

Affirming the value of ESG in emerging market debt

When applying environmental, social and governance (ESG) factors to emerging markets, we favour a flexible approach that balances impact with opportunity.

We believe sustainability is a crucial factor for investing in emerging markets. Many countries are developing rapidly, but slow-moving key

performance indicators (KPIs) and poor data coverage can fail to capture inflection points.

We initially adopted a cautious approach to the sustainability classification of our emerging markets funds. Regulatory expectations under Europe's Sustainability Finance Disclosure Regulation (SFDR) for sovereign funds were unclear – we therefore opted to position the funds as Article 6 (having no formal sustainability scope).

With the improvement in data and evolution of market standards since then, we have begun a process to align our flagship emerging markets funds with Article 8 reporting requirements (funds that promote environmental and social characteristics). We started by reclassifying our Emerging Markets Sovereign Bond strategy as Article 8 effective September 2025. This

Key takeaways

- We believe ESG analysis is critical for emerging markets, but there are data challenges in applying rigid frameworks.
- We favour a flexible approach involving quantitative and qualitative inputs, especially for countries starting from a lower ESG base.
- To reflect our aim to support positive change in emerging markets while maintaining robust ESG standards, we aim to reclassify all three of our flagship emerging market debt funds from Article 6 to Article 8 by March 2026.



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combines with evident client interest in Article 8 fund classification.

Why Article 8 is an important fund category

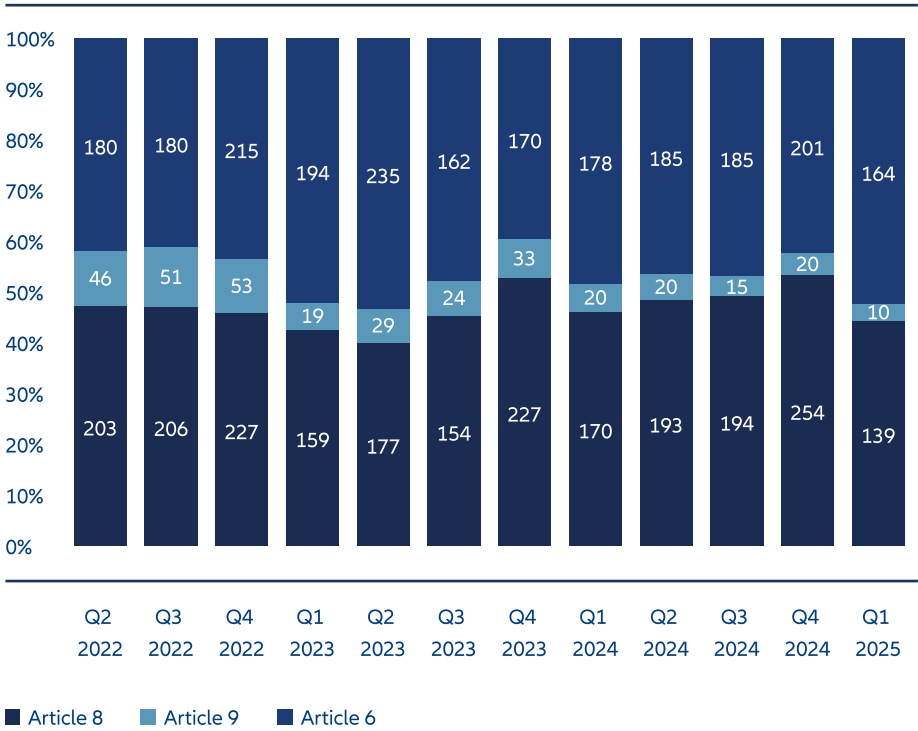
Data on recent fund launches shows that sustainable fund categories remain front of mind for many investors despite increased noise around the term ESG. When including funds labelled Article 9, the data shows significant launch activity. (Article 9 funds, known as “dark green”, have sustainable investment as their objective, while Article 8 funds are “light green” and promote environmental or social characteristics.)

For example, in the first quarter of 2025, Article 8 and Article 9 funds together accounted for 58% of funds launched in the EU, with Article 8 funds accounting for 139 of these and Article 9 funds accounting for 10 (see Exhibit 1). A sign of the success of this category is that Article 8 funds now account for 55% of assets under management in funds available for sale in the EU (see Exhibit 2).

Despite what appears to be an ESG backlash in the US, Article 8 remains the go-to for European investors. While there are different standards within the full universe of Article 8 funds, European investors appear to broadly support sustainability conviction, and an active approach to engagement and stewardship.

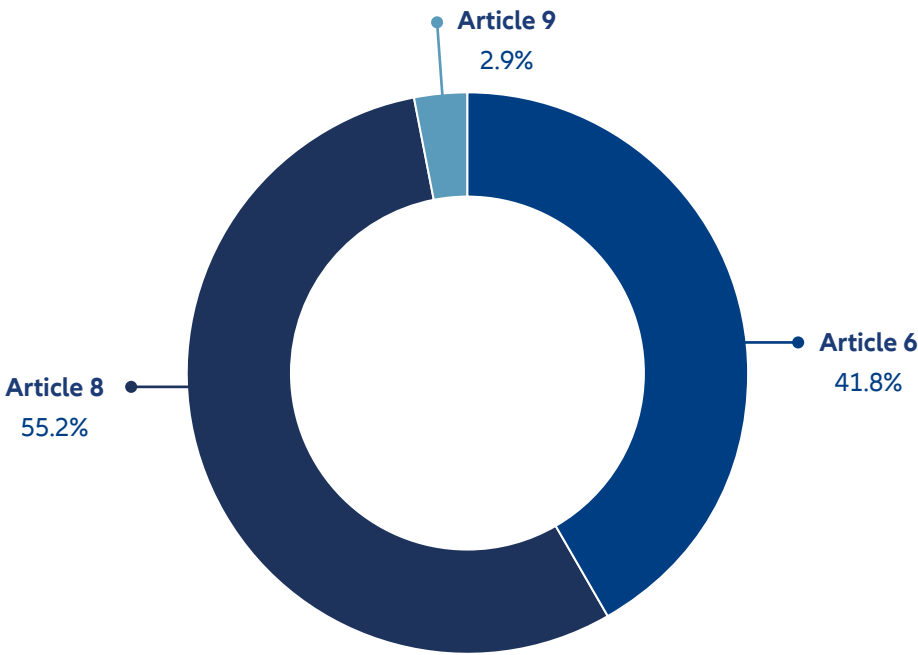
In Europe, investors continue to support ESG initiatives, maintain high levels of engagement and stewardship, and, most importantly,

Exhibit 1: Funds launched in the EU by classification



Source: Morningstar Direct as of March 2025. Based on SFDR data from prospectuses on 98% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds.

Exhibit 2: Share of assets under management by category
SFDR fund type breakdown (by asset)



Source: Morningstar Direct. Assets as of March 2025. Based on SFDR data collected from prospectuses on 98% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds.

prioritise investment managers with a clear ESG focus. Some European institutional clients have, in fact, replaced traditionally managed funds with ESG-focused peers, reinforcing the region's commitment to sustainable investing.

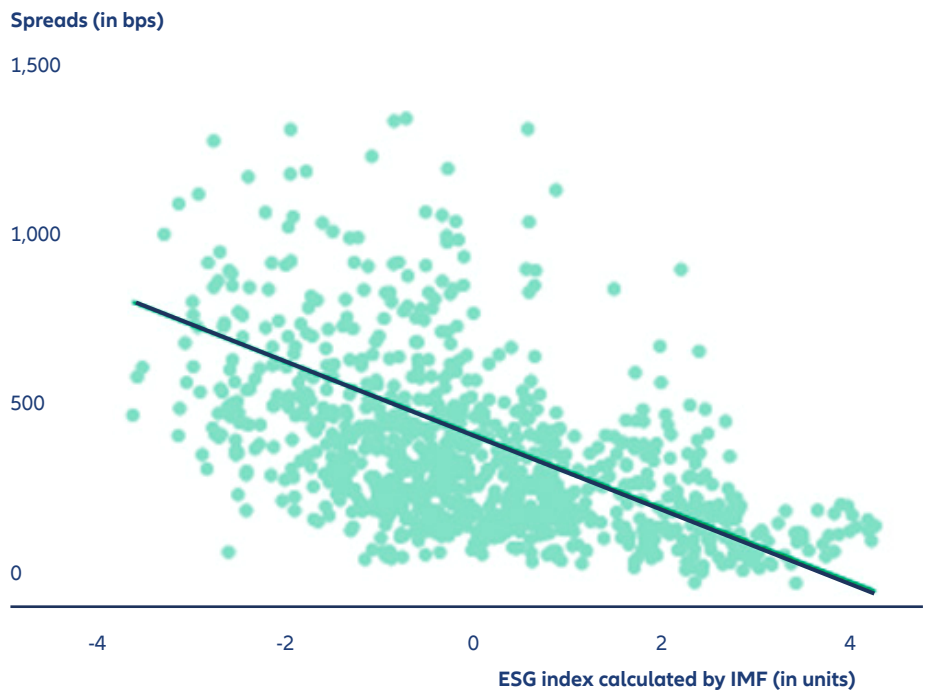
How ESG factors may affect fund performance

There have been criticisms that ESG can be a headwind to fund performance. However, we believe integrating ESG analysis is critical to investment conviction and can potentially enhance the performance of the fund.

For example, we believe improving and improved ESG scores can be linked to lowering sovereign bond spreads in emerging market countries, which can support fund performance. This has been substantiated by research including a recent working paper by the IMF (see Exhibit 3).

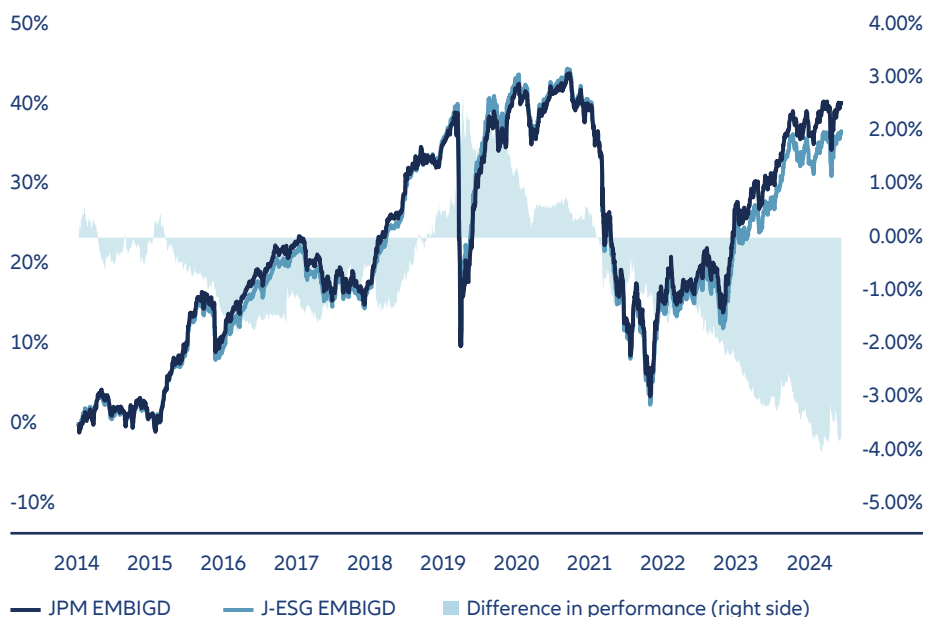
We have seen the integration of ESG factors into our investment process as contributing to investment alpha. It has allowed us to avoid deteriorating situations (including sovereign defaults) as well as identifying turnaround stories, including new governments with credible economic, social and governance plans. Some examples include avoiding the defaults of Belarus and Lebanon, among others.

Exhibit 3: Better ESG scores are linked to lower sovereign spreads, says IMF



Source: "Do ESG Considerations Matter for Emerging Market Sovereign Spreads?" Carmen Avila-Yiptong, Mahamoud Islam, Ayah El Said, Chima Simpson-Bell; International Monetary Fund (IMF). The chart is an authors' illustration. The ESG index used here is an externally calculated measurement by the IMF. A higher ESG index indicates better ESG performance. Outliers in spreads have been excluded. Excludes all observations of sovereign spreads that fall outside two standard deviations from the mean of the sample.

Exhibit 4: Comparison of JP Morgan EMBI index with its ESG counterpart



Source: Allianz Global Investors, Bloomberg, JP Morgan, as of June 2025. Past performance is not a reliable indicator of future results.

The pitfalls of relying on ESG exclusions in emerging markets

Some believe that the application of ESG exclusions can enhance the sustainability profile of a fund. However, we believe exclusions can unduly penalise certain countries and investment opportunities. This can be particularly acute for the most vulnerable and least developed economies. We prefer a more nuanced approach that allows us to identify and support transition plans to a more sustainable path, no matter what the starting point.

Exclusions methodologies often apply a relatively static list of exclusions, which reflect slow moving economic

KPIs, which are unlikely to reflect inflection points to sustainable improvements. This can impact allocations of capital towards the excluded sovereigns, further compounding the challenges to implement transition.

Supporting our investment process with “sovereign scores”

We believe our commitment to transitioning our flagship emerging market debt funds to Article 8 disclosure status is a testament to our proprietary sovereign scoring framework. The methodology under the framework ensures the vast majority of the portfolio meets a

minimum threshold, while providing the opportunity for selective investments in below-threshold sovereigns, which demonstrate improving dynamics.

ESG is fundamental to our investment approach

We believe environmental stewardship, social responsibility and good governance are the building blocks for a resilient emerging markets investment portfolio. Through active management and stewardship, we can support the most vulnerable economies in their transition, while potentially generating attractive investment returns.

Fund	Opportunities	Risks
Allianz Emerging Markets Sovereign Bond	• Above-average yield potential of emerging-market bonds, capital gains opportunities on declining market yields • Currency gains possible with share classes not hedged against investor currency • Broad diversification across numerous securities • Potential additional returns from single security analysis and active management	• Interest rates vary, bonds suffer price declines on rising interest rates • Considerably higher risk of volatility, illiquid markets and capital loss than with high-grade government bonds. The volatility of the fund unit price may be strongly increased. • Currency losses possible with share classes not hedged against investor currency • Limited participation in the potential of individual securities • No guarantee of the success of single security analysis and active management

AFFIRMING THE VALUE OF ESG IN EMERGING MARKET DEBT

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