tend to be oversubscribed at much higher rates than for non-green labeled bonds. And that is a real sign of high and increasing appetite from investors for this impact-oriented debt instruments. So, this, in turn, should lead to the further growth in the volume and quality of sustainable debt offerings. So, yeah, it's a really interesting space.

>> Yeah. I mean, I'm really interested obviously in the valuations, you know, what you need to get paid extra to own a bond that isn't as socially responsible or sustainability linked. So, what are some of the spread differences you're seeing in those green bonds or sustainability bonds relative to non-green bonds?

>> Well, there's a lot of data out there. But, you know, it depends on the quality of green bonds because, you know, not all green bonds are made equal. You have a higher quality, lower quality. You have a higher commitment from the issuers into -- in terms of using the process of the bonds. It depends on whether you use the process for new projects, which obviously offer an incremental environmental and social impact versus the use to refinance the existing projects. It depends on whether the green bonds, the process from the green bonds are going to be used to really add to have this additionality to it. To bring the new impact to direct capital to new causes compared to the bonds which is just recycling the existing projects. So, there is a big difference in the quality of ESG or sustainable label bonds. And I think this is part of the issue that at the moment, it's -- all of these instruments are self-labeled. There's no -- there's -- the green bond principles or social bond principles. But this is just principles, they're voluntary. There is not -- no common standard. Europe is developing the green bond standards right now to make sure that, you know, we have a consistency and quality, and that the label actually corresponds to the content of the issuer. So, it's hard to talk about spreads when we have such a diversity. But based on the information that we have for high quality green bonds; we see much tighter spreads compared to the non-labeled bonds.

>> Yeah. So, it is lowering the cost of capital for issuers who are dedicating those funds for green usage. And I'm really interested in the development of that because I know there's a lot of confusion, even on our desk as we talk about these green bonds, what the source of funds are really being used for, and how do you track that? So, I think that market will continue to develop. And I totally understand your point about the younger generation really emphasizing this. And I know the listeners of all the credit tend to be on average, a younger demographic, and I know speaking personally. I have three children in their 20s. And they are all believers in climate change and in, you know, using money and capital to create more sustainable solutions. So, I totally understand that this is a trend that is in place and is only going to accelerate, especially in the US. You touched on the difference in performance expectations and an ESG mandate versus a non ESG. I mean, how

are clients expected to think about that? Are they expected to get more return in an ESG-oriented mandate or a lower return or the same return? How do they generally think about it?

>> That's a very difficult question to answer because ESG mandates are very similar to other investment mandates in the sense that they have different investment objectives, both financial and non-financial. They may perform differently over different time periods. So, it's very, very difficult to generalize. But what -- I want to say is that when you look at an ESG strategy as an investor, you need to understand what that strategy seeks to achieve from the ESG perspective. And there could be many different objectives. For example, is it there to integrate credit material ESG factors into the investment process? Or is it there to capitalize on ESG-related structural trends via thematic investing for example? Is it there to express certain moral or ethical values? Is it to achieve positive environmental and social impact? So, depending on the answer to each of these questions, you will have a different investment approach. You'll have a different ESG methodology. And that may lead to a different range of outcomes in terms of your performance expectations as well. You also have to think whether you prefer active or passive approach to investing. That can make a very big difference. So, the answer here, I suppose, is that investors should not follow just some generic conclusions or perceptions about ESG and its impact on performance. But you really need to look into individual ESG strategies, methodologist, track records. But if extensive academic research on this topic has anything to go by that probably you'll find that ESG investing can and does bring performance benefits. But as always, you know, the devil is in the detail. And you really need to understand what you're investing in and what you're investing for.

>> Yeah. One thing we've seen, certainly, in the few years, we've really been emphasizing it that PGIM Fixed Income is that, you know, ESG-oriented strategies and mandates tend to, you know, exclude or have a smaller allocation to things like the energy industry, right? So, if energy's in favor, certain strategies will do better, and if energies out of favor, vice versa. So, so is there -- if nothing else, is there a diversification benefit to having, you know, ESG impact investing as part of your strategy?

>> I think there is. I think there is. And really at the beginning, you know, of at the outset of ESG, This is what many of the asset owners were looking for when investing in ESG strategies. So, yeah, I think you're right.

>> So, let's bring it back home, Eugenia at PGIM Fixed Income. Obviously, we brought you on board, as you said it's a kind of underscoring the importance of ESG in our shop. You're relatively new here. You have a really large responsibility to kind of shape the future of our organization at least with regard to ESG. What are some of your top priorities and goals as the head of ESG research going forward?

>> Yes, I mean, as you said, it's a big job. And there's a lot of different opportunities that we want to explore. But if I were to name my maybe top five priorities I would say, firstly, you know, PGIM Fixed Income is doing a great job on ESG integration. And credit material ESG risks are integrated into credit analysis for all issuers and across all asset classes. The priority for me and my team is to work closely with credit analysts, to help identify and analyze the emerging ESG risks and opportunities. And help assess their impact on the credits. So that's number one. Number two is PGIM Fixed Income has embarked on an exciting and very challenging parts of developing proprietary ESG impact ratings for all issuers and for issues that we cover and invest in. And the priority of my team is to build out and enhance this framework. So, we can offer our clients and our investors a clear insight into the impacts that our investments have on the environment and society. And also, to offer them an additional investment tool that they can use to pursue their impact objectives. Certainly, as an active manager, we've been actively engaging with issuers on ESG risks and impact. However, I cannot help but noticing that bondholders remain

rather disadvantage compared to shareholders in companies when it comes to access to the boards meetings with the chairman to address these important issues. So, I think one of the priorities for my team would be to draw attention to this issue and to address this issue, you know, as fast as we can. Obviously, we talked about climate risks. And one of our priorities is to develop internal approaches and tools for climate risk analysis, the one that would be useful and meaningful for our investment decisions. And maybe finally, we're also there to help our firm to meet the growing regulatory requirements related to ESG. For example, the sustainable finance disclosure regulation in Europe and other regulatory frameworks that we need to be compliant with. So, these are the top priorities for now, but there are many, many other things that are on the agenda.

>> Yeah. You certainly have your hands full. Why don't you tell the listeners a little bit about our internal ratings, you know, our ESG impact ratings framework, how we measure and score these factors?

>> Sure, and it was a pleasure. Maybe I'll start to say that we approach ESG analysis from two perspectives. And this is very important. The first perspective is focused on economic value. So, the credit materiality of ESG factors to what extent ESG risks or opportunities impact financial performance of issuers, or prices present bonds. So, this is the part of every credit analysis, but this is just one side of the story. The other side is that we're also trying to measure to understand, analyze, and measure the impact that issuers have on the environment and society. And this is reflected by our ESG impact ratings. So, what we're looking for here is how issues economic activities, products, business practices impact the environment or impact the society. This is the external impact of our investments. And this is much more challenging, in many ways, because an analyst has to look at both the negative impacts that the issuers have and the positive contributions to the environment and society that they make. Some industries as you know will have an inherently stronger social function than others. Some activities will have the same. Others can deliver significant social benefits, but that may come at the expense of environmental health. So, this is a very different approach from the ESG ratings that are currently available from service providers or in the industry more general. But we believe that focusing on these external impacts of our investments alongside credit material ESG factors is very valuable for us internally, because we have a very holistic 360 degrees view on the issuers that we cover. But also, very valuable for our clients because they want to understand both the economic performance as well as the impacts that their investments have. So -- and -- so, we really think it's going to be a very valuable. It is already being a very valuable tool for us and our clients and that's why we're putting the resources of the entire credit research platform behind it. So, it's a very big effort for us.

>> Yeah. And I think it will be viewed as a competitive advantage to have our own proprietary scoring system. So, what else can clients expect from PGIM Fixed Income in the future on the topic of ESG, with regard to new strategies, et cetera?

>> Well, as usual, our clients can expect continuing high-quality integration of credit material ESG factors into credit analysis and investment process. Our clients can certainly expect continued high-quality engagement with bond issuers on ESG risks as well as ESG impacts topics. But very importantly, PGIM Fixed Income is also rolling out a series of ESG mandated strategies where our impact ratings play a critical role in the portfolio construction. So.

>> Yeah, that's exciting. I know I'm looking forward. I will be managing or co-managing one or more of those strategies myself, and I'm really excited to participate in that and dive in. So, to wrap up, Eugenia, what else should clients and investors know about ESG, about thinking about ESG approaching it, in conclusion?

>> The key message is always do your homework when it comes to ESG, because although ESG investing has been around for a rather long time. It is still a very new area for very many investors. And there are no established standards or common ways of assessing ESG approaches. There's also a lot of innovation in this space. Some of this is driven by regulations and policies, others by the existential challenges facing the humankind, like for example, environmental pollution and climate change. And some of this innovation is driven by the changing expectations of clients as we discussed just now. So, the key to successful ESG investing is to know what you want to achieve by investing with ESG considerations in mind, and then do your own due diligence. My advice is do not simply rely on off the shelf ratings. If you do your own homework, you will be surprised by what variety and diversity and the quality of strategies you discover.

>> [Background Music] All right. Well, Eugenia, thank you so much. I know I learned a lot just -- in just 30 minutes or so about ESG. And for all of our listeners, you can actually see our ESG research, our research on climate change on our website, pgimfixedincome.com as well as along with all of our other thought leadership. So, thank you for listening.

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October 2020