Index-based ESG strategies: key things to watch for

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The combination of rising demand for index-based investment products and an increasing appetite for strategies based on environmental, social and governance (ESG) criteria has led to a sharp increase in ESG-branded products. We highlight a number of reasons why these simple, low-cost solutions may not provide either the financial or sustainability outcomes investors are likely to expect.

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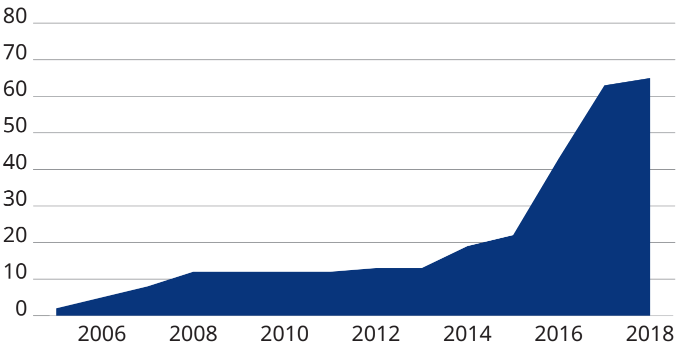
The volume of passive strategies using ESG measures and exclusions as standalone investment criteria has ballooned in recent years. Currently, we identify close to 70 in our dataset of funds listed in major ETF databases, following a tripling in the number over the last three years (Figure 1) and similar growth in terms of assets.

Figure 1: There has been explosive growth in ESG index-based strategies



Source: Schroders, February 2018

ESG approaches vary widely

While passive ESG funds provide a simple and low-cost solution for investors, it is important to consider the way they work. They are based on ESG measures that lack clear outcome targets, which make assessing their strengths and weaknesses challenging. As a result, there is a tendency to treat the "ESG-ness" of these strategies in the same way as the other blunt measures that typically form the basis of passive portfolio construction, such as market capitalisation, sector or domicile. However, ESG strengths and weaknesses are the result of a series of judgements and analyses that can vary significantly and lead to very different conclusions.

When constructing index-based ESG strategies, asset managers typically seek out ESG ratings from one of a handful of data providers, such as MSCI, Sustainalytics and Thomson Reuters, each of which represents one view of ESG performance, not a definitive answer. The table in Figure 2 summarises the main types of ESG implementation in passive investment strategies.

Figure 2: How ESG funds work

Typical approaches	
ESG/SRI	Allocation: – ethical screening for tobacco, alcohol, gambling, weapons, etc. – ESG ratings and controversies above certain minimal levels Selection: overweight companies with highest ESG ratings
Thematic	Allocation: negative screening based on ethical criteria (as above) Selection: overweight companies with low carbon footprints, operations in clean energy, water etc.

Source: Schroders

Investors' expectations of sustainability go beyond screening

It is clear that ethical screening is almost always a building block of passive ESG products, yet we recognise that investors have many reasons for selecting ESG-focused funds. Financial performance is only one criterion, and often not the main one. Our 2017 *Global investor study*[1] showed that consumers have become relatively knowledgeable about the characteristics of sustainable products. Their views point to a widening range of reasons for selecting them. More than half (53%) of respondents expected sustainable funds to invest in companies that were prepared for environmental and

1 http://www.schroders.com/en/sysglobalassets/digital/insights/2017/pdf/global-investor-study-2017/schroders_report_sustainable-investing_final.pdf

social change, while 46% viewed sustainable investment as focusing on best-in-class companies, even if they were not the most attractive investments. On the other hand, less than a quarter (23%) of investors expected sustainable investing to focus on excluding companies active in controversial areas such as alcohol, tobacco or weapons manufacturing.

As investors become more discerning, they expect more from their investments than the simple screening out of controversial industries. Many recognise the benefits of robust ESG analysis if approached as investment analysis rather than as a compliance activity. However, capturing the implications of environmental and social trends on company profitability cannot be distilled into simple rules. ESG analysis comes in many flavours; investors expecting it to strengthen investment processes should recognise that bluntly-applied third party ratings are more likely to hinder than help investment returns[2].

In that sense, it is important investors recognise that "ESG" in fund labels doesn't say much about the ingredients or recipe used. The right passive products exist for some investors, but finding them requires digging into the strategy's construction, rather than focusing solely on the label.

ESG scores capture policy disclosure rather than investment-relevant criteria

The sustainability evaluation of ratings firms is usually synthesised into a single ESG measure, akin to the stock recommendations investment banks or credit rating agencies produce. Mainstream research analysts reach different conclusions about the same companies using broadly the same information. These diverse views are valuable for fund managers seeking to better understand the businesses they might consider investing in. It would make little sense for these managers to use a single bank's research to get a definitive view of a stock's attractiveness. All the more so if they had no clear understanding of that firm's research process, the basis on which its conclusions were reached and the outcomes its recommendations were designed to achieve.

We would argue that this is essentially what investors are signing up for when they buy a passive ESG fund. Despite the perception of transparency, many passive products disclose surprisingly little about how they actually implement ESG. The majority of them rely on a single third party ESG rating provider. The ratings methodologies are hard for most professional investors to decipher, let alone retail investors. These methodologies typically emphasise tick-the-box policies and disclosure levels, data points unrelated to investment performance and/or backward-looking negative events with little predictive power. Recent research from Goldman Sachs says that "widely-used ratings services tend to incorporate somewhere in the range of 100 to 200 inputs or more", but 80% or more of those inputs relate to policies rather than more tangible measures of performance[3].

2 "Investors fear ESG investment will hurt returns", *Financial Times*, 11 October 2017: https://www.ft.com/content/112dd68a-ad01-11e7-beba-5521c713abf4

3 *The Emerging ESG Toolkit: Promise and Pitfalls*, Goldman Sachs, 19 February 2018.

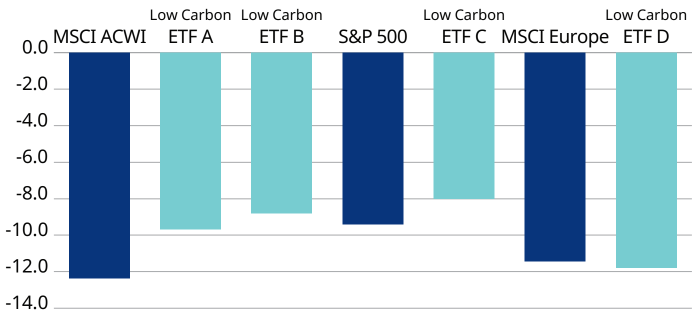
Managing carbon risk is more than reducing footprints

A case in point is carbon risk, which is a much more complex topic than simply managing fossil fuel divestments or limiting carbon footprints. Yet this is how most passive ESG products approach it. For example, some of the largest low carbon index-based strategies specifically target companies with low carbon footprints, which means reducing fund exposures to sectors such as energy, materials and utilities.

For us, however, low carbon footprints and the transition towards a low carbon economy are two very different forms of analysis. The latter is much more nuanced and requires analysis of industry structures and business models, while the former is simple but too blunt to provide a meaningful investment signal in isolation.

Compounding the application of potentially misleading models, companies' disclosure of carbon emissions is generally poor. More than 60% of footprints are estimated by organisations such as CDP[4], a non-profit organisation that runs a carbon disclosure database, or MSCI, each using its own methodology, often with very different results.

Figure 3: Carbon exposures of climate funds don't vary much from mainstream indices



The ETFs illustrated are the four largest low carbon ETFs by assets under management.
Source: Schroders, May 2018

We've taken a more thoughtful approach to climate change[5]. As a result, we have developed Carbon Value at Risk (Carbon VaR) as a more robust tool to address the impact of higher carbon prices on companies' profitability. When seen through the Carbon VaR lens, the carbon risks of some of the largest low carbon index-based strategies are not much lower than those of the broader market indices. This is illustrated in Figure 3, where the negative numbers represent the aggregate effect on profits of higher carbon prices. Our analysis leaves us unconvinced about these funds' alignment with the changes required by a transition towards a low carbon global economy.

4 See www.cdp.net

5 See "Climate Progress Dashboard forecasts global warming of more than 4ºC", Schroders Sustainable Investment Team, July 2017; "How rising carbon prices could cut company profits", Schroders Sustainable Investment Team, September 2017; and "It's not black and white for fossil fuel investing", Schroders Sustainable Investment Team, December 2017.

Index-based ESG portfolio construction can lead to skewed exposures

Many of the index-based ESG strategies available to investors have a relatively straightforward portfolio construction process. The initial step is almost always the screening of a much larger investable universe with the aim of eliminating industries seen as undesirable, such as gambling, alcohol, tobacco, weapons etc. The second stage sees stock selection targeted at companies with higher-than-average ESG scores. Lastly, positions are sized using outputs from risk optimisation tools designed to minimise tracking error compared with the respective benchmarks.

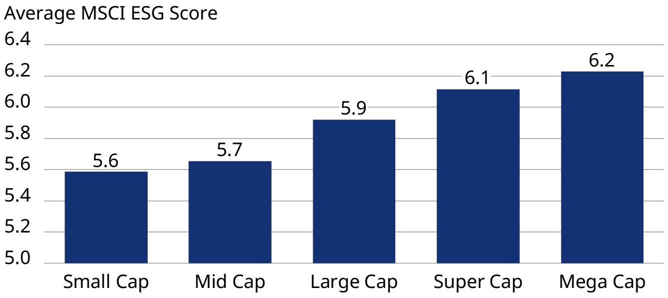
While all these steps are sensible, they leave the door open to allocation biases which can have unintended impacts on performance.

Overexposure to larger companies

Larger companies tend to have better ESG ratings, which we think is down to a multitude of factors. Larger companies benefit from having more resources to dedicate to measuring and disclosing ESG data, and usually have longstanding internal processes. They are also more publicly visible, and therefore likely to be under more pressure and scrutiny from regulators and investors. All these make it easier to gather and report the necessary data to calculate ESG scores.

Such factors mean that focusing on third party ESG scores can introduce a bias towards larger companies (Figure 4). In reality, these companies may simply have better disclosure rather than genuine strengths in relevant ESG areas.

Figure 4: Are bigger companies more sustainable?



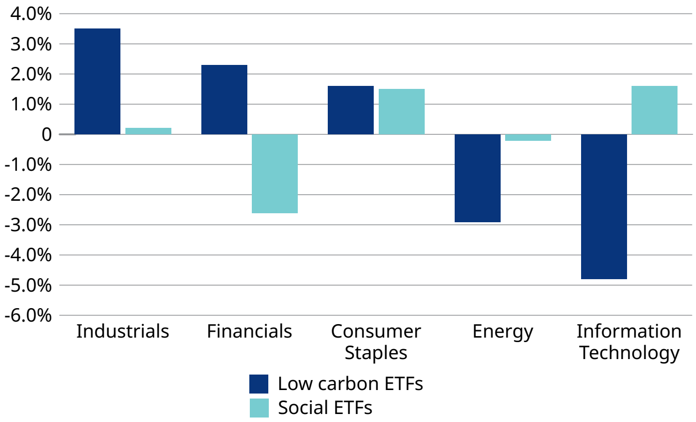
Source: Schroders, March 2018

Overexposure to certain sectors

We analysed the sector exposure of the largest low carbon and social-index-based strategies relative to their benchmarks and found they had skewed exposures to certain sectors, such as financials and technology (Figure 5). Considering that these sectors are significant drivers of market returns, this unbalanced risk exposure is likely to affect investors' results, particularly in the short term as these sectors move in and out of favour. Such misalignments are not well communicated to investors.

Figure 5: Index-based ESG products are disproportionately exposed to certain sectors

Average sector exposures of the largest low carbon & social ETFs relative to their respective benchmarks



Only the sectors with the largest benchmark relative exposures are shown here.
Source: Schroders, May 2018

ESG scores are inconsistent across providers

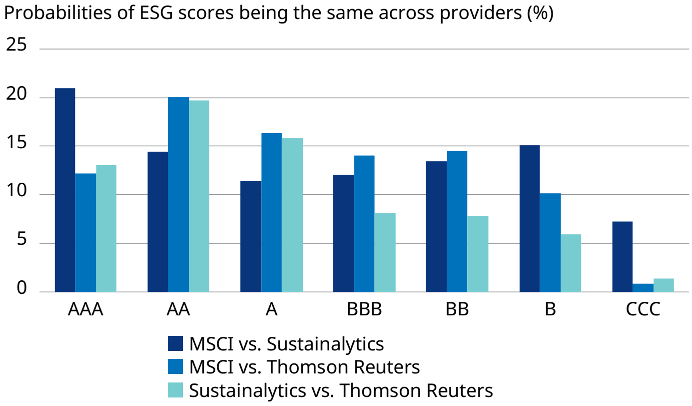
Our analysis also reveals a lack of consistency in ESG scores between the main data providers: MSCI, Sustainalytics and Thomson Reuters. For each of them and all the MSCI ACWI benchmark constituents[6], we analysed the overlap of ESG scores at the company level. We realised that each provider might have a different definition of what strong ESG means. Still, we expected a high degree of commonality among the best-in-class companies accorded the highest scores (i.e. AAA).

In fact we found that the probability of companies being given the top ESG score by the main data providers is only around 10-20% (Figure 6), with even lower levels in the weaker score bands. We also calculated the correlations across the entire company dataset of E, S and G scores from MSCI, Sustainalytics and Thomson Reuters, finding surprisingly low numbers (Figure 7).

This lack of consistency raises important questions about how weaker companies are filtered out and has implications for the screening phase of the portfolio construction process. As we said earlier, the majority of passive processes eliminate companies with weak ESG scores, so investors seeking to allocate to best-in-class companies on ESG grounds will come up with very different answers, depending on which rating provider they use.

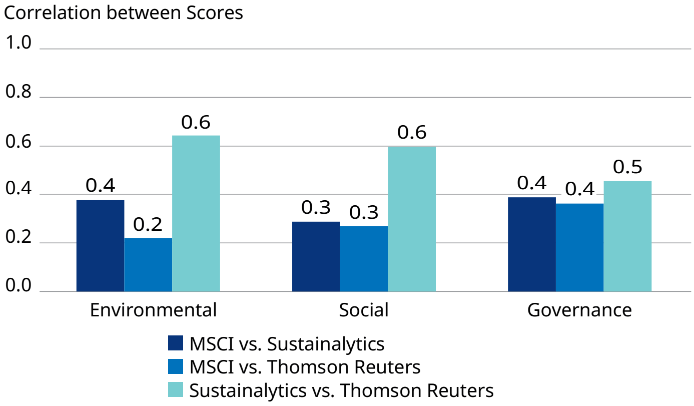
6 Approximately 2,450 companies.

Figure 6: There's precious little in common among ESG ratings



Source: Schroders, December 2017.

Figure 7: The links are loose between the various ratings providers



Source: Schroders, March 2018.

Effective stewardship is difficult for index-based strategies

The strong growth in index-based strategies has brought increased scrutiny by policymakers, clients and other stakeholders of the role investment managers play in the ownership of a growing share of publicly-listed companies. Many managers of index-tracking products have responded by becoming more vocal about their stewardship activities and by expanding their governance teams.

While there is no single best way to undertake stewardship, the approaches used by firms primarily focused on managing index-based strategies face several issues. It is hard to engage with companies and bring about change without having developed industry knowledge in the areas where these companies operate and having an understanding of how their business models are affected by long-term ESG challenges. Stewardship teams covering all markets and companies are unlikely to be able to guide businesses in navigating these specialist areas. There is a clear distinction between, on the one hand, drafting position statements and, on the other, engaging companies in tailored discussions over many years on specific circumstances and strategies.

We would argue that this is less of an issue for an active management firm, where stewardship is an important element of its role and a responsibility of fund managers, analysts and specialist sustainability experts alike. We believe that oversight is made easier by an active investment philosophy, where regular management meetings can be complemented by targeted engagements on specific company, environmental and social issues. The effectiveness of this engagement will be directly tied to the manager's understanding of industries and business models. Conversations with companies should reflect an understanding of the pressures they face and are likely to be far less effective without that perspective.

Conclusion

Index-based products integrating ESG criteria have seen strong growth lately, helped by low fees and ease of access. Nonetheless, the main providers of those products often seem to offer little clarity about the outcomes their strategies are expected to achieve, or how the ESG ratings on which they are based are determined. We have analysed these portfolios from several different angles and found that in many cases index-based ESG products follow tick-the-box policies, oversimplify complex topics and are built on ESG measures which provide little consistency between data providers. We believe investors' expectations of sustainability are better served by more thoughtfully constructed strategies, which delineate and capture companies' ability to adapt to environmental, social and governance challenges. In our view, the most effective way to do this is to integrate ESG expertise into active investment solutions. These should be designed to capture investment-relevant ESG issues, both at the company-specific and portfolio construction levels. The manager of these products should then be able use their expertise to undertake targeted engagements with companies throughout the life of the investment with the aim of improving both returns and capital stewardship for investors.

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