Embedding sustainability requirements

Bespoke solutions: A case study

Creating a portfolio which adheres to company policies on responsible investing, without compromising alpha generation.

In 2017, a large European insurer (“the client”) partnered with Russell Investments on an advisory basis to initially leverage Russell Investments’ manager research capabilities. This advisory partnership soon advanced into a bespoke offering, resulting in Russell Investments designing two new actively managed responsible investment funds; one global fixed income and one global equity.

The journey

The client wanted the portfolios 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%.

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 13,999 manager products.[1] (as at 30 September 2019).

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.

Putting standards in place to support ESG capabilities

On 31 January 2018, the European Commission's High-Level Expert Group on Sustainable Finance published its Final Report.[2] In this report it formulates eight strategic recommendations for a financial system that supports sustainable investments.

In order to meet the client's objective of responsible investing throughout both funds, Russell Investments helped the client meet the needs of achieving the Febelfin qualification, receiving the 'Sustainable label' – a visible label which aims to instill trust and guarantee potential investors of the sustainable nature of the fund.

The comprehensive requirements for the sustainable label were met in November 2019, where Russell Investments worked closely with the client to ensure the following standards were achieved:

Negative / exclusionary screening, In the investment guidelines of both ESG funds we include the guideline that 15% of the companies and countries with the lowest ESG score will be excluded.

Integration of ESG factors, Russell Investments selects the best investment managers and rates them out of 5, based on their environmental, social and governance policies. Only managers ranking 4 or above are considered for both ESG funds.

A sustainable product shall not finance:

1. Worst offenders of the UN Global Compact
2. Weapons
3. Tobacco
4. Coal
5. Unconventional oil & gas

Transparency, A sustainable product shall provide an overview of its position towards potentially unsustainable practices and issues that are the subject of societal debate and controversy.

Information, the sustainable character of the product shall be clearly stated in the prospectus. In addition to the ESG criteria being applied, all securities will be subject to an exclusion list that is revised and updated on a periodic basis and which will identify companies or issuers that are responsible for producing and/or commercialising controversial weapons or which are domiciled in countries that are deemed to have high levels of corruption or which lack transparency.

Supervision, the product manager shall designate a qualified independent third party of its choice to verify if and attest that the portfolio is compliant with its sustainability policy and with the quality standard.

In addition to the above standardised requirements, the funds also demonstrated positive best in class screening, outlining the positive tilt in the funds toward underlying companies with the highest ESG scores.

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. There will be an appropriate oversight and governance of exclusion list part of quarterly fund review process.

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

Russell Investments and the client formed a joint investment committee, enabling the client to still have full control of the investment decisions, with a strategic partner in order to successfully achieve the following:

- Consistently high ESG scores within the top two quintiles of the active management universe
- A selection of the best investment managers which have been ranked 4 or above, based on their environmental, social and governance policies.
- 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
- We reduced the fund's carbon emissions and carbon reserve exposure by 25% relative to the MSCI World Index benchmark

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, contains specific exclusions, supports carbon reduction and benefits green energy investment, please get in touch.

[1] Source: Russell Investments, 30 September 2019
[2] Source: https://ec.europa.eu/info/publications/180131-sustainable-finance-report

For more information

Call Russell Investments at **+31 20 567 4055**

or visit **russellinvestments.com**

Further information on Russell Investments' ESG practices and Sustainable Risk policy can be found **here**.

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