MACKAY SHIELDS
A NEW YORK LIFE INVESTMENTS COMPANY

INSIGHTS & PERSPECTIVES
from MacKay Shields Fundamental Equity and Global Credit Teams

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Responsible Investing Can Align Equity and Fixed Income Investor Interests, Benefitting Both

Equity and fixed income securities are often thought of as distinctly different animals. Investors view them as unique asset classes, varying by degrees of risk tolerance, promoting different financial policies/priorities of corporate management, and demanding dissimilar levels of investor engagement. However, when analyzing the investment processes of MacKay Shields' Fundamental Equity and Global Credit teams through a responsible investing lens, we find that despite these obvious differences, the objectives of equity and credit investors appear to be much more aligned than not.

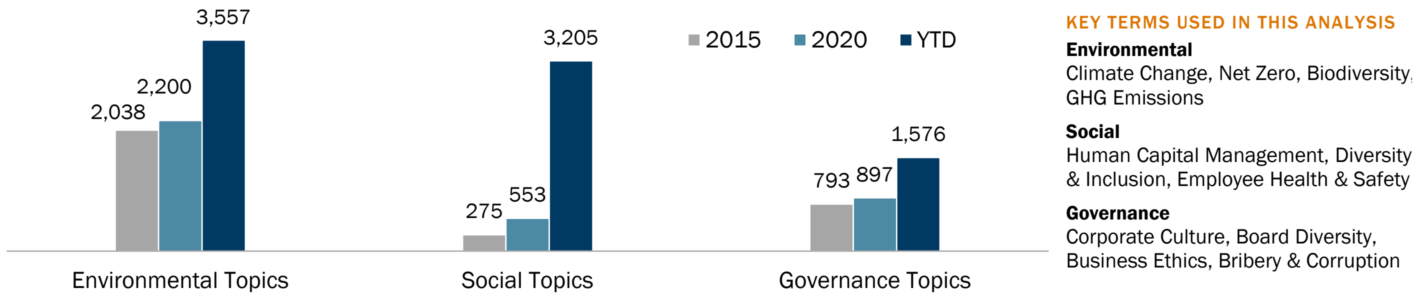
There is a natural tendency to view equity investors (owners) and credit investors (lenders) at odds with one another, particularly with respect to the best use of cash in investment decisions. However, we find when the core principles of responsible investing are embedded in the investment process, the asset classes speak more as different dialects of the same language rather than as different languages altogether. This leads to the logical next step whereby both investor groups might act in unison to support the long-term strategic growth of a company.

The overarching objectives of MacKay Shields' Fundamental Equity and Global Credit teams are as follows: Identify business models that are expected to remain profitable over the long term; be able to weather unexpected shocks and subsequently deliver on financial obligations; provide investors with attractive returns on their committed capital. Our teams are strongly aligned in their investment approaches in many ways. They both conduct rigorous fundamental research grounded by long-term perspectives, focus deeply on risk management, and take an approach to engagement that promotes constructive and collaborative dialogue with company management.

Long-Termism: The Key To Sustainable Growth

Change in the modern era is unfolding at unprecedented rates. Many of the factors driving markets today were fringe topics a decade ago, and many of these emerging topics do not fall within the confines of traditional financial analysis. In particular, we note that issues pertaining to the environment and society are playing increasingly material roles within the business world, as evidenced through the growing number of publicly listed firms that mention ESG topics in their annual regulatory filings (Figure 1).

FIGURE 1: NUMBER OF SEC 10-K FILINGS CONTAINING KEY ESG TERMS



YTD as of July 13, 2022
Source: SEC EDGAR Database, MacKay Shields

The MacKay Shields Fundamental Equity team views success in the long term as requiring preparedness today for the unforeseen; the longer the investment horizon, the more likely the investor is to experience some of the tail-risks or low probability events that may occur. In this vein, the Global Credit team first evaluates the health of a company by analyzing expected profitability, which cannot be determined solely by current asset value. Bond prices discount the probability of future outcomes, making such analysis an imperative for any investment. Today's market dynamics mandate that investors consider longer-term perspectives beyond medium-term investment horizons or typical bond maturities. This requires deep fundamental analysis of business models, management structures, and emerging trends and risks, regardless of asset class.

As an example, we are increasingly turning our investment attention to how banks are incorporating climate considerations into their loan underwriting and credit assessment decisions. With the many risks posed to property and other assets due to physical climate change, including rising sea levels, extreme flooding, and severe and prolonged periods of drought and wildfires, banks are implementing underwriting systems and policies to appropriately price environmental risk. At the same time, by year-end 2024, banks within the EU will be required to show they can manage risks related not only to physical climate change but also to delays in transitioning to low carbon alternatives. As an example, some business models rely on owning stranded assets to generate the bulk of their returns. We have seen several European banks already account for such transition risks.

Incorporating Non-Traditional Risks in Valuation Metrics

While long-term thinking is required to properly assess a business's ability to generate sustainable cash flow, it is important to consider tail risks to better understand the fair or appropriate value of a particular security. This process is captured through the teams' risk assessments and cost of capital analysis, which is another element of alignment between our Global Credit and Fundamental Equity investors.

One way to think about similarities between credit and equity investors is through the impact of environmental and social risks on the cost of capital. For example, the Global Credit team places increased scrutiny on sustainability-linked bonds where specific key performance indicators (KPIs) are linked to a bond's coupon rate. This relationship would typically result in a coupon step-up every time the company fails to meet its pre-determined KPI goals, thereby increasing its outstanding debt obligations and overall cost of capital. The Fundamental Equity team considers such fluctuations in debt markets when calculating an appropriate weighted average cost of capital (WACC) for the enterprise. Thus for both asset classes, we find risk management through valuation adjustments as an effective way to connect long-term risk with present day value.

Recently we saw a corporation issue a bond with a coupon tied to achieving certain targets every calendar year rather than achieving a few KPIs at key milestone years. We see merit in this approach as it provides investor groups with more transparency and gives a better sense of how a company expects its ESG/sustainability journey to evolve. For equity investors, the format allows better visibility into the cost of capital for achieving stated targets and for bond investors it

allows for different maturity preferences to participate rather than being left out if their investment horizons do not match up with those of the bonds' KPI milestones.

We also consider how companies incorporate environmental and social metrics to evaluate management's performance. Our Fundamental Equity team has invested in a UK-based spirits company that calculates long-term incentive awards by analyzing carbon reduction and water efficiency in direct operations as well as metrics associated with inclusion and diversity. The company has attempted to address inequities in pay by requiring executives to defer one-third of their short-term incentive awards and instead receive shares with a three-year vesting period. It has also cut pension benefits for executives in alignment with those of the general workforce. At the board level, 77% of directors are independent and 60% are female. Management of long-term environmental and social risks that are embedded within governance structures is viewed favorably as it intrinsically aligns executive performance with the organization's key strategic objectives.

Engagement as a Healthy Partnership

Methods for engagement tend to be one of the main areas for which the market expects stark differences in approaches between equity and credit investors. Equity holders tend to have more natural points of direct feedback with company management through proxy voting, which occurs on an annual basis. However, an interesting phenomenon is starting to emerge within the capital markets due to the rise and prominence of passive investing. Because of the sheer size of the world's largest asset managers, traditional engagement on issues relating to the environment or society is disproportionately beholden to a handful of global players. In this regard, the avenues and gravitas for smaller equity investors is starting to share more in common with their fixed income counterparts than with their larger equity peers.

The MacKay Shields Fundamental Equity and Global Credit teams approach responsible investing similarly through their engagement methods. Seen largely as another tool through which they can analyze not just risk exposures but also capacity and willingness of management to mitigate such risks, engagement with company management is seen best conducted as a productive ongoing dialogue. Both sets of investors view engagements as opportunities to express their view to management and to gain better insight into softer-skill strengths such as company culture, management flexibility and accountability. The goal of this ongoing relationship is to allow management to feel comfortable enough with our teams to actively seek out perspective or advice on how to address challenges within their sectors based on our observed best practices. It is through these engagements as healthy partnerships that teams feel that they can further their own investment goals, and as those of a broader group of responsible investors, who might otherwise lack the natural levers of influence that are usually associated with large shareholders.

More in Common Than Conflict

Our drive towards more responsible investment practices lead us to the conclusion that credit and equity investors have more in common than they do in conflict. Fundamental analysis with a long-term perspective combined with a deep focus on risk mitigation and productive two-way dialogue with company management have proven to showcase strong alignment between our Fundamental Equity and Global Credit teams. We view these asset classes as different expressions of similar principles, but most importantly, similar goals.

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