NEW EDITION

PASSIVE INVESTING 2019

The rise of stewardship

Foreword

Dear Reader

It is a pleasure for DWS to once again sponsor this report by CREATE-Research. Last year's survey provided us with deep insight into how pension funds use index trackers and, crucially, how active and passive strategies are being used symbiotically.

This year's survey confirms the on-going movement of passive investment into the mainstream with 66% of survey respondents considering passive index investing as a mature part of their portfolio. A large part of this year's report also deals with the important issue of active ownership in the context of index investing. In recent years, providers of index-tracking products have taken steps to actively engage in stewardship. In the case of DWS, this has meant bringing stewardship on our passive products in line with the processes and standards already established for our active funds. We take our responsibility for active corporate governance engagement seriously, which is both in line with our values as a socially responsible investment firm but also the fiduciary interests of our clients – indeed, we strive not only to meet but to go beyond our fiduciary duties.

I was pleased, therefore, upon reading this report, to see that the awareness of stewardship with respect to passive funds is increasing at a fast pace.

It is also clear however that there is more to do. The entire asset management industry has a duty to invest in stewardship, to ensure that this is not done on the basis of meeting minimum requirements but on the basis of best practice and that over time deep knowledge pools are developed so that best practice can be improved upon. As the report states, stewardship effectiveness will not only become an important signifier of a positive business culture but will also be a key point of competition.

I do of course understand that this is a difficult challenge in an industry where profit margins are becoming ever tighter. Here at DWS, we have chosen to invest to meet that challenge. I hope that across the industry other asset managers will also invest to improve and develop their stewardship, and that this report provides some inspiration to rise to the occasion.

Asoka Woehrmann
CEO, DWS

Acknowledgements

"Games are won by players who focus on the playing field, not by those whose eyes are glued to the scorecard."

Warren Buffet

This 2019 global survey is part of the annual research programme started by DWS and CREATE-Research in 2018.

Last year, the main theme was how the rise of passive investing was reshaping the investment landscape.

This year, the programme focuses on how this rise has fueled interest in stewardship and the outcomes so far.

For most pension plans, stewardship, as applied to passive funds, is a recent phenomenon; indeed, it is a voyage of learning.

This report provides a record of progress so far and the barriers that remain to be overcome.

I am deeply grateful to 127 pension plans in 20 markets who participated in our research and follow-up structured interviews.

Their background details are set out in the two charts on page 3, showing a fair cross-section of different segments of the pension market.

Their regular involvement in our surveys has helped to create an impartial research platform that highlights the emerging challenges in the global investment industry and the solutions they call for.

My special thanks go to DWS for sponsoring the publication of this survey report without influencing its findings in any way.

This arms-length relationship has enabled us to present a candid appraisal of the unfolding reality on the ground, which is widely welcomed by our readers.

Finally, I would like to thank Lisa Terrett for managing the survey and the interview programme; and to Dr Elizabeth Goodhew and Anna Godden for their excellent editorial support.

After all the help and support I have had, if there are any errors and omissions in this report, I am solely responsible.

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Executive summary

Background and aims

Are passive index funds the lazy owners of companies, allowing unaccountable management to drain dynamism from the economy?

Or, are they becoming too activist by venturing into controversial areas of public policy that are best handled by regulators and politicians?

These questions have come to the fore as the rise of passive funds has become a foundational trend, doubling their share in pension portfolios in this decade.

Their critics hold that index funds do not exercise their voice or clout enough, when engaging with their investee companies. Nor are they designed to do so. By mechanistically targeting the performance of their chosen indices, such funds have neither the motivation nor the resources to improve the performance of the individual constituent stocks. The result is ownerless companies.

Their supporters retort that, since passive funds cannot divest their positions in poorly performing stocks, they are forced holders of the shares they own. They have every incentive to exercise their stewardship role to boost beta via the sheer weight of their shareholdings. The result is ultimate long-term investors.

This debate has intensified with the emergence of yet another foundational trend: the headlong rise of environmental, social and governance investing, after the worldwide adoption of the UN's Sustainable Development Goals in 2015.

Among others, these require strong corporate engagement to a degree previously unimaginable.

Unsurprisingly, so far, the debate has been dominated by active and passive asset managers or academics supporting either camp. But as ever, the reality is far more nuanced. Nothing is black and white. It is time to widen the scope of the debate by soliciting the views of the biggest users of passive investment vehicles: pension plans.

Many among them increasingly demand that their money is run within holistic guidelines that emphasise non-financially material factors as well as financially material ones. To them, passive funds should not mean passive owners.

In response, passive index managers have started promoting engagement in earnest on behalf of their clients over the past three years.

Accordingly, this survey report does a stock-take of progress so far by obtaining the views of pension plans globally. It pursues the following questions:

- How are passive funds reshaping the portfolios of pension plans?
- How important is the stewardship function in these funds, and what are its key drivers?
- How effective have the index managers been so far in discharging this role on behalf of their clients, and what constraints have been encountered?
- Going forward, what best practices will deliver better outcomes?

These questions were pursued in an electronic survey involving 127 pension plans in 20 countries, with a combined AuM of €2.2 trillion.

Details on the background of survey respondents are given on p.3.

The survey was followed up by structured interviews with 50 senior executives.

The survey provided the breadth and the interviews the depth. Together, they offer fresh insights into recent progress and future outlook.

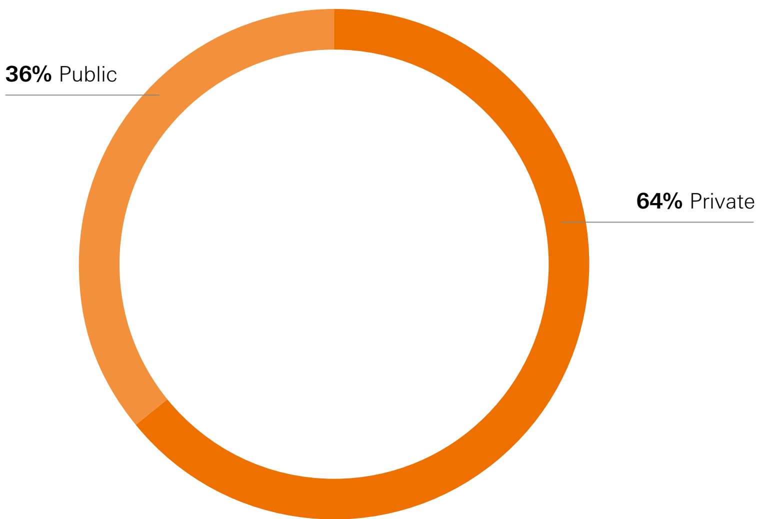
The rest of this section gives the survey's highlights followed by its five key findings.

"There is nothing so powerful as an idea whose time has come."

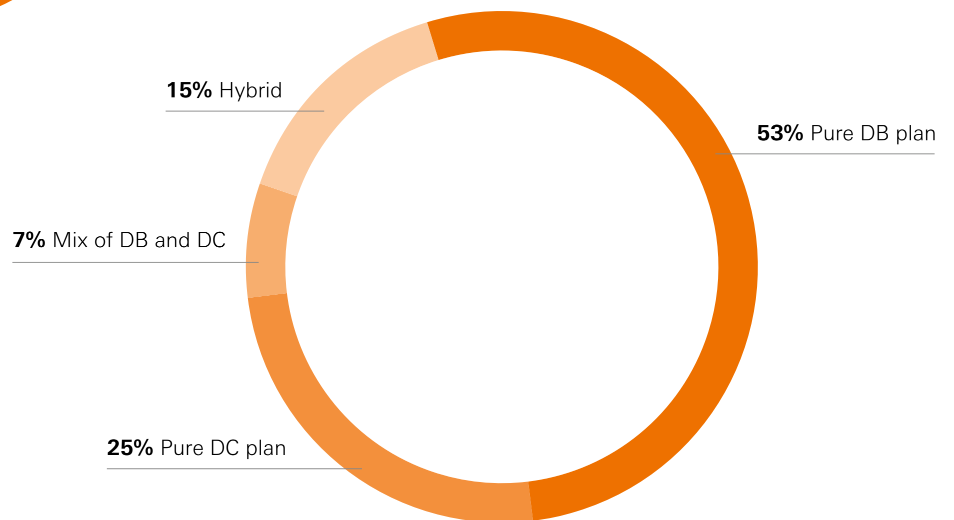
Victor Hugo
Author of Les Miserables

FIGURE 1.1
Profile of the survey respondents

Sector:
% of respondents



Nature:
% of respondents



Source: CREATE-Research Survey 2019

“With stewardship, we are in the early innings of a long game.”

Interview quote

Survey Highlights

- By advancing into the core portfolios of pension plans, passive funds are going from peripheral to mainstream, as cited by 85% of survey respondents.
- Passive funds now account for 34% of pension assets worldwide, with 78% of respondents expecting that share to rise over the next three years.
- This structural rise of passives has aroused interest in stewardship with 60% of respondents regarding it as 'very important' and 38% as 'important'.
- Stewardship is about seeking good long-term investment returns (83%), meeting social responsibilities (57%) and managing reputational risk (49%).
- Over 84% cite various stewardship practices as pivotal in improving the quality of beta while generating positive societal spin-offs.
- 56% currently use a manager's track record on stewardship as a criterion in manager selection to a 'large extent' and 27% to a 'medium extent'.
- 19% said that their passive managers have met their stewardship goals to a 'large' extent, 31% said 'medium', 23% said 'some', and 27% said 'not at all'.
- Three key barriers so far include: no clear definitions and metrics of corporate engagement (62%), too many companies in indices (60%) and question marks over the worth of proxy voting (52%).
- Stewardship will become a key point of competition for index managers, as fierce competition has already driven down their fees.
- 80% expect stewardship demands on their index managers to increase while emphasizing the importance of direct engagement as well as proxy voting.

Key findings

1. Passive funds continue to advance into core pension portfolios

Based on the usual adoption cycle of funds, 66% of our survey respondents report that index funds are part of their 'already mature' portfolio, a further 19% report that they are now in the 'implementation phase', 2% report that they are 'close to decision making', and the remaining 13% are still in the 'awareness raising phase' (Figure 1.2).

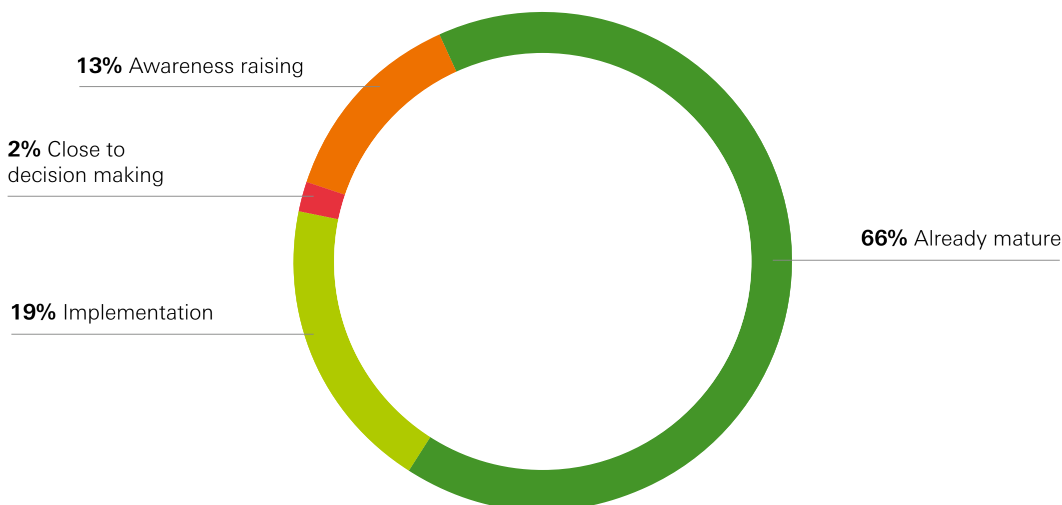
Since our 2018 survey ''Passive Investing: Reshaping the Global Investment Landscape'', the main change has been the increase in the proportion of pension plans who have migrated from awareness raising into the implementation phase: from 16% in 2018 to 19% in 2019.

This continuing shift reflects the network effect usually associated with digital brands: a product becomes more credible as more people use it. The key drivers are their lower costs, continuing superior performance over active funds in this decade and ability to slice and dice the investment universe in search of new opportunities.

In the process, there is a growing separation of alpha and beta. Passive funds are now advancing into the core part of a typical pension portfolio that targets beta returns, leaving specialist or illiquid strategies to generate alpha.

This separation is expected to continue over the next three years (Figure 1.3).

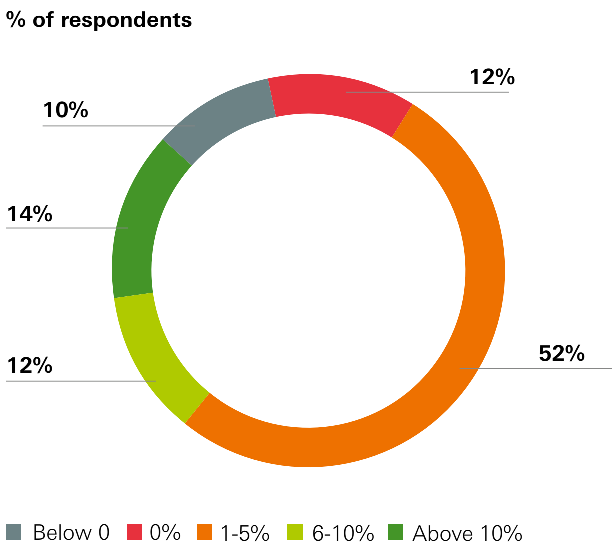
FIGURE 1.2
In which stage is your pension plan currently with respect to passive investing?
% of respondents



Source: CREATE-Research Survey 2019

FIGURE 1.3
What will be the approximate annual growth in your pension plan's investment in passive strategies over the next 3 years?

% of respondents



Source: CREATE-Research Survey 2019

Only 10% of respondents expect negative annual growth and a further 12% expect zero growth. The remaining 78% expect positive growth with 12% expecting growth of 6–10% and a further 14% expecting a rate of over 10%.

There are other salient features about future growth that are worthy of note, as highlighted in Section 3.

First, the share of passives in the total pension assets in our selection of countries has inched up from 32% in 2018 to 34% in 2019.

Second, the current wave of growth has mainly impacted equities and fixed income. The next wave will expand the asset base to include real assets, commodities and multi-asset funds.

Third, the average holding periods of the different components of passive funds have inched up slightly as well: 81% of respondents hold cap-weighted traditional index funds for over 2 years. The corresponding figure for ETFs is 48% and for segregated accounts is 83%. In sum, passive portfolios are expected to maintain their upward, outward and onward trajectory. Of course, much depends upon how they will fare in a future market correction. For now, in that scenario, many pension plans expect to increase their holding periods and rely on mean reversion to recover the resulting losses over time.

The rise of passives, thus, is seen as a structural phenomenon. Concerns about a future correction have not detracted from pension plans' growing interest in the stewardship of their index funds.

2. Stewardship is set to be the new normal

By their nature, passives cannot deliver alpha, nor can their managers vote with their feet. Hence, pension plans are keen to enhance their beta quality via better stewardship that fosters an effective dialogue with investee companies to achieve certain targeted outcomes.

This is all the more essential since the pronounced concentration in the index industry gives its managers the requisite scale and reach to exercise their voice. Many passive fund managers are amongst the pivotal shareholders in the firms they own, holding commanding votes in the largest quoted companies in all the key financial markets. Besides, they are also exposed to regulatory and reputational pressures to provide strong corporate oversight. As a result, they have become increasingly vocal in promoting sustainability goals linked to long-term value creation.

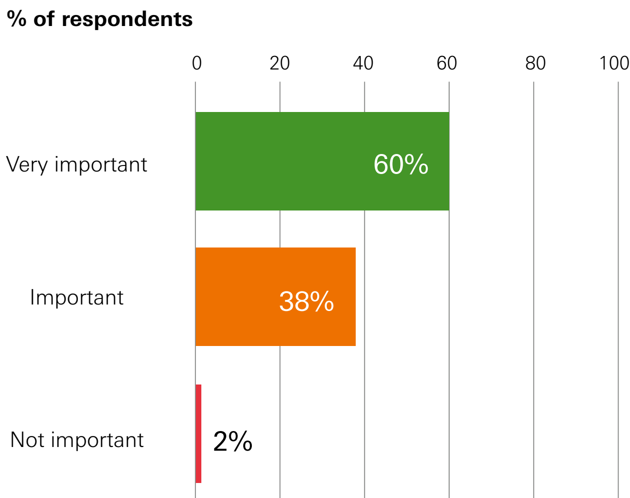
"Stewardship offers a better model of capitalism with its focus on purpose, inclusion and sustainability."

Interview quote

That these goals are also firmly anchored in pension plans' agenda is underscored by the fact that 60% of them regard stewardship as 'very important', 38% as 'important' and only 2% as 'not important' (Figure 1.4). There are four key contributory factors, as discussed in Section 2.

FIGURE 1.4

How important is the stewardship role that protects and enhances shareholder interests?



Source: CREATE-Research Survey 2019

First, the UN Sustainable Development Goals have highlighted all too vividly the ways in which the ecosystem of financial markets is changing with the emergence of new forces like global warming, artificial intelligence, mass migration and social upheavals. The risk universe is thus expanding into the unfamiliar space of fat-tail and far-off risks that are vital for companies to manage. The soft metrics of their performance matter as much as the hard ones.

Second, 83% of our respondents believe that sustainable businesses need sustainable societies. This calls for a regular constructive dialogue on soft as well as hard areas that impact on the corporate bottom line and its long-term viability. Key areas include strategy, governance, risk, ethics, independent audits, supply chain management, corporate culture, human capital, climate change and societal needs – to name a few.

Third, 57% of respondents accept that their fiduciary responsibilities now extend beyond their members to include the wider society. The legal element in their conventional 'license-to-operate' is now being reinforced by a moral one.

That means minimising the negative externalities that often result from day-to-day corporate activities and inflict uncompensated costs on the wider society in areas like carbon pollution, poor labour practices and governance lapses. Company boards need to not only be called to account but also held accountable. BP's Deep Horizon oil spill in the Gulf of Mexico in 2010 and Volkswagen's emission-cheating scandal in 2014 caused huge shareholder value destruction.

Finally, 49% of respondents want to minimise reputational fallout from financial manipulations that eventually cause spectacular corporate collapses – like Enron, WorldCom, Lehman Brothers and Royal Bank of Scotland – that left their investors virtually penniless.

Currently, stewardship is perceived as a nascent phenomenon, on the whole. But its evolution has been gaining traction along its 6-stage value chain, after the global adoption of the UN Sustainable Development Goals (Figure 1.5).

"There is no free lunch with effective stewardship. Without quality resources, it can degenerate from an investment imperative to a compliance activity."

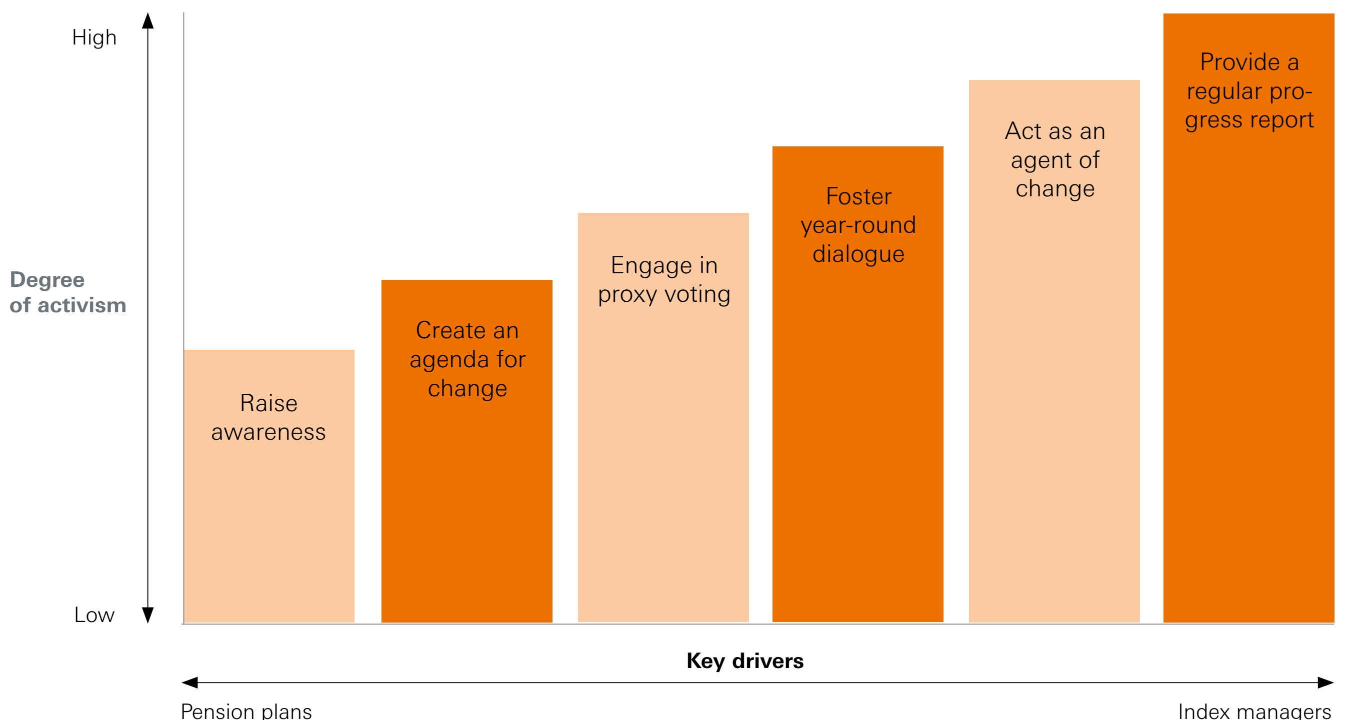
Interview quote

This extended process requires pension plans to kickstart the first two stages and pass on the baton to their index managers thereafter. The stages involve the following:

- Raising awareness of pension plans about the latent power of their index holdings and how that can be harnessed to improve the quality of their beta assets while also producing positive spin-offs for wider society.
- Creating an agenda for change and acceptable standards that are consistent with its delivery.
- Engaging in proxy voting that can ensure that investors' standards are observed and their voice is heard on board resolutions, board independence and a raft of other hot-button issues like strategy, governance and ESG.
- Fostering year-round dialogue with investee companies beyond shareholder meetings on issues that impact on long-term value creation and brand enhancement.
- Acting as an agent of change via deeper engagement with investee companies that envisages the index manager as an active owner, instead of a passive holder of paper assets.
- Providing regular feedback to end-investors on stewardship activities and outcomes.

The specific practices associated with this evolution of voting and advocacy – as described in Section 2 – are regarded as 'very important' or 'important' by between 84% and 96% of respondents. Not only are they important in their own right, they are also mutually supportive, such that success begets success.

FIGURE 1.5
Expected evolution of stewardship in passive funds



Source: CREATE-Research Survey 2019

> "Over-rapid growth in passive funds has, as a side effect, over-industrialised the proxy voting business to the lowest common denominator."

Interview quote

Currently, the majority of our respondents believe that stewardship activities have progressed up to the third stage – proxy voting – with the expectation that they will get to the final stage over the next five years. For pension plans and their index managers, the journey so far has relied on learning-by-doing. The lessons learnt are then being used to ratchet up the quality of stewardship to its next level.

3. The scorecard is mixed at this early stage

When asked the extent to which their passive funds managers have been able to meet pension plans' stewardship goals in the last three years, views were somewhat divided: 19% cited to a 'large' extent, 31% 'medium', 23% 'small' and 27% 'not at all' (Figure 1.6).

The realists among them view stewardship as a relatively new concept whose DNA needs time and experience to develop.

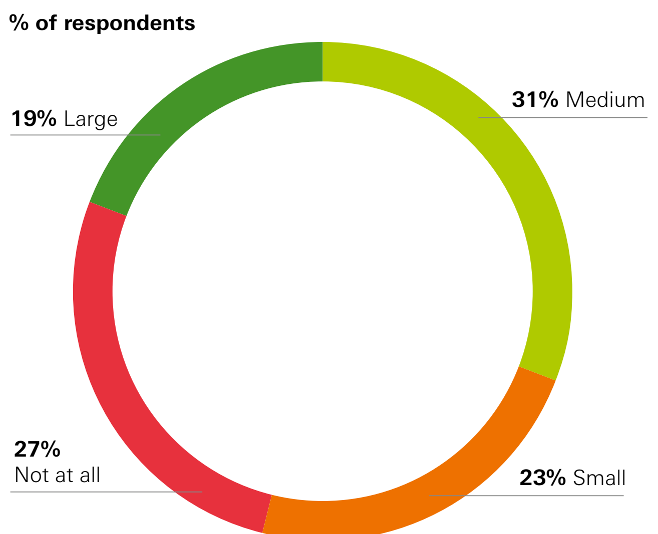
The sceptics among them think passive managers have a lot to do before they can be active owners in any meaningful manner.

The cynics among them doubt whether activism is possible given the sheer number and range of companies covered by indices and their cumulative resolutions.

That the stewardship of passive funds has more substance than hype is not in doubt; nor that it is getting more muscular. Corporate management now reportedly face a more attentive and demanding but also a more supportive shareholder base. Progress, however, has been moderated by a number of inter-related factors described in Section 2.

FIGURE 1.6
To what extent has (have) your passive fund manager(s) been able to meet your pension plan's stewardship goals in the last three years?

% of respondents



Source: CREATE-Research Survey 2019

To start with, there are too many companies in indices in global financial markets to allow effective engagement on the part of index managers (cited by 60% of respondents).

As a result, they have to rely on proxy voting advisors. But the extent to which such advisors work in the best interests of their end-clients remains unclear (52%). They remain relatively unknown outside the listed corporate sector.

There are contentious issues around their decision making, transparency, accountability and conflicts of interest.

The problem is compounded by the fact that currently there are no widely accepted definitions of engagement, templates for their adoption or metrics of their outcomes (62%). Nothing is black and white. Apart from big splashes, for many it remains unclear as to how engagement is actually done and what it delivers.

Besides, engaging investee companies in customised discussions requires a breadth of knowledge and depth of experience about pertinent topics like industry dynamics, their business drivers, capabilities, talent pool and business culture – not to forget the subtle nuances around each of them.

Navigating these areas requires year-round conversations instead of just annual general meetings that go well beyond setting minimum standards of business conduct. It costs time and money. This could raise fees (48%). Much of engagement so far has been a matter of 'best endeavours' on the part of passive managers. Significant active ownership will take time and resources.

But one thing is clear. Managers' stewardship effectiveness will not only become a key barometer of their business culture but also a key point of competition.

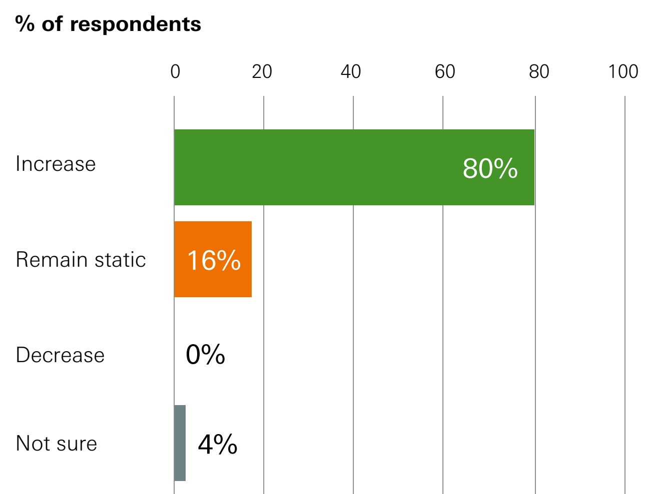
4. Back to basics will drive stewardship demands

Factors driving stewardship are set to intensify as investors enter a low return–high volatility environment, ushered in by the unwinding of the crisis-era, ultra-loose monetary policies that have brought forward future returns in this decade.

Unsurprisingly, therefore, 80% of respondents expect stewardship demands on their passive managers to 'increase', 16% expect them to 'remain static', 0% expect a 'decrease' and 4% are 'unsure' (Figure 1.7).

FIGURE 1.7
What will happen to your stewardship demands on your passive funds manager(s) over the next three years?

% of respondents



Source: CREATE-Research Survey 2019

"Stewardship is not a new religion that is here today and gone tomorrow. It serves to re-emphasise the core purpose of financial markets."

Interview quote

Stewardship is no longer just a nice-to-have. Equity markets are no longer conduits between savers planning for a decent retirement nest egg and borrowers who deploy savings to create wealth, jobs, skills and prosperity. Instead, they mostly promote the second-order trading of existing assets with the main focus on trying to anticipate the behaviour of other investors. This has little to do with actual investing.

The global financial crisis has woken investors up to the design faults that produced it. A key fault has been the lack of alignment between equity ownership and the long-term health of the company.

Stewardship is thus seen as a means to revisit the basics of investing and restore the core mission of financial markets. It is set to become a key point of competition in the index industry, especially since large pension plans in France, Germany, Japan, the Netherlands, the Nordics and the UK now insist that their investments are backed by credible stewardship guidelines as much as strong in-house stewardship teams at the index manager end.

5. Best practices go well beyond proxy voting

Given a choice between proxy voting and direct engagement to achieve effective stewardship, 19% of our respondents chose 'proxy voting', 29% chose 'direct engagement' and 52% chose 'both' (Figure 1.8).

As we saw in Figure 1.5, the choice is not binary: one evolves out of the other. The majority chose both since they are part of the same evolutionary value chain that eventually delivers more effective shareholder activism.

The fact that 52% chose 'both' speaks to a simple imperative: in stewardship, the whole has to be greater than the sum of its individual parts.

To achieve that, certain best practices have to be observed with respect to policies and processes, as shown in Section 2.

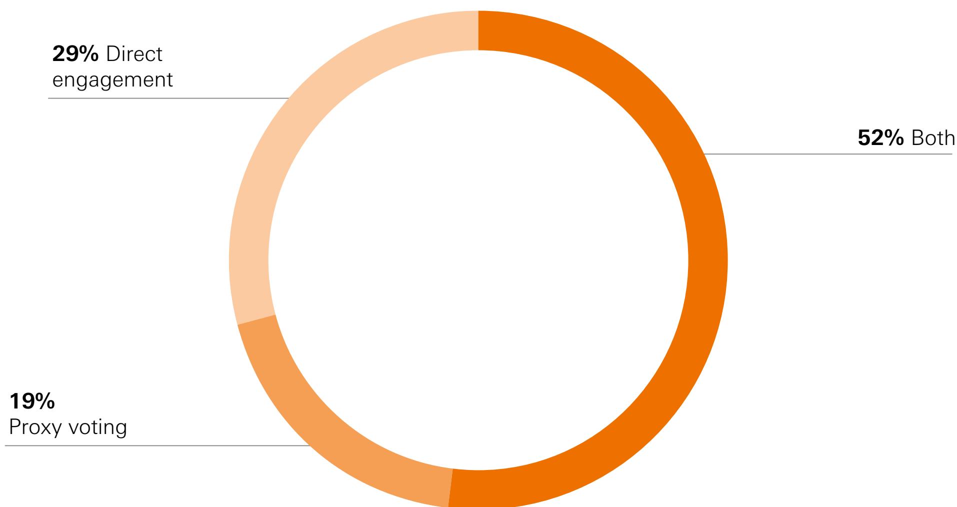
On the policy side, index managers should have clear explanations of their investment policy in general, their stewardship policy in particular and their regular stewardship activities on their websites. Their reports should provide voting records, their rationale, the number of engagements, issues covered and their outcomes. The aim is to ensure that stewardship policies are observed in letter and spirit. Beyond reporting, index managers should also consolidate their active and passive portfolios to ensure a common stance on voting and engagement.

"The CEOs of listed companies can no longer be relied upon to decide what's best for the shareholders as well as wider society."

Interview quote

FIGURE 1.8
When it comes to a choice between proxy voting and direct engagement, which is more important?

% of respondents



Source: CREATE-Research Survey 2019

On the processes side, passive managers should act like active owners in all that they do. This means demonstrating how their voting decisions protect and enhance shareholder interests, instead of being a simple tick box exercise. It means demonstrating how proxy voting advisors add value to what they do and are duly held accountable for their decisions.

Looking ahead, under pressure from pension plans, stewardship will emerge as a banner theme for the passive funds industry as it enters the next decade, enjoining its key players to step up their efforts.

We are at the dawn of a new phenomenon where pension plans are reshaping their ideas on what stewardship should actually mean and index managers are duly learning how to respond.

Both are climbing a learning curve in the belief that perfection cannot be the enemy of progress.

“Passive funds are rewiring the market and reshaping the competitive environment.”

Interview quote

The rise of stewardship

What is driving it?

The adoption of the UN Sustainable Development Goals in 2015 marked an inflection point. In passive funds, stewardship is transitioning from nice-to-have to must-have; even though such funds are simply designed to track the performance of chosen indices without being able to buy and sell individual stocks.

The main reason is that the ecosystem of financial markets is changing in the light of new fat-tail and far-off risks. The index revolution also shows little sign of abating. Pension plans are, thus, refining their ideas on what stewardship entails and how it should be implemented by the managers of their passive funds.

For both groups, however, stewardship is a nascent phenomenon, requiring a delicate trial and error balancing act between financial and non-financial goals. Its rise will need to attract more resources to ensure that it does not degenerate into a compliance activity.

1. Emergence of 'new' active management

The UN Sustainable Development Goals have sent out a blunt message: the ecosystem of financial markets is changing with the emergence of new forces like climate change, artificial intelligence, mass migration, urbanisation, and societal upheavals.

Their inherent investment risks are nigh impossible to model statistically, since their historical data are sparse or non-existent. The risks are also dynamic in nature. Hence, it is no longer enough to manage traditional risk factors, while the risk universe expands into unfamiliar space. Alignment with the Sustainable Development Goals is seen as one of the means to manage risks as financial markets transition towards a different ecosystem in which soft metrics matter just as much as hard ones; and judgement matters as much as facts.

Against this background, our survey identified a number of complementary drivers of stewardship in the indexed part of their pension portfolios. Between them, they aim to deliver better returns, meet social responsibilities and comply with the latest batch of standards from national regulators and voluntary international bodies (Figure 2.1). Three drivers were singled out as being especially powerful in our post-survey interviews.

a) Search for bottom-line improvements

83% of our respondents believe that good stewardship of their index portfolio could deliver good long-term returns, since these now require sustainable economies and stable societies. Businesses with a clear sustainability agenda will fare better.

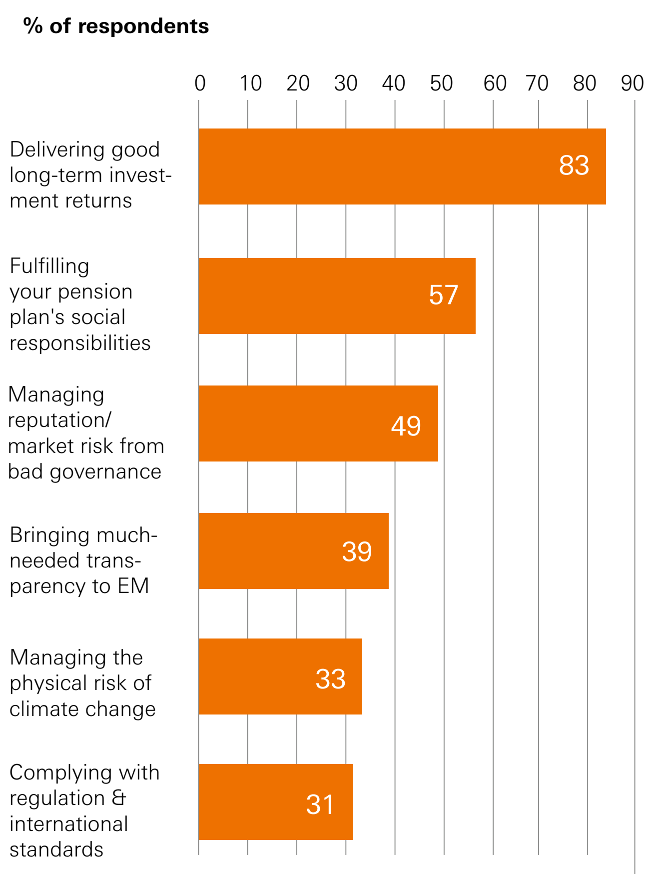
In the world of indexing, this is more likely to come about as asset managers build on-going relationships with the management of their

"Paying lip service to stewardship is no longer possible in the face of client pressures."

Interview quote

FIGURE 2.1

What is driving your pension plan's interest in enhancing the stewardship of your passive fund portfolio?



Source: CREATE-Research Survey 2019

investee companies via healthy and regular dialogue that seeks specific improvements that directly or indirectly impact on the corporate bottom line as well as future growth. The dialogue is as much about raising awareness as about seeking change. It is also as much about collaborating with other investors as working one-to-one with investee companies.

The key target areas are strategy, risk, ethics, governance, remuneration, independent audits, capital structure, corporate culture, human capital, supply chain management, technology, climate change and societal needs.

b) Reduce negative externalities

57% of our respondents believe that their fiduciary responsibilities now extend beyond their members to wider society in many respects.

The 2008 financial crisis has provoked widespread societal interest in expanding the scope of the old concept of 'license-to-operate'. Businesses can be Janus faced. They can be a source of innovation, jobs and prosperity. But they can also inflict a negative impact on society. Hence, the legal element of the license has to be reinforced by the moral one.

The world has yet to recover from the financial crisis sparked by dodgy subprime loans in the US, for example. Carbon emissions from coal-fired power stations are another example where the cost of energy fails to take into account the detriment to the physical environment, which inflicts a cost on wider society. The new generation of investors – millennials and women – are especially keen that their pension assets 'do well' and 'do good' by promoting the best ESG practices in their investee companies.

Thus, the license-to-operate now not only means complying with the letter of business rules and regulations but also observing the spirit behind them.

Hence, at the international level, the European Union is in the process of setting out a roadmap to boost asset managers' role as stewards who target ESG goals as well as financial goals. Japan and the UK are now implementing the

> "High profile governance lapses have whipsawed share prices and cost investors dearly."

Interview quote

most ambitious measures that require all asset managers to be responsible owners.

So far, Europe has been a trend setter. Its host of regulators expect their pension plans to be ever mindful of the negative externalities of corporate action and take pre-emptive actions as a part of their overall fiduciary responsibilities. North America and Asia Pac are expected to follow suit.

c) Minimise reputational damage

49% of respondents are keen to reduce the negative reputational fallout from governance lapses in the companies covered by their index funds. Exclusive focus on financial numbers in the past have concealed structural weaknesses, causing existential threats.

The Enron bankruptcy in 2001, the largest in US history at that point, provides a vivid example of how financial data can conceal far more than they reveal and a classic example of what can be measured can also be massaged!

BP's Deep Horizon oil spill in the Gulf of Mexico in 2010 and Volkswagen's emission-cheating scandal in 2014 show all too clearly how governance lapses can cause huge value destruction while posing existential threats.

These are by no means isolated examples. They serve to make a general point: exercising the stewardship of companies in their indexed funds can be beneficial in re-energising them. In the past, a lack of shareholder accountability has reportedly sapped corporate dynamism and undermined the wider economy. The winds of change are now evident.

2. Stewardship in action

The stellar rise of passive funds in pension portfolios worldwide is one factor behind the growing momentum towards stewardship. Just as important, however, is the concentration in the passive industry.

The Big Three of the US asset industry – BlackRock, Vanguard and State Street – now manage 80 per cent of the money invested in the US index industry. European-based index managers, too, manage a fair chunk. Thus, the size of their holdings gives them the requisite scale and reach to exercise their voice cost effectively.

Currently, stewardship in passive funds is at an early stage in its evolution, where it is not a simple black and white topic. Both pension plans and their index managers rely heavily on learning-by-doing. The lessons learnt are then used to ratchet up the quality of stewardship to its next level over time.

As we saw in the Executive Summary (Figure 1.5), stewardship is first and foremost about fostering an effective dialogue with investee companies within a six-stage value chain.

For their part, pension plans have identified the practices that uphold their vision of stewardship (Figure 2.2).

The most noteworthy point is that all the practices listed in the figure are deemed 'important' or 'very important' by between 84% and 96% of the respondents.

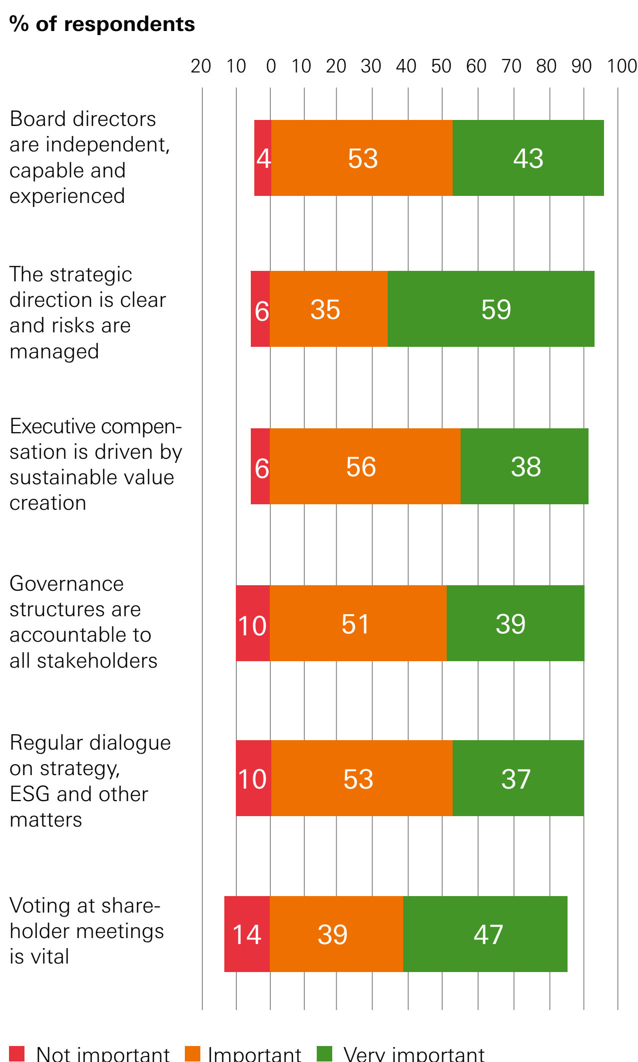
This overwhelming emphasis across the board underscores the fundamental belief that sustainable businesses require the whole to be greater than the sum of its individual parts.

> "Fish always rot from the head. Preventing that means having high calibre, experienced people on the company board, capable of independent thinking and judgement."

Interview quote

Thus, each practice in Figure 2.2 is not only essential in its own right to create viable businesses; it also mutually supports other practices such that success breeds success.

FIGURE 2.2
How important are the following stewardship practices to your pension plan?



Source: CREATE-Research Survey 2019

Corporate failures in the past have suffered from unbalanced support structures, where weaknesses in one area have spilt over into others in a chain reaction.

In our interviews, this self-reinforcing circularity was expressed in a narrative that went as follows:

A viable business needs clear strategic direction, backed by the necessary resources and effective management of downside risks (94% cited that as 'important' or 'very important'). The aim is to ensure that the business has a clear and credible vision for the future.

Its implementation requires robust regular oversight by a board of directors who are independent, experienced and capable, with no conflicts of interest (cited by 96%). The aim is to ensure that full-time business executives are not over-confident about their abilities and blindsided by wider forces that often derail the best-laid plans. Gender balance on the board is vital to ensure the cognitive diversity that harnesses a variety of views and experiences.

The resulting governance structures should represent all stakeholders and be accountable to them (90%). The aim is to comply with today's stakeholder model that requires companies to balance the diverse aspirations of shareholders, customers, employees and wider society.

The structures should also ensure that executive compensation is based on value creation over multiple periods (94%). The aim is to connect compensation to personal merit and goals delivery and not be overly influenced by competitive leapfrogging in the external labour market.

Hence, managers of passive funds should foster a regular dialogue with the investee companies covering strategy, ESG and other matters pertinent to their future success, downside risks, upside opportunities, regular course corrections and outcomes (cited by 90%). The aim is to act like active owners – not as passive holders of paper assets – who receive updates, review progress and have a say on major issues arising from the implementation of the strategy as well as the overall conduct of the business.

Another potent tool of engagement is for passive funds managers to vote at regular shareholder meetings (cited by 86%). The aim is to ensure that the shareholders' voice is heard on every major issue and the board members are not only called to account but are also held accountable for the delivery of the strategy and the overall reputation of the business.

3. Stewardship as a manager selection tool

Given the effort put into designing stewardship practices, it is not surprising that stewardship credentials are also taken into account when selecting a passive funds manager (Figure 2.3, left-hand chart).

56% of our respondents cite that the manager's capacity and track record to fulfil the stewardship goals of its clients are taken into account to a 'large extent', 27% cite 'medium extent' and 10% cite 'small extent'. Notably, only 7% do not take them into account.

The main reason behind these numbers is the need to improve the quality of beta, as passive funds are now increasingly dominating the core portfolio of pension plans, accounting for around a third of global pension assets. There are concerns that without effective stewardship, index funds may be dumbed down with rising inflows. They risk being a disincentive for innovation and growth, thus undermining the future dynamism of their constituent companies.

Another reason for using stewardship track record as a selection tool is the intensifying bottom-up pressures from pension plan members. As countries have become more aware of the Sustainable Development Goals, members want their plans to not only adopt an activist stance but also provide tangible evidence that it delivers positive results.

ESG investing is gaining powerful momentum in all regions. Stewardship sits at the heart of it.

Other critera now being applied by pension plans in manager selection is managers' geographical domicile and business culture (Figure 2.3, right chart).

17% take these factors into account to a 'large extent', 42% to a 'medium extent', 23% to a 'small extent' and 18% report 'not at all'.

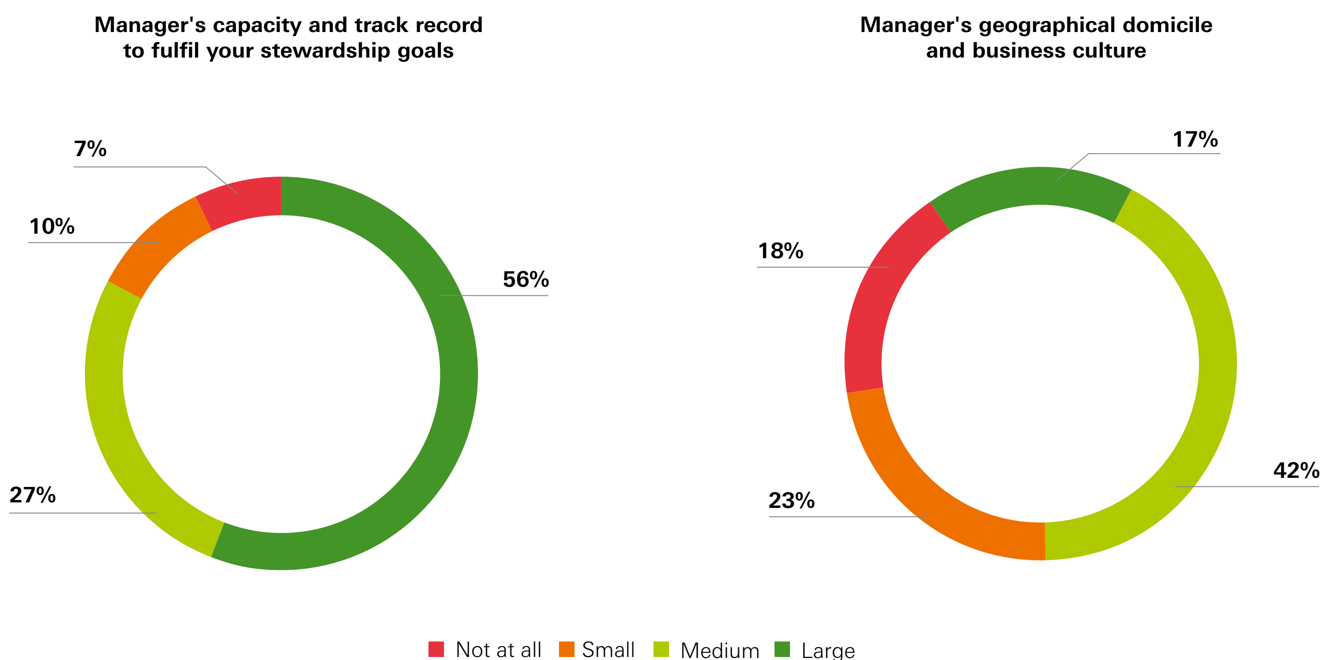
Stewardship in its current incarnation is a new phenomenon. Different regions are progressing at different speeds.

For example, the latest corporate governance codes now being implemented in France, Germany, Japan, the Nordics, Switzerland and the UK are far more refined than what prevails in other countries. Generally, European pension plans want to be sure that their index managers are fully cognizant of the local laws and customs.

> "The simultaneous rise of passive funds and ESG investing is no coincidence."

Interview quote

FIGURE 2.3
When selecting a manager of your passive funds, to what extent do you take into account the following aspects?



Source: CREATE-Research Survey 2019

The issue is less pressing elsewhere in the world, where the index fund industry is dominated by three top US managers who have common standards and protocols, with a regional overlay.

However, if there is a common thread running across all regions, it is this: passive funds managers need to differentiate themselves by the quality of their stewardship, as competitive pressures have commoditised their funds and driven down their fees. Their stewardship effectiveness will not only become a key barometer of their business culture but also a key point of competition.

Eventually, passive funds are expected to display stewardship on a par with their active peers, whose activism has a longer pedigree and better track record.

“The proxy voting industry has a vital role. But for us, it remains a black box. It needs to step-up on transparency and accountability.”

Interview quote

4. Current barriers to progress

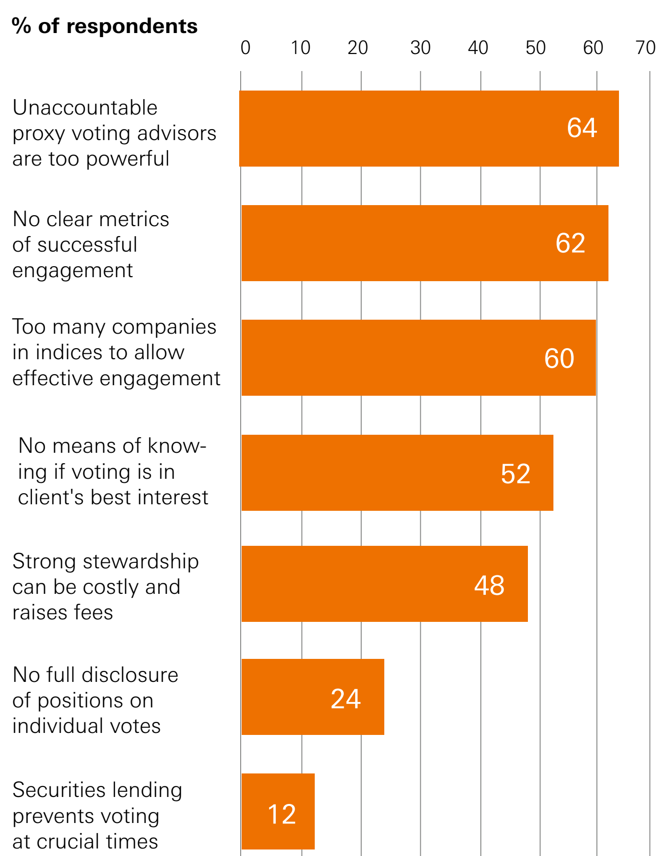
That the stewardship of index funds is now a major imperative is not in doubt; nor is there any doubt that it is becoming muscular. Index fund ownership is reportedly associated with a decline in the share of votes in support of management proposals. Corporate management thus faces a more attentive, contentious and demanding shareholder base. Progress is evident; however, its pace has been constrained by various inter-related barriers (Figure 2.4).

To start with, there are way too many companies in indices to allow effective engagement (cited by 60% of respondents). Nasdaq, the tech-based stock exchange in the US, estimates that a mind-boggling 600 billion shares are voted on each year at 13,000 shareholder meetings, as reported in The Financial Times (14 February 2019). This is well beyond the current resources of index managers, notwithstanding a rapid expansion in their stewardship teams lately.

As a result, they have to rely on proxy advisors to handle an enormous amount of information in a short timespan to give investors a meaningful voice in corporate strategy and governance. In the process, shareholder voting has been overly influenced by unaccountable proxy advisors (64%). The industry is dominated by the ever-powerful duopoly of Institutional Shareholder Services and Glass Lewis. Market dominance aside, they are exposed to conflicts of interest, as one of them also provides consultancy services on corporate governance and shareholder voting.

Proxy advisors also do not provide granular transparency around the rationale underpinning their decisions and their outcomes. In its current form, proxy voting is perceived as too mechanical. Its providers need to be far more transparent about how they vote, why, and to what effect – to counter their current image problem. There is no feedback for end-investors on whether their proxy votes have been executed in accordance with their wishes.

FIGURE 2.4
What factors are currently constraining your passive fund managers from fulfilling their stewardship role most effectively?



Source: CREATE-Research Survey 2019

More generally, the problem is compounded by the fact that there are neither clear metrics of successful engagement (62%), nor any certainty that voting is in end-clients' best interests (52%), nor full disclosure of positions on individual votes (24%). The need for a common set of impact performance indicators has never been greater.

Over-rapid growth in index funds has, as a side effect, over-industrialised the proxy voting business to the lowest common denominator, according to our post-survey interviews. No wonder it has come under the spotlight from regulators, corporate groups and trade associations this year.

To remedy matters, the interviews also emphasised that to move up the value chain of stewardship – as defined in the Executive Summary (Figure 1.5), it is vital to realise that it is very hard to engage with companies and bring about change without knowledge of their industry, their business drivers, their opportunities and challenges, their capabilities, their business culture, their management quality, their talent pool and their staff motivation – not to forget the subtle nuances around each of them. There is a world of difference between stated policies in these areas and their hard reality on the ground.

For passive managers, it is one thing drafting stewardship policies, quite another engaging companies in customised discussions about them. In sum, they require breadth and depth of expertise, which is taking time to evolve. It also requires year-round conversations beyond annual general meetings.

Much of the engagement so far has been a matter of 'best endeavours' on the part of index managers. Raising the bar from here on means recognising that there is no free lunch with stewardship: strong stewardship can be costly and raise fund fees (48%). This issue will come to the fore before long, as pension funds want their index managers to move up rapidly in the value chain of stewardship, which will be easier said than done.

They can neither vote with their feet nor threaten to secure control of a failing company: options that are only open to activist investors. Whilst they can't generate alpha, index managers can improve beta through effective stewardship via the sheer weight of their holdings over time.

"Inherent in passive funds is a big stewardship challenge: they are forced holders of the stocks they own."

Interview quote

Although their scale and reach have contained the resulting cost pressures so far, continuing growth in passive funds in different pension jurisdictions will likely reverse the current 'price wars' between index managers. Translating well-intentioned goals into tangible outcomes will cost time and money.

5. Stewardship policies: adopting best practices

That stewardship is not just a matter of lip service is evident from the rise of various transnational networks with an ESG focus.

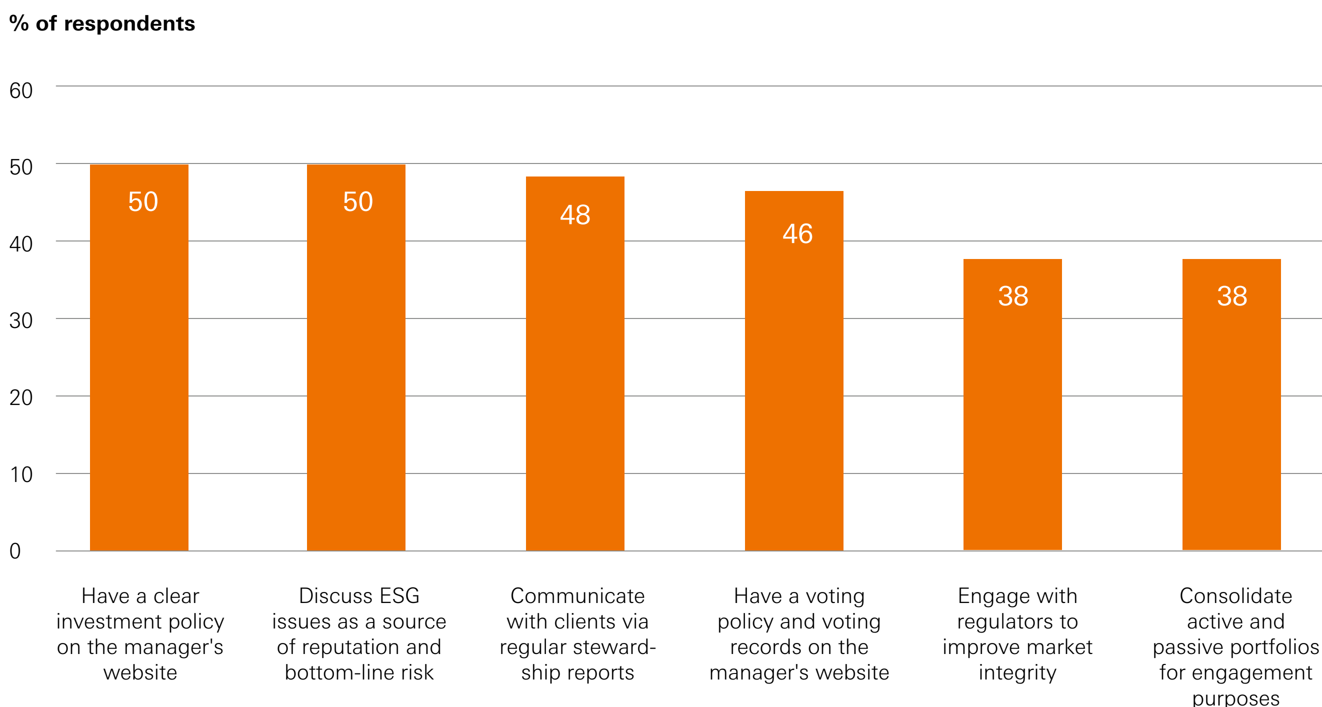
Prominent among them are the International Corporate Governance Network, the Global Corporate Governance Principles, the G20/OECD Principles of Corporate Governance, the Coalition for Responsible Economies Network on Climate Risk and Sustainability, Climate Action 100+ and the Global Sustainable Investment Alliance.

Between them, these and other bodies have refined standards across the ESG spectrum. Based on them, pension plans have adopted their own best practice policies that they require their index fund managers to implement (Figure 2.5).

To start with, they would like their passive managers to have a clear investment policy on their websites (cited by 50% of respondents). The aim is to show what the goals are, the investment beliefs that underpin them, what the key return drivers are and how they are likely to fare at different phases of the market cycle.

FIGURE 2.5
What constitutes best practice in the stewardship role in terms of policies that passive fund managers have to adopt?

% of respondents



Source: CREATE-Research Survey 2019

On the same website, they would also like to see regular stewardship reports (48%), including voting records (46%) and the underlying rationale. The aim is to a have a clear picture of stewardship activity, its scale, its aims and its outcomes.

Beyond information sharing, best practices also enjoin index mangers to undertake three activities.

First, discuss ESG issues with investee companies as a source of reputation and bottom-line risk (50%). The aim is to ensure that the company management develops a hard-nosed approach to issues over the distant horizon that influence business sustainability.

Second, engage with regulators to improve market integrity (38%). The ESG movement has attracted its share of imposters: greenwashing, a marketing gimmick, is common in all jurisdictions. The aim is to ensure that such practices do not hold back progress towards meeting the UN Sustainable Development Goals.

“Our passive managers should combine their active and passive portfolios for the purpose of voting so as to have a common stance.”

Interview quote

Third, consolidate active and passive portfolios for engagement purposes (38%). As integrated houses, all index managers also have large active businesses. The aim is to ensure that there is a common stance on voting and engagement when a company is covered by both index and active portfolios.

In sum, best practices are fundamentally about setting out an investment agenda, determining its core items and reporting regularly on progress.

6. Stewardship processes: adopting best practices

Having set out their stall of best practices in stewardship policies, our survey respondents went on to identify best practices in their underpinning processes (Figure 2.6).

Far and away, the most important one is to act like an active owner and engage directly or collaboratively with other asset managers, subject to local regulations (cited by 81%). This encourages index managers to go well beyond their current baseline level of engagement.

Whereas there is widespread acceptance among our survey respondents that index managers cannot exercise an activist stance in every company in their indices, managers need to provide demonstrable evidence that, overall, they are acting in the best interest of their clients – both in engagement and outcomes. As we saw in the Executive Summary (Figure 1.6), 50% of respondents have yet to be convinced that their stewardship goals are being met. The figure is highest in Europe where pension plans have set ambitious targets.

The realists amongst them take the view that maybe they have set unrealistic expectations for this early stage in the evolution of stewardship. The sceptics among them, on the other hand, believe that index managers have a long way to go before they act like active owners in any meaningful way.

> "We are climbing the learning curve of stewardship. Textbook lessons are no substitute for experience."

Interview quote

The cynics among them doubt whether index managers can ever be active owners, given the number and range of companies covered by their indices. The breadth and depth of expertise required makes this sound like mission impossible.

However, for the current evolution to progress to the next stage, passive managers should observe a number of inter-related processes.

First, they should disclose how voting protects shareholders' interests (67%). The aim is to go beyond the hype and prove that voting is not just a tick-box exercise, but one that has a material impact on how a company performs.

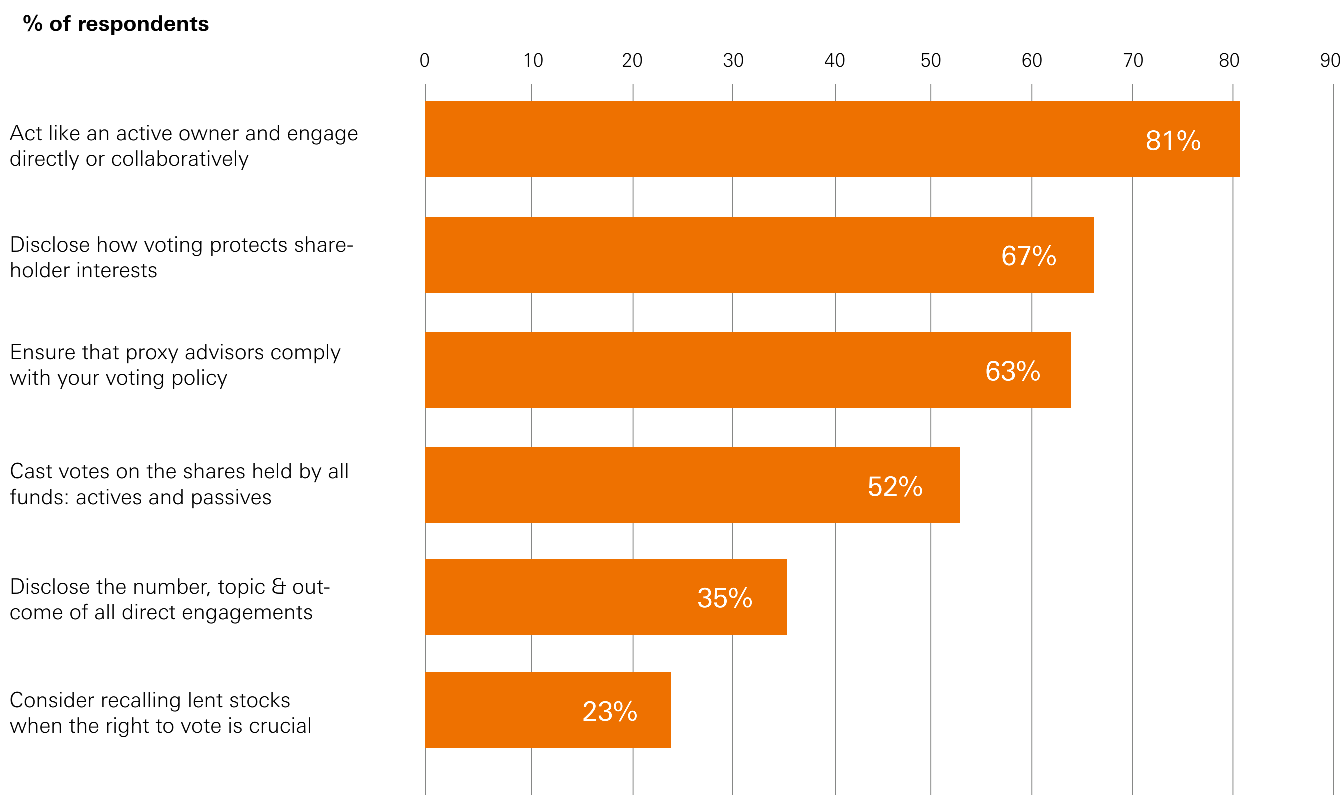
Second, they should warrant that proxy advisors comply with index managers' voting policy (63%). The aim is to ensure that advisors add value to what they do and are duly held accountable for their actions. There are real fears that rapid growth in passive funds is over-industrialising proxy voting.

Third, passive managers should cast votes on all shares they hold: actives and passives (52%). Voting and engagement are seen as the twin pillars of stewardship. Hence, the aim is to extract maximum leverage out of them.

Finally, passive managers should disclose the number, topic and outcomes of all their direct engagements (35%). The aim is to ensure that stewardship policies are observed both in letter and in spirit. Their biggest concern is that stewardship may become a compliance activity, given the sheer enormity of the task on the part of index managers.

At the same time, there is recognition that both pension plans and their index managers are at a nascent stage of stewardship, where some degree of trial and error is inevitable – as is learning by experimentation. Yet, the burden of proof remains with index managers.

FIGURE 2.6
What constitutes best practice in the stewardship role in terms of processes that passive fund managers have to adopt?



Source: CREATE-Research Survey 2019

"With thousands of companies in indices, stewardship requires quality resources to be at all meaningful. There is much box-ticking at the moment."

Interview quote

Growth dynamics of index funds

Why it favours stewardship

Our 2018 survey report ´´Passive Investing: Reshaping the Global Investment Landscape´´ provided a snapshot of how passive funds are advancing into the core portfolios of pension plans in various jurisdictions. Some of the key data sets covered by that survey are reported in this section to highlight the salient changes between 2018 and 2019.

They show that passive funds are progressing simultaneously on three fronts and growing their overall share of pension portfolios. They are widening their asset base to extend beyond equities and bonds to pursue new themes and deepening their commitment to index funds by extending their holding periods. Together, these moves underscore the importance of pension plans' interest in stewardship.

At the same time, however, there is ample recognition that passive funds have not yet been stress tested after their exceptional rise in this decade. Currently, they are seen as a cheaper alternative to active funds that have struggled to beat their benchmarks, while central bank policies have disconnected market prices from their fundamentals.

No investment style or rule holds in every market environment. That is why our respondents hold a pragmatic balance of actives as well as passives in their portfolios. On stewardship, they want to replicate in passive funds what they have experienced in their active portfolio. This imperative has come to the fore with the changing dynamics of index funds.

1. Growth will be changing the composition of passive funds

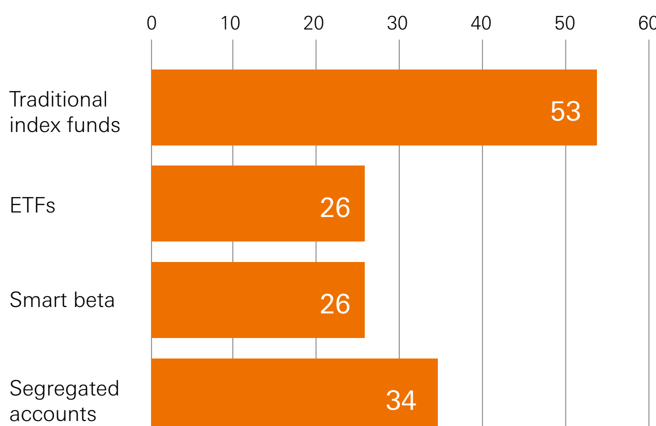
Three aspects of growth stand out, as described below.

a) Simpler vehicles have been becoming more popular

Traditional cap-weighted indices remain by far the most preferred vehicle for index investing (Figure 3.1). They have also advanced 5 percentage points since our last survey: from 48% in 2018 to 53% in 2019.

Their continuing popularity is due to two factors. First, while markets have been buoyant, they

FIGURE 3.1
If you already invest passively, what is your preferred vehicle?
% of respondents



Source: CREATE-Research Survey 2019

"The popularity of passive funds may well outlast the next crisis that hits them."

Interview quote

have delivered annual double-digit returns in this decade at a fraction of the cost of active funds. Second, their simplicity conforms to the old investment mantra: buy what you understand and understand what you buy. This is a big plus, at a time when more fiduciary responsibilities are being heaped on the trustees of pension boards.

Additionally, ETFs have also advanced by 3 percentage points since our last survey (rising from 23% to 26%). They remain an easy route into an asset class without having to pick individual funds or securities. Furthermore, they are seen as a cash equitisation vehicle that parks excess money that would otherwise languish in a low interest rate environment. They are also used to hedge or short the market.

Smart beta, too, has made a similar advance. Ever more pension plans are moving to these systematic strategies because they are seen as combining the best of active and passive investing.

Finally, segregated accounts have declined in popularity by 3 percentage points between the two years (from 37% to 34%). The decline owes more to rising interest in other vehicles than to changes in their intrinsic worth.

b) The share of index funds in total pension portfolios is up

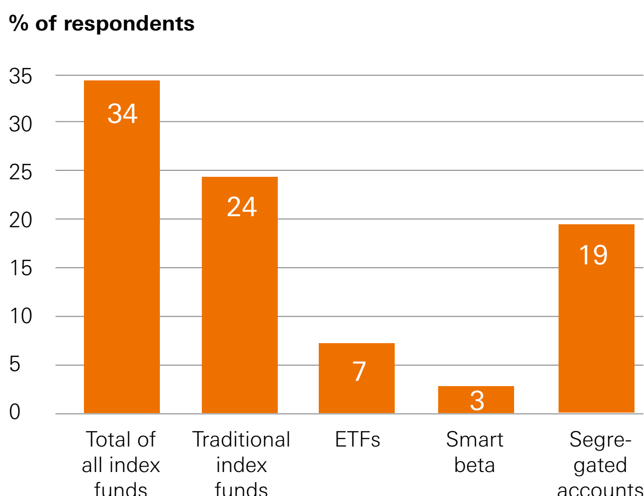
The rising popularity of index funds is duly reflected in their overall share of asset portfolios at 34%, up from 32% in 2018 (Figure 3.2).

Similar upward shifts in percentage points are also evident in traditional index funds, ETFs and smart beta. In contrast, the share of segregated accounts has moved down by 2 percentage points from 21% in 2018 to 19% in 2019.

Of course, not much can be read into such year-on-year shifts. But our interviews do suggest that while markets continue to trade at high multiples – with no credible threats of an economic recession or aggressive rate rises – allocations to index funds will continue to rise.

FIGURE 3.2
What is the approximate percentage share of your passive allocation in your pension plan's total portfolio currently?

% of respondents



Source: CREATE-Research Survey 2019

On the downside, however, there is acceptance that passive funds reduce diversification benefits, since the stocks inside them move in lockstep with swings in the overall market. Reportedly, the correlations within indices have quadrupled over the past two decades.

But this is not yet a concern at present. While market valuations remain distorted by central bank action, the emphasis remains two-fold: use investment styles that are delivering good returns, but also take actions to guard against major reversals, as shown in the next sub-section.

"We are taking advantage of the bull market but also trying to build some downside protection in our passive portfolio."

Interview quote

c) Future growth will be tilted towards vehicles with downside protection

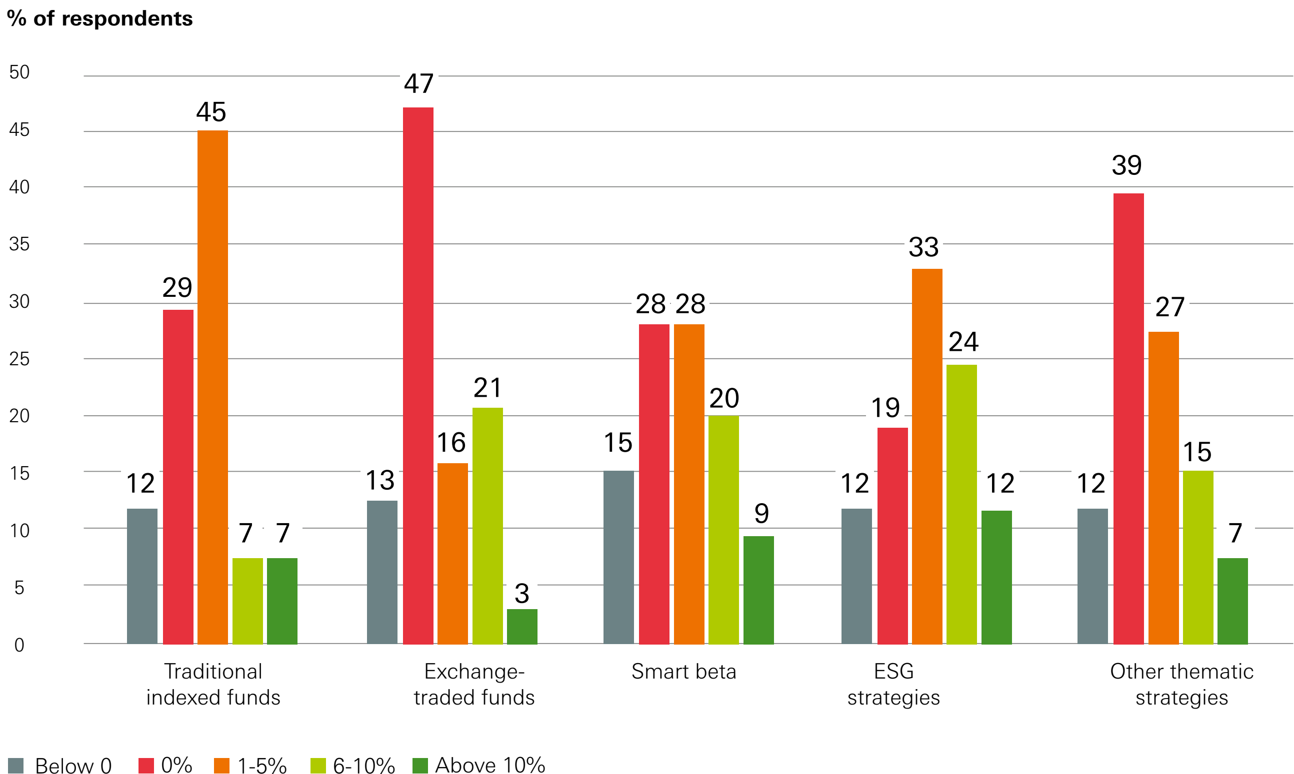
Taking a 3-year forward view, there will be an across-the-board increase in the demand for passive funds with a central thrust tilted towards three kinds of portfolio strategies: smart beta, ESG strategies and other thematic strategies (Figure 3.3). The underlying reasons in each case are given below.

The rising interest in smart beta is based on the belief that seemingly different asset classes can have unusually high correlations due to their common exposure to their underlying risk factors. Typical factors include value, quality, size, momentum and low variance. Smart beta blends other indices to harvest these factors, while factor-based strategies blend indices with active funds. Research shows that a high contribution to market-beating returns comes from simple systematic exposure – conscious or otherwise – to these factors. Their main appeal for pension plans today is that they target alpha returns at beta fees and beta risks, which marks a big improvement on cap-weighted indices.

They also offer better diversification than that based on old-style asset classes: it failed when it was most needed in the 2008 crisis when seemingly uncorrelated asset classes turned highly correlated.

FIGURE 3.3

What will be the approximate annual growth in your pension plan's investment in passive strategies over the next 3 years?



Source: CREATE-Research Survey 2019

"ESG is used to discover fat-tailed or far-off risks."

Interview quote

Moving on to index-based ESG strategies, these have gained strong momentum after the adoption of the UN Sustainable Development Goals.

A whole raft of new strategies has emerged. Ever more pension plans have been deploying them as a part of their cost-effective advance into the ESG space to enhance their stewardship agenda.

Finally, growth in thematic index strategies is based on the belief that despite modest growth in the global economy since the 2008 crisis, the spectre of secular stagnation has not receded. All key economies are delivering sub-par growth by their historical standards.

Accordingly, thematic strategies – based on secular trends like the rise of artificial intelligence, urbanisation, demographic changes, debt restructuring – are an ideal way of capitalising on those selective growth points in the global economy unaffected by the ups and downs of the business cycle.

2. Passive portfolios will be widening

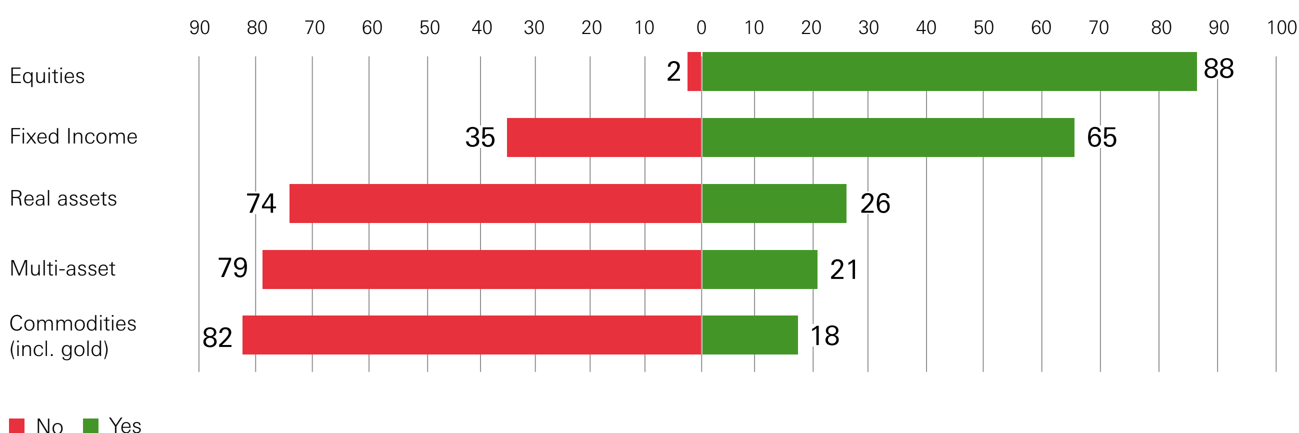
Within overall growth, one notable change has been the increase in the coverage of asset classes (Figure 3.4). It has increased in all cases, albeit at varying rates, leading to a widening in the asset base of passive funds.

Equity coverage has increased from 82% last year to 88% in 2019. From a high base, the increase of 6 percentage points is all the more significant. Reportedly, one in every two new equity mandates that come up for renewal is going into index funds, to avoid costly manager selection in the late stage of the market cycle.

Even more significant is the increase in the coverage of fixed income: from 54% last year to 65% this year. Much of this is due to the growing reliance on ETFs to gain liquidity in bond markets, as banks have shrunk their market-making role in the aftermath of the Volcker Rule.

The biggest percentage point rise, however, is in real assets: from 7% in 2018 to 26% in 2019. Index funds are seen as an ideal vehicle for

FIGURE 3.4
Which asset classes are currently covered by your plan's investment in passive funds?



Numbers may not add up to 100% due to rounding. Source: CREATE-Research Survey 2019

"We use ETFs to hedge our portfolio against macro risks."

Interview quote

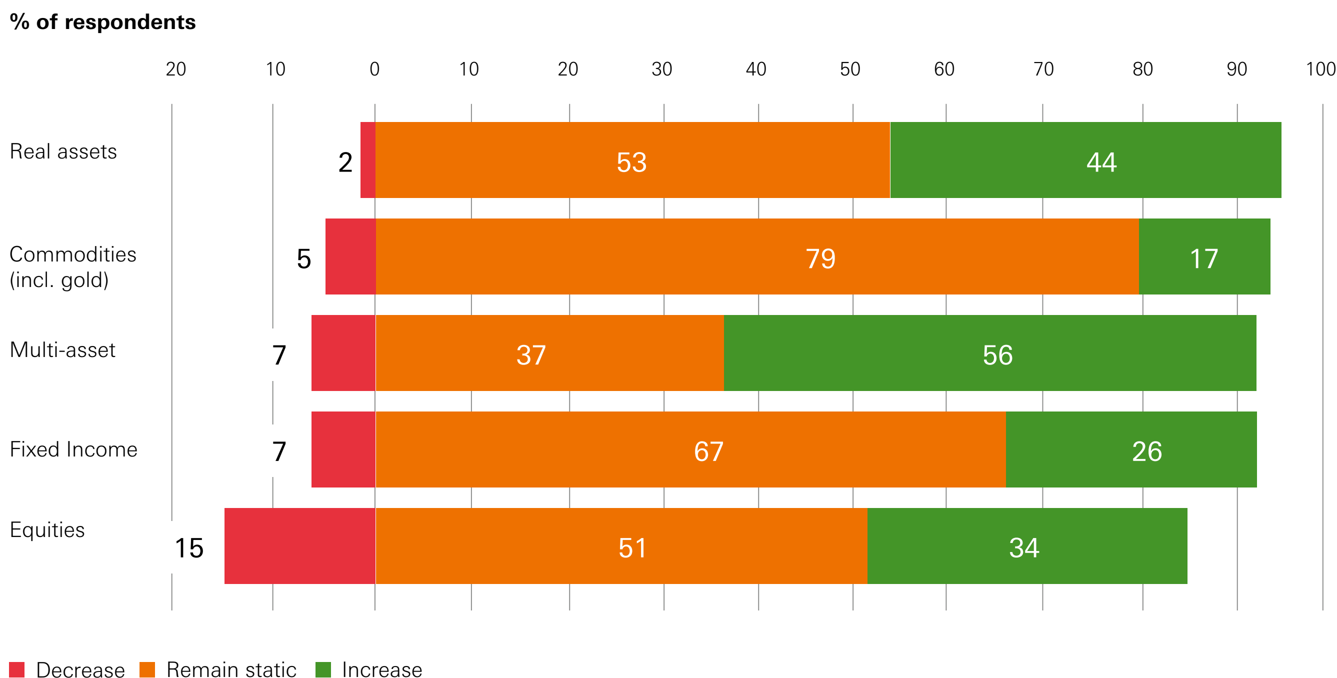
fractional ownership of physical assets that also come with ready liquidity and a significant cost advantage over actively managed real assets.

Moving on, multi-asset funds have registered the smallest rise: from 20% in 2018 to 21% in 2019. In large part, this is due to the headwinds experienced over the past 12 months, which have overly impacted their returns. Finally, commodities have registered a 5 percentage point rise from 13% in 2018 to 18% in 2019. Worries about trade wars between America and China and an impending recession have enhanced the appeal of gold as a hedging asset, fueling the rise of ETFs.

So much for the changes between our 2018 and 2019 surveys. Looking ahead to the next three years, coverage of the following asset classes is expected to continue to increase (Figure 3.5).

FIGURE 3.5
How is your future coverage of these asset classes likely to change over the next three years?

% of respondents



Numbers may not add up to 100% due to rounding. Source: CREATE-Research Survey 2019

"Liquidity is a big unknown. We don't know what returns our passive funds will deliver if we become forced sellers."

Interview quote

"Active and passive funds will co-exist in a diversified portfolio."

Interview quote

In descending order, the projected 'increases' are the following:

- multi-asset, cited by 56%
- real assets, 44%
- equities, 34%
- fixed income, 26%
- commodities, 17%

This pattern underlines two points.

First, the biggest relative increases in future coverage may well be in asset classes currently amongst those with the lowest coverage: multi-asset funds and real assets.

Thus, the appeal of index funds will span new areas of the investment universe.

As the comfort level of pension plans is rising, they are more willing to venture into other asset classes via the index route.

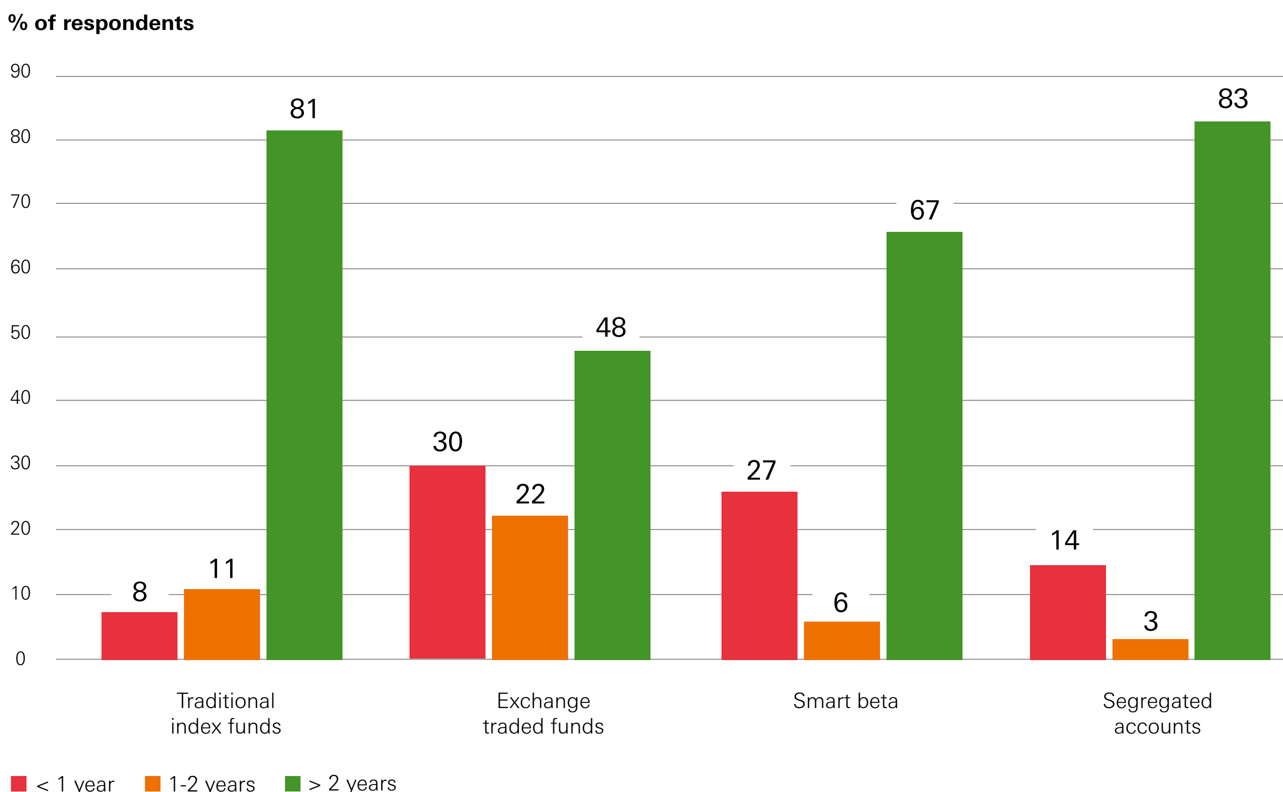
Second, and at the same time, mature areas like fixed income and equities will continue to make proportionately greater use of index funds.

Overall, therefore, this widening in the product base of index funds in pension portfolios is yet another indication of why stewardship has raced up the agenda of pension plans.

FIGURE 3.6

What is the approximate holding period of the four categories of passive vehicles currently?

% of respondents



Source: CREATE-Research Survey 2019

3. Passive portfolios will be deepening

This deepening, expressed as the increase in the holding periods of index funds, has been modest since our last survey in 2018 (Figure 3.6).

The percentage of respondents holding traditional cap-weighted index funds was 80% in 2018, rising to 81% in 2019.

For ETFs, the corresponding rise was from 45% to 48%.

For smart beta or other factor-related strategies, it was from 66% to 67%.

For segregated funds, there was a reduction between the two years from 86% to 83%.

It is unwise to read too much into one-year changes. After all, holding periods are highly influenced by changing investment sentiment and market environment.

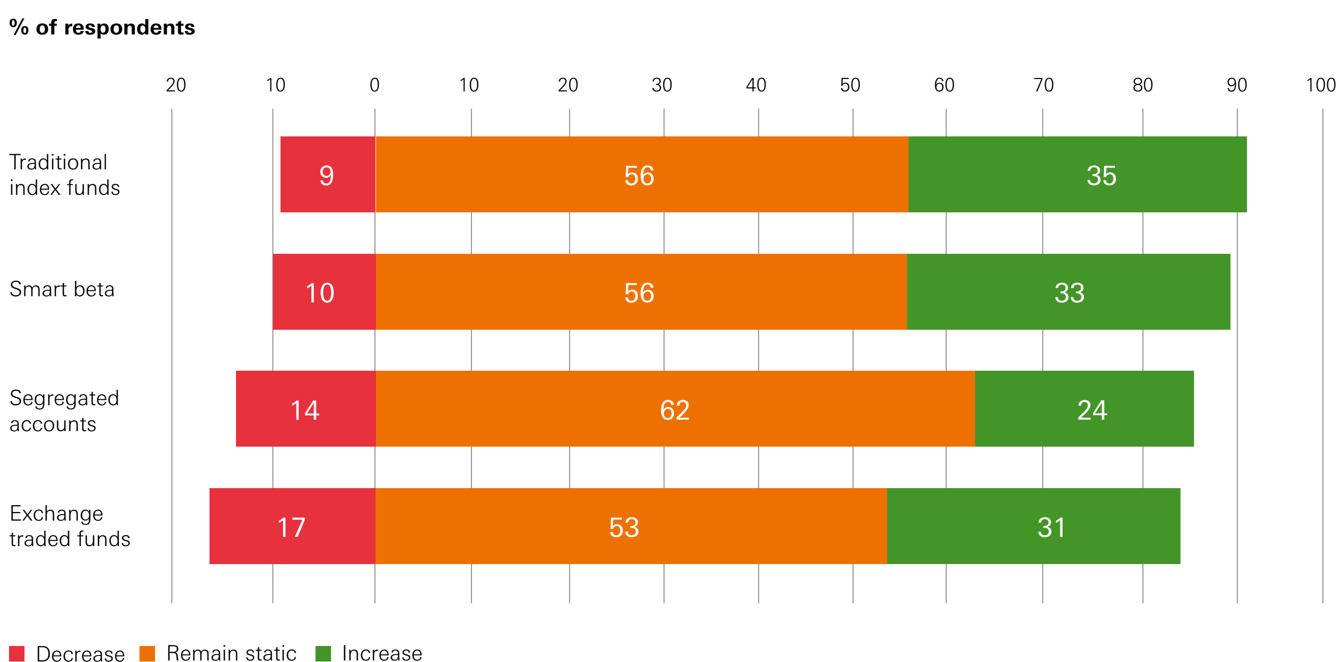
More instructive are the expectations of holding periods over the next three years (Figure 3.7).

The majority of survey respondents expect the holding periods to remain static. Yet, a significant minority expect them to increase for the following vehicles:

- traditional index funds, cited by 35%
- smart beta or factor-based strategies, 33%
- ETFs, 31%
- segregated accounts, 24%

FIGURE 3.7

How will the current holding period of the four categories of passive vehicles change over the next three years?



Numbers may not add up to 100% due to rounding. Source: CREATE-Research Survey 2019

On the flip side, a small minority also expect to reduce the holding period, notably for segregated accounts and ETFs. But in all cases, the 'increases' outweigh the 'decreases'.

The upshot is clear: index funds are going mainstream in buy-and-hold pension portfolios. They are expanding their breadth, depth and reach.

Their stewardship is seen as a tool for enhancing investment returns as much as portfolio robustness while creating positive externalities for the wider society.

Looking ahead, a swing of the pendulum back towards active funds cannot be ruled out. But there will always be uncertainty about when that might happen and how far it will go. The prevailing view amongst our survey respondents is that it will not go back to where it was at the start of this decade, but it will moderate.

After all, portfolio construction cannot be a binary active–passive decision. Prudence, in fact, argues for a pragmatic balance between these as well as between different asset classes.

In the emerging configuration, index funds are increasingly becoming part of the core portfolio targeting beta and active funds are left to target alpha. The alpha–beta distinction will continue to become more pronounced.

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