UNDERSTANDING & COMPARING ESG TERMINOLOGY

A Practical Framework for Identifying the ESG Strategy That Is Right for You

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Background

According to a survey of 475 institutional investors titled **"Performing for the Future,"** more than half of institutions that have adopted environmental, social and governance (ESG) investing cite a lack of clarity over ESG terminology.[1] At the heart of the challenge is that the terms used to describe the various ESG strategies are not universally defined and can mean different things to different investors.

To address this problem, we reviewed the usage and definitions of ESG terminology adopted by a broad range of industry participants, including standard setters, asset managers, data providers and academics. Even though there is some variation in the nomenclature, we found general consensus in the marketplace for five dominant and distinct ESG strategies. On page 4, we present these strategies in a practical framework that reconciles the definitions with the underlying objectives and considerations of each strategy. This framework has been developed to facilitate conversations with investors and help them choose the ESG approach that meets their investment objectives.

In our research we also found that there was no market consensus for terms that describe the overall genre of investing that incorporates ESG factors into the investment process.

In Figure 1 on the next page we explore ESG investing through a historical lens to understand the nuanced differences between *Social Responsible Investing (SRI), Responsible Investing (RI), Sustainable Investing (SI) and ESG Investing*. At State Street Global Advisors, we view *ESG investing* as the most appropriate term to describe the overall genre since it incorporates all factors — environmental, social and governance.

Today, investors are increasingly accepting that material ESG factors not only impact the financial performance of companies but also have societal and environmental outcomes. However, obtaining data from portfolio companies and reaching consensus in the marketplace about which ESG factors materially impact each industry remains a challenge. Nevertheless, by supporting initiatives such as the Sustainable Accounting Standards Board (SASB), the industry is moving closer to common ESG reporting standards.

Further, the development of emerging technologies like big data and artificial intelligence are making it increasingly possible for asset managers to perform complex analysis on data sets to further improve investment decisions.

56%

of ESG adopters say there is a lack of clarity over ESG terminology

As ESG investing continues to grow, we expect that the strategies that comprise ESG investing will also evolve to meet changing client objectives, new opportunities and better data quality.

[1] Performing For the Future, Longitude Research, April 2016.

Figure 1

The History and Evolution of ESG Investing

1920s	1930s	1990s	2000s Latest Iteration
Socially Responsible Investing (SRI)	**Responsible Investing (RI)**	**Sustainable Investing (SI)**	**ESG Investing**
Rooted in religious values (Tohra, Old Testament, Sharia etc.) First SRI fund launched in 1928 (Pioneer Fund) focused on exclusionary screens based on **social issues** — ex tobacco, alcohol and gambling **Strong demand for SRI products** resulted in the launch of many other values-based funds	**Differing views** of what to deem socially responsible resulted in some investors dropping the "S" from SRI The Great Depression and a number of **corporate scandals** and controversies lead to more focus on governance issues	**The ecological word 'sustainability'** was introduced in the 1990s **Increased awareness about climate change**	**UK Pensions Act is amended** in 2000 to require the consideration of ESG issues during the investment process In 2006, the United Nations launched its **Principles of Responsible Investing**, which require the incorporation of ESG issues into the investment process

Reconciling the Various ESG Strategies

We have identified five primary strategies of ESG investing — exclusionary screening, positive screening, ESG integration, impact investing and active ownership. These strategies reflect a wide range of objectives that include avoiding or reducing ESG risks, generating higher investment returns and seeking measurable impact, among others. They also reflect a wide range of investment and impact considerations that investors should take into account before investing. In our *Framework for Understanding ESG Strategies* on the next page, we reconcile the definitions with the underlying objectives and considerations of each strategy. It's worth noting that some objectives span different ESG strategies to varying degrees, and multiple ESG strategies can be combined within a single investment vehicle to achieve the unique goals of investors.

Contrary to popular belief, these strategies can be implemented across asset classes and investment styles. For instance, at State Street Global Advisors we offer equity and fixed income ESG products within beta, smart beta and actively managed investment strategies.

SSGA's Framework for Understanding and Comparing ESG Strategies

	EXCLUSIONARY SCREENING	POSITIVE SCREENING	ESG INTEGRATION	IMPACT INVESTING	ACTIVE OWNERSHIP
DEFINITION	Excludes, from the investment universe, companies, sectors or countries involved in activities that do not align with the moral values of investors or with global standards around human rights, labor practices, the environment and anti-corruption	Tilts portfolio toward one of following: **Best in class:** companies outperforming peers in ESG measures **ESG momentum:** companies improving ESG measures more quickly than peers **Thematic investing:** companies solving specific ESG challenges (climate change, gender diversity, etc.)	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	Entails engaging with companies and voting company shares on a variety of ESG issues to initiate changes in behavior or in company policies and practices
COMMON OBJECTIVES	**Align** portfolios with investors' moral and ethical values **Mitigate** ESG risks **Influence** a company to change its business model or stop an objectionable practice	**Mitigate** ESG risks **Achieve** higher returns **Support** a business model that aims to solve an environmental or social problem **Improve** or maximize a portfolio's ESG score	**Mitigate** ESG risks **Achieve** higher returns	**Generate** and measure specific social and/or environmental benefits that align with purpose	**Influence** company strategy for long-term value creation **Help** company management capture value by mitigating risk or seeking opportunities **Advance** ESG disclosure and practices
INVESTMENT CONSIDERATIONS	Introduces tracking error and potentially impacts performance	Securities selection is based predominately on ESG scores and ratings. Sourcing quality ESG data remains a challenge	Sourcing quality ESG data remains a challenge. Securities selection is based on quantitative and qualitative assessment of ESG factors, requiring analyst expertise. A long-term mindset is necessary as it is difficult to time the occurrence of a negative event resulting from an ESG issue	Investments may be illiquid and investment returns could aim to be at or above the market rate	A significant ownership stake is needed to exert influence. Substantial resources are also needed to engage with companies. Active ownership is crucial for index strategies
IMPACT CONSIDERATIONS	Generally can't impact companies in which you don't own shares, but well-coordinated divestment campaigns can be effective	Rewards companies that have higher ESG scores with capital. Impact is generally targeted around specific sectors or themes (e.g. climate change, gender diversity, etc.)	No deliberate impact strategy as the primary objective is to achieve higher returns and/or mitigate ESG risks	Impact is highly targeted on specific outcomes	Broad impact due to continued engagement with company management on ESG issues
EXAMPLES	Equity fund that excludes companies that generate more than 5% of their revenue from the sale of tobacco products	Equity fund that invests in oil & gas companies deemed to be least carbon intensive	Actively managed fixed income fund that considers ESG issues during the securities selection process	Community investment fund that provides micro financing to low-income or disadvantaged communities	Could apply to any fund (including those not tagged as ESG funds) where the asset manager or asset owner is committed to active ownership

Advantages of Adopting a Common Vernacular

Establishing a standard language can help asset owners, asset managers, consultants and advisors more clearly communicate with each other. Using language more deliberately and precisely can also help investors begin to address some of the practical steps involved in ESG investing. These steps, which we call the **investor challenge**, include:

1. **Identifying** beliefs and objectives
2. **Educating** internal investment staff
3. **Engaging** stakeholders, such as beneficiaries
4. **Choosing** the right ESG strategy
5. **Manager selection**
6. **Measuring** and monitoring performance and impact
7. **Reviewing** and fine-tuning a long-term strategy

To learn more about ESG terminology and how to incorporate ESG into your portfolio, contact your relationship manager or email us at: **esg@ssga.com.**

Visit **ssga.com** for ESG insights and research.

With $176 billion in dedicated ESG assets under management,[2] we draw on a rich 30-year heritage of ESG innovation and helping clients achieve their ESG objectives.

When you partner with SSGA, you'll have the full resources of one of the world's largest ESG managers working for you — not only in ESG portfolio management, but in investment research and data analytics.

We are committed to helping our clients harness the potential of ESG investing and to transform their ESG ambitions into action.

[2] Source: SSGA as at 31 December 2016.

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third largest asset manager with US $2.72 trillion* under our care.

*AUM reflects approximately $32.9 billion (as of June 30, 2018), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

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