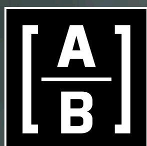
JUNE 2021



ALLIANCEBERNSTEIN®

CUTTING THE GORDIAN KNOT

HOW ESG INTEGRATION CAN HELP SOLVE CHALLENGES TO INVESTING IN EMERGING-MARKET CORPORATES

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IN THIS PAPER: Over the past few years, the emerging-market (EM) corporate bond sector has grown enormously and generated compelling risk-adjusted returns. Yet investors remain wary of the sector's environmental, social and governance (ESG) risks. In our view, the key to unlocking the opportunity lies in fully integrating ESG factors into bottom-up research and the investment process.

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EM OPPORTUNITIES OR ESG CHALLENGES?

Most investors need little persuading that emerging markets offer exciting opportunities. But emerging markets also pose challenges so significant and entangled that investors are reminded of the legendary Gordian knot. Some challenges—such as inconsistent regulations and a lack of standardization across countries—reflect the diverse nature of emerging markets. Others, such as the seemingly intractable problems of pollution and corruption, are ESG risks.

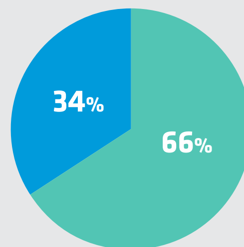
This is particularly relevant for investors in EM corporate bonds. Our analysis shows that more than half of the worst-performing credits in the J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) during the last five years were those with weak ESG practices (*Display 1*).

DISPLAY 1: ESG FACTORS ARE MAJOR RISKS FOR EM CORPORATE BONDS

Factors* That Caused the 10 Worst Bond Performances Each Year in the CEMBI, 2016–2020

PRIMARILY NON-ESG REASONS:

+ COVID-19 disruption to sector
+ Industries in secular decline
+ Countries with macro challenges



PRIMARILY ESG REASONS:

+ Accounting fraud
+ Self-dealing owners
+ Conflicts of interest with non-debt stakeholders
+ Catastrophic environmental events

Analysis provided for illustrative purposes only and is subject to revision.
***** Based on AB's internal ESG classifications
As of December 31, 2020
CEMBI = J.P. Morgan Corporate Emerging Markets Bond Index
Sources: J.P. Morgan and AllianceBernstein (AB)

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Given these challenges, why would anyone want to invest in EM corporate bonds? There are five reasons, in our view. Some of the most compelling are ESG-related.

First, the ESG risks to investing in EM corporates should be kept in perspective. Not all EM companies are ESG laggards. Mexican chemical company Orbia Advance, for example, has some of the lowest emissions and most ambitious carbon-reduction plans in its industry—indeed, better than those of many leading US and European chemical companies.

Second, there is a strong case for thematic investing in emerging economies. It may seem counterintuitive, given the perceived ESG risks of EM corporate bonds, but investing in emerging economies can help finance the world's transition to greater social and environmental sustainability.

Emerging countries are home to about 70% of the world's population and own a large share of the resources that will help drive the transition to a cleaner-energy future. For example, they produce 80% of the world's copper—demand for which is expected to rise 50% during the next 20 years—and more than half of all lithium, for which demand is expected to double by 2024.[1] Further, EM investing can support sustainable growth and social empowerment in some of the least developed parts of the world, by contributing to better health and educational opportunities.

Third, given a sufficiently robust research methodology and investment process, it's possible to identify and manage the ESG and other risks associated with EM corporates. Such capabilities can identify opportunities as wells as risks, making EM corporate bonds a rational and attractive proposition—not only for investors who are explicitly targeting responsible-investment outcomes but also for those who are primarily concerned with capturing competitive risk-adjusted returns.

Fourth, EM corporate bonds compare favorably on many points with developed-market (DM) bonds. From 2015 to 2020, for example, the CEMBI had a Sharpe ratio—a measure of return per unit of risk—double that of EM sovereign bonds.[2] Similarly, the Sharpe ratios for the high-yield and investment-grade portions of the CEMBI were higher than those of their DM equivalents. EM corporate bonds' credit quality compares favorably too. On average, investment-grade EM credit ratings have been catching up with the average rating of US investment-grade corporate bonds.

Fifth, EM bonds provide portfolio diversification. The EM corporate bond market comprises more than US$2.5 trillion of international US-dollar bonds across more than 600 companies. That's considerably larger than the EM sovereign debt market and as big as the US-dollar and euro high-yield markets combined. EM corporate bonds also have low correlations to other corporate bond markets.

In our view, the key to identifying and managing the risks of the EM corporate bond market lies in applying a deep and rounded research methodology and investment process, with ESG factors fully integrated into both.

In an earlier paper, we described our model for incorporating ESG into sovereign-credit analysis. Building on this approach, we discuss below how investors can combine comprehensive credit analysis and ESG research to clarify the risks and potentially benefit from the opportunities presented by EM corporate bonds.

1 "Meeting Future Copper Demand," Copper Alliance (website), International Copper Association, accessed June 10, 2021, https://sustainablecopper.org/meeting-future-copper-demand/. "Global Lithium Demand Expected to Double by 2024," mining.com (website), Glacier Media Group, October 8, 2020, https://www.mining.com/global-lithium-demand-expected-to-double-by-2024/.
2 J.P. Morgan

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ESG RATINGS OFFER ONLY PARTIAL INSIGHTS

When developing an ESG-aware research and investment process for EM corporate bonds, the first point to consider is data—its availability, comprehensiveness, accuracy and comparability. Many EM companies are majority owned by families or governments, and so are subject to less demanding disclosure requirements than those that apply to publicly listed entities. This can be a challenge for investors who attempt to carry out their own research. It can also present challenges to EM indices (*see* "EM ESG Market Indices Are No Substitute for Research," *page 3*).

Because of this, many investors turn to ESG rating agencies that—rather like traditional credit rating agencies—analyze companies' ESG risks and assign ratings as a guide for investors. While such ratings can be helpful, they may be misleading or confusing if taken at face value, for two reasons. First, the agencies face the same problems as investors in trying to acquire the necessary data. And second, there can be significant differences in the way agencies assess the risks.

In a survey of ESG rating agencies published in 2020, the Sustainability Institute noted that ratings challenge and sometimes frustrate investors: "Investors interviewed expressed strong critiques of ratings, from inaccuracies and use of old or backwards-looking data, to more fundamental concerns about whether ESG performance can ever be distilled into a single score." [3]

Our own comparison of the two most widely used agencies, MSCI and Sustainalytics, illustrates the problem (*Display 2, page 4*).

The agencies' rating nomenclatures are very different, making comparison between the ratings difficult, if not impossible. While MSCI rates companies relative to their industry peers, Sustainalytics rates them on an absolute basis, across all sectors.

These differences have real consequences, as seen from the agencies' sharply contrasting views on the ESG risks of Chilean state-owned copper miner Codelco. MSCI places the company toward the middle of the risk spectrum, while Sustainalytics assigns it a near-maximum-risk score. In our analysis, the overall correlation between the agencies' ratings is low, at less than 0.5.

Overreliance on third-party ESG ratings creates, in our view, a risk similar to that described in the ancient story of the blind men and the elephant. The men were told to touch a part of the animal, not knowing what it was. When asked to identify the object, each gave a different answer: the man who touched the trunk, for example, believed the object was a teapot, while the man who touched its side thought it like a wall. Each man understood only part of the picture and failed to conceive the animal in its entirety.

How can EM corporate bond investors be confident that, when assessing ESG risk, they're not just seeing a fragment of the whole?

CAPTURING THE BIG PICTURE: INTEGRATED RESEARCH

The answer lies in applying a research methodology that gathers and synthesizes varying views to capture the full picture of EM corporate ESG risk. Such a methodology must embrace as much data as possible from multiple perspectives and subject it to systematic analysis.

EM credit analysts are front and center in assessing the risks of EM corporate bonds. However, to overcome the challenges of the proverbial blind men with the elephant, they need to form as rounded a view as possible. This means drawing on data from a variety of sources and investment disciplines. Credit analysts should also take a lead role in integrating the combined data into meaningful research insights.

3 "Rate the Raters 2020: Investor Survey and Interview Results," The Sustainability Institute (website), ERM Group, March 2020, https://www.sustainability.com/thinking/rate-the-raters-2020/.

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EM ESG MARKET INDICES ARE NO SUBSTITUTE FOR RESEARCH

A number of market indices, including EM indices, consist of companies weighted according to their ESG scores. While in theory such indices might serve as a useful proxy for ESG research, they are less helpful in practice, as they are subject to the same data challenges that affect investors.

Some base their weightings on ESG agency ratings. Where those ratings are influenced by company news and other short-term data, they can be quite volatile, leading in turn to volatility in the indices.

For example, one of the criteria for companies to be included in the J.P. Morgan ESG EMBI (JESG EMBI)—the largest ESG EM bond index—is a sufficiently high ESG score from Sustainalytics. In November 2019, Pemex, the Mexican state-owned petroleum company, was removed from the index after its ESG ratings score fell below the required level. It was reinstated 12 months later, when its score recovered. For investors tracking the index, these changes were significant: The company, one of the top 25 by index weight, accounts for around 1.5% of the index and is the highest-weighted quasi-sovereign in the index.

Unfortunately, Pemex didn't stick the landing. In March 2021, JESG EMBI announced that the company would again be excluded from the index because its ESG score had fallen. Sustainalytics had lowered it in response to recent oil spills and industrial accidents in Pemex's operations.

Indices also give extra weighting to green bonds, but we disagree with the green classifications of many such issuers. For example, Mexico City Airport Trust acquired a green rating for bonds to finance a new international airport, based partly on the use of LED lighting and other minor environmentally friendly measures. The issuer had a history of corporate governance problems, however, and the project—which was discontinued after a change of government—was to have been built on wetlands.

Similarly, Majid Al Futtaim Group, a developer and shopping mall operator in the United Arab Emirates, issued a green bond to support projects related to renewable energy and sustainable water management. But some of the company's operations—including Ski Dubai, an indoor ski slope in the desert—are environmentally controversial.

For deeper insight into evaluating green bonds and other ESG bonds, see Making Sense of ESG Bond Structures.

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DISPLAY 2: HOW THE MAJOR ESG RATING AGENCIES COMPARE

	MSCI	Sustainalytics
Coverage	Most but not all EM corporates	Most but not all EM corporates
Ratings goal	"Designed to help investors to understand ESG risks and opportunities and integrate these factors into their portfolio construction and management process"	"Measure the degree to which a company's economic value is at risk driven by ESG factors or, more technically speaking, the magnitude of a company's unmanaged ESG risks"
Ratings nomenclature	From AAA (low risk) to CCC (high risk)	Scores from 0 (low risk) to ~50 (high risk)
Ratings absolute or relative	Relative to industry sector	Absolute across all sectors (e.g., oil firms will always score as higher risk than financial firms)
Score reference points	35 governance risks and industry-specific key issues based on impact and the time horizon of risk or opportunity	Four subcategories to determine risk: company exposure, manageable risk, managed risk and unmanaged risk
Score determinants	Composite of underlying metrics	Unmanaged key-issue risks
Overall score correlation	Below 0.5	
	Example of individual rating: Codelco*	
Rating	BBB (toward the middle of the risk spectrum)	49 out of ~50 (nearly maximum risk)
Rater comments	Strong governance offset by weaker environmental factors	Codelco is in a high-risk industry and has more risk than an average miner. Plus, its management mitigates only a portion of the risk

* Chilean state-owned copper mining company
As of March 31, 2021
Source: MSCI, Sustainalytics and AB

Display 3, page 5 shows how this can work in practice in the case of a global asset manager with research capabilities that are both deep and broad, geographically and across the asset spectrum.

Working in collaboration with EM sovereign analysts, DM credit analysts, equity analysts, a responsible-investing team and external specialists, the EM credit analysts marshal information and knowledge with the aim of creating as comprehensive and accurate a data set as possible.

But that's just the beginning. Each collaborator brings additional value to the process in their own way. For example, EM sovereign analysts are country experts. Their knowledge of political, policy and regulatory developments in individual countries helps build an overview that serves as a benchmark for country norms—a useful guide from an investment perspective. Similarly, DM credit analysts, as global industry experts, provide standards by which to judge how EM corporates and sectors measure up against global ESG trends. Together, these two disciplines help to systematize the research process.

Equity analysts offer a still different view. The ultimate aim of credit research is to determine a company's ability to pay its debt (and hence tends to focus on factors that affect the company's cash flow). Equity analysts additionally look at a company's growth prospects, and so provide an important forward-looking dimension. They can be particularly knowledgeable, for example, about how companies are using ESG initiatives to drive growth or to differentiate themselves in other ways. (For an example of how credit and equity analysts can work together to identify, analyze and address ESG issues in EM corporates, see Protecting the Amazon by Investing in Brazilian Beef.)

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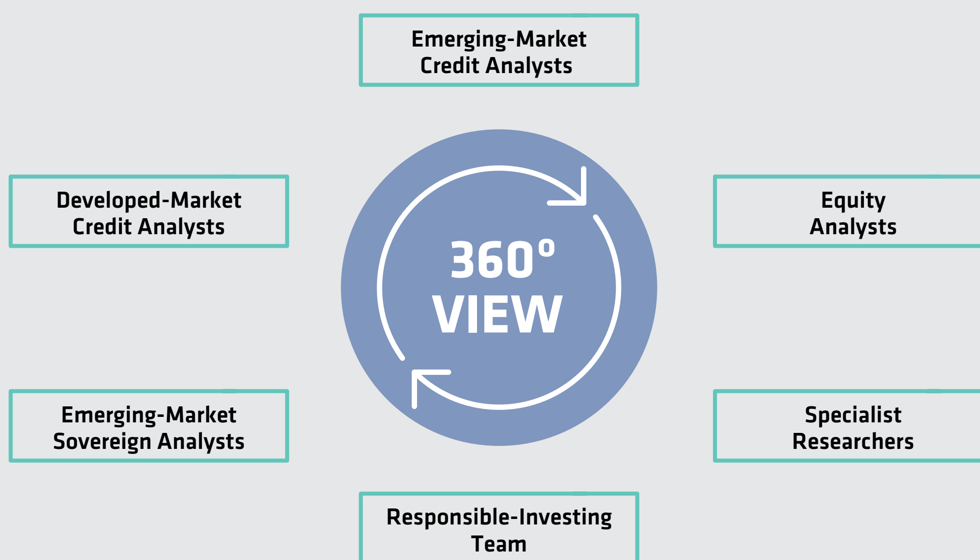
DISPLAY 3: SEEING THE WHOLE PICTURE
An Integrated Approach to Researching EM Corporate ESG Risk



Source: AB

An in-house responsible-investing team can help incorporate specialist expertise on ESG topics into the research process by exploring the nuances of such knowledge and explaining their investment implications. This can be helpful, for example, in calibrating the carbon footprint of a portfolio—a process that, despite the apparently objective nature of the data involved, can be surprisingly complicated.

External specialists may include academic institutions with thought-leading expertise on different aspects of ESG.[4] This expertise, sourced from outside the investment industry, can be important in challenging assumptions underlying some aspects of ESG investment research. Collaboration between investment professionals and subject experts may also lead to new developments in investment research methodologies and in the way that portfolios are built and managed.

EM credit analysts must ensure the adequacy of the data and the soundness of the interpretations and judgments based on it. They typically have a long history of scrutinizing ESG factors that companies may face on a number of fronts, including environmental and social. They know and understand the entire ecosystem of risk that surrounds each company they follow, gaining insight from competitors, suppliers and regulators.

This makes them best suited to synthesize the various elements of the research process into actionable insights and to help integrate them into investment decisions.

4 Rate the Raters 2020, p14.

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WEIGHTS AND MEASURES: PUTTING RESEARCH TO WORK

Such a robust, bottom-up ESG research methodology can help identify both risks and opportunities.

And that's important, because the stakes can be high. *Display 4* illustrates the impact of just one ESG risk—in this case, governance—on EM corporates.

NMC Health, a private healthcare provider based in the United Arab Emirates, illustrates how governance risk can adversely affect investors. The company understated its borrowings by US$4 billion. When the extent of its poor governance came to light, it was placed in administration and bondholders suffered an 80% loss.

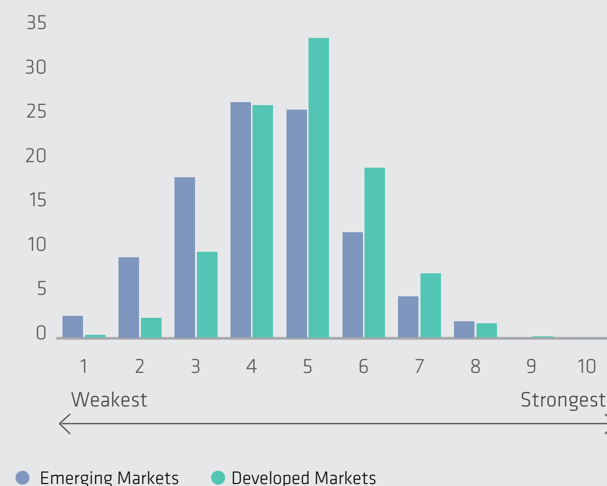
But the stakes can be high in a positive way, too. For example, efforts by conscientious companies to improve their governance may pay off handsomely for investors. ContourGlobal, a UK-based power generation company with operations in Brazil, Bulgaria and Africa, enhanced its governance and environmental risk profiles by carrying out an initial public offering—making it subject to increased scrutiny and standards of transparency—and committing to build no new coal plants.

These initiatives resulted in a decline in the company's cost of funds. After issuing five-year bonds at a coupon of 7% in 2014, for example, it issued five-year bonds at less than 4% in 2020—a much bigger decline in rate than that of the broad market. As bond yields move inversely to price, investors in the company's bonds during this period saw their holdings outperform.

The challenge for investors is to integrate these insights across the portfolio. Exposure to each security needs to be weighted appropriately, taking into account not only issuer-specific risks but also risks associated with an issuer's industry and the geography of its operations.

To help portfolio managers make such decisions, fundamental research insights need to be systematized and standardized.

DISPLAY 4: EM COMPANIES SCORE LOW ON GOVERNANCE



Analysis provided for illustrative purposes only and is subject to revision.
As of March 31, 2021
Source: AB

Quantitative analysis has become a well-established way of doing this, and, for investors in EM corporate bonds, it can be a powerful tool for fully integrating ESG factors into the investment process.

We believe that managers should systematize their fundamental insights into the ESG risks of global industries by assigning weightings to each industry based on the sector's sensitivity to individual ESG factors. In *Display 5, page 7*, we've assigned each subsector—there are 30 in total—its own ESG risk weighting. Subsector risk weightings then roll up into sector weightings.

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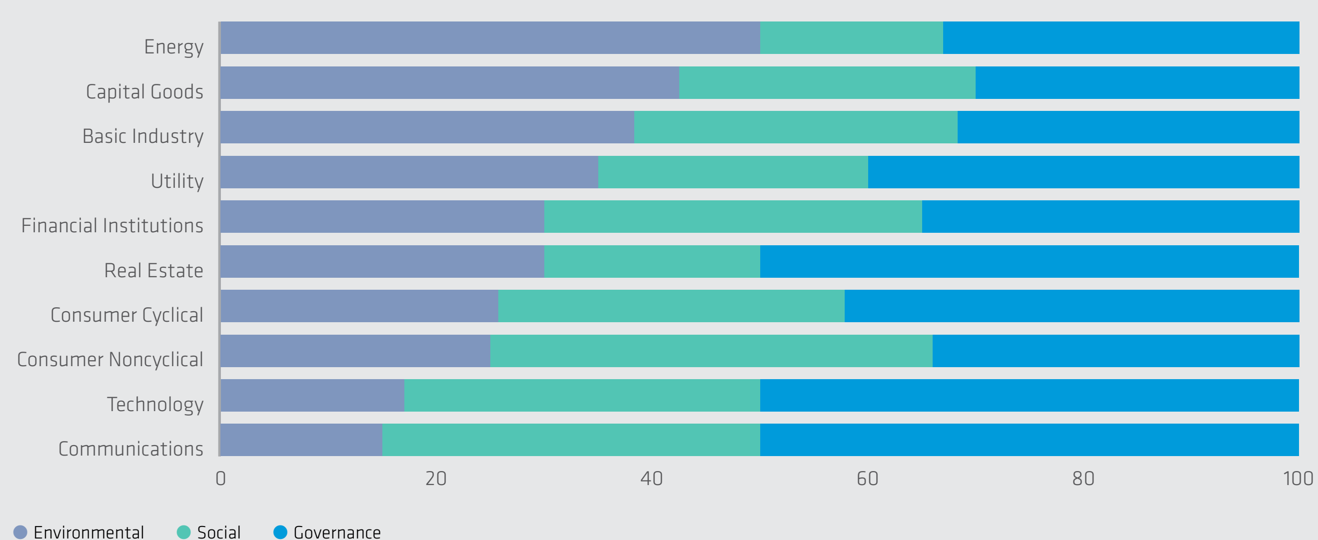
While the visual representation is simple, the data and insights behind it run deep. It may be no surprise, for example, that the energy sector rates highest for environmental risk, but given the huge social costs of environmental disasters, it may seem odd that the energy sector rates so low for social risk. That's because governance risk is even more important for energy companies: They need strong balance sheets to withstand cyclical downturns and farsighted capital-allocation strategies to enable them to transition to renewable energy sources.

Analysis of country ESG risks shows how fundamental and quantitative research can work hand in hand. For example, fundamental analysts can compare a country's quantitatively derived internal ESG score to its sovereign credit rating assigned by an external agency such as Standard & Poor's or Moody's Investors Service (*Display 6, page 8*).

The comparison can help flag areas of interest. For example, a low ESG score coinciding with a high credit rating—as is the case with some East Asian and Middle Eastern countries—should alert analysts to weight a country's ESG score more heavily. Analysts take this into account when assessing the ESG risks of a company domiciled or operating inside such a country—especially if the company doesn't manage its ESG risks according to international best practices.

DISPLAY 5: A SNAPSHOT OF GLOBAL INDUSTRIES' ESG RISKS

ESG Weights by Sector (Percent)



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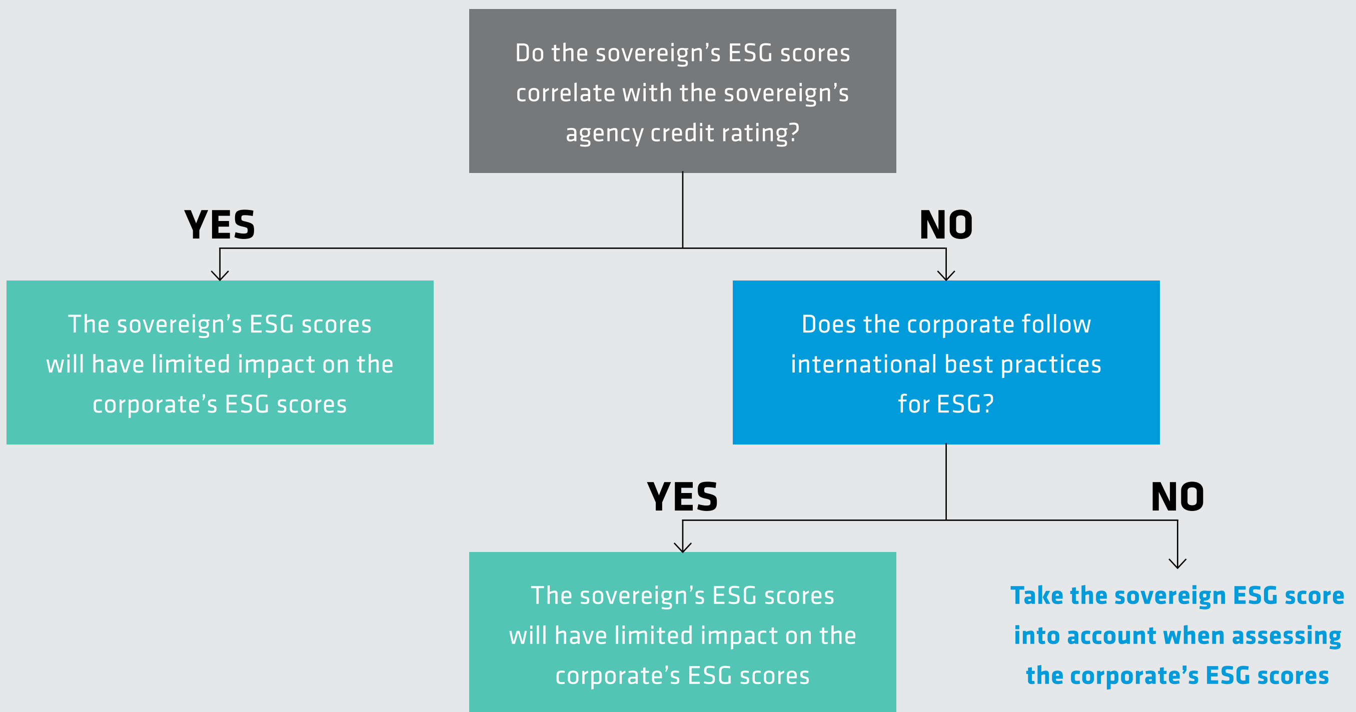
SOLVING AN ESG CONUNDRUM

Despite having access to strong research methodologies and investment processes, some investors still wonder if EM corporate bonds are worth the risk, given the scale of the ESG challenges they face. In our view, they are.

From a financial-market perspective, the asset class is becoming more attractive. Relatively ESG-friendly sectors are taking up a larger share of the index at the expense of traditional polluters such as oil and gas producers. They include utilities, where many companies are transitioning to renewable energy sources, and consumer, including healthcare and some e-commerce enterprises (*Display 7, page 9*).

DISPLAY 6: HOW SOVEREIGN ESG SCORES CAN FLAG CORPORATE RISK

Integrating Sovereign ESG Ratings into Credit Analysis



Source: AB

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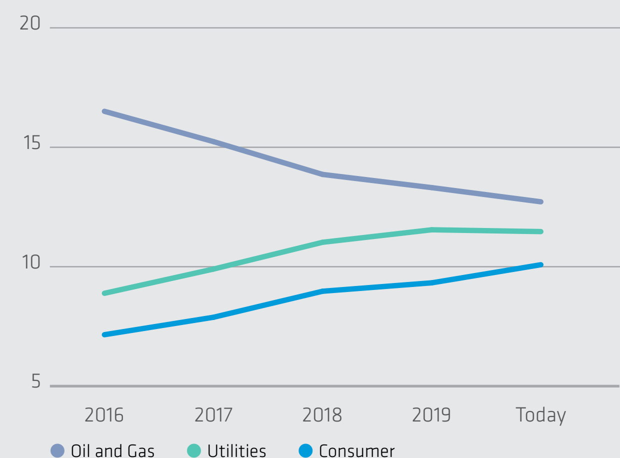
DISPLAY 7: THE EM CORPORATE BOND MARKET IS DIVERSIFYING AWAY FROM OIL AND GAS

CEMBI Industry Weights (Percent)



Analysis provided for illustrative purposes only and is subject to revision.
As of February 26, 2021
Source: J.P. Morgan

From an economic perspective, the picture is more nuanced but no less interesting. It's true, for example, that emerging countries account for two-thirds of global carbon dioxide emissions, and their share is growing. But it's also true that their per capita emissions are much lower than those of developed countries.

For investors who are concerned about ESG risk, this represents both a challenge and an opportunity. How can they help emerging countries move toward sustainable development models that are less resource-intensive and less dependent on fossil fuels, but still deliver rates of growth that help support social progress and a better standard of living?

The solution, in our view, lies in actively engaging with companies and governments to advocate for better ESG outcomes.

In our experience, EM corporates and governments can be highly receptive to such engagements, some of which have resulted in real changes in corporate practices and government policies, with broad benefits for the environment, companies' costs of funds and local populations.

The reason for this is that EM companies, compared to their DM counterparts, have relatively few alternative sources of finance, so they tend to listen closely to their investors. Bond investors have the potential to be particularly influential in this respect because most EM companies are privately owned and have no public equity holders. Bondholders, in other words, are the main check on such companies' ESG practices.

Conversations with bond investors helped Codelco—the world's biggest copper producer, which is 100% owned by the Chilean government—to switch to a more sustainable path. The company illustrates the conundrum posed by competing environmental and social objectives. The copper it mines plays an important role in decarbonizing the global economy, but it is a huge consumer of energy in an industry with a history of causing damage to communities and the environment.

To preserve Codelco's positive social attributes while reducing the environmental harm it causes, bond investors helped the company align itself with the United Nations Sustainable Development Goals by committing to a 70% reduction in its carbon emissions and a 60% reduction in its use of water by 2030.

Suzano, the largest forestry company in Brazil, provides another example of how effective such engagement can be. The company was vilified by the international media for seemingly benefiting from the destruction of Amazon rain forests that followed the government's loosening of environmental protections in 2019.

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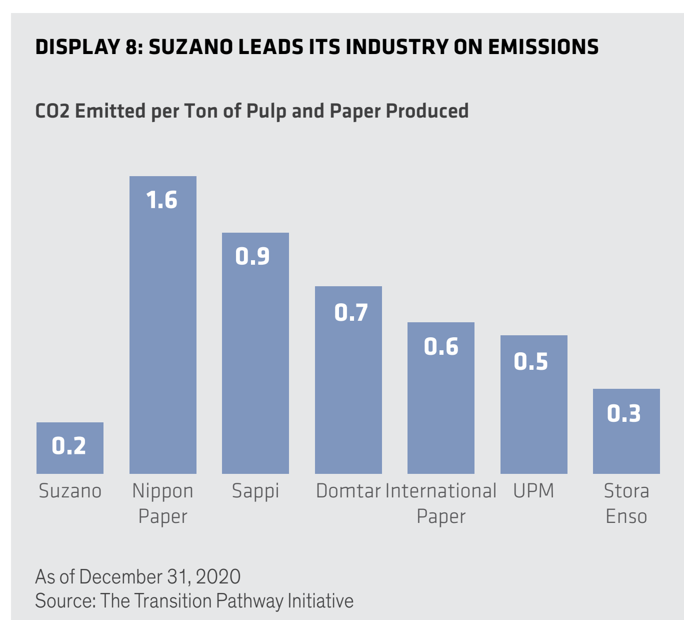
After engagement with investors, Suzano publicly clarified that it harvests only trees that it had planted itself (not old-growth forests) and that it had set aside 40% of its land for conservation. Suzano is also entirely self-sufficient in electricity and has the lowest carbon dioxide emissions of any forestry company—0.2 per ton of pulp produced, compared to nearly 0.3 for the next-lowest emitter (*Display 8*).

Investor engagement led the company in 2020 to issue a sustainability-linked bond with a 3.75% coupon that will rise to 4.0% if it fails to reduce its emissions to 0.19 by 2025.

Other areas in which investor engagement has led to notable results include helping the electricity sectors of Chile and Israel diversify away from coal in favor of renewable energy sources.

Active engagement is powerful for two reasons, in our view: It allows investors to influence ESG risks directly, thereby potentially improving the risk/return trade-off on their EM corporate-bond holdings. And it creates an extraordinary opportunity for investors to help change the world for the better, by persuading companies and governments to improve their ESG practices.

DISPLAY 8: SUZANO LEADS ITS INDUSTRY ON EMISSIONS



As of December 31, 2020
Source: The Transition Pathway Initiative

A WIN-WIN PROPOSITION

The EM corporate bond market presents a tantalizing prospect for investors: Its size and strong historical performance make it impossible to ignore, but the challenges it poses, particularly in terms of ESG risk, can be daunting. Fortunately, as was the case with the Gordian knot, it's possible to cut through these challenges.

Doing so requires, first, a robust research methodology based on data that are comprehensive, accurate and multifaceted. This can be achieved by bringing together research analysts from different investment disciplines—not just EM credit but also EM sovereign credit, developed-market credit and equities. Given the specialized nature of many ESG risks, the research should also draw on in-house responsible-investing expertise as well as knowledge from outside the investment industry, such as academic expertise on climate change.

Managers should then integrate the research insights into the investment process using quantitative analysis to weight portfolio bond exposures appropriately, according to their ESG and other risks. While the standardization and systematization provided by quantitative tools are essential to the process, the final investment decisions can be subject to adjustment in light of fundamental research insights.

Finally, investors should be open to engaging actively with EM bond-issuing companies and governments, with the aim of promoting best ESG practices in corporate behaviors and government policies. Such engagement may lead, over time, to a better risk/return trade-off on their bond holdings, as well as to real-world improvements on a range of ESG issues.

We think that bond investors—whether or not they are driven by explicit responsible-investment objectives—are likely to see the merit of such a win-win proposition.

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