OAKTREE INSIGHTS

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AN ESG FOCUS FOR EM EQUITIES INVESTING

OAKTREE

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KEY POINTS

- In this paper we highlight the particular importance and implications of incorporating environmental, social and governance (ESG) matters into emerging markets (EM) investing.
- ESG factors are part and parcel of the fundamental, bottom-up research conducted by Oaktree's Emerging Markets Equities strategy.
- In our view, opportunity can be found in the less-efficient emerging markets, where ESG investing remains less prevalent than in developed markets. Oaktree's proprietary ESG analysis—coupled with what we believe to be a knowledge advantage vis-a-vis the regions, markets and sectors we cover—can positively affect our ability to select the right companies and position our portfolio for success.
- We recognize there are various closely related terms that are used to describe ESG investing. For the purpose of this paper, we use the terms "responsible investing" and "ESG investing" interchangeably, in line with the definition put forth by the United Nations-supported Principles of Responsible Investing (UN PRI) that "responsible investment [is] a strategy and practice to incorporate environmental, social and governance factors in investment decisions and active ownership."

ESG investing is here to stay. Growing interest in responsible investing continues to drive investors to assign greater weight to ESG factors in their portfolio management. Assets dedicated to "sustainable" investing were estimated at $30.7 trillion across major global regions in 2018, representing a 34% increase from two years earlier and about a third of the regions' total investment assets under management.[1] Among U.S. individual investors, attention paid to "sustainable" investing is at a new high, with 85% of the general investor base and 95% of Millennials expressing interest.[2]

It wasn't very long ago that ESG investing was considered a niche practice, something that suggested the potential for an unfavorable trade-off between do-goodism and financial performance. This investment approach had largely to do with exclusionary screening, practiced by organizations that restricted investing in industries or companies that they saw as running counter to their values or ethics. Over the years, however, ESG investing has expanded in scope and evolved from something of a satellite bucket to a key element in due diligence and portfolio management. This categorical shift has taken place more or less in line with societal and demographic developments (even as individual calls to action and landmark studies should be credited with pushing the story forward).[3] Investing in anything is an evolutionary process, in our view, and ESG investing has taken root as markets become more sophisticated; businesses take on broader responsibilities; and society moves toward more holistic investing variables.

Oaktree as a firm recognizes that ESG considerations are at the core of ethical and socially responsible investing and can positively impact investment performance over the long term. As a signatory to the UN PRI, we believe integrating ESG factors into our investment decisions is consistent with our fiduciary duty to act in the best interest of our investors. This view is exemplified in the approach taken by our Emerging Markets Equities strategy, which has actively developed and deployed its proprietary ESG investment matrix as part of everyday investment analysis. This matrix informs our fundamental bottom-up, quantitative research process and, ultimately, supports potential alpha generation. We believe utilizing this process helps us approach investing through an ESG "lens," whereby we can better collaborate with management and guide companies to higher standards of behavior, as well as seek greater shareholder returns.

ESG CHALLENGES AND OPPORTUNITIES IN EMERGING MARKETS

As understanding of ESG investing deepens, global investors would be remiss if they overlooked the relevance of ESG factors in regard to investing in emerging markets, which we believe have greater potential for long-term economic growth than the more developed geographic areas around the world.

The pace of growth in ESG investing in major world markets such as Europe and the U.S. hasn't exactly translated into emerging markets. An estimate by the Global Sustainable Investment Alliance (GSIA) pegged "sustainable" assets in Asia ex-Japan at $52 billion in 2016, an increase of about 16% from 2014 and a tiny fraction of the trillions invested in comparable strategies in developed markets.[4] A lack of quality information remains a challenge in digging deeper into ESG-focused EM investing—supporting this, in one way, is the fact that the 2018 issue of the abovementioned biennial GSIA report did not update this figure but instead has removed the category altogether. Investor perception also may get in the way: Accounts of political strife, corruption and social unrest might have created a negative image in some investors' minds and led to hesitation or skepticism around the idea of successfully implementing ESG considerations in emerging markets.

There's a layer of truth in these images—emerging markets do have vulnerabilities that are different from those in developed markets, chief among them political risk at the country level that can affect the quality of governance at individual companies. Concentrated state or family ownership also could abridge the rights of minority shareholders. **However, partly owing to these vulnerabilities, we believe ESG factors are that much more important in EM investing.** We find support for this conviction from both theoretical and empirical sources.

Plenty of findings have been published that suggest ESG investing is likely to have a positive effect on investment performance generally. Studies also show that ESG considerations have a particularly positive impact on corporate financial performance (CFP) of companies in emerging markets, more so than those in developed markets (see Figure 1).

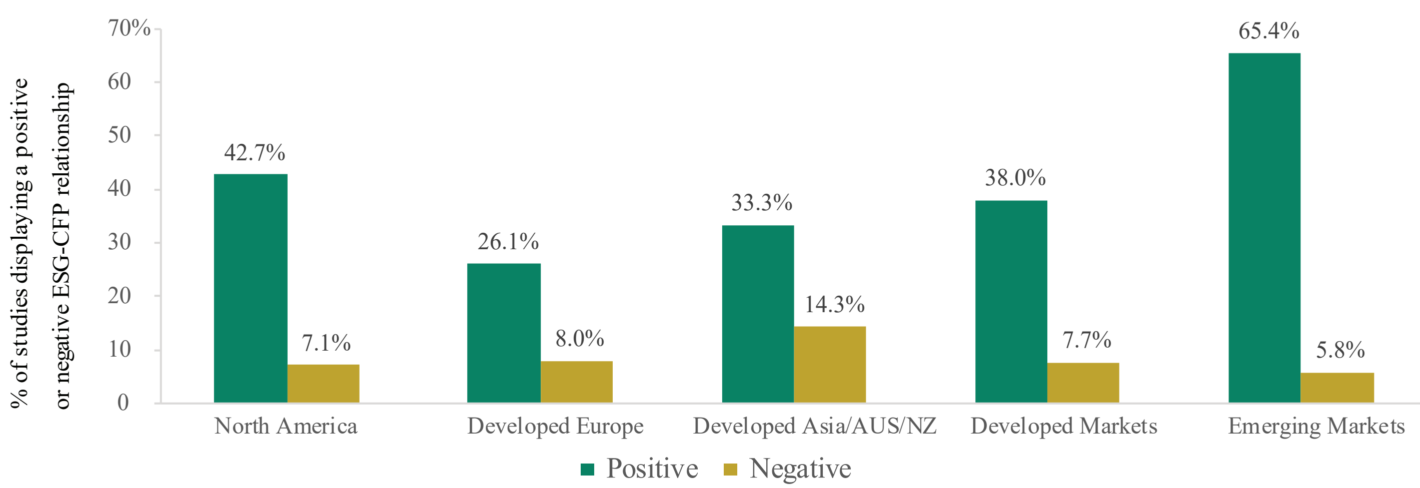
Also notable is the comparison of general EM investing with ESG-focused EM investing (see Figure 2). Over the last decade, the MSCI Emerging Markets ESG Leaders Index, which tracks companies with high performance in ESG metrics relative to their sector peers, has outpaced the broader MSCI Emerging Markets Index.

Similarly, in our own practice, we have found that ESG integration informs and complements our fundamental research process by bringing additional dimensions to gauge management effectiveness and measure sustainable business practices (which we discuss in further detail in following sections). We believe that this in turn helps us uncover investment opportunities in what are often less-efficient markets, while reducing investment risks and ultimately making us better investors overall.

The potential for improvement in both corporate finan-

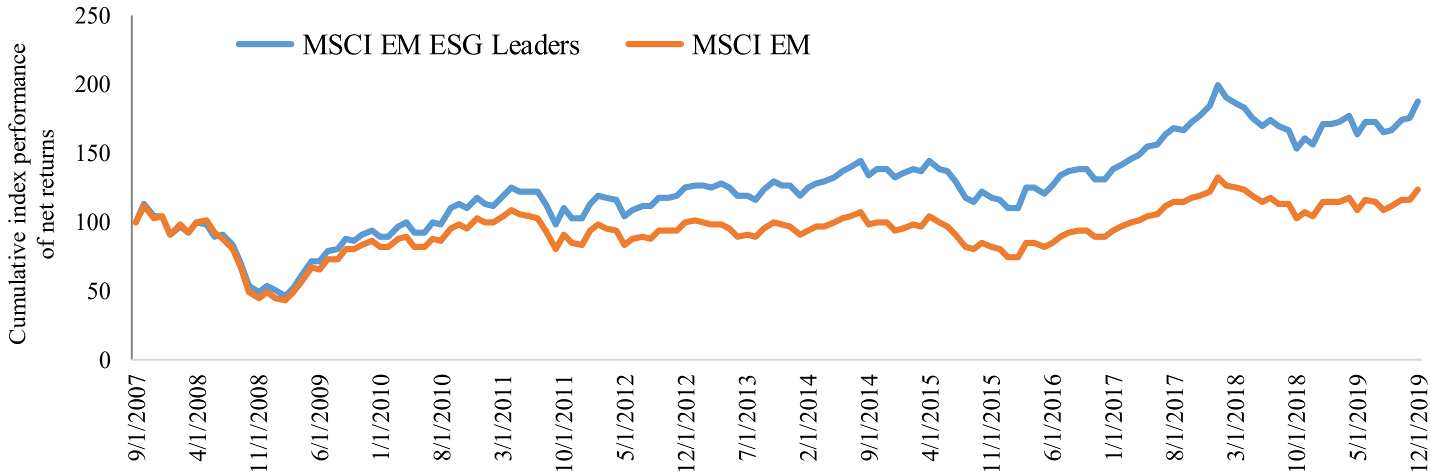
Figure 1: ESG-CFP Link by Region

Findings (based on a net sample of 402 studies with disclosed regional identifiers) show emerging markets claim a higher share of positive outcomes than developed markets when ESG considerations were factored in.



Source: Gunnar Friede, Timo Busch and Alexander Bassen (2015). ESG and Financial Performance: Aggregated Evidence from More than 2,000 Empirical Studies. Journal of Sustainable Finance and Investment.

Figure 2: EM ESG Leaders Outshine Broader Pool of EM Equities (September 2007 – December 2019)



Source: MSCI

cials and investor returns is accentuated when viewed in parallel with the fact that the concept of investing in emerging markets with an ESG framework is relatively young. We could say Europe is in the "sixth or seventh inning" of the ESG game, if you will; North America is in the third; and emerging markets in the first. **In that respect, ESG investing in emerging markets is less crowded and competed-in, and thus we believe it presents greater opportunity for investors to gain attractive returns and contribute positively to social and economic development in these fast-growing regions.**

OAKTREE'S RUBRIC

As mentioned, ESG factors are part and parcel of the fundamental, bottom-up securities research conducted by Oaktree's Emerging Markets Equities strategy. The concept of evaluating non-financial characteristics of companies—such as the environmental, social and governance aspects—has always been part of our due diligence. In the last 12 months, however, we've formalized these processes by developing a proprietary model within which we score every company that we consider for investment across the E, S and G verticals. A key part of the analysis is a set of 69 questions we ask about a subject company, including 30 related to governance. Some questions in that category are:

- Is executive compensation linked to performance metrics?
- Do outside directors bring a diverse mix of expertise?
- Does the company have a circular holding structure dominated by controlling shareholders?

For the environmental and social scores, we look at a variety of factors including:

- emissions trends;
- water efficiency;
- waste disposal policy;
- anti-bribery policy;
- employee whistle-blower policy; and
- workplace fatalities trends.

We tally the scores for each of the three categories and assign a weighting to ultimately arrive at a composite ESG score. These detailed questions and evaluation process, often requiring extensive research and communication with management, allow us to quantify ESG considerations and apply consistency to our process of ESG integration.

Also part of this evaluation method is an "ESG escalation" process, which involves in-depth analysis into a company upon material news. The ESG committee scrutinizes the new information and its implications, with a goal of arriving at an action plan. Through formalization and documentation of this process, we now have a robust historical database of ESG-related notes and reports that could add substantial depth to our investment analysis. We've found this to be an efficient way to keep a record of how our companies are evolving.

IDENTIFYING WINNERS THROUGH ENGAGEMENT

We also value the power of engaging directly with portfolio company management. We believe engagement can pick up where data fall short, where regulations may not yet be in place to mandate ESG-related disclosures.

An example of engagement done right is our experience with a low-cost Brazilian airline carrier. Oaktree analysts engaged the company, providing guidance on how it could improve its ESG-focused efforts. This prompted the airline to publish a sustainability report and reach out to rating agencies to make sure appropriate questions and concerns were addressed. Improvements have been, and continue to be, made. For instance, the company has been reducing its carbon dioxide emission per available seat kilometer[5] through the renewal of its fleet for more fuel-efficient models, according to a recent S&P Global Ratings report on the company. By 2023, all of the airline's domestic capacity is expected to be produced by fuel-efficient aircraft. The airline also has the youngest fleet in Brazil, with an average age of 5.9 years, versus most large airlines in the U.S., whose averages range from 10 to 16 years.[6] The S&P report assesses the company's management and governance as "fair," with the view that "management has a solid knowledge of the airline industry, amid absence of high turnover with many of directors working in the company since its inception." We expect that, as a result of these factors, this airline carrier should continue to see significant improvements in its pursuit of more comprehensive corporate stewardship, as well as a bump in its ESG score in Oaktree's model.

> *"We believe ESG integration helps us uncover investment opportunities in what are often less-efficient markets, while reducing investment risks and ultimately making us better investors."*

Another example of the positive impact of direct engagement regards a Chinese company that provides contract research and manufacturing services to the global pharmaceutical sector. Oaktree engaged with the company prior to its initial public offering on the Hong Kong Stock Exchange in December 2018. In our very first meeting, we discussed ESG matters with management, including board composition and executive management compensation. We also emphasized the importance of disclosing key environmental data, and we asked the company to provide sustainability information such as that pertaining to employee training and community-relations initiatives. The company's management told us that we were the only investor that had inquired about these ESG issues and that they had no idea that such matters were important to international investors. In March of 2019, we met with the company again and further pressed some of our concerns. The company in turn engaged a dedicated ESG management officer, produced the data we required and, with our help, engaged external ESG ratings groups. Not only did this company see its stock significantly outperform the market by the end of 2019, but it had also recently been given an "A" rating by MSCI, which called the organization one of the highest-rated Chinese companies in its coverage on ESG issues.

We believe stories like the foregoing are emblematic of how engagement with management on the topic of ESG can result in both improved corporate ESG behavior and strong investment performance.

ESG investing is not just about avoiding disasters and reacting to bad news, but it's also about recognizing good corporate citizenship and improvements in business principles that are fundamental to a well-run organization. If in the past ESG practices focused solely on mitigating risks, today they're more about guiding investors and companies to higher standards that could materially benefit the bottom line and create broader impact. This approach increases the possibility for win-win situations for both the investor and the company.

ALIGNMENT WITH OAKTREE'S LONG-TERM FOCUS

Investing with an ESG lens closely aligns with Oaktree's investment philosophy, which focuses on the long term and emphasizes risk control, knowledge advantage and bottom-up research. Successful ESG integration requires rigor: case-by-case analyses of risks and return potential from a holistic perspective; disciplined monitoring; and direct engagement. Such thoroughness and scrutiny have always been part of Oaktree's DNA, characteristics that we believe enhance risk control and the overall quality of each of the investments we make.

Challenges remain for widespread and standardized adoption of ESG integration, especially in emerging markets. However, growing demand from investors and positive receptiveness of management mean the pace of improvement is likely to accelerate in the near term. Meanwhile, the relative inefficiency in EM investing brings opportunities for Oaktree to apply its culture of rigor and independent ESG-research capabilities in service of finding attractive, high-quality investments there.

Endnotes

[1] The Global Sustainable Investment Review, published by Global Sustainable Investment Alliance. The major regions are Europe, the U.S., Canada, Australia/New Zealand and Japan.

[2] Morgan Stanley Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice. September 2019.

[3] For instance, the 2005 publication of "Who Cares Wins" by the UN Global Compact is credited with laying the foundations of ESG investing. The Global Compact is an international initiative launched in 2000 by then-UN Secretary General Kofi Annan.

[4] We recognize Asia ex-Japan is not a complete representation of emerging markets. We estimate this statistic to be a close read, however, in the absence of more comprehensive data. Thirteen markets were considered in this report for the Asia ex-Japan category: Bangladesh, China, Hong Kong, India, Indonesia, Malaysia, Pakistan, Philippines, Singapore, South Korea, Taiwan, Thailand and Vietnam.

[5] Represents aircraft seating capacity multiplied by the number of kilometers the aircraft is flown.

[6] S&P Global Ratings. Sept. 6, 2019.

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Prior to joining Oaktree in 1999, Mr. Carroll was the head of trading for Columbus Advisors LLC, where he worked for two years. Mr. Carroll previously was the Head Trader for Latin American Fixed Income at Banco Santander and Bankers Trust. For six years prior to joining Bankers Trust, Mr. Carroll was an emerging markets trader for Salomon Brothers Inc. He received a B.A. degree in history from Fairfield University. He is currently the Chairman of Fairfield's Board of Trustees as well as a Trustee at Brunswick School in Greenwich, Connecticut.

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Before joining Oaktree in 2002, Ms. Wang worked for ABN Amro Asia as a research assistant, covering the building materials and airline sectors. Prior thereto, she worked for Evergreen Funds in the Institutional Services department where she served as an institutional services representative. Ms. Wang holds a B.S. degree in finance and marketing from Boston College and an M.B.A. with a concentration in finance from Columbia Business School. She is fluent in Mandarin.

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