PGIM FIXED INCOME

# Fixed On ESG, Ep. 1

## Transcript

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**Female Voice:** You're listening to *Fixed on ESG*, a monthly podcast series brought to you by PGIM Fixed Income, an active global fixed income investment manager.

**Sarah McMullen, Head of EMEA:** Welcome to *Fixed on ESG*. Thank you so much for joining us today. I'm very excited and honored to be hosting our first ESG podcast. PGIM Fixed Income's rotating lineup of ESG-expert hosts will explore the latest topics and trends of ESG investing with a focus on fixed income. Throughout the series, we'll provide our take on investment implications and opportunities that we see in the space and how the market is changing. Listeners will hear from a variety of different leaders, as well as industry professionals and some of our clients. My name is Sarah McMullan, and I head up distribution in Europe for PGIM Fixed Income. I'm excited, as I say, to be hosting this and joined by two of my colleagues who are experts in their field. So let me introduce them now. Firstly, Armelle de Vienne who is Co-head of ESG Research at PGIM Fixed Income. She's based in Newark, New Jersey, and joined the firm relatively recently in 2021, having previously held an equity in ESG research role, and prior to that, a consultant that specialized in corporate responsibility. Armelle received her BA in political science from Colgate University and an MSc in sustainability management from Columbia. So welcome, Armelle.

**Armelle de Vienne, Co-head of ESG Research:** Thanks for having me, Sarah.

**Sarah:** Great. And then moving on to our second guest for today, John Ploeg. John co-heads with Armelle ESG Research for PGIM Fixed Income based in London, and he's responsible for the strategic integration of ESG Research across all elements of the firm. He has an undergraduate degree from Brown and a Masters in Environmental Policy from Science Po Paris School of International Affairs. We're going to come back to the French connection a little later on. But John, thank you very much for joining us.

**John Ploeg, CFA, Co-head of ESG Research:** Thank you for having me.

**Sarah:** Right. Well, onto our first set of questions. And we would really love to hear from you both on why you chose a career in ESG maybe starting with you first, John.

**John:** Yeah, so I joined the company back in 2007 in a totally different job and I've had several positions throughout the years with the company. And it sounds weird, but as you alluded to before, the reason and I got into ESG might have been French. So for a while, I was trying to learn French and I was listening to a podcast called News in Slow French. And the host there kept choosing environmental stories to talk about. And I started to look into some of these stories and I got really surprised by what I was learning. And then it kind of led me down a spiral. I just kept wanting to learn more and more. And this led me to change a lot of things about my own life, the way I was doing things personally, and then eventually, it made me want to change my career. And to come full circle, that led to me ending up studying environmental policy in Paris. So, I guess all the French that I studied did come in useful after all.

**Sarah:** Good stuff. Armelle, we'd love to hear from you and the reason you ended up in ESG.

**Armelle:** Absolutely. So, I have a little bit of a different story. This was in a previous life and I thought I was going to be a marine biologist. I had the opportunity to study in the Bahamas for a semester, which sounds very flashy and, you know, very touristy and whatnot, but it really wasn't that. I was there during a very interesting time because the island that I was on was quite underdeveloped. There were no fancy resorts. We lived on an entirely sustainable campus. We collected our own drinking water and shower water through rainwater catchment systems. And while I was there, land, just a couple miles away, had just been purchased by a new resort and it started developing. So I was able to witness first-hand some of the environmental impacts, clear cutting, some previously very pristine and untouched nature, but then also some of the social impacts. So, on the one side a positive because you have economic opportunity now on island, where previously people had been going to some of the neighboring islands, like Nassau, for job opportunities, but there was also a real lack of financial education. So, it was a constant give and take and pros and cons associated with development, if you will. And for me, what I started to think -- or what was really important was you can't think about these environmental and social issues in isolation. You always need to think about the whole picture and you need to think about it holistically, and there will always be pros and cons. So what I really wanted to do, which I eventually got into consulting, but really not just specialize in one of these areas, but think about the complete picture and recognize that there's never going to be a perfect solution, but we need to come up with the best solution for the environment and society. So that's a little bit why I always wanted to think about ESG holistically and how I got into this. But, you know, we're obviously very happy to be here. John and I talk about ESG all day long and we only listen to each other. So, to have a platform now and make you all listen to us is very exciting for us. And Sarah, given that you're now our first host for our first podcast episode, I'd be very curious to also hear from you what is your interest or personal interest in ESG and why this podcast now?

**Sarah:** Yeah. Well, thanks for putting the questions back to me. I meant to be asking you questions, but happy to answer it. You know, why this podcast now? I think there's two pieces. I think firstly from a business perspective, my area is in Europe. And obviously it's been a huge focus area for clients and consultants for a long time. But we've seen that play out across the globe now with clients and consultants wanting to talk about the topic and trying to learn about different ways of implementation and execution. So, I think it's very topical. I find it fascinating that ESG and sustainability mean very different things for each individual client. And with those client conversations, you know, I hear this come up every day, be it as a strategic priority or a challenge that they are trying to work through. And it feels like while we have talked about this on all the credit podcasts, it really deserves a focus on its own. There was just so much to cover and we felt that we could really share some of our insights and thoughts and best practices and ideas from clients across the globe. And this would be a great platform, both for us to learn more and also hopefully for our clients and consultants. And then bringing it back to a personal perspective, you know, my own philosophy, I think we all have an obligation to make a positive difference in the world and not just in work, but making informed choices. And the second piece is I continue to be amazed by how complex and nuanced the subject matter is. I have a huge amount to learn myself. So from that perspective, just learning more about it is a big reason to be involved in this. So, maybe moving the questions away from me, back to you guys. You know, Armelle, there is just so much terminology and maybe even jargon. We'd love to start by a sort of level setting on framing some of these subjects -- you know, what do we mean by ESG sustainability, responsible investing? Can you help us frame some of this terminology?

**Armelle:** You're absolutely right, Sarah, there is a lot of jargon. And I think a lot of the terminology is also the umbrella terms, really, which to a certain extent, I think has done the ESG industry also a disservice because we've conflated terminology and we've confused a lot of people, quite frankly. So maybe just taking a step back, trying to be a little bit clearer and concise here. So when we say, you know, ESG investing, sustainable investing, responsible investing, all these terms have been used interchangeably. I don't want to go into a glossary definition. So how we think about it is in terms of approaches and how we actually integrate some of these considerations into our investment decisions. And one of the terminology that you might hear is ESG integration, which is the integration of credit material, ESG risks, and opportunities into our investment process, research, and decision making. So essentially, if there's an environmental, social, or governance factor issue that can impact an issuer's financial outlook, those would get considered in credit assessments and investment thesis. There are also a number of other approaches such as screening. There's positive and negative screening. So, where you either exclude the worst ESG companies or include and tilt towards some of the better ESG companies. But this is now heavily dependent on how you actually define a good ESG company or issuer. So, what does it mean for a company to be good at ESG? Are you looking at how that company is managing the ESG risks to the business? Are you thinking about how the company is impacting the environment and society? These are all questions and I think that's where we -- the industry -- gets confused because we all have different definitions. And you mentioned this earlier, Sarah, is we see our clients having their own interpretations and understanding of what it means to be good at ESG. So, you know, for us internally, we think about it from a risk and impact perspective because we recognize that some clients are more interested in the integration and the consideration of these factors and the investment thesis, and some want to go a step further. So, the main point is, for us, is while there is a lot of jargon, we want to make sure that we understand what our clients' objectives are, and then have the tools at our disposal to ensure that we implement those different definitions of ESG and objectives appropriately for all our clients.

**Sarah:** Excellent. Well, thanks for clarifying that one. Maybe, John, bringing you into the conversation, what's the difference between ESG risks and ESG impact? Comes up an awful lot. We'd love to hear your perspective on that topic.

**John:** Yeah. I think this is a source of a lot of confusion. And I think rarely is the question explicitly asked, are you talking about impact or risk? Although I think that's starting to change slowly. So, when people talk about ESG risk, usually they're talking about it in the traditional sense of kind of credit risk. And what that means is they're interested in risk to the company from the environment or social issues. But sometimes companies are creating risks or impacts for the environment or society that don't necessarily create risks for the company itself. And it's very easy to assume that ESG risks and impacts overlap so much that they're essentially the same, but it's really less correlated than you might think. The best example I can think of to illustrate this is COVID vaccines. So, during the pandemic, we saw that there were some pharma companies out there that were selling their vaccines basically at cost, so as cheap as they could make them. But there were others that decided they were going to take advantage of kind of the government's demand, especially in developed countries, for these vaccines to charge those governments higher margins. And when you think about it from a credit risk perspective and an ESG risk perspective to the company, having a better profit margin is usually a good thing. And especially if you're selling it to governments, you know, they've agreed to do this. So, your risks are pretty low and it's actually helping your overall balance sheet and income. That's a positive risk. But, of course, making vaccines more expensive for everyone and potentially then making it so that some countries can't even afford it is creating a lot of risks for other people and a lot of negative impacts. And another example that kind of illustrates this confusion of -- that I've been thinking about a lot lately -- is how a lot of ESG strategies that say they're focused on ESG risks will have exclusions for certain activities, complete sectors like tobacco. And to me, it's a question of why would an exclusion of an entire sector be the best way to manage risk if risk is all you really care about? Because managing risk isn't really about avoiding risk entirely, it's about getting paid enough for the risk that you do take. And a lot of tobacco company bonds do pay you for that risk. So, to me, excluding a sector like tobacco doesn't really make sense if you're talking about risk. It really only makes sense if you're trying to achieve an impact. But yet, ESG is so often framed as just a risk thing. And you can see that there's just a lot of confusion around this.

**Sarah:** Right. Appreciate you clarifying that one. Maybe moving on, you know, to another thing that comes up quite a lot with clients and I've heard this number of times is, does ESG have to come cost to returns? Maybe, Armelle, you can give me your thoughts on that.

**Armelle:** Sure. So again, I think it really depends on what we mean by ESG and that definition and actually bringing it back to John's definition also of risk and impact. I mentioned ESG integration earlier. That portion is really looking at the risk portion and making sure that we're being compensated appropriately for any level of ESG risk that we're taking or that investors are taking overall. And that, at least at PGIM Fixed Income, we truly believe does add to alpha generation. We're thinking about risk holistically, and we're making sure that anything that matters is getting incorporated into our credit assessments and into our view on the pricing and the relative value. So thinking about it from that perspective and the financial materiality make sense. it's just good investing to make sure you're considering all the factors and not just the financial factors or, I would say, what's on the income statement and balance sheet. When it comes to having a positive impact, I think the jury is still out and the example that John just gave is interesting because it shows that sometimes having the most impact may not always be the most profitable. So, if you take the vaccine example, obviously you want to be able to charge as much as possible for those vaccines, but that's not going to have the most impact on society, especially in a time of crisis. So that's the portion where, again, jury is still out and we'll need to see on a going forward basis if those types of issuers that are really being the most responsible citizens in our society outperform or not. But it's tough to make that judgment call just looking at an ex ante basis.

**Sarah:** So Armelle, maybe another question for you is concerns from clients when they're looking at ESG strategies. What are the biggest concerns, you think, from them and the questions that you get asked about investing in ESG strategies?

**Armelle:** Absolutely. So, I think one of the big questions we get asked really is how do we evaluate an insurer's ESG profile? And what's the kind of data that we use and how does it factor into our ratings? And I think, unfortunately, you know, clients are hoping for a simple answer. They want to know that we've looked at 50 to 60 data points, that we have clear definitions of what the right answer is, what the wrong answer is, this is what good is, this is what bad is, and then hopefully it spits out into some very concise number at the end, very simple process and easy to explain. And unfortunately, that's just not the case. There are still so many nuances in ESG and there isn't always one correct answer or one right answer. Because we have so many different industries, different business models, idiosyncratic issues, new business models that we've never seen before come about, that there's still a lot of qualitative and assessment and judgment that's needed. You know, when we think about net zero, there isn't one path to achieve it. There are different manners that companies can go about it. So that's why there's not one correct way. So, we can't just rely on quantitative data to spit out a happy rating. We still need our analyst judgment and conversations with companies to understand the pathways and trajectories. And let me just say that's not just true for ESG, it's also true for financial analysis. There's a reason we all have large research teams and credit analysts, and even among peers, equity shops have big research teams to parse through all of this qualitative assessment. So, the analytical portion is still very important to us. The other question we get asked is, how does ESG actually affect investment decisions? And as we've been saying, it really depends on what you mean by ESG, if it's about risk or impact. And when it comes to risk, it's really hard to isolate the ESG component. We're thinking about ESG holistically with other elements of risk to come up with an end assessment, if you will. Just teasing out the ESG portion doesn't really tell you much at all or about how it's going to impact your credit. You need to think about it in conjunction with what does the balance sheet look like? Is it healthy? What does leverage look like? Maybe if there's an ESG controversy but you have a company that has a healthy balance sheet, they might be able to mitigate some of those issues down the line. Whereas somebody with this -- maybe an issuer in the same industry doesn't have the same type of financial backing and would be more exposed. So, you need to think about these issues together. And so, again, unfortunately, the answer isn't always a straightforward one, which I think many are hoping for as we're developing an ESG and parsing through a lot of this information.

**Sarah:** I'm intrigued to know that in a world that looks for sound bites and simple answers, does that make communicating and talking about ESG increasingly challenging?

**Armelle:** I certainly think it is a challenge, I think because -- and John can hop in here as well, but we want to be able to convey the nuances. I think it shows also a thoughtfulness and it gets to the real impact because a simple story is going to be too general. There's going to be loopholes. And so we want to explain the nuances. The challenge is having somebody sit through and listen to the nuances and try to really understand it with us. So, in a world where we're constantly looking for one-liners and headlines and a simple answer, it's tough to condense that into something snappy.

**John:** Yeah. And I would just add in, I think a lot of people are starting to realize that if you want to do ESG well, it is actually a lot of work and you need a lot of resources for it. You have to really consider the nuances that Armelle was talking about earlier. And you can't do that when you're just looking at one or two numbers. Take for example, we have some issuers in our portfolios that still have a lot of coal power and they have kind of high-carbon intensities, but maybe they're closing their coal power down in the near term. And they're actually going to retire those plants. So those plants will be out of commission. And then you have other issuers that had some coal in their fleets, but they're selling the coal. So that coal is not going away, it's just going to be in someone else's business. And which do you prefer? You know. It depends on some circumstances. But, yeah, you might prefer the one that's actually going to close the coal plants, even though their numbers don't look as good today. And that's why you need to look at more than one thing. You need to think about the whole story.

**Sarah:** Okay. Thanks, folks. And now back to sort of a bit more, you know, what we've been to discussing earlier, and I'm sure our audience would love to hear from your perspectives. And this is your day job and you spend every day in ESG topics and themes and trends. You know, what do you see as the top three market-impacting events related to ESG? We would love to hear from you on that.

**John:** There are a lot of big events in the last year. But to pick three, let's start with net zero pledges. You could kind of call 2021 the year of the net zero pledge, I think. These were proliferating, not just across investors, but also countries and companies as well. A lot of that driven by COP26. And, of course, think pledges are great news. But the problem is that a lot of times people have still yet to work out how to actually achieve their pledges, which is where I think it's going to get interesting. For example, if you look at the IPCC's latest report that came out just a little while ago, it showed a pretty big gap between what countries have pledged and what their actual policies would achieve. I think it showed kind of, if all pledges were met, we still might be looking at a bit more than two degrees. And then if you look at their policies, we're looking at something closer to three degrees. And unfortunately, it's the case that policies matter. If the private sector could solve this problem on its own, then we wouldn't need COPs and summits and treaties. So, in a few years, sadly, I do think that we're going to start to see some actors who have set these pledges not being on track to actually meet those pledges. And I think another area here that's going to be key is emerging markets. Because if all the advanced economies get to net zero, it really only slightly moves the needle when you look at the big picture. Yes, those are the countries that are most responsible for using up most of the carbon budget up to this point, but their share of future emissions is shrinking pretty quickly while the share of emerging markets is growing. So unless a lot more financing for decarbonization makes its way into EMs, I personally believe that Paris targets are going to be completely out of reach. And then I think a second big development in the market in the last year was probably ESG regulation. So maybe 2021 wasn't just the year of the climate pledge, but also it was the year of ESG regulation. And we saw SFDR kick in, in Europe, the EU taxonomy kind of made some progress, and now we're seeing the SCC kind of getting into the game. It's honestly a little hard to keep up sometimes. I think SFDR is probably the most immediate and far reaching of the regulations we've seen so far. And to me, it actually still seems really misunderstood. So, the regulators are constantly saying, this is not a labeling regime. But unfortunately, in the market, that's still what it's being used as. The view is kind of that Article 8, for those who know the regulation, was supposed to be a standard for ESG funds. But when you actually read the regulations, you see Article 8 just says, the kinds of disclosures are required if you market something as an ESG fund. The idea was that investors would then read the disclosures and pick out the greenwashing themselves. But Article 8 was never actually meant to be a label. It was just about being transparent. And then I think Article 9 is getting even more misunderstood. At least as we understand it, the idea is these should be kind of thematic funds where all the investments are clearly contributing to fairly specific environmental or social objective. And that actually be a pretty different animal from a broad market fund like most managers run. But a lot of people seem to think that going from Article 8 to Article 9 is just about adding some more exclusions, which we are pretty sure isn't the right way to do it. And I think it's also important to remember that none of the periodic reporting that's required under SFDR has actually come out yet. So I think it'll also be pretty interesting to see what happens next year when these disclosures start to kick in and people can start to scrutinize this. And I think the third very obvious big development in the last year was the crisis with Russia. It's pretty hard to avoid that question. It's still a little too early to say what the outcome will be here, but I do think it's a great illustration what we were talking about earlier about how ESG isn't simple. I think we can all probably agree that what Russia is doing is pretty bad from an impact perspective, and we actually rate them zero on our impact rating scale right now. But then you have to start looking at companies in Russia. And I think the knee-jerk reaction from a lot of people is that we should just downgrade all Russian companies to something bad. But a lot of them aren't really involved in the war. And then you have to start thinking about all the non-Russian companies that are operating in Russia and do you treat them like that. And then you have to think about all the European countries that are buying oil and gas from Russia still with one hand and then sanctioning Russia with the other hand. So again, I think you have to take a much more nuanced view of things. And from a risk perspective, you can also see that the risks just spiral out. It's not isolated to Russia. You can see a lot of supply chains are very dependent on Russia. And actually if companies pull out of Russia, then it's going to kind of cripple the global supply chain and that's not necessarily desirable either. And even more concerning is the importance of Russia to food supplies, particularly in a lot of emerging markets where food security has been a chronic issue that led to social unrest. Again, this is kind of all just to say that ESG is complicated, and it's not simple to draw a clear circle around the good and the bad.

**Sarah:** You know, I hear you on the regulation and, you know, fascinating to see how this continues to develop. We talked a bit about sort of the backward-looking events and the big things. And you mentioned in your answer how some of the things that you'd be looking at going forward. Armelle, kind of bringing you into the conversation, you know, when you think, when we are looking forward to, in the coming months and in the next year, are there things on the horizon that you think we should be flagging to our clients and consultants that they should be looking out for as well? Is there anything that you can share on your thoughts there?

**Armelle:** One of the things we're starting to see also from more sophisticated investors is really the desire for more meaningful long-term impact. Because there's a lot of ways to game the system. If you're just looking to meet certain emissions targets, you can, you know, sell a few issuers, no real impact here, and it becomes a bit of an accounting issue. But if the investors who are really starting to think about the long-term impact, recognizing the nuances. And, again, I made this comment earlier that there isn't one path to net zero. Not all issuers are going to follow the same path. Some will meet it earlier and some will meet it later. So, understanding that there's different pathways, leaving enough room for those nuances, but then also holding issuers' feet to the fire a little bit and making sure that they are progressing. That it's not just a lofty pledge or commitment for 2050, and that we'll get to 2049 and all of a sudden realize, whoops, we're not quite there yet. So, figuring out now how we want to be monitoring that progress down the line, I think, is crucial as we start to also get more consistent data, more standardized data. Really figuring out how can we, in a meaningful and impactful way, achieve our actual objectives.

**Sarah:** We've a lot to think about there. I know we're running out of time. And so, I would love to continue to kind of talk about these things that are coming up on the horizon too because I know people will find it super interesting. But to sort of bring it back sort of full circle from where we started this discussion on and touching on the personal reasons of why you went into ESG, I really wanted to kind of end on a point of, you know, how can our listeners think about building up their knowledge, right? I'm always interested to hear recommendations on books, on podcasts. I would love to know any suggestions from you both on things that people might want to look into to build out their ESG knowledge.

**John:** Probably one of the books that's influenced me the most in my thinking is called *Thinking in Systems* by Donella Meadows. It's pretty short and easy to read actually. But I think if you do, it completely changes the way that you see the world. And you'll have to read the book to understand what systems thinking is. But I think it's something that everyone should learn how to do.

**Sarah:** Okay, great. I like a good book suggestion. I'm going to add that to my wish list. Armelle, we'd love to hear from you too.

**Armelle:** I'll add another one to your list. It's called *Think Again* by Adam Grant. I think it's actually pretty funny that both of our book titles have something about thinking. You can tell there's a theme among our team here. But it's basically about how we should all really strive to think like scientists. And it goes through the different types of people. There's politicians, there's preachers, there's different types of personas. But really we should all aim to think like scientists and to question ourselves and revise our thinking and our views. And I think especially in this field where a lot of ESG topics, especially in ESG, in this industry, and in the U.S., have become very politicized. Always trying to take a step back and to think about the science behind it, I think, is crucial.

**Sarah:** Great. Well, I've read that book and I would equally say it's a really interesting read. Big Adam Grant fan from a sort of organizational psychology perspective. So, with that, we draw to a conclusion our first

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