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ESG Principles Need to Apply to Countries First

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Environmental, social and governance investors believe they can lower the risk of a portfolio and maybe even boost its return by investing in companies with robust ESG policies. The idea is that companies that take ESG seriously are better stewards of the environment, are less likely to be in the path of climate change, take better care of workers, suppliers and customers and are better managed. Those attributes keep them out of trouble and help them realize their full potential, all to the benefit of shareholders. (ESG is not to be confused with socially responsible investing, or SRI, which tries to align money and values.)

But if ESG is a crucial part of companies' success, then the ESG-related policies of their home governments should be just as important. After all, governments have more influence than anyone over many of the issues ESG cares about, including environmental and climate policy, the health and education of their people and the rules governing companies' rights and responsibilities. If government has little regard for the environment, its citizens or the rule of law, then the ESG policies of companies within its borders may not be much help to investors.

Recent events in Russia have made that clear. Its companies were a small but growing component of emerging-market ESG funds in recent years, presumably on the strength of their ESG policies. But none of that matters now that Russia's stock market has imploded in response to Vladimir Putin's brutal invasion of Ukraine and the devastating economic sanctions heaped upon Russia. The MSCI Russia Index dropped 65% from its February high through Tuesday, the last day for which a quote is available. Top index providers, including S&P Global Inc., MSCI Inc. and FTSE Russell, are pulling Russian companies from their indexes, essentially declaring their stocks worthless. They're not far off. The forward price-earnings ratio for the MSCI Russia Index plummeted to 2.5 on Tuesday, which is among the lowest single country valuations ever recorded.

The invasion of Ukraine, however, merely highlighted what was already in plain sight. Russia, an autocratic, repressive state fueled by oil and gas, has long been an ESG nightmare. Cato Institute's Human Freedom Index ranks countries based on more than 80 indicators of personal and economic freedom, including the rule of law, property rights, security and freedom of movement, assembly and expression. Russia ranks 126 out of 165 countries in the latest index and regularly places in the bottom quartile. Fraser Institute has a similar freedom index, and it ranks Russia only slightly higher.

ESG adherents would no doubt say that any company with Russia's dreadful ESG record is unlikely to prosper and may even be a ticking time bomb. There are good reasons to think the same applies to countries. Those that rank highest in freedom indexes tend to be among the

richest and most developed nations. Their stock markets are also more highly valued. It's no accident that the MSCI Russia Index has never had a higher forward P/E ratio than the MSCI World Index, which tracks stocks in 23 developed countries, including the U.S., all of which rank highly in freedom indexes.

It makes little sense, therefore, to focus on companies' ESG policies and ignore those of their governments. Not everyone made that mistake with Russia. Perth Tolle is the founder of the Freedom 100 Emerging Markets Index, a stock index that favors countries ranked highest on Cato Institute and Fraser Institute's freedom metrics. "ESG typically looks at companies, not countries," Tolle told me. "But if country level governance is poor, company governance doesn't matter much. There is no price at which Russia is investible. Autocracy risk can't be quantified, so there's no way to value the future earnings of Russian companies." Tolle's stock index has never had an allocation to Russia.

In hindsight, ESG investors should have held Russia to the same standard as its companies, but it's not too late to apply that lesson to other countries. While Russia had a modest allocation in emerging-market ESG funds, China does not. Chinese companies had a weighted average allocation of 28% in U.S.-based emerging-market ESG stock mutual funds and exchange-traded funds at the end of last year, according to Morningstar. And China is no less concerning than Russia. China ranks near the bottom and below Russia in both the Cato Institute and Fraser Institute's freedom indexes. Tolle's stock index has never had an allocation to China, either.

Still, some investors will see Russia as a historic buying opportunity. Russia isn't going anywhere, and more than likely neither are its industries and top companies. As long as that's the case, Russian stocks will eventually recover from their fire-sale valuations. The vultures are already circling, including China and Russia's government.

ESG is still a young investing style, at least in practice, so it's too soon to know whether it will ultimately be profitable for investors. But what Russia shows is that when governments have little regard for ESG, their companies' ESG policies may be the least of investors' concerns