ESG in emerging markets: recognising the risks and opportunities

Topic of the month February 2015

Evaluating risks linked to Environmental, Social and Governance (ESG) criteria can be difficult in the best of circumstances, but in emerging markets it is particularly challenging. The single biggest hindrance to ESG analysis in emerging markets is the limited availability of reliable information. Despite these challenges, Vontobel's Thematic Investment Boutique approach for integrating ESG does not materially differ between developed and emerging markets. The boutique, which is based in Zurich, has been investing in ESG portfolios for many years and invests independently from our New York based Quality Growth boutique.

ESG analysis: a critical component of the Vontobel investment process

As a fundamental, active asset manager, at Vontobel Asset Management we focus on identifying the individual strengths and weaknesses of the companies in our investment universe and selecting the most attractively valued stocks for inclusion in our portfolios. We developed a proprietary investment framework whereby a stock must pass four key criteria to qualify for our company universe. Figure 1 highlights these four criteria. First, above average returns on invested capital, secondly, strong industry positioning, and thirdly, attractive valuation offering a margin of safety to a company's intrinsic value. The fourth criteria measures how a company's management demonstrates leadership by successfully addressing ESG issues. We believe that effectively managing sustainability criteria is an increasingly important factor in companies' ability to post strong financial performance and maintain a leading position in their industry.

Identifying ESG issues early on

We fully integrate ESG analysis into our evaluation of each company. As well as conducting their own ESG research, our sector analysts also consider inputs from external sustainability specialists and Vontobel Group's Sustainability Management team. This helps us form a comprehensive view of the issues that are most likely to affect a company's prospects. In general, we do not automatically exclude any companies or sectors, although there are a few exceptions: we exclude from our investment universe all companies involved in making weapons of mass destruction, tobacco firms, and utilities companies whose exposure to nuclear power accounts for over 20 percent of their activity.

Objective ESG analysis ensures we make informed decisions

We adopt a targeted approach to ESG analysis, focusing on issues that are relevant to the industry in which a company operates. These issues are identified by our sector specialists and summarised in sector reports and result in a Minimum Standards Framework (MSF) for each sector. Our MSFs are checklists that enable us to assess the ESG performance of companies in each sector in a standardised, objective manner – in what can be a highly subjective area.

Figure 2 shows our MSF for the consumer staples sector. We assign each of the nine ESG factors we consider a score between 0 and 10, with 0 the worst score and 10 the best. As each MSF is sector-specific, the weights we assign

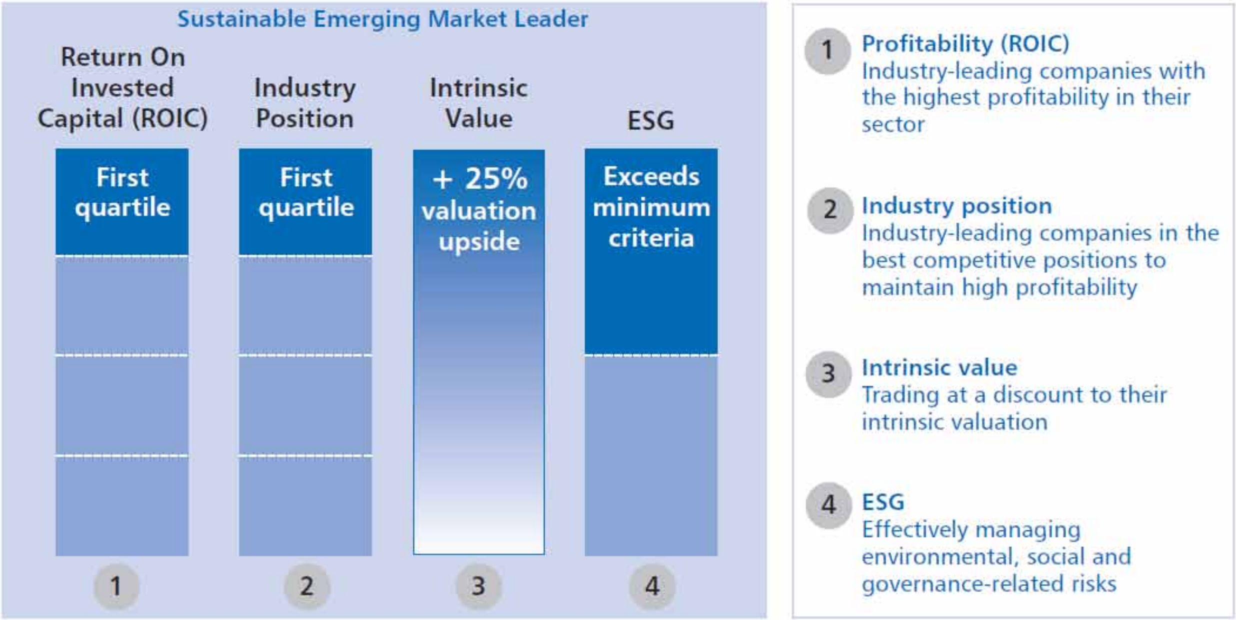

Figure 1, The four pillars of the nvestment process; Source: Vontobel Asset Management

Minimum Standards Framework 9 critical ESG factors, each scored from 0-10		
Environment	**Social**	**Governance**
Environment Management System	**Employee relations**	**Board efficiency**
• Environmental considerations integrated into key processes • Systematic targets, monitoring	• Fair compensation • Training, health & safety • Equality of recruitment	• Independent diversified board • Separation of CEO and Chair • Independent auditors
Eco-efficient operations	**Social & economic development**	**Shareholder rights**
• Emissions and water use disclosure • Waste & resource use policies	• Code of conduct • Ethical policy • Human rights	• Disclosure of structure • No anti-takeover devices • Founder privileges
Product stewardship	**Supply chain**	**Executive remuneration**
• Use of life cycle assessment • Ecological impact of products • Packaging reduction and recycling	• Responsible marketing • Health and content claims, labelling • Supplier monitoring	• Transparancy and appropriateness • Compensation models link to ESG • Independent compensation committee
Average 'E' score	**Average 'S' score**	**Average 'G' score**
Average ESG Score >5 to be investable		

Figure 2, Minimum Standards Framework for the consumer staples sector; Source: Vontobel Asset Management

to the environment, social and governance factors to obtain an overall score can vary. For example, in the energy, mining and chemicals sectors we give the environmental factors a 50 percent weighting, but for financials it is just 20 percent. We only invest in companies with good practices in the ESG criteria that are most relevant for their sector.

A company must achieve a minimum overall score of 5 to be eligible for our portfolios. We monitor all of our holdings on an ongoing basis: if a company's score falls below 5, we sell the stock within three months. While the governance criteria we consider are the same across sectors, the environmental and social factors differ slightly from sector to sector: we do not follow a one-size-fits-all approach. Our MSFs aim to define the most important factors that are likely to influence the future cash flows of companies in each sector, and as a result are an important risk management tool. The goal of our Framework is to ask the right questions as opposed to many questions.

External audit

The scoring rationale for individual companies is verified by a dedicated ESG professional who is not involved in the other areas of investment analysis to ensure that the scores are a true reflection of the company‘s ESG performance unbiased by an otherwise potentially strong investment case. This professional is an external consultant and audits the MSF. During bi-weekly meetings borderline cases are discussed and the analyst's views are challenged. Participants of these meetings are the analysts, the external consultant, and the Vontobel Head of Corporate Sustainability.

The challenges of evaluating ESG risks in emerging markets

In many emerging markets, companies are not legally obliged to disclose as much information about ESG criteria as they are in developed markets. And there can be other problems. In some cases where information is available, it is only published in the local language. In other cases the data are there, but companies do not officially disclose them as they do not realise how important they are to global institutional investors with strict ESG policies. Another issue is that ESG reporting in some emerging markets is often compliance-driven and little more than a "box-ticking" exercise, leading to lower standards and results that are not credible. Local business culture and sticking to the official party line are also contributors to this, along with a reluctance of subordinates to challenge their superiors. But on a more positive note, as more emerging market companies – and they are increasingly doing so – the better their disclosure tends to be. In some cases, such as health care companies in Brazil, they disclose more than their counterparts in the United States.

The need for proprietary ESG research in emerging markets

A direct result of the general lack of information in emerging markets is that providers of independent ESG research are somewhat limited in what they can deliver – despite the fact that some have ESG analysts posted on the ground in those markets. As a consequence, our analysts tend to conduct proprietary ESG research so that we can thoroughly assess all the companies we are considering for investment. This means that compared to firms in developed markets, we ask more questions on ESG in one-on-one meetings, during conference calls, and via email questionnaires. Building a strong relationship with companies is key, as regular dialogue helps create greater awareness of the importance of ESG issues. We seek to understand a firm's motivations and what drives the board early on in our relationship with a company as part of our engagement procedure. But lack of disclosure remains an issue in many cases, as sometimes companies simply do not respond to ESG questions. If this happens, we emphasise the importance of

our questions by involving key brokers in the informationgathering process. We may also seek to obtain information from suppliers to the company or through internet research. If there is insufficient information, we exclude the stock from our investment universe.

An improving picture

But it's not all bad news. Despite the many challenges, there have been some positive developments with respect to the availability of ESG information in emerging markets in recent years. These include:

- Listing requirements: Some countries have introduced new mandatory ESG reporting requirements. For example, South Africa and Brazil have launched responsible investment indices: the Johannesburg Stock Exchange sustainability index, launched in 2004, was the first SRI index in an emerging market. The Sustainable Stock Exchanges (SSE) initiative – a platform for exploring how exchanges, in collaboration with investors, regulators and companies, can improve corporate transparency on ESG issues – has been a big promoter of implementing such listing requirements in further countries.
- Joint ventures: Emerging market companies involved in joint ventures with parent companies from developed markets in most cases have to apply minimum ESG reporting standards set by the parent company. However, in some cases there are major discrepancies between the disclosure practices of the parent and the emerging market subsidiary. Meanwhile, multinational companies from the developed world with operations in emerging markets often inspire local companies to improve their ESG disclosure.

Vontobel's experience in emerging market ESG criteria

Vontobel Asset Management has been investing in emerging markets for many years, and in our experience we have found that there are still significant differences in the level and quality of ESG disclosure in emerging markets as compared to developed markets. We consider how companies in emerging markets approach environmental, social and governance factors separately below.

Corporate governance

We implicitly put our main focus on governance themes, which also tend to be the basis for a more comprehensive approach when it comes to environmental and social matters. The prevalence of difficult corporate structures (such as cross-holdings), family ownership, and majority shareholders are important governance issues in emerging markets. For example, 14 percent of the companies in the MSCI World have a controlling shareholder, but in the MSCI Emerging Market index this figure rises to 44 percent. With this in mind, we focus on the rights of minority shareholders of emerging market companies and how they have been treated in the past. What's more, in many firms in emerging markets the government is the majority shareholder, so free-float shareholders are exposed to government actions. Dual share-class structures are also widespread which tend to erode minority shareholder rights. Many companies in emerging markets disclose information about director remuneration and have separated the roles of CEO and Chairman. However, the level of board independence still tends to be low. A lack of clarity about nomination processes when electing members to the board is also a common concern. On a positive note, emerging market companies tend to provide less exaggerated compensation packages than many companies in developed markets. For example, in China the major banks are state-controlled and staff – including members of the management – are basically government employees and as such do not receive excessive compensation. This is good news for shareholders.

Social issues

Many emerging market companies lag behind on labour and human rights practices and reporting, and child labour can also be an issue. These are important considerations that we carefully assess in our ESG research. Corruption may also be a concern in some developing markets. While many companies have put in place an anti-bribery policy, often they do not put their policies into practice or report on their anti-bribery initiatives. The measures companies take against corruption are important factors in our analysis, as is how they train their employees to avoid corruption. Companies' consultations and involvement with the communities they are part of tend to be limited in emerging markets, which can be another problem. But there are exceptions. For example, the oil industry, which is perceived by some as a "polluting" industry, tends to be relatively proactive when it comes to investing in the communities in which it operates. This is in part because expats working within the industry need basic infrastructure such as hospitals and schools in their dayto-day lives. Ignoring social risks can weaken a company's competitive position due to increased external costs such as remediation costs in the chemical industry. Other consequences may be loss of licences to operate, boycotts, or opposition from the communities the companies are part of. This can in turn detract from a company's long-term financial results.

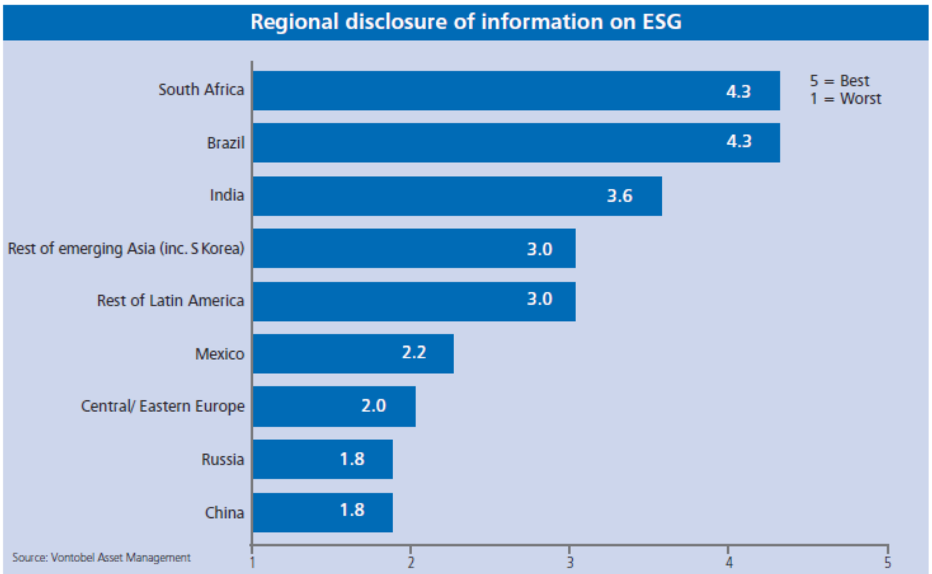

Figure 3, Vontobel analysts' assessment of disclosure of ESG information by region; Source: Vontobel Asset Management

Environmental issues & the importance of active ownership

Emerging market economies are overall more productionbased than developed economies, which means they automatically have a higher environmental impact. In our experience, while emerging market companies may issue policies or statements about their commitment to the environment, the way they implement and track the progress of their policies is often weaker than for developed market firms. Land conservation is another major challenge for many emerging markets, with serious problems including deforestation for soy and palm oil production, and major water shortages in countries such as India, China and South Africa. Such factors can have major impacts on local populations and factor heavily in our analysis. Meanwhile, major accidents can have positive long-term impacts on environmental standards by highlighting weaknesses, which can lead to stricter regulations in the future.

We see active ownership as a core part of sustainable investing, and exercising voting rights in the best interests of our clients a central part of our fiduciary duty. To maximise our positive impact, we have partnered with Hermes Engagement Ownership Service (HEOS), a responsible investment advisory service with a large team of engagement and voting specialists, to actively vote all proxies according to the policy agreed with HEOS. In addition, our analysts and portfolio managers informally engage with company management throughout our research and investment monitoring process, raising any causes of concern directly with them when appropriate. More formal engagement is carried out by HEOS on behalf of us and its other clients whenever we or HEOS identify a potential issue. Acting alongside HEOS enables us to exert greater influence than the size of our holdings would otherwise permit, and our clients also benefit from HEOS‘s specialist resources and experience.

Conclusion

Companies in developed markets have improved considerably in how they approach ESG issues and report on them, but there is still much room for improvement in emerging markets, where many companies are lagging behind in this respect. We believe ESG factors play an important role in the analysis of investments and are an integral part of our investment process. We further believe that material ESG issues can impact the future cash flows of a company and thereby its performance potential. This is even more so in emerging markets, where the potential to add value through diligent analysis of sustainability aspects is particularly valuable, in addition to being an important part of risk management. Our experience has shown that proprietary research, the ability to ask the right questions, and engagement are critical in identifying the best investments in emerging markets. As a signatory to the UN Principles for Responsible Investment, Vontobel has committed to being an active owner and to incorporate ESG issues into all aspects of our business. We believe this is important for the development of sustainable economies, societies, and the environment.

Case study: ESG reporting in China

Since 2006, Chinese companies have been covered by government and stock exchange corporate responsibility reporting requirements, with a particular focus on environmental issues. Both the Shanghai and Shenzhen exchanges have ESG guidelines for listed companies, including the requirement to report on a range of environmental, social, and governance issues in their annual reports. In 2012 there were further initiatives to improve ESG reporting, but as yet these have had little visible impact, and enforcement has become a clear issue for Chinese securities regulators recently. In general, we still find it difficult to obtain information on ESG issues from Chinese companies, although it can be similarly challenging to find financial figures. One reason is that the availability of corporate reports and announcements in English is still limited. It is much easier to obtain information on Hong Kong-listed companies than it is for Chinese A shares.This is the type of situation where our proprietary research and engagement plays a particularly important role in the ESG assessment.

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Vontobel Asset Management's Global Thematic Equities Boutique offers a comprehensive range of thematic strategies investing in Renewable Energy/Energy Efficiency, Future Resources and Environmental Technologies, as well as regional ESG strategies focusing on Emerging Markets, Asia ex-Japan and International Equities.
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