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SRI/ESG: recent trends for Emerging Markets Funds

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Key points

- Flows to Emerging Markets (EM) Equity and Bond Funds with socially responsible (SRI) or environmental, social and governance (ESG) mandates accelerated sharply in 2020. The AUM of EPFR-tracked SRI/ESG EM Equity Funds nearly doubled; it increased over 100% for SRI/ESG EM Bond Funds.

- Investors steering money into SRI/ESG EM Equity Funds are, on average, getting a better return (before fees) than they would from non-SRI/ESG funds. SRI/ESG EM Bond Fund performance still lags unconstrained funds.

- Motivations for shifting to SRI/ESG strategies vary widely, but their defensive qualities showed up strongly in 2020 and appeal to the asset-rich 'Baby Boomers'.

- The goals embedded in ESG strategies are often at odds with the political imperatives of EM governments. There are signs that, in the case of Russia, investors are questioning whether SRI/ESG Funds can really move the needle.

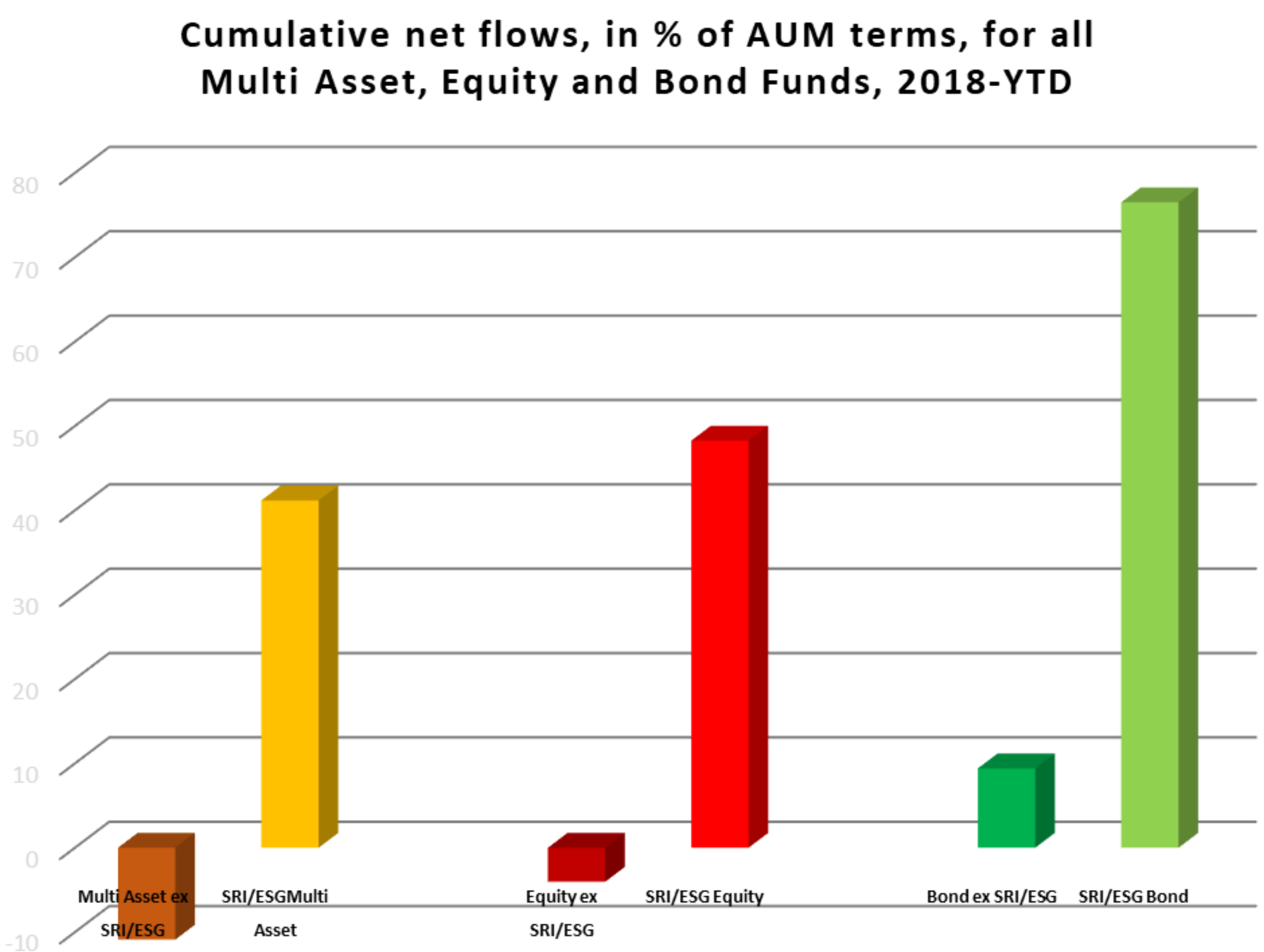
- The expected reset of Sino-US trade relations in 2021 and significant outperformance is prompting investors to shift assets into China-dedicated funds with SRI/ESG mandates.

- Technology, telecoms consumer and healthcare plays are getting a bigger share of the flows from SRI/ESG Growth Emerging Market (GEM) Funds.

For mutual funds, there is a cure...

In 2018 it was rising US interest rates. In 2019 it was Sino-US trade tensions. Last year it was the COVID-19 pandemic. But the result has been the same for many of the fund groups tracked by EPFR: consistent outflows. Since 1Q18 net redemptions from all Equity Funds and Balanced Funds represent 2.8% and 9.8% of their AUM respectively. But, for funds in both those groups with socially responsible (SRI) or environmental, social and governance (ESG) mandates, it has been a very different story.

Over the past 36 months flows into SRI/ESG Balanced, Equity and Bond Funds stand at 43%, 57% and 83% of their AUM coming into 2018.



For mutual funds, there is a cure...

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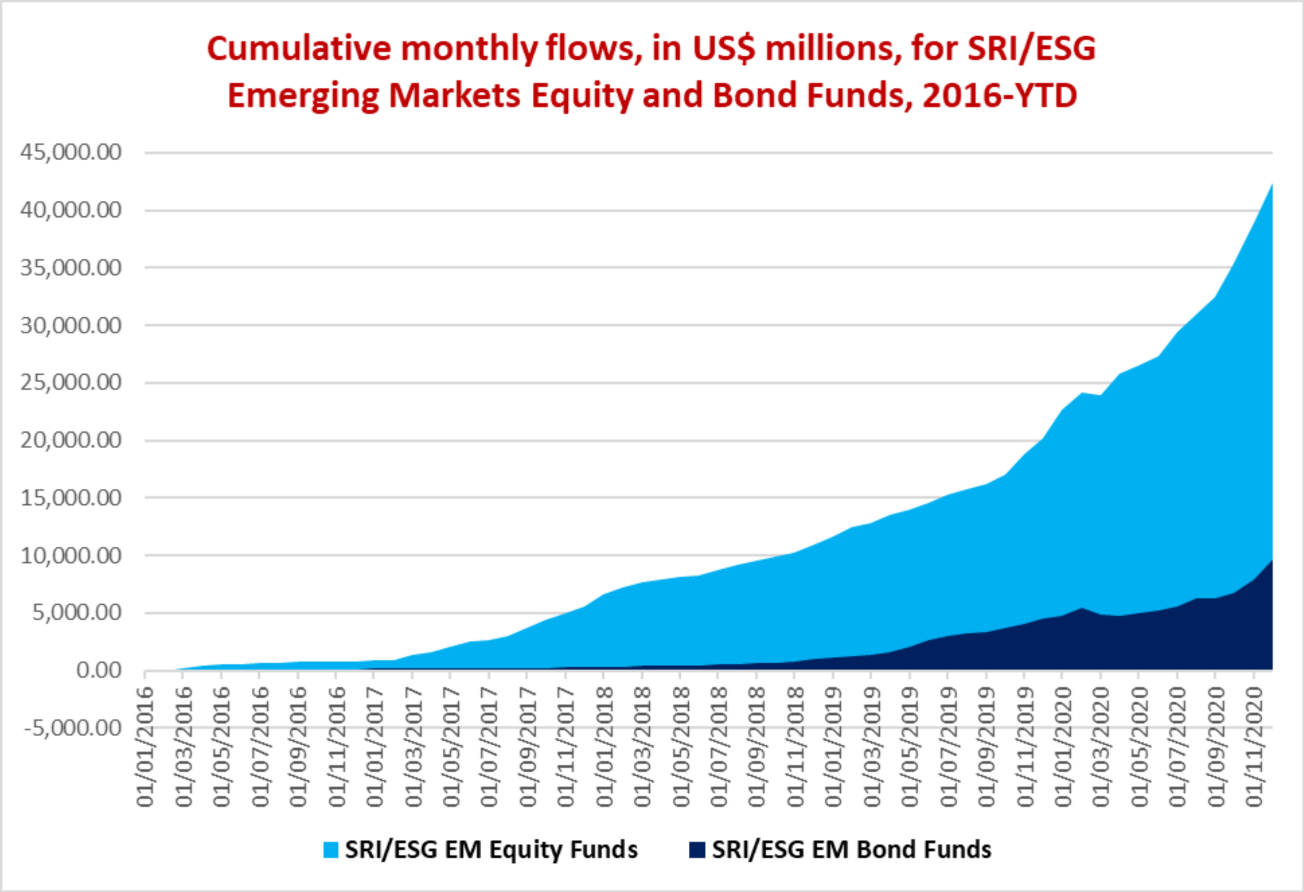
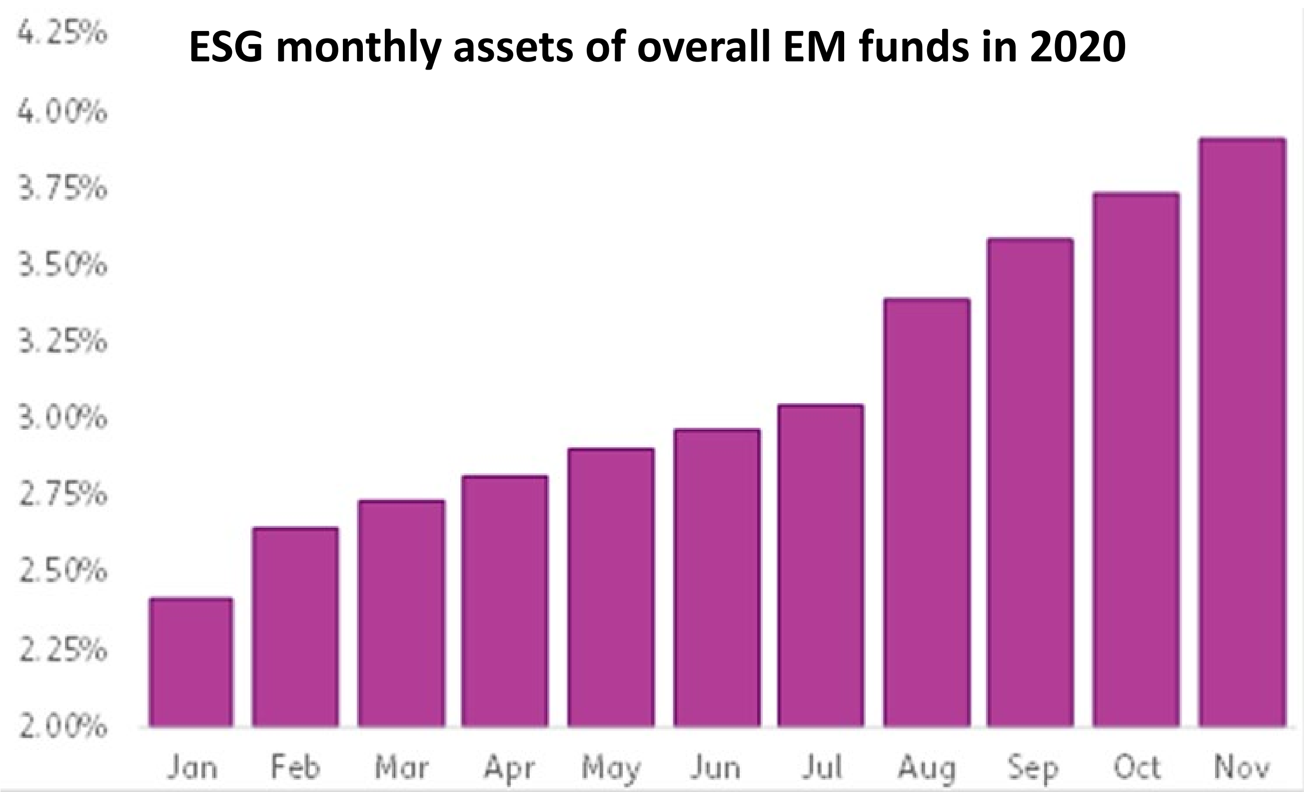
While the growing appetite for SRI/ESG exposure has been evident since the middle of the past decade, there have been some new sub-plots since the beginning of 2018. One of them is the acceleration of flows into Emerging Markets SRI/ESG Equity and Bond Funds.



For mutual funds, there is a cure...

Emerging Markets Equity Funds with socially responsible (SRI) or environmental, social and governance (ESG) mandates carried an inflow streak stretching back to early June into 2021 while SRI/ESG EM Bond Funds posted two new weekly inflow records during the second half of 2020. The share of the total assets managed by all EM Equity Funds that are held by SR/ESG funds has grown from 2.4% to over 4% in the past 12 months.



How much are you paying for your beliefs?

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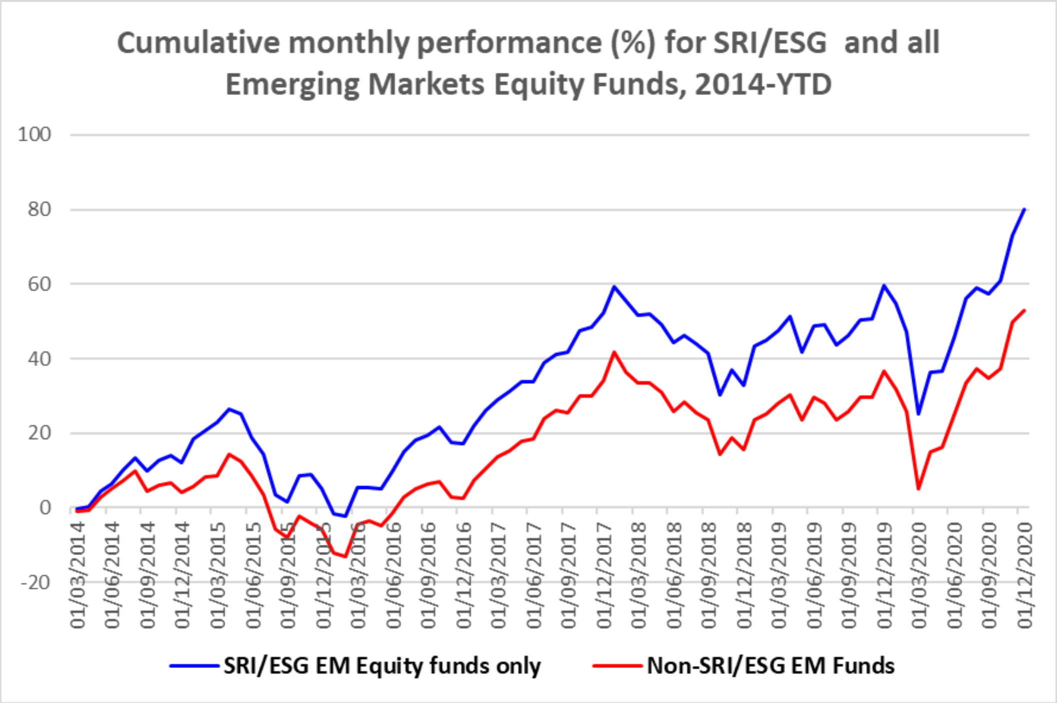
Of the assets currently managed by EPFR-tracked Emerging Markets SRI/ESG Equity and Bond Funds, 74% and 90% respectively arrived since the beginning of 2019. Why? Three reasons crop up repeatedly. First, they are the growing outperformance of SRI/ESG Equity Funds. Second, the extra layer of due diligence they provide investors across all asset classes. And third, the hunger – especially among Millennials and Generation X'ers – for 'non-monetary' returns in the form of social and environmental gains.

The question of whether investing for good requires taking a hit on performance has dogged SRI/ESG Funds for years. However, over the past six years SRI/ESG Emerging Markets Equity Funds tracked by EPFR have collectively outperformed the overall group by an average of 3.9% a year.

That number needs some qualification, since, they need to apply screens to their portfolios on a regular basis, SRI/ESG funds tend to be actively managed – though that is changing -- and to have higher running costs than their unconstrained peers.



Playing good defense...

Although much of the current narrative about SRI/ESG investing centres around the growing role of more idealistic younger investors as the demographic balance between Baby Boomers and subsequent generations starts tilting in favor of the latter, the Baby Boomer generation still control an estimated 60% of all investible assets in the US.

Millennial demand gets a lot of the credit for the surge in flows. But, it is certain that a significant share of the money that has arrived over the past four or five years is coming from other investor cohorts. This group of investors see SRI/ESG as another layer of 'bread-and-butter' due diligence that provides additional downside protection, while generating gains comparable with unconstrained funds and strategies.

The defensive benefits are highlighted in one of EPFR's broader, stock level strategies for unlocking excess value from SRI/ESG fund flows by focusing on the most widely owned assets in SRI/ESG equity fund portfolios.

The strategy ranks stocks (in ascending order) according to the number of SRI/ESG funds holding each security at the end of the previous month, going long the stocks in the top quintile (highest fund ownership) and short the bottom quintile (lowest fund ownership). These portfolios are rebalanced monthly using equal weights.

The table overleaf shows the annualized average monthly returns to the top quintile in excess of that of the bottom quintile, organized against a range of benchmarks. The column "Cross-univ average" is simply the equal-weighted average of the quintile spreads across the four universes.

Playing good defense...

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Sector-neutral annualized quintile spreads (201012-202002)					
Filter	**Cross-univ Average**	**S&P 500**	**Russell 1000**	**MSCI EAFE**	**MSCI EM**
All Funds	+1.4	+2.3	+2.5	+1.5	-0.8
ESG funds	**+2.5**	**+4.1**	+1.8	**+3.1**	**+0.8**
Non-ESG funds	+0.1	+2.5	**+4.5**	-1.1	-5.4

While the excess returns for stocks in MSCI's EM Index and the top quintile of SRI/ESG Fund holdings are not stellar, the poor performance of the top quintile of stocks owned by non-SRI/ESG Emerging Markets Equity Funds highlights the defensive benefits of screening exposure to emerging markets by way of SRI/ESG criteria.

SRI/ESG and the question of divisions

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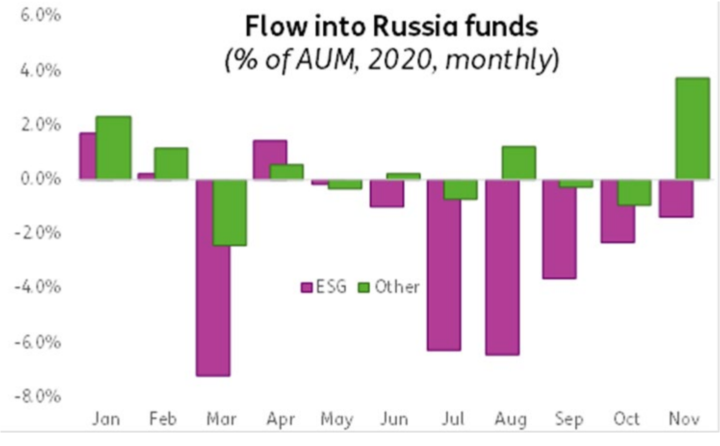
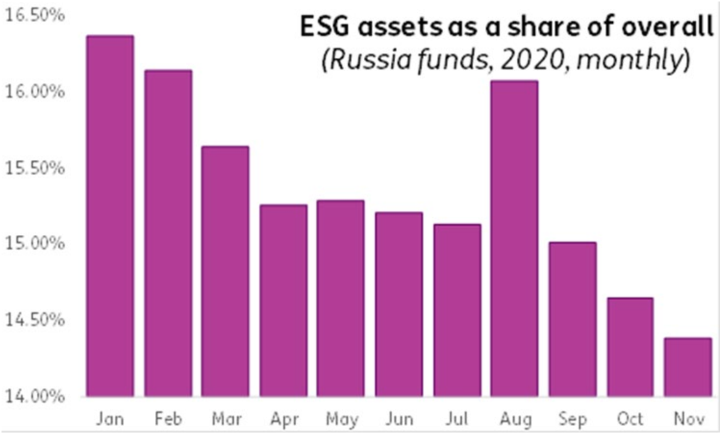
Fairly or not, emerging economies are frequently associated with environmental damage, social disruption and weak governance. For those who commit money to SRI/ESG funds seeking decent ‘non-monetary’ returns, there are plenty of things that need attention in these markets. But the pressure that capital, either foreign or domestic, can exert on recalcitrant governments or profit-oriented companies remains limited.

In 1935, in response to a question about the oppression of Catholics, Russian leader Joseph Stalin responded with a question: “The Pope? How many divisions has he got?” Russia’s current leadership has a similarly hardnosed view of moral authority versus realpolitik. Although equity funds with SRI mandates have, until last year, been committing money to Russia while their conventional peers have headed for the exits, the country has shown itself willing and able to resist the range of sanctions applied by two of the world’s three largest economies, the US and the European Union, for its take-over of the Crimea.

Investors with an ESG/SRI focus are starting to take note. In contrast with the broad trends for emerging markets, flows to dedicated SRI/ESG Russia Equity Funds buckled in 2020 and their AUM declined steadily.



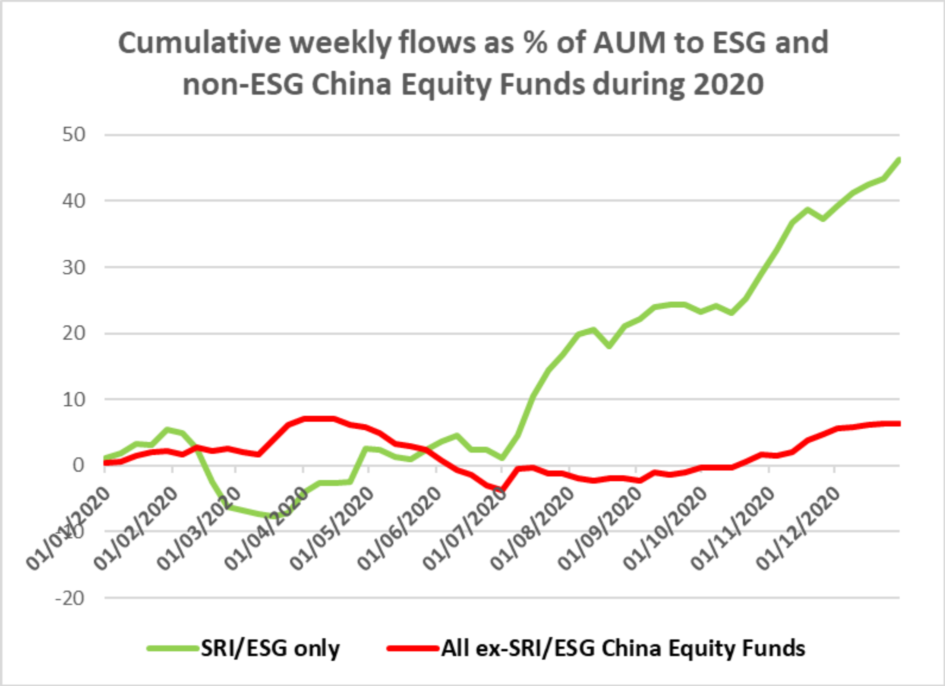


What is the key to China in 2021?

Russia is not the only emerging market that has proved impervious to external pressure on the environment, corporate governance and labor issues. China has given foreign criticisms of its imposition of a new national security law on Hong Kong, its initial response to the COVID-19 pandemic and its treatment of its Uighur minority short shrift. Nevertheless, flows to China Equity Funds with SRI or ESG mandates picked up sharply – in relative terms – during the second half of 2020.

Among the reasons for this increased interest is the perception that President-elect Joseph Biden's administration will frame any reset of Sino-US trade using – at least in part – ESG principles and standards. If this plays out, funds that are already screening their portfolios for compliance with these goals are going to provide investors with a smoother ride than those that do not.

The outperformance of SRI/ESG China Equity Funds relative to their non-ESG peers is also drawing attention, with the collective performance of the former during 2020 near double that of non-SRI/ESG China funds.



Support for healthcare and communications

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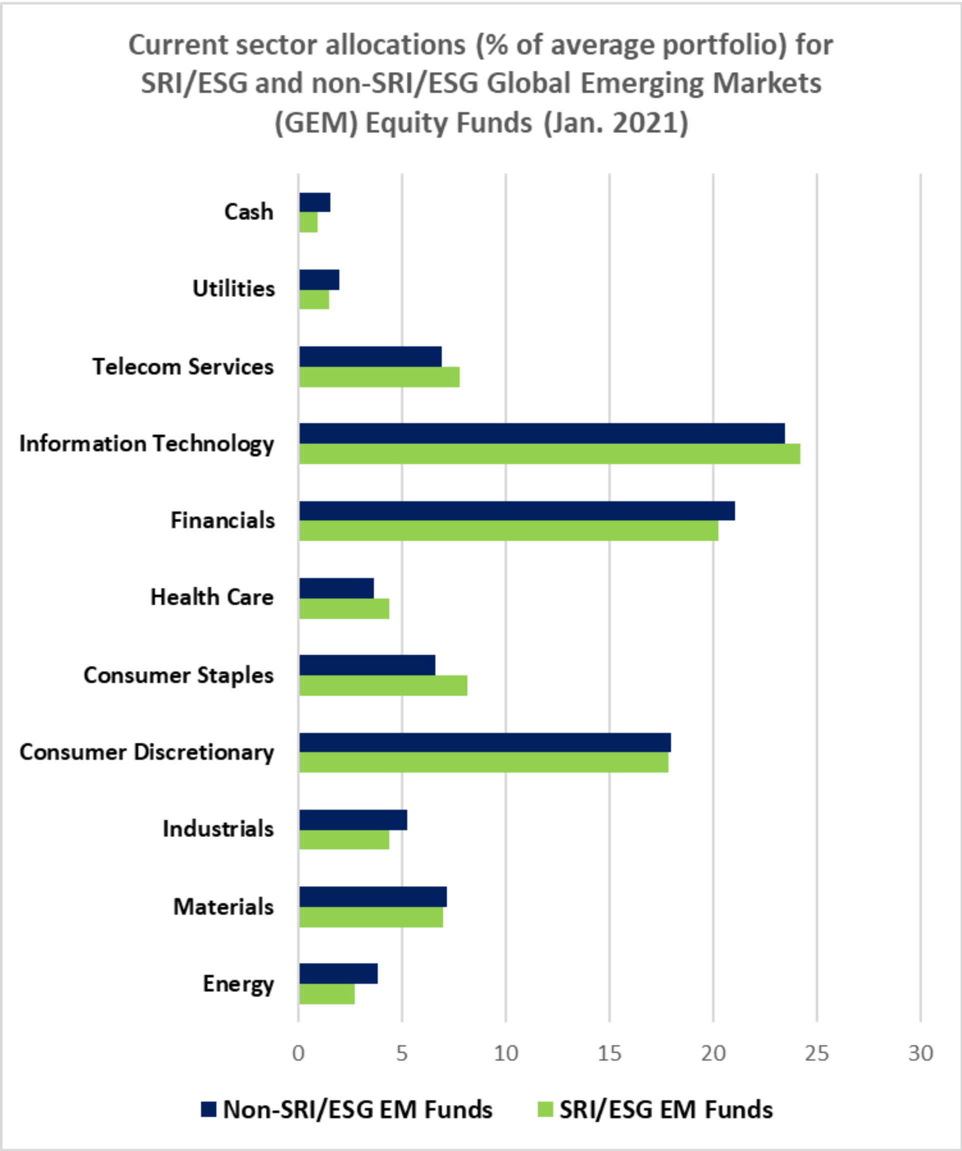
While China looks set to be a major beneficiary at the national level of increasing SRI/ESG flows in the emerging markets space during the coming year, the trend has implications at the sector and industry level.

A comparison of the sector allocations data for SRI/ESG and non-SRI/ESG GEM Equity Funds shows that SRI/ESG fund managers are steering more money to communications, healthcare, technology and consumer staples plays than their non-SRI/ESG counterparts.

With SRI/ESG EM Equity Funds enjoying steadier, more consistent flows than non-SRI/ESG funds, these sectors may have an edge while the global reflation story remains hostage to vaccination roll outs and the ability of the COVID-19 vaccine to mutate.



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