INFORMATION FOR INVESTMENT PROFESSIONALS

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Why responsible investment has greater potential in EMs

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With more room for businesses to improve their environmental, social and governance credentials comes greater potential alpha generation, making company selection and data analysis key

The emerging markets universe has 26 countries and, arguably, environmental, social and governance (ESG) issues matter far more in these regions than in developed markets. There is more room for companies to improve and for investors to influence change, for the good of society and investors themselves. That means greater potential for alpha generation and having a positive impact. Emerging markets rely more on natural resources and have more labour-intensive manufacturing businesses, so there is naturally more opportunity for improvement.

ESG standards are also beginning to matter more. Consider the growing populations, rising middle class, urbanisation and expanding energy consumption. Clearly you need to improve regulation and governance for these economies to grow in a responsible way. Countries such as China and India are jumping ahead in terms of renewable energy adoption. India has a target of generating 57% of its energy from renewable sources like wind and solar by 2027.[1]

ESG investing in emerging markets adds value. Research from the University of Waterloo in Canada shows that the MSCI Socially Responsible Investing (SRI) Index not only ranked higher in terms of mean return than most emerging market portfolios, but also was less vulnerable to negative shocks.[2]

Finding ‘quality’

There is a huge spectrum of “quality” – defined in terms of both ESG and investment generally – but I would argue this is greater in EM than in developed markets. Quality businesses look after the interests of investors, employees and society; they manage capital responsibility and have good corporate governance. Well-run businesses can take market share away from competitors such as state-owned enterprises that aim primarily to provide employment and

[1] The Guardian, India plans nearly 60% of electricity capacity from non-fossil fuels by 2027, 22 December 2016
[2] Weber, Olaf, and Ang, Wei Rong. ‘The Performance, Volatility, Persistence and Downside Risk Characteristics of Sustainable Investments in Emerging Markets’

aren't as competitive. Additionally, there are family-run businesses which studies show tend to generally outperform. While they do not always have great corporate governance, often the family's interests are aligned with investors' interests in terms of long-term growth and avoiding risk.

Clearly, there is also a long list of bad players. While the situation is improving, loose regulations and unstable policy environments do allow bad practice to continue.

Data analysis

Our data models act as a first screen, allowing fund managers to focus their research with greater intensity. A fund manager may, for example, look at a company that the models indicate as being of lower quality but decide it is improving and that is not being picked up by the models quite yet. There is a great opportunity to generate alpha by engaging with these companies to uncover hidden value. That's where our most fruitful dialogue happens.

Columbia Threadneedle's bespoke responsible investment model has more than 250 million data points. We are also working on a platform to go alongside that with more than three billion data points. The data covers about 90% of the MSCI Emerging Markets Index and tells us if a company is making an impact or not. Even if a company doesn't publish a data point, you can infer that through machine learning by capturing related data. For instance, gallons of water used, or hazardous waste emitted. While there is still less data in emerging markets, corporate disclosures are growing quickly in response to pressure from governments and large investors like sovereign wealth funds and pension funds.

Emerging market themes

Among the themes we are interested in is FinTech, which is an exciting area because it increases financial inclusion across our markets. There are huge benefits in moving from cash to digital transactions, and this transition is happening quickly in some emerging markets and digital payments are the first step towards digital banking. While recognisable names include Alipay and Tenpay – China's payments duopoly – the likes of StoneCo and PagSeguro[3] in Brazil also enable digital payments.

Turning to renewable energy, countries such as China and India are adopting these technologies on a massive scale. Companies in solar and wind have large numbers of potential consumers. Furthermore, China has poured billions of dollars into support for electric vehicles and leads the industry worldwide.

There are also opportunities in education companies as there is a big appetite for online education services that give children in rural areas more opportunity.

The power of engagement

Engagement is important for sourcing data from companies and helping them to improve ESG practices. We make our views known and help companies to improve performance. Say, for example, you are Coca-Cola and water is a key input. Obviously, reducing wastewater improves your income statement and increases free cash flow. Collaborating with companies helps them to achieve a double win – in terms of ESG performance and financial performance.

A lot of policy makers are taking action, setting renewable energy targets as well as introducing stewardship codes. We feel that with the right team and tools there is an opportunity to influence change and be at the forefront of change. We believe it is a great time to dive in and invest in emerging markets using an ESG strategy.

[3] Mention of specific companies should not be taken as a recommendation to buy

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