Principles for Responsible Investment

HOW CAN A PASSIVE INVESTOR BE A RESPONSIBLE INVESTOR?

A PRI DISCUSSION PAPER

UNEP FINANCE INITIATIVE | United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1 We will incorporate ESG issues into investment analysis and decision-making processes.

2 We will be active owners and incorporate ESG issues into our ownership policies and practices.

3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4 We will promote acceptance and implementation of the Principles within the investment industry.

5 We will work together to enhance our effectiveness in implementing the Principles.

6 We will each report on our activities and progress towards implementing the Principles.

PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

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EXECUTIVE SUMMARY

Passive funds and responsible investment have been two of the key themes in asset management over the last 10 years.

The growth in passive funds has been driven by a combination of factors related to costs, evidence on the relative benefits of active versus passive investing, and new financial products such as exchange-traded funds. Increasing evidence of correlation between the ESG incorporation and enhanced risk-adjusted returns, a desire to reflect investor values in investment strategies and increasing availability of ESG data have encouraged the growing interest in responsible investment.

These trends have come together to drive a proliferation of ESG indexes and the growth in assets managed using passive ESG strategies. As with any developing market, the growth of ESG in passive investing has faced and is facing challenges.

This discussion paper looks to identify some of the issues associated with the development of this market and, as part of a consultation process, to gather feedback and ideas from signatories and other stakeholders for further guidance from the PRI on the incorporation of ESG issues in passive rule-based investments (see page 18).

As an introduction to the subject, this paper includes an overview of the ESG and passive market landscape, before discussing some key challenges associated with ESG in passive investments, specifically looking at:

1. ESG incorporation – PRI Principle 1
Issues include availability and consistency of corporate data, consistency of ESG scores, complexity and transparency of benchmarks and indices, unintended portfolio skews and costs.

2. Active ownership – PRI Principle 2
Issues include free-riding, familiarity with holdings, resourcing, contribution to overall portfolio performance, divestment, proxy voting regulations, stock lending and acting in concert.

DISCUSSION POINTS
This paper does not outline a PRI view or represents the views of our signatories but will be the first step in the process of collating a range of views to develop further guidance for asset owners, asset managers and other service providers. The PRI is looking to gather signatory feedback on 12 questions, covering four topics:

- Market overview;
- Identifying the challenges;
- Creating solutions; and
- Active ownership

The responses to these questions will help the PRI develop further guidance on the development of ESG factors into passive rule-based investments. We look forward to input from signatories and other interested parties, and we welcome feedback and queries to passiveinvestments@unpri.org.

ABOUT THIS PAPER

This discussion paper provides an overview of the market for passive strategies that incorporate environmental, social and governance (ESG) factors and outlines challenges in the integration of ESG into passive funds. The objective of the paper is to gather feedback and ideas from PRI signatories and other interested stakeholders with a view to producing further guidance on the incorporation of ESG issues in passive rule-based investments.

The PRI has already published research and case studies focusing on the integration of ESG into passive, quantitative and smart-beta strategies however we are interested in developing market thinking in this area due to its rapid development over the last couple of years and the increasing importance of passive strategies. The PRI has received significant interest from our signatories on this topic.

ESG integration in passive strategies

ESG integration in quantitative strategies

ESG integration in smart beta strategies

The paper is designed to be accessible to a range of audiences and does not specifically target ESG index specialists. It therefore provides an initial overview of the ESG and passive market landscape.

The paper is being made available for consultation alongside a set of accompanying questions (page 18). This consultation process will involve the publication of this discussion paper and accompanying questions on the PRI's Collaboration Platform (open to all signatories), two planned consultation events in New York (July) and Paris (September), and will conclude at the end of October 2019. After the collation of feedback, the PRI will publish a short paper summarising the conclusions and key points arising from the consultation process. Any queries relating to this process should be directed to passiveinvestments@unpri.org.

THE GROWTH OF RESPONSIBLE INVESTMENT IN PASSIVE STRATEGIES

KEY POINTS

- There has been significant growth in assets allocated to both passive and ESG strategies over the last ten years.
- Growth in passive funds has been driven by a combination of factors related to costs, evidence of the relative benefits of active versus passive management, and new financial products such as exchange-traded funds.
- Rising interest in responsible investment strategies has been driven by increasing evidence of the correlation between the incorporation of ESG factors and enhanced risk-adjusted returns, a desire to reflect investor values in investment strategies, and increasing availability of ESG data.
- ESG passive strategies often use benchmarks offered by the major index providers, which are supported by ESG data providers.

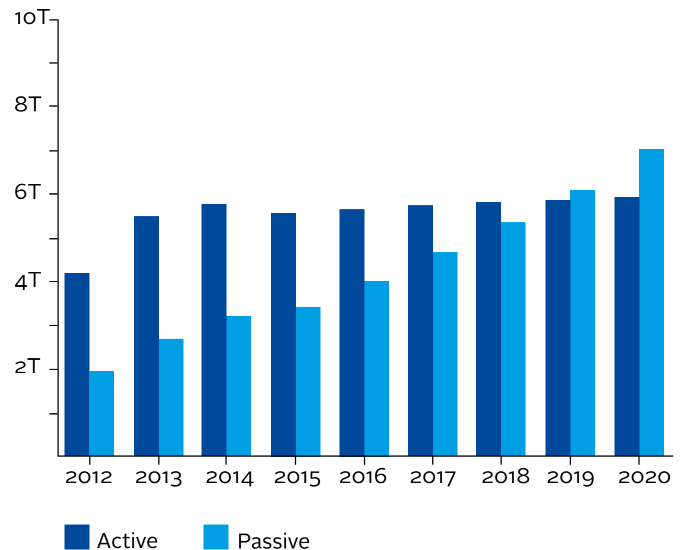
GROWTH OF PASSIVE INVESTMENT

In this paper, we define passive investing as a rules-based investment approach that does not involve discretionary investment decisions.[1] Early passive investment strategies used equity indexes weighted by market capitalisation, but market cap is just one set of rules that investors can choose to create a passive investment portfolio.

To simplify this discussion, we have focused on equity indexes, but many of the arguments and discussion points are valid across other asset classes.

The chart to the right reflect the rapid growth in assets under management (AUM) in passive equity funds. There is now believed to be a greater volume of assets following passive strategies than there is in active funds.[2] The AUM in passive strategies is also often under-estimated, as it frequently does not include segregated investment mandates. In the US, the value of passive investment assets in mutual funds and exchange-traded funds (ETFs) has increased from US$220bn twenty years ago to US$7trn today[3], now accounting for 45% of the total market capitalisation of the S&P 500.[4] This growth has also been seen in fixed income products, with over 25% of assets managed in global corporate fixed income funds following passive strategies.

Figure 1: AUM growth, passive vs active products
Source: Bloomberg[5]



1 The implications of passive investing for securities markets, Vladyslav Sushko and Grant Turner, 11 March 2018, Bank of International Settlements Quarterly Review.

2 The Shift from Active to Passive Funds Put Asset Managers On Sale, But Be Selective and Patient, 25 April 2019, Seekingalpha.com.

3 The Shift from Active to Passive Investing: Potential Risks to Financial Stability?, Patrick McCabe, 29 November, 2018, Harvard Law School Forum on Corporate Governance and Financial Regulation.

4 Passive investing automatically-tracking indexes now control nearly half the US stock market, Jeff Cox, 19 March 2019, CNBC.

5 Next Year Could Be the Last Time Stock Pickers Rule Investing, Alan Mirabella and Brandon Kochkodin, Bloomberg News, accessed July 2019.

Table 1: Examples of investable equity indexes[6]

INDEX TYPE	DETERMINANTS
Market cap-weighted	Securities are weighted according to their free float-adjusted market capitalisation.
Capped indexes	A maximum limit or "cap" is set on the weight of individual constituents, with the aim of reducing excessive concentration.
Fundamentally-weighted	Specific financial accounting metrics such as profitability, book value or cash flow are used to weight constituents.
Equally-weighted	Each constituent in the index has the same weighting.
Volatility	Constituents are weighted to achieve the lowest volatility of returns. These indexes try to reduce the occurrence of outlier returns.
Stability	These indexes include securities which have a higher (or lower) sensitivity to economic or credit cycles, or to market volatility.

INDEXES – THE BASIS FOR PASSIVE PRODUCTS

For investors, indexes fulfil three roles: as benchmarks to gauge the performance of a specific capital market; to measure the relative performance of investment products; or for the construction of specific, low-cost financial products.

1. Performance benchmarking: Indexes can be used to evaluate active managers and measure relative portfolio risks. By comparing managers' performance and portfolios to a comparable benchmark index, investors can better understand the extent to which managers add value relative to a selected index. The deviation (tracking error) from a benchmark index can serve as a risk measure. Active managers can also set or target specific returns relative to indexes over set time periods.

2. Passive management: Indexes can be used as frameworks to implement passive strategies in segregated or pooled portfolios. Investors use passively managed products for asset allocation, portfolio diversification and to enable replication of an index. Indexes have been used to develop a range of associated low-cost financial products, such as ETFs. They differ from active investments, where assets are selected on a discretionary basis.

3. Reducing costs: One of the key attractions of financial products or strategies (such as ETFs) that track specific indexes are their lower annual management costs when compared with active funds. This is largely due to lower overhead costs from research, trading and administration.

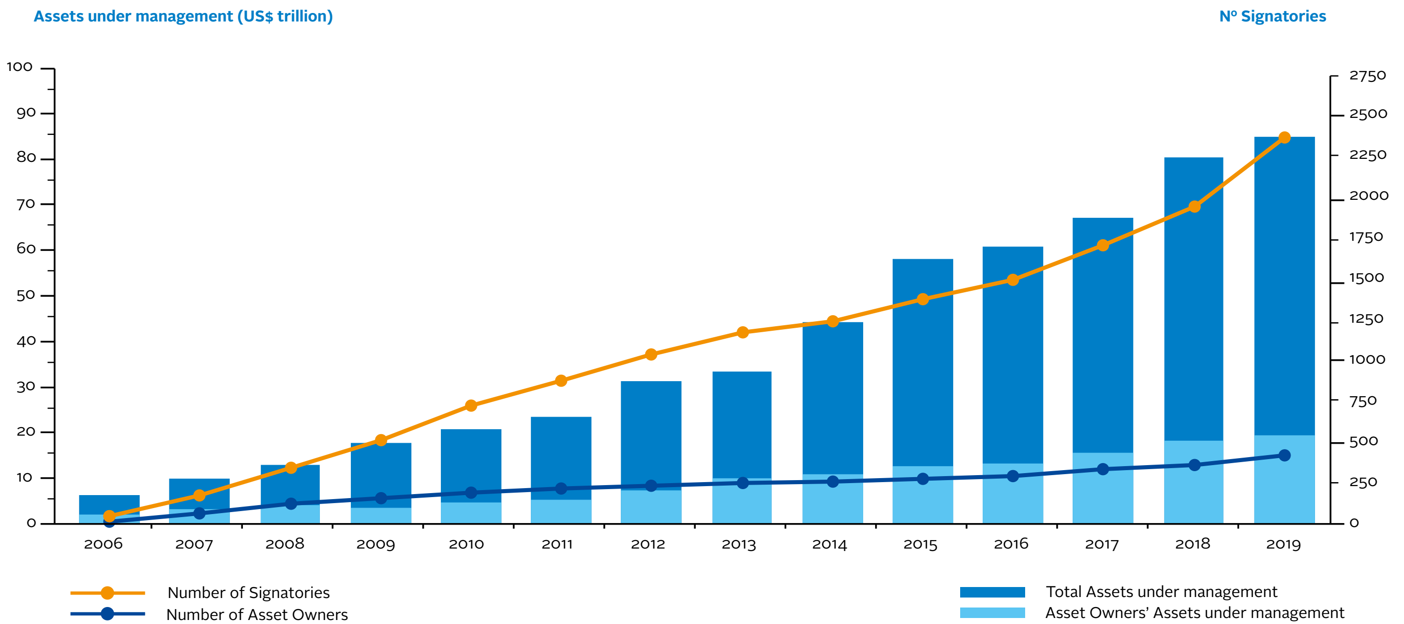
6 Equities index tracking, Legal & General Investment Management, accessed May 2019.

GROWTH OF ESG FACTORS IN PASSIVE INVESTMENT

As passive investing has grown rapidly over the last 10 years, so has interest among asset owners and asset managers in the incorporation of ESG factors into active and passive investment strategies. This has resulted in significant AUM growth in ESG passive strategies[7]. For example, Morningstar reports that AUM in open ended ESG passive funds has increased from approximately $20bn AUM in 2008 to in excess of $100bn AUM in 2018 with this growth mainly been driven by European investors.

This increasing interest in responsible investment is also evidenced by the growth in PRI signatories (Figure 2).

Figure 2: Growth in PRI signatories by number and AUM. Source: PRI
AUM and growth. In March 2019, there were 2372 PRI signatories, including 2092 investors representing US$86.3 trn, a 6% growth against 2018.

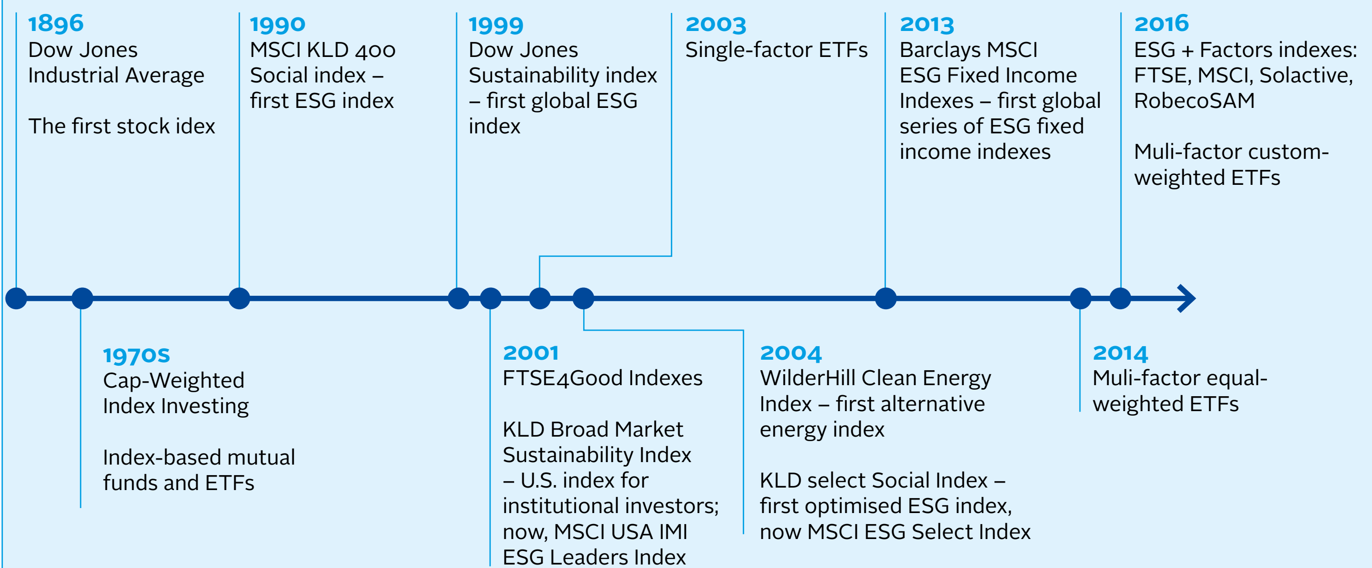


7 Global Pension Dialogue: ESG Trends for Asset Owners, Michael Jantzi, Sustainalytics, accessed July 2019.

HISTORY OF ESG INDEXES

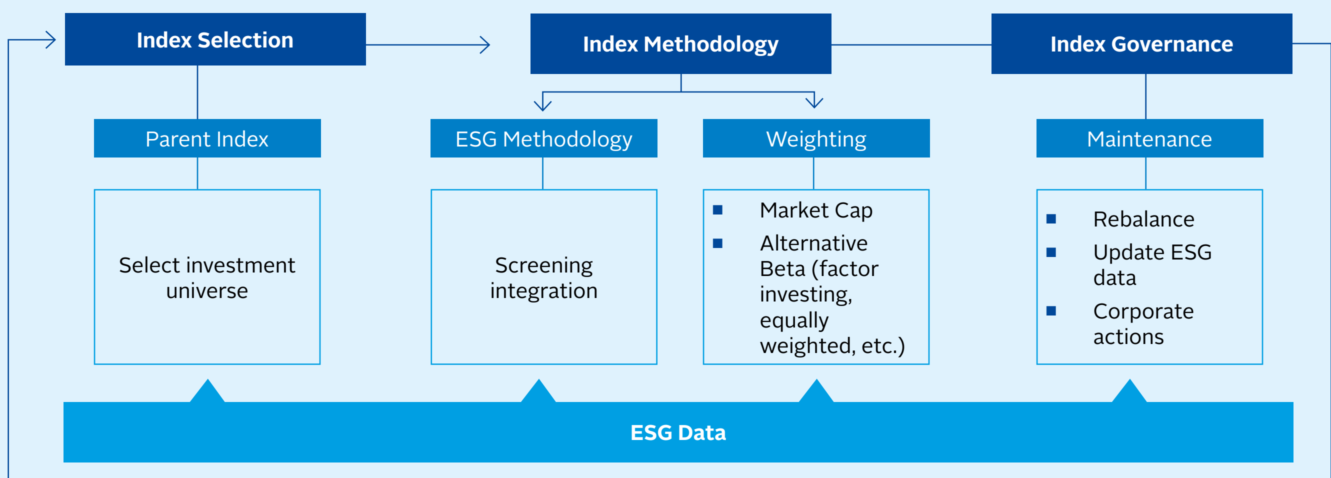
The first ESG index, the Domini 400 Social Index (now the MSCI KLD 400 Social Index), was launched by KLD Research & Analytics in the United States in 1990. The NPI Social Index was launched in the UK in 1998, while the next year saw the first big index provider enter the market, with the Dow Jones Sustainability Group Indexes in 1999, followed by FTSE4Good in 2001. Today, there are over 1,000 ESG indexes, reflecting growing demand from institutional and retail investors for ESG products and passive investing.

Figure 3: Passive and ESG timeline – 1896 to present. Source: PRI



Unlike established market cap-weighted indexes, ESG indexes use different information sources to reflect a set of values or ethical positions, or to try to capture a perceived informational advantage. Some ESG indexes seek both goals. ESG indexes are generally based around a parent index, which acts as the initial universe of equities or assets. A set of rules is then applied to decide the constituents of the ESG index, and to enable ongoing maintenance and rebalancing.

Figure 4: Typical ESG index is constructed. Source: PRI



The combination of ESG and passive themes has been driven by four main factors:

1. **Enhancing returns:** a growing body of academic and industry research[8] provides strengthening evidence that incorporating ESG factors into passive investment strategies can enhance long-term returns (see Appendix 1).
2. **Reflecting values:** Certain categories of investor have sought to reflect a set of values or beliefs in the investment process and passive indexes can provide a cost effective means to do so (see Appendix 2). 'Millennial' savers in particular have also increased client demand for values-based approaches.[9]
3. **Data availability:** Specialist ESG data on listed equities has been available since the 1990s. However, this was largely limited to large-cap equities in developed markets and had significant quality and availability issues.[10] Increasing availability, has enabled index providers to develop ESG indexes.
4. **Cost:** As with the overall growth in AUM in passive strategies, lower costs have encouraged inflows into ESG passive strategies. According to a study from Morningstar, passive ESG funds are on average one-third the cost of active alternatives.[11]

8 Sustainability: The future of investing, Blackrock investment institute, February 2019

9 From 'why' to 'why not': Sustainable investing as the new normal, Sara Bernow, Bryce Klempner and Clarisse Magnin, October 2017, McKinsey & Company.

10 Gunnar Friede, Timo Busch and Alexander Bassen, December 2015. ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies. Journal of Sustainable Finance & Investment, Volume 5 Issue 4.

11 "Behind the numbers: How passive ESG funds really fare against their active rivals", Hortense Bioy, 9 October 2018, *Money Marketing*.

COMMON APPROACHES TO INCLUDING ESG FACTORS IN PASSIVE STRATEGIES

There is a wide range of different approaches used by asset managers and index providers to incorporate ESG factors into passive investment strategies and benchmarks. These approaches broadly fall into three categories:
1. screening and thematic approaches allow indexes to reflect and incorporate investors' values, strategies and beliefs, 2. integration of new information aims to improve index returns, while 3. engagement and voting can be used to drive the behaviour of index constituents. These approaches are not mutually exclusive and are often used in combination.

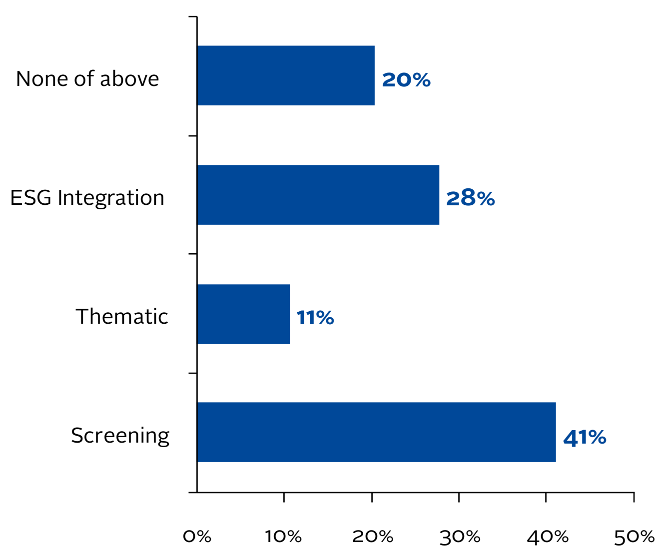
Table 2: Approaches to including ESG factors in passive investment strategies

ESG INCORPORATION			ACTIVE OWNERSHIP		POLICY ENGAGEMENT*
ESG issues can be incorporated into existing investment practices using a combination of three approaches: integration, screening and thematic.			ESG issues can be incorporated into discussions with companies. The objective might be to encourage better practices or disclosure or to improve ESG risk management.		ESG issues are discussed with regulators, government or quasi-government bodies with the objective of changing the regulation or guidance on how corporations or capital markets approach certain ESG issues.
Integration	**Screening**	**Thematic**	**Engaging with companies**	**Proxy voting**	
The overall exposure to a particular ESG factor is reduced or increased by adjusting the weights of constituents dependent on ESG factors. This may be reflected in a bespoke index.	Applying filters or screens to the investment universe based on an investor's preferences, values or ethics	Companies are selected based on their exposure to specific themes (e.g. clean technology).	ESG issues are discussed with companies to improve their handling of such issues. This can be done individually, or in collaboration with other investors.	Formally expressing approval or disapproval by voting on resolutions or proposing shareholder resolutions on specific ESG issues.	

* Engaging on policy is broadly the same for both passive and active strategies and so is not covered further in this document.

Despite the emergence of new data sources and techniques, screening continues to be the most common approach to the incorporation of ESG factors into externally managed passive portfolios.

Figure 5: ESG incorporation into passive strategies. Source: Results of the 2019 PRI Reporting & Assessment Framework. Respondents could only select one approach.



ESG INCORPORATION

The PRI's Principle 1 requires signatories to incorporate ESG issues into investment analysis and decision-making processes. This is applicable to both passive and active strategies and across different asset classes.

Integration
ESG integration into passive strategies involves the use of ESG scores to tilt (over- and underweight) portfolio constituents relative to a benchmark. These portfolio tilts might be done to reduce its 'impact' or 'footprint' (e.g. to reduce exposure to carbon emissions from portfolio holdings), or to incorporate ESG factors to alter the portfolio or benchmarks risk-return characteristics.

Screening
Screens can be positive, negative or norms-based. Negative or norms-based screens are applied to passive investment strategies through the construction or selection of specific or bespoke benchmarks. Negative screening excludes certain sectors, companies or practices from a fund or portfolio, based on specific ESG criteria. Norms-based screening requires investee companies to meet certain standards of business practice based on international norms.

Positive screening involves investment in sectors, companies or projects selected for positive ESG performance relative to industry peers. If conducted by sector, this is also known as best-in-class screening.

Thematic investing
Applying the thematic approach to passive investments is intended to capture long-term opportunities from structural trends such as environmental change, demographic shifts or technological advances. Companies from the parent index or universe with high exposure to a specific trend or activity are incorporated into an index. Examples of themes include water (for example, the S&P Global Water Index). These indexes are then used to develop various passive financial products, often structured as ETFs, for retail or institutional clients. The development of the EU taxonomy (see page 14) should provide a framework for further standardised information in the categorisation of thematic passive strategies.

ACTIVE OWNERSHIP

Engagement and proxy voting
The PRI's Principle 2 requires signatories to be active owners and incorporate ESG issues into their ownership policies and practices, including their engagement with companies and the exercise of their voting rights. This is applicable to both passive and active strategies and across different asset classes.

As with active investors, passive investors can use their voting rights (if they hold equity) and engage with investee companies on ESG issues either individually and/or collaboratively. Again, the PRI has produced guides focusing on active ownership in equity and fixed income. Approaches and challenges to active ownership practices can differ between active and passive strategies. These differences are outlined on page 16.

CHALLENGES OF INCLUDING ESG FACTORS IN PASSIVE STRATEGIES

KEY POINTS

- Challenges to ESG incorporation (Principle 1) in passive investment include the availability and consistency of corporate data, the consistency of ESG scores, complexity and transparency of benchmarks, and unintended portfolio skews and costs.
- Challenges to addressing active ownership (Principle 2) in passive strategies include free-riding, familiarity with holdings, resourcing, its contribution to overall portfolio performance, divestment, proxy voting regulations, stock lending and acting in concert.

Some of the challenges around including ESG factors in active investment strategies are more pronounced for passive investors, while passive investors also face some additional challenges not shared with active investors.

ESG INCORPORATION CHALLENGES

AVAILABILITY AND CONSISTENCY OF CORPORATE DATA

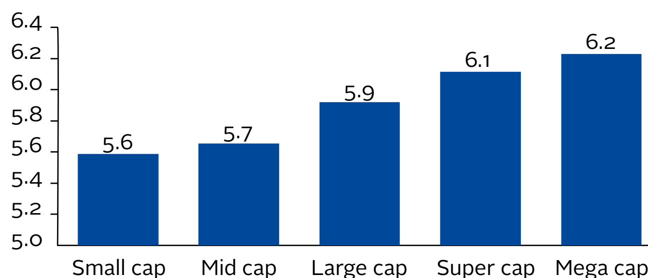
Accounting information follows established national and international rules, guidelines and regulations and undergoes a process of audit (albeit one that is not without issues). This ensures that financial datasets are available for comparison over long time periods and between entities. In contrast, ESG data is often not available, especially for smaller companies and for those based in non-OECD countries. Where available, it tends to be relatively recent and less comparable.

The collection and publication of ESG data by companies is generally voluntary (with some national and regional exceptions), resulting in limited availability and little standardisation. The lack of a defined global taxonomy for ESG data has resulted a range of ESG data collection methodologies. The lack of regulatory disclosure requirements has meant data is not as robust or comparable as it could be. For example, Trucost research found that 7% of companies under-report greenhouse gas emissions.[12]

Differences in ESG regulations and disclosure guidelines make geographic comparisons difficult. Historically, European companies tend to have higher levels of ESG disclosure than their US or Asian counterparts, which can contribute to higher ESG scores among European companies.[13] Analysis by WHEB Asset Management found that the average ESG score for European companies is nearly 20 percent points higher than the average score in the US.[14]

Research also shows that large companies tend to have higher ESG scores than mid- or small capitalisation companies. This may be due to the greater resources that larger companies have to collate, publish and promote comprehensive ESG data.

Figure 6: Average MSCI ESG score. Source: Schroders, 2018[15]



Given that much ESG disclosure is voluntary, there is a tendency for companies to focus disclosure on positive information. A study by the Sustainable Accounting Standards Board found that 90% of known negative ESG events were not reported by the company involved.[16] Many companies have taken steps to voluntarily audit or review ESG information, but the lack of a commonly accepted audit or review process for ESG data remains a barrier to development of consistent ESG data sets. Furthermore, for cost and practicality reasons, voluntary auditing is not common among smaller companies and is often limited, for example excluding supply chain data.

Notwithstanding these challenges, ESG scores are used in the construction of benchmarks or indexes. Methodologies for the calculation of ESG scores are often complicated and rely on a large number of inputs or data points.

12 Mind the Gap: Corporate Carbon Disclosure in EMEA, Sören Stöber, 13 March 2018, S&P Global: Trucost Blog.
13 Smart sustainability integration in Quant Equity, Bart van der Grient and Machiel Zwanenburg, 12 September 2016, Robeco Insight.
14 What Do ESG Ratings Actually Tell Us?, Seb Beloe, 19 April 2016, SustainAbility: Our Insights.
15 Index-based ESG strategies: key things to look out for Sustainable Investment Team, Schroders August 2018
16 Sustainability reports as simulacra? A counter-account of A and A+ GRI reports, Accounting, Auditing & Accountability Journal, Volume 26, Issue 7, Olivier Boiral, 2013

A 2019 survey by SustainAbility listed 600 organisations that provide ESG scores.[17] ESG scores for the same company from different providers are often poorly correlated, due to different methodologies (see Figure 7). State Street, meanwhile, reviewed 30 data providers and found different correlations between ESG scores (see Table 3) reflecting different methodologies and inputs.

This lack of consistency creates challenges in the construction of ESG benchmarks and passive strategies, as these scores inform integration (weighting/tilting) decisions. As a result, asset owners are keen to encourage greater consistency and comparability across scoring methodologies.[18]

Figure 7: Comparison of ESG rating FTSE vs MSCI. Source: Government Investment Pension Fund[19]

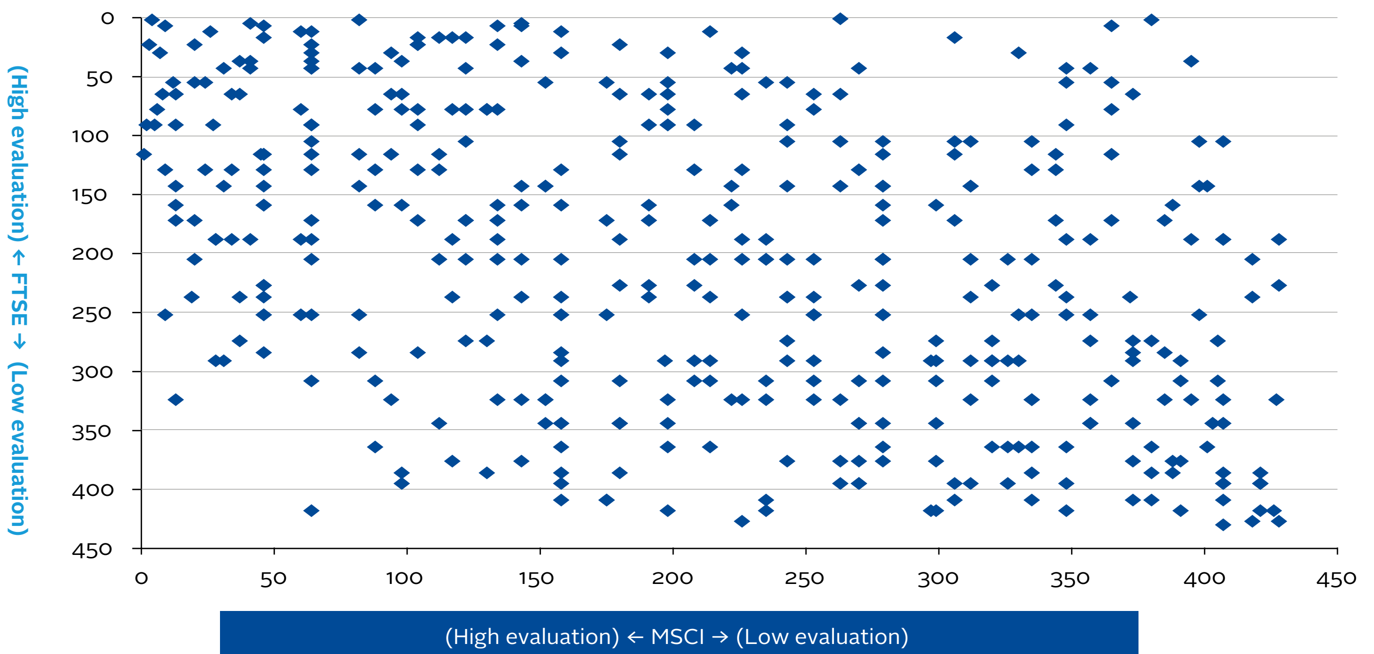


Table 3: Cross-sectional correlation for constituents of the MSCI World Index, June 30, 2017. Source: State Street Global Advisers[20]

	SUSTAINALYTICS	MSCI	ROBECOSAM	BLOOMBERG ESG
Sustainalytics	1	0.53	0.76	0.66
MSCI		1	0.48	0.47
ROBECOSAM			1	0.68
BLOOMBERG ESG				1

17 Rate the Raters 2019: Expert Views on ESG Ratings", Christina Wong, Aiste Brackley and Erika Petroy, 25 February 2019, SustainAbility: Reports.

18 Ibid.

19 GPIF Selected ESG Indices, Government Investment Pension Fund, viewed March 2019

20 The ESG Data Challenge, State Street Global Advisers, viewed March 2019

COMPLEXITY AND TRANSPARENCY OF BENCHMARKS AND INDEXES

Compared with market capitalisation indexes, the construction of ESG indexes often requires complicated calculations and qualitative judgements.[21] Most index providers therefore publish some details of their index construction methodologies to improve transparency. However, lack of information and commercial interests often prevents the recreation or replication of indexes, making external verification difficult.[22]

This is not an issue specific to ESG indices and in response to these broader concerns, regulators, including the European Securities and Markets Authority and the International Organization of Securities Commissions, have introduced guidance or regulations to improve index governance and transparency.[23] As ESG passive strategies attract growing volumes of AUM, the construction of the underlining benchmarks will come under increasing scrutiny.[24]

As many ESG indexes have relatively short track records, and given the limitations to the length and reliability of ESG data time-series, some providers and asset managers use estimates when back-testing index performance. The degree of discretion and the precise calculation methodology used might not always be transparent to users, leading to questions over the reliability of back-testing to evidence performance records.[25]

THE EU TAXONOMY – POTENTIAL IMPLICATIONS FOR ESG BENCHMARKS & PASSIVE FUNDS

Source: EU Technical Expert Group on Sustainable Finance July 2019 'Using the taxonomy'

The EU taxonomy is a classification tool to help investors and companies make informed investment decisions by providing a set of definitions on environmentally friendly economic activities.

Published in June 2019, the EU taxonomy provides a definition of which economic activities are 'environmentally sustainable'. Asset managers marketing investment products as environmentally sustainable will need to explain whether, and how, they have used the taxonomy criteria. Investors can state that they are seeking to invest in taxonomy-eligible activities, or they can disclose their own preferred approach to determining that their investments are environmentally sustainable.

This process is applicable to a range of UCITS funds and is intended to support the proposed Regulation on Disclosures Relating to Sustainability Risks and Sustainable Investments.

More details can be found in a guide to using the taxonomy from the EU Technical Expert group on Sustainable Finance.

The taxonomy is likely to have a number of implications for ESG benchmark providers or passive funds. By providing a common language to define 'environmentally friendly' economic activities, it potentially improves transparency around ranking or rating ESG activities. It may also facilitate comparability between active and passive funds or benchmarks marketed as 'environmentally sustainable'.

The full implications of the EU taxonomy will not become clear for some time. However, it provides an important framework likely to influence the construction of ESG indexes and passive funds.

21 Government Pension Investment Fund press release, Ibid.

22 Index Funds and the Use of Indices by the Asset Management Industry, Technical Committee of the International Organisation of Securities Commissions (February 2004).

23 Index Funds and the Use of Indices by the Asset Management Industry, IOSCO (2004) and Benchmarks Regulation, ESMA.

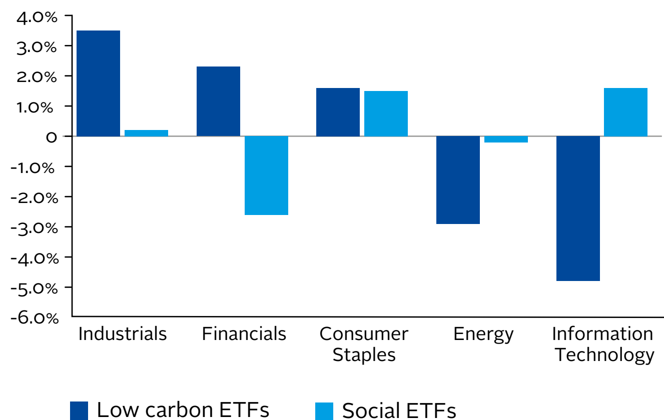
24 EU Benchmarks Regulation, Financial Conduct Authority, 13 September 2016.

25 Ibid.

UNINTENDED PORTFOLIO SKEWS

Screening or re-weighting companies or sectors due to ESG scores can skew portfolios towards companies of certain market capitalisations, industries or geographies. Such biases can introduce unintended consequences for the portfolio's risk characteristics. The chart below shows examples of how incorporating low-carbon or social factors has skewed the exposure of certain ETFs to various sectors - with implications for their risk/return profiles. Tracking these portfolio skews is relatively easy; however, the implications in different market conditions may be less apparent. Asset owners investing in passive strategies need to be aware of potential performance implications introduced by such skews under different market conditions.

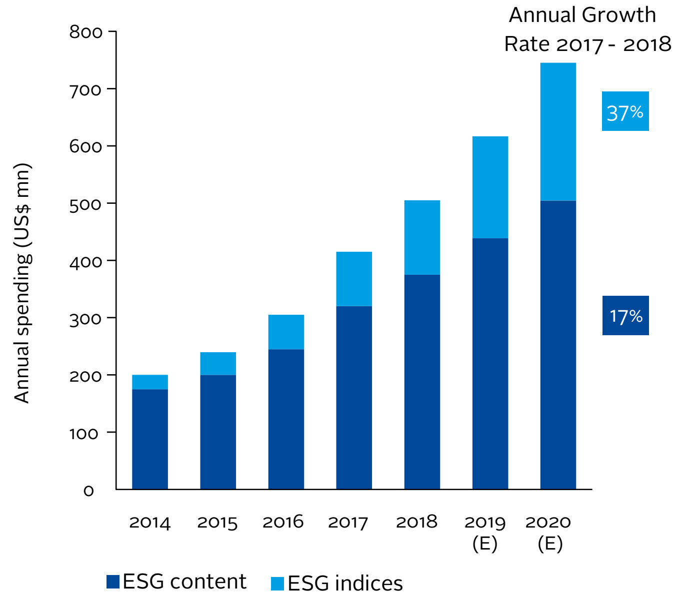
Figure 8: Average sector exposure of the largest low carbon & social ETFs relative to their respective benchmarks. Source: Schroders August 2018[26]



COSTS

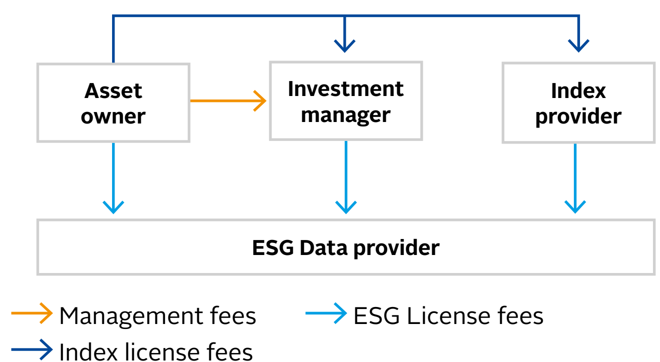
One of the key drivers attracting investors to ESG passive funds are the low management fees. However, the use of ESG passive strategies have higher costs associated with their construction and sourcing ESG data. These are likely to result in higher fees when compared with standard passive funds.[27] The expenditure by asset owners and asset managers on ESG data (both content and indexes) has grown rapidly over the last three years,[28] and asset managers are increasingly reporting that costs of data, process and investment talent. They are a key near-term barrier to the integration of ESG into a range of investment strategies.[29]

Figure 9: ESG data index costs. Source: Opimas[30]



Some large institutional investors can also find themselves effectively paying multiple fees for the same underlying data used in the construction of ESG indexes, as well as for other purposes such as engagement or ESG integration into other strategies.

Figure 10: Fee payments. Source: PRI



26 "Index-based ESG strategies: key things to look out for" Sustainable Investment Team, Schroders, August 2018.

27 Asset managers warned of ESG cost hike", Joe McGrath, ESG Clarity, accessed 12 June 2018.

28 ESG Data: Mainstream Consumption, Bigger Spending", Axel Pierron, Opimas, accessed 9 January 2019.

29 Great Expectations: ESG – What's next for asset owners and managers?", Trevor Allen, BNP Paribas Securities Services article, accessed 7 September 2017.

30 Optimas, Ibid.

ACTIVE OWNERSHIP CHALLENGES

The PRI's Principle 2 also poses a number of challenges for investors following passive strategies. These are sometimes different in nature to active investors and are relevant to both 'standard' passive strategies and ESG passive strategies.

FREE-RIDING

Institutional investors with diverse portfolios and large numbers of holdings, such as those investing in passive strategies, may feel they are not adequately incentivised to undertake ESG engagement with investee companies. This is because the economic benefits involved will be minimal due to the relatively small size of each individual holding. The costs of engaging with a diverse, widely spread portfolio may also be prohibitive in the context of the low fees passive funds are able to attract. Under these circumstances, passive investors may prefer to 'free-ride' on the efforts of other investment managers and asset owners.

RESEARCH AND RESOURCING

Active investors need to undertake investment research to support an investment process or strategy. Passive investors' asset level decisions are dictated by the constituents in an index, rather than research into an underlining asset. Therefore the asset owner or asset manager may consider it has not undertaken sufficient research on, or have sufficient knowledge of, portfolio holdings to be able to engage in constructive bilateral or collaborative engagement efforts.

CONTRIBUTION TO OVERALL PORTFOLIO PERFORMANCE

The large number of companies usually held in a passive portfolio makes it less likely that engagement with any one company will have a material impact on the portfolio's overall performance. Therefore the justification for the benefits of engagement, for example better risk management by companies, may be more diluted and less material to the overall portfolio.

DIVESTMENT

Investors sometimes have escalation procedures if engagement does not progress positively. These escalation procedures may include reducing their exposure or divesting from a position either temporarily or permanently. While active investors can freely follow such an escalation procedure, passive investors will not be able to reduce exposure or divest unless they exit the index entirely or adjust the weightings of a tailored index. This limits possible options if engagement proves unsuccessful and escalation is deemed to be necessary.

PROXY VOTING

A combination of a lack of resources and the large numbers of holdings in passive funds means research on proxy votes is often 'outsourced' to third parties such as proxy voting agencies. Some commentators are critical of 'outsourcing' such decisions as they are an important part of shareholder responsibilities.[31]

Proxy voting on large diverse portfolios also raises some logistical issues, especially regarding rules and regulations on holding periods around AGMs. New regulations mean that 'share blocking' (where asset owners are required to hold a stock for a certain period before an AGM to be able to vote) is no longer permitted in most OECD markets.[32] However, there are various rules or guidance in some markets around record dates (how long an investor needs to hold the shares before an AGM to have them registered in time to vote) which create similar barriers[33] with some capital markets or custodians requiring long record dates. These regulations may provide a disincentive for managers with large diverse portfolios to exercise the right to vote at AGMs.

31 Re: File No. 4-725 · SEC Staff Roundtable on the Proxy Process, Paul Rose, Ohio State University, accessed May 2019.

32 Shareholders' rights directive Q&A, European Commission press release, 14 March 2017.

33 ICGN Securities Lending Code of Best Practice, International Corporate Governance Network (ICGN), 2007.

STOCK LENDING

Stock lending is the temporary transfer of shares by an investor to a borrower in exchange for a fee, with agreement by the borrower to return equivalent shares to the lender at an agreed time. This may be done to enable hedging, arbitrage, or short-selling. When shares are lent, voting rights are passed to the borrower, the underlining owner may recall the shares to undertake proxy voting. The PRI and the International Corporate Governance Network have developed practice and guidance relating to stock lending.[34]

Due to low annual fees, income from stock lending tends to represent a larger proportion of their overall income on passive funds when compared with active funds. The potential implication of this is that passive managers may be incentivised not to recall stock to vote at AGMs.

ACTING IN CONCERT

Some investors have interpreted regulations from the EU and elsewhere as restricting an investor's ability to collaborate during engagement processes.[35] Regulators have recognised this concern and ESMA, for example, has published a "white list" to identify issues where investors can collaborate without being presumed to have acted in concert.[36] This list explicitly includes measures to promote corporate social responsibility. Despite clarifications from certain regulators, some asset managers continue to avoid collaborative engagement because of concerns around breaching acting-in-concert rules. This may be a more significant issue for investors with passive portfolios due to some of the issues outlined above on costs, research and diverse portfolios.

34 Ibid.

35 Information on shareholder cooperation and acting in concert under the Takeover Bids Directive (Public statement), European Securities and Markets Authority (ESMA), 8 February 2019.

36 Ibid.

DISCUSSION POINTS

As part of its work to help investors incorporate ESG in passive investments, the PRI is undertaking a consultation to gather views from PRI signatories and other interested stakeholders, with a view to producing further guidance on the subject.

The objective of the survey is to obtain feedback from asset owners, investment managers and index providers about the challenges and possible solutions to incorporating ESG factors into passive strategies. The PRI will be collecting responses until 31 October 2019.

Respondents will have the opportunity to retain anonymity by ticking a box below. These results referred to only in aggregate or on an unattributed basis.

This short survey consists of 12 questions and can be answered online here.

Job title:

Organisation:

Type:

☐ Asset owner ☐ Investment manager ☐ Index provider

Country

AUM (USD)

Do you want your responses to remain anonymous (as outlined above)

☐ Y or ☐ N

Are you responding as an individual (as supposed to on behalf of your organisation)?

☐ Y or ☐ N

MARKET VIEW

1. Do you intend to increase your relative allocation to ESG passive strategies over the next year? The next three years? (ASSET OWNER)
2. Do you expect your third-party assets managed under ESG passive strategies to increase over the next year? The next three years? (ASSET MANAGER)
3. What impact will the European Union's taxonomy of environmentally sustainable activities have on the market and development of ESG passive strategies?

IDENTIFYING THE CHALLENGES

4. Please rank, in order of significance, the challenges in the table to the incorporation of ESG factors and active ownership into passive strategies, with '1' representing the greatest challenge.

ESG INCORPORATION

- Availability of corporate data [ ]
- Consistency of corporate data [ ]
- Complexity of benchmarks and indexes [ ]
- Transparency of benchmarks and indexes [ ]
- Unintended portfolio skews
- Costs

ACTIVE OWNERSHIP

- Free-riding [ ]
- Lack of research and resourcing [ ]
- Contribution to overall portfolio performance [ ]
- Divestment [ ]
- Proxy voting regulations [ ]
- Stock lending [ ]
- Acting in concert [ ]

5. Are there other issues that are not listed above? If yes, please describe them, and indicate how significant you feel they are.

CREATING SOLUTIONS

6. Based on your own experiences, what advice would you give to an institutional asset owner considering including ESG factors in passive strategies?
7. Can you provide an examples of how an asset manager, asset owner or service provider has addressed any of the challenges mentioned in questions 4 and 5?
8. What actions should the PRI take to develop solutions to the challenges outlined above?

ACTIVE OWNERSHIP

9. As passive strategies become an increasing percentage of global AUM, what are the implications for active ownership and promoting better practice or disclosure among corporations or issuers?
10. Given the typically diverse nature of passive portfolios, how might approaches to engagement differ compared to those taken by active investors?
11. How can passive managers approach potential disincentives to active ownership (stock lending, acting in concert etc.) to ensure they fulfil the PRI's Principle 2?
12. Without the option of divestment, how can passive managers escalate engagement effectively?

If you have any comments or questions, please email passiveinvestments@unpri.org

PRI PASSIVE WORKING GROUP MEMBERS

THANK YOU TO THE WORKING GROUP MEMBERS

- **AP1,** Nadine Viel Lamare, Formerly Head of Sustainable Value Creation (now Director at Transitions Pathway Initiative), Tina Ronnholm, Portfolio Manager, External Asset Management, Majdi Chammas, Head of External Management
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- **UTAM,** Douglas Chau, Chief Risk Officer, Head of Research – Working Group Chair
- **Vanguard**, Marc Lindsay, Senior Strategist

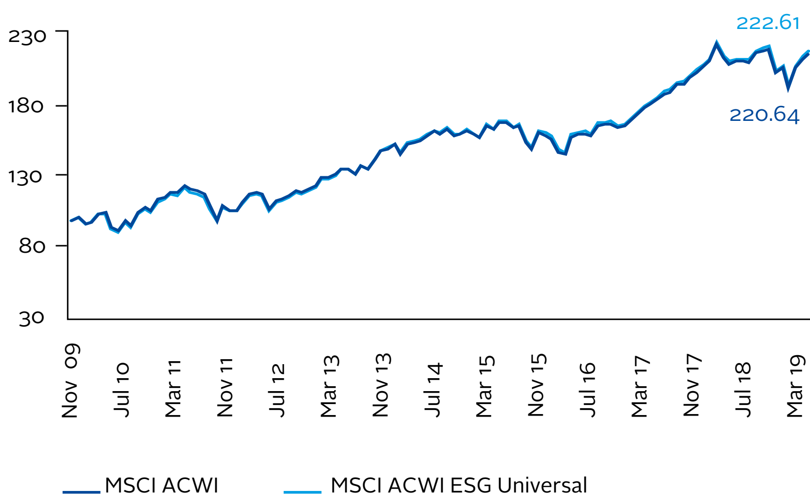
APPENDIX 1

PASSIVE STRATEGIES – ESG AND SHAREHOLDER RETURNS: CORRELATION AND CAUSATION

The evidence around incorporating ESG issues into investment decision making and the impact on returns is mixed. One of the most widely quoted academic pieces showed that there was little evidence incorporating ESG factors into investment practice impairs performance, but it provided no clear consensus around causation - whether ESG factors resulted in enhanced risk-adjusted returns.[37] A review of various indexes with long track records (as opposed to using back testing) also provides a mixed picture. For example, reviewing the performance of MSCI's ESG indexes shows that performance relative to the parent indexes varies depending on geographic region and the time period selected.[38] Despite this mixed picture there is an increasing amount of academic and industry research that supports some positive correlation between ESG factors and shareholder returns.[39]

Figure 11: KLD 400 Social Indexes. Source: MSCI Research, as of March 29, 2019[40]

Cumulative index performance — USD gross returns (November 2009 - March 2019)



	MSCI ACWI ESG universal	MSCI ACWI
Tracking Error	0.99%	0.00%
Number of constituents	2,453	2,771

The table below shows how the FTSE4Good index has outperformed its benchmark in five of the last 10 years, and underperformed in three.

Table 4: Year-on-year Performance – total return. Source: FTSE Russell[41]

Indexes % USD	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
FTSE4Good Developed	33.5	7.9	-6.8	19.8	27.0	5.1	-0.3	7.1	24.1	-8.2
FTSE Developed	31.4	12.3	-5.5	17.0	26.8	5.1	-0.3	8.2	23.9	-8

37 ESG & Corporate Financial Performance: Mapping the global landscape, DWS Global Research Institute (2015).

38 MSCI ESG Universal Indexes, MSCI, web page accessed 24 June 2019.

39 How ESG investing affects financial performance", PRI, 11 January 2017.

40 MSCI, Ibid.

41 FTSE Russell Factsheet - FTSE4Good Index Series, FTSE Russell, web page accessed 31 January 2019.

Other studies have tried to identify causation, and have attempted to identify the mechanisms by which improved ESG performance might support improved relative shareholder returns. These mechanisms include:

- Impact on profit and loss or cashflow: Better managed businesses, as reflected in ESG indicators, are likely to be more efficient users of resources and better at human capital development. Improved performance in these areas may support growth with implications for relative profitability.
- Minimising idiosyncratic risk: All businesses are exposed to a series of operational and market risks that can result in shareholder value destruction. Businesses that are able to better identify, prepare for and insulate themselves from ESG risks ought to be more profitable.
- Supporting intangible value: Being viewed as a better corporate citizen has public relations and stakeholder relationship benefit that may result in a broader shareholder base, and better relationships with customers, employees and regulators.

Broadly speaking, the available research would seem to indicate that integrating ESG factors into the construction of indexes does not harm performance, and indeed there are some clear transmission mechanisms that connect better ESG performance with shareholder returns. However, these relationships are complicated, and evidence suggests the relationships change over time, geography and industry sector, and between environmental, social and governance factors.

APPENDIX 2

PASSIVE STRATEGIES AND NEGATIVE SCREENS

Passive strategies that screen out certain businesses or sectors were the basis for early ESG indexes in the late 1990s. Indeed, many current ESG indexes combine both negative and positive screens. Typically, such strategies screen out companies involved in certain business activities, such as the production and distribution of alcohol, tobacco or weapons, meeting ethical or values-based requirements of their users.[42]

A 2017 survey found that the following major asset managers and asset owners had statements or positions on excluding certain sectors across their portfolio:[43]

Table 5: 'Selected major global asset owners are now applying a variety of different screens across some or all of portfolios'. Source: Schroders[44]

ASSET OWNER	EXCLUSIONS	AUM (USD BILLION)[45]
Allianz	Coal, weapons	1968
AXA	Tobacco, fossil fuels	1265
Government Pension Fund Norway	Coal, nuclear weapons, tobacco, human rights, corruption	893
Kuwait Investment Authority	Gambling, alcohol	592
Aviva	Fossil fuels	556
CalPERS	Coal, tobacco, human rights	306
Malaysian Employee Provident Fund	Alcohol, gambling, adult entertainment, tobacco	170
AP7	Nuclear weapons, human rights	34

The exclusion of certain sectors has implications on the investable universe and tracking errors compared with market benchmarks. The impact on the investable universe/ tracking error varies not only by sector, but also due to definitions and the criteria used. For example, the extent of the implications of screening for nuclear power generation vary depending on the use of revenue thresholds. A low revenue threshold will result in the exclusion of much of the diversified utilities sector.

The choice of data supplier will also influence the screened universe as data providers often disagree on the levels or type of permitted involvement in certain activities, resulting in different screened universes.

While active managers may be able to offset the effects of negative screens by the selection of positions with similar characteristics (e.g. growth, large/small cap, income or dividend), investors in passive screened funds do not have this flexibility.

42 Global Sustainable Investment Review 2016, Global Sustainable Investment Alliance (GSIA).

43 Demistifying negative screens: The full implications of ESG exclusions, Schroders (December 2017).

44 Ibid.

45 Assets under management (AUM) shown represent the total AUM of the asset owner as at year end 2016. Asset owners may have divested fully or partially from the exclusions listed, and positions may have subsequently changed.

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The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org