Parametric Responsible Investing

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The amount of information available to investors about the companies they invest in has grown exponentially. While this has been helpful to investors looking to incorporate environmental, social, and governance (ESG) information into investment decisions, this wealth of information and the diversity of investment approaches can be overwhelming. This paper is meant to guide investors through the noise.

Key takeaways

» Investors interested in responsible investing around ESG concerns must understand how portfolio construction and active ownership interact. Combining responsible investing portfolio construction with active ownership helps investors influence those companies in which they invest.

» Active ownership—through proxy voting and shareholder engagement—is the most direct path responsible investors can take to help bring about the ESG change they wish to see.

» When it comes to portfolio construction, investors choose between two distinct methods for enhancing a portfolio's ESG characteristics: screens and integration.

» Whether through screens or integration, ESG incorporation in a portfolio requires making three more detailed decisions: target exposure, responsible investing criteria, and the weighting method.

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The interaction between active ownership and portfolio construction

The first thing to understand about responsible investing is how portfolio construction and active ownership interact. *Portfolio construction* refers to the process of selecting and weighting portfolio constituents. When this process specifically includes environmental, social, and governance (ESG) information, we call it ESG incorporation.

For our purposes, ESG is simply a convenient way to refer to a large and evolving set of information but doesn't indicate how a portfolio might incorporate that information. How it's incorporated is important not only because it drives portfolio returns and risk characteristics but also because it impacts the investor's ownership rights and opportunities; that in turn can further affect returns.

In other words, while ESG incorporation helps investors determine which companies they own, active ownership helps them influence those companies, which in time can lead to different investment decisions.

The second thing to keep in mind is that investors can influence only the companies they own. When they avoid owning a company, they give up the opportunity to influence it.

That's why ESG incorporation can make the most sense when the investor doesn't believe 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 inadequate independence on their boards or companies with high carbon emissions if there's an opportunity to encourage them to improve on these metrics.

Investors have become increasingly aware of the importance of building a portfolio with their active ownership approach in mind. Let's discuss active ownership in more depth first, then turn to the topic of ESG incorporation.

Active ownership

Active ownership is the most direct path investors can take to help bring about ESG change in the companies they invest in by encouraging them to reduce risks and improve performance. Technically, 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 market-wide changes by engaging with policymakers.

But most investors and the professional managers that invest on their behalf focus active ownership on proxy voting and engaging with company management. Diversified buy-and-hold investors 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, using the Parametric offering to illustrate.

Proxy voting

Proxy voting consists of simply casting votes, mostly for board nominees at regular annual meetings. Shaping the composition of the board is arguably one of the most important functions of shareholders. After all, it's through the board that shareholders can oversee company management and hopefully preserve and enhance the value of their investment. Detailed company ESG information can be useful when casting votes.

Unlike a mutual fund or ETF, in the case of a separately managed account, the end investor retains voting rights for the underlying holdings. Some investors choose to vote their shares themselves, but more typically they outsource this to a professional manager.

When a manager delegates voting authority to Parametric, we take on a fiduciary role and vote all securities in the client account based on the Parametric Proxy Voting Guidelines. These guidelines encourage corporate disclosures and transparency. We've designed them 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. We make summary versions of our voting guidelines and annual voting record publicly available.

Shareholder engagement

Shareholder engagement complements proxy voting by enabling investors to have conversations with companies to encourage them to reduce risks and maximize returns by adopting better practices or behaviors. While proxy voting is limited to the election issues in the shareholder meeting's agenda, shareholder engagement allows investors to address areas of concern with management that are not on the proxy ballot.

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For example, shareholders might nudge companies that consistently have boards that don't seem to reflect their customers, workforce, or communities to reconsider their director nomination process or disclose additional workforce data. These types of initiatives are instrumental in improving company outcomes over the long run.

ESG incorporation

Incorporating ESG data when selecting and weighting portfolio holdings is very popular. Although it doesn't affect company behavior, it allows investors to own companies they believe are doing well along various ESG dimensions and underweight those that aren't. This may be necessary when the investor no longer believes 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 tend to 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 responsible investing criteria; 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. Managers may construct portfolios 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. On one hand, screens are generally better suited to 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.

In either case, there are three decisions that determine the final holdings and resulting returns: the target exposure, the responsible investing criteria, and the weighting method. Understanding each will help investors make sure they own a portfolio aligned with their goals and better understand how responsible investing criteria might affect portfolio returns.

Target exposure

This refers to the potential portfolio before ESG criteria are applied. The portfolio might contain stocks that meet particular return expectations, which an active manager has weighted to reflect conviction. It might instead comprise stocks 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.

Responsible investing criteria

This refers to the specific parameters the investor uses to determine which companies are acceptable and which are unacceptable based on ESG information. The manager uses these parameters 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 acceptable in the eye of the first investor but unacceptable in the eye of the second.

Furthermore, the company may seem low emitting and therefore 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.

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Weighting method

This 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; the manager must decide this 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 using prebuilt portfolios rather than being customized for each client.

Choosing between screening and integration

Although technically investors can incorporate any metric into a portfolio through 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 ensuring particular ESG characteristics in their holdings 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 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.

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.

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. For illustrative purposes only.

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Notes

1. *Integration* in this paper refers to *quantitative integration*, in contrast to *fundamental integration*, under the 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.

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