Active Insights Podcast – CS McKee's ESG Core Bond Strategy and Approach to Investing

Diane Merritt:

Welcome to North Square Investments Active Insights podcast. North Square Investments is dedicated to bringing differentiated active investment strategies to financial advisors and investors through our multi-boutique asset management platform. Today, Mark Goodwin, Chief Executive Officer of North Square Investments, will discuss fixed income investing with a focus on ESG principles and the investment approach of CS McKee. Brian Allen, Senior Vice President and Portfolio Manager, and Jason Pettner, Quantitative Analyst, both with CS McKee, will provide us with their insights and outlook for this sector of the market. CS McKee is a partner firm in the North Square platform. Mark, Brian, Jason, we look forward to your discussion.

Mark Goodwin:

Thanks, Diane. As you mentioned, at North Square, we seek out best-in-class active managers for our platform. And our partners at CS McKee have a proven repeatable approach to fixed income investing. Brian, your firm has primarily worked with institutional investors, so financial advisors and individual investors may not be as familiar with CS McKee. Can you give us some background on the firm and your investment team?

Brian Allen:

Sure. CS McKee was founded in 1931, Pittsburgh. So, we're celebrating our 90th year in business. On the fixed income side of the firm, we manage funds across the maturity spectrum all under a high-quality and high-liquidity primarily bottom-up investment process. Our goal is to deliver a consistent market outperformance and lower volatility.

Fixed-income team is comprised of four portfolio managers, who average 22 years with the firm, and three analysts, who average about seven years with the firm. Collectively, we manage about 250 institutional accounts, totaling approximately $6.5 billion in assets. And for the record, we've been a socially responsible investment portfolio manager for more than 20 years.

Mark Goodwin:

Thanks, Brian. Today, I'd like to focus on the ESG core bond strategy, particularly with CS McKee now sub-advising the AdvisorShares North Square McKee ESG Core Bond ETF, ticker MENV. This strategy covers a pretty broad range of investments that you and your team consider when building the portfolio. Can you tell us how you develop an overall portfolio strategy with an objective to both deliver performance and manage risk?

Brian Allen:

Yes. Our process for managing an ESG strategy really builds off of our longstanding approach to managing our typical fixed-income portfolios. The hallmark of this approach has always been consistent net-of-fee benchmark outperformance and doing so with lower volatility than the market. These characteristics emanate really from discipline in risk taking, building portfolios from the security level up in compliance with the group consensus view on fiscal and monetary policy, market rates, yield curve, all the general market risk characteristics that typically come into play when structuring a bond portfolio.

From there, we really spend the vast majority of our time focused on individual securities within the corporate government and securitized sectors. We develop a "buy list" of securities, best ideas in each of those sectors, then begin to build a portfolio using those ideas. And after a first pass at it, review the portfolio to make sure that all the active risk exposure being taken is intentional and that any adverse outcome that may occur in various market scenarios have been tested or vetted by the group and approved for final use.

On the ESG front, we frankly pick up right where we just left off and apply our internally developed ESG model, which is a quantitative tool that allows us to evaluate corporate issuers efforts and progress in adopting sustainable measures. Our focus on the largest and most liquid names in the credit universe brings with it a bias towards ESG rankings and effectively gives us a head start from a scoring perspective.

Mark Goodwin:

Thanks, Brian. Now, turning to you, Jason. CS McKee has always looked for strong governance in evaluating quality issuers. In 2020, you all signed onto the United Nations Supported Principles for Responsible Investing, UNPRI, which is a significant commitment in CS McKee's focus on ESG investing and is reflected in your ESG core bond strategy. Can you talk about the process for measuring ESG characteristics among fixed- income issuers?

Jason Pettner:

Sure. Our process for evaluating issuers is largely built upon our proprietary ESG model, which was built with the help of conversations and feedback from some of our largest consultant partners. Since ESG's a term that means different things to different people, we wanted to build our process around what our partners were looking for so that we could ultimately advance toward our goal of ESG integration together.

Our proprietary ESG model uses a multifaceted approach to establish a holistic stakeholder score. This approach is largely quantitative in nature and incorporates hundreds of inputs from raw metrics, such as metric tons of carbon emissions to third-party rating data from some of the most reputable third parties in ESG, including MSCI and Thomson Reuters Refinitiv, to sustainable development goal alignment data from the UNPRI, and even more data than that.

Across the industry, ESG scores have significant variability between providers. So, the goal of our approach is to create an unbiased objective measurement of a company's action based upon a large breadth of data available. At each stage, we attempt to put all input scores on the same playing field because even though a score from a third-party rating agency may be from zero to 100, that doesn't mean they're on the same scale. For example, some providers score issuers using a normal distribution approach, while others use percentile ranks and others even use a checklist approach with no standardized distribution.

The ESG model is built bottom up in nature and assesses how a company's ESG actions compare against multiple peer groups. At the top level, scores are a combination of quantitative scores, current events, and disclosure scores, which are then adjusted for how well the company aligns with the 17 UNPRI sustainable development goals. Although there are many steps underlying data points, our goal is focused upon gathering all the trusted data possible to assess a company's commitment to ESG from a high level. We view each major fixed-income sector through a slightly different lens, with credit being the most in-depth, quantitatively in nature.

Mark Goodwin:

Thanks, Jason. As you think about the hundreds of possible fixed-income characteristics, how do you work through it to weighting them and using them to evaluate which issuers are suitable for inclusion in the portfolio or not, from an ESG perspective?

Jason Pettner:

We weigh each pillar and factor at the sub-industry level with the goal of emphasizing the aspects that are most material to a given industry. For example, for the environmental pillar, an industry like oil and gas will have a higher environmental weighting than an industry sector like software or financial services since their business model is more heavily tied to environmental concerns. Similar to our statement earlier about the variability of scores due to scoring scales, weights are very similar because people may view materiality and weights in a slightly different way. As a result, there's not consistent industry consensus on weighting at the moment.

I like to contrast ESG with another common topic in investments, EPS or earnings per share. With EPS, management can attempt to report adjusted earnings or other tricks, but there are always fundamental financial processes that you can use to get back to the true EPS root number. Unfortunately, with ESG there is no true ESG score to solve for because there's so many qualitative assumptions and inputs in every score. So as a result, attention to detail for each input, like weight, is specifically important. So as organizations, such as FASB, attempt to help standardize these reports and materiality across the industry. We too are dedicated to constantly improving our process to also meet these improving standards.

With regards to the sustainability for the portfolio, speaking specifically to our credit sleeve, we implement a two-part method. The first part is eliminating laggards. Companies with ESG scores below 40 are automatically eliminated from consideration in the portfolio, as well as emphasizing leaders where we place a heavier emphasis on the companies within our investible universe that have scores above 80 and maintain a portfolio level score above the benchmark.

As it relates to the agency sector, we assess sustainability by evaluating the purpose of the agency itself and the funds being raised. On the securitized side, we assess the issuer as well as the proceeds of the purpose of the bond to ensure that the underlying securitized portfolio doesn't engage in controversial sources, such as predatory lending.

Mark Goodwin:

Brian, I'm going to pivot back to you. Can you talk about the process you use to evaluate the investment universe to develop a workable set of potential investments and also discuss how ESG as a focus has impacted this process for this strategy?

Brian Allen:

Sure. As we discussed earlier, our select focus on the largest issuers in the corporate sector brings with it a bias towards higher-scoring investments. In the government space, we take the opposite approach, expanding our investible universe to include securities and various structures that don't qualify for benchmark inclusion. Our experience in that sector gives us a bit of another head start familiarity with those issues. And it's a sort of natural next step for us to look at these non-index securities and further evaluate their green or sustainable offerings for inclusion in the portfolio.

Our very active approach in both of those areas generates performance that we think offsets any modest yield give-up that may occur when buying a sustainable or a green security. Certainly, one of the concerns when implementing an ESG approach is degradation of performance and whether or not there's a direct cost in implementing these strategies versus what total return might be in the absence of these additional requirements. But with our approach and types of securities that we look at, the broad universe of the securities that we look to, we can implement a fairly stringent set of ESG requirements with minimal, if any, real impact on performance.

Mark Goodwin:

Thanks, Brian. Changing gears slightly, can you talk about what key factors or events might lead you to sell a particular portfolio security or significantly decrease your allocation to a particular type of security within the ESG strategy?

Brian Allen:

Yes, much like the strategy itself is built off of our longstanding approach to fixed income, we really, operationally speaking, process-wise do not alter this approach when implementing the ESG criteria. When it comes to all active risk exposures within the portfolio, they're initiated with both target and stop-loss valuation considerations, both of which we think are critical in pursuit of excess returns, especially on the sell side.

So, reductions in specific portfolio holdings typically and ideally due to those securities attaining outperformance goals versus other securities usually measured by relative yield, spread conversions against treasuries or other like securities. And then, like I said before, even more important on the sell side, stop-loss orders or levels must be established prior to the initiation of the position. And it takes agreement by the group where necessary to alter those goals should a security begin to fall below our return expectations.

So really, it's a disciplined process, risk management on the back end that has the most significant impact on minimizing portfolio return variability.

Mark Goodwin:

That’s very helpful. Jason, back to you. Risk-adjusted performance is very important to CS McKee in evaluating your fixed-income strategies. Do you see stronger ESG characteristics of a portfolio having any impact on the strategy’s long-term performance?

Jason Pettner:

So, in the long run, as the investment world continues to evolve and ask for more companies to take active ownership of ESG principles, we do see it is an important part of the investment landscape in the future. In terms of performance in the near term, there are many great studies that attempt to decompose returns and provide value-added return possibilities, but it’s honestly really difficult to separate out the purely ESG-related factors. So, at CS McKee, we tend to view ESG as a valuable source of risk mitigation that ultimately helps to add value with risk-adjusted returns, which is an important part of our core fixed-income process.

We consider ESG scores to be a useful source of alternative data. So alternative data is a common buzz word across the investment industry at the moment. Essentially, alternative data refers to useful information that will not be found within traditional fundamental financial sources. You know, in other words, data you won’t necessarily find from scouring a company’s 10-K. As it relates to ESG, we view the scores as a way to assess non-financial risks that may ultimately impact the company and their performance. For example, understanding a company’s ESG standing may help to avoid environmentally risky companies that are more prone to an unexpected oil spill or a company with poor governance that may be more likely to be involved in a scandal or violation.

On the positive side, emphasizing companies with stronger ESG principles can help us identify companies that are more likely to thrive in a future that demands more sustainable practices. A great recent example can be found within the initial COVID-19 draw down of last year. During that period, the world struggled with several unforeseen challenges, from a global pandemic to social injustice. Using our ESG scores to evaluate the Bloomberg Corporate Index during this period, from the end of January till the end of April, issuers with scores above 80 actually outperformed issuers with scores below 40 by 3.12%, emphasizing the real potential value of ESG evaluation.

Mark Goodwin:

With the growing emphasis on ESG principles in general across the investment landscape, would you expect this to impact issuers attention to these characteristics over time and eventually result in expanding your investible universe?

Jason Pettner:

Absolutely. Even within the past year or so, we’ve seen a lot more receptiveness from corporate issuers with regard to ESG issues. Here in America, we’re several years behind our European counterparts on the ESG front. But if we look to Europe as any type of indication, we expect issuers to take ownership and make ESG a priority moving forward. You know, given our fundamental focus and dedication to maintaining a portfolio with high-quality and liquidity, many of the issuers that we currently invest in have already taken notice and are actively integrating ESG principles in their organizations.

Now, as the market continues to demand more transparency and ESG integration, these larger issuers understand the importance of keeping up with ESG requests to continue accessing the capital markets at the scale and at the terms that they need. To the extent of expanding our universe, we run our ESG model each month on a universe of over 7,500 different global companies, so we are consistently monitoring for companies that are ESG criteria. And as these issuers also do well and continue to meet our criteria from the fundamental investible universe, we could definitely see our investible universe expand once they reach both these criteria.

Mark Goodwin:

Brian, back to you. 2021 has seen a change in administration, continuing battles with the pandemic, including a new variant, solid GDP growth with much higher inflation that now apparently is no longer transitory. Can you talk about where you see the economic environment currently and what's your outlook for the economy and fixed-income markets in 2022?

Brian Allen:

Yes. We'll generally remain constructive on economic growth headed into next year. And I think payroll growth should continue to exceed long-term averages. Participation rate should inch higher as we've seen just this morning with the November numbers. Certainly, have an additional fiscal stimulus to drive consumer spending. A little bit of a different story when it comes to inflation. There we believe that the Fed, frankly, is a little behind the curve. They've made comments recently admitting as much with discussions about the taper working to move starting in December and possibly conclude as early as April, where the initial discussion on that subject had it starting the middle of next year or concluding sometime into the third quarter.

We will say that right now, the market has taken heed of these comments. Certainly, seen proof in the numbers over the last three to six months. The idea being that, again, inflation is a little further advanced and likely to be a little stickier than originally expected. The Fed has now officially dropped the word transitory, and the markets again have, rates in the short end of the curve have risen to accommodate what they think will now be likely at least two rate hikes in 2022. So, we're beginning to see what we think is a discounting of, to our mind, what is a more likely scenario for next year.

One remaining item of interest with respect to the Fed is that as much as the market is now concerned about the Fed being a little behind the curve, they still think of inflation as being something other than transitory but a little longer timeframe. But the peak rate the Fed will put into place sometime in 2023 right now looks to be about 1.5%. And I think if inflation does really prove to be a little more than transitory, the market has totally discounted the initial moves for next year but is really underplaying what may be a continued rate hike cycle that goes into 2023.

Mark Goodwin:

Can you talk about how this landscape might impact how you're currently positioning the portfolio and where you're seeing the best opportunities for taxable fixed-income securities in the current market?

Brian Allen:

Yes. So, we’ve had this view of inflation, frankly, back to June, July of this year when looking into the contributors and the makeup of overall inflation recognized that the first boost to the overall numbers coming from those industries and businesses most affected by COVID and that the reopening trade really saw price pressures in those areas in particular and more broadly on the good side of the equation, not so much in services. As we’ve moved forward from that date, we’re seeing a little bit of a modest reversal in those reopening trades or industries and that’s being replaced by greater pressure on inflation from a growth in wages and a delayed impact from an increase in owner’s equivalent rent. And as a result, we think as we continue to see these higher than comfortable overall inflation numbers, there is a definite shift underneath the surface and as to the contributors and they’re changing weights and the top-line number.

So as a result, we’ve had a short position both long end and in the very front end of the curve discounting what we thought was going to be a market realization of greater inflation and been very active in the floating rate securities market as well, replacing some short fixed-rate treasuries and corporates with floating rate commercial mortgages. And then over the last month or so, we’ve seen quite significant increase in market volatility, making callable agency bonds attractive once again. And we think given a somewhat muted, by historic standards, muted rise in market interest rates, callable securities offer us a fairly attractive addition to total portfolio yield and a bond that we think will outperform equal duration treasuries over the next 12 to 18 months.

Mark Goodwin:

And changing gears, Brian. Many investors use passive strategies for portfolio exposure, not only in equities but also in fixed income. Do you see advantages from CS McKee’s style of active management for investors evaluating active and passive strategies for fixed income? And part two of that question, for investors looking for investments with strong ESG characteristics, what advantages do you see in an actively managed strategy?

Brian Allen:

Yes. Regarding your first question, we certainly see an advantage from our style of active management. Active in general versus passive core fixed incomes features or consistent benchmark outperformance with lower volatility, the high degree of downside protection, which is especially valuable in a rising rate environment like the one we’re-facing right now, and outperformance when equity and other high-beta markets suffer losses.

In our case, meaningful allocations to the government sector boost our total return and better withstand the spread-widening that impacts credit in periods of economic uncertainty. So, it ultimately makes sense, not only to look to active management in core fixed income but to frankly avoid what is a more standard or typical approach in this space, which is simply to overweight credit and assume greater degrees of credit risk as a way to boost overall returns, which are great if you’re a long-term fixed-income-only investor but doesn’t do a broad portfolio much good by way of diversification.

Now, for investors looking for investments, strong ESG characteristics, I think you take the factors I just mentioned and add to that even further improvements in risk-adjusted scoring. Again, I think when, as Jason outlined earlier, ESG means different things to different investors, and there are a myriad different ways to implement an ESG strategy, certainly as an investor benefit from an active approach in that space, not only given the changing nature of the constituent companies but also when customizing a portfolio to that particular client's individual needs.

Mark Goodwin:

A final question, Brian. How do you see an active core bond strategy with a focus on ESG principles being best positioned in the diversified portfolio of an individual investor?

Brian Allen:

Given current risk asset valuations, fairly lofty levels by every historic measure, and market volatility now on the rise, frankly, a high-quality, highly liquid core product continues to offer one of the best forms of portfolio diversification. We certainly are in a period, at least in the short run, where a surprise in inflation can upset returns in both equity and fixed-income markets. But frankly, have not seen a better replacement for core fixed income when it comes to hedging the risk in an otherwise somewhat overvalued equity market. You add to that the opportunity for investors to contribute to sustainable development goals at the same time, and I think what you end up with is portfolio diversification that feels good.

Mark Goodwin:

Brian, Jason, thank you for joining me today. This has been a great conversation as always.

Brian Allen:

Thank you, Mark.

Jason Pettner:

Thank you for having us.

Diane Merrick:

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