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insights

INVESTING SUSTAINABLY IN EMERGING MARKETS

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engaging with experts

Aline Reichenberg Gustafsson, CFA
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As we enter 2024, the investment landscape in emerging markets defies the notion of "business as usual". The enduring effects of the COVID-19 pandemic, geopolitical tensions stemming from the Russian invasion of Ukraine, and the humanitarian crisis in Israel have profoundly shaped investor sentiment and practices.

To understand how emerging market investors can continue to direct capital sustainably to the parts of the world that require it the most, we convened six seasoned professionals over lunch on a chilly January day in Stockholm.

Although emerging markets typically evoke heightened awareness of risk, for emerging market specialists, recent global changes don't necessarily translate to increased risk; instead, they underscore the need for specific skills.

Take, for instance, a large asset owner like AP3: recent geopolitical turmoil necessitated a reassessment of the fund's global allocation. Their team's methodology resulted in a country ranking based on relative risks, ultimately leading to China's exclusion. Similarly, other investors, including a sovereign debt manager at Ninety One and a listed equity manager at Premier Miton, also rely on country rankings. On the other hand, for a private debt investor at Cardano, geographical choices are intrinsically linked to having "boots on the ground."

What our investor group unanimously agrees upon are the tremendous opportunities inherent in engaging with companies and, in some cases, even with governments. Whether it is communicating with management to obtain reliable data or dictating more stringent terms for refinancing (linked, for example, to environmental targets), investors wield a wide array of tools to affect change.

In responsible investing, faced with the choice between engaging and excluding, preference should go to the former, resorting to the latter when necessary. This principle also applies broadly to capital allocation in emerging markets. Thus, these markets merit a place in every sustainable portfolio but require expert handling. Whether you're embarking on or continuing your journey into this dynamic investment space, we trust this conversation will help you along the way.

who is who?

Nicolas Jaquier, CFA
Portfolio Manager, Emerging Market Debt
Ninety One

Nicolas Jaquier has been in the business for almost two decades, working since 2021 at Ninety One, an asset manager with its roots in South Africa. He is the Co-Portfolio Manager of Ninety One's Emerging Markets Sustainable Blended Debt strategy, which launched in 2021. Prior to joining the firm, he worked for Allianz Global Investors as an emerging market debt strategist focusing on Latin American markets and the development of an ESG process for EMD. Previously, he was an econoomist at Standard Life investments.

Nicolas began his career working for the Swiss National Bank. He graduated from the Graduate Institute of International Studies, Geneva with a Masters in International Studies – Economics. Nicolas is also a CFA® Charterholder.

Cecilia Kellner
Chief Investment Officer
Nordea Life and Pension

Cecilia Kellner has been at Nordea since 2016. Before assuming her role as a CIO for the Life and Pension entity of the bank, she was a Senior Portfolio Manager and Sustainability Strategist. Previously, Cecilia has worked as a Senior Credit Analyst at BNP Paribas, Senior Portfolio Manager at Strand Kapitalförvaltning and Senior Equity Research Analyst at Carnegie Investment Bank.

Kellner holds a Master's degree in Accounting and Finance from Stockholm University.

Xuan Li, CFA
ESG Analyst
Söderberg & Partners

Xuan Li joined Söderberg & Partner in January 2024 after working as a senior associate at ISS ESG. She is in the process of completing a PhD at the Norwegian School of Economics (NHH) and holds a Master's degree in Economics from the University of Uppsala. She is also a CFA® Charterholder.

Xuan is part of Söderberg & Partners' ESG team that is responsible for the group-wide sustainability analysis. Their sustainability analyses cover the Nordic market and consist primarily of Sustainable Funds, Sustainable Life-Insurance Companies, Sustainable Unit-linked Insurance Companies, and Sustainable Non-life Insurance Companies.

Fiona Manning, CFA
Fund Manager, Emerging Markets Sustainable Fund
Premier Miton

Fiona Manning joined Premier Miton in August 2022 following 17 years at Aberdeen Standard Investments where she was Senior Investment Director and lead manager of the firm's emerging market sustainable equity strategies, including the Emerging Markets Sustainable Equity Fund and the Emerging Markets Sustainable Development Equity Fund.

Fiona also co-managed the firm's emerging market equity strategies and, until 2016, the firm's Latin American Equity strategies. Fiona started her career at Deutsche Asset Management in 2001. Fiona is a CFA Charterholder.

Claudia Stanghellini
Head of External Management
AP3

Claudia Stanghellini joined AP3, one of the Swedish pension system's giant buffer funds, in 2002. Her role in the organisation has evolved over the years as she has moved from the fund's quantitative group to the external management team, initially on the traditional long only side. In 2013 she became head of the team which has since ventured into the absolute return space.

Claudia holds a Master's degree in actuarial science from London's City University and has previously worked at Sun Life Financial in Boston.

Sinisa Vukic
Lead Portfolio Manager, Impact Investing
Cardano

Sinisa Vukic has been with Dutch boutique asset manager ACTIAM Impact Investing, now part of Cardano Group, since 2008. In addition to being a lead portfolio manager, he is also a member of the Investment Committee where he is responsible for monitoring the macroeconomic developments in the countries targeted by the firm's impact investments.

Sinisa has a strong background in development economics and sustainability. He holds a degree in International Economics and Foreign Trade from the University of Belgrade and a Master's degree in Environmental Management from the University of Wageningen.

From left to right: Claudia Stanghellini, Cecilia Kellner, Xuan Li, Sinisa Vukic, Fiona Manning, Stefan Lundberg, Aline Reichenberg Gustafsson, Chris Hamer , Anahita Asadi, Nicolas Jaquier, Julia Axelsson

Investing Sustainably in Emerging Markets

Stockholm
25 January 2024

Unusual Business

As we enter 2024, it seems like this year will hardly be one of 'business as usual' in emerging markets. Maybe we should not wish for it, either. How do you even start describing 'business as usual' after the pandemic era of 2020-2021, the geopolitical upheaval created by the Russian invasion of Ukraine in 2022 causing higher energy and commodity prices and, most recently, the Palestinian atrocities in Israel leading to a humanitarian crisis in the region? The deep and permanent impact of these events on investors in emerging market is undeniable.

Geopolitics rule

To set the scene for the discussion, Nicolas Jaquier walks us through these recent turbulent times. "If we have learned anything over the past four years, it has been the prevalence of geopolitics," he says. "High credit ratings pale in comparison. Russia's investment grade rating, pre-invasion, is certainly a case in point. It has taught us the importance of doing our own homework and being aware of the key ESG issues that might suddenly take over."

Geopolitics are not about to go away any time soon, either, according to Jaquier. Yet, he feels slightly more optimistic about the global macro environment this year. "The economic impact of these calamitous events is slowly working its way out, with inflation normalising and central banks that have started or are about to start cutting rates, especially in many emerging markets," he points out.

"The past four years' events have been highly detrimental for investing in emerging markets, deterring capital flows from the region," says Jaquier. "Investors are still thinking of Russia, and they keep away from all emerging markets. This is catastrophic, as these economies desperately need the capital to power the green transition," he adds.

Swedish pension fund AP3 was one of the institutional investors to temporarily withdraw their money from the emerging markets, selling all equity holdings in the region back in the fall 2022. Claudia Stanghellini explains why. "When Russia invaded Ukraine, AP3 had exposure to the market via externally managed global emerging markets funds. There wasn't any time to act, really," she recalls. "Like many of our peers, we were stuck with the exposure. Thankfully, it was rather small, but it forced us to rethink our strategy. What if it were much larger exposure? Given the geopolitical tensions around the world we took a step back and re-think our approach," she adds.

AP3 decided to change the approach to emerging markets and launched an analysis of all the countries in the category, looking at parameters like democracy, rule-of-law and corruption risks, using data from several sources. "It has taken some time, but we have come up with an internal proprietary country ranking where some countries score green on most of the parameters, some are red, and others are in the middle," says Stanghellini. "Clearly this is a long-term indicator that moves slowly but historically there is a correlation between for example the degree of democracy and a country's economic and financial development."

Selective inclusion

AP3 is now re-entering emerging markets, albeit in a selective way. "We have started with Asia, deciding not to include China as a first step," explains Stanghellini. "Apparently, we were one of the first institutional investors to actually launch a search for an emerging markets ex China mandate. In the future, we want to have more control of our regional exposures, so we are opting for a customised solution," she adds.

"It has gone almost full circle now," comments Fiona Manning. "Twenty years ago, I remember investors also being keen on allocating regionally for emerging markets. We saw a huge number of specialised fund

launches, investing in China, or LatAm, or the BRICs. Then these strategies sharply fell out of favour, and flows became much more global. It is interesting to think that the geopolitical tensions imply much more focus on individual country or regional idiosyncrasies," she reflects.

For Manning the current environment has increased the appetite of emerging market investors for a different kind of risk analysis. "Having been through this very volatile period, many investors in Europe, including ourselves, have started thinking more about some of the non-financial risk factors, typically those you put in the sustainability bucket. This provides a contrast to the ESG-backlash in the US," she adds. "When we were structuring our products, we were very clear that we wanted to focus on the impact of our investments, as well as ensure that the risks we take were managed and priced appropriately. So, we decided to use the framework of the UN SDGs which allows us to align our investments with the global priorities."

Back to basics

Another important lesson Manning has learned is not to rely too much on off-the-shelf ESG ratings. They may be a convenient shortcut but offer poor visibility and do not promote true understanding of the risks in a specific investment. "We have gone back to basics," she says. "Nothing can replace first-hand experience on the ground, looking at the structures in place, understanding the culture."

Just like AP3, Premier Miton, too, has developed a proprietary ranking of countries, based on data from various external providers, such as Transparency International, Freedom House, the World Bank, etc. "This ranking plays into how we view state-owned entities. Effectively, where countries are not acting in conformity with global models of behaviour, we are not comfortable providing capital even to equities that are state controlled. We have tried to embed this analysis in a bottom-up way, in the way that we think about strategy and allocating within emerging markets," Manning comments.

Sinisa Vukic welcomes a more differentiating and granular approach to emerging markets. "Many investors tend to apply a broad brush

"Analyses written on the desk in London do not tell you much about the underlying reality. We rely more on our team who is on the ground, in Nairobi, or in Delhi."

approach, disregarding that there are enormous differences, especially if you include the diverse group of frontier markets," he says. "As impact managers in private market debt, we always start from the basics, analysing each specific project in its context. Understanding the dynamics on the ground, the culture, and the people, is crucial."

Vukic does not pay much attention to ESG ratings, either. "Analyses written on the desk in London do not tell you much about the underlying reality. We rely more on our team who is on the ground, in Nairobi, or in Delhi," he says. From that vantage point, the manager warns that we might all be underestimating the risks associated with the increased food prices, post-pandemic. "Maybe the world is in better shape now, but we need to watch out for a second cycle of risk coming across in developing countries. We are not quite out of the woods yet."

With investments in some 35 developing economies, from Tanzania to El Salvador, Vukic and his colleagues at Cardano are highly aware of the governance and sovereign risks involved. What provides some comfort is holding a well-diversified portfolio. "What happens with the El Salvador government will most probably not affect the rest of the portfolio due to our private markets focus correlations are generally low," he says. "Diversification is key, especially in the current geopolitical climate."

Far from a Swede's comfort zone

Cecilia Kellner has been presented with numerous opportunities for growth and innovation amidst the dynamic geopolitical landscape. "Even leaving aside the geopolitical aspects, however, investing in emerging markets is problematic for us from a sustainability perspective," she admits. "Being Swedes, we have a particular view of governance, an extremely low tolerance for bribes or corruption, for instance. From this standpoint, investing globally can be challenging. Even the US has a different approach to corporate governance and a different regulatory landscape. Emerging markets require us to step even further away from our comfort zone," she explains.

That said, Nordea Life & Pension does invest in emerging markets but has very limited exposure. "We have set up a model to analyse countries in the investable universe, trying to assess which sovereigns are eligible to invest in. This applies on the corporate side as well, as many

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companies are state-owned or governed," explains Kellner. She adds that they are currently discussing the exposure to China in view of the heightened geopolitical risks.

"We have shifted away from emerging markets in general," sums up Kellner. "In a way, it is easier for us to get out than to stay in and cope with the sustainability-related and geopolitical risks. I know it might not be the right solution in the long-term, but for the moment, we are still discussing how to deal with this exposure and haven't reached a conclusion."

Too important to exclude

"It is not easy to find the right emerging funds for the portfolio," admits Li. "It is difficult to tick all the boxes, from both a financial and a sustainability perspective." When selecting funds, Söderberg & Partners also needs to consider how asset managers interpret and comply with SFDR. "In that respect, the distribution among emerging markets funds looks very different from that in developed markets. It is something to be mindful of, because SFDR

is a very important framework for us in our analysis," she adds.

The data challenge

One issue that seems equally frustrating to asset owners and asset managers alike is that of collecting the data necessary to analyse investments in emerging markets. Admittedly, this is a problem that plagues also European and American small- and mid-cap strategies, but the challenge is much bigger once you stray away from developed markets. "Collecting data for small cap companies in emerging markets is actually a blessing and a curse in equal measure," points out Manning who runs such a strategy. "It is not as easily available, but the advantage is that you often get to engage directly with the people in charge - the CFO, or the CEO, or the head of strategy. They can indicate whether the metrics and risks you are enquiring about are important and relevant to the business. Likewise, easily available data can sometimes be misleading."

At AP3, the ESG data challenge has had clear implications. "It has led us to the realisation that we need to hold a more concentrated portfolio," says Stanghellini. "We have come to appreciate the fundamental work that needs to be done and the importance of partnering with the right external managers who have the knowledge and the resources to do it. We definitely encourage our managers to engage actively with the companies they invest in, and not just to collect data," she adds.

Engaging in Emerging Markets

How do you engage with states?

Engaging with companies in emerging markets is universally considered an important part of investing sustainably. When it comes to engaging directly with sovereigns or with state-controlled entities, however, most investors seem to shy away. This is a mistake, according to Jaquier. "We engage with policymakers on a regular basis," he says. "We find that a lot of times our incentives are quite aligned as they are actively trying to improve their climate commitments and social indicators."

"When we engaged with Uruguay, for example, they were looking to be one of the first sovereigns globally to issue sustainability-linked bonds, linking their financial and their climate commitments," recalls Jaquier. "We helped them to design this strategy and highlighted how they could be more ambitious with their emission targets We suggested that they move from carbon intensity to an absolute carbon target to avoid the risk of not meeting their Paris-aligned goals. Eventually, they took our advice and adopted the absolute target when revising their indices."

Despite successful engagement examples like the Uruguayan one, Jaquier admits dealing with sovereigns is challenging and slow. "Let's not kid ourselves, it is a long-haul process," he says. Yet, even when engaging with companies, you sometimes end up at state level. Another example he quotes is Ninety One's dialogue with Samsung. His colleagues in the equity team had been urging the company to improve their emissions profile for years. "Eventually, they realised that one of the biggest hurdles for Samsung is the South Korean grid, which is still heavily reliant on coal. So, we are starting to engage directly with the South Korean government, getting in contact with the Ministry of Environment, so that we can push them to accelerate the move away from coal," he concludes.

Collaborative engagement works

Being minority owners should not necessarily discourage investors from engaging, either, according to Jaquier. "This is where collaborative engagement comes in," he says quoting the case of Pemex, one of Mexico's biggest emitters. "We are part of a Climate Action 100 initiative engaging with the company. That really shows to Pemex the seriousness with which investors take these issues," explains Jaquier. "Discussing with NGOs is also important as it helps us to understand the issues that we should take up with the companies where they could realistically deliver," he adds.

Vukic echoes Jaquier's conviction that collaborative engagement works, even when it comes to influencing sovereigns. "Few years ago, we cooperated with a local university in Cambodia on client protection issues, i.e. to support financial service providers practice good ethics and responsible lending ," he recalls. "We, together with our partners and peers, provided them with data, pointed them towards companies they could talk to and let them do their research independently and transparently. They studied the issues thoroughly and published a couple of articles on it. That was a trigger for the government to start thinking about implementing appropriate policies. Sometimes, initiatives like this can become a game changer. You must be creative about how to engage," he concludes.

When engaging is not an option

Kellner wonders whether there might be countries that are extra challenging, or even impossible to engage with. "You have to be realistic," admits Jaquier. "We cover over 80 countries, so there is no way we can engage with every country on every issue. We choose those where we think we can get results by engaging.

"We have this forward-looking framework, where we score countries on a scale of minus three to plus three, and we don't invest in the countries with a score lower than minus one in our Sustainable strategy," explains Jaquier. "We can still invest in frontier markets that might not look so great on some of the World Bank global indicators, but only if they are improving."

"Many of our institutional clients have country exclusion lists," Vukic flicks in. "They wouldn't touch Nicaragua, for instance. Yet, given our focus on private investments with clear strategy to avoid state-owned entities and other links to the governments of these countries we have been able to provide sufficient comfort to our clients to invest in these countries. We focus on investments that are helping the common people there, tackling issues like climate, or income generation. These types of investments, even though they are in an excluded country, are often not on the exclusion list of asset owners (or exempt from this) as they are set up to support the people and communities who usually have nothing to do with the reason(s) these countries are excluded. We try to show clients that it is possible, and necessary, to approach these markets as well."

"They say that engaging with companies is much easier to do as an equity investor," continues Vukic. "I tend to disagree, at least when it comes to the primary private market. The kind of companies we lend money to really need the capital and are much more concerned about the bond market. This gives us some leverage when we discuss the impact or governance targets with them," he adds.

Engaging cross-asset

Manning brings up the possibility of collaborative engagement across asset classes. "When I first started investing, there was very limited overlap between the companies that were issuing credit into the market and those that had equity," she says. "Opportunities for co-engagement were much more limited. As markets have developed, it happens much more frequently these days."

"One of the organisations I have worked with, for instance, the Emerging Markets Investors Alliance, brings together equity and fixed income in a seamless way," says Manning. "It can be really powerful to approach a company with an issue that is problematic from both perspectives. Ultimately, if you are doing your

"We want to see evidence that managers have selected clear priorities, that they have the right access and that they follow up in a timely manner. The key question is, how you define successful engagement."

engagements right, focusing on specific material issues that are fundamental to the overall cost of capital of the business, then that is beneficial for both equities and fixed income. It applies to both sovereign and corporate credit and to equity," she concludes.

What is a successful engagement?

Engagement is extremely important for Söderberg & Partners, which is reflected in the way Li and her colleagues evaluate asset managers. "I believe there is a lot of room to advance in this space, because so much work hasn't been quantified yet," she comments. "It is very difficult to compare managers on this parameter. We want to see evidence that managers have selected clear priorities, that they have the right access and that they follow up in a timely manner. The key question is, how you define successful engagement. The answer varies across asset managers, but having a clear definition is what we expect as a first step to prevent potential 'engagement-washing'," says Li.

"Actually, an unsuccessful engagement can be a successful engagement, too," points out Manning. "It tells you that the company doesn't care and is not interested in changing, which is valuable information. That helps me understand how the company's management is thinking about strategy, what risks are inherent in the business that are effectively being unmanaged. So even an unsuccessful engagement, if done right, is massively important."

"I would be a bit sceptical when asset managers say they have engaged with 500 companies, though," cautions Manning. "How many of those engagements were substantive? I don't count writing a letter or just chatting casually with management as engagement, for instance. Not that relationship building isn't important, of course, but the objective of an engagement should be to understand better an issue you have identified as important or to affect change. And you need to set milestones around that and follow the progress."

"Rather than a blank exclusion rule, we now look at if the companies can prove that they are Paris-aligned, if they have a credible transition plan, if they really want to change. If we can see evidence of that, then we won't divest. And, of course, that is something we look for in our external managers, too."

The more, the merrier

"When it comes to emerging markets, I think local collaboration might be very beneficial for the engagement process," suggests Li. "The intersection of local knowledge and an outsider perspective is a sweet spot, and often the key to success in emerging markets."

Collaboration is important even for big institutional investors like AP3, especially when they venture beyond the Nordics. "Some companies in the US haven't even actually heard about the Swedish pension funds," says Stanghellini. "Being part of collaborative investor pools makes our voice so much stronger."

Having worked in the financial industry all her life, Kellner is aware that collaborating with competitors is mostly a no go. "When it comes to sustainability, however, it is a different game," she says. "The attitude here is the more, the merrier. Everyone seems happy to share ideas and knowledge with others. If you and I engage with the same company and we share our progress with each other, then we can push the company in the right direction much more efficiently. We all want the same thing, and we all need each other," she concludes.

Selective exclusions

"Nordea has always had the approach to engage rather than exclude," continues Kellner. "It is challenging, however, as we are under a lot of pressure and heavy scrutiny from the public and media. We seldom get the opportunity to explain why we haven't divested from this or that company. We are excluding, of course, quite significantly in some sectors, but we are also engaging where we deem it meaningful.

"Rather than a blank exclusion rule, we now look at if the companies can prove that they are Paris-aligned, if they have a credible transition plan, if they really want to change," Kellner continues. "If we can see evidence of that, then we won't divest. And, of course, that is something we look for in our external managers, too. We have outsourced investments to quite a lot of managers who act as our lengthened arm in the engagements, so we need to rely on that they do it well and provide sufficient feedback to us."

Kellner is convinced that engagement is becoming more and more important. "It is difficult to measure, though. We have also featured in external reviews comparing us to peers focusing

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too much on the numbers. So maybe we reported 400 engagements and our peers had 500, does it mean we are not as good as them? For us, it is more important to know the details and build a database with all available material on the engagement," she concludes.

Can you do well by doing good in emerging markets?

Most sustainable investors would argue that by improving the sustainability of investment companies, especially in emerging markets, risk and returns are also optimised, at least in the long-term. Some high-impact projects seem, however, not to be compensated by an attractive risk-adjusted return. Is that a fair observation, wonders the moderator.

"I guess a lot of our assumptions are based on historical data and maybe a little misleading," responds Jaquier. "Five or ten years ago, nobody had the focus on sustainability issues that we have now. I do believe that going forward, these issues will become much more material and relevant. Some of the risks we discussed may be a bit mispriced. Take Russia, for instance, and the Russian spreads. Before the war, they did not reflect these risks at all. If you manage to pick them up, then you can deliver a lot of alpha for your clients."

"You need to put in place the right framework, of course," continues Jaquier. "If you are overly reliant on third party data that has an income bias, you might exclude the least developed countries, the ones with the highest spread. Then you end up with a low-return bias. Emerging markets are a vast and hugely varied universe, comprising of countries with different characteristics. You can be very selective in your approach, but still find frontier countries with very attractive risk return profile and improving sustainability characteristics. It is possible to have a Paris-aligned portfolio that has exposure to a wide range of emerging markets," he concludes.

De-risking with labelled bonds and blended finance

Innovative financial and legal structuring such as blended finance vehicles or sustainability bonds can help lower risk while increasing impact, too. "It is positive that there is more and more of this type sustainable issuance," says Jaquier. "One of the challenges with sovereign debt is the lack of visibility on the use of proceeds. They are meant

"It is a balancing act, juggling sustainability, risk and return simultaneously. Mind you, it is not just a requirement imposed by the government, we do believe that a well-run sustainable company will deliver better returns over the long-term."

for general use. With these new labelled bonds, you have direct attachment of the proceeds to positive outcomes. You know exactly which projects are being funded. More recently, we have seen the development of sustainability-linked bonds with issuers choosing KPIs to align their financial incentives with their climate commitments."

"It is telling that there are only two sovereigns that have issued such sustainability bonds and both of them are emerging market countries," continues Jaquier. "It is very encouraging that EMs are at the forefront of innovation when it comes to sustainable finance and a sign of their commitment. There are a lot of great opportunities in the space. Earlier this week, Côte d'Ivoire issued their first sustainable bond. It is a poor country with large areas of forest that need to be protected. It is great to see that they are allocating part of the bond's proceeds to these projects. In the strategy that I run, we have about 40% of our exposure to these types of sustainable and sustainability-linked bonds."

Another innovation that has revolutionised private debt investing in emerging markets is blended finance. "The perception of many investors is that private debt in emerging markets is too risky," explains Vukic. "We need to de-risk and structure the investments to make them palatable. In blended finance structures, the junior tranche is taken by development finance institutions (DFIs) which can absorb the higher risk. That provides some comfort for the senior lenders to step into the structure. What also helps is that all our funds are earmarked for impact. Our clients know what we are targeting, which KPIs we are aiming to achieve and what we deliver."

Squaring the magical sustainability 'risk-return-impact' triangle

As for the triangle of risk, impact and return, while these are very important Vukic says he misses one component in it – costs. "The clients always want to know how much our strategy costs, of course. I believe, adding that component to the square is probably one of the solutions going forward is to hit all four targets. There are funds in the emerging markets private space that have been able to solve this puzzle. That is why you need these blended structures, in order to make these strategies as efficient as possible. Collaboration and syndications are very welcome developments," he concludes.

As a state pension fund, AP3's mandate has always been to maximize the contribution to the pension system. In the latest revision of the investment guidelines, however, it says explicitly that the fund should invest in a sustainable way. "It is a balancing act, juggling sustainability, risk and return simultaneously," admits Stanghellini. "Mind you, it is not just a requirement imposed by the government, we do believe that a well-run sustainable company will deliver better returns over the long-term. Short-term, however, you can have huge swings and you need to be prepared to take them. You need to remember that you are acting in the interest of the future generation and the pensioners by holding a sustainable portfolio."

Lessons learned and portfolio shifts

The new focus on sustainability has led to significant shifts in AP3's portfolio. "Now, when we invest in illiquid assets, we do it directly," explains Stanghellini. "This way we can sit on the boards of companies and can influence decisions directly. Another huge trend has been moving away from passive investments. A decade ago, these used to be our largest allocation, as they are very cost-efficient and liquid. What we end up with, however, is a huge portfolio and a lot of sustainable risk. So, we have veered to active, more focused portfolios managed internally. This way, we have better control of our portfolios and can also engage directly with companies."

"It has been a real learning curve," agrees Manning. "Thinking back to my own experience, I have always had a focus on quality companies, but structuring that around sustainability which is front and centre for us. This makes it a dual outcome strategy, thinking about products and services alignment. One of the things that became clear across the market, not just for us, was that there was a much stronger growth bias in such strategies than perhaps people appreciated.

Everyone expected the sustainability credentials of those quality companies to offset the growth bias. So, when the market shifted back to value, we were all left feeling very uncomfortable, because the performance in the equity space did not stack up in the way that we had expected it to do. The sustainability and the quality of those businesses didn't compensate for the shift back into value."

"We have spent a lot of time thinking about how to increase the focus on quality and, what we call, financial sustainability," Manning continues. "We mean in the broadest sense: the culture of the business, how they use their cashflow, how they think about the value chain, how they think about their stakeholders. We are explicitly targeting the top two quintiles of the highest quality companies, in addition to our products and services focus. When we look at the style of the portfolio that we have today compared to the portfolios that we were running previously, we can see that by bringing in that financial discipline in a more explicit way, we have managed to strike a better balance between growth and quality. Yet, we are still underweight value, which is almost inescapable in emerging market sustainable strategies, unfortunately," she adds.

"Clients looking for a very dark green strategy should be aware that we are never going to be able to invest in many of those companies. And

we don't want to, given the long-term time horizon that we have for our strategy. That doesn't mean they are not right for other managers; they are just not right for us. We believe that by having a much greater focus on getting the style balance we are now able to manage the risks in the portfolio better. Mind you, it is only after living through that huge market cycle, that you realise the true meaning of these risks, especially the unintended risk positions in the portfolio," admits Manning.

Set-backs and repercussions

Sustainability stocks' recent underperformance has had consequences also for Nordea Life & Pension. "Although our exposure to the sector was relatively small, it has affected our portfolio as a whole," says Kellner. "Naturally, some products were hit worse than others. Sustainability-labelled products in particular underperformed other parts of the portfolio."

"I believe this is okay, however, as I have a long-term view and I can understand why this happened. In the years before, so many investors suddenly woke up to the sustainability trend and rushed into, say waste management stocks," Kellner explains. "Everyone started chasing the same investments as they needed this type of exposure in their portfolios to justify the label 'sustainable'. So, of course, these stocks became overvalued. At some point we had to recognise that, whether you consider yourself a sustainable investor or not, these stocks were simply too expensive. Also, there was the realisation that many of these companies that were supposed to save the world use early-phase technologies, yet to be proven. Many were essentially start-ups, that could become really big, or not," she adds.

"Promoting sustainable investments is a strategically decision for us. It is important for the bank, just as it is important for most people," asserts Kellner. "The recent underperformance does not change our positive long-term view. Yet, the challenge we are facing is explaining it to our customers and the advisors in the bank. We do ask all our clients whether they want to invest their savings in a sustainable manner, and we respect their preferences.

A dangerous bump in the road

"That is why I really hope that the performance slump we have experienced recently will not last for too long," continues Kellner. "This underperformance is not good for the whole industry or for the shift towards sustainable investments. I truly hope it is just a bump in the road," she concludes.

Li echoes Kellner's concern. "As financial advisors, our starting points is always the clients," she says. "It is their preferences, their risk tolerance that dictates what the right strategy for them is. We aim to provide them with some degree of flexibility to choose the products they feel

comfortable with. Our role is to make it very clear whether the portfolio they have chosen is a sustainable one or not, based on our own sustainability analysis. We also strive to educate clients on what sustainable investment means in an easy-to-understand manner and explain what Söderberg & Partners' sustainability strategy means in terms of returns, risks, and impact. Some clients may opt for an impact profile that sometimes overrides the returns expectations, and we are not really in any way in a position to advise against it. Of course, the best would be to combine everything in a perfect way, but ultimately, it is up for them to decide," she adds.

dessert

The wish list

Aladdin's magic lamp to the rescue

Coming to the end of the discussion, it is time to indulge in some wishful thinking alongside the chocolate pralines. Each of the participants is granted no more than three wishes by a most unselfish genie who encourages them to request something that is going to benefit the world rather than themselves personally.

"If I could wish for anything, I would ask the genie to put a spell on politicians in every country so they would genuinely want to save the planet and make it a priority to do everything they can from that perspective," says Kellner. "Imagine each president, each prime minister in the world driving the sustainability agenda! I know it is impossible, but you did not say it had to be realistic," she adds.

Manning wants to use all three of the wishes allowed, splitting them into two focused asks and a slightly more frivolous one. "Firstly, I do wish that as developed nations we showed much greater discipline in delivering on the promises that we have made to support the transition in emerging and frontier economies," she starts. "I firmly believe the progress on achieving net-zero and energy transition sits within emerging markets and that is where the greatest negative impact in terms of climate adaptation lies."

"My second wish would be about increasing education for women in developing countries," continues Manning. "It would lead to reducing family size and increasing savings rates, creating enormous benefits in terms of economic development and GDP per capita improvements in a huge range of markets, but particularly in Sub-Saharan Africa."

"My third wish is really frivolous and a bit selfish, too," admits Manning. "I do wish for carbon-neutral travel to accelerate, as one of the things that I absolutely love about my job is the ability to go to different markets to meet people from different backgrounds, different cultures, to have that exchange of views. And if I could do that in a completely carbon-neutral way, that would be absolutely fantastic," she says.

Jaquier wants to combine Kellner's and Manning's wishes into one. "It would be amazing if more

politicians could adopt the transition agenda," he says. "We have seen a few such cases, like in Brazil, or in Colombia, but I wish it could become much more widespread. With so many key elections this year, hopefully, it might happen to some extent. I also wish for that agenda to not be so politicised. I am hopeful, because EM nations are very young, and the youngsters feel strongly about sustainability. Look at Chile, for instance, where the right and the left-wing parties have alternated, but the climate agenda has moved forward regardless."

"I also wish for a stronger commitment from developed markets to finance the just transition in developing countries and for capital flows to start going into emerging markets again, to make that transition possible," adds Jaquier.

"My first wish is to see a reduction in inequality between the richest and the poor," says Stanghellini. "When you travel to emerging and frontier markets, you see so many people living in absolute poverty. Even if starvation is rare these days, except in countries like Yemen, perhaps, you realise that most people really don't have anything compared to us in the western world."

"My second wish is for peace," continues Stanghellini. "I cannot get my head around that in 2024 we have two wars, in Europe and in the Middle East. We should know better. This means money going to the military, instead

of healthcare, education or bringing frontier and emerging markets out of poverty. And we seem to be heading in the wrong direction, towards more tensions, more war."

Stanghellini confesses she fears her third wish, reaching net-zero by 2040, is rather unrealistic. "To get there, we really must accelerate in the right direction. AP3 has set clear goals in reaching net-zero by 2045. Primarily through engagement with companies to set science-based targets, to design and implementing transition to net-zero plans and to report back on progress. We focus on four areas to do so: Governance, Climate Change, Human Rights and Biodiversity. Hopefully the genie is listening," she adds.

World peace is high up on Vukic's wish list, too. "It is indeed ridiculous that in the 21st century, despite all our advancements, we are still fighting," he says. "There must be tons of better ways to solve conflicts than with weapons."

"Secondly, I wish for much more investments in emerging markets. There are not nearly enough right now. There is a lot of talk about impact among institutional investors, but no money backing the statements. I wish that they would put at least 2% of their assets under management into causes such as education programs for women and children in the developing countries. That would change the world. In all fairness, the problems of emerging markets are our problems, their CO_2 emission are felt here. It is not they or us, it is we, that should be the way forward," he concludes.

"My wish is for artificial intelligence to be deployed generously in developing countries, so that everybody could benefit from it," says Li. "This revolutionary technology has the potential to close so many gaps, education-wise, for instance. I am quite fascinated by this new development and can't help imagining how it would have changed my life had it been there when I was growing up. I believe AI could be a very powerful tool for all the children in developing countries, provided they get access to the technology," she adds.

Back to Manning's wish to be able to travel the world with a minimal carbon footprint, most of those around the table agree that it is not just a frivolous desire. Post-pandemic, we have all learned to value the importance of building human connections across borders in person or appreciating the amazing biodiversity in different parts of the world. "You can't trade mangroves in Borneo for heathland in the UK, they are not interchangeable," says Manning. "Talking face-to-face is the best way to create trust and understanding. The less we can travel, because of carbon impact concerns or other issues, the more insular we become. I know there are other technologies, but there is nothing like sitting around a table, sharing a meal, to make those connections and start a serious conversation."

We couldn't agree more.







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