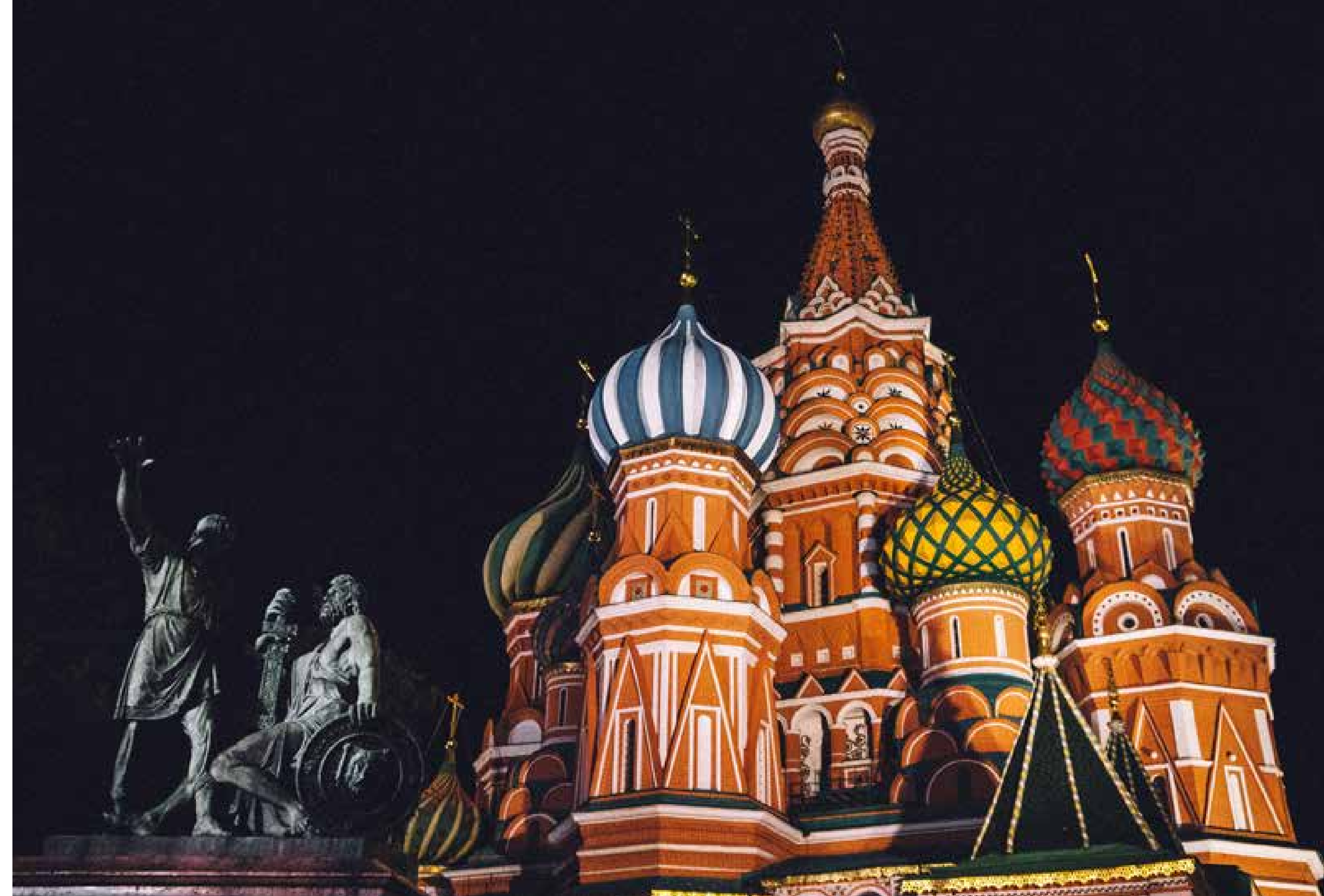

Russia, exclusions versus engagement and returns

At the end of March, **Tell Media Group**, in cooperation with **Barings**, **Insight Investment** and **MFS Investment Management**, invited investors to discuss emerging market debt. Tell Media Group founder Niklas Tell and Nordic Fund Selection Journal editor Caroline Liinanki moderated the roundtable.

By: Niklas Tell

The discussion started out with Niklas Tell asking the investors about their current exposure to emerging market debt and how this has changed over recent years.

KLAUS SØLUND: "Our allocation has actually been fairly stable over time. We're a growing pension fund so we have added capital but as a percentage of our overall assets, it has been stable. We sometimes reallocate within the asset class and right now we have increased our high yield position. In terms of internal versus external, it's a mix where we manage some 60 per cent internally and the rest externally. We specifically don't do emerging market corporates internally."

THOR SCHULTZ CHRISTENSEN: "I joined Velliv a year and half ago and then it had already been decided that we should change our exposure – especially when it comes to local currency. Our EMD hard currency exposure is unchanged and part of our return seeking portfolio. Local currency is now managed internally. What we've done is replaced developed markets with high quality emerging market local currency debt to get exposure to local interest rate curves in these markets. This part of the portfolio is also used for diversification purposes and our core competence internally is to identify the top emerging market countries where we see a potential for interest rates to fall if we have an economic downturn. Our allocation is currently roughly 50/50 between externally managed hard currency and internally managed local currency."

CAROLINE LIINANKI: WHAT IS THE ROLE OF EMERGING MARKET DEBT IN A PORTFOLIO AND WHY SHOULD YOU HAVE AN ALLOCATION?

THOR SCHULTZ CHRISTENSEN: "We invest in emerging market hard currency debt because we believe that there are returns to be found there, whereas an allocation to local currency debt is more for diversification reasons. Chinese debt, for example, will give you some 3 per cent in returns but then the currency hedge will cost you some 3 per cent, which makes it comparable to German rates. However, there's more room for Chinese rates to fall if there's a crisis compared to German rates."

RICARDO ADROGUÉ: "The diversification is the main reason to invest. And if you pick the right credits and the right countries, you can get a higher yield. When you look at the long term – in US dollar terms – the risk characteristics are compelling relative to other risk assets. You typically get shorter drawdowns, consistent returns over time and diversification."

SIMON COOKE: "It's absolutely a return driving asset class over the long term, with consistently high Sharpe ratios. And if you look at the hard currency universe, it's important to recognise that emerging market debt is not what it was 10 years ago. Today, the hard currency universe is USD 4 trillion and across corporates and sovereigns, you're talking about some 1500 issuers from 100 countries, providing significant diversification. That also means there is a huge, heterogeneous opportunity set for active managers to exploit when you have short sharp indiscriminate drawdowns, like right now, which have historically corrected very quickly."

WARD BROWN: "What drives these strong sharp ratios and returns over time is the way investors approach the asset class. They tend to treat it as one homogenous block and when something like Russia/Ukraine happens, there's not a lot of fundamental spillover to other parts of the asset class but investors just exit the asset class. That creates an excessive risk premium over time and it happens time and time again. There's always a crisis somewhere in the emerging world that mostly doesn't spill over to other parts and yet we see this risk premia built into the asset class. I would also echo what Ricardo said – it's a good asset class for active managers because we can hopefully avoid the problems and instead focus on the fundamentally sound areas."

GEORG SKARE LUND: "Simon, you said that the market isn't what it was 10 years ago but what's your expectation going forward? Specifically, do you think that hard currency is a dying asset class as more countries will be able to issue debt in local currency?"

SIMON COOKE: "When it comes to corporate debt, we've been waiting a long time for an explosion in local currency corporate issuance. A decade ago, we would have argued that it would happen in the next five years but it never came. I'm therefore hesitant to come up with a timeframe for the growth of local currency corporate issuance. On the other hand, we continue to see that our hard currency universe is growing, with no signs of dying. A clear trend is, of course, the exponential increase in issuance of green and other

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sustainable bonds, which now contribute 20 to 30 per cent of overall issuance, creating the potential for positive impact while generating attractive returns."

RICARDO ADROGUÉ: "While one would hope that local currency debt would grow, there's no evidence for that. There are some 120 countries that can issue hard currency debt and only about 15 that issue local currency debt that are liquid enough."

WARD BROWN: "I honestly don't think that the outlook will be radically different to what we have today. Local currency has declined over the last 10 years but we're actually more optimistic than we have been for a long time, so maybe it will make a comeback."

NIKLAS TELL: DOES THE PANDEMIC AND THE RUSSIAN INVASION OF UKRAINE CHANGE HOW WE VIEW EMERGING MARKET DEBT? IS THERE A RISK OF LESS GLOBAL TRADE, WHICH COULD HURT THE ASSET CLASS?

WARD BROWN: "I understand the argument but I don't think it's well supported. In the last two years, export growth in emerging markets has been the highest since the financial crisis. It's not so much about bottle necks in supply chains as excess demand. I think it will take more to disrupt global trade."

THOR SCHULTZ CHRISTENSEN: "Long term, I still think that it will be a convergence trade. If you look at the Paris Agreement and the green transition, that's about helping the poorest emerging market countries raise their living standards in the most environmentally-friendly way possible. I completely agree that we can worry about deglobalisation and the world splitting into three areas but I would still argue that emerging markets will be a long-term convergence play."

SIMON COOKE: "99 per cent of the world's poorest people live in emerging markets. 85 per cent of the world's population live in emerging markets. 77 per cent of the world's land mass is in emerging markets. Whichever way you look at it, if you want to deliver on the UN SDGs or the Paris Agreement, you need to focus on emerging markets. There really is a great opportunity to invest in emerging markets in order to drive positive change."

CAROLINE LIINANKI: YOU ALL PAINT A VERY POSITIVE PICTURE WHEN IT COMES TO EMERGING MARKET DEBT BUT IF YOU LOOK AT THE RETURNS, THEY HAVE BEEN VERY VOLATILE OVER THE PAST FEW YEARS WITH NEGATIVE RETURNS BOTH LAST YEAR AND SO FAR THIS YEAR AS WELL.

KLAUS SØLUND: "We of course always want positive returns but you can't always get that. I think last year was a case of US treasuries selling off and we had a positive return on the credit part of emerging market debt. This year has been more difficult but we're still optimistic. Spreads are high but they usually don't stay at these elevated levels for very long."

RICARDO ADROGUÉ: "Just as Ward said earlier, there is always bad news somewhere in emerging markets, which can cause a lot of investors to exit the asset class altogether. Arguably, times like these are some of the best times to invest as history tells us that the turnaround from sharp declines tends to be fairly quick. In the 1990s, the longest the market took to rebound was 18 months. More recently it has taken no longer than three to six months."

NIKLAS TELL: IT SEEMS THAT THE GENERAL VIEW IS THAT THE ONGOING INVASION BY RUSSIA AND THE CURRENT WEAK RETURNS DON'T CHANGE YOUR VIEW ON EMERGING MARKET DEBT BUT RATHER CONFIRMS HOW THE ASSET CLASS WORKS.

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>
> *– Ward Brown, MFS Investment Management*

THOR SCHULTZ CHRISTENSEN: "Yes, I think that's fair. Regarding the convergence, we would like to replace the larger countries in our portfolio with smaller ones over time – replace Brazil with sub-Saharan countries, for example. We've always been a bit hesitant when it comes to countries with too strong leaders and smaller countries are typically more reliant on working with their neighbours. You can, of course, have bad politicians in smaller countries as well but when change happens for the better, such as in Ethiopia, we should support that."

GEORG SKARE LUND: "I'm worried that we've had a long period where we have become too used to stability. Maybe the high Sharpe ratio can be explained by the fact that risk has been too low and maybe we need to get used to more instability in emerging markets. The situation in Ukraine and the problem it causes for food production could lead to unrest in a lot of countries."

WARD BROWN: "We're always concerned about the risk outlook for countries. However, I still think that what matters is the market perception rather than the risk itself and the market perceives the risk for emerging markets as very high already. As I said before, even if an event in one country doesn't affect other countries, it will still have an effect on the asset class as a whole. What you mention about food shortages could be a risk for this year but I'm not convinced that it's a broad asset class vulnerability. Some markets will be exposed to that for sure but other countries will be less effected. The asset class has robust fundamentals and the way it's structured from a macro perspective is solid compared to when I started in the late 1990s. Then we had weaker macro structures that were common across the asset class and that was problematic."

CAROLINE LIINANKI: TO WHAT EXTENT HAVE YOU BEEN HURT FROM EXPOSURE TO RUSSIA FOLLOWING THE SANCTIONS? AT PENSIONDANMARK, YOU DID, FOR EXAMPLE, SELL INVESTMENTS IN RUSSIA BEFORE OUTBREAK OF THE WAR.

KLAUS SØLUND: "Yes, we sold all government bonds and all government-related corporate bonds before Russia invaded Ukraine. At that time, there was, of course, a functioning market but we've all seen the shock to all emerging markets more recently. I think we were a bit lucky to get out in time."

RICARDO ADROGUÉ: "We had been underweight Russia ever since Crimea due to fear of sanctions and as we know, it took some seven years until it happened. We had no exposure to local currency bonds in Russia but we did have hard currency exposure, as well as exposure to Ukraine and Belarus. That is, of course, challenging—but what we're doing now, as we do in any crisis, is to look for the opportunities in other markets that comes from a crisis."

SIMON COOKE: "We were neutral Russia heading into the conflict. The conflict raises all sorts of questions for investors but perhaps particularly with regards to ESG. Part of our exposure was to Russian Railways, via a green bond where the proceeds were being used to electrify the railway, which of course is a great thing from an environmental point of view. The company was well run with appropriate ESG policies in place. But it's owned by the Russian government and it became apparent to us that the railway network was being used to transport troops, equipment and ammunition towards Ukraine. Therefore, we immediately decided to exit. Our money was earmarked for the electrification of the railway but we would be indirectly supporting the Russian war effort and that's something we didn't want to do. It raises questions rather than answers for the industry and we can talk about our fiduciary duty from a financial perspective but we must also look at the impact of the investments we make. Many competitors have sought to separate the use of proceeds from the issuer. We think you need to look at the issuer of the bond and not only focus on the fact that it's a green bond. The two are linked."

THOR SCHULTZ CHRISTENSEN: "We were also lucky not to have any exposure to Russia, except a small part from an index holding. All our emerging market mandates have an ESG focus and we accept a higher tracking error and our managers therefore had the opportunity to sell out of Russia."

CAROLINE LIINANKI: WHAT ARE SOME OF THE LESSONS LEARNT FROM THE CURRENT EVENTS? HAS THIS, FOR EXAMPLE, MADE IT EVEN MORE IMPORTANT TO LOOK AT HUMAN RIGHTS WHEN IT COMES TO EMERGING MARKET DEBT?

GEORG SKARE LUND: "I think the biggest lesson learnt is that we need to look at leading indicators to look out for what could happen. To exclude Russia when the war is a fact is too late and this is problematic. It's easy to say that we should have seen what was going on in Ukraine, in Russia and with Putin. Crimea happened in 2014 so we've had a long time to prepare. We also saw dissidents being killed in London, allegedly by Russian agents, but as investors we took no action. Today, on the other side of the world, we see a government detaining millions of people of a certain ethnic/religious group in internment camps and we tacitly accept that today but will we accept that tomorrow? The

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>
> *– Georg Skare Lund, Storebrand*

sentiment turns very quickly in this media-driven world. I'm a bit uncertain how politics in general and human rights in particular will affect our future approach to ESG in general and especially ESG in emerging markets going forward."

RICARDO ADROGUÉ: "On the topic, China's political system isn't vastly different from that in Russia, yet investors remain invested in China. One of the big surprises in the case of Russia was the very aggressive sanctions, by Europe primarily. Russia had moved all of their foreign reserves from US treasuries to Europe and now they don't have access to those. What Putin has done now is very different from what he did in Georgia and what he did in Crimea. He tried to take the whole country, which many thought he wouldn't do, and now we're seeing the repercussions."

THOR SCHULTZ CHRISTENSEN: "I think one of the lessons learnt is what we have done with our ESG focus and that is to allow managers to manage emerging market debt with a higher tracking error. That will allow them to avoid big countries such as Russia."

NIKLAS TELL: EVEN IF YOU HAVE AN ESG FRAMEWORK THAT WILL ALLOW EXTERNAL MANAGERS TO RUN A HIGHER TRACKING ERROR, WHERE DO YOU DRAW THE LINE AND SAY THAT YOU WILL NOT ACCEPT INVESTMENTS IN CHINA OR SOME OTHER COUNTRY DUE TO ESG REASONS?

WARD BROWN: "As Ricardo says, there are issues in almost every country in emerging markets and the 'S' and the 'G' of ESG is part and parcel of the development, both economically and politically, of these less developed countries. The project that we're part of has been going on for decades and I find that disengaging from that is really problematic. We have to stay engaged. When I first started, the type of macro discussions we had was nothing like what we have today. Just those constant conversations and forcing them to tell their stories transparently contributed to making things better. I believe that's how engagement works. It takes time but I don't think disengagement works. Coming back to the lessons learnt, I think it's very much about integrating ESG into your investment process. We were underweight Russia but that wasn't because we were concerned about the macro outlook – we were underweight because of governance concerns."

GEORG SKARE LUND: "So you don't believe in disengagement but at the same time you underweight a country if the yield isn't fair given the governance structure? My question is if you should own these countries at all."

WARD BROWN: "This current situation in Ukraine is, of course, very special. It's a war that we're talking about. I think to explain the pros and cons of disengagement, it might be easier to think about environmental issues where there's a lot of work to be done. We don't really engage with emerging market governments on their environmental targets yet. To me, that looks like how it was in the 1990s with macro policy. As all of us implement environmental engagement, it will make an impact in emerging markets and those investments are needed. We

need to fund the transition to a green economy in emerging markets. Disengaging because everything isn't perfect today is not the way forward."

GEORG SKARE LUND: "Of course, the problem as a fund selector is to have transparency to know if the engagement is really working – especially when it comes to nations rather than companies."

SIMON COOKE: "In terms of engagement, I agree with both Georg and Ward. Bondholders in emerging markets have perhaps a unique opportunity. Over 60 per cent of companies in emerging markets have no publicly-listed equity. And obviously, sovereigns have no listed equity. That makes bondholders one of the primary providers of capital, giving us great capacity for positive influence. Now if I engage with a small company, I can have a massive influence and I can't have the same influence with the Brazilian government. But that doesn't mean that I don't have any influence. We've been engaging with a range of governments on their green bond issuance in making sure they have a solid framework for that and that has been successful. At the same time, I think we need to be realistic about the change and influence we can have and that's something we've learnt the hard way. You need to target the right sovereigns and the right companies. There's always a risk of wasting time lobbying an issuer that has no interest in changing. It's better to focus on the ones that might be very bad today but that are open to change. In our experience, that leads to tangible results over the long term. Openness in that regard is really important: we report regularly on our engagement and progress but we do anonymise the country or company when we report given the sensitivity of issues involved."

RICARDO ADROGUÉ: "Regarding the transparency, reporting on engagement is, of course, important but you can also look at our holdings and see where we are over- or underweight in order to get an idea of how we view different countries and companies. On the topic of exclusions and disengagement, I think that's problematic because if you exclude, you put an infinite price on something that's relative and this is the real challenge we have as investors. We need to decide the correct price for something that will drive action in the way we would prefer. If you put an infinite price on 'E', 'S' and 'G', you would probably need to exclude all of emerging markets."

WARD BROWN: "The indicators for 'S' and 'G' map very clearly to bond pricing. Weak ESG is correlated with higher spreads, so the market is actually already doing a good job at pricing these additional risks. The incentive structure is there and the reason it's working is that these indicators really matter for sovereign risk. Indicators for 'E' is different and we don't see the same correlation there and that's a challenge for investors. There's really no history of environmental risks that we can build on but as markets starts to incorporate environmental concerns in the dialogue, just as we did with macro, it will be reflected in the pricing as well. It will just take a little time."

CAROLINE LIINANKI: WHAT'S YOUR TAKE ON THIS AT PENSIONDANMARK AND VELLIV AS YOU FOCUS A LOT ON THE 'E' AND CLIMATE CHANGE?

KLAUS SØLUND: "I agree with a lot of what has already been said. What we want to do is move to ESG 2.0 where we don't really exclude but instead engage with companies. That said, we do exclude some of the worst companies if we see that there's no willingness to improve."

THOR SCHULTZ CHRISTENSEN: "We're also very much in line with what has been said by others already. We do have an exclusion list today but we want to move towards positive selection and accept a higher tracking error – basically paying less attention to the label of things and instead focusing on the content."