While ESG standards are being integrated into the China A-share universe, limited structured disclosure, inconsistent third-party ratings and a shortage of quality data make progress a challenge, especially in small and mid-cap firms. In this investment note, Eric Nietsch, Head of ESG Asia and Ronald Chan, Chief Investment Officer (Equities, Asia ex-Japan) explain how active ESG engagement cuts through the noise and can guide the investment decision-making process for active managers.

# Navigating ESG integration in China A-Shares investing

### 1. What challenges do investors face with ESG integration in China A companies?

**Eric Nietsch, Head of ESG Asia**: Although rapidly improving, there is a lack of high-quality, structured ESG disclosure in China. This makes any assessment of ESG data difficult, as ESG reporting is not mandatory in China. According to UNPRI and CFA Institute[1], only one-third of companies are issuing ESG/CSR reports. Moreover, the information contained in these reports is not always directly relevant to financially material factors. For example, many companies are reporting charitable contributions but not fully disclosing metrics on the key sustainability trends affecting their business. A deep fundamental understanding of the business is required to see the full ESG profile.

Investors also often use ESG ratings from third-party providers such as MSCI and Sustainalytics to complement sustainability reports. However, coverage of such ratings can present challenges, especially for small and mid-cap companies. While MSCI ESG ratings cover 97% of the CSI 300 constituents by market weight, only 13.7% of the combined 2,611 companies in the MSCI China A Onshore Mid Cap Index and the MSCI China A Onshore Small Cap Index are covered by the same provider[2]. This poses a data challenge that investment managers focusing on the growth potential of this asset class need to overcome. In the absence of data, direct ESG engagement is a valuable tool to help understand ESG risks and opportunities.

Third-party ESG ratings are useful, but over-reliance on them can bring its own risks. Each third-party ratings provider has a specific methodology for assessing ESG performance. The correlation between the overall ESG ratings of major third-party providers is 0.46[3], according to UNPRI, meaning the ratings are difficult to compare. Global third-party providers also typically use the same methodology to assess companies across all markets, meaning they may not account sufficiently for cultural, economic, and geographical differences.

For example, a state-owned enterprise in China could be a sound investment case; however, its governance practices may lag those of developed-market counterparts when rated by a third-party provider, resulting in a low overall ESG score. We believe active managers with ESG capabilities have an advantage here, as we can use the third-party ESG ratings or scores as a starting point for additional analysis on what is material to the investment decision-making process.

[1] ESG INTEGRATION IN CHINA: GUIDANCE AND CASE STUDIES, UNPRI, CFA Institute.

[2] Manulife Investment Management ESG Research, MSCI ESG Manager, FactSet

[3] ESG rating disagreement and stock returns, UNPRI,

## 2. What specific ESG challenges for China A-shares do your team focus on?

**Ronald Chan, Chief Investment Officer (Equities, Asia ex-Japan):** Shareholding structure and corporate governance are vital parts of our investment process. It is common to see a high concentration of major shareholders among China A-share companies, so checks and balances remain low. Unlike in Europe, most boards in A-share firms have a one-tier system as opposed to a two-tier vertical[4].

Recently, there have been some improvements in both areas. Although there is still a relatively low percentage of equity under the stock incentive scheme, we see more companies adopting management incentive schemes to align their interests with those of shareholders.

Furthermore, in 2018, China Securities Regulatory Commission (CSRC) issued the Code of Corporate Governance for Listed Companies to improve corporate governance issues[5] and protect minority investors. There are also Board of Director rules about the role of independent directors, as well as improvements to the evaluation of performance schemes and the provision of an ESG framework for listed companies.

## 3. Looking ahead, what can global investors expect with ESG integration among China A-shares?

**Ronald Chan, Chief Investment Officer (Equities, Asia ex-Japan):** With the opening up of the domestic capital market to foreign investors, we do see some positive developments led by the local regulator, global index inclusion, and greater institutional participation:

Firstly, China's stock exchanges are planning to raise their requirements for ESG disclosure for A-share firms.

Besides, the inclusion of A-shares in MSCI indexes drives global investor interest, which then prompts regulatory action, and improvements in ESG disclosure. The majority of large-cap A-shares disclose metrics on ESG issues; however, there is less information available among smaller companies. Inclusion should, therefore, generate greater disclosure.

There is also an increase in institutional shareholding in China A-shares. As active management with ESG capabilities becomes more popular among institutional clients, this could promote awareness of the importance of sustainability trends and encourage corporate responses to these trends that would help to improve shareholder returns.

## 4. What is Manulife Investment Management's ESG engagement approach with China A companies?

**Eric Nietsch, Head of ESG Asia**: In our view, the challenges noted above demonstrate the need for proprietary ESG research and active ESG engagement with China A companies.

In terms of proprietary research, we work towards fully embedding ESG in our investment process. Every quarter, our ESG analysts highlight the key risks and opportunities with the portfolio managers. Our proprietary research template, GCMV (Growth, Cash, Management, Valuation), incorporates ESG elements, including third-party ESG scores and metrics. We also have ESG handbooks that represent our house views on the materiality of certain ESG issues in specific industries. This helps our analysts go beyond the third-party ratings and form their own views.

For ESG engagement, we have an on-the-ground ESG team in Hong Kong to engage directly with companies in China. During the past two years, we have regularly engaged with many businesses that

[4] Under a one-tier system, the company is governed by a unified board performing both management and supervisory functions. Under the two-tier system, the board of directors and the supervisory board exist side by side.

[5] On 30 September 2018, the CSRC issued the revised "Code of Corporate Governance for Listed Companies", some key changes under the New Code include: Establishing ESG requirements, such as green development and targeted poverty alleviation; companies are encouraged to develop concepts of "innovation, coordination, green development, openness, sharing" and social responsibilities; promoting board diversity; strengthening audit committee functions, and restricting powers of controlling shareholders.

have significant operations in China on ESG issues. This includes on-site company visits in Beijing, Shanghai, and Shenzhen. The ESG topics being discussed include climate change, green buildings, water stress, cybersecurity, and board diversity.

Elsewhere, Manulife Investment Management is a founding signatory of one of the world's largest investor initiatives on climate change: Climate Action 100+ [6]. Under this initiative, we support several corporate engagements, including with the three large oil and gas companies in China.

We have also been engaging with regulators in China to help shape the ESG landscape. Recently, we submitted a consultation response to the People's Bank of China on the revision of green bond standards. We have also been working with different partners, including the Asian Corporate Governance Association (ACGA), on ESG, stewardship and governance issues in the region. In particular, we are part of the China Working Group of ACGA that is engaging with the China Securities Regulatory Commission to promote ESG disclosure in China A-share market.

## Conclusion

ESG integration is a complex process for China A-shares and the landscape is rapidly changing. While drivers do exist and steady progress is being made, the picture is still being clouded by mixed data and patchy disclosure. In this environment, our active management approach and proprietary research enable us to navigate these changes and offer a better qualitative ESG opinion as part of fundamental due diligence, especially in the mid and small-cap space.

[6] Manulife Investment Management joined Climate Action 100+ as a founding Investor Signatory in 2017, an investor engagement initiative to align the world's largest greenhouse gas emitters with the Paris Agreement goals (450+ investors with US$40+ trillion AUM to date).

**Manulife Investment Management**

Manulife Investment Management is the global wealth and asset management segment of Manulife Financial Corporation. We draw on more than 150 years of financial stewardship to partner with clients across our institutional, retail, and retirement businesses globally. Our specialist approach to money management includes the highly differentiated strategies of our fixed-income, specialized equity, multi-asset solutions, and private markets teams—along with access to specialized, unaffiliated asset managers from around the world through our multimanager model.

These materials have not been reviewed by, are not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the following Manulife entities in their respective jurisdictions. Additional information about Manulife Investment Management may be found at www.manulifeim.com/institutional

**Australia:** Hancock Natural Resource Group Australasia Pty Limited., Manulife Investment Management (Hong Kong) Limited. **Brazil:** Hancock Asset Management Brasil Ltda. **Canada:** Manulife Investment Management Limited, Manulife Investment Management Distributors Inc., Manulife Investment Management (North America) Limited, Manulife Investment Management Private Markets (Canada) Corp. **China**: Manulife Overseas Investment Fund Management (Shanghai) Limited Company. **European Economic Area and United Kingdom:** Manulife Investment Management (Europe) Ltd**.** which is authorised and regulated by the Financial Conduct Authority**,** Manulife Investment Management (Ireland) Ltd. which is authorised and regulated by the Central Bank of Ireland **Hong Kong:** Manulife Investment Management (Hong Kong) Limited. **Indonesia:** PT Manulife Aset Manajemen Indonesia. **Japan:** Manulife Investment Management (Japan) Limited. **Malaysia:** Manulife Investment Management (M) Berhad (formerly known as Manulife Asset Management Services Berhad) 200801033087 (834424-U) **Philippines**: Manulife Asset Management and Trust Corporation. **Singapore:** Manulife Investment Management (Singapore) Pte. Ltd. (Company Registration No. 200709952G) **South Korea:** Manulife Investment Management (Hong Kong) Limited. **Switzerland:** Manulife IM (Switzerland) LLC. **Taiwan:** Manulife Investment Management (Taiwan) Co. Ltd. **United States:** John Hancock Investment Management LLC, Manulife Investment Management (US) LLC, Manulife Investment Management Private Markets (US) LLC and Hancock Natural Resource Group, Inc. **Vietnam:** Manulife Investment Fund Management (Vietnam) Company Limited.



519801