

Socially Responsible Investing in Emerging Markets

SOCIALLY RESPONSIBLE INVESTING (SRI)

- ▶ a \$2.7 trillion global industry — a fast-growing segment of the investment market
- ▶ a strategy that runs the spectrum from single issue screening (e.g., no tobacco) to comprehensive E&S evaluation
- ▶ based on the dual philosophy of providing an additional hedge against risk and long-term value investing

WHAT'S NEW

- IFC/SFMF has commissioned two reports:
- ▶ by ASrIA (Association for Sustainable & Responsible Investment in Asia) — SRI in seven Asian emerging markets (EMs) to analyze market potential; and
 - ▶ by Enterprising Solutions — an inventory of SRI in EMs.

A number of investors are incorporating environmental and social (E&S) criteria into traditional portfolio analysis. Commonly referred to as “socially responsible investing,” SRI is a \$2.7 trillion global industry¹ broadly defined to encompass the most basic E&S evaluation and the most complex. SRI is based on the following beliefs: 1) a company's level of social responsibility can be an indicator of its overall health, and 2) shareholders can influence corporate behavior.

SRI is an investment strategy that evaluates publicly held companies on their financial strength and their E&S impacts — the “triple bottom line.” This serves two investor groups — those who want to align their financial goals with their personal values, and those who believe that socially responsible companies will do better financially in the long term, despite inconclusive returns in the short term (see box below).

the brief

Its business rationale stems from a joint philosophy:

- ▶ evaluating a company's environmental and social impact on top of its financial performance provides an **additional hedge against risk**;
- ▶ socially responsible companies tend to be top-performing industry leaders, thus offering **long-term value investing** (e.g., BP Amoco, Microsoft, Sony, Citigroup, Honda, UBS).

Depends on Whom You Ask . . .

- ▶ In 2003, 67% of the 52 screened U.S. funds tracked by SIF earned the highest ratings for performance from Lipper and/or Morningstar.
- ▶ A Morgan Stanley study found that sustainability leaders in the MSCI World Index financially outperformed sustainability laggards over the past 4 years.
- ▶ A Wharton School study found that SRI mutual funds underperformed portfolios representing a broader fund universe.
- ▶ A study of 103 German, US, and UK SRI mutual funds found no significant difference between their returns and those of unscreened funds.

Sources: SIF, 2003; www.sri-advisor.com; www.sristudies.org



¹ Social Investment Forum (SIF), 2003; SIF is one of the few organizations offering high-quality SRI data.

THE BOTTOM LINE

- ▶ Although current returns are not in the top quartile, SRI's evolution from an ethics-driven to a business-driven strategy provides investors with an additional hedge against risk and long-term value investing
- ▶ Global desire to help developing countries and international supply chain pressure are the primary drivers in the emerging markets (EMs)

FUTURE FORECAST

- § SRI's success in EMs will hinge on: international and domestic pressure, increased awareness and cultural adjustments, EM-specific data/analysis, growth of corporate social responsibility among EM companies, E&S evaluation becoming a mainstream analytical tool, increased liberalization of EMs, increased transparency, limited supply of traditional investment options
- § As the EM SRI industry matures, a number of questions will be raised:
 - How should SRI be defined for EMs? Is the current definition misleading?
 - Is it reasonable to apply SRI methodologies from the developed world to EMs?
 - How does the bias toward large capitalization companies restrict SRI's impact?
 - How will the industry confirm analytical veracity when EM data are limited and lacking transparency?
 - Which evaluation methodologies will be feasible and have the greatest impact on sustainability?
 - How will the market react to the wide range of SRI evaluation? Will the simplest screening approach be considered insufficiently rigorous to meet the definition of "social responsibility"?

OPPORTUNITIES

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|--------------------|--|
| Risk reduction | <ul style="list-style-type: none"> ▶ including top performers helps weather bear markets ▶ SRI's specialized research is not found in typical investments ▶ SRI and EM investments diversify a portfolio |
| Good returns | <ul style="list-style-type: none"> ▶ EMs include some fast-growing economies ▶ nascent market provides undiscovered opportunities ▶ many EM companies are undervalued |
| Secondary benefits | <ul style="list-style-type: none"> ▶ relatively easy way to leverage capital into social benefit ▶ provides incentive for social responsibility; practices can permeate local supply chain ▶ investors have role in sustainable development |

RISKS

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| Different investment approach | <ul style="list-style-type: none"> ▼ two poorly understood, niche markets — EMs and SRI ▼ no conclusive proof that SRI outperforms its traditional counterparts ▼ SRI has to be accepted as long-term, value investing ▼ "one-size-fits-all" methodology cannot work ▼ lack of high-profile funds and limited long-term performance data |
| Cultural barriers | <ul style="list-style-type: none"> ▼ varying definitions/valuations of social responsibility ▼ traditional SRI drivers not as influential |
| Data availability and lack of transparency | <ul style="list-style-type: none"> ▼ limited data availability and costly data collection create barriers to entry and reduce fund availability ▼ difficult to transfer developed world methodologies to EMs ▼ many EM countries experience economic instability, weak investment and legal infrastructure, weak regulatory enforcement, unpredictable government involvement ▼ negligible independent oversight can encourage false claims |
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