# GLOBAL EVOLUTION
# EMERGING INSIGHTS TRANSCRIPT

**ESG INSIGHT: OVERCOMING THE SOVEREIGN INCOME BIAS**



**YK**: Hello, and welcome to Global Evolution's Emerging Insights Podcast. I am your host, Yulia Kosiw. And today's episode my guest, Nathalie Larsen Global Evolution's Senior ESG Analyst will discuss the findings of her latest paper on overcoming the persistent income bias that exists in sovereign ESG ratings.

Thank you for joining me, Nathalie.

**To start, can you please tell our listeners about global evolution's philosophy when it comes to evaluating and integrating ESG factors into our sovereign debt investment process?**

**NL:** Yes, so we believe that when it's done right, ESG integration can contribute to improved sustainability in the countries where we invest and also generate attractive returns for our clients along the way. In global evolution, we see a particular opportunity to invest in frontier and emerging markets even if these markets typically have weaker ESG credentials than more developed countries, because in our view, it's really in the less developed [00:01:00] countries that we see the greatest opportunity to support ESG improvements. And it's also in these countries that financing is needed the most to drive their development.

Now, of course, this leaves the task of managing ESG risks, but in our view, the impact that can be created in these countries is much more significant than more advanced economies that have already undergone development and have developed stronger ESG conditions already. And at the same time, we have researched into the relationship between sovereign debt investing and ESG indicators.

And we have found that countries' positive progress on ESG indicators typically is associated with cheaper market financing. And so knowing that there is a clear interrelatedness between sovereign funding costs and ESG dynamics, we would really sacrifice essential information if we would not integrate ESG related [00:02:00] information into our investment decisions.

Of course, ESG data cannot form the sole basis for investment decisions, but it can definitely provide additional information that is not captured in traditional credit analysis. So for these reasons, our basic philosophy is to really not be too focused on ESG levels, but give attention to countries ESG trajectories, and also the opportunities for countries to improve their ESG performance, even when they are improving from low levels.

**YK: What does this mean for global evolutions country exclusion?**

**NL:** Naturally, some countries have so poor ESG credentials that we can't justify investments, but we don't really believe that a hard exclusion process is the most sustainable choice, as this would. Again, direct financing away from the countries that need capital the most to improve their ESG conditions.

So since our investment philosophy is [00:03:00] focused on supporting countries positive development, our exclusion approach seeks to only exclude those countries with exceptionally poor ESG levels, while then investing in countries where we see opportunities for improvement. But we have a very clear process in place for country exclusion, it's a simple quantitative framework that is combined with the qualitative country assessments.

So, this allows us to screen out countries when they fall below a certain threshold where we can no longer justify investments.

**YK: Could you please give our listeners some examples of how ESG factors can be incorporated into sovereign analysis to assess a country's risk level?**

**NL:** Actually, ESG factors matter in different ways depending on country's development so what is relevant for advanced economies is not necessarily the same as what is relevant for frontier and emerging markets. And in the context of frontier and emerging markets, ESG factors that [00:04:00] are related to country's socio-economic development is particularly important.

If we look at governance, it's something that's already captured in traditional credit ratings, and it has for not long been known that good governance and strong and stable institutions are important drivers of economic growth and lower financing costs. But also in the broader ESG context, the quality of governance and institutions largely affects countries social and environmental performance.

And so governance indicators and the changes in these are particularly important because they will give information on the governance risks that can differ from what we already know for more developed economies with stronger institutions, but also these indicators can signal an improving governance environment that can have a positive effect on the country's further socioeconomic development.

Now social factors are related to the socio economic conditions in a society which we also know is [00:05:00] key to development. Just consider basic services such as clean water and sanitation. A lack of these is among the leading causes of illness and death and lower productivity. And also electricity, even in its most basic form, provides light for small business owners running their business for longer hours and children being able to do their homework, even after the sun has set.

Such very basic services have a huge impact on countries development by contributing to the country's stock of human capital, which we know from economic development literature is among the key contributors to development and growth.

Environmental indicators are then focused on how sovereigns perform in relation to protecting the natural environment and how they manage their energy resources, hopefully in a sustainable manner. And both is something that has benefits for economic development. Just [00:06:00] consider a simple example as water. Again, it's a natural resource and we see how critical it is for agriculture, nutrition, and health. And so managing such an important resource sustainably is of very high importance, especially considering also that the global demand for water is expected to increase, and research has even suggested that the world will experience a significant shortfall between demand and available supply of water by 2030.

So, all these are just a few examples, but demonstrate well how ESG indicators matters to economic growth and also countries development, which is then related to their ESG progress.

**YK: Let's now turn to your paper. It explores the correlation that exists between country's income levels and their ESG scores. What are some of the most common sources of ESG ratings and how reliable are they?**

**NL:** Yes, so the correlation means that the more developed countries are, [00:07:00] the higher the ESG score they tend to have. This is not really a surprise, considering that many ESG components are linked to countries income and development levels, in line with some of the examples that I just gave on institutions and human capital and management of natural resources.

And the data behind these ESG ratings is generally limited when wanting to cover majority of countries in the world, so ESG ratings are often based on much of the same data from, for instance, the World Bank and Transparency International. And even when you have alternative data sources from other data providers, in the end, they will typically give close to the same results when rating countries relative to each other because more advanced economies have the prerequisites for higher ESG credentials. But this also means that most ESG ratings following traditional ESG rating methodology will be highly correlated because the underlying indicators link [00:08:00] back to the income level of a country. So investors should be careful in how they use these traditional ESG ratings when in reality these ESG ratings are just an expression of a country's income level and therefore these scores are systematically biased against frontier and emerging markets.

**YK: And what are the pitfalls of investors relying on these traditional ESG rating scores?**

**NL:** First of all, there is a risk of investors thinking that countries with higher ESG ratings will be a more sustainable investment choice. And when this is the perception investors can be inclined to tilt investments towards high performance and perhaps even seek to outperform a benchmark's ESG level.

Now of course this is something that can help reduce some ESG risks but it will also channel away funding from the countries that need the funding the most to progress on their development journey. And it's also [00:09:00] something that will add to the global inequalities, where stronger ESG performers will continue to progress with the funding that they have or the financing that they have available, and the lower performers will lag further behind, because these countries will have less financing available for reforms, and because their debt will continue to be more expensive. So therefore it's important for us as investors to consider countries' ESG levels in the context of their income level, and not to expect countries to have reached the same ESG levels as richer countries when they're still in the process of building socioeconomic capacity.

And the second pitfall is that focusing solely on ESG levels disguises more richer and developed countries negative ESG trajectories, which is something that can have a negative influence on a country's sustainable development level and also on investment risks.[00:10:00] If a country has a high ESG level and its negative trajectory is ignored, It will continue to seem as a more sustainable investment over a country demonstrating important improvements, but just starting from a lower level.

And then finally, investors should be careful not to rely too much on a country's overall ESG rating, but also be mindful of understanding the underlying indicators comprising the ESG rating because the ESG rating s simply a quantitative expression of a country's ESG level relative to all other countries. However, it's also important to understand what drives the performance, the lack of performance, and what are the underlying challenges and opportunities.

And also to see if there are any important reforms or initiatives under way in a country, but where outcomes are just not yet captured in data because it tends to be slow moving.

**YK: Considering the shortcomings you just mentioned, how does Global Evolution approach assessing ESG factors as part of our sovereign analysis?**

**NL:** ESG levels do give important information, and in global evolution we also have a framework for evaluating ESG levels in the traditional sense, where we systematically score 198 countries ESG performance on a scale of 0 to 10 based on 123 indicators. But, since we know that this rating is highly correlated with the country's national income level, we would of course miss out on significant information if we relied only on this information.

So what we do is first also to evaluate countries ESG performance in the context of their development level. And we do so through a regression analysis, where we estimate the relationship between ESG level and country's income level per capita, where we also control for the World Bank's four income groups ranging from low to high income.

And we then use the residuals from this model to calculate a new and different ESG score on a scale of 0 to 10 also. But the score is more an expression of how a country performs relative to what would be expected from that income level. Now, of course, such score doesn't work well on its own, as some countries that have ESG performance levels, that have lower ESG performance levels in the traditional sense, have higher ESG risks relative to other countries.

And of course, this should not be ignored. But it's still an important assessment to see how well a country performs in the context of the country's development and income level. And second, since we know that there is a clear interrelatedness between sovereign funding costs and ESG dynamics, we also rate countries ESG trajectories.

We do so by scoring countries' ESG development over the past five years [00:13:00] by constructing a separate ESG rating based on the country's ESG level today compared to the level five years ago, and also convert this into a scale zero to ten. So, this allows us to identify a country's level of ESG improvements or deterioration relative to other countries.

And we also have a similar score that compares countries' more recent developments, so that we can identify if there's any significant momentum that we should look into.

And lastly, it's important to be aware that quantitative sovereign ESG data does not form a full picture of the ESG conditions in a country.

There are so many nuances that are difficult to quantify, and data is backward looking, and there are often delays in data. And this is where a more qualitative assessment is needed to understand the underlying drivers of countries' ESG conditions and the developments. And [00:14:00] also to form a picture of what can be expected going forward.

So for instance, a newly elected president can implement a variety of reforms that will have important socio economic implications. But those implications will take years to show in ESG readings. So combined, the different scoring methodologies and qualitative insights helps us form a more nuanced view of a country's ESG performance and ESG trajectory than more than a simple... rating can do. So it's something that helps us form a stronger country conviction alongside more traditional credit analysis.

**YK:** Thank you, Nathalie. This was very interesting.

Nathalie's paper is available so please reach out to us if you would like to receive a copy

We hope you found this discussion informative and welcome your feedback and questions. You can reach us via our website at www.globalevolution.com or by emailing marketing@globalevolution.com. We hope you join us next time.