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ESG. Impact. Sustainable. Does anyone really know what these terms mean?

This question reminds me of the start of my career over a quarter of a century ago. At the time, I joined a small (on its way to being a large) hedge fund in Texas. At that time, hedge funds were actively engaged in the practice of hedging risks they could not control or did not want so they could take only those risks in which they had a high degree of confidence. At least, this is what hedge funds did until they became popular. Then, the term "hedge fund" lost all meaning, or maybe more accurately, it acquired all meanings. Once pop investing culture took ownership of the term, it meant whatever the person using it decided it should mean; the hedging that originated the term "hedge fund" all but disappeared.

As the awareness of ESG, sustainable and impact investing has grown and become a part of the same pop investing culture, these terms have similarly acquired all meanings and, in the process, have been rendered meaningless. At this point, some investors throw up their hands and argue that this is why these issues should be ignored altogether; others decry pop investing culture as bad for markets and society as a whole. We disagree with both of these extremes. On the one hand, we see awareness, transparency and mainstreaming as evidence of progress, beneficial to both Wall Street and Main Street. On the other hand, we believe it is crucial that investors reclaim and reframe these terms before it is too late.

ESG: A Data-Driven Definition

As it turns out, ESG is not an investing strategy. Strategies that claim to "use" ESG can be quite different, with varying degrees of success. But before we can dive deeper into how ESG is used, we must lay the groundwork for what "success" means. For many ESG-oriented investors, success may simply mean that a portfolio of companies scores highly by some quantitative or subjective ESG measure.[1] In this case, a strategy is placed on a spectrum of "good" to "bad." Unfortunately, this kind of snapshot approach doesn't capture progress or regression toward a goal. Instead, we find that these portfolios miss the opportunity to enable companies who are looking to change. Moreover, this approach doesn't consider the effect on performance of being "good." On the other hand, this kind of approach is easier to implement and market, which may be why a majority of ESG portfolios seem to have gone this route.

Here at Zeo, we define success differently. As readers know, we have made our careers as fundamental investors, and though terminology may have changed over the decades, this basic

1 The ESG rating method being created by Morningstar to evaluate ESG portfolios falls into this category. Suffice it to say here that we believe this method to be tragically flawed for too many reasons to enumerate in a footnote. But the use of a globe icon is sheer marketing genius.

truth has not: ESG factors are credit factors. Period. A company is not creditworthy if it is behaving in a way that is not long-term sustainable for its business. Especially within credit, every company is dependent on its access to capital markets. If a management team puts future capital raising at risk because it behaves irresponsibly and sets the stage for unexpected liabilities down the road, we believe that is likely to be disqualifying behavior. In this way, we don't view success as a binary battle between "good" vs. "bad." We define success the same way we always have as fundamental investors – mitigating risk without compromising performance. By evaluating companies based on their intentional progress toward a sustainable equilibrium, not where they are at a moment in time without regard for their trajectory, we believe we are able to accomplish our goals on behalf of our clients more consistently.

Unfortunately, little data exists to evaluate different styles of ESG investing… until now. Through extensive data analysis, researchers at the Wharton ESG Analytics Lab, headed by Dr. Witold Henisz, have identified six main investment styles which use ESG factors (see Table 1).[2]

Segment	Description	Fee Level	Alpha vs. ESG Correlation	Average ESG Score, Relative to Benchmark
Active ESG Engagers	Activist, active engagement	High	None	Middle Tier
ESG Integrators	ESG integration into fundamental analysis	High	Positive	Top Tier
Passive Screeners	Low turnover, exclusion-based	Medium	Negative	Bottom Tier
Transient Screeners	High turnover, exclusion-based	Medium	Negative	Top Tier
Budget Focused	Low fee, single-issue focus	Low	Negative	Top Tier
Budget Screeners	Low fee, exclusion-based	Low	Negative	Middle Tier

Table 1: Summary of ESG investment styles from Wharton research. The segments with the largest fund inflows since 2007 are highlighted. Note that the descriptions were written by Zeo based on the information provided by the researchers. The segments were determined using factor analysis on 12,916 holdings across 425 ESG-oriented equity-focused mutual funds and ETFs. If the above segmentation were to be applied to fixed income strategies, Zeo would be considered an ESG Integrator.

The analysis reveals some interesting insights. First, they found that only one investment style (ESG Integrators) had a positive correlation between ESG factors and investment performance. They also noted that this was among the most expensive segments, both in the fees they charged and in the amount of effort they put into incorporating ESG issues natively and inextricably into fundamental investment analysis. This makes sense to us. ESG factors are risk factors, so evaluating them properly (i.e. not just as a negative screen) requires a risk management effort,

2 Though this particular research is yet to be published, the researchers presented a preview in November 2020, and we have received permission to share some of the most interesting takeaways. It is worth highlighting that, in our experience, the styles of investing do not differ between equity and credit, with one caveat being that the most active styles are much harder to find in fixed income. That said, the methods (i.e. what it means to be active or how a manager integrates ESG) differ greatly. Note that when we discuss data here, the researchers used the ESG data service developed by TruValueLabs, a firm with which Zeo has partnered as well due to their emphasis on raw data and AI-based analysis, which allows firms like ours and groups like the Wharton ESG Analytics Lab to draw our own conclusions rather than rely on someone else's research or ratings.

which ultimately is what one is paying for in a management fee. Put simply, the researchers concluded that the higher fee strategies got better results precisely because of the extra work necessary to engage companies and integrate ESG factors into their investment processes.

On one end of the spectrum are active ESG strategies like these; at the opposite end are indices, which are unmanaged risk by their very nature. Sadly, the ESG investment styles that saw the largest asset inflows since 2007 were not the best performing but rather funds closer to this passive end of the spectrum, which tend to use exclusion-style screens as their primary method for considering ESG issues. Why? They have lower fees and are from the largest fund families. Meanwhile, the research also showed that managers seem to benefit most from selecting for high ESG scores (i.e. companies that look good in one-time snapshots), while they were not rewarded for selecting investments which showed ESG improvement (i.e. companies that actually made progress).

Put another way, managers are most successful using low-cost simple screens even if the data shows that approach doesn't seem to work, and their clients are left holding the bag. [3] Even so, the flows show where investor focus is, and this may begin to explain why ESG strategies have a reputation for forcing investors into a tradeoff between performance and progress. It also explains why some managers knowingly "greenwash" their portfolios.[4] It is little wonder why ESG skeptics think the way they do. However, investors play a supporting role here, not paying much attention to the differences in styles and focusing primarily on factors that don't drive performance.

So what is the meaning of ESG? Put simply, ESG cannot be a term for a particular style of investing. To date, treating it as such has incorrectly equated very different strategies and forced counterproductive apples-to-oranges comparisons. It is, rather, a term for a specific subcategory of risks that companies face regarding effects they have on stakeholders and society which fall under the areas of Environmental, Social and Governance issues. The differences in how these ESG risks are considered in various portfolios is nuanced but important. With funds flowing to strategies in which ESG efforts are negatively correlated to financial performance, and with this noise obscuring the potential for superior risk/rewards elsewhere within the ESG landscape, it may be time for investors to reevaluate the meaning, and purpose, of ESG in their portfolios.

Impact: The Future Is Not What You Think

In January, during the market frenzy which saw GameStop Corporation stock go from approximately $20 to nearly $500 intraday within two weeks, some asked why the company did not capitalize on the demand by issuing shares. At Zeo, we saw this as a potentially notable governance case study. While some directors did make a few stock sales at much lower prices, the company itself did not

3 This is a good place to remind readers that the business of asset managers is to raise and retain capital, and their product is the investment portfolio. Sometimes, portfolio performance (better product) and asset growth (successful business) are aligned. Unfortunately, here they don't appear to be at the moment.

4 The researchers at Wharton used this pejorative term, "greenwash," to describe what managers were being incentivized to do in the current ESG investing environment where funds flow to low fees and large fund families. And it pays off. They also highlighted that 70% of ESG-oriented equity-focused assets were held by the ten largest fund families. In other words, it will take a concerted effort to redirect both traditional and mission-driven investors in a more productive direction.

take advantage of these markets.[5] Some governance advocates might even applaud the company for understanding that it would be wrong to benefit at the expense of retail investors who could lose substantially when the stock returns to a more fundamentally reasonable price.

It is also possible, however, that the company acted out of fear, worried about the image of profiting from Main Street investors who might not have understood the underlying fundamental value of the stock, which even the company could have determined was much lower than the $483 where it traded at its highest point on January 28. We suspect it wouldn't take much for this to have become a public relations debacle for the company, but even if this less altruistic reason was indeed the consideration, we agree with the decision.[6]

Should investors take any of this into consideration? The debate over the importance of ESG factors has two major factions. There are those who believe any priority placed on ESG factors comes at the expense of investment performance and always will. We will call them the Cynics, as there is an inherent distrust that doing good and doing well can coexist as motivations. On the other hand, there are those who believe that, at some point, the world will see that ESG priorities are good and necessary, and eventually the default assumption of both investors and companies will be to prioritize ESG factors. We will call them the Idealists, as there is an inherent expectation that today's progressive ideals will be tomorrow's prevailing truths - it's just a matter of time.

This battle between the Cynics and the Idealists is one of ideology. Neither is likely to convince the other that they are wrong for the simple reason that they are starting from fundamentally different views of what motivates people and companies. And in some ways, they are both right. The Cynics are probably justified in saying that a focus on ESG will not put an end to fossil fuels or casinos anytime soon. The Idealists are equally justified in their view that recent increases in boardroom representation of women and minorities (in part due to their activism) will become the norm for companies at some point in the future. But this presents a rarely discussed conundrum. If both are correct in at least some of their basic assumptions, neither can be correct about their overall ideology or vision of the investing world, now or in the future, as ESG continues to mature.

In between these two factions, we find the Realists, with an assortment of views, not all of which are compatible, but which generally focus less on ideology and more on financial materiality. The Realists look for ways to tie ESG factors to better performance. Returning to our example of GameStop, the Realist mindset, due precisely to its big tent and results-oriented nature, doesn't welcome only companies which are motivated by ideals; there is also room for companies motivated by fear instead.

But does this distinction matter? Does the motivation affect the impact of the good behavior? The answer to this carefully worded question is no. Regulatory frameworks illustrate why this is the case. In the financial services industry, investors are better protected not because companies are motivated to limit their self-interest but because they are compelled to do so. One may not agree

5 For that matter, neither did the relatively new CEO, though he would have required board approval to do so. Given that some board members were also selling, presumably, this approval may not have been denied, but there is no guarantee it would have been granted either.

6 The company has since announced it will do an equity issuance to raise capital, but only recently after investors have had ample opportunity to understand the consequences of investing at the current valuation and after the stock price settled into a more stable (if elevated) range.

with all regulatory requirements in a given industry, but taken as a whole, regulations enforce a better alignment between companies and their consumers, employees and communities.

Today, technology has made it easier than ever for “citizen regulators” to organize and potentially punish companies who don’t behave responsibly. As a result, the fear is no longer limited to whether they get caught by a regulator but is more pervasive, as the bar is lower for groups of people to organize online around an issue and aim to hold companies accountable for their actions. Admittedly, not every criticized action should be punished, and I expect we will eventually see the pendulum swing to a longer-term balance while honoring the newly enabled role of citizen regulators. But especially because this is now possible, we believe the most societal change will come from an environment as accepting of companies acting to avoid sticks as it is hopeful for those seeking carrots.

The strength of the Realists is that they are the only group who, for lack of an ideology, use ESG factors to make investment decisions all along the spectrum from fear on one end to ideals on the other, which is objectively better for the world. The flaw of the Realists is that, with their varied investment strategies, they are a group that is all-encompassing precisely by not committing to a specific ideology. As ESG has gained prominence, the Realists are probably the group most at fault for diluting the meaning of ESG and impact to the point where these terms have no meaning and all meanings at once. But for what? We saw in the previous section that the majority of ESG investment styles that might be best classified under the Realist umbrella don’t deliver better investment results.[7] So how do investors reconcile this problem and find the intersection between performance and progress? They do it by focusing on intentionality.

Readers familiar with Zeo’s philosophy know that intentionality sits are our very core. Everything we do, both in our portfolios and in our business, is done with an intentionality that borders on obsessive. To manage fundamentally and sustainably strong portfolios, we cannot simply start with an index and throw out the undesirable companies. We must start with a blank slate and proactively select every security in our portfolios, each with its own fundamental reasons for meeting our high standards for creditworthiness. Those standards go beyond snapshot “good” and “bad” ratings, whether they come from credit agencies or ESG assessments. Indeed, our approach to credit would be incomplete if ESG factors were not treated as credit factors, on equal standing with other credit factors in more commonly considered value-investing risk areas (e.g. financial metrics, competitive landscape, management strategy, etc.). We are focused on investing in good companies which will exist not just long enough to pay off our debt but long enough to pay off the debt that comes next and the debt after that. A creditworthy business is one that can be resilient in the face of both short- and long-term risks. Such risk management cannot happen by accident; it is the result of an intentional strategy to mitigate the material risks to which a business is exposed, including ESG risks.

7 Two observations further demonstrate the challenges for investors here. First, the Idealist approach can fit under the Realist tent if the end goal was the only priority, without considering the underlying motivation. Second, there are Cynics who openly hide among the Realists and aim to capitalize on the growing interest in ESG without believing in the thesis even in its most reductive form. In the previous section, we noted that independent research has revealed these Cynics in Realist clothing to be among the best asset gatherers using the least effective ESG-based strategies, with the strategies designed to appeal directly to Idealists nor faring much better.

In other words, a company's sustainability is a key ingredient in evaluating its longevity. The overwhelming majority of actions related to sustainability which are deemed unnecessary are not unnecessary because they accrue no benefit. Rather, they are deemed unnecessary because the perceived benefit is too far away and/or too costly in the short term, or, even more commonly, because those making the assessment are too myopic to evaluate the impact of both actions and intentions beyond a short-term timeframe. In our experience, there is a material difference in our fundamental assessments between those companies that take deliberate action to ensure sustainability, those who are simply acting out of fear and those who aren't paying attention at all. Issuers which act with intentionality are the ones in which our confidence is highest. Our investment process is designed to evaluate not just a company's strategy but its motivations; not just ESG but ESGI™ - Environmental, Social and Governance with Intentionality.

This is crucial because bondholders like Zeo and our clients don't get to vote for a company's directors. Activism is an equity investor's weapon in the fight to compel companies to make changes, act responsibly and ensure their longevity. But debt capital is critical to many businesses and allocating to one company instead of another does send a message. However, generally in fixed income, this doesn't even make much of an impact, as many companies are too large to pay attention to stakeholders they don't deem as important as stockholders. On the contrary, in our credit subset of the fixed income universe, we are often working with companies who better recognize their dependence on debt capital. Perhaps this is because they are smaller; perhaps because the cost of capital is high enough that small changes can make big differences; or perhaps because many of them do not have publicly traded stocks to soak up their available time and mindshare. Regardless, we tend to have an opportunity to engage with our companies as a boutique credit specialist that our peers in other asset classes may not have.

This gives our investigation into a company's ESG issues dimension and depth. More importantly, our issuers often (though not always) embrace our inquiry; they don't get these questions as frequently as others, and quite frankly, we suspect some of them don't see the consequences of giving us answers we don't like. We have the generally untapped opportunity not just to gather information for a passive snapshot but to identify patterns over time and influence and guide in a collaborative way. Without voting rights, we would get nowhere trying to use a stick, antagonizing a company publicly and privately until they do what we want just to make us go away and not because they want to. Rather, we must recognize what most equity investors don't have to: Change can be effected through a dialogue in which "good" and "bad" is not determined by where a company is at a moment in time but by where it wants to be, why it wants to be there and how intentionally it works to make progress toward those goals. This is a growth mindset,[8] applied to ESG, and in this way, we strongly believe our approach results in more ESG impact from our companies' actions than would come of snapshot screens or overlays.

Let's reword the earlier question then: Does the motivation affect *how one should evaluate* the good behavior?[9] *This* answer is a resounding yes. As we discussed earlier, fear may indeed be a

8 Among the most influential books of my lifetime, Carol Dweck's Mindset is easily in the top five. As many readers know, I recommend it to anyone who will listen. If the term "growth mindset" is new to you, I highly suggest you put this book on your summer reading list.
9 In addition to being the topic of the current section of this letter, this is also the subject of Season 1, Episode 11 of *The Good Place*, a philosophy course cleverly disguised as a top-rated TV comedy series.

powerful motivator and can force companies to do what is in the best interest of society whether they want to or not. However, just as companies often trip over their false motivations and run into financial trouble, they may do the same with ESG issues unless they intentionally focus on them. Here, we find a key difference between what's best for the world and what's best for the portfolios we manage.

We made the case that the Idealists, to achieve their goals, must give room for all ESG investment styles and should allow for companies regardless of their motivations. After all, carrots and sticks can lead to the same goal. But to execute on our long-term, fundamentally focused mandate, intentionality matters; we at Zeo look for the issuers motivated by the carrots. We look for those that are appropriately focused on their risks and which we therefore believe are fundamentally stronger. We look for those who recognize the ESG issues which are material to their company's long-term sustainability. We look for those who intentionally aim to improve their risk exposures, including those related to their own and their industry's issues in environmental, social and governance areas. If they succeed as we expect, they will have made an impact on the world in the process, but not at the expense of financial performance.

In a way, we have proven our original thesis, that both the Cynics and the Idealists are mistaken. But we've done so by disproving both their means and their ends. The biggest impact on the world comes from a willingness to disregard motivation and to accept actions rooted in materiality rather than ideals – the Idealist's goal needs the Cynic's worldview. Yet performance may be enhanced by taking those very motivations into account – the Cynic's goal needs the Idealist's worldview. Meanwhile, the Realists have fallen prey to the same game of musical chairs that has plagued the investment industry since long before our time: ignoring fundamentals in favor of a quick buck. But not us. Zeo integrates both motivation and materiality into a cohesive investment approach across multiple strategies. By doing so, we believe we offer the biggest tent: strategies with competitive performance which deploy capital to companies who are intentionally improving their impact on the world. And in doing so, we enable our own clients to have a real impact with their investments without compromising their performance goals, through our differentiated focus not just on ESG but on ESGI™.

Sustainable: Mainstreaming ESG

The origin of the modern day meaning of sustainability can be traced back to a publication from October 1987 in a report entitled "Our Common Future," the culmination of an immense amount of work by the UN World Commission on Environment and Development.[10] In that report, the first known reference to sustainable development (and ultimately the UN's sustainable development goals) can be found:

> *"Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs."*

10 Interested readers can find the report here: Our Common Future: Report of the World Commission on Environment and Development (un.org).

At Zeo, in our effort to break through the noise and get to the heart of why material ESG factors affect a company's creditworthiness, we thought long and hard about how this original meaning of sustainability applied to credit analysis and recognized in it a foundational philosophy of our approach to fundamental investing:

> Sustainable business practices are practices that enable management teams to meet the needs of current stakeholders without compromising the ability of future management teams to meet their own stakeholders' needs.

That is, a company is not creditworthy if it is not behaving in a way that makes it long-term sustainable. This is not new, and it is certainly not a trend. This is a simple prerequisite for a fundamental investor. For example, in early 2012, shortly after Apple executive Ron Johnson was hired as CEO of J.C. Penney, we asked the company for a call to discuss their capital markets strategy. To be successful and sustainable, a retail company such as J.C. Penney not only needs to satisfy its shareholders and customers but also its bondholders. With Mr. Johnson's clear signal that he wanted to "upgrade" the customer profile of the company, it became clear that he was not necessarily adapting to the differences between his new employer and his previous one, where customers were significantly more affluent and demand was largely inelastic. From a governance standpoint, paying attention to other key stakeholders is important in general but is mandatory for a company as dependent on access to capital as a leveraged retail business. The response from the company to our request (made in March) was that we could attend their roadshow for bondholders… in September.

This fundamental failure of governance by the company's board in hiring an executive unprepared for the job and by the management team in virtually ignoring two classes of key stakeholders (customers and bondholders) was a key driver in prolonging the company's financial woes for years. The consequences of Mr. Johnson's actions as CEO persisted long after he departed the company in 2013 and would eventually lead to the company's undoing in May 2020, albeit years later than we had originally anticipated when the company did not have the flexibility to manage through even the initial impacts of the global pandemic. Sadly, this was not due to Mr. Johnson's strategic decisions; partnerships and business initiatives that he set in motion in 2012 remain with the company today and, in some cases, perform well. Rather, this was due to his and his team's governance decisions.

Notably, this anecdote predates the recent and rapid increase in awareness of sustainable investing among those in the credit markets who don't prioritize ESG issues. But it highlights the link between creditworthiness and a company's approach to long-term sustainability that has underpinned our approach to credit since the founding of Zeo. However, it is only recently that a focus on ESG issues has become mainstream. Just a few examples from the last few months show this to be true:

1. Environmental: On March 3, the SEC's Division of Examinations released their examination priorities for 2021. This is an annual release to give compliance managers a sense of what

the SEC is focused on when they do routine examinations of investment advisers. Here is an excerpt from the press release accompanying this year's Examination Priorities:

> "This year, the Division is *enhancing its focus on climate and ESG-related risks by examining proxy voting policies and practices to ensure voting aligns with investors' best interests and expectations,* as well as firms' business continuity plans in light of intensifying physical risks associated with climate change," said Acting Chair Allison Herren Lee. "Through these and other efforts, we are integrating climate and ESG considerations into the agency's broader regulatory framework." *(emphasis added)*

This quote should send shivers down the spine of any investment manager whose primary approach to ESG is through negative screening or any issuer who views ESG reports as marketing rather than disclosure. Why? Because we believe the SEC is sending a clear signal that ESG issues are increasingly being viewed as aligned with investors' and stakeholders' best interests.

Among the consequences to this is that investment processes, not just individual investments, will need to be justified and that corporate sustainability reports will fall under the SEC's mandate to ensure full and fair disclosure. While the proxy voting focus of the SEC this year is a potential headache for equity managers, the natural evolution into fixed income is inevitable. Portfolios which rely on issue-specific characteristics (e.g. "green bonds" issued for image-building special projects with little impact relative to the issuer's size) rather than issuer behaviors overall are likely to come under scrutiny in the future.

Whether one agrees with the SEC's focus on this area or not, the foundation has been set for the "broader regulatory framework" they have promised, one which places ESG standards and disclosures on equal footing with the financial standards and disclosures required by the SEC since it was established in the Securities Act of 1933.

2. Social: The day before, on March 2, an interesting research report from Bank of America was released entitled "Everybody Counts! Diversity & Inclusion Primer."[11] In short, the analysts cite research conducted at the San Francisco Fed that gender and race inequities in education and the workforce have cost nearly $70 trillion in economic output over the last 30 years. That's a big number, and while it does seem worthy of skepticism, any doubt is undermined by an independent study by the World Bank from 2018 quantifying the cost of gender inequality alone to human capital wealth at $160.2 trillion globally, which the Bank of America report cites as well.[12]

11 The actual report requires access through a Bank of America representative, but Saijel Kishan at Bloomberg wrote a story about it that readers can find at this link.

12 For those who want to read the original World Bank report, it can be found at this link.

But the point of highlighting this research is less to start a debate about the benefits of D&I as a social good. Those who read our letter from last quarter know our position in favor of diversity and inclusion in financial services, as well as our view that the slow pace of gains in this area is due less to difficulty and more to a lack of commitment on the part of those who currently benefit from institutional advantages. That debate won't continue in this letter. Rather, the point of highlighting this report is to note its source.

This report was not written by an ESG analyst. In the not-so-recent past, that would not only have been the case; it would have been the only way such a piece could get published. Most banks have hired ESG analysts to satisfy those clients who value sustainability while allowing the bulk of their business to go along its merry way unconcerned with what the ESG folks were up to over in their corners. At some point in the recent past, the ESG research teams got emboldened by large clients who started asking questions about where the banks as a whole stood on ESG, and little by little, the awareness of their work slowly crept into their colleagues' field of vision.[13] ESG became inescapable to the point that it is now the domain not just of analysts dedicated to it but of the teams responsible for global research and strategy across all asset classes and themes. Indeed, this report was written by BofA's global thematic research team; the authors include just one ESG strategist but no fewer than four general equity strategies, three general equity & quant strategists and two US economists. This was a mainstream report sharing mainstream strategic views by mainstream analysts about a social issue.

They were not alone. A global economist at Citigroup published a similar report highlighting an analysis of the drag on GDP of racial inequality in the United States, with a similarly staggering price tag of approximately $16 trillion over the last 20 years. Again, this is not coming from ESG analysts. This is coming from global strategists, whose research helps drive the overall direction of both the firm and the advice the firm gives to clients.

It is worth pointing out that both reports came after the horrific injustices earlier in 2020 that led to a heightened awareness of the Black Lives Matter movement. So we do appreciate that there may be some skepticism that these changes only happened out of fear and will not last. However, as we discussed in the last section of this letter, it is ok to envision a future in which there are some motivated by fear, while others are motivated by ideals. Especially as it pertains to the very sticky issues that fall under the social pillar of ESG, those who want to see change must be willing to embrace both.

3. Governance: There are many ways in which owners, boards, companies and executives can be held to account for negligent governance. The most common comes in the form of shareholder activism. Often, governance issues shine a light on a lack of representation and diversity on corporate boards and in the executive ranks. However, more insidious

13 We'd like to think this goes without saying, but this colorful caricature of the history of ESG analysts on Wall Street is just that, a caricature: part exaggeration, part dramatization and part factual with a goal to share observations that are solely our own. Maybe, however, there is at least a little truth lurking in the humor.

governance failures can also be found in the incentive structures and resulting behaviors of companies and their boards as well. And there are more than just activist shareholders who are sensitive to and take action to address these issues.

In June 2018, BC Partners, the private equity owner of pet supply retailer PetSmart, came under intense scrutiny for using loopholes they embedded into the company's credit agreement. The company announced a transfer of approximately $1.65 billion of value out of the lender's collateral (in the form of 36.5% of the stock in its recently acquired subsidiary Chewy Inc.). The secured debt balance was just over $6.6 billion, so this move took away collateral that was worth approximately 25% of face value. The move was opposed in court, and though the actions taken were contractually allowed, the parties ultimately reached an agreement to allocate value from the diverted assets to repay the lenders if the Chewy stock was sold later. [14]

Fast forward to November 2020 and we are faced with an unexpectedly friendly credit market, allowing many issuers to raise debt at record-low interest rates even though the underlying financials have never been more uncertain due to the still-unknown long-term effect of the pandemic on the US economy. Put another way, very few companies were turned away by debt-hungry investors, let alone one as large and well-known as PetSmart.

Unfortunately, BC Partners never learned their lesson. They decided that this was the right market to raise debt for the purpose of separating the Chewy business from the legacy PetSmart retail business. If not the same move as in 2018, this one certainly rhymed. The fingerprints of the 2018 attempt to separate the very valuable Chewy business for the benefit of shareholders at the expense of bondholders were unmistakable; not even an unexpected market frenzy could erase the lenders' memory of that battle. As a result, the debt deal failed, and while that does happen from time to time, in the frothy credit markets of late 2020, it is as close to a sign of the apocalypse as we've seen in a long time.[15]

Notably, investors aren't the only ones taking governance matters into their own hands. On February 28, the New York Times published an opinion piece about a company's board of directors agreeing to a sale of the company to a firm which saddled it with too much debt, and the company later filed for bankruptcy. What's the big deal? Capitalism at work, right? The twist in this story is that a judge held the company's board liable for approving

14 It is outside of the scope of this letter to analyze the lawsuit and the outcome, but some readers may recall we analyzed this situation in early 2019 as part of our case for hidden risks in the syndicated loan market, a theme we reiterated in our Q4 2020 letter, which can be found at this link. For those interested in the details, S&P Global published a well-written summary of the covenant issues that allowed this collateral diversion to happen. Be warned: This is a dense and technical document that may put you to sleep if you don't enjoy covenant analysis as much as we do!
15 The coda to this story is that PetSmart decided to capitalize on the issuer-friendly debt markets in a much more traditional way: by refinancing its debt with new bonds and loans. Notably, the company was able to reduce its interest expense somewhat, but the shenanigans from the past loomed large in requiring them to agree to higher coupon rates than may have been achievable if they had not eroded the trust of the capital markets. In other words, poor governance can lead to higher cost of capital, which has a very real effect on the company's financial situation.

the transaction even though the bankruptcy happened four years later! [16] Though this decision may be a one-off, it puts boards and leveraged buyout firms on notice that their practice of bleeding companies dry through leverage, even if the market will bear it, has a lower bar for malfeasance in the eyes of the courts. That a judge sees this as his domain is as notable as the SEC's apparent decision to plant a stake on climate change.

In all of these examples, the primary players are not activist investors, and the results were not motivated by mission-driven objectives. Rather, these were decisions and actions taken by people in the mainstream – the SEC, traditional investment strategists and bond investors, a federal judge in New York – because they did not see ESG issues as separate and extraneous, as some investors believe them to be. Rather, they saw them for what they are – indigenous risk factors, with the same material consequences as other risk issues which are well understood to affect a company's ability to operate consistently over the long-term… or, in a word, sustainably.

What does it all mean? Investors who are willing and able to see beyond the easy and conventional road of simple screens, low fees, large managers and suboptimal performance may find doing so can help them target their financial goals more consistently. We at Zeo believe that performance and progress can coexist, and that Cynics and Idealists can also. It starts by giving ESG, impact and sustainable investing the actionable meanings they deserve. The countless investors who fell prey to failed hedge funds who didn't hedge anything can attest to the consequences if we don't.

As always, we are available for your questions, comments or feedback. We thank you for your continued support and confidence in our management.

Sincerely,

Venk

Venkatesh Reddy
Chief Investment Officer

16 The piece by William Cohan can be found at this link. Mr. Cohan makes a good effort to summarize a complicated situation, and investors should take notice of his conclusions. Typically, if a company files for bankruptcy four years after it raises debt, there would be plausible deniability. After all, a lot can happen in four years. It is true that the company had too much debt for its circumstances in 2018. But was that true in 2014? This seems to be one of the first visible signs that the judiciary has directly linked a board's (and private equity sponsor's) actions to a credit event so long afterwards. The excess leverage that killed the company had an accomplice - bad governance.

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