



ESG INTEGRATION IN HIGH YIELD PORTFOLIOS

WHITE PAPER

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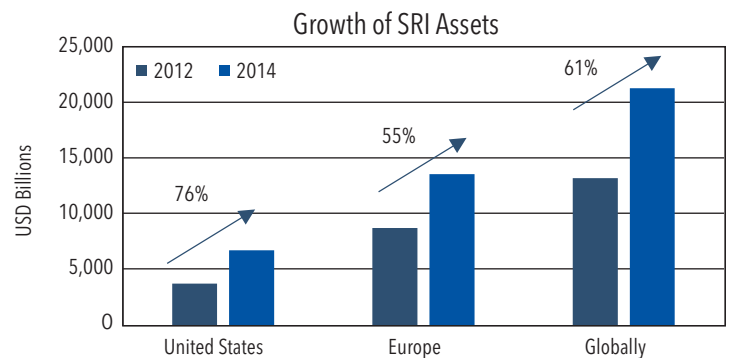
ESG investing—the integration of environmental, social and governance factors into a fundamental research process—continues to gain momentum from investors as consumers and corporations alike place greater emphasis on corporate social responsibility. As the body of evidence linking ESG issues and corporate bond returns continues to grow, we believe that incorporating these factors into traditional credit analysis can lead to more prudent security selection decisions and improve the risk-adjusted returns of high yield bond portfolios.

Demand for ESG Continues to Grow; Fixed Income Integration in Short Supply

We believe the amount of attention being paid to corporate social responsibility (CSR) has never been higher, as more and more companies are incorporating responsible practices into long-term business plans. Consider, for example, that in 2010, 81% of companies reported having a corporate citizenship budget. That number stands at nearly 100% today.¹ All in all, American and British companies in the Fortune Global 500 spend more than \$15 billion annually on funding responsible business practices.² Additionally, more often than not, these functions are placed in the hands of corporate executives, with approximately 60% of companies tasking vice presidents (or higher) with responsibility for their CSR plans, up from 33% in 2010.³ No matter how you slice it, one thing seems clear: corporate social responsibility is growing in importance.

But what has driven this growth? While the old adage “vote with your wallet” is typically reserved for political arenas, it appears to be relevant here, as the general populace deserves significant credit for the increased adoption of socially responsible business practices. More and more consumers are demanding that companies act with a conscience by threatening to take their business elsewhere if they don’t. One recent study highlighted this trend after finding that 85% of consumers would switch from an existing brand to one associated with a social cause. Perhaps more telling, two-thirds of consumers, led by the increasingly relevant Millennial demographic, are willing to pay more for sustainable brands.⁴

Not to be outdone, the investment community has also put its money where its mouth is and, while socially responsible investing (SRI)—along with its extension, ESG investing—might have been viewed as a fad a decade or two ago, this form of investing continues to gather impressive momentum. The numbers support this claim. According to the Forum for Sustainable and Responsible Investment, assets committed to SRI strategies have increased at a rapid pace, with \$6.57 trillion in the United States at the beginning of 2014, up 76% since the start of 2012. This represents nearly 20% of assets under professional management in the United States. Global market share is even higher, with SRI assets accounting for approximately 30% of assets under management, up from 22% in 2012.⁵ However, the vast majority (roughly 80%) of these assets are in equity strategies.⁶ We believe that the fixed income markets have been largely ignored in this regard, and that incorporating ESG analysis into the management of bond portfolios—especially corporate credit—can add value while reducing risk.

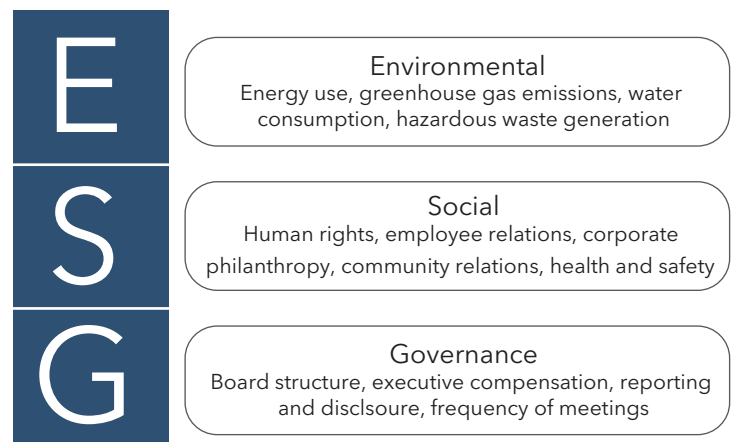


Source: Global Sustainable Investment Alliance

ESG’s Impact on Bondholders

Over the years, investors have been made keenly aware of governance failures wreaking havoc on a company’s business, resulting in substantial investment losses. More recently, the global financial crisis elevated issues such as corruption, board structure, aggressive accounting practices, business ethics, conflicts of interest, risk management and executive compensation to the top of investors’ agendas.

Although there is no shortage of academic research examining the contribution of ESG factors to excess returns in equities, the link between ESG factors and corporate bonds has not been as widely explored. However, history suggests this link exists. In cases such as Enron, WorldCom, Adelphia, Tyco, Lehman Brothers, Bear Stearns, MF Global and, more recently, Volkswagen and Valeant, shareholders were not the only ones to lose out; bondholders were also significantly impacted.



A 2015 study by Barclays Research showed that investment-grade bonds with higher ESG scores outperformed those with lower ESG scores between 2007 and 2015.⁷ And while all three pillars contributed, perhaps not surprisingly, governance emerged as the strongest contributor of the three. It makes intuitive sense that bonds in the high yield market are more susceptible to governance failures given that the underlying companies are typically smaller and more levered. To prove the link to high yield bond returns, MSCI ESG Research (MSCI), a top-rated provider of independent ESG data and analysis, conducted its own internal study and found that, in 2015, high yield companies with low MSCI governance scores fared much worse than companies with higher scores. The study showed that, for non-commodity sectors, the best-in-class companies by MSCI governance score returned +4.2% versus -3.1% for the worst-in-class companies, suggesting that governance ratings had a material effect on high yield bond returns, at least in 2015.⁸ The difference was even more pronounced when including commodity sectors, which significantly underperformed last year. Case in point: governance challenges at Volkswagen and Valeant just this past year coincided with spreads widening by up to 220 and 490 basis points, respectively, within one month of the event.⁹

For more information on the role of governance in credit analysis for high-yield bonds, refer to our first quarter ESG commentary, [Good Governance is Essential to Good Performance](#).

Regarding the remaining two pillars of ESG, a number of studies have explored environmental and social factors and their relationship with corporate credit, and this growing body of academic work lends further credence to the notion that ESG factors and bond performance go hand in hand. Corporate issuers with major environmental concerns find it more difficult to access debt financing and generally have higher borrowing costs (on average, 20% higher) and lower credit ratings than issuers with environmental strengths.¹⁰ In times of stress, this reduced financial flexibility could prove challenging as companies struggle to maintain operations. Studies on social issues yield similar results: issuers with poor employee relations, weak benefit programs, and health and safety concerns generally have a higher cost of debt than they would otherwise.¹¹ Conversely, companies that excel in these areas are at less risk of legal action.¹² In addition, they have greater success in times of financial distress due to the flexibility afforded to them by the employee “goodwill” they have created.¹³

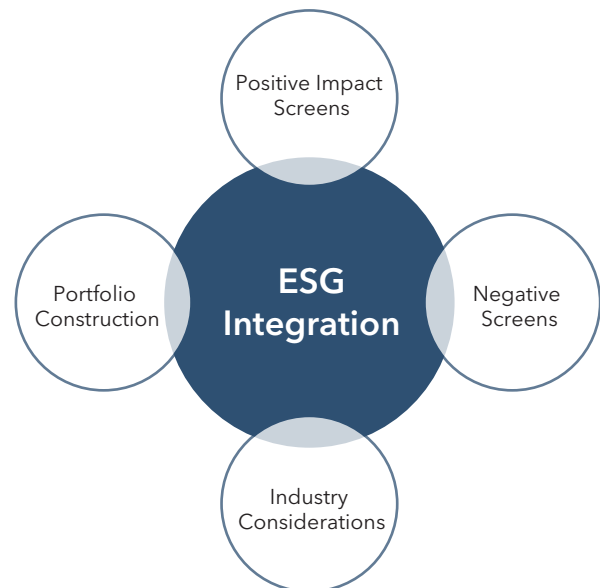
While the “E,” the “S” and the “G” may differ in terms of their specific impacts on corporate bond spreads, one thing seems clear: issuers that are deficient in any one of these three areas open themselves up to the potential of increased credit risk. Because many of these factors—especially those related to environmental and social issues—are not addressed in traditional credit analysis, we believe integrating ESG factor analysis into the management of high yield bond portfolios can be an effective way to reduce volatility while producing competitive risk-adjusted results.

Integrating ESG Factors Into High Yield Portfolios

Overview

Aristotle Credit’s bottom-up, fundamentally driven research process incorporates ESG factors across all of our products, with a particular emphasis on corporate governance. We go a step further in our High Yield Bond Broad ESG and High Yield Bond Faith-Based strategies. Our process consists of a dual-pronged approach and incorporates both positive ESG integration and negative screening into our analysis. We believe the amount of leverage used by high yield issuers makes bondholders a critical source of capital alongside equity owners and can provide meaningful opportunities for engagement with company management teams. This provides an opportunity to positively influence these companies from an ESG standpoint.

With industry and individual credit considerations in mind, we construct ESG portfolios that maintain key characteristics and themes present in our unconstrained High Yield Bond strategy. An emphasis is placed on investing in companies that provide the greatest transparency and higher ESG-rated companies will be substituted whenever reasonable. We also subscribe to MSCI ESG Research, which we have fully integrated into our internal research process to help us identify and select the highest ESG-rated companies while striving to achieve superior risk-adjusted returns.



Positive Impact Screens

ESG factors are integrated into our fundamental credit research process in order to select credits that meet our investment objectives while aiming to provide the greatest positive ESG impact on the portfolio. Our focus is on investing in companies that provide transparency on material ESG data, possess higher ESG scores relative to their peers and show the propensity to improve ESG disclosure and scores. By investing in this manner, we are encouraging ESG best practices within our investable universe.

Negative Screens

We believe that select industries and individual credits should be avoided to enhance the positive ESG impact of the portfolio. Examples of excluded industries and issuers include coal miners, oil sands E&P companies and producers of tobacco or tobacco products. These select industries are prohibited, as they are deemed to cause great harm to human life or the environment and can be replaced by viable substitutes that perform similar functions, but in a more ESG-positive way.

Industry Considerations

The energy industry provides a particular challenge to ESG investing given its material environmental impact and the fact it cannot be substantially eliminated or substituted, as it represents an economic and societal necessity. It also accounts for a material component of the high yield market (15% to 20% over the last several years until recent oil price declines). Therefore, we believe it is most responsible for the High Yield Bond Broad ESG strategy to limit the industry allocation relative to the benchmark while favoring credits with higher ESG scores. Whenever possible, we look for energy companies that disclose more ESG information and have solid governance practices, favorable labor relations, demonstrated efforts to contain their environmental impact, and peer-leading safety records, among other considerations. We believe investing in this manner can positively influence companies that may otherwise be ignored by solely relying on negative screening.

Portfolio Construction

Our portfolio construction process starts with the High Yield Bond strategy's unconstrained model and optimizes it according to our internally developed ESG guidelines. The main goal in this optimization is to construct an ESG-centric portfolio that maintains the key characteristics and themes present in the unconstrained model, including but not limited to broader quality and maturity themes, economic outlook, regulatory themes and M&A trends. If a credit is excluded due to ESG considerations, to the extent possible, substitutions will typically possess similar characteristics, including industry classification, financial metrics, risk characteristics, geographical sensitivities, underlying business trends and bond structure.

Aristotle Credit & UN PRI

In early 2005, the United Nations (UN) Secretary gathered a 20-member investor group to develop a framework of best practices to help asset managers incorporate ESG issues into their investment processes. With the goal of encouraging companies across the globe to engage in socially and environmentally responsible business practices through wider adoption of ESG investing, the Principles for Responsible Investing (PRI) were launched in April 2006.¹⁴ Aristotle Credit became a signatory in 2015.

As a signatory of the UN PRI, Aristotle Credit is committed to upholding the six principles as follows:

Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.

We incorporate ESG factors into our process across all of our strategies and go a step further in our High Yield Bond Broad ESG and High Yield Bond Faith-Based strategies, placing additional emphasis on selecting issuers with greater transparency and higher ESG ratings to enhance the positive impact of the portfolios.

Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.

We believe the amount of leverage used by high yield issuers makes bondholders a critical source of capital alongside equity owners and can provide meaningful opportunities for engagement with company management teams. This provides an opportunity to positively influence these companies from an ESG standpoint.

Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

We believe the second and third principles go hand in hand, as our process also encourages businesses to be more transparent in disclosing ESG-related data. By integrating ESG factors with traditional credit analysis, we believe we are encouraging ESG best practices within our investable universe.

Principle 4: We will promote acceptance and implementation of the principles within the investment industry.

We promote acceptance and implementation of the principles by communicating our investment process and adoption of the UN PRI to the investment community. We also publish commentaries specific to ESG to highlight the positive impact ESG research can have when integrated with traditional credit analysis.

Principle 5: We will work together to enhance our effectiveness in implementing the principles.

Our investment committee meets regularly to review the effectiveness of incorporating ESG factors into our investment process, as well as to set specific ESG guidelines for the firm's High Yield Bond Broad ESG and High Yield Bond Faith-Based strategies. Through the annual reporting framework, we receive feedback directly from the UN PRI regarding implementation and reporting of our ESG investment process.

Principle 6: We will each report on our activities and progress towards implementing the principles.

We adhere to the sixth principle by participating in the UN PRI reporting framework, an annual disclosure which makes public our process for ESG integration and assesses the progress we are making in implementing, reviewing and enhancing that process.



Conclusion

As discussed throughout this paper, there is a growing body of evidence establishing a link between ESG factors and corporate bond performance. We believe it is important to consider these factors throughout all stages of the investment process due to the higher borrowing costs, reduced financial flexibility and greater credit risk associated with ESG-deficient issuers. Therefore, our process integrates ESG research and traditional credit analysis in an attempt to identify bonds that meet our investment objectives and provide the greatest positive ESG impact on the portfolio. We believe this integration can lead to improved risk-adjusted returns while also encouraging companies within the high yield market to adopt responsible business practices.

¹Boston College Center for Corporate Citizenship, "Profile of the Practice 2013," 2014.

²Alison Smith, "Fortune 500 companies spend more than \$15bn on corporate responsibility," *Financial Times*, October 12, 2014.

³Boston College Center for Corporate Citizenship, "Profile of the Practice 2013," 2014.

⁴Cone Communications, "2015 Cone Communications Millennial CSR Study," September 2015.

⁵Global Sustainable Investment Alliance, "2014 Global Sustainable Investment Review," February 2015.

⁶Based on information gathered from US SIF and eVestment.

⁷Albert Desclée, Lev Dynkin, Anando Maitra and Simon Polbennikov, "ESG Ratings and Performance of Corporate Bonds," Barclays Research, November 2015.

⁸Linda-Eling Lee, Matt Moscardi, Laura Nishikawa and Ric Marshall, "2016 ESG Trends to Watch," MSCI ESG Research, Inc., January 2016.

⁹Based on the option-adjusted spreads of senior five-year bonds observed one month following initial announcements by U.S. regulators (September 18, 2015 and October 15, 2015).

¹⁰Sudheer Chava, "Environmental Externalities and Cost of Capital," *Management Science*, Vol. 60, Issue 9, September 2014, pp. 2223-2247.

¹¹Gregory D. Kane, Uma Velury and Bernadette Ruf, "Employee Relations and the Likelihood of Occurrence of Financial Distress," *Journal of Business Finance & Accounting*, Vol. 32, No. 5-6, June 2005, pp. 1083-1105.

¹²Rob Bauer, Jeroen Derwall and Daniel Hann, "Employee Relations and Credit Risk," *SSRN Electronic Journal*, October 2009, DOI: 10.2139/ssrn.1483112.

¹³Kane, Velury and Ruf, pp. 1083-1105.

¹⁴<https://www.unpri.org/about>

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