Nordea
ASSET MANAGEMENT

ESG Insight

ESG in Emerging Markets Equity

How ESG analysis expertise can add value and mitigate risk

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Key highlights

- Investors who want to access growth opportunities in EM face a unique challenge in finding low risk investments given the dispersion of practices, reporting and ESG regulation in EM
- Asset managers that provide deep in-house ESG analysis expertise bring extra value by mitigating risk with techniques like ESG scoring
- Engagement is also a powerful tool for EM investors to proactively manage ESG risk and protect or enhance the value of their investments
- At Nordea Asset Management (NAM) we have developed robust ESG integration analysis and engagement practices that enable us to deliver returns with responsibility and are particularly effective in our Emerging Stars Equity strategy[1]

When the celebrity who breaks the record for the greatest number of new Instagram followers is not a Hollywood superstar, but the venerable naturalist, Sir David Attenborough, it's obvious that environmental awareness isn't just mainstream – it's at the very top of global awareness.

Last year was 'the year of ESG' according to The Financial Times, with assets in the 'environmental, social and governance' (ESG) space reaching a record high of USD 960bn by the end of the year[2]. This is good news for conscientious investors—particularly those in Emerging Markets (EM), but understanding the field is essential.

Meta research leveraging the results of over 2000 studies in relation to ESG and its impact on the financial performance of companies revealed ESG factors were more important in EM than they were in the developed markets (DM).[3] In addition, the likelihood an investor is exposed to severe ESG risks is much higher in EM, where there is less published ESG data. In general, an EM equity investor is exposed to 14.2% more unmanaged ESG risks than a DM investor.[4]

1) **There can be no warranty that an investment objective, targeted returns and results of an investment structure is achieved. The value of your investment can go up and down, and you could lose some or all of your invested money.** 2) Imogen Tew, 'ESG to rally army of new investors' (FTAdvisor, 21 February 2020) 3) Gunnar Friede, Timo Busch and Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance and Investment, 5:4, 210-233, DOI: 10,1080/20430795, 2015, 1118917. 4) Sustainalytics, ESG Spotlight - Emerging market equities: key sources of ESG risk, 8 August 2019.

For EM investors in general, looking at ESG factors makes sense as the market is increasingly recognising responsible investment. In addition to the benefit of risk reduction associated with ESG factors, we are convinced companies that implement ESG practices are more likely to succeed over the long term. As many eyes are now turning to EMs, it is crucial to properly understand and analyse ESG benefit and risk.

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Finding strong ESG credentials in emerging markets

The challenge for investors who want to access the myriad opportunities for growth in emerging markets is how to find investments that satisfy the high ESG criteria set in the developed world. Finding ESG-aligned investments in Emerging Markets is undoubtedly difficult. They are both in short supply and highly sought after. And the danger of making uninformed and risky investments in these markets is high. No investor wants to be involved with a company like Boohoo, a UK-based fashion retailer which was investigated after a scandal broke about working conditions at its factories. The company's shares plummeted by GBP 1bn amid claims of poor pay and working conditions. Major retailers and investors were quick to distance themselves. The possibilities for making the wrong investment decision abound from companies involved with unethical labour practices, ecological disasters, pollution, blood diamonds, and other ethics violations.

Robust ESG legislation has yet to be put in place in many developing countries where there is also a vast dispersion of ESG practices and a relative lack of reporting. Hence, often the only way to find out if a company has good enough ESG credentials to be a viable investment is for an asset manager to have an in-house team of experts able to conduct extensive analysis before investing.

Nordea's ESG analyst Olena Velchyko on a field trip to a Cambodian factory

Meeting ESG challenges head on

At Nordea Asset Management (NAM), we believe that more sustainable companies will find both opportunities and risk reduction arising from their treatment of ESG issues, and this is reflected in our valuation. We specifically take our internal ESG scoring into consideration when we value a business, so that a more sustainable business will enjoy a higher valuation of its current earnings and a better trajectory for its future earnings. Intuitively, this makes sense but our methodology ensures it is applied consistently across our ESG STARS strategies.

We're focused on evaluating companies holistically: looking for growth potential, competitive advantages, a strong return profile, and the material ESG risks and opportunities. Our forward looking approach to scoring companies assesses how we can get involved, if necessary, to strengthen the ESG credentials before or during investment. We also assess how sustainability trends can positively or negatively impact the company's business model, its value chain, products and services. In short, what we really want to find out is – does this business have a great and sustainable future ahead?

Our Emerging Stars Equity Strategy is at the forefront of fully integrating ESG considerations into fundamental analysis – from idea generation to valuation. Portfolio managers work closely with our inhouse Responsible Investments Team to synthesize fundamental analysis and ESG research. We have embedded in each strategy's investment team a dedicated ESG specialist. Our ESG analysts are there every step of the way through the investment process – participating in daily and weekly meetings, as well as in idea generation and case presentations.

Ping An: A Good Doctor

To find the very best companies for our ESG STARS strategies, Nordea Asset Management not only looks at the fundamentals, but also engages with companies on ESG topics that can be of material risk to a company's business.

When e-health player Ping An Good Doctor was added to our **Emerging Stars Equity Strategy**, we began an engagement with the company to discuss ESG challenges associated with data privacy and quality control being the core material risk of the company.

To address these risks, the company has implemented data security protocols like encryption and de-identification, monitoring of system vulnerabilities, and reactive incident response. To ensure quality control, the company monitors user satisfaction and feedback on consultation services. Its AI diagnostics solutions have market-leading accuracy rates, but are used only as a complement to consultations with medical practitioners.

Throughout the Covid-19 pandemic, the company's platform has been particularly well positioned for the rapid surge in demand for its services, and has been helpful in reducing the strain on hospitals during these difficult times. The number of new users on the platform rose nearly 900% in January 2020, over the prior month.

We feel the company demonstrates strong risk management practices across both data privacy and quality control. It is a good fit for Nordea's Emerging Stars Equity Strategy because it can produce attractive returns while providing safe, reliable online consultations at a time when many healthcare users prefer to avoid physical hospital visits.[5]

In our effort to deliver returns with responsibility, we will continue to engage with companies like this to ensure they address ESG challenges and opportunities.[5]

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How to lower the risks of Emerging Market investment

Engagement is a powerful tool for EM investors to proactively manage ESG risk and protect or enhance the value of their investments. At the heart of our responsible investment strategy is the ongoing drive to engage with the companies and the industries we have chosen to invest in. We believe this is the duty of active investors.

Our approach of regularly engaging with companies on material risk allows those in developing regions to improve their way of doing business to meet investor standards. This way they gain investment, and the ESG benefits are all positive.

NAM's Responsible Investments Team proactively screens out companies with poor environmental records, those that don't look after their workforce, and those in which management structures and oversight don't meet high standards. We also have restrictions around weapons manufacturers, oil sands and coal extractors.

But we are also aware that in different cultures, with different legal frameworks, we can't necessarily expect business practices to be in place that are identical to those in DM. In EM, there is often little disclosure in relation to material ESG risks. Therefore, before we buy a company, we need to meet, preferably face-to-face, and ask questions.

Therefore, we seize many opportunities to actively engage with companies to bring about beneficial change. At NAM, our engagement efforts include working with companies to improve disclosures.

Encouragingly, we are seeing improvements in ESG disclosure. For example, Hong Kong Stock Exchange, one of Asia's major stock exchanges, is in the process of making ESG disclosure of material issues a responsibility of boards - not just a simple box ticking exercise. In addition, insurance giant Ping An, with whom we have engaged, is building an ESG scoring system, which it will not only use itself, but will also make available to other Chinese investors. We have also worked with Ping An to address challenges around data privacy and quality control after our team identified these as core risks to the company.

Emerging Markets represent an exciting opportunity for us as we search for companies that can become ESG STARS in the future. When we identify companies that demonstrate potential, we work with them to examine areas where their ESG credentials can be improved and brought up to standard. This way they gain investment, and the ESG benefits are positive for portfolios. It's a true win-win.

Danger in the Water: Engaging with pharma companies in India

India's pharmaceutical industry is a major driver of the country's economy, but it also contributes to a severe water pollution crisis—**163 million people lack access to clean water**. Moreover, pharmaceuticals in drinking water have been identified as a cause of antimicrobial resistance (AMR), a global threat that kills more than 700,000 people annually.

That's why, **in 2015, NAM's Responsible Investments Team initiated a long-term engagement with pharma companies based in India that we are invested in**. The team visited Hyderabad and witnessed the fierce industrial pollution surrounding pharma manufacturing sites. Consequently, we have commissioned two independent on-the-ground investigations over the past five years to understand the environmental and health impacts of pharmaceutical manufacturing.

We shared our findings with industry stakeholders and, as a result **the Pharmaceutical Supply Chain Initiative (PSCI) developed an action plan**. This included taking an industry approach to address pharma water pollution in India, developing a shared audit program and building the capabilities of Indian suppliers through training conferences and webinars.

As the only investor member of PSCI's Advisory Board, NAM continues to meet regularly with pharma industry leaders to discuss progress. Most of our expectations have been met; **the pharma industry has taken important steps to engage with suppliers and address water pollution**. As the ongoing Coronavirus crisis emphasizes the importance of responsible action by the pharma sector and the continued need for AMR stewardship, NAM is continuing our engagement on antimicrobial resistance through the AMR Benchmark, World Water Week events and company dialogues.

Investing in our future

As the world and the market become more attuned to ESG factors, we are moving farther away from the era when investors closed their eyes to the impact a company's actions had on the planet and people and just thought about profit. Good companies do good things in good ways because this ensures they will have a bright, long-term future. At NAM we make it our business to find those companies and help them to thrive.

NAM has developed robust ESG integration analysis and engagement practices that are particularly effective in our Emerging Stars Equity Strategy. There's no doubt that putting ESG at the forefront of the investment case is crucial to how we deploy capital.

In the asset management industry, what is good for the planet and its inhabitants is also good for businesses and their investors. This applies to EM every bit as much as it does to DM, if not more so. Diamond miners are now nurturing herds of elephants in their very own nature reserves (De Beers), while soft-drink manufacturers focus on replenishing vulnerable water reserves (Varun). As we work to safeguard the value of assets in EM, we have discovered that it is indeed possible to deliver returns with responsibility if you have the right team in place.

The desire to make business better for the planet is at the top of the investor agenda, and surely this is something Sir David Attenborough would applaud.