CONCISE CAPITAL

October 2021 High Yield Market Insights

- Investing in sustainable assets has gained significant momentum over the past two years
- A recent survey found 41% of US institutional investors consider ESG in manager selection
- Assessing HY ESG and HY non-ESG performance reveals no significant return difference
- HY ESG portfolios may struggle to access the small-cap or 144A sectors

Over recent years, momentum within the investment community and corporate boardrooms to favor sustainable investing has gained ground. Searches for the acronym "ESG," for environmental, social, and governance, in Google's Trends analytics have quadrupled since the start of 2020. Indeed, all recent investment conferences seem to include high-profile panels arguing the merits of ESG investing.

The idea of sustainable investing has been around for decades. A recent article in the "Financial Analysts Journal" cited a 40-year history of publishing articles on ESG.[1]

Today, corporate executives and buy-side and sell-side firms are falling over themselves to jump on the ESG bandwagon. An October survey by "Traditional Fund Intelligence" and "The Allocator" on current US ESG trends polled nearly 300 US investors that control just over $8 trillion in assets across foundations/endowments, family offices, public pensions, financial institutions, corporate pensions, and not-for-profits. The survey found that 41% of US investors say that ESG considerations have a material impact on their manager selection process.[2]

Does an ESG portfolio out-perform or under-perform? We try in this article to answer this question for the high yield market. Some investors argue that those companies that adhere to ESG standards will be better run and better managed, leading to out-performance. Other investors expect an ESG portfolio to under-perform, as liquidity rushes into the securities of ESG companies, bidding up prices and leading to inferior returns. Which scenario is correct, or is neither?

We start by identifying comparable conventional and ESG high yield indices. The table below is broken down into three different time frames with data that summarizes monthly and daily returns, aggregate total returns, and volatility (standard deviation). The closest conventional and ESG HY indices necessary to perform a comparative analysis without designing a custom index are the ICE BofA US High Yield Index Master II (Broad US HY) and the ICE BofA US High Yield Best-in-Class ESG Indices. In reviewing these results over time, we ask whether investors sacrifice returns to follow an ESG mandate.

In both the inception-to-date and the year-to-date time frames, we see that the Broad US HY index fractionally outperformed the Best-in-Class index based on median monthly returns, though with slightly higher volatility. From a total return perspective, Best-in-Class is better within the inception-to-date period, but inferior year-to-date.

The year-to-date and inception-to-date time periods reveal inconsistent, marginal alpha. Does ESG provide downside support during a period of duress? Do "non-ESG friendly" sectors sell off more than "ESG friendly" sectors? The data rejects this hypothesis. While the Best-in-Class index outperformed on a total return basis during the March 2020 market swoon, due in part to the 92 basis point underweight in the CCC group and its overall better credit quality, the Broad US HY market had a less deep median daily drawdown, though at a higher level of volatility.

[1] Environmental, Social, and Governance Issues and the Financial Analysts Journal (Aug, 18, 2021).
[2] US ESG Trends 2021 - The latest views from US allocators on the impact ESG has on their fund manager selection process (October 2021)

Comparison of ESG and conventional HY index total return - monthly			
	Median (%)	Std. dev (%)	Total Return (%)
Inception-to-date*			
Broad US HY	0.468	2.197	33.564
BB HY	0.550	1.921	36.359
ESG Tilt	0.518	1.840	34.208
ESG Best-in-Class	0.435	2.066	33.898
Year-to-date **			
Broad US HY	0.356	0.438	4.675
BB HY	0.251	0.612	3.783
ESG Tilt	0.320	0.457	4.041
ESG Best-in-Class	0.320	0.379	4.116
March 2020 - Daily Data			
Broad US HY	-0.091	1.928	-11.728
BB HY	-0.087	1.789	-9.243
ESG Tilt	0.002	1.837	-9.252
ESG Best-in-Class	-0.182	1.797	-10.862

Source: ICE Indices, LLC; Concise Capital; *(Jan '17 - Sept '21); ** Through Sept 30

Conclusion

Despite the relatively short time frame for empirical data of the relevant HY ESG indices (4.8 yrs.), the answer to the question of whether investors need to sacrifice returns to follow an ESG mandate is “no.” This opinion is based on the fact that the comparative performance differences across the three time periods between the Broad US HY and ESG Best-in-Class indices are minimal when considering median and total return results. Moreover, statistical analysis between these two series while employing a 95% confidence level reveals t-statistics and p-values for each period that fail to meet the threshold of statistical significance. At the same time there is no evidence for the narrative of the superiority of ESG investing. The data tells us that the choice of ESG versus a non-ESG portfolio does not matter when it comes to return, volatility, or downside protection.

While not penalized for choosing to invest in ESG-friendly bonds, an ESG investor is limiting his investible universe. As a point of comparison, the broad ICE BofA US High Yield Index Master II includes 2,127 issues. That compares to 1,639 issues for the ICE US High Yield ESG Tilt Index and 989 issues for the ICE BofA US High Yield Best-in-Class ESG Index. A smaller universe could lead to a more concentrated, less diverse portfolio.

An additional consideration, worthy of further analysis, concerns mandates focused on small-cap to mid-cap issues and 144A issues, in order to capture superior liquidity premiums relative to larger-cap issues. The broad HY market’s average outstanding size is $725 million. That compares to the ESG Best-in-Class index, identified as the closest quantitative match to the broad market index, which has an average issue size of $1.56 billion. Executing an ESG strategy within niche issues could therefore be challenging. As these sectors have traditionally out-performed the broad high yield market, a small-cap, non-ESG strategy could out-perform most ESG strategies.

Methodology

Doing a comparative analysis between two HY investment disciplines is fraught with compositional differences. In this review, we evaluate the ICE BofA high yield indices that include the ICE BofA US High Yield Masters II, ICE US High Yield ESG Tilt Index, and the ICE BofA US High Yield Best-in-Class ESG Index. ICE launched these ESG indices in June 2020, with data starting on December 31, 2016.

The following are definitions of these ESG indices: ESG Tilt index is constructed by excluding bonds of companies with significant involvement in controversial weapons, and tilts the weights of remaining issues in favor of those with better (lower) ESG Risk Scores provided by Sustainalytics[3]. The ESG Best-in-Class index follows the same criteria as the Tilt index while also adjusting the weights of the remaining issues to closely match the ICE BofA US High Yield Index's ratings and industry sector distributions.

Achieving an apples-to-apples comparison requires aligning ratings, industry sector weights, and durations, since index characteristics affect relative returns. Aligning industry weights is particularly important when comparing historical performance.

To illustrate the compositional difference between a conventional HY index (Broad US HY) and ESG HY indices, we updated the following edited tables initially compiled by Martin Fridson[4] as part of an article in August 2020[5]. The first table below breaks down the indices across term risk, risk premiums, and ratings. Note that the table includes the conventional BB high yield index[6] since the market-weighted average rating of the ESG indexes is BB3, which compares favorably to the BB index (BB1) and above the broad HY market's average weighting (B1).

Comparison of ESG and conventional high-yield index, by term risk, risk premium and ratings - October 2021

Index	Average maturity (yrs)	Effective Duration	OAS (bps)	Ratings (Avg)
Conventional				
Broad US HY	6.60	4.17	307	B1
US HY BB	7.46	4.87	210	BB1
ESG				
Tilt	6.79	4.28	268	BB3
Best-in-Class	6.19	3.90	304	BB3

Source: ICE Indices, LLC; Concise Capital

While aligning term, premium and rating are necessary, differences in sector weights may have a disproportionate impact on comparative results.

This is particularly true with the high yield market where the energy sector has historically contributed to oversized influence on the broad high yield market. From Dec. 31, 2016, to Sept 30, 2021, the comparative observation period, the ICE US High Yield Energy Index has a median monthly return of +0.79% vs +0.49% for the ICE BofA US High Yield Index. Moreover, year-to-date through September 30th, the HY Energy sector is up +12.05% compared to the high yield market's +4.68%.

[3] https://www.sustainalytics.com/

[4] Chief Investment Officer - Lehmann, Livian, Fridson Advisors, LLC

[5] "Assessing ESG Profiles and Returns Against the Broader High-Yield Sector," S&P Global Market Intelligence (Aug 4, 2020)

[6] ICE BofA US High Yield BB Index

Energy share of market value - October 2021	
Index	%
Conventional	
Broad US HY	13.62
ESG	
Tilt	6.94
Best-in-Class	13.59

Source: ICE Indices, LLC; Concise Capital

The significant difference in energy weighting between the conventional HY index and ESG Tilt supports the preference to compare the conventional HY market to the ESG Best-in-Class index. Not only is the Best-in-class index's energy sector aligned with the broad HY index, but these indices are also relatively aligned in risk premiums and to a lesser extent term risk.

Another important element is the weighting in the CCC segment across the conventional and ESG indices. Similar to the energy sector, despite its relatively small market position, the CCC sector can have a disproportionate influence over broad HY market returns while possessing volatility that is 60% higher than the broad HY market. An analysis of the weightings of the CCC group finds the group represents 10.95% of the broad HY market and 6.8% and 10.03% of the Tilt and Best-in-Class ESG indices. Yet this is further evidence that the Best-in-Class index makes for a better benchmark vs. the broad HY market.

Disclaimer

This material is furnished by Concise Capital Management, LP or affiliates (collectively "Concise"). This material and its contents have been prepared solely for illustration and discussion purposes and should not be considered as an offer to buy or sell any interests in the Funds. Any reproduction of this information, in whole or in part, without the prior written consent of Concise is prohibited. Additional information is available from Concise upon request. Neither Concise nor its affiliates are acting as your advisor or agent. This material is not intended to provide a sufficient basis on which to make an investment decision. An offer can only be made to qualified investors by means of a private placement memorandum. Please refer to the private placement memorandum, Prospectus, and/or any supplements for complete details, including information about risk, charges, and expenses. There can be no guarantee that the Fund will achieve its investment objective. Investment in the Fund involves investment risks, including the possible loss of the principal amount invested. All market and commercial data in this message are not warranted as to completeness or accuracy.

An investment in a Fund is speculative and may involve substantial investment and other risks described in the relevant Fund Offering Documents. Such risks may include, without limitation, risk of adverse or unanticipated market developments, interest rate risk, risk of counterparty or issuer default, and risk of illiquidity. The performance results of any of the Funds can be volatile. No representation is made that a Fund's investment objectives will be achieved, that its risk management processes will be successful, or that the Fund or any investment will make any profit or will not sustain losses. Any investment in a Fund will be subject to applicable advisory fees and expenses. The Funds' high fees and expenses may offset their profits. Past performance is no indication of future results. The Funds have substantial restrictions on investors' ability to redeem or transfer their interests, and there is no secondary market for the Fund's interests.

The information and opinions expressed herein are as of the date appearing in this material only, are not complete, are subject to change without prior notice, and do not contain material information regarding the Funds, including specific information relating to an investment in a Fund and important risk disclosures. The descriptions herein of the Funds' investment objectives or criteria, the characteristics of their investments, investment processes, or investment strategies and styles may not be fully indicative of any present or future investments, are not intended to reflect performance, and may be changed in the discretion of Concise. While certain data contained herein has been prepared from information that Concise believes to be reliable (including data supplied by third parties), Concise does not warrant the accuracy or completeness of such information.

This document contains certain forward-looking statements and projections. Such statements and projections are subject to a number of assumptions, risks, and uncertainties that may cause actual results, performance, or achievements to be materially different from future results, performance, or achievements expressed or implied by these forward-looking statements and projections. Prospective investors are cautioned not to invest based on these forward-looking statements and projections.

Concise Capital Management, LP is an SEC-registered investment advisor, managing assets for institutions, family offices, and wealthy individuals. The firm is also a manager of onshore funds, offshore funds, a UCITS fund, and a sub-advisor to mutual funds. Concise Capital Management, LP was incorporated in March 2004 and is based in Miami, FL.