DEFINING ESG:

Clarifying the Myths and Facts

August 2020

INSTITUTE FOR
Pension Fund Integrity

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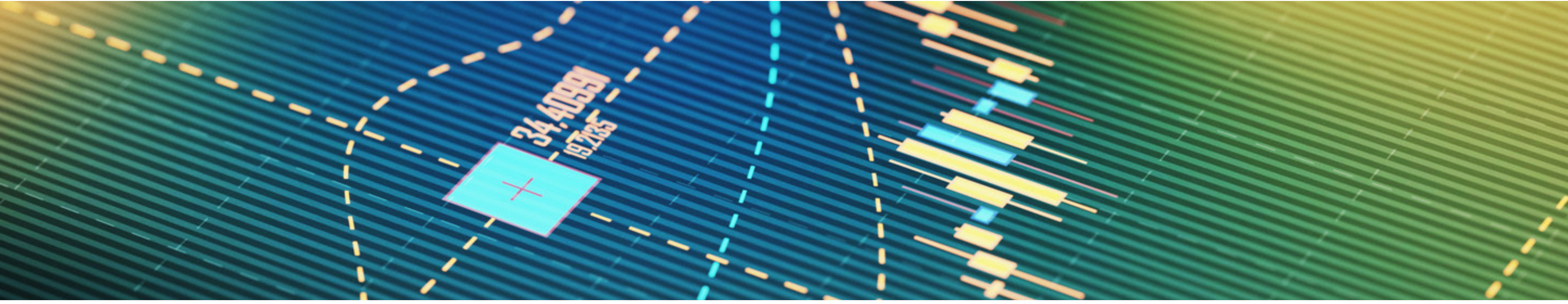
With efforts underway by the Department of Labor and other government agencies to address ESG investing in pension plans and other investment products, the topic has garnered significant attention over the past several months. Given its prominence, it comes as a surprise that the investment strategy remains ambiguous and lacks a standardized definition. This paper seeks to shed light on these ambiguities. The definition and background of ESG will be examined, the variations in ESG definitions across firms will be identified, case studies on two ESG funds will be analyzed, and a recommendation for more formal definitions will be made.

DEFINITION AND BACKGROUND OF ESG

The term ESG is an acronym which stands for environmental, social, and governance - categories representing values that drive investment. These values diverge from the traditional values used in investment, such as exclusively prioritizing stability and opportunities for growth.

The term ESG was first used when in 2004 former UN Secretary General Kofi Annan asked over fifty CEOs of important international financial institutions to join an initiative to explore integrating ESG into capital markets. A year later, the initiative produced the Who Cares Who Wins report, which concluded that focusing on ESG leads to more sustainable markets and aligns with the best interest of businesses. That being said, there have been sustainable investment funds and indices on the market since the early 1970's, with the first being the Pax World sustainable mutual fund (PAXWX) in 1971. Currently, there is over $20 trillion in ESG assets under management, and the sector is growing.

Even though ESG has been gaining momentum in recent years, the sector is still vague in its composition. Throughout the history of ESG and sustainable investment, many indices and standards have been created by different institutions and organizations. This has led to large variations in the practices of ESG investing, which should become more uniform.



VARIATION IN ESG DEFINITIONS

All investment firms overlap in their ESG definitions, but some go further than others in their commitment to describing exactly what it means and how they're incorporating ESG into their firm. On the base level, all firms describe ESG integration as the practice of incorporating ESG information into investment decisions; some elaborate further using a variety of strategies to summarize ESG integration.

1. Descriptor Words: Words such as "sustainable," "responsible," and "impact" are utilized by firms to comprise their definitions. These are often generally used interchangeably with ESG to cover a wide spectrum of goals and strategies. Although this vocabulary helps to partially define the spirit of ESG, it effectively erases the differences between ESG, SRI, or other sustainable investment strategies.

The Socially Responsible Investment movement, which has been around longer than ESG, is based on ethical and moral principles. SRI actively eliminates investments based on ethical guidelines, which can range from personal values, religion, or political beliefs (examples include refraining from investing in tobacco or firearms). ESG, on the other hand, places a stronger focus on the factors which have financial relevance. The distinction is important because ESG investing requires consideration of how a company's adherence to ESG standards affects its performance on the market.

Graphics and visuals are often utilized by firms to define ESG principles, which either work to display the meaning of ESG or contextualize it among other similar initiatives. Visuals vary in their message between contrasting ESG with other forms of investing or showing ESG on a spectrum made up of many elements. Each firm holds their own individual priorities among this range of possibilities, considering their varying missions, business models, and resources.

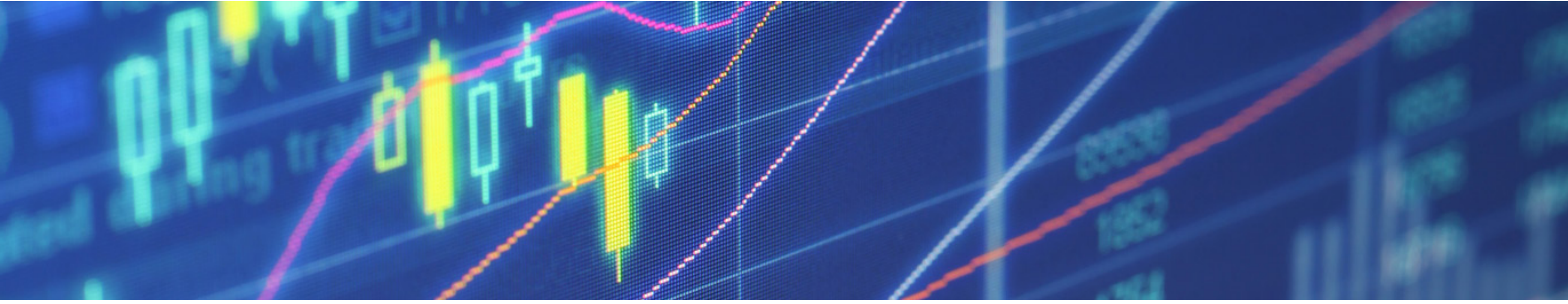
2. Spectrum: Instead of pinpointing a solid definition, some firms choose to view ESG as a spectrum where "At one end of the scale, ethical screens eliminate companies engaged in controversial activities, reflecting asset owners' values and should have little expectation of improved investment returns. At the other end, sustainability analysis can, when approached thoughtfully and integrated with more traditional analysis, improve insights and enhance performance. Each approach has different objectives, requiring different skills and demanding different tools." Firms' commitment to ESG widely varies on the spectrum.

3. Promises, Pillars, and Themes: Other firms include some form of "pillars" to convey their related corporate priorities. Most of these pillars are tailored to the firm's mission and vision and can be classified into themes such as a commitment to the environment, which then leads to subgroups such as renewable energy. These pillars can include certain unwavering determinations as well, such as a promise not to invest in companies that disregard human rights or high-quality labor laws.

Some firms' pillars are simply the deconstructed ESG acronym and individually define "environmental," "social," and "governance" standards.

4. Step-by-step: Some use a step-by-step plan to define ESG and their approach to ESG integration, demonstrating the process of narrowing down options to ensure that investments fit ESG standards. A firm's elimination process and their priorities when weighing an investment is one way to demonstrate how they set a definition.

Firms typically use at least one of these strategies in their public definitions of ESG, and quite often use combinations of several.



CASE STUDIES

Vanguard FTSE Social Index Fund Admiral

The Vanguard FTSE Social Index Fund Admiral tracks the performance of FTSE4Good US Select Index, a series of ethical investment stock market indices created by the FTSE Group. This subsidiary of the London Stock Exchange Group vets companies based on ESG criteria.

Even though the index used by the Vanguard fund accounts for ESG criteria, the fund doesn't include corporate governance quality or the environmental impact of its holdings beyond the simple fossil fuels business involvement exclusion, according to Morningstar Director Alex Bryan. Therefore, while the fund targets ESG stocks, the ones included in the Vanguard fund aren't ESG stocks of the highest standards.

Not only does the Vanguard FTSE Social Index Fund Admiral include ESG considerations, but the fund also uses Socially Responsible Investment (SRI) principles to guide investment. For example, the fund excludes companies with large business connections to tobacco, alcohol, nuclear power, adult entertainment, gambling, and fossil fuels. The fund also does not invest with companies that are entangled in human rights, labor, corruption or environmental controversies. These considerations take out 30% of the US large-cap market and are used to help create long term success.

Overall, Vanguard has been a major proponent of ESG investing. They created the aforementioned fund almost 20 years ago, which has since become the largest ESG-screened fund in the US. Additionally, Vanguard has been a signatory to the UN-supported Principles of Responsible Investment for over 40 years. Vanguard has three pillars to their dedication to responsible investing: investment stewardship, corporate stewardship, and investment management. For Vanguard, the pillar of investment stewardship is aimed at ensuring businesses operate using good governance to help create long term value for investors. Corporate stewardship's purpose is to invest back into the community and/or sector to help innovate to create new ways to further clients' interests. Lastly, Vanguard holds investment management as a core part of their dedication to responsible investment because it works to ensure all funds are being invested with the same standards in mind.

The top ten holdings by the fund are Microsoft, Apple, Amazon, Alphabet, Facebook, Visa, Proctor and Gamble, JPMorgan Chase, UnitedHealth Group and Home Depot. They comprise 30.90% of the total net assets of the fund as of June 2020.

iShares MSCI Global Impact ETF (By BlackRock)

BlackRock, the world's largest asset management corporation, has been increasingly shifting towards ESG integration. They cite an increasing awareness that material environmental, social, and governance factors can be linked to a company's long-term performance.

Based on the firm's definitions, ESG is equated to sustainable investing. They describe the connection between the two as "sustainable investing as the umbrella and ESG as the data toolkit for identifying and informing our solutions." They differentiate between the two by noting that ESG data is most often "non-accounting" information because it captures a wider range of factors in its valuations. According to BlackRock, ESG can help provide insights into intangible factors by measuring decisions made by a company's management team.

BlackRock then adopts a "Promises, Pillars, and Themes" approach to ESG investing. First, they deconstruct the ESG acronym to individually define "environmental," "social," and "governance." They then proceed with the same approach to describe their ESG integration process, which is structured around three main themes: investment processes, material insights, and transparency.

As part of investment processes, BlackRock expects all active funds and advisory strategies to integrate ESG. They tasked portfolio managers with this task. Secondly, they use material insights in their ESG investments, and lastly they aim for transparency in their investments.

One particularly well-rated family of exchange-traded funds is iShares by BlackRock. Its description includes references to SDG and it lists three reasons SDG is worthwhile. First, it promises to obtain exposure to global stocks aiming to advance themes related to the U.N.'s Sustainable Development Goals. Secondly, it targets companies with ESG business practices that use their work and business to drive wanted change. Finally, investing in SDG funds also increases exposure to sustainable themes in equity portfolios. iShares' objective is to observe how an index composed of positive impact companies that derive revenue from products or services that address at least one of the world's social and environmental challenges delivers investment results.

DEFINITION SUGGESTION

The ESG sector so far has been largely nonstandard, with different indices used in ESG investing. This variation has created the need for a comprehensive definition of "ESG Investment." A comprehensive and official definition of ESG Investment would help begin the process of standardizing the growing industry, allowing it to formally expand and be more widely understood in the coming years. In the future, the definition of ESG investment should include the aforementioned variants in ESG practices.

Including multiple facets to a definition illustrates the complexity of ESG investing and conveys a more comprehensive understanding of ESG integration. Descriptor words, such as *sustainable*, *responsible*, and *impact* are a useful introduction to a longer definition, helping to express a very broad idea of ESG. This beginning portion of the definition should also differentiate ESG from other forms of sustainable investing, such as SRI. A company should then connect ESG with their corporate mission through promises, pillars, or themes. This links ESG, which is highly variable between companies, to a firm's own morals, values, and goals. It also helps to contextualize the firm's commitment to ESG on a larger spectrum. Companies should follow these pillars, promises, or themes, which they linked to their mission, with a step-by-step plan explaining concrete ways they will implement their aforementioned promises. Finally, each element of their definition could be accompanied by graphics to contextualize ESG and illustrate their commitment.

CONCLUSION

Since the acronym's first use in 2005, ESG has become a widespread term in the finance world. Although there are over $20 trillion in ESG assets under management, it lacks a standardized definition under which all firms can unite and under which regulators can address legitimate concerns. Most definitions, however, use certain strategies to define ESG on an individual level. Some firms make more of an effort than others to define ESG and demonstrate their commitment to ESG investing.

Given that ESG is highly variable, companies should take the extra step to convey how they define ESG and how it impacts their investment strategies. Implementing a multidimensional definition would serve to eliminate some inevitable confusion and create a better understanding of ESG as it relates to a firm's mission and vision.

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