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RECONCILING **RESPONSIBLE INVESTMENT** WITH **PASSIVE MANAGEMENT**

novethic RESEARCH

CONTENTS

KEY POINTS

■ Limited policies

Responsible investment has spread to all asset classes but hitherto played little or no role in the rapidly growing field of passive management. Most investors find the integration of Environmental, Social and Governance (ESG) criteria in passive management complex by nature and next to impossible for technical reasons Yet 40 European asset owners interviewed by Novethic in 2013 said they applied a responsible investment policy to their passive management.

■ Discreet pilot initiatives

A few pioneer investors have already introduced policies, but make discreet mention of them. The policies can be grouped into three categories: the use of indices excluding blacklisted issuers, the design of indices specific to the investor's responsible investment policy, and the use of assets under passive management to emphasise engagement initiatives.

■ Promising innovations

The integration of ESG criteria in passive management for now concerns modest volumes but has already generated some interesting innovations. It has led in particular to asset owners building their own indices, reflecting the ability of responsible investment to change financial models to a substantial degree. The creation of SRI indices by non-financial rating agencies and index providers has led to the emergence of tools that as yet have not proved particularly successful with investors.

■ Conventional benchmarks as strong as ever

Out of over 300 SRI funds distributed on the French market, Novethic has identified just six using an SRI index as a benchmark for financial performance. These indices, backed by stock exchanges or the main global promoters of stock indices, have failed to attract investors, who instead continue to measure the performance of their responsible investment policies using conventional benchmarks.

OVERVIEW

Asset owners are gradually switching their assets from active management to passive management, aimed at replicating the performance of a stock market index. According to the Boston Consulting Group[1], funds under passive management have increased 25% in the space of four years. Asset management companies had $7,900 billion under passive management in 2012, or 13% of assets under management worldwide. Passive management can account up to 80% of the asset allocation of some US pension funds. The financial crisis called into question the active management model, aimed at outperforming the market, and boosted the appeal of passive management with its lower costs.

Is this market trend compatible with another trend, namely the adoption of global responsible investment policies including all asset classes, particularly for the 1,000 signatories of the Principles for Responsible Investment?

Until now, selecting companies on the basis of Environmental, Social and Governance (ESG) criteria has largely been equated with active management. At first glance, replicating an index involves sticking closely to it, preventing investors from taking a position on the ESG performance of the underlying securities by excluding or selecting them. This is why a number of investors see passive management as falling outside the scope of their responsible investment policies.

The Novethic research centre wanted to go beyond this assumption to see if investors were already exploring the integration of ESG criteria in passive management. This first study on the subject shows that adapted tools such as SRI indices exist and that a handful of pioneers are rolling out interesting passive management strategies.

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[1] *Global Asset Management 2013: Capitalizing on the Recovery*, Boston Consulting Group, July 2013

ARE PASSIVE MANAGEMENT AND RESPONSIBLE INVESTMENT REALLY INCOMPATIBLE?

Passive management is based on the idea of replicating as closely as possible an index with a predefined composition (see *Overview of passive management* on page 21). The passive management style is in theory and for a number of reasons considered incompatible with the integration of ESG criteria in the analysis and selection of issuers.

Objective: diversification

Apart from the advantages stemming from the low cost of passive management, replicating an index enables investors to build a portfolio invested in all the representative securities of a market, making for a highly diversified portfolio. This ties in with the portfolio theory developed in 1952 by Harry Markowitz whereby there exist two financial risks, market risk and the risks specific to each security, which can be cancelled out by diversifying securities.

But excluding or selecting securities on the basis of ESG criteria, as responsible investors do, would reduce the benefits of diversification, and even create sector biases. As such, SRI passive management would not be representative of a market and would generate specific risks.

The constraint of limiting tracking error

Excluding or favouring securities on the basis of ESG criteria involves deviating from the benchmark, which can lead to higher tracking error. But keeping tracking error low is part of the fiduciary duty of passive managers, who make a commitment to investors to respect the fund's objective, namely by replicating an index to achieve the same performance.

Some asset management companies, in compliance with Article 224 of France's Grenelle Act, highlight this objective to justify not taking ESG criteria into account in their management. For example, Ossiam, a subsidiary of Natixis Global Asset Management, states the following on its website: "*Given Ossiam's systematic and index-replicating management approach, these criteria are currently not factored in to the company's investment policies and fund management*".

Another type of fund, the synthetically replicated exchange-traded fund (ETF), can be invested in securities different from those in the index while using derivatives to mimic the performance of the index. With synthetic ETFs, it would be easier to break free of the constraints mentioned above and integrate ESG criteria, since securities can either be excluded or favoured.

ESG synonymous with active management

SRI management is generally associated with active, “high-conviction” management, which involves choosing securities in line with ESG criteria and according to investor sensibility. The active approach is the opposite of passive management, which is based on an automatic calculation of the weight of the index constituents and leaves no room for a manager’s opinion of a company. In its 2012 annual report, the Australian pension fund VicSuper wrote: “*Where a portfolio is indexed, there is little scope to integrate ESG factors in a fundamental sense, unless an ‘enhanced’ index approach is used, however that means the investment is no longer purely passive or index*”.

A PRECONCEIVED IDEA DISPELLED THROUGH PRACTICE

Asset managers, like asset owners, communicate very little on how they apply responsible investment policies to passive management. The policies in question rarely address the specifics of passive or index-fund management and as a whole contain few details on their scope of application.

However, the results of the survey carried out by Novethic in 2013 with 160 major European asset owners show that some of them have already initiated policies, challenging the idea that passive management and ESG-based management are incompatible. Quite simply, 45% of the investors interviewed using passive management said they applied a responsible investment strategy to this management style.

RESPONSIBLE INVESTMENT AND PASSIVE MANAGEMENT

38 European investors interviewed by Novethic in 2013 said they had a specific policy for passive management.

Source: *ESG Strategies of European Asset Owners: From Theory to Practice,* Novethic, December 2013

The most common strategy consists in using indices excluding controversial weapons or indices excluding companies found guilty of violating international norms, generally on human rights, working conditions, corruption and environmental protection. This is known as norm-based exclusion.

To make those exclusions, investors can use existing offers from index providers or use a tailored index. All the asset managers interviewed by Novethic talked about requests from asset owners for index-based mandates based on “custom” indices. Investors do not publicly disclose information on these policies as they are led as part of segregated mandates. Asset owners with relatively advanced knowledge of responsible investment provide their fund managers with a list of sector- or norm-based exclusions or an investment universe based on ESG criteria with which to design their own index, the aim being to create a passive management style reflecting their in-house ESG methodology.

Pioneering players

A few investors have undertaken innovative approaches to passive management by creating their own index, thereby circumventing the limits encountered by asset owners invested in open-ended funds.

KLP: a range of custom indices respecting a blacklist

The Norwegian pension fund KLP excludes manufacturers of controversial weapons, companies having violated international norms, and tobacco producers. To apply this policy to all its assets, KLP has developed its own range of indices excluding the companies on its blacklist. These indices are used for passive management but also as benchmarks for its management approach as a whole.

PGGM: a custom ESG index for passive equity management

In the Netherlands, PGGM, which manages the assets of several large pension funds, introduced its own "ESG index" in 2012 to improve the ESG performance of its passive portfolio. More than 25% of the company's assets, equal to some €34 billion, are now invested using this index, which also serves as a benchmark for active equity management. PGGM analyses the 2,800 companies in the FTSE All World Index on the basis of ESG criteria. In each sector, the 10% worst-rated companies are excluded or placed on a watchlist, particularly when PGGM holds a major share in their capital or the market capitalisation is high. An engagement policy is applied to these companies, which are excluded if the engagement fails to produce results. PGGM chose a custom index in order to take account of its in-house ESG research but also to avoid "giving the impression of a black box" by choosing an external index. PGGM is currently reviewing the introduction of a similar fixed-income index.

ERAFP: best-in-class rather than capitalisation-based

The 100% SRI investment policy of ERAFP, an establishment that manages supplementary pensions for public-sector employees, is applied to its passive mandates, accounting for a little over 4% of total assets. ERAFP created its own best-in-class selection indices in 2009 in collaboration with EDHEC Risk Institute. ERAFP defines the universe of securities in the two indices, the FTSE EDHEC-RISK ERAFP SRI Indices, one for large capitalisations the other for small capitalisations, on the basis of Vigeo ESG ratings. ERAFP sought to build these indices using an approach differing from that of conventional indices in order to achieve better financial performance, as the weight of the securities in the index is not determined by their capitalisation, a calculation that tends to reduce diversification, but by their risk/return ratio. ERAFP is also committed to selecting managers able to vote on these mandates.

Storebrand: limited room for manoeuvre in fund selection

It is harder to apply a responsible investment policy to a selection of funds. The minimum standards of the Norwegian insurance company Storebrand led it to exclude 176 companies and 30 States from all its portfolios in late 2013. Storebrand's standards cover international norms on human rights, corruption, environmental damage, controversial weapons, as well as the exclusion of the tobacco industry and companies with the lowest ESG ratings. Storebrand's responsible investment policy addresses the question of ETFs, stipulating that the company may invest in ETFs even if the companies in the portfolio fail to correspond to its minimum standards, providing that the businesses concerned do not account for over 10% of the ETF or the benchmark.

REVIEW OF RI IN PASSIVE MANAGEMENT

Exclusion of controversial weapons

According to the NGO IKV Pax Christi, which sheds regular light on the responsibility of financial institutions in the financing of controversial weapons[2], exclusion policies on cluster munitions often fail to address passive management. However, passive management is gradually making up lost ground in terms of the exclusion of controversial weapons, with investors now able to rely on a range of special indices.

Ex controversial weapons indices now exist, enabling investors to bypass the difficulty of excluding a security from a passive fund. In 2011 the index provider MSCI launched a range of global and regional indices excluding companies implicated in controversial weapons (cluster munitions, anti-personnel mines, depleted uranium, and chemical and biological weapons). Fewer than ten companies are concerned by the global indices.

EXCLUDED COMPANIES LISTED IN MAJOR STOCK INDICES

COMPANY	COUNTRY	INDICES
BAE Systems	United Kingdom	MSCI World
General Dynamics	United States	MSCI World, S&P 500
Hanwha	South Korea	MSCI Emerging Markets
L-3 Communications	United States	MSCI World, S&P 500
Lockheed Martin	United States	MSCI World, S&P 500
Northrop Grumman	United States	MSCI World, S&P 500
Raytheon	United States	MSCI World, S&P 500
Safran	France	MSCI World, CAC 40
Singapore Technologies Engineering	Singapore	FTSE ASEAN 40
Textron	United States	MSCI World, S&P 500

Source: Novethic, 2014

The ten companies above are those included in the major indices and the most frequently excluded for their involvement in controversial weapons (mainly cluster munitions, anti-personnel mines and nuclear weapons). The list was drawn up on the basis of the public data of 39 European investors in January 2014.

Nearly 30 MSCI indices, international and regional, are used by investors and fund management companies to respect their exclusion policy in this area, and even national legislation.

In Europe, three countries explicitly prohibit the financing of these types of weapons: Belgium, Luxembourg and the Netherlands. France does not, though the Act of 20 July 2010 prohibiting cluster munitions does state that it “is also prohibited to assist, encourage or incite any party to engage in one of the prohibited activities

[2] *Worldwide Investments in Cluster Munitions; a shared responsibility*, IKV Pax Christi, December 2013

mentioned above”. During discussions over the bill adopted by the French Senate, Hubert Falco, Secretary of State for Defence and War Veterans, said that financing “*would constitute assistance, encouragement or incitement punishable under criminal law*”. In 2013 the French Asset Management Association, AFG, issued “recommendations on the prohibition of financing cluster munitions and anti-personnel mines” including a section on passive management.

AFG position on the exclusion of controversial weapons

In its recommendations on the prohibition of financing cluster munitions and anti-personnel mines, AFG stated that all asset management companies should implement a policy excluding cluster munitions (CMs) and anti-personnel mines (APMs), and recommended that the exclusion should be publicly disclosed. It focused specifically on passive management and the use of index derivatives:

> “*Indices exist excluding CMs and APMs, weapons covered by French law. AFG recommends using these indices.*
>
> *When creating their own indices, asset management companies should design them in compliance with their exclusion policy.*
>
> *AFG sincerely hopes that policies are initiated at French, European and international level by index providers that could lead to the exclusion of CM and APM securities from all indices.*”

THEAM, a subsidiary of BNP Paribas IP, has for several years, without using special indices, excluded controversial weapons from all its physically replicated ETFs and passive management, equivalent to €16.3 billion in assets at end-September 2013. For Guido Stucchi, Head of ETFs and Passive Management, “*to make these exclusions last we need to favour indices that integrate them, enabling us in particular to anticipate any changes in the list of companies concerned*”. Further encouraged by the NGO Handicap International and AFG’s recommendations, in January 2014 THEAM started using MSCI Global ex Controversial Weapons Indices as benchmark for ten index equity sub-funds in its SICAV Parworld. The ten funds represented €1.4 billion AuM at mid-January 2014. THEAM hopes that this type of index will become the norm in the future.

Norm-based exclusions

As with controversial weapons, lists of companies excluded for violating international norms are limited, both in the number of securities and the percentage of the index capitalisation. As such, they have little impact on asset management, including passive management. Some investors choose to exclude these securities while keeping their traditional benchmark. According to a 2013 Novethic survey, 8% of asset owners using passive management excluded companies from their passive management without recourse to *ad hoc* indices.

Among asset managers, Dexia Asset Management applies a policy of norm-based exclusions to six index funds aimed at replicating a conventional benchmark and representing over €1 billion AuM at end-2013. The management of the funds excludes controversial weapons (anti-personnel mines, cluster munitions and depleted uranium), companies implicated in serious violations of the Global Compact principles, and countries having failed to ratify certain international treaties. The list of funds concerned and the methodology are publicly disclosed in Dexia AM’s response to the Eurosif Transparency Code.

Exercising voting rights

According to the Novethic survey, 6% of asset owners, most of them British, say they vote and engage on passive management. This percentage might seem low compared with practices in active management, but it marks a real advance for this management type.

In France, the securities regulator Autorité des Marchés Financiers (AMF) requires asset management companies to draw up a voting policy and a report on the exercise of voting rights including the "comply or explain" principle. Providing that they justify the decision and make it accessible to the public, companies are allowed to not exercise their voting rights or not respect their voting policies. In practice, the exercise of voting rights is common among French asset managers. According to AFG, they voted on two-thirds of AuM in 2012.

However, voting rights, even in France, are exercised less by passive managers. When "buying an index", they are not overly concerned by what happens at each individual company in the index, because it has no direct impact on the management of their fund. Lyxor says that it is "*not interested in the performance of the share held by the collective investment fund; Lyxor merely seeks to respect the formula or indexation proposed to investors*". As such, the exercise of voting rights is a real step forward for the passive management profession.

For other asset managers, the exercise of voting rights is part of a responsible investment policy. BlackRock, the world's leading asset manager, highlights in its responsible investment policy its objective to vote at all annual general meetings, for actively and passively managed funds alike. Passive management, accounting for roughly two-thirds of the shares managed by Blackrock, is part of its voting and engagement policy with companies. –BlackRock also publicly discloses details on all its votes for each company in its portfolio, particularly through its subsidiary iShares, specialised in ETFs.

Securities lending

The exercise of voting rights presupposes that any lent securities be recalled prior to annual general meetings. While securities lending is not a practice inherent to passive management, it is extremely widespread in the field. It can be used to at least partly offset management costs and offer investors the same return as the benchmark index.

VOTING REPORT FROM THE WEBSITE OF ISHARES, A BLACKROCK SUBSIDIARY, JANUARY 2014

Proxy Voting Results - iShares Dow Jones U.S. ETF

Google Inc.

Ticker: GOOG **Security ID:** 38259P508
Meeting Date: 6/6/2013 **Meeting Type:** Annual
Record Date: 4/8/2013

#	Proposal	Mgt Rec	Vote
Management proposals			
1.1	Elect Director Larry Page	For	For
1.2	Elect Director Sergey Brin	For	For
1.3	Elect Director Eric E. Schmidt	For	For
1.4	Elect Director L. John Doerr	For	For
1.5	Elect Director Diane B. Greene	For	For
1.6	Elect Director John L. Hennessy	For	For
1.7	Elect Director Ann Mather	For	Withhold
1.8	Elect Director Paul S. Otellini	For	For
1.9	Elect Director K. Ram Shriram	For	For
1.10	Elect Director Shirley M. Tilghman	For	For
2	Ratify Auditors	For	For
Shareholder proposals			
3	Report on Reducing Lead Battery Health Hazards	Against	Against
4	Approve Recapitalization Plan for all Stock to Have One-vote per Share	Against	For
5	Stock Retention/Holding Period	Against	Against
6	Adopt Policy on Succession Planning	Against	Against

Shareholder engagement

Along with voting, engagement is the approach most commonly highlighted by investors seeking to apply a responsible investment policy to passive management.

Shareholder engagement is defined as investors taking a position on ESG issues and requiring the companies concerned to improve their practice in the long term. Requirements are expressed through direct dialogue with the company. When direct dialogue fails to produce results, other approaches can be employed, such as questions at annual general meetings, the refusal of tabled resolutions, and support for or the submission of shareholder resolutions.

In a report[3] published in 2011, the Principles for Responsible Investment (PRI) noted that "passive managers' responsibilities are largely exercised through active ownership activities", adding that the size of a number of passive portfolios had a strong impact on this type of strategy. Most of the best practices cited by the PRI involved English-speaking entities, including the Health Employees Superannuation Trust in Australia and the National Pensions Reserve Fund in Ireland.

[3] *Responsible investment in passive management strategies – Case studies and guidance*, PRI, January 2011

ESG selection

In addition to bespoke mandates, investors can also rely on a broad range of SRI indices to apply an ESG selection strategy to their passive management strategies.

Over 100 SRI indices worldwide

The first SRI index, KLD 400 Social, was launched in 1990 by the US firm KLD, a pioneer in ESG ratings. Renamed after MSCI's takeover of KLD, the MSCI KLD 400 Social consists of the 400 companies with the best ESG performance out of the 3,000 largest US stock capitalisations. The MSCI KLD 400 Social index was followed by the Dow Jones Sustainability Indices (DJSI) in 1999 and the FTSE4GOOD Indices in 2001, both series based on the selection of the best companies from an ESG standpoint in the S&P Dow Jones and FTSE indices. This first generation of indices saw the start of collaborative work between providers of conventional indices and ESG research teams, those of RobecoSAM for the DJSI and the EIRIS rating agency for the FTSE4GOOD.

Subsequently, all the ratings agencies launched their own SRI index, such as the Jantzi Social Index (main Canadian capitalisations) by Sustainalytics and the GAIA Index (small French capitalisations) by EthiFinance, followed in recent years by a number of local stock markets, including the Mexico stock exchange, which launched IPC Sustentable, based on EIRIS research, in 2012. SRI indices have developed around the world over the last decade to form a substantial offer today. Novethic counted some 160 SRI indices worldwide in 2013. Most of them are equity indices, although a range of fixed-income indices, called Barclays MSCI ESG Fixed Income Indices, were launched in 2013.

MAIN SRI INDEX FAMILIES WORLDWIDE

INDICES SERIES	INCEPTION	ESG ANALYSIS	METHODOLOGY	EXCLUSIONS	DISCLOSURE OF INDEX COMPONENTS
Dow Jones Sustainability Indices	1999	RobecoSAM	Best-in-class		No, ten first positions and leaders of each sector
FTSE4 Good Index Series	2001	Eiris	Tailor-made Analysis	Arms, nuclear energy and tobacco	No, list of biannual entry and exit
MSCI ESG Indices	2010	MSCI	Best-in-class	For the SRI Serie: alcohol, arms, firearms, nuclear energy, gambling, GMO, pornography, tobacco	No, ten first positions
STOXX Global ESG Leaders Indices	2011	Sustainalytics	Best-in-class	Companies violating the Global Compact principles	Yes
Indices Euronext Vigeo	2013	Vigeo	Best-in-class	Controversial companies	Yes

Source: Novethic, 2014

Most of these indices are based on a best-in-class ESG selection. Once the best companies in each sector have been selected on ESG criteria, the weights of the companies in the index can be determined either by their capitalisation or their ESG ratings. This is the case for the NYSE Euronext Vigeo indices launched in 2013. Following the exclusion of companies with ESG scores under 30/100 in one of the six ratings pillars and those having violated international norms, the securities with the best ESG scores are overweighted in each sector.

The calculation of the index is then left to a conventional index provider, with which the ratings agency forms a partnership. Regardless of the SRI methodology chosen, SRI indices need to be created by index providers with proven financial skills. For the index to be credible in the eyes of investors, securities transactions (including dividend payments) have to be fully factored in to the calculation of the index.

For some of the firms we interviewed, including Lyxor AM, "*the weight of index providers in the index management market actually gives them a key role in the promotion of responsible investment*". The MSCI ex Controversial Weapons indices enabled THEAM to switch the benchmarks of a part of its fund. That kind of strategy would not have been possible for funds following an index other than MSCI's, because MSCI is currently the only player to offer ex controversial weapons indices without an additional non-financial approach.

MSCI, provider of ESG indices and research

MSCI, provider of some of the world's leading indices, is the only stock market index provider to have made ESG research an internal development strategy. In 2010, MSCI took over RiskMetrics (having itself taken over Innovest and KLD, two key players in the history of ESG ratings, in 2009) and launched a range of SRI indices based on ESG selection and norm- and sector-based exclusion, benefitting from MSCI's reputation in the financial calculation of indices.

SRI indices rarely used

The use of SRI indices, seemingly the simplest solution for applying an ESG strategy to passive management, is in the end a rare occurrence in the field of passive or index-linked management.

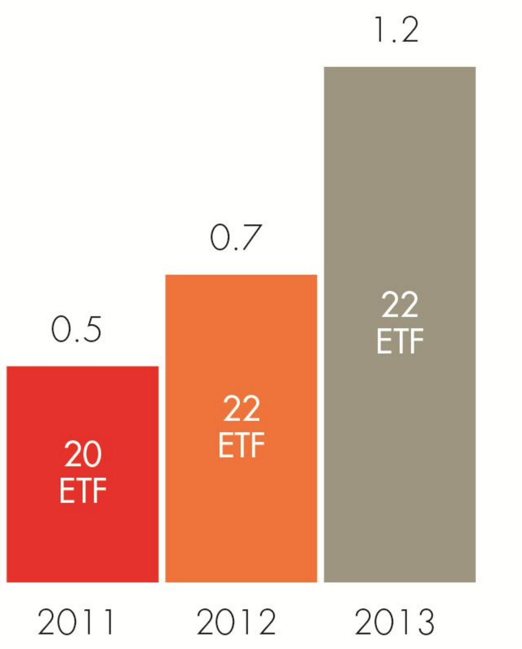
SRI indices are used more by ratings agencies as a way of encouraging companies to respond to questionnaires, in order to establish an ESG rating, or encouraging them to improve their ESG practices, while providing them with a communication tool for their CSR policy. Guido Giese, Head of indices at RobecoSAM, says that the main objective of DJSI indices – namely, to foster transparency on the part of companies concerning their CSR policies and create competition between them – has been met. In his opinion, companies are making considerable efforts to be included in these indices. Many of them communicate proudly about belonging to one or more SRI indices. Encouraging companies to do better on CSR is also the stated objective of the SRI indices launched by numerous stock exchanges worldwide in the last few years.

Dow Jones Sustainability Indexes
Member 2012/13

However, the offer of investment vehicles replicating these indices is extremely limited. A mere 20 ETFs worldwide replicate an SRI index (see list on page 23), for total AuM of €1.2 billion in 2013 – a drop in the ocean given the size of the ETF market. According to the ETFGI consultancy firm, ETFs were worth almost

€2,170 billion worldwide at end-October 2013, compared with €1,040 billion in 2009. Even if SRI ETF assets under management have doubled in two years, Novethic estimates that they still account for less than 0.1% of ETF AuM worldwide. With a full 60% of these assets, BlackRock is by far the leading SRI ETF manager.

AUM OF SRI ETFs WORLDWIDE (€ BILLION)



Source: Novethic, 2014

In addition to ETFs, note should be made of the rare examples of “Certificats 100%” based on SRI indices. “Certificats 100%” are listed debt securities aimed at replicating an index, an equity or a commodity. For example, the French bank Societe Generale launched a “Certificat 100%” on the Euronext Vigeo France 20 index in October 2013, aimed at retail and private banking clients and worth around €3 million.

However, these amounts do not take into account the index funds and mandates for which no precise figures exist. For example, the Japanese pension fund National Federation of Mutual Aid Associations for Municipal Personnel, which manages over €87 billion in assets, launched a call for bids in 2012 for a passive SRI management mandate aimed at tracking the MSCI Japan ESG Index. This index is made up of the 154 top-performing Japanese companies on ESG criteria, accounting for 50% of the capitalisation of each sector in the MSCI Japan. The asset manager RobecoSAM, which is seeing a rise in demand on the part of European pension funds to switch from conventional index to ESG index management, estimates that €3.4 billion are now managed by tracking DJSI indices.

OBSTACLES TO THE DEVELOPMENT OF RESPONSIBLE PASSIVE MANAGEMENT

A lack of consensus on ESG criteria

In asset management in general, indices such as the MSCI World, S&P500 and CAC40 are used as a benchmark because all the market players see them as representative. In SRI, each investor has his own definition of what constitutes good ESG performance. The lack of a common definition of SRI and the ESG criteria to be used is the main reason given by the asset managers interviewed for making little use of SRI indices.

Yet indices excluding controversial weapons could draw on the support of a sufficient number of investors to become a benchmark. Encouraged by regulatory authorities and regulation, the exclusion of companies involved in controversial weapons is starting to become a minimum requirement for financial players, at least in Europe. The list of companies concerned may differ from one investor to the next, but it stands today as the most consensual in the field of responsible investment.

Insufficient liquidity for passive management

The lack of consensus on SRI is a major obstacle for index funds and ETFs to reach critical mass. For Lyxor AM, an ETF has to weigh between €200 million and €300 million in AuM to have the liquidity required to be used in a passive management strategy. The SRI ETFs currently available on the market are modestly sized, with only four worth over €100 billion AuM. The largest ETFs are also the most liquid. And that liquidity is essential, particularly for synthetically replicated ETFs for which counterparty could not offer derivatives in underlying indices.

Lack of an SRI benchmark

Neither do asset managers use SRI indices as benchmark indices for their open-ended SRI funds. Out of the 300 SRI funds available in France, Novethic has identified just six using such an index to assess their performance, each fund using a different index (see table below).

OPEN-ENDED SRI FUNDS IN FRANCE USING AN SRI BENCHMARK FUND

SRI FUNDS	ASSET MANAGER	BENCHMARK
Aviva Valeurs Responsables	Aviva Investors	Euro Stoxx® Sustainability 40
EasyETF Low Carbon 100 Europe	BNP Paribas IP	Low Carbon 100 Europe
GIS European S.R.I. Equity	Generali Investments	STOXX Europe Sustainability
Avenir Partage ISR	Groupe OFI	STOXX Europe Sustainability
Macif Sélection Développement Durable	Groupe OFI	DJSI Sustainable World
JPMF Global Socially Responsible Fund	JP Morgan Fleming AM	ECPI Ethical Index Global

Source: Novethic, 2014

Only a few investors, such as PGGM and KLP, use SRI indices as benchmark indices, since comparisons with a reputed benchmark such as MSCI Europe remain a major concern. Even using an SRI index or a non-benchmarked management strategy, investors ultimately end up comparing their performance with that of a conventional benchmark.

The quest for diversification

Excluding a limited number of securities from a passive fund does not pose a problem, but a stricter ESG selection poses more problems. Even across a broad universe, ESG selection involves less diversification, which in theory leads to riskier management. Index providers have upgraded their offer to meet the demands of clients looking to apply a responsible investment policy without changing the parameters of their passive management.

While the first generation of ESG indices selects a limited number of companies, new, more diversified index series are now available. The DJSI, launched in 1999, is made up of 10% of the best-performing companies on ESG criteria per sector in the S&P Dow Jones Indices, representing 333 companies for the DJSI World. A new family of DJSI Diversified families was launched in May 2013 based on a less demanding ESG selection, which makes them more diversified. For example, the DJSI Diversified World is made up of 600 companies.

Mainstream indices are also emerging, including the EURO iSTOXX 50 SD-KPI index. Based on the EURO STOXX 50, all the companies in that index are included in the EURO iSTOXX 50 SD-KPI index, with a maximum 10% of the weighting of a company in the index varying in line with its ESG performance. The set-up enables managers to keep a low tracking error compared with the EURO STOXX and use EURO STOXX derivatives, which resolves problems stemming from a lack of liquidity.

Keeping tracking error to a minimum – a mantra in passive management – thus leads to the greater diversification of indices integrating ESG criteria. As a result, they are increasingly closer to their underlying indices, reducing their ability to foster a different economy.

Carbon allocation of indices to be called into question?

Through its calculation model, based on the capitalisation of companies, a stock index reflects the current economy, in others words an economy strongly dependent on carbon-intensive sectors. Stock indices today are unable to take account of the financing requirements of activities that will likely become essential with the ongoing reduction of carbon emissions.

According to a 2012 Carbon Tracker Initiative report[4], between 20% and 30% of the stock market capitalisations of Australia, London, Moscow, São Paulo and Toronto are exposed to fossil energies. In an economy that is supposed to be drastically cutting greenhouse gas emissions owing to their impact on the climate, stock markets with high exposure to fossil energies could rapidly lose their value. So thinks the Generation Foundation, an entity dependent on the asset management company founded by Al Gore. In a report[5] published in 2013, the Foundation wrote that "*managing carbon risk is therefore relevant to passive managers as investors might turn away from these funds as fossil fuels become less profitable investments, materially impacting the performance of mainstream indices*".

That said, SRI indices are not a solution for investors managing their assets with a long-term horizon and seeking to control carbon risk. SRI indices do not call into question the sector allocation of conventional indices. Even where they significantly reduce their initial investment universes, these are above all best-in-class indices.

Low-carbon and carbon-efficient indices selecting companies with the lowest CO_2 emissions exist. In February 2012 the FTSE and Carbon Disclosure Project (CDP), a coalition of investors seeking to encourage companies to publish precise information on their CO_2 emissions, launched a series of four indices called the FTSE CDP Carbon Strategy Index Series. Companies are weighted on the basis of their carbon emissions, while retaining a low tracking error vis-à-vis their underlying benchmark. Their originality lies in the fact that they take account of the future rather than the past emissions of companies. While still best-in-class indices, they pave the way for indices that meet the needs of responsible investors looking to reduce exposure to carbon risk.

In addition, through the "2° Investing Initiative", investors are asking questions about the role of benchmark indices in long-term decisions, particularly as part of the financing of the energy transition[6].

[4] *Unburnable Carbon – Are the world's financial markets carrying a carbon bubble?*, Carbon Tracker Initiative, March 2012

[5] *Stranded Carbon Assets: Why and How Carbon Risks Should Be Incorporated in Investment Analysis*, Generation Foundation, October 2013

[6] Due out in June 2014

CONCLUSION

- **The integration of ESG criteria in passive management has only just begun.** Examples of this management strategy are few and far between and generally exist in the form of tests. PGGM aside, the policies in question cover just one aspect of responsible investment, norm-based exclusion, securities selection or engagement.

- The main objective now is to convert these tests into more global responsible investment policies applied to substantial assets under management. **An initial step has been taken with indices excluding controversial weapons**, the growing use of which could make these strategies essential.

- While **the offer of index providers is playing a decisive role in the growing use of exclusions**, it is insufficient to extend the use of SRI indices, which are not seen as representative by investors. But the number of SRI indices has begun to grow only in the last ten years, long after the first MSCI indices were launched in the 1960s.

- **The main obstacle** to the introduction of ESG strategies in passive management **ultimately lies in the purely technical vision of this management approach, limited to replicating an index**. Having an opinion on the financial performance of a company is not part of the passive manager's job, while responsible investment hinges at the very least on acknowledging the importance of non-financial analysis.

- **Passive management could surmount this obstacle**. Relatively recently in active management, asset managers and asset owners saw their profession as limited to taking account of the financial assessment of issuers. **Asset owners are the most likely to give impetus to the trend** by calling for the alignment of their entire management strategy with their responsible investment policies.

APPENDICES

Overview of passive management

Passive management

Passive management consists in replicating the performance of a benchmark market represented by an index. For example, an investor looking to achieve the same performance as the market of the largest capitalisations in France could choose to replicate the CAC40, or to achieve the same performance of large and mid-size European capitalisations, the MSCI Europe. The main focus of passive management is keeping down tracking error, which measures the difference in performance between a portfolio and its benchmark. For the AMF, the collective investment schemes marketed in France have to keep tracking error below 1% or volatility lower than 5% of the index to qualify as passive.

There are two ways to replicate an index. The first, physical or direct replication consists in buying the same securities as those of an index and in the same proportions. The second, synthetic replication consists of portfolios made up of a basket of securities more or less aligned with those of the index. Asset managers make extensive use of derivatives to obtain the same performance as the benchmark.

Two investment vehicles are used in passive management, collective investment schemes and Exchange Traded Funds (ETFs) also called trackers. Unlike collective investment schemes, ETFs are listed funds, so investors can trade them daily.

Benchmarked active management

Benchmarked active management, like passive management, has to respect the limits of tracking error. But the objective is different, with active managers aiming to outperform a benchmark market. The benchmark here serves as a comparison point for performance, measured in a relative rather than absolute manner.

Nevertheless, the make-up of a number of benchmarked funds is so close to their benchmark that they can be compared to passive funds. Based on that observation, the Danish Financial Supervisory Authority announced in December 2013 that it would be asking asset managers marketing so-called active funds to provide it with two indicators, tracking error and active share, to make sure the practice at hand is indeed active management. Active share measures the proportional difference between the securities held by a fund compared with the benchmark.

Capitalisation-weighted indices

An index is made up of securities in a given category (for example, the share of large listed companies) traded on a stock market (the FTSE for the London market) in a given geographical area or countries with the same economic characteristics (Emerging Markets indices). Thousands of stock indices exist but only a handful serves as a benchmark for investors.

Most indices are weighted automatically according to the capitalisation of the constituent companies. The higher the market capitalisation of a company, the heavier is its weight in the index. The common practice today is to take account of the free-float, rather than total capitalisation, reflecting the number of securities actually traded on the markets.

List of SRI ETFs worldwide at 31 December 2013

FUNDS	ASSET MANAGER	INCEPTION	DOMICILE	BENCHMARK	ASSETS (M€)
It Now ISE Index Fund ETF	Banco Itaucard	2011	Brazil	Corporate Sustainability Index (ISE)	14
iPath Global Carbon ETN	Barclays Funds	2008	United States	Barclays Capital Global Carbon Index	1
iShares Carbon Efficient Index	BlackRock	2012	Brazil	Carbon Efficient Index (ICO2)	127
EasyETF Low Carbon 100 Europe	BNP Paribas	2008	France	Low Carbon 100 Europe	34
CCB Principal SSE Social Responsibility ETF	CCB Principal AM	2010	China	SSE Social Responsibility Index	40
CIMB S&P Ethical Asia Pacific Dividend ETF	CIMB-Principal AM	2012	Singapore	S&P Ethical Pan Asia Select Dividend Opportunities Index	13
db x-trackers Ethical MSCI World Index ETF	db x-trackers	2013	Luxembourg	MSCI Total Return Net World Index	152
iShares Dow Jones Europe Sustainability Screened	iShares	2011	Ireland	Dow Jones Sustainability Europe Index ex ATGAF*	22
iShares Dow Jones Eurozone Sustainability Screened	iShares	2006	Germany	Dow Jones Sustainability Eurozone Index ex ATGAF*	78
iShares Dow Jones Global Sustainability Screened	iShares	2011	Ireland	Dow Jones Sustainability World Enlarged Index ex ATGAF*	85
iShares Jantzi Social Index	iShares	2007	Canada	Jantzi Social Index	15
iShares KLD 400 Social Index	iShares	2006	United States	MSCI KLD 400 Social Index	221
iShares MSCI USA ESG Select Index	iShares	2005	United States	MSCI USA ESG Select	178
KDB Pioneer SRI ETF	KDB AM	2011	South Korea	KRX SRI Index	4
KTB Great SRI ETF	KTB AM	2009	South Korea	KRX SRI Index	6
Nedbank BettaBeta Green ETF	Nedbank Capital	2011	South Africa	Nedbank Green Index	9
Pax MSCI EAFE ESG Index ETF	Pax World	2011	United States	MSCI EAFE ESG	41
Think Sustainable World ETF	ThinkCapital AM	2013	The Netherlands	Think Sustainable World Index	37
UBS-ETF MSCI Europe & Middle East Socially Responsible	UBS Global AM	2011	Luxembourg	MSCI Europe & MiddleEast Socially Responsible	14
UBS-ETF MSCI North America Socially Responsible	UBS Global AM	2011	Luxembourg	MSCI North America ESG	42
UBS-ETF MSCI Pacific Socially Responsible	UBS Global AM	2011	Luxembourg	MSCI Pacific ESG	9
UBS-ETF MSCI World Socially Responsible	UBS Global AM	2011	Luxembourg	MSCI World ESG	80

** Alcohol, arms, firearms, gambling, pornography, tobacco*

* Alcohol, Tobacco, Gambling, Armaments & Firearms

Sources: Novethic, Morningstar

RECONCILING **RESPONSIBLE INVESTMENT** WITH **PASSIVE MANAGEMENT**

A study by the Novethic research centre on responsible investment
Written by: Aurélie de Barochez and Aela Cozic – Research director: Dominique Blanc

Novethic is a leading research centre on responsible investment. Founded in 2001, it produces studies and awards an SRI Label. Novethic is a part of Caisse des Dépôts. **www.novethic.com**