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# A framework for ESG decision-making

**Vanguard research** | Commentary

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This document is based on the paper ESG, SRI and Impact Investing: A primer for decision-making. Douglas M. Grim and Daniel B. Berkowitz. The Journal of Impact and ESG Investing, autumn 2020.

## 1. Introduction

Investors around the world are increasingly interested in environmental, social and governance (ESG) issues as they seek to address a wide range of personal values, preferences and beliefs as well as financial goals. However, the growing array of terminology and different approaches to ESG can be bewildering for clients. In this guide, we aim to clarify some of the terms and suggest an objective and practical framework that can help investors and their advisers make informed decisions.

Despite the growing interest in ESG investing, definitions of and approaches to ESG vary widely. No universal ESG strategy exists and the most important consideration in selecting an approach is likely to be unique to each investor. As with any other form of investing, investors must establish their goals and weigh the potential benefits of the various approaches against any relevant risks and costs to give themselves the best chance of achieving their desired outcome.

## 2. Defining ESG investing

### What is ESG?

ESG refers to environmental, social and governance considerations.

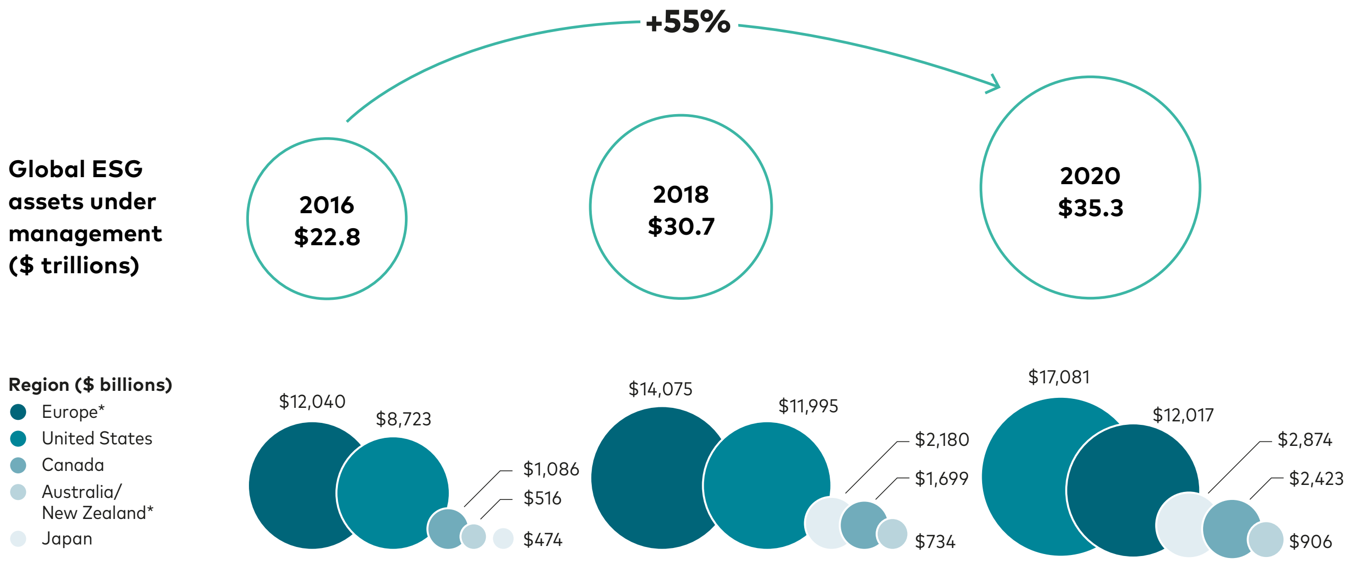
**Environmental**
How a company or industry performs as a steward of the natural environment. For example, through their carbon emissions, energy use or waste management

**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.

## 3. Trends

Figure 1. ESG investing assets have grown significantly



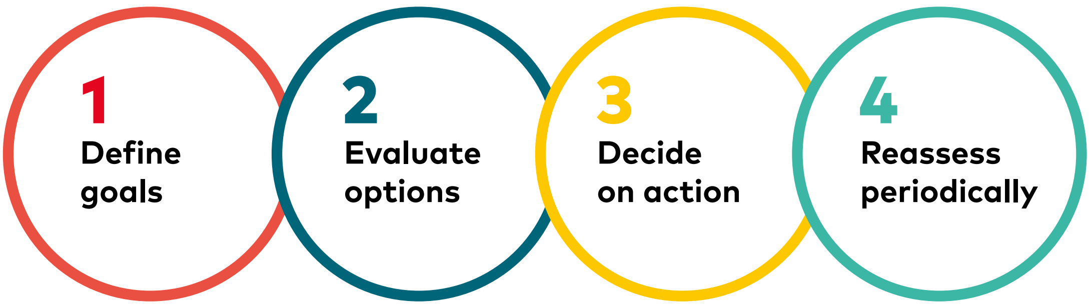

Source: Global Sustainable Investment Alliance (from the report Global Sustainable Investment Review 2020). Asset values are expressed in billions or trillions of US dollars. Assets for 2016 were reported as at 31 December 2015 for all regions except Japan, as at 31 March 2016. Assets for 2018 were reported as at 31 December 2017 for all regions except Japan, which reported which reported as at 31 March 2018. Assets for 2020 were reported as at 31 December 2019 for all regions except Japan, which reported as at 31 March 2020.

*Europe and Australasia have enacted significant changes in the way sustainable investment is defined in these regions, so direct comparisons between regions and with previous versions of this report are not easily made.

## 4. A decision-making framework

Our clear four-step process helps investors and their advisers establish specific goals, evaluate potential options and decide on an ESG investing approach based on their client's specific criteria and personal trade-offs.

Figure 2. Key steps to making a prudent ESG investment decision




Source: Vanguard.

## 4.1 Define goals

As with any investment, the first step for an adviser is to define their client's goals. What ESG issue or set of issues is the investor seeking to address? This decision is not always easy, given the large and growing list of ESG-related issues that may be important to different investors, as shown below.

Figure 3. The list of potential ESG issues is extensive and growing

| ENVIRONMENTAL | SOCIAL | GOVERNANCE |
|---|---|---|
| • Air emissions and air quality<br>• Biodiversity protection<br>• Community health, safety and security<br>• Energy conservation<br>• Fossil fuels<br>• Hazardous materials use<br>• Land contamination<br>• Natural resource preservation<br>• Occupational health and safety<br>• Renewable energy sources<br>• Waste generation<br>• Water use and conservation | • Adequate housing<br>• Adult entertainment<br>• Alcohol<br>• Animal testing<br>• Casinos and gambling equipment<br>• Consumer privacy<br>• Employment of minorities and women<br>• Human rights standards<br>• Income inequality<br>• Obesity<br>• Opioids<br>• Religious values<br>• Tobacco<br>• Union relationships<br>• Weapons<br>• Workforce exploitation | • Antitrust violations<br>• Auditor independence<br>• Board independence and elections<br>• Board diversity<br>• Consumer fraud<br>• Disclosure of material risks<br>• Executive compensation<br>• Oversight of strategy<br>• Political contributions<br>• Reporting transparency<br>• Short-term focus<br>• Voting rights |

Note: This represents a sample, not an exhaustive list, of ESG issues.
Source: Vanguard.

Even where an investor is clear on the ESG issue(s) they would like to address – the environmental impact of fossil fuels, for example – there may be several ways to express this preference. Some investors may prefer to take a zero-tolerance approach by excluding any company participating in the fossil-fuel supply chain through an exclusionary screening approach. However, some fossil-fuel firms may also spend a significant amount of capital on the development of clean-energy alternatives to diversify their revenue streams and potentially increase their energy market share. Some investors may not want to exclude such companies from their universe. It is therefore important to understand your client's specific preferences and also how different products deal with these issues in order to determine which options will give them the best chance of meeting their personal goals.

To help determine your client's objectives – and therefore the best course of action for them – it can help to think about their aims in one or more of the following ways:

**1. Are they seeking to satisfy a values preference?**

This preference will be based on the investor's ethical, moral, religious, humanitarian, political and/or environmental beliefs. For example, a company may be conducting a legal business activity, but the investor may not want to co-profit from this activity because it is at odds with his or her values. The values preference may be so strong that the investor would be prepared to sacrifice a financial return. In other words, the utility derived from their values more than offsets the financial cost of the action.

**2. Are they seeking to generate a financial benefit?**

Some investors are interested in an action that they believe will improve their financial results, such as enhancing risk-adjusted return or reducing certain types of risk. For instance, an investor may choose to invest in a group of solar energy companies with a belief that the market is underestimating their ability to take market share from traditional fossil fuel firms in the next few years.

**3. Are they seeking to bring about positive change?**

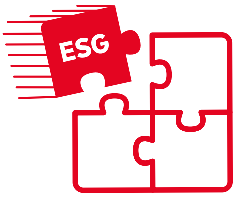
Some investors desire an approach that will lead to positive ESG-related change on one or more issues that concern them. For example, they may aspire to influence a change in working conditions for employees of a company in an emerging-market country.

**4. Are there external requirements?**

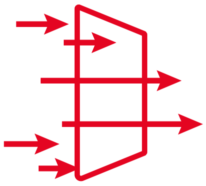
In some cases, the investor, fund manager or adviser may need to adhere to ESG-related recommendations or guidelines, such as specific exclusions, set by an external party such as a regulator.

## 4.2 Evaluate options

Once an adviser has defined their client's goals, the next step is to study ways to address them. Importantly, the strategies outlined below are not necessarily mutually exclusive, meaning that investors can pursue multiple approaches, depending on their objectives.




**ESG integration**



**Portfolio screening/tilting**

**Stewardship**

**Impact investing**

### 4.2.1 Portfolio screening and portfolio tilting

#### Portfolio screening

Portfolio screening can be an active or index strategy that selects from a universe of investments that meets specific screening criteria. **Exclusionary screening** excludes sectors, securities or countries from the investment universe based on specific ESG-related criteria. **Inclusionary screening,** on the other hand, only purchases those securities that meet certain criteria. Such criteria may be, among others, revenue exposures to a specific sector or industry or a minimum ESG risk score.

#### Exclusionary (negative) screening

Screening out or limiting exposure to securities of companies or countries that engage in or support what an investor believes are undesirable activities – regardless of the current market price – is probably the most well-known approach to ESG investing. The goal is often to avoid co-profiting from or financing an activity that is at odds with an investor's values. This may be an appropriate option if the investor is seeking to satisfy a values preference.

When assessing screened products, however, the methodology may not match the investor's ideal screening preference exactly. If so, it is important to assess if the strategy is close enough to their screening preferences and also the impact the screening approach will have on the characteristics of their portfolio in terms of weightings to certain styles or sectors.

*Example*

A client wants to invest according to their religious beliefs by avoiding companies whose core business involves alcohol, adult entertainment and tobacco. Their adviser therefore helps them select a product that tracks an index that excludes companies involved in those business activities.

#### Inclusionary (positive) screening

These strategies often involve purchasing the securities of companies or countries that have strong ESG ratings relative to their peers or other investment opportunities. However, there can be material differences in ratings across agencies[2]. These inconsistencies can produce very different holdings in inclusionary screening strategies. Because of these inconsistencies, advisers should conduct due diligence on the provider's selection and weighting methodology.

Strategies that only select securities that generate revenues in a specific industry or sector can also be included in this category.

#### Portfolio tilting

Rather than excluding or including companies that do not meet certain (minimum) criteria, portfolio tilting involves the under- and overweighting of companies based on ESG-related information. For example, an ESG equity index fund may weight its holdings based on their market capitalisation and an ESG rating, which allows it to over- or underweight stocks with higher or lower ratings relative to peers.

2 For example, according to Berg, Koelbel, and Rigobon (2022), the average cross-sectional correlation of ESG scores from six different raters—KLD, Sustainalytics, Moody's, S&P Global, Refinitiv, and MSCI was 0.54 on 31 December 31 2017. This is in contrast to the high level of correlations among credit rating agencies that determine default probabilities of fixed income instruments (Hawley, 2017).

### 4.2.2 Impact investing

Impact investments are targeted investments, often made in private markets, with the dual objective of generating some level of financial return as well as some degree of positive ESG-related impact on issues such as (but not limited to) renewable energy, conservation and affordable access to housing, healthcare and education.

> *Example*
>
> An active equity fund invests in companies with core products and/or services that help address key environmental and social issues and which the manager believes are priced to deliver superior investment returns over the long term.

### 4.2.3 Investment stewardship

Stewardship is defined by the UK Stewardship Code 2020 as the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries, leading to sustainable benefits for the economy, the environment and society[3]. Asset managers promote effective corporate governance practices at the companies in which they invest through a range of activities including public advocacy on corporate standards, ongoing engagement with companies and also proxy voting on behalf of shareholders in equity funds.

> *Example*
>
> **Case study: Engagement on diversity at consumer goods company**
>
> **Issue:** Board of directors lacked diversity.
>
> **Objective:** A large investor wants to encourage the company to increase representation of women on the board, because diverse boards can make better decisions and this can lead to improved long-term value for shareholders over the long term[4].
>
> **Approach:** The investor meets with the company to share its expectations on board diversity, including disclosure of diversity measures, and to encourage it to add more women to the board. The investor believes this would, among other things, better reflect the composition of the company's customer base as well as its employees.
>
> **Outcome:** Soon after the investor's engagement, it receives an update from the company that it had appointed two new directors, one of them a woman. This increases its female board representation to 30%. The chairman said the move was only a first step in the board's progress toward greater diversity.

Investment stewardship activities are one of the levers that asset managers can use to address material ESG risks within their funds. Because material ESG risks can undermine returns over the long run, investment stewardship and fund management teams engage with constituent companies to promote effective corporate governance practices and encourage long-term value creation at those companies.

At Vanguard, our investment stewardship team's dialogue with the management and boards of companies is a year-round process that goes beyond proxy voting at a company's annual meeting. We represent the interests of our investors through public advocacy and ongoing engagement and dialogue with companies to understand their governance practices and long-term strategy. Vanguard expects companies to disclose information relating to material risks to shareholders, such as an assessment on the impact of climate-related risks; set out a strategy for mitigating those risks and any related targets or goals; and report on progress.

### 4.2.4 ESG integration

Integration is the systematic inclusion of material ESG information – both risks and opportunities – in investment analysis and decision making. It does not necessarily preclude investment in a company, sector or country because of an undesirable activity.

Some active investors have been implicitly considering ESG-related information in their research process for years or even decades, in a process that is now often labelled ESG integration. With the substantial growth in the availability of ESG-related information and the number of active investors who are formally or informally integrating it into their analytical process, it is worth assessing how managers examine any material ESG opportunities and risks for the securities they own.

> *Example*
>
> An active equity manager, who does not have a specific ESG mandate, considers financially material governance issues when evaluating a company's earnings growth prospects.
> The manager might examine the company's financing decisions and the quality of its financial statements to help identify companies that could be over-managing their earnings or have a higher probability of earnings manipulation.

3 Source: Financial Reporting Council. The UK Stewardship Code 2020.

4 Hewlett, Sylvia Ann, Melinda Marshall, and Laura Sherbin, December 2013. How Diversity Can Drive Innovation. Harvard Business Review.

## 4.3 Decide on action

Once an adviser has determined the client's goal or set of goals and reviewed the potential options, the next step is to decide what to do based on the investor's customised decision-making criteria. This can include an assessment of direct or indirect implications of each option they are considering. The potential trade-offs of ESG-related actions will differ by investor and sometimes will require significant judgment, particularly if the investor has particular values preferences.

Advisers should document the decisions, include the pros and cons of any action, how the decision was reached and any next steps, including plans for future review. This due diligence helps ensure that the goals and expectations of any action are clear.

ESG investing should not be a reason to abandon sound investment principles. At Vanguard we consider ESG investments, as with any investment, in the context of our four investment principles – goals, balance, cost and discipline.

**Goals**

Create clear, appropriate investment goals

**Balance**

Develop a suitable asset allocation using broadly diversified funds

**Cost**

Minimise cost

**Discipline**

Maintain perspective and long-term discipline

**What are the performance implications of investing in ESG funds?**

The main finding of our industry-level research, conducted in 2020, was that ESG funds perform differently from the broad market[5]. However, we don't find that, in aggregate, ESG funds collectively outperform, nor do they collectively underperform.

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. Differences in style or industry tilts seem to play a role in some cases. As a result, investors who choose to invest in ESG equity funds are best served by assessing investment implications on a fund-by-fund basis.

Most importantly, ESG investing should not mean deviating from sound investment principles. ESG is not a reason for investors to pay much higher fees, nor to be encouraged into high-risk strategies. Focusing on keeping costs low, taking a long-term approach and being diversified apply just as much to ESG as they do to any other type of investment.

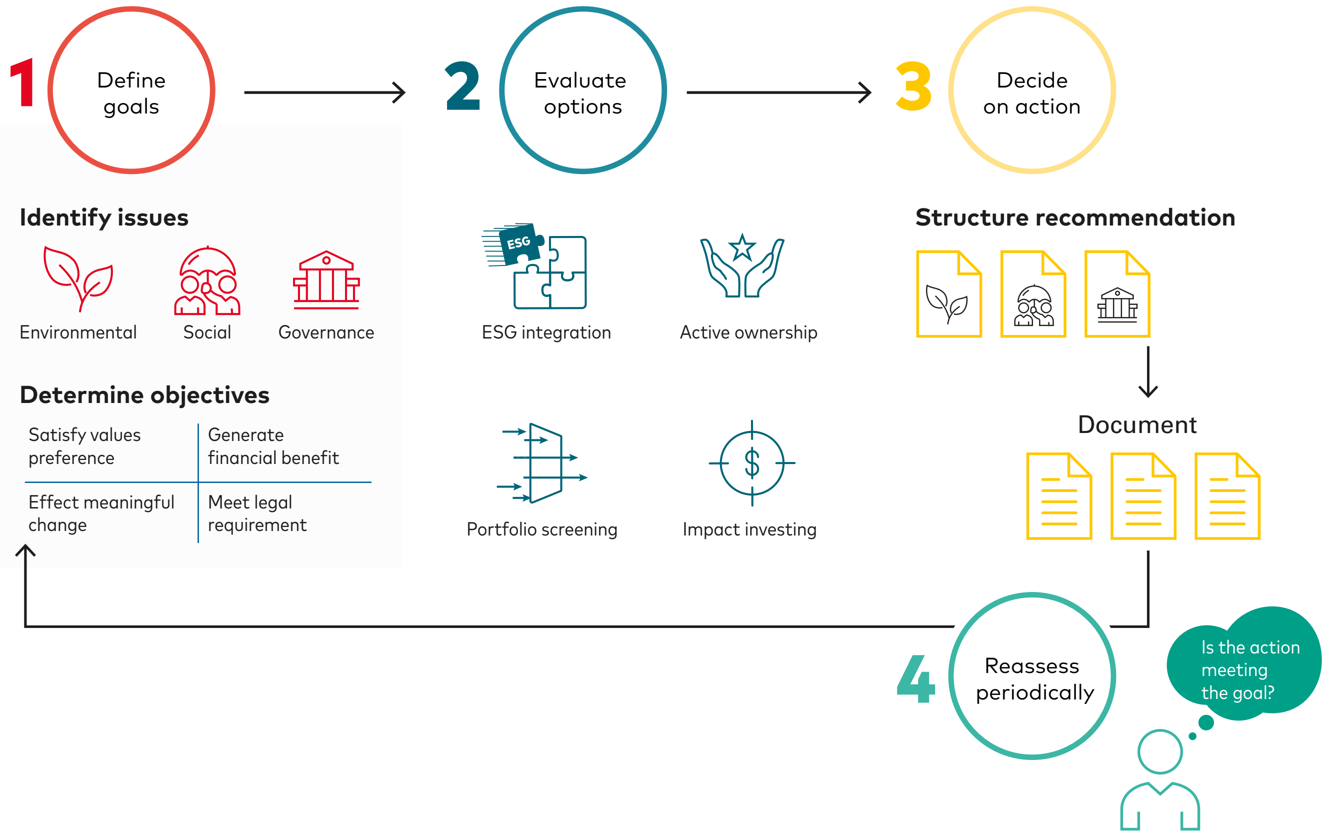
5 Research originally published in the Journal of Portfolio Management: Plagge, J.-C. and D. M. Grim. 2020. 'Have Investors Paid a Performance Price? Examining the Behavior of ESG Equity Funds.' JPM Vol 46 Issue 3 Ethical Investing: 123–140. Performance of US index and active equity mutual funds and ETFs that indicate the use of ESG factors, as determined by Morningstar. Time period observed: 1 January 2004-31 December 2018.

## 4.4 Reassess periodically

As with any other investment decision, the last step in the process is to periodically monitor and review previous decisions and determine whether they still make sense in the context of the investor's specific goals and objectives. In cases where screening was chosen, for example, a monitoring step might include checking whether the screened product still meets the investor's preferences.

By the end of this four-step process, investors will have identified their goals, assessed an array of potential courses of action and made a choice supported by thoughtful evaluation of important considerations and trade-offs.

Figure 5. Making informed decisions on ESG investing actions




Source: Vanguard.

## 4.5 Conclusion

Investors around the world are increasingly interested ESG issues and different approaches to ESG investing continue to proliferate. We believe it is critically important for investors to carefully decide on goals and weigh the options for addressing ESG-related issues. Many ESG investing approaches are available and deciding which tool or set of tools to use – if any – depends on a variety of factors. Our objective and practical framework can help investors make well-informed decisions through a prudent process that considers their beliefs, preferences, goals, resources and circumstances.

**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.

**Important information**

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