July 2021

Parametric Responsible Investing

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With an ever-growing number of investors looking to incorporate their environmental, social, and governance (ESG) principles into their portfolios, responsible investing is no longer a niche investment approach—it's mainstream. From long-standing concerns such as tobacco and firearms to newer issues such as climate change and boardroom diversity, investors increasingly want to understand and manage the environmental and social impact of their investments.

In our experience, investors can have two interrelated primary objectives: trying to influence companies to behave better and controlling what kind of companies they own. Parametric's approach to responsible investing aims to meet both sets of goals, helping investors understand their choices and those choices' effects on their portfolios. This paper details the approaches involved and helps investors forge appropriate solutions.

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Understanding the choices

Investors can control what they own when they construct their portfolios through *ESG incorporation*. This is the process of using ESG metrics to select and weight holdings from a known opportunity set, such as an equity index. While ESG incorporation can help investors get exposure to preferable companies from an ESG standpoint, it doesn't encourage companies to behave better. This is in contrast to *active ownership*, in which investors try to influence the companies they own. This can include proxy voting, filing shareholder resolutions, engaging with company management, or advocating for change with policy makers.

These two approaches are related in that one can influence only what one owns. When investors avoid owning a company, they give up the opportunity to influence that company. Additionally, making an active decision to invest in only a subset of eligible companies has portfolio performance implications that the investor must consider carefully. Therefore, we encourage investors to identify the goal for each of their concerns to determine whether ESG incorporation or active ownership would apply better.

Controlling what kinds of companies the investor owns through ESG incorporation makes the most sense when the investor has lost hope that a company can be changed or lacks the patience to see the change through. Otherwise, owning and potentially influencing the company through active ownership is a good starting point. For example, it may make sense to avoid tobacco manufacturers or companies with egregious and persistent human rights violations. However, the investor may choose to own companies with no diversity on their boards or companies with high carbon emissions if there's an opportunity to encourage them to improve on these metrics.

Although many investors begin and often end with ESG incorporation, we encourage investors to instead begin by thinking about which concerns they can address through active ownership. Once that's been determined, we can look at the remaining concerns to decide whether any can or should be addressed through ESG incorporation.

Active ownership

Active ownership is the most direct path investors can take to help bring about environmental and social change in their portfolio, encouraging companies to reduce risks and improve performance. It involves a spectrum of activities, including informed proxy voting, filing shareholder resolutions, and engaging with company management around particular issues. Investors can also advocate for marketwide changes by engaging with policy makers. Diversified buy-and-hold investors—particularly those invested in broad indexes—are positioned especially well to practice active ownership because they tend to have long-term holdings in a wide range of companies. These universal owners benefit directly from promulgating best practices throughout the market.

Let's look at two of the more common ways active owners can try to influence company behavior:

Proxy voting

While some of our clients vote their shares themselves, the vast majority delegate their voting authority to Parametric. In this case, Parametric takes on a fiduciary role and votes all securities in the client account based on the Parametric Proxy Voting Guidelines. These guidelines are designed to safeguard investor capital over the long run by supporting qualified, independent boards that demonstrate accountability and responsiveness to shareholders. In this effort, we consider the work of recognized corporate governance experts, outside research providers, and collaborative investor groups.

Shareholder engagement

Shareholder engagement complements proxy voting by empowering investors to have conversations with companies to encourage them to reduce risks and maximize returns by adopting better practices or behaviors. For example, shareholders might nudge companies that don't have any gender diversity on their board to explore instituting formal diversity policies or disclose workforce diversity data. These types of initiatives are instrumental in improving company behavior over the long run.

ESG incorporation

Incorporating ESG data when selecting and weighting portfolio holdings is increasingly popular. Although it doesn't affect company behavior, it allows investors to own companies they believe are doing well along various environmental or social dimensions and underweight those that aren't. This may be necessary when the investor has stopped believing that changing company behavior through active ownership is possible.

Responsible investing covers a diverse set of priorities. Yet when it comes to ESG incorporation, investors really have only two distinct methods to choose from: screens and integration (previously referred to as a tilt).[1] Both can enhance a portfolio's ESG characteristics, but they're quite different in terms of implementation and impact.

A screen limits the companies in a portfolio to a subset of the eligible investment universe that meets specific ESG criteria, and it contains no guidance on portfolio weights. Integration reweights the eligible universe to reflect each company's ESG qualities but doesn't necessarily remove any securities from consideration. Portfolios may be constructed using just one of these methods, but a combination of the two may better achieve the investor's objective.

There may be specific scenarios where it's preferable to use a screen versus integration and vice versa. In general, screens are better suited for mandates in which ESG criteria are of primary importance and the list of acceptable investments is delineated very precisely. On the other hand, integration is useful when controlling portfolio impact is the primary concern and there's flexibility in the acceptable ESG characteristics of the holdings.

1 *Integration* in this paper refers to *quantitative integration* in contrast to *fundamental integration*, under the UN =PRI definition. Fundamental or traditional integration refers to a process of adjusting forecasted financials for the expected impact of ESG "factors." Quantitative or systematic integration refers to a process of constructing models that integrate ESG "factors" alongside factors such as value, size, or momentum. For more information, see "Executive Summary," *A Practical Guide to ESG Integration for Equity Investing*, United Nations Principles for Responsible Investment, accessed April 27, 2021, https://www.unpri.org/listed-equity/a-practical-guide-to-esg-integration-for-equity-investing/10.article.

Investors can design a portfolio themselves or select from already available options. All responsible investing portfolios have three key components that determine the final holdings and resulting returns: target exposure, ESG criteria, and weighting method. Understanding the differences among these components can help investors understand how they might affect potential returns in the portfolio.

Target exposure

This baseline component refers to the potential portfolio before ESG criteria are applied. It might be made up of stocks that meet return expectations, which an active manager has weighted to reflect conviction. It might instead be composed of stocks contained in a passive index, weighted according to market capitalization. The target exposure determines the initial eligible investment universe as well as the preferred risk characteristics—such as average market cap or dividend yield—for the final portfolio.

Target exposure options at Parametric include market-cap or alternative-weighted indexes, factor strategies, and our own rules-based actively managed strategies. In the case of index- or factor-based exposures, clients may select just one or combine a few to emphasize certain geographies, sectors, or other characteristics.

ESG criteria

This component refers to the specific parameters the investor uses to determine which companies are acceptable and which are unacceptable. These parameters are used to construct the desired portfolio by modifying the target exposure. For example, two investors may list the environment as a key concern, but one investor focuses on carbon emissions while the other focuses on the effects of factory farming. A low-carbon-emitting factory farming company might be an acceptable company in the eye of the first investor and an unacceptable one in the eye of the second. Furthermore, the company may seem low emitting and therefore only acceptable based on direct emissions alone, but this may change if we include its electricity suppliers' emissions or if emissions are normalized by sales. There are hundreds of metrics available from dedicated ESG research providers, and it's essential to understand the nuances and select the data thoughtfully to best determine which companies are acceptable and which are not.

Given the number of possibilities, Parametric has created a menu of ESG options that captures the most common requests while still allowing for a high degree of flexibility. This includes ESG screens that investors can apply to any target exposure to create a portfolio that meets specific criteria, as well as prebuilt portfolios that already incorporate ESG criteria.

Weighting method

This component refers to how the portfolio is reweighted once the ESG criteria are determined. This largely depends on whether the investor has chosen a screen or a quantitative integration technique to construct the portfolio.

A screen identifies companies in the target exposure that meet the investor's ESG criteria and are therefore still eligible for the final portfolio. The screen itself doesn't prescribe the final portfolio weights; this must be decided separately. One approach is simply to increase the weights of those that pass pro rata. At Parametric, we most commonly weight screened portfolios using an optimization process to reduce any active biases relative to the target exposure. We use optimization to try to dampen the screen's potential impact on relative investment performance.

In contrast, quantitative integration allows all companies in the target exposure to remain eligible for investment but reweights them to reflect their ESG characteristics and risk profile. The weight is determined by balancing the attractiveness of the stock from an ESG perspective with its usefulness in mimicking the risk characteristics of the target exposure. Given the complexity of this technique, it's available at Parametric primarily via prebuilt portfolios rather than being customized for each client.

Choosing between screening and integration

Although technically investors can incorporate any metric into a portfolio via either a screen or integration, in reality many metrics lend themselves better to one approach or the other. In general, screens are preferable when the investor's primary objective is ESG and the criteria can easily be made explicit. Human rights abuses, for example, where the investor has a clear notion of a threshold below which companies are intolerable, tend to be better suited to a screen. An environmental score, on the other hand, is a metric for which it's difficult to intuitively specify a threshold at which point a company switches from acceptable to unacceptable, which means it might be better suited to integration. Furthermore, when the investor's primary concern is controlling the portfolio impact of incorporating ESG—for example, by reducing predicted tracking error—integration might be more suitable than screening.

But the choice doesn't always need to be either-or. Many of Parametric's clients choose to combine an initial exposure built using integration that's then further refined through the application of a screen. Investors should consider both screening and integration as complementary tools for building the portfolio that best matches their objectives.

Figure 1: Screening versus integration

Market-cap-weighted portfolio
Consists of a mix of companies with acceptable and unacceptable business involvement or behavior.

Integrated portfolio
Uses ESG characteristics to weight companies subject to constraints aiming to maintain a diversified exposure.

Screened portfolio
Reconfigures the eligible investment universe to remove companies with objectionable characteristics and invest only in those with acceptable ones.

Source: Parametric.

Conclusion

Parametric is dedicated to remaining at the forefront of responsible investing, partnering with clients of all types as their needs evolve. In recognition of their wide range of objectives and priorities, we provide flexible solutions to help investors achieve a diverse range of goals. Our approach appeals to those taking their first steps down the path of responsible investing as well as experienced responsible investors looking for a fresh take.

About

Parametric Portfolio Associates® LLC ("Parametric"), headquartered in Seattle, is registered as an investment advisor with the US Securities and Exchange Commission. Parametric is a leading global asset management firm, providing investment strategies and customized exposure management directly to institutional investors and indirectly to individual investors through financial intermediaries. Parametric offers a variety of rules-based investment strategies, including alpha-seeking equity, fixed income, alternative, and options strategies. Parametric also offers implementation services, including customized equity, traditional overlay and centralized portfolio management. Parametric is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley, and offers these capabilities through offices located in Seattle, Boston, Minneapolis, New York City, and Westport, Connecticut.

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33960 | 6.30.2021

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