GOOD GOVERNANCE IS ESSENTIAL TO GOOD PERFORMANCE

Over the years, investors have been made keenly aware of governance failures wreaking havoc on a company's business, resulting in substantial investment losses. More recently, the global financial crisis elevated issues such as corruption, board structure, aggressive accounting practices, business ethics, conflicts of interest, risk management and executive compensation to the top of investors' agendas.

Although there is no shortage of academic research over the years demonstrating the material contribution of Environmental, Social and Governance (ESG) factors to excess returns in equities, there are only a handful of academic articles exploring the link between ESG factors and corporate bonds. Clearly, in cases such as Enron, WorldCom, Adelphia, Tyco, Lehman Brothers, Bear Stearns, MF Global and, more recently, Volkswagen and Valeant, shareholders were not the only ones to lose out; bondholders were also significantly impacted.

A new 2015 study[1] by Barclays Research showed that investment-grade bonds with higher ESG scores outperformed those with low ESG scores between 2007 and 2015. And while all three pillars contributed, perhaps not surprisingly, governance emerged as the strongest contributor of the three. It makes intuitive sense that bonds in the high-yield market would be even more susceptible to governance failures given that the underlying companies are smaller and more levered. To prove the link to high-yield bond returns, MSCI ESG Research (MSCI), which is a top-rated[2] provider of independent ESG data and research, conducted its own internal study and found that, in 2015, high-yield companies with low MSCI governance scores fared much worse than companies with higher scores. The study showed that, for non-commodity sectors, the best-in-class companies by MSCI governance score returned +4.2% versus -3.1% for the worst-in-class companies, suggesting that governance ratings had a material effect on high-yield bond returns, at least in 2015. The difference was even more pronounced when including the commodity sectors, which significantly underperformed last year. Case in point: Governance challenges at Volkswagen and Valeant just this past year coincided with spreads widening by up to 220 and 490 basis points[3], respectively, within one month of the event.

In the case of Volkswagen, the German car manufacturer made global headlines when it admitted to installing software in its diesel engine cars to circumvent and cheat emissions testing in the United States. The willful manipulation of the emissions tests has led to a profound loss of reputation and confidence among consumers and investors alike, as well as dramatic legal costs yet to be fully realized. An examination of the board of directors at Volkswagen reveals a concerning lack of independence. The company is controlled primarily by two families that have greater than 50% of the voting rights and hold four seats on the supervisory board. The next-two largest shareholders account for an additional 37% of the voting rights and also hold two seats each on the supervisory board. The lack of independence calls into question whether the actions of the board are excessively aligned with the interests of the controlling shareholders.

[1] Albert Desclée, Lev Dynkin, Anando Maitra and Simon Polbennikov, ESG Ratings and Performance of Corporate Bonds, Barclays Research, November 2015

[2] MSCI ESG Research was awarded first place in 13 out of 17 categories in the 2015 IRRI survey, including "Best Firm for SRI Research" and "Best Firm for Corporate Governance Research"

[3] Based on the option-adjusted spreads of senior five-year bonds observed one month following initial announcements by U.S. regulators (September 18, 2015 and October 15, 2015)

Valeant Pharmaceuticals has become the subject of federal investigations into its excessive drug pricing strategies, as well as its relationship with a mail-order pharmacy called Philidor. Most recently, CEO J. Michael Pearson has been ousted, and the company has announced it will be recalculating previously reported earnings. Shares of Valeant have plummeted over the past six months, and the company missed its deadline for filing its 10-K, requiring a waiver from its lenders. When it comes to Valeant's governance structure, there are a few areas of concern. Until recently, the roles of CEO and chairman of the board were not split, giving Mr. Pearson excessive influence over the direction of the company. The company's accounting and financial reporting practices have exhibited evidence of material internal control weaknesses, as shown through the company's dealings with Philidor, as well as its history of restatements or special charges. Additionally, there are concerns over executive pay practices at Valeant, including early vesting provisions and a lack of quantifiable performance targets for the CEO, both of which fail to align compensation with good performance.

While Volkswagen and Valeant are recent cautionary tales of the consequences of weak or compromised corporate governance, there are many examples of businesses with strong governance policies established to align the actions of the company with stakeholder interests. The board of directors is the primary component of corporate oversight; consequently, the makeup of the board has large implications for the quality of internal controls in place. Independent board members allow for impartial analysis of company policies and strategies, and a board composed of a majority of independent directors reduces the risk of senior management or related parties wielding undue influence over a company. Further, the separation of the roles of CEO and chairman also helps avoid an imbalance of power, with best practices dictating the chairman should be fully independent. Companies with strong governance adopt robust accounting and financial reporting practices, which are essential to instill confidence in the health, transparency and longevity of the company.

One example of a high-yield company with such controls in place is United Rentals. 81.8% of its board is made up of independent directors, the roles of CEO and chairman have been split, and the chairman is fully independent, which is a characteristic exhibited by only 30.8% of companies in the Russell 3000 Index.[4] The United Rentals board includes an independent compensation committee, which is considered best practice for oversight of executive compensation. United Rentals is highly rated by MSCI, with an overall ESG rating of "A" and particularly high scores in Governance. Another example of a high-yield company with good governance is ExamWorks Group. Both the compensation and audit committees at ExamWorks are fully independent, and the latter contains two financial experts (as defined by MSCI). These elements of independent oversight provide a structure of corporate governance best suited to protect stakeholder interests. ExamWorks has an overall ESG rating of "AA" by MSCI,[5] placing it in the top quartile of all rated companies.

Aristotle Credit's rigorous, bottom-up, fundamentally based research process incorporates ESG factors, with a particular emphasis on corporate governance across all of our products. We go a step further in our High Yield Bond Broad ESG and High Yield Bond Faith-Based products. Our focus in these strategies is on investing in companies that provide transparency on material ESG data, possess higher ESG scores relative to their peers and/or show the propensity to improve ESG disclosure and scores. By investing in this manner, we believe we are encouraging ESG best practices within our investable universe. We also believe

[4] MSCI ESG Ratings Report for United Rentals, Inc. (URI) dated January 12, 2016
[5] MSCI ESG Ratings Report for ExamWorks Group, Inc. (EXAM) dated November 17, 2015

that, relative to larger investment-grade companies, the management teams of high-yield companies are much more engaged with bondholders, viewing them as a critical source of capital. This provides an opportunity to positively influence these companies from an ESG standpoint.

Aristotle Credit subscribes to MSCI ESG Research, which we have fully integrated into our internal research process in order to identify and select the highest ESG-rated companies while striving to achieve superior risk-adjusted returns.

PERFORMANCE SUMMARY

FIRST QUARTER 2016

The **Aristotle High Yield Bond Broad ESG – Retail/SMA Composite** returned 2.26% gross of fees (2.13% net of fees) in the first quarter. The **Aristotle High Yield Bond Faith-Based – Retail/SMA Composite** returned 2.34% gross of fees (2.21% net of fees) in the first quarter. Both strategies underperformed the 3.16% return of the Bank of America Merrill Lynch BB/B U.S. Cash Pay High Yield Constrained Index.

FULL YEAR 2015

The **Aristotle High Yield Bond Broad ESG – Retail/SMA Composite** returned –1.43% gross of fees (–1.92% net of fees) in 2015. The **Aristotle High Yield Bond Faith-Based – Retail/SMA Composite** returned –1.29% gross of fees (–1.78% net of fees) in 2015. Both strategies outperformed the –2.82% return of the Bank of America Merrill Lynch BB/B U.S. Cash Pay High Yield Constrained Index.