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The Future of Investment: Sustainable Index Investing

September 2010

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Introduction

Penny Shepherd MBE
Chief Executive, UKSIF

Exciting new trends are emerging within investment. Unlike some innovation of the recent past, these are firmly grounded in delivering wealth by creating value for wider society. Arguably, they are the future of investment.



UKSIF's “**Future of Investment**” Reports seek to highlight the activities and views of those driving this new flowering of successful long-term investment. As the UK's hub for sustainable and responsible investment, we are privileged to have many of these leading-edge investment practitioners among our members.

We hope that these reports will be of value to significant institutional and private investors and their advisers. While nothing in them should be regarded as investment advice or product recommendations, they should give insight into the growing sophistication of sustainable investment and the breadth and depth of opportunities becoming available.

This second report, “**Sustainable Index Investing**” considers the various approaches and some of the product offerings that have already been developed as well as identifying trends, challenges and future directions. It brings together specialists from index and ETF providers, investment consultants and research firms.

The dialogue demonstrates:

- Investors are increasingly looking at sustainable indexes, for both products and performance measurement, to help them to achieve both financial and social and environmental value
- Experts anticipate growing demand. This includes, but is not limited to, Exchange Traded Funds (ETFs)
- Sustainable index investing takes a number of different forms, meaning it can meet a range of investors' priorities and needs. Leading-edge firms are helping investors through new products, research and advice
- Challenges of data quality, transparency and standards are evident but are being addressed by these leading-edge firms.

We welcome your feedback on “The Future of Investment: Sustainable Index Investing”, including themes you would like to see covered in future reports. Contact us at info@uksif.org.

The Panel



David Harris

Director of Responsible Investment - FTSE Group

David joined FTSE in 2002. His responsibilities include overseeing index management, engagement with index constituents, managing research partnerships and developing new Responsible Investment indices. Additionally, David serves as board director of UKSIF and as a judge for the FT Sustainable Banking Awards. Previously, David worked for Arthur D. Little's Global Environment and Risk Practice and with PwC's climate change consulting team.



Will Oulton

Head of Responsible Investment - EMEA - Mercer

Will joined Mercer in May 2010. Previously, Will was Director of Responsible Investment at FTSE Group where he led the development of FTSE's sustainability indices and services. In June 2009, he edited the book "Investment Opportunities for a Low Carbon World" and in February 2010 was appointed Vice President of Eurosif. Will is also a Special Lecturer at Nottingham University Business School and sits on a number of advisory committees.

Thomas Kuh

Business Manager- ESG indices - MSCI

Thomas was Head of ESG Indices at RiskMetrics Group, which MSCI Inc. acquired in June 2010. He joined RiskMetrics in November 2009 through the acquisition of KLD Research & Analytics. During his 17-year career at KLD, Dr. Kuh held a number of positions, most recently Managing Director of KLD Indexes. Prior to KLD, he was a Professor of Economics at Simmons College and a Teaching Fellow at Harvard University.



Rory Sullivan
Head of Responsible Investment - Osmosis

Rory is widely recognised as an international expert on the investment implications of climate change and has played a leading role in UK and EU public policy debates. He is a member of the World Economic Forum's Taskforce on Low Carbon Economic Prosperity, was formerly a member of the Steering Committee of the Institutional Investors Group on Climate Change and Chair of the Confederation of British Industry's Carbon Reporting Working Group. He writes widely on these issues, his works include *Corporate Responses to Climate Change* (2008) and *Responsible Investment* (2006).



Emma Hunt
Senior Investment Consultant - Towers Watson

Emma joined Towers Watson in February 2010. Emma supports the management team in integrating sustainability considerations into its manager research process as well as encouraging clients to integrate sustainability principles into their investment policy and practice. Previously, Emma was Head of Responsible Investment for Europe at Mercer. She has also held positions in an independent think tank researching issues relating to sustainable finance, as well as working in fund management.



Simon Thomas
Chief Executive - Trucost

Simon Thomas is a founding director of Trucost with 24 years senior business experience in the financial, publishing and self-storage industries. He is a regular commentator on the quantification of environmental impacts and frequently addresses the investment and corporate community on related issues. Previously, Simon co-founded the Emerging Markets Investment Trust business at LCF Edmond de Rothschild and held senior positions at Swiss Bank Corporation, Nomura International and Reed International.

1. What are the opportunities for sustainable index investing you are focusing on? Are these built around specific themes or markets?

Emma Hunt: Sustainable index investing can take a number of different forms. Traditional sustainable investment indices combine positive and negative environmental, social and governance (ESG) criteria, and are aimed primarily at investors that want to match their investments with their values. Best-in-class indices seek to take an overweight position in better performing companies on a range of ESG criteria as a way of isolating an ESG premium. Sustainability-targeted or “thematic” indices seek to isolate and take advantage of a thematic beta such as clean technology or water.

We note that indices can be investment vehicles, but they can also be tools for investment. For example, they could be used as part of the investment process for identifying risks and opportunities, or for measuring a sustainability impact.

Our pension fund clients have different priorities that will influence their decision as to whether and which investment solution might meet their needs. Main differentiating factors include the nature, breadth and depth of consensus and conviction towards the impact of sustainability factors and the governance resources available to the client, that is to say the time and expertise available to the client to make and manage their investment decisions. The type of fund (for example, defined benefit or defined contribution), its maturity and asset allocation details such as asset class, region, sector, style, theme and market cap are also determining factors.

At Towers Watson, we work with clients to unpack these different factors, and consider whether and what part sustainability might play across their assets.

Will Oulton: For consultants, sustainability indices are helpful as a complement to the mainstream benchmarks their clients use in performance measurement reporting. Such indices can be particularly helpful in explaining performance drivers in portfolios and adding an additional layer of information on financial risk and performance.

Interest in thematic indices has increased in the past two years as a number of clients have looked to gain exposure to specific investment opportunities in environmentally themed sectors. Many of these clients have taken the approach of a relatively small initial allocation at the outset as they become more comfortable with the sector.

One of the challenges the industry faces is in integrating ESG data into the investment process. As this is an important area of focus for us at Mercer, we have amassed a database of some

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3,500 investment strategies and assessed how well they have integrated ESG into their investment approach. These ratings are increasingly being used by clients as they form part of the information set provided to them during new mandate searches and for their ongoing manager monitoring process. A further layer of useful information can be added by comparing these strategies to the performance of both sustainability and mainstream indices.

In the longer term we believe that sustainable investment approaches will form an increasingly important part of our clients' asset allocation decisions and a significant amount of our work consists of helping them find the best ideas and strategies.

Thomas Kuh: MSCI's in-house ESG research expertise enables us to create innovative ESG indices addressing four key client objectives.

Financial: Universal owners (with diversified portfolios that spread across the entire market) collectively own a significant share of the economy and depend on global markets to produce sustainable economic growth. ESG investing, along with active ownership, can help them measure and manage their long-term risk exposure to negative ESG factors and to identify opportunities associated with positive ESG factors.

Values: Many investors want their investments to express their values, based upon religious views, international norms, institutional codes of conduct, legislative requirements, or ethical concerns about specific business activities. Values-based ESG indices are valuable tools for investors building portfolios that are consistent with their beliefs. This dimension is not always driven by financial considerations, but helps ensure that investment portfolios are congruent with investors' values.

Environmental: A growing number of investors are pursuing thematic strategies in sectors such as clean tech or energy efficiency that may benefit from structural changes in the world economy. Our environmental indices provide focused benchmarks for thematic investment opportunities that are not effectively captured by standard benchmarks or industry classifications.

Custom: Many investors including foundations, endowments, pension funds, NGOs and/or sovereign wealth funds have specific needs that are best met with custom indexes designed for the investor.

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Simon Thomas: Trucost has built a standardised database of the environmental impacts of companies (including carbon, water, waste, metals and chemicals) which is truly quantitative and comparable over time, sector and geographical location. Trucost data covers 4,500 companies globally, including all the constituents of most major equity market indices.

Trucost data has been used to construct investment indices with both passive and active characteristics. The data's comprehensive nature enables Trucost to specialise in low-carbon or carbon-optimized tracker indices. These indices have precisely the same constituents as the parent benchmarks and are sector neutral, but companies are re-weighted according to their carbon efficiency (relative to their sector). The aggregate carbon emissions of the resulting indices are typically 25-50% lower than the parent indices, but because the sector weights are neutral and the constituents identical, tracking error is very low. They have been described as tracker indices with a free call option on carbon emissions becoming more expensive for companies.

Trucost measures a company's environmental performance in quantitative terms. This data can then be used in portfolio and index construction in just the same way as any mainstream analyst would use traditional metrics such as P/E ratios or dividend cover. It can be used as a factor to screen a universe of stocks or when deciding what weight to give a holding.

Trucost clients use our data in index tracker, long-short equity and bond portfolio products, aimed at both institutional and retail investors. The data enables them to offer financial performance AND lower carbon risk exposure.

Rory Sullivan: Our approach to investment starts with a detailed understanding of the structural drivers that will create the successful businesses of the future. There are two that are of particular relevance to our activities in this area.

The first, which is now widely recognised by the market, is the Green Economy Theme. Driven not only by climate change but also concerns about energy security and access to natural resources, governments around the world have taken action to reduce energy and water consumption, to reduce greenhouse gas emissions and wastes, and to promote renewable energy. These types of policy interventions will continue to create significant opportunities for companies.

The second, which is much less well recognised, is the Emerging Market Technology Champions Theme. Over the past five years, we have seen market-leading positions in many environmental markets (solar, wind, waste water treatment) being taken by companies from outside the traditional investment markets of North America, Europe and Japan. Contrary to popular perception, the source of market leadership is not just about cost. Increasingly, the best

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(measured across core product metrics such as performance, capital costs, operating costs, reliability) technologies are being provided by companies from the emerging markets.

David Harris: FTSE has four categories of Responsible Investment (RI) indices encompassing various client approaches.

The first is the FTSE4Good Series, established almost a decade ago, which continues to evolve and lead the sustainability debate. New inclusion criteria are regularly introduced including; environmental management, climate change, human and labour rights, supply chain standards, and bribery.

The second supports investments into environmental technology and solution companies, as defined by the FTSE Environmental Market Classification System (EMCS), which includes six sectors and 25 sub-sectors. The FTSE Environmental Market Series, a family of 18 indices cover these growing sectors including Water and Waste Technologies, Energy Efficiency, Renewable and Alternative Energy and regions including; US, Europe, Asia, and UK.

The third and most recent, the FTSE CDP Carbon Strategy Index Series, takes established FTSE benchmarks and re-weights constituent companies on exposure to carbon risk. Weights of each sector in the index is kept proportional to the underlying benchmark by ensuring those constituents that are over weighted equal those under weighted, per sector. This achieves minimal tracking error.

The fourth category is that of custom indices, where FTSE's dedicated custom and RI teams tailor and apply research and methodologies from a variety of FTSE indices and classification systems, to meet individual client needs or specific mandates.

FTSE works with independent research providers and partners including CDP, EIRIS, ENDS Carbon and Impax. In addition we use independent expert committees who oversee index rules, criteria, and the changes made at reviews, ensuring the indices remain relevant and accurate at all times.

2. How does an approach to index investing that considers sustainability factors differ? And how can this add value for investors?

Thomas Kuh: Indices define investment opportunity sets, benchmark financial performance and facilitate investment strategies. ESG indices have emerged over the past two decades as an increasingly popular alternative to standard market benchmarks, i.e. market capitalisation-weighted indices that define investments based on size, country, industry and style.

Standard market benchmarks reflect the opportunity set available to all investors today. ESG indices are an option for investors who believe that capital markets do not fully account for the financial impact of environmental, social and governance factors.

How do ESG indices differ? Simply put, as compared with standard market benchmarks, they integrate ESG factors into their methodology, affecting the selection of companies and the financial characteristics of the benchmark. ESG indices add value to the investment process for investors who believe that these factors are not adequately accounted for by conventional investment analysts, and are often mispriced by the markets.

Investors can incorporate sustainability factors into their portfolios either by defining an ESG investment opportunity set by selecting a subset of a standard market benchmark based on ESG ratings or by creating an ESG-optimized benchmark by re-weighting a standard market benchmark based on sustainability factors.

David Harris: There is a growing realisation amongst the investment community that investment decision making needs to capture and consider a much broader variety of company performance factors, for long-term investing. Sustainability indices can be a simple, cost-effective and transparent manner to do this. Passive investing tends to have significantly lower costs associated than using active managers. It is a common belief among academics, that on average, once fees are considered, index returns beat those for the average active manager.

There are two different approaches to integrating sustainability factors into indices. The first is to apply an approach that selects only certain companies for inclusion based on ESG factors. This approach is used for FTSE4Good and FTSE Environmental Markets. The other approach uses these factors to adjust the weight of the company in the index rather than to exclude them, as reflected in the new FTSE CDP Carbon Strategy indices. These follow a comprehensive range of non-market cap weighted “strategy” indices which FTSE has been pioneering in partnership with a range of specialist and academic organisations.

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Simon Thomas: Many approaches to sustainable index investment seek to reduce exposure to negative sustainability factors or increase exposure to positive sustainability factors. Almost universally, this is done through positive or negative screening; this can lead to additional volatility and risk relative to standard benchmarks.

Trucost has shown that there is a different way of doing this, which does not involve positive or negative screening. Low carbon indices simply rebalance stocks based on carbon efficiency across sectors. This adds value to investors either through outperformance as regulatory costs are imposed on companies or beta performance with reduced risk. Furthermore, such outperformance or risk reduction is accurately quantified and can be correlated to financial outcomes.

Emma Hunt: At risk of over-simplifying, we note differences in sustainable investment philosophies being between those seeking to align investments with investors' values, isolate and take advantage of an ESG premium and those wanting to capitalise on thematic beta.

Some indices e.g. carbon or climate change indices may also be a tool for investors, as opposed to an investment vehicle.

Indexed solutions can offer investors a number of advantages over actively managed funds. Typically they are simple to understand, transparent in their process and results, offered at reasonable cost, easy to access and influential levers for change. ETFs are worth mentioning as they can offer affordable exposure to an index in a way that can easily be accessed by (primarily) retail investors.

Towers Watson would add a few notes of caution to investors considering index solutions. Investors may be giving up a stock picking, alpha return opportunity; reducing their ability to capture quick-moving market developments and putting themselves at greater risk of investing in over-priced assets resulting from pricing bubbles. We also note that indexed solutions have traditionally favoured mature markets with less inherent risk and volatility. As sustainability themes and markets are still evolving, these are yet to be considered mature markets.

Will Oulton: The key to the success of sustainability indices is identifying and capturing the best investment themes, producing high quality research and ensuring that the data that drives the selection process is robust. The same issues apply whether the approach is a sector-screened or a tilted weighting factor approach. If the combination of design, construction and rigorous governance coupled with high quality data input can be achieved, then the indices can

be extremely helpful in performance attribution and analysis and provide tactical asset allocation opportunities as well as broad benchmark use.

They can also be used for more progressive strategies such as combining long and short positions to fine-tune specific exposures.

Rory Sullivan: There are two questions that investors need to answer to. Is my money really being invested in “sustainability-related” areas and what does it cost?

Osmosis’ Climate Solutions Index (an Exchange Traded Fund) provides a good illustration of how well designed indices can address both of these questions. In relation to the former question, the Index can only invest in companies that generate more than 50% of their turnover from climate change solutions and related activities (e.g. renewable energy). That is, the 100 stocks held in the fund are all explicitly leveraged to the Green Economy Theme. It is also relevant to note that the fund has significant leverage to the Emerging Market Technology Champions Theme, with typically 30-40% of the stocks held in the fund coming from these markets.

In relation to the latter question (i.e. the costs of investor), because the Climate Solutions Index is a quant fund, the transaction and management costs of getting diversified access to the Green Economy Theme are kept to a minimum.

3. Where are you seeing demand for sustainable index investment opportunities coming from? Are there groups of clients that are particularly interested?

Rory Sullivan: The demand that we are seeing for sustainability ETFs reflects the wider market interest in the sustainability/green energy space.

What is interesting is that the queries we are receiving – in particular from institutional clients – are not confined to the specifics of how exactly we access sustainability themes or the stocks that we invest in, important though these are. These investors are interested in how they can manage and mitigate the operational and other risks associated with these stocks, and how they can work with us to promote responsible investment more generally. We are receiving an increasing number of questions about how we vote our holdings, how we engage, how we collaborate, how we work with policy makers and about the support we can provide to clients in relation to their responsible investment strategies.

Will Oulton: One area of demand which should increase is in the customisation of indices according to specific client mandate requirements. We have seen clients take various approaches to sustainable investment ranging from specific dedicated sustainability mandates, to more process orientated applications that typically ensure greater clarity around investment policies by determining how their investment beliefs should be executed and reported by their asset managers.

As the debate around stewardship, corporate governance and responsible and sustainable business practices continues, asset owners will look for a range of approaches to ensure that they continue to meet their stated obligations and commitments and, in the case of larger public funds, avoid any public relations risks.

Simon Thomas: Trucost is seeing strong demand from large asset owners. There are three major reasons:

Firstly, universal owners have widely diversified portfolios. Companies that externalise costs to the detriment of others are "robbing Peter to pay Paul"¹ from this perspective.

Secondly, reports by UNEP FI² and Mercer³ assert that pension trustees have a fiduciary duty to address the financial risk posed by climate change to investment returns in their portfolios. This view is gradually gaining precedence.

Finally, the credit crunch showed that value-at-risk models did not reflect the true nature of the systemic risk. Trucost believes there is a movement to incorporate systemic risk into quantitative models. Climate change is a systemic risk and demand for carbon data is growing rapidly. "We cannot be certain (until it is too late) that continuing to emit carbon at our current pace will lead to disaster; but we do know that the chance of a catastrophic outcome is high enough to make insuring against worst-case scenarios the rational response. Surely the financial crisis has taught us that a low-probability tail risk is still a risk."⁴ Trucost has proved that reducing systemic carbon risk does not reduce financial performance. A number of leading pension funds are now significantly investing.

David Harris: The range of clients using FTSE RI indices is extremely broad across regions and market segments. However there are trends in demand. In Japan for instance, there is particular interest in environmentally themed indices; in the US the focus is on environmental technology, whilst in Europe the interest is much broader across all RI approaches. Much demand is led by public pension schemes but we are seeing increased interest now from

corporate schemes too. There are also increasing numbers of ETFs allowing easier access to index investing for smaller institutions and retail investors.

The FTSE4Good Series was launched in 2001 and over ninety clients have used the indices for the basis of structured products, tracker funds, ETFs and as a performance benchmarks. The environmental thematic indices are more recent, but the investor base for this is steadily growing. A number of pension funds including AP7 and NYSCRF have used the indices to gain exposure to the environmental technology market. There are three ETFs using the indices, and it is used as a performance benchmark by a range of active environmental technology funds.

Emma Hunt: The large majority of Towers Watson's clients are large corporate pension funds. To date we have not seen much money flow into sustainability funds from this group, be they actively or passively managed funds. But there are early signs that this situation is beginning to change.

In the corporate pension fund world, we believe the demand is more likely to come from the following sources. Firstly, corporate pension funds that have a strong bias towards indexed funds across their entire investment structure.

Secondly, defined contribution schemes that favour the easy-to-understand, good availability, and reasonable cost characteristics of indexed funds. In addition to this we recognise the growing trend to offer members of defined contribution schemes choice, and sustainability options often play a part here, especially in the light of an increasingly sustainability-aware consumer.

Finally, pension funds whose sponsor has a strong reputation in sustainability may well be the early movers.

Thomas Kuh: A growing number of institutional asset owners - pension funds, sovereign wealth funds, foundations, endowments - believe that ESG factors are material to their portfolios. They seek to avoid risks, identify opportunities, and capture financial performance by integrating ESG in their investments. Many institutions, as universal investors, support policies to help markets internalise external costs with an eye towards long-term risk profiles, not just short-term returns.

High net worth investors and family offices are a steady source of demand for ESG. Demand for values-based ESG indices also comes from investors seeking to invest in companies consistent with their moral tenets or personal beliefs, and from institutions (e.g. environmental and human rights groups) seeking investments congruent with their missions. These mandates are often satisfied by custom indices.

Asset managers' demand for sustainable indices is growing as they seek to meet client mandates, integrate ESG into their investment process and benchmark the performance and quality of ESG portfolios.

With initiatives like the United Nations-backed Principles of Responsible Investment (PRI), asset managers need tools to implement ESG integration and reporting. Some MSCI ESG indices are designed to define ESG beta, and we are developing tools to measure ESG quality, i.e. a portfolio's ESG score relative to an MSCI ESG index.

4. What do you perceive as the barriers to further growth in sustainable index investment?

David Harris: One issue for investors is transparency. Indices need transparent methodologies. There is a danger that indices using opaque assessment approaches may affect the sector's reputation. It is important for all providers to be clear on index methodologies and how securities are assessed on ESG factors.

Another barrier for ESG integration is data quality. Company ESG reporting is often still inadequate for high quality analysis. Too many companies do not provide ESG data, and the data that is available often does not allow for reasonable comparison.

Some argue stewardship is difficult with index investment and hence is a barrier, because the manager, who typically implements the voting strategy, is not in a position to divest. Therefore, the argument goes, it is harder to influence company practices. However our experience has shown that company practices can be directly influenced through indices. New tougher environmental and social criteria are periodically introduced for FTSE4Good. FTSE contacts CEOs of constituent companies to explain new criteria and timelines. The transparent criteria, specific deadlines and FTSE's market position have resulted in hundreds of companies improving ESG practices and disclosure to remain included in FTSE4Good. Company feedback is that it's easier to engage an index provider representing many investors.

Rory Sullivan: Investor interest in the sustainable/green investment space is now quite mature; there have been significant inflows into funds targeting this area. There has also been a significant growth in investors' use of ETFs, because of their liquidity and relatively low cost. However, as yet, investors have been relatively slow to use ETFs to access opportunities in the sustainability area. This is changing quickly and it is likely that in 12 months' time, accessing

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sustainability themes through an ETF will be seen much as accessing these themes through specialist actively managed funds is today.

There is a more important issue which – while not a barrier today – is central to the longer term success. Our research has found that many smaller companies do a poor job of explaining to investors how they are managing their environmental and social issues. First, the lack of disclosure potentially indicates a lack of management focus on these business risks. This, in turn, creates risks for investors in the specific stocks and may even undermine investor confidence in the sector as a whole. Second, the lack of disclosure may limit the investor base for these stocks. As an increasing number of investors make commitments to responsible investment, it is more likely that companies will be expected to have robust operational management systems in place and be able to demonstrate the effectiveness of these systems before they can be considered for investment.

Emma Hunt: The elephant in the room is asset allocation. Until investors start to seriously consider sustainability within their asset allocation process, and how they want to incorporate it, any exposure to sustainability will be around the margins.

Traditionally sustainable investing has been confined to a separate asset class, with the decision to allocate assets being relatively binary – to invest in funds or not. We believe that this is too simplistic. Sustainability can also be considered as an overlay to existing asset classes and allocation. For example, there are ESG factors *within* equities, infrastructure, real estate etc. The decision is no longer binary. The question then arises as to how this is handled in the asset allocation process? At Towers Watson, we believe the answer lies in exploring and articulating your view and investment beliefs around how sustainability issues will play out in investment markets and across asset classes. Once these are established, a more appropriate integration of sustainability into the asset allocation process will occur. Depending on the beliefs and characteristics of the investor this might be via an active or passively managed product. Indices may also be a useful tool for implementing, or measuring the impact of such an approach.

Thomas Kuh: One significant barrier to the growth of sustainable index investing is the lack of broadly accepted sustainability standards and disagreement over the definition of sustainability. This poses a challenge to creating widely accepted standards for sustainable investment research and indices. However, the increased adoption of the PRI principles may be the first step towards a more standardised definition of sustainable investing.

The limited availability of information beyond large to mid-sized companies in developed markets may restrict the application of sustainability criteria across the global investment

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opportunity set. Coverage of emerging markets and smaller sized companies in developed markets has proven to be relatively challenging so far.

Finally, the growth of sustainable index investment will depend on the ability of ESG investing to establish itself as a long-term investment trend. Many investors seem to view ESG investing as a niche market and have not yet recognised the potential financial benefits of fully integrating ESG considerations into their investment processes.

Will Oulton: There is still a great deal of education of trustees to be done around sustainable investment in general and sustainability indices in particular. Most trustees currently, on average, spend less than an hour a year dedicated to corporate governance and sustainable investment issues so the time budget is very small therefore having trustees aware of the subject is key for effective decision making. In addition, the quality of research and ESG information generally, although improving, still has some way to go to before becoming widely accepted by investors.

Simon Thomas: In a study for WWF⁵, Trucost found the barrier to considering climate change was, “the lack of visibility about where government regulations were going globally.” This has been somewhat abated by the EU Emissions Trading Scheme but permit prices are still too low to represent a material cost to most companies. Therefore carbon costs have not yet significantly impacted investment returns. Concerns about the future of carbon markets have undermined investor confidence that regulatory action will match regulatory rhetoric. US cap and trade proposals are now almost completely stalled.

Growing public interest in sustainability has coincided with the loss of confidence in financial markets and retail demand for sustainable investment remains nascent.

Portfolio managers prefer unconstrained investment choices. Sustainable investment has traditionally been associated with negative screening, restricting choice and therefore discouraging fund managers. Another disincentive is that while several studies link sustainability factors to increased returns, the evidence is not yet overwhelming. Fund managers often prefer higher margin active investment and sustainable investing is not presently a significant source of alpha. Management fees on passive investments are very low; even modest sustainability research costs can dramatically increase overall costs.

Finally, there is a perceived disconnect between sustainable investment professionals and portfolio managers since sustainable investment staff seldom manage money.

5. What are your expectations for the future direction of sustainable index investing? And what needs to be done to get us there?

Will Oulton: Our belief is that sustainability as an investment theme and approach will increasingly feature in our discussions with clients. Over time, we expect an increasing number to adopt a range of strategies to reflect these discussions. The challenge remains regarding the quality and range of data, its integration into analytical platforms and the limited range of asset classes covered by both data and index vendors. Areas such as sustainable infrastructure and property are as yet to see any significant index developments.

These challenges are also relevant to global index vendors as their products are important tools used by both clients and their selected managers, in implementing sustainability strategies and in measuring their success or other, over time.

Simon Thomas: Trucost expects growth and diversification in sustainable index investing as government acts to drive the transition to a more sustainable economy through the creation of green investment opportunities and implementation of “polluter pays” regulation.

In the UK, government has moved to unlock the investment needed to deliver a low carbon economy by proposing the creation of a Green Investment Bank (GIB). A key theme proposed by the GIB Commission is the creation of green ISAs, which would direct investment to ETFs and other retail orientated investment vehicles which track, “green/low carbon indexes. For example ETFs for large companies with low carbon emissions compared with others in their industry sector.”⁶

The implementation of “polluter pays” regulation forcing companies to internalise their environmental costs, will increasingly allow sustainable index products to demonstrate alpha. As other sustainability issues gain traction, sustainable indices will diversify. For example, Trucost data is also able to drive low water, low waste and low pollutant indices.

NGOs and industry groups such as UNEP FI, TEEB and PRI will continue to play an important role in driving sustainable investing by providing compelling research on the impact of business on sustainability.

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David Harris: Important initiatives such as the PRI and CDP are receiving substantial backing. This is prompting asset owners to consider ESG capabilities in asset owner manager selection processes, although this tends to be centred on active management. A major focus going forward will be incorporating ESG considerations into passive strategies.

There is also a growing need for more appropriate performance benchmarks to measure active manager performance. This is to ensure that the performance measure reflects the manager's ability to be able to add value, distinct from the investment theme or approach.

The ESG indices which FTSE and some of our peers offer are becoming increasingly sophisticated and there is an ability to meet requirements for customised approaches to meet specific mandates or investment strategies. This allows multiple investment objectives to be met, and can support both active and passive approaches.

Fifteen years ago, if you asked a large listed company about its approach to sustainability you would receive a confused response, but today most companies understand the business case. The investment community is in a similar position. In fifteen years time sustainable investing will be a core component of the investment landscape, and indices will play a crucial role in this transformation.

Rory Sullivan: Over the short term, the scale of investment in sustainable indices is likely to continue to grow, in line with the broader market trends in this area. The biggest challenge will be maintaining the credibility of the investment thesis over the medium to long-term. This requires that we, as investors, take action in two areas. First, we must work ensure that the companies in which we are invested effectively manage all of their social and environmental impacts, and proactively communicate their performance on these to their investors and to wider society. Second, we must work with government to create the right conditions – appropriately long-term policy frameworks, clear incentives, well structured institutions – to enable us to move much more quickly to the low-carbon sustainable economy of the future.

Thomas Kuh: Sustainable investing is an investment strategy applicable across a range of asset classes. In addition to the creation of ESG benchmarks for multiple asset classes, we also expect to see the creation of ESG index-based derivatives.

Investors want to understand more about the materiality of ESG factors. Developments in ESG research and analysis will facilitate this discovery and in establishing market standards for defining and measuring sustainability. Increasingly sophisticated ESG research will contribute to better ESG indices.

It is likely that questions about the performance of sustainability investments will persist despite evidence that incorporating ESG factors does not hurt – and might help – returns in the long run.

As investors embed the materiality of ESG factors into their expectations about changes in an investment's value, the market will generate opportunities for arbitrage around ESG performance. As a result, ESG indices could ultimately converge with standard market benchmarks. Until then, their role is to provide investors with a means of integrating ESG into their investment processes and to provide historical insight into of ESG's impact on risk and returns.

Emma Hunt: In the words of Niels Bohr, "Prediction is very difficult, especially if it is about the future." But if we were to hazard a guess as to what might happen and how we might get there, we look to three points.

First, the defined contribution market will prove to be a strong driver for the sustainable index investing. Continued supply of low cost and easy-to-understand products across the spectrum of sustainable investing will help to facilitate this. In addition greater financial literacy will be crucial if investors are to feel confident to make their own choices about their investments.

Second, as sustainability factors play a more explicit role in characterising investment risk value, and a more convincing "sustainability premium" starts to emerge, indexation products that can successfully isolate and take advantage of this sustainability premium will provide an important opportunity for investors seeking exposure to this opportunity.

Third, we envisage that indices, such as carbon indices, will play a larger part as a tool for investment – for example, as a tool for identifying risk or opportunity or as a measurement tool – alongside its more traditional role as an of investment fund.

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Sustainable Index Investing

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FTSE Group is a world-leader in the creation and management of indices, working with investors in 77 countries globally. It calculates and manages a comprehensive range of equity, fixed income, real estate and investment strategy indices, on both a standard and custom basis. FTSE has collaborative arrangements with a number of stock exchanges, trade bodies and asset class specialists worldwide.

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Glossary

CDP - the Carbon Disclosure Project is a global corporate climate change reporting organisation that acts on behalf of 534 institutional investors, holding \$64 trillion in AUM. www.cdproject.net

TEEB - the Economics of Ecosystems and Biodiversity is a major international initiative to draw attention to the global economic benefits of biodiversity. www.teebweb.org

UNEP FI – the United Nations Environmental Programme Financial Initiative is a partnership between UNEP and the finance sector that works to understand the impact of environmental and social considerations on financial performance. www.unepfi.org

PRI – the United Nations-backed Principles for Responsible Investment is an initiative and set of aspirational and voluntary guidelines for investors. It has over 800 signatories. www.unpri.org

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