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WHY ESG FOR EMERGING ASIA

Given the challenges, why bother?

- Using Environmental, Social and Governance (ESG) factors in the search for alpha is complex, particularly in Emerging Markets.
  - Investors will often have their own standards for what constitutes acceptable ESG criteria.
  - The contribution of ESG to investment performance is often difficult to establish, especially a priori.
  - In Emerging Markets (EM), many stocks are off benchmark and therefore not captured by independent ESG data providers, which can lead to mispricing.
- However, there is consistent evidence that in Emerging Markets, good Governance is a key indicator of value. Similarly, Environment and Social factors are important red flags as part of buy and sell disciplines.
- Hence, we believe that there is a strong case for ESG criteria—in particular Governance—to be an integral part of a fundamental research process for stocks in EM, and Nikko AM's Asia Equity team has been incorporating this criteria into its analysis since inception over ten years ago.

This paper reflects on recent industry research into ESG and Nikko AM's own experience in applying ESG analysis - particularly Asian EM stocks, as well as what we see as key lessons learned.

The issues with ESG

A recent RBC survey* highlighted investor dissatisfaction with ESG approaches. 52% responded that negative screening is not applicable to a broad spectrum of investors, and less than a third felt that negative screens contributed to alpha—i.e. that applying negative screens was a philosophical rather than an alpha-driven choice. In the same report, only 17% of respondents said they were satisfied with the quality and quantity of ESG related data from companies.

These concerns are particularly relevant in EMs, where institutional controls are not as robust and the effectiveness of ESG policies can be harder to identify. As the PRI** notes "Disclosures on environmental and social issues tend to be weaker—many companies do not report and those that do usually focus on philanthropic activities."

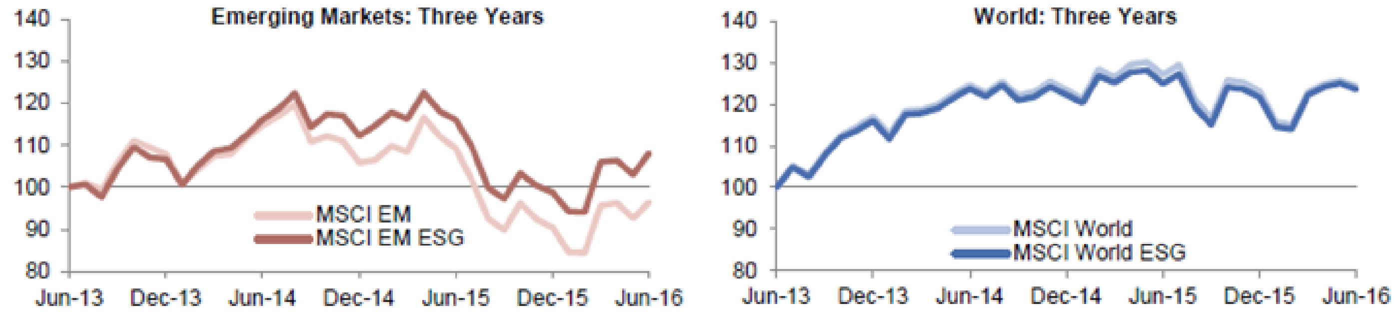
Nikko AM's experience in Asian EMs is that benchmarks are of limited value, particularly to active management. Around 25% of the stocks in our Core Asian Equity portfolios are not covered in the MSCI AC Asia ex Japan benchmark, and these include companies involved in waste water treatment, healthcare services and solar panel glass manufacturing—that rate highly on our own ESG criteria, but are invisible to a benchmark screening approach.

In the small- to mid-cap segment of the market, where there are many alpha opportunities this problem is more acute. Essentially, a benchmark leads to a larger cap bias to ESG, not necessarily aligned to performance.

*RBC Survey Reveals Opportunities and Obstacles in ESG Investing – press release 15 Nov. 2016

**PRI Report "Asian Markets Investor Obligations and Duties in Asian Markets", 7 September 2016

MSCI ESG indices vs. parent indices—EM outperforms World



Source: Cambridge Associates The Value of ESG Data, October 2016

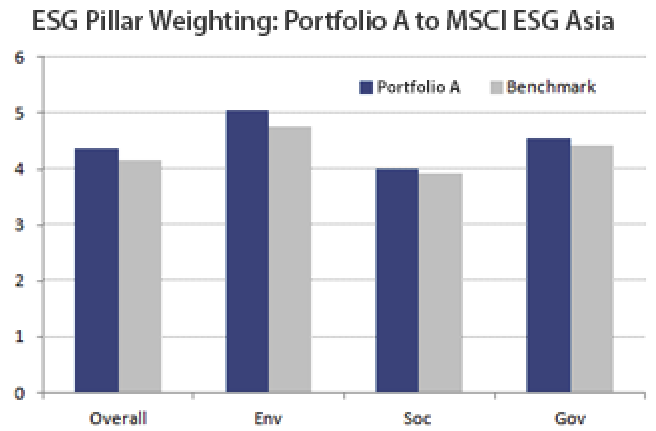
Cambridge Associates analysis shows that ESG-based stock selection can add value in EMs, after screening out for other factors such as style, country and sector exposure. With the MSCI EM ESG index outperforming its parent MSCI EM index by a cumulative 12% in USD terms since its launch in June 2013.

Interestingly, a key reason why MSCI EM ESG outperformed MSCI EM is because of Governance factors, which resulted in it underweighting many State Owned Enterprises (SOEs), whose large market cap is a significant portion of the EM Index. Cambridge Associates does mention that if the same ESG criteria had been applied in earlier periods such as pre-2010, when SOEs were seen as a safe way to access EMs, then the ESG EMs criteria would not have performed so strongly. However, in the last five years SOEs have lagged the rest of EMs—which Nikko AM also sees reflected in our belief, that there is a growing divide between New and Old Asia businesses. Our experience has been that SOEs that improve ESG can perform well and thus should not be ruled out purely for state ownership.

This experience is supported by ECCE & NN IP research* which shows ESG momentum can improve Sharpe ratios. For EM markets, if a company makes a meaningful effort to improve its ESG credentials, it can on average expect its share price performance to improve. ESG momentum positive EM companies had an average Sharpe ratio of around 0.46, versus ESG momentum negative EM companies with a rating of around 0.17.

Similarly, many Asian firms are family owned enterprises, and this can also be seen as a negative Governance indicator**. However, as with SOEs, we believe that ownership structure needs to be viewed in the context of Governance policies and behavior, such as treatment of minority shareholders, prevalence of intercompany transfers and other factors, in order for an informed assessment to be made in an ESG rating.

There is also the difficulty of separating ESG from other sector / style and country sector factors for active managers.



Source: Nikko AM analysis on MSCI Asia ESG. Any references to particular sectors are for illustrative purposes only and are as at the date of publication of this material. This is not a recommendation in relation to any named sectors and no warranty or guarantee is provided.

* EECE & NNIP "The Materiality of ESG Factors for EM equity investment decisions" Oct 2016

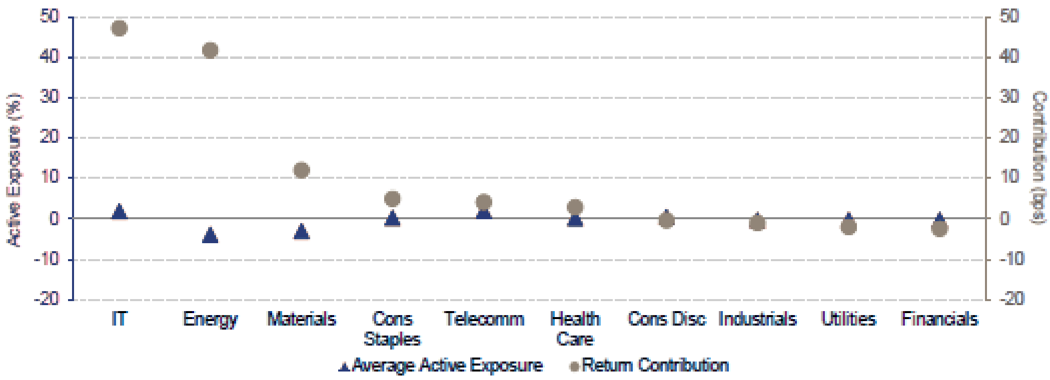
**The Influence of Family Ownership on Corporate Social Responsibility" Rees & Rodionova 2014

As the previous charts show, Nikko AM's Portfolio A is heavily overweight in MSCI Asia ESG AA and A rated stocks. By factor, while we are overweight all—Nikko AM is higher on Environment than Governance. This is odd, given our emphasis on Governance as a key purchase criteria, as we see it as indicative of good business ethics and hence Social and Environmental responsibility as well.

The likely reason for this is that Nikko AM's Portfolio A currently has a large weighting in new emerging growth industries in Asia, including technologies such as electric vehicles and solar energy, and limited positions in older more commodity oriented industries and utilities, such as coal and power. These sector allocations are less a reflection of ESG principles per se, and more where our Asia Equity research team sees long-term growth opportunities at reasonable valuations.

Similarly, country allocation also can impact ESG attribution. Singapore and Malaysia score relatively highly in terms of MSCI ESG criteria, whereas both countries are underweights for Nikko AM—again based on our investment expectations rather than ESG concerns. Hence, Nikko AM's Portfolio A's current country allocation vs. benchmark is also a likely factor in the higher Environmental factors over Governance factors in our weights against benchmark.

MSCI EM ESG Index: Active Exposure and Excess Return Contribution by Sector



Source: Cambridge Associates The Value of ESG Data October 2016

This highlights the difficulty in comparing concentrated active-management against ESG benchmarks—particularly in EM where limits on market capitalization deviations mean that ESG indexes still tend to favor large established industries, while smaller companies in new growth sectors (potentially with higher ESG impact) are not captured.

Nikko AM Asia Equity Team's Approach to ESG

From the analysis performed by Cambridge Associates and Nikko AM's own experience, we see a consistent link between ESG factors and returns—particularly when it comes to Governance. As discussed, the assessment of governance in relation to ownership structure creates many contrasting opinions. The underweight allocation to SOEs contributed to MSCI ESG Index outperformance relative to the headline MSCI Asia ex Japan but this may not always be the case particularly when an SOE improves its ESG factor. Another key challenge with performing ESG analysis in Emerging markets is data availability, reliability and comparability. We generally find that firms with lower level of disclosures tend to perform less well over the long term.

For these reasons an assessment of ESG factors, with emphasis on Governance, has been part of our bottom-up fundamental research process since the inception of Nikko AM's Portfolio A. Nikko AM's Asia Equity team describe the approach as "ESG Incorporated" rather than ESG specialist—the analysis is integrated in our investment process rather than leading it. ESG issues are incorporated into the investment analysis and decision-making process at Nikko AM where they are consistent with our fiduciary responsibilities.

Above all we focus on Governance factors in Asia with an emphasis on beneficial ownership, track record, capital allocation decisions and management quality. Environmental and Social factors are becoming increasingly important to returns and while we do assess them independently we generally find a strong adherence to good Governance practices are complemented with good Environmental and Social practices. This approach helps guide us where data integrity is lacking.

Companies are assessed relative to their industry and country peers by our team of sector analysts through both background research and management engagement. This relative assessment allows us to incorporate ESG principles into our allocation decisions in a way that is compatible with our concentrated, active approach to alpha generation.

Conclusions

- There is economic value in incorporating ESG factors into the investment process for Asian EMs—and Governance is a particularly useful indicator.
- However, context is important; for example, ownership needs to be examined in context of how control is exercised, and what disclosures are provided.
- EMs are alpha-rich, and active managers should be able to invest off-benchmark to capture excess returns. An active strategy incorporating ESG requires fundamental research, rather than a reliance on screening.

Important Information