INTERVIEW

How are investors approaching sustainable investment?

FTSE RUSSELL CONVENES

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Interviewed by

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Jamie: Tony, it's always great to have a conversation with you. So thanks for joining us today.

Tony: Great to be here.

Jamie: The last time we spoke was a few years ago, so I wondered if you could just give us a bit of a summary of ESG was so in the limelight in 2020 and what you think the pandemic did to it and where we are today.

Tony: So, where we are today, I think is a growing realisation that ESG just isn't a one size fits all kind of term. Really I think we would talk more about sustainable investment as an umbrella term, and within that we see probably three approaches our clients taking. One is ESG integration, which probably mostly aligns with what you're sort of thinking of ESG and the journey that we're all on. And that's definitely about, you know, looking at companies, environmental, social and governance related risks, how they're managing those, how well they're managing those. But that's a little bit distinct from two other categories that we see many of our clients focusing on. One is the traditional exclusionary approaches, which is a little bit less about risk management and more about, you know, what are the things I don't want to invest in because they don't align with my preferences or beliefs. Maybe avoiding tobacco or weapons or fossil fuels. That's still very common and is probably the longest running approach in this sustainable investment kind of area. And then the third is where we're seeing a lot of innovation is climate related and green focused investing. So kinda that E in ESG. You know, that's driven often by a lot of our institutional investors that are focused on, you know, navigating the transition to a low carbon economy. What does that mean for their portfolios? And how can they as a universal owner often, you know, help deliver returns that reflect their beliefs around the low carbon transition.

Jamie: So you mentioned there about a higher demand for those people who are looking to invest as the world is moving towards this greener economy. How are you looking to re-engineer indices to sort of give more weight towards those companies who are embracing that transition?

> **"We've done a lot of work trying to measure, identify and classify the global green economy"**

Tony: Well, it sort of has to happen in the context of what the index is originally designed for. So, you know, many times these investors, usually large asset owners, are using the indexes as an allocation tool to core equity or fixed income allocations. So there's an existing pool of capital already tracking the traditional benchmark index. Now, the re-engineering has to come in within the constraints of not totally, you know, disrupting the existing allocation model, risk return profile of that index. So for example, if we look at a US equity index like the Russell 1000, and we work with some large asset owner clients that have organisational beliefs and objectives around the transition to a low carbon economy, how would we help them re-engineer that Russell 1000 allocation to reflect the low carbon transition? So one thing we've done there is partnered with an organisation called the Transition Pathway Initiative or TPI, which is an asset owner led group that's trying to focus on this very question. They're doing it through data, through transparency, and through what I would describe as kind of an evolving framework of approaches. This is not something that we have a clear capital T truth answer to right now. We need a framework that can evolve. We need data sets that will be able to be applied in a way that can be dialled up or dialled down depending on your beliefs, your allocation, your geographic exposure, your risk appetite. So in that way we can maintain a broad market benchmark exposure, but in effect re-weighting towards companies that are better positioned for the low carbon transition and away from those that aren't.

Jamie: So the last time we spoke, we were talking about some of the hurdles that we all face in terms of actually deciding the level of ESG that a corporation has. Transparency and disclosures were issues. Is that getting better and is that helping people like you and others come up with a methodology and a benchmark, as you say?

Tony: Definitely getting better. Still a long way to go. So disclosure and data is kind of the raw material that feeds into any of this analysis. And oftentimes, you know, the bulk of that is coming from the corporate entities themselves, right? So they're describing to the market the issues that they have and how they're managing them. That often comes in a narrative based qualitative set of information. It's non-uniform in the way it's disclosed, how it's disclosed, who it's disclosed by. But there are some positive signs. Three that I would think of. One, the EU in particular has focused on a corporate disclosure regime that is still in draft form, but has the potential to be very stringent. The draft form has about 82 different indicators, things like greenhouse gas emissions, water, gender pay gap, also looking at things like third party auditing, and crucially the potential to impact non-EU companies as well, depending on your sort of scale of operations or size in the EU. So that could kind of set a global standard. Again, don't have the final rules just yet. In the US the SEC is still to finalise their proposal on a climate risk disclosure. Now that's very specific to climate as the name would imply.

Jamie: Yeah.

Tony: And a lot of anticipation on what that final rule will be. I know they had a record number of comments during the proposal period, over 15,000 or right around there. So a huge amount of interest and kind of we're a little bit behind the expected timeline of when that might get announced. But I think that reflects the importance that the SEC and investors put behind it. And the third is maybe most interesting, the International Sustainability Standards Board set up by the IFRS to kind of be an equivalent to the International Accounting Standards Board, which everyone kind of is used to working with in an investment context, but for sustainability metrics. So the objective there being kind of a global template for disclosure, you know, with really the potential to kind of give the markets a much more consistent global basis of information. But, you know, some years off, that work is really just kind of getting started. No matter what, the trends are all going in the right direction. And this is good news for investors who want better raw information to feed into the things like ESG scores, ratings indexes, or whatever analytics they're looking for. What we try and do is, you know, try and see where investors are most interested. Where can we find some consensus? As I said, there's always a range of approaches, but there's actually one area where I think we have found some consensus and taken some recent action where we looked at the concept of baseline exclusions for all of our sustainable investment indexes. Basically saying there's going to be a set of criteria, transparent rules-based data-driven criteria that we would apply across any sustainable investment index that says these types of companies that follow these criteria cannot be in the index.

Jamie: Straighten out.

Tony: Exactly. Now it's, you know, it's very nuanced. We're looking at like the value chain of different products and services. We're looking at revenue estimations and things like that. It's very targeted. So tobacco was on the list. Things like certain controversial weapons like landmines, cluster munitions, things like thermal coal were all on this list. We had a public consultation. We talked to clients, we got market feedback and there was broad support for using baseline exclusions. Most of our SI indexes, our sustainable investing index already had this covered.

Jamie: Okay.

Tony: Some did not. You know, maybe if you had a clean energy index or something that wouldn't necessarily have a tobacco screen a few years ago, if we were building it, now it will. And we're going to roll that out across the board. So, again, there's different approaches, but what we found, there's still appetite for this baseline exclusion concept, which would still reflect what we think to be in a baseline of consensus around sustainable investing.

Jamie: As we move towards a more global greener economy, lots of debate about how much energy we're going to need, where that energy is going to come from. We're going to need a lot more copper if we're going to go down that road. To what extent is that a hurdle to this sort of transition or this more ESG kind of focus?

Tony: I've definitely talked a lot about sort of the low carbon economy and the transition to that low carbon economy. And a lot of the clients that we're working with are approaching it from a risk management point of view. But there's an opportunity component to this as well that is very exciting for a lot of our clients. So we've done a lot of work trying to sort of measure, identify, classify the global green economy. And there's a really interesting story there. First of all, it's large and it's growing. So if we looked at the beginning of the year, we're talking about $8 trillion and about 8% of global equity market cap.

Jamie: Okay.

Tony: So it's substantial.

Jamie: Yeah.

Tony: Actually bigger than the oil and gas super sector in our industrial taxonomy. Now, that means there's already exposure to companies that have what we would call green revenues. And what I mean there is we've developed a taxonomy that has sectors and sub-sectors and micro sectors, just like traditional industrial classification systems, but are focused on green products and services. In that way it's a little bit more granular. What we found, we've researched about 16,000 public companies. There's really only about 3000 that have any green revenue whatsoever. But with that information, you can start to really identify, classify, and accentuate exposure to those green companies or that green revenue in your broader exposure. And the performance can also be measured as well, of course, if you want to look at different things. Now, the interesting thing is that it's a diversified group. Everyone would think, of course about windmills, solar panels.

Jamie: Yeah.

Tony: The energy transition is crucial, but it's not just about generation, it's about energy transmission, it's about energy efficiency technologies, also about things like water, pollution control, agriculture, and food. So it's much broader than you might expect. And the performance has been very compelling. Now, 2022 was not a very strong year for a lot of green stocks, especially if you were comparing it to the fossil fuel industry. So if I look at our, I would say most appropriate broad global benchmark for the green economy, it's called the FTSE Environmental Opportunities All-Share Index. It's about 700 names. What they have in common is 20% of their revenue is from green products as we classify it. But it's a big group, large, mid cap, small cap companies, emerging developed markets. Now, that was the worst performing sustainable investment index for FTSE Russell in 2022. About 6% worse than its benchmark. That came in the context of substantial growth since the start of the pandemic and even before. And even that bad 2022 couldn't offset the previous high. So really over the last five years, that broad benchmark still had 4% per annum excess return compared to the benchmark.

Jamie: You need to be giving perspective to these.

Tony: Exactly. And you could actually look at 2022 and say, you know, what is this long-term trend around the transition to a low carbon economy? You know, has that truly been disrupted and put onto a different path? I would argue no.

Jamie: Yeah.

Tony: And you could even say that maybe some of the sort of valuations in that sector have now been adjusted back to more of a normal trajectory. And in fact, if we look at Q1 of 2023, that same index, FTSE Environmental Opportunities All-Share Index was the best performing of all of our sustainable investment indexes.

Jamie: I just suddenly started thinking about nuclear then. To what extent could nuclear ever be like an appropriate form of energy? Could it be clean?

Tony: So when we classify green products and services, nuclear power is part of that classification structure. Now, we've been doing this for a number of years in terms of running a green industrial taxonomy. And what we realised some years ago is that we actually needed to iterate from the first version, and we needed to provide a little bit more precision because there are these questions around nuclear power, things like rare earth metals as well, which are crucial to delivering a lot of the like hardware type products that we need. But, you know, have environmental consequences in the way that they're brought out of the earth. And what we found is some clients were less comfortable in including those in their green portfolios, or in our case, green indexes. So what we decided to do was, in effect, in our taxonomy, our green sectors and sub-sector definitions, we put all these groups into tiers of effectively dark green, green, and light green. And in that way we can sort of say, all right, well nuclear, that's in the light green category, all things considered. So then when we build an index, like the one I referenced before, the FTSE Environmental Opportunities All-Share Index, we kind of don't include that light green category when we're tallying up the 20% revenue threshold that we're looking for each company. I see. But there's flexibility there because we've also worked with clients who are quite comfortable with nuclear and see that as a crucial technology as part of the low carbon transition. So you want flexibility, you want good robust data and then a flexible framework to apply it.

Jamie: Well, Tony, it seems that this is all evolving as the years go on and you're being able to get more and more granular and specific and have clearer and clearer benchmarks, which is helping, but seems like everything is moving in the right direction, at least.

Tony: I hope so.

Jamie: Tony, it's so, so great chatting with you. Thanks again for your time.

Tony: Thanks. My pleasure.

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