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ESG investing in EM debt: enhancing sustainable development outcomes

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Because of their biases toward wealthier countries, relying on existing external ESG frameworks results in skewing capital toward countries with less need for it. ***Nuveen seeks to correct this inequity.***

Nuveen: An innovator in the EM ESG investing space

Nuveen's framework is built on a long track record in both responsible investing (RI) and EM debt. We launched our first responsible investing fixed income account in 1990. In 2007, Nuveen's RI and fixed income teams created clearly defined impact standards based on direct and measurable use of proceeds, exceeding the high standards set in voluntary industry guidelines such as the Green Bond Principles and Social Bond Principles, which emerged only years later. Meanwhile, EM debt has been a core competency of our organization since the 1990s. Nuveen first invested in EM securities as far back as the 1970s and formed a dedicated EM debt team in 1997. Today, Nuveen manages over $13 billion in EM debt assets across the entire spectrum of the asset class.

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INHERENT CHALLENGES IN EM ESG ANALYSIS

Today's financial markets are at an extraordinary juncture, grappling with persistently high inflation, war in Eastern Europe, global climate change and the ongoing and severe effects of the COVID-19 pandemic. Against this backdrop, fixed income investors are increasingly seeking to generate financial returns while building portfolios that support positive outcomes through environmental, social, and governance (ESG) investing.

In an emerging markets (EM) sovereign debt context, Nuveen's focus is on enhancing sustainable economic, environmental, and human development outcomes, which we believe are highly correlated with material ESG factors. But executing on an EM ESG strategy is no easy feat. Research shows that existing third-party ESG frameworks generally fall short when it comes to accounting for countries' differing starting points on the journey of economic development, leading to inherent income biases.[1] The significant diversity within EM requires a highly refined approach to assess the ESG performance — and potential — of each country.

Drawing on Nuveen's decades of experience investing in EM debt and longstanding leadership in fixed income responsible investing, we developed a proprietary EM ESG scoring framework that addresses the shortcomings of third-party approaches. Our framework adjusts for each country's specific level of economic development, while ensuring that governance remains the cornerstone of every assessment. Furthermore, we address both environmental risks and related social consequences, recognizing the conflicts that can arise between the two when moving rapidly on climate change.

Most third-party ESG frameworks were created primarily for public equities in developed markets, making them ill-equipped to address the elements that make emerging economies unique. The complexity of sovereign issuers only adds to the challenge of ESG assessment.[1]

Specifically, we find that:

- Prevailing commercially available ESG methodologies tend to embed inherent wealth biases, by measuring performance against a peer group of both developed and emerging market issuers, without accounting for vast differences in stages of economic development. A country's level of economic development is highly correlated with performance on social and governance criteria — the more advanced the economy, the higher it scores on these two metrics.
- In addition, external frameworks tend to apply the same methodology for assessing each E, S and G pillar to all countries, regardless of their level of economic development. This leads to over- or under-emphasis of environmental and social factors, depending on a country's starting point. For instance, the number of years of schooling may be a more important differentiator as a social indicator for the lowest-income countries, whereas it tends to be a homogeneous metric in most developed countries. Moreover, external frameworks historically have placed a lower weight on governance compared to what we view as necessary. Our long experience managing EM debt portfolios has shown us that governance is the most significant driver of improvement on sustainable development objectives.
- It's unclear to what degree third-party models can incorporate new data and forward-looking views of a country's progress toward meeting international standards or best practices. Doing so is a challenge given the different routes EM countries are taking to meet various ESG-related benchmarks, particularly related to climate change.

EMERGING MARKETS REQUIRE A NUANCED APPROACH TO ESG INVESTING

Nuveen's goal in developing a proprietary ESG framework is to address wealth and development biases found in third-party approaches, while also incorporating a forward-looking view toward the progress an issuer is achieving — all with the intention of directing capital to countries where it is most needed and can be deployed most effectively. This begins with recognizing the wide and complex divergences among EM countries based on economic structures and development levels,

heterogeneity of populations and extent of political freedom, and degree of exposure to physical climate risks, to name just a few characteristics. Each EM sovereign's approach to managing through these currently turbulent times and working toward a more sustainable future will depend on its specific set of circumstances, including its starting point.

Our philosophy for assessing ESG performance in EM adjusts for initial position, evaluates ambition and directionality of progress, and supports equitable approaches in addressing environmental and social pillars, while keeping governance as the cornerstone. On the latter point, we believe that if a country's institutional frameworks are robust and improving, this can support the proper policy calibration needed to achieve sustainable outcomes both on environmental and social dimensions.

We also advocate for a "Just Energy Transition," a gradual path toward achieving development outcomes that weighs the possible trade-offs between investing to meet climate change objectives and achieving economic growth and other development goals (such as increased employment and social cohesion). Transition dilemmas can be seen in African countries, many of which have some of the lowest energy consumption per capita and greenhouse gas emissions globally, but also burgeoning populations with growing demand for reliable electricity and other basic needs, such as health care, quality education and food security, to name a few. In such countries, there are economic and social consequences of not relying on more abundant hydrocarbon resources, particularly gas, in the near-to-medium term.

Earlier this year, Nigeria's Vice President Yemi Osinbajo wrote an opinion piece in The Economist where he argued against blanket bans for fossil-fuel financing in developing countries. Although solar will provide most of Nigeria's power in the future, Osinbajo contended the country still needs natural gas for baseload power. He also enjoined European regulators to include liquefied petroleum gas "as a clean cooking alternative to save the lives of [Nigeria's] women and girls," many of whom currently use wood or other biomass burning. Underscoring the negative effect of blanket bans on fossil-fuel financing for economic development and net zero targets, Osinbajo stated, "Europe says it needs a decade more of gas investment to meet its 2050 climate targets. Africa—with our greater challenges—should have at least two more decades in order to meet our climate targets." We recognize that the latest proposals for the EU Green Taxonomy allow for the inclusion of nuclear and gas energy as environmentally sustainable activities, with final implementation expected on January 1, 2023.

Some EM countries, such as South Africa, are already making efforts toward a "Just Energy Transition." The South African government is seeking to grow renewable electricity production while gradually phasing out coal-fired power plants and training coal workers to be redeployed in the clean technology space. There will undoubtedly be hiccups in such transitions, but we believe they are achievable with high-level focus and financial support from wealthier nations.[2]

NUVEEN'S PROPRIETARY SOVEREIGN SCORING FRAMEWORK

Nuveen's proprietary ESG framework for sovereign debt issuers is a blend of quantitative and qualitative components. The quantitative aspects are described in detail in the next section. On the qualitative side, we rely on analyst expertise to assess trend momentum, forward-looking commitments (as an example, countries' Nationally Determined Contributions or "NDCs" to meet Paris Climate Accord targets) and insights from our direct issuer access and engagement efforts.

Systematically addressing wealth biases

Because of their biases toward wealthier countries, relying on existing external ESG frameworks results in skewing capital toward countries with less need for it. Nuveen seeks to correct this inequity by grouping and comparing countries based on the World Bank's four income group classifications: high-income, upper middle-income, lower middle-income and low-income.[3]

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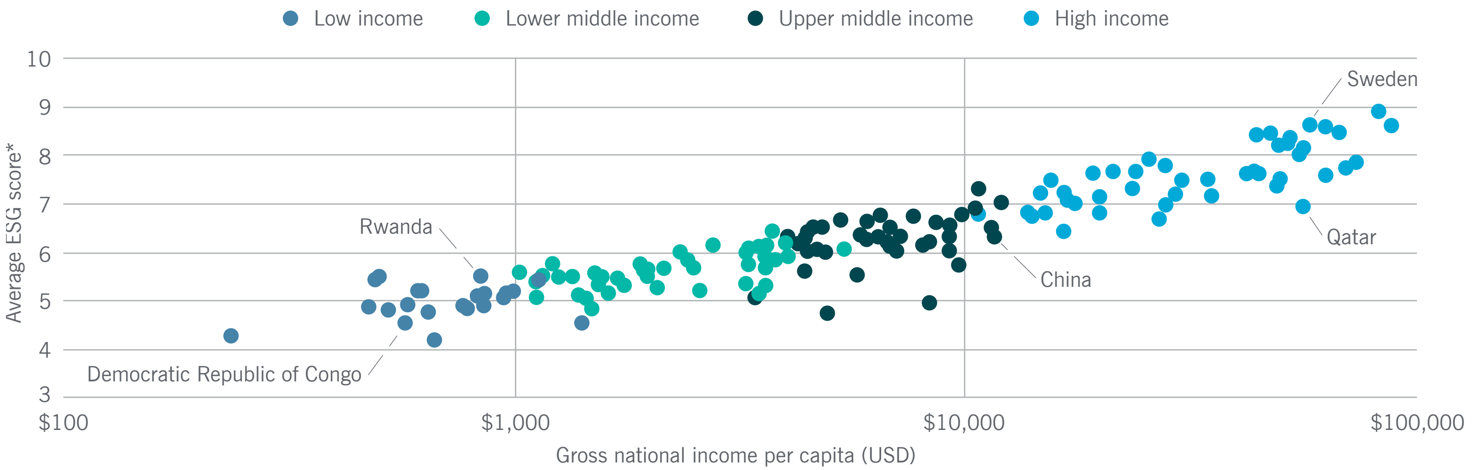
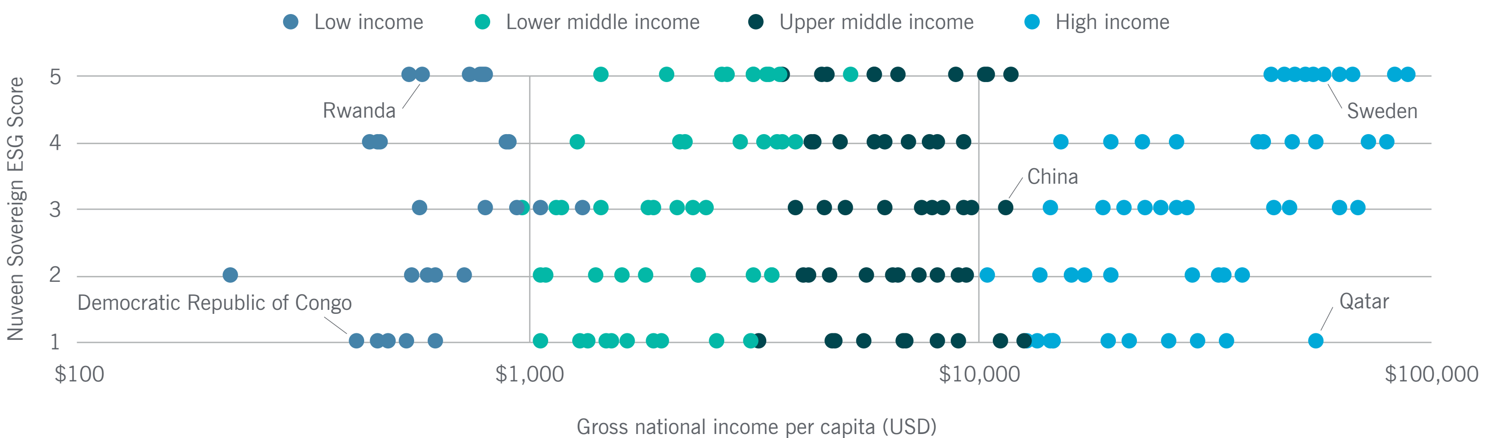
Figure 1: Country income levels drive commercially available ESG scores

Sovereign ESG scores from two major third-party ESG rating providers show high correlation (83.5%) with income per capita across 100+ countries.



Source: Nuveen, MSCI, Sustainalytics, World Bank. Data is as of Sep 2022.
* Score for each country is based on average scores among two leading ESG rating providers normalized to 1-10 scale.

Figure 2: Nuveen's best-in-class approach re-frames material ESG risks by income level, leading to dispersed ESG scores within each income cohort



Source: Nuveen, World Bank. Data is as of Sep 2022.

With these classifications, a low-income country such as Rwanda will not be penalized when assessing quality of institutions or public services relative to a high-income country such as Sweden. Meanwhile, Qatar is held accountable for its below-average performance on certain social indicators, including human rights and gender equality metrics, relative to its high-income peer group, rather than to all countries. As a result, the income bias is reduced while helping identify countries that are either more ambitious and/or more enterprising in achieving their sustainable development goals.

To take the assessment further, Nuveen's framework adjusts factor weights based on income group to take into account differing levels of development. For example, the quantitative aspect of our framework puts greater emphasis on improving governance, achieving basic needs and

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reducing physical climate risks for low-income countries in order to reward institution building, poverty reduction and resilience to climate change. In contrast, high-income countries — many with established institutions in place and greater resources to support a transition away from fossil fuels — will have scores weighted more toward environmental (e.g., emissions reduction, conservation) and social inequality (e.g., wealth gap, gender) metrics. We believe these nuances better incorporate a country's development stage and help codify the principle of "Just Energy Transition" to ensure balanced and equitable progress.

Across all income groups, the importance of Governance factors in the scoring approach is notable and consistent with our bottom-up, credit-intensive process. The focus on Governance stems from our belief that institutions and rule of law play an all-important role, regardless of income level or the stage of development. Sound Governance ensures consistency and predictability across stakeholders, while providing additional assurances that assigned capital is used for its intended purpose.

Incorporating momentum, ambition, and engagement

Two additional issues related to ESG analysis of EM sovereigns are 1) timeliness and availability of data, and 2) the lack of forward-looking indicators. In some cases, official published data can be more than five years old. We seek to address this deficiency by placing lower emphasis on the stalest data points and considering trend performance across each E, S and G pillar. We complement this step by comparing and contrasting each country's national ambitions and commitments (e.g., NDCs, UN Sustainable Development Goals) with other countries in its cohort. We also leverage our decades of investment experience and relationships with EM sovereign and corporate issuers to facilitate more direct engagement on data and information gaps and to address specific ESG issues.

ALLOCATING CAPITAL TO EMERGING MARKETS THROUGH AN ESG LENS

In our view, investors can help drive positive sustainable development outcomes in emerging markets by channeling capital to those countries that perform well, not only on macroeconomic policies, but also on multiple ESG factors, including business climate, political participation, social cohesion, individual rights and well-being, and environmental stewardship. Based on our proprietary scoring framework, the general purpose debt issued by countries that perform in line with, or better than those in their income-based peer group (earning a score of 3 or higher on a scale of 1-5), are eligible for intentional ESG EM portfolios. General obligation bonds issued by countries that lag their income-class peers (earning scores of 1 or 2) are not eligible.

Diversified opportunity set

Because our proprietary ESG scoring framework focuses on "best in class" in all income groups, it allows for diversified investment opportunities among issuers that perform well on ESG indicators. We believe our approach restricts eligibility for EM ESG underperformers, while preserving a diverse and robust opportunity set across credit ratings, geographic regions and macroeconomic drivers, creating stronger potential for enhancing financial returns.

Limitations of a model-based approach

We acknowledge that there are limitations to any ESG scoring framework, which is ultimately model-based. Picking investment winners and losers based solely on the output of a given model might not be a reliable strategy in the long run, particularly true in the context of emerging markets, where myriad factors and fast-moving developments require special attention.

- First, given data shortcomings and market innovations taking place to address such gaps, it's important to maintain an approach that is flexible enough to adapt to new information as it becomes available.

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- Second, as with all investment strategies, consideration of broader ethical, geopolitical, regulatory and other issues that do not fit neatly within an ESG framework will contribute to security selection and risk management decisions. A frequent example of this is China, which meets a minimum eligibility standard based on our ESG scoring framework, but where we exercise caution in all of our investment strategies given concerns about the country's trade, geopolitics, domestic regulation and growth outlook.

*In our view, investors can help drive **positive sustainable development outcomes in emerging markets** by channeling capital to those countries that perform well, not only on macroeconomic policies, but also on multiple ESG factors.*

Relative value still rules the day

Our proprietary sovereign ESG scoring framework establishes eligibility, but is far from the sole criteria used for security selection in intentional ESG EM portfolios. Eligible securities must also provide an attractive risk/reward profile to be selected for portfolios. In other words, they're subject to the same intensive, bottom-up fundamental credit analysis used in non-ESG-focused portfolios.

We believe constructing an EM ESG portfolio using our approach may provide better risk-adjusted returns versus the benchmark, over a cycle. Improvements in sustainable development — which we measure based on the holistic set of ESG metrics in our framework — should lead to stronger structural economic growth, and in turn, improved creditworthiness in the long run. Bonds issued by EM sovereigns that do not score well on ESG metrics, but demonstrate compelling alpha-generation opportunities over shorter time horizons, may be considered in our traditional (non-ESG) EM debt portfolios.

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For more information, please visit nuveen.com.

Endnotes

1 Several published papers, including from the World Bank, address these shortcomings. See Ekaterina M. Gratcheva, Teal Emery, and Dieter Wang. 2020. Demystifying Sovereign ESG. EFI Insight-Finance. Washington, DC: World Bank.

2 As was committed to South Africa by the United Kingdom, United States, France, Germany and the European Union during COP-26 in November 2021.

3 The World Bank income group classifications are updated each year on July 1st and are based on GNI per capita in current USD (using the Atlas method exchange rates) of the previous year. For more information, please visit this site: https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups.

Sources

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