pi ESG CLUB

Pollution and inequality have made emerging markets an ESG nightmare. But with growth forecasts for developing economies outstripping those for the developed world, this month's ESG Club looks at how investors are aligning the need for a return with their responsible investment policies.

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IS ESG FACING A BACKLASH?

ESG is facing a backlash on many fronts, and seemingly led by the prime minister. But all is not lost for investors, finds *Andrew Holt*.

Environmental, social and governance (ESG) has been central to how institutional investors manage their investment portfolios for some years, but it is coming under pressure in some quarters.

Prime minister Rishi Sunak has backtracked big time on the government's climate commitments in the face of the rising cost of living, which has seen some pushback from investors.

Investors and the CEOs of the UK Sustainable Investment Finance Association (UKSIF), the Institutional Investors Group on Climate Change (IIGCC) and the Principles for Responsible Investment (PRI), penned a letter to Sunak, focusing on the importance of an 'enabling policy environment' so investors can make long-term investment decisions.

It added that a delay to key targets risks the UK missing out on investment to other regions and nations that are taking a more consistent, long-term approach.

Clarity and consistency

James Alexander, chief executive of UKSIF, set out the importance of clarity surrounding ESG. "With his background in financial services, the prime minister knows how important it is that investors get clarity and consistency from government if they are to choose to invest at scale in this country," he said.

Alexander then added: "The UK is already at risk of falling behind other countries, who are forging ahead with huge incentives to accelerate net-zero investment, and the PM's speech may only make matters worse.

"We urge him to reconsider his watering down of a number of climate change commitments, including the pushing back of the electric vehicle target, so that we do not miss out on the transformative investments needed to get to net-zero by 2050."

Investor confidence

Putting the position of the IIGCC, chief executive Stephanie Pfeifer pointed to maintaining investor interest on the issue. "Investor confidence is crucial to the UK being able to enjoy the economic opportunities presented by the net-zero transition, including investment and the jobs that brings," she said.

"By backtracking on climate commitments, or taking steps that put into question whether the UK will deliver on its legislative long-term commitment to net-zero, the government's announcement risks undermining this confidence."

David Atkin, chief executive of PRI, also fired a warning over Sunak's decision. "The entire global economy – including the UK, its workers and communities – stands to benefit tremendously from a continued and accelerating transition to net-zero," he said.

Indeed, analysis by the CBI earlier this year indicated an up to £57bn boost to UK economic growth by 2030 if the government accelerates progress on net zero.

"To secure these benefits, the UK government must not abandon its ambition on this vitally important topic. Investors remain committed to action on net zero and clearly recognise the benefits of doing so," Atkin added.

It is now incumbent on the UK government, Atkin said, to "mirror this ambition" and take steps to "deliver the benefits of a net-zero economy to the investment community and the country at large".

It is self-evident that if the government cannot lead on ESG and climate change why should institutional investors follow?

So does this scepticism towards ESG equate to an ESG backlash? Indeed, this has been something that investors and others have discussed for some time. If so, the debate surrounding ESG is probably taking place at a quicker pace in the US, where the issue has become something of a political football. Particularly among some Republicans, who kick it around at will in an attempt to gain public support to stop its march. Sunak could be well be following this tactic.

ESG is missing

In a sign that there is a wind of change on ESG, the US Securities and Exchange Commission, in a surprising move, omitted ESG from in its 2024 Examination Priorities Report.

Instead, the report said its examinations will prioritise "areas that pose emerging risks to investors" or the "markets in addition to core and perennial risk areas". The fact that a US regulator felt the need to do this speaks volumes.

In addition, global think tank and business membership organisation the Conference Board surveyed more than 100 large US companies, which revealed that almost half have experienced an ESG backlash, with 61% expect it to persist or intensify in the next two years. So on this evidence the ESG backlash is real and being felt by corporations.

That said, it is not all one-way traffic. As corporates seem to be doubling down on ESG rather than letting it go. Indeed, most companies (63%) said they are increasing their focus on the business case for ESG.

This could then in fact be good for investors, who could expect companies to present a greater coherent, cohesive narrative of their company's strategy involving ESG.

In other words, to have a business strategy that is sustainable, not just a separate sustainability strategy. This would be an advancement of ESG, not a retreat. So out of a challenging ESG environment, could spring some real investor benefits.

INTERVIEW – CLAIRE CURTIN

"The social aspects have potentially suffered at the expense of a narrow-minded focus on climate."

The Pension Protection Fund's head of ESG and sustainability sits down with *Andrew Holt* to discuss the changing investment universe, stepping out of the E's shadow, the option of last resort and not knowing everything.

How has ESG and responsible investing changed since you joined the Pension Protection Fund (PPF) in 2018?

I joined from an ESG data provider where I spent years convincing pension funds and asset managers that ESG is critical. Having seen a slow take up, the launch of the Task Force on Climate-related Financial Disclosures (TCFD) in 2015 saw a massive shift in the industry, and not just around climate.

UK pension funds have also seen measurable change in their reporting thanks to regulation. This is the oversight that we, as an asset owner, should have.

That is probably one of the biggest changes I have seen: that expectation, particularly from larger asset owners, about what we should be doing to continue overseeing and standing by our values and commitments on ESG.

Has ESG grown in importance as an issue during the past couple of years, or have you seen a gradual change?

It has been gradual, and definitely not linear, but suddenly in the last two years we have seen a big pick up. The number of organisations involved in working groups has significantly increased. The sheer numbers of attendees at the responsible investment roundtable we join forces with quarterly has grown. And that's mainly been in the last couple of years.

I would have struggled to have a detailed conversation with some of these groups two to three years ago, but we have much more thorough conversations now.

What is the PPF's approach to ESG and responsible investing?

We have been thinking about responsible investment pretty much since our inception. That's the benefit of being a younger organisation, you can adopt things from the start.

We were an early signatory to the Principles for Responsible Investment (PRI), and those founding principles have been key for many years. That focus has been on the integration of ESG and thinking about materiality, so that helps emphasise our strategy. We are thinking about the material risk, but also the opportunities. And with that, our focus tends to be more on engagement and trying to improve a company's practices, rather than shifting to a divestment decision. That would be a last resort for us. And driving change in the real economy is what we are trying to push with all of this.

Have you ever implemented that last resort?

We have, in a few specific areas where we feel from a financial perspective that it's no longer a sustainable business. We changed our equity benchmark a couple of years ago and removed a few companies.

From a financial perspective, there wasn't going to be a place for coal in the future, so we started to reduce that exposure.

Do you have something like a three strikes and you're out approach?

Yeah. We have been working on a formal

escalation policy. That's going through our committee approval process and means we can be explicit about the steps that would be needed to progress to that level.

Your climate change report highlighted the many successes of your ESG approach. What were the main findings?

This is our third climate change report. The evolution of the report tells a story. The first was just a narrative, it was the start of the journey. I look at the report we've just published and we are reporting progress, putting more quantitative data and visuals into it, which is great to see.

That in itself is a kind of success: that we've been able to show that evolution. We have tried to include a number of real life examples of our work.

More widely is the work we've been doing on our portfolio alignment assessments. Which again, it is something that has taken a couple of years. It's a multi-year process, and we are definitely not done yet.

When we started there was little out there publicly that we could apply to the types of assets we had. So we had to build a lot of assessments, or make a lot of assumptions and decisions ourselves and try to use data as much as we could.

In the portfolio, what we hold in this asset class is to make it relevant to us rather than a broader top-down assessment, as that is time-consuming, resource intensive and involved lots of debate.

We are starting to see the progress we have tracked over the last couple of years to where the overall distribution of the fund is. It's great to see that.

We have seen an increase in the assets that we can classify as aligned with Paris [Accord] and net zero, but also, coupled with that, a decline in assets that are not aligned. It is not that we have made sizable shifts in the portfolio. The equity benchmark is something we [changed] a couple years ago.

It's about supporting our engagement, rather than a divestment argument, and showing that change. We created a climate watchlist because we cannot monitor everything. This is more than 80 companies and accounts for a substantial amount of our financed emissions in our listed assets. By prioritising our efforts, we can track the progress of those companies.

Why have you set such high responsible investment targets?

A lot of what we've communicated has been driven by the organisational sustainability strategy we published in the summer. We have tried to leverage our development of that and think about who we are as the PPF, the uniqueness of us and our position within the industry, who we work with, partner with, and how we operate.

That's been a real focus for us: thinking about not just sustainability, and not just environmental sustainability, but also the social aspects. Part of our diversity and inclusion strategy is how we utilise our human capital, while also engaging with our stakeholders.

With net zero in particular, the big challenge is how do we achieve [the transition to net zero] in our direct operations, but also how do we achieve it in our supply chain? Before we can see real change, we're going to need more data.

And we're hoping that by talking about it and getting involved with other groups trying to address the same problems, that together it becomes a more comprehensive ambition.

Are you on target with all your ambitions?

Yes. Some of these things are going to take three to five years, or perhaps even 10 years to move towards.

Are there areas where you want the PPF to improve in terms of responsible investment and ESG?

We don't have all the answers. We haven't got it all signed, sealed and delivered. But we want to be more open, sharing the challenges and obviously accept that most people are going to be in the same boat as us. We found that collecting data to report more on Scope 1, Scope 2 and Scope 3 emissions is a challenge.

What are the key initiatives that you feel have shifted the ESG narrative?

The TCFD was absolutely a game changer globally, but the European Union's Sustainable Finance Action Plan has shifted the reporting and the transparency of our European managers.

It's not just thinking about climate as an E issue, but also the social and economic impacts. The just transition narrative has been critical and will be even more so as we start thinking about what it means in emerging economies. Being involved in a transition that creates jobs and levelling up will lead to a better real world outcome.

Where are the ESG failures on an industry, governmental or supranational level?

It is probably quite topical in the UK. That centres around the time-horizon issue. The focus on cost now, versus costs tomorrow, and then what is driving decisions that get made.

> **We have been thinking about responsible investment pretty much since our inception.**

It's definitely a challenge. We are seeing more at the governmental level globally. But even this is a much broader problem than just what one country will face, and that fairness aspect is always going to be incredibly challenging.

The failure is also possibly more around the way it's being positioned: just focusing on costs and not focusing on the benefits or opportunities.

What have been your biggest challenges in your role and how have you dealt with them?

The sheer breadth of issues and areas that now fall under the ESG-sustainability umbrella can be overwhelming. The ongoing data challenges alongside that standout.

I'm someone who always wants to know more. I always have a desire to know more, to learn more, to understand more. But then you have to prioritise. So the way I deal with it is to have a subconscious re-prioritisation going on in my head.

Alongside that, I need to have patience. Things take time. None of this stuff is going to happen overnight. So it is about being pragmatic as well.

Have you ever felt being a woman in investment has been a barrier in your work? Have you experienced discrimination?

I've always been aware of the imbalance in the industry. The diversity element has been talked about for the 23 years I have been in this area. Of all the areas in asset management, ESG is probably the most diverse and I don't know what has led to that. But potentially, I guess the diversity of issues within ESG has a part to play.

What can the industry do to achieve more on the social side: both when investing and bringing more diverse people into the industry?

The social aspects have potentially suffered at the expense of a narrow-minded focus on climate. So we have been quite heavily involved in the DWP's taskforce on social factors and looking to see it build guidance for asset owners to think more about that side.

It is hard to demonstrate some of the benefits from taking a social lens within the investment consideration. Less data makes it harder to track or even to prove.

A great deal of research tells us much about more diverse teams having much better productivity. And having a more socially diverse group of people is critical. We are looking at it across our recruitment practices. It is crucial to broaden people's minds around the importance of getting a broader mix of people.

Why has the social side been relegated below the environmental aspects of ESG?

I don't know if it is one particular thing. You can only deal with deep diving on one area at a time. But it is the data aspect as well. It's a lot harder to standardise. You have to get into the nuance of knowing what's going on.

What have been the biggest lessons you have learned in your career?

The main lesson is being brave, being open to change, to new themes and new ways of doing things. Alongside that, a thirst for learning and to continue developing yourself. You never know everything.

EMERGING MARKETS: AN INVESTOR'S DILEMMA

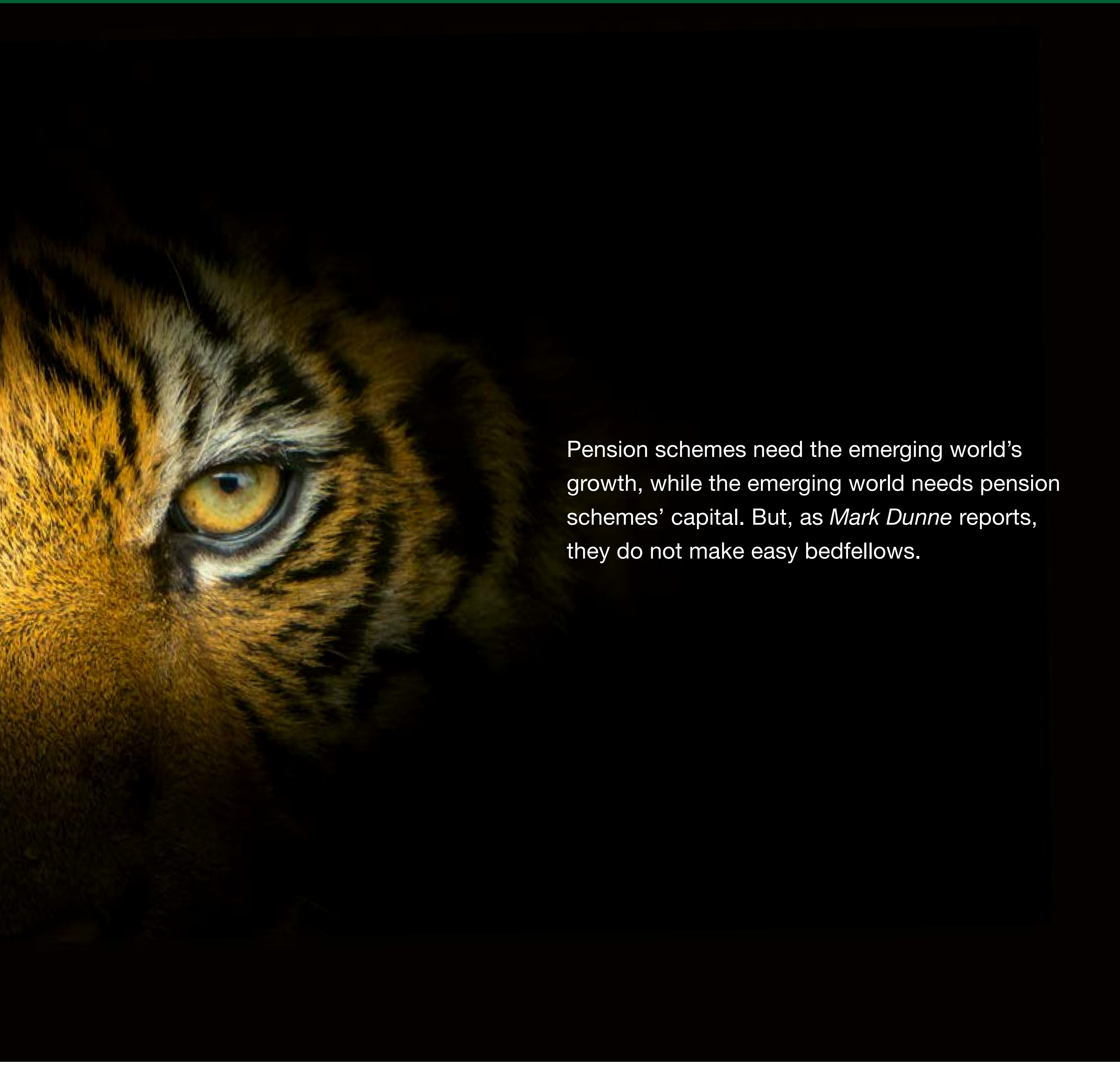
There is a distinctly different flavour to meetings at Oxfordshire County Council these days. In March, councillors voted to ban meat and dairy produce from being served on their premises. Instead, they now tuck into a plant-based menu.

This has not been the council's only move to help protect the environment. Three months later, its pension scheme started reducing its exposure to the extractive names in the FTSE100. But it then went a step further by deciding to dump its entire £80m portfolio of emerging market assets.

This could be seen as a surprising move, given that developing nations are expected to drive most of the world's economic growth in the coming years. Indeed, the IMF predicts that emerging markets will grow by 4% in 2024, led by China, India, Indonesia and Brazil. This is more than double the 1.4% expected from the developed world.

"Despite the uncertainties we have seen in China, emerging market growth is strong, especially compared to developed markets," says Jean Charles Sambor, head of emerging market fixed income at BNP Paribas Asset Management. "In the US and Europe, we are talking about soft or hard landings, while in emerging markets we are seeing some resilience."

This does not appear to be a blip. HSBC predicts that emerging markets could be responsible for 70% of the world's economic growth in 2030. These projections are five years old, but emerg-



Pension schemes need the emerging world's growth, while the emerging world needs pension schemes' capital. But, as *Mark Dunne* reports, they do not make easy bedfellows.

ing markets are growing as expected, and if there is to be a geopolitical-driven downward revision, it will likely hit the developed world just as hard.

But there is a problem. While the emerging world offers high growth potential, it is also home to an abundance of sustainable risks. Indeed, eight countries in Asia are responsible for 45% of the world's carbon emissions, according to impact investor Thomas Lloyd.

The asset class also has big inequality and governance issues, which the Oxfordshire Pension Fund named as a reason why it was looking elsewhere for growth. The scheme has singled out China and Saudi Arabia as particular concerns.

A spokesman for the Oxfordshire Pension Fund told *portfolio institutional* that there are concerns around risks to future investment returns stemming from the governance arrangements around a number of companies, particularly in China. "The future financial risks led the committee to determine they did not wish to increase the specific allocation to emerging markets to a material size."

We can work it out

Many institutional investors are aware of these concerns and, judging by their responsible investment policies, are probably uncomfortable at being exposed to them. Yet their approach is to work with governments and corporate boardrooms in the developing world to create the sustainable outcomes they are targeting.

One such investor is Nest, which has around 10% of its £31.5bn of assets working in these markets. The master trust works with its fund managers to ensure the assets in each mandate align with its climate change policy.

"We are not looking to reduce our exposure to emerging markets," says Katharina Lindmeier, Nest's senior responsible investment manager. "It is more a case of better understanding the risks, but also the opportunities.

"It is crucial to the transition that we invest in emerging markets," she adds.

Indeed, it is unlikely that climate change can be stopped by just reducing harmful gas emissions in the developed world. Research by economist Nicholas Stern found that $2bn (£1.6bn) a year until 2030 needs to be invested by developing countries, excluding China, to reduce their climate-harming gases and to deal with the impacts of a changing climate. Most of this will have to come from private sources.

The good, the bad and the uncertainty

Yet private capital is not being put to work at the levels needed in the emerging nations of Africa, Asia, the Americas and Eastern Europe. During September, around $13.8bn (£11.3bn) flowed out of such securities, $12bn of which were equities, the Institute of International Finance estimates.

"We have seen outflows from emerging markets on the equity and debt sides," Sambor says. "ESG uncertainties might have triggered some short-term pressures, but it has been something of a sideshow to top down global macro sentiment."

A Fed tightening cycle, geopolitical risk in Ukraine and uncertainty in China have been greater influences over investors' decisions, but sustainability issues could be having more influence over these portfolios.

Sambor says that ESG will play a greater role in how investors pick developing market stocks. "Once we see appetite return to emerging markets, there will be more discrimination between the good and bad ESG countries and companies," he adds.

Slow progress

Once that appetite returns, what outcomes will investors be targeting? Human rights? Reversing deforestation? Providing access to healthcare, education or clean drinking water?

Nest is focused on the energy transition. "It seems easier to focus on climate because there are fairly consistent metrics in terms of emissions," Lindmeier says.

It is harder to define the other ESG issues, such as, for example, what is needed and where in terms of healthcare to improve equality in India. "Whereas with carbon emissions you can see the levels [that] different countries have, what the trend is and which are struggling with the transition," Lindmeier says. And some economies are struggling to decarbonise. China, for example, has re-opened some of its mines despite pledging to achieve carbon neutrality, Sambor notes.

> **Just because it is difficult to engage with a sovereign is not a reason to not invest.**
>
> Katharina Lindmeier, Nest

"On average, emerging markets tend to be more dependent on coal than their developed market peers," he says. "We are seeing attempts to diversify away from that, but progress is slow."

Indeed, more than 90% of new global carbon emissions emanate from emerging markets. "That is more a function of where they stand in their development cycle," Sambor says.

The elephant in the room

So investing in emerging markets responsibly is a challenge, especially with China being so dominant in the asset class.

The world's second largest economy will expand by 4.2% next year, the IMF believes, despite problems in its property market, lower inward investment and weaker consumer spending. Although this is slightly down on the 5% expected for 2023, it beats the 1% projection for the US and the 1.5% in the eurozone. However, China is responsible for around 30% of the world's carbon emissions and is aiming for net zero by 2060, while India has given itself a decade longer before joining them.

So what is a fair pathway for emerging market portfolios to decarbonise, considering that they are dominated by China and India, which have different net-zero targets? "It's not just about their contribution to the transition, but also their physical vulnerability," Lindmeier says.

Here lies another challenge. Getting data on the physical risks of emerging market assets, even equities, is harder than in developed markets "where there are similar trajectories" that investors want to achieve. But the standards of disclosure are improving, Sambor believes.

"Some emerging market sovereigns and corporates tend to be less transparent than their developed market peers, but we are seeing some improvement," he says. "There is a strong commitment to communicate better and to engage."

Come together

Engagement is important in cleaning up dirty assets and reducing inequality. But how easy is it to change a sovereign's policies? "It is a challenging area," Lindmeier says. "Just because it is difficult to engage with a sovereign is not a reason to not invest.

"We have engaged with state-owned companies and there are challenges. They are always going to pitch their target on what the government has set. In economies that do not have a net-zero target by 2050, it can be challenging to engage with them," Lindmeier says.

Indeed, a large part of the emerging markets space is quasi-sovereign. Being owned by the sovereign means their disclosures are typically weaker. "Engagement is crucial here, way more than in developed markets," Sambor says.

"Success in engaging and tracking ESG in emerging markets requires a lot of commitment and co-ordination between your dedicated individuals and your investment people," he adds.

BNP Paribas AM has a sustainability centre in Singapore, which tracks the ESG profile of its emerging market exposures.

"It also requires a local presence to do daily or weekly engagement," Sambor says. "It is not enough to do due diligence twice a year and pretend that the job is done."

But for those with no presence on the ground in emerging nations, understanding if your investments are making the agreed changes could be difficult outside of owning publicly listed companies.

One approach could be to collaborate with local investors when engaging. This could also help with any language barrier. The Church of England, USS, Border to Coast, Brunel Pension Partnership, BT Pension Scheme and Railpen are some of the institutional investors working within collaborative agreements in the emerging world.

Nest has focused its emerging markets stewardship on Climate Action 100+ and has been working with other pension schemes to form a collective voice. It has also joined an emerging market just transition initiative. Identifying the challenges, such as deciding what a fair transition looks like in emerging markets, is part of their work.

For example, if investors have a policy to phase coal out of their portfolios, are they penalising some countries, particularly in Asia? So are investors excluding Indonesia, for example, from their investment universe when they should be working with them to adopt cleaner alternatives to coal-fired power.

Working with development banks could be a way to improve governance in the emerging world. "They have more experience on the ground," Lindmeier says. "There could be more information sharing that allows investors, such as ourselves, who are worried about risk, governance and policy risk around renewables.

"Having local partners could give us more comfort about investing in those countries," she adds.

Common ground

Emerging markets is not an easy asset class for sustainable investors to hunt for value, growth or income. But it is needed in a world where the economic picture is deteriorating by the day and growth at fair value is becoming scarce.

Indeed, it turns out that the Oxfordshire Pension Fund may not have completely ditched its developing world exposures after all. It has recycled part of the proceeds from the sale of its emerging market portfolio into a passive Paris-aligned benchmark portfolio.

However, most of the funds will be directed through a sustainable equities fund managed by its pool, Brunel Pension Partnership. This could see some of its funds invested in emerging market assets "with all investments selected to deliver long-term sustainable investment performance", Oxfordshire's spokesman said.

This is an example of how important the developing world is with its abundance of natural resources and growing, younger workforce. But it is also a major contributor to climate change and needs capital to reduce its impact.

"In my mind, there is no global success in ESG without emerging market involvement," Sambor says. "Emerging markets will be a key driver of ESG improvement globally."

Developed world investors and emerging market assets will have to continue to be uneasy bedfellows. Our retirements and even our lives could depend on it.

> **Emerging markets will be a key driver of ESG improvement globally.**
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> Jean Charles Sambor, BNP Paribas Asset Management


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