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The Investment Engineers

# Passive investing and sustainability are incompatible

- Passive funds buy the entire market without using ESG factors
- Sustainable indices are active, not passive strategies
- Best of both worlds possible with Sustainable Enhanced Indexing

Passive investing and sustainability integration are fundamentally irreconcilable investment philosophies, say David Blitz, PhD, Head of Quantitative Research, and Wilma de Groot, PhD, Head of Core Quant Equities.[1]

## 1. Introduction

One of the biggest investment trends over the past decades has been the shift from active to passive investing. The idea behind passive investing is that active management is a zero-sum game before costs, which implies that passively following the capitalization-weighted market portfolio at minimal costs should result in better than average performance. Another very popular trend among investors is to make serious work of integrating sustainability considerations, such as environmental, social and governance (ESG) criteria, into the investment process. In this note we argue that these twin desires of passive investing and sustainability integration are fundamentally at odds with each other. In other words, investors can have one or the other, but not both.

Intuitively, it may seem that sustainability considerations can be integrated effectively into a passive investment approach. Examples that are often given are active voting and engagement, excluding the stocks that are most problematic from a sustainability perspective, or passively following an ESG index. In this note we will discuss each of these approaches and explain the limitations of the

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passive investment framework. Because comprehensive sustainability integration involves many active decisions, it requires active portfolio management, active risk management and active performance evaluation techniques. As a result, investors find themselves in the active management space…whether they like it or not. We conclude that passive investing and sustainability integration are both strong investment philosophies in isolation, but very difficult to unite.

## 2. Passive sustainability integration

### 2.1 Voting and engagement

In this section we discuss the voting and engagement of passive managers, focusing on their behavior, incentives and effectiveness.

#### 2.1.1 Voting and engagement behavior

Investors may be able to influence corporate policy with their voting and engagement activities. The extent to which they exert their influence as shareholders varies significantly. Some active managers do little or nothing with their shareholder power, while at the other extreme we have activist investors who have based their entire business model on this. Most passive assets, however, are controlled by a small number of big passive investment firms.

A recent study by the University of Amsterdam examined the historical voting behavior of these big passive managers and found that they sided with corporate management in over 90% of votes.[2] This result suggests that corporate executives do not need to be very concerned about these large passive stakeholders. The picture below is a screenshot of a short video, which summarizes the paper.

CORPNET research group. University of Amsterdam

The study also found that "a large majority of proposals where the Big Three vote against (against the proposal itself, not against the management recommendation) are related to environmental, social and governance (ESG), which are mainly proposed by activist shareholders. Based on additional data from ProxyInsight we know that 77% of BlackRock's 'against' votes are in the domain of ESG, followed by 44% of Vanguard's and 43% of State Street's

#### 2.1.2 Voting and engagement incentives

Our impression is that the big passive investment managers are stepping up their voting and engagement efforts, as are many institutional investors with large passive holdings. Since passive investors are the ultimate long-term investors, corporate executives can expect them to be present at every future shareholder meeting, so they probably do not want to antagonize these strategic owners. However, the business model of passive managers presents a number of major obstacles that stand in the way of effective voting and engagement. These obstacles concern the incentives of passive managers, the nature of their holdings, and a lack of credible threats in case firms ignore their efforts. We discuss these points separately below.

Passive and active investors have fundamentally different incentives when it comes to voting and engagement. The business model of passive managers is to replicate the market index as closely and as efficiently as possible, and for achieving that objective it does not matter in which way and how actively they vote and engage. Unless their clients are willing to pay an attractive additional fee for this service, there is no explicit incentive for passive managers to spend valuable resources on this. Indirect considerations may be that their clients consider voting and engagement to be important, and they want to prevent an erosion of the market return if firms get the impression that they can do whatever they like. The main task of active managers, on the other hand, is to generate added value, and active voting and engagement can be a powerful instrument for realizing that objective. Moreover, the detailed knowledge about firms that is needed for effective voting and engagement is present among analysts who are on the payroll of active managers, but who do not fit in the business model of passive managers, which is based on cost minimization.

Another difference is that active managers invest in a select set of firms, while passive managers invest in every firm. This means that the incentive for active managers is that certain individual firms do well, if necessary at the expense of their competitors, while passive managers do not have this incentive, as they are invested in the entire

[2] Fichtner, J., Heemskerk, E.M., and J. Garcia-Bernardo (2017) "Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk." Business and Politics 19 (2), 298-326.

industry. A recent study examining this 'horizontal ownership' issue, i.e. owning all stocks in a certain industry, argued that it leads to reduced competition and should even draw attention from anti-trust authorities. The holdings of passive managers are also characterized by very large positions in a small number of firms, and a large number of minuscule positions in the vast majority firms, as such is the nature of capitalization-weighted benchmark indices. Active managers tend to have more balanced position sizes. The result is that passive managers have the incentive to focus their voting and engagement efforts on the very largest stocks, while active managers do not have the incentive to neglect a stock which is just 0.01% in the index but in which they do have a large stake.

2.1.3 Voting and engagement effectiveness

The biggest fundamental limitation of passive managers is that, apart from threatening firms with bad publicity, there is very little that they can do if firms do not take their engagement efforts seriously. Passive investors cannot actually sell their positions in firms that only pay lip service to ESG issues, because, by definition, passive investing entails buying and holding the entire market portfolio. Active investors, on the other hand, can translate their words into action by selling off or reducing their stake in a firm, or by not even taking a position in the first place based on sustainability considerations. That tends to worry corporate managers, because their cost of capital may go up, and because their remuneration is often linked to share price performance, such as via options packages. In other words, at the end of the day active investors can put their money where their mouth is, while passive investors can only put their money where the index tells them to put it.

It becomes particularly clear that passive managers are toothless tigers when a firm wants to raise fresh capital, for instance in case of an initial public offering (IPO) or a secondary offering. From a sustainability perspective, this primary market is much more important than the secondary market, because the primary market is about the efficient allocation of capital in the real economy, while the secondary market is merely the trading in shares that are already out there between investors. If a firm successfully issues new shares, index providers proceed to incorporate this into their standard indices, regardless of any sustainability considerations. This forces passive managers to follow suit, and, because of their sheer size, to already subscribe to the offering in advance if they expect it to succeed and enter the index. Active managers, on the other hand, can take sustainability aspects into consideration when deciding whether or not to subscribe to a share offering. In this way, active managers can be held accountable for their own decisions, while passive managers are obliged to follow the behavior of others.

2.2 Exclusion

Passive managers can offer to track the broad market index but exclude the stocks that are most problematic from an ESG perspective. Classic examples of industries that have been subjected to exclusion are tobacco, weapons, gambling and alcohol. In recent years other industries such as thermal coal have emerged as popular targets for exclusion. Stocks that are shunned because their business models raise moral concerns are commonly referred to as 'sin stocks' in the academic literature.

Excluding certain firms is an active decision which prevents passive investors from replicating the broad market index to the best extent possible. One way of dealing with this is by assuming that the market index with excluded names is the relevant index, and to focus on tracking that index. One may get away with this as long as the number of exclusions is limited and performance deviations are small, but it becomes increasingly difficult to hold up in case of more extensive exclusions, and a higher tracking error. Another way of dealing with exclusions is to replace them with the best substitutes, such as firms from the same broader industry. This is essentially an active investment approach, albeit a light one as long as the number of exclusions is limited. This approach also becomes increasingly challenging as the exclusion list grows.

A problem with excluding sin stocks is that this may be costly from a financial performance perspective, as research shows that these stocks have historically delivered a significant outperformance. The studies which first documented this result suggest that this outperformance reflects a premium for reputational risk, arguing that since many investors prefer to stay away from sin stocks, an extra financial incentive is needed to compensate for this.[3] In a recent study, however, we found that the outperformance of sin stocks can be explained by their factor exposures, in particular their quality and low-risk characteristics.[4] By excluding sin stocks, investors effectively go short the attractive factor characteristics of these stocks. In an active strategy, these unintended undesirable factor exposures may be restored by selecting stocks with offsetting factor characteristics.

[3] Fabozzi, F.J., K.C. Ma, and B.J. Oliphant (2008) "Sin Stock Returns." Journal of Portfolio Management 35 (1), 82-94; Hong, H., and M. Kacperczyk (2009) "The Price of Sin: The Effect of Social Norms on Markets." Journal of Financial Economics 93 (1), 15-36; Statman, M., and D. Glushkov (2009) "The Wages of Social Responsibility." Financial Analysts Journal 65 (4), 33-46.
[4] Blitz, D.C., and F.J. Fabozzi (2017) "Sin Stocks Revisited: Resolving the Sin Stock Anomaly." Journal of Portfolio Management 44 (1), 105-111.

A more fundamental issue with merely divesting from the worst offenders is that this only concerns a relatively small number of firms, while for the rest no differentiation at all is made. As such, exclusion is only one dimension of sustainability integration. Investors need to have more tools at their disposal for comprehensive sustainability integration, such as if they also want to make a distinction between a firm with a slightly negative ESG profile and a firm with a strongly positive ESG profile. This would be an example of positive screening, while exclusion policies are limited to negative screening.

### 2.3 ESG indices

Comprehensive sustainability integration means that the weight of every stock is potentially affected by its ESG characteristics. This is fundamentally at odds with the idea behind passive investing – to simply invest in each stock in proportion to its share in the market portfolio. Some passive investors believe that this issue can be solved by investing passively in an ESG index, i.e. a capitalization-weighted index consisting only of stocks with the best ESG profiles. Although passive management techniques can be used to replicate the performance of such an index, the index itself is an active investment strategy at heart. To illustrate this point, consider the example where one would replicate the performance of an index containing only stocks for which the name starts with the letter S, such as Starbucks. Although such an index may be tracked passively, the investment strategy itself is clearly not a passive strategy. An ESG index is actually even more active, because the ESG profiles of firms change over time, and because ESG criteria themselves are also subject to change: what was deemed sustainable 20 years ago might nowadays not pass scrutiny anymore.

ESG indices are a major departure from the unique capitalization-weighted market portfolio. They can have very different country, sector and factor exposures, resulting in a sizable tracking error. And whereas weighing stocks in proportion to their market capitalization has strong theoretical underpinnings when investing in the entire market portfolio, there is no reason to assume that this approach is still optimal once you restrict yourself to only investing in stocks with strong ESG scores. Such a portfolio is therefore clearly an active portfolio, giving rise to many active investment decisions, e.g. regarding the choice of the universe, portfolio construction, rebalancing approach, rebalancing frequency, individual stock weights, risk controls, etc. Like active strategies in general, ESG strategies require active portfolio management, active risk management and active performance evaluation techniques.

## 3. Active sustainability integration

### 3.1 Comprehensive sustainability integration means active investing

Comprehensive sustainability integration means that investors use the full arsenal at their disposal: engagement, voting, giving more weight to ESG leaders, giving less weight to ESG laggards, reducing the environmental footprint of the portfolio (e.g. CO2 emissions), and excluding firms if everything else proves to be of no avail. Integrating all these elements into one portfolio requires active decisions, and it results in a portfolio which is no longer a passive but an active portfolio, and which therefore requires an active management approach. Besides sustainability objectives, such an active approach can focus on risk, return or combined (risk and return) objectives. An example of a risk objective is to minimize the amount of tracking error versus the market portfolio for a given degree of sustainability integration. An example of a return objective is to prevent negative exposures towards quantitative factors that are known to be rewarded with a premium in the long run, such as size, value, momentum, quality and low volatility. Such exposures can arise from exclusions and from deviating from market capitalization weights in general. Another example of a return objective is to combine a positive sustainability exposure with positive exposures towards these established factor premiums, in a balanced way.

### 3.2 An active sustainable approach that stays close to the passive market index

At Robeco, we have extensive experience with efficiently integrating many kinds of sustainability requirements into investment portfolios. And the result does not have to be a very active portfolio. Even when individual stock weights are not allowed to deviate much from the capitalization-weighted index, it is still possible to achieve a portfolio with a strong sustainability profile. A good example is the Robeco QI Global Developed Sustainable Enhanced Index Equities fund, which has an expected tracking error of only 1%. This strategy does not invest in a broad range of controversial industries. Besides this negative exclusion, companies with positive ESG scores get a higher weight in the portfolio, as a result of which we can provide a 30% better ESG profile than the index. Next to that, we reduce the environmental footprint of the portfolio by 20% on four different measures: greenhouse gas emissions, water use, waste generation and energy consumption.

The aim of this strategy is to deliver higher net returns than the MSCI World index by tilting the portfolio towards stocks with strong scores on proven quantitative factors, such as value and momentum. This way, undesired negative factor exposures that may arise from excluding

sin stocks are more than compensated for by investing in other (and more) stocks with positive factor exposures. Last but not least, voting and engagement are applied. When a company breaches the United Nations Global Compact principles and long-term enhanced engagement does not lead to the desired result, we may proceed to exclude the company. At the same time, the strategy preserves the main benefits of passive investing, by offering a highly diversified portfolio at low costs.

## 4. Conclusion

In the past decade we have seen strong trends towards both passive investing and sustainability integration. In this note we have argued that these two investment philosophies are fundamentally at odds with each other. Passive managers can try to influence corporate policy with voting and engagement, but they cannot sell a stock if the management simply refuses to take them seriously, as their job is to follow the index as closely as possible. Excluding a small number of the worst offenders may still be manageable, but comprehensive sustainability integration goes beyond mere negative screening. Once the weight of every stock can potentially change as a result of its ESG characteristics, investors are effectively in the active management space. That also brings the need for active portfolio management, active risk management and active performance evaluation techniques. Passively replicating an ESG index does not circumvent these issues, as the index itself is still an active strategy. Robeco has extensive experience in efficiently integrating many kinds of sustainability requirements into investment portfolios, including approaches which are designed to combine the benefits of passive investing with a pronounced sustainability profile.

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