Implementing ESG in an Index-Based Framework

The topic of ESG investing receives boundless coverage across the financial industry. While it obviously means different things to different investors, much of the coverage centers on this thesis: active managers that invest in companies with better stewardship of the world's resources and have top tier governance practices will outperform their competitors over the long term. On the other hand, a custom passive investment strategy can offer a couple of different ways to implement ESG themes more narrowly tailored to clients' objectives. These strategies can deliver risk-controlled portfolios that track a benchmark, and can be customized to fit nearly any specified ESG factor in virtually any asset class.

Different Implementation Methods

There are a number of ways to implement ESG criteria in a portfolio, among them: exclusionary screening, factor targeting, and rules-based portfolio construction. The first approach, exclusionary screening, is akin to traditional SRI investing where screening criteria are selected—say, for example exclusion of companies that make their money developing fossil fuels. Next, a minimum or maximum threshold is selected to screen companies out of the available investment universe—perhaps a trigger of 15% of revenues are derived from the targeted activity. After the screened companies are excluded, a narrowed investable universe remains. From here, the portfolio can be optimized against a passive objective to deliver the client a minimal tracking error against the agreed benchmark without the screened securities in the portfolio. This approach ensures that a client's investments align with their personal values or corporate mission.

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However, clients can go a step further with factor targeting, also known as overweighting and underweighting. When utilizing this approach, rather than excluding companies from the investable universe, the proposition is to change the weighting scheme of a portfolio to target certain ESG factors. Using the example above, imagine a client does not like the impact of fossil fuels on the environment. Rather than exclude companies involved in the development of fossil fuels, the portfolio could underweight the most significant developers of fossil fuels. And, this can be done with multiple factors—for example, overweighting companies with diversity in management or on boards. We would then optimize the portfolio to reduce factor and asset risk while seeking to achieve the ESG targets. Thus, all companies within the investable universe would be eligible for inclusion in the portfolio. This counters the fear-of-missing-out issue some investors have with exclusionary screens.

A third approach to implementing ESG criteria in a client's portfolio is creating a custom rules-based portfolio that includes a much narrower slice of companies within the investable universe. An example of this is our approach the issue of anti-BDS (Boycott, Divest, and Sanction) investing. Rather than exclude companies, or overweight factors, the portfolio only invests in large cap companies with a minimum level of economic or educational engagement as illustrated with our Israel Impact Portfolio , for example. This process requires more in-depth research, which can lead to the exclusion of a significant number of companies from the investable universe. From here, the portfolio can be optimized against a benchmark, equal-weighted, or adjusted to fit another weighting scheme.

Conclusion

There are many ways to implement ESG criteria outside of a traditional active portfolio. A passive optimized investment methodology allows for flexibility to meet a myriad of client objectives. No two clients are alike, which is why it is important to understand the various ways to implement ESG investment objectives within a portfolio. In our next update, we will cover the different types and sources of ESG data available.

About Crossmark's 30 Year History

Crossmark Global Investments is an innovative investment management firm. We provide a full suite of investment management solutions to institutional investors, financial advisors and the clients they serve. We have a multi-decade legacy of specializing in values-based investment strategies for clients. Founded in 1987, the firm is headquartered in Houston, Texas.

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