



Madness in Markets: Coming Soon to an Emerging Market Near You

At no other time in history has a deeper investigation of our investment portfolios made better sense than today. The last four years have brought forth many surprises for almost all types of investors. It is common wisdom that no one can take the markets for granted anymore. There was a sudden surge in food prices in 2007-08 that came in and went away without giving many in the industry a decent opportunity for serious thought or reflection. Then suddenly sprang the Sub-prime induced economic crisis in 2008. The Sovereign debt crisis in the Euro region started developing this year. And sometime ago the BP Oil spill highlighted the downside consequences of a risky company on our portfolios. The spate of these crises and their implications are still not very clear to all types of investors. We can be sure that each of these events just represents a tip of the iceberg and in the minimum should invite us to be more careful with where our money is invested and where not.

On the other hand, to all those who prefer to escape the series of crises appearing on the Developed world horizon, investing in Emerging markets appears to be a very attractive opportunity. However, very few realize that if investors continue with the same approach (of going with the popular sentiment) and move their money into any and every opportunity that comes their way in the Emerging markets landscape, they are likely to meet the same fate. Sudden money chasing very few well understood assets could easily create a similar result in Emerging markets in the next 4-5 years or earlier! The same process would inevitably create the same outcome, only the canvas would change. What happened in US in 2008 is happening now in Europe. It is very likely it would happen in Asia in a couple of years and later, in Latin America and Africa. Why not? One definition of Madness is “Doing the same thing over and over and expecting a different result”.

How can we avoid this? What should change? Clearly the investment and research process that guides these investments! It is common knowledge that Analysts usually spend an average of two days (if you are lucky) to cover a company during their rating process. That too, remotely! Thus an ESG / traditional analyst sitting in an air conditioned office, enabled by Internet sifts through all the publicly available information on a company and combines it with his / her own understanding of that sector to rate the likely future performance of that company. This is clearly suboptimal for various reasons.

We are all aware that most companies, especially the very successful ones, have well primed PR machinery. Therefore companies usually select and manage what gets said about them very actively. Any smart Analyst trying to rate a company is aware that he / she cannot solely rely on what is publicly available. Even if you try to talk to the senior management of the company about their commitment to a particular issue, it does not necessarily translate into a guarantee to honor that commitment. A clear case is BP. Despite the various assurances in the last few years from their senior management to rectify a track record of oil spills it is obvious that neither did they prevent nor were they ready to manage the recent oil spill in Gulf of Mexico. It makes sense therefore to check the facts on the ground before we put too much emphasis on the company's position and put our valuable investments behind their word. A clear example of this is how a major SRI research firm listed BP at the top of the list (see image on the following page) for its social and environmental performance in 2006. Clearly, this rating was based on publicly released information, rather than deeper research through primary data collection.



August 01, 2006

BP, Suncor, and Shell Top Oil Sector Sustainability Rating; Chevron and ExxonMobil Rank Low

by Bill Baue

The report by Jantzi Research examines 23 oil companies worldwide on environmental issues such as greenhouse gas emissions as well as human rights and other social issues.

SocialFunds.com -- Oil and gas companies have been fueled by record profits and strong investment returns recently--and are continuing to be exposed to social and environmental risks. These "above ground" issues, as they are called by some energy companies, are increasingly understood as having material impacts on financial performance by mainstream investors. So implementing best practice to address social and environmental issues is not merely an ethical statement by oil and gas companies to appeal to social investors, but also a financially savvy risk management strategy attractive to more conventional investors as well.

Toronto-based socially responsible investing (SRI) research firm [Jantzi Research](#) recently released a report entitled *Oil and Gas in a Bull Market: The Shifting Sands of Responsibility* that rates and ranks 23 oil and gas companies on their social and environmental performance. UK-based BP (ticker: [BP](#)) topped the list with a score of 6.8 (out of 10), with second through fourth places going to Canada-based Suncor Energy ([SU](#)--6.5), Nexen ([NXY](#)--6.3), and Petro-Canada ([PCZ](#)--6.1) respectively, and UK-based Shell ([RD](#)--6.0) rounding out the top five.

We recently tried the deeper research approach using primary data collection on a very popular Information Technology (IT) company in India. This company has been very successful at creating and maintaining a positive image of its operations. It rightfully deserves the success it has achieved in its sector. However, when ten (10) members of our Research team did a deeper on the ground ESG / Sustainability assessment by interviewing 300+ stakeholders over a period of eight (8) weeks, we found that the ground reality did not match the public image of this company. Customers, employees and vendors were indeed telling us that this company has several risks that it has not communicated to the market. Therefore, for example, despite the fact that it has won many 'Best place to work for' awards, large number of its employees are not happy with its HR policies. We are not confident that it will last the next crisis as well as it did the previous one. Since the company does not want markets to know about these risks it is likely then that these risks will hit the markets one day, by surprise!

The problem gets bigger as even the companies that are known to be leaders have several operational risks in Emerging Markets that are never reported widely. One example is Nestle, a AAA rated company by most ESG / Sustainability & traditional Research firms. Though it has received some negative publicity about its Palm Oil sourcing from Malaysia, not many know that its sales suffered in India starting Sept, 2009 because it refused to reveal the Genetically Modified (GM) components in all its products, including Baby food! Though Nestle has agreed to reveal such facts and avoids using GM components in its products in US and Europe, it refused to do so in India and China. Indian customers got furious in Sept, 2009 when this was highlighted by Greenpeace in a very visible campaign and started to boycott Nestle, leading to a loss in sales lasting several months. There are several such stories waiting to be discovered in Emerging markets where lack of accurate and reliable information about all types of companies is the norm.

What we are highlighting here is endemic: there is a need to go below the surface and highlight the deeper business and ESG / Sustainability risks in every company we want to invest in. We hope that this new approach to drilling deeper while rating a company becomes an industry norm rather than an exception. This is the only way to sustain the Global Financial industry in the long run and the only strategy that works well during bull and bear phases: "Know your Investments well!"

Vipul Arora is Founder, Director, of Solaron Sustainability Services and an Emerging Markets Fellow of the Stanford University. Solaron (www.solaron.in) is a niche Sustainability / ESG research firm with a global team of 65+ Analysts present across several Emerging markets like India, Brazil, China, UAE, Mexico, Russia, Europe, USA and Africa. Each of the Solaron analysts covers their specific market based on the ground using this in-depth approach to rate companies and their true impact by talking to various stakeholders in the process.