LatAm Equity Strategy

LatAm ESG conference – what did we learn?

Investment Strategy

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Latin America

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We held our fourth annual LatAm ESG conference

We held our fourth annual LatAm ESG Virtual Conference (February 20th) with a strong attendance. We discussed key themes on the ESG front including: new perspectives on ESG investing & capital flows, corporates protecting from natural hazards amid climate change, regulation, corporate governance and more. See our main vies on LatAm ESG in our LatAm ESG primer.

#1: Higher interest rates were a headwind for ESG

ESG active funds showed outflows last year in Europe amid high interest rates. In the US, outflows from ESG funds were also driven by higher interest rates and politization on the theme. But we are optimist for the future: in Europe, despite the elections, we don't see agenda changing and new ETF launches attract. Key themes to watch are the process of a "just transition" (i.e, one that promotes decent work, protects workers' rights, and ensures the benefits of a green economy are widely shared), carbon credit markets, cybersecurity, biodiversity and regulations.

#2: Evolving regulations & disclosure create opportunities

Interest about ESG may be cyclical, but a changing world is not. ESG should be an integral part of the investment process, and not analyzed separately. We expect a pickup of flows into ESG funds driven by lower interest rates going forward, evolving regulations and a bigger pool of opportunities in the future, as corporates are more open on ESG engaging and disclosure.

#3: Four pillars to improve corporate governance

In Brazil, laws and corporate policies related to corporate governance are robust and sophisticated. However, corporate governance issues are difficult to prevent because Brazil has limited mechanisms of enforcement. Tools for recovering losses are also limited. Fraud prevention depends on 4 pillars: 1) board independence, 2) management compensation, 3) evaluation & auditing of board and 4) tools for enforcement.

#4: Corporates addressing natural hazards & climate chg

In Brazil, we recently saw several climates events: record-breaking high temperatures, cyclones in the south and severe drought in the Amazon region. We see infrastructure companies taking strategies to overcome climate changing events. Engagement from the govt is key but founding for prevention projects is limited. For some sectors, company management has yet to acknowledge the risks of climate change. Agribusiness is putting the most attention. Tourism and real estate could be lagging.

See main takeaways for each panel on page 2 onwards.

Panel 1: Global themes in ESG investing.

Higher interest rates were a headwind for ESG investing

ESG active funds had outflows last year in Europe. High interest rates in the region were a key factor. But we are still optimist for the future. In Europe, despite the elections, we see the ESG agenda moving forward. New ETF launches could drive inflows into passive funds looking forward.

In the US, outflows from ESG funds were also driven by higher interest rates and politization of the ESG theme. Net outflows were about 2% of the ESG funds' total AUM.

Themes to watch: green transition, carbon markets, biodiversity, regulations

Our analysts consider that the process of a "just transition" is key to watch, i.e, one that promotes decent work, protects workers' rights, and ensures the benefits of a green economy are widely shared. Europe is leading coordinated skill policies in the world for a just transition. For instance, the European green deal aims to make Europe the first climate neutral region by 2050.

Carbon credit market has been an important way towards a decarbonized world. In Europe, carbon offsets are being used reach net zero targets. Europe and the US stepped up regulations on how companies should disclose offsets to avoid greenwashing.

The biodiversity theme is gaining momentum. There's a rise in biodiversity rules regarding disclosure, implementation, target setting and social goals. Europe is already coming up with rules for company to follow regarding the theme. We also saw biodiversity funds gaining momentum in the past years. One of the main challenges is the data availability.

Panel 2: Climate change is exacerbating natural hazards: how do companies respond?

Corporates start to prepare for more climate events & natural hazards

Climate change is not just a problem for the future. It's already here. In Brazil, we saw several climate hazards: record-breaking high temperatures, cyclones in the south and severe drought in the Amazon region. We see more hurricanes in Colombia, droughts in all the Andean region, also water scarcity.

Brazilian infrastructure companies are taking strategies to overcome climate changing events. For instance, Rumo installed temperature sensors on train rails to identify heat damages, CCR changed operational schedules to deal a cyclone in the south and Hidrovias do Brasil had to mitigate the impacts of the drought in the Amazon – they had to operate with smaller convoys to navigate through shallower rivers.

While some companies are already taking action, the perception from industrial insurers is that many companies have yet to acknowledge the climate risk in some sectors. Agribusiness is putting the most attention. Tourism and real estate could be lagging.

Public policies for prevention of natural hazards are key

Adapting to the new reality needs public policies. Today, Brazil doesn't have a culture of investing in prevention. We have limited budget for prevention. When disasters happens, it is easier to raise funds than it was to do so for prevention projects.

Transportation companies engaged with energy transition

We see companies advanced on energy transition agenda. Rumo aims to reduce emissions by 21% by 2030. CCR recently announced carbon reductions targets using renewables. The carbon market regulation should be beneficial for the sector since companies are already engaged with green targets.

Panel 3: is the ESG focus changing?

What is the difference between ESG and sustainable investing?

The discussion started with the distinction between ESG and Sustainable Investments so are not conflated.

'ESG' is the practice of considering environmental, social and governance aspects when investing in companies. Sustainable investing' is the practice of making investments in companies that aim to achieve market-rate financial returns while considering positive social and/or environmental impact.

ESG as an inherent part of investment decisions

ESG should be the core part of an investment process, not a separate evaluation. It will be interesting to see how analyst increasingly include ESG aspects into their financial models though time.

Some markets, like Brazil, might be too small to have a diversified portfolio of sustainable investments. EM-focused portfolios might provide more options. However global portfolios might have exclusions because of regulations.

ESG investing has been cyclical.

We saw a big surge in 2021, which was aligned with financial returns. However flows into ESG/sustainable funds declined since global interest rates climbed higher.

Still very optimistic that those conversations will be more frequent so there could be more opportunities. Interest about ESG is cyclical but climate change is not. Since pandemics, people are more concerned on basic things, like food and energy. Supply chain became a big risk for companies and forced people to think about it. The pool of opportunities is growing, as companies are more open on engaging and reporting.

Panel 4: Governance in LatAm: how to move forward?

Private enforcement in Brazil is not yet efficient

In Brazil, laws and corporate policies related to corporate governance are robust and sophisticated. However, corporate governance issues are difficult to prevent because Brazil has limited mechanisms of enforcement. Perception is that courts are overloaded. There are only a few specialized in corporate matters, causing a lot of ineffectiveness within the system. Brazil doesn't have class actions, which makes legal action more difficult for minority shareholders.

Brazil was a slow starter in terms of regulation, but we saw significant progress in recent years. For example, until 2001 we didn't have criminal charges for insider trading. Until 2017 we didn't have criminalization of tipping.

Four pillars to improve corporate governance

According to our panel, 4 pillars are important to prevent fraud and improve corporate governance: 1) True independence of board members; 2) Management compensation, as management receive a lot of pressure from shareholders for financial results; 3) Board should be evaluated and audited and 4) tools for enforcement legal/administrative system.

What tools can investors use to regain losses after a fraud has come to light

There are laws in the corporate law that investors can use to find each other. A big issue is legal uncertainty: after a fraud is detected, in many cases it is unclear who (is it the shareholder or the company?) and who can be sued (is the company or the individuals?).

After incurring losses related to fraud, individuals can start administrative proceedings with the local regulator. But this is more related to applying penalties rather than a loss recovery process.

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