ESG integration into passive investing becoming the new norm

BY JOLANDA DE GROOT

The world of index-based investing is in flux as ESG integration into passive investing is on course to become the norm for new mandates. In the last year there has been a quiet revolution taking place as asset owners have been moving to integrate ESG considerations into index designs to address new mandates on core passive portfolios. Financial Investigator asked Aled Jones, Head of Sustainable Investment Europe at FTSE Russell, some questions.

Sustainability has many meanings – how does FTSE Russell define it?

'We see a huge amount of confusion over the definition of sustainable investment and we believe there are two fundamentally different ways to define it. The first approach is about how a company manages its operational risks, typically referred to as ESG – and is concerned with how companies operate; the efficiency of their operations, how well governed they are and their interaction with different stakeholders. We have developed ESG Ratings and data models to capture how well companies perform in this regard. Our ESG data covers over 4.100 companies on 14 different 'Themes' such as health and safety, anti-corruption, tax transparency, climate change, and water use. The methodology is clearly defined and a tiered data set of ESG Ratings is calculated, reflecting each company's overall exposure to, and management of, ESG risks.

The second approach focuses on the revenues that companies generate from green products and services, and is covered by our Green Revenues data model. As such, it addresses the positive side of sustainability which is how companies are progressing towards providing solutions to climate change and increasing resource use. Our Green Revenues model, which includes detailed corporate financial history, covers 13.500 companies (98% of global market capitalisation) - of which more than 3.000 have green revenues from one or more of the 60 green subsectors that we have defined. As with our ESG model, data is collected using a transparent, rules-based process. The data is then mapped by our analysts to the Green Revenues Classification System – a new industrial classification system specific to the green economy.

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Our ESG and Green Revenues data allows users to clearly understand a company's ESG risk exposure as well as its contribution in the transition to a green economy. For investors in particular it enables granular analysis of individual or aggregate portfolios based on a range of ESG and/or Green Revenue criteria.'

Can you tell us more about the importance of data reporting and company disclosure?

'Company disclosure on ESG issues has improved significantly over the last decade. The reliability is improving and in many – in particular developed – markets we have a reasonable time series. However, it's not perfect and could still improve, especially in some market segments (for example small cap stocks).

Earlier this year, on the back of a year-long process involving consultation with listed companies and investors, the London Stock Exchange Group (our parent company), issued a global guide to ESG reporting for companies. This guide provides good practice recommendations and the key attributes of 'investment grade' ESG and Green Revenues data. In addition, it sets out details of potentially relevant reporting metrics for different industries.

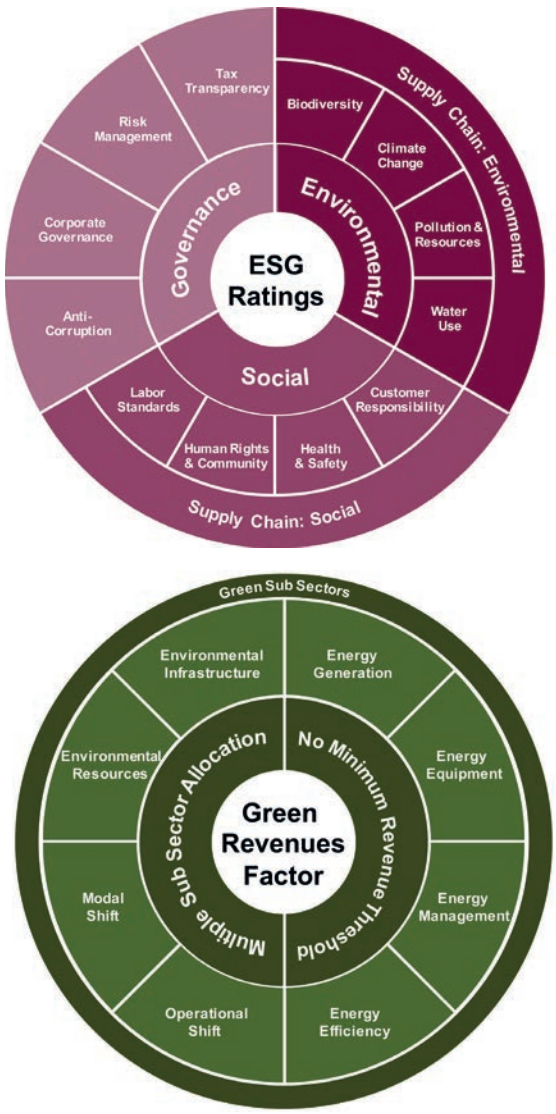
Gathering data on green revenues can be more challenging. Whilst the reliability of revenue data is strong, because it is generally audited, not all companies provide revenue breakdowns for green products and services. For example, you may have a lighting company that isn't breaking out its LED lighting sales versus its tungsten or halogen products.'

How are you seeing ESG being integrated into passive strategies – can you give a current asset owner example?

'We have been building ESG indexes since 2001 – when we launched the FTSE4Good Index Series. Approaches to implementation of ESG have evolved significantly since then and we are currently seeing a lot of demand for alternative index construction, in particular via our 'Smart Sustainability' capabilities which allows investors to combine ESG considerations with tilts towards alternative risk premia. For asset owners, Smart Sustainability enables the alignment of investment beliefs with specific ESG objectives, such as managing exposure to climate risks, whilst maintaining a largely passive approach.

For example, in the UK, late last year, HSBC Bank UK Pension Scheme, switched its defined contribution (DC) equity default fund to follow a new Legal & General Investment Management passive fund with a three-pronged climate change tilt: the Future World Fund. The fund tracks FTSE Russell's first 'Smart Sustainability' index – the FTSE All-World ex Controversial Weapons Climate Balanced Factor Index. This index is designed to combine a smart beta factor approach with parameters that account for risks and opportunities associated with climate change. The index incorporates a range of factor tilts – including volatility, value, quality and size – and underweights companies with high relative carbon emissions and fossil fuel assets, while increasing index weights for companies with revenues that contribute to the transition to a green economy. With a further defined benefit (DB) allocation added to the DC mandate, HSBC Bank UK Pension Scheme has now assigned around £ 4billion to the fund.'

Figure 1: ESG Ratings and Green Revenues Factor



Source: FTSE Russell

How can an index integrate ESG and climate considerations without impacting the efficiency of a portfolio?

'Well designed multi-factor indexes help to build diversification and can be used to provide a more efficient allocation to several factors irrespective of factor correlations.

Our Smart Sustainability indexes offer a 'tilt-tilt' methodology to provide increased, but balanced, exposures to specific factors (that is, value, quality, volatility, size etc.) as well as improving exposure to climate change criteria as discussed already (that is, reduced fossil fuel reserves and carbon emissions exposure, along with increased exposure to green revenues).

This 'tilt-tilt' approach uses a bottom-up process of sequential tilts toward each factor, using the product rather than the sum of the normalised factor scores. To determine a stock's weight in the multi-factor index, all target factor scores are multiplied together and the result is then multiplied by the stock's weight in the underlying index. The resulting index increases the weights of those stocks exhibiting the highest relative exposure to all of the target factors, thereby providing much greater levels of factor exposure for any potential combination of factors. Our methodology also allows the integration of any data without compromising the other factors or other preferences.' «

For asset owners, 'Smart Sustainability' enables the alignment of investment beliefs with specific ESG objectives.