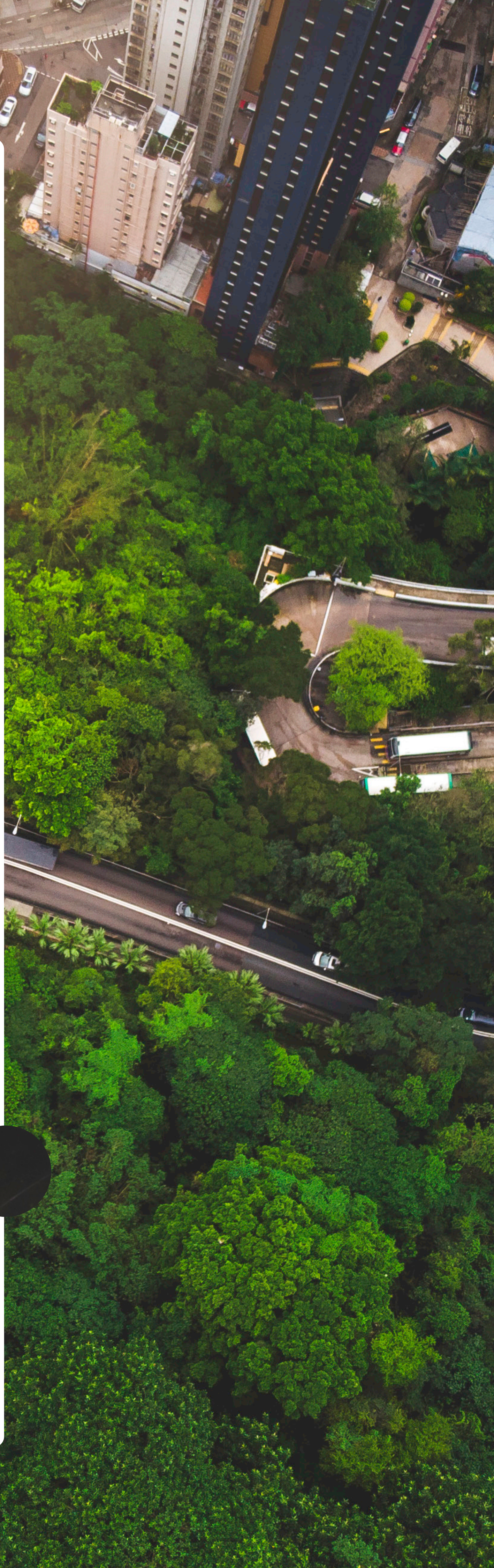
CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

Sustainable : an emerging market for emerging debt

60 seconds with the fund manager



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This marketing communication is intended for non-professional investors.

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60 SECONDS WITH THE FUND MANAGER

Kroum Sourov and Christopher Mey, portfolio managers of the sustainable emerging market debt strategy, describe the significance this type of analysis can have for a bond portfolio. They explain Candriam's investment process, with our emphasis on relative value and risk management. This approach is intended to allow the strategy to adapt the ever-changing markets over the course of an economic cycle.

Why is emerging market debt a potential attractive investment?

The speed at which emerging countries have developed since the 1980s has fuelled fast-paced growth in their debt markets. Emerging market external sovereign debt provides access to more than 80 countries with outstanding debt in excess of $1.6trn[(1)]. External debt should present a limited currency risk as it encompasses government debt denominated in hard currency, mainly US Dollars and Euros. Nowadays, these markets may offer attractive yields and diversification benefits closer to US and European rates and credit markets.

How do you define the sustainable universe, and what are its implications?

Candriam defines our sustainable universe using our proprietary sustainable sovereign analysis, which is built on four pillars. These four are the Natural Capital, Human Capital, Social Capital and Economic Capital. We calculate a score for each pillar of each cousntry, based on more than 400 individual time series[(2)], and adjusted to reflect the materiality of each type of data series.

Our methodology differs by emphasising Natural Capital, using it as a multiplier of the other pillars. We do this to incorporate the significant and often irreversible cost to Natural Capital when it is used to enhance the other types of capital. Multiplying the Natural Capital score times the average of the other three pillar scores generates an overall ESG score, and we exclude the issuers that score below the 25th percentile. Further, we exclude countries which fall short of norms-based standards, including those on the FATF (Financial Action Task Force) «Call to Action» list, those on the Freedom House «Not Free» list, or those on the Candriam Oppressive Regime List. We may also apply discretionary exclusion when our analysis and engagement efforts offer us the conviction that this is necessary. Furthermore, we exclude all issuers that are rated below B- by one of the three major rating agencies[(3)].

As a result of these analyses, the investable universe of the strategy offers a superior sustainability profile and we believe it to consist of the group of countries with greatest chances to prosper in the economy of the future. Our strategy aims to support these countries on their development path and to also offer exposure to the most promising set of opportunities in the economic transition. However, the method does imply certain biases. Firstly, the strategy has a higher quality bias since it cannot include issuers rated CCC+ and below. Furthermore, the strategy has a structural underweight of energy exporters as they typically have lower scores in our sovereign sustainability model (weaker Natural capitals). Finally, from a regional perspective, the strategy has no exposure to the Middle East and consequently a higher allocation to Latin America and Eastern European regions.

How is the extra financial performance monitored?

We had identified three sustainable KPIs that we believe are pivotal to Emerging Markets issuers, which we apply to the strategy. The strategy aims to achieve an overall ESG Score above its benchmark (JPM EMBI GD Index), seek a CO2 intensity that is less than 70% of the benchmark, and maintain minimum standards of democracy (which we measure through the Freedom house score).

(1) Source: JP Morgan, December 2023.
(2) Source: Candriam, November 2020. "Sovereign Analysis: Natural Capital fs the Nature of Capital", page 17.
(3) Moody's, Standard & Poors and Fitch Ratings

The KPIs are monitored daily not only by the investment team, but also by our independent risk management team. We also monitor indicators such as the Paris Equity Check, the Democracy Index and the Corruption Perception Index, though we do not set limits on these elements.

How can investors integrate emerging debt into their portfolios?

The emerging debt asset class has benefited from improvements in economic stability, institutional strength and political decision-making in these countries. Over the past 40 years, emerging market debt has developed at a spectacular pace, and today offers a wide variety of opportunities for investors to capitalize on: government bonds (denominated in USD, EUR, or local currency), corporate debt and emerging markets currencies. As a result of these changes, emerging debt evolved from a niche to a major asset class by the late 1990s.

What are risks to be considered when investing in emerging debt?

Since our primary aim is to generate risk-adjusted returns, we continuously analyse the risks associated with this asset class.

Investing in emerging market debt presents a number of important risks that need to be carefully considered. First and foremost, US interest rate policy has a strong impact on these markets. Higher US interest rates translate into higher borrowing costs for emerging countries, which can impact their ability to repay their debt.

The volatility of the US dollar is also a major concern. A stronger dollar can increase the burden of dollar-denominated debt for these countries, as their tax revenues remain in local currency.

Raw materials are also key. Many emerging nations are heavily dependent on exports. Fluctuations in commodity prices can affect the fiscal health or the foreign exchange reserves of these countries and, consequently, their funding costs and ability to meet their debt obligations.

China's influence should not be underestimated. As a major trading partner for many emerging countries, changes in China's economic policies or trade relations can have far-reaching consequences, affecting both the economic stability of other emerging nations and the attractiveness of their bonds to investors.

As a result, a comprehensive understanding of these risks is essential to making informed investment decisions in emerging market debt.

Why is relative value such an important part of your investment process?

Our emerging markets debt investment process include a bottom-up analysis to assess the issuers and an analysis of the security based on the relative value. Relative value plays a pivotal role in our investment process as it allows us to pinpoint the right security across various countries and/or companies, aligning with our investment convictions. By measuring relative value through an analytical and disciplined approach to valuations, we are able to identify the bonds which, in terms of risk/return profile, best reflect our views. Then, we are able to build a portfolio enhancing the opportunities and managing the risks emanating from the debt of emerging markets.

For example, once a conviction has been identified through our fundamental analysis, this conviction can be incorporated into the strategy through different types of bond instruments, such as sovereign, quasi-sovereign, corporate, long-term or short-term debt, denominated in US Dollars or Euros. This analytical approach empowers us to align our investment choices with our investment objective.

What aspects of relative value do you take into account?

We identify relative value opportunities in securities issued by sovereign, quasi-sovereign and corporate issuers, based on three levels of analysis.

Firstly, we carry out a quantitative analysis, particularly through our sovereign risk modelling framework, to assess the creditworthiness of each country. This analysis standardizes risk assessment across all Emerging Markets, based on an analysis of macroeconomic and ESG trends.

The analysis of issuers' creditworthiness forms the foundation of our approach which drives value creation.

Subsequently, we complement the quantitative analysis with a qualitative review of the macroeconomic and structural reform, political risk trends to which emerging sovereign issuers are exposed. This qualitative review, drawing from both external sources and internal research, serves to capture nuanced performance drivers and political risks, enhancing our Sovereign Risk Model insights.

We integrate the results of the quantitative Sovereign Risk Model with our qualitative assessment to arrive at our final portfolio positions.

In addition, the team examines relative valuations of instruments, typically with comparable risk categories. On the instrument side, relative value opportunities tend to cover several dimensions: type of security, cross-analysis of currencies, maturities.

What are the main strengths of Candriam's emerging market hard currency debt strategy?

Our methodology was developed – and is continuously being improved – to meet our objective of generating risk-adjusted performance. Our approach aims to identify investment opportunities through an analysis of issuing countries and instruments, while controlling risk.

This approach largely explains our track record in a wide variety of market configurations since the strategy's inception in 1996.

Our team draws on a comprehensive set of analytical tools, developed in-house, to identify investment opportunities. Our process is based on rigorous fundamental analysis and relative value assessments. It incorporates ESG (Environment, Social & Governance) factors, which are essential for us to judge the creditworthiness and long-term development potential of countries and companies.

We pay close attention to risk, not only when choosing what to invest, but also during the implementation phase. Our internal investment limits, together with an analysis of the overall market environment, guide us in building the portfolio. We only include those risks that we consider worth taking.

Finally, we have a dedicated investment team and a flexible, collaborative decision-making process. Our team's experience in emerging markets is reinforced by complementary product and regional expertise.

The main risks of the strategy are:

• Risk of capital loss:

There is no guarantee for investors relating to the capital invested in the strategy in question, and investors may not receive back the full amount invested.

• Interest rate risk:

A change in interest rates, resulting in particular from inflation, may cause a risk of losses and reduce the performance of the strategy (especially in the event of a rate increase if the strategy has a positive rate sensitivity and in the event of a rate reduction if the strategy has a negative rate sensitivity). Long term bonds (and related derivatives) are more sensitive to interest rate variations. A change in inflation, in other words a general rise or fall in the cost of living, is one of the factors potentially affecting interest rates.

• Credit risk:

Risk that an issuer or a counterparty will default. This risk includes the risk of changes in credit spreads and default risk. Some strategies may be exposed to the credit market and/or specific issuers in particular whose prices will change based on the expectations of the market as regards their ability to repay their debt. These strategies may also be exposed to the risk that a selected issuer will default, i.e. will be unable to honour its debt repayment, in the form of coupons and/or principal. Depending on whether the strategy is positively or negatively positioned on the credit market and/or some issuers in particular, an upward or downward movement respectively of the credit spreads, or a default, may negatively impact the performance. When evaluating the credit risk of a financial instrument, the Management Company will never rely solely on external ratings.

• Emerging market risk:

Market movements can be stronger and faster on these markets than on the developed markets, which could cause the performance to fall in the event of adverse movements in relation to the positions taken. Volatility may be caused by a global market risk or may be triggered by the vicissitudes of a single security. Sectoral concentration risks may also be prevalent on some emerging markets. These risks may also heighten the volatility. Emerging countries may experience serious political, social, legal and fiscal uncertainties or other events that could have a negative impact on the strategies investing in them. In addition, local depositary and sub-custodial services remain underdeveloped in non-OECD countries and emerging countries, and transactions carried out in these markets are subject to transaction risk and custody risk. In some cases, it may be impossible to recover all or part of the assets invested or delays in delivery when recovering assets may arise.

• Counterparty risk:

The sub-funds may use OTC derivative products and/or efficient portfolio management techniques. These transactions may cause a counterparty risk, i.e. losses incurred in connection with commitments contracted with a defaulting counterparty.

• ESG investment risk:

The non-financial objectives presented in this document are based upon the realization of assumptions made by Candriam. These assumptions are made according to Candriam's ESG rating models, the implementation of which necessitates access to various quantitative as well as qualitative data, depending on the sector and the exact activities of a given company. The availability, the quality and the reliability of these data can vary, and therefore can affect Candriam's ESG ratings.

The risks listed are not exhaustive, and further details on risks are available in regulatory documents.