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# Innovation in integrating ESG considerations to a sovereign bond allocation

**Channels:** Sustainability

**Companies:** Aegon Asset Management

Sovereign bonds are a key asset class for insurers. Aegon Asset Management takes an innovative approach to incorporating sustainability characteristics into sovereign bonds investing.



Aegon Asset Management has developed a Global Sustainable Sovereign Bond strategy that takes an innovative approach to incorporating the sustainability characteristics of sovereign bonds. Co-managers of the strategy, Jesus Martinez and Irina Kurochkina, discuss the attractions for insurers of adopting a sustainable approach to investing in sovereign bonds.

## What is the current state of sustainable investing in sovereigns?

Demand for sustainable investment solutions continues to grow. The long-term consequences of short-term decisions are becoming clearer. From consumers and businesses to governments and investors, a broad secular shift toward sustainability is underway. The concept of responsible investments is strengthening every year as investors pursue focused investment solutions that can generate competitive financial results and drive real change for people and for our planet.

To implement responsible investing techniques, investors use a variety of tools. From exclusions and best-in-class selection to ESG integration and sustainability-themed portfolios, different strategies across all asset classes can help investors pursue competitive financial outcomes and redirect capital flows to effectuate responsible investing objectives.

Although sustainable investing within sovereign bonds has lagged other mainstream asset classes due to the slow nature of the market, ample opportunities exist to align capital with sustainability initiatives, potentially providing a first mover advantage. By utilizing a comprehensive sustainability framework that is tailored to reflect the unique attributes of sovereign issuers, asset managers can assess sustainability alignment in sovereigns and construct a sustainability-themed government bond portfolio that can align with investors' beliefs and provide attractive long-term performance opportunities.



Jesus Martinez

A dominant theme in sustainability alignment in sovereigns focuses on issuers' ability to improve sustainability practices, while continuing to promote healthy economic growth. Sovereign issuers play a major role in



Irina Kurochkina

the journey toward a more sustainable world. After all, governments are responsible for creating a groundwork for sustainable growth and enforcing rules that facilitate sustainable long-term growth. For asset managers, aligning a government bond portfolio with sustainable growth initiatives requires incorporating a new way to look at sovereign issuers and utilizing methodologies that go beyond traditional tools in the research process.

## United Nations Sustainable Development Goals

In 2015, 193 Member States of the United Nations adopted 17 Sustainable Development Goals (SDGs) to be achieved in a time horizon of 15 years. This set of 17 goals incorporated a total of 230 individual indicators to monitor the 169 individual targets that would apply to every country in the world, regardless of their level of development. These provided a broad landscape for objective measurement of the efforts towards sustainable development globally. In such a context, sovereign states are in a key position to tackle sustainability challenges, as governments themselves have the power to drive the change towards a more sustainable future.

Their role will only be more relevant as the different sustainability challenges become more visible for the development of our society.

# SUSTAINABLE DEVELOPMENT GOALS



The 17 SDGs encapsulate challenges that apply to every country in the world in a clear and straightforward manner. For investors, the SDGs can provide a helpful framework to analyze countries on the methodology that was designed as an assessment instrument for governments' progress on their own pledges. However, scores or indicators require context and expert assessment is key to scrutinize the detail of individual countries salient challenges and to evaluate whether these challenges are being met.

Despite the growth in responsible investing, inconsistent terminology remains a key obstacle for asset managers and asset owners alike. To uphold the credibility of the market and to ensure that different best practices are recognized and reinforced, several regulatory authorities are incorporating frameworks and taxonomies that will translate into diligent disclosure requirements. It is therefore necessary that the preferred investment methodology remains transparent and allows for a granular approach that helps to understand the impact that a sustainable portfolio aims to achieve.

At Aegon Asset Management we base our sustainability methodology on the works of the Bertelsmann-Stiftung and Sustainable Development Solutions Network partnership, sponsored by the United Nations. Our transparent scoring methodology is founded on this independent and credible framework and leverages reliable data sources. By using more than 100 indicators per country we have built an SDG scoring methodology that allows us to reflect our views on sustainability in 172 countries across the world.

## Issuer engagement

We believe active engagement with issuers can improve investment decisions and potentially drive positive change. As investors, we have a responsibility to drive positive changes by implementing capital allocation mechanisms that encourage countries to develop sustainably.

Our sovereign engagement framework provides an objective and measurable standard. This invaluable insight then opens up the opportunity to improve communication with sovereign issuers. Through this engagement, we aim to improve our assessment on the long-term economic growth and macroeconomic stability in a more inclusive and sustainable way as outlined in the UN SDGs. In the context of sustainability, SDG analysis can be used to foster engagement dialogue with governments and monitor their progress toward achieving the stated sustainability challenges.

We identify two key communication objectives - dialogue and action. We aim to ensure that we have regular points of contact with a country representative to ask our questions, raise concerns and improve transparency on

fundamental, ESG and sustainability topics. To drive positive action, the commitment should address specific issues within a country that requires attention from the government.

## Aegon Global Sustainable Sovereign Bond Strategy

In 2020 we introduced a new strategy in Europe that had taken three years to develop. This award-winning strategy provides an innovative approach to analyzing the sustainability characteristics of sovereign bonds and is attractive to insurers looking to balance their liability-matching needs with a full understanding of the underlying sustainability profile.

The strategy invests in financially strong countries that contribute to the improvements in sustainability targets as defined by the UN Sustainable Development Goals (SDGs). The investment universe is:

Global investment grade government bonds (BBB- and higher).

Focus on developed markets (70-90%) and emerging markets (10-30%).

100% hard currency bonds, with investments hedged to the base currency of the investor (mitigating the cost of capital for insurers).

A balanced exposure to sustainability leaders, influencers and improvers.

We have built a proprietary global sovereign database covering 172 countries and which captures 110 separate sustainability indicators per sovereign issuer, with a total of 47,000 data points.

Our Global Sovereign Research and RI teams assess the sustainability profile of each country, working closely with our Global Fixed Income team, who are responsible for portfolio construction and issue selection.

While various investment approaches are aligned with UN SDGs, Aegon Asset Management's sustainable sovereign strategy reflects the specific challenges at a country and regional level. We identify whether a country is on course to achieve its targets and compare it to representative peers.

Another distinctive aspect of our approach is our Sustainable Investment Committee, which ensures that responsible investment principles determine the investment universe and provides a final sustainability classification per country based on data and qualitative information.

The strategy is available on a segregated basis with a pooled offering soon to be available. Segregated mandates can be tailored to an insurer's individual requirements, including bespoke SDG and KPIs. Our heritage and deep understanding of the needs of insurance clients means that we can work with insurers to mitigate the impact of currency risk (and cost of capital) as well as accommodating individual accounting considerations.

## Alignment with the needs of insurers

We believe there are five key benefits of a sustainable sovereign bond strategy for insurers:

**Long-term risk & return profile** - Sustainable countries should be more resilient in the long-term under certain scenarios, such as climate change and social instability due to inequality. Achieving sustainable returns in a stable manner is especially relevant for insurance clients with long-term investment horizons.

**Global scope** - Being global broadens the opportunity-set and does not tie the portfolio to a specific region. The methodology allows us to have opinions on a country's sustainability approach regardless of their rating and whether they have issued bonds or not.

**Future-focused** - The investment universe consists of sustainable leaders and improvers, which are visibly moving towards sustainable development. It allows our insurance clients to finance the transition of countries towards sustainability, while also offering yield pick-up versus only sustainable leaders from developed markets.

**Meeting the reporting needs of insurance clients** - Our approach is compliant with the direction of European regulations. Beyond this, the range of KPIs considered enables flexible reporting that can be adjusted to fit the



requirements of individual insurance clients.

**The proposition can be used as a first step for engagement with sovereigns** - Our regular contact with government officials, debt management officers and other sovereign investors enables us to be a force for positive change.

We have published a detailed paper titled Sustainability Alignment on Sovereign Portfolios, which is available at [www.aegonam.com/insurance](http://www.aegonam.com/insurance).

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