AGF INSIGHTS

MARKETS

The Importance of Shareholder Engagement in Emerging Markets

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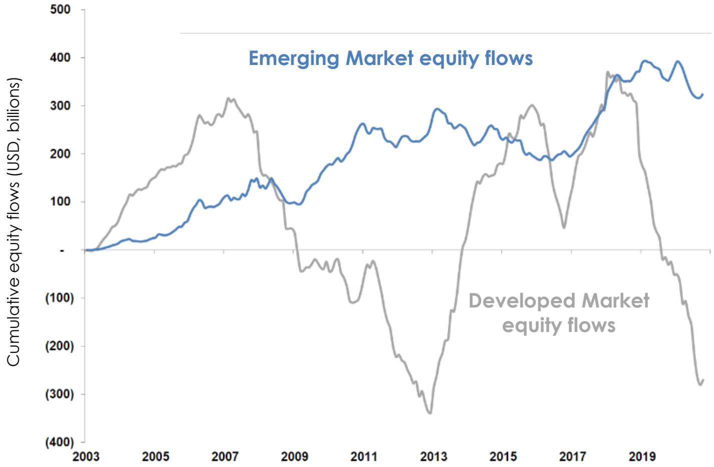
Mark Weinberg, ASA, ACIA
Vice-President, Global and Emerging Markets Portfolio Specialist
AGF Investments Inc.

Regina Chi, CFA®
Vice-President and Portfolio Manager
AGF Investments Inc.

This paper highlights the importance of shareholder engagement in Emerging Markets where environmental, social and governance (ESG) data is sparse. We review third-party ESG rating agencies' role in advancing ESG investing globally but highlight caution in basing investment decisions on ratings alone. We have found limitations and inherent biases behind the analysis and ratings, including the lack of quality ESG data and the comparability between rating agencies. We thus conclude ESG integration with active shareholder engagement is more vital to understanding and analyzing a company's ESG issues.

Over the last 30 years, Emerging Markets (EM) have experienced GDP growth of 24%, now accounting for almost 60% of the global total on a PPP basis[1]. Projections show that EM economies like Indonesia, Brazil and Mexico are likely to be larger than the U.K. and France on a PPP basis by 2050. This highlights the long-term attractiveness of the EM asset class, as evidenced by cumulative equity flows over the last two decades (Figure 1)[2].

Figure 1: EM growth advantage has attracted equity flows

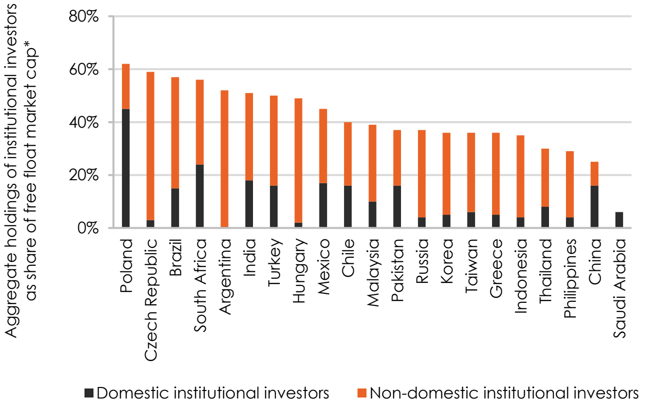


Source: EPFR Global, Country Flows Database, Morgan Stanley Research, November 4, 2020.

The economic growth advantage and rising institutional investor base have raised global awareness on issues such as worsening income inequality, child and forced labour in supply chains, human rights violations, water use and intensity, and heightened environmental issues. Importantly, these ESG issues could threaten economic development for developing countries and impact long-term sustainable returns for companies if not addressed.

Fortunately, interest in ESG investing has grown in popularity in recent years, with the value of global ESG assets doubling over four years and more than tripling over eight years to US$40.5 trillion in 2020[3]. While the bulk, and growth, of these assets are mainly tied to developed markets (DM), the sheer size of the EM asset class, together with increased attention from EM policymakers and global institutional investors (Figure 2), has resulted in a greater focus on ESG issues within EM.

Figure 2: Institutional investor participation in EM is high



Source: Schroders, De La Cruz, A., A. Medina and Y. Tang (2019). Owners of the World's Listed Companies' OECD Capital Market Series, Paris. Only EM countries are shown. Domestic and non-domestic institutional ownership, end 2017. Aggregate holdings of institutional investors as share of free float market capitalization. * Free float market capitalization is estimated as being comprised of Institutional Investors plus Other Free-Float.

[1] IMF, October 2020. Share of global total GDP for emerging market and developing economies estimated at 57.5% for 2020 based on purchasing power-parity (PPP).

[2] pwc, The World in 2050, February 2017.

[3] Global Sustainable Investment Alliance, 2018 Annual Report.

The lack of quality ESG data

Despite the surge in ESG-focused funds and the improvement in ESG disclosures over the last several years, ESG data is still lacking in consistency, comparability and materiality. This largely stems from the fact that many countries do not have the necessary regulations to mandate ESG-related disclosures and reporting standards. However, the regulatory landscape has been improving in recent years. Through initiatives like Sustainable Stock Exchanges (SSE), regulators worldwide have been encouraging investor interest and participation in sustainable investing by instituting improved company disclosures on ESG performance and risks. While Europe is the furthest ahead in this regard, other countries are making progress as well.

In EM, reforms on urbanization, pollution, water stress and climate change are just some of the factors that increase pressure on policymakers to commit to addressing environmental concerns. China and India are leading the way. China aims to position itself as a leader in the global push to target climate change. The China Securities Regulatory Commission is making it mandatory in 2020 for all listed companies and bond issuers to disclose ESG risks associated with their operations. Additionally, the International Platform on Sustainable Finance (IPSF), launched in 2019, has initiated a dedicated working group on taxonomies co-chaired by China and the E.U. These two jurisdictions, along with India, also an IPSF member, already have classification systems for green finance products in place. The Securities and Exchange Board of India (SEBI) has been driving the green finance agenda, primarily by implementing sustainability reporting and disclosure regulations[4]. In 2012, SEBI made it mandatory for the largest 100 listed companies to publish an annual business responsibility report, and its disclosures were expanded for the largest 500 companies in 2015. Brazil, Hong Kong, India, Indonesia, Malaysia, Peru and South Africa have also improved ESG regulations with required reporting as a listing rule, annual sustainability reports and ESG-related training[5].

While organizations such as the Sustainability Accounting Standards Board (SASB) and Task Force on Climate-related Financial Disclosures (TCFD) are helping to standardize investment-related reporting, improved corporate disclosures are also required. Without legislation and standardized reporting frameworks, it is at the discretion of each company to determine the ESG issues that are material to their business and decide what factors to report.

Another issue is that the vast majority of ESG disclosures are unaudited and therefore may not provide a holistic view of a company's ESG performance. These shortfalls make it more challenging for investment professionals who rely on quality ESG data. However, we believe that engagement provides an opportunity to gain additional insights that may not be voluntarily disclosed. This is important in EM where disclosures are typically weaker due to the lack of regulation, cultural differences or constraints on company resources – i.e. the people and time required to generate and publish the significant amount of data demanded by its stakeholders.

Increasing interest in ESG has given rise to numerous third-party ESG data and rating providers that investors are increasingly relying on for information, despite their many shortcomings.

Third-party ESG rating providers – a good starting point

Increased focus on ESG issues and performance, and the significant amount of internal resources required to collect, analyze, rate and monitor each company, has inevitably given rise to several third-party ESG data and rating agencies that investors are increasingly relying on for information. The data collected by rating agencies uses a combination of questionnaires and public information. The agencies gather and assess lots of information about a company's ESG policies and practices, and then they analyze and score the company.

While the analysis and scores produced by ESG rating agencies can be helpful to reference during the early stages of company analysis, investors should be cautioned against basing investment decisions on third-party ratings alone. In the following section, we outline some of our concerns and reiterate why active engagement is so important:

- **Data is backward-looking** – ESG data is a good starting point, but much of it is backward-looking.

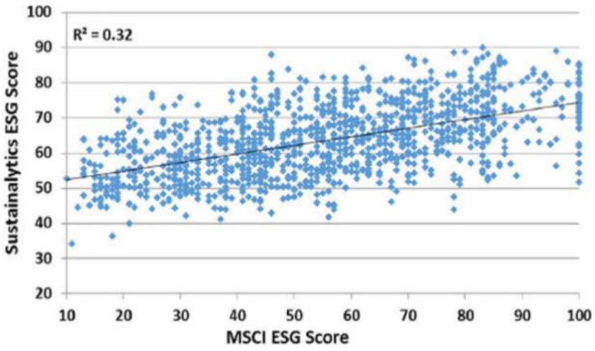
[4] International Platform on Sustainable Finance, Annual Report, October 2020.

[5] Source: Sustainable Stock Exchanges Initiative.

While it is useful to analyze a company's progress using many ESG data points, active managers require forward-looking analysis and ongoing engagement underpins this, especially in understanding and analyzing capital allocation decisions. Moreover, engagement develops a rapport between shareholders and company management due to the ongoing conversations about the company's developments and investors' feedback and concerns.

- **Lack of comparability between rating agencies and inherent biases** – ESG rating agencies have their own sourcing, research and scoring methodologies and subjective interpretations. This often leads to a wide disparity in ratings for the same company. CSRHub found that when comparing ESG ratings from MSCI and Sustainalytics for companies in the S&P Global 1200 Index, there was a weak correlation of 0.32 between the two firms' ratings (Figure 4).

Figure 4: A wide dispersion in rating agency ESG scores



Source: CSRHub. S&P 1200 equities, January 2015.

Compared to credit ratings, Moody's and S&P had a strong positive correlation (0.90). The difference is attributable to consistent information. Credit ratings are based on audited financial statements that have mandatory reporting requirements, contain financially material information and are comparable, while ESG ratings are based on unaudited and voluntary disclosures (in many jurisdictions) and often lack materiality and comparability.

Given the evolution of sustainability issues, the ongoing regulatory and legislative reforms across different jurisdictions and the numerous stakeholders involved, the variability between ESG ratings is likely to remain for the foreseeable future. For example, the COVID-19 pandemic has shifted stakeholder focus from environmental to social issues, focusing on companies' actions to manage their employees, supply chains and local communities. It remains to be seen whether rating agencies will adjust their methodologies in light of the pandemic, potentially focusing on new factors or re-configuring the weights assigned to existing ESG factors. These societal events, which are difficult to predict, will likely further compound the inconsistency of ratings depending on how each provider approaches these issues.

- **Inherent biases** – A significant concern with ESG ratings is the inherent biases, including institutional biases based on company size, geography and industry sector. In reviewing thousands of ESG ratings from major agencies, studies have found evidence of:
    - company size bias – larger companies typically maintain better ESG ratings. Often, this is a factor of greater resources available at larger companies, i.e. being able to devote more capital and people, which often leads to higher ESG ratings.
    - geographic bias – companies in regions with better reporting requirements typically have higher ratings, which may not reflect the true quality of ESG practices.
    - industry sector bias – rating agencies assign weights to E, S and G issues according to their industry, without factoring in company-specific risks, which can lead to industry-biased ratings.

These biases can distort an investor's ability to understand a company's actual ESG performance. This is not to say that the scores and reports published by rating agencies shouldn't be used as additional tools to aid in ESG integration. It is just to say that the methods used by rating agencies are fraught with subjective assessments and potential biases, contributing to rating variability between providers. Investors should, therefore, be mindful of their different methodologies and biases.

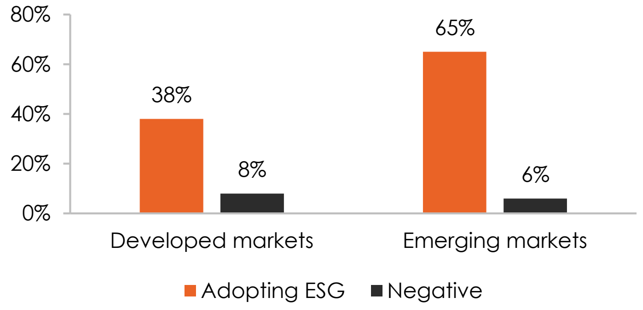
- **Financial materiality** – Company disclosures generally lack financial materiality for several reasons. These may include the multitude of requests a company may receive from a broad stakeholder base or the lack of ESG regulatory frameworks in many jurisdictions. While organizations such as the SASB help companies, asset owners and asset managers focus on ESG issues that are financially material, these issues may not always be incorporated by analysts at ESG rating agencies or, if they are, can vary in the weight assigned to them. This, in turn, can impact a company's ESG rating and potentially alter an investor's assessment of a company and overall investment decision.

- Investors should, therefore, use caution when basing decisions off overall ESG ratings. Investors should scrutinize the analysis and the data used in third-party reports and determine whether the ESG issues are financially material. Ongoing active engagement is strongly encouraged to gain additional insights and to verify any inconsistencies, errors and omissions in rating analysis.

Our approach: ESG integration and active engagement

It has been our experience that considering ESG factors in the investment process improves long-term risk-adjusted returns, mitigates ESG risks (thus reducing portfolio risk) and uncovers investment opportunities. Further, we believe that ESG analysis is most impactful when fully integrated within the fundamental investment research process. The integration of ESG combined with active engagement is a critical component of our ESG process that can add value to the investment process, especially in EM where there is generally less disclosure. Research has shown that while adopting ESG factors in DM positively impacts corporate financial performance in 38% of cases, the impact in EM is significantly higher, at 65% of cases (Figure 5), making a compelling case for ESG integration and active engagement in EM[6].

Figure 5: Relationship between ESG and corporate financial performance (% of studies with positive impacts)



Source: Gunnar Friede, Timo Busch & Alexander Bassen, 'ESG and financial performance: aggregated evidence from more than 2000 empirical studies', Journal of Sustainable Finance and Investment, November 2015.

At AGF, we are committed to engaging with management on ESG issues to support and encourage improvement and foster positive change over time. Some of the insights we gain from our ongoing engagements with company management include gaining a deeper understanding of the company's material risk exposures, management quality and a company's strategic positioning. We want reassurance that companies can manage material ESG issues within their business and have a sustainable business model.

We combine individual and collaborative engagement efforts to achieve the best possible engagement result. While most company management meetings are conducted on a one-on-one basis, we recognize that collaborative engagement opportunities can add value to specific issues when we perceive that engaging collectively will be more successful than engaging individually. We also believe that collaborative engagement opportunities can effectively enhance industry standards and best practices. AGF Investments Inc. is a signatory and member of several organizations, including the UN Principles of Responsible Investment (UNPRI) and the Sustainability Accounting Standards Board (SASB).

We focus on ESG issues that are financially material to the company's long-term sustainability. In determining financial materiality, we believe the best approach is to leverage a combination of SASB's industry-specific

[6] Gunnar Friede, Timo Busch & Alexander Bassen, 'ESG and financial performance: aggregated evidence from more than 2000 empirical studies', Journal of Sustainable Finance and Investment, November 2015.

standards, third-party ESG data, the knowledge and experience of our analysts and active engagement. This approach provides a strong starting point in understanding the financial materiality of company-specific ESG issues and incorporating them in our financial forecasts.

It has been our experience that our analysts retain a greater depth of knowledge of the companies and sectors within their coverage compared to the analysts at third-party rating agencies, owing to either less experience or being spread too thinly. As such, we believe that our analysts are better able to assess the materiality of ESG risks and opportunities and the impact they would have on the valuation and the long-term sustainability of the company. For this reason, we do not take ratings at face value. Instead, we use ESG data from several sources, including rating agencies, to form a mosaic of material sustainability data that is integrated within our fundamental research process. Further, by covering both Developed and Emerging Markets, our analysts can provide an additional layer of insight when conducting fundamental research and interpreting and comparing material ESG issues across companies globally. For example, ESG issues in EM can differ from DM. State-owned enterprises and family-owned and controlled businesses are quite prevalent in EM. While this is not an ideal ownership structure from a minority shareholder point of view, it can be beneficial for shareholders if these long-term employees with a vested interest in the company create shareholder value over time.

By incorporating material ESG issues in our valuation framework and financial forecasts, we become more aware of a company's risk-reward profile, given its company-specific merits. Further, by understanding a company's capital allocation decisions on specific ESG issues (e.g. supply chain management, capital expenditures, etc.), we gain a deeper understanding of a company's ability to grow economic profits, which can impact the future value of the stock.

We prefer a combined approach of active engagement and ESG integration as opposed to exclusions or negative screening. For example, EM investors must consider unique conditions and challenges to ESG investing that can be differentiated from Developed Markets. One potential challenge to employing more straightforward sustainable investment strategies such as negative screening is the potential for shallow markets, which can prevent excluding industries or sectors without eliminating a considerable portion of the investable universe. Exclusions can also create unintended consequences, such as style, industry, geographic or market cap biases within the portfolio. Employing ESG negative or exclusionary screens based on ratings is also more complicated given the lack of reliable data, especially if the data contains errors or omissions.

On several occasions, it has been our experience when engaging with companies that management teams have expressed their frustration over incorrect or omitted data in ESG rating reports or ESG rating agency analysts have misunderstood their business model. These issues could stem from a variety of reasons. For example, rating agencies do not typically engage with companies the way investors would. If a rating agency cannot find a specific ESG-related policy, it would not typically contact the company to acquire the documentation, and thus, it would not be used in its analysis, whether the policy exists or not. This can have a negative impact on the company's score or rating. These inconsistencies can skew weightings for material ESG issues, as well as ESG scores and ratings. We believe these inconsistencies underscore the importance of engagement as it provides the ability to gain an information edge and the potential for an improved line of sight into the risks and opportunities that a company may face.

One example of where we gained additional insight was through our engagement with Ping An Insurance (Group) Co. of China, Ltd., a financial conglomerate and the high-quality life insurer in China. Management stated its disagreement with the framework used by a rating agency to assess the company's score and overall rating. Because the company is a financial conglomerate with diversified business lines in life and non-life insurance operations, a securities division, a trust company and bank subsidiaries, management articulated a one-size-fits-all framework used by the rating agency was inaccurate. We encouraged management to reach out to the rating agency to convey its opinions and clear up any inconsistencies. While we continue to engage with Ping An on various ESG issues, including disclosures, we are encouraged that the company's ESG rating has since improved.

Another example is Haier Electronics Group Co. Ltd. (Haier), a leading manufacturer of washing machines and water heaters, and a leading integrated channel service provider of home appliances to rural areas in China. In one of our engagements with management, we discussed the company's weak ESG rating prescribed by one of the rating agencies. Management advised us that there were errors in the report, clarifying that the rating agency had cited issues related to poor labour practices and the company's procurement of raw materials. We advised the company to engage with the rating agency. Management stated that it had shared its strict labour evaluation system with the rating agency and provided its raw materials' procurement process. Positively, Haier's ESG rating subsequently improved. Encouragingly, in preparation for stricter ESG rules in 2021 set forth by the government, the company has formed a special ESG committee at the Board of Directors level to provide oversight to their ESG initiatives.

Conclusion

The economic growth advantage in EM will likely attract further investment flows in the years ahead. The rising importance of sustainable investing and the increasing participation by institutional investors in EM financial markets should pressure policymakers and companies to improve regulations and policies around ESG disclosures.

Given that EM represents a heterogeneous set of markets leading to vast local differences across countries, active shareholder engagement becomes even more important where quality data is less available. We believe investors can use ESG issues to differentiate companies, providing investment opportunities and the ability to reduce portfolio risk. Engagement with management can help gain additional insights into important topics such as company strategy, capital allocation decisions and how ESG risks and opportunities are managed. Finally, engagement can also provide an opportunity to help companies become better corporate citizens and improve their ESG profile, potentially leading to higher long-term risk-adjusted returns.

While ESG rating agencies can offer value from the ESG data they provide, we caution investors using ratings without the proper analysis. We also encourage using multiple data sources and rating providers due to the lack of quality data, the difficulty in comparing rating agencies and the inherent biases behind the ratings and analysis.

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www.AGF.com

AGF Offices

Toronto
66 Wellington Street West, Suite 3300
Toronto, ON M5K 1E9
Phone: 416 367-1900
Toll Free: 1 888 243-4668

Dublin
34 Molesworth Street
Dublin 2
Ireland
Phone: + 353 1 661 3619

Boston
53 State Street, 13th floor
Boston, MA 02109
Phone: 617 742-3290
Toll Free: 1 866 622-2438

Beijing
Suite 11A16, Tower A, Han Wei Plaza
No. 7, Guang Hua Road, Chao Yang
District
Beijing 100004, China
Phone: 86-10 8526-1820x15

London
80 Coleman Street, 6th Floor
London
EC2R 5BJ
Phone: + 44 207 653 6737