

**Responsible Investing 3.0:
Understanding the Environmental, Social, and Governance
Context of Emerging Markets**

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Abstract

Responsible investment has in recent years shed its common perception as a niche market and developing as an important global financial investment market instrument. What is less clear whether – and how quickly – the mainstreaming of RI will materialize outside of North America and Western European regions, in the emerging markets in Asia-Pacific, Latin America, and Africa.

We argue in this paper that we are about to enter what we are calling the third stage of responsible investing (RI), in which RI is becoming a market reality if not a force in a number of emerging economies.

To improve our theoretical as well as business practice-based understanding of responsible investing in emerging economies, we will examine three RI-related sets of issues and questions in this paper. First, what are the important strategic dimensions at the nexus of corporate responsibility, investing, and emerging markets. Second, what are the critical operational dimensions at the nexus of corporate responsibility, investing, and emerging markets. Third, what are the significant leadership dimensions at the nexus of corporate responsibility, investing, and emerging markets.

Keywords

Responsible Investing, Emerging Markets, Sustainability, ESG (Environmental, Social, Governance)

1. Understanding the Strategic, Operational and Leadership Dimensions of Corporate Responsibility, Investments, and Emerging Markets

Responsible investing (RI) is an investment process that considers the social and environmental consequences within the context of traditional financial analysis. Responsible investors include individuals, government pension funds, and a wide array of nonprofit organizations who use responsible investing to achieve an inter-linked set of economic, social, and environmental objectives. By integrating analysis of environmental, social, and governance issues onto traditional quantitative financial analysis, responsible investing professionals and researchers are working toward mainstreaming the importance of corporate social and environmental risks, while engaging businesses to improve their corporate environmental and social responsibility business practices.

In recent years, RI has shedd its common perception as a niche market and developed as an important global financial investment market instrument. About \$3.1 trillion or about nearly one out of every eight dollars under professional management or 12 percent of the \$25 trillion in total assets under management in the United States - is estimated to be involved in some strategy of responsible investing (Social Investment Forum, 2010), while the European responsible investment market has reached €5 trillion (as of December 31, 2009) from an estimated €2.7 trillion figure in December 2007 (Eurosif, 2010).

Among academics and practitioners that track the responsible investment industry worldwide, there is little disagreement that responsible investment has the 'potential' to advance a deeper set of social, environmental and ethical business norms on the global level. However it is less clear is how quickly the mainstreaming of RI will materialize outside of North America and Western Europe, into the emerging markets of Asia-Pacific, Latin America, and Africa.

We argue in this paper that we are about to enter what we are calling the third stage of responsible investing (RI), in which RI is becoming a market reality if not a force in a number of emerging economies. The first stage of the modern RI movement came from the turbulent period in the 1960's and 1970's when powerful social undercurrents including environmentalism and anti-war activism fueled a rise in a dramatic change in business, environment, and society. RI 2.0 saw a rapid acceleration of responsible investments in North America, Western Europe, and other OECD-level countries around the world.

To improve our theoretical as well as practice-based understanding of responsible investing in emerging economies, we will examine three RI-related sets of issues and questions in our paper. First, what are the important strategic dimensions at the nexus of corporate responsibility, investing, and emerging markets. Second, what are the critical operational dimensions at the nexus of corporate responsibility, investing, and emerging markets. Third, what are the significant leadership dimensions at the nexus of corporate responsibility, investing, and emerging markets.

2. Corporate Responsibility, Investing, and Emerging Markets: Strategic Implications

Whether one chooses to call them emerging markets or frontier economies, it is hard to underestimate the importance of markets outside of North America. Corporate responsibility, often seen as the preserve of major companies in developed economies, is gaining ground in emerging markets. Initiatives such as the UN Global Compact, the UN Principles for Responsible Investment and the Carbon Disclosure Project are increasingly focusing on

emerging markets as investors turn towards these markets, attracted to their traditionally dramatic, if volatile, returns.

While emerging markets investments typically account for only a small portion of their portfolios, developed country investors' exposure to emerging markets is much larger than is implied by their notional allocations, given the operational exposure of developed world multinationals to emerging markets. Combining responsible investment with corporate responsibility actions provides a unique set of risks and opportunities for investors.

Disparities in corporate responsibility performance as well as developments in corporate responsibility research in emerging markets may also create market inefficiencies and thus opportunities from which clever investors can profit although emerging market volatility may need to diminish before ESG issues add to or subtract noticeably from shareholder value (EIRIS 2009). Even with the recent global financial crisis, it is important to note that the overall trend of responsible investing becoming a more mainstream investment vehicle in emerging markets has not diminished.

In a joint survey with the International Finance Corporation (IFC), Mercer Investment Consultants surveyed 514 investment managers in their database and detailed the results in a 2009 report. They found that over US\$300 billion in assets under management invested in emerging market equities are in either an RI-labeled fund or a mainstream fund that has made some commitment to integrate ESG into the core investment process. The IFC/Mercer report concludes that about \$50 billion of this investments which are specifically branded as socially responsible or sustainable (see **table 1**).

3. Corporate Responsibility, Investing, and Emerging Markets: Operational Implications

The second critical trend that lies at the nexus of corporate responsibility, investing, and emerging markets is related to the impact on business operations. Specifically, the increasing call for environmental, social, and governance (ESG) disclosure practices by institutional investors and other investment entities are pushing the disclosure of environmental, social, and governance (ESG)-related business practices in emerging markets. The United Nations Principles for Responsible Investment (UNPRI), for instance, currently has 855 asset owner and asset manager signatories from 45 countries. They control \$22 trillion of assets under management – almost 10% of the global capital markets. A lack of consistent ESG disclosure is a feature of companies around the world but the problem is especially stark in emerging markets in that it seems to be holding up investment for responsible investors.

An emerging market investor survey from the Emerging Markets Disclosure Project (EMDP 2009) highlighted the lack of ESG disclosure as the biggest challenge to investing in emerging markets for responsible investors. The survey brought together the views of responsible investors representing \$130 billion of assets invested in emerging markets. Survey respondents commended two emerging market countries, Brazil and South Africa, for having made the most progress towards greater ESG disclosure. This corresponds with the results of a report published in the same year by the Sustainable Investment Research Analyst Network (SIRAN), a working group of the US Social Investment Forum. The report assessed 40 leading companies in ten emerging markets against key ESG criteria and found that the South African and Brazilian companies stood out as consistently having the highest assessments of the companies sampled.

These countries also developed some of the first responsible investment indices in emerging markets (the Johannesburg Stock Exchange SRI index in South Africa and the Bovespa Corporate Sustainability Index in Brazil). The SIRAN report found that of the 40 leading

emerging market companies sampled, the majority have shown evidence of addressing at least some ESG issues in their public disclosures. While there is still considerable variation in performance, companies scored much better in environmental areas than in social or governance areas, with some reaching grades on a par with developed country environmental leaders in environmental performance and systems.

It seems as though corporate responsibility, long seen as a luxury for large companies in developed economies, is gaining ground among some corporations in emerging markets. This issue is explored further in **figure 1**, using bribery as a proxy for social issues. The chart compares emerging and developed market company assessments and shows a polarization of leaders and laggards. While emerging market companies' environmental policies range in quality, some companies achieved the highest grades in line with their developed peers. This research only looked at the public ESG disclosure of large emerging market companies but the EMDP survey referred to earlier identified poor disclosure especially among smaller companies as hampering their efforts. These investors were concerned that those companies appeared to be failing to mitigate their ESG risks.

In emerging markets, this is particularly pertinent given lower generally levels of regulation and enforcement surrounding these issues. In emerging markets there are great differences between regions. Leading Brazilian and South African companies often seem to have more in common with each other than they do with companies in neighboring countries. There also appears to be a substantial gap between companies doing a great deal (often at a similar level to their developed country peers) and those doing little or nothing. As one starts to look beyond the very largest companies, corporate responsibility in emerging markets is far less common. However, the role of local civil society, investors, and stock exchanges is likely to have a growing impact on the development of corporate responsibility going forward.

4. Corporate Responsibility, Investing, and Emerging Markets: Leadership Implications

The third significant trend that lies at the nexus of corporate responsibility, investing, and emerging markets is related to the impact on business leadership. Many emerging markets lack the intensity of stakeholder pressure to improve ESG disclosure seen in developed economies from governments, non-governmental organizations, and consumers. To this end, an increasing number of stock exchanges in emerging markets are playing a key leadership role in promoting sustainability, transparency, and greater disclosure by their listed companies. Because of their ability to directly influence and monitor the operations of companies seeking to access the equity markets, emerging market stock exchanges can directly influence the sustainability-related business approaches of the listed companies (as well as companies who wish to be listed in the respective stock exchanges) through such market mechanisms as sustainability indices (see **table 2**)

This flurry of activity in many emerging markets reflects the recognition and the need to internalize environmental and social considerations into financial markets in order to promote more sustainable development. A key aspect of this process is producing more and better ESG reporting. Over the last two years, private-public ventures such as the Sustainable Stock Exchanges initiative (<http://www.unpri.org/sustainablestockexchanges>) has started to explore how exchanges can work together with investors, regulators, and companies to enhance corporate transparency, and ultimately performance, on ESG issues and encourage responsible long-term approaches to investment.

According to a 2009 survey conducted by the World Federation of Exchanges among its 51 members, the sustainable investment strategies currently endorsed by stock exchanges fall into three categories: (1) promoting ESG awareness and standards through IPO or ongoing listing requirements; (2) providing information products and services in the form of sustainability indices; and (3) creating markets for specialized products such as carbon trading and clean-tech investment.

As a company's profile can be linked to the reputation of the exchange where it is listed and the requirements for companies listing, there is a business case for exchanges to lead by example on ESG disclosure and performance. However many exchanges have also become for-profit entities and thus are generally disinclined to introduce strong mandatory disclosure requirements which may cause companies to list on alternate exchanges with less regulation. Those exchanges are also unlikely to enact changes which would reduce high-frequency trading which drives their revenues.

However there is a paradox in that this short-termism goes against exchanges' interests of continued strength and stability in their capital markets promoted by a long-term focus by companies and their investors. Many emerging market stock exchanges are moving quickly beyond their developed peers in terms of promoting sustainability. The South African Johannesburg Stock Exchange (JSE) is perhaps the most celebrated example because of the extent of reporting integration that is required. But there are many other exchanges which have developed rules and guidance surrounding ESG disclosure including Egypt, Brazil, China, India, Indonesia, Malaysia, Thailand, and Taiwan, among others.

While most stock exchanges have some sort of mandatory corporate governance disclosure requirements incorporated in their IPO and ongoing listing rules, only four exchanges go further, by also taking account social and environmental factors - three of them are in emerging markets. Bursa Malaysia and the Johannesburg Stock Exchange have incorporated full ESG disclosure requirements into their ongoing listing rules while the Shanghai Stock Exchange has introduced environmental requirements for companies in the 14 most energy intensive industries before they can initiate an IPO. This requirement to integrate ESG and financial reporting holds the key to real change in creating a level playing field necessary to push the implementation of the sustainability agenda to a higher level. Companies turning to public equity markets for capital are a good target for increased ESG disclosure. Increased disclosure can help investors with their decision making and thus allow companies greater access to capital.

As an example of business leadership and innovation coming from unlikely places, China has been at the forefront with its IPO environmental disclosure requirements. In 2008, the Chinese Ministry of Environmental Protection (MEP) launched the "Green Securities" policy and the "Green IPO" policy in partnership with the China Securities Regulatory Commission (CSRC). These policies aim to make it harder to raise capital by requiring companies who want to list to disclose more information about their environmental record. Enterprises in 14 polluting industries must go through an environmental assessment by the MEP before initiating an IPO or obtaining refinancing from banks. During a 10-day pre-IPO evaluation period, the MEP conducts its own assessment and calls for the public's opinion. Within the first year of the new rules, 20 out of 38 companies had their IPOs rejected or were subject to further assessment by the MEP. More recent data has not been released.

5. Future of Responsible Investing in an Era of Global Complexity

If the past is any guide, any prediction about the future of the emerging or frontier markets need to be layered with many caveats and the future of responsible investments is no exception. With the usual caveats in mind, we would like to offer the following three thoughts about the future of responsible investments in emerging economies.

First, with India as a rising global economic power and China likely to supplant the U.S. as the largest economy in the world over the next few decades, responsible investors' depth of knowledge and understanding needs to increase about China's financial market conditions outside of Hong Kong, Shanghai, and other relatively wealthier band of coastal cities regions.

One can be excused for overlooking the fact that the second largest province in China in terms of GDP (Jiangsu, \$620 billion) is equal in size to Turkey (\$614 billion) and the third largest province (Shandong, \$597 billion) is larger than Indonesia (\$540 billion), according to estimates by the Eurasia Group (Ma 2011). But, with so much future market growth of the 20,000 Western multinationals tied up in emerging markets (up to 70 percent of the future global market growth) and China and India alone accounting for nearly 40 percent of the future global market growth (Eyring, Johnson, Nair, 2011).

Perhaps international responsible investors can learn from domestic emerging market responsible investors. It is worthy of note that emerging market domestic investors are taking a greater interest in responsible investing in their own countries. For example, a 2009 BSR/IFC report identified vehicles for Chinese investors to invest responsibly domestically. The report noted that there has been a retail socially responsible mutual fund available for domestic Chinese investors since 1998.

In addition, the National Social Security Fund of China (NSSF) – the country's largest pension fund with total assets of US\$82 billion – lists "responsible investment" as one of its four core investment principles and has expressed interest in learning more about responsible investment practices overseas. In the report, BSR estimated that domestic Chinese responsible investments totaled \$3.6 billion, leaving much room for the development of responsible investment in that country.

Second, while the political uncertainty that is currently gripping the countries in the Middle East region has captured the imagination of the international community, a business trend of growing Shari'ah-compliant investment assets with strong ties to the Middle East region has also captured the imagination of the financial markets worldwide. According to Credit Suisse, Islamic finance is now one of the fastest growing business segments in the world. Its compound growth rate was 26 percent between 2004 and 2009, and is estimated to be \$822 billion by end of 2009. Moreover, Shari'ah-compliant assets are likely to triple by 2016 and expected to reach \$3 trillion (see **figure 2**) (Leins, 2011).

What is interesting about the market development of Islamic finance is that the historical genesis of responsible investment markets in North America and Europe can be linked back to the various religious faiths. Responsible investing funds were once primarily known, and still in some circles referred to, as ethical funds. The very notion of an 'ethical business enterprise' has strong roots in Judeo-Christian traditions with references in the book of Deuteronomy dating back more than 3,000 years (Kreander, 2001).

A recent International Finance Corporation report (2011) made the following observations, among others, about the state of responsible investments in the Middle East and North Africa (MEMA) region:

- *MENA responsible investment levels are low, but not insignificant.* While the MENA responsible investment levels are low, they are higher than comparable markets in India and China.
- *Shari'ah-compliant investment funds are similar to "negative-screen" responsible investment funds in North America and Europe.* In many parts of the world, negative-screen responsible investment funds typically precede positively screened responsible investment funds that then adopt increasingly aggressive criteria for environmental, social and governance screening. While Shari'ah compliant investing may not follow this pattern, the IFC report notes that "their commitment to Islamic ideals and general interest in betterment of society has the potential to translate into support for "positive-screen" sustainable investments" (IFC 2011, pg. 11)
- *Sovereign wealth funds (SWFs) may represent the greatest responsible investment opportunity in the MENA region.* There are a number of sustainability-related investment trends in the MENA region, all of which have important implications for the regional SWFs. Most notably, the growing emphasis on sustainability within the national agendas of MENA region countries, including investments in sustainability and clean technology sectors, as well as increased use of ESG screens in the SWFs' investment portfolios.

Third, among emerging market investors in particular, there is a tendency towards what may be best described as "short-termism", that is, to always be looking for a slightly higher interest rate or currency arbitrage opportunity. Corporate social responsibility indicators, while being a good proxy for management for long-term investors, are often ignored by these hot money flows. These flows of money with their attention deficit disorders are detested by the leaders of emerging market countries and institutions as they create large economic imbalances and are especially unreliable, being withdrawn just when they are needed most.

Many of the mistakes that have been made by companies in developed markets pressured by shareholders to show good short-term results at the expense of long-term prospects should not be emulated by their emerging market peers. Accountable boards with representation from labor and other stakeholders are attuned to the long term interests of shareholders which includes many facets of corporate social responsibility so necessary to a company's and a country's success.

Directed perhaps by policies set by forward thinking stock exchanges, investors and multinational corporate leaders need to think much more strategically about where they are investing their money, taking corporate responsibility indicators in account rather than being uni-directionally focused on the minutia of a fleeting situation.

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Table 1

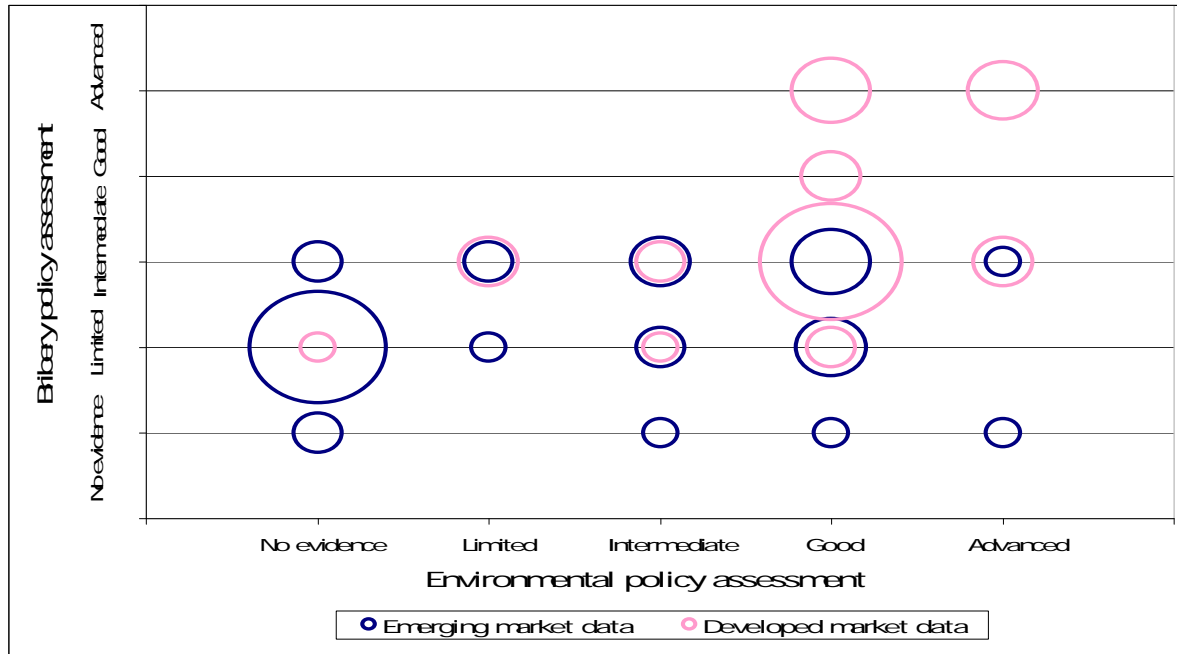
Responsible Investment (RI) Equities in Emerging Markets

	RI-focused (US\$ million)
Products investing all their assets in emerging markets	37,712
Products investing a portion of their assets in emerging markets	14,275
Total	51,987

SOURCE: International Finance Corporation/Mercer (2009)

Figure 1

A bubble chart comparison of environmental and bribery policies in large emerging market and developed market companies



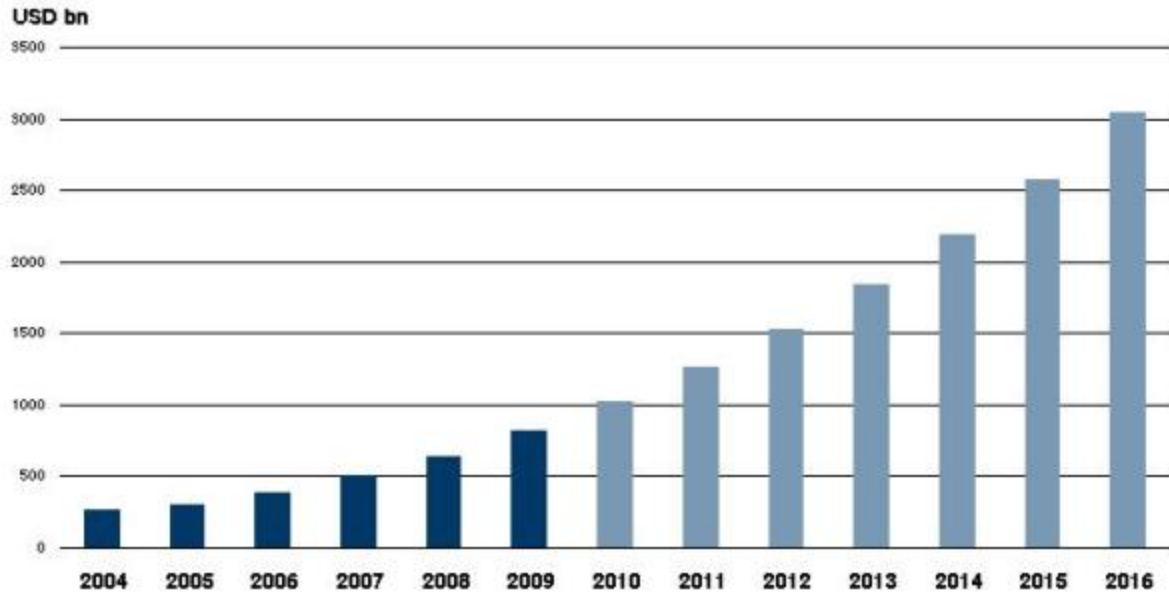
SOURCE: Sustainable Investment Research Analyst Network (2009)

Table 2**Examples of ESG guidance & policy in emerging market stock exchanges**

South Africa	For years, the Johannesburg Stock Exchange (JSE) has encouraged disclosure through the requirement for listed companies to comply with the King Codes on Corporate Governance. In 2010, the exchange became the first in the world to mandate the disclosure of financial and non-financial performance in one integrated report for all listed companies, on a “comply or explain” basis.
Malaysia	In 2006, Bursa Malaysia introduced a CSR Framework to guide its listed companies with regards to implementing and reporting on CSR. The exchange retained the group CSR Asia to evaluate the quality of CSR reporting in the country and published a detailed report on companies’ progress in 2008. For the last three years, listed companies have been required to disclose their CSR activities or practices (and that of their subsidiaries) and if there are none, a statement to that effect. The exchange also has plans to improve CSR information flow within the country.
Brazil	The Bovespa Exchange does not require ESG criteria for all listed companies. Instead it has three listing segments that companies can voluntarily adhere to with different standards of corporate governance. Though adherence is voluntary, once listed in a particular segment, adopting the standards is mandatory and enforced by the Exchange.
China	The Shenzhen Stock Exchange issued CSR guidance for listed companies in 2006 and has followed this with training programs. The Shanghai Stock Exchange introduced similar measures in 2008 in the form of the “Shanghai CSR Notice” and the “Shanghai Environmental Disclosure Guidelines”. These measures sit within a wider framework of government policy to harness the capital markets to foster environmentally and socially sustainable private sector development.
Taiwan	In Taiwan, the regulator has asked all public companies to disclose the state of the company’s CSR performance in their annual report. Although this is not articulated in the stock exchange’s listing criteria, companies are still obliged to do so in order to be listed on their exchange. The Taiwan stock exchange is considering revising its CSR Best Practice Principles to recommend listed companies allow shareholders to comment on and approve their CSR reporting.
Thailand	In 2006, the Stock Exchange of Thailand (SET) established the Principles of Good Corporate Governance for Listed Companies. In addition, SET has been working with the SEC, the country’s regulator, to urge listed companies to disclose such information in accordance with GRI standards

Figure 2

Shariah-compliant assets are expected to triple within the next six years.



SOURCE: The Banker, Booz & Company, Credit Suisse (2011)