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ESG in Index Investing: Deconstructing Five Myths

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Two of the most prominent investment trends of the post-global financial crisis world have been the sustained rise of both indexing and environmental, social and governance (ESG) investing. These trends have combined with many investors now seeking ESG and climate indexing strategies to achieve long-term and cost-effective sustainable returns.

Yet, many myths have arisen over the years around what sustainability-minded investors can achieve within an index approach. This piece aims to set the facts straight and clear up some misunderstandings of ESG in index investing.

Myth 1: Investors Cannot Fully Express Their ESG Preferences Within an Index Approach

When they were first developed, index approaches to ESG centred around negative screening, essentially exclusion of selected 'sin stocks', or broad sectors like tobacco, based on an investor's values and preferences. Today, however, screening is far more comprehensive, targeted and precise. Improvements in ESG data mean that more sophisticated types of screening are possible, including norms-based exclusions (e.g. UN Global Compact principles), product involvement-based exclusions (e.g. thermal coal and controversial weapons), as well as exclusions based on overall ESG risk scores, controversy-level rating and climate metrics (e.g. carbon intensity and fossil fuel reserves). Given these improvements in available ESG data, investors can now be far more targeted in their approach to tailor their portfolios or benchmarks to exclude unwanted exposures to ESG factors and ensure alignment with their ESG policy, principles and values.

Yet, index investing is about much more than screening. Investors can incorporate a wide variety of ESG strategies into their index portfolios, from best-in-class approaches and ESG integration, to thematic investing, including climate strategies. ESG index approaches benefit from rigorous and transparent objectives that are clearly defined and executed, which makes them appealing to investors wanting to adhere to specific ESG attributes in a controlled manner.

Investors can be creative when selecting the methodologies of ESG indexing propositions which can include targeting specific outcomes, like alignment with the Paris Agreement goals. A great deal of innovation is taking place to target other specific sustainability-related areas.

One criticism has been that ESG data coverage is deemed insufficient for highly diversified index approaches. This not true anymore with ESG data coverage well above 90%, and close to 100%, for many ESG data points and investment universes.[2]

Some investors have not adopted ESG indexing approaches because of concerns around relying on one external ESG top-line rating. Data providers can assign different ESG ratings to the same company, something largely driven by variations in the scope of ESG categories covered and the different ways of measuring ESG factors by different data providers (Berg et al, 2020). Average correlations of ESG ratings from different providers is estimated to be 0.54 (Berg et al, 2020), far lower than credit rating correlations, for example.

At State Street, we have addressed the ESG data challenge by constructing a proprietary ESG score for companies called R-Factor™. This ESG score draws on multiple data sources and maps them to the materiality framework of the Sustainability Accounting Standards Board (SASB) to ensure a meaningful ESG score by which to rate, rank and also engage with companies. Incorporating these new developments in ESG data sources into our processes means we can ensure that our clients' ESG preferences are accurately reflected in their portfolios and benchmarks alike.

Data improvements are also being driven by ESG standard setters and regulators. The SASB, Taskforce on Climate-related Financial Disclosures (TCFD) and others are collaborating to align ESG reporting standards.[3] In addition, the European Union has introduced a taxonomy of sustainable activities, which is expected to boost green financing and which may inspire other regions to act.

Myth 2: Stewardship is not Effective in an Index Approach

Index approaches are often termed 'passive', which conveys an image that an index manager's role is simply to replicate an index and sit back. Yet, index managers can play a powerful active ownership role in the companies they buy.

As a long-term holder of the constituents of the world's primary indices, State Street has a strong incentive to use its voice and vote to influence companies on long-term governance and sustainability issues. We use sustained, multi-year engagements to drive improved disclosure and standards around material ESG risks and opportunities and ensure the long-term preservation of the value of the companies in which we invest. In 2020, State Street voted in over 19,000 meetings and engaged with over 2,400 companies on a variety of sector and thematic issues, including our multi-year campaigns — climate change and gender diversity.

Given our size and scale, we can also push for stronger industry standards through thought leadership and partnerships. As an example, State Street joined Climate Action 100+, a global investor-led initiative to foster the clean energy transition by engaging the companies and sectors with the highest greenhouse gas emissions. We look forward to working closely with asset managers and asset owners to scale our impact on climate change risks.

Recent months have seen the debate around engagement vs. divestment becoming a hot topic. When an investee company's strategy or operations are not in line with ESG expectations, investors face a fundamental question: divest or engage? In the case of divestment, investors lose their voice, and hence, a seat at the table to influence positive change. Investors may have a greater impact by engaging directly with companies to improve standards and using their vote, a core element of an index investor's approach.

Myth 3: ESG Index Approaches Only Work for Equities

ESG factors are equally important for bond investors as they are for equity investors. Factors like a company's ability to manage carbon emissions or maintain a diverse workforce can have a direct impact on its creditworthiness. As environmental and social issues come to the fore, particularly in the wake of the COVID-19 pandemic and the growing climate crisis, bond index investors are also holistically implementing ESG factors alongside financial considerations.

Like equities, fixed income investors can use a variety of methods to incorporate ESG principles into their portfolios, from screening, ESG integration and thematic investing to active ownership.

Robust ESG data and off-the-shelf ESG indices now exists for many corporate bonds, allowing investors to be consistent in how they reflect their ESG values and objectives across their corporate bond exposures. This includes the aforementioned R-Factor™ methodology, which is included in fixed income index propositions.

However, there remain challenges in assessing sustainability risks of other fixed-income security types, such as sovereign bonds and securitised products. In these areas, the availability of ESG indices, and the range of ESG metrics and indicators is much more limited and currently lags that of corporates. Nevertheless, the increasing availability of country-level data from sources such as the World Bank, United Nations, World Health Organisation and International Energy Association, is facilitating ESG implementation by allowing investors to measure a country's current and trending ESG performance, and severe ESG-related events, to assess a country's overall ESG profile. This data can ultimately be embedded in index solutions.

Fixed income investors are also able to invest in green and social bonds, in the context of index (aware) investing. Green bonds are instruments that fund projects with a positive environmental and/or climate impact, while social bonds fund social projects like new schools and hospitals. Both green and social bonds have experienced significant growth in recent years. These securities with their particular "use of proceeds" differentiate them from their "non-green" counterparts and facilitate an investor's ability to identify and "reward" issuers based on their future intentions, rather than on their historical record on sustainability. They also create important incentives, which can contribute to changing behaviours and business practices over time. This is significant given that many of the solutions required for a low-carbon economy will come from carbon-intensive sectors.

Another interesting development is around fixed income stewardship. Stewardship approaches have traditionally focussed on equity investors, but bond investors are increasingly playing an important role in addressing an issuer's ESG risks. Equity investors have an ownership stake in a business and therefore voting rights, something bond investors lack. Yet, bond investors can still use active engagement to push for robust ESG standards and adequate ESG disclosures.

Myth 4: ESG Indexes Underperform Standard Indexes

Indexing involves techniques focused on minimising costs and controlling risks, while also adding value. It is a straightforward and effective way to both efficiently gain diversified market exposure and incorporate ESG considerations. This attractive combination has led to a huge growth in flows into ESG index funds in recent years.

The COVID-19 pandemic has put the subject of sustainability and ESG issues into sharper focus, while regulation has also driven flows. In 2020, assets under management in sustainable passively funds increased 80%, compared to 45% for active funds. Sustainable open-end and ETFs available to European investors attracted net inflows of €233 billion in 2020, almost double the figure for 2019 (Morningstar, 2021). Morningstar also reports that of 26 sustainable index funds that it selected at the start of 2020, 25 outperformed their traditional index counterparts.

Myth 5: Index Investing Won't Help Tackle Global Sustainability Challenges

Climate change, ecosystem damage and biodiversity loss pose some of the most serious threats that humanity faces. It is widely recognised that the financial sector will play a fundamental role in tackling these challenges through allocating capital to the green transition. The European Commission's Green Deal Investment Plan aims to mobilise over €1 trillion of sustainable investments over the next decade to aid the transition to a climate-neutral, green, competitive and inclusive economy.

Index investing can mobilise capital at the magnitude required to tackle the systemic risks associated with climate change. Institutional index and exchange-traded funds allocate capital to hundreds or thousands of companies across various global indices. Through effective stewardship, large global index investors like State Street can monitor and engage with a huge number of companies on sustainability issues.

Conclusion

Various criticisms have been laid at ESG index approaches, yet they largely reflect confusion around what is possible in an index approach. Index investing is not a 'passive' approach per se and can include tailored and nuanced investment strategies and an active ownership approach.

With increased ESG data transparency and improved reporting, index investors now have access to more insights than ever before to understand their exposures, take action to achieve their investment goals and monitor progress.

As a result, we would expect investors to transition the core of their portfolios to sustainable index investments.

Endnote

1 In September 2019, Bloomberg launched a series of Bloomberg SASB ESG indices powered by R-Factor™. In October 2020, SSGA launched the first ETFs benchmarked to the Bloomberg SASB ESG Index series.

2 The exact percentage coverage depends on the ESG data and universe in question.

3 Statement of Intent to Work Together Towards Comprehensive Corporate Reporting (September 2020).

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- Build from breadth
- Invest as stewards
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* This figure is presented as of December 31, 2020 and includes approximately $75.17 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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