**Paper Review:** “*Promoting Sustainability Using Passive Funds*” (The Journal of Index Investing Fall 2019, jii.2019.1.071; DOI: https://doi.org/10.3905/jii.2019.1.071)

***Passive funds can promote sustainability actively***

Two big forces have shaped the investment management industry in recent years. Many people wish their investment had a positive impact on society, fueling a boom in sustainable investment. For example, sustainable investing topped $30tr in 2018.[[1]](#footnote-1) Many people also wish to avoid “active” managers’ heavy fees, fueling a boom in cheap “passive” (index) funds. For example, index funds owned 48% of US stocks last year. [[2]](#footnote-2)

Such developments beg a question: how could investors mix both? That is, how could investors promote better environmental, social and governance outcomes while paying index managers’ low fees?

Such question may seem as paradoxical. Many refer to index investing as “passive” investing. Yet, sustainable index investing tries to address this very demand. So how well do (supposedly passive) index funds promote better ESG corporate practices? And, relatedly, how shall investors select sustainable index funds?

Investors, index or not, can foster better ESG corporate practices in two ways. First, by investing in firms with better ESG practices. Doing so rewards “good behavior” and funds a more sustainable economy. For example, firms with good ESG performance have also been able to borrow 7 to 18 bps cheaper than firms with social responsibility concerns[[3]](#footnote-3).

Second, by engaging these firms and voting at their general assembly. Doing so promotes change. For example, Duke and Stern scholars find that shareholders’ “vote no” campaigns reduce CEO compensation.[[4]](#footnote-4)

Interestingly, promoting better ESG practices yields long-term financial benefits, too. For example, successful votes on corporate social responsibility adds nearly 3% to shareholder value[[5]](#footnote-5). London Business School scholar Elroy Dimson and co-authors also find that ESG engagement at US firms adds 2.3% to returns the year following initial engagement.[[6]](#footnote-6) Crucially, index managers have the same voting rights and engagement opportunities as active ones.

How can investors promote ESG using index managers, then?

***A few good funds, a lot of greenwashing***

The good news is that sustainable index investing is booming, with over 400 funds available. The less good news is that few funds promote ESG well.

The first lever to promote sustainability is investing in companies with better sustainable practices on average. Yet, 37% of sustainable index funds have a *lower* ESG score than their non-ESG benchmark. Only 9% of sustainable index funds have an ESG score at least 10% higher (to put figures in perspective, US large caps have ESG scores 64% higher than US small caps’ on average).

Index managers’ engagement and voting varies a lot, too. A striking example is using derivatives. Derivates do not hold voting rights. Yet, 16% of sustainable index funds still use derivatives–foregoing a key lever to promote ESG. Managers differ, however. For example, over 60% of Amundi and Lyxor sustainable index funds use derivatives. By contrast, no BlackRock or UBS sustainable index funds use them. Yet, keeping voting rights does not mean using them to promote sustainability. For example, BlackRock supported only 23% of climate change proposals last year, when Legal and General supported 85%[[7]](#footnote-7). Amundi did not support a single climate change resolution.

***Managing ESG biases***

A “passive” sustainable investor faces another challenge, though. Namely, ESG strategies (passive or not) tend to create investment biases. For example, larger companies tend to have higher ESG ratings. ESG can introduce country or sector biases, too.

Biases are not necessarily negative. Yet, investors should be aware of them. That way, investors can decide whether they are comfortable with them.

***A bright future ahead***

Overall, and contrary to popular belief, “passive” investing can promote sustainability efficiently. Investing with sustainable index funds requires analyzing funds across new dimensions, though. An investor should assess how well an index fund promotes sustainability. Moreover, s/he should check potential biases associated with an ESG strategy. Yet, the fact that investors can increasingly promote ESG at a low cost should give a new impetus to the sustainability revolution.

For a more detailed look at this subject matter please see the original article “*Promoting Sustainability Using Passive Funds*” (The Journal of Index Investing Fall 2019, jii.2019.1.071; DOI: <https://doi.org/10.3905/jii.2019.1.071>).

**Firm Overview**

Two Goldman Sachs Managing Directors and a CEO of HSBC Asset management founded Arvella Investments with a dual ambition:

* **Be world-class wealth investors**. We invest for the long term, emulating non-profit endowments.
* **Make our world a better place**. We promote better environmental, social and governance outcomes. We also donate the equivalent of 20% of profits to charities.

Arvella has offices in London and Paris.

1. Global Sustainable Investment Alliance, 2018 Review. [↑](#footnote-ref-1)
2. <https://www.bloomberg.com/news/articles/2018-12-31/shift-from-active-to-passive-approaches-tipping-point-in-2019> [↑](#footnote-ref-2)
3. Goss, Allen, and Gordon S. Roberts. 2011. “The Impact of Corporate Social Responsibility on the Cost of Bank Loans.” Journal of Banking & Finance 35 (7): 1794–1810. [↑](#footnote-ref-3)
4. Ertimur, Yonca, Fabrizio Ferri, and Volkan Muslu. 2010. “Shareholder Activism and CEO Pay.” The Review of Financial Studies 24 (2): 535–92. [↑](#footnote-ref-4)
5. Cuñat, Vicente, Mireia Gine, and Maria Guadalupe. 2012. “The Vote Is Cast: The Effect of Corporate Governance on Shareholder Value.” The Journal of Finance 67 (5): 1943–77. [↑](#footnote-ref-5)
6. Dimson, Elroy, Oğuzhan Karakaş, and Xi Li. 2015. “Active Ownership.” *The Review of Financial Studies* 28 (12): 3225–68. [↑](#footnote-ref-6)
7. Gladman, Kimberly. 2018. “Asset Manager Climate Scorecard 2018.” 50/50 Climate Project. <https://5050climate.org/news/2018-key-climate-vote-survey/> [↑](#footnote-ref-7)