ESG Deepens Insights in European High Yield

How integrating ESG adds a valuable dimension to our investment process.

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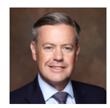
KEY INSIGHTS

- ESG factors are incorporated into the research process, serving as an important input into decision-making.
- The growing importance of ESG in Europe is having a trickle-down effect on companies.
- Seeing a greater awareness of ESG among high yield companies, the trend is on an improving trajectory.



Mike Della Vedova
Portfolio Manager

How do you think of ESG factors within your investment process?

Bottom-up research is at the heart of our approach, so to a certain extent, we have always incorporated environmental, social, and governance (ESG) factors into our investment process. The area of governance is particularly important to sub-investment-grade companies as they tend to be younger with less of a track record. They often have higher debt ratios and more complex capital structures than investment-grade companies. That's why in-depth, integrated research is so important because it is vital to understand when ESG issues could have a material impact on our investment case. Our analysts consider a range of ESG factors, including supply chain sourcing, health and safety records, and accounting standards. Additionally, they collaborate closely with our dedicated ESG specialists to ensure all material factors are considered as part of our decision-making. This dual approach really helps us to identify ESG risks, as well as gauge the potential impact of these on the company in the future. Ultimately, we are looking for long-term, improving stories, so if there is a trend of positive ESG progression, this is usually a good sign.

How important are ESG factors within Europe?

ESG has been growing in importance for some time in Europe and not just from an investor perspective. Authorities are taking significant steps, particularly with regard to the environment. The European Commission, for example, have unveiled a "Green Deal for Europe," setting out a range of environmental initiatives and targets aimed at making Europe the first carbon-neutral continent by 2050. Other significant developments include the head of the European Central Bank, Christine Lagarde, stating that tackling climate change is a "mission

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critical" priority for the bank and will form part of the strategic review into its monetary policy toolkit. There are also government-led efforts across Europe aimed at improving diversity on company boards. All these developments underline how important ESG has become in the region, and they are having a trickle-down effect on companies.

What are the ESG trends to watch in high yield credit?

When it comes to ESG considerations, high yield credit starts from a lower base than other major asset classes. That is because high yield companies are typically younger with shorter track records and less reporting history than investment-grade companies. This usually leaves more space for improvement and active engagement. It is also important to remember that a higher proportion of high yield companies are owned by private-equity firms. These typically have fewer reporting and disclosure requirements than their publicly listed counterparts. Nevertheless, we are seeing a greater awareness of ESG among high yield companies. The trend is certainly on an improving trajectory, even if the pace might be a little slower than other sectors, such as investment grade.

What is an example of ESG factors directly influencing your investment decision?

A good example of this is in relation to a North America-based pharmaceutical company that develops and manufactures a range of pharmaceutical and medical device products. In 2018, with a new management team in place, the company underwent a name change, underlining a shift in its business strategy. Under the former CEO, the company pursued an aggressive growth strategy, favoring buying established drug firms over investing in its own research and development. In 2015, however, serious concerns were raised about the company's social and governance standards, including its practice of buying established drugs and significantly raising the prices. Close ties with a specialty online pharmacy company, where executives were convicted of large-scale fraud, also damaged the company's reputation with investors, causing its share price to fall sharply. To address and move on from these controversies, the company made sweeping changes, including bringing in a new CEO and CFO. A number of businesses were sold as the company prioritized reducing its large debt burden, pricing practices were changed, and the company began to focus on its own research and development once more. These changes, and our meetings with the new management team, gave us confidence that governance standards were clearly on an improving trend. A marked improvement in overall transparency seemed to confirm this positive trend, adding to our conviction in the company.

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