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Integrating ESG into your passive strategy

Is integration into passive becoming the new norm?

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Responsible Investor &
FTSE Russell

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Integrating ESG into your passive strategy

A look at how two leading asset owners are integrating ESG into passive investing and smart beta strategies.

The world of index-based investing is in flux as ESG integration into passive is on course to become the norm for new mandates as we enter the era of "Smart Sustainability".

Recorded on November 14, 2017

It was with this in mind that FTSE Russell and Responsible Investor convened a high-level webinar in November 2017.

Webinar Agenda:
- **Global Developments:** ESG, sustainability metrics and indexes
- **Smart Sustainability:** bringing together ESG with smart beta factors
- **The why:** rationale from asset owners on integrating ESG into passive strategies

The expert panel included:
- **David Harris,** Head of Sustainable Investment, FTSE Russell
- **Mark Thompson,** Chief Investment Officer, HSBC Bank UK Pension Scheme
- **Maurice Versaevel,** Investment Strategist, PGGM

Moderated by Daniel Brooksbank, Editor at Responsible Investor, in partnership with **FTSE Russell**

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Head of Sustainable Investment
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Mark Thompson
CIO
HSBC Bank UK Pension Scheme

Maurice Versaevel
Investment Strategist
PGGM

FTSE Russell's David Harris opened the webinar with a short history of smart beta, recalling how the FTSE4Good Index family, launched in 2001, was initially a niche area, mainly for retail investors. It took quite a while for institutional investors to become interested – indeed PGGM was an early adopter.

Then came the launch of the Principles for Responsible Investment (PRI) in 2006 and the spread of the term 'ESG'. Harris said: "What's starting to happen now is people are asking 'how do we integrate this?' And that's also been driven by the rise of smart beta."

"On the one hand you've got traditional passive investing, and what's opening up is this area in the middle between that and active, where – if you can create clears rules – you can build that into the index." On top of that has been the development of multi-factor indexes.

From there it's a relatively easy step for an asset owner with investment beliefs about sustainability/climate to be able to use the "same technology, the same approaches, to bring that together into a single index design, alongside different risk premia factors". For example, an investor can reduce exposure to carbon emissions or fossil fuel reserves whilst increasing their exposure to alternative risk factors such as size, quality and value.

This 'building blocks' approach to ESG index construction can also be applied to traditional (i.e. market cap weighted) index design. So ESG integration into passive should be thought about in the same way as integrating risk premia factors. "This is driven ultimately by investment beliefs and by being able to bring them together in a consistent way, rather than seeing these as something separate." In short, the growth in smart beta is leading to "large scale" market adoption of ESG into index-based investing as investors understand how traditional and ESG considerations can be combined.

FTSE Russell carries out a survey each year looking at the use of smart beta by asset owners globally, garnering responses from around 200 asset owners. This has found that almost 60% of large asset owners (>$10B) evaluating smart beta are looking at incorporating ESG into their smart beta allocations.

"So this is no longer a small part of the market, this IS the market," Harris said, adding the main rationale was "avoiding long-term risk" – i.e. there's an investment case.

This led nicely onto Maurice Versaevel, who began by describing PGGM's responsible investment framework.

There are seven focus areas: climate & environment; water; food; health; human rights; corporate governance; stable financial system.

PGGM has ambitious long-term strategic targets (set by its owner, the health and well-being fund PFZW).
These include quadrupling clients' positive impact to €20bn (2015: €5bn) and reducing the negative CO_2 footprint of its equities portfolio by 50%.

The structure of the listed equities portfolio is built on three 'buckets':
1) passive/market cap; 2) active/factors ('smart beta'); 3) active/fundamental.

For the first there is a focus on CO_2 reduction, which has involved the construction of a low CO_2 index and the removal of the most intensive companies (utilities, materials and energy). Versaevel said: "We take a gradual approach, we don't divest all the companies right away: companies do have the means and opportunity to improve and get back into the index and portfolio. We also engage with these companies to say this is about to happen and that they really have to improve."

For the second segment, Versaevel said changing the benchmark "doesn't really do much in the portfolio". Rather, PGGM had to integrate CO_2 intensity into the factor models. "We did that by assigning a CO_2 budget which functions as a constraint and we gave this to the portfolio managers." He added the firm gradually tightens the CO_2 budget, meaning that the amount of carbon that the managers can have in the portfolio is being reduced.

"If two companies are very similar in terms of value and all the other factors, but if one has a lower CO_2 intensity – so a lower carbon footprint - I would much rather have that company."

For the third bucket, PGGM has created a proprietary universe of around 350 companies, with enough green revenues to be identified as making an impact. From that universe the portfolio manager can choose what stocks to pick – on a buy and hold philosophy.

The final speaker was Mark Thompson, who explained how the trustees at the HSBC scheme see managing ESG risk as a key part of their fiduciary duty: "Everything we do is built upon that."

It means that ESG is integrated into all fund management mandates – with onsite meetings to make sure the managers are doing what they say they're doing!

Thompson said the 82,000-member fund adopted a climate change policy in 2015. But, one issue was that most members went into the default option. This was a global equity fund, passively managed against the FTSE All-World® Index.

Thinking he could improve on this, Thompson envisioned a three-pronged strategy: a better risk adjusted neutral position; climate change risk protection; and improved company engagement by fund managers. He contacted FTSE Russell and incumbent passive manager Legal & General Investment Management: "We got together and formed a project." Initially nothing to do with ESG, a universe was created with four factors: value, low volatility, quality and small size. This showed strong performance and the next step was to incorporate climate change protection.

This involved tilting away from companies with carbon reserves and carbon emissions – and tilting towards companies with green revenues. "The question is, how far do you set the tilt?" Just green companies would be quite volatile compared to the market as a whole. "So we didn't set the dials on full." In this way he was able to convince his trustees that this was still a mainstream index that was incorporating climate change protection.

The result is that the FTSE All-World ex CW Climate Balanced Factor Index has a very significant outperformance, with lower volatility, relative to the FTSE All-World Index. Most of that performance comes from the risk premia factors but some also comes from the three climate parameters.

"Even if it modestly underperformed, I'd have still wanted to do it because I'm putting these tilts in here for the long run," Thompson said – pointing out it means lower carbon reserves and emissions in the portfolio.

The next element is engagement. So Thompson worked with L&G to identify six sectors where engagement would have the greatest impact: oil & gas, mining, electric utilities, auto, banks, insurance and food retail.

L&G then wrote to the chairs of the 84 largest companies in those sectors and asked them to explain how they will align with a sustainable world. He summed it up:

"It's about us as an asset owner putting pressure on our agent, the fund manager, to put pressure on companies to make sure they're making plans to be sustainable in the long run."

And the costs of the initiative? Thompson explained that the parties worked together for free at the start and are now operating on commercial terms. "So the innovation part was all free but it is now structured so that everybody is paying an appropriate amount."

This webinar was viewed live by more than 375 individuals representing 240+ institutions globally and has since been viewed on demand by a further 300+ individuals.

To learn more about FTSE Russell's "Smart Sustainability" products please visit: http://www.ftserussell.com/sustainable-investment-data-and-indexes

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