ESG received unparalleled attention in 2020. A "movement" that was expanding rapidly in financial and commercial markets took on frenzied urgency as a consequence of many high-profile events. ESG factor-focused investing along with sustainable and impact investing have long been the purview of equity investors where stock ownership provides a platform for consequential activism. Fixed income has been a slow adopter for a variety of reasons, including the prevalence of government bonds and asset-backed securities among the universe of fixed income alternatives. As asset owners become more discerning about the deployment of their wealth, responsible investment is climbing in priority across all available asset classes. According to Morgan Stanley, allocations to sustainability focused fixed income funds last year were twelve times the prior year growing total assets to about $304 billion. Furthermore, citing Morningstar data, they noted that 15% of all fixed income ESG-focused funds were launched last year.[1] To complement this fast-evolving theme, index providers like J.P. Morgan and ICE Bank of America launched new ESG-focused fixed income indexes and data providers like Bloomberg expanded their coverage of ESG factors to inform investors.

We developed an ESG rating methodology in 2017 that we have been refining over the last three years. The breadth and complexity of the subject has led market participants and regulators to raise questions on the proper way to define sustainable investing, the best way to integrate ESG into investment processes and what responsibility managers have to clients regarding marketing and disclosures. Our own efforts to define the process, identify reliable data sources and settle on appropriate measures for relevant factors raised more questions than answers. From the beginning, we believed ESG would gain traction in fixed income and expect its new-found attention will lead to market-accepted definitions and practices. For now, our experience has already cemented a few valuable conclusions.

Framework and Definitions

ESG conscientiousness was well ensconced prior to the pandemic. In fixed income, the evolution of responsible or sustainable investment might be broadly categorized into three phases: negative screening, ESG focused directives and impact-oriented pursuits. These phases can also be described in terms of the evolution of investor behavior from passive to active in directing their resources for sustainability purposes. A critical consideration in this transition is the role of market participants. During the negative screen phase, the process and responsibility of each participant was straightforward. The asset owner instructed the manager, generally through guidelines or fund selection, and the owner's preferences were observed with little room for deviation. The more active phases of resource deployment are substantially more complex. ESG is broadly understood to be associated with responsible investment. However, a precise definition of what constitutes a responsible choice does not exist. Unless directed via a "positive screen," the person deciding which securities to purchase has to apply substantial judgment across a range of factors with often conflicting data from a number of self-appointed ESG arbiters. This leads to a quandary regarding how to conduct analysis and choose investments.

Investment managers build strategies across asset classes to attract investors. Whether for retail or institutional clients, each strategy is built around a process that leads to security selection and portfolio construction within a defined set of securities. Generally, the investment universe for each type of investment has well-defined criteria that allow investors to know what they are buying: large cap equity, investment grade fixed income, commodities or government bonds, for example. We believe sustainable investment should have a similar framework. Not surprisingly, managers have pursued

[1] "ESG Considerations for Fixed Income Investors," Sustainability & Global Fixed Income, Morgan Stanley. February 26, 2021.

the same paths to establish funds, although their actions appear more focused on capturing the flow of money than offering legitimate products. Managers have generally taken two approaches to offering ESG products: 1) creating portfolios within a defined universe of ESG-accepted securities (generally through an index built by a recognized indexing firm); and 2) offering portfolios with an ESG tilt which is achieved through an integrated ESG vetting process. Given the dearth of definitions, it is interesting to observe that portfolios within the ESG-accepted realm effectively cede the security selection criteria to an index provider or a self-appointed arbiter of ESG. Unlike most widely followed indexes, ESG-tilt indexes do not solely rely on objectively defined criteria. We believe that decision should reside with the asset owner or the manager, provided it is accompanied with adequate disclosure.

For example, a manager may be hired to build a global high yield portfolio. Absent specific restrictions, companies in controversial ESG industries like energy or gambling would be eligible for investment. That same mandate with an ESG tilt should include those industries, with the added responsibility of identifying the companies with the best ESG profile, even if they operate in ESG-sensitive industries. The selection of negative (or positive) screens should belong to the asset owner, and in this example, can be manifested by agreeing to the applicable ESG index or granting the manager broader security selection autonomy. This matters because just calling a product ESG compliant does not, at this juncture, deliver the investor the same composition integrity as an objectively defined asset set would.

Furthermore, we believe it is important to frame ESG's role in decision-making. For us, as a manager, ESG factors constitute risks that affect companies we analyze for investment. Clients hire us because of our ability to analyze credits, which includes risks or benefits associated with ESG. Generally, investment mandates seek high returns with low levels of risk. As fiduciaries, we are bound to work toward those objectives responsibly, including with the proper assessment of ESG factors. Since the concept of responsible and sustainable investment has taken on an "independent" track, newer mandates may have three objectives: maximize return, minimize risk and be ESG compliant. The last objective, like the first two, is the purview of the asset owner. If the asset owner does not define the ESG objective, then the manager should be in position to disclose how its approach meets the client's objectives.

Fixed Income and ESG

A commonly used benchmark for U.S. investment grade fixed income is the Bloomberg Barclays U.S. Aggregate Index. That index consists of approximately 38.4% of government bonds, 29.4% of securitized bonds (primarily agency-backed mortgage pools) and 30.6% credit. The credit portion lends itself nicely to ESG considerations because of its substantial overlap with equity. However, when thinking of applying an ESG filter to the fixed income market, proper assessment of the U.S. sovereign becomes critical because almost 70% of the index consists of government-related obligations. We developed a sovereign ESG rating methodology predominantly to inform ratings of emerging market corporate bonds. For the core U.S. bond market, though, if the U.S. sovereign ESG rating becomes the default rating for 70% of the benchmark, the total ESG score for a core bond portfolio would have little meaning.

A major U.S. mutual fund provider has the following statement in the prospectus for its ESG-focused broad market fixed income fund: - "Under normal circumstances, the Fund invests at least 80% of its assets in bonds and other fixed income-related securities that meet the Fund's environmental, social and governance (ESG) guidelines at the time of investment." So, with 70% of the Fund's universe being government-related obligations there are only two possible conclusions: 1) the U.S. government will always meet the Fund's ESG guidelines; and 2) the ESG hurdle for the portfolio is not very steep. In the interest of full disclosure, the mutual fund company uses the exact same language for its ESG stock portfolio, just substituting the fixed income section with "common stocks."

That raises the question of the proper ESG treatment for a number of fixed income securities. Asset-backed securities, commercial mortgage-backed securities, municipal bonds, bank loans, collateralized loan obligations and other instruments have typically not been analyzed in ESG terms. We believe that for an ESG rating to have meaning, at least one of the factors (E-S-G) has to be clearly identifiable and deliver a measurable benefit to society. Arguably, securities for which direct credit exposures can be segregated, ESG analysis makes sense. Securitizations provide a financial benefit to issuers, but, given the pooling of assets, there is limited value to detailed ESG analysis. Analyzing 500 mortgages in a pool or 60 loans in a collateralized loan obligation yields no useful ESG information. These limitations do not, however, negate the value of applying ESG analysis to all credit holdings.

ESG Application

Consistent with the philosophical framework expressed above, we believe it is important to integrate ESG analysis into an investment process in the same way financial analysis may be integrated. For most active managers a decision to buy or sell a security involves analysis of many factors that when aggregated point to a favorable investment outcome. Frequently, analysis is complemented with analyst judgement regarding changes a company may experience as a result of events or actions taken by management. We believe ESG should be treated the same way. Absent asset owner directives, no investment should be qualified or disqualified automatically based on their business (unless it is illegal). The scrutiny ESG-focused investors place on the controversial aspects of a company's activities surely induces it to mitigate the harmful aspects. We, for example, have a "mitigation" factor within the environmental component of our ratings to reward companies that take action to mitigate their environmental footprint. We believe companies that take action to reduce their carbon emissions should be rewarded in a manner similar to upgrading a company for disposing of a loss-generating asset. In a recent news release, a Ukrainian steel company in which we have an investment issued a statement announcing an improved Sustainalytics ESG Risk Rating. The Chairman said, "In recent years we have sought to progressively incorporate ESG into our business, and it is now an integral part of our thinking. As such, it is a particular honour to receive authoritative recognition of this, especially in relation to our peers. As COVID-19 has shown, companies that take ESG matters seriously perform better overall. Given that and the steel industry's high-risk exposure, our focus on this area will become only greater from here."

Finally, we believe managers should interpret ESG data in a consistent manner across industries and in context within industries. Many respected entities provide ESG analysis, ratings and recommendations which are often relied upon for security selection. Unfortunately, given the complexity of the subject, these entities frequently disagree on the appropriate recommendation for many companies. This is analogous to S&P and Moody's disagreeing on the credit rating of a company. As analysts, it is our responsibility to look at the same information the rating agencies have and take the investment decisions that are most beneficial to our clients. ESG should be no different. We believe, absent a client directive related to an ESG data provider, it is fiduciarily preferable to apply the internal analyst's lens to the information and make decisions that help achieve our clients' objectives.

April 15, 2021

GIA Partners, LLC

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