EM equities: ESG as risk management

Lara Kesterton reveals why ESG is a valuable risk management tool in emerging-market equity investing

Environmental, social and governance (ESG) analysis has the potential to add more value in emerging markets (EM) than in developed markets (DM) since it helps to avoid companies with significant and unmanaged ESG risks, which could harm performance in the mid to long term. However, simply maximising ESG scores is unlikely to deliver the expected performance results.

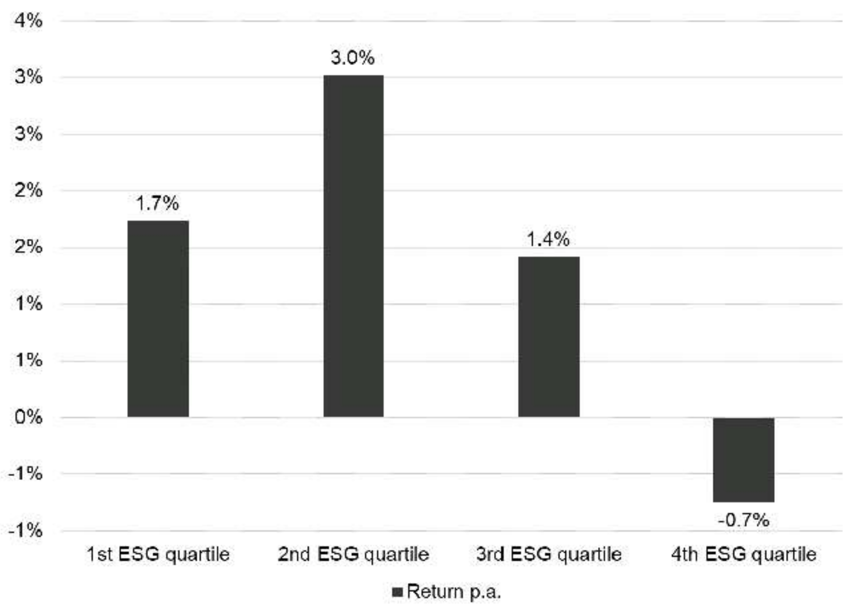
Many studies have proven that there is a higher dispersion in ESG performance in EM than in DM companies, which lays the foundation for the value-add of ESG analysis by identifying and excluding ESG laggards to the benefit of portfolio performance. This is because EM companies tend to be more exposed to both systematic and stock-specific risks from ESG factors.

EM: Lower ESG data quality but higher risks

The problems with quality, quantity and reliability of ESG data seem to translate into less reliable ESG scores in EM. This means that headline ESG scores in EM do not work as effectively as signals of risk or future performance as they do in DM. This is because there is a weaker culture of ESG reporting in EM. This information blind spot is exacerbated by weaker interrogation of corporate performance by the press and civil society. EM companies typically face less scrutiny than their DM counterparts through for example employee surveys, NGO reports, customer reviews and investigative journalism. However, change is under way with the emergence of ESG reports and new information gathering tools. Therefore, data quality is improving leaving fewer companies under the radar but there is still a long way to go to be similar to the DM playing field. We can assume that over time this will correct but for now it means the active ESG manager needs to do more homework themselves to form a more accurate picture of risk management. Our quantitative analysis showed that while in DM, one might take a best in class or top 50 per cent approach to ESG selection, in EM this could hurt performance. In EM, we found that among top performing companies excluding the worst ESG performers adds most alpha (see chart).

Furthermore, ESG risks in EM can be more acute and closer to home. Employee protections, health and safety regulations, environmental audits, product quality standards are often weaker or just less enforced. Against this regulatory weakness, companies must do much more than just comply with the law to protect against their material environmental and social risks. Similarly, bribery and corruption is more commonly endemic, as flagged by indices such as Transparency International's Corruption Perception Index. Therefore, companies need more robust practices to achieve zero corruption. In short, there is a lottery of birth – companies based in countries with weak sovereign ESG performance based on factors such as education, institutional governance, human capital productivity and natural resource management can suffer a market drag. Fragile ecosystems, prevalence of natural disasters, water scarcity, above

Chart: Excluding ESG laggards from a high-quality EM stocks pays off



Past performance is not a reliable indicator of current or future performance. The chart shows the net performance in USD of the most profitable companies within the MSCI Emerging Market Index divided by ESG categories. First, we defined the most profitable companies as those with the top 25% ROIC for the previous fiscal year within each sector (GICS Level 1 sector neutral). Next, we built quartiles based on ESG ratings within these top 25% most profitable companies. Companies contained in the 1st ESG quartile are ESG leaders. Only companies that have an ESG rating and that are within the top ROIC quartile were included. A sector-neutral approach was used. Time period: 31.01.2013 – 31.08.2020
Source: MSCI, CS HOLT, Factset, Vontobel Asset Management

average and more severe workplace safety and labour incidents are all heightened considerations in EM and may affect some companies more than others, depending on where they are located.

The 'G' in ESG separates the wheat from the chaff in EM

In this regard, governance is a particularly important pillar in EM and is commonly raised as the major differentiator between EM and DM companies. We regularly observe that how a company is governed sets the baseline of corporate culture and therefore how the company behaves towards environmental (E) and social (S) issues. Corporate governance is often the area which needs the closest scrutiny in EM for the following reasons:

- Board independence is typically significantly lower than in DM high. Therefore, special attention is needed on the quality and skill set of the board – will they be 'yes men' to the executives or rather provide good checks on management in the interests of minority shareholders and other stakeholders? A key area of concern is the rights and protections for minority shareholders, in particular where governance structures further minimises their voice. Deeper analysis of the board's track record vis-à-vis the long-term interests of minority shareholders is therefore needed. To overcome the information gaps, it is important to undertake more proprietary research and engage directly with companies.
- State-owned enterprises and family-controlled firms are more prevalent than in DM. These ownership structures are often associated with market underperformance as there is greater risk of prioritising political, social or private ends over shareholder value. Related Party Transactions are prevalent and need to be examined to see if they are on market terms in the best interests of the company and are all fully disclosed.
- And also let's not speak of EM as one uniform whole – the investor needs an appreciation of the norms and corporate governance codes of different countries. Applying strict Western thinking on what governance structures are required can blinker the investor to some attractive companies that conform to home, but not Western, governance norms.

ESG ratings must be complemented by fundamental research

Since there are considerably more weaknesses and disagreements with ESG ratings in EM than in DM, it is particularly important that investors do their own ESG research to form a robust view built up from many sources.

There are a few key elements that enable ESG to add meaningful investment value. The approach to evaluating the key ESG risks a company faces should focus on the most material issues and tailor the assessment based on deep sector knowledge. ESG should complement fundamental company analysis by a thorough investigation of real world issues that can have a significant impact on company performance. The greatest value-add is the ability to go in-depth and investigate critical issues – from allegations of forced labour in the supply chain, accounting irregularities, SOE interventions to compliance breakdowns. This often involves speaking with the company directly as well as canvassing outside opinions from accounting specialists or brokers who know the company well. Such an approach helps to fully integrate ESG in the investment case rather than being siloed thinking or simplistic adoption of external ratings.

Within the area of risk management the challenge is to learn what signal level constitutes a red flag triggering an exit of portfolio positions or barring an investment in the first place. As the reporting and regulatory landscape as well as the data evaluation tools are constantly changing, as an active ESG manager, it is important to remain committed to constant improvement and evolution while maintaining a rigorous research discipline when investing in EM companies based on ESG criteria.

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