INVESTING DIFFERENTLY TO MAKE A DIFFERENCE

Exploring a more sustainable approach to investing in emerging markets

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Make a difference where it matters

Emerging markets are home to 85% of the world's population—roughly 6 billion people.[1] These are people that deserve and demand the same welfare comforts of the developed world. Many developing economies do not lead with sustainable achievements today, yet they hold tremendous potential to contribute to a more sustainable future. As stewards of capital, we believe asset managers should find ways to partner with the poorer and most rapidly developing economies to help them grow consistent with a sustainable world and achieve deserved levels of welfare.

At Aegon Asset Management, we believe in the industry's ability to harness these insights for good. We believe engaging in these activities can promote sustainable societal and welfare outcomes, better wealth outcomes, and finally, over long periods of time, can help support a meaningful reduction in credit risk and the related cost of capital while still pursuing better market returns.

Conventional approaches may doubly disappoint in EMD

Most people want to leave the world a better place for the next generation. Likewise, we think nearly all responsible investors deploying capital in responsibly focused strategies expect their investment will, in some small way, make a positive difference. However, not all approaches to responsible investing (RI) are created equal—a statement that reigns especially true when investing in emerging markets debt (EMD).

Applying a conventional approach[2] to ESG investing in EMD, where the investment strategy focuses solely on the best ESG opportunities, exposes weaknesses and poses challenges. We believe four key structural features keep investors from realizing their targeted outcomes when investing responsibly in EMD. However, if investment managers change the way they frame their approach to ESG, we believe investors have a greater chance of using their EMD allocations to help improve societal outcomes.

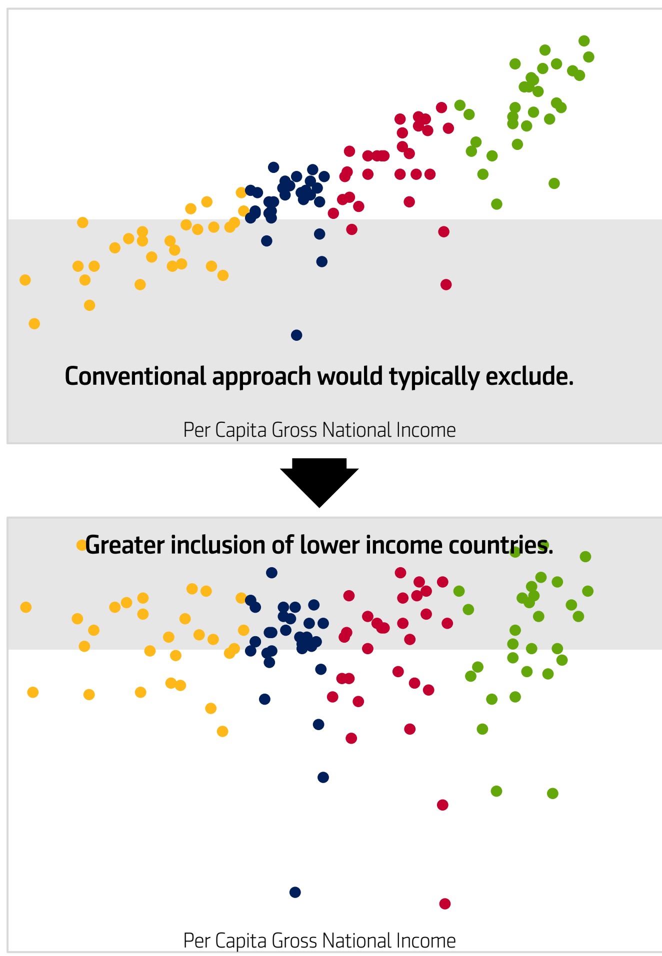
Challenge #1: Data providers rank issuers on how the world affects issuers instead of how issuers affect the world.[3]

Like traditional credit risk evaluation, most popular ESG scoring metrics are designed to reward an issuer by the degree to which it is immunized from the risks of operating and engaging with the world around it. Unfortunately, little emphasis is placed on evaluating how an issuer degrades the world much less how to use this knowledge to create products and strategies designed to oppose these dominant trends.

Challenge #2: ESG scoring methodologies are highly correlated with per capita wealth, penalizing the poor and rewarding the wealthy.

Research indicates nearly 90% of a country's ESG evaluation is tied to the country's wealth.[4,5,6] The World Bank goes further, stating, "A country's national income permeates all sustainability-linked measures used by the market."[7] As illustrated in **Exhibit 1**, average ESG scores across providers are highly correlated with gross national income per capita and by eliminating the income bias, results differ significantly.

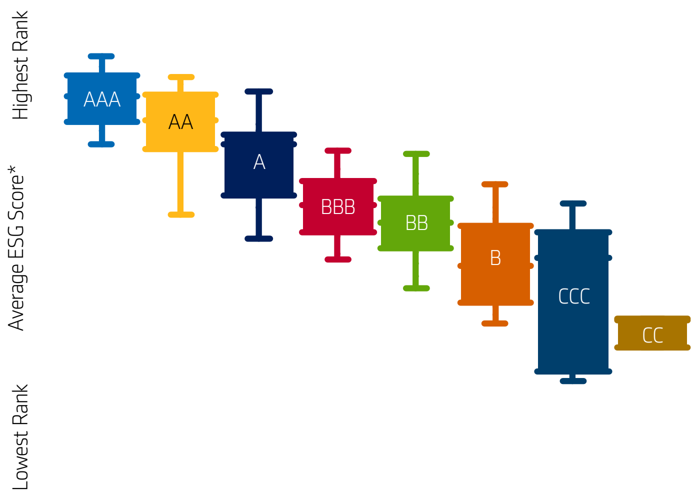
Exhibit 1: ESG scores have a strong income bias



For illustrative purposes only. Source: MSCI (data as of May 2019), Sustainalytics (data as of February 2020), and Aegon AM. Analysis completed June 2022. *Average ESG Scores are equal to the average of MSCI and Sustainalytics ESG scores.

A country's wealth and governance are also evaluated as a part of traditional rating agencies' evaluation of an issuer, compounding the weight of this factor and explaining the high degree of correlation between ESG scores and traditional credit ratings, as illustrated in **Exhibit 2**.[8]

Exhibit 2: ESG scores are highly correlated with credit scores



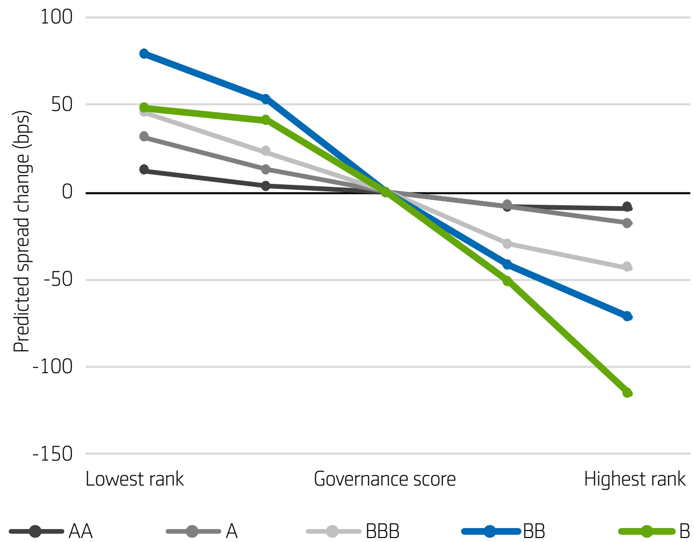
Source: MSCI (data as of May 2019), Sustainalytics (data as of February 2020), Moodys, and Aegon AM. Analysis completed June 2022. *Average ESG Scores are equal to the average of MSCI and Sustainalytics ESG scores. Credit ratings are reflective of Moody's issuer ratings

Summarized well by the World Bank, "Failure to account for this bias in investment decisions would lead to misaligned incentives for investors and could potentially divert flows to wealthier countries at the expense of lower income countries in need of finance for development."[9]

Challenge #3: There is no free lunch – investors are reducing the likelihood of favorable financial outcomes.

The dominant academic conclusion is that expected excess returns typically fall when using an investment strategy that restricts.[10,11] Further, while ESG restrictions have the potential to reduce downside risk through credit enhancement, they likely also lower upside potential. That is, issuers with better ESG scores typically are higher-rated credits, have lower cost of capital, and commensurate lower ex-ante asset returns.[12] We do, however, believe skillful forecasting of ESG can improve excess returns, in particular within the poorer, weaker countries.[13] Examining changes in governance scores and changes in credit spreads across 25 emerging market countries as an example, **Exhibit 3** illustrates how a skillful forecaster of governance could potentially reap rewards in the same way a skillful forecaster of credit quality can potentially reap rewards.

Exhibit 3: Predicted spread changes per Governance changes



Source: Aegon AM as of December 2017. **Hypothetical example for illustrative purposes only.** Predicted spread change and governance scores are based on regression analysis and internal ratings methodology of 10-year sovereign bonds of 25 emerging market countries selected by Aegon AM.

Until asset managers adjust ESG scoring methodologies or portfolio weightings to neutralize the wealth and credit effects of conventional ESG approaches for EMD issuers and portfolios, they must prepare to structurally underperform traditional benchmarks as a consequence of this ESG approach. In general, explanations for how ESG restrictions help improve excess returns appear to be based on skill, luck or lack of strict adherence to a meaningful set of ESG restrictions.

Challenge #4: Divestment rather than engagement often results in worse societal outcomes.

There are times when an issuer is simply so abhorrent or reckless that you cannot face the mirror knowing you are doing business with them. However, we believe speaking with and encouraging issuers to do better by the world can often be a successful strategy.[14,15,16]

"Failure to account for this [wealth] bias in investment decisions would lead to misaligned incentives for investors and could potentially divert flows to wealthier countries at the expense of lower income countries in need of finance for development."[9]

-World Bank

A more sustainable perspective when investing in emerging market debt

For investors looking to advance positive change while pursuing competitive returns, emerging markets provide intriguing opportunities to accelerate the shift to a sustainable and inclusive global economy. Relative to developed markets, that seemingly have abundant resources to meet a sustainable trajectory, EM companies and countries are often early in their journey. The improvement potential offers opportunities to utilize capital to accelerate positive change.

Within dedicated EMD RI strategies, we believe that by investing in emerging market issuers that are interested in contributing to a more sustainable world can create value over time, by aligning investments with issuers committed to improving their stakeholders' welfare and credit profile.

Examples include:

- Investing in sovereigns, quasi-sovereigns and corporates that are underpinned by strong governance with clear objectives in improving human welfare standards in a sustainable manner
- Pursuing long-term value creation by combining traditional credit-based investing with long-term improvements in human capital
- Measuring a commitment to sustainable change with a focus on governance, health, wealth, climate change, resource efficiency and economic/social rights
- Relying on a research-intensive process and proprietary, country wealth-agnostic assessment framework to help understand how issuers might affect the world
- Advancing positive outcomes by proactively engaging with issuers when possible

References

[1] https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp020416
[2] The standard approach that we see in EMD, and are referring to, is a style that ranks an issuer on its ESG score from best to worst and then seeks to exclude lowly ranked issuers or concentrate some majority portion of the portfolio in these highly ranked issuers.
[3] https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/
[4] https://www.aegonam.com/en/aegon-insights/responsible-investing/the-integral-role-of-esg-factors-in-emerging-markets-investing---archived/
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