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Less is more: reducing more than just carbon emissions through index investment

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Index funds are often accused of being behind the beat regarding environmental, social and governance ('ESG') investment. Typically, index solutions tend to look at only one aspect of ESG integration, such as reducing carbon emissions, or excluding whole sectors. But responsible investment is evolving quickly and as a consequence, pension schemes are under pressure to incorporate more sophisticated approaches to ESG issues within their portfolios, in our view.

We are increasingly receiving requests from local government pension scheme (LGPS) clients who are keen to integrate ESG criteria into their investments without switching to active funds, and for whom the sweeping exclusions and broad-based approach that is common to the market isn't aligned with their investment objectives. While not wanting to potentially change their return profiles through general sector exclusions, they want their portfolio to have a positive impact upon the world we live in, and to see that their investment manager is looking after their assets.

In this article, we explain how our index construction methodology for our Future World Index Funds* works and demonstrate how, by embedding responsible investment principles in both the index methodology and the overall fund construction, it can provide a more nuanced approach to sustainability.

Case study: Tyne and Wear Pension Fund**

One such client who began this conversation with us was local government pension fund Tyne and Wear. A long-standing client of ours, Tyne and Wear sought to improve the sustainability of their overall portfolio without sacrificing their return targets. They decided to invest £650m into a new range of LGIM Future World Equity Index Funds, based on their belief that this is the most appropriate way to enhance the Fund's responsible investment credentials while providing members with exposure that should deliver similar performance and risk characteristics to traditional funds.

*Key Risk: the value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.
** Case study is shown for illustrative purposes only.

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More than just exclusions

For many providers, ESG index investment begins and ends with exclusions. Exclusions will always have a place in responsible investment, but we go further than divestment because we are also trying to effect positive social change through our engagement activities and the way we allocate capital. Our multi-faceted, coherent approach to responsible index investment allows us to tilt portfolios through our index construction methodology. Using our proprietary ESG scores, we build our ESG views directly into the index design.

LGIM-designed indices

Our index funds in the Future World range use a bespoke LGIM-designed index to embed our responsible investment views at the beginning of the investment process.

We use our proprietary ESG scores to re-weight a market-cap index, and this re-weighted index then forms the basis of portfolio construction. It allows for greater capital allocation to those stocks with better ESG scores, and tilting away from those with lower scores.

Index-level: LGIM's ESG scores and Future World Protection List

Our proprietary ESG scores combine assessments on environmental, social and governance criteria for over 16,000 companies based on various established metrics, with adjustments made for a company's overall levels of transparency on related issues, to embed ESG credentials in index construction.

Additionally, for our Future World Index Funds, our Future World Protection List is applied at the index construction level. While exclusions are not the defining feature of our approach to index investing, we do operate a broad-based exclusion of companies who fail to meet either globally accepted principles of business, or do not meet LGIM's minimum requirements on the carbon transition. Those on the list are:

- Controversial weapons manufacturers
- 'Pure' coal miners (companies which derive more of their revenues from coal extraction than any other venture)
- Perennial violators of the UN Global Compact

Fund level: LGIM's Climate Impact Pledge and engagement

Our Climate Impact Pledge is also applied at the broader fund level. The Pledge is our in-depth engagement process with companies we deem critical to meeting the aims of the Paris Agreement. Those that we believe are not doing enough to limit climate change are then excluded from our Future World building blocks until they improve their standards. In parallel, LGIM will vote against the re-election of their board chairs across all funds where we hold voting rights.

Our broader voting and engagement activities are also relevant to index investment, as we aim to improve the ESG credentials of the companies in which we invest, including those which often form part of commonly used indices. All of LGIM's funds incorporate our Investment Stewardship team's approach to engaging with companies. The team ensures that the companies in which you are invested are run with your interests in mind. In 2019, we held 739 engagements with companies to raise their ESG standards, and voted against more than 4,000 board directors globally on behalf of our customers and clients.

Investing for the future

After working with us to transition their investment portfolio to suit their financial and ESG objectives, the Tyne and Wear Pension Fund issued the following statement:

> "We believe that this allocation will both deliver better returns for our members over the long term, while also helping to build a world in which they will be able to most enjoy their retirement".
>
> **Councillor Eileen Leask**
> Chair of the Pensions Committee at South Tyneside Council, **which administers the Tyne and Wear Pension Fund.**

At LGIM, creating a better future through responsible investment is a core element of our corporate identity. We are keen to help as many clients as possible create and amend their portfolios to integrate responsible investment considerations. The solution that we reached with the Tyne and Wear Pension Fund was suitable for this particular scheme and its requirements, but we recognise that all schemes have their own specific objectives and situations. By working with each client to understand their aims, we are able to help them achieve their responsible investment objectives.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

LGIM talks

The LGIM blog

Key Risks

Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

Important information