Global Investment Insights

with Jonathan Bailey, Managing Director, Global Head of ESG & Impact Investing, Neuberger Berman

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Jonathan is a Managing Director and Global Head of ESG & Impact Investing at Neuberger Berman. He joined in 2017 and leads the ESG investing team, working with portfolio analysts and managers across the firm's equities, fixed income and private investment portfolios. He is a member of the firm's Governance and Proxy Voting Committee and Partnership Committee. He also Chairs the firm's ESG committee.

Neuberger Berman was founded in 1939. It is a private, independent, employee-owned investment manager. In November 2021, the firm joined the Net Zero Asset Managers Initiative as a commitment to support investments aligning with net zero emissions by 2050 or sooner.

In this exclusive interview with the Global Investment Institute (GII), Jonathan shares the areas of focus driving his team's research agenda, he addresses the implications of the upcoming US Presidential election on the Inflation Reduction Act (IRA), the role for active engagement and how to measure companies' true progress towards reducing real world emissions.

> *The impact of the US presidential election on the IRA is perhaps the most salient question for investors involved in the energy transition.*

Q.

What are the main areas of focus driving your research agenda in your role as Global Head of ESG and Impact Investing at Neuberger Berman?

A.

My role can be split into three key areas of focus, which I outline as follows:

1. **Investment Solutions:** There is a clear and growing demand from investors to express their values and goals through their investment choices, something that traditional aggregated ESG data simply cannot provide.

   Universally all stakeholders believe meaningful data on the social and environmental outcomes of funds could be transformational for the investment industry. For example, through the integration of the UN SDGs or net zero alignment, investors can target businesses growing sustainably or making genuine progress on decarbonisation.

   We recognise the growing importance of engagement with our clients. This has led us to develop a range of tools and investment solutions across asset classes that respond to specific sustainability needs. To this extent, we have developed proprietary climate tools that have allowed us to target investments in companies with improving net zero alignment profiles over time and launched investment solutions that focus on issuers whose business operations have the

potential to contribute to the United Nations Sustainable Development Goals (SDG).

2. **Voting & Engagement:** Against the backdrop of rising proposal complexity and varied proposal quality, transparency of voting rationales has never been more important to ensure companies understand the drivers of investor voting decisions and can therefore, in turn, determine how best to respond. In addition to our direct engagement with companies, NB has continued to leverage its NB Votes initiative as a means to provide further transparency into voting decisions and rationales. We saw more investors pursue similar forms of advance disclosure which we believe validates this approach we began back in 2020 and is a positive trend for the industry.

3. **Regulation:** Despite the staggering progress made during 2023, we believe 2024 will see a continued proliferation of sustainable finance frameworks which will test the ability of asset managers, investors, and companies to respond effectively to evolving and new requirements.

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There are several currently unresolved initiatives of which investors will eagerly await clarity in the year ahead, including:

- ESG fund disclosure and/or labelling requirements in the US, Australia, and the EU (Level 2 clarifications)
- Sustainability reporting requirements for companies in the US and a few APAC jurisdictions
- A final EU rule for funds with ESG names
- Rules and standards across jurisdictions on ESG rating providers

In addition, a positive trend that is likely to continue in the months ahead is the increasing regulatory efforts to consider the role of sustainable finance in supporting transitioning companies on their journeys to net zero. This is reflected by the work that some jurisdictions are doing to provide frameworks for credible transition planning (e.g., the UK and Singapore), the development of sectoral pathways for companies (e.g., the EU), and the adoption of transition taxonomies (e.g., the Singapore-Asia Taxonomy).

As an active investor, we welcome this growing focus on forward-looking metrics and objectives which, in conjunction with investor engagement and stewardship, could lead to the achievement of real-world decarbonisation. While traditional measures such as carbon footprint and carbon intensity are useful in that they are comparable across companies and portfolios, there are major pitfalls associated with relying heavily on them when assessing net zero alignment.

In this ever-changing landscape, Neuberger Berman continues to engage in emerging ESG regulations and standards to ensure that we stay ahead of the curve to help our clients and the companies in which we invest to navigate these complex frameworks.

Q.

What implications has the Inflation Reduction Act (IRA) had on the investment opportunity set for investors allocating to the US? What impact do you expect this year's Presidential election outcome to have on the IRA?

A.

Landmark legislation such as the US Inflation Reduction Act and the European Green Deal Industrial Plan have been welcomed, but equally met with concern that too many built-in hurdles are delaying implementation. The IRA's clean-energy tax credits are an important part of the bill, but they are also considered overly complex from a financial structuring point of view and do not lend themselves very well towards a replicable and scalable system. Government policy initiatives are clearly flowing through to the real economy, creating an impressive number of expected new jobs, however, they have so far proven futile to macro headwinds and, as a result, yet to translate into tangible financial results.

The impact of the US presidential election on the IRA is perhaps the most salient question for investors involved in the energy transition. The IRA was passed in August 2022 with no Republican support in the House or Senate. As such, if Republicans win in November, it is uncertain if the party's ideological view against the bill will prevail or the weight of the support

for the bill from the business community will prevail, anchored by Republican-leaning states that are already gaining the most investment from the IRA. If Democrats win, there will be a desire from some to double down on the IRA and further extend climate policy in the US, but this would no doubt face a similar challenge given Republicans have voted 31 times in attempts to repeal IRA provisions or rescind funding allocated by the IRA.

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Looking at the 271 major clean energy projects that have been announced between the passage of the IRA and November 2023, 31.4% of them have been in states with a Democratic trifecta, 19.9% have been in states with a divided government, and 48.3% of them have been in states with a Republican trifecta. Note, the remaining 0.4% is for one project that has been announced in Puerto Rico and the status of the state government is as of 2023.

Q.

What are the challenges to achieving active engagement in a world of passive ownership (in the context of a higher interest rates environment)?

A.

Engagement is core to our investment process as an active manager. We embed stewardship responsibilities including engagement within our investment teams which we believe are crucial to integrating stewardship insights into the investment process and informing investment decisions. This approach enables us to combine subject matter expertise with fundamental insights to engage on financially material issues specific to a given company and its operating profile to drive sustainable value creation on behalf of our clients.

As a result, we have found that companies are often eager to engage and seek our input on topics ranging from long-term strategic priorities to capital allocation to emerging sustainability risks. Particularly in a higher-for-longer interest rate environment, many companies will look to proactively engage with active managers like Neuberger Berman as they look to reassess business priorities and capital allocation decisions.

Index funds on the other hand, by their design, must heavily rely on proxy voting to influence companies. Yet there appears to be a disconnect between passive managers' voting records and sustainability objectives embedded into index funds, particularly when it comes to those relating to climate.

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To begin, passive manager support for environmental and social shareholder proposals remains tepid. In 2022, when measured across several large global passive managers, backing for such proposals lingered in the low teens to just over 20%. These numbers have declined even further in the 2023 proxy season, with support from these managers on environmental and social shareholder proposals falling below 10%.

Furthermore, we find, there is neither sufficient rationale for, nor timely disclosure of these voting decisions. Absent this type of disclosure, we fear that companies may incorrectly interpret falling support for climate proposals as a de-prioritisation of climate risk by investors. Hence our NB Votes initiative, through which we publish our proxy-voting intentions in advance of select shareholder meetings. Now in its fourth year, NB Votes allows our teams to share opinions on various voting topics that, in our view, have material economic consequences for companies—not least their climate transition plans. We believe this approach can encourage management teams to improve their governance practices and deliver long-term value.

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But proxy voting is just one way we believe asset holders can help support matters such as the climate transition. In our view, investors can gain deeper insights into their portfolio companies' transition plans—and potentially influence them—by actively engaging with management teams and board members. While we find that passive funds tend to engage mainly with their largest holdings, we believe there is more work to be done and potential progress to be made. Research has shown that passive managers historically under-engage with small-cap companies, implying that significant contributors to the climate transition may not be sufficiently held to account.

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Q.

What approach can investors take to tracking companies' true progress toward reducing real-world emissions?

A.

While backward-looking metrics such as carbon footprint and intensity are important, robust quantification of climate risk should go beyond those metrics and seek to capture forward-looking real-time insights.

To better capture real-time insights, we designed a forward-looking net zero alignment indicator that seeks to capture a company's status and progress over time toward net zero targets. The indicator was created in partnership with our clients with decarbonisation targets and incorporates specific sub-indicators that were informed by the high-level expectations of the Institutional Investor Group on Climate Change (IIGCC). The indicator utilises multiple quantitative data points from both traditional ESG data providers and specialised climate data sets, as well as real-time insights from both our credit and equity research analysts. The indicator is utilised across our listed public equities and fixed-income universe.

The current sub-indicators are:

1. Long-term ambition
2. Short- and medium-term targets
3. Emissions performance
4. Disclosure
5. Decarbonisation strategy
6. Capital allocation

Q.

Where are you seeing the biggest progress being made by companies in reducing their carbon footprint across sectors and geographies? And, to the contrary, where is the least progress being made?

A.

Data is only the starting point when it comes to ESG analysis, and analyst judgement is essential. This point is illustrated by the importance of the qualitative assessment stage of our net zero alignment Indicator.

Looking beyond the large proportion of scores that have been overridden by our analysts, it's important to dive deeper into the distribution of overrides across asset classes and the six sub-indicators. This confirms our intuition about the additional insights our analysts can bring.

Scores associated with issuers of bank loans and high-yield bonds are typically subjected to the largest proportion of upgrades by asset class, which is consistent with the lower availability of quantitative data and third-party assessments for issuers active in those markets. Our analysts allow us to capture the positive progress being made by those issuers, despite the lack of third-party data.

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Sub-indicators 4, "Disclosure" and 6, "Capital Allocation," are subjected to by far the largest proportion of overrides, reflecting substantial lags in emissions data and the importance of specialist qualitative judgement in assessing companies' spending and investment plans. Sub-indicator 3, "Emissions Performance," was subjected to the fewest overrides, this is because most issuers have not disclosed actual emissions for long enough to allow

analysts to compare them directly with previous emissions projections.

Geographically speaking, in a representative multi-sector credit portfolio, we see the highest alignment in EMEA, followed by Emerging Markets, and finally the US and Canada, but there's very small variation overall – no more than 5% of the market value in each asset class.

This tells us there are issuers in all markets that are seriously considering their climate risks and opportunities and taking appropriate action.

Q.

What are the driving forces that set apart companies making significant progress towards decarbonising, from those that aren't? How can investors identify the leaders from the laggards?

A.

Many companies are at the very beginning of their net zero journey and are either just making commitments or are now figuring out how they will deliver on the commitments made.

We have very specifically defined what constitutes a leader and laggard on each of our six sub-indicators.

The best-performing leaders will have publicly committed to net zero by 2050, followed that up with concrete short- and medium-term carbon targets, transparently disclosed current emissions, demonstrated declining emissions intensity, and already started to allocate capital toward achieving the goals of a corporate climate strategy.

Real laggards are those that are resistant to disclosure or even considering setting science-based targets, despite being in a sector or region where they face significant climate transition risk, but we see very few of these companies.

Most companies fall into the "committed" category, where they have taken some action on climate and are assessing the next steps.

Every sector is on a different path to net zero, and within each sector, every company is on a slightly different path to net zero. A great example of the need to apply qualitative judgement is within the mining sector.

The path to net zero within the mining sector will be anything but linear, but its role undoubtedly in the wider transition is unequivocal. Back in June 2023, BHP CEO warned investors about its decarbonisation pathway, and rather than tracking downwards it expects an upturn around 2025 and a decline closer to 2030.

This is due to a combination of new growth projects to meet the unrelenting demand for raw materials but also delays in scaling carbon abatement technologies that BHP is dependent on in meeting their reduction targets.

At face value, this is a negative, but pulling back the layers on BHP's decarbonisation plan you see that the company is currently working on solutions such as electrifying its hauling trucks (now largely diesel) and installing infrastructure to make renewable power more accessible in remote areas of Australia and Latin America where some of its largest mines are located. However, these types of solutions require time and capital.

Although the forward guidance from BHP was disappointing, this shouldn't necessarily drive investors from the sector. Large miners like BHP are going to be essential in the energy transition, providing the hardware required for climate solutions. This is an opportunity to recalibrate expectations and engage in decarbonisation more effectively with the mining industry. In our engagements, with BHP and its peers, we adjusted our discussions to deal more with the testing of the feasibility of abatement technologies and realistic timelines behind these.

Having adjusted our alignment status for BHP by bringing down expectations for short to medium-term targets and emission performance in line with company guidance. The indicator allows us to react in real time and adjust our engagement to focus on the critical areas to create a positive feedback loop.

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