Sovereign ESG Integration: Assessing Risks, Seizing Opportunities?

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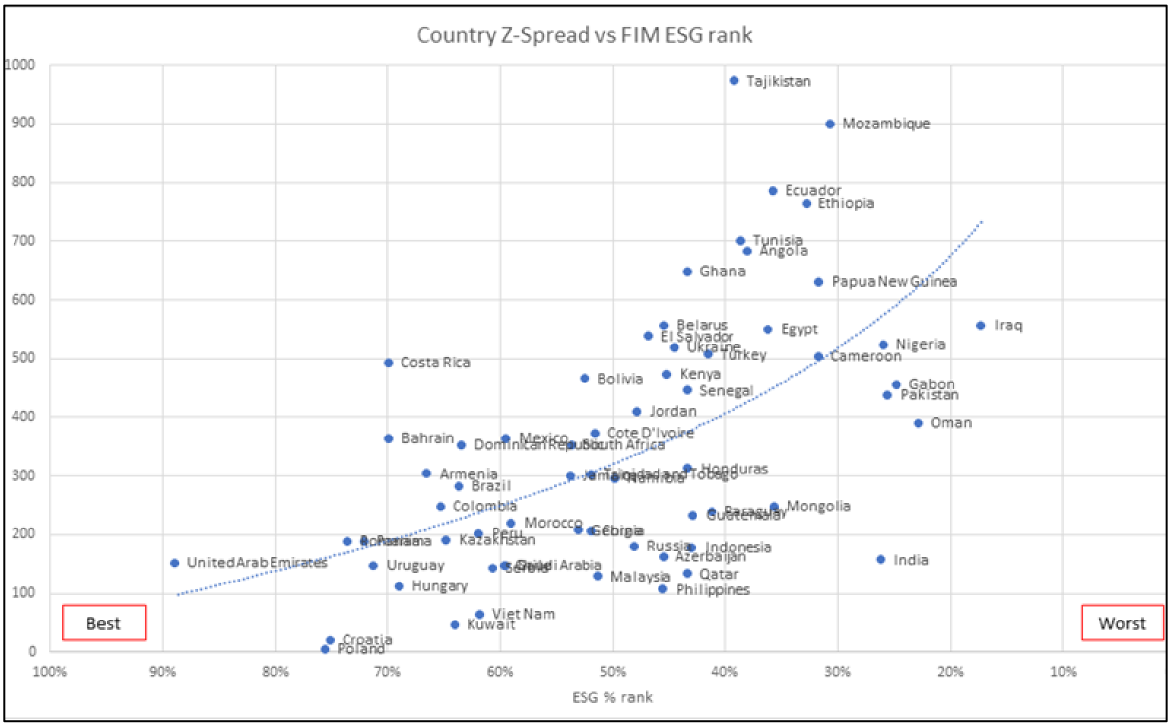
ESG factors are central to country risk assessment, and are causal in movement of sovereign credit spreads, currencies, and local markets. While macroeconomic factors create vulnerabilities, the triggers are often emanating from within the scope of ESG. A review of major asset price movements in EM would likely show a pattern of macroeconomic trends that led to pressures building while asset prices did not adjust, and that a governance or social event triggered the correction in asset prices.

Momentum for the application of ESG into investment processes had been building for some time, and the pandemic has accelerated this. Social discontent, economic collapse, and the links between human pressure on the planet via climate change, resource depletion and health risks have created an unfortunate landscape which demands the use of ESG metrics for its analysis. And as you pass from developed to emerging to frontier markets, you see bigger impacts on financial assets. In Figure 1, our ESG Scoring vs Ratings model shows this quite clearly. In this note, we will outline our process and methodology, and present examples of how our framework identifies the dislocations between ESG developments and asset price movements to our advantage – both to mitigate risk and create enhanced returns.

Figure 1: FIM Sovereign ESG Rankings and Credit Spreads



Source: JPM EMBI and FIM

Identifying the essential among ESG factors

So what are those most critical of factors and once you have identified them, how do you use them? Governance must come first. Run a country well, and you get good results – you conduct transparent and orthodox policies, have institutional strength and flexibility to face challenges, and have a sense of social contract that works for the long-term benefit of the population and achieves sustainable growth. Good governance, in

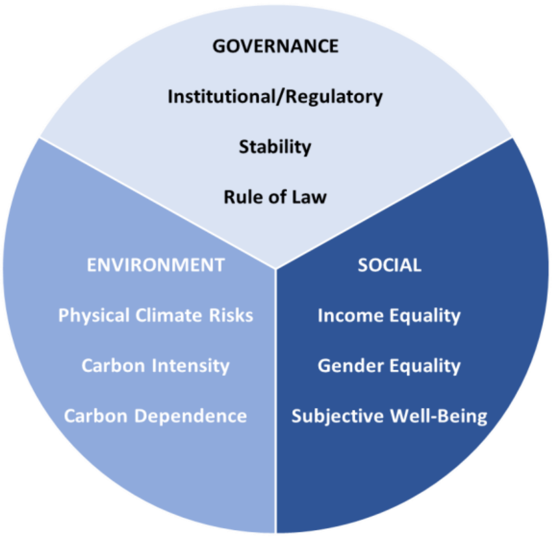
[1] FIM Partners is a UN PRI signatory and uses an in-house ESG framework for its fixed income products. The sovereign framework discussed in this paper is also used by the firm's equity funds as an overlay to the investment process, in addition to its own company ESG framework.

turn, should confront and address the social and environmental factors that are often catalysts for economic and financial crises. As you go further down the credit curve from developed market to emerging market to frontier market, ESG factors become more critical determinants of asset price performance – the worst freeze in France's wine region this century can be dealt with via government support, but a drought in Kenya may lead to civil strife, significant budget pressure, and increased questions on fiscal consolidation. However, it could also lead to, if there is good governance, stakeholders addressing these vulnerabilities with the assistance of the IMF and the donor community. The increasingly global and local focus on ESG should provide countries with more solutions to their challenges, not less. This also underlines the importance of engagement to understand government responsiveness to those challenges.

In the scope of **environmental factors**, we think there are three sub-pillars. Physical climate risks are self-explanatory – the "South" seems more vulnerable to increasingly adverse weather conditions. We will discuss Kenya and Egypt later in this regard. In terms of the carbon intensity pillar, we are considering those countries which are either misusing natural resources (such as water supplies) or, for example, are heavily biased towards dirty energy technologies, such as coal-fired power, and could see disruption in inputs and investments as coal producers face greater problems at home. At this stage, we are thinking more in terms of power supply links to growth, rather than the human health cost, but this, too, is increasingly important as stakeholders may push for governments to abandon such technologies. The carbon dependence pillar refers to those countries reliant on natural resources to finance growth, and whether they can adapt their economic models to diversify.

In the **social sphere**, we consider the social contract essential. Perhaps it is not so important if the population experiences high real wage growth and life expectancy. Chile's extreme income inequality was not a problem until it was a problem, and the Chileans are now trying to make a new social contract – one which has important implications for its economic model. We find the concept of subjective well-being as a useful complement to the metrics of income, life expectancy, education and health, in that it can provide greater understanding about whether people believe the government acts in its interests, to feel safe and taken care of. This stakeholder metric has proven to be statistically important in our analysis of materiality.

Figure 2: ESG Headline Factors Influencing Country Risk

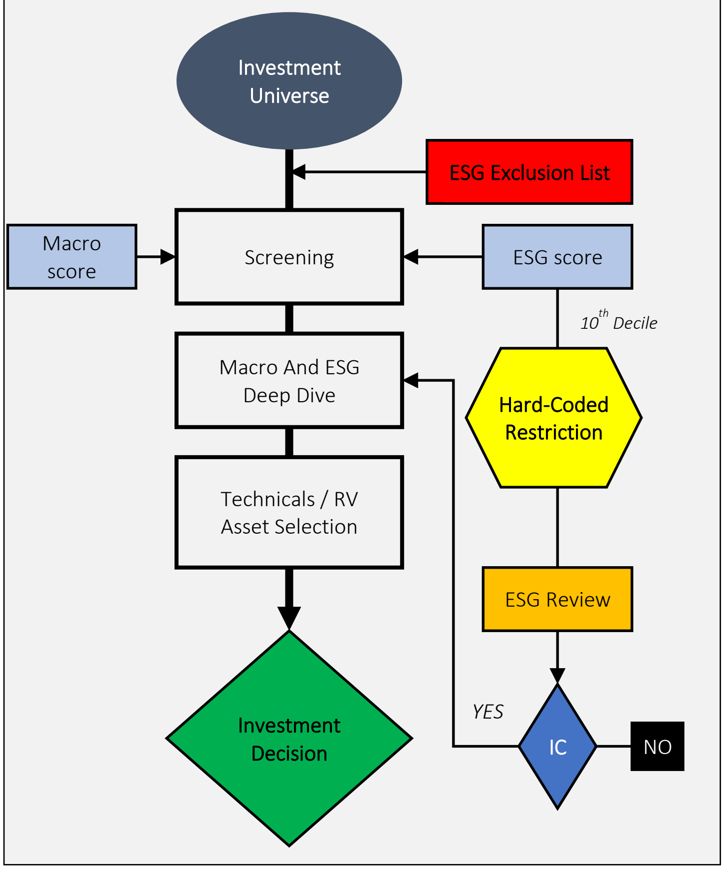


ESG in the FIM investment process: a multi-layered approach

Our framework seeks to capture factors which are going to drive country risk and its manifestation in asset prices. An index system, no matter how dynamic, is not sufficient (and as insufficient, provides a false sense of comfort at best, and "greenwashing" at worst). We have added a number of other tools to maximize the impact our assessment can have on returns. The rigors of the framework force discipline in its use – critical in weighing the allure of high spreads and potential returns vs often obscure risks. [2]

The first level of ESG analysis is the exclusion list

Figure 2: FIM GEM Debt Investment Process



Before any screening, there will be some countries which should be excluded. We use the countries in the US sanctions list and the bottom 10 countries in the Fragile States Index (FSI). The frequency of revision in this list is at the time sanctions changes occur and for the FSI, annually at the time the index is updated.

Example: The bottom of the FSI do not contain important potential markets. But it is notable that in the next 15 are Ethiopia, Myanmar and Nigeria. In 2020 and 2021, Ethiopia and Myanmar are experiencing significant episodes of civil unrest which have impact on FX and debt prices.

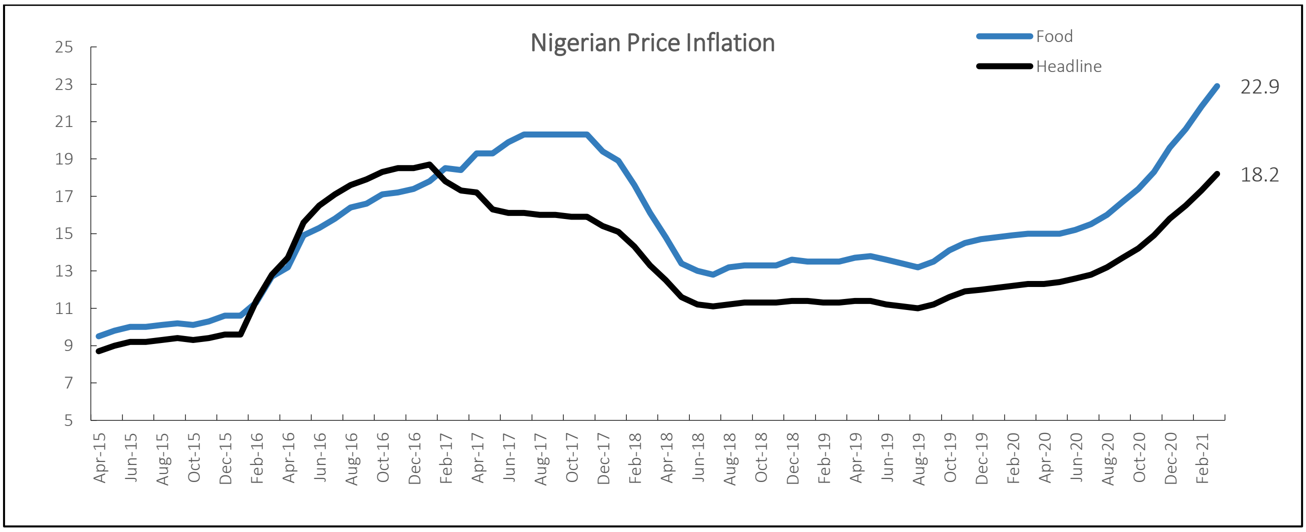
In the summer of 2020, we exited our Ethiopia positions on the news of the conflict in Tigray. Our debt sustainability work indicated significant rollover risk, and we felt the conflict would impact on donor financing and have DSSI implications.

In early 2021, we conducted a deep dive into Myanmar as, in our macro framework, it was screening very well. It has become an increasingly large issuer via Development Finance Organizations (supras) also, so the macro and market development convergence was making it increasingly attractive. In our ESG screen it scored poorly. It also scored in the second lowest decile on the FSI; we conducted a deeper analysis and had some red flags on key governance risks. It did not make it to the IC for consideration.

Nigeria is preoccupying. Population growth has exceeded GDP growth since 2015 – they are in the seventh year of a per capita recession, and projections show them remaining in this recession for the coming 3-4 years, barring significant reforms). Flawed policies to stimulate domestic agriculture by banning the importation of staple products like rice and edible oils, as well as chemical fertilizers, have been catastrophic. Domestic agricultural production is not responding. Food price inflation has soared to over 20%. Nigeria is not on our exclusion list, but the factors we look at point to the need to maintain it in a level of high monitoring.

[2] Prior to the inception of our formalized sovereign ESG framework in January, 2019, we had been running a macro tracker since 2014 – a monthly scorer of our investible countries which was presented each month in our Frontier EM Equity Fund investment committee. The scoring inputs were 9 macro variables and 2 governance variables – one for institutional strength and one for reform outlook. It was a dynamic model that was very effective in flagging risks and opportunities to our portfolio managers, and the governance variables were often the differentiating factors in influencing investment decisions.

Figure 3: Nigeria’s 23% Food Price Inflation: Social cohesion and policy risk



The next level of ESG analysis: a dynamic screening process[3]

The countries that are not excluded then enter into the Dynamic Screening Process. Our index inputs may change over time, but we analyze them against several return horizons using multivariate regressions. The indices capture critical indicators for E, S and G, and we weight them with a bias to G and S factors. This is in line with our analysis of the subindices and their statistical significance. Furthermore, rather than using static index scores alone, we include the change in the scores where relevant. The level is important, but the direction is often most informative.

- This dynamic score is run bi-annually. At the time of revision, indices are updated, different index and sub-index aggregations are tested and applied to optimize materiality.
- In the bi-annual revision, we also assess new ESG factor indices for use, but we require a minimum of 5 years historical data and that the index covers our investible universe.
- Example: The 2020 World Bank Doing Business Survey flagged important score improvements in Pakistan and Saudi Arabia (top 4 normalized percentage improvement among 193 countries in the survey). This improvement provided a quantitative score was acting as a flag and also validated our on-the-ground, in-depth research work and engagement with stakeholders on a range of structural, institutional reforms. These explained a lot of why policy-management in the near-term was improving and what we should potentially assess for medium-term impacts on capital flows and growth.
- The worst 10 performing countries in our scoring system enter into a hard-coded restricted list that can only be investible after an ESG report is presented in the Investment Committee and a unanimous decision is taken.

Post-screening, the work really begins

Our markets need regular in-depth analysis, which we conduct via Deep Dives and the use of an events calendar and high frequency socioeconomic data. Any number of factors may trigger a requirement for a deeper analysis, which may focus on the overall ESG picture or on one pillar or on one specific issue.

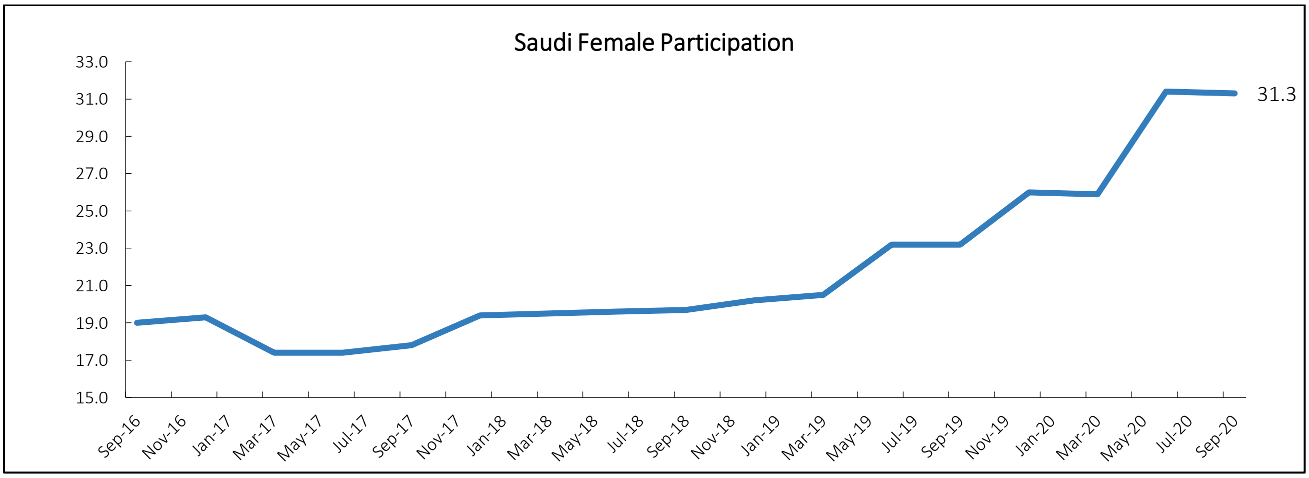
> Example: **Saudi Arabia is viewed as uninvestible for some investors due to human rights issues**. We are seeing some encouraging developments very recently, for example, with the decision to withdraw from Yemen under pressure from the US. The Saudis seem receptive to the Biden Administration’s focus on human rights issues. There is a long way to go, but what is happening domestically in the area of social reform is, lacking a better term, remarkably empowering to the vast majority of the population, especially youth and women. The National Transformation Plan (NTP) has set forth an ambitious plan for economic and social reform to turn the country away from its dependence on oil while it can still use its hydrocarbon buffers. The oil-funded welfare state is being abandoned under the foresight of its leaders. The NTP is producing results already, changing the fortunes and futures of millions. The structural reform program is extraordinary

[3] Index selection is tested for materiality using multivariate regressions on our selected indices. For additional information, please contact investorrelations@fimpartners.com to obtain our latest report on ESG methodology, updated on a semi-annual basis.

(World Bank Doing Business Survey and many other metrics capture the governance-related factors) and we have a pipeline of additional measures taking hold. In the social sphere, a number of reforms are enacted or due to be enacted which are addressing major shortcomings in the area of human rights. These reforms are a giant leap forward from a low base, but the resultant change for millions of Saudis is real.

- The right to liberty is being addressed through the removal of rules requiring women to be accompanied by men and not being able to travel internally and internationally alone. Women's right to drive, given in June 2018 is by no means a superficial measure.
- The kafala system, whereby employers control the freedom of movement of their contracted expats is being abolished.
- The Government has announced that it will adopt a codified legal system, which would be a substantial change, creating a fairer legal system.
- female participation in the labor force has gone from 17% in 2017 to 31% in 2020 (we acknowledge some measurement issues in this data due to our discussions with academics and NGOs working on this topic). An extremely controlled foreign worker regime called kafala, which bound workers their employers, has been abolished. Leisure activities and personal freedoms are blossoming and in early 2021, the Kingdom announced it will adopt a codified legal system.
- We think these measures, combined with economic reforms, are mutually reinforcing to stimulate investment, innovation, and job creation. The herculean fiscal efforts in 2020 and prospective achievement of a balanced budget, expected in 2023, may be and will remain sufficient for KSA sovereign performance to continue, but we feel the direction in reforms is boosting the prospects for non-oil economic growth and social cohesion. These are invariably credit positive.
    - Our social factor indices do not yet capture the improvements we are seeing in Saudi Arabia – the changes are happening too quickly, but we expect them to start showing results. Other metrics, regular visits and discussions with stakeholders and the data we do see at the national level in terms of Labor Force Surveys and others are crucial.[4]

Figure 4: Saudi Female Empowerment Cannot Be Ignored



Example: Environmental risks in Egypt. The country has long had vulnerabilities to climate change due to its low rainfall and extreme reliance on the Nile. The supply side issues are made worse by population growth and inefficient agricultural sector. While a Nile-event with Ethiopia over its slowing of the river flow due to its large dam project is arguably more geopolitical than environmental risk, it is a poignant reminder of Egypt's precarious water resources.

As Egypt has vociferously defended its rights to the Nile, objective stakeholders have been highlighting for years the country's poor management of its water resources. An agreement with Ethiopia that is lasting would seem to need international support and could imply that the Egyptians adopt measures for better water and wastewater management. If handled well, Egypt could receive substantial low-cost lending from the official sector to undertake the needed investments.

[4] FIM's MENA Horizon Fund, launched in 2009 invests heavily in Saudi Arabia, with a focus on domestic businesses in themes of structural change in consumption and social sectors, with an extremely robust corporate governance/underwriting checklist. With this approach, it has heavily invested in healthcare and health insurance, taking advantage of government reforms to stimulate private investment in the sector. The Fund has made 23.5% since 2019 and 261% since inception, vs 96% for the index.

Environmental risk mitigation will find official financing support across EM and FM. The scope for thematic ESG investing is wide open. Does the country have the leadership and institutions to take advantage of this? Will they create buffers to face climate risks? Will they invest to meet the challenges?

> Example: Climate risks in Kenya. Kenya is a country which has been rapidly running up a large debt burden. A growth at all costs model has been debt-financed. And as with so many frontier economies, the contribution to GDP growth rely on services and agriculture. Kenya is experiencing more frequent droughts, has recently endured a locust infestation, and with the outlook for global warming, the incidence of these climate events may persist. Of course, farmers can be funded to plant more pest-resistant plants and water conservation can be improved - official creditors will be there to fund these efforts. But with the country running such large fiscal and current account deficits on a persistent basis, some risk premium for these climate risks is increasingly important. In our last visit to Nairobi our discussion focused on the 2019 drought and growth risks from it.

An event calendar is essential to ensure socio-political assessments are made prior to elections, national dialogues on reform, and other potentially catalytic events. Changes in government can impact structural reform, and macroeconomic policymaking and thus drive asset prices. As we see with the growth of thematic ESG capital market activities, governments that tackle environmental and social risks stand to get cheaper and more stable financing. On the risk side, a government that dissolves its judiciary and erodes rule of law will see weaker FDI and potentially weaker portfolio flows.

> Example: Ivory Coast was facing a contentious presidential election in 2020. With the same actors as those that participated in the second Ivoirian Civil War in 2010, that led to over 3,000 deaths, we conducted a series of discussions with elements of the leading parties as well as with academics and think tank experts. Based on these discussions, we felt there was a high enough risk of civil unrest that our investment committee chose not to invest in Ivory Coast in Q4 2019, and would await clarity into or post-election on the state of civil affairs. The market shrugged it off and Ivory Coast bonds in line with the EMBI. Post-October election, which was boycotted by the opposition, we remain concerned with the political outlook but the country is no longer on our self-imposed restricted list.

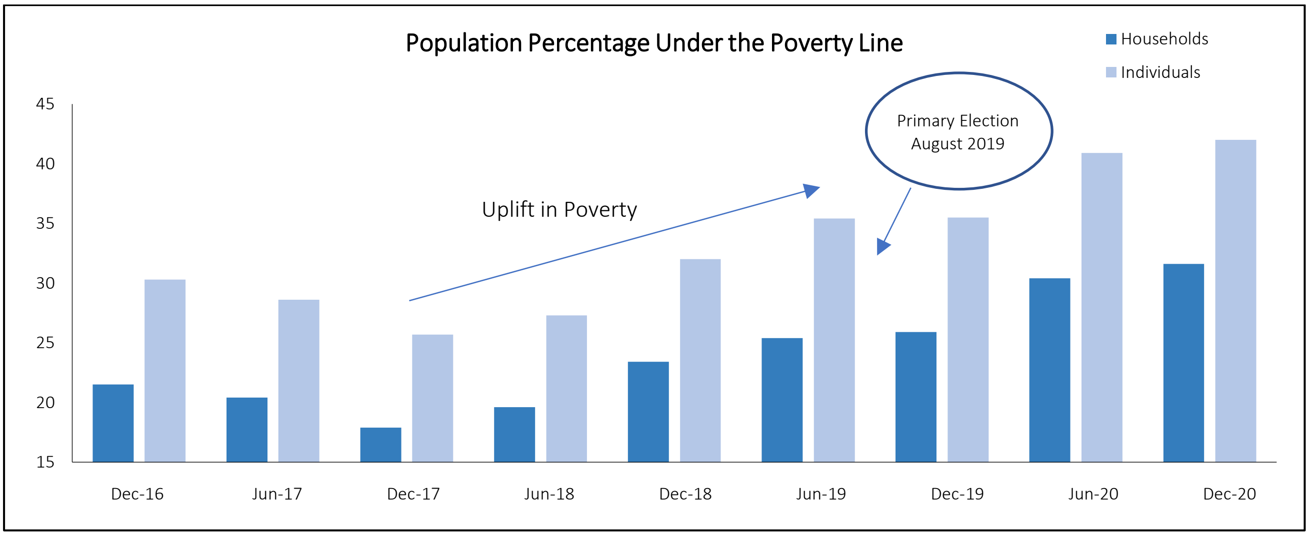
Civil strife, for which the FSI captures most risk factors, is a major red flag for us. As such, in 2019 we dropped Ivory Coast from the investible set and in 2020, we dropped Ethiopia. To invest anew, we would need to start with an ESG discussion.

The dynamic score from the Level Two analysis can catch a lot. But in countries with greater macro/creditworthiness concerns, it is often not sufficient to capture critical ESG developments. As part of our ongoing analysis, we therefore track higher frequency socio-economic data such as poverty, unemployment and real wages as key metrics which can be causal in asset price movement.

> Example: Argentina in the first half of 2019 was an economy trying to emerge from crisis. The largest ever IMF bailout of $57bn in 2018 was an attempt by the international community to help Argentine President Mauricio Macri win the 2019 presidential election – it certainly was not a reward for his disastrous mismanagement. The IMF had experimented with supporting gradualism with a debt addict, and that its best course of action was to continue with President Macri. The equity market rallied very strongly on signs he would succeed in his re-election campaign, keeping some hope at small signs of economic pick-up would gather momentum. Fixed income was a bit more conservative, and for good reason. Debt sustainability still required that foreign and domestic private creditors provide substantial financing. Our own assessment was that Argentina had a high risk of default in 2021/2022; we did not think they would make it, so we were monitoring for potential triggers. The elections were that trigger.
>
> Effectively, polling was unclear but the market wanted to believe that Argentines saw their self-interest in continuity. The primary elections on 11 August 2019 were to affirm the re-election prospects of President Macri. However, given Argentina's fraught history in elections and with populism, we referred to social data for a more accurate view on his chances of re-election; and with the market bullish or even neutral, an opposition victory would be catastrophic. Poverty indicators had risen sharply from late 2017 into 2018, with 17.9% of households below the poverty line in H2 2017, rising to 25.4% in H1 2019. While most of these people would be

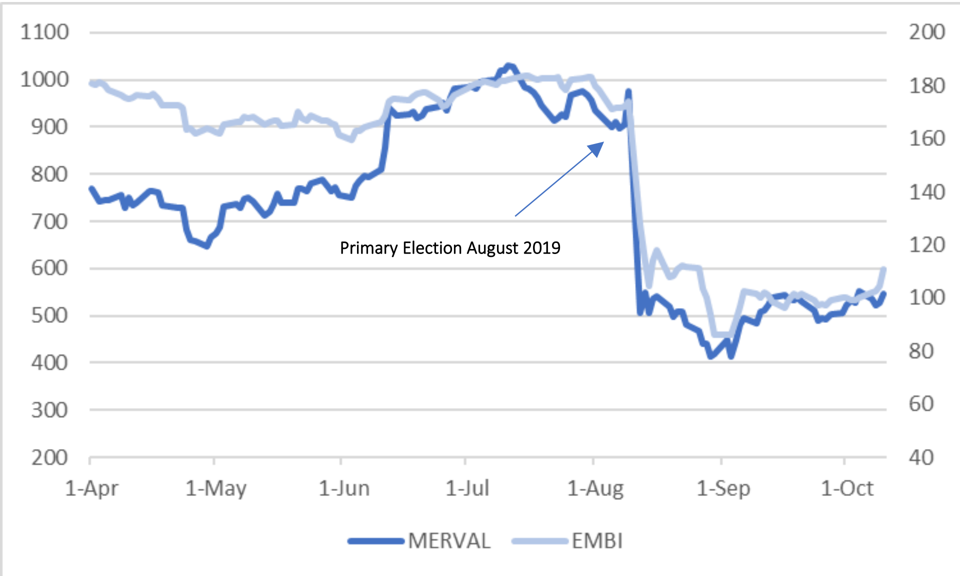
opposition voters, discontent was tangible – Macri's first term was a failure, even in the eyes of his supporters. The August primary results pointed to an opposition victory in the October general elections, and the markets reacted violently on 12 August. By end-August, credit spreads tripled from 870bp to 2530bp by end-August, the currency fell 31% and the stock market fell 55%.

Figure 5: Argentina: Rise in % of Population under the Poverty Line



Source: INDEC, Encuesta Permanente de Hogares

Figure 6: Argentina: Wishful Thinking and Harsh Realities – Debt and Equity Prices Collapse in August 2019



Source: JPM EMBI and Merval Stock Index in USD

The role of engagement: Two-fold

First of all, we seek engagement to help us assess risks better. The basis for this will have been made clearly in this note. With low ESG scores in many EM and FM countries, the role of policy and political risk is paramount and these are best assessed on the ground and by engagement with a broad set of stakeholders [5].

[5] In Pakistan, we conducted discussions on the grey list status under the Financial Action Task Force (FATF). If actions were not taken, a black list qualification would end a bulk of development finance and commercial banks would have to cut lines. Discussions with the then-Minister of Economic Affairs, responsible for addressing the outstanding items on the FATF reports, as well as discussions with the State Bank of Pakistan and other stakeholders left us with a good understanding of the risks.

Secondly, but increasingly important, is engagement as a way to build partnerships with stakeholders. We want governments, NGOs, opposition, IFIs, corporate leaders to understand our positions on ESG factors. We think building these relationships increases the chance that challenges are addressed. While we are a relatively small investor, we represent our own community of stakeholders – our investors, our portfolio companies in the countries where we invest, our regulators, etc. Our collective voice must be heard.

An example of "research" engagement: Understanding the prospects for central bank independence

One of the easiest ways to identify whether a country has strong institutions is looking at inflation as a metric of central bank independence. Of course, monetary policy has many challenges, and an independent central bank may be able to do little in a discrete period if, for instance, the currency must adjust sharply to a terms of trade shock. In our markets we have two good examples, where our discovery came early and analysis stronger via engagement, i.e. meetings and discussions with key players. In Pakistan, we have seen a sharp rise in institutional strength in the central bank. Pakistan traditionally had a heavily managed exchange rate and the State Bank (SBP) provided direct budget financing. A new governor and reforms at the SBP have resulted in the adoption of a floating exchange rate, the winding down of direct budget financing and a new central bank law to reinforce its independence. This has become increasingly visible to many, as the SBP has embarked on a program of increased transparency via engagement with investors. But having been on the ground there since 2014, we had an intimate knowledge of the dysfunctions of the SBP and what reforms could achieve – including the empowerment of very strong teams in various departments, including research and money markets. Discussions included numerous talks with the Governor and with senior and mid-level professional staff.

Meanwhile, an IMF program in Sri Lanka floundered in 2019 on the eve of new elections, stumbling with reform fatigue and a suspended adoption of a new law creating an independent central bank a la Pakistan. But the new government due to form amidst the pandemic had a large mandate and gave cause for optimism that reforms could be initiated again. We held discussion with senior individuals in local academia and in the entering ruling party to discuss the prospect for a new reform program. Our assessment meant there would not likely be a renewed push to take of the stalled central bank act, and that other key reforms might also be left out of the Government's economic plans.

Conclusion: Active ESG and active investing in EM produce results

Good EM investing will have always included the integration of ESG factor analysis. The increasing popularity of a formalized ESG framework is welcome and we think that the institutionalization of ESG investing will keep investors honest -- reducing the risks of greenwashing and helping all stakeholders work towards achievable sustainability targets. In an increasingly ESG-aware world, and one in which those ESG factor risks are rising, a high conviction and active investment approach will greatly diminish drawdown risks and lead to better investment outcomes.

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