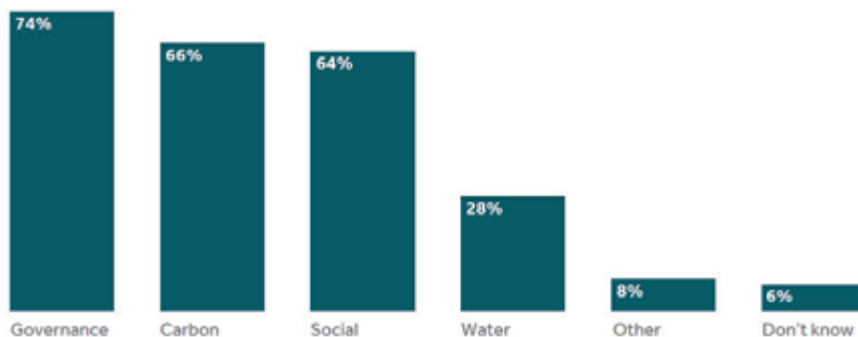


# The rise of smart sustainability: Size matters. Location matters

Henry Odogwu explores the growing interest in blending ESG with smart beta

What ESG issues are you considering using in a smart beta and ESG allocation?



Multi-pick. Segment - Anticipate applying ESG considerations to a smart beta strategy.

Source: FTSE Russell. Smart beta: 2019 global survey findings from asset owners

Our latest annual survey of global institutions' use of smart beta shows a rise in smart beta adoption among asset owners and an increase in combining smart beta strategies with sustainability parameters.

We've noticed rising interest in the blending of ESG and smart beta in recent years, an approach we call 'smart sustainability'. So, this year we produced a separate report to explore the motivations and regional differences in the application of ESG to smart beta.

Overall, of respondents using and/or evaluating smart beta strategies, only 42 per cent have ruled out applying ESG considerations to their smart beta strategy of choice while nearly half (44 per cent) are actively considering doing so. Governance, carbon, and social considerations were all commonly cited among respondents, suggesting a growing sophistication with the use of ESG risk management tools.

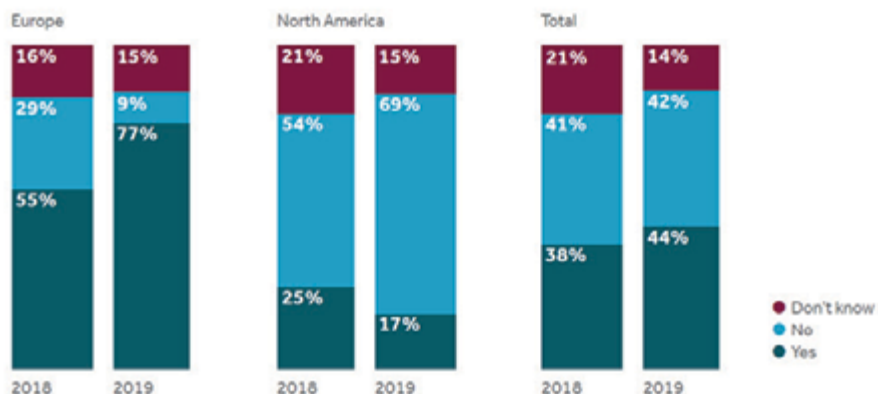
**But the upward trend is not universal.** We found a size bias in appetite for ESG and smart beta combined strategies. Fifty eight per cent of larger organisations (but only 30 per cent of smaller ones) are looking to increase their allocation over the coming years. And only a tiny

minority (4 per cent) of larger funds ruled out increasing allocations to ESG and smart beta. This seems logical: larger institutions tend to have the resources to investigate and often allocate to newer fund strategies before their smaller peers.

We also found a geographical imbalance in appetite for smart sustainability strategies; In Europe, 77 per cent of European asset owners expressed interest in applying ESG considerations to smart beta (up from 55 per cent from 2018), while 17 per cent of North American asset owners indicated similar interest (down from 25 per cent on 2018).

We think Europe's lead in incorporating ESG into smart beta strategies may reflect the changing regulatory context with European regulators encouraging greater disclosure by both companies and investors. There have not to date been similar

Do you anticipate applying ESG considerations to a smart beta strategy?

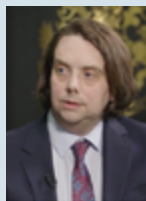


Segment - Have a smart beta allocation OR are currently evaluating/re-evaluating smart beta strategies OR are planning to evaluate smart beta strategy next 18 months.

Sample size for Asia Pacific and Other regions not large enough to break out; respondents from these regions are included in total.

Source: FTSE Russell. Smart beta: 2019 global survey findings from asset owners

## Mersey's long horizon:



### Why pension schemes can lead on climate change

*At the beginning of this year Merseyside Pension Fund adopted a FTSE Russell smart sustainability index, the FTSE All-world Climate Balanced Comprehensive Factor Index. The long-term investment time frame that pension schemes take poses enormous challenges but can also lead to innovative investment approaches to difficult issues. In this section of the article we hear from Merseyside Pension Fund (MPF) portfolio manager, monitoring and responsible investment, Owen Thorne, where he explains how the fund approached the climate change challenge.*

### How long has addressing climate change been an issue for the scheme?

As one of the larger pension schemes in the UK, we have consistently taken a progressive role in active stewardship and engagement on ESG issues, and we have had a long-standing interest in climate change. Recently it's been apparent that the rate of climate change is accelerating; the global transition to a low-carbon economy and a more sustainable future is well underway, and the policy responses towards climate change are accelerating, too, so it became incumbent on us to

regulatory developments in the US, although Canada is moving ahead and has established an expert panel on sustainable finance to advise the government.

Regardless of implementation differences across regions, assets owners globally who anticipate applying ESG

take account of these macro trends at an inflection point in the world of responsible investing.

MPF stakeholders have been strongly supportive of the view that ESG factors are financially material and that their integration in investment strategy is consistent with fiduciary duty. But it's fair to say that the Paris Agreement was a turning point in terms of a realisation that action on climate change needed to be larger scale and targeted at both risk and opportunity. At that point, it was determined that the fund's responsible investment policy be brought into line with the goals of the Paris Agreement.

The direction of travel on responsible investing (RI) and environmental, social and governance (ESG) issues in UK and Western Europe is clear: regulators are acting. This affirms our view that urgent action on climate shaped by a policy response to Paris (however mixed) was a much more likely scenario than an ongoing business as usual scenario.

### How did you address this investment challenge?

Paris was a strong factor in persuading us to undertake a strategic review of our exposure to climate-related financial risk; and to consider decarbonisation plans in mitigation. Throughout the process we consulted with a cross-section of internal and external stakeholders of the fund. It was clear to us that the global transition to a low-carbon economy and a more

considerations to a smart beta strategy are doing so for investment reasons. More than three-quarters are motivated by avoiding long term risk as compared to a little over half of respondents last year. But it's clear that adoption is happening at different speeds in different market sectors.

sustainable future was well underway, and seemed to be accelerating. It was also apparent that our approach should not compromise on our ability to deliver investment returns while managing climate change risk.

Because of that review, we allocated a third of passive equities in our £9 billion portfolio to a low carbon index-based strategy, with a tilt to a number of equity factors. The index achieves our targeted reduction in carbon emissions intensity and fossil fuels reserves, but also increases exposure to 'green revenues', and over time we expect will generate a return in line with or ahead of the market.

### Does climate change pose a problem for pension schemes like MPF, which operate with very long-term time horizons?

As a pension scheme open to new members, we are aware that those new members could be participating in the scheme for a long time, creating pensions liabilities 80 years into the future, which must be funded.

We therefore must operate with very long time horizon. For MPF, 2050 is not that far along in terms of our event horizon. And our existing liabilities to pay pensions to our members exceeds beyond the year 2100. That's how long-term we have to be in terms of looking at liabilities and risks, which of course include the systemic risk posed by climate change.



Written by Henry Odogwu, managing director, head asset owner & consultants, Europe, FTSE Russell

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