



Emerging markets have long been a no-go area for many ESG investors, but it's time to think again

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For most of the history of ESG and responsible investing, emerging markets have stood just beyond the pale – both theoretically and practically. Challenges have ranged from issues with market transparency and a simple lack of data to out-and-out corruption.

As a result, many investors in listed securities have tended just to skip that part of the asset allocation. Even the more intrepid impact-focused investors out there generally avoid the public markets by turning instead to direct equity investments and microfinance, which are out of reach for most retail investors.

However, with new ESG strategies coming to market in a variety of structures, it may be time to reassess that. Exposure to broad and more targeted emerging and frontier markets – in both passive and active forms – is now within the reach of mainstream ESG investors. But from a gatekeeper's perspective, is the menu complete enough to start making credible selections?

WEIGHING IT UP

The answer lies in the criteria that is used to assess these strategies on their own and for inclusion in complete portfolios. In the past, emerging market inclusion necessitated lowering the bar for ESG. Alternatively, investors could get to it through the side entrance, relying on active managers with research-driven and quality-oriented portfolios. Indeed, many of the systemic risks that are priorities for a fundamental manager in these markets overlap with ESG criteria – the most obvious being governance, the 'G' part of ESG.

For example, a country where companies

cannot operate ethically and independently, where graft is systematic, and where the risk of fraud or nationalization hangs over the business of doing business is a bad locale for finding quality. Companies without clear executive codes of conduct, or where family interests are tightly intertwined with shareholder or lender interests, present clear risk – whether or not ESG is the guiding investment philosophy.

This is undoubtedly a barrier for governance-centric investment in equities, as well as in sovereign and corporate debt. But if you can find investment opportunities that overcome these challenges, you will probably also find environmentally, societally and economically aligned investments supported by high quality, trustworthy management teams.

The improving level of quality in many emerging markets has certainly made investors' jobs easier. Today, countries still labeled by some as emerging markets – such as South Korea and Israel – have all of the hallmarks of investable developed markets. Concurrent with these markets' moves toward maturity, data providers have also made great strides in terms of the depth and quality of the information on offer, including ESG data that can now be obtained for use in securities analysis and portfolio construction.

It is now possible, both quantitatively and fundamentally, to isolate investments that reflect environmental, social and ethical standards that would satisfy clients at home. In fact, in terms of separating the ESG wheat from chaff, the distinction between the best- and the worst-run companies is clearer in emerging markets than it is in more developed markets. However, that may mean that a well-constructed ESG strategy for emerging markets will look rather different than a domestic ESG approach.

IN OR OUT?

Even so, there are still questions hanging over these strategies. In the broad context of a

multi-asset, multi-manager ESG portfolio, is the bar still lower for emerging markets than for developed markets? Also, in the language of traditional investing, an investor would seek a risk premium over developed markets in exchange for an emerging market allocation, but is there such a thing as an ESG premium for accepting greater risk or more unknowns?

Context is everything. Is the portfolio manager delivering an objectively good standard of ESG practice regardless of the market, or is it a relative standard for ESG (out)performance within the market and among its peers?

That raises a further question. Is it even reasonable to apply North American or Western European criteria to emerging markets? Would a company that performs heroically in a market where ethics and environmental controls are in short supply, that operates more cleanly than its peers, that pays and treats its workers better, and that has a strong track record on human rights qualify as ESG-compliant even if it would not stack up as such in a developed market?

As with all things in investing, it depends. This is where gatekeepers are tasked with acting as the bridge between the expectations of their constituencies – consultants, advisors and allocators – and the realities of the marketplace.

Equally strong cases could be made for favoring best-in-class investments within individual emerging markets and, alternatively, prioritizing investments that meet the standard we would expect in a developed market. The first might satisfy the investor seeking to be exposed to investments that are demonstrably better than a weak peer universe and showing a trajectory of continuous improvement, while the second might suit the investor who wants to invest in companies that are 'good' by any standard in any market.

These choices might even result in differences in size and style. For example, larger, more seasoned companies can do more to manage optics and look more Western, but smaller, more innovative companies climbing up the market ladder may be able to create more positive change. That 'impact' may well be the sought-after ESG premium. After all, emerging markets are where ESG contributes the most – but this comes at the cost of simplicity and objectivity. ■