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Addressing Stewardship Misconceptions in Passive Investments: Can Indexes Enable Scale Engagement?

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FTSE Russell is a leading global provider of innovative benchmarking, analytics and data solutions for investors worldwide. With over 20 years of sustainable investment (SI) experience, FTSE Russell provides clients with sustainable investment data models, analytics, and indexes covering thousands of companies, and the main sovereign issuers globally.

Our **Sustainable Investment Hub** brings you the latest SI insights and analysis from our researchers and specialists.

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David is responsible for sustainable investment and finance strategy for LSEG working within the Data and Analytics business. He has worked in sustainable investment for over 20 years, with most of that time at LSEG and FTSE Russell.

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Arne Staal is the Group Head of Benchmarks and Indices for the LSEG and CEO of FTSE Russell. Arne was previously the Global Head of Research & Product Management for the Information Services Division of LSEG.

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With experience on both the sell-side and buy-side in a variety of roles, including Head of Product Research & Innovation at BlackRock, European Head of Index Products & Strategy at Barclays Capital, and Head of Quantitative Strategies at Standard Life Investments, Arne has a track record of producing widely recognised thought-leadership and delivering innovative product development. His most recent focus has been on efficient and scalable investment problem-solving through data science and technology. Arne joined LSEG from Aberdeen Standard Investments where he served as Global Head of Macro Systematic Strategies and Macro Risk. Arne started his career at Lehman Brothers in NYC and has lived and worked in both the US and UK for large parts of his career.

COMMENTARY

Addressing Stewardship Misconceptions in Passive Investments: Can Indexes Enable Scale Engagement?

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KEY FINDINGS

- Sustainability and climate indexes offer the potential for efficient and impactful engagement across entire markets. The inclusion or exclusion of particular companies within ESG indexes can drive meaningful investment flows to sustainability leaders and away from laggards.
- Indexes can encourage companies to improve their sustainability performance by clearly and transparently communicating both inclusion and weighting criteria.
- Passive investment is no longer incompatible with corporate engagement and may become one of the most important mechanisms to impel market-wide changes toward a more sustainable world.

ABSTRACT

Passive investing and sustainability engagement were historically deemed at best challenging and at worst incompatible. Now, a growing realization acknowledges that combining index investing and sustainability engagement is not only possible but can reinforce and mobilize significant global assets under management to enable collaborative engagement. By linking engagement to transparent capital reallocation, passive investing has the potential to influence and achieve changes in corporate practices and strategies, which can produce real-world impacts. This article explores the evolution of environmental, social, and governance (ESG) engagement and passive investing and demonstrates that sustainability index design can lead to scalable, efficient, and impactful corporate engagement across entire markets. The use of such indexes to steer investment flows provides clear incentives for companies to improve sustainability performance and deliver the outcomes sought by both asset owners and society at large.

Over the last decade, two important trends in investment management have emerged with important implications for stewardship: The first is the dramatic rise in passive investing, and the second is the increasing adoption and integration of sustainable investment techniques by the global investment community.

Investors are increasingly interested in passive investment vehicles because their management fees are lower compared to those of actively managed alternatives while providing diversification benefits. The trend is particularly clear in the US. By March 2020, passive funds accounted for 41% of the assets held in open-ended mutual funds and exchange-traded funds (ETFs), up from 3% in 1995 and 14% in 2005 (Anadu et al. 2018). In August 2019, assets in US index-tracking equity funds exceeded those in active funds—$4.271 trillion compared to $4.246 trillion (Gittelsohn 2019).

Meanwhile, sustainable investment has (depending on the definitions used) started to become the norm among institutional investors. Signatories to the Principles for Responsible Investment (PRI) now represent around $110 trillion of assets under management worldwide. In the second quarter of 2020, net inflows of $71 billion into funds that explicitly incorporate environmental, social, and governance (ESG) factors pushed their volume of assets under management to more than $1 trillion, according to Morningstar (Meredith 2020). In Europe, ESG funds made up almost one-third of all European fund sales in the second quarter of 2020, attracting 63% more new money than traditional equity funds, according to Morningstar (Riding 2010).

These two trends overlap. Lyxor Asset Management reports that passive ESG funds grew at an average annual rate of 33% in the 5 years running up to June 2019—three times faster than the growth of active ESG funds over the same period (Paquin 2020).

The overlap of these trends is supported by the parallel rise in smart beta, or factor, investing whereby index providers tilt investment portfolios to capture factors such as value, quality, low volatility, momentum, and size. This approach provides investors with investment vehicles that combine the cost-benefits of index-based passive investments with elements of active investment.

APPLICATION OF ACTIVE OWNERSHIP TO PASSIVE INVESTMENT

An important element of responsible investment is active ownership, or stewardship. The PRI's second principle commits signatories to be "active owners and incorporate ESG issues into [their] ownership policies and practices." These practices are generally understood to include voting at company annual general meetings and engaging with company management on sustainability issues of concern.

Active ownership plays a critical role in well-functioning financial markets. It warrants that managers of companies are held accountable by their owners (shareholders) and lenders (debt providers). Active ownership can help ensure that individual companies develop effective governance structures and act responsibly to reduce the risk of environmental pollution, human rights abuses, or executive corruption, for example.

Increasing evidence indicates that engagement can reduce risk and enhance returns. One of the best-known examples is the co-called "CalPERS effort," where the US pensions giant engaged on corporate governance with underperforming companies and registered excess cumulative returns of 13.72 percentage points above the benchmark over 5 years (Wilshire 2013).

Academic researchers Dimson, Karakas, and Li (2015) report similar findings. They analyze more than 2,000 ESG engagement processes in US companies from 1999 to 2009 and find that engagements produced an average abnormal return of 2.3% (adjusted for company size) over the year, following the initial engagement. This figure increases to 7.1% for successful engagements (Dimson, Karakas, and Li 2015).

Perceived Barriers to Aligning Engagement and Passive Investment Together

A strong case supports investors undertaking active ownership of their passive investments. However, combining passive investment and active ownership presents challenges, such as the following perceived issues and potential misconceptions:

- **Inability to divest:** The fundamental issue for passive rules-based investors is that if engagement fails, they lack the ultimate sanction provided by selling shares. Many investors argue that, for engagement to be effective, an investor must be prepared to walk away if a company's management refuses to respond appropriately. Because passive investors invest in all of the constituents of an index, such divestment is not typically an option. To borrow the terminology of the classic economics work by Hirschman (1970), companies are likely to give less weight to engagement from investors who are all "voice" and no "exit."
- **Sheer number of stocks involved:** In contrast to active investors—who often favor concentrated exposure to a small number of companies, backed by in-depth research—passive investors typically own shares in a large number of companies. This approach can make it difficult or impossible for investors to adequately research portfolio holdings and to engage regularly with management. Indeed, the influential Kay review of the functioning of UK equity markets explicitly advocates for active investors to move toward more concentrated portfolios to allow greater involvement in the day-to-day management of those companies (Department for Business, Innovation and Skills 2011).
- **Resources and research:** As a related issue, passive investors are unlikely to be able to justify the resources needed to engage with a large number of portfolio companies. Effectively, engaging with companies usually requires in-depth industry knowledge and a good understanding of internal corporate operations. Similarly, the low fees that passive investment managers can offer make it difficult for them to resource effective engagement programs.
- **Free riding:** The large number of holdings in a typical passive investor's portfolio means that the portfolio is likely to have a very small percentage of each company's shares. The economic benefits of engaging with a company will therefore be limited for each end investor, making it easy to free-ride on engagement by others.
- **Acting-in-concert rules:** The issues of limited resources and the small proportions of companies owned by individuals have encouraged investors to collaborate. However, in certain markets, particularly the US and Japan, some investors believe that acting-in-concert rules—designed to protect the rights of small shareholders—prevent investors from working together to engage with companies.

ESG STEWARDSHIP IN TRADITIONAL PASSIVE INVESTMENT

Many of these challenges can—and indeed should—be overcome by investors. First, clients expect it. In a survey of pension fund use of passive investments, a poll of 127 pension funds in 20 countries, with combined assets of €2.2 trillion (US$2.6 trillion), finds that almost all consider stewardship either "very important" (60%) or "important" (38%). However, the survey also notes that only 19% of funds felt that their passive managers met their stewardship goals to "a large extent" (Rajan 2019).

Second, the inability of passive investors to divest the securities of individual companies makes engagement even more important. Many passive investors are,

effectively, universal owners who own small percentages of most (or all) listed companies across an economy (or, in many cases, across many economies). As a result, passive investors not only are forced to remain invested in companies with poor sustainability track records but also are subject to sustainability externalities that any one company can offload onto society, possibly impacting other investments across the economy. For example, a chemicals company might avoid costs by dumping untreated waste into a river—but a downstream water utility company or brewery would face additional costs to treat the water to the necessary standard. A passive investor will be broadly invested across the economy and thus is likely to be invested in all related entities.

Indeed, this universal ownership incentivizes passive investors to engage in a manner that is ultimately more sustainable, argues the chief executive of Lyxor Asset Management (Paquin 2020). Because they remain invested in stocks while they remain in the index, "voting can be a potent tool in the hands of passive managers, because the act of voting is by nature for them disconnected from that of portfolio management per se." An active investor may be disinclined to vote for a shareholder resolution that imposes costs on an individual portfolio company but would benefit the broader economy whereas it would make sense for a passive investor to do so (Paquin 2020).

Collaborative engagement—regardless of whether participating investors invest actively or passively—can help address several of the other challenges. Investors can pool resources and collectively engage with a greater number of companies than would otherwise be possible. As for acting-in-concert rules, for the EU at least, the European Securities and Markets Authority (ESMA) published a list of issues where investors are permitted to collaborate—including issues around corporate social responsibility (European Securities and Markets Authority 2019).

However, investors can use an additional mechanism: indexes and index providers as engagement tools. By developing indexes with clear and transparent rules on sustainability issues—and by engaging broadly with investee companies so that they understand the index rules and criteria—index providers can do much of the heavy lifting of engagement on behalf of passive index investors. If the indexes have significant assets following them or if a particular prestige is attached to being included, then companies can be highly motivated to improve their sustainability practices to gain inclusion or additional weight in the indexes. This motivation can complement, rather than replace, the type of shareholder engagement carried out by investment managers. In addition, by applying factor or weighting index construction practices to these passive indexes, providers can also reward or penalize companies through index overweighting and underweighting.

CONCLUSION

Through their design, sustainability and climate indexes offer the potential to have an efficient and impactful engagement across entire markets, representing a way to systematize and scale corporate engagement. As capital continues to flow into climate and sustainability indexes, their inclusion or exclusion of particular companies can in turn drive meaningful investment flows into sustainability leaders and away from laggards.

In particular, with increasingly joined-up global investor engagement through initiatives such as the Climate Action 100+ and the Transition Pathway Initiative, a real potential exists to reinforce that corporate engagement with associated indexes. In such indexes, companies can be rewarded (with index inclusion or greater index weights) for improving their climate strategies, so greater investment flows are

generated through positive responses to engagement in passive portfolios following the indexes.

By clearly and transparently communicating both inclusion and weighting criteria, such indexes can encourage companies to improve their sustainability performance. As more investors back indexes that link to and reinforce established corporate engagement initiatives, real-world outcomes can be generated in ways that were unimaginable only a few years ago.

Indeed, such engagement can produce measurable environmental (and social) impact, potentially on a much larger scale than more targeted impact investment strategies can achieve.

Clearly, passive investment is no longer incompatible with corporate engagement. We would go further. Passive investment may become one of the most important mechanisms to drive market-wide changes toward a more sustainable world.

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