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R-Factor™
Reinventing ESG Investing Through a Transparent Scoring System

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- **The universe of ESG data coverage is expanding, but the lack of transparency into ESG materiality considerations, as well as opaque scoring systems, highlight the limitations of relying on any one ESG data provider.**
- **To address this challenge, State Street's R-Factor™ is built off a transparent scoring methodology that leverages the Sustainability Accounting Standards Board (SASB) Materiality Map, corporate governance codes and inputs from four best-in-class data providers, while drawing on State Street Global Advisors' stewardship and investment expertise.**
- **R-Factor™ supports the development of sustainable capital markets by giving investors the ability to invest in ESG solutions that integrate financially material ESG data while incentivizing companies to improve their ESG practices and disclosure in areas that matter.**

Why We Built R-Factor™

The availability of high-quality, financially material, and consistently reported ESG data represents the biggest challenge facing asset managers as they work to meet the growing demand for sustainability-focused investing.

Investors face two key data challenges: the lack of a consistent and commonly accepted materiality framework, and opaque ESG scoring methodologies of existing data providers.

While firms providing valuable ESG data have proliferated in recent years, they provide limited transparency into how they consider materiality. (For a deeper exploration of this topic, please see "The ESG Data Challenge.")

Lack of transparency into how data providers determine which ESG issues are material to their scoring system poses a challenges for investors. It is difficult for users of this data to understand and explain which ESG factors have been considered in the investment process. This has led to a broader debate in the market among companies, investors, and regulators on whether there is a tension between ESG investing and fiduciary responsibility.

At State Street Global Advisors, we firmly believe that ESG investing and fiduciary responsibility are not contradictory, but rather that the consideration of material ESG factors in the investment process is an integral part of honoring our fiduciary duty. Consequently, we have made a commitment to fully integrate ESG into our investment processes over the long term.

We see this as our responsibility and so we have created an innovative solution to these data challenges. We call it the R-Factor™ score.

R-Factor™
A Transparent ESG Scoring System

R-Factor™ is an ESG scoring system that leverages commonly accepted transparent materiality frameworks that are supported by a large group of companies and investors to generate a unique ESG score for listed companies. The score is powered by ESG data from four different providers (Sustainalytics, ISS-Oekom, Vigeo-EIRIS, and ISS-Governance), in order to improve overall coverage and remove biases inherent in existing scoring methodologies. R-Factor™ is designed to put companies in the driver's seat to help create sustainable markets. (For more on how R-Factor™ is helping to build sustainable markets, please see our blog “Putting Companies in the Driver's Seat to Enhance ESG Reporting.”)

These scores will power our investment and client reporting capabilities, and be fully integrated into our stewardship program.

Defining Characteristics of R-Factor™

We designed R-Factor™ around four core pillars. These pillars define our approach to ESG data and scoring:

1 Focus on materiality	**2 Commonly Accepted, Transparent Frameworks**	**3 Strong Stewardship**	**4 Multiple data sources**
For investors to be able to fully trust and integrate ESG scoring into their investment process, they must have confidence that the ESG considerations are material and have a demonstrated link to sustainable long-term value creation.	We selected the SASB materiality map (See page 4 for more on SASB), as well as national and/or investor-developed corporate governance codes, because they are transparent frameworks supported by large numbers of investors. We support these frameworks as they send a unified message to companies about which ESG factors are material to a company’s performance and are therefore important to disclose and address	R-Factor™ supports the efforts of our Asset Stewardship team to provide clear expectations of company performance on material ESG factors. We screen companies for voting and engagement based on their scores. During engagements with portfolio companies, we disclose companies’ R-Factor™ scores, as well as the underlying basis for those scores. This gives boards and management teams a roadmap for the specific dimensions that investors are evaluating to assess a company’s sustainability efforts. It also helps companies identify which metrics to disclose and manage to improve future scores, creating a positive feedback loop in the market.	R-Factor™ is powered by the raw metrics from four different data providers: three that inform the environment and social component of the score and one that informs the governance component of the score. This approach increases the overall coverage of our data set, filling in the gaps that exist with any one data provider. Using the inputs from multiple providers also reduces the potential biases that may be built into a provider’s methodology.

Materiality Frameworks and the R-Factor™ Methodology

In building R-Factor™, we sought frameworks that could transparently address material environmental, social, and governance issues. In doing so, we differentiate between Environmental & Social ("E&S") issues, which are market-agnostic but industry specific, and Governance ("G") issues, which are industry-agnostic but market specific. For example, the impacts of climate change do not stop at geographical borders, but they impact industries differently. In contrast, the business practices, governance structures, and market expectations of firms vary widely when it comes to different geographic regions, and we believe it important to hold companies to the standards appropriate to their market. R-Factor™ takes these nuances into account.

Materiality Framework and Methodology for Environmental and Social ("E&S") Factors

We selected the SASB materiality framework as the E&S framework for R-Factor™. Unlike SASB, other sustainability reporting frameworks that pre-date SASB provide disclosure guidance on a broad set of ESG topics and do not provide guidance as to which topics are financially material by sector. This leaves the difficult decision of defining materiality by sector to companies. This has caused the current inconsistencies in company reporting related to ESG. With its laser focus on financial materiality defined by industry, SASB gives specific and standardized guidance to companies, removing guesswork for all users of the framework.

Given the recent codification of the SASB standards as well as the voluntary nature of the framework, companies have yet to fully align their disclosure practices to it. To access appropriate data, we leverage raw metrics from three different E&S data providers, and identify which metrics are material to an industry according to the SASB framework.

Here, we provide two examples of how we leverage that data with precision. We illustrate applications in two industries: Asset Management and Custody, and Household and Personal Products.

- Starting point: 180 metrics provided by a data provider
- Of these, 91 metrics are considered material according to the SASB framework
- Of the 91 material metrics:
  - 22 metrics power the R-Factor™ scores for companies in the Asset Management and Custody industry
  - 26 metrics power the R-Factor™ scores for companies in the Household and Personal Products industry

This mapping approach helps ensure that the R-Factor™ score is only informed by material ESG metrics and not all of the 180 metrics provided by the data provider.

Since materiality of the metrics differs by industry, companies in the Household and Personal Products industry are asked to report on only four general issues: water and waste management, product quality and safety, product design and lifecycle management, and supply chain management.

In contrast, there are five general issue items that apply to companies in the Asset Management industry. These include selling practices and product labeling, employee engagement / diversity and inclusion, product design and lifecycle management, business ethics, and systemic risk management. Within each general topic, SASB's accounting standards provide guidance to companies by industry on specific metrics to be disclosed. While many of these metrics are not currently reported in financial statements, they obviously contain investor-relevant information.

Who is SASB? The Sustainability Accounting Standards Board (SASB) is non-profit organization with a mission to help businesses around the world identify, manage, and report on the sustainability topics that matter most to investors.

Established in 2011, SASB has developed two key pieces of market infrastructure: a commonly accepted materiality map identifying financially material E&S issues for 11 sectors and 77 industries, as well as a set of sustainability accounting standards that companies can use as a guide to report on material topics and related metrics.

SASB's standards were developed over six years, with consultation and public comment from investors, companies and other stakeholders. SASB's standards are supported by investors representing $32T.

The value of SASB's materiality framework is validated by academic research showing that companies that score higher on material ESG metrics for their industries according to the SASB framework generate stronger long-term sustainable returns.[2]

To learn more about the SASB's materiality framework, visit materiality.sasb.org.

Materiality Framework and Methodology for Governance ("G") Factors

The SASB materiality framework does not incorporate traditional corporate governance factors, which tend to be more market specific and are well defined by the myriad of the corporate governance codes globally.

To construct the "G" component of the R-Factor™ score, we draw on country-level corporate governance codes, developed by either regulators or investors. Like the SASB materiality map, these codes are transparent and supported by a large number of investors. In all, we draw on 16[3] market-specific codes, with the remaining markets aligned to the International Corporate Governance Network (ICGN) code.

Corporate governance codes are written as sets of principles. To incorporate them into the "G" component of R-Factor™, we relied on the expertise of our Asset Stewardship team to systematically map the appropriate metrics from our fourth data provider, ISS-Governance, to the principles articulated in each code.

Here, too, we draw only on the corporate governance metrics that are material to a given geography. We have leveraged the expertise of our Asset Stewardship team to build out a consistent framework that identifies and aligns material corporate governance metrics with the different corporate governance codes. For example, of the 230 metrics provided by ISS-Governance, only 86 are relevant to the United States to align with the Investor Stewardship Group Code[4] while 95 are relevant to companies governed by the United Kingdom's code.

Adapting our model to different geographies allows for this market specificity, and honors differences in governance structures and business practices, without placing judgment on those differences. This allows us to identify, within a given market, companies who are relatively stronger and those who are underperforming, within the context of investors' governance expectations for companies in that market.

Conclusion

The composite R-Factor™ score is comprised of a company's E&S and G scores, and allows for a global comparison of companies' ESG performance within a sector or industry. Companies can improve their scores through better practice of and disclosure on industry-specific SASB topics, as well as better adherence to their applicable corporate governance code.

For **companies**, R-Factor™ offers clear guidance on which ESG topics to focus on and disclose to investors. In doing so, this is the first ESG scoring system to put companies in the driver's seat, allowing them to take the action needed to enhance their scores and improve investors' view of their ESG performance.

By investing in ESG solutions powered by R-Factor™, **investors** have the opportunity to ensure their capital is being allocated to companies that are focusing on managing and mitigating material ESG risks. Investing in an ESG scoring methodology that provides clear guidance to companies on what to disclose will ultimately lead to better available data and will allow for ESG to be more accurately priced into financial markets.

At State Street Global Advisors, we believe that R-Factor™ is the change needed for ESG to become an integral part of the financial system. We look forward to further exploring this innovation with you.

For more information about R-Factor™ and our ESG investment capabilities, please contact your State Street Relationship Manager.

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Endnotes

01 Khan, Serafeim, et al. "Corporate Sustainability: First Evidence of Materiality." Harvard Business Review, 2016.

02 Australia, Denmark, Finland, France, Germany, Hong Kong, Italy, Japan, Netherlands, Norway, Singapore, Spain, Sweden, Switzerland, UK, US.

03 State Street Global Advisors is a founding member of the Investor Stewardship Group and currently chairs the group's Steering Committee.

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 $2.5 trillion* under our care.

* AUM reflects approximately $32.4 billion (as of December 31, 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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