



Do emerging markets & ESG mix?

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AUTHOR



Anthony Kettle
Senior Portfolio Manager

Anthony Kettle tackles the common misconception that emerging markets – which make up c.25% of the global bond universe – are behind the curve on this industry megatrend.

While ESG is quickly becoming a big part of most asset managers' day jobs, for those specialising in emerging markets (EM), many ESG considerations are already considered standard practice.

Ahead of the ESG curve

EM issuers typically undergo more investor scrutiny than their developed-market peers, as a consequence of their operating environment. Certain ESG factors, such as governance (G) and political backdrops (S), have always played a critical role in the fundamental and risk analysis of EM credits – both sovereign and corporate.

Extending traditional EM analysis to cover a more explicit ESG framework has therefore

been a natural and relatively seamless progression. The focus on environmental factors is the newest element of the equation. Here, EM investors who have well-established dialogues with issuers have been successfully extending their engagement efforts to include environmental topics.

Advancing the ESG agenda globally

The EM universe represents roughly 60% of the global economy and 75% of global growth – almost double that of 20 years ago. It also accounts for more than USD2trn – about a quarter – of the global fixed income market.

The role of EM issuers will inevitably become more significant in global economic and social developments, including the ability to progress ESG objectives. As in developed markets, governments and companies have embraced these objectives to varying degrees, but we believe that investors can play an instrumental role in the effort to create greater alignment across all stakeholders within the ESG landscape.

ESG credentials are improving

Although it can seem counterintuitive, our experience shows that despite often starting at a lower base in terms of ESG profile, EM issuers tend to be more receptive to engagement on ESG topics than you might expect. This can be partially attributed to the fact that many do not have as many alternative sources of financing beyond capital markets, therefore creditors have more leverage.

We have also found that bondholder engagement plays a positive role in heightening awareness among EM issuers when it comes to the value of transparency and open dialogue.

Many EM corporates have made significant strides in strengthening their ESG credentials in recent years. Certain sectors naturally lend themselves to stronger ESG credentials, with the renewables sector across both Asia and Latin America proving a key growth area.

Other sectors, particularly those that are resource intensive, have more challenging ESG profiles but EM corporates have largely been receptive to trying to improve their ESG ratings. For example, we have recently seen a pick-up in the issuance of sustainability-linked bonds, particularly from the industrial sector, which sits at the higher-risk end of the ESG spectrum.

EM sovereigns are also increasingly appreciating the impact ESG can have on investors' views and therefore their borrowing costs, further opening up opportunities for dialogue on these issues.

Focus on ESG is creating opportunities

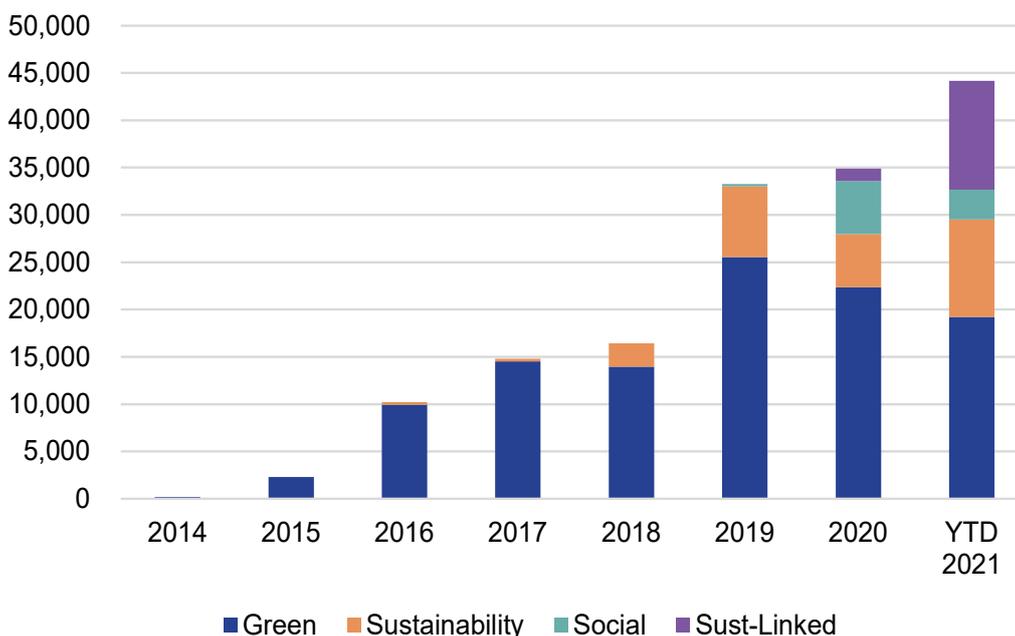
Positive ESG developments have not only contributed to improving the credit profile of issuers, they have also created more opportunities in the market. Over the last few years, we have seen a wave of ESG-influenced

How we're tackling Brazilian deforestation

Through our work as co-chair for the Investors' Policy Dialogue on Deforestation, we have held talks with Brazilian government officials to address our concerns around the illegal deforestation of the Amazon. We recognise that Brazil's overall ESG performance is generally good, with robust institutional governance and a green energy matrix. But deforestation is a threat to water and food security and to export-market access. Our efforts are aimed at ensuring that the Brazilian authorities understand that we see deforestation as a risk in our portfolios.

[Click here to read more on our efforts to tackle deforestation.](#)

EM ESG ISSUANCE, US\$MMN



Source: Bank of America; latest monthly data for April 2021

issuance, including green, social, sustainability and sustainability-linked bonds (see chart). This trend has been gaining traction beyond the typical sectors (such as renewable energy), with issuance out of cement, petrochemicals and auto part companies. This not only shows that the relevance of the ESG discussion is growing, but that it is providing investors with a broader opportunity set.

Beware of greenwashing

The force of this trend shows how quickly the market can seize new opportunities, while the recognition of the value of ESG as a key selling point in raising capital is a positive development.

However, it also raises valid concerns regarding greenwashing. In our experience, the importance of looking beyond labels can't be emphasised enough. The market currently hasn't adopted a standard set of criteria for establishing or measuring ESG metrics.

In EM, we have the added complexity that agency ESG ratings are often inconsistent or backward looking, with many companies and countries poorly understood by most of the market. This makes it even more important to rely on specialists who have a deep understanding of the nuances around each name and can apply this unique knowledge in the context of a credible ESG framework.

Outlook

There is often a misconception that EM and ESG don't mix. While the lack of transparency from some EM companies is certainly challenging, it is also fair to say that certain ESG evaluation metrics are highly correlated with income levels and therefore can disproportionately impact poorer countries, which are likely to be those most in need of capital flows. The rather static approach to agency ESG ratings has perpetuated this perception further, as they don't distinguish between the 'snapshot' level of ESG risk and the materiality of the direction of travel among EM issuers.

Over the last few years, we have seen the level of commitment to ESG development strengthen meaningfully across issuers and investors within EM. While there is still work to do, we believe that EM will play a key role in the evolution of the global ESG investment landscape. This should create a multitude of opportunities to build momentum behind this trend and invest in the resulting positive stories.

Over the last few years, we have seen a wave of ESG-influenced issuance. This not only shows that the relevance of the ESG discussion is growing, but that it is providing investors with a broader opportunity set.

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