

FTfm

## Investors must share blame for corruption

### Talking head

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“How do you deal with corruption in your industry?” we asked the CEO of a newly listed emerging markets company.

He sighed. “Last year one of our competitors hired a local politician to make life difficult for us.” We started to commiserate with him. “No, no. It wasn’t a problem.” He paused for effect, started grinning, then slapped the table. “We just hired a bigger politician!”

There is a spectrum of corruption haunting emerging markets – and investors are partly to blame. At one end lies the day-to-day corruption endemic to many developing economies. In the middle sits the grey, ambiguous world of corporate lobbying, *guanxi* (“relationships”) and dubious political donations, while at the other extreme are the huge, rent-seeking bribes and payments for lucrative contracts or political favours.

It is at this end of the spectrum where investors have a significant role to play. Far too often as an industry we shut our eyes to companies who have overstepped the mark.

Corruption matters for investors for three key reasons. First, it represents a direct investment risk. Contracts and licences won under murky circumstances

are far more likely to be torn up in future years. Entire business franchises can disappear. Second, corruption provides vital clues to the wider culture. If management are prepared to cut corners and act with such little integrity in their search for profits, how will they treat minority shareholders, or local communities, when things aren’t going well? Third, corruption is a drag on wider economic growth and, therefore, share prices.

What then can investors do? There are several steps that need to be taken. First, as an investment community we must open our eyes and start analysing corruption properly.

This is not hard. Simple questions to management teams can elicit telling answers. Poor quality companies are surprisingly open about their willingness to cut corners. “Why do you have joint managing directors?” we asked the joint managing director of an emerging markets property company. He looked surprised. “So we can visit twice as many politicians!”

Quick reputation checks can be extremely effective; a surprising number of management teams have criminal pasts. Political donations can be telling, particularly for a single politician, while initial listing documents are also useful as companies are

forced to air all their dirty laundry in public.

The second challenge for investors is to allow this analysis of corruption to flow through into capital allocation decisions. The more companies believe corruption affects their cost of capital, the quicker they are likely to stop it. Unfortunately, we are a long way from that. In recent years, companies with serious corruption question marks have raised large

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amounts of capital. In part, this is because the time horizon of the industry has shrunk from years to months.

Thirdly, investors must do much more to engage companies on corruption. The need to generate shareholder returns is often used as an excuse. This thinking needs to be turned on its head. Strong messages must be sent from shareholders on the importance of avoiding short-cuts, regardless of the impact on profits.

Finally, investors must

look closer to home.

Questionable practices still occur within the investment industry. For example, some of its client entertainment practices would benefit from closer scrutiny. Perhaps only when the industry has its own house in order will it shine a spotlight on the companies it invests in.

In short, there is plenty that investors can and should be doing. As the saying goes, the accomplice to the crime of corruption is frequently our own indifference. It is time the investment industry stopped being quite so indifferent. Creating a corruption-free investment portfolio is probably impossible, but it is, however, possible to ensure that our eyes are wide open to the risks of corruption. Where we spot it we must allow it to impact our investment decisions and drive our engagement activities. That way, not only will we have less chance of losing our clients’ money, but we will also play an invaluable role in discouraging corruption along the way.

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