BlueBay
Asset Management

# BROADENING OUR HORIZONS

## Integrating ESG factors into emerging market debt investing

**JANA VELEBOVA, CFA**
SENIOR PORTFOLIO MANAGER

OCTOBER 2020

# The rising tide of ESG

Integrating ESG factors into our investment process isn't just about doing the right thing for people and the planet, it is also about delivering returns for our clients.

Environmental, social and governance (ESG) indicators form three central pillars of how we measure sustainability and the social impact of an investment in a company or a sovereign country. Many of these factors have historically played a prominent role in our emerging markets (EM) investment process.

The effectiveness of sovereign governance and corporate management practices, for instance, has long been recognised by us and the broader industry as an important driver of investment performance. Whereas environmental and social issues played a more marginal role in sovereign and corporate debt analysis in the past, we are witnessing a dramatic change. Shifting weather patterns causing droughts are directly impacting sovereign balance sheets and long-standing income inequality issues are triggering social unrest, directly impacting market price action.

As ESG factors play an increasingly prominent role in issuer credit ratings, markets are becoming acutely aware of risks of stranded assets, while projects financing green or sustainable development goals-aligned investments are attracting lower yields and cheaper funding. ESG 'megatrends' such as climate change are having far-reaching effects on a global scale – shaping the investment environment, driving fast change to the regulatory landscape and increasing pressure on transparency and data disclosure.

Not only do these rapid changes to the world as we know it present long-term challenges for societies and economies, they also offer huge opportunities for active investors to play a role in shaping the outcomes while delivering investment returns.

With a changing world, our investment process has also evolved. Today, our active dialogue on topics such as deforestation with EM governments and low-carbon strategies with our corporate counterparts reflects broadening recognition that these factors have the potential to impact issuers' balance sheets. They are likely to increasingly influence market pricing and therefore present new opportunities for potential outperformance. In this paper, we show how we are integrating ESG factors into EM debt investing, sharing:

- **How we are tackling the challenges of ESG integration within fixed income.**
- **Examples of tangible results of our value-add ESG engagement initiatives & research.**
- **Our perspective of seeing ESG through the lens of alpha opportunity, rather than as just a risk-management tool.**
- **How we are embedding ESG into our investment mindset and team culture.**

## Our ESG investment journey

### Organisational developments

**2013** – Introduced a firm-wide formal ESG investment risk management framework with ESG integration as standard; developed ESG investment policy, sourced external ESG data, recruited an ESG investment consultant

**2014** – First permanent in-house ESG investment specialist resource employed, enhanced ESG reporting

**2017** – First ESG-orientated fund launched

**2018** – Rolled out proprietary ESG integration framework for issuer-level evaluation process to input into fundamental credit analysis across investment team

**2020** – ESG investment team of four moved to investment function; we begin to introduce new ESG client reporting capabilities to increase transparency and credibility of our ESG credentials

### ESG participation/publications

**2013** – Signatory to and active member of the PRI: Principles for Responsible Investment

**2018** – ESG white paper was written on EMD credit investing

**2019** – Published a range of ESG white papers with a focus on EMD; participated in PRI's sovereign debt working group; joined the Green Bond Transparency Platform focused on LAC markets

**2020** – Added to ESG membership/participation through the Climate Action 100+ and the Emerging Market Investor Alliance; conducted more strategic corporate and sovereign ESG engagements

While ESG integration has been well established within the equity universe, fixed income investors face unique challenges. These include:

- **Multi-layered investment analysis, potentially requiring several ESG perspectives for a single issuer, due to unique investment materiality of ESG factors, depending on the tenor, structure & currency of individual investment instruments.**
- **Fragmented ESG data sources of various quality, especially for sovereign issuers, with a broad range of investment materiality implications and inconsistent implications for market pricing.**
- **Challenges to engagement given the different legal status of lenders relative to owners (equity investors).**

In response to these challenges, we have developed a proprietary framework to evaluate environmental, social and governance risks tailored specifically to sovereign and corporate bond issuers. We recognise the importance of clearly articulating how ESG factors influence our investment decisions as well as the EM debt asset class as a whole – something we have sought to do through a range of research studies, participation in industry-wide initiatives, sharing best practices and contributing to thought leadership in this area.

The outcome has been our multidimensional approach to assessing ESG risk, linking structural ESG risks and their materiality in investment decisions. We analyse ESG factors that are investment relevant for each issuer to derive a fundamental ESG (risk) rating, informed by a combination of external resources and our own internal assessment. We also assign an investment ESG score for every security we have invested in, based on our assessment of how that issuer's fundamental ESG risks are likely to impact investment performance.

| Fundamental ESG (Risk) Rating | Investment ESG Score | |
|---|---|---|
| Very high ESG risks | -3 | Very high ESG investment-related risks |
| High ESG risks | -2 | High ESG investment-related risks |
| | -1 | Some ESG investment-related risks |
| Medium ESG risks | 0 | ESG considerations are unlikely to have an impact |
| Low ESG risks | +1 | Some investment opponunities as a result of ESG considerations |
| | +2 | High investment opportunities as a result of ESG considerations |
| Very low ESG risks | +3 | Very high investment opportunities as a result of ESG considerations |

### Fundamental ESG (Risk) Rating

- Determines overall risks of issuer across all three dimensions – describing how well an issuer manages its material ESG risks
- One per issuer
- Co-owned by credit/ESG analysts
- Scale from 'very high' to 'very low' ESG risks
- Formal review cycle but ad-hoc where needed

### Investment ESG Score

- Focuses on the extent to which there are elevated investment risks highlighted in the fundamental ESG rating and flags up resulting opportunities/risks for individual securities
- Assigned at a security level, so can potentially have a different ESG score per issuer, allowing for different ESG investment risk/reward profiles
- Owned by investment professionals only
- Score ranges from +3 to -3
- Dynamic updates

This approach, as illustrated above, provides two ESG metrics for every investment idea, allowing us to be both pragmatic and tailored in the way we evaluate the impact of ESG issues on our asset class. A good way to think about this is to consider how credit ratings work: a fundamental credit rating is assigned for an issuer, but the rating for specific bonds from that issuer can deviate from that depending on the specific security characteristics. Our proprietary issuer ESG metrics are integrated into our internal research systems and trade-monitoring platforms, enabling investment teams to reference and incorporate ESG-specific analysis alongside conventional issuer credit metrics.

*"Separating the ESG risks posed by an issuer from its investment fundamentals enables us to better understand the extent to which ESG risks are investment-relevant and in which circumstances. This level of transparency is particularly important in fixed income, where ESG factors play out in different ways to equities. Such insights inform our wider knowledge and understanding of ESG fixed income dynamics, allowing us to make more informed investment decisions."*

**My-Linh Ngo**
Head of ESG Investment

## Effective stewardship in the fixed income context

**Engagement is an integral part of a successful ESG integration process. However, in the fixed income context, investors can encounter multiple headwinds.**

As lenders, fixed income investors may find issuers less responsive to engagement efforts relative to equity owners. Accountability of corporate management towards lenders is limited to covenants and lenders have fewer opportunities to directly change the course of a company through direct voting rights. Access to management and information availability is often more limited, while engagement with sovereign issuers presents a whole new dimension of issues, including regular election cycles, political sensitivities and extension of engagement beyond governments to other key stakeholders.

To overcome these challenges, our focus has been on targeted and value-add engagement, prioritising quality over quantity. We focus on capitalising on our strengths to secure the highest-possible positive impact on relevant ESG issues, where our interests are aligned with those of other stakeholders without undue interference in political processes in the case of engagement with sovereign issuers. In particular, our team's flat structure allows us to act fast. Our targeted approach focuses on corporates that will be most receptive to our engagement efforts given their need for capital, limited alternatives to capital markets and our position as large, longstanding bondholders. We lean on our strong relationships with issuers built over years of regular dialogue. Along with our deep analytical resources and decades of expertise, this facilitates engagement and allows us to be key partners in industry-wide initiatives. We continue to evolve our engagement efforts, ranging from bilateral, direct engagements with issuers to active involvement and leadership in industry-wide initiatives, with encouraging initial results. The table below outlines some examples of our activity to-date.

| ESG participation of initiative / organisation (since when) | Background | EM sovereigns (and scope of our focus) | EM corporates (and scope of our focus) |
|---|---|---|---|
| **PRI** (July 2013) | A leading proponent of responsible investment; working to achieve a sustainable financial system by encouraging the adoption of the PRI principles and collaboration on their implementation. | Sovereign debt working group: active member of this group set up in late 2018 to explore and clarify ESG integration and engagement practices in sovereign debt investing. First publication of ESG integration report in September 2019, forthcoming report on ESG engagement due end-2020.<br>**Scope**<br>✓ Investment-industry level<br>✓ Thematic<br>✓ Issuer level | Participation in collaborative engagements at both an issuer level on specific ESG matters and an industry level (e.g. mining activities and tailings dam management (since 2019).<br>**Scope**<br>✓ Investment-industry level<br>✓ Thematic<br>✓ Issuer level |
| **Green Bond Transparency Platform** (December 2019) | Initiative to develop a digital tool created by the Inter-American Development Bank (IDB) that brings greater transparency to the Latin American and Caribbean's green bond market. | Supporter status: providing input to the pilot development of the platform. Participating in an upcoming report on the ESG analysis of sovereigns and its impact on investments globally. BlueBay case study on integration to be featured.<br>**Scope**<br>✓ Investment-industry level<br>✓ Thematic | N/A |
| **Emerging Market Investor Alliance (March 2020)** | A non-profit enabling institutional EM investors to support good governance, promote sustainable development and improve investment performance. | Active participation and contribution to discussions on post Covid-19 sovereign financing solutions and carbon transition challenges.<br>**Scope**<br>✓ Investment-industry level<br>✓ Thematic<br>✓ Issuer level | Expanding insights on evolving ESG risks, most recently across extractives and agricultural industries, engaging with leading EM issuers on their ESG practices.<br>**Scope**<br>✓ Sector/thematic<br>✓ Issuer level |
| **Climate Action 100+ (March 2020)** | Signatory to this investor initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change. | N/A | Recognised the need to expand focus to debt-only issuers, proposed to act as co-lead investor on engagement with a major LATAM energy issuer.<br>**Scope**<br>✓ Sector/thematic<br>✓ Issuer level |

## Engagement with Brazil over deforestation concerns

**Fundamental ESG (Risk) Rating[1]:** Medium ESG risks
**Investment ESG Score[1]:** -2 (high ESG investment-related risks)

### ESG view

- Brazil is home to a third of the world's rainforests, which cover almost 60% of its landmass. Such assets function as carbon sinks and critical ecosystems services. They contain an important source of global biodiversity and provide a home and livelihood for many communities which exist within and alongside the rainforest. Deforestation is the result of agriculture, urbanisation, infrastructure and logging activities.
- The sovereign has historically had a good record on combating deforestation in conjunction with providing favourable conditions for business and investments.
- In June 2020, a group of investors including BlueBay signed an open letter to Brazilian embassies in their home countries seeking dialogue and expressing concerns over escalating deforestation and the associated adverse impact on biodiversity, climate and human rights, which present systemic risks to our investments in the country. Engagement was timed ahead of an impending approval of land-ownership regulation, which could increase deforestation risks further, and ahead of the upcoming forest-fire season.

Note: The information provided is to illustrate the investment process of the BlueBay ESG team and should not be deemed a recommendation to buy or sell any security or financial instrument.

### Status & outcome

- **Engagement secured with the Vice President in his role as Head of the Amazon Council, the ministers of environment and agriculture and the governor of the central bank, as well as key officials in the Congress.**
- **In July 2020, the government announced a 120-day moratorium on forest fires in response to the initiative.**
- **BlueBay to co-chair a formal two-year engagement programme with the sovereign to tackle the issue in a sustainable way.**

Note: [1] BlueBay Asset Management, May 2020

# ESG as an alpha opportunity

**We believe ESG factors are investment relevant and that incorporating material elements into our investment process will result in better investment decisions. While our primary focus was originally on downside risk management, over time, integrating ESG factors into our investment process has also become a source of alpha generation.**

A research study that we conducted with Verisk Maplecroft in 2019 focused on ESG factors in sovereign bond investing. Our analysis confirmed empirically a range of our prior beliefs. We were able to show that market pricing of ESG risks in sovereign credit spreads is highly imperfect, particularly for environmental factors, while irregularities also exist in the governance dimensions. Moreover, markets are slow to react to shifts in all three E, S & G categories. Finally, ESG risks have proved to be highly non-linear, making markets prone to sharp repricing risks when factors reach tipping points.

These findings point to great opportunities for active investors. Those who can analyse ESG risks more precisely than the market can potentially profit from these inefficiencies and blind spots, presenting important alpha opportunities.

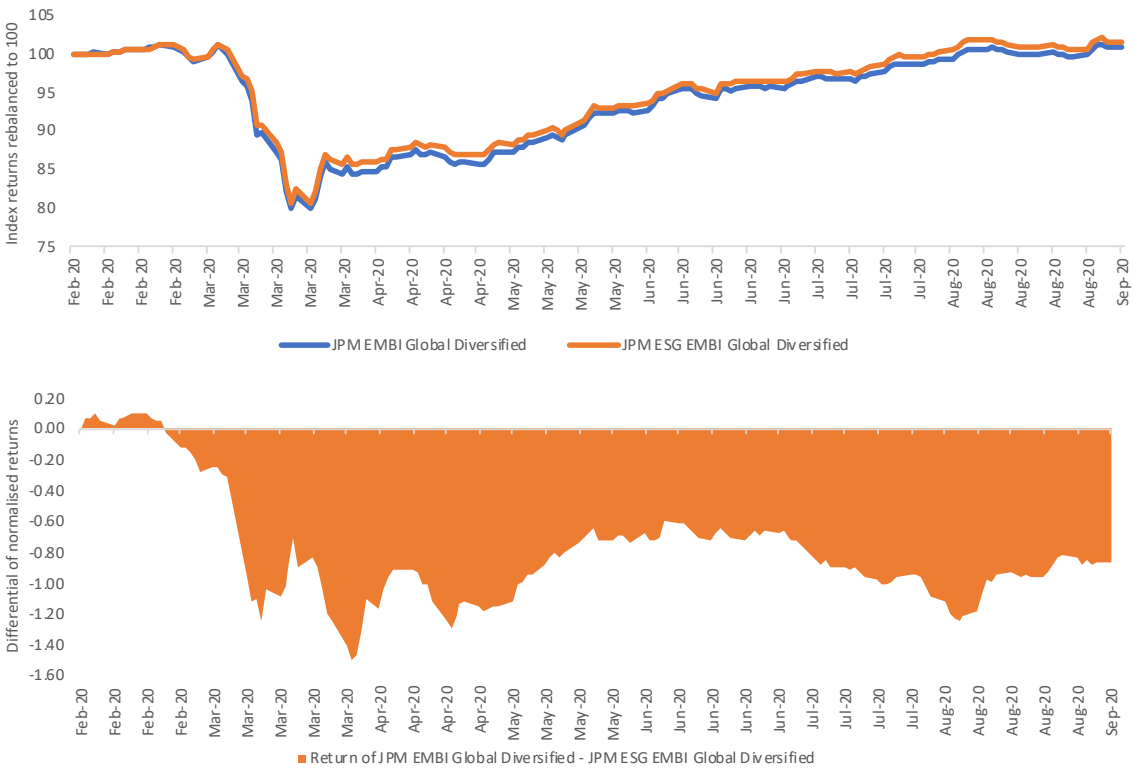
As we gain greater experience with ESG integration, we continue to see compelling evidence that our enhanced risk-management framework and holistic analysis of investment risks and opportunities brings noteworthy benefits for both performance and volatility management.

## Performance attribution challenges

While alpha opportunities clearly exist, precise performance measurement of successful ESG integration into an investment process is not straightforward.

In some cases, the benefits are clear. The JP Morgan ESG EMBIG Diversified Index outperformed its conventional counterpart during the Covid-19 sell-off in March 2020. Not only did the ESG sovereign index register a smaller drawdown in March, it also maintained its outperformance during the recovery phase.

ESG VS CONVENTIONAL INDEX ANALYSIS DURING THE COVID-19 SELL-OFF




Source: JP Morgan, September 2020

Short-term positive returns cannot always be immediately attributed to an ESG-driven decision, given tipping points are often hard to time and, as mentioned earlier, markets tend to react to changes in ESG factors with a notable delay. However, there are other benefits of ESG integration. In particular, these can translate into lower volatility and more robust portfolios that are less susceptible to sharp repricing risks. The following case studies illustrate these effects.

## CASE STUDY 1: Concerns over environmental risks led us to steer clear of a leading Brazilian iron ore and steel producer

**Fundamental ESG (risk) rating[1]:** Very high ESG risks
**Investment ESG score[1]:** -3 (very high ESG investment-related risks)

**ESG view**

- ESG analysis resulted in material concerns about the company's ESG practices. Specific concerns centred around the company's use of tailings dams within their production process, which we believe could be better managed. In our view, a permanent shift in required risk premium is appropriate.
- External views: MSCI ESG rating 'CCC' since 2017, facing ongoing severe structural ESG controversies[2].

**Investment outcome**

- No exposure in our long-only EM funds. This absolute underweight was maintained even when the company received a credit rating upgrade by Moody's to B2 in 2019 for financial reasons – improvement in liquidity on the back of refinancing and an iron ore prepayment deal.
- No participation in the company's new issue.
- While bonds sold off in line with their peer group in March 2020 they lagged the recovery.

Note: [1] BlueBay Asset Management, October 2019 [2] MSCI ESG Research as of August 2020. The information provided is to illustrate the investment process of the BlueBay ESG team and should not be deemed a recommendation to buy or sell any security or financial instrument.

**Performance during the Covid-19 crisis relative to its sector peers**


Source: Bloomberg, August 2020

## CASE STUDY 2: Position sizing reflects ESG concerns in an Indonesian aluminium producer with otherwise positive fundamentals and attractive valuations

**Fundamental ESG (risk) rating[1]:** Very high ESG risks
**Investment ESG score[2]:** -2 (high ESG investment-related risks)

### ESG view

- Review revealed many structural ESG issues with this company's original operations; these subsequently increased following its most recent acquisition. While there are indications of intent to tackle these, its government-owned status could impede the speed and scale of remedial action. ESG issues are already impacting the company's asset prices and could continue to do so.
- External views: MSCI initiated coverage in March 2020 with an ESG rating 'B', conveying a consistent view to ours in terms of the company's ESG status[2].

### Investment outcome

- Cognisant of the ESG risks and requiring valuations to compensate for this, we moved to a modest overweight position in May 2020 via a new 30-year bond issue ('+1' conviction score), while fundamentals and significant concession to existing curve as well as sovereign would justify a larger position. While bonds traded well initially, they lagged their quasi-sovereign peers in the recovery post March 2020 sell-off.
- Seeking to mitigate ESG risks, we initiated engagement with the sovereign owner to highlight our concerns, encourage greater transparency and more effective management of key ESG impacts associated with the mining operations.

Note: [1] BlueBay Asset Management, May 2020 [2] MSCI ESG Research as of March 2020. The information provided is to illustrate the investment process of the BlueBay ESG team and should not be deemed a recommendation to buy or sell any security or financial instrument.

**Performance (blue) during the Covid-19 crisis relative to another Indonesian quasi-sovereign with a stronger ESG profile**


Source: Bloomberg, August 2020

## CASE STUDY 3: Negative ESG view led us to non-participation in a new issue from a B-rated Eastern European sovereign issuer

**Fundamental ESG (risk) rating[1]:** High ESG risks
**Investment ESG score[1]:** -3 (very high ESG investment-related risk)

### ESG view

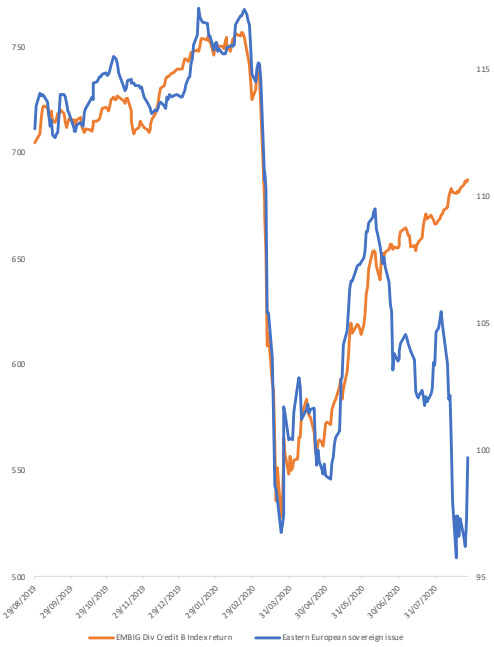
- ESG review highlighted meaningful concerns for this sovereign issuer, which operates an authoritarian regime under the current president who has been in power for over two decades. There is little scope for genuine opposition parties to function effectively. The 2020 election result keeping the current administration in power is being contested, with questions raised about the nature of its relationship with Russia and criticism levelled at its handling of the Covid-19 crisis. We see heightened social unrest and potential EU sanctions risks which are not being sufficiently priced.
- External views: Verisk Maplecroft assigned a 'medium' ESG risk rating, reflecting weaker performance on governance and political factors and stronger relative performance on social and environment[2].

### Investment outcome

- No exposure in our long-only EM funds. We sold our positions and moved to an absolute underweight. Our ESG concerns started to affect price action in Q2 2020, causing notable underperformance relative to similarly rated peers.

Note: [1] BlueBay Asset Management, May 2020 [2] Verisk Maplecroft as of October 2018. The information provided is to illustrate the investment process of the BlueBay ESG team and should not be deemed a recommendation to buy or sell any security or financial instrument.

**Performance during the Covid-19 crisis relative to B-rated peers**




Source: Bloomberg, August 2020

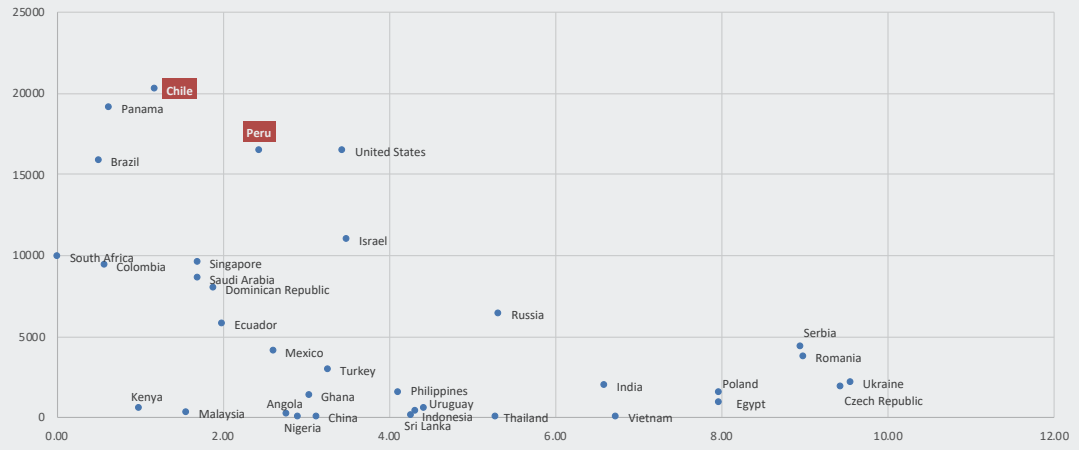
## Enhanced fundamental analysis

In our view, ESG analysis contributes not only to more robust portfolios but also to a more robust macroeconomic analysis. During the Covid-19 crisis, we were able to lean on our ESG analysis to evaluate countries' abilities to cope. We examined factors ranging from the preparedness of their health systems to the likely behaviour of their population under extreme lockdown conditions. Outside of the obvious indicators such as healthcare capacity, we closely monitored income inequality, as this variable proved to be a much better predictor of just how much Covid-19 is likely to spread within the individual countries, cripple economic activity and weigh on fiscal resources.

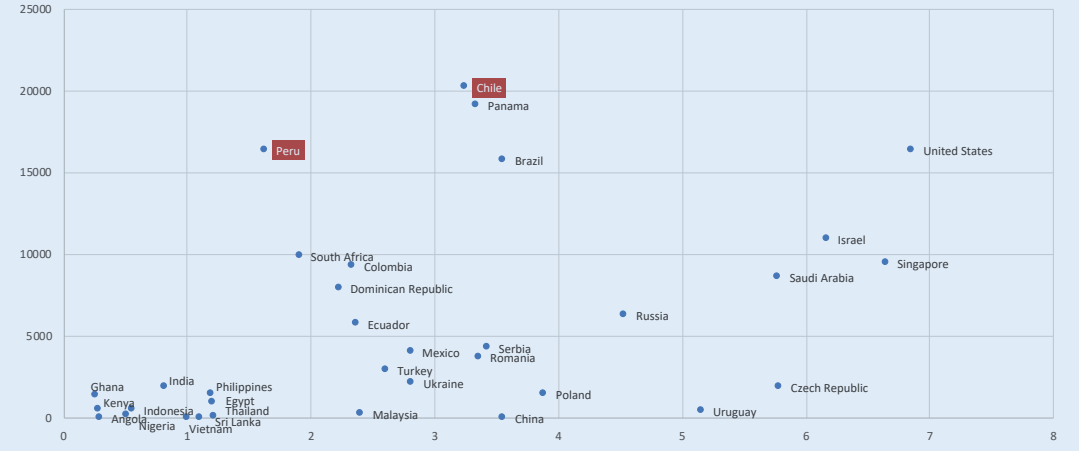
*"Many investment-grade EM countries, which should have otherwise been better equipped to deal with the Covid-19 crisis, have been less effective than the average EM sovereign. High levels of income inequality meant that these governments' highly informal approaches to lockdown were relatively ineffective in flattening the curve. A good example is Peru, where a surprisingly high number of people had to leave their homes every day, not just to generate income but also to buy food, as they don't have refrigerators."*

**Graham Stock**
EM Senior Sovereign Strategist

### Peak of Covid-19 cases per million vs Gini Index*




### Peak of Covid-19 cases per million vs Healthcare capacity index*




Sources: Our World in Data, Verisk Maplecroft. Gini/Healthcare capacity index – the lower the number the higher the inequality/the weaker the healthcare capacity.

* As at August 2020.

### Value of ESG integration for illiquid strategies

Finally, we find ESG analysis particularly valuable in our illiquid investments. Many of the risks falling under the ESG umbrella are longer-term in nature and while not always investment material in the short term, they can significantly impact the value of an investment when held over the medium term.

Given the longer investment horizon of an illiquid portfolio, we believe it is even more critical to conduct rigorous analysis of these risks upfront. At the same time, because the demand/supply balance of credit in this market is favourable for lenders, the opportunity to engage with issuers on ESG topics and influence their outcomes can also be enhanced in such investments.

## ESG is embedded in our mindset & team culture

As we have progressed with ESG integration, we have sought to hardwire ESG into our DNA, so that taking environmental, social and governance factors into account in our day-to-day decisions remains at the core of our investment process. We have implemented a number of measures to ensure this.

**Integrating our ESG specialists within the investment team, reinforcing the value we place on ESG analysis for alpha generation rather than viewing it purely as a risk management tool.**

**Promoting ownership and accountability: ESG is a key performance indicator in the evaluation and remuneration process for all our investment professionals.**

**Helping advance industry knowledge and best practices through our involvement in industry-wide working groups, constant dialogue with peers and collaboration with other leaders in this field to broaden our understanding of ESG factors and their influence on markets.**

**Encouraging our employees to develop their knowledge through educational opportunities, including the CFA Certificate in ESG Investing.**

*"We have observed a high correlation between credit quality and the existence of a robust ESG framework and policies among underlying borrowers. This relationship is even more relevant for an illiquid strategy with a buy-and-hold approach where default risk and permanent impairment of capital is our primary concern. There are numerous examples where weak ESG standards, such as loose environmental policies or founding-shareholder driven governance, have ultimately led to substantial capital losses."*

**Mihai Florian**
Senior Portfolio Manager

## Conclusion

We firmly believe that the importance of ESG themes and factors will play a growing role in our investment decision making. With ESG analysis now fully embedded in our investment process and with several years of practical experience under our belts, we are excited to see positive results in our investment outcomes.

The next stop on our journey towards a progressively more sustainable approach to investing is an increase in engagement efforts – both directly with our issuers and with the industry as a whole. Our aim is to generate tangible results for more sustainable growth, long-term health and prosperity among the countries and companies in which we invest. While our early successes in engagement, raising awareness and bringing change are extremely encouraging, these are merely the tip of the iceberg in terms of what we believe we can achieve. We are optimistic that our ambitions will be matched with results in the years to come.

*"While we have made significant progress incorporating ESG into our investment process and team mindset, we don't want to stop here. We believe that in order to fulfil our role as responsible, long-term investors, we also need to be ambassadors for ESG topics among the investment community."*

**Polina Kurdyavko**, Head of Emerging Markets

**Jana Velebova, CFA**
Senior Portfolio Manager

Jana is a Senior Portfolio Manager within the Emerging Markets Team. Prior to joining BlueBay in December 2014, Jana was a Partner and Portfolio Manager at Rogge, where she co-led the EM team in London and Singapore and managed EM assets across a range of active global fixed income and currency portfolios. Following experience in banking, she started her asset management career at Threadneedle in 2006, where she became a deputy fund manager in the emerging market fixed income team. She holds a BSc in International Economics from the University of Economics in Prague, an LLM in Finance from J.W. Goethe University in Frankfurt and a Postgraduate Certificate in Complex System Modelling from King's College, London. Jana is a CFA charterholder and holds the CFA Certificate in ESG Investing.

Global Asset Management

BlueBay Asset Management