

# ESG Index Considerations for Brazilian Pension Funds

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## INTRODUCTION

What is ESG? How can ESG be integrated into an index, especially in smaller markets? How can the divestment versus engagement arguments affect indices? How do ESG indices perform?

ESG risks have been poking their head above the water in Brazil over recent years, from issues surrounding the Amazon rainforest fires to corruption at Petrobras (BBC, 2018) and JBS (Schipani, 2018). At S&P Dow Jones Indices (S&P DJI), we have increasingly seen demand for ESG indices in Brazil and throughout Latin America in response to specific incidents and global shifts toward more responsible investment practices.

## WHAT IS ESG?

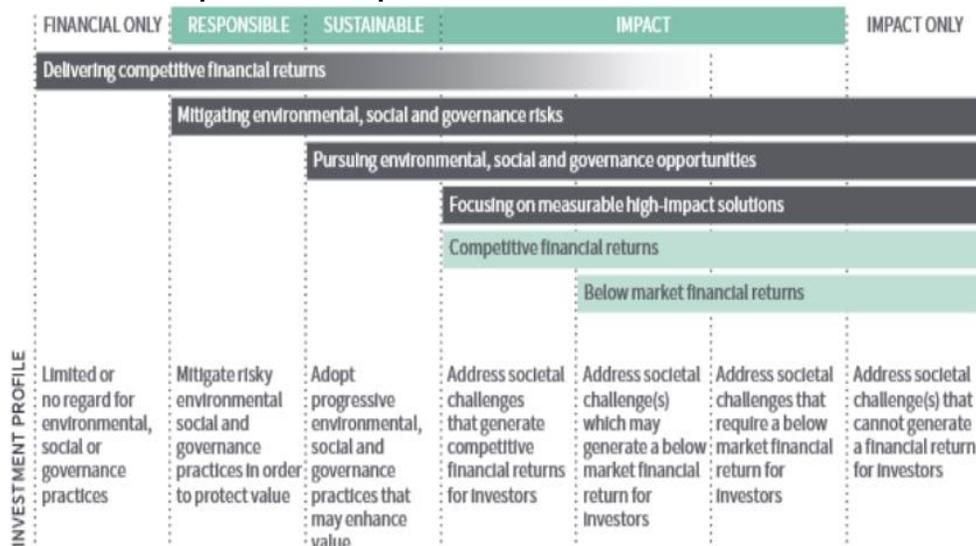
ESG stands for environmental, social, and governance. Environmental factors look at issues connected to global warming, energy usage, pollution, etc. Social factors encompass issues such as a company's management of health and safety, human capital practices, etc. Governance factors primarily address how a company is run, with metrics used including board structure and independence, executive compensation, and many more.

There are so many different terms floating around, including responsible investment, sustainable investment, and impact investing. These are all methods of incorporating ESG, with differing objectives. Exhibit 1 shows The Spectrum of Capital, which does a good job of defining the difference between different types of integration of ESG and how they differ from investments looking for purely financial returns.

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**Exhibit 1: The Spectrum of Capital**

*Environmental factors look at issues connected to global warming, energy usage, and pollution.*



Source: OECD (2015), Social Impact Investment: Building the Evidence Base, OECD Publishing, Paris. [https://read.oecd-ilibrary.org/finance-and-investment/social-impact-investment\\_9789264233430-en#page3](https://read.oecd-ilibrary.org/finance-and-investment/social-impact-investment_9789264233430-en#page3). Chart is provided for illustrative purposes.

*Social factors encompass issues such as a company's management of health and safety and human capital practices.*

**HOW SOCIAL NORMS ARE CHANGING**

There are ever-strengthening demands from pension members globally around their expectations of how their pension is invested. The Defined Contribution Investment Forum (DCIF, 2018) surveyed pension members about how they feel about their pension being invested responsibly (aligned with ESG principals), and only 5% disagreed that a responsibly invested pension would make them feel more positive about their pension. Furthermore, 31% said they would want to move their money elsewhere if a responsible approach was not taken.

The World Economic Forum (World Economic Forum, 2019) also classifies many of the most prominent ESG risks as being the largest risks companies face. These include cyber-attacks, natural disasters, extreme weather events, and failure of climate-change mitigation and adaptation. All of these are key drivers of integrating ESG into investment decision-making.

*Governance addresses how a company is run, including board structure and independence and executive compensation.*

Another driver of ESG is regulation. The Grantham Institute shows there was a roughly 15-fold increase (Gratham Research Institute on Climate Change and the Environment, 2019) in climate-related regulation between 2000 and 2018; this is a substantial jump!

These trends resulted in ESG ETF assets seeing a seven-fold rise (ETFGI, 2019) between January 2012 and December 2018 alone.

## HOW ESG SCORES CAN BE INTEGRATED INTO AN INDEX

*How can one choose a specific ESG score?*

Before considering how ESG can be integrated systematically into an index, ESG needs to be quantified. For this, we use ESG scores. ESG scores are an aggregation of various ESG metrics, which can be qualitative or quantitative in nature. These scores can also use a materiality matrix to include and weight different ESG metrics for different industries, corresponding to the areas on which the metrics have the most financial impact.

However, how can anyone choose a specific ESG score? There are many different methodologies for how data is collected, how the materiality matrix is constructed, how missing data is dealt with, and many more factors, all of which produce different outcomes. For example, the American Council for Capital Formation found there to be a correlation of 0.32 between Sustainalytics and MSCI ESG data, based on the [S&P Global 1200](#) universe (Doyle, 2018).

*There are many different methodologies for how data is collected and interpreted...*

One way to judge ESG scores is to look at an independent survey. SustainAbility produces a Rate the Raters survey, which assesses the strength of ESG Scores. The survey is based on polls in which ESG professionals are asked to answer questions about various data providers. At S&P DJI, we have our own methodology for ESG scores, which is based on underlying data from SAM, as we believe them to be the market leader. This is backed up by SAM being rated as the highest quality ESG data source in the Rate the Raters survey (SustainAbility, 2019).

Once the data is selected, there is a big decision to be made: how to use the ESG scores. There are two main methods used to construct an ESG index: screening and tilting the weights. This also sparks one of the great debates between ESG professionals: to divest or to engage. There are benefits of using either approach, and depending on the level of tilt or exclusions, similar levels of tracking error can be achieved.

*...all of which produce different outcomes.*

In screening out the companies with the worse ESG scores, the overall weighted average ESG score will be improved. Furthermore, it can have reputational benefits to not hold those companies. However, this is not always applicable across markets. An intricacy of many ESG scores is that they are industry relative. Therefore, an industry-group-neutral approach is taken where possible. When an index has a smaller number of stocks, such as the S&P Brazil LargeMidCap, trying to target a percentage of market cap within each industry group becomes impossible, as there simply aren't enough companies within each industry group.

As excluding stocks is difficult or impossible in smaller indices, tilting is a great option. Tilting weights toward higher-scoring ESG stocks and away from lower-scoring ESG stocks can cause an improvement in the index-level ESG score. With tilted indices, a higher ESG improvement per unit of

tracking error is usually observed. For example, the [S&P 500 ESG Index](#) (which excludes companies based on ESG scores) has a tracking error of 0.74% and an ESG improvement of 25%, whereas a hypothetical index of the S&P 500 Tilted ESG, with a tracking error of 0.76%, has an ESG improvement of 35%. Therefore, if pure ESG improvement is the goal, tilting based on ESG scores has been more efficient than exclusion.

*Staying invested in companies with poor ESG scores may be the more responsible option...*

Furthermore, staying invested in companies with poor ESG scores may be the more responsible option, as engagement with these companies can see their practices improve, which can also improve performance.

## **DIVESTMENT VERSUS ENGAGEMENT**

Theoretically, divestment has two impacts. First, divestment washes your hands of a company, often done because an investor does not want the reputational risk of holding it or because engagement is futile (for example, asking a tobacco producer to stop producing their only revenue generator, tobacco products, is unlikely to work). Second, removing investors' money from the demand curve for shares of a specific company shifts the demand curve to the left, lowering the price. For liquid companies, however, this has to be a large reduction in demand for there to be any economically meaningful impact on the long-term share price of a company.

Academic research supports this. The Stranded Assets Programme final report (Ansar, Caldecott, & Tilbury, 2013) states there is limited impact on equity or debt from divestment. This is specific to fossil fuel divestment, but the conclusions likely still hold true for other exclusions within liquid public markets. The rationale for this is that divested holdings quickly find their way into the hands of neutral investors, who may welcome their chance to increase their holdings at a short-term discount.

*...as engagement with these companies can see their practices improve, which can also improve performance.*

Recently, Bill Gates added his input into the divestment versus engagement debate (Edgecliffe-Johnson & Nauman, 2009), saying divestment in fossil fuels has had “zero” impact to date. This statement has been met with a mixed reception, some citing aims to weaken the political power of those divested sectors (Divestment Advocates Hit Back at Bill Gates Criticism, 2019) as a benefit of divestment.

On the other side of the fence, there is evidence of outperformance caused by engagement on ESG topics (Dimson, Karakas, & Li, 2015), in which after successful engagements, companies experienced improved accounting performance and governance as well as increased institutional ownership. In addition, ESG shareholder engagement was found to create value (Hoepner, Oikonomou, Sautner, Starks, & Zhou, 2017) by reducing downside risk, as measured by lower partial moments and value at risk.

Furthermore, there is anecdotal evidence of how engagement has created a genuine impact on corporations, rather than changing ownership of

shares in secondary markets. The Principles for Responsible Investment (PRI) collaborative engagement platform has documented case studies of successful engagement on topics such as the quality of carbon disclosure, anti-corruption measures, and sustainability disclosure in Brazil (PRI, 2013).

It is important to note that engagement tends to benefit every investor in a company, whether they themselves are engaging or not. Therefore, the benefits of engagement are not a driver of relative performance, but absolute performance. Thus, whether asset owners choose to engage directly or via their asset managers, this can be beneficial to pension members' returns.

*It is important to note that engagement benefits every investor in a company...*

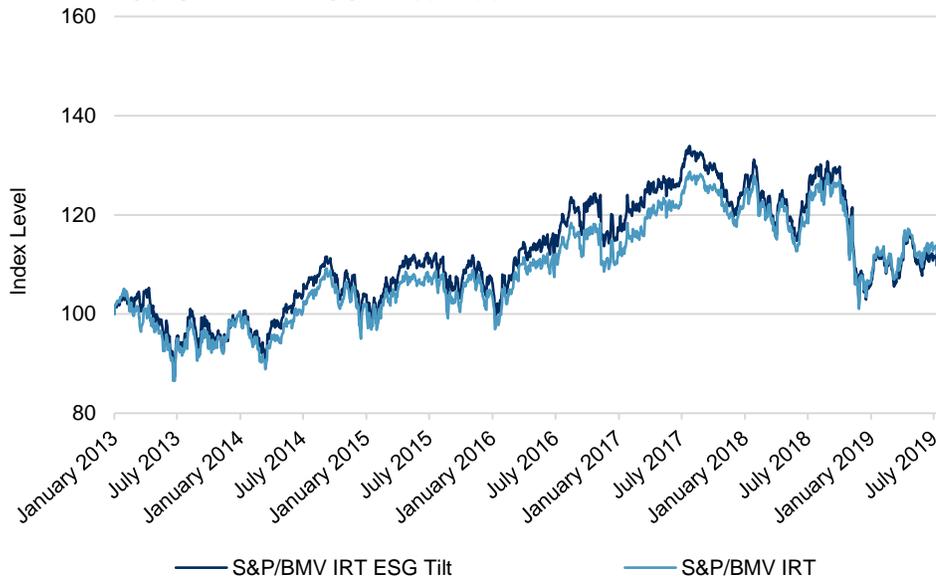
There is certainly a balance between the reputational risks of holding certain securities, which can be solved by divestment, and the performance benefits and impact that engagement can bring by staying invested in companies that are misaligned with ESG objectives.

### BETA-LIKE ESG INDICES

At the time of writing, we do not have a Brazilian tilted index designed; however, we do have an ESG-tilted concept for the S&P/BMV IRT (see Exhibit 2). This hypothetical index has a tracking error of just under 2%, with a similar performance to its benchmark and an ESG improvement of almost 30%. This illustrates what can be achieved using a tilted methodology within smaller markets.

*...therefore, the benefits of engagement are not a driver of relative performance, but absolute performance.*

**Exhibit 1: S&P/BMV IRT ESG Tilted Index<sup>1</sup>**



The S&P/BMV IRT ESG Tilt is a hypothetical index. Source: S&P Dow Jones Indices LLC. Data from Jan.1, 2013, to July 31, 2019. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

<sup>1</sup> Please note, this is a hypothetical index, and therefore the index levels and design are subject to change.

## CONCLUSION

*Overall, ESG is a growing area in Brazil...*

Overall, ESG is a growing area in Brazil, which can aid member engagement in pension funds and align member interests further with their investments. In indices with smaller numbers of constituents, tilting methodologies may be more efficient than exclusion-based indices, as they can be more inclusive. This offers investors the benefit of staying invested and engaging with poorer-performing companies, while seeking superior returns from the process and having a direct impact on corporations. This can all be done, while observing similar historical returns and a large ESG improvement.

*...which can aid member engagement in pension funds and align member interests further with their investments.*

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