**Top 1000 Interview - Behind PGGM's ESG index**
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In 2010 PGGM conducted a study to see if it was possible to reduce the number of companies it invested in from 4000 to 400, based on its environmental, social and governance leanings, and still maintain it's beta risk/return profile. The idea was that the €133-billion ($174-billion) fund would better know and understand what it owned, and be able to better control those companies. That experiment failed in that PGGM realised that while the ESG-based reduction in stock investments suited it's responsible investment and long-term ownership preferences, it altered the beta profile and skewed the long-term cumulative risk. The strategy persisted in its active responsible equity portfolios, and PGGM has an aggressive active ownership policy for all its equities portfolios.

However, in passive equities, where 90 per cent of the equities investments reside, about $44 billion in market-cap and smart beta strategies, the dual goals of it's risk/return profile and responsible investment have been more challenging. PGGM is not alone in this problem, with ESG strategies tending to be active. But now PGGM has developed an index in house, which measures the 2800 companies in the FTSE All World Index for their environmental and social policy and good governance. The index re-ranks the companies based on these criteria, which also include a minimum threshold. As a consequence of this, about 200 companies that don't make it into the index have been sold by PGGM, which amounts to about 1 per cent of the portfolio. The capital is reallocated to companies within that sector, so the index is sector neutral. There is a slight bias away from small companies, which don't make it in to the index straight away. About 80 mid-to-large companies are on watch.

**Matching profiles**
Managing director of responsible investment at PGGM, Marcel Jeucken (pictured below), says the fund has a clear engagement, voting and exclusion policy, and the new index is an extension of its existing responsible investment activities. "We believe responsible investment is important," he says.

The threshold is also important and while he adds it could be higher, Jeucken says the approach is not to choose the top 10 or 50 per cent of companies because then it would need an active investment strategy. "This is an approach that fits passive," he says. "It meets our risk/return profile. We have the same beta risk/return characteristics as the past but we now also have an ESG selection instrument on top of our existing ownership instruments." PGGM believes that screening companies on ESG factors will reveal early warnings of where things go wrong, and engagement and exclusion can take place. "We have built a system and a database, and we now better know the companies from an ESG perspective," he says. "This strategy works if you have a strategy to be an active owner and engage, vote and exclude. The index doesn't work alone. It is not black and white for us. We don't blindly follow the index from third party providers as we have created our own ESG index and have an increased effort in engagement."

**The way it works**
Last year PGGM voted in 3106 shareholder meetings and talked with 746 companies about improving ESG. It excluded 42 companies. The new ESG index screens companies on 70 factors, varying from labour practices to climate policy and management or carbon dioxide emissions, and weights those factors to various sectors according to that their profiles. For example, in banks the screens concentrate more on governance, but in mining it is an

environmental focus. The rule-based model uses external data, but the data points and weights have been determined in house.

Jeucken responds to the debate over whether ESG is a risk- or return-generating strategy by saying there is logic to both arguments, but that return fades away quicker. However, PGGM has particular views on alpha per se. More generally, Jeucken says alpha is to be made but in small parts of the investable universe, which is why PGGM believes in a strategy of index and alternative strategies, not traditional alpha strategies. ESG, he says, reduces risk over time – whether it be reputational or financial risk. According to Jeucken, PGGM is willing to discuss the index with its pension fund peers and is open to the idea of sharing information.

By AMANDA WHITE

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