BNY MELLON | INVESTMENT MANAGEMENT

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WHY ACTIVE BEATS PASSIVE FOR SUSTAINABLE INVESTING

Why we believe an active sustainable strategy can afford investors greater control over the positive outcomes they desire from their investments.

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Interest in passive investing and sustainable investing continues to grow, and in some investors' minds the two styles are becoming increasingly intertwined.

Passive investing is the fastest growing area within ESG (environmental, social and governance) investing; only last month we saw the world's largest asset manager, BlackRock, pledge to double its sustainability-focused exchange-traded funds to 150, as part of its response to critics urging it to do more to combat climate change.

Perhaps the growing interest is in part because passive sustainable investing is perceived as both 'green' and low cost, but are these two attributes really such a good match?

Below, we set out some of the reasons **why we believe that an active sustainable approach is worth considering over a passive one.**

More than a letter... or a number

A growing number of passive asset managers claim that they are able to offer a suite of sustainable investment products by working closely with index providers such as MSCI, as well as using quantitative tools to aid the screening of ESG criteria.

This can seem reassuring and objective, but it potentially masks the underlying value judgements that are inevitably required to balance up the positive and negative ESG attributes of most substantial companies.

Another issue for passive ESG investment firms is that they normally need an index that they can easily replicate. The responsibility for this normally falls to the index providers who require quantitative data to build an index.

While the data collection carried out by index providers is gradually becoming more sophisticated, some continue to outsource data collection, and hire agencies to collect data by screening company annual reports to determine their sustainability policy. It is here that we believe some of the practical problems with this approach can be found.

ESG ratings: a lack of transparency?

The difference in the availability and reliability of corporate information provided on ESG inputs cannot be easily compared with that of conventional financial data. Companies are not obliged to provide 'soft' data on ESG factors in the way they are for conventional financial data, which makes like-for-like comparisons difficult.

Moreover, a listed company that communicates about sustainability is not automatically a more sustainable investment. ESG ratings suggest exactness, but are, in many instances, more akin to a 'black box'.

Exclusion: a binary process of 'in' or 'out'

Exclusion is the oldest and most transparent form of sustainable investment. However, it remains stark: a share is either in the index or it is not.

The real world is nuanced and complex, while indices are defined simply by what is included. In active sustainable investing, there can be a holistic, balanced and detailed consideration of all environmental, social and governance inputs. This requires strong research capabilities; it cannot simply be outsourced to algorithms, especially when the materiality of the available data is not standardised and, in some cases, may be incomplete or unreliable.

Your capital may be at risk. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested.

ACTIVE ENGAGEMENT: A FORCE FOR POSITIVE CHANGE...

in equities...

A key part of sustainable investing is **active engagement** with investee companies, with the aim of encouraging and persuading companies to improve their ESG practices in order to provide better outcomes for all stakeholders.

In our view, the problem for passive ESG strategies is not just that they have to rely on some form of normalised ESG scoring system, it is that, by virtue of having to own the whole (or most of the) market, the level of engagement they can achieve with companies is more limited.

Even where investors complete a detailed analysis to engage and track company progress, they still lack the **ultimate sanction** of selling their shareholding, because, as it remains in the replicable index, it is their duty to continue to hold the shares.

...and fixed-income

In active sustainable fixed-income investing the argument is broadly the same. While debt investors do not own shares in companies, they do often provide the primary or only source of capital to a company in the private sector, and even for certain countries.

We believe that having the ability to invest in private companies provides one of the most **powerful** engagement opportunities for fixed-income investors. We find actively engaging with issuers that have weaker credit ratings and/or are private, especially in the high-yield market where often bondholders provide the company's only access to capital, means that our questions, views and recommendations on ESG issues are increasingly being heard.

Put simply, companies are having to answer more bondholder questions related to their respective ESG strategies, and active investors are taking an increasingly dim view of those that are ill-prepared. This gives active investors a better chance of **effecting positive change**.

Passives missing out on the 'path to improvement'?

Another potential advantage that an active approach has over a passive approach to sustainable investing is that, in most cases, **passive investing relies on historical data** and, therefore, always looks backwards rather than forward. This creates a structural flaw in the assessment of the sustainability of a portfolio.

If investors wish to have an impact on society, they need to invest in companies that are improving or have the ability to improve, as well as those companies that already have strong ESG profiles.

In fact, a large part of the energy transition will have to come from companies that do not have a strong 'green' image just yet; active investors who understand this **'path to improvement'** are able to invest in, and **work with**, companies that they believe will benefit from this transition.

Finding tomorrow's winners

We believe that, in essence, this is the primary difference between opportunities in active and passive ESG investing.

A passive sustainable portfolio is mainly aimed at filtering out companies that have not performed adequately in this area or are operating in markets that do not meet the criteria.

By way of contrast, active investors can and should also look for companies with the highest potential for improvement and innovative ideas that can make the difference. It is precisely in this field that portfolio managers have to invest the majority of their time: it is not only about current sustainability goals, but also about investing in the potential winners of tomorrow.

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Lower cost, but at what price?

Although passive sustainable investing offers a cheaper solution, in our view the price difference stems from the lack of in-depth meaningful security selection which, in turn, supports active and informed corporate engagement.

We understand that cost is an important fiduciary consideration for many institutions and a personal one for many individuals, but when investors only pay attention to the costs, they may also be potentially abrogating real responsibility.

Passive sustainable investment can certainly look like a 'green' option in the market, but we believe that sustainable investing requires **a human solution for a human problem**. Investors who choose the passive option may be able to appease their conscience, but whether they can make the impact that they had set out to, remains in many cases open to debate.

Moreover, another issue with passive investment vehicles is that they are obliged to hold shares within an index irrespective of their valuation, whereas an active manager can take a view not only on a company's value as a sustainable entity, but also on its valuation relative to its peers.

> *"Our view is that picking an active sustainable strategy means that investors are choosing to invest in a much smaller number of stocks that have been positively evaluated to better reflect the outcomes investors are seeking from their sustainable investments."*

CONCLUSION

In our view, while we accept that they have a place in the sustainable suite of options as a low-cost alternative, passive sustainable strategies have less opportunity to drive company improvement through engagement than an active sustainable approach.

We also believe that, given the vast spread of companies passive sustainable strategies are obliged to own, they simply cannot provide the same **depth of analysis** that a market-leading active sustainable manager is able to achieve – or have the same leverage to effect positive change.

By way of contrast, our view is that picking an active sustainable strategy means that investors are choosing to invest in a much smaller number of stocks that have been positively evaluated to better reflect the outcomes investors are seeking from their sustainable investments.

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