ASSESSING ESG FACTORS WHEN INVESTING IN EM DEBT

By Bryan Carter

Investors are increasingly considering environmental, social and governance factors alongside traditional financial risks. Nevertheless, many balk at using ESG criteria for emerging markets, worried this limits opportunities or potential returns.

- There are opportunities in 'long-term improvers', as these emerging markets (EMs) need investment for growth, jobs and stronger foundations.
- Selectivity is key: EMs include those improving living standards, policy frameworks and democracy, but also those ignoring pollution controls, facing growing social tensions or institutions in crisis.
- For investors, an approach oriented on environmental, social and governance (ESG) criteria fits with ethical investing, a long-term stance and risk mitigation.
- Blending alpha potential and an ESG ranking can produce a ESG-tilted portfolio without limiting diversification or the alpha set.

Photo: Archive BNP Paribas AM

Bryan Carter

Just a decade ago, most EM countries facing fragile political, social or economic situations were low-income. Now, metrics such as human development indices are showing significant progress, enabling many countries to advance to middle-income status. Looking ahead, some of the poorest countries with the lowest ESG scores may in fact record the largest improvements. This could make investing in their debt an attractive opportunity.

Some of the poorest countries with the lowest ESG scores may in fact record the largest improvements.

Without question, many EM countries are departing from a low(er) base. This provides many with 'low-hanging fruit' – areas that can be improved relatively easily. These fields include ESG aspects such as greater environmental efficiencies (the 'E' of ESG), safeguarding social goods (the 'S') and improving institutions of government (the 'G'). These are precisely the countries that are most in need of long-term responsible investment to stimulate economic growth, create jobs and strengthen their economic foundations.

We believe these countries represent the best set of 'long-term improvers', capable of generating outsized growth and asset gains for patient investors. Demographic trends and a growing middle class are generating rising demand for consumer goods, infrastructure, services and agribusiness. This should drive economic growth, as well as prosperity and wellbeing.

Why couch these opportunities in an ESG framework? We believe there is a moral imperative for investors and asset managers to concentrate fiduciary assets in sustainable investments. This reflects our belief in ethical investing, in acting as long-term investors, and in mitigating risk, for ourselves and our clients.

As said, there is no longer a single EM bracket. From an ESG perspective, there are countries that are improving the standards of living, policy frameworks and democracy, while others are regressing as pollution controls are reversed, social tensions rise or

institutions fall into crisis. These are not necessarily the same groups. Here, an ESG framework helps us separate the wheat from the chaff. Such a selective approach also sends a clear signal to EM debt issuers that investors are focused on sustainability.

In short, there are two ways to generate alpha for investors: by overweighting EM champions (the 'long-term improvers') or underweighting the pitfalls, the laggards and the backsliders. We strongly believe that EM investing is not just about finding the best markets; it is also about avoiding the worst ones. Long-term sustainability, in our belief, is synonymous with minimising exposure to crises or 'blow-ups'. This requires an innovative and nuanced implementation of ESG research.

As an early adopter of ESG investment approaches, going back almost two decades, we can now rely on a deeply skilled ESG research team, we have access to hundreds of data sources spanning all categories of ESG ratings, and we have the capabilities to adjust to the nuances and dynamic realities of EM countries.

Our sovereign debt ESG model assesses governments' ability to protect citizens' best interests and provide ESG-appropriate services and goods. However, making this assessment can be a challenge given that for the 90 EM countries that we invest in, a full set of data is not always available and certainly not always regularly. Navigating this constraint, we screen EM debt for both economic factors and ESG criteria. The latter include:

- A commitment to the Paris Agreement and measures to implement it;
- Current ESG policy and the evolution of that policy, in other words: land management and deforestation, but steps to reduce the carbon footprint;
- The share of renewable energy sources in a country's energy mix;
- Its ranking on the corruption perceptions index.

Overall, our ESG assessment covers 89 factors.

How does our approach differ? Instead of inclusion or exclusion lists, we work with a composite score on each EM country to determine the size of the investment that we include in our portfolios. We blend the opportunity to earn alpha on a country's debt with its ESG rating, in essence increasing our overweights in high-ESG countries. We do still invest in low-ESG countries where our conviction that we can earn alpha is high, but we invest less in such countries than would otherwise be the case.

Beyond the traditional sovereign and other investment-grade issues and high-yield bonds, we also assess EM green bonds for portfolio inclusion. Here, the same standards apply as do for developed market green debt: funds need to be used appropriately, we have to make sure there is no green washing, the issuer should provide transparent reporting, etcetera. Investors need to be careful: about half the EM green bonds are not green, while in developed markets, 80% actually are. Nevertheless, this is a promising area.

In general, we believe EM debt portfolios need to be managed actively. While there is more information on emerging markets and EM economies, markets do not necessarily digest this efficiently and still fairly often act on headlines (for instance: 'noise') and irrational concerns. At the same time, investors cannot rely on rating agencies since they often act with a lag. We believe it is best for investors to work with an experienced asset manager with a local presence and local knowledge when it comes to this complex asset class.

Investors need to be careful: about half the EM green bonds are not green.

In summary, blending alpha potential and an ESG ranking can produce an overall ESG-tilted portfolio without limiting diversification or trimming the alpha set. Attribution analysis has shown that ESG tilting can generate additional portfolio performance. It also appeals to investors wanting or needing to take ESG factors into account, for fiduciary, ethical or regulatory reasons, for example, or investors strongly focused on mitigating risk, including reputational risk. Like many investors, we are keen on the long-term viability and performance of the investments, hence our view that ESG investing should be adopted widely. «

EM investing is not just about finding the best markets; it is also about avoiding the worst ones.

This article was written by Bryan Carter, Head of the Emerging Market Debt Investment Team, BNP Paribas Asset Management.

Disclaimer
The value of investments and the income they generate may go down as well as up and it is possible that investors will not recover their initial outlay. Investing in emerging markets, or specialised or restricted sectors is likely to be subject to a higher-than-average volatility due to a high degree of concentration, greater uncertainty because less information is available, there is less liquidity or due to greater sensitivity to changes in market conditions (social, political and economic conditions). Some emerging markets offer less security than the majority of international developed markets. For this reason, services for portfolio transactions, liquidation and conservation on behalf of funds invested in emerging markets may carry greater risk.