Briefing:
When is an ESG Fund No Longer ESG?
ESG ETFs, Ratings and Indices

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Introduction - A Short Overview of ESG Investing:

"I do believe that the demand for ESG is going to transform all investing," said BlackRock CEO Larry Fink of ESG (Environmental, Social and Governance) investing in late 2018. This theme is represented in Fink's 2019 Letter to CEOs, where he contends that "as wealth shifts and investing preferences change, environmental, social and governance issues will be increasingly material to corporate valuations."

These pronouncements reflect the expansion of sustainability-minded investment approaches in recent years, with sustainable investments assets rising to $30.7 trillion globally. ESG is at the forefront of this change, and has been credited for fuelling growth in sustainable, responsible and impact investing, as asset managers accounting for ESG criteria represent $11.6tn in AUM. According to Robert Eccles, Visiting Professor of Management Practice at the Saïd Business School and co-author of *The Integrated Reporting Movement*, "There's data that shows … a little over 50 percent, of assets are invested in sustainable investing in Europe. It's about a third in Canada. It's about 25 percent in the United States."

What qualifies as a sustainable investment is therefore of consequence. As Eccles notes, commitments to sustainability vary. This briefing will assess the ESG qualities of two ESG ETFs (Exchange Traded Funds) with respect to these headlines in order to determine the extent to which the data, analytics and evaluation services for ESG investing are compliant with what investors (and laypeople) may consider to be reasonable benchmarks for ESG-compliant portfolios.

ESG ETFs:

Exchange-Traded Funds (ETFs) are passively managed vehicles that collect holdings tracking an underlying index. Globally, approximately $17.7bn is invested in ESG ETFs, and Fink projects that ESG ETFs will comprise an AUM over $400bn within a decade. This may be catalysed by ETFs' unique benefit of lower fees, which, when coupled with an ESG approach, theoretically makes ethical investing cheaper than ever.

ESG ETFs – Looking Under the Hood:

However, ESG ETFs have been criticised for inadvertently including holdings that ESG investors may exclude from their portfolios. Two Vanguard ESG ETFs was recently found to possess holdings in gun and private prison companies, and a Vanguard ETF claiming to specifically exclude fossil fuel stocks has been found to possess several oil and gas holdings.

This paper will assess the ESG holdings of these responders to gauge, to a minor extent, how systemic such infections of ESG ETFs can be.

Is This Systemic?

In order to assess the carryover between an ETF's stated ESG stringency and the ESG quality of its holdings, this report evaluated five ETFs in order to obtain a continuum of ETFs from exclusively sin stocks to an ESG Enhanced ETF. The funds may also be fairly compared as they have all been assigned MSCI ESG Quality Scores. The methodology below outlines the criteria their holdings must meet in order to be flagged as not ESG-compliant.

The ETFs analysed for this briefing are:

ESG ETFs:
1. World ESG Screened UCITS ETF
2. World ESG Enhanced UCITS ETF

Non-ESG ETFs:
1. Core FTSE 100 UCITS ETF
2. World UCITS ETF

Sin Stock ETFs:
1. U.S Aerospace & Defense ETF

The fund manager and custodian names have been omitted, as the focus of the briefing is on the nature of ESG ETFs generally rather than a specific company.

Methodology:

The categories were split into traditional ESG offenders and into "ESG+" violative holdings, based on the level of exclusion in investor may prefer. The number of holdings and AUMs they represent in each of the ETFs were then tallied and presented in a table. The definitions have been defined reasonably broadly; this caters for varying levels of ESG-sensitivity. The funds have all been awarded MSCI ESG Quality Scores, which have been included to allow for a fair comparison of their ESG credentials. This report would particularly like to highlight their lack of consistency with respect to an ETF's actual holdings.

Basic ESG Exclusions:

Defence: Companies that manufacture weapons, military equipment, military vehicles, chemical disinfectant gloves for warfare and build and equip military bases have all been included here. Additionally, any company with an Aerospace and Defence section on its website or advertising products with military applications have also been included. Companies competing for military contracts are also a part of this report. Any of these subcategories could be filtered out based on an investor's ESG sensitivity.

Gambling: Holdings including gaming or gambling services have been flagged for gambling. Certain flagged holdings operate small numbers of casinos across a global chain and could be removed from this list if needed.

Tobacco: This category includes tobacco producers.

<u>ESG+ Exclusions:</u>
There is less consensus regarding whether these holdings qualify as ESG relative to the above categories.

> **Fossil Fuels - Oil and Gas:** Here, the category was restricted to fracking, oil exploration and oil extraction companies. Midstream and downstream companies were excluded from this list.
>
> **Fossil Fuels - Coal:** Coal mining companies were included as a separate category on this list due to inclusion in the funds' materials rather than energy sector, as well as their additional environmental harms relative to other fossil fuels.

<u>Results (on following page):</u>

Least ESG Compliant ETF >>>>>--->: Aggressive ESG ETF

		U.S. Aerospace & Defence ETF		Core FTSE 100 UCITS ETF		MSCI World UCITS ETF		MSCI World ESG Screened ETF		MSCI World ESG Enhanced UCITS ETF	
	Number of Holdings in ETF	33		101		1644		1528		1316	
		Number of Holdings	% AUM	Number of Holdings	% AUM	Number of Holdings	% AUM	Number of Holdings	% AUM	Number of Holdings	% AUM
Basic ESG Exclusions	Weapons, Defence, Military Contractors	32	100%	5	2.9%	93	5.0%	78	3.3%	76	3.89%
	Gambling	0	0	3	1.1%	24	0.6%	19	0.6%	15	0.37%
	Tobacco	0	0	2	4.9%	5	0.9%	0	0.0%	0	0%
	TOTAL BASIC ESG EXCLUSION	**32**	**100%**	**10**	**8.9%**	**122**	**6.5%**	**97**	**3.9%**	**91**	**4.3%**
ESG+ Exclusions	Oil and Fracking	0	0	6	19.8%	70	5.6%	61	5.1%	53	5.4%
	Coal	0	0	4	4.30%	11*	0.76%*	7*	0.42%*	5*	0.42%*
	TOTAL ESG+ EXCLUSION	0	0	10	24.09%	81	6.33%	68	5.50%	58	5.82%
0 Bad, 10 Perfect	**MSCI ESG Quality Score**	**5.1**		**6.7**		**5.9**		**6**		**7.1**	

* Including Ball Corp, which maintains a Defence & Intelligence section on their website but is classified in the materials section of the portfolio

Key Findings:

Holdings:
All of the funds evaluated possessed holdings in the ESG-violative categories described above. What is perhaps surprising is the number of offending holdings in the ESG ETFs, which, after including their fossil fuel holdings, are well above 100 holdings each. 10.7% of the companies in the ESG Screened ETF were flagged as either Basic or ESG+ Exclusion holdings. This figure rises to 11.3% for the ESG Enhanced ETF, raising questions as to what the material difference in their ESG stringency is, particularly as the ESG Enhanced ETF has a higher percentage of its AUM in the Basic ESG Exclusions category than the ESG Screened fund.

The argument that the levels of ESG infractions indicated by the findings is unreasonably high due to the breadth of the classification into the above categories may be fairly advanced in response to this argument. However, from a qualitative perspective, the fact that both ESG funds have holdings in Raytheon, Rolls-Royce and L3Harris (among other major arms manufacturers and defence contractors) should cause some alarm at the strength of ESG filtering deployed by their tracking index. The same is the case for the ESG funds' holdings in the world's major gambling companies, such as Las Vegas Sands and MGM Resorts.

Takeaways:

1: ESG Ratings and Standards

The ETFs' respective MSCI ESG Quality Scores do not appear to reflect the funds' classification as ESG or not-ESG, MSCI or not-MSCI or the general contents of their portfolios, particularly their exposure to sin stocks. Moreover, it is difficult to appreciate, based on the data above, how the discrepancy in scores between the ESG Screened and Enhanced ETFs could be 1.1 points given the similarity in their holdings (for example, the ESG Enhanced ETF has 0.42% of its AUM in Raytheon, compared to 0.14 for the ESG Screened ETF).

Additionally, if the ESG Quality Score is meant to be an indicator of the strength of an ETF's compliance with ESG principles, then it is unclear how the difference between a fund holding exclusively weapons could only be 0.9 points worse on the scale than an ESG Screened ETF, which itself is rated only 0.1 points higher than a non-ESG ETF with a substantially larger chunk of its AUM in sin stocks. Moreover, the FTSE 100 ETF has over double the AUM in sin stocks as the ESG Enhanced ETF, but only ranks 0.4 points lower than it.

The MSCI ESG Quality Scores are therefore of limited use when judging an ETF's ESG strengths. If anything, they obfuscate the reality of the funds' holdings and expose fund managers to accusations of greenwashing or deliberately misleading investors. This has been noted by Remy Briand, head of ESG at MSCI, stating in light of BlackRock disclosing their ETF range's sin stock exposures, that "There's a lot of greenwashing" in ESG investing. Ultimately, greenwashing, or a mismatch between ESG Quality Scores and the actuality of an ETFs' holdings can negate promises of "sustainable and coherent investment portfolio[s]."

2: Impending Standards Convergence and Government Intervention

Eccles predicts eventual government regulation as the need for transparency and common standards for ESG becomes mainstream. A precursor for government intervention may be represented by impending UK pension fund regulations, which are responding to the effects of climate change. ESG ETFs, if found to regularly violate consensus views on what their holdings should contain, may similarly fall victim to tightened standards.

3: Active Management and Sustainable Investing

Some contend that ETFs, as a vehicle, are prone to the "errors" found above. For example, their passive, index-oriented design may predispose them to afford equal attention to companies with strong ESG credentials and ones with substantially weaker ones.

Conversely, actively managed funds may hold fund managers' best ideas regarding sustainable investing. Moreover, the *Financial Times* cites Hugh Lawson, head of ESG and impact investing at Goldman Sachs, contending that active management of non-ESG companies affords shareholders to raise concerns with corporate managers and influence AGM votes. Passively managed funds do not offer this opportunity.

Conclusion:

The findings point to a need for a consensus on what ESG portfolios should resemble, as well as how a fund's ESG characteristics should be evaluated. This briefing will therefore conclude that an ESG label alone cannot certify a portfolio's environmental, social and governance credentials. This is particularly relevant given acknowledgements regarding the growing relevance of transparency in the investment world, as well as warnings against greenwashing aiming to capture growing demand for ESG offerings. Furthermore, the ETFs examined here feature minimal differences in the nature and standard of ESG filtering in their portfolios.

This is not necessarily the fault of any particular fund, fund manager or index compilation service. It is reflective of an absence of agreed-upon principles regarding what comprises ESG-compliant portfolios. Moreover, some have contended that the opacity behind ESG index creation allows for several problematic stocks (from an ESG investing perspective) to sneak into a fund manager's portfolio. The ESG ETFs assessed here are illustrative of this conundrum: their MSCI ratings and sustainability characteristics indicate moderate-to-strong sustainability investing, but their holdings belie this. Some investors may tolerate their levels of exposure to sin stocks, others may not. The issue here regards the quality of disclosure provided to investors such that they can make these decisions, as the simple distinction between ESG and non-ESG does not seem sufficient. This issue is compounded by the backward-looking, index-tracking nature of the ESG ETF.