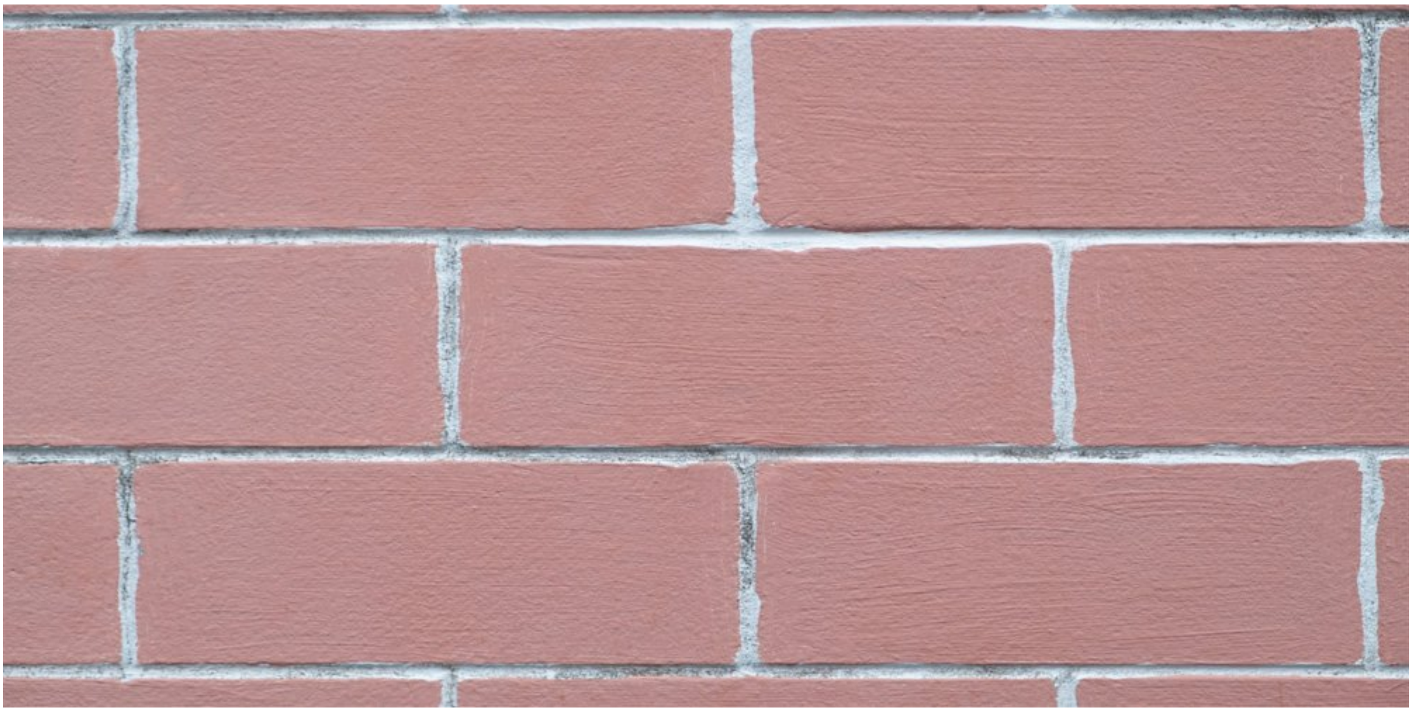

ESG in EMD: Fundamental, Not Fashion

July 6, 2020

As environmental, social, and governance (ESG) factors come to the forefront of investing, more and more managers are using them for sovereign and corporate debt analysis—but we developed our ESG framework before ESG became fashionable, so we're not jumping on the bandwagon. In this second part of a three-part series, we explain how we developed that framework, and how we use it.

Could you provide an overview of your team's ESG process?

Yvette: An integral part of our investment process is the sovereign risk model, which rests on two pillars. Those two pillars inform our view of fair value for sovereign credit spreads. One pillar is financial, and the other is ESG. The financial pillar informs the macroeconomic score for a country. Within the ESG pillar, the governance framework focuses primarily on political processes, institutions, and other governance factors; we also look at some environmental and social aspects of individual credits. Our bottom-up sovereign credit work looks at the individual country ESG policies and frameworks.

Luis: For corporates, we have created an ESG scorecard with which we analyze ESG factors and subfactors through direct interaction with issuers. Our scorecard aims to be comprehensive, comparable, and easy to use by analysts, but also flexible enough to apply to the diversity of our investable universe. We enhance the traditional ESG factors by separating social factors into internal and external—how a company interacts with its people and how a company interacts with its community. We also create a separate incident management report as we believe that how a company responds to ESG-related incidents can add as much insight as the incident itself.

Can you talk about the importance of managing incidents?

Luis: ESG situations are going to occur. Some external providers call them controversies. Maybe there are accidents or maybe policies are not followed, but the truth is these things happen, and to us it is extremely important to evaluate how a company manages those situations. Does the management team really live by what they say? A management team's reaction is what is important.

How is this an important part of your risk-management process?

Luis: We believe the way to create better portfolios is to manage downside risks. And using ESG as a framework to look at these potential financial and reputational risks helps us understand the potential downside of companies, and thus create the potential for better risk-adjusted portfolios.

Yvette: Sovereign risk involves not only financial factors, but a large number of non-financial factors, which include ESG factors. Environmentally, those may include risks that may evolve from vulnerability to climate change or external shocks that follow from natural hazards. Socially, we would look at situations that can reach a critical point and lead to social unrest and destabilization of governments.

Luis: As a follow-up to Yvette's comment, not having a full understanding of ESG factors could lead to the wrong investment decisions. At the same time, looking at ESG factors in isolation—without combining them with a financial framework—could also lead you in the wrong direction. We like to look at a multifactor risk model when analyzing an issuer. We believe an issuer has a financial risk profile factor, a sovereign risk profile factor, a business profile factor, a management strategy profile factor, and an ESG risk factor. We believe these factors can rise and wane in importance over time, but undoubtedly ESG is becoming an increasingly more vital factor.

And analysts are important to this process, correct?

Luis: Our ESG process is absolutely analyst-driven. We approach investments from a very strong bottom-up perspective. Having an intimate and direct relationship with issuers helps us gauge their momentum, their improvement, their direction. Analyzing them on a static basis does not give us the full picture.

Yvette: We believe *the experience* of covering emerging markets is pivotal to understanding emerging markets. Therefore, we have chosen to do the analysis ourselves, using a bottom-up approach to apply our experience in assessing what is relevant to emerging markets.

And this is a proprietary framework you use, correct?

Luis: Yes, we as analysts created an ESG scorecard. This scorecard analyzes the material factors within the E, the S, and the G. Under environmental factors we look at the company's management of raw materials and natural resources, its approach to climate change, and risks to its policies. As far as social factors are concerned, we think it makes sense to look at a company's policies toward its employees in terms of equality, training, working conditions, and union relationships separately from its policies toward its community; in the latter case, we look at the company's interaction with its supply chain, community, and customers. Studies have shown governance is the most impactful factor, and as experienced corporate credit analysts, we have looked at G factors for many years. Including the G analysis in the ESG framework does give it a different angle. In our framework we focus on board and management dynamics, corruption/lobbying incidents, fiscal responsibility, and transparency in communications.

Yvette: The combination of factors and the weight thereof have followed from years of research and practical application of these principles.

Does the proprietary framework evolve?

Yvette: Yes, and we are consistently evaluating the outcomes of that framework to understand the degree to which it is correct in assessing the individual credits relative to fair value. How it has evolved has been a reflection of how we see the world changing. We have sought to apply the factors that we feel are most relevant in understanding a country's willingness and ability to pay.

What differentiates your approach to ESG?

Yvette: I think what sets our approach to ESG apart is that we have been doing this for a very long time, and it has been an integral part of our team's work. We developed our ESG framework before ESG became fashionable. That experience and practical application throughout the years has created something that is very solid.

Luis: The way we created our ESG framework is also important. Some frameworks may be created by socially responsible teams and not by the people who actually manage portfolios. Our framework was created by analysts for emerging market analysis. It is based on really understanding the data available and confirming it through direct communication with the company and monitoring. That is important because not a lot of the data is available. Asking a company for something it has not analyzed in the past can be problematic if your framework requires that data. Therefore, we understand what is available, and we have incorporated it into the way we do things.

How does your approach help drive better client outcomes?

Luis: We believe in ESG integration as a way to understand the potential financial and reputational risk to a company. We then try to find the deviations between a security's price and a security's value, which is ultimately what our clients want.

Yvette: We have consistently sought to relate the influence of ESG factors on the return performance of individual credits. ESG is statistically proven to influence the return performance of individual credits, and we believe our framework can be predictive in terms of where value and/or spreads are likely to move based on changes in financial and non-financial sectors.

ESG in Emerging Markets Debt Series

Yvette Babb and Luis Olguin, CFA, are portfolio managers on William Blair's Emerging Markets Debt Team

Disclosure:

This content is for informational and educational purposes only and not intended as investment advice or a recommendation to buy or sell any security. Investment advice and recommendations can be provided only after careful consideration of an investor's objectives, guidelines, and restrictions.

Information and opinions expressed are those of the authors and may not reflect the opinions of other investment teams within William Blair Investment Management, LLC, or affiliates. Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Information is current as of the date appearing in this material only and subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. This material may include estimates, outlooks, projections, and other forward-looking statements. Due to a variety of factors, actual events may differ significantly from those presented.

Investing involves risks, including the possible loss of principal. Equity securities may decline in value due to both real and perceived general market, economic, and industry conditions. The securities of smaller companies may be more volatile and less liquid than securities of larger companies. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks. These risks may be enhanced in emerging markets. Different investment styles may shift in and out of favor depending on market conditions. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result.

Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, and inflation risk. Rising interest rates generally cause bond prices to fall. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Sovereign debt securities are subject to the risk that an entity may delay or refuse to pay interest or principal on its sovereign debt because of cash flow problems, insufficient foreign reserves, or political or other considerations. Derivatives may involve certain risks such as counterparty, liquidity, interest rate, market, credit, management, and the risk that a position could not be closed when most advantageous. Currency transactions are affected by fluctuations in exchange rates; currency exchange rates may fluctuate significantly over short periods of time. Diversification does not ensure against loss.

There can be no assurance that investment objectives will be met. Any investment or strategy mentioned herein may not be appropriate for every investor. References to specific companies are for illustrative purposes only and should not be construed as investment advice or a recommendation to buy or sell any security. Past performance is not indicative of future returns.