VOLUME 31
NUMBER 2
SPRING 2019

Journal of APPLIED CORPORATE FINANCE

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ESG as a Value-Creation Tool for Active Investors: A Profile of Inherent Group

by Tony Davis, CEO/CIO, and Beau Lescott, PM, Inherent Group*

At Inherent Group, we believe that businesses that incorporate sustainability factors into their strategy, operations, and culture will outperform over the long-term. As an investment firm, our goal is to compound capital at superior rates of return. We use environmental, social, and governance (ESG) analysis as a tool throughout all stages of the investment process to identify attractive investment opportunities and engage with companies. Through our engagements, we aim to improve our portfolio companies' financial performance and to encourage business owners and managers to incorporate sustainability factors into their decisions.

Our firm was established and organized with these values in mind. Although we look and operate like a fundamental value-oriented investment firm, Inherent Group is a certified "B Corporation" that considers the firm's impact on the community, environment, and other stakeholders. We also participate in a range of initiatives to encourage and coordinate the efforts of like-minded investors and provide guidance on ESG-integrated investing. For example, the firm is a member of the Ceres Investor Network on Climate Risk and Sustainability, whose goals are to promote investor incorporation of ESG factors into their decision-making and to demonstrate to other investors and corporations how these factors affect long-term performance. We are also a signatory of the United Nations Principles for Responsible Investment. Signatories incorporate ESG into their investment processes and produce detailed annual, publicly available reports that reflect their approaches.

The aim of this article is to illustrate, from a practitioner's perspective, how integrating ESG factors into the investment process can create value for active investors in publicly traded companies. Most studies of ESG investing to date show how the use of historical data in the construction of large rules-based portfolios can add alpha by over-weighting better ESG performers and underweighting, shorting, or excluding poor ESG performers.[1] But few if any studies have tried to shed light on the *process* of integrating these considerations into investment analysis and decision-making with the goal of identifying and, in some cases, catalyzing ESG progress that should eventually be valued by the capital markets. This is particularly important given the growing number of funds that claim to integrate ESG factors into their investment processes and strategy without fully describing how they do so. One of the arguments of this article is that ESG, as applied to both corporate operations and strategy, is an important factor in determining a company's cost of capital. This idea is also the lynchpin of our strategy and anchors our approach to investment sourcing, underwriting, and corporate engagement.

*The views and assessments expressed in this article are largely or entirely those of the personnel of Inherent Group, LP ("Inherent") as of the time that this article was prepared and are subject to change. They may prove to be incorrect in whole or in part. The investment illustrations described in this article are included solely to illustrate the manner in which certain aspects of Inherent's ESG-focused investment strategy may be implemented. Such investments are not representative of all of the investments made or anticipated to be made by Inherent on behalf of its clients. Further, such investment illustrations, and the other information and opinions in this article, are not and do not purport to be investment advice. Operational, industry, sector, and market information contained herein was compiled from sources that Inherent believes to be reliable. Inherent makes no representations or warranties as to the accuracy or completeness of such information, nor of the other information or opinions expressed in this article. This is not an offer of investment advisory services.

1 See, for example, Gunnar Friede, Timo Busch & Alexander Bassen (2015), "ESG and financial performance: aggregated evidence from more than 2000 empirical studies," *Journal of Sustainable Finance & Investment*, 5:4, 210-233, DOI: 10.1080/20430795.2015.1118917; Anirudh Agrawal & Kai Hockerts (2019), "Impact investing: review and research agenda," *Journal of Small Business & Entrepreneurship*, DOI: 10.1080/08276331.2018.1551457.

Defining the Opportunity Set

Some ESG issues, like societal efforts to decarbonize, are clearly aligned with at least one of the United Nations' Sustainable Development Goals (SDGs).[2] Many of the SDGs reflect multi-year "mega trends" that provide a large and growing market for businesses to address. We seek to invest in companies we believe are poised to benefit from such mega trends, such as increased adoption of electric vehicles, cleaner power, and healthier food. Such trends may also guide the thinking behind our short positions, as we seek companies for which the trend poses a financial headwind. Examples have included companies in the coal and processed food value chains.

Other ESG issues, like workforce relations, are operational in nature and may not be obvious today from financial statement analysis or risk-factor disclosures. In such cases, our work is informed by the standards set out by the Sustainability Accounting Standards Board (SASB), which provide industry-specific metrics for companies to guide their reporting on "material" ESG exposures and their progress in managing them.[3] While we use the SASB standards as a starting point, we find that direct engagement with companies is the most effective way to determine the materiality of their exposures. This approach is also important for companies that don't neatly map to SASB's industry verticals or that straddle two or more verticals.

In general, portfolio companies where our ESG focus is operational have particular variables that, if improved, are expected to contribute to the long-term value of the business and reduce the company's cost of capital by limiting sources of risk. In some cases, Inherent Group actively encourages the company to make such improvements. At the same time, we take "operational" short positions in companies whose poor performance on ESG factors has raised our view of the company's risk profile in ways not fully recognized by the market, and with significant potential to impair the fundamental health of the business.

By mining both SDG-related and operational opportunities, we have a large investable universe. We do not feel that we are constrained to a small subset of companies that could limit our ability to find the best risk-reward investments.

Our Process: ESG in Sourcing, Underwriting and Engagement

ESG plays a central role in our idea sourcing process. Sometimes, as in the case of a wind-turbine blade manufacturer we have a long position in, the business model itself is aligned with an SDG. In other cases, our study of an SDG-related mega trend reveals an overlooked or misunderstood opportunity in or risk to a business, as in the cases of a specialty chemical business and a protein rendering business that we describe later. Because such mega trends, or themes, impact each of our investments in different ways, we organize our team thematically, assigning each investment analyst a thematic priority in which to develop expertise. By organizing this way, we ensure that we identify business models that actively address environmental and social issues as well as the secondary effects of those issues on businesses across a wide range of industries. For us, key themes include decarbonization, the electrification of transportation, education and human capital development, the shift to healthier foods, the transition to value-based healthcare delivery, and the growing role of trust in our digital interactions.

> In our experience, gathering information on ESG issues along with financial research offers richer data and, therefore, a more informed perspective. We have been pleasantly surprised by the level of access and positive reception we have received from many of the companies in our portfolio.

All of our investment ideas are subject to an ESG evaluation and underwriting process that unfolds as part of our traditional financial analysis. We believe that an integrated approach (as opposed to conducting the ESG evaluation in a distinct organizational silo) is crucial to success. A critical step in our analysis is to identify the material issues facing a company—such as, for example, emissions in need of mitigating or misaligned executive pay incentives. What is financially material varies by industry and by company. Identifying such factors almost always requires communicating directly with the company as well as analyzing associated risk-reward tradeoff questions in the course of fundamental underwriting and decision-making.

Ultimately, we seek to incorporate our specific ESG findings into our revenue and expense forecasts. And we use our assessment of governance, management, and culture to inform the discount rate we apply to the cash flows expected from the investment and the size of the investment position in our portfolio.

2 See https://www.un.org/sustainabledevelopment/sustainable-development-goals/.
3 See https://materiality.sasb.org/.

Along with identifying critical drivers of value through our underwriting work, we also assess which companies could benefit from a direct constructive engagement—and whether management is likely to be receptive to such an engagement. Our engagement approach is partly driven by mounting evidence that shows a strong positive correlation between improvements on financially material ESG issues ("ESG momentum"), financial performance, and equity and credit returns.[4]

Our engagement with management usually begins with a conversation where we share our views on material areas for improvement, including those more traditionally defined as ESG. The engagement then generally progresses to written letters to management and the board that outline our views. We vote proxies and file shareholder resolutions accordingly. We are prepared to nominate our own directors when necessary, but our preferred approach is to work constructively with the current management and board.

One of the by-products of our approach to engagement is more frequent and varied interactions with the company. In addition to the C-suite, we often interact with heads of safety, human resources, legal, and operations. These interactions facilitate deeper understanding of the company, particularly with regard to company culture. How does management think about taking care of their people and the environment? How does decision-making occur? Does executive management prioritize long-term strategic imperatives over short-term expediencies? How are financial and advancement incentives aligned with strategy throughout the organization? Our understanding of culture figures prominently in our assessment of a company's ability to create and sustain enterprise value.

Put simply, in our experience, gathering information on ESG issues along with financial research offers richer data and, therefore, a more informed perspective. We have been pleasantly surprised by the level of access and positive reception we have received from many of the companies in our portfolio.

Below we present three detailed examples to illustrate our approach. In each, we describe how ESG issues factored into our valuation of the investment. We then conclude with a short discussion of ESG data services and questions for investment allocators to consider.

Example 1: Value from an EPA Settlement

Our first example is a specialty chemical company where we saw a clear line of sight to closing a valuation gap that we attributed to the financial markets' misunderstanding of some fundamental ESG issues.

For several months, we engaged with the management team of the company on certain ESG issues that we viewed as potentially increasing its cost of capital (and depressing its earnings multiple). At the time of our investment, the stock was trading at a lower earnings multiple than its closest competitor. We saw a path whereby resolution of these ESG issues could lead to the closing of that gap.

The primary valuation disconnect impacting the stock appeared to be related to an Environmental Protection Agency (EPA) enforcement action regarding emissions of sulfur dioxide and nitrogen oxides. Based on the company's disclosed cost estimates, the consensus among sell-side analysts was that the company would likely incur a cost equal to 5-10% of its current market capitalization to bring its plants into compliance.

Our own analysis, however, suggested that the sell-side's view failed to recognize significant potential follow-on benefits from such an investment in environmental compliance. First, we believed that the company's success in settling with the EPA would prove to be the tipping point in an industry where a then majority of competitors (and capacity) would come into compliance with the EPA on emissions. In our view, this development would then pressure the few remaining companies to comply, as the prospects of holding out for a better deal with the EPA were reduced. Once the entire industry settled, we expected the pricing of products to rise to reflect the higher costs associated with producing an emissions-compliant product. Since each company would have to invest more capital to keep its capacity online, the potential for more plant closures would also increase. As we had observed in a similar situation in Europe some years ago, even a modest reduction in capacity was likely to have a positive effect on prices. Our internal analysis suggested that the net present value of an EPA settlement, including the consequent changes to market dynamics, was materially positive. We accordingly suggested to the company that it swiftly settle with the EPA and bring all its plants into compliance or shut down any plants that could not justify the investment.

The company did in fact settle with the EPA in December 2017, as did the other holdouts in the industry. See Figure 1, in which the date of the settlement is represented by the vertical dotted line. Prior to the settlement, the company's stock traded at an earnings multiple that was 3.0x lower than that of its closest peer, which had already been in compliance. After the settlement, the company began to trade at a slight premium in earnings multiple to that of its closest peer.

4 Nagy, Zoltan, Altaf Kassam, and Linda-Eling Lee, "Can ESG Add Alpha? An Analysis of ESG Tilt and Momentum Strategies," *The Journal of Investing*. Summer 2016. https://doi.org/10.3905/joi.2016.25.2.113; "ESG + Quant = alpha; activists could play matchmaker," Bank of America Merrill Lynch. 3/20/2018.

Figure 1
Specialty Chemical Company's Forward P/E Premium/(Discount) to Peer*

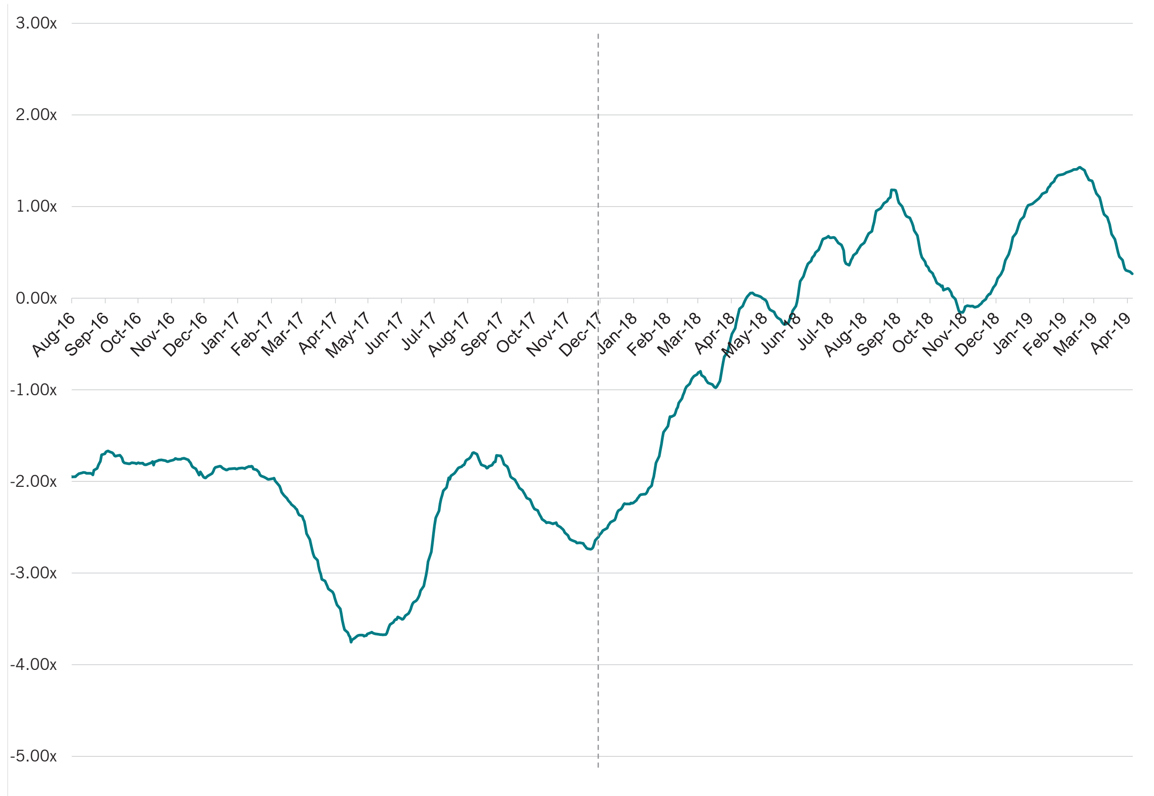


*Chart shows trailing 30-day average multiple of stock price to next-twelve-month earnings of company versus its closest peer.

Sources: Inherent Group analysis; S&P Global Market Intelligence. Information, including ratings, obtained from S&P Global Market Intelligence ("SPGMI") should not be relied on as investment advice. Ratings are opinions and not recommendations to purchase, hold or sell securities, and they do not address the market value of securities or their suitability for investment purposes. SPGMI does not guarantee the accuracy or completeness of information obtained from it and shall not be responsible for any errors or omissions with respect to such information or be liable for any results or losses arising out of the use of such information. Please read important disclaimer at https://www.spglobal.com/marketintelligence/en/legal/disclosures. Reproduction of SPGMI information is prohibited without the prior written permission of SPGMI.

As an investor focused on a company's long-term sustainability, our engagements generally involve more than one material ESG issue. In this case, we have also encouraged management to begin integrating other ESG factors into strategy, operations, and executive compensation. In addition, we have pressed management to improve disclosure of its executive compensation policy and to integrate various carbon-pricing scenarios into its long-term planning. We believe there is still significant long-term value to be created through execution of these best practices working in concert with the improved industry fundamentals resulting from the EPA settlement.

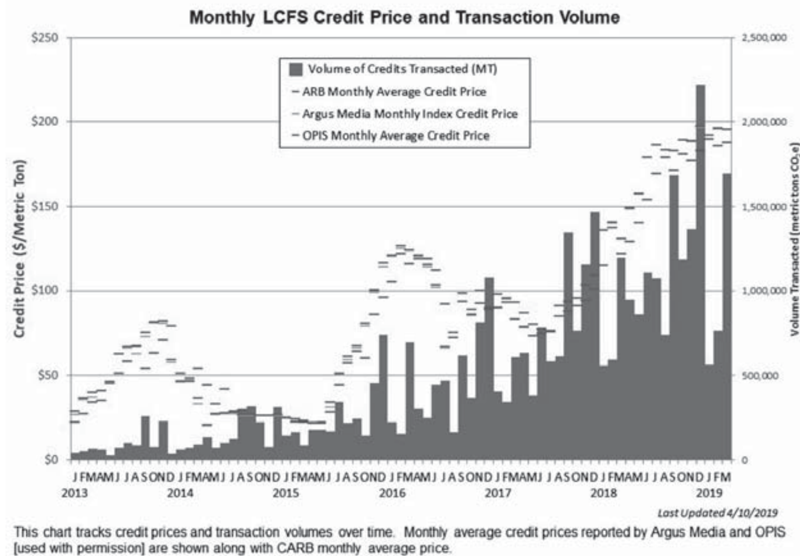
Example 2: Value in the Pricing of Externalities

One fertile area for sourcing ideas is in those sectors where an externality is not currently priced, but where we expect that to happen over time. This can present a risk or an opportunity that the market may be overlooking.

Carbon dioxide emissions are priced in an increasing number of geographies, and prices are rising. For example, there are mandatory CO_2 compliance schemes in the EU, California, and Canada that cover a variety of industries. The price of a metric ton of CO_2 in these schemes varies widely from $15-25 per metric ton (MT), but prices generally have been increasing since the signing of the 2016 Paris Agreements. In the EU, for example, CO_2 prices have nearly tripled from about €8 in January 2018 to €25/MT today.[5] And according to scientists and economists, limiting global

5 https://markets.businessinsider.com/commodities/co2-emissionsrechte.

Figure 2
Monthly LCFS Credit Price and Transaction Volume



Source: https://www.arb.ca.gov/fuels/lcfs/dashboard/dashboard.htm, tab 4.

warming to 1.5 °C may require a CO_2 price of at least $135/MT by 2030.[6]

It is our belief that increasing CO_2 emissions costs across a growing number of industries and jurisdictions globally will cause significant dispersion in corporate performance over time. This dispersion will be driven mainly by two factors: the current and potential emissions intensity of each company relative to its peers in a given vertical, and a company's ability to pass on increasing CO_2 costs to its customers. Consider that, at $50/MT, CO_2 emissions costs for the ten most carbon-intensive European utilities would represent over 40% of their aggregate forecasted 2019 EBITDA.[7]

The pricing of CO_2 emissions is just one example in our strategy of an externality that, depending on the industry and location, is either unpriced or underpriced. As such externalities are priced over time, they will be increasingly relevant to companies' long-term performance. In seeking to capitalize on this dispersion, an investor may choose to go long companies that are expected to help bring about the transition to a low-carbon economy, such as those enabling growth in renewable power, the electrification of transportation, and a reduction in the carbon-intensity of industrial and agricultural practices. Likely candidates for short investment ideas include companies expected to bear the brunt of higher CO_2 prices and lacking the ability to pass these costs on to their customers. Generally, these are companies that will find themselves on the high end of supply cost curves or where there are close substitutes for their more carbon-intensive products.

As part of our work on carbon pricing, we analyzed California's decarbonization regulations and programs, one of which is the Low Carbon Fuel Standard (LCFS), which targets transportation fuel and aims to reduce by 20% the carbon intensity of such fuels consumed in California by 2030.[8] The program works by setting up incentives for the production and distribution of transportation fuels with progressively lower "full-cycle" greenhouse gas intensity. Providers of transportation fuels must either demonstrate that the mix of fuels they sell meet California's LCFS compliance standards annually, or buy offsetting LCFS credits to the extent they fail to do so.

After analyzing the structure of the LCFS program, we came to the conclusion that there is an elevated probability that the supply and demand of LCFS credits available to fuel distributors will remain tight, largely because of the limited supply or growth of alternative fuels relative to the require-ments set by the declining benchmark. Consistent with our analysis, Figure 2 shows that LCFS credit trading volumes and pricing have been trending higher. And we accordingly sought out companies

6 "Special Report: Global Warming of 1.5 ºC," IPCC (October 2018).

7 Shown for reference purposes only. A significant portion of such costs are likely to be passed through to customers rather than reducing EBITDA dollar-for-dollar. Source: Inherent Group analysis; company disclosures.

8 https://www.arb.ca.gov/fuels/lcfs/lcfs.htm.

Figure 3

Conference Board C-Suite Issue Ranking, 2018

HOT-BUTTON ISSUES*	Global	US	Asia	Europe	Latin America
Failure to attract/retain top talent	1	1	1	2	1
Creating new business models because of disruptive technologies	2	2	2	3	2
Volatility in cash flow	3	4	3	7	3
New competitors globally	4	7	5	1	4
Developing "Next Gen" leaders	5	3	9	6	5
Cybersecurity	6	6	11	4	7
Income inequality/disparity	7	13	4	9	6
Threats to global trade systems	8	10	10	16	12
Health care benefits for employees	9	5	15	17	14
Failure to devise an effective internal performance measurement system for employees	10	12	8	20	11
Workforce diversity	11	14	13	14	9
Political instability/conflict in Asia-Pacific	12	22	7	19	17
Rebuilding public trust in business	13	16	16	13	10
Corporate tax reform	14	11	12	25	18

Source: "C-Suite Challenge 2019," The Conference Board. 2019. (https://www.conference-board.org/press/pressdetail.cfm?pressid=7650).

expected to benefit from the tailwind of this LCFS credit dynamic.

Our work unexpectedly led us to a protein-rendering business. Protein rendering is the process whereby waste from slaughterhouses is recycled into ingredients and specialty products for the pharmaceutical, food, and pet industries. Protein rendering is thus part of the circular economy and relevant for ESG-focused investors.

In this example, however, our case for investing was premised on the prospective value of the company's own fat and grease co-products that are being sold into a new joint venture (JV) with an energy company to produce renewable diesel fuel, which is one of the lowest-carbon fuels available today.[9] As one of the largest suppliers of low-carbon fuel to California, the company benefits substantially from LCFS credits, with cash flow associated with its renewable diesel JV likely to comprise as much as 50% of the company's cash flow by the time the JV is fully scaled in 2023.[10] This is important because the core rendering operations are relatively capital intensive, and diversifying the company's cash flow stream should reduce the company's business risks and associated capital requirements.

The company's pivot toward environmentally sustainable fuels has several important valuation implications. First, because its JV was an early mover in the space, it benefitted from lower construction costs, which have since risen and made it more difficult for new entrants. Second, because the JV benefits from a direct fat and grease supply agreement with the company, volatility in input costs functions as a natural hedge of the rendering company's core fats and grease sales; when one entity suffers, the other benefits. We believe that these factors should make the company's consolidated cash flows more stable, and therefore command a higher multiple.

Over the course of our investment, we have also been engaging with the company's management on select ESG issues that we believe are material—specifically, workforce safety, diversity, and more effective communication of the company's sustainability story. In our opinion, the biggest ESG challenge the company faces is attracting and retaining talent. By focusing on this challenge, we believe the company can increase the pool of potential candidates and better attract and retain top talent. A key requirement for us to increase the size of our investment is to see progress on this.

Example 3: Value from SDG alignment

For intangibles-driven sectors such as software, services, and healthcare, one approach we have taken is to seek out companies that are creating financial value by addressing SDGs in novel or more efficient ways than legacy offerings do. One focus area for us is SDG #4—Quality Education. We have invested in a software-as-a-service (SaaS) company that facilitates education delivery and human capital development. Its core product is a learning management system (LMS) that

9 https://www.eia.gov/todayinenergy/detail.php?id=37472.

10 Inherent Group analysis; company disclosures.

helps universities and K-12 schools administer courses more efficiently, both in delivering content and managing logistics such as assignments and grading. Its cloud-based offering and functionality is meaningfully superior to that of legacy offerings, resulting in high win rates on requests for proposals, revenue retention of existing customers in excess of 100%, and high net promoter scores.[11]

While we see continued growth in this area of the business, the company is using its data to develop student success products that will allow for better student guidance and early intervention for struggling students. Given that six-year college graduation rates are approximately 60% in the United States, any improvements in student success would be welcome indeed.[12] Too often, students attending college leave without a degree and with significant debt. Colleges at the same time forgo valuable tuition payments.

At the same time, U.S. corporate leaders increasingly cite gaps in the capabilities of current and prospective personnel as one of the top risks to their businesses. This makes the need to motivate, advance, and retain productive employees increasingly critical. As Figure 3 shows, CEOs and other C-suite executives around the world rank attracting and retaining talent and developing the next generation of leaders among their top concerns.[13] U.S. companies spend roughly $275 billion annually on recruiting, much of which is to replace churn, and $88 billion on training their staff.[14]

The company is expanding its expertise more generally into human-capital development for corporate clients. It has developed a talent management system that enables continuous learning for employees and facilitates a more real-time performance review process by encouraging regular engagement and feedback. To the extent it succeeds, it will help companies employ the key practices that high-performing organizations use to develop and engage employees—including aligning employees with the company mission, bringing structure and cadence to one-on-one employee-manager meetings, and providing a framework for employees to consider what gives them career satisfaction and motivation. And there is clear demand in the market for a solution like this: Almost 70% of employees say they are not engaged in their jobs; 50% of all employees are looking for a new job; 35% reported changing jobs in the past three years; and the top reason employees leave jobs is lack of development and career growth.[15]

From a valuation perspective, the company is generally compared to other peers in the SaaS space based on current and forward-year revenues and gross profits. Given the dominance of its current LMS products and the large addressable markets for its new products, we believe it can sustain growth at high levels for many years to come. As this approach shows, investing in mega trends such as human capital development can yield time-arbitrage benefits. With such opportunities, an excessive focus on the next quarter or next twelve months risks missing an opportunity possibly orders of magnitude larger than what the current sales backlog or other near-term indicators might imply.

The Role of ESG Data Services

Company-disclosed ESG information lacks standardization, is unaudited, and in many cases is a year old when published. While disclosure and data are improving, we are wary of an over-reliance on existing ESG data and scoring products. The inconsistency of such methodologies is readily apparent in the example of Tesla. Whereas one leading ESG data provider gives Tesla high marks for environmental performance based on the environmental promise of electric versus internal-combustion vehicles, another grades the company's environmental performance poorly by focusing on emissions associated with the production process rather than the product.[16] Their ratings also diverge when it comes to the social dimension, which generally includes things like workforce safety and management.[17] As a result, we don't rely heavily on rating agencies' scoring in our underwriting assessments. We hope this improves in the future with better mandated disclosures and scoring approaches. Nevertheless, we have found ESG datasets useful in initial screening for both long and short opportunities.

Investment Allocators and ESG

Institutional investors and other investment allocators are increasingly asking how ESG analysis factors into a manager's investment decisions as they perform due diligence on the investment process and philosophy. While the institutions that have historically valued environmental or social impact tend to be the first movers in this line of questioning, ESG as a risk-reward consideration is rising in importance

11 Company disclosures.

12 U.S. Department of Education, National Center for Education Statistics. (2018). The Condition of Education 2018 (NCES 2018-144), Undergraduate Retention and Graduation Rates.

13 "C-Suite Challenge 2019," The Conference Board. 2019.

14 Job Openings and Labor Turnover Survey, Bureau of Labor Statistics; 2016 Human Capital Benchmarking Report, Society for Human Resource Management; 2018 Training Industry Report, Training Magazine.

15 Gallup State of the American Workplace, 2017

16 https://www.wsj.com/articles/is-tesla-or-exxon-more-sustainable-it-depends-whom-you-ask-1537199931.

17 See, e.g.: https://www.thendobetter.com/investing/2018/9/21/why-esg-ratings-will-never-agree-and-some-of-the-problems-of-ratings.

for a much broader swath of investors, from pension funds to family offices.[18]

In some cases, particularly in Europe, increased focus on environmental and social issues is being mandated. For example, the European Parliament and EU countries agreed in March 2019 on sustainable-investment disclosure rules for institutional investors that will require money managers to integrate ESG factors into their investment decisions and disclose how they are doing it. In Sweden, the National Pension Insurance Act requires some of its funds to be "exemplary" on sustainability.[19]

Given our strategy, we are often asked whether our focus on ESG factors limits our investable universe and therefore our ability to generate returns. Because we are incorporating ESG analysis as an evaluation tool in the pursuit of better risk-adjusted returns across a broad range of industries and companies, rather than as just a screen, we believe that our approach does not limit our investable universe nor should it be a constraint on our potential returns. On the contrary, our belief is that by integrating ESG factors we can generate better performance than we would otherwise. Perhaps as a consequence, investor interest in our firm ranges from those who care deeply about ESG considerations as a component of investing to those who are simply focused on financial returns.

We encourage investors to ask the investment managers to whom they have allocated capital whether and, if so, how ESG analysis is being integrated into their investment processes. How do they identify long-term drivers of value? How do they treat matters like the current and potential cost of CO_2 emissions, resource efficiency, and governance? How do they identify the most material issues for a given company or industry? How do they assess the potential for those issues to create or destroy value? What data sources do they use relating to ESG performance, and how do they overcome the false precision and lack of disclosure from which so many such data sources suffer? How, specifically, has consideration of ESG factors actually led such investment managers to make or avoid certain investments? And where do ESG considerations appear in their investment committee memos?

Conclusion

Our basic view is that two otherwise identical companies with different levels of performance on material ESG issues should have different costs of capital. Our intuition is that the laggard's cash flows are riskier and therefore demand a higher cost of capital and thus be valued using a high discount rate. To the extent we can help improve a company's performance, the market should assign it a lower cost of capital over time, which is likely to be reflected in higher earnings multiples as well as lower credit spreads.[20] But, of course, the timing of such effects is hard to predict, which partly explains why our strategy has a long-term focus. This also leads us to take a more concentrated private equity-style approach, which can increase alpha.[21]

We believe that investment managers who have thoroughly integrated material ESG factors into their investment process will be best positioned to outperform their peers. Doing so provides advantages in an investment manager's ability to source, underwrite, value, and engage with portfolio companies. As flows to passive funds increase and algorithms become ever better at short-term trading than humans, we believe that ESG analysis as a source of longer-term insight and action will help us perform and attract capital.

TONY DAVIS founded Inherent Group in 2015 and serves as its CEO and CIO. Prior to Inherent, Mr. Davis was the president of Anchorage Capital Group, which he co-founded in 2003 and where he served as a PM. Prior to Anchorage, Mr. Davis worked in the fixed income, currency, and commodities division of Goldman Sachs from 1997 to 2003. Mr. Davis is a trustee of Inherent Foundation and a board member of Ceres, the corporate and environmental advocacy organization. He earned a BS in Electrical Engineering from Brigham Young University in 1993. He received an MBA from The Wharton School and an MA from The Lauder Institute in 1997.

BEAU LESCOTT joined Inherent Group 2017 and serves as PM of Inherent ESG Opportunity Master, LP. Prior to Inherent, he was president of Chimney Rock Investments, an investment manager founded in 2008 in partnership with Ziff Brothers Investments. Previously, Mr. Lescott worked in distressed and leveraged credit investing roles at Satellite Asset Management, Sagamore Hill Capital Management, and the Blackstone Group, and in fixed income at Salomon Brothers. Mr. Lescott received a BA in Philosophy from the College of the Holy Cross in 1995 and an MBA from Harvard Business School in 2002.

18 Bank of America, "Evolving attitudes to ESG, SRI and Sustainability considerations in the Alternatives industry." February 2019.

19 https://www.responsible-investor.com/home/article/looking_to_the_leaders_what_do_swedens_ap_funds_have_lined_up_on_esg_in_201/.

20 Kölbel, Julian Fritz and Timo Busch, "The link between ESG, alpha, and the cost of capital: Implications for investors and CFOs," *Corporate Finance*. 3/27/2017.

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