

Socially Responsible Investing in Emerging Markets

overview

BACKGROUND

SRI began with a religious focus, expanded with 1960s activism, and was galvanized by anti-apartheid divestment efforts in the 1980s. A portion of it has evolved from a purely ethical/social basis by incorporating the business component and becoming a “triple bottom line” strategy for both individuals and institutions.

The US and UK were at the forefront of SRI, initially driven by a combination of domestic consumer and institutional demand, impending environmental/social regulation, internal management vision, and access to corporate data. In the past several years, institutional investors in the US and Europe have chosen to apply SRI to their portfolios. Recent US corporate scandals and anti-globalization protests solidified the link between company activity and investor behavior. Enron's corporate governance breach pushed its stock price from \$82/share to pennies in less than 11 months¹ and in doing so, pushed an SRI-type issue firmly into the investment mainstream.

SRI funds consist of publicly held stocks and/or bonds from many sectors, at various levels of market capitalization, and can range from single issue (e.g., a tobacco-free fund, an Islamic fund) to comprehensive (all socially responsible issues). As the industry has evolved, SRI has become an umbrella term that encompasses the most basic environmental and social (E&S) evaluation to the most complex (see “How SRI Works”). Based on the

broadest definition, currently there are 200 SRI mutual funds in the US alone, and SRI assets under management equal \$2.18 trillion, representing 11% of total US assets under management.² In the UK, institutional SRI assets equal \$399 billion, including \$6.6 billion in retail SRI funds.³ SRI has therefore become an established industry in many parts of the developed world.

HOW SRI WORKS

SRI involves two major approaches: company screening and shareholder engagement (examples are listed below). Screening is classified as either *avoidance* (excluding a company if it makes harmful products or has patterns of egregious behavior) or *positive* (including a company if it proactively engages in socially responsible behavior). Shareholder engagement is conducted through active board participation, proxy voting, direct communication with management, and, in some extreme cases, even lawsuits. Screening is conducted pre-investment, while shareholder engagement is pursued post-investment.

The SRI industry commonly uses some combination of avoidance and positive screens and more and more firms in the industry are adopting shareholder

facts & figures



EMs Offering SRI Funds

- South Africa
- South Korea
- Brazil
- Malaysia

engagement tactics. In the absence of a standardized definition of SRI, however, there are nearly as many screening methodologies as there are practitioners. Some SRI institutions use the simplest avoidance screen (e.g., no tobacco), some use both avoidance and positive screens, and some use a “best-in-class” approach, which selects only the most socially responsible companies in a given industry. The more complex the approach, the greater the attempt to quantify the non-financial aspects of a company's operations.

SRI AND EMERGING MARKETS (EMs)

SRI is in the early to mid-stage of maturity in the developed world, but in the early stages in the EMs. The initial activity was very sparse — as in the developed world, it was limited to religious funds. SRI in EMs has expanded in recent years and is offered via developed country funds and indigenous

SRI TOOLS

AVOIDANCE SCREENS	POSITIVE SCREENS	SHAREHOLDER ENGAGEMENT
Alcohol	Environment	Proposing shareholder resolutions
Tobacco	Corporate governance	Meeting with company officials
Gambling	Labor relations	Attending shareholder meetings
Nuclear power	Human rights	NGO buying shares to interact with company
Defense/weapons	Community relations	

¹ Business Week, 2002.

² SIF, 2003.

³ Eurosif, 2003; Enterprising Solutions, 2003.



EM funds. Today, 55 such funds with a combined \$2.7 billion in assets contain EM holdings.⁴

This growth stems from two external sources:

- ▶ global concern for developing world problems;
- ▶ international supply chain pressure – SRI's progress has been slower in EMs than in the West because domestic consumer and institutional demand has yet to fully materialize.

The industry also faces some unusual challenges:

▶ **Cultural climate**

- the definition of social responsibility varies across EMs. In some countries, E&S issues are believed to be solely the government's job;
- individuals, investors, and companies may not embrace civic responsibility or demand it from the private sector, both of which are the core of the SRI market;
- there is a skewed perception of risk/return balance. Treating EMs as a homogenous group misrepresents individual country risk and dilutes the business case.

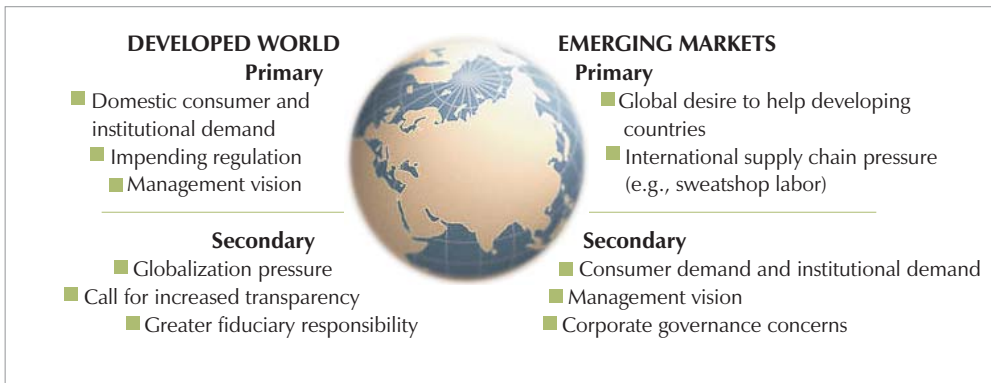
▶ **Data availability and lack of transparency**

- the quality of SRI evaluations hinges on the data. Publicly available company data on E&S issues are limited in EMs. Having to contact each company increases data collection costs and subjectivity. In countries with disclosure regulations, enforcement may be inconsistent.

ITS FUTURE

It is difficult to predict SRI's potential in EMs at this early stage. If SRI does

sri drivers



indeed offer better risk reduction and long-term value growth, these benefits could be even more pronounced: EMs include some fast growing economies and undervalued companies, which can generate good returns. Traditional EM investments are considered risky because company practices generally are not transparent and EMs often face economic instability and a weak investment infrastructure. SRI's additional layer of research asks questions that traditional investments do not, potentially exposing hidden risk.

SRI-type evaluation may also act as a useful proxy tool for gauging a company's strategic awareness and overall management quality. As corporate social responsibility is a relatively new concept in EMs, it is reasonable to assume that a company adhering to SRI criteria has done so based on internal motivation and a desire to be a global player. Such a company is likely to also excel in terms of corporate governance, financial control, labor relations and quality assurance.

Other arguments for SRI in EMs include:

- ▶ it could help international investors to reduce their exposure to market volatility by diversifying their portfolios;
- ▶ EMs are largely untapped, so there are opportunities to discover the next market leader;

- ▶ there is evidence that shareholder engagement can have a positive influence on EM corporate behavior;⁵
- ▶ a recent survey estimated a \$500-\$700 million latent demand for EM SRI investments;⁶
- ▶ on a dollar per dollar basis, EM investment can have a greater positive economic and development impact.

Investors will need to test such arguments carefully. Even in the presence of a compelling business case, some unusual and complex challenges will need to be addressed for SRI to gain real traction in EMs.

The question mark on SRI's future in EMs stems from the unique challenges associated with this particular industry and to a lesser degree, the typical growing pains facing any new industry. Despite this uncertainty, a rising interest in the potential investment and development impact of SRI in EMs has led several groups to begin to address these challenges (see "What's New," page 1 of The Brief and "Regional Activities" on page 4 of this document).

trends

GROWTH

Increased awareness of developing world issues, increased liberalization of EMs, increased NGO activism, legislative stimulus, institutional investor activity, and consumer demand can stimulate SRI. EMs also offer new market

⁴ Enterprising Solutions, 2003.

⁵ Ibid.

⁶ Ibid.



opportunities for SRI financial institutions in the developed world. Conversely, the demand for SRI will be constrained by limited awareness of its business and development benefits, limited individual and private sector involvement in E&S issues, SRI industry's reluctance to embrace EMs, and cultural, cost, and informational barriers.

It is important to realize that as the EM SRI industry matures, it will be heavily scrutinized. It is an industry with two major goals — providing a long-term investment option that can reduce risk, and stimulating sustainable development in EMs — so it will be questioned on several key issues: definitions, methodologies, its actual impact on sustainable development, and its analytical rigor, feasibility, and veracity.

TOOLS AND METHODOLOGY

Traditional SRI tools and methodologies cannot be applied directly to EMs due to different economic climates and cultures. Country-level data/screening analysis, reporting tools, certification, and indices will be needed. The more marketable funds are likely to be regional or country funds, funds that address specific sustainability issues (e.g., poverty fund, AIDS fund) and high social impact investments. Infrastructure supporting EM/SRI research and information dissemination will become critical. Corporate governance issues and shareholder engagement will be popular.

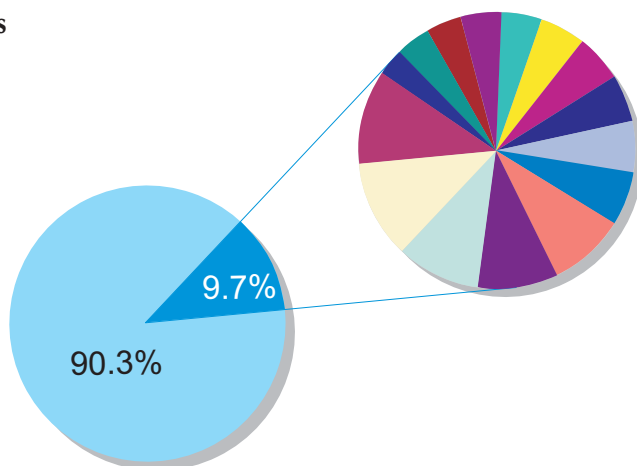
FUND HOLDINGS

In the near term, SRI EM funds will consist of: MNC operations in EMs, brand-name domestic companies, and domestic financial institutions. In the longer term, these funds will expand to include large domestic suppliers to MNCs and small/medium and lesser-known large companies.

US-based International SRI Fund: Emerging Markets Holdings

Developed Countries ■

Brazil	0.6%
Czech Republic	0.5%
Hungary	0.5%
India	0.9%
Indonesia	0.5%
Israel	0.4%
Mexico	0.6%
Philippines	0.2%
Poland	0.4%
Russia	0.3%
South Africa	1.25%
South Korea	1.3%
Taiwan	1.1%
Thailand	1.0%
Turkey	0.3%



the numbers

SRI IN EMs

- ▶ Assets of retail SRI mutual funds (from developed countries and EMs) with EM holdings = \$2.7 billion across 55 funds⁷
- ▶ South Africa and Asia are the largest recipients of EM SRI investments⁸
- ▶ Institutional SRI in EMs is \$2.4 billion (held mainly by a few pension funds)⁹

As shown in the table on the right, the developed world offers 38 SRI funds with EM assets and the EMs offer 17 SRI funds. In most cases, however, EM countries comprise a nominal amount of a fund's total holdings.

An example of a US international SRI fund is provided above — it shows that 15 EM countries together comprise only 9.7% of the entire fund (total fund assets = \$147 million).

SAMPLE LIST OF EM COMPANIES IN SRI PORTFOLIO

- South African Breweries; Nampak (S. Africa)
- PetroChina (China); Samsung Electronics (S. Korea)
- Bajaj (India); Unibanco (Brazil)

SRI Emerging Markets Assets*

	Number of Funds	Emerging Markets Assets (\$US millions)
Developed Country Retail Mutual Funds with Emerging Markets Assets		
Asia**	5	0.41
Australia	1	0.6
Canada	9	13.6
Europe	0	0.0
United Kingdom	6	3.6
United States	2	21.5
Subtotal	23	39.1
Institutional SRI***	15	1,440
Total	38	1,479.7
Emerging Market Retail Mutual Funds		
Brazil	1	4.7
Korea	2	18.8
Malaysia	1	39.0
South Africa	5	228.0
Subtotal	9	290.7
Institutional SRI****	8	956.0
Total	17	1,246.7
Total Emerging Market SRI	55	2,726.4

* Does not include Islamic funds.
 ** Assets for Singapore only. Data not available for Hong Kong funds.
 *** Includes only CalPERS.
 **** Includes only South African institutional funds.
 Source: *Enterprising Solutions*, 2003.

⁷ Ibid.
⁸ Ibid.
⁹ Ibid.

Regional Activities

- ▶ Johannesburg Stock Exchange and FTSE will launch an SRI index in April 2004
- ▶ In Asia, companies ranked highly based on corporate governance criteria outperformed their respective country indices in 9 out of 10 markets
- ▶ Malaysia's leading institutional investors formed the Minority Stakeholders Watchdog Group
- ▶ India, Taiwan, Thailand, Russia, Chile are introducing initiatives to strengthen shareholder rights, particularly minority stakeholders
- ▶ South Korea's Center for Good Corporate Governance was set up to act as a watchdog for institutional investors
- ▶ 1st International Korean SRI Conference was held in 2003
- ▶ 1st SRI in India Conference was held in 2003
- ▶ Brazil's Bovespa New Market (SRI) Index has outperformed its main index by 1% since its inception in 2001

- ▶ Business in the Environment Index/Business in the Community Index (www2.bitc.org.uk/index.html)
- ▶ Gradient Index (www.gradient-index.net)
- ▶ Global Reporting Initiative (www.globalreporting.org)
- ▶ UN Global Compact (www.unglobalcompact.org)

EM Organizations

- ▶ ASrIA (Association for Sustainable & Responsible Investment in Asia) (www.asria.org)
- ▶ AICC (African Institute of Corporate Citizenship) (www.aiccafrica.com/index.htm)
- ▶ INCAE (Latin American business organization) (www.incae.ac.cr/EN)
- ▶ Ethos Institute of Brazil (www.ethos.org.br)

INTERNATIONAL SRI IN THE DEVELOPED WORLD

TOTAL ASSETS (U.S.\$)¹⁰
US SRI assets under management: \$2.18 trillion
US SRI mutual funds: \$162 billion
US international SRI funds: \$283 million
PENSION FUNDS ADOPTING SRI
CalPERS (US)
TIAA-CREF (US)
Universities Superannuation Scheme (UK)

SRI Indices and Guidelines

- ▶ Dow Jones Sustainability Index (www.sustainability-index.com)
- ▶ FTSE4GOOD Index (www.ftse4good.com)
- ▶ Ethical Sustainability Index (www.ethibel.org/subs_e/4_index/Main.html)

All About IFC

The International Finance Corporation (IFC) is an international organization which promotes sustainable private sector development in its developing member countries as a way to reduce poverty and improve people's lives. Since its inception in 1956, IFC has committed more than \$34 billion of its own funds and has arranged \$21 billion in syndications for 2,825 companies in 140 developing countries. In terms of annual investment, the financial markets sector has become the single largest recipient (49% of total investment in FY2003).

About SFMF

IFC's Sustainable Financial Markets Facility (SFMF) is a donor-funded technical assistance program focused on the private financial sector in the emerging markets. Through the Facility, IFC provides a range of capacity building, best practice development and market-making activities to promote environmental and socially responsible and sustainable business practices in banking, insurance and investment.

The Facility currently receives funding from IFC and the Governments of Switzerland, the Netherlands and Norway.

About MIBs

This Market Intelligence Brief (MIB) is produced by IFC through the support of SFMF. The goal of the MIB series is to collate, analyze and disseminate intelligence on sustainability business issues relevant to emerging market lenders and investors.

The information provided in this document is not intended to be nor should it be construed as investment advice. Recipients should undertake their own independent evaluation and analysis with respect to any potential investments discussed herein.

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Sample Emerging Market SRI Fund Performance

Fund	Period (%)		
	3 Months	1 Year	3 Years
South African Equity Funds			
African Harvest Women's Initiative Fund	-9.4	1.9	9.3
Community Gift Fund	7.4	24.3	19.3
Community Growth Fund	11.7	-4.9	7.0
Fraters Earth Equity Fund	10.8	9.7	NA
Futuregrowth Albaraka Equity Fund	7.7	4.0	26.2
South African Equity Fund Benchmarks			
FTSE/JSE Free Float All Share Index	9.7	-8.30	6.8
MSCI World (Equity) Index	11.9	-42.40	-9.6
JP Morgan Global Bond Index	6.7	-14.6	20.3
Asian Equity Funds			
Kingsway China Fund	NA	-9.0	-24.0
Kingsway Emerging Economies Fund*	NA	-26.0	-49.0
Kingsway Pacific Fund	NA	-31.0	60.0
Asian Equity Fund Benchmarks			
MSCI China		-1.0	-51.0
MSCI Indonesia*	—	38.1	-23.1
MSCI Pacific	—	-11.0	-45.0
Brazilian Equity Funds			
ABN AMRO Fondo Ethical	NA	1.57	NA
Brazilian Equity Funds Benchmark			
Ibovapex	—	-17.8	—

Source: *Enterprising Solutions*, 2003.

TOP SECTORS IN INTERNATIONAL SRI FUNDS

Banking/Financial	Utilities
Telecommunications	Information Technology
Retail/Consumer Goods	Industrials
Health Care	Energy

¹⁰ SIF, 2003.

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