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Understanding Sovereign ESG

April 4, 2022

Environmental, social, and governance (ESG) frameworks have led to dramatic changes in corporate strategy and behavior. But it's easier for a company to change than a country. In this episode of The Active Share, William Blair's Hugo Scott-Gall speaks with Teal Emery, founder of Teal Insights, a boutique research consultancy focusing on sustainability issues in sovereign debt markets, and Yvette Babb, a portfolio manager on William Blair's Emerging Markets Debt team. The topic of discussion: What does ESG mean in the context of sovereigns versus corporates?

Comments are edited excerpts from our podcast, which you can listen to in full below.

https://media.blubrry.com/the_active_share/b/content.blubrry.com/the_active_share/The_Active_Share_Teal_Emery_MI

We have a lot to talk about, but let's start with the basics. What do we mean by sovereign ESG?

Teal: Sovereign ESG looks at ESG frameworks in places that involve sovereign governments as opposed to corporates.

What does ESG actually mean in the context of sovereigns as opposed to corporates?

Teal: Governments are different from companies—in size, in scope, in motivation.
For corporates, governance may mean how Rio Tinto deals with its board members and minority shareholders. With sovereigns, you're looking at how Brazil deals with its population—democracy, government effectiveness,

and other things of that sort that are quite a bit more complicated. A lot of the empirical findings and mechanisms of impact we talk about in the equity markets don't necessarily apply directly to sovereign fixed income.

How is a sovereign ESG rating different from a credit rating?

Yvette: As a portfolio manager, what we seek to do with ESG integration is understand the nonfinancial factors that inform a country's willingness and ability to repay its debt.

Many of the things that are now being coined "sovereign ESG analysis" are already a part of good sovereign research—understanding credit from a bottom-up perspective. The social DNA of a country, the political and institutional systems, the government policies—those are all a long-standing part of sovereign risk research.

What's changing—driven by public opinion and normative values—is the shift toward social and environmental considerations and the externalities of country policies in light of climate change risks, public policy, and international agreements.

What started as a risk-mitigation tool is now taking into consideration the objectives of social and environmental outcomes in and of themselves.

As someone who comes from the equity universe, it seems to me that the bigger the company, the more resources it has, and the better-quality data it publishes. There is some correlation between ESG scores and company market cap. So it's reasonable to think that there's also a correlation between a country's income level and its risks. But just because a country has a low per-capita income doesn't necessarily mean it's not capable of ESG improvement over time. How do you think about that?

Teal: To get past this ingrained income bias, it's much better to look at a country's ESG momentum than its ESG score. But it's very difficult to quantify momentum.

Part of that has to do with the data. There are large gaps and lags. For example, I created the first sovereign ESG framework for Morgan Stanley Investment Management. In doing my analysis, which looked at the World Bank's sovereign ESG data portal, I found that the median lag for environment data was five years. That means in 2021, if you're lucky, you're looking at 2016 data. Social and governance data is a bit more refreshed, but the lag is still three years.

Over the medium to long term, there are other options to help with this, such as big data sources that use geospatial analysis to create hard data points at a greater time frequency. But for the foreseeable future, understanding momentum will probably still include analyst judgment—active insight from people who are looking at countries on a day-in, day-out basis.

Yvette: I echo that. There is most certainly a difficulty generating ESG metrics that are timely and consistent enough for us to align our investment decisions with them.

In emerging markets, in particular, we see a lack of resources. The national statistician in Nigeria, for example, is struggling to get 12,000 surveys answered by national companies just to determine how fast Nigeria's economy grew, let alone determine what emissions are generated from the industry within its geographical boundaries.

To Teal's point, to understand the very complex array of factors that will inform a sovereign's ability to repay its debt, there needs to be an integration of statistical measures with a very large discretionary overlay.

I'm interested in the idea of context. Different things matter at different times in a country's evolution. I assume you both have a template or mental model for the common characteristics of successful countries. And those conditions for growth, I imagine, overlap quite a bit with ESG.

Yvette: The factors can vary by country, but we've clearly found that strong institutional frameworks and government effectiveness are key to ensuring long-term economic growth (and thus better social and environmental outcomes)—certainly at the onset of the development.

But external competitiveness is not sufficient. One could argue that there is a pyramid of needs a county goes through in improving environmental and social outcomes. A country like Nigeria, which is still seeking to meet the basic needs of its population (such as providing shelter, electricity, water, and sanitation), needs to move very much up that scale of social outcomes.

We must understand those dynamics; it's all part of unpacking the myriad factors that apply in very individual contexts.

Teal: It helps to put it in the context of what asset owners are doing and why this matters for pension funds and other people who are the ultimate investors.

They're managing money for the long term. Particularly with the rise in climate risks that are becoming more evident every year, investors see this will matter in the long term, and probably will matter more in the future than it has in the past.

So part of the theme that we've been talking about—ESG being an extension of good sovereign credit analysis—is extending the remit of analysis to looking at things like natural capital. The World Bank has a project, along with a number of other institutions, to create national accounts that include what you would normally see (such as gross domestic product) and also account for natural and human capital.

That can be quite helpful because it gives a framework for measuring things that matter. You can raise GDP using natural resources, but that's going to be a depletion potentially of natural capital. And having some accounting framework that allows us to look at economic growth within a wider context will be useful, I think.

Yvette: Just to drive that point home, consider Nigeria. An oil-exporting country, it currently has the capacity to produce around 2.2 million barrels of oil per day.

Under climate action—the Paris Accord and de-carbonization of financial portfolios across Europe—there are questions about Nigeria's long-term potential as a hydrocarbon exporter. It may need to attract new investment to sustain that level of production of oil.

So, Nigeria's growth model moving forward will most certainly need to look very different than it has over the past four decades. The country will need to have a mitigation plan in place for diversification away from oil. How and when that pans out is now increasingly the focus of the macro-climate forecast that we take into consideration when analyzing Nigeria's long-term credit.

There must be quite a few countries whose revenue and wealth comes from things judged as bad by others. For example, emerging countries with few near-term pathways to growth may be reliant on low-cost labor; to someone else, that looks like labor exploitation. How do you make judgments around countries that may score poorly through an average lens, but are making improvements through a context-specific lens?

Teal: We have to ask, are we measuring how wealthy countries are in the first place? The social pillar, in particular, is highly correlated with how wealthy countries are. Just to give a number to it, the average aggregate ESG score has a 0.9 positive correlation with a country's level of income. That's very high.

Actually framing everything around ESG risks winds up potentially having perverse consequences. Climate vulnerability and cumulative emissions have a very strong negative correlation, 0.891. That means the countries that have historically emitted the most carbon have the least climate vulnerability, and the countries that have emitted the least carbon have the most climate vulnerability. To ground this in actual examples, Canada (a wealthy country) has emitted 12 times more carbon than Brazil (a large upper- and middle-income emerging market) and 37 times more than Angola (a frontier market).

Since Angola is a country with a $7,000 per-capita GDP, we should have a slightly different view of exactly how it is doing what it is doing.

I think that there are ways that investors who care about both financial returns and sustainability outcomes can look for ways to compensate these countries and help them build less carbon-intensive ways of growing without forsaking their populations.

Yvette: There is a combination of macroeconomic fundamentals, socioeconomic circumstances, and governance scores that could imply a degree to which a country is almost certain to fail.

Lebanon is one example. It had a collapsed government and large number of external shocks. The prices of bonds fell to the low teens. This clearly reflected the degree to which the country was dysfunctional, and unlikely (in the short term at least) to succeed.

As a sovereign debt investor, we need to ask ourselves if we are adequately rewarded for the risk that we're taking by investing in a country like that. At what point do you, for normative screening purposes or ethical reasons, choose to not invest in a country? And what are the considerations? What values inform that decision?

Asset owners, in some cases, have a view as to the degree to which they are not willing to invest in countries. This can be on the basis of perceived human rights violations or exposure to controversial activities.

For countries, that argument—choosing not to invest because the economic growth model and/or the social levels are too low-level to generate growth—is more difficult. Unlike companies, countries cannot fail or disappear. So we have a model that is premised on exclusions of companies and quasi-sovereigns that are violators of the UN Global Compact.

I think judging countries on factors that simply reflect their level of development (or size of GDP), as Teal alluded to, is not adequate to exclude countries from the capital markets. It is in no way serving a sustainability objective, and is most certainly, in my view, not reflective of the intention of a greater focus on social and environmental outcomes.

Teal: The academic literature is fairly clear that divestment doesn't have an impact. But there's empirical evidence that investors can actually help move sustainability outcomes through engagement, particularly with capital-constrained issuers (which in this case you can consider lower-income countries). There's a lot still to come in terms of what actually makes the most effective engagement. But I think we're making progress and it's probably one of the more promising solutions.

There's a school of thought with some credibility behind it that companies' behavior is being influenced by what is said about it in terms of ESG. ESG has led to changes in corporate strategy, corporate behavior. You could even argue that there is a changing cost of capital based on how a company is doing on ESG. Do you see similar feedback channels at work for sovereign ESG?

Teal: I think there can be. One part of it is the realization that looking at ESG risk levels in sovereign debt may not actually lead to the outcomes that people want. It's much more effective to look at momentum.

If we're just looking at levels, and the ESG score is very highly determined by how wealthy countries are, there's not really much incentive for countries to improve. But if the market, indices, regulators, and other folks start looking more at momentum, it actually incentivizes improvement on the margin. That's what we want to be doing.

Yvette: We're seeing that clearly in the way we engage with government debt management offices (DMOs) across emerging markets. There is specific attention paid to ESG in the primary market, but also follow-up engagements with us as investors.

We're also seeing that in the change in type of issuance—introducing green bond frameworks and other labeled instruments. That space has clearly been dominated by developed markets and corporates rather than by sovereigns. But we're seeing an increasing number of emerging markets introduce labeled instruments, specifically to allocate part of their public budget towards sustainability themes. Most recently Serbia has issued. We have a utility company in Pakistan. Egypt was the first African country to debut in this space. We have Benin issuing sustainability bonds.

That's most certainly informing disclosures, so there's that feedback loop where countries are producing more ESG information and engaging with investors.

Teal: I don't know that we've seen a very significant change in the cost of capital in terms of sovereigns. But sovereigns are different from corporates. Sovereigns care about their cost of capital, but a few basis points probably isn't going to sway what a country wants to do, if it has domestic stakeholders that think otherwise. Also, the place where this is most likely to be effective (the cost of capital incentivizing better behavior in terms of ESG goals) is with lower-income issuers with lower credit ratings.

Let's look forward five or 10 years. What does sovereign ESG look like? Has it changed much? If it has, is that due to a change in availability of data, or more by behaviors and attitudes?

Teal: I do think there is going to be a big change, and I think we've already seen some of it. The sovereign ESG 1.0 era tried to take the equity framework and apply it to fixed income using the data and limitations available.

Going forward, I think there has been a realization that purely risk-based ESG doesn't necessarily make the world a better place. It may or it may not, but there's a real question about how much the circles overlap in that Venn diagram.

Ultimately, many investors are saving for retirement. And in their retirement, there are two different things that will make their lives better. One is having enough money to retire, so financial returns are a real thing. But people also want to be able to retire in a place where they can breathe the air, where there's peace and stability, where other nonfinancial things make their lives better. Everybody will have slightly different preferences in terms of expected returns and sustainability outcomes.

One of the other more challenging things we have to do, aside from having better data, is figure out a way to actually measure the sustainability impact of investing in sovereign debt. Current ESG scores aren't trying to measure that; they're trying to measure financial materiality.

Yvette: I believe the world is going to look different in five years when it comes to the issuance of sovereigns. Public opinion is shifting quickly. I think the data needs to catch up to changing norms—i.e., how do we measure the values that our end investors and asset owners are seeking to achieve? And how do we shape legislation that is not creating distortions in the market along the way? We're already seeing shifts in asset owners' demands, and I imagine that in five years, that demand will generate much better data.

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