

An Integrated Approach to ESG and Quality

ESG factors are key considerations in evaluating a company's quality and sustainable growth prospects. Our Fundamental Growth and Core Equity team incorporates ESG considerations, including climate transition planning and climate risk, into its fundamental analysis of companies via a proprietary Confidence Quotient metric.

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 to incorporate ESG concepts into their investment philosophies, with an 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 Global Advisors' (State Street's) Fundamental Growth and Core Equity (FGC) team has a long history of integrating ESG concepts into its fundamental company analysis.

The FGC team believes that quality companies with sustainable growth at attractive valuations can drive above-average, long-term investment returns. The team incorporates ESG considerations into the quality assessment of a company using a proprietary metric called the Confidence Quotient (CQ), based on the belief that companies which are strong in ESG are more likely to deliver sustainable growth. ESG considerations are therefore integral to the team's alpha thesis and not an overlay to 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 factors¹ — and engaging with our firm's industry-leading Asset Stewardship team have further strengthened FGC's integrated ESG investment process.

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

— State Street Global Advisors Mission Statement

The Fundamental Research Process

Drawing on its fiduciary heritage, the FGC team invests as long-term asset owners, not traders. Its bottom-up approach is built on three pillars: Quality, Sustainable Growth, and Reasonable Valuation.

The team's research analysts conduct detailed fundamental company analysis, which includes quantitative projections — i.e., forward-looking estimates of a company's financials — as well as a qualitative assessment.

Qualitative analysis is based on the FGC team's proprietary Confidence Quotient framework, which allows analysts to quantify key characteristics of a company such as market position, management strength, and transparency. A numeric CQ score is a measure of company quality and an indicator of an analyst's 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 the FGC team.

ESG Integration into CQ Scoring

ESG factors are important considerations in evaluating the quality of a company and, ultimately, the sustainability of a company's growth. FGC analysts assess ESG factors like company governance, labor practices, climate transition risk, and other environmental concerns as part of the CQ process. Strong ESG practices will enhance the sustainability of a company's business model, typically raising a company's CQ score and making it more attractive in the CQ framework (see Figure 1).

Figure 1
ESG Considerations in Evaluating a Company's Quality and Sustainable Growth Prospects

CQ Category	Quality/Sustainability Assessment	ESG Considerations
Management	"Conviction in leadership" <ul style="list-style-type: none"> • Clear, effective strategy • Execution • Effective stewards of capital 	<ul style="list-style-type: none"> • Management and board diversity • D&I best practices relative to peers • Code of conduct/Anti-corruption • Governance • Management of ESG issues
Market Position	"Sustainable competitive advantage" <ul style="list-style-type: none"> • Porter five forces • Sustainable business model • Government/regulatory influence 	<ul style="list-style-type: none"> • Brand impact of failure to comply with regulations and/or shifting consumer preferences • Compliance with fair labor standards • Environmental track-record
Financial Condition	"Strength of the financial model" <ul style="list-style-type: none"> • Balance sheet strength • Returns • Cash flow generation 	<ul style="list-style-type: none"> • Risk of environmental/regulatory fines • Increase in operating costs/capital expenditure to meet regulatory and customer requirements
Transparency	"Visibility of business model" <ul style="list-style-type: none"> • Financial disclosure • Quality of earnings • Predictability of business model 	<ul style="list-style-type: none"> • Timely and useful sustainability disclosures • Key performance metrics (KPIs) for ESG goals with associated timetable
Fundamental Momentum	"Business is trending positively" <ul style="list-style-type: none"> • Revenue/earnings revisions • Catalyst strength • Industry conditions 	<ul style="list-style-type: none"> • Exposure to environmental/regulatory changes • Impact of rising carbon and other required costs/investments

Company X	CQ Score
Management	8.3
Market Position	8.3
Financial Condition	7.7
Transparency	7.3
Fundamental Momentum	7.3
Overall CQ Score	7.8
R-Factor Category	Leader

Source: State Street Global Advisors. Scoring shown is for illustrative purposes only.

ESG is not a new addition to the Confidence Quotient. ESG concepts have been integrated into CQ since it was developed in 2002, but have evolved and become more formal over time (see Figure 2).

Figure 2
ESG Evolution in FGC's CQ Framework

Milestones

2002	2015	2016	2019	2021
<ul style="list-style-type: none"> ESG considerations integrated in FGC's proprietary CQ framework 	<ul style="list-style-type: none"> Sustainalytics reporting added ESG considerations formalized and expanded in CQ framework 	<ul style="list-style-type: none"> State Street Global Advisors' acquisition of the FGC team brings a dedicated, well-resourced firm-wide ESG effort FGC and Asset Stewardship collaborate to enhance company engagements and share best practices 	<ul style="list-style-type: none"> Access to the firm's ESG reporting and R-Factor SASB-aligned scoring model Sustainalytics Controversies incorporated R-Factor scores automated and incorporated in FGC's data visualization tool 	<ul style="list-style-type: none"> ESG sub-scores added to capture company climate risks and Net Zero transition progress

Source: State Street Global Advisors.

Enhancements to the process have included the incorporation of external sources of ESG information — such as Sustainalytics and, more recently, R-Factor — to augment analysis. Figure 3 shows a sample dashboard that breaks out all of the components that go into the calculation of a company's R-Factor score.

Figure 3
Sample R-Factor Dashboard

Security Details				ESG Scores					Data As Of: 3/31/2020							
Name	Bloomberg Ticker	Sics Industry	Processed Foods	R Factor Score	Score	Global Avg	Universe %	Universe Rating	Global Industry Avg	Industry %	Industry Rating					
				86.39	86.65	50.00	99.5 %	Leader	49.64	100.0 %	Leader					
				ESG Score (90%)	50.85	49.39			48.36							
				Corp Gov Score (10%)	Total Universe Population		Total Universe Industry Population		115							
R Factor Sub Scores																
Environment				Social Capital			Human Capital			Business Model & Innovation			Leadership & Governance			
Category	Score	Global Ind. Avg	Country Ind. Avg	Category	Score	Global Ind. Avg	Country Ind. Avg	Category	Score	Global Ind. Avg	Country Ind. Avg	Category	Score	Global Ind. Avg	Country Ind. Avg	
GHG Emissions				Human Rights				Labor Practices				Product Design Lifecycle Management	74.93	45.27	50.61	Business Ethics
Air Quality				Community Relations				Employee Health Safety				Business Model Resilience				Competitive Behavior
Energy Management	68.78	50.79	56.61	Customer Privacy				Employee Engagement				Supply Chain Management	66.03	48.48	61.87	Management Of The Legal Regulatory Environment
Water Wastewater Management	77.79	47.72	55.10	Data Security				Diversity Inclusion				Material Sourcing Efficiency	69.28	48.87	59.81	Critical Incident Risk Management
Waste Hazardous Materials Management				Access Affordability								Physical Impacts Of Climate Change				Systemic Risk Management
				Product Quality Safety	76.48	54.36	62.40									

Source: State Street Global Advisors. Company name has been removed.

The FGC team's most recent enhancement to the CQ process was to create explicit ESG CQ scores. Analysts identify the material ESG issues that each company faces using the SASB² materiality map. Sustainability issues are then analyzed using the CQ's "lens" through which each of five CQ categories — Management Team, Market Position, Financial Condition, Fundamental Momentum, and Transparency — receive an ESG-specific sub-score.

While the assessment of ESG remains embedded in the overall CQ framework and is only part of an overall CQ score, the ESG performance of the company is broken out (see Figure 4). This makes the ESG score more explicit and gives the team the ability to implement positive ESG screening for clients when desired.

Figure 4

**Sample CQ Scorecard,
Highlighting ESG Scoring**

CQ Framework

Company: XYZ Inc.
Subsector: Industrials

Management Team	8
Market Position	6
Fundamental Momentum	7
Financial Condition	9
Transparency	5
CQ Score	7

"Composite" ESG Score	7
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Management Team		Transparency		Market Position	
Metric (4)	Score	Metric (3)	Score	Metric (6)	Score
Clear and effective strategy	9	Financial disclosure	5	Rivalry	4
Execution track record	6	Quality of earnings	5	Supplier power	9
Overall Management Quality	6	Predictability of the business model	5	Buyer power	4
ESG Management Practices	9	ESG Transparency	5	Entry barriers	9
Final Score	8	Final Score	5	Substitutes	4
Financial Condition		Fundamental Momentum		ESG Market Position	8
Metric (4)	Score	Metric (5)	Score	Final Score	6
Balance Sheet strength (leverage)	8	Earnings & Revenue Revision	8		
Returns (Margins)	9	Catalyst strength	8		
Cash Flow generation	8	Industry Conditions	5		
ESG Financial Strength	9	ESG Momentum	5		
Final Score	9	Final Score	7		

Source: State Street Global Advisors. For illustrative purposes only.

FGC research analysts are not obligated to follow an external data source's view on a company and will often disagree with external opinions. It is important to the CQ process that our analysts apply independent judgment to all aspects of their scoring, and this applies to their ESG evaluation as well. FGC analysis is forward-looking and seeks to anticipate improvement or deterioration in a company's prospects (many external sources tend to be backward-looking). Analyst independence and a forward-looking view are core characteristics of our process.

Integrating Climate Risks, Opportunities and Transition into the CQ Framework

With the global economy fast transitioning from dependency on fossil fuels and toward clean energy, climate transition planning and progress have become key areas of differentiation for companies — and we see them as key drivers of valuation that may not yet be priced into the market. In this shifting climate landscape, the FGC team anticipates re-ratings, valuation dislocations, and emerging climate winners and losers — all of which help create an environment ripe for active stock-picking.

To capture analysts' insights and better discriminate between leaders and laggards on the climate front, FGC further refined the ESG component of the CQ framework to incorporate three explicit and proprietary climate scores:

- **Climate Transition Score** evaluates disclosure, credibility, and accountability of companies' transition plans.
- **Climate Risks Score** evaluates direct costs (e.g., carbon pricing), opportunity costs, and physical risk due to climate change.
- **Climate Opportunities Score** evaluates resource-intensity of companies' operations and green solutions offered by companies.

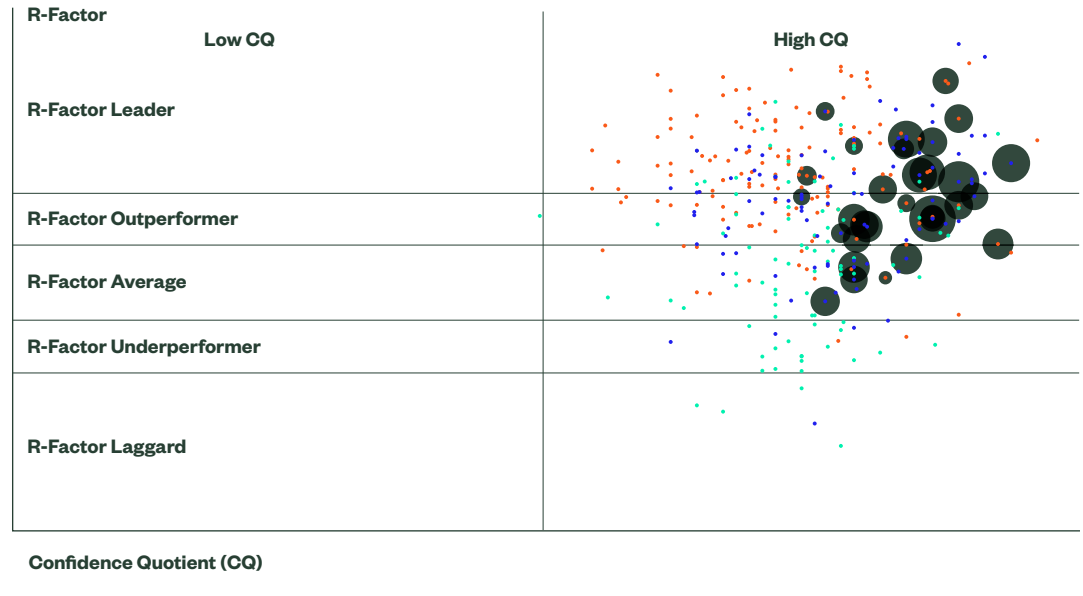
As in the rest of our CQ framework, each of these three areas is scored by our analysts on a 1-10 scale and has a number of sub-scores to guide the assessment. The three scores are averaged for an overall Climate Score.

Integrated CQ Approach Creates a Positive ESG Tilt

The FGC team does not explicitly exclude companies with low ESG performance from consideration unless directed by a client.³ However, industries like tobacco or oil and gas are less likely to be attractive due to business model and ESG headwinds, which would be reflected in the CQ scoring. This integrated approach results in portfolios that have a positive ESG tilt, i.e., they are influenced by the natural bias of our investment philosophy.

The R-Factor model assigns a score and a qualitative rating to almost all companies in the MSCI All Country World Index universe. Exhibit 5 shows the relationship between R-Factor scores and CQ scores for companies in State Street's Global Equity Select (GES) and Research portfolios. Most of the companies chosen by the FGC team 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 ACWI, the GES strategy also has a positive ESG tilt as measured by R-Factor (see Figure 6).

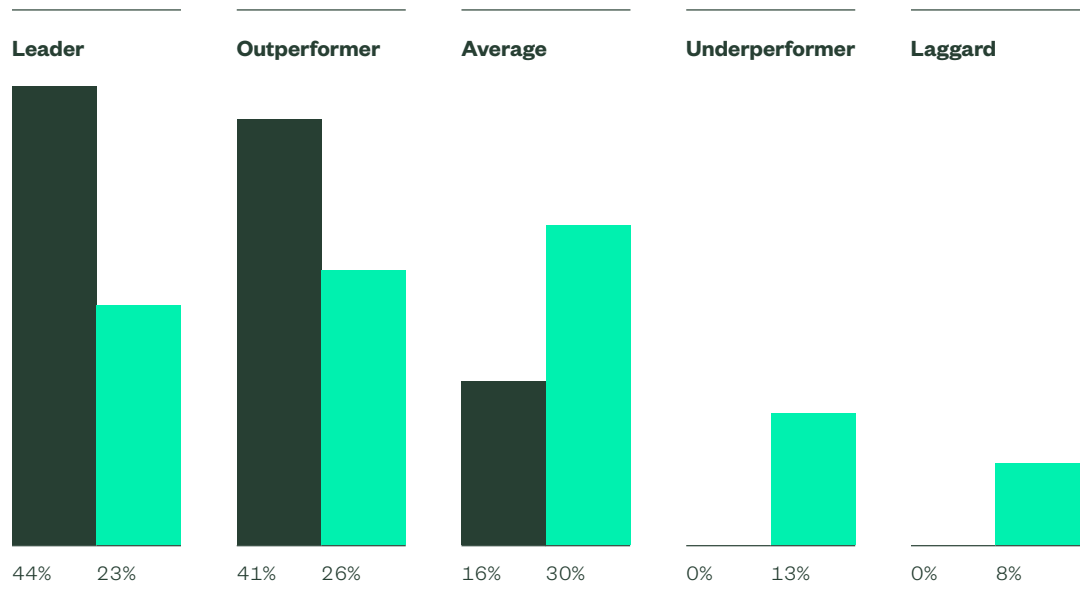
Figure 5
CQ and R-Factor Scores for Global Equity Select Strategy (Bubbles) and Research Holdings (Dots)
 Bubble Size Represents Amount of Overweight versus the MSCI ACWI



Source: State Street Global Advisors. As of March 31, 2022.

Figure 6
R-Factor Exposure of Global Equity Select Strategy vs. R-Factor Exposure of the MSCI ACWI

■ Global Equity Select
 ■ MSCI ACWI



Source: State Street Global Advisors. As of March 31, 2022.
 Note: MSCI ACWI data shown does not reflect the 6% of ACWI securities that are unclassified.

One example of a company that is demonstrating ESG integration is a US-based manufacturer of heating, ventilation, and air conditioning (HVAC) equipment that was held in the FGC team’s Research portfolio as of March 31, 2022. 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 disclosure. In our framework, it has a high CQ, reflecting its ESG strength as well as strong management and market position.

Portfolio Company Engagement

The FGC team is also integrated with State Street's broader ESG efforts and works closely with the firm's Asset Stewardship team to engage with companies. As one of the largest asset managers in the world, State Street engages with companies regularly; our scale and breadth in the marketplace give the FGC team's analysts better access to company management. The FGC team's analysts also serve as a resource to the Asset Stewardship team, providing comprehensive insight on company engagements to inform action. As State Street continues to strengthen its position as an industry leader in ESG topics, companies seek our input to improve their efforts in responsibility and sustainability best practices.

A recent example of engagement on ESG issues took place during a large takeover bid between two companies the FGC team held as active positions (State Street broadly was also a large shareholder). State Street's prominence as a shareholder provided the FGC team with rare access to top management and the Boards of both companies. Our team had multiple conference calls with the CEOs and lead directors. Also, because the takeover company was looking to nominate six new Board members to form a majority of the other company's Board, the FGC team was able to host a meeting in its offices that included the takeover company's CEO, CFO, four of the six Board nominees in person, and one Board nominee on the phone. This access enabled the FGC team to properly score each company from a governance perspective, as well as to assess and develop much deeper conviction on the relative strengths and weaknesses of each company's management teams and strategies.

Bottom Line

A core value of the Fundamental Growth and Core Equity team is what it calls a fiduciary mindset. The team was formed decades ago as the fiduciary for a large pension plan. From those roots, it has developed an approach to investing founded on basic tenets that include a strict adherence to compliance, a strong risk-awareness, a focus on company quality, and a long-term perspective that requires process discipline.

At its root, ESG is about long-term sustainability and is therefore integral to a fiduciary mindset. From the beginning, ESG concepts were embedded in the team's assessment of company quality because they are a key driver of long-term sustainable growth. The FGC team takes an ESG-integrated approach not just because it's the right thing to do, but because it is an intrinsic part of the investment philosophy that the team believes will lead to higher alpha.

Contributors

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Endnotes

1 For additional information on the R-Factor™ methodology see [R-Factor™ — A Roadmap to Build Sustainable Companies](#).

2 Sustainability Accounting Standards Board.

3 The only exception is manufacturers of certain controversial weapons, which are excluded from consideration.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- 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 30 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US \$4.02 trillion[†] under our care.

* Pensions & Investments Research Center, as of December 31, 2020.

[†] This figure is presented as of March 31, 2022 and includes approximately \$73.35 billion USD 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 views expressed in this material are the views of the Fundamental Growth and Core Equity team through the period June 1, 2022 and are subject to change based on market and other conditions.

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Past performance is not a guarantee of future results.

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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

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