Insight INVESTMENT

DEBUNKING THE ESG MYTHS IN EMERGING MARKET DEBT

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A correctly integrated ESG process can, through mitigating ESG risks, potentially lead to improved risk-adjusted returns and value creation over the long term.

SIMON COOKE, EMERGING MARKET INVESTMENT TEAM

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DEBUNKING THE ESG MYTHS IN EMERGING MARKET DEBT

INVESTORS OFTEN DISCOUNT THE IMPORTANCE OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) ANALYSIS IN EMERGING MARKET DEBT (EMD) INVESTING, BASED ON PERCEPTIONS THAT EMERGING MARKET GOVERNANCE IS INHERENTLY WEAK OR THAT DATA IS LACKING. IN OUR VIEW THESE ARE MISCONCEPTIONS. ESG ANALYSIS HAS, IN OUR OPINION, THE POTENTIAL TO GENERATE ENHANCED ALPHA FOR INVESTORS AND SHOULD BE A STRUCTURAL COMPONENT OF EMD INVESTING.

ESG IS JUST AS RELEVANT FOR EMERGING MARKETS AS IT IS FOR DEVELOPED MARKETS

ESG adoption by EMD investors has been lacking due to common misconceptions

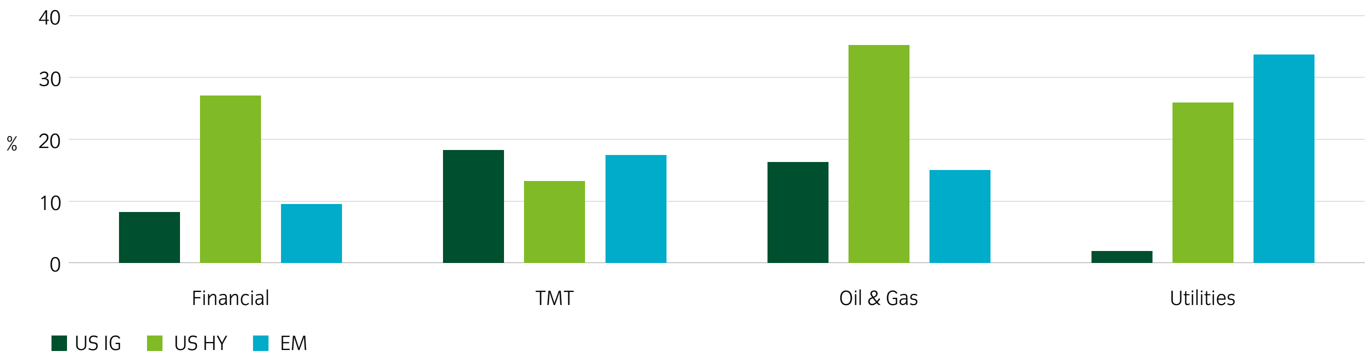
ESG analysis has become an important part of credit analysis for developed market corporates, principally as part of investment grade corporate portfolios. When one understands the benefits that can accrue from integrating ESG factors into the investment process, it is not difficult to see why this has become the case. ESG analysis can serve to generate early warning signals that potentially enable investors to avoid 'landmine' investments and the losses that often ensue. A correctly integrated ESG process can, through mitigating ESG risks, potentially lead to improved risk-adjusted returns and value creation over the long term.

Despite the clear benefits of ESG analysis, its adoption by EMD investors has been lacking. Investors mistakenly see ESG and EMD as incompatible, with two misconceptions typically cited. First, governance standards for emerging market corporates are perceived as being much lower than for their developed market equivalents. Linked to this is the impression that because standards are intrinsically weak across emerging markets, ESG analysis is largely irrelevant because markets will not price in good or bad governance. Second, ESG analysis is seen as being prohibitively challenging to conduct for emerging market corporates given poor data quality, and lack of availability and disclosure of data.

Correcting the misconception

However, we would argue that these are misconceptions. Comparing similar-sized corporates from the same industry in emerging and developed markets, we find that ESG ratings in some sectors are closer than investors might expect. This is illustrated graphically in Figure 1, which compares the percentage of corporate issuers that achieve our lowest ESG rating of 5, across four industry sectors for emerging market corporate, US investment grade and US high yield issuers. Insight uses a scale of 1 to 5 to score issuers on ESG factors, 1 being the best possible score and 5 the worst. Historically, material ESG risks have been concentrated in those issuers scoring a 5. The four industry sectors of financial; technology, media and telecoms (TMT); oil and gas; and utilities were chosen because they represent over 70% of the emerging market corporate universe.

Figure 1 – Percentage of emerging market corporate, US investment grade and US high yield issuers scoring the worst ESG rating[1]



[1] Source: Insight, MSCI, JPMorgan, Barclays, 28 February 2018.

For the financial, TMT and oil and gas sectors, emerging market corporate issuers compare very favourably to US corporates. For two sectors, the percentage of emerging market corporate issuers scoring a 5 is marginally lower than for US investment grade issuers, and substantially lower than for US high yield issuers. Clearly the perception that ESG standards in emerging markets are always dramatically lower than developed markets is a misguided one. For utilities, emerging market corporates do score considerably worse than US investment grade equivalents in particular and this can be largely attributed to the former's reliance on fossil fuels.

Investors need to do their own ESG legwork

In terms of data availability, data providers such as MSCI only cover a limited portion of the universe: less than 80% of the JPMorgan Corporate Emerging Market Bond Index (CEMBI) Broad Diversified. This coverage number becomes even lower for emerging market issuers with high yield credit ratings (60% for single B-rated names, and 55% for unrated names), and is significantly below coverage levels for US investment grade (99%) and high yield (85%). This does not, however, render it impossible to conduct an ESG analysis for emerging market corporates. Investors need to perform their own ESG legwork and should not blindly outsource their ESG analysis. With the right resources and processes in place, this is certainly achievable.

We believe this involves designing an ESG process that sits as a core component of the overall credit research process. Investors need to engage directly with the companies in order to properly evaluate potential ESG risks and mitigants. An active dialogue with management is essential. The process of analysis is no different to that for developed market companies. Assessing ESG within a standardised credit process enables investors to identify material risks whether for a US bulge-bracket bank or a regional Chinese fishery. For similarly sized peers, we believe ESG factors are comparable no matter the corporate's domicile; poor governance is poor governance no matter where it occurs.

USING ESG TO MANAGE RISKS

Manage risks with the aim of generating alpha – it pays to be proactive

It is not sufficient to undertake an in-depth analysis of ESG risks once an ESG-related event has occurred. By that point it is likely too late and sometimes a default may be just around the corner. Instead it pays to be proactive and, by considering the materiality of ESG risks, investors can generate the potential for enhanced alpha and aim to better manage risks overall. For investment grade investors, by avoiding ESG landmines, one can avoid painful mark-to-market movements and the occasional capital losses that may arise.

For high yield investors, however, the risk management and alpha generating benefits of a robust ESG analysis framework can be even more material. When ESG failings such as corruption, opaque ownership structures or inadequate safety controls afflict high yield corporates, it may lead not only to mark-to-market losses, but frequently also to distressed exchanges or defaults. Therefore, the costs of ignoring ESG issues for high yield investors' returns are potentially enormous.

Case study: Food and beverage company – an example of why ESG risks need to be monitored

This food and beverage company looked attractive following an acquisition, with meaningful synergies expected. The owners intended to IPO in late 2016 and refinance the capital structure. During 2016 it became apparent the integration programme was struggling, partly due to strong competition. The situation deteriorated further in late 2016, with weaker earnings and a cancelled bank loan syndication. There was no remediation plan, disclosure was very poor, and governance appeared weak. Ultimately, in May 2017, the company defaulted. New auditors were appointed to check the company's accounting. They found several accounting irregularities, with debt significantly understated, and the cash balance overstated by 75%.

Figure 2 – Food and beverage company bond price, US$[2]

[2] Source: Bloomberg, 28 February 2018 . Bond issuance date 28 September 2012.

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USING ESG TO IDENTIFY RETURN OPPORTUNITIES

How ESG could be used to generate return

Outright avoidance or screening for negative factors to avoid losses is not the only way that ESG analysis can support performance; ESG can also be used to generate positive returns. In our experience, not only do investors generally have a poor track record of pricing ESG risks appropriately, they also largely fail to properly account for initiatives that a company sets in place to mitigate ESG risks. This creates further inefficiencies in the pricing of EMD risk that can manifest in dramatic overreactions to ESG-related headlines. We believe that by properly integrating ESG within the overall credit process, diligent investors can analyse both the risks as well as risk mitigants and stand well placed to take advantage of these bouts of price volatility that are driven more by noise than fundamentals.

Case study: Telco company – investors who properly understand ESG have the potential to get rewarded

This telco company reported potentially improper payments made on its behalf. This resulted in bond prices falling 25% as investors worried over the prospect of a substantial fine, a potential loss of its operating license, or bankruptcy. Yet the payments were made on the company's behalf, not by the company itself. Furthermore, the anomalies were spotted because of the company's internal controls. Its cash flow and capital were such that it could potentially absorb even an abnormally large fine. Its license had been granted under 'usufruct', granting the company free use and transfer of the license indefinitely. Over the course of the next year the market repriced the risk arising from these 'potentially improper payments' appropriately, with the bonds entirely recovering their previous losses.

CONCLUSION

ESG analysis has long been an important component of developed market corporate bond investing, but its adoption by EMD investors has been lacking, restrained by perceptions of chronically weak governance and inadequate data availability. In our view these are misconceptions. ESG analysis has the potential to generate enhanced alpha and help manage risks for investors, and should stand as a structural component of an EMD investor's analysis toolkit.

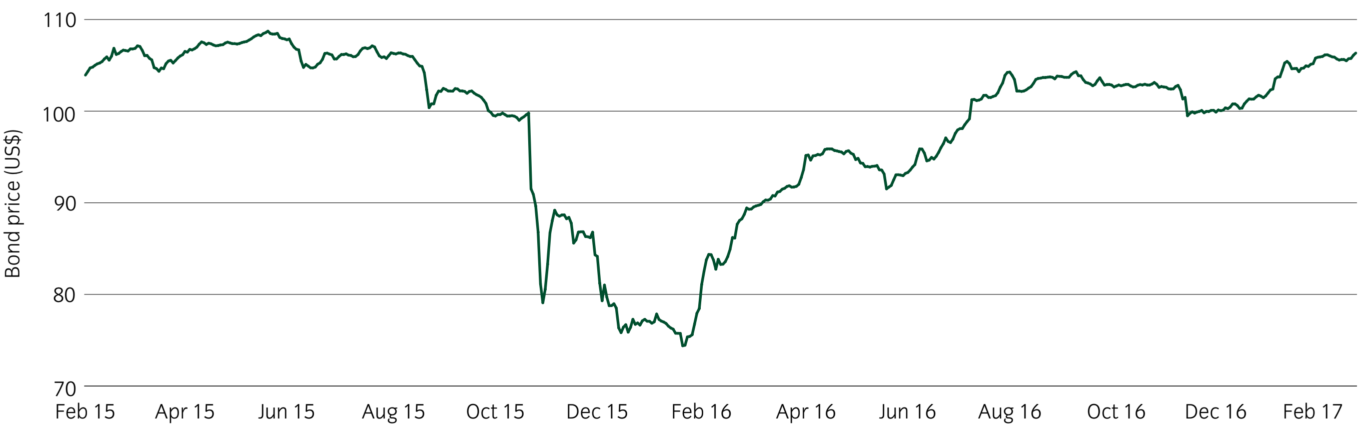
Why Insight for ESG?

At Insight, ESG analysis is embedded within our credit analysis framework. We analyse the risks, and factors that could mitigate these risks, and weigh up their materiality versus what is reflected in current pricing levels. We increasingly engage directly with bond issuers on ESG factors. We believe this enables us to potentially generate superior alpha for our clients, avoiding names where markets are not pricing in risks and adding exposure to names where mitigating factors have been ignored. Whether mandates are ESG-driven or not, whether mandates are developed market or emerging market-focused, we believe the embedded evaluation of ESG risks and opportunities is key to security selection.

Simon Cooke, CFA – Analyst, Emerging Markets

Simon joined Insight in 2011, working in the Credit Analysis Team, before joining the Emerging Market Debt Team as an analyst in August 2017. Prior to Insight, Simon worked in audit and financial due diligence at Grant Thornton. Simon holds a BA in History from the University of Durham. He also holds the Investment Management Certificate from the CFA Society of the UK, is a Chartered Accountant and CFA charterholder.

Figure 3 – Telco company bond price, US$[3]



[3] Source: Bloomberg, 28 February 2017. Bond issuance date 30 January 2014.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed

FIND OUT MORE

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