actiam
PERSPECTIVE

Emerging Market Debt 2.0: incorporating ESG

For most institutional investors having both an allocation to Emerging Market Debt (EM Debt - issuers from emerging countries) and an ESG policy[1] seems common practice. However, linking the two seems to be a somewhat greater challenge. The collection of data on (companies in) those countries is still in its infancy and an effective engagement policy requires a great deal of knowledge and is highly labour-intensive.

Recently, however, we have seen the launch of indices that do attempt to establish a link between ESG and EM Debt. In this article, we will take a closer look at this link. For the sake of transparency and clarity, we will focus on the national debt of emerging markets. This segment also boasts the longest history[2].

THE 4 C's IN ASSESSING LENDING

All types of lending are rooted in the 4 C's: **C**apacity (payment capacity), **C**ollateral, **C**haracter (features) and **C**onditions (covenants).

As a rule, these fundamental investment principles dovetail with the process of selecting debt instruments of sovereign entities. For sovereign states, the analysis is limited to the parameters 'Capacity' and 'Character'. Sovereign states rarely issue collateral and are never truly subject to conditions, for the very reason that they are not controlled by outside forces. A brief explanation of how we incorporate these factors into the EM Debt process is provided below.

DILEMMAS IN INCORPORATING ESG CRITERIA INTO EM DEBT

One index that has recently linked EM Debt to ESG criteria is for instance the JPM EMBI index, the emerging market debt index that is tracked the most. The choices made, greatly impact the investment portfolios of institutional and retail investors. Until recently, Saudi Arabia, Bahrain, Kuwait, Qatar and the United Arab Emirates (Dubai, Abu Dhabi) were not part of the investment universe of this index. However, when these countries wanted to issue hard-currency government bonds on a large scale, the criteria were adjusted to allow these countries to be included in the index (this did not lead to any additional in- or exclusions). These countries cannot, however, be classed as developing countries if we look at both income and rating (>A-, except for Bahrain).

A *sustainable* version of the frequently tracked EMBI index was launched in 2018. The weightings of the various bonds were adjusted in the index according to sustainability scores supplied by an external data provider. The five aforementioned Gulf States were also included in the index. This is striking, given the human rights issues that are a point of concern in many of these Gulf States.

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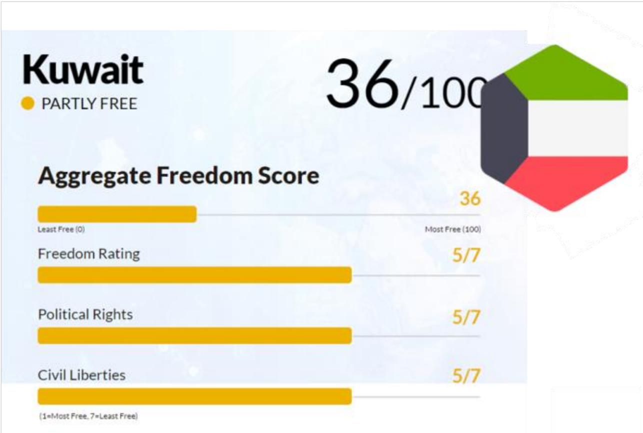
[1] ESG: Environmental, Social and Governance, i.e. attention to the environment, society and good corporate governance
[2] It is the first investable segment of EM bond market when US Treasury issued so-called "Brady bonds" back in 1989. Since then, it has evolved into a popular asset class as gauging from the approximately US$365 billion in assets tracking the space. In fact, the EM external sovereigns AUM is almost half of the combined assets that track various J.P. Morgan EM bond indices.

Based on our own criteria, four of those five countries would be excluded from the investment universe. Only Kuwait would qualify for investment based on data from Freedom of the World 2019:



Source: https://freedomhouse.org/

Another concern regarding these indices is that they include bonds of state-related (100% state-owned or state-guaranteed) organisations in addition to government bonds. These are oil and gas companies, coal mines and electricity producers that use relatively large volumes of coal and do not belong in a sustainability index for emerging countries. For instance, one of the world's largest oil companies, PEMEX, has a weighting of 1.8% in the aforementioned sustainability index. Moreover, a significant number of the organisations have poor environmental profiles.

We do, therefore, have clear reservations concerning the degree of sustainability of these indices.

COMBINING ETHICAL STANDARDS WITH THE 4 C's

We believe that every asset owner and asset manager should, first of all, draw up a number of ethical standards. These could be basic principles such as respecting human rights, fundamental employment rights and corruption. The stricter the ethical standards, the more government bonds will be excluded outright.

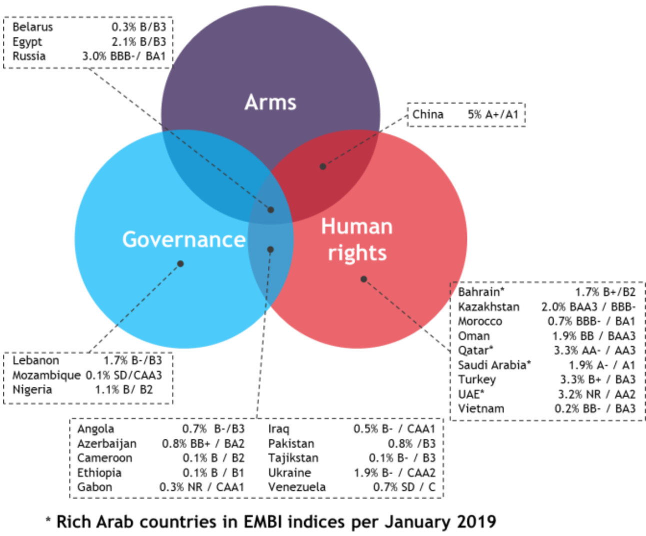
IN ADDITION TO ETHICAL STANDARDS, A PROPRIETARY ASSESSMENT IS ESSENTIAL

In addition to the advice issued by large data providers, it is essential to have a proprietary view on and to make an assessment of emerging countries. A number of asset managers have now developed a method for testing countries against ESG criteria (put briefly, to test their sustainability). Asset managers generally assign their own weight to the advice and data provided by large data providers. They may also – and often do – place their own emphasis/focus on a number of topics, such as land, water and climate themes.

The water theme may include a consideration of future water scarcity and how countries prepare for this. The land theme mainly involves an analysis of deforestation and the degree to which the economy depends on the extraction of non-renewable mineral resources (metals, minerals and fossil fuels). The climate theme may involve a review of a country's general climate change policy (taxing or conversely subsidising fossil fuels), whereby the contribution that countries make to climate change is adjusted for the effects of trade. Last but not least, additional weight is assigned to future population development. We do not see such emphasis in data providers' data.

An 'ESG country method' allows us to obtain an even better picture of the tenability of a country's debts. A country's future payment capacity does not benefit from overexploitation in the form of deforestation or the extraction of finite minerals, an economy that is not used to high energy prices or an excessive birth rate. Such birth rates also put pressure on society.

ACTIAM Fundamental Investment Principles versus EMBI-universe: large part benchmark not sufficient



Source: ACTIAM

ESG SCORES DETERMINE REPAYMENT CAPACITY

Although traditional rating agencies generally set great store by the stability and quality of the public administration, a correct estimate of the political risk – and the associated economic risk – requires us to look at more variables. Political and economic tensions can build up in many ways. Identifying tensions between groups and/or within the ruling elite, economic flight whether or not combined with an imbalanced population structure and external sources of political risk caused by large flows of refugees and threats from neighbouring countries are aspects that need to be considered. However, most of all, respect for human rights reveals much about a sovereign state's character. The factor 'good corporate governance' as measured using the World Bank Governance Indicators is strongly correlated to a country's repayment capacity and plays a major role in the methods of regular rating agencies. Screening for arms boycotts has an equally risk-mitigating effect. Wars are detrimental to repayment capacity and countries rarely emerge any richer (Germany was probably the last country to make money from a war in 1870).

IN SUMMARY

In order to establish the right link between ESG criteria and investments in EM Debt, collecting additional sustainability information to supplement data from traditional rating agencies is desirable. Clear ethical standards, a proprietary assessment of ESG data from data providers and an eye for the various dimensions of political and economic tensions are indispensable to an optimum portfolio structure.