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# Parametric Responsible Investing

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Responsible investing has a long history in the United States, with more and more investors wondering how they can incorporate their environmental, social, or governance (ESG) principles into their portfolios. From long-standing concerns such as tobacco or firearms to newer issues such as climate change or boardroom diversity, investors increasingly want to understand and manage the environmental and social impact of public companies.

In our experience, investor goals fall into one of two categories: controlling what kind of companies to own or trying to get companies one owns to behave differently. Parametric's approach to responsible investing aims to meet both sets of goals, helping investors understand their choices and those choices' effects on their portfolios. This paper details the approaches involved in each category and helps identify which may be appropriate depending on an investor's objectives.

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## Understanding the choices

Investors can control what they own through what we call **portfolio construction**. This is the process of selecting and weighting holdings from a known opportunity set, such as an index of equities (S&P 500®, Russell 2000, and so on). The second category, influencing the companies one owns, falls under what we call **active ownership**. This could include proxy voting, filing shareholder resolutions, or engaging with company management.

These two goals are related in that one can influence only what one owns. When investors avoid owning a company, they give up the opportunity to influence that company. Additionally, making an active decision to invest in only a subset of eligible companies has portfolio performance implications that must be considered carefully. Therefore, we encourage investors to identify the goal for each of their concerns to determine whether portfolio construction or active ownership applies.

The goal of controlling what kinds of companies the investor owns (portfolio construction) makes the most sense when the investor has no hope that a company can be changed or no patience to see the change through. Otherwise, owning and potentially influencing the company (active ownership) is a good starting point. For example, one might avoid tobacco manufacturers or companies with egregious and persistent human rights violations. But one might choose to own companies with no women board members or companies with high carbon emissions if there's an opportunity to eventually change that behavior.

Given this, although many tend to begin (and often end) with portfolio construction, we encourage investors to instead begin by thinking about which concerns they can address through active ownership. Once that's been determined, we can look at the remaining concerns to decide whether any can or should be addressed by portfolio construction.

With that in mind, let's start by looking more closely at active ownership.

## Active Ownership

Active ownership is the most direct path investors can take to help bring about environmental and social change at the companies in their portfolio. It involves a spectrum of activities, including informed proxy voting, filing shareholder resolutions, and engaging directly with company management around particular issues. Only those who remain invested in a security can vote proxies or file resolutions. Diversified buy-and-hold investors (particularly those invested in the broad indexes) are especially well positioned to practice active ownership because they tend to have long-term holdings in a wide range of companies.

Let's look at two of the more common ways active owners can try to influence company behavior.

### Proxy voting

Clients have two choices with regard to proxy voting: whether to vote their shares themselves or delegate voting authority to Parametric. Although we do have clients who choose the former, the vast majority choose the latter. In this case Parametric votes all securities in the client account based on the Parametric Proxy Voting Guidelines. The guidelines are designed to safeguard investor capital over the long run by supporting qualified, independent boards that demonstrate accountability and responsiveness to shareholders. In this effort we consider the work of recognized corporate-governance experts, outside research providers, and collaborative investor groups.

### Resolution filing

Parametric's active-ownership practices focus on informed proxy voting, but we also stand ready to facilitate filing shareholder resolutions for clients. Any Parametric client in a separately managed account can initiate a resolution, assuming they meet the requirements for filing. Parametric can verify ownership and ensure a security is held during the requisite filing period. Clients may file resolutions on their own initiative or work with existing organizations or investor groups to do so.

## Portfolio Construction

Incorporating ESG data when selecting and weighting portfolio holdings is increasingly popular. Although it doesn't affect company behavior, it allows investors to own companies they believe are doing well along various environmental or social dimensions and avoid or underweight those that aren't. This may be necessary when changing company behavior through active ownership doesn't seem possible. In this section we outline the key components of this decision and the available portfolio-construction techniques.

Responsible investing covers a diverse set of priorities. Yet when it comes to portfolio-construction techniques used to reflect these considerations, investors really have only two distinct methods to choose from—screens and integration (also sometimes referred to as a tilt).[1] Both can enhance a portfolio's ESG characteristics, but they're quite different in terms of implementation and impact.

A screen limits the companies in a portfolio to a subset of the eligible investment universe that meets specific ESG criteria, and it contains no guidance on portfolio weights. Integration reweights the eligible universe to reflect each company's ESG qualities but doesn't necessarily remove any securities from consideration. Portfolios may be constructed using just one of these methods, or a combination of the two may better achieve the investor's objective.

There may be specific scenarios where it's preferable to use a screen versus integration and vice versa. Screens are better suited for mandates in which the ESG criteria are of primary importance and the list of acceptable investments must be delineated very precisely. On the other hand, integration is useful when controlling portfolio impact is the primary concern and there's flexibility in the acceptable ESG characteristics of the holdings.

Investors can design a portfolio themselves or select from already available options. All responsible-investing portfolios have three key components that determine the final holdings and resulting returns: target exposure, ESG criteria, and weighting method. Understanding the differences among these components can help investors understand how they might affect potential returns in the portfolio.

[1] *Portfolio construction* refers to selecting and weighting constituents for a portfolio. This is separate from the company valuation process, where the traditional, and most common, concept of integration has applied. In this form of integration, investors adjust forecasted financials, such as revenue, operating cost, asset book value, and capital expenditure, or company valuation models, including the dividend discount model, the discounted cash-flow model, and adjusted present value model, for the expected impact of ESG issues. In contrast, quantitative integration operates by influencing a stock's weight in the portfolio rather than any estimation of its intrinsic value. In this sense it's actually a portfolio-construction technique. However, for ease of reference, we omit the modifier and simply refer to this as integration. For more information, see UN Principles for Responsible Investment, "A Practical Guide to ESG Integration for Equity Investing" (2016): https://www.unpri.org/listed-equity/a-practical-guide-to-esg-integration-for-equity-investing/10.article.

### Target exposure

This component refers to the potential portfolio before ESG criteria are applied. It might be made up of stocks that meet return expectations and that an active manager has weighted to reflect conviction. Or it might be composed of stocks contained in a passive index, weighted according to market capitalization. The target exposure determines the initial eligible investment universe and the preferred risk characteristics (for example, average market cap or dividend yield) for the final portfolio.

Target exposure options at Parametric include market-cap or alternative-weighted indexes, factor strategies, and our own rules-based actively managed strategies. In the case of index- or factor-based exposures, clients may select just one or combine a few to emphasize certain geographies, sectors, or other characteristics.

### ESG criteria

This component refers to the specific parameters the investor uses to determine which companies are “good” and which are “bad” and to modify the target exposure accordingly. For example, two investors may list the environment as a key concern but one investor is focused on carbon emissions and the other on the effects of factory farming. Hence, a low-carbon-emitting factory farming company might be a “good” company in the eye of the first investor and a “bad” company in the eye of the second. Furthermore, the company may seem low emitting, and therefore “good” based on direct emissions alone, but not if we include its electricity suppliers’ emissions or if emissions are normalized by sales. There are hundreds of metrics available from dedicated ESG research providers, and it’s essential to select the data thoughtfully to best determine which companies are “good” and which are “bad.”

Given the number of possibilities, Parametric has created a menu of ESG options that captures the most common requests while still allowing for a high degree of flexibility. This includes ESG screens investors can apply to any target exposure to create a portfolio that meets specific criteria as well as prebuilt portfolios that already incorporate ESG criteria.

### Weighting method

This component refers to how the portfolio is reweighted once the ESG criteria are applied. This largely depends on whether one has chosen a screen or a quantitative integration technique to construct the portfolio.

A screen identifies companies in the target exposure that meet the investor’s ESG criteria and are therefore still eligible for the final portfolio. The screen itself doesn’t determine the final portfolio weights; this must be decided separately. One approach is to simply increase the weights of those that pass pro rata. At Parametric we most commonly weight screened portfolios using an optimization process to reduce any active biases relative to the target exposure.

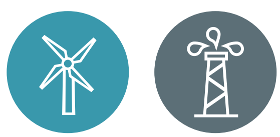
In contrast, quantitative integration allows all companies in the target exposure to remain eligible for investment but reweights them to reflect their ESG characteristics. The weight is determined by balancing the attractiveness of the stock from an ESG perspective with its usefulness in mimicking the risk characteristics of the target exposure. Therefore, unlike a screen, quantitative integration is a weighting method. Given the complexity of this technique, it’s available at Parametric primarily via prebuilt portfolios rather than being customized for each client.

## Which is better: screening or integration?

Although technically investors can incorporate any metric into a portfolio via either a screen or integration, in reality many metrics lend themselves better to one approach or the other. Human rights abuses, for example, where the investor has a clear notion of a threshold below which companies are intolerable, tend to be better suited to a screen. An environmental score, on the other hand, a metric for which it's difficult to intuitively specify a threshold at which point a company switches from "acceptable" to "unacceptable," might be better suited to integration.

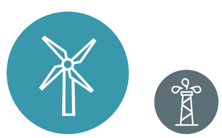
But the choice doesn't always need to be either-or. Many of Parametric's clients choose to combine an initial exposure built using integration that's then further refined through the application of a screen. Investors should consider both screens and integration as potentially complementary tools for building the portfolio that best matches their objectives.

Figure 1: Screens versus integration



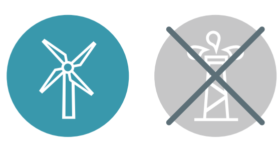
**Market-cap-weighted portfolio**

Consists of a mix of companies with acceptable and unacceptable business involvement or behavior.



**Integrated portfolio**

Uses ESG characteristics to select and weigh companies, both acceptable and unacceptable and subject to constraints, to maintain a diversified exposure.



**Screened portfolio**

Reconfigures the eligible investment universe to remove companies with objectionable characteristics and invest only in those with acceptable ones.

Source: Parametric

## Conclusion

Parametric is dedicated to remaining at the forefront of responsible investing, partnering with clients of all types as their needs evolve. In recognition of their wide range of objectives and priorities, we provide a flexible tool kit to help investors achieve a diverse range of goals. Our approach appeals to those taking their first steps down the path of responsible investing as well as veterans looking for a fresh take.

**Disclosure**

Parametric Portfolio Associates LLC ("Parametric"), headquartered in Seattle, is registered as an investment advisor with the US Securities and Exchange Commission under the Investment Advisers Act of 1940. Parametric is a leading global asset management firm, providing investment strategies and customized exposure management directly to institutional investors and indirectly to individual investors through financial intermediaries. Parametric offers a variety of rules-based investment strategies, including alpha-seeking equity, alternative and options strategies, and implementation services, including customized equity, traditional overlay, and centralized portfolio management. Parametric is a majority-owned subsidiary of Eaton Vance Corp. and offers these capabilities through investment centers in Seattle, Minneapolis, and Westport, Connecticut.

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