



Sustainable Investment

The added value of sustainability analysis for countries

On the one hand, the IMF reiterated its cautious stance with regard to the surge in global debt levels. Indeed, in 2016 this amounted to USD 164,000 billion, equivalent to 225% of global GDP.

The euro crisis showed the extent to which high debt renders a state's financing vulnerable to shocks on financial markets and substantially undermined the status of risk-free investments. Many states lost their coveted AAA rating granted by extra-financial rating agencies.

On the other hand, the COP 21 calls upon investors to assume responsibility for the financing that is required for the energy transition. In this respect, government bonds represent a major source of financing and provide considerable leverage as well.

From added value to investment decision-making

The sovereign bonds of more sustainable countries have proven to be more resilient during crisis periods. When looking at the 2008 euro crisis, Scandinavian countries or other countries that are generally well positioned in the rankings **have held up much better** than, for example, Southern European countries.

Many links have been proven between ESG factors and a country's long-term economic

growth and development. Already in the sixteenth century, a link had been established between the environment/geography/climate and a country's agricultural system, in other words access to food for the people, possible diseases and economic growth.

Academic research has also demonstrated a **correlation between the quality of a country's governance institutions and its debt default**

risk. Overall governance acts as the cornerstone for the implementation of policies that foster other sustainability dimensions (social and environmental). As a matter of fact, governance relates to the quality, stability and predictability of the policies that have been implemented. This will enable institutions to be resilient in the light of the endogenous and exogenous events that affect states. This stands in contrast to unsustainable factors such as corruption, lack of freedom, red tape, etc. which are detrimental to foreign investments in particular.

Fiduciary duty

It is now a **fiduciary duty** for investors to integrate ESG factors into their investment processes and risk management. Government bonds, which are thus issued by countries, are not an exception to this rule.

Indeed, 30% of the portfolios of occupational retirement provision institutions (referred to as IORPs or pension funds) are exposed to sovereign bonds. The ESG risks associated with this investment must therefore be included in the Statement of Investment Principles ("SIP"), risk management and portfolio construction.

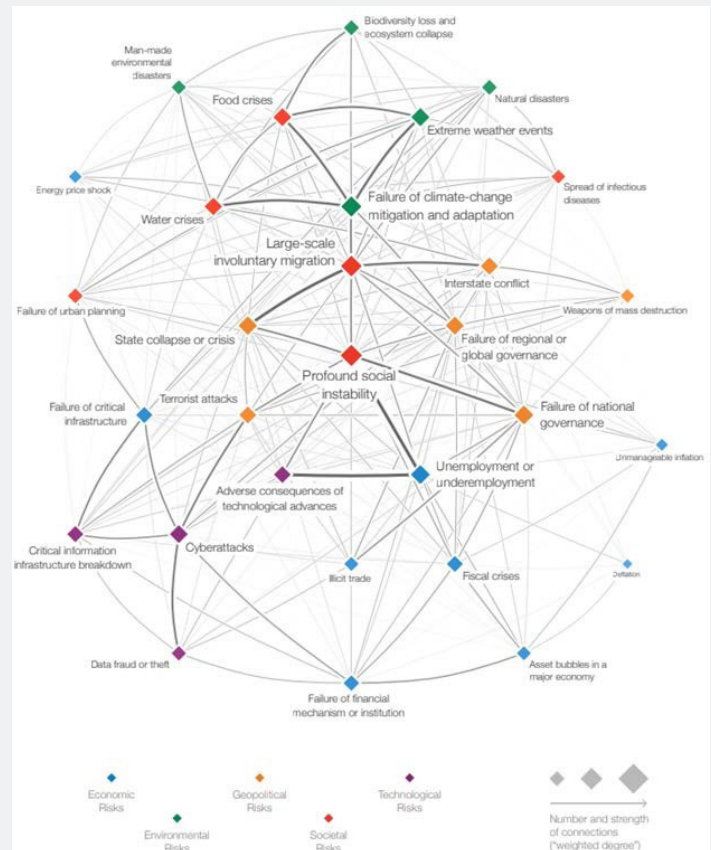
How can a country's sustainability profile be assessed and defined?

It makes sense to refer to the three **sustainability dimensions** which are studied for companies, i.e. **E, S and G**.

Climate, social, technological and other risks are inextricably linked to one another. This interconnectivity between various risks is particularly well illustrated by the risk experts of the World Economic Forum (WEF). They demonstrate that it is important to adopt a **holistic approach to these three dimensions** - environment, social and governance - which are part and parcel of the fundamental analysis of countries and the sovereign debt they issue.



The interconnectivity of risks



Source: World Economic Forum, the Global Risk Report

Most definitely a relevant analysis!

Firstly, by looking into the aspect of transparency and democratic values, the analysis allows an initial assessment to be made of the political context of a country and its stability. The quality of its public institutions is evaluated, as well as its transparency or the lack thereof, in terms of corruption and press freedom, for instance.

It also involves looking into the **fundamental rights of civil society**, including political rights and civil liberties. Furthermore, the analysis of the population and its well-being also enables flaws and discontent to be detected within civil society which may give rise to instability, and which are detrimental to a sound investment climate.

In the framework of an investment in sovereign bonds, the contribution of the sustainability filter becomes even more important as market volatility increases and markets' performance goes down. This demonstrates the strength of the tool in better understanding risks.

Sustainable Development Goals (SDGs) to assess the relevance

As successors of the **Millennium Development Goals** (MDGs) which were launched by the United Nations between 2000 and 2015, the 17 **Sustainable Development Goals** (SDGs) aim to foster sustainable development on the economic, social and environmental front. They reassert human rights and the willingness to eradicate poverty, famine and inequality by the end of 2030.

The eight MDGs had obtained excellent results

on all fronts. However, that success varied across the board, and the poorest and most vulnerable populations continue to be left behind.

Their successors, the SDGs, have primarily targeted governments as well as the public sector. It is very encouraging to see that these ambitious principles have been extended to the whole of the private sector as well as to investors. The Paris Agreement has greatly increased awareness. Therefore, the timing was just right. Indeed, substantial investments will be required to achieve all these objectives.

Nearly 200 countries have adopted the 17 social, environmental and economic objectives. They represent a unique opportunity to step up investments in the light of major environmental and social challenges.

Now, the question is why government bonds do not pay more attention to these **major challenges**, which are also **economic challenges**. Government bonds remain an important asset class for long-term investors after all. And yet, the universes and reference indices still do not fully take into account these dimensions.



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Conclusion

As is often the case, it has taken an important crisis to unveil the flaws of certain economic and financial models that are unidimensional. In a context of a **globalising economy** facing major challenges such as the demographic challenge, the scarcity of natural resources and climate change, it seems obvious that states, as major actors in the economy, have a key role to play. They are pivotal to the sustainability of the systems that are put in place. Therefore, for an economy to operate efficiently, it must have an appropriate democratic framework, composed of effective and stable governance institutions. When there is a lack of investment in the well-being and knowledge of current and future generations, an economy jeopardises its sustainability perspectives. Without an objective of sustainable management of its resources and environment, it will incur significant costs to adapt to the major challenges our planet will be facing in a few years' time. Finally, failing to comply with international commitments (treaties, agreements, etc.) means that it is very likely that a state will renege on its commitments vis-à-vis its creditors. Hence, while this is an **extremely complex matter**, it is **essential to take a holistic view of countries as economic actors and actors of sustainable development**, and to analyse them according to a matrix taking into account **financial and economic criteria as well as social, environmental and governance dimensions**. This is comparable to what is increasingly being done for companies.

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