HEALTH WEALTH CAREER

# A GUIDE TO RESPONSIBLE INVESTMENT INDICES

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In recent years, investor demand for responsible investment (RI) solutions has increased significantly, as observed by the growth of assets being allocated to RI-related investments. Combined with a shift toward low-cost equity index tracking, this has led to an increase in the number of RI indices that are now available. As environmental, social and governance (ESG) data become more readily available, higher in quality and more standardized, we expect RI indices to become an important first step in integrating ESG considerations for many investors with existing passive or factor-based investments.

Although we believe RI indices will have an important role to play for many investors, they are not passive investments and should be subject to due diligence. We have undertaken initial research on several RI index providers. Today, the majority of RI-indexed/benchmarked assets are tracking indices developed by index providers. However, asset managers are increasingly focusing on self-indexation using proprietary ESG ratings and developing solutions using their own intellectual capital. We believe there are many potential benefits to using this latter approach, making them equally worthy of consideration.

Our detailed paper on RI indices provides:

1. A more comprehensive view on the opportunity set of RI categories that are reflected in indices

2. Aspects to consider in index construction and the potential unintended consequences of selecting an index

3. The pros and cons of selecting an index provider versus a self-indexed solution through an asset manager

On the following pages, we provide a summary of these areas.

# WHAT RI INDICES ARE THERE?

The opportunity set of RI indices can be grouped into three main categories:

- Indices that **integrate** RI, incorporating ESG or carbon emissions data, for example, into the investment process to determine index allocations
- Indices that use **screening** to exclude certain investments based on a stated set of values or beliefs
- Indices that target thematic **investments** (exposure to sustainability themes) or positive impact investments (companies scoring well on ESG metrics at a product level) that may reflect the investors' stated beliefs

**INTEGRATION**

ESG integrated

- Broad market
- Best in class

Low carbon

- Broad market optimized
- Best in class

**INVESTMENT**

Sustainability themed

- Broad sustainability
- Focused thematic

Positive impact

- Global/thematic impact

**SCREENING**

Exclusions

- Negative screening

**STEWARDSHIP (VOTING AND ENGAGEMENT)**

Stewardship tends to be an overarching function of index management and can be undertaken by the asset owner or through an asset manager. Policies on voting and engagement are not typically set out by an index provider and will be driven primarily by the asset manager.

# AREAS TO CONSIDER WHEN SELECTING AN RI INDEX

Key reasons investors select RI indices include managing ESG risks and meeting explicit sustainability targets (for example, investing 10% of total portfolio in low-carbon assets by 2020) in a cost-effective manner as well as benchmarking their investment strategies against an RI index that better reflects their investment beliefs.

It is crucial for investors to have a clear (and documented) set of investment beliefs relating to sustainability and responsible investment before considering an allocation to an RI index. These are typically agreed upon in order to guide decisions on ESG integration, climate change and other topics around environmental, social and governance issues. Investors pursuing the indexation route should determine what responsible investment approach best reflects their sustainable investment beliefs.

Mercer's Sustainable Growth Framework provides guidance on developing sustainable investment beliefs, embedding these into policies and processes and allocating to investments that focus on ESG integration as a risk management tool — as well as identifying the opportunities that provide solutions to sustainability challenges.

Once those investment beliefs have been established, determining whether or not an index-based approach offers the most suitable way to protect against the ESG risks investors are trying to manage will be relatively straightforward. Those investors who are looking for an RI index solution should consider the following key areas:

### INDEX CONSTRUCTION

Index construction methodologies vary considerably, and unintended style and sector biases can result. When comparing index construction methodologies, investors should ask themselves whether this methodology aligns with their investment beliefs and broader approach to ESG integration and sustainability. Testing for unintended exposures or style biases is a worthwhile approach to determine this.

## CHOICE OF INDEX PROVIDER

What index provider is most suitable? There are hundreds of third-party ESG data providers offering ESG products. We have seen several major index providers developing ESG rating methodologies from which RI indices have been launched, and the quality and outpout of ESG research and ratings can vary substantially. Key questions to ask when selecting an index provider should include:

- Are investment philosophies aligned between the investor and index provider?
- How transparent is the index solution?
- What is the difference in index license fees among index providers?

In recent years, asset managers have increasingly sought to establish proprietary ESG ratings through which they can leverage their intellectual capital to develop index solutions. This sort of self-indexation can have a number of benefits, which we believe makes it worthy of consideration. Potential benefits include:

- Better alignment with sustainable investment philosophies
- Greater breadth of data sources
- Better reflection of stewardship, with clearer links to voting and engagement policies

## APPROACH TO STEWARDSHIP

Stewardship activities are typically undertaken at the implementation level (that is, in-house with the asset owner or through an asset manager). At the asset-manager level, this activity often sits within a central corporate governance team that votes and engages on behalf of overall firm (equity) assets under management.

Based on our experience in assessing passive asset managers and their approaches to incorporating ESG, we recommend that investors ask themselves the following four key questions when trying to evaluate a manager's stewardship capabilities:

1. How are the firm's stewardship activities aligned with its investment philosophy?
2. What is the voting and engagement process at the company, industry and regulatory levels?
3. What resources and expertise are in place to engage at the highest level?
4. What communication and reporting can the investor expect from stewardship activities?

## MERCER VIEW

We believe RI indexation can be a useful tool to manage ESG risks. Where clients are cost-constrained, these indices provide broad market exposure with an additional RI focus that can be aligned with investors' sustainable investment beliefs. However, where cost is not a constraint, investors should also think about allocating to actively managed investment strategies that integrate ESG factors and capture other sustainability themes.

The environment for RI investing is evolving quickly, and an appropriate solution for one investor is unlikely to be suitable for all — particularly in the world of responsible investment. Please speak to your Mercer consultant for more details on the various approaches to RI indexation and additional areas to consider when selecting and implementing an investment in an RI index.

# ABOUT MERCER

At Mercer, we make a difference in the lives of more than 115 million people every day by advancing their health, wealth, and careers. We're in the business of creating more secure and rewarding futures for our clients and their employees — whether we're designing affordable health plans, assuring income for retirement or aligning workers with workforce needs. Using analysis and insights as catalysts for change, we anticipate and understand the individual impact of business decisions, now and in the future. We see people's current and future needs through a lens of innovation, and our holistic view, specialized expertise, and deep analytical rigour underpin each and every idea and solution we offer. For more than 70 years, we've turned our insights into actions, enabling people around the globe to live, work, and retire well. At Mercer, we say Make Tomorrow, Today.

# HOW MERCER CAN HELP

Wealth and investment require sophisticated solutions. We offer research and advice on how to assess risk and design investment strategies while keeping in mind the need to optimize throughout changing times. Along with more than 140 manager researcher with in-depth knowledge of the complexities and ever-changing factors that impact investment, Mercer's consultants can help you make effective decisions that align with your business needs and ensure more rewarding futures for your employees.

For further information, please visit www.mercer.ca

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**Important Notices**



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