Sustainability risks are increasingly important for emerging markets

Successful management of emerging market bonds concerns understanding the risks. To an increasing extent this concerns sustainability.

8.5 per cent of AP2's strategic portfolio is allocated to government bonds in emerging markets. In total, the Fund invests in more than 60 different emerging countries, with China and Brazil as some of the largest exposures. Return and risk are related and in the case of government bonds, risks can be expressed in many ways.

"The challenge is that many of the markets may be quite volatile and sometimes illiquid. This is a matter of following up and understanding the risks in the positions taken. Because it can go wrong. Venezuela is a case in point, as a country that is unable to pay its debt," says Kristian Hartelius, Head of Emerging Markets.

Assessing political risks

The Fund is strongly focused on integrating sustainability in its asset management. For government bonds in emerging markets, as a first step this takes place by integrating sustainability factors in the benchmark index. But sustainability is also considered in the next step, which is active asset management.

"Among other things, we use assessments of political risks, the degree of internal conflict, and the strength of the legal system to understand and be able to act proactively," says Kristian Hartelius.

As a consequence, during the year the Fund managed to avoid both Venezuela and Lebanon, two countries whose bonds have performed weakly.

Internally developed model

As an element of the analysis work, there are regular study visits of the most important markets, but in order to maintain the required breadth, the Fund relies on external sources.

"This is a strength of our modelling method, which means that we can maintain breadth and weigh up Ghana and Gambia as easily as Brazil. But this requires good data sources," says Kristian Hartelius.

The internally developed model has classical macroeconomic projections, and also elements known from quantitative investment methods. The asset management team is now working for greater integration of environmental factors and climate risks.

"It has traditionally not been so easy to relate climate and environmental factors to prices for government bonds, but this will become ever more important. Countries with high transition costs ahead of them will see an impact on government budgets, among other things. Understanding these links and incorporating them in asset management is something we're doing a lot of work on," says Kristian Hartelius.

Well-calculated risks

Besides picking the right countries, the Fund can manage its risk and return by choosing where on the yield curve to place the exposure. Bonds with longer maturities are more sensitive to changes in the level of interest rates and usually yield higher returns. The Fund's model has tools to time changes in the yield curve, but as a rule, and over time, the Fund must take on risk across the entire yield curve.

"We need to do this, to be able to deliver the right risk-adjusted return to the pension system. Our task is to take risks, but these must be the well-calculated risks in which we have the greatest faith," says Kristian Hartelius.

"It has traditionally not been so easy to relate ***climate and environmental factors*** *to prices for government bonds, but this will become ever* ***more important****"*