Putting responsibility at the core of ETFs

Through active engagement with the companies in which they invest, and by refraining from holding those that fail to meet the minimum standards of business practice, ETF investors could potentially benefit from something truly different.

What if it were possible for an exchange traded fund (ETF) to offer exposure to an index, yet without holding constituent stocks that are simply uninvestable for responsible investors – while maintaining the same risk-and-return profile as the index in question?

Our research indicates that this is, indeed, possible. And the secular, global trend of investors allocating to index strategies suggests that such products are more necessary now than ever before.

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A new era for ETFs

Assets under management within 'passive' investment strategies are set to swell from $14 trillion worldwide in 2016 to a staggering $37 trillion by 2025, according to PwC.[1] That would be almost half the size of the global economy last year.[2]

We believe much of this growth is likely to come from ETFs, which can provide the building blocks for core allocations as well as exposure to investment themes, such as robotics or commodities, at the same time as allowing investors to control costs.

But, to coin a phrase, with great assets under management comes great responsibilities. We believe it is incumbent upon asset managers to seek to raise the standards of the companies and markets in which they invest – regardless of the investment strategies they oversee – through active engagement.

We also believe that investors should be given the option of index providers refraining from including certain companies, where the minimum global standards of business practice are not being met, within their index-construction processes. This way, end-investors can be shielded from deep environmental, social and governance problems as well as the potential attendant future investment risks.

[1] PwC, Asset & Wealth Management Revolution: Embracing Exponential Change, 2017

[2] According to the World Bank, the value of global GDP in 2017 was $80.7 trillion

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What companies do not make the cut?

There are three types of companies that responsible investors, in our view, should aim to avoid holding:

CONTROVERSIAL WEAPONS MANUFACTURERS

These weapons have an indiscriminate and disproportionate humanitarian impact on civilian populations, the effects of which can be felt long after military conflicts have ended. **They include antipersonnel landmines; cluster munitions; and biological and chemical weapons.**

PERENNIAL VIOLATORS OF THE UN GLOBAL COMPACT

This is a set of standards on human rights, labour, the environment and corruption created to encourage businesses to adopt environmentally and socially responsible policies. **We believe companies that breach such principles present future investment risks, due to lax governance and management of their operations. For more information, please see the appendix.**

'PURE' COAL MINERS

These companies produce significantly high levels of greenhouse gas emissions, contributing to the accelerated warming of the planet. They face regulatory pressure and are imperilled by advances in renewables. **Due to an inability to diversify, we do not see a future for this business model.**

Together, these companies currently make up LGIM's Future World Protection List, which is revised every six months. The methodology is formally reviewed on an annual basis by our industry-leading Corporate Governance team, who take a proactive approach to the changing investment landscape.

We refrain from including the companies on the list in our starting investment universes for our core ETF range and Future World funds, in part by helping to design market indices. At the same time, we are encouraging major index providers to consider taking a similar approach in their own index-construction processes, in order for a similar approach to apply to our other tracker funds and to benefit investors elsewhere.

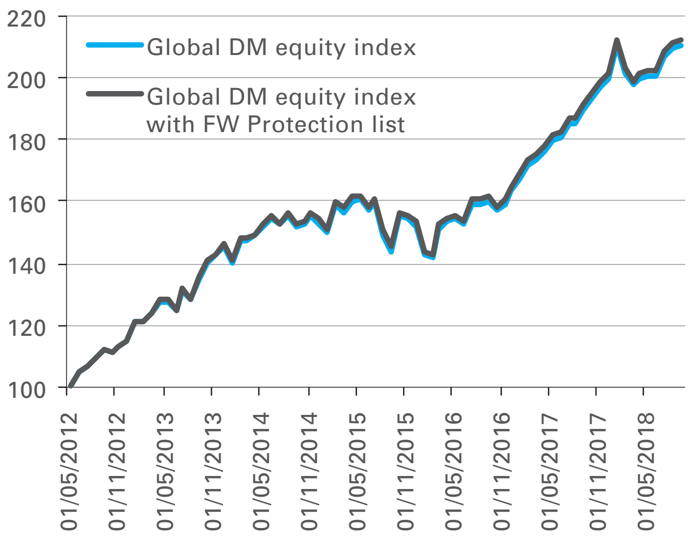
Design matters

There are clear advantages to avoiding these stocks beyond averting exposure to companies that are harming the world in which we live, such as the potential for risk mitigation and even the possibility of stronger returns. But might this approach actually cost investors in terms of the performance and level of volatility they expect to derive from an index?

Our analysis suggests that this should not be the case. Through backtesting, we compared the characteristics of two global, developed-market equity indices, the same in every way except that one incorporated the Future World Protection List, and one did not.

We found that the index in which the list was incorporated displayed almost exactly the same volatility and delivered almost exactly the same performance over the period from June 2012 as its sister index, to which it was also highly correlated.

Figure 1: Moving in lockstep



Source: Bloomberg, LGIM as at 28 September 2018. The figures refer to simulated past performance, which is not a reliable indicator of future performance[3]

	Global DM equity index	Global DM equity index with FW Protection List
5-year annualised return	9.3%	9.4%
5-year annualised standard deviation	9.6%	9.5%
Correlation to Global DM equity index	-	1

None of this means, of course, that these characteristics would remain quite so similar over an extended period of time in the future, especially if a large index constituent were to be placed onto the list. However, this analysis should give comfort to investors that avoiding these companies need not necessarily entail a sacrifice in terms of performance or volatility.

Meanwhile, academic research suggests that corporate engagements can improve investment returns, on average generating outperformance by companies targeted.[4] However, the collection of hard, empirical data on this area remains somewhat in its infancy.

[3] The indices are: Solactive GBS Developed Markets Large & Mid Cap USD and Solactive Core Developed Markets Large & Mid Cap USD Index.

[4] Elroy Dimson, Ouzhan Karaka, Xi Li, Active Ownership, Review of Financial Studies, 2015.

Case Study 1

Tokyo Electric Power Company Holdings Inc

Tokyo Electric Power Company, the Japanese utility that ran the Fukushima Daiichi nuclear plant, is deemed to be a perennial violator of the UNGC. According to a commission formed by Japan's National Diet, TEPCO failed to meet basic safety requirements at the plant, the site of a 2011 disaster. Decommissioning of the site has also been highly problematic. The company still lacks strong environmental or community policies, and has a track record of falsified reporting and untimely disclosure.

Case Study 2

Freeport-McMoRan Inc

Freeport-McMoRan, a US-listed miner, is also deemed to be a perennial violator of the UNGC. Every year, the company dumps tens of millions of tons of mining waste into the Ajkwa River system in Indonesia, prompting a backlash from environmentalists, indigenous groups and human-rights watchdogs. Freeport's reluctance to abandon this practice may pose further reputational risks in the future. In addition, the miner faces the threat of stricter environmental regulations.

Taking stewardship seriously

We believe asset managers can effect real, positive change by engaging with companies and, as such, demonstrate active ownership. This can promote long-term success in such a way to benefit investors – the ultimate providers of capital – and the economy as a whole.

At LGIM, as one of the world's largest asset managers, we take our stewardship responsibilities seriously. This is reflected in the following activity:

- **Company engagement**
- **Exercising our voting rights globally, with one voice across ETFs, active funds and index funds**
- **Addressing systemic risks and opportunities**
- **Seeking to influence regulators and policymakers**
- **Collaborating with other investors and stakeholders**

Investors who own shares in our ETFs are, therefore, able to leverage the scale of our entire book, on some of the most pressing issues of our time – including climate change, workplace diversity and income inequality.

Our Corporate Governance team, which spearheads this activity, operates independently of the business and reports directly to the LGIM board. This structure is designed to ensure that any potential investment conflicts of interest are minimised, and that we always act to achieve the best outcome for our clients.

Our responsibility to investors

For us, responsibility also encompasses how we treat our clients. This means that in addition to focusing on offering value for money, we construct core ETFs to help safeguard investors against potential losses suffered from index events, such as rebalancing, through thoughtful design that seeks to avoid crowds, which we discuss in a separate piece.

Together with the Future World Protection List and our approach to active ownership, this helps us to embed the principles of responsible investing into our core ETFs. We believe that by doing so, we can offer investors in an increasingly crowded market – where the emphasis is frequently on price above all other considerations – something truly different.

Appendix: the UN Global Compact

The UN Global Compact is a voluntary initiative based on commitments to implement universal sustainability principles and to take steps to support UN goals. These principles are generated from the Universal Declaration of Human Rights; the United Nations Convention Against Corruption; the International Labour Organisation's Declaration on Fundamental Principles and Rights at Work; and the Rio Declaration on Environment and Development.

The compact seeks wide participation from a diverse group of businesses – including more than 9,500 companies, based in over 160 countries, representing nearly every size and sector. As a participant, a company:

- **Sets in motion changes to business operations so that the UNGC and its principles become part of strategy, culture and day-to-day operations**
- **Is required to communicate with stakeholders on an annual basis about progress in implementing the compact's principles and efforts to support societal priorities**
- **Is expected to publicly advocate the UNGC and its principles**

A communication on progress issued by participants is a visible expression of their commitment to sustainability; companies that fail to report or to meet the criteria over time may be removed from the initiative.

At LGIM, we believe the compact represents the globally accepted minimum standard for business practice – whether or not a company has publicly endorsed the initiative. We use data to identify companies in breach of the compact's principles, sourced from a well-known and highly respected data provider.

Companies that are in breach of at least one of the principles for a continuous period of three years (36 months) or more will be considered to be persistent violators of the compact and incorporated into the Future World Protection List.

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