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INSIGHT INVESTMENT
ESG-CONSTRAINED EQUITY DERIVATIVES

MANY PENSION SCHEMES USE SYNTHETIC SOLUTIONS TO GAIN EQUITY MARKET EXPOSURE WITHOUT BUYING PHYSICAL EQUITIES. WHERE SYNTHETIC EXPOSURE REPLACES PHYSICAL EXPOSURE, THIS RELEASES CAPITAL WHICH CAN BE USED TO ENLARGE COLLATERAL POOLS. EQUITY TOTAL RETURN SWAPS (TRS) AND FUTURES ARE INCREASINGLY BEING USED TO ACCESS ESG-CONSTRAINED INDICES, AS WELL AS MORE WIDELY KNOWN INDICES. THIS IS A TREND THAT FITS WELL WITH THE ENHANCED FOCUS ON RESPONSIBLE INVESTMENT FROM REGULATORS AND PENSION SCHEMES, ALLOWING TRUSTEES TO ENSURE THAT INVESTMENTS REFLECT THEIR ESG VALUES, AND MORE EASILY REPORT THIS TO MEMBERS.

SYNTHETICALLY SEEKING RETURNS

For pension schemes that are allocating to return-seeking assets, using derivatives makes it possible to gain market exposure while committing only a limited amount of capital. This can be advantageous as:

- Freed up capital can be used to top up collateral pools and liquidity buffers.
- Schemes can prepare for long-term strategic changes without committing additional capital.
- It can diversify a scheme's sources of leverage, reducing reliance on repo markets and resulting in funding cost benefits. For example, when equity markets fall sharply, it is not uncommon to see long synthetic equity exposure become cheaper while repo funding costs increase.

A SYNTHETIC SOLUTION WITH AN ESG FOCUS

- Demand is growing for investments that reflect environmental, social and governance (ESG) risks appropriately. In response to this, index providers are increasingly creating ranges of ESG-constrained equity indices across both developed and emerging markets.
- Access to ESG-constrained equity indices, via both total return swaps (TRS) and futures, continues to improve.
- Our recent analysis suggested that ongoing funding costs, as well as transaction costs, for exposure to mainstream ESG-constrained equity indices were not materially higher than for traditional equivalents.
- Insight's clients are increasingly focused on ESG reporting and disclosure requirements. Our reporting allows clients to receive information detailing our analysis and engagement on ESG factors, as well as individual exposures. This enables our clients to ensure the companies in which they invest reflect their ESG values.

HOW ARE ESG INDICES CREATED?

There is no single 'right' way to create an ESG-constrained equity index, but most index providers take similar approaches. The starting point is generally a mainstream index. Companies within the index are then screened.

This can be a negative screen, excluding companies that have poor ESG credentials or operate in certain sectors (for example tobacco), or a positive screen, which puts greater emphasis on the companies with the highest ESG scores.

Overleaf, we have compared a broad global equity index – the MSCI World – with an ESG-constrained equivalent, the MSCI World ESG Leaders Index.

There are many other ESG indices of course: for example, the MSCI World Low Carbon Leaders Index aims for at least a 50% reduction in carbon footprint across carbon emissions and fossil fuel reserves of the parent index, with similar sector weights to reduce systematic risk. However, acceptance and liquidity in related derivatives can vary greatly.

For investors interested in different forms of ESG exposure, we encourage you to get in touch with Insight for more customised analysis.

MSCI ESG LEADERS INDEX SUITE

Using their mainstream index suite as a base, MSCI target the companies that have the highest MSCI ESG ratings. Their aim is to include around 50% of the parent index, with similar sector weights to reduce systematic risk.

Intercontinental Exchange (ICE) has partnered with MSCI to offer futures contracts in five of the most popular indices: World, USA, Europe, EAFE and EM.

Liquidity in derivative markets is largely provided by banks who sell derivatives as an efficient way to hedge their balance sheet exposures.

HOW DO THESE INDICES COMPARE?[1]

Comparing the MSCI World ESG Leaders Index and the parent MSCI World Index shows that both indices have (or have experienced) broadly similar long-term performance, valuations and sector weights. Between end September 2007 and end July 2021, the MSCI World ESG Leaders Index had a tracking error of 1.17% versus the MSCI World Index.

Table 1: Performance and fundamental comparison

	3y	5y	10y	Yield	P/E
MSCI World ESG Leaders	15.9%	14.9%	11.7%	1.7%	27.5
MSCI World	15.1%	14.9%	11.7%	1.7%	27.0

Table 2: Sector breakdown

	MSCI World ESG Leaders	MSCI World
Information Technology	22.5%	22.5%
Financials	13.5%	13.3%
Health Care	13.4%	12.8%
Consumer Discretionary	11.9%	11.9%
Industrials	10.8%	10.6%
Communication Services	9.5%	9.1%
Consumer Staples	7.1%	7.0%
Materials	5.0%	4.5%
Real Estate	2.8%	2.8%
Energy	1.9%	2.9%
Utilities	1.8%	2.8%

A MARGINAL PRICING IMPACT

The simplest way for a pension scheme to access ESG-constrained synthetic equity exposure is often via a total return swap (TRS): the scheme pays a regular amount – for example, an interest rate plus a spread – in return for payments that rise and fall in line with the MSCI World ESG Leaders Index (or similar).

Recent analysis suggested that for a 1-year TRS on the MSCI World Index, there was only a marginal difference in pricing (1bp difference in best offers) to synthetically buy the ESG Leaders version of the index than the parent index, with the dispersion between bank pricing bringing the best bid/offer to similar levels.

Table 3: Example TRS pricing[2]

	MSCI World ESG Leaders			MSCI World		
Bank	Bid	Offer	Spread	Bid	Offer	Spread
A	-9	+9	18	-12	-12	24
B	-18	+2	20	-5	+1	6
C	-15	+4	19	-12	+5	17
Best bid/offer	-9	+2	**11**	-5	+1	**6**

TAX CONSIDERATIONS

Please note that investors may be subject to withholding tax on US source of dividends under the US HIRE Act. We understand that UK pension scheme segregated investors may be eligible for exemption due to the UK-US tax treaty, whereas Irish-regulated pooled fund (e.g. bespoke or multi-client Irish QIAIF) investors may be subject to withholding or deduction unless an exemption applies (e.g. if the index in question meets certain criteria).

If you have any concerns regarding your direct or indirect tax position, we would encourage you to seek advice from your tax advisors.

CONCLUSION

For many trustees and pension scheme members, it is important to know that the companies in which they invest are run in a way that satisfies ESG standards. A synthetic approach to equity exposure that utilises an ESG-constrained index can allow trustees to express those values, with the additional flexibility that synthetic strategies provide.

If you would like to know more about this approach, or would like to obtain pricing for your scheme, please reach out to your Insight contact or see the contact details at the end of this document.

[1] Source: MSCI, data as of 31 July 2021. Performance data is annualised and is quoted in US dollars.

[2] Based on pricing from counterparty banks on 1 September 2021 and quoted as basis points above SONIA for a one-year TRS.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

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