Environmental, social and governance (ESG) themes have risen to the forefront of many investment strategies over the last decade, but there are still significant inconsistencies in how ESG is integrated into the analysis of sovereign issuers. In our view, ESG cannot be summarized in a few regression or data compiling exercises. Instead, we believe ESG factors should be considered on a case-by-case basis. In particular, we believe a focus on what makes for sustainable institutions helps us identify countries with policies that will lead to sustainable growth, sustainable debt and sustainable returns for investors.
In considering how an ESG framework can be applied to the analysis of sovereign issuers, a few key questions must be addressed:

- Is the approach meant to support specific values such as democracy, equality, women’s rights or others?
- If so, how do we prioritize these objectives if there are tensions among them?
- Should investors reward a level of achievement or a trend that indicates progress?
- Do these considerations represent additional measures of creditworthiness and sustainability that generate better—and more sustainable—returns for clients?

Some investors prioritize risk exposures rather than specific values, which leads them to focus on areas of social risk rather than the social responsibility of governments. In this approach, for example, they might assign a poor ESG rating to a country hit by an unexpected wave of refugees from a neighboring war. Meanwhile, others look more closely at development outcomes, such as educational levels or the efficiency of the health system. In this case, they might assign lower ESG scores to countries with fewer hospital beds per capita.

A more effective approach, in our view, is a dynamic analysis that takes into account the institutional specifics of each country and its current trends toward progress. Below, we outline key elements that we believe constitute a successful approach to analyzing ESG factors as they pertain to sovereign issuers.

**Elements for Successful ESG Analysis**

1. **Focus on Sustainability**
   The development economics literature—relevant for ESG analysis and implementation—rarely produces unqualified policy prescriptions, but tends to include generally accepted conclusions that can serve as guideposts. One of the broadly agreed upon conclusions is the importance of sustainability. For Barings’ EM Sovereign Debt team, the definition of sustainability is sustainable improvement in institutions and policymaking, which leads to sustainability of management of natural resources, improvement in social outcomes for citizens and sustainable returns for investors.

   Our strong conviction around the importance of sustainability in ESG is based on our thorough analysis of, and familiarity with, related economic literature. Below, we have outlined some key findings in support of a strong focus on sustainability and its link to economic growth:
   
   - It has been demonstrated across many studies that a country’s income level, as measured by GDP per capita, is highly correlated with its development outcomes—meaning, the wealthier a country is, the more likely it will be to have better schools, more hospitals, better infrastructure and a better functioning judiciary system.
   - Studies have also shown that returns in EM Sovereign Debt are driven largely by improving sovereign creditworthiness—and sovereign creditworthiness is correlated with income levels. In fact, rapid and sustained improvements in income levels typically drive improvements in creditworthiness in the medium and long term.
   - The achievement of high GDP per capita over time, and therefore better development outcomes, is driven more by growth sustainability than by growth magnitude. Related to that, growth volatility, severe shocks and growth collapses have been shown to be disproportionately detrimental to a poor country’s development.

   These findings, when considered together, strongly support the notion that sustained economic growth is a key driver of higher income per capita and positive development outcomes—and, ultimately, higher sovereign creditworthiness.

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1. See Blühm and Szirmai’s 2012 extensive literature review.
“Many traditional ESG indicators measure outcomes rather than root causes. This can be fairly limiting, in our view, as outcomes are unlikely to reveal much more information about a country than common economic indicators.”

So, what are good predictors of sustained growth periods?

It can be very difficult to predict how long periods of growth will last. For this reason, economists and political scientists tend to focus on institutional quality, and specifically the resilience of a country’s institutions to conflicts and challenges. For instance, improvements in the quality of a country’s political regime have been shown to be a significant predictor of growth accelerations. And comprehensive economic reform has been shown to be a significant predictor of growth accelerations that are sustained.²

Therefore, the quality of a country’s policymaking—in terms of managing sustainable environmental wealth, promoting social advancement and developing growth-enhancing resilient institutions—is key to both promoting long-term returns for clients and improving conditions for citizens.

2. Focus on Causes, Not Outcomes

Many traditional ESG indicators measure outcomes rather than root causes. This can be fairly limiting, in our view, as outcomes are unlikely to reveal much more information about a country than common economic indicators—such as GDP per capita. Rather, we believe there are advantages to exploring indicators that can better predict medium to long-term growth, as well as financial and development performance. Even better are indicators that operate through predictable channels.

The challenge, here, is that it can be very difficult to establish both correlation and causality. Many studies have shown that, more often than not, it is unclear whether a correlation between a development outcome and sustained growth is negative or positive. Causality is often even more difficult to establish, especially if there is no strong theoretical model supporting it. As a result, the literature around how certain factors are (or are not) connected to growth and development can be contradictory. For example, when it comes to measures of inequality, ESG research providers often rely on measures like the Gini coefficient, health care access, and gender income inequality. But these can be misleading—does income inequality drive political inequality, which in turn drives growth and development? Or, on the other hand, is it inequality in political rights that drives economic inequality, which in turn impacts growth and development? The literature seems to have contradictory evidence on this matter.³

Therefore, one pitfall to be avoided is drawing conclusions, such as “high ESG scores cause tighter spreads” or “better scoring ESG corporates are located in better scoring ESG countries” when correlation and causation have not been properly established. These types of conclusions can lead to tautological statements such as “wealthy countries with tighter spreads have better ESG scores as a result of choosing ESG indicators that reflect country wealth.”

3. Engerman and Sokoloff’s research shows that income inequality drives political inequality, which in turn drives growth and development. Taking the opposite view, Acemoglu and co-authors tend to show that the start is political inequality in rights, which drives economic inequality, which in turns impacts growth and development.
3. Avoid Erroneous Data

While it may seem obvious, when it comes to ESG, data isn’t always accurate. Gaps in data are sometimes filled by extrapolating or averaging other existing data, which can lead to misleading conclusions. Some studies have also shown instances in which data from multiple sources have been repackaged, and then used to construct new composite variables and rankings that are often less meaningful than the original data—and in some cases, these data inputs are double or triple-counted to produce ESG ratings. A very interesting example is the use of the Notre Dame Global Adaptation Index “ND-GAIN,” and the overlap between its Readiness component and the World Bank Governance Indicators.

We have also seen analysis that relies on a country’s exposure to an environmental risk—such as drought, hurricanes or earthquakes—as the main component for that country’s environmental score. At the other end of the spectrum, we have seen analysis interpreting a country’s lack of natural resources (including fossil fuels) as an environmental risk, on the basis that a lack of natural resources signifies a country is less environmentally wealthy. This assumption is misleading, in our view, particularly to investors truly concerned with environmental policy. There is little evidence suggesting wealth in natural resources is an accurate predictor of medium-term economic performance. In fact, much of the economic literature on the topic highlights that countries with abundant natural resources may be more prone to certain economic risks—such as the so-called Dutch Disease that comes from an overvalued exchange rate or mismanagement of the natural resource, such as the case of Venezuela.

4. Tread Carefully With Environmental Factors

Environmental factors are particularly difficult to analyze, as a country’s environmental condition depends heavily on global collective action and remains vulnerable to free riders. Said another way, it is very complicated—and perhaps even unfair—to analyze environmental policy at a country level when it is a global challenge to solve. This is especially true for the large number of emerging markets that are disproportionately affected—negatively rather than positively—by deteriorations in environmental conditions that are the result of climate change. Nonetheless, we do see value in considering policy resilience to climate-related shocks as part of a broader ESG analysis. Ethiopia’s resilience to droughts is an interesting example. Previously, a severe drought in Ethiopia might have led to dire economic, social and political disruptions such as a collapse in FX reserves, soaring inflation, disruptions in food supply, significant migration movements, and domestic political instability. However, thanks to recent improvements such as productivity gains in Ethiopian agricultural, better infrastructure, better macroeconomic management, and better social programs, Ethiopia’s social and political resilience to severe climatic shocks has materially increased.

5. Consider the History Behind the Institution

Another frequent pitfall we see across ESG analysis is the application of ESG standards that are inappropriate or irrelevant for developing countries. Studies suggest that even government institutions deemed inefficient by some standards are capable of bringing about improvements in a country’s sustainable growth path. At a high level, political and institutional systems have been implemented over time for the purpose of resolving problems—from mitigating violence and power struggles to organizing productive resources to go to war. When analyzing a country’s institutional arrangements today—and forming an opinion on whether the country government needs to change or evolve—it is important to take into account the problem that the institution originally solved. Related to this, many emerging market institutions maintain very close ties—and even dependency—on a colonial inheritance. In fact, scholars have long-studied this dependency on countries’ historical legacy. The point is not to justify the status quo, but to better analyze the sustainability of reforms.

6. One Size Does Not Fit All

In our research, we have seen many instances in which comparisons are made, based on historical analyses, between countries that have succeeded in creating industrialization, sustained growth, and development—and those that have not. While these comparisons may be accurate for the particular set of countries being studied, they are not necessarily relevant to developing countries today.

For example, even though the formalization of property rights was an important growth milestone for most economies in the 19th century, the absence of strong formal property rights in many developing countries cannot necessarily be viewed as a binding

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5. ND-GAIN is an indicator published by researchers from the University of Notre Dame that looks at vulnerability to climate disruptions and readiness to “leverage private and public sector investment for adaptive actions.” The components of the vulnerability measure span a wide range, including projections of deaths from climate change-related diseases, percentage of slum population, aged dependency ratios and percentage of paved roads. The components of the readiness dimension include a mix of outcome variables that may be unrelated to environmental policy (like social inequality or educational attainment measures) and institutional variables such as the governance indicators published by the World Bank. The issue is that several research providers use the ND-GAIN as the main indicator for the E dimension in ESG, while at the same time using many of the same sub-variables included in the ND-GAIN indicator as variables for the S and G dimensions—such as educational attainments and percentage of slum dwellings as social indicators and World Bank governance indicators as governance indicators. This is basically the same information repeated 3 times.
7. Bluhm and Szirmai’s (2012): “ostensibly inefficient and corrupt institutions can exist for the deeper purpose of ensuring social stability and restraining violence among competing factions.”
8. Insights from the works of M. Khan, North et al. or R. Bates
constraint to growth today—especially given that the transition to formality can actually be very disruptive.\textsuperscript{10} That’s not to say formal property rights aren’t desirable—they are. But the transition needs to be managed carefully, and sustainably. For instance, while the creation of a formal framework for property rights may help a developing country advance in the World Governance Indicators rankings, it may not change the de facto security of investments in the country given the still-informal framework. This is also what Rodrik describes as the necessity of considering “Second Best Institutions” for developing countries, instead of first-best practices. His example on equally inefficient contract enforcement for firms in Ghana and Vietnam—with private sector development in Vietnam not being impaired by these constraints compared to Ghana—is very enlightening.\textsuperscript{11}

This approach is not about settling for lower standards for developing countries; it is about implementing a more efficient and sustainable path of change, even if that means some short-term challenges. “It is the admixture of formal rules, informal norms, and enforcement characteristics that shapes economic performance,” writes Douglas North, the Nobel-prize winning economist. “While the rules may be changed overnight, the informal norms usually change only gradually. Since it is the norms that provide “legitimacy” to a set of rules, revolutionary change is never as revolutionary as its supporters desire and performance will be different than anticipated.”

How to Implement ESG for Sovereign Investing

Barings’ Approach to EM Sovereign Debt

Given the complexity of implementing ESG factors into investment analysis, a simple one-size-fits-all approach can be extremely limiting when it comes to assessing the wide range of countries in this space. At Barings, our EM sovereign debt team comprises investment professionals with strong backgrounds in economics and development policymaking, many having worked for governments (ministries, central banks) or as policy advisors (IMF staff or financial advisors, for instance).

Our experience in these areas forms the foundation from which we approach the high-level questions posed at the beginning of this piece:

- We believe in responsible investing and define it as country management that is politically, socially and economically sustainable.
- We believe the country’s longer-term trend—the direction it appears to be heading—matters more than its current level of development. As such, we seek to invest in countries that are improving politically, socially and economically—and we see improvements in these areas as mutually reinforcing.
- We make a concerted effort to distinguish between a country’s initial or current conditions and its actionable policies, giving preeminence to the latter when considering the sustainability of our investments.

Based on our conviction that creditworthiness and sustainability go hand in hand, our process for incorporating ESG considerations is based on the principle, “know the country”—including its political system, institutions, economic structure and competitiveness, and policy framework. For us, it’s not just about the numbers—flows and stocks, deficits and debt. It is also, and even more importantly, about knowing where the numbers come from and whether or not they can be sustained.

This is precisely why our approach to country analysis begins with an analysis of high-level ESG factors—governance, institutions, transparency, policy framework and credibility—as key determinants of sovereigns’ financial performance—fiscal and external deficits, public and external debt, and external liquidity—and the sustainability, or lack thereof, of that performance. We then incorporate a mix of quantitative and qualitative analysis, which leads us to our overall assessment of ESG factors in the context of a country’s policy framework and decision-making.

\textsuperscript{11} See Rodrik (2008) for examples in Ghana and Vietnam
The credibility and quality of a country’s policy framework are pivotal to our investment decisions, as we believe they are key to determining a country’s ability to withstand uncertainty and shocks—whether external, internal, political or economic—as well as environmental challenges. Ultimately, we believe taking a disciplined approach to ESG—and prioritizing the correlation between sustainability and creditworthiness—helps us improve our performance. In the below examples, we explore how a country’s alignment with ESG considerations can be a good predictor of improving or deteriorating creditworthiness.

**CASE STUDY**

**Venezuela: Insights from Emigration Patterns**

For several years before its default, Venezuela pursued an economic model that we believed was unsustainable. The country also stopped publishing data in 2015, making public finances virtually impossible to analyze—in effect, Venezuela became uninvestible.

A key question surrounding Venezuela, and a possible basis for investing in the country’s bonds, was whether a regime change could bring about a transition to a more sustainable economic model. Beginning in December 2018, opposition to President Nicolás Maduro started gaining momentum, with calls for massive street protests on the day of the inauguration. Around the same time, the Trump administration signaled additional sanctions, which many market participants interpreted as a sign that a political transition was likely. As a result, the price of Venezuela Eurobonds increased roughly 50%, from the low 20s to the mid 30s.

Assessing the likelihood of an ongoing political transition is challenging, as supporting data or evidence is often more anecdotal than concrete. In our research on the subject, we have come across the interesting insight that people vote with their feet. Using this theory, our EM Sovereign Debt team looked at Venezuelan emigration data to try and gain insight on the likelihood of political transition. We relied on a recent paper by Hausmann, Hinz and Yildirim (May 2018), which used data from social media to estimate the number of emigrants leaving Venezuela.

Based on the number of Venezuelan internet and twitter users, as well as migration patterns, the paper estimated 2.9 million migrants left the country between early 2017 and early 2018—roughly 10% of Venezuela’s population at the time. This figure included roughly 815,000 regular Twitter users. Our team interpreted this data as evidence of people—especially politically informed and active people—voting with their feet. From this, we concluded that a political transition was unlikely in the immediate future, which proved to be true. This makes Venezuela an interesting case where some specific social indicators, namely emigration and social media activity, have revealed political trends that are key to triggering improvements in creditworthiness—and therefore value for investors.
CASE STUDY

EL Salvador: Look at the Institutional Improvement, Not Just the Homicide Rate

El Salvador is another interesting case study from an ESG standpoint, as it is a country that would likely have contradictory ESG scores if rated purely according to some of the flawed methodologies described earlier—crime rate, inequalities, balance of power, institutional independence and macro stability, for instance.

A look at El Salvador’s recent credit history suggests the country is evolving toward better social and institutional equilibrium, which could positively impact growth and macro stability. But there were a number of factors that could have been perceived as impeding this progression, such as:

• A negative labor market structure with high unemployment and high informality
• The highest homicide rate in the world
• High, albeit declining, emigration rates
• A remittance-driven economy

These features suggested significant constraints to growth, as well as bad policy, challenged social conditions and bad labor market equilibrium. From a volatility standpoint, there was also the potential effect on macroeconomic and social stability to consider. Adding to these fragilities, El Salvador experienced a substantial market sell-off amid ratings downgrades in 2016, as a political stalemate fueled doubts about the government’s ability to remedy its financing gap and reach necessary debt authorizations. President Trump’s election in November 2016 didn’t help matters, as remittances make up roughly 20% of El Salvador’s GDP, with the majority of that coming from migrants located in the U.S.

While we certainly acknowledged these negative pressures, we took a different view on the country overall, based on our thorough analysis of ESG and sustainability considerations.

Specifically, having monitored El Salvador closely, we were seeing several positive signs of improvement on the institutional, fiscal and social issues:

• Inequality and poverty were coming down
• Unemployment and labor force participation were rapidly improving
• Anti-gang policies were proving effective, evident from still-high but rapidly decreasing homicide rates

Most importantly, El Salvador’s two historically opposite political factions—ARENA and the FMLN—had begun to fight legally and institutionally in Parliament, indicating a respect for the institutional process. Less than 30 years ago, for comparison, the conflict between these groups had claimed more than 80,000 victims.

Additionally, structural enhancements such as the separation of powers has allowed for fiscal discipline when disagreements over debt borrowings have occurred in parliament. With a law that requires the support of two-thirds of Congress for borrowing authorization, there is an internal control on borrowing in place that limits the need of the IMF or markets to discipline the authorities. This illustrates the institutional mechanisms that can help drive positive socioeconomic outcomes.

For us, these factors were significant enough to inform our more positive—and somewhat contrarian—view of the country. In El Salvador, we saw functioning institutions that had been formed in response to a specific historical challenge. This enabled the country to more efficiently tackle crime, maintain fiscal discipline, decrease emigration rates and improve labor productivity. It also elevated the potential of the country’s economy, and paved the way for improvements in various social and economic outcomes such as poverty, inequalities and security—and ultimately had a material (positive) impact on sovereign creditworthiness.
Space for Engagement?

Based on our extensive research, we do not believe ESG engagement with sovereign creditors is particularly feasible, nor is it desirable, with the exception of a few areas. One of these areas is improved fiscal transparency. Often, independent organizations working in this field will attribute a country’s “lack of fiscal transparency” to factors such as a lack of capacity at a relevant ministry, lack of coordination between different government agencies, lack of political willingness to share data, etc.

However, we see value in continuing to push for fiscal transparency, as it is one of the few areas that can be a win-win for all stakeholders:

- Consistent indicators by reliable, independent organizations are available
- Interests are ultimately aligned between governments, citizens and investors
- There has been a consistent improvement in the recent years
- Investors can be a positive force for change in that it is one of the few areas where sovereign investors’ engagement is possible

In our work on countries, we have come across independent organizations that do excellent work in this area, such as CABRI in Sub-Saharan Africa, the Observatorio de la Politica Fiscal in Ecuador, or the Independent Budget Partnership. The Emerging Markets Investors Alliance provides instances of how investors can organize to discuss these topics as well, especially ahead of meetings with relevant country delegations.

Conclusion

At Barings, our EM Sovereign Debt team incorporates ESG analysis into each investment opportunity we consider. We rely on our strong experience—and rigorous analysis of related literature—to assess ESG factors in the context of sustainability and, ultimately, creditworthiness. This deliberate approach gives us thorough insight into the countries we analyze, and enables us to uncover opportunities—and avoid risks—even when that means taking a contrarian view to prevailing market sentiment.
References

• Khan, M.H. 2009. “Governance Capabilities and the Property Rights Transition in Developing Countries.” Project Report. DFID.
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