Insights

Smart Sustainability: Examining regional appeal

FTSE Russell

Assessing the differences

There is rising interest in investment strategies with an environmental, social and governance ('ESG') focus. At the same time, asset owners are allocating steadily higher portfolio weightings to non-market-capitalization ('smart beta') index-based strategies.

Unsurprisingly, therefore, investors tell us that they are interested in combining ESG with smart beta, a practice we've named Smart Sustainability

But there are marked regional differences in ESG adoption. European asset owners have much higher rates of ESG implementation than their North America counterparts. Why do these regional differences exist? What are investors' motivations for applying ESG considerations, and which ESG issues are they considering when combining smart beta and ESG? How much demand will there be for this type of combined portfolio approach?

In this FTSE Russell Insight we address these questions, drawing upon our analysis of asset owners' responses to our latest (2019) annual smart beta survey.

The growth in ESG investing

There are two principal reasons for the growth of interest in ESG among asset owners.

First, there is a growing recognition amongst investors that ESG-related issues can have a material impact on investment performance. Second, the fiduciaries of large pools of capital—including endowments, insurance companies, pension schemes and sovereign wealth funds—increasingly consider ESG as an integral part of their investment decision-making process.

The Global Sustainable Investment Alliance (GSIA) has identified almost US$31T of assets worldwide that now incorporate some form of sustainable investment approach.[1] However, it is important to note that the sophistication of these approaches will be highly variable, and a large proportion will be relatively simple implementation such as exclusion of specific companies or industries.

[1] The GSIA publishes its Global Sustainable Investment Review every two years. The data referenced here is from its most recent review in 2018. All reports can be found on its website at: http://www.gsi-alliance.org.

*Smart Sustainability is the combination of sustainability parameters and smart beta risk premia—for example, via factor exposure—within a single index solution.

By region, the total AUM represents between an 18 percent and a 63 percent share of total managed assets (see the table).

Sustainable investment assets by global region

Region	Sustainable Assets as % Total Managed Assets
Europe	48.8%
United States	25.7%
Canada	50.6%
Australia/New Zealand	63.2%
Japan	18.3%

Source: GSIA 2018 Investment Review

Nevertheless, many asset owners are still at an early stage of considering how to capture ESG issues within their investment processes. The diversity of terminology and the range of implementation approaches—including screening, integration and engagement—mean that market practices can vary widely.

Similarly, ESG index construction methods are quite varied. They include negative and positive screening methodologies, thematic/factor weighting and impact approaches.

Negative screening means the exclusion of certain companies (or sectors) from the index due to their underlying business activities. Positive screening typically means selecting index constituents which have favorable ESG characteristics, for example through ESG Ratings. Thematic approaches emphasize one or more factors, such as energy efficiency or climate change, in the index construction process. And impact indexes target specific social, governance or environmental objectives. Implementation can be through re-weighting/tilting portfolios as well as security selection.

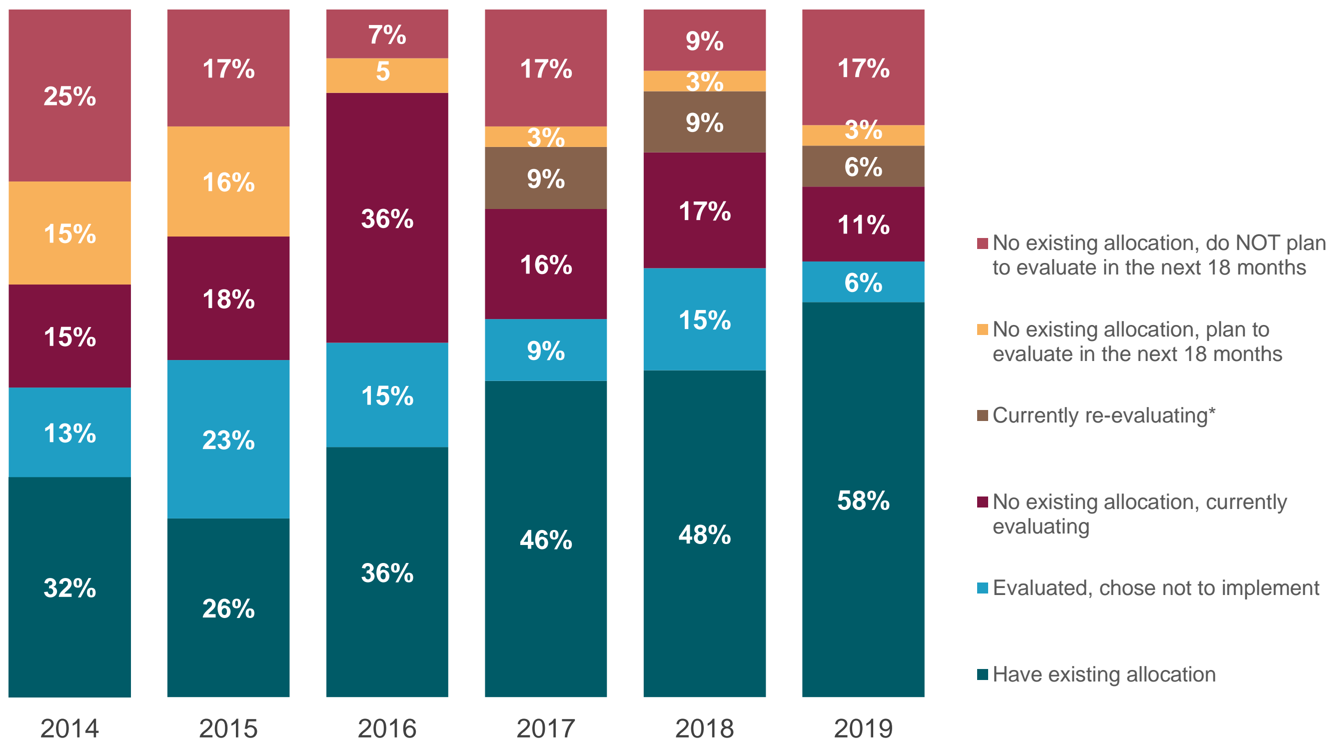
The growth in smart beta investing

FTSE Russell defines smart beta as any index-based investment strategy where constituents' index weights are determined by measures other than their market capitalization.

This broad category includes fundamentally weighted, equal-weighted, factor-weighted, optimized and other index-like approaches. Worldwide, nearly three-quarters of institutional investors and asset owners are now either using or evaluating smart beta for their portfolios.[2]

According to the 2019 FTSE Russell smart beta survey[3], which included responses from 178 asset owners with combined assets under management of over $5T, 78 percent of survey respondents have implemented, are currently evaluating, or plan to evaluate smart beta strategies. Smart beta allocation levels have risen steadily since FTSE Russell started its survey in 2014.

"Which best describes your organization's usage of smart beta strategies?"



* Currently re-evaluating not included in 2014-2016.

Source: FTSE Russell. Smart beta: 2019 global survey findings from asset owners

Asset owners said that risk reduction, return enhancement and improved diversification remain the top three motives for allocations to smart beta. Cost savings were also cited by nearly a third of respondents.

[2] https://www.ftserussell.com/files/research/anatomy-smart-beta

[3] Smart Beta 2019 Global Survey Findings from Asset Owners

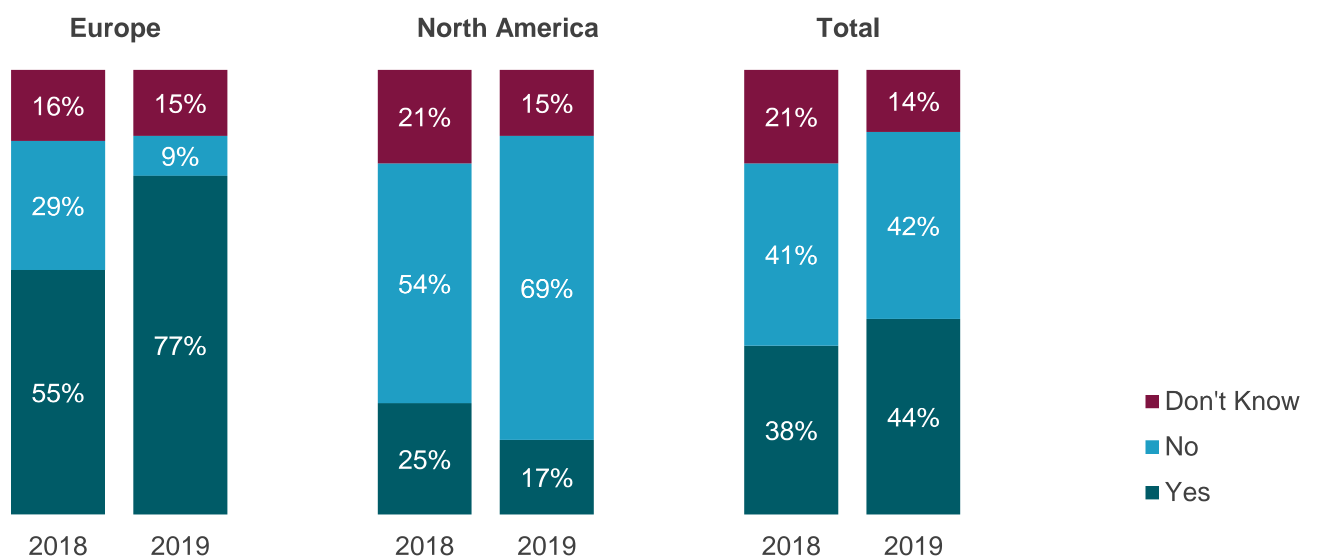
Combining ESG and smart beta; “Smart Sustainability”

Over the past three years, our annual smart beta survey has included questions about applying ESG considerations to smart beta strategies. Among those respondents who are using or evaluating smart beta, 44 percent (worldwide) said they anticipate applying ESG considerations to their smart beta strategy.

However, there were pronounced regional differences in the responses, most notably between respondents based in Europe and North America.

Seventy-seven percent of European survey respondents with an existing or possible future smart beta allocation said they might incorporate ESG considerations. However, only 17 percent of North American survey respondents with an existing or possible future smart beta allocation gave the same response.

Do you anticipate applying ESG considerations to a smart beta strategy?



Segment = Have a smart beta allocation or are currently evaluating/re-evaluating smart beta strategies or are planning to evaluate smart beta strategies in the next 18 months. Sample size for Asia Pacific and Other regions not large enough to break out, and respondents from these regions are included in total.

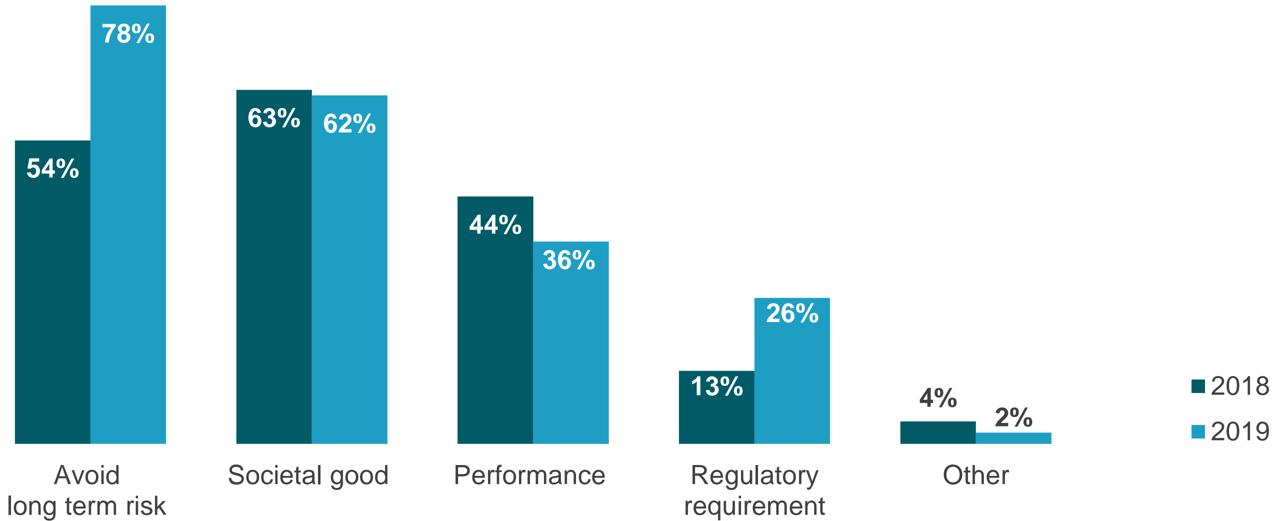
For survey respondents who said they were considering the addition of ESG to a smart beta strategy, the most commonly cited reason for doing so was to avoid long-term risk. Promoting societal good and, to a lesser extent, performance considerations or regulatory requirements were also cited as reasons for applying ESG.

Compared to 2018, there has been a big jump in the percentage of respondents citing the avoidance of long-term risk as a motivation for adding ESG to smart beta. This chimes with rapidly increasing public concern about climate change, pollution and sustainability.

Financial risks around climate change in particular have been rising up the regulatory agenda. Mark Carney, Governor of the Bank of England, has been taking a particular lead setting out that central banks and prudential supervisors must find ways of testing the resilience of the financial system to stresses caused

by climate change. The Financial Stability Board (FSB) has also stepped in and created a Task-force on Climate-Related Financial Disclosure that issued a report 18 month ago. This is reflected in public sentiment. Last year witnessed spontaneous grass-roots action against perceived inconsistencies in government policies on climate change and ecological damage: for example, the Extinction Rebellion protests, which took place in a number of cities worldwide in spring 2019.

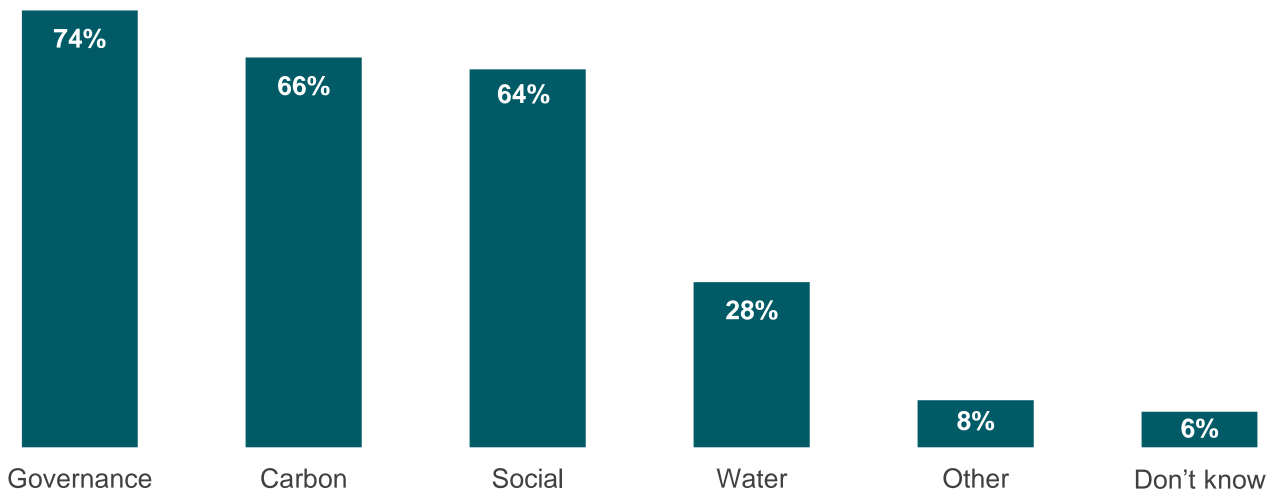
What is your motivation for applying ESG considerations?



Multi-pick. Segment = Anticipate applying ESG considerations to a smart beta strategy.

In turn, the same cohort of survey respondents cited governance, carbon and social issues as the top three ESG issues they wished to address in a combined smart beta/ESG allocation.

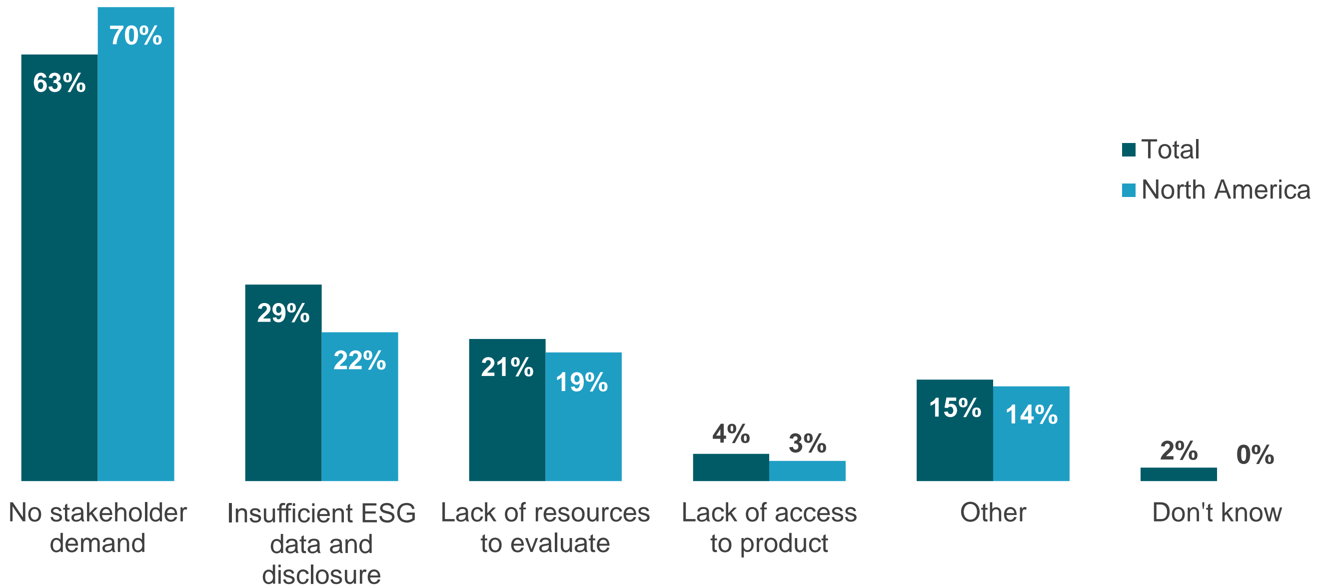
What ESG issues are you considering using in a smart beta and ESG allocation?



Multi-pick. Segment = Anticipate applying ESG considerations to a smart beta strategy.

But what about the survey respondents, including over four-fifths of those based in North America, who said they had no plans to integrate smart beta and ESG? For this group of asset owners, by far the most commonly cited reason was a lack of stakeholder demand. If pressure to promote sustainable investment policies is heightened in some markets, in others it appears relatively absent.

Why don't you anticipate applying ESG considerations to a smart beta strategy?



Multi-pick. Segment = Do not anticipate applying ESG considerations to a smart beta strategy.

What's causing the regional differences?

What is causing the lack of stakeholder demand for ESG/smart beta combinations in North America, compared with Europe?

Part of the reason may be the still common belief that ESG issues should be considered separately from traditional risk/return measures in the assessment of portfolio performance. In other words, those responsible for the investment strategy of pension plans in North America may be concerned about fiduciary liability if they allow ESG criteria to influence their return-seeking approach.

Such thinking is likely to be heavily influenced by the local regulatory environment. As an example, in April 2018 the US Department of Labor (DOL) addressed the use of ESG factors by US pension plans and emphasized the importance of prudent decision-making and of not sacrificing investment returns.

In Europe, by contrast the rationale is often entirely reversed to this; that given the growing expectation of the financial impact of sustainability issues, such as climate change, that fiduciary investors therefore have a duty to consider these issues. An example is the UK Department for Work and Pensions now mandates trustees of both defined benefit (DB) and defined contribution (DC) plans to state their policy on taking account of "financially material" considerations, including ESG factors, such as climate change.[4] Outside of the US, integrating climate change and sustainability considerations in investment decision-making processes is a rapidly growing trend, both as a result of top-down policymaking and in response to bottom-up investor demand.

In France, Article 173 of the law on Energy Transition requires a wide range of investors to report on how they integrate environmental, social and governance (ESG) factors into their investment policies and on how they are incorporating climate change considerations.

And a recent survey of members of a large Dutch pension plan found that 68 percent of participants wanted to invest their pension savings in a sustainable manner, even if this decision came at the expense of lower prospective returns.[5]

There may also be broader socio-economic factors at play, including pressure in some markets to produce consistently rising profits. In a study of 615 US large- and mid-cap publicly listed companies published in 2017[6], McKinsey found evidence that pressure on senior executives to deliver strong short-term results had increased in the previous five years and, as a result, many executives believed their companies were using excessively short time horizons in their strategic planning.

However, such a short-term approach may hinder long-term performance: McKinsey also found that companies that it classified as long-term strategic planners outperformed their shorter-term peers on a range of key economic and financial metrics, including revenues, investment, earnings volatility and job creation.

Canada

It is interesting to note that Canadian respondents are diverging from their North American neighbors, with 83% implementing ESG considerations into their broader portfolios, while 43% plan to apply ESG considerations to smart beta.

[4] https://www.ftadviser.com/pensions/2018/09/11/pension-schemes-mandated-to-disclose-esg-risks/

[5] "Get Real! Individuals Prefer More Sustainable Investments": Rob Bauer, Tobias Ruof, Paul Smeets, February 2019.

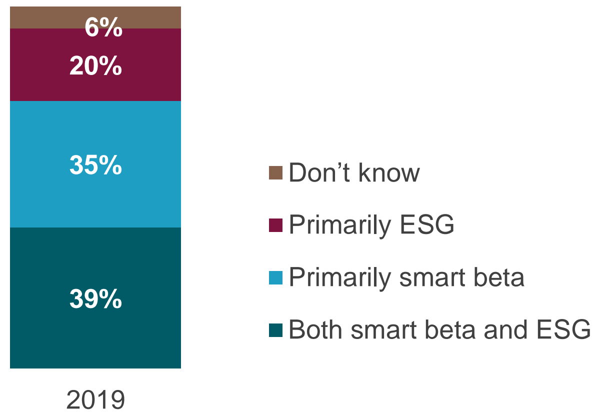
[6] McKinsey Global Institute, "Measuring the economic impact of short-termism," February 2017.

The outlook for Smart Sustainability is strong

Survey respondents told FTSE Russell that their interest in combining ESG with smart beta was seldom driven by ESG considerations alone: only 20 percent of asset owners gave this as their reason for investigating combined ESG/smart beta investment strategies.

Instead, around three-quarters of respondents said that their interest was driven primarily by smart beta, or by both smart beta and ESG.

Was your interest in smart beta and ESG motivated primarily by smart beta, primarily by ESG or both?

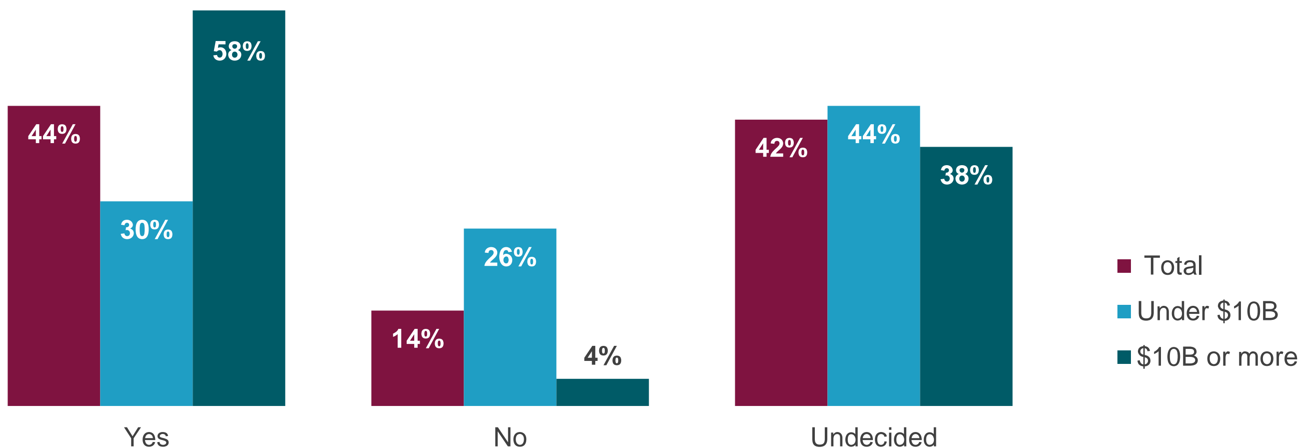


Segment = Anticipate applying ESG considerations to a smart beta strategy.

In aggregate, the demand for Smart Sustainability is strong: nearly half of those who anticipate applying ESG considerations to a smart beta strategy expect to increase their allocation to smart beta ESG, while 42 percent are undecided.

And demand is strongest among the largest asset owners. For those survey respondents with assets under management in excess of $10B, 58 percent expect to increase their allocation to smart beta and ESG during the next year or two.

Do you expect to increase your allocation to smart beta ESG over the next one to two years?



Segment = Anticipate applying ESG considerations to a smart beta strategy.

Summary

Among existing or prospective users of smart beta, there are pronounced regional differences in adopting ESG. Europe leads the way in applying ESG considerations to smart beta: over three-quarters of European asset owners evaluating or using smart beta expect to apply ESG considerations to smart beta. In contrast, only 17% of North American asset owners do.

The reduced interest in combining smart beta and ESG in North America according to the survey results is due to lack of stakeholder demand, which may reflect the impact of recent local regulatory guidance, linked to political differences with other global regions.

However, the demand for ESG/smart beta combination strategies worldwide is strong: nearly half of those who anticipate applying ESG considerations to a smart beta strategy expect to increase their allocation to smart beta ESG, while 42 percent are undecided. Among the larger asset owners who anticipate applying ESG considerations to a smart beta strategy, 58% globally expect to increase their allocation to smart beta ESG. The survey suggests that through a desire to reduce investment risks to issues like climate change, we will continue to see growth in ESG integration into smart beta.

Get your copy of the 2019 Global Smart Beta survey of Asset Owners and the special Smart Sustainability supplement.

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