SDGs: A Framework for Investing

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Anu Rajakumar: In 2015, the United Nations developed 17 sustainable development goals, also known as the UN SDGs, as a universal call to action to end poverty, protect the planet, and ensure that by 2030, all people enjoy peace and prosperity. From an investment perspective, these 17 SDGs can be used as a framework for investors to apply sustainable thinking to their investment decision-making process and engagement practices. It's 2022, and we are now past the halfway point from the inception of the SDGs and many are wondering whether we're on track to meet that 2030 goal or not.

My name is Anu Rajakumar and today, I'm excited to bring back Chris Kocinski, co-head of US High Yield and a Senior Portfolio Manager. And Sarah Peasey, Director of European ESG Investing to explore how these 17 goals can be integrated into an investment process and a framework for company engagement. Chris, Sarah, thanks for returning to the show.

Chris Kocinski: Thank you.

Sarah Peasey: Thanks, Anu. Great to be back.

Anu: So, let's start off with a high-level overview of what the United Nations Sustainable Development Goals are, and explain what it means to have investment strategies that integrate these UN SDGs. Over to you, Sarah.

Sarah: Great. Thanks, Anu. As you mentioned in your introduction, UN SDGs were set back in 2015, and they were set by 193, of the UN member states. And the 17 goals are aimed at the likes of anti-poverty, improving health, education, reducing inequality and then focusing on climate change, preserving oceans, and forests. But I often think that everyone and rightly so is quite fixated on 2050 as a timeline, given the global net zero goals are aligned with the Paris Agreement, but the SDGs actually have a target of 2030. The concerning news is that prior to the global pandemic, the world was already off course to actually hit this 2030 milestone.

And unfortunately, post-COVID has only exacerbated these problems, further. And in certain cases, with some of the SDGs, we've actually gone back below the 2050 baselines in which they were set. And all these measurements are captured annually in a UN SDG report. And the latest report, in fact, revealed some pretty shocking statistics and there's a couple that I think are just worth sharing just to kind of drill it home. An additional 120 million people were pushed back into poverty in 2020. And the equivalent of 255 million full-time jobs were lost globally. And the number of people suffering from hunger, which was already climbing, obviously prior to the pandemic, now they think may have increased in excess of 100 million. And actually probably one of the most shocking ones for me, when I was reading, was that around 68 vaccines were administered for every 100 people in Europe and North America, but if we compare that to Sub-Saharan Africa, that was fewer than two. So I wish I could say that there wasn't as many kinds of shocking facts in this report, but there were even more when I was reading through it. And ultimately, that really prompted me and it's prompted us before this point even, to really ask what investors are doing about this. And this is really where our thinking gets going and how to integrate SDGs into fund objectives. And we actually work out how can we more positively contribute towards them?

Now, I mentioned that the SDGs were established by UN states, but they weren't necessarily set up with investors like us in mind. However, given the absolute mind filled out there of industry frameworks, ESG scores, the SDGs are actually good at providing this kind of universal framework or some kind of common ground between different stakeholders. And those stakeholders, most importantly, of course, still remain governments, but for us, it's that dialogue between corporates and investors. At NB, we use the SDGs to structure and communicate objectives for our impact strategies and the contribution to the UN SDGs for these strategies actually for us comes from not only investing but also engaging with these companies and getting an understanding of the product services that we think could actually positively contribute to some of these outcomes.

But one of the asset classes that we've actually found that the SDGs can be particularly relevant and compatible for is-is non-investment grade credit or-or high yield.

Anu: All right. Terrific. Thank you for that background. And obviously, it's a shame to hear that we are not really on track to meet that 2030 goal or, you know, even the 2050 goal, uh, given some of the challenges that we've experienced in the last few years. Maybe, Chris, turning to you, you're a portfolio manager responsible for constructing portfolios aligned with the UN SDGs. And as Sarah mentioned, these seem to be quite well aligned to non-investment grade or high yield portfolios. And I understand that you prioritize engagement as a tool within your investment process. So tell our listeners why you place an emphasis on engagement and also what the intended outcome is.

Chris: Well, I think starting from a high level, I think private markets are going to have an important role to play if we're going to continue to make progress around the world towards the-the SDGs. And the high yield market, and non-investment grade markets, in general, are a great place to reach companies that may not traditionally be reached by public markets. The global high yield market is about 40% comprised of privately owned companies. And many of the others, tend to have a smaller market cap and might not be a focus for public equity funds. And so what we've found is that when you have a real relationship with company management teams, that they're seeking guidance on how to approach these topics. And it's very helpful to provide them with a common framework to align their business objectives around such as the SDGs. We're having a good amount of success engaging with management teams on those topics. I think that when we look at what is the key driver of success if you're going to establish an engagement platform, it really centers around the depth of your management relationships. And that's critical to underwriting credit and producing attractive financial returns for investors. But it's also critical to driving a successful engagement program over time.

And we've decided to structure our engagement approach where our investment team, our research analysts, are leading the engagement activity because they have a relationship with senior management team given the scale of our platform. And they get advice and oversight and guidance from ESG experts that are part of our ESG investing team. But our research analysts are the ones reaching out to the CFO of a company and having a dialogue that's comprehensive, discussing balance sheet issues, industry issues, and also specific ESG topics.

Very important to pair the access to management with a systematic process. In our view, our team generally, is very process oriented in how we invest and underwrite credit. And our approach to engagement is-is no different. We judge the likelihood of engagement upfront before we invest in an issuer. We then have a specific engagement objective that we set for each of the issuers. And it's an iterative process between research analysts and the ESG investing team to set those objectives. And importantly, to set the KPIs that we'll use to judge how progress is, moving along over time for each of those goals. I think the key principle that-that we've used in organizing these activities in non-investment grade credit is that we understand that asset owners need income in their portfolios. And many of them don't have the ability to sacrifice income, but at the same time, they need to move forward, on sustainable objectives of their own. And we think that we've been able to pair an attractive level of income and a robust engagement framework together into the way that we've structured the platform.

And if you think about, you know, if asset owners really want to make a difference in terms of moving towards the SDGs, we're probably not going to have a situation where 1% or 2% or 3% of funds are formally incorporating these objectives and that, share of the pie is likely going to have to grow over time.

Anu: Yeah, absolutely. And I think even further, you know, just to your point that you need to have those impactful and thoughtful engagements in order to do that. Chris, I want to just pick up on something that you mentioned. You said that the ESG investing team at Neuberger helps to set up a framework to judge the progress and kind of monitor those metrics, for those companies. So maybe if I turn over to Sarah, how do you set engagement goals aligned to UN SDGs? And if one of you doesn't mind, maybe you can walk us through an example of a recent engagement with the company.

Sarah: Yeah. So I think really important to kind of stress and this point that you've made, is the collaboration between the High Yield research team and the ESG Investing team. Our starting point is obviously to assess the opportunity, from a company management perspective to actually establish the objectives and where do we actually think the opportunities lie. We can look at these from different angles and sometimes we might draw upon what we consider to be mega trends happening in the wider economic environment or, whether it's actually more industry-specific initiatives. But where can we then draw upon some clear mapping with-with the SDGs, which aligns to companies that are in our direct investible universe? And I know it probably sounds obvious, but one of the most important points for us is to-to properly focus on when we're setting an SDG link goal, is it actually relevant to-to the business model? And by that, I mean the businesses' products and services.

And we are looking for a real kind of natural fit when we're actually applying this goal because for us, it's about trying to deliver the most impact or incremental change because these objectives that we're setting should not just be ceremonial in some kind of way. And as Chris probably, has heard too many times from me, they shouldn't be easy either. We should really be trying to test these companies and their ability to properly deliver change. Because as I stated upfront, we are behind and these are some really lofty goals that are intended behind this framework. But in parallel with all of this, one very important point to us as well is assessing the likelihood of engagement success. So before we've even embarked on engaging, with any of these companies, we've really got to call upon the strength in relationship with management, as Chris has already alluded to and judge the willingness for these companies to actually engage on these topics. And from a business model perspective, does their balance sheet look healthy enough to adapt and to actually change in line with some of these objectives, that we're setting?

So, all of this happens before we've even got down to the point of crucially selecting the key performance indicator or the KPI, which is crucial to us obviously, then measuring ongoing success and progress at the company level. So if I was to summarize every engagement objective and its related KPI, we think of it as kind of a combination of top-down SDG goals, but also maybe issuer or industry-specific opportunities, and also this assessment for potential engagement. And we have actually just released our global high yield SDG engagement report. And I'd love to encourage all of our listeners to a read. And it includes engagement statistics, for the quarter, but also some direct case studies as well, which show this distribution of objectives mapped to the SDGs.

Chris: Yeah. I mean, I can just take you inside of a typical scenario where we're talking with the management team, you know, the dialogue would be taking place between a senior research analyst on the non-investment grade team and the CFO of the issuer that we're investing in. And most likely, we're one of the larger bondholders in the company's capital structure.

And on average, likely have been invested for somewhere between two and four years in the business. And the dialogue between those two would encompass a broad range of topics, you know, from financial and industry topics to ESG topics. And then importantly, a specific engagement objective that we communicate to the-the management team and-and indicate to them that we're going to track progress on that over time. So the key point being that this is a relationship, this isn't a one-time interaction. This is most frequently, a years-long relationship where ESG goals are one of the things that we're talking to management teams about. We find that to be a very successful way to access senior management teams. And about half of our engagements on the SDG topics that we set in these portfolios are with the CFO level or higher in the companies that we invest in, which is a statistic that we're particularly proud of.

In terms of bringing to life, what-what an engagement objective would be, you know, we are invested in an LNG export business as a recent example. And they have said publicly that they would like to achieve net zero before 2050, but in this instance, the company hasn't set any tangible ways through metrics or otherwise, for how the market could judge their progress. It's just a vague commitment. Our engagement objective for them is to be more specific, right? Align their activities with a certain framework, make information available to the public, to prove out their progress over time. And we think that's important to lend credibility to the objective that they've put out there in the public. So that's one recent example.

Anu: Perfect. Thank you very much. Going on from that example where you're asking the company to just be really specific, and then I assume, you know, kind of following up with them and measuring their progress, you know, Sarah, you said earlier on that, you really are trying to challenge these companies, to do better and to seek these positive outcomes. One big pushback that investors often highlight or concerned about is whether doing all of this sacrifices shareholder value. What do you have to say about that? Do you think that there is, a potential hit to portfolio yield as you pursue, these UN SDGs with these companies?

Chris: The simple answer is no, and we've designed our approach, following many dialogues with our asset owner clients around the world. And we understand that they need income in their portfolios and as I mentioned earlier, many of them don't have the ability to sacrifice income, but they still need to move forward on sustainable objectives. And when you think about an engagement-centric portfolio, you know, the investible universe is still broadly available to the portfolio management team.

And you're not investing in companies that aren't willing to engage with you, but in today's world, that's pretty rare, to be honest. And you're not taking a heavy exclusionary approach, you're prioritizing helping to drive progress as opposed to, divesting from a variety of different industries. by taking that approach, you can continue to generate competitive total returns and yield for asset owners. And at the same time, you're invested in businesses. That means you have a dialogue, and you can hopefully help them improve over time. So if you're authentic in how you're approaching the engagement, and you're truly helping to move the needle over time, I think that we can successfully achieve both income generation and progress on engagement objectives for our clients.

Anu: Terrific. That was very well said. And again, just a reminder that the reason why we do these engagements is because they are thoughtful, they're thorough, they're impactful. Now in the volatile climate that we live in, I'm curious, how has the dialogue with these companies shifted in the last 12 months? have there been any changes in the tone or the focus that you've been seeing as you engage with company management?

Sarah: First of all, of course, conversations have changed. We've all seen the very severe global economic fallout from the horrendous war in Ukraine and the biggest of which has obviously been a surge in energy crisis. In an extreme kind of macro situation such as this, the conversations that we have with companies requires a degree of pragmatism and for this particular situation, it's a case of acknowledging that carbon emissions are simply just not the only evil in the world and we are living in extraordinary times, especially with energy markets. So being able to leverage those strong relationships with management that we've built up, over the years, that is what's especially valuable when markets do become more volatile. And of course, there are instances where goals have to be deprioritized and to focus more on the short-term business issues around operations and finances. But having these strong relationships in place means that we can still hopefully influence over time and ensure that when things do stabilize from a market standpoint, we can get them reprioritized. Look, fundamentally, we do still see lots of momentum in the corporate world, particularly with issues around climate change. And this is in spite of pretty severe ongoing challenges tied to pandemic recovery, but obviously now inflation and the geopolitical conflict that I've already mentioned. And look, I appreciate we're talking about fixed income today, but we are just obviously wrapping up the proxy voting season as well. And I think it's important to highlight that during this period, we saw a number of board recommendations proposing net-zero strategies. But also more tangible targets toward reductions in GHG emissions. And up until this point, it's been very rare, especially from US companies to see these kinds of proposals. So my point being that there are challenges and conversations are different, but the challenges aren't going away or even slowing down. So we still have to add this degree of pragmatism, as I said, in the way that we're approaching it. But Chris, you are on the ground. So, yeah I'll hand over to you for more color.

Chris: Well, I think importantly, the first takeaway is that the SDGs represent in many ways, megatrends that are happening in the global economy, and those are moving forward sort of, regardless of whether you're in a volatile environment or not. And I think companies understand that. And as a result, there's momentum towards trying to make progress on these topics that isn't necessarily exposed to what's going on in the broader economy at any given point in time. And I say that that's broadly true, you know, probably for 80% or 90% of the companies. And of course, if you have an issuer that gets in, you know, to a deeply distressed balance sheet situation or something like that, that may be different, but broadly there continues to be a lot of dialogue.

I think increasingly what I've been seeing over the last year is management teams want more specific guidance and a common instance would be a CFO coming to us saying, "Everyone is coming to me asking me for something, no one is specific. What do you guys recommend?" And those are terrific conversations to be having with management teams. So they appreciate the specific dialogue. Because ultimately in their business, they need to get down to, how are they going to change operations over time, et cetera. So providing a common framework, such as the SDGs, to organize their activities around, is very helpful to them. And the more specific, the better.

One trend we've noticed in the last 12 to 18 months really is more companies are bringing on ESG-specific staff into their senior management teams. And we've seen probably about a 10% shift over the past 18 months in dialogue from CFO to, senior ESG officer or something a-akin to-to that title. We view that as probably a neutral effect because it shows a commitment from companies to make progress on these topics, at the senior level of management.

Anu: All right. you know, it sounds like when you speak to companies they're asking for specific guidance, what do you recommend? But I also just want to pick up on some of Sarah said, that you have to approach some of these with pragmatism. What happens when an engagement is not successful, right? So you're giving them all these recommendations, you're sharing the guidance. You want to see them succeed and align with these specific goals, but sometimes that's just not feasible. What happens then?

Chris: Well, I think most importantly, if you think about what we're driving towards here, it's trying to remain invested in issuers, have a dialogue with senior management and help them improve their business alignment with the SDGs over time. And so from that perspective, divesting from a company is not an ideal circumstance and we try to avoid it.

The method that we use in doing so is we try to take several different angles to get a dialogue going when we're in this situation. First would be our senior research analyst would elevate the dialogue and make it clear that it was very important to us that we have discussions on topics related to our engagement objective. If that was unsuccessful, our PM team would likely try to reach out to the senior management team, potentially in conjunction with a member of our ESG Investing team. And also, we use High Yield conferences or other venues as methods to try to get a dialogue going with company management teams. We do screen for the likelihood of a company engaging with us before we invest. So the situation I'm describing is not very common, but it has happened. And we think that a two to three-year timeframe is a reasonable one for judging whether a management team is willing to have a legitimate dialogue with us on these topics.

Anu: All right. Thank you very much, Chris. Now as we come to a conclusion would like for both of you to briefly summarize some of your key takeaways from this discussion.

Chris: I think that if progress towards the SDGs is going to be accelerated, I think the share of the pie in terms of capital devoted to investments and funds that are specifically incorporating the SDGs is going to need to grow. And we've approached that with the dual objective of generating income and total returns that are competitive with traditional strategies and then also having a very robust engagement framework centered around the SDGs. And by doing so, we think that we're having authentic dialogue with company management teams and that leads to rich, important case studies. And we hope to continue to produce those over time for the investors in our funds.

Sarah: Firstly, the SDGs actually act as a universal framework, so sort of a common language or common ground between companies investors, which we've never really had before. So it's incredibly helpful when engaging and obviously setting objectives. But as a society, we can't shy away from the fact we are significantly off track, and we need to do more to make progress toward that 2030 deadline. And this is exactly why capital markets are and will continue to play such a fundamental role in deploying this capital.

I think universally all stakeholders believe that more meaningful data on whether it's social or environmental impact of funds could be absolutely transformational for the investment industry. And through the integration of the UN SDGs, investors are actually able to measure this positive contribution coming from these investments which is why we stand behind it, and its integration into a number of our sustainable and impact strategies.

I think people are largely comfortable with how you engage on the equity side because of voting rights. But I think it's very important to us on the fixed income side to really challenge that notion that engagement through debt can be very effective and it doesn't necessarily just has to be focused around an issuance cycle. The fixed income investor has a far bigger voice around the table than it's ever had before. And this is because of some of these really pressing global challenges that we've discussed today. And companies will need to draw upon their capital to make progress towards them and this couldn't be more relevant than for the asset class of high yield.

Anu: Excellent. That's a great place to end on, Sarah. Thank you very much. Before I let you go, we do have a quick bonus question. Today, we focused our discussion on the UN SDGs. So I would love to hear from both of you, which of the 17 SDGs resonates most closely with you and why? And while you think about that in case our listeners are not familiar, I'm going to quickly rattle off those 17 goals, which are no poverty, zero hunger, good health and well-being, quality education, gender equality, clean water and sanitation, affordable and clean energy, decent work and economic growth, industry innovation and infrastructure, reduced inequalities, sustainable cities and communities, responsible consumption and production, climate action, life below water, life on land, peace, justice, and strong institutions and number seeing partnerships for the goals. So Chris, over to you first.

Chris: Affordable and clean energy for me and I think, both of those terms are important and I think we're seeing that in the current environment that, you know, if you take a true engagement and transition-focused approach, that's probably the best on a global basis and that being part of those discussions, I find to be personally enriching for me.

Anu: Lovely, thank you very much, Chris. And Sarah.

Sarah: So I'm going to go number 13, climate action. If anybody knows me well enough, they know how dear climate is to my heart and I actually think in progressing with some of these climate challenges, we can make simultaneous progress with a number of the other SDGs as well. So that, for me, is a really kind of crucial one to unlock to be able to actually make progression with all other 16 of the SDGs.

Anu: Excellent. Well, thank you very much. That's an excellent note to end on. Chris, Sarah, it's been great having you back on the show to discuss how these SDGs truly are advancing the investment and engagement process. Really appreciate hearing a few examples of how they work within your engagement with companies, and how these goals can really create a plan of action for people, the planet and its prosperity. Thank you again, both, for joining me.

Chris: Thank you.

Sarah: Thanks, Anu. Thanks, Chris.

Anu: And to our listeners, if you've liked what you've heard today on *Disruptive Forces*, you can subscribe to the show via Apple Podcasts, Google Podcasts, or Spotify or you can visit our website www.nb.com/disruptiveforces for previous episodes as well as more information about our firm and offerings.