GlobalCapital

# New socially-aware bond index feeds funds' need to spot shabby dealing

## JPMorgan's launch of an environmentally and socially conscious version of its EMBI index is well timed as fund managers realise that dodgy moral scan lead to shabby financial statements

*By Jon Hay* *08 May 2018*

The launch of new emerging market bond indices that take environmental, social and governance (ESG) factors into account has been hailed by fund managers who are under an increasingly powerful obligation to invest in a more sustainable and responsible way.

In April, JP Morgan, author of the EMBI index family that dominates emerging markets (EM) bond investing, launched new versions of three of its most followed indices that incorporate ESG analysis.

JPM was already compiling bespoke ESG indices for clients, but it was a specific demand from BlackRock's EM debt team that spurred it to create public benchmarks for the EMBI Global Diversified, the benchmark for sovereign and quasi-sovereign dollar bonds from 67 countries, the GBI-EM Global Diversified, which tracks local currency bonds of 18 sovereigns, and the CEMBI Broad Diversified, which follows corporate dollar bonds.

Increasingly, investors are deciding they do need to pay attention, not just to issuers' financial metrics, but to how well they behave. "In the last couple of years, we have seen an intensification of interest from clients to invest in a more sustainable and responsible way," says Giulia Pellegrini, a portfolio manager in BlackRock's EM debt team in London. "Most of the interest has been institutional, but we've also picked up some retail. There have been new clients [asking] 'how do you incorporate ESG into the investment process?' And existing clients have come to us and said 'we need to increasingly respond to our own boards about what we do in this space'."

The motivation is partly ethical - investors want to do good and be seen to be doing good by their customers - and partly that they believe ESG can improve investment performance.

But there is also a strong push from government. France's Energy Transition Law of 2015 obliges asset owners - and hence asset managers - to report on how they manage climate and other ESG risks.

The indices' ESG analytics come from Sustainalytics and RepRisk, two providers that already score the relevant issuers. All companies involved in weapons, tobacco or thermal coal, or that have violated the UN Global Compact on human rights and anti-corruption standards, are excluded. JPM has given special prominence to green bonds. Any bond classed as green by the Climate Bonds Initiative, an NGO, is bumped up a weighting band.

## VALE'S TRAVAILS

A clear illustration of the impetus for developing such an index is the twin crises that hit Vale of Brazil, the world's largest iron miner. In 2012 sustainability research analysts at Union Investment in Frankfurt found weaknesses in its environmental and social performance as part of their routine work analysing companies the €320bn asset manager invests in.

In January that year, Vale had been given an (In)famous Award by Public Eye, a Swiss NGO. It was criticised for its "repeated human rights abuses, inhumane working conditions and the ruthless exploitation of nature". In particular, Vale was a shareholder in the Belo Monte Dam being built in the Amazon, which the NGO said could mean 40,000 people being forcibly relocated.

Ugly headlines and activism like this do get picked up by ESG rating providers such as MSCI and RepRisk, which are used by many asset managers. Union lowered its ESG rating on Vale, prompting its ESG-focused global and emerging market debt portfolios to exclude the company.

Three years later, a toxic waste dam at the Samarco mining site, owned by Vale and BHP Billiton, collapsed, killing 17 people, destroying a village and polluting a river with 60m cubic metres of iron waste. It has been called Brazil's worst environmental disaster. In 2018, Vale is still negotiating with public prosecutors about civil claims totalling $50bn.

"The breaking of the dam and the associated ecological and social costs have affected Vale's performance massively, but we were not invested in Vale debt in our EM ESG mandates," says Sergey Dergachev, portfolio manager in EM rates at Union in Frankfurt.

This is a textbook case of how ESG investing is supposed to work. The Samarco disaster was an unpredictable accident - but investors listening out for other ESG noise around Vale were forewarned.

## WIDER VIEW OF RISK

Emerging market bond investors are not, traditionally, the most attuned to such issues. EM investing requires buying into some countries where human rights, social welfare and environmental standards are far below those in the West.

But that trend is changing and investors have welcomed the JPM initiative. "It's welcome, and I think we'll see the other bond benchmark providers follow suit," says Will Oulton, global head of responsible investment at First State Investments.

The indices are likely to stimulate interest in applying ESG to emerging market debt, especially among passive investors, which can only create funds if they have a benchmark to track. But even active managers that have been doing ESG for a long time are enthused. NN Investment Partners, based in The Hague, applies ESG criteria to all its investments. "For EM sovereigns, we conduct an in-depth analysis on a country's governance, competitiveness and institutional quality," says Roy Scheepe, senior client portfolio manager for EM debt at NN.

NN assigns its own scores and builds its own index. Scheepe says the JPM indices are "a useful initiative that is meeting demand from investors," and will "provide a useful comparison versus the traditional indices".

He says it is too early to tell if the indices will prompt NN to launch new products or increase allocation to ESG strategies but says that NN will "constantly monitor closely" how well accepted this benchmark becomes.

Ultimately the purpose of ESG investing is to drive improved behaviour among issuers.

"We do hope that this index launch is taken as an incentive for issuers to do more work in improving their ESG standing, and hence lead to a virtuous circle of capital going to better performers," says Pellegrini.

The creation of ESG equity indices such as the FTSE4Good appears to have made at least some companies try harder. "There's a Hotel California effect," says Oulton. "Once companies are in these benchmarks they do not want to drop out, because it's embarrassing."

Bond issuers engage with investors when they market new issues, giving investors plenty of opportunity to make their feelings known.

Issuers are beginning to notice it. Batuhan Tufan, head of financial institutions at Garanti Bank in Istanbul, says the bank increasingly faces questions from investors about ESG issues. "To be more conscious about our world and resources becoming scarce - any person or institution at an individual level would be interested in this and find it welcome," he says. "I don't have enough information to know if this translates into a specific benefit for issuers financially yet. However, it's clear that if there is a benefit, the banks that have spearheaded on this will get it."

## PENETRATING THE STATE

In the private sector, the financing of the business is a concern very close to the top management's heart. It is different with governments. The debt management office may have little chance to influence the president's view on human rights or the environment.

However, Pellegrini said there is an increasing awareness among sovereigns too. "To the extent that policymakers talk to each other, the message does eventually filter through," she says. "Routinely, a minister of finance or some other cabinet member does go on the road [to market a bond issue]. If you show you care about these issues, it is noticed, maybe not the first or second time, but eventually."

Poland has certainly noticed. It has started to co-operate with Sustainalytics on its ESG rating and took its environmental image seriously enough to issue the first ever sovereign green bond in December 2016.

"Nowadays, different aspects are taken into account by investors, and the overall perception of the issuer can very often influence an investment decision," says Piotr Nowak, Poland's deputy minister of finance. "People are more aware of climate change, and this attitude is also reflected in the financial market.

"We are in permanent contact with investors and we see the interest in our ESG activities. We try to be transparent with our environmental targets, that's why we take every opportunity to talk about these important issues."

Despite its recent brushes with the European Commission over judicial independence, Poland stands to benefit if EM investors focus more on ESG. It gets the largest weighting increase in the ESG EMBI index, up 2.3 percentage points. Nowak also thinks the green bonds have helped broaden the investor base for Poland's ordinary bonds.

If more EM investors had been switched on to ESG six years ago, and had dumped Vale like Union Investment, might it and BHP have smartened up their act and prevented the Samarco disaster?

Counterfactuals can never be proved. But Scheepe at NN points to how it cut its weighting in "an Asian technology contract manufacturer" that hit the headlines in 2016 for "many weak labour practices". The issuer underperformed the benchmark for a time but has not collapsed - perhaps a sign that stakeholder pressure has corrected its course.

The growth of ESG has been gradual so far. But there are signs that it might be about to become exponential. While incremental improvements to investment performance are unlikely to bring this about, regulation is more likely to have that impact.

Until recently, many asset managers thought their fiduciary duty to maximise returns for clients prevented them from taking into account softer factors such as ESG. But in March, the European Commission's Sustainable Finance Action Plan turned this on its head. Investors now have a duty to consider ESG - and more than that, will have to ask clients about their sustainability preferences.

Before long, JP Morgan might find its ESG indices have supplanted the regular EMBI as the go-to benchmark. At that point, EM companies and governments will certainly sit up and take notice.