



Can a country be sustainable?

A Case Study & best practice approach of asset manager Petercam

Topic of the month November 2013

Extra-financial research on corporations has been around for several years, and company rankings based on a 'best in class approach' are common nowadays. Nonetheless, it looks as if the Eurozone sovereign crisis has been a necessary evil to question the status of Eurozone government bonds as risk-free assets. This has led to the emergence of rankings based on extra-financial criteria for governments as well. Most of the models are quite recent. However, some investors, such as Petercam, have been acknowledging the usefulness of assessing the sustainability of countries, even before the crisis of late 2008.

In-house sustainability analysis model

The number of country sustainability models remains fairly limited today, especially given the lack of a universal definition, which has proven hard to establish. Nonetheless, the first lessons of the sovereign crisis in the Eurozone seem to shed some light on the notion of the financial sustainability of a country. It is clear that public debt cannot be analysed as such. It must be analysed in relation to the level of private, corporate and household debt levels. The current account balance is a crucial sustainability parameter.

But what about sustainability criteria that are beyond the financial scope? What are the other sustainability parameters of a country, and is there a link between those two dimensions?

Given the lack of a universal definition for sustainability, Petercam, as an investor in government bonds, started developing an in-house sustainability analysis model in 2007. Its sustainability approach draws on five dimensions:

The political and democratic dimension

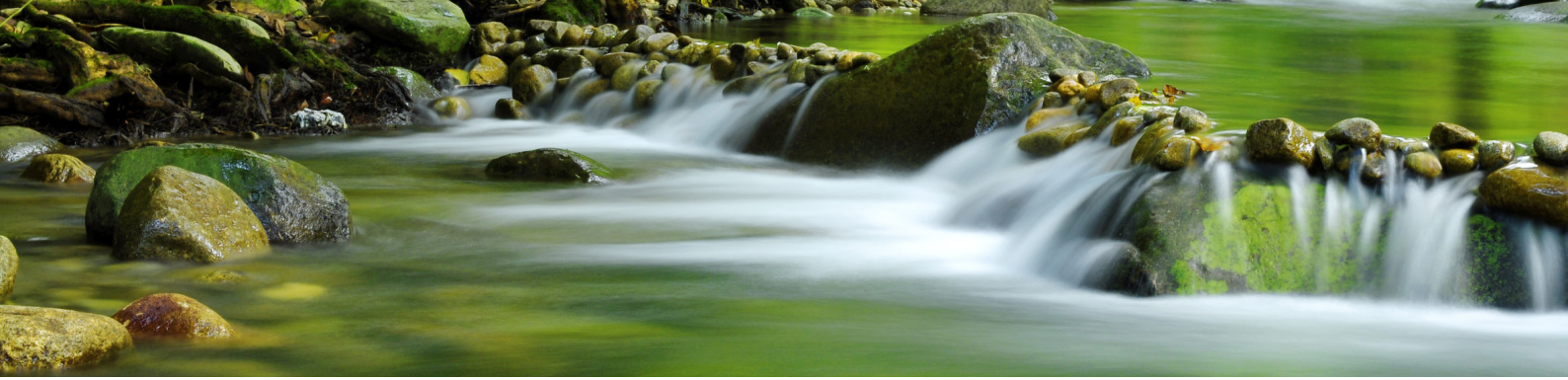
A sustainable country respects its commitments vis-a-vis other countries and its citizens. Sound governance of a country ensures the implementation of development institutions and adequate controls in order to guarantee the optimal working of a country. Institutions are founded democratically, corruption is legally forbidden and citizens are free to express themselves;

The environmental dimension

A sustainable country that cares about its natural resources and acts to the benefit of the environment. It considers the planet as a public good which everyone needs to respect and preserve;

The social dimension

A sustainable country looks after the wellbeing of its population. To this end, government authorities ensure a quality of life that is acceptable for the entire population. They guarantee safety and access to quality healthcare;



The future dimension

A sustainable country invests in future generations; not only by ensuring the best conditions for the arrival of future generations, but also by offering them sufficient education in order to safeguard the development and the governance of the country in the future;

The economic dimension

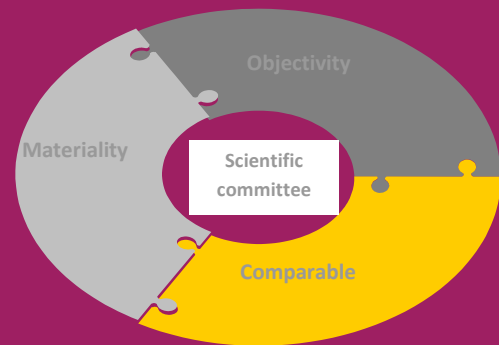
Finally, a sustainable country should have the means to ensure its economic viability by avoiding excessive debt, by assuring price stability for its population and by managing income and expenditure in a sensible way.

In selecting the relevant criteria enabling the assessment of the five dimensions mentioned above, a differentiation clearly emerges between the countries of a relatively similar universe such as for example the OECD. With regard to these five dimensions, several countries position themselves at the top of the ranking, such as Scandinavia or Switzerland. Conversely, countries such as Greece, Turkey or Mexico exhibit sustainability flaws, which are pervasive throughout the five dimensions.

Assessing Sustainability

In assessing the sustainability of countries, Petercam has opted for a pragmatic and objective approach based on four key principles:

- *Quantifiable data*
- *Similar for all studied countries*
- *Coming from reliable sources*
- *The relevance and weighting must be validated by the scientific advisory committee, consisting of three external experts*



A pioneer in sustainability analysis for emerging countries

Emerging countries are generally considered as high potential countries, notably due to their attractive young and growing population. Although most emerging countries are not exactly examples in terms of sustainability or democratic processes, it is worthwhile analysing them from this angle. Indeed, integrating sustainability criteria into the management of a portfolio investing in these countries, can be of real added value.



The world population currently has 7 billion people, and according to United Nations statistics, this number is projected to grow to 9.5 billion by 2050. This increase will be prevalent in emerging countries, which are currently confronted with overpopulation and a lack of natural resources. The demographic challenge is related to energy and ecology challenges. In other words, it also entails a challenge for the entire economy.

The Arab Spring has shown the importance of democracy process, guarantee of the civil rights and freedoms. Inequalities within a population, with high unemployment, particularly among the youth, create a unsecure and unstable climate, which will lead in the future to population rebellion.

This is why the analysis on the attractiveness of an emerging country should also be based on an analysis of the sustainability of this country in terms of transparency and democratic value, the environment, demographics, health care, wealth distribution, education and economy.

Thanks to the experience that Petercam has accumulated in the sustainability analysis of OECD member states, it has enabled our investment professionals to construct a sustainability model specifically designed for emerging markets i.e taking into account the particularities of these countries.

‘Making a clear and full analysis of the sustainability of a country is a real added value.’

The underlying principles of the model remain the same namely quantifiable criteria that can be applied to all countries, coming from acknowledged and reliable sources. At the same time, the assessment criteria must be adapted to the specific context. The level of development strongly varies from one country to another. That is why it is of key importance to focus on a limited number of criteria which are crucial to sustainability. For instance, the literacy rate is not relevant in developed countries in Europe, but quite relevant in countries such as Brazil, Ghana or Malaysia.

The essential conditions to a population’s wellbeing and its sustainable development must be guaranteed. Indeed, political rights and civil liberties, including the freedom of press, are of key importance to lay the foundations of economic and social development. It is also of paramount importance to abolish corruption. If it could appear impossible to do business without corruption, this corruption will have an influence on the assessment of investments in the involved country. The lack of transparency and stability should be taken into account in additional risk premium.

The core of the model is the democratic values. Upholding them is a moral obligation to Petercam which is intrinsically linked to the stance of a sustainable investor. As a matter of fact, academic research has demonstrated that there is a clear correlation between the quality of the institutional framework of a country and its default risk.

Petercam uses the research of the international NGO *Freedom House* to assess the democratic development of a country. Based on an annual survey containing 25 questions on political rights and civil liberties, a country is attributed the status of ‘free’, ‘partially free’ or ‘not free’. This addition is complemented by the democracy index by *The Economist*, which is also based on twenty-odd questions to assess the democratic level of a country, and by the *Human Rights Watch* and the annual report of these organisations on human rights.

It appears that there is a clear link between the democratic level of a country and its sustainability. It should therefore not come as a surprise that majority of not-free countries are at the bottom of the sustainability ranking. The analysis



provides important information on several domains about the sustainability level of the studied countries. It enables to compare several countries which have a similar level of economic development, but which have varying levels of social, ecological and corporate governance development.

Making a clear and full analysis of the sustainability of a country is a real added value in constructing an investment portfolio, in addition to the ideological values that may be presented. In essence, it boils down to putting into context the opportunities and risks linked to a country.

The objective is not to exclude countries which still have low sustainability scorings, as several countries in the universe have just started their democratization process. Many years of dictatorship weigh on a country's sustainable development. The transition to a full respect of civil liberties and political rights, freedom of press and gender equality does not happen overnight if these rights have been violated for many years. It should be noted that this takes time and that the progress made should be closely monitored. In that sense, Ivory Coast is a good example of a country with a promising economic future, which has an abundance of natural resources and commodities. As the former president Laurent Gbagbo was toppled, the country was plagued by instability and social upheaval. Although the country seems to be on track for a better future, it is too early to say it is a full and real democracy.

Petercam's extra-financial research now covers the global average of countries investors may want to invest in. That is a strong argument for conviction management, which is based on seeking risk-adjusted performance. Investors having a clear and full view of the risks and opportunities of a specific country, have an outstanding source of information to assess whether the companies active in that particular country may be successful. After all, the quality of a financial investment is judged, among other things, by the characteristics of the markets the company operates on, and of the specificities of those countries.

'It's all about taking a holistic view of a country'



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Petercam is a leading independent investment firm specializing in private banking, institutional asset management and investment banking (corporate finance and brokerage activities).

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