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Five ESG findings for sovereign debt investing

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ESG has evolved from niche consideration to mainstream investment component. But with the 'G' standing for 'governance', arguably no one is more influenced by ESG developments, or stands to gain more from the advancement of ESG practices, than sovereign bond investors.

Our research, undertaken in partnership with Verisk Maplecroft, into the role of ESG factors in sovereign debt investing, has resulted in an innovative approach to factoring ESG into sovereign bond analysis.

Accounting for the non-linear and multidimensional character of ESG factors has resulted in five insights into how ESG helps to explain risk premia in sovereign bond investing.

Here's what we found out...

MORE IS MORE

1. ESG integration can be a tool to enhance investment risk management

Our research has shown that sovereign debt analysis that includes ESG considerations alongside standard macroeconomic variables is more robust than analysis based on macroeconomic variables alone.

How does this manifest? Good ESG performance by a sovereign is generally rewarded by lower credit risk, as measured by spreads.

Our findings reveal that differentiating between countries using ESG characteristics can help investors prioritise their time and effort for maximum benefit. We have shown that it is both possible and helpful to generalise and group countries into clusters sharing similar ESG characteristics for the purposes of fundamental credit analysis.

Our findings suggest a persistent mispricing of environmental performance, indicating a potential long-term alpha opportunity.

TRUE VALUE-ADD

2. ESG factors can translate into potential alpha opportunities

ESG integration is not just about risk management, it's also about alpha.

Our work underscores how inefficient markets still are in relation to ESG. In general, when the ESG characteristics of a country change, the spreads are slow to adjust and countries can remain persistently overpriced or undervalued for many months afterwards. This pricing lag can create value pockets for discriminating managers.

In particular, our findings suggest a persistent mispricing of environmental performance, indicating a potential long-term alpha opportunity.

MAN VS. MACHINE

3. Active management can add value in ESG sovereign investing

Individual countries and the global economy are complex systems, not machines with simple input-output relationships. Models and quantitative techniques can provide useful insights, but so can humans.

We see an enduring role for analyst and portfolio manager judgement, as well as value in humility in recognising that judgement calls under these conditions can be wrong as well as right, hence a strategic focus on optionality and preparedness is required.

Even if a rules-based quantitative approach generates alpha under certain market conditions, we believe there will always be an additive role for active management.

A DIFFERENT APPROACH

4. Alternative ESG sovereign investment strategies can be developed using our outputs

For managers with the freedom to construct alternative ESG portfolios – rather than track specific benchmarks based on traditional market designations overlaid with ESG screens – our approach also provides an alternative frame of reference.

Beyond basic measures of wealth, some of the criteria underpinning these traditional designations are arguably downstream manifestations of various factors captured in our country ESG performance typology.

While our country ESG performance typology does not control for economic variables or other key considerations, for example, liquidity or technical considerations, it can easily be screened with these for the purposes of portfolio construction.

A key lesson of our research is that there are no easy answers to understanding how sovereigns, the global economy and ESG factors interact

EVOLVING TOGETHER

5. Our data can be used to inform ESG sovereign engagement efforts

The insights resulting from our work can potentially be used to inform and enhance ESG engagement efforts. Investors can use our data to identify the ESG factors that should be most relevant to explore in greater detail with sovereign issuers and other key stakeholders.

NEXT STEPS…

A key lesson of our research is that there are no easy answers to understanding how sovereigns, the global economy and ESG factors interact.

Our work focuses entirely on how ESG is priced under normal circumstances, based on just a few years of data. That does not translate into findings on how it should be priced and will be priced in the future – whether markets are sufficiently accounting for major risks such as climate change.

More generally, there is benefit from more quantitative work to be done to better capture non-linear country, macroeconomic and ESG dynamics.

Our approach only takes an initial step towards accounting for this in the way we have built the typology and used it in the regression analysis.

Significant further work to understand the extent of causal connections between ESG and credit risk, and as part of that, the ways in which threshold effects or tipping points actually work, will help.

Together, we are excited to continue to explore ways to move forward in these areas.

To read more on our research, download the full report.

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