Vanguard

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ESG screening approaches: a primer

What is ESG?

ESG refers to environmental, social and governance considerations.

Environmental
How a company or industry performs as a steward of the natural environment. For example, through their carbon emissions, energy use or waste management

Social
How a company manages its relationships. For example, how companies treat their employees, clients, suppliers and communities, and whether they offer equal job opportunities.

Governance
Supporting sound business practices by considering how a company is run. For example, by ensuring executive pay is tied to performance, company boards reflect society and minority shareholders are protected.

How Vanguard approaches ESG investing

Vanguard currently integrates ESG considerations into our product design and investment processes in three ways:

1. **Engage:** As long-term owners of the companies in which our funds invest, we engage with companies on material ESG issues as we believe they can impact long-term value creation at those companies.

2. **Allocate:** Many of our active funds aim to allocate capital to companies based on how they manage ESG considerations, alongside other factors, even where they don't have an explicit ESG investment strategy.

3. **Avoid:** We develop products that allow investors to avoid exposure to companies that are not aligned with their values, or to mitigate certain ESG risks.

The focus of this primer is the "avoid" section above, particularly portfolio screening, and the factors investors should consider when choosing an ESG screening approach.

Portfolio screening and exclusions

Portfolio screening is an active or index investment strategy that selects from a universe of investments which meet specific screening criteria.

There are essentially two methods of screening portfolios:

Exclusionary screening – this method excludes certain sectors, subsectors, countries and securities from an investment universe based on specific ESG-related criteria.

Inclusionary screening – this method proactively invests in companies or sectors considered to be more effective in the management of ESG risks, including those demonstrating meaningful improvement in the management of those risks.

ESG product-construction considerations

ESG-screened indices generally attempt to address one of two questions. “What do companies do?”, or, “How do companies do what they do?”

The first question is about removing or including companies based on their business activity. This approach is largely based on quantifiable information, such as industry classification or revenue exposure. For example, an ESG index might remove certain industries owing to their direct involvement in specific activities – including fossil fuels, tobacco or controversial weapons. Other companies might be removed based on their revenues from a specific product.

The second question, however, is more about how a company conducts its business. Indices that are intended to address this second question typically use ESG scores provided by ESG research providers. These scores can be based on a range of environmental, social and governance issues such as climate change, human and labour rights and anti-corruption. ESG scores can be used to determine which stocks to select for inclusion or exclusion or whether to “tilt”—that is, over- or underweight allocations—to a security depending on its ESG rating.

Vanguard’s approach to ESG screening

Vanguard currently offers several exclusionary ESG products across equity and fixed income that help investors to avoid certain ESG risks. These products use transparent exclusion measures to remove certain companies from the investment universe based upon pre-determined ESG screening criteria.

Three key principles underpin Vanguard’s current approach to exclusionary screening:

Transparency – exclusionary screening can offer a objective, transparent and rules-based ESG methodology to remove certain companies from the investment universe based upon predetermined ESG screening criteria.

Standardisation – exclusionary approaches tend to have a high level of standardisation and agreement about the quantification of ESG components, such as revenue exposure.

Lower active risk – exclusionary screening typically results in lower active risk than inclusionary approaches when comparing popular ESG indices[1]. Moving from broad market, index-based exposures to exclusionary-screened portfolios necessitates investors deviating from the market portfolio. As investors move from exclusionary ESG-screened approaches to more actively managed inclusionary screening methodologies they may take on higher active risk too, where their holdings become more concentrated.

We have been encouraged to see that the quality of ESG data disclosed by companies or available from third parties is improving all the time. We continue to assess developments in the industry and evolve our ESG approach to ensure it delivers long-term value to Vanguard's investors.

The performance implications of ESG investment

Many investors wonder whether moving from a non-ESG to an ESG investment should influence their return expectations. The academic literature is divided on the issue, and there are theories in support of all possible outcomes.

The predominant finding of Vanguard’s industry-level research[2] is that ESG funds perform differently from the broad market. However, we do not find that ESG funds collectively outperform, nor do they collectively underperform.

This has implications for how investors should think about investing in ESG-screened products. Our analysis of ESG equity funds indicates that return and risk differences relative to the broad market can be significant, but appear to be mainly driven by fund-specific criteria rather than by a stand-alone ESG factor. As a result, investors who choose to invest in ESG equity funds for non-financial reasons are best served by assessing investment implications on a fund-by-fund basis.

1 Vanguard investor briefing, Evaluating ESG ratings and methodologies, October 2020. The number of stocks in global equity ESG indices can range from 386 to 4,825. Risk and returns for ESG funds are highly dispersed, and more so for non-exclusionary funds than for exclusion-based funds.

2 Plagge, Grim (2020), Have investors paid a performance price? Examining the behavior of ESG equity funds, Journal of Portfolio Management Vol 46 Issue 3 Ethical Investing 2020.

Partnering with aligned ESG index providers

We partner with ESG index providers who are most closely aligned to Vanguard's approach to exclusionary index investing outlined above.

Equity ESG exclusions

For Vanguard's ESG equity index funds, we have chosen the FTSE Global Choice Index Series to help investors remove exposure to controversial business activities and/or conduct, as outlined below.

The index series:

- Helps investors remove exposure to companies involved with controversial business activities or conduct, as outlined in the box below.
- Provides a rules-based, transparent exclusions methodology – the index series provides a comprehensive set of rules-based product and conduct screens. The standards for exclusions are determined based on certain criteria and applied across the entire index series consistently.

ESG exclusions across equity[3]

- Non-renewable energy (fossil fuels, nuclear power).
- Vice products (adult entertainment, alcohol, gambling, tobacco, cannabis).
- Weapons (controversial weapons, conventional military weapons, civilian firearms).
- Controversies[4].

Source: FTSE Russell.

Fixed income ESG exclusions

For Vanguard's ESG fixed income index products launched since 2020, we have chosen Bloomberg MSCI, namely the Bloomberg MSCI Global Corporate Float-Adjusted Liquid Bond Screened Index.

Bloomberg works with MSCI, which identifies the securities for exclusion from the benchmark at an issuer level. Bloomberg has a proven track record as a fixed income index provider, while MSCI has over 40 years of experience in measuring and modelling ESG performance. Together, they have become a leader in the fixed income ESG space.

Vanguard's fixed income products allow ESG-conscious investors to build low-cost, diversified bond portfolios by combining ESG and conventional exposures.

The Bloomberg index with the MSCI exclusions:

- Helps investors remove exposure to bond issuers with ties to controversial business activities or conduct, as outlined in the box below.
- Provides a rules-based, transparent exclusions methodology – Bloomberg has established a set of criteria that screens issuers based on product and conduct involvement research from MSCI.

ESG exclusions across fixed income[3]

- Non-renewable energy (fossil fuels, nuclear power).
- Vice products (adult entertainment, alcohol, gambling, tobacco).
- Weapons (controversial weapons, conventional military weapons, civilian firearms).
- Controversies.

Source: Bloomberg, MSCI.

Vanguard has also offered investors in Europe ESG-screened exposures through its socially responsible investing (SRI) products since 2013. SRI methodologies generally adopt a lighter screen and exclude a smaller portion of the benchmark than the equivalent ESG methodology.

Find out more about screening methodologies

We aim to address the evolving needs of ESG investors with the same investing principles across all of our products: clear goals, broad diversification, low costs and a long-term view. Our exclusionary ESG-screened funds and ETFs are designed to align with these principles.

If you would like to find out more about the screening methodologies Vanguard uses for its equity and fixed income index products, please refer to the product information for the individual fund or ETF.

3 Selected exclusions. For a full list of ESG exclusions that are screened from our equity funds, please see the product information for the individual fund or ETF.

4 United Nations Global Compact controversies.

Investment risk information

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

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