GAM Investments

Sustainability in Emerging Market Bond Strategies

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Integrating ESG factors into sovereign strategies, in particular in emerging markets, requires a deeper look at ESG metrics and what they can tell us.

Sovereign ESG ratings are increasingly used in investment decisions, but as with corporate ESG ratings, it is important to understand what they are measuring. Typically, ESG assessments are an aggregation of data from recognised NGO country rankings (such as Transparency International's Corruption Perception Index) or ratings (such as the Freedom House score for civil and political freedoms, World Bank Governance Indicators or World Bank data on various subjects).

However, these aggregate scores mask deeper insights. For example, our research indicates that governance ratings, which capture issues such as levels of bribery and corruption, ease of doing business, quality of institutions and political stability, have the highest correlation with credit spreads, followed by social and environmental variables. But these issues are often inter-related – physical climate risks may materialise as water shortages; without adequate infrastructure to manage this shortage, social unrest may result, particularly in countries where governments and institutions are weaker and there are fewer resources to manage these risks. This trend is more pronounced in emerging markets compared to developed markets. While we believe governance issues are key, we also recognise much of the data commonly used in ESG ratings is infrequently updated and often significantly lagging, in particular for statistics that are submitted by countries which have little data collection infrastructure.

That is why we use a Crisis Cycle Filter to help us with our investments. The filter is designed to identify country-specific factors – including quantitative factors such as foreign exchange reserves or current account deficits, as well as an assessment of the vulnerability of the banking sector – considered to be the most reliable, early indicators of financial crises. These are frequently precipitated by poor governance. Using this tool alongside daily monitoring of relevant political, economic and ESG events and trends can be a valuable addition when making active investment decisions for emerging market bond strategies.