ESG Viewpoint:
LM Capital Group

RepRisk
ESG data science and quantitative solutions

RepRisk interviews Patrick Faul, Director at LM Capital Group's Research Department

LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

1. RepRisk: Please provide some insight into your specific role at LM Capital and explain the work that you and your team do.

Patrick Faul: I am a Director in LM Capital's Research Department. I think of the Research Department's role as making sure our entire investment team understands the risks in our portfolios. As a fixed income shop, we're primarily concerned with not losing money. In this low interest rate environment, losing 20 points on a corporate bond that goes bad can wipe out the interest income from ten corporate bonds that have performed perfectly well.

One of the things that we discuss often internally is that we want to avoid low-probability, high-cost events. I think that so many of us investment analysts were taught that portfolio diversification can largely eliminate idiosyncratic risk, so we tend to dismiss these low-probability, high-cost risks. When one of these events happens in a portfolio, not only can they hurt performance, but they can distract the investment team from their usual surveillance of markets. The desire to overcome the negative event can also push an investment team to take on risks that they would normally not take. Aside from the lost money, those losses can really disrupt the smooth functioning of your investment process.

At LM Capital, our portfolio managers choose credit risk from an approved list of about 150 issuers. Sometimes, I feel like the shepherd of 150 sheep. I need to know which ones are sick, which ones have a bad leg, and which ones are prone to running off and doing something crazy and unexpected. It really comes back to just understanding the risks in our portfolios, and asking ourselves if we are getting properly compensated for taking on those risks.

2. RR: LM Capital has been a client of RepRisk since 2018. How do you and your team leverage RepRisk's ESG risk data in your daily operations, and how does it fit into LM Capital's larger mission?

PF: We use RepRisk's ESG risk data to help us understand the fundamental risks of a bond issuer. I often talk about how we are largely trying to do the same thing as the issuer's enterprise risk managers. So much risk is captured in what now falls under the "ESG risk" label. I'm overgeneralizing a bit, but issuers often have the same business risks as their peers (i.e. companies in the same industry will be exposed to a similar set of inherent ESG risks), but the little things that really give them their identity may fall under the ESG risk label. For example, many issuers have a strong, highly-paid CEO or a founder who does things their own way, with a rubber-stamp board. They often get labeled as "cowboys" which I think has both positive and negative connotations. Think Elon Musk, for example. Having been through Enron, Worldcom, HealthSouth, and Tyco, when I see that kind of governance risk, I immediately want to steer clear. But not every cowboy gets on the magazine covers. The daily-updated, rules-based ESG risk data that RepRisk provides on both public and private companies can help us understand what issuers have characteristics that we want to avoid. For most of our clients, the fixed income portions of the overall portfolios that we manage are meant to be relatively boring. We try to be boring. Let the equity managers deal with the cowboys.

3. RR: ESG risks can translate into a variety of compliance, reputational, and financial impacts. With that in mind, why is it important to have reliable, highly granular data for decision-making?

PF: The immediate answer that comes to mind is that we need to understand how the risk of issuers is changing. Sometimes the change that happens is external to the issuer, such as an issue that suddenly captures the attention of regulators and NGOs. Often, issues will be in the headlines and a careful analyst may say, “well, the market already knew about that issue and it’s baked into the price.” But actually, the new found attention (i.e. broadened exposure of that issue) changes the fundamental risks of the issuer. We need to understand trends that are affecting the issuers, and RepRisk’s dynamic, daily-updated metrics and qualitative research help us understand the changing ESG risk landscape in a comprehensive way.

4. RR: LM Capital applies negative screening in their decision-making. Will you discuss what that looks like and the importance of using risk-focused data for that process?

PF: About one third of our assets under management have some type of negative screen besides tobacco. Our clients provide us reference lists of issuers that we need to avoid, but sometimes those lists can get stale or they are incomplete. I sleep better at night knowing that I have some other way to monitor issuers for ESG risk exposure on a daily basis by using RepRisk in addition to those negative screens.

5. RR: What trends have you and your team seen in investment risk and ESG adoption over the past few years and in 2020 in particular? What trends do you anticipate for the near future?

PF: In the past few years, it is really amazing how the language around ESG in the larger investment community has changed. The community has really adopted the risk framework of ESG to examine fundamental risks. At the risk of offending those who wear Birkenstocks and eat granola, ESG was really associated with them in the not-so-distance past. Now we know that they were really just early adopters. It wasn’t too long ago that anybody who mentioned the risks of fossil fuels could count on being accused of being a hypocrite for driving a car. The idea that people who focus on ESG risks were just narrow-minded and too focused on a single issue has really changed.

One trend that I anticipate is that ESG risk profiles will govern access to capital markets. As a fixed income analyst, I really need to be careful about the bond maturities I recommend. Maybe I’m comfortable that an issuer will be able to borrow money from the bond market to repay a 2023 maturity, but I may be significantly more nervous about a 2030 maturity.

Conclusion

Patrick Faul leads the Research Department at LM Capital Group in ensuring that the investment team understands material ESG risks in their portfolio of 150 issuers. The Research Department relies on RepRisk’s granular, daily-updated risk metrics and research to identify and assess emerging risks – thereby avoiding the potential of high-cost risk events in their portfolios.

Bio – Patrick Faul

Patrick Faul, CFA, FRM, joined LM Capital Group in May 2017. Prior to joining the firm, he was Vice President, Head of Credit Research at Calvert Investments, where he led a team of credit analysts responsible for analyzing fixed income securities for prospective purchase and sale, served as portfolio manager for the firm’s high yield bond fund, and was an active member of Calvert’s Valuation Committee, Fixed Income Strategy Committee, and Strategic Accountability Taskforce. His professional experience further includes serving as Senior Treasury Analyst and Senior Investment Accountant for ICMA Retirement Corporation. A CFA charterholder and Certified Financial Risk Manager, Mr. Faul is also a member of the Association for Investment Management and Research, The CFA Society of San Diego, and the Global Association of Risk Professionals. Mr. Faul received a Bachelor of Science Degree in Economics, with a concentration in Finance, from the University of Pennsylvania, Wharton School.