

Sustainable investing

Sustainable value creation in emerging markets

Chief Investment Office Americas, Wealth Management | 14 July 2017

Alexander Stiehler, CFA, analyst; Soledad Lopez, strategist, soledad.lopez@ubs.com; Laura Kane, CFA, CPA, Head of Investment Themes Americas, laura.kane@ubs.com

- 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.
- Here we highlight a research paper that examined several hundred studies of the ESG-CFP (corporate financial performance) relation across regions. The paper's conclusion mirrors our analysis that ESG works financially, particularly in emerging markets.
- In our view, the range of sustainability profiles within the EM equity universe is wide. This may help explain why selecting companies based on their ESG characteristics has proven valuable in recent years.
- We recommend that investors add exposure to the MSCI EM ESG Leaders Index; the index is trading at attractive valuations relative to its parent index, the MSCI EM Index. Higher ESG standards should also help reduce exposure to tail risk events.



Source: iStock

Related publications

- Investor's guide to corporate governance, 30 March 2017
- Gender-Lens Wealth, 6 March 2017

Source: UBS

Our view

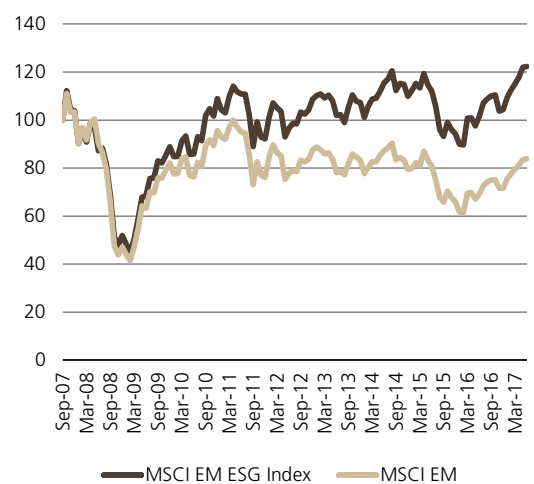
Demand for SI is increasing in EM investor circles. At the same time, investment vehicles to invest sustainably in EM have been multiplying. We see this as an encouraging development; investors seeking to integrate environmental, social, and corporate governance (ESG) considerations into their portfolios gain in opportunity. 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 trade off between SI and performance in developed markets. Based on academic studies and our own analysis, EMs may even offer the most compelling opportunity to include ESG considerations while adding value to the portfolio.

Based on our analysis, we expect a low-single-digit outperformance of the MSCI EM ESG Leaders 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 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. In the long 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.

Fig. 1: MSCI Emerging Markets ESG Leaders Index shows strong outperformance

Cumulative index performance, indexed to 100 (gross performance, September 2007 – June 2017)



Source: MSCI, UBS, as of July 4, 2017

ESG investing is relevant in EM

In the academic world, thousands of empirical research papers have been published on the relationship of ESG factors and corporate financial performance (CFP). Here we highlight a paper that uses a different approach than predecessor research. It fills a gap in that the authors conducted a second-order meta-analysis* examining more than 2,000 studies across asset classes. Compared to other research papers that are based on first-order meta-analysis, where findings are generalized based on small samples, their approach combines 60 academic review studies with more than 2,000 primary studies. What makes the analysis notable in our EM ESG context is that part of the analysis also considers the ESG-CFP relation across regions (based on 402 primary studies). The results (see Fig. 2) support analysis that we published in July last year. The analysis shows that the ESG-CFP relation is positive. Two-thirds of all studies find a positive ESG-CFP relationship in EM and only 6% a negative. In other words, more than 90% of all studies find a non-negative ESG-CFP relationship, and compared to other regions, ESG works financially in particular in EM.

In our initial report (published on 11 July 2016), we discussed two potential reasons for the positive relationship: a) a greater dispersion of high and low ESG performers in EM compared with the developed markets, and b) potentially a less robust regulatory environment in the developing world may tolerate EM companies with weak corporate governance profiles. Therefore, EM companies with higher corporate governance standards may enjoy a relative advantage in the coming years as regulation is set to continue to tighten.

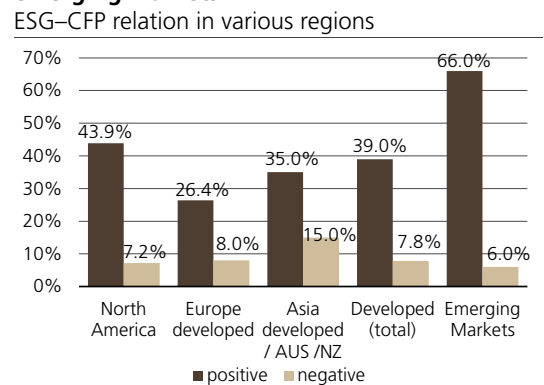
* A meta-analysis is a statistical analysis that combines the results of multiple scientific primary studies. A second-order meta-analysis goes one step further and combines the results of multiple meta-analysis'. This approach enables examination of large numbers of primary studies.

Attractive relative valuation

Aside from considering the benefits outlined above and in our initiation report of integrating ESG analysis as an investment approach, the question of timing deserves attention. We approached this question by using a longer time series (including a back-tested period from MSCI ESG Research), for the valuation analysis. The latter is thus based on valuation data for nearly 10 years. During this period, the MSCI EM ESG Leaders Index traded on average at an 8.9% premium (on one year forward P/E) to the broader MSCI EM Index (see Fig. 3).

At present, the relative premium is only 6.8%, suggesting some upside potential. In absolute terms, too, the valuation level still looks decent. The MSCI EM ESG Leaders Index is trading at a one-year forward PE multiple of around 13.4x, slightly above the long-term average of 12.3x. Both valuation metrics give us confidence that this is still a relatively good entry point to invest in the ESG index for investors who seek exposure to EM equities (see Fig. 4).

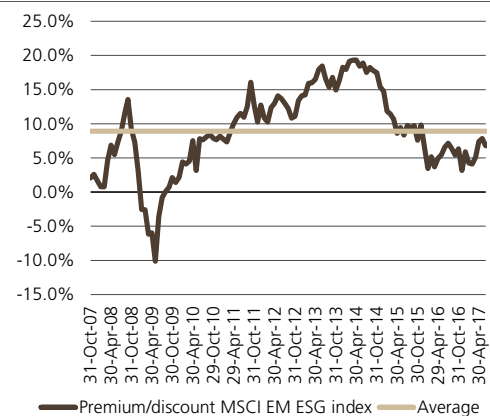
Fig. 2: ESG works financially, particularly in emerging markets



Source: Gunnar Friede, Timo Busch & Alexander Bassen (December 2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance & Investment, 5:4, 210-233.

Fig. 3: MSCI EM ESG trading at a lower premium than usual

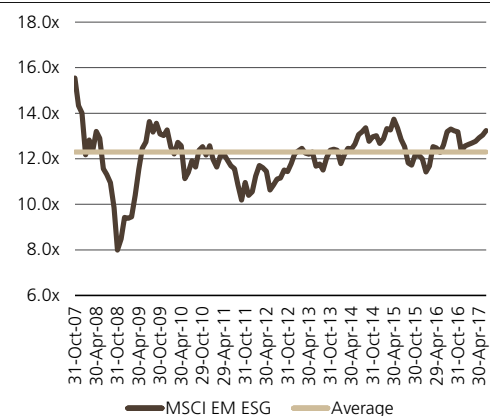
Relative valuation premium MSCI EM ESG Leaders vs. MSCI EM Index (monthly data)



Source: MSCI ESG Research, UBS, as of 30 June 2017.

Fig. 4: Absolute valuation is fairly in-line with historic average

One-year forward P/E multiple MSCI EM ESG Leaders Index (monthly data)



Source: MSCI ESG Research, UBS, as of 30 June 2017.

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. CIO Americas, WM 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, CIO Americas, WM 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. For more background on emerging markets generally, see the CIO Americas, WM Education Notes, *Emerging Market Bonds: Understanding Emerging Market Bonds*, 12 August 2009 and *Emerging Markets Bonds: Understanding Sovereign Risk*, 17 December 2009.

Investors interested in holding bonds for a longer period are advised to select the bonds of those sovereigns with the highest credit ratings (in the investment grade band). Such an approach should decrease the risk that an investor could end up holding bonds on which the sovereign has defaulted. Sub-investment grade bonds are recommended only for clients with a higher risk tolerance and who seek to hold higher yielding bonds for shorter periods only.

Research publications from Chief Investment Office Americas, Wealth Management, formerly known as CIO Wealth Management Research, are published by UBS Wealth Management and UBS Wealth Management Americas, Business Divisions of UBS AG or an affiliate thereof (collectively, UBS). In certain countries UBS AG is referred to as UBS SA. This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein does not constitute a personal recommendation or take into account the particular investment objectives, investment strategies, financial situation and needs of any specific recipient. It is based on numerous assumptions. Different assumptions could result in materially different results. We recommend that you obtain financial and/or tax advice as to the implications (including tax) of investing in the manner described or in any of the products mentioned herein. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS). All information and opinions as well as any prices indicated are current only as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria. At any time, investment decisions (including whether to buy, sell or hold securities) made by UBS and its employees may differ from or be contrary to the opinions expressed in UBS research publications. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and options trading is considered risky. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in FX rates may have an adverse effect on the price, value or income of an investment. This report is for distribution only under such circumstances as may be permitted by applicable law.

Distributed to US persons by UBS Financial Services Inc. or UBS Securities LLC, subsidiaries of UBS AG. UBS Switzerland AG, UBS Deutschland AG, UBS Bank, S.A., UBS Brasil Administradora de Valores Mobiliarios Ltda, UBS Asesores Mexico, S.A. de C.V., UBS Securities Japan Co., Ltd, UBS Wealth Management Israel Ltd and UBS Menkul Degerler AS are affiliates of UBS AG. UBS Financial Services Incorporated of Puerto Rico is a subsidiary of UBS Financial Services Inc. UBS Financial Services Inc. accepts responsibility for the content of a report prepared by a non-US affiliate when it distributes reports to US persons. All transactions by a US person in the securities mentioned in this report should be effected through a US-registered broker dealer affiliated with UBS, and not through a non-US affiliate. The contents of this report have not been and will not be approved by any securities or investment authority in the United States or elsewhere. UBS Financial Services Inc. is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the "Municipal Advisor Rule") and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of the Municipal Advisor Rule. UBS specifically prohibits the redistribution or reproduction of this material in whole or in part without the prior written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect.

Version as per May 2017.

© UBS 2017. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.