Investing sustainably

Environmental, Social and Governance (ESG) in Emerging Markets

WHEN WE FIRST LAID OUT A RESEARCH FRAMEWORK FOR INVESTING IN EMERGING MARKET EQUITIES, WE WANTED TO CONSIDER ALL FACTORS THAT COULD AFFECT A COMPANY'S PROFITABILITY AND VALUE IN THE FUTURE – in other words, to think about the duration of a business and its worth. Duration as we used the term was a broad definition of sustainability which, while incorporating what is usually understood by "ESG", was not limited to it. We wanted our research to consider all risk factors that could affect the value of our clients' investments in the long term, including of course those arising from environmental and social issues, and corporate governance. Without making this broad assessment of future risks, how could we know what a fair price might be for a stock? And how could we understand the risks that we face as owners of businesses on our clients' behalf?

Because we took this broad view of sustainability, our analysis was neither led by nor limited to specific emphasis on ESG as a separate element in our investment approach; ESG considerations were simply a natural and integral part of our fundamental research and our approach to investing. As a result, our fundamental portfolios have typically exhibited characteristics that stood up well to scrutiny from an ESG perspective.
But given the growing attention to ESG issues, and the fact that clients are increasingly insisting on processes that address them, we decided it was important to be more explicit about what we do in this area and why. That is the objective of this brief paper.

Why think about ESG?

There are three very simple reasons we need to think about ESG:

- We have a responsibility to consider the broader consequences of our investment choices
- It is important to many of our clients
- It is entirely consistent with a long-term approach to investing

Our responsibilities

Some might argue that our only responsibility as managers of assets is to maximize returns for our clients' portfolios. It's a point of view, but I think this is a simplistic argument. We would not expect a business that we invested in to take this view, so it is hard to argue that we should do so ourselves. There is always a trade-off to be made between duration and return in the near term, but greater rewards are garnered by prioritising duration over short term outcomes, and this means thinking about sustainability in the broadest sense. The most impressive corporate managers that I come across are alert to this trade-off; they don't just think about risks in a very broad way; they also understand the value of compounding and

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know that they must manage their companies in a way that promotes such outcomes; they tend to think about the long term; they have a natural interest in sustainability. We like companies that adopt this mind-set; and we should do the same ourselves. The investment industry cannot argue that it bears no responsibility for the choices that it makes beyond pure financial outcomes: to do so would be to ignore its broader social and economic function as an allocator of capital in market-based economies. This broader responsibility of our own industry is the first reason we need to consider ESG issues.

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But this argument is not a straightforward one; where does that responsibility end? Should we avoid investing in certain industries altogether? When does a risk factor with potential economic consequences become a political or even a moral view about how societies and individuals should act? Is it reasonable to impose such views, even though they may have negative consequences in other ways? There are no simple answers to these questions. I have always found it easiest to think about ESG factors from the point of view of their economic significance and risk: we need to understand what effect these issues may have on the value of businesses in the long term. This is an important point to emphasize, because taking account of ESG issues is not the same as what is often called “ethical investing.” We think about sustainability because it is important for us as investors; beyond that, we need to listen to what is important to our clients.

Clients are increasingly focused on ESG

That leads on to the second reason we integrate ESG into our investment approach: put simply, many of our clients, and their own customers, now require it. They want to be sure that we act responsibly as their agents, and they want to know how we approach ESG issues. We’ve seen an increasing client focus on ESG for several years now, and in anticipation of this, we added more explicit ESG elements to our research framework several years ago, knowing that the onus would be on us to explain how we think about these issues. In addition to this standard research framework, which is explained below, we also incorporate individual client concerns that may go beyond purely economic considerations, applying specific restrictions at an individual portfolio level as appropriate. It’s not just clients who are stepping up their focus on ESG: regulators and in some cases governments are also paying more attention to environmental issues and other aspects of sustainability.

Sustainability matters for long term investing

The original reason we incorporated a focus on sustainability in our investment approach is the simplest, and the easiest to explain: it is entirely compatible with and, indeed, essential for an investment approach that focuses on the longer term. Rather than seeing ESG as something that restricts our ability to generate returns, I think of it as a necessary part of what we do; rather than constrain our portfolios, it refines them. We don’t arbitrarily choose to take a long term view; we do it because we believe it delivers better results, reduces costs, and allows the power of compounding to translate into investment outcomes. So anything which affects the long term prospects of companies is important to us, just as it should be to the companies themselves.

What is our approach to ESG?

Our approach to ESG is best described by answering three questions:

- How do we incorporate ESG in our research process?
- How do we engage with companies?
- How do we apply this to portfolios?

The first and most important point to make about what we do, in all these areas, is that we exercise our own judgment and we make our own decisions about the sustainability of a business. While we subscribe to and consider the work of outside vendors that analyse the behaviour of EM corporates with respect to ESG issues, we do not automatically invest based on their conclusions. Third party services – whether they offer recommendations about how to vote at shareholder meetings or screen companies for environmental impact –

can be very useful in supplying information and in provoking our thoughts, but they also vary considerably in their methodologies, and can be formulaic. In this respect, as in others, we must be careful not to let databases replace thought and judgement; we consider ESG holistically as part of the overall investment judgement; we try to think about what is material and relevant, and how companies may change over time. Third party sources are useful, but we make our own decisions, and our research framework and investment approach are designed to enable this.

What does all this mean in practice for our research, for corporate engagement and for portfolios? A high-level summary of what we do looks like this:

Research approach	• Strategic Classification is our assessment of a business's potential for long-term value creation • 98-question Risk Profile assesses multiple factors, including ESG, with a heavy tilt to Governance
Engagement	• A commitment to proxy voting, with elections proposed by EMAP analysts and approved by PMs • >5,000 company meetings annually to enhance our understanding of issues and encourage best practices
Portfolio construction	• Position sizing informed by Strategic Classification and Risk Profile • Target companies rated Premium or Quality

ESG in the Research Framework

Our framework for fundamental research of companies has the following components:

- a fundamental analysis of economics, duration and governance that produces a ***strategic classification***
- a checklist of questions on qualitative risk factors that produces a ***risk profile***; and
- a set of financial forecasts that produces an ***expected return***.

This framework is shown graphically below: all three parts of it involve consideration of ESG issues to varying degrees.

Our fundamental analysis of any company examines what we call its economics, duration and governance. Environmental and social issues are a part of the consideration of a company's duration and its economics; a business simply isn't thinking about its long term future if it's destroying the environment or abusing the community in which it operates, and it will eventually pay a price for this. So we need to consider these areas when thinking about future cash flows. In this respect, it's no different from any other factor which could have the same effect, whether that be competition, innovation, or regulation. These are all part of a broad consideration of the sustainability of corporate value.

Research process summarized

THREE SEPARATE OUTPUTS INFORM OUR UNDERSTANDING AND VALUATION OF A BUSINESS

Strategic Classification
(Premium/Quality/Trading)

- **Economics** — Does the business create value for shareholders?
- **Duration** — Can this value creation be sustained?
- **Governance** — How will governance impact shareholder value?

Risk Profile

Classification	Average red flags
Trading	20
Quality	12
Premium	7

Five-year expected return

Earnings growth
Dividends
Change in valuation
Currency
=
Expected return

Source: J.P. Morgan Asset Management. Data as of September 30, 2019.

ENVIRONMENTAL factors per se are becoming easier to evaluate in emerging markets; more companies now produce sustainability reports as a matter of course, and investor and customer attention is also pushing companies to improve their standards. Nevertheless, we still need to understand whether companies are actively working to mitigate risks or to improve their performance, and this too forms part of the strategic classification assessment, as well as being addressed by specific questions in the risk profile.

SOCIAL responsibility is a broader and more complex topic to address. We invest in many countries, all at different stages of development and with a range of social norms and legal systems. It would be naïve to think that all companies in emerging markets can apply developed world standards today; for this reason, we consider corporate social behaviour in context. That said, it's also obvious that when major social imbalances threaten a society, the corporate sector has a responsibility and a role to play in addressing them, and failure to do so can severely affect shareholder returns. Perhaps the starkest example of this was in South Africa after the ending of apartheid. The task of addressing social inequalities had to be borne in part by the owners of businesses, whether they liked it or not; good companies moved ahead of the trend; poor ones thought they could carry on as before, and were not ready for the necessary changes which were enforced by legislation. Our fundamental analysis addresses social responsibility issues at the company level as part of the strategic classification, and the checklist underlying our risk profile includes specific questions on it. We must acknowledge, however, that consideration of social responsibility is a more nuanced and complex area than the assessment of environmental issues.

GOVERNANCE sounds self-explanatory, but we devote a specific section to it in our fundamental assessment of companies, and it accounts for the majority of the questions that lie behind the risk profile. For us, governance is not just about the composition of the audit committee and the number of non-executive directors; it's more important than that. In the developed world, governance codes have concerned themselves with addressing agency risk, particularly conflicts of interest between corporate management and public shareholders. This is natural when dealing with mature equity markets, which have institutional ownership and a diverse shareholder base. But in emerging markets, corporate ownership is not the same as in developed markets; often we are not dealing with dispersed public ownership, but with a single dominant shareholder, and the risks that we encounter most frequently arise when our interests as minority investors diverge from those of the majority owner.

So when we talk about governance, we are again using the term in a wider sense than the conventional ESG meaning. When considering governance, we focus on two areas:

- whether a company shows a proper regard for the interests of all shareholders; and
- whether it can demonstrate proper stewardship of a company's assets and value over time.

As one of my colleagues has put it, this means assessing the motives and competence of the decision-makers. Motives are about how conflicts of interest are addressed or avoided (or created). Competence is about the skill with which shareholder value is developed over time; this is largely about the returns made on incremental capital retained within the business and how managements balance considerations of risk and reward. For those with a long term mind-set, these are critical considerations, but they are also unavoidably qualitative judgements applied to the future. This part of an investment judgement cannot always be based on historical evidence, since it concerns risks arising from infrequent but very important decisions: a company may make one disastrous acquisition, for example, but that might be enough to destroy much of its value. How can we assess such risks? Partly by being familiar with the management and their previous behaviour, which we address in our strategic classifications; partly too, though, by looking for other indicators which will give us hints about managements' skill, judgement and motivation. The checklist behind our risk profile incorporates many questions, some of them perhaps unusual; but they are all intended to help us build a holistic view of management, which in the long term is the most important of all determinants of corporate value.

Finally, the work that we do to understand companies must be reflected in the forecasts that we make, and in the discount rates that we apply to future cash flows, so our fundamental analysis is needed to inform our valuation work too. An important part of our expected return work is an assessment of the fair valuation for each business; we cannot hope to

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get this right unless we understand all risks, including those deriving from ESG factors. As mentioned above, if we don't take these issues into account, how can we value businesses appropriately? In this respect too, an assessment of ESG issues is simply a necessary part of considering future risk and reward for any investment.

Engagement on ESG

It's one thing to carry out research on companies; it's another thing to engage proactively. We seek to understand how companies consider ESG issues, but we also engage with them to try to influence their behaviour. We have many meetings with companies each year – more than 5,000 last year alone – and, over time, we may meet a single company on many occasions. A key purpose of these interactions is to understand and evaluate corporate managers and the way they think about the issues they face, including ESG questions. Given our fundamental investment process, we hope not to have many instances in which governance issues surface as a point of major concern in portfolios; but there are occasions where we disagree with specific proposals, and we communicate this. In the past, this has happened mostly in cases where we perceive conflicts of interest that could affect minority shareholders. Beyond this, we also want to make sure that companies are meeting their broader responsibilities and operating in a sustainable fashion; therefore questions about their operations – whether related to water usage, treatment of waste materials, safety of supply chains, recycled content, sales incentives, product quality and so on – are a recurring feature of our discussions. I'd like to think that our engagement influences companies, and there have certainly been occasions in which corporate managements have been prepared to make that explicit linkage; but, more often, I think we can be useful to companies by making them aware of other perspectives, and of what best practice looks like; in other words, by trying to make them see advantages for themselves in improving what they do in the ESG arena and elsewhere.

In addition to this, we are active voters on our clients' behalf wherever possible. Again, we do not automatically follow third party recommendations; we vote in what we believe to be the best interests of our clients. We produce reports for clients to show our voting behaviour and highlight other specific interventions we may have made on our clients' behalf. Since much of the attention on this area tends to be on the negative side, though, we should also stress that our voting and engagement is mostly supportive. We do not want only to take the negative track; we also vote in support of developments that we approve of and encourage corporate initiatives when we believe they will enhance corporate value or mitigate risks that would otherwise diminish it.

ESG and Portfolio Construction

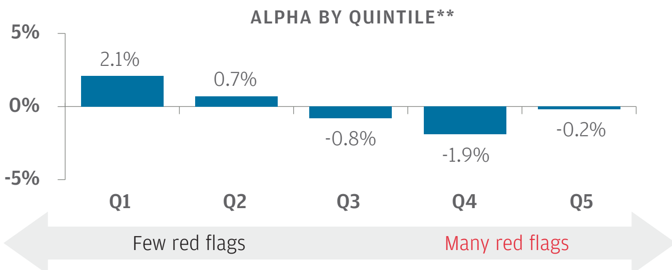
While we integrate consideration of environmental, social and governance issues into our research process, our emerging market portfolios are not explicitly promoted as ESG portfolios. Nevertheless, our fundamental research tends to lead us towards investments which screen well in this respect, and when our portfolios are assessed by outside agencies, they have tended to score above the average.

Looking at our own research framework, it's obvious why our fundamental portfolios screen the way they do: companies we classify as Premium and Quality typically account for a significant share of our fundamental portfolios, much more than is the case for our overall research coverage or for the index.

When viewed in terms of our Risk Profile, our portfolios also come out well above the average of stocks we cover. None of this should be surprising: our investment approach steers us away from capital-intensive, resource-intensive, very often state dominated sectors, and towards more asset-light and largely private sector businesses; it also leads us to have a significant exposure to companies which have very large numbers of customers, whether in the consumer sector, the financial sector, or the internet services industry. This is important: such companies are to some extent regulated by their customers, and the need to preserve brand equity and the loyalty of customers acts as a powerful incentive for companies to follow best practices. As the CFO of a Latin American retail company once remarked to me, retail is the most democratic industry: your customers vote with their feet every time they buy something. We like industries in which the market determines outcomes, because it is where the greatest return to corporate skill can be made: among stocks that we research, we see a correlation between the number of red flags and share price performance:

Excess return* by Risk Profile quintile (Jan-12 to Mar-19)

RISK PROFILE



- Businesses with strong governance and few red flags tend to outperform over time
- Businesses with numerous red flags tend to underperform significantly over time

*Per annum, relative to team's coverage **Quintiles are based on total number of stocks, not market capitalization.

THE FUTURE

While we do not claim to have all the answers on ESG, we have long integrated consideration of these issues into our research process; as this paper has argued, this is natural for any investment approach that concentrates, as we do, on the long term. Increasingly, our clients view attention to ESG issues as critical in their assessment of investment managers, so I hope this summary of our approach will help reassure them of our commitment to this aspect of our work. We will continue to look for ways to enhance our research process and to invest responsibly, to meet the fiduciary responsibility entrusted to us by our clients.

OUR COMMITMENT TO SUSTAINABLE INVESTING

Environmental, Social and Governance (ESG) factors are non-financial considerations that are important for stakeholders to keep in mind when assessing a company's performance.

ENVIRONMENTAL:

Issues relating to the quality and functioning of the natural environment and natural systems, e.g., carbon emissions, environmental regulations, water stress and waste

SOCIAL:

Issues relating to the rights, well-being and interests of people and communities, e.g., labor management, health & safety and product safety

GOVERNANCE:

Issues relating to the management and oversight of companies and other investee entities, e.g., board, ownership and pay

Source: Definitions, PRI; Examples, MSCI.

J.P. Morgan Asset Management is committed to putting our clients' interests first. With decades of investment experience and over 1200 professionals, we have a deep understanding of investment portfolios across multiple dimensions and a goal of producing the best risk-adjusted returns that align with our clients' objectives. Through our engagement and partnership with various organizations, we continually increase our knowledge and views on key ESG issues and best practices. We have been a signatory to the United Nations' Principles for Responsible Investment initiative since 2007 and are committed to incorporating ESG factors into our investment practices, where material and relevant.

To help drive our commitment, we have established a Sustainable Investment Leadership Team (SILT) which has begun implementing a coordinated strategy for sustainable investing across Asset Management. This cross-functional team is comprised of senior leaders spanning across all regions with a deep and diverse set of expertise across asset classes and client channels.

SILT's mandate includes:

- Promoting internal best practices, including identification and assessment of ESG issues across asset classes and investment offerings.
- Driving thought leadership and innovation through information, education and partnerships to encourage broader awareness and adoption.
- Deepening and broadening current investment capabilities including portfolio analytics, measurement and reporting.
- Sharing our views on sustainable investing and helping clients better understand our capabilities across asset classes and investment strategies.

We strive to be transparent around our commitment to sustainable investing. To learn more about our efforts please visit **jpmorgan.com/esg.**

ECM Material ID: 0903c02a8270b527

LV-JPM52432 | 10/19

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