LM CAPITAL GROUP

30TH ANNIVERSARY 1990-2020

by Patrick Faul, CFA, FRM

Director of Research

LM Capital's Approach to ESG Integration

LM Capital Group, LLC recognizes the importance of environmental, social and governance factors (ESG) and their potential link to value creation for our clients. In order to understand the financial risks facing a bond issuer, it is necessary to have a comprehensive understanding of the ESG risks that they face.

Risk Analysis Through an ESG Lens

We view our risk analysis as being a mirror of an issuer's Enterprise Risk Management (ERM). If a company is well managed, we expect them to have identified the same risk issues that we identify. If we identify a material risk that the issuer has not identified and mentioned in regulatory filings, we would consider this to be a signal that it has an inadequate ERM. An inadequate ERM is itself a risk factor.

Each of these risks have probabilities and impacts that vary across time. This variance across time is particularly important in differentiating among risks facing different issuers and different maturities of the same issuer. Our investment team weighs the risks facing different issuers, and among an issuer's bonds, to identify attractive relative values among bonds in the marketplace. For a given ESG risk facing an issuer, we may be willing to hold a one-year bond, but not a 30-year bond.

One important point to make is that risks have both a range of probabilities and a range of financial impacts. Generally speaking, lower rated issuers are more vulnerable to negative ESG events that have equal probabilities across different issuers. The exhibit below is from a Moody's Rating Methodology for the packaged goods industry. The factor weightings remind us that credit ratings are not all about balance sheets and credit ratios. A packaged goods company that has fifty factories will, all else being equal, tend to have a higher rating than a company with the same credit ratios, but only three factories. Credit ratings provide a very good proxy for vulnerability to negative risk events, including negative ESG events.

Global Packaged Goods Industry

Broad Rating Factors	Factor Weightings	Rating Sub Factor	Sub-Factor Weighting
Scale and Diversification	44%	Total Sales (USD Billions)	20%
		Geographical Diversification	12%
		Segment Diversification	12%
Franchise Strength and Potential	14%	Market Share	7%
		Category Assessment	7%
Profitability	7%	EBIT Margin	7%
Financial Policy	14%	Financial Policy	14%
Leverage and Coverage	21%	Debt/EBITDA	7%
		RCF/Net Debt	7%
		EBIT/Interest Expense	7%
Total	100%	Total	100%

Market Mispricing of ESG Risks Associated with Political Governance Risk

As we assess the probabilities and financial impact of negative events, it is important to recognize that we are not saying that something negative will necessarily happen. We are saying that we believe the market underestimates the probability and/or financial impact of a negative event. For example, Moroccan fertilizer company, OCP SA, is 94% owned by the Moroccan government. The offering documents for their bonds do not mention that a substantial portion of their operations are in a territory that is not internationally recognized as being part of Morocco. There is a separatist movement seeking sovereignty over the territory, commonly known as the Western Sahara. Based on credit spreads, it appears that the bond market dismisses the risk of independence of the Western Sahara as being very close to zero. We don't know if there is a 3% chance of independence in the next five years or a 10% chance of independence in the next twenty years, but we do not think the chance is almost zero. If we avoid investing in OCP, we are not saying that we think the Western Sahara will achieve independence. We are saying that the bond market is underestimating the probability and/or financial impact of Western Sahara independence.

Another aspect of LM Capital's approach to ESG risks is to avoid issuers from countries that lack the "rule of law". A shorthand way to explain this avoidance is to say that we do not truly own anything that can be taken away from us by a capricious ruler. We believe that issuers from countries that lack "rule of law" pose unacceptable risks. The most prominent countries that we currently avoid are China, Russia and Turkey. We would note that this list is not engraved in marble at the entrance of LM Capital. We have invested in these countries in the past and we hope to invest in them again, when their political situations change.

Implementation and Tools

We currently engage in negative screening. On behalf of individual clients, we subscribe to and adhere to many standards regarding our investment decisions, including restrictions in companies that do business in the Sudan, Northern Ireland and Iran, among other countries. We also screen investment choices for their involvement in the production of tobacco and firearms, as well as monitor our current investment holdings for Green or Sustainability Impact bonds.

We consider ESG research to be a mandatory part of our fundamental credit research process and use tools that are well-known to the ESG community. Some of the tools we use to identify ESG risks are subscriptions to RepRisk and MSCI's ESG Manager. We also use SASB's Materiality Map to help identify material risks across different industries. There are well-known shortcomings to the rankings and scores of issuers that lead us to hesitate to use the top-line rankings and scores themselves. A primary shortcoming is that the scores and rankings are designed for equity investors, not fixed income investors. Because of this, we use the underlying information from the ESG rating providers in our investment process. The ESG rating providers provide a great deal of important information that is not provided by traditional research firms.

Risk Over Different Time Horizons

One aspect of our attention to ESG risks is the examination of the long-term implications of social costs. The issue highlights the time horizon difference between fixed income investors and equity investors. Consider the social costs of carbonated soft drinks and the way that these costs are spread across society and individuals who do not consume soft drinks. Looking forward, we anticipate that society will attempt to push these social costs back onto producers and consumers. The long-term implications of how society treats social costs are far more important for Coca-Cola equity investors than for an investor looking at a three-year bond. Also, those long-term implications are far more important for an investor in a thirty-year Coca-Cola bond than for the three-year note.

One tool that we have developed to standardize our approach to these risks is our ESG Assessment matrix. Our matrix identifies whether there appear to be material E, S or G risks that pose material risks to the issuer. In addition, we assess other factors that assess an issuer's vulnerability to those risks. A company with high business diversification, high geographic diversification and high credit ratings will tend to be better insulated from ESG risks. We have not yet been able to apply this across all issuers on our Approved List, but it is a work in progress.

JP Morgan Chase & Co.
Credit Ratings A2/A-/AA- ESG Assessment

Materiality

	Short-term	Medium-term	Long-term
Environmental			
Social			
Governance			

Issuer Risk Factors

	Low	Medium	High
Business Diversification			
Geographic Diversification			
Vulnerability (Ratings)			
Emphasis on Sustainability (1-10, 1 being low)		6	

The primary responsibility for assessing ESG risks falls upon the members of the Research Department and their work on the Approved List. However, it is imperative that Portfolio Managers understand the important time dimension risks that apply for issuers on the Approved List.

Performance Impact of ESG Integration

We have not yet been able to deconstruct ESG factors from our investment performance and are not hopeful that we can ever do that over a short investment period. We are inclined to believe that the benefits of ESG Integration will appear as part of security selection in our performance attribution and that we may be able to extract the ESG factor only over the long-term.

Outlook for ESG Integration

It has become apparent to us that there has been a change in the last few years in how mainstream investors think about ESG Integration. There has been a huge shift in the willingness to think of investment risk through an ESG lens. The best example of this shift is the language that the credit rating agencies use to discuss the impact of the COVID 19 pandemic. Over and over again in rating downgrades, the agencies cite the effects and impacts of the pandemic as social risk.

Yet, in 2014, Moody's was fighting a shareholder proposal that their Board of Directors report to shareholders an "assessment of the feasibility and relevance of incorporating ESG risk assessments qualitatively and quantitatively into all credit rating methodologies conducted by Moody's in a uniform, consistent manner across all firms, sectors, and geographies so that institutional investors can compare and contrast forward-looking credit rating analyses." Moody's won the battle, but lost the war. They are currently doing exactly what they refused to even consider just six years ago.

The lesson from this past battle is that mainstream society is changing and investors must be forward looking and anticipate continued change in the way that society views ESG risks.

Addendum:

Over the last few years, we have published several papers that give greater detail on our approach to individual aspects of ESG Integration. We hope that these papers give additional detail to the LM Capital approach. The papers are available upon request.

LM CAPITAL GROUP

30TH ANNIVERSARY 1990-2020

750 B Street, Suite 3010, San Diego, CA 92101
info@lmcapital.com | 619-814-1401

www.lmcapital.com

For more information please contact

Brenda Alfaro
Vice President -
Business Development
305-467-2191

Cheryl King
Senior Vice President -
Business Development
415-215-8882

Peter Capotosto
Vice President -
Business Development
619-814-1401 ext 110