The materiality of ESG factors for emerging markets equity investment decisions: academic evidence

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Executive Summary

This report presents the results of a study performed by the European Centre for Corporate Engagement (ECCE) in cooperation with NN Investment Partners (NN IP) to understand how environmental, social and governance (ESG) factors affect share price performance in emerging markets equities and to help implement a successful ESG-focused investment policy within the asset class. This unique empirical study focuses on evaluating the performance of emerging market equity portfolios that are formed using ESG criteria. We summarize the most important findings below.

- ESG scores for emerging markets display size, sector and country (location) bias that can have implications for portfolio construction and performance. Emerging market ESG scores vary particularly across countries and sectors. Hence, using ESG criteria in portfolio selection without proper adjustments may lead to undesirable geographic and sector tilts in equity portfolios.
- When adjusted for country/sector effects, high absolute levels as well as positive changes in ESG ratings can lead to positive relative performance in emerging markets. Positive returns to absolute ESG scores is in contrast to the experience in developed markets.
- Aggregate governance ratings are a poor indicator of performance. Concentration of ownership is a better potential indicator as it gives an indication of the ability of one individual person or organization to influence company strategy.
- The exclusion of firms that have exhibited significant controversial behavior may have led to improved portfolio performance over the research period.
- Across most factors, portfolios with high relative ESG ratings in emerging markets yielded better relative returns than the similar studies found in developed markets.

Introduction

Emerging market companies are often assumed to give little or no consideration to the sort of sustainable practices that are increasingly considered an essential requirement for companies in developed markets. We believe, however, that the asset management industry has an obligation to hold emerging market companies to account on ESG factors, which will play an increasingly important role in investment decisions. This study, an ECCE-NN IP collaboration, is the first comprehensive investigation into the performance of emerging market equity portfolios formed on the basis of various ESG criteria. Academic research to date has focused almost exclusively on the impact for developed market companies. The general assumption is that while corporate governance standards and practises are important considerations when investing in emerging markets, companies and investors pay little attention to environmental and social factors and, as a result, relative returns to these factors are likely to be negative.

There are at least two reasons why studying the materiality of ESG information in emerging market equity selection is important. First, there is a growing demand for ESG portfolios that cater to investors interested in asset classes that stretch beyond global stock universes, such as emerging markets. Therefore it is important to understand how the investment performance of emerging market portfolios is affected by ESG considerations. Second, it is doubtful that evidence based on studies in developed markets will be a good guide for emerging market portfolios. Emerging markets potentially face fundamentally different ESG challenges, and companies operating in these environments can address different risks and opportunities by integrating environmental and social factors in their strategy and business models. In addition, ownership structures for emerging market companies tend to be different, and understanding the governance track record and motivations of these owners is an important factor in stock selection.

The main focus of this study is to evaluate the returns of various EM equity portfolios, each of which is formed using one of several possible ESG criteria for stock selection, in order to identify which ESG factors may or may not work in creating successful investment portfolios. Building on an earlier report, which shows ESG ratings can vary by size and sector, we normalize our study for size. We then look at sector effects. But to tailor the study more specifically for emerging markets, we also look at country influences. Additionally, the report considers the impact of a specific driver of corporate governance. And finally we look at the impact on portfolio performance from excluding companies that have had more serious breaches of best ESG practices, reflected in higher controversy scores.

Data description

This study draws on ESG data from Sustainalytics, corporate governance data from Governance Metrics International (GMI, now part of MSCI ESG Research), and stock returns data from Factset. Sustainalytics and GMI are currently the primary suppliers to NN IP of data on corporate ESG scores and underlying indicators. Sustainalytics provided us with all indicators fundamental to their aggregated ESG scores known at the start of each monthly interval running from January 2010 to October 2015. The ESG database used in this study covers all companies scored by Sustainalytics that are in the MSCI Emerging Markets index. The first date with EM coverage is September 2011, and the number of firms scored in EM increases over time from 650 in June 2012 to 751 in June 2015.

Sustainalytics also provides ESG indicators on controversial business practices ("Controversies"). Sustainalytics evaluates firms along a newly identified controversy by rating firms on a 0 ("no controversies found") to 5 ("severe controversies found") scale. Controversies refer to evidential controversial behavior of companies such as environmental pollution, bribery and corruption, human rights issues, etc.

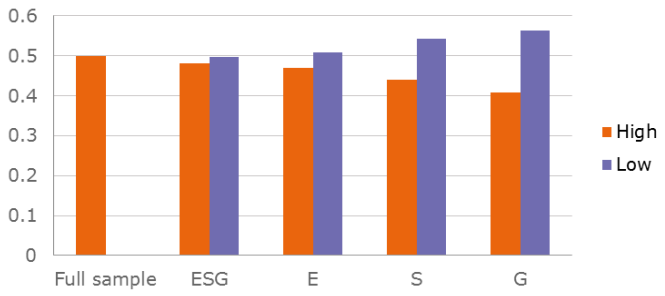
Besides using ESG data from Sustainalytics, this study uses corporate governance data from GMI as a more specialist measure of the specific building blocks of overall governance performance. This is augmented with an analysis of ownership structure and control, a governance issue that is *a priori* arguably one of the most important factors in emerging markets.

Main results

Following a similar comprehensive research study in developed markets, we know that it is important to adjust for size when looking at relative returns to ESG factors. The results in Figure 1 suggest that

the skepticism about looking at ESG in an emerging market context is well-founded. The Sharpe Ratio (a measure of risk-adjusted return) for a portfolio of low-scoring ESG stocks in fact is higher than for a high-scoring portfolio.

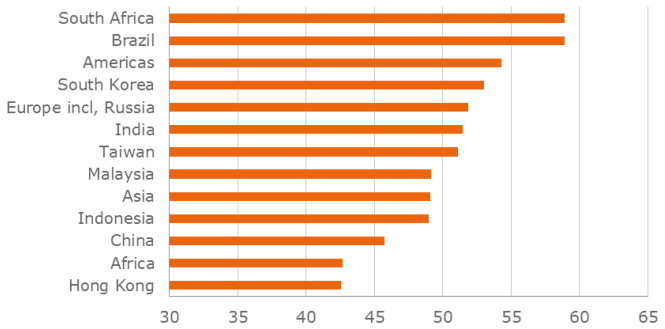
Figure 1: Sharpe Ratios - Sorting controlling for sector-size effects



Source: ECCE & NN IP Research, Sustainalytics, Datastream

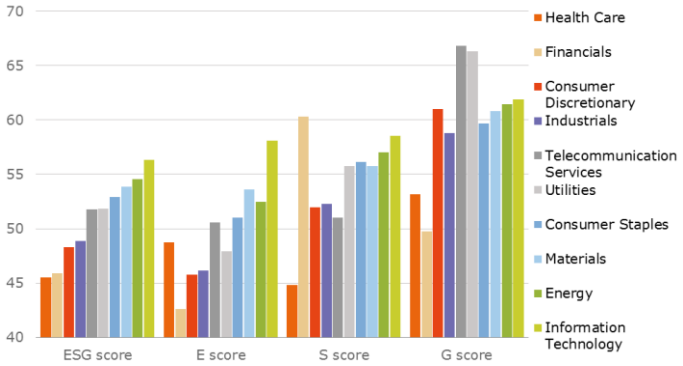
It is important however to note the systematic country effect on ESG ratings. At the top end of the scale, South African and Brazilian companies typically have high ratings, while at the bottom end, Chinese companies have the lowest ratings (see Figure 2). Cultures, regulatory regimes, ownership structures, business practices are among the factors that contribute to a different ESG approach. The disclosure of such policies is also a major factor in a company's overall rating. Analyzing ESG ratings and relative stock price performance by factor, then, will inevitably lead to strong country biases in the outcome. With large divergences between country performances each year in emerging markets, an unadjusted portfolio of high ESG stocks will inevitably have a large overweight in South African and Brazilian companies and an underweight in China. Performance would be driven by these country allocations.

Figure 2: ESG ratings differ significantly by country



Source: ECCE & NN IP Research, Sustainalytics, Datastream

Figure 3: Mean Sustainalytics ESG rating by sector

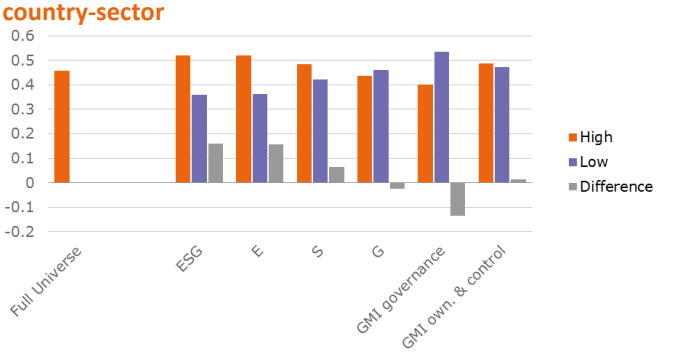


Source: ECCE & NN IP Research, Sustainalytics, Datastream

We see similar biases present on a sector basis in Figure 3. To isolate the impact of ESG factors and to better analyze the performance of ESG within a specifically EM context, we look at performance in a country and sector context by measuring the performance of high ESG-rated companies relative to low ESG-relative companies.
We can clearly see that in the time period analyzed, companies with a high absolute ESG rating have, on average, a higher Sharpe ratio than those with a low ESG rating (see Figure 4). Moreover, when we look in detail at the drivers, the higher ratio comes from both higher returns and lower volatility. By selecting companies within a particular country-sector with a high absolute ESG score, portfolios can be expected to outperform on average, with less risk.

Looking at the three separate factors, the most positive factor is "E" -- companies with a high environmental score. Social factors also show a positive Sharpe ratio. In contrast, there is a small negative when looking at the Sustainalytics measure of governance. This is confirmed by a stronger negative return under the GMI assessment of governance. However, when we look instead at ownership and control, we get a small positive variance. In our experience, it is the policy priorities and intentions of major shareholders and alignment of interests that determines whether an emerging market company's corporate governance is good or bad. This is something that cannot be precisely measured *ex ante*, although ownership structure is a better guide than formal governance policies.

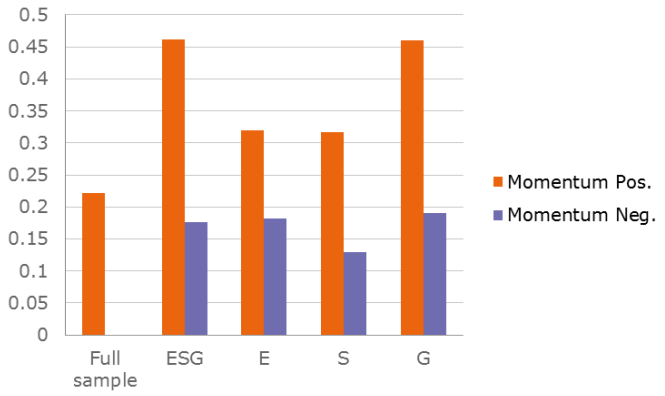
Figure 4: Sharpe ratios - Sorting stocks on ESG levels within country-sector



Source: ECCE & NN IP Research, Sustainalytics, GMI, Datastream

We then look for a link between momentum in ESG policies and share price performance. It is increasingly established that for developed market companies, the absolute score is no longer a guide, whereas the momentum in ESG rating is a good indicator of higher Sharpe ratios.
Investigating the impact on ESG momentum on Sharpe ratios for EM companies strongly appears to confirm this indeed can drive enhanced performance (see Figure 5). Moreover, positive momentum is rewarded for the aggregate ESG score and for all three component factors. If a company makes a meaningful effort to improve its ESG credentials it can, on average, expect better relative share price performance.

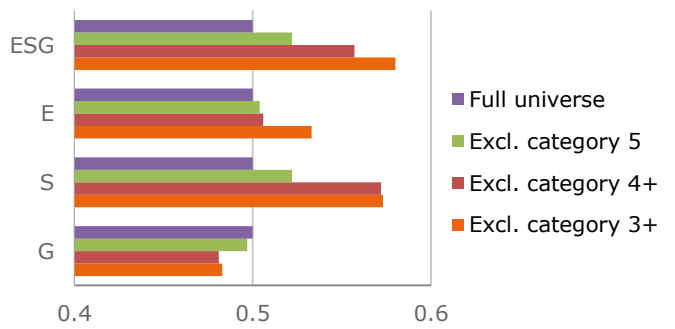
Figure 5: Sharpe ratios - Positive ESG momentum and negative-momentum portfolios



Source: ECCE & NN IP Research, Sustainalytics, Datastream

Finally, we look at the impact of "severe" to "significant" breaches of good ESG practises on share price performance – i.e., companies with high controversies. In Figure 6, we compare a portfolio that makes no exclusions with portfolios that exclude controversies of category 5, categories 4 and 5 and categories 3, 4 and 5.
We see clearly that a portfolio excluding companies at all 3 controversy levels generates superior Sharpe ratios. Indeed, whilst excluding categories 4 (high) and 5 (severe) add incrementally to the Sharpe ratio, a similar gain can be seen from excluding category 3 controversy companies.

Figure 6: Sharpe Ratios – Controversy free universe



Conclusion

This report summarizes the results from the ECCE - NN IP research collaboration into the impact of ESG factors on investment returns in emerging markets. By combining academic research practices with practical understanding of the dynamics driving emerging market we have sought to identify how to best generate positive investor returns while implementing an ESG driven portfolio in emerging markets. Taken together, four broad conclusions emerge from this study on emerging markets.

First, ESG ratings for emerging-market stocks on average display clear sector and country (location) effects. These effects can cause tilts in investment portfolios with potentially negative consequences for portfolio performance.

Second, we find that both *levels* of aggregate ESG ratings (and E & S sub ratings) and *changes* in ESG ratings help to produce "High-ESG" emerging-market portfolios that outperformed their "low-ranked" counterparts, provided that levels of ESG scores are adjusted for sector/country effects prior to stock selection. Without controlling for country effects, stocks with high levels of ESG underperformed those with low levels of ESG.

Third, the results hint that stocks selected based on high aggregate corporate governance ratings might be less capable of delivering superior performance than stocks selected on the basis of a high score for a more specific sub-rating. In contrast, the GMI sub-rating "ownership & control" was able to produce "high-governance" portfolios with higher Sharpe ratios than "low-governance" portfolios. This offers some support for the position that companies in emerging markets might be more vulnerable to governance issues stemming from disproportionate control in the hands of a few shareholders, to the detriment of firms' stock market performance.

Fourth, we find that excluding stocks based on Sustainalytics' indicators of ESG controversies improves the Sharpe ratio of an emerging-markets portfolio. The improvements mainly hold for exclusions based on environmental and social controversies rather than governance controversies. Although statistical testing in this study is hampered by small-sample issues, we found that reducing the universe to those firms without E&S controversies yielded an improvement in "alpha" that was occasionally not only economically but also statistically significant.

The results have a number of implications for investors:

1. In the pursuit of portfolios that are both environmentally, socially, and financially sustainable, it is useful to monitor both changes in ESG factors as well as levels of ESG factors, provided that levels of ESG ratings are adjusted for sector-country (location) effects. Indeed, absolute ratings levels deliver much stronger returns in Emerging Markets than in Developed Markets, and likely reflects the relatively new application of ESG considerations.
2. Aggregate governance ratings as such may be less material in comparison to specific governance issues in emerging markets. We recommend paying particular attention to issues related to the ownership structure, and potential wedges between the

ownership of certain shareholders and their control. We recommend that active research be undertaken to understand the alignment of interests for minority shareholders with controlling shareholders.

3. Excluding companies with “significant” to “severe” controversies in environmental and social factors can lead to higher Sharpe Ratios.

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About NN Investment Partners

NN Investment Partners is the asset manager of NN Group N.V., a publicly traded company listed on Euronext Amsterdam. NN Investment Partners is headquartered in The Hague, the Netherlands. NN Investment Partners in aggregate manages approximately EUR 197 bln* (USD 219 bln*) in assets for institutions and individual investors worldwide. NN Investment Partners employs over 1,100 staff and is active in 16 countries across Europe, Middle East, Asia and U.S.

On April 7 2015, ING Investment Management was renamed NN Investment Partners. NN Investment Partners is part of NN Group N.V., a publicly traded corporation.

* Figures as per 30 June 2016

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About ECCE

The European Centre for Corporate Engagement (ECCE) at Maastricht University's School of Business and Economics is the world's leading research institute on sustainable finance and responsible investing. ECCE offers high-quality research on the impact of environmental, social, and governance (ESG) standards on the pricing of assets in financial markets. Moreover, ECCE studies the different ways investors can engage with the companies they invest in.

The mission of ECCE is to develop, communicate, and promote a thought-provoking and innovative body of knowledge concerning sustainable business and finance, through high-quality research, teaching, training, international networking, conferences, and other conventional outlets. Its core purpose is to encourage an ongoing dialogue between all parties capable of contributing to sustainable development, including capital markets investors, financial analysts, corporate managers, consultants, academic institutes, governmental bodies, and NGOs.

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