II Thought Leadership Studio

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Context is Everything

Experience matters, perhaps more in emerging markets and sustainable investing than in any other aspect of asset management. The core of the team led by Maria Negrete-Gruson, Portfolio Manager, Sustainable Emerging Markets **Team** *at Artisan Partners, has been investing together for nearly 20 years. In that time, a philosophy has emerged that stresses the context of sustainability in emerging markets, along with a focus on the progress made by companies on their individual journeys. The result is a compelling and original approach to sustainable investing in emerging markets. II recently spoke with Negrete-Gruson about the team's singular approach.*

II: As a firm, Artisan is particularly focused on ESG strategies and opportunities in emerging markets (EMs). Why is that?

Negrete-Gruson: We've been building our EM strategy for a long time, and we've always wanted to offer a broader perspective on sustainability in the specific context of emerging markets. From that perspective, we feel that ESG isn't only about "do good now."

ESG is essential — almost existential — to a lot of the opportunities in emerging markets. Given the needs in EM countries and the importance of long-term investing, our approach has always been that of bottom-up investors with a long-term horizon. Having clarity and a strategy about what type of opportunities are sustainable has always been important to us.

You mentioned the specific context of emerging markets. What is the context you use to frame ESG opportunities in EMs?

Negrete-Gruson: In short, we don't think you can simply apply a developed market perspective to what are the right practices and approaches to ESG in EMs.

You're not a big fan of ESG ratings. Why is that?

Negrete-Gruson: They fail to capture what is actually happening in emerging markets, where things are evolving and moving rapidly. So, to create categories of "good" and "bad" isn't appropriate in EM, because it doesn't take a long-term view, and the truth is that these companies are evolving, positively or negatively, constantly.

The second problem with ratings is how the metrics are developed. It can't be all about a single opinion or definition. We must acknowledge where emerging markets are coming from, and reward positive change.

It sounds as if rather than worrying about ratings you're concentrating on the evolution of EM companies?

Negrete-Gruson: Exactly. It's a journey for businesses in EMs, and a journey for us, too, which is why we reject permanent exclusion lists or criteria that are set in stone in terms of good or bad, or emission standards. The journey is about factually assessing where the companies are coming from — where they started, and whether their sustainability-related behavior is improving.

For example, a company could have a mixed track record, but we see it's transforming in a way that will lead to a more constructive future. From that perspective, there is a reward for us as investors. Even if we just narrow it to governance — perhaps a company that never paid dividends establishes a dividend policy — there is reward in that. As citizens of emerging markets, these companies are evolving from the reality of EMs of the past, and that progress has a very positive impact for the company and the community. We look to identify that positive change and reward it, and to penalize negative change.

Can you give an example of journey and context compared to a company being simply good or bad?

Negrete-Gruson: Some investors will say they don't want fossil fuels in their portfolio – period, end of story. We would never say that. We would all prefer a world in which fossil fuels didn't exist, but the reality of the journey of India or China includes setting priorities. Do you want no emissions, or do you want electricity for hospitals and schools? It's not the activity itself, but rather how companies go about the activity. If you feel a company operates responsibly in regard to its community and environment, and you can quantifiably measure that, that's where the focus should be. It might sound like a strong word, but it's hypocritical to sit in New York, for example, and say companies in EMs should be doing this or that. Developed economies became developed based on doing the very things they say EMs shouldn't be doing. You can't just tell EMs to go ahead and develop, feed your population, give them access to education and healthcare, but don't use any of the tools you have at your disposal — which, by the way, happen to be the same tools developed countries used. On our team, we are trying to identify progress toward positive change within the context of reality.

When it comes to the ESG, there is a lot of focus on the "G." Is that because it's already a basic part of assessing the value of a company?

Negrete-Gruson: Yes, and that's one of the challenges. Over the years, as fundamental investors, we have become quite good at identifying the "G" — the quality of the exposure, quality of communication, and so on from EM companies. But it's a mistake to ignore "E" and "S" simply because we cannot quantify them — that excuse is no longer valid. Based on the staleness of the data that are available, and the bias that goes into how ESG ratings are developed, we developed our own way to quantify "E" and "S" in an incident-based manner. Rather than importing scores or ratings, we get access to the incidents experienced by a company.

How does your proprietary assessment work?

Negrete-Gruson: We don't concern ourselves with the stated policy of the company because it's relatively easy for any company to put policies on paper. But how do you execute? How do you prove that these policies are being enforced? That is the tricky part. We can't walk away from that, but we also can't only listen to what companies say. Instead, we look at what companies have done. It's not your policy on sexual harassment, but rather how many times have you been sued for sexual harassment? It's not your policy on the environment, but how many oil spills have you had? To measure change, we look at the number of incidents a company has had historically, how many incidents it had three years ago, how many incidents it has had recently.

We are not necessarily aiming to have a portfolio of companies that have had no incidents. We're looking for companies that show improvement by, for example, reducing the number of incidents in a given time frame. In contrast to that, if a company has had no incidents historically and suddenly they start to pop up, we're measuring that, too. There is a lot of information in that history. Usually when an incident happens, it's not the first time. Companies demonstrate patterns of behavior; we're trying to identify improvement or deterioration in those patterns.

Is there a qualitative component of your assessment as well?

Negrete-Gruson: Yes, based on our interactions with the company. We match the quantitative incident-based scoring with our qualitative assessment, and based on that we create a score for a company which has an effect on our target price for the stock. Incidents are captured as soon as they occur and are immediately incorporated into our target stock prices.

As many emerging markets move toward being technology- and service-driven economies, and less commodities based, will that affect your ESG strategies?

Negrete-Gruson: EM economies and investment opportunities will always include the extractive industries — that's the reality. Appropriately and sustainably utilizing their natural resources is part of the path a country needs to follow to develop. So, that is part of emerging markets — but only part.

We're also seeing companies in EMs producing microchips and processors for devices that are used in developed markets and also adopted in other EMs. Alibaba is a good example. They initially developed technology in China, but it has transformed the way commerce operates in other emerging markets, as well as its own. The impact that type of transformational technology has on emerging markets is very important, but it doesn't eliminate the important roles of other industries that are still very relevant in EMs and very necessary in the process of development.

And what about the service-driven aspects of EM economies?

Negrete-Gruson: The consumer staples story of multinationals penetrating emerging markets is played out and has been replaced by meeting the desires of an emerging middle class in EMs. These are people who, for example, are looking for their first international vacation. There is a whole crop of opportunities in companies that specialize in services for people who, for the first time, are starting to use their leisure time and their disposable income to travel. There are companies doing this that are very indigenous — very much EM companies. We have businesses in our portfolio, from China and Brazil, that specialize in those services.

I would also include casual dining in the same category. As middle-class households emerge and change, perhaps the mother works, and casual dining becomes more frequent. That's an opportunity that's not exclusive to multinationals – local companies could have a greater edge into capturing and understanding what consumers want and offering these types of services to the population.

Are there particular sectors within emerging markets that you feel merit special attention for ESG strategies going forward?

Negrete-Gruson: It's almost ironic that a lot of the industries that have a bad reputation from an ESG perspective represent some of the best opportunities. Industries and companies and even regions in emerging markets that have historically poor sustainability track records can be the greatest delta for positive change.

Russia is a good example. Everybody knows the social, the environmental, and governance horror stories of the past. But our experience and our long trajectory with that country tell us there are real forces of change happening there, and in many cases exemplary change. Investors might have ignored these companies in the past, but they might present a great opportunity for transformation going forward. There is often opportunity in places that, from the top, might appear among the more unappealing options at first glance.