Focus

Reconciling ETFs and Responsible Investing

The popularity of Socially Responsible Investment (SRI) shows no sign of slowing. Global assets under management grew by 36% to 2017 from 2015. And over the first eight months of 2018, assets have reached €610bn outstripping 2017 total of €555bn[1].

While the value of AUM in the US is a third a size of those in Europe, expansion is as rapid (at roughly 30%) on both sides of the Atlantic.

As investors become more comfortable with the concept of SRI, they become more demanding. They want sophisticated options which implement these criteria effectively across their entire portfolio.

Asset managers can meet this demand by embedding these characteristics in their passive portfolios and taking advantage of the voting rights to act as concerned stewards of these assets. Amundi has recently enhanced its product offering to enable investors to combine responsible investment with ETFs.

Defining responsible investment

Despite its popularity, responsible investing is still complex to define. Does it mean integrating Environmental, Social and Governance (ESG) factors into a screening process? Or should companies, like arms manufacturers, be avoided? And what duties do investors have as responsible stewards of their assets?

Any commitment to this style of asset allocation requires a clear investment philosophy. A good starting point is to evaluate companies systematically using a rating system based on Environmental, Social and Governance criteria. This can be implemented for publicly-listed companies as well as corporate bond issuers.

For example, a company's impact on its environment should be assessed to determine if it is actively managing the risks associated with climate change. How well a company manages its staff and its clients also needs to be analysed as well as evaluating its corporate processes to determine if it is well governed.

Mapping these factors enables an investor to determine which businesses are likely to be sustainable over the long-term. These metrics give greater insight than financial metrics alone.

Investors can also use their voting rights to act responsibly on their assets.

But how can these levers be applied to indexing management? ■

Applying SRI to index investing

Contrary to conventional wisdom, index management is compatible with responsible investment. The first stage is the voting policy. Amundi has a dedicated team which votes on behalf of its clients for all its passive and actively managed products. The firm's size and scale makes it an effective influencer.

The next stage is to screen systematically individual stocks for ESG characteristics. This is now possible because there is far more data on ESG today than there was some years ago. Companies from around the world can be screened against a broad variety of different characteristics.

As a result, index providers can now respond to investor demand by producing more sophisticated indices. For example, MSCI has used its large ESG data services to develop its SRI index range. This has been selected by Amundi as a benchmark for its equity (MSCI US SRI, MSCI Europe SRI, MSCI World SRI and MSCI Emerging Markets SRI indices) and fixed income SRI ETF range.

The methodology of the MSCI SRI index family is designed to exclude those stocks which are known as 'ESG controversies'. That includes those firms which are in breach of international norms such as the UN Global Compact.

The benchmark also excludes stocks participating in 'controversial activities' such as manufacturers of civilian fire arms, conventional weapons, gambling, genetically modified organisms, nuclear power, tobacco, alcohol, thermal coal or adult entertainment.

The remaining stocks are only included in the index if they have a minimum ESG rating, which is determined by systematically screening against these criteria.

Once this screening has been carried out, each sector will be reconstructed using only 25% of the stocks of each individual universe by selecting those with the best ESG score. As a result, the index narrows the investable universe to around 400 stocks from a total of 1,600 in the case of the MSCI World universe. ■

1. Source: Broadridge Financial Solutions - FundFile, open-ended funds worldwide, August 2018

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STOCK UNIVERSE		The constituents of the MSCI Global Investable Market Indexes
ELIGIBILITY		The MSCI SRI Indexes use company ratings and research provided by MSCI ESG Research to determine eligibility for index inclusion.
EXCLUSION	ESG Controversies	Red Flag
		Controversial Weapons
	Controversial Activities	Business activities excluded from the MSCI SRI Indexes: • Civilian Firearms • Tobacco • Alcohol • Adult Entertainment • Conventional Weapons • Gambling • Genetically Modified Organisms • Thermal coal • Nuclear Power For further information on tolerance levels, please consult the MSCI SRI Indexes Methodology document available on www.msci.com
SELECTION	Min ESG Rating	"B" - "A" (new constituents)
	Min ESG Controversy score	"4" (new constituents)
	Stock Selection	25% of each sector with the best ESG score

Investing responsibly in corporate bonds

It's possible to apply similar investment criteria to corporate bond indices. Not only does this make sense as it helps to identify more specific factors which could have an impact on a company's credit risk, it also allows investors to take a consistent approach across their portfolio.

Amundi's SRI ETF range includes two bond ETFs, namely on Bloomberg Barclays MSCI US Corporate SRI and Bloomberg Barclays MSCI Euro Corporate SRI Index.

These benchmarks combine Bloomberg's and Barclays' expertise in corporate indices with MSCI's ESG research capabilities. They offer a way to invest responsibly in the corporate market both in Europe and in the US.

Like the MSCI SRI equity counterparts, these indices do not invest in companies involved in alcohol, civilian firearms, gambling, military weapons, nuclear power, tobacco, thermal coal, adult entertainment, and genetically modified organisms.

They also incorporate an additional 'controversial activities' and a minimum ESG score filter. This produces a socially responsible investment in corporate bonds, which despite excluding stocks, has a very low level of tracking error compared to reference benchmarks. This makes it possible to use these ETFs as a core allocation. ■