

ESG Integration: A Strategic Update

Introduction

SKY Harbor is increasingly formalizing Environmental, Social, Governance (ESG) integration and analysis in our operations and strategies to enhance identification of risks in our investment process and better align with organizational values and goals. In this update, we address our ongoing work with respect to ESG integration to answer the fundamental question of authenticity: *Are we true believers?* As a follow-up to our [Responsible Investing Policy Statement](#) this report highlights SKY Harbor’s commitment and scope of work, as well as presents growing evidence for potential performance attribution and suitability for high yield fixed income. Above all, we aim to be honest about our beliefs, and genuine and transparent about future work.

Commitment and Scope

As a boutique organization, our initiatives are group efforts led by an ESG Task Force comprising individuals with primary responsibilities ranging from investment research, investment operations, client relations and marketing. In October 2015, SKY Harbor became a signatory to the Principles for Responsible Investment (PRI), formally launching our commitment and scope of work with respect to systematic ESG integration. In May 2017, SKY Harbor also became a participant in the UN Global Compact, further developing on initiatives that began with our PRI engagement. Both organizations serve as guideposts, calling attention to specific work we see as applicable to our internal operations and investment process. We value the [six Principles for Responsible Investment](#) (Figure 1), the [ten Global Compact Principles](#) (Figure 2), and [17 Sustainable Development Goals](#) (Figure 3) as important frameworks that target global challenges specific to the environment, corruption, labor and human rights, and serve as inspiration for the spirit of SKY Harbor’s integrated approach.

 <p>Principles for Responsible Investment</p>	1	We will incorporate ESG issues into investment analysis and decision-making processes	4	We will promote acceptance and implementation of the Principles within the investment industry
	2	We will be active owners and incorporate ESG issues into our ownership policies and practices.	5	We will work together to enhance our effectiveness in implementing the Principles.
	3	We will seek appropriate disclosure on ESG issues by the entities in which we invest.	6	We will each report on our activities and progress towards implementing the Principles.

Figure 1

As of March 2017, we completed our first transparency and assessment reports for the PRI, as well as participated in the “ESG Credit Ratings and Analysis” initiative focused on developing more standardized and transparent approaches to considering ESG factors in assessing an issuer’s creditworthiness. The PRI assessment report confirmed our positioning among peers with respect to ESG integration insofar as we predominantly met or exceeded expectations. Among 41 fixed income managers in our size bracket, we scored among the largest grouping of our peers. While the assessment report is not public, the transparency report is available through the PRI website as an overview of our answers to the reporting framework. More recently, in July 2017, SKY Harbor joined 389 other investors, representing over \$22 trillion in assets, in signing a letter to G20 leaders in support of the Paris Agreement, reiterating the call for governments to continue to support and fully implement the Agreement.

 <p>United Nations Global Compact</p>	Human Rights	
	1	Businesses should support and respect the protection of internationally proclaimed human rights; and
	2	make sure that they are not complicit in human rights abuses.
	Labor	
	3	Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
	4	the elimination of all forms of forced and compulsory labour;
	5	the effective abolition of child labour; and
	6	the elimination of discrimination in respect of employment and occupation.
	Environment	
	7	Businesses should support a precautionary approach to environmental challenges;
8	undertake initiatives to promote greater environmental responsibility; and	
9	encourage the development and diffusion of environmentally friendly technologies.	
Anti-Corruption		
10	Businesses should work against corruption in all its forms, including extortion and bribery.	

Figure 2



Figure 3

Beyond the formalization of ESG risk factors within our investment process to potentially enhance future returns, SKY Harbor and our 29 employees embrace the organizational and personal aspirations set forth by the Global Compact and thus, the Sustainable Development Goals. As an organization, we have committed to holding one another accountable for practicing better environmental stewardship in our workplace through purchasing practices as well as waste and resource management. We are also committed to fostering gender equality and women-led leadership, which informs our hiring practices and office culture. Further, we are on a path to becoming a certified women-owned entity, because we believe increased and higher level female participation in business can lead to greater diversity of thought, better outcomes and expansion in the global economy. In addition to our work on environmental stewardship and women’s empowerment, our firm has committed employee availability to volunteer at the Wilson Food Pantry in Stamford, CT, serving community members who struggle to provide food for themselves and their families. As SKY Harbor grew beyond our first five years and made commitments to strengthen our core values around sustainability, it was a natural step for us to look outside our workplace to have a positive impact on the local community.

An Integrated Approach Focused on Identifying Risks

Built through multi-decade experience with High Yield companies, our integrated approach serves to identify issuers that better manage ESG factors related to their businesses and their market environments. These issuers have historically maintained financial flexibility and lower default risk on a relative basis. At present, our ESG integration resides in a middle ground defined by a factors-based approach (Figure 4). This strategy serves to enhance our view of credit risk to drive better investment outcomes while aspiring to encourage socially and environmentally positive behavior. While the latter suggests an Impact or values-based approach, it is important to differentiate that we are not making ESG values-based assessments to shape portfolios. Rather, we expect issuers that use best practices in these areas to more likely be rewarded in capital markets. With respect to ESG values-based investing, we recognize that cultural and historical differences inform what defines socially and environmentally positive activities, creating variance among different investors. To that end, we are ready and available to engage on a discretionary basis with our clients to address investor-defined ESG goals.

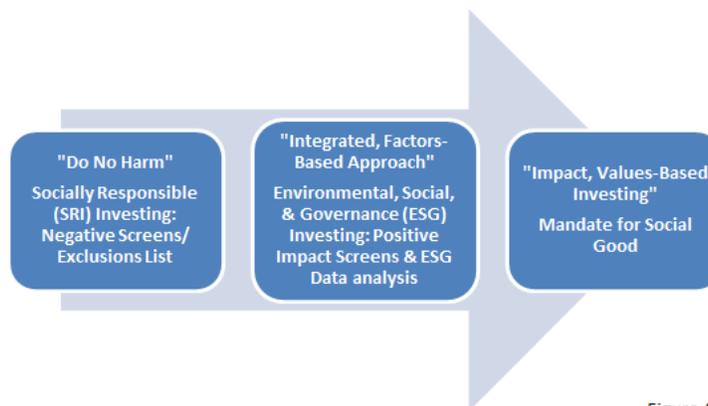


Figure 4

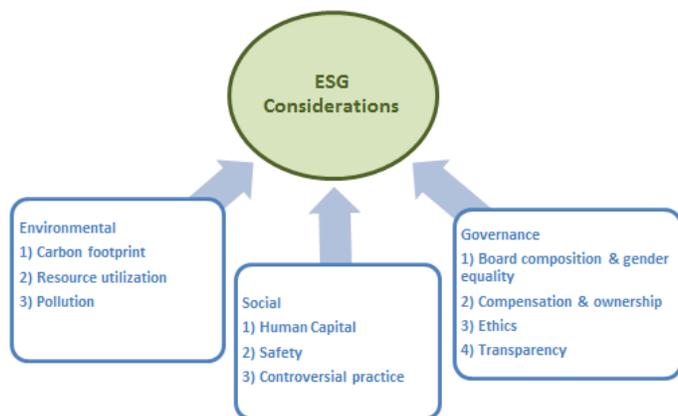


Figure 5

Across all of SKY Harbor’s product offerings, we seek complete fundamental and technical analysis of all prospective investments to inform and formulate our view of risk. For SKY Harbor, an integrated ESG investment process embodies a broader view of risk that extends beyond a company’s financial statements to include its reputation and governance principles as well its impact and relationship with the environment, its workforce, its customers and society. To that end, our approach does not seek rules-based ESG compliance, but rather a best-in-class method for evaluating issuers and portfolios.

Figure 5 depicts primary ESG considerations in the fundamental analysis of our investment process. Central to our fundamental research is a focus on companies that have sustainable business models in light of economic globalization

and the interrelatedness of capital markets which may lead to rapid shifts in financial flexibility. As such, we look for themes that both support and sustain corporate profitability and enhance financial flexibility.

With respect to our specific research process, we have added E, S and G fields to our proprietary database that analysts populate as part of their ongoing issuer assessments, which then inform credit review discussions and investment decisions. We have also integrated four external data sources into our database, including Sustainalytics Industry Ranking, Bloomberg ESG Disclosure Score, Bloomberg ESG Equity Screens and the Carbon Disclosure Project Score. While we do not use this data to exclude issuers unless specifically mandated, we incorporate it into our view of potential risks and opportunities. Finally, we incorporate these ESG risk factors within our SKYBox summaries (Figure 6), which helps identify strengths and weaknesses when analyzing a company.

The ESG portion of the SKYBox works in concert with the other themes within the SKYBox (industry, operating potential, financial flexibility) in that we score each item with a 1 for positive factor, 0 for neutral and -1 for a negative factor. The intent of the SKYBox is to help identify the dominant strengths and weaknesses of an issuer regarding these key points. While we score the sub-totals and totals for comparative purposes at times, we do not drive investment decisions based on those numbers alone, as we believe that factors can have higher and/or lower weights at any given time, depending on the market environment.

A recent example of identifying a dominant risk related to an ESG factor that led us to alter an investment action was the aluminum manufacturing company, Arconic (ARCN). Our decision to divest all ARCN holdings reflects a Governance risk related to the potential fallout from the fire that occurred at the Grenfell Tower in London in July 2017. While the aluminum materials supplied by Arconic were just one component in the cladding panels used to refurbish the tower, we believe that Arconic could be mired in endless litigation over allegations that its products were improperly applied or constructed, resulting in an unintended and potentially dangerous application. To that end, we decided to not only divest, but also withhold from investing in this issuer until we see resolution of these matters and forward remediation.

ESG Data

While issuers are increasingly reporting ESG-specific data and specialized ESG research providers are growing, coverage of the high yield debt universe is still nascent. Third-party data providers have increased coverage across the high yield universe, partially because 50-60% of the universe are public companies; however, the breadth and depth of coverage is much more limited for smaller companies. For this reason, we have been conducting an extensive search and analysis of data providers, with hopes of integrating a platform to better benchmark our research and portfolio construction process once the depth of ESG analysis improves. At this time, we integrate data from Bloomberg, Sustainalytics and the Carbon Disclosure Project that has helped our analysts familiarize with the type of information companies are disclosing outside of their financial statements and better formalize where in research reports and financial models we choose to formally incorporate that information.

Third-party providers often focus on ESG ratings that aim to answer the question of whether a company's negative externalities may turn into unanticipated costs in the medium to long term, or whether a company's deliberate sustainability measures create opportunities for long-term success. Similar to how we view traditional credit ratings from nationally recognized statistical rating organizations (NRSROs) though, ESG ratings may be static and serve as one indicator among many to categorize a credit's risk. Away from ESG ratings, other providers focus on real-time, non-company-reported data (news reports, journal articles, public research, etc.) to remove a company's inherent bias. These big datasets are then mapped to ESG criteria and weighted by materiality to formulate company rankings among industry peers. We believe these tools are gaining momentum in the industry and could serve as potential complements for an ESG integrated approach like the one we are building; however, we also recognize the shortcomings relevant to our universe. Thus, we remain focused on developments and progress third-party providers are making with respect to specific high yield coverage but maintain that the current ratings and scoring services do not yet meet our needs at this time.

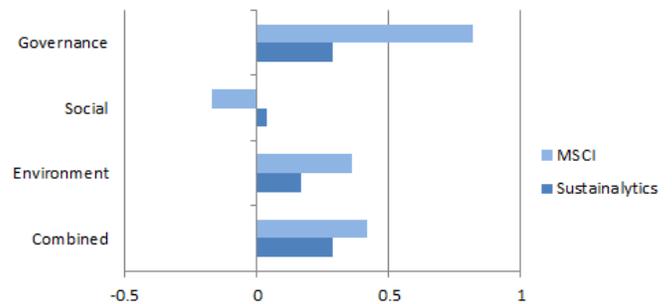
Fundamental Analysis - Industry & Issuer Level					
Industry Outlook					
Cyclical trends	1	Industry sustainability	0	Environmental impact	1
Secular trends	0	Regulatory outlook	1	Social impact	0
Industry Score				3	
ABC Co.					
Operating Potential		Financial Flexibility		ESG	
Industry Positioning		Credit Trends		Environmental	
Market potential	1	Current credit metrics	-1	Carbon footprint	1
Market share trends	1	Projected credit metrics	1	Resource utilization	1
Geographic footprint	0	Potential ratings change	0	Pollution	1
Diversity of end markets	1				
Execution Strategy		Liquidity Profile		Social	
Management credibility	1	Asset encumbrance	-1	Human capital	0
Organic growth strategy	1	Maturity & amort. schedule	1	Safety	1
External growth strategy	0	Available sources of liquidity	1	Controversial practices	1
Operating Trends		Use of Excess Cash		Governance	
Revenue	1	Growth capex	-1	Board composition	0
Margins	1	Acquisitions	0	Compensation / ownership	1
EBITDA	1	Debt pay down	1	Ethics	1
Capacity utilization	1	Dividends	0	Transparency	0
Currency exposure	0	Share buy backs	0		
Fundamental Score				17	
Operating Potential Score				9	
Financial Flexibility Score				1	
ESG Score				7	

Figure 6

Impact on Performance and the Case for ESG in High Yield

Even though the data on high yield companies is incomplete, we recognize that companies that embark on sustainable and responsible business practices that promote safety, diversity and inclusion, transparency and integrity, and responsible use of natural resources to best position themselves for the future should perform better in the long run. On the other hand, companies that cut corners and lack future-focused practices are more likely to face constraints on financial and operational flexibility, increasing the likelihood of a default event. It follows then that taking account for these ESG criteria when making security selections and constructing portfolios better positions investments to capture the risks and opportunities these factors create. In 2016, Barclays Capital published a report, "[Sustainable Investing and Bond Returns](#)," that analyzed the impact of ESG on credit portfolio performance. Barclays constructed broadly diversified portfolios tracking the Bloomberg Barclays US Investment-Grade Corporate Bonds Index, matching key index characteristics, while also imposing a positive and negative tilt to different ESG factors. They found a positive ESG tilt resulted in a small but steady performance advantage, with the strongest effect from Governance factors (Figure 7).

**Strong ESG attributes lead to better returns with IG issuers
(return difference in % per year)**



Source: Barclays Research, Sustainalytics, MSCI ESG Research

Figure 7

Bonds with high MSCI Governance scores have experienced fewer credit ratings downgrades

12-month rolling downgrade notch rates for bonds with high and low Governance



Source: Barclays Research, MSCI ESG Research

Figure 8

Further, issuers with high Governance scores experienced lower incidence of downgrades by the NRSROs (Figure 8).

While this research focuses on investment grade bonds with positive governance impact, we see how similar analysis and trends could be applied to a high yield universe, albeit more often with greater negative impact. Across our investments, ESG factors are relevant to varying degrees, and while our approach does not target any one theme, we track items that may positively or negatively affect an issuer's market value or its ability to meet its obligations.

The Basis for Being Responsible Investors

Responsible Investing and the systematic monitoring of ESG factors help illuminate an issuer's long-term viability and operational capacity—the sustainability of a company and its functions. For SKY Harbor, being a Responsible Investor is a commitment to the sustainability and integrity of markets and the people they serve by exposing drivers of, or changes to, current and future risks and opportunities. Beyond the sustainability and integrity of markets, we aspire to understand the societal and environmental impact of our investments. To that end, we see RI considerations as a growing opportunity to eventually implement a values-based investment strategy in combination with our integrated, ESG factors-based strategy.

We Welcome Customization

SKY Harbor's approach to ESG integration is rooted in a middle ground that can support customization and is adaptable to varying investor needs. We have expertise in bespoke portfolios customized for unique client objectives and constraints defined by specific ESG criteria or values. At this time, approximately half of firm assets under management are managed with adherence to some specific, client-directed values-based or regulatory compliant factors. Our pre-trade compliance order generation tool, as well as our post-trade compliance application, are custom coded for any of these guidelines or constraints and are routinely audited to ensure effectiveness. We also embrace that ESG and RI passions may vary from institution to institution and person to person. We welcome the opportunity to engage in these topics and work in a collaborative manner to build a high yield portfolio that balances these factors.

Summary

Ultimately, we embrace the ESG movement within capital markets. While we have long incorporated ESG risk factors into our fundamental analysis, we believe the formalization and chronicling of these issues creates further opportunities for us to explore. Today, third-party data providers lack robust products focused on the high yield universe, but we continue our due diligence so we may add tools once we believe they sufficiently add value to our analysis of investment risks or enhance investment returns. Our factors-based

approach to ESG integration has helped formally establish and guide Responsible Investing at SKY Harbor, and we see collaborative potential to engage with clients, specifically with respect to applying values-based screens, to enhance the impact of our investment decision making and our clients' goals. Ultimately, we believe it is imperative to pursue a RI approach that is inherently sustainable and best positioned for the future, which manifests itself not only in the investments we make, but also in how we operate as a company and as a contributor within our communities.

Further Reading

Eccles, Robert G., Ioannis Ioannou, and George Serafeim. "The impact of corporate sustainability on organizational processes and performance." *Management Science* 60.11 (2014): 2835-2857.

Principles for Responsible Investment. *Fixed Income Investor Guide*. 2014.

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