PICTET
Asset Management

EMERGING MARKETS

ESG INVESTING IN EMERGING MARKET DEBT

Sustainable investment: ESG in emerging market debt

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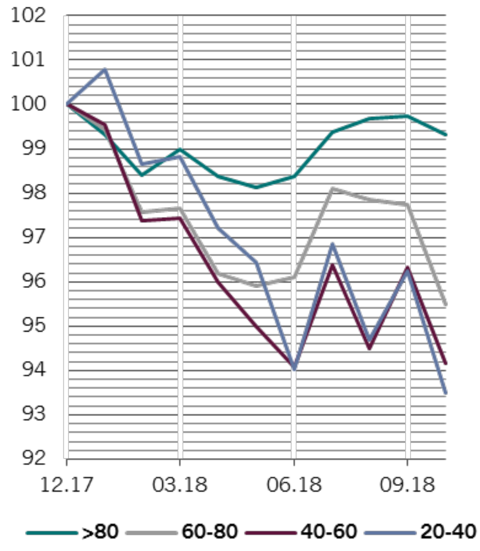
Why investors in emerging market sovereign bonds need to pay attention to environmental, social and governance factors.

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 spreads[1]. 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 points[2].

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 it 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.

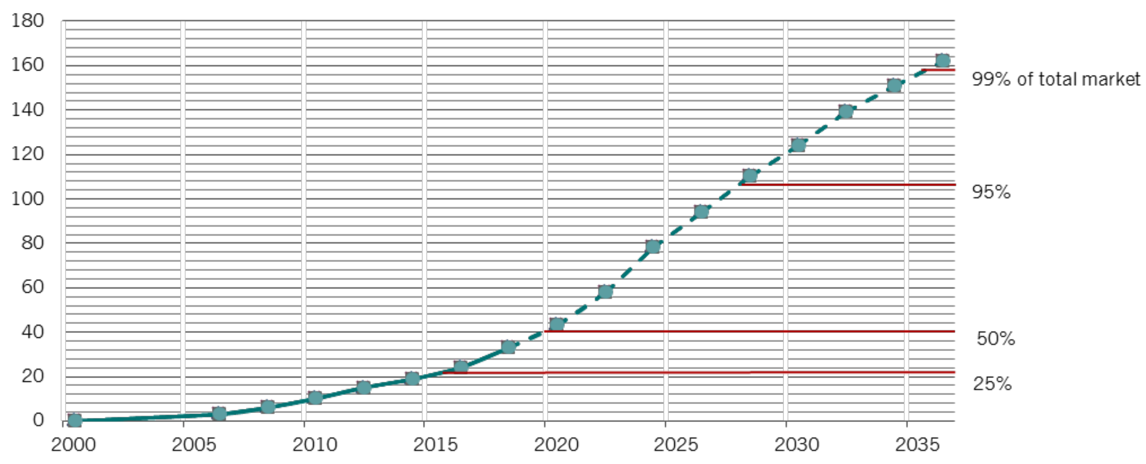
Joint efforts

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