ESG and Emerging Markets Investing

Interest in environmental, social and governance (ESG) issues is undoubtedly growing among investors, with 'ESG' assets reaching an estimated $22.89 trillion in 2016.[i] Despite this, ESG investing continues to be less prevalent in emerging markets (EM) and the bulk of ESG assets, as well as the majority of growth in ESG assets, remains in developed markets.

A study by the Global Sustainable Investment Alliance estimates that global ESG assets increased by 25% between 2014 and 2016. A continuation of this trend is supported by Schroders' Global Investor Study 2017 which found that 78% of participants felt that sustainable investing is more important to them now than it was five years ago.

There are many different types of ESG investing and various methods of assessing the ESG credentials of a specific investment. ESG investment approaches can vary from defined exclusions of specified stocks, sectors or practices, to positive screening, or a more nuanced integration at various stages of the investment process. This can include in-depth analysis and proactive engagement with companies. As ESG and impact investing become more mainstream, this is likely to encourage improvements in corporate standards globally, including in EM – where there is potentially even greater scope for growth.

With increasing attention on the importance of ESG considerations and growing public interest in this area, we take a look at some of the common questions surrounding ESG investing in EM.

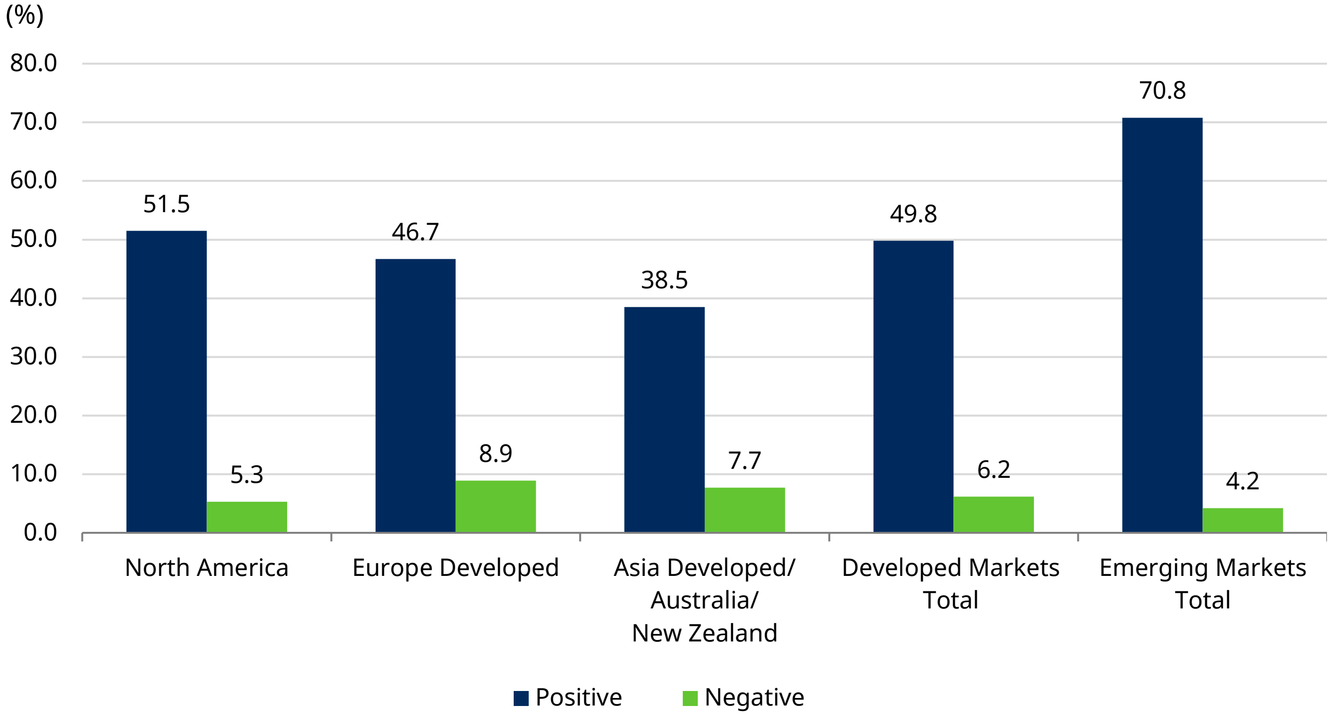
1. Does ESG matter in Emerging Markets?

Studies point to ESG investing having a particularly positive impact on returns in EM.

It would seem obvious that better run companies will outperform their peers in the longer run and that, in an inefficient market, deeper research and analysis into investments - including a consideration of ESG issues – should lead to enhanced investment outcomes. Given the relative information inefficiency of EM, fundamental research should enable investors to identify good companies which outperform. But does the evidence support the theory?

Much empirical work has concluded that ESG investing is likely to have a positive impact on returns. The following chart, taken from a meta-analysis which combined results from more than 2,200 unique primary studies released since the 1970s, shows that across all regions, the majority found a positive ESG impact on corporate financial performance. Furthermore, Figure 1 (on the next page) illustrates an even stronger positive impact on corporate financial performance from ESG investing in EM versus developed markets.

Figure 1: ESG-CFP* relation in various regions (vote-count studies samples), n=402 net studies



Source: Gunnar Friede, Timo Busch and Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance and Investment, 5:4, 210-233, DOI: 10.1080/20430795.2015.1118917. Only ex-portfolios data is shown above. *Corporate Financial Performance (CFP) measures were defined as accounting-based performance, market-based performance, operational performance, perceptual performance, growth metrics and risk measures.

Consideration of ESG factors can also contribute to risk reduction in these historically volatile markets

EM have tended to exhibit greater volatility than developed markets. Less stringent regulation, rapidly changing demographics and evolving policy environments can add to the uncertainty for EM investors. These issues are less likely to impact better managed, more sustainably run companies.

For instance, companies with stronger ESG standards may be less likely to face the financial and reputational implications of corporate controversies or fines. Companies with a focus on sustainability may be more likely to take pre-emptive actions to mitigate risks from potentially costly events such as natural disasters or litigation.

ESG analysis can provide investors with additional insight into (among other things) the material risk exposures faced by the company, the quality of a company's management, and the company's strategic positioning. The integration of ESG analysis can therefore lead to better informed investment decisions and provide a potentially higher level of safeguard against uncertainties.

Improving ESG standards can be an indicator of financial outperformance

As highlighted by a study performed by the European Centre for Corporate Engagement in collaboration with NN Investment Partners[ii], besides high absolute ESG ratings, positive changes in ratings may also result in higher relative returns by emerging market companies.

ESG scores for EMs tend to be lower, and therefore have more scope for positive momentum. In recent years, improvements in global ESG scores have tended to be led by EM. According to research from HSBC, Malaysia, Taiwan and Thailand exhibited some of the biggest positive changes in ESG scores between 2010 and 2015.[iii]

It should be noted that ESG scoring methodologies and outcomes vary by provider, a topic that we have explored previously. Relying on ratings to assess a company's ESG credentials can risk oversimplifying the issue and an understanding of the rating's criteria is essential. We believe that active investors, who are engaging with companies, will therefore have an advantage in identifying true ESG leaders and encouraging improvements in the practices of investee companies.

2. Do EM policymakers and companies even care about sustainability? If not, then should we?

Improving policies and initiatives indicate that ESG concerns are increasingly on policymakers' radar, including those in EM

Policies and practices within EM are improving. At the country level, reforms have been moving in the right direction in recent years. Urbanization, pollution, water stress and climate change are just some of the factors which are increasing the pressure on policymakers to commit to addressing environmental concerns. China and India are leading the way, with China aiming to position itself as a leader in the global push to target climate change. President Xi used his party's 2017 National Congress to emphasize efforts including the reduction of energy consumption, development of alternative energy sources and the strengthening of environmental laws and regulations. This comes in sharp contrast to the US' announcement of its withdrawal from the Paris Agreement.

Some stock exchanges are also promoting more sustainable behavior by introducing environmental, social and governance reporting standards, notably in South Africa and Brazil.

Additionally, local standards for EM investors are also getting tougher, as evidenced by the recent introduction of stewardship codes in several countries, as listed below.

Figure 2: Recent stewardship code launches in developing countries

Country	Name of Code/Principle	Issued by
Brazil (2016)	Amec Stewardship Code	Associacao de Investidores no Mercado de Capitas
Korea (2016)	Principles on the Stewardship Responsibilities of Institutional Investors	Korean Stewardship Code Council
Malaysia (2014)	Malaysian Code for Institutional Investors	Securities Commission & Minority Shareholders Watch Group
South Africa (2011)	Code for Responsible Investing in South Africa (CRISA)	Committee on Responsible Investing by Institutional Investors in South Africa
Taiwan (2016)	Stewardship Principles for Institutional Investors	Taiwan Stock Exchange
Thailand (2017)	The Investment Governance Code	The Securities and Exchange Commission

Source: Various agency websites.

Global standards are converging, and this includes EM

In the past, less stringent regulation has made it difficult to compare environmental or governance standards in EM with those of developed market companies and even with each other. Variation with regards to regulation, reporting requirements and generally accepted standards still remain across countries. However, governments and companies increasingly understand the importance of adhering to a certain level of standards.

Globalization and modern technology make it easier for companies to compete on a global level, and EM companies are increasingly looking to expand beyond their home market. Meanwhile, the spread of the internet and social media mean that reputations can be quickly destroyed, or at least, brand perception can be easily swayed. These factors increase the pressure and motivation on companies to comply with the stricter global standards.

There is a potential for accelerated growth for early adopters of improved practices

Given that EM have further to go in terms of economic development and, by definition, tend to be growing faster than developed markets, there is the potential for EM to embrace positive environmental and social solutions at an earlier stage of development and at a point when these could actually be more readily established. For instance, where infrastructure is not already in place, EM can get a head start on their developed market counterparts by creating more sustainable facilities and services in the first place.

One example is the energy sector in India. The Indian government announced that "universal access to electricity is one of the primary aims of the government, and meeting demand is a major facet of this initiative."[iv] In the process of trying to meet this growing demand, India has made a major push to replace polluting coal power generation with more 'green' energy sources. Solar photovoltaics and wind energy account for more than 90% of India's capacity growth.[v]

Investors in EM can encourage and benefit from this potential for growth in more environmentally friendly initiatives or positive social projects, which are increasingly promoted or enforced by governments, regulators and global lobbies such as environmental groups.

In the fixed income space, EM have been increasingly active in the rapidly growing green bond market. Green bonds, which are designed to encourage sustainability and the development of brownfield sites, have been issued by multilateral organisations, government backed entities, sovereigns, local governments and corporations. China led the way, issuing $36.4 billion of green bonds last year.[vi] Poland was the first country in the world to issue a sovereign green bond in 2016, and also the first country to return to the market with a second green bond in January 2018.

3. Is ESG data available for EM?

Policies are encouraging improvements in transparency

There remains a lack of universally accepted reporting standards. Historically, disclosure has been much weaker in EM and a lack of transparency has made it difficult for investors in some EM to accurately assess ESG concerns.

A report by Transparency International from 2016, which assessed the disclosure practices of 100 major emerging market multinationals, produced a disappointing average overall score of 3.4 out of 10[vii]. However, the report also acknowledges that "regulation works" and points to India as an example where the Companies Act, requiring firms to disclose key financial information on all subsidiaries, led to India achieving the highest score in this area of the assessment.

In recent years, policy changes and listing requirements have promoted improvements in transparency in EM. For instance, 2016 saw the introduction of corporate governance codes in Brazil, Egypt, Poland and the Philippines. In China, a corporate governance code by the Securities Regulatory Committee (CSRC) has been in place since 2001 and a review was announced in 2016. India's securities regulator is also undergoing a review of its governance rules as the government seeks to increase transparency across the financial system.

Furthermore, stock exchanges are playing their part in encouraging clearer reporting and disclosures and providing corporate governance recommendations. Many EM stock exchanges have increased their listing requirements and, in recent years, several EM stock exchanges have joined the United Nations' Sustainable Stock Exchange (SSE) initiative, which provides guidance on governance reporting as well as environmental and social disclosures.

Figure 3: Corporate governance codes in developing countries

Country	Name of Code/Principle
Brazil	Code of Best Practice of Corporate Governance (5th Edition) 2016
China	Provisional Code of Corporate Governance for Securities Companies 2004
Czech Republic	Corporate Governance Code based on the OECD Principles (2004)
Egypt	Egyptian Code of Corporate Governance August 2016
India	Corporate Governance Voluntary Guidelines 2009
Indonesia	Code of Good Corporate Governance 2006
Malaysia	Malaysian Code for Institutional Investors June 2014
Mexico	Código de Mejores Prácticas Corporativas 2010
Pakistan	Public Sector Companies (Corporate Governance) Rules 2013
Poland	Best Practice for GPW Listed Companies 2016
Russia	Russian Code of Corporate Governance (2014)
Saudi Arabia	Corporate Governance Regulations in the Kingdom of Saudi Arabia March 2010
South Africa	Draft Code for Responsible Investing by Institutional Investors in South Africa September 2010
South Korea	Code of Best Practices for Corporate Governance February 2003
Taiwan	Corporate Governance Best-Practice Principles for TSE/GTSM Listed Companies December 2010
Thailand	The Principles of Good Corporate Governance for Listed Companies 2012
The Philippines	Code of Corporate Governance November 2016
Turkey	Principles of Corporate Governance January 2014
UAE	Corporate Governance Code for Small and Medium Enterprises Dubai September 2011

Source: European Corporate Governance Institute and various agency websites. This is not intended to be a comprehensive list.

ESG coverage of EM is growing

In the past, a lack of ESG coverage of EM companies by research houses and ratings providers has made it harder for some investors to incorporate ESG analysis into their EM investments. However, ESG coverage in EM is growing.

For instance, MSCI now covers and provides ESG ratings for over 800 EM stocks, up from less than 300 in 2012. ESG indices such as the MSCI EM ESG Leaders Index (launched in June 2013) and the FTSE4Good ASEAN 5 Index (launched in April 2016) have also emerged in recent years.

In addition, many stock exchanges are creating listed ESG indices. For example, the Johannesburg Stock Exchange's Socially Responsible Index was launched in 2004 with the aim of encouraging alignment with global standards while also taking into account local issues and developments. ESG indices have also been developed by stock exchanges in Brazil, Indonesia, Shanghai, Egypt and Korea.

These developments are evidence of the demand for ESG investing in EM. As the wealth of ESG research and ratings available to investors grows, ESG investing in EM is becoming increasingly accessible.

While improved data helps, data alone is not sufficient – analytical interpretation is critical

Identifying strong ESG performers is challenging. There is no consistent definition of ESG investing and a company's environmental, social and governance credentials are not easily quantified.

Tick box approaches or quantitative screens may be easier to execute but can be inadequate in providing an understanding of a company's business model within the context of its operating environment.

We believe that while a quantitative approach is useful in raising awareness, a more nuanced analysis is required to paint the full picture.

4. When it comes to ESG in EM, is it only worth looking at governance?

With governance, all is not always what it seems

In the case of EM, conventional metrics of governance quality may be insufficient. Local market structure and cultural issues need to be taken into account. For instance, EM governance scores tend to be much lower than those in developed markets due to the prevalence of majority shareholders.[viii] These corporate structures are particularly common in EM, with State Owned Enterprises (SOEs) being especially common in China, the largest EM.

Large SOEs may be perceived as having their interests more closely aligned with those of the state rather than other shareholders. Similarly, family owned enterprises, which are particularly prevalent in India, may put a focus on founder shareholders.

Rather than excluding all such companies on the basis of their corporate structure, a more careful analysis can help investors to understand the business models and the motivations of management, and therefore be able to identify the better run companies in this segment.

For example, a study by UBS[ix] in 2016 found that family owned companies consistently outperformed across all regions. The research indicated that listed family owned companies combined the benefits of access to funding via capital markets with stable ownership. They therefore tended to take a long-term approach to value creation, with a focus on their core business and a preference for conservative growth. This generally resulted in better governance overall and improved stock performance.

Governance standards alone will not sufficiently capture a company's sustainability

While governance concerns can sometimes be easier to identify and more commonly understood, environmental and social considerations often require deeper analysis.

This creates an opportunity for active managers with the resources to undertake thorough research and analysis, including engagement with company management, to select those companies with the most sustainable business models.

5. Can engagement make a difference in EM?

Engagement can pick up where disclosure falls short

The typically reduced disclosure by EM companies makes engagement all the more crucial.

Furthermore, local differences across the EM universe can be vast. Engagement therefore becomes even more important in helping investors to navigate the complex landscape of these markets and achieve a better understanding of companies within their business and cultural context.

Responsible investment can drive positive development

Traditionally, investors had looked to EM for growth, possibly overlooking sustainability concerns. There is now an increasing understanding of the opportunity that investors have to encourage better ESG standards by actively engaging with investee companies.

Sustainability issues can be particularly important in EM, which represent some of the world's fastest growing populations and a wealth of natural resources. These concerns can be compounded by a lack of regulation and governance to protect individuals. EM also represent some of the countries which are most likely to be impacted by issues such as climate change, as discussed in our own Economics study.

All of this makes supporting sustainable growth in EM even more important. By engaging with companies and government bodies and by encouraging improved disclosure and more ethical practices, responsible investors can bolster positive development of EM where laws and regulations may not yet be in place to do so.

In summary

Historically, it has been more difficult to integrate ESG considerations into EM portfolios than those investing in developed markets. While challenges remain, they create opportunities for growth.

EM represents a heterogeneous set of markets. This makes it a complex and large opportunity set. The increasing availability of quantitative screens and indices is making ESG investing progressively accessible and raising awareness of the importance of incorporating such considerations into investment decisions. We believe that understanding how ESG issues may impact these markets and the relevant companies is vital and that detailed, fundamental analysis is required to develop a true insight and be able to apply it appropriately.

As the importance of ESG is becoming more widely acknowledged globally, investors who are able to incorporate ESG considerations at each stage of the investment process will benefit from these opportunities. Active, well-resourced asset managers, who are able to take a longer term view, are well positioned to do so.

In our view, engagement with companies and governments, thorough due diligence, a consideration of investments on a case by case basis, and participation in industry groups are just some of the ways that investors in EM are able to positively influence the direction of growth for some of the fastest developing markets in the world.

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[i] Data from the 2016 Global Sustainable Investment Review: http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf The Review collates results from market studies of regional sustainable investment forums. A broad definition of 'ESG' is used, including: negative screening, positive screening, norms based screening, integrative approach, sustainability themed investing, impact/community investing, and corporate engagement and shareholder action.

[ii] The Materiality of ESG Factors for Emerging Markets Equity Investment Decisions: Academic Evidence, January 2017. ESG scores are adjusted for sector/country effects prior to stock selection.

[iii] HSBC: Global Equity Strategy – 10 Reasons ESG Matters, September 2017. Data from Thomson Reuters Datastream ESG, HSBC calculations.

[iv] http://www.livemint.com/Industry/rufXYuN0JLfnyzs3gSe7gN/By-2026-Indias-power-demand-would-be-met-TERI.html

[v] http://www.iea.org/Textbase/npsum/renew2017MRSsum.pdf

[vi] https://www.climatebonds.net/files/reports/cbi-green-bonds-highlights-2017.pdf

[vii] https://issuu.com/transparencyinternational/docs/2016_transparencyincorporatereporti
The study was based on publically available data collected between November and December 2016 and measurements of transparency were based on three dimensions: reporting on anti-corruption programme, organisational transparency, country-by-country reporting.

[viii] HSBC: Global Equity Strategy – 10 Reasons ESG Matters, September 2017. Data from Thomson Reuters Datastream ESG, HSBC calculations.

[ix] UBS, Global Research: Family-Controlled Firms, 29 September 2016

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