Index investors can shape the future

There are multiple ways for 'tracker' funds to help foster better financial and societal outcomes

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Markets depend on information: traders and fund managers compete for the key insights that they believe will give them an edge over their peers. But markets cannot live on information alone.

Over recent decades, people have increasingly recognised economic growth as being dependent upon a complex hierarchy of resources, from a stable environment to a healthy workforce. Indeed, an agenda set by the UN has been built on this view, adopted internationally as the 17 Sustainable Development Goals, which has significant implications for long-term investors. Some pension funds, for example, use this when making decisions for the coming decades. Will the investments of today be resilient in the future? And, more importantly, are these investments financing a world worth retiring in? Both of these questions are pressing; both require comprehensive answers.

The face of traditional investing is changing. Stocks worth hundreds of billions of dollars are still traded daily, but a growing number of investors are turning to index investing. Rather than attempting to beat the market by picking securities that are likely to outperform, index fund managers seek to track the market. In equities, they own shares in every company that form part of an index, such as the S&P 500. This can result in a diversified portfolio, but with lower management costs than funds that are actively managed. As such, index fund managers may be less concerned with the fate of any particular stock, but will probably care about the systemic issues that can affect entire markets.

Automation, digitalisation or climate change are examples of such macroeconomic trends. Carrying both investment risks and opportunities, we do not know with certainty the future winners and losers they will give rise to. But we do know that the impact of these trends is likely to be felt across all sectors. We also know that the timeframes are narrowing: it takes less time for changes in technology, policy and consumer preferences to have a significant effect on markets. We believe index investors should be alert to such shifts.

Diversification can help reduce risk, but only up to a point. Consider that, out of every £1 paid in dividends by the largest 100 UK companies, about 20p comes from just two large energy companies, our research suggests. More broadly, around a third of the world's equity and bond markets are linked to carbon-intensive sectors, such as energy, utilities and mining.[1] As the pressures stemming from climate change intensify, how many of these companies will reinvent their business to survive – or even thrive – in the low-carbon economy?

Collectively, investors may be consistently underestimating the changes that lie ahead. Of course, none of us can predict the future, but this should not be an excuse for inaction. In fact, in a conventional globally diversified equity portfolio, investors could be unknowingly financing global warming of 4°C compared to the pre-industrial period – a world of "unprecedented heat waves, severe drought, and major floods in many regions," according to the World Bank. It goes without saying that portfolio returns are unlikely to be positive when even the road to the ATM might be under water.

Active fund managers may see this as an opportunity to reallocate capital to solutions that are not yet valued properly by the market, enabling them to select investments that are likely to outperform at the same time as benefiting the global economy. But managers in index funds have little scope to change positions. This does not mean they are powerless, though. We outline a few options below.

Tilting

There is more than one way to construct an index. One useful option is 'tilting', which starts from a broad universe of companies and then increases or reduces their index weight according to specific criteria (for example, the management of climate change risks).

Index provider MSCI has found that starting from an alternatively weighted multi-factor index, a tilt in favour of companies that scored better on environmental, social and governance (ESG) criteria, suggested that passive investors could improve the ESG characteristics of their strategies without having a negative impact on their ability to capture market returns efficiently.

This approach can benefit both investors and society. For example, the alternative investment approach of one of Legal and General Investment Managements (LGIM's) funds has lowered exposure to the carbon emissions of its underlying companies equivalent to that produced by 20,000 cars (compared to traditional index investing). Without sacrificing diversification, profits and long-term purpose can be combined, in our view.

Engagement

Traditionally, active fund managers can buy or sell stocks at will. But index fund managers must hold on to stocks for as long as they are part of an index. So they will want all the companies they invest in to do well. This raises the importance of engagement – using one's shareholder rights to hold companies accountable and help shape their business models. We will meet company boards, have a direct dialogue and vote at shareholder meetings to send a consistent message to the companies in which we invest. During 2017, for example, LGIM supported 100% of shareholder resolutions calling for better disclosure on climate change.

Evidence is mounting that this strategy works: a recent study from the London School of Economics found a firm's returns were about 2% higher in the year following an initial engagement and 7% higher following a successful engagement. Moreover, by calling on companies to raise their standards and increase transparency, engagement helps to make markets work more efficiently, to the benefit of everyone. This is why, as a positive-sum game, engagement offers opportunities for collaboration.

Divestment/Reduction in holding weights

Blanket divestment from companies and entire sectors can be a risky strategy, since it results in a more concentrated portfolio. Yet limited exclusion – and the threat of it – can still be a potent tool: research has shown that the targeted exclusion of certain stocks (e.g. the companies with the worst ESG record) need not have significant impact on the tracking error of index funds, or the difference between their returns and those of the index they follow.[2] At LGIM, we have designed index funds, that exclude companies that consistently fail to meet sustainability standards, but with very little impact on overall performance.

These tools at our disposal are not mutually exclusive. In fact, we believe they are best used in combination. We seek to provide index portfolios with the risk/return profiles that are desired by our clients, while aiming to make a positive market impact in a way that protects their future.

To further strengthen this effect, LGIM has implemented the Climate Impact Pledge, a systematic way of analysing and engaging with companies on the topic of climate risk. We work directly with the companies in which we invest, communicating clearly our expectations for governance and disclosure in relation to the energy transition. Most importantly, we support companies over time to improve their resilience and performance. A failed engagement can ultimately lead to divestment, where stocks can be excluded within a tightly controlled tracking error margin in designated funds. As a result, the impact on returns is expected to be minimal, while the message to the companies is magnified. Our commitment to disclose publicly the methodology and final divestment candidates means there is a tangible incentive to respond to engagement, thereby improving the market practice overall.

At LGIM, we offer index investors the opportunity for exposure to entire markets, while seeking to lower the chance of 'nasty surprises' in their holdings. In addition to helping lead to better financial outcomes, we believe this approach can also make a positive contribution towards societal goals. ■

1 www.bankofengland.co.uk/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability

2 Tim Verheyden, Robert G. Eccles, Andreas Feiner (2015) – ESG for All? The Impact of ESG Screening on Return, Risk, and Diversification

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