# Index investing: lifting the lid on ESG integration

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In the first of a series of articles on how LGIM integrates ESG criteria into portfolios, we discuss different approaches to responsible investing within index strategies – and look at what the future may have in store for this important field.

Index investing is not passive investing. Yet a conflation of the two concepts sadly persists despite the numerous observable ways in which index investors are not necessarily passive: they proactively allocate in and out of funds, they select strategies that adhere to proactively designed methodologies, and this in turn can reinforce the already proactive use of their voting rights.

It is worth emphasising this distinction between index and passive investing because it helps debunk the myth that index investors cannot be responsible investors. Even setting to one side the role index investors can play as active owners in equities (discussed on page 6), it is clear that they make proactive decisions about what they own. One such proactive decision can be to integrate environmental, social, and governance (ESG) considerations into their index strategies.

Just as investors in the S&P 500 index have historically made the proactive decision, implicitly or explicitly, to exclude Tesla – a stock that has grown larger than the likes of JPMorgan Chase*, Walt Disney*, Walmart*, or Pfizer* – so index investors can reflect ESG criteria.

We believe this can make a genuine difference to portfolios. For example, through their choice of strategy index investors can:

- Eliminate their exposure to businesses that conflict with their own values.
- Reduce the amount of carbon emitted by the companies in their portfolios.
- Allocate more of their capital to firms that have more diverse executive teams or stronger governance.

However, it must be remembered that in index investing, *what* you want to achieve can only be understood in the context of *how* you intend to achieve your desired outcome. Index funds are rules based, and for ESG strategies investors must understand how those rules have been structured.

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## The power of three

There are generally three methods for integrating ESG criteria into an index.

**Exclusion:** Historically, the exclusion approach – or negative screening – has been the most widely used to avoid specific stocks or industries in an index. The most prominent exclusions have tended to be tobacco, alcohol, gambling, fossil fuels, and weapons. The advantages of this type of approach are that it is transparent and tends to give a guaranteed impact and peace of mind if an investor's ultimate objective is to remove exposure to specific securities and sectors.

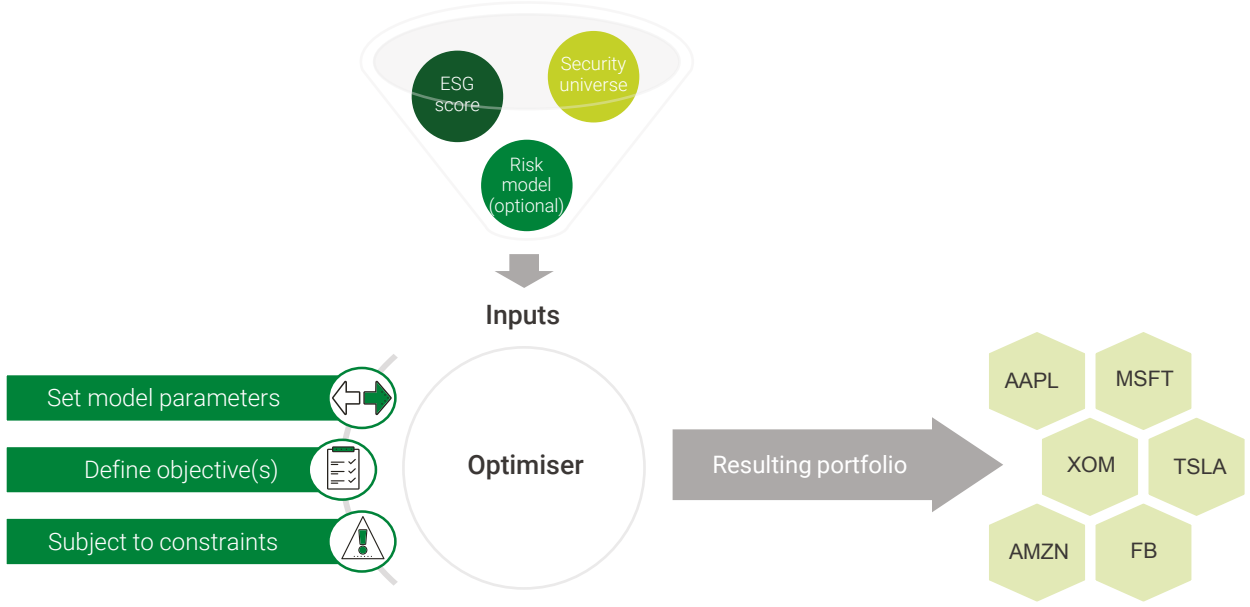
However, this type of integration also tends to alter the profile of the portfolio quite significantly if the sector or issuer excluded has a material weight in the parent index. Consequently, with more exclusions, the index tends to deviate from generating market-like returns and to some extent a market-like risk profile as investors are inevitably taking on tracking error or active risk from the market. Exclusions also remove the possibility of the asset owner engaging with issuers to change their behaviour and hold companies accountable for any sustainability risks.

**Optimisation:** This approach aims to maximise the ESG score or rating of an index. This can be helpful for investors looking to identify companies that are setting the standard in ESG criteria and practices, or companies that have committed to moving toward best practices. Unlike the exclusion approach, optimisation tends to overweight and underweight securities – rather than removing them – to achieve an ESG outcome subject to tracking-error targets or an active-risk budget.

Furthermore, optimisation can also be quite efficient when applied to an index solution that requires meeting multiple objectives simultaneously, such as adhering to Climate Transition and Paris-aligned benchmarks. For example, an index optimised for these objectives may have constraints including:

- a tracking-error target;
- reducing carbon intensity by 50% from inception and by a further 7% every subsequent year;
- specific or general sector deviations of no more than 1% relative to a benchmark.

## Optimisation approach

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However, optimisation methodologies are not always transparent or intuitive (see case study), and if the index is to be optimised frequently to reflect developments in securities then its turnover is likely to increase. This is a particularly important consideration for bond index managers due to the generally higher transaction costs in fixed income than in equities.

**Optimisation in practice**

Consider an index optimised to reduce its carbon intensity. Because this is not an exclusionary strategy, which can simply remove all carbon-intensive sectors, it also has a requirement to keep its expected future tracking error from its parent index below 30 basis points. To reconcile the competing objectives of reducing carbon intensity without incurring a large tracking error from excluding all fossil-fuel stocks, the optimised index actually has to be overweight some energy companies. Optimisation in its basic form can thus create unintended exposures.

**Tilting:** The tilting approach simply allocates more capital to companies with higher ESG scores and less to companies with poor ESG scores. This capital allocation can be based on various techniques such as deciles of ESG scores, whereby the lowest deciles have their index weight downgraded by 80% and the top decile obtains twice the capital allocation of the original weight in the index.

At LGIM, we believe tilting provides a compelling blend of impact, transparency, and market exposure.

## Example: A tilting approach

$$W_{tilt} = (\text{Security Score})^n * W_{MarketCap}$$

In other words... Weight in tilted index = ESG score (adjusted as required by methodology) x market-cap weights

**Microsoft: Score of 1.5**

$$5.58\% = (1.5)^2 * 2.48\%$$

**Up-weight**

Proportionately move capital toward higher scores

**ExxonMobil: Score of 0.5**

$$0.18\% = (0.5)^2 * 0.72\%$$

**Down-weight**

Proportionately move capital away from higher scores


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## On tilt

Nevertheless, we must be aware that tilting can create unintended exposures to investment styles, sectors and countries if the underlying methodology is not robust. In formulating our own tilts, we acknowledge two primary challenges:

- The data informing the ESG score, which is central to the tilting calculation, must be reliable. LGIM's proprietary scores draw on 28 different ESG indicators that we have identified as quantifiable, consistent and available across broad investment universes, with the raw data purchased from four market-leading providers. We score over 16,000 public companies globally, making our universe of coverage among the largest on the market.

- The ESG impact must be balanced against the tracking error an investor is prepared to tolerate. In the illustration above, for example, the ESG score is modified by a factor of two. This multiplier could be increased to yield a greater ESG impact, but this would take the risk profile of the tilted index further away from the starting universe.

Emerging-market equities provide an instructive case study on this point, demonstrating how tilting can preserve broad market exposure while still having a measurable impact on an index's ESG profile.

In many ways, companies in emerging markets lag their peers in developed markets by wide margins across ESG and transparency scores.

### Emerging markets have more room for improvement


Source: LGIM ESG Scores as of 03/2020. Developed Market refers to the universe represented by the FTSE Developed Market Index as of 11/05/2020. Emerging Market refers to the universe represented by the FTSE Emerging Market Index as of 11/05/2020.

## Example: Emerging market equities

Back-tested performance


Source: LGIM, Solactive. Back-tested by Solactive. Return is gross total return per annum, from 02/05/2012 to 18/09/2020 (in USD). Benchmark Index: Solactive GBS EM Index. ESG index: Solactive L&G Emerging Markets Future Core Index. 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. Back-tested past performance is not a guide to the future.

For investors, this shows how an ESG tilt to an index can deliver both a high degree of market exposure and a high ESG impact. Moreover, we believe there are several other advantages to tilting in this way:

- A tilted ESG index can not only reduce the risks facing companies with weak governance or poor environmental credentials, it can also capture more of the opportunity inherent in responsible, sustainable businesses. And unlike exclusionary approaches, tilting can preserve exposure to more companies that are improving their ESG scores and so benefit from their potential re-rating by the market.

- Tilting can create a positive feedback loop, whereby the capital allocation process of investing more in companies with stronger scores incentivises ESG improvements throughout the index, while retaining a stake in weaker companies so we can use our influence as shareholders to demand improvement.

## Integrated example: the feedback loop

Integrating ESG scores with engagement and voting


Source: LGIM

## Looking for the index factor

However, we don't believe tilting represents the end of the ESG story in index investing. We therefore continue to explore new frontiers of ESG integration in index strategies, including:

- **Combining ESG criteria and factor-based investing.** Given the emphasis in factor-based approaches on back-testing, it is important to examine which factors are more cyclical and draw logical conclusions about how ESG considerations may overlap and move through time. For example, we believe a misstep in early ESG integration and factor combination analysis was the conclusion that the value factor was very negatively correlated to ESG scores. This conclusion was drawn during a period of significant oil price weakness (2014-2017), when many energy companies scored poorly on responsible investing metrics because of their high emissions intensity and carbon reserves. As the oil price dropped, energy stocks were sold en masse, becoming prominent in value indices but neglected by ESG investors.

- **Improving not only ESG data, but its use.** There are approximately 300 raw ESG metric indicators used today (e.g. carbon intensity, board diversity, etc.) but often only a subset of these metrics are used for single-company scoring. If we assume scores are based on around 30 indicators that are common across providers, with another five selected on provider preferences, and that ESG themes and 'pillars' are created under the same weighting scheme, there are about 11.5 billion possible scoring combinations for a single company.

- **Becoming a more active owner.** We believe stewardship is an essential component of being a responsible index investor (as discussed in the text box opposite). So as well as maintaining our record as an industry-leading responsible shareholder[1], we will continue to strive to raise market standards through our corporate engagement. For example, in 2020 we announced a new policy whereby we will vote against the chair of a company's nomination committee or the chair of its board if it fails to meet our expectations on ethnic diversity.

- **Monitoring the relationship between ESG integration and performance.** Over the longer term, presuming that there is sustained demand for responsible investment strategies, purely as a matter of financial theory it is possible to argue that any potential outperformance from the latter could dissipate for reasons such as investors neglecting value-relevant information or a higher risk premium becoming attached to securities shunned by ESG approaches. We don't expect a slump in such strategies any time soon – flows into responsible mandates should continue to increase for many more years, while many companies neglected on ESG grounds from fossil fuels to tobacco may be classic value traps rather than value opportunities – but will keep analysing these trends to help clients meet their goals.

### Investment stewardship and index strategies

*Iancu Daramus, Senior Sustainability Analyst, Investment Stewardship*

Further integration of ESG factors into index strategies can be achieved through investment stewardship.

This entails engaging with companies, policymakers, stock exchanges and index providers, on behalf of the end investors in such portfolios, to address company-specific and market-wide risks and opportunities. These range from combating climate change to upholding investor rights.

When companies fail to take sufficient action, investment stewardship teams can then sanction them by exercising the voting rights held by index funds. They can also work with policymakers and index providers to discourage companies from listing on stock exchanges (or becoming included in major indices) without sufficient investor safeguards – such as provisions for equal voting rights, board independence or minimum levels of free float.

As we have detailed in this article, expectations of such ESG safeguards can increasingly be codified into the index construction process itself, to create a positive feedback loop between stewardship and capital allocation. Companies falling short of standards are sanctioned through a vote against and a reduced weighting in the index, whilst companies taking positive steps are rewarded with more capital.

At LGIM, for example, our proprietary ESG scores were developed through a partnership between the Index and Investment Stewardship teams, and we have made them publicly available for thousands of companies who can identify and tackle gaps in their strategies and their disclosures, thereby contributing to better market outcomes.

So while we believe ESG integration is perfectly compatible with index approaches, we urge investors to interrogate the methodologies underpinning any strategies they use. We will do the same to ensure we remain at the forefront of this exciting and important field.

# In 2019, LGIM:

**Engaged** with
**493**
companies

**Voted** on
**50,900**
resolutions*

**Opposed** the election of
more than **4,000**
company directors
globally in 2019*

**Opposed**
**35%**
of pay packages
globally

Co-filed our **1st**
**shareholder resolution**, which led to oil major
BP adopting industry-leading climate targets

Took sanctions
**against** **11**
companies named as laggards
under our Climate Impact Pledge**

**Supported**
**more climate resolutions**
than any of the world's 20 largest
asset managers***

* These votes represent instructions for our main FTSE pooled index funds
** Source: InfluenceMap
*** Source: ShareAction

1. LGIM ranked third out of the world's largest 75 asset managers for stewardship, transparency and governance in Share Actions 'Point of no returns' report in March 2020. This survey analysed the world's 75 largest asset managers on a range of responsible investment themes, including governance, climate change, biodiversity and human and labour rights, as well as ESG products, voting record, and engagement on ESG issues.

# Contact us

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







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