ESG & DC – creating the right tools

Francesca Fabrizi meets Manuela Sperandeo, Head of Sustainable Indexing, EMEA, BlackRock and Mark Guirey, Executive Director, MSCI to discuss how innovative developments in sustainable index investment is helping enable DC schemes to meet their ever-evolving ESG goals

The environmental, social and governance ("ESG") considerations discussed herein may affect an investment team's decision to invest in certain companies or industries from time to time. Results may differ from portfolios that do not apply similar ESG considerations to their investment process.

The adoption of ESG investment has been rapid and wide-reaching in DC since 2019. What trends are you seeing?
Sperandeo: There have been several interesting trends that have come about, if we focus on DC in particular. First of all, the fast-moving regulatory landscape has encouraged the whole industry to take a serious look at ESG considerations when building portfolios. Within that, index solutions have been a key enabler because, over the past few years, we have seen incredible growth in ESG indexing, availability of different ESG solutions, better data, but also advancements in indexing technology which lend themselves to having a stronghold at the core, for example, of the default offering.

So, the interplay between the regulatory trends and the rise of ESG indexing has been key – trustee boards are keen to execute on some strong commitments that they've made to sustainability, but also member demand is there. Industry surveys indicate that a vast majority of members want to have meaningful and measurable sustainability considerations in their pension portfolios.

Guirey: I agree the evolving regulatory environment has helped influence the adoption of ESG and the integration of ESG into DC funds. But there's clearly an awareness that many members of a DC fund will go with the default option.

Whilst the vast majority of DC pension arrangements have incorporated some form of ESG, they've done so more on a self-select basis and the trend has largely been that members don't self-select, they don't feel confident enough to self-select and, ultimately, they go with the default. So a big portion of the discussion has been: how do we put sustainability in default funds?

Why should schemes consider sustainable index investing?
Sperandeo: There are multiple reasons. First of all, the traditional benefits of index funds remain as relevant as ever: transparency, efficiency and scalability – these are characteristics which have enabled the adoption of index strategies in defaults more broadly. In the context of ESG, when we look at integrating sustainability characteristics, the transparency point is particularly important, given the role ESG data plays in the security selection and portfolio weighting.

A lot of the concerns and anxieties that arise when you talk about sustainability relate to the different interpretations that are out there. Our experience has shown that, by having very clearly articulated and transparent index construction rules, investors can also ascertain what to expect from an investment perspective.

This is very much a default conversation, so it is actually an investment conversation that we are having with our largest pension investors.

The level of transparency that indexing provides means predictability. There is clearly a consideration around the consistency of the methodology that you can apply across different exposures. Increasingly, it's multi-asset in nature – the first developments took place in equity but are now actually expanding to the fixed income universe.

Guirey: Manuela touched on several interesting points there – relating to data, relating to it being about more than just equities but rather across the portfolio; that is all absolutely front and centre of where we are today. That plays to thoughts around how MSCI will look to ensure that the data is available, that it's across different asset classes, that it is through the lens of environmental, social and governance.

We are looking at climate as a material, potential impact. Of course, many schemes are now making commitments on how they'll deal with climate change or being required to from a regulatory framework. So, the development of solutions that deal with those aspects is very important in order for us to step forward.

In indexing, a number of alternative benchmarks have emerged. How can DC schemes navigate the options?
Guirey: Part of this is knowing where you are today, so taking a bearing, how is the scheme positioned? What is it that

we as a scheme, if you're talking in the scheme context, want to do? How do we present as a company? What do our members want? Doing that analysis and taking a bearing is an important aspect.

How you then step forward into selection can somewhat be driven by that, because if you are clear where you are today, and you know where you might want to go, then the assessment of available solutions somewhat falls into place from there.

Sperandeo: A lot of the index insights that MSCI provides us feed into some of the portfolio consulting activities that we carry out, especially with pension funds. So, it's about measuring where you are today, and understanding the objectives. For example, with regards to net zero, we know that a lot of schemes have made net zero commitments, but there are different ways in which they can fulfil those.

So, having clarity around this – whether it's about decarbonisation, whether it's about weighting in favour of companies that are better prepared, or whether it's about excluding some companies – is key. There are different options and based on that you can simulate different scenarios.

We also, as a firm, have invested heavily in a whole portfolio solution mindset and, to do that, we have made available our climate-aware market assumptions. Investors have been using our market assumptions for many years, we make them publicly available, and now we think, given how meaningful climate risk is as an investment risk, we also need to account for that, so also have the option to calibrate market assumptions and expectations based on climate scenarios.

There has been an increased focus on the 'E' pillar of ESG. Can you comment on the trends you are seeing in terms of strategy design in this space? Is now really the best time to be avoiding assets like oil and gas?

Sperandeo: This is a huge topic, given market conditions and this is where the concept of choice that the different approaches provides is key.

There is a lot of focus on transition. Today we have the advantage of being able to collaborate with index providers and offer portfolios that are more transition oriented. Some of these may also align with existing regulatory labels and related recommendations, such as the EU Climate Transition Benchmark or Paris Aligned Benchmark.

So, we have a have a useful framework to help us build benchmarks that enable this transition. As part of that, a lot of these benchmarks also have constraints with regards to proximity to the parent universe in terms of active risk targets or sector and country deviation.

This is very much an investment consideration, so it needs to be evaluated in the context of the fiduciary duty. Indexing technology allows us to also keep the risk considerations at the centre, whilst promoting the transition for example by remaining broadly invested in high climate impact sectors but allocating within them to companies that are making progress.

Guirey: Climate change is a really important aspect and as we get to a point where commitments are being made and investors are aligning themselves to different frameworks – the IGCC, the Net Zero Asset Owner Alliance – they need to try to invest in order to achieve their alignment.

Therefore, consideration as to how to integrate environmental into being beyond just the rating of a company, but thinking about a company's impact on climate change, and climate change's impact on a company, is very important.

Therefore, real world decarbonisation goes way beyond consideration to just decarbonisation of your own portfolio – it's actually about what the real world impact of your actions are. Our journey towards net zero will be beholden on all of us ensuring that the appropriate solutions and appropriate data is in place to enable that real world decarbonisation.

Do you have any forecasts of how much ESG will make up of a standard UK DC portfolio?

Sperandeo: What we're witnessing is that there are some schemes which are offering sustainable portfolios as an option. Others are being more ambitious and are transitioning the default.

Some of the work we've been doing as part of our portfolio consulting activity demonstrates that if we look at portfolios broadly, at the European level, penetration is still quite limited. Last year, it was around 17%, it's now about 21%, so it's growing. We believe it will continue on an upwards trajectory in terms of adoption because of all the trends that we have been discussing today.

This year is going to be pivotal - the TCFD reporting requirements are likely to be a huge catalyst here, so I expect this percentage to increase.

Guirey: I agree – we spoke about regulation earlier and the impact that it has, and the requirement for schemes to report on a TCFD basis, and the limit on which they have to report moving from £5 billion down to £1 billion in terms of assets, the expectation is that £1.3 trillion of pension assets will be measured by the end of this year in terms of climate implications. Now of course once you start measuring something, you will ultimately start to think about how you can solve it. Therefore, that will become a big part of what we're seeing, it will become a big part of adaption of full solutions, and it will become part of everything that we do from here on.

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