ARTICLE
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For professional investors

ROBECO
The Investment Engineers

Country Sustainability Ranking Update

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- **Top trio enjoys a solid lead in ESG ranking**
- **Ireland new ESG leader in euro area**
- **Mixed ESG performance for emerging markets**

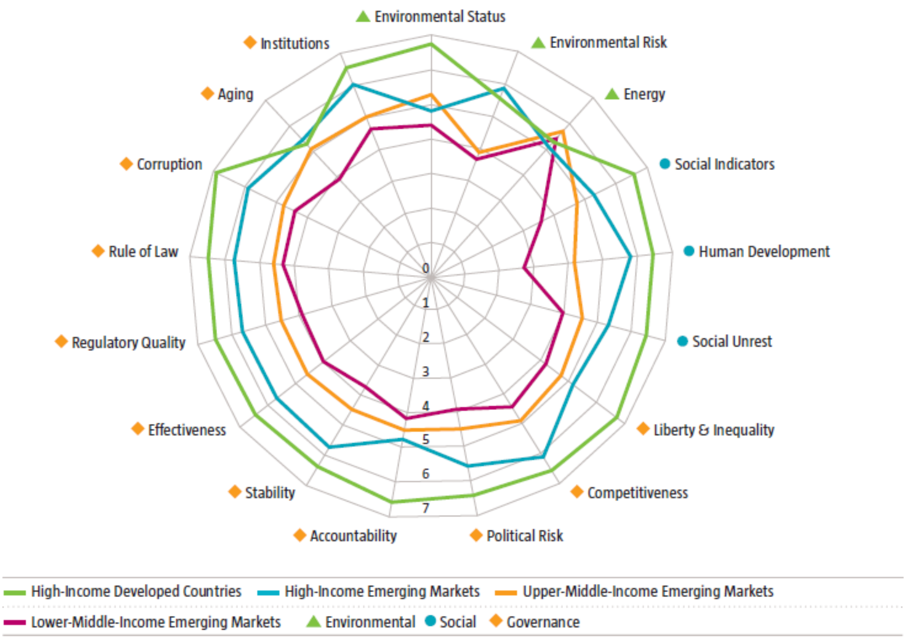
RobecoSAM's country sustainability framework

RobecoSAM's country sustainability framework evaluates 60 countries on a broad range of Environmental, Social and Governance factors that we consider to be key risk and return drivers relevant for investors. This analysis complements findings gained from the more traditional country risk assessment and is particularly focused on integrating long-term perspectives. Once again, the April 2015 update of the Country Sustainability Ranking reveals some interesting trends: within EMU economies, the scores of the periphery countries have continued to improve, with Ireland now leading the ranking among euro area countries.

Within the emerging markets, Mexico's score declined the most, followed by Kazakhstan, UAE and South Korea. BRIC rankings remained low, with Brazil ranked 38th, way above China, India and Russia, all of which are among the bottom 10 performing countries. Jamaica, Indonesia, Romania, Saudi Arabia and Thailand, on the other hand, are among the emerging markets winners, registering small increases in their scores. Looking at the global universe, the three frontrunners – Sweden, Switzerland and Norway – maintained their firm lead, with Sweden remaining at the top of the overall country sustainability ranking. The ranking confirms that countries with a stronger ESG profile also tend to be more creditworthy. A closer look at the underlying dimension scores reveals that countries diverge significantly on governance factors. Countries with a poor quality of governance are seemingly more crisis-prone, risking their ability and willingness to service debt – an important factor to be considered in today's global economic environment with the pervasive build-up of debt and limited economic growth prospects. With regard to the environmental and social factors, the performance of various countries also differs considerably, with the exception of 'energy,' where the scores are fairly close –as illustrated by the four country groups categorized according to their income levels in Figure 1 on the next page.

Ireland matches Germany on sustain-ability measures while BRICs struggle

Figure 1: Average country ESG scores by income group



Source: RobecoSAM

The income groups follow the World Bank Atlas classification[1] and include High-Income Economies (including both developed and emerging markets according to RobecoSAM terminology), Upper Middle-Income Economies, Lower Middle-Income Economies and Low-Income Economies, and comprise all countries covered by the RobecoSAM country ESG ranking.

Figure 2: Top 10 country ESG scores

Source: RobecoSAM

Sweden leads a solid trio of top performers

As in September 2014, Sweden is firmly in the lead, closely followed by Switzerland and Norway. All three countries reveal consistently high scores on most of the 17 ESG indicators and are well ahead of the UK, which is ranked fourth.

[1] For the current 2015 fiscal year, low-income economies are defined as those with a Gross National Income (GNI) per capita of USD 1,045 or less in 2013, calculated using the World Bank Atlas methodology. Middle-income economies are those with a GNI per capita of more than USD 1,045 but less than USD 12,746; high-income economies are those with a GNI per capita of USD 12,746 or more. Lower middle-income and upper middle-income economies are separated at a GNI per capita of USD 4,125.

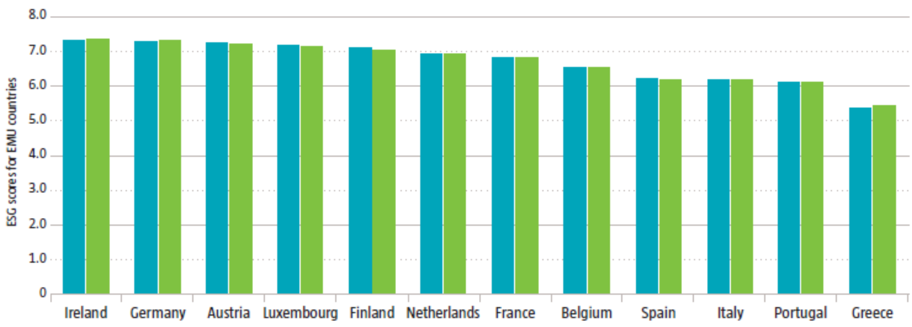
Mixed ESG performance for Euro area economies

The development of ESG scores for EMU member states has been mixed. For the vast majority of the countries, the scores remained relatively high, with the Southern European countries, particularly Greece, clearly lagging behind the others. While Austria, Finland and Luxembourg's scores have dropped slightly – mostly due to small declines across various governance factors – the peripheral economies of Ireland, Greece and Portugal achieved an improvement in their score, primarily due to improved competitiveness, with particularly striking progress in Ireland.

Ireland continues to climb up the ranking

Ireland's score improved by 0.09 to 7.35 and is almost back to its pre-crisis level. It also climbed 3 ranks to the 6th place, matching Germany, showing that the country is back on track following a deep crisis. Ireland stands out as a prime example of a country that has successfully introduced decisive reforms, markedly improving its ESG profile over recent years.

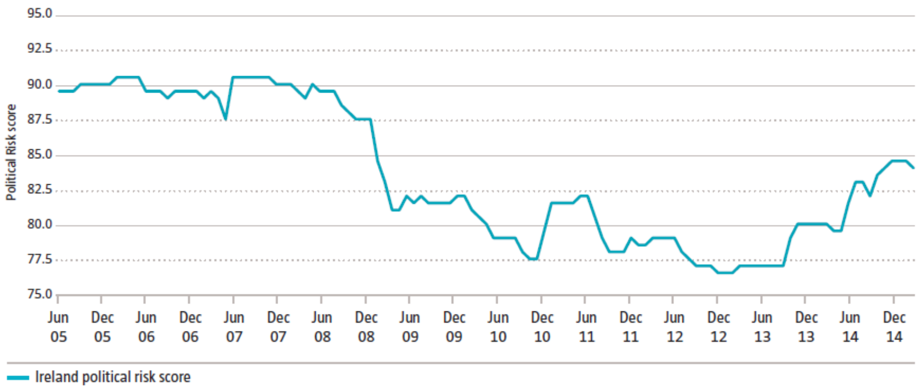
Figure 3: ESG scores for EMU countries



Source: RobecoSAM

A key component of Ireland's overall ESG profile that has shown a marked and steady improvement since the end of 2012 is political risk. Given that political risk relates to both the ability and willingness of sovereigns to service their debts, a decline in political risk also suggests an improvement in a country's creditworthiness, as shown in a recent paper by Senior Researcher at Robeco Quantitative Strategies Johan Duyvesteyn.[2]

Figure 4: Ireland's political risk score improves



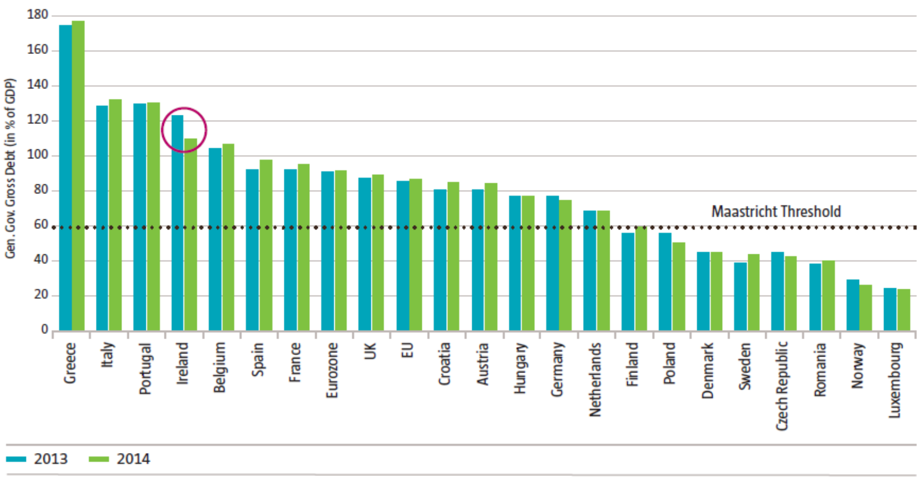
Source: PRS

[2] Duyvesteyn, Johan; Martins, M.; Vermijmeren, P. "Political risk and expected government bond returns," March 2015.

In line with its improved ESG profile and political risk, not only has Ireland become the fastest-growing EU economy, with its GDP expected to expand by 3.5 % in 2015, but it has also been able to markedly reduce its government debt from 123 % in 2013 to 110% of GDP in 2014, i.e. the only significant debt reduction among Europe's highly-indebted countries. Even though Ireland's ESG profile never ranked as poorly as those of the Southern European peripheral countries, the recovery of its sustainability score is nevertheless striking when compared to the other euro area countries.

Ireland's stronger social fabric and governance profile reflected in its country sustainability ranking have helped us to early identify the opportunities for investing in Irish government bonds. Funds such as Robeco Euro Government Bonds, Robeco Euro All Strategies and Rorento – total return bonds fund have been invested in the bonds.

Figure 5: Ireland achieved the largest debt reduction



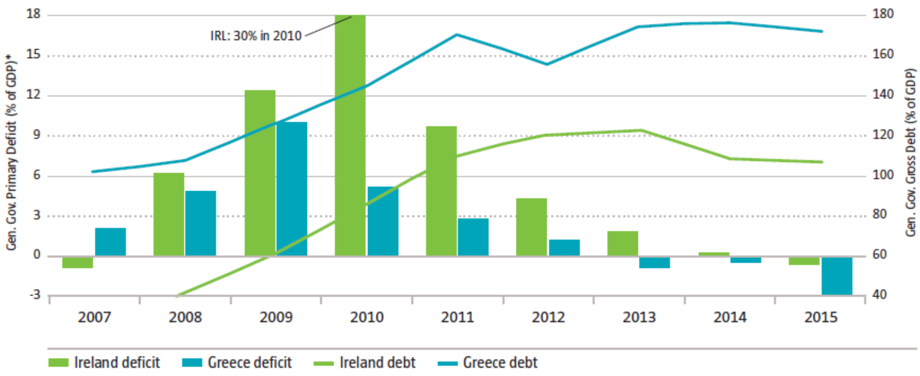
Source: Eurostat

Greece's governance woes continue

Greece, on the other hand, still exhibits significant shortcomings in its governance structure, despite a small improvement since September of last year. Rampant corruption, weak institutions, shaky political stability, and poor competitiveness are all hampering effective policy making, necessary reforms and ultimately, economic performance. As a result, Greece's economic recovery from the crisis is significantly lagging that of the other periphery countries. Figure 6 compares Greece's public finance development with that of Ireland. Social unrest and political uncertainty ahead of the elections have also hurt fiscal consolidation. Hence, Greece's primary surplus in 2014 reached only 0.4 % of GDP, largely missing its 1.5 % target, and is also below the 0.8 % surplus recorded in 2013. Syriza's election victory in January 2015 and the new government's showdown with the troika and European partners have resulted in a fragile political situation. The outlook remains highly uncertain with looming large downside risks such as the strained relationship with international creditors, a widening funding gap, simmering social tensions, another early election, the implementation of capital controls, or even a possible 'grexit' from the Eurozone.

The lack of convincing improvement in the ESG profile was one of the factors that helped us not to participate in Greek bond auctions in 2014. At the time the consensus on Greece was much more positive than currently is the case.

Figure 6: Ireland outpaces Greece on debt measures



* – = Surplus

Source: IMF WEO, April 2015

Mixed ESG performance within emerging market economies

Among emerging markets, Mexico experienced the biggest drop in its ESG score, (–0.16 to 4.74), largely due to a fall in its governance score (–0.14), followed by Kazakhstan, UAE and South Korea – mostly due to small declines across various governance aspects. Jamaica, Indonesia, Romania, Saudi Arabia and Thailand appear among the winners within the emerging economies, registering a small increase in their overall score, also thanks to gains predominantly in the governance dimension. None of these countries made it to the top half of the ranking though, reflecting continued weaknesses in their overall sustainability profiles.

Mexico exhibits relatively poor scores on stability, political risk and rule of law. Despite some recent high-profile cartel arrests, the government has been unable to curb the influence of organized crime and stop violence. The security situation remains fragile due to the state's failure to assert the rule of law and guarantee security throughout the country. Moreover, Mexico is plagued by chronic corruption, ranking only 103rd of 175 countries, according to Transparency International's (TI) Corruption Perception Index, which is one of the measures used to determine the country sustainability scores.

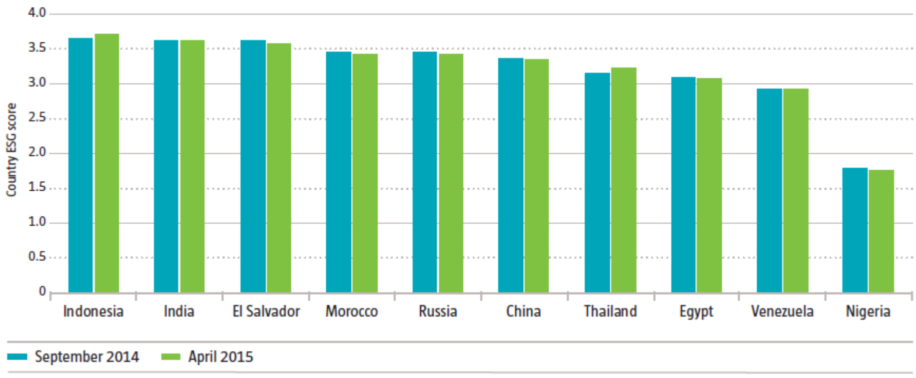
Poor ESG profiles persist among the BRICs

Rampant corruption is also a common factor among BRIC countries, whose overall ESG profiles remain rather weak. Indeed, Brazil ranks 69th, India 85th, China 100th, and Russia 136th in the aforementioned TI Corruption Perception Index. Corruption is a complex phenomenon and its effect on development varies with country-specific conditions.

Although it can coexist with high growth in some cases – as in China, for instance – experience suggests that over the long run, corruption hampers economic development, undermines a government's ability to enact effective policies, weakens public services, reduces investment, creates fiscal distortions, and hurts a government's credibility, holding back entire societies. Overall, governance is the key weakness in BRIC countries' ESG profiles, none of which made it into the top half of the current Country Sustainability Ranking. Quite the contrary: three of the BRICS belong to the bottom 10, as shown in Figure 7. Ultimately, the level of corruption also has an adverse impact on a country's creditworthiness and is associated with a higher risk premium as can be seen in the relevant literature[3].

[3] Butler, A.W., L. Fauver, Mortal, S., 2009. Corruption, Political Connections and Municipal Finance. Review of Financial Studies 22, 2873-2905.

Figure 7: Bottom 10 Country ESG scores



Source: RobecoSAM

Brazil

In Brazil (# 38 on the RobecoSAM Country Sustainability Ranking), the corruption scandal surrounding the national oil giant Petrobras is contributing to investor mistrust, affecting investment flows and the currency. Dilma Roussef's government is facing strong opposition in Congress and social dissatisfaction, which could further grow in light of the weakening economy. This is also reflected in the relatively weaker scores for political risk and stability. Markets' growing unease with the developments in Brazil have also been reflected in rising risk premia and a depreciating currency, with the real having lost more than 20 % over the past twelve months. Moreover, Brazil suffers from rather poor government effectiveness, regulatory quality and lagging human development despite its recent progress in reducing poverty levels, whereas it performs much better on environmental aspects, as it is rich in natural resources and energy (including oil, biofuels such as sugarcane ethanol and renewables such as hydropower). Brazil's higher risk profile as reflected in its ESG profile was one of the factors that that prevented us from investing in Brazilian bonds in mid 2014 on a large scale. This has contributed to the performance of the Rorento fund.

India

In India (# 52), the convincing victory of the Prime Minister Modi's BJP raised hopes of genuine reforms, but expectations may prove to be too high. The country continues to suffer from political gridlock, a delicate relationship with Pakistan, and an opaque, inefficient bureaucracy. Nevertheless, India's governance score is similar to that of Brazil, but its environmental and social performance is far behind its BRIC peers. India is highly dependent on energy imports, has a poor environmental record, and an especially poor level of human development. The economy currently benefits from lower oil prices, which help to keep external accounts under control, but public finances remain fragile.

Russia

Russia (#55), which ranks third among the BRIC economies, exhibits not only widespread corruption, but also major deficiencies with regard to civil liberties, accountability, property rights protection, transparency, freedom of the press, rule of law and, in particular, aging, due to its aging population. Russia scores much better on the environmental and social dimensions, thanks to its abundance of natural resources, relatively good education system and higher living standards, with the country belonging to the group of high-income economies according to the World Bank Atlas methodology. The slowdown in the economy observed since 2013 is likely to sharpen in 2015 as a result of lower oil and commodity prices, Russia's involvement in the Ukraine conflict, and Western sanctions. The ruble reached an all-time low of RUB 72.45 to the USD in December of last year. Even though the currency has since recovered by some 30 %, reaching 51.24 RUB against the USD within the last couple of months, the ruble remains highly volatile given the country's current situation. Despite polls showing President Putin's high approval ratings, there is also some discontent among the population, and the social situation could deteriorate in view of the shrinking economy.

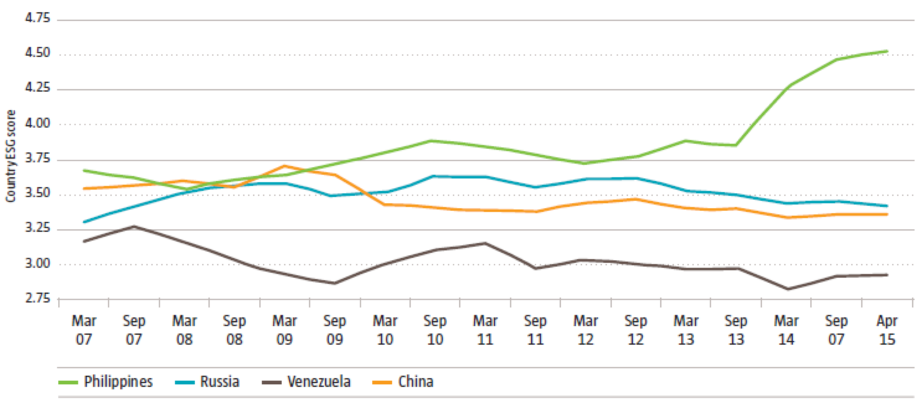
China

China (# 56), the worst performing BRIC country, exhibits poor scores across all three dimensions, with governance being the weakest. Similar to Russia, aging is a particularly weak feature, due to its aging population and the lack of a social security net. But China also scores way below average on civil liberties and accountability, while it performs much better on competitiveness. On the social dimension, rising inequality is leading to increasing social tensions. Chinese policymakers are currently trying to engineer a more balanced growth pattern, as booming investment and credit have resulted in strong growth, but have also contributed to a buildup of vulnerabilities in the last few years. However, this rebalancing is a delicate challenge with the risk of a hard landing, potentially resulting in more widespread social discontent.

Philippines' ESG profile outshines its low-income peers

When comparing ESG scores across countries, one would expect a country's sustainability profile, and in particular, its governance structure, to improve with a higher income level, as rich countries simply have more resources available to tackle sustainability challenges. However, a look at trends and cross-country comparisons within the same income group can help identify countries that use their limited resources more efficiently and achieve better sustainability performance than their income group peers. In this regard, the Philippines is a striking positive example, showing a steady and marked rise in its sustainability score (+0.66 to 4.51) and rank (from #49 to #44) since September 2013. Not only does the country have the highest ESG score among the low-income economies covered by our sustainability rating framework, but it also performs well compared with higher income level economies such as Russia (# 55) – a high-income economy – or Venezuela (# 59), an upper-middle-income economy (see also Figure 8).

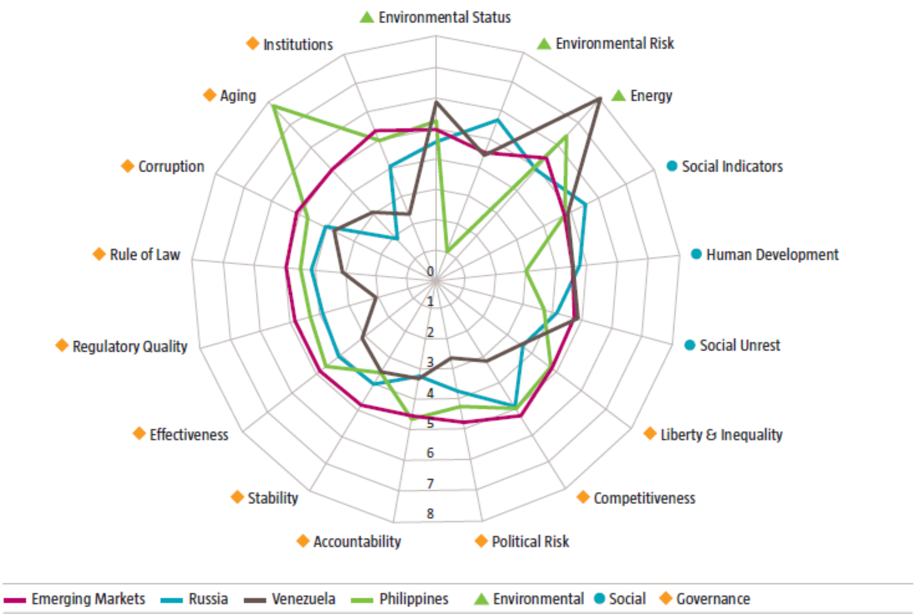
Figure 8: ESG score trend for selected countries



Source: RobecoSAM

The Philippines' governance structure is clearly the strongest pillar in its overall ESG profile. It is also what sets it apart from its low-income peers or other emerging economies such as Russia and Venezuela (see Figure 9). Still, major shortcomings persist concerning the quality of its regulations, rule of law, political risk and stability, with the latter two reflecting some ongoing unease about the prospects of peace with the Muslim rebellion movement in the southern Philippine region of Mindanao. The country shows a significantly weaker sustainability profile in the social and environmental areas, in particular with regard to social unrest, the level of human development, and, above all, its exposure to natural disasters and extreme weather conditions. The Philippines scores well on specific social issues such as child labor and gender equality. Its score is also relatively high on aging related costs. Finally, the quality of its institutions, such as the functioning of the judicial system, has improved, albeit from a modest level.

Figure 9: Comparison of selected countries' ESG profiles



Source: RobecoSAM

Due to its geographic location, The Philippines is highly exposed to natural disasters and has suffered numerous typhoons, cyclones, earthquakes and volcano eruptions during the past decade, leaving thousands of people dead and the large parts of the country's infrastructure and economy in ruins. Thus, it is all the more remarkable to see how the country's macroeconomic fundamentals have strongly improved over the last few years, a further indication of the importance of a robust governance structure for economic development.

"The country sustainability ranking provides additional insights into a country's underlying risk drivers that we believe are critical to making well-balanced investment decisions."

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