Investment perspectives

Alternative indices as a first step on the RI journey

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Alternative indices offer a simple and cost-effective mechanism for many trustees to more directly integrate ESG and climate considerations within their overall strategy design. This might be, for example, from adopting an alternative index as a benchmark or investing in an alternative index tracking product. These indices typically tilt conventional market cap indices to take into account data on carbon emissions, fossil fuel reserves and other ESG metrics. This article looks at how alternative index offerings have developed, along with key challenges and considerations for investors in selecting a suitable approach.

Evolving solutions

Initial RI-tilted approaches applied basic exclusions, removing exposure to certain companies with operations in what may be considered controversial business lines, or applied tilts to reduce exposure away from carbon intensive stocks.

Tilted approaches have become more complex, looking to exploit opportunities associated with a decarbonising economy and the approach being taken by corporate management in that process.

While this evolution has brought about a progressive shift from the use of much improved backward-looking data based on ESG scoring to integrate forward-looking projections of corporate behaviour, there are several key considerations to bear in mind before investing. Is it preferable to specifically manage climate risk (focusing on the 'E' only) or should solutions focus more broadly on Environmental, Social and Governance ('ESG') risks? Are forward looking approaches favoured over backward-looking approaches? These key considerations revolve around a broader question of data quality and availability and are discussed below.

Evolution of solutions

The quality and availability of data

When considering the spectrum of solutions, we observe that they fall broadly into two categories – those that are managing ESG risks more broadly and those focused only on the risks and opportunities arising from climate change. The long-term trend that is expected to emerge, particularly when supported by the policy goals of a low-carbon transition, will inevitably result in winners and losers.

ESG vs climate risk

Investors are demanding better quality data, particularly in relation to climate risk, in order to understand where risks lie within portfolios. While data quality is improving, climate metrics are currently not yet at a stage where they are being consistently reported across all industries, which raises the question of whether climate risk is being fully priced into market valuations.

In comparison, ESG data is even less standardised and significantly more subjective, leading to discrepancies in how different companies measure and report on ESG factors. It is not uncommon to find a low correlation between different ratings provider's ESG scoring for the same stock, due to varying methodologies and priorities being applied to different underlying factors. In addition, scores can be biased towards larger companies, not always because they are better at managing ESG risk but because they have greater resources available to report on ESG activity.

Sectoral context is also an important consideration. Some indices may favour higher scoring stocks within carbon intensive sectors such as oil and gas over medium or low scoring stocks in more sustainable sectors.

Alternative index solutions considerations

- Tilt on ESG vs Climate
- Backward vs forward looking approach
- Divest vs engage
- Red lines to be applied?

Both data sets present challenges. However, increasing demand for better climate data, and its more objective nature, makes it more robust than ESG metrics, and therefore a more favourable starting point for alternative index construction.

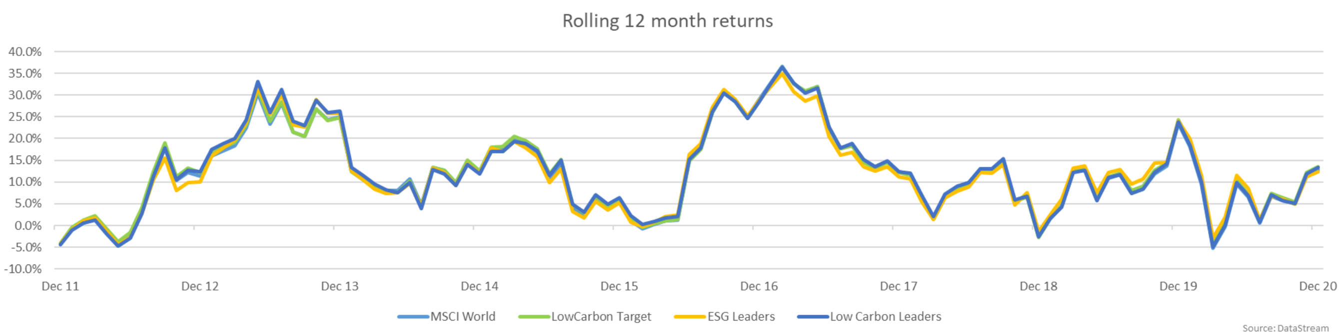
Backward vs forward-looking data

When considering whether a forward-looking or backward-looking approach is preferable, once again, data quality is a key factor. Backward-looking methods use ESG scores and climate metrics to construct tilts based on a company's ability to manage past risks. This type of data has the advantage of being concrete and readily available, however it is a relatively blunt construction tool with the potential to reduce exposure to companies prepared to adapt business models to better manage future risk.

On the other hand, forward-looking approaches will consider how corporate behavioural change may be implemented, what company targets are in place and how likely it is those targets will be met. Subjectivity plays a part in these forward-looking approaches with judgement being applied on how ESG or climate risk may impact a company's future valuation and the expected trajectory of corporate action relative to pre-agreed targets. **This perhaps poses the question as to whether investors would be better reverting to active management where such considerations are directly integrated into investment processes.**

Performance and fiduciary duty

While the track records are mostly short, some indices do have a long enough history to draw a reasonable comparison. Historic performance demonstrates that both ESG and climate risk approaches have not left investors worse off from an outcomes perspective.



	MSCI Low Carbon Target	MSCI W Low Carbon Leaders	MSCI ESG Leaders	MSCI World
1 Year	13.5%	13.3%	12.3%	12.9%
3 Year Annualised	11.1%	11.0%	11.1%	10.8%
5 Year Annualised	14.6%	14.6%	14.4%	14.5%
Volatility (5 Year Annualised)	12.6%	12.6%	12.2%	12.6%

Rolling 12 month returns to 31/12/20

Source: DataStream; Currency: Sterling

One of the key objectives of such approaches is to reduce exposure to left-tail risk. For example, the lack of pricing of carbon emissions which policy change may correct. Well-positioned companies should benefit and there needs to be some scope within the construction of indices for performance to vary. Strategies that "hug" the performance of a parent index may not offer this scope.

Engagement considerations

A key benefit of forward-looking approaches is that these indices can be used as an effective tool for engagement with companies, meaning investors and their managers can more effectively drive change. If a stock is excluded from an index, companies may be more incentivised to improve behaviours over a future time horizon to become an index constituent, or to maintain a certain standard to remain within the index.

Implementation considerations

Over the last year, more pension schemes have looked to explicitly allow for responsible investment within equity benchmarks. The proliferation of products creates a challenge for investors and, to navigate this, they need to be clear on their responsible investment goals.

In selecting a suitable solution, we set out below some principles which can be applied:

1. We believe the case for tilting to manage climate risk specifically is stronger, given the clearly emerging policy ambitions around the world. ESG data and associated solutions are improving but are heavily subjective.

2. While most ESG and climate data reflect point estimates or historic practice, particularly when considering climate tilts, we think there is a need to consider plans to change in the future. Forward-looking approaches aim to incorporate these.

3. While divestment reduces exposure, it does not create change. We prefer strategies that tilt away from less desirable exposures and permit ongoing engagement, but which retain the flexibility to divest where engagement fails over time.

4. The use of limited red lines covering areas such as controversial weapons, thermal coal and persistent breaches of the UN Global Compact is becoming normalised, often reflecting financial concerns. Investors can select funds that apply exclusions without needing to formally adopt those exclusions as their own policy.

5. Stewardship (engaging with underlying companies and the exercising of voting rights where they exist) remains a significant tool for capital value preservation and influencing corporate risk management practices which address climate and/or ESG.

6. Some caution should be applied when investing in less transparent products as the asset manager will have the discretion to go beyond what an index may do, for example, through further application of exclusions.

Summary

The approach that is most appropriate for an investor will depend on their Responsible Investment beliefs and policies, which will in turn inform which risks an investor is most concerned with. Underlying data quality used within the construction of solutions, and the methodology itself, must also be properly understood.

Overall, alternative index investing will reduce climate and/or ESG risk to a varying extent, and some methods will go further than others. We believe these types of solutions act as an initial step towards gaining familiarity with the implementation of a responsible investment strategy, and potentially set-up for further management of climate and/or ESG risks in the future.

Please speak to your Hymans Robertson consultant or contact Caoimhe Bain (caoimhe.bain@hymans.co.uk) to find out more.