



# ESG CAN DRIVE THE EXPANSION OF PASSIVE SOLUTIONS IN ASIA





**E**SG investing—the incorporation by asset managers of environmental, social and governance (ESG) factors into investment criteria—has grown rapidly. Investors can seek to use their assets in many different ways. For example, they can encourage companies to adopt responsible business practices, or to hedge portfolio risk by excluding companies that do not. Approaches to ESG investing have also evolved considerably in recent years, according to Laurent Trottier, Global Head of ETF, Indexing and Smart Beta Management at Amundi. In the past, he says, investors and asset owners viewed ESG as a constraint on portfolio performance. “Now they see it as a way to enhance performance and add alpha.”

ESG’s growth is evident in passive, as well as active, investment management. Banks and asset managers have created a wide range of passive solutions for investors of differing levels of size, maturity and risk appetite. The early adopters may have been in Europe and North America, says Mr Trottier, but there is also considerable growth now in Asia. Evidence of the burgeoning Asian interest in applying ESG to passive investment was a 2018 move by Japan’s US\$1.5 trillion Government Pension Investment Fund to track ESG indices.<sup>1</sup> In Asia and globally, Amundi is at the forefront of developments in the use of ESG criteria to support the growth of passive investment portfolios.

#### **AN INTEGRATED APPROACH TO ENGAGEMENT**

In the different passive solutions it provides to clients—

core indexing products (investment in all benchmarked companies), exchange-traded funds (ETFs) benchmarked to standard indices or ESG-adjusted ones, and bespoke solutions—Amundi has found that marshalling all the forces at its disposal can deliver the desired results for both ESG adherence and portfolio growth.

Voting and engagement are two of those levers.<sup>2</sup> “In passive investing,” says Mr Trottier, “a portfolio manager does not have the same power as an active manager to influence how the companies they invest in are managed. Voting is one of the opportunities to exert such influence.” Amundi’s approach is to have a dedicated team to manage voting and engagement in both active and passive portfolios. “Managers of invested companies become more open to outside views when they see Amundi bringing both active and passive teams into the discussion,” says Mr Trottier.

#### **BREAKTHROUGHS IN BENCHMARKING**

In the past, applying ESG criteria to passive holdings involved a significant amount of tracking error in index benchmarking. That has now changed.

Improved accuracy and increased datasets give Amundi and other asset managers the ability to offer more customised solutions to clients. “The breadth and quality of ESG data in the market has improved significantly,” Mr Trottier explains. “Index providers are building more innovative ESG indices. This means we now have the

<sup>1</sup> “GPIF Chooses Two Indices for Its ESG Benchmark”, *Chief Investment Officer*, September 26, 2018.

<sup>2</sup> For a discussion of engagement in ESG investing, see “Lifelong promise: Engagement process reaps ESG gains in Asia”.





ability to propose passive products, such as ETFs, that track ESG indices.” As an example, he points to the US stock index provider MSCI, which offers a range of socially responsible investing (SRIs) indices with different levels of ESG integration.

#### **THE BESPOKE ESG APPROACH TO PASSIVE INVESTMENT**

Some investors have more specific ESG requirements to ensure their portfolios fit with their individual strategies. Amundi’s approach to these scenarios is to gradually layer ESG criteria onto the passive elements of the portfolio. For example, this involves the phased implementation of an exclusion policy towards companies that produce prohibited anti-personnel mines and cluster bombs. This, according to Mr Trottier, usually adds a small amount of tracking error. The next step is to incorporate other layers of ESG. “We can either work with the client’s list of companies it wishes to exclude,” he says, “or we can use Amundi research to analyse the client’s ESG policy, excluding companies on that basis.”

In an additional layer of customisation, Amundi can work with a “tracking error budget” provided by the client, says Mr Trottier. Amundi will work within this range to help the client reach its ESG targets. The latter may involve reducing the portfolio’s fossil fuel footprint by removing coal mining companies, for example. A social target could be the exclusion of tobacco firms or arms producers. “There are many optimisation techniques that we can apply using the ESG data now available,” says Mr Trottier.

#### **EXPANSION AHEAD**

All these developments—especially the ability to incorporate ESG data into portfolios—mark a turning point in passive approaches to ESG investing. Mr Trottier expects Asian investors to benefit as much from this approach as their US and European peers.

“When we see how passive investing has grown in the US and Europe, it’s clear what’s ahead for Asia,” says Mr Trottier. “We’ve proven that we’re able to significantly improve the ESG elements of portfolios, while reducing the tracking error. This is helping to create a virtuous circle of ESG investing in Asia and around the world.”

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