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Executive Summary

Emerging markets present both a huge investment opportunity as well as a distinct set of environmental, social and governance (ESG) risks and challenges. Although investors generally perceive ESG risks to be larger in emerging markets than in developed markets, they are applying responsible investment strategies to a lesser degree when making emerging markets investments. Yet, especially in the context of emerging markets, addressing ESG risks can be very rewarding for investors wanting to reduce portfolio risks or looking for investment opportunities.

A comparison of the ESG scores of emerging market and developed market companies in Sustainalytics’ Global Platform shows that, in general terms, emerging market companies’ disclosure of relevant ESG policies and programs is relatively poor. It would seem that emerging market companies are less aware and less prepared to mitigate ESG risks or take advantage of ESG opportunities. The most notable differences between emerging market and developed market companies’ ESG scores are in the areas of governance and business ethics. Family-owned and state-owned governance models are common in emerging markets. While this may help ensure that companies are well-rooted in society and/or benefit from protection by the government, it also creates risk that minority shareholder interests will not be adequately represented. With respect to business ethics, emerging market companies’ lower disclosure rates of anti-bribery policies and procedures are especially worrying considering the generally higher prevalence of corruption in emerging economies. Corporate corruption in emerging markets is less frequently reported in the public domain than in developed markets.
due to less scrutiny from government, non-governmental organizations (NGO) and media. This information gap leaves investors unaware of, and exposed to, the risks associated with bribery and corruption.

Overall, emerging market companies are exposed to far less scrutiny from the media and NGOs than their developed market peers, and therefore their involvement in other controversial activities is often underreported. While this lack of scrutiny may lower short-term reputational risks to some degree, Sustainalytics’ data suggests that emerging market companies are still overrepresented among companies facing the most severe ESG controversies, which can create significant reputational and/or material risks to investors.

The ESG risks faced by companies within emerging markets vary greatly from country to country. Looking at Brazil, Russia, India, China and South Africa (BRICS countries) in particular, we note differences in the development of regulations and the level of ESG integration into business operations. Although issues such as labour concerns, pollution and corruption are prevalent in all BRICS countries, each country is faced with unique challenges of which investors should be aware. For instance, in Brazil deforestation and relations with indigenous people are of concern, whereas in Russia complicated governance structures that discourage influence from foreign investors pose the greatest risk. In China product quality and safety is of primary concern, and in India and South Africa depleting water resources are a key risk to many industries.

Local variations in ESG risks and practices along with limited ESG disclosure from emerging markets companies represent significant challenges for responsible investors. Various case studies included in this report explain these challenges and illustrate how some investors are addressing them. Direct engagement with companies can be very useful in overcoming information gaps. Alliances with local investors, the use of local language, and awareness of cultural differences are important factors in making such engagement successful. Investor flexibility is essential to ESG integration, which needs to be based on available ESG information rather than on the desired availability of such data. Combining company-specific information with an analysis of ESG risks at country and industry levels already provides investors with meaningful insights.

Although ESG disclosure in emerging markets is expected to increase in the coming years, investors are encouraged not to wait for improved disclosure, but instead to take active steps in the implementation of a responsible investment strategy for their emerging markets investments. Where possible investors should reach out to investee companies to overcome data gaps as well as the gap that exists between many investors’ expectations and companies’ understanding of these expectations.
Introduction

The financial allure of emerging markets has grown rapidly during the last decade, particularly given the prolonged volatility of global stock markets and the disappointing performance in recent years of many developed market stocks. Although there has been a significant increase in emerging market investments, many investors remain cautious due to risks stemming from factors such as poor corporate transparency, differences in corporate culture and differences in business legislation. These risks are particularly challenging for investors seeking to incorporate environmental, social and governance (ESG) factors into investment management. Many responsible investors have nonetheless made strides towards overcoming these barriers, demonstrating that applying an ESG strategy to emerging market investing is more feasible than many perceive.

The aim of this report is to provide investors with insights and tools to effectively implement an ESG strategy into their emerging market portfolio management. Drawing from existing studies as well as emerging markets data from Sustainalytics’ Global Platform, this report highlights some of the ESG risks specific to emerging markets and underlines the importance of applying an ESG strategy to emerging markets investments in order to better manage these risks. Attention will be given both to the challenges associated with responsible investing in emerging markets and to approaches to addressing these challenges. We provide case studies based on interviews with responsible investors from around the globe to illustrate the challenges they face and the variety of ESG strategies they have adopted. For the sake of clarity and overall conciseness, the scope of this study is limited to investments involving emerging markets listed equities.
Background: Responsible Investment in Emerging Markets

A growing number of investors, both foreign and domestic, are attempting to integrate ESG factors into their emerging markets investments. In its 2011 annual Report on Progress, the United Nations-backed Principles for Responsible Investment (PRI) reported that the value of listed equities managed by PRI signatories amounted to USD 4,956 billion in developed markets versus USD 975 billion in emerging markets. Of this USD 975 billion, 75 per cent (USD 729 billion) was reported to be subject to some degree of ESG integration, representing about five per cent of the total emerging markets equities market.\(^1\) Although the Principles are aspirational and practical implementation often lags behind stated commitment, this finding shows that some responsible investors have started to take serious and considerable steps towards incorporating ESG factors into their emerging markets investments.

The PRI’s Report on Progress reveals some interesting differences in investors’ consideration of ESG when looking at developed versus emerging market listed equities. Eighty-seven per cent of investment manager signatories reported integrating ESG issues, to some extent, into their management of emerging market listed equities, as opposed to the 95 per cent that integrate ESG into the management of developed markets equities. Among asset owner signatories, only 58 per cent integrate ESG into emerging market equity investing while 79 per cent do so for developed market listed equities.\(^2\)

Motivations for ESG Integration

The integration of ESG issues into investment decisions is more prevalent for developed market equities; however, investors contend that they perceive ESG risks to be greater in emerging markets.\(^3\) Applying a responsible investment strategy that considers ESG factors when investing in emerging market companies enables investors to identify ESG risks and determine which companies have more effective risk management and are therefore likely to be more profitable in the long run. As an example, considering the resource constraints under which many companies in India and China operate, companies in these countries that have adopted resource-efficient strategies represent important opportunities for investors.

Indeed there is evidence that proper consideration of ESG factors can significantly reduce a portfolio’s risk exposure. A study by Allianz and Risklab (2011)\(^4\) suggests that “tail risks,” the risk of unlikely events causing catastrophic damage, can be reduced by nearly 40 per cent by optimizing ESG risk exposure in an emerging markets equity portfolio, compared to an ESG-risk-neutral strategy.\(^5\) The study, using various ESG metrics provided by several ESG research providers, concludes that while all portfolios gain from ESG risk management, this benefit is greatest for emerging markets investments.

While both searching for opportunities and reducing risks are strong motivations for investors to include ESG factors in their investment process, doing so is not a simple
exercise, and it requires that investors be informed about the local factors that shape the risk environment. The following sections will highlight differences between emerging markets overall and developed markets, as well as the large variation in the risk profile of individual countries within emerging markets. Case Study 1 below illustrates the importance of such local factors for those investing in Central and Eastern Europe. This case study also highlights the issue of incomplete corporate disclosure, a common challenge in emerging markets, as is also further elaborated in the following section.

Case Study 1 - Limestone Investment Management, Estonia
Limestone Investment Management was founded in 2007. It launched its New Europe socially responsible investment (SRI) fund one year later. Rein Ojavere (CIO) and Alvar Roosima (Head of Research), co-founders of Limestone, explain the motivation underlying their SRI fund and provide insight into some of the challenges faced by responsible investors in Central and Eastern Europe.

ESG analysis and investment in Central and Eastern Europe
Ojavere and Roosima consider an ESG strategy relevant for two reasons. Firstly, they believe such an investment strategy represents a superior risk analysis tool. Furthermore, they believe that maintaining close relationships with their invested companies and understanding the full scope of business risks allows them to invest in “great companies” rather than just “great stocks.” While Western European SRI funds have access to more data “in the context of Eastern Europe processes need to be more flexible.” Given the shortage of publicly available information and incomplete disclosure by local companies, engagement forms an essential component of Limestone’s research process.

Local ESG risks and trends
Roosima and Ojavere identify governance (G) as the largest risk for Eastern European companies. Due to Estonia’s history of communism, many companies are relatively new, with the original founders and owners often owning the majority of shares. For minority shareholders, aligning their interests with those of majority owners and understanding the majority owner’s ambitions for the company and the motivations of management can be difficult. In addition, there are often concerns over a lack of board independence.

With regard to social (S) and environmental (E) risks, Roosima and Ojavere believe that Eastern Europe compares favourably to other emerging markets. This is primarily because environmental and regulatory risks are mitigated by EU accession or membership. Roosima further highlights that companies’ understanding of ESG is increasing rapidly. “The transition of Eastern Europe is not only about GDP per capita growth, but even more importantly a conversion of rules, business culture and legislation.”

ESG Practices in Emerging Markets and Developed Markets
Sustainalytics’ Global Platform provides ESG ratings and profiles for more than 3,600 companies worldwide, including more than 800 emerging markets companies. The scores presented below are based on a universe of 809 emerging market companies and 1,593 developed market companies, all of which are constituents in the MSCI All Country World Index. For an overview of the countries included refer to Appendix I.
A Comparison of ESG Scores in Emerging and Developed Markets

Figure 1 provides a snapshot of emerging and developed market companies’ ESG scores in the areas of policies, management systems, programs, and disclosure on the topics of business ethics, governance, employees, contractors and environment (operations). The figure shows that across all topics emerging market companies, on average, obtain significantly lower scores than developed market companies, with the largest difference shown in the area of business ethics. Poor disclosure on the part of many emerging market companies accounts for much of this difference in scores.

A comparison of scores at the indicator level reveals that the largest differences between emerging market and developed market companies’ performance are in the areas of governance and business ethics-related practices, as shown in Table 1. In addition, Table 2 suggests that emerging market companies outperform their developed market peers in some areas with lower controversy records. This outcome is largely related to low media and NGO scrutiny in emerging markets, which results in less publicly available information about breaches and controversies.

Table 1: ESG indicators with the largest EM underperformance based on average scores

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Average EM Score</th>
<th>DM Average Score</th>
<th>EM Average Score</th>
<th>Asia-Pacific</th>
<th>CEE* + Turkey</th>
<th>Latin America</th>
<th>North Africa + Middle East</th>
<th>South Africa</th>
</tr>
</thead>
<tbody>
<tr>
<td>Whistle-blower Programs</td>
<td>-34</td>
<td>58</td>
<td>26</td>
<td>18</td>
<td>17</td>
<td>48</td>
<td>11</td>
<td>47</td>
</tr>
<tr>
<td>Board Independence</td>
<td>-34</td>
<td>54</td>
<td>20</td>
<td>21</td>
<td>14</td>
<td>16</td>
<td>13</td>
<td>46</td>
</tr>
<tr>
<td>Policy on Bribery and Corruption</td>
<td>-30</td>
<td>58</td>
<td>28</td>
<td>23</td>
<td>25</td>
<td>53</td>
<td>25</td>
<td>44</td>
</tr>
</tbody>
</table>

*EM = Emerging Markets, DM = Developed Markets
**CEE = Central and Eastern Europe
Table 2: ESG indicators with largest the EM outperformance based on average scores

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Average EM Score - DM Score*</th>
<th>DM Average Score</th>
<th>EM Average Score</th>
<th>Asia-Pacific</th>
<th>CEE* + Turkey</th>
<th>Latin America</th>
<th>North Africa + Middle East</th>
<th>South Africa</th>
</tr>
</thead>
<tbody>
<tr>
<td>Separation of Board Chair and CEO Roles</td>
<td>+23</td>
<td>47</td>
<td>70</td>
<td>64</td>
<td>89</td>
<td>75</td>
<td>43</td>
<td>100</td>
</tr>
<tr>
<td>Customer Related Controversies or Incidents</td>
<td>+8</td>
<td>90</td>
<td>98</td>
<td>98</td>
<td>95</td>
<td>99</td>
<td>100</td>
<td>99</td>
</tr>
<tr>
<td>Employee Related Controversies or Incidents</td>
<td>+3</td>
<td>94</td>
<td>97</td>
<td>98</td>
<td>98</td>
<td>95</td>
<td>100</td>
<td>92</td>
</tr>
</tbody>
</table>

*EM = Emerging Markets, DM = Developed Markets
**CEE = Central and Eastern Europe

Notable Areas of Difference: Governance and Anti-corruption Standards

Emerging Market Governance Models

As illustrated in Tables 1 and 2, there are major differences between governance practices and disclosure standards in developed and emerging markets. Governance models in many emerging economies greatly differ from common practice in developed markets. As companies in emerging markets are generally “younger” than in developed markets, they are often still largely controlled and owned by their founders or founding families. Ownership by state governments is also common in many emerging market countries. In addition, and partially related to the former, board independence is generally less well-established. Within most of the emerging market companies assessed in Sustainalytics’ Global Platform, the majority of non-executive directors or (supervisory) board members are not independent. In contrast, while more than half of the developed market companies assessed have a combined CEO and Board chairman role or have a former CEO in the role of Chairman of the Board, at the majority of emerging market companies in the sample, the CEO and Chairman roles are separated. However, this separation of Chairman and CEO roles is subject to regional variations as outlined in Table 2. Most notable is the average score of 100 for South African companies, indicating that all South African companies researched have separated the CEO and Chairman roles, which is in line with the South African King III Corporate Governance Principles.

Risks for investors: Family-owned businesses and (partially) state-owned businesses are common in emerging markets, with local and regional variations. These ownership structures may, on the positive side, ensure that companies are well-rooted in society, since they are connected to a family’s reputation and business relationships and/or protected by the government. However, the connectedness of a firm to a founder, founding family or government may also lead management to be inattentive to the interests and concerns of external investors, as illustrated in Case Study 1. In addition, in family businesses the transition of leadership from one generation to the next can lead to uncertainty. In more general terms, local variations in the implementation of governance codes and standards also imply variations in the strength of investor protection.

Anti-corruption standards

As shown in Table 1, emerging market companies significantly underperform with respect to the implementation of anti-corruption policies and whistle-blower programs. Fifty-three per cent of the emerging market companies in Sustainalytics’ research universe do
not report having an anti-corruption statement, compared to 19 per cent of developed market companies. Similarly, 53 per cent of emerging market companies do not publish information regarding whistle-blower programs. Yet corruption is a far more prominent issue in emerging markets than in developed markets, as is shown by Transparency International’s Corruption Perception Index 2011.¹⁴

The degree to which corporate corruption scandals and breaches are reported in the public domain is subject to local variations. In India, for example, the recent scandal involving telecom companies, considered India’s largest corruption scandal, has received major public attention and led to a widespread rejection of corruption. This greater local awareness is reflected in local companies’ disclosure practices: of the 83 Indian companies researched, 70 per cent disclose an anti-corruption statement, versus 43 per cent of the remaining emerging market companies analyzed. The average ESG score for Indian companies (52.6) is, however, in line with the average of the entire sample of emerging market companies (53.0), pointing to a specific focus of Indian firms’ disclosure on anti-corruption issues.

**Risks for investors:** Without established policies and procedures to address corruption, companies operating in countries where corruption is prevalent face significant risk, both reputational and financial, of which many investors may not be adequately aware. Often, and especially in situations where corruption is perceived as “part of doing business,” corrupt practices remain hidden and are not reported in the public domain. However, even if hidden most of the time, there is always the risk of revelation, and the consequences of cases being revealed are often great.

**Emerging Market Companies’ Exposure to ESG Controversies**

The fact that certain controversies are not reported in the public domain is underscored by controversy statistics from Sustainalytics Global Platform, as shown in Figure 2. Emerging market companies are less frequently reported to be involved in ESG controversies than developed market companies. This difference is strongest for controversies with low to medium severity, which Sustainalytics assesses as Category 1, 2 or 3 on its controversy scale of 1 to 5.¹⁵ However, the frequency of the most severe type of controversy (Category 5) is higher among emerging market companies, especially in the areas of Society and Community-related incidents. Considering the latter, the assessment that emerging market companies face fewer “minor” controversies than developed market companies is likely due to the degree to which emerging market companies face public and media scrutiny. In addition, internet and media censorship in some countries means that news on certain types of controversies does not easily reach a broad audience.

**Risks for investors:** For investors aiming to avoid reputational risks, having fewer reported controversies may seem reassuring. However, emerging market companies are still overrepresented on the list of companies with the most severe ESG controversies (also refer to Figure 3). Severe ESG controversies often have a large negative impact on stakeholders and often lead to investor action such as shareholder engagement and/or divestment, imposing significant reputational and/or material risks on investors. In addition, limited government, NGO or media scrutiny results in information gaps, leaving investors uninformed about breaches and risks. Where controversies remain
unreported and local populations do not perceive the situation to be controversial, reputational risks for investors might be non-existent in the short term. However, the economic growth in emerging markets is accompanied by increasing attention on the part of a growing middle class, a societal group that is likely to develop a greater awareness of reputation, along with greater influence in the marketplace.

**Figure 2: Recurrence of ESG controversies by category of severity**

*The category scale applied indicates the severity and materiality of the controversy, category 5 reflecting the most severe and material ESG controversies.*

**Figure 3: Frequency of the most severe (Category 5) ESG controversies amongst developed and emerging market companies**
Variations in ESG Practices and Risks across the BRICS Countries

Stepping away from comparisons between emerging and developed market companies’ ESG performance, this section will focus on the large variations that exist between the emerging economies and examine local corporate social responsibility standards, disclosure levels and context-based risks. Figure 4 provides a general comparison of average ESG scores by emerging markets region. Overall, the highest-scoring companies are South African while the lowest-scoring companies are those in North Africa and the Middle East.

Figure 4: Average ESG scores per geographic region

Even within these regions there are significant differences among countries. Companies from BRICS countries (Brazil, Russia, India, China, and now South Africa) constitute the largest proportion of emerging market companies. Due in part to increasing interest on the part of foreign investors, BRICS economies have grown exponentially since 1980, when their stock market value represented a mere 10 per cent of their GDP. In 2011,
that value increased to 150 per cent, whereas the average stock market value of G7 countries was 120 per cent of GDP.\textsuperscript{19}

BRICS have seen some positive changes in regulatory environments, legal frameworks and the enforcement of regulations relevant to corporate ESG performance, and these serve to mitigate some types of risk. Of particular note are initiatives in Brazil and South Africa that have raised ESG disclosure standards for companies listed on BM\&FBOVESPA and South Africa’s Johannesburg Stock Exchange, as described below.

Despite such initiatives, business ethics concerns stemming from corruption are still common and the respective Corruption Perception Index scores of BRICS countries reflect this. Similarly, according to Sustainalytics’ research, serious labour and human rights infringements are common in these countries and are increasingly the focus of civil society groups. Furthermore, environmental legislation is lacking and companies operating in these countries often have poor track records resulting in, for example, significant water management and climate change risks. Drawing on data from Sustainalytics’ Global Platform, this section highlights ESG performance and risks in the five BRICS countries.

![Figure 5: Average ESG Scores BRICS Countries](image)

**ESG Performance in Brazil**

**Background:** With a population of 203 million (the fifth largest population globally) and a GDP of USD 2.518 trillion,\textsuperscript{20} Brazil is by far the largest of the Latin American economies and proportionally, within the Sustainalytics platform, houses the largest number of companies relative to other Latin American countries. Brazil was one of the first emerging market economies to rebound from the global financial crisis, experiencing 7.5 per cent growth in 2010. Brazil has grown to become the 10\textsuperscript{th} largest global economy and has attracted substantial foreign investment over the past decade.
**ESG in the local context:** Brazil has made significant steps at promoting a more sustainable business culture, launching two local sustainability-related indices, BM&F Bovespa’s Corporate Sustainability Index and a Carbon Efficient Index, which, in turn, have had a positive influence on the sustainability practices of Brazilian companies.²¹ Brazil has put considerable effort into improving corporate governance practices, rolling out the voluntary Novo Mercado corporate governance practices and introducing “report or explain” requirements for listed companies. Nevertheless, Brazil still faces corruption issues, ranking 73rd out of 183 countries and scoring 3.8 out of 10 on the Corruption Perception Index. Although almost 58 per cent of the Brazilian companies assessed in the Sustainalytics platform have some sort of policy on bribery and corruption, 70 per cent of these policies are considered weak.

According to the United Nations Development Program’s Human Development Indicators (HDI), Brazil has shown considerable improvement since the 1980s, improving its score from 0.549 to 0.718 in 2011. However, the country still faces a relatively high illiteracy rate, particularly in rural areas, high unemployment, low GDP/capita (USD 11,600, ranking third among BRICS countries), and inequality, illustrated by an adjusted for inequality HDI score of 0.519.²² Whereas the government has successfully focused on poverty and inequality reduction through its implementation of the World Bank-backed Bolsa Familia program,²³ the country still faces considerable social issues, mainly in the areas of labour and human rights infringements. Positive trends are sparked by international initiatives such as the United Nations Global Compact (UNGC), to which 47 per cent of the Brazilian companies represented in the Sustainalytics platform are signatories.

Deforestation is one of Brazil’s main concerns, with a rate reaching almost nine per cent between 2005 and 2008. Scientists estimate that, under the current scenario, 40 per cent of the Amazon forest (5.4 million km²) will be eliminated by 2050, releasing 117,000 Mt of CO₂.²⁴ Brazil has made notable commitments to reduce its impact on climate change by establishing its National Climate Change Policy of Brazil (Law 12.187, adopted in December 2009), which establishes “voluntary” national GHG reduction targets of between 36.1 per cent and 38.9 per cent of projected emissions by 2020. However, the voluntary nature of these targets has caused some confusion, and Brazil has yet to clarify what a legislated voluntary target means in practice. Eighty-one per cent of the Brazilian companies in the Sustainalytics platform have adopted environmental policies and just over 60 per cent have implemented environmental management systems.
**Take away for investors:** Brazil’s sustainability performance far exceeds that of its peers. Whereas in other BRICS countries, such as China, the lack of transparency poses a risk to investors, Brazilian companies are seen as front-runners because of their relatively strong disclosure on ESG-related topics and their growing use of internationally recognized reporting standards such as the Global Reporting Initiative (GRI). Brazil also strongly promotes adherence to international initiatives such as the United Nations Global Compact, the Carbon Disclosure Project and the PRI, and NGO campaigning and social awareness are at a comparatively high level. Nevertheless, investors looking at Brazilian companies still face various risks, including those related to business ethics and corruption, labour and human rights (especially employee-related concerns such as child labour), occupational health and safety concerns, and the contentious issue of relations with indigenous communities and, in some cases, their forced displacement. Environmental concerns will also pose significant risks to investors that are bound to grow if not properly mitigated.

**ESG Performance in Russia**

**Background:** Russia is one of the wealthiest BRICS countries, with a GDP per capita of USD 16,700, double that of China and almost five times that of India. Although it had a relatively strong and stable economy, it was one of the countries hardest hit by the economic crisis due to its dependency on oil exports and foreign credits and its invasion of Georgia. The country has a vast array of natural resources, including oil, natural gas and coal, as well as a large industrial base, making it an interesting option for those who wish to invest in emerging markets.

**ESG in the local context:** Scoring a mere 2.4, Russia ranks last among BRICS countries on the Corruption Perception Index, while the Russian companies assessed by Sustainalytics rank second last (averaging just above Chinese companies) in the areas of business ethics-related practices and policies. With respect to specific business ethics indicators such as policies on bribery and corruption or whistle-blower programs, Russian companies also rank just above Chinese companies on average, as shown in figure 6 below. Whereas China’s low scores are in part due to a lack of transparency, Russian companies simply have not established relevant policies.
Unlike other emerging market countries, Russia has a monopolistic business environment. The state owns a major stake in many of the largest listed companies, particularly those in the oil sector, and in many cases the ownership structure is such that one person controls a majority stake in the company. A plan to reduce government assets has been initiated and the receipts from privatization are expected to reach USD 214.3 billion, offering huge opportunities for foreign investors. However, in many cases, such as the possible sale of 10 to 15 per cent of the Russian government’s shares in Rosneft, the state will retain a “golden share” allowing its representatives to stay on the board, and granting them the power to veto any significant transactions, changes in capital and corporate reorganization. These conditions, in combination with the aforementioned lack of transparency regarding business ethics and involvement in corrupt practices, sets the precedent for a difficult investment environment for foreign investors, as their ability to influence company decisions will be questionable. Although some governance reform has taken place over the last few years, Russia still lags behind its Eastern European neighbours who are aligning their governance practices with requirements set by Western European countries.

The social challenges faced by Russian companies are often related to customers and employees. Customers have been greatly affected by the monopolistic nature of many companies. Concern about antitrust practices are increasing in Russia as exemplified by companies such as Gazprom, which the European Union began investigating in September 2011. Employee health and safety concerns are also significant due to the nature of Russia’s primary industrial sectors (namely steel, mining, and oil and gas) and the lack of adequate oversight in this regard. Many of the controversies involving Russian companies have to do with incidents and fatalities on work sites.

Russia is plagued with outdated industrial infrastructure and has a history of industrial environmental pollution. Strict environmental standards have yet to be imposed on companies and thus this is not yet a matter of regulatory compliance. However, NGOs are increasingly targeting Russian companies, campaigning against their practices and inflicting considerable reputational damage. Analysis conducted by Sustainalytics shows that, of the seven Russian companies facing the greatest controversies, three are involved in severe environmental controversies due to operational issues. Of the Russian companies Sustainalytics analyzes, only 60 per cent have environmental policies or environmental management systems in place.

**Take away for investors:** Russia’s industrial and oil and gas sectors make the country a lucrative investment option; however, investors should be weary of governance and business ethics issues. Although the country is politically stable, corruption is still a key concern. Monopolistic practices have given rise to several large-scale investigations that can affect a company’s bottom line. Meanwhile, outdated infrastructure, an inadequate regulatory environment and a lack of enforcement continue to create risk for and cause negative impacts on employees (especially with respect to health and safety issues), communities and the environment.

**ESG Performance in India**

**Background:** India has the second largest population in the world at 1.19 billion people, but compared to its BRICS peers, it is the poorest of the nations with a GDP per capita.
of only USD 3,700. Despite an extremely unequal distribution of income, Indian markets have shown strong and consistent growth (GDP growth of 7.8 per cent in 2011 and 10.1 per cent in 2010) and have drawn a lot of attention from foreign investor in recent years. Between January and October 2011, India saw a 36 per cent increase in direct foreign investments (valued at USD 23.69 billion).29

**ESG in the local context:** While some companies have started to respond to investors’ concerns about transparency in the area of ESG, there is still much room for improvement. Seventy-eight per cent of the Indian companies tracked by Sustainalytics do not publish CSR reports. However, there has been an upward trend in the amount disclosure from companies as a result of increased foreign investment activities and interactions with Indian suppliers. Not surprisingly, the three best performing Indian firms are all IT services providers with highly international operations and customer bases. Looking at the aggregated ESG scores of Indian companies in the Sustainalytics Global Platform, a group of leaders emerges and includes companies that have taken considerable steps to implement and report on their relevant CSR programs. The top 10 Indian ESG performers have an average score of 68.8, and the top 25 companies a score of 63.1, compared to an average of 47.9 for the remaining Indian firms analyzed.30

India has a longstanding history of philanthropy aimed at improvement in education, poverty reduction, livelihood creation and skill development, and several recent regulatory changes in India have led to a new surge in CSR activities. In addition, in November 2011, SEBI, the Indian market regulator, mandated that the 100 top listed companies by market capitalization report on aspects included in the Ministry of Corporate Affairs’ National Guidelines on Social, Environmental and Economic Responsibilities of Business, which is expected to lead to an increased level of disclosure.
With rapid growth of both India’s economy and population, the environment has been put under considerable strain. Concerns over issues such as air and water pollution are growing as industries flourish. Water management a key area of concern and often leads to strained relations between industries and local populations that are competing for this critical resource. A prime example is the case of The Coca-Cola Company, which has faced persistent protests from local communities in the areas in which it operates. When comparing company disclosure on environmental issues and involvement in related controversies among companies operating in BRICS countries, India closely follows China as being one of the least transparent as well as having a relatively high reoccurrence in incidents. Nevertheless, India does have some global disclosure leaders, which China does not. India is also beginning to raise awareness on environmental issues at a national level, particularly focusing on the threats associated with climate change. The launch of the National Action Plan on Climate Change places a clear focus on key issues such as energy efficiency, water management, protection of ecosystems and reduction of solid waste. In 2010, India set targets to reduce its carbon intensity by between 20 per cent and 25 per cent.

**Take away for investors:** Although India has a longstanding history of corporate philanthropy and awareness about good corporate practices is clearly on the rise, responsible investors interested in India would do well to pay attention to several risks related to companies operating in the country. Society and community relations are particularly important given the increasing pressure on natural resources, such as water, which can pose certain operational risks. Similarly, employee issues and labour concerns, particularly those related to discrimination and child labour, could lead to reputational damage for companies and responsible investors alike.

The following case study illustrates how an Indian-based ESG investor is considering Indian companies’ ESG performance in general terms, and highlights some ESG trends among companies and investors in India. The case study illustrates that the Indian government, along with companies and some investors, is taking steps towards a stronger CSR/ESG legislation, albeit slowly. In addition, the case study points out that the relevance of ESG for local investors as well as for companies is tied to prominent locally perceived risks.
Case Study 2- ESG in India: Insights from Canara Robeco Asset Management, India

Canara Robeco is a joint venture between Canara Mutual Fund (India) and Robeco (Netherlands). The company operates one of the largest domestic fund houses in India, focusing on traditional equities and fixed income. Influenced by its parent company Robeco, Canara Robeco has adopted responsible investment as one of its strategic initiatives. Ms. Swati Ahuja, Manager of Corporate Development, gives her insight into the importance of ESG factors for companies and investors in India.

The relevance of ESG for India: Inclusive growth

Although local investor interest in ESG is still fragmented in India, Ahuja believes that ESG factors are particularly relevant for monitoring societal risks associated with unequal development. “India is one of the world’s fastest growing economies but the development and implementation of a legal and corporate governance framework hasn’t kept pace with the economic growth.” While the Indian government is working on diffusing the concept of all-inclusive development in the corporate world, this movement will only gain the momentum needed when local investors and companies participate.

In this context, one of the main ESG issues in India is corruption. Following the recent major scandal over bribery and corruption in the telecom industry, there has been growing awareness of bribery and a sense of urgency to counter it. Corruption not only exposes institutional investors to potential legal and reputational repercussions, but also works against the objective of all-inclusive growth by perpetuating the unequal division of wealth.

The role of companies

Despite the issues described above, Ahuja notes that many companies, both public and private, have made substantial contributions towards CSR initiatives. “Although such activities are still at a basic level, we see that corporate India is making progress around themes like town planning, education and medical facilities.” Progress has nonetheless been slow as most Indian companies do not structurally report ESG relevant information through their websites, annual reporting or CSR reports. This lack of information represents a major challenge for responsible investors.

Given the limited public pressure Ahuja believes that the implementation of CSR initiatives by companies depends largely on whether management has an interest in the issue. As is the case in many other emerging markets economies, the founding member(s) of a firm often play a strong role in strategic decision making.

Going forward

The Indian government is viewed as the most important actor in developing India’s responsible Investment (RI) and CSR landscape. For example, the proposed amendment to The Companies Bill (2009) obliges companies with a market cap or annual profit above a certain level to formulate a CSR Policy. The latter is meant to ensure that at least 2 per cent of such companies’ average net profits is spent on CSR activities in the three following financial years. In addition, legislation has also moved investors to a somewhat more active role: the regulatory authority (Securities and Exchange Board of India) mandates asset management companies to vote on their top 10 holdings and publish the same annually. Despite these significant movements, Ahuja acknowledges that the effective adoption and implementation of ESG legislation is a time-consuming process.

ESG Performance in China

Background: Chinese firms represent the largest group within the emerging markets universe tracked by Sustainalytics. Much like India, China has experienced rapid economic growth in recent years (GDP growth of 9.5 per cent in 2011 and 10.3 per cent in 2010) and is now the second largest economy worldwide following the U.S. Its tremendous growth has generated much attention and interest on the part of foreign investors. While some companies have started to respond to investors’ and society’s ESG and transparency concerns, there is still much room for improvement. Chinese companies have the lowest overall scores (an average overall score of 47.4 in the Sustainalytics platform) among BRICS companies and rank consistently low across most ESG indicators.

ESG in the local context: Chinese companies face several operational and business risks, including contract repudiations, given the country’s political background. According to AON’s study of political risks in 165 countries, China, like Russia, is considered of
medium risk, whereas South Africa, Brazil and India are all considered of medium-low risk. This perception of business risk is exemplified by China’s political interference, supply chain disruptions, legal and regulatory risks, and political violence. Not unlike the other countries described in this chapter, China deals with corruption, an issue which has been flagged by political leaders as a key area of concern and an issue that businesses should be addressing. However, when it comes to managing exposure to bribery and corruption and being transparent about such initiatives, Chinese companies fall short compared to those in other BRICS countries.

Incidents related to employee relations occur frequently in China and far outstrip those of its BRICS counterparts. Notorious examples include Foxconn, which has come under intense scrutiny and suffered reputational damage following a number of suicides allegedly stemming from poor labour conditions. Western companies are increasingly establishing policies to monitor the activities of their suppliers, which often include Chinese companies. Failure to meet internationally recognized labour standards and involvement in related controversies could effectively pose a serious risk for such businesses.

China has experienced serious environmental degradation, characterized most notably by air pollution, soil erosion, the fall of the water table, pollution of water networks and desertification, caused by various factors including its rapid economic expansion and the sheer size of its population.

**Take away for investors:** China’s exponential economic growth creates investment opportunities, but also poses challenges and risks. Large-scale infrastructural changes and industrial expansion have resulted in serious environmental degradation, and with lagging enforcement of health, safety and labour standards, controversies continue to arise. The lack of transparency and disclosure at a company level, paired with the continuing censorship of local media, also poses a risk to investors. By the time a controversial activity is exposed by the international media, damage to the company’s reputation and finances may already have occurred.
ESG Performance in South Africa

**Background:** With a population of 49 million, South Africa is by far the smallest of the BRICS countries; however, with respect to GDP per capita (estimated at USD 11,000 for 2011) it is comparable to Brazil. South Africa is the largest economy in Africa and has seen huge growth in terms of foreign investment over the past 10 years. The Johannesburg Stock Exchange is currently the 18th strongest in the world and has made a significant contribution to the improvement of ESG disclosure standards. The Johannesburg Stock Exchange launched a socially responsible investment index requiring listed companies to provide extensive ESG reporting. With the development of the Code for Responsible Investing in South Africa (CRISA) in July 2011, aimed at helping investors develop their RI policies based on global best practices, South Africa has set itself apart as one of the front-runners in ESG reporting. According to a report by the International Finance Corporation, sustainable investment in Sub-Saharan African countries totals USD 125 billion, an equivalent of approximately 20 per cent of total assets under management, to which ESG issues are factored into investment decision making processes.34

**ESG in the local context:** The regulatory environment has developed greatly in the recent years, setting South Africa apart not only from its emerging markets counterparts but also from many developed market countries. This regulatory leadership is exemplified by the establishment of the King III code, which requires extensive reporting not only on governance issues but also on environmental and social performance. As a result, South African companies score higher on board independence as well as board oversight of ethics and CSR issues; they also have a greater level of diversity among board members than in other BRICS countries.

Despite their high ESG scores, South African companies, especially those operating in the mining sector, have been involved in a number of community-related controversies that have received international media attention. Concerns have arisen about the operations of South African-based companies in neighbouring countries, such as the Democratic Republic of the Congo, where mining has been linked to brutal human and labour rights violations. Much like other countries with growing mining and oil and gas industries, South Africa increasingly faces issues related to land grabbing, which could result in reputational damage to the companies involved.
With its rapidly growing economy, South Africa is faced with a delicate situation regarding its water supply, which threatens to become the subcontinent’s main environmental issue and is likely to affect businesses operating there. Studies indicate that the groundwater tables are quickly diminishing and, with a rainwater to surface water conversion rate of a mere 10 per cent, the country is perhaps worse off than any other in the world. Pollution of this dwindling resource by the country’s large mining industry is also a key concern and is expected to worsen over time. In line with water scarcity issues, soil erosion and desertification are key environmental concerns, in part due to its agricultural practices and the overgrazing by livestock.

Take away for investors: Although South Africa sets a healthy precedent in terms of developing a mature regulatory environment with an increased focus on ESG reporting, it is not immune to risk. The country’s mining industry faces human and labour rights risks at operations both at home and in neighbouring countries. In addition, water scarcity is likely to impose significant challenges to companies’ operations in the coming years. Other issues that are receiving increased scrutiny from NGOs and responsible investors alike are those related to land grabbing in the agricultural industry. Poor record-keeping of land ownership and questionable ethics and corruption in local municipalities have resulted in strained community relations and may generate reputational risk.

Effectively Using ESG Data: Challenges and Solutions

Challenges for Investors: Disclosure, Language and Local Context

A key challenge for responsible investors is finding a process that helps them to identify and understand risks in their emerging market portfolios. The 2009 Emerging Markets Development Project (EMDP) Emerging Markets Investor Survey found that the most common challenge faced by responsible investors in this regard, cited by 70 per cent of the respondents, was a lack of corporate ESG disclosure. While the growing interest in emerging markets has triggered an expansion in coverage by ESG research providers such as Sustainalytics, disclosure from companies in these regions remains limited. Language can be a considerable barrier for investors as well, as discussed in Case Study 3.

Furthermore, foreign investors often find it challenging to use available information to evaluate corporate ESG performance effectively because they do not fully understand locally rooted risks and local standards relevant to ESG performance and disclosure. This not only presents a problem for integrating ESG information into investment decisions, but it also hinders constructive engagement with companies. In Case Study 3, Geoffrey Mazullo, an ESG professional in Poland, explains some of the biggest challenges for foreign investors that are applying an ESG strategy to emerging markets investments. He points to the importance of making connections, where possible, between companies and investors.
Case Study 3 – Insights from an ESG professional
Geoffrey Mazullo is Principal of Emerging Markets ESG and Adjunct Professor at the School of American Law in Gdansk and in Wroclaw, Poland. He has been involved in ESG research and advisory work for more than 20 years. Mazullo gained professional experience with ESG research through his work in several Eastern European countries and is a knowledgeable consultant and advisor to companies, investors, professional associations and regulatory authorities in Central and Eastern Europe.

ESG disclosure and the role of local drivers and investor demand
Based on years of research, Mazullo notes an overall positive trend in ESG disclosure in emerging markets, though this trend differs among countries. His survey work on corporate disclosure in emerging markets shows that data availability has increased significantly between 2001 and 2010. This growth is incremental and Mazullo expects to see disclosure increase every year by 2-3 per cent.

Discussing disclosure, Mazullo emphasizes that ESG practices and disclosure are very much determined by context-based factors. Within each country, there are specific drivers of improved ESG disclosure and ESG performance such as increased public pressure, local media, legislation, business relations with neighbouring countries, and developments like EU accession. Investor demand could also be a driver if (foreign) investors were able to connect with local companies and link their demands to the local drivers for disclosure. However, there is often a lack of communication between foreign responsible investors and local companies in emerging markets.

Obstacles and recommendations for foreign investors
Mazullo explains that language barriers form the largest obstacle for foreign responsible investors in emerging markets. Survey work by Mazullo in Eastern Europe found significant differences between what a company discloses in English and what it discloses in its local languages. Working with a local partner that can understand the local language, culture and context is often crucial to bridging the gap and aligning investor action with local drivers for improved reporting. While making a link with local drivers might be difficult for foreign investors, Mazullo sees that local responsible investors in emerging markets do act as drivers for change. At the moment, investor influence is still limited due to the infancy of the RI market in these countries.

The Challenges and Benefits of an Engagement Strategy
As stated in Case Study 3, investor demand is a driver of improved corporate disclosure in emerging markets under the right conditions. A notable example of investor action aimed at promoting disclosure is the Emerging Markets Disclosure Project (EMDP), highlighted in Case Study 4, through which responsible investors have collaborated in an attempt to push companies in emerging markets towards improved CSR reporting. Company engagement allows investors to obtain relevant information about corporate activities and is essential to gaining mutual understanding, aligning corporate and investor interests, and prompting company action on urgent ESG risks.
Case Study 4- Collaborative engagement: the Emerging Markets Disclosure Project in Brazil

The UN-backed PRI initiative has 54 Brazilian signatories – significantly more than the 19 signatories in Japan or the 23 in Germany, by comparison. The large number of signatories in Brazil illustrates that responsible investment is becoming embedded in the country and its markets. One of the initiatives supported by the PRI is the Emerging Markets Disclosure Project (EMDP), which was launched to improve ESG reporting by emerging markets companies. Local teams were established in Brazil, India, Indonesia, South Africa and South Korea. Investor engagement with companies in emerging markets generally focuses on the lack of disclosure as one of the first challenges. However, the country team in Brazil, consisting of local investors, foreign investors and service providers, decided to go beyond disclosure and encourage companies to adopt the Global Reporting Initiative (GRI) standard as a reporting framework to communicate to stakeholders.

Engagement efforts

ESG reporting in Brazil is far stronger than in most other emerging economies. In total, 153 Brazilian companies adopted the GRI framework in 2010. In its efforts to further promote GRI adoption, that same year the EMDP country team in Brazil sent engagement letters to all companies on the IBrX100, encouraging them to report according to the GRI standard. Various other efforts, such as workshops and more extensive engagements, have taken place since. In 2011, the local team focused on a group of ten companies and is planning to engage twelve additional listed companies in 2012.

The benefit of joining forces

The efforts described above have led to generally positive responses. In 2011, only two companies did not respond to the letters and the invitation to meet with investors. The other eight companies were interested in hearing about the investors’ perspective on ESG reporting. While companies clearly saw the benefit of knowing their investors’ perspectives, collaboration with the country team has also been a positive experience for investors. Had they not collaborated with the local team, some investors would not be engaging with investee companies on ESG issues at all as the practice of engagement is relatively new in Brazil. International investors are increasingly interested in the Brazilian market and engaging with local companies. Collaborating with local investors, like in the EMDP country team, provides those investors with better insight into local practices and strategies to attract management attention.

Emerging Market Disclosure Project (EMDP), is an international initiative led by representatives from Boston Common Asset Management and Calvert Investments. The group is coordinated by the Forum for Sustainable and Responsible Investment (US SIF) and US SIF’s International Working Group (IWG) and benefits from technical advisory support from the Principles for Responsible Investment (PRI) Secretariat. For more information see www.unpri.org/collaborations/em.php.

The investors consulted for Case Studies 1, 2, 5 and 6 point out that companies in emerging markets are generally receptive to engagement and often show more interest in ESG issues than would otherwise be assumed based on their disclosure rates. Nonetheless, experiences from other investors might be more varied. What is clear is that engagement requires considerable effort as well as readiness to adapt to local context. For example, the varying governance structures in different emerging markets countries may influence the appropriate choice of engagement approaches. In the case of state-owned entities, a twin-track approach that includes lobbying relevant government agencies may be most effective. In the case of family-owned companies, appeals to selected individuals may be most effective. Local investors have an advantage over foreign investors in finding the right approach, given their shared language, cultural background and contextual understanding. Therefore, it is beneficial for foreign investors to obtain research from local-language ESG analysts and to engage collaboratively with local investors.

Dealing with Cultural Differences

While corporate transparency may improve as a result of concerted efforts from both investors and companies, the process of engaging with companies and integrating ESG criteria still faces the challenge of cultural differences. Some of the terminology used by developed market investors may point to values or notions that do not resonate within the cultural context in which investee companies operate and may even be perceived
by company management as an imposition of Western values. Such differences can hinder communication between foreign investors and investee companies and lessen the chances of successful outcomes if the investors are unaware of local perceptions. For example, it may be helpful not to invoke the overarching concept of human rights, which may bring with it the assumption of a common understanding of this term or of the universality of human rights. Instead, referring to specific human rights-related concerns such as child labour or labour conditions may create a larger basis of mutual understanding.

In defining engagement goals, therefore, investors should critically evaluate how their discourse and concepts may be culturally shaped and attempt to shape goals using terminology conducive to achieving mutual understanding. Involving a local partner can be very beneficial in achieving this. Case Study 5 provides some practical experiences and advice based on the intercultural engagement work of MN Services.

Case Study 5 – Intercultural Engagement at MN Services, the Netherlands
MN Services, a Netherlands-based fiduciary manager for pension funds, is an active player in the local RI market. As a foreign investor in emerging markets, MN Services actively engages in dialogues with companies in those regions. Kris Douma, Head of Responsible Investment and Active Ownership, and Faryda Lindeman, Responsible Investment Officer, share their experiences.

Engagement efforts and collaborations at MN Services
MN Services uses ESG research to provide the broadest possible understanding when identifying ESG risks and developing its engagement strategy. When no data is available the company uses its engagement procedures to contact the companies and obtain the necessary ESG information. To stimulate improved emerging market company disclosure, MN Services also supports the Emerging Markets Disclosure Project and is an active member of the working group for South Africa. In addition, MN Services participates in other investor collaborations such as the PRI Sudan Engagement Group and partners, where possible, with local investors in setting up an engagement dialogue with local companies. Lindeman and Douma note that such work with local partners in emerging markets can be incredibly beneficial.

Dealing with differences in culture and perception
In engagement dialogues where local engagement partners are not present, cultural differences can and have been prominent. Topics raised by MN while engaging with an emerging market company have, at times, been completely new to the companies contacted. Due to differences in local standards and perceptions, company management may have a completely different understanding of the ESG issues presented and, consequently, defining shared standards and guidelines that both parties agree upon can be a real challenge. Douma and Lindeman point out that in each country or region there are certain topics that are more difficult to discuss. Instead of using specific human rights-related terminology conductive to achieving mutual understanding. Involving a local partner can

Despite cultural differences successes can be made in intercultural engagement processes. Douma provides an example of a Malaysian oil company where company management initially viewed CSR as being a synonym for charity. Through dialogues with MN Services, the company came to see the value of strategic social investments. Such changes in focus and understanding are the first crucial step towards realizing further environmental and social improvements. Based on their experiences, Douma and Lindeman advise foreign investors to conduct thorough research, to be realistic in their expectations and to maintain flexibility. Setting the right tone in engagement dialogues is equally important. To enable a constructive dialogue, investors should show genuine interest in the company and its business activities and act as an investor rather than an activist.

ESG Integration for Emerging Markets Equities
To date, few mainstream investors have adopted ESG integration as a strategy for their emerging markets equity portfolios. The effective integration of relevant ESG indicators in investment processes naturally depends on the availability and comparability of data. Due to limited availability of data, investors in emerging markets are often forced to adopt greater flexibility when incorporating ESG criteria into their emerging market equities. This section provides practical advice for investors and examples of how to integrate ESG factors into their emerging market equities portfolios.
When company disclosure falls short

In situations where company disclosure falls short and company-specific ESG data from other sources is also very limited, ESG integration can be problematic. In such cases, investors can choose to look at ESG risks and opportunities using a top-down analysis, through understanding ESG risk at the country or industry level.

Country ESG risk management tools are increasingly used by investors for their sovereign bond portfolios. The same instruments can also be used for ESG integration purposes in other asset classes. As ESG risks are connected to situational factors, awareness of country-level risks is essential to understanding the ESG risks faced by companies. Examples include indicators on governance and political risks such as corruption, strength of rule of law and exposure to natural catastrophes. In addition to country-level analysis, industry reports prepared by ESG research providers can serve as tools for identifying the key ESG risks and trends per industry. Such reports can help responsible investors define sector-wide engagement topics or provide input to portfolio managers that wish to integrate ESG factors through sector tilting.

Using ESG ratings

ESG ratings (aggregated scores) are designed to facilitate comparison between companies in the same industry with respect to their overall ESG performance and how well they manage ESG-related risks and opportunities. However, the comparison of companies in emerging markets and developed markets presents a significant challenge due to significant variation in the nature of ESG risks as well as levels of ESG disclosure. These differences make such a comparison largely an “apples-to-oranges” exercise and it is important to take this into account when integrating ESG ratings into portfolio management. If, for example, criteria based on industry rankings are incorporated into screening or stock selection, it is advisable to rank emerging markets companies separately from developed markets companies. It is also important to assess performance qualitatively at the level of the individual company, identifying the specific risks faced by each, and taking into account the ways in which disclosure gaps may point to risk. Non-disclosure on basic governance indicators or on ESG issues most material to the industry may represent a red flag.

Finding the right ESG data for compliance analysis and/or exclusions

For investors that apply exclusionary criteria to their emerging markets portfolios, such as controversy or product involvement screens, relevant data are at first sight not hard to find. Controversy- and product-based exclusions are fairly easy to implement even without detailed ESG disclosure from companies. Generally speaking, companies tend to report their product ranges, allowing investors to apply product-based exclusions (such as screens on tobacco production), while the media, both domestic and international, are a generally a good source of information on major issues and controversies.

However, as discussed in Section 3, a level of caution is needed. It is important to be aware that, in the context of limited scrutiny by the media and civil society, particularly in countries in which local media are censored and not free from government interference, the absence of reported controversies is not necessarily an indication of acceptable ESG performance. In such cases, it is all the more important to supplement company-specific information with analysis of industry risks at the country level.
of information about how a company is managing such risks may raise red flags and prompt investor engagement. For some investors it may even result in exclusion from a portfolio.

Summarizing the above, the successful integration of ESG information in emerging market equities investments is enhanced by the inclusion of country- and industry-specific analysis, as well as by a flexible process. Case Study 6 describes this process at ING Investment Management.

Case study 6 – ESG Integration at ING IM, the Netherlands
Nina Hodzic, ESG Specialist at ING Investment Management (ING IM) in the Netherlands explains how ING IM integrates ESG factors in its investment processes for its emerging markets investments.

ESG integration
At ING IM the process of ESG integration for investments in emerging markets companies is in line with the process for developed markets. Essential to this process are the investment cases of individual companies prepared by in-house sector analysts, which include ESG factors. During the ESG integration process ING IM considers ratings from Sustainalytics which are based on ING IM’s criteria and/or specific information on ESG controversies (such as violations of international conventions and structural ESG issue within a company). Local analysts in emerging markets provide input in this process as well. Even though these analysts have no specific ESG focus, they can provide highly relevant information, such as local news regarding scandals and controversies that affect local companies.

Local teams at ING IM have regular contact with companies worldwide. Unlike some other Dutch institutional investors, ING IM does not have a separate engagement team, but chooses to address ESG issues during the regular meetings between its mainstream analysts and companies. Hodzic feels that companies are more responsive to this approach, as the person they are speaking with is the same person that will make the investment recommendation to portfolio managers.

ESG risks and trends
Hodzic explains that while local ESG standards in emerging markets are generally lower compared to developed markets, from a risk perspective, the differences between companies that do address ESG issues and those that do not are also more prominent. From an operational risk point of view companies in emerging markets can lose their license to operate if they fail to address ESG issues properly. As an example, Hodzic points to China, where local authorities close companies because of health and safety controversies, such as the melamine scandal in 2008.

Looking at the future, Hodzic expects that many things will change. The current debate about integrated reporting among companies in developed markets for example, might be easily overcome by companies in emerging markets that have started developing ESG strategies and programs. While in developed markets CSR reporting is often also used as a marketing tool, companies in emerging markets show a much more strategic focus on ESG, often primarily aimed at mitigating operational risks.
ESG risks in emerging markets are both significant and subject to local variations. As shown in Sustainalytics’ research, emerging market companies generally lag behind their developed market counterparts in implementing policies, governance structures, and systems to manage ESG risk, as well as in reporting on such initiatives. In general terms, the following factors are most notable when comparing the ESG practices and related investor risks in emerging markets with developed markets:

- Concerns about the representation of minority shareholders’ interests resulting from centralized governance models in emerging markets;
- The prevalence of corruption combined with little disclosure of effective policies and programs to address corruption;
- Higher exposure to the severest type of ESG controversies, implying material and/or reputational risks;
- Information gaps regarding violations and controversies as a result of lower levels of scrutiny by governments, media and NGOs.

For responsible investors, these characteristics of emerging markets countries pose significant challenges, which are often exacerbated by important variations in ESG practices and standards among countries.

Local drivers, such as tightening legislation, increased local pressure, local media, and supply chain demands, together with investor action, will increasingly push companies in emerging markets to improve their CSR standards and transparency in the coming years. Furthermore, with the growth of a middle class in many emerging economies, ESG-related reputational factors are increasingly likely to become material even within the local context, creating an additional incentive for companies to improve their disclosure and practices in order to build a strong brand.

In the meantime, however, a responsible investment strategy can and should be implemented. Even when company-specific information is limited, investors can still attend to ESG factors in a meaningful way by combining whatever company-specific data is available with country and industry-level ESG risk analysis. The following recommendations, provided by both local and foreign ESG investors in emerging markets, can contribute to investors’ overall success in implementing a responsible investment approach for emerging markets investments:

- Invest in research, both in-house and from external providers;
- Make use of local-language analysts and sources;
- Design flexible processes that are based on using whatever data is available rather than requiring extensive disclosure;
- Maintain direct relationships with investee companies in order to overcome data gaps and increase mutual understanding;
- Wherever possible, join forces with local investors, civil society organizations and other local partners in engagement processes;
- Be aware of cultural differences.
The following countries are included in the comparisons presented in Section 3.

- Brazil
- Chile
- China
- Colombia
- Czech Republic
- Egypt
- Hungary
- India
- Indonesia
- Korea
- Macau
- Malaysia
- Mexico

- Morocco
- Papua New Guinea
- Peru
- Philippines
- Poland
- Russia
- South Africa
- Taiwan
- Thailand
- Turkey
- Ukraine
- United Arab Emirates
Appendix II: Experts Consulted for This Study

Alvar Roosimaa, CIO of Limestone Investments, Estonia
Working in equity markets from 1996 as an equities trader and portfolio manager, Alvar joined Suprema Fund Management in 2000 as a fund manager. In 2003, Alvar began working at Hansa Investment Funds where he initiated the set-up of the Central and Eastern European investment management team and a portfolio of funds including the Morningstar 5* rated Hansa Eastern Europe Equity Fund. In 2007, Alvar co-founded Limestone Investment Management, an independent specialist Eastern Europe equity funds investment manager. He was nominated the Fund Manager of The Year in Estonia in 2005 and 2006. Alvar has a MSc in Finance degree from London Business School.

Rein Ojavere, Head of Research, Limestone Investments, Estonia
Rein is responsible for heading the research process at Limestone and Northern Star Group. Before co-founding Limestone in 2007, Rein ran the research team in Hansa Investment Management, the largest investment manager in the Baltic region. He also managed Hansa Central Asia Equity Fund, the first dedicated UCITS fund investing in the region. Rein started as an equity analyst at Suprema Securities, the leading pan-Baltic investment bank, in 1997. Rein later moved to corporate finance, where he held the positions of Senior Analyst, Associate Director and Director until 2006. He participated in a number of landmark M&A transactions, privatization deals and public offerings in the Baltic region with responsibilities in the areas of valuation and structuring. Rein is a CFA Charterholder and holds MSc in Economics and Business Administration degree from University of Tartu.

Swati Ahuja, Canara Robeco Asset Management Company, India
As former Manager of Corporate Development at Canara Robeco Asset Management, Swati Ahuja was responsible for the ideation and execution of strategic initiatives determined by top management, including ESG integration for offshore mandates and own investment processes. Her responsibilities also included business planning and management reporting. Swati Ahuja recently joined KPMG Mumbai as a Consultant. Prior to working for Canara Robeco, Swati worked with other investment management firms such as JP Morgan in Mumbai and Société Générale in Paris.
Geoffrey Mazullo, Emerging Markets ESG, Poland

Geoffrey Mazullo is Principal of Emerging Markets ESG and Adjunct Professor at the School of American Law (SAL) in Gdansk and in Wroclaw, Poland. Following studies in diplomacy, economics and political science in Washington, DC, Krakow, Poland, Berlin and London, Geoffrey worked as a corporate governance analyst, first with Institutional Shareholder Services (ISS) and later with Investor Responsibility Research Center (IRRC). Following an assignment with the Russian Privatization Center from 1992 to 1993, he worked on several long-term capital market development projects in Bosnia and Herzegovina, Bulgaria, Moldova and Russia. From 2001 to 2009 he directed the Partners for Financial Stability (PFS) Program, a regional financial sector development program in Central and Eastern Europe, for which he designed, launched and conducted two semi-annual surveys of listed companies in Eastern European emerging markets: Investor Relations Online (2001-2009; 2011-) and Reporting on Corporate Social Responsibility (2003-2009). Since 2006 Geoffrey has been chair of the evaluation committee of the NASDAQ OMX Baltic Market Awards. Complementing his research and teaching activities, he publishes a weekly expert interview, “Five Questions about SRI” on Emerging Markets ESG which can be read at http://www.emergingmarketsesg.net/esg/.

Nina Hodzic, ESG Specialist, ING Investment Management, the Netherlands

Nina Hodzic joined ING Investment Management in 2005 and has been the ESG Specialist in Responsible Investments since 2008. The responsible investments team manages a significant pool of dedicated ‘sustainable’ assets in addition to group-wide exclusions in mainstream strategies and screening services for segregated mandates. In her role as ESG Specialist she is responsible for ESG analysis and reporting, screening methods and communication with various internal and external parties on sustainability topics. Nina also advises clients on their responsible investment policy and is actively involved in setting up responsible investment client solutions across different asset classes. She is the global coordinator of the UN Principles for Responsible Investment for ING IM, a member of the proxy voting committee of ING IM Europe and a member of the sustainable investment committee of the VBA (the Dutch Association of Investment Professionals).

Previously, Nina worked on various projects regarding stock analysis and portfolio construction within several sector teams of the Equity Investments department at ING IM. She started her career at ING Group Market Risk Management as market risk analyst, where she was responsible for the development and implementation of stress testing practices for ING Bank trading portfolio. Nina holds a Master’s degree in Econometrics from Erasmus University in Rotterdam. She is DSI (Dutch Securities Institute) registered.
Kris Douma, MN Services, the Netherlands
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Endnotes


3 In the interviews conducted by Sustainalytics for this report, the perception of greater ESG-related risks was shared among respondents. For more information about investors’ perspectives on ESG risks in emerging markets, also refer to http://www.emergingmarketsesg.net/esg/category/research/.

4 Allianz Global Investors and Risklab, Responsible Investing Reloaded: Sustainability Criteria Matter, April 2011.

5 The study shows that the tail risk of an ESG-risk-neutral emerging market equity strategy, as defined by the MSCI Standard Index - Emerging Markets, could be reduced from -64.5 per cent p. a. to -38.8 per cent p. a. by optimizing ESG risk factor exposure. Tail risk is measured as Conditional Value at Risk (CVaR) at a level of 95 per cent.

6 in Sustainalytics Global Platform the set of ESG indicators researched for emerging market companies is smaller than the set used for developed market companies, being adjusted to reflect disclosure practices in these markets. The comparisons provided in this section are exclusively based on indicators that have been researched for both emerging and developed market companies.

7 Averages are based on generic (non-industry-specific) indicators only.

8 These are the ESG themes within Sustainalytics’ assessment framework that have the largest sets of indicators both for emerging market and developed market companies.

9 This comparison has been limited to generic (non-industry-specific) indicators, on which all companies are assessed irrespective of industry or size.

10 This comparison has been limited to generic indicators.

11 This comparison has been limited to generic indicators.


13 “Dusk for the patriarchs: As ageing tycoons die, their heirs are feuding and their empires are at risk”, The Economist, 3 February 2011.


15 Sustainalytics analyzes and assesses controversies and incidents using a hurricane scale that includes five levels, with Category 1 representing the least serious controversies and Category 5 representing the most egregious. For more information about Sustainalytics’ Global Platform research methodology and the assessment framework of controversies, contact Sustainalytics.

16 Sustainalytics Global Platform, January 2012. Percentages are based on a research sample consisting of 809 emerging market and 1,593 developed market companies.

17 Sustainalytics Global Platform, January 2012. Percentages are based on a research universe consisting of 809 emerging market and 1,593 developed market companies.

18 Aggregated ESG scores as of early January 2012. All scores reflected in this section are based on a sample universe of 813 emerging market companies included in the MSCI Emerging Markets Standard Index.


22 UNDP International Human Development Indicators, Brazil 2011 data.

23 World Bank, Bolsa Familia: Changing the lives of Millions in Brazil, http://go.worldbank.org/3Q1JC75U0.

24 Intergovernmental Panel on Climate Change (IPCC), Climate Change 2007, the Fourth IPCC Assessment Report.


30 These are aggregated ESG scores as of early January 2012 for 83 Indian companies, using Sustainalytics’ scoring scale of 0-100.


World Bank, Special Investigation Phase Two: Understanding How Land Deals Contribute to Famine and Conflict in Africa, 2011.


These and other indicators are included in Sustainalytics’ Country Risk Monitor. For more information see: www.sustainalytics.com/country-research-0.

These recommendations were collected during the interviews for the various case studies in this paper.

About Sustainalytics

Sustainalytics provides environmental, social and governance (ESG) research and analysis as well as responsible investment services to investors around the world. The firm offers global perspectives and solutions that are underpinned by local experience and expertise, serving both values-based and mainstream investors that integrate ESG information and assessments into their investment management.

Headquartered in Amsterdam, the firm has regional offices in Boston, Frankfurt, Madrid, Paris, Timisoara and Toronto and representatives in Brussels, Copenhagen and Colombia. The firm has more than 100 staff members with a variety of multidisciplinary and industry expertise. In 2012, Sustainalytics celebrates 20 years of collaborating with responsible investors worldwide.

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