Enhanced Indexing: The Sustainable Sweet Spot

For investors interested in cost-efficient sustainable investing, enhanced indexing could provide the answer. Enhanced indexing attempts to generate modest excess returns compared to traditional index funds and other passive management techniques.

Summary

- Passive investment funds are unable to deliver a comprehensive sustainable investment solution
- We believe that a low-cost enhanced indexing approach could be the sustainable investment sweet spot
- The approach targets outperformance, retains the market's risk profile, and significantly improves the sustainable footprint
- Identification of a successful alpha signal is key, but a challenge solved by only a few in the ESG space
- Osmosis has successfully identified Resource Efficiency as a persistent environmental performance driver

For over a decade now, enhanced indexing has become an increasingly popular way of generating modest outperformance in a cost- and risk- efficient manner. More recently, the question of how to combine Environmental, Social, Governance (ESG) factors with this quantitative investment approach has been widely considered.

Described as the sweet spot between active and passive management there are a plethora of funds and investment solutions on the market claiming to offer a source of uncorrelated and extra return over their passive counterparts at a fraction of the cost of active management. Conventional ESG scoring methodologies, however, tend not to fit into traditional factor models and the lack of quantifiable ESG data remains a persistent challenge. In short, there are very few approaches to sustainability that have proven to deliver consistent and uncorrelated alpha.

In this article we consider the challenges that exist for the investor looking for a cost-efficient yet sustainable investment solution. We also demonstrate how Osmosis uses its unique alpha signal, the factor of Resource Efficiency, as an environmental performance driver in its Core Equity Fund.

ESG: Passive versus Active

The arguments for active versus passive investing are well researched by investors, yet the significant growth in ESG assets in the last few years has re-ignited the debate. Sustainable investing generally requires in-depth research consistent with an active approach and associated with higher management fees. For those seeking a cost-effective sustainable allocation of their capital, additional consideration is required.

In recent years there has been a remarkable shift toward passive fund management. Passive indexing was born out of the realisation that active managers often struggle to outperform their benchmark net of fees[i] suggesting that investors might be better off buying into a low-cost strategy that mirrors the market index. This has the advantage that no in-depth research into the constituents of the market index is required and transactions are limited to rebalancing. Overhead costs from research, trading, and administration are thus largely reduced allowing passive managers to charge significantly lower fees.

The market index, however, exhibits characteristics that are undesirable for some investors which a passive strategy is simply unable to address. Such characteristics include poor sustainability credentials.

Traditionally, investors had to turn to active strategies to express their sustainability preferences. By choosing active strategies, investors are often exposed to restricted investment universes and specific industry, country, and factor profiles. Importantly, the active stock-picking decisions are based on expensive research into sustainability characteristics; the associated costs are passed on to investors as higher management fees.

What about a Sustainable Index?

Why then not simply invest in a passive strategy that follows a sustainable index? Passive ESG programmes are generally derived from well-known broad market indices. Since passive managers focus on minimising costs and do not employ ESG specialists themselves, the selection criteria for inclusion in the ESG index are commonly based on third-party ESG scores. This might be a cost-effective way of taking ESG considerations into account, however, these ESG indices suffer from their own flaws.

An ESG index is often based on exclusion criteria, screening out so-called sin stocks related to alcohol, tobacco, and gambling, restricting the investment universe and substantially changing the return profile of the ESG index relative to the market index[ii].

Moreover, an ESG index often suffers from industry biases, for instance through penalising intensive industries as a whole, such as oil and gas, in order to achieve environmental footprint reductions. The result is an ESG index that has substantially different industry, country, and factor exposures and a high tracking error relative to the market index. Investing in a passive ESG strategy is thus an active decision in itself.

Finally, fees and friction costs mean that passive strategies will, by definition, never outperform the market.

Sustainable Enhanced Indexing

While active investing builds a preferred portfolio and passive investing mirrors the benchmark, enhanced indexing is a hybrid between the two and uses alternative construction methods to emphasise stock characteristics such as traditional factors or sustainability criteria.

Enhanced indexing aims to outperform the market index while minimising the tracking error and retaining the market's general risk profile by balancing the untargeted country, industry, and factor exposures of the benchmark. The concept of enhanced indexing is related to passive investing with the important difference that it has the goal of outperforming the benchmark by taking advantage of inefficiencies or market abnormalities. Enhanced indexation fees are reduced by combining the efficiencies of quantitative investing with a narrow set of deep stock research limited to specific areas of interest; in this case, sustainable investing.

The Challenges of this Approach

Combining ESG factors with this quantitative investment approach has been widely considered. But it presents its own challenges. Enhanced indexing tries to amplify benchmark returns and thus depends on a favoured performance driver. The never-ending debate on whether it is possible 'to do well while doing good' suggests that identifying a persistently successful sustainable investment signal is demanding.

First, ESG is a complex construct with hundreds of indicators within the E, S, and G categories available to measure a firm's non-financial performance. Among the hundreds of indicators, many are redundant as they measure related concepts adding little on top of similar indicators and generating noise when assessing firms' ESG performance.[iii] Aggregate ESG scores are therefore poor alpha signals and difficult to successfully integrate in an enhanced index strategy; determining the right indicators to focus on is essential.

Second, corporate disclosure quality on non-financial metrics is unstructured and has no common standard: many indicators require subjective interpretation making it challenging to establish a consistent link to financial performance. Access to quantitative data on objective indicators is therefore key in the crowded ESG space.

Third, specialist knowledge is crucial in uncovering sustainable alpha. Data needs expert validation and careful analysis before it is possible to expose any link to economic value creation. Such investments in data and human capital generate material overhead costs. However, by cutting through the noise and conducting deep research on specific indicators with strong economic rationales, it is possible to contain the costs.

Academic research suggests that certain ESG metrics are more promising financial performance indicators than others. Eco-efficiency, i.e. the creation of economic value while leaving the least possible environmental footprint compared to sector peers, is an example of an environmental performance measure[iv] that has been linked to financial performance. Other examples are accruals as a measure for governance[v] and employee satisfaction as a social performance measure[vi].

Over and above being linked to financial performance, it is important that the sustainable investment signal is independent and uncorrelated to other common factors. If not, the resulting enhanced index strategy will still have sustainable credentials, but the excess return can be attributed to other common factors; sustainability is not the performance driver. In other words, the signal correlates with other rewarded firm characteristics that are identifiable through conventional investment analysis.

Once in-depth research has successfully identified a sustainable alpha-generating signal in practice, an outcome that is only achieved by very few, an enhanced index strategy can be built using the signal. Stocks with poor signal performance can be underweighted or excluded while the resulting change in risk exposures can be compensated by overweighting stocks that exhibit good signal performance. Enhanced index managers can therefore tilt away from undesirable negative exposures and tilt towards desirable positive exposures and, crucially, otherwise reproduce the country, industry, and factor exposures of the benchmark subject to a tight tracking error. Financial outperformance is thus targeted through active exposure to the sustainable alpha signal—the sweet spot balancing cost-effective and meaningful sustainable investment.

Voice versus exit: What sustainable impact can an enhanced strategy have?

Another advantage of an enhanced index strategy is the use of both 'voice and exit'.

A sustainable investor can either stay and try to enact change through shareholder engagement and voting rights (voice) or they can vote with their feet and leave (exit).

While divestment is often the simpler and more convenient option and can have reputational benefits, managers often use their voice first, engaging with companies, to incentivise the change that they want to see, knowing that once divested they are no longer able to establish a dialogue. Nonetheless, the threat of being able to completely exclude a company from portfolios can be an important pressure point.

One of the shortcomings of passive fund management is that they can only rely on the voice tactic. A passive manager needs to buy and hold the entire market portfolio (of which a company with poor sustainability characteristics is a part). Therefore, by not having access to the exit option, passive managers have arguably less influence over their portfolio constituents. A debate on the impact of voice and exit is ongoing[vii], but clearly, having recourse to both tactics rather than just one is advantageous. Moreover, studies suggest that passive managers are also passive shareholders not employing their voice effectively[viii].

Sustainable enhanced indexing provides access to both voice and exit. On top of voting and engaging with portfolio firms, enhanced strategies can underweight sustainable underperformers or completely exclude the worst offenders from their portfolios while compensating for resulting country, industry, and factor biases relative to the benchmark by overweighting other stocks with desirable characteristics. In this way, managers can express their sustainability preferences by rewarding the sustainability leaders and penalising the sustainability laggards. Enhanced strategies can thereby closely replicate the market's risk exposures while providing substantially improved sustainable footprints; something that both active strategies and passive ESG indices struggle to deliver.

Sustainable enhanced indexing at Osmosis: The Core Equity Fund

Osmosis builds sustainable portfolios based on the concept of Resource Efficiency. Resource Efficiency is defined at the company level, using Osmosis' proprietary environmental database measuring the carbon emission generated, the water used, and waste created to produce one unit of revenue. Stocks with a high Resource Efficiency score are those which most efficiently use limited resources to create economic value.

Through the development of Osmosis' proprietary database and its team of sustainability and environmental researchers, we are able to link corporate Resource Efficiency to economic value generation and financial performance—a sustainable alpha signal that can subsequently be incorporated into our enhanced index strategy by our dedicated portfolio managers.

The Osmosis Resource Efficient Core Equity Fund seeks superior risk-adjusted returns by maximising Resource Efficiency exposure while targeting a tight tracking error of 0.7% to the MSCI World. There are strict geography and industry active weight limits. There are also minimum holding requirements as well as maximum turnover constraints to ensure a fully replicable strategy. The strategy is rebalanced on a quarterly basis in line with the underlying benchmark.

The portfolio takes advantage of the inefficiencies of market cap weighted strategies by closely mimicking the factor exposure of the underlying benchmark with the active exposure being delivered through the Resource Efficiency factor. The resulting portfolio delivers a significantly reduced environmental footprint relative to the benchmark. The portfolio has been historically more than 65% more resource efficient than the benchmark, while maintaining investments in all relevant economic sectors.

The enhanced index strategy of the Core Equity Fund allows Osmosis to make use of both voice and exit. Sustainability preferences are expressed through overweighting and underweighting stock positions and corporate engagement targets the environmental disclosure practices of the portfolio constituents. We work with companies to understand how they react to their data and advise management on how their practices, reflected in their resource data, will impact their possible inclusion in our programmes.

As a last resort, Osmosis is willing to exit. Currently, all portfolios exclude the tobacco sector and social and governance safeguards are ensured by adhering to the United Nations Global Compact principles. Subject to breaches and when long-term engagement does not lead to improvements, we may proceed to exclude companies from the Core Equity Fund.

In summary, Osmosis' Core Equity Fund offers a highly diversified cost-effective sustainable portfolio that has shown consistent outperformance (as of 31 August 2020) relative to the MSCI World Index since its launch in May 2017, while retaining its general risk profile.

---

[i] See for example:

Cremers, Martijn, et al. "Indexing and active fund management: International evidence." Journal of Financial Economics 120.3 (2016): 539-560.

Cremers, KJ Martijn, and Antti Petajisto. "How active is your fund manager? A new measure that predicts performance." The review of financial studies 22.9 (2009): 3329-3365.

Gruber, Martin J. "Another puzzle: The growth in actively managed mutual funds." Investments and Portfolio Performance. 2011. 117-144.

Guercio, Diane Del, and Jonathan Reuter. "Mutual fund performance and the incentive to generate alpha." The Journal of Finance 69.4 (2014): 1673-1704.

Kosowski, Robert, et al. "Can mutual fund “stars” really pick stocks? New evidence from a bootstrap analysis." The Journal of finance 61.6 (2006): 2551-2595.

Pástor, Ľuboš, Robert F. Stambaugh, and Lucian A. Taylor. "Scale and skill in active management." Journal of Financial Economics 116.1 (2015): 23-45.

Wermers, Russ. "Mutual fund performance: An empirical decomposition into stock-picking talent, style, transactions costs, and expenses." The Journal of Finance 55.4 (2000): 1655-1695.

[ii] See for example:

Hong, Harrison, and Marcin Kacperczyk. "The price of sin: The effects of social norms on markets." Journal of financial economics 93.1 (2009): 15-36.

[iii] Berg, F., Koelbel, J.F. and Rigobon, R., 2019. Aggregate Confusion: The Divergence of ESG Ratings.

[iv] For more information, contact Osmosis for its own in-house research or refer to independent evidence such as the study by Derwall, Jeroen, et al. "The eco-efficiency premium puzzle." Financial Analysts Journal 61.2 (2005): 51-63.

[v] Sloan, R.G., 1996. Do stock prices fully reflect information in accruals and cash flows about future earnings?. Accounting Review, pp.289-315.

[vi] Edmans, Alex. 2011. “Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices.” Journal of Financial Economics 101 (3), 621–640.

[vii] See for example:

Dimson, E., Karakaş, O. and Li, X., 2015. Active ownership. The Review of Financial Studies, 28(12), pp.3225-3268.

Dimson, E., Karakaş, O. and Li, X., 2018. Coordinated engagements.

Hoepner, A.G. and Schopohl, L., 2018. On the price of morals in markets: An empirical study of the Swedish AP-Funds and the Norwegian Government Pension Fund. Journal of Business Ethics, 151(3), pp.665-692.

Trinks, A., Scholtens, B., Mulder, M. and Dam, L., 2017. Divesting Fossil Fuels: The Implications for Investment Portfolios. Trinks, PJ, Scholtens, L., Mulder, M., & Dam, L.(2017). Divesting Fossil Fuels: The Implications for Investment Portfolios.(SOM Research Reports). Groningen: University of Groningen, SOM research school.

Pedersen, Lasse Heje and Fitzgibbons, Shaun and Pomorski, Lukasz, 2019. Responsible Investing: The ESG-Efficient Frontier.

[viii] See for example:

Fichtner, Jan, Eelke M. Heemskerk, and Javier Garcia-Bernardo. "Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and new financial risk." Business and Politics 19.2 (2017): 298-326.
Heath, Davidson, et al. "Passive investors are passive monitors." SSRN Electronic Journal (2018).
Lund, Dorothy S. "The case against passive shareholder voting." J. Corp. L. 43 (2017): 493.

Important Information

This document is issued by Osmosis Investment Management US LLC ("Osmosis"). Osmosis Investment Management UK Limited ("Osmosis UK") is an affiliate of Osmosis and has been operating the Osmosis Model of Resource Efficiency. Osmosis UK is regulated by the FCA. Osmosis and Osmosis UK are both wholly owned by Osmosis (Holdings) Limited ("OHL").

Investments like these are not suitable for most investors as they are speculative and involve a high degree risk, including risk of loss of capital. There is no assurance that any implied or stated objectives will be met.

The Osmosis Resource Efficient Core Equity Fund is not available for U.S. Investors. A Client's account will be managed by Osmosis based on the strategy, but the actual composition and performance of the account may differ from the Fund due to differences in the timing and prices of trades, and the identity and weightings of securities holdings.

Past performance may not be indicative of future results.

Information pertaining to Osmosis's advisory operations, services, and fees are set forth in Osmosis's current disclosure statement (Form ADV Part 2A), a copy of which is available from Osmosis upon request and from the SEC at http://www.adviserinfo.sec.gov.

You are solely responsible for making your own independent appraisal of and investigations into the products, investments and transactions referred to in this report and you should not rely on any information in this report as constituting investment advice. Neither Osmosis nor any of its officers, employees or agents are responsible for providing you with legal, tax or other specialist advice and you should make your own arrangements in respect of this accordingly.

Under no circumstances is this report to be used or considered as an offer to sell, or a solicitation of any offer to invest in the Fund.

Benchmarks. The historical index performance results for all benchmark indexes do not reflect the deduction of transaction, custodial, or management fees, the incurrence of which would have the effect of decreasing indicated historical performance results. Indexes are unmanaged and are not available for direct investment. The referenced benchmarks may or may not be appropriate benchmarks against which an observer should compare our returns.

The MSCI World Index captures large and midcap representation across 23 Developed Markets countries. With 1,645 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Any views expressed are those of Osmosis only and should not be construed as investment advice or in any way recommending a specific security.