

Index Insights | Investment process

Achieving scale in active ownership and engagement through index investing

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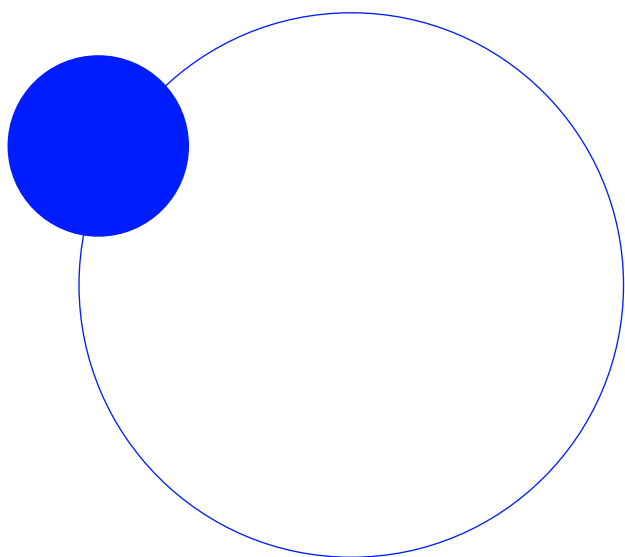
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Overview

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. Passive investment has the potential to influence and achieve changes in corporate practices and strategies leading to real world impact through linking engagement to transparent capital re-allocation.

This paper explores the evolution of ESG engagement and passive investing, especially the role of index providers in marrying passive investing and scalable engagement.



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Executive summary

- **Historically, passive investing and sustainability engagement were deemed to be at best challenging, at worst incompatible.** A case has been frequently made in the past that passive investors are best able to engage the management of investee companies because they are usually low-turnover and long-term orientated. However, some have argued that the inability of passive managers to divest or “exit” outside formal index changes can undermine their engagement strength with companies.
- **The growth in the use of sustainability indexes by asset owners for large mandates has led to an opportunity for a new type of issuer engagement that is linked to the index methodologies and rules.** For this to be effective, sustainability index providers must set clear and transparent rules and ensure corporate issuers across the whole market can understand the assessment methodologies they use.
- **If companies have clarity on how they can meet the index inclusion rules, or increase their weighting in the index, then they can be incentivized and rewarded to achieve real-world improvements in corporate sustainability performance.** The incentives for companies to respond positively to meet index criteria can be the reputational benefits, if there is visibility in index selection, and can increasingly be through greater investment flows as larger asset volumes follow the resultant indexes.
- **There are examples where sustainability indexes have had an impact on corporate practices.** The FTSE4Good index series, launched in 2001, has led to measurable improvements in corporate sustainability performance. This has been driven by incremental increases in inclusion thresholds, together with grace periods, where the corporate CEOs are notified 12 months in advance of an index deletion to improve their standards.
- **The growing popularity of sustainability indexes employing tilt methodologies promises to enhance the effectiveness of index-based engagement.** Tilting an index composition towards and away from companies based on transparent sustainability criteria provides a clear incentive for companies to improve their performance. The launch of the European Union Paris-aligned and Climate Transition benchmarks also aims to link corporate environmental performance with available capital. However, questions exist over the strength of the market signal likely to be provided by this initiative, unless the indexes can be tied into effective corporate engagement.
- **Collaborative engagement and indexing, as exemplified by the Transition Pathway Initiative (TPI), may provide a powerful and simple approach to engagement on climate performance.** The weight of asset owner-backing for the TPI and the related Climate Action 100+ initiative, the clear engagement agenda involved, allied with the simplicity and transparency of the TPI index send a strong message to companies about what is expected of them by investors.
- **While traditional shareholder engagement remains important, indexes can provide an effective new lever for engagement.** This type of corporate engagement through index investing can complement, and certainly does not aim to replace, more traditional forms of shareholder engagement carried out by asset managers, and asset owners through direct engagement, engagement service providers, and shareholder voting.
- **This paper demonstrates that sustainability index design can deliver scalable, efficient, and impactful corporate engagement across entire markets.** It offers clear incentives for companies to improve sustainability performance and deliver outcomes sought by asset owners and society at large.

Introduction

There have been two main themes in investment management over the previous decade. The first is the dramatic rise in passive investing. The second is the acceptance of sustainable investment techniques by the investment community.

Investors have become increasingly attracted to passive investment vehicles due to the lower management fees they charge, compared with actively managed alternatives, while providing diversification benefits. The trend is particularly clear in the US. As of March 2020, passive funds accounted for 41% of the assets held in open-ended mutual funds and exchange-traded funds (ETFs), up from 3% in 1995 and 14% in 2005.¹ In August 2019, assets in US index-tracking equity funds exceeded those in active funds, at \$4.271 trillion compared to \$4.246 trillion.²

Meanwhile, sustainable investment is booming. Signatories to the Principles for Responsible Investment (PRI) now represent around \$110 trillion of assets under management worldwide. In the second quarter of 2020, net inflows of \$71 billion into funds that explicitly incorporate ESG factors pushed the volume of assets they account for above \$1 trillion for the first time, according to Morningstar.³ In Europe, ESG funds accounted for almost a third of all European fund sales in the second quarter of 2020, attracting 63% more new money than traditional equity funds, according to Morningstar.⁴

These two trends overlap. According to Lyxor Asset Management, passive ESG funds grew at an average annual rate of 33% in the five years to June 2019 – three times faster than the growth of active ESG funds over the same period.⁵

The overlap has been supported by the parallel rise in smart-beta, or factor investing, whereby index providers tilt investment portfolios to capture factors such as value, quality, low volatility, momentum, and size. This approach provides investors with investment vehicles that combine the cost benefits of index-based passive investments with elements of active investment.

Application of active ownership to passive investment

An important element of responsible investment is active ownership, or stewardship. The PRI's 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 regarding sustainability issues of concern.

Active ownership is an important element of well-functioning financial markets. It warrants that managers of companies are held accountable by their owners (shareholders) and lenders (debt providers). It can help ensure that individual companies develop effective governance structures and act in a responsible manner, potentially reducing the risk of environmental pollution, human rights abuse, or executive corruption.

There is a growing body of evidence that engagement can reduce risk and enhance returns. One of the best-known examples is the co-called 'CalPERS effort', where engagement by the US pensions giant on corporate governance with underperforming companies generated excess cumulative returns of 13.72 percentage points above the benchmark over five years.⁶

¹ Federal Reserve Bank of Boston (2020), *The Shift from Active to Passive Investing: Risks to Financial Stability?*

² ["End of Era: Passive Equity Funds Surpass Active in Epic Shift"](#), John Gittelsohn, *Bloomberg*, 11 September 2019.

³ ["Sustainable investment funds just surpassed \\$1 trillion for the first time on record"](#), Sam Meredith, *CNBC*, 11 August 2020.

⁴ ["ESG funds attract record inflows during crisis"](#), Siobhan Riding, *Financial Times*, 10 August 2010.

⁵ ["How index investing can drive sustainable finance transition"](#), Lionel Paquin, *The Financial Times*, 2 July 2020.

⁶ "Wilshire: 'CalPERS Effort' improves company stock performance", *Pensions & Investments*, 10 October 2013.

Similar findings were reported by academic researchers Elroy Dimson, Oguzhan Karakas, and Xi Li. They analyzed more than 2,000 ESG engagement processes within US firms from 1999 to 2009 and found that engagements generated an average abnormal return of 2.3% (adjusted for company size) over the year, following the initial engagement. This figure increased to 7.1% for successful engagements.⁷

Perceived barriers to bringing engagement and passive investment together

Clearly, there is a strong case for investors undertaking active ownership regarding their passive investments. However, combining passive investment and active ownership presents challenges.

- **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 invest in all of the constituents of an index, such divestment is not typically an option. To borrow the language of the Kay review, companies are likely to give less weight to engagement from investors who are all 'voice' and no 'exit'.⁸
- **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 large numbers of companies. This can make it difficult or impossible for investors to adequately research portfolio holdings and engage with management on a regular basis. Indeed, the influential Kay review of the functioning of UK equity markets explicitly advocated that active investors move towards more concentrated portfolios to allow greater involvement in how those companies are run.⁹
- **Resources and research:** As a related issue, passive investors are unlikely to be able to justify the resources needed to engage with a large number of portfolio companies. Effectively engaging with companies usually requires in-depth industry knowledge and a good understanding of the internal operations of the companies involved. Similarly, the low fees that passive investment managers are able to attract make it difficult for them to resource effective engagement programs.
- **Free-riding:** The large number of holdings in a typical passive investor's portfolio means that it is likely to hold very small percentages of each company's shares. The economic benefits of engaging with a company will therefore be minimal for each end-investor, making it more attractive to 'free-ride' on engagement by others.
- **Acting-in-concert rules:** Issues around resources and the small proportions of companies owned by individual investors have encouraged investors to come together to engage collaboratively. However, in certain markets, particularly the US and Japan, some investors believe that acting-in-concert rules – designed to protect the rights of small shareholders – prevent investors working together to engage with companies.

Companies are less likely to give weight to engagement from investors who are all 'voice' and no 'exit'.

⁷ Elroy Dimson, University of Cambridge and London Business School, Oguzhan Karakas, Boston College, Xi Li, Temple University (2015), "Active Ownership", *Review of Financial Studies (RFS)*, Volume 28, Issue 12, pp. 3225-3268, 2015.

⁸ Ibid.

⁹ Department for Business, Innovation and Skills (2012), [The Kay review of UK equity markets and long-term decision making](#).

ESG stewardship in 'traditional' passive investment

Many of these challenges can – indeed should – be overcome by investors. First, clients 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%) or “important” (38%). However, the survey also found that only 19% of funds felt that their passive managers had met their stewardship goals to “a large extent”.¹⁰

Second, the inability of passive investors to divest the securities of individual companies makes engagement all the more important. Many passive investors are, effectively, ‘universal owners’, who own small percentages of most (or all) large listed companies across an economy (or, in many cases, across many economies).

This means that not only are they forced to remain invested in poor sustainability performers, but they are also subject to sustainability “externalities” that any one company is able to offload onto society at large. For example, 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 in treating 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. Because they remain invested in stocks as long as they remain 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.¹¹

That begs the question of how investment managers can overcome the challenges above. 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 tackle a greater number of companies than would otherwise be the case. As for acting-in-concert rules, for the EU at least, the European Securities and Markets Authority has published a whitelist of issues where investors are permitted to collaborate – including issues around corporate social responsibility.¹²

But there is an additional tool that investors can use: they can outsource the work involved in setting standards and ensuring that they are met by investee companies to index providers. By developing indexes with clear and transparent rules on sustainability issues, and engaging broadly with investee companies to ensure compliance, index providers can do much of the heavy lifting of engagement on behalf of passive index investors. This should complement, rather than replace, the type of shareholder engagement carried out by investment managers. In addition, by applying smart beta index construction practices to these passive indexes, providers can also reward or penalize companies through index over- and under-weighting.

¹⁰ CREATE-Research (2019), *Passive Investing 2019: The rise of stewardship*.

¹¹ “[How index investing can drive sustainable finance transition](#)”, Lionel Paquin, *The Financial Times*, 2 July 2020.

¹² “Information on shareholder cooperation and acting in concert under the Takeover Bids Directive” (Public statement), European Securities and Markets Authority, 8 February 2019.

Building ESG engagement into index design

By creating transparent index criteria and assessment processes, index design can create a powerful, scalable incentive structure and competitive framework that can complement direct investor engagement. This allows organizations responsible for index design and calculation to effectively undertake some elements of ESG engagement on behalf of their clients.

Indeed, 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. Below, we examine approaches to index design that combine active ownership and passive investment.

First, we consider the origins of engagement through ESG indexes via inclusion indexes such as FTSE4Good, where companies are included in the index based on ESG criteria. Second, “Smart Sustainability” methodologies are considered that employ tilt methodologies to determine constituent weights, and how those can be used for engagement purposes. Third, the recently introduced EU defined environmental benchmark categories are considered. Fourth and last, an approach is considered that brings together collaborative climate engagement and index design which may provide an indication for the future of scale investor engagement.

1. The origins of engagement through ESG indexes

FTSE4Good

Launched in 2001, FTSE Russell’s FTSE4Good Index Series is one of the world’s longest running sustainable investment index families. The FTSE4Good indexes include companies from the relevant parent benchmark index which meet a variety of sustainability thresholds that form a set of inclusion criteria, creating a form of ‘best-in-class’ sustainability indexes.

These criteria have been developed over many years, drawing from established standards and frameworks. The criteria have been developed through market consultation processes and are reviewed by an independent committee of experts, the FTSE Russell ESG Advisory Committee. A broad range of stakeholders help shape the criteria, which has included NGOs, government bodies, consultants, academics, the investment community, and the corporate sector. These inclusion criteria are revised regularly to ensure they remain consistent with market expectations and developments in ESG practice.

Crucially, FTSE Russell analysts communicate with companies globally about the sustainability methodologies and index entry requirements. There is also a detailed 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. These deletions are counterbalanced by companies improving their sustainability performance to gain inclusion in the index family: the number of constituents added to the FTSE4Good Developed Index has exceeded the number of constituents deleted from the index every year since 2011, with a total over that period of 835 companies added and 366 removed.

This has created a powerful lever to improve corporate ESG performance. The experience with FTSE Russell provides several examples of real-world outcomes linked to FTSE4Good engagement.¹³

Breast milk substitute marketing

The marketing of breast-milk substitutes (BMS), especially in developing countries, has been a subject of controversy for many years, with the two sides of the debate – food industry giants and NGOs – at an impasse.

In 2010, FTSE4Good introduced new BMS marketing criteria to attempt to bridge the divide. 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.

FTSE Blossom Japan and the GPIF

FTSE Russell has supported Japan's Government Pension Investment Fund (GPIF) – the largest pension fund in the world – to help improve stewardship and corporate governance practices among listed Japanese companies. This work has been through the FTSE Blossom Japan Index, an industry-neutral benchmark that comprises Japanese companies which demonstrate strong sustainability practices. The index encourages improvements in corporate disclosure and sustainability performance, with companies required to meet international standards to gain inclusion. GPIF, alongside other a number of other investors, are clients of this index.

Given its level of visibility in Japan due to the clients using it, 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.

Partnering with local stock exchanges

National stock exchanges have worked with FTSE Russell to develop local-market versions of the FTSE4Good Index, using sustainability indexes to drive economy-wide engagement.

One of the first such collaborations came in 2014, when Bursa Malaysia and FTSE launched 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 to 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.

¹³ For more information, see the Appendix to this report, and FTSE Russell (2018), *FTSE Russell Stewardship, Transition and Engagement Program for Change: 2018 STEP Change Report*.

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.¹⁴ 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.¹⁵

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 other than market capitalization – such as size or value – 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 contrasts with 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 latest annual survey of institutional asset owners found that 58% of asset owners globally anticipate applying sustainability considerations to smart beta strategies, up from 44% in 2019.¹⁶ 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 several sustainability factors in its index design.¹⁷ 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.

¹⁴ Craig Mackenzie, William Rees and Tatiana Rodionova (2013), "Do Responsible Investment Indices Improve Corporate Social Responsibility? FTSE4Good's Impact on Environmental Management", *Corporate Governance*, Volume 21, Issue 5, pages 495-512.

¹⁵ Catharina Henrike Slager (2012), [SRI indices and responsible corporate behaviour: a study of the FTSE4GOOD index](#). PhD thesis, University of Nottingham.

¹⁶ "FTSE Russell 2020 survey finds 58% of asset owners globally anticipate applying sustainability considerations to smart beta strategies, up from 44% in 2019", press release, FTSE Russell, 6 August 2020.

¹⁷ See Ground Rules, [FTSE Smart Sustainability Index Series v.16](#).

3. Using the EU 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.¹⁸ The taxonomy identifies those activities which are deemed to contribute to the EU'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.¹⁹

Similarly, the EU 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 – EU Climate Transition benchmarks and EU Paris-aligned Benchmarks – should meet.²⁰

The Paris-aligned Benchmark is the more ambitious of the two, requiring a 50% carbon-intensity reduction compared with the investible universe, while the Climate Transition benchmark must deliver at least a 30% reduction. In addition, the index constituents should collectively deliver an average 7% 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.^{21, 22}

The EU'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.

¹⁸ [Regulation \(EU\) 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 (EU) 2019/2088.

¹⁹ FTSE Russell 2020, [Sizing the green economy: Green Revenues and the EU taxonomy](#).

²⁰ [Commission Delegated Regulation \(EU\) of 17.7.2020](#) supplementing Regulation (EU) 2016/1011 of the European Parliament and of the Council as regards minimum standards for EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks.

²¹ Yang, W. Gunthorp, P. and Harris, D. et al (2020), "Deconstructing Paris Aligned Benchmarks". FTSE Russell Research Paper: <https://www.ftserussell.com/research/ftse-russell-study-eu-paris-aligned-benchmarks>.

²² State Street Global Advisors (2020), [Insights, Environmental, Social & Governance \(ESG\): EU Climate Benchmarks: A Guide](#).

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 \$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 \$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, recently launched the FTSE TPI Climate Transition Index. The index, which at launch the 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 Index, according to their performance against five criteria: fossil fuel reserves; carbon emissions; green revenues; TPI management quality; and 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 & 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.”

Conclusion

As this paper demonstrates, sustainability and climate indexes offer the potential, through their design, for efficient and impactful 'virtual' engagement across entire markets. As capital continues to flow into ESG indexes, their inclusion or exclusion of particular companies can, in turn, drive meaningful investment flows into sustainability leaders, and away from laggards.

By clearly and transparently communicating both inclusion and weighting criteria, such indexes can encourage companies to improve their sustainability performance: indeed, there is clear evidence of this effect from experiences with the FTSE4Good index series. As more investors back indexes, such as that developed for the TPI, 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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