Sustainable investing

Sustainable value creation in emerging markets

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• Emerging market (EM) equities offer investors a good opportunity to add value to their portfolios by incorporating environmental, social, and corporate governance (ESG) considerations into their investments.

• The range of sustainability profiles within the EM equity universe is particularly wide. This may help explain why selecting companies based on their ESG characteristics has proven valuable in recent years.

• We recommend investors add exposure to the MSCI EM ESG index; the index is trading at attractive valuations relative to its parent index and has higher expected forward 12-month earnings growth. Higher ESG standards should also help reduce exposure to tail risk events.

Emerging markets late to the sustainable investing game

Until recently, sustainable investing was largely a matter for developed countries. The discipline, which is best established in Europe but has caught on in Australia and North America too, is not as popular among investors in emerging markets (EM). Also, investors in developed countries have found it difficult to find satisfactory sustainable investment (SI) solutions that provide exposure to EMs. Both aspects have begun to change. Demand for SI is increasing in EM investor circles. At the same time, investment vehicles to invest sustainably in EM have been multiplying.

We believe that this is an encouraging development, as we see an interesting opportunity for investors seeking to integrate environmental, social, and corporate governance (ESG) considerations into their portfolios. As we have argued elsewhere (see “To integrate or to exclude: approaches to sustainable investing”, July 2015), investors with interest in SI strategies often fear that such approaches will lead them to sacrifice performance. In fact, the balance of evidence suggests that there is no tradeoff between SI and performance in developed markets. Based on the limited available evidence, EMs may even offer the most compelling opportunity to include ESG considerations while adding value to the portfolio.

Related publications

• Doing well by doing good: impact investing, published in May 2016
• Bond markets: Green bonds are investable, published in April 2016
• Bond markets: More green shoots for Green bonds, published in December 2015
• In challenges lies opportunity, published in September 2015
• To integrate or to exclude, published in July 2015
• Adding value(s) to investing, published in March 2015

Source: UBS

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Based on our analysis, we expect a low-single-digit outperformance of the MSCI EM ESG index versus the broader MSCI EM index over the next 12 months. An important driver is the observed pattern of outperformance by EM companies with higher sustainability characteristics relative to the broader index (see Fig. 1). This conclusion is also supported by better expected EPS growth and an attractive relative valuation. In our view, the expected outperformance combined with a low tracking error to the parent index provides an attractive investment opportunity. Longer term higher rated ESG companies should expose investors’ portfolios less to tail risk events (black swans) due to a lower level of stock-specific risk.

ESG investing is relevant in EMs

EMs face major challenges in the coming decades, including a rapidly growing population, in particular in Africa and Asia, continuing urbanization, and a growing middle class that will have sufficient disposable income to match the purchasing power of higher income countries today. All this puts stress on resources like water, food, and energy, as well as waste management, and may result in increased environmental and social risks in these countries. Unsurprisingly, the World Economic Forum rates a water crisis as the primary global long-term risk, followed in descending order by the failure to mitigate climate change, extreme weather events, a food crisis, and social instability. The challenges outlined above certainly create opportunities (see Doing well by doing good: impact investing, 29 May 2016), but could also translate into higher investment risk. On top of that, less strict corporate governance rules in EMs often make it hard to quantify risks and opportunities.

In this report, we look at the question of whether the integration of ESG factors can add value in EM portfolios. We start with an analysis of the effect of an ESG integration approach to investing in EM equities and then provide a traditional investment analysis based on valuation and earnings growth.

Integration of ESG factors works in EM portfolios

When considering SI, investors often ask whether it may hinder financial performance. As we alluded to in the introduction, integrating ESG analysis in the investment approach is helpful to avoid investing in EM companies with high risk exposure to ESG issues and thereby reduce tail risk in portfolios. While most ESG-related studies analyze the difference in performance of listed equities in developed markets, so far, EMs have hardly been covered. This is mainly due to the more limited availability of data in emerging markets and shorter time series. In the following section, we present the effects of ESG integration in EM portfolios based on our own analysis and some of the few external studies we found on this topic. In sum, we believe that investing in companies with a higher sustainability profile within EM should lead to outperformance as they offer higher EPS growth, lower investment risk, and attractive valuations.

Fig. 1: MSCI Emerging Markets ESG Index shows strong outperformance
Cumulative index performance, indexed to 100 (gross performance, base currency is EUR, 1 October 2007 – 30 December 2016)

Source: MSCI, UBS, as of December 31, 2016

Box 1: How does the index work

The MSCI Emerging Markets ESG Index is based on the MSCI Emerging Markets Index, its parent index. It relies on the ESG rating methodology of MSCI ESG research. This methodology provides companies with a rating between AAA and CCC that combines their performance along a variety of ESG dimensions. For the index construction, a best-in-class approach is applied that targets the same sector and country composition as the parent index, but limits positions to companies with the highest rating representing 50% of the market capitalization of each sector and region. Based on our analysis, the MSCI EM ESG index’s sector and country under- and overweights compared to its parent index are within the range of two to three percentage points at the time of writing.
Why ESG investing can be good for your EM portfolio

For our analysis we use the MSCI Emerging Markets ESG index. The index was launched in June 2013, but MSCI provides back-tested data from October 2007 (see fig. 1). A first analysis of the index underlines the importance of ESG integration in EMs. The MSCI Emerging Markets ESG Index clearly outperformed the MSCI Emerging Markets Index over the entire period (incl. back-testing) and since its launch (live trading since June 2013).

In a second step, we seek to understand what is driving the out-performance. For transparency reasons, we use only three years of historic data in our analysis, so as to mainly focus on the index’s live trading performance.

The aim of our analysis was to identify the factors responsible for the sizeable outperformance of the MSCI EM ESG index between May 2013 and May 2016. During this period, it outperformed its benchmark, the MSCI EM index, by 14.42%, achieving a total return of 15.11% versus the benchmark’s 0.69%. We derived the return attribution using the Barra Portfolio Manager model. Fig. 2 shows the detailed performance attribution, while fig. 3 presents the same result as a time series. As you would expect in a multi-country and industry index like the MSCI EM ESG, there are country, industry, currency, and risk factors that lead to return deviations compared with the parent index (MSCI EM). Whereas country, industry, and currency factors are very intuitive (e.g. a country or industry over-/underweight), the risk factors deserve some explanation. In the Barra model, different style components that can impact performance – such as size (e.g. small, mid, or large cap companies), growth, momentum, or liquidity effects – are summarized as risk factors (in total, the risk factors comprise 18 potential return sources). As the return attribution to risk indices is only a small part of the total active performance (1.51%, see fig. 2) and several elements within the risk factors are responsible for return (some make a positive, some a negative contribution), we interpret this as a normal outcome in a multi-country/industry index.

However, while well-known (common) factors have a positive return impact of 3.52% (see fig. 2), non-systematic, specific factors contribute by far the most to the active return (outperformance). Specific factors are responsible for 11.33% of the outperformance (see fig. 2). It is also interesting to note that the specific outperformance happened gradually over time and was not a one-off event (see fig. 3), which we see as a very positive characteristic. Aside from applying the Barra model, we also conducted our own analysis, controlling for the country factor. The results confirmed the outperformance of the MSCI EM ESG index.

Fig. 2: Active performance attribution in detail
MSCI EM ESG versus MSCI EM (both indices in EUR; time period: 2 May 2013 - 31 May 2016)
The key questions of course are: what’s behind the specific factors, and can we conclude that the significant outperformance is the result of ESG integration? Statisticians would immediately say that the time period is too short to draw a proper conclusion; however, considering that most of the outperformance is driven by specific factors, it makes sense to drill a bit deeper. Using a number of specific examples, we will show that, despite the short time period, ESG integration together with traditional analysis adds value in EM equities. Based on MSCI data, Samsung Electronics, one of the heavy weights in the MSCI EM index, wasn’t included in the MSCI EM ESG index during the investigated period; Gazprom was also excluded. Both companies have ESG issues, in particular in the governance area, and the exclusion of Samsung resulted in a 1.7% contribution to the outperformance of the MSCI EM ESG index. Meanwhile, Taiwan Semiconductor Manufacturing (a company with a high ESG rating) was weighted more heavily during this time period in the MSCI EM ESG index, which added 0.68% to its outperformance. The exclusion of PetroChina and Hyundai Motors from the MSCI EM ESG index, two stocks with weaker ESG ratings, led to a contribution to the outperformance of 0.25% in the case of PetroChina and 0.24% in the case of Hyundai Motors. PetroChina was affected by corruption investigations that resulted in several arrests. Hyundai Motors has a weak corporate governance profile; one family keeps control of the company through a web of cross-holdings despite only having minority shareholdings.
The outperformance of the MSCI EM ESG index has also been the subject of research reports by other institutions. Risklab, an investment and risk advisory expert (part of insurance Group Allianz), sees one possible reason for its strong outperformance in the larger dispersion of high and low ESG performers in the EMs compared with the developed markets (source: Hörter, S. (2015) ESG in Equities). Comparing the availability of ESG disclosures from emerging and developed market companies, we found that the percentage of companies in EMs disclosing relevant ESG indicators is lower (see fig. 4) but has been increasing. Another interesting aspect was highlighted in an earlier study by Hörter, which showed that optimizing a portfolio on the basis of ESG factors can lower the tail risk measured as conditional value at risk (CVaR) by 40% – from -64.5% p.a. to -38.8% p.a. (source: Hörter, S. (2011) Responsible Investing Reloaded - Sustainability Criteria Matter). Sustainability specialist RobecoSAM’s 2016 Sustainability Yearbook also provides interesting insights, including a ranking of global industry leaders in sustainability and high ESG performers (see fig. 5). While the number of so-called sustainability leaders is far lower in the EMs than in Europe, there are almost as many in the EMs as there are in North America. This supports Hörter’s view that the outperformance of the MSCI EM ESG index is possibly driven by the fact that the EMs feature a wider spectrum of corporate performance in terms of ESG than the developed world does.

Governance as a key driver
Another interesting analysis was published by fund manager Hermes, which investigated the impact of ESG factors on global equities, as well as the impact of each factor on performance. The analysis of MSCI World companies between 31 December 2008 and 30 November 2013 showed that high ESG performers tend to outperform companies with negative characteristics. Companies with weak corporate governance in Asia/Pacific ex-Japan underperformed the broader market by around 0.6% per month over this period; in North America, Japan, and Europe, this factor had a much smaller impact (source: Hermes Investment Management – ESG investing, January 2014). This further highlights the importance of the ESG analysis in EMs where regulation is less robust than in the developed world. Consequently, EM companies with higher corporate governance standards may enjoy a relative advantage in the coming years as regulation is set to continue to tighten.

Attractive valuation and EPS growth
Aside from considering the benefits outlined above of integrating ESG analysis as an investment approach, attention should of course also be paid to the question of timing. To be able to better answer this question, we used a longer time series, this time including the back-tested period, for the valuation analysis. The latter is thus based on valuation data for more than nine years. During this period, the MSCI EM ESG index traded on average at a 9.1% premium (on forward P/E) to the broader MSCI EM index (see fig. 6).

Source: MSCI ESG Research, UBS, as of 31 December 2016

Note: The RobecoSAM 2016 Yearbook looks at companies’ sustainability performance in 2015 and ranks them based on their sustainability scores. The top-performing company from each of the 59 industries is named the RobecoSAM Industry Leader. The rest of their industry peers are ranked in the ‘silver’ and ‘bronze’ classes. The top-performing company is awarded a gold medal, the second best gets a silver medal, and the third and fourth get bronze medals. The top ten industries with the highest number of sustainability leaders are China, India, Brazil, South Korea, Peru, Philippines, Poland, Qatar, Russia, and South Africa. The EMs feature a wider spectrum of corporate performance in terms of ESG than the developed world does.

Source: RobecoSAM as of 1Q 2016; EM includes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, United Arab Emirates
At present, the relative premium is only 6.2% (as of 31 December 2016), which suggests some upside potential. In absolute terms, too, the valuation level looks supportive. The MSCI EM ESG index is trading at a one-year forward PE multiple of 12.56x, fairly close to the long-term average of 12.23x. Both valuation metrics give us confidence that now is a relatively good time to invest in the ESG index (see fig. 7). The growth outlook for the MSCI EM ESG index is also compelling. Based on estimated earnings, EPS growth (next 12 months) is slightly higher than it is for the MSCI EM index. In summary then, we view the current combination of attractive valuation and higher EPS growth a good opportunity to enter a structurally sound investment case.

Note that between the end of July and end of November 2016 the MSCI EM ESG index slightly underperformed the MSCI EM index. Based on MSCI analysis, the amplitude of the underperformance was in-line with prior corrections and also consistent with its tracking error (less than 1.5 standard deviation). The overweight in South Africa and underweight in China were the main contributors of the underperformance. Since the end of November both indices performed fairly in line. Beside the valuation and earnings growth argument, the recent underperformance in 2H16 provides an attractive entry point.

Last but not least, a few words on the tracking error (sometimes also called active risk), a risk matrix that measures the standard deviation of returns between the MSCI EM ESG index and the parent index MSCI EM. Based on MSCI analysis, the tracking error is only 3.1% (as of November 2016). A low tracking error indicates that the MSCI EM ESG index exhibits low volatility compared with its parent benchmark, which we see as a positive in the investment context.
Appendix

Emerging Market Investments

Investors should be aware that Emerging Market assets are subject to, amongst others, potential risks linked to currency volatility, abrupt changes in the cost of capital and the economic growth outlook, as well as regulatory and socio-political risk, interest rate risk and higher credit risk. Assets can sometimes be very illiquid and liquidity conditions can abruptly worsen. WMR generally recommends only those securities it believes have been registered under Federal U.S. registration rules (Section 12 of the Securities Exchange Act of 1934) and individual State registration rules (commonly known as "Blue Sky" laws). Prospective investors should be aware that to the extent permitted under US law, WMR may from time to time recommend bonds that are not registered under US or State securities laws. These bonds may be issued in jurisdictions where the level of required disclosures to be made by issuers is not as frequent or complete as that required by US laws.


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