Summary
• There has recently been an increase in demand for, and interest in, passive investment strategies that effectively incorporate ESG factors.
• Many index providers have increased the customisation options available to clients with passive strategies.
• In addition to focusing on strategies relating to engagement and voting, many approaches to ESG integration in passive mandates now also focus on how best to capture ESG within index design.
• Emerging areas include aligning engagement with ESG and climate transition.

A non-passive attitude to ESG

Andrew Williams explores how ESG factors can still be taken into account with passive investment

A growing number of institutional pension fund investors are focusing attention on the incorporation of environmental, social and governance (ESG) considerations within their passive investments.

Customisation

According to Redington research team manager, Tom Baird, there has recently been a step change in demand and interest in strategies that effectively incorporate ESG factors, prompting asset managers to significantly up their game when it comes to researching and developing ESG integration into lower risk investments.

"Index providers have been increasing the customisation available to clients with passive strategies. For instance, creating more flexible strategies that allow individual clients to target certain outcomes, such as strong governance or reduced carbon emissions, within a certain degree of tracking error," he says.

Elsewhere, R&M Solutions associate director, Emily Forsyth-Davies, reveals that another interesting trend has come from investors like local authorities looking to invest in low-carbon passive funds in a bid to cut their carbon footprint. For example, last year the Local Government Pension Scheme (LGPS) Central launched the All World Equity Climate Multi-Factor Fund, which tracks the FTSE All-World Climate Balanced Comprehensive Factor Index and considers carbon emissions, green revenues and fossil fuel reserves, which attracted pension assets of £2.1 billion.

"Other investors are looking at this trend closely, as the goal of keeping global temperature increases to below 2°C above pre-industrial levels – is one of the main goals of the 2015 Paris Agreement," says Forsyth-Davies.

Meanwhile, London Stock Exchange Group head of sustainable business, David Harris, points out that ESG integration into passive mandates was initially about engagement and voting, but now also focuses on how to capture ESG within index design. He also observes that the biggest area of focus is on integrating climate change, although others are going further with ESG more broadly, including sustainable development goals.

"Over the past five years we have seen a growing number of asset owners reallocate assets under management from traditional passive equity mandates into climate-adjusted benchmarks. In conjunction with this, there have also been significant developments in the tools, data and methodology that global investors have access to, to create portfolios that account for the transition to a low carbon economy," he says.

"We are developing not only equity-climate benchmarks, but also fixed-income indexes, including the groundbreaking FTSE Climate WGBI, the first government bond index to adjust weights based on each country's preparedness and resilience to climate change risk," he adds.

Smart sustainability

DWS head of passive sales, Europe and Asia-Pacific, Simon Klein, also points to the clear difference between US and European providers when it comes to recognising the rising importance of stewardship in relation to ESG passive investments.

"If you look at analysis provided by, for example, the independent UK research group Influence Map, or the US-based Majority Action, European asset managers have a much better record of voting in favour of decisions that make positive ESG changes," he says.

On a more cautious note, SRI Services and Fund EcoMarket founder, Julia Dreblow, observes that, although passive ESG investment is theoretically straightforward, trustees fears about deviating from standard benchmarks have led to the development of some pretty complex passive funds that underweight companies with poor ESG standards and significant carbon risk and overweight those with hopefully higher standards.

"My concern about such funds is that although they may make sense intellectually, they are neither in one camp or the other. Presumably most members will either want to retain 'big oil' – perhaps in order to retain income flows and so on – for example, or move into assets with stronger sustainability credentials," she says.

"My fear is that trustees will find explaining today's middle ground options to scheme members rather difficult – perhaps akin to saying someone is only 'a bit pregnant.' Not necessarily entirely convincing – and quite likely to give rise to further questioning," she adds.

Forsyth-Davies believes there are two main ways to incorporate ESG considerations within passive investments. The first is to invest in a standard index and, at the outset, ensure your manager has beliefs that align with your own and monitor and challenge them on this through time. The second is to invest in an ESG positive-tilt index, which aligns with your own investment beliefs.

"Judging effectiveness is scheme specific; for schemes that have an ethical focus, avoiding controversy will be key. For the majority of schemes this will be about using ESG to add value and you are seeing this more and more across the board," she says.

Harris reiterates his observation that the de minimis approach to ESG in passive mandates only considers voting and engagement, but not index design and fund structure. In his view, a more advanced approach focuses on building this into index design through both traditional, as well as more nuanced, weighting methodologies.

He also points to the concept of smart sustainability, which links together smart beta and sustainability, using the same factor methodologies but applying these consistently to sustainability parameters in combination with risk premia.

"An example is the LGPS Central pension fund that made a £2 billion allocation to the FTSE Climate Comprehensive Factor Index, which uses the FTSE All World Developed as the starting index and then applies five risk premia factors – value, quality, size, momentum, and volatility – together with three climate parameters, carbon emissions, carbon reserves and green revenues," he says.

Climate transition

Elsewhere, Klein reveals that, whereas many will opt for a passive mandate providing exposure to an ESG version of a well-known equity index, others might prefer an ETF.

"Last year, for example, we launched a new ETF in the US – the Xtrackers MSCI USA ESG Leaders Equity ETF – that we created after a request from Ilmarinen, Finland's largest pension insurance company, for a socially responsible investment solution for the US equity space. They seeded the product with an investment of $850 million, and the ETF has since grown to $1.8 billion in assets under management," he says.

Meanwhile, Dreblow prefers to adopt a perspective of sitting on the fence a little – and does not believe that any single strategy suits all schemes as each has a different profile. However, in spite of these concerns, she expects that fund strategies will continue to evolve, and agrees with the view that passive funds which underweight companies with poor ESG scores are better than those that do not.

"However, to truly protect member assets, trustees must learn to think differently as the future will not be like the past. I'd suggest a clear focus on climate change – and favouring funds that swiftly drop laggards. I'd also suggest focusing on what companies actually do rather than focusing entirely on often opaque ESG scores, although this can be tough for passives," she says.

Looking ahead, Harris observes that new emerging areas include aligning engagement with ESG and climate transition, and cites the FTSE TPI Transition Index as a key development. The Transition Pathway Initiative (TPI) is an asset owner-led initiative co-chaired by the Environment Agency and the Church of England Pension Fund, with FTSE Russell as the data partner. Companies in high-carbon industries are assessed by the TPI on the quality of their climate management strategies and their carbon performance. The assessment is transparent and the companies are categorised on how advanced their strategies are. The investors then use this as a basis for collaborative engagement.

"The new FTSE TPI Transition Index weights companies based on these scores, so powerfully aligns engagement with investment. As investors encourage companies to improve their climate strategies, their scores increase, and their weight in the index and index funds increases," says Harris.

"Other emerging areas include aligning passive investment with the Sustainable Development Goals. Building out methodologies to capture climate risk, including across asset classes, is also a growing theme," he adds.

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In association with FTSE Russell