In Conversation

ESG in Emerging Markets:
Applying sustainability factors to EM credit portfolios

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For ten years you have been running a short duration emerging markets corporate bond strategy that has been gaining attention from investors, not only for its performance, but also for its ESG characteristics. When you speak with investors, what surprises them most about this?

WH: Historically, I think investors are used to thinking of emerging markets (EM) as an asset class that offers attractive yields, but with heightened economic and off-balance sheet risks that are harder to quantify. They are not totally wrong. EM can be seen by many as a kind of “Wild West” for investing. But it also offers a great deal of diversity.

This benefits active managers willing to get deeply involved in understanding the sovereign backgrounds and the company particulars relevant to their investments. Information gaps present not only risk, but also opportunity. For those who can fill the gap with relevant knowledge, that leads to insight.

EM investors have often been trained to accept less information, and to assume that there are lower governance standards at a sovereign and corporate level. Our analysts are highly experienced in gathering the information we need to make meaningful decisions about limiting or avoiding material balance sheet and off-balance sheet risks that may challenge both returns and sustainability.

Analysing Risk Premiums

Risk: The risk management process includes an effort to monitor and manage risk but does not imply no or low risk.
Source: Muzinich Analysis, For Illustrative purposes only. *Asset Allocation Group.
Are there any core commitments or ground rules you use as a first filter to help narrow your investment universe? What makes your portfolios stand out for their ESG commitments in this space?

WH: We only invest in companies who we believe have viable businesses across the whole economic and political cycle. They have to be able to weather the rough with the smooth.

I think we stand out amongst EM strategies because we don’t buy into setting different financial or environmental, social and governance (ESG) standards for developed and emerging markets. With a lot of data gathering, questioning, and research, we can impose a single global quality standard for our investments. And we set those standards to continue to seek the long-term stability of risk-adjusted returns and liquidity for our investors. There is a financial basis for examining off-balance sheet risks.

Clear examples of our credit discipline in any market would be our exclusion of credits based on their revenue sources—regardless of market or location—or our exclusion of companies based on business practices we find unacceptable. There are not multiple standards of acceptability based on market.

Additionally, we set below-benchmark carbon intensity limits for many of our portfolios. Historically, EM investments have been dominated by investments in carbon-intensive, commodity and natural-resource driven industries. Setting limits helps force us to dig for investments that are more carbon efficient per unit of return and therefore helps direct our client money to the types of efficient businesses they want to see across a wide range of sectors. We envision further tightening our carbon standards over time.

Finally, we have developed our own ESG scoring metrics. This helps us rank investments globally, in each sector and between sectors, on a consistent basis heavily focused on the sustainability risks our credit analysts have identified as most material in predicting a company’s future advantages and exposures.

ESG Scoring Overview

01 Source
Source issuer ESG data, identify well reported, sector-relevant ESG metrics with good coverage and apply weights

02 Generate
Generate base ESG score by combining ESG and climate risk components then allow analysts to “notch” base for final score

03 Integrate
Global and industry ratings are integrated into investment research templates and reporting
You are investing primarily in corporate credit, but in your first answer you mentioned sovereign risk. You seem to not be agnostic regarding the company’s country of risk. Is that right?

WH: For EM investing, a key part of our process for rating companies also includes rating the sovereign markets they each call “home.” We create proprietary company ESG ratings and have our own Sovereign Sustainability Index. This is a multi-factor quantitative model which helps us assess relative political stability, leverage, economic strength, funding, competitiveness and market confidence. We complement this with more in-depth qualitative research sourced through country visits and meetings with sovereign delegations including central bankers and politicians. We use our views on sovereign strength and stability as a factor in our evaluation of corporate issuers from each country.

Finally, why is sustainability even important in EM? If this is the minority of the portfolio for many investors, is it even worth the bother?

WH: If you care about sustainable investing in your developed markets portfolios, we think it behooves to pay attention to EM which today cover the majority of the earth’s geographical footprint, population and total GDP, as well as offering tremendous potential for future economic growth. Many EM are especially susceptible to the ravages of climate change and, we think, can become strongly engaged in the conversations and actions that lead to change—and to investment opportunities. As many EM countries are still in an earlier stage of development it gives us a wonderful opportunity to have a positive impact on how the companies are responding to and combatting megatrends such as climate change. Investor selectivity and engagement can help bring opportunities to the fore, magnifying both economic benefits and the impact of change.

But fundamentally, we are credit people so before assessing opportunity, we always seek to understand risk. Our job as credit managers is to measure risk appropriately and make sure our investors are getting paid appropriately for the risks they are taking. We just don’t think you can do that job on a long-term basis in a corporate credit portfolio anywhere, without looking at sustainability.

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