Opportunities and ESG risks in uncertain times

In mid-March, **Tell Media Group**, in cooperation with **Invesco**, **Franklin Templeton** and **State Street Global Advisors**, invited Finnish investors to discuss emerging market equities. Tell Media Group founder Niklas Tell and FBNW editor Janina Sibelius moderated the roundtable.

By: **Niklas Tell** Photo: **Jennie Nyström**

The roundtable discussion on emerging market equities in Helsinki on March 12 took place just before the world started closing down and put a temporary halt to most face-to-face meetings. While things are evolving rapidly, this summary reflects the discussion from mid-March with the insights everyone had at the time. Invesco's Nikki Noriega and State Street's Akbar Ali were unable to come to Helsinki and participated in the discussion via conference call.

NIKLAS TELL: MANY ASSET MANAGER COMMENTS GOING INTO 2020 WERE OPTIMISTIC ON EMERGING MARKETS BUT NOW THERE'S THE CORONAVIRUS AND EVERYTHING IS SHUTTING DOWN. WHAT'S YOUR GENERAL TAKE ON EMERGING MARKETS RIGHT NOW AND WHAT HAS CHANGED FROM EARLIER THIS YEAR?

KRZYSZTOF MUSIALIK: "As a long-term investor, we continue to find compelling opportunities in the region over a three to five-year period. The current coronavirus has not changed our outlook despite the near-term challenges. Today, the challenge is the coronavirus but if I had been here four months ago, we probably would have focused on the trade war between the US and China. That was also a challenge for emerging markets but now the discussion has shifted towards the virus. My point is that these challenges will come and go. Following a transformation in the asset class with policy reforms over the last 10 to 15 years, emerging markets are well prepared to weather the storm and economies are much more immune to external shocks today compared to earlier crises. Of course there has been a slowdown in economic activity since the outbreak of the virus but we're already seeing China starting to come back to almost full capacity. Q1 profits will naturally be weaker but as long as China continues to contain the virus, we could still see a positive Q2 for many companies."

LAURI TILLMAN: "I agree. These things do happen and they are bad but they usually go away. Over the next five years, some 70 per cent of global growth will come from emerging markets according to some estimates. It's the growth engine of the world. Maybe things are stalling right now but the potential is there."

NIKKI NORIEGA: "I don't think we have any edge in predicting the spreading of the coronavirus – that's not our expertise. We continue to do what we've always done, which is to focus on our own research and I do think this situation reinforces the argument for active management in emerging markets. Yes, we have a total collapse right now but in this kind of environment the strong gets stronger and the weak gets weaker. If you're exposed to everything, I don't think you will get the returns you expect even when the market recovers because some companies will not recover as well as others. You want an active manager that's able to do real analysis to find companies with strong balance sheets, good structural growth opportunities and the right strategy to navigate through this situation. We remain positive on the long-term, recognising that it's difficult to predict what's happening in the short term, other than that it creates opportunities for bottom-up stock-pickers."

AKBAR ALI: "We're an active quant manager and as we look at 3000 plus stocks across emerging markets, we're seeing many large opportunities in this turmoil. Given the giant shocks to the market, we now see in every industry and in almost every country attractively priced companies with solid balance sheets, high and improving profits and strong management."

NIKLAS TELL: COMING BACK TO PRICING, WOULD YOU SAY THAT MARKETS HAVE SOLD OFF IN SUCH A WAY THAT YOU'RE STARTING TO SEE GOOD STOCKS BEING PRICED ATTRACTIVELY?

AKBAR ALI: "I think the markets have under-reacted or over-reacted thus far. Information is stale or inadequate. For example, analysts' revisions have been limited and very few companies have updated their guidance. We systematically identify the stocks whose prices have moved out of line with fundamentals. In many cases, the misalignment is severe and comparable to what we witnessed during the global financial crisis. We've rebalanced some names with careful attention to turnover costs."

KRZYSZTOF MUSIALIK: "We don't define 'value' as low price-to earnings or low price-to book ratios. We look for companies with sustainable earnings power that trade at a discount to intrinsic worth. We look further down the road and the sustainability of earnings can come from brand, technology or great management and yes, we do find these companies today. For example, we find a lot of value in consumer stocks and if you look at our portfolio, you will find consumption as a well-represented theme."

LAURI TILLMAN: "I think it was a bit indiscriminate selling when it all started, especially if you look across both developed and emerging markets. More recently, I think that has changed and it's more company or sector-specific today. Somebody said that the most difficult time to invest is 'now' and it doesn't matter when 'now' is. If I had to invest today, I would go for solid business models with good cash-flow generation."

PARTICIPANTS

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- **NIKKI NORIEGA**
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Sustainability expert, ESG analyst and co-author of a book on sustainable investing. Prior to joining the Finnish oil refining and renewables company Neste last year as a sustainability manager, she was a senior responsible investment officer at Ilmarinen. She has also been a board member of Finsif and an advisor on corporate responsibility and responsible investment at KPMG.

NIKLAS TELL: “BECAUSE THIS TOO WILL PASS?”

LAURI TILLMAN: “That’s what I think and hope but who knows? Usually the time to buy is when you think the world is ending and you feel miserable. It’s bad right now but maybe not that bad.”

KRZYSZTOF MUSIALIK: ”Just as Nikki said earlier, the strong will get stronger. That’s a trend that had already started before this current crisis and it’s continuing to happen in the economy and in society. We’re also seeing polarisation in the markets and it makes sense to stick with the winners, market leaders or leaders in niche areas, provided they have this sustainable edge.”

NIKKI NORIEGA: “I think whether it feels indiscriminate or not depends on your approach and your time horizon. Similar to Franklin Templeton, we look for companies that have some sort of structural growth opportunity beyond the business cycle. Our time horizon is three to five years and preferably longer. If you look at companies that have sold off right now – yes, from a cyclical perspective earnings will get hammered but from a longer-term perspective it’s different. If you’re a hotel company with a really great balance sheet in a place like China, you will have opportunities right now. This is a fairly unconsolidated market and there will be a lot of family-owned hotels that will not survive the downturn and a hotel chain will be able to go in and create a lot of value. Yes, earnings will get hit but they will come out stronger and we would rather keep our eye on the longer-term value than on the short-term price.”

LAURI TILLMAN: “I agree. This will create M&A opportunities for companies with strong balance sheets.”

JANINA SIBELIUS: MOVING ON TO ESG, HOW WOULD YOU ASSESS THE AVAILABILITY OF ESG DATA IN EMERGING MARKETS?

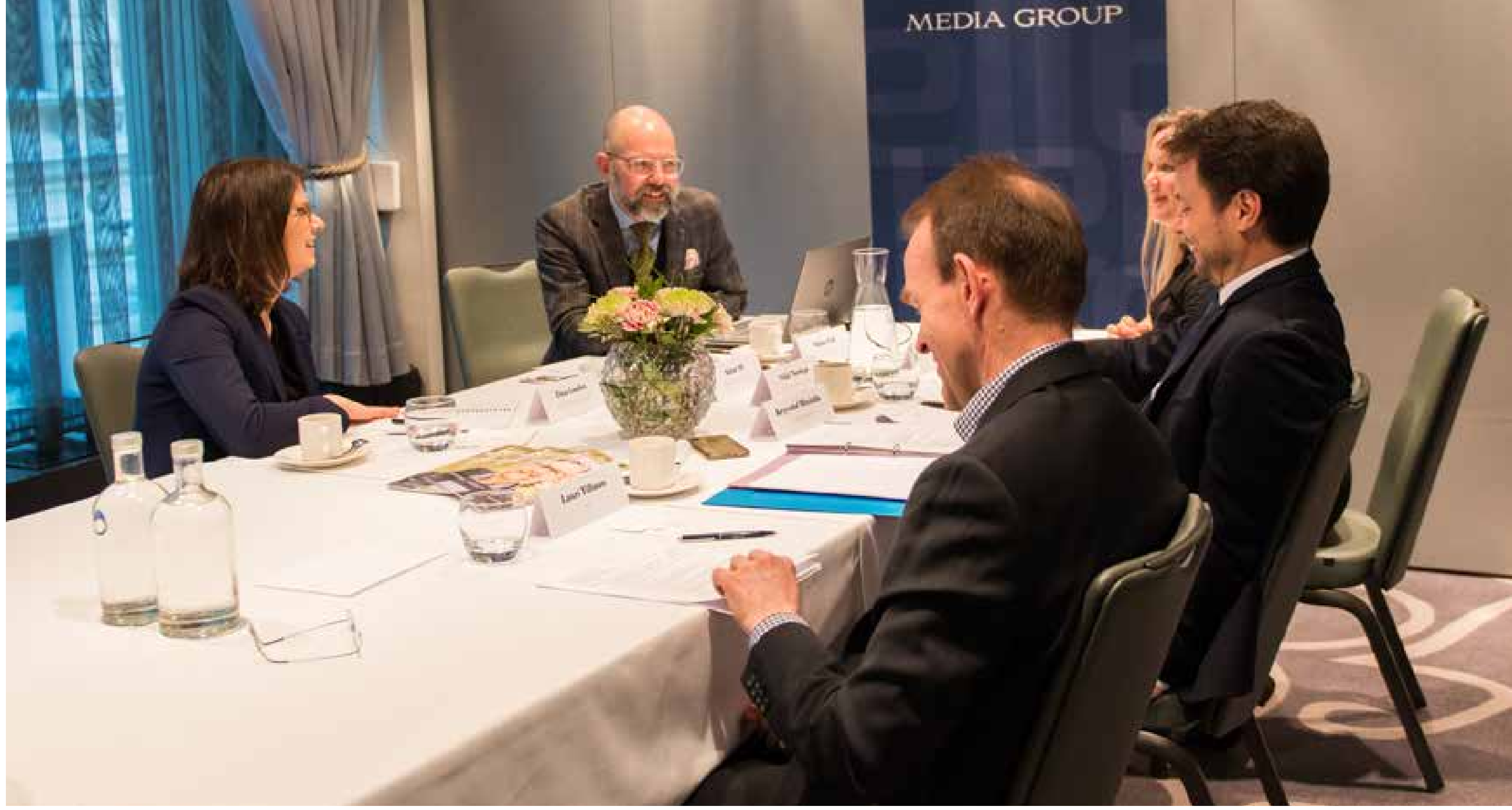
TIINA LANDAU: “Firstly, the legal requirements in emerging markets are not the same and the regulation is not as heavy. So even if companies are following the minimum requirements, those will be less compared to developed markets. There are companies that report more and that’s increasing but there’s still a lot of work needed to be done.”

JANINA SIBELIUS: IS IT IMPORTANT TO BE ON THE GROUND OR HAS TECHNOLOGY HELPED SO YOU CAN GET WHAT YOU NEED ALSO FROM A DISTANCE?

TIINA LANDAU: “I think you need a local presence – a lot of information is not available in reports. You need to ask around and learn about companies locally. That could, for example, be how a company is connected to the informal economy in the supply chain. Also, even if there are standards in place, it’s often a good idea to be on the ground to see how these standards are implemented and enforced. When you do your due diligence, you also need to check how good the company is at monitoring their suppliers and whether they fully understand what questions they need to ask.”

NIKLAS TELL: DO YOU ALSO NEED TO BE ON THE GROUND TO GAIN ACCESS TO DATA IN GENERAL?

KRZYSZTOF MUSIALIK: ”I think local presence is essential both for ESG as well as for interpreting financial data and it’s especially important for mid-cap and smaller companies. These companies are often exposed to subtle local nuances that only an on the ground presence can truly understand, given the advantage of speaking the local language and understanding the culture. From a governance point of view, it also helps us to better understand how minority shareholders are treated. We also shouldn’t underestimate the benefits that a local presence has



on building relationships with companies, which ultimately can help to mitigate investment risk.”

NIKLAS TELL: AKBAR, RUNNING A QUANT STRATEGY, DO YOU FULLY DISAGREE OR IS THERE A VALUE IN LOCAL PRESENCE?

AKBAR ALI: “Based on almost 20 years as an EM investor, data trumps local presence and the data is constantly improving with more detail on supply chains, economic linkages, a higher number of conference calls whose transcripts we use to assess management, financial quality and market sentiment. There’s also plenty of new ESG data but investors must, for example, pay attention to the nuances across industries. One must zoom in on a specific industry and decide which data and metrics are useful for that particular segment.

TIINA LANDAU: “When it comes to data, there’s one more thing to consider: that data provides an insight into the history of the company. When it comes to ESG, you can also be helped by a diversified portfolio. For example, it’s unlikely that all companies will be accused of a human rights violation at the same time. Meanwhile, there are also megatrends such as climate change that can affect a large number of companies and sectors simultaneously and you cannot manage these types of topics with diversification only.”

AKBAR ALI: “When it comes to ESG data, the important thing is to know what to focus on in your qualitative assessment. For some companies, for example those in real estate, it will make sense to focus mostly on the ‘E’, whereas for others you need to look equally at the ‘E’, ‘S’ and ‘G’. We did this by developing a materiality map as the metrics vary greatly across industries and geography. For example, employee safety is a key indicator for the future financial performance of a mining or chemicals company, whereas for a software firm, employee safety is important but not a driver of future financial success.”

NIKKI NORIEGA: “I agree that data is incredibly important, as well as the interpretation of that data. However, for longer-term investors, I think there’s another thing that’s equally important and that’s imagination. We’re all based in New York but travel throughout the regions a lot and what I think you need to do is to use your imagination and ask how the future can be different from what everyone else is thinking.”

NIKLAS TELL: IF WE TAKE THE DISCUSSION BACK TO WHAT IS HAPPENING RIGHT NOW, WHERE ARE YOU CURRENTLY SEEING THE MOST OPPORTUNITIES?

KRZYSZTOF MUSIALIK: ”I’m involved is our emerging markets small-cap strategy, which can be considered as a complement to an exposure to emerging market large caps. For example, large caps are dominated by financials whereas small caps give investors a greater exposure to consumption. In the small-cap strategy, premiumisation is an important theme and this is especially true in China. Chinese consumers are hungry for ‘good’ brands, especially Western brands, and we’re seeing Chinese companies buying Western brands and taking them to China. We’re in Finland today and one example is Amer, the owner of brands such as Wilson tennis rackets and Salomon skiing gear, which was acquired by Anta Sports, a Chinese company in 2019. Also, given how the coronavirus has affected the world, I think it will mean structural shifts in consumption patterns and in how societies operate. We saw during the outbreak in

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> "I think it's rare to find perfect companies because they're run by imperfect humans"
>
> *– Nikki Noriega, Invesco Asset Management*

China how demand for online tutoring exploded as Chinese parents expect their children to learn and pass their exams regardless of what's happening. Now with schools closed across most of Europe, I think demand for e-learning will continue to grow. As an active manager, we believe it's important to stay on top of these shifting consumption patterns."

NIKKI NORIEGA: "I agree that consumption is an important trend and we've all been waiting for the growth of the middle class but that has not really happened much outside of China. What we've seen instead is the rich getting richer and the poor not really moving up. I agree on the premiumisation story, especially in China, and for us that's very much about luxury goods. That's being hit right now but it's still an important long-term trend. There are no listed luxury goods companies in China, which is why we typically would seek exposure through European companies. For us, the really interesting thing about emerging markets is not really the GDP growth rate of China or other economies but that the opportunity set for investors is becoming more and more interesting over time."

LAURI TILLMAN: "You have a lot of trends that are happening in both emerging markets and developed markets, such as urbanisation, automation and ageing. That's, of course, interesting for firms operating globally as they will be able to offer the same products and services in more markets than before."

TIINA LANDAU: "If I can comment from a sustainability perspective and the opportunities that we see. I published a book last year on sustainable investing and we hope that this will become available in English as well soon. The research that we refer to shows that you can beat the market by selecting the most sustainable companies in each sector. There are also opportunities created by active ownership and you can make a lot of impact in emerging markets. One challenge can, of course, be to explain to companies why they should go beyond the local legislation and then I think it will help if you can show that their financial development will benefit as well."

NIKLAS TELL: I GUESS YOU WANT TO INVEST IN COMPANIES THAT ARE IMPROVING BECAUSE THAT WILL GIVE YOU THE MOST RETURNS. BUT ARE YOU HAPPY TO INVEST IN COMPANIES THAT ARE NOT ALL THAT GREEN BUT ARE IMPROVING?

NIKKI NORIEGA: "I think it's rare to find perfect companies because they're run by imperfect humans. There will always be issues that can be improved and it's probably the 'G' where most can be done because everything starts with good governance. That's where we spend a lot of time. We're not activist investors but we do advocate changes. We don't have a lot of turnover in the portfolio and we're therefore able to create longer-term relationships and we do make our voice heard."

JANINA SIBELIUS: WHAT ARE SOME OF THE BIGGEST CHALLENGES WHEN YOU TRY TO INCLUDE ESG FACTORS IN YOUR RESEARCH?

NIKKI NORIEGA: "There are a lot of different challenges out there. We invest in

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manufacturing and we can't visit every plant. We also don't want to rely purely on data. We saw one food company in China that scored poorly because they didn't have enough organic products, which to us doesn't make a lot of sense in China. There's a long way to go with regards to data and understanding the context. Sometimes, engaging with management to ensure our interests are aligned can be a challenge but it's an important part of our research process."

NIKLAS TELL: ARE INEFFICIENCIES THE MAIN REASON FOR INVESTING IN EMERGING MARKETS AND ARE THEY STILL GREATER THERE THAN IN DEVELOPED MARKETS?

LAURI TILLMAN: "I think the main reason to invest would be that we see a higher growth potential in emerging markets rather than inefficiencies. That said, maybe there's more of an improvement potential in emerging markets if you see that as inefficiencies."

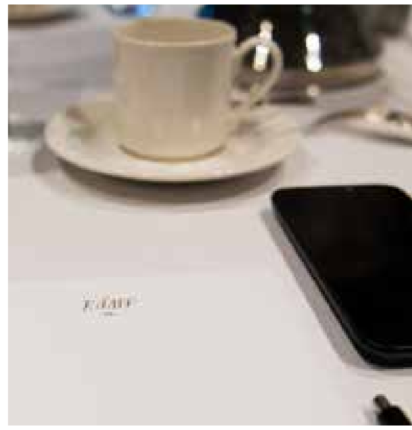
AKBAR ALI: "Inefficiencies are great but it's the underlying development that we want to own. The reason why we care about inefficiencies is that it helps us find companies that may outperform and the current state of emerging markets gives us opportunities to do that, especially as data is not as complete and the analyst coverage might not be as good for smaller companies. When it comes to inefficiencies, we often see larger opportunities in more illiquid stocks, such as emerging market small caps but then we as investors, of course, have to scale our bets."

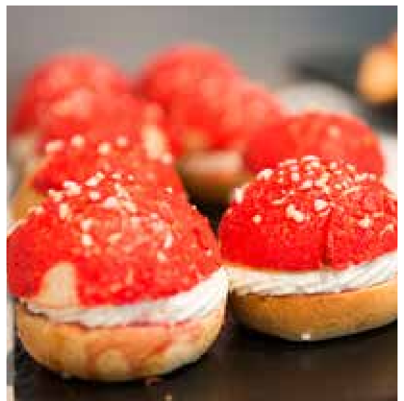
KRZYSZTOF MUSIALIK: "If we look at inefficiencies from a macro point of view, I see many such attributed to poor infrastructure. Maybe not specifically in China but rather in countries such as Brazil or India. If someone in Sao Paolo has to spend two hours to get to his or her job, he or she will probably be tired before they even start to work. So there's huge potential to improve productivity if poor infrastructure can be addressed. Red tape is another obstacle to boost growth even further and we're seeing progress being made here in India. On the other hand, we also have to remember that emerging markets, and especially China, are well ahead of the West in areas such as digital payments and e-commerce."

NIKKI NORIEGA: "Inefficiencies is partly a reason for why you want to be in emerging markets. If you look at economies, you have inefficiencies for historical reasons in many areas and as we've said before, this is why reforms will be an important driver for growth going forward. You also have domestic capital markets that can become more efficient in, for example, China. Then you also have inefficiencies due to the fact that many small and mid caps don't have the same analyst coverage as in developed markets, which gives us more room to meet with them and form our own views. I would, however, agree with Akbar that the main reason for investing in emerging markets is the underlying growth opportunity."

NIKLAS TELL: WE TALKED EARLIER ABOUT THE DIFFICULTY IN GETTING ESG DATA IN EMERGING MARKETS. TIINA, WOULD YOU SAY THAT ESG IS ONE OF THE INEFFICIENCIES THAT YOU CAN EXPLOIT IN EMERGING MARKETS?

TIINA LANDAU: "Yes, I think it's fair to say that there's a lot that can be improved when it comes to ESG and we touched on some of the things earlier. One thing that we haven't discussed is corruption, which is a topic that needs to be taken into account as well."





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> *– Lauri Tillman, OP Financial Group*

NIKLAS TELL: ARE ESG WHERE THE BIGGEST RISKS ARE WHEN IT COMES TO EMERGING MARKET EQUITIES?

KRZYSZTOF MUSIALIK: "The opportunity is where ESG headwinds can turn into tailwinds and we're seeing a number of opportunities as countries and companies in emerging markets are making significant progress around ESG risks. But it's important to also consider other risks. We're bottom-up stock pickers but we, of course, consider macro and political risks. One macro risk is that we have record low interest rates, which means that the effectiveness of monetary policy is limited. Another risk is everything related to climate change. But we also have to remember that the other side of risk is opportunity and we own companies that are working on solutions when it comes to climate change."

LAURI TILLMAN: "I would like to add a comment on risk from a top-down perspective. Emerging markets are often volatile and many smaller countries can be exposed to one commodity or one industry and if something happens there, it will affect the whole country. If I own a building company in the US that has the government as a big client, I probably don't have to consider the risk of the government not being able to pay. However, if I own a similar building company in a small emerging market country, that's probably a risk I will have to consider."

NIKLAS TELL: NIKKI, WOULD YOU SAY THAT THE BIGGEST RISKS IN EMERGING MARKETS ARE INTERNAL OR EXTERNAL RISKS?

NIKKI NORIEGA: "It's a combination. We've been in this low inflation, low interest rate world for a long time and when that changes, it could create issues in emerging markets. We're also on a de-globalisation path and some countries are more prepared for that than others. It could become more difficult for countries that are more tied into the global supply chain. Then there are, of course, also internal policy issues with rising levels of inequality, which can create political turmoil. However, when you talk about risks you also have to talk about probabilities and we're optimistic that the rewards will be greater than the risks.

NIKLAS TELL: IF WE LOOK AT THE PERFORMANCE OF EMERGING MARKET EQUITIES, I THINK IT'S FAIR TO SAY THAT IT HAS BEEN BETTER TO INVEST SOMEWHERE ELSE OVER THE LAST DECADE. WHAT ARE YOUR EXPECTATIONS GOING FORWARD?

LAURI TILLMAN: "If you take a top-down view, emerging market equities have been a good investment over the last 20 years. However, the last ten years have been bad relative to developed markets."

KRZYSZTOF MUSIALIK: "The underperformance of emerging markets versus global markets can to a large extent be explained by the performance the US, notably tech stocks. Much of the strong performance of the US has been through superior earnings growth, which in turn has been a result of leverage or buy-backs, financed through buy-backs which we think are unsustainable. Going forward, the expectations for EPS (earning per share) growth is higher in emerging markets compared to the S&P 500."

AKBAR ALI: "As a quant, I think one of the reasons that emerging markets as a group have disappointed is that earnings growth has simply not been high enough compared to developed markets."

NIKKI NORIEGA: "EM performance in the last ten years needs to be seen in the context of what happened in the ten years prior to that. That was a period of strong growth and EM market performance as China joined the WTO and the growth in China lifted the rest of emerging markets. You also had economies releveraging after the Asian crisis. Overall, it was a unique period of economic growth and one that I don't think we will see again. In the past decade, the common thinking was that emerging markets didn't live up to the hype and at the same time, it was the decade when the US, the US dollar and especially US technology really took centre stage. The question is where we're going from here and in my view, macro and benchmarks are really not the way you should look at emerging markets. We now have some world class companies listed in emerging markets and part of the bull case for emerging markets would be investors starting to focus on companies that are well-positioned to benefit from structural growth, that have durable competitive advantages and a host of options that manifest over time."

JANINA SIBELIUS: IT'S A COMPETITIVE MARKET OUT THERE. WHAT SHOULD ASSET MANAGERS DO TO STAY AHEAD AND BE AN ATTRACTIVE PARTNER TO INVESTORS?

LAURI TILLMAN: "I think my first comment is not really about staying ahead but rather about staying in the game at all and that's about making sure you do what you promise. If you're a US value manager, do US value and if you're an emerging market small-cap manager, please do that. Another important factor, especially in times like these when things are bad or uncertain, is that you need to be there for the client. Even if you haven't changed anything in the portfolio, tell your clients that you haven't changed anything. You need to continue to communicate. Then, if you have good performance, that always helps."