Insights
ESG

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Using ETFs to Gain ESG Exposure

Cost-Effective & Transparent Options in a Rapidly Growing Area of Investment

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- Investors increasingly want to align their investments with their values and sustainability preferences. In 2020, this shift is taking place alongside strong momentum in ESG regulation.
- ETF providers have responded, offering a range of cost-effective, transparent ESG products including exclusionary, best in class and thematic.
- The asset managers behind ETFs have also significantly invested in stewardship and engagement activity. Investors do not need to employ active managers for greater disclosure and commitment to sustainability.

Demand for ESG Investment

Investors have various reasons for integrating Environmental, Social and Governance (ESG) factors into their portfolios. Some are motivated by a desire to be more responsible investors, others believe it could help to enhance the portfolio performance, while some investors are required to adopt sustainable investment for regulatory reasons. There is now a large body of academic and industry research showing a positive relationship between a high ESG score and performance.

There is also a growing focus on risk control, with the argument that incorporating ESG factors can help investors to avoid, for example, risks associated with climate change or poor governance. These characteristics could favour higher quality stocks, which have been shown to perform better over time than less well run companies. We saw many of these factors at play during the crisis created by the COVID-19 pandemic.

2020 was originally heralded as a year of substantial change for sustainable investment. At the start of the year, we looked forward to seeing fruition of the Paris Agreement, progress towards the European Green Deal (what Ursula van der Layden called Europe's "Man on the Moon" moment), the launch of an EU sustainability classification system (or "green taxonomy") and introduction of new climate benchmarks. While some actions have been delayed out of necessity, for example the postponement of COP26 in Glasgow, ESG has remained top of mind for many investors during the COVID-19 crisis.

The ESG Offering in ETFs

While active ESG funds have traditionally dominated the scene, indexed ESG funds (including ETFs) are growing faster. The ESG ETF landscape is evolving quickly in response to investor demand. Sustainable investing is no longer considered a niche option and it is now one of the fastest-growing areas of ETF product development in Europe.

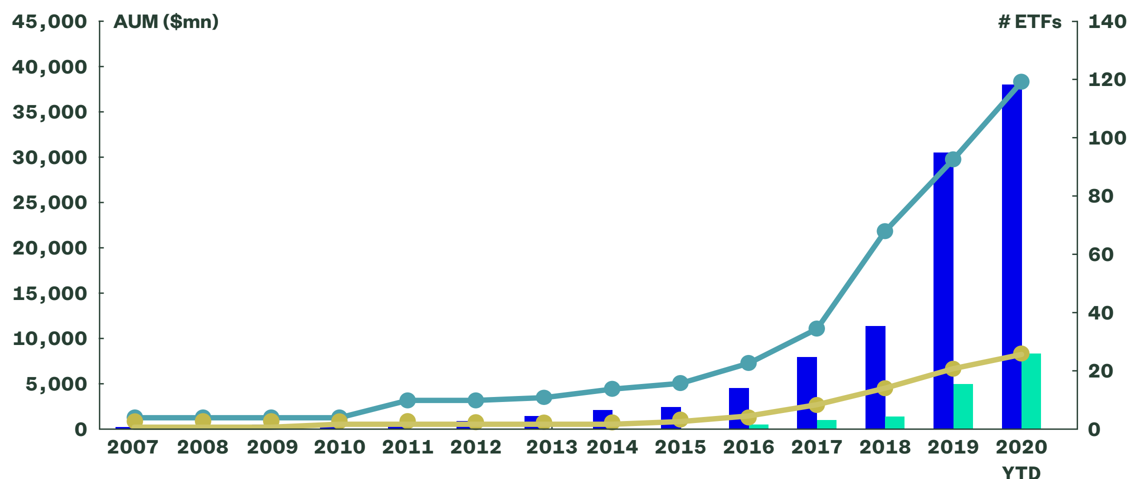
Providers are increasingly offering a core set of ESG-focused ETFs that take varying approaches, including ESG integration and hard exclusions, employing off-the-shelf indices or incorporating their own or partner intellectual property. In many cases, the indices tracked by European-domiciled ETFs employ ESG methodology scores or they screen controversial stocks without sacrificing tracking to their parent benchmarks.

Morningstar data has shown an acceleration of inflows into ESG ETFs year on year, which has continued in 2020. In the first five months of this year, European-domiciled ESG ETFs enjoyed net inflows of $8.1 billion, taking the combined AUM to $47.1 billion. Remarkably, inflows have been consistent throughout the COVID-19 crisis, even when flows into equity ETFs turned negative for some of the period. While equity investment was the traditional focus of ESG, there is now also significant growth in corporate bond funds that take ESG into consideration.

Over 30 new funds have been launched year to date, bringing the total number of European-domiciled ESG ETFs to 147, (121 of which track equity indices). In terms of size of assets invested, best in class remains the most popular ESG strategy, although negative screening strategies have grown rapidly.

Figure 1
Inflows into ESG ETFs

Equity ESG AUM
Fixed Income ESG AUM
Equity ETFs (RHS)
Fixed Income ETFs (RHS)



Source: Morningstar, as of 29 May 2020. Characteristics are as of date indicated and shouldn't be relied thereafter.

Despite this significant growth, there could still much more to come in absolute terms. ESG investments are still not mainstream for all. Many investors are in transition to ESG investment, in the process of making sustainability integral to portfolio construction and risk management, as well as exiting investments that present sustainability-related risk. All of this suggests further momentum for ESG ETFs. The economic and health crisis surrounding COVID-19 appears to have reinforced the popularity of sustainable investment, disproving earlier critics who thought ESG would not survive difficult markets.

More Relevance During Covid Crisis

Throughout the pandemic, we have seen a new focus on the "S" in ESG. The social part of ESG analysis has often been perceived as rather vague and less significant than other factors. However, social considerations have been vital in this crisis, through accessibility and affordability of health care, financial services, utilities, education, and telecommunications. As an example, think of the issues surrounding drug availability and pricing. Also high on the agenda has been companies' ability to create and maintain a safe and healthy workplace environment.

Asset managers' engagement is important. As shareholders, we at State Street Global Advisors encourage companies to refrain from undertaking undue risks that are beneficial in the short-term but harm longer-term financial stability and the sustainability of the business model. Communication is always among our top priorities for company management. This is relevant to learn about the short and medium-term potential impact the COVID-19 pandemic on the business, overall operations and supply chains, including management preparedness and scenario planning and analysis. We also want to hear how this crisis might impact or influence a company's approach to material ESG issues as part of their long-term business strategy.

How to Include ESG Factors In Indexed Investment Strategies

As mentioned earlier, there is a wide range of approaches being used to incorporate ESG factors into benchmarks and indexed investment strategies. We have summarised them into the following five categories:

Exclusionary Screening	Positive Screening	ESG Integration	Impact Investing	Active
Exclusionary screening: Excludes companies, sectors or countries involved in activities that do not align with global standards or investors' moral values	Tilts portfolio toward: • Best-in-class companies on ESG measures • Companies with strong ESG momentum • Companies solving specific ESG Themes	Incorporates ESG data, alongside traditional financial analysis, into the securities selection process	Targets a measurable positive social and/or environmental impact. Investments are generally project specific	Refers to active rather than passive investment management

Exclusionary Screening is often seen as the first step in ESG equity investing strategies, and is the approach offered by SPDR. The approach aligns portfolios with investor preferences, values and ethics. Also known as "negative screening," it excludes certain activities from a fund, based on specific ESG criteria, and therefore can help mitigate a range of ESG risks. Norms-based screening requires investee companies to meet certain standards of business practice based on international norms.

Positive Screening is also known as "best in class" and its popular can be seen in the rapid rate of new products entering the market. As with negative screening, portfolios can be aligned with investor preferences and possible mitigation of ESG risks. Such strategies may support business models solving sustainability issues and will seek to improve or maximise a portfolio's ESG score. There may also be a target for higher returns.

Integration involves tilting the overall exposure of a fund to a particular ESG factor by adjusting the weights of constituents depending on certain ESG factors. Securities inclusion in the underlying index is based on quantitative and qualitative assessment of ESG factors.

Impact Investing targets specific areas of ESG improvement. The objective is to generate and measure specific social and/or environmental benefits that align with an investor's goal. This approach has not yet become a major feature of ETF landscape, as investments may be illiquid. Investment returns could aim to be below or at/above the market rate.

Active ESG ETFs are still in their infancy, with only a handful in the European market so far. The active behaviour describes any move away from the benchmark, as opposed to active ownership activities, which are used broadly across many of other funds' holdings.

For investors looking to invest in an ESG strategy for the first time and show their commitment to this revolution, SPDR offers a simple solution. Our ETFs provide broad exposure to key indices S&P 500 and STOXX 600. The SPDR ETFs incorporate popular exclusions and have transparent methodologies.

The exclusion criteria aim to eliminate exposure to controversial weapons and civilian firearms, tobacco and thermal coal, as well as companies that violate or are at risk of violating commonly accepted international norms and standards, enshrined in the United Nations Global Compact (UNGC) Principles, the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises, the UN Guiding Principles on Business and Human Rights (UNGPs), and their underlying conventions. The goal to is to exclude certain major ESG risks without deviating too far from the overall market. The result is low tracking error and similar performance characteristics to the parent indices.

Greater Engagement

Asset management plays a pivotal role in the financial system given the vast portfolios under management, the manager interactions with companies, and power in shaping government policy as a key economic sector in its own right.

There was criticism in the past that index managers (which account for the majority of ETFs) may prefer to 'free ride' on the efforts of other investment managers rather than incur the costs of engaging with a large number of companies. The explanation was that the large number of companies held in funds made it less likely that engagement with any one company would have a material impact on overall performance. Indexed fund providers cannot divest or reduce exposure to a company based on a risk assessment values (including ESG). However, this is misleading, and large asset managers, including State Street Global Advisors, take their role of steward of client assets very seriously, considering it their duty to improve performance across the universe.

State Street Global Advisors has developed a rigorous, research-based asset stewardship program to consider the long-term impact of ESG issues on the companies in which we invest. This activity, along with other leading ETF providers, has become newsworthy in the last few years.

Asset Ownership at State Street Global Advisors

As near-perpetual holders of the constituents of the world's primary indices, we use our voice and vote to influence companies on long-term governance and sustainability issues. State Street Global Advisors takes an approach to stewardship that focuses on making an impact. Accordingly, our stewardship program proactively identifies companies for engagement and votes in order to mitigate ESG risks. To measure and demonstrate impact, we monitor and follow up with companies that we previously engaged with and evaluate company responsiveness to our feedback. This requires a long-term, multi-year approach to stewardship.

In order to engage on ESG issues, a robust and comparative measure is needed. In 2019, State Street Global Advisors began integrating R-Factor® into its asset stewardship program. R-Factor® measures the performance of a company's business operations and governance as it relates to financially material ESG challenges facing the company's industry. We share companies' R-Factor® scores with them, and we use the scores as a screen for voting and engagement. Because the score leverages transparent materiality frameworks, companies have the information needed to understand exactly what drives the score, and which ESG issues to focus on managing and disclosing.

Over time, the integration of R-Factor® into the State Street Global Advisors stewardship program should bring better ESG data to the market, ultimately helping to build more sustainable companies and financial markets. For information on importance of stewardship at State Street Global Advisors, please see our paper *Accessing ESG exposure with State Street Global Advisors & SPDR ETFs*.

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* This figure is presented as of March 31, 2020 and includes approximately $51.62 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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