WHAT USE IS A GREEN YARDSTICK?

There are now plenty of ESG benchmarks to choose from, but what's the best way to put them to work?

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For a number of years, I wrestled with the question of what should be the appropriate benchmark comparison when evaluating and selecting ESG managers. All told, it was a fairly short debate because there were simply not that many to choose from.

However, providers and indices have now proliferated to the point that there is a methodology, formula or filter for almost any angle on ESG, at least in the public equity space.

From an analyst's perspective – and even a portfolio manager's – this may be too much of a good thing. Sometimes, the better the analytic tool, the more obscure the insight.

But that is not to say that these new indices do not have a use. These more refined tools simply require more targeted application. For example, in the explosion of 'active' indices and their companion ETFs, we have witnessed the sort of processes that fundamental managers have used for generations being put to systematic and formulaic use. Why can't the same happen for ESG indices?

THE NEW GENERATION

Teams of analysts and accountants sporting green vizors and tapping away at adding machines have now been replaced by more efficient computer-based statistical tools that approximate or even replicate what those analysts used to do. The funds based on these active indices are being used to supplant active money managers, because, for many, the trade has been reduced to exchanging the possibility of additional differentiated insight and alpha for the certainty of basis points saved. In other words, I can now buy relatively cheaply the same style and factors that an active manager would be looking to exploit, pocketing the difference rather than paying for the possibility that the manager can outperform the factors themselves.

When it comes to ESG, an important by-product of the market-wide push for disclosure, transparency, materiality and coherence in how environmental, social and governance information is reported is that the databases and indices derived from this information are improving. What was once a crude set of tools is now a bonanza of indices and sub-indices that address individual ESG factors or entire policies, or provide a variety of filtering and weighting schemes to drive portfolio construction. A lot of the front-end work that used to be the domain of active managers – simply because there was no one else to do it – is now systematized.

GREEN SHOOTS

The problem is this: With such highly refined indices available in the equity space, a lot of information about a fundamental manager can be lost through layers of index complexity. Measuring a strategy against an index that already holds not just country, size, style and factor tilts, but also E, S and G biases limits an analyst's ability to discern where a manager is adding value. Of course, you could argue that if it can be indexed it has no value and should therefore be discounted to zero. That is for the free market to sort out, but it still leaves the question of what exactly the manager is doing.

Personally, I choose to use multiple benchmarks as well as a qualitative axis, visualizing them in a 3D space to understand what makes an ESG manager tick. These benchmarks include:

- A traditional market benchmark – ESG strategies operate in the broad market, and understanding how a strategy functions in its unfiltered asset space is therefore important. This has the follow-on benefit of addressing the frequent (and misguided) assumption that ESG strategies intrinsically underperform their traditional peers and the market as a whole.

- An ESG benchmark – evaluating a strategy against a more refined ESG-specific benchmark will help to distinguish manager skill from the by-products of the systematic biases of these indices and the processes they approximate in areas such as market cap, style, quality, industry and sector.

- Qualitative criteria – fundamental ESG managers often establish systematic but subjective policies regarding engagement, activism, impact and social yield. A manager's stated policy can be used as a form of qualitative benchmark against which the portfolio's performance can be measured.

However, I give fixed income ESG benchmarks short shrift because – with apologies to some great index companies – the indices are simply not that good yet. As I have mentioned before, fixed income is orders of magnitude more complex for ESG analysis because every security can have its own distinct ESG profile, even from the same issuer. With any luck, the systematization of reporting and information gathering will advance in the bond space to the point that robust indices can be constructed for more than just green bonds. But for now, the advantage lies with fundamental bond managers. ■