Parametric

Parametric Responsible Investing

The amount of information about companies to invest in has grown exponentially. For investors looking to incorporate their own preferences into portfolio decisions and investment stewardship, this wealth of information and the diversity of investment approaches may be helpful—and overwhelming at the same time. Here we attempt to guide investors through the noise.

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Understanding the interaction between investment stewardship and portfolio construction

The first thing to understand about responsible investing is how portfolio construction interacts with investment stewardship. Let's start by defining those two interdependent concepts:

PORTFOLIO CONSTRUCTION is the process of selecting and weighting portfolio constituents. Investors can decide to incorporate what matters to them into their investment decisions.

INVESTMENT STEWARDSHIP is the toolkit of investor rights used to protect and enhance the value of investments owned. Investors looking to encourage better corporate behavior can start with investment stewardship.

How investors decide to incorporate their environmental, social or governance priorities or preferences is important because it may impact not only portfolio returns and risk characteristics but also the investor's ownership rights and engagement opportunities. And effective engagement can affect returns, in what we might call a virtuous circle.

In other words, incorporating metrics that reflect their priorities can help investors determine which companies to own and how large of a stake to take, while investment stewardship may affect those companies and their characteristics. Over time, that could lead to different investment returns.

The second thing to keep in mind is that investors can only influence the companies they own. When they avoid investing in a company, they give up the opportunity to engage with it. If the investor doesn't believe a company can be changed, or lacks the patience to see the change through, not owning a company can make the most sense. Otherwise, owning and potentially influencing the company through investment stewardship is a good starting point.

For example, an investor may avoid manufacturers of tobacco products or companies with egregious and persistent human rights violations. By contrast, they may choose to own companies with inadequate board independence or high carbon emissions, where they see opportunities to engage and encourage improvement on these metrics.

Investors have become increasingly aware of the importance of building a portfolio with their investment stewardship approach in mind. Before we turn to the topic of portfolio construction, let's discuss investment stewardship in more depth.

Investment stewardship

Investment stewardship is the most direct path investors can take to help bring about the improvements in corporate behavior that they wish to see. Through a spectrum of activities—including informed proxy voting, filing shareholder resolutions and engaging with company management around specific issues—investors can encourage companies to reduce risks and potentially improve performance. They can also advocate for market-wide improvements by engaging with policymakers or trade groups.

Most investors and the professional managers who invest on their behalf tend to focus on proxy voting and engaging with company management. Diversified buy-and-hold investors are especially well positioned to practice investment stewardship because they tend to have long-term holdings in a wide range of companies. These ***universal owners*** may benefit directly from promulgating best practices throughout the market.

Let's look at these two common ways that active owners can try to encourage better company practices, using the Parametric offering to illustrate.

PROXY VOTING

Proxy voting refers to casting votes, mostly for board nominees at annual meetings. The board is responsible for preserving and enhancing the value of the company by overseeing management and helping to set company strategy. The election of directors is arguably one of the most important proxy votes, as it impacts the composition of the board that represents the interests of shareholders.

In the case of a separately managed account (SMA), unlike mutual funds or ETFs, the end investor retains voting rights for the underlying holdings. Some investors choose to vote their shares themselves, but more typically they outsource this to a professional manager.

When an investor delegates voting authority to Parametric, we take on a fiduciary role and vote all securities in their account based on the Parametric Proxy Voting Guidelines, which encourage corporate disclosures and transparency. We've designed these guidelines to safeguard investor capital over the long run by supporting qualified, independent boards who demonstrate accountability and responsiveness to shareholders.

In this effort, we consider the work of recognized corporate governance experts, outside research and collaborative investor groups. We make summary versions of our voting guidelines and annual voting record publicly available.

SHAREHOLDER ENGAGEMENT
Complementing proxy voting, shareholder engagement involves direct conversations with companies to encourage them to adopt better practices or behaviors, which can potentially reduce risks and maximize returns. While proxy voting is limited to issues on the shareholder meeting's agenda, shareholder engagement allows investors to address areas of concern with management that aren't explicitly on the proxy ballot.

For example, shareholders might nudge companies whose boards consistently fail to reflect their customers, employees or communities to reconsider their process for director nomination or to disclose additional workforce data. These types of initiatives have been instrumental in improving company outcomes over the long run.

Portfolio construction

Whether or not investment stewardship proves viable and effective, investors may also decide to incorporate their preferences into their investment decisions, prioritizing the metrics through two distinct portfolio construction methods: screens and reweighting. While both tend to align the portfolio with an investor's preferences, let's consider how the methods differ in terms of implementation:

SCREENING limits the companies in a portfolio to a subset of the eligible investment universe that meets the investor's preferred specific responsible investing criteria, without offering guidance on portfolio weights.

REWEIGHTING changes the weights of the securities, but without necessarily removing any securities from consideration.

Managers may construct portfolios by combining the two methods to better achieve the investor objectives. In specific scenarios, it may be preferable to use a screen over reweighting, or vice versa.

- Screening is generally better suited when the investor's priorities are the most important consideration and the list of acceptable investments can be delineated precisely.
- Reweighting is useful when the primary concern is controlling for the impact of incorporating the investor's priorities on the investment experience and when the acceptable characteristics of the holdings are more flexible.

In either case, three decisions determine the final holdings and resulting returns: the target exposure, the responsible investing criteria and the weighting method. Understanding each decision will help investors make sure they own a portfolio aligned with their goals and better recognize how their responsible investing criteria might affect portfolio returns.

TARGET EXPOSURE
Target exposure refers to the potential portfolio before any customizations. The portfolio might contain stocks that meet particular return expectations, which an active manager has weighted to reflect conviction. Instead, it could comprise stocks in a passive index, weighted according to market capitalization. The target exposure determines the initial eligible investment universe and the preferred risk characteristics—such as 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, investors may select just one or combine a few to emphasize certain geographies, sectors or other characteristics.

RESPONSIBLE INVESTING CRITERIA
Responsible investing criteria include the specific parameters that the investor uses to determine whether companies are acceptable or unacceptable. The manager uses these parameters to construct the desired portfolio by modifying the target base exposure.

For example, two investors may list the environment as a key concern, but one investor focuses on carbon emissions while the other focuses on the effects of factory farming. A factory farming company with low carbon emissions might be acceptable to the first investor but unacceptable to the second.

Extending this example, the company may seem low emitting and therefore acceptable based on direct emissions alone, but this may change if we include the emissions of its electricity suppliers or normalize emissions by sales. Hundreds of metrics are available from dedicated research providers. At Parametric, we believe it's essential to understand the nuances and select the data thoughtfully when determining which companies are acceptable and which are not.

Given the number of possibilities, Parametric has created menus of responsible investing customizations that capture the most common requests while still allowing for a high degree of flexibility. This includes screens that investors can apply to any target exposure to create portfolios meeting specific criteria, as well as prebuilt portfolios already incorporating responsible investing metrics that are commonly sought after.

WEIGHTING METHOD

Weighting method refers to how the portfolio is reweighted once the responsible investing criteria are determined. This largely depends on whether the investor has chosen a screen or a reweighting technique to construct the portfolio.

A screen identifies the companies in the target exposure that meet the investor's criteria and are therefore still eligible for the portfolio, without prescribing the final weights. The manager must decide these separately, and one simple approach is to increase the weights of those companies that pass the screen on a pro rata basis.

At Parametric, we most commonly weight screened portfolios using an optimization process to reduce any active biases relative to the target exposure. This process helps to dampen the screen's potential impact on relative investment performance.

In contrast, reweighting allows all companies in the target exposure to remain eligible for investment but reweights them to reflect the investor's prioritized characteristics and risk profiles. The weight is determined by balancing a stock's attractiveness relative to the investor's priorities with its usefulness in mimicking the risk characteristics of the target exposure.

Given the complexity of this technique, it's available at Parametric primarily using prebuilt portfolios, rather than being customized for each client.

Choosing between screening and reweighting

In theory, investors can incorporate any metric into a portfolio through either screening or reweighting. In practice, however, many metrics lend themselves better to one approach or the other.

In general, screens are preferable when the investor's primary objective is ensuring that their prioritized characteristics are reflected in their holdings, and the criteria can easily be made explicit. When the investor's primary concern is controlling the portfolio impact of incorporating a desirable characteristic—for instance, by reducing predicted tracking error—reweighting might be more suitable than screening.

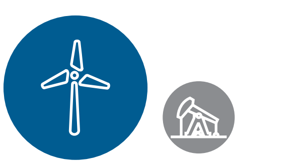
For example, human rights abuses tend to be better suited to a screen, as the investor can probably draw a clear line that separates which companies are intolerable. By contrast, with

DISPLAY 1

Screening versus reweighting

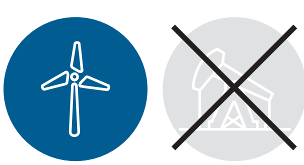
Market cap weighted portfolio

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



Integrated portfolio

Uses ESG characteristics to weight companies subject to constraints aiming 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. For illustrative purposes only.

an environmental score, it can be more difficult to specify an intuitive threshold between what is acceptable or unacceptable, so this metric might be better suited to reweighting.

Yet the choice doesn't always need to be exclusive. Many Parametric clients opt to combine an initial exposure built using reweighting, then further refined by applying a screen. We've found that investors should consider both screening and reweighting as complementary tools for building the portfolio that best matches their objectives.

In summary

Investors interested in responsible investing should understand how investment stewardship interacts with portfolio construction. Those looking to encourage better corporate behavior can start with investment stewardship, taking the most direct path to influence company management through proxy voting and shareholder engagement.

Investors who seek to incorporate their priorities into the construction of their portfolios can choose between two distinct methods—screens and reweighting—and make three more decisions about their target exposure, responsible investing criteria and weighting method.

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

About Parametric

Parametric partners with advisors, institutions and consultants to build innovative portfolio solutions focused on achieving their long-term financial objectives. A leader in custom solutions for more than 30 years, Parametric helps investors efficiently access market exposure, solve implementation challenges and design multi-asset portfolios that respond to evolving needs. Parametric also offers systematic alpha strategies to complement clients' core holdings. Parametric is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley.

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In evaluating an investment, the investment advisor is dependent upon information and data that may be incomplete, inaccurate, or unavailable, which could adversely affect the analysis of the ESG factors relevant to a particular investment. Successful application of the investor's responsible investment strategy will depend on the investment advisor's skill in properly identifying and analyzing material ESG issues.

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