COLUMBIA THREADNEEDLE INVESTMENTS

Why responsible investment has greater potential in emerging markets

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An interview with **Young Kim** and **Kyle Bergacker** looking at the case for ESG integration, company selection and data analysis

Q: What is the case for environmental, social and governance (ESG) integration in emerging markets?

YK: The emerging markets universe of the MSCI Emerging Market Index (EMI) has 26 countries, and I would argue that ESG matters far more in them than in developed markets. There is more room for companies to improve and for investors to influence change, for the good of society and investors themselves. That means greater potential for alpha generation and having a positive impact.

KB: I agree. Emerging markets tend to rely more on natural resources and have more labor-intensive manufacturing businesses. So there's naturally more opportunity for improvement.

YK: ESG standards are beginning to matter more. Consider the growing populations, rising middle class, urbanization and expanding energy consumption. Clearly you need to improve regulation and governance for these economies to grow in a responsible way. Countries like China and India are jumping ahead in terms of renewable energy adoption. India has a target of generating 57% of its energy from renewable sources like wind and solar by 2027.[1]

Q: Does empirical research show the potential for adding value through ESG integration in emerging markets?

KB: Many emerging market-related academic papers show just that. For instance, a researcher from the University of Waterloo, Canada, published a paper a few years ago showing that the MSCI Socially Responsible Investing (SRI) Index not only ranked higher in terms of mean return than most emerging market portfolios, but also was less vulnerable to negative shocks.[2]

Q: How do you find the companies that represent "quality" in terms of ESG and are making improvements?

YK: Step back and you see a huge spectrum of "quality," defined in terms of both ESG and investment generally. I would argue a lot more so than in developed markets. The quality businesses look after the interests of investors, employees and society; they manage capital responsibly and have good corporate governance. Well-run businesses can take market share away from competitors such as state-owned enterprises that aim primarily to provide employment and aren't as competitive.

Additionally, there are family-run businesses. They tend not to have great corporate governance, but we believe that often the families' interests are aligned with investors' interests in terms of long-term growth and avoiding risk.

There are bad players as well, of course. The situation is improving, but loose regulations and unstable policy environments mean that bad practice does still persist.

Q: What role does data analysis play in selecting companies?

KB: Our models act as a first screen. They allow Young to focus his research with greater intensity. He might look at a company that the models are indicating as lower quality but decide it is improving, and that is not being picked up by the models quite yet. Young has a great opportunity to generate alpha by engaging with these companies to uncover hidden value. That's where our most fruitful dialogue happens.

Q: Is there enough data disclosed to build your model?

KB: Yes. Columbia Threadneedle's proprietary responsible investment ratings model draws on more than 250 million data points. Other complementary models we have in development draw on more than 3 billion data points. The data covers about 90% of the MSCI EMI and tells us if a company is making a real socioeconomic impact or not. Even if a company doesn't publish a data point, data can be obtained via machine learning approaches; for instance, gallons of water used, or hazardous waste emitted. While there is still typically less data produced by companies in emerging markets, corporate disclosures are growing quickly in response to pressure from governments and large investors such as sovereign wealth funds and pension funds.

Q: Can you give examples of investment themes you like?

YK: FinTech is exciting because it increases financial inclusion. There are huge benefits in moving from cash to digital transactions, and this transition is happening quickly in some emerging markets. You will likely have heard about Alipay and Tenpay, China's payments duopoly. Some more examples in Brazil, StoneCo and PagSeguro,[3] both enable digital payments. Digital payments are the first step toward digital banking.

Turning to renewable energy, countries such as China and India are adopting these technologies on a massive scale. Companies in solar and wind have large numbers of potential consumers. Furthermore, China has poured billions of dollars into support for electric vehicles and leads the industry worldwide.

KB: I would add the opportunities in education companies. There is a big appetite for online education services that give children in rural areas more opportunity.

Q: Does engagement make a difference?

YK: Engagement is important for sourcing data from companies and helping them to improve ESG practices. We make our views known and help companies to improve performance. Say, for instance, you are Coca-Cola and water is a key input. Obviously, reducing wastewater improves your income statement and increases free cash flow. Collaborating with companies helps them to achieve a double win—in terms of ESG performance and financial performance.

Q: Why is now a good time for ESG investing in emerging markets?

YK: A lot of policymakers are taking action, setting renewable energy targets as well as introducing stewardship codes. We feel that with the right team and tools there is an opportunity to influence change and be at the forefront of change.
We believe it is a great time to dive in and invest in emerging markets using an ESG strategy.

Sources:
1 Michael Rafi, "India plans nearly 60% of electricity capacity from non-fossil fuels by 2027." The Guardian, December 22, 2016.
2 Weber, Olaf, and Ang, Wei Rong. "The Performance, Volatility, Persistence and Downside Risk Characteristics of Sustainable Investments in Emerging Markets." ACRN Oxford Journal of Finance and Risk Perspectives 5 (2): 2016, 1–12.
3 Mention of specific companies should not be taken as a recommendation to buy.

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