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SEPTEMBER 2023

**Premier Miton**  
INVESTORS

## How Emerging Markets can help pension schemes meet their sustainability objectives

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### Has an obsession with ESG ratings created a false perception of the value of Emerging Market equities?

Equity allocations across UK Defined Benefit (DB) schemes continue to fall, which in turn has impacted allocations to Emerging Market equities. Where schemes do have allocations to Emerging Markets these are generally less than 10%, reflecting the make-up of major MSCI world reference indices. It is a similar story in the Defined Contribution (DC) space where most scheme participants are invested in the default investment option which tend to have similarly low allocations, declining as scheme participants move closer to selected retirement dates. This process of financial de-risking has coincided with asset owners setting clearer climate and sustainability commitments.

More recently we have seen renewed interest in equities as open DB schemes, DC investors and consultants review their asset allocations with a backdrop of more uncertain economic growth in the developed world amid increasing interest rates. This has brought back to the fore an active discussion of both the opportunities and challenges of investing in Emerging Markets.

### An emerging opportunity

The long-term opportunities associated with this group of markets have been outlined by many Emerging Market fund managers, ourselves included. It is worth reiterating that whilst emerging and frontier markets account for 80% of the world's population and 59% of global GDP\* they represent just 15% of global equity market value. The IMF forecasts an increasing GDP growth premium for emerging over developed economies, and within a portfolio context an allocation to Emerging Market equities can add diversification benefits. However, anecdotally in our discussions with asset owners, we hear that many are discouraged from initiating or increasing their allocation to Emerging Markets. Why?

### Addressing Emerging Market ESG perceptions

The most common area of concern we observe when we speak to UK pension funds is the perception that investing in Emerging Market companies means an exposure to significantly higher levels of ESG risk and poorer management of them. Beyond this, comes the more complex issue of carbon emissions, and finding space in shrinking carbon budgets to what is understood to be an intrinsically higher-emitting asset class.

It is true that the availability and consistency of non-financial, ESG data can be a challenge in Emerging Markets. Traditional ESG data providers have poorer coverage of emerging and frontier markets and many companies, particularly smaller businesses, may not have the resources to collate and publish data different reporting frameworks have required.

As a result, there is on average a lower level of disclosure of non-financial metrics in Emerging Markets, particularly as you move down the corporate market capitalisation scale and into smaller emerging and frontier markets. It is also true that in many Emerging Markets the legal and market structures may be different from and offer less protection to investors than in the UK. Financial disclosure standards may differ slightly. However, all these gaps continue to narrow.

The Chinese and Hong Kong markets have been consulting market participants on the introduction of mandatory ESG and climate disclosures for listed companies. India has announced a phased-in process for mandatory ESG disclosures for the top 1000 companies over the next 3 years which will include disclosures both up and down the value-chain. The long-awaited announcement of the new International Sustainability Standards Board guidelines for sustainability and climate disclosures in June 2023 will, we believe, accelerate this process.

\* [https://www.imf.org/external/datamapper/profile/NGDP\\_RPCH@WEO/OEMDC/ADVEC/WEOWORLD](https://www.imf.org/external/datamapper/profile/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD)

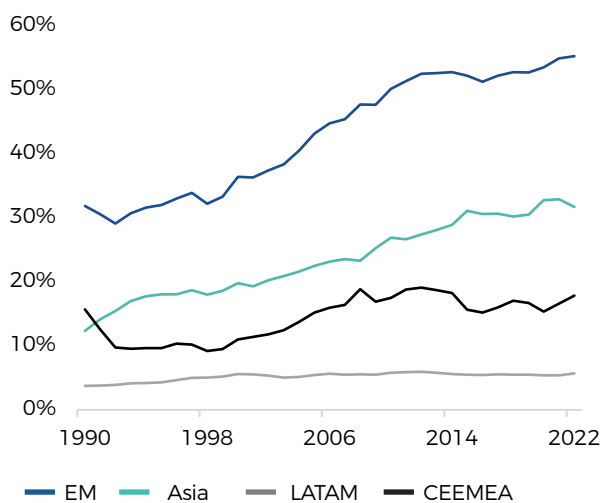


### Composition issues

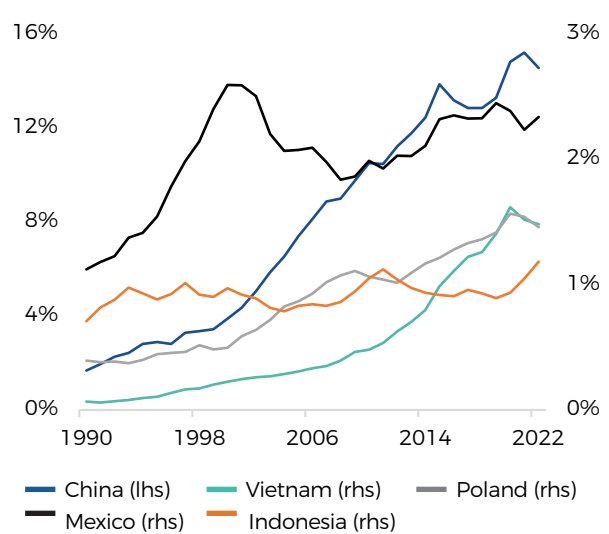
The perception of intrinsically higher carbon intensity needs to be understood in the context of the structure of Emerging Market indices, which in turn reflect the role they play in the global economy. A look at the sector breakdown of the relevant MSCI indices shows that the weight of energy and materials in the Emerging Markets Index is 13.4% compared to 8.9% in the World Index. But moving further downstream the differences are more pronounced. Supply chain

and manufacturing globalisation over the last 30 years has allowed developed economies to take advantage of the cheaper cost of labour offered in emerging economies. Emerging economies now account for 55% (2022) of global manufacturing output, up from 32% in 1990. While Asia dominates here – and within Asia, China in particular – shifting preferences for more proximal markets and a more diverse roster of suppliers are helping to drive share gains for a broader set of countries and offer further investment opportunities to those considering the Emerging Market asset class.

Global market share of manufacturing exports (by region, %)



Global market share of manufacturing exports (select countries, %)

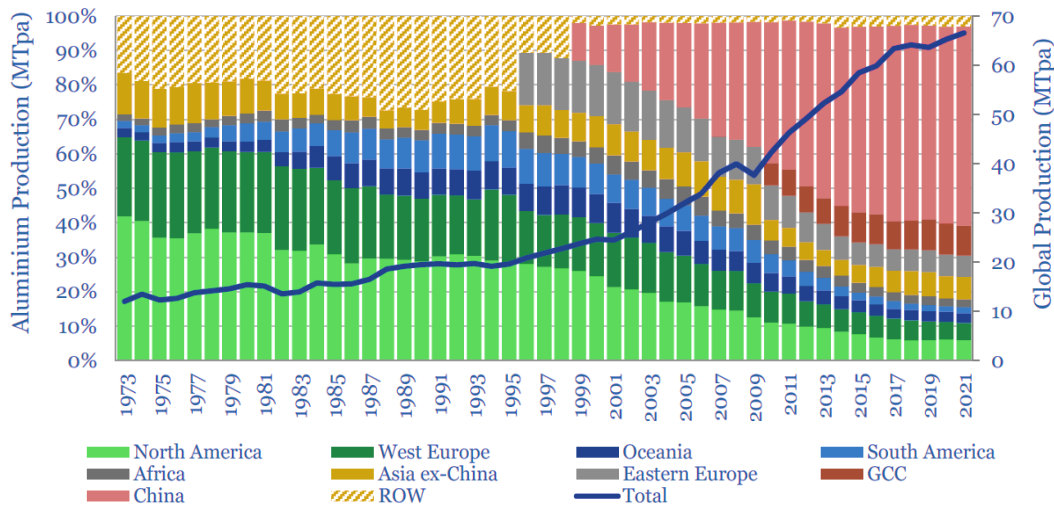


Source: IMF, World Bank, Haver, data from 1990 to 2022.

However, this does not change the ongoing reliance by developed economies on the rest of the world for some of the most energy-intensive activities. According to the IEA (International Energy Agency), emerging and developing economies now account for 70-90% of the output of chemicals, steel and cement, which together consume nearly 60% of industrial energy demand. China alone now accounts for 53% of global steel production and 57% of aluminium smelting, whereas 30 years ago 70% of world production was centred in the US and Europe.

Moreover, while 'industry' is the single largest category of global direct and indirect emissions, we must also consider agriculture, forestry and land use where again Emerging Market countries dominate the top sources of cultivated cropland providing the world's food supply. These are not emissions that can simply be allocated to Emerging Markets, nor are they likely to be reduced or abated through divestment.

**In the 1970s, two thirds of the World's aluminium was smelted in the US and Europe; today the share is just 10%; China has ramped up to 57% of world supply.**



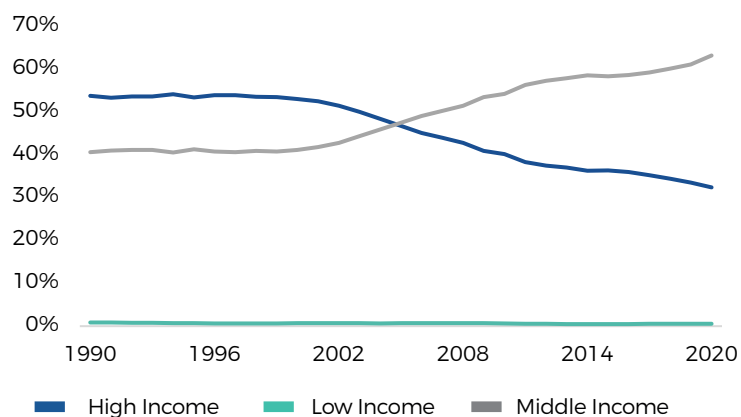
Source: Thunder Said Energy, data from 1973 to 2021.

### A shift in the source of CO2 emissions

It is not a coincidence that if we examine the World Bank climate databank, we can see that over a similar time the largest share of global CO2 emissions has shifted from high income, developed countries to middle income, emerging countries. In 1990, high income countries accounted for 54% of world CO2 emissions with middle income's share at 41%.

Fast-forward to 2020, the latest data available from the World Bank, we see that high-income countries' share has fallen to 32% whilst middle income countries now account for 63% of CO2 emissions. The poorest countries' share has remained stable at 1%.

## Share of global CO2 emissions (%)



Source: World Development Indicators, data from 1990 to 2020.

Unsurprisingly, Emerging Market indices mirror the trends seen at a country level, and typically exhibit a substantially higher carbon footprint than developed market indices\*\*. As such, any increase in exposure to emerging versus developed markets within the asset allocation framework by asset owners – assuming a passive, index-matching approach – will result in an increase in carbon footprint.

### A nuanced and challenging issue for investors

The issue is even more nuanced and challenging than it would appear at first glance. Despite the effective outsourcing of carbon footprint to emerging economies, if we look at per-capita emissions, the data shows that middle-income, emerging economies' emissions are only 41% of those of high-income economies and the very poorest countries have per-capita emissions of only 3% of the richest\*\*\*.

It has been estimated that in developed economies over the course of the twentieth century, energy consumption increased in alignment with the creation of wealth with approximately 0.3-1.0 MWH of incremental energy consumption per USD1,000 increase in income on a per capita basis. As such, the global climate transition equation must incorporate rising energy intensity on a per capita basis from emerging nations due to rising prosperity. No wonder then, current forecasts are for 88% of the growth in electricity demand between 2019 and 2040 to come from emerging economies\*\*\*\*.

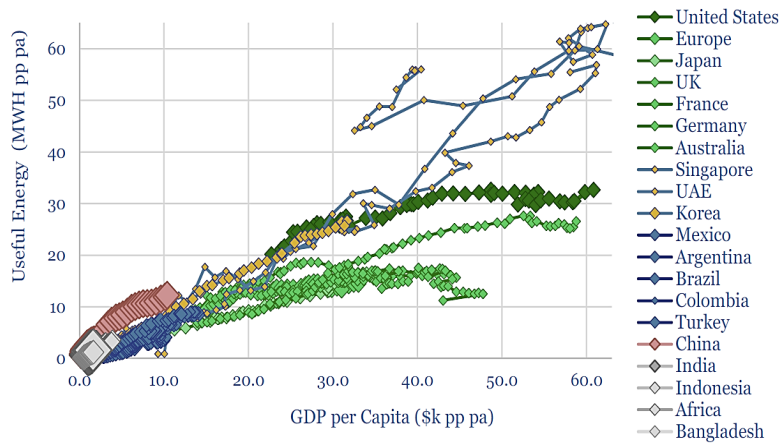
\*\*data from MSCI for 29.10.2021 shows that the weighted-average carbon intensity as measured in tons of CO2e/USDm sales was 132.1 for the MSCI World against 322.9 for the MSCI Emerging Markets.

\*\*\*<https://data.worldbank.org/indicator/EN.ATM.CO2E.PC>

\*\*\*\*<https://www.ceew.in/publications/electricity-leapfrogging-in-emerging-markets>



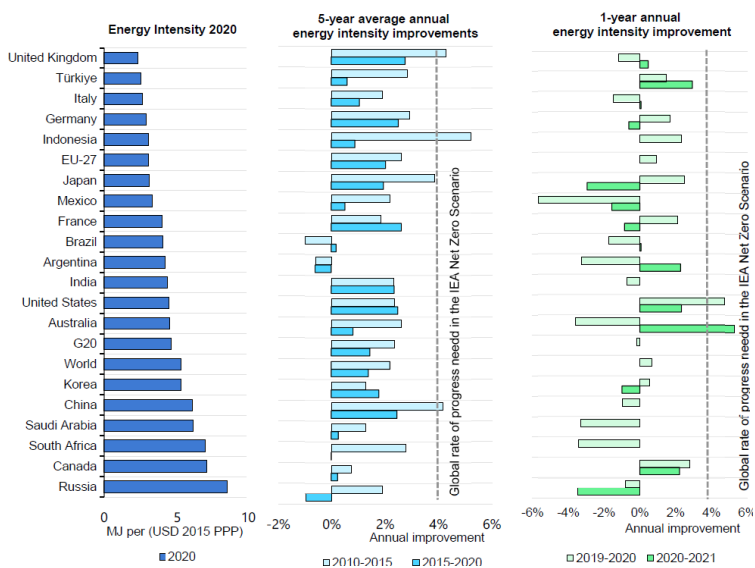
## Energy use rises by 0.3 – 1.0MWH pp pa per \$K rise in GDP per capita



Source: World Bank, IMF, BP Stat Review, TSE.

One of the potential solutions to this equation lies in the ability of emerging economies to harness energy efficiency investment and 'leapfrog' the path set by developed nations. The IEA estimates that energy-efficiency-related investment is set to rise by 16% in 2022, and under currently stated policies this figure is expected to increase to nearly USD 840bn per year from 2026-2030. This is unlikely to be enough, being around half of the IEA's energy efficiency-related investment required to align with the Net Zero scenario. Expressed differently, doubling the rate of global energy intensity improvement from the 2% per year achieved from 2010 to 2020 to just over 4% from 2020-30 is necessary to put the world on a pathway consistent with the Net Zero Scenario. Yet, comparing the period 2015-2020 to 2010-2015, only five countries globally delivered improvements in energy intensity: Brazil, India, Korea, the US and France. None reached the critical improvement threshold.

## Primary energy intensity, in G20 countries, 2020 and annual improvement 2010 - 2021



Source: IEA Energy Efficiency 2022 report. Energy Efficiency 2022 was prepared by the Energy Efficiency Division (EEfD) of the International Energy Agency (IEA).

## Dilemma, or trade-off?

So, how to answer the question we hear asset owners struggle with? How to reconcile commitments on sustainability, ESG-risk and climate change with the growth opportunities in Emerging Markets?

First, active managers are not bound to allocate in the same proportions to fossil fuels, or heavy industry or manufacturing, as their reference benchmark indices might do.. We believe that investing to deliver a dual outcome – an attractive financial return and positive real-world environmental and social outcomes – can be achieved through active investing and engaged stewardship.

Second, through targeting investment in companies allocating capital to activities that directly support sustainable development, productivity, and by extension efficiency.

## Three key questions we ask

We focus on answering three key questions in our research to uncover attractive investment opportunities: is what a company does sustainable, is how they do it sustainable and can they deliver a sustainable financial return to investors? We find this a powerful lens through which to view the opportunities in Emerging Markets. This framework guides our bottom-up research and helps us to identify investments which can deliver both attractive financial returns and positive social and environmental outcomes. It also helps to inform our engagements with company management which form the bedrock of our stock selection process and allows us to mitigate the ESG and climate risks outlined above.

Taking each of these aspects in turn, to answer the question “is what a company does sustainable” we start by identifying areas of under-investment which are aligned with the UN Sustainable Development Goals. This acts as an independent

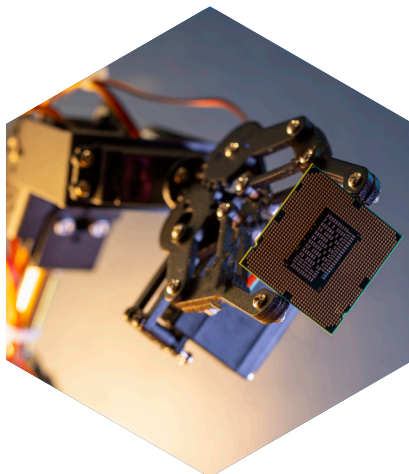
framework for the assessment of sustainable activities. We then assess how the company’s products and services address this issue and quantify the investment a company is making to address the problem, considering both the potential positive outcome as well as the risk of creating obstacles to the achievement of the SDGs.

Turning to “is how they do it sustainable,” here we look to understand the company culture and governance structures and how key risks are identified and managed. We do not rely on ESG ratings providers, instead regular engagement with company management and assessment of key data points versus peers allows us to develop an understanding of both governance structure and more importantly the culture of sustainability within the business.

Finally, to understand the financial sustainability of the business we look at several specific financial metrics and use our engagement with management to understand how they have built the business and what it will look like in future. We only consider the companies with the highest financial sustainability scores for inclusion in the portfolio.

In general, we will not invest in companies that we believe have a material negative societal or environmental impact and we exclude certain activities and behaviours which we consider to be unsustainable, for example companies involved in banned weapons, tobacco manufacturers or those that significantly contravene human rights and those with over 10% of revenue from the distribution of tobacco products, gambling or oil & gas.

By allocating capital to those companies which are offering solutions through their products and services to the global challenges we face collectively, that are managing their ESG risks and opportunities in an appropriate way, where corporate culture, governance structures and management incentives are aligned with the interests of stakeholders, we aim to deliver both attractive financial returns and positive social and environmental outcomes which we believe will be aligned to asset owners’ broader objectives.



## IMPORTANT INFORMATION

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