PRAGMATIC ENGAGEMENT – OUR APPROACH TO ESG IN EM

By Edward Cole and Simon Pickard

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We are long-term investors. We analyse stocks based on a five year investment timeframe, have been running our strategy for 8 years and fully expect to continue managing it for another 20. This philosophy means that ESG, far from being a hoop we jump through to negotiate due diligence questionnaires, is a core part of our investment process. If we managed money on a three month basis, we might ignore it, as over these eye-blinks financial metrics and short-term corporate news noise tend to dominate stock price moves. But compounded over years, we believe that the small differences in the integrity of management, and how a company interacts with the world and community around it, will be likely to have a tangible outworking in financial statements.

For Emerging Markets (EM) specifically, the greater opacity and instability of the political and macroeconomic environment means that the impact of ESG deviations can be even greater. In terms of the ‘G’ (‘governance’) of EM companies, all-too-common catastrophic losses can be alleviated by a thorough analysis of whether the company’s business is sustained by market forces or by precarious relationships. Over-reliance on an autocratic regime, for example, might bring years of supernormal profits that evaporate the moment the administration in question is overthrown. Many monopolistic rent seekers that benefitted from cosy connections with a particular regime would have turned into bad investments if they were still held when their political patrons were removed from office. Indeed, even if the regime maintains power, there is often very little impediment about it changing its mind – as Mikhail Khodorkovsky, once the richest man in Russia, discovered when Yukos, his previously state-sanctioned oil production business, was effectively nationalised in December 2004.

As far as the ‘E’ (environment) goes, one thing that we often notice is how little a company is penalized for the environmental externalities which go along with its business. We are all aware of the environmental degradation which has been part and parcel of commodity exploitation across the emerging world, as well as the polluting effects of China’s industrialisation. Yet it is highly unusual to find an EM regime which attempts to put a price on a company’s environmental footprint, as the EU has attempted to do with carbon taxes. For an investor who expects to still hold his or her shares in a polluting EM company in a decade’s time, this is a horizon over which this ‘free lunch’ could start to become expensive. Indeed, we have been struck by how much local communities and pressure groups *have* started to make their voices heard to good effect when it comes to resituating plants and the like. The same goes for the far-too-often cavalier attitude to health and safety and community welfare (the ‘S’ or ‘social’ side). Attitudes are changing across the emerging world. It seems to us to be imperative to make some attempt to quantify the downside risks of such situations when considering long-term investments.

In EM, conducting ESG analysis which can give warning of such deficiencies is not simple, though. There are a number of systems which can help with the process and we do find providers such as Sustainalytics, ISS-Ethix and TruCost give us a useful starting point. In our area, however, such tools will only take you part of the way, as they are generally designed for Developed Markets (DM) companies and place a very high premium on levels of disclosure. This automatically puts EM companies on the back foot given that they will rarely have the fully fledged IR apparatus to properly communicate the ESG activities that they are involved in. Added to this, coverage is often lacking with frontier markets, China A-shares and EM small-caps not being included. To put this into context, we currently estimate that around 25% of our portfolio is not covered by Sustainalytics’s research.

From a more philosophical perspective as well, an over-reliance on hard numbers alone can be inappropriate. EM managers need to remember that one of their core functions is to efficiently connect DM capital with EM need. This will lead to some circumstances where our role as portfolio managers conflicts with theoretical best practice as defined by traditional ESG metrics. For example, if you were to apply TruCost’s environmental impact calculation to Coal India it would take up 120% of its EBITDA. We believe, however, that a more nuanced view is necessary. India’s coal consumption today is the same as that of the US in 1850. It is therefore hard for Western investors to lecture on environmental sustainability to a country where around 300m people still lack access to reliable electricity. This makes the point that it is more important to be concerned with ‘ESG alpha’ than beta. In other words, an Indian mining company may be an environmental laggard on a global, absolute basis, but within the context of a more applicable peer group its ESG record could be far more comparatively impressive.

More generally, it is important to note that, whilst ratings data does give us useful information about a company’s current position, it is fundamentally backward looking and does not tell us much about trajectory. So whilst we do consider analysing the past to be an important part of ESG in EM, we think that engaging with the future is even more so. If we can accompany an EM company in its long-term journey towards more ESG engagement, we believe that we will reap the financial rewards we seek as shareholders – in terms of owning a higher-quality business and also benefiting from a likely higher market valuation of that business.

We believe that our role in encouraging that journey includes ensuring ongoing dialogue with management teams. This is one good reason why it is important to us, not only to use our shareholder vote wisely and responsibly, but also to ensure that management knows that we are active and interested shareholders in all aspects of the business, including ESG. Our role also consists of helping to shape the debate within the investment industry. In this regard, representatives from Man GLG have recently chaired the UNPRI's hedge fund committee, whilst we are also engaged in ongoing discussions with Sustainalytics to help them incorporate EM-specific considerations more deeply into their analysis.

In summary, we believe that the peculiar environment of EM means that ESG investing cannot be boiled down to a potted off-the-peg process. Instead a more intelligent approach is necessary, one which uses the conventional tools that are available but has the flexibility to deal with numerous situations which do not fit the playbook. Awareness of past ESG performance is important to us, and represents a tangible input into the growth rates we use in DCF analyses, which in turn play a key role in the way we identify value dislocations. But we do not think this goes far enough. We see engagement as even more important, and the outlet by which we can most efficiently and ethically steward our investor's capital.

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