Getting smart with sustainability

Francesca Fabrizi speaks to David Harris, Head of ESG at FTSE Russell, about how sustainable investment is coming to the fore

The investment world has changed and sustainability has finally moved into the investment mainstream. Why is this happening now?

You are right, it's changed hugely. When I joined FTSE almost 15 years ago, when we launched the FTSE 4 Good Index Series, this was a niche area and it was really of interest mainly to retail investors, very few institutional investors and that has changed completely.

A lot of that has to do with the views on fiduciary duty turning 180 degrees. Fifteen years ago the view was that looking at environmental, social and governance (ESG) factors from an investment context was potentially a breach of fiduciary duty, in that these were somehow ethical non-investment related topics and that's changed now. There is an increased understanding that these are highly relevant for investment, but it's a matter of identifying what are the relevant ESG themes and how they apply to different companies across different sectors.

For example, for a mining company community relations could be important because strikes can cause mine shut down; for an engineering company, health and safety is very relevant; and climate change is a topic that will have many effects across a huge range of industries.

The Governor of the Bank of England Mark Carney in a recent speech at Lloyds talked about three risks to financial stability from climate change - physical risks, liability risks and transition risks. A lot of institutional investors are looking at that and asking: "What does that mean for our asset allocation, for our portfolios and how can we start to think about these ESG and climate risks within our investment process?"

You mentioned 'transitional risk' in your answer – could you explain more?

The global economy has been through a number of different industrial cycles, and some leading economists think we are about to enter or are already entering a period of industrial change, which links to the transition to a low carbon economy. This is going to have an impact both within sectors and between sectors – so companies which are more efficient relative to their sector peers, which are positioned well to compete, but also new green sectors of the economy are emerging.

A lot of people when thinking about this area tend to think about pure play renewable energy companies and that's only one small part of this. We've gone through a process to develop a low carbon economy industrial classification system, with 60 green sub-sectors, and we have been through a painstaking process of mapping the revenues from over 10,000 companies across these sub-sectors, to try and get an understanding of how companies' revenues are changing, how their industrial output is changing, and how this transition to a low carbon economy is starting to take place. That data can be used to understand a portfolio, to understand exposure to these green sectors but also we are seeing it being used to inform index construction as well.

Sustainability is a catch all term for a raft of different approaches. How do you at FTSE Russell think about it?

We see a huge amount of confusion over the definition of sustainable investment. We think there are two fundamentally different ways to define this. One is what typically gets referred to as ESG - this is about how companies operate, how efficient their operations are, how well governed they are, how they interact with different stakeholders.

The other side is more about companies' goods, products and services, and the revenue they generate from those, so this is more industrial classification systems, sectors, sub-sectors and measuring the revenues associated with those.

So we provide two different types of data sets, one around ESG ratings where companies get an overall ESG rating and we break that down into environmental, social and governance and that breaks down into 14 themes for example health and safety, anti-corruption, tax transparency, climate change, water use etc.

Then the second type of data is regarding the goods, products and services; this area is looking at green revenues. So we have a taxonomy of 8 sectors, 60 sub-sectors, 7 years' worth of history where we have then been mapping the levels of revenues that companies are deriving from these different industrial low carbon sectors.

FTSE Russell has coined the term Smart Sustainability –what does that actually mean?

Over the last 15 years we have seen two different trends, one around alternatively weighted indexes. We launched the FTSE RAFI index more than a decade ago and this was one of the first alternatively fundamentally weighted indexes which grew in market usage over time. It took a number of years before institutional investors started making significant allocations based on alternatively weighted smart beta type approaches.

The other trend we have seen is on ESG, from the launch of the FTSE4Good Index Series years ago, to now, it has been a major focus for institutional investors and what we have started to see is these two worlds coming together. So we have developed a building blocks approach, both in terms of the risk premia factors - so we cover volatility, value, size, quality, momentum, yield - and at the same time we also have a focus on ESG and sustainable investment parameters, and being able to break those down into sub-parts.

What you can then start to do is bring these together into a single index design. What we are seeing from a lot of asset owners and asset managers is them wanting to reflect different investment beliefs, and in thinking about how these are going to affect investment returns, and in order to be able to design an index which in their view should deliver better risk adjusted long-term returns, now you can start to try to combine these factors and these parameters into a single index.

You recently won the Pensions Age Index Provider of the Year award. Your submission focussed on your FTSE Ex- CW Climate Balanced Factor Index. Could you expand on this?

The HSBC Bank UK Pension Scheme was taking our ESG ratings and they were using those in their active manager monitoring meetings. So they were meeting with a manager, they would sit down and they would look at our ESG data on the fund and they would be able to ask them quite detailed questions about ESG exposure of the fund. They'd been doing that for a number of years and we had in the past talked them through our ability to bring together certain sustainable investment parameters with risk premia factors into an index. Mark Thompson, the CIO, then called me in January last year and said that he wanted to try and work with us to build such an index. So we went through a process which took us over 11 months, working with HSBC Bank UK Pension Scheme and also with Redington their consultants and Legal & General Investment Management, the manager they had selected, to be able to design an index that did this.

They had very strong investment beliefs on four specific factors - value, size, quality and volatility - but they also had strong beliefs on climate change, that climate change was going to have an economic impact on the value of companies and they wanted that reflected. Plus, they didn't want to focus on just one climate parameter, but they wanted a comprehensive approach looking at reserves. There is a lot of debate around so called stranded assets, so they wanted that reflected.

They also wanted to focus on carbon emissions, and the costs associated with high levels of carbon emissions; and thirdly, this change to a low carbon economy and a focus on companies which are generating green revenues from exposure to green sectors.

So based on those three climate parameters and the four risk premia factors, we were able to put together a single index design and they now use this for their DC equities default fund, which is really interesting. In the past, we have seen this with public pension schemes and I guess, in the back of people's heads, they were perhaps always wondering whether there was a public good element for doing that, but here is a corporate pension scheme for their default fund saying, "actually climate change is going to have an impact on the value of companies and we have a fiduciary duty to consider that and build that into the index design".

So I think this is a really exciting development and we expect many other pension schemes, both DB and DC, to start to follow that approach.

To view this video interview in full, please visit pensionsage.com

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