Vanguard

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Exclusionary indexing: A transparent approach to ESG investing

Key points

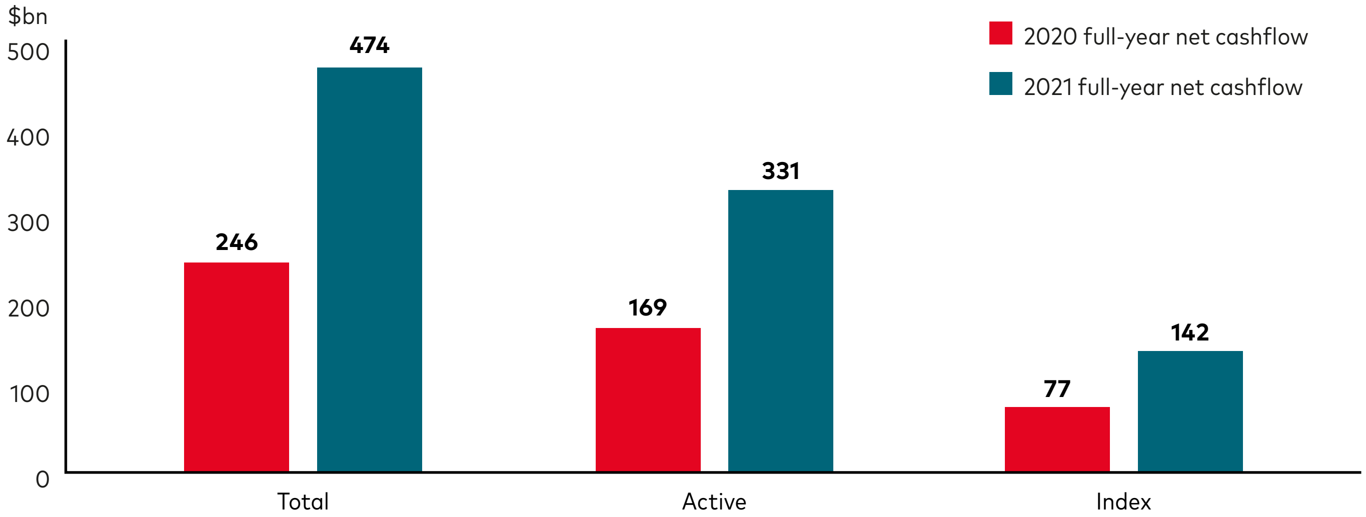
1. Many investors are turning to index products to meet their environmental, social and governance (ESG) investing preferences.
2. ESG index products vary widely in their complexity and approach.
3. Exclusionary index products may be a suitable option for investors seeking to limit their exposure to business activities that conflict with their ESG preferences.

As interest in sustainable investing grows, many investors are turning to index products to meet their ESG investing preferences[1].

The growth of ESG indexing mirrors the growth of indexing within the broader fund industry, but with one notable difference. Whereas the broader industry trend has seen most assets flow to traditional market-cap-weighted products, the ESG indexing trend has seen assets dispersed across products that use a wide variety of approaches for incorporating ESG criteria. The proliferation of methodologies has left some investors confused about how to assess and select an appropriate product.

ESG indexing is on the rise

European ESG industry cash flow – active vs. index



Source: Morningstar Global Sustainable Fund Flows Report, as at 31 March 2022.

1 European sustainable fund flows (USD). Source: Morningstar Global Sustainable Fund Flows Report, as at 31 March 2022.

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How Vanguard approaches ESG exclusionary indexing

By avoiding or reducing exposure to certain business activities while seeking to achieve a market-like return, exclusionary ESG products can meet the investment needs and preferences of a broad subset of ESG-aware investors. Here's why:

Exclusionary funds are transparent

The first of Vanguard's is to create clear and appropriate goals. When a product's objective and strategy are clear, it's easier for investors to identify the role it plays in helping them reach those goals.

Vanguard's exclusionary ESG funds track benchmarks that are derived from common market-capitalisation-weighted indices. Our benchmark providers then apply transparent screening criteria to avoid or reduce exposure to certain activities that many investors view as being controversial, such as firearms, tobacco or fossil fuels.

While our exclusionary funds' benchmarks apply clearly defined ESG screens, the approach isn't overly restrictive. Some investors, for example, may wish to maintain exposure to companies with diverse business lines even though alcohol sales account for a relatively small amount of their revenue. These investors may not want to risk the potentially negative impact of entirely eliminating exposure to such companies on diversification and returns.

To account for these nuances, our funds' benchmarks use a revenue-based screening methodology that groups companies involved in certain business activities according to three levels of restrictiveness. Within each level, the indices exclude companies that exceed certain revenue thresholds. The thresholds vary based on whether the involvement is primary or secondary to their business. Within our most restrictive category, for instance, the threshold is 0% for both primary and secondary involvement.

The benchmarks also exclude companies that, as determined by the benchmark provider, are involved in severe controversies related to United Nations Global Compact Principles which cover labour, human rights, the environment and anti-corruption[2].

A revenue-based ESG screening methodology

		Revenue thresholds	
		Primary involvement (Producing/manufacturing)	**Secondary involvement** (Retailing/supplying)
Most restrictive	Controversial weapons Civilian firearms Nuclear power	0%	0%
	Fossil fuels	ICB classification† (and in some cases, 0%)	ICB classification† (and in some cases, 0%)
Moderately restrictive	Tobacco Cannabis* conventional (military) weapons	0% (and for cannabis, ICB classification†)	<5% (cannabis is not screened)
Least restrictive	Adult entertainment‡ Alcohol‡ Gambling	<5%	<10%

Notes: The table shows the business involvement screening methodologies used by FTSE (for our ESG equity index funds) and Bloomberg MSCI (for our ESG fixed income index funds).

* For cannabis, companies are screened for primary involvement only for equity indices and not screened at all within fixed income indices because of data limitations with the index providers. The cannabis screen for our equity products is defined by the Industry Classification Benchmark (ICB). For fossil fuels, companies are screened based on revenue-based thresholds for some activities and ICB classification for others.

† ICB classification applies only to FTSE, the index provider for our equity ESG products.

‡ Our fixed income ESG indices use a 10% aggregate revenue tolerance across all secondary involvement for both the alcohol and adult entertainment categories (e.g., if a company earns 7% of its revenue as an alcohol retailer and 3% as a supplier, the aggregate 10% revenue would result in the company being excluded from the index). This nuance exists because of data limitations of the index providers.

2 This applies to the screening methodology used by FTSE (for our ESG equity index funds); Bloomberg MSCI (for our ESG fixed income index funds) excludes companies that have an MSCI controversy score of zero.

An exclusionary approach captures the core benefits of indexing

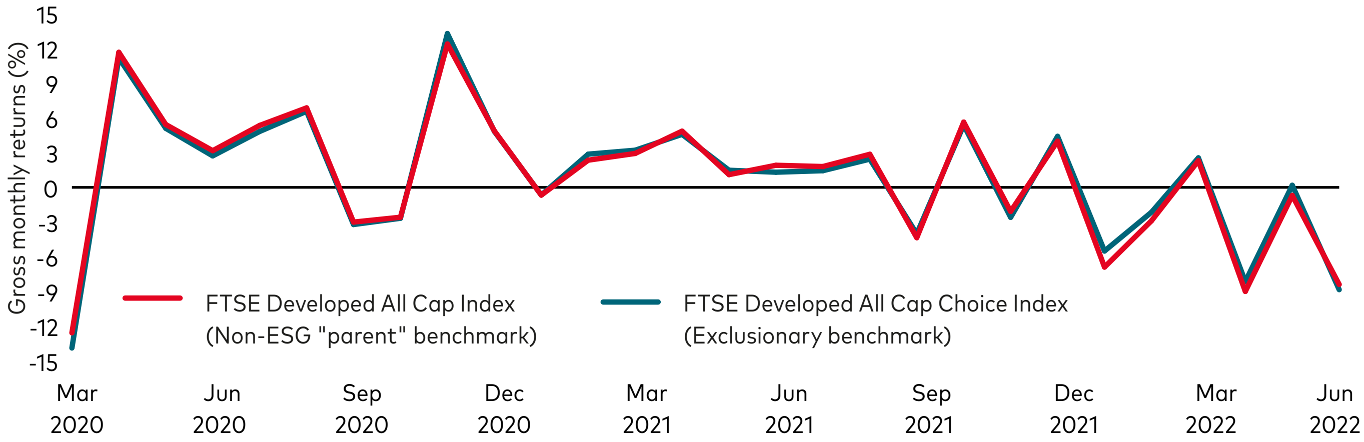
Exclusionary funds offer many of the advantages of conventional index funds, including broad exposure to a market or market segment, which enables them to serve as building blocks for a broadly diversified portfolio.

Like conventional index funds, exclusionary ESG funds hold securities in proportion to their market-capitalisation weighting. Weighting securities by market capitalisation harnesses the market's collective wisdom on security valuations. It also helps keep portfolio turnover low, since market-weighted funds generally don't need to buy or sell securities except when a firm is added to or removed from the benchmark.

Exclusionary screening can significantly affect sector and industry exposures related to screened products and activities. However, because the screened indices are broadly diversified and market-cap weighted, the impact on overall benchmark composition and long-term returns is generally minor. The chart below compares the returns of the FTSE Developed All Cap Choice Index, with those of its non-ESG "parent" benchmark.

Exclusionary indices can be close substitutes for their non-ESG "parent" benchmarks

Gross monthly returns (USD) of the FTSE Developed All Cap Choice Index and its non-ESG "parent" index



Past performance is no guarantee of future returns.

Notes: The FTSE Developed All Cap Index is a market-capitalisation-weighted index that measures the performance of large-, mid- and small-cap stocks of companies located in developed markets around the world. The FTSE Developed All Cap Choice Index measures the performance of the FTSE Developed All Cap Index after it is screened for certain ESG criteria by the index sponsor, which is independent of Vanguard Returns are gross monthly returns (USD)..

Data from 31 March 2020 to 30 June 2022, in USD with income reinvested The FTSE Developed All Cap Choice Index was launched on 19 February 2020. The index performance data shown here is from 31 March 2020, which is the first quarter-end date after the launch of the index.

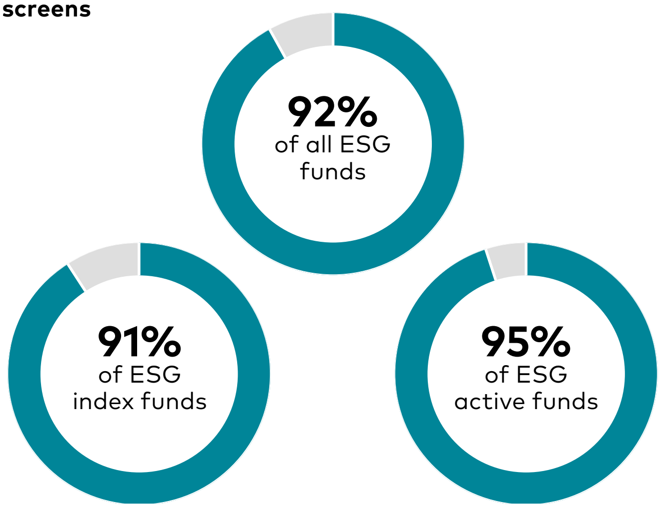
Sources: Vanguard and FactSet, as at 30 June 2022.

ESG exclusions continue to stand the test of time

The merits of exclusionary ESG screening are widely recognised, and the approach is employed across ESG product types. As at the end of March 2022, 91% of European ESG index funds and 95% of ESG active funds used exclusionary screens in some form to narrow down the universe of securities eligible for inclusion in their portfolios[3]. The broad use of exclusionary screening suggests that investors in ESG funds would like to limit their exposure to certain businesses and industries, irrespective of an ESG fund's overall strategy or approach.

Exclusionary screens are used across ESG product types

Percentage of ESG funds that employ exclusionary screens



Note: Includes Europe-domiciled ESG funds only.

Sources: Vanguard and Morningstar, as at 31 March 2022.

3 Vanguard and Morningstar, as at 31 March 2022.

Investment risk information

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

Past performance is not a reliable indicator of future results.

Important information

This is a marketing communication.

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