Insight INVESTMENT

NOVEMBER 2022

EMERGING MARKET DEBT
THE OPPORTUNITY FOR IMPACT

THIS FIRST PAPER IN A SERIES ON EMERGING MARKET DEBT IMPACT INVESTING, CONSIDERS THE OPPORTUNITY TO TARGET A POSITIVE IMPACT ALONGSIDE AN ATTRACTIVE FINANCIAL RETURN.

WHAT IS IMPACT INVESTING?

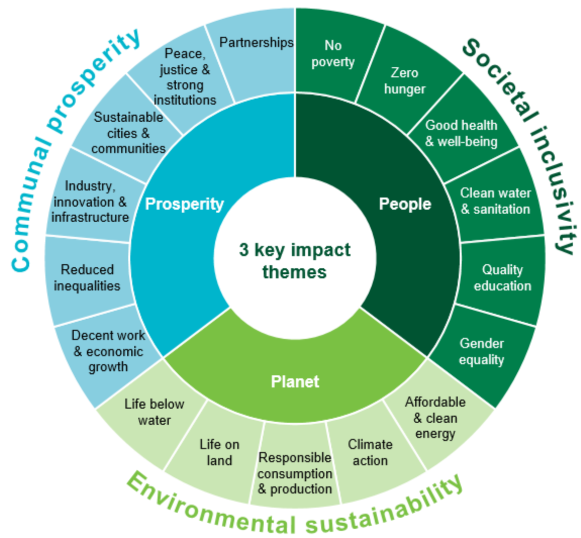
Impact investing is a broad term used to refer to investment approaches that emphasise aiming for a positive environmental and/or social impact.

Not being purely philanthropic, such an intention will typically sit alongside one of attempting to achieve financial returns, creating a **dual objective** in a single strategy.

DEFINING 'IMPACT'

A helpful first step is to define what is meant by 'impact', or 'positive environmental and/or social outcomes'. The 17 United Nations Sustainable Development Goals (SDGs) are widely regarded as reflecting the industry standard framework for defining impact. We believe they can best be grouped into three subsets covering People-oriented goals, Planet-oriented goals and Prosperity-oriented goals. These three groups may be thought of as reflecting key impact themes.

Figure 1: SDGs and impact themes



Source: United Nations Sustainable Development Goals, Insight. As at September 2022.

People

The **People** theme includes six of the SDGs that can be thought of as seeking to improve the outlook for people and overall societal inclusivity, such as gender equality.

Planet

In our view, goals that look to improve environmental sustainability could be considered to have a **Planet** theme, which would include affordable and clean energy.

Prosperity

Prosperity at a communal level is another impact theme we believe encapsulates a number of SGDs well. A good example is industry, innovation and infrastructure. Under the Prosperity theme we also include the final two SDGs of peace, justice and strong institutions, and partnerships for the goals.

UNPARALLELED OPPORTUNITIES IN EMERGING MARKETS FOR MAKING A POSITIVE IMPACT

What emerging markets offer for impact investing

There is little doubt that the world currently faces a variety of crises at both the social and environmental levels. Climate change perhaps represents the most global threat, while solvable social emergencies remain commonplace.

Whether considering the potential scale of impact investing, or the broad scope for positive change, emerging markets (EM) are arguably unparalleled.

Most of the world's population, and nearly all of the poorest people, live in EM countries

The countries of the EM are home to 85% of the world's population[1], so when considering how it could be best to address the furtherment of social and gender equality and other SDGs, contained within the **People** impact theme, it is worth understanding the sheer scale of the potential to make an impact in EM.

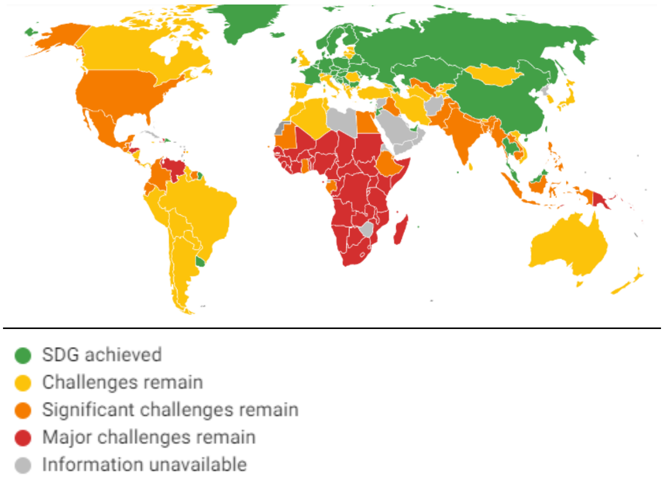
Similarly, we believe an investment oriented toward UN SDG objectives such as no poverty, providing clean water and sanitation or quality education in the emerging markets is likely

[1] Source: Insight analysis as at December 2021, using International Monetary Fund (IMF) data and categorisation of Advanced, Developing and Emerging countries (Emerging markets = Developing and Emerging countries).

to help achieving a demonstrable impact aligned to the **People** theme.

As the UN Sustainable Development Report 2022 shows, the goal of reaching no poverty remains difficult, particularly as 99% of the world's poorest live in EM countries[2]. Figure 2 shows that much of Africa still faces major challenges, while other EM countries such as India, Pakistan and Indonesia, to name just three, continue to face significant challenges.

Figure 2: Eradicating poverty remains a major challenge for large swathes of the EM world (SDG1)



Source: United Nations Sustainable Development Report 2022 dashboard, (https://dashboards.sdgindex.org/map). As at September 2022.

Most of the world's land mass is within the EM

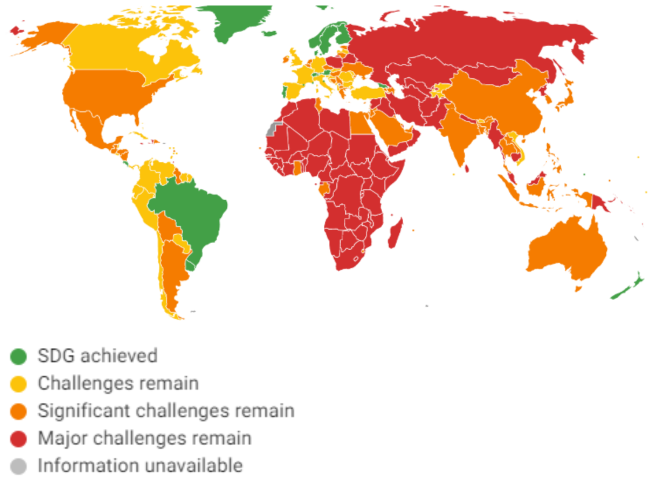
With 77% of the earth represented by EM[2], there is significant scope for impact capital aligned to the **Planet** theme within EM. The need to focus on SDG 13, climate action, is clear, particularly for EM where we can regularly witness the devastating effects of environmental disasters and climate change.

Most of the energy supply in EM is reliant on fossil fuels

If you are serious about making an impact on fossil fuels at a global level, you cannot ignore EM, where over 70% of the energy supply is reliant on fossil fuels[3].

Given the existing dependency on fossil fuels as the source of so much energy supply in EM, they arguably should be a focal point for capital. It may help enhance **Prosperity**, aligning with SDG 9 focused on industry, innovation and infrastructure, as well as address the **Planet** theme through improving the provision of affordable and clean energy (SDG 7) – where the UN Sustainable Development Report 2022 shows there are significant and major challenges remaining across much of the world (see Figure 3).

Figure 3: Providing affordable and clean energy is difficult in many EM countries (SDG 7)



Source: United Nations Sustainable Development Report 2022 dashboard, (https://dashboards.sdgindex.org/map). As at September 2022.

THE SCALE OF OPPORTUNITY

The monetary scale of impact opportunities in EM is also eye-catching. According to the International Monetary Fund (IMF), meeting the SDGs in 2030 would require spending of US$2.6trn in 121 EM countries and low-income developing countries[4]. This represents approximately 2.5% of 2030 world GDP.

The International Finance Corporation (IFC), as long ago as 2018, suggested that cities in EM countries could attract more than US$3.1trn in investments across renewable energy, public transportation and waste and climate-smart water by 2030.[5] Even that sum is dwarfed in the same report, by the estimated US$24.7trn investment potential in green buildings in cities from the EM world.

They perhaps present unparalleled potential to benefit all **People**, the **Planet** as a whole and **Prosperity** in general.

Potential financial benefits of EM investments

High inflation, tightening financial conditions and the growing risk of recession have led investors to reconsider their allocations to and within fixed income, looking for ways to cushion against those risks.

EM corporate bond yields are currently at their highest level for about a decade (Figure 4) and are becoming more attractive. EM green bonds have offered a structural yield premium over developed market equivalents (Figure 5) since 2019, when the EM green bond market really began to achieve scale.

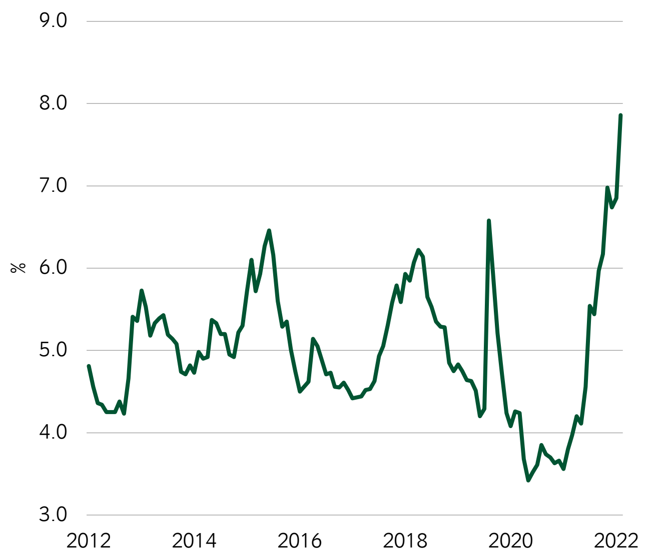
[2] Insight analysis using World Bank data available on poverty, land mass and poverty as at September 2021, setting the poverty gap at USD5.50 a day (2011 purchasing power parity, PPP).

[3] Source: BloombergNEF, New Energy Outlook 2020 dataset.

[4] Source: International Monetary Fund: Fiscal Policy and Development: Human, Social and Physical Investment for the SDGs January 2019.

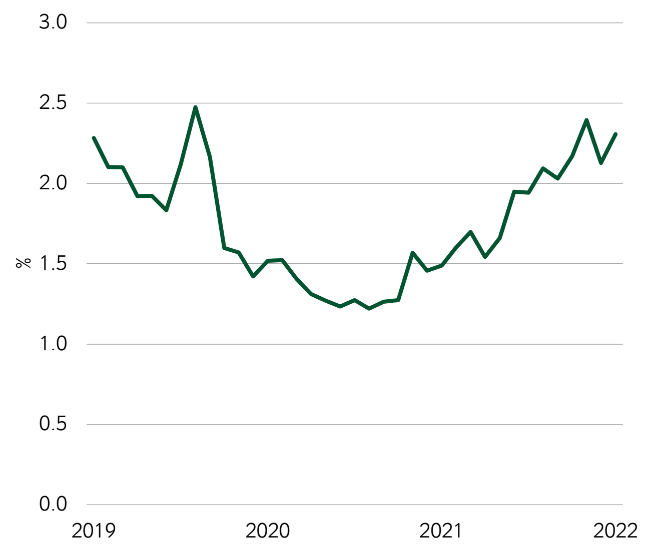
[5] Source: International Finance Corporation – Climate Investment Opportunities in Cities (2018)

Figure 4: EM corporate yields at 10-year highs



Source: Bloomberg. As at 30 September 2022. JP Morgan CEMBI Broad Diversified Index Yield to Worst

Figure 5: Persistent green bond yield premium over developed markets



Source: Bloomberg. As at 30 September 2022. JP Morgan GENIE EM Index versus JP Morgan GENIE DM Index Yield to Worst

This yield surge and spread widening is occurring while leverage among EM corporates is generally less than half that of US corporates, and with interest cover at decade highs.

Last, despite the challenging macro backdrop globally, we believe the fundamental outlook for EM corporates also remains positive.

ATTRACTIVE FEATURES FOR PERFORMANCE POTENTIAL

Structural yield premium on EM impact debt: EM currently offer the highest duration-adjusted yield anywhere in the mainstream fixed income markets. The same yield premium seen in the broader EM debt markets is also available within the impact universe. For instance, as at 30 September 2022, EM green bonds offered a yield of 6.1%, compared to 3.8% for developed market green bonds, for the same average rating, and despite duration of EM green bonds being four years shorter, on average[6].

EM green bonds typically have an average rating of A- / BBB+, compared to the BBB- average rating of the JP Morgan CEMBI Broad Diversified Index. In our view, this higher average rating for green bond primarily accounts for the difference between 6.1% and the nearly 8% shown in Figure 4 for the broad corporate index. Additionally, we estimate the so-called greenium, which reflects the lower level of yield available, and accepted by investors, on green bonds compared to standard bonds, contributes approximately 0.05%-0.15% to that difference.

Diversification across a large, heterogeneous asset class: The war in Ukraine and ongoing tensions between the US and China have led to a cloud of uncertainty over markets, particularly in emerging markets. Yet with issues available across five continents as varied as the people that inhabit them, EM countries are offering vastly differing fundamentals and impact opportunities across that universe, and thus significant opportunities for active managers to seek to exploit.

Market size exceeds other mainstream fixed income areas: The hard currency EM bond market is roughly US$4 trillion in size according to JP Morgan, as at September 2022. This is made up of 1,500 issuers from over 100 countries, across all sectors. Sovereign and corporate issuers represent approximately $1.5 trillion each, with the remaining $1 trillion being quasi-sovereign issues. This compares to the US high yield market of about $1.6 trillion, or the euro investment grade market of approximately $2.8 trillion (€2.7 trillion).

Additional demand from conventional bond strategies: Impact debt may be equivalent to conventional debt issued by the same entity, with similar risk/return characteristics, albeit with an additional impact commitment. So, conventional bond strategies may decide to invest in an impact bond based on its financial characteristics alone.

THE RAPIDLY EXPANDING IMPACT OPPORTUNITY SET IN EMERGING MARKETS

The opportunity set for achieving impact began a decade or more ago with the introduction of green bonds, but it has grown substantially since then, and now accounts for a significant proportion of EM issuance. At the end of September 2022, impact bond issuance in the EM had represented 31% of all EM issuance for the year to date[7] (Figure 6), with the hard currency impact bond universe now totalling over USD 250bn outstanding, from over 200 issuers.

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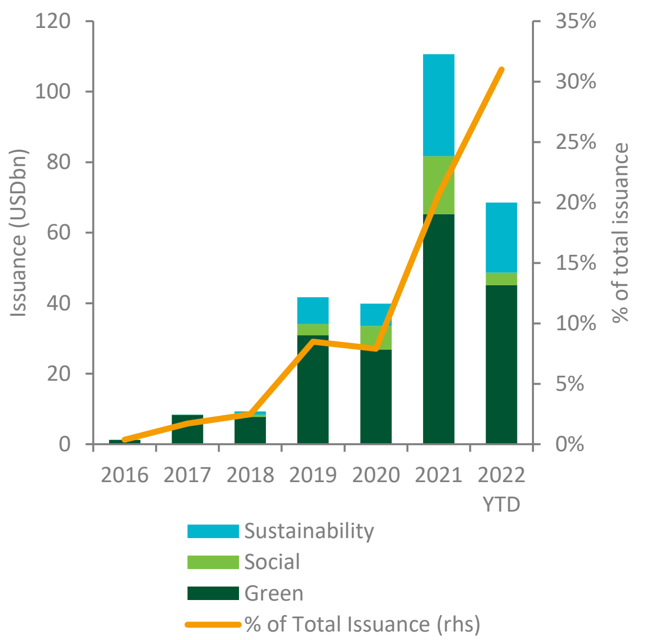
[6] Source: JP Morgan GENIE Index, EM and DM respectively. As at 28 September 2022

[7] Source: Insight analysis of Bloomberg data, as at 28 September 2022.

Figure 6: EM impact bond issuance has surged



Source: Insight, Bloomberg, as at 28 September 2022. For illustrative purposes only.

The first generation of EM impact funds mostly focussed purely on green bonds, those with specific projects targeting environmental outcomes. As the broader market has evolved and matured, we can now see a wider opportunity set in public fixed income. We expect this will improve both potential financial returns and the potential breadth and extent of impact through three types of impact security: 'impact bonds', and bonds from what Insight refers to as 'impact issuers' and 'improving issuers'.

An impact bond is one that specifies its proceeds will be used to have a positive environmental or social impact. Common types include green bonds, social bonds and sustainability bonds. As data availability and issuer frameworks have developed, it has now become possible to also target impact via issuers whose revenue (impact issuers) or capex (improving issuers) is directly aligned to the UN SDGs or EU taxonomy. For all three types of impact security, we believe it is critical to assess the risk of 'impact-washing', to ensure capital is genuinely being used for the positive advancement investors target.

THE OPPORTUNITY FOR IMPACT INVESTING

As we have seen, we believe EM offer potentially unparalleled opportunities for making a positive impact, in a rapidly expanding investment universe that also has the potential to deliver very attractive long-term financial returns.

PART 2

In the next paper in this series, we aim to introduce and illustrate how Insight approaches investing for impact in EM.

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.

ASSOCIATED INVESTMENT RISKS

ESG

- **Investment type**: The application and overall influence of ESG approaches may differ, potentially materially, across asset classes, geographies, sectors, specific investments or portfolios due to the nature of the specific securities and instruments available, the wide range of ESG factors which may be applied and ESG industry practices applicable in a particular investable universe.
- **Integration**: The integration of ESG factors refers to the inclusion of ESG risk factors alongside financial risk factors in investment analysis and research to judge the fair value of a particular investment and may also include the monitoring and reporting of such risks within a portfolio. Integrating ESG factors in this way will not typically restrict the potential investable universe, but rather aims to ensure that relevant and material ESG risks are taken into account by analysts and/or portfolio managers in their decision-making, alongside other relevant and material financial risks.
- **Ratings**: The use and influence of our ESG ratings in specific investment strategies will vary, potentially significantly, depending on a number of factors including the nature of the asset class and the structure of the investment mandate involved. For an investment portfolio with a financial objective, and without specific ESG or sustainability objectives, a high or low ESG rating may not automatically lead to a buy or sell decision: the rating will be one factor among others that may help a portfolio manager in evaluating potential investments consistently.
- **Engagement activity**: The applicability of Insight firm level ESG engagement activity and the outcomes of this activity relating to buy, hold and sell decisions made within specific investment strategies will vary, potentially significantly, depending on the nature of the asset class and the structure of the investment mandate involved.
- **Reporting**: The ESG approach shown is indicative and there is no guarantee that the specific approach will be applied across the whole portfolio.
- **Performance/quality**: The influence of ESG criteria on the overall risk and return characteristics of a portfolio is likely to vary over time depending on the investment universe, investment strategy and objective and the influence of ESG factors directly applicable on valuations which will vary over time.
- **Costs**: The costs described will have an impact on the amount of the investment and expected returns.

- **Forward looking commitments and related targets**: Where we are required to provide details of forward-looking targets in line with commitments to external organisations, e.g. Net Zero Asset Managers Initiative, these goals are aspirational and defined to the extent that we are able and in accordance with the third party guidance provided. As such we do not guarantee that we will meet them in whole or in part or that the guidance will not evolve over time. Assumptions will vary, but include whether the investable universe evolves to make suitable investments available to us over time and the approval of our clients to allow us to align their assets with goals in the context of the implications for their investments and issues such as their fiduciary duty to beneficiaries.

Insight applies a wide range of customised ESG criteria to mandates which are tailored to reflect individual client requirements. Individual investor experience will vary depending on the investment strategy, investment objectives and the specific ESG criteria applicable to a Fund or portfolio. Please refer to the investment management agreement or offering documents such as the prospectus, Key Investor Information Document (KIID) or the latest Report and Accounts which can be found at www.insightinvestment.com and where applicable information in the following link for mandates in scope of certain EU sustainability regulations https://www.insightinvestment.com/regulatory-home/sustainability-regulations/; alternatively, speak to your main point of contact in order to obtain details of specific ESG parameters applicable to your investment.

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.
- A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.
- 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.
- Exposure to international markets means exposure to changes in currency rates which could affect the value of the portfolio.
- Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.
- While efforts will be made to eliminate potential inequalities between shareholders in a pooled fund through the performance fee calculation methodology, there may be occasions where a shareholder may pay a performance fee for which they have not received a commensurate benefit.

FIND OUT MORE

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