

An Integrated Approach to ESG and Quality

- ESG factors are key considerations in evaluating a company's quality and sustainable growth prospects.
- State Street's Fundamental Growth and Core (FGC) Equity team has a long history of integrating ESG concepts into its fundamental analysis of companies.
- We incorporate ESG considerations into the quality assessment of a company using a proprietary metric called the Confidence Quotient (CQ), based on our belief that companies that are strong in ESG are more likely to deliver the sustainable growth we seek.

In the past, environmental, social and governance (ESG) considerations were often used as overlays in existing portfolios, i.e., as screening tools rather than as an integrated component of the investment process. The last decade has seen a shift by asset managers toward incorporating ESG concepts into their investment philosophies, with the aim of enhancing alpha generation and risk mitigation.

While some investment managers are just waking up to the idea of incorporating ESG into their investment process to meet client needs, State Street's Fundamental Growth and Core (FGC) Equity team has a long history of integrating ESG concepts into its fundamental analysis of companies.

Our team and investment philosophy are united by a common belief — that quality companies with sustainable growth at attractive valuations can drive above-average, long-term investment returns. We incorporate ESG considerations into the quality assessment of a company using a proprietary metric called the Confidence Quotient (CQ), based on our belief that companies that are strong in ESG are more likely to deliver the sustainable growth we seek. ESG considerations are therefore integral to our alpha thesis and are not merely an overlay in the process.

The FGC team is focused on sustainability in every sense of the word. “Sustainable growth” refers to the durability of a company’s competitive advantage over the long term. The team firmly believes that companies with superior ESG practices that are material to their business are better positioned for sustainable growth over the long run. Having access to R-Factor™ — State Street’s transparent scoring model built on best-in-class data about financially material sustainability factors — as well as our firm’s industry-leading insights about asset stewardship, have strengthened the team’s effort to incorporate ESG into our investment process.

Our mission is to invest responsibly to enable economic prosperity and social progress.

—State Street Global Advisors Mission Statement

Figure 1

Core Strengths of the R-Factor Methodology

What is R-Factor?

A transparent ESG scoring system aligned with SASB designed to address challenges in ESG infrastructure and help build more sustainable capital markets

Financial Materiality (SASB)	Commonly Accepted, Transparent Frameworks	Multiple Data Sources	Strong Stewardship
Scores based on what matters most for business: the ESG issues that have been shown to contribute to long-term sustainable returns ¹	Gives companies a roadmap to improve their ESG performance and score, supported by investors representing \$33T in assets	Powered by multiple data sources to minimize the bias of any one data provider and provide coverage of more companies	Helps build sustainable capital markets by incentivizing companies to enhance ESG disclosure for all investors

¹ Serafeim Khan et al. "Corporate Performance: First Evidence of Materiality." HBR 2017.

Source: State Street Global Advisors. For additional information on R-Factor methodology, see the **R-Factor™ Scoring Model** [whitepaper](#).

The Fundamental Research Process: The Confidence Quotient (CQ) and an Integrated Approach to Measuring Quality

Drawing on our fiduciary heritage, we invest as long-term asset owners. Our bottom-up research process is built on the three pillars of our philosophy: quality, sustainable growth and reasonable valuation. It begins with a screening process that seeks to identify companies that merit further fundamental analysis. The screening process is based upon a quantitative scoring methodology that uses a number of factors, including measures of quality, growth, momentum and valuation.

Our analysts then seek to develop conviction through deep fundamental analysis. Research analysts conduct both quantitative and qualitative analyses. On the quantitative side, analysts develop forward-looking models, which include estimates of cash earnings, yield, growth rates, profitability and price targets. They also produce an estimate of each company’s long-term sustainable growth rate. Valuation is paired with sustainable growth rate to identify companies that are attractive on a growth-at-a-reasonable-price basis.

Qualitative analysis is founded on the FGC team’s proprietary Confidence Quotient framework. CQs allow analysts to quantify key characteristics of a company, such as market position, management strength and overall transparency; a numeric score indicates the analysts’ confidence in the company. CQ is a measure of company quality and an indicator of our conviction in the company’s ability to deliver long-term sustainable growth. Unlike factor definitions of quality, CQ is forward-looking and is based on the deep industry and company knowledge of our team.

We believe that ESG factors are important considerations in evaluating the quality of a company and the sustainability of its growth. We explicitly incorporate ESG factors into the CQ evaluation. This includes assessments of a company’s governance, labor practices and environmental concerns. We believe that strong ESG practices enhance the sustainability of a company’s business model, and such practices would therefore likely raise a company’s CQ score, making that company more attractive in our framework.

Figure 2
**ESG Integration
in Confidence
Quotients**

ESG factors are key considerations in evaluating a company’s quality and sustainable growth prospects.

Management	Management/board diversity Code of conduct/anti-corruption Governance
Market Position	Fair labor standards Environmental track record
Fundamental Momentum	Exposure to environmental/regulatory changes
Financial Condition	Exposure to environmental/regulatory fines
Transparency	Disclosure

Source: State Street Global Advisors.

ESG is not a new addition to the Confidence Quotient. ESG concepts have been integrated in CQ since the framework was developed in 2002, but over time this has evolved and become more formalized. Enhancements to the process have included the incorporation of external sources of ESG information, such as Sustainalytics and, more recently, State Street’s R-Factor, to augment the analysis. In addition, we have increased the rigor of our CQ process by adding additional detailed questions to the CQ scorecards, including questions about specific ESG factors. Finally, we have significantly improved our visibility into ESG issues by using automated data visualization tools (see Figure 3) and detailed R-Factor reports.

Our analysts may disagree with an external source’s view on a company. We want our analysts to apply independent judgment, and this includes the realm of ESG. We are forward-looking and seek to anticipate improvement or deterioration in a company’s prospects, whereas many external sources tend to be backward-looking. We rely on our analysts’ original and independent research to determine the appropriate CQ assessment of a company’s quality, including the ESG evaluation.

Figure 3
ESG Scorecard

Our proprietary ESG dashboard gives a full breakdown of R-Factor (company's name has been removed).

Security Details		ESG Scores					Data As of: 4/30/2020	
		Score	Global Avg	Universe %	Universe Rating	Global Industry Avg	Industry %	Industry Rating
Name	R Factor Score	86.91	50.00	99.50	Leader	49.80	100	Leader
Bloomberg Ticker	ESG Score (90%)	86.26	50.00	–	–	49.91	–	–
SICS Industry	Processed Foods	Corp Gov Score (10%)	63.82	49.55	–	–	48.51	–
	Total Universe Population	7289	–	Total Universe Industry Population		114		

R Factor Sub Scores			
Environment			
Category	Score	Global Ind. Avg	Global Ind. Avg
Energy Management	68.72	50.75	56.81
Wastewater Management	77.74	47.52	53.98
Social Capital			
Category	Score	Global Ind. Avg	Global Ind. Avg
Product Quality Safety	76.32	54.55	62.18
Customer Welfare	63.48	48.16	53.67
Selling Practices Product Labelling	75.42	46.75	49.22
Business Model & Innovation			
Category	Score	Global Ind. Avg	Global Ind. Avg
Product Design Lifecycle Management	74.67	45.26	50.73
Supply Chain Management	65.99	48.60	62.06
Material Sourcing Efficiency	69.42	48.92	60.24

Source: State Street Global Advisors.

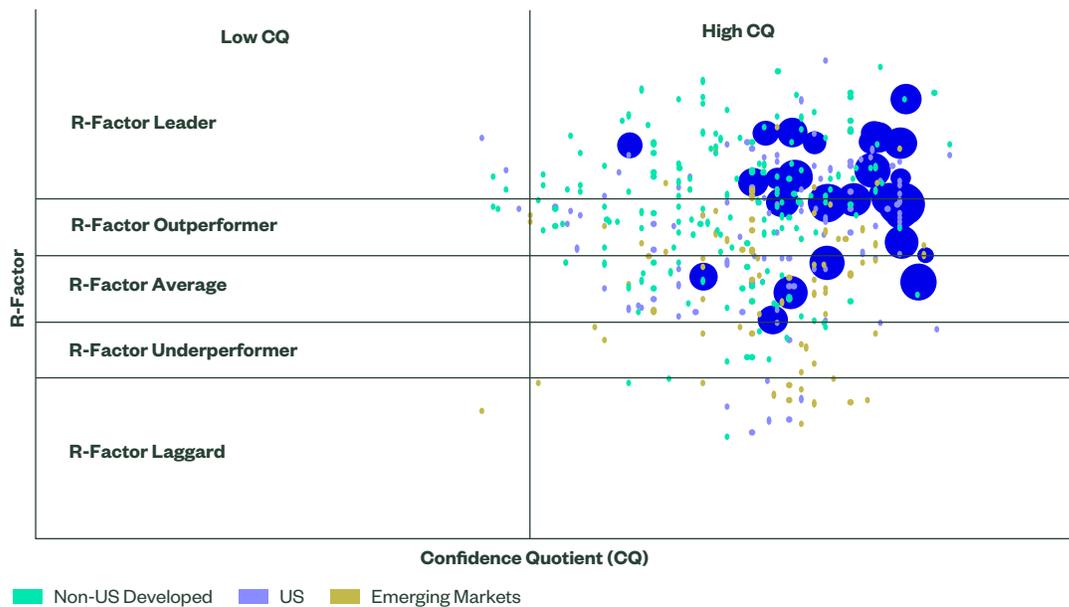
Other than manufacturers of certain controversial weapons, we do not explicitly exclude companies with low ESG performance from consideration unless directed by a client. Instead, we rely on our investment process — focused on quality and sustainable growth — to find attractive investments (which includes attractiveness using an ESG lens). Industries like tobacco are less likely to be attractive because of ESG headwinds, and therefore they are unlikely to exhibit the sustainable growth that we seek. This results in portfolios that have a positive ESG tilt that comes from the natural bias of our investment philosophy.

The R-Factor model assigns a score and a qualitative rating to almost all companies in our universe. Figure 4 shows the relationship between R-Factor scores and CQ scores for companies in our Global Equity Select and Research portfolios. Most of our positions have a strong CQ score and a qualitative R-Factor score of “Outperformer” or “Leader,” which indicates a positive correlation between fundamental quality and ESG. Compared to the market, the Global Equity Select strategy also has a positive ESG tilt as measured by R-Factor (see Figure 5).

ESG considerations are an inherent part of our investment approach because we believe they will improve our assessment of sustainable growth and therefore our alpha generation. As an example of this, in the five years leading up to March 31, 2020, the allocation impact of the ESG tilt shown in Figure 5 accounted for roughly 10 percent of the strategy’s alpha during this time period.

Figure 4
**State Street’s
 Confidence Quotient
 and R-Factor Score
 for Global Equity
 Select Strategy**

Confidence Quotient and R-Factor scores for State Street’s Global Equity Select strategy (bubbles) and research holdings (dots) demonstrate a tilt toward both high CQ and high R-Factor scores. (Bubble size represents amount of overweight versus the MSCI All Country World Index).



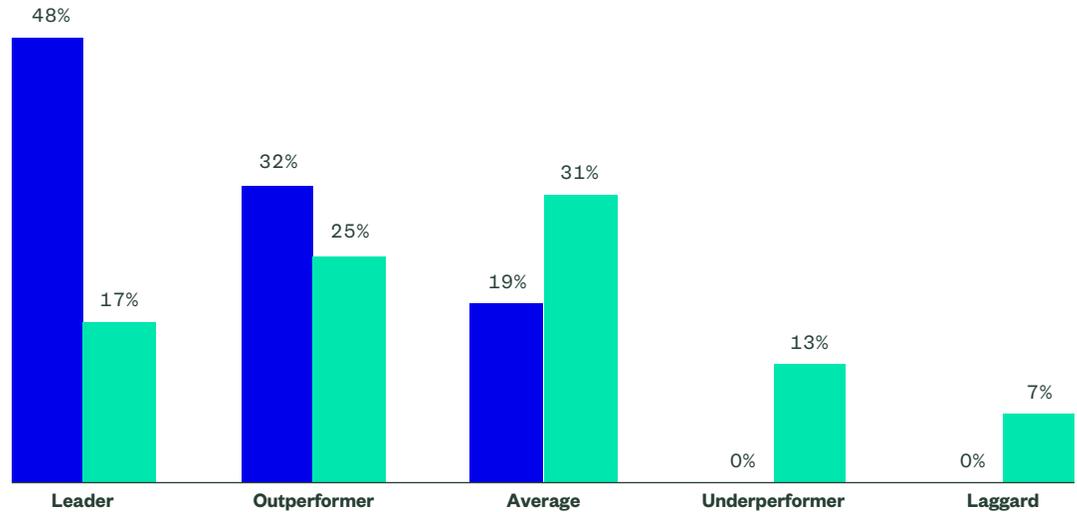
Source: State Street Global Advisors.

Figure 5

State Street Global Equity Select vs. MSCI All Country World Index R-Factor Exposure

■ Global Equity Select
■ MSCI ACWI

R-Factor exposure of State Street’s Global Equity Select strategy versus R-Factor exposure of the MSCI All Country Index:



Source: State Street Global Advisors.

Note: Total does not sum to 100% for MSCI ACWI because of 6% unclassified securities.

One example demonstrating ESG integration is a U.S.-based manufacturer of heating, ventilation and air-conditioning (HVAC) equipment that was held in State Street’s US Equity Select and Global Equity Select Strategies as of March 31, 2020. The company is rated as a “Leader” in the R-Factor framework. It is a longtime leader in HVAC product innovation, with a focus on advancements in sustainability. The company is committed to reducing its customers’ carbon emissions by changing the way the world heats and cools buildings and moves refrigerated food, medicines and other perishables. It is strong in ESG both in its core mission as well as its adherence to ESG precepts such as governance and disclosures. In our framework, it has a high CQ, reflecting its ESG strength and strong management and market position.

Portfolio Company Engagement

The FGC team has developed synergies with State Street Global Advisors’ broader ESG efforts. Not only do we incorporate ESG considerations into our fundamental analysis, but we also work closely with the firm’s Asset Stewardship team to engage with companies. As one of the largest asset managers in the world, State Street Global Advisors engages with companies regularly, and we leverage State Street Global Advisors’ scale and breadth in the marketplace to provide our analysts with access to company management. In the same vein, the FGC team’s analysts serve as a resource to the Asset Stewardship team, providing comprehensive insight on company engagements to inform action. As State Street Global Advisors continues to strengthen its position as an industry leader in ESG topics, companies seek our input to improve their efforts in responsible and sustainable best practices.

A recent example of engagement on ESG issues took place during a large takeover bid between two companies that the FGC team held active positions in (and which SSGA broadly was a large shareholder of). State Street's prominence as a shareholder is an advantage of our scale. In this case, we had rare access to top management and the boards of both companies. We had multiple conference calls with the chief executive officers and lead directors. Also, because the takeover company was looking to nominate six new board members to form a majority on the other company's board, we were able to host a meeting in our offices that included the takeover company's chief executive officer, chief financial officer, four of the six board nominees in person, and one board nominee on the phone. This access enabled us to properly score each company from a governance perspective, as well as to assess and develop much deeper conviction about the relative strengths and weaknesses of each company's management teams and strategies. This ultimately informed our decision about whether to continue to hold each stock through the merger process and beyond.

Conclusion

A core value of the Fundamental Growth and Core team is what we call a fiduciary mindset. Our heritage, which spans decades, began as the fiduciary for a large pension plan. From those roots, we have developed an approach to investing founded on basic tenets that include a strict adherence to compliance, strong risk-awareness, a focus on company quality, and a long-term perspective that requires process discipline. At its core, ESG is about long-term sustainability and is therefore integral to our fiduciary mindset. From the beginning, ESG concepts have been embedded in our investment approach's assessment of company quality, and we believe that ESG principles are a key driver of long-term sustainable growth. We take an ESG-integrated approach not just because it's the right thing to do but also because it's an intrinsic part of our investment philosophy, which we firmly believe will lead to higher alpha.

Related Resources

To learn more about our Fundamental Growth and Core Equity or ESG Solutions, please contact your State Street Global Advisors Relationship Manager at SSGAINstitutional@ssga.com.

Additional information regarding State Street Global Advisors ESG investment approach can be found on our website at ssga.com/esg.

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* AUM reflects approximately \$50.01 billion USD (as of March 31, 2020), 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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