Summary
• Pension funds' allocation to emerging markets has been low in recent years, but sustainable investment in these regions will likely be vital in the fight against climate change.
• An investment barrier is the perception that ESG discipline is poorer in emerging markets relative to developed markets, and that emerging markets feature a number of carbon-intensive industries. However, a key reason for this is that developed markets have shifted their manufacturing to developing economies.
• There have been significant improvements in data availability and quality when monitoring ESG consideration within emerging markets.
• Investors' engagement with issuers and companies is key to bringing a change in behaviour across EM.
• A bottom-up, active management approach to sustainable investing in EM is suggested. Meanwhile, looking at the MSCI EM index versus the MSCI EM ESG index, the latter returned +14.2 per cent over three years, outperforming the former by 4.9 per cent, as of end May 2023.
• Pension funds' interest in sustainable investing within emerging markets is expected to increase.

ESG and emerging markets: Not so incompatible?

Laura Blows considers why, and how, pension schemes should overcome concerns about sustainable investing within emerging markets, and how to factor ESG considerations within EM investments

"It is well established that many of the worst consequences of global warming are felt in emerging markets (EM), despite most of the emissions resulting from developed markets' activities," Ashmore Group head of research, Gustavo Medeiros, states. "It is essential that these markets receive international finance assistance to mitigate and adapt to climate change. However, such public financing has been limited and there are now calls for private finance to be actively redirected to developing economies to fund the low-carbon transition."

Meanwhile, the Church of England Pensions Board chief responsible investment officer, Adam Matthews, warned recently at the PLSA Investment Conference: "If we do not support the transition *[to sustainable investing]* in EM, we will all, every pension fund *[…]* have a more disruptive climate transition, which will have a greater negative impact on your future horizons and the landscape to which you invest in. So, you actually have a financial interest in seeing EM transition *[…]* We need to be much more innovative and roll up our sleeves to get on with it."

So, as Matthews and Medeiros say, the need is there, but is the willingness for pension funds to invest sustainably within EM, and what developments have occurred to be able to do so in these arguably more challenging regions?

EM performance

EM performance over the past five years may have dampened investor desire, averaging around 1 per cent, WTW director, head of emerging markets equity and sustainable investment manager research, Amandeep Shihn, reveals.

"But investors can sometimes forget that the term EM is a slightly clumsy catch-all term for a number of very different markets. Over the past five years the dispersion between returns between different emerging markets has been around 20 per cent, and around 40 per cent over the past three years, so there have been some opportunities for active managers to generate good returns," he adds.

"If long-term asset allocators, such as pension funds, invest more capital in ESG EM mandates, the demand for better corporate practices and EM sovereign debt issuance linked to environmental, social and/or sustainability targets will increase"

However, Premier Miton emerging markets sustainable fund manager, Fiona Manning, notes that at the start of the year "we heard a lot of optimism amongst emerging market equity managers that 2023 would be a time for EM to shine after a decade of underperformance against broader global indices".

"Whilst we have seen a better showing from EM this year, EM has not yet outperformed world markets in a sustained way. Investors have been frustrated by a weak recovery in China following the relaxation of the zero Covid policy and destabilised by persistent inflation and greater geopolitical and trade-related tensions, amid ongoing monetary tightening in developed economies," she adds.

This, coupled with UK DB pension funds' de-risking trend to reduce equity exposure, has resulted in low allocations to EM, "often sub-10 per cent, if at all", Manning states.

However, those not investing in EM miss out on "faster GDP growth, portfolio diversification and innovation. In terms of real world – as opposed to portfolio – outcomes, it also means that we risk not allocating capital in markets that will likely determine the success or failure of our climate transition", she adds.

ESG concerns

Jupiter Asset Management head of equities, Kiran Nandra-Koehrer, notes that an investment barrier is the perception that ESG discipline is poorer in EM relative to developed markets.

"Specifically, for potential reputational issues from violation of United Nations Global Compact on Human Rights (UNGC) norms, and the perceived incompatibility with pension funds meeting their own net-zero goals. We believe both of these concerns are surmountable through discerning active management," she says.

Another issue is the alignment with investors' net-zero ambitions. "While it is true that there are a large number of carbon intensive, commodity-based businesses in EM, there are also a large number of businesses that have committed or are looking to commit to a net-zero target," Nandra-Koehrer adds.

Focusing on net-zero targets, Manning notes that "there are a couple of issues to unpick" with EM indices typically having a substantially higher carbon footprint than developed market indices.

"The first of these centres around the differences in the relative stage of economic development and how we work historic carbon emissions into the equation. Fundamentally linked to this is the fact that per-capita carbon emissions in emerging economies are at levels materially below those seen in developed economies. China's per-capita emissions are half that of the US. And India's are one quarter of China's.

"Furthermore, the globalisation of supply chains that we have seen over the past two decades means that we, in developed markets, have effectively outsourced a high proportion of our carbon emissions into developing

economies as the products we consume and the inputs for those are manufactured elsewhere, predominantly in Asia," she explains.

A nuanced view is also needed when considering ESG ratings, as "it is important for investors to understand that third-party ESG ratings providers take a developed-markets-based view on ESG and governance structures when assessing ESG information published by EM companies, and so do not take local market context into consideration when applying ESG ratings to companies, such as state control or founder-led and owned businesses, which are more typical of developing markets", Shihn says.

"This lack of context will often mean that EM companies appear to be poorer on ESG metrics compared to developed market counterparts."

These differences can cause complications, Nandra-Koehrer finds. She gives the example of a Brazilian company that was making a transition from the original owners to professional management with a 10-year remuneration glidepath, "which we thought was excellent, but we were asked to vote against that because it was too long".

"Similarly, we have been asked to vote against directors in India who have been on a board of a well-run company for 15 years because that is out of alignment with the UK, whereas this is not unusual in India," she adds.

Despite the "historical false narrative" around the difficulties with ESG investing and EM, "we believe we are in the midst of a paradigm shift, with a significant improvement in data availability and quality, as well as the rise in best-in-progress, i.e. investing in companies that have been under a pall from a sustainability perspective but are key to us transitioning to a more sustainable future economy", American Century Investment head of sustainable investing, Sarah Bratton Hughes, states.

While there is still caution around sustainable EM investing, conversations are turning more positive, Redington manager research team, senior vice president, Tom Baird, agrees.

"There have been plenty of concerns around the geopolitical risks, regulatory burdens, governance issues and lack of transparency surrounding China, and amid the wider trend of de-risking from equities, the EM allocation has been often in the cross hairs. However, investors still see the diversification potential, long-term growth prospects and compelling valuations," he explains.

Investors' engagement with issuers and companies is key to bring a change in behaviour across EM, Medeiros predicts. "If long-term asset allocators, such as pension funds, invest more capital in ESG EM mandates, the demand for better corporate practices and EM sovereign debt issuance linked to environmental, social and/or sustainability targets will increase," he explains.

Implementation

Historically, sustainability reporting focused more on the philanthropic CSR activities of businesses, something that has been viewed favourably in local markets, Manning says. "However, companies are now seeing the value of demonstrating how they manage their operational ESG risks and the positive impacts that their products and services can deliver."

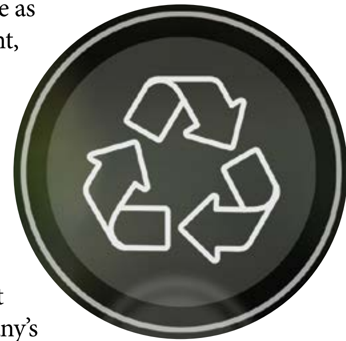
Within ESG, governance is the most widely looked at within EM investing, Baird says, looking at areas such as unusual corporate structures, Variable Interest Entities, related party transactions and government ownership.

"However, EM stands to be impacted the most by climate change and will also play a huge part in any solutions, so this is becoming an increasing focus for investors too.

"Social aspects are more often overlooked, but with several key issues being particularly pertinent in these regions – workers' rights, labour standards, product quality and community relations – the best investors have a close handle on these considerations too," he adds.

When investing sustainably in EM, Premier Miton implements a bottom-up approach that does not rely on ESG ratings. "Instead, we talk regularly to the company management and look at key data points versus peers where that is possible, encouraging companies to disclose targets and progress against those targets," Manning says.

"In terms of industries and business activities, we use the UN Sustainable Development Goals (SDGs) as our guide. This works well for us because the SDGs serve as an independent, universally agreed framework for global priorities and provide great context for the assessment of each company's exposure to sustainable business opportunities," she adds.



Nandra-Koehrer highlights the use of the United Nations Global Compact on Human Rights (UNGC).

"If a company becomes a UNGC violator during our ownership, we engage with a view to understanding the nature of the violation, its validity, and practical steps the company can take to remediate it. We believe in engaging to encourage change and would only divest if there was no probable path to remediation," she explains.

When considering the path to net zero, Jupiter categorises companies based on their disclosures and targets into five

Case study: A pension fund's view of sustainable EM investment

While EM hasn't been an area of focus for its investment strategy lately, no longer having holdings in emerging market debt, and just having some exposure through listed equities portfolios, Railpen head of sustainable ownership, Michael Marshall, states that ESG is fully integrated into the investment process at Railpen, regardless of region.

"So, there's no delay between our developed and our emerging market programmes in terms of starting to consider ESG. Railpen traces its sustainable ownership origins back to the 1990s with the publication of its first proxy voting policy in 1992," he explains.

For Marshall, the most difficult challenge when incorporating ESG into EM investment is cultural.

"How do you engage a company on a topic that is of concern to you as a Western investor but might not be a top five issue locally? How do you balance developing a long-term, trust-based relationship with a company with using your stewardship rights to hold companies to account and set a high bar? What standards do you expect in a market where corporate governance might be less established?" he asks.

Marshall expects that in the near future investors will get serious about applying frameworks (such as net-zero frameworks) to EM and will determine that middle income and frontier markets require different treatment to DM. "I also expect there to be more interest in the idea of transition finance in emerging markets," he adds.

buckets, from 'not aligned' to 'achieving net zero by 2050'.

"We've found that some of our companies that appear to be 'not aligned' are either not reporting data, not reporting in the correct format, or not aware of the need to make certain commitments. Our engagements can sometimes be the first time they have had these conversations with an investor. This low general knowledge of net zero provides significant opportunities for our active investment approach to seek better outcomes for investors seeking alignment with net zero," she says.

Benefits

Focusing on ESG matters within EM can result in significant benefits. As Manning says, "research has shown that quality and ESG quality as factors have been two of the most successful investment styles for delivering risk-adjusted returns in emerging markets".

For instance, in 2019, Jupiter's concern about the direction of travel for property rights and sanctions between Russia and the West led to it selling down its positions in Russia, fully exiting in 2020.

"We were one of 8 per cent of emerging market managers globally that had a zero weighting in Russia going into the Ukraine invasion. While we don't claim to have predicted the invasion, the consideration of material ESG issues helped the strategy avoid this permanent loss of capital; a core risk to all investors," Nandra-Koehrer says.

The Ukraine invasion is just one of numerous 'ESG incidents' that have hit asset managers in recent years, Baird notes, such as the crackdown on education companies in China and increased regulatory burdens on technology companies.

"It is no coincidence that the managers who take ESG seriously did a better job of avoiding these headwinds," he says.

The figures back this up: According to Nandra-Koehrer, looking solely at the MSCI EM index versus the MSCI EM ESG index, the latter has returned +14.2 per cent over three years, outperforming the former by 4.9 per cent, as of end May 2023.

Looking ahead

It is little wonder then that sustainable investing within EM is expected to increase.

Manning acknowledges that whilst it is true that many emerging markets, particularly in Asia, have been slower to adopt formal ESG frameworks, she says that this is now changing rapidly.

"Significant markets like China and India have announced new reporting standards, whereas markets like Brazil, which have been active in this space for many years, are seeing a resurgence in interest. Local investors, including local institutional investors, are becoming more engaged in the subject and companies are responding to this," she states.

Back in the UK, Nandra-Koehrer is starting to see a shift in pension funds' consideration of ESG issues in EM.

Indeed, a poll at the recent PLSA Investment Conference found that, while 52 per cent of the poll's respondents did not invest in sustainable assets within EM, 76 per cent responded that they intend to increase their exposure to sustainable asset classes in EM, with 10 per cent stating that they were keeping their allocation the same, and 14 per cent unsure.

It seems that when it comes to investing sustainably within EM, UK pension fund investors may now be starting to roll their sleeves up.

Written by Laura Blows