

# SUSTAINABILITY RANKING EMERGING COUNTRIES

OCTOBER 2014

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## A pioneer in sustainability analysis for emerging economies

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Contrary to popular belief, adding a sustainability overlay to the analysis of emerging market issuers is compatible with, and adds value to a sovereign debt portfolio. Indeed, this helps provide a holistic view by focusing on the long-term perspectives for key institutions that are vital for the functioning and development of markets. The analysis is complementary to credit rating by mapping the risk situation in terms of sustainability and by providing valuable additional insights to sustainability-oriented investors.

The world population currently stands at 7 billion, and according to United Nations statistics, this number is projected to grow to 9.5 billion by 2050. This increase will be particularly prevalent in emerging economies, which are currently confronted with overpopulation and a lack of natural resources. The demographic challenge is not only related to energy and ecology challenges, it also entails a challenge for the entire economy.

The uprisings in the Middle East have, and continue to highlight the importance of the democracy process, the guarantee of civil rights and freedoms. Inequalities within a population where high unemployment exists, in particular among the youth, create an insecure and unstable climate, which may ultimately lead to population rebellion.

Therefore, analysis of the viability of an emerging economy should include the sustainability of the country in terms of transparency and democratic values, as well as the economy, environment, demographics, health care, wealth distribution and education.

The experience Petercam has gained in the sustainability analysis of OECD member has led to a sustainability model designed for emerging markets which incorporates the specifics of these countries.

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## Sustainability ranking – October 2014

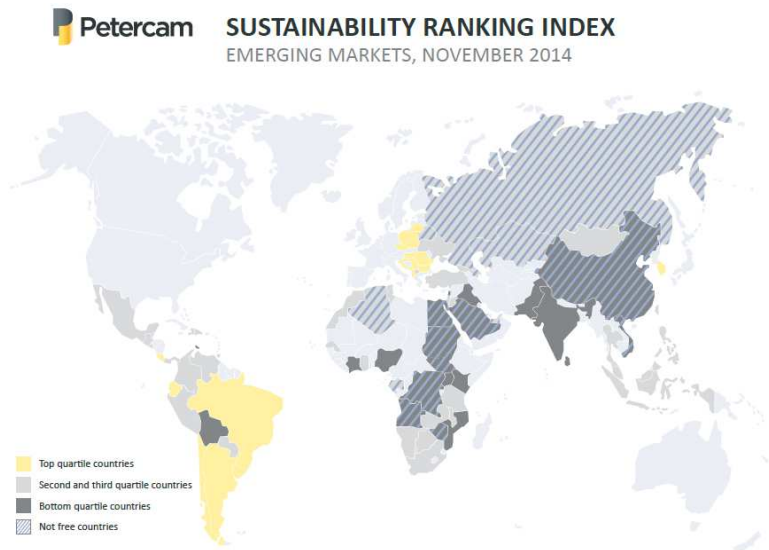
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The starting universe is composed of 84 countries, mainly defined by the existence of a local or hard currency sovereign debt market. The sustainability ranking enables the identification of the countries which have fully integrated global challenges into the development their medium-term objectives.

This complements the information gathered from credit rating, which is traditionally used to assess the short term valuation of sovereign debt.

Integrating long-term perspectives, which have no direct impact on the current valuation of an investment, but will influence medium and long-term performance, allows to highlight those countries that are expected to outperform and therefore to be solvent.

**Figure 1: Sustainability map and evolution over one 1 year**



#	COUNTRY	SCORE H2 2014	ΔSCORE H2 2013
1.	Poland	71	+5 ▲
2.	Hungary	69	+4 ▲
3.	Lithuania	69	+3 ▲
4.	Uruguay	69	+5 ▲
5.	Czech Republic	69	+6 ▲
6.	Costa Rica	68	+2 ▲
7.	Croatia	67	+4 ▲
8.	Chile	67	+4 ▲
9.	Bulgaria	66	+6 ▲
10.	Romania	65	+4 ▲
11.	Serbia	64	+1 ▲
12.	South Korea	64	+5 ▲
13.	Argentina	63	+2 ▲
14.	Albania	63	n.a.
15.	Montenegro	63	-4 ▼
16.	Ecuador	62	+2 ▲
17.	Brazil	61	+1 ▲
68.	Iraq	45	-1 ▼
69.	Aruba	45	+3 ▲
70.	Kenya	44	-4 ▼
71.	Lebanon	43	-4 ▼
72.	Vietnam	43	-1 ▼
73.	India	41	-5 ▼
74.	Ivory Coast	41	-3 ▼
75.	Uganda	41	-6 ▼
76.	China	40	-3 ▼
77.	Angola	40	-4 ▼
78.	Zimbabwe	40	- ●
79.	Pakistan	39	-5 ▼
80.	Mozambique	38	-3 ▼
81.	Nigeria	37	-4 ▼
82.	Sudan	35	-4 ▼
83.	Congo	30	-2 ▼
84.	South Sudan	26	-5 ▼

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## Democracy as a starting point

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The core of the model is the democratic values. Upholding these is a moral obligation to Petercam, which is intrinsically linked to the stance of a sustainable investor. Indeed, academic research has demonstrated that there is a clear correlation between the quality of the institutional framework of a country and its default risk.

Petercam uses the research of the international NGO Freedom House to assess the democratic development of a country. Based on an annual survey containing 25 questions on political rights and civil liberties, a country is attributed the status of 'free', 'partially free' or 'not free'. This information is complemented by the democracy index published in The Economist, which is also based on approximately twenty questions to assess the democratic level of a country, and also by the Human Rights Watch and the annual report of these organisations on human rights.

Several countries within the emerging universe do not fulfil the minimum requirements in terms of democracy and investment leeway. In total, the investment strategy linked to this sustainability ranking refrains from investing in 19 countries which have been categorised by reputable international sources as 'not free'. These include United Arab Emirates, Egypt, Jordan, Belarus, Gabon, Kazakhstan, Bahrain, Saudi Arabia, Russia, Azerbaijan, Algeria, Vietnam, China, Angola, Congo (Brazzaville), Rwanda, South Sudan, Sudan & Zimbabwe.

Studies indicate there is a clear link between the democratic level of a country and its sustainability. It should therefore not come as a surprise that the majority of those countries deemed 'not free' are at the bottom of the sustainability ranking.

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## Sustainability: a real added value to manage investment in emerging markets

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The analysis provides important information regarding sustainability levels of the studied countries. It enables comparison with several countries which have a similar levels of economic development, but differ with regard to social, ecological and corporate governance development.

Making a clear and full analysis of the sustainability of a country adds real value as part of the construction of an investment portfolio, in addition to the ideological values that may be presented. In essence, the model puts into context the opportunities and risks linked to a country.

The objective is not to exclude countries which have low sustainability scorings, as several countries in the universe have just started to improve their democratic process. Many years of dictatorship weigh on the sustainable development of a country. The transition to full respect of civil liberties and political rights, freedom of press and gender equality is a long term process, in particular if these rights have been violated for many years. Therefore, the progress made by countries should be closely monitored. The Ivory Coast is a good example of a country with a promising economic future, which has an abundance of natural resources and commodities. Following the toppling of the former president Laurent Gbagbo, the country was plagued by instability and social upheaval. Although the country now seems to be on track for a better future, it is too early in the process to be recognised as a full and genuine democracy.

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## Global coverage

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The extra-financial research performed by Petercam covers those countries into which investors may want to invest (34 OECD countries and 84 emerging countries). This forms an integral part of Petercam's conviction management, which is based on seeking risk-adjusted performance. Investors having a clear and full view of the risks and opportunities of a specific country have a comprehensive source of information to assess whether the companies active in that particular country may be successful. The quality of a financial investment is judged, among other things, by the characteristics of the markets the company operates in, and of the specificities of those countries.

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## What is sustainability?

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**Sustainable** development meets the needs of the present generation without compromising the ability of future generations to meet their own needs.<sup>1</sup>

Sustainability at country level is not the same as the sustainability of a corporation. **A sustainable country** is committed to fully ensuring the freedom of its citizens, invests in the personal development and welfare of its citizens (education, healthcare, wealth) and is also respectful towards its environment and reliable in terms of its international responsibilities and commitments.

The essential conditions to the wellbeing of a population and its sustainable development must be guaranteed. Indeed, political rights and civil liberties, the freedom of the press and the abolition of corruption are key factors in laying the foundations of economic and social development. If it appears impossible to do business without corruption, then this will have an influence on the assessment of investments in the involved country. The lack of transparency and stability should be taken into account in additional risk premiums.

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## How to measure sustainability of a country?

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There are three main approaches to measuring the sustainability of a country:

1. The **legal approach**, with the emphasis on treaties and offenses related to government actions. It should be noted however that agreement treaties is not always fully binding and there is often no penalty where violations occur.
2. The extreme **stakeholder approach**. The inconvenience of this approach is the importance of the number of stakeholders and parameters to be considered, giving rise to the possibility of dilution and irrelevancy of the indicators.
3. The **exclusion approach**, which consists of exclusions on the basis of controversial activities, examples being whale hunting and deforestation.

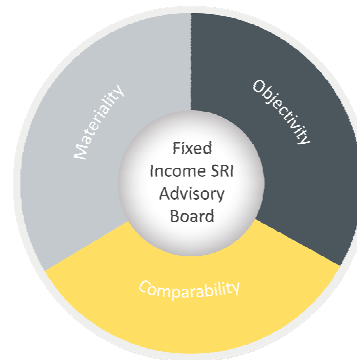
The approaches raise the issue of the moral threshold level and, subjectivity is likely to make it questionable. In contrast to corporates, for which extra financial information is largely provided by external parties, for countries there is a perceived lack of information.

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<sup>1</sup> Brundtland Report for the United Nations – 1987

The lack of information and an associated model encouraged Petercam to develop an in-house research model in 2007. Given the subjective character of the issue, key principles were defined from the beginning:

1. Existence of an **advisory board**, consisting of external specialists providing input to the model
2. Assessment of the country commitment to its **sustainable development**: variables on which the country can have influence through decisions (for example biodiversity relies heavily on the location and climate of a country and cannot always be changed by the latter)
3. **Comparability and objectivity**: criteria are numeric data, available from reliable sources and comparable for all countries.




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### The Fixed Income SRI Advisory Board (FISAB) ensures the objectivity of the model

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The role of the FISAB is threefold:

1. To select the SRI criteria which fulfil the preliminary requirements and are the most relevant in the framework of sustainability assessment of the OECD universe.
2. To determine the weights attributed to each indicator.
3. To critically and accurately review the model and the ranking to ensure continuous improvement
4. To validate the list of eligible countries

The FISAB consists of six voting members, three external and three internal. The objective of the board is to raise awareness on ESG issues among the portfolio management teams. The complementary background of the members guarantees a high level of expertise and knowledge of the issue in constructing the most relevant model.

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### Selective and objective criteria to assess the sustainability of countries

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The SRI overlay is characterised by indicators, which governments can utilise to influence their policies (government, authorities, law). Thus, it avoids data linked to the geography or population density of the country. The model is quantitative and tracks the current performance of a country, with comparable data. Only a limited number of treaties are considered as they do not guarantee genuine commitment.

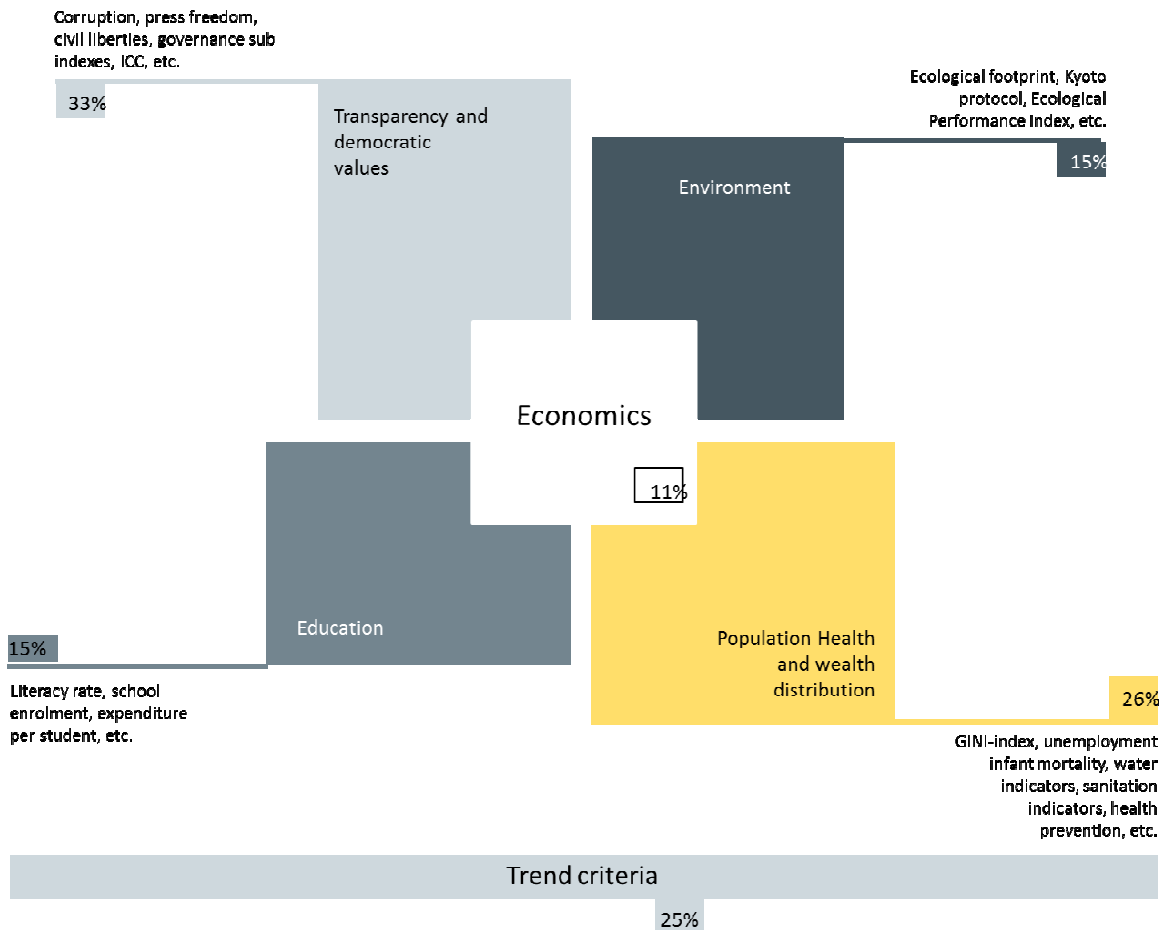
The underlying principles of the model remain the same, quantifiable criteria that can be applied to all countries, coming from acknowledged and reliable sources. Simultaneously, the assessment criteria must be adapted to the specific context. The level of development strongly varies from one country to another, which is why it is crucial to focus on a limited number of criteria which are vital to sustainability. For instance, the literacy rate is not relevant in developed countries in Europe, it is more so in countries such as Brazil, Ghana and Malaysia.

## Petercam Best-in-class approach

The sustainability analysis focuses on five key drivers (Transparency & Democratic Values, Environment, Education, Healthcare & Wealth Distribution and Economics) which contribute to the total score according to their relative weight. Each criterion gets an assigned weight and each country receives a score ranging from 0 (worst) to 100 (best) based on its relative position compared to other countries (comparison to the difference between the maximum and the minimum). For binary criterion (death penalty, signing Kyoto protocol, for instance) a score of either 0 or 100 will apply.

The final and overall score of a country is equal to the weighted average of the scores on each criterion, using the weights which are decided by the Fixed Income SRI Advisory Board.

The selection process results in a ranking of the 84 countries. The final scoring is rounded up to avoid an excessively unstable universe as decimals are statistically irrelevant.



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Specific economic data are taken into account to assess the fiscal situation of a country. Indeed, the stronger the fiscal and budgetary position, the more a country needs to invest in purposeful governance programs to manage social and environmental risks and support long-term sustainability goals. Economic data is therefore an additional key driver (competitiveness index, budget balance, public debt, etc.) but the weight assigned is lower than the four other key drivers as this type of data are also taken into account by the investment team in their fundamental research and analysis.

For the sake of comparability, data are historical. To avoid subjectivity in the model, no data based on future promises (policies, etc) are considered. Nevertheless, progress and improvement are taken into consideration through a **trend indicator**, which provides insights into the robustness of a country's commitment to sustainability. The trend is calculated over the previous three years and a 25% weight of the scoring is allocated to it.

In total, the model counts over 30 indicators.

The approach is dynamic as the selected criteria are reviewed twice per year with the intention of selecting the most appropriate and relevant criteria for each domain. An indicator may be replaced and adapted, or omitted. New indicators can enter the model and the allocation of the weightings may also vary.

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### Sources are internationally recognised

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The model aims for highest possible level of objectivity. Accordingly, statistical data to support the analysis of the country's sustainability are mainly collected from government databases and international government agencies such as the International Energy Agency, World Bank, International Monetary Fund, United Nations Development Programme and US Central Intelligence Agency. Data are complemented by information drawn from leading non-governmental organisations such as Freedom House, Transparency International and World Economic Forum.

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### Features of the investment fund Petercam L Bonds Emerging Markets Sustainable

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#### Objective of the investment fund

**Petercam L Bonds Emerging Markets Sustainable** invests in bonds and/or other debt securities, including but not limited to, perpetual bonds, inflation-linked bonds, zero coupon bonds and structure products, such as for example, credit linked notes, with a fixed or floating rate, denominated in any currency, issued (or guaranteed) by emerging countries, including its regional public authorities and public (or equivalent) bodies or by international public bodies, such as World Bank or the European Bank for Reconstruction and Development and selected on the basis of sustainable development criteria, such as for example, social equity, environmental awareness and socially equitable political and economic governance.

#### Technical details

Petercam L Bonds Emerging Markets Sustainable is a sub-fund of Petercam L Fund, a sicav under Luxembourg law



ISIN Income class A	LU0907927171
ISIN Accumulation class B	LU0907927338
ISIN Income class E	LU0907927841
ISIN Accumulation class F	LU0907928062
Entry fee	Negotiable with a maximum of 3%
Exit fee	0%
Management fee (class A and B)	1.00% annually

**Please refer to the KIID, (simplified) prospectus and fund factsheet for additional information.**

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### **Petercam and its commitment towards sustainability**

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In September 2011 Petercam **signed the UNPRI**, aiming to encourage the integration of environmental, social and governance (ESG) issues into investment decision making. Petercam is therefore committed to adopting and implementing the six relevant Principles. By signing the UNPRI principles, Petercam has publicly demonstrated its top level commitment to consistently integrating ESG factors with its fiduciary duty, and to contributing to the development of a more long-term oriented and sustainable investment approach. Being part of a collaborative and dynamic global network, Petercam has a better understanding and knowledge of risks and opportunities related to responsible investments.

As testimony to its commitment, Petercam has initiated a **Responsible Investment Committee**, comprising members from diversified business lines within the company who share the same willingness and pro-activity to enhance SRI and ESG issues within Petercam.

In addition, Petercam has **appointed a fully dedicated RI Co-ordinator** whose main objectives are:

1. steer all initiatives, projects and methodologies related to the SRI aspect of Petercam’s investment processes
2. be responsible for streamlining initiatives regarding ESG challenges (Environmental, Social, Governance) on the Petercam group level.
3. be the privileged contact person for the UN PRI, of which Petercam became a signatory in September 2011 and for other stakeholders (Beama, Eurosif, FIR, etc.).

Today Petercam manages **four SRI strategies**: Petercam Equities Europe Sustainable and Petercam Equities World Sustainable on the equity side and two fixed income strategies: Petercam L Government Sustainable (OECD universe) and Petercam L Bonds Emerging Markets Sustainable (Emerging market universe). With the latest strategy, Petercam benefits from a global coverage of countries sustainability screening.

Furthermore, Petercam has defined its responsible investor policy and approach to integrate ESG issues within the buy-side investment research and its mainstream Investment Processes.

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