Round Table Discussion
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NORDSIP
NORDIC SUSTAINABLE INVESTMENTS

insights

INVESTING SUSTAINABLY IN EMERGING MARKETS

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subtle shades

Listening to emerging market managers, I dream of adventure. I picture hot and humid days, dusty roads, amazing opportunities, but also cultural differences, communication lost in translation and corruption. Certainly, impact investors can find plenty of opportunities in such places to make a difference and improve the situation for populations whose basic needs are unmet. But beyond these 'for-profit charity' projects that are not in everyone's reach, what does sustainability mean in the Wild Wild East?

Even in Sweden, where large institutions have taken sustainable investment practices into accounts for at least two decades, SRI specialists still debate standards and measurements. Even in developed economies, ESG is far from black or white, nor green or brown. Investors need to take decisions based on nuances and make judgement calls with ambiguous data. How can such an inexact science be applied to emerging market? Moreover, can western investors, who are still struggling in defining their own limits, impose their criteria on less prosperous economies without falling into downright imperialism?

With the help of six seasoned investors, we discussed the everyday challenges of emerging market managers. We discovered where some opportunities lie, such as the ESG-related cost savings private equity ownership can extract or the downside protection ESG analysis provides emerging market debt investors. We also talked about how the right words can transform attitudes towards human right issues.

Data quality, management trust and educational gaps were some other focal points in the discussion. Feet-on-the-ground is therefore an essential item in any emerging market manager selection process.

When it comes to corruption, accountability doesn't start only when investing directly in emerging markets. Even European companies that conduct activities in emerging markets can be affected. Sometimes, refusing to engage in certain practices may impede regular business altogether. Companies, managers and investors need to draw lines. On the other hand, a clampdown on corruption may not always be motivated by honourable intentions, but to generate turmoil for opposite political factions.

Cultural differences may arise even between developed markets, in the simplest expressions of sustainable investing: exclusions. It is only natural that fund managers will adapt to their home country's demand, which may entail taking into consideration flagship industries, regardless of their involvement in controversial areas. Excluding weapons, for instance, may prove challenging when selecting a fund focused on the US or the French market.

The ambiguities we discussed here are what makes sustainable investing so fascinating. Unlike the neophyte may believe, SRI and ESG is indeed a matter for specialist. Not because the basic concepts are hard to understand, but precisely because of the necessity to act and decide between subtle shades.

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MENU

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who is who?

"In my role, I focus on integrating ESG factors into investment decisions and active ownership activities, across asset classes."

Kristofer Dreiman
Head of Responsible Investments
Länsförsäkringar AB

Prior to joining Länsförsäkringar's asset management division, which manages both Life & Non-life assets, Kristofer Dreiman worked as Responsible investment and sustainability advisor at PwC, both in Sweden and in the UK, and as Reporting and Assessment Project Manager at the PRI.

Dreiman holds an MSc in Industrial Management from the Royal Institute of Technology in Stockholm, where he wrote a thesis on the operational benefits of ESG engagements for investors and investees.

"At responsAbility, I am Head of Agri and Food Private Equity. ESG is key in every aspect of what we do."

Rik Vyverman
Head of Agriculture Equity and Ventures
responsAbility

Based in Zurich, Switzerland, Rik Vyverman joined responsAbility in 2013. Previously, he worked as an advisor to Acumen Fund and as Chief Executive Officer for the SEAF Blue Waters Growth Fund.

Vyverman also founded and managed a private equity fund in Vietnam. He started his professional life as an entrepreneur.

Rik holds a Master of Science degree in Applied Economics from the Free University of Brussels.

"I am responsible for Nordea Life & Pension's sustainability work within the Nordics. We have a high ambition and we aim to integrate ESG into all of our asset classes."

Cecilia Kellner
Senior Portfolio Manager, Sustainability Strategist
Nordea Life & Pension

Prior to joining Nordea in 2016, Cecilia Kellner worked as a Senior Credit Analyst at BNP Paribas, Senior Portfolio Manager at Strand Kapitalförvaltning and Senior Equity Research Analyst at Carnegie Investment Bank.

Kellner holds a MSc in Accounting and Finance from Stockholm University.

"I am Head of the Emerging Markets Corporate Debt Team. At BlackRock, we've used ESG as the main component of our qualitative analysis for most of our funds for several years."

Jack Deino, CFA
Head of Emerging Markets Corporate Debt
BlackRock

Prior to joining BlackRock in 2015, Deino spent more than 9 years at Invesco where he was most recently Head of Emerging Market Portfolio Management and lead portfolio manager for the firm's corporate and sovereign credit funds. Prior to Invesco, Deino held positions at Daiwa Securities America, Zephyr Management, Orix Capital Markets and APS Financial Corp. He has 24 years of combined industry experience in EM fixed income and equities.

Deino earned a BA degree in Latin American Studies from The University of Texas at Austin.

"As Head of Fund Selection within the unit-linked insurance at Folksam, I look at all the external funds available to Folksam's customers."

Susanne Bolin Gärtner
Head of Fund Selection & ESG
Folksam

Prior to joining Folksam in 2009, Susanne Bolin Gärtner has held several senior positions within finance, banking and insurance institutions such as Alecta, Max Matthiessen and SEB.

Bolin Gärtner graduated in Business Administration and Economics from Uppsala University as a Civilekonom (MSc).

Susanne is also a board member of Swesif as well as a member of the Finance Committee of Barncancerfonden (the Swedish Childhood Cancer Foundation).

"My specific responsibilities are in the EM equity space. I am the ESG specialist sitting with the investment team doing ESG integration and active ownership."

Juan Salazar
Ass. Dir. Governance & Sustainable Investment
Bank of Montreal Global Asset Management

Based in London, Juan Salazar joined BMO GAM in 2010. Previously, he worked at ABN AMRO Bank, first as Credit Structuring Analyst, as Credit Risk Manager and last as Sustainable Risk Advisor.

Salazar holds a Master in International affairs from Columbia SIPA, and a BSc in Industrial Engineering from the Universidad de Los Andes.

From left to right: Jack Deino, Robert Elfstöm, Cecilia Kellner, Mattia Scolari, Susanne Bolin Gärtner, Juan Salazar, Aline Reichenberg Gustafsson, Rik Vyverman, Kristofer Dreiman, Kim Hansson, Balder Vestas, Sirikitt Bergendal

Investing Sustainably in Emerging Markets

TAK Restaurangen
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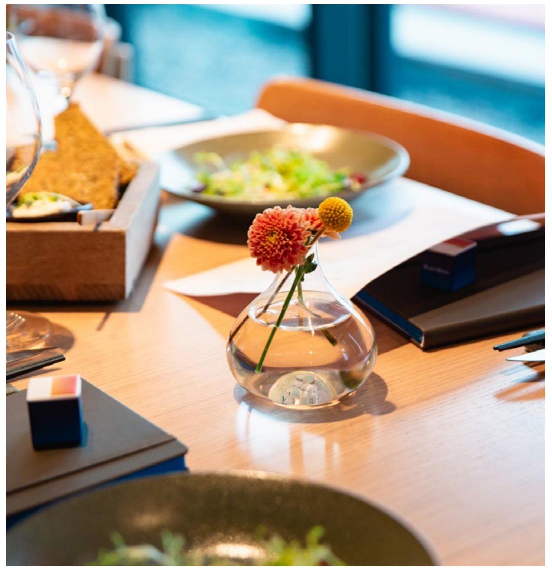
20 October 2018



starter

Translating ESG in emerging markets

For **Jack Deino**, who comes from the fixed incomes side, ESG is nothing new. “It's something we have always focused on in our investment process. In fixed income, we mostly look at avoiding default and drawdowns. We want to detect early warning signs. We have put in place a comprehensive multi-faceted investment process that includes liquidity and relative value screening, income statement analysis and cash flow forecasting. The quantitative part of it is robust. There are, however, specific tangible qualitative aspects about an investment in fixed income that are quite important and that the initial quantitative assessment is not going to highlight. ESG analysis is, from our perspective, an invaluable tool to understand the quality of management, and to understand the vulnerability of a credit that could result from qualitative and less tangible risks.”

> *“ESG analysis is, from our perspective, an invaluable tool to understand the quality of management, and to understand the vulnerability of a credit that could result from qualitative and less tangible risks”*

Juan Salazar comments from his point of view as an ESG analyst: “ESG management can be an indicator of management quality. That is something that my portfolio manager colleagues have been drilling down into. They want to get to know management to be able to trust them with our clients' money and have an essential conversation about anything that might matter for the business going forward. With the incorporation of the ESG factors, what probably has changed the most is, that we now try to direct that engagement with companies towards a more long-term focus. And in emerging markets, in particular, companies are very concerned about their day to day business. What is the P&L going to look like? What are the cash flows going to look like in the next month 2 or 3 months? Getting to a long-term mindset is difficult but bringing in ESG factors into the discussion has helped to an extent to get that dialogue started.”

For someone on the private equity side, like **Rik Vyverman**, ESG can have slightly different implications: “In private equity, we get heavily involved in our investment companies. We believe that our ESG-focused approach is part of the value we create with these companies. On the one hand, we create better-run companies, but on the other, we can also add directly to the bottom line by improving the way companies are run. For example, we can help them to optimise the use of water or energy, by changing sources of energy... ESG has become part of our value creation as, and it is no longer only about the ESG-related risks. Of course, no manager or investors want to be exposed to the negative effects that a lack of sustainability can generate, but there is a positive side which we can capture as well. I have been doing this for 20 years and looking back, 20 years ago, the approach on ESG was predominantly a risk-focused one. Investors didn’t want to get into the newspapers due to an investment company polluting this or that. Now ESG has turned into a much more positive approach where investors can add value to the companies, to be managed better also, from a sustainability point of view, operating at a higher level and improving their bottom line.”

> *“In emerging markets, in particular, companies are very concerned about their day to day business (...) Getting to a long-term mindset is difficult but bringing in ESG factors into the discussion has helped to an extent to get that dialogue started.”*

> *“In private equity, we get heavily involved in our investment companies. We believe that our ESG-focused approach is part of the value we create with these companies.”*

Salazar agrees on the direction of the change that Vyverman described, but he believes there is still room for improvement. “I think that shift is on the way, but there are still a lot of people that remain focused on the risk end of ESG, which is not by any means the wrong one, but they may be missing out on many of the opportunities.”

Deino retorts that one may not preclude the other: “While focusing on the risks, you may identify downside and upside opportunities. As per downside, I have seen companies where both management as well as investors are heavily focused on the short-term P&L and cash flow. Let’s say that there is an IPO of a steel mill and the analyst from the investment bank says, ‘Jack, what's not to love about this? It’s generating significant free cash flow.’ But then I'll look closer, and I'll see that there is a problem as capex is well below what depreciation is. I'll go down to the company for a visit, and I'll see a rolling mill where employees that are probably earning $1 or $2 an hour are running a broken rolling mill on a stationary bicycle! At the end of the day, if a management team is so acutely focused on free cash flow, the company will be more vulnerable.”

> *“Everyone has their own view of what is important, and therefore we need to define and communicate clearly what matters to us and, in particular, which risks we don't want to be exposed to. Still, opportunities are quite significant, especially in emerging markets, when it comes to E, S and G because there is so much room for improvement. This is why we always look at the risks in combination with the opportunities.”*

“On the other hand, you may find other companies where a management team is concerned about more long-term issues such as minority shareholder rights (because minority shareholder rights have long-term repercussions), or about how they interact within their community, that they worry about their employee relationships and employee retention, and the

"It is highly relevant to discuss ESG risks specifically with the managers because we still meet those that don't necessarily have a holistic idea on how to identify and address those risks."

environment. You could probably bet that these guys have their eyes on the ball – offering medium to long term stability and potential improvement in credit metrics.

"One of the things that we have entrenched in our DNA," Deino adds, "is that we don't want to be investing in countries and companies only for the sake of a superior ESG rating. Our focus in not building a portfolio that has a triple-A weighted average ESG rating. If we wanted to do that, we would only invest in countries like Sweden. Instead, we want to identify companies that perhaps some of the agencies, like Sustainalytics or MSCI score poorly at present, but that have identified their ESG weaknesses and are determined to improve. So, for us, what is more important is not that we are going to maintain a triple-A rated ESG portfolio, but a portfolio where we could have an actual impact as far as an improving delta."

Kristofer Dreiman who selects fund managers at Länsförsäkringar AB believes that the risk part of the ESG equation is still a significant component. "It is highly relevant to discuss ESG risks specifically with the managers because we still meet those that don't necessarily have a holistic idea on how to identify and address those risks. We need to keep that focus, especially in emerging markets, where the inherent risks are much greater than in Sweden, for example. We often share our views on what we refer to as inherent ESG risks in the country or countries where the fund invests, to stimulate the discussion, but also to test the manager and see if they have conducted a similar analysis or not."

Cecilia Kellner who identifies sustainable strategies for Nordea's Life & Pension's portfolio agrees. "For our part, we don't want to look only at the risks, but at the combination of risks and opportunities, especially in emerging markets, because there is a country risk that investors are not necessarily exposed to developed markets, such as the Nordics. Country risk is not considered an issue in places like Germany or Sweden. We don't have to scrutinise companies about corruption to the same extent as we do when investing in emerging markets."

Identifying what risks matter to an investor is also crucial a part of the investment process for Kellner. "There are many different views on what ESG is," she says. "Everyone has their own view of what is important, and therefore we need to define and communicate clearly what matters to us and, in particular, which risks we don't want to be exposed to. Still, opportunities are quite significant, especially in emerging markets, when it comes to E, S and G because there is so much room for improvement. This is why we always look at the risks in combination with the opportunities."

ESG can bring risk management and opportunity seeking closer together, especially in emerging markets. Vyverman builds on that point: "In Sweden, Germany as well as Switzerland, legislations exist, and they are implemented. In some places, be it in Africa or Asia, we need companies to comply at a minimum with their local regulations, and we need to ensure that it is indeed the case. That is a minimum requirement, but it doesn't mean that we don't have an opportunity to lift those companies to internationally accepted standards. That is an important part of the discussion: how do you get companies up the curve? That is a process, and it needs an engagement."

"In many countries, you can hardly conduct any business unless you follow that country's practices which may not at all times comply with our way of conducting business."

Cultural differences and no-go zones

Kellner opens up the discussion and brings up different shades of acceptable standards. "A tricky part is to consider the difference in business culture. Take Nordic companies, for instance, which are exposed to emerging markets. They will face different regulations and legislation in those countries, but also different business practices. If a Swedish construction company is to build something in an emerging country, their processes will be different than at home. In many countries, you can hardly conduct any business unless you follow that country's practices which may not at all times comply with our way of conducting business. Some things are not acceptable from our point of view. Others are. We cannot have an entirely rigid approach when looking at how businesses are run in emerging markets, but we need to be firm and determine where we draw the line, even if this means that we will not be able to invest everywhere."

"There are clear no-go zones," **Vyverman** agrees. "If you come across a company that has to pay for getting access to something and they do pay that is a no-go zone. No corruption under whatever form can be accepted."

"In some countries, for example, the anti-corruption campaign may be a score-settling among political factions, as opposed to something more tangible."

Deino shares his experience in the matter of grey zones and corruption across public and private investments: "Being part of BlackRock, there are many things that we absolutely cannot get involved in, because it just does not meet our standards. We are definitely held to a higher standard than several other investors, from my perspective."

"On the other hand, I have seen how some of the anti-corruption campaigns such as those we are seeing to varying degrees in Argentina, Brazil and Mexico can be enormously disruptive for business, but lay the groundwork for a more transparent field of play for the longer-term. Suddenly, companies that were simply conducting business in a way that was culturally accepted for years may face losses. Business could become paralysed. Take a country like Brazil, where an ongoing anti-corruption campaign is generating an endless stream of unpredictable and disruptive headlines. Any local officer, approving a hospital project, for instance, may be terrified to sign off on it. There can be negative side-effects, even if the progress, in the long run, should be positive. In some countries, for example, the anti-corruption campaign may be a score-settling among political factions, as opposed to something more tangible. In many places, however, slowly but surely, we see some improvement in the landscape."

Starting with 'G'

For Folksam's Fund Selection Manager, **Susanne Bolin Gärtner**, the 'G' in ESG may be a good starting point. "If you think about emerging markets then, G is a good starting point. For us to be able to move forward, there needs to be a governance structure in place. Chinese companies that are now in the MSCI index, for example, have suddenly needed to shape up in the way they report. If you start asking questions, the discussion gets going, and the situation improves, as the dynamic changes."

"Boots on the ground is an essential component, from our perspective, when we talk to managers, given that the risks are higher, and the disclosure level might not even be there, or is still not on par with developed markets."

Salazar nuances Bolin Gärtner's assessment: "I agree that 'G' is the most sensible entry point. And yet, dealing with family-run companies or state-owned enterprises makes the challenges related to governance look very real, and some things are challenging to overcome. Having said that, I have been engaging with companies in emerging markets for ten years, and the keenness that most companies demonstrate to learn what foreign investors have to say or ask and their willingness to enter into a dialogue has changed almost unrecognisably. Ten years ago, you would not have been able to go to a company in Asia and ask them about the absence of independent directors on its board."

"We often need to start with the basics," adds **Vyverman**. "And when talking to family-run businesses, this means installing proper accounting principles and appointing reputable auditors."

"When I started in this business some 25 years ago," **Deino** explains, "we had to learn local accounting standards for each individual country. Now we benefit from standardization using IFRS accounting. One may think that it is a one-size-fits-all solution, but in reality, it is not. The level of knowledge is not homogeneous across finance departments of companies in different countries, and the same goes for external auditors. On the other side, a high number of family-run companies, or companies where the incentives are based on EPS and the stock price, focus very much on the short term. Companies can hence record several expenses above and below the operating line, among other measures to enhance EBITDA, net income as well as EPS. We have also seen multiple accounting and alleged fraud scandals in EM in recent years. I do think that emerging markets have come a long way these past 25 years, but it still isn't the same as investing in some of the world's most advanced economies."

The local presence is, therefore, a crucial element when selecting managers, Dreiman emphasises. "That's why boots on the ground is an essential component, from our perspective, when we talk to managers, given that the risks are higher, and the disclosure level might not even be there, or is still not on par with developed markets."

"Bringing up social issues such as Human Rights when trying to engage with companies domiciled in countries with poor human rights records was a bit of a struggle. I quickly learned how weighted the words were."

Management

What about 'E' and 'S'?

Salazar goes back to his experience with certain sectors to illustrate the challenges he faced: "I can think of Human Rights, for example, when I used to cover the mining stocks. Engaging in conversation with mining companies about environmental issues was straightforward – you either comply with the regulations or you don't. But bringing up social issues such as Human Rights when trying to engage with companies domiciled in countries with poor human rights records was a bit of a struggle. I quickly learned how weighted the words were. To start a conversation about Human Rights, I couldn't mention the term 'Human Rights'. Employee relations, relations with the community, stakeholder management, those were terms that made dialogue possible. Again, the understanding of the local context is crucial to open a conversation that is constructive and productive. Boots on the ground are imperative. When my colleagues in Hong Kong started to grasp ESG as a component of their investment process, it was a game changer. They could go and speak in their native language to the companies, and that makes a huge difference. It is all about making it relevant to the companies you cover."

ESG analysis cannot be applied on an apples to apples basis across countries. "It requires quite a bit of soul-searching," adds **Deino**. "For example, going to the Middle East and talking to a company about gender equality, and having female members of the board of directors, may not be the same conversation as with a firm in the US or Sweden. There are some countries and some companies that are making solid inner roads, even there. To some extent, however, we may have to draw a line before becoming culturally invasive, and imperialist. We also need to try and understand what the mind frame and the cultural nuances are for the CFO, the CEO or the Chairman, standing in front of us."

"The industry matters as well, particularly in emerging market," Deino continues. "The banking industry is one that I follow particularly closely. There is a real shortage of qualified, basically educated potential employees in many countries. The education system is not always adaptable or adapted to the current economic climate. In this context, we want to make sure that companies are doing everything they can to retain their best employees. We are very focused on understanding Mexican state-owned enterprises, for example. The recently inaugurated left-of center government in Mexico has proposed placing a salary cap on all public sector employees. We are working to understand if this threatens a meaningful 'brain-drain' for government-controlled entities."

Considering country risk

Looking at governance risks such as corruption, **Bolin Gärtner** wants to know if, in emerging markets, certain countries should be avoided altogether, or engage more with the government. **Salazar** believes that it is indeed an important question. “We, as fund managers, have a responsibility to engage with policymakers in the countries that we are investing in. We have a frontier strategy, and we are exposed to countries such as Zimbabwe, Egypt, Nigeria, Pakistan, which are not the easiest countries to invest in. Like in the other emerging countries, we take the dialogue beyond the companies to the policymakers and local investors to try to move the needle in a way that is going to be beneficial for everyone. In the more established markets like South Africa, China, Brazil where the authorities are working on raising the bar in terms of reporting governance, it is perhaps easier. However, going to less-developed countries, we have the opportunity to be a significant voice in instigating change, even if it won’t happen from one day to the other – it takes time. It also has to be a consistent and concerted effort together with other investors and stakeholders.”

“In our investment process, we use a purely a bottom-up approach and do not exclude countries just because they're too risky from an ESG perspective,” Salazar concludes.

Kellner also finds it difficult to look at ESG from a country’s perspective. “How easy it is to get access to the government in Pakistan, or other frontier countries?” she asks. “The usual entry point for us is through the stock exchanges,” says Salazar. “Then we may go to securities regulators and then the ministry of finance. If you have done your homework right then you can get to that level, but it's not easy.”

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From ESG to SDGs

Bolin Gärtner suggests that, especially when looking at the Social dimension of ESG, the Sustainable Development Goals are a useful framework. “We meet a lot of external managers, and it is exciting to see their different approaches to the SDGs. We see different examples such as spiderwebs, as they try to map their funds’ exposure to each goal, and some funds are cherry-picking some of these SDGs and working more towards those. It is a good starting point because everyone can relate to something in these 17 goals and their 169 associate targets, which have been broken down even further into with sub-targets now.”

Both **Salazar** and **Dreiman** question the sincerity of some of these managers. “A lot of people have jumped on the train without really understanding what it is,” says Salazar. “I agree that the SDGs constitute a great framework, something that everyone can relate to one way or another but perhaps in this mad rush to get to the top, people are misusing it.” “We find a lot of SDG washing,” Dreiman agrees.

For **Bolin Gärtner**, SDGs may not represent a perfect absolute base for measurement, but they can be useful in relative terms. “The interesting part is the change,” she says. “If a manager says one thing the first year, what will happen the year after? We have set up a yearly due-diligence process, and if we receive the same answer every year, that means they are not moving upwards on the experience curve. We are all beginners, and we need to get started somewhere. Everyone can have a different starting point. Some may stay in their spiderweb forever, while others might jump to some conclusions and focus on some specific SDGs.

“For instance, for me as a fund selector,” Bolin Gärtner continues, “when I look at our sustainability work within Folksam and for external funds, I have found that goal number 3 (Good Health and Wellbeing for People) is very useful because we want all our investments to be tobacco-free. I can lift the debate from Folksam up to the SDGs. This is a way to use these broader goals in our internal discussion. It is yet another way of opening the communication channels and highlight issues.”

Dreiman concurs but remains somewhat sceptical. “For example, we can link goal number 13 (Climate Action), to the exclusion criteria we have implemented on thermal coal for instance, but also to our involvement in investor initiatives like the *Climate Action 100*, and lastly, climate mitigation in individual fund strategies. We can easily relate to the framework in different discussions, both on ESG integration and engagement strategies, but a key point remains that many managers may have just jumped on this three-letter term now, opportunistically. Some may have just changed the name of an existing strategy, and suddenly, it has become an SDG strategy.” “Many companies have done the same,” adds **Deino**. “developing a narrative using the goals, instead of generating impact or having a concrete action plan. It has become reactionary.”

main course

Accountability, measurements & taxonomy

Kellner believes that the lack of measurements reduces the accountability of SDG-related investment narratives. “When we come to the point where we are better able to measure the SDGs, then it will be more difficult to hide behind the goals. Today, anyone or any fund can pick an SDG that applies to their current strategy. For a fund with a climate strategy, for example, it is easy to plug into the climate-related goals, and there are many products focused on climate at the moment. But when it comes to measurement, we may be able to assess a funds impact on all SDGs, and then target specific, quantifiable goals. At the start, it may not be so easy, but if and when we find good measurements, it will make more sense. Of course, some of the targets are easier to measure than others. Carbon emissions are more quantifiable than the impact an investment has on poverty, for instance. Today, a manager may be able to show that they have picked specific SDGs and that they focus on those in a fund. Then they can illustrate what they have accomplished or what impact their fund has in specific areas thanks to real-life examples or case studies. Without measurements, it remains a difficult endeavour.”

> *“Often as managers, we find ourselves in a position where every investor comes with a different set of reporting criteria, and it becomes quite impossible to comply with all of them.”*

Deino agrees that quantifying impact is tricky. “It may not even be quantifiable in some cases. I could put a number on my ESG fund and my traditional mutual fund, and I could say, that we are cutting carbon emissions by 60 percent. I can show how we are coming from a high level, calculated based on sales, or capital, and going to another level. Risk characteristics are not dissimilar. The yield, the duration, everything remains practically unchanged. Hard numbers look exciting, but for most of the SDGs the impact is more very subjective.”

For **Vyverman**, intentionality is at the core of the SDG-washing question. “Beyond the fact that people are jumping on the SDG train and using them, it is all about the intentionality that investors have when targeting one or more of goals. The intentionality of targeting SDGs is key, which means that companies or investors need to be able to report on it. They need to communicate about it before starting and then be held accountable just like they are with their financial return which brings us to the point that SDGs needs to be quantifiable as well. You need to be able to put figures behind them, and that is a challenge, but I believe that it is feasible.”

“Often as managers,” Vyverman adds, “we find ourselves in a position where every investor comes with a different set of reporting criteria, and it becomes quite impossible to comply with all of them. There is a need for a more uniform taxonomy to define targets. Efforts are being made already. The GIIN, as far as impact investing goes, has put out a taxonomy, which is fairly simple. I also want to have metrics which are relevant to companies. Otherwise, they are going to look at is as a burden and there will be gaps, or blanks.”

“The Sustainability Accounting Standards Board (SASB) has made a real effort to develop and refine the initial classification on an industry basis,” comments **Deino**, “but it's important to have a somewhat uniform standard, because looking at sustainability reports in general, a great deal of what they contain is different from company to company.”

“Ultimately it is not the managers that will determine reporting standards,” continues **Vyverman**. “Every manager will determine which ones are the most appropriate in his view, but if investors can find consensus around the taxonomy, the managers' task will be infinitely more straightforward, as they will have clear guidance of what their investors want, instead of having to follow a myriad of different standards.”

Comparing & selecting managers

"In emerging market funds, we pay even more attention to inherent ESG risks, and to what extent individual funds mitigate this cocktail of different risks."

At Länsförsäkringar, **Dreiman** explains, the organisation is making quick advances in the demands it imposes on external managers. "We have just defined a set of new minimum ESG criteria imposed on all external managers (liquid funds), both during the selection process and the ongoing monitoring. These criteria focus on the managers' commitments and activities related to ESG, as well as the outcomes of these activities on a fund level. Regarding the outcomes, meaning the funds' investments, we focus on minimising controversial holdings, as well as climate risks, and finally, that the companies the fund selects have either a better ESG profile than their peers or a positive ESG momentum. They could lag today but have made commitments to improve, or the manager can show that this company is moving in the right direction, and the investment and its engagement activities can support that change. On the other side, we look at and analyse a broad array of ESG controversies, among which, environmental incidents, human rights violations and involvement in corruption. We want to make sure the manager is aware of them, engage with relevant companies and adjust the investment if an individual company is acting irresponsible. For us, that is a minimum standard. These criteria will be applied on all the liquid funds both in the institutional portfolio and on our platform. At the beginning of 2019, we hope to have defined the minimum criteria also for illiquid fund managers."

Once the funds have passed the entry barrier, the fund selection process at Länsförsäkringar relies on an in-depth analysis of each fund's holdings. "We collect external data," explains Dreiman, "both through Morningstar Direct, where you can compare individual funds against its peers in a defined fund category, across different ESG indicators in Bloomberg, but also through individual positions, and we look at the number of holdings in tobacco, weapon manufacturers, thermal coal, et cetera. We look at the aggregated fund level but also individual stocks. In emerging market funds, we pay even more attention to inherent ESG risks, and to what extent individual funds mitigate this cocktail of different risks. Often, we need to take many more ESG controversies and incidents into account, but the strategy and market focus needs to be taken into consideration as well."

Kellner finds it challenging to impose minimum criteria, for global managers in particular. "We find cultural differences regarding exclusions. What is controversial in Sweden may not be considered so in another country, and it may be linked to that country's flagship industries. For example, we have a policy of not investing in nuclear weapons or weapons production, and Boeing is a huge U.S. company who happens to manufacture weapons and is also a very common holding in the portfolio of a U.S. manager. The same is true for Airbus for French managers. We might be too small in each of these managers' universe of clients, and then they won't exclude these holdings for us. What should we do? Should we let them implement our exclusion list? It could be tricky because each client has its norm-based screening and exclusion list. Should we stick with our list no matter where we invest? Or should we let the managers themselves control their norm-based screening and trust them that it is compliant with ours and then some elements of the list may differ? In our team, we are still discussing the best practice to impose a minimal load. How do you deal with that, Kristofer?" Kellner asks.

"We find cultural differences regarding exclusions. What is controversial in Sweden may not be considered so in another country, and it may be linked to that country's flagship industries.

At Länsförsäkringar, according to **Dreiman**, the exclusion list represents a firm threshold for our own funds and discretionary mandates. This list and the additional minimum criteria are then imposed on external funds in selection and ongoing monitoring. "First you need to differentiate between the selection process and funds that you already own," Dreiman adds. "Starting with the selection process, if you have individual holdings linked to controversial weapons the fund will not get through the minimum ESG criteria threshold, which means the fund is out. On the funds that have been selected already, we screen holdings both in recommended funds on the unit-linked platform and funds in the institutional portfolio, every six months. If an individual fund is identified as having high ESG risks, we will engage with the manager and give them a time span to improve or otherwise, we, in the responsible investment unit, will provide a recommendation saying that we want to replace this fund."

At Folksam, comments **Bolin Gärtner**, the process is similar but sometimes not as strict. "We do follow Folksam's exclusion list, but we do not enforce it in a strict black-or-white manner. We use it as a discussion point because managers can have different views on certain companies and someone might have divested while someone is engaging instead. What is important for us is to follow up, and we also raise the bar continuously. So, for instance, for new funds coming on board, they need to show that ESG is integrated into their investment process, transparently. Then we very much like to engage with the funds and to see how they evolve. In the beginning, it was all about getting everyone onboard the PRI for instance. There are several fund companies that we have helped sign on. Last week, I met a manager at a lunch seminar, where they mentioned that they signed the PRI in 2014 thanks to Folksam and that they are now turn-

"We work out an ESG plan with this company, and it becomes part of the legal documentation, and it is, therefore, part of an obligation. If the company doesn't comply, it may trigger rights for an exit."

ing their portfolios tobacco-free because of us, again. The interesting part is that we are not currently invested in that fund as they had a period when their performance was not as we had expected, but we have continued to work with this fund company because they like our way of discussing these questions. It doesn't matter how big an investment you have, if you have a solid approach and you want to engage, you can create a meeting point with the manager. Then, of course, you want to invest in these funds, but they also have to perform. This is how the equation has to hold."

Dreiman agrees with the notion that there can be grey-zones in the application of exclusion lists. "It is crucial to explain the underlying drivers and reasoning behinds different exclusions. We share the list of ESG related norm breaches, and the companies linked to those, with our external managers, and often they get back to us with their analysis and opinion. Sometimes they don't have an opinion. That's bad and will result in a low mark. Sometimes they share an opinion that is entirely different opinion from ours. And we appreciate the dialogue that follows." "In the case of nuclear weapons, for instance," ads Bolin Gärtner, "you may have nuclear power plants, and those are okay for Folksam, but not nuclear but weapons, and you have to double check how each holding relates to the exclusion list."

Deino explains why norm violations may translate into different decisions when implementing exclusions. "It is hard to draw the line sometimes. I have managed diverse flavours of exclusionary and blended sustainable strategies, and at some point, we sat around and thought about some cases that are hard to place. As an example, looking into buying exposure to a bank. In many instances, there is no disclosure as to 100% of their loan portfolio. We can never hence be 100% sure they are not lending to, let's say, a tobacco company? Are they lending to, for example, a company that produces nuclear weapons or turbines for the wrong kind of power plant? And if so, where do you draw the line?"

Vyverman agrees that, even in a private equity fund, lines need to be drawn in some cases. "Our team deals with these questions quite a lot, in our agriculture fund. GMO is a discussion point; however, we decided as a company to put it on our exclusion list. Even then it depends, again, how far you go through the value chain: production of GMO crops, GMO seeds, yes. But do you go as far as the logistics company that transports the GMO crops or that processes the GMO crops into food? We have drawn that line at the production of the seeds. After that, the lines become extremely blurry. It is also tough to track what is going on. You cannot open every single container to test and see what is in there. But when it comes to discussing the matter with our investors, our policy is clear enough. I haven't had those types of discussions, we are using IFC / World Bank guidelines for our agriculture-focused investments."

In private equity, the due diligence process can also go further than in public market companies. "We dig very deep," says Vyverman. "The whole ESG diligence is outsourced because we don't claim to be specialists in every segment. One day we look at processing, the next at retail, and so on. We have the ESG department that supports the investment team, but use independent experts. The process starts with screening, where each target receives a score, which indicates the risk, rather than rating whether they are high, medium or low in ESG. Then we do our due diligence. When the investment is approved, we engage into a comprehensive outside due diligence which is outsourced to different experts, depending on what the specific underlying company does. The result comes back to the investment committee, which makes the call, including specifically on ESG. Typically, we have companies complying with everything, but where we see room for improvement. We work out an ESG plan with this company, and it becomes part of the legal documentation, and it is, therefore, part of an obligation. If the company doesn't comply, it may trigger rights for an exit. It is on that basis that we can report to our investors. A company is at this level, we are aim to bring them at a higher level, and this plan how they will get there. Then we report on their progress on an annual basis. For us the idea is, I mentioned earlier, to create better-run companies also from an ESG point of view. That is where we see many opportunities to improve the bottom line of a company by doing things in a better or alternative way. We look at energy cost, water usage or inputs. That is part of the value we add. As a private equity fund, we have a limited number of companies, and we can work with them."

Data quality in emerging markets

In public markets, access and influence are more restricted. In particular, data might not always be readily accessible. **Salazar** comments: "You can always have more ESG data. The availability of data out there has increased and to the credit of big service providers, such as MSCI and Sustainalytics, they have been doing a lot of work on collating and presenting data. However, the lack of sufficient disclosure by companies in emerging markets makes it challenging to solely rely on publicly available information to assess our companies' ESG practices or performance. We do use the services of ESG data providers; however, the vast majority of the information we use comes directly from the companies. The best way for us to overcome the data challenge has been to establish good relationships with companies, to go to them and ask for the data ourselves. If they don't have it, we may work on a plan or try to work on a plan for them to be able to provide it. Again, it is important that the information is relevant to their business, and that it is going to add value in the long term. In general, we are still navigating difficult waters in which data scattered here and there."

"Would you be able to put a percentage on the companies that have data and the ones that don't, the ones which are in a transition, if you look at your portfolio?" asks Vyverman.

"Most of the large caps have data," says Salazar. "We run a responsible global emerging markets portfolio, and I would say around 60 percent of the companies in that portfolio display a good set of data, and that is mostly because we have specific ESG criteria for them to be able to be part of that portfolio. And most of that data we obtain directly from the companies. For the other 40 percent, the investment case revolves around the momentum. We need to see that they have at least started measuring the data. They may not be at the point where they can report it, but at least they take measurements now, and we are observing that journey. There is a risk we need to be willing to take when investing in companies where not all the data is available."

"The type if data we require will be reflective of the business of the company, specifically where the most material ESG risks and opportunities lie" Salazar continues. "If it is a food and beverage company in China, for instance, my questions are going to be more about, what are you doing about food waste? What are you doing with the emission along the supply chain? Where are you sourcing from? Have you identified high-risk spots within your supply chain? To the extent that we can, we refer to companies to international ESG reporting standards like GRI or SASB, which have done excellent work on incorporating materiality in their standards."

Deino contrasts the difference between his work and that of the large data providers. "Essentially what we do is take a closer look," he says. ESG data agencies have to cover a remarkably vast universe of companies, and as a result ESG scores are built using widely available information. We use data from ESG agencies as an input, and usually we calculate average scores from different providers. But we go one step further. We can be more targeted in terms of investment universe, which allows us to engage directly with the companies, and build our own proprietary ESG ratings on specific credit exposures."

BMO Global Asset Management

dessert

Setting the investment horizon

ESG or sustainability is often mentioned as being long-term in nature, and sometimes it seems less compatible with high-liquidity investments.

Being able to invest in long-term vehicles like private equity, for example, or infrastructure funds, which are even longer term, is not always possible for all institutional investors. At Nordea Life & Pension, **Kellner** can look further than many others. “There is an advantage of managing pension money,” she says, “because our beneficiaries are in for the long run. In Sweden, pension beneficiaries can select their investments on a short-list of product, or they can choose to rely on an institution like Nordea to manage the money for them. Most clients don't even know what they are invested in, so they trust us in all aspects and now also ESG. The money is locked in for a long time so that we can invest in both liquid and illiquid vehicles. Even regarding the liquid funds, there is hardly any in- and outflow, from our side. The same is true for the fund selection part, where people can decide themselves which ones they want to pick. Most of the clients are not that active in changing vehicles. This opens possibilities to venture into the illiquid side, which is very interesting when it comes to ESG and emerging markets in particular.”

At Folksam, all funds have to be daily-traded and open-ended, which restricts the field for **Bolin Gärtner** and her fund selection team. “We have to abide by these restrictions when we choose funds of course, and we need to accept the world we live in. That said, funds that claim to have an ‘impact’ seem to have spread to the liquid side. Several global funds have changed name, all of a sudden, and now they are ‘impact funds’. You might think that it takes a long time to make an impact; hence I would call some of these funds perhaps ‘impact-light’. Maybe that is the way it has to be in the unit-linked world, as long as you understand what they are doing, and they are not pretending to do something that is very long-term, because that is not possible. To be genuinely long-term a vehicle needs to be illiquid and that means private equity or a similar structure.”

> *“What we sign today might not be 100 percent relevant in two or five years. But we still need to make sure that whatever we put in the side letter is also somewhat future-proof.”*

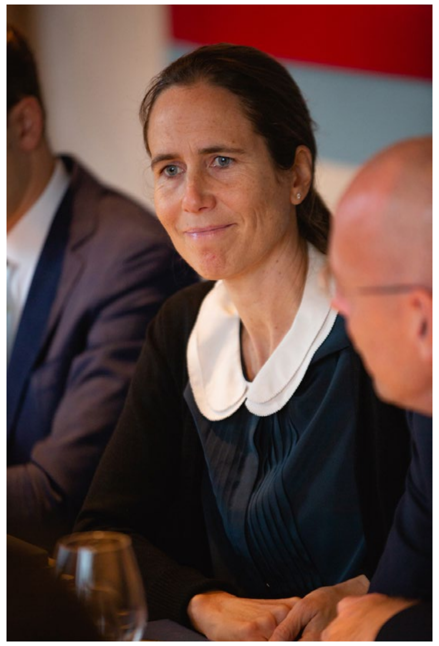
At Länsförsäkringar, **Dreiman** talks about a portion of the portfolio that is linked to alternatives. “What is interesting about long-term commitments there, is something that comes up when we discuss side-letters with both private equity and private debt investors. From our but also the managers’ perspective, we can end up with paragraphs linked to everything from the manager’s commitment to ESG management but also to report on the ESG profile of the individual fund, and how the manager is supposed to future-proof that, say ten years ahead. For example, looking at climate risks, today many Swedish investors have some exclusion criteria linked to thermal coal, and some on other fossil fuels as well. Soon we will probably also have a holistic view on that and talk about those that use the fossil fuels, such as transportation, industrial manufacturing, and agriculture, and other climate-deteriorating activities such as deforestation, and more. Many more sectors will also be analysed through both transition and physical climate risk lenses. But those discussions and developments about where we are supposed to head to are ongoing and evolving as we speak. Our ownership policies, responsible investment policies or equivalent policies, will change as well. Hence, what we sign today might not be 100 percent relevant in two or five years. But we still need to make sure that whatever we put in the side letter is also somewhat future-proof. We often have these discussions with private equity managers.”

Vyverman agrees with Dreiman’s point: “I see your point, Kristofer, even if I haven't been confronted with the question from our investors. Given what we do, and responsAbility stands for, I don't think we would have an issue with agreeing on an evolving target. This point comes back to the idea of intentionality.”

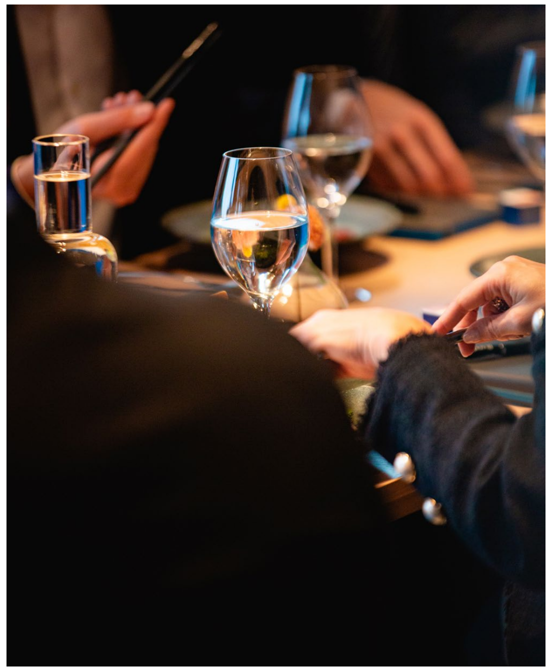
A PE Fund has typically a life of ten years. Vyverman considers that it is long enough to generate impact. “In the end, one needs to be realistic. You need to provide liquidity, and you need to provide proof of concept. Which means you need to provide for an attractive return.” **Deino** adds: “You need to return the capital, and there is a discount rate associated to it. The money is not free.”

“The investment horizon is something that we need to think about the moment we deploy our money. We project a financial return over those five-, six- or seven-year holding periods. We do the same thing on the impact side. What positive impact can we generate during that time? We take stock of what there is today and make growth assumptions. If you talk about impact investing, it needs to be growth capital. Financial engineering is something that may not create anything, so there needs to be growth to create a positive impact. The company is likely to continue to grow beyond our five- to seven-year investment, for sure. We could surely generate more impact as well. But we take that into account in our exit process. Who am I selling this to? Who is taking this over? Are they subscribing to what we are subscribing to? That is why it is crucial that the impact we generate is inherent to the business models that we invest in. It is not a company that does everything wrong, and we change it into a company that does everything right, but from one day to the other, the company can go back to doing everything wrong again and make more money out of that. That is not what we are doing.”

> *“The investment horizon is something that we need to think about the moment we deploy our money.”*



From **Kellner**’s point of view, the embedding of ESG investment practice may procure a fund like responsAbility an advantage over others, further down the line. “You are holding this company in your possession for many years, and at that point, you may hand it over to someone else. Fast-forward ten years, I assume some of these ESG requirements are going to be relatively more significant than they are today. It may be a necessity to get the companies up to scratch or else, you will have difficulties finding a buyer when your investment time is over, or you will not be able to collect as much money as you would like. Rik, you are already focusing on this, but there are so many other private equity companies, which in my view are way behind other asset classes because they haven't even put up a policy on their webpage. They have a long way to go. They are probably going to run fast and implement it quickly, but they are also going to have to sell the companies they have today to another world in a few years. The requirements will change, and they will have to work hard, on the ESG aspects as well as on the traditional issues, to be able to get a good return when they exit.”



As a fixed income investor, the investment horizon can also be very long. The main focus around ESG from a pragmatic aspect is uncovering vulnerabilities and avoiding drawdown. There is another side of the coin, however, and I am very acutely focused on the long-termism of management as a concept because it means that this is a proven management team, and everything from the staffing of senior management to accounting is going to be geared towards the long-term sustainability of the business. Here is an example. Most recently, we noticed a housing developer in Mexico saying: our product is very important socially because we are providing housing, while there is an amazing housing shortage in Mexico. That all sounds great and good, but then over the quarters we would see revenues consistently increasing, then we would notice accounts receivable also growing as a percentage of total revenues. And what does that mean? To generate and maintain EPS in an environment where short term growth and EPS was foremost, management was “going the extra mile”, until one day the balloon popped. This is a tangible example of why the long-term perspective is quite important. As I said, it is not necessarily our primary focus, as our priority is to avoid drawdown and uncovering vulnerabilities and risk. We also have great flexibility. There are about 600 issuers in our asset class so that we have enough to select from. If we don't like the management team that we're dealing with we can move on to the next.”

Dreiman wonders how Deino reconciles the long-term dialogue he has with companies with the fact that his performance is often evaluated on a more short-term basis. “I have met most of our external managers to date, now,” explains Dreiman, “and sometimes I see either directly or between the lines that they have deployed their ESG strategy either five years ago or yesterday. And they feel that they need time to let it sink in and have an effect on the fund overall, but we evaluate them on a much shorter time span.”

“The two perspectives are compatible, actually,” **Deino** replies. “If you look at our fund over the last three years, for example, we have delivered strong absolute returns, and reduced volatility. Looking at the information ratio, we are in the top quartile of our peer group. Unlike many of our peers, yield to maturity of our portfolio has generally been below the yield on the benchmark. We felt that there was too much risk in higher-yielding assets and not enough compensation ever since we began to see a QE-induced increase of flows into our markets, which has enabled us to avoid defaults. I would attribute that to our engagement with companies' management, and our understanding of the ESG aspects of the investments given our integration of ESG analysis into the process.”

Scalability and capacity to execute is important. “As a fund or portfolio manager, it is also paramount that you evaluate the resources that you have at your firm and in your team.” When you are looking at ESG, it is not just about writing a white-paper and launching a strategy because it's the flavour of the day. If someone wants to walk over and talk to your analyst about the process, you need to be able to demonstrate what you do on a consistent basis. Scalability is also crucial to making it work.”

BMO Global Asset Management.

coffee

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