The ESG Conundrum

Environmental, Social and Governance Factors for the Fixed Income Investor

Implementing Environmental, Social and Governance (ESG) factors into the investment process presents different challenges for fixed income and equity investors. Fixed income investors who use an equity investor's ESG roadmap should not be surprised when they lose their bearings.

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The ESG Conundrum

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Fixed income investors who use an equity investor's ESG roadmap should not be surprised when they lose their bearings.

Among the unique considerations for fixed income investors are the lack of ESG data on many issuers, the use of scores from equity-centric data providers, time horizons related to different maturities and the role of the issuer's capital structure on the measurement of material risks.

Developing a complete picture of the risks and opportunities facing an issuer must include an examination of ESG factors. A successful implementation of ESG factors into a fixed income investment process requires a careful consideration of these differences.

Acolytes of Benjamin Graham, Peter Lynch, John Moody and Henry Varnum Poors have long ignored or struggled with the thought of incorporating moral values and social costs into the valuation of a company's cash flows. In recent years, the investment industry has developed a consensus that incorporating environmental, social and governance risks into investment valuation is generally consistent with fiduciary responsibilities. This approach has come to be called by the general term, ESG Integration.

ESG Integration, as commonly practiced, does not exclude companies based on attributes which are not considered to be material investment risks.

Unhappy with this constraint, many institutional investors have decided that due to moral values or social costs, they will not invest in companies that have business involvement in certain sectors, such as alcoholic beverages, or political entities, such as Sudan and Iran.

The Benefits of ESG Integration in Fixed Income

One of the primary factors in the success of a company is having a comprehensive and accurate view of the risks facing that company. Companies that devote a great deal of resources to Enterprise Risk Management (ERM) should be better positioned to face challenges than more poorly prepared competitors.

In the same sense, investors who comprehensively understand the risks facing an issuer are better positioned to make proper relative valuation comparisons. The old phrase, "what gets measured, gets managed," gives a window into why this is true. Firms and investors who are poorly prepared for unanticipated challenges that arise can be expected to react poorly.

It is particularly true in today's low interest rate environment that one bad bond can ruin a portfolio. In a fixed income portfolio that has 100 equally weighted bonds earning 2% annually, a single bond dropping from $100 to $50 can wipe out a quarter of the annual income. An investor who ignores important information about issuers runs the same risk as chemistry students who only read the even-numbered chapters of a textbook. Developing a complete picture of the risks and opportunities facing an issuer must include an examination of ESG factors. Investment analysts who rely on the news feeds that appear on their Bloomberg terminals may very well miss a series of small adverse events that make it obvious that a company is poorly managed.

A company that places an importance on reducing worker injury metrics will be stressing adherence to proper processes. In mining, small missteps can be deadly and quickly mushroom into very large, costly events. That emphasis on managing proper processes reduces the financial risks facing mining companies, and their bondholders and shareholders. In fixed income, it is important to remember that credit ratings attempt to measure an issuer's creditworthiness. Part of creditworthiness is an ability to withstand adverse circumstances. Generally speaking, higher rated companies should be able to better withstand adverse ESG events than lower rated companies. At one point, BP estimated that the cost of the Macondo oil spill was $62 billion. These costs could have easily driven a smaller, lower rated peer into bankruptcy, leaving bondholders unpaid and in court hoping to get their money back. Because of BP's financial strength and size, shareholders bore the full cost of this disaster. Had this happened to a smaller, lower-rated peer, shareholders could have lost everything, bondholders could have lost everything and victims would be left suffering from uncompensated monetary losses.

For the same reason that the equity portion of a portfolio is expected to have a higher return than the fixed income portion, shareholders can stand to benefit the most and lose the most from ESG related events and trends.

Very few bondholders spend their nights dreaming of "10-baggers" On the other hand, the anchoring role that fixed income is expected to play in a portfolio can make underperformance painful.

Social Costs

Societies have long struggled with conflicts between economic activities and the associated noises, smells and pollution.

The first person who cooked food over a fire probably had neighbors complaining about the smoke. The earliest academic literature on the social costs of economic activity primarily considered the actions of neighbors and subsequent changes in the value of property rights. As the economic study of social costs and their impact evolved, the regulation of these costs has become more likely. The societal costs of smoking, obesity and climate change have made angry neighbors of many of us. Social costs were the justification for early regulation of air and water pollution and have become the justification for today's soda taxes.

The examination of the long-term implications of social costs raise a time horizon difference between fixed income investors and equity investors. The long-term implications of 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 bond.

Early socially responsible investors often avoided certain companies solely because of the social costs that companies were imposing on society, without the expectation that society would address the social costs.

One can now argue that looking at social costs as an investor is merely looking at long-term risks.

There are certainly industries in which one can reasonably argue that increased regulation of social costs will impose costs on the firm, therefore making securities unexpectedly risky. Past investors in coal companies can certainly appreciate this. Buyers of McDonald's and Pepsico securities must consider regulation of social costs into their investment process. On the other hand, changing regulations also present opportunities. Grupo Bimbo, a Mexican baked goods producer, successfully adjusted their product mix when Mexico's 8% tax on snack foods went into effect.

AN EARLY ESG OPPORTUNITY

from the Guardian, Manchester, England, February 1, 1845:

SMOKE NUISANCE.—C. W. WILLIAMS'S, ESQ. PATENT ARGAND FURNACES.—WILLIAM ROUTLEDGE, Engineer, Agent for the issuing of Licenses, 4, Town Hall Buildings, Cross-street, Manchester, respectfully begs to direct the attention of Manufacturers and others using steam power, that upwards of 400 furnaces have been altered to this smoke-preventing plan. In Manchester he can refer to parties who have used the smokeless furnaces upwards of four years.

N.B.—W. R. respectfully cautions parties against adopting any infringements of this patent.

Improved Fire Bars, Furnace Doors, &c. supplied to order.

Source: Newspapers.com

The Benefits of Looking at the World Through ESG-Colored Glasses

A careful consideration of ESG issues and social costs that are likely to be addressed in the near future by societies can frame an investment outlook.

For example, diabetes is taking an increased toll on societies and it is reasonable to think that action will be taken to address these increasing costs. According to the Centers for Disease Control, in 2012, "(a)fter adjusting for age group and sex, average medical expenditures among people with diagnosed diabetes in the U.S. were about 2.3 times higher than expenditures for people without diabetes." According to the World Health Organization, the global rate of adult diabetes has risen from 4.7% in 1980 to 8.5% in 2014.

To capitalize on this trend, one might invest in the bonds of pharmaceutical companies working to address the health and mortality effects of diabetes. Looking at the diabetes issue as one of social costs to families and societies may lead to a different approach. Using the roadmap that led to a decreased use of tobacco in the developed world, it may be reasonable to expect increased taxation and restrictions on the marketing of certain products associated with the causes of diabetes. The International Diabetes Foundation (IDF) has published a "Framework for Action on Sugar" that advocates government incentives, including taxes, and marketing restrictions and regulations.

We may also expect consumer education and awareness to cause changes in consumption patterns. The IDF framework includes the advocacy of public health campaigns to educate the public on the health risks associated with excess sugar intake.

Changes in consumer behavior due to health concerns have a precedent. It may be useful to remember what happened with "Tobacco Bonds", municipal bonds that were backed by future payments dependent on cigarette sales. Some Tobacco Bonds that were particularly sensitive to cigarette consumption trends suffered severe downgrades as consumption declined more than expected. Tobacco Bonds have become a substantial portion of the municipal high-yield market due to these downgrades.

Keeping in mind possible changes in consumer behavior, one may find better investment alternatives than a pharmaceutical company specializing in diabetes.

Companies in the consumer goods sector that are in the process of pivoting to benefit from those societal changes may prove to be a better investment.

Stakeholders with Different Needs

A fixed income investor must be aware that the ESG data providers are focused on the needs of equity investors and their coverage universe.

The companies that are covered generally do not include companies that do not have publicly listed shares. This excludes broad swathes of the fixed income market. The existence of the excluded companies raises an interesting question. The data providers are, in part, grading companies on their disclosures to shareholders. One might assume that a privately-owned company, managed by the owners, has excellent disclosure to shareholders.

On the other hand, to whom does a government-owned corporation owe a duty of disclosure? Government bureaucrats or public citizens?

The arrival of a shareholder activist is expected to positively affect a stock price and negatively affect bond prices. Stock buybacks are generally welcomed by shareholders and despised by bondholders. Rare indeed is the bond investor who cares about the process for electing boards of directors.

There is an additional issue with the focus of the data providers on the interests of shareholders: the interests of bondholders and equity-owners are often at odds.

The fact that bondholder claims on a company are limited to the amount borrowed by the company (and interest due on the borrowings) may easily lead to different definitions of material investment risks. Bondholders care about the company's ability to pay them back, shareholders care about the company's ability to pay future dividends.

It is not unusual to see a company's stock price rise or fall dramatically on a news article, while the price of the company's bonds barely move.

ESG for Sovereign, Municipal and Asset-Backed Securities

The fixed income universe also includes a wide variety of securities other than bonds issued by the for-profit corporations covered by the ESG rating agencies.

There are also bonds issued by non-profit corporations, such as universities. Sovereign bonds, asset-backed bonds and municipal bonds each have their own ESG consider-rations. For example, an investor looking at a thirty-year sovereign bond from a low-lying island nation would be remiss to ignore the risks of climate change. The same investor may want to consider governance risk by looking at Transparency International's Public Sector Corruption Perceptions Index (PSCPI).

Analysts may want to differentiate between two different types of corruption. There is the type of corruption that arises from a government that fails to recognize individual rights and property rights, and there is the type of corruption that is used to facilitate government behavior. As a manager with Emerging Market debt mandates, we have long been concerned with both country and corporate governance, particularly with regards to property rights and corruption. We avoid companies that have significant operations in countries with absolute monarchies, dictatorships or "strongman" governments.

For example, we currently avoid investments that are based in Russia (135th on 2017 PSCPI), Venezuela (169th), and Turkey (81st) but we do consider investments in Brazil (96th) and Mexico (135th). At its very core, this avoidance is based on governance risk: the fear that the government will capriciously take away property rights.

Industry allocation within a sovereign nation that is perceived to be corrupt can be used to lessen that risk. Companies that have revenues primarily from government contracts can be avoided, with a preference for companies that primarily cater to retail customers. An investor may also express a preference for companies with many customers compared to companies with only a few customers, and for companies with revenue spread across several countries compared to companies with revenue from one country.

Most careful investors also consider governance risks when considering municipal and asset-backed bonds. Experienced municipal investors know that governance risk and credit risk go hand in hand. Late financial filings and a willingness to kick fiscal issues down the road are standard governance issues that are examined by muni bond analysts, as are labor issues that are considered part of sustainability risk.

ESG risks can also be material in asset-backed securities. Governance risk in asset-backed securities was a key trigger of the Great Financial Crisis. The inability of the sponsor to manage sloppy and fraudulent underwriting led to losses for many investors. Investors in securities backed by commercial real estate loans may use LEED Silver, Gold and Platinum status of buildings as proxies for evidence of the marketability of the underlying building.

ESG Incorporated into LM Capital's Long-Standing Investment Process

LM Capital's long-standing five step investment process has incorporated many elements that are also ESG elements.

1. MATRIX CONSTRUCTION. In the first step of LM Capital's investment process, Matrix Construction, some of the elements take into account factors that are shaped by ESG risk factors. For example, the political fallout from Brazil's Carwash corruption scandal, and the corruption itself, has had a very negative effect on Brazil's economy. The ESG elements are primarily non-data elements, but there are data elements that are affected by ESG factors and to accurately predict change in the data, one should be aware of factors that have shaped the data.

2. TREND IDENTIFICATION. The second step of LM Capital's investment process is focused on Trend Identification. An important way that ESG factors affect this step is through increased regulation due to social costs. The government of China has identified the heavy social cost of pollution as a cost that must be reduced. The need to reduce these social costs are having a profound effect on the Chinese economy, particularly among the utility, energy, metals and auto sectors.

3. DURATION AND SECTOR ALLOCATION. The third step of LM Capital's investment process is Duration and Sector Allocation. Generally speaking, any effect of ESG factors on the duration allocation will be societal issues flowing through the economic factors identified in the two prior paragraphs. There are many ESG factors that affect Sector Allocation. In developed economies, the social costs of the sectors in China that are costs and trends are important in identifying sectors to avoid and sectors to overweight.

4. SECURITY SELECTION. The fourth step of the investment process, security selection, involves both issuer selection and maturity selection. The vulnerability of companies to ESG risks, and the time horizon of ESG risks, are primary risks to be considered in each part of the security selection process. As in sector allocation, identifying ESG trends can help identify opportunities, particularly relative to peers. For example, the companies that are leading the industry reaction to ESG trends are often manufacturing higher margin products that have better growth prospects than peers stuck in products lines that are becoming outdated and commoditized.

5. SCENARIO PLANNING. The fifth step of the investment process, Scenario Planning, is important in identifying the future vulnerability of portfolio holdings to sudden ESG risks. For example, one should recognize issuers that are particularly vulnerable to sudden catastrophic events. Companies that lack geographic diversification, rely on a small set of suppliers or customers and sell directly to consumers are particularly vulnerable. One can tailor issuer selection to avoid those risks for which the investor is not compensated.

An Example of ESG in Sector Allocation

The anticipation of social change, seen through the lens of ESG risk, is often expressed through an investor's sector allocation.

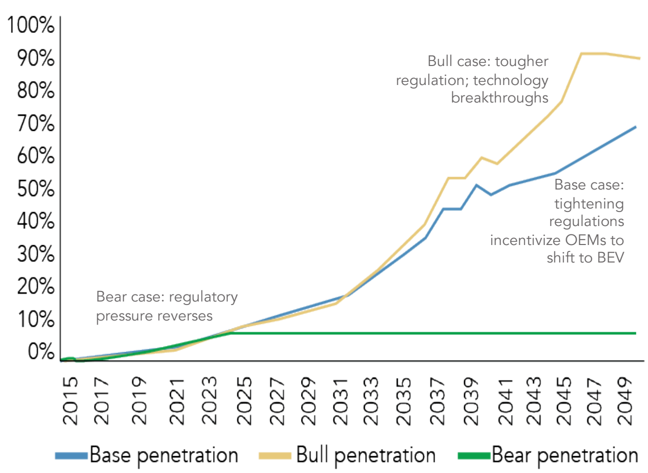
An investor's estimate of the growth rate in electric-vehicle (EV) adoption will be a major factor in sector allocation. This growth rate will have profound effects on auto parts manufacturers, auto manufacturing, utilities and the broad energy sector.

Some investors believe that adoption of EVs will continue at a moderate pace while others feel that there are factors that will accelerate the adoption. China, because of its pollution problems, is making an increased push for EVs. Many investors believe that the Volkswagen diesel fiasco will lead to fuel efficiency standards that reflect real driving conditions. This change, along with fuel efficiency regulations given Europe's reliance on diesel cars, may rapidly accelerate the adoption of EV's in Europe.

Like most careful fundamental analysts, in portfolio construction, we take ESG factors into account when making sector allocation and security selection decisions. Any competent analyst will consider environmental and labor issues for a mining company.

Our Investment Strategy Group, which oversees our Approved List, has deliberately avoided sectors and companies that present outsized investment risks due to ESG investment risks. For example, electric utilities that own nuclear reactors and companies that have significant operations prone to corruption have long been avoided.

EV SALES: A WIDE RANGE OF OUTCOMES



Source: Ward's, CAAM, Morgan Stanley Research estimates from 2017 onwards. Chart show new battery EVs as a % of total new car sales.

LM Capital's ESG Strategy

There is an old expression, "there's no such thing as a bad bond, just a bad price." The ESG Strategy rejects this expression. Significant, negative ESG events will make securities ineligible for inclusion in the investment universe, regardless of price. We offer an eight factor ESG policy to clients. The first four factors are essentially exclusionary or negative screening and are specific to the ESG strategy. The other four factors are part of our regular investment process to identify relative value opportunities.

1.EXCLUDE COMPANIES INVOLVED IN CERTAIN BUSINESS LINES or industries, as chosen by the client. For example, the client may choose to exclude issuers with involvement in the alcohol industry or fossil fuels.

2. EXCLUDE COMPANIES THAT ARE IN AN ESG "WORST OF CLASS". This is to eliminate companies that are known as bad corporate actors which a client would not expect to see in an ESG Strategy. Volkswagen AG's widespread use of soft-ware to cheat emission test-in places them in this category.

3. EXCLUDE COMPANIES WHICH HAVE A TRACK RECORD THAT DEMONSTRATES AN INABILITY or unwillingness to manage material ESG risks. We believe that such a track record demonstrates a failure in Enterprise Risk Management (ERM). For example, we may exclude Vale and BHP from consid-eration due to the dam burst near the Samarco iron ore mine.

4. IDENTIFY COMPANIES THAT HAVE SIGNIFICANT OPERATIONS IN NATIONS that present governance issues due to "rule-of-law" and potential corruption issues. We believe that such companies are exposed to significant financial and operational risks because of such operations.

5. IDENTIFY THOSE ESG FACTORS WHICH PRESENT MATERIAL INVESTMENT RISKS TO BONDHOLDERS. It is important to recognize that the dominant ESG data providers are centered primarily on the concerns of shareholders. The same concerns may not be as material to bondholders. This is where the existing LM Capital investment process adds value to the ESG investor.

6. IDENTIFY SECTORS AND COMPANIES THAT HAVE "GREEN" BUSINESS LINES that present outsized opportunities. Societal change, such as the imposition of social costs back onto their originator, may also present opportunities.

7. CONSIDER THE VULNERABILITY DEPENDENT ON THE MATURITY OF THE BOND within the bonds of a particular issuer. In general, a thirty-year bond will be more exposed to ESG risks than a three-year bond. This is in line with the normal term structure of a company's credit curve, the credit spread on a 30-year Ford bond is wider than the credit spread on a 3-year Ford bond.

8. CONSIDER, AS A PROXY FOR A COMPANY'S ABILITY TO WITHSTAND RISKS, CREDIT RATINGS FROM THE well-known credit-rating organizations. A single A rated global multi-national is probably much able to withstand a negative ESG risk event than a single B rated competitor.

LM Capital's ESG Strategy

In addition, we note that while mega-cap, investment grade, global multinationals may have extensive staffs to gather information for the ESG data providers, smaller and higher yielding companies may ignore data requests from these companies and may not feel the need to craft policies which check the boxes for the ESG data providers.

The lack of data may result in undeservedly low scores that do not actually reflect the ESG risks of these companies. In addition, ESG data providers frequently only gather information on companies which have publicly listed equities. A great deal of the fixed income universe is ignored by these data providers.

The lack of data may result in undeservedly low scores that do not actually reflect the ESG risks of these companies.

Applying a top-line, overall score of an issuer from an equity-centric ESG data provider provides little information to its fixed income securities. On the other hand, identifying material ESG investment risks and doing fundamental ESG research by using the underlying data and information gathered by the ESG data providers and applying our own internal research provides the opportunity to construct fixed income portfolios that add value to our clients.

We all know that many corporations benefit society, and many impose costs on society. The increased identification of these social costs has increased investor interest in ESG Integration. It has also increased the likelihood that bad corporate actors will be penalized by financial markets.

We believe that integrating ESG factors into the fixed income management process is prudent and necessary. And importantly, as other investors pursue ESG Integration, it has become increasingly urgent to incorporate this information into the investment process.

LM Capital Group

LM Capital Group's mission is to deliver consistent, competitive risk-adjusted returns for global fixed income investors.

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