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Squaring the circle: cost-effective and responsible active investing

How can responsible owners of assets reduce costs, yet meet their fiduciary environmental, social and governance (ESG) responsibilities and achieve outperformance? Royal London Asset Management (RLAM) believe this can be achieved, by offering cost-effective and bespoke segregated equity solutions using active management with a quantitative overlay. This can help meet our clients' specific ESG requirements through engagement, active decision-making and stewardship.

In the last two decades, asset owners have faced increasing and often conflicting pressures. As well as record low yields in financial markets, competitive and regulatory pressures, improved data and greater scrutiny of risk-adjusted performance have led to a profound shift from active to passive investing.

Yet asset owners now face a counter challenge: the regulatory requirement to demonstrate a responsible investment approach, observing ESG factors. The UN Principles for Responsible Investment define responsible investment as "a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership".

Most asset owners are familiar with ESG factors, but it is much more difficult to understand and articulate how these principles are incorporated through active ownership, particularly where investment decisions are in part delegated to investment managers and other third parties.

Are the challenges of responsible investing, with the considerable costs that are involved with additional ESG research, engagement and stewardship, really compatible with no-frills passive investing? Can asset owners 'square this circle'? We propose a solution that may help to overcome the challenges involved and generate alpha for the beneficiaries of the assets.

The challenge

Pension funds and other institutions have the power to effect real change, given the scale of assets at their disposal, but clear guidance around how they might do so has been more limited. The broad nature of the guidance and regulation has led individual investors to formulate their own investment strategy, taking into account the views of underlying beneficiaries or other stakeholders. As a result, the range of views across investors is diverse.

Consider engagement versus divestment. Initially, many asset owners instinctively favour divestment – it seems right to remove 'dirty' or antisocial assets from a portfolio. But the reality can be more nuanced. To illustrate this, we recently met a UK mining company that has a small portion of its portfolio in thermal coal assets. While it is recognised that these assets are managed to a high standard from an ESG perspective, the company was under intense pressure to sell them or face divestment by several shareholders.

Management said three parties were interested in purchasing the assets. All three were Chinese state entities wanting to expand production and potentially run them with less focus on social and environmental factors (e.g. lower health, safety and environmental standards). While such a sale would take the issue 'off the books' for the company and its shareholders, the broader impact would be more and cheaper coal combined with worse environmental and social standards in its extraction.

Instead, we have supported the company in a more nuanced engagement approach to deprioritise these assets, by not investing incrementally beyond a bare minimum, while continuing to improve health and safety and environmental standards in the developing markets where those assets are based. We believe that this engagement-led approach is more impactful than divestment, but it is necessarily more time-intensive. It only makes sense to take this approach, however, if investing actively.

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Passive and responsible investing – mind the gap

Competitive and regulatory pressures, improved data and greater scrutiny of risk-adjusted performance have led to a profound shift from active to passive investing. Many asset owners concluded that the risk of underperformance from active investment strategies was too great, particularly as active fees were often unjustifiably high given pedestrian returns and index-hugging strategies.

Around half of US equities are now managed on a passive basis and similar trends have been witnessed across the globe. Although index-tracking approaches have evolved over time, away from basic market-cap weight indices, even the most sophisticated strategies suffer from the constraint that the decision to buy or sell a particular security is driven by a quantitative formula, and not through detailed research and due diligence. So, is it possible to be a responsible steward of assets by investing on a purely passive basis?

We recently met a US corporate and discussed a meeting it had hosted in New York with corporate governance specialists from 10 of their largest investors to discuss remuneration. Only 20% of those present owned the share actively and had teams that had scrutinised the long-term performance and strategy of the firm. The rest, as passive investors, were following a rules-based approach to incentives and knew almost nothing about the company. In our view, this isn't responsible investment or stewardship.

Collective investing

One solution is to use actively-managed pooled funds. These are popular with institutional investors, particularly those with small investment portfolios. This is in part due to their relatively low governance burden, but also the costs can be lower than for segregated funds.

From a responsible investment perspective, the challenge with pooled funds is that it is very hard to find a fund solution that entirely reflects your investment beliefs, while remaining in line with your broader investment objectives around risk and return. Pooled funds will suit some investors, who can accept the trade-off between cost and fit. Others, however, will struggle to reconcile the imperfect fit with their values.

The requirements

Any solution to these challenges should meet four criteria:

- **Low cost** – passive strategies are here to stay, so for investors looking to take a more active approach to stewardship, justifying the additional cost is an important consideration.
- **Bespoke** – investment requirements vary between investors, so a flexible solution that can accommodate these differences is helpful.
- **Responsible** – it is very difficult to incorporate active stewardship through a purely passive investment approach. An investment approach that incorporates detailed quantitative and qualitative due diligence provides better outcomes and better meets regulatory requirements.
- **Active insights** – fundamental analysis will add value in a risk-controlled framework N.B. this will be even more important in the post-Covid-19 economy, where there will be clear winners and losers.

Implicit in these criteria is the need to **generate alpha and outperform the index**, otherwise passive investing will be too compelling, despite its clear shortcomings around responsible ownership.

Our solution

At RLAM, we have the necessary tools to design cost-effective and bespoke client solutions. These can incorporate fundamental research and active management, including proprietary ESG research and active stewardship, with systematic portfolio construction within a competitively priced bespoke segregated solution.

The starting point is our actively-managed Diversified Global Equity strategy, which is underpinned by our team's 18-year track record of successfully managing portfolios using its proprietary investment process to identify attractively-valued superior wealth-creating companies.

This portfolio would typically hold c.200 stocks with relatively high active-share and stock-specific risk, and low tracking error and systematic risk, against the benchmark. We believe that the portfolio also has higher wealth creation (a quality metric) and a more attractive valuation pay-off.

With this core portfolio, or a subset of this core portfolio (for example, US equities), our Passive & Quantitative Equities team can incorporate bespoke client requirements (ESG screening, tilting, etc.), and use proprietary systems and its expertise in portfolio construction to implement these solutions in a scalable and systematic manner. We can also create and track proprietary internal benchmarks, leading to a significant cost-saving for our client.

Figure 1 sets out the key stages of our approach.

Conclusion: squaring the circle

Passive equities are an imperfect solution for clients who want to be good stewards of capital, and it is also difficult to find a 'one-size fits all' pooled fund solution in terms of ESG requirements. Instead, we can design a customised solution based on active stewardship and ESG, with active manager insights in a low tracking-error portfolio. Given the combination of bespoke design, active stock selection, stewardship and competitive fees, we believe that this is a cost-effective and responsible alternative to passive investing; particularly given the possibility of out-performance against the client's chosen benchmark.

To find out more, please call your RLAM contact.

Figure 1 The systematic implementation of our active alpha investment process for global equities.

Active global diversified process	ESG/ responsible investment (RI) integration	Systematic implementation	Client specific requirements
220 actively selected stocks from proven track record of £2.4bn strategy	Integrated into existing global equity diversified process	Targets a subset of global diversified	Customisable ESG constraints
Proprietary lifecycle approach	Dedicated team of RI professionals	Constraints minimise sector risk and maximise stock specific risk	Tailored exclusions and business involvement
Focus on wealth creation, cash flows and quality	Proactive engagement and active corporate governance	Fully embedded into independent RLAM risk framework	Customisable to specified tracking error

Source: RLAM, for illustrative purposes only.

Figure 2 Checklist of cost-effective and responsible active investing aims

Stock-specific insights	Yes
Wealth-creating companies	Yes
Attractive cash valuations	Yes
Active alpha	Yes
Responsible Investment (RI)	Yes – fully integrated, transparent, credible
RI – ESG integration	Yes – fully integrated
RI – Engagement	Yes – bespoke
RI – Proxy Voting	Yes – bespoke
RI – Client reporting	Yes – bespoke
RI – SRI/Ethical stock restrictions	Yes – bespoke
Tracking error	0.5% to 8.0%
Number of stocks	40-250
Investment universe	MSCI ACWI countries, >$1.5bn market cap
Regional exposure	Any subset of MSCI ACWI countries
Life Cycle exposure	Diversified or specific stage focus (e.g. early 'growth' or mature 'value')
Custom benchmarks	Yes

Source: RLAM, for illustrative purposes only.

Past performance is not a reliable indicator of future results. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

Contact us

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