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Strategy Insights | Fixed Income

Assessing the viability and value of ESG investing in EM debt

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Overview

- We believe the EM debt space provides a compelling opportunity for ESG-oriented investors. Though EM countries lag developed markets in terms of sustainability, the potential to drive positive change through investment decisions is, therefore, greater.
- EM investors may not have to sacrifice returns to achieve ESG goals. We have found that long-term performance is not diminished by integrating ESG considerations into the investment process and, in some cases, can be improved.
- At Invesco Fixed Income, assessing ESG factors is a core part of our investment analysis. We work closely with our clients to understand their ESG goals while seeking to provide compelling returns.

Environmental, social and governance (ESG) goals, or responsible investing, have become an important consideration for many investors across the globe. Often, it is no longer enough for asset managers to focus purely on returns. Increasingly, investors now want to ensure that their capital is allocated in a responsible manner consistent with their values. In some instances, they hope to drive positive change with their investment decisions.

This dynamic, along with regulatory changes in some markets, has had, and will likely continue to have, a profound impact on the way capital is allocated. In our view, this focus on responsible and sustainable investing is a formalization of what has long been an important consideration for long-term oriented investors, especially in the emerging market (EM) space.

This paper provides an overview of the ESG investment landscape as it relates to EM fixed income. It is our view that the EM debt space provides a compelling opportunity for ESG-oriented investors, since such considerations are typically important in making good long-term investment decisions and avoiding the pitfalls that can be especially costly in the EM debt space. In addition, while the starting point for many EM entities, in terms of sustainability, is often significantly lower than in developed markets, the potential to drive positive change through one's investment decisions is similarly greater.

ESG investing framework

One of the challenges with the rise of ESG, or sustainable investing, is that there are myriad views regarding what constitutes a "good" or "proper" approach to such investing, and even base line criteria. There is no single best approach, in our view, but we believe there are common principles necessary to formulate a credible ESG strategy:

- **The strategy must have a clear set of investment criteria that are objectively measurable.** This can be a simple best-in-class approach or a detailed set of positive, negative and exclusionary criteria, but there must be an objective standard for measuring compliance. This helps to avoid strategy drift and makes evaluating the success of the strategy more straightforward.
- **Adequate resources are needed to conduct independent ESG analysis.** Third party research providers, such as MSCI, are excellent resources that can provide useful data and a starting point for evaluation. However, given their breadth of coverage and dependence on easily accessible public data, we think their value from an investment standpoint is limited, especially in areas like EM debt, where obtaining relevant data can be more challenging. In our view, to deliver a value-added ESG strategy, an investment team must be able to conduct robust independent research that allows the assessment of an issuer's position among peers in terms of overall fundamentals, specific ESG criteria and the issuer's progress on ESG goals.
- **We believe it is important to work with a manager who can deliver a strategy consistent with an investor's values while offering potentially attractive risk-adjusted returns.** We view investors' increasing focus on ESG-oriented capital allocation as a positive development, especially considering the environmental and social challenges facing the world. However, for such an emphasis to be sustainable, we believe such strategies must deliver compelling returns.

Why should ESG investors consider EM?

We believe EM presents an excellent opportunity for investors to drive change while participating in an asset class with strong investment potential. Over 80% of the world's population lives in EM countries and EM economies generate more than half of global GDP.[1] Growth in EM populations and economies also outstrips developed markets. The growth of EM markets represents a significant investment opportunity, in our view, and EM development will likely help shape the objectives of sustainable investing going forward.

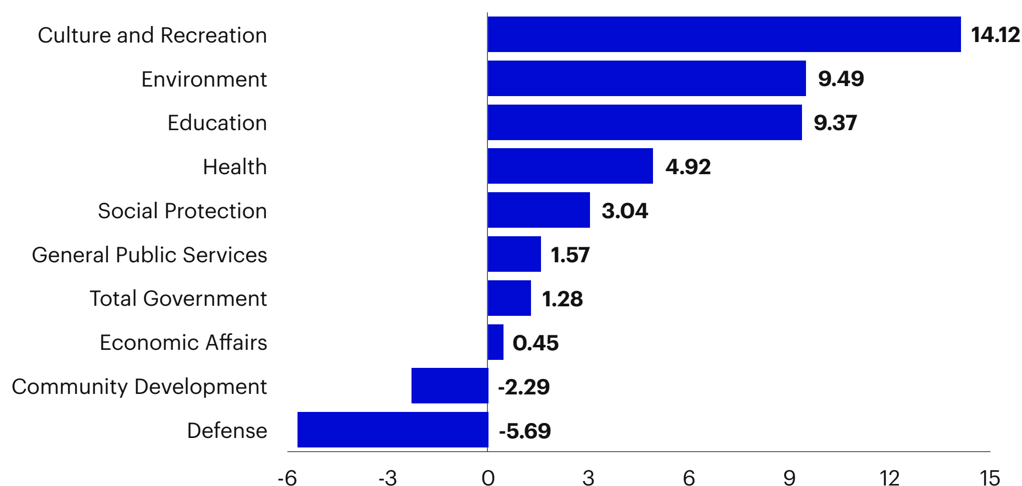
Focusing on EM might seem counterintuitive to many ESG investors. Compared to developed markets, EM countries tend to have inferior corruption and transparency scores, weaker institutions, greater social inequality and many produce and export commodities with negative environmental impacts. But for these reasons, we believe ESG-oriented investing in EM debt affords investors a greater opportunity to support and drive positive change than in developed markets. For example, while EM countries currently account for 60% of global carbon emissions and face underdeveloped energy infrastructures, they also have some of the world's best resources for renewable energy.[2] The use of onshore wind power in Brazil and solar power in India and Africa, for example, highlight opportunities to democratize energy in an environmentally sustainable way for growing populations.

Issuer engagement and the potential to drive positive change

Compared to developed market issuers, EM issuers lag in the availability of sustainability and governance metrics. However, EM sovereign and corporate issuers have good reasons to care about ESG goals and ESG-related investing. At the sovereign level, for example, ESG investment can effectively reduce the cost of capital for nations that demonstrate efforts toward goals like improved transparency. Many countries have a desire to improve such ESG factors, but are faced with financing shortfalls and immediate concerns like food insecurity, poverty, and healthcare. Steering private capital toward countries willing to improve ESG conditions can entice other countries to address ESG standards. Countries able to spend on ESG improvements may also generate greater economic activity within their own borders, helping to create a positive feedback loop (Figure 1).

Figure 1: ESG-Themed Fiscal Spending Generates Greater Multiplier Effect

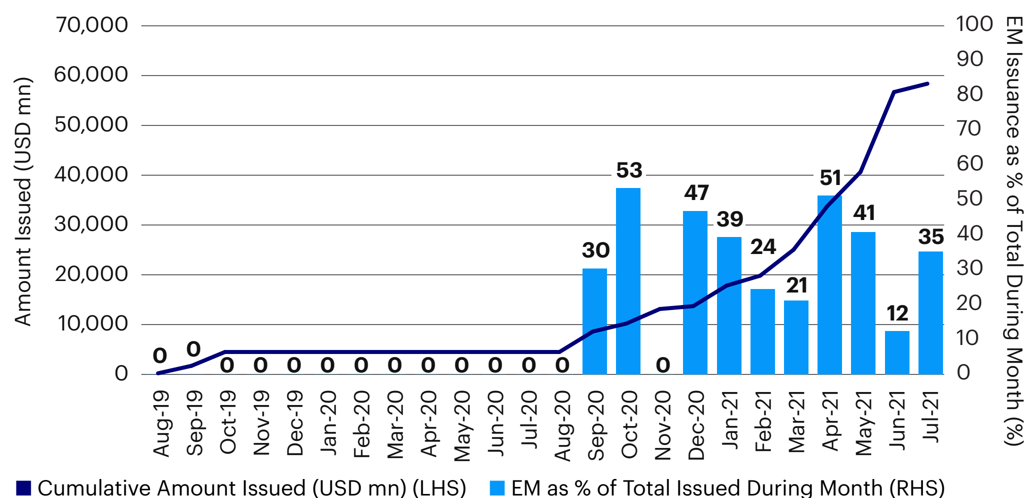
Fiscal multiplier, by type of government spending



Source: Institute of International Finance, data as of December 31, 2020.

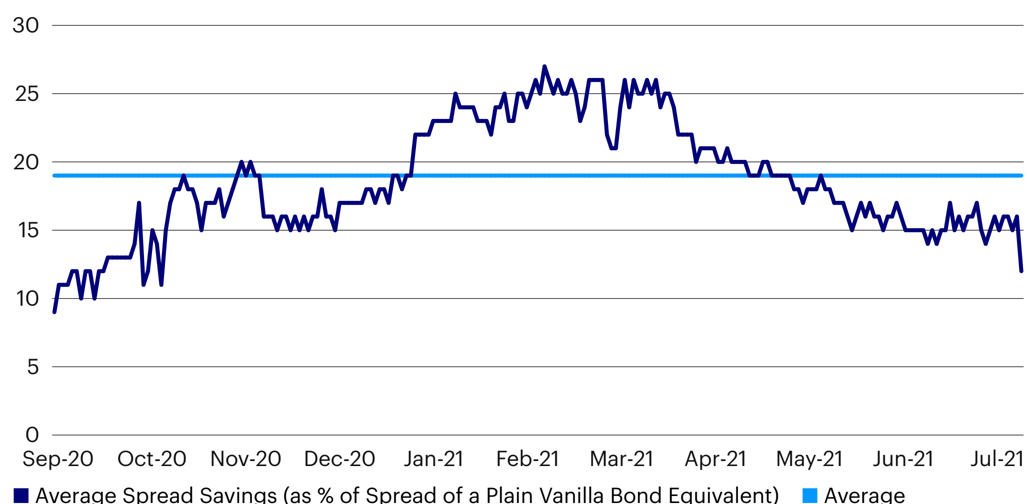
EM corporate bond issuers are likely to increasingly engage with investors since debt is often a more important part of their capital structures. Engagement can broaden the EM corporate investor base and potentially lower the cost of capital. We have seen evidence of this in the rise of sustainability-linked bonds (SLBs) issued by EM companies (Figure 2) and their lower bond spreads versus sector peers (Figure 3).

Figure 2: Global and EM SLB Issuance



Source: Bloomberg L.P., Invesco. Data from December 18, 2018 through July 7, 2021.

Figure 3: Spread Savings in EM Pulp and Paper Sector SLBs (%)



Source: Bloomberg L.P., Invesco. Data from September 11, 2020 to July 16, 2021.

Case study: SLBs gain momentum in EM space

SLBs are a new type of bond that gained popularity in 2020. The issuer of an SLB attempts to achieve predefined key performance indicators (KPIs) by a specified target date. If the objective is not achieved, the financial or structural characteristics of the bond change, such as a step-up in the coupon rate. This structure provides a meaningful incentive to issuers to achieve targets. One drawback of SLBs is that the proceeds of the bond issuance can be used for general corporate purposes, providing issuers with the flexibility to allocate new capital any way they see fit. Another common pitfall of SLBs is that the financial penalty for not achieving the KPIs may only have a modest impact on the issuer's cost of debt since the typical step-up coupon is 25 basis points. The target date may be also late in the life of the bond. Having an internal framework to analyze and compare SLBs (and other sustainable bonds) is important in determining if issuers are "greenwashing." Below, we provide an overview of Invesco Fixed Income's ESG framework.

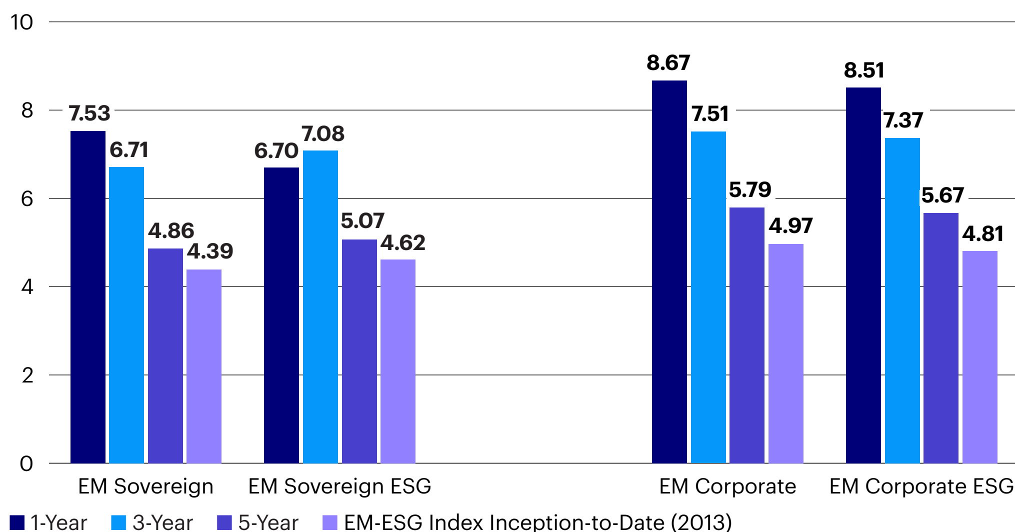
While the EM corporate asset class was not the first to issue SLBs, it has adopted the structure as its own. Since September 2020, about a third of all SLBs issued globally have been EM corporate bonds (Figure 2). On a monthly basis, EM companies now account for about half of all global SLB bonds issued (Figure 2).

This SLB structure is interesting because it holds issuers accountable for sustainable objectives and provides a lower cost of capital to companies. We evaluated the EM pulp and paper sector, as there have been multiple companies that have issued SLBs with well-defined credit curves, allowing better comparisons to their "plain vanilla" corporate bonds. We found that since September 2020, EM pulp and paper SLBs have traded about 45 basis points tighter on average than where we estimate a plain vanilla corporate bond would trade (Figure 3). This has resulted in significant spread savings for these companies, representing about 19% of the spread on a plain-vanilla bond (Figure 3).

Impact on investment performance

In addition to the broader merits of ESG investing, we have found that investors do not have to sacrifice returns to achieve ESG goals (Figure 4). We have found little evidence of diminished long-term performance from integrating ESG considerations into EM debt investing. In many cases, we have found that considering ESG factors can positively impact longer-term investment outcomes.

Figure 4: EM ESG Index Returns vs. EM Benchmark Index Returns (%)



Source: Bloomberg L.P. Data as of: 1-Year is June 30, 2020 to June 30, 2021; 3-Year is June 30, 2018 to June 30, 2021; 5-Year is June 30, 2016 to June 30, 2021; Index Inception-to-Date is December 31, 2012 to June 30, 2021.

ESG intertwined with credit fundamentals

In practice, ESG analysis has always been fully intertwined with fundamental credit analysis. A focus on governance, in particular, can identify material financial risks and opportunities. We have found that issuers that operate in a more sustainable manner and actively engage with investors on ESG topics are often better managed and follow business models more aligned with our long-term investment objectives. Empirically, this increases the likelihood of positive investment outcomes and mitigates the likelihood of negative surprises, which are often related to ESG deficiencies.

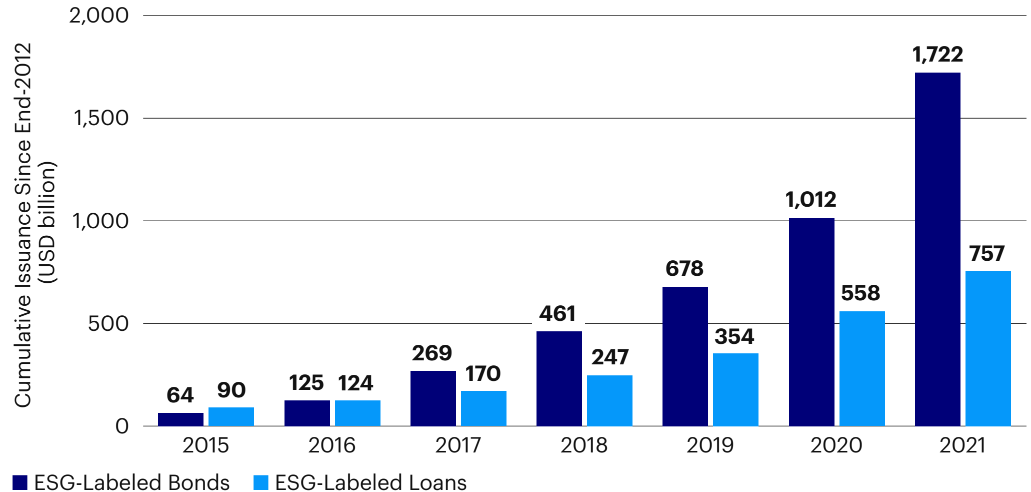
ESG as a driver of market technicals

Another driver of return potential is the demand for the asset class. EM hard currency debt as an asset class has grown rapidly since the global financial crisis (GFC), driven in part by demand for yield among global investors in a low yield environment. Since the GFC, volumes of outstanding EM sovereign and corporate debt have grown by more than four and seven times, respectively.[3] The combined sovereign-corporate hard currency EM market is now a mature, but still growing, asset class that currently surpasses the US high yield market in terms of size.[4] ESG has also grown up during this period. Since 2010, ESG-dedicated issuance has grown from around USD15 billion to over USD2 trillion, and is expected to reach USD3 trillion by the end of 2021.[5]

Yet, ESG issuance in EM is still in its infancy, representing less than one percent of outstanding bonds.[6] This, however, is changing rapidly. JP Morgan estimates that by the end of the first quarter of 2021, only USD30 billion of EM debt was benchmarked to its leading ESG EM indices, out of a total of USD800 billion benchmarked to all of its EM debt indices.[7] Notably, USD10 billion of this ESG-benchmarked debt is new in 2021 — representing around one third of net retail flows into the broad EM debt asset class this year.[8]

This data point is just one demonstration of what we expect to be a long-term trend of increased supply and demand for ESG issuance. There are many others — for example, over the next decade, it is expected that over USD35 trillion in capital will be deployed globally in the transition to clean energy.[9] We expect the net financial effect of this ESG groundswell to be an increased investment opportunity set and a substantial increase in demand, much of which will likely be directed toward EM.

Figure 5: Record ESG-Labeled Debt Issuance in Q1 2021



Source: Institute of International Finance. Data from March 1, 2015 to March 1, 2021.

Challenges and considerations for investors interested in EM ESG investing

ESG investing in EM is still in its formative stages and complexities exist at every level of the capital allocation process. For one, issuers must credibly demonstrate that their practices align with the shifting priorities of the investment community. To this end, issuers face increasing demands for ESG disclosures and must staff investor relations departments to address a new line of investor inquiry. This adjustment is more difficult for some. Commodity sector corporations or sovereigns in their early stages of development facing large financing gaps, for example, may face decreased access to capital, even if they demonstrate a willingness to improve their ESG profiles.

Investors face a multitude of considerations as well, including making decisions on how to approach and assess ESG. ESG scores and ratings, which seem like a tidy summary, are an amalgam of many underlying considerations that individual investors value differently. Even after investors detail their objectives, applying them is not necessarily straightforward. Standardization and frequency of data is one obstacle. Often data are updated only yearly or quarterly, are backward looking, and may be inconsistent from country to country or firm to firm. Some metrics are also inherently more quantifiable and objective than others. For example, a common exclusionary criterion is United Nations Global Compact compliance. However, industry data providers have different interpretations of compliance. Which data provider or combination of data providers one relies on can materially alter the investible universe.

Putting aside data issues, an important question remains on how to apply ESG criteria to a disparate group of issuers. Should a poor nation reliant on fossil fuels be treated the same as a wealthy nation that willfully ignores carbon output? As highlighted above, the differences between EM and developed market issuers (and even among EMs), are stark, meaning so is the opportunity to drive change in EM.

Another consideration is how to measure ESG implementation success in conjunction with financial performance. Given the bespoke nature of ESG, ideally, clients should have access to the sustainability results of their portfolios in addition to financial results. To meet the needs of large institutional clients, professional money managers, such as Invesco, are developing tailored mandates and reporting solutions. For small to medium-sized investors who utilize commingled fund products, there are, at present, fewer customized options. However, regulations such as the European Commission's Sustainable Finance Disclosures Regulation aim to increase transparency and data availability across the industry. We also expect to see a proliferation of funds and strategies, as the demand for ESG products increases.

These are just a few examples highlighting the challenges to be addressed in the coming years in the EM-ESG investing community. The issues of greenwashing, regulation and standards are also among these. However, we do not believe these challenges should dissuade investors from considering the asset class. On the contrary, we view them as an opportunity for investors to shape ESG investing at its nascent stage. The key, in our view, is to partner with firms that demonstrate a commitment to driving thoughtful change.

Invesco Fixed Income's approach to ESG investing in EM credit

One of Invesco Fixed Income's core principles is to take ESG factors into consideration as part of the robust investment analysis required to drive good, long-term outcomes in the EM space. As such, ESG analysis has been integrated into our investment process for some time. As our clients' needs have evolved, we have formalized this part of our process along with the rest of Invesco Fixed Income. Our analysts and economists now assign issuers standardized, proprietary ESG ratings and our sector research teams establish core ESG risks for each sector to guide consistent research globally. We also evaluate issuers' ESG trajectories and their performance relative to peers. This relative comparison is important in analyzing EM issuers because, while overall ratings often lag developed market peers, their rate of change is often greater. In our view, an issuer's ESG trajectory, or rate of change, can be as important as the rating itself, depending on client preferences.

To prevent "greenwashing," we use a scoring framework to evaluate SLBs and other sustainable bonds. Our scoring methodology focuses on the use of proceeds or KPIs to determine if the bonds are aligned with the United Nations Sustainable Development Goals. The scoring framework also evaluates the issuer's reporting commitment and external verification by multiple parties. For SLBs, our framework evaluates the difficulty in achieving the KPIs and the financial penalty for failing to achieve them.

From a portfolio perspective, we work closely with our clients to understand their objectives and values. From there, we seek to construct strategies with well-defined parameters that enable us to meet our clients' investment objectives in a manner consistent with their values.

Conclusion

In our view, the demand for ESG-oriented investment strategies is a positive and durable change to the investment landscape. For ESG-oriented investors, we believe EM debt warrants consideration since, in our view, the EM asset class offers the opportunity to generate attractive returns while adhering to ESG principles. In addition, the EM debt space is further compelling given the potential for investors to drive significant positive change through their investment decisions. This is an important consideration for ESG-oriented investors, especially considering the increasingly important place that EM holds in the global community and economy.

1. Source: World Bank DataBook, June 2021.
2. Source: World Bank DataBook, June 2021.
3. Source: JP Morgan, as of July 2021.
4. Source: Bank of America, July 2020.
5. Source: Bloomberg L.P., June 2021.
6. Source: JP Morgan, Institute of International Finance. Data as of June 2021.
7. Source: JP Morgan, March 2021.
8. Source: JP Morgan, June 2021.
9. Source: Wood Mackenzie, March 2021.

Investment risks

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