Invesco Emerging Markets Local Bond Strategy

Our Global Debt team's approach to ESG investing

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Environmental, social and governance (ESG) investing is a fundamental commitment at Invesco. Our philosophy is based on our belief and experience of the impact it has on sustainable value creation and risk management. Our approach focuses on integrating ESG risk and opportunity features into investment decisions across asset class and decentralized by local investment centers. At the heart of our firm is our ability to think independently. The diversity of Invesco means that our investment centers will vary in their approaches to the implementation of responsible investment. Our global team of ESG experts works closely with our investment professionals to develop industry-leading practices and deliver an investment experience that helps people get more out of life.

Managing Invesco's Emerging Market Local Bond strategy, our Global Debt investment team is part of the broader Invesco Fixed Income (IFI), a well-resourced group that interconnects local market knowledge with a strong global perspective. IFI has managed ESG-aware portfolios for more than two decades, and our approach has consistently evolved during this time. This reflects how industry dynamics have changed and how the appetite for more sophisticated and targeted sustainability-linked outcomes has grown among clients. We believe that our independent research and global approach to sustainable investing creates a strong proposition for clients seeking strategic partnership for fixed income allocations.

With diverse international backgrounds, including fluency in over 20 languages, our Global Debt investment team manages over $7 billion in assets, including over $3 billion emerging markets debt. Our investment process combines top-down global macroeconomic analysis with bottom-up country analysis to determine the portfolio's risk budget and identify favorable country-specific opportunities. Governance and the impact of environmental and social policies are key inputs in our analysis for country-level growth and sustainability. Our approach is rooted in our decades-long experience that evaluating ESG criteria can lead to better long-term risk-adjusted returns.

Global ESG macro drivers and approach

We believe that the integration of ESG into sovereign investing needs to incorporate an assessment of a government's policy intentions, which bridges the gap between specific investment projects and behavior that promotes ESG goals at a macro level for a specific country. Our approach focuses on considering sovereigns along with momentum and potential, favoring those countries where momentum is strong and/or potential is high, and disliking investments where momentum is weak (or negative) and/or potential is low.

ESG factors play an important part in assessing macroeconomic contexts in sovereign investing (as per the table below) as they are long-term drivers for the global economy. Our research is also informed by Invesco's fixed income framework on sovereign debt rating, which gathers relevant information in a proprietary scoring tool to generate a composite ESG profile for each country so that relative performance and directionality of change across developed and emerging markets can be compared.[1]

[1] Available upon request.

Table 1: ESG factors as macroeconomic drivers

Macro governance factors	
Policy and effectiveness of policy: A picture of the sustainability of a country's economic performance given its institutional capacity to support long-term stable growth.	■ Infrastructure ■ Rule of law ■ Corruption

Macro social factors	
Inequality in income and access to basic resources: A picture of the sustainability of a country's economic performance given its efficacy in meeting basic needs, in reducing poverty and equity issues and in investing in human capital.	■ Health ■ Education ■ Gender diversity

Macro environmental factors	
Resource use and risks: A picture of the sustainability of a country's economic performance given the management of its natural resource endowment and its resilience to natural hazards.	■ Pollution ■ Energy consumption ■ Climate change

ESG integration in investment process

We make efforts to integrate ESG factors at all steps of the investment process and portfolio construction. Our top-down global macro analysis aggregates individual country views into a global economic baseline and helps us determine the portfolio's overall risk profile. Our global macro view also emphasizes a country's growth level and direction of change towards sustainability, such as incorporating sustainable energy and health care access and food security that are crucial factors for stable long-term economic growth. The identification and analysis of aggregate macroeconomic ESG themes allow us to identify and better monitor risks at the overall portfolio level.

At its core, our investment process is based on an active bottom-up portfolio construction that is carried at a sovereign level. For each country, we seek to identify favorable country-specific opportunities related to monetary and fiscal policy, political and social stability, the independence of its institutions, and long-term sustainability, among others. We believe that a country with good government quality and a strong pro-investment policy mindset is inherently beneficial to long-term sustainability and has an enduring positive environmental and social impact on the wellbeing of its citizens.

Our active approach: ESG momentum and potential

We assess a country's sustainability profile in a comprehensive manner, targeting the rate of change and directionality towards achieving a sovereign's long-term policies and goals. Instead of ranking countries, we seek to analyze them on a case-by-case basis. We consider each country's individual wealth of resources, the stage of development, the opportunity presented and the probability of achieving it. This allows us as investors to encourage positive development and policy output on various environmental and social issues, which is at the core of our sustainable investing strategy.

ESG Factors of Directionality	**Impact on Investment Decision (degree based on valuation)**
Positive Momentum and/or High Potential	Benchmark or Overweight
Negative Momentum and /or Low Potential	Underweight

Our investment approach focuses on assessing ESG momentum and potential of countries fully integrated with the fundamental economic analysis. A country's momentum and potential, specifically, has an impact on our portfolio's sizing positions. A country with negative ESG momentum and low ESG potential will be limited to an underweight position in our portfolios, while a sovereign with strong positive momentum and high potential will have at least a benchmark weight, but often an overweight in our portfolios. In Latin America, for instance, we look at countries such as Peru and Chile with generally either positive potential or high momentum, because of their strong allocation of capital and budgets to increase social services, improve the quality of life and provide access to sanitation, albeit at different speeds and under different incentives. For example, the COVID-19 pandemic is challenging countries across the board; while Peru was among the first to adopt strong policies and practices in response, we take note that Brazil's actions were, at least initially, poorly handled from a health perspective. This may not only lead to political repercussions but may also have a longer-lasting impact on growth and productivity.

Hungary is another example where the COVID-19 crisis was used by the government to further promote its authoritarian agenda, eroding the country's democratic institutions and freedom of expression. In March, a new state law gave Prime Minister Orban sole authority to end the newly declared state of emergency around the pandemic. It also allowed him to easily prosecute people for breaching quarantine orders and disseminating false information. The government used this opportunity to suspend all elections and referendums as well. We observed how a gradually worsening governance momentum has now also spilled over into negative social momentum. We therefore further reduced our exposure from a small underweight to a significant underweight (almost no absolute exposure).

ESG engagements and investor stewardship

We view ourselves as proactive and engaged investors. Our engagement with local policymakers forms a core part of our due diligence and investment process and helps us gather insights and form our investment convictions. We engage prior to investing and after the investments are made for monitoring purposes. We assess the policy quality of countries via research trips and by engaging directly with policymakers and stakeholders, including senior government officials, central bank representatives, state administrators and agencies, local politicians, Non-Governmental Organizations (NGOs) and consultants, as well as with senior executives from the private sector. Acting on driving the patchwork picture come together, gives us confidence in assessing the feasibility and sustainability of policies that are critical for long-term economic prospects and returns.

As the momentum of a country may change significantly over time, a continuous interaction is required to provide feedback and update recommendations ultimately reflected in investment positions. For example, a country's governability may be challenged at a key point in time when social and environmental demands of a growing middle class are not met. The interplay among ESG factors is evident, and it generally materializes in changes to policy intentions and risk assessments first. We therefore continuously engage with local policymakers not just on their fiscal and monetary policy agenda, but also on the impact of the social and environmental policies impacting their growth and productivity.

Engagement example

Colombia
While rich in natural resources, Colombia's diverse geography and its population of over 50 million people, has long been a challenge for its productivity. Transportation between vibrant cities is not only costly in pesos and in time, but it is also fraught with environmental and social questions. A history of armed conflict only exacerbated the challenge. Moving a ton of cargo from Asia to its main port in Cartagena often costs as much as moving that ton from Cartagena to Bogota, its capital. Earlier this decade, Colombia's government set out to build roads and reduce travel times by 30 percent and transport costs by 20 percent. A toll road concession program was launched; it is part of a larger strategic goal to invest nearly $50bn in transport infrastructure, which had been struggling to keep pace with the country's rapidly expanding economy. Moreover, the infrastructure improvements are expected to have clear environmental and community benefits as they will reduce the negative impact of truck traffic by moving the same volume with fewer trucks and less time on the road.

During our due diligence, we worked with various stakeholders in Colombia and invested in the Fourth Generation (4G) road infrastructure program, linking industrial centers to major ports. Our engagement spans from providing guidance on structuring, to encouraging a deeper investor base and market liquidity, to advising when delays due to economic slowdowns are encountered. So far, we have entered two deals, fully exited one at a profit and are in talks and providing guidance on a third. Although these investments often lack market liquidity given the smaller size and the more complex credit component, we view the extra spread pick up as a rewarding compensation for the longer-term horizon positions in our portfolio. Addressing such challenges can go a long way toward improving the country's growth prospects and the competitiveness of its currency.

We believe our active approach and integration of ESG factors throughout our entire process, being robust and systematic, not only leads to better investment outcomes for our clients but also supports the long-term development of countries in a responsible manner, improving social and environmental standards globally. It is this accountable stewardship of clients' investments that spurs economic growth, narrows social gaps, eradicates corruption and reverses climate change.

Investment Risks

The opinions referenced above are those of the author as of June 15, 2020. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Special Risks: The use of environmental and social factors to exclude certain investments for non-financial reasons may limit market opportunities available to funds not using these criteria. Further, information used to evaluate environmental and social factors may not be readily available, complete or accurate, which could negatively impact the ability to apply environmental and social standards.

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. As a large portion of the strategy is invested in less developed countries, you should be prepared to accept significantly large fluctuations in value. Debt instruments are exposed to credit risk which is the ability of the borrower to repay the interest and capital on the redemption date. Investments in debt instruments which are of lower credit quality may result in large fluctuations in value. Changes in interest rates will result in fluctuations in value. The strategy may invest in distressed securities which carry a significant risk of capital loss. The strategy may use derivatives (complex instruments) in an attempt to reduce the overall risk of its investments, reduce the costs of investing and/or generate additional capital or income, although this may not be achieved. The use of such complex instruments may result in greater fluctuations of the value of a portfolio. The Manager, however, will ensure that the use of derivatives does not materially alter the overall risk profile of the strategy.

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