Smart Sustainability: 2019 global survey findings from asset owners

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Contents

Introduction

For the last six years we've conducted and published the FTSE Russell Smart Beta survey of asset owners. With each passing year we learn more details about asset owners' awareness, attitudes and behavior related to smart beta, and we continue to adapt the questionnaire to accommodate emerging trends and areas of investment interest to our clients and the global asset owner community.

We first included ESG in the survey back in 2017, asking if asset owners were thinking of applying ESG considerations to smart beta to develop a better understanding of the emerging demand for ESG that appeared to be bubbling up into smart beta. We and our readers were surprised to find out the degree to which ESG was being considered an option to accompany smart beta indexation—in 2017 over 40% of asset owners using or evaluating smart beta said they were looking to apply ESG considerations to a smart beta strategy.

This is reflected in our client work where we work with a growing number of asset owners who wish to integrate ESG parameters—especially climate risk—into smart beta indexes. We call this Smart Sustainability and apply a consistent factor methodology across both risk premia factors and ESG parameters. Therefore, we decided to dig deeper into this approach this year by producing a separate report to sharpen the focus and help us better understand the motivations and regional differences in the application of ESG to smart beta. The results are striking, with pronounced regional differences within Europe and North America, which appear to be growing.

- For example, 77% of European asset owners expressed interest in applying ESG considerations to smart beta which was up from 55% last year. In contrast only 17% of North American asset owners indicated similar interest, which was down from 25% last year.
- This may reflect the changing regulatory context with European regulators encouraging ESG integration, while in the US, recent interventions under the current administration, including for pension plans subject to the Employee Retirement Income Security Act (ERISA), have arguably been in the opposite direction.
- When those who indicated interest were probed further for their motivations, "long-term risk mitigation" was the most popular response, up from 54% of respondents last year to 78% this year.
- The most common application of ESG data was negative screening (over 60%). However, 46% of

larger asset owners (over $10B AUM) are likely to go beyond screening and use ESG data akin to factors within the re-weighting methodology, versus only 26% of smaller asset owners.

- Appetite for ESG & smart beta is also higher among larger funds; with 58% of larger funds (but only 30% of smaller funds) looking to increase their allocation over the coming years. Only 4% of larger funds did not think they would increase allocations to ESG & smart beta.

We hope you enjoy reading through this past year's findings and welcome any feedback or questions you may have about how combining smart beta and ESG could address your institutions' investment objectives.

David Harris
Group Head of Sustainable Business, FTSE Russell

Smart Sustainability is the combination of sustainability parameters and smart beta risk premia—for example, via factor exposure—within a single index solution. It reflects the growing demand for the incorporation of factors as well as Environmental, Social, and Governance (ESG) data into investment tools including indexes.

Survey background

The results included in this report are sourced from the 2019 FTSE Russell Smart Beta survey of asset owners. While this is the sixth year FTSE Russell has conducted our smart beta study, it is the third year we have included questions about applying ESG considerations to smart beta strategy. As interest in the topic of ESG has grown, in each of the past three years we have expanded the line of questioning around ESG within the smart beta survey.

The 2019 survey was conducted in January and February, with 178 global asset owners participating. The majority of participants were located in North America (46%), Europe (29%), and Asia Pacific (19%).

A wide mix of organization types are represented, including government organizations (31%), corporations or private businesses (16%), unions or industry-wide pension schemes (15%), and non-profit organizations or universities (14%). The rest is a mix of insurance companies, sovereign wealth funds, health-care organizations and family offices.

Fifty-three percent of the asset owners who responded manage defined benefit plan assets, 36% manage defined contribution plan assets and 14% manage endowment or foundation assets. In some cases, respondents selected more than one of these categories. Participants also include asset owners with insurance general accounts, sovereign wealth funds and other types of institutional entities.

Asset owners with $10B or more in total AUM account for 51% of responses, those with AUM between $1B and $10B account for 27% and the remaining 22% of responses are from asset owners with under $1B in total AUM. Aggregate AUM of the survey participants is estimated to be over $5 trillion.

The distribution of our asset owner sample has shifted from year-to-year across regions and AUM tiers. This can contribute to year-over-year changes in the results.

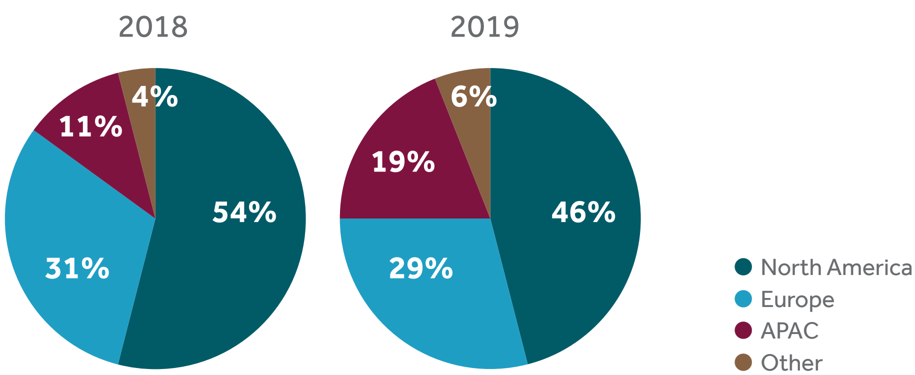
For the purposes of our survey, "smart beta" is defined as an investment strategy that applies an index-based investment strategy that is not traditionally market cap–weighted (i.e. fundamentally weighted, equal weighted, factor weighted, optimized, etc.).

For a sample size of 178, the margin of error is +/- 7% at a 95% confidence margin. Throughout the report, percentages may not total 100 due to rounding and/or because some questions allowed for multiple responses (allowance for multiple responses is noted as "multi-pick" in each exhibit footer).

Sample distribution by year for 2014 – 2019.

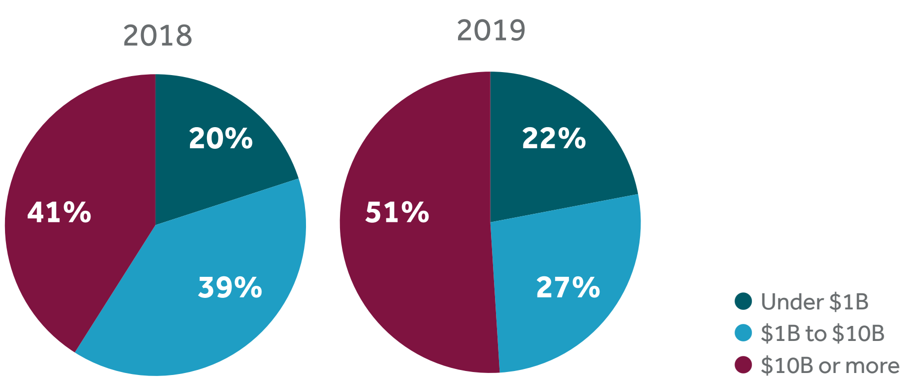
Exhibit 1

Region distribution



Asia Pacific was not included in 2014.

AUM tier distribution



1

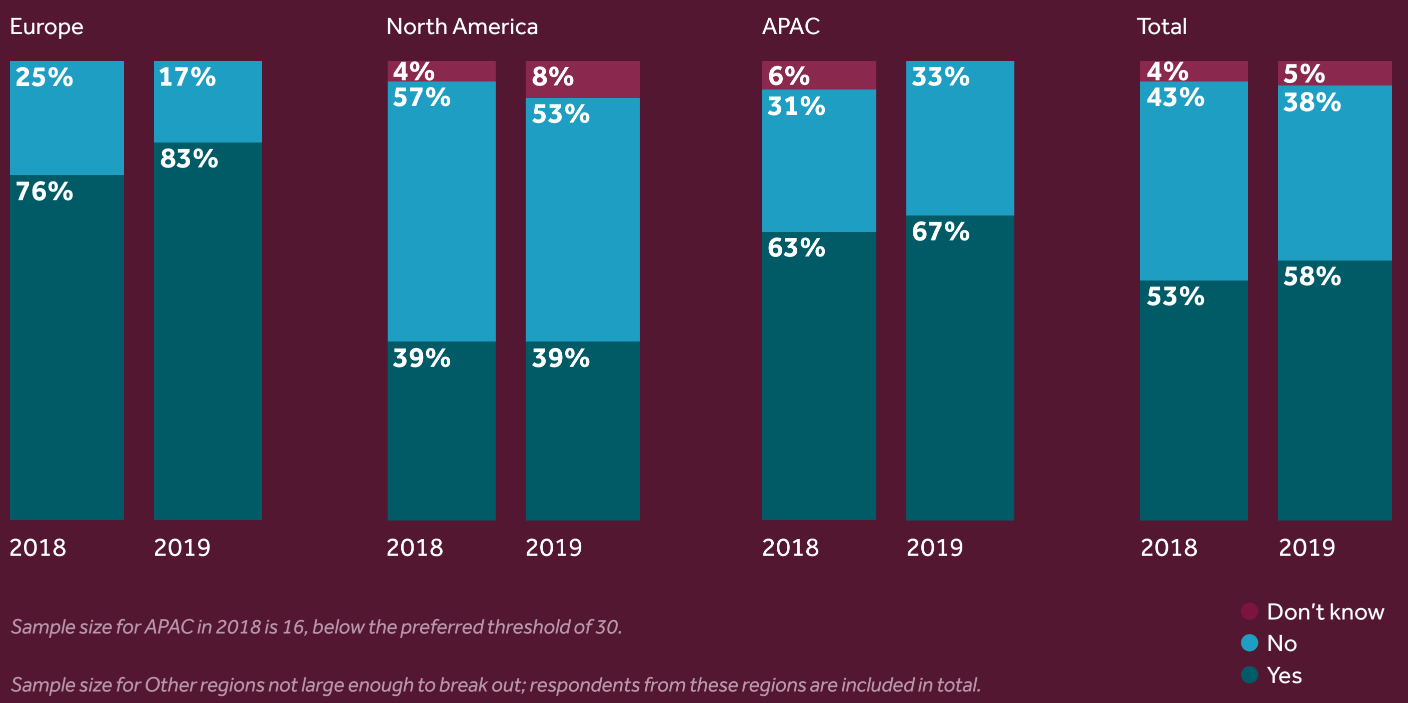
Implementation of ESG considerations

Globally, nearly six in ten asset owners are currently implementing or evaluating ESG considerations in their investment strategy. Pronounced regional differences in ESG usage exist.

The 2019 rate of ESG evaluation and adoption in Europe (83%) is more than two times that of North America (39%), while the APAC ESG evaluation and adoption rate lies between the two (67%). ESG evaluation and implementation ticked up slightly in Europe and APAC, has declined slightly in North America.

Exhibit 2

Is your organization currently implementing or evaluating ESG considerations in your investment strategy?



Sample size for APAC in 2018 is 16, below the preferred threshold of 30.

Sample size for Other regions not large enough to break out; respondents from these regions are included in total.

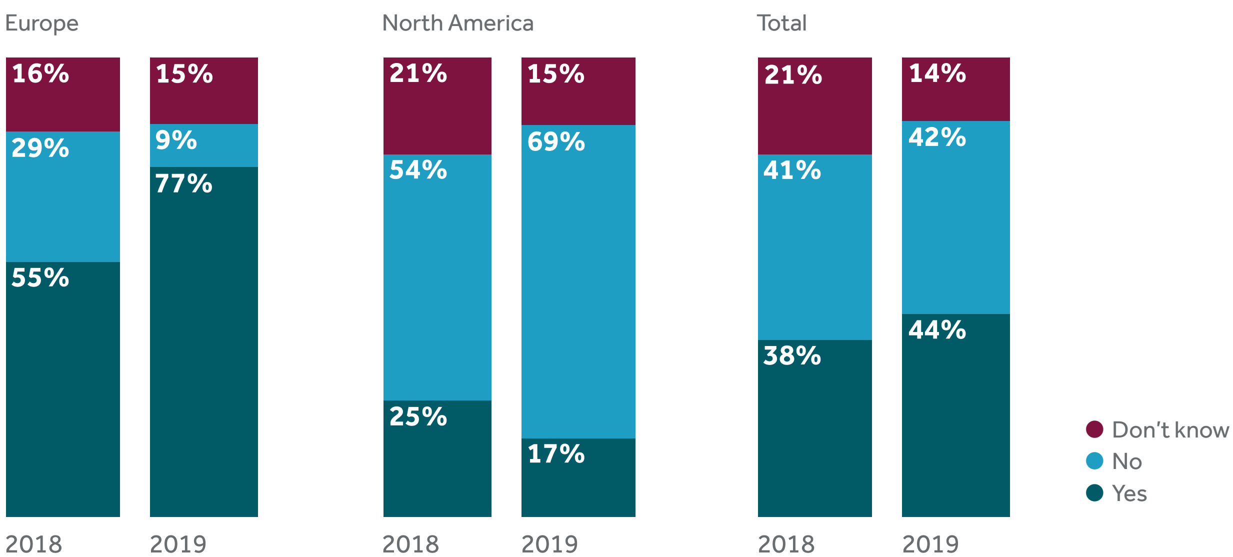
Among those who are using and/or evaluating smart beta strategies, 44% globally anticipate applying ESG considerations to their smart beta strategy of choice.

Marked regional differences have grown over the past year. More than 75% of European asset owners evaluating or using smart beta expect to apply ESG considerations to smart beta, which is up from 55% last year. In contrast, only 17% of North American asset owners do, and this has declined from 25%.

The share of European asset owners who anticipate applying ESG considerations to a smart beta strategy increased substantially.

Exhibit 3

Do you anticipate applying ESG considerations to a smart beta strategy?



Segment = Have a smart beta allocation OR are currently evaluating/re-evaluating smart beta strategies OR are planning to evaluate smart beta strategies in the next 18 months.

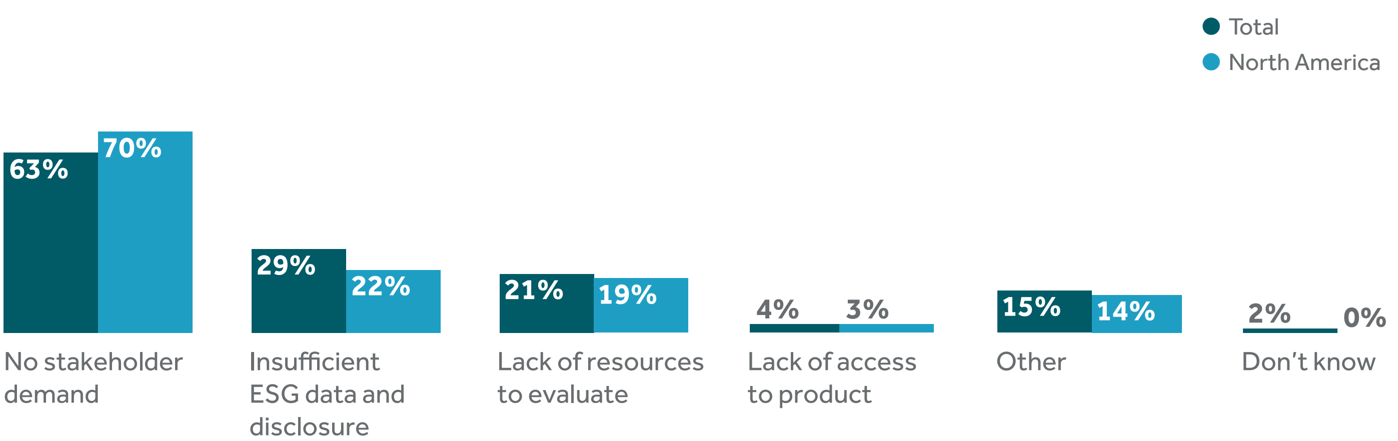
Sample size for Asia Pacific and Other regions not large enough to break out; respondents from these regions are included in total.

Among those who do not anticipate applying ESG considerations to a smart beta strategy, lack of stakeholder demand is cited as the key barrier, particularly in North America.

More than 75% of this segment is based in North America because the majority of respondents for other regions were applying ESG considerations. Given this regional slant our sample of those who do not anticipate applying ESG considerations to smart beta heavily reflects the North American viewpoint. It is perhaps worth noting that outside of North America there appeared an equal split between concerns over sufficient data and no stakeholder demand.

Exhibit 4

Why don't you anticipate applying ESG considerations to a smart beta strategy?



Multi-pick. Segment = Do NOT anticipate applying ESG considerations to a smart beta strategy.

2

ESG and smart beta: Motivation and approaches

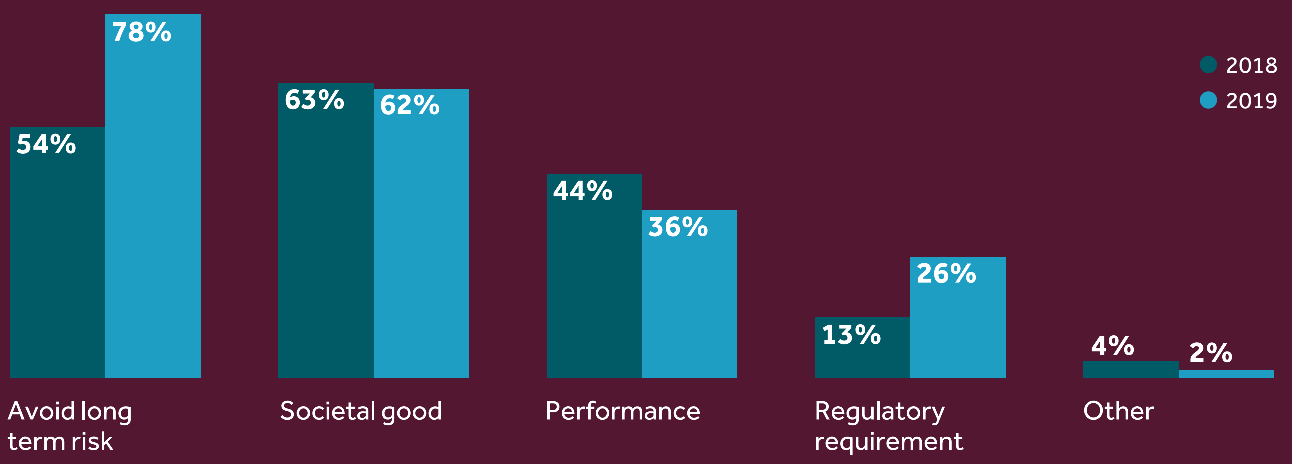
The top motivation for applying ESG considerations to a smart beta strategy is avoiding long term risk, and this rationale has grown.

Among those who anticipate applying ESG considerations to a smart beta strategy, over three quarters are motivated by avoiding long term risk compared to a little over half last year. Sixty-two percent are motivated by societal good. Performance and regulatory requirements motivate a smaller proportion of respondents.

Half of the 2019 survey respondents who anticipate applying ESG considerations to smart beta strategies are based in Europe; 18% in North America and 32% in other regions.

Exhibit 5

What is your motivation for applying ESG considerations to a smart beta strategy?



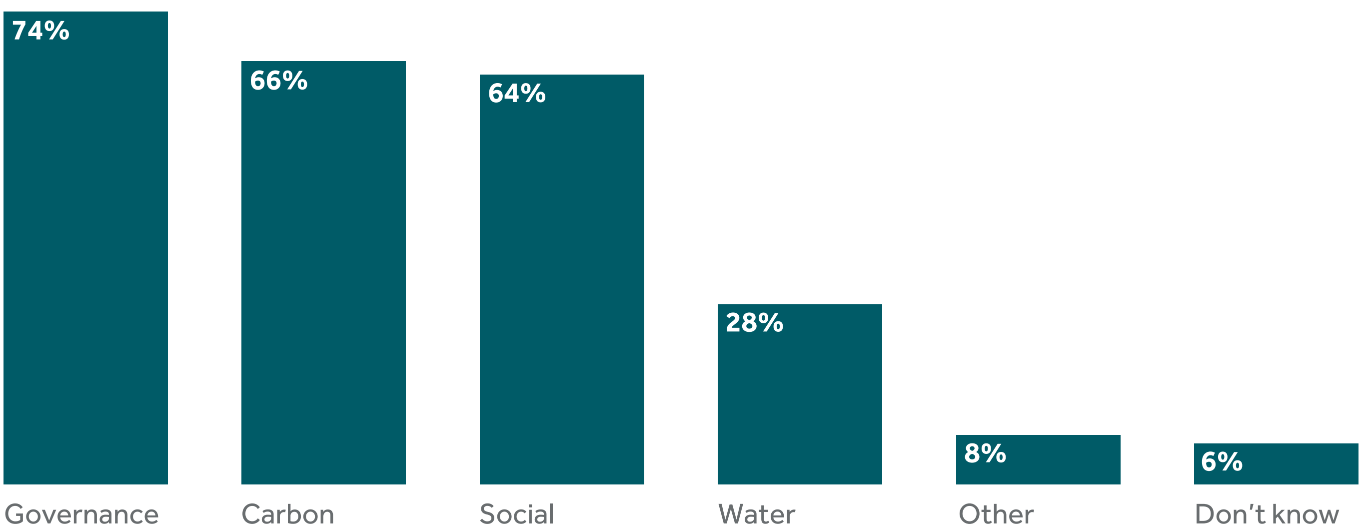
Multi-pick. Segment = Anticipate applying ESG considerations to a smart beta strategy.

Among those who anticipate applying ESG considerations to their smart beta strategy, governance, carbon, and social are the key issues under consideration.

There are a variety of different ESG themes that appear to be a focus with environmental, social and governance themes all coming in over 60%, with governance featuring the highest.

Exhibit 6

What ESG issues are you considering using in a smart beta and ESG allocation?



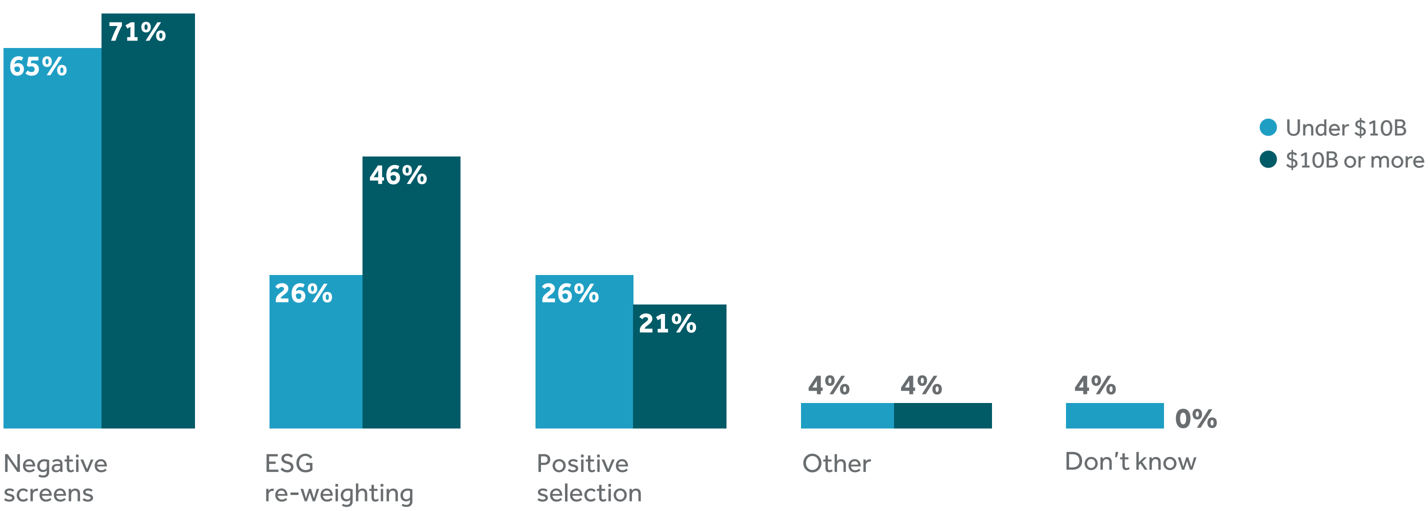
Multi-pick. Segment = Anticipate applying ESG considerations to a smart beta strategy.

The primary ESG investment approach being used or considered with smart beta is negative screens but using ESG akin to factors to re-weight is growing in popularity with larger asset owners.

For both large and mid/small tier AUM asset owners, negative screens are used and considered more frequently than ESG re-weighting, positive selection and other approaches. However, ESG re-weighting is more likely to be used or considered by large asset owners. Given that this is a more sophisticated approach than screening it is perhaps not surprising it is more popular with larger schemes with more resources.

Exhibit 7

What ESG investment approaches are you using or considering using in a smart beta and ESG allocation?



Multi-pick. Segment = Anticipate applying ESG considerations to a smart beta strategy.

Sample size for Under $10B AUM is 23 and for $10B or more AUM is 24, below the preferred threshold of 30.

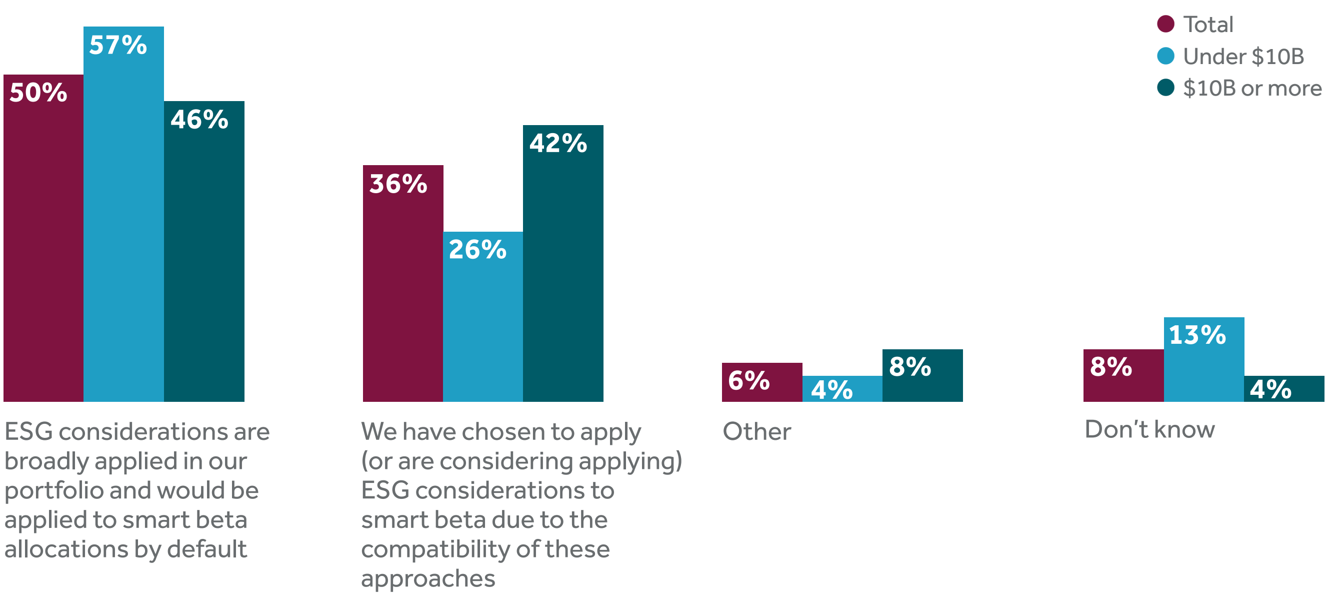
Half of those who anticipate applying ESG considerations to a smart beta strategy would do so by default rather than due to perceived compatibility of approaches. Large asset owners are more likely to act due to perceived compatibility than mid- or small-tier asset owners.

Of those with AUM greater than $10 billion who anticipate applying ESG considerations to a smart beta strategy, asset owners are just about as likely to apply ESG considerations by default as to do so due to perceived compatibility of approaches. Asset managers with AUM under $10 billion are more likely to apply ESG considerations by default.

This question and result appear to back up the previous question with "compatibility of approaches" likely to be considered where ESG parameters are being used to influence re-weighting, and hence the similar result with larger asset owners.

Exhibit 8

Which statement best describes the application or evaluation of ESG considerations to smart beta within your organization?



Segment = Anticipate applying ESG considerations to a smart beta strategy.

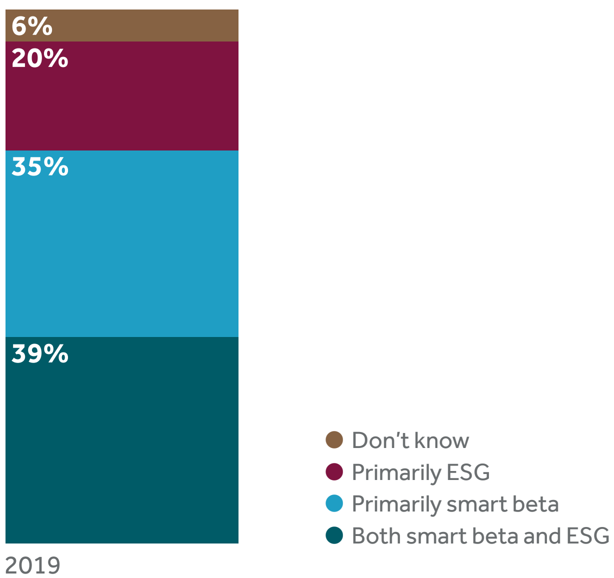
Sample size for Under $10B AUM is 23 and for $10B or more AUM is 24, below the preferred threshold of 30.

Interest in combining smart beta and ESG is most commonly driven by a strong motivation for both rather than being motivated primarily by ESG or smart beta alone.

Over a third of asset owners interested in applying ESG considerations to smart beta are primarily motivated by smart beta and nearly 40% are motivated by both smart beta and ESG.

Exhibit 9

Was your interest in smart beta and ESG motivated primarily by smart beta, primarily by ESG or both?



Segment = Anticipate applying ESG considerations to a smart beta strategy.

3

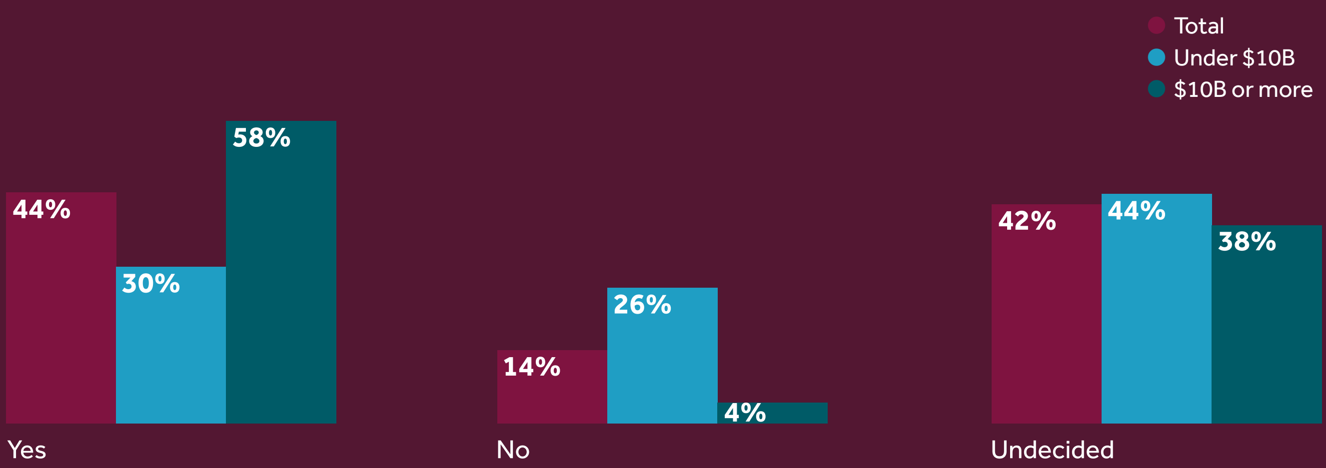
Outlook

The outlook for smart beta ESG is strong

Nearly half of those who anticipate applying ESG considerations to a smart beta strategy expect to increase their allocation to smart beta ESG over the next year or two, while 42% are undecided. For asset owners with AUM greater than $10B, 58% expect to increase their allocation to smart beta and ESG.

Exhibit 10

Do you expect to increase your allocation to smart beta ESG over the next one to two years?



Segment = Anticipate applying ESG considerations to a smart beta strategy.

Sample size for Under $10B AUM is 23 and for $10B or more AUM is 24, below the preferred threshold of 30.

Conclusion

One of the key themes that emerged from our 2019 smart beta survey findings was in fact the merging of two widespread trends already underway—smart beta and ESG. Global adoption rates of smart beta have reached a record high of 58% in 2019, and 58% of survey respondents are either implementing or evaluating ESG considerations in their investment strategies

Clearly there are pronounced regional differences in ESG usage, with Europe leading the way with its enthusiasm for applying ESG considerations to smart beta: Over 75% of European asset owners evaluating or using smart beta expect to apply ESG considerations to smart beta. In contrast, only 17% of North American asset owners do; their relative lack of interest stems from a lack of stakeholder demand. The path forward for the marriage of smart beta and ESG looks promising, as many asset owners reported plans to add to these allocations.

In terms of ESG smart beta implementation, asset owners use and consider negative screens more frequently than ESG re-weighting, positive selection or other approaches. ESG re-weighting is more likely to be used or considered by large asset owners than smaller ones, but re-weighting is still considered less often than negative screens across the AUM spectrum.

We will continue to include ESG questions in future smart beta surveys to continue monitoring how this confluence of trends takes shape and matures over time.

Appendix

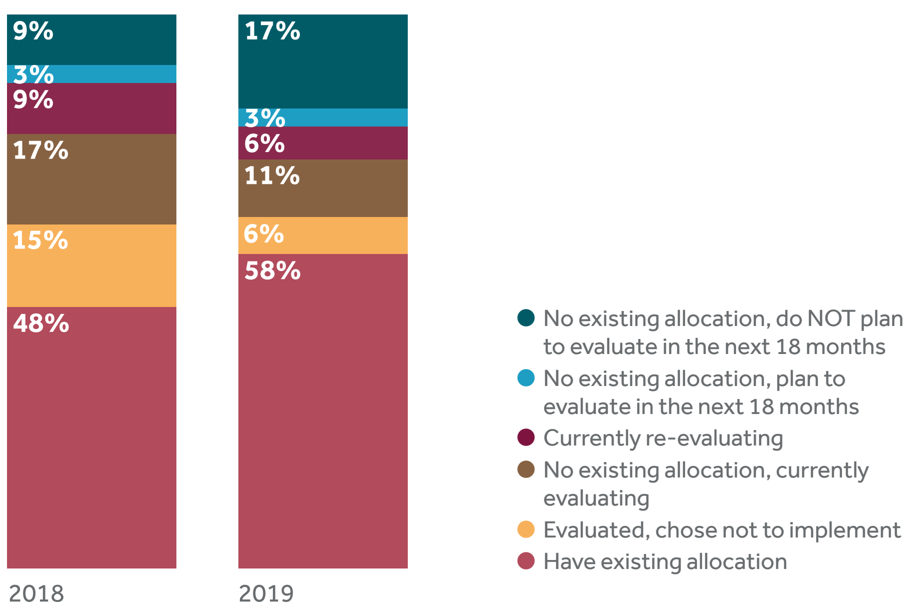
Organization type

	2018	2019
Corporation or private business	20%	16%
Government	36%	31%
Non-profit, university	15%	14%
Union or industry-wide pension scheme	10%	15%
Other	20%	24%

Plan type

	2018	2019
DB	67%	53%
DC	36%	36%
E/F	15%	14%

Which best describes your organization's usage of smart beta strategies?



Source: FTSE Russell. Smart beta: 2019 global survey findings from asset owners.

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About FTSE Russell

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