Investment theory holds that capital flows to assets that generate superior returns with reasonably acceptable levels of risk. Analytically, risk has been interpreted to mean the likelihood of suffering negative returns. To defray risk investors seek diversification, limit their investment arena, provide guidelines to their managers and often prohibit certain investments. Regulators also intervene to protect the quality of investment products and assure the integrity of investment managers. In a world more attuned to matters affecting people's wellbeing, the investment community has begun to focus on a different type of risk. Over the last few years plan sponsors, foundations, high net worth families and other investor groups have begun to pursue investment strategies that attend to social responsibility, sustainability and thoughtful development. These investors want to influence corporate and public sector decision-making in a socially beneficial manner by allocating resources to entities that incorporate social concerns into their processes and work flow. The most commonly watched, and now measured, corporate actions relate to the environment, social practices and responsible governance (ESG). In their broadest dimensions, these three categories capture most of the elements of socially responsible investing.

For years investor groups held that protestations of a few should not be carried over to larger groups when not every member shared the objections. Generally, this was dealt with by the addition of "negative screens" in portfolio guidelines and security selection. Industries like tobacco, which increased the health care costs of employers, were often targeted for exclusion. However, a seminal effort in investor activism took hold in the 1980s with the global adoption of anti-Apartheid divestiture. While this action, widely adopted by pension funds, governments and retail investors, was still a "negative screen," it demonstrated the pressure investors could apply in transforming decision-making. Today, more investors are wielding that influence to direct investments toward companies and countries that incorporate sustainable development and social responsibility into their mindsets and work flow.

We believe institutional investors are moving toward socially responsible investment and are initiating an ESG process that can be applied to all of our strategies. Thus far, the ESG investment focus has been predominantly in equity markets of developed countries. In part, this occurred because corporations with publicly traded stock in developed economies have been pressed on these factors and willingly provided more information on their activities. Public interest led investment managers to develop strategies and research groups to propose measurement methodologies for ESG factors. Entities like index provider MSCI and market data provider Thomson Reuters, have teams of analysts who rate companies based on their ESG practices. While these companies do extensive work, ratings do not often reach many companies in the high yield and emerging markets fixed income space. This occurs, in part, because smaller companies have not adopted ESG policies and because ESG investing has not figured prominently in fixed income.

We believe entities that incorporate ESG practices into their processes and work flow tend to generate compelling financial results and, therefore, should be favored in investment decisions. In an academic research piece entitled Establishing ESG As Risk Premia, Julia L. Pollard, Matthew W. Sherwood and Ryan Grad Klobus cite a supportive study. "Kotsantonis *et al* (2016) also note that ESG factors are not currently well-integrated in investment portfolios, although companies with high ESG scores offer better long-term stock returns due to lower risks, lower cost of capital, superior operating efficiency, and rapid expansion compared to competitors."[1] Furthermore, in a separate study focusing on emerging markets equity, Sherwood and Pollard find, "In excess returns, 10 year returns, and Conditional Value at Risk,

[1] Julia L. Pollard, Matthew W. Sherwood and Ryan Grad Klobus (2018). "Establishing ESG as Risk Premia," *Journal of Investment Management*, Vol 16 No. 1 pp. 1-12.

MSCI Emerging Market indices with ESG strategy integration provide higher returns at a significantly lower risk than non-ESG MSCI Emerging Market indices."[2] Considered logically, the diligence, conscientiousness and discipline necessary to incorporate elements that may seem secondary to an efficient and cost effective work flow, suggest entities with high ESG marks are also effective in their core business. Simply put, companies that possess an ESG culture tend to be better companies.

ESG, social responsibility and sustainability have existed for years, but their wholehearted adoption has been slow and, at times, motivated by regulation. We believe the most successful companies pursue and internalize ESG because it is the right thing to do for their customers, employees and stakeholders. The challenge for investors is that ESG has many dimensions, is fraught with "judgement," sometimes penalizes companies for matters unrelated to their core activities and is difficult to apply seamlessly across industries. In addition, when investing in emerging markets, for example, decision-makers often face conflicting considerations between environmental purity and economic development.

Despite its challenges, we believe investing for social good has merit and should be pursued. We have used ESG factors in our credit analysis for years, generally as complements to our review of managements, strategy and financials. Over time, as companies and investors attach greater weight to these factors, commercial activity and social responsibility should coexist. Confident ESG offers value to investors, we decided to add ESG focused credit strategies in Global Credit, Global High Yield, High Yield and Emerging Markets Debt to our product offerings. To do this properly, we are initiating an ESG measurement process that will enable us to build globally diversified portfolios invested in fixed income securities of companies and sovereigns that meet minimum ESG qualifications.

In building an ESG investment process and measurement methodology we articulated a guiding philosophy. This philosophy was formulated around two principles that must coexist in the portfolios: return-oriented investments and ESG compliant operations. Currently, our fixed income strategies adhere to client-directed guidelines related to sectors, ratings and other risk factors. ESG portfolios will also conform to investor preferences on both traditional risk factors and ESG factors, including areas of client emphasis such as the environment or social responsibility. Based on these considerations, our ESG focused strategy will be guided by the following philosophical principles:

- To qualify for ESG, every company or sovereign must, on balance, take steps to enhance social wellbeing, promote sustainability and protect the environment through their processes, products, actions or behavior;
- ESG measurements are complementary to our credit analysis and all investments will be selected with an excess/total return mindset;
- Like other GIA strategies, ESG may be customized to fit client preferences.

In time, we expect socially responsible investment will become the norm amongst institutional investors. As early adopters in fixed income, we believe we can help influence a globally desirable outcome.

April 15, 2018

[2] Matthew W. Sherwood and Julia L. Pollard (2017). "The risk-adjusted return potential of integrating ESG strategies into emerging market equities," *Journal of Sustainable Finance & Investment.*

GIA Partners, LLC

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