ESG Credit Spotlight

3Q 2016 Commentary

Wells Fargo Scandal Highlights Importance of Analyzing Social Factors

On September 8, news broke that Wells Fargo had been fined $185 million for employees opening more than two million accounts without customer consent between 2011 and 2015. In an attempt to make amends, the company has terminated more than 5,000 employees linked to the fraudulent activity, scrapped its sales targets for bankers and customer service representatives, and, most recently, announced the resignation of CEO John Stumpf. The topic has become so ubiquitous in recent weeks that one would need to sever all ties with television and the Internet to avoid headlines about the events that took place at the bank—and that still might not be enough. (Case in point: The drafting of this commentary was interrupted by a Bloomberg app notification delivering the news of Mr. Stumpf's departure.) Fixed income investors have also reacted negatively since the Consumer Financial Protection Bureau announced the fine, with spreads widening 25 basis points on the bank's shorter-maturity bonds and 50 basis points on its longer-maturity bonds. Because the story is so widely known at this point, we will not recount all of the details here. Instead, we will explore the scandal, its causes and its effects through an ESG lens. We begin with an introduction to social factors.

The Forgotten Factor

When it comes to ESG investing, it seems that many investors often fall into the routine of emphasizing environmental and governance factors while leaving the third leg in the stool—social issues—alone in the dark. While Aristotle Credit incorporates all three categories into our rigorous, fundamentally based credit research process, even we have somewhat mirrored this behavioral pattern by beginning our ongoing ESG Credit Spotlight series with pieces dedicated to environmental and governance issues. So why have we given the social edition of this series the last spot in the rotation? Perhaps it is for the same reasons that many other investors tend to de-emphasize this area in their research—the "S" in ESG can be somewhat difficult to define, it is incredibly broad and it may, in certain cases, be difficult to analyze.

On paper, social issues seem obvious. We all know the meaning of employee relations, consumer relations, health and safety, inclusion and diversity, human rights, and corporate philanthropy. However, analyzing these factors can present a challenge, as they may not be as measureable as certain environmental and governance factors, such as greenhouse gas emissions or the percentage of board members who are independent. In other cases, social factors may overlap with, result in, or stem from the other two categories. For example, a poor governance system that leads to an inequitable pay structure between executives and non-executives will almost certainly harm employee relations. Or an environmental disaster such as an oil spill will likely worsen a firm's health and safety record. While these blurred lines may complicate how one categorizes or analyzes various issues, they also demonstrate the interconnectedness of the underlying factors of ESG, and show how one must analyze all three categories to gain a more comprehensive understanding of how these factors impact the fundamentals of a company.

Scandal Rooted in Social Issues

When news of the Wells Fargo scandal initially broke on September 8, there was a visceral reaction from the press and the public alike. Both Congress and the FBI announced investigations into the bank's misconduct, and many called for CEO John Stumpf to resign—a call that was eventually answered. At the heart of the outrage was not just the fraudulent activity that took place, but the firing of thousands of lower-level employees for that fraud, which appeared to be driven by issues with corporate culture and a flawed incentive plan based on aggressive sales targets. The overwhelming majority will see the events at Wells Fargo as a governance failure. While we agree with that assertion, we believe the scandal can be analyzed on a number of social issues as well, namely employee and consumer relations.

Previous academic research has found that companies with strong employee relations generally possess higher credit ratings and, therefore, lower borrowing costs. The conclusion is a logical one—firms with sound employee relations are more likely to benefit from less turnover and higher productivity, and are less likely to fall victim to the potentially harmful behavior of unhappy employees. This can lead to more stable cash flow as well as lower reputational and litigation risks. If you have read any of the news stories about the Wells Fargo scandal, you will see an obvious connection here, as several reports have shown examples of the bank's high-pressure sales culture damaging relationships between branch managers and lower-level employees, in addition to hurting employee morale.

While the actions of the employees who opened these unauthorized accounts are inexcusable, one could argue that, by unfairly holding employees to unrealistic sales goals, the company had created a culture in which these actions were more likely to happen. At the very least, it is obvious some employees focused more on meeting sales targets than providing good customer service. To back this up with data, according to the MSCI ESG Research report on Wells Fargo (last updated June 29, 2016), the bank ranked worst for customer complaints (per dollar in assets) among the major banks in the United States. It may take time to understand the true costs of the scandal—lost revenue and costs associated with employee turnover, reputational damage and litigation—but it is clear that the company's employee relations are partly to blame.

If employee relations are one cause of the scandal, how Wells Fargo addresses its relationship with consumers will surely be an effect. Before this fraudulent activity became known, Wells Fargo was considered one of the most reputable money center banks. In fact, a list of the "World's Most Admired Companies" currently on Fortune's website places the bank at number 25, with social responsibility, people management and quality of services listed among its key attributes. However, one need only look at the MSCI ESG Research report on the bank to see that the investment-grade company possessed a below-investment-grade ESG rating (BB when the scandal became public knowledge, but since downgraded to B) due to concerns regarding various governance and social factors. There is no question the bank's brand has taken a hit. How large of a hit remains to be seen, but based on the first public statement from newly elevated CEO Timothy Sloan, one should expect the company to make significant investments to repair its relationships with customers going forward.

Aristotle Credit's Approach to ESG Investing

Our 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 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. We also utilize an ESG scoring model that analyzes companies across more than 30 factors and assigns a rating relative to each company's industry group.

"Pleasure in the job puts perfection in the work."

–Aristotle (384-322 BCE)

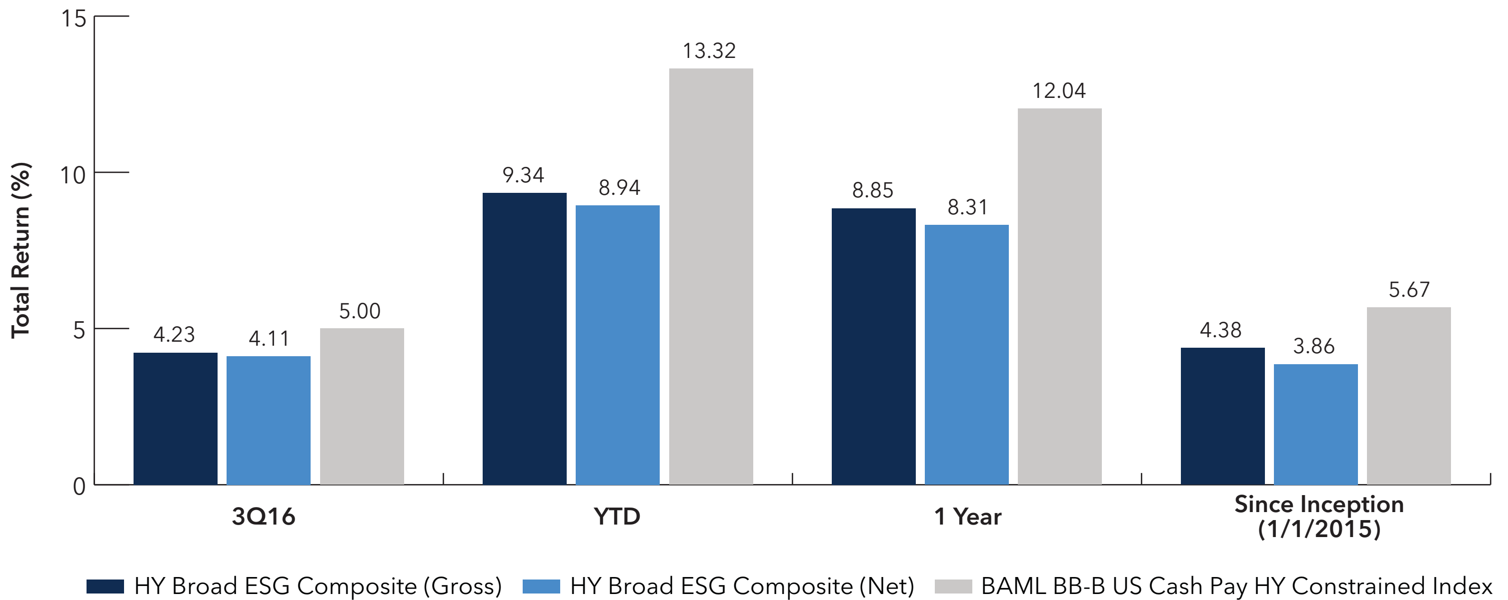
Performance Summary

Third Quarter 2016

The **Aristotle High Yield Broad ESG – Retail/SMA Composite** returned 4.23% gross of fees (4.11% net of fees) in the third quarter. The **Aristotle High Yield Faith Based – Retail/SMA Composite** returned 4.23% gross of fees (4.10% net of fees). Both strategies underperformed the 5.00% return of the BofA Merrill Lynch BB/B U.S. Cash Pay High Yield Constrained Index.

Year to Date 2016

The **Aristotle High Yield Broad ESG – Retail/SMA Composite** returned 9.34% gross of fees (8.94% net of fees) in the first nine months of 2016. The **Aristotle High Yield Faith Based – Retail/SMA Composite** returned 9.47% gross of fees (9.06% net of fees) over the same time period. Both strategies underperformed the 13.32% return of the BofA Merrill Lynch BB/B U.S. Cash Pay High Yield Constrained Index.

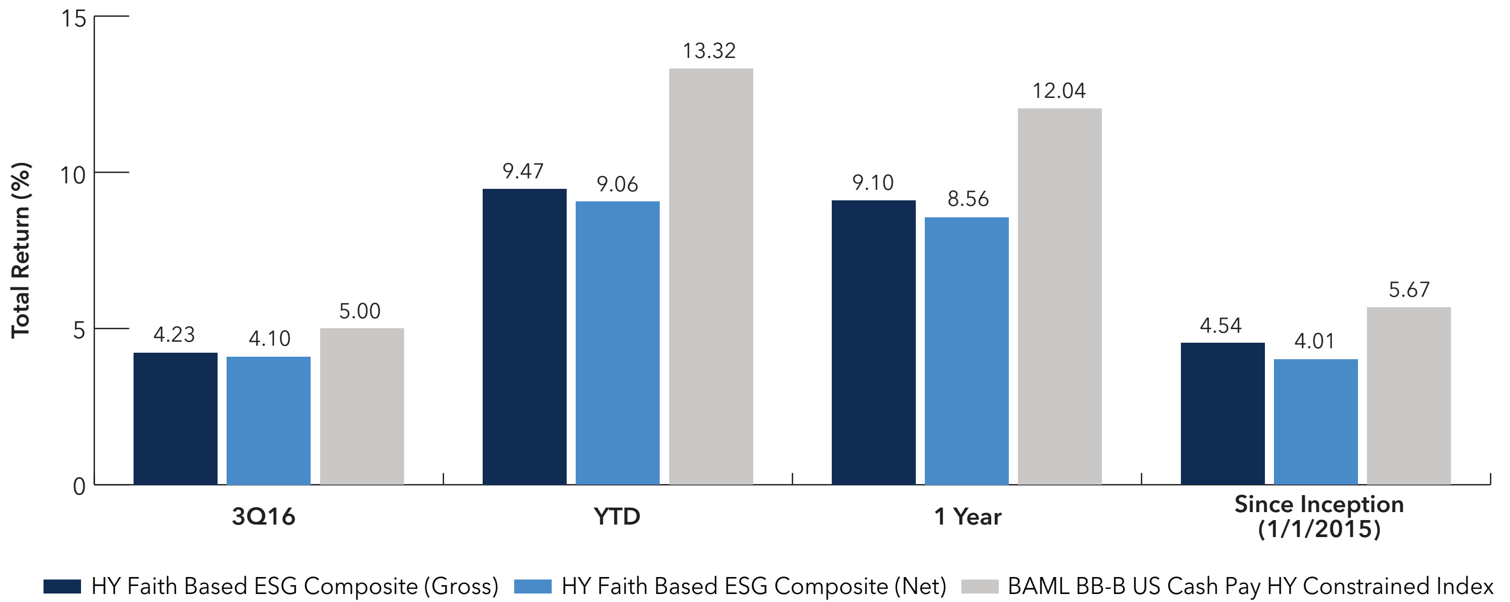


Year	High Yield Broad ESG Composite (Gross, %)	High Yield Broad ESG Composite (Net, %)	BAML BB-B US Cash Pay HY Constrained Index (%)
YTD 2016	9.34	8.94	13.32
2015	-1.43	-1.92	-2.82

Source: Merrill Lynch
Composite returns for periods ended September 30, 2016 are preliminary pending final account reconciliation.
The Aristotle High Yield Broad ESG Composite strategy has an inception date of January 1, 2015; however, the strategy initially began at Terence Reidt's predecessor firm. The returns are based on a separate account from the strategy while it was being managed at Terence Reidt's predecessor firm and performance results are based on custodian data. During this time, Mr. Reidt had primary responsibility for managing the account.
Past performance is not indicative of future results. Returns presented are gross and net of investment advisory fees and include the reinvestment of all income. Please refer to disclosure at the end of this document.

Aristotle High Yield Faith Based ESG Composite Performance

All Periods Ended September 30, 2016



HY Faith Based ESG Composite (Gross) | HY Faith Based ESG Composite (Net) | BAML BB-B US Cash Pay HY Constrained Index

Year	High Yield Faith Based ESG Composite (Gross, %)	High Yield Faith Based ESG Composite (Net, %)	BAML BB-B US Cash Pay HY Constrained Index (%)
YTD 2016	9.47	9.06	13.32
2015	-1.29	-1.78	-2.82

Sources: Bloomberg, MSCI, Merrill Lynch

Composite returns for periods ended September 30, 2016 are preliminary pending final account reconciliation.

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Composite 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 index. One cannot invest directly in the 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.

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