How RPIA Integrates Environmental, Social & Governance Factors into the Investment Process

Our ESG Commitment

In our ongoing conversations with investors, we are increasingly being asked whether we have an Environmental, Social and Governance ("ESG") framework, and if so, what part it plays in our investment process.

With this in mind, we thought this would be a opportune time to set out:

1. Our approach to ESG
2. How we incorporate ESG analysis into our credit research and portfolio management processes
3. Examples of our ESG framework in action

> *"There are three very simple reasons why we take ESG seriously - to minimize risk, to improve the quality of our returns, and to fulfil our fiduciary duty to our investors"*
>
> *– Mike Quinn, Chief Investment Officer*

Background and Our Approach to ESG

While the motivations behind the adoption of an ESG framework may vary, a simple fact should be sufficient justification to take the matter seriously - *there is growing empirical evidence that ESG factors are correlated with credit quality*. We have seen numerous examples of how investors in corporations can be adversely impacted by "ESG events". For example, investors in Anadarko Petroleum Corp and BP PLC have seen bond prices adversely impacted by multi-billion dollar fines from the Environmental Protection Agency on the back of Environmental lapses. Likewise, the emissions scandal at Volkswagen AG in 2015 reminded investors that the absence of robust governance controls can lead to disastrous corporate outcomes which can affect all stakeholders in a business.

In recent years there has been a marked evolution of the ESG landscape. Early on in the development of sustainability-minded investments, the principal tool used by investment managers were negative screens – client-driven, definitive restrictions on certain types of investments. An example of this would be a mandate restriction whereby a manager is prohibited from investing in petroleum exploration companies or munitions manufacturers.

Sustainable investing has since evolved beyond this type of passive screening to a more active approach that embraces dynamic analysis that aims to accurately quantify and assess the risks that arise from a company's approach to ESG related issues.

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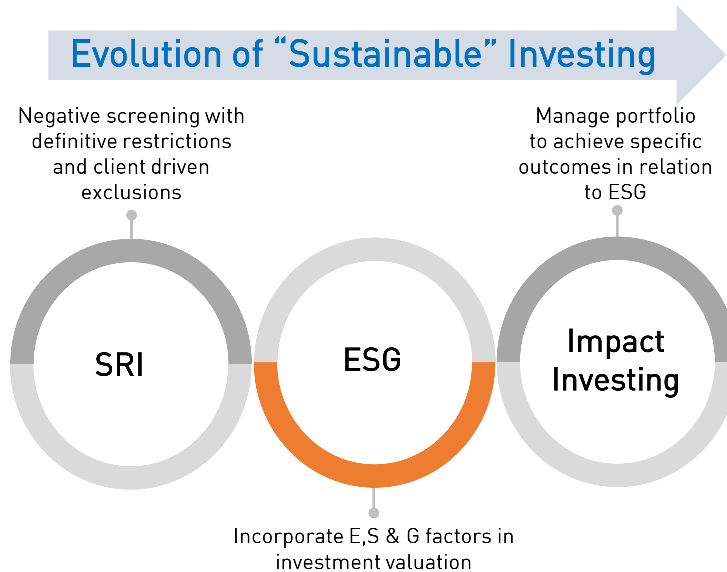
In other words nothing is excluded a priori but rather relevant information is sought out and analyzed with a view to more comprehensively analyzing the investment and understanding how ESG factors affect risk. This is the approach we take at RPIA. We incorporate ESG analysis into our credit decisions, and monitor how ESG factors impact the performance of our portfolios. Furthermore, because ESG analysis is part of good fundamental credit research, we incorporate our ESG analysis into all our portfolios rather than running an "ESG dedicated" strategy.

Certain investment managers have gone a step further and embraced "impact investing" – investments that explicitly seek to achieve certain ESG-related goals. Within this area different investors may have very different goals. One firm may be focused on making capital available to renewable energy products while another may be focused on enabling the provision of educational services in aboriginal communities in Canada. Currently RPIA does not have any mandates that would fit into this category, but would consider launching an impact mandate should investor demand exist for such a strategy.



In other words, there is a spectrum of approaches to sustainable investing. It's also fair to say that what started out as a relatively niche area has now become mainstream. The demonstrated materiality of ESG factors on company performance has meant a growing number of institutions in Canada and elsewhere have started to incorporate ESG analysis and themes into their regular investment decision processes.

In practice, our commitment to ESG is a commitment to three things:

1. We incorporate ESG factors in our investment process.
2. We engage issuers on ESG matters.
3. We advance ESG through peer collaboration and public action.

1. Incorporating ESG Factors in our Investment Process

When analyzing the ESG profile of a company we look at both quantitative and qualitative factors. Our proprietary quantitative ESG scores are produced by combining four third party scores (Sustainalytics, Bloomberg, CDP and ISS Governance) alongside our own 15-factor quantitative score. This analysis is then supplemented by qualitative information gleaned from discussions with management teams, company disclosures / management notes and the subjective judgement of our credit analysts. Both quantitative and qualitative ESG analysis is conducted prior to investing in a new issuer. After initial investment our ESG scores are updated and monitored on a weekly basis for all portfolio holdings alongside the normal credit monitoring conducted by our research team. This combined quantitative and qualitative framework allows us to dynamically track how an issuer's ESG scores and fundamentals change over time and how they compare relative to peers in similar industries. Any subsequent ESG risks are flagged in our Credit Memorandums, and are discussed in our weekly Portfolio Management and Credit Research meetings. Responsibility for overseeing implementation of the ESG framework lies with Mike Quinn (Chief Investment Officer).

2. Engaging Issuers on ESG Matters

We believe bondholder engagement is critical to properly understanding the risk-reward profile of the issuer. As such, we actively engage in ESG dialogue with the companies we are analyzing and/or investing in. This can take the form of in-person meetings with management, conference calls and other correspondence. Engagement with issuers is a critical factor in effecting change. Although bondholders don't have the same power to effect change that equity holders have through their proxy voting rights, it is still possible for bondholders to engage and guide issuers given the importance of debt financing to many companies.

Engagement Example: Petróleos Mexicanos ("Pemex")

RPIA's mining and energy credit analyst ran our proprietary ESG screen on the Mexican state-owned petroleum company ahead of their multi-tranche BBB+ rated USD transaction in July 2017. Given the private nature of the company, the issuer scored poorly. As a result, we proactively engaged the issuer asking them for missing information and additional clarification in certain areas. The corporate finance team at Pemex responded by providing us with additional disclosures and information to help us get comfortable with how the company approached ESG related risks in their line of business. As a result we participated in the new issue transaction, which performed well in the secondary market.

3. Advancing ESG Analysis Through Peer Collaboration and Public Action

The final element of our framework is a commitment to advance knowledge and understanding of ESG through engagement with peers and the broader investment community. As part of this commitment, we have participated in several round-table events and conferences to discuss ESG issues impacting the investing community and capital markets.

RPIA's ESG Framework in Practice

Below we provide several examples of how integrating ESG analysis into our credit research process has impacted our portfolio managers' investment decisions.

Example I – Valeant Pharmaceuticals International Inc. (Social & Governance)

Valeant (VRX) is a developer and distributor of pharmaceuticals. When our health care analyst looked at the company his findings raised some issues in relation to certain ESG factors. Specifically, we had significant concerns around the company's corporate governance and accounting practices. Valeant employed a roll-up strategy and grew through acquisitions driven by:

1) R&D spending cuts, which undermined long-term sustainability and also overstated current earnings
2) Aggressive price hikes, which have drawn regulatory scrutiny
3) Questionable accounting, including the presentation of non-GAAP metrics that had unusually large differences vs. GAAP metrics, and
4) Poor corporate governance, as there was a lack of separation between board and management as well as executive pay incentive structures that were tied to non-GAAP metrics.

We avoided investing in the company given these concerns. Over time, VRX spreads widened materially as there was increased regulatory scrutiny around price hikes on products as well as the fact that non-affiliated sales/transactions were actually being made to affiliated firms of VRX to bolster sales/prices. In 2015 the VRX stock plummeted and corporate spreads followed suit.

Source: Bloomberg

Example II – Avolon Holdings Ltd. (Governance)

Avolon is a global commercial aircraft leasing company. We were initially interested in the credit given our involvement with another aircraft leasing firm (Aercap) that successfully transitioned from crossover to investment grade, and our existing positions in CIT Group (a firm that sold its aircraft leasing division to Avolon).

Avolon is a BB-rated subsidiary of China-based HNA Group. Our initial thesis suggested that the company could follow the same "rising star" path as experienced in our Aercap investment. We initiated a small position in the bonds believing that we were being compensated for the risks associated with the company. However, we were cautious to grow the exposure before further assessing the future direction of the company's governance framework.

Overtime our credit monitoring revealed that the parent of Avalon, HNA group, was increasingly relying on debt-funded acquisitions to drive growth and had spent over $40 billion in foreign acquisitions, including stakes in Hilton Worldwide and Deutsche Bank. HNA drew regulatory scrutiny from Chinese authorities trying to stem capital outflows as well as investor concerns over its opaque ownership structure, strategic motivations, and financial health. These developments were "red flags" from the perspective of both credit fundamentals and in regards to issuer governance (via our ESG analysis).

We exited our small position in Avolon in August 2017 as we felt the company was not improving their governance oversight and the acquisitive nature of HNA made the Avalon bonds too risky to own in size. Three months later, in November 2017, it was reported that airlines owned by HNA had missed payments due on leased aircraft. Avolon bonds dropped in price on reporting of this news.

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Example III – Kinross Gold Corp. (Social & Environmental)

Kinross is a gold mining company with operations in Russia, Mauritania, the U.S., Brazil, Ghana, and Chile. Our credit team had some concerns around the company's geopolitical risk profile, particularly with regards to its operations in Russia and Mauritania and their handling of social and environmental issues. As part of our due diligence process we met with the company's management team on two occasions and discussed Kinross' government, local community, and employee relations in great detail. Through our discussion with management we were able to gain comfort in Kinross' management of their ESG risk profile and ultimately entered into a position. We continue to manage our position size in Kinross relative to the potential environmental and social risks that come with the business' mining operations in emerging markets.

"Kinross (rated Ba1/BB+(Pos.)/BBB-) is well positioned for an upgrade at S&P in early-2018, which will help the company return to IG status. The company is one of the lowest leveraged senior gold producers and has a solid pipeline of low cost brownfield projects that will further improve the company's production and cash flow profile going forward, allowing the company to stay within upgrades credit metrics thresholds at S&P"
- RPIA Credit Memo

Sample Political/Social Risk Comparative Analysis

Source: Bloomberg

KCN 5.95% 03/15/2024

Summary

We believe that unless analysts and investors acknowledge ESG factors in their credit analysis, they won't be fully taking account of the risks that are presented by their investments. This in large part explains why ESG has made the transition to the mainstream. It's nothing more than a complement to "traditional" financial analysis that incorporates a broader range of factors – factors that are highly relevant to investors. We welcome dialogue with our investors on this issue and hope you have found this to be a useful introduction to the what and why of our ESG framework.

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