Manager Perspectives

ESG in Emerging Markets: More than Meets the Eye

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Although the ESG acronym is relatively new, the idea of developing a powerful franchise by looking after the interests of a range of stakeholders – beyond shareholders – has been successfully implemented for more than 100 years. In the Victorian era, a few enlightened industrialists, including William Lever (Unilever) and George and Richard Cadbury (founder of Cadbury, now Mondelez International), realized that their businesses would be better in the long run if their workers were properly housed and given opportunities for education and healthcare. Since then, many investors have discovered the benefits of ESG considerations within their investment holdings.

This is particularly true in emerging markets, where transparency around the activities of companies and governments is often still low compared to developed market peers.

Sudhir Roc-Sennett, Senior Portfolio Adviser to the Vontobel Emerging Markets Equity strategy, discusses some of the Quality Growth Boutique's insights into ESG for investors in emerging markets.

Q. *Is ESG more important in emerging markets?*

A. Sustainability and governance are just as important in emerging markets as in any other parts of the world. Finding weaknesses in companies can be particularly challenging in emerging markets where the media is less active or free and where regulators may have less incentive, or ability, to represent minority shareholders against powerful interests. On top of that, there is the added challenge in some countries, such as China, where many materials (e.g., local state filings, update reports) may only be available in local languages or hard to find.

Q. *What is your ESG philosophy?*

A. As bottom-up quality growth investors, we believe ESG issues are critical to a company's long-term success. For a company to sustain its growth, and have a chance to reach its long-term potential, its management team has to maintain a healthy balance between four core stakeholders: shareholders, employees, customers, and society. Good managers (effective governance) are key to a company's ability to navigate the many challenges it will face over time beyond the central challenge of finding and catering to demand.

With more than 25 years of experience in emerging markets, we have learned that we need to look at each company individually and in great depth. We have found that ESG risks and opportunities lie within the company and they are rarely obvious. We don't take ESG scores at face value – as deeper issues are not typically at the forefront. A company knows you will look at published data, but we dig deeper to try and unearth things a company may not want to publicize – often the information is available, but harder to find. Our three investigative analysts on the team help us with these issues.

Q. *How do you implement ESG?*

A. To turn a philosophy into a process – first, over the past 25 years we have accumulated the experience to identify a broad set of issues to look for from an ESG perspective. There are some things you can read about, but others you have to learn the hard way. We find that checking for ESG or sustainability-related issues brings a discipline as we dig through our initial bottom-up research - as well as ongoing research as ESG issues can change or surface over time.

Q. *Is ESG a developed market luxury?*

A. In our view, ESG is shorthand for sensible and sustainable, which we see as a universal need. However, the challenges in emerging markets can be different from those in developed economies. For example, we think of the core goal of an independent director ("ID") in the U.S. as primarily designed to protect the interests of minority shareholders and to play an important role in assuring investor confidence. However, in a market such as Brazil, while the number of IDs a company has can easily be found, the deeper issue we have discovered is that the primary goal of the IDs are not necessarily to look after the interests of minority investors. The Brazilian Code of Best Practices of Corporate Governance's (IBGC code) definition of an ID's role includes "once elected, all board members have a responsibility to the organization, regardless of the shareholders" .[1] From experience we have found sometimes IDs in Brazil represent a considerably broader set of stakeholders than minority shareholders, which can compete sharply with the interests of minority shareholders. As a result, the support from IDs can, at times, be less than the number of IDs alone suggests.

Q. *What type of ESG research do you do?*

A. We think ESG in research is much like safety is to driving. If you drive without using the mirrors, it does not mean you will get to the supermarket quicker or slower the first year, but with time the chances of a costly encounter rise. Our ESG analysis is not done in isolation – it's melded into our bottom-up research and plays an integral part in understanding a company and the goals of its management. A management's inclination to follow or disregard ESG best practices will not necessarily have an immediate impact on the company's performance – but over a few years, the likelihood of a negative impact becomes much greater.

Q. *Are ESG issues the same in all emerging markets? Are some markets or regions more focused on "G" than others?*

A. ESG issues vary greatly from company to company worldwide, although in some markets there will be certain consistent issues. A constant about governance is its lack of consistency, and it is constantly evolving – such as the #MeToo movement's impact on key man risk that we have seen in certain businesses. For instance, this year an accusation from within the U.S. impacted a well-known Chinese business leader: Richard Qiangdong Liu, the CEO of JD.com, the second largest online retailer in China. Investors were left questioning whether Liu was involved in illegal activity with potentially sharp downside consequences for him personally, and as a result heightened uncertainty for the company. This was magnified by the governance structure at JD.com as he holds both the CEO and Chairman roles and is the company's controlling shareholder through dual class shares.

Q. *What type of ESG challenges do you find when investing in the EM?*

A. Some of the more challenging issues to understand are where information on a company is not easily found and has to be discovered. This requires time and a certain skill set that a generalist may not necessarily have. For example, in certain cases an analyst needs to be able to read Chinese characters as well as have a good understanding of local Chinese documentation in order to get a complete picture of the financial standing of a Chinese A-share company.

It is also challenging to find evidence related to customer satisfaction where customer feedback is not captured in readily available research from third-party providers. In these cases, investors have to do their own due diligence. Our research approach incorporates extensive on-the-ground proprietary research to get a sense of a company's standing. This is necessary for us to gain the depth of understanding to underwrite conviction in the company's market position. Conviction is important for long-term holders in the emerging markets as macro outlooks can change dramatically through the cycle and confidence in the stability of an underlying company's future is important to remain invested during uncertain markets.

Q. *How do emerging markets compare to developed markets when it comes to ESG?*

A. We cannot stress enough that ESG issues are driven by management at the company level. Let's consider Germany and India: Germany has strong regulations and efficient enforcement but that doesn't mean there aren't dishonest managers at some German companies – as we have seen with VW recently. On the other hand, India may have a chaotic legal system and poor enforcement, but there are Indian companies we have been invested in for more than a decade whose governance we regard as exceptional.

Certainly advanced legal systems and a fully open press reduce the amount of abuse in a market. But the point for an investor is that ESG, or sustainability, sits at the company-by-company, and management-by-management level. Integrity and culture is of great importance at the company level. This is why ESG is part of our bottom-up analysis. It's just not a top down call for us.

Q. *What advice do you have for investors to align their values better with their investing?*

A. Different investors see ESG through different lenses. And it's important to understand managers share your goals. For us, it's about long-term sustainable growth of businesses operating in the real world that we get to know first-hand that we believe can deliver value to shareholders over the long haul.

[1] IBGC 5th edition, section 2.3 Independence of Board Directors

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