PICK PASSIVES FOR IMPACT

LOW COSTS AND A CONSISTENT APPLICATION OF ESG CRITERIA MAKE INDEXED PRODUCTS AN EFFECTIVE AND COMPETITIVE WAY FOR INVESTORS TO MAKE A DIFFERENCE

ALEXANDRA JANSSEN
Ecofin Portfolio Solutions

What motivates private and institutional investors to invest their assets sustainably? Specific goals might differ, but research shows that two objectives are generally prevalent: investors want to achieve a positive impact and they also want to optimise the risk/return profile of their portfolios by means of ESG criteria.

Both of these objectives can be reached most effectively and efficiently through the use of indexed investment products.

STREAMLINING INVESTORS' IMPACT

Many sustainable investors want to make a positive impact on the world by applying ESG criteria. Their rationale is that companies will want to align their business practices with sustainability criteria if this helps them to attract sufficiently large investment volume flows.

However, academic research shows that the impact of sustainable investing today is often insignificant or very low. This is especially true in large and efficient markets, such as large-cap equity and bonds.

One reason for this outcome is that the sustainability criteria applied by investors are very diverse. Therefore, even companies that want to align themselves with ESG criteria can find it impossible to identify which criteria are relevant to attract investors. As a result, the desired impact does not materialise.

One way to increase investors' influence is to narrow down the plethora of investors' ESG requirements into a consensus or industry standard. ESG indices address this challenge. They define a selection of variables according to which they evaluate companies' sustainability. These sustainability indices form the basis for many indexed investment products, which passively replicate them.

Therefore, a large volume of investors' assets is invested according to the same criteria. This in turn increases the incentive for companies to align their business practices with the indices' ESG criteria. The indices therefore act as a lever to investors' impact by pooling their assets according to the same sustainability metrics.

Consequently, investors seeking to achieve impact with their investments are more likely to do so through indexed investments than by investing in actively managed ESG products that apply their own proprietary metrics.

OPTIMISING RISK AND RETURN

Extensive research has shown that, in the long run, there is no significant difference between the risk/return characteristics of sustainable and traditional portfolios.

For this reason, investors should apply the same rules when implementing sustainable investment strategies as they would for traditional ones.

First, the portfolio should be highly diversified to minimise exposure to non-remunerated risks. Second, investors can increase their net returns by choosing a cost-efficient implementation of their investment strategy. Both of these aspects are best addressed by indexed investment products, which almost always offer a higher diversification than active ones.

Furthermore, the costs for indexed sustainable investment products are significantly lower. This can be an important argument especially for institutional investors, who may find it difficult to justify additional expenditure for sustainable investments.

Overall, indexed or passive sustainable investment products offer the most effective and efficient way to achieve investors' main sustainability objectives, regardless of whether they are prioritising the impact of their investment or want to optimise the risk/return characteristics of their portfolio.