October 2024

Ninety One

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Investing for a world of change

Three years, three insights

Emerging Markets Sustainable Blended Debt Strategy

Peter Eerdmans
Portfolio Manager

Nicolas Jaquier
Portfolio Manager

Emily Patton
Portfolio Specialist

Three years ago, we launched the Emerging Markets Sustainable Blended Debt Strategy. The broad aim was to help investors tap into the best opportunities among countries with improving ESG trends, while providing exposure to sustainable investments including green, social, sustainable, sustainability-linked and supranational bonds.

The strategy is underpinned by the following beliefs:

- Focusing on better ESG dynamics does not mean sacrificing returns.
- Countries with improving ESG metrics will build sustainable economies and can unlock higher productivity, leading to outperformance of their assets.
- Engagement is necessary to help improve ESG metrics.

Here we share insights gained over the past three years of managing the strategy.

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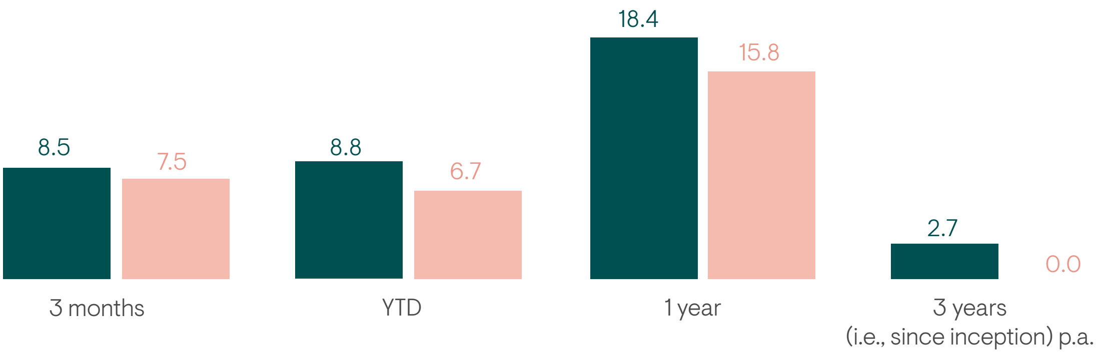
For further information on the investment team, please see Important information section.

1 Sustainable investing in emerging market debt can deliver alpha

The Emerging Markets Sustainable Blended Debt Strategy was built on our belief that countries with improving ESG metrics will forge more sustainable economic paths, and that this should help their assets outperform over the long run. In other words, investing in emerging market (EM) countries on sustainable development paths should lead to a positive risk-return outcome for long-term debt investors.

While three years is a relatively short time frame for such dynamics to play out, the behaviour of the strategy since inception lends support to this view. The strategy has achieved annualised alpha, gross of fees, of 2.7%.

Figure 1: Strategy composite performance (USD, %)



Calendar (%)	2021 (Oct)	2022	2023	2024 (YTD)
Composite (gross)	-0.6	-10.8	12.1	8.8
Benchmark	-1.5	-14.9	11.7	6.7
Active return	1.0	4.1	0.4	2.1

Past performance does not predict future returns; losses may be made.
Source: Ninety One, 30 September 2024.
Performance is gross of fees (returns will be reduced by management fees and other expenses incurred), income is reinvested, in USD.
Performance start: 01 October 2021. Strategy: Emerging Markets Sustainable Blended Debt. Benchmark: 50% JPMorgan GBI-EM Global Diversified Net; 50% JPM EMBI Global Diversified. Indices are shown for illustrative purposes only.

Portfolio insights

Investments in the portfolio focus on countries where we see improving sustainability dynamics, regardless of their starting point. Given its focus on sustainability trends, the portfolio is almost exclusively invested in countries that are moving in the right direction. Only a very small share is allocated to countries on a negative trend, but this is implemented via either supranational bonds or green, social, sustainable and sustainability-linked (GSSS) bonds.

Among our highest-conviction positions from a sustainability perspective, Costa Rica and Chile have been key contributors to performance since inception. Furthermore, underweight positioning in the lowest ESG scorers has had a significant positive impact on relative returns. A notable example is Russian debt; its absence – on sustainability concerns – from the portfolio was beneficial after bond prices were marked down to zero when Russia invaded Ukraine. That said, underweight positioning related to sustainability concerns can hold back performance over shorter time frames; the absence of exposure to Turkey in the portfolio has meant the strategy could not benefit from the outperformance of Turkish local currency debt this year. While the significant macro adjustment that has driven this outperformance is encouraging, broad ESG trends are not sufficiently positive for us to include Turkey in the portfolio at this point.

The nature of our proprietary ESG scores – namely, a forward-looking, qualitative assessment of ESG trends – also means the portfolio has avoided sector or defensive biases. Typically, that's not the case for approaches that rely on third-party ESG data, which tends to be backward looking with a bias towards high-income countries – often translating into a quality/low-yield bias in portfolios.

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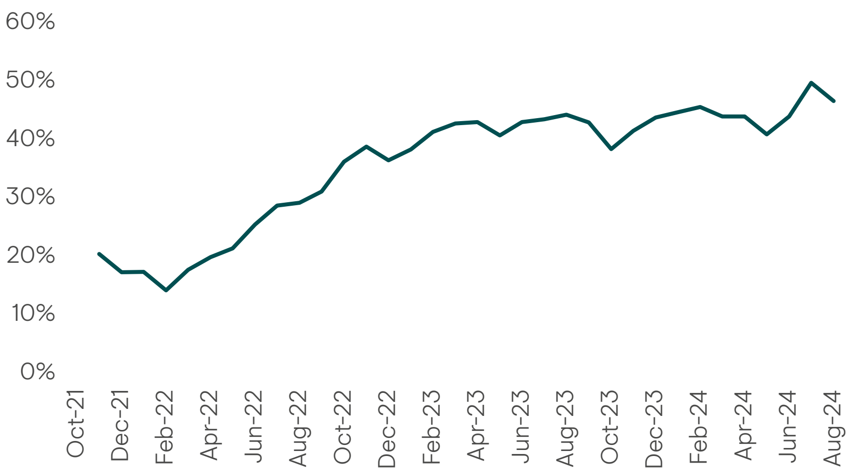
For further information on the investment process, please see Important information section.

2 Opportunities to make a positive impact are plentiful

In addition to delivering on its return objectives, the strategy has also been able to make a positive contribution to a variety of sustainability related activities via its direct investments in GSSS bonds.

Upon launching the strategy, the GSSS market was already starting to take off. Even so, the growth in number and breadth of opportunities has been surprisingly impressive, as we charted here. This has meant that even when using our in-house sustainable bond selection criteria (which is aligned with Emerging Markets Investors Alliance's enhanced labelled bond principles), we've easily surpassed the portfolio's target of a minimum of 30% in sustainable investments including GSSS and supranational bonds, as shown in Figure 2.

Figure 2: Evolution of sustainable bond* exposure in the strategy



Source: Bloomberg, Ninety One, as at 31 August 2024. *Sustainable investments include: green, social, sustainable, sustainability-linked, supranational bonds, and bonds issued by Development Finance Institutions that pass our assessment.

Investment case study: Uruguay

Uruguay's Sovereign Sustainability-Linked Bond (SSLB), first issued in October 2022, directly links the country's financing strategy and cost of capital to the achievement of its climate and nature-based goals set under the Paris Agreement.

Target	Progress
Reduction of greenhouse gas (GHG) emissions intensity To achieve at least a 50% reduction in aggregate gross GHG emissions intensity by 2025, from the 1990 base year.	By the time of issuance in 2022, Uruguay had already achieved a 46% reduction in GHG emissions intensity. During 2022, GHG emissions decreased a further 4.1% year-on-year, leading the reduction target being updated to 52%.
Maintain native forest area To maintain at least 100% of the native forest area by 2025, from the 2012 base year.	The latest data available (reported for 2021) showed 100% maintenance of the native forest area with respect to the base year. Data is reported every four years. During 2022, the country completed the first stage of the Reduction of Emissions from Deforestation and Forest Degradation (REDD+ project).

Investment case study: Benin

The sustainable bond issue in 2021 was a first for Benin and for the African continent. Proceeds from the issuance will be used to finance the country's progress toward the United Nation's Sustainable Development Goals (SDGs).

Target	Progress
SDG4: Quality education By 2030, to expand educational services and improve the capacity to take on students.	Between 2020 and 2022, there was a 6% increase in primary school education enrolment, plus 389,346 new beneficiaries of school canteens. During 2022, just under 10,000 new teachers were recruited.
SDG6: Clean water and sanitation By 2030, to ensure universal and equitable access to safe and affordable drinking water.	The bond has financed seven projects to ensure access to drinking water and sanitation for all: two in rural areas; four in urban areas; and one structuring project in the water sector.

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This is not a buy, sell or hold recommendation for any particular security.

Case study

3 Data enhances the quality of engagements

Another key tenet of the strategy is that engagement with issuers can help improve sustainability dynamics in the issuing country. Again, this is a long-term endeavour. But in the three years since the strategy launched, we've found data-driven conversations to be among the most fruitful. We have generally found that policymakers respond well to being shown concrete measures of how they are scoring across a variety of metrics and engaging in a two-way discussion around how to improve.

Several proprietary tools have proven useful in this regard. In 2020, we launched the Climate & Nature Sovereign Index, which quantitatively assesses the long-term risks relating to climate change and nature loss at a country level. The following year, we launched the Net Zero Sovereign Index, which provides an independent, quantitative assessment of a country's progress towards net zero, within the context of a just transition. More recently, we have created a Sovereign Biodiversity Index - the next quantitative tool underpinning our Environment score for emerging countries[1].

An example of where our Net Zero Sovereign Index has been particularly helpful is in discussions with Chile's Debt Management Office. Chile has ambitious targets – also reflected in its sustainability-linked bond key performance indicators – to increase the share of renewable energy to 60% by 2032. We used our Net Zero Sovereign Index to encourage continued progress in the development of renewables (an area of strength) and to understand bottlenecks around upgrading transmission lines. The Index also highlighted areas where Chile lags peers, e.g., it has a high level of energy intensity given the importance of the energy-hungry mining industry in the country and from inefficient energy subsidies (introduced during COVID). We learned of plans to adopt electric vehicles in the state-owned mining company. This, together with the gradual removal of energy subsidies, is something we are monitoring.

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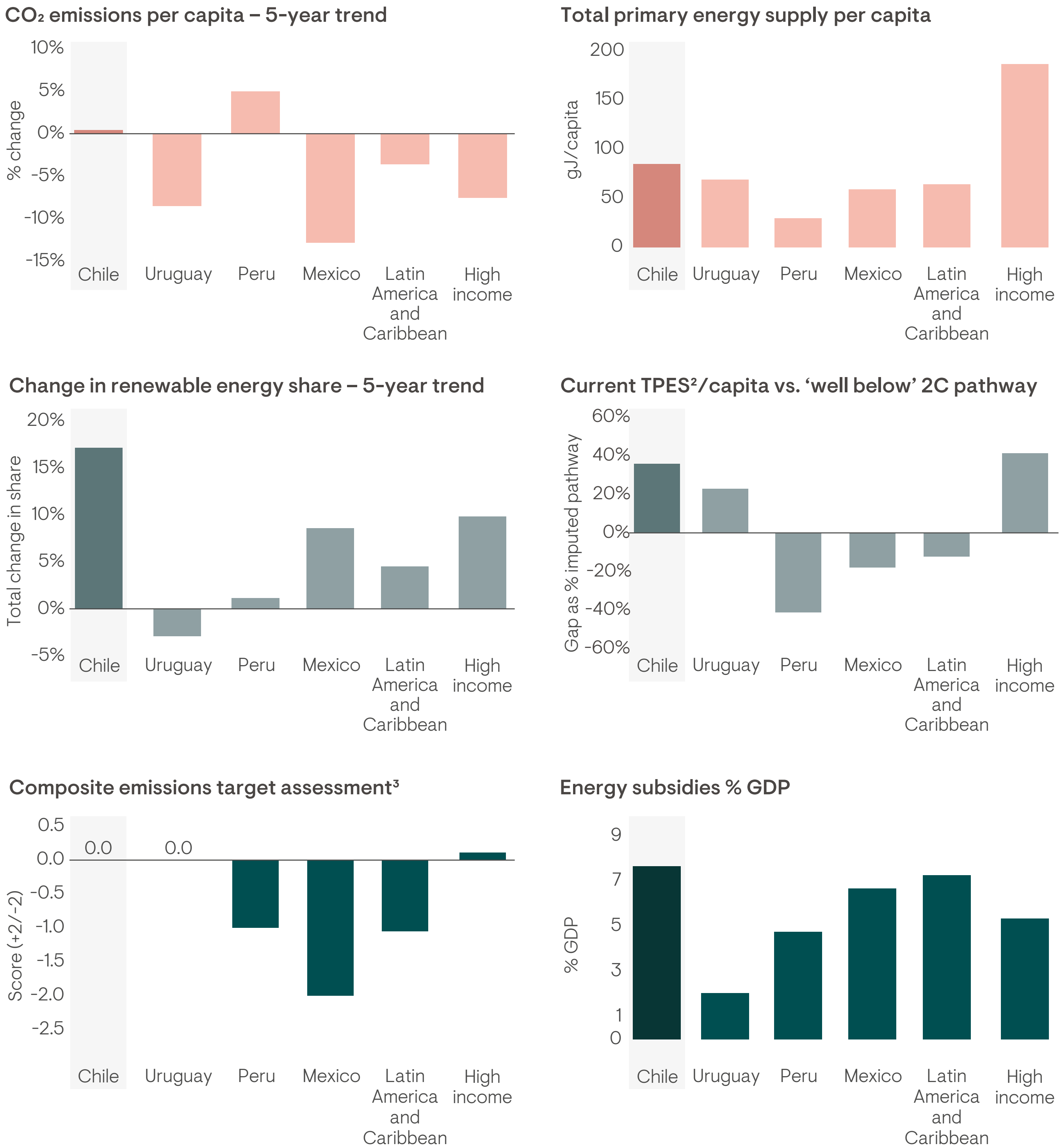
1. For more details on the Climate & Nature Sovereign Index and Net Zero Sovereign Index please see: https://ninetyone.com/en/insights/no-one-left-behind

Figure 3: Net Zero Sovereign Index snapshot - Chile



2. TPES/capita is defined as "Total primary energy supply per head of population.
3. A composite indicator from the Net Zero Tracker including Nationally Determined Contribution target status, interim targets, scope, reporting, equity and accountability.

Source: Ninety One Net Zero Index 2023. For illustrative purposes only. For further information on investment process, please see the Important information section.

In summary

While three years is a relatively short time frame for sustainability dynamics to play out, the behaviour of the strategy since inception lends support to our view that sustainable investing in EM debt can deliver alpha. Since managing the strategy, we've witnessed impressive growth in the sustainable bond market, where we have found ample opportunities to make a positive contribution to a variety of sustainability related activities. We have also found that our Net Zero Sovereign Index has enhanced the quality of our engagements with policymakers.

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Australia
Level 28 Suite 3, Chifley Tower
2 Chifley Square
Sydney, NSW 2000
Telephone: +61 2 9160 8400
australia@ninetyone.com

Botswana
Plot 64289, First floor
Tlokweng Road, Fairgrounds
Gaborone
PO Box 49
Botswana
Telephone: +267 318 0112
botswanaclientservice@ninetyone.com

Channel Islands
PO Box 250, St Peter Port
Guernsey, GY1 3QH
Telephone: +44 (0)1481 710 404
enquiries@ninetyone.com

Germany
Bockenheimer Landstraße 23
60325 Frankfurt am Main
Telephone: +49 (0)69 7158 5900
deutschland@ninetyone.com

Hong Kong
Suites 1201-1206, 12/F
One Pacific Place
88 Queensway, Admiralty
Telephone: +852 2861 6888
hongkong@ninetyone.com

Luxembourg
2-4, Avenue Marie-Thérèse
L-2132 Luxembourg
Telephone: +352 28 12 77 20
enquiries@ninetyone.com

Namibia
Am Weinberg Estate
Winterhoek Building
1st Floor, West Office
13 Jan Jonker Avenue
Windhoek
Telephone: +264 (61) 389 500
namibia@ninetyone.com

Netherlands
Johan de Wittlaan 7
2517 JR Den Haag
Netherlands
Telephone: +31 70 701 3652
enquiries@ninetyone.com

Singapore
138 Market Street
CapitaGreen #27-02
Singapore 048946
Telephone: +65 6653 5550
singapore@ninetyone.com

South Africa
36 Hans Strijdom Avenue
Foreshore, Cape Town 8001
Telephone: +27 (0)21 901 1000
enquiries@ninetyone.com

Sweden
Västra Trädgårdsgatan 15,
111 53 Stockholm
Telephone: +46 8 502 438 20
enquiries@ninetyone.com

Switzerland
Dufourstrasse 49
8008 Zurich
Telephone: +41 44 262 00 44
enquiries@ninetyone.com

United Kingdom
55 Gresham Street
London, EC2V 7EL
Telephone: +44 (0)20 3938 1900
enquiries@ninetyone.com

United States
Park Avenue Tower, 65 East 55th Street
New York, 10022
US Toll Free: +1 800 434 5623
usa@ninetyone.com

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