



Discussion Paper

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Emerging Markets Vaunt Sustainability Credentials

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On February 14, 24 institutional investors with more than \$1.6 trillion in assets under management announced that they were writing the world's top 30 stock exchanges to demand that they address deficiencies in environmental, social and governance (ESG or sustainability) reporting by listed companies. Based on research indicating relatively low rates of corporate sustainability reporting, the investors said, the Santiago and Philippine stock exchanges were among their top targets.

Mounting external pressures and homegrown demand are prompting many emerging market exchanges and regulators already to require companies to disclose material sustainability information and metrics. Some emerging market exchanges are going even further to evaluate corporate issuers and to include the best performers in special sustainability indices. These developments pose a key question for emerging market exchanges, investors and companies: Are markets that venture into the sustainability frontier gaining a strategic advantage or only creating onerous requirements for companies that are dissuading them from listing or placing existing issuers at a competitive disadvantage?

Investors concerned about these types of risks say sustainable stock exchanges and markets with better sustainability disclosure requirements have an edge, and a growing number of stock exchanges and regulators agree with them. Just in 2010, the primary exchanges in Egypt, Indonesia, Korea and Mexico launched sustainability indices.

They weren't the first. Brazil and South Africa have had similar offerings for years.

Demand from Abroad

"A growing camp of investors view good corporate management of environmental, social and governance issues as a proxy for good overall management and prospects for long-term growth," says Boston Common Asset Management Managing Director Lauren Compere. "Moreover, in emerging markets, where legal protections or enforcement structures might not be as well developed, investors are looking for greater assurances from companies that they have internal safeguards to manage these issues proactively, so that they do not react to them ineffectively in the moment when crises are buffeting them."

Are markets that venture into the sustainability frontier gaining a strategic advantage or only creating onerous requirements for companies?

"With the unprecedented growth in emerging markets in the past decade, corporate disclosure expectations have changed," says Mike Lombardo, Senior Sustainability Analyst and Manager, Index, for Calvert Investments. "Global investors have helped shift the playing field as the result of a more sophisticated understanding of the materiality of ESG factors, but also through increased demands on companies operating in emerging markets to provide greater transparency of ESG risks." Calvert offers a wide array of products based on these assumptions.

Boston Common and Calvert are not alone. Lisa Hayles, Head of Client Services for North America for EIRIS, a provider of research services to investors looking to integrate ESG factors, says

large pension funds in Europe and private funds in the United States are in part driving demand. “These funds are quite large, invest in stocks globally and believe that they have a duty to incorporate ESG standards into their investment process,” she says. “As global investors they want to apply similar minimum standards to their investments in both developed and emerging markets, and we have definitely seen an increase in demand over the last several years.”

Hayles believes that the explosive growth in the relatively nascent United Nations Principles for Responsible Investment (PRI) initiative also is a key driver of demand for emerging market ESG disclosure and performance, as is interest among these investors in incorporating sustainability themes in infrastructure development. PRI, launched only in 2005, today has more than 870 signatories with more than \$25 trillion in assets under management. It is an investor-led initiative, convened by the United Nations Environment Program Finance Initiative (UNEP-FI) and the UN Global Compact, established “to help investors achieve better long-term investment returns and sustainable markets through improved analysis of environmental, social and governance issues.”

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SRI developments in emerging markets echo those in developed markets, where investors are moving beyond pledges to actual SRI-oriented investments, as evidenced by a series of reports from associations representing SRI interests:

The United States—The U.S. Social Investment Forum (SIF) recently found that more than \$3 trillion in assets under professional management in the United States, or one in eight dollars, was invested in a socially responsible investment (SRI) vehicle at the start of 2010. Furthermore, its *2010 Report on Socially Responsible Investing Trends in the United States* notes that SRI assets in the United States grew in overall size by more than 13 percent since 2005, during a period when total

assets under professional management in the United States increased by less than 1 percent.

Europe—U.S. SIF’s counterpart in Europe, Eurosif, found in its *2010 European SRI Study* that the total value of European assets under management engaged in sustainable and responsible investment was approximately €5 trillion at the end of 2009, up about 87 percent from €2.7 trillion at year-end 2007. Eurosif notes that: “These numbers may appear high to the reader,” but, it says, “large asset owners in many domestic markets have now adopted integration strategies for screening of specific criteria such as climate change factors across their portfolios—this is a major shift in the SRI field and helps to explain the growth in the total SRI figures.”

Canada—Similarly, Canada’s Social Investment Organization, in its *Canadian Socially Responsible Investment Review 2008*, documented the Canadian SRI market growth from CDN\$503.6 billion at year-end 2006 to more than CDN\$609.2 billion at the end of 2008. It noted that this 21 percent increase in SRI assets occurred over a two-year period “when markets generally experienced great difficulty.”

Australia—Unlike the other developed markets reporting, Responsible Investment Association Australasia’s ninth annual benchmark report, *Responsible Investment 2009*, covering the 12 months ending June 30, 2009, says that Australian SRI assets, including management portfolios, community finance, green loans and ethical portfolios of charities and clients of financial advisors, fell to AU\$15.83 billion in 2009 from AU\$17.71 billion in 2008 and \$19.4 billion in 2007. While an outlier, the report still notes that from 2008 to 2009 the Australian market posted positive net inflows into SRI accounts of \$185 billion.

Retail demand for sustainable investment products covering emerging markets hasn’t fomented as of yet, but Hayles believes it is coming. She predicts that in the next three to five years, as retail investors from around the world increase their exposure to emerging markets, and emerging markets by their sheer size demand attention from global investors, demand from the retail side will grow rapidly as well.

Multilateral Push

Another multilateral development is focusing on exchanges, including several in emerging markets, to advance the sustainable investments movement. The PRI, the UN Conference on Trade and Development (UNCTAD) and the UN Global Compact launched Sustainable Stock Exchanges (SSE) last year 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.” The initiative has already hosted two high-level global conferences for CEOs of investors, stock exchanges, regulators and other stakeholders to encourage further dialogue on the topic.

SSE also commissioned a study by Aviva Investors on the sustainability practices of world's top 30 exchanges, unveiled last year at an SSE event in Xiamen, China. The study found that emerging markets exchanges are, in many ways, leading the way in terms of implementing required sustainability disclosure and other measures to enhance corporate sustainability reporting of listed companies.

The report notes that ESG disclosure rules were launched in Egypt, Brazil, China, India, Indonesia, Malaysia and South Africa, among others in recent years. It spurred investors with \$1.6 trillion in assets under management, led by Aviva Investors, last month to write to the world's 30 largest exchanges to request improved sustainability reporting requirements in these markets. Among emerging markets, the investors called out the Korea Exchange, Santiago Stock Exchange and Philippine Stock Exchange for lack of disclosure. At the launch of the report, Paul Abberley, CEO of Aviva Investors London, said: “Markets are driven by information. A lack of information as a result of limited or non-disclosure of ESG data makes it difficult for long-term investors such as us to assess the wider ESG risks and opportunities associated with a company. We believe that stock exchanges can play a crucial role in helping to create more sustainable global capital markets because of their ability to directly influence and monitor the operations and strategy of companies

seeking to access the equity markets. This can only be a good thing for investors.” The report drew data from Bloomberg, which launched an ESG disclosure data platform on its Bloomberg terminals in 2009, to reach its conclusions.

Specifically the investors are asking stock exchanges to:

- “Encourage better internal corporate governance within companies, such as improving structure, independence and quality of boards of directors and disclosing how sustainability issues are addressed at the board level.
- “Consult with companies on how they should be integrating sustainability into long-term strategic decision-making—e.g. highlighting risks and opportunities within the existing business model on their website and in their financial report. This includes encouraging companies to undertake integrated reporting.
- “Distribute guidance for listed companies on material sustainability issues, global initiatives and other opportunities that encourage ESG disclosure.
- “Consider mandating that listed companies have a non-binding shareholder vote on the sustainability report or sustainability strategy to be put to the [annual general meeting].”

Local Responses

According to the Association for Sustainable and Responsible Investment in Asia (ASrIA), there are now more than 417 active SRI funds, including faith-based funds, in China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Singapore, Taiwan, Thailand and Vietnam. KoSIF, the social investment association in South Korea, reports that in 2009, the SRI fund market totaled 3.58 trillion Korean won. Another bellwether of local demand for ESG integration came in June 2010, when AfricaSIF, an independent, not-for-profit pan-African network, debuted to promote

sustainable investment across the continent. In fact, over the past decade, many emerging market exchanges have entered the sustainability space, and local demand is spurring innovation.

Brazil: In 2005, the Sao Paulo Stock Exchange (BOVESPA), in coordination with the Brazilian Ministry of the Environment, the Brazilian Association of Pension Funds, the United Nations Environment Program (UNEP) and other stakeholders, created the Corporate Sustainability Index as a benchmark SRI vehicle in the country. Brazil's Center for Sustainability Studies of the Business Administration School of São Paulo identifies companies for inclusion in the index, using a questionnaire to verify the sustainability performance of the exchange's most liquid stocks. BOVESPA is a signatory to PRI and has set an example for its listed companies by publishing its own sustainability report.

China: In 2008, the Shanghai Stock Exchange issued a "Notice of Improving Listed Companies' Assumption of Social Responsibilities" and a list of guidelines aimed at prompting listed companies to improve ESG performance by committing to "promoting sustainable development of the economy and society." To promote these practices, the exchange has introduced incentives for listed companies attaching "importance to assumption of social responsibilities." Similarly, the Shenzhen Stock Exchange published social responsibility guidelines for its listed companies in September 2006. Under the exchange's listing requirements, companies must issue sustainability reports for investors, either alone or as part of their annual reports, that review their "implementation of social responsibility relating to employee protection, impact on environment, product quality and community relationship; assessment of implementation of these instructions and reasons for the gap, if any; and measures for improvement and the timetable." Both exchanges have launched sustainability indices in the past year and issued their own sustainability reports.

India: Also in 2008, the Global Reporting Initiative (GRI), the sustainability reporting standard most used by corporations, entered into a strategic alliance with the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) to set up

the IICA-GTZ corporate responsibility initiative with the Indian Institute of Corporate Affairs and the GTZ on behalf of India's Ministry of Corporate Affairs and the German Federal Ministry of Development Cooperation. The initiative seeks "to develop a sustainability reporting framework and upscale sustainability reporting in India." GRI established a local presence last year to "support and promote the general practice of sustainability reporting in India," as well as to advise on the development of an Indian voluntary disclosure framework with the goal of promoting and facilitating close alignment with the GRI Reporting Framework."

Indonesia: The Indonesian Biodiversity Foundation KEHATI, supported by IDX, the Indonesian Stock Exchange, launched the first SRI Index in Indonesia in 2009 to appeal SRI investors. However, the IDX also notes that the move also was aimed at helping listing companies to attract employees and contracts from companies in industrialized countries asking for similar reporting and performance standards, according to its website.

Korea: While chastised by the SSE report mentioned earlier, Korea's exchange launched its own sustainability index in 2009. Compere, who leads an investor effort to persuade Korean companies to improve sustainability reporting practices and performance, says that external and internal dynamics in Korea are prompting transformation of financial markets there. "Locally listed firms are global firms," she notes, "with multinational customers that are demanding better sustainability practices." She says ESG disclosure practices are improving in Korea, especially in the areas of good governance and social issues, where Korean companies have lagged competitors.

Mexico: In November, Mexico's primary exchange, the Bolsa Mexicana de Valores (BMV), partnered with global responsible investment research firm EIRIS and local firm Ecobanca to develop a new sustainability index. The index will be based on the 60 most liquid shares, and each company will be assessed separately on ESG performance, impact and responses. The companies must obtain a score in each area which puts it on a par with sustainability practices

globally, which the exchange believes is essential for the index to have credibility and widespread acceptance by the investment community. Hayles confirms local uptake for the index, noting that local pension funds have been big proponents of the concept.

South Africa: Like Brazil, the Johannesburg Stock Exchange (JSE) is a relative veteran of SRI, having launched an SRI index in 2004. “South Africa has clearly led the way among emerging markets on ESG reporting,” notes Lombardo, who also spearheads an investor effort on corporate ESG disclosure in South Africa. Furthermore, he says, “The JSE’s 2010 requirement for listed companies to begin producing integrated reports is a game changer and sends an unequivocal message to companies about the value and necessity of ESG disclosure for all investors.” In 2010, the JSE became the first exchange in the world to require listed companies to move towards integrated reporting as required in King Code on Corporate Governance III. Beyond ESG reporting, integrated reporting calls on companies to discuss ESG risks, responses and performance in the context of their annual investor reports, traditionally focused exclusively on financial matters.

The 2010 constituents of the JSE’s SRI Index passed 74 of 106 companies assessed, five for the first time. “This year’s composition reflects the fact that companies now see ESG principles as part of normal business practice and institutional investors now face pressure to consider sustainability criteria when assessing potential investments” says Corli Le Roux, head of the JSE SRI Index. Similar to Mexico, South Africa’s Government Employee Pension Fund has been an advocate of the JSE SRI index, as have a wide range of local investors, giving the index local popular appeal. A local culture for corporate social investment also has helped foster a high adoption rate of sustainability reporting among corporations in South Africa.

Turkey: A new entrant in the SRI field, the Istanbul Stock Exchange (ISE) and Turkey Business Council for Sustainable Development (TBCSD) in August 2010 launched the Istanbul Stock Exchange Sustainability Index (ISE SI)

Project. Its aim is to review listed companies on the ISE based on their management of sustainability issues and to create an index that will demonstrate the leadership of listed Turkish companies. The exchange notes that Turkish companies are facing stiff global competition for contracts and capital “that demand accountability for the role of companies as corporate citizens and the size of their environmental, social and governance footprints.” The project hopes to create a market mechanism to address sustainability challenges that will catapult Turkish companies ahead of their global competitors.

Challenges

While there is much growth in sustainable investing and movement on the sustainable exchanges front, responses largely have not been challenged to produce equal or superior returns for investors. There are costs to reporting and improving sustainability performance, and these are not always offset by immediate benefits, as they are addressing long-term challenges. Therefore, companies and their shareholders might not always see quick returns for their efforts. Only the market will tell if investors have the long-term investment horizons and patience to continue to drive demand.

Even in well-developed markets, accusations of green-washing—the practice of glossing over sustainability challenges and highlighting token environmental efforts—have been widely reported and ridiculed

In addition, the depth of the various SRI indices and other research efforts is surely to be tested as more investors assess ESG performance. Even in well-developed markets, accusations of green-washing—the practice of glossing over sustainability challenges and highlighting token environmental efforts—have been widely reported and ridiculed and, at times have called into question sustainability assessments by investors. In addition, the SSE report mentioned earlier notes that most exchanges in emerging market still focus on governance disclosure requirements that themselves do not meet standards sought by most

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international investors and ignore environmental and social issues altogether.

And, while the Global Reporting Initiative (GRI) has established itself as the most widely cited reporting standard by reporting companies, its guidelines are only adhered to by about 1,000 globally—a clear achievement and leader position but falling far short of offering comparable data on the tens of thousands of publicly traded

companies international investors assess when choosing investments.

Still, demand is clearly growing for investments that address sustainability challenges from climate change to water, poverty, human rights and many others, and markets are responding. Only time will tell which solutions prove sustainable themselves.