SKY HARBOR
CAPITAL MANAGEMENT

November 2018

ESG Investing at SKY Harbor: Update from the Managing Director

Since the high yield market's early wild, wild west days, investors have been faced with companies threatened by the risks associated with business models that lack core sustainability: companies with excessive employee post-retirement health benefits and 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 that were 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 SKY Harbor's investment process dates back to the earliest days of the high yield market and has long included a holistic assessment of such risks and their potential to negatively impact near-term credit trends and default risk.

SKY Harbor became a signatory to the Principles for Responsible Investment (PRI), in 2015 in recognition of the power to impact access to capital that is associated with the growing number of asset owners investing with a sustainability focus and in support of our desire to collaborate with those asset owners and other asset managers. In 2016 we formally adopted an assessment of ESG risks in our bottom-up fundamental research process. We added dedicated resources to our process in 2017 as the global movement towards ESG and sustainability-focused investing accelerated, creating, in our view, the chance to enhance investor returns through ESG-related risk mitigation as well as through the identification of companies whose credit trends could benefit from well-conceived sustainability strategies and positive ESG positioning.

SKY Harbor integrates an assessment of both the risks and opportunities associated with sustainability concepts and ESG behaviors into all our high yield investment strategies. Our analysts assess fundamental risks at the issuer level in the context of a company's industry outlook, operating potential and financial flexibility, along with certain ESG concepts using the Sustainability Accounting Standards Board's (SASB) industry-specific Materiality Map where possible. But beyond how we implement ESG factors and values in portfolios, I want our ESG initiatives to reflect our understanding that the private sector has an important role to play in achieving global sustainable development goals. In addition to the integrated ESG risk assessment that is embedded in our investment research process, we have also enhanced our engagement efforts with companies and sectors. While we encourage our analysts to engage directly with company management teams on ESG-specific criteria relating to their businesses and industries, I personally am excited by our participation in collective engagements through investor coalitions (e.g., PRI and the Thirty Percent Coalition) to engage companies on discrete but truly important topics. In a short time, we have focused on gender diversity on corporate boards, risk relating to climate change in the oil and gas sector and urging credit rating agencies to include ESG risks in their credit rating assessments. I see so much potential in these collective efforts and believe that through both the collective and our bespoke engagements we can in fact inch the universe of high yield companies towards more sustainable business models and corporate practices.

I am also excited by the launch of a dedicated Short Maturity Sustainable High Yield strategy. We believe this strategy affords investors the opportunity to benefit from our long history of investing in the short end of the high yield credit curve, targeting low-volatility income, while at the same time, limiting negative externalities associated with environmental degradation and controversial sectors and emphasizing companies with well-conceived sustainability strategies and positive ESG positioning. This strategy is benchmarked to the ICE BofAML 1-5 Yr BB-B Cash Pay High Yield Constrained Index (“JVC4”) to allow investors to assess the long-term impact of their values-based investing as well as track our success as a manager. We think it is a crucial goal to not give up investment performance to “do good.” While the exclusions and positive values-based focus creates some clear differences in security selection and industry allocation versus our long-standing short duration high yield strategy, our general risk taking is framed by our assessment of the economy and markets (using our robust and repeatable FAST process: Fundamentals, Asset Values, Sentiment and Technicals) and is aligned with our thematic risk taking where possible.

We and other capital managers have come a long way in our efforts to support capital owners in their desire to align their investment objectives with their values as they relate to sustainability goals. SKY Harbor is committed to continuing the evolution of our investment process through increased knowledge on ESG topics that are increasingly accelerating the manifestation of business risks for high yield market issuers. We look forward to engaging with our global investors as we collectively move forward.

Thank you,

Hannah Strasser, CFA
Managing Director and Co-Founder of SKY Harbor