

# ESG Spotlight

## Emerging market equities: key sources of ESG risk

8 August 2019

**Themes:**  
ESG risk, GDP analysis

**Industry:**  
Multiple

**Region:**  
Emerging markets, developed markets

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### Key insights

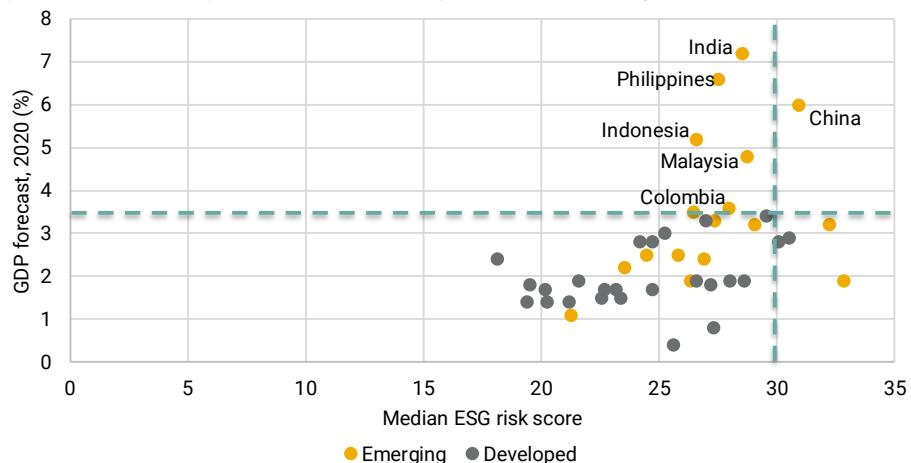
- Investors in the FTSE Emerging Index are exposed to over 14% more unmanaged ESG risk than those in the FTSE Developed Index.
- The risk gap between these indices is largest on the issue of Data Privacy & Security, which investors could potentially address in corporate engagements.
- Investors in select equity markets, such as China, may face a trade-off between chasing higher economic growth and mitigating portfolio ESG risk.

### Renewed interest in emerging markets

Emerging market (EM) equities have largely delivered on their promise, offering outsized returns compared to developed market (DM) equities over longer time horizons.<sup>2</sup> While they have struggled over the last five years due in part to mounting trade concerns between the US and China, some strategists are forecasting favourable winds for EM equities over the near term, particularly given the Fed's rate cut in July.<sup>3</sup>

In this report, we support EM equity investors by analyzing this asset class through an environmental, social and governance (ESG) lens. Part I of this study assesses the ESG risk associated with the FTSE Emerging and Developed indices, and introduces a list of ESG issues for investors to consider in their engagement strategies. Part II looks at the relationship between gross domestic product (GDP) growth and ESG risk in 42 markets (25 DMs, 17 EMs). As shown in Figure 1, investors in firms based in India, the Philippines, Indonesia, Malaysia and Colombia (upper left quadrant) may benefit from a favourable combination of high short-term growth and a relatively moderate equity ESG risk profile.

**Figure 1: Comparing ESG risk and GDP growth in 42 equity markets\***



\*Horizontal line denotes IMF global real GDP growth forecast for 2020 (3.5%); vertical line separates negligible to medium ESG risk on the left from high to severe ESG risk on the right.

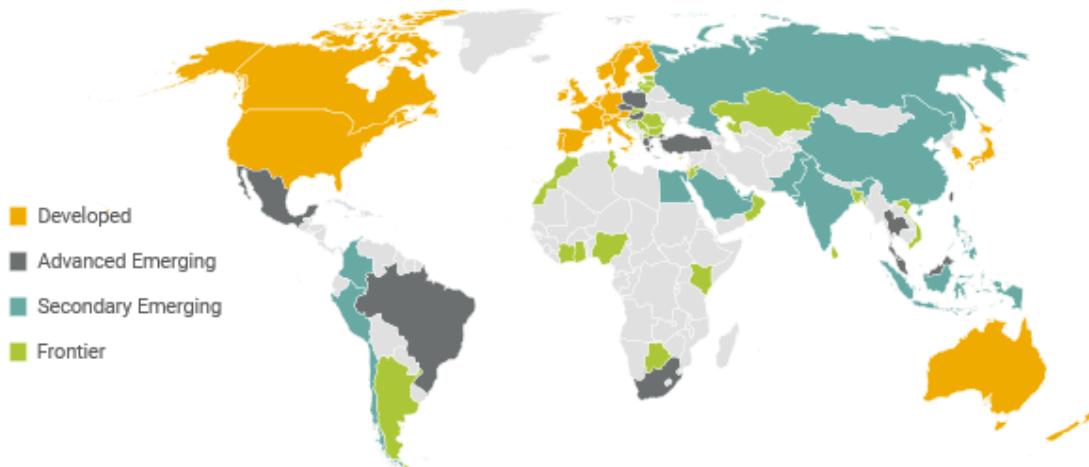
Sources: Sustainalytics, IMF<sup>4</sup>

## The emerging markets landscape

Market classification

Although index providers classify markets in different ways and the definition of “emerging market” varies from one context to the next, EMs are typically characterized as young markets perceived to offer greater returns at higher risk.<sup>5</sup> The importance of EM classifications was recently demonstrated when index providers added Chinese and Saudi Arabian shares to their EM index suite, which led to a significant increase in foreign capital into the shares of these firms.<sup>6</sup> For the purposes of this study, we apply the FTSE Russell equity market classification depicted in Figure 2, grouping markets into four segments: developed, advanced emerging, secondary emerging and frontier.

**Figure 2: FTSE Russell equity market classification**



Sources: FTSE Russell,<sup>7</sup> Sustainalytics

High risk and returns

EM equities present opportunities related to portfolio diversification and high growth potential, but they also tend to be volatile. The total return of the FTSE Emerging Index from 2000 to 2018 was 245%, compared to 117% for the FTSE Developed Index and 121% for the FTSE All World (AW).<sup>8</sup> Over the same period, the volatility in the monthly returns of the EM index was 21%, compared to 14% for the DM index and 15% for the AW benchmark.<sup>9</sup>

When heavyweights hit

A major source of uncertainty across global markets today is the trade dispute between the US and China. Mounting tit-for-tat tariffs have encouraged trade diversions and changes to capex spending as US companies consider relocating manufacturing and supply chain activities. The International Monetary Fund (IMF) estimates that new and envisaged tariffs will entail short-term losses in annual real GDP of up to -0.6% for the US and up to -1.5% for China.<sup>10</sup>

Local markets riding global trends

Although the fallout of escalating tariffs has already hit capital markets, the extent of their long-term impacts may be partly dampened by other global trends that are reshaping EM businesses and trade, including the adoption of emerging technologies, the concentration of production near demand and increasing local consumption.<sup>11</sup> Indeed, some economists argue that EMs may experience less of a downturn than DMs from a deepening trade war, depending on how quickly consumer spending in China and India grows.<sup>12</sup>

Index analysis

The big picture

Five MEIs account for bulk of ESG risk

EMs trail on Data Privacy &amp; Security

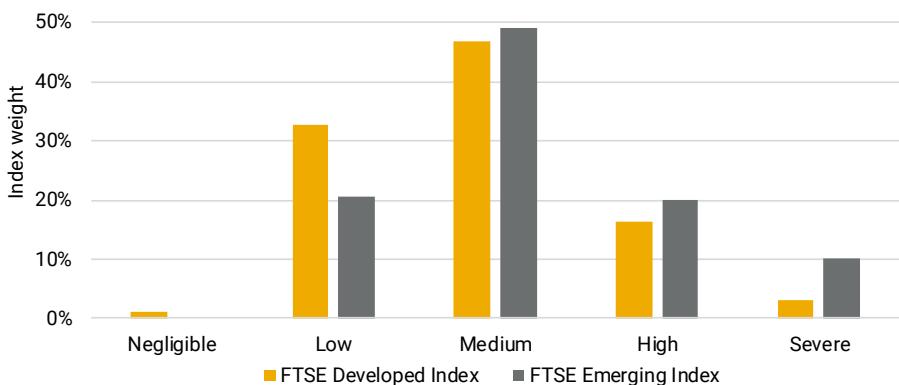
## The ESG edge

This section seeks to support EM equity investors with two key deliverables. In Part I, we compare the FTSE Emerging Index and the FTSE Developed Index using Sustainalytics' flagship ESG Risk Ratings product and reveal different sources of risk that investors in these benchmarks face. In Part II, we turn our attention to the relationship between ESG risk and GDP growth forecasts.

### Part I – ESG risk decomposition

The FTSE Emerging Index has an overall weighted ESG risk score of 27.4, compared to 24.0 for the FTSE Developed Index.<sup>13</sup> This gap suggests that a typical EM equity investor is exposed to 14.2% more unmanaged ESG risk than a typical DM equity investor. Another indication of the higher ESG risk facing EM equities is that 10% of the FTSE Emerging Index falls into the severe ESG risk category, compared to just 3% of the FTSE Developed Index, as shown in Figure 3. In general, these differentials reflect the prevalence of weaker regulatory systems, poor corporate governance practices and lax disclosure requirements in EMs.

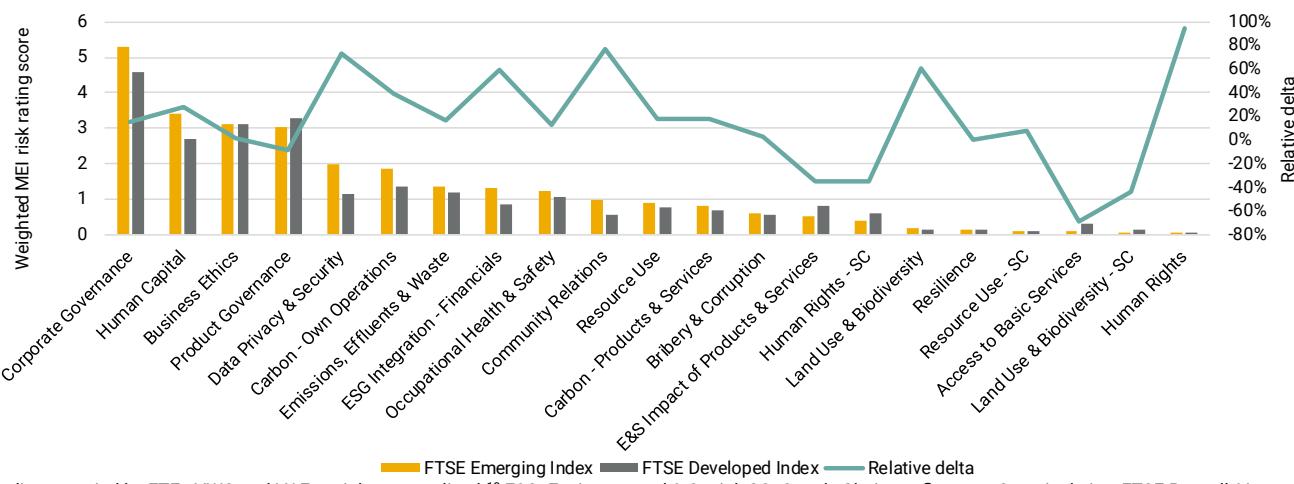
**Figure 3: Distribution of index weight across ESG risk categories**



\*Indices proxied by ETFs VWO and VAE; weights normalized.<sup>14</sup>      Sources: Sustainalytics, FTSE Russell, Vanguard

Figure 4 (p. 4) reveals the sources of risk at the Material ESG Issue (MEI) level.<sup>15</sup> Three main takeaways are apparent. First, five MEIs – Corporate Governance, Human Capital, Business Ethics, Product Governance and Data Privacy & Security – account for half of each index's overall weighted risk score. Their outsized influence reflects the fact that a large portion of the stocks listed in each index are exposed to these issues. These MEIs may constitute a reasonable starting point for index investors looking to engage with firms on material ESG risk.

Second, while the EM index has a higher weighted risk score than the DM index on 16 MEIs,<sup>16</sup> the gap on Data Privacy & Security is the most significant. The weighted risk score of the EM index on this MEI (2.0) is almost a full unit of risk greater than that of the DM index (1.1). We attribute this differential to two main drivers: (i) this MEI applies to more of the market cap of the EM index (5.5%) than the DM index (4.0%), and (ii) the firms represented in the EM index are on average at higher risk on this MEI. Our analysis suggests that while EM-based technology and financial players are exposed to similar levels of data privacy and security risk, they trail their DM counterparts on their management of this issue.<sup>17</sup>

**Figure 4: Assessing Material ESG Issue risk – FTSE Emerging Index vs. FTSE Developed Index\***

\*Indices proxied by ETFs VWO and VAE; weights normalized.<sup>18</sup> E&S=Environmental & Social. SC=Supply Chain. Sources: Sustainalytics, FTSE Russell, Vanguard

Large relative delta on human rights

Third, we calculate the relative difference (delta) between the two indices on each MEI.<sup>19</sup> On this measure, Human Rights stands out as an issue on which the EM index trails the DM index by 94%. While only about 1% of each index is exposed to this MEI, it can still be a material portfolio risk, as affected firms face risks of reputational damage, reduced demand for products, the cancellation of contracts and regulatory interventions. Candidate EM companies for engagement on human rights include those rated at high to severe risk in the industries of agriculture, textiles and non-residential construction, where labour protections may be weakly enforced and workers are exposed to human rights abuses, such as forced labour, human trafficking, slavery and child labour.<sup>20</sup>

## Part II – An integrated ESG risk and GDP growth framework

Considering domestic market growth

The second part of our study develops a framework to compare the ESG risk of companies in EMs and DMs with the economic growth prospects of these markets using the IMF's 2020 GDP growth forecasts. While GDP growth is one of many factors to gauge the relative attractiveness of equity markets, it is a widely used metric that offers a broad indication of expected economic output.

A moderately positive relationship

Accounting for both EM- and DM-based firms covered by the FTSE Emerging and Developed indices, we find a moderately positive correlation (coefficient=0.47) between the median ESG risk scores of 42 equity markets (25 DMs and 17 EMs) and 2020 GDP growth forecasts. Although the sample size of each market varies substantially, on the face of it, this result suggests equity investors may face a trade-off between chasing higher economic growth and mitigating ESG risk.<sup>21</sup>

A simplified framework

However, as shown in Figure 1 (p.1), we also find substantial variation in the relative positions of these 42 markets. This simplified framework lets investors compare the short-term growth prospects of markets with the ESG risk profile of each market's underlying public equities.<sup>22</sup>

Grouping markets into quadrants

Markets can effectively land in four quadrants: upper left (higher growth, lower ESG risk), upper right (higher growth, higher ESG risk), lower left (lower growth, lower ESG risk) and lower right (lower growth, higher ESG risk).

Higher growth, lower ESG risk

Five markets – all of which are EMs – fall into the higher growth, lower ESG risk category: India, the Philippines, Indonesia, Malaysia and Colombia. Equity investors in these markets may potentially benefit from a favourable combination of relatively strong economic growth prospects and domestic equities with a moderate ESG risk profile. We stress, however, that the ESG risk of companies in these markets varies significantly, even though the median score is moderate.

Higher growth, higher ESG risk

A single market – China – falls into the higher growth, higher ESG risk quadrant. Investors in Chinese equities may benefit from China's high expected growth rate (although recent data suggest the country's growth rate may be stalling),<sup>23</sup> but they may incur higher ESG risk relative to firms based in other EMs, such as India.

Lower growth, lower ESG risk

Most markets fall into the lower growth, lower ESG risk quadrant (33 of 42, or 79%). Of the markets in this category, most are DMs (24 of 33, or 73%). Markets that fall into this quadrant include Germany, Australia and Japan (DMs), Brazil, South Africa and Taiwan (EMs). These markets are characterized by comparatively lower growth expectations (although many sit on the cusp of higher growth) and domestic equities with lower ESG risk (on average). Effectively, investors in these markets may be faced with a trade-off between economic growth and ESG risk that merits further exploration.

Lower growth, higher ESG risk

Four markets fall into the lower growth, higher ESG risk quadrant. Two of these are DMs – New Zealand and South Korea – and two are EMs – Qatar and Russia. While our simplified framework leaves many factors off the table, it suggests that equity investors in these markets may face the dual headwinds of below-average economic growth prospects and relatively high domestic equity ESG risk.

## Conclusion – the next frontier

Closing material ESG issue gaps

This report presented an original approach for investors to build upon when developing EM engagement and portfolio strategies. The first part of this study focused on the role of MEIs in driving the overall ESG risk ratings of companies covered by the FTSE Emerging and Developed indices. Comparing the ESG performance of these two benchmarks on 21 MEIs, we highlighted issues that may be candidates for corporate engagement, especially for portfolio companies that fall into the high and severe ESG risk categories. Prominent themes for potential engagement include corporate governance, human capital, business ethics, product governance, data privacy and security, and human rights.

Targeting markets

The second part assessed the positions of markets from an integrated ESG risk and GDP growth perspective. One of the key findings of this analysis is that investors in companies based in some markets may face a trade-off between chasing economic growth and mitigating portfolio ESG risk.

New ground ahead

The results of this study and the approach we took comprise an initial step for investors to consider when designing corporate engagement and portfolio management strategies aimed at mitigating ESG risks associated with EM equities. Additional analysis of the unique set of ESG risks facing each market and the contributions of specific industries and companies would further advance this field of research.<sup>24</sup>

# Endnotes

- <sup>1</sup> Acknowledgements: The authors wish to thank their Sustainalytics colleagues Andrei Apostol and Nonvignon Kpadonou for data analysis support and Palle Ellemann for reviewing a preliminary draft of this report.
- <sup>2</sup> Wheatley, J. (11.06.2019), "The great emerging-market growth story is unravelling," Financial Times, accessed (17.06.2019) at: <https://www.ft.com/content/ad11f624-8b8c-11e9-a1c1-51bf8f989972>.
- <sup>3</sup> Ferreria, V. (21.06.2019), "How the Fed's dovish turn on interest rates could unleash emerging market rally," Financial Post, accessed (17.06.2019) at: <https://business.financialpost.com/investing/u-s-interest-rate-cut-could-hold-the-key-to-unlocking-emerging-markets>; Ghosh, A. (30.07.2019), Emerging Markets-EM shares prop up ahead of Fed meet; currencies mixed," Reuters, accessed (31.07.2019) at: <https://www.reuters.com/article/emerging-markets/emerging-markets-em-shares-prop-up-ahead-of-fed-me>; Russell, K and Smialek, J. (31.07.2019), "Why the Federal Reserve Cut Interest Rates for the First Time Since the Crisis," The New York Times, accessed (31.07.2019) at: <https://www.nytimes.com/interactive/2019/07/31/business/economy/federal-reserve-interest-rates.html>.
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- <sup>6</sup> Bird, M. (03.02.2019), "How China Pressured MSCI to Add Its Market to Major Benchmark," The Wall Street Journal, accessed (17.06.2019) at: <https://www.wsj.com/articles/how-china-pressed-msci-to-add-its-market-to-major-benchmark-11549195201>.
- <sup>7</sup> FTSE Russell (29.03.2019), FTSE Equity Country Classification March 2019 Interim Update, accessed (17.06.2019) at: [https://research.ftserussell.com/products/downloads/FTSE-Country-Classification-Update\\_latest.pdf](https://research.ftserussell.com/products/downloads/FTSE-Country-Classification-Update_latest.pdf); FTSE Russell (2018), FTSE Country Classification Process, accessed (17.06.2019) at: [https://research.ftserussell.com/products/downloads/FTSE\\_Country\\_Classification\\_Paper.pdf](https://research.ftserussell.com/products/downloads/FTSE_Country_Classification_Paper.pdf).
- <sup>8</sup> For this comparison, we selected the year 2000 as the starting point because it is the earliest year for which Morningstar data was available for all three benchmarks. The volatility analysis is based on standard deviation of monthly return of indices. Data from Morningstar Direct (2019), accessed (17.06.2019) at: <https://www.morningstar.com/products/direct>.
- <sup>9</sup> Morningstar Direct (2019), op. cit.
- <sup>10</sup> The International Monetary Fund (2019), op. cit.; The International Monetary Fund (23.07.2019), op. cit.
- <sup>11</sup> McKinsey Global Institute (2019), "Globalization in transition: The future of trade and value chains" accessed (25.06.2019) at: <https://www.mckinsey.com/~media/McKinsey/Featured%20Insights/Innovation/Globalization%20in%20transition%20The%20future%20of%20trade%20and%20value%20chains/MGI-Globalization%20in%20transition-The-future-of-trade-and-value-chains-Full-report.ashx>.
- <sup>12</sup> Sivabalan, S. and Bartenstein, B. (25.06.2019), "Look Past Trade War and Emerging Markets Seem Surprisingly Good," accessed (17.06.2019) at: <https://www.bloomberg.com/news/articles/2019-06-25/look-past-trade-war-and-emerging-markets-seem-surprisingly-good>.
- <sup>13</sup> Sustainalytics' comprehensive ESG Risk Ratings cover 80% of the marketcap weight of the EM benchmark and 90% of the DM benchmark. We normalize the weights of the matched security results within each benchmark to equal 100% of the total index weight by evenly redistributing unmatched security weights. Weighted scores are calculated by aggregating normalized security weighted scores.
- <sup>14</sup> We normalize the weights of the matched security results within each benchmark to equal 100% of the total index weight by evenly redistributing unmatched security weights. Weighted scores are calculated by aggregating normalized security weighted scores.

- <sup>15</sup> While Corporate Governance is a material issue, in the ESG Risk Ratings model it is distinct from MEIs. Corporate Governance is a unique building block of the risk rating; while it applies to all subindustries, MEIs are subindustry specific, and apply to some subindustries and not others. For more information, see: Garz, H. and Volk, C. (2018), The ESG Risk Ratings, Moving up the Innovation Curve, White Paper – Volume 1, Sustainalytics, accessed (02.04.2019) at: [https://marketing.sustainalytics.com/acton/attachment/5105/f-0b6c/1/-/-/-SustainalyticsESGRiskRatings\\_WhitePaperVolumeOne\\_October%202018.pdf](https://marketing.sustainalytics.com/acton/attachment/5105/f-0b6c/1/-/-/-SustainalyticsESGRiskRatings_WhitePaperVolumeOne_October%202018.pdf).
- <sup>16</sup> The EM index has a lower weighted risk score than the DM index on five MEIs. For four of these – E&S Impact of Products & Services, Human Rights - SC, Access to Basic Services, and Land Use and Biodiversity - SC, the main driver of the higher weighted risk score of the DM index is its higher exposure to the issues. In contrast, for Product Governance, the proportional exposure of both indices is about the same (~80%). The higher risk score of the DM index on this MEI may in part reflect DMs' stricter regulations about the quality of products and services.
- <sup>17</sup> Although related regulations tend to be stricter in DMs, EM firms are exposed to similar data privacy and security risks as DM companies due to international data flows, which exposes them to DM regulations and customer expectations. Furthermore, EM-based firms tend to have relatively weak governance systems in place to address privacy violations that may occur from sharing data with governments.
- <sup>18</sup> We normalize the weights of the matched security results within each benchmark to equal 100% of the total index weight by evenly redistributing unmatched security weights. Weighted scores are calculated by aggregating normalized security weighted scores.
- <sup>19</sup> A relative delta compares the difference between two numbers as a percentage. We calculate delta as follows as  $(E-D)/D$ , where E=the EM index's weighted score on an MEI and D=the DM index's weighted score on the same MEI.
- <sup>20</sup> Other MEIs with high relative deltas include Community Relations and Land Use and Biodiversity.
- <sup>21</sup> This analysis covers companies represented by the two indices and markets in which at least six companies are based. Some markets include more than 300 covered issuers (e.g. China and Japan). EM and DM index constituents that are not based in EMs or DMs, respectively, are excluded from this part of our analysis.
- <sup>22</sup> These equity market ratings are distinct from Sustainalytics' Country Risk Ratings. For more information about country level ratings, see: <https://www.sustainalytics.com/country-risk-rating/>.
- <sup>23</sup> He, L., "China's economic growth slumps to lowest in 27 years as the trade war hits," CNN Business, <https://www.cnn.com/2019/07/15/economy/china-gdp-growth/index.html>.
- <sup>24</sup> For more information about Sustainalytics' engagement services, see: <https://stewardship.sustainalytics.com/>.

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