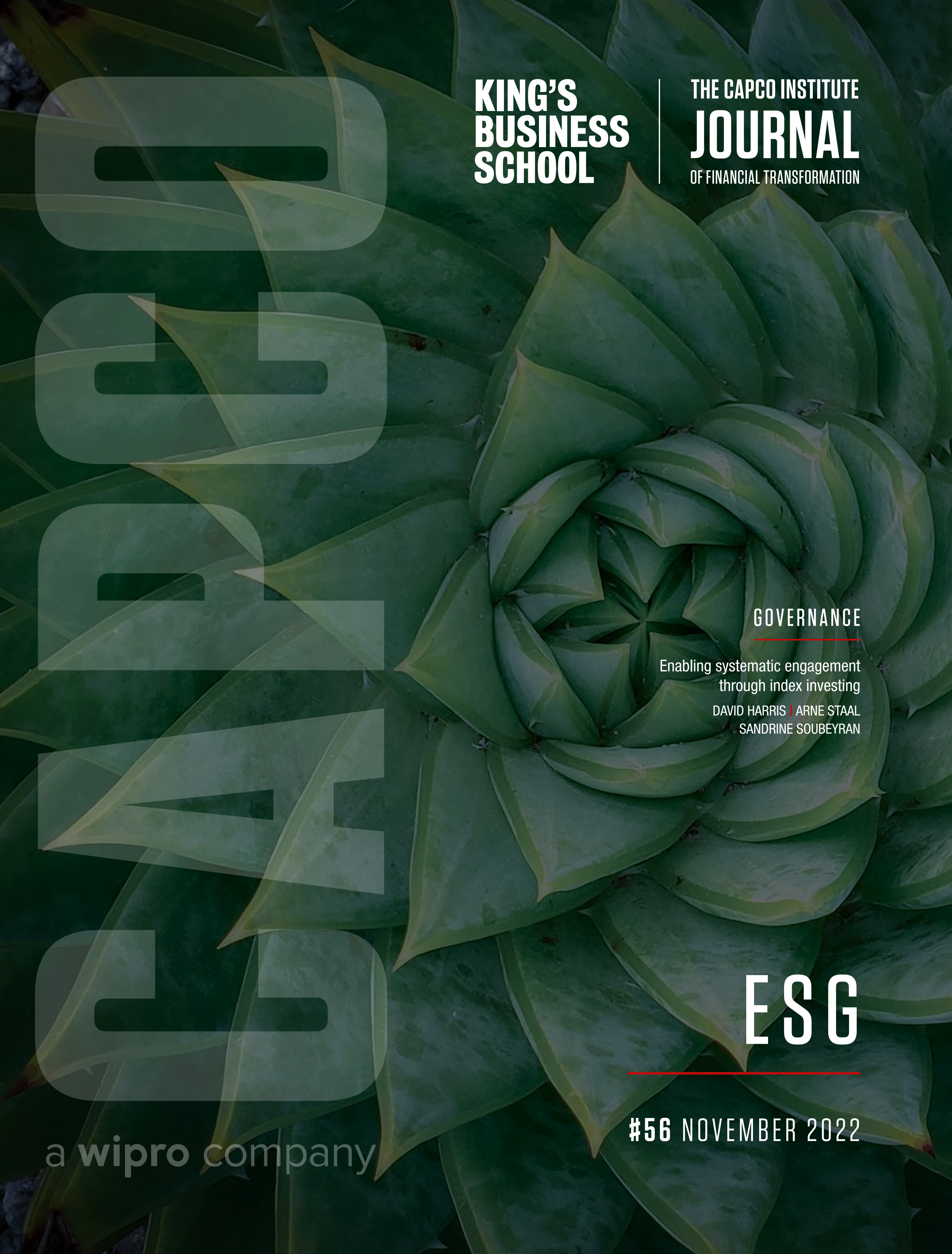

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GOVERNANCE

Enabling systematic engagement through index investing

DAVID HARRIS | ARNE STAAL
SANDRINE SOUBEYRAN

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DEAR READER,

Welcome to edition 56 of the Capco Institute Journal of Financial Transformation, produced in partnership with King's Business School and dedicated to the theme of ESG – environmental, social and governance.

We all recognize that transformation towards a green economic system via sustainable finance is needed, welcome and inevitable. Our clients have a crucial role to play here. Acknowledging the scope and complexity of the evolving ESG landscape, we are perfectly positioned to prepare them for the ESG era.

With climate change accelerating and generating physical events on an unprecedented scale, governments and societies are considering measures to mitigate carbon emissions via net zero initiatives. The focus is firmly on greater sustainability and more equitable policies in response to shifting public attitudes. ESG considerations are reshaping investment risks on the one hand, and opening the way for green financing and sustainable technologies and innovations on the other.

This edition of the Journal examines all three pillars – environmental, social, and governance, highlighting efforts by regulators and practitioners to create a unified approach.

Moving forward, compliance with emerging ESG standards will be a critical differentiator for long-term business success. Data will also play a critical role in delivering the transparency and insights required to validate the ESG credentials of businesses, and investment strategies. Advances in areas such as machine learning, artificial intelligence and cloud technologies will be key to establishing a future model of sustainable finance.

This edition draws upon the knowledge and experience of world-class experts from both industry and academia, covering a host of ESG topics and innovations including the value of tracking Return on Sustainability Investment (ROSI) and the importance of moving away from purely external risks to addressing issues that can have positive commercial and societal impacts.

I hope that that the research and analysis within this edition will prove valuable for you as you shape your own ESG strategies, policies, and innovation.

Thank you to all our contributors and thank you for reading.

Lance Levy, **Capco CEO**

ENABLING SYSTEMATIC ENGAGEMENT THROUGH INDEX INVESTING

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ABSTRACT

Passive investing and sustainability engagement were historically deemed to be at best challenging, at worst incompatible. There is a growing realization that combining index investing and sustainability engagement is not only possible but can reinforce and mobilize significant global assets under management to enable collaborative engagement. By linking engagement to transparent capital re-allocation, passive investing has the ability to influence and achieve changes in corporate practices and strategies, leading to real world impact. This paper explores the evolution of ESG engagement and passive investing and demonstrates that sustainability index design can lead to scalable, efficient, and impactful corporate engagement across entire markets. The use of such indexes to steer investment flows provides clear incentives for companies to improve sustainability performance and deliver outcomes sought by asset owners and society at large.

1. INTRODUCTION

Sustainability and climate indexes offer through their design the potential to have an efficient and impactful "virtual" engagement across entire markets, offering a way to systematize and scale corporate engagement. As capital continues to flow into climate and sustainability indexes, their inclusion, or exclusion, of particular companies can in turn drive meaningful investment flows into sustainability leaders, and away from laggards.

This paper explores the evolution of ESG engagement and passive investing and demonstrates that sustainability index design can lead to scalable, efficient, and impactful corporate engagement across entire markets.

2. APPLICATION OF ACTIVE OWNERSHIP TO PASSIVE INVESTMENT

An important element of responsible investment is active ownership, or stewardship. The U.N. Principles for Responsible Investment's (PRI) second principle commits signatories to be "active owners and incorporate ESG issues into [their] ownership policies and practices." These practices are commonly understood to include voting at company AGMs and engaging with company management on material sustainability issues.

Active ownership is critical in a well-functioning market. It warrants that managers of companies are held accountable by their owners (shareholders) and lenders (debt providers). Active ownership can help ensure that individual companies develop effective governance structures and act in a responsible manner. Examples include developing robust climate transition plans, or reduce the risk of environmental pollution, human rights abuse, or executive corruption.

There is increasing evidence that engagement can reduce risk and enhance returns. One of the best-known examples is the co-called "CalPERS[1] effect" where engagement by the U.S. pensions giant on corporate governance with underperforming companies registered excess cumulative returns of 13.72 percentage points above the benchmark over five years [Wilshire (2013)].

Similar findings were reported by academic researchers [Dimson et al. (2015)]. They analyzed more than 2,000 ESG engagement processes within U.S. companies from 1999 to 2009 and found that engagements produced an average abnormal return of 2.3 percent (adjusted for company size) over the year, following the initial engagement. This figure increased to 7.1 percent for successful engagements.

2.1 Perceived barriers to bringing engagement and passive investment together

There is a strong case for investors undertaking active ownership of their passive investments. However, combining passive investment and active ownership presents challenges. Here are several perceived challenges and potential misconceptions:

- **An inability to divest:** the fundamental issue for passive, rules-based, investors is that if engagement fails, they lack the ultimate sanction provided by selling shares. Many investors argue that, for engagement to be effective, an investor must be prepared to walk away if a company's management refuses to respond appropriately. Because passive investors need to match the returns of their selected index, such divestment is not typically an option. To borrow the language of the economist Albert O. Hirschman, companies are likely to give less weight to engagement from investors who are all "voice" and no "exit" [Hirschman (1970)].
- **The sheer number of stocks involved:** in contrast with active investors, who often favor concentrated exposure to a small number of companies backed by in-depth research, passive investors typically own shares in a large number of companies. This can make it difficult, or impossible, for investors to adequately research portfolio holdings and engage regularly with management. Indeed, the influential Kay review[2] of the functioning of the U.K. equity market explicitly advocated that active investors move toward more concentrated portfolios to allow a greater involvement in the day-to-day management of those companies.
- **Resources and research:** as a related issue, passive investors are unlikely to be able to justify the resources needed to engage individually with the very large number of companies in a typically passive portfolio. Effectively, engaging with companies usually requires in-depth industry knowledge and a good understanding of their internal operations. Furthermore, the increasingly lower margins that some passive investment managers operate within may make it difficult for them to resource effective management programs.
- **Free riding:** the large number of holdings in a typical passive investor's portfolio means that it is likely to have a small proportion of each company's shares. The economic benefits of engaging with a company may, therefore, be limited to each end-investor, making it easy to "free-ride" on engagement by others.
- **Acting-in-concert rules:** issues around resources and the small proportions of companies owned by individuals have encouraged investors to collaborate. However, in some markets, including the U.S., some investors believe that acting-in-concert rules – designed to protect the rights of small shareholders – prevent investors working together to engage with companies.

2.2 ESG stewardship in 'traditional' passive investment

Many of these challenges can – indeed should – be overcome by investors. First, the clients, i.e., the asset owners, expect it. In a survey of how pension funds use passive investments, 127 pension funds in 20 countries, with combined assets of €2.2 trillion, were polled and found that almost all considered stewardship either "very important" (60 percent) or "important" (38 percent) [CREATE-Research (2019)]. However, the survey also found that only 19 percent of funds felt that their passive managers had met their stewardship goals to "a large extent".

Second, the inability of passive investors to divest the securities of individual companies makes engagement even more important. Many passive investors are, effectively,

[1] The California Public Employees' Retirement System (CalPERS) provides health benefits and manages the largest public pension fund in the United States. See https://www.calpers.ca.gov/ for further information

[2] Kay Review is an independent review of the U.K. equity market from Prof. John Kay published in July 2012. In his review, "UK equity markets and long-term decision making," Prof. Kay sets out a clear vision and a set of principles to ensure that equity markets support their core purpose of enhancing the performance of U.K. companies, and providing returns to savers. https://bit.ly/2M19UBZ

> *“Voting can be a potent tool in the hands of passive managers.”*

“universal owners”, who own small percentages of most (or all) listed companies across an economy (or, in many cases, across many economies). As a result, they are not only forced to remain invested in companies with poor sustainability track records, but they are also subject to sustainability “externalities” that any one company is able to offload onto society and which may also impact other investments across the economy. The typical example is that a chemicals company might avoid costs by dumping untreated waste into a river – but a downstream water utility company or brewery would face additional costs to treat the water to the necessary standard. A passive investor will be broadly invested across the economy and is likely to be invested across both entities.

Indeed, this universal ownership incentivizes passive investors to engage in a manner that is ultimately more sustainable, argues Lionel Paquin, the chief executive of Lyxor Asset Management [Paquin (2020)]. Because they remain invested in stocks, while they are in the index, “voting can be a potent tool in the hands of passive managers, because the act of voting is by nature for them disconnected from that of portfolio management per se.” An active investor may be disinclined to vote for a shareholder resolution that imposes costs on an individual portfolio company, but which would benefit the broader economy, whereas it would make sense for a passive investor to do so, he argues.

Collaborative engagement – regardless of whether participating investors invest actively or passively – can help address several of the other challenges. Investors can pool resources and collectively engage with a greater number of companies than would otherwise be the case. As for acting-in-concert rules, for the E.U. at least, the European Securities and Markets Authority has published a list of issues where investors are permitted to collaborate – including those around corporate social responsibility. PRI commissioned Linklaters[3] to provide legal guidance on this topic, which focuses on the status primarily within the U.K. and E.U. and sets out how investors can navigate any perceived or potential legal risks.

3. BUILDING ESG ENGAGEMENT INTO INDEX DESIGN

In this last section, we set out some of the barriers to stewardship and engagement in passive investments. However, there is an additional mechanism for investors; they can use indexes and index providers as engagement tools. By developing indexes that have clear and transparent rules on sustainability issues, and engaging broadly with investee companies so they understand the index rules and criteria, index providers can do much of the heavy lifting of engagement on behalf of passive index investors. If the indexes have significant assets following them, or there is a particular “prestige” to being included, then there can be a high level of motivation for companies to improve their sustainability practices to gain inclusion or additional weight in the indexes. Companies often also want to avoid the negative implications of being removed (deleted) from such indexes and the media and analyst interest it creates. This can complement, rather than replace, the type of shareholder engagement carried out by investment managers. In addition, by applying “factor” or weighting index construction practices to these passive indexes, providers can also reward or penalize companies through index over and underweighting.

Numerous examples exist of sustainability index design helping to drive improved corporate performance among index constituents and companies aspiring to join or remain in ESG indexes. Using a range of case studies, we examine approaches to index design that combine active ownership and passive investment.

First, we review the origins of engagement through ESG indexes via some of the first inclusion indexes such as the Domini Social 400 Index, the Dow Jones Sustainability Index, and the FTSE4Good Index, where companies are included in the indexes on the basis of ESG criteria. Second, we consider “smart sustainability” methodologies, which employ tilt methodologies to determine constituent weights, and how those can be used for engagement purposes. Third, we look at the recently introduced E.U. defined environmental benchmark categories. Finally, we explore an approach that brings together collaborative climate engagement and index design – providing an indication for future mechanisms to deliver systematic investor engagement at scale.

[3] Linklaters’ consultation paper Principle 2 of the Principles for Responsible Investment encourages signatories to be active owners and to incorporate environmental, social and governance (“ESG”) issues into their ownership policies and practices. Principle 5 states: “We will work together to enhance our effectiveness in implementing the Principles.” Active ownership, or stewardship, is generally regarded as one of the most effective mechanisms for responsible investors to have a positive impact on society and the environment, and in turn reduce risks and maximize returns.

3.1 The origins of ESG indexes and associated corporate engagement

3.1.1 DOMINI SOCIAL 400 INDEX

The first sustainability index was launched in 1990 by a U.S. firm called KLD Research & Analytics and was named after Amy Domini, one of the founders. There was no explicit engagement with the companies and selection in the index was made on the basis of analyst judgement. The index is now calculated by MSCI and has been re-named the MSCI KLD 400 Index.

3.1.2 DOW JONES SUSTAINABILITY INDEXES

The Dow Jones Sustainability Indexes (DJSI), launched in 1999, were the first global sustainability indexes. The Dow Jones calculated the indexes, while the sustainability assessment was conducted by the pioneering Swiss asset manager, Sustainability Asset Management (SAM), and was based on a questionnaire that was, and in 2022 is still, sent to companies. After the index business came together with S&P, and Robeco acquired SAM, the sustainability research was transferred to S&P Global, which is currently responsible for calculating these indexes.

Companies that provide information through the survey are assessed relative to one another and to other companies in their sector. The starting universe of stocks for the index is the 2500 largest companies in the Dow Jones Global Total Stock Market. To create, and subsequently re-balance the Dow Jones Sustainability Indexes (DJSI), each industrial sector is taken in turn and the top 10 percent are selected based on the sustainability assessment of these companies.

This assessment creates an incentive for leading companies in each sector to compete with one another to be included in the indexes. This leads to a competitive pressure to improve their sustainability assessments each year and creates a form of index engagement. A potential limitation is that, while it leads to a competition between the leading companies that respond to the survey, this approach may have had less impact on the sustainability performance of the wider market, and companies ranked in the lower three quartiles.

3.1.3 FTSE4GOOD INDEX SERIES

A different approach to the DJSI is the FTSE4Good Index Series, which includes around half of the underlying market, referred to as the eligible universe.[4] Launched in 2001, these indexes are calculated by the London Stock Exchange Group's FTSE Russell and include companies from the relevant parent benchmark index, which meet a variety of sustainability thresholds that form a set of inclusion criteria, creating a different form of "best-in-class" methodology.

These criteria have been developed through market consultation, drawing from established standards and are reviewed by an independent committee of experts, the FTSE Russell ESG Advisory Committee. Stakeholders have helped shape them, which has included NGOs, government bodies, consultants, academics, the investment community, and the corporate sector.

Like the DJSI, there is an ability to influence corporate behavior through the thresholds set for index inclusion. However, a key difference is that the inclusion thresholds for FTSE4Good are set on an absolute, rather than a peer-relative basis. The requirements for each company differ depending on their sector and geographical footprint, and the precise threshold is set by clear rules. This means companies know what to aim for to gain inclusion or avoid index deletion. FTSE Russell analysts communicate with companies globally about the sustainability methodologies and index entry requirements, and there is a dedicated communication and engagement program with companies that no longer meet the index inclusion hurdle as the thresholds rise over time. This can involve engagement with several hundred firms each year. Companies are given a grace period of usually 12 months to improve their practices, and hence their scores; if they fail to reach the new thresholds, they are removed from the index.

This process has created a lever to improve corporate ESG performance. The experience with FTSE Russell provides several examples of real-world outcomes linked to FTSE4Good engagement [FTSE Russell (2018)].

[4] The FTSE4Good Developed Index represented over 60 percent by market capitalization and 50 percent by the number of constituents of the FTSE All-World Developed Index, as of August 31, 2022.

3.1.4 BREAST MILK SUBSTITUTE MARKETING

The marketing of breast-milk substitutes (BMS), especially in developing countries, has been a subject of controversy since the 1980s. According to the World Health Organization (WHO), babies that are breastfed are 14 times less likely to die than babies who are not [WHO (2020)]. The two sides of the debate – food industry giants and NGOs – have been in conflict for decades, which has been well documented over the years (Baker et al. (2021)].

In 2010, FTSE4Good introduced BMS marketing criteria to attempt to bridge the divide which required companies to adhere to more stringent responsible marketing standards than were followed at the time. Initially, Nestlé was the only one of the five large BMS manufacturers to move to meet the criteria, but an engagement process encouraged Danone and RB (formerly Reckitt Benckiser) to follow, creating momentum and corporate progress on a thorny ESG theme.

This example illustrates how a transparent approach to assessing companies against the sustainability criteria built into an index can support and incentivize corporate change and influence market norms.

3.1.5 THE JAPANESE PENSION FUND: GPIF

Japan's Government Pension Investment Fund (GPIF) – the largest pension fund in the world – aims to help improve stewardship and corporate governance practices among listed companies in its portfolios. The fund is so large that it is invested across a very broad spread of companies worldwide and has a very long investment horizon. By improving sustainability practices in companies, GPIF expects to help improve the long-term global stability and economic growth; therefore, helping their returns.

At the FTSE Russell Climate Finance and Investment Summit – held in New York in 2019[5] – Hiro Mizuno, the Chief Investment Officer at the time said "What are the fundamental traits of an asset owner? One is universal ownership. The second one, at least for us, is cross-generational investment. Those that are skeptical about the investment relevance of ESG are probably not thinking long-term enough."

He added "Passive [investment] is the most important for engaging on long term issues. We really count on the use of benchmark; we try to affect the whole system, so we need to affect the benchmark. We are shifting the money from the conventional market-based benchmarks to these ESG weighted indexes."

GPIF has selected sustainability indexes from a number of index providers, including FTSE Russell, Morningstar, MSCI, and S&P.

One of these indexes is the FTSE Blossom Japan Index, an industry-neutral benchmark that comprises Japanese companies that demonstrate strong sustainability practices. The index encourages improvements in corporate disclosure and sustainability performance, with companies required to meet certain sustainability standards to gain inclusion.

Given its level of visibility in Japan, the Blossom Japan Index generates significant engagement and dialogue with Japanese companies and, importantly, catalyzes action from companies seeking to improve their practices to qualify for inclusion. The recent announcement in December 2020 that small-cap Japanese companies are now eligible is expected to further extend this engagement.

3.1.6 PARTNERING WITH LOCAL STOCK EXCHANGES

A number of national stock exchanges have created domestic sustainability indexes, sometimes in partnership with global index providers. Both S&P and FTSE Russell have a number of these relationships.

For example, S&P has partnered with the Egyptian Stock Exchange (EGX) in 2010, and it also established the B3 Brazil ESG Index in 2020 and the Japanese S&P/JPX 500 ESG Score Tilted Index Series in 2022.

In addition, FTSE Russell has developed a number of partnerships with various exchanges to develop local-market versions of the FTSE4Good Index. This includes partnering with Bursa Malaysia in 2014, which followed the launch of the FTSE4Good Bursa Malaysia Index. That was followed by South Africa's Johannesburg Stock Exchange's FTSE/JSE Responsible Investment Index series, launched in 2015. Two years later, the Taiwan Stock Exchange helped develop the FTSE4Good TIP Taiwan ESG Index.

Membership of such indexes can help companies improve their ESG practices and their disclosure, potentially attracting international capital. If a significant domestic asset owner also allocates capital to such an index, the incentive to comply with index requirements becomes greater.

[5] https://bit.ly/3diavyt

3.1.7 ACADEMIC INVESTIGATION INTO INDEX ENGAGEMENT

Academic research has found that the FTSE4Good Index Series has had a material impact on the sustainability practices of companies within the index through raising the inclusion requirements over time.

For example, research by the University of Edinburgh Business School found that engagement by FTSE and the threat of expulsion from the FTSE4Good Index doubled the probability that a firm failing to meet the environmental management criteria would comply within a three-year period if they were engaged [Mackenzie et al. (2013)]. Another study, from the University of Nottingham, found companies adjusting their behavior in response to the index criteria. This study found that engagement based on index inclusion criteria was a catalyst for internal sustainability champions within the investee companies to advance the agenda [Slager (2012)].

3.2 The potential for "smart sustainability" or tilted indexes to be used for engagement

The growth of smart-beta investing has been a clear theme within asset management over the last decade. This is an approach to passive index construction that weights or selects index components on metrics – such as size or value – other than market capitalization to achieve diversified portfolios with exposure to historically rewarded risk premia. Smart sustainability refers to the integration of objectives concerned with exposure to rewarded factors with sustainable investment considerations via the index or portfolio construction process. A natural evolution of this approach is to apply such techniques to the construction of portfolios that are solely concerned with sustainable investment outcomes. This is in contrast to exclusionary approaches and has important implications for preserving essential engagement links between a companies' actions and its representation in any resulting index.

FTSE Russell's annual survey of institutional asset owners found that 58 percent of asset owners globally anticipate applying sustainability considerations to smart beta strategies, up from 44 percent in 2019 [FTSE Russell (2020b)]. Of particular note was the survey finding that respondents are increasingly viewing smart-beta allocations as more akin to traditional active rather than passive strategies, as the weighting process allows for divergence from the benchmark, based on predefined rules.

For example, FTSE Russell's Smart Sustainability Index Series takes account of a number of sustainability factors in its index design.[6] Specifically, it weights constituents according to their carbon efficiency, fossil fuel reserves, and green revenues in addition to traditional style factor exposures.

Transparency around these rules and engagement with companies within the underlying benchmark index provide a means by which smart-beta index construction can help drive improved corporate sustainability performance.

3.3 Using the E.U. climate transition and Paris-aligned benchmarks for engagement purposes

Ultimately, while investors can encourage improved corporate ESG performance, it is policy and regulation that set the context in which businesses operate and which define minimum standards on issues such as climate change, plastics pollution, or labor rights. With its Sustainable Finance workstream, the European Commission is taking a broad approach to regulatory intervention, using financial markets tools and techniques to influence investment flows.

Its taxonomy for sustainable activities, published in June 2020, builds on industry classification techniques used by investors to categorize the economic activities in which companies participate.[7] The taxonomy identifies those activities that are deemed to contribute to the E.U.'s environmental objectives, with the goal of encouraging investment towards those activities. There is significant alignment with certain global market-based classification systems such as the FTSE Russell Green Revenues Classification System [FTSE Russell (2020a)].

Similarly, the E.U. has produced minimum requirements for climate change benchmarks in an attempt to impose some consistency and rigor on an important part of financial market infrastructure, initially relating to taking action on climate change. In a regulation adopted in June 2020, it sets out minimum standards that two benchmarks – E.U. Climate Transition benchmarks and E.U. Paris-aligned benchmarks – should meet.[8]

The Paris-aligned benchmark is the more ambitious of the two, requiring a 50 percent carbon-intensity reduction compared with the investible universe, while the Climate Transition benchmark must deliver at least a 30 percent reduction. In addition, the

[6] See Ground Rules, FTSE Smart Sustainability Index Series v.16.

[7] Regulation (E.U.) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment and amending Regulation (E.U.) 2019/2088.

[8] Commission Delegated Regulation (E.U.) of 17.7.2020 supplementing Regulation (E.U.) 2016/1011 of the European Parliament and of the Council as regards minimum standards for E.U. Climate Transition Benchmarks and E.U. Paris-aligned Benchmarks.

index constituents should collectively deliver an average 7 percent year-on-year annual reduction. To avoid the creation of climate indexes that deliver reductions by simply excluding large-emitting sectors, the weights of highly climate-exposed sectors must reflect those of the investible universe.

The benchmark design process includes a number of elements that should help drive improved performance. It provides a four-year grace period before companies need to phase in measurements of their Scope 3 emissions. It allows for increased weighting towards companies based on their decarbonization objectives. And the minimum requirements for inclusion will be reviewed every three years to take into account market developments and technological and methodological advances [Yang et al. (2020), SSGA (2020)].

The E.U.'s approach is designed to encourage capital to flow towards companies that are aligned with its environmental objectives and, implicitly, away from those that are not, thus impacting their cost of capital. However, to have a meaningful impact on capital costs, those flows will have to be substantial. To what extent these indexes can achieve this alone is perhaps questionable.

To achieve real world impact, there is a need for corporate engagement to be a fundamental part of these processes. Companies need to understand the criteria for inclusion and exclusion; if they do not, the potential for any of these indexes (whether designed by policymakers or index providers) to exert influence on corporate behavior is reduced.

3.4 Taking collaborative engagement and index design to the next level – the Transition Pathway Initiative

The Transition Pathway Initiative (TPI) offers just such an example of combining corporate engagement with index design. The TPI was set up in 2017 by asset owners to help assess the alignment of their portfolios with the goals of the Paris Agreement and to drive emissions reductions from portfolio companies. As of November 2020, it comprises 90 investors globally who have pledged their support, jointly representing U.S.$22.8 trillion in combined assets under management/advice. In addition, it provides a central part of the data and analysis for the Climate Action 100+ initiative, which brings together investors managing more than U.S.$50 trillion in assets in a collaborative engagement to encourage the world's largest corporate emitters to take action on climate change.

Using publicly disclosed corporate information sourced and provided by FTSE Russell, the TPI's data partner, the TPI evaluates and tracks the companies' carbon management, their risks and opportunities related to the low-carbon transition, and their alignment with the reductions needed to meet national and international climate targets. This analysis is distilled into a tool that provides a transparent, comparable assessment of a company's preparedness for the low-carbon transition.

The analysis is made publicly available via the TPI's academic partner, the Grantham Research Institute on Climate Change and the Environment at the London School of Economics and Political Science. This is important in that it allows companies to easily see and understand how they, and their peers, are ranked. It also provides the wider market with access to the TPI data.

To supplement this tool, FTSE Russell, in partnership with TPI, launched the FTSE TPI Climate Transition Index. The index, which at launch the U.K.'s Church of England Pension Board announced it would use for its core passive equity fund, uses TPI data to adjust the weights of companies in the underlying FTSE Developed Indoex, according to their performance against five criteria: (1) fossil fuel reserves, (2) carbon emissions, (3) green revenues, (4) TPI management quality, and (5) TPI carbon performance.

The index does not exclude entire sectors, and it offers a pathway for inclusion if companies improve their performance – providing a platform for engagement and creating a lever for change. As Adam Matthews, Director of Ethics and Engagement for the Church of England Pensions Board and Co-Chair of the TPI said at the launch of the index: "The message is clear to all publicly listed companies: put in place targets and strategies aligned to Paris and be rewarded with inclusion in the index, or work against the long-term interests of beneficiaries and wider society, and be excluded … The index leaves open a path for any one of these excluded companies to transition in line with the Paris Agreement and claim their place in the index at a later date."

4. CONCLUSION

With increasingly joined up global investor engagement through initiatives like the CA100+[9] and Transition Pathway Initiative, there is a real potential to reinforce corporate engagement with associated indexes. In such indexes, companies can be rewarded for improving their climate strategies with index inclusion, or greater index weights, so greater investment flows are generated through positive responses to engagement in passive portfolios following the indexes.

By clearly, and transparently, communicating both inclusion and weighting criteria, such indexes can encourage companies to improve their sustainability performance. As more investors back indexes, which link to and reinforce established corporate engagement initiatives, real-world outcomes can be generated in ways that were unimaginable only a few years ago.

Indeed, such engagement can generate measurable environmental (and social) impact, potentially on a much larger scale than can be achieved by more targeted impact investment strategies.

Clearly, passive investment is no longer incompatible with corporate engagement. We would go further. Passive investment may become one of the most important mechanisms to drive market-wide changes towards a more sustainable world.

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[9] Climate Action 100+ is an investor-led initiative that ensures the world’s largest corporate greenhouse gas emitters take necessary action on climate change.

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