Building sustainable portfolios using passive investment vehicles

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All six Thurgauer Kantonalbank strategy funds have a fund of funds structure, with the strategy and investment policy implemented by index components. Traditional indicators such as the cost (TER) and volume of a tracker (ETF or index fund), as well as liquidity, spreads, taxes, replication type and domicile are all factored in when evaluating passive investment vehicles. When building sustainable investment portfolios, it is also necessary to use additional criteria to determine the degree of sustainability. We systematically include sustainability criteria in the process, which prioritises choosing the sustainable index for each asset class. In addition to the ESG criteria, the selection process for the instruments has to balance the impact on costs and on the tracking error (TE) versus the fund's benchmark subindices.

Over the last few years, the number of sustainable passive investment vehicles has increased significantly. They now range from products with a light green sustainability approach, which excludes companies with controversial business practices, to dark green sustainability approaches. The latter will only consider positions with the best ESG ratings or companies with the lowest carbon emission intensities. This approach significantly reduces the number of portfolio positions compared to the underlying index and this tends to be reflected in a higher tracking error.

Ultimately, it is an optimisation problem with a range of variables like ESG rating, carbon footprint and carbon intensity plus the tracking error and TER. This is particularly important when building a portfolio using passive investment vehicles as the various aspects of sustainability can impact each other. For example, a portfolio comprising companies with the best ESG ratings won't necessarily be a portfolio with the lowest carbon emission intensity. It is not that simple, there is a discreet decision to be made by the investment manager.