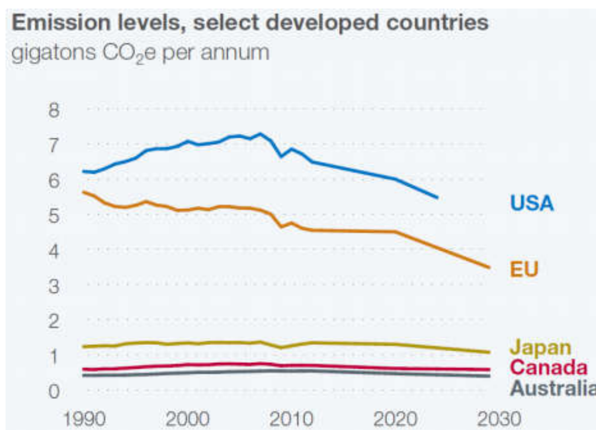
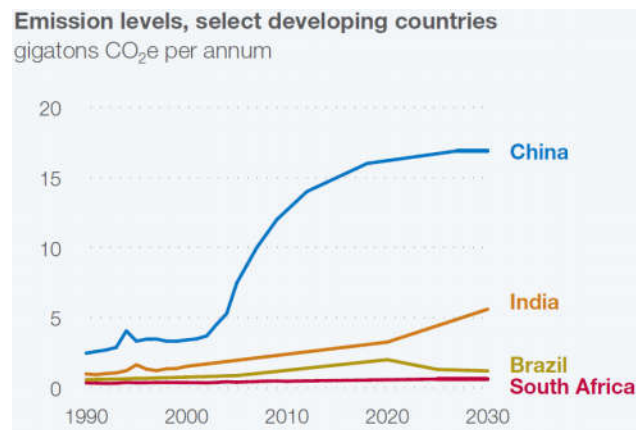
The Paris Climate Conference and Practical Low Carbon Investing for High Yield ESG Portfolios

On December 12, 2015, a landmark and unprecedented climate agreement was approved at the 2015 Paris Climate Conference, also known as COP21. For the first time in over 20 years of U.N. negotiations, a total of 195 countries agreed to work together to limit global warming to less than 2°C above preindustrial levels and aim for net zero[1] carbon emissions by the second half of the 21st century. Countries submitted documents known as Intended Nationally Determined Contributions (INDCs), which outlined national plans for limiting greenhouse gas (GHG) emissions and established a framework for monitoring, measuring and verifying emissions reductions. In addition, developed countries agreed to mobilize financial resources of at least $100 billion per year by 2020, with plans to increase their commitment over time, in order to support smaller and less-developed countries.

In the submitted INDCs, developed economies typically set absolute targets against a base year. For example, the U.S. target is a 26%-28% reduction below 2005 levels by 2025, and the EU has committed to a 40% reduction below 1990 levels by 2030. Large developing economies set GHG intensity targets per unit of gross domestic product (GDP), so as not to hamper development. For example, China agreed to lower emissions per unit of GDP by 60%-65% and India aims to lower emissions by 33%-35%, both by 2030.





Source: Environmental Resources Management (ERM) review of the COP21 INDCs

[1] The point at which CO_2 emissions have fallen to where they balance the world's ability to absorb that CO_2

This much seems clear from the various country pledges submitted at COP21: The world's major economies are planning to significantly transition away from "business as usual" emissions over the next decade, and industry will bear much of the responsibility and the cost of compliance.

That being said, MSCI ESG Research estimates that as many as two-thirds of large and mid cap companies[2] globally have not set any internal GHG reduction targets.[3] Furthermore, the top three GHG-emitting sectors—Energy, Materials and Utilities, representing approximately 84% of total emissions—appear to lag the country commitments. The Energy sector stands out as the least prepared globally, with only a small fraction of large and mid cap energy companies setting targets in line with country commitments. In fact, the vast majority of these energy companies disclosed no GHG emissions reduction targets at all. As a result, expected corporate-level emissions reductions will fall significantly short of the proposed aggregate country reduction commitments, leaving companies unprepared to meet escalating country-level targets over the next decade. These companies face greater risk of increased compliance costs associated with a patchwork of regulations in the form of carbon taxes, mandatory emissions accounting and reporting, fines, and increased capital expenditures for low carbon technologies.

According to the Climate Bonds Initiative, a nonprofit organization working to mobilize the global bond market for climate change solutions, there are $694 billion of climate-aligned bonds outstanding globally as of July 2016, including $118 billion of "green bonds" whose proceeds are earmarked for green projects.[4] In comparison, the New Climate Economy[5] estimates that $93 trillion of investment will be required across the global economy by 2030 in order to remain within the two-degree target put forth at COP21. It is important to note that the vast majority (76%) of these climate-aligned bonds are non-U.S. dollar-denominated, and only a fraction of the total (less than 6%) are below investment grade, limiting their suitability for high yield bond investors.

The Energy industry, in particular, provides a challenge to ESG and low carbon investing for high yield portfolios, given that it accounts for a material component (15%-20%)[6] of the U.S. dollar-denominated high yield market. In addition, despite its material environmental impact, it is clear that the Energy industry in its current form represents an economic and societal necessity that cannot be substantially supplanted with renewable energy in the near to medium term. Therefore, as an alternative to "fossil free" or "carbon free," Aristotle Credit believes that a practical and appropriate approach to low carbon investing for high

[2] As measured using the constituents of the MSCI ACWI Index
[3] Ankit Sayani; Laura Nishikawa, CFA; and Manish Shakdwipee, "Implications of COP21: How Do Corporate Carbon Reduction Targets Stack Up?," MSCI ESG Research, December 2015
[4] The Climate Bonds Initiative, "Bonds and Climate Change: The State of the Market in 2016," July 2016
[5] The New Climate Economy is the flagship project of the Global Commission on the Economy and Climate. It provides independent and authoritative evidence on the relationship between actions that can strengthen economic performance and those that reduce the risk of dangerous climate change.
[6] Including the Independent Power Producers sector

yield ESG portfolios may be a low carbon tilt combined with the selection of best-in-class companies with the highest ESG ratings and trends.

AES Corporation (AES)[7] exemplifies a high yield energy company that has shown improving environmental risk management metrics. While the core business still includes coal and natural gas power plants, the company also draws revenues from renewable energy sources for approximately 29% of its installed capacity. AES has shown improvement with regard to its GHG emissions intensity and its water usage intensity.[8] The majority of the water utilized by AES' businesses worldwide (94.9% in 2014) is directly returned to the source at a similar or higher quality than the raw water extracted. While AES remains exposed to the costs associated with potential carbon and emissions regulations, we believe it appears to be well positioned to expand its footprint in the renewable energy space and continues to improve its environmental performance metrics. AES has been selected for inclusion in the Dow Jones Sustainability Index (DJSI) for North America annually since 2014 and ranks in the top quartile for sustainability among all electric utilities assessed by RobecoSAM.[9] The company also receives high marks from MSCI, with a BBB overall ESG rating and a second-quartile ranking in carbon emissions, water stress and opportunities in renewable energy.

One cautionary tale of the importance of environmental risk management is Transocean, Ltd. An offshore drilling company, Transocean operates in austere environments under extreme conditions that carry significant environmental risks. The company was operating the Deepwater Horizon oil rig in 2010 when the rig exploded in the Gulf of Mexico, causing one of the worst environmental disasters in U.S. history. The financial fallout from this disaster led to billions of dollars in remediation and punitive payments. While the company appears to follow the ISO 14001 standard for environmental management systems, it does not disclose any performance statistics that would allow for greater transparency.[10] An overall ESG rating of CCC and bottom-quartile rankings by MSCI in the areas of Biodiversity & Land Use, Carbon Emissions, Toxic Emissions & Waste, and Water Stress paint a concerning picture for potential investors when it comes to how well equipped Transocean is to navigate environmental risks.

Aristotle Credit's High Yield Bond Broad ESG product utilizes a dual-pronged approach that incorporates both negative screening and positive ESG integration into our analysis. For the Energy industry, we believe it is most responsible to limit the industry allocation relative to the benchmark while favoring credits with higher ESG scores. We exclude thermal coal, or steam coal, miners given that coal-fired plants are one of the largest sources of GHG emissions. We also exclude oil sands miners, since GHG emissions for oil

[7] The above referenced securities are for ESG guideline illustrative purposes only and are not holdings in any of Aristotle Credit Partner's strategies.
[8] MSCI ESG Ratings Report for AES Corporation dated June 10, 2016
[9] RobecoSAM is an investment specialist focused exclusively on sustainability investing. It offers asset management, indices, impact analysis and investing, engagement, voting, sustainability assessment, and benchmarking services.
[10] MSCI ESG Ratings Report for Transocean Ltd. dated April 28, 2016

sands extraction and upgrading are significantly higher than they are for conventional crude oil production. On the power generation side, we exclude companies that have higher net exposure to coal-fired generation relative to peers. Data permitting, we favor credits with below-average GHG emissions, hazardous waste, environmental fines and water consumption per unit of production. Overall, we look for energy companies that disclose more ESG information and that have solid governance practices, favorable labor relations, demonstrated efforts to contain their environmental impact, and peer-leading safety records, among other considerations. We also subscribe to MSCI ESG Research, which we have fully integrated into our internal research process to help us identify the most suitable credits for our High Yield Broad ESG product.

We believe that our investment approach not only allows us to select the companies that are best positioned to measure, monitor and help meet the GHG emission targets from COP21, but that are poised to achieve superior risk-adjusted returns in our High Yield Broad ESG product.

"In all things of nature there is something of the marvelous."

–Aristotle (384-322 BCE)

Performance Summary

SECOND QUARTER 2016

The **Aristotle High Yield Bond Broad ESG – Retail/SMA Composite** returned 2.58% gross of fees (2.45% net of fees) in the second quarter. The **Aristotle High Yield Bond Faith-Based – Retail/SMA Composite** returned 2.63% gross of fees (2.50% net of fees). Both strategies underperformed the 4.62% return of the BofA 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 (BAML) BB/B U.S. Cash Pay High Yield Constrained Index.

The opinions expressed herein are those of Aristotle Credit Partners, LLC (Aristotle Credit) and are subject to change without notice. Past performance is not a guarantee or indicator of future results. This material is not financial advice or an offer to buy or sell any product. You should not assume that any of the securities transactions, sectors or holdings discussed in this report are or will be profitable, or that recommendations Aristotle Credit makes in the future will be profitable or equal the performance of the securities listed in this report. The portfolio characteristics shown relate to the Aristotle High Yield Bond Broad ESG and the Aristotle High Yield Bond Faith-Based strategies. Not every client's account will have these characteristics. Aristotle Credit reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed may not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. For a full list of all recommendations made by Aristotle Credit during the last 12 months, please contact us at 949-681-2100. This is not a recommendation to buy or sell a particular security.

Returns are presented gross and net of investment advisory fees and include the reinvestment of all income. Gross returns will be reduced by fees and other expenses that may be incurred in the management of the account. For example, a 0.50% annual fee deducted quarterly (0.125%) from an account with a ten-year annualized growth rate of 5% will produce a net result of 4.4%. Actual performance results will vary from this example. The Bank of America Merrill Lynch BB/B U.S. Cash Pay High Yield Constrained Index includes publicly registered U.S. dollar-denominated BB/B-rated corporate bonds issued in the U.S. domestic market that have a fixed coupon schedule and a minimum amount outstanding of $100 million. Allocations to an individual issuer in the Index will not exceed 2%. The volatility (beta) of the account may be greater or less than the benchmark. It is not possible to invest directly in this index. Composite and index returns reflect the reinvestment of income. Additional information regarding policies for valuing portfolios, calculating performance, and preparing compliant presentations is available upon request. Returns are presented net of trading costs. Net returns reflect the additional deduction of management fees and are based on the actual account level net returns. Performance is expressed in U.S. dollars. Aristotle Credit Partners, LLC is an independent registered investment adviser under the Advisers Act of 1940, as amended. Registration does not imply a certain level of skill or training. More information about Aristotle Credit, including our investment strategies, fees and objectives, can be found in our ADV Part 2, which is available upon request. ACP-16-117.