For professional investors

Guide to emerging markets investing

INVESTING IN TODAY'S DRIVERS OF GLOBAL ECONOMIC GROWTH

Sustainable Investing Expertise by ROBECOSAM

Contents

Foreword

Emerging markets have undergone significant changes since the term was initially coined in the early 80s. Having become an asset class in their own right, emerging markets equities have moved from being an exciting, but also rather volatile investment, to showing signs of stability and maturity. Combined with dynamic growth prospects, this has turned them into a must-have for many investors.

In this publication, we explain why emerging markets equities can be a valuable addition to global equity portfolios. We also discuss several ways to gain exposure to this multi-faceted asset class, as well as some of the key considerations to bear in mind when reflecting on an allocation to emerging markets equities.

We start our journey with an overview of the asset class. We cover its origins, its coming of age, and some important milestones reached along the way. We then discuss the opportunities emerging markets offer, as well as some of the challenges that come with them. In particular, we zoom in on China's ascent and on the so-called 'middle income trap' many countries are striving to avoid.

Furthermore, we look at the many options investors have, when they consider getting exposure to emerging markets equities. Indeed, investors need to make quite a few decisions before they even start to make any transaction. Depending on their own convictions and investment objectives, they can choose from a wide array of investment approaches, styles and strategies.

Finally, we show that sustainability integration in emerging markets investment is not a contradiction in terms, but can be applied to varying degrees, ranging from basic exclusions, 'standard' ESG integration to impact investing or even contributing to the United Nations' Sustainable Development Goals.

Robeco has long been an advocate of sustainable investing in general, and in emerging markets in particular. A testament to this is the governance-related questionnaire we have been sending to companies since 2001, a time when sustainable investing was most definitely not mainstream. In a way, this was a precursor to the ESG integration processes that are now widely applied by asset managers.

But Robeco's pioneering spirit did not only start with sustainable investing. We were also among the very first asset managers to look to emerging markets as a potential investment. In fact, we started investing in emerging markets long before the concept even existed – since 1930 to be precise – and have been captivated with the transformation of this asset class ever since.

We hope this guide will give you an insight into the many aspects of emerging markets investing and will help you to achieve your long-term investment objectives.

Mark van der Kroft
Chief Investment Officer
Quant and Fundamental Equity

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The asset class

While the concept of emerging markets is widely recognized, there is no accompanying widely accepted definition. Searching for a definition on-line will result in a multitude of criteria reinforcing the notion that there is no universally agreed classification of an emerging market. Generally, the criteria focus on poverty, capital markets and the growth potential categories. As a result, there is often disagreement whether a country qualifies as an emerging market.

What's in a name?

South Korea provides a good example. The country has a GDP per capita higher than many so-called developed markets. It is among the top 15 largest economies in the world, and anyone visiting it would be impressed by its advanced infrastructure. Yet index provider MSCI classifies South Korea as an emerging market,[1] mainly due to the country's capital market restrictions. Meanwhile, rival firm FTSE Russell classifies South Korea as a developed market because of its strong economic position.

[1] MSCI defines an emerging market as a one that has some characteristics of a developed market, but does not fully meets its standards.

Though many find the term 'emerging market' outdated, no replacement has won widespread favor to date. The term itself was never originally conceived as a definition of an actual emerging market. Rather, it was the World Bank's International Finance Corporation (IFC) that coined the term "emerging markets" in 1981, in the hope of attracting investment capital to those countries that needed it most.

At the start of the 1980s, foreign investment in the stock markets of developing countries was minimal and did not yet play a role in supporting growth and modernization. There was a real negative perception of these countries – called 'Third World' – at the time. The IFC decided to reach out to potential investors, and make a case for investing capital using encouraging new data on investment returns from these countries.

Drawing on this quantitative work, the IFC proposed to list a fund on the New York Stock Exchange called 'Third World Equity Fund'. The story goes that this name went down badly with the hard-nosed investors who disliked it for the negative connotation associated with the label. After a huddle between the IFC and their advisors, the name "emerging markets" was born and the rest, as they say, is history.

Countries included in the fund were characterized by an above-average economic growth, a rather inaccessible capital market and a relatively low GDP per capita, i.e., lower than USD 10,000. The label proved wildly successful, and although some argue that the term is too all-encompassing – lumping together very disparate economies – the aim, from the IFC's point of view, was always more about raising the profile of these countries and thus attracting capital for investment into them.

Although the label 'emerging markets' is relatively new, emerging markets, as described by the IFC, are definitely not new. Due to the differences among and the factors that drive them, the members of this grouping are in constant flux, both in terms of number and composition. Most, if not all, developed economies that we see today were once emerging markets themselves. In some instances, countries that are classified as emerging today were in the past developed.

For example, Argentina achieved advanced development status early in the 20th century and had become the world's tenth wealthiest state per capita by 1913.[2] Unfortunately, its economy deteriorated significantly from the 1930s onwards. This was mainly due to economic mismanagement such that by the 1970s, the country was once again considered as an emerging market.

[2] Source: Eiras, A., Schaefer, B., 2001, "Argentina's Economic Crisis: An absence of capitalism", Backgrounder report, Heritage Organisation.

The stand-out example is China, which can boast of an ancient civilization going back over 4,000 years, according to the consensus among historians. During that time, we have seen the middle kingdom become a global power, inventing technologies such as the compass, movable type print, paper and gunpowder, then declining from the 1500s onwards before making a remarkable comeback since the 1980s.

In the 15th and 16th centuries, China accounted for 25% to 30% of the global economy,[3] with historian Eric L. Jones once arguing that the Chinese empire "came within a hair's breadth of industrializing" during that period. But by the 1950s and 1960s, it had fallen to below 5% of global GDP, as the accelerating pace of industrial revolutions in the rest of the world ushered in a modern age of much faster productivity growth rates in those countries.

[3] Source: Macquarie Research, Viktor Shvets client note, January 2017.

Since the early 1980s the Chinese economy has recovered strongly, implementing far-reaching market economy reforms, the so-called 'capitalism with Chinese characteristics' under the then leader of China Deng Xiaoping. In fact, referring to the reforms Deng once said: "It doesn't matter if a cat is black or white, so long as it catches mice."

Today, China accounts for roughly 19% of the global economy, with many economists forecasting that it will overtake the US as the largest economy in the world in the next decade or so. The prognosis from the UK-based Centre for Economics and Business Research is even more aggressive, projecting that China will overtake the US to become the world's largest economy by 2028 due to its 'skillful' handling of the Covid-19 pandemic.

> 'Robeco's approach has been to classify emerging markets as any market not defined as developed by the MSCI'

The example of China being classified as an emerging market shows that the term is indeed multi-faceted. Robeco's approach has been to classify emerging markets as any market not defined as developed by the MSCI. This allows us to invest not only in markets defined as emerging by the MSCI, but also those defined as 'frontier', and other 'standalone' countries such as Malta. Figure 1 summarizes the current potential country universe for our emerging market equity strategies.

Figure 1: The potential emerging market universe

MSCI ACWI & Frontier Markets Index								
MSCI ACWI Index					**MSCI Emerging & Frontier Markets Index**			
MSCI ACWI Index			**MSCI Emerging Markets Index**			**MSCI Frontier Markets Index**		
Developed Markets			**Emerging Markets**			**Frontier Markets**		
Americas	**Europe & Middle East**	**Pacific**	**Americas**	**Europe Middle East & Africa**	**Asia**	**Europe & CIS**	**Middle East**	**Asia**
Canada	Austria	Australia	Argentina	Czech Republic	China	Croatia	Bahrain	Bangladesh
United States	Belgium	Hong Kong	Brazil	Egypt	India	Estonia	Jordan	Sri Lanka
	Denmark	Japan	Chile	Greece	Indonesia	Lithuania	Oman	Vietnam
	Finland	New Zealand	Columbia	Hungary	Korea	Kazakhstan		
	France	Singapore	Mexico	Kuwait	Malaysia	Romania		
	Germany		Peru	Poland	Pakistan	Serbia		
	Ireland			Qatar	Phillipines	Slovenia		
	Israel			Russia	Taiwan			
	Italy			Saudi Arabia	Thailand			
	Netherlands			South Africa				
	Norway			Turkey				
	Portugal			United Arab Em.				
	Spain							
	Sweden							
	Switzerland				**MSCI Standalone Markets Indexes**			
	United Kingdom				**Americas**	**Europe & CIS**	**Africa**	**Middle East**
					Jamaica	Bosnia Herzogovina	Botswana	Lebanon
					Panama	Bulgaria	Zimbabwe	Palestine
					Trinidad & Tobago	Malta		
						Iceland		
						Ukraine		

Source MSCI. The gray area represents Robeco's emerging markets investable universe.

Not for the faint-hearted

Emerging markets have also often been characterized by bubbles and stress throughout the ages. In 2017, a report[4] from Renaissance Capital, an investment bank focusing on emerging and frontier markets, claimed – somewhat tongue-in-cheek – that the first emerging markets crisis happened as early as around 400 BCE, in Greece, when the Attic Maritime Association defaulted on their loans contracted from the Delos Temple.

4 Salter, D., Lopez, V., Robertson, C., Mhango, Y., Kouzmin, O., 5 November 2017, "Now that's what I call EM!", Renaissance Capital report.

However, many would argue that the first, and most beautiful, real bubble was the so-called Tulip Mania of 1636-37 during the Dutch Golden Age, when contract prices of tulip futures – especially bulbs infected by a virus that caused the petals to develop 'flames' of color – led to rampant speculation. And speculate they did; prices for traded tulips rose 59-fold within 16 months before collapsing to nearly zero by early 1637, leading to a series of defaults across the Netherlands.

But the actual term 'bubble' only came into official use a few decades afterwards, with the passage of the 'Bubble Act' in 1720 by the British parliament. During that year the whole of England became involved in what has since become known as The South Sea Bubble. This bubble centered around the fortunes of the South Sea Company, which was founded in 1711 to trade with then Spanish America.

In 1720, in return for a loan of GBP 7 million to finance the war against France, the British House of Lords passed the South Sea Bill allowing the South Sea Company a monopoly in trade with Spanish America. The company underwrote the English National Debt, which stood at GBP 30 million, on a promise of 5% interest from the government. Share prices immediately rose tenfold and speculation ran wild.

All sorts of companies, some optimistic, some fraudulent and some downright lunatic were launched. One company floated to buy the Irish Bogs, another to manufacture a gun to fire square cannonballs, and the most ludicrous of all: "For carrying-on an undertaking of great advantage but no-one to know what it is." This last one eventually managed to raise GBP 2,000.[5]

5 Source: Mackay, C., *Extraordinary Popular Delusions and the Madness of Crowds*, first published in 1841.

Huge fortunes were made as investors followed what is now known in finance as the 'greater fool theory' – the belief that even if the investment isn't worth the asking price – and in many cases it isn't – sooner or later, a "greater fool" will come along and wish to purchase it for an even higher price, thus earning the original investor a profit. Of course, bubbles are not sustainable and, in late 1720, the bubble burst spectacularly.

Stocks crashed and the whole country suffered a catastrophic loss of money and property, including the government, since the total state's revenue that was absorbed by interest payments had risen from one-third to over 50% by 1720. The National Debt that had been the

South Sea Company was sub-divided into three: between the Bank of England, the Treasury and the Sinking Fund. The Sinking Fund was made up of a portion of the country's income that was put aside every year, and eventually stability returned to the country.

The South Sea Bubble was followed by the London Panic of 1825, which was the culmination of several years of euphoric investment in Latin American sovereign debt, as well as gold and silver mines. It included a remarkable scam: bonds sold in the name of a made-up country called Poyais. Then, in 1825, the Bank of England decided to raise interest rates resulting in the share price of Real del Monte Mining – the leading South American miner – collapsing from GBP 1,550 to GBP 200 within a few months, presaging a major stock market crash in London and numerous bank failures throughout England.

Since then, we had the Latin American debt crisis in the 1980s, also known as the Lost Decade, in which countries such as Brazil, Argentina and Mexico borrowed so much that they reached a point where their foreign debt exceeded their earning power, and they were unable to repay the debt. Subsequently, we had the Mexican peso crisis of 1994-95 after the Mexican government suddenly announced a sharp devaluation of its currency, negatively surprising the markets.

A few years later, there was the Asian crisis of 1997, a macroeconomic shock experienced by several Asian economies due to structural imbalances in the economy. This precipitated the Russian ruble crisis of 1998, with the fall in oil prices and metals coming as a severe shock to the Russian economy due to its over-reliance upon oil exports. The ruble ended up losing 40% of its value in a matter of days, resulting in the Russian government defaulting on its debt obligations in the bond market.

Change Alley, London,1853.by John Carter. Street scene depicting events surrounding the South Sea Bubble (1711-1720). The scene is taking place in front of Garraway's Coffee House, with a pawn shop at left.

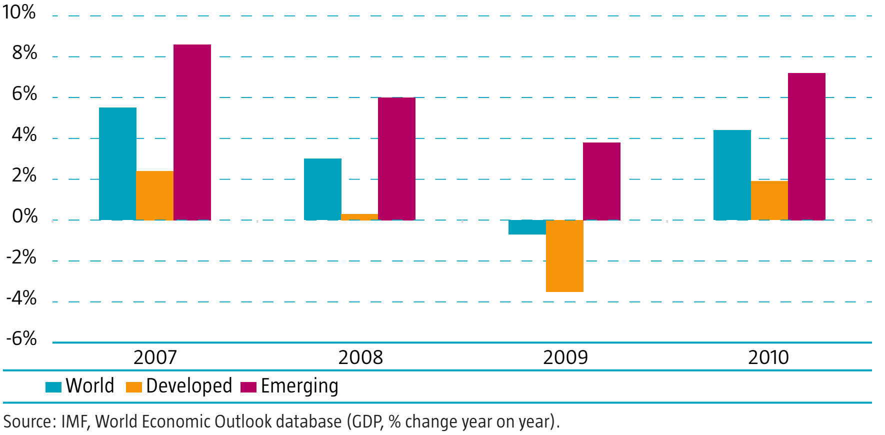
Coming of age

Since the Russian ruble crisis, things have been remarkably quiet for emerging markets. Where previously we had the domino effect – in which a crisis in one emerging country would roll out to the rest of the emerging markets – in recent years there have only been isolated, country-specific crises. A good example of this is Argentina's series of sovereign debt defaults since 2001, which have been contained within the country.

In fact, the most recent significant crisis, the global financial crisis of 2007-08, was a developed market one. It was noteworthy for the fact that, though emerging markets did not fully escape from the fallout, overall, they showed greater resilience during the worst of the crisis and bounced back faster, as shown in Figure 2, emerging from the crisis in much better shape than the developed world.

In part, this was thanks to lessons learnt from previous crises, and the majority of emerging markets had been running disciplined fiscal policies in the years leading up to the crisis, with lower levels of government deficits and public debt on average than developed economies. Many had also implemented better monetary policy frameworks with a focus on low inflation and flexible exchange rates.

Figure 2: Emerging market's GDP growth bounce-back post financial crisis



Source: IMF, World Economic Outlook database (GDP, % change year on year).

How the emerging markets deal with the latest global crisis – the Covid-19 pandemic – will provide a litmus test as to how robust these economies really are. Unlike previous crises, this one is not due to financial mishandling, although the impact will be financial, and it is very much global in nature. The jury is still out, but some emerging market countries, such as China, South Korea and Taiwan, have coped relatively well and seen their economies recover swiftly from the shock.

Emerging markets have undergone significant changes since the 1980s. Their market capitalization has grown from less than USD 50 billion in 1988 to over USD 5 trillion today, although it is still dwarfed by the US, which has a total market cap of USD 49 trillion.[6] And while emerging economies' current share of global GDP now stands at over 65%,[7] the asset class remains underrepresented in most investors' portfolios, due to what we believe is an outdated view of the risks involved.

As the footprint of emerging markets has expanded, so too have the drivers behind their growth. Where previously commodities, heavy industry and utilities dominated, now, technology, or consumer goods and services dominate. Many emerging markets have moved up the global value chain, implemented far-reaching structural reforms and seen their middle-class segment of the population increase.

These changes, combined with technological innovation such as ecommerce and internet banking, are creating fundamentally different investment opportunities across emerging markets, resulting in a new and powerful long-term investment case for emerging markets equities.

[6] Source: Siblis Research, March 2021.

[7] Source: UBS Research, December 2020.

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Challenges & opportunities

Having become an asset class in their own right, over the past few decades, emerging markets have also moved from being a rather volatile investment to showing signs of stability and economic maturity. But what of the future? Emerging markets are currently the primary driver of global growth and wealth accumulation, and we expect this trend to continue.

From copycat to leaders

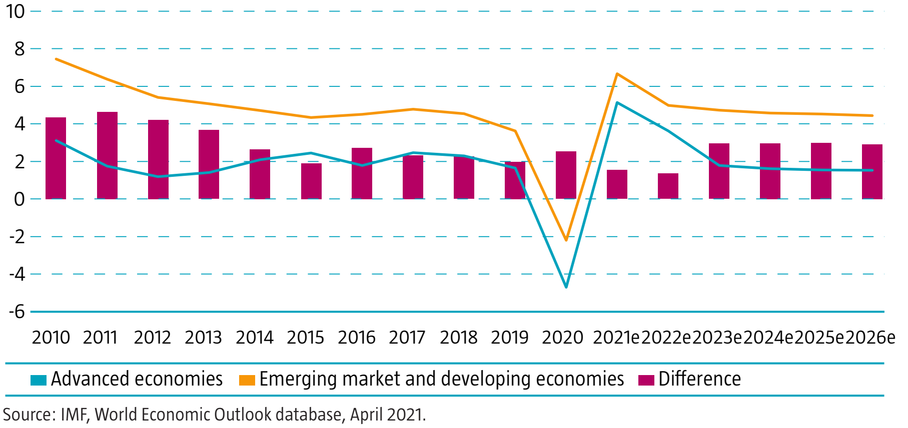
In 1980, emerging markets' share of global GDP was 37%.[8] It is currently 58% and is forecast by the IMF to be 61% by 2026. Meanwhile, emerging markets account for roughly 86% of the world's population and 36% of its exports, yet they represent only 12% of the global equity market capitalization.[9]

Along with an increase in their economic heft, emerging economies are also becoming more important players in setting global priorities. The unofficial anointment of the G20 as the major body determining the global economic agenda has given emerging markets a prominent seat at the table. The same is true in international institutions such as the Financial Stability Board and the IMF, where emerging economies have a much larger say than before.

Furthermore, the global financial crisis of 2007-08 presented a unique opportunity for emerging markets to mature in another dimension – taking on more responsibility for global economic and financial stability. While emerging markets such as China and India remain relatively poor in per capita terms, their sheer overall size makes it important for them to consider the regional and global spillover of their policy choices.

This requires them to play an increasingly active role in guiding international debates on key policy issues, including strengthening global economic governance. It is in their own long-term interest to take the lead on global challenges, from dismantling trade barriers to tackling climate change, rather than focusing narrowly on their own perceived short-term interests.

Figure 3: Growth rates between advanced and emerging economies



Source: IMF, World Economic Outlook database, April 2021.

8 Source: IMF, World Economic Outlook database. Based on PPP.

9 Source: Horton, R. L. and Jauregui, D. H., 2019, "Emerging opportunities: The case for growth investing in emerging markets", Investment Focus, Lazard Asset Management.

Many emerging markets have changed dramatically as they developed and climbed up the value-add curve. Commodities, raw materials, basic manufacturing and utilities declined significantly in relative importance while sectors such as consumer and technology sprung up, reflecting the rising spending power of the emerging middle class, the integration of Asian manufacturers into the global supply chains, and the trend towards global outsourcing that took root in the late 1990s onwards.

One outcome of this is that many emerging markets companies have become leaders in key sectors such as internet-related technologies, electric vehicle battery manufacturing, and computer chip manufacturing. Firms such as TMSC, a Taiwanese chip maker, and Samsung Electronics, a South Korean consumer electronics and DRAM manufacturer, are leading players in global supply chains, competing with companies from the developed markets.

Nearly 60% of the population in emerging markets are now connected to the internet, compared to less than 25% in 2010.[10] Table 1 shows that growth has been much faster in emerging markets than in developed ones since 2009, with 90% of all new internet users now coming from emerging markets. India sped past the US to become the world's second largest internet user market behind China in 2017[11] with over 460 million internet users.

[10] Source: Pew Research, 2020.

[11] Source: Internet live stats, www.internetlivestats.com, 2017.

Table 1: The growth of internet users since 2009

	Number of internet users (millions)					
	Asia	**Europe**	**US**	**Latam**	**Africa**	**ME**
2009	764	426	260	187	86	58
2020	2,525	728	333	468	566	185
% growth	**230**	**71**	**28**	**150**	**558**	**219**

Source: International Telecommunication Union, Statista, 2021.

The drivers of this growth in emerging markets are wide ranging and include demographics, economic development, business conditions, technology, innovation, infrastructure development, environmental change and capital markets developments. These drivers will be the source of many future opportunities, but we believe that technology and innovation will play a particularly unique part in the continued growth of emerging markets.

Traditionally, developed countries first developed and commercialized innovations at home and in a second stage set up subsidiaries to introduce them in emerging countries. Over the last two decades, however, the origin and direction of innovation flows has changed significantly, with many examples of products being introduced in emerging countries first. This innovation in emerging markets has helped them to leapfrog the developed world in terms of infrastructure and business models.

We've seen this unfold in areas such as social media, messaging platforms, ecommerce and e-payments, and more recently in new areas such as online education and health care as well as transformational technologies like artificial intelligence, robotics and supercomputers. These business models are highly suited to the structures of emerging markets and benefit from the availability, often, of superior data coverage at substantially lower cost in countries such as China and India.

Farmers in India, who usually have no access to computers or landlines, can now use smartphones for transactions, loans and tax payments. They can also access tools, such as the popular IFFCO Kisan app, that helps Indian farmers take informed decisions by accessing customized agricultural information related to their needs. The app provides the latest crop prices, weather forecasts, agricultural advisory, best practices tips related to agriculture, and a buyer and seller platform.

Emerging market companies are at the forefront both as the end provider and as a supplier of the components and building blocks for developing technologies. For example, many of the chipsets – which manages the communication between the processor, memory and peripherals – used in all kinds of technology such as computers, mobile phones and electric vehicles originate from companies in emerging markets.

'Three of the world's five-largest semiconductor manufacturers are based in Asian emerging markets'

The 5G rollout and developments in areas such as autonomous cars and the Internet of Things all have a core component in common: semiconductors. Three of the world's five-largest semiconductor manufacturers are based in Asian emerging markets, with the world's largest one – Samsung Electronics in South Korea – accounting for a whopping 45% of the combined revenues of all the global semiconductor industry.[12]

[12] Source: BizVibe, December 2020

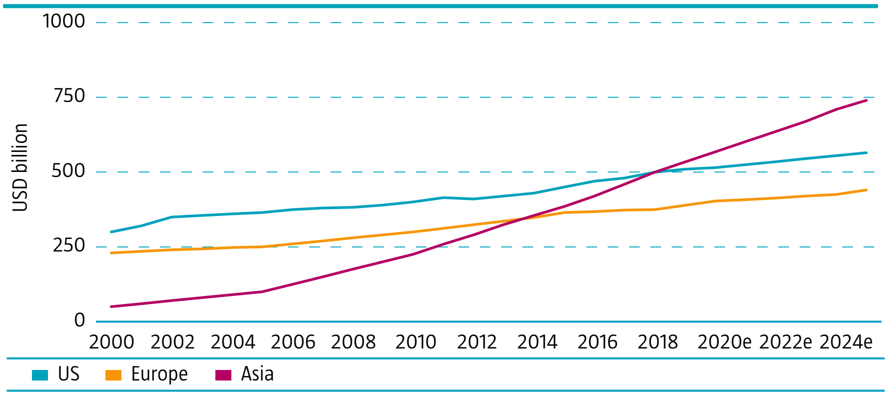
Technological change frequently enables emerging markets to be more agile and innovative than developed ones, as they feature three distinct advantages for adopting new technologies compared to developed markets:

1. They are unlikely to have deeply embedded legacy infrastructure systems that need to be upgraded or even replaced at great expense. Lacking a technological infrastructure has paradoxically helped emerging markets with less disruption and fewer regulations as a result.
2. They have a large, tech-savvy young population (emerging markets account for nearly 90% of the global population aged under 30[13]) that translates into faster adoptive rates than developed markets.

[13] Source: International Labor Organization, 2019.

3. In emerging markets, governments often play a key role, unlike in developed markets where the private sector tends to drive innovation. This is because R&D-based innovation in emerging markets faces significant financial and institutional constraints making it more difficult for the private sector to get involved or make a satisfactory return on their investment. The advantage of this government involvement is that since governments are not usually driven by a profit-only motive they will actively partner and support entrepreneurial efforts in new technologies as a way to nurture local talent and skills in an effort to further develop the country. In some cases, state-owned firms are a key driver in R&D and innovation. For example, in India the Small Industries Development Bank of India (SIDBI) Start-Up Mitra is a digital initiative by the Indian government to address gaps in the technological start-up ecosystem. In China, the government of Tianjin has set up a USD 5 billion fund to support the AI industry. The resulting increase in R&D spending means that Asia is forecast to outpace the US and Europe's expenditure, as shown in the table below:

Figure 4: R&D Expenditure



Source: OECD, UBS, July 2019.

Although the trends in rising R&D spending are currently most visible in North Asia, there are also increasingly pockets of technological innovation elsewhere in emerging markets, for example in countries such as Russia, South Africa and Brazil. A recent research paper[14] by the Emerging Multinationals Research Network (EMRN) established a framework of innovation analysis in emerging markets, as Figure 5 shows.

These three advantages have enabled emerging economies to skip entire stages of conventional development. This so-called Fourth Industrial Revolution[15] whereby the digital and physical worlds merge, characterized by the convergence of new technologies such as nanotechnology, biotechnology, new materials and artificial intelligence, is changing the way we interact, work, eat, exercise, pay and educate.

[14] Casanova, L., Cahen, F., Miroux, A., Finchelstein, D., Davila, A., García, J., Andonova, V., Miranda de Oliveira, M. Jr., 2019, "Innovation in Emerging Markets: The Case of Latin America", AIB Insights, special issue on Latin America.

[15] The term 'The Fourth Industrial Revolution' was coined in the 2010s by Klaus Schwab, founder and executive chairman of the World Economic Forum.

Homegrown innovations are then often adopted internationally. For example, retailer JD.com has been using drones to support Covid-19 contact tracing and delivery efforts in rural China.[16] Certain African countries have also embraced the use of commercial drones to deliver vital medicines and blood transfusions, in particular to rural communities with little infrastructure.[17] M-Pesa, a Kenyan mobile money transfer service, is credited with sparking the boom of mobile money in Africa.[18]

[16] Song, J., 12 February 2021, "JD.com makes drone deliveries as coronavirus cuts off usual modes", NIKKEIAsia article.
[17] Elmi, N., 9 September 2020, "Here are 4 technology trends from emerging economies", World Economic Forum article.
[18] Food and Agriculture Organization of the United Nations, 11 May 2017, "10 years of M-Pesa: The world's most successful money transfer service", e-Agriculture news.

Figure 5: Drivers, types and outcomes of innovation in emerging markets

Drivers of innovation in EM

Institutional context
- Institutional voids (products, labor, and capital markets, institutional macro-context)
- Role of the government

Social Demands
- Resource scarcity
- Large populations – large bottom of pyramid

Industry
- Industrial competition
- Industrial policies
- Presence foreign subsidiaries

Firm
- Innovation capabilities
- International orientation
- Managerial resources scarcities
- Digitalization

Innovation systems in EM
- Government (Innovation Policies Support institutions public R&D center)
- Universities (human capital education, researchers)
- Companies (investors private R&D centers)
- Technology parks, Incubators

Types of innovation from EM

Technology driven and R&D-based innovation

Process and organizational innovation

Business model innovation

Frugal innovation
(and other types: low-cost, bottom of the pyramid, etc.)

Innovation outcomes in EM

Competitive advantages
- INew organizational capabilities
- Brand creation and recognition
- Internationalization performance
- Connection to global value chains

Social development
- Prosperity, equality (transcends economic growth to establish social stability)

Country performance
- Economic growth
- Job creation
- Competitiveness

Source: Casanova, L., Cahen, F., Miroux, A., Finchelstein, D., Davila, A., García, J., Andonova, V., Miranda de Oliveira, M. Jr., 2019, "Innovation in Emerging Markets: The Case of Latin America", AIB Insights, special issue on Latin America.

Services like this drive the move towards greater use of mobile-based services ranging from payments to medical advice all over the world.[19] The lockdown measures resulting from the Covid-19 pandemic have thus benefited emerging markets players with an unprecedented boost in adoption of all sorts of digital services and a change in consumer behavior towards living essentials, including healthcare and environmental issues.

[19] Source: Runde, 12 August 2015, "M-Pesa and the rise of the global mobile money market", Forbes article, 2015.

The global tech ecosystem is becoming dominated by India and China. In 2006 the two countries accounted for around 2% of global-deal value. By 2017 this has grown to nearly 27% and both are now in the top 20 startup ecosystems in the world[20] with Beijing (China) in fourth place, Shanghai (China) in eighth position and Bangalore (India) in 20th. But other emerging market countries are also getting involved. In 2019 the total annual investment in technology start-ups came to USD 258 billion in China compared to USD 130 billion in the US.[21]

[20] Source: Startup Genome: Global Startup Ecosystem Report, 2017.

[21] Source: World Economic Forum, 2021.

> 'China, South Korea and India are already in the top 10 rankings of retail ecommerce sales in 2020'

In the ecommerce sector, China, South Korea and India are already in the top 10 rankings of retail ecommerce sales in 2020. The Chinese ecommerce market is number one globally with a market size of USD 2.3 trillion (the US is USD 795 million) thanks to the availability of affordable smartphones – made in Asia. The actual internet opportunity lies with expanding services online as internet merchants move beyond goods into services such as insurance and food delivery.

Growth in emerging markets is critical as it is leader of global economic growth. Emerging markets innovations form the engine for such growth, and continue to rise in importance. These innovations differ significantly from developed market innovations and are very clearly not copycats but original. Emerging market economies have thus not followed the same evolutionary pattern as developed markets.

Furthermore, the type and nature of the innovation differs markedly across countries in emerging markets depending on the drivers that have evolved. For example, the drivers for innovation in Africa are based on poor infrastructure, low landline penetration rates, demographics, poverty rates and so on, resulting in a different set of innovations compared to that of China where the drivers are related to consumption and financial service.

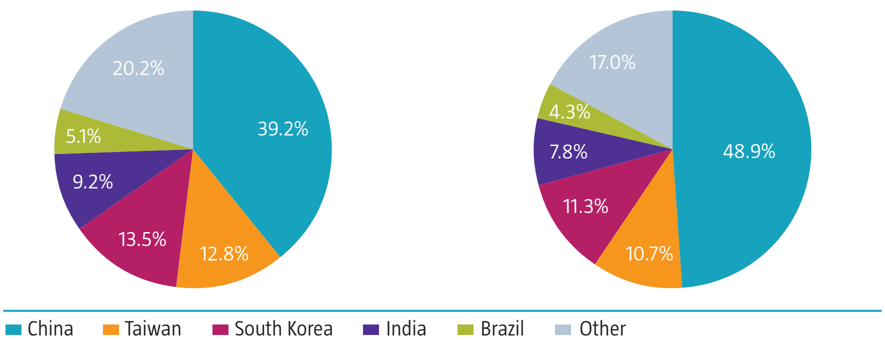
Regardless of the technological innovation involved, as the world continues to shift to a knowledge-based economy, we are seeing a rise in the importance of intangible assets and several emerging markets now lead developed markets in areas such as ecommerce, digital payments and mobile banking. We believe this trend is likely to continue.

China becomes the dominant force

In just a few years, China has become an essential player in emerging markets. The inclusion of domestically listed stocks, so-called A-shares, in MSCI's Emerging Market Index in 2018 combined with strong and resilient growth as well as relatively sound economic fundamentals have turned Chinese equities into a must for investors. As a result, the amount of domestically listed equities owned by foreign investors has grown sharply over the past five years.

Despite this, Chinese stocks remain largely underrated and 'under-owned' by foreign investors. We believe the participation of foreign investors will continue to rise, provided China manages to sustain its economic growth impetus. Further inclusion of A-shares by MSCI should also boost this trend. At the end of 2020, Chinese stocks represented 39.2% of the emerging markets universe. Yet, with full inclusion of A-shares, Chinese equities could represent roughly 50% of that universe (see Figure 6).

Figure 6: MSCI Emerging Markets Index weights at the end of 2020 and with A-shares full inclusion



Source: Factset, MSCI, RIMES, Morgan Stanley Research, December 2020.

While MSCI has voiced concerns over further inclusion over the past couple of years, indicating key reforms were still needed, the pace of reforms has accelerated. These include new rules on Qualified Foreign Institutional Investors (QFII) and RMB QFII, as well as the ChiNext market reform to further allow ADRs and red chips to come home. Moreover, China is ready to launch A-share derivatives in Hong Kong. Finally, the Master SPSA (Special Segregated) Service will soon be installed for Stock Connect Northbound trading.

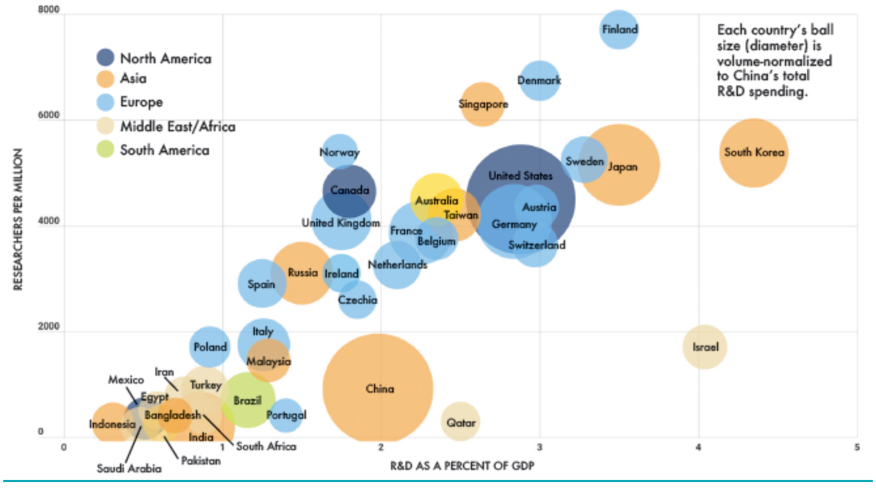
From a longer-term perspective, Chinese equities also benefit from promising prospects in a number of areas. China's 14th Five-Year Plan for the 2020-2025 period focuses on quality of economic growth. The plan does not stipulate specific annual GDP growth targets, but it has explicitly made two broad goals: achieving high income status by 2025 and doubling the size of the Chinese economy by 2035.

Besides further opening up of Chinese financial markets to foreign investors, the next five-year plan outlines various other critical areas for future growth and development. This will support the country's ongoing shift towards a more service-oriented, high-value-added economy and a broad-based industrial upgrade trend. China has the largest manufacturing base in the world and wants to move up the global value chain.

In terms of R&D, for instance, China has been investing heavily for over two decades. The country is expected to take global leadership in 2021 and outspend the US in R&D for the very first time (see Figure 7).[22] Amid political tensions with the West, China has also embarked on a journey towards technological self-sufficiency. One key example concerns the semiconductors industry, where considerable resources are being dedicated to catch up the country's lag relative to the US.

[22] Source: R&D World, April 2021.

Figure 7: 2020 R&D spending in selected countries



Source: R&D World, April 2021.

Low carbon transition

Meanwhile, China's recent pledge to become carbon neutral by 2060 also supports the long-term outlook for equity markets. Making the world's largest CO_2 emitter carbon neutral within the next 40 years is no mean feat. But the formidable challenges associated with the transition also come with many investment opportunities. We see opportunities in three major areas: renewables, electric vehicles, and distribution and storage infrastructure.

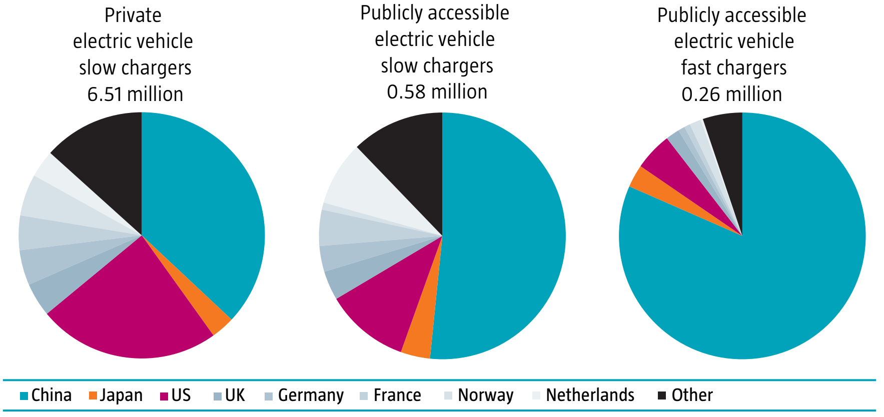
Renewables are expected to retain the lion's share of investments. Recent official announcements suggest there will be an ambitious ramping up of clean power over the coming decade, with the share of non-fossil fuels in primary energy now expected to reach

25% by 2030, compared to an earlier target of 20%. Given the gradual exhaustion of hydropower potential and slowing nuclear power additions, this target implies a rapid step-up of wind and solar.

But electric vehicles are also expected to be among the big winners. Beijing has also made it clear that it wants to continue leading the way in new energy vehicles (NEVs), with a recently approved plan for the industry. According to the plan, NEV sales are expected to reach 20% of overall new car sales by 2025, up from 5.4% last year.[23] This target for 2025 is lower than the previously stated target of 25% as it takes into account the rough patch of 2019 and 2020.

[23] Source: Yu, C., 4 November 2020, "High-quality growth of new energy vehicle sector prioritized", China Daily article.

Figure 8: China already leads in the number of EV charging points



Source: IEA, 'Global EV Outlook', 2020.

Finally, upgrades in power networks and energy storage technologies as well as the hydrogen industry are likely to capture a significant portion of total investments too. While renewables will play the most critical role in the transition, additional storage technologies will also be needed. From this perspective, two complementary technologies – batteries and hydrogen – are likely to play a key role as they can convert electricity into chemical energy and vice versa.

Avoiding the middle-income trap

In theory, all emerging markets are bound to become developed ones someday, as their economies develop, and their financial systems mature, and their standards converge towards those of developed markets. In practice, however, development paths rarely follow a smooth upward trajectory. Economic booms and bursts, political crises and numerous other hiccups often come to disrupt emerging economies and their stock markets.

In fact, only very few stock markets have managed to move from the emerging to the developed category over the past 30 years. Most emerging markets of the late 1980s, such as India, Brazil, or Mexico, still remain in that category. This is usually due a combination of both insufficient progress in terms of economic development as well as the accessibility of their financial markets to foreign investors.

According to MSCI's classification framework, for example, only three countries – namely, Portugal, Greece and Israel – have been reclassified from emerging to developed market since the MSCI Emerging Markets Index was launched in 1988. Meanwhile, several countries, including Jordan and Morocco, have actually seen their situation worsen and have been downgraded from emerging to frontier category.

This underscores the need for equity investors not to trust the emerging bandwagon blindly. When it comes to investing in emerging equity markets, a robust country selection framework is required to avoid extreme scenarios such as brutal currency devaluations or sudden restrictions in international capital flows. This also explains why so many investors are mindful of the so-called 'middle income trap', in which most emerging market countries appear to be stuck.

The term of 'middle income trap' was originally coined by Homi Kharas and Indermit Gill of the World Bank in 2007.[24] Building on earlier work by Jeffrey Garrett,[25] among others,[26] the two researchers investigated the circumstances that had led a significant number of once fast-growing economies to suddenly slow down and stagnate – or sometimes even worse – for periods of time of several decades.

The term describes economies "squeezed between the low-wage poor-country competitors that dominate in mature industries and the rich-country innovators that dominate in industries undergoing rapid technological change". Typical examples can be found in Latin America and in eastern Europe, where most countries have failed to fully catch up with their western counterparts since the end of the cold war.

Over the years, the 'middle income trap' has taken on a life of its own, expanding across the academic literature, especially after prominent economists and policymakers started to publicly warn against it. For instance, further research by Barry Eichengreen, Donghyun

[24] Gill, I. S. and Kharas, H., 2007, "An East Asian Renaissance: Ideas for Economic Growth." World Bank.
[25] Garrett, G., 2004, "Globalization's Missing Middle", Foreign Affairs.
[26] See also: Easterly, W., Kremer, M., Pritchett L. and Summers, L. H., 1993, "Good policy or good luck? Country growth performance and temporary shocks", Journal of Monetary Economics.

Park and Kwanho Shin[27] found that growth slowdowns occurred in the neighborhood of USD 10,000-11,000 and USD 15,000-16,0000 of per capita income, suggesting a deceleration in steps rather than at a single point in time.

Meanwhile, Shekhar Aiyar, Romain Duval, Damien Puy, Yiqun Wu, and Longmei Zhang[28] of the IMF found that middle-income countries indeed differ from other categories of countries in experiencing higher frequency of growth slowdowns. In their research, they also looked at the potential determinants that might explain such a tendency, and established 'growth slowdown risk maps' for individual middle-income countries.

Among the number of emerging countries at risk of falling prey of the middle-income trap, China is especially important, given the sheer size of its economy and its role as a growth engine for many other emerging markets. Back in 2015, Lou Jiwei, then finance minister of China, warned at a forum at Tsinghua University that, without further reform, the country had a "50/50 chance" of sliding into the middle-income trap, citing a rapidly aging population and shrinking labor force.

And although the Chinese official has since then updated his prognosis,[29] indicating that it should be "no problem for the China to avoid the middle-income trap", given the reforms implemented in recent years, further developments will likely be closely monitored in the coming years. For example, one of the main goals of the country's current five-year economic plan is to achieve high-income status by 2025.

The upshot for investors is that they should not consider emerging markets as a homogenous category. Within emerging markets, they will find technology-driven, fast-growing economies as well as less advanced commodity-dependent ones. Country selection is key. And while there is no definitive proof that a trap specific to middle-income countries really exists, the term is a good reminder of how difficult the transition from emerging to developed status tends to be.

27 Eichengreen, B., Park, D. and Shin, K., 2013, "Growth Slowdowns Redux: New Evidence on the Middle Income Trap." NBER Working Paper No. 18673, National Bureau of Economic Research.

28 Shekhar Aiyar, Romain Duval, Damien Puy, Yiqun Wu, and Longmei Zhang

29 Zhang Z., Liu J., Wang X., 23 October 2017, "China Focus: How China can avoid middle income trap in a new era", Xinhua news article.

3

Equity Investment approaches

As with any equity investment, the reason to invest in emerging markets is to benefit from a combination of future income and capital appreciation. Emerging market economies now account for the bulk of global growth, and for investors to ignore this is to miss out. With the decision to invest in emerging markets, the next step is how to get exposure to them.

Making important decisions

Equity investors in emerging markets need to make quite a few decisions. As Warren Buffet once stated: "Risk comes from not knowing what you're doing". Firstly, they will need to decide how they want to put their money to work in emerging markets. As a result of the growing popularity of investing in emerging markets, there are an increasing number of ways for investors to gain access to emerging markets.

Secondly, investors will need to decide whether they want to invest actively, or passively follow a public stock market index. Finally, they will need to decide what investment style they want to follow. Growth, value, growth at a reasonable price (GARP) and a blended approach are just a few examples of such styles.

In a nutshell, there are two main ways for equity investors to gain access to emerging markets. They can invest in either public or private companies. In the case of public emerging markets companies, investors can buy securities that are listed on a stock exchange, the so-called secondary market. In the second case, they can buy shares of private, that is non-listed, companies operating in emerging markets.

For the vast majority of investors, the private route is usually not really an option, mainly for practical reasons. As a result, the most common way for them to get exposure to emerging markets is via the public route. This, in turn, can be done in a multitude of ways, including by buying individual listed stocks, or shares of exchange traded funds (ETFs), mutual funds, hedge funds, microfinance funds, and so on.

Investing in individual stocks listed on the emerging markets' stock exchanges is not practical for most investors due to the costs and risks involved. Transaction costs, exchange rate risks, political risks, transparency risks, lack of research, liquidity risk, regulatory and legal risk, the need to set up separate trading accounts in some countries, and the constant monitoring of your investments are just some of the inherent issues that often create insurmountable hurdles for most retail investors.

As a result, buying shares of ETFs or mutual funds often turns out to be the more practical and preferred route chosen by equity investors looking for exposure to emerging markets. For one, it provides relatively straightforward and cost-effective 'one-stop' access to a diversified range of countries and companies.

The second choice then, for an equity investor, is between passive and active investing. The active versus passive debate has been raging for many years and is far from closed. Passive investment funds have grown in popularity and offer one key benefit – immediate market beta. A key bone of contention between active and passive is the ability to exploit market inefficiencies to consistently generate alpha over time.

While passive investing might make sense in a deep and relatively efficient market like the US, we believe there is much to be gained by adopting an active approach to the emerging markets thanks to the significant inefficiencies that exist in emerging markets. These inefficiencies result in a greater probability for stocks to be mispriced, since for a company to be priced at its true value requires a totally transparent and open market.

Any restrictions preventing this will cause the share price to deviate from the underlying company's true value. For example, many emerging markets impose foreign ownership restrictions or have capital market controls in place. Financial statements also often turn out not to be transparent, while companies may be partially owned by their government, which may not always act in the best interests of all shareholders. This mispricing can be exploited by a skilled manager to generate alpha.

Furthermore, a passive investment approach favors certain countries/sectors/stocks. A passive approach is only as good as the index it seeks to replicate. For example, China is approximately 37.5% of the MSCI EM Index[30] and is expected to continue to increase in size going forward. Add in South Korea and Taiwan and your passive MSCI EM Index tracker has 65.5% focused in three countries at all times. The five largest index stocks in the MSCI EM Index are all technology/internet-orientated companies and represent 22% of the total. [31]

[30] Source: MSCI, April 2021.

[31] Source: MSCI, April 2021.

The methodology of the index construction is also an important consideration. The MSCI's approach is a market cap-weighted one which disproportionately favors larger cap stocks and is backward-looking by skewing exposure to previously strong performing areas of the market. In the case of emerging markets, this approach currently leads to unbalanced exposure to state-owned companies, potentially at the expense of other faster growing and more dynamic enterprises.

Figure 9: The Morningstar equity style box

	Value	**Blend**	**Growth**
Large cap			
Medium cap			
Small cap			

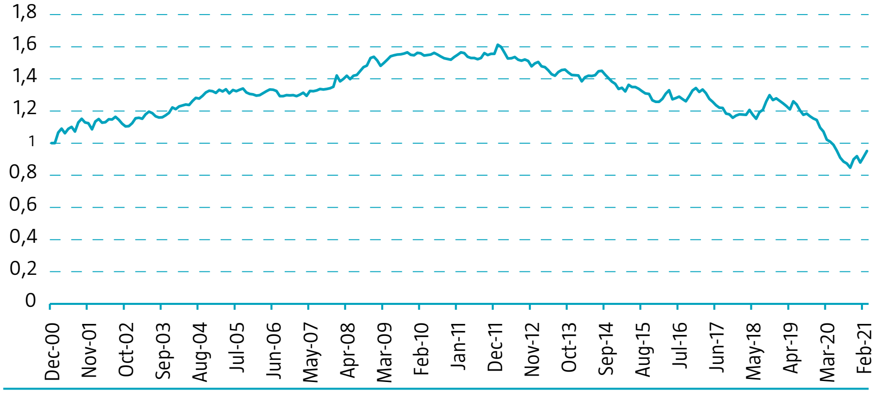
Source: Morningstar.

The third decision investors need to make is to decide the investment style they want to follow. Although there are a variety of different styles, investment consultants will generally use a relatively simple framework to evaluate where an equity strategy sits in a style matrix. Figure 9 provides an example of a typical style matrix used by consultants to categorize different active investment strategies.

Beyond the market capitalization size criterion, there are thus two broad investment style approaches at either end of the style spectrum: value and growth. Growth investing is a style of investing where an investor seeks out stocks with above average growth potential compared to the market and its industry peers. With value investing, investors seek stocks that they believe are trading below their intrinsic value.

The high growth and the possibility of spectacularly high returns form the primary allure of emerging markets. Many investors thus connect high economic growth with high earnings growth and subsequently higher stock returns. However, studies show that this approach has not worked in the long run. In fact, the emerging markets value versus growth performance story has been one with two sides over the past two decades. Emerging markets value stocks performed strongly between 2000 and 2010. But they succumbed to the resurgence of growth stocks from 2011 onwards.

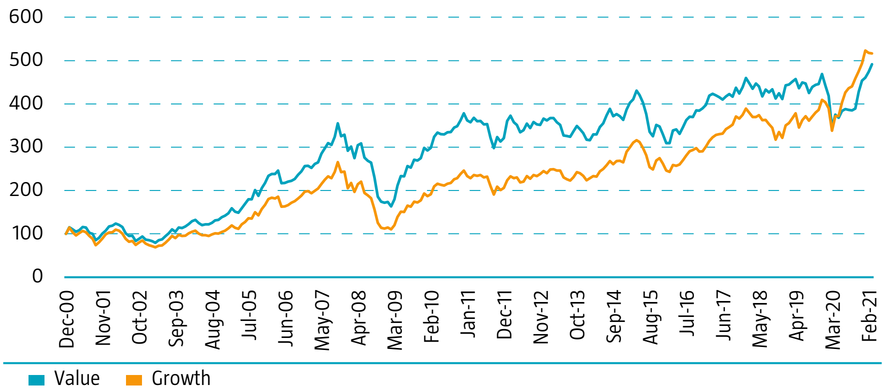
Figure 10: MSCI Emerging Markets Value Index over MSCI Emerging Markets Growth Index



Source: MSCI, Robeco, February 2021.

In fact, emerging markets value did so well during the 2000s that it was only around 2020 that growth finally overtook value, if invested since 2001. Nevertheless, there is no denying that the 2010s have been a miserable decade for emerging markets value investors.

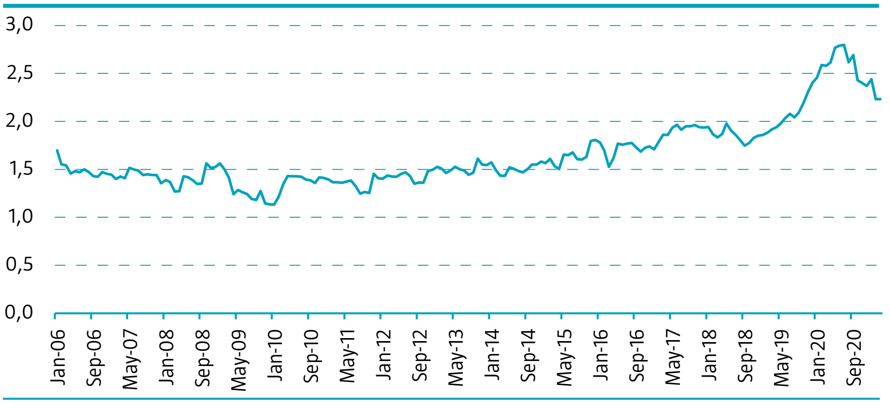
Figure 11: MSCI Emerging Markets Value Index versus MSCI Emerging Markets Growth Index rebased to 100



Source: MSCI, Robeco, February 2021.

For those who believe that value investing is the best style, there is hope going forward. Figure 11 suggests that a modest recovery in value stocks started towards the end of 2020. Meanwhile, the hypothesis of a continuation of this recovery is supported by the chart showing that the valuation differential between growth and value is trending back down after reaching historically high levels, as Figure 12 shows.

Figure 12: MSCI Emerging Markets Growth P/E to MSCI Emerging Markets Value P/E



Source: MSCI, Robeco, September 2021.

Why this recovery? Starting in November 2020, encouraging results for several Covid-19 vaccine candidates to fight the pandemic proved to be a turning point for style performance. With the approval and subsequent rollout of vaccines, the outlook for global economic growth improved drastically and prospects for highflying growth stocks started to stand out less screamingly from those of other stocks.

With the global economic growth pick-up, long-term interest rates started to rise steeply from the depressed levels. US 10-year Treasury yields soared from 0.9% to more than 1.6% during the first quarter of 2021. Simultaneously, growth stocks started to clearly underperform value stocks, while energy and commodity prices also rallied. The earnings outlook for companies in the energy, financial, and materials sectors improved significantly.

Yet buying a stock on valuation grounds alone can be treacherous. After all, a stock may remain cheap for a very long time or forever. At Robeco, we believe investors must therefore focus on stocks that are not only attractively priced, but also have future earnings growth that we believe is not expected by the market consensus. In addition, this type of approach can act as a buffer during periods when value stocks underperform.

Country selection is key

Once investors have addressed the three questions explained in the previous section, they will need to look at another crucial aspect: the relative importance of investing with a focus on either countries or sectors. Recent Robeco research shows that though industries (sectors) are the dominant force driving stock market returns for developed markets, for emerging markets, countries fulfil this role.[32]

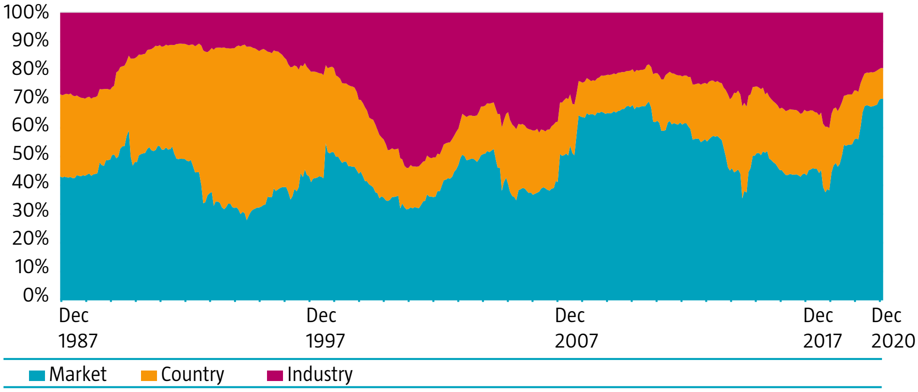
[32] Swinkels, L., March 2021, "Countries and industry effects in developed and emerging markets", Robeco article.

This should come as no surprise. As mentioned in Chapter 2 of this publication, emerging equity markets are far from homogeneous, and the optimal way to gain exposure to emerging markets is to take an approach that looks at the opportunities afforded within each emerging market country. Understanding the economic drivers of the countries in which companies operate is important for successful stock selection.

Investing in emerging markets is far more subtle and nuanced than just investing in companies that benefit from a country's growth – it is important to distinguish between countries in different stages of growth, composition of demographics, approaches to policy implementation, and fiscal management. Figures 13 and 14 illustrate the relative importance of country versus sector selection in emerging and developed markets.

The two figures break the stock returns in each period down into three components: a component that is explained by the general market effect, a second reflecting a country effect, and a third representing a sector effect. The developed equity markets dataset runs from January 1985 until January 2021, while the emerging equity markets data starts seven years later, in January 1992

Figure 13: Market, country, and industry variance decomposition for developed markets



Source: Robeco, Refinitiv DataStream. Variance decomposition (three-year rolling window) of the market, country, and industry effects using the method by Griffin and Karolyi (1998) with country-industry indices for the 12 level two industries and 23 developed market countries. Monthly returns hedged to US dollar. Sample period data January 1985 to January 2021.

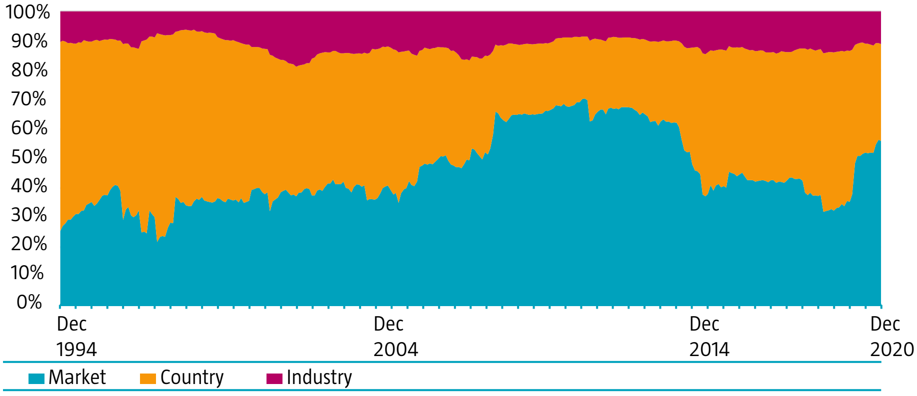
As Figure 13 highlights, the market effect's impact on the performance of developed markets has ranged between 30% and 50% since the beginning of our sample, in the late 1980s, up until the global financial crisis of 2008, when it spiked to almost 70%. The market effect's impact then slowly decreased over the following decade to roughly 40%, and spiked back up to 70% in the runup to the Covid-19 crisis.

Meanwhile, the country effects were initially as important as the overall market effect, in the beginning of the sample. But with the rising importance of the online economy in the second half of the 1990s, and the technology euphoria that followed, industry effects became more dominant. By the early 2000s, industry effects explained an even larger share of overall variance than the overall market effect.

Although the country effects increased again after the bursting of the technology bubble, they never again regained the dominance seen in the late 1980s and early 1990s. In fact, they have become even weaker over the past few years, decreasing to about half the size of industry effects. This long-standing decrease of country effects over time is often attributed to financial and economic globalization.[33]

[33] See, for example: Stulz, R. M., 2005, "The limits of financial globalization." The Journal of Finance. See also: Eun, C. S and Lee, J., 2010, "Mean-variance convergence around the world." Journal of Banking and Finance.

Figure 14: Market, country, and industry variance decomposition for emerging markets



Source: Robeco, Refinitiv DataStream. Variance decomposition (three-year rolling window) of the market, country, and industry effects using the method by Griffin and Karolyi (1998) with country-industry indices for the 12 level two industries and 22 emerging market countries. Monthly returns in US dollar. Sample period data January 1992 to January 2021

This, however, does not apply to emerging markets which tend to be less integrated with the global financial system than developed ones. Our analysis of the role played by industry, country and market effects, for the 22 emerging market countries, shows this (see Figure 14). We see that the decision of which country to pick is by far the most important investment decision in emerging markets, with sector effects playing a minor role.

This, at least, has been the case for the last quarter century. Figure 14 does not show a rise and subsequent fall of the impact of industries, like the one seen for developed markets. Meanwhile, the importance of the market effect remains generally limited, close to 40% in 'normal' times, although some spikes to 60% have occurred during rougher periods such as the global financial crisis and, more recently, the Covid-19 pandemic.

Whereas country allocation effects have become less important over the past few decades, due to financial and economic integration in developed markets, they remain the dominant driver of returns in emerging markets. Investors looking for exposure to emerging markets equities must therefore keep in mind that country selection is therefore far more important than industry selection. The key is to analyze where growth in the world and within individual markets is coming from, and identify themes and companies that are best positioned to benefit from this growth.

4

Sustainability

Sustainable investing has become a popular buzzword. Yet the concept has been around for longer than you would think . The term 'sustainable' was first used by the Club of Rome in a March 1972 to report on the 'limits to growth'.[34] In 1987, the Brundtland Commission Report[35] defined sustainable development as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs." This report is often credited with making sustainability mainstream.

[34] Meadows, D. H., Meadows, D. L., Randers, J. and Behrens, W. W., 1972, "The limits to growth", a report for the Club of Rome.

[35] World Commission on Environment and Development, 1987, "Our common future", report transmitted to the General Assembly of the UN. This report is also known as the Brundtland report.

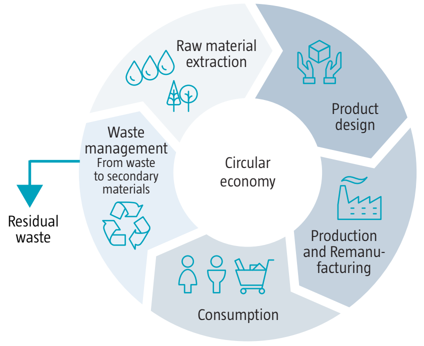
Many dimensions to consider

Since then, other dimensions have been added, including the UN Sustainable Development Goals (SDGs) as well as a series of multinational corporate practices labeled 'corporate social responsibility' (CSR). More recently, the concept of sustainable investing has been extended to the circular economy approach, an economic model that places a greater reliance on reusing existing materials in a series of loops.

The circular economy entails gradually decoupling economic activity from the consumption of finite resources. This means designing waste out of the production process, while regenerating natural ecosystems. Nowadays, the dominant global economic model is still mostly linear, but research shows that this model consumes finite resources at 1.75 times the planet's annual regenerative capacity, while less than 12% of materials are recycled and brought back into the economy.[36]

[36] Source: European Commission, 11 March 2021, "Changing how we produce and consume: New Circular Economy Action Plan shows the way to a climate-neutral, competitive economy of empowered consumers", press release.

Figure 15: The circular economy



Source: European Commission, Circular economy action plan, 2020

As the importance of sustainable growth has become clear, integrating sustainability criteria into investment processes has moved from niche to mainstream. However, investors have often been skeptical of sustainable investing in emerging markets. Worries over the quality and reliability of data, the lack of transparency, and a lack of motivation from both corporates and governments are just a few of the issues that have been raised.

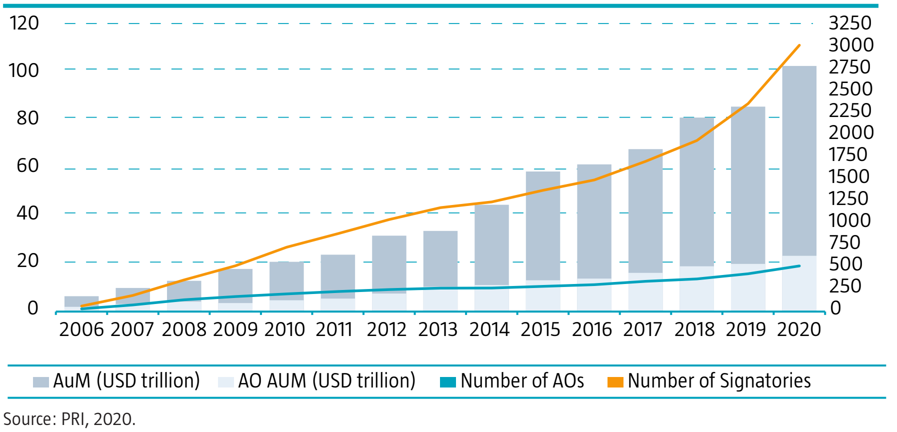
However, though it is true that emerging economies and corporates have at times found it challenging to apply sustainability concepts, great advances have been made and the sustainability gap between the developed and emerging countries has narrowed significantly. Importantly, contributing 58% to global GDP, emerging markets – individually and collectively – have the potential to make the single most important contribution to the sustainable development agenda.

The growth of emerging powers such as China, India, Brazil and South Africa and the implications of this growth on sustainable development is understudied.[37] Yet, this group can significantly influence the rest of the emerging markets. In particular, China and India can have a large impact on reducing carbon dioxide emissions as well as help to tackle global warming. China and India account for close to 30% and 7% of the world's CO_2 emissions respectively, versus 15% for the US and 9% for the European Union.[38]

Initially, only a few fund managers – including Robeco – took any meaningful steps to consider sustainability aspects in their investment process. Today, however, sustainability integration has become a must for many fund managers and asset owners alike, not only in developed markets, but also in emerging ones. Where managers previously did not go beyond voicing sustainability concerns, their words are now gradually being translated into action.

Figure 16 illustrates this. In 2006, when the UN-backed 'Principles for Responsible Investment' (PRI) were launched, only 63 asset managers, with USD 6.5 trillion in assets under management (AuM), committed to consider environmental, social and governance (ESG) criteria in their investment decisions. By the end of 2020, the number of signatories had grown to over 3,000 with USD 100 trillion in AuM. Globally, around USD 30 trillion worth of professionally managed assets are now subject to some type of ESG criteria. This is nearly a third of all managed assets.

Figure 16: The growth of ESG incorporation into investment decisions



Source: PRI, 2020.

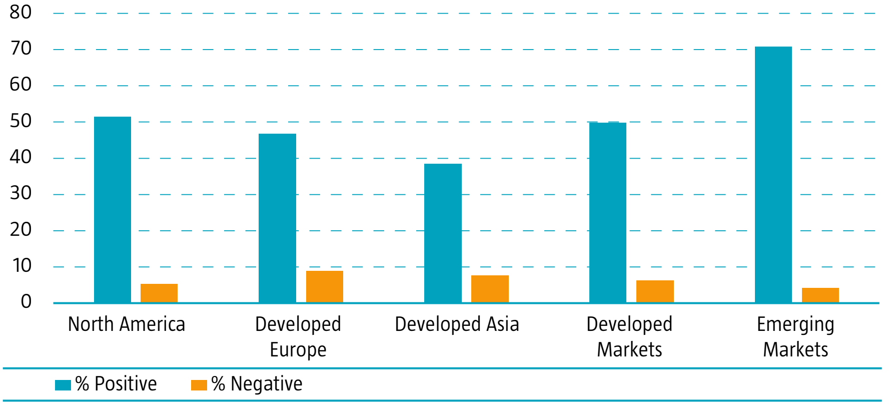
Meanwhile the positive effects of sustainable management practices on corporate financial performance have slowly been surfacing. For instance, a 2015 empirical meta-study by Gunnar Friede, Timo Busch and Alexander Bassen[39] concluded that taking ESG criteria into account had clear benefits for companies. It also found that it was of particular importance in emerging markets, as Figure 17 shows.

[37] Papa, M. and Gleason, N. W., 2012, "Major emerging powers in sustainable development diplomacy: Assessing their leadership potential", Global Environmental Change.

[38] Source: International Energy Agency (IEA), based on CO_2 emissions from fuel combustion for 2019.

[39] Friede, G., Busch. T. and Bassen, A., 2015, "ESG and financial performance: aggregated evidence from more than 2000 empirical studies", Journal of Sustainable Finance & Investment.

Figure 17: Results of over 2,000 empirical studies on the impact of ESG on corporate financial performance



Source: Friede, G., Busch. T. and Bassen, A., 2015, "ESG and financial performance: aggregated evidence from more than 2000 empirical studies", Journal of Sustainable Finance & Investment.

Until recently, sustainability aspects tended to be more frequently overlooked in emerging markets than in developed ones. Yet emerging markets are particularly exposed to many related issues, including climate risk, corruption and poor labor practices. Of course, developed markets face these issues too, but their regulatory framework is usually more advanced. Legal enforcement is also often stronger and more adequate in developed markets.

But the landscape is changing rapidly. Sustainability awareness has been growing across emerging countries, and not only among companies. For example, stock exchanges in emerging markets are establishing ESG reporting standards. There is a trend towards stronger corporate governance codes and listing requirements, that are improving transparency. Stewardship rules are being introduced in countries such as Brazil, South Korea, Malaysia, South Africa and Thailand.

A growing number of emerging markets companies clearly state their financial objectives in their annual report, and publish their financial accounts in English on their corporate website. ESG coverage of emerging markets companies by third-party providers has also expanded significantly. This has further improved transparency and information flows. As a result, reporting standards of emerging markets are converging rapidly with those of the developed markets.

Meanwhile, emerging markets individual investors' attitudes towards sustainability have also radically shifted, over the past few years. For instance, a recent PRI survey that polled pension fund holders in both developed and emerging markets found that retail investors in countries such as South Africa and Brazil were, in fact, more engaged with ESG issues than those in the developed world.[40]

[40] PRI YouGov, Responsible investment survey, September 2019.

Pioneers in sustainable investing

Robeco has long been an advocate of sustainable investing in general, and in emerging markets in particular. We started to explicitly integrate ESG criteria into our investment processes for emerging markets equities as early as 2011. Prior to that, we had already been including certain governance aspects in our processes since 2001 by sending a corporate governance-related questionnaire to listed companies. This was an early precursor to the ESG smart scores we use today.

At the time, the purpose of this ESG integration was to help us get a better understanding of the value drivers of each investable company. In fact, this is still the case. We believed, and still believe, that ESG aspects have an explicit impact on these value drivers. Understanding them leads, in turn, to better informed investment decisions, as it provides a more considered assessment and a better view on the risk-return profile of a stock.

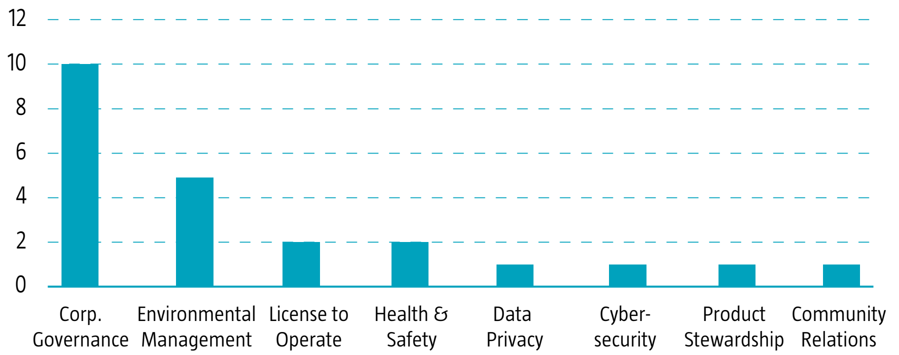
Broadly speaking, sustainability aspects can be integrated either via a data-driven approach – for example, using a simple screen to exclude any stocks that do not meet a specific ESG criteria level – or by using a more holistic approach, in which the emphasis is on making better informed investment decisions, and material sustainability variables are considered alongside traditional financial metrics. At Robeco, we believe this second approach yields better results.

We assess the impact of ESG aspects at both the country and stock level, since neither GDP nor company accounts directly reflect them. The most financially material ESG variables are taken into account in our investment cases. We adjust the cost of capital (at countries' level) and make explicit adjustments to corporate financial metrics, such as expected capex, revenues and margins, in our discounted cash flows (DCF) models.

The importance of each ESG variable will vary from one company and from one industry to another. But, generally speaking, items such as corporate governance and environmental management tend to have the largest impact on valuations in emerging markets. Figure 18 shows the number of times an issue is mentioned in the materiality framework used by Robeco when deciding which ESG issues have the most financial impact on a particular company.

Another key aspect of sustainable investing is to actively engage with companies held in portfolios, to help them enhance their sustainability profile and financial results. Identifying potential sustainability-related risks or opportunities can help firms address them, and ultimately create alpha for investors as they engage in a discussion with management teams to trigger change. Information gathered during this process can be used to support and complement fundamental analysis.

Figure 18: Material ESG issues in emerging markets



Source: Robeco, April 2020.

Finally, for companies for which engagement is not possible, exclusions lists are the last resort. These are companies that structurally breach the United Nations' Global Compact and do not show any sign of improvement after an intense process of three years of engagement. Such breaches can relate, for instance, to human rights, corruption and environmental issues. Companies that are involved in the production of controversial weapons are also excluded from the investable universe.

Three approaches to sustainability

Today, Robeco offers emerging markets investors three main types of sustainable investing solutions, depending on their aims and objectives in terms of sustainability, labelled as Inside, Focused and Impact solutions. Although they offer different levels of sustainability integration, they do all share the same ESG integration process, as well as our active ownership offering, which includes voting and engagement.

Figure 19 summarizes the main features of these three categories of sustainable investing solutions offered for the emerging markets equity asset class.

Figure 19: Sustainable investing solutions at Robeco Fundamental Equities

Robeco Sustainability categories		INSIDE	FOCUSED	IMPACT**
Values-based exclusions		✓	✓	✓
			✓	✓
				✓
Negative screening	Exclude bottom 20% worst from universe*		✓	
ESG integration	Improve the risk/return profile	✓	✓	✓
Active ownership	Voting	✓	✓	✓
	Engagement	✓	✓	✓
Improved ESG profile	Better ESG score versus the index*		✓	
Environmental footprint reduction	GHG Emissions – Scope 1 & 2		-20%	
	Energy Consumption		-20%	
	Water Use		-20%	
	Waste generation		-20%	
Sustainable Development Goals (SDGs)	Contribute positively to realizing the SDGs			✓

UN PRI Global Compact Breach, Weapons, Tobacco, Palm oil, Thermal Coal, Oil Sands, Arctic Drilling, Military Contracting, Firearms, Nuclear Power, Alcohol, Gambling, Adult Entertainment, Cannabis

Source: Robeco. For mandates we can offer customized solutions. *Based on Smart ESG scores. **SDG Engagement strategy: available as model portfolio.
This information is intended to provide the reader with information onR obeco's specific capabilities, but does not constitute a recommendation to buy or sell certain securities or investment products.

Source: Robeco.

Sustainability Inside solutions can be considered as a first step in terms of the sustainable investing. These strategies apply a combination of values-based exclusions and ESG integration, as well as our voting and engagement capabilities. But although these solutions aim for portfolios with improved sustainability features compared to their benchmarks, their primary objective remains to achieve a competitive financial return.

For investors looking for both competitive financial returns and high sustainability standards, Sustainability Focused solutions incorporate additional criteria. For instance, they apply additional values-based exclusions, exclude the bottom 20% of the investable universe based on Robeco's Smart ESG score, ensure that the portfolio's ESG profile is better than the index, and that its environmental footprint is at least 20% lower than that of the index.

Finally, Impact solutions focus on companies making a positive contribution to the United Nations' Sustainable Development Goals (SDGs), while targeting attractive financial returns. For example, a company producing solar energy is contributing to SDG 7 (affordable and clean energy). A business creating educational materials for schools is contributing to SDG 4 (quality education), and a firm that actively works to promote women in leadership roles is advancing SDG 5 (gender equality).

Conversely, companies with a negative impact on SDGs are excluded from SDG range. Others may contribute both positively and negatively, for example, an energy utility that uses both wind power and thermal coal. Scoring systems are used to calculate the overall contribution. Robeco uses a three-step process to find candidates for its SDG range, analyzing what the company does, how it goes about doing it, and whether it has been involved in any controversies.

'Impact investing is a relatively new phenomenon in emerging markets. But it has caught up rapidly'

Impact investing is a relatively new phenomenon in emerging markets, as the SDGs were only launched in 2015. But it has caught up rapidly in recent years, with the Global Impact Investing Network (GIIN) estimating the size of the global impact investing market to be around USD 715 billion at the end of 2019. The SDGs are especially relevant for emerging markets, as they tend to be further away from attaining most of the SDGs than their developed counterparts.

They also tend to have a greater need for investment in infrastructure, technological innovation and educational improvements. And living standards tend to be lower, generally leading to profound socioeconomic, gender and income inequalities. Emerging market countries are often also more vulnerable to environmental shocks, such as climate change and natural disasters, as well as to pandemics.

This means much greater opportunities for investors to capture performance potential arising from SDG-related improvements. For example, connecting a community to water and electricity networks is a quick and easy way to make the lives of a large number of people dramatically better. Based on our investment process, companies are selected where it is believed that the contribution to SDGs can be improved through engagement by transforming their business model towards greater impact.

Of course, impact investing in emerging countries also often turns out to be challenging. One of the key issues is disclosure and reporting. The impact investing methodology is in its infancy globally, and particularly patchy in emerging countries. Here, companies tend to lag their developed counterparts in terms of sustainability reporting, making it harder to assess the impact of an investment. However, as mentioned earlier, the gap is narrowing fast.

There are already some strong players in most emerging markets, with countries like Brazil, China, South Africa, India and Thailand being the largest sources of opportunities. According to the GIIN, attaining the SDGs by 2030 will require an estimated USD 2.5 trillion of investment per year in emerging markets alone. One way for investors to make a real impact will be to find the companies that will benefit from these necessary investments.

Appendix

While this guide's focus is mainly on fundamental active investing in emerging markets equities, Robeco offers a wide range of strategies that invest in emerging markets.

This overview shows some of the different strategies available, varying in terms of active share, investment universe, style, asset class or level of sustainability integration.

	Global	Regional/Country	Fixed Income
Low vol/ß	QI Conservative EM		
Freestyle	Emerging Stars Sustainable Emerging Stars*	Africa	
Active management	Emerging Markets Core QI EM Active QI EM Sustainable Active*	China A-shares India China QI China A-shares	Emerging Credits
Alternative to passive	QI EM Enhanced Indexing QI EM Sustainable Enhanced Indexing*		

Active share

Fundamental Equity Quant Equity Fundamental Fixed Income

* 'Sustainability focused' strategies.

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