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The hidden threat of passive management
By Emma Cusworth
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Investors are piling money into index strategies as they become disenchanted by active management. However, as Emma Cusworth writes, could this be compromising their role as effective stewards?

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The tide continues to swing in favour of passive management as scepticism of active managers and a keen eye on cost play out for institutional investors. However, passive management potentially presents an increasingly important,but oft-overlooked or underestimated threat – it largely fails to hold the corporate world to account.

THE PASSIVE TIDE

Institutional investors globally have continued to err in favour of passive management in recent years, preferring the low-cost, benchmark-driven approach to investment in both equities and bonds.

Mercer's 2015 European Asset Allocation survey, for example, found what it called a "meaningful increase" in the use of passive management for traditional equity and bond assets. According to the Mercer data, the average scheme increased its passive equity exposure by 4% from 45% in 2014 to 49% this year while in fixed income, the move has been more dramatic with a 7% swing in favour of passive from 37% to 44% over the same time frame.

Many experts worry about the subsequent decline in influence that asset owners are able to exert on the companies they own, not just to their own long-term detriment, but also to society at large.

The argument goes thus: passive investments, particularly given the bulk of these assets are still invested in market capweighted benchmarks, simply track the market today and, in doing so, are effectively forced to buy or sell shares according to the value placed on them by the market at large, rather than a view of corporate sustainability. As such, the ability to push

corporate management for change on environmental, social or governance (ESG) factors is vastly diminished and, with more money flowing towards passive, the potential to create a desirable economic and societal environment tomorrow is diminished.

According to Philippe Zaouati, CEO at Mirova: “The bulk of the assets managed by pension funds and institutional investors is now passively invested. That is a copy/paste of the world as it is today, not the world we want to create in the future.”

FIDUCIARY DUTY?

As the body of evidence mounts in support of ESG factors having a material impact on long-term returns and on the long-term sustainability of companies, there are those who argue passive management could be seen as a neglect of fiduciary duty.

TOBAM president Choueifaty

Choueifaty, for example, argues: “Long-term investors want sustainable performance in the long term, which is why it is absolutely critical that they invest in strategies that are also sustainable in the long term. It doesn’t make sense from a sustainability perspective to be close to a benchmark. Cap- weighted benchmarks are detrimental to the ability to improve on ESG factors.”

Choueifaty urges against what he says is a confusion of fiduciary duty with acting as a custodian of assets. “A custodian simply needs to safe-guard the existence of the assets, but a fiduciary is there to ensure the assets are looked after and invested properly. Passive management effectively means resignation and is the definition of a custodian, rather than a fiduciary.”

The interpretation of fiduciary duty today, based on the UN Principles for Responsible Investment and Freshfields’ landmark 2005 paper, suggests failing to take ESG factors into account could be a failure of fiduciary duty. The paper states: “In our opinion, it may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them appropriate weight, bearing in mind that some important economic analysts and leading financial institutions are satisfied that a strong link between good ESG performance and good financial performance exists.”

IS PASSIVE REALLY A RESIGNATION?

In large part the argument of whether passive management erodes the ability of capital owners to use their collective might to improve investment and economic sustainability comes down to engagement.

Until recently, there were few, if any, academic studies into the ability of passive managers to act as watchdogs of the companies they own and push to improve how they are managed and run. However a study published earlier this year showed a clear effect of an increase in passive and improvements in governance policies.

A new study from The Wharton School, University of Pennsylvania, written by faculty members Todd A. Gormley, Donald B. Keim and doctoral student Ian R. Appel entitled Passive Investors, Not Passive Owners suggests passive investors in fact “play a key role in influencing firms’ governance choices” as it was associated with an increase in the number of independent directors, the removal of takeover defenses and more equal voting rights. For example, they found a 10% increase in ownership by passive investors is associated, on average, with a 9% increase in the share of independent directors on a firm’s board.

The influence of passive investors – the report looked at large US managers in particular – lies in their ability to vote in large blocks, thus giving them a more material impact on outcomes.

According to Sandra Carlisle, head of responsible investment at Newton Investment Management, UK passive managers are also big corporate influencers. “There is a big role

for passive managers in engagement," she says. "Some of the most engaged investors in the UK are passive investors. They have to invest, so there is a sense that we are all in this together." However, whether their engagement is as effective as that of active managers remains a hot topic of debate.

A MATTER OF CHOICE

The question largely stems from the ability of a fund manager to choose whether to invest in a particular company or not.

"Engagement thus far has largely been about exercising voting rights," according to Zuhair Mohammed, partner, Global Investment Practice, Aon Hewitt. "Passive managers do exercise their votes, but in today's commercial environment not holding, or threatening not to hold, shares gets more attention than simply voting down resolutions. Passive managers cannot do that."

Ultimately a company knows passive investors will still have to be invested despite their views on a particular issue. By contrast, an active investor can divest at any time and, according to Newton's Carlisle, "is likely to be very vocal in reporting about the reasons they chose not to be invested".

Active investors also tend to have more concentrated portfolios, allowing them to take a more detailed approach to their engagement.

"Realistically," Carlisle says, "if you're voting on 10 or 100 companies' resolutions, the level of focus will be different. A concentrated portfolio allows a manager to vote more actively."

ROLE OF THE INDEX PROVIDERS

At the index, rather than passive manager level, there are of course ESG-focused benchmarks available so not all passive exposure is created equal and the development of smart beta products, including those with a focus on ESG factors, such as low carbon indexes and funds tracking them, have played an important role in allowing investors to access ESG-focused investments passively while still benefitting from lower fees than active managers. Institutional investors globally have been working with index providers to create index- based products and have been investing heavily in the area.

The MSCI World Low Carbon Leaders index, for example, was developed in conjunction with France's Fonds de Reserve Pour Les Retraites (FRR) and Sweden's AP4. FRR has allocated almost €1bn in mandates tracking the benchmark, according to Anne-Marie Jourdan, chief legal officer at FRR, which plans to make further "significant" investments.

Similarly, the UN Joint Staff Pension Fund worked with iShares and State Street to develop two low carbon ETFs for which it also provided initial funding. The choice of ETF wrappers for the funds was reportedly to allow other investors to benefit from their expertise and invest with a similar ESG-minded goal.

Mirova's Zaouati says: "It is the job of the investment industry to create appropriate products. Clearly creating good ESG indexes would be interesting and we have seen a lot of innovation in the smart beta industry in terms of smarter indexes."

However, while they allow investors to gain passive exposures to ESG factors, investors shouldn't assume the index provider is engaging with the underlying companies in the index to push for improvement.

Undoubtedly, if index providers were to embark on engagement programmes with the companies in which they invest, the cost of those indexes would rise significantly, eroding the case for passive.

ESG indexes are typically more expensive than their cap-weighted counterparts, although some exceptions are made. iShares' Core MSCI World UCITS ETF, for example, carries a

total expense ratio (TER) of 0.2%. The firm's MSCI ACWI Low Carbon Target ETF (developed with the UN Joint Staff Pension Fund) also carries a TER of 0.2%, but this includes a temporary 0.13% fee waiver, which will only last until the end of November 2016.

According to Saker Nusseibeh, CEO of Hermes Investment Management: "To get more engagement does cost money. If that is done at the index level, it raises the cost of the index, but if they don't do it, investors are linked to an index for the long term without any say in how the underlying companies are run. They will have locked their money in without any control over these factors, which means they are not effectively managing their long-term risks.

"Saying index funds are a cheap way to get market exposure is a misunderstanding of what cheap means," Nusseibeh continues. He points to what he says are "hidden risks" in not engaging. "Governments will start to intervene if global warming goes to a certain level, for example," he says. "They will impose their will, which will have a negative impact on carbon-based assets. To not take that into account assumes an investor is either churning their investments, or is discounting the possibility of a significant price correction in the future."

Investors choosing passive management for their portfolios will increasingly have to consider the long-term impact of ESG factors on the sustainability of their returns.

As Choueifaty says: "Investors have a responsibility to sustainably increase prosperity, and a large role to play as allocators of capital. We cannot resign those duties. Allocating money to companies that create value in the long-term contributes to a sustainable and prosperous economy. Investing in companies not creating value in the long term will result in future disasters, which is why passive doesn't make sense for medium to long-term investors."

Link: http://www.portfolio-institutional.co.uk/features/strategy/the-hidden-threat-of-passive-management/