

EMERGING MARKETS

ESG INVESTING IN EMERGING MARKET DEBT

Sustainable investment: ESG in emerging market debt

December 2018

Mary-Therese Barton, Head of Emerging Market Debt, Guido Chamorro, Co-Head EM Hard Currency Debt

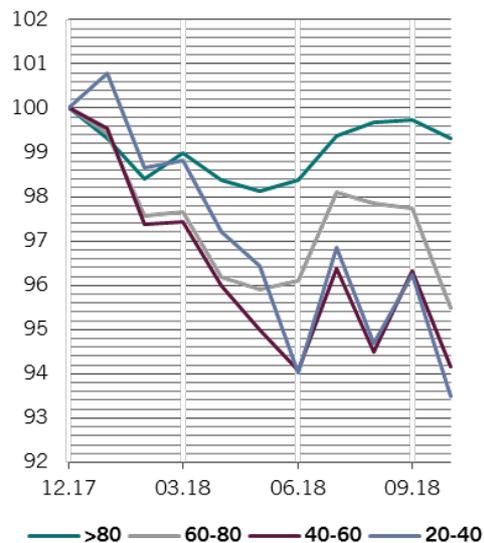
Why investors in emerging market sovereign bonds need to pay attention to environmental, social and governance factors.

The images of the vast stacks of near-worthless Zimbabwean or Venezuelan currency notes needed to buy basics like bread and meat that frequently circulate through social media are a stark reminder of how critical governance is to emerging market economies. But trying to discover – never mind read – the signposts that point to how conditions are changing, whether for the better or worse, is hard.

Complicating matters further are the social and environmental dimensions that have the potential to play equally critical roles in weighing up investments. For example, Haitian deforestation and the Arab Spring have had dramatic consequences in the shape of wholesale currency debasement.

IT PAYS TO BE GOOD

Performance of EM country debt by ESG scores rated from 1-100*, rebased to 27.12.2017 = 100.



*Issuers with scores below 20 are excluded. Source: Pictet Asset Management, JP Morgan. Data as of 31.10.2018.

But investors have largely struggled to join the dots across countries' environmental, social and governance characteristics in any overarching or systematic way, particularly in fixed income markets.

One reason sovereign bond investors have been considerably slower than, say, equity investors in coming to recognise the importance of ESG is a relative lack of quality information. While ESG factors are increasingly being quantified at the company level and applied to equity and credit investing, there's been less research into how such considerations affect the creditworthiness of sovereign borrowers.

Recently, however, advisory services and rating agencies have responded to the growing demand for sovereign-based ESG analysis. And that's likely to grow as investors see direct evidence of a relationship between how sovereigns rank on various ESG criteria and how their bonds perform. For instance, there's growing evidence of a correlation between good governance and lower sovereign default risk and spreads¹. Elsewhere, another recent study found that while climate change raised emerging countries' average cost of debt by 117 basis points, those that invested in social preparedness managed to reduce costs by 67 basis points².

Information please

But while agency ratings help, they're not a magic cure – country ESG analysis is not a black box that spits out unequivocal answers. For one thing, some ESG metrics don't change much or often. For another, these factors can have variable effects on economies. That's to say, some matter more than others – it all depends on a country's particular circumstances. All of which necessitates a subtle approach in integrating ESG criteria with more traditional metrics.

“ The most fruitful approach to sovereign ESG investing is likely to be an industry-wide one.”

Because ESG factors tend to evolve over longer time horizons, their inclusion within portfolio building processes necessitates long-term involvement on the part of the investing institution. This includes, but is not restricted to, direct contact with sovereign borrowers – continuous contact with treasury ministries through face-to-face meetings, letters, targeted questionnaires and asking ESG-related questions during roadshows. Sometimes it can even boil down to explaining to civil servants what ESG is and why it matters.

Building a model

One approach is to incorporate ESG factors in country risk models. At Pictet Asset Management, we use a wealth of ESG data – from both external and internal sources – that are then aggregated into a country score. The environmental factors we monitor include air quality, climate change exposure, deforestation and water stress. Social dimensions include education, healthcare, life expectancy, scientific research. And governance covers elements like corruption, electoral process, government stability, judicial independence and right to privacy.

Together this aggregate score then becomes one of six pillars in the country risk index (CRI) ranking produced by our economics team.

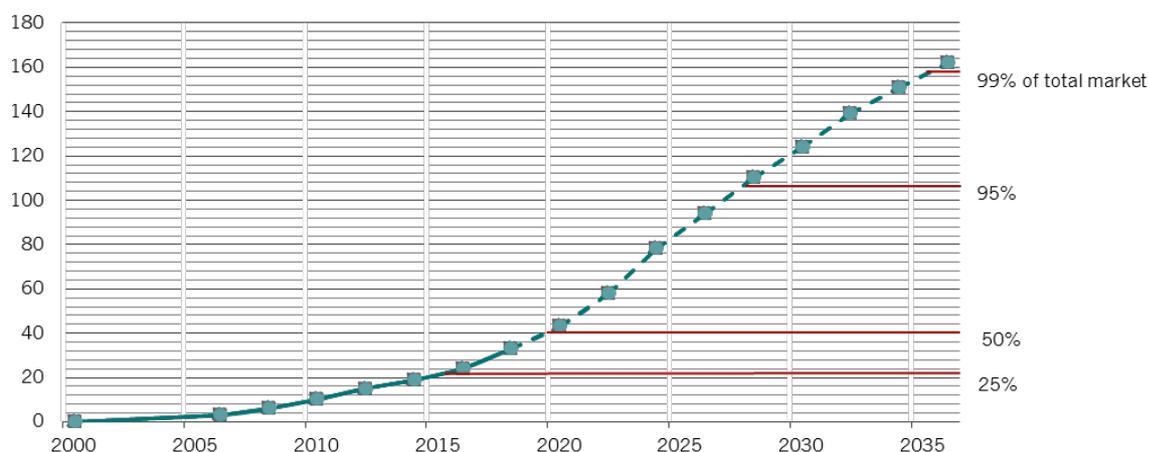
Joint efforts

The most fruitful approach to sovereign ESG investing is, however, likely to be an industry-wide one. Governments that are required to improve their ESG credentials are likely to exhibit stronger, more stable growth and to be better able to withstand macro-economic headwinds. In effect, improving ESG across emerging markets would lift the asset class' trend performance – or boost its beta, in market vernacular.

Individually, portfolio managers have relatively little sway, though there are examples where sovereign borrowers have bowed to pressure exerted by fund managers, such as when we voiced some concerns about land reforms in South Africa.

UNIVERSAL

Total investment industry assets with an ESG mandate, in USD trillions. Broken line represents projections.



Source: Deutsche Bank, October 2018

But as a whole, the industry has the clout to steer governments in the right direction – some USD592 billion of USD8.311 trillion of emerging market sovereign debt outstanding is held by asset management firms.

Investment firms are already taking some steps in that direction. For instance, the United Nations-sponsored Principles for Responsible Investment, an initiative with more than 1,800 industry-wide signatories that manage more than USD2.25 trillion of assets, has recently set up a sovereign engagement working group to encourage greater dialogue and cooperation between the asset management industry and sovereign borrowers. There is an increasing number of other industry initiatives, like, for instance, the Global Green Finance Council, which is aiming to coordinate efforts by various industry bodies to encourage the development of green finance.

Making a difference

Sustainability has been central to Pictet Asset Management's business. Which is why we're also at the forefront of incorporating ESG into all our investment processes – not least for our emerging market debt strategies.

We're not only engaging directly with sovereign bond issuers. We're also working with our peers and relevant multi-national bodies to develop an industry-wide approach that will support and encourage governments to be better run, more environmentally friendly and to do what's best for their societies. Because that's how best to improve the welfare of people across emerging economies, and, along the way, to make our investors better off. And because it's the right thing to do.

[1] Capelle-Blancard et al. "Environmental, Social and Governance (ESG) performance and sovereign bond spreads: an empirical analysis of OECD countries," Ecole Polytechnique CNRS <https://hal-polytechnique.archives-ouvertes.fr/hal-01401718/document>

[2] "Climate Change and the Cost of Capital in Developing Countries: Assessing the impact of climate risks on sovereign borrowing costs. UN environment, Imperial College Business School, SOAS University of London

Important legal information

This marketing document is issued by Pictet Asset Management. It is neither directed to, nor intended for distribution or use by any person or entity who is a citizen or resident of, or domiciled or located in, any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation. Only the latest version of the fund's prospectus, the KIID (Key Investor Information Document), regulations, annual and semi-annual reports may be relied upon as the basis for investment decisions. These documents are available on [assetmanagement.pictet](https://www.assetmanagement.pictet.com).

This document is used for informational purposes only and does not constitute, on Pictet Asset Management part, an offer to buy or sell solicitation or investment advice. It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date. The effective evolution of the economic variables and values of the financial markets could be significantly different from the indications communicated in this document.

Information, opinions and estimates contained in this document reflect a judgment at the original date of publication and are subject to change without notice. Pictet Asset Management has not taken any steps to ensure that the securities referred to in this document are suitable for any particular investor and this document is not to be relied upon in substitution for the exercise of independent judgment. Tax treatment depends on the individual circumstances of each investor and may be subject to change in the future. Before making any investment decision, investors are recommended to ascertain if this investment is suitable for them in light of their financial knowledge and experience, investment goals and financial situation, or to obtain specific advice from an industry professional.

The value and income of any of the securities or financial instruments mentioned in this document may fall as well as rise and, as a consequence, investors may receive back less than originally invested. Risk factors are listed in the fund's prospectus and are not intended to be reproduced in full in this document.

Past performance is not a guarantee or a reliable indicator of future performance. Performance data does not include the commissions and fees charged at the time of subscribing for or redeeming shares. This marketing material is not intended to be a substitute for the fund's full documentation or for any information which investors should obtain from their financial intermediaries acting in relation to their investment in the fund or

funds mentioned in this document.

EU countries: the relevant entity is Pictet Asset Management (Europe) S.A., 15, avenue J. F. Kennedy, L-1855 Luxembourg

Switzerland: the relevant entity is Pictet Asset Management SA , 60 Route des Acacias – 1211 Geneva 73

Hong Kong: this material has not been reviewed by the Securities and Futures Commission or any other regulatory authority. The issuer of this material is Pictet Asset Management (Hong Kong) Limited.

Singapore: this material is issued by Pictet Asset Management (Singapore) Pte Ltd. This material is intended only for institutional and accredited investors and it has not been reviewed by the Monetary Authority of Singapore.

For Australian investors, Pictet Asset Management Limited (ARBN 121 228 957) is exempt from the requirement to hold an Australian financial services license, under the Corporations Act 2001.

For US investors, Shares sold in the United States or to US Persons will only be sold in private placements to accredited investors pursuant to exemptions from SEC registration under the Section 4(2) and Regulation D private placement exemptions under the 1933 Act and qualified clients as defined under the 1940 Act. The Shares of the Pictet funds have not been registered under the 1933 Act and may not, except in transactions which do not violate United States securities laws, be directly or indirectly offered or sold in the United States or to any US Person. The Management Fund Companies of the Pictet Group will not be registered under the 1940 Act.

Pictet Asset Management Inc. (Pictet AM Inc) is responsible for effecting solicitation in North America to promote the portfolio management services of Pictet Asset Management Limited (Pictet AM Ltd) and Pictet Asset Management SA (Pictet AM SA).

In Canada Pictet AM Inc. is registered as Portfolio Manager authorised to conduct marketing activities on behalf of Pictet AM Ltd and Pictet AM SA. In the USA, Pictet AM Inc. is registered as an SEC Investment Adviser and its activities are conducted in full compliance with the SEC rules applicable to the marketing of affiliate entities as prescribed in the Adviser Act of 1940 ref. 17CFR275.206(4)-3.