Fixed Income Engagement Roadmap

abrdn.com

2024–2026

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What is our engagement approach?

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What is our approach?

At abrdn, our aim is to both enhance and preserve the value of our clients' investments by considering a broad range of factors that can affect the long-term success of the bond issuer. We engage with companies and assets to gain insight and encourage action which we believe creates and protects long-term value. By drawing from our stewardship experience across various geographies and asset classes, we make better-informed investment decisions.

The diagram below shows how we divide our ESG engagements into two categories: priority engagements and ongoing engagements. Ongoing engagements are part of our regular communications with issuers, while priority engagements are characterized by meetings where ESG is the central topic of discussion. Priority engagement may be a response to news flow; a way to enhance our understanding of the issuer; or thematic.

The roadmap section of this document focuses solely on the last pillar, thematic. While engagement is not new, this approach and roadmap aims to offer transparency to clients, portfolio investments and stakeholders.

We aim to set milestones with issuers during priority ESG engagements. We follow up annually or as needed to track progress, updating milestones and setting new ones when necessary. We initiate and close off milestones via our lifecycle approach: identity, acknowledge, plan, execute and close. If the milestone is not progressing through these stages within an acceptable timescale, we may choose to escalate the milestone by a different channel, such as writing a letter to the board or collaborating with Equity colleagues to vote against management. These strategies are discussed in detail in section 4 of this document.

Engagement types

Priority engagement

Respond
Reacting to an event or news flow that may impact a single investment or a selection of similar investments

Enhance
Designed to seek change that, in our view, would minimise risk and enhance value

Thematic
Focus on a particular ESG theme, such as climate change, diversity and inclusion or modern slavery

Ongoing engagement

Review
Ongoing diligence and stewardship; frequent interactions led by the investment team

Engagement lifecycle

Identify
We have identified specific concerns or issues to be raised with the issuer

Acknowledge
The concern has been acknowledged

Plan
There is a credible plan to mitigate the issue

Execute
The plan is being executed to address our concerns

Close
The plan has been successfully delivered and this issue is closed

Informed and constructive engagement helps foster better companies

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Why do we engage?

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Why do we engage?

The expanding role of ESG engagements for bondholders

ESG engagements have traditionally been associated primarily with equity investors. However, this perspective is evolving. At abrdn we recognise that bondholders, as significant providers of capital, can also benefit from and effectively drive change through ESG engagements. To maximise our impact, we work in close collaboration with our Equities colleagues, pooling our efforts on initiatives like voting to guarantee a cohesive approach in our demands from issuers.

The world faces critical sustainability challenges, including climate change and equitable access to basic services. Addressing these challenges requires substantial capital investments, often facilitated through debt instruments, some of which carry sustainability labels.

While equity markets receive considerable attention given the focus on voting, it is worth highlighting that the majority of primary-market financing occurs in the debt market. Fixed income investors thus maintain a direct interface with issuers actively seeking capital.

Beyond publicly traded companies, fixed income investors can engage with a diverse range of non-listed issuers. These include private entities, high yield issuers, government municipalities, infrastructure projects and housing associations. Engaging with non-listed issuers demands a nuanced approach. Our collaboration with non-listed issuers often marks the first time they've discussed ESG topics with an external stakeholder, and they are typically receptive to our inquiries and eager to integrate sustainable practices into their operations. Often, our impact on these issuers can be more influential than with large, publicly listed companies.

At abrdn, we engage issuers primarily for the following reasons:

1. **Improve insight**
   a. Forward-looking assessment: Engagement provides a forward-looking view on the management of ESG risks, opportunities and the ability to encourage value-enhancing best practice standards. Informed and constructive engagement can add value from a risk/return perspective, helping portfolio managers to make informed investment decisions and capture potential alpha opportunities.
   b. Cost of capital: For fixed income investors, the cost of capital for issuers is a crucial metric that reflects a given issuer's financial health and access to financing. Additionally, ESG considerations now factor into this evaluation, as issuers are increasingly assessed not only based on financial metrics but also on their commitment to sustainable and responsible business practices. Engaging with issuers enables bondholders to understand the potential drivers of an issuer's cost of capital.
2. **Encourage action**
   a. Across a bond's lifecycle: Sustainability factors can impact an issuer's access to favourable financing. It's therefore crucial for fixed income investors to engage before issuance to shape sustainability frameworks, especially in the labelled and sustainability-linked bond market. By providing feedback on labelled bond frameworks and post-issuance reports, investors can help refine reporting mechanisms and disclosure. Active engagement with issuers throughout the bond's lifecycle ensures adherence to objectives, promotes transparency and accountability standards and ultimately strengthen the integrity of the sustainable finance market.
   b. Cost of capital: ESG engagement from bond investors may be able to reduce the issuer's risk and cost of capital, as these discussions can help issuers to understand investors' ESG-related concerns . Alignment with investor values may lead to a more favourable reception in capital markets and a wider pool of investors, fostering a lower cost of capital over the issuer's financing horizon.

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How do we engage?

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How do we engage?

Our preference is generally for our engagements to be bilateral, conducted in a way that allows for an open exchange of ideas between the issuer and abrdn. Within abrdn we engage collaboratively, therefore Fixed Income, Equity and Active Ownership team members may engage with an issuer together. This collaboration ensures effective resource utilisation and maximises the impact of our engagement efforts.

As an active investor, we can engage with our investments directly in a number of ways:

- Face-to-face meetings.
- Conference calls arranged by sell-side banks.
- Collaborative engagements with other investors who may be seeking to achieve similar change from a single investment or a range of investments.

Through the methods above, we may gain access to board members, senior executives and decision-makers.

We undertake research in preparation for engagements, identifying objectives and any potential milestones. This helps us to establish success markers at the start of the engagement, and monitor (and report on) our dialogue with issuers on an ongoing basis. Ongoing monitoring is crucial, as some of the outcomes we are expecting will not be immediate, and it may be appropriate to set an engagement milestone which allows us to assess the steps taken by the issuer. We highlight the areas where we wish to see improvement to issuers, and carry out desktop analysis or further engagement to measure progress.

Setting engagement priorities:

In planning engagements, our approach is to focus attention on either a) thematic issues where we believe a theme represents a significant risk or opportunity across sectors and geographies (including the themes highlighted in this document, such as biodiversity), or b) issuer-specific engagements, i.e. where we have identified priority issues that require further dialogue.

In the case of issuer-specific engagements, there are many factors that might drive our engagement activity. These engagements focus on the factors which we believe to have the greatest potential to enhance or undermine our investment case, including:

- Issues identified as part of due diligence
- Size of holding
- Internal ESG ratings
- External ratings, including assessments from providers such as MSCI
- Milestones, where we have asked for actions from the issuer and seek to measure responses.

At the beginning of each year, we create our priority engagement list based on the factors mentioned above. This initial list is subject to additions or removals throughout the year, during the quarterly Fixed Income engagement priorities meetings. Updates to the list occur through "review, respond and enhance" channels. This collaboration ensures effective resource utilisation and maximises the impact of our engagement efforts.

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Escalation

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Escalation

We consider escalation on a case-by-case approach, aiming to identify risks early and set measurable milestones with issuers. We may use escalation in certain instances, such as where an issuer is unresponsive, or the issuer's response to a material issue is viewed as insufficient. We have a decision tree that provides potential tools of escalation in cases where an investment is viewed as inadequately responding to a material risk. Our use of escalation is designed to drive change and achieve key objectives.
A flexible escalation approach is essential, given certain escalation actions may occur simultaneously or as part of regular due diligence with issuers. More detail can be found in the abrdn **Engagement Policy**.

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The Roadmap 2024-2026

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The Roadmap 2024-2026

This section serves as a roadmap for our engagement activities within active Fixed Income over the next three years (2024-2026, inclusive). It is important to note that not all engagements will focus solely on the topics emphasised. Our primary objective is to concentrate on the most material ESG risks and opportunities during our interactions with issuers. Therefore, the roadmap is not exhaustive and does not encompass the wide range of unique risks and opportunities that an issuer might encounter. The roadmap enhances our existing investment-wide thematic engagement activities through collaboration with our central Sustainability Group and other asset classes. Our Equity activities also have an **engagement roadmap**.

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Our thematic engagement priorities

Corporate governance

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Why corporate governance?

We believe that good corporate governance is a cornerstone for fixed income investors seeking high-quality issuers, as it signifies an issuer's commitment to responsible practices, ethical conduct, and a strategic approach to risk management – all crucial elements for sustained bond performance. Issuers with strong governance practices are perceived as more creditworthy, which reduces the risk of default and instils trust in bondholders. Effective risk management and experienced, skilled board members contribute to the stability and resilience of bond issuers.

While the recent growth in interest in sustainability (effectively, the E and S in ESG) is encouraging, we are concerned that it has come at the expense of the G, i.e. corporate governance. While our focus on corporate governance has never faltered, we believe that insufficient attention has been paid to governance structures and processes in recent years. For example, a Moody's report published in 2023 notes that governance is cited as the key driver in over 80% of rating action announcements that highlight ESG factors as a consideration.[1] Therefore, corporate governance is a key engagement focus due to its influence on rating actions, creditworthiness and cost of capital.

Potential topics we may focus on

Boards:

Good governance starts with the board. Our focus is on ensuring that the right individuals are appointed to the right roles, and that boards have the right structure, composition and diversity. A diverse and well-structured board brings a wider range of perspectives, experiences and expertise, which can lead to better decision-making and improved financial performance. We acknowledge that appropriate structures may vary depending on the nature of the issuer and jurisdiction.

Risk management:

Effective governance, including policies and processes, is crucial in mitigating risks and ensuring our investment's long-term stability. By focusing on risk mitigation, we can assess how well the issuer identifies, manages and monitors various risks, including financial, operational and ESG-related risks. This understanding of risk management directly impacts the creditworthiness and risk profile of bonds.

Disclosure and assurance:

Bond issuers often have varying levels of disclosure and assurance; some provide more comprehensive, audited and transparent information, while others might have limited or less detailed reporting. Non-listed or high yield may lack the resources, and may be subject to less market scrutiny, both of which can result in limited disclosures. We see this as an opportunity to engage and identify positive practices that might be overlooked by others. By actively engaging with these issuers, we can gain valuable insights into their operations, strategies, risks and competitive advantages that may not be readily apparent from publicly available information. As fixed income investors, we may have specific asks around the disclosure of labelled bond allocations and impact data.

[1] Moody's, 20th June 2023 - Share of rating action announcements citing ESG factors as key driver declined in 2022.

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Our thematic engagement priorities

Decarbonisation

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Why decarbonisation?

The energy transition, which is crucial for meeting 2050 net-zero goals, is estimated to cost around $9.2 trillion annually.[2] Bond issuance will play a pivotal role in raising the necessary financing for this transition. As a result, fixed income investors have the opportunity to actively contribute to decarbonisation across their portfolios through strategic engagement and investments. It is also essential to recognise the physical and transition risks that are becoming increasingly financially material for our investments. These risks are not only manifesting in the obvious high-emitting sectors (such as energy, utilities and transportation), but also along the supply chain, among providers of finance and among those reliant on agricultural outputs and water. In our view, companies that successfully manage climate change risks will perform better in the long term. It is important that we assess the financial implications of material climate change risks across our fixed income investments, and make our portfolios more resilient to climate risk.

Example topics that we may focus on

Climate change governance:

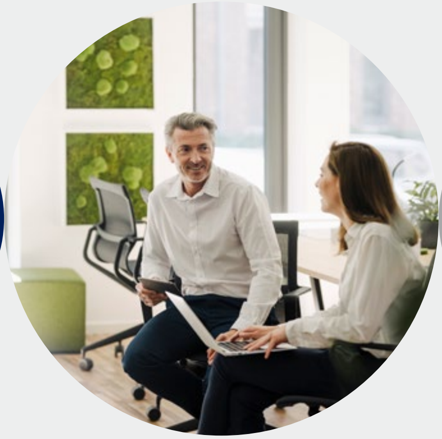
We believe good governance is the key to strong performance on environmental and social issues. Climate change is no different. We recognise that different issuers in different sectors and/or regions will have different roles to play. Fundamentally, an engaged and knowledgeable board will manage climate change risks and opportunities more effectively.

Greenhouse gas (GHG) emissions:

Our investments operate in different industries and regions, and so have different roles to play in the transition to a low-carbon economy. However, decarbonising operations is a key factor in decarbonising economies overall. Disclosure levels vary within Fixed Income, so in some instances we may be encouraging issuers to report on GHG emissions for the first time, such as in the high yield space. For more advanced companies, we may have a focus on understanding the credibility of net-zero roadmaps and the readiness of low-carbon technologies. In addition to carbon emissions, we consider other harmful emissions, such as methane, which has a much higher global warming potential.

Just transition:

We strongly encourage our investments to consider the social dimension of the energy transition to ensure it is inclusive and 'just'. This means worker and community needs are considered on the path to a low-carbon economy so that stakeholders are not left stranded, which may pose risk to our investments. For instance, during engagements with emerging market energy companies, we emphasise the importance of upskilling employees, while simultaneously safeguarding the affordability and reliability of energy supplies.



[2] https://www.mckinsey.com/~/media/mckinsey/business%20functions/sustainability/our%20insights/the%20net%20zero%20transition%20what%20it%20would%20cost%20what%20it%20could%20bring/the-net-zero-transition-executive-summary.pdf, page vi

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Our thematic engagement priorities

Biodiversity

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Why biodiversity?

The UN COP15 biodiversity summit (held in Montreal in December 2022) resulted in a landmark agreement to halt biodiversity loss by the end of the decade and achieve recovery and restoration by 2030. The increasing recognition of biodiversity's importance is influenced by several interconnected factors including an improved understanding of biodiversity's critical role in essential ecosystem services; importance in climate mitigation and adaption; and wider knowledge of threats to global food security. Biodiversity loss presents risks to the global economy, as biodiversity directly impacts supply chains and the availability of natural resources. By focusing on biodiversity as one of our key engagement priorities, we aim to promote the conservation of biodiversity and position our portfolios for resilience, adaptability and sustained long-term value in a rapidly changing world.

Example topics that we may focus on

Pollution:

Pollution by an issuer refers to the release or introduction of harmful substances into the environment as a result of their operations. This pollution can take various forms such as direct air, water, soil and noise pollution; or indirectly, as a result of the use, disposal or distribution of products (e.g. plastics, e-waste, etc). Both direct and indirect pollution can lead to significant environmental degradation, harm to ecosystems and adverse effects on human health. Engagement can help investors understand how issuers implement pollution control measures and adopt sustainable practices to minimise negative impacts on the environment and public health.

Changes in land use:

Land-use change is a major human influence on biodiversity and can include the conversion of land cover (e.g. deforestation), changes in the management of ecosystems (e.g. intensification of agriculture) or fragmentation of habitats (e.g urbanisation). Engagement aids our understanding of how issuers manage the land that they operate on and impact indirectly through supply chains.

Natural resources consumption:

The anthropogenic exploitation of natural resources has led to biodiversity loss and extinctions, with a notably sharp acceleration in the recent rate of loss.[3] A significant factor in this decline is the impact of issuers directly consuming natural resources, encompassing sectors such as agricultural commodities, food production, paper & packaging and pharmaceuticals. Our analysis primarily focuses on issuers with high-risk exposures; through engagement, we can help issuers identify leading practices to conserve natural resources.

[3] UN Report: Nature's Dangerous Decline 'Unprecedented'; Species Extinction Rates 'Accelerating' – United Nations Sustainable Development.

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Our thematic engagement priorities

Labour

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Why labour?

Labour is an increasingly significant topic for ESG engagements with issuers as recent supply and demand shocks in the labour market during and after the COVID-19 pandemic have led to changing workforce dynamics, increased wage and cost inflation, subsequently raising labour costs on balance sheets. In developed markets, trends such as hybrid working models, increased union action, and efforts to address wage disparities are prominent. Whereas in emerging markets, the formalisation of informal sectors, gender disparities and enhancement of labour rights and protection are key issues. Across both markets, the emergence of AI and the just transition necessitates the reskilling of employees and structural changes across various sectors. Therefore, engaging with issuers on labour-related themes allows for a more comprehensive assessment of an issuers' ability to adapt, innovate and maintain a sustainable workforce, which ultimately contributes to their long-term success and value creation.

Example topics that we may focus on

Wage and cost inflation:

Engaging on wage and cost inflation enables us to gain deeper insights into how issuers are effectively managing increased labour expenses and addressing wage disparities. We promote fair compensation and equitable distributions of benefits and respect of the International Labour Organization's core convention's (child labour, forced labour, discrimination etc). This can support an issuer's competitiveness in the market and their ability to attract and retain talent. However, there is a balance between ensuring long term value for stakeholders, equitable compensation and fair pricing of products and services.

Reskilling and upskilling:

As issuers increasingly adopt advanced technologies such as AI and machine learning (alongside clean technologies), there is a growing need for a skilled workforce. We seek to understand issuers' strategies for workforce transformation, including initiatives for employee reskilling and upskilling and hiring new talent with specialised skills.

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How will we be reporting on this?

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How we will be reporting on this?

We believe we have a responsibility to actively engage with our portfolio investments and proactively inform our clients and stakeholders of our stewardship activities. We publish regular **stewardship reports** that detail our engagement activities, including breakdowns of engagements by country and topic. These reports include discussions of notable engagements, including a discussion of where in the engagement lifecycle a meeting took place.

Monitoring progress and evaluating engagement outcomes are essential components of this roadmap, along with reporting on this progress. We commit to reporting our progress against the four themes outlined in this roadmap annually. This includes disclosing the number of engagements on specific topics by region and providing case studies.

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