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Finding Emerging Markets Stocks With Social Consciences

By TIM GRAY APRIL 13, 2018

Until recently, investors interested in emerging market funds had few ways of singling out companies with standout environmental, social and governance records.

That has begun to change over the last several years, as the popularity of investing with an eye to these issues has surged. There are now 10 mutual funds and exchange-traded-funds that invest in stocks in emerging markets while making environmental, social and governance performance an explicit part of their mission, according to Morningstar.

And early evidence suggests that these feel-good funds have been able to outkick their conventional kin. In 2016, Chris Varco, a managing director at Cambridge Associates, an investment consultant, conducted a study comparing the returns of MSCI's standard emerging markets index to what's now known as its Emerging Markets E.S.G. Leaders Index. (The latter is made up of companies with higher scores for environmental, social and governance performance, as ranked by MSCI.)

For its first several years, the E.S.G. index outperformed its peer benchmark. Mr. Varco wanted to determine whether that was luck. He crunched the data and concluded that selecting companies based on nonfinancial factors had helped. Simply put, the E.S.G. index did better because the companies within it appeared, on average, to be better run. “There’s yet to be a year where the standard index did better,” he said.

Within this niche, there are actively managed options, like the Calvert Emerging Markets Equity and JPMorgan Emerging Markets Equity funds, and indexed ones, like the Nushares E.S.G. Emerging Markets Equity E.T.F., SPDR MSCI Emerging Markets Fossil Fuel Reserves Free E.T.F. and the iShares MSCI E.M. E.S.G. Optimized E.T.F. The iShares offering is built around the MSCI Emerging Markets E.S.G. Focus Index, which resembles the index that Mr. Varco studied but contains fewer stocks.

People who opt for funds of this sort should understand that their performance will diverge from that of well-known emerging-markets benchmarks, said Todd L. Rosenbluth, director of E.T.F. and mutual fund research at CFRA, an investment research firm.

“Because the holdings and the weightings differ, the performance is likely to differ,” he said. “E.S.G. strategies tend to have hefty weightings in technology stocks. So when tech is in favor, as it was in 2017, that will help them. If we hit a time when energy or old-line industrials shine, they won’t perform as well.”

Some investors may be happy to occasionally sacrifice a tincture of return for the sake of ditching polluters. That’s the sort of thinking that undergirds the SPDR MSCI Emerging Markets Fossil Fuel Reserves Free E.T.F.

“Energy conservation and lowering their carbon footprint is something that a lot of people are trying to do,” including in their portfolios, said Matthew J. Bartolini, head of SPDR Americas Research for State Street Global Advisors in Boston. So the exchange-traded fund is composed of companies in the MSCI Emerging Markets Index *minus* those that own fossil-fuel reserves, such as oil producers and coal miners, he said.

Nuveen, sponsor of the Nushares E.S.G. Emerging Markets Equity E.T.F., constructs its index differently, but it, too, aims to cut the number of air polluters in the portfolio by favoring companies with lower carbon-dioxide emissions. “E.S.G.

investors expect low carbon, and standard E.S.G. screens won't necessarily give you that," said Martin Y. G. Kremenstein, head exchange-traded funds for Nuveen.

Over the last five years, emerging markets have chugged upward, with MSCI's conventional index gaining an annualized average of 4.99 percent. In the first quarter, the index gained 1.42 percent. MSCI's Emerging Markets E.S.G. Leaders Index has outpaced its peer — rising an annualized average of 8.6 percent over the last five years, though only 1.01 percent in the first quarter.

When Mr. Varco, of Cambridge Associates, did his study, he didn't dig into precisely why companies in the E.S.G. index might excel or, conversely, why ones in the conventional index might lag. But he said one reason might be that state-owned enterprises, like Brazil's Petrobras, where a prominent bribery scandal has implicated dozens of government officials, loom large in the standard index. These outfits are often not run as well as their nonstate kin, he said.

Managers of actively managed funds echoed his assessment.

"The MSCI index includes a lot of energy" state-owned enterprises, said Elena Tedesco, a portfolio manager of the Calvert Emerging Markets Equity Fund. "Those companies tend to have very poor governance — they allocate capital to fulfill political goals. The Russian gas companies, for example, don't have a strong reputation for creating value for shareholders. They'd rather build a pipeline to fulfill a political need." Gazprom, the giant Russian natural-gas producer, is majority state-owned and a part of the standard index.

Leon Eidelman, the lead manager of the JPMorgan Emerging Markets Equity Fund, is even more broadly skeptical of state-owned companies and their aims.

"The Chinese state doesn't work for you," he said. "It works for itself. Its goals and incentives aren't aligned with those of minority shareholders." Two Chinese state-owned enterprises — China Mobile and China Construction Bank — are among the top 10 constituents of the standard index.

Put differently, the problem with state-run companies, besides potential political agendas, is governance. They don't have procedures in place, as developed-world public companies typically do, to ensure that minority investors are treated fairly and have access to all the information they need about company operations, investments and finances.

Philippe Langham, senior portfolio manager for the RBC Emerging Markets Fund, said concerns about governance in the emerging world extend beyond state-owned ventures. Plenty of emerging-market outfits without state ties don't hew to developed-world standards, he said. Assessing environmental, social and governance performance, he added, isn't just a matter of ethics when investing in emerging markets.

"For me, the emphasis is sustainability," he said. "Companies that plan for the future, with adequate infrastructure and R.&D., and look to build long-term relationships with all their stakeholders, I believe they'll ultimately have higher returns."

And governance isn't the only nonfinancial factor that aids in these sorts of assessments, said Thomas Wilson, co-manager of the Hartford Schroders Emerging Markets Equity Fund. Environmental and social performance also "relate to the integrity and quality of management," he said. "They provide a window into whether management is good at their jobs."

The case for investing in the emerging world can be boiled down to a word: growth. Compared with developed countries, emerging ones are, on average, growing faster, and they are pulling hundreds of millions of people into the middle class for the first time. That's giving rise to new companies and creating huge new markets for existing ones, said Binu George, portfolio strategist for the emerging markets team at GMO, an asset management firm. "There are 24 emerging-market countries," he said. "In those countries and their stocks, there's a massive opportunity for you to make money."

With that faster growth comes greater risk: On average, the returns of emerging markets stocks roller coaster more than those of developed market ones.

"The asset class is incredibly volatile, and yet there are still many great businesses in the emerging world," said Mr. Eidelman of the JPMorgan fund. Over time, patience — and attention to environmental, social and governance factors — can pay off, leading to superior performance, he said.

"The time frame really matters. If you're looking to own a business for a long time — not just trade a stock — then factors around how that business interacts with all of its stakeholders become much more important. If you're just trading monthly, the fact that you think the management is dodgy might not matter."

For someone committed to so-called socially responsible investing, including a relatively small allocation — say 5 or 10 percent of a diversified portfolio — to this niche can make sense, added Mr. Rosenbluth of CFRA.

"E.S.G. factors are perhaps even more relevant outside the U.S., especially governance," he said. "This sounds obvious, but in less developed countries, the companies have less developed governance. By investing in ones that are providing better governance, you're encouraging other companies to act more responsibly."

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