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Benefits of Sustainability in Sovereign Investing

CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

"Estimates show that between 1992 and 2014, produced capital per person doubled...but the stock of natural capital per person declined by nearly 40%... we would require 1.6 Earths to maintain the world's current living standards."

–The Dasgupta Review[1]

With ESG factors now frequently integrated into investment processes and capital allocation, analytical frameworks must become increasingly robust in using sustainability data. Analysing sovereign sustainability is arguably more complex than analysing corporate sustainability. Candriam's most recent sovereign model offers two distinct methodological advances in measuring environmentally-efficient development. Importantly, our model was designed to feed into the investment processes for our strategies.

Why do investors need to consider Sustainability and ESG factors in Sovereign investing?

It is our view that a country's overall development consists of an interaction between economic and non-economic – human, social, and environmental -- development. In periods of global growth, nations with strong human and social capital can leverage on new economic opportunities, while underdevelopment of human and social capital can constrain potential. Conversely, strong human and social capital can cushion national economies during economic slowdowns, while weaknesses exacerbate the damage.

How does Candriam reflect the finite nature of Natural Capital in Sovereign Sustainability?

The four-pillar Sovereign model of Natural/Environmental, Human, Social, and Economic capitals is widely used by organizations such as the OECD. These models typically envision frictionless substitution among these four types of capital. A corollary is that we should leave future generations with at least as much total capital as we received – even if that total consists of more Economic capital but less Natural Capital. Some scholars call this 'Weak Sustainability'.

It is our conviction that Natural Capital *cannot* be replaced with any of the other three forms of capital. The defining concept of 'Strong Sustainability' is that Natural Capital is *non-substitutable*. Further, Natural Capital is a *finite* resource.

When nations convert a part of the finite supply of Natural Capital into well-being, they do so with varying degrees of efficiency. Countries that pursue environmentally efficient prosperity are more likely to build sustainable economies in the long run, reducing sovereign risks and enhancing long-term prosperity. Candriam's Sovereign Sustainability analysis is consistent with, and goes beyond, the seventeen UN Sustainable Development goals.

What differentiates the Candriam Sustainability scores?

Our new model both *constrains* Natural Capital, and *emphasizes* its importance. Candriam's previous country ESG model, like most, allowed for substitutability among the four forms of capital and unlimited use of Natural Capital. Country scores were calculated as an average of each nation's scores for its four types of capital. Now, however, we construct each country's Sovereign Sustainability score as the *product* of Natural Capital, times the average of the other three capital scores – Human Capital, Social Capital, and Economic Capital. Using this method, a country's ranking cannot seamlessly make up for a poor Natural Capital score by, for example, outperforming in Economic Capital.

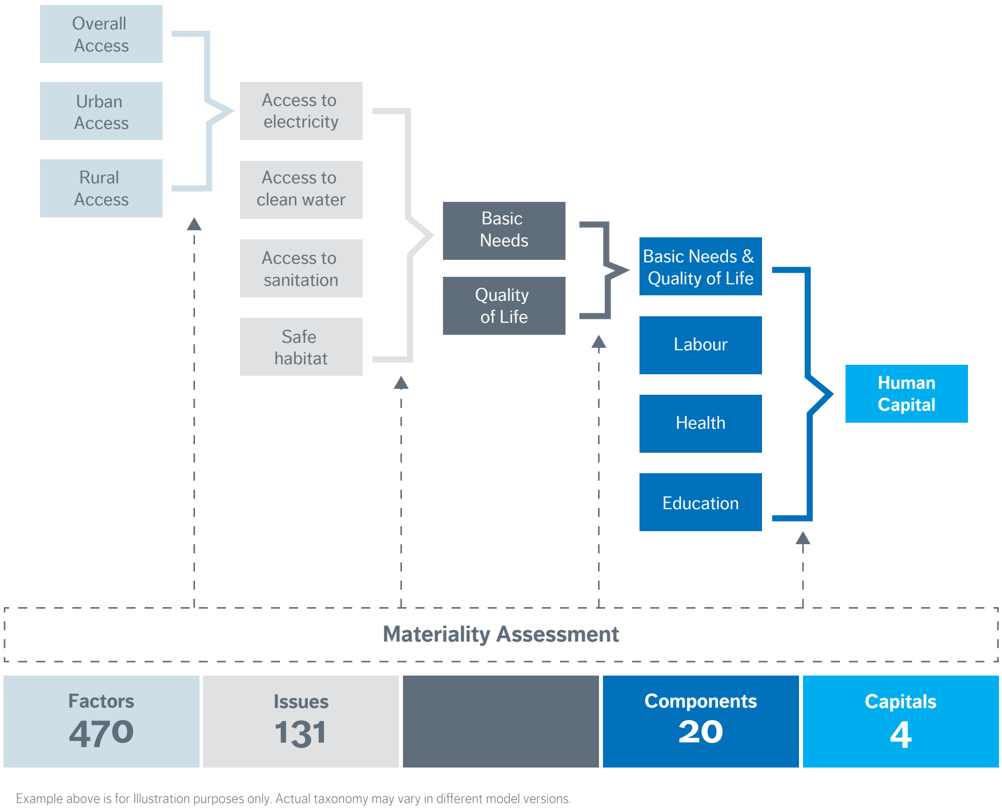
How do we calculate our capital pillar scores?

We have developed a materiality-based approach to sustainability, to adjust for the differences among countries in their level of development. As a nation is more complex than a company, it requires a broad view on a variety of interconnected Factors. Taking just a few Factors in isolation can generate a biased conclusion. Our database includes time series of more than 400 individual Factors, and evaluates the relevance of each Factor for each country at

1 HM Treasury, Government of the United Kingdom. The Economics of Biodiversity: The Dasgupta Review. February, 2021. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/957629/Dasgupta_Review_-_Headline_Messages.pdf**, accessed 11 February, 2021.**

Figure 1:

Construction of the Capital Pillar Model



Source: Candriam

every level of development and point in time over the last ten years. Our model identifies key performance indicators (KPIs) for each Issue under consideration (currently 131 Issues), and constructs scores for each of the Capitals, giving more weight to the areas that matter for each country.

Our country scores weight those Factors which will influence the future development of each individual country. For example, the proportion of electric cars can tell us quite a bit about Norway, nothing about Uganda, where securing food is of much greater concern.

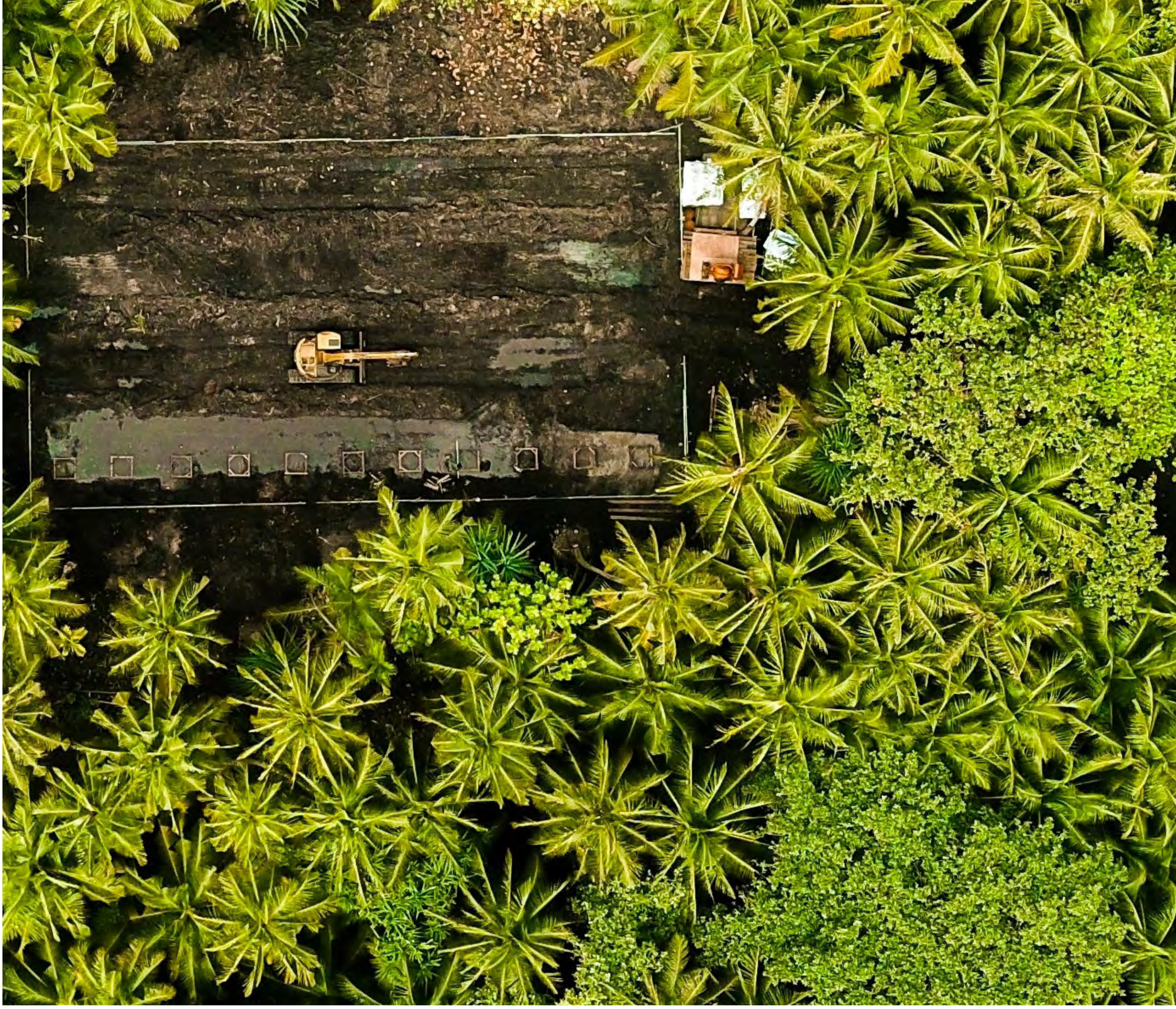
What are the benefits to the investment decision?

The materiality weighting of Factors allows us to rank developed and emerging nations on the same scale.

This approach also improves the usefulness of the sustainability scoring across horizons, making the scores more applicable for both the near-term outlook as well as for long-term trends.

The sustainability assessment incorporates the trajectory of each country, taking into account projections based on observed trends. The assessments are dynamic and can be adjusted for current events. We are closely monitoring a number of countries on particular topics, one example being the US, where we alerted clients of potential Rule of Law and Democracy issues surrounding the 2020 Presidential Elections.

While our framework does not directly price Sovereign Sustainability, it is fully integrated into Candriam's sovereign creditworthiness models and asset selection processes. Because each country sustainability score is rich with additional information, our investment professionals use these insights to delve deeply into areas of opportunity or concern. Our sovereign and corporate asset selection processes fully integrates ESG factors as we believe that the credit analysis of a country or company is not complete if it primarily focuses on financial metrics. Investors need to be adequately compensated for all risks to which they are exposed.



€128 B
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550+
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25 years
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