

Why isn't SRI going south?

Investors are placing increasing amounts of capital in emerging markets. But environmental, social and governance considerations inform very little of this investment, and valuable commercial as well as development opportunities are being missed, says **Dan Siddy**

In 2006, the International Finance Corporation (IFC) celebrated its 50th anniversary of investing, as part of the World Bank group, in private sector development in the world's poorer economies. One of the IFC's more obvious accomplishments in that time was coining the phrase 'emerging markets' in the 1980s. This simple act had a big impact in shifting business perception of countries that had previously been lumped together as the more easily dismissible 'Third World'.

However, nearly 25 years later, those countries are still referred to as emerging markets, and about 2.6 billion people (more than 40% of our global 'marketplace' of humanity) are still living on less than \$2 a day. This figure could rise dramatically as populations grow and traditional natural resources dwindle further. In strictly dispassionate terms, this represents a serious market failure that has grave economic, social and ecological implications from which no one is immune.

For example, anyone paying into a pension plan in Europe and hoping for a reasonably comfortable retirement is relying partly on the ability of today's emerging markets to deliver tomorrow's long-term risk-adjusted returns. This growth depends on companies building shareholder value by exploiting intellectual, supply, production or consumption opportunities in developing countries. The emerging market firms that do this most successfully will become domestic or regional players, positioning themselves to become tomorrow's multinationals. For such commercial exploitation to be durable, stable and acceptable to society requires responsible, long-range management of environmental, social and governance (ESG) issues, alongside more traditional business considerations.

It's also safe to assume that, for most people (at least in OECD economies), a comfortable retirement also means one that is free of social and environmental blights such as sea-level rise, energy shortages and armed conflict. This future largely depends on how well emerging market investors and businesses

gear up now to deal with issues such as climate change, natural resource depletion and human rights.

The corporate and investment community hold the ace cards in deciding whether globalisation can go hand in hand with poverty reduction and sustainable development. They also stand to gain (or lose) a great deal commercially from ESG-related business opportunities and risks in developing countries. Governments, NGOs and organisations such as the World Bank need to play their part in creating the framework conditions for business and the capital markets to succeed, and intervening to prevent failure.

Net portfolio equity flows to emerging markets have almost doubled since 2003 to about \$70 billion today, overtaking both bank loans and non-bank credit as the second largest type of private capital flow after foreign direct investment. Stock market capitalisation in emerging markets has more than tripled from \$1.8 trillion in 2002 to \$6.6 trillion last year and now accounts for 16% of global stock markets, up from 9% in 2003.

In parallel, ESG issues have begun to rise up the emerging market investment agenda.

Pension funds including ABP, PGGM and that of the UK Environment Agency have shown a strong strategic interest in emerging market socially responsible investment (SRI), and some have even allocated capital. Leading pension funds from Brazil and Thailand were among the founding signatories of the UN Principles for Responsible Investment in April 2006. Blue-chip asset managers such as State Street, ABN Amro and First State have successfully brought new products to the market for ESG-enhanced investment in large-cap emerging market stocks.

In terms of specialised SRI research and information infrastructure, both the São Paulo and Johannesburg stock exchanges now operate SRI-based indexes, and will be joined in 2007 by similar initiatives in India and Thailand. The Australian ESG rating firm Reputex opened for business in Shanghai in 2006, and

other leading research firms such as Innovent, ISS and EIRIS are also widening their service offerings to cover emerging market stocks.

A key factor in accelerating SRI in emerging markets may turn out to be the IFC's Capturing Value competition, designed to stimulate more access to ESG research on listed companies from developing countries. The two winning consortia of this \$500,000 grant programme were announced in September (see *Environmental Finance*, November 2006, page 10).

The IFC and other international organisations such as the UN Global Compact and UN Environment Programme Finance Initiative have also played key roles in raising awareness and building networks through a range of regional conferences and other events.

But a positive signal is that this 'top-down' advocacy is slowly, but rightly, being displaced by 'bottom-up' services led by local markets. For example, Europe's widely respected Triple Bottom Line Investing (TBLI) conference series ventured into the emerging markets for the first time in 2006. The Association for Sustainable & Responsible Investment in Asia (ASrIA) continues to play a hugely influential awareness-raising, networking and market intelligence role. A Latin American counterpart, hosted by the FGV business school in São Paulo, was established in 2006. In the Middle East, Israel seems to be emerging as a possible centre of new momentum on regional SRI issues.

Surprisingly, there is little evidence of comparable market development activity in Central and Eastern Europe. Given EU enlargement, the relatively advanced nature of the Polish, Czech and Hungarian markets, and the immensity of ESG challenges posed by Russian and Kazakh companies (many of which are now listing in London or New York), this is a worrying gap. The European Bank for Reconstruction and Development has been taking exploratory steps in this area with investment bank UBS and Hungarian bank OTP, but it remains to be seen where this may eventually lead.

Has all this activity had any real impact so far?

The brutal answer is (probably) no. Up-to-date data are scarce, but research undertaken by consultancy Enterprising Solutions in 2003 indicated that out of the total global SRI asset class of \$2.7 trillion (using a broad definition of 'SRI'), less than 0.1% was being invested in emerging market companies. Regardless of whether SRI means using ESG insights to deliver long-term profit, or 'doing good' through ethical screening and engagement, this is a very troubling number.

Since 2003, the global SRI market has grown by about 30%. Rather than growing from 0.1%, the emerging markets are now likely to

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São Paulo stock exchange – pushing SRI into emerging markets

have an even smaller share of the overall SRI capital pool. According to the European Social Investment Forum, SRI investors in the UK are now allocating up to 10% of assets to the emerging markets, but the rest of Europe is lagging far behind. The US SRI community has shown interest, but there has been no noticeable change in the trajectory of their dollars.

In the development finance community, the IFC's Capturing Value grants (indirectly provided by the Swiss, Norwegian and Dutch governments) will hopefully have a major impact by reducing information barriers to emerging market SRI. However, the IFC has barely begun to act with its own money in any serious way: although, in February, board approval was finally given for its first emerging market SRI fund (see page 7).

The most authentic progress in considering ESG factors in emerging market investment decisions – and the best bet for the future – probably lies beyond the US and European SRI movement and the international donor community.

'Mainstream' investors – including those who place about \$70 billion a year into emerging markets – are now beginning to understand that ESG issues can be material, are not the sole preserve of the ethical investment niche, and taking them into account is not inconsistent with fiduciary responsibilities. The 'ESG mainstreaming' trend (exemplified by the UN Global Compact's Who Cares Wins programme, the Enhanced Analytics Initiative and the PRI) is being embraced by influential players with very significant interests in developing and transitional economies.

An important reason for such enlightened self-interest is that there is arguably a much stronger case for ESG materiality in emerging market firms compared to companies operat-

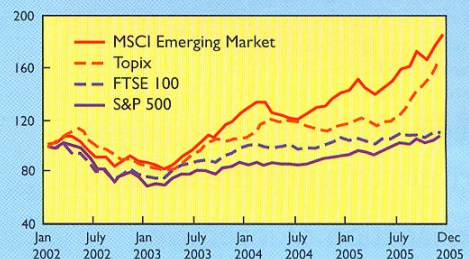
ing from better regulated and less environmentally or socially stressed countries. With the quiet but effective support of the US think-tank the World Resources Institute and similar catalysts, investors such as Hermes, ABP, Goldman Sachs, ABN Amro and State Street may well be pivotal over the next three to five years.

The second band of pioneers is likely to be the small but growing cross-section of investors from emerging markets. Pension reform, liberalisation of the non-bank financial services industry and the accumulation of record levels of foreign reserves are contributing to significant growth of domestic capital. This money is invested in the domestic economy and is also increasingly being used for South-South and South-North investment, and many of the people making these decisions understand the ESG imperative.

Brazil alone has almost \$420 billion in its private pension and mutual funds. It also has, among other things, companies that employ around 50,000 slave labourers to clear the Amazon jungle for cattle-ranching and soybean production. Perhaps it's not surprising that Brazil's pension funds association launched its version of the Principles for Responsible Investment two years before the PRI itself entered the stage.

Equally, black economic empowerment is a major factor for institutional investors in South Africa, where the Johannesburg Stock Exchange's listing rules include some of the

Performance of global equity markets, 2002–05



Source: Global Development Finance 2006, based on Bloomberg and World Bank staff calculations

most far-reaching ESG disclosure requirements to be found in any market. In both countries, fund managers are offering local investors a growing and competitive range of SRI-flavoured investment products. Strategic thinkers and decision-makers in markets as diverse as Chile, Thailand and Kenya are also beginning to take practical action around the question of ESG in portfolio investment.

The emerging markets continue to offer huge societal and business challenges and opportunities – and ESG-literate investment is core to success. For the phrase 'emerging markets' to become obsolete, continued progress now depends on smarter thinking, swifter innovation and more consistent commitment. Above all, it requires new leaders in both thought and action to emerge from the ranks in these last three years of the new millennium's first decade.

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