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Sustainable investing in emerging markets

By George Crowdy – Fund Manager, Royal London Asset Management

In launching the new RL Global Sustainable Equity Fund, we sought to create a single-asset fund that could select the best sustainable companies from around the world, whatever their country of domicile. The world has changed and the lines between developed and emerging markets are extremely blurred. Many companies operate across borders and, provided your investment process is rigorous, there is no reason to exclude certain countries or companies from a global sustainable fund.

Consequently, we chose the MSCI All Countries World Index (ACWI) as the new fund's benchmark, rather than the MSCI World. This brings into play 26 additional countries as well as the 23 developed markets. This creates a much larger opportunity set to seek out the best sustainable companies globally, including in technology-rich, high-growth countries like South Korea, China and India. It also dials down the US from 64% to 56% of the index, giving a more balanced portfolio that reflects global equity weightings. Importantly, as emerging markets continue to develop, we feel the fund is 'future-proofed'.

The reasons for investing in emerging markets are well known. The demographics are favourable, with younger, faster-growing populations and developing middle classes with increasing disposable income. In addition, from a sustainable investment perspective, there is a huge opportunity to invest in companies providing solutions to environmental and social challenges, particularly addressing areas such as financial inclusion, education and healthcare.

Yet, there can be clear downsides to investing in less developed markets. They can be more vulnerable to economic shocks, particularly if they have borrowed heavily in US dollars. It's possible, for example, that the recessionary effects of the measures to limit the coronavirus pandemic will fall disproportionately on some developing countries. Political risk can also be higher, as can legal risk and challenges with corporate governance.

As a result, some may think that sustainable investing is unsuited to emerging markets, seeing it as an 'optional extra' for developed markets that they perceive to be better suited to applying environmental, social and governance (ESG) analysis? While this may have been true 20 or so years ago, we now see such thinking as wrong-headed. There are world-leading companies in so-called emerging markets and some standards can be higher in these countries – look at how South Korea has coped with the coronavirus.

There can be additional challenges to sustainable investing in some emerging markets that we wouldn't face in buying stocks in the UK, Europe or the US. It would be disingenuous to say otherwise. Data can be patchier and less reliable, particularly on issues relating to ESG; shareholder voting and engagement may be more challenging; and there may be lower absolute standards of ESG in some developing countries.

These are hardly insurmountable challenges. Before addressing them, I should make several points. Most importantly, we haven't gone mad! While we are pleased to consider a wider opportunity set, we will not be stacking the fund with new emerging markets holdings. Indeed, six weeks after launch, in the current portfolio of 43 companies, only two are based in emerging market countries: Taiwan Semiconductor (TSMC) and MercadoLibre, which is a South American hybrid of PayPal and Amazon. As the fund will hold only 30-50 stocks, the emerging markets component will remain small and manageable: those companies that we do buy will be high conviction.

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Furthermore, we will still use our long-standing sustainable investing criteria. Our job as fund managers is to deliver strong risk-adjusted performance to our investors. While sustainable investing can be beneficial to society and raise standards of corporate behaviour, first and foremost the stocks that we buy must have the potential to deliver significant investment returns.

We will be using the same proven investment process for global equities as for our other sustainable funds – it is the same philosophy and process, the same intellectual property and expertise, and the same high-quality input from our colleagues on the research side. Our wider team – as well as our independent external advisory committee – is culturally diverse and will add insight and perspective to our understanding of some emerging markets.

We have already seen these benefits in our overseas investments for our existing funds. We have been investing globally through our mixed-asset funds since 2009, so it isn't new to us. Our new global equity fund is very much an extension of our current approach across a wider opportunity set.

We screen the universe of 3,000+ stocks to narrow it down to around 700; our team will then do due diligence on these names to highlight the better prospects. Crucially, we do our own independent analysis, rather than buying in data – this addresses the point about data quality in some emerging markets. Lastly, we conduct a consistent, scorecard-driven approach across the strong candidates for investment, scoring financial and ESG factors equally.

So far, so similar. So what are the challenges that could pose a risk? Earlier, I referred to governance challenges in some emerging markets. Our first hurdle is always corporate governance – if we can't get comfortable with that, we never proceed. We will still take this approach, but will also include an assessment of the company's national standards of governance. This isn't so much about emerging markets as a whole, but country-specific factors. Besides, these can be challenging in some developed markets. Japan, for example, has very different corporate mores and governance from parts of Europe or the US.

Some of the differences in emerging markets stem from their business culture. Different capital markets practices have sometimes led either to bigger state holdings or family stakes in companies. We can get comfortable with such differences if there is clearly a level playing field. This tends not to be the case with a state holding in a company – politicians are more likely to make popular decisions than those which are in the interests of all shareholders.

Conversely, a significant family holding can work as it is far more likely that the family's economic interests would align with ours. Of course, this is not the case where a family has special shares and has voting powers well beyond its financial commitment. Of course, this can also be a challenge with US technology giants. Equally, complex webs of family ownership with cross-holdings in banks or other companies are usually a bad sign. But one can't be too hard line about such things – 25 years ago, such things could have been said about many continental European companies. Some were value traps, but some had just evolved differently from the UK and US model and are now world leaders in their sector.

Emerging markets add potential opportunities to invest in the world's best sustainable companies. The markets are fast growing and the companies can be 'fast followers' of developed market technology or approaches, with a resulting high chance of success. We can reduce or manage much of the risk by applying our expertise and proven process. But, in the end, investment can never be about eliminating risk completely. After all, without investment risk, there can be no returns.

This article first appeared in the Portfolio Adviser ESG supplement.

George Crowdy co-manages the Royal London Global Sustainable Equity Fund with Mike Fox. To find out more about RLAM's approach to sustainable investing and our range of funds, please visit rlam.co.uk/sustainable

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69977 05 2020