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Elston Insights

Mitigating ESG risk within world equities

- Focus on ESG risk will become a requirement
- Screening approaches can be simple or nuanced
- Choice of index methodology is key

With the upcoming COP27 week from 6th November 2022 in Sharm El-Sheikh, there is renewed focus on how to climate change. The energy crisis that has worsened since the Russia/Ukraine war. This creates more challenges towards decarbonisation in the near-term. Energy will have to get dirtier, before it gets cleaner, which raises concerns about the Government's commitment to energy transition and Net Zero.

Sustainable investing rightfully gained much attention in recent years, as investors large and small seek to mitigate ESG risk. Furthermore, studies show that ESG score downgrades have a financial impact on companies[1].

Choice of index methodology is key

There are a number of ways of how to invest sustainably whilst maintaining a diversified world equity exposure. To compare the differences, the choice of index is key. Index methodologies range from very simple exclusionary-based approach, to a more nuanced set of filters and screens.

ESG indices typically assess and score company's environmental, social, and governance risks. Additionally Socially Responsible Investing (SRI) indices screen out companies based on reputational risk criteria. "Positive screening" means applying a best-in-class approach and selecting companies that score better than their industry peers, in a given sector.

Implementing a sustainable equity exposure

How can investors use ETFs to build in a sustainability perspective to their world equity exposure to mitigate ESG risk? We contrast three different approaches:

1. Reduced fossil fuel & reputational focus: the MSCI World Socially Responsible Investing (SRI) Select Reduced Fossil Fuels index approach screens out firms with high ESG risks and also non-renewable energy such as companies involved in fossil fuels extraction and production (coal, oil sands and gas), as well as nuclear power generation and uranium mining. iShares MSCI World SRI UCITS ETF (LSE:SUWG) tracks this index.

[1] https://www.sciencedirect.com/science/article/abs/pii/S1544612321003342

2. **Values-based exclusions:** indices may exclude companies that negatively impact the society and environment by involvement in conduct controversies, vice products, weapons manufacture and nuclear power, such as the FTSE Global All Cap Choice index tracked by Vanguard ESG Global All Cap UCITS ETF (LSE:V3AM).
3. **Low carbon and improvers:** the FTSE Developed ESG Low Carbon Select index aims to halve carbon emissions and fossil fuel reserves at an index level as well as targeting companies with improving in ESG ratings while excluding weapons and conduct controversies. HSBC Developed World Sustainable Equity UCITS ETF (LSE:HSDS) tracks this index.

When evaluating ETFs for a target exposure, a detailed analysis of underlying index methodology is key. These are three different ways of screening out high ESG risk exposures from your portfolio while staying invested in a diversified range of world equity investments.

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