Insights
ESG

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Integrating the S&P 500 ESG Exclusions II Index in a Portfolio Context

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As part of their strategic asset allocation, investors can use the S&P 500 ESG Exclusions II index to gain broad US equity exposure while limiting exposure to certain types of contentious companies.

How to Use This Index in a Portfolio Context?

The S&P 500 ESG Exclusions II index can be used as part of strategic (core) allocation within investment portfolios to gain exposure to broad US equities. The index is designed to maintain a similar risk profile to traditional beta benchmarks while removing controversial business areas, such as companies that have exposure to controversial weapons, tobacco and thermal coal, or that violate the Ten Principles of the United Nations Global Compact.

Rationale Behind Applying Exclusions

Exclusionary screening is by far the most adopted sustainable investing approach, and 20% of globally invested assets exclude companies involved in controversial activities.[1] These strategies deliberately avoid generating revenues from potentially objectionable activities, as depending on the nature of the screens, they may help mitigate reputational risks and promote ethical well-being.

A case in point for this type of investment approach can be found in the recently launched S&P 500 ESG Exclusions II index. Exclusionary criteria are applied to the S&P 500 benchmark. These restrictions include the removal of companies that are non-compliant with the Ten Principles of the United Nations Global Compact (UNGC) and those that are engaged in 'undesirable' activities, namely controversial weapons, tobacco or thermal coal.

For investors, excluding companies that fail to adhere to the UNGC Principles may make sense and be consistent with their investment philosophy. These Principles, which fall within the realm of human rights, labour, environment and anti-corruption issues, are designed to integrate sustainability into the heart of business operations, allowing for greater corporate transparency and accountability.

> **“Removing controversial companies and undesirable industries may help mitigate reputational risks and promote ethical well-being.”**

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Therefore, divesting companies implicated in violation of the UNGC Principles could help to alleviate a potential risk faced by investors, which may arise from an insufficient focus on governance and corporate culture. Deficiencies in internal corporate controls often foreshadow poor future behavior. In this respect, investors can consider removals of badly managed companies as a longer-term risk management tool.

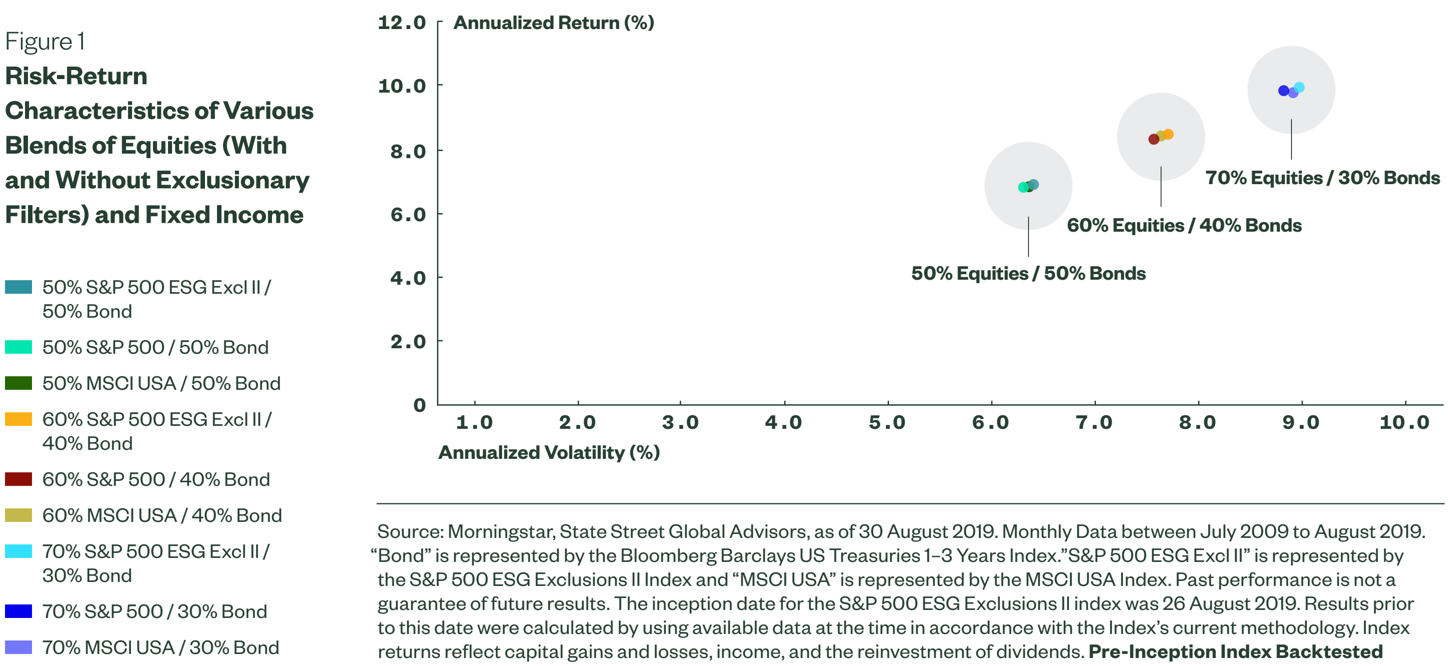
In addition to norms-based screening, such as that based on UNGC Principles, the S&P 500 ESG Exclusions II index discards companies involved in controversial industries, such as tobacco and weapons. In this instance, investors may view divestments as a mechanism to drive change in business strategies, activities and practices.[2]

Using the S&P 500 ESG Exclusions II Index as a Replacement for Core

Investors often fear that integrating exclusionary screens, or any type of ESG overlays, will inevitably undermine portfolio returns. To assess this, we created a number of simple stylized equity/fixed income portfolios to examine whether using the S&P 500 ESG Exclusions II index as a replacement for popular benchmarks, such as S&P 500 index or MSCI USA Index, have meaningfully changed their risk-return profile.

Over the time horizon under analysis, there appears to be little performance differential between the portfolios that used the S&P 500 ESG Exclusions II index, S&P 500 or MSCI USA Index as their core US equity building block (see Figure 1). To further confirm that these building blocks delivered a similar risk-return profile, we focused our attention on the 70% equity/30% fixed income portfolios and ran additional statistics on them. The results in Figure 2 corroborate the finding above.

Figure 1
Risk-Return Characteristics of Various Blends of Equities (With and Without Exclusionary Filters) and Fixed Income



Source: Morningstar, State Street Global Advisors, as of 30 August 2019. Monthly Data between July 2009 to August 2019. "Bond" is represented by the Bloomberg Barclays US Treasuries 1–3 Years Index."S&P 500 ESG Excl II" is represented by the S&P 500 ESG Exclusions II Index and "MSCI USA" is represented by the MSCI USA Index. Past performance is not a guarantee of future results. The inception date for the S&P 500 ESG Exclusions II index was 26 August 2019. Results prior to this date were calculated by using available data at the time in accordance with the Index's current methodology. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. **Pre-Inception Index Backtested Performance:** This document contains index performance data based on backtesting, i.e. calculations of how the index might have performed prior to launch if it had existed using the same index methodology and based on historical constituents. Backtested performance information is purely hypothetical and is provided in this document solely for information purposes. Backtested performance does not represent actual performance and should not be interpreted as an indication of actual performance.

Figure 2
Selected Risk-Return Characteristics of Equity-Fixed Income Portfolios Containing Different US Equity Benchmarks (With and Without Exclusionary Filters)

	Replacing S&P 500 Index as Core		Replacing MSCI USA Index as Core	
	70% S&P 500 ESG Excl II Index / 30% Bonds	**70% S&P 500 Index / 30% Bonds**	**70% S&P 500 ESG Excl II Index / 30% Bonds**	**70% MSCI USA Index / 30% Bonds**
Annual Return	10.16%	10.08%	10.16%	10.08%
Annual Volatility	8.97%	8.85%	8.97%	8.91%
Market Beta	1.00	0.99	1.00	0.99
Sharpe Ratio	1.13	1.14	1.13	1.13
Maximum Drawdown	-11.4%	-11.6%	-11.4%	-11.7%

Source: State Street Global Advisors, Bloomberg Finance L.P., as of 30 August 2019. "Bond" is represented by the Bloomberg Barclays US Treasuries 1–3 Years Index. "S&P 500 ESG Excl II" is represented by the S&P 500 ESG Exclusions II Index and "MSCI USA" is represented by the MSCI USA Index. Past performance is not a guarantee of future results. The inception date for the S&P 500 ESG Exclusions II index was 26 August 2019. Results prior to this date were calculated by using available data at the time in accordance with the Index's current methodology. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

Assessing the ESG Profile

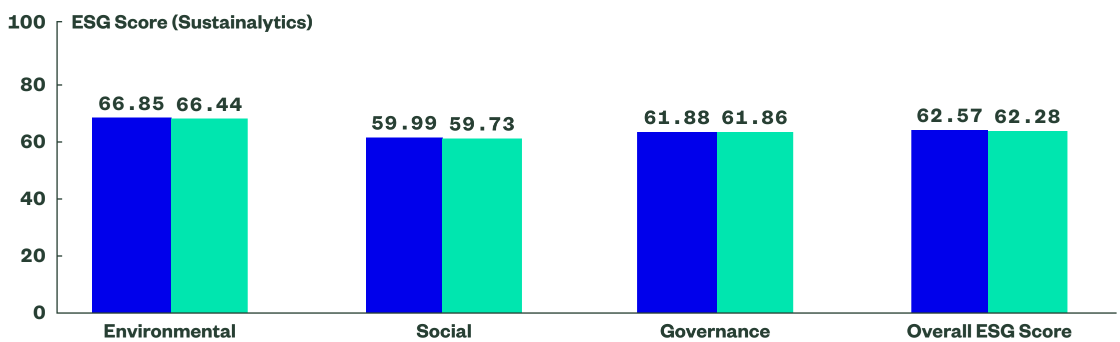
Portfolio with S&P 500 ESG Exclusions II vs. Portfolio with S&P 500

Next, we examined the ESG profile of portfolios of the S&P 500 ESG Exclusions II index and the S&P 500 index, using both Sustainalytics and State Street Global Advisors R-Factor™ scores. R-Factor™ scores are computed on the basis of the ESG components of each of the individual companies, whereas the S&P 500 ESG Excl II methodology removes companies that violate the UNGC Principles and are exposed to certain sectors.

Figures 3a and 3b show that there is a very slight improvement in the ESG profile of the portfolio that uses S&P 500 ESG Exclusions II index, rather than the S&P 500 index. This can be expected, as the S&P 500 ESG Exclusions II index is designed to root out US companies that do not comply with the UNGC Principles as well as those that are involved in controversial business activities, rather than specifically to target companies with a strong ESG profile. Refer to Figure 4 to see the index weight of the companies removed when applying the exclusionary filters in the S&P 500 ESG Exclusions II index.

Figure 3a
ESG Profile of Portfolios with Different US Equity Benchmarks
Sustainalytics Scoring

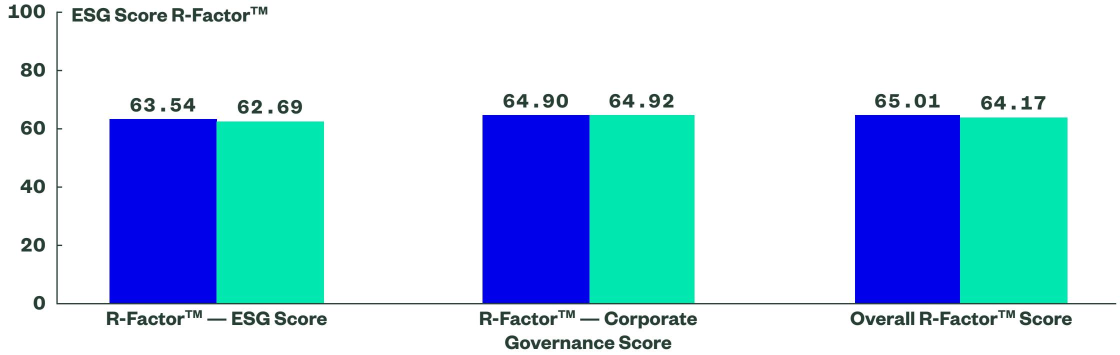
70% S&P 500 ESG Excl II / 30% Bonds
70% S&P 500 / 30% Bonds



Source: FactSet, State Street Global Advisors, as of 30 August 2019. Only the equity component has been taken into account in the computation of the portfolio ESG score.

Figure 3b
ESG Profile of Portfolios with Different US Equity Benchmarks
R-Factor™ Scoring*

70% S&P 500 ESG Excl II / 30% Bonds
70% S&P 500 / 30% Bonds



Source: FactSet, State Street Global Advisors, as of 30 August 2019. Only the equity component has been taken into account in the computation of the portfolio ESG score.

* The R-Factor™ score is composed of ESG scores, an aggregate of the industry-specific ESG scores from four specialist ESG data providers (Sustainalytics, Vigeo-Eiris and ISS-ESG), on the basis of the Materiality framework developed by Sustainability Accounting Standards Board (90% of overall score) and Corporate Governance scores from ISS-Governance (10% of overall score).

Figure 4
Total Exposure of Companies Excluded in the S&P 500 ESG Exclusions II Index

	S&P 500 ESG Exclusions II Index	S&P 500
Non-compliance of UN Global Compact Criteria	0.0	2.3
Controversial Weapons Involvement	0.0	2.8
Tobacco	0.0	0.8
Thermal Coal	0.0	3.4
Total Index Weight	0.0	9.3

Source: S&P 500, as of 30 August 2019. Characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

Endnotes

1 2018 Global Sustainable Investment Review.

2 Demystifying negative screens: The full implication of ESG exclusions, Schroder, December 2017.

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