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Responsible Investing at Parametric

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Principles-based investing has a long history in the United States, and recently there has been a surge of interest in incorporating environmental, social or governance issues (ESG) into portfolio construction and management. In reaction to a number of diverse issues such as climate change, lack of board room diversity, or human rights violations, investors increasingly consider the environmental or social impact of the companies in their portfolio.

At Parametric we specialize in implementing the investor's vision rather than imposing our own views. Over the last 15 years, we have helped hundreds of clients design portfolios customized to their particular ESG requirements. As the availability of responsible investing resources has deepened, our capabilities in this area have also continued to expand. In this brief, we introduce Parametric's approach to responsible investing.

What is Responsible Investing?

Despite the proliferation of similar terms, the definition of responsible investing is actually quite straightforward. All responsible investing takes into account considerations outside of potential returns. Though the particulars of how this is accomplished may vary, this definition applies across asset classes and is as true today as it was generations ago. The goal of responsible investing is to ensure consistency with an investor's principles or to influence company behavior. At Parametric, this can be achieved in an index-based or active strategy via both portfolio construction and shareholder engagement.

Portfolio Construction[1]

For any given responsible investing portfolio there are three essential components which determine the final holdings and resulting returns: exposure, ESG criteria, and weighting method. When comparing portfolios, particularly in the case of historical returns, it is critical that investors identify and understand the differences in any of these components. This in turn can help them understand the potential return drivers.

- Exposure is the eligible investment universe and security weights before the ESG criteria are applied. This might be stocks that meet return expectations, that an active manager has weighted to reflect conviction; or stocks contained in a passive index, weighted according to market capitalization.

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[1] Portfolio construction refers to selecting and weighting constituents for a portfolio. This is separate from the company valuation process, where the concept of "ESG integration" is relevant.

- ESG Criteria refer to the specific parameters used to express an investor's principles. Once determined, they are used to modify the original exposure. Criteria refer to both the topic and the method of measurement. For example, a climate aware investor could focus on fossil fuel reserve ownership, carbon emissions, toxic waste, or something else. Toxic waste, could be measured based on frequency of spills, aggregate amount spilled, fines levied, or other social costs. If a screen is being employed, the threshold of minimum acceptance must be specified. In the case of a tilt, no threshold is required as the objective is to maximize desirable (and minimize undesirable) criteria, subject to other portfolio construction requirements.
- Weighting method is how the portfolio is reweighted once the ESG criteria is applied. In the case of a screen, the weights of each constituent that passes can simply be increased or optimized to reduce tracking error relative to the original exposure. In the case of a tilt, the weight of each constituent is determined by simultaneously trying to enhance the portfolio based on the selected ESG criteria while minimizing tracking error relative to the original exposure. Portfolios may be constructed using only a screen or a tilt, or a combination of both. (Sireklove, 2016)[2]

Shareholder Engagement

Shareholder engagement is the most direct path to affecting environmental and social change available to owners of publicly listed equities. These investors can participate in a range of activities from informed proxy voting to filing shareholder resolutions.

For many investors, engagement can be as important to their responsible investing approach as portfolio construction. This is underscored by the second principle of the United Nations' Principles for Responsible Investing (UNPRI):

> We will be active owners and incorporate ESG issues into our ownership policies and practices.

Only investors who remain invested in a security have the opportunity to vote proxies and file resolutions. Therefore, long-term investors deciding to remain fully invested in the broad universe are best able to employ effective shareholder engagement strategies. Given the complexity, time intensiveness and long-term nature of engagement, many investors prefer to rely on outside expertise for this component.

Responsible Ivesting at Parametric

Responsible investing at Parametric is client-driven. Our goal is to determine the most effective and transparent way to build a portfolio that aligns with the investor's specific principles. This approach lends itself to a variety of environmental, social or governance objectives and can be employed by taxable and tax-exempt investors.

Our responsible investment capabilities are most commonly accessed through our Custom Core™ offering, where clients design their chosen market exposure within a separately managed account (SMA). The following is written from the perspective of a Custom Core client, but these capabilities can also be applied to any equity SMA at Parametric. We have extensive experience doing so across our Systematic Alpha, Centralized Portfolio Management, and Defensive Equity products in a similar manner.

[2] Sireklove, Jennifer, (2016), Understanding the Difference Between ESG Screens and Tilts, Parametric Brief.

We recognize that responsible investing mandates can be fulfilled in different ways and some investors prefer more guidance than others. To address this, Parametric offers two solutions: standardized options for those who would like to adopt commonly used approaches designed in a transparent manner or client-designed options that enable the client to further customize the equity exposure, ESG criteria, or weighting method. In addition, because clients own the securities in an SMA, they can decide how to vote proxies and whether to file any shareholder resolutions. In all cases, Parametric partners with dedicated outside providers for the latest ESG research.

Screens and tilts are distinct construction approaches that can be used to enhance a portfolio's ESG characteristics.

Screen:

- Narrows the eligible investment universe to those companies that meet specific criteria
- Tracking error depends on screen definition, ESG criteria is absolute
- Does not in itself determine portfolio constituents or weights

Tilt:

- Reweights the eligible investment universe with respect to company-specific metrics, no absolute minimum ESG threshold for inclusion
- More explicit tracking error control, ESG characteristics judged on relative basis
- Results in investable portfolio with constituents and weights

Standardized Portfolio Construction Options

In our standardized options, all three essential portfolio components (exposure, ESG criteria, weighting method) are determined either by Parametric or an outside index provider. Parametric has developed a series of proprietary screened or tilted index-based responsible investing strategies based on ESG criteria and exposures that are most popular with clients. This list includes Fossil Free, Catholic Values, and Shariah screened strategies as well as one based on a comprehensive ESG tilt. All of these standardized options are optimized to reduce tracking error to either the S&P® 500 or MSCI EAFE Index.

Separately, we license a number of diversified and thematic responsible investing indexes from outside providers and may be able to access additional options as requested, subject to licensing requirements. These options are an expedient way to access commonly requested responsible investing themes and serve as a good starting point for the client conversation, particularly as historical performance is available for each. While convenient, the limitation of the standardized options is that the client must accept the portfolio as is. Other than applying additional screens, no further customization is possible.

Client-Designed Portfolio Construction Options

If a client's desired exposure, ESG criteria, or weighting method is not available in any of the standardized options above, we generally have the tools to create a fully customized portfolio. A relationship manager at Parametric is available to help clients navigate the choices below.

Exposure

Parametric licenses an exhaustive array of indexes ranging from traditional market-weighted choices, such as the S&P® 500 or MSCI® EAFE, to alternative-weighted such as FTSE RAFI®, as well as common factor- and style-based indexes. Clients may select one index for the exposure or combine some number of them to express geographic, sector or other preferences. These indexes provide both the eligible investment universe and target weights for our Custom Core client portfolios before the ESG criteria are applied.

ESG Criteria

The most practical and popular method of incorporating client-driven ESG criteria at Parametric is by applying a screen. Portfolio tilts using ESG criteria are typically accomplished by tracking a proprietary strategy or licensed index that is constructed utilizing this method. Although this limits the degree of customization, it allows us to make tilted portfolios widely accessible.

Potential ESG criteria consist of both metrics from our approved providers as well as client-provided data. Parametric maintains a list of standard screens on common topics and can create custom screens based on existing data sources. In addition, we have a number of clients provide their own screen based on their own research. Defining the optimal screen depends on many things, but screen complexity and sensitivity to tracking error are two especially important considerations. Generally, the majority of clients are well-served by selecting any number of our standard screens to apply to their portfolio. But in certain cases, a more consultative approach exploring different criteria and the effect on predicted tracking error is required to develop the best screen.

Weighting Method

Parametric's standard approach to portfolio management within Custom Core is based on a sampled, optimized approach.[3] This approach utilizes a risk model to select and weight a subset of the exposure to help minimize tracking error rather than fully replicating the index. The sampled portfolio weights are directly influenced by the weights in the original exposure.

A typical U.S. large cap equity portfolio benchmarked to the S&P 500 Index, for example, will consist of approximately 250 to 325 securities with weights that are selected to constrain deviations from the original benchmark weights.[4] When we apply ESG criteria to an index, our approach is essentially the same. For example, consider a case in which a client applies carbon emissions and firearms screens to this same portfolio. Our eligible investment universe has been reduced, as we can invest only in securities that pass both the screens. But we still produce a portfolio with 250-325 holdings that are weighted in order to reduce expected tracking error relative to the original benchmark. Expected tracking error tends to increase as screens are applied, depending on which securities in the original exposure fail and how critical they are to minimizing performance differences.

Shareholder Engagement

At Parametric, shareholder engagement refers both to proxy voting as well as filing shareholder resolutions. Because they own the securities within an SMA, every client at Parametric can take advantage of our Responsible Investing Proxy Voting Policy or shareholder advocacy services regardless of their portfolio construction approach.

Parametric's Responsible Investing Proxy Voting Guidelines are designed to encourage high environmental, social and governance standards. We utilize research by outside ESG research providers, when casting votes on behalf of clients who have chosen this policy. Coverage is global and includes voting on management proposals from an ESG lens as well as an elevated level of support for shareholder proposals. This support exceeds what an investor might have if deciding purely from the perspective of economic return to shareholders. In other words, our guidelines are intended to support good corporate governance as well as broader environmental and social objectives.

We can also help clients file shareholder resolutions by verifying ownership and ensuring a security is held during the requisite filing period. Clients may pursue resolution filings of their own initiative but others may prefer to work with existing advocacy organizations in order to determine how to focus their resources. One such advocacy organization is As You Sow, a non-profit with a focus on improving corporate responsibility with regard to energy, waste, environmental health, and human rights. As You Sow periodically chooses to file shareholder resolutions when dialog alone has been insufficient and relies on a network of investors who will allow As You Sow to file on their behalf. The entire resolution filing process is initiated and guided by As You Sow.

Partnering with High Quality ESG Research Providers

For both portfolio construction and shareholder engagement we rely on ESG metrics from outside providers produced via in-depth company research. While this research process resembles that of classic security analysis, it makes no attempt to identify sources of future outperformance. Analysts continually comb through official company filings as well as outside sources including media, government and private organization reports and interviews. They then translate business involvement or company behavior into consistent metrics that can be utilized in a portfolio to reflect any number of ESG concerns.

[3] In contrast, outside of Custom Core, our typical approach is to simply increase the weights of the securities that pass the screen, with no optimization.

[4] Number of holdings per account will depend on selected exposure as well as other client specific considerations.

At Parametric, we own of thousands of global companies and manage portfolios relying on hundreds of ESG metrics. Maintaining accurate and consistent coverage sufficient for our needs could easily require a full-time team of a hundred analysts. Given this, we find it more effective to partner with dedicated providers of such research rather than conduct this analysis ourselves. This approach allows us to focus on evaluating providers and overseeing data quality, where we have considerable expertise, and enables us to evolve our responsible investing capabilities more quickly and efficiently.

Potential research providers are carefully vetted based on their breadth of coverage and depth of knowledge, the robustness and transparency of their methodology, and the timeliness of data updates. We subscribe to a wide range of topics including business involvement, controversies, and comprehensive environmental, social and governance scores, and continually review new topics as they are available. Once a provider has passed our due diligence we regularly verify data accuracy and completeness. Although we defer to our partners' judgement on more subjective matters, such as ESG scoring, we do monitor the results to ensure that the outcome is warranted and have full insight into the underlying components. The continual feedback loop between client demand, Parametric portfolio management, and the deep resources of our research providers contributes to the expansion of available topic areas and improvements in data quality.

Conclusion

In recognition of the wide range of responsible investing objectives and priorities, Parametric provides a uniquely collaborative and client-centric approach. Our goal in all cases is to provide an equity exposure of the client's choice while considering the environmental and social impacts of these investments. The separately managed account structure allows for maximum flexibility in portfolio construction and enables clients to control proxy voting and shareholder advocacy efforts. By combining our technologically-driven, rules-based portfolio management expertise with best-in-class outside ESG research, we provide responsible investors of all types unparalleled choice and transparency. Parametric is dedicated to remaining on the forefront of this evolving space and welcomes the opportunity to serve both those taking their first steps down this path as well as veterans looking for a fresh take.

Parametric is located at 1918 8th Avenue, Suite 3100, Seattle, WA 98101. For more information regarding Parametric and its investment strategies, or to request a copy of Parametric's Form ADV, please contact us at 206.694.5575 or visit our website, www.parametricportfolio.com.