HEPTAGON Capital

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Driehaus Emerging Markets Sustainable Equity Fund

Q&A with Portfolio Manager Richard Thies

On the 1st October 2020, the **Driehaus Emerging Markets Equity Fund** changed to the **Driehaus Emerging Markets Sustainable Equity Fund** ("Fund"), on which date Environmental, Social and Governance ("ESG") criteria were formally implemented into the investment process. Prior to that, ESG analysis was already integrated into the investment process for over three years, and related factors such as governance have been an important investment consideration for Driehaus for more than ten years.

Whilst the Fund has the same Portfolio Managers and investment team, the same investment objective and uses the same philosophy, the Fund now operates with an investment strategy that has an even stronger ESG profile, as it now formally includes a focus on companies with strong or improving ESG attributes and growth opportunities tied to social and environmental solutions. Additionally, the Fund excludes companies with involvement in adult entertainment, coal production, gambling, tobacco and weapons from the investable universe.

In light of the recent changes to the Fund, we are pleased to share with you below excerpts from an interview with Mr. Thies, please find his bio at the end of this document, on ESG factors, sustainability opportunities and risks within the Emerging Markets.

1. How does ESG analysis differ in emerging markets vs developed markets?

As a general rule, emerging market corporates have lagged their developed market peers in communicating sustainability principles in their public disclosures, so the main difference is that there is a bit more work involved in deducing where the corporates stand in relation to sustainability principles. **When you review the external ESG ratings and reports on emerging market corporations, the most frequent reason they are penalized is for a lack of disclosure or public commitment to improving known issues.** The former provides a unique opportunity for sustainability-focused emerging market investors to be ahead of the pack in assessing the true position of these companies, a reality that will be more publicly known at some point in the near future. While there is currently less pressure on emerging markets companies to provide these disclosures, we believe this will be forthcoming as local investors start to place increased emphasis in this regard.

Apart from differences in disclosures, there are some unique peculiarities of emerging market investing that extend to ESG analysis as well. Governance structures are frequently different and oftentimes less geared toward protecting minorities, consideration of the environmental impact of business is generally a lower priority in countries that are less economically-advanced as are labour standards. **We see the biggest**

difference though being something a bit more esoteric which is that we find it much more common for emerging markets corporates to be considerate of governmental priorities in order for their businesses to be successful. Frequently, those governmental considerations are things that line-up with ESG principles, but occasionally they are not and are considerations for the government's own benefit, which can present a challenge.

2. **What do you think the biggest challenges in regards to ESG in emerging markets are?**

We see several nuances to ESG investing in emerging markets. First, less disclosure on sustainability-related topics is more challenging inherently. We think it makes it a bigger opportunity for alpha generation as we do believe that more sustainable businesses will do better over time, but it does create an extra layer of effort. The second is that, broadly, the mindset in emerging markets is not as geared toward these issues so it takes a bit of extra effort to change companies' mindsets. In addition, there are some peculiarities of emerging market corporate structures (higher level of family-ownership, higher levels of state involvement, cross-shareholding by corporates, etc) that are somewhat unique challenges to emerging markets.

We think the biggest challenge pertains to the relationship corporates sometimes have with their governments. In a country like China, for example, you cannot realistically be a successful company without playing ball with the wishes of the CCP. Sustainability-minded investors have to consider what the ultimate impact of that alignment really is, because it's not as cut and dry as it seems. The CCP itself has orchestrated many policies that investors should be rightly concerned about but they have also focused more recently on rooting out corruption, environmental clean-up and trying to ensure that large companies are having a positive 'social impact.'

3. **Do you see differences between countries in emerging markets with regards to ESG efforts and improvements?**

As an asset class with very disparate levels of development and political characteristics, we see a wide array of ESG performance and reporting. In general, countries in the EMEA (Europe, the Middle East and Africa) region, who tend to interface more with European investors and do business with European companies are more advanced. This is true as well for companies who are parts of developed market company's supply chains. For example, **an agriculture company in Brazil who is a major source of inputs for a U.S. based food producer will be much more aware of ESG expectations than one whose entire business is local.** On the other side, Chinese domestic companies tend to be less well-versed in these subjects, in large part because the majority of their investors are local and are not as focused on issues of sustainability. It is not an easy story to generalize, however, because mainland Chinese companies tend to be far more considerate of the social impact of their business activities insofar as it presents a risk of them running afoul of the government's wishes. There also tends to be less robust disclosure as you go down the cap spectrum, with small cap emerging companies being more resource-constrained and having a relatively harder time providing the disclosure level that you can expect to see from larger cap peers.

4. What sectors in emerging markets would you say lend themselves to ESG investing?

We certainly see some sectors as being better-suited toward ESG investing (i.e. healthcare vs. gambling), but we think the approach is important to implement across the board. Companies in the healthcare, internet and consumer space tend to score better than some old economy sectors, but engagement on each side is important. The impact of a behaviour change on the part of an energy or mining company, for example, is likely to be huge relative to what you could expect from a company in a 'better' sector.

5. Can you tell us about a company in emerging markets that you think is leading in regards to ESG efforts? What about a laggard?

We see Taiwan Semiconductor as a leader in regards to incorporating ESG principles into their business at every level and it has certainly been a factor in the company's strong performance. As a semiconductor foundry, the company's business has the potential to be a contributor to environmental damage within Taiwan (where 90% of its fabrication facilities are located). In part out of necessity, **Taiwan Semiconductor has advanced industry-leading water conservation practices in a country where fresh water is in relatively scarce supply.** They have also advanced much better than typical governance practices in an emerging markets context, with half of the board independent and a robust corporate social responsibility committee. The company also prides itself on its human capital development where they receive extremely high marks for their development and remuneration of employees. Human capital is one of the biggest differentiators in long-term success in semiconductor production and are one of the main reasons that Taiwan Semiconductors business prospects are so strong, having recently leapfrogged the old industry leader (Intel) in leading edge production.

Unfortunately, there are many laggards that come to mind. As a whole, locally-listed Chinese companies have been a bit slower to implement best governance and environmental practices. There have also been a number of examples over the years where US-listed Chinese companies have had accounting irregularities. **Even among good fundamental performers, like Foshan Haitian, where accounting is sound and financial performance has been exemplary, the food seasoning producer refuses to acknowledge or address its sourcing issues and the environmental impact of its business.** Russia is also a source of some newer laggards in terms of environmental impact as climate change is changing the topography in the north of the country, causing a melting in the permafrost. Unfortunately, many Russian businesses in extractive industries are seeing their production capacity become unstable as a result of this change in conditions are have seen the incidence of environmental catastrophes starting to rise. This was most recently the case for Norilsk Nickel, but unfortunately seems to be an issue that won't be going away anytime soon.

6. You have invested in Alibaba before – can you elaborate on your ESG reasoning for this?

Alibaba Group Holding Limited (BABA) is one of the most important companies in emerging markets and the world. The company's large business portfolio positions it at the forefront of many critical sustainability issues.

Additionally, the company's massive customer base, employee base and financial resources give it the unique opportunity to effect change at a scale that very few other companies can**. While the ownership is unfriendly to minority shareholders and the company is not without controversy, we believe Alibaba can be a positive force for change in the world.** We further believe that the trajectory of their sustainability strategy is unquestionably positive, which we view to be at least as important as the absolute level of where the company is today. Finally, we think Alibaba's primary asset, the ecommerce marketplace, is a uniquely positive social force in China, providing a marketplace for millions of sellers and hundreds of thousands of small businesses.

This this is not intended to portray Alibaba as a model of governance and sustainability practices. Alibaba has made great progress in some areas and still lags in others. **We think the best way to drive the company forward is to be an attentive shareholder and repeatedly engage with the company over the long-term.** Given the size of our holding relative to the company and limited impact on shareholder votes, we recognize that we alone will not be able to directly drive change. However, we can add our voice to the investment community chorus and help the company understand what values and practices we find to be important.

If you are interested in a deeper analysis of Alibaba from a sustainability perspective, our thoughts are captured a sustainability report we published in August 2020, and which is available upon request.

7. How do you approach the issue of governance in emerging markets?

Governance standards on the whole are lacking in emerging markets compared to those in developed markets, though they have been improving over the past many years. **We have always placed a very high focus on governance in our emerging markets strategies, in part, because it is such a differentiating factor within the asset class and because accurately assessing governance risks has been an essential tool for limiting downside risk in our portfolios.** We tend to focus our efforts on companies with less complicated shareholding structures, where founders do not retain excessive influence, and those with disclosures that meet our standards. A more dogmatic approach, excluding companies without a certain percentage of independent board members or where the chief executive and chairperson are the same, for example, would be too limiting in this asset class today. We are, however, regularly engaging on those topics with our portfolio companies.

8. Do you engage with companies to try and improve their ESG behaviour?

As signatories to the Principles for Responsible Investing, we do actively engage with our portfolio companies and potential investments on sustainability issues. While we recognize the limits of our impact in isolation, we do think it's important for companies to hear that investors care about ESG principles as awareness is the first step toward improvement. There is great disparity on how new these concepts are across the wide country mix in emerging markets and while European companies are very-well versed in these conversations, some other countries are much less ready to discuss sustainability. We try to identify what we think are the salient issues and where the companies do have the chance to improve.

9. Pollution seems to continue to be a problem in emerging markets, how do you approach the environmental aspect in your analysis?

We believe that the negative externalities of highly polluting companies are often not properly discounted in share prices, so we think of all the ESG factors, environmental considerations are perhaps the most important. There are the obvious first-order considerations when assessing a company's environmental track record (disclosure, carbon emissions, water usage and cleanliness, etc) that are front of mind in our sustainability analysis. There are also second-order considerations, both negatively and positively. We mentioned our belief that **the market currently underappreciates the degree to which environmental factors themselves will have a large impact over time on behaviour** and to that end, being more critical of highly polluting enterprises and holding more favour toward those industries providing solutions to environmental issues where demand is likely still underestimated and in those industries which will not see demand destruction from their climate impact.

10. What are your thoughts on the ESG rating providers? Do you do your own analysis?

We think the external ESG rating providers are a useful starting point but not sufficient for our purposes. The external agencies provide a valuable service in attempting to standardize an area that is not ripe for standardization and easy comparison and by providing immediate info on controversies and areas of importance for specific companies. However, we find they are also slow to adapt to new information and to efforts made by companies to improve their behaviour. **We believe pretty strongly that changes in the trajectory of a company's sustainability performance can be as important as the absolute level** and as such it's essential to be aware of improvements or adverse changes. This reality is borne out in the data as well in terms of being a predictor of future performance, so we prioritize having more updated information than what the external ratings providers can offer.

11. Tell us a bit about your background; what got you interested in sustainable finance?

This is something I have been interested in my entire career and even earlier, dating back to my time in university. My educational focus was in development economics and my first jobs were all in that capacity, working primarily in microfinance in sub-Saharan Africa. **That work gave me some real world introduction to both the positive and negative impacts such businesses can have, particularly in the lesser developed economies of the emerging and frontier markets asset classes.** Ultimately, I moved into the field of investments because I saw the transformative power that larger businesses can have on societies and economies at large and I wanted to be a part of that in some capacity.

From a personal level, that more altruistic interest gave way to several more practical ones. First, it's quite clear that the days of capitalism as the end-all be-all of government policy are over and governments and voters are beginning to think more about externalities. That isn't necessarily positive or negative, but it is real. We have seen this in China for quite some time where you invest in companies who aren't aligned with the government's desires at your own peril. We can certainly question whether an actor like the Chinese government has sustainability in mind when setting the ground rules for their corporations but increasingly many countries do have that exact thing in mind and more and more younger people certainly do. **At Driehaus, we are big believers that being successful in investing requires getting the big things right and spotting the major inflection points.** While ESG has certainly been getting attention for some time, I still feel that the market and people in general are understating how much the world is likely to change in the next ten to twenty years. With increasing frequency, the younger generations are avoiding air travel due to the carbon impact, are celebrating how few new items of clothing they are buying and are eating increasingly plant-based diets**. Younger generations are sacrificing in ways that we haven't seen and given that even small changes in behaviour have huge impacts on businesses, we think these large behaviour changes will have huge impacts on investment returns for those paying attention to them.** A final note, as someone with a young daughter, I would like to be playing at least some small part in being part of the solution to some of our great challenges rather than potentially contributing to making them worse.

About the Author: Richard Thies

Richard Thies is a portfolio manager of the Heptagon Driehaus Emerging Markets Sustainable Equity Fund. He leads the Driehaus Emerging Markets Team's ESG efforts in addition to holding primary responsibility for macroeconomic analysis and primary coverage of the financials sector. Mr. Thies idea generation, security analysis, ESG work, portfolio construction, and risk management responsibilities are leveraged across the strategies managed by the Driehaus Emerging Markets Team.

Mr. Thies has spent his entire career focused on emerging markets. Prior to joining Driehaus Capital Management in 2011, he worked as an international economist covering emerging markets at The Northern Trust Company. In advance of his time at Northern Trust, Mr. Thies worked in microfinance banking in sub-Saharan Africa with both the International Finance Corporation of the World Bank Group and Opportunity International. Mr. Thies received his Bachelor of Arts in international studies from Emory University in 2005 and his Master of Arts degree focused in international political economy from the University of Chicago in 2007.

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Risk Warnings

The Fund is subject to special risk considerations including geographic concentration risk, portfolio concentration risk and operational risk. The investment return and principal value of an investment will fluctuate so that the investor’s shares, when redeemed, may be worth more or less than their original cost. Any investor should consider the investment objectives, risks and charges and expenses of the fund carefully before investing. Where an investment is denominated in a currency other than the investor’s currency, changes in rates of exchange may have an adverse effect on the value, price of, or income derived from the investment.

SFDR

This Fund has been classified as an Article 8 for the purposes of the EU’s Sustainable Finance Disclosure Regulation (‘SFDR’). The Fund promotes environmental and/or social characteristics but does not have sustainable investment as its primary objective. It might invest partially in assets that have a sustainable objective, for instance assets that are qualified as sustainable according to EU classifications but does not place significantly higher importance on the environmental objective of each underlying investment. Please see prospectus for further information on the Funds environmental and/or social characteristics and relevant sustainability risks and principal adverse impacts which may impact the Fund’s performance.

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