

**Spring 2018 Columbia SIPA Capstone Executive Summary
For United Nations Development Programme
ESG Investing: How to increase ESG investing in developing countries**

[Client] United Nations Development Programme (UNDP)

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Project overview

Environmental, Social, and Governance (ESG) is a risk analysis framework which complements traditional financial analysis with different factors that theoretically could impact investments. It's related to responsible investment themes, but is not necessarily aimed at fostering development or accomplishing a social goal, and it does not entail foregoing some profit to pursue these objectives. It has slowly moved from the margins to the mainstream quite recently. However, our research shows that most of the capital is sourced and invested in developed countries.

The goal of this project is to figure out why ESG investments do not actively flow into developing countries as opposed to developed countries, and where the majority of ESG investments flows into.

1. ESG investing in developed countries

Developed countries such as Europe, the United States and Canada have seen a steady rise in ESG investing in recent years. In 2016, more than 90% of ESG investments (\$10.37 trillion) were concentrated in these three regions. The overall market for ESG investing in these regions is expanding. For example, in Europe ESG investment grew 39% from 2014 to 2016 and reached \$2.88 trillion. In 2016, approximately 67% (\$5.8 trillion) of US sustainable investing (SRI) assets was affected by ESG integration. In addition, ESG investing dominated in Canada's responsible investment market—96% (\$1.05 trillion) of the assets were managed using ESG integration strategy (Global Sustainable Review 2016).

According to the Japan Sustainable Investment Forum (JSIF), the ESG investment market in Japan amounted to \$120 billion in 2016. As ESG investing is becoming increasingly appealing in Japan, the overall size of the ESG investment market continues to grow at a high speed. This rapid increase was partially caused by the ESG focus of Japan's Government Pension Investment Fund (GPIF), the world's largest pension fund with \$1.3 trillion in hand. GPIF allocated \$8.9 billion to ESG-related investments in July 2017, and thus in total GPIF poured \$29 billion into ESG investing.[1]

From the supply side, the asset management firms and investment companies across all channels have seen increased demand for ESG investing from clients. Considering that the ESG market is fairly

fragmented and each ESG-related fund holds a small pool of assets[2], asset managers are motivated to move towards consolidation in hope of increasing competitiveness. To increase investor appeal, investment management companies such as BlackRock and Eaton Vance lowered fees for ESG exchange-traded funds in 2017 and 2016 respectively. Lower fees together with consolidation of the ESG market could boost ESG asset growth.[3]

2. ESG investing in developing countries

From the ESG Country Strategic Risk report by Bloomberg, we noticed that there is a divergence between developed countries and developing countries when it comes to ESG Country Risk Score. Developed countries such as Sweden, Norway and Denmark topped the list of best performing countries, and most of the best performing countries are in developed markets, while countries that have the highest ESG risk score are mostly from developing countries. High ESG country risk may partially explain why interest in ESG investing is limited in developing countries besides the other factors of vague ESG criteria, lack of validity of ESG reporting and market barriers.

Another report by Bloomberg Intelligence indicates that global ESG assets grew to \$445 billion in 2017[4], while the total ESG funds focused in Asia were limited to \$24.5 billion as of 2016[5]. Despite the small market for ESG investment in Asia, ESG assets allocated to the Asian market increased 35% in 2017, which is greater than the ESG-asset growth in Europe and North America.[6] Developing countries such as South Korea and Singapore are making efforts to improve records on ESG disclosure in their stock exchanges.[7] This action will improve companies' transparency in terms of ESG performance and risk, and may catalyze ESG-investment growth in Asia.

3. ESG Research Databases

Bloomberg ESG Data Service: Bloomberg provides the largest financial reporting and ESG reporting data set in the world. Bloomberg ESG Disclosure Scores evaluates companies' transparency based on their disclosure of environmental, social and governance data. Company coverage is dependent on the data that is provided in company published reports, such as Corporate Social Responsibility (CSR), annual reports, Annual General Meeting (AGM) results, ESG releases or any other publicly available documents.

MSCI ESG Research: The MSCI Rating covers 6,400 companies and over 400,000 equity and fixed income securities globally. Their model emphasizes more on significant ESG risks and opportunities through company, industry and thematic reports as well as analyst calls and webinars.[8]

Thomson Reuters ESG Research: Thomson Reuters provides standardized ESG research data regarding issues such as climate change, diversity, Corporate Social Responsibility (CSR) strategy, human rights, etc. which are all dependent on publicly available information sources and manually collected data. More than 7,000 global companies are evaluated in terms of their sustainability performance.[9]

RepRisk: A leading research provider specializing in ESG and business conduct due diligence data. They are the only ESG research provider to cover private companies as well as emerging and frontier markets. Their ESG reports analyze more than 100,000 global companies, 17,529 NGOs and 12,373 governmental bodies in 34 sectors.[10]

Despite the existence of various ESG research providers in the market, they often offer different ESG scores/ratings due to their proprietary methodologies, which makes it difficult for investors to compare one source to another.

Hypotheses

We explored two hypotheses that could explain the reasons behind the fact that ESG investing does not flow into developing markets.

1. Vague ESG criteria definition and lack of validity of the ESG framework

The specific factors that compose each part of the ESG criteria are quite vague with no standardized definition. As a result, typically each industry player (such as investment firms, consulting firms, or independent institutions), has their own definition. This lack of comparable and accessible data deters its use by investors. In addition, investors may have doubts about ESG risk analysis producing value in investments, since its mainstream appearance is relatively recent.

In conjunction, these features of ESG investing may be stalling capital flows to developing countries

2. Market barriers in developing countries

A second explanation to the lack of ESG flows to developing countries is their relative inaccessible financial markets. Even if there weren't any problems with the definition and validity of ESG criteria, we would still see smaller capital flows to these economies, as the existence of structural factors is what deters investment. Regulation, taxation, corruption, financial market development, and liquidity are all good examples of these market barriers.

Research

Preliminary research on both hypothesis showed some promises. On one hand, the issue of market barriers has been deeply studied and tested in the last decades. There is strong evidence showing that structural barriers do deter investment flows, which in turn impacts economic growth through a number of channels.

Research conducted in the early 1990s, just as a number of developing countries were opening up to global financial systems, such as papers by Bekaert and Harvey (1995)[11], and Claesen and Rhee (1994)[12], identify and test the significance of a number of barriers. The IMF, in its World Economic Outlook[13], still stresses the importance of these factors in the access to capital markets, and in

receiving foreign investment. In short, based on these studies, we should expect smaller ESG investment flows into developing countries.

On the other hand, research on ESG investing is sparse. Despite the fact that ESG has been, at least nominally, around for decades, it was a niche until recently, and there is a severe lack of studies on its validity as a risk assessment framework. As mentioned in the introduction, the lack of a standardized definition severely hampers the comparability of data, and of the little research there is on the topic.

Some recent research, both academic and from investors, has shown positive results for ESG criteria in investments. A meta-study carried out by Friede, Busch and Bassen (2015)[14] concludes that in 90% of the cases, the relationship between financial performance and ESG criteria is at least non-negative. MIT Sloan School of Management and Breckenridge Capital found that there is positive correlation between measures of financial health and ESG criteria[15].

However, there is definitely a lack of long term research, which is compounded by the lack of usable and accessible information. It may well be that investors harbor doubts about ESG criteria validity, despite its adoption (in whatever form they choose) by well-known names in the industry.

Interview

The interviews we conducted further supported the two hypotheses. All interviewees gave a vague and broad definition of ESG. They all claim to believe that ESG integrated investing leads to more positive returns and that their investment portfolios incorporated some level of ESG. The majority of investors are still using the negative screening method as their main ESG investing strategy. Other are gradually shifting towards actively assessing companies on actually adopting good business practices. However, the incorporation of ESG in investing varies among companies and industries. Therefore, the ESG framework/risk assessment methodology is determined by each individual investment teams and is most of the time, a “judgment call”.

In regards to the second hypothesis, lack of data availability was the biggest market barrier according to the interviewees. Larger investing companies claim to face fierce local competition in emerging markets while smaller sized investors are concerned about the lack of transparency and reporting standards. The smaller sized investors also have a poor image of governance in emerging markets due to media portrayal. Furthermore, there is limited demand from the clients’ side on investing in emerging markets, thus the investors do not have the pressure to do ESG-integrated investing in emerging markets and tends to stick with the more familiar developed markets.

Conclusions

ESG investing has started to move from the niche to the mainstream. Although sustainable investing are still mainly concentrated in the US and Europe, some parts in Asia and South America have been caught up with the trends quite rapidly. Nonetheless, many developing countries are still non-ESG-investment

friendly. We came up with two reasons behind this problem: 1) there is no single commonly agreed and validated definition of ESG, and 2) market constraints in developing countries.

1. The interview findings have supported the fact that ESG definition is indeed obscure and unstandardized. Hence, many firms have come up with their own versions of ESG definition, criteria, ratings and scorings; making it impossible for a single institution to synthesize all versions into one single summary report.
2. While valuing companies, investors will look at risk associated within the companies. Developing countries are considered “risky” due to its small market size, lack of liquidity, low quality of governance, and high sovereign risk. This has also been mentioned in many research papers and reports.

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