For Some Investors, ETFs Help Take ESG Up a Notch

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Environmental, social and governance always had an ethical component, but its methodology has come under greater scrutiny recently since Russia's invasion of Ukraine.

The actions of an undemocratic, aggressive authoritarian regime in attacking Ukraine have cost investors a lot of money. Those losses occurred suddenly, and there is no end in sight.

Previously, traditional ESG screens tended to disregard country-level issues as an area of concern, but many investors are rethinking this approach. A few recent ETFs offer new ways of approaching emerging markets in a more comprehensive, nuanced way.

There are currently two passive ETFs in the market that give countries a governance ranking and adjust portfolio weightings accordingly. The **Democracy International Fund ETF (DMCY)** launched last year, and the **Freedom 100 Emerging Market ETF (FRDM)** kicked off in 2019.

Each country is assigned a score as to how free/democratic or unfree/undemocratic they are. Freer and more democratic countries, and thus the stocks in those countries, get more heavily weighted. Less free, less democratic countries get lighter weights or, in some cases, zero weights in the portfolio.

They do differ in several ways. FRDM, as the full name states, is an emerging-market-only fund. It offers exposure to 27 emerging markets, excluding countries with the worst human rights records. Since they only have limited overlap in holdings, the two ETFs can be thought of as more complementary and not in competition with each other.

DMCY starts the process by making use of The Economist's Democracy Index and its score on the approximately 50 countries with investable stock markets, not counting the U.S. It then adjusts a country's weight in the Solactive GBS Global Markets. The best-scoring country, which is currently Norway, had its normal weighting increased by 29%.

The worst-ranked country, Saudi Arabia, had its weighting reduced by 70%. Norway's and Saudi Arabia's market capitalizations are not very large to begin with, but with about half the countries seeing an increase in their weights and half seeing a decrease, the cumulative effect of this approach starts to become quite large. Using Asia for comparison to a traditional index, you

would up your holdings in Japan and Taiwan while lowering your weightings in China and Hong Kong.

FRDM's Freedom 100 Emerging Markets Index uses country freedom rankings produced by the Cato Institute and the Fraser Institute. This ranking adds a healthy dose of personal freedom metrics alongside the government concerns. Unlike DMCY, which might take a poorly listed country's weight down by 50-70%, the Freedom 100 will take a low-ranked country down to 0%. Since FRDM starts with fewer countries and weights some at zero, it is a more concentrated portfolio.

Freedom As An Investment Metric

This type of screening offers several advantages.

"We are allocating capital based on democracy scores to lessen the cost of capital for democracies and to increase it for authoritarian states," said Democracy Investments Chief Economist Richard Rikoski. "By making investment proportional to democracy scores and never dropping investment in a nation to zero, we hope to maintain a market-based incentive for democratic reforms."

Freedom may strike some investors as an abstract concept to build your strategy around, but we're seeing more investors embrace it as a valuable metric to assess countries and regions where reliable data may be hard to come by.

The FRDM fund, issued by Life + Liberty Indexes, "provides an alternative option with freer country exposures for investors who believe in the long-term benefits of freedom and want to express those preferences in their EM allocations," according to fund materials. It also "allocates higher weights to freer markets with potential for more sustainable growth, more innovation and adaptability to market trends, and more efficient use of capital and labor."

Although the ETFs are fairly new, the country rankings from The Economist, the Cato Institute and Fraser Institute can be taken back as far as 2006 for The Economist rankings. Applying those rankings retroactively to appropriate stock indexes shows that investors do not appear to pay a price in terms of lower performance when they choose to look at the world through freedom-colored glasses. In fact, there is evidence that modest outperformance is seen, particularly in emerging markets.

This is not a total surprise. DMCY's Julie Cane, citing a 2019 study by MIT, noted that "democracies historically performed better over time," offering less political risk.

With the global economic fallout from Russia's war in Ukraine impacting a widening range of industries and geographies, we are likely to see more ESG providers adopt broader criteria into their methodology.

While it is important that investors become aware of this new approach, there are, however, two caveats to consider.

Although the early results as evidenced by FRDM and DMCY suggest there can be a performance benefit to this new approach, we only have a few years of live data.

As MSCI Managing Director Meggin Thwing Eastman told Reuters recently, many emerging market investors would want exposure to countries with questionable governance and human-rights track records, no matter what.

"If what you want to do is buy EM, that's part of what you're buying into," she noted.

Secondly, there is a question of consistency around the moral dimension. If you want to try and support freedom and democracy around the world, it would open any investor or issuer to questions about potential bias and the progress on these metrics like poverty and human rights in issuers' home countries.

For ETFs based on governance ideals, it's still early days. FRDM, for example, already applies a screen to companies within a country by excluding companies where the government owns more than 20%, which shows that additional screens can be developed.