ESG integration in emerging markets investments

Some EM countries are making strides in addressing ESG considerations which can help mitigate risk but also offer improved earnings and stock appreciation. In recent months, the Russian war, and regulatory changes in China have reminded investors that EM companies may still be subject to external macro governance risk.

Third-party data providers, such as Sustainalytics, ascribe ESG risk to a higher level of companies in the EM index than in the US, or ACWI ex-US index. There are two main reasons.

One is that EM companies don't disclose specifically in the way that these third-party data providers are asking them to disclose information, which in some cases leads to a negative rating, even though they might provide the information in a different format. This creates space for active management to step in, do the analysis and add value.

The second reason is the more obvious one. Corporates operating in emerging markets have been slow to embrace best practices around ESG in general. There certainly are EM countries that have been leaders in adopting ESG. Some Latin American countries stand out in this respect, such as Mexico and Brazil, while China and others have been slower. Emerging markets also appear to carry a higher ESG risk because of macro externalities.

However, outside of macro risk, progress is evident. In our emerging markets portfolio, 90% of our holdings file sustainability reports. A couple of years ago, the percentage filing would have been substantially lower. The level of disclosure varies from country to country.

Perhaps surprisingly, some of the highest-scoring ESG companies in our portfolio were based in Russia. Some corporates in Russia knew that they had the headwind of a government system that didn't provide the level of transparency that most global investors would want and therefore, took it on themselves to provide more transparency and to be ESG leaders.

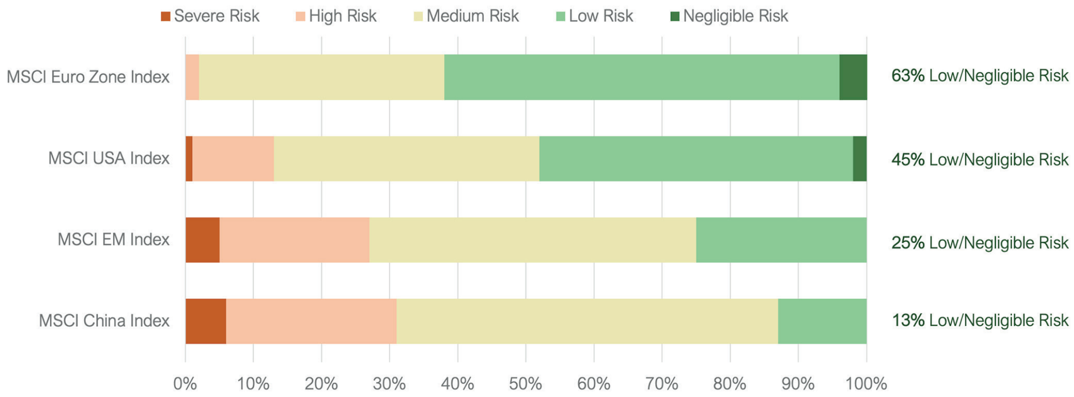
Some of the most aggressive GHG reduction targets, and most efficient operators in the resource and extractive resource industries are Russian and many have been filing sustainability reports for more than a decade. Although we exited our Russian positions before the war broke out, the companies that we held are experiencing windfall profits because of the geopolitical situation and their operational efficiency.

Corporate approaches to material industry issues make the difference

In Latin America, Mexico and Brazil are the standouts in the region for ESG awareness. The Rio de Janeiro Stock Exchange has created the Novo Mercado, which requires higher standards around governance and other aspects of sustainability for listings. This type of forward-looking market segmentation will help to shine a light on the leaders and bring some of the SOEs along.

One such SOE is Petrobras, which has had corporate governance issues, especially when the government has intervened around fuel pricing. Over the last few years, it overhauled its board-level oversight substantially to bring in truly independent directors. The Board of Directors is now personally liable for any economic damage inflicted upon Petrobras related to fuel pricing.

Emerging markets appear to carry higher ESG risk
Sustainalytics ratings band by region



Source: FactSet and Sustainalytics; as of 31 December 2021

The company has strengthened its pricing mechanisms and is moving local prices closer to global prices in a normal way. This shows how the company went from being almost a zombie extension of the government to a true standalone entity that's thoughtful about capital allocation and with good oversight.

Another example is an online investment/brokerage firm in Brazil. It is a tech-based company and is offering its own product and competitor investment products through its platform, with low to zero brokerage fees. It is also concerned about diversity in the workplace, ensuring that work-life balance is good, and providing health benefits to employees. This company went public in 2019 and has been delivering excellent results since then.

Understanding how a commodities company approaches material issues such as pricing or a service company approaches retaining staff really helps identify those that are likely to outperform. There are also good companies that are trying to do the right thing, but where some improvement is needed.

An example is an Indian bank, which had issues on and off for the last ten years with credit risk management. Periodically, there was a spike in NPL formation, especially on the corporate side. Along with other shareholders during the 2016 to 2017 period, we tried to communicate to management the importance of market confidence in the way the bank managed its credit risk, and the need to take this seriously. Given the position within the market, the bank was underperforming.

The bank revamped the credit risk management process and brought in new management to oversee that. At the same time, banks had help from the Indian government, which tightened up the legal framework so that it became easier for Indian banks to recover assets in the event of bankruptcy. Those two things allowed them to reduce their bad loan provisions.

ESG considerations need to be integrated into EM stock selection

ESG considerations are an extension of our stock selection process and help us identify good investment opportunities across emerging markets. ESG extends the way that we analyze a company beyond traditional financial analysis, which is, in our view, quite a narrow way to think about the company and how it drives its business. ESG considerations help to extend perspective on a company's impact on customers, local populations, and all stakeholders. Why that's important is not just because we want our companies to do the right thing.

We want them to be good stewards of the resources at their disposal, which is often a reflection of how they manage their business overall. If company management is thoughtful about ESG issues in general, it is likely also careful about how it allocates financial capital, and how it thinks about acquisitions and growing human capital. These are all things that can lead to better financial performance over time, which ultimately should drive share price performance. In many cases, doing the right thing for ESG reasons brings good financial planning as well.

Charles Wilson
PhD, is a Portfolio and Managing Director at Thornburg Investment Management.

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