ESG engagement through passives
It's all in the detail

This marketing communication is for professional investors.

Nearly half of European ETF flows (over US$50 billion) went into environmental, social and governance (ESG) ETFs from January to August 2021[1]. However, from a survey conducted by Invesco after a proprietary event (60 clients surveyed), investors' primary concern is selecting funds and providers who avoid greenwashing, as some ESG ETFs may be misaligned with their stated goals.

This paper examines whether a passive (ETF) approach can provide materially positive outcomes for ESG investors and highlights some questions investors can ask to sort through the plethora of solutions to find the ESG ETF for their needs.

1. Backdrop

> 46% of all European-domiciled ETF flows went into ESG products

Strong flow
In the first eight months of 2021, 46% of all European-domiciled ETF flows went into products that include some degree of environmental, social and governance (ESG) considerations. In fact, independent ETF and ETP research and consultancy firm ETFGI noted that the first seven months of 2021 flows surpassed those from all of 2020. Indeed, strong and consistent monthly inflows over the past two years have pushed total ESG ETF assets under management (AUM) to US$187.8 billion[2].

This is not just a European phenomenon either. According to Bloomberg Intelligence, global ESG ETF assets are on track to hit US$1 trillion by 2025[3]. July 2021 marked the 64th consecutive month of positive net flows for ESG ETFs globally[4], a period also covering the market turbulence at the beginning of the global pandemic.

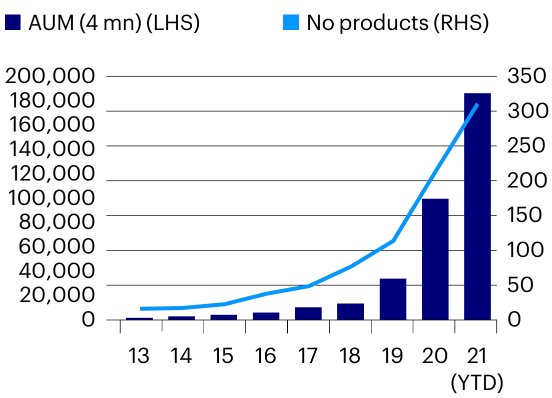
Abundance of choice
ESG is not a 'one size fits all' solution because ESG means different things to different investors. Consequently, one of the benefits of ETFs – a wide choice of offerings – becomes even more important for meeting personalised ESG outcomes.

ESG ETFs range from funds involving simple exclusions to those applying stricter "best in class" methodologies that combine positive and negative screens, and numerous solutions in between. With more than 250 ESG products currently available on the European ETF market[5] investors have an overwhelming number of funds to meet their needs.

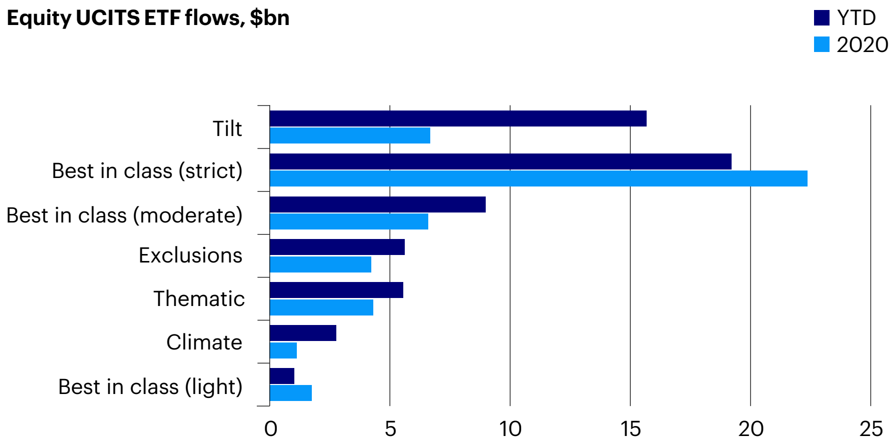
For 2021, nearly 75% of year-to-date ESG ETF flows went towards passive products that either "tilt" weightings to securities with higher ESG scores or apply strict or moderate "best in class" criteria[2]. For a more detailed view on the common ESG ETF approaches, see section 'Financial goals'.

Increasing AUM and flows into ESG UCITS ETFs[6]

Growth in ESG-focused UCITS ETFs



Equity UCITS ETF flows, $bn



Data: Bloomberg, as at 31 August 2021

ESG standards as guiding stars
The wide range of choice and a current lack of clear industry standards makes comparing and choosing solutions difficult. Even the term 'ESG' is not universally understood, lacking a common definition across the industry.

The recently introduced Sustainable Finance Disclosure Regulation (SFDR) aims to improve transparency across the market on ESG. In particular:

- Article 8 products are those designed to promote an environmental or social characteristic using binding criteria that goes beyond integration of financially material sustainability risks and is measurable
- Article 9 products are those with "sustainability" as a specific objective.

In the context of SFDR, 'sustainable investment' means an investment in an economic activity that contributes to an environmental or social objective, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices. Read our update on European ESG Regulations "Recent developments on Sustainable Finance" for more information.

These regulations and similar initiatives provide greater clarity to help investors understand what an ETF is trying to achieve so they can identify the closest match to their specific needs.

At best, investors may expend much time and effort to find the ESG ETF that meets their needs. At worst, they may end up holding ETFs that run counter to their stated ESG expectations. Advisers, in particular, must ensure their clients understand the implications of initial sustainability or Principal Adverse Impact (PAI) assessment questions.

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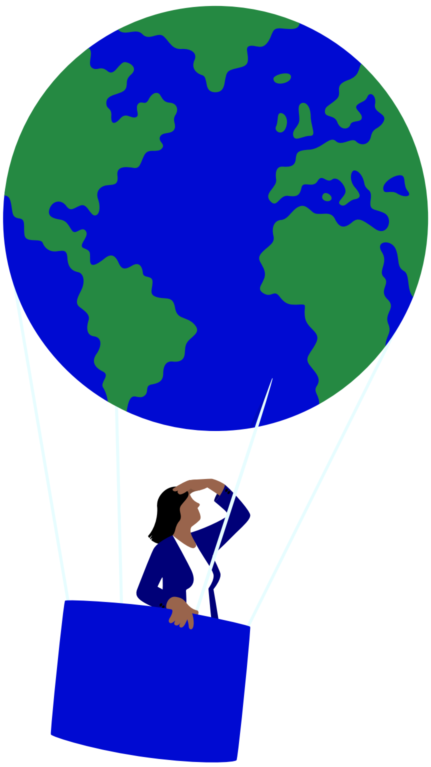
The order of importance between financial and non-financial sets of goals varies by investor

2. What are your goals?

An investor's ESG investing objectives can be separated into financial and non-financial goals.

- **Financial** – Can a passive ESG ETF deliver long-term investment performance, for instance as compared to a benchmark, including tracking error/risk guidelines?
- **Non-financial** – Can a passive ESG ETF produce specific ESG outcomes, which depend on each investors' particular ESG goals?

The order of importance between the two sets of goals vary by investor. For some, non-financial goals such as those related to ESG could be more important than their financial objectives. On the other hand, investors who have a fiduciary responsibility to meet certain outcomes – such as meeting long-term liabilities – could prioritise financial objectives but still adhere to some non-financial objectives as a secondary goal.



Financial goals
An investor's financial goals typically refer to any performance objectives, usually either an absolute return target or, as is more common, a return referenced to a benchmark performance, often with an acceptable level of tracking error.

If an investor's portfolio is benchmarked to non-ESG indices, the choice of ESG ETF may be driven by the investor's confidence that the ETF offers a performance profile similar to that of the respective benchmark.

There are generally two facets relevant to performance when looking at a passive ESG ETF:

1 How does the ESG index compare to its parent index?

2 How well does the ETF track the ESG index?

Besides comparable performance and tracking, other financial goals that investors may take into consideration include volatility and drawdown.

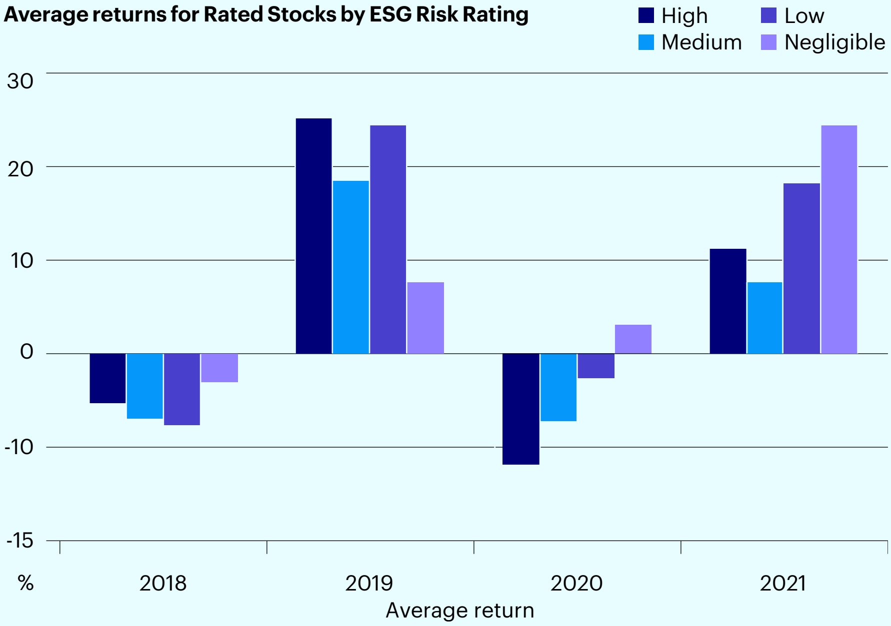
Does 'ESG' = outperformance?

An improvement in ESG does not necessarily require a sacrifice in performance as was once thought. In fact, the relative performance of ESG indices in 2020 demonstrated that companies with better ESG profiles could outperform lower ESG-rated industry peers. According to Morningstar, companies with low levels of ESG-related risk significantly outperformed companies with higher ESG risks in 2020 and in the first seven months of this year. This is in contrast to 2019, when both low- and high-risk ESG companies had broadly similar returns.

As well as past performance not being an indicator of future returns, this is also only two years' results, which were partly due to natural sector biases. ESG indices avoided capital equipment-heavy industries and had limited exposure to falling oil prices, while being overweight technology.

Another possibility is that an 'ESG premium' is being factored into the share prices of companies with low ESG risk, a phenomenon which may or may not persist moving forward.

Average returns for Rated Stocks by ESG Risk Rating



Source: Morningstar Direct, July 28, Created with Datawrapper. **Past performance is not a guide to future returns.**

Recent academic literature is mixed on the efficacy or persistence of ESG outperformance as a factor. Some proponents note that companies with favourable ESG ratings carry lower costs of capital and default risks, which enables future earnings to be priced higher (Sustainalytics, Kris Douma, 11 August 2021 https://www.morningstar.co.uk/uk/news/214249/do-esg-stocks-outperform.aspx). Another study, found that companies with weaker ESG scores experienced a 2.5% annual underperformance compared to a broad European portfolio and 3.5% underperformance for a US portfolio (Simon Glossner; February 17, 2021; University of Virginia – Darden School of Business) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3004689

Opponents of an 'ESG premium', such as New York University Stern School of Business's Aswath Damodaran, point to weak evidence tying excess positive returns to ESG-focused investing, and note a causation problem whereby it is equally likely that companies are successful because they adopt high ESG standards as the possibility that simply signalling ESG standards without taking material action attracts customers and investors, making firms successful. (Damodaran, 'Sounding Good or Doing Good', 21 September 2020, http://aswathdamodaran.blogspot.com/2020/09/sounding-good-or-doing-good-skeptical.html

Non-financial (ESG) goals
Non-financial or ESG-related goals cover a breadth of issues across the three pillars of ESG and are more diverse than financial goals.

Environmental

- Clean water and sanitation
- Affordable and clean energy
- Responsible resource consumption and production
- Climate action
- Life on land
- Life below water

Social

- Eliminating poverty
- Improving health and wellbeing
- Providing education
- Promoting gender equity
- Reducing other social inequalities

Governance

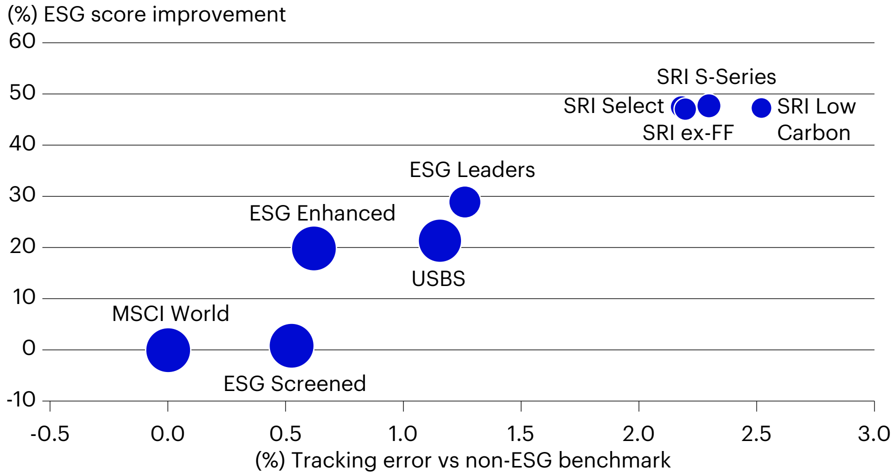
- Executive renumeration
- Board composition
- Transparent reporting
- Oversight and accountability

For illustrative purposes only.

3. Implementation: how can investors balance financial and non-financial ESG goals in practice?

Once investors are clear about their financial and non-financial goals, they are ready to select a matching ESG ETF. As seen in the chart below, ESG ETFs can be designed any number of ways, each varying in the manner and precision by which ESG issues are targeted.

ETFs offer a wide range of ESG exposures[7]



Source: Invesco, Bloomberg, MSCI, as at 31 August 2021. MSCI World based indices, Tracking Error calculated from common index inception date of 30 November 2015 to 31 May 2021. Bubble size shows % market coverage by market cap.

With clear goals in mind, investors can balance objectives and select exposures

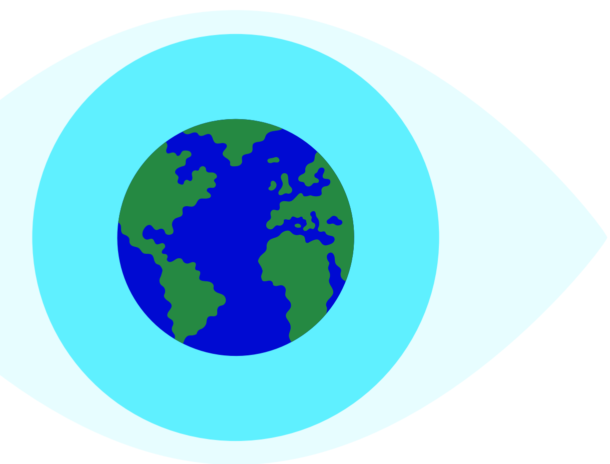
The chart illustrates the amount of improvement in overall ESG scores and the resulting tracking error for a range of ESG indices derived from the parent MSCI World Index.

In general, the more securities an ETF excludes from its parent index by way of stricter negative or positive screening, the greater potential improvement in ESG but also the higher level of tracking error.

An investor who has low tolerance for tracking error versus the parent index is more likely to value an ETF that tracks more in-line with the parent index. At the bare minimum, ESG ETFs can achieve non-financial goals by excluding companies involved in certain undesirable industries or business practices. The list of exclusions can vary greatly, and each additional exclusion will reduce the investable universe accordingly. 2021 flows suggest a relatively low level of demand for these exclusion-only ETFs.

Fortunately, the spectrum of ESG ETFs spans beyond exclusions, extending to positives screens that overweight or even focus exclusively on companies seen as ESG leaders.

In another example, an investor could reasonably expect an SRI strategy that excludes 75% of the parent index to offer the greatest improvement in overall ESG scores relative to the parent index. This approach would also entail the highest tracking error relative to the same parent index. While such an SRI strategy may meet the objectives of some investors, the tracking error will be unacceptable for others.



Tracking Error increases with ESG improvements

	MSCI World Index	MSCI ESG Screened Index	MSCI ESG Enhanced Focus Index	MSCI ESG Universal Select Business Screens	MSCI ESG Leaders Index	MSCI SRI Index
ESG Controversy exclusions:		Companies that fail to comply with UN Global	Companies with a score of 0 (severe)	Companies with a score of 0 (severe)	Companies with a score below 3	Companies with a score below 4
Exclusions in addition to tobacco, controversial weapons, civilian firearms and nuclear weapons		Thermal coal, oil sands	Thermal coal, oil sands	Thermal coal, oil sands, conventional weapons, cannabis (recreational)		Conventional weapons, oil and gas sector, fossil fuel reserves, thermal coal, nuclear power, GMOs, alcohol, adult
ESG Trend (momentum)		No	No	Yes, use for weighting	No	No
Best-in-class selection		No	No	No	Yes, target sector coverage of 50%	Yes, target sector coverage of 25%
# constituents	1,561	1,472	1,469	1,407	725	380
Tracking error		**0.52%**	**0.63%**	**1.16%**	**1.25%**	**2.21%**
ESG Quality Score	6.2	6.2	7.5	7.7	8.0	9.7
Carbon Intensity	136	93	99	91	80	60

Sources: Invesco, Bloomberg and MSCI, as at 30 June 2021.

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Be careful of what your ESG ETF really holds

As illustrated in the table above, which expands on the previous chart, tracking error increases as greater restrictions are placed on the parent MSCI index. At the same time, the number of exclusions increased through negative screens and/or a "best in class" focus leads to an improvement in ESG Quality and Carbon Intensity.

While we have used MSCI indices in this illustration, investors could expect to see similar trends when applied to other broad benchmarks, although actual results will vary depending on the composition of the parent index.

Go deeper into ESG ETF goals
Besides the trade-off between tracking error and ESG improvement, investors should be mindful of other metrics related to ESG (non-financial) goals.

1. **Ask how the ESG goal is defined.** Two ESG ETFs may share the same ESG goal–exposure to and promotion of clean energy, for example–yet they may have sharply contrasting methods for targeting the outcome. Perhaps one ETF scores companies based on the percentage of revenues derived from clean energy activities. While perhaps the other ETF selects companies based on patents and market leadership within the clean energy sector.
2. **Check the intensity of your exposure.** What percentage or intensity of the ETF is devoted to the ESG goal selected? Different ETFs may not have the same concentration to the stated ESG goal. Sometimes this comes as a result of other trade-offs, such as tracking error, as noted earlier in this paper, or to maintain liquidity standards for the ETF.
3. **Be careful of unintended consequences.** Similar to point #2 above, ESG ETFs may have exposures that are contrary to the stated ESG goal. For example, in the case of a clean water ETF, the ETF may have exposures to companies with exposure to commercial fishing or seemingly unrelated but equally negative activities such as land waste.

4. Voting and engaging to affect change – what can a passive ETF do?

In addition to the stated goals of an ESG ETF, other ways of affecting positive change include voting on company proxies and engaging with company management.

Traditionally, investors have viewed voting and engagement as activities solely within the purview of active funds. But the term "passive" is often misunderstood, especially as it relates to voting and engagement. An ETF is passive if it methodically follows an index.

Crucially, an ETF that uses physical replication buys and holds the securities in the index, which confers voting rights and the opportunity to begin engaging with company management. But not every ETF provider has the capabilities to vote shares and interact with executive teams of investee companies.

5. An ETF issuer's capabilities

Not every ETF issuer is created equal. An investment provider with robust processes in place and an in-house ESG team or embedded ESG functions within its investment teams can effectively vote on proxies and conduct meetings with company management teams on behalf of its entire physically invested fund range, including passive ETFs.

Nevertheless, a lack of in-house resources should not automatically negate a provider's overall ability to be a responsible investor, as it could use third-party research or proxy voting firms to pursue similar activities.

For investors wanting to make the most of their ESG investments, it is important to ask the right questions when deciding on an investment provider:

- What role does ESG play in the investment decisions?
- Are any resources dedicated to ESG, such as an in-house team? If not, does the provider outsource the ESG research to specialist firms?
- What are the proxy voting and engagement philosophies and processes?
- What is the track record in terms of ESG? How are results communicated with investors?
- Does the investment provider exhibit measurable ESG integration across its business?

The answers to these questions are not going to be discovered through investment performance data, but they should be available.

Invesco's approach to ESG ETF investing

As a leading global asset manager we leverage our wider investment research, proxy voting and company engagement capabilities through our echo-voting and engagement processes. Positions held by our ESG ETFs cross-reference and follow the voting decisions of Invesco active fund managers with the largest holding in the same security. Likewise, our ESG ETFs can benefit from company engagement carried out by the Invesco ESG and investment teams.

Our patented proxy voting portal facilitates investment-led voting decisions. This proprietary tool encourage knowledge collaboration, leverages multiple sources of research and enables investors to focus on long-term shareholder value.

We also take our responsibility as asset owners very seriously and see engagement as an opportunity to encourage continual improvement. Dialogue with investment companies is a core part of our investment process and one of the most powerful mechanisms for reducing risks, enhancing returns and having a positive impact on society and the environment.

Read more about our Invesco ESG policies.
invesco.com/middle-east/en/about-us/esg-and-responsible-investing.html

Case study: affecting change with ESG ETFs

Details into action: MSCI ESG – ArcelorMittal case study

As one of the world's largest manufacturers of steel, a highly energy-intensive industry, ArcelorMittal is not a name many people think of in terms of ESG. However, it is also one of the leaders in its industry on carbon reduction. As a result, the stock is included in MSCI ESG Universal Screened indices.

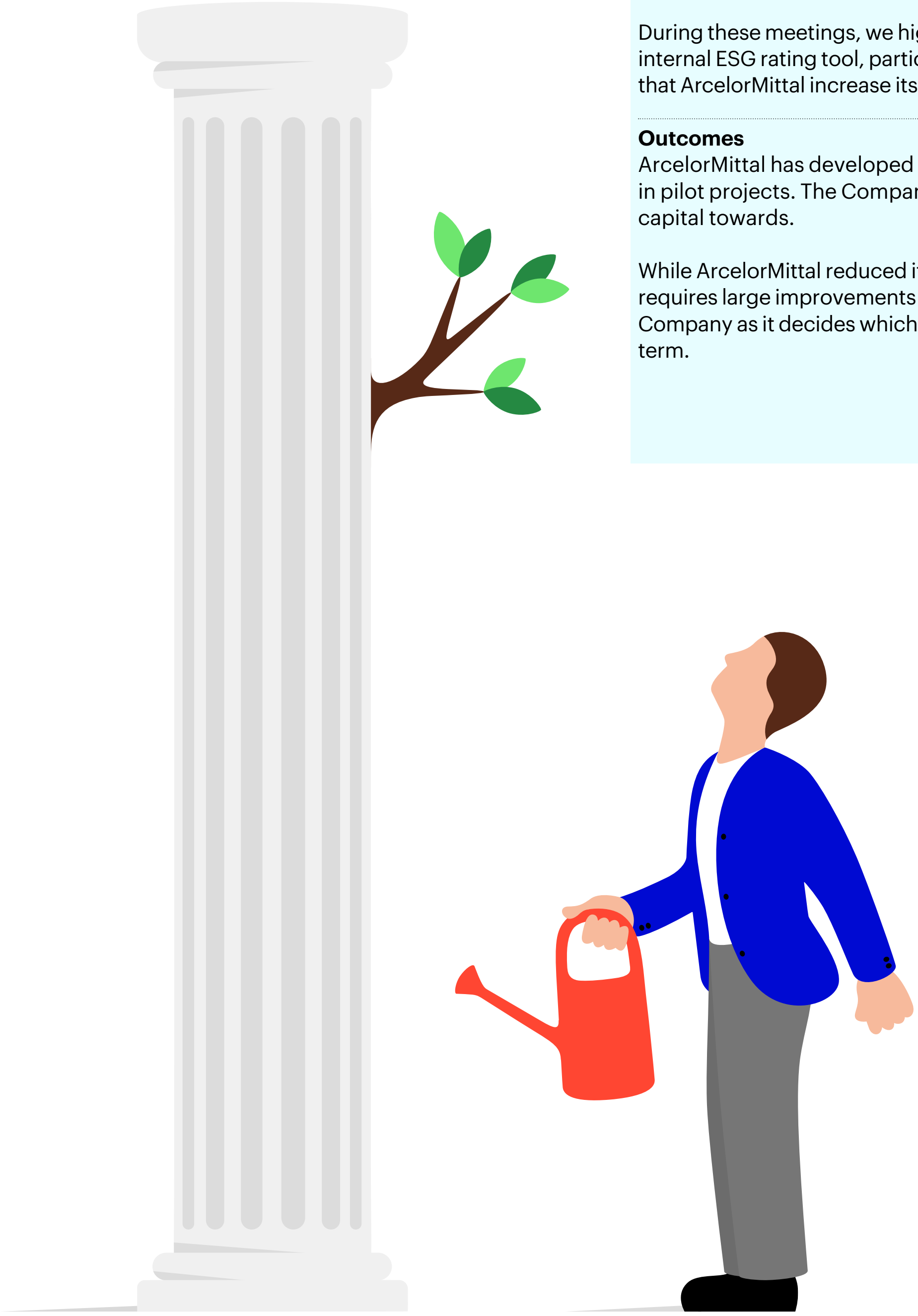
Opportunity
Although ArcelorMittal is an industry leader in championing carbon reduction, its total carbon emissions are high on an absolute basis. As a result, the Company continues to receive weak ratings from Invesco's proprietary ESG tool.

Action
From 2020 to 2021, Invesco held four separate engagement meetings with ArcelorMittal regarding its performance on environmental factors. Three meetings were held by our global ESG team, while the fourth was conducted by our European equity team. Participants on ArcelorMittal's side have included its CEO, head of sustainability and investor relations.

During these meetings, we highlighted key areas where ArcelorMittal scored poorly on our internal ESG rating tool, particularly total carbon emissions. Ultimately, we recommended that ArcelorMittal increase its capital expenditures related to climate change.

Outcomes
ArcelorMittal has developed three decarbonisation technologies that have been tested in pilot projects. The Company is now deciding which of these to scale up and commit capital towards.

While ArcelorMittal reduced its carbon emissions by 17% year-over-year in 2020, it still requires large improvements in this area. We plan to maintain dialogue with the Company as it decides which decarbonisation technologies to commit capital longer term.



A step by step process to select ESG ETFs

Conclusion

Passive ESG ETFs *can* tick all the right boxes
The proof is in the pudding: with significant and persistent flows into ESG ETFs, investors are harnessing the benefits of ETFs (transparency, accessibility, general low costs) to achieve their ESG investing goals.

Choosing a proper ESG ETF is far from clear, though, given the nascency of the ESG ETF market and further development underway for regulatory and measurement standards. In fact, some investors may be unknowingly exposed to companies, sectors and outcomes that they did not want.

As increasing investor demand drives an ever-expanding range of ESG solutions, it is important to understand what different ESG ETFs aim to achieve – and how each product has been designed – in order to match funds most appropriately with investors' personal objectives, both financial and non-financial. While some ESG investors have requirements for a certain level of relative investment performance, most also want to see their funds used to achieve non-financial outcomes.

Trade-offs are necessary between financial goals, such as tracking error, and non-financial goals, like ESG improvements, which cover a wide array of ESG-specific outcomes. Like ETFs generally, ESG ETFs offer a range of potential solutions, a spectrum between low tracking error and significant ESG score improvement.

Within non-financial or ESG goals, it's also critical for investors to check how potential ETFs defining ESG outcomes, as well as the intensity of ESG exposures and whether there are any unintended exposures. Having clarity over ESG measurements and ensuring these align with your goals is key.

Besides stated ESG goals, investors should also consider whether their ESG ETFs vote proxies and engage with companies. Voting and engagement is arguably one of the most effective mechanisms to reduce risk, maximise returns and have a positive impact on society and the environment.

Just as passive ETFs can offer a range of investment outcomes, they also have the potential for voting and engagement opportunities, including highlighting and understanding ESG risks and opportunities and encouraging positive change.

Lastly, investors should not overlook the resources and capabilities of their ETF providers more broadly, including dedicated teams, proxy voting and engagement processes, ESG track records, and demonstrating measurable ESG integration.

By being clear on their goals and thorough in investigating the measurement and outcomes of ESG ETFs, as well as the capabilities of ETF providers, investors can increase the probability of finding an ESG ETF that is right for them. Any product that demonstrates high standards across these dimensions may really tick all the right boxes.

1 Source: Bloomberg, as at 31 August 2021
2 Sources: Invesco and Bloomberg, as at 31 August 2021
3 Source: Bloomberg Intelligence "ESG 2021 Midyear Outlook report", July 2021
4 Source: ETFGI, published August 2021 for data to 31 July 2021
5 Sources: Invesco and Bloomberg, as at 31 August 2021
6 Source: Invesco and Bloomberg, as at 31 July 2021
7 Source: Invesco, Bloomberg, MSCI, as at 31 August 2021. MSCI World based indices, Tracking Error calculated from common index inception date of 30 November 2015 to 31 May 2021. Bubble size shows % market coverage by market cap.
8 Source: Invesco as at 1 September 2021.

Risk warnings

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Important information

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Data as at 27 Jul 2021 unless otherwise stated.

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