Environmental, Social, and Governance Investing in Emerging Market Sovereign Debt

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In contrast, this ranking tends to favor energy-importing countries that depend a lot on tourism and nature.

Social: The European countries tended to do well when we looked at social ranking. The indicators encompass education, health and income, and gender equality. India, Pakistan, and a number of African countries ranked poorly in this category.

Governance: The governance ranking accounts for political stability, democratic accountability, rule of law, degree of corruption, and the quality of regulation. Several oil exporting nations did rather poorly in this category.

Environment: The environmental indicators we looked at include the Yale Environmental Performance Index and various indicators of energy efficiency and use of renewables. Thus, unsurprisingly, energy exporters that use a lot of energy quite inefficiently relative to their economic output rank poorly in this category. However, the ranking also shows that mining exporters probably suffer in such rankings because mining is a highly energy-intensive industry.

Investing according to environmental, social, and governance (ESG) criteria is growing rapidly across asset classes. However, sovereign debt lags corporate credit and certainly equities in this arena. “Higher ESG ratings will reduce my yield,” is the most frequently heard pushback against ESG-conscious investing in emerging market debt (EMD). This is because higher ESG-rated countries also tend to have higher sovereign credit ratings and thus lower yields. Although this is true on average, it does not necessarily hold when considering credits on a case-by-case basis. Here we explore strategies for ESG investing in EMD without having to sacrifice yield.

RANKING EMERGING MARKETS BY ESG CRITERIA

To explore some of the potential issues arising in ESG investing in emerging market sovereign debt, we created a simple ranking system to evaluate EM sovereigns according to select ESG indicators that provide a good overview. These indicators tend to be highly correlated among themselves, especially within a category, e.g., the various environmental indicators tend to result in quite similar rankings.

To create our rankings, we used various indicators from sources such as the World Bank. To standardize the data, we ranked each country for each indicator (e.g., fossil fuel usage). The ranking for each of the three main categories (E, S, and G) is the simple average of a country’s ranking for each of the underlying variables; for example, the environmental ranking is the average of the rankings for greenhouse emissions per capita, fossil fuel usage, etc. The overall ESG ranking was then the simple average of the E, S, and G rankings. A lower number means a better ESG rank.

These ESG rankings were intended to be an indicative metric only and may not be used for reference purposes or as a measure of performance for any financial instrument or contract, or otherwise relied upon by third parties for any other purpose, without the prior written consent of BofA Merrill Lynch Global Research. These ESG rankings were not created to act as a benchmark. Source: BofA Merrill Lynch Global Research estimates, WB, EDGAR, Yale, ILO, Haver, Bloomberg

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Overall ESG ranking: European countries dominated the best scores, and they were joined by some of the smaller, wealthier, and more stable Latin American nations. Most of the poorest performers were oil exporting nations. From a regional perspective, Eastern Europe tends to be most ESG–friendly: The region did better than others on the governance and social rankings though not the environmental ranking. Sub-Saharan Africa did the poorest due to weak rankings in governance and social indicators, but it did better on the environment (see figure 1).

ESG = LOWER YIELD?
One might expect ESG indicators to be highly correlated with per capita income, based on the wealth of academic literature that causally relates economic growth to the quality of institutions. Indeed, richer countries performed better in our ESG ranking (see figure 2). This is particularly due to the high correlation of the governance and social indicators with income.

However, the correlation is less obvious for the environment, where some low-income countries also do pretty well. The divergence between the environmental rankings versus the two others suggests that the usual environmental indicators are biased somewhat in favor of lower–income, less–industrialized countries. More–industrialized countries would do worse in terms of energy consumption in particular.

Sovereign credit ratings tend to be highly correlated with per capita income, and thus the ESG ranking is highly correlated with sovereign credit ratings, too (see figure 3). This is particularly driven by the tight correlation of the governance indicator with sovereign credit ratings. In contrast, the environmental ranking has little correlation with sovereign credit ratings, and the social ranking is only moderately correlated with credit ratings.

An index with an ESG bias may have a lower beta to risk appetite given that such an index normally would have a higher average sovereign credit rating. A higher average rating also means a lower scope for spread compression in risk–on markets and thus a greater vulnerability to the sell–off in highly rated government bonds in such a situation. The country weighting also may be different from those in standard indexes and imply different betas to key drivers of EM sovereigns. This would be true for energy prices, because the weight of energy exporters likely would be lower in an ESG than in a standard index, considering that energy exporters tend to rank poorly in ESG terms.

ESG portfolios are likely to have a lower beta to U.S. high yield (HY) credit than a conventional index because we would expect an ESG index to have a higher exposure to higher credit–rated countries, and thus have a higher overall average credit rating; vice versa the beta to U.S. investment grade (IG) credit should be higher. This is indeed what we find comparing an ESG to a standard EMD index (see figure 4).
**BEFTER ESG FOR THE SAME YIELD**

On average, better ESG means higher sovereign credit ratings and thus lower yields, but this does not necessarily hold when considering credits on a case-by-case basis. There are plenty of opportunities in sovereign credit for switches that improve the ESG quality of the portfolio while leaving the yield roughly unchanged. Figure 5 shows that for a given yield level, there are plenty of opportunities to replace countries with poor ESG scores with countries that have better ESG scores—but it goes without saying that there are also considerations beyond ESG.

**IMPROVING ESG = IMPROVING CREDIT QUALITY**

From an inter-temporal perspective, investing in improving ESG credits is also likely to dovetail with investing in improving credit stories. Expanding the analysis with a time dimension over the past five and 10 years tentatively shows that improving ESG ranks are associated with improving credit quality, driven mostly by the G factor (see figure 6).

The simple correlation between the 10-year change in the ESG rank and the sovereign credit rating is 0.49, mostly driven by the governance factor. The correlations over five years show a somewhat weaker but still noticeable relation between sovereign ratings and the G and then ESG ranks. (Note that these are just correlations rather than statements about statistical causation and that many other factors will be driving ratings changes.)

Figures 7–10 show the 10-year relations of the changes in E, S, G, and ESG ranks versus the change in sovereign ratings over the same time span. In all cases there is at least a vague positive relationship visible, mostly so for the G factor. This is not surprising because governance is a significant factor in the assessments of the sovereign rating agencies because it has been shown to be a crucial determinant of defaults.
**ESG HELPS TO AVOID CREDIT PITFALLS**

For Asian corporate credit, some of our colleagues at Bank of America led by Asia ESG head Sameer Chopra examined the relationship between ESG factors and four financial metrics relevant in corporate credit rating assessment: gross debt to earnings before interest, taxes, depreciation, and amortization (EBITDA); free cash flow to debt; EBITDA margin; and earnings per share volatility. Although governance provides the broadest signal across sectors, environmental issues, including carbon emissions and water stress, provided a strong signal as well. For the consumer, financials, and industrials sectors, workforce management, a social factor, is relevant.

In equities, our U.S. strategist Savita Subramanian and team found that co-

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**10-YEAR CHANGE IN E RANK POSITIVELY CORRELATED WITH 10-YEAR CHANGE IN SOVEREIGN RATING**

![Graph showing the relationship between 10-year change in Environmental Rank and 10-year change in Sovereign Rating](image)

Source: Bloomberg, Haver, BofA Merrill Lynch Global Research

**10-YEAR CHANGE IN G RANK POSITIVELY CORRELATED WITH 10-YEAR CHANGE IN SOVEREIGN RATING**

![Graph showing the relationship between 10-year change in Governance Rank and 10-year change in Sovereign Rating](image)

Source: Bloomberg, Haver, BofA Merrill Lynch Global Research
companies with poorer ESG ratings are less prone to major negative surprises such as bankruptcies. We examined whether the same can be said for countries by looking at the future change in sovereign ratings as a function of the level of ESG ranks in the base year.

Indeed, it appears that sovereigns with a poorer ESG rank are more likely to experience a sharp fall in sovereign ratings over the next five years (see figure 11). By the same token, countries with better ESG ranks are more likely to be upgraded. Again, the governance component is crucial; Better institutions provide better safeguards against the rapid deterioration in fundamentals that typically results from major social conflict, fiscal spending sprees, or the inability to make an orderly adjustment to external shocks due to the weak legitimacy of the government.
CONCLUSIONS

We have demonstrated that ESG-oriented EM sovereign debt investing is likely to result in a portfolio with a higher average credit rating, implying a lower beta to EM credit and a lower beta to commodities and particularly energy prices. Thus, ESG investing could well suit the needs of investors that currently prefer IG funds. However, many EM sovereign credit investors are looking for higher spreads.

A few avenues could be pursued to make ESG investing in EM debt more compelling by avoiding a loss of yield:

- Focus on ESG-improving credit switches within a given sovereign rating bucket, e.g., by selecting the best ESG credits among the single-Bs. This improves ESG without sacrificing yield.
- Align ESG with the forward-looking credit analysis. We find that countries that improve their ESG, especially the governance part, over time also will experience improving credit ratings and thus tightening spreads.
- Use ESG to avoid credit pitfalls and select good stories. We find that the credits with the poorest ESG scores are more likely than others to experience major sovereign credit rating downgrades in the future, and vice versa. This makes sense because better ESG typically is aligned with better institutions, and institutions are a key driver of sovereign credit ratings in the present as well as the future.
- Define ESG criteria on the basis of improvements rather than current levels, e.g., a country implementing a credible anti-corruption drive could improve its ESG scores. However, this requires a forecast of the future or at least a more qualitative assessment of policies, and would it make it harder to define ESG compliance.
- Focus on local currency sovereign debt. Local currency debt tends to be better institutions, and institutions are better ESG typically is aligned with the country ceiling in sovereign credit ratings. However, this approach would require that the ESG criterion is applied only at the company level, not the country level.1

ENDNOTE


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