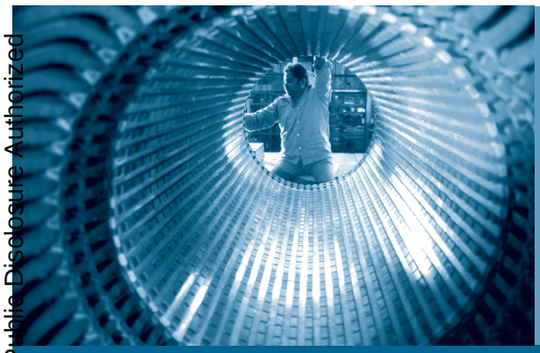
IFC Advisory Services in Environmental and Social Sustainability

Sustainable Investing in Emerging Markets: Unscathed by the Financial Crisis

ISSUE BRIEF

In partnership with Italy, Luxembourg, the Netherlands, and Norway



IFC International Finance Corporation
World Bank Group

Introduction

To support the growth of sustainable capital flows, IFC's advisory services seek to influence, support, and enable capital market stakeholders to better integrate environmental, social, and governance (ESG) factors into capital allocation and portfolio management processes, using IFC's own investment practices as a model. IFC is playing its part to support the growth of the market by funding the development of enhanced stock market indices, financial instruments, and through targeted market research.

Sustainable Investing in Emerging Markets: Unscathed by the Financial Crisis is a research paper commissioned by IFC, and prepared in cooperation with the Economist Intelligence Unit (EIU). It provides a unique "before and after" snapshot of mainstream investor opinion on sustainability issues in emerging market equity investment, comparing pre-crisis (2007) to mid-crisis (2009). The report surveys the attitudes of corporate executives and investment professionals; summarizes the challenges that they face in adapting to the growing use of environmental, social, and governance investment criteria; and recommends actions to capitalize on relevant trends. This report is based on:

- Two surveys, conducted two years apart (early 2007 and early 2009), addressing the same audience of:
  - public companies based in emerging markets
  - asset owners and asset managers with significant investments in emerging markets
- In-depth interviews with 23 emerging market investors, investment consultants, ratings agencies, and academics, as well as post-crash follow-up interviews with selected interviewees.
- Comments from investors, advisors, and emerging market corporations at roundtables in Buenos Aires, Hong Kong, London, and New York.

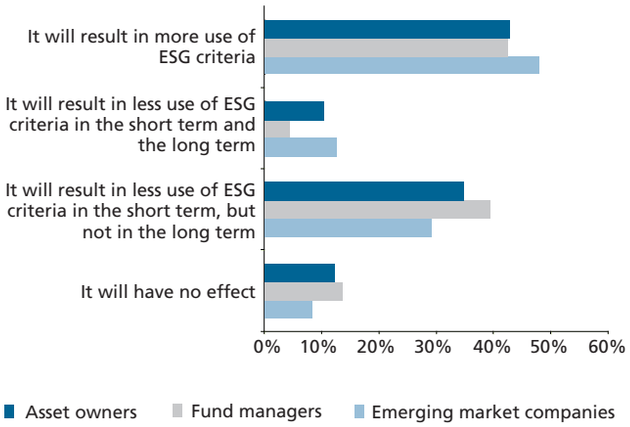
The report can be downloaded in full from IFC's website; this summary version highlights the major findings of the surveys.

EXECUTIVE SUMMARY

Over a century ago Rudyard Kipling told his countrymen, "If you can keep your wits about you while all others are losing theirs…the world will be yours and everything in it." For investors caught in the market turmoil of 2008 and 2009, these words have special resonance. Years of short-term thinking by a wide range of market participants culminated in a global financial crash. Leading the way out will be those who "keep their wits about them" by focusing single-mindedly on choosing emerging market investments with advantages that can be sustained over the long term. Such an approach almost by definition requires the use of ESG measurements as an aid to evaluate an investment's fundamental strength.

In tumultuous times, the behavior of market participants changes. They become less rational. They make bad decisions. They miss opportunities. Most importantly, they lose sight of fundamentals, act on the basis of short-term events, and fall prey to the "madness of crowds." It seems reasonable that investors in this frame of mind would be ready to abandon the use of sustainable criteria and revert to a narrower set of short-term metrics for evaluating investments. But the asset management community is not abandoning ESG criteria; far from it. Two surveys of asset owners, fund managers, and emerging market corporate issuers were conducted by the EIU for this project: the first in March 2007, when market participants watched indices move toward record highs; and the second in March 2009, when the same indices were in free fall. In both surveys, market participants confirmed the importance of sustainability criteria in analyzing emerging market investments. If anything, respondents were more enthusiastic about sustainability criteria after the crash than before. For instance, asset owners (arguably the most influential participants in the investment

How will the financial crisis affect the integration of ESG factors into traditional investment practices?



value chain) were more inclined to agree with the statement "ESG issues are an important part of our research, portfolio management, and manager selection process" in 2009 than in 2007. Approximately 46 percent strongly agreed with this statement in 2009, up from 36 percent in 2007. Those who agreed "somewhat" were the same at about 35–36 percent.

In 2009, a plurality of asset owners (42 percent) said that the financial crisis would result in more use of ESG criteria than before and 13 percent said it would have no effect. Another 35 percent said that the crisis might have the effect of reducing the use of sustainability criteria in the short run, but not in the long run. Only 1 in 10 respondents felt that the financial crisis would reduce the focus among investors on ESG.

Other major findings presented in the report:

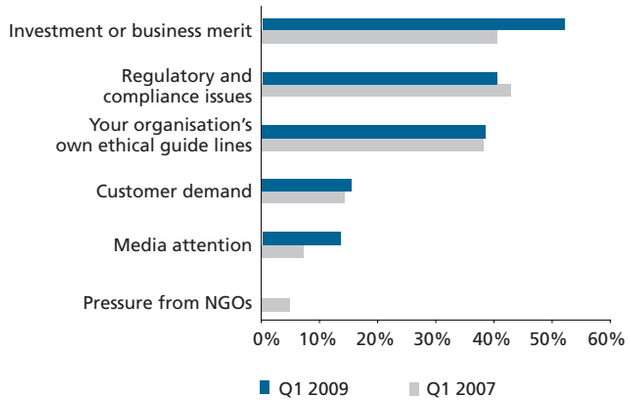
- **Asset owners ranked "investment or business merit"** far ahead of other motives for sustainable investing in 2009, suggesting that sustainable investing criteria are less a matter of fulfilling compliance mandates than an aid to choosing strong investments. In the 2007 survey, asset owners ranked "regulatory and compliance considerations" slightly ahead of other motives.

- **The ranking of obstacles to sustainable investing** did not change much between the sunny days of 2007 and the bleaker ones of 2009, but significantly fewer asset owners ranked transparency as one of the top obstacles in 2009.

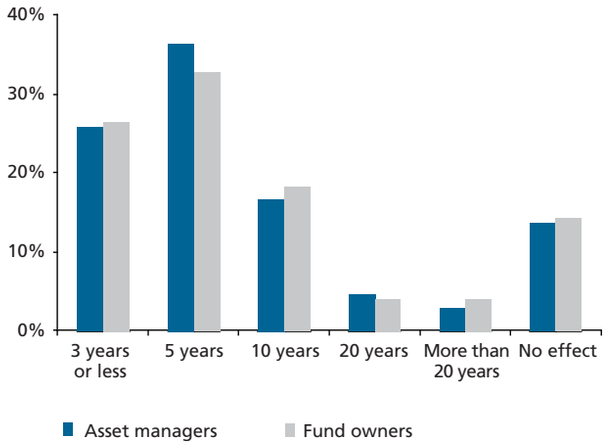
- **The 2009 survey reinforced the need to take climate change** into account when evaluating investments. Most asset owners and funds managers (86 percent of both groups) believe that it will have a significant effect on their emerging markets portfolios. Moreover, 60 percent of asset owners and 62 percent of money managers say that this effect will be felt within the next five years.

- **In both surveys, asset owners and fund managers** noted the growing importance of ESG criteria in emerging markets; they also expect increased demand for emerging market investment products over the next three years. Among publicly traded companies headquartered in emerging markets, there is also a high level of awareness of sustainable criteria.

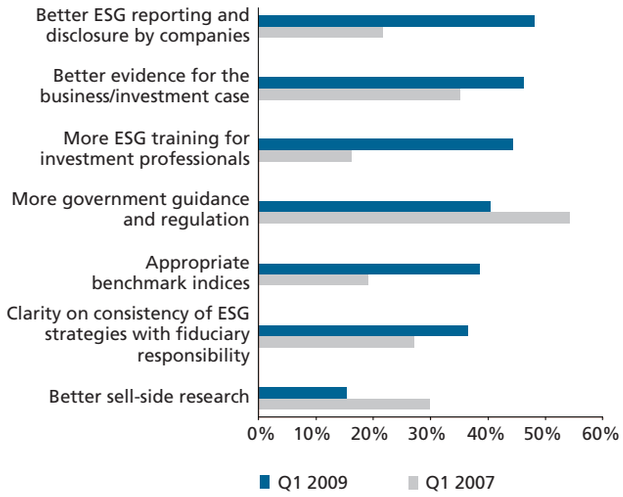
Asset Owners: What is your organization's motivation for addressing ESG issues? (choose up to two)



Asset Owners and Asset Managers: Over what time horizon will climate change have a significant impact on your emerging market investment porftolio?



Asset Owners:
What is needed to improve the climate for ESG investing in emerging markets? (select all that apply)



Asset Managers:
What is needed to improve the climate for ESG investment in emerging markets? (select all that apply)

In sum, the investment community continues to see the use of sustainable investment criteria in emerging markets as both mainstream and persistent, even after the value of their portfolios has shrunk; and emerging market corporate issuers continue to see sustainable practices as important for fund raising. Investors who neglect these sustainability criteria run the risk of missing opportunities to make a profit, while companies that fail to build sustainable operations may end up paying too much for capital.

The full annual report gives a detailed analysis of mainstream investor opinion on sustainability issues in emerging market equity investments, highlighting the business case for ESG, as well as identifying the challenges and opportunities that lie ahead.

Sustainable investing in emerging markets: Unscathed by the financial crisis, full report: http://www.ifc.org/sustainableinvesting

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