For professional investors/qualified investors only

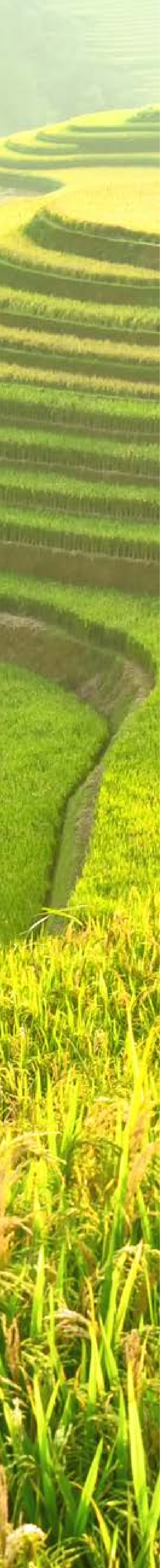
Integrating Emerging Market Debt into **Article 8 portfolios**

Can you have your cake and eat it?

BMO Global Asset Management

Part of COLUMBIA THREADNEEDLE INVESTMENTS

Contents



Does ESG in EMD harm returns?

Despite concerns among some investors that ESG-informed investing could harm returns, research over recent years consistently shows that applying environmental, social and governance (ESG) indicators to fixed income investing does not come at the expense of financial returns, and in fact typically delivers comparable and even improved returns.

Environmental, social and governance factors are significant determinants of the level of sovereign spreads over and above the effect of macroeconomic, credit, regional and global market variables. In addition to analysis of financial variables, ESG matters. Social and governance factors have significantly more impact on spreads than the environmental factors in emerging market (EM) countries.

We analysed the JESG EMBIG-D Index (J.P. Morgan's ESG Emerging Market Bond Index Global Diversified) versus the JPM EMBIG-D (J.P. Morgan's Sovereign Emerging Market Bond Index Global Diversified) and found that returns were comparable and risk-reward factors correlated by more than 99% on an annualised basis.

Emerging market sovereigns clearly benefited from ESG alignment. The JESG EMBIG-D performed better than the baseline JPM EMBIG-D, with more than 23 basis points of annualised outperformance from 31 December 2012 until 2 September 2021.

In other words, when it comes to responsible investing, you *can* have your cake and eat it.

Key risks

The value of investments and any income derived from them can go down as well as up and investors may not get back the original amount invested.

Changes in interest rates can reduce the value of your investment.

Investing in emerging markets is generally considered to involve more risk than developed markets. Screening out sectors or companies may result in less diversification and hence more volatility in investment values.

Helping emerging markets **emerge**

The financial case for investing in Emerging Market Debt is reinforced by a moral and broader economic case. Considering ESG issues in investments not only makes financial sense; it is the right thing to do.

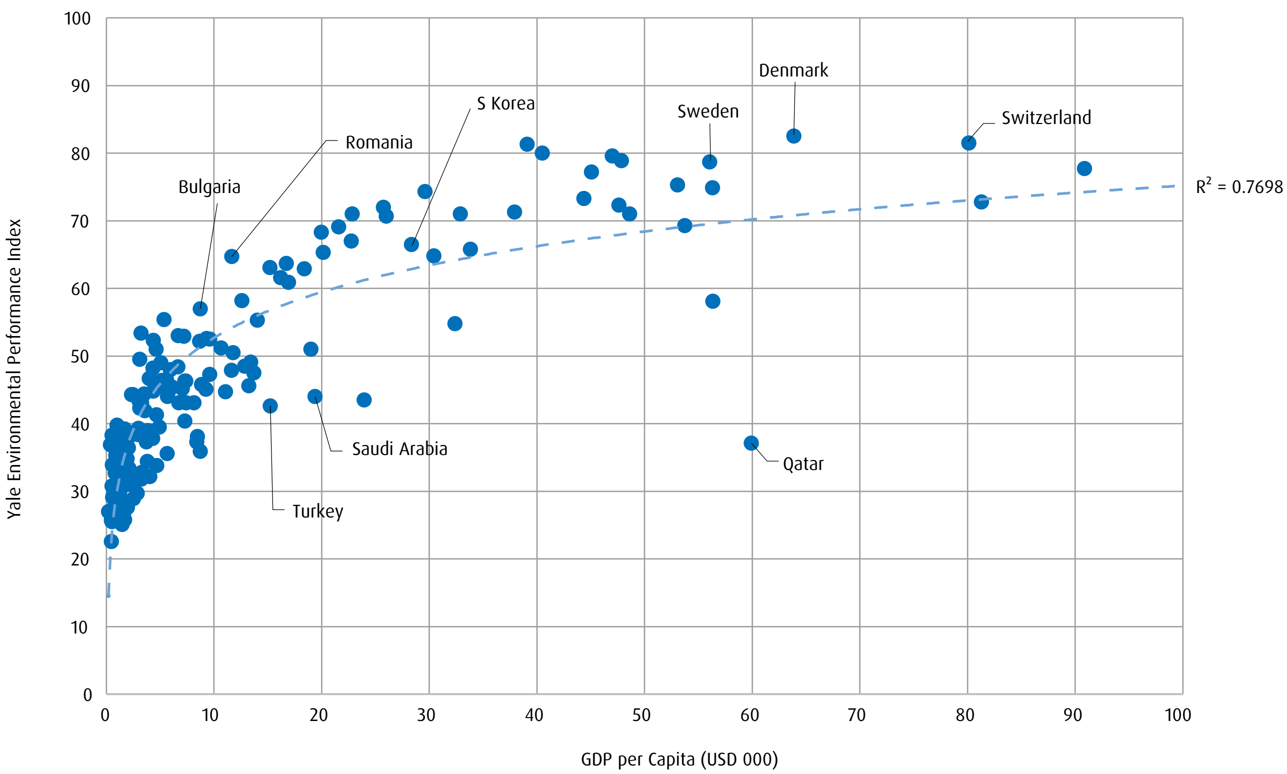
Investing in emerging markets means providing financing to help these countries 'emerge' – such funding enables EM countries to develop and achieve better economic growth. Integrating ESG into this investment process leads to the creation of stronger institutions that the market in turn rewards.

That doesn't mean EM investing is without challenges. Typically, emerging markets inherently have low ESG scores. Yet that is no reason to dismiss these markets' investment potential. Quite the contrary; what matters is their progress in ESG aspects, and the changes they make for the better.

Investing in them is a means to accelerating that positive change, offering a greater opportunity for consequential change than investment in developed markets.

Emerging markets should not be 'punished' for low ESG scores; our study below shows (chart 1), for example, that wealthy countries strongly correlate with high environmental scores. What is key is the direction of travel and giving the countries a chance to improve their ESG performance. In chart 1, we have plotted the GDP per capita of individual emerging markets countries. Evaluating this relationship and relatively high R-squared, we can see the positive correlation between

Chart 1: Yale Environmental Performance Index



Source: Environmental Performance Index (https://epi.yale.edu/) and BMO Global Asset Management

economic prosperity and desirable environmental outcomes.

ESG factors are often drivers of the near-term and long-term health of economies, with positive ESG factors such as sound political systems, fiscal policy and structural reforms propelling long-term economic growth. Whether structural or political, ESG factors contribute to determining the direction of travel in emerging economies.

In environmental terms, emerging countries are some of the world's largest producers and consumers of commodities – making them highly significant players. Through proactive governance, policymakers and industry leaders have the ability to mobilise in order to protect resources, provide for clean drinking water, adequate sanitation, reduced air pollution and improved human health and well-being. Effectively managed, this serves to both protect the environment and promote economic growth. In fact, data suggests that countries effectively managing environmental factors produce economic performance that beats peers.

In this way, ESG drivers can be major determinants of outperformance or underperformance. They are therefore crucial elements to consider when analysing these countries and trying to influence change within them.

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Classifying funds under SFDR: **why Article 8/9?**

The EU Sustainable Finance Disclosure Regulation (SFDR) aims to increase transparency on sustainability within the markets and set standards for the reporting and disclosure of sustainable investing information. SFDR helps investors compare sustainable strategies and make decisions that align with their investment objectives, by classifying funds according to their ESG characteristics and objectives.

Under the regulation, Article 8 funds are classified as those which actively promote environmental or social characteristics. Under Article 9, SFDR delineates that qualifying funds must have "sustainable investment... or a reduction in carbon emissions as its goal." Article 9 funds, therefore, qualify as 'impact funds', and are subject to higher standards of disclosure under SFDR. Amongst ESG-informed investors, there is particular focus on Article 8 strategies. Investors seeking to direct investments toward a specific and measurable ESG goal tend to invest in impact and Article 9 funds, in Europe.

ESG risks are already integrated into BMO GAM's investment process across all asset classes. We have taken a thoughtful and considered approach to classifying our funds, in keeping with our long standing high-integrity approach to responsible investment.

For each of our funds classified as Article 8 and 9 under SFDR, we use the UN Sustainable Development Goals to map a clear framework for demonstrating sustainability, and we therefore embrace the SDGs throughout the investment process: from security selection and engagement discussions, through to client-level disclosure within our fund-level ESG Profile and Impact Reports.

Spectrum of **investment approaches**

Every institutional investor is unique in their financial goals and ethical convictions. To ensure investments align with those preferences, a customised approach to building sustainable portfolios is a must.

Sustainable and responsible investment can be seen as a spectrum. Broadly speaking, client preferences range from ESG-informed strategies, where ESG analysis is applied across all portfolio assets, investment decisions are impacted by ESG factors and competitive returns are generated, to impact-only or charitable strategies that invest to address societal issues with no expectation of financial return.

The Sustainable and Responsible Investment Spectrum

	Financial	ESG strategies				Impact Investments		
Investment Goals	Traditional Investment	ESG Informed	ESG Informed with Responsible exclusions	Sustainable: Exclusions + ESG overweights	ESG Indexed	Impact market returns	Impact sub-market returns	Impact only /charitable
Characteristics	ESG factors not considered in investment process	ESG analysis across all portfolio assets. Investment decisions impacted by ESG factors	ESG risks mitigated via exclusions based on client preferences and/ or sustainable goals	ESG mitigated risks / exclusions maintained. Overweights applied to achieve positive goals	Tailored to ESG benchmark. Typically apply exclusions and ESG weight rebalancing	Investment directed toward specific, measurable ESG goals	Investment directed toward specific, measurable ESG goals. Partial sacrifice of returns	Measurable goals. Societal changes addressed with no expectation of financial return
Benchmark	Market	Market	Custom: exclusions may be greater to or less than ESG benchmark		ESG Indexed Benchmark(s)	Custom: Impact goals quantified and measured		
Return profile	Competitive Returns	Competitive Returns					Anticipated below market return	Financial return sacrificed

Source: BMO Global Asset Management

Aligning with institutional investors' ESG policies

Driven by regulations and investor preferences towards responsible investment, flows are increasingly moving into assets with stronger ESG credentials. For institutional investors, this means they need to ensure that the assets in which they invest are aligned with their own ESG policies. In Europe, this has led to increased diligence, with the introduction of the EU Sustainable Finance Disclosure Regulation (SFDR), aimed at increasing transparency on sustainability within the markets and setting standards for the reporting and disclosure of sustainable investing information.

SFDR helps investors compare sustainable strategies and make decisions that align with their investment objectives, by classifying funds according to their ESG characteristics and objectives. We see growing demand from institutional investors who are particularly focused on 'Article 8' strategies, which promote social and/or environmental characteristics, and may invest in sustainable investments. Constructing portfolios that comply with SFDR Article 8 typically involves adding exclusions based on client preferences and/or sustainable goals to mitigate ESG risks, and potentially overweighting positions with high ESG scores.

Screening and active selection in emerging markets

The ESG risks most commonly associated with Emerging Market Debt tend to differ from those of developed markets. Structural ESG risks typically centre on governance, human rights, regulatory quality, rule of law, freedom, corruption and environment. The weight of these factors in ESG analysis will vary by country: for most EMs, governance tends to be the key driver, followed by entwined social and environmental factors. Together, these factors directly influence the path for future potential growth. However, for certain outlying countries, like Turkey, the political risk becomes a singular dominating factor dictating the direction of economic development and growth.

Understanding political risks within EM sovereigns is crucial, for example, since these countries typically have shorter, more volatile political cycles, and often need to address structural issues impacting the social fabric as their economies grow. Evaluating structural reforms and politics must therefore be integral parts of the research progress as these are key ESG factors – both during initial valuations of sovereign and corporate issuers, and thereafter on an ongoing basis.

For EM countries where commodity production and/or export is a significant component of their economies, monitoring environmental footprints and their transition to greener economies with lower carbon footprints is a key consideration. Other important environmental factors to consider are countries' management of natural resources/biodiversity, water, and pollution/waste. This analysis needs to extend beyond the sovereign level and into corporate processes, where ESG analysis, stewardship and engagement occurs on a more granular level.

Looking beyond the risks

An effective ESG investment process should look at both negative and positive criteria, focusing as equally on identifying factors that can foster economic growth as on problematic factors that may yield economic pitfalls and idiosyncratic tail risks.

Successfully analysing the structural strength of an economy entails assessing each sovereign's institutional strengths and weaknesses, and whether these are on improving or declining trends. Key factors to evaluate include the strength of a country's infrastructure, its regulatory systems and corruption levels, as well as the strength, education level and stability of its workforce.

Political analysis should consider factors such as free and fair participation of citizens in elections, the stability of the government, its ability to implement policies and reforms, and the likelihood the policies implemented will remain in place through longer economic and political cycles.

Often, structural issues and political issues may be interlinked. For example, political platforms may drive the improvement of education and healthcare systems – resulting in lower social strife, a decreasing disparity in income levels, and stronger and more stable political systems. Ultimately, this may serve to foster more stable long-term economic growth.

There are significant differences, too, between ESG aspects at the sovereign and at the corporate levels. For EM corporates, ESG risks can be most effectively assessed by differentiating between sectors. Some sectors are, for example, more prone to environmental risks, while for others governance concerns are paramount. Significant exposure to commodity producers in emerging markets naturally draws attention to climate change issues and energy transition. Governance standards should be a key consideration when assessing the credit quality of an issuer: corporate governance has historically been a negative driver of performance for certain EM corporate bonds.

Drawing a clear line between governments and corporates is not always easy for emerging markets, however. Many EMs have significant numbers of state-owned companies – the so-called quasi-sovereigns. This poses a specific challenge when analysing governance standards: disclosure tends to be limited, and there can be inherent conflicts of interest between stakeholders. Depending on where the company is located, state ownership can have either a positive or negative effect on credit quality.

An effective ESG investment process should look at both negative and positive criteria, focusing as equally on identifying factors that can foster economic growth as on problematic factors that may yield economic pitfalls and idiosyncratic tail risks.

Our investment process: **ESG incorporated from the get-go**

ESG analysis is a critical component of BMO GAM's Emerging Market Debt investment process.

This is increasingly entering mainstream thinking in EM Debt analysis, but we identified over 10 years ago that the market was frequently omitting the consideration of ESG factors as important drivers of asset prices. Recognising this, we embedded ESG analysis into our investment decisions within our investment process and have formally applied ESG scores to sovereign analysis dating back to 2012. In collaboration with our clients we pioneered responsible EMD investing, and these clients are still with us today.

A deep understanding of country fundamentals can uncover attractive, mispriced securities that lead to consistent long-term outperformance. Country level research is the cornerstone of a successful investment approach and has been the strongest contributor to BMO GAM EMD returns over time.

For investment success, ESG factors need to be actively incorporated into portfolio construction at the outset. In our investment process, we seek to identify what the market is missing or wrongly focused on by analysing six key drivers consistently across the emerging markets universe at individual country level, which forms the basis for asset selection and portfolio positioning. ESG analysis is included together with structural reforms, in our country analysis. (See chart below)

Our in-house ESG model covers five important indicators across categories (regulatory quality, rule of law, freedom, corruption, and environment) to produce one ESG score per country. This process normalises ESG scores across the universe, makes countries comparable with each other, and enables us to assess trends over time.

Our ESG-informed investment process for EMD begins with an in-depth scan that identifies countries with low and deteriorating ESG sovereign risk scores using input from organisations such as the World Bank, Transparency International, Freedom House and MSCI.

Investment process – 6 factor fundamental framework

Politics
Research focus:
– Elections, governability

Fiscal policy
Research focus:
– Government revenues vs expenditure

Structural reforms / ESG
Research focus:
– Outlook for potential growth
– ESG scores and momentum

External sector
Research focus:
– Balance of payments, reserves

Growth / Monetary / FX policy
Research focus:
– Central Bank stance

Technical
Research focus:
– Supply and demand for bonds

Source: BMO Global Asset Management

ESG analysis – Research approach

Our investment process is ESG informed: environmental, social and governance factors are monitored and analysed continuously.

1 ESG scan	• Utilise inputs: World Bank, Transparency International, Yale, Freedom House and MSCI. • Identify countries with improving or deteriorating ESG sovereign risk model scores.
2 ESG analysis	• Analyse, research and comment on the sources of ESG scores and ratings, assess whether risk premium compensates sufficiently for ESG risks, evaluate trend and momentum.
3 ESG actions	• Limit exposure to countries where ESG risks are high and not compensated by attractive valuations, or where client guidelines specify limits. • Adjust allocations for countries and credits with strong and improving ESG factors.
4 ESG monitoring	• Monitor the EMD universe continuously for changes in ESG dynamics. • Amend analysis and exclusions when appropriate. • Update ESG assessment in sovereign AA paper when needed.

Rank	Country	Governance	Regulatory Quality	Rule of Law	Social	Freedom	Corruption	Environment	ESG Score	1yr momentum	3yr momentum	5yr momentum
1	South Korea	77.57	71.40	73.88	69.31	80.00	61.00	73.81	73.56	6.25	8.43	10.56
12	United Arab Emirates	72.82	69.59	66.80	52.11	35.00	71.00	61.71	62.21	3.41	3.16	5.05
23	South Africa	54.24	53.12	48.47	60.95	80.00	44.00	47.84	54.35	2.77	3.01	-1.13
36	Ecuador	38.43	33.53	38.45	53.58	70.00	39.00	56.61	49.54	2.47	5.62	7.37
48	India	51.35	46.79	49.38	56.53	75.00	40.00	30.63	46.17	0.92	2.59	-0.01
62	Ivory Coast	44.74	45.14	38.66	47.19	60.00	36.00	28.64	40.19	-3.82	-2.35	-0.91
74	Venezuela	3.43	2.82	3.60	24.58	35.00	15.00	55.83	27.94	-2.15	-3.81	-5.25

Source: World Bank (WB), Transparency International (TI), Yale, Freedom House, BMO Global Asset Management as at Aug-21. For illustrative purposes only.

In addition, we utilise data and research from Institutional Shareholder Services, broker research, Sustainalytics, Bloomberg, NGOs and international governance associations.

In our next step we analyse, research and evaluate the sources of ESG scores and ratings for the EMD universe, then assess whether risk premium adequately compensates ESG risks, taking into account the ESG trends and momentum impacting credits within the universe. This allows us to identify situations where we believe the momentum of ESG factors may be determinants of future improvements or deteriorations in asset prices.

Once evaluations have been made, these considerations are implemented into the portfolio by limiting exposure to countries where ESG risks are high and not compensated by attractive valuations, or where client guidelines call for exclusions. Allocations are adjusted for countries and credits with strong and improving ESG factors. The final, ongoing step is dynamic and intensive ESG monitoring: continuously monitoring the EMD universe for changes in ESG dynamics, amending research and applying exclusions, if and when appropriate.

Using screening, exclusions and asset selection, we are able to construct funds which take client investment preferences and these ESG factors into consideration from the onset and throughout the period assets are held within our funds.

Such a tailor-made approach allows creation of portfolios that fulfil responsible investment goals without compromising return objectives.

Corporates for return and diversification

Excluding sovereign issuers on the basis of ESG policies often makes the investment universe more concentrated, leading to concentration risk and giving rise to concerns, whether valid or not, that exclusions may potentially limit returns.

To enhance diversification and maintain the same risk-return profile, it can be advisable to add off-benchmark corporate debt positions into the EMD portfolio. Emerging markets boast significant numbers of high-quality corporates. Many are first-class multinational operators with significant businesses, assets, distribution, and revenue streams in developed market countries – offering stability, diversification and potential outperformance. In some cases, companies in countries that are excluded from the specific investment universe might have ESG scores that warrant inclusion in the portfolio and can, therefore, offer attractive investment opportunities.

Furthermore, important new trends such as green bonds and impact investing are often piloted by corporates, and companies also typically offer greater scope for engagement on ESG issues than do sovereigns.

Have your cake and eat it

Investing in emerging market countries has challenges, particularly because their ESG scores are typically lower than DM countries. However, on the upside, the opportunities for positive changes are much higher and, with more investment, improvements can accelerate even faster.

The financial case for investing in EM countries is also strengthening. An analysis of the JESG EMBIG-D Index (J.P. Morgan's ESG Emerging Market Bond Index Global Diversified) versus the JPM EMBIG-D (J.P. Morgan's Sovereign Emerging Market Bond Index Global Diversified) showed comparable returns and risk-reward factors on an annualised basis.

For investors making an EM country investment, it's essential to conduct an in-depth analysis. For example: consider whether the premium for ESG risks is sufficient; adjust the allocations for countries and credits with strong and improving ESG factors and, of course, continuously monitor the EM spectrum for changes in ESG dynamics. With these precautions, responsible investors in EM countries really can have their cake and eat it.

BMO Global Asset Management

A leading voice on a vital conversation

35+ years

of investing responsibly

20+ years

of driving positive change through ESG engagement

A+ rated

for strategy and governance, and ESG incorporation and active ownership in listed equities by UN Principles for Responsible Investment

Recent awards

INVESTMENT WEEK SUSTAINABLE & ESG INVESTMENT AWARDS 2020 WINNER Best Sustainable & ESG Research Team

Environmental Finance Sustainable Investment Awards 2020 Winner ESG research of the year (fixed income)

WINNER ESG Investing Awards 2020

WINNER ESG Investing Awards 2021

ESG Investing Winner: Awards 2021

Past performance is not a guide to future performance. All information as at 31-Dec-20

Case study: Article 8 integration – a practical approach

We helped a German institution for whom we have long managed a pooled EMD portfolio convert that portfolio to become compliant with SFDR Article 8.

This was achieved by applying a combination of exclusion criteria and best-in-class approach to security selection within the portfolio. For the latter, we used our bespoke ESG investment process, where companies that are in the bottom decile of ESG scores were automatically excluded. For the remaining universe, we applied portfolio construction criteria, where maximum position sizings within the fund are based upon assets' ESG scores.

In order to address the main ESG objectives, we devised a tailored solution that included exclusion criteria for countries as well as corporates. On a country level, we applied exclusions relating to political freedoms, environmental performance, adherence to the Paris Agreement, the Treaty on the Non-Proliferation of Nuclear Weapons, Transparency International's Corruption Perceptions Index, the Global Peace Index and the death penalty.

Separate screening criteria were applied to corporate and quasi-sovereign issuers. For quasi-sovereign and corporate issuers, we used exclusions related to fossil fuels, nuclear energy, weapons, production of tobacco/alcohol or adult entertainment and UN Global Compact violations. Fulfilling the determined ESG criteria led to a shift in the portfolio's composition. Excluding sovereigns compressed the investment universe, making it favourable to add carefully selected corporate issuers.

The overall outcome was an Article 8-compliant portfolio that remains well diversified, albeit with a more concentrated sovereign universe. Sovereigns account for 16% of the blended portfolio, with quasi-sovereigns making up 31% and corporates the remaining 53%. The addition of corporates improved the portfolio rating to investment grade, and the resultant portfolio had a shorter duration profile.

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