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Governance Matters: Assessing Sustainability in Emerging Market Debt

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To listen to the full conversation.

Understanding the financial materiality of sustainability factors is key

In Mahesh's view, understanding how sustainability risk factors affect the return profile is the fundamental question. MFS® takes an integration approach rather than an exclusionary one, meaning we don't tend to punish a certain country or company by excluding their bonds from our portfolios because they're associated with a particular industry or controversy. Instead, we assess sustainability in the context of financial materiality: Is this factor going to be financially material and cause returns to be compromised?

For emerging market debt (EMD), it's the same fundamental application as other asset classes for integrating sustainability factors into the investment analysis. However, there are various factors that weigh differently for each asset class or region, depending on what is most financially material.

Governance factor matters the most for EMD

The importance of governance factors on the corporate side is well understood. For example, is it a good management team? Is there an independent board of directors overseeing the management team in terms of the execution of policy and strategy? For sovereign bonds, Mahesh applies the same thought process for assessing the quality of governance for a country. For example, is there a stable government in place to create the economic conditions for growth in a country? Is there rule of law and courts and jurisdictions to pass laws? What is the level of corruption?

These kinds of important governance factors drive emerging market returns. Strong governance factors, like government stability, enable the population to contribute, live healthy lives and thrive. Ultimately, this leads to what we investors look for in emerging market sovereign debt, which is growth, development and investment returns. Without the necessary conditions for stability and growth, Mahesh believes it is difficult to assess social factors like access to education, health care and technology infrastructure. Increasingly, he sees environmental factors playing a more important role as many emerging market countries are dependent on commodities (minerals, oil, gas) for exports to finance their budgets or from a physical risk perspective as these countries are exposed to extreme weather events.

Return drivers are different across emerging versus developed markets

Mahesh points out that MFS analysts have empirically tested the drivers of spreads and therefore returns. The analysis showed that governance factors were the predominant drivers for spreads for emerging market debt since negative headlines quickly cause spreads to blow out and bond prices to fall. The second pillar that drives spreads is social factors and social stability, with environmental factors the least correlated in terms of spread movement.

The big difference between emerging and developed markets is the difference in materiality of those factors, says Mahesh. All sovereigns need good governance and social stability and are exposed to either transition risk or physical risk. Good governance is taken for granted in G7 or G10 countries globally as they generally have stable political systems, so investors have tended to focus on social and environmental factors. Emerging markets are at a lower stage of development so good governance and social factors are an existential threat for them versus for developed markets.

MFS approach — EMD strategy under SFDR

A challenge for investors is how to provide better transparency, reporting or disclosure to clients. European legislation called the Sustainable Finance Disclosure Regulation (SFDR) is one leg of the EU's Green Deal. SFDR helps to label investment funds according to their sustainability levels — Article 6, Article 8 or Article 9. At its heart, SFDR is about how you provide high-quality, useful disclosures to clients so they can assess whether investors are actually doing what they're claiming.

The MFS emerging market debt strategies will be classified as Article 8, which is expected to take effect on 28 August 2023. SFDR is not causing MFS to suddenly rethink how we invest money or think about active management. For these strategies, the investment team decided to show that the funds are solving for integrating sustainability factors by measuring countries whose bonds are held in portfolios on a combination of governance and social factors. Mahesh explains that MFS did that because good governance promotes good social factors; they are both interdependent and interlocked. So, we decided to show what the governance profile looks like for the various countries in our portfolio alongside what the social profile looks like — especially in terms of the most fundamental social aspects, health care and education, since they are requirements for development.

We welcome the opportunity to discuss key sustainability themes with you. Please contact allangles@mfs.com and we will be happy to help.