Embedding sustainabiliy requirements: ESG and decarbonisation

Russell Investments

Aim to generate alpha whilst adhering to company policies on responsible investing.

Executive summary

In 2016, a large European insurer (“the Client”) partnered with Russell Investments to design two new actively managed responsible investment funds; one global fixed income and one global equity. The Client wanted the funds to adhere to their ESG (Environmental, Social and Governance) and climate preservation policies, whilst generating alpha within their specific risk thresholds. We bundled our best thinking to construct a robust solution with positive retail attention within the Client’s market.

The challenge

With the Client’s strict and comprehensive specifications, both products were required to:

- Have a transparent and consistent ESG methodology with minimal impact on the excess return generation of the managers
- Adhere to the Client’s specific exclusion policy by screening for: controversial weapons, tobacco and companies with the lowest ESG scores in the investment universe
- Achieve an above average ESG score versus peers, reduce the funds’ carbon footprint and reserves by 25% and support those who actively invest towards the economy’s transition to green energy

After an extensive selection process, we decided to work exclusively with Russell Investments as the firm can continuously research, monitor and visit the best managers globally.

The solution

Manager research – accessing the best

At the heart of this solution lies the expertise to select highly specialised managers who have the ability to generate excess return. The Russell Investments’ research process covers approximately 13,000 strategies (as at 31 August 2017). Less than 500 typically make it on to our buy list.

For these funds, only managers who can clearly demonstrate a high awareness of ESG in their investment process and resulting portfolio positioning have been selected from the buy list.

Moreover, the selected managers' portfolio positions have very low correlations. This is important to ensure that the alpha sources within the portfolio are as diversified as possible. The combined portfolio is ESG aware, has a high excess return generating capability and a low tracking error.

The selected managers act as advisers to the portfolio that we manage on behalf of the Client. This allows us to achieve a substantial improvement in both ESG and carbon footprint scores while, keeping as close as possible to the securities positions as preferred by the specialist active managers.

Exclusions – without reducing alpha potential

As per the Client's requirements, controversial weapons, tobacco and companies with the lowest ESG scores in their investment universe are continuously screened for - and excluded where possible.

Exclusions however, can shrink a fund's investable universe and expose it to reduced excess return potential and/ or increased tracking error risks.

Besides this (and more importantly), exclusions can be harmful. A classic example is where exclusions myopically focus on carbon emission, while neglecting investments in renewable sources of energy.

We are therefore very reluctant to utilise exclusions as a tool beyond this point. To hit the remaining ESG targets for the fund, a tilting methodology is utilised.

Portfolio tilting – minimal moves, maximum results

At this stage in the process, the portfolio's ESG and carbon scores are compared to their targets. Where improvements are required, we apply our proprietary tilting methodology to lift the average ESG score and/or reduce carbon reserves and footprint to the desired levels.

All positions in the portfolio are scored and ranked. By lowering the weighting towards the lower scoring companies in favour or better scoring ones, the portfolio characteristics are tilted to achieve the desired ESG and carbon targets.

When it comes to managing the carbon footprints of the portfolio, we carefully avoid just penalising 'heavy emitters'. Instead we also give an incentive to companies that actively support the transition to green energies.

This considerate re-weighting methodology focuses on stabilising the portfolio's active share, rather than on correlations. While the latter is commonly used, it suffers from correlation instability. The process results in a very modest additional ESG specific tracking error of 30-50 bps (at the most).

Why Active Share?

The active share is a measure that summarises the differences of a portfolio's stock positions against those of a representative index. It plays an important role in our portfolio construction process. To optimise the excess return generating capability of the portfolio, we seek to exploit high active shares of the specialist managers. By combining manager portfolios with low correlation, the overall portfolio embeds highly dispersed security positioning, leading to a low tracking error.

As we apply our unique ESG and climate preservation screens, we seek to minimise tracking error in this part of our process to prevent dilution of the security selection of our managers. Instead of seeking further dispersion, we aim to stay as close to the individual security holdings as possible. This ensures that, while arriving at the desired ESG and carbon targets, the original portfolio's risk and return characteristics are preserved as much as possible.

Responsible voting – and ownership governance

We have two global committees dedicated to ensuring that our Proxy Voting Guidelines are aligned with current best practices regarding voting on ESG issues.

In voting, Russell Investments aims to protect and enhance minority shareholder rights and shareholder value. To protect the financial outcomes of the funds, Russell Investments supports solid governance standards and high levels of disclosure when voting on behalf of the Client.

The outcome

Since the launch, there has been strong interest in the retail space. Furthermore, the funds have met all of their requirements (as at 30 July 2017):

- Consistently high ESG scores within the top two quintiles of the active management universe
- The Equity portfolio managed over 30% reduction in Carbon Reserves & Footprint. For Fixed Income, this reduction was over 60%
- On track to realise the excess return targets

Concluding thoughts

Responsible Investment solutions are growing in popularity as businesses, including Russell Investments and clients alike, look to engage more with the people and environment around them - both today and in the future.

For a solution that considers ESG factors, contain specific exclusions, support carbon reduction and benefits green energy investment, please get in touch.

For more information

Call Russell Investments at **+44 (0)20 7024 6000** or

visit **russellinvestments.com**

Important information

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