

Sustainable equity investing: Is passive sustainable a win-win?

How active and passive equity approaches measure up on sustainability, performance and value

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Summary

Introduction and Key Findings

In recent years there has been a considerable shift out of actively managed funds into passive mandates. Passive equity strategies have become increasingly popular over time; the market share of long-term index funds rose to 30% as of November 2024 from 27% in November 2023 (Morningstar Direct). In recent times, despite a growing political backlash against ESG investing, many investors have shown increased interest in investing sustainably and have switched their investments into sustainable versions of their given strategy, including in the passive equity market.

We wanted to test the effectiveness of passive sustainable investing from a sustainable perspective versus active sustainable funds, and also reflect on the performance of passive sustainable funds to see if there is a material trade-off of taking a sustainable approach versus the broader market.

Key findings

▶ Sustainable passive funds deliver enhanced sustainability without compromising financial objectives.

- Passive sustainable funds take a wide range of approaches, but on average lead to better sustainability metrics than the non-sustainable market cap index, including:
 - i. 40% lower carbon emissions
 - ii. Roughly half the exposure to thermal coal
 - iii. Implied Temperature Rise consistent with the Paris Agreement at 2°C versus the market cap index which returns 2.6°C.
- Passive sustainable funds demonstrate minimal ex-ante tracking error (around 0.1%) and low active share at 2.4%. As a result, there is minimal deviation in observed performance from the market cap index (deviating by about 0.9% p.a. on average versus the market cap index).
- In our view this is a relatively modest deviation, expected to balance out over the long term and means investors can expect to achieve their financial objectives with superior sustainability credentials.

▶ Active sustainable funds deliver even better sustainability credentials, but the active positions have historically underperformed the market

- The high conviction approach of active managers means they can be even stricter around selection criteria. Compared to passive sustainable funds, active sustainable funds have 73% lower carbon footprint and zero exposure to thermal coal or controversies linked to deforestation.
- Where investors are looking to pay more for superior sustainability credentials in active management, higher fees are not expected to be offset by higher returns: on average active management is seen, net of fees, to underperform the passive market.

Therefore, investors with strong mandates to drive specific environmental or social outcomes may find actively managed sustainable funds more aligned with their objectives. However, the combination of lower fees and meaningful improvement in sustainability credentials means passive sustainable strategies will be compelling for most investors seeking equity exposure.



1. Definitions

In this report we have analysed a sample of 12 equity funds rated by XPS. These include:

- Three active sustainable funds,
- Seven passive sustainable equity funds and
- Two non-sustainable market cap index funds for comparison (which have no ESG objective).

We set out below how we define active and passive strategies in this document:

Active management

- Stock selection decisions are made by a portfolio management team who perform independent analysis on the wider market. An active approach may include risk controls to ensure that the portfolio delivers returns aligned to the market benchmark that the fund is aiming to outperform, but some funds are unconstrained and do not view risk versus the benchmark.
- In this paper we focus on 'sustainable active' funds which adopt a process to select companies the manager feels will benefit from long-term sustainable trends. Where we refer to 'traditional active funds' these relate to actively managed funds that do not pursue sustainable objectives.
- The manager will consider sustainable themes from a top down and bottom-up perspective to select names based on their perceived contribution to advancing sustainability (e.g. addressing climate change or align to delivering the UN Sustainable Development Goals).

Passive management

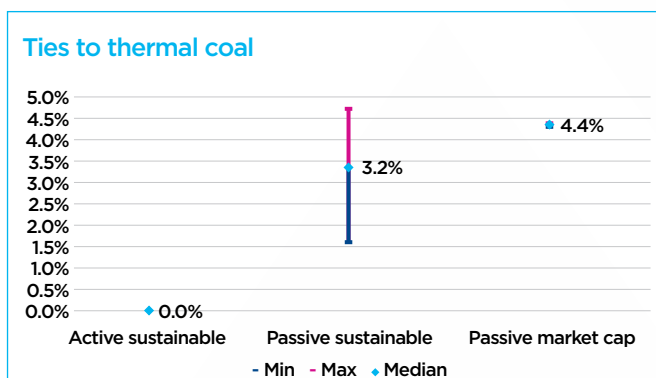
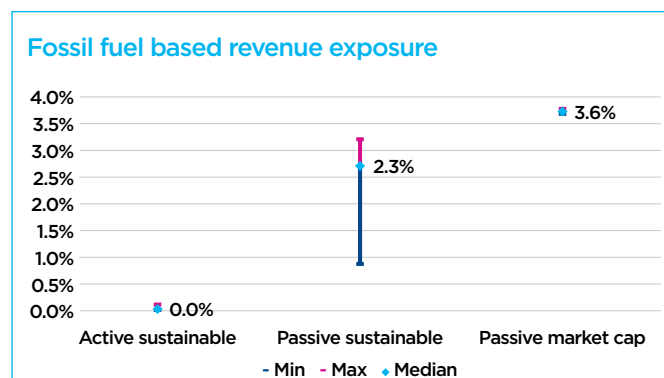
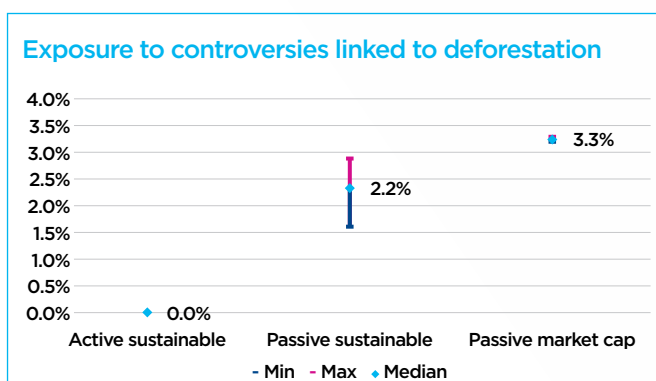
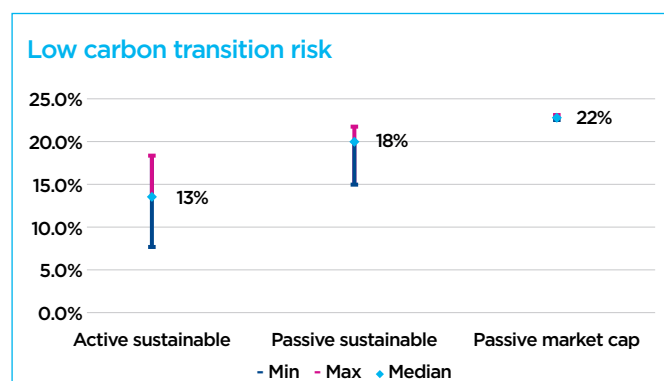
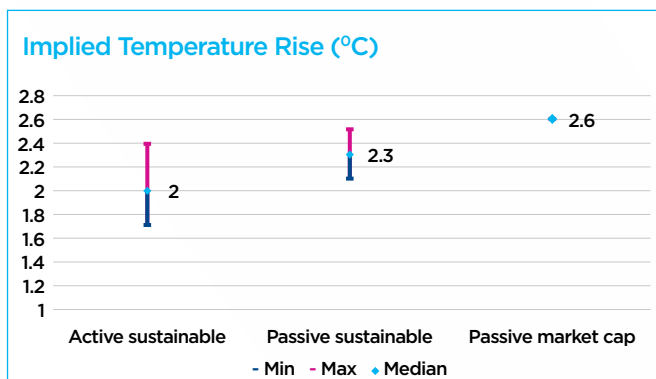
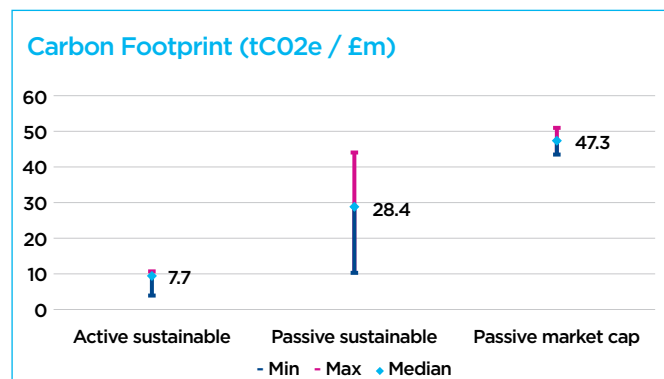
- These are rules-based strategies that do not seek to identify mispriced individual holdings, but instead are designed to track an index, with minimal portfolio manager intervention. This has traditionally involved tracking an index based on company market capitalisation (we refer to this as 'market cap passive'). However, as investor preferences for ESG and sustainability have increased we see a range of approaches emerging within 'sustainable passive' investing:
 - a. **Sustainable Index** - Funds track tailored indices that include only companies meeting sustainability criteria. Exclusions/tilts to company weightings are applied to the non-sustainable market cap passive index and then the manager mechanically tracks this adjusted index. Benchmarks for these funds are usually the sustainable index and therefore to assess the impact of the sustainable aspect, performance needs to be compared to the non-sustainable market cap passive index.
 - b. **Enhanced Index approaches** - In this approach the manager will have the objective of tracking the passive market cap index, but will take a relatively more active approach in their portfolio construction. The portfolio remains very large (often 600-800 names) and is designed to maintain a low tracking error vs the non-sustainable market cap index.

Exclusions

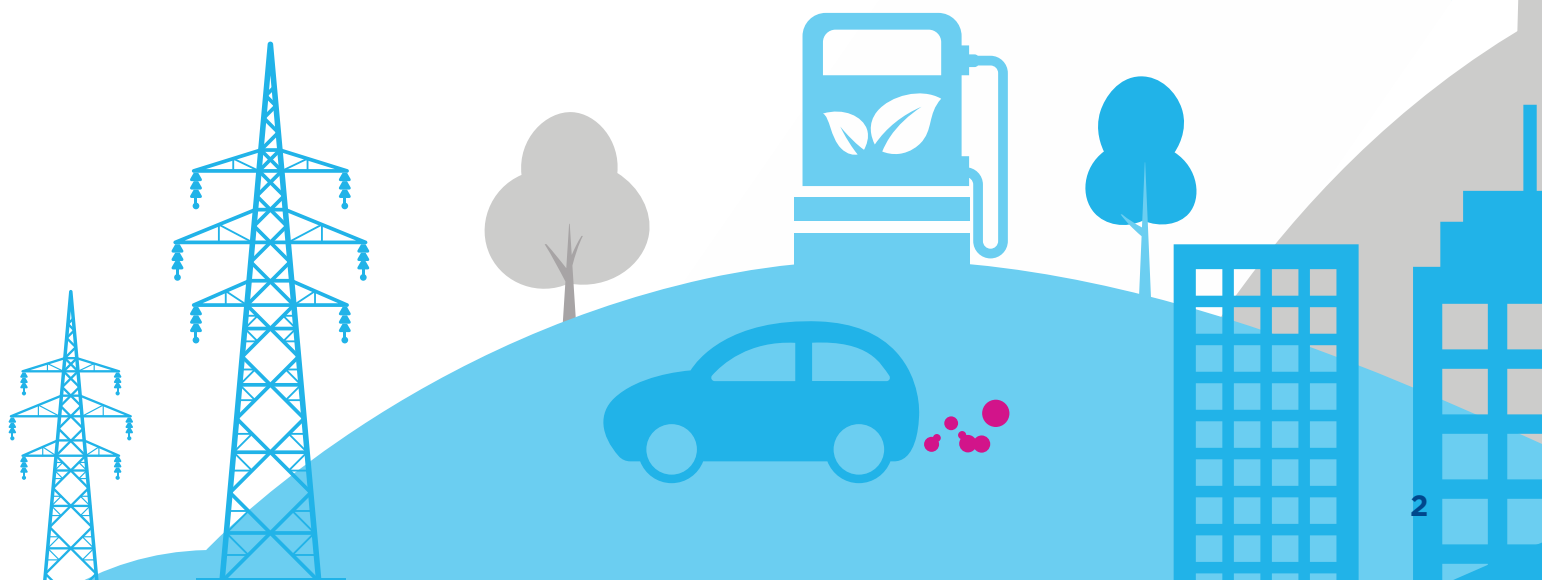
- Within all the above sustainable approaches as a minimum, most managers will implement exclusions whereby they will not invest in certain companies deemed unacceptable from a sustainable perspective - e.g. violators of UN Global Compact Principles, or companies engaged in activities relating to thermal coal, controversial weapons or tobacco.

2. Sustainability credentials

The charts below set out a range of ESG and sustainability metrics for the funds in the peer groups.



Notes:
 1. Source: Fund managers holdings and MSCI One tool for analysis, based on portfolios at 30 June 2024. Range and median across peer group of different strategies.
 2. Carbon transition risk based on MSCI assessment.

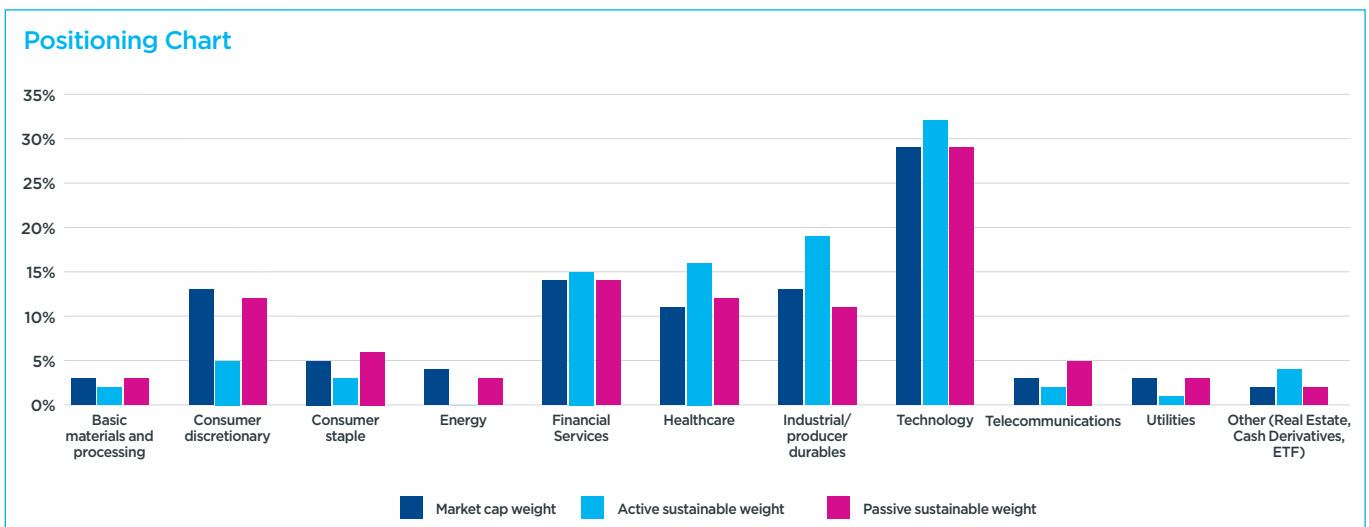


Carbon metrics and forward-looking climate risk

- Both active and passive sustainable equity funds have better ESG metrics than their non-sustainable counterparts, with active funds outperforming passive funds in climate credentials and measures.
- Passive sustainable funds in our sample have a large range of outcomes, reflecting the different approaches taken towards sustainability; some focus on carbon reduction for example (and we see that on average carbon footprint is 40% lower than market cap index), but others may take a softer approach tilting based on ESG scores and therefore this does not translate into significant reduction in carbon emissions. Investors should be clear on their preferences and select sustainable funds accordingly.
- Investors are increasingly focused on forward-looking transition alignment metrics as well as carbon emissions footprint. We see here that across the sustainable funds, which take a variety of approaches, the Implied Temperature Rise is on average around 2°C (below the market benchmark) suggesting better alignment to the targets under the Paris Agreement. As a result, sustainable funds are better positioned to manage ongoing climate transition risk.
- Additionally, active sustainable equity funds have considerably lower exposures in their portfolios to fossil-fuel-based revenues, controversies linked to deforestation and thermal coal. In fact, the active sustainable funds in our sample have virtually zero exposure to any of these controversies.

Positioning

The chart below sets out the **average % allocation** to given sectors of active and passive sustainable funds, compared to the non-sustainable market cap index.



- It's clear that adopting a sustainable approach introduces sector deviations, in some cases quite materially, relative to the market cap benchmark.
- All funds with a sustainable objective in this study overweight technology stocks in comparison to the non-sustainable 'parent' index.
- Conversely, the majority of sustainable funds in our study are underweight energy stocks, including all the active sustainable funds in our sample which had no exposure to energy. There's broad consensus that most major energy stocks come with key ESG risks which will impact their long-term viability unless there are significant changes to capex to align to a greener economy.
- There is consensus that as a society we need energy and therefore this is a critical sector for a successful global transition, and where sustainable funds in the sample hold these names the focus will be engaging with management to understand plans for contributing to the transition.

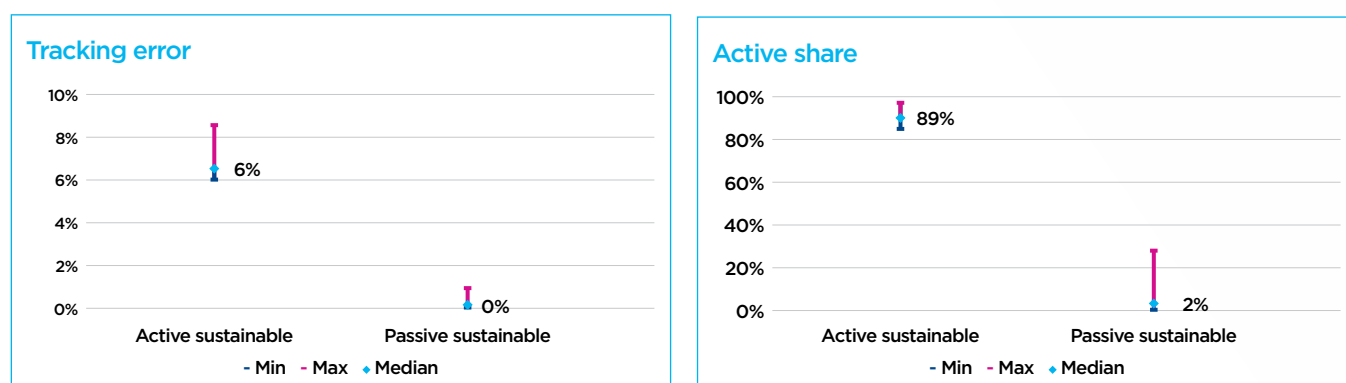
3. Performance of sustainable funds

When considering a move to sustainable funds, a key source of concern is that sustainability comes at a cost to financial performance. We have therefore considered tracking error and active share which are forward-looking metrics that indicate the deviation in portfolio construction from the parent index, and which managers look to control as inputs. We have also reviewed the historical observed performance of the sustainable funds to see how they have done in practice.

Tracking error and active share

- Tracking error here refers to 'ex-ante' tracking error and is a forward-looking estimate of how much a portfolio might deviate from its benchmark in the future.
- Active share is a measure of the difference between a portfolio's holdings and its benchmark index, calculated as the sum of the difference between the weight of each stock in the portfolio and its benchmark weight.

The charts below set out the tracking error and active share for the active and passive sustainable funds. In both cases we are comparing against the non-sustainable passive market-cap index.



It was found that most sustainable passive funds have low tracking error and hence performance only varied slightly in comparison to the non-sustainable parent index.

Sustainable active equity funds do not attempt to track the index, instead they are aiming to outperform the index over a given time period. Therefore, as expected, these funds were found to have a higher tracking error ranging from 6% to 9%.

We do note that for certain passive strategies which have strict sustainable parameters such as Paris Aligned Benchmark strategies (which includes the requirement to reduce the carbon intensity of the fund by 7% per annum and have strict climate-related exclusions), adhering to these parameters may put pressure on the tracking error. For example, if the carbon intensity of the wider market does not reduce at the rate required, such strategies will be forced to introduce significant active share in certain sectors. Investors need to be mindful of this, maintaining frequent dialogue with asset managers to ensure the sustainable targets are not compromising the financial objectives.



Historical performance

The chart below shows the average **relative performance of the funds versus their respective non-sustainable market cap index**.

	2024	2023	2022	2021	2020	2019
Active sustainable	-13.2%	-4.3%	-10.4%	-3.9%	15.8%	1.4%
Passive sustainable	-1.2%	-0.8%	-0.5%	-0.3%	1.7%	0.0%
Passive market-cap	-0.4%	-0.1%	-0.2%	0.0%	-0.1%	0.1%

Note: Average for the funds within the different approaches. Performance provided by the relevant managers gross of fees.

Passive sustainable

Out of the 5 years analysed, passive sustainable funds (on average) underperformed their respective parent indexes in 2021-2024 by between 0.3% and 1.2% p.a. This modest deviation will be in part due the underweighting to the energy sector which has performed well since the Russian invasion of Ukraine as well as overweighting certain sectors (such as renewables and healthcare) which have lagged the market in recent years. In 2020, passive sustainable marginally outperformed their respective parent non-sustainable indexes by around 1.7% on average, driven positive performance from sectors such as tech and healthcare.

Overall, the magnitude of this relative out- and under-performance is within a reasonable tolerance and consistent with the target tracking error. As a result, investors in a passively managed sustainable fund have been able to achieve similar financial outcomes as in non-sustainable passive market-cap-weighted funds, and that investing sustainably won't have compromised their broader financial objectives.

It's also important that investors reflect on what their objectives actually are. For example, a pension scheme exists to pay pensions, and charities may have an 'inflation plus' objective. The objective is therefore not simply to track the performance of the market, so that even if a sustainable passive fund does deviate modestly from the wider market from time to time, that does not mean the sustainable fund will not support delivery of the overall investment objective.

Active sustainable

Having significantly outperformed in 2020, over the last 4 years the active sustainable funds analysed here have performed below their benchmark. As with the passive sustainable funds mentioned above, this has also been driven in part by the low allocation to energy stocks which have performed well in the wake of Russia's invasion of Ukraine.

Also, these funds have often not held most (or all) of the 'Magnificent Seven' mega-cap tech stocks which have famously pulled global stock markets upwards. The decision not to hold these stocks is a result of the high-conviction nature of the active funds and indicates those managers did not feel these companies aligned to the sustainable themes they are trying to target.

Furthermore, active managers in our study often also have higher exposures to small-mid cap companies where many new climate solutions are being developed. The growth of many of these companies has been hampered during recent years amid a backdrop of high inflation and increasing interest rates.

It should be noted that active management more generally has underperformed the market benchmark for the most part; the FT recently reported that around 90% of active funds underperform index funds over the last 20 years when compounded. So it's not purely a function of the sustainable aspects leading to this underperformance, but active management more broadly.

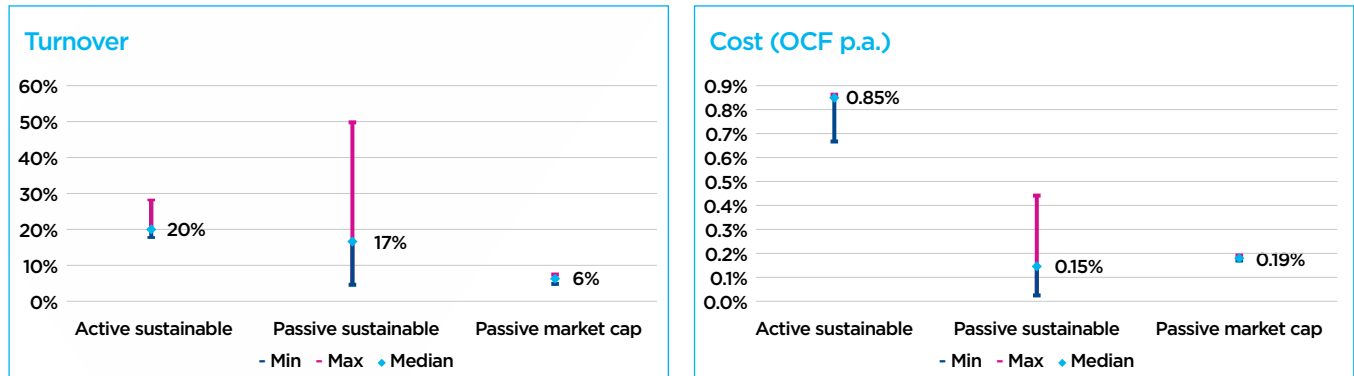
Overall, investors in sustainable active equity need to be comfortable with higher conviction strategies, looking to "take a view" and benefit from long term sustainable trends which may not currently be priced correctly in the market. There may be market inefficiencies in sustainable sectors which will take longer to realise, so that active management can take advantage of its ability to recover from a low point and seek to outperform the market in future years.



Sustainable passive funds are seen to deliver meaningful improvement in sustainability outcomes whilst closely tracking broad equity market performance

5. Turnover and cost

The charts below illustrate the turnover and cost (Ongoing Charge Fee (OCF)) for the fund types in our sample.



Turnover

We find the turnover in passive sustainable funds to be higher on average than passive market cap. This is due to regular rebalancing which will account for both changes in market capitalisation but also updates to underlying ESG data / scoring for each company.

Under an active sustainable approach, it's desirable for managers to find companies with long-term approaches to sustainability and therefore adopting a long-term investment horizon. As such, some portfolio managers are not trading in and out of companies as much as other managers who may be more focused on shorter term financial metrics.

Costs

We observe that taking a sustainable approach does not implicitly lead to higher fees. We find compelling sustainable passive options with fees which are comparable to market cap passive index investing.

Investment manager fees for investing in an active sustainable fund are higher compared to investing in a passive sustainable fund but, based on observing the wider universe of active managers, not necessarily higher than analogous non-sustainable traditional active approaches. The active approach is more research-intensive and there is an additional layer of analysis that captures more nuanced sustainability factors when making high conviction decisions.



6. Summary

Active sustainable equity funds provide a more detailed and sophisticated approach when taking sustainability factors into consideration; active sustainable equity funds outperform their passive counterparts on all ESG metrics analysed.

However, active sustainable funds have, like the broader active equity market, underperformed their passive counterparts over the time period considered.

Sustainable passive funds have low tracking error and active share versus the market and have observed close performance tracking of the broader unsustainable market. Therefore, demonstrating that it is possible for investors to switch into funds which deliver superior sustainable credentials without compromising their financial objectives in the long-term.

It's key to bear in mind that any sustainable strategy must have a clear link to real world benefits (i.e. beyond simply portfolio decarbonisation), and that the portfolio construction approach manages the introduction of risk and bias as they pursue the sustainable objective.

In our view, it seems likely that many of the long-term sustainability related challenges and structural shifts required in the economy have not yet been fully priced into the market. For example, the scientific views on climate change and need for a low carbon transition are not yet reflected in carbon pricing and volume of investment in low carbon technology.

We're clear that the case for sustainable investing must be made with a forward-looking mindset. There will be short term fluctuation in political sentiment, and unfortunate events such as wars or other crises which disrupt the exact pathway, but the Paris Agreement and other international frameworks should support a long-term shift in finance towards sustainable investing in order to manage systemic risks such as climate change, biodiversity loss and global inequality.

Actions for Trustees

- 1 Use XPS Beliefs Survey** to understand Trustee preferences for active or passive options in the context of the broader investment objectives, and clarify your objectives and priorities in relation to sustainability.
- 2 Review your existing investment funds** in terms of the sustainability and financial characteristics. The XPS ESG Ratings framework provides a cost-effective way to review the sustainable credentials of your funds.
- 3 Consider allocating towards sustainable funds** in order to protect against long-term sustainability risks, and take advantage of opportunities arising from the sustainable transition.

Find out more

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