Investing for tomorrow: applying ESG principles to emerging market debt

FOR WHOLESALE INVESTORS - August 2018

L. Bryan Carter
Head of Emerging Market Fixed Income
bryan.carter@bnpparibas.com

Helena Vines-Fiestas
Head of Sustainability Research & Policy
helena.vinesfiestas@bnpparibas.com

Key takeaways

- There is no longer just a single EM group, with poor countries converging to industrialized status slowly and surely over time, and advanced emerging markets graduating to developed countries.
- With a deeply skilled ESG research team, we have amassed the data and monitoring capabilities to tailor and craft a unique approach suited to the nuances and dynamic realities of emerging markets.
- The novelty of our approach is that instead of inclusion lists or exclusion lists, we use our composite score on each of the 90 EM countries to determine position sizing for investments in our portfolios.
- We must look to the future and take a stand on the implications of our enterprise and the long-term viability of our holdings.

Full commentary

Many investors balk at the idea of using environmental, social and governance (ESG) criteria when investing in emerging markets (EM). Pictures of wood-burning stoves polluting tropical air or military tanks in a coup d'etat are often the associations one has with emerging markets and run counter to the growing need for environmental sustainability and good governance.

Just a decade ago, most countries facing fragile situations (whether political, social or economic) were low-income. This situation has hugely improved, with human development indices and other metrics demonstrating significant progress as many countries have graduated to middle income status. If we look ahead, some of the poorest countries with the lowest ESG scores may in fact produce the largest improvements.

Combining the expertise of our Emerging Markets Fixed Income team and our dedicated Sustainability Centre, our ESG in emerging market debt (EMD) report explores:

- How – and why – we apply an ESG framework to EMD
- Examples of the factors included in ESG screening
- Incorporating ESG into the EMD investment process
- The future of EM and the role of ESG

Without question, many emerging markets are departing from a lower base. We agree that many of these countries arguably face the lowest hanging fruit in terms of gaining environmental efficiencies, safeguarding social goods and improving institutions of government. But these are precisely the countries that are most in need of long-term responsible investment to stimulate economic growth, job creation and strengthen their economic foundations.

We think it is also possible that these countries harbour 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 in many of them are generating rising demand for consumer goods, infrastructure, services and agribusiness, which provide new opportunities for investors.

Motivation

How -- and more importantly why -- do we mould this asset class into an ESG framework? We at BNP Paribas Asset Management do this not because we can demonstrate past returns from ESG factors but rather because we believe there is a moral imperative that drives our investment ethos to concentrate fiduciary assets in sustainable investments. This is driven by who we are as a firm, our role as first among peers in ethical investing, our long term investment horizon, and our overarching risk mitigation philosophy.

It is our conviction that the future will not look like the past: there is no longer just a single EM group, with poor countries converging to industrialized status slowly and surely over time, and advanced emerging markets graduating to developed countries. The reality is different: some countries are evolving in a positive direction, with improving standards of living, strong policy frameworks and an institutionalisation of democracy; while others are retrogressing, with deteriorating policy trajectories and declining quality of life factors. Here, an ESG framework helps us separate the wheat from the chaff, applying a forward-looking focus on long-term success that is different from our daily, alpha-oriented investment process. Such an approach sends a clear signal to countries of the increasing value investors accord to sustainability-related factors.

A related point is this: there are two ways to generate alpha -- overweighting the champions but also underweighting the pitfalls. 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 crisis or 'blow up' potential. Moreover, it is potentially harder to predict crises than it is to find alpha in EM given that the environmental, social and governance risks in the world have evolved. We cannot rely on past cycles and backtests; for the future, we must have a forward view on what will matter in this brave new world.

This brings us to our final point: investors do increasingly expect asset managers to don ESG lenses. Asset holders' ethos and views are increasingly shaping the industry. In many countries, the drive toward ESG-tailored investing is inescapable. Investors have grown sceptical of exclusion lists and are looking for a more innovative, nuanced implementation of ESG research.

Our process

BNP Paribas Asset Management was an early adopter of ESG investment approaches across its portfolios. With a deeply skilled ESG research team, we have amassed the data and monitoring capabilities to tailor and craft a unique approach suited to the nuances and dynamic realities of emerging markets. This team has access to hundreds of data sources spanning all categories of ESG and Socially Responsible Investing (SRI) ratings. For EM, coverage is a special challenge given that for the 90 countries that we invest in, a full spectrum of data is not always available and certainly not on a regular basis.

Our sovereign debt ESG model assesses governments' ability to protect citizens' best interests and provide services and goods embedding environmental, social, or institutional strength. Navigating this constraint, our EMD ESG screen incorporates environmental, social and governance criteria alongside economic factors with consistent cross-sectional coverage such as those shown below:

Figure 1. Example of the factors included in ESG screen

E Environmental	S Social	G Institutions
• Renewables on energy ratio	• School enrolment gender parity index • Internet access ratio	• Corruption perceptions index • Press freedom index

Source: BNP Paribas Asset Management, August 2018

Our intuition on EM investing resonates with governance data which we have long found to be a proxy for positive economic trends. Intuitively, a government that invests in its people and in a sustainable future is more likely to invest in long-term projects with a positive return on investment, avoiding irresponsible or wasteful short-term expenditures. A country that allows democratic freedoms and supports equal access is more likely to have an open and transparent civic debate about public finances, improving the quality of spending and the accountability regarding taxpayer funds. Policymakers that manage today's resources sustainably create a civic culture of responsibility and are more likely to set the stage for repeated and reinforced positive decisions by subsequent leaders.

The novelty of our approach is that instead of inclusion lists or exclusion lists, we use our composite score on each of the 90 EM countries to determine position sizing for investments in our portfolios. We blend the country's alpha opportunity with its ESG rating in the portfolio construction process, in essence increasing our overweights in high ESG countries and curbing our overweights in low ESG countries. We do still invest in low ESG countries where the alpha conviction is high, but we invest less in such countries than would otherwise be the case. In aggregate, this bottom-up ESG sizing approach produces an overall ESG-tilted portfolio without limiting diversification or truncating the alpha set.

The uniqueness of EM as an asset class derives from the very idea that some constituents begin from a very low base and may offer outsized investment gains as they develop. In tandem with development, side effects can arise that we label ESG-unfriendly or unsustainable: pollution, social tensions and institutional crises. Our approach allows for this character of EM investing, while limiting the potential for unsustainable policies to become 'blow-ups'.

Figure 2. ESG incorporated in the EMD investment process

Sample factors

Governance

- Corruption perception index
- Press freedom index

Environmental

- Renewables as % of energy mix

Social

- School enrolment, primary, GPI*
- Internet users

ESG tilting applied at final portfolio construction

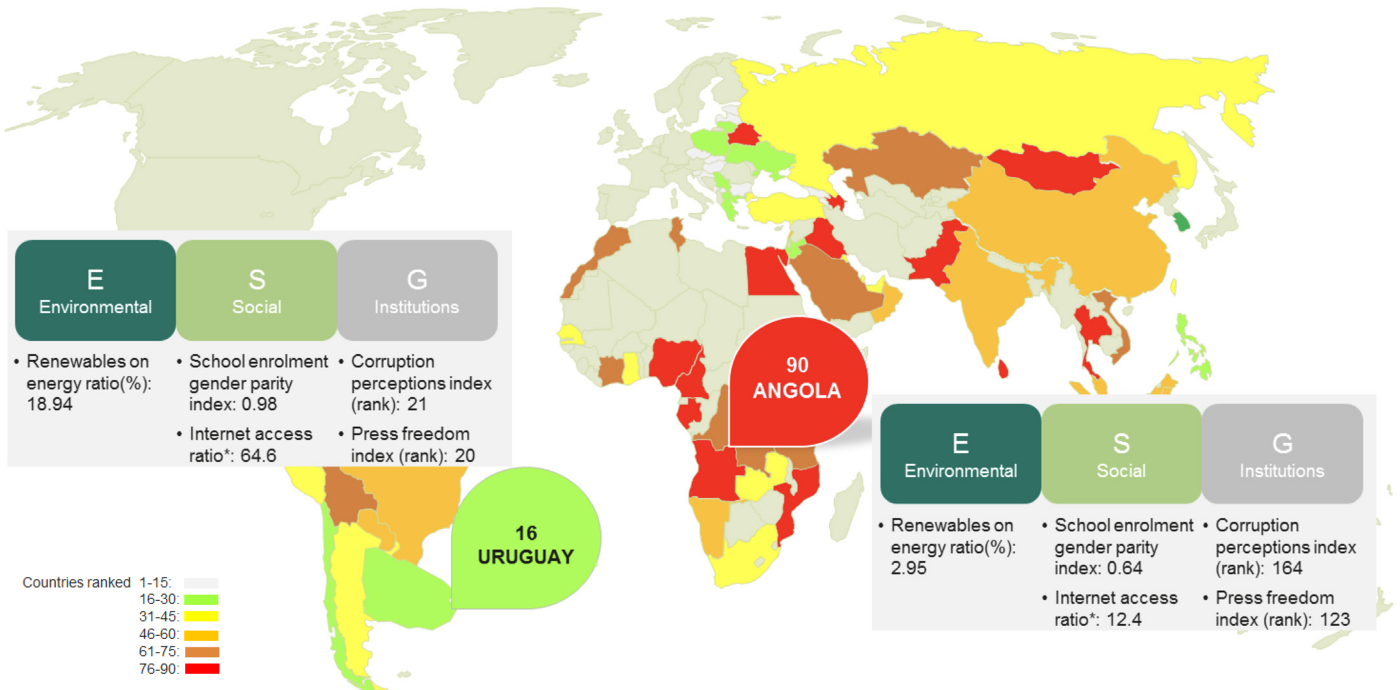
- For countries in 1st tercile by ESG ranking: alpha trade will be magnified accordingly
- For countries in the bottom tercile by ESG ranking: alpha trade will be curtailed accordingly
- For countries ranking in the middle tercile: alpha trade will be sized according to trade convinction without increase or decrease due to ESG
- The ESG tilting for any corporate alpha trade would follow the same pattern as that of their sovereign ranking

Source: BNP Paribas Asset Management, August 2018
GPI: Gender Parity Index

Additional alpha generated by ESG tilting in portfolios

Attribution analysis has shown that ESG tilting at the portfolio construction stage of our investment process does indeed generate additional performance for portfolios. To evidence the ESG screen in practice, we have highlighted below the differences between Uruguay and Angola, two countries that the screen has shown to have very different ESG attributes. Uruguay is currently overweight in our flagship blended portfolio, the size of the position having been increased thanks to its positive ranking in the ESG screen. Conversely, Angola which is the lowest ranking country in the screen has been consistently underweight in the portfolio.

Figure 3. ESG country screen ranking



Source: BNP Paribas Asset Management, August 2017
*Internet users per 100 people

Another key rationale for taking ESG rankings into consideration when trades are sized is to help us avoid 'blow ups' when a country may renege on its debt obligations. Three examples of this are Mozambique, Venezuela and Republic of Congo. All three countries score in the bottom tercile of our ESG methodology. These countries have had very low governance scores historically and recently poor governance has become manifest increasingly via sharp deterioration in macroeconomic conditions and fiscal management leading to debt distress; the impact of which has not affected our portfolios since we have been underweight these markets as indicated by the low rating in our ESG screen.

INVESTING FOR TOMORROW

There are various reasons that investors favour ESG approaches, including the exposure to reputational risk. Some investors – but not all – believe in the data demonstrating the long-term outperformance and potential dividends of ESG factors. Other investors – a growing number – are driven by mandates or by the fact that asset owners demand that ESG factors are taken into account. Many investors simply want to do well by doing good. Their investments are providing the much needed finance for long-term sustainable growth where it is most needed. We believe each of these reasons are valid for ESG investing.

BNP Paribas Asset Management embraces an ethos of responsibility, that to be a global leader, we must look to the future and take a stand on the implications of our enterprise and the long-term viability of our holdings. We choose to lead the market, rather than to be led by the market, towards greater ESG and SRI awareness. Similarly, we aim to educate our clients on ESG issues and choices rather than wait for clients to demand change.

The rise of ESG investing is not a trend that we ride, but rather one that we embrace. Our longstanding position as a market leader is irrelevant to the pride we take in being part of the changing investment landscape and the collective call for better investment products. Applied to EM, we see our ESG process as ahead of the curve and we hope to help trigger greater awareness of ESG among all investors with a nuanced and considered approach specific to a unique and exciting asset class.

BNP PARIBAS
ASSET MANAGEMENT

The asset manager
for a changing
world