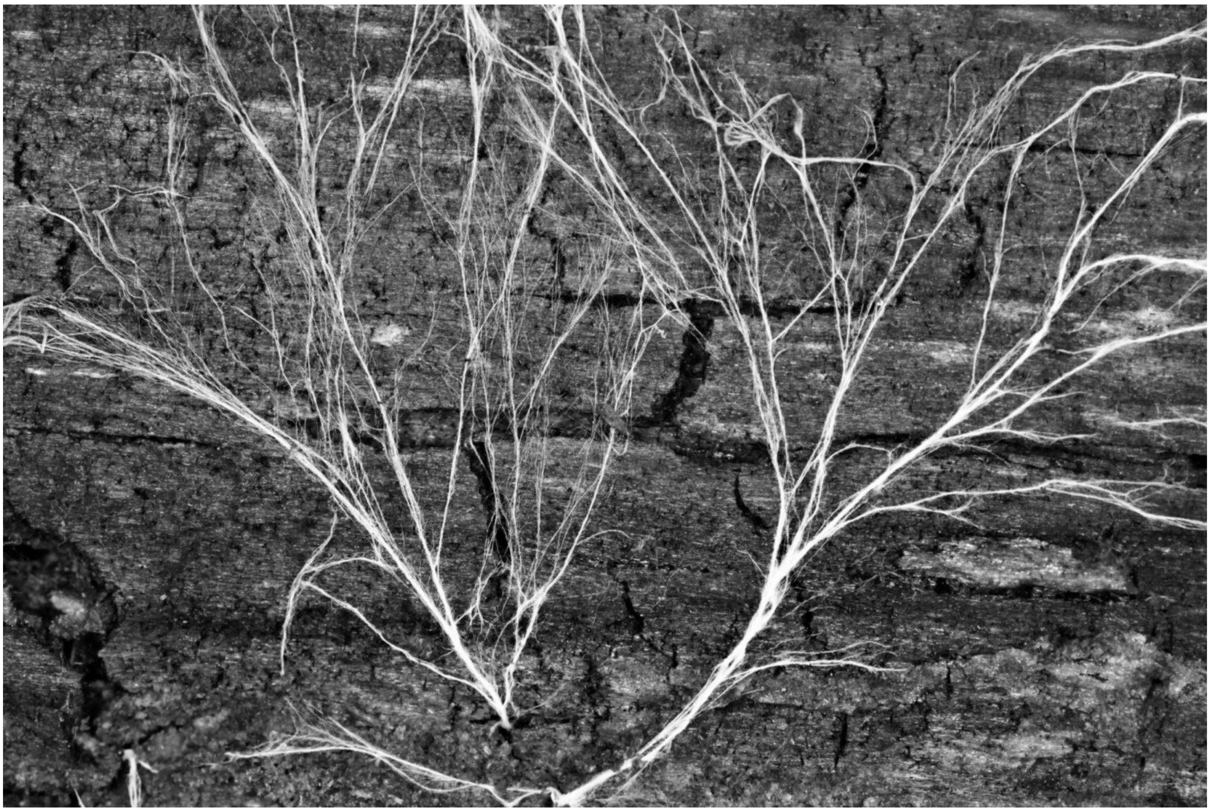

Green indices mushroom as investor interest grows

The variety of environmental benchmarks has proliferated from pure-play to broad market, smart beta and bespoke.

Sophie Robinson-Tillett

Environmental indices have traditionally been considered the remit of impact investors, with a few token allocations from bigger houses.

But, as climate change and resource scarcity begin to creep up the list of financial risks and opportunities, the index world has responded with a vast array of options for those looking to embed green themes in their passive strategies.

“There’s been a bit of confusion in the market around environmental thematic indices,” says Tony Campos, Director of ESG Product Management at FTSE Russell.

“There are a lot of preconceived notions that they are all just ‘pure-play’ clean energy strategies, so they’re often dismissed by asset managers and consultants. But there are much broader approaches in the market now – you don’t have to box yourself in.”

Tony Campos, director of ESG product management, FTSE

Of the four green sectors included in FTSE’s long-standing Environmental Opportunities and Environmental Technologies Indices, alternative energy has underperformed its benchmark over five years, but the other themes - water technologies, waste & pollution and energy efficiency - have all outperformed over the same period.

“And some to a pretty sizeable degree,” says Campos, pointing to the FTSE EO Water Technology Index which saw a five-year return of 81.8% compared to 57.1% from its benchmark, the FTSE Global All Cap.

HSBC’s UK pension fund

HSBC recently axed their Climate Change and Water indices and has “ceased coverage for the sector”, but the bank’s UK pension fund has taken a more bullish approach.

In November 2016, the £1.85bn fund caused a stir by announcing that the new default strategy for its defined contribution scheme would be the climate-titled Future World Fund run by Legal & General Investment Management (LGIM).

The specially-created fund uses the FTSE All-World Ex CW Climate Balanced Factor Index, which combines four factors (value, quality, size and volatility) with carbon reserves, carbon emissions and green revenues.

The latter is based on data from its in-house green revenues database, which calculates the proportion of revenue a company generates from goods, products and services across 60 “green” sub-sectors.

Smart beta

Unlike FTSE's more established environmental indices, it takes a 'smart beta' approach – allocating weights based on the climate and factor parameters rather than market capitalisation – on the presumption that these are where the opportunities and risks lie.

One of the key developments in environmental indices that has made them more viable for mainstream investment strategies is the "sector neutral" approach that many of the latest offerings take, and which gives the products bigger, more diversified pools of constituents than their predecessors.

The FTSE Opportunities and Technologies indices, for example, use the firm's green revenue data as a threshold for inclusion – so many companies simply don't make the cut – whereas its more recent Green Revenues index includes all companies, but gives a bigger weighting to those with higher green revenues.

The outcome is an index with no exclusions from the original universe, as opposed to the Environmental Opportunities index which ends up with just 500 holdings.

"In that way you get something that looks and feels a bit more like the underlying benchmark and appeals more to mainstream investors who are interested in gaining exposure to climate change themes, but doesn't want to deviate too much from the risk/return profile of the standard benchmark," says Campos.

"One of the key developments in environmental indices that has made them more viable for mainstream investment strategies is the 'sector neutral' approach that many of the latest offerings take, and which gives the products bigger, more diversified pools of constituents than their predecessors"

The other key innovation being employed is tracking errors constraints, which limit the amount an index can underperform its benchmark (outperformance has no ceiling).

FTSE's index does not use tracking error limits "because its methodology means tracking error is naturally very low", whereas MSCI's flagship carbon-focused indices do – and it's been a big selling point.

Low carbon

Launched in 2014, the MSCI Global Low Carbon Leaders and Targets indices have garnered backing from big names including AP4, FFR and Amundi. Key to their appeal is that they include mechanisms that keep performance within just 30 basis points of their benchmark.

“That’s important, because these kinds of low-carbon products are in demand from investors who want to hedge medium- to long-term climate risks without having to deviate from the market.

“These tracking error controls, and the fact that they address climate themes in a sector-neutral way, means that they can be used for core asset allocation,” explains Thomas Kuh, Executive Director of ESG Indexes at MSCI.

Hannah Skeates, who directs the thematic indices group at S&P Dow Jones Indices, says that this move towards integrating green issues into a broader universe is a growing trend, and one that has been helped both: by the widening debate around environmental risks, and by the increasing quality of data available to index providers.

Some investors interest in integrating these green indices stems from being bound by diversification constraints in their portfolios, others “are simply deciding they want to look at themes like carbon in relation to their whole portfolio because the theme presents potential risks and opportunities throughout their holdings,” she explains.

Future focus

Natural capital and resource scarcity look set to be the next focal points for integration, now that carbon has become a more established theme.

S&PDJI has an existing water index, for example, which comprises companies that participate in utilities, infrastructure, equipment and materials linked to water, but is now also looking at ways to incorporate water scarcity risk considerations into the development of new indices.

Responsible Investor reported last year that it was also seeking to create a hybrid offering that looks at water, waste and carbon in one product – a first for the provider.

Already combining multiple natural capital themes into one index is research and investment firm EFW Swiss AG. In October, the firm launched a UCITS fund based on its Energy, Food and Water Efficiency index, with initial commitments of €10m from high-net worth investors and external asset managers.

The index uses data from Trucost and Sustainalytics to calculate the potential for higher profits among more resource and energy efficient companies in developed countries.

Sectors that aren't exposed to water and resource intensity, such as financials, are automatically excluded, whereas those that are traditionally ruled out of "environmental" indices – namely, gas and oil – are included, on the basis that they are particularly highly exposed. Fossil fuel exclusions can be added as an overlay, however, if investors wish so.

"We're saying that in the context of resource scarcity and climate change, the environment is one of the biggest investment opportunities," explains co-founder of EFW Swiss AG, Benjamin Ergas.

"So our starting point is profits that come from good management of water, food and energy, and those companies that are providing innovative solutions to resource scarcity issues."

"We're saying that in the context of resource scarcity and climate change, the environment is one of the biggest investment opportunities"

Between its launch in January 2014 and January 2017, the index returned 19.4% – outperforming the MSCI World by 2.95% and its benchmark, the MSCI ex-financials, by 4.5%.

Recent innovations in green indices have focused primarily on how to make them a more viable investment tool for mainstream and core allocations. But for many investors the traditional impact and values-based indices are still the Holy Grail and offer a chance to do more than simply hedge risks.

"Many mission-driven investors need something that's a little darker green than the new wave of sector neutral, diversified approaches."

High standards

As this slew of new and complex options for investors develops, standards are expected to become a topic of conversation for the index world. "Some concepts that investors are interested in incorporating into indices, like green and social bonds for example, would benefit from having accepted standards," says S&P DJI's Skeates.

"That would be very useful to us as an industry, and it's positive to see the various task forces that are now out there looking at ideas around greenness and impact."

MSCI's Kuh sees the index providers as playing a role in creating those standards themselves.

"We regularly hear from investors that the market would benefit from having standards. We're working overtime to firmly embed our existing standards in the market place to evolve those standards and grow their adoption; because, in addition to making the market more accessible from a conceptual standpoint, that will make it easier for asset owners that are new to ESG to understand how to find strategies that meet their objectives."

FTSE's Campos believes that green indices will continue to become more sophisticated, with increasing hybrids of environmental and non-environmental aspects.

"There's a vast range of index innovations out there, and that will continue," he predicts.

"The surprising thing so far is how few products have been offered using those indices. I think that's the next thing to change: asset managers will begin catching up in terms of the thematic funds they're offering investors in the passive space."