Colchester®
GLOBAL INVESTORS

ESG Engagement Report

July 2021

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What is Sovereign Engagement?

At Colchester we believe that traditional sovereign balance sheet analysis should be supplemented with a systematic integration of Environmental, Social and Governance (ESG) factors to allow us to fully assess the financial stability of those developed and developing markets in which we may invest. Engagement with issuers and other stakeholders is an integral part of the firm's investment process and is undertaken by members of the Investment Team.

There are clear differences when it comes to engagement as a sovereign investor compared to other asset classes such as equities. Unlike those asset classes where shareholders can use annual general meetings and their voting rights to engage and challenge corporate management, sovereign bond investors do not have "votes" and can only make an impact through engagement or, at an extreme, by withholding capital. The latter is only effective if there is collective commitment to do so. Accordingly, Colchester puts great emphasis on engaging with sovereign issuers in an effort to encourage best practices.

While a sovereign investor may wield less direct influence, we believe we can still play an important role in driving change – through encouraging more targeted action to progress the country's ESG agenda, discussing funding needs for ESG-related reforms, and offering our opinions on how issuers can address balance sheet and ESG concerns. We also seek to use engagement opportunities to better evaluate ESG and other risks that are inadequately addressed by current disclosures or existing policies. We believe that sovereign engagement, if done effectively, should be recognised as being mutually beneficial to both issuers and investors.

In this inaugural ESG Engagement Report, we aim to provide the reader with summary information on key ESG themes and observations we have made over the past six months, our efforts this year on ESG engagement, and relevant case studies.

Key ESG themes in 2021

2021 thus far has seen an increased focus on ESG awareness and an acceleration of pre-existing trends. This is perhaps most obvious in the area of **climate change**. We have seen a rapid growth in focus and support to tackle climate risks. The surge in Net Zero emissions targets being announced by companies, investors and governments reflects the powerful momentum being generated ahead of the 26th United Nations Climate Change Conference (COP26) summit in November this year.

ESG regulation is another area that has gained increasing importance. The drive for more transparency, disclosure, and use of common language has seen a number of regulatory developments which will shape the investment industry's ESG practices. At the forefront of this, the European Commission has introduced the Sustainable Finance Disclosure Regulation (SFDR) which aims to increase the transparency and accountability of financial products in the EU that claim to have ESG or sustainability-related objectives. Other regions are also considering their own frameworks around ESG disclosure and reporting requirements.

Lastly, the impact of the Covid-19 pandemic is still upon us, with many countries struggling to return to pre-pandemic growth paths. The impact of Covid and the recovery from its economic disruptions have been uneven across and within countries, posing significant risks to livelihoods and increasing **socio-economic inequality**. The pandemic has clearly demonstrated that strong governance and robust institutions are critical in supporting a country's economy and protecting the lives of its citizens especially in times of crisis.

Highlights of Engagement Activities

22 engagements, across 43 issues

32% Of engagements directly with government officials

47% Of engagements are industry-level collaborations

21% Of engagements are with Non-Issuer Stakeholders

H1 2021 engagement activites

We look to participate in and contribute to industry events and forums in order to learn from other market participants, and to provide our perspective as a sovereign bond specialist. In the first half of 2021 Colchester contributed to the following:

- Principles for Responsible Investment (PRI): ESG in sovereign debt analysis podcast
- Chartered Financial Analyst APAC: panel discussion on ESG
- Emerging Markets Investors Alliance: physical climate risk panel discussion
- Investment Management Association of Singapore: Practical ESG Applications to Investment Risk & Performance panel discussion
- Inter-American Development Bank: Green Bond Transparency Platform panel discussion
- BBVA LATAM conference: ESG panel discussion

We have also contributed to industry development by providing feedback to the EU Taxonomy consultation, the JP Morgan investor survey on ESG in Emerging Market sovereign debt, as well as to the FTSE Index and JP Morgan index advisory committees.

Colchester has also joined a number of additional initiatives including the Investment Management Association of Singapore (IMAS) and the Emerging Markets Investors Alliance (EMIA).

Finally, as part of our effort to increase the transparency of our ESG activities, we have launched a new, dedicated ESG, CSR & Sustainability section on our company website.

Sovereign Engagement Activities

Environment

Colchester recognises that climate change will likely have a profound impact on the global economy. As average temperatures around the globe continue to rise, the consensus across the scientific community is that human activity is the cause of long-term changes to temperatures and weather patterns – largely due to greenhouse gas emissions[1]. In our view, climate-related risks are significant as are the costs to transition to a low-carbon or more sustainable future. As sovereign bond investors, we need to be cognisant of these risks and seek to incorporate them into our investment analysis, recognising that different economies are likely to be impacted in different ways, and that policymakers can influence and mitigate the negative impacts through well-considered policy choices today. We are closely monitoring government responses to climate risks in many areas, such as carbon pricing, green investments and sustainable financing.

Australia

Australia had introduced a carbon pricing scheme in 2011 as part of the Clean Energy Act intended to control emissions in the country, as well as support the growth of the economy through the development of clean energy technologies. However, the scheme was repealed after just two years of operation, having faced significant challenges from the opposition political party and the public, as it resulted in increased energy prices for both households and industry. In a recent set of meetings with Australian Treasury officials, we raised the possibility of re-introducing a carbon tax given the increasing movement in this direction in other countries. The Treasury officials would not address the question directly as it was "off topic." Although this was not the kind of engagement we were looking for, it does suggest a carbon tax reintroduction remains relatively unlikely under the current Administration.

We did however have a more constructive discussion with Austrade (Australian Trade and Investment Commission), the government agency charged with promoting Australian exports. Our discussion focused on the possibility of Australia facing carbon tariffs in new trade agreements and their potential implications. The EU is already examining this policy, known as a Carbon Border Adjustment Mechanism (CBAM), which is due to come into force by the end of 2022. The goal behind carbon tariffs is to provide a level playing field for local businesses who may be subject to carbon emission regulations competing with imports from countries that do not have strong climate policies. This could have serious implications for a country like Australia, that not only has high CO2 emissions per capita[2], but its main export industries are also high emitters of CO2.

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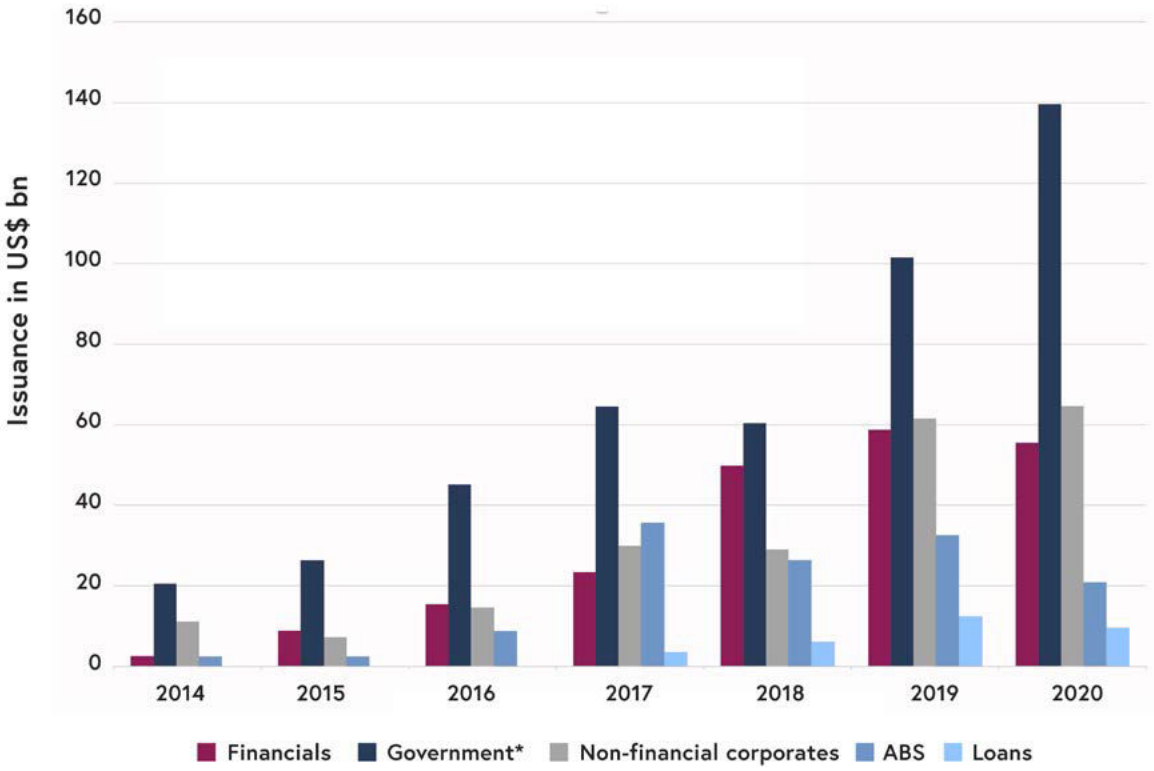
[1] Source: Intergovernmental Panel on Climate Change
[2] Source: World Bank, as of Dec 2018

Iron ore, coal and petroleum gas are Australia's three main goods exports making up over 50% of the total. This is in addition to the potential trend decline in demand for Australia's fossil fuels and carbon-intensive goods as a consequence of emission reduction pledges. We have observed the increasing global expectation that the cost of emissions be reflected in government policy. Against this backdrop we suggest that Australia needs to take a more proactive approach.

Sovereign Green Bonds Issuance

There has been a rapid growth in the issuance of sustainable bonds (green, social and sustainability bonds) as can be seen in Chart 1. Sustainable bonds are an important source of capital to support targeted sustainability goals and the challenges of climate change. Within sustainable bonds, green bonds are by far the most popular, with over US$1 trillion[3] in cumulative issuance since market inception in 2007. We believe this trend will continue as governments look to increase their issuance of green bonds to fund investments aimed at achieving their climate action goals. For example, the European Commission announced that 30% of the €750 billion borrowing for the Next Generation EU Recovery Fund will be raised through green bonds.

Chart 1: Rapid growth in green bond issuance



Source: Climate Bond Initiatives, Colchester, as of December 2020
* includes sovereigns, government agencies, supranational, municipals

As such, green bond issuance has been one of the themes of our issuer engagements this year. For example, we discussed in our interaction with the New Zealand Local Government Funding Agency (LGFA) the challenges they faced in building a sustainable bond framework given that LGFA is a conduit for local council funding (and proceeds are unlikely to be earmarked specifically for one project). We shared our insights on some of the frameworks we have seen with Nordic LGFA green bonds and green bond issuance from the European Bank for Reconstruction and Development (EBRD). We hope to continue the discussion with the New Zealand LGFA at future meetings.

[3] Source: Climate Bond Initiatives, as of Dec 2020

Similarly, in our discussions with the Finance Ministry of Colombia, we asked the authorities about the medium to long-term impact of climate change. In our view, investment in renewable energy generation, potentially funded through issuance of green bonds, could spur growth and employment, and aid the transition of the Colombian economy away from fossil fuels. We asked the government about potential issuance of green bonds and they confirmed a local currency green bond was included in the funding plan for this year. We believe this could potentially broaden the investor base for COP-denominated government debt and support the wider funding needs of the government. Going forward, we will look to monitor the country's progress on green bond funding and the long-term re-orientation of the economy away from fossil fuel extraction.

In addition to our direct engagements with sovereigns, we have also collaborated with the Inter-American Development Bank (IDB) on the development of its Green Bond Transparency Platform (GBTP). The platform aims to support the standardisation of green bond reporting across Latin America and the Caribbean (LAC). We believe this platform, by promoting transparency, comparability and accessibility of green bond data is an important development to further the growth of the LAC green bond market.

"Colchester Global Investors is proud to have collaborated with IDB on the Green Bond Transparency Platform as a sovereign only asset manager. The timing of this Platform is particularly relevant as the COVID-19 fallout has negatively impacted the balance sheets of every country. Sovereigns along with the private sector are focusing on innovative green and sustainable solutions for building more robust and lower carbon economies. The Green Bond Transparency Platform with freely available, comparable, transparent and standardized data will help to further mobilize sustainable investments."

Claudia Gollmeier

Managing Director – Singapore,
Senior Investment Officer

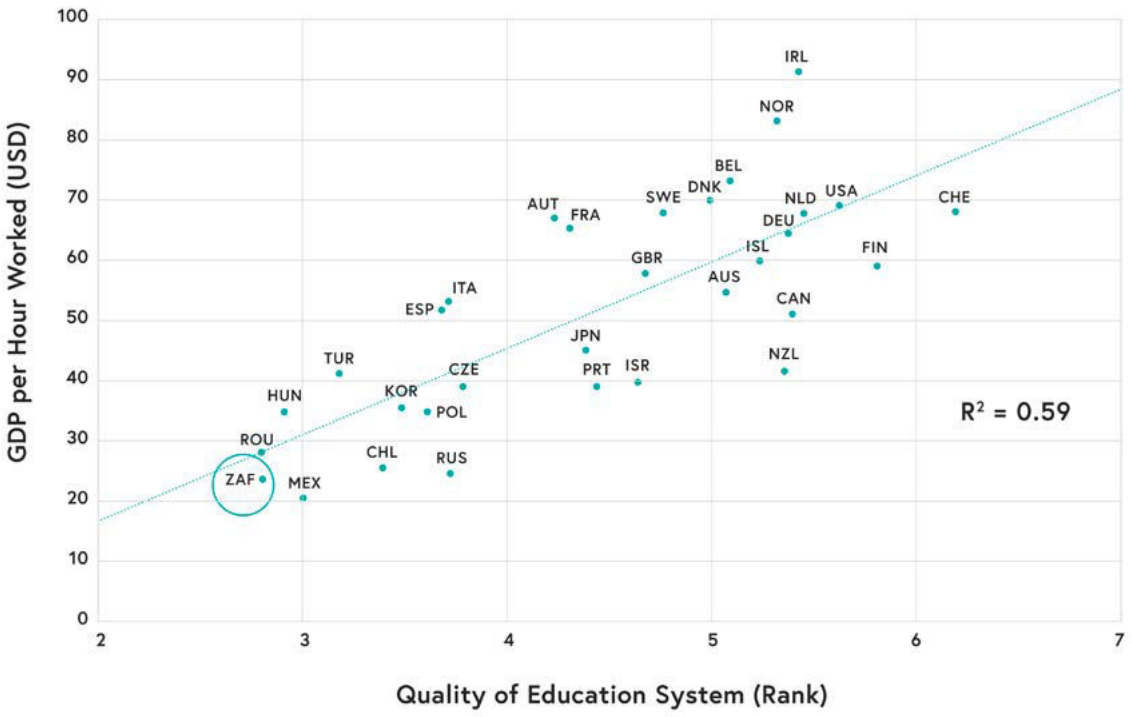
Social

Social factors and the quality of human capital are key determinants of a country's long-term economic growth. Measures of a country's demographic, education, income inequality and social cohesion can inform its potential for economic progress. In particular, education is a core feature of any country's ability to progress. Education provides knowledge and skills to the population; it is also an effective tool for reducing poverty and fostering broad socio-economic development.

South Africa

The state of education in South Africa is one of the weakest in the world. According to the World Bank's Quality of Educational System index (2018), South Africa ranked 55th out of 63 countries. The importance of education cannot be underestimated as it has a direct impact on productivity. Higher productivity is typically associated with stronger economic growth and better living and social standards. The positive relationship between the two can be seen in Chart 2.

Chart 2: Productivity and Education



AUS	Australia
AUT	Austria
BEL	Belgium
CAN	Canada
CHE	Switzerland
CHL	Chile
CZE	Czech Republic
DEU	Germany
DNK	Denmark
ESP	Spain
FIN	Finland
FRA	France
GBR	United Kingdom
HUN	Hungary
IRL	Ireland
ISL	Iceland
ITA	Italy
ISR	Israel
JPN	Japan
KOR	South Korea
MEX	Mexico
NLD	Netherlands
NOR	Norway
NZL	New Zealand
POL	Poland
PRT	Portugal
ROU	Romania
RUS	Russian Federation
SWE	Sweden
TUR	Turkey
USA	United States
ZAF	South Africa

Source: World Bank, Colchester. GDP Per Hour Worked is a measure of labour productivity. Data as at end 2018. Quality of Education System refers to how well the education system meets the needs of a competitive economy (1 = not well at all; 7 = extremely well). Data as at end 2018.

Unfortunately, Chart 2 also highlights the comparatively weak performance of South Africa. Despite,

(i) successive governments making education a focus in several development plans over the past decade or more; and,

(ii) the government consistently spending more on education than its emerging market peers and a number of developed economies,

there has been little real progress. South Africa's public spending on education is 6.5% of GDP. This contrasts with an average public spend in EU countries of 4.7% of GDP[4]. Despite spending more, the quality of "education output" has been severely hampered by inefficiencies, lack of accountability and the poor quality of teachers.

[4] Figures from World Bank, data as at 2019.

The quality of education has been a constant issue discussed in our engagements with the sovereign, multilateral organisations and local institutions. In a recent meeting with a large multilateral organisation, we discussed the structural constraint the quality of education was placing on the economy. Consistent with our thinking and efforts, the organisation noted their concerns and discussed their own direct engagement with the sovereign on this matter.

Clearly there are some factors which set South Africa apart from its emerging market peers, especially stemming from the Apartheid years. For example, the tiered school system and resulting discrepancy between public and private schools, and the impact that spatial planning or geographic segregation of black areas away from large towns and cities have on the access to, and quality of, education across the country.

Whilst acknowledging these structural historic issues, we believe that more can be done to improve the efficiency of the education system in South Africa. Doing so will potentially unlock a large underutilised labour resource, particularly among the young, and help lift the quality of life for many. We are encouraged to hear through our engagement with a local financial institution and an important stakeholder in the sector that, helped by the Broad-Based Black Economic Empowerment (B-BBEE) framework and private sector involvement, targeted spending on education and training is accelerating. Such initiatives may be expected to slowly improve the delivery of education over time.

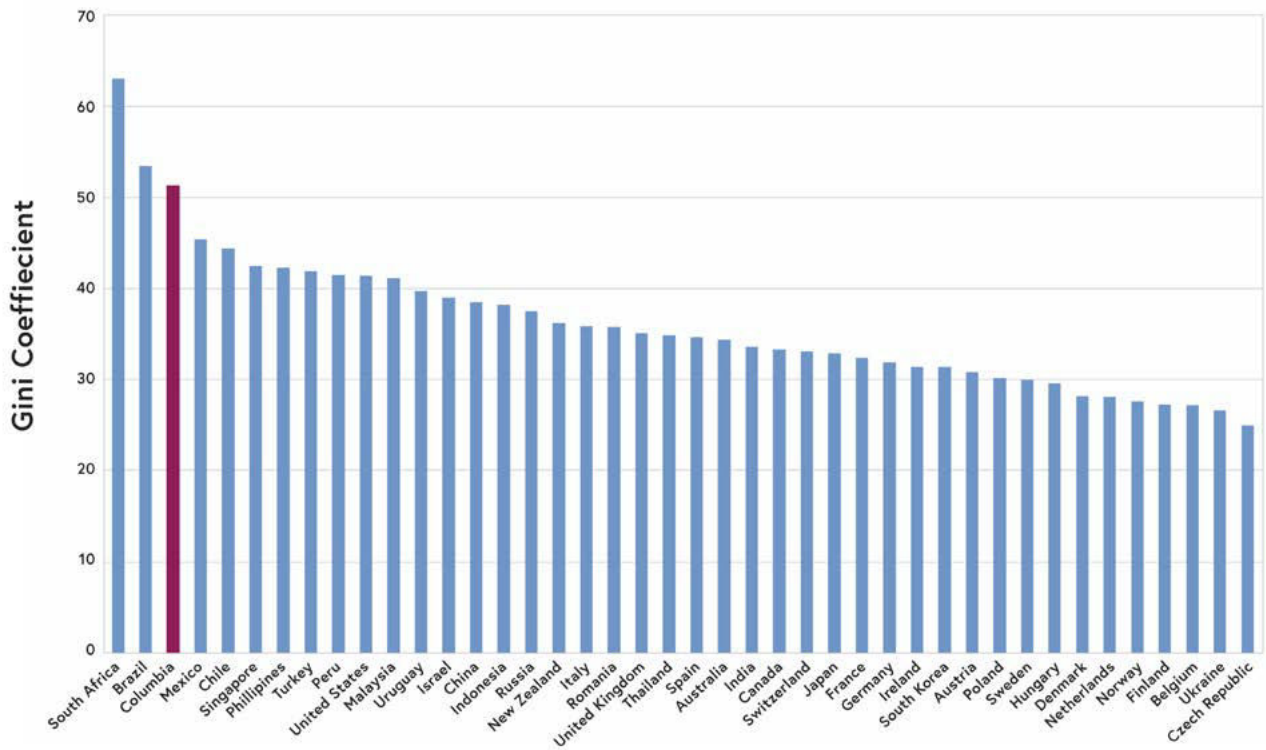
Going forward, we believe that it is critical that the South African government continue its efforts to improve the quality of the education system. Improving the quality of education would not only serve to boost the country's human capital accumulation, but also address the country's chronic issues of high levels of inequality and unemployment. Furthermore, we believe that reforms in this area are critical towards restoring South Africa's growth potential.

Colombia

As well as a public health crisis, the Covid-19 pandemic has had a devastating impact on poverty levels and inequality. The pandemic has exposed the fragility of the health infrastructure and social safety net in many countries. As such, poverty levels are rising, and inequality is accelerating between and within countries. It has also stoked social discontent, political polarization and populist nationalism. In particular, we have observed the impact this has had in Colombia.

Colombia today is still suffering from the legacy of its history of extreme inequality, social tensions and political violence. Whilst great progress has been made and political violence has mostly come to an end, the country does remain one of the most unequal in the world (please refer to Chart 3). Even prior to the Covid-19 pandemic, the social and political stability of the country has been tested in recent years with the collapse of the economy, in its neighbour, Venezuela. Anger and frustration boiled over this year as protests against a proposed tax reform turned violent. Colchester has regularly engaged with institutions in Colombia and in the first half of this year, took part in investor meetings with the Finance Ministry and the Colombian Central Bank. Amongst other topics these interactions focused on official plans to reduce deep-seated inequalities, whilst maintaining fiscal discipline and credibility.

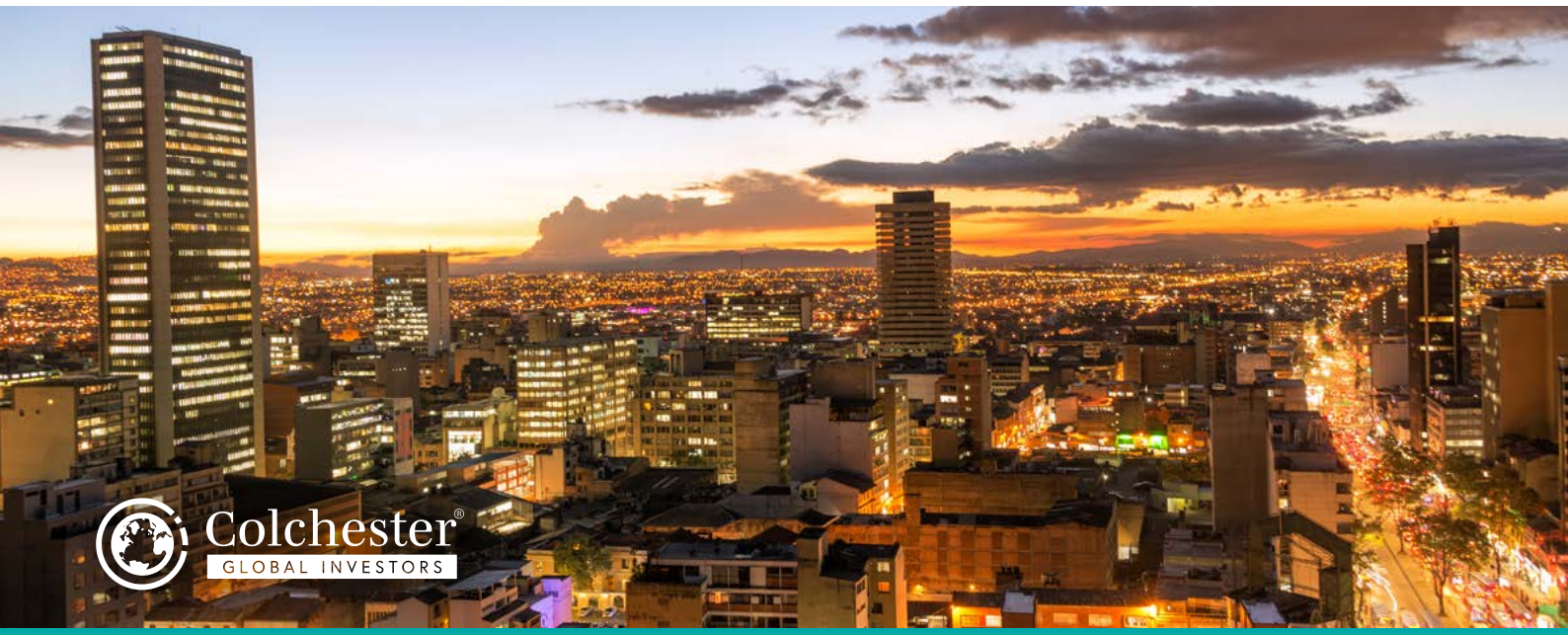
Chart 3: Colombia has one of the highest levels of inequality in the world



Source: World Bank, using most recent data available (years range from 2014 to 2019)

Note: the Gini coefficient is a measure of the degree to which income is unequally distributed. The higher the coefficient, the more unequal.

In our opinion, authorities in Colombia responded to the external shock of the Covid-19 pandemic with an appropriate loosening of fiscal policy, in effect taking advantage of the credibility built up with financial markets over many years. The response has also sought to mitigate the risk that the pandemic and associated public health measures exacerbate existing inequalities. The government's response therefore targeted lower income segments of society. Going forward, we believe the Colombian government needs to tread a fine path between supporting growth, and reducing poverty and inequality on one side, whilst maintaining fiscal credibility on the other. We support a tax reform that seeks to raise government revenues and move toward a simpler, more efficient and equitable tax system.



Governance

As sovereign investors, we have long recognised the importance of good governance. The quality of governance, as indicated by factors such as government effectiveness, credibility of institutions, the rule of law and control of corruption, has direct bearing on the government's ability and willingness to repay its financial obligations. Strong governance also promotes stronger economic and social outcomes. The corollary to good governance is fiscal transparency. Fiscal transparency helps to foster better overall economic governance by providing legislatures, markets and citizens with the information they need to hold governments accountable.

A Latin American Country

Colchester is a member of a Fiscal Transparency Engagement Working Group, as a member of an EM Investors Association. In this forum, we had a frank and open discussion with the Budget Office and Ministry of Finance of a Latin American country about their budget and fiscal transparency[5]. Amongst the topics, we raised issues highlighted in the country's most recent Open Budget Survey. These included the desirability of releasing a pre-budget statement aligned to the timing and requirements of the International Budget Partnership (IBP) who compile the Open Budget Survey, improving public participation in the overall budgeting and allocation process, and strengthening the existing framework of the internal auditing process. Representatives from both ministries welcomed the dialogue and we were encouraged by their receptiveness to our suggestions for improvements. We agreed with the ministry on a follow-up call in the fourth quarter of 2021.

[5] Note, due to a confidential agreement with the sovereign concerned, that enabled an open and frank discussion, the country cannot be named here.

Epilogue

As outlined above, ESG engagement is an integral part of Colchester's investment process. Colchester strongly believes engagement can help drive positive outcomes and we take this responsibility seriously on behalf of our investors. Engagement with issuers not only serves as an opportunity to better understand ESG risk factors, but also as an important tool to share our thoughts on best practices and highlight investor concerns. As a government bond investor, our engagement necessarily differs from that with a company. We recognise the "sovereignty" of the issuers we are engaging with and are sensitive to the different cultural and economic conditions of each country. The focus therefore is often on having a dialogue with a country to better understand their national priorities and to seek greater transparency in their sustainability efforts. Given the nature of these engagements, and unlike other asset classes, the expectation for immediate change may be unrealistic. However, that does not deter us from trying. We have also observed that we can leverage our effectiveness by collaborating with other investors and by contributing to industry-level developments. We believe that these channels may be as equally as effective as direct engagement.

Our engagement work is ongoing and as part of the process, we track and monitor, where relevant, any mitigating policy actions and response by governments to the issues raised. We are committed to reporting to our clients and stakeholders on our engagement activities on a biannual basis.

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