William Blair

EMERGING MARKETS DEBT

Investment Management
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ESG in Emerging Markets Debt

As environmental, social, and governance (ESG) factors come to the forefront of investing, more and more issuers are taking heed—including those in emerging markets. We sat down with our emerging markets debt team to discuss how they view and integrate ESG factors in a highly analyst-driven approach.

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Head of Emerging Markets Debt Team

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Introduction

Marcelo Assalin, CFA

A robust, disciplined research process helps us better uncover mispricing in emerging markets debt, and ESG is an important component of that process: It provides a lens through which we can assess ESG-related risks while supplementing our views with external analysis and big data. We fully integrate ESG factors in a structured, quantitative, and qualitative process that provides a holistic assessment of an issuer's opportunities and risks.

Our ESG process is analyst-driven because we believe having an intimate relationship with issuers helps us understand them, particularly in regard to a topic as important as ESG. Moreover, the way we created our ESG framework is significant. While cooperation from ESG specialists is important, we believe the process should be driven by people who actually manage portfolios and understand the potential financial and/or reputational risks to issuers and their impact to portfolios. Some frameworks may be implemented firmwide, without accounting for differences in asset classes. Our framework was created by emerging markets debt analysts for emerging markets debt analysis.

In this Q&A, two of our portfolio managers, Yvette Babb and Luis Olguin, CFA, explain how we think about ESG and use it to help create sustainable value on behalf of our clients. I hope you find this informative.

Marcelo Assalin, CFA
HEAD OF EMERGING MARKETS DEBT TEAM

> "The journey to deeper, more authentic ESG integration at William Blair is an ongoing one—and it's central to our mission to continually improve as investors."

Stephanie Braming, CFA, Partner, Global Head of Investment Management

Before we discuss ESG in emerging markets debt, could you tell me why you consider ESG important more broadly?

Luis: When we look at corporate credit investments, we like to look at a multifactor risk approach, and we believe ESG is one of these important risk factors. We view the ESG framework as a lens through which we can analyze the potential financial and/or reputational risks an issuer faces. It is definitely something that has become more predominant in the industry right now, although many of its core beliefs have been around for decades, particularly when it comes to governance analysis. But ESG is about more than that: As society evolves, it is important that investors and the corporate community work together toward a sustainable future.

> "I truly believe emerging markets debt is the last frontier of investing. You can still uncover a lot of value through rigorous bottom-up analysis."

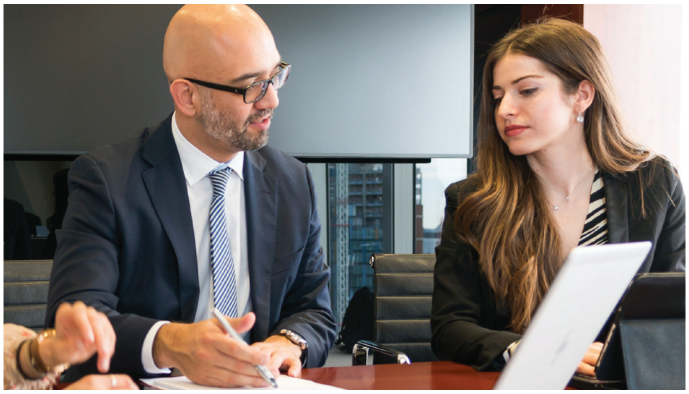
Luis Olguin, CFA

As emerging markets debt investors, why is ESG particularly important in that asset class?

Yvette: We see ESG as an integral part of sovereign risk analysis. It is important to understand all of the factors that influence a country's ability and willingness to pay. ESG factors are, in addition to macroeconomic factors, extremely important to understanding each individual country's ability to meet its obligations to creditors.

Is ESG more important in emerging markets than developed markets?

Yvette: Understanding the political and social context of countries that are at an early stage of development is most certainly important. We like to analyze how ESG factors relate to the economic and financial development of a country. That is somewhat different from developed markets, where you already have a high degree of social development and well-established institutions. Social and political factors can be more driven by non-financial sectors when countries are less mature from an institutional and developmental perspective.



"The only way to really understand whether a policy is just a check on a checklist or actually engrained in the company's values is to have this intimate, direct relationship."

Luis Olguin, CFA

Is ESG integration more difficult when investing in emerging markets?

Luis: Somewhat. Emerging markets are quite diverse, and geographic and cultural diversity leads to diversity in terms of ESG integration. Companies may have very high standards in some countries, while other countries need a lot of development. If there is one thing we have learned in our research, it is that a blanket approach to ESG analysis is unlikely to yield the best results.

Are emerging markets becoming more aware of the importance of ESG? Have you seen momentum toward ESG integration changing in recent years?

Luis: It has come a long way. Today, companies are very aware of the importance of ESG. Some even have responsible investment teams fully focused on energy transition, climate change, or best practices in their governance factors. Developed markets have higher standards, but in emerging markets, there is a path. Emerging market companies know where they have to be, and they are focused on getting there. They know they need to continue to evolve, not only by having high ESG standards but also by improving their transparency and disclosures.

Is governance the most critical ESG factor in emerging markets debt because default risk is linked to governance?

Yvette: Absolutely. When it comes to a country's default risk, we believe governance is central. Governance informs the degree to which a country can manage its economy and the degree to which it can execute policies. One cannot have improved environmental and social factors without a degree of focus on improving governance structures and overall performance of the political process.

Luis: We focus on governance because we believe governance permeates the other factors. If you have very strong environmental policies but no governance around them, what do they really mean? Are policies being implemented and monitored? Because of this, it is essential to have a strong relationship with a company. The only way to understand whether a policy is just a check on a checklist or actually engrained in the company's values is to have this intimate, direct relationship—and that is the way we approach it. We do not rely on third-party analysis, although we use it to complement our own analysis.

Could you explain what it means when you talk about the importance of trend rather than starting point?

Luis: Emerging markets, by definition, are still developing—so if you only focus on where an emerging market company currently stands on ESG standards, you may get the wrong sense of where it will be in the future.

Yvette: There is an intrinsic relationship between wealth levels and environmental and social outcomes: Countries that are at low levels of development can have poor environmental and social outcomes. We do not want to penalize a country that has poor environmental and social outcomes because it is at an early stage of development. At the same time, we are looking for countries that are seeking to improve those outcomes. We want to treat the countries that are improving favorably. That is why the trend is important as we monitor momentum.

You naturally want to focus on issues that are financially material to an issuer. Is financial materiality different in the context of sovereigns?

Yvette: Yes, materiality in the context of sovereigns is somewhat different than it is in the context of corporates. It is important for us to understand which of the E, S, and G factors have a material impact and the degree to which they influence financial returns. We have found that the E factors, on a five-year horizon, generally have had a limited impact on the financial returns of creditors.

Luis: The approach we like to take when it comes to financial materiality is bottom-up. Our ESG framework is analyst-driven. There seems to have been a big drive in the industry to apply ESG standards across all companies. In contrast, our analysts have an intimate relationship with individual companies and thus understand which ESG factor really affects the potential financial profile of an issuer.

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Luis Olguin, CFA

ESG at William Blair: Enhancing Our Search for Quality

By incorporating ESG factors into our fundamental analysis, William Blair aims to create a more complete picture of the risks and opportunities facing companies today and in the future.

- **Naturally Aligned**
  As an active manager whose heritage is built on rigorous, fundamental analysis, ESG considerations have always informed our investment decisions.

- **A More Holistic View**
  By incorporating ESG factors into our fundamental analysis, William Blair creates a more complete picture of the risks and opportunities facing both companies and countries today and in the future.

- **A Nuanced Approach**
  Our research analysts develop long-term relationships with corporate management teams and understand how sustainability aligns with longer-term strategy and financial performance—a more thoughtful, nuanced approach that we believe can create significant value for our clients.

Blake S. Pontius, CFA
Director of Sustainable Investing

Is ESG different when evaluating sovereign credit versus corporate credit?

Yvette: With corporate credit, we are trying to evaluate the performance of an individual company. The company's management or the board can be held accountable for the way in which they conduct themselves and influence sustainable outcomes. With sovereign credit, we are trying to evaluate the performance of a country. That involves the ability and the willingness of a government to repay its creditors. So, we need to understand the degree to which social and environmental factors are a function of government policy or external factors, and the degree to which these factors influence the country's ability to repay debt.

Is ESG more difficult when evaluating sovereign credit than it is when evaluating corporate credit?

Yvette: Yes, understanding a country's balance sheet, revenue flows, and expenditures is somewhat more difficult because countries do not necessarily present their financial information or ESG information in the same way that companies do. There is no standardized way in which countries present this information. Additionally, these factors may extend beyond the horizon of a single government's tenure.

> "We approach investments from a very strong bottom-up process. Having an intimate relationship with issuers helps us gauge their momentum, their improvement, their direction."
>
> **Luis Olguin, CFA**

Could you provide an overview of your team's ESG process?

Yvette: An integral part of our investment process is the sovereign risk model, which rests on two pillars. Those two pillars inform our view of fair value for sovereign credit spreads. One pillar is financial, and the other is ESG. The financial pillar informs the macroeconomic score for a country. Within the ESG pillar, the governance framework focuses primarily on political processes, institutions, and other governance factors; we also look at some environmental and social aspects of individual credits. Our bottom-up sovereign credit work looks at the individual country ESG policies and frameworks.

Luis: For corporates, we have created an ESG scorecard with which we analyze ESG factors and subfactors through direct interaction with issuers. Our scorecard aims to be comprehensive, comparable, and easy to use by analysts, but also flexible enough to apply to the diversity of our investable universe. We enhance the traditional ESG factors by separating social factors into internal and external—how a company interacts with its people and how a company interacts with its community. We also create a separate incident management report as we believe that how a company responds to ESG-related incidents can add as much insight as the incident itself.

"We believe the way to create better portfolios is to manage downside risks. And using ESG as a framework to look at these potential financial and reputational risks helps us understand the potential downside of companies, and thus create the potential for better risk-adjusted portfolios."

Luis Olguin, CFA

How is this an important part of your risk-management process?

Luis: We believe the way to create better portfolios is to manage downside risks. And using ESG as a framework to look at these potential financial and reputational risks helps us understand the potential downside of companies, and thus create the potential for better risk-adjusted portfolios.

Yvette: Sovereign risk involves not only financial factors, but a large number of non-financial factors, which include ESG factors. Environmentally, those may include risks that may evolve from vulnerability to climate change or external shocks that follow from natural hazards. Socially, we would look at situations that can reach a critical point and lead to social unrest and destabilization of governments.

Luis: As a follow-up to Yvette's comment, not having a full understanding of ESG factors could lead to the wrong investment decisions. At the same time, looking at ESG factors in isolation—without combining them with a financial framework—could also lead you in the wrong direction. We like to look at a multifactor risk model when analyzing an issuer. We believe an issuer has a financial risk profile factor, a sovereign risk profile factor, a business profile factor, a management strategy profile factor, and an ESG risk factor. We believe these factors can rise and wane in importance over time, but undoubtedly ESG is becoming an increasingly more vital factor.

And analysts are important to this process, correct?

Luis: Our ESG process is absolutely analyst-driven. We approach investments from a very strong bottom-up perspective. Having an intimate and direct relationship with issuers helps us gauge their momentum, their improvement, their direction. Analyzing them on a static basis does not give us the full picture.

Yvette: We believe *the experience* of covering emerging markets is pivotal to understanding emerging markets. Therefore, we have chosen to do the analysis ourselves, using a bottom-up approach to apply our experience in assessing what is relevant to emerging markets.

Can you talk about the importance of managing incidents?

Luis: ESG situations are going to occur. Some external providers call them controversies. Maybe there are accidents or maybe policies are not followed, but the truth is these things happen, and to us it is extremely important to evaluate how a company manages those situations. Does the management team really live by what they say? A management team's reaction is what is important.

And this is a proprietary framework you use, correct?

Luis: Yes, we as analysts created an ESG scorecard. This scorecard analyzes the material factors within the E, the S, and the G. Under environmental factors we look at the company's management of raw materials and natural resources, its approach to climate change, and risks to its policies. As far as social factors are concerned, we think it makes sense to look at a company's policies toward its employees in terms of equality, training, working conditions, and union relationships separately from its policies toward its community; in the latter case, we look at the company's interaction with its supply chain, community, and customers. Studies have shown governance is the most impactful factor, and as experienced corporate credit analysts, we have looked at G factors for many years. Including the G analysis in the ESG framework does give it a different angle. In our framework we focus on board and management dynamics, corruption/lobbying incidents, fiscal responsibility, and transparency in communications.

Yvette: The combination of factors and the weight thereof have followed from years of research and practical application of these principles.

Does the proprietary framework evolve?

Yvette: Yes, and we are consistently evaluating the outcomes of that model to understand the degree to which it is correct in assessing the individual credits relative to fair value. How it has evolved has been a reflection of how we see the world changing. We have sought to apply the factors that we feel are most relevant in understanding a country's willingness and ability to pay.

> "We developed our ESG framework before ESG became fashionable."
>
> **Yvette Babb**

What differentiates your approach to ESG?

Yvette: I think what sets our approach to ESG apart is that we have been doing this for a very long time, and it has been an integral part of our team's work. We developed our ESG framework before ESG became fashionable. That experience and practical application throughout the years has created something that is very solid.

Luis: The way we created our ESG framework is also important. Some frameworks may be created by socially responsible teams and not by the people who actually manage portfolios. Our framework was created by analysts for emerging market analysis. It is based on really understanding the data available and confirming it through direct communication with the company and monitoring. That is important because not a lot of the data is available. Asking a company for something it has not analyzed in the past can be problematic if your framework requires that data. Therefore, we understand what is available, and we have incorporated it into the way we do things.

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> **Luis Olguin, CFA**

> "Emerging markets debt is at the forefront of how flows of money, government decisions, and private actors determine outcomes that can alter the paths of countries."
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> **Yvette Babb**

What got you interested in emerging markets debt? Was it something you were always interested in from a young age, or did you get into investing and gradually hone in on emerging markets debt?

Yvette: I am South African, born and raised in Johannesburg, so I have lived in emerging markets for most of my life. I have witnessed quite phenomenal developments in that country. As a result, I had a very strong interest in emerging markets from a very young age, and in high school I became very interested in economics and investing with the intention of trying to understand the way in which financial markets, governments, and developmental processes unfold. Emerging markets debt is exactly that. It is at the forefront of how flows of money, government decisions, and private actors determine outcomes that can alter the paths of countries.

Luis: I really believe emerging markets debt is the last frontier of investing. You can still uncover a lot of value doing bottom-up analysis. My analytic background was in developed markets, and what I learned through that experience, analyzing sectors like oil and gas and metals and mining, has been extremely valuable in assessing where emerging market companies are going. And frankly, the diversity of emerging markets really excites me. Coming in to work every day, seeing different cultures and different issuers, and getting to understand the world through them, really makes my day.

Your team has been working together for a while, but you cross many cultures and time zones. Can you tell me how that benefits your approach?

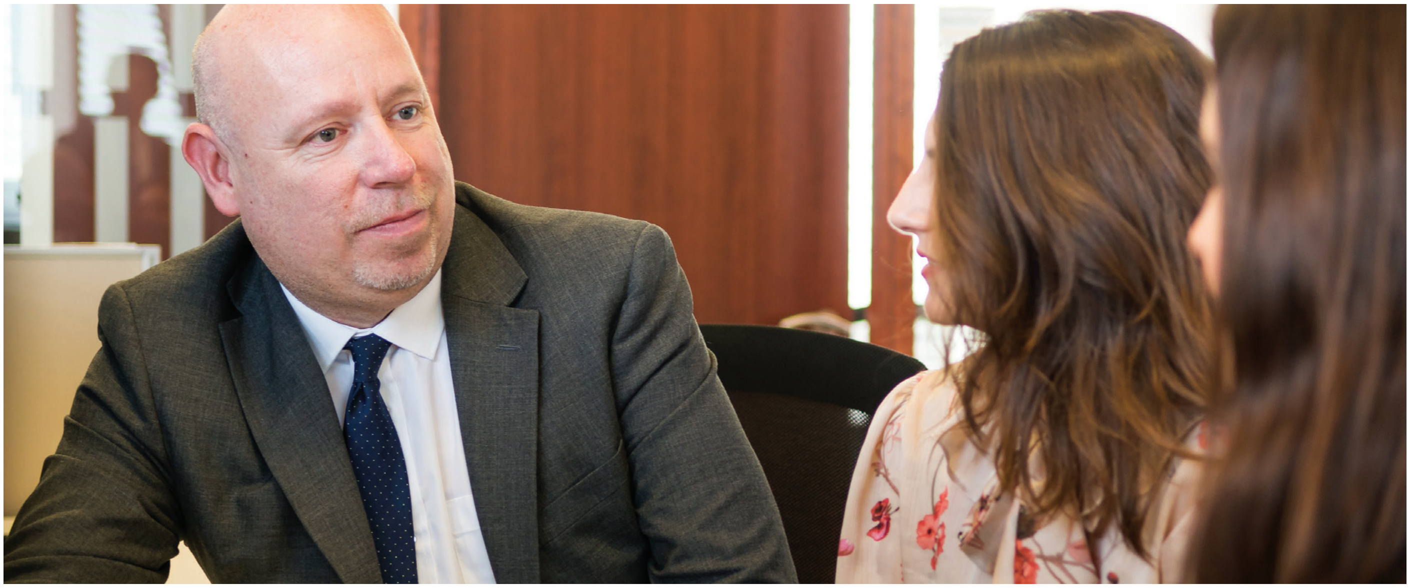
Yvette: Our team is unique in that it encompasses a number of nationalities. We have perspectives that derive from Latin America, emerging Europe, and Africa. Having lived and breathed in emerging markets has definitely given us insight as to how we look at these markets and how we believe developments are likely to unfold. Not only does that give us on-the-ground experience, it also offers different perspectives. The team is also quite diverse in terms of age and gender. We are complementary.

How do you work together?

Yvette: Our team is very open, and we have direct lines of communication that allow us to offer our own perspectives and challenge each other. We embrace a very invigorating degree of debate—in the way in which we see our asset class from a historical perspective, from a regional perspective, and from an ideological perspective.

Is it difficult to communicate across multiple locations and time zones?

Luis: Of course it is a challenge to manage a global team and have everybody on the same page. But even though we are in different settings, we are constantly communicating. That is essential and what makes our team unique. We like working and interacting with each other. A failure to pass along information through the appropriate channels so the right decision can be made is a mistake we will not accept.



What are the benefits of that communication?

Luis: Good communication builds a personal relationship, which leads to trust—trust that goes both ways, from portfolio managers to analysts, and from analysts to portfolio managers. I think that just leads to a better decision-making process. At the end of the day, that is core to our job. We seek to make the right decisions with the right information.

How long has your team been doing ESG?

Luis: The drivers behind our framework have been around for a long time. I was fresh out of university in the 2000s when the Enron situation occurred, and that, to me, was the beginning of analyzing governance factors. In that sense I have been looking at ESG factors for almost 20 years. That governance focus has now evolved into understanding the risks around climate change and the risks around social factors, including how you treat your community and how you treat your people.

"We seek to make the right decisions with the right information."

Luis Olguin, CFA

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Outcomes

How does your approach help drive better client outcomes?

Luis: We believe in ESG integration as a way to understand the potential financial and reputational risk to a company. We then try to find the deviations between a security's price and a security's value, which is ultimately what our clients want.

Yvette: We have consistently sought to relate the influence of ESG factors on the return performance of individual credits. ESG is statistically proven to influence the return performance of individual credits, and we believe our model can be predictive in terms of where value and/or spreads are likely to move based on changes in financial and non-financial sectors.

Luis: We believe client outcomes may also be enhanced by the fact that we have had years to apply this framework, ensuring that we understand the relationship between ESG and the performance of individual credits.

About William Blair
William Blair is committed to building enduring relationships with our clients and providing expertise and solutions to meet their evolving needs. We work closely with private and public pension funds, insurance companies, endowments, foundations, and sovereign wealth funds, as well as financial advisors. We are 100% active-employee-owned with broad-based ownership. Our investment teams are solely focused on active management and employ disciplined, analytical research processes across a wide range of strategies, including U.S. equity, non-U.S. equity, fixed income, and multi-asset. As of September 30, 2019, William Blair manages $54.2 billion in assets. William Blair is based in Chicago with resources in New York, London, Zurich, Sydney, and Stockholm, and dedicated coverage for Canada. "William Blair" refers to William Blair Investment Management, LLC.

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