Insights
Environmental, Social & Governance (ESG)

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ESG Investing
An Introduction for Investors

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At State Street Global Advisors, we have a more than 30-year legacy in environmental, social and governance (ESG) investing. As an extension of our firm-wide commitment to ESG investing, we have developed a series of educational modules to guide you on how to incorporate ESG considerations and build sustainability across your investment portfolios.

State Street Global Advisors is a signatory of the United Nations Principles for Responsible Investment (UN PRI), and therefore we have developed these modules to align with the guidance offered by the UN PRI.

The goals of this education series are to:

- Introduce investors to the practice of incorporating ESG factors into investment decisions
- Discuss common approaches to ESG investing and manager selection
- Provide access to additional resources for further research

This first module provides an overview of the reasons to incorporate ESG considerations into your investment decisions.

What Is ESG Investing?

The question of defining 'ESG investing' sounds simple; however, a Google search pulls up several million results from countless sources. Here, we will use the definition from The Forum for Sustainable and Responsible Investment (US SIF), which also aligns with the UN PRI.

ESG investing is defined as the practice of incorporating environmental, social and governance (ESG) factors in investment decisions and active ownership (asset stewardship). At State Street Global Advisors, we further extend this definition to specify that ESG investing is the assessment of **material** environmental, social and governance issues during the investment process. Materiality can be defined as the relevance of a particular ESG measure to a company or sector.

A common point of confusion is the number of terms used synonymously in referring to ESG investing, such as *responsible investing, socially responsible investing, sustainable investing and impact investing*. Often these terms are used interchangeably, which can fuel more confusion.

The chart below shows some common ESG factors.

Environmental	Social	Governance
Green building/ Smart growth	Executive compensation	Corporate political contributions
Climate change/ Carbon emissions	Human rights	Executive compensation
Clean technology	Harmful products	Board diversity
Pollution/Toxics	Community development	Anti-corruption policies
Sustainable natural resources/Agriculture	Diversity & anti-bias issues	Board independence
Water use & Conservation	Workplace benefits	
	Labor relations	

Source: US SIF Foundation, State Street Global Advisors.

Another good source of information on materiality of ESG issues is the Sustainability Accounting Standards Board's (SASB's) materiality map. More information on this can be found **here**.

Does ESG Matter?

Should investors really care about ESG issues? We argue that they should and that failure to address ESG risks and opportunities could negatively affect you and the long-term risk and return of your portfolio.

ESG investing is much wider than values-driven investing. It is based on the understanding that material ESG factors play a substantial role in long-term value creation. Several academic studies have examined the link between ESG factors and performance. One large meta-study found that around 90% of academic studies identify a non-negative relationship between ESG and corporate financial performance, with the large majority of studies reporting positive findings.[1] Another meta-study concluded that "ESG factors are correlated with superior risk-adjusted returns at a securities level."[2]

Here are a few "real world" examples of how ESG issues can impact a company's strategy and operations, with potentially negative financial and/or reputational implications.

ESG matters if you believe that:

- Pharmaceutical companies should maintain responsible selling practices, given the opioid crisis and regulatory concerns.
- Car companies should have a strategy for managing fleet fuel economy, emissions reductions and passenger safety.
- Airlines should ensure that their aircraft are fitted with all safety features available at the time they go to market.
- Social media platforms need to be aware of and held accountable for risks related to data protection and consumer privacy.
- Children's toy companies need to ensure that they mitigate hazards associated with chemicals in their products.

Aside from the ethical implications, failure to address these issues could have catastrophic effects on a company's financial health, growth potential and ability to maintain compliance with governance principles and applicable laws.

Factors Driving ESG Adoption

We believe there are four primary reasons why investors are increasingly considering ESG factors in their investment decisions:

1. Financial Relevance of Material ESG Factors	2. Significantly Increased & Improved ESG Data	3. Regulation & Legislation	4. Greater Transparency of ESG & Climate Risks
Research suggests that incorporating material ESG factors alongside traditional financial metrics improves returns over the long term.	ESG data quality and availability have increased exponentially over the past few years, as have the number of companies reporting on ESG metrics. Currently more than 150 public and private organizations publish ESG data.	The European Union continues to implement new regulations specifically addressing ESG risks. Such regulations are expected to be adopted globally, as ESG factors become increasingly relevant from a fiduciary perspective.	Details behind avoidable corporate ESG incidents are becoming more visible and continue to impact profitability. Climate change risks are also gaining greater publicity.

1 "ESG and financial performance: aggregated evidence from more than 2000 empirical studies," Friede, Busch & Bassen, *Journal of Sustainable Finance & Investment* (2015).
2 "Sustainable Investing: Establishing Long-Term Value and Performance," Fulton, Kahn & Sharples, Deutsche Bank Group (2013).

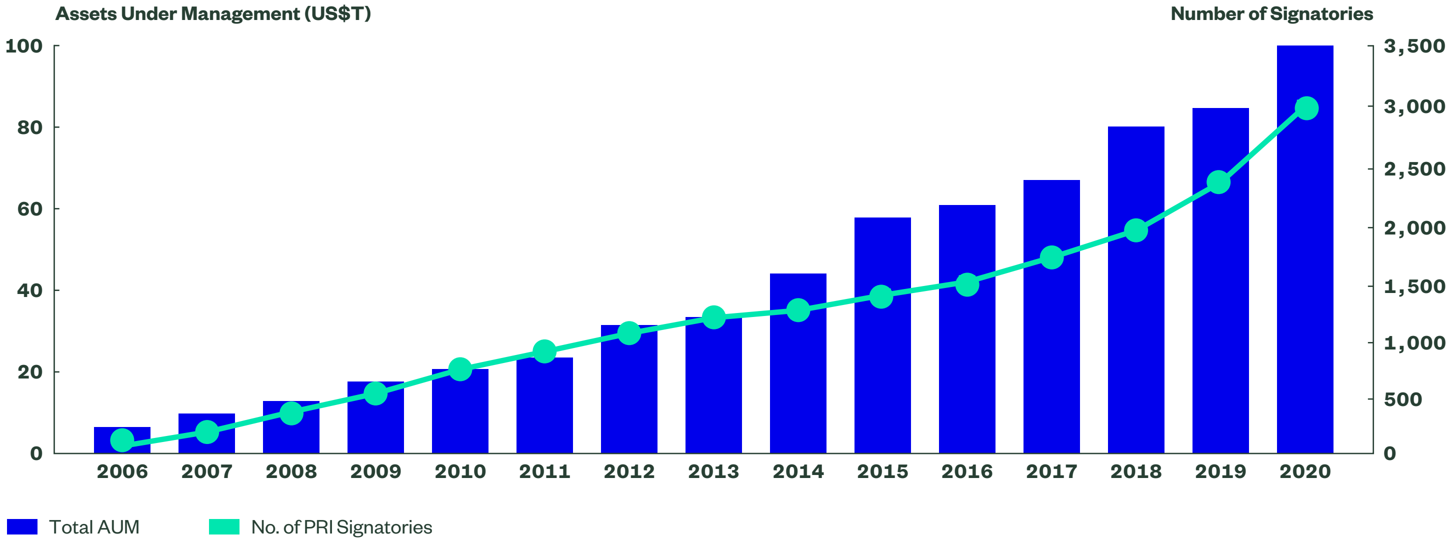
Growth of ESG Strategies

Together, these four drivers have resulted in rapid growth in investor adoption of ESG strategies globally.

As the chart below shows, the number of signatories to the UN-backed PRI has grown from 100 in 2006 to 2,900 in 2020. Those signatories represent a total of US$103 trillion in assets under management.

PRI signatories are required to publicly report on their responsible investment activity through the PRI's Reporting Framework, and failure to do so will result in delisting.

Figure 1
Global ESG AUM as Reported by UN PRI Signatories



Source: UN PRI, State Street Global Advisors as of March 2020.

More broadly, the value of global assets applying ESG data to drive investment decisions reached $40.5 trillion in 2020, a value that has almost doubled since 2016 and more than tripled since 2012.[3]

Common Methods of ESG Incorporation

Some of the most common methods that investors can use to incorporate ESG considerations into their investment process, along with the benefits and risks of each method, are shown in the chart on the next page. These approaches can be used in isolation or can be combined in a single investment strategy. For example, you can use an exclusionary approach to screen out investments in tobacco companies, while also investing in a specific theme like climate change mitigation.

3 Opimas, 2020.

Exclusion/ Negative Screening	Positive/Best-in-Class	ESG Integration	Thematic	Impact
The exclusion of specific companies, sectors or countries based on ESG factors and/or to comply with values-based ideals	Investment in sectors, companies and countries selected for superior ESG performance relative to universe or industry peers	Systematic and explicit inclusion of material ESG metrics into traditional investment analysis and decision-making process	Investing in specific ESG themes, such as climate/ carbon, health products and human rights	Targeted investments aimed at specific social and/or environmental concerns, most often with measurable aspects
Benefits • Mitigates reputational risk • Values-based ideals	**Benefits** • Strong belief that ESG leaders will outperform in the long term	**Benefits** • Better informed investment decisions • No impact to investment universe	**Benefits** • Focused ESG investment aligned with thematic convictions • Measurable impact	**Benefits** • Targeted investments aligned with convictions • Measurable impact • Potential local impact
Risks • Limits eligible investment universe • ESG impact open to debate	**Risks** • Limits eligible investment universe	**Risks** • Credibility of investment approach/methodology	**Risks** • Restricted investment universe • Hype effect and speculative activity	**Risks** • Uncertain/volatile financial return • Often illiquid

Source: UN PRI, Eurosif, State Street Global Advisors.

Exclusionary (Negative) Screening was the first ESG investing approach, and it is still the most common. This method excludes specific companies, sectors or countries based on ESG factors and/or an investor's values-based ideals. The benefits of this strategy include mitigating reputational risk and helping to ensure that investors do not allocate funds to companies or sectors that directly conflict with their beliefs. Examples include religious investors who exclude investment in "sinstocks" based on involvement in certain business activity areas, or investors aligned with initiatives such as the United Nations Global Compact (UNGC), which exclude companies and/or sectors in violation of the UNGC principles.

This is often the approach that investors first implement when accounting for ESG considerations in their portfolios. Using this method, ESG indexes based on broad market indexes can be created.

Positive/Best-in-Class is an ESG investment approach that focuses on investment in sectors, companies and countries that have superior ESG performance relative to the universe or industry peers. This method is gaining attention because of the increasing availability of ESG data and research showing that companies with high ESG scores tend to outperform companies with low ESG scores in the long term.

ESG Integration is the systematic and explicit inclusion of material ESG metrics into the investment analysis and decision-making process. This is a more systematic investment approach than an overlay.

Thematic Investing is investing in line with specific ESG themes, such as those encompassed by the United Nations Sustainable Development Goals (UN SDGs), including climate change and carbon emissions reduction, health care, diversity or human rights. These strategies often have specific metrics that they hope to achieve. A common objective is investing in a way that aligns with the Paris Climate Agreement, which sets out a global framework to avoid catastrophic climate change by limiting global warming to well below 2°C and pursuing efforts to limit it to 1.5°C.

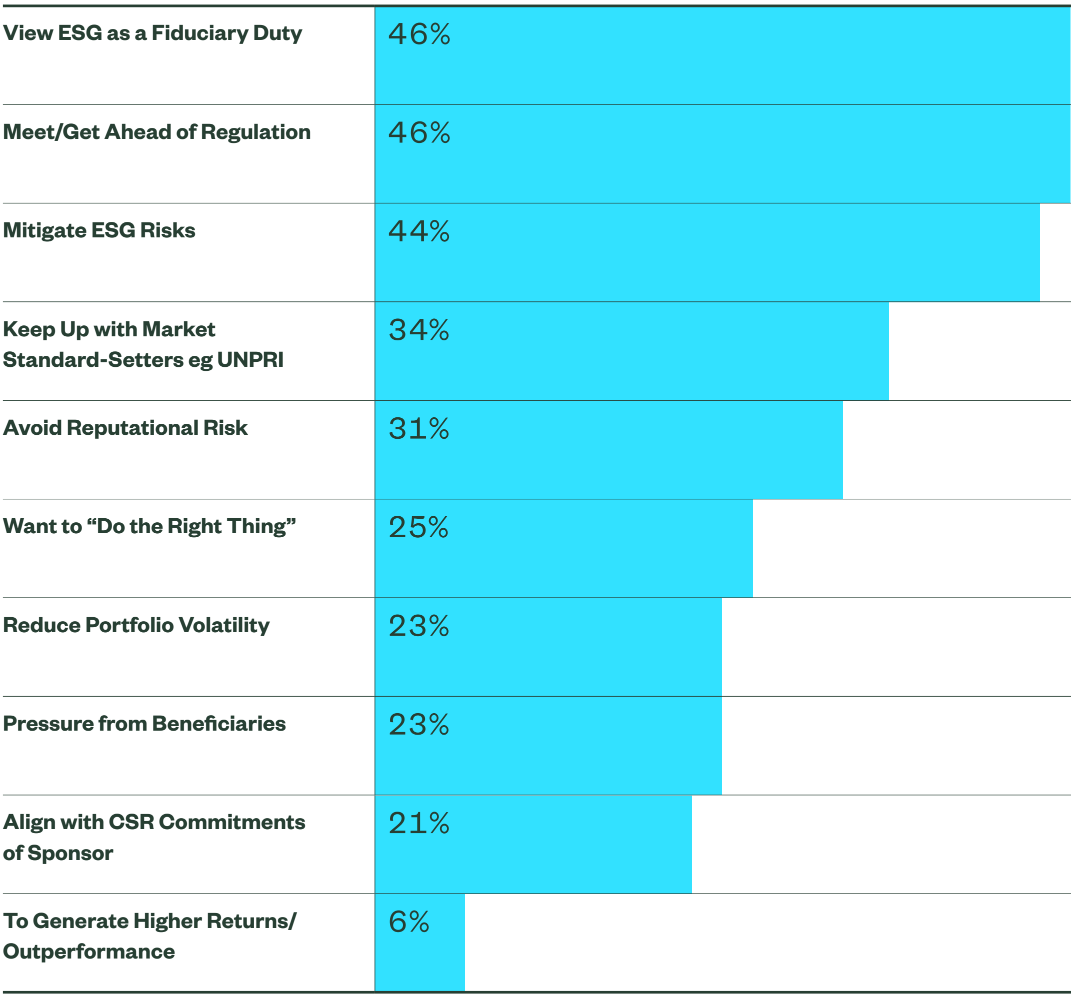
Impact Investing typically targets investments that are aimed at specific social and/or environmental issues. These investments often prioritize "impact" objectives over or at par with return/performance objectives, and reflect specific targeted and measurable outcomes. Examples are funds that invest in renewable energy, conservation or improving access to affordable health care and education.

These methods are not necessarily mutually exclusive. They can, where feasible, be combined to achieve an investor's overall investment goals and objectives.

Asset Owner Insights
A Regional Perspective

The following chart is taken from our “**Into the Mainstream**” survey of 300 institutional investors completed in November 2019. The survey responses below show the state of ESG adoption across North America, Europe and the Asia-Pacific region combined.

Figure 2
State Street Global Advisors Survey of Asset Owners
Factors Leading to ESG Adoption Globally



Source: State Street Global Advisors: “Into the Mainstream ESG at the Tipping Point”, Survey respondents reflected pension funds 78%, foundations 11%, endowment funds 6%, SWFs 5%; regions represented North America 40%, Europe 40%, APAC 20%; AUM represents <$1B 29%, $1B–$10B 43%, $10B–$20B 15%, $20B+ 14%.

In a survey we commissioned of over 5,000 individual investors, a high proportion of millennial (age 23–38) investors (82%) indicated that they always or sometimes consider a company’s social, political or environmental impact in their decision to invest or not in ESG. Almost 70% of Gen X (age 39–54) indicated that a company’s social, political or environmental impact always or sometimes influences their decision to invest or not.

Furthermore, adoption of ESG investing and asset growth has accelerated, with younger investors, in particular, planning to increase their allocation to ESG investments.

Challenges Incorporating ESG

Navigating through your ESG journey will be rewarding on many levels; however, most investors will inevitably face internal and external obstacles.

In the following graphic, we illustrate some common challenges you are likely to face, along with suggestions on how to mitigate these challenges as you develop an ESG investment approach.

	Risk/Return	Terminology	Data	Knowledge Gap
Common Challenges	Many investors remain skeptical about the correlation between ESG and financial performance, despite research showing that ESG has either a non-negative or positive impact on performance.	Even experts in the field of ESG can be confused by the variations in terminology, as there is not one universally accepted set of responsible investing definitions or standards	The availability of ESG data has increased significantly over the past few years. Currently, there are more than 150 different providers offering ESG metrics. However, the lack of industry standards, limited historical data and lack of transparency make selecting data providers challenging	Lack of ESG knowledge or understanding to assess ESG managers and develop investment strategies related to ESG integration
How to Mitigate Common Challenges	• Do your research, as there is growing, clear and compelling research suggesting a correlation between ESG and corporate financial performance	• Adopt ESG terminology from suggested standards provided by industry-leading organizations, such as the PRI, SASB and others	• Select a data framework that provides transparency around materiality • Consider using multiple data sources • Fully understand ESG scoring methodologies	• Leverage external advisors, such as consultants, and asset managers, and information sources from the PRI and other ESG organizations

Source: State Street Global Advisors.

The scale of the challenges will be closely related to your ESG goals and objectives. Module 2 in this series will provide guidance on how you can develop your own set of relevant and meaningful ESG goals and objectives. This will include advice on how to craft an ESG investment strategy that is both comprehensive and relevant to your portfolios.

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- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 31 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $3.47 trillion* under our care.

* This figure is presented as of December 31, 2020 and includes approximately $75.17 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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The returns on a portfolio of securities which exclude companies that do not meet the portfolio's specified ESG criteria may trail the returns on a portfolio of securities which include such companies. A portfolio's ESG criteria may result in the portfolio investing in industry sectors or securities which underperform the market as a whole.

Responsible-Factor (R-Factor™) scoring is designed by State Street to reflect certain ESG characteristics and does not represent investment performance. Results generated out of the scoring model are based on sustainability and corporate governance dimensions of a scored entity.

Equity securities may fluctuate in value and can decline significantly in response to the activities of individual companies and general market and economic conditions.

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