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Rethinking ESG in emerging markets

Arif Joshi

A forward-looking ESG analysis framework combined with traditional economic and balance sheet analysis can provide investors with a comprehensive view of the creditworthiness of borrowers in emerging markets.

Understanding the creditworthiness of emerging markets borrowers increasingly depends on assessing the sustainability of their operations. This includes the way companies and governments treat the natural environment, transparency, and good faith of their governance. For governments in particular it is also about how supportive they are with a fair society.

Our research shows that strong environmental, social, and governance (ESG) factors tend to indicate a more resilient borrower, while weak ESG characteristics can pose significant risks if overlooked.

Therefore, thorough analysis of ESG considerations is a critical component of how investors should assess the viability of borrowers in these markets.

Such a comprehensive approach includes the combination of forward-looking ESG analysis with traditional economic and balance sheet analysis, providing a more in-depth view of the creditworthiness of borrowers. It also gives investors a stronger basis for investment decisions.

Developing a rigorous ESG model is an ongoing journey, rather than a final destination. As investors in emerging market debt, it is crucial that we continue to re-think our approach when applying ESG standards to emerging markets debt.

Refining an investment approach is also a reflection on the lessons learned from our experience, as well as an increase in the availability and quality of ESG data in emerging markets.

Data limitations

Here it is important to understand that there are current limitations when it comes to using ESG data particularly in emerging markets.

This is because some emerging markets countries either don't report certain data and some data may not be reliable. Time lags in updating data often makes it backward-looking. For example, the political unrest in Belarus and the suppression of political opposition in Russia that unfolded in late 2020 indicate heightened ESG risks that are not yet reflected in the available data. At the same time, high pollution, corruption and less access to clean energy are characteristics in developing countries which caps their maximum possible ESG scores. However, this does not mean that that companies in emerging markets should be off the radar of ESG investors.

Approaches that use forward-looking ESG analysis can uncover companies with strong ESG credentials in the region.

In order to make ESG scores more forward-looking, data must

also reflect trends which allows investors to better assess the progress companies make on ESG. For example, we believe that an issuer such as Cote d'Ivoire – The Ivory Coast government – with a low ESG score, is also working to improve its outcomes. The government therefore should not be penalised because it is in an early stage of development.

Another shortcoming of ESG data is that certain factors are more subjective and not easily quantifiable. For example, it would be somewhat arbitrary to assign numbers to the strength of a country's institutions. Therefore, using both quantitative scoring which uses specific measures with qualitative assessment which uses measures based on observations is key. This approach provides a more holistic view of the potential borrower.

Building a foundation for rigorous ESG analysis

Data from other sources such as intergovernmental organisations like the United Nations and the World Bank can strengthen ESG analysis.

The World Bank's ESG Data Framework has been developed with other international organisations and includes a total of 17 broad themes as highlighted in the graph below.

Together, these themes encompass a multitude of factors likely to impact a country's long-term prospects. In addition to the World Bank themes, ESG analysis could also include the United Nations Sustainable Development Goals (UNSDG) Index. The index ranks countries based on progress toward achieving a number of 18 sustainable goals, such as poverty, inequality, climate change, environmental degradation, peace and justice. It is also a rigorous and outcomes focused approach to assessing ESG credentials.

Bringing it to life

A forward-looking approach to ESG that harnesses data from established organisations dedicated to sustainable approaches can be brought to life by illustrating how we as an investor would apply the ESG framework in order to understand Uruguay's ESG credentials.

According to our assessment, Uruguay's E, S, and G scores are all better than the median, with a particularly strong governance score. Uruguay underperforms only on the Food Production and Ease of Doing Business rankings.

How did we reach that conclusion? As highlighted earlier we took the approach of analysing Uruguay across 18 indicators in the United Nations Sustainable Development Goals (UNSDG) Index and 17 additional indicators based on the World Bank's ESG Data Framework.

What hasn't changed about our approach is that ESG considerations continue to be fully integrated with the analysis of more traditional economic factors in our fundamental research process and asset valuation targets. Our systematic framework allows for consistent com-

parison of ESG risks across countries. As always, we seek to directly engage with issuers whenever possible as we believe this engagement can positively influence behaviour and is preferable to outright exclusion from our investment universe. **FS**



The quote

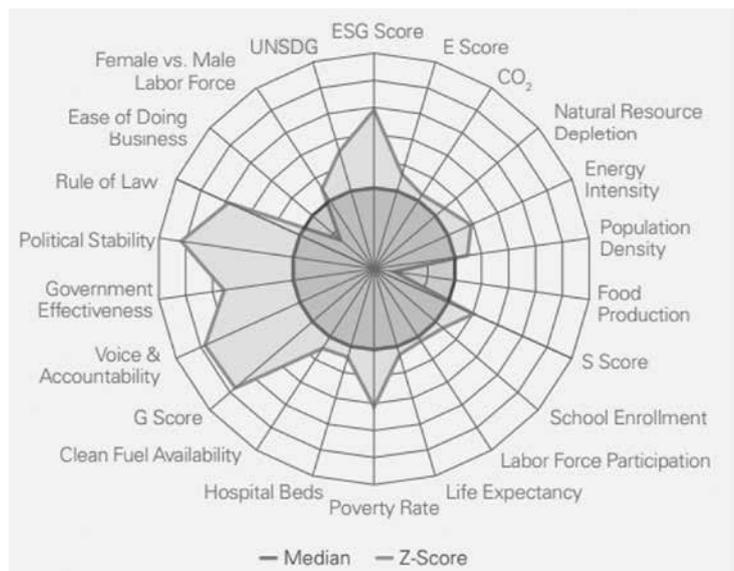
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Table 1: Broad Range of Sustainability Themes

Environment	Social	Governance
Emissions & pollution	Education & skills	Human rights
Natural capital endowment & management	Employment	Government effectiveness
Energy use & security	Demography	Stability & rule of law
Environment/climate risk resilience	Poverty & inequality	Economic enforcement
Food security	Health & nutrition	Gender
	Access to services	Innovation

Source: World Bank

Figure 1: Uruguay's ESG Scores



As of March 2021

Source: World Bank, United Nations and Lazard Asset Management