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Emerging Market Equities: Understand What You Own

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The Edinburgh, UK-based Janus Henderson Emerging Market Equities Team believes it is imperative to understand non-financial as well as financial risks to the companies they invest in. Glen Finegan, Head of Emerging Market Equities, explains that, while not managing an environmental, social and governance [ESG] investment strategy, the team finds certain factors particularly important when assessing the sustainability of a company.

One of the features of investing in emerging markets is a weak or sometimes nonexistent rule of law. The minimal protections for foreign minority shareholders such as us mean that we are unlikely to be in a position to win compensation in, for example, a Russian or a Chinese court for the rights that we might expect in many developed markets. This makes the up-front assessment of quality the most important part of assessing companies in which to invest.

Assessing the sustainability of a business

A core determinant of our view of the quality of a business is what we regard as the sustainability of a franchise. We believe that a business is either implicitly or explicitly granted a license to operate by all of its stakeholders – communities, employees, customers, shareholders and the government. In order for a company to have a sustainable business we believe the interests of all of these stakeholders, and environmental factors, have to be considered.

Look out for the warning signs

A company that dumps toxic waste in a river, abuses its employees or has questionable governance is providing a warning sign that it may not sufficiently care about the long-term future of its business, which should be (but is often not) reflected in its valuation. A business that abuses its stakeholders for the sake of improving its returns will likely be caught out when customers or the government respond to these abuses, resulting in profound damage to the economics of the business. Even if this does not happen, a business that is prepared to abuse one set of stakeholders will likely, in time, find a way to abuse us as shareholders, given their primary interest would appear to be short-term gain for themselves.

What we look for

Taking this broad view of a company's place in its social, commercial and physical environment leads to a different style of interaction with management, which we have found helps to build relationships as they understand that our interests are broader than simply trading pieces of paper. This also leads us to more unconventional sources of information on a company, such as non-governmental organizations (NGOs), whose unpopularity is often a sign of their credibility, or the news service RepRisk, which monitors negative news coverage.

We do not believe in a tick-box approach to sustainability because understanding "why" can be as important as understanding "what." Many companies are controlled either by an individual or by a group, such as a government or a family, but not all controlled companies are bad. For example, if a family is aligned with you as a shareholder and cares about its reputation, having a long-term steward behind a corporation can lead to a very stable business. This can lead to a management team with confidence in its backers, which allows the team to take brave decisions when others are fearful.

We also do not believe that there is such a thing as a perfect company and tend to look at the direction of travel rather than simply where a business is at a given moment in time. Where we like the underlying business but believe there are changes that would enhance shareholder value, we will engage personally with management to try to effect change. We do not lose sight of the fact that we are only minority investors and believe in building effective relationships with management based on mutual respect and a long-term investment horizon. We have also found that this kind of engagement helps to build conviction in the broader investment case as it can provide a way to see different sides of a management team.

Our approach is firmly based on understanding these risks from every angle and using ESG-type criteria to assess these plays a key part in our approach to seeking long-term opportunities within emerging markets.

Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility, lower liquidity and differing financial and information reporting standards, all of which are magnified in emerging markets.