Indexing active ownership: How index trackers deliver stewardship

Author

Greg Kearney
Senior Responsible Investment Analyst

Introduction

Passive investment vehicles are not typically associated with active ownership. Implementing effective stewardship in index tracker funds presents a unique set of challenges. Unlike active funds, where managers can selectively buy and sell based on company performance and engagement outcomes, most index trackers are bound by replicating the composition of specific indices. This inherent limitation restricts the ability to divest from underperforming or non-compliant companies, making it harder to apply traditional stewardship techniques. However, the stewardship activities of large fund managers who typically hold material percentages of most publicly listed companies play an important role in addressing broad systemic risks, like climate change and market standards in shareholder rights, that cannot be adequately managed through portfolio diversification.

We have delved into the various stewardship strategies employed by fund managers handling our index-fund and exchange traded fund (ETF) investments. When fund houses discuss their responsible investment approaches, they often describe methods typically tailored for active strategies. Our interest lies in understanding how these practices are translated to indexed products. Given their passive nature, certain aspects of stewardship, such as divestment escalation, face limitations. However, the rise in index-based products with sustainability-specific weightings and mechanical divestment for underperformers, informed through stewardship activities as well as ESG ratings, is noteworthy. Our evaluation of index stewardship is based on key criteria such as resourcing, consistency of approach, voting alignment, and systemic focus. Outlined below are the key findings from our engagements as well as the qualitative assessment of stewardship approaches. Most of the fund managers engaged were majority equity index product providers although many had some fixed income exposure, and a few were active in passive commodity trackers. We have anonymised the assessment as this is an ongoing dialogue that is best approached through direct engagement.

Resourcing

Of the four criteria assessed, this measure had the least dispersion.

- Six of the eight fund managers received tops marks for stewardship resourcing related to passive products and it was rare to see dedicated resources fall below twenty employees. This is a positive signal as most managers, all of which are of a significant size, have prioritised the execution of stewardship activities. The normative application of engagement and voting is well entrenched, and best practice is often defined by the content of their approach rather than the level of activity.
- Firms that received a better assessment rating often had more specialised teams, with analysts separated by thematic, sector and geographic expertise. In our view this structure improves the effectiveness of the approach, with local market and industry experts having better access and higher quality dialogue.
- One manager included a policy focus within the stewardship function, where the thematic area of interest was systemic in nature and better served by industry and regulatory engagement activities.
- One firm, despite having resources dedicated to stewardship, did not appear to apply their activities thoroughly for passive products and engagement was an ad hoc function of individual fund manager requests.
- One provider with a significant commodity ETF focus received the low rating as it did not have clear dedicated resources but prioritised applying appropriate ethical certification regimes. Given the asset class and limited levers for engagement or escalation, this approach is reasonable.

Stewardship consistency

Most firms where we have passive exposure also manage active funds. It is important to understand how firm-wide stewardship processes translate into index trackers. In policies describing firm wide approaches to stewardship, it can be difficult to distinguish any variation between the two but in practice there is often a gap. This can be owing to the natural limitation of escalation actions for indexed strategies, but descriptions of broad firm approaches can also ignore a lack of dedicated passive stewardship resource, an issuer level engagement process, stewardship driven by individual funds (rather than the firm as a whole) and a strategic focus on enabling and encouraging clients to take voting decisions.

One of the main trends that emerged from our engagement is the differing approaches taken by US and European based investment managers. Three of the US managers engaged received the lowest rating for consistency. A common thread was the lack of firm level direction when it came to engaging issuers. The political backlash against 'ESG' strategies in the US has created a fragmented stewardship landscape. Some US managers take different engagement approaches for difference strategies, with main plain vanilla funds focusing on purely governance topics, only moving outside of these issues where the strategy has a thematic focus (sometimes conducted by a separate teams). One manager reiterated they "are not an ESG shop" and see the ESG Research function as an ad hoc resource supporting the investment team driven requests. The hesitancy to implement a firm wide engagement strategy is well represented (and discussed further below) by a push among US managers to implement direct (or pass through) voting solutions. At one US firm, this has even been extended to an opt-in sustainability engagement service.

Conversely, most of the large European based managers (often without large US client bases) admitted that they were not seeing significant demand for direct voting or opt-in engagement and were not targeting solutions in these areas. At the three firms engaged, there was a high degree of consistency applied to the stewardship process across passive and active mandates. Engagement is typically prioritised and executed at an issuer level across all portfolios. Stewardship teams had sector, geographic and thematic expertise that was applied across strategies and asset classes. In our opinion, this 'house view' on stewardship creates clearer signalling of company expectations and ESG risks as well as potentially better engagement outcomes.

Voting alignment

As highlighted above, on the issue of voting, we witnessed another US-European divide. Enabling direct client voting is a key target for two out of the three large US firms. Direct (or pass through) voting solutions allow clients to either make direct voting decisions or stipulate a preferred voting alignment policy to be followed (e.g. sustainable, always support management etc). While this is often presented as a client centric approach, and we would advocate for the availability of specific client instructed voting, the enthusiasm for pushing mass adoption of the solution points to a perceived opportunity to avoid growing US political scrutiny. In our view, this is a technical solution to a political problem. Many of the items put forward at company AGMs involve topics that have be engaged upon and tracked by expert stewardship (and investment) professionals for a number of years, and while clients should always be able to vote directly, the wisdom of encouraging all clients to adopt policy directives like 'always support management', does not appear a sensible way to address nuanced governance and investment risks than can be managed through voting. At US managers it was also more likely that, rather than take a firm wide voting stance, individual portfolio managers had final say on voting, creating a higher chance of split opinions and a less coherent approach overall.

By contrast, all European managers implemented firm wide voting standards across indexed products, driven by stewardship teams. In all instances, these were consensus-based processes which involved voting panels with investment, legal and risk teams participating. All also implemented on-demand client voting but direct voting solutions were not a strategic focus. Firms often cited lack of demand, but in some cases, highlighted that stewardship and specifically voting is a key risk management tool in which a house view should be taken. Firms that did not receive the highest rating for vote alignment either did not have a firm wide view driven by the stewardship team, took a product specific approach, did not translate voting choices to passive strategies or relied very heavily on proxy service providers.

Systemic focus

Large index product providers are seen by some as 'universal owners' as they hold significant portions of public equity, debt and commodity markets. These portfolios face significant exposure to several systemic risks that cannot be managed through diversification, like erosion of shareholder rights, climate change and the degradation of natural capital. These issues could have material market wide costs which are not effectively addressed through traditional one-on-one company stewardship. Levers to address these systemic risks include contribution to collaborative engagement initiatives and policy level stewardship. This is a landscape where the US-European dispersion was still evident but less clear. Most (but not all) US managers have actively withdrawn from major collaborative initiatives, believing one-on-one climate engagements to be more effective (and providing relief from legal pressures in US). One US manager continues to value case-by-case participation in collaborative groups and frameworks – notably in emerging issues like natural capital.

By contrast, three out of four predominantly equity-based managers in Europe received middling scores with only one receiving the highest rating. Of those firms that did not receive a top rating, all were active participants in collaborative engagement initiatives but failed to convey a strong approach to integrating stewardship priorities into policy engagement efforts of a wholly separate global affairs function. The one manager that did receive top marks in this category (and, in fact, the highest ratings across the board), has a more integrated approach. Practices extended beyond direct company engagement and into looking to create a more supportive environment for stewardship goals through policy engagement. The stewardship team was divided by thematic responsibility, rather than sector or geography, some of which face regulatory or industry-wide challenges that are unlikely to be influenced by individual company engagement (e.g. anti-microbial resistance). In these instances, the stewardship analysts focused on work with regulators, standard setters and industry bodies.

Conclusion

Index fund managers often face challenges with limited leverage for escalation actions compared to their active counterparts. Positively, indexed product managers have allocated material resources to engagement and voting activities. However, exceptional stewardship practices, particularly for passive products, are marked by a clear and consistent approach to both engagement and voting. In our view, the firms that excel in this area are those with specialised teams, equipped with thematic, sector, and geographic expertise. This structure enhances the quality of dialogue and the overall effectiveness of stewardship activities. Adopting a firm-wide strategy that integrates both active and passive mandates ensures consistent messaging and a unified approach to managing ESG risks.

European managers frequently lead by example, implementing firm-wide voting standards through consensus-based processes that involve investment, legal, and risk teams. This comprehensive approach mitigates risks while aligning stewardship objectives with broader firm goals. The US-based landscape is more fragmented, influenced by political pressures, which contribute to inconsistencies in stewardship practices. The emphasis on direct client voting solutions indicates a strategic adaptation to these challenges. It remains to be seen whether this is a client centric approach or an abdication of responsibility.

Addressing systemic issues like climate change or the erosion of shareholder rights demands a proactive, collaborative approach. The firms that excel in this domain extend their stewardship efforts beyond direct engagements with companies to include active participation in collaborative initiatives, policy-level contributions and dialogue with regulators and industry bodies. This integrated strategy not only tackles regulatory challenges but also fosters an environment that supports and enhances systemic stewardship goals. These nominated ‘universal owners’ can and should have appropriate resourced, effective stewardship approaches to help maintain the health of the financial markets and societies in which they are embedded.

	Resourcing	Consistency	Voting Alignment	Systemic Focus
Investment Manager 1	Green	Green	Green	Amber
Investment Manager 2	Green	Red	Red	Red
Investment Manager 3	Green	Green	Amber	Amber
Investment Manager 4	Amber	Red	Red	Amber
Investment Manager 5	Green	Green	Green	Green
Investment Manager 6	Green	Red	Amber	Red
Investment Manager 7	Green	Amber	Amber	Red
Investment Manager 8	Red	Red	Red	Red

Key
- Green indicates a company satisfied the criteria clearly.
- Amber indicates the company satisfied the requirement but could improve relative to peers.
- Red indicates a company did not satisfy these criteria.

QUILTER CHEVIOT

SPECIALISTS IN INVESTMENT MANAGEMENT

This is a marketing communication and is not independent investment research. Financial Instruments referred to are not subject to a prohibition on dealing ahead of the dissemination of marketing communications. Any reference to any securities or instruments is not a recommendation and should not be regarded as a solicitation or an offer to buy or sell any securities or instruments mentioned in it. Investors should remember that the value of investments, and the income from them, can go down as well as up and that past performance is no guarantee of future returns. You may not recover what you invest. All images in this document are sourced from iStock.

Approver: Quilter Cheviot, April 2025

QC000364_1 (04/2025)