Global Environmental, Social, and Governance through an Asia Lens

By Vivek Tanneeru

For those aiming to include environmental, social, and governance (ESG) factors in their investing decisions, Asia represents one of the best opportunities to gain exposure to companies that could make a long-term difference. Many global ESG issues cannot be addressed effectively unless they are addressed and solved in Asia.

Sometimes businesses appear to build shareholder value when, in fact, they are doing the opposite over the long term. A basic example is a manufacturing business that cuts costs and boosts short-term profits by releasing untreated sewage into a river. This may lift the company's short-term cash flows, but it threatens its financial prospects longer term. The company could face regulatory sanctions, fines, and legal action that might thwart its business. It could become the target of community activism and negative publicity campaigns, causing reputational damage that could take years to repair. It might even experience management instability and turnover if those deemed responsible are forced to step down. Any such outcome would drag down the company’s valuation over time. Shareholders could end up paying a steep price for the original short-term gain.

Clearly, observers and investors may draw misleading conclusions about a company’s long-term prospects by focusing solely on short-term profits. An accurate assessment of a firm’s long-term prospects needs to include the environmental and social impact of its business practices on all stakeholders—shareholders as well as employees, customers, and the communities in which it operates, and also supply-chain partners, industry associations, and regulators.

The incorporation of ESG factors into investment analysis purports to achieve this result. Businesses that meet ESG standards generally make a conscious, deliberate effort to conduct their businesses in ways that have a minimal impact on the environment and that promote positive social and economic advancement. ESG is part of a larger focus on the creation of long-term shareholder value. It is not just good conscience. It can be good business. Companies that act responsibly may be better able to identify and execute on long-term growth opportunities. Of equal importance, such companies also may be better able to identify and manage risks effectively, potentially resulting in improved risk-adjusted outcomes for shareholders.

MANAGING THE ENVIRONMENTAL CONSEQUENCES OF GROWTH

On the back of impressive growth over the past several decades, the Asia Pacific region accounted for 30 percent of global gross domestic product (GDP) in 20161 and 31 percent of stock market capitalization in 2017.2 Asia’s growth has lifted hundreds of millions of people out of poverty and created a large and vibrant middle class. But an economic model that prioritized growth without regard to consequences has led to a rapidly deteriorating environment. Asia has accounted for 85 percent of the increase in global carbon emissions over a 25-year period to 2015.3

China is the world’s second-largest economy and, since 2006, the largest carbon dioxide (CO2) emitter.4 But it is still a relatively poor country by developed world standards. In 2010, China was only as rich as the United States was in 1941, but with an economy eight times as large. The United States has quadrupled its real GDP per capita since 1941. If China, with its much larger economy, were to do the same over the coming decades without addressing the environmental impact of growth, it likely would push the world’s atmospheric concentration of CO2 over 450 parts per million—a critical threshold at which scientists say global warming may be irreversible (see figure 1).

For China and Asia, climate change isn’t just an abstract concern. There are real costs. Much of the CO2 emitted has resulted from burning coal for energy, which also emits harmful particulate matter. It is not a surprise that the vast majority of the 7-million global deaths annually due to air pollution occur in Asia.

These issues present an enormous challenge. They also present potentially big investment opportunities. Governments, regulators, and private-sector companies are gearing up to tackle these
critical issues by investing in such things as urban transit systems and infrastructure, energy efficiency, and pollution-alleviation technologies. Asian countries are among the world’s leading players in alternative and renewable energy development, including solar, wind, and hydroelectric power.

China’s attitude and behavior toward environmental issues appear to be changing, in recognition that growth at the expense of the environment is not sustainable—and that environmental protection includes growth potential. The country has invested an average of 1.45 percent of its GDP in pollution control over the past few years. In 2015, coal generated less than 70 percent of Chinese electricity, a drop of 10 percentage points from 2011, and China’s CO2 emissions dropped for the first time in 15 years. Meanwhile, low-carbon sources of energy such as hydroelectric and wind climbed to 28 percent of power production.

Having signed the 2015 Paris Agreement on climate change, China has set ambitious emission reduction targets. In the 2016 Environmental Performance Index of some 180 countries, China rose to 109 in the rankings, up from 176 just three years prior (see figure 2). Following the U.S. administration’s decision to exit the Paris accord, China’s President Xi Jinping has sought to claim the mantle of moral authority on climate issues.

In addition to the climate change and air pollution challenges, half of Asian households don’t have access to a safe, piped water supply (see figure 2). According to the Asian Development Bank’s 2016 Water Development Outlook, an estimated 3.4 billion people could be living in water-stressed areas of Asia by 2050. The report notes a direct link between water management and economic growth, and calls for investments in water infrastructure and institutions, particularly in the region’s developing countries. There is a large investment opportunity as countries see the benefits of shifting from an eco­nomic model that once didn’t care about negative environmental consequences to one that now does.

**A NEW EMPHASIS ON QUALITY OF LIFE**

For Asia’s vast, newly minted middle classes, economic growth has met basic needs and then some, allowing them to turn their attention to quality-of-life issues. Meanwhile, governments and regulators are becoming increasingly serious about enforcement of fair market practices as well as environmental standards. This focus creates enormous opportunities for forward-thinking companies that can provide goods and services that improve quality of life as they address social, economic, and environmental challenges.

Asian ESG investing offers the biggest opportunity to make a global impact simply because of the sheer number of

---

**Figure 1**

**ENVIRONMENTAL: ASIA IS THE EPICENTER OF CARBON EMISSION**

![Graph showing annual CO2 emissions in billions of tons for various years from 1960 to 2012, with a critical threshold marked at 16.1 billion tons.]

**Figure 2**

**ENVIRONMENTAL: POLLUTION PRESENTS AN ENORMOUS CHALLENGE (AND POTENTIAL OPPORTUNITY) IN ASIA**

<table>
<thead>
<tr>
<th>AIR ISSUE RANK</th>
<th>COUNTRY</th>
<th>AIR QUALITY SCORE</th>
</tr>
</thead>
<tbody>
<tr>
<td>173</td>
<td>South Korea</td>
<td>45.5</td>
</tr>
<tr>
<td>174</td>
<td>Myanmar</td>
<td>44.3</td>
</tr>
<tr>
<td>175</td>
<td>Pakistan</td>
<td>34.6</td>
</tr>
<tr>
<td>176</td>
<td>Laos</td>
<td>32.5</td>
</tr>
<tr>
<td>177</td>
<td>Nepal</td>
<td>29.8</td>
</tr>
<tr>
<td>178</td>
<td>India</td>
<td>28.1</td>
</tr>
<tr>
<td>179</td>
<td>China</td>
<td>23.8</td>
</tr>
<tr>
<td>180</td>
<td>Bangladesh</td>
<td>21.9</td>
</tr>
</tbody>
</table>

*Note: Ranking out of 180 countries

**WATER NATIONAL WATER SECURITY IN 49 ASIAN PACIFIC COUNTRIES 2013 vs. 2016**

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>Hazardous</th>
<th>Engaged</th>
<th>Capable</th>
<th>Effective</th>
<th>Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>8</td>
<td>2</td>
<td>10</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>2016</td>
<td>5</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>0</td>
</tr>
</tbody>
</table>

*Note: The national water security index is a composite of the five key dimension indexes of water security: Household Water Security Index, Economic Water Security Index, Urban Water Security Index, Environmental Water Security Index, and Resilience to Water Related Disasters Index. Each index value ranges from one to five, and the average value represents the NWASI. Sources: Air quality scores—Environmental Performance Index (EPI); Yale; data as of 2016; National Water Security data as of 2013; Asian Development Bank, data as of 2016
lives affected. South and Southeast Asia has more than 1.6 billion people who spend less than US$100 per year on health care on average. Given their lack of spending power, providing access to affordable healthcare products and solutions is a critical social issue. There are millions of hepatitis C patients in South Asia, for instance, but very few, if any, have been able to afford Gilead Sciences’ highly effective drug Sovaldi for the simple reason that it was priced at US$1,000 per pill in the United States and the treatment lasts 12 weeks, adding up to US$12,000. To make this wonder drug available to people across the developing world, Gilead licensed it to several generic drug manufacturers that make the 12-week treatment available for under US$1,000. With its high-quality, globally competitive pharmaceutical and biotech businesses that have very low-cost structures, the Asia region has begun to address this problem of affordable access profitably.

Access to finance is another area in which Asia presents both challenges and opportunities. Hundreds of millions of people in Asia are without bank accounts or access to credit. In parts of South and Southeast Asia, access to credit is abysmally low. Credit, even in small amounts, often can make the difference between families becoming mired in poverty with no prospects or having a sustainable livelihood that will enable them to educate their children—whether that’s operating a bike repair shop in Jakarta or a fresh vegetable cart at a wet market in Manila.

This represents a genuine investment opportunity in Asia. Microfinancing and group-based lending models have sprung up throughout the region, particularly in rural areas, and big banks have taken notice of this growing market. In Indonesia, for example, the rural population has relied largely on the system of village-owned and operated Badan Kredit Desas or BKDs, established more than a century ago to take deposits and grant loans. The country’s major banks now have set up their own village-based financing units to get in on this market.

Microfinance is clearly a critical component of Asia’s rural economy that, by fostering entrepreneurship, is essential to sustained and more evenly distributed growth. With little bureaucracy, fast approvals, localized services, and flexible terms, microfinance—whether at the village or national bank level—provides rural entrepreneurs with much-needed capital. And borrowers who pay on time can look forward to larger loans to fund expansion, which ultimately may elevate them to the world of mainstream finance.

OVERCOMING THE INCOME DIVIDE

For all of Asia’s vaunted growth, not everyone has reaped the benefits equally. Income disparity has become a stark issue, most notably in the disproportionate distribution of wealth between urban and rural areas.

For Asian countries to sustain their recent achievements, growth needs to be more inclusive. Narrowing the income inequality gap is critical to providing more opportunities to a wider cross-section of society. Cheap labor is no longer Asia’s only competitive advantage. Today’s economies demand more skilled labor, which can provide more value-added production and services and create the opportunity for upward mobility. At the individual level, decent wages and access to social benefits increasingly depend on one’s skills, education, location, and gender. As more people search for the quality of life and personal fulfillment that come with income growth, equal access to education, health care, and benefits will be critical.

GENDER EQUALITY: MILES TO GO

Asia is also ripe for addressing gender diversity in the workforce, particularly in management and on corporate boards. The unequal representation of women in high places is often a reflection of underlying social and cultural mores. Some Asian countries have quite skewed demographic gender ratios because families have traditionally favored male children over female children. This has led to inequality that persists through school, university degrees, and job markets.

These imbalances have serious implications for the sustainability of growth. For North Asian countries such as Japan and Korea, the dynamics of aging populations necessitate a stronger role for women in the workforce. For South Asian countries, educating and including women in the workforce would be crucial in further boosting GDP growth rates and taking full advantage of favorable demographic trends.

Female representation on corporate boards appears to be improving, albeit at widely varying rates across Asia. Korea lags noticeably and Thailand is a surprising standout—almost on a par with the United States. In Japan, where the government is making concerted efforts to improve corporate governance standards, things are moving in the right direction, but much more needs to be done.

Evolving Corporate Governance Standards

Most observers of Asia’s growth over the past three decades would agree that corporate governance standards are improving (see figure 3). The pace of progress varies widely among countries, given the great diversity of traditions and cultures in Asia, and often is driven by government and regulatory mandates. China has imposed strict transparency and disclosure requirements for public companies listing on its A-shares market, for example, with harsh consequences for companies that misrepresent their financial performance. Japan, in contrast, has been slow to clean up its lax accounting standards but is now taking steps toward stronger corporate governance under Prime Minister Shinzo Abe’s economic reforms. Among its many provisions, India’s
2013 Companies Act requires listed companies of a certain size to donate 2 percent of net profits to charities. In Korea, where corruption scandals led to the impeachment of a president and a prison term for a prominent chief executive officer, calls to reform the large “chaebol” conglomerates that dominate the economy have swelled up from the street level to the halls of government.

Does good corporate governance really pay? It’s a fair question for investors to ask. Conventional wisdom holds that improving governance of a company pays because its valuation multiples typically expand and good governance may lead to tangible benefits in the longer term. Downside protection may be greater in well-run companies during market volatility, potentially leading to better risk-adjusted returns. In sectors such as banking, where raising capital is critical, good governance could lead to more inexpensive and reliable sources of funding. Good governance attracts honest employees, which may reduce risks for the company, increase its lifespan, and potentially deliver compounded returns for a longer time.

Well-governed companies in Asia share certain attributes. High quality of management is paramount. Increasingly, the people running public companies in Asia have strong educational and professional pedigrees. A company’s incentive structure is usually a key yardstick for evaluating whether management incentives are aligned with minority shareholder interests. How a company allocates capital is another measure—is management investing wisely in business growth? Is it willing and able to return capital to shareholders? And is management intent on creating value rather than growth for its own sake? These are the hallmarks of quality management that typically translate to good governance.

One noteworthy measure of improved corporate governance is that, according to a 2015 KPMG survey, the Asia Pacific region now has a higher percentage of companies that include corporate responsibility reporting in their annual financial reports and websites than any other region (see figure 4). This is due in some measure to the introduction of mandatory and voluntary reporting requirements in many countries. Asian companies’ reports tend to focus on compliance and risk management in areas such as supply chains, community relations, and human rights. Apparently, companies are coming around to the idea that it pays to invest in social responsibility and to outline for shareholders the impact of their operations.

In recognition of the growing importance of ESG investing in the region, MSCI, a major provider of market indexes covering Asia, recently announced its intention to add staff and expand its research coverage of Asian companies’ ESG commitments. The firm notes a trend toward institutional investors and funds looking to invest in carbon-friendly opportunities.
WHERE DOES ASIAN ESG FIT?

To make a meaningful dent in important global problems such as climate change, air and water pollution, access to health care, financial inclusion, and gender inequality, it simply makes sense to tackle these issues in Asia. Asia presents an exciting and meaningful opportunity to make an impact by virtue of being the world’s most populous region, with a mix of dynamic developed, emerging, and frontier countries and widely diverse growth drivers. Asia is contending with some of the world’s most challenging ESG issues, but it is also growing companies that are providing effective, often innovative solutions to its problems.

Asia has an inherently long-term horizon as well as a focus on companies with a strong propensity to recognize and mitigate risks; investing in Asia from an ESG perspective has the potential to help generate solid risk-adjusted returns over time.

Incorporating global ESG investing into a portfolio could be of benefit to a range of investors. Advisors might consider offering such investments to clients who already own stocks of U.S.-based companies that are managing ESG risks and opportunities. A broader strategy might better capture the ESG alpha that is potentially available globally. For those clients who have not yet considered ESG strategies, here is a possible way to gain international diversification with the potential of higher risk-adjusted returns.

Vivek Tanneeru is a portfolio manager at Matthews Asia, where he manages the firm’s Asia ESG Strategy and co-manages the Asia Dividend Strategy. He earned an MBA from the London Business School and a master’s degree in finance from the Birla Institute on Technology & Science in India. Contact him at clientservices@matthewsasia.com.

ENDNOTES

1. World Development Indicators database, World Bank, April 17, 2017.