ESG opportunities within high yield

ESG considerations are a core part of the investment process of Artemis' global high yield bond strategy – as can be said for many of their competitors. But co-manager Jack Holmes argues that ESG investing must look beyond sustainability ratings and exclusion lists to be meaningful. He sets out why the team's ESG integration approach helps them to unlock attractive opportunities often overlooked by others.

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19 April 2022

In our last article we discussed the benefits of a high-conviction approach and referenced the benefit to ESG integration. In this piece, we are going to touch on what this looks like in practical terms within the Artemis Global High Yield funds

Negative screening

ESG considerations are a core part of our investment process. We start with a list of excluded areas ('negative screening'). We spent a long time considering whether exclusion lists were right for our strategy, given our index-agnostic, unconstrained approach. We came to the conclusion that there were areas we simply would not invest in, and it made sense for us to disclose them[1] up-front to investors. It also fitted in well with our investment process, in which we are not aiming to either cover or invest in every issuer within the index. There are over 4,000 bonds in the global high-yield bond index, and our portfolio holds between 60 and 100 securities. By excluding a number of industries at the start, it helps us to focus our analytical efforts on the areas where we believe we can add meaningful value.

Our approach versus index-led funds

This approach also shows how our high-conviction portfolio can benefit where index-led funds cannot. Put simply, excluding c.15% of the over 4,000 issues in the global high yield bond market because they face significant ESG issues does not materially impair our ability to select a portfolio of 60-100 securities. However, if you are an index-led investor it does meaningfully weaken your ability to perform – because that 15% is a vital part of the risk profile of the index (not least because it broadly tends to be from particularly high-beta sectors, such as energy).

ESG ratings

ESG investing needs to go further than just using exclusion lists in order to be meaningful. Many of our competitors use ESG ratings provided by third parties (the largest two being MSCI and Sustainalytics). They then focus their investment on companies that are highly rated and avoid those that are poorly rated.

However, we see four major problems with this:

1. Third-party ratings are formulaic 'box-ticking' exercises. MSCI, for example, covers almost 10,000 companies. In order to do this, it needs to have a standardised process to decide on ratings. But every company is different. ESG issues are inherently non-standard, and are skewed towards qualitative – rather than quantitative – factors. None of these fit well within a standardised, automated approach.

2. These ratings are largely tailored to equity investors: they tend to focus on board independence and voting rights, which are of less interest to bondholders. They also ignore bond documentation and management's views on their responsibilities to debtholders, both of which are obviously very important to investors in bonds.

3. They tend to be backwards looking. Due to being formulaic and standardised, third-party ratings use backwards-looking data. This means they miss looking forward. The problem was demonstrated in the case of WireCard, which had median ESG ratings from MSCI and Sustainalytics in 2020 when it collapsed under a fraud investigation.

4. Coverage is limited. Because third-party ratings tend to be provided for equity holders, unlisted companies (such as private equity and family owned companies, which make up a very significant part of the high yield market) tend to not be covered.

We believe many high-yield investors use third-party ratings simply because it is the only possible way to get data for most of the hundreds of companies within their portfolio. By instead focusing our efforts on a small selection of credits (we have on average held 70 securities in the fund), we can conduct qualitative, in-depth research to fully integrate ESG into the investment process.

Our process has three key elements:

- **Focus our energy: we believe the transition to a low-carbon future is both the most pressing matter we can influence and also the most impactful factor within high-yield market fundamentals.** So we focus our efforts here. We have a formal target of having a lower carbon intensity than the wider index, but this is only a small part of our approach. We will of course incorporate consideration of Social and Governance factors within our investments. But we believe the capital intensive and high emission nature of much of the high-yield market makes environmental factors the most vital part of our ESG analysis.

- **Intertwine our ESG analysis within our analysis of other factors, such as business fundamentals, market structure, and financial statements.** We need to consider how ESG factors are going to affect the ability of our companies to meet their coupon and debt repayments. Only in this way can we achieve truly sustainable cash flows, which we believe are vital to a high yield strategy.

- **Identify both threats and opportunities from ESG factors within the market.** High yield is inherently a downside-focused market (for the simple reason that a best-case scenario for us is that a company pays us back in full while a worst case scenario is a total loss of investment). Yet we believe that ESG can help unlock some positive opportunities as well as providing an improved lens through which to consider risk.

Adient

As an example of a positive opportunity, one of our largest investments over the last few years has been in Adient, the world's largest producer of car seats. MSCI rate Adient on the second-lowest possible ESG rating (out of seven possible levels) because, as an auto parts company, they regard Adient's lack of a clean-tech department as a risk in a market that is transitioning towards electric vehicles.

While this analysis makes sense for a business that produces parts for petrol engines, it makes less sense for a maker of car seats, which electric cars also need. Indeed, further analysis would show that a need for electric vehicles to incorporate lightweighting (to offset the greater weight of the battery within the car) and having heated seats (as, unlike a petrol engine, the car's powertrain doesn't generate a significant amount of heat itself) are actually higher-margin opportunities for Adient. So while the box-ticking approach may suggest risks, in-depth analysis and ESG integration show not only the absence of risk, but also the significant opportunity.

[1]These consist of producers of tobacco; producers of weapons; thermal coal producers and power generators; nuclear energy providers; hydraulic fracturing oil & gas companies; Arctic drilling; and companies that have breached the principles of the UN Global Compact. You can find more detail about our investment policy and risk on the fund page

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Manages:
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Jack co-manages Artemis' 'global high yield', 'high income' and 'monthly distribution' strategies

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