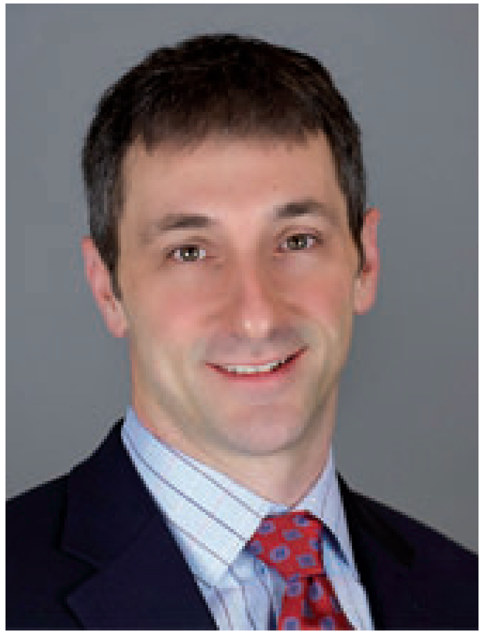
The application of ESG to high yield investing

By David KINSLEY, Head of Investing at SKY Harbor Capital Management*

As the global movement towards sustainability-focused investing has accelerated, so has the opportunity to enhance investor returns. This is not only through environmental, social and governance (ESG) risk mitigation but also through the identification of companies whose credit trends could benefit from well-conceived sustainability strategies and positive ESG positioning. We believe that companies that embark on sustainable and responsible business practices and promote diversity and inclusion, ethical governance principles, responsible use of natural resources and moderate carbon emissions are companies best positioned for the future. Over time, companies that operate with higher standards are more likely to lower financial risks, which should reduce their cost of capital, creating a virtuous investment cycle for short duration high yield investors in particular.

We recently launched a short maturity sustainable high yield bond fund designed to prove this point. It's constructed with a focus on current income, preservation of principal and low volatility as well as attention to values-based ESG factors aimed at minimizing environmental degradation and controversial activities, and promoting diversity, transparency and sustainability leadership. We weight holdings towards companies that exhibit the highest levels of relative sustainability reporting, community engagement and disclosure of ESG indicators. Aligned with European Sustainable Investment Forum aspirations, the fund excludes fossil fuels as well as munitions, tobacco, alcohol, adult entertainment and gambling sectors.

We believe this approach affords investors the opportunity to invest in the short end of the high yield credit curve, targeting low-volatility income, while limiting negative externalities associated with ESG risk factors and emphasizing companies with well-conceived sustainability strategies and positive ESG positioning.



We have chosen to benchmark the fund to a non-ESG-constrained index to reinforce our belief that investors should be able to assess the long-term impact of values-based investing. Investors need not give up investment performance to '"do good."

While there's been a good deal of ESG work done with regards to equities, robust industry standards and reliable data sources for applying ESG to fixed income are still evolving. This is even more the case within high yield, where only 50-60% of the universe has ESG data available, from both a disclosure perspective as well as third-party coverage. Additionally, roughly 45% of issuers within the high yield universe are private companies, which in general have less disclosure and transparency compared to public issuers. As a result, we believe it is important to focus on engagement.

Still, a lack of disclosure doesn't mean a lack of analysis of these issues. We would argue that long-time high yield investment managers should be some of the most knowledgeable investors in confronting ESG risks, due to the very nature of the asset class. Since the high yield market's infancy, investors have been faced with companies threatened by the risks associated with business models that lack core sustainability: companies with excessive employee pension obligations, waste contamination clean-up costs, long-tailed liabilities associated with product manufacturing and use, fraudulent accounting due to lax corporate oversight policies, and businesses poorly positioned for a digital world and rapidly changing consumer behaviors. These risks are magnified by high relative financial leverage, small scale and limited organic growth opportunities that are often characteristic of the corporate non-investment-grade issuer universe.

The DNA of our investment process dates back to these earliest days of the high yield market and has long included a holistic assessment of ESG risks and their potential to negatively impact near-term credit trends and default risk. Our co-founders Hannah Strasser and Anne Yobage have managed high yield portfolios through multiple economic markets for nearly three decades. Through this collective investing experience, our portfolio managers have seen how high yield issuers and management teams have handled some of the most formidable ESG issues. Understanding company histories in the context of today's regulatory environment and demographics is fundamental to understanding how companies will manage ESG-related risks in the future.

In alignment with the Principles for Responsible Investment (PRI) we believe the best approach is to integrate ESG risk assessment as part of a bottom-up fundamental research process, implementing systematic capture and monitoring of ESG factors to better inform risk-taking over time and identify issuers with stronger sustainability potential. Key sustainability traits to consider include governance, diversity, transparent reporting, emissions disclosure and community engagement.

Engagement is an important pillar of being an active investment manager and a responsible steward of capital. While dedicated fixed income investors have historically played a lesser role in engagement than their equity peers, we as bondholders are committed to increasing our communications with companies on topics relating to sustainability and environmental, social and corporate management. Not only does engagement help us gather valuable insights into a company's sustainability approach, but it also provides a dialogue to encourage increased disclosure and transparency, raising the overall standards of the high yield universe.

We undertake two primary means of engagement: direct company engagements and through collaborations and coalitions. Individual engagements can be triggered by an event but are generally prompted by lack of information, as transparency and disclosure of non-financial ESG information by high yield issuers has lagged investment grade or large equity issuer peers.

Company engagements may also include communication with the private equity (PE) sponsors of high yield companies. A growing number of PE firms have incorporated ESG-related practices in their own organizations, including becoming a PRI signatory, and can be a positive influence for addressing sustainability principles within their portfolio companies.

While direct engagements can be constructive, we recognize that we don't have the same influence as an equity holder and may not be able to effect change as quickly. To expand our impact, we participate in collective engagements through coalitions and network organizations which bolster our engagement power with a range of stakeholders. We've recently participated in a global initiative led by the PRI to engage oil and gas companies, which includes meaningful overlap with high yield energy companies. Engagements through the Thirty Percent Coalition give us a stronger voice to advocate for diversity in governance and senior leadership positions. As women-founded and led organization, SKY Harbor holds the advancement of gender parity and inclusion in the workplace as a core value, and we work to engage companies to better disclose their policies on this important area.

Alongside other capital managers, we have come a long way in supporting end investors in their desire to align their investment objectives with their values as they relate to sustainability goals. We believe continued evolution requires the participation of company managements as well. Through collective efforts and bespoke engagement, we can inch the universe of high yield companies towards more sustainable business models and corporate practices.

** David Kinsley, CFA, is Head of Investing at SKY Harbor Capital Management, and is the portfolio manager for SKY Harbor Global Funds–Short Maturity Sustainable High Yield Bond Fund. He has 17 years of investment experience and was previously co-head of US investing at AXA Investment Managers and lead portfolio manager for Custom Credit Strategies.*