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Growing Adoption Driving Surge in ESG Investing

Like Other Investors
Globally, Australian
Investors Have
Increasingly Embraced
ESG Investing

Incorporating ESG Considerations in Australian Equities: A Strategic View

- The S&P/ASX 200 ESG Index,¹ which applies exclusions and targets the strongest ESG companies, historically achieved around a 5% ESG improvement compared to the S&P/ASX 200 Index, the institutional benchmark of choice for Australian equities.
- The risk-return profile of the ESG-enhanced index is similar to that of the broad-based S&P/ASX 200 Index.
- The ESG-enhanced index can be used as a strategic allocation in investment portfolios, especially for investors targeting Australian equities with an improved ESG profile.

In recent years, there **has been increasing awareness of and interest in environmental, social and governance (ESG) investments. Inflows have skyrocketed globally** (see Figure 1), with assets under management incorporating key ESG elements now exceeding US \$175 billion.² This trend is mirrored in the Australian market with ESG exchange traded products growing 76% p.a. over the last 3 years from \$325 million to \$1.8 billion.³ With increased demand for ESG products, the number of approaches to selecting companies with the strongest ESG profile has also risen. The two most widely adopted approaches to incorporating ESG are:

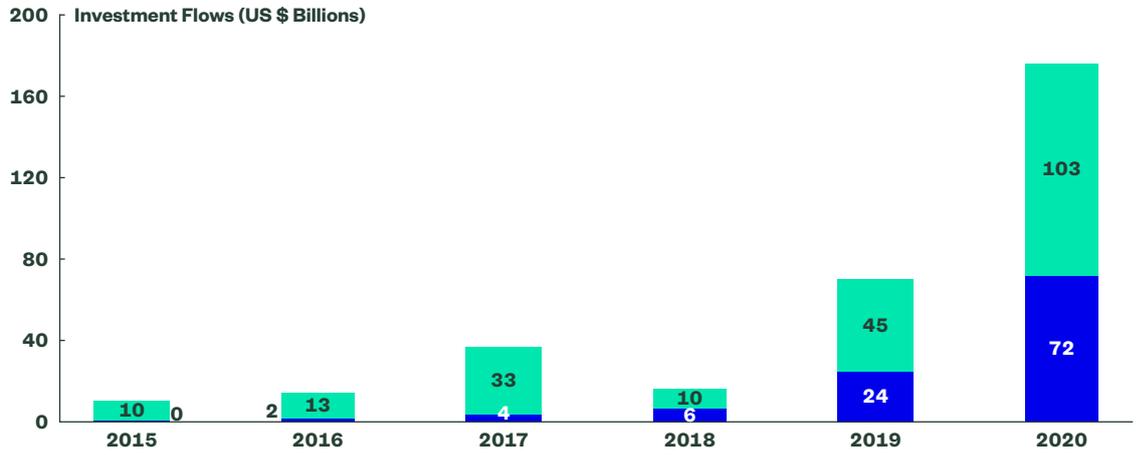
- **Best-in-Class*/Positive Screening:** Investment approach that is primarily designed to emphasise firms with more positive ESG traits relative to peers based on certain levels of ESG criteria.
- **Exclusionary:** Investment approach that is primarily designed to exclude companies based on specific ESG criteria.

Amid the growing interest in ESG, investors have asked how these building blocks can be incorporated in investment portfolios. To this end, we analyse the differences between the **S&P/ASX 200 ESG Index, a hybrid strategy that applies exclusions and selects the strongest ESG companies while maintaining a broadly similar risk-return profile as the S&P/ASX 200 Index.**

* "Best-in-class" is an industry term referring to an investment approach that selects companies with high ESG scores relative to their industry/sector peers.

Figure 1
Global Flows into ESG Investment Products

ETF
 Managed Funds

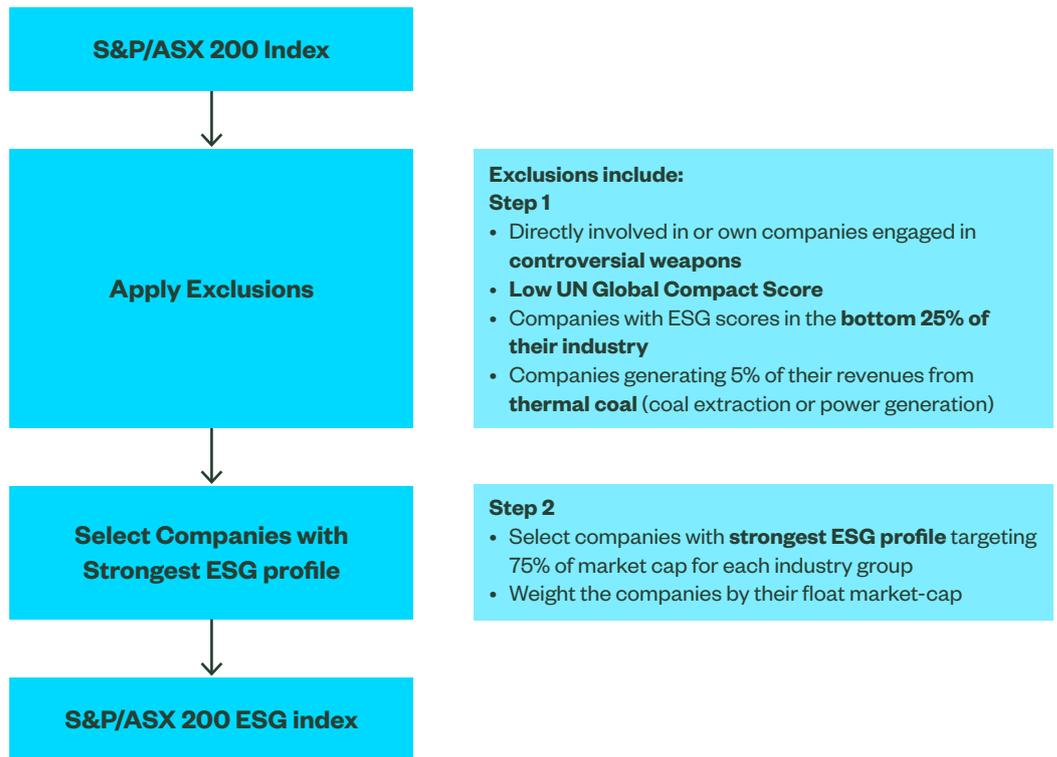


Source: State Street Global Advisors, Morningstar, as of December 2020.

The S&P/ASX 200 ESG Index Methodology

The S&P/ASX 200 ESG Index starts off by applying exclusions to the broad-based S&P/ASX 200 Index, removing companies that have low UN Global Compact scores and low ESG scores,⁴ as well as companies involved in tobacco, controversial weapons and thermal coal.⁵ The index selects companies with the strongest ESG profile within the S&P/ASX 200 Index based on S&P Dow Jones Indices ESG Scores while targeting 75% of market capitalisation for each industry group (see Figure 2 for more details). The final selection of companies that are eligible for the S&P/ASX 200 ESG Index are then weighted by their corresponding float market-capitalisation.

Figure 2
Stock Selection Process of the S&P/ASX 200 ESG Index



Source: State Street Global Advisors, S&P Dow Jones Indices, as of December 2020.

The S&P ASX/200 ESG Index Applies Certain Values-based Exclusions and Targets the Companies with Strongest ESG

The S&P/ASX 200 ESG Index can form part of a strategic (core) allocation within investment portfolios as it **has a stronger ESG profile than the S&P/ASX 200 Index, while maintaining a fairly similar risk-return profile**. In addition, incorporating the S&P/ASX 200 ESG Index in portfolios can improve the ESG profile and mitigate certain risks and drawdowns.

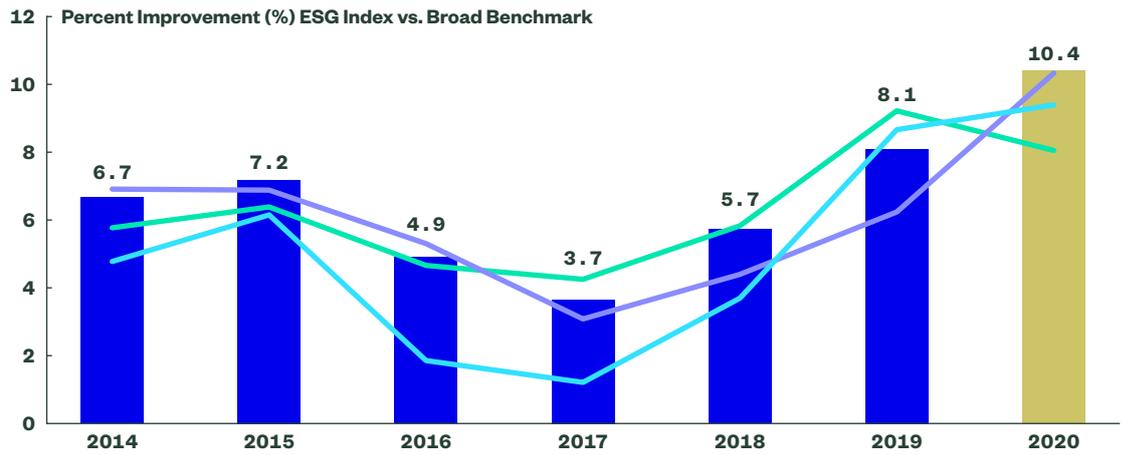
Enhanced ESG Profile

The ESG score⁶ of the S&P/ASX 200 ESG Index was 5–6% higher than that of the broad-based benchmark on average (see Figure 3) and this result is consistent for each of the six years we analysed. **More interesting still is the fact that the S&P/ASX 200 ESG Index had a consistently stronger individual E, S and G profile than the benchmark** for the entire study period.

Figure 3

Average Yearly ESG Improvement

Consistent improvement in the overall ESG profile as well as in each of the individual pillars of E, S, and G



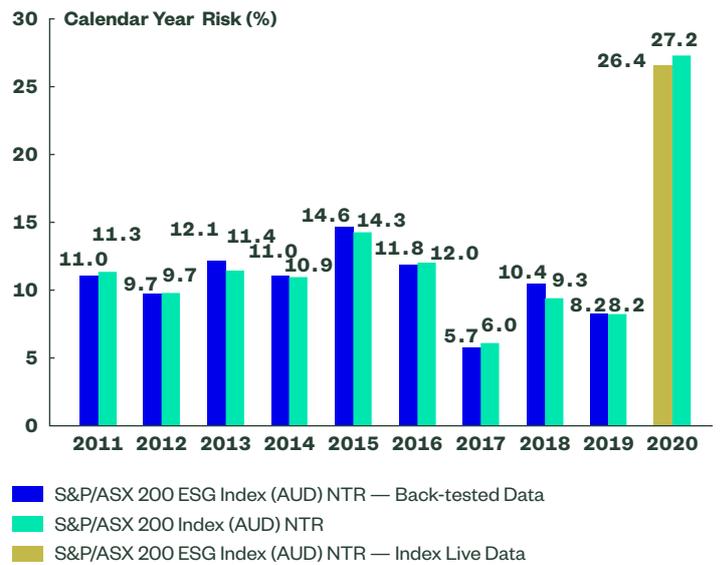
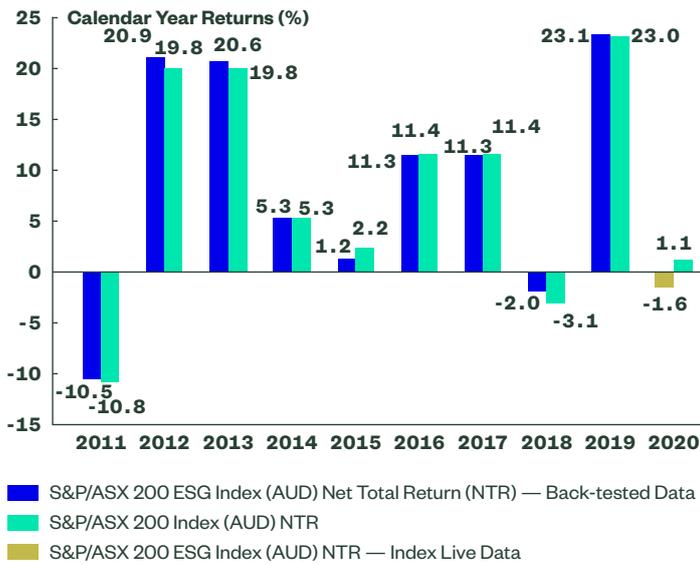
Source: State Street Global Advisors, S&P, data from 2014 to 2020. Scores are averaged on a semi-annual basis. This chart looks at the S&P/ASX 200 ESG Index (ESG Index) vs the S&P/ASX 200 Index (Broad Benchmark). **Pre-Inception Index Performance shown above is Back-Tested.** The S&P/ASX 200 ESG Index was launched by S&P on 6 July 2020. All information for an index prior to its launch date is hypothetical back-tested data calculated by S&P based on the index methodology in effect on the Launch Date. Market indices are unmanaged and are not subject to fees and expenses which could lower returns. Index performance is not intended to represent the performance of any particular product managed by SSGA. Actual performance may differ substantially from the back-tested performance presented, as the performance was calculated with the benefit of hindsight, cannot account for all financial risk that may affect the actual performance, and is not a guarantee of future results. The Back-Tested Pre-Inception Index Performance data is reported on a gross of fees basis. You cannot invest directly in an index. The performance includes the reinvestment of dividends and other corporate earnings and is calculated in AUD.

Comparable Return Profile

Over the entire study period, the S&P/ASX 200 ESG Index had a similar return profile to the S&P/ASX 200 Index (see Figure 5). This was also the case when we examined the returns on a calendar-year basis, which is very much in line with one of the stated objectives of the index.⁷

Figure 4

Calendar Year Returns of S&P/ASX 200 ESG Index vs. S&P/ASX 200 Index



Source: Bloomberg Finance L.P., State Street Global Advisors. Monthly Returns data from January 2011 to December 2020. **Pre-Inception Index Performance shown above is Back-Tested.** The S&P/ASX 200 ESG Index was launched by S&P on 6 July 2020. All information for an index prior to its launch date is hypothetical back-tested data calculated by S&P based on the index methodology in effect on the Launch Date. Market indices are unmanaged and are not subject to fees and expenses which could lower returns. Index performance is not intended to represent the performance of any particular product managed by SSGA. Actual performance may differ substantially from the back-tested performance presented, as the performance was calculated with the benefit of hindsight, cannot account for all financial risk that may affect the actual performance, and is not a guarantee of future results. The Back-Tested Pre-Inception Index Performance data is reported on a gross of fees basis. You cannot invest directly in an index. The performance includes the reinvestment of dividends and other corporate earnings and is calculated in AUD.

Evidence of Some Drawdown Mitigation

Over the entire study period, the S&P/ASX 200 ESG Index had slightly lower volatility than the broad-based benchmark and, in six out of the ten calendar years we studied, the S&P/ASX 200 ESG Index incurred slightly lower risk, too. In the worst two drawdowns during the analysis period, the S&P/ASX 200 ESG Index also had a slightly lower drawdown. Taken together, these results may suggest that the S&P/ASX 200 ESG Index offered a degree of drawdown mitigation.

Figure 5

Full Period Risk and Return Metrics of S&P/ASX 200 ESG Index vs. S&P/ASX 200 Index

| | S&P/ASX 200 ESG Index (AUD) NTR | S&P/ASX 200 Index (AUD) NTR |
|--|---------------------------------|-----------------------------|
| Return | | |
| Annual Return | 7.43 | 7.53 |
| Risk | | |
| Annual Volatility | 13.60% | 13.62% |
| Maximum Drawdown | -26.68% | -26.80% |
| Ratio | | |
| Return per unit Risk | 0.55 | 0.55 |
| Market Beta | | |
| Market Beta | 0.99 | — |
| Drawdown Statistics Based on the 60 Equity — 40 Fixed Income Drawdown Dates (%) | | |
| Jan 2020 to March 2020 (COVID-19) | -26.68% | -26.80% |
| March 2011 to September 2011 (Second Largest Drawdown) | -15.20% | -15.29% |

Source: Bloomberg Finance L.P., State Street Global Advisors. Monthly Returns data from January 2011 to December 2020. **Pre-Inception Index Performance shown above is Back-Tested.** The S&P/ASX 200 ESG Index was launched by S&P on 6 July 2020. All information for an index prior to its launch date is hypothetical back-tested data calculated by S&P based on the index methodology in effect on the Launch Date. Market indices are unmanaged and are not subject to fees and expenses which could lower returns. Index performance is not intended to represent the performance of any particular product managed by SSGA. Actual performance may differ substantially from the back-tested performance presented, as the performance was calculated with the benefit of hindsight, cannot account for all financial risk that may affect the actual performance, and is not a guarantee of future results. The Back-Tested Pre-Inception Index Performance data is reported on a gross of fees basis. You cannot invest directly in an index. The performance includes the reinvestment of dividends and other corporate earnings and is calculated in AUD.

Risk Attribution and Sector Biases Analysis of the S&P/ASX 200 ESG Index vs. the S&P/ASX 200 Index

The Tracking Error Between S&P/ASX 200 ESG and S&P/ASX 200 Suggests That the Company ESG Scores May Have a Material Impact on Stock Selection

We also conducted a risk attribution analysis of the S&P/ASX 200 ESG Index against its benchmark in order to understand the sources of tracking error. Tracking error is a benchmark-relative (active) risk that indicates by how much the S&P/ASX 200 ESG Index moves away from the broad-based S&P/ASX 200 Index. The aim of this analysis is so that we understand the source of the tracking error between the S&P/ASX 200 ESG Index and S&P/ASX 200 Index and the reason why it has occurred. This is particularly useful when investors would like to appreciate the drivers of risk and return of the S&P/ASX 200 ESG Index against the S&P/ASX 200 Index.

As Figure 6 shows, a substantial amount of the tracking error came from selection risk; that is, risk that cannot be attributed to any systematic factors⁸ (such as industry risk, broad equity market risk, smart beta risks). **This suggests that the stock selection process on the basis of ESG criteria, as described in Figure 2, could have led to higher selection risk** and implies that ESG may be relevant in determining the outcome and the risk-return profile of the ESG-enhanced index versus the benchmark.

The second largest source of tracking error comes from industry. This means that the sector weights in the ESG index deviate from those in the broad-based benchmark. Figure 7 shows that, although sector differences were modest for most of the sectors, the S&P/ASX 200 ESG Index tended to have a higher underweight in the financial sector and, in particular, banks. Among overweight sectors, the two largest are health care and consumer staples, although these overweights are small.

Figure 6

**Tracking Error
Contribution Analysis of
S&P/ASX 200 ESG Index
vs. S&P/ASX 200 Index**

| Factors | S&P/ASX 200 ESG Index vs. S&P/ASX 200 Index |
|-------------------------------|---|
| Market | 0.04 |
| Style | 0.25 |
| Industry | 0.54 |
| Selection Risk | 1.64 |
| Currency Risk | 0.02 |
| Tracking Error (Total) | 2.47 |

Source: MSCI Barra, as of December 2020. **Pre-Inception Index Performance shown above is Back-Tested.** The S&P/ASX 200 ESG Index was launched by S&P on 6 July 2020. All information for an index prior to its launch date is hypothetical back-tested data calculated by S&P based on the index methodology in effect on the Launch Date. Market indices are unmanaged and are not subject to fees and expenses which could lower returns. Index performance is not intended to represent the performance of any particular product managed by SSGA. Actual performance may differ substantially from the back-tested performance presented, as the performance was calculated with the benefit of hindsight, cannot account for all financial risk that may affect the actual performance, and is not a guarantee of future results. The Back-Tested Pre-Inception Index Performance data is reported on a gross of fees basis. You cannot invest directly in an index. The performance includes the reinvestment of dividends and other corporate earnings and is calculated in AUD.

Figure 7

**Sector Biases Between
2010 and 2020 (S&P/ASX
200 ESG Index vs. S&P/
ASX 200 Index)**

| Year | 2010 (%) | 2011 (%) | 2012 (%) | 2013 (%) | 2014 (%) | 2015 (%) | 2016 (%) | 2017 (%) | 2018 (%) | 2019 (%) | 2020 (%) | Average (%) |
|------------------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|-------------|
| Health Care | 0.5 | 0.1 | 0.1 | 0.6 | 0.5 | 0.9 | 1.2 | 1.7 | 1.7 | 2.4 | 3.2 | 1.2 |
| Consumer Staples | 2.2 | 2.2 | 2.0 | 2.1 | 2.3 | 2.2 | 1.8 | -1.0 | -2.6 | 0.0 | 1.2 | 1.1 |
| Financials | -0.4 | -1.1 | -3.3 | -3.3 | -4.3 | -3.7 | -3.9 | -3.8 | -2.6 | -3.3 | -3.4 | -3.0 |
| Information Technology | 0.0 | -0.1 | -0.1 | -0.2 | -0.1 | 0.0 | -0.2 | -0.3 | 0.1 | -0.2 | -0.6 | -0.1 |
| Industrials | -0.7 | -1.4 | -0.3 | -0.4 | 0.6 | -0.2 | 0.1 | 0.3 | 0.2 | 0.0 | 0.0 | -0.2 |
| Utilities | -0.2 | 0.0 | 0.1 | 0.0 | 0.0 | 0.2 | -0.1 | 0.4 | 0.2 | 0.4 | -0.2 | 0.1 |
| Materials | -1.4 | -0.1 | 0.9 | 1.1 | 0.5 | -0.8 | -0.1 | 0.4 | 1.1 | 0.7 | -1.8 | 0.1 |
| Consumer Discretionary | -1.0 | -1.2 | -0.7 | -1.7 | -0.6 | -0.3 | -0.2 | 0.5 | 0.9 | -0.9 | 0.9 | -0.4 |
| Communication Services | 0.7 | 1.2 | 1.3 | 1.3 | 1.4 | 1.6 | 1.1 | 0.8 | 0.4 | 0.5 | 0.1 | 0.9 |
| Energy | 0.3 | 0.4 | -0.1 | 0.4 | -0.3 | 0.2 | 0.3 | -0.2 | 0.6 | 0.1 | 0.3 | 0.2 |
| Real Estate | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 1.1 | 0.0 | 0.3 | 0.1 | 0.1 |

Source: Bloomberg Finance L.P., State Street Global Advisors. Monthly Returns data from January 2011 to December 2020. **Pre-Inception Index Performance shown above is Back-Tested.** The S&P/ASX 200 ESG Index was launched by S&P on 6 July 2020. All information for an index prior to its launch date is hypothetical back-tested data calculated by S&P based on the index methodology in effect on the Launch Date. Market indices are unmanaged and are not subject to fees and expenses which could lower returns. Index performance is not intended to represent the performance of any particular product managed by SSGA. Actual performance may differ substantially from the back-tested performance presented, as the performance was calculated with the benefit of hindsight, cannot account for all financial risk that may affect the actual performance, and is not a guarantee of future results. The Back-Tested Pre-Inception Index Performance data is reported on a gross of fees basis. You cannot invest directly in an index. The performance includes the reinvestment of dividends and other corporate earnings and is calculated in AUD.

Endnotes

- 1 Also referred to as the “ESG-enhanced index” in this paper. The S&P/ASX 200 ESG Index was launched by S&P on 6 July 2020. All information for an index prior to its launch date is hypothetical back-tested data calculated by S&P based on the index methodology in effect on the Launch Date.
- 2 Source: State Street Global Advisors, Morningstar, as of December 2020.
- 3 Source: Rainmaker, as at 30 June 2020.
- 4 Companies that have the lowest 25% of ESG scores within their industry group are also removed.
- 5 Companies generating 5% or more of their revenues from thermal coal (including coal extraction or power generation).
- 6 The ESG scores used here originate from Robeco SAM, which is part of S&P Global. They are derived from Robeco SAM’s Corporate Sustainability Assessment, which is a bottom-up research process that aggregates underlying company ESG data to score levels. The aim of these ESG scores is to focus on the most financially material ESG issues within specific industries and takes into account circa 21 industry-specific criteria on average. Around 3,500 of the world’s largest company take part in this assessment every year.
- 7 Source: The S&P/ASX 200 ESG Index: Integrating ESG Values into Core in Australia, S&P Dow Jones Indices.
- 8 Systematic factors are factors inherent in the equities market or part of the equities market and are important drivers of return and risk. They differ from selection risk, which is often based on “manager skill” (or sources of risk and return that cannot be attributed to “market” factors).

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