PUBLIC FIXED INCOME

# Solving for the Climate Transition in High Yield

INSIGHTS

A holistic approach to climate considerations can offer an opportunity to invest in a diversified portfolio of high yield issuers that are committed to reducing or maintaining a low carbon footprint, while also targeting high current income and capital appreciation.


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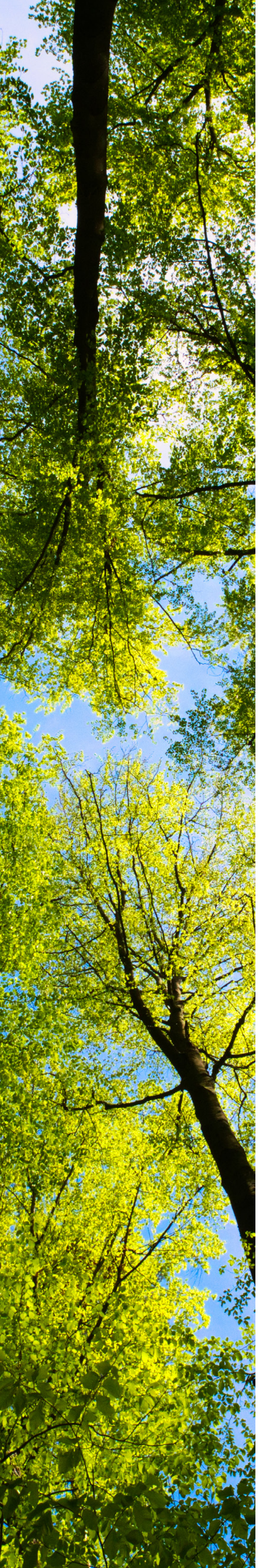
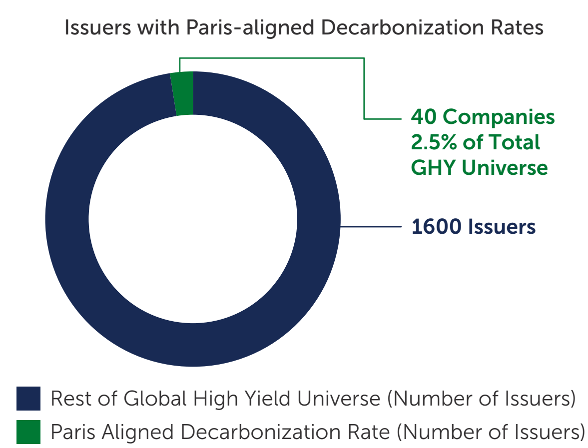


The climate transition is becoming increasingly urgent. Given the strengthening efforts to achieve net zero, as well as the rise in regulation, climate change mitigation is unquestionably playing a role in investment decisions across the globe.

In recent years, much of the focus around the climate transition has centered on the Paris Agreement, which aims to limit global warming by holding temperature increases to well below 2°C and pursuing efforts to limit increases to 1.5°C. For companies to be Paris-aligned, they must be committed to reducing carbon emissions by around 7% p.a. by 2030 from a 2019 baseline. While there are plenty of companies on track to meet this goal—particularly large, higher-rated companies in asset-light industries—the reality is that for most issuers in the high yield universe, meeting this standard is much more challenging. This is partly due to the nature of the high yield universe, which consists primarily of large and mid-sized companies that typically prioritize capital to deleverage or grow their business. In addition to comprising many asset-heavy companies and industries—energy, metals & mining, for example—these companies can be smaller than their investment grade peers, with less personnel and capital to dedicate to meeting stringent climate targets or other initiatives. As a result, by our estimates, of the roughly 1,600 issuers across emerging and developed market corporate high yield, only about 2.5% are fully Paris-Aligned today **(Figure 1)**.

**Figure 1: A Very Small Percentage of the HY Universe is Paris-Aligned**




Source: Barings. As of February 28, 2023.

This creates some clear challenges when it comes to portfolio construction. For one, building a portfolio that focuses only on Paris-aligned high yield companies would inevitably lead to significant concentration risk as well as sectoral bias. In addition, an approach focused solely on Paris-alignment would exclude the many solid companies and/or entire industries that, while perhaps not on track today to cut emissions by around 7% p.a. by 2030, are still making significant progress in reducing their overall environmental footprint through other initiatives or less aggressive targets.

## A Holistic Framework

Given the risks and challenges of Paris-alignment, specifically when it comes to high yield, there is a case to be made that a holistic approach to considering emission reductions and other environmental initiatives is a more viable long-term strategy. For this reason, we have created a climate transition investment framework—a four-pillared approach—that not only provides insight into an issuer's current state, but also considers that issuer's longer-term outlook in the context of the climate transition. It does this by incorporating third-party data that helps us track the current and future carbon emissions of companies, and combining that with rigorous, bottom-up, credit selection and integrated ESG analysis to help us uncover those issuers that are best-positioned to deliver attractive relative value opportunities, from a total return perspective, over a long time horizon.

### PILLAR 1: PARIS-ALIGNED

The first pillar is the narrowest in scope and identifies issuers on a carbon reduction trajectory that is aligned with or better than that outlined under the objectives of the Paris Agreement. European mobile and fixed network operator Vodafone is an example. The company has a projected annual decarbonization rate of 19% p.a. by 2030, and has set 2030 carbon reduction targets that are in line with the reductions necessary to keep warming to 1.5°C.[1] However, as mentioned, only a very small subset of the high yield universe currently meets this target, creating the potential for both concentration risk and sector bias when it comes to portfolio construction on a standalone basis. While we expect this segment of the market to grow over time, it is not a viable portfolio construction solution today for the high yield market.

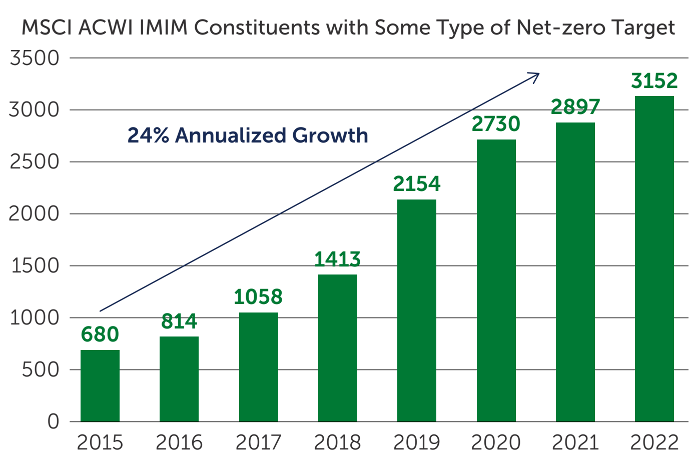
### PILLAR 2: CARBON REDUCTION TARGET

There are a number of high yield companies today that, while not Paris-aligned, are committed to decarbonization targets, in some cases just below the approximate 7% p.a. threshold. Pillar 2 includes these issuers that have set explicit, measurable carbon reduction commitments, including Paris alignment or other science-based targets. With each company, there are only so many levers that can be pulled in order to reduce their emissions profile—and in our view, having some level of decarbonization is better than having no decarbonization.

The component of the market signing up for science-based target initiatives, whether Paris aligned or not, is much larger, and includes over 650 issuers by our estimates—a much more viable opportunity set for investing, portfolio diversification and relative value assessment. Ford Motor Credit Company is one example. While not Paris-aligned, the company has set targets to achieve carbon neutrality by 2050, targeted a 50% reduction in Scope 3 emissions by 2035, and has pledged to use 100% local, renewable energy in all manufacturing by 2035.[2]

Encouragingly, this opportunity set is growing rapidly—and stands to increase even further as more companies begin to track, report and set carbon emissions targets. In the first quarter of 2022, almost 700 companies set or committed to science-based targets.[3]

**Figure 2: The Number of HY Issuers Setting Emissions Targets is Expected to Grow**




Source: MSCI. As of August 31, 2022.

1. Scope 1 covers direct emissions from owned or controlled sources; scope 2 covers indirect emissions from the generation of purchased electricity, steam, heating and cooling consumed by the reporting company; scope 3 includes all other indirect emissions that occur in a company's value chain.
2. Source: Ford Integrated Sustainability and Financial Report 2022.
3. Source: SBTI. As of February 28, 2023.

## PILLAR 3: LOW CARBON FOOTPRINT

The third pillar encompasses issuers that, due to the nature of their business and the sector in which they operate, have already materially mitigated greenhouse gas (GHG) emissions and/or are operating under a low carbon footprint framework today. While these companies may not have pledged alignment to a specific carbon target, they operate with a low carbon profile, or in some cases, have dedicated capital expenditures to green or sustainable initiatives in order to significantly cut or maintain their lower emission profile.

Virtually all of the companies that fall into this category today are in low carbon sectors such as media, telecommunications, technology and financials. One example is a U.S.-based digital only bank, which has a naturally lower carbon footprint versus traditional branch-based institutions. As a result, it has already achieved operationally carbon neutrality for Scope 1 and 2 emissions, as well as LEED certification in 29% of its building portfolio.[4]

In addition to being fairly concentrated, the third pillar comprises a smaller subset of the high yield universe—somewhat unsurprisingly, given that many high yield issuers are still in the early stages of addressing and reducing their carbon footprint. However, the intention here is to identify companies that are further along, or committed to making progress, on their climate transition relative to some of their high yield peers. Over time, we expect this opportunity set to grow and evolve, not only as more companies become truly net zero or begin operating with much lower emissions, but also as regulations change and advance.

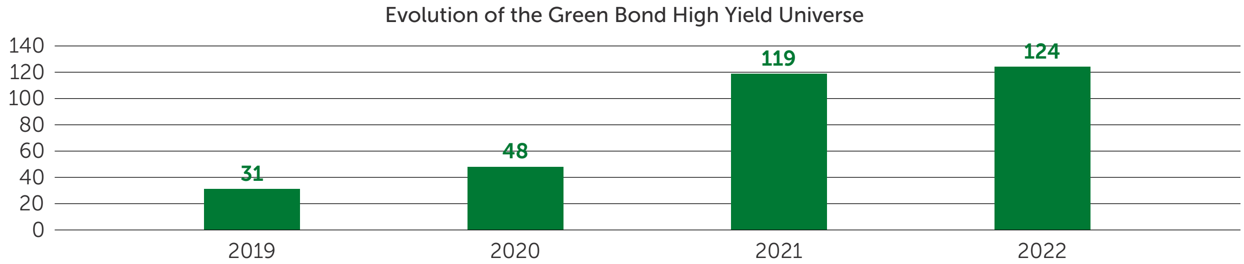
## PILLAR 4: SUPPORTING THE CLIMATE TRANSITION

The fourth and final pillar includes issuers nearer to the start of their journey and looking to improve their environmental footprint. In some cases, this is by companies issuing green or sustainability-linked bonds to fund their climate transition. These are bonds where the proceeds are specifically earmarked to finance climate, environmental and sustainable projects. Often, they are tied to project financing aimed at helping reduce carbon emissions, such as through capital expenditures, realignment of property plant and equipment, or targeted acquisitions. In our view, these projects represent a starting point for companies to align with climate change initiatives over time, which suggests there is strong potential for forward progress and, ultimately, value creation.

4. Source: Company 2021 Corporate Social Responsibility Report.

While the green bond high yield universe has expanded significantly—growing by more than 70% over the last three years—green bond issuers still represent a relatively small opportunity set, encompassing roughly 100 companies **(Figure 3)**. Most of the issuers are also concentrated in either real estate or utilities. Therefore, while a green bond-only strategy may not be viable in and of itself for a high yield specific strategy, we believe including these companies within our framework presents, and will continue to offer, unique opportunities as more companies align their interests with climate change longer-term.

**Figure 3: Green Bond Issuance has Increased Significantly**




Source: Barings; Bloomberg; ICE BofA Global High Yield Bond Index. As of December 31, 2022.

## ENGAGING FOR CHANGE

A key tenet of our four-pillared approach is to reward positive improvement and good behaviors from a climate perspective. We place a strong emphasis on allocating toward progress, which we believe paves the way for value creation over time.

Engagement, of course, plays a critical role in this. While high yield investors—as debt rather than equity holders—cannot vote to influence company behavior the same way equity investors can, their ability to influence and engage with companies has become increasingly significant. At a high level, the global credit market provides the bulk of financing to companies, meaning fixed income investors have a very real ability, and arguably responsibility, to hold issuers accountable on ESG. In many of our high yield investments, for example, we hold material positions in the company's capital structure—and our position as a sizeable lender to an issuer gives us access to decision makers at the company and therefore the ability to encourage improvements and promote better reporting and disclosure. Engagement can also include collaborating with industry peers through organizations such as the European Leveraged Finance Association, which is leading the development of guidance on ESG disclosures and best practices in the global high yield market.

During the engagement process, when a company faces an issue, we meet with the management team with the intention of encouraging the company to take steps to mitigate climate risk—this includes having ongoing conversations with key stakeholders to monitor changes over time. If the company shows positive momentum and an ongoing commitment to their climate transition, we will remain invested. However, if the company goes off track and shows no signs of improvement or progress, we will choose to divest. In our view, this approach helps pave the way for stronger performance over time.

## Alignment with the Broader High Yield Market

One key question on many investors' minds today is whether a portfolio constructed around climate-related parameters can be well-balanced and well-diversified across ratings and industries, while still targeting traditional high yield-like returns. We believe this broader framework helps make that possible—as mentioned, looking at different elements of how companies are adapting to climate change not only increases the potential opportunity set, but also helps build diversification relative to a singular approach.

Indeed, based on our framework, we have identified roughly 750 high yield companies that are well-diversified across industries and ratings, and that have good or improving sustainability credentials or appear to be moving in the right direction to reduce their environmental footprint. While this is a smaller universe than the approximately 1,600-company unconstrained global high yield universe, it is large enough, in our view, to create a portfolio—through rigorous, bottom-up credit and relative value analysis—that is comparable to a traditional global high yield portfolio, and similar across major metrics such as, coupon, spread, yield and duration.

Over a longer time horizon, there is also reason to believe that this identified climate transition universe, as it continues to grow and include more companies, will lead to an expanded opportunity set over time. This is especially true given the trajectory of regulations in Europe, in particular, as well as in the U.S. and many emerging markets. In addition to playing a role in shaping companies' ESG and climate practices more broadly, we expect these efforts to drive continued forward momentum around reporting and disclosure.

## Key Takeaway

While there are inherent challenges facing high yield companies when it comes to reducing emissions, issuers are making significant progress. However, given that each company is at a different stage of the climate transition journey, taking a singular approach to accounting for climate transition within a high yield portfolio can lead to significant portfolio bias and concentration risk. For this reason, we see value in taking a more comprehensive or holistic approach that both incorporates where issuers are today and considers how they may evolve in the future. Ultimately, we believe this type of approach—when combined with robust credit analysis—offers an opportunity to invest in a diversified portfolio of high yield issuers that are committed to reducing their environmental footprint, while also targeting high current income and capital appreciation.

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**As of December 31, 2022*

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