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NORDSIP
NORDIC SUSTAINABLE INVESTMENTS

# insights


# INVESTING SUSTAINABLY IN EMERGING MARKETS

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# the editor's word

*Not for the fainthearted*

Investing in emerging markets can easily be summed up in two words: potential and risk. Yes, the prospects can be dazzling in those fast-growing places, densely populated with entrepreneurs and consumers, rich in resources and opportunities. Yet, there are plenty of challenges, too, not least for investors with sustainability high on the agenda. Those who enter the space are in danger of losing not only their money but also their reputation if things go wrong.

In this edition of NordSIP Insights, we explore both the potential and the multifaceted risks that investors encounter upon venturing into emerging and frontier markets, ESG lens in hand. With the help of experts and veterans in the field, we try to untangle a dense and intertwined jungle of related topics: from public and private equities, sovereign and corporate debt, to microfinance and impact investing.

The experienced investors contributing to this publication take us on an adventurous trip to some remote corners of the world, from Nicaragua to Saudi Arabia, from Burkina Faso to Ukraine and from Pakistan to Haiti. They share fascinating case studies and examples of investments that change peoples' lives. They describe eloquently the many reasons for financing sustainable solutions where they are needed the most. Many of them argue that we should all be embracing the motto "Leave no man behind," if only out of a sense for self-preservation in an increasingly global world.

We also look at how the wave of greenwashing, another global phenomenon, manifests itself in emerging markets. Unfortunately, the lack of homogeneity in green regulation and the abundant corruption in many of these markets seem to provide perfect conditions for this type of financial weeds.

COVID19 is inevitably on the mind of investors and pops up in most of the interviews. Whether surprised by the developing countries' enviable resilience in the face of the pandemics or lamenting its devastating effects on the world's poorest nations, the investors we talk to seem to agree on one point: the opportunity to transform the world into a more sustainable version of itself.

Aline Reichenberg Gustafsson, CFA

Editor-in-Chief

NordSIP

Credit: Andrey Yalansky via Twenty20

*Emerging Market Debt*

# Filling the ESG Data Gaps

*by* Filipe Albuquerque

*"The first challenge is the eternal conundrum that countries in the earliest development stages tend to have the biggest financing gaps. Investors don't always appreciate what these countries are doing to improve their status."*

Marcin Adamczyk
Head of Emerging Market Debt
NN Investment Partners

Edith Siermann
Head of Fixed Income Solutions & Responsible Investing
NN Investment Partners

Although the returns are often appealing, sorting the wheat from the chaff in emerging markets is a particularly difficult endeavour. While ESG factors can assist investors in their selection process, the prevalent lack or incompleteness of data in emerging markets complicates the task faced by sustainable investors.

To understand how such hurdles can be overcome, NordSIP reached out to Marcin Adamczyk, head of emerging market debt, and Edith Siermann, Head of Fixed Income Solutions & Responsible Investing at NN Investment Partners (NN IP), the asset management arm of Dutch insurance company NN Group.

**RI Strategies that make sense**

Siermann joined NN IP at the start of 2019 and has more than 25 years of asset management industry experience in senior positions in the financial industry, including spending the last decade leading ESG integration in different financial organisations.

"One of the goals of my career was to promote ESG integration. To a large extent, my role at NN IP is to help our team incorporate and develop how we apply these factors to NN IP's investment decisions in a way that makes sense both from an investment point of view as well as from a real-world perspective," Siermann explains.

"Reporting $CO_2$ emissions of a portfolio is one way to try to show ESG integration. However, that number itself is backward-looking and tells me very little about the plans of the company or country," she adds. "Using several indicators can be useful, but that does not automatically translate into an investment strategy. At NN IP our goal is to create responsible investment strategies that make sense and lead to tangible outcomes, both financially and non-financially."

According to Adamczyk, EMs are changing quickly and most countries have been adapting to the rise of sustainable concerns. "It's tough to put a regional stamp on it. Some regions might lag on certain aspects, but the reality can be surprising". As an example, he points to China's 2060 carbon neutrality target, and the rapid expansion of its green bond market. Adamczyk identifies three challenges in emerging market: financing gaps, data and sorting.

**Focus on the journey**

"The first challenge is the eternal conundrum that countries in the earliest development stages tend to have the biggest financing gaps," Adamczyk says. "Investors don't always appreciate what these countries are doing to improve their status. They need capital to reach social development goals, such as becoming safer, providing better education, and improving access to fresh and clean water."


EM asset managers need to use an analytical approach that takes these specific conditions into account when considering their options. "We've found that the key to investing in emerging markets is to focus on the journey," he says. "The focus should be on the path a country is on as well as where things stand today. Otherwise, simply excluding these countries denies them the capital they need to continue improving."

"At NN IP, we look at the improvement or deterioration of the ESG ratings. A static approach narrows down the universe of potential investment opportunities and limits diversification," Adamczyk explains.

### Emerging market data concerns

"The second challenge is that available data is often old, backward-looking, or plagued with missing values. Again, tackling this comes down to building the right frameworks that can handle this data carefully and provide confidence in their explanatory power," Adamczyk explains. Frequent analysis is also crucial. "If you review only at yearly or two-year intervals, you deprive yourself of opportunities that are arising now or will arise soon."

"You also constrain yourself from rewarding countries that are taking steps now, as opposed to three or five years ago," he says. Beyond integrating ESG analysis via proprietary stability and development scores into its quarterly assessments, NN IP's regional EMD portfolio managers also conduct a weekly ESG assessment for all EM countries in its universe. A big data tool is one of the inputs they use for their weekly ESG assessment.

Adamczyk adds that "the quantity of data isn't necessarily the issue." Thanks to investor demand for increased transparency and to the efforts of multilateral organisations like the World Bank (WB) and IMF "countries are becoming more willing to disclose, and data is becoming much more accessible. "The issue is not the amount of emerging market data, but rather its quality and the ability of asset managers to analyse it and reach the right conclusions," Adamczyk adds.

NN IP's view is that what matters is the ability "to assess the data and draw comparisons between countries to reward countries that are making progress and take a more cautious approach to those that are deteriorating." According to Adamczyk the value-added of experienced managers is in their ability to identify "the common denominator in all the data and make it usable in a forward-looking manner." Data from the WB is a good starting point, but it needs to be enhanced with more frequent assessments. "That's where experience and quality of management come in," Adamczyk adds.

### Finding the common denominator

The last challenge facing emerging market investors is the difficulty of finding a common denominator in an investment universe that includes countries as different as Brazil, China, Egypt, Indonesia, India, Mexico, Morocco, Pakistan, Poland or Russia. NN IP's solution was to develop an in-house ecosystem of data solutions and analysis to help it sort the wheat from the chaff.

"The advantage of developing our own proprietary model is twofold. First, we can ensure that the model fits well with your established investment process. Second, we can adapt more quickly to a changing world. In this environment you need to be able to adjust and enhance your framework quickly, rather than relying on an index provider that is slower to react and that uses a one-size-fits-all approach," Adamczyk explains.

### The NN IP analytical eco-system

NN IP's analytical ecosystem covers both EM sovereigns and EM corporates. At the sovereign level, the asset manager operates an EM Sovereign risk model that fully integrates the NN IP ESG Lens to calculate a proprietary country score for all of the over 80 countries that make up the EM investment universe. "The ESG Lens is made up of a Development Score, which captures traditional ESG factors and is geared towards the long term, and a Stability Score, which captures the potential impact of ESG risks as well as mitigating factors that may be in place," Adamczyk explains.

"In our investment process, we use a mix of macroeconomic factors and the ESG Lens to predict sovereign risks, as captured by yield spreads. The inclusion of the Stability and Development scores actually increases the model's predictive power, especially for high-yielding countries. This is intuitive because investing in EMs works best in the medium term", Adamczyk tells NordSIP. "You need to be able to identify risks and be mindful of whether the country can handle those risks."

At the corporate level, NN IP is interested in incorporating ESG insights to identify companies' material risks and reveal how well they are being managed. The corporate framework works in a similar way to the sovereign framework, it applies the ESG Lens for corporate analysis. For each company, the granular ESG information is translated into an ESG Lens score between 0 and 100, based on NN IP's sector-specific materiality framework.

According to Siermann, the problem for corporates issued in Emerging Markets is that data is extremely incomplete. "52% of the data is missing for the investment universe," she tells NordSIP. To overcome this problem, Adamczyk and Siermann can rely on the work of NN IP's Innovation & Responsible Investing which have developed a model for filling in the sustainable data gaps for emerging market borrowers.

### ESG-net

Faced with missing values, investors can either ignore the dataset, or replace the missing values with estimates. However, the options for replacing values are normally not very appealing, involving the use of averages from the dataset or the industry. To resolve this issue, NN IP's EMD investment team collaborated with the investment scientists from its Innovation & Responsible Investing platform to build a solution that can intelligently estimate data points using a neural networks approach: ESG-Net.

The ESG-Net estimation process for missing data takes a two-step approach. First, it teaches the model what the relationships are within the dataset. Neural networks are particularly well-suited to identifying non-linear relationships, and can be trained quickly to identify complex patterns hidden in the data. For example, if it is available, the model can use existing data on bribery and corruption risk to predict a variable like business ethics score based on the relationships estimated across the rest of the dataset. This methodology allows NN IP to fill in all originally missing ESG inputs with estimated values.

In the second step, NN IP uses a similar neural network to estimate top-level ESG scores. The Dutch asset manager uses this model to predict ESG scores for the companies which had been removed from the dataset and then compares the network's prediction of the ESG score and the actual score. This comparison also allows NN IP to estimate its model's error. The process is repeated several times to get a robust estimate of the distribution of estimation errors.

According to NN IP, the distribution of the estimation error does not have fat tails: the average estimation error of ESG-Net is relatively low at 5.8%, while at the same time the estimated ESG score was less than 18 percentage points away from the actual score in 95% of cases.

Operating in this analytical ecosystem is an advantage for NN IP. "The EMD team can combine the ESG Lens scores and the predicted scores from ESG-Net to understand the material risks they are facing and make better investments decisions," Siermann explains.

### Looking ahead

Going forward, Siermann hopes to shine some light on the sustainability analysis of sovereigns. "We are putting a lot of focus on the sovereign side, which is very important for EMD investors but is not as developed as ESG integration on the corporate or on the equity side. There is no reason for this. Sovereign issuers are a very important part of the fixed income market," Siermann says.

"A lot of work remains to be done in the sovereign space, both in terms of the broader ESG data as well as climate, which is an area high on the agenda of governments and regulators. Sovereigns play an enormously important role in this field," she explains.

Siermann hopes to extend the use of big data sources and statistical techniques to the ESG Lens. "Our goal is to extend the range of tools at our disposal to stimulate and continue to enhance the responsible investment insights we are able to gain about the market," Siermann adds.

"At the moment, corporates are the main focus of climate investment strategies, not sovereigns, because there are no mandatory reporting requirements for sovereign institutions. This leads to questions like: how do we assess the climate footprint of a sovereign? Do we focus on the whole country or just what is directly attributable to specific sovereign organisations? Regulations, such as the EU Taxonomy or Sustainable Finance Disclosures Regulation, focus also exclusively on corporates. We believe there's a lot to gain here, hence is why we are focusing on making progress in this area," Siermann adds.

"We have a very loyal client base that has been investing in our EMD strategies for over 20 years, which also includes Nordic institutional investors," says Siermann. "We believe our innovative way to integrate ESG factors, and the flexibility it provides us to tailor solutions to our clients' needs will further strengthen our relationships with investors in the Nordic region. Going forward, we expect to continue to expand our EMD footprint across the region by continuing the intimate dialogue with institutional investors and provide solutions that aid them in reaching their objectives," she concludes.

Credit:Usukhbayar Gankhuyag on Unsplash

# Powerful potential

## *Financing renewable energy in emerging markets*

*by* Angeles Toledo Rodriguez and Greig Blackie

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**The urgency, the underlying trends, and the benefits to your investment portfolio**

Emerging markets and developing countries are facing a dual challenge. On the one hand, they are particularly vulnerable to climate change, lacking the financial power to prevent or adequately respond to the impacts of climate change.

On the other hand, a dependable and affordable energy supply is crucial to further socio-economic development. Many countries have underdeveloped energy systems that can scarcely cope with today's demand, let alone with increased demand in the future. Close to a billion people worldwide have no access to energy at all, especially in sub-Saharan Africa. At the same time, the population of emerging economies is expected to increase by a further 30% (around 1.8 billion people) by 2050 1.

Emerging markets are an increasingly important factor on the global energy market. Between 2019 and 2030 it is expected that the strongest growth in power demand will come from non-OECD countries, due to population growth, economic development, and current electricity deficit.

**An interesting business case**

Switching to renewable energy sources enables countries to strengthen their energy security and achieve greater independence by harnessing the vast local renewable energy sources that are available. Democratisation of energy through decentralisation of production and distribution is a powerful element in the energy transition. Energy is produced where it is consumed, allowing users such as companies and local communities to gain direct access, thus diminishing their dependence on an unreliable grid or the government and fostering their social-economic development.

Technological innovation and cost reductions have contributed to a faster growth in renewables than any other energy source in recent years. Along with innovative business and financing models, this has created momentum to boost clean, scalable energy solutions in emerging markets, further stimulated by the increasing demand for energy.

**Interesting impact, risk and return characteristics**

These trends indeed build a strong business case for investing in renewable energy in emerging countries, from the triple perspective of impact, risk and return. Fund managers Angeles Toledo Rodriguez (winner of the Women Powering Smart Energy Awards 2021) and Greig Blackie share their insights.

"Financing renewable energy in emerging markets requires expertise, experience and a strong network. At Triodos Investment Management we have all three, built up in many years investing in many different projects", says Angeles Toledo. "By investing in renewable energy in emerging markets we generate triple impact with each investment: we stimulate social and economic development and we contribute to a sustainable energy transition."

Do you want to learn more how investing in Renewable Energy in Emerging Markets benefits your portfolio? Download the strategy paper here.

**Thorough risk assessment**

"Investing comes with risks. Systemic risks, either economic or political, are inherent in investing in emerging markets. The environmental and social risks also need a careful assessment, especially those of utility-scale projects", explains Toledo. "Possible negative impacts must always be compensated, for example by replanting trees or relocating people, or by making sure that communities directly benefit from the project."

"For us, the environmental and social risk assessment is extremely important. There is more needed than simply doing your homework if you intend to have a positive impact on local communities", adds Blackie. In addition to applying strict ESG criteria, we aim to achieve this positive impact by both improving the access to affordable energy – which is our priority - and by identifying potential development opportunities, together with the developer or owner of the project, which bring social and economic benefits to the community."

**Investment instruments and the role of trust in a good network**

"It is crucial to have knowledge about the renewable energy markets in emerging countries - for example about fall-back scenarios or insurances when a client cannot pay back the loan - and have a strong network of trusted partners", continues Toledo. "This is not something you can build up overnight. We have a track record of more than 20 years of financing projects in emerging countries and more than 30 years in financing renewable energy projects. This combined knowledge is firmly anchored in our funds and in every transaction we do.

"As we usually enter a contract for at least 15 years, we agree on a set price with the off taker of the energy", Toledo continues. "This is usually the national electricity company, owned or backed by the government. Working with a good network of trusted partners we enjoy strong structures and negotiation power should it be needed. To mitigate currency risks, we always hedge our positions in local currencies. In addition, some of the institutions benefit from a preferred creditor status, which also benefits us when cooperating with them. The combination of a well-balanced portfolio across technologies, financial instruments and geographies results in an acceptable risk profile and a solid return for investors."

Do you want to learn more on the investment instruments use in investing in renewable Energy in Emerging Markets? Download the strategy paper here.

**Make a difference**

"But most importantly: we must walk the talk. It is one thing to talk about urgency and opportunities, but we must also act", concludes Blackie. "Nearly 40 years ago, in the early 80s, we financed the first wind turbines in the Netherlands, and today we are still a pioneer in the energy transition. It is now time to increase our impact on financing the energy transition in emerging markets and inspire others to join us and unlock more funding."

This article is part of a detailed strategy paper on investing in Renewable Energy in Emerging Markets. The full version can be downloaded here.



# Decentralised generation of clean energy

## *Run-of-the river hydropower in Nicaragua*

Credit: Triodos Investment Management

Nicaragua has made huge progress in improving its energy supply. The electrification rate of the country has increased from less than 50% in 2002 to around 95% in 2018. Compared to other countries in the region, however, this is still relatively low. Especially in remote, rural areas where sometimes less than 40% of people have access to electricity. The country is committed to further improve its energy system by increasing the share of renewable energy in the energy mix. By 2030, renewables should represent 73% of total capacity installed.

In this dual ambition, private initiatives play an important role. One such initiative is the San Martín hydroelectric plant. This is a typical small-scale, 6 MW run-of-the-river hydro project with a dam of around 18 meters high to capture water in a small lake. While maintaining an ecological flow in the original riverbed, water is led through a buried 'penstock' (steel pipe) to the turbine house three kilometres further downstream (and 82 meters lower), where it passes through the turbines and back to the riverbed. The electricity generated is around 26 GWh per year. This is equivalent to the consumption of around 43,000 households, based on a monthly average use of 600 KWh. The electricity is delivered to the grid through transmission lines that feed into the substation of the distribution company.

Generating clean energy, the hydroelectric plant contributes to countering climate change by saving up to 20,000 tons of $CO_2$ emissions per year. The energy it produces is a direct substitution for imported heavy fuel which is utilised in outdated plants; the project is the equivalent of 2,000 tonnes of oil-equivalent per annum. The project also increases the reliability of energy supply by adding decentralised generation capacity to the system, facilitating distribution expansion in the poor and remote area where the project is located.

More investment examples can be found in our strategy paper on investing in Renewable Energy in Emerging Markets. The full version can be downloaded here.

# Emerging Market Debt

## *An unbiased approach*

*by* Barney Goodchild and Aaron Greham

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*An unbiased and flexible approach, deep understanding of risk, and robust portfolio construction are the keys to delivering consistent outperformance in emerging market debt strategies.*

Emerging market debt (EMD) can offer significant returns, but has historically been susceptible to periods of increased volatility and rapid spread widening, as recently witnessed during the initial economic and market fallout from the COVID-19 pandemic. During these periods, many active managers struggle to outperform their benchmarks. As shown below, when the JP Morgan EMBI Global Index declined 4.6 per cent in 2018, 66 per cent of managers underperformed. Similarly, when the index fell 1.9 per cent in the first six months of 2020, more than 70 per cent of managers lagged the index.

An analogous pattern emerges when we look at significant monthly drawdowns. In one of the most turbulent months during the global financial crisis, October 2008, the index fell 14.9 per cent and 82 per cent of managers underperformed. More recently, 94 per cent of managers underperformed when the benchmark declined 12.6 per cent in March this year as the economic impact of strict lockdown measures became clear* (Source: eVestment Global Emerging Market Debt Hard Currency Universe).

We believe there are three main reasons many managers fail to outperform during periods of market weakness:

1. A structural bias towards the higher-yielding parts of the EMD market;
2. A poor understanding of EM-specific risk factors and overreliance on traditional risk metrics;
3. Deficiencies in portfolio construction that leads to concentrated portfolios and overreliance on credit spread compression.



Index Returns vs. Peer Group Performance

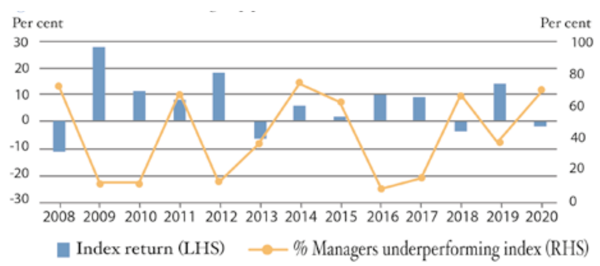
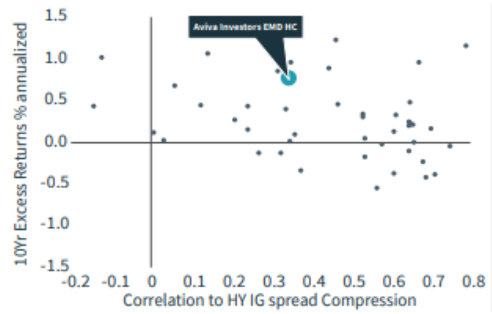



Chart does not depict performance of any Aviva product or strategy
Source: Aviva Investors, eVestment as at June 30, 2020. Index returns: JP Morgan EMBI Global Index, Peers are from the eVestment Global Emerging Markets Hard Currency benchmarked to the EMBI Global or Global Diversified Index.

Uncorrelated alpha




**Past performance is not a guide to future performance.**
Aviva Investors performance is based on Aviva Investors Emerging Market Bond composite
Source: Aviva Investors, JP Morgan, as at June 30, 2020. Index returns based on the JP Morgan EMBI Global Investment Grade and EMBI Global High Yield Indexes. Based on 10 yrs of monthly data. Peers from the eVestment Emerging Markets hard Currency universe.

A failure to fully consider these factors is likely to lead to higher drawdowns and increased volatility of excess returns over the long run. In this article, we examine the key elements of our approach to investing in EMD, which we believe are crucial to delivering superior outcomes for clients. These include uncorrelated alpha, a smoother return path and robust portfolio construction to drive consistent outperformance.

### A differentiated approach to emerging market debt

Emerging markets are typically less efficient than their developed market counterparts. In our view, alpha opportunities are created by the breadth and diversity of an under-researched and under-reported universe. Our approach to generating consistent outperformance in this market is underpinned by the three core pillars detailed below.

### 1. Unbiased, flexible process to generate uncorrelated alpha

The EM hard-currency debt universe is split approximately 60/40 between investment-grade and high-yield issuers. Our analysis of the EMD hard-currency peer universe suggests most managers have a structural bias towards higher-yielding parts of the market.

Whilst this can be profitable at certain points in the cycle, over the long run it is likely to lead to higher drawdowns and increased volatility of returns. Periods like Q4 2018 and Q1 2020 are particularly good examples of when a high-beta approach to the asset class can be costly.

We take a different approach. We believe attractive investment opportunities exist across the investable universe, not only within the higher-yielding parts of the market. Our approach considers the full opportunity set without bias, resulting in flexible positioning between the high-yield and investment-grade portions of the market.

The result: Alpha generation that has historically been uncorrelated to spread differentials between high yield and investment grade.

Ultimately, our ability to generate alpha is less dependent on high yield spread compression. We generate alpha from active country selection decisions, not broad-based beta allocations.

### 2. Deep understanding of EMD risk fosters capital preservation and smooth return path

As an asset class, EMD offers potentially attractive returns; however, different markets can exhibit periods of high volatility and idiosyncratic risk that are difficult to capture within traditional risk measures.

Tracking error is one such example. The measure is widely used by portfolio managers and Investment managers to understand the levels of risk within a portfolio. However, it has several serious limitations that we believe make it a poor risk metric:

- **Fails to measure risk of loss:** Tracking error measures the deviation from a benchmark rather than the risk of loss. If a benchmark index is inefficient, deviations from the benchmark should be beneficial by reducing risk or improving portfolio returns. Too often, however, deviation from a benchmark is viewed as "taking risk" rather than reducing it or improving risk-adjusted returns.
- **Engenders forced ownership:** Investment Managers and consultants often focus on tracking error as a measure of the degree to which a portfolio is active. Strategies with low historical levels of tracking error are often labeled as "closet trackers" or "semi-passive." This forces managers to add risk or off-benchmark positions as a means to appear sufficiently active.
- **Incorrectly assumes more risk leads to excess returns:** In some asset classes, such as US investment-grade credit, a strong correlation exists between tracking error and excess returns.

This suggests that adding risk on average improves manager returns. Our analysis, however, indicates there is no correlation between tracking error and excess returns for EMD hard-currency managers. This is likely to be the result of higher downside risks.

We focus on variety of risk measures, such as duration times spread, alongside a deep understanding of EM-specific risks built over decades of experience. Our process is not predicated upon a foundation of imperfect metrics. We believe this is a critical differentiating factor in our ability to deliver superior client outcomes. It is also important to consider non-financial risks, such as environmental, social and governance factors. These can highlight risks and opportunities that would not be captured by quantitative risk metrics or traditional fundamental analysis.

An in-depth understanding of EM risk is embedded throughout our investment process, which is centered around fundamental analysis. Through this, we believe we are able to thoroughly assess an issuer's risks to determine if we will be compensated accordingly.

We draw on a blend of quantitative and qualitative analysis to assess an issuer's ability and willingness to repay debt, their vulnerability to external shocks, and the ability of the authorities to take appropriate action if required.

3. **Focused portfolio construction can drive consistent outperformance**

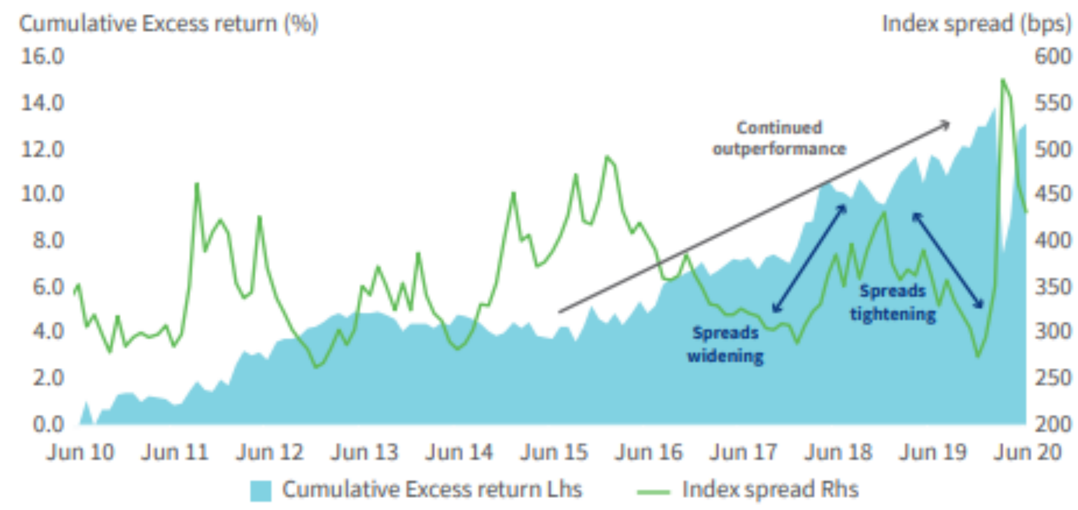
Robust portfolio construction is essential to transforming good ideas into portfolios that meet clients' risk and return objectives, as well as constraints. Our process is focused on maximising risk-adjusted returns rather than total returns. We target the most attractive opportunities irrespective of credit rating.

In order to build a high-conviction portfolio, we are benchmark agnostic at the issuer level, which allows us to concentrate on countries that are meaningful from a risk/reward perspective at the total portfolio level. While the EMBI Global universe is defined by 74 countries, as at 30 June 2020, the portfolio will typically have exposure to only around two-thirds of that total, with 15-20 positions driving risk contributions at a portfolio level.

To help strike the right balance between long-term and short-term opportunities, we break down the portfolio into core, active and tactical positions. This seeks to ensure capital is allocated to credits that offer improving prospects across a diversified universe with an appropriate blend of opportunities to maximise risk-adjusted return.

| | |
|---|---|
| Core (75 per cent) Long-term holdings<br>• Stable and/or improving credit stories throughout the business cycle.<br>• Credit selection driven by deep understanding of fundamentals.<br>• No fromal exit price, but rather a continuous assesment of the original investment thesis | Example: Ukraine<br>• Ukraine has been a favored high yield overweight since February 2019.<br>• Following elections mid-2019, Ukraine' s credit metrics had improved materially relative to "B"-rated peers under an earlier IMF programme, a trend we expect to continue.<br>• Despite the COVID-19 crisis, we maintain our positive fundamental view on Ukraine. We believe it has an above-average capacity to cope with the ensuing economic challenges.<br>• Key strengths include low debt and interest cost, as well as a moderate current account deficit.<br>• In our view, Ukraine's governance is above average compared to "B"-rated peers, and has been improving in recent years. |
| Active (20 per cent) Medium-term holdings<br>• Relative-value driven selection of alpha opportunities.<br>• Expectation currrent valuations offer potential attractive returns.<br>• Clear exit price ot "valuation target" outline at time of purchase. | Example: Romania<br>• Fundamentals in Romania were already on a worsening trajectory pre COVID-10, and will certainly deteriorate further down the road. But there is light at the end of the tunnel: The EU recovery fund, has provided a significant stabilising factor with Romania expected to receive about €80bn in support for the Romanian economy.<br>• The moderate debt to GDP ratio also buys Romania some time.<br>• The Political landscape has already shifted and a more pro-market government with stable parliament majority is likely to take over after elections. |
| Tactical (five per cent) Short-term holdings<br>• Tactical positions that take advantage of mispriced securities.<br>• Exit strategy outlined at time of purchase. | Example: US Treasuries<br>• Tactical use of US treasuries to isolate interest rate component of EM hard currency returns.<br>• Can be used as an alternative to low spread EM issuers that are less liquid and more volatile in risk of periods.<br>• Direct beneficiary of extremely accommodative global monetary policy. |

Aviva Investors Emerging Market Bond composite




**Past performance is not a guide to future performance.**
ASource: JP Morgan, as at June 30, 2020. ICummulative Excess returns vs JP Morgan EMBI Global Index. Based on 10 yrs of monthly data. Based on GIPS composite performance.

**The result:**

To recap, we believe there are three main reasons many managers fail to outperform in periods of market weakness:

1. A structural bias towards the higher-yielding parts of the EMD market;
2. A poor understanding of EM-specific risk factors; overreliance on traditional risk metrics; 3. Deficient portfolio construction that leads to concentrated portfolios and overreliance on credit spread compression.

By understanding and correcting for the biases and pitfalls, we believe we can deliver:

1. Alpha generation that is uncorrelated to spread differentials between high yield and investment grade;
2. Enhanced capital preservation and a smoother path of returns versus peers and the benchmark;
3. A differentiated process that can generate positive excess returns throughout market cycles without being overly reliant on a single source of alpha, such as credit beta.

For more information, download the whitepaper 'An unbiased approach to finding opportunities in emerging market debt'.


Contact Peik Wardi, Head of Nordics Institutional at Aviva Investors Tel +358 400 804 458.
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**Key Risks**

The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Investors may not get back the original amount invested.
Investments can be made in emerging markets. These markets may be volatile and carry higher risk than developed markets. Bond values are affected by changes in interest rates and the bond issuer's creditworthiness.
Bonds that offer the potential for a higher income typically have a greater risk of default. Investments can be made in derivatives, which can be complex and highly volatile. Derivatives may not perform as expected, meaning significant losses may be incurred.


Philipp Müller
CEO
BlueOrchard

*"There is so much demand for capital, scale is definitely achievable, mostly through a larger footprint and by targeting capital intensive asset classes."*

## *Impact & Microfinance*

# A Twenty-Year Journey

*by* Aline Reichenberg Gustafsson, CFA

The acceleration of sustainable investment and ESG practice ever since the Paris Agreement has been tremendous. While impact investment remains out of reach for too many investors, this emerging asset class is also experiencing somewhat of a boom of late. Philipp Müller, CEO at Swiss-headquartered impact pioneer manager BlueOrchard, part of the Schroders Group, tells us about the industry's journey on the occasion of the firm's 20th anniversary.

The history of BlueOrchard starts in 2001 when, by the United Nations' initiative, the firm became the first commercial manager of microfinance debt investments worldwide. "At the time, Kofi Annan was Secretary-General of the UN. He focused on how to implement solutions to the Millennium Development Goals, the predecessors to what we now know as the Sustainable Development Goals," Müller explains.

"In 2001, BlueOrchard was founded as the first commercial manager to join the existing initiatives organised by NGOs and specialised banks, such as Grameen, to help drive microfinance into the mainstream. Later other managers emerged or were spun out of BlueOrchard, and together we were able to prove the benefits for the end beneficiaries while building a very resilient track record. Meanwhile, we witnessed a professionalisation of the entire value chain, growing from the initial NGO-centric market to a more mature industry with regulations, credit bureaus and consumer protection agencies ensuring a safe space for both lenders and borrowers," Müller explains.

BlueOrchard soon widened its scope from its initial focus on microfinance to offer impact investment funds, deploying more capital to fund entrepreneurs in emerging and frontier markets. "Through both private equity and public and private debt, it was possible to scale up the deployment of capital that drives positive change in emerging and frontier markets," Müller continues. "It has been exciting to partner up with leading development finance institutions (DFIs) as well as work on dedicated mandates to advance particular themes. For example, we have been supporting female entrepreneurs. Another advantage of thematic funds is that they are

*"Since 2019, we are also very proud to have become part of the Schroders Group. Partnering with such a renowned global asset manager provides us with a tremendous opportunity to expand our reach and offering."*

attractive for investors who seek a direct impact that focused on their particular goals."

The most crucial development in the impact asset class is on the investor side. "The idea that there is a trade-off between doing something good and making money has been disproved. Larger investors with vast pools of capital are now accessing the space. It has taken a while, but we can finally accelerate impact investing," Müller says. "The financial system is moving at an increasingly rapid pace away from the 80's notion of 'greed is good'. The new generations also care a lot more than their parents about what money can achieve beyond pure financial profits. The Nordics, where society is more egalitarian, have always been far ahead. They provide an encouraging model for how market forces can be used for the greater good."

Lack of scale is a common obstacle for large investors entering into impact, but Müller dismisses this argument. "There is so much demand for capital, scale is definitely achievable, mostly through a larger footprint and by targeting capital intensive asset classes. On the bond side, there are many projects to be financed. There is a once-in-a-generation opportunity to finance infrastructure projects which are sustainable from the outset. When travelling to emerging markets, you immediately see the tremendous need for infrastructure. Anything from effective transportation means to renewable energy can drive lasting positive change both for the climate and for society, simultaneously. By nature, some projects will always be more niche, but that is not to say that investors can't find the scale they need to invest in impact," he says.

Climate insurance is one of the exciting opportunities BlueOrchard has been investing in. "Improving resilience for farmers is now possible thanks to parametric insurance. Today's technology that integrates weather observations with advanced data analysis allows much cheaper insurance. This is an exciting project where, together with DFIs, we are opening up new investment opportunities that could ultimately be very large and profitable. Here we can talk about additionality in several aspects," Müller explains.

"Climate change and increasing inequality are global challenges that need immediate attention. Even if impact investing has made significant strides and momentum is accelerating, it is not fast enough. These investment opportunities also need to be accessible to everyone, and it is not yet the case. People want it, but they can't invest because of regulation or other barriers. One of our top priorities is the democratisation of impact investing," he adds.

"Since 2019, we are also very proud to have become part of the Schroders Group. Partnering with such a renowned global asset manager provides us with a tremendous opportunity to expand our reach and offering. It also allows us to bring our know-how and impact management and assessment techniques to an asset manager that already overseas over half a trillion pounds in assets. Both these advantages perfectly meet our main goal, which is to make impact investment solutions accessible to all and to advance the conscious use of capital which benefits society and the environment," Müller continues.

At the moment, Schroders and BlueOrchard are collaborating to launch a climate change mitigation and adaptation investment strategy. Schroders is providing the initial capital and the investment network. "This is an important initiative, and we will definitely benefit from having Schroders's backing to reach our goal



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faster. The fact that a global firm like Schroders is focusing on impact shows a long-term vision which will truly benefit investors and the planet."

Müller, who has been with BlueOrchard since 2018, was well placed to take over the reins as CEO. "To join BlueOrchard was a no brainer for me," he comments. "I had been working in financial services for a long time, and I was ready to take on a new challenge aligned with my values where I could drive change at scale. I'm passionate about solving global issues, and I already knew that we need financially viable solutions to address them. Charity can support a cause, but in many cases it's a one-off. This works for many causes, but certain issues can benefit from an impact investment approach that can help to bring lasting change at scale. With BlueOrchard, I found a firm with an amazing track record and a large footprint, both geographically and in terms of its impact methodology."

At first, Müller was responsible for investment solutions, thereby influencing its product offering and asset allocation. In this role, Müller was often in contact with investors to understand their needs. "I got the opportunity to build an in-depth knowledge of our client base and their requirements. This way, I could help design and build attractive offerings to channel capital towards worthwhile investments. When the board asked me to take the reins as CEO, I didn't have to think twice. The appointment humbled me."

The timing could have been better, given that Müller took over as CEO just as the pandemic-related restrictions came in place. "I was working in Peru when things started getting serious," he remembers. "Since then, it's been tough not being able to travel far given that we have such a global presence, but I'm happy with how we have come together as an organisation to face the challenges."

"I'm proud of what the team has achieved," Müller continues. "We've had long workdays, most of us in the confinement of our own space, but we managed to synchronise our efforts and to reach our target effectively. When we saw the impact Covid was having on communities where governments couldn't deploy the types of rescue packages and the social safety net we have in our countries, we decided to secure 200 million jobs in those regions. We also worked hard to build out our platform to reinforce its resilience in times like these."

The case for microfinance is especially telling in times when financial markets are unstable. One of the main advantages of the asset class is its diversification effect. Müller explains why, despite the pandemic, the returns continue to be stable. "65 per cent of the portfolio of end borrowers are located in rural areas. Agriculture is an important sector, which means they are far less affected by global crises, even in a pandemic," he says. "People still need to get to the market to sell or buy fruits and vegetables, for example. There is no social security system that allows you to work from home, so life goes on. There are winners and losers, of course, and some institutions are more resilient than others, but mostly, in our markets they are sufficiently capitalised to weather extreme events. Health-related crisis, earthquakes or weather-related catastrophes are unfortunately not an exception in these regions, which means they have built resilience over time. Emerging markets are far less risky than some people think," Müller concludes.

Kiran Aziz,
Senior Analyst - Responsible Investments
KLP Asset Management

Credit: KLP Asset Management

*Responsible Ownership & Engagement*

# Saudi Arabia & Shipbreaking

*by* Filipe Albuquerque

The ability to help companies overcome developmental hurdles or leapfrog to the latest state-of-the art practices is one of the main appeals of emerging markets for sustainable investors. For institutional investors looking to make a difference through more in-depth interactions, emerging markets also present intricate engagement opportunities. NordSIP reached out to Kiran Aziz, Senior Analyst, Responsible Investments at KLP Asset Management, to understand how such dialogues work in practice and hear about the Norwegian pension fund's engagement efforts with Saudi Arabia and shipbreaking in Southeast Asia.

KLP is Norway's largest pension company, mainly owned by the municipalities and state health enterprises. "KLP's investments have a long-term perspective and the objective is to derive the best possible return on the pension funds and savings we invest. To enable KLP to increase the value of its investments over time, the underlying economic activity must be responsible and sustainable," Aziz says. "KLP has US$80 billion in assets under management (AUM) and passively follows the MSCI Index. We have invested in almost 10,000 companies across 70 countries. Our owners have clear and high expectations on how the pension money is invested, which is why KLP has been working with responsible investments for more than 20 years."

### Engagement Guidelines

"KLP's responsible investment activities are based on standards as UN Guiding Principles on Business and Human Rights (UNGP) and on the OECD's sector guide for institutional investor," Aziz explains. The latter document provides a common understanding of the responsibilities of institutional investors and how they can make due diligence assessments in a demanding and complex financial sector. "Over 50 different representatives with different backgrounds from the world's leading financial institutions, authorities and civil society and have contributed to the development of the guide," Aziz adds.

"The OECD's guide emphasizes that by conducting due diligence assessments in line with OECD guidelines and UNGP, investors will not only be able to avoid negative effects on people, society and the environment, but they will also be able to avoid financial risk and loss of reputation. The essence is that the investors have to do the due diligence assessment upfront and while the investment is part of the portfolio," she says.

### Saudi Arabia's on the Radar

According to Aziz, Saudi Arabia's market came on the radar of KLP when it entered the MSCI Emerging Markets Investable Market Index (IMI) in July 2019. "At that point Saudi Arabia was set to represent around 2.6% of the Index. The country's inclusion in the index means that a lot of investors, including KLP, should invest in the country if it belongs to a benchmark we are following. We provide tracker funds which include all index components that are not specifically excluded from our investment universe."

KLP decided to do a thorough assessment of the companies that were included in the index, due to its awareness of potential risks and the scarcity of public information. "We knew from the history of Saudi Arabia that there were potential human rights and women's rights issues, and it became clear that there was not enough available data during the due diligence on publicly available information. Because there is no free press in the country, information on these issues would not normally be available to the public," Aziz says.

### Ground Work in Saudi Arabia

As part of due diligence, and to overcome the aforementioned hurdles, the Norwegian pension fund decided to send its Responsible Investment team to Saudi Arabia to gather information on the ground. "The Responsible Investment team at KLP Asset Management engages with the investee companies and monitors the investments on a daily basis," says Aziz, one of the members of KLP's delegation to Saudi Arabia. "The information that we gather through contact with companies, forms a basis for the efficient and effective exercise of ownership rights. A lack of comprehensive and consistent reporting on environmental, social and governance issues, means that the company meetings are a good way to gather information that we need for further risk analysis."

In addition to meeting the relevant companies, KLP visited the stock exchange as well as local institutional investors that are already shareholders in Saudi Arabian companies. "Our main purpose was to understand where the companies stand on ESG. When KLP does human rights risk evaluations it looks at the responsibility of each company separately, distinguishing between their and the state's responsibility. However, the companies have to meet the pension fund's ethical criteria for investment," Aziz explains.

"Our dialogue took place at board and management level because KLP's expectations are normally addressed to those levels. The boards are responsible for ensuring accountability for company strategy, which in our view extends to the environmental and social consequences of company operations," she adds.

### Investment Considerations for Saudi Arabia

KLP's focus was on human rights risks, including labour rights. "It is important that the companies are responsible for ensuring that human rights are respected, not only in their own organisations but throughout their entire supply chain," Aziz says. "There is a lot of positive change in the country in terms of the position of women, with many companies having clear ambitions to increase women in the workplace and management. However, our conclusion was that from among the ESG factors, companies have focused most on governance, in general."

KLP has yet to make a decision on whether to invest and in which companies in Saudi Arabia including Aramco, the country's state owned oil company, the largest in the world according to last year's IPO. "We are still conducting a comprehensive evaluation of the investment opportunities. The final decision will be based on a risk assessment at the country, sector and company level. KLP has ambitious climate targets and has excluded coal and oil-sands companies from its investments. If we decide to invest in some Saudi Arabian companies, we will be very clear about our expectations that the companies need to have clear goals to improve the ESG performance and contribute to a positive change in the country."

"Positive change lies at the heart of KLP's strategy. Active ownership via stewardship, engagement and ultimately exclusions allows a large passive allocator such as ourselves to integrate ESG. Our strategy is based on openness and transparency. It is designed to build global attention around 'high risk industries' and the 'worst offenders' as well as put new issues in centre stage. For us it is important to draw a line between what is acceptable and what is not. It is a small effort to raise the bar."

**Shipbreaking and its Risks**

The other topic on KLP's emerging market engagement agenda is shipbreaking, the practice of taking apart commercial sea-faring ships at the end of their life cycle, including tankers and container carriers. Beaching, the controversial practice of dismantling ships in the tidal zone without appropriate oversight and minimal or no protective gear for the workers involved, is one of the risks inherent to the shipping industry.

"Shipbreaking has been on KLP's agenda for many years. Our goal is to work towards a future where responsible shipbreaking is the industry standard, as the shipping industry is and will be an important part of Norwegian investors' portfolios for the foreseeable future. We want to raise awareness of the severe human and environmental risks beaching can entail for shipping industry companies, their customers, and other investors," Aziz says. "As an investor with clear requirements regarding human rights and the environment, the risks from this type of activity are obvious."

"The challenge is very often that the ships are sold through intermediaries and third parties where the original owners try to pass on the problem to someone else," she explains. "A common practice is to sell ships for scraping through so-called 'cash buyers', which are companies specialised in buying, flagging out and scraping old ships."

This challenge is complicated by the fact that detailed and verifiable information about beaching is scarce, according to Aziz. "We use information from the NGO Shipbreaking Platform to find which companies in KLP's portfolio have sent ships to beaching in Bangladesh, India and Pakistan. We review this information annually and follow up with the relevant companies."

**Regulatory Efforts and Industry-Led Successes**

Like many others, KLP expected the introduction of the 2009 Hong Kong Convention[1] to lead to necessary improvements in the industry. "Unfortunately, that has not been the case thus far. Shipping companies continue to use yards that are not approved by the European Union (EU) and vessels continue to be sent to beaching in countries like Pakistan, Bangladesh and India," Aziz laments.

To overcome this problem, Aziz notes that recent efforts, such as new regulation from the EU on the safe and sound recycling of ships and new certification schemes, have attempted to improve standards for these operations. "Since January 2019, all EEA-flagged ships have been subject to these new regulations and must be dismantled at shipyards that are on the EU's list of approved shipyards, which does not currently contain any shipyards from Southeast Asia. The costs of bringing the shipyards up to the necessary infrastructure and safety standard of secure dismantling will drive many shipowners to flag ships and fleets out of the EU," Aziz says.

Given these challenges, large players in the shipping industry have decided to take action, she adds. "Companies like Maersk, Transocean and Stolt-Nielsen have worked to raise the standard of the yards they use for several years, leading to improved standards at some shipyards in India. In November KLP visited the region of Alang in India to understand how ship scraping works in practice. Although those shipyards remain excluded from the approved EU list, recent and significant improvements could change that."

However, these improvements come at a cost according to Aziz. "The best shipyards in India who have made significant investments in tight cover, drainage, water collection and treatment, workers' housing, safety equipment and more cannot compete with Bangladesh on price."

"Companies will scrape dozens of ships in the coming years. With the COVID-19 pandemic, and growing social and economic inequalities, the vulnerable have become more vulnerable. There is a great risk that workers in Southeast Asia will be forced into unacceptable working conditions to survive the ongoing crisis. Other actors must contribute to ensure decent working conditions and prevent serious environmental damage," Aziz concludes.

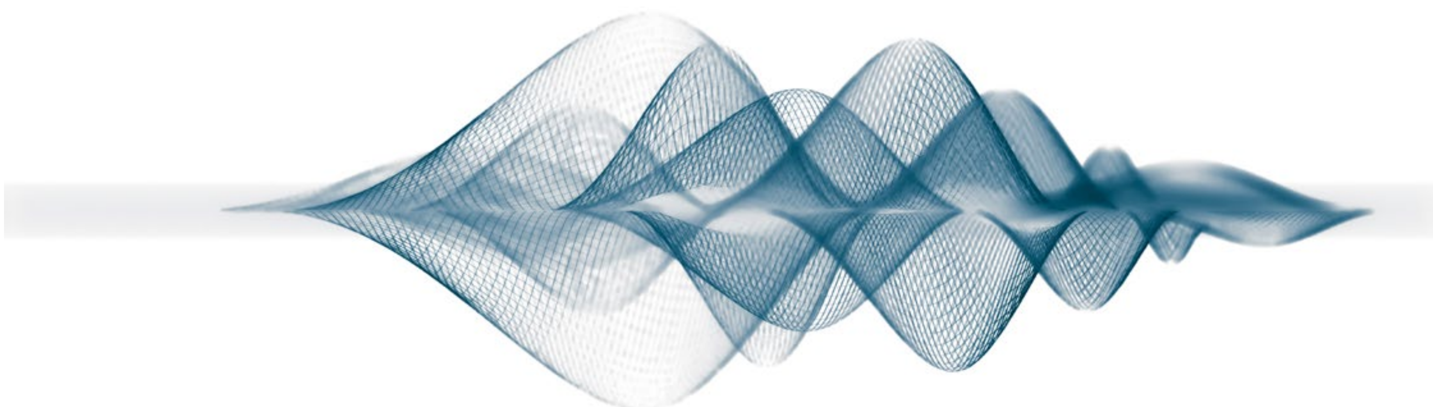
[1] As of 2021, the Hong Kong International Convention for the Safe and Environmentally Sound Recycling of Shipshas been ratified by 15 countries, including Denmark, Panama, Norway, India and Malta, as well as India and Turkey are signatories to the convention. However, Greece and Singapore, the two countries with the largest merchant fleets in the world, are not members.



*Emerging Market Sustainable Investments*

# Oslo Pensjonsforsikring's Dynamic Approach

*by* Filipe Albuquerque



***Investing sustainably often calls for portfolio managers to balance overlapping considerations. On the one hand they must uphold their fiduciary duty to maximise risk-adjusted returns for their clients while, on the other hand, minimising negative externalities and optimising positive impact. As the time passes, the interpretation of this balancing act evolves. This is particularly true in emerging markets, where investors often face stronger governance hurdles than in developed markets.***

To better understand how these dynamics play out, NordSIP reached out to Magnus Riiber, senior portfolio manager in charge of fixed income and equity fund selection in developed markets (DMs) and emerging markets (EMs) at Oslo Pensjonsforsikring (OPF).

"I come from an equities background, both US and Nordic. Now my focus has shifted to a more global perspective," Riiber says. Prior to joining OPF in 2017, he worked as portfolio manager for Nordic equities at KLP for ten years following a decade as a senior portfolio manager at Storebrand, selecting the US equities directly.

"Sustainability has been a salient feature everywhere I have worked. From the late 1990s and throughout the early 2000s, all the organisations I worked with focused on socially responsible investments (SRI). However, the interest for these type of factors has really exploded outside of Scandinavia over the last couple of years, which has moved a lot of money in the process," Riiber adds.

**OPF and the Municipality of Oslo**

Set up by the municipality of Oslo, OPF is responsible for managing the pensions of the city's civil servants. "We have a few other clients, but we are fully owned and tied to the municipality. The chairman of the board of OPF is appointed by the administration of the municipality," Riiber explains. The company manages roughly €10 billion in assets under management (AUM) and is organised as a pension and life insurance company managing mainly defined benefit pension plans.

"Regulatorily, as a pension and life insurance company, we have to comply with solvency regulations and capital requirements. At the same time, our mandate is the exclusive prerogative of the administration of the city of Oslo who, through the board, provide us with guidelines and targets for our investments," Riiber adds.

"Our mission is to provide the municipality of Oslo the most cost-effective pension over the long-term, regarding the risks we take and our approach to investments," he says.

## OPF's Approach to Sustainability

These fiduciary duties are pursued within the framework of OPF's sustainability preferences, according to Riiber. "There are also sustainability guidelines and targets, including exclusions, which are aligned with the Government Pension Fund Global (GPFG) , the sovereign wealth fund run by Norges Bank Investment Management (NBIM), responsible for managing the revenues from Norway's oil and gas industry."

"The exclusion list is set by the board, and includes those used by NBIM with the exception of the exclusions done for diversification reasons," Riiber clarifies. "The municipality and the board of OPF also come together to develop long-term goals. We approach them with suggestions and see how we can match those within the sustainability preferences of the municipality. For example, last year, the municipality wanted to focus on animal welfare, so we incorporated that into our long-term strategy," Riiber says.

OPF aims to achieve a 90% emissions reduction by 2030 from 2015 levels on its internally managed equity portfolio, according to Riiber. "However, this goal is conditional on the world progressing as we expect it to and progressively meeting the 2015 Paris Agreement goals of containing global warming to 2°C above pre-industrial levels. If in ten-years the global scenario appears to not be evolving in this manner, we will have to revisit our own goal," the portfolio manager explains.

Nevertheless, this framework helps guide OPF through its investment universe. "As a portfolio manager, it informs me of what I can and cannot look at," Riiber explains

## OPF and Emerging Markets

According to Riiber 3% to 4% of OPF's investments are exclusively focused on emerging markets, although some of its global mandates will also invest in emerging markets. "Two-thirds of our dedicated EM investments are equities and the remaining third is fixed income. This is a simpler approach than the broader distribution of our asset across the aggregate balance sheet, where 20% goes to equity, 10% private equity, 10% high yield fixed income, 20% real estate and 50% bonds and cash."

"OPF does not invest directly in emerging markets. We select external managers. My responsibility is fund selection in the liquid part of the portfolio and asset allocation," Riiber adds. "We have selected three emerging market funds, where we have invested between €300 and 400 million. Our two equity funds are Skagen Kontiki and C WorldWide Asia, which OPF has held since before I joined in 2017. Then in 2019 we also added M&G's Global EM fund for fixed income exposure."

"Funds with different strategies yield different performances but we are very happy with our choice of funds. We don't want to put all our eggs in the same basket," Riiber says. "Sustainable finance is still a new field and there are many approaches available to advance that agenda and its goals. It is not always very clear what the right way of doing things is at this relatively early stage."

"As a result, we don't want to be overly targeted and follow a single sustainability approach. We have our goals and guidelines. Within that framework, we prefer to have many strategies so as to remain diversified both for financial as well as sustainability reasons. We are satisfied because the funds have done as expected, both on sustainability and on financial grounds," the portfolio manager argues.

## Governance in EMs

Having worked in both developed and emerging markets, Riiber notes that governance is perhaps the most salient of the ESG factors when doing business in developing countries. "Generally speaking, the quality of the rule of law tends to be lower in emerging markets. Moreover, the political systems that govern the country also tend to be less stable. It is more likely that companies will do something wrong and not be called out on it by shareholders and government officials. This added risk is also why one would expect a higher return on EM investments."

One of the consequences of this environment is that EM investors need to take more responsibility for due diligence. "Generally speaking, you can believe the financial statements of a company in Germany or the USA. That is not as much the case in some EMs, where reporting may be inaccurate, be it because of lack of capacity or fraud. They are also more like to slide on the rules regarding how they conduct their business and be involved in corruption."

"As an investor, you don't want to be involved with companies that do that. Not only is it morally reprehensible, practically speaking, if they are caught, their financial performance will suffer. This is particularly important for OPF given our strong links with the democratically elected leaders of the municipality," Riiber explains.

"This is the reason all our mandates are active. We want our managers to engage with the companies and talk with management to know what is going on first-hand. The managers don't necessarily hold dedicated dialogues on ESG issues," the portfolio manager says. "Engagement is ongoing and discussions about governance are an integrated part of our interaction with these companies on their risks and performances."

"It's important to also realise that not all EM companies are the same. The concerns implicit to investing in a super-market chain are not the same as if one is investing in Samsung, which strictly speaking qualifies as an EM company," Riiber says.

## What is Sustainability?

Riiber is keen to emphasise the variable nature of sustainability, both across space and time. "As an investor, it is also important to be sensitive to the different realities that define life in countries coexisting in time but at vastly different stages of economic development. There are moral, reputational and business reasons to reject abhorrent abuses of human rights, as well as environmental and politically abusive practices."

"However, it is not always a case of 'one rule fits all'. The choices that companies and investors face are not always black or white," Riiber explains. "Even the Paris agreement treats developed and developing countries differently. By imposing stricter requirements on rich countries, it acknowledges that the difference in development between DM and EM countries creates a need for accommodation when dealing with sustainability requirements."

The adaptable approach to sustainability described by Riiber can also be understood as a function of his role at OPF. "There are many ways to define good and bad sustainability practices. In some instances the issue is very clear. But sometimes the situation is more subjective. I have my own views of what is good or bad. But it's important to note that I am an agent of the municipality of Oslo. If portfolio managers were to impose their own views on sustainability on investment decisions, it could raise agency issues. My personal views cannot carry the same weight as those of my principal."

"The targets and guidelines defined by the municipality create a framework within which we can think about sustainability, but what fits into it can change across space and over time," the portfolio manager argues. "I'm old enough to remember how terrible everyone thought nuclear energy was in the late 1990s. Nowadays, the debate has returned. People recognise that nuclear is not necessarily perfect and that there are problematic issues, but they are more willing to give it a second look. Hydro power is another good example. In Norway, we always thought it was a sustainable approach to energy production, but that's not the impression you get from looking at the EU Taxonomy. The opposition to land-based windmills has also grown a lot lately. Things change and we have to stay with the times."

## COVID19 and the EU Taxonomy

Going forward Riiber is focused on the effect of the COVID-19 pandemic and of the EU Taxonomy on emerging markets.

He notes that there are some important global trends about the impact of the pandemic on the economy. "COVID-19 had a differential effect across industries. Any business operating online benefitted from it. The hospitality industry, on the other hand, has been completely decimated. Clearly EM countries for which tourism is important suffered. Fuel producers also suffered."

However, there are also specific dynamics at play in emerging markets, according to Riiber. "EMs are structurally different from developed markets. Demographically, they have a younger population, so they have not necessarily been hit as hard. From a consumption point of view, luxury represents a smaller share of their disposable income on hotels and travelling, which are the areas that were the most affected."

"The EU Taxonomy will create demand for disclosures from EM companies selling to Europe, they will have to internalise the demands of the Taxonomy. Large companies are better at handling regulation so the Taxonomy may end up benefiting large companies in EMs, much like it is likely to have that effect in Europe. However, it's hard to say whether this will impact the market, " Riiber concludes.

*Emerging Market Healthcare*

# Investments in Times of COVID-19

*by* Filipe Albuquerque

Besides the death toll left in its wake, the negative effect of COVID-19 on the global economy was the dominant driver of financial developments in 2020. However, these dynamics vary widely across investment strategies. Given the nature of the crisis, NordSIP was particularly keen to explore the impact of COVID-19 in the healthcare industry, particularly in developing countries where opportunities may be more limited.

According to Patricia Ribeiro, Senior Portfolio Manager for Emerging Market Strategies at American Century Investments (ACI), a well-defined approach focused on clear impact sectors provides a good guide to tough times.

"Unexpected challenges stemming from the COVID-19 pandemic have presented a critical testing ground for ESG investing," Ribeiro explains. "Our impact approach allows us to invest in companies that contribute to the United Nations' Sustainable Development Goals (UN SDGs) and demonstrate solid ESG risk management practices. We believe this can be achieved while also generating alpha through our distinct investment philosophy."

Patricia Ribeiro
Senior Portfolio Manager
Emerging Markets
American Century Investments

Each stock recommended by an investment analyst must meet specific criteria. As part of idea generation, and throughout the fundamental research process, ACI's analysts look for companies whose business could generate an SDG impact. Recommendations must also align with ACI's investment philosophy and process, with the SDGs and in-house proprietary ESG risk assessment.

ACI's approach to ESG materiality is different for each sector. Environmentally, the approach to healthcare investments focuses on the material impact of carbon and toxic emissions and hazardous waste. From a social perspective, important factors include access to medicines, data privacy and security, as well as product safety and quality. Labour chain concerns are also considered, such as working conditions and controversial sourcing. Governance factors in the healthcare sector such as accounting irregularities, board structure and shareholder rights are also considered.

According to Ribeiro, there are specific challenges involved in investing in healthcare in emerging markets, compared to developed markets. "We must quantify the direct impact of the business," she says. "In emerging markets, most companies do not yet have sustainability reports and impact measurement can be a challenge."

"Often, we find that they have the information but have not been required to publish it, so engagement is very important. Measurability is difficult but it's not impossible. It takes time and effort and requires an understanding of the business to position the questions in a way that supports measurability. Therefore, we believe engagement with a company on SDG issues is an essential part of the investment process," Ribeiro adds.

To go into more detail into the investment and engagement opportunities available to healthcare investors in emerging markets, Ribeiro discusses her experience with four such companies: Wuxi Biologics, Top Glove, Coway and Hapvida.[1]

### Wuxi Biologics Fights COVID-19

Wuxi Biologics is a contract development and manufacturing organisation (CDMO) headquartered in China, which provides comprehensive services from drug development through drug manufacturing to other companies in the pharmaceutical industry on a contract basis.

[1]Source: 2020 Impact Report.

*"Unexpected challenges stemming from the COVID-19 pandemic have presented a critical testing ground for ESG investing."*

"In 2020, the company demonstrated strong execution and achieved strong financial performance, despite having lost two months of productivity in February and March due to the lockdown. It added a record-high of 103 new projects into the pipeline, reaching more than 330 integrated projects, a 34% annual increase. Management estimates that they won 40% of the global new projects last year, including 11 external projects," Ribeiro says.

Wuxi has been on the front lines of the fight to stop COVID-19, according to the senior portfolio manager. "It enabled 12 COVID-19 neutralizing antibodies (mAbs) with over 20 Investigational New Drug Application (IND) globally and winning more than 80% of its global IND development projects for COVID-19 mAbs. The company had a 100% success rate in its IND enabling services, with an average timeline to approval shortened to 3-5 months," she adds.

"Wuxi is a global supplier of COVID-19 vaccine to the Top 10 pharmaceutical companies in the world. At the end of March 2021, the company disclosed that they signed another COVID-19 vaccine contract and initiated technology transfer and were in discussions with two other pharmaceutical companies for COVID-19 vaccine manufacturing," Ribeiro explains. "Apart from COVID-19 vaccines, the company has been planning its expansion into the vaccine CDMO business since 2018 – it signed a US$3 billion long-term contract in 2019 and is building the manufacturing facilities in Ireland dedicated to this business."

According to the senior portfolio manager, prior to the pandemic, Wuxi had been recognized globally for its business capabilities and execution. "In the wake of the pandemic, the company further solidified its capabilities, winning businesses from both existing and new clients. Its backlog more than doubled to US$12 billion as of March 15, 2021, up from US$5.1 billion at the end of 2019."

ACI's engagement with Wuxi Biologics has focused on environmental impact and certification for its manufacturing facilities, talent recruitment and retention and gender diversity, among other issues according to Ribeiro. "The company has increasingly been focusing on ESG-related disclosure and investor communication. The company has established an ESG committee at the Board level that is led by its CEO who acknowledged the importance of ESG during the recent FY2020 results analyst briefing."

**Top Glove and Coway**

"In addition to Wuxi Biologics, Top Glove which produces a wide range of medical gloves, also experienced a surge in demand driven by the COVID pandemic and the need for gloves. The COVID-19 outbreak spurred increased awareness of hygiene practices at hospitals, especially in emerging markets where the current penetration is still very low," Ribeiro says.

Coway, a South Korea-based manufacturer and retailer of environmental home appliances, witnessed increased demand in overseas markets such as U.S. and Malaysia. "In the USA, bidet sales picked up by over 300% year-on-year due to pandemic-driven toilet paper shortage," she adds. "In Malaysia, the total revenue picked up by over 30% largely due to discomfort of consuming bottled water post lockdown, thereby leading to more water purifier sales."

"However, given the door-to-door characteristics of the domestic business, performance on the home market was lacklustre during the pandemic," Ribeiro says. "Moreover, air quality improved as people traveled less due to the pandemic, resulting in lower sales in air purifiers." Engagement with Coway has centered on product recycling and eco-friendliness, and the company's practices for supply chain management on raw material and controversial sourcing.

**Helping Expand Healthcare Coverage in Brazil**

Hapvida is the largest private healthcare provider in Brazil. "Hapvida started operations in the poorest regions of Brazil and has been expanding, mainly through acquisitions into the other regions of the country. It is currently the only healthcare system with its own network present in all regions of the country," the senior portfolio manager says of the company.

*"EMs are particularly in need of investments in infrastructure, technological innovation and education at the same time as they face profound socioeconomic, gender and income inequalities, and some of the lowest living standards in the world."*

"Hapvida's business is based on a vertically integrated model, in which care for beneficiaries is primarily done in their own network of hospitals and clinics and with their own doctors," she adds. This strategy allows Hapvida to offer medical and dental healthcare plans at very affordable and much lower prices than the competition, according to Ribeiro.

"Hapvida has been gaining market share in the very fragmented Brazilian healthcare market. Healthcare coverage is still very low in Brazil, with only 47 million private health care plan beneficiaries covered, equivalent to 24% of the country's population," she explains. Ribeiro notes that although Hapvida has increased its health plan beneficiaries significantly faster than competitors its competitors it was only responsible for 7.4% of the Brazilian market in 2019.

"In the North and Northeast regions however, the poorest regions of Brazil where Hapvida is the market leader, their market share was 25% and 30% respectively," she adds. However, the company is focused on correcting this tilt and has started expanding into the other regions of Brazil. "With the proceeds from its 2018 IPO, Hapvida acquired assets in the Central-West, Southeast and South regions of Brazil, where they are replicating their strategy. More recently, Hapvida announced plans to merge with its peer, NotreDame Intermedica which shares similar verticalized strategy and complementary footprint."

According to Ribeiro, "Hapvida is very committed to ESG practices and they have been producing Sustainability reports since they became a public company." Engagements with the company have focused on clarifications of Hapvida's strategy for managing social risks, including talent retention and development, patient health and safety, data security and privacy controls.

**Accepting the Challenge**

"Transforming society requires the collaboration of various stakeholders. If we are to find the US$5 trillion to US$7 trillion the UN estimates we must invest annually to attain the 17 SDGs by 2030, governments need to galvanise the necessary public and private resources," Ribeiro says.

"EMs are particularly in need of investments in infrastructure, technological innovation and education at the same time as they face profound socioeconomic, gender and income inequalities, and some of the lowest living standards in the world," she adds. "They are also more vulnerable to environmental and health-related issues, including access to clean water and rare diseases. These conditions make investing in emerging markets with an SDG focus especially significant."

# Who's (Not) Afraid of Emerging Markets?

## *The Nordic Asset Managers' Perspective*

*by* Julia Axelsson, CAIA

Emerging and frontier markets can be intimidating to investors with high sustainability standards. A combination of poor governance, lack of transparency and patchy ESG data render responsible investing in these markets somewhere between difficult and impossible. Yet there is no doubt that these economies desperately need sustainable investments. And the rewards to successful investors, in terms of impact as well as profits, can certainly be worth the effort.

The key to entering confidently into this space that so many investors shy away from is spelled 'expertise'. We reached therefore out to a few Nordic asset managers, all specialising in emerging and frontier markets, hoping to gain some valuable insights.

**A Rewarding experience**

"Our loans can literally change people's lives," exclaims Camilla Löwenhielm, Portfolio manager at SEB Microfinance Fund. For millions of microenterprises and low-income households, excluded from the mainstream financial system, the products and services that microfinance institutions offer translate directly into financial security, more employment opportunities and higher living standards. "Micro- and small businesses in these markets need financing to run and grow their businesses in the same way that companies in Sweden do. The difference is that there are few borrowing opportunities available to them, apart from those through informal channels with questionable terms."

Camilla Löwenhielm
Portfolio Manager
SEB Microfinance Fund

*"Promoting the sustainable development goals in frontier and early-stage emerging markets is crucial, everyone will be worse off if we leave those countries behind."*

Jennie C. Ahrén, Head of ESG and Partner at Tundra, is also profoundly aware of the role her firm's investments have to play: "Promoting the sustainable development goals in frontier and early-stage emerging markets is crucial, everyone will be worse off if we leave those countries behind." Tundra's portfolio companies are often found at the low end of supply chains, inadvertently affecting the rest of those chains and eventually the end products.

Investing in emerging markets can be gratifying in other ways too. "Companies in those markets are often keen to hear from foreign investors like ourselves," explains Karine Hirn, Partner and Chief Sustainability Officer at East Capital, based in Hong Kong. They are not spoiled by the attention of too many professional investors and welcome the opportunity to engage and learn.

**Pick a letter: 'E', 'S' or 'G'?**

Despite their ambition to cover all the bases by attending to all ESG aspects, responsible investors often need to prioritise. The informal hierarchy of sustainability goals, it appears, is not quite the same for investors in developed and emerging markets. While environmental issues tend to dominate the discourse in our part of the world, the asset managers we interviewed seem to emphasize other sustainability aspects in their work.

"Of the ESG the 'G' is easiest to explain to companies," says Ahrén. According to her, the companies that Tundra invests in are often at the stage where sustainability issues still need to be acknowledged at director and management level. At East Capital, Hirn agrees, governance is and has always been at the basis for all sustainability work. A well-functioning board with independent directors and an efficient and competent management team can achieve a great deal. They can make sure, for instance, that KPIs, connected to the material 'E' and 'S' issues, are put in place.

Jennie C. Ahrén
Partner, Head of ESG
Tundra

For SEB Microfinance, the 'S' is bound to be in focus, embedded as it is in the very nature of the fund. Yet governance is crucial for them too, explains Löwenhielm, as the fund invests through intermediaries. These partners' integrity and reliability are essential for the end beneficiaries as well as for the fund's own reputation. The 'G' and 'S' aspects are therefore fully integrated in the fund managers' financial analysis. "We need to know all about the microfinance institutions that we partner with; who the owners are, what their mission and vision is and how this is implemented throughout the organisation and in the products and services offered to end-clients..."

For Löewnhielm, 'E' is relatively less of a priority at present. "The environmental footprint of those we lend money to is still typically quite small," she says. Yet the market is developing and the ambition is to finance more green projects, she points out. Meanwhile, the importance of environmental issues is becoming increasingly obvious in emerging and frontier markets. Some of these countries are extremely exposed to the negative effects of climate change, reminds Ahrén, and quotes the example of devastating flooding in Bangladesh.

At East Capital, with their substantial investments in countries like Russia and China, ignoring the 'E' has never been an option. As an example, Hirn relates that "Russia is the fourth largest polluter in the world, yet


Karine Hirn
Partner and
Chief Sustainability Officer
East Capital

Credit: Andrea Bjorsell

*"One of the main costs of greenwashing is the reputational erosion it imposes not just on specific entities but on countries and entire regions."*

the sense of urgency is not there, at least among public authorities, possibly as they feel that on aggregate they might stand to win from global warming." East Capital has therefore decided to co-lead three of the engagements of Climate Action 100+, a shareholder initiative, hence nudging some of the biggest Russian GHG emitting companies, Gazprom, Lukoil and Norilsk Nickel, towards emissions reduction, climate governance and disclosure.

**No lack of challenges**

"We operate in some very challenging countries, such as Burkina Faso, or Haiti, with poor basic infrastructure," relates Löwenhielm. It is quite impressive how the institutions manage to offer financial solutions in a market where the borrowers may lack financial records, and sometimes even identity papers. Or where cash is the only financing alternative. "Sometimes these countries can be surprisingly technologically advanced though. We can learn a lot about mobile financial transactions in West Africa for instance."

For Ahrén, the biggest challenge to investing sustainably in these markets is often the lack of general knowledge and awareness. Locals may be used to doing things in a certain way, simply accepting lower standards. Demanding more of portfolio companies is rarely enough when the basic infrastructure in the country is not there to support the efforts. "What is the use of introducing a recycling station in a Pakistani factory," she adds, "if there is no waste management in the city around it."

Often quoted as a major obstacle when investing in emerging and frontier markets is the lack of reliable and comprehensive information. "Do it yourself," is a lesson that Hirn learned early on in her career, as one of the first investors in Russia in the 90s. The realisation that there are no shortcuts available when investing in these markets was probably the one of the reasons behind East Capital's executive decision to develop a proprietary framework for integrating ESG. The framework has been in place since 2016.

"We let the portfolio manager and analysts do the ESG analysis for each portfolio company, find out which factors are material for it and dig down deeper," says Hirn. Data providers' ESG scores are often backward-looking, she argues. They also tend to focus too much on policies, rather than on practices. "Why should we, as shareholders, care that a Russian company's ESG score has improved by adopting a child-labour policy, when we know that child labour was never a problem there to begin with," she adds.

**Engagement matters**

"Another advantage of doing our own ESG analysis," continues Hirn, "is that it means we can integrate the sustainability outlook for the company, partly based on our engagement with them." At East Capital it has become a tradition by now to send each new portfolio company's chair a "Letter from Your New Shareholder" and a "Letter from the CIO to the CEO" once a year. Engagement is not just about demanding information and action from companies, according to her. It is also about explaining to them on a regular basis how they are being scored on ESG issues and what they could do to improve those scores. It is about opening up a dialogue.

Tundra adopts a similar attitude, focused on educating and raising the awareness among their portfolio companies rather than just demanding that they transform into ESG champions by themselves. After sending an ESG questionnaire to each company for five years in a row now they can finally see some progress. Sending annual feed-back letters and regularly encouraging companies to set goals aligned with the SDGs must have had some effect.

The ambition at Tundra, however, is to go further than engaging only with their own portfolio companies. Ahrén is proud of some of the initiatives that her firm has been involved in recently: collaborating with UNDP to organise a seminars tour in Pakistan, co-sponsoring a sustainability conference in Sri Lanka, helping the Ho Chi Min Stock exchange to introduce the first ESG index, etc. "Being one of the few foreign investors in these countries creates opportunities for bigger impact, it also entails responsibility," she concludes.

Löwenhielm can certainly relate to Ahrén's sense of moral responsibility. Lending money to those most in need might be a noble aim, but "we need to make sure that the people who borrow from the institutions that we finance understand what they are doing. And these are often people without much education or safety nets." One way of helping their borrowers, for example, is by taking away the currency risk. For SEB, providing local currency funding is the right ethical choice. When lending in hard currency the foreign exchange risk is passed to the microfinance institutions or the end client. As it turns out though, there is a financial rationale to it too, the local currency risk premium. Historical analysis suggests that a well identified local currency strategy yields higher returns for investor portfolios.

**What about COVID?**

For asset managers working in emerging and frontier markets, the current pandemics has emphasized the urgency of the 'S' in ESG, as well as the complex interdependency between the different sustainability aspects. It has also accelerated the need for a just transition. The global environmental challenges must be met with solutions that do not leave half of the world behind. In the same vein, a pandemic must be addressed globally.

Engaging with the Access to Medicine Foundation, working for equitable distribution of vaccines, is one way that Tundra is supporting the communities they operate in. "Oddly enough, some of the countries we invest in seem less affected by the pandemics," according to Ahrén. Maybe because of their inbuilt resilience, the way they are used to lockdowns and know that they cannot rely on the system, or the government for help, she muses. Companies in emerging markets are often more self-reliant because they are less used to state support, Hirn agrees. Meanwhile, some of the problems in the countries that East Capital invests in are exacerbated by COVID, such as poor healthcare system and income disparity, she notes.

Choosing to focus on the opportunities is one of the prerequisites for even considering investing in emerging markets, and the asset managers we interviewed are not an exception from the rule. Used to tackling an array of challenges, the added onus of COVID does not seem to scare them. "We needed a catalyst, and we have it now," concludes Ahrén.

Credit: Alena Koval, Pexels

*Case Studies*

# Greenwashing in Emerging Markets

*by* Filipe Albuquerque

*"One of the main costs of greenwashing is the reputational erosion it imposes not just on specific entities but on countries and entire regions."*

There is a consensus among the global investment community that emerging market companies are exposed to a higher degree of ESG risks than their developed market counterparts. While the focus is often on governance problems created by higher levels of corruption, among other issues, the developmental needs of EM countries and associated energy consumption needs also raise important environmental risks. The balancing act between achieving development goals and climate commitments is not always easy for EM companies and can lead to greenwashing.

The four cases below discuss different greenwashing dynamics driven by the contradicting compartmentalisation of funding operations, overreporting, regulatory heterogeneity and negative reputational spillovers, which investors should be aware of when investing in EMs.

**JBIC and KEXIM Fund Coal in Vietnam**

Given the developmental needs facing many EM countries, development banks often compartmentalise their activities leading to contradictions between the projects they fund and their climate commitments they have made. Inevitably, the contradictions lead to concerns that these organisations are using deceiving announcements that distract investors from the polluting commercial interests they are actually pursuing.

A recent operation by the Japan Bank for International Cooperation (JBIC) and the Export-Import Bank of Korea (KEXIM) provide an illustration of the dangers of greenwashing. In response to the 2015 Paris agreement, the JBIC announced it was committed to "respond to global environmental problems by promoting growth of developing countries under its environmental operations called 'Global action for Reconciling Economic growth and ENvironmental preservation' ('GREEN') and providing various financial instruments to support the overseas deployment of Japan's advanced environmental technology."

However, as recently as the end of December 2020, JBIC disclosed the signing of "a loan agreement with Vung Ang II Thermal Power Limited Liability Company (VAPCO), a Vietnamese company invested in by Mitsubishi Corporation and others." According to the announcement, "JBIC will provide project financing amounting to up to approximately US€636 million (JBIC portion) for the Vung Ang 2 coal-fired power plant in the Socialist Republic of Viet Nam (Vietnam), under JBIC's Growth Investment Facility. The loan is co-financed with private financial institutions as well as KEXIM." The total co-financing amount is approximately US$1.767 billion according to JBIC.

Reviewing this transaction, Ulf Erlandsson, Executive Chair of the Anthropocene Fixed Institute (AFII) labelled it as a clear case of greenwashing. "Buying JBIC and/or KEXIM bonds are effectively funding coal incineration through Vung Ang II and should not be part of a climate aligned SSA portfolio. (...) The KEXIM financing is clearly part of a package to allow South Korean private companies to build the plant. This is the reality for investors in KEXIM bonds: you are lending money in order for South Korea companies to win orders to deliver coal-based turbines and construction. In the same vein, JBIC financing appears to be opportune for Mitsubishi Corporation."

"In this project, VAPCO will build, own, and operate an ultra-supercritical coal-fired power plant with an installed capacity of 1,200MW (two units of 600MW each) in the Vung Ang district, Ha Tinh province in central Vietnam. The electricity generated from this plant will be sold to Vietnam Electricity (EVN), the country's state-owned power utility company, for 25 years," Erlandsson explains.

"The lending decisions of these institutions are taken with full awareness of what they entail climatewise and we cannot do anything but suggest that investors buying JBIC and KEXIM bonds are contributing capital to climate destruction. They should be excluded from a climate aligned SSA portfolio," he concludes.

**Overreporting Green Investments**

Greenwashing does not rear its ugly head exclusively through blatant and contradictory investment propositions. Another way in which investors are exposed to greenwashing is when the green credential of projects and companies are overstated.

A recent review by KPMG of the 426 ESG notes issued in Korea over the last three years shows that less than 3% of the funding has been focused solely on environmental projects, according South Korean stock exchange data shows. Only 22 of these transactions targeted green projects, while the remaining transactions were social (387) or sustainable (17) bonds.

A more complicated issue emerges when multilateral development institutions issue green bonds to fund projects that do not necessarily fit the green label. Using investment disclosures from developed countries regarding climate finance to help vulnerable people and countries adapt to climate change, a recent CARE[1] report concluded that "current official figures for adaptation finance are severely overstated and far too high." The research focuses on 112 projects conducted between 2013 and 2017 and estimates that almost half of all climate adaptation finance is over-reported.

According to the report, Japan and the World Bank (WB) and the two worst absolute offenders, over-reporting US$ 1.334 billion (out of US$ 2.009 billion) and US$872 million (out of US$2.542 billion) in climate adaptation finance, respectively. Other offenders include the Asian Infrastructure Investment Bank (AIIB)[2], the African Development Bank (AfDB)[3], the Asian Development Bank (ADB)[4] the International Fund for Agricultural Development (IFAD)[5] and the Nordic Development Fund (NDF)[6], among others. The funds deployed by these multilateral development banks (MDBs) would most likely have been acquired via the issuance of green bonds.

CARE highlights two sources of over-reporting climate adaptation finance. One problem, pervasive in Japan is the method that "makes no distinction between the financial reporting of projects with adaptation as their main objective and projects with adaptation as a minor objective". Another problem the inclusion of "non-concessional loans, often at face value. Non-concessional loans do not have conditions (such as grace periods, maturities, or interest rates) favourable enough to recipients to be reported as Official Development Assistance (ODA) loans, yet they can still be reported as adaptation finance."

**Greenwashing, Regulation and Trust**

One of the main costs of greenwashing is the reputational erosion it imposes not just on specific entities but on countries and entire regions. In a recent article[7], SEB Sustainability Specialist Anne Kästner and Zhiting Yun from China's International Institute of Green Finance (IIFG) Green Bond Lab, comparing the EU's Green Taxonomy with the China's Green Bond Catalogue acknowledged the role reputation played for green investors. "In Europe, knowledge about the Chinese green finance regulation framework is still scarce. Without trust in China's definition of sustainability, investors will not want to engage in the Chinese market," the authors argue.

"For European investors, the most challenging part of the Chinese definition might be the inclusion of nuclear energy as well as projects regarding energy minerals and fossil fuels. Besides classification differences, the limited availability of investment channels is also a barrier for European investors given that foreign investors only own 3% of the total Chinese bond market," Kästner and Yun add.

The issue appears to have also been prominent on the mind of policy makers. At the Roundtable of the China Development Forum held at the end of March 2021, the People's Bank of China (PBoC) Governor, Yi Gang (Pictured), disclosed that China was cooperating with the EU in the development of a harmonised taxonomy of green economic activities. The authorities hope this cooperation could help investors navigate green investments across the two economic blocs.

**Negative Reputational Spillovers**

The reputational risk of greenwashing is not confined to Asia. European EM countries are equally likely to lead sustainability specialists to raise an eyebrow. The discussion triggered by the green bond the government of Hungary issued in 2020 provides an example of pre-existing reputational concerns hurting the credibility of a green bond.

Although the green bond was rated a respectful "medium green" by Cicero Shades of Green, the reputation of corruption that plagues the country's government was enough to raise suspicions that the green transaction was an exercise in green washing.

On that occasion Zsolt Lengyel, co-founder and chair of the Institute for European Energy and Climate Policy, reportedly commented that the green bond, "qualifies both for a greenwashing prize and a corruption medal". According to the same report, although CICERO Shades of Green was encouraged by the country's government's "very solid step forward to being Paris-aligned", it noted that "it is not quite there yet".

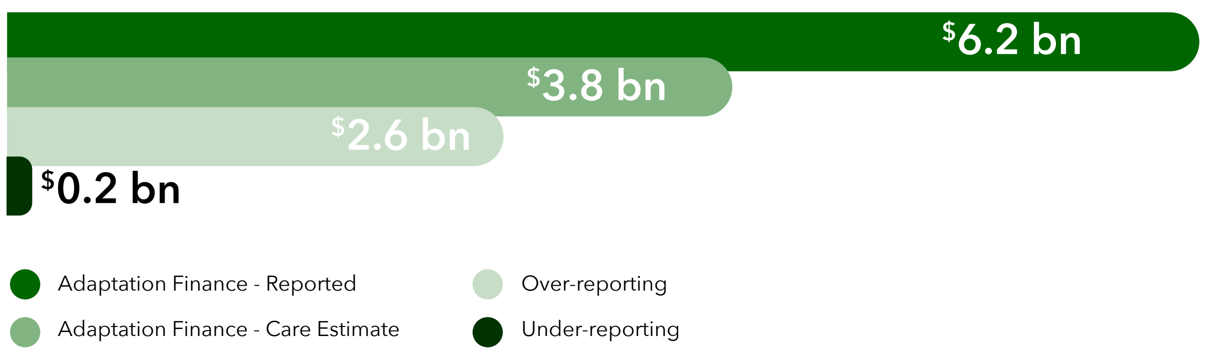
Although she noted such concerns were outside CICERO Shades of Green's mandate to assess the environmental credibility of a green bond, Christa Clapp, research director of climate finance at CICERO add that "of course we are concerned about corruption and it could have some impact here".

**The Need for Due Diligence**

As the latest form of agency problem between investors and investees, greenwashing is impossible to completely eradicate, much like any other form of corporate abuse. By their very nature, this risk is higher in EMs. However, asset managers and asset owners can mitigate the risk by engaging with investment opportunities and researching the details of the companies and projects they are embracing. There is no substitute for due diligence.

*"Asset managers and asset owners can mitigate the risk by engaging with investment opportunities and researching the details of the companies and projects they are embracing. There is no substitute for due diligence."*

Climate Adaptation Finance
(as reported by donors and assessed by civil society organisations




Source: Climate Adaptation Finance: Fact or Fiction?, CARE International, January 2021

[1] CARE International is a global confederation of 14 National members and 4 Affiliates with a common vision and mission to defeat poverty. Each CARE Member is an independent organization that leads programs, raises funds, advocates on key issues, and communicates to the public in their country, thus supporting the work of CARE's programming in 95 countries around te world.
[2] CARE estimates that the AIIB overreported US$75 million oout of US$204 million it claims to have provided.
[3] CARE estimates that the AFDB overreported US$26 million oout of US$75 million it claims to have provided.
[4] CARE estimates that the ADB overreported US$22 million oout of US$48 million it claims to have provided.
[5] CARE estimates that the IFAD overreported US$31 million oout of US$240 million it claims to have provided.
[6] CARE estimates that the NDC overreported US$1 million out of US$6 million it claims to have provided.
[7] Anne Kästner and Zhiting Yun, A comparison of the Chinese and European Sustainable finance classification, in The Green Bond: Your insight into sustainable finance, SEB, February 2021

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NORDSIP

NORDIC SUSTAINABLE INVESTMENTS

# Investing Sustainably in Emerging Markets

Handbook Series

April 2021

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