Customisation: the new frontier of passive investing

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Commentators often oversimplify investing to a binary choice between what they perceive as two competing alternatives: actives and passives. The commentators overlook the fact that choosing a standard index is really an active asset allocation decision. Also, the way an index is constructed ultimately drives the selection of securities and, in some cases, the countries or regions in which an indexed portfolio will invest.

However, the reality is far more nuanced, according to the 2022 annual DWS/CREATE-Research survey titled 'Net zero: going beyond the hype'. It involved 50 large pension plans with €3.3 trillion of assets and based in seven key pension markets. Three themes stand out from the survey.[1]

1. Passives and actives can coexist

Active and passive investing is no longer a binary decision, according to 64% of the survey respondents. They are seeking a pragmatic complementarity between them within their core–satellite model.

In sectors and geographies where markets are efficient and highly liquid, passives are fast advancing into core portfolios, via cap-weighted indices and their refined versions such as smart beta and alternative risk premia. Currently, around 40% of pension assets are managed this way.

In contrast, satellites cover sectors and geographies where markets are inefficient and illiquid. Actives are used to harvest the resulting alpha opportunities. This is especially the case during periods of high volatility, when actives have more degrees of freedom than their passive peers who have to remain invested come what may. This way, pension portfolios are seeking to target momentum when it is working and long-term risk premia when they look promising.

There is one exception, however: climate investing is viewed as a long-term strategy. Thus, it sits in the buy-and-hold bucket, even though it relies on passives as well as actives.

2. Customisation embeds two innovations

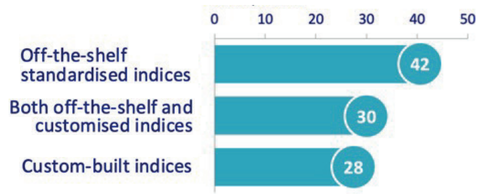
When it comes to investing in climate change via passives, traditional off-the-shelf indices remain the key vehicle (Figure 1). They are used by 42% of survey respondents, whereas newly emerging custom-built indices and exposures are used by 28%; 30% use both.

In asset-weighted terms, off-the-shelf versions predominate. For a modest amount of tracking error, they can have a meaningful impact on climate metrics — be that carbon emissions, biodiversity or water scarcity. However, future growth is expected to centre on custom-built indices and be driven by two innovations.

The first one integrates climate risks into their makeup. The reason is that off-the-shelf low-carbon indices seek to reduce emissions relative to their respective parent indices without targeting an explicit temperature scenario. In contrast, custom-built versions are explicitly linked to the absolute 1.5°C target scenario goal.

The second innovation gives pension investors the opportunity to engage directly with companies in their index, specifically when implemented through segregated mandates. Pooled vehicles such as traditional index funds or ETFs only give the investor indirect ownership of a security via their external managers. This makes it more difficult for an investor to become a direct active owner. In contrast, custom-built indices and exposures afford the opportunity of taking ownership of voting to boost the quality of their beta – to those pension investors with the necessary governance expertise and resources to do so.

Figure 1: What types of indices are being used in your pension plan's passive portfolio oriented towards climate change?



Source: CREATE-Research Survey 2022

3. PACT indices are set for take-off

In the climate context, most custom-built indices now seek to meet the requirement of the EU's two newly introduced benchmarks: Climate Transition Benchmarks (CTBs) and Paris-Aligned Benchmarks (PABs), collectively referred to as PACT indices.

Broadly speaking, they target an absolute reduction in carbon emissions over the next ten years by underweighting, or excluding, companies with fossil fuel reserves and/or excessive greenhouse gas emissions. They also overweight companies with higher green revenues.

In the Climate Transition Benchmark, the underlying asset mix is weighted or excluded to position the portfolio firmly on a decarbonisation pathway. It allows fossil fuel investments in the transition process.

The PAB goes one step further in this ambition by putting portfolios immediately in line with where they need to be by 2030: a 50% reduction in carbon intensity and the exclusion of fossil fuel-related activities. This is the key intermediate step to carbon neutrality by 2050. It also gives credibility to the net zero journey. Overall, it targets a 7% year-on-year reduction in carbon emissions plus a 1.5°C limit on global temperature rise by 2050.

When asked how important the PACT indices are likely to be in achieving net zero targets, 52% said 'very important', 28% said 'somewhat important' and the remaining 20% said 'not important' (Figure 2).

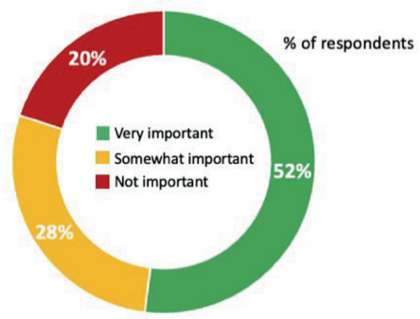
As for their adoption, 22% of our respondents use them currently on a notable scale and 56% expect to use them in the near future (Figure 3).

Their expected growth is underpinned by two desirable design features.

First, even if the world increases its carbon footprint and misses the 2050 goal, these new indices will stick to their decarbonisation trajectory regardless. Thus, climate action is hardwired into these indices, come what may.

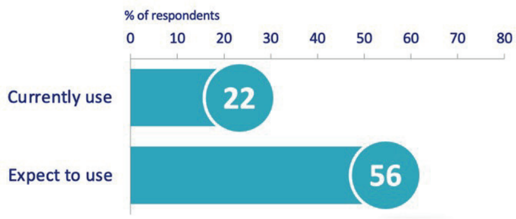
Second, index providers are required to increase their disclosures of alignment with the Paris Agreement goals for all significant indices, and in ways that enable investors of all sizes to have easy access to labelled financial tools that align their investments with a 1.5°C pathway.

Figure 2: How important are the PACT indices likely to be in delivering your pension plan's net zero target



Source: CREATE-Research Survey 2022

Figure 3: Do you currently use or soon expect to use the PACT indices on a notable scale?



Source: CREATE-Research Survey 2022

Following the release of the European Commission's minimum standards for these two benchmarks, index providers have started to build eligible, science-based indices with two key attributes: full disclosure on their alignment with the 1.5°C pathway and easy access to clearly labelled tools that align with it.

To enhance their alignment, the EU has taken the lead in devising a gold standard for ESG investment in general with its Sustainable Finance Disclosure Regulation, as set out under Articles 8 and 9.

Essentially, Article 8 funds will have some level of broad ESG integration, while Article 9 funds will have specific sustainability targets as the driving force behind their investment mandate. Hence, passive funds have strong tailwinds behind them.

To learn more, download the report at go.dws.com/create-study-2022

FOOTNOTES

1 Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

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