# THE SPIRIT OF COMPROMISE

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BAILLIE GIFFORD

# RISK FACTORS

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# THE SPIRIT OF COMPROMISE

BY LUCY ISLES

*Cement accounts for 5 per cent of global carbon emissions and Cemex, a leading Mexico-based producer lacks governance and sustainability appeal. But we cannot ignore well-financed companies whose products contribute to economic growth, least of all when they promise to travel the road to redemption. Compromise is essential.*

# BALANCING FACTORS

Life is full of compromises. Many of us, for example, are quite capable of arguing for a sustainable world, while continuing to drive cars, eat meat and vote for mainstream political parties.

We could ride bicycles, go vegan and vote green. But we are reluctant to change our comfortable way of life. So we compromise by driving less, cutting back on meat or backing mainstream politicians with a sincere interest in the environment.

Arguments are also settled by compromise. In due course, Brexit protagonists in the UK will need to strike one. It's all about embracing the art of the possible.

Baillie Gifford's High Yield team believes in the importance of Governance and Sustainability (G&S) but we do not believe in taking a dogmatic approach. So we seek a compromise between G&S and financially material issues, explaining how we reached our decision, as and when required.

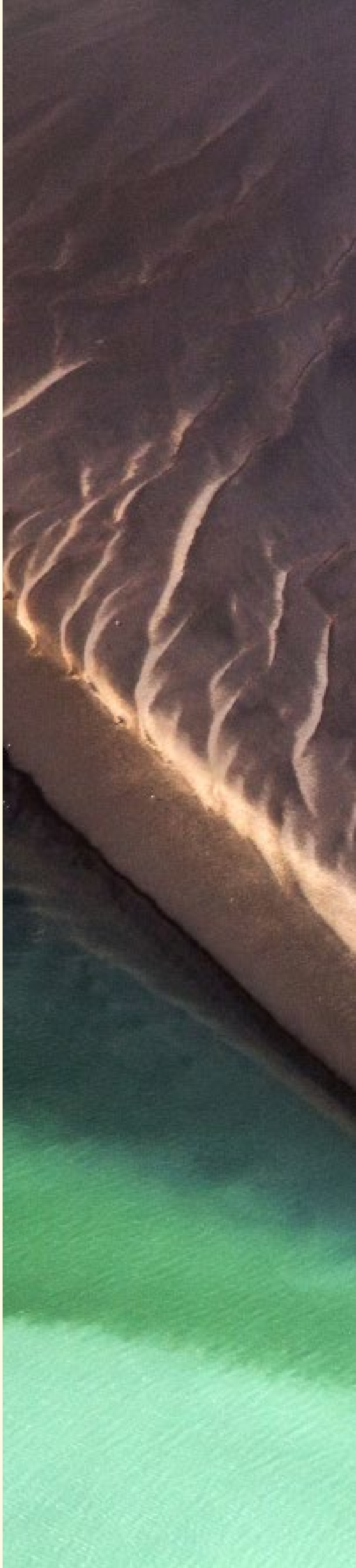
On occasion, we are prepared to grit our teeth and invest in companies operating in sectors that damage the environment, as long as their financial position is strong; their products are essential to local economies - and they are on a road to redemption.

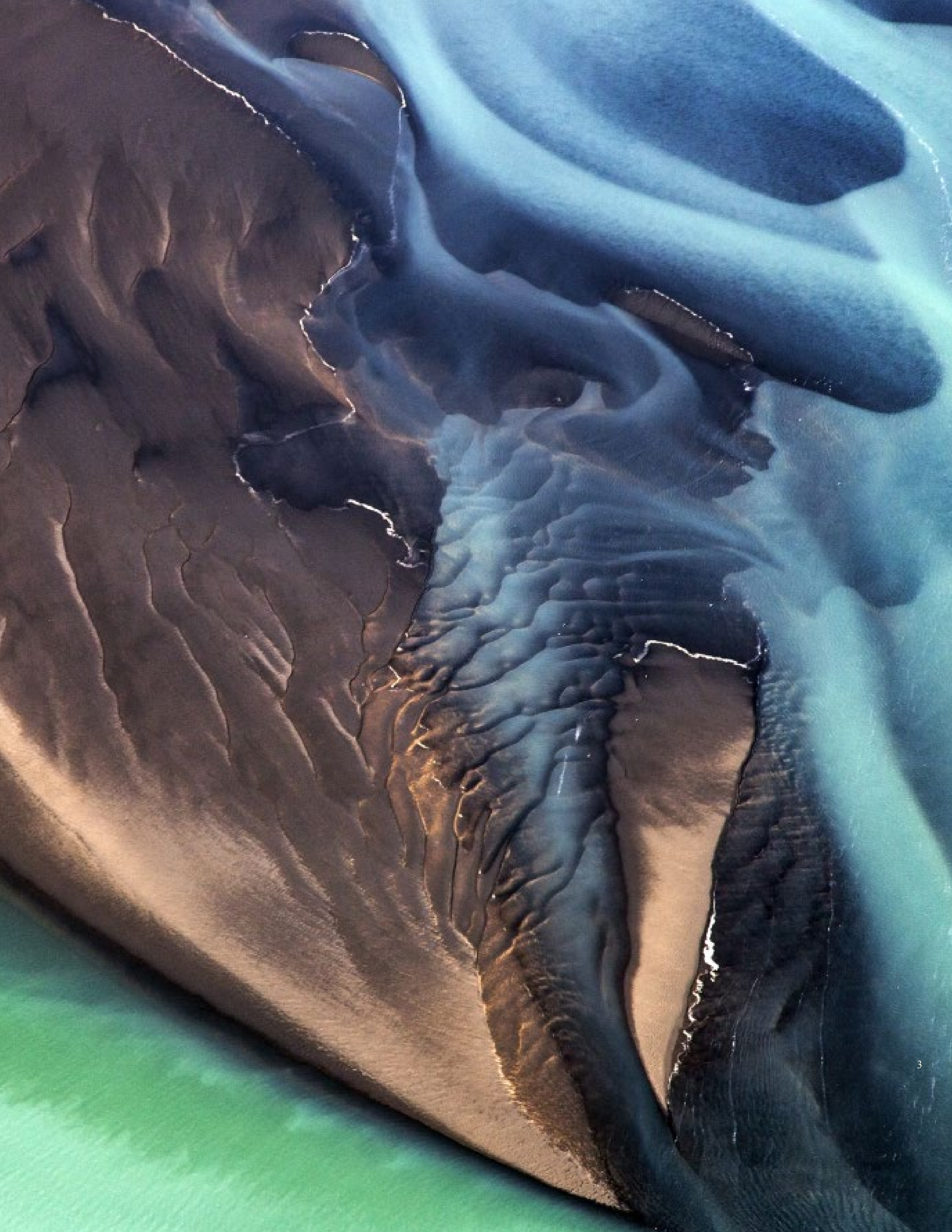
Take Cemex, a leading global company headquartered in Mexico, which produces building materials, notably cement and ready-mix concrete.

Cement is lethal to the atmosphere, producing 5 per cent of the world's carbon emissions. Cemex also has a poor track record for employee safety at some of its plants.

Far worse, an associate company suffered an accident in the Philippines in 2018, killing 49 people. Cemex has suffered bribery accusations. Its predominantly male board (there is one female independent director) hails from the city of Monterrey and completely lacks diversity. Cemex rates zero on our G&S scale. No surprises there.

But there are balancing factors. It retains a leading competitive position in emerging markets, where it operates in benign supervisory environments. The company scores highly in terms of financial stewardship, with the help of timely asset sales and commitment to further improvements. This potential for upgrade out of the riskier High Yield rating and into an Investment Grade rating also makes its yield compelling.





Urban and infrastructure projects, crucial in raising the prosperity of poor economies, rely on cement. Cemex is a reliable supplier. It is making conscious efforts to improve via sustainability targets, investment in green building projects and initiatives in Research & Development (R&D) as well as recently incorporating a price of carbon into their business planning.

We believe that, in this instance, we would do better to facilitate further improvements at Cemex by continuing to lend it money, rather than turning our backs.

Other Baillie Gifford teams invest in Cemex equity, which brings further influence to bear on our governance stance. Following a review of G&S issues in 2018, our team reduced our bond holding in Cemex, reflecting our lower conviction in the company's overall resilience. But we intend to maintain our position, as long as it maintains its direction of travel in G&S along with a strong financial position.

Not all reviews of our holdings resulting in low conviction - and thus a score of 0 for G&S - remain in the portfolio. In fact, Cemex is the only bond we hold that scores 0 for G&S, down from approximately 4 per cent at the start of the year. One such sale out of our portfolio was a bond issued by Goodyear, the tyre company.

We took the view it was an average player in a competitive market but with some exposure to growth markets in Asia and top market shares. On Goodyear's financial position, however, it was highly leveraged, and far too keen to pump up its shareholders with buybacks and dividends. Not a strong starting position.

When it came to G&S analysis, however, the picture only got worse. In 2019 alone, Goodyear's suppliers had been accused of unsustainable practices and a large number of employees sued for unfair dismissal and exposure to toxic chemicals.

While no individual issue could have resulted in default or anything financially material, collectively it looked as if management had taken a dismissive approach to sustainability. Our limited conviction in G&S combined with our limited conviction on Goodyear's overall resilience and resulted in a sale.

Our approach has been validated by the Principles for Responsible Investment initiative, backed by the United Nations. Our assessment within Fixed Income was raised from B to A earlier this year, reflecting our increased integration of G&S issues in our analysis and decision making.

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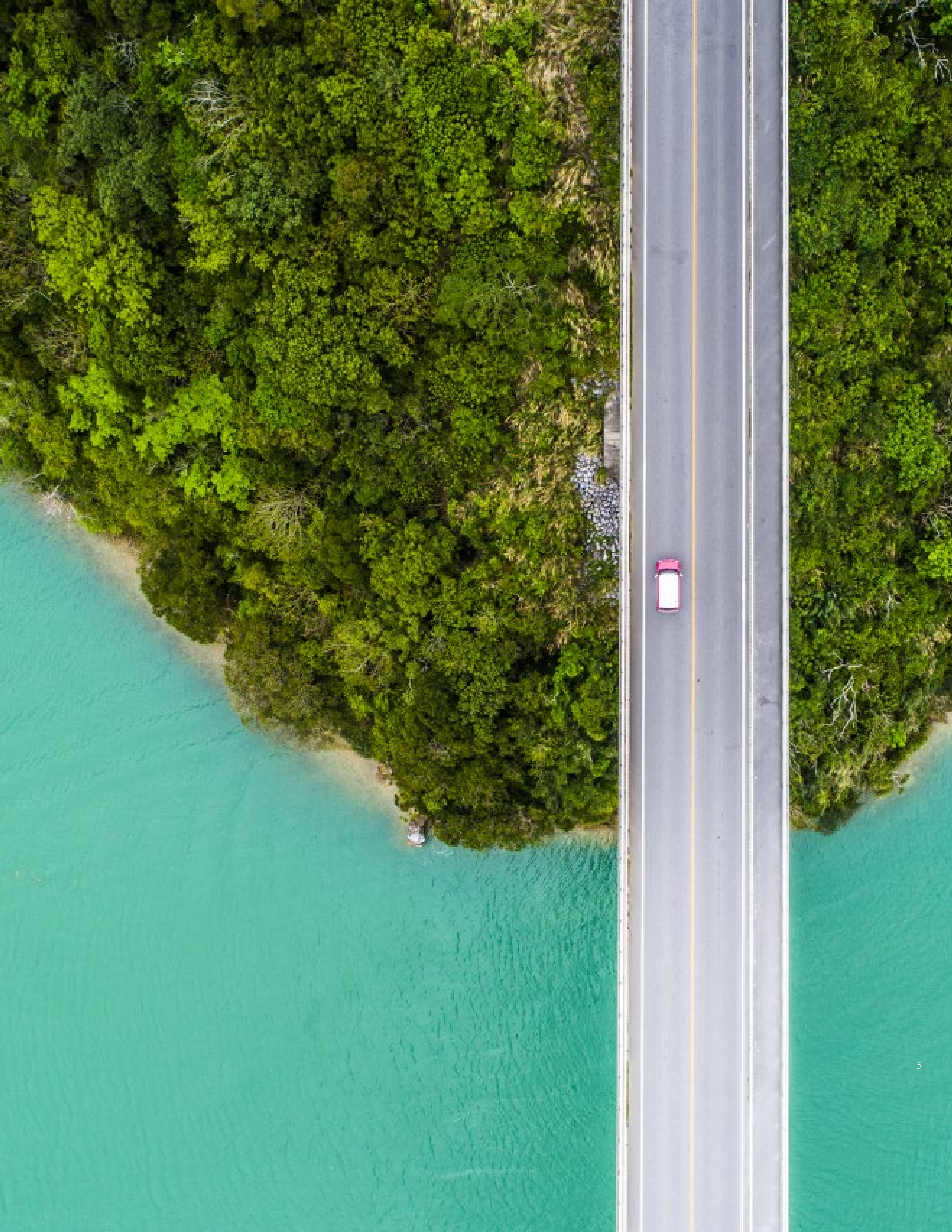

# *WE BELIEVE G&S ADDS DEPTH TO OUR HIGH YIELD OFFERING*

*We are equally convinced that our flexible approach to the issue means a score of 0 on G&S need not lead to a zero-portfolio position, if we spot potential for improvement and when a strong competitive position, sturdy capital structure and/or compelling valuation justifies a more generous view.*

*This is true to the spirit of compromise which has been so important to our team for years and results from our determination to be good stewards of the capital our clients entrust to us.*

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Lucy joined Baillie Gifford in 2012 and is co-manager of the High Yield Bond Fund. Lucy graduated MA (Hons) in International Relations and Modern History from the University of St Andrews in 2011.

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