

SOLVING THE PUZZLE: ESG ASSESSMENT IN SOVEREIGN BOND PORTFOLIOS

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In 2021 Aegon AM received the Environmental Finance Sustainable Investment Award for proprietary research by its fixed income and responsible investment teams to help align sustainability factors within sovereign bond portfolios.

Personnel may be employed by any of the Aegon Asset Management affiliates. Research teams may support multiple platforms. The Environmental Finance Sustainable Investment Awards 2021 gave Aegon Asset Management the Award for ESG Research of the Year (fixed income)-Sustainability alignment in sovereign portfolios based on a survey of active market participants. Aegon AM provided a description of why they believed the firm should win in addition to providing highlights and evidence to support the participants approach to ESG research and the application to sovereign portfolios. Winners were judged by a panel of industry experts who individually and confidentially judged each entry. No fee was charged to enter a submission.

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Sovereigns are difficult to assess, given their complex social, economic, political, and geographic makeup. Environmental, Social and Governance (ESG) analysis of sovereigns is thus inherently complicated since it builds on an already-challenging typical sovereign assessment. In part, this is due to limits to data availability and a lack of consistency in defining and measuring ESG factors, as well as an understanding that more than raw data is needed. Social unrest, political and economic stability, and the impact of climate change all play a role in an issuer's ability and willingness to pay its debt. A dedicated team is required to analyze both the quantitative and qualitative aspects of sovereigns to ensure proper understanding of each country. Our efforts in this at Aegon Asset Management are guided by our experienced Sovereign Research team.

Factors to consider in sovereign bonds

Responsible investing in sovereign debt requires an additional set of tools beyond traditional portfolio management practices. Our Sovereign Research team utilizes a comprehensive framework to provide a tailored approach which we discuss in more detail in [this paper](#). Important factors to consider when assessing responsible investing in sovereigns include the following:

- **Data is not exact.** Quantitative measures are not always reliable. In some cases, consistent data points are not available across different countries.
- **Trends are key.** Rather than looking at specific measures, watching the direction of a country's movement is essential and may need to be analyzed over the long term.
- **Politics and policy.** Government policy is critical but is prone to fluctuations due to changes in leadership. Therefore, monitoring politics (trends in the country, the region and the world) is essential.
- **Unique attributes.** Economics, geopolitics, climate, weather and geography must be taken into

consideration when assessing responsible investments in sovereign issuers. These attributes form the backdrop upon which societies form and policies must be constructed.

- **Longer time horizons.** Relevant time periods differ for sovereigns as compared to corporate issuers. Corporations are much more nimble, short-term profit-oriented, and can change policy much more clearly than a sovereign can. Often, changes to sovereigns can take generations to occur, sometimes through various economic and political cycles.

An ESG framework that supports qualitative research

These factors led us to develop a proprietary ESG scoring methodology to support our qualitative research process. This ESG calculator collates multiple data sources to identify material ESG factors and the level of risk countries face considering their development profile. The result is a proprietary ESG score for each sovereign. The ESG scores can help contextualize ongoing ESG issues and their materiality, as well as recent ESG trends in that country. This information is then used as an input to our qualitative

ESG research integration process which underpins our Sovereign ESG assessments.

An ESG assessment is a complex puzzle that must combine any available quantitative information, qualitative assessments, and historical experience and knowledge to understand and analyze each sovereign. This is also important when weighing one country against another to help determine a relevant score. The entire international community must be kept in mind since the world is one entity, with each country being a member of that group. There are notable relative differences in assessments between developed and emerging market sovereigns. For example, economic limitations for emerging sovereigns need to be accounted for and analyzing ESG factors on a relative scale that matches the level of development is pivotal. Conversely, developed sovereigns may have higher exposure to ESG risk reflected in abundant resources and higher consumption patterns, raising the expectations on ESG risk management. The starting point is thus certainly different, and views on relative policy implementation and its trends should be incorporated.

Integrating ESG factors to help improve decision making

ESG integration can be used as a tool to help manage risk and identify potential opportunities. As a result, we believe the assessment of ESG elements may contribute to alpha over the long term. The Sovereign Research team includes ESG analysis as part of its fundamental research, allowing for a comprehensive assessment. As shown in Exhibit 1, sovereigns across the globe can exhibit various types of ESG-related risks and opportunities.

Exhibit 1: Examples of ESG-related risks and opportunities

| | Risks | Opportunities |
|----------------------|---|--|
| Environmental | <ul style="list-style-type: none"> A sovereign with significant coal deposits continues to expand its ability to produce and export coal throughout the world. A sovereign with significant mining industry has lax environmental policies, such as allowing strip mining, permitting poor construction of dams and placing them upstream from cities, etc. | <ul style="list-style-type: none"> A sovereign with abundant sun throughout the year develops large solar facilities to produce electricity, eventually becoming self-sufficient, and then able to export clean energy. A sovereign with significant mining industry has robust regulation for the industry, including protection for people and wildlife areas, reclamation and protection of mining areas, and strong safety requirements for workers. |
| Social | <ul style="list-style-type: none"> A sovereign restricts the rights of its citizens by excluding people or parties from elections or intervenes in the outcome of national elections. A sovereign has poor labor laws, which don't provide for the health, safety or unemployment protection of workers, and allows human rights abuses to occur. | <ul style="list-style-type: none"> A sovereign works to enact policy providing equal pay for men and women and promotes and enforces it. A sovereign sets up strong labor laws that provide protection, safety, and unemployment benefits for workers, avoiding any abuse, and providing a forum to redress of any violations. |
| Governance | <ul style="list-style-type: none"> A sovereign has a culture and government that ignores corruption, thus allowing it to flourish. A sovereign not enforcing company accounting and information standards allowing inappropriate practices to occur. This permits fraud and may lead to reduced confidence in corporate entities. | <ul style="list-style-type: none"> The sovereign's constitution provides for strong separation of powers and allows for prosecution of government officials for corrupt activities. A sovereign sets up enforcement agencies to police corporations, avoiding any inappropriate actions and setting up a system to address problems and promote fairness, transparency, and rule of law. |

A comprehensive approach to ESG assessment

Our research process combines external ESG information with our analysts' internal ESG assessments, along with more traditional financial/economic sovereign credit evaluations. The regionally focused Sovereign Research analyst team provides this perspective on sovereign ESG topics, as well as country-specific historical and relative fundamental analysis. We believe it is important to blend quantitative and qualitative perspectives with our combined sovereign expertise and historical experience in the field to arrive at an educated, informed, independent assessment. This assessment incorporates the expected possible effects that ESG issues could have on the sovereign's ability and willingness to pay its debt, which is paramount in sovereign analysis. The level of credit impact is based on five levels with increasing magnitude (Exhibit 2).

Exhibit 2: Aegon AM ESG categories for sovereign credit

| Category | Description |
|-----------------------------------|---|
| 1 Responsible Leader | A leader in sustainable business practices or positive ESG practices are combined with the pursuit of Sustainable Development Goals as established by the United Nations. |
| 2 Minimal Risk | Fundamentally low exposure to ESG risks or policies in place that mitigate most ESG risks. |
| 3 Event Risk Potential | ESG risk exposures could negatively affect the sovereign but the effect is not measurable and timing is uncertain; the sovereign's response is likely to influence the severity of such risk. |
| 4 Credit Outlook Impact | ESG risks are resulting in pressure on the sovereign's credit fundamentals, but there is still an ability to address these risks and limit the impact on the credit rating. |
| 5 Internal Rating Override | ESG factors have resulted in a material effect on the sovereign's credit quality that is not reflected in its credit rating. |

ESG sovereign credit case studies

To illustrate the process in action, the following case studies provide examples of sovereigns that fall within ESG levels one, three and five. The categories are shown in Exhibit 2.

Exhibit 3: ESG sovereign credit case studies

| Case Study #1 – Responsible leader | |
|--|---|
| Sovereign description | Latin American nation |
| ESG-related opportunity or risk | <p>Environmental</p> <ul style="list-style-type: none"> Leader in transitioning into renewable energy, regularly sourcing most of its energy from renewables, even exporting some energy at times. <p>Social</p> <ul style="list-style-type: none"> Very strong levels of literacy and gender equality. <p>Governance</p> <ul style="list-style-type: none"> Strong democracy, institutions, and rule of law, with lower corruption than peers. The country employs consensus-based decision making, involving many parties in the process. |
| Aegon AM ESG category | Responsible leader (category #1) |
| Case Study #2 – Event risk potential | |
| Sovereign description | African metals & mining exporting sovereign |
| ESG-related opportunity or risk | <p>Environmental</p> <ul style="list-style-type: none"> High percentage of coal in electricity generation (around 80%); slow trend of improvement (reduction of coal pollution is ongoing while gradually increasing renewables). <p>Social</p> <ul style="list-style-type: none"> Good levels of gender equality, with significant representation of women in congress; strong education, with almost 100% enrollment through secondary school and high university enrollment as compared to the region. <p>Governance</p> <ul style="list-style-type: none"> Very good quality of institutions, especially for the region; rule of law and democracy. |
| Aegon AM ESG category | Event Risk Potential (category #3) |

Case Study #3 – Internal rating override

| | |
|--|--|
| Sovereign description | Gulf energy producer/exporter |
| ESG-related opportunity or risk | <p>Environmental</p> <ul style="list-style-type: none"> • Heavily dependent on hydrocarbon sector (oil and gas). <p>Social</p> <ul style="list-style-type: none"> • Human rights concerns, especially over the treatment of foreign workers and other expats, with many dying during work. <p>Governance</p> <ul style="list-style-type: none"> • Firm grip of rulers on society, low level of democracy |
| Aegon AM ESG category | Internal Rating Override (category #5) |

Although ESG analysis of sovereigns is complex, the combination of external information with our experienced group of sovereign researchers' proprietary view allows us to perform a comprehensive evaluation. We utilize the research process to identify both risks and opportunities among sovereigns based on their ESG characteristics and share these views with portfolio managers as part of our holistic credit assessment.

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