

GLOBAL FIXED INCOME PROCESS

The philosophy and approach to environmental, social and governance (ESG) in global fixed income portfolios



Our ESG process and philosophy is embedded into our overall process for investment reasons. To us, solving the agency problem, where managers of a business have an information advantage over its principles, is fundamental. Good governance practices mitigate the agency problem, aligning owners and managers, while operating with responsible environmental and social practices bring all stakeholders into alignment.

As debt investors, it is this fundamental alignment we are interested in when it comes to the consideration of ESG factors, albeit, of course, from the angle of lenders who cannot vote, rather than owners who can. Indeed, lenders are typically not represented on the board of directors.

In our research process, we seek a high level of transparency, both in terms of historic data and the strategic direction of the company

we are lending to. Such features are usually more evident in public market businesses. As such, our fund range tends to have a high proportion of listed companies within our bond issuers. The high yield market has a greater proportion of non-public businesses than its investment grade counterpart. Notwithstanding this, our High Yield Bond Fund has been 70-85% listed (including operational subsidiaries of listed businesses) since launch.

The fact we prefer listed businesses and, within our research framework, place a strong emphasis on competitive advantage, means these listed companies typically have a high market capitalisation. This helps foster other important characteristics we look for, namely access to capital and liquidity. It also means we tend to have a quality bias in our funds, which are typically underweight the parts of the market with lower-quality credit ratings.

Central to our research process is our PRISM research framework, which consists of the following:



Two of the five pillars in PRISM relate to ESG factors, namely the 'S' and 'M'. In Sustainability, we combine internal research with that of third-party providers such as MSCI and Moody's to assess how ESG factors pertain to the investment case. With

a high proportion of listed companies, we can expect a large proportion of our holdings to be covered and rated by MSCI, giving us the ability to accurately measure ESG standards in our fund range.

Recognising there is more to good governance as it relates to creditors than may often be found in traditional ESG analysis, we add an additional layer in the Motivations section, where we explore how the alignment of interests specifically impacts creditors. For example, MSCI may not look favourably on small boards that lack independence. Yet creditors may appreciate owner-managed businesses and the care and diligence that can come with high inside ownership, alongside the natural removal of the principal-agent problem that is so common in finance. Among our issuers that are privately owned, our clients can expect a strong preference for owner-managed bond issuers versus those owned by private equity companies. Furthermore, we favour private businesses that open up to scrutiny in terms of their own ESG processes.

Environmental factors feature heavily in our process in two main ways: first, we will consider any environmental risks and resulting contingent liabilities, though we would consider this the role of any credible credit analyst; second – and something that is very specific to our process – in portfolio construction we seek to avoid accumulations of thematic risks, which can so often be found in bond indices. For example, the energy sector is a large constituent of the high yield index and companies in this sector are typically very highly correlated to the oil price, therefore can rise and fall in concert based on one exogenous factor. With the asymmetric risk inherent in the fixed income asset class, we believe investing in themes opens you up to more downside risk than upside risk, from not only defaults but also the increased risk of selling bonds at stressed prices where capital losses are crystallised.

We tend, in fact, to be significantly underweight all commodity cyclical sectors, including energy, mining, metals and chemicals. In addition to being commodity-like and cyclical, therefore making it more difficult to find competitive advantage (see ‘P’ in PRISM), these sectors can often come with greater ESG risks, and with the potential for thematic risk other than commodity price exposure to emerge. An example of this would be the risk of orphan finance

that is faced by the coal industry. Our screening process aims to exclude companies:

- Associated with controversial, civilian, nuclear weapons
- That derive over 30% of revenues from thermal coal or own thermal coal reserves
- That are involved in tobacco products (producers, distributors, suppliers, and retailers if the combined revenue is more than 5%)
- Deemed by MSCI to be non-compliant with the Global Compact and not provided an acceptable explanation or rationale (monitored by Liontrust’s Stewardship team).

Similarly, we view disruption or technological obsolescence risk as a theme we seek to minimise, and therefore have historically looked to avoid large aggregate exposures to combustion engines and bricks and mortar retailers.

Our portfolios can also invest in sovereign debt. However, we generally view bond-holder influence over sovereign borrowers as very limited so we apply an “exclusion over engagement” approach to ESG. Here, we use MSCI ratings-based exclusion. We apply the same broad principles as we do with corporate debt – our funds’ focus is mainly on G7, hard currency sovereign bonds where transparency is high and the rule of law applied in a consistent manner. Specifically, we exclude any sovereign bond where the MSCI ESG rating is lower than “BB”.

Lower-rated sovereign bonds tend to be a feature of emerging market issuers, investment in which is not a core part of the GFI fund range. Moreover, our focus is on large, liquid bonds, whereas lower-rated sovereign bonds tend to be smaller in size and less liquid than higher-rated equivalents. The GFI portfolios were launched in 2018 and have never invested in sovereign bonds of BB MSCI rating or lower.

For a comprehensive list of common financial words and terms, see our glossary at: <https://www.liontrust.co.uk/benefits-of-investing/guidefinancial-words-terms>

Key Risks: Past performance is not a guide to future performance. Do remember that the value of an investment and the income generated from them can fall as well as rise and is not guaranteed, therefore, you may not get back the amount originally invested and potentially risk total loss of capital. The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term. Investment in Funds managed by the Global Fixed Income team involves foreign currencies and may be subject to fluctuations in value due to movements in exchange rates. The value of fixed income securities will fall if the issuer is unable to repay its debt or has its credit rating reduced. Generally, the higher the perceived credit risk of the issuer, the higher the rate of interest. Bond markets may be subject to reduced liquidity. The Funds may invest in emerging markets/soft currencies and in financial derivative instruments, both of which may have the effect of increasing volatility.

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