ESG Factors should be applied to the Emerging Markets – May 2019

INTRODUCTION

We recently posted notes reflecting on the tremendous increase in interest in sustainable or responsible investing.

Many clients would like responsible investing to play a fundamental role in the decisions shaping their investment portfolios. The goal is to feel that you are doing good while seeking financial returns, by supporting positive social and environmental changes.

Investment managers increasingly understand the need to accommodate *sustainable investing.* This is, in part, because surveys suggest that millennials and women are particularly focused on responsible investing, two demographics that will become increasingly active in selecting investment managers.

GENERAL RATIONALE

Applying ESG factors to investment decisions likely leads to a more complete analysis because it involves analysis that might have been overlooked by traditional approaches.

While there are significant definitional and measurement issues to applying or measuring sustainable or ESG investing, investors appreciate that certain key sustainability issues will certainly impact a company's ability to generate long-term financial returns. These include a failure to anticipate changes in environmental standards, poor governance and financial transparency and labour practice that impede retention or promotion of qualified employees.

Not all ESG risks are company-specific. Investment surveys have also identified countries with poor ESG performance that contribute to poor financial outcomes for investors and domestic companies. This could be the result of inequitable regulatory regimes, political interference or corruption, inadequate preparation for extreme weather or poor-quality financial infrastructures.

For these and other reasons, many commentators suggest that emerging economies may be more vulnerable to ESG-related issues than are developed economies. In addition, emerging market companies themselves often rate poorly on ESG measures. This may be, in part, a measurement issue resulting from managements often failing to appreciate the importance of providing useful information.

As a result, proper implementation of ESG factors into the investing process may well enhance performance or reduce volatility to a greater extent than would be the case with respect to developed markets. For instance, Blackrock has found that application of ESG factors in EM resulted in a more significant improvement than they found in DM.

And yet, ESG issues appears to be less embraced by Asia-based investors than has been the case in Europe. A UBS survey suggests that the majority of HNW investors in China are concerned that "sustainable investing" will result in lower investment returns.

Letko, Brosseau & Associates, a Montreal-based investment manager that manages our client portfolios, takes the same bottom-up approach to stock selection to its emerging markets strategies. LBA takes a long-term investment approach and believes that integrating ESG considerations into its investment decision-making as part of their mandate to deliver long-term returns. Oversight of ESG integration resides within their management committee. Its investment committee is responsible for ensuring that all material ESG considerations are incorporated into the analysis and selection of each emerging market investment.

Those fund managers applying ESG factors to EM, including LBA, have identified a number of useful signals:

- strong (or lack of), independent board oversight,
- the competence, experience and diversity of senior management,

- exposure to inappropriate political interference or involvement,
- transparency in financial reporting and with respect to related party transactions and interests,
- a commitment to global environmental and labour standards (or at least local standards), and
- preparedness for environmental disasters, damages to important infrastructure or social unrest.

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