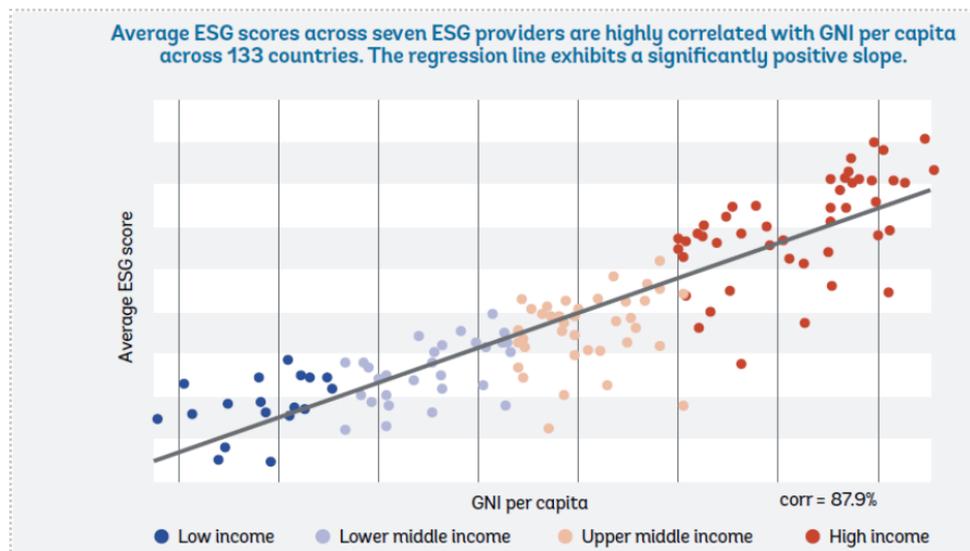


RETHINKING SOVEREIGN ESG: HOW CAN PATHWAYS REMOVE THE WEALTH BIAS?

As sustainable investing continues to grow in popularity, it is no surprise to see asset managers, institutional investors and economists apply ESG “screens” to sovereign debt. On the surface this seems a logical step – as stakeholders apply greater scrutiny to portfolios, holding the debt of nations that support the ongoing heavy use of fossil fuels or enable gender inequality through policy making is seemingly unpalatable.

As the World Bank has noted, about 90% of sovereign ESG scores used by asset managers are determined by a country’s national income. It finds the correlation between a sovereign issuer’s wealth and its “ESG score” is a high 88%.



Source: World Bank, 2021. Demystifying Sovereign ESG.

In short, the screening processes done by institutions today heavily favour developed economies. These are the countries that have the wealth to begin transitions to low-carbon economies or enact programmes aimed at addressing social equity. Developing countries, who

may be more reliant on extractive or heavily polluting industries for economic prosperity in the near term, risk being entirely excluded.

Emerging markets aren't the only "losers" in this scenario. By only focusing on the debt of developed economies, investors confine themselves to lower-yielding assets for their portfolios. The World Bank also notes how a bias towards national income can hide some ESG failings of developed nations.

At Impact Cubed we've addressed this issue by finding a new way of looking at sovereign ESG data. Our newly launched sovereign fixed income impact data and multi-asset portfolio reporting tool, developed in consultation with leading asset managers, doesn't just assess where a country is today, but its pathway to meeting each of the UN Sustainable Development Goals (SDGs).

The tool builds on our existing corporate equity and debt impact models, and provides data gathered over the past 20 years on 29 objective ESG factors. It gives investors visibility on which sovereign issuers are making progress towards the 17 SDGs.

The model's foundation is built on empirically determined global pathways, that benchmarks progress at each level of development. Why?

- The pathway approach allows investors to see a nation's current level of performance and its actual rate of progress compared with the expected rate of progress. Higher performance relative to the pathway means a country is improving faster than expected.
- This pathway approach creates a level playing field for developing issuers, who may have started efforts towards achieving the SDGs from a lower level than their developed counterparts.

Looking across factors, investors can find a number of potentially higher-yielding countries which are making real progress towards achieving the SDGs. Some examples:

- Take climate action (SDG 13), for example. Addressing progress, rather than where a country is now in its low-carbon transition, uncovers an issuer like Bosnia and Herzegovina where hydropower accounts for 35% of electricity production and wind power has seen substantial investment over the past five years.
- Focusing elsewhere on which countries are making progress towards gender equality (SDG 5) shows positive progress in the United Arab Emirates – recently becoming the first nation in the region to introduce paid parental leave for private-sector employees.

Neither of these two nations would make a list of the top 20 highest ESG scoring countries. That list, as expected, is dominated by developed nations – the usual suspects, if you like.

When addressing progress being made towards SDGs, however, the top performers list has a very different complexion. A list of leaders, compiled using Impact Cubed's new tool, would only include four of the "usual" cohort. The tool not only shows developing issuers "catching up" in terms of SDG achievement, but also that many developed nations – such as **Austria, Norway or Sweden** – have actually stalled in the progress being made. These countries are replaced in the list by the likes of **Botswana, Lithuania and the UAE**.

Having this transparency should empower ESG-oriented investors to look differently at emerging sovereign debt, the proceeds of which are contributing to economies that are growing in their ability to meet sustainable objectives. Sustainable investors want their capital to be put towards achieving the SDGs; better data allowing them to diversify holdings away from the developed world towards those sovereigns making significant progress should help this aim be realised.

For more information, please see our recently published detailed [research](#) on the impact of sovereign debt.

ABOUT IMPACT CUBED

Impact Cubed provides ESG analytics and investment solutions for building more sustainable portfolios with greater impact. It combines an award-winning approach to integrating impact into risk and return with technology-enhanced portfolio design and management. The outcome is a seamless approach to customized sustainable investing.

You can find out more about our data and portfolio models at www.impact-cubed.com and if you would like to contact us at info@impact-cubed.com we would be happy to hear from you.

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