THE DRIVE YOU DEMAND

SUSTAINABLE EM CORPORATE DEBT

A new asset class for Responsible Investors

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Asset Management | March 2018

UNION BANCAIRE PRIVÉE

Key points

- *Responsible Investment has been growing steadily over the last years, reaching $22.9 trillion in 2016.*
- *Still, the offering of sustainable emerging market (EM) credit portfolios is limited as investors remain sceptical that ESG considerations and emerging markets are compatible.*
- *In reality, ESG champions already exist amongst EM corporate issuers. EM sovereigns are also stepping up, especially in the fight against climate change.*
- *We believe that the number of ESG-mindful EM companies will continue to rise, as issuers respond to investors' new requirements for sounder business practices and stricter local environmental and social regulations.*
- *This creates opportunities to construct sustainable EM corporate bonds portfolios, which should offer superior and more sustainable risk-adjusted investment returns and provide new attractive and diversifying opportunities for responsible investors.*

Responsible Investments has grown but often ignored EM credit strategies

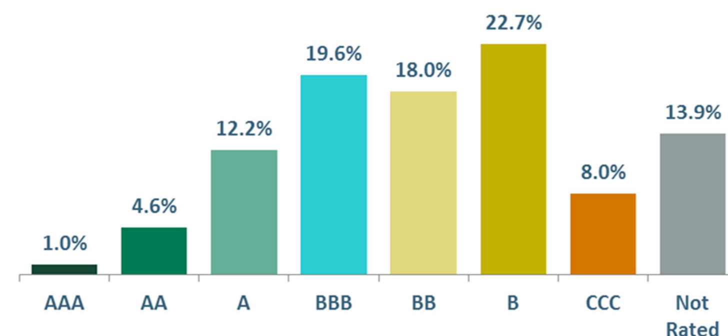
According to the latest Global Sustainable Investment Review[1], **Responsible Investment** (RI) has been growing rapidly over the last few years. Assets professionally managed under responsible investment strategies reached $22.9 trillion in 2016, an increase of 72% since 2012. In relative terms, RI now stands at 26% of all professionally managed assets globally. Penetration is even higher in Europe, where it reaches 53%.

Still, when it comes to the management of emerging market (EM) fixed income portfolios, sustainable investment approaches are still marginal, despite the fact that several academic studies have shown that the positive relationship between ESG and financial performance tends to be stronger in fixed income than in equities and in Emerging Markets than in Developed Markets

A few strategies are focusing on EM sovereigns, primarily through exclusions of a number of countries. But best-in-class ESG approaches to EM corporate bond portfolios are rare. Indeed, when one mentions the benefits of integrating environmental, social and governance (ESG) criteria in constructing EM portfolios, the first reaction is often one of scepticism. Admittedly, the level of extra-financial disclosure by EM issuers is still below that of DM countries. Moreover, ESG norms and requirements can be looser in EM countries, and news headlines often point at cases of poor practices, involving for instance child labour, severe pollution or corruption.

Despite this, however, EM corporate issuers with strong or average ESG credentials (rated AAA to BB by MSCI ESG Research LLC), already represent more than half of the JP Morgan CEMBI Broad Diversified index, while companies with poor ESG credentials – so-called "ESG Laggards" (i.e. companies with a B or CCC ESG Rating) – represent about 30% of the index.

JP Morgan CEMBI Diversified Index – ESG Rating Distribution



Source: @2018 MSCI ESG Research LLC[2], JP Morgan, UBP – March 2018

EM ESG Champions do exist

There is in fact an increasing number of EM issuers which distinguish themselves for their **ESG credentials** or for their positive social or environmental impact in line with the UN 17 Sustainable Development Goals (SDG),

Among them, **Arcelik Anomim Sirketi** is a high yield Turkish company which enjoys a **AAA ESG rating from MSCI ESG Research LLC**. Arcelik produces and distributes consumer durable goods and electronics, and operates across seven countries, ranging from Russia, Thailand or South Africa. It owns recycling facilities, conducts regular internal & external audits, and participates in the **Global Reporting Initiative's (GRI's) Supplier Business Transparency Program**.

Also in Turkey, the CEO of **Turkcell Illetisim Hizmetleri A.S.** was recognised by the United Nations (UN) as one of ten **2017 SDG Pioneers**.

[1] Global Sustainable Investment Review 2016 – published by the Global Sustainable Investment Alliance

[2] @2018 MSCI ESG Research LLC. Reproduced by permission

Kaan Terzioglu was distinguished for creating the "Hello Hope" mobile app, which helps refugees access key health and education services.

Another example in Mexico, **Infraestructura Energética Nova** (IEnova) is a company which develops, builds and operates energy infrastructure. It demonstrates strong sustainability policies, notably in terms of **Social factors** – thanks to its **best practices in terms of health and safety standards** – as well as on **Environmental factors** – thanks to the development of projects to **preserve biodiversity**, such as reforestation and the protection of wild fauna. MSCI ESG Research LLC recognised such best practices by assigning it a **single-A ESG rating**.

EM Sovereigns take a leading role in the fight against Climate Change

The trend is also true at sovereign levels. Environmental considerations are by essence global, and emerging countries are aware of this. Among the 79[3] EM countries included in JP Morgan EM sovereign and corporate bond indices, **all are signatory of the Paris Agreement on Climate Change** and only twelve have not ratified it yet.

The recognition by EM countries of the necessity and importance of environmental policies can also be illustrated by recent events, which all happened this month:

- Mar 11: the **first International Solar Alliance** (ISA) summit, co-hosted by **India** and France, was held in New Dehli. The ISA was launched in 2015 at the initiative of Prime Minister Modi and now groups 121 nations.

> In April 2017, India's renewables accounted for 57.5 gigawatts (GW) of its 329.4 GW overall installed electricity capacity. This is expected to triple over the coming years, as indicated by **Prime Minister Narendra Modi** in his opening statement at the ISA summit on 11 March 2018: "*India will produce 175 GW of electricity from renewable sources by 2022. Of this, 100 GW will come from solar energy*"

- Mar 13: creation of **a new Ministry of the Ecological Environment** in **China**, in charge of the country's ecological environment policies, monitoring and law enforcement.
- Mar 18-23: the 8th **World Water Forum** was organised in **Brasilia** by the World Water Council (WWC), whose members include over 300 organisations from more than 50 countries. Out of the 99 private company members of the WWC's third college of Enterprises and Facilities, 72 are domiciled in an EM country.

While these government initiatives will not immediately shape their domestic companies' creditworthiness, it seems reasonable to expect that over time, stricter environmental requirements will affect EM as much developed market (DM) corporate issuers, which will need to adapt to the new standards.

Already, **China**'s engagement to reduce pollution has resulted in **stricter norms** over the last few years, such as the Air Pollution Prevention and Control Action Plan, implemented in 2017 as well as the launch of its national carbon market on December 19th 2017, thereby setting a price on carbon for many of its power generating firms. Companies have to adapt or face the risks of high litigation costs & fines, or even closure. Not all will be able to do so, which is expected to lead to further concentration in industries like aluminium, steel, paper or textile. Over time, this will likely impact companies' operating performance, credit metrics, financing costs and eventually the returns of portfolios invested in the fixed income or equity securities issued by these companies.

The Atacama Desert in Chile is amongst the sunniest places on Earth. Solar energy is expected to sky rocket over the coming years, as part of the country's efforts to increase the share of renewable energy from 40% of total electricity production today to 60% in 2035 and 70% by 2050.[4]

In fact, according to MSCI[5], countries located in Southern Asia and Sub-Saharan Africa face the highest potential GDP losses in the event of a 2.5 degree warming by the end of the century. Moreover global collective efforts to address climate change may force some EM countries, especially those in the Middle East, North Africa and Eastern Europe, to shift their economies away from being fossil fuel dependent. Some countries have already taken measures to diversify their economies, such as Saudi Arabia unveiled their 2030 Vision". This will, no doubt, have an impact of corporate strategies in the countries affected.

[3] This excludes Taiwan which is not a member of the UN. The country has, however, also announced strict targets to reduce its carbon emissions.

[4] International Energy Agency – Chile 2018 Review - Energy 2050 policy adopted in 2015

[5] MSCI ESG Research LLC - 2018 ESG trends to watch - January 2018

ESG integration: a source of risk mitigation

ESG analysis is not only useful to single out the "good" companies. It can also be a means to **identify potential sources of risks**, which may result in sharp underperformance.

In the case of **Samarco**, a Brazilian mining company, the recognition of the weak history of both its parent companies in terms of pollution could have served as signal of future risks, which eventually materialised when the Bento Rodrigues dam collapsed in November 2015. This disaster released about 60 million cubic meters of iron ore waste, killed 19 people, left hundreds homeless or without access to clean water, and damaged the ecosystem across some 600 kilometres. The company faced USD 5.6 billion in damage charges and its bonds collapsed by close to 60% in a month before eventually defaulting.

Taking into account ESG practices in asset and risk management decisions may thus prove even more useful when investing in emerging markets than in DM, given the **variety of local EM regulations, which do not always provide investors with the same safeguards as in developed markets**.

ESG credentials can affect creditworthiness

Credit rating agencies are increasingly recognising the importance of ESG factors in assessing an issuer's creditworthiness. **Both Moody's and S&P Global Ratings are signatories of the UN PRI** (Principle for Responsible Investment) **statement on "ESG in Credit Ratings".**

In a recent report[6], Standard and Poor's noted that "*Environmental, social, and governance (ESG) risks and opportunities can affect the capacity and willingness of an entity to meet its financial commitments… [S&P's] management and governance assessment includes consideration of environmental and social risk management, as relevant. At the industry level, we also consider industry-specific key credit factors which may include the effectiveness of ESG risk management.*"

S&P has also indicated that over the last two years to August 2017, environmental and climate (E&C) considerations affected 717 corporate ratings, and resulted in a direct rating impact (e.g. upgrade or downgrade) in 106 cases. This marked a significant increase compared to their previous study of October 2015 where E&C criteria had affected only 299 ratings and resulted in 56 rating actions.

Similarly, Moody's explains that "*for corporates [they] seek to assess how ESG issues influence drivers of credit quality, such as demand for products, reputation or costs of production.*"[7]

Given that consequences of environmental disasters tend to be greater in EM countries, due to factors such as wider inequalities, the higher share of the agriculture sector, looser health & safety norms or lower insurance coverage, the integration of E&C considerations will likely affect more EM issuers' ratings. For instance, S&P notes that "*although climate change poses a negligible direct risk to sovereign ratings on advanced economies, on average, ratings on many emerging sovereigns (specifically those in the Caribbean or Southeast Asia) would likely come under significant additional pressure over time.*"[6]

Which ESG criteria are the most relevant to EM credit performance?

The coverage of EM fixed income issuers by ESG rating providers is fairly recent. Academic research is thus still limited. However, given the now extensive research covering the effects of ESG factors on the performance of DM equity and fixed income and on EM equity markets, it seems reasonable to infer that:

- For EM issuers, as for DM ones, high sustainability practices are likely positively correlated with lower cost of capital;[8]
- ESG considerations should bring more **sustainable performance** over the longer term, in both EM equity as well as EM fixed income markets;
- ESG analysis is particularly useful as a means to **mitigate tail risks**;
- Overall ESG ratings, in isolation, may not be the best predictor of a corporate's spread levels. A **detailed understanding of its ESG practices**, taking into consideration the ESG credentials of the country(-ies) and sector(s) in which it operates, is likely needed;
- For EM corporates, **governance and environmental** (G&E) factors seem to have a greater impact on equity performance than social ones. Anecdotal evidence shows that G&E are also more likely to influence an issuer's cost of financing (hence the spread of its bonds).

[6] How does S&P Global Ratings incorporate Environmental, Social and Governance risks into its rating analysis – 21/11/17

[7] Moody's ratings incorporate ESG considerations with material credit implications – 25/10/17

[8] Evaluating the relationship between ESG and corporate fixed income – Clubb, Takahashi & Tiburzo – Breckinridge Capital Advisors and MIT Management Sloan School of Management – Spring 2016

Sustainable EM corporate debt is the new Responsible Investment opportunity

In reality, with globalisation, EM corporate issuers' business practices have already come closer to that of their peers in developed markets. For instance, the need to access international financing has led them to gradually adopt similar transparency and accounting disclosure requirements.

Similar trends exist for ESG practices (though with a lag). One reason is that many EM corporate issuers are in fact global players; hence they have to adopt early on changes in international business standards, like DM companies.

As investors' demand for RI increases, more and more EM issuers are being incentivised to adopt sounder ESG policies and to disclose extra financial data more broadly.

We thus believe that there are already enough EM companies mindful of ESG issues, or generating positive social or environmental impact, to construct viable and diversified portfolios of EM corporate issuers. Moreover, this ESG-compliant investable universe should continue to widen as more and more EM corporate issuers adopt higher ESG standards to meet investors' requirements as well as to comply with stricter environmental or social regulations in their countries.

This in turn should lead to sounder EM business operations, a reduction in tail risks, and superior and more sustainable risk-adjusted investment returns for those EM credit portfolios which integrate ESG factors in their selection process.

As emerging market fundamentals continue to improve, we believe that this constitutes an attractive and diversifying opportunity for Responsible Investors.

Karine Jesiolowski

Senior Investment Specialist - Emerging Fixed Income
Member of UBP ESG Committee
karine.jesiolowski@ubp.ch

Union Bancaire Privée, UBP SA
Asset Management Division

Disclaimer

This is a marketing document and is intended for informational and/or marketing purposes only. This document is confidential and is intended only for the use of the person(s) to whom it was delivered. This document may not be reproduced (in whole or in part) or delivered, given, sent or in anyotherway made accessible, to any other person without the prior written approval of Union Bancaire Privée, UBP SA or any entity of the UBP Group ("UBP"). This document reflects the opinion of UBP as of the date of issue.

This document is for distribution only to persons who are Qualified Investors in Switzerland or Professional Clients, Eligible Counterparties or equivalent category of investors as defined by the relevant laws (all such persons together being referred to as "relevant persons").This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. It is not intended for distribution, publication, or use, in whole or in part, in any jurisdiction where such distribution, publication, or use would be unlawful, nor is it directed to any person or entity to which it would be unlawful to direct such a document. In particular, this document may not be distributed in the United States of America and/or to US Persons (including US citizens residing outside the United States of America).

This document has not been produced by UBP's financial analysts and is not to be considered as financial research. It is not subject to any guidelines on financial research and independence of financial analysis.

Reasonable efforts have been made to ensure that the content of this document is based on information and data obtained from reliable sources. However, UBP has not verified the information from third sources in this document and does not guarantee its accuracy or completeness. UBP accepts no liability whatsoever and makes no representation, warranty or undertaking, express or implied, for any information, projections or any of the opinions contained herein or for any errors, omissions or misstatements. The information contained herein is subject to change without prior notice. UBP gives no undertaking to update this document or to correct any inaccuracies in it which may become apparent.

This document may refer to the past performance of investment interests. **Past performance is not a guide to current or future results.** The value of investment interests can fall as well as rise. Any capital invested may be at risk and you may not get back some or all of your original capital. In addition, any performance data included in this document does not take into account fees and expenses charged on issuance and redemption of securities nor any taxes that may be levied. Changes in exchange rates may cause increases or decreases in your return.

All statements other than statements of historical fact in this document are "forward-looking statements". Forward-looking statements are not guarantees of future performance. The financial projections included in this document do not represent forecasts or budgets, but are purely illustrative examples based on a series of current expectations and assumptions which may not eventuate. The actual performance, results, financial condition and prospects of an investment interest may differ materially from those expressed or implied by the forward-looking statements in this document as the projected or targeted returns are inherently subject to significant economic, market and other uncertainties that may adversely affect performance. UBP disclaims any obligation to update any forward-looking statement, as a result of new information, future events or otherwise.

It should not be construed as advice or any form of recommendation to purchase or sell any security or funds. It does not replace a prospectus or any other legal documents that can be obtained free of charge from the registered office of a fund or from UBP. The opinions herein do not take into account individual investors' circumstances, objectives, or needs. Each investor must make his/her own independent decision regarding any securities or financial instruments mentioned herein and should independently determine the merits or suitability of any investment. In addition, the tax treatment of any investment in the fund(s) mentioned herein depends on each individual investor's circumstances. Investors are invited to read carefully the risk warnings and the regulations set out in the prospectus or other legal documents and are advised to seek professional advice from their financial, legal and tax advisors.

The tax treatment of any investment in the Fund depends on your individual circumstances and may be subject to change in the future.

The document neither constitutes an offer nor a solicitation to buy, subscribe for or sell any currency, funds, product or financial instrument, make any investment, or participate in any particular trading strategy in any jurisdiction where such an offer or solicitation would not be authorised, or to any person to whom it would be unlawful to make such an offer or invitation.

Telephone calls to the telephone number stated in this presentation may be recorded. When calling this number, UBP will assume that you consent to this recording.

UBP is authorised and regulated in Switzerland by the Swiss Financial Market Supervisory Authority and is authorised in the United Kingdom by the Prudential Regulation Authority. UBP is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority.

MSCI
Although Union Bancaire Privée, UBP SA information providers, including without limitation, MSCI ESG Research LLC and its affiliates (the "ESG Parties"), obtain information from sources they consider reliable, none of the ESG Parties warrants or guarantees the originality, accuracy and/or completeness of any data herein. None of the ESG Parties makes any express or implied warranties of any kind, and the ESG Parties hereby expressly disclaim all warranties of merchantability and fitness for a particular purpose, with respect to any data herein. None of the ESG Parties shall have any liability for any errors or omissions in connection with any data herein. Further, without limiting any of the foregoing, in no event shall any of the ESG Parties have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.