Passive managers actively involved in transition to the green economy

FTSE Russell

Growth in ESG benchmarks are putting issuers' sustainability performance in the spotlight and changing the notion that passive investment managers are always 'forced buyers'

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The Covid-19 pandemic is teaching us two important lessons that have applicability to climate change. Firstly, it is important to act upon high probability and high impact risks in a timely manner. Secondly, sectors of the economy can be quickly disrupted when governments swiftly and decisively implement measures to avoid threats to humanity.

Studies have shown that the cost of transition to meet the Paris 2050 target of less than 2 degrees global warming differs drastically on a sectoral and country level. A publicly available tool developed by companies including London Stock Exchange Group's Beyond Ratings, demonstrates the extent to which sectors such as energy and aviation face a disproportionate cost. These projected costs serve as a stark reminder of the extent of the challenge ahead.

More so than ever, investors recognise the risks and opportunities associated with the low carbon transition. They are increasingly integrating climate considerations into their portfolios, which is fundamentally changing the investment landscape. Investors are bringing a wider set of criteria such as carbon, green revenues and climate governance into their decision making. This is happening across asset classes, with one of the most pronounced changes happening in passive investing through Exchange Traded Funds (ETFs).

ETFs have transformed the investment landscape, with trillions of dollars being directed into thousands of lower-cost market-cap weighted index funds. Today, instead of simply reflecting the underlying market, there is increasing use of alternatively weighted indexes to integrate a variety of environmental, social and governance (ESG) considerations directly into index construction.

FTSE Russell's annual smart beta survey for 2019 captured investor appetite for ESG investing. 77% of European respondents expressed interest in applying ESG considerations into smart beta allocation - up 22% from 2018. Among those who anticipate applying ESG considerations to a smart beta strategy, over three quarters are motivated by avoiding long term risk, compared to a little over half last year.

Investor demand to incorporate sustainable investment issues into passive portfolios has already translated into a growing number of listings. Sustainable Investment ETFs represent a growing portion of new ETFs listing on London Stock Exchange. There are now approximately 80 Sustainable Investment ETFs providing equity or fixed income exposure listed, with about a third of the total listed in 2019. Trading volumes based on ESG ETFs were up by 54% between 2018 and 2019 to £650 million in turnover.

The growth in Sustainable Investment index funds is also placing a spotlight on how passive funds can be a used as a positive force to encourage change in corporate behaviour. Companies may be over or underweighted or completely excluded based on sustainability metrics applied to index funds. Transparent, rules-based index construction methodologies help companies understand how they are assessed and what actions are required to be included or have improved weighting in an index. This will incentivise companies to improve disclosure on ESG issues and demonstrate that their corporate activities are aligned with investor's long-term objectives.

The latest example of this development is HSBC Global Asset Management's new range of Sustainable Investment UCITS ETFs which provide access to several dedicated equity markets including the FTSE Developed and FTSE Emerging indexes as well country-specific exposure to USA, Japan and UK. The ETFs adjust the weights of company constituents to achieve carbon emissions and reserves reduction by 50% and 20% improvement to the index level ESG Ratings, based on FTSE Russell's ESG Ratings[1]. The ETFs also exclude companies involved with controversial product activities - weapons, thermal coal, tobacco, nuclear power and companies involved with controversies related to the UN Global Compact principles.

Sustainable Investment products, such as these, help investors incorporate climate and ESG considerations into their investments and provides a tool to incentivise corporates to align their behaviour with sustainability objectives. Innovative products such as these are way for passive investing to be actively engaged in the transition to a low carbon, more sustainable economy.

[1] FTSE ESG Low Carbon Emissions Select Indexes Ground Rules

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