Invesco

Guide to compare ESG ETFs

For professional/qualified investors/qualified clients only

Survey highlights the increasing importance of ETFs

Once considered a niche segment applicable to only a relatively small number of "ethically minded" investors, ESG is now seen as a core strategy for a growing and diverse investor audience. The evolution has accelerated in recent years and is being driven by multiple factors, including:

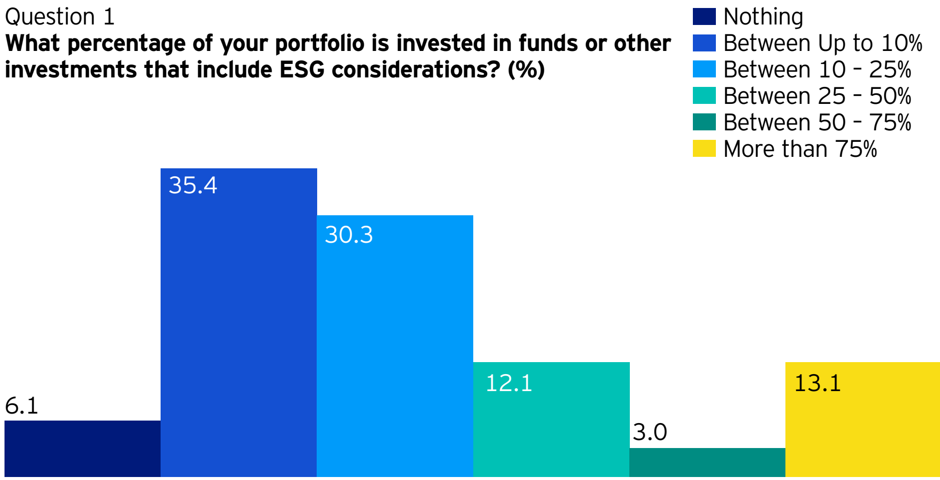
- The influence of a new generation of socially and environmentally conscious investors;
- Increased regulation and public pressure exerted on corporations and asset owners;
- Heightened global awareness on climate change, health and welfare, and equality.

The growing demand is being met by increased supply in the form of new ESG funds, including both actively managed mutual funds and passive ETFs. However, "ESG" is a broad category that includes a wide range of strategies, which vary by objective, methodology and expected outcomes. In this "Guide to ESG" we will look at some key questions you need to consider when choosing strategies and individual funds.

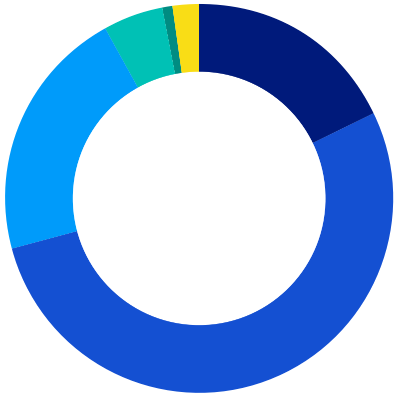
Growing importance of ETFs for ESG investors

In the summer of 2020, Invesco commissioned a survey[1] of institutional investors in Europe. The results suggest a trend of increased adoption of ESG ETFs into client portfolios, with passive strategies featuring more prominently in the coming years.

Question 1
What percentage of your portfolio is invested in funds or other investments that include ESG considerations? (%)



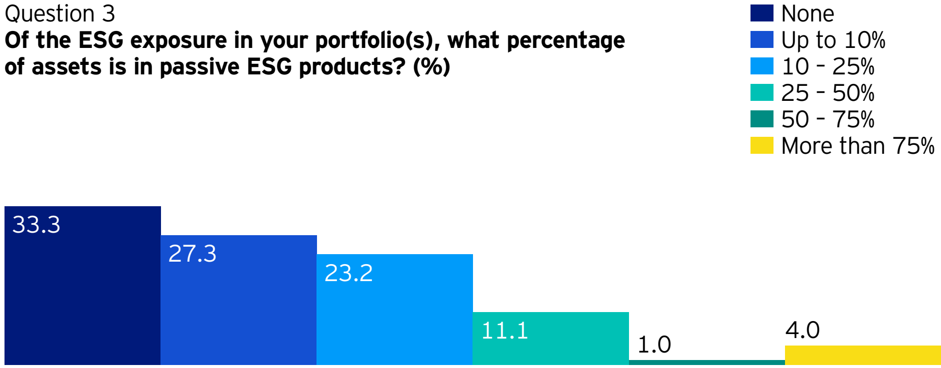
Question 2
How do you expect this to change in the next 2 years? (%)



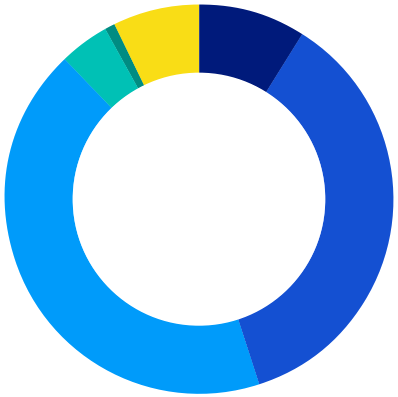
Increase significantly (i.e., more than double)	18.0
Increase modestly	53.0
Remain the same	21.0
Decrease modestly	5.0
Decrease significantly	1.0
No opinion	2.0

[1] Survey of 101 institutional investors in Europe conducted by PollRight, the research arm of Citigate Dewe Rogerson, during the period May to July 2020.

Question 3
Of the ESG exposure in your portfolio(s), what percentage of assets is in passive ESG products? (%)

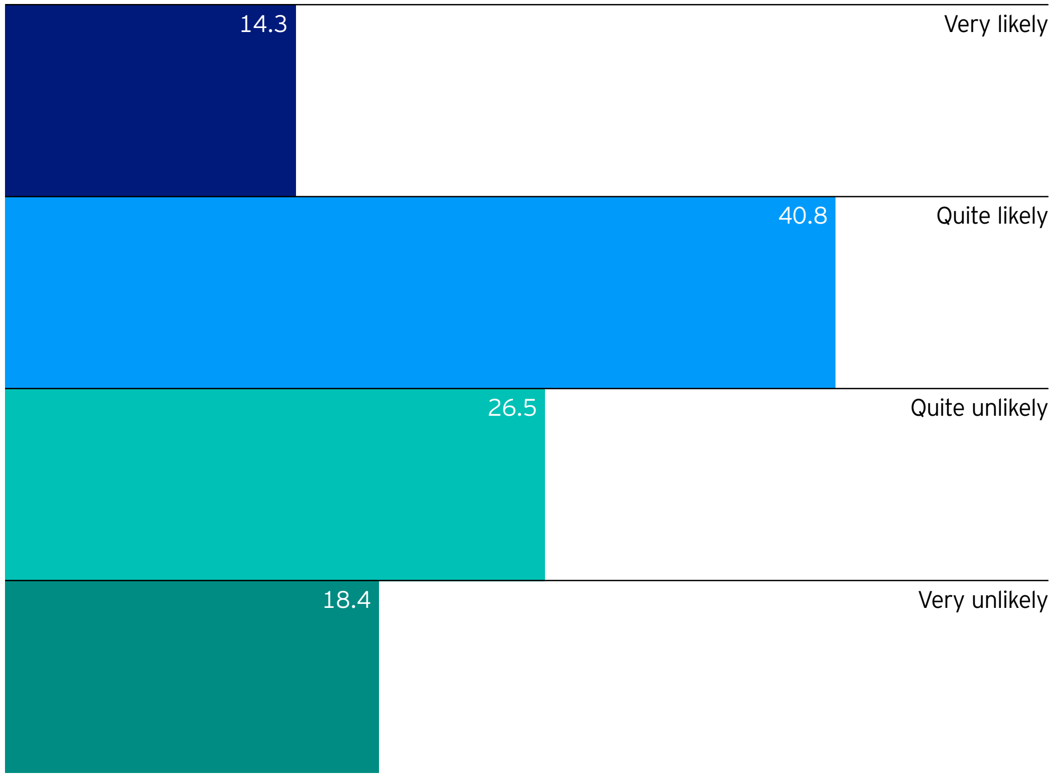


Question 4
How do you expect this to change in the next 2 years? (%)



Increase significantly (i.e., more than double)	9.2
Increase modestly	35.7
Remain the same	42.9
Decrease modestly	4.1
Decrease significantly	1.0
No opinion	7.1

Question 5
How likely is it that the majority of your exposure to ESG investments will be held in passive products within five years? (%)



Question 6
If you are looking for a passive ESG fund, what would be the most important factors?

	The most important consideration		**Very important**		**Moderately important**		**Not important**	
	%	Responses	%	Responses	%	Responses	%	Responses
That the fund exercises proxy voting and has engagement with companies on ESG issues	18.3	17	39.8	37	31.2	29	10.8	10
The fund provider's reputation on ESG issues	16.5	15	39.6	36	29.7	27	14.3	13
Potential for outperformance versus non-ESG benchmark	12.0	11	34.8	40	40.2	27	13.0	16
Specific exclusions (beyond institutional norms)	11.7	11	42.6	32	28.7	37	17.0	12
Positive ESG filters, e.g. increasing weight to ESG industry leaders	9.7	9	45.2	42	35.5	33	9.7	9
Low tracking error versus ESG benchmark	8.8	8	34.1	31	45.1	41	12.1	11
Lower costs than competitors	4.4	4	42.4	39	43.5	40	9.8	9
The size of the fund	3.3	3	23.1	21	55.0	50	18.7	17

Question 7
When considering a passive fund for ESG exposure, how important is it that it aims to provide a performance similar to that of a standard (non-ESG) benchmark? (%)

Extremely important	14.6
Very important	34.4
Somewhat important	37.5
Not so important	6.3
Not at all important	7.3

Question 8
When selecting a passive fund for ESG exposure, what would you consider acceptable for annualised tracking error versus a standard (non-ESG) benchmark? (%)

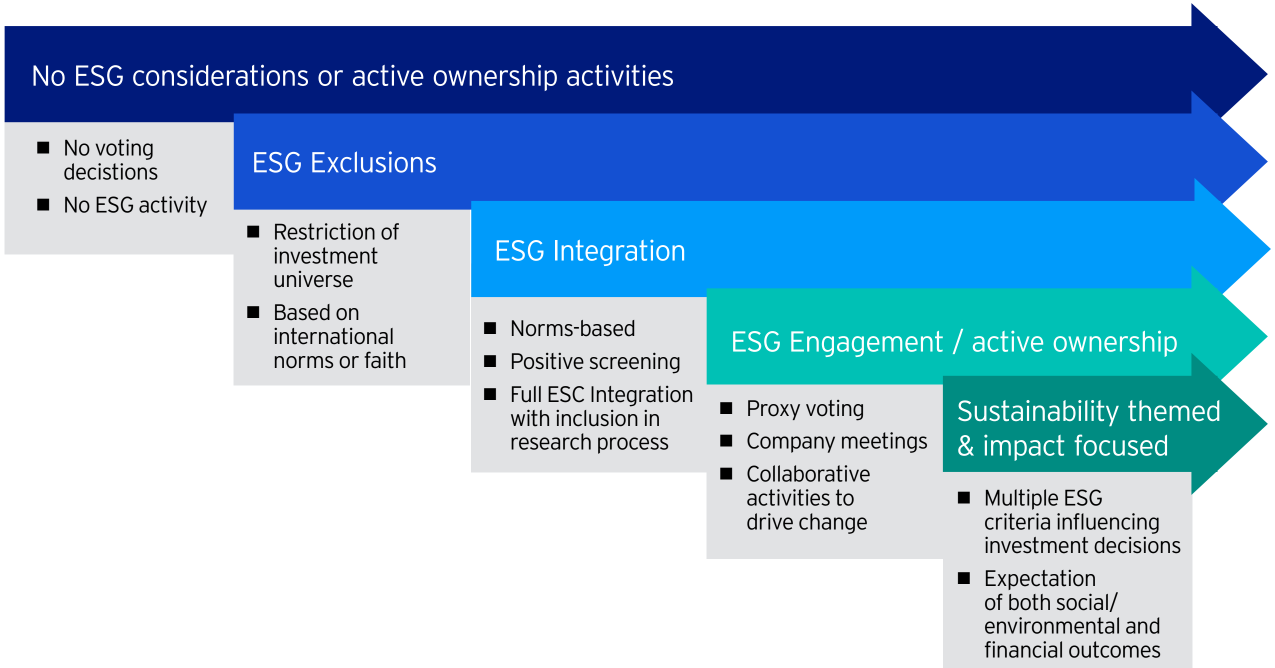
Less than 1%	15.6
Between 1% and 2%	39.6
Between 2% and 3%	26.0
More than 3%	4.2
n/a – Tracking error is not important	14.6

Strategy spectrum: from simple exclusions to impact investing

The investment industry has evolved to meet the needs of the growing and changing ESG investor base. The concept of values-based investing is not new, with early examples of investors avoiding investing in the stocks of companies involved in practices with which the investor disagreed, for instance the sale or production of tobacco or alcohol, or the financial support of war or oppressive regimes. The more recent focus on fighting climate change has seen the launch of environmentally targeted strategies, which not only avoid certain companies but select those driving positive change.

While the immediacy of the need to address climate change makes the environmental part of ESG clearly important, most investors will want to ensure social and governance issues are not ignored. However, this complexity and variety of issues makes evaluating individual companies more difficult. Fortunately, several ratings agencies and index providers take much of the hard work away from the investor by analysing and scoring individual companies based on specific ESG criteria. For example, MSCI assesses companies relative to their industry on 37 issues across the three pillars.

A consistent, transparent and robust scoring system enables investors to compare indices and strategies. The caveat is that while one index provider or ratings agency may apply a consistent approach across companies, the approach may deviate from that used by other agencies, even where differences are subtle. The more material difference is likely to appear due to the methodologies employed by different indices and, in turn, the ETFs that are designed to follow them.



What is the best ESG strategy?

Before investors begin to look for and compare products, they first need to clearly understand what they are looking for from the ESG exposure. It's no longer a simple question of "Do I want to exclude sinful companies?" or "Do I want light green or dark green?" More traditional investment objectives are featuring more regularly in the decision-making, particularly with institutional managers who have a fiduciary responsibility to their investors. As the investment industry has evolved, fund providers have developed a diverse array of strategies, which unless you appreciate the differences may leave you with a sub-optimal product for what you're trying to achieve.

Four criteria to consider:

1. **Scope**. You can reduce the fund universe quite considerably once you understand whether you want broad coverage that considers securities in terms of each of the three ESG pillars or you want to focus specifically on just one pillar, such as environmental issues, or even a more concentrated approach such as one targeting companies involved in clean energy. The requirement may be for core equity or fixed income exposure or for portfolio tilting, in a similar way that you may use sector ETFs to overweight specific industries under certain conditions.

2. **Performance**. What performance profile are you looking for? In the early days of socially responsible investing, performance was often an afterthought in the selection process, with many investors believing you had to be willing to sacrifice returns in order to invest ethically. This is no longer the case. If the ESG fund is intended to replace an existing non-ESG holding, do you want them to have similar risk and return characteristics? Will the ESG holding be benchmarked to a standard index? What is an acceptable tracking error versus a standard benchmark, or is that not even a concern?

3. **Methodology**. While this is really where the hard part begins, the transparency of the ETF structure should make the task easier, although there have been instances where an ETF was not designed to behave as the name might have implied. It is imperative to fully understand what the index or strategy is aiming to do, and how it is constructed to achieve its objectives. Even in the most basic strategy that uses negative screens alone, there will often be differences between indices in what exactly is being removed, and what if any tolerances are being applied. However, most strategies go beyond just negative screens, and you need to understand other screens and weighting methodologies being used.
   For example, how are companies treated if they are not excluded from the index during the negative screening process but still have poor ESG profiles? This is an important consideration and is generating debate among investors. On the one hand, maintaining a position in the company gives the asset manager voting rights, making it possible to drive positive change, which is the ultimate goal for many ESG investors. On the other hand, you could argue that companies with poor ESG records could pose risks relative to their peers, so you may only want to include the leading companies in each sector. Both sides have merits, and you not only need to consider which makes most sense to you, but also what impact the methodology has on the portfolio.

4. **Impact**. What impact does my ETF have on the real world, and is that important to me as an investor? Indeed, if the impact has greater significance than the financial return from investing, you may want to consider impact investments. However, there are other ways that an investor can use their funding to help drive positive change. At Invesco, we exercise our voting rights on the equities we hold and maintain a company-wide database of individual voting records by each fund manager. In terms of our passive ETFs, we vote in accordance with the largest overall holder of the equity within the firm, which provides a greater voice for engaging with companies. This is one of the potential benefits of investing with a global asset manager with a strong ESG commitment and more than $1.2 trillion in AUM[2]

   These four criteria are of course not the only ones you need to consider but will hopefully provide a good starting point as you navigate your way through the vast universe of ESG strategies.

Case Studies: comparing two ESG indices

When looking for broad ESG strategies, as opposed to more targeted approaches such as those focussed on climate change, you should certainly expect them to have better ESG characteristics versus their standard (parent) index. The result of screens – negative and/or positive filters – should help eliminate companies with the lowest credentials and, depending on the objective and methodology, could increase exposure to those with better-than-average scores. The net effect should be an improved ESG score, but the degree of improvement may vary greatly
between indices.

[2] Source: Invesco, as of end August 2020.

	MBCI ESG Screened Index	MSCI ESG Universal Index	MSCI ESG Universal Select Business Screens Index	MSCI ESG Leaders Index	MSCI SRI Index
ESG Controversies (UN Global Compact)	All companies that fail to comply with UN Global Compact principles	Excludes companies with score of 0 (severe)	Excludes companies with score of 0 (severe)	Score of 3 or above for inclusion	Score of 4 or above for inclusion
Exclusions (Negative ESG screen)	Controversial weapons, Thermal coal, Oil sands, Tobacco, Civilian firearms, Nuclear weapons	Controversial weapons	Controversial weapons. Conventional weapons, Nuclear weapons, Oil sands, Thermal coal, Tobacco	Controversial weapons, Alcohol, Gambling, Tobacco, Nuclear power, Conventional weapons, Nuclear weapons, Civilian firearms	Controversial weapons, Civilian firearms, Nuclear weapons, Tobacco, Alcohol, Adult entertainment, Conventional weapons, Gambling, GMOs, Nuclear power, Thermal coal
ESG Rating	No	Yes, use for weighting	Yes, use for weighting	Yes - rated BB or above for inclusion	Yes - rated A or above for inclusion
ESG Trend (momentum)	No	Yes, use for weighting	Yes, use for weighting	No	No
Best-in-class selection	No	No	No	Yes, target sector coversage of 50%	Yes, target sector coversage of 25%

Source: MSCI ESG Universal Select Business Screens Indexes methodology April 2019, MSCI ESG Universal Indexes methodology August 2018, MSCI ESG Screened Indexes September 2018, MSCI SRI Indexes Methodology May 2018, MSCI ESG Leaders Indexes methodology May 2018. Data from Invesco, Bloomberg, and MSCI. Tracking Error calculated from common index inception date of 26 July 2017. ESG Quality Scores and Carbon Intensity as of 31 March 2020.

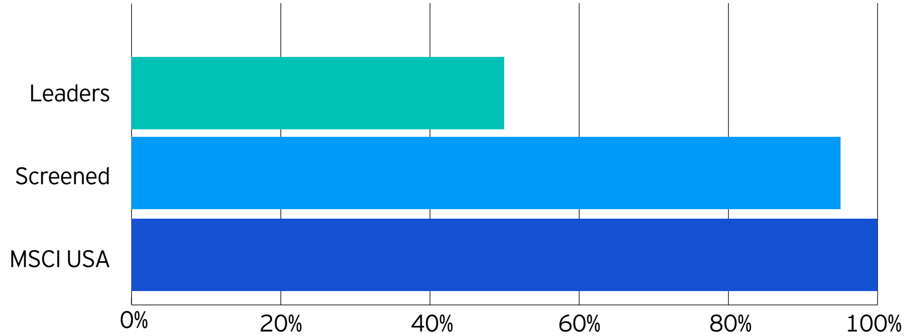
Here, we compare two of the above indices that, on name alone, you may expect to be reasonably similar - and in some ways are. However, the indices differ in some meaningful ways, driven by their specific objectives and methodologies.

- **MSCI ESG Screened** index excludes companies from the parent index (in this case, MSCI USA) that are associated with controversial, civilian and nuclear weapons and tobacco, that derive revenues from thermal coal and oil sands extraction and that are not compliant with the United Nations Global Compact principles.
- **MSCI ESG Leaders** Index also makes key exclusions, but one of the index's main differentiators is that it provides exposure to companies with high ESG performance relative to their sector peers.

Coverage of the parent index

By focussing on industry leaders, the MSCI ESG Leaders Index provides coverage of less than 50% of the parent MSCI USA Index (289 out of the 616 stocks), whereas the MSCI ESG Screened Index covers around 94% of the index (579/616)[3].

Coverage of Standard MSCI USA Index

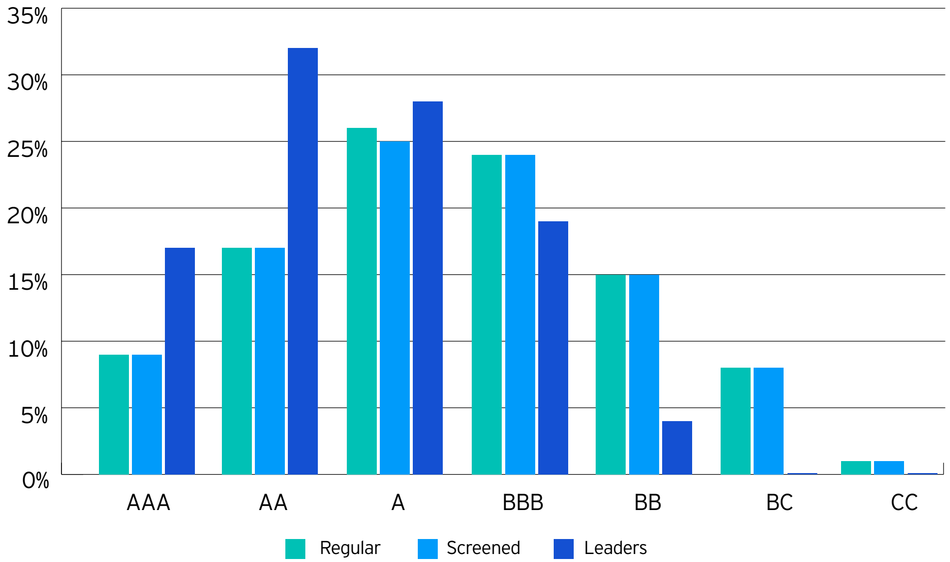


Data: MSCI as of end of August 2020.

ESG ratings breakdown

The increased focus of the MSCI ESG Leaders index also concentrates exposure to those companies ranking higher in terms of their ESG ratings as defined by MSCI[4], whereas the greater coverage of the MSCI ESG Screened index provides a similar profile to the parent index.

Performance vs. Standard MSCI USA Index



Data: MSCI as of end of August 2020.

[3] Data: MSCI, as at 31 August 2020

[4] the Fund ESG Rating is designed to assess the resilience of a fund's aggregate holdings to long term ESG risks. Highly rated funds consist of issuers with leading or improving management of key ESG risks. To learn more, please consult the MSCI ESG fund ratings methodology.

Individual exposures and scores

The different methodologies also result in variations in certain exposures and overall scores. There is no clear "winner" as the preference depends on what is important to the investor. For instance, the MSCI ESG Leaders comes out on top in terms of MSCI ESG Quality Score[5] as well as in each of the three pillars but has a significantly higher carbon footprint than the MSCI ESG Screened index.

Standard Data points

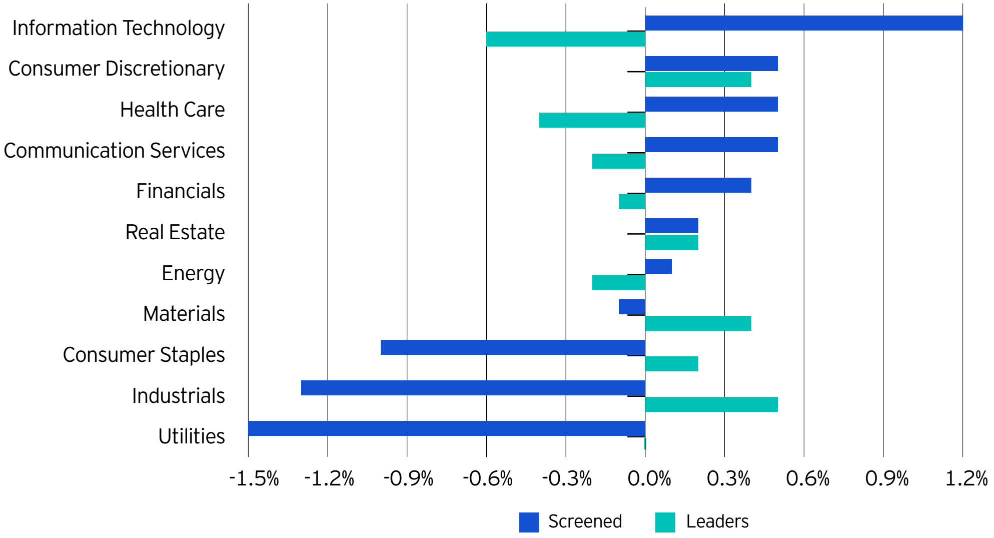
Name	MSCI ESG Quality Score (0-10)	MSCI ESG % Coverage	Carbon footprint	Oil Sands	Controversial Weapons	Nuclear Weapons	Tobacco	Alcohol	Adult Enter-tainment	Gambling	Nuclear Power	Board Inde-pendence >= 75%	Female Directors (>=3)	Enviromental Pillar Score	Social Pillar Score	Governance Pillar Score
Screened	6.27	99.8%	86.13	1.22%	0.00%	0.35%	4.34%	11.79%	7.85%	3.65%	2.14%	77.74%	76.18%	6.46	4.84	5.46
Leaders	7.83	100.0%	134.02	0.26%	0.00%	0.00%	2.29%	6.09%	2.06%	3.16%	1.58%	80.78%	83.50%	6.89	5.36	5.84

Data: MSCI as of end of August 2020.

Active sector weights, relative to MSCI USA

Different methodologies can also result in different sector exposures, which in this case are quite dramatic, such as in the relative weightings of technology stocks versus the parent index.

Active Sector Weightings

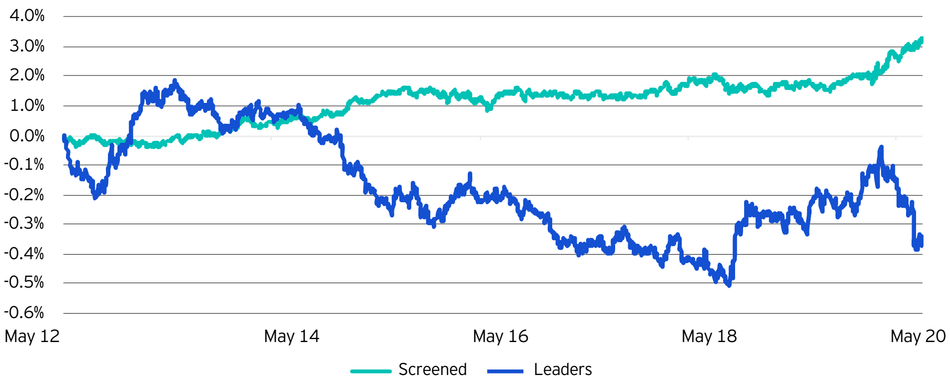


Data: MSCI as of end of August 2020.

Performance, relative to MSCI USA

The difference in exposures and overall market coverage has had a material effect on the relative performance of each of the two indices, as can be seen in the chart below dating from the inception of the MSCI ESG Screened index in 2012. Although the MSCI ESG Leaders Index states that it "is designed for investors seeking a broad, diversified sustainability benchmark with relatively low tracking error to the underlying equity market" you could expect it to deviate from the benchmark more materially than the MSCI ESG Screened Index, which has a methodology that lends itself to closer tracking. Indeed, the MSCI ESG Leaders index has had a higher tracking error (1.51% versus the MSCI USA), compared to 0.55% for the MSCI ESG Screened index.

Performance vs. Standard MSCI USA Index



Data: Bloomberg as of end of August 2020.

[5] The "Fund ESG Quality Score" assesses the resilience of a fund's aggregate holdings to long term ESG risks, based on a granular breakdown of each issuer's business: its core product or business segments, the locations of its assets or revenues, and other relevant measures such as outsourced production. The "Fund ESG Quality Score" is provided on a 0-10 score, with 0 and 10 being the respective lowest and highest possible fund scores. To learn more, please consult the MSCI ESG fund ratings methodology.

Conclusion

The path to greater and more widespread adoption of ESG into portfolios seems clear. However, the subtle and often quite stark differences between fund strategies and index methodologies can provide not only increased choice but also challenges for some investors. Not every investor is alike in this search, so a thorough understanding of the investment objectives and requirements is required, as is careful analysis of the investment options.

At Invesco, we have designed our range of ESG ETFs to provide transparent and cost-efficient solutions for investors who wish to maintain broad exposure similar to that of a standard benchmark but with a significantly improved ESG profile. This includes ETFs that follow tailored versions of the MSCI ESG Screened indices shown in the case study, seeking to deliver low tracking error but improved ESG scores over and above those achieved by the standard ESG Screens.

Please get in touch if you wish to discuss your specific requirements and explore potential solutions, including comparisons between funds you may be considering.

Invesco's commitment to ESG

Our ambition at Invesco is that our investors see the same strong principles reflected not only in our product range but in everything we do. From the way we treat one another and our clients, to supporting communities and reducing any negative impact our business has on the environment, doing the right thing is a fundamental commitment of our firm.

From an investor perspective, we believe ESG aspects can have an impact on sustainable value creation as well as risk management, and that companies with ESG momentum may present opportunities. We serve our clients in this space as a trusted partner by adopting and implementing ESG principles in a manner consistent with our fiduciary responsibilities.

Invesco was awarded an A+ rating for the fourth consecutive year in the 2020 assessment by the PRI (Principles for Responsible Investment). As well as receiving the highest overall score for our approach to responsible investment, we were also scored A or A+ in each individual category. The PRI carries out the annual assessment based on how a signatory progresses year on year and relative to its peers. More than 3,000 firms globally are signed up to the Principles, representing over $103 trillion of assets (as at 31 March 2020).

Investment Risks

Investment strategies involve numerous risks. Investors should note that the price of your investment may go down as well as up. As a result you may not get back the amount of capital you invest.

Important information

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Data as at September 30th 2020, unless otherwise stated.

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