Monitoring Country ESG Risks in Emerging Markets

The RBC Emerging Markets Equities Team

Summary

- Over time, material changes in the environmental, social and corporate governance (ESG) performance of countries can create positive or negative macroeconomic and political risks. There have been a number of examples, in recent years, of how poor ESG performance has resulted in real economic costs in countries such as China, Venezuela and, more recently, Brazil.
- As a whole, the ESG scores for the largest 15 countries[1] in our investable universe are above the global average and have improved over the last eight years.
- Turkey stands out as having had a significant deterioration in its social and governance scores. As such, we believe this poses the largest ESG risk in the coming year.
- Despite Russia's strong environmental performance, its social and governance scores remain very low and we do not expect any material improvement in the near term.
- We have a more positive view on Brazil this year. We expect the conclusion of the current corruption scandal to reduce corruption and result in an improved governance score in the coming years.
- India, Indonesia and the Philippines stand out as having seen material improvements in their overall ESG scores. We expect this to continue under their respective pro-reform governments, especially in the area of reducing corruption. Despite this, India's very low environmental score is a risk and something we need to continue to monitor.
- Finally, China's gradual improvement of its environmental and governance performance is very positive for its long term economic stability. However, the lack of improvement in its social score, due to limited political rights and civil liberties, is notable.

Introduction

ESG factors are an important part of our investment process. In our view, companies that are mindful of their ESG responsibilities are typically more likely to generate sustainable long term returns. Similarly, we are also of the view that countries with high or improving ESG scores are more likely to have sustainable economic growth; compared to countries with low or falling scores. In this report, we analyse the ESG performance of the largest 15 countries in the EM universe to identify positive and negative risks.

Over time, material changes in the ESG performance of countries can create macroeconomic and political risks and opportunities. There have been a number of examples in recent years of how poor ESG performance has resulted in real economic costs. Examples include China's poor environmental performance, which has resulted in a number of industries having to be shut down in order to reduce smog in large cities. The loss of political rights in Venezuela has been a key factor in its economic and political collapse, and the corruption scandal in Brazil has exacerbated its recent recession.

In this report, we use third-party metrics to measure the ESG performance of countries in our investment universe. These third parties are independent, include data on most countries (enabling a global comparison), and have been collecting standardised data for many years (which allows us to track changes over time).

[1] Largest 15 countries in the EM Universe: Brazil, Chile, China, India, Indonesia, Malaysia, Mexico, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand, Turkey

Environmental risks

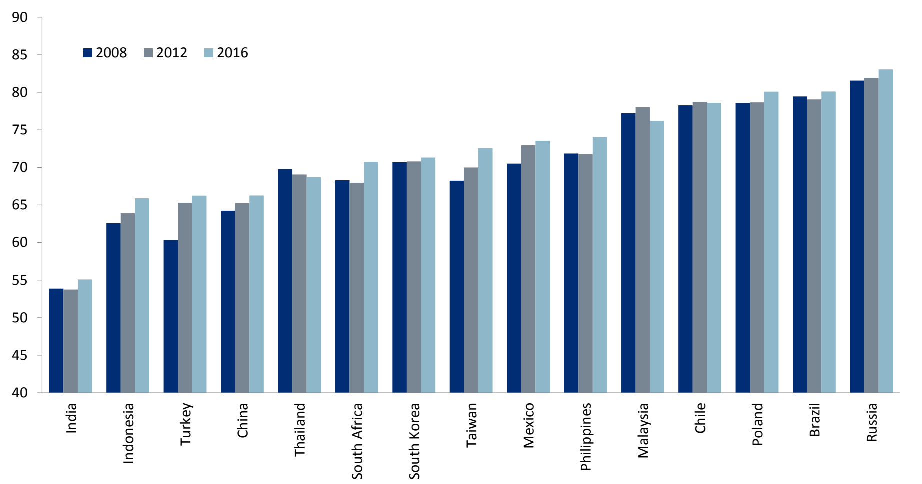
For the environmental scores, we have used Yale University's Environmental Performance Index (EPI). The EPI scores a country's performance on environmental issues in two key areas: Environmental Health, which measures the protection of human health, and Environmental Vitality, which measures the protection of ecosystems. Within these two policy objectives, the EPI scores national performance in nine issue areas comprising more than 20 indicators. Within the largest 15 EM countries, there is a significant variation in environmental performance as measured by the EPI. However, the majority of these countries have a 2016 score above the global average of 67.3.

None of the largest 15 countries have experienced a large fall in performance over the last four years and, encouragingly, there is a clear improving trend over time. Almost all included countries have improved their scores in the last eight years with the notable exceptions of Thailand and Malaysia, caused by a deterioration in their Environmental Vitality sub-index. Upon investigation, this appears to be driven by increasing tourist numbers impacting each country's ecosystem negatively, something to be mindful of when investing.

India stands out as having very poor environmental performance compared to other countries in the sample and against the global average. On closer inspection, this is because of very low Environmental Health scores of less than 50, which is a reflection of India's poor air and water quality in many large cities.
We remain positive on India's overall outlook, however, if India's environmental performance does not continue to improve, it may pose a risk to the country's economy in the long term.

China's economic growth rate up until the global financial crisis was clearly not sustainable, not just from a credit growth point of view, but also from an environmental perspective. This is a good example of how ESG can impact the sustainability of growth, as air pollution in a number of large cities became so bad that people were unable to go to work or attend school. At the peak of the air-quality crisis in 2011, the government had to shut down large swathes of industries, which was partly responsible for the economic slowdown in 2011 and 2012. In response to growing pressure from the public, the central government has now added air and water pollution targets to its economic performance assessments of local governments and has set up air quality monitors that stream real-time data to the public over the internet.

Exhibit 1: Environmental Performance Index - Largest 15 EM Countries



Source: Environmental Performance Index, 2016 Report. December 2017

China's environmental score is still low, but we are encouraged by its improvement over the last eight years.

Social risks

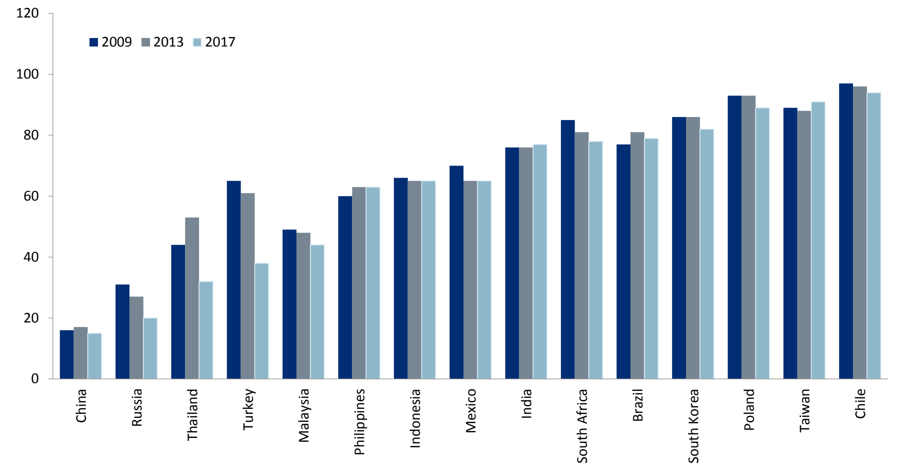
For the country social scores, we have used Freedom House's Freedom in the World Index (FWI). The FWI evaluates the state of freedom in 195 countries and is made up of two main sub-categories; Political Rights and Civil Liberties. Each country is assigned a score between zero and four points on a series of 25 indicators for an aggregate score of up to 100.

The global average FWI score in 2017 was 58.0. As Exhibit 2 indicates, the majority of the countries in our sample have better-than-average political rights and civil liberties. In contrast to the EPI scores, however, most countries have seen a reduction in the level of freedom afforded to their citizens over the last eight years.
China remains the lowest-scoring country in the group, in sharp contrast to its improving environmental and governance scores. This reflects the fact that although China has continued to open up and liberalise its economy and increase it focus on pollution in recent years, political rights and civil liberties have not improved. One has to question whether increasing wealth is compatible with limited freedom in the long term, particularly as Chinese citizens gain access to more information about other political systems through travel and the internet.

The countries that have seen their FWI scores fall most significantly in the last eight years are Russia, Turkey and Thailand. We are most concerned about the long term economic prospects of Russia and Turkey due to a fall in political rights, as their authoritarian presidents have undermined democratic institutions in their countries.

In Russia, we have seen a further deterioration of economic and political rights in Putin's third presidential

Exhibit 2: Freedom in the World Index - Largest 15 EM Countries



Source: Freedom in the World Index, 2017 Report. December 2017

term, with limited prospects of a viable opposition at the next election. In particular, there have been several cases of the assets of private companies being expropriated by the government and given to government owned competitors.

While Russia's low social performance is well known, the deterioration in Turkey's score over the last four years is more concerning from an economic risk perspective. The AKP party, under President Recep Erdogan, has continued to consolidate power. In our opinion, this has undermined the independence of a number of important institutions, particularly the judiciary. We view the success of Erdogan's referendum in January last year, enabling him to change the constitution to grant more executive powers to the presidency, as negative for political freedom and stability in Turkey.

Turkey's Political Rights and Civil Liberties sub-indices have both fallen in the last four years, but the drop has been starker in the Political Rights sub-index. We are also concerned about the independence of the central bank, after its timid response to rising inflation in the second half of 2017. Inflation has risen to over 13%, but the Turkish central bank's hike of its reference rate by 50 bps on 14 December 2017 was much lower than market expectations, prompting investor concerns that it was bowing to political pressure as Erdogan has publicly pressured the central bank to keep interest rates low.

The fall in Thailand's score was due to the ousting of the democratically elected Shinawatra government in a military coup in 2014, which saw the country's Political Rights sub-index fall considerably. The coup was a response to Thailand's escalating political crisis in 2014 and, as such, we remain optimistic that Thailand will return to democratic civilian rule. The military has committed to reinstating democratic elections once the constitution has been changed to prevent future political stalemates.

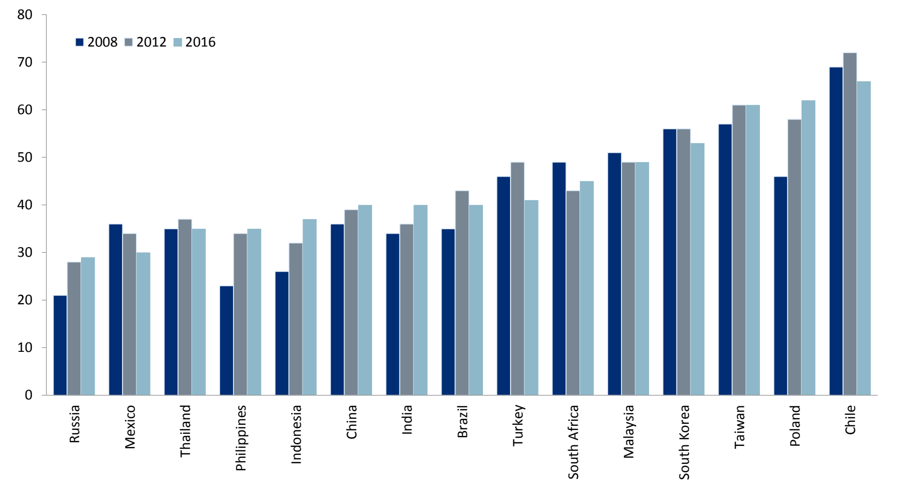
Governance risks

Finally, for country governance scores, we have used Transparency International's Corruption Perceptions Index (CPI). The CPI measures the quality of governance in 176 countries and territories. It aggregates data from a number of different sources that provide business people and country experts perceptions of corruption levels in the public sector. It is calculated using 13 different data sources from 12 different institutions, that capture perceptions of corruption within the past two years.

In contrast to our environmental and social measures, the majority of the countries in our sample had a governance score that was less than the global average of 43. However, although the global average has fallen over the last four years, the average score for the top 15 countries in our universe has improved.

Russia is the lowest-scoring country. Despite a marginal improvement in the last four years, significant reduction of corruption in Russia seems unlikely. On the other hand, Mexico's low, and falling, score is a surprise and more of a concern for us. While we had hopes for an improvement in governance when the PRI party assumed power under President Enrique Peña Nieto, Mexico's CPI score has continued to fall, as his

Exhibit 3: Corruption Perceptions Index - Largest 15 EM Countries



Source: Corruption Perceptions Index, 2017 Report. December 2017 administration has been implicated in a number of corruption scandals. The most prominent incident involved Peña Nieto's wife buying a house on unusually favourable terms from a close friend whose construction company has won a large number of public infrastructure projects. Since then, the president's popularity has fallen considerably, hitting a low of 12% in January 2017.

Brazil's score has also dropped materially in the last four years and provides another stark warning of how governance risks can have a significant economic impact. The Operation Car Wash investigation has uncovered rampant corruption among the political class, involving officials from all parties, and has resulted in the impeachment of former president Dilma Rousseff. That said, now that the investigation is moving into its final stages, we are optimistic that the new government, under President Michel Temer, will be able to push through more reforms, including initiatives to tackle corruption.

Turkey has also seen a significant drop in its CPI score in the last four years. We would argue that this is due to the weakening of institutions under President Erdogan, as outlined above. Perhaps the most significant example of this was the judicial purge that occurred after the attempted military coup in 2016. The government took this as an opportunity to disqualify 2,745 judges, accounting for 36% of all judges in Turkey at the time.

On the positive side, a number of countries have improved their CPI score considerably over the last four to eight years. The Philippines, Indonesia, India and Poland all stand out in terms of their improvement. One fly in the ointment is the recent judicial reforms in Poland under President Andrzej Duda that have been criticised by the European Union (EU) – something for us to watch in the future.

Given China's importance to the asset class, we are also encouraged by China's gradual improvement over the last eight years. The corruption crackdown since President Xi came to power in 2012 has not been just about tackling corruption, but also consolidating his power and reducing the influence of conservatives in the Politburo. However, there is plenty of evidence to suggest that the large number of disciplinary actions against lower-ranking officials, including imprisonment, has reduced low-level corruption. President Xi himself has repeatedly argued that high levels of corruption risk undermine the Chinese Communist party's grip on power, by reducing its legitimacy in the eyes of the public.

Conclusions

On average, the ESG scores for the largest 15 countries in our investable universe are above the global average and have improved over the last eight years. Given the large diversity in terms of economic and political development within emerging markets, there is considerable variation in scores between countries and regions. In aggregate, emerging Europe scored the highest across ESG factors with an improving trend. South Asia had the lowest aggregate score with a slightly improving trend.

Turkey stands out for having had significant deterioration in its social and governance scores and, as such, poses the largest ESG risk in the coming year. Despite Russia's strong environmental performance, its social and governance scores remain very low and we do not expect any material improvement. We are more positive on Brazil in 2018, as we expect the fallout from the current corruption scandal to result in reduced levels of corruption and an improved governance score in the coming years.

India, Indonesia and the Philippines stand out as having made material improvements in their overall ESG scores and we expect this to continue under their respective pro-reform governments, especially in the area of reducing corruption. Despite this, India's very low environmental score is a risk and something we need to monitor.

Finally, though China's gradual improvement in terms of its environmental and governance performance is very positive for its long term economic stability, the lack of improvement in its social score due to limited political rights and civil liberties is particularly significant.

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Richard is a Portfolio Manager in the Emerging Markets Equity Team in London.

Richard joined RBC Global Asset Management as an Equity Analyst in 2013. Prior to joining the firm, Richard worked at Aviva Investors providing fundamental equity analysis in the energy and materials sectors within Global Emerging Markets.

Richard began his career in the investment industry in 2006 as an Analyst in HSBC's Corporate Finance Department.

In 2005, Richard obtained a BSc in Business and Finance from Kings College in London. In 2009 he obtained an MSc in Investment Management from Cass Business School in London. Richard is a CFA charterholder.

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