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.
- 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

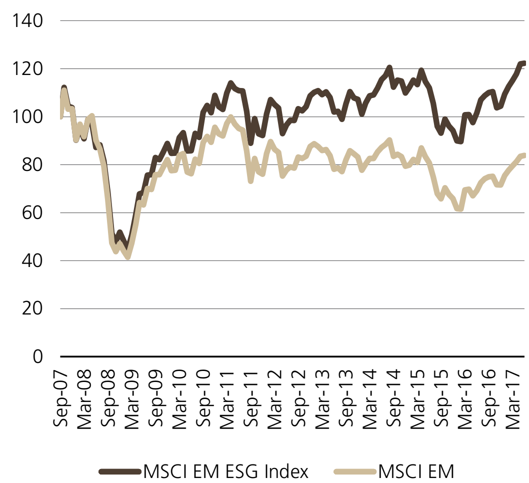
Demand for SI is increasing in EM investor circles. At the same time, investment vehicles to invest sustainably in EM have been multiplying. We see this is as an encouraging development; investors seeking to integrate environmental, social, and corporate governance (ESG) considerations into their portfolios 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.*

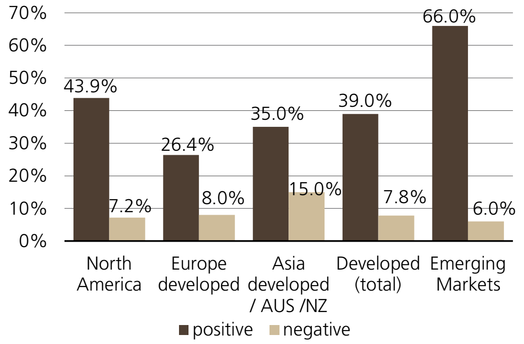
Attractive relative valuation

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

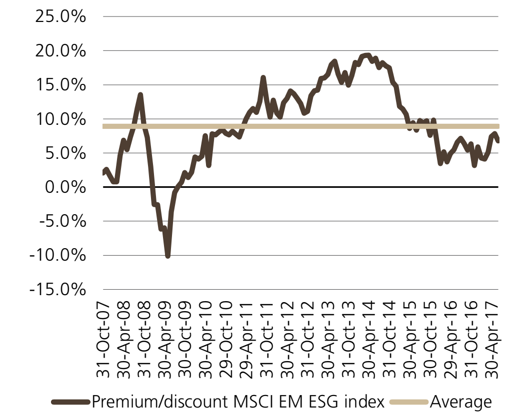
ESG–CFP relation in various regions



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

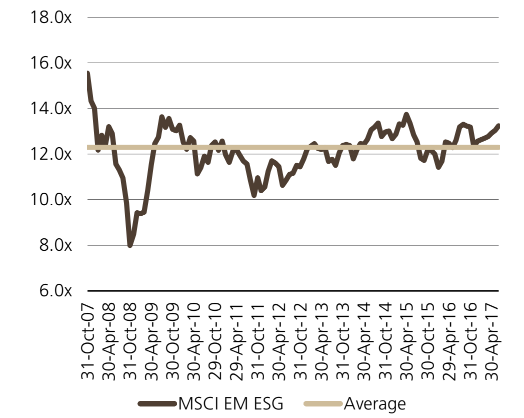
Relative valuation premium MSCI EM ESG Leaders vs. MSCI EM Index (monthly data)



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.