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Integration of ESG in Sovereign Debt Assessment

Which solutions?

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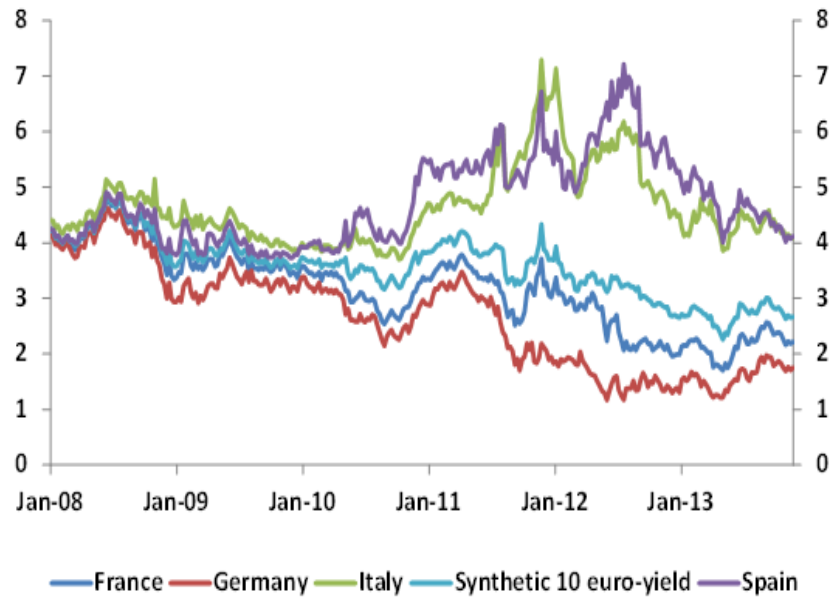
As a result of the Eurozone crisis, demand from institutional investors for integration of ESG issues in countries assessment continues to grow

- Until recently, investors mostly focused on ESG issues related to corporate stocks and bonds but much less for sovereign debt.
- Since the crisis in the Eurozone, investors have had to reevaluate sovereign debt as a defensive holding – this is now a global phenomenon, not just Eurozone
- ESG issues are more and more considered as key complements to economic analysis for assessing the sustainability of sovereign debt.

Euro-Area 10-year government yield



Sources: Bloomberg, Datastream, AXA IM Research, November 2013

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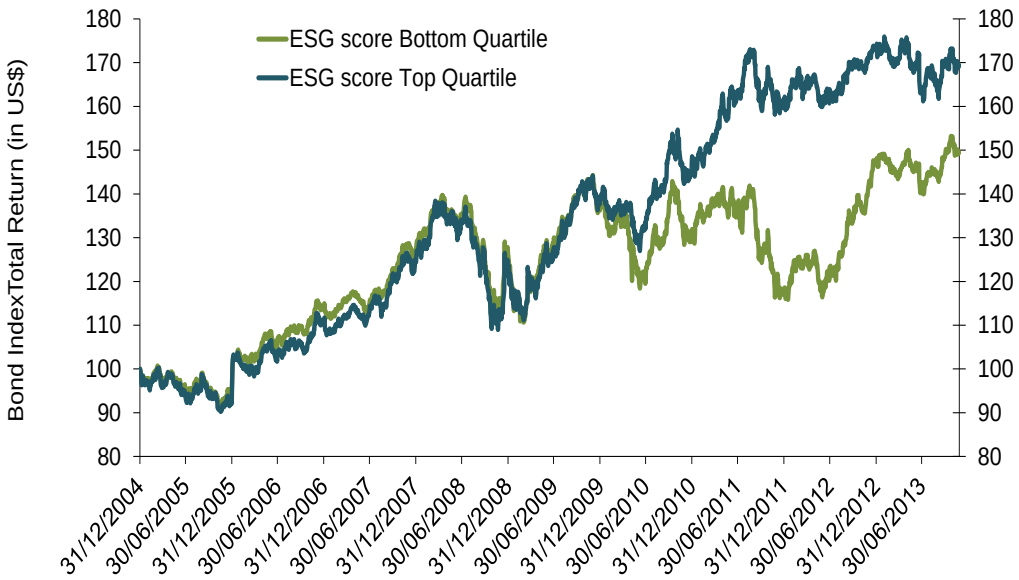
ESG factors as a signal for financial performance (1)
Best vs. Worst ESG countries

- During the financial crisis, ESG factors became - and remained - important sovereign differentiators.
- The most highly ESG rated countries outperformed those with the poorest ratings.
- In times of stress, ESG factors may be the some of the most important differentiators in effectively balancing sovereign debt portfolios

Divergence in performance of best and worst ESG countries



Sources: AXA Investment Managers 2013

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ESG Methodology for Country Risk Assessment

- **The choice of the ESG factors has been based on clear criteria:**

  – Objective
  – Verifiable
  – Measurable

  - Published by credible organisation
  - Updated regularly
  - Long history available (5 Years)
  - Broader coverage (World)

- **ESG + P**

E

1) **Environment** - CO2 – normed by population and GDP-PPP (sources: Energy Information Administration, U Penn)

S

2) **Social** (Human Development Index (UN HDI). The HDI is based on 3 dimensions:
   - Long and Healthy Life >> Life expectancy at birth
   - Knowledge >> Mean years of schooling + Expected years of schooling
   - A descent standard of living >> GNI per capita

G

3) **Governance** - World Bank Governance Index (WBGI). The WBGI is based on 6 dimensions:
   - Rule of Law, Voice and Accountability, Political stability and Absence of violence, Government effectiveness, Regulatory Quality, Control of Corruption.

+

P

4) **We calculate a « Political Commitment -** The conventions used are classified in 4 categories:
   i) International Labour Organisation
   ii) Human rights
   iii) Weapons
   iv) Climate Change/Biodiversity

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Client demand (1a)
Reputation risk management

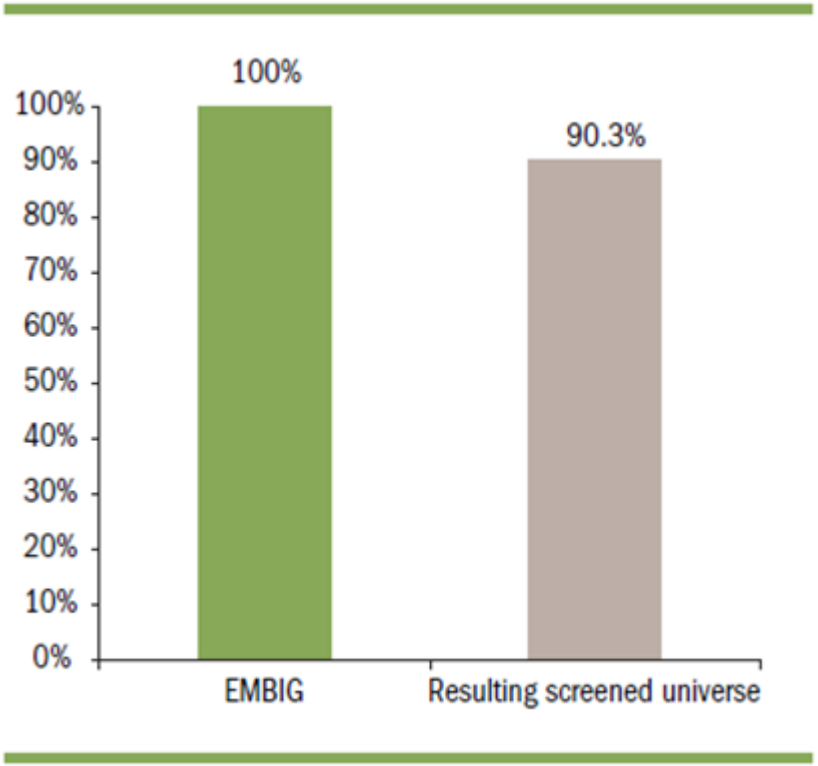
Countries excluded for high reputation and long-term S&P ratings

Country	Sovereign Rating	Weight in EMBIG universe
AZERBAIJAN	BBB-	0.2%
BELARUS	B-	0.6%
BELIZE	CCC+	0.1%
CAYMAN ISLANDS	B2 (*)	0.2%
ECUADOR	B	0.2%
IRAQ	Not Rated	0.8%
NIGERIA	BB-	0.2%
PAKISTAN	B-	0.4%
PANAMA	BBB	2.8%
VENEZUELA	B	4.3%

(*) Moody's long-term rating

Sources: AXA Investment Managers, 2013

Emerging Market Universe before/after reputation screening



Sources: AXA Investment Managers, 2013

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Client demand (1b)
Reputation risk management - Case study of Venezuela

- ESG signals can be a key means to monitor country risk

The Venezuela case:

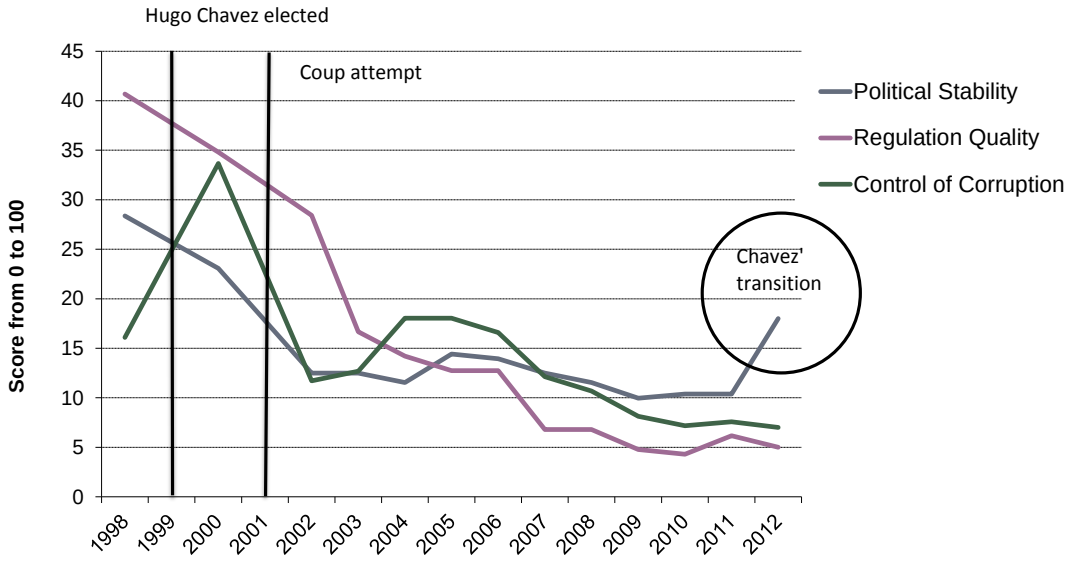
- A poor Governance profile: corruption, lack of freedom of expression, no free media …
- Economy driven by Oil reserves and focused on Crude Exports
  - Pressure on consumer goods prices
  - Food scarcity

- June 2013: Venezuela downgraded from B+ to B by S&P, outlook negative despite Maduro's election

"Growing political uncertainty is weakening the implementation of economic policies and may possibly undermine governability" said S&P

Source: S&P, June 16, 2013

Venezuela's declining ESG performance (*)



(*) 1999 and 2001 data are missing and derived from linear interpollation

Sources: AXA Investment Managers, World Bank 2013

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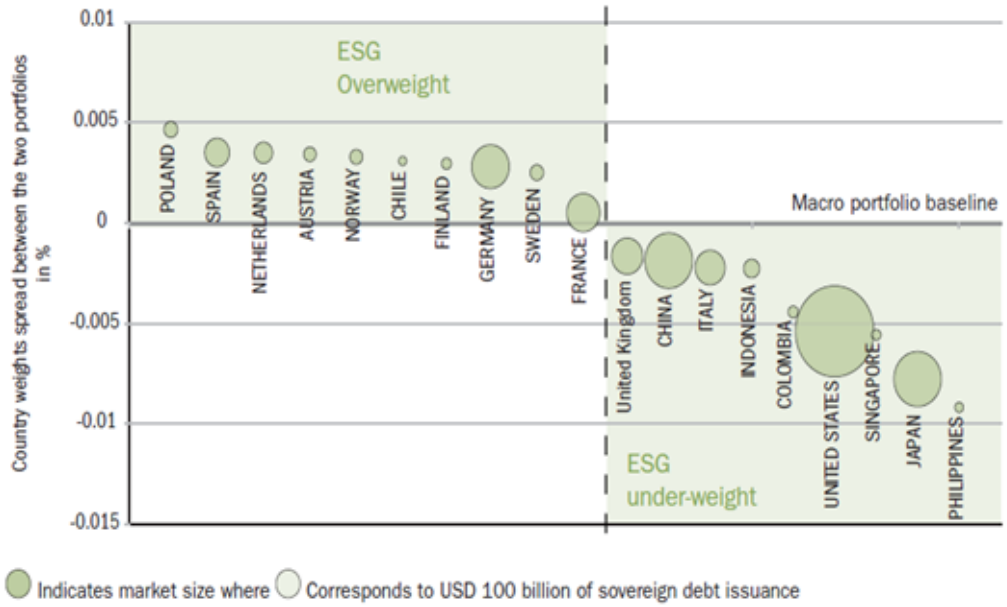
Client demand (2)
Alternative asset allocations

- Applying a rating model using ESG criteria would yield a specific profile of sovereign debt allocation, relative to a purely macro-financial strategy.
  - The model compares developed to developed and emerging to emerging
- Northern European countries, such as the Scandinavian countries, Germany and Switzerland, would achieve higher rankings
- The United States, Japan, Italy and emerging market countries such as China and Russia would be ranked lower.
  - United States >> governance slippage, CO2 emissions
  - Japan >> continued poor governance

ESG overlay over and under-weights versus macro expectations portfolio



Sources: AXA Investment Managers 2013

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