ADVISOR

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Emerging markets, the importance of ESG integration

28/05/2021 | Lorenza Roma

1. How important is integrating ESG criteria in investments and which of the letters of the acronym is the main one?

There is no good investing in emerging markets that does not have elements of ESG analysis embedded in the investment process. Historically, before the rise in popularity of the ESG acronym, investors in these markets would need to have incorporated fundamental analysis of key risks factors such as strength of institutions, rule of law, poverty and social cohesion, and other parameters, which have since become codified in ESG metrics. In our view, it is clear that the "G" – governance – factors are most important. Social or environmental risk factors may be triggers for economic and political crises that trigger asset price corrections, but countries which are well governed tend to either address the "S" and "E" risk factors sooner, and are more responsive in the event of adverse risk factor developments. It is notable, however, that the post-pandemic world is leading to world in which many countries are rethinking their social contracts through protest and electoral processes, and the "S" factors are rising in prominence for EM investing.

2. In a world increasingly aware of environmental and social issues, which is the best investment approach to reduce risks and gain yield?

Countries and companies which ignore the broader issues of stakeholders will face more difficult financing conditions and greater vulnerability to shocks. The best investment approach is to raise your level of engagement with stakeholders in the target investment markets, while incorporating high frequency social data to provide a quantitative framework to foresee risks and opportunities. Saudi Arabia, a country facing a decarbonizing world would seemingly face worsening country risk, but authorities there are taking on radical social and governance reforms to reduce oil dependence, improve social cohesion and enhance basic human rights for its population – female labor force participation since 2017, for example, has risen from 17% to 33%, nothing short of remarkable. A multi-layered approach to using ESG yields its best results as part of a high conviction, active approach to investing. The quantitative framework screens for risks and opportunities, and engagement and in-depth analysis has proven to generate substantial alpha for our portfolios. In our own investments, we would have to say that alpha generation from the integration of ESG has been as valuable as the risk mitigation from the same ESG approach.

3. Do you believe it's more important to integrate an ESG analysis on EM rather than developed markets? Why?

Yes! There is a high correlation between lower yields and better performance on ESG metrics, mostly attributable to governance performance. As you move to lower rated countries, invariably weaker and more volatile economic performance is almost invariably married with weak institutions, corruption, political risk, weaker education and health. However, as mentioned earlier, the pandemic has led to a welcome, major re-thinking in developed markets, too, on our social contract and approach to climate change. We cannot rule out surprises, but we think for every risk, there will be an opportunity. In our own investments, we would have to say that alpha generation from the integration of ESG has been as valuable as the risk mitigation from the same ESG approach.