

Vanguard's approach to ESG

Investors around the world are increasingly interested in environmental, social and governance (ESG) issues as they seek to balance personal values and financial goals. Integration of ESG information into investment processes isn't new, but global interest in different approaches to ESG investing continues to grow.

With more than 30 million investors globally who look to us to both safeguard and grow

their investments, we think about ESG risks and opportunities in the context of delivering long-term value to our investors and helping them to meet their objectives.

We believe that material ESG risks, if left unchecked, can undermine long-term value in the companies in which we invest. Over time, well-governed companies, including those with sound practices to mitigate material ESG risks, should outperform those that are poorly governed. As a result, we integrate ESG considerations into our investment processes and our product design in a number of ways, which we will explore in this document.

What is ESG?

ESG refers to environmental, social and governance considerations.



Environmental

How a company or industry performs as a steward of the natural environment. For example, through their carbon emissions, energy use or waste management



Social

How a company manages its relationships. For example, how companies treat their employees, clients, suppliers and communities, and whether they offer equal job opportunities.



Governance

Supporting sound business practices by considering how a company is run. For example, by ensuring executive pay is tied to performance, company boards reflect society and minority shareholders are protected.

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Different approaches to ESG investing



How does Vanguard approach ESG?

We currently integrate ESG considerations into our product design and investment processes in three ways.

Engage: As long-term owners of the companies in which our funds invest, we engage with companies on material ESG issues as we believe they can impact long-term value creation at those companies. On behalf of Vanguard funds, we express expectations for company boards to oversee key ESG risks.

Allocate: Many of our active funds aim to allocate capital to companies based on how they manage ESG considerations, alongside other factors, when selecting investments – even where they don't have an explicit ESG investment strategy. For example, they may consider how social and environmental factors might affect a company's future earnings.

Avoid: We develop products that allow investors to avoid exposure to companies that are not aligned with their values, or to mitigate certain ESG risks.

Vanguard is also a member of, or signatory to, a number of collaborative initiatives focused on governance, long-term value creation and climate. These include, but are not limited to, the following:

- Signatory to the **Principles for Responsible Investment (PRI)**, a voluntary set of principles that commit signatories to incorporating ESG issues into investment analysis and decision-making.
- Member of the **30% Club**, a global organisation that advocates for greater representation of women in boardrooms and in leadership roles.
- Supporter of the **Taskforce on Climate-Related Financial Disclosures (TCFD)**. Vanguard encourages companies to disclose climate-related risks in line with the TCFD framework.
- Signatory to the **Net Zero Asset Managers (NZAM)** initiative, a commitment by global asset managers to support the goal of net-zero greenhouse gas emissions, and to support investing aligned with net-zero emissions, by 2050 or sooner.
- Signatory to the **UK Stewardship Code 2020**.

ESG in our index funds

Equity index funds



Our investment stewardship activities are the principal levers Vanguard uses to address material ESG risks within our index funds.

Because material ESG risks can undermine returns over the long run, Vanguard's Investment Stewardship team engages with the constituent companies of equity indices to promote effective corporate governance practices and encourage long-term value creation at the companies in which our funds invest.

Our dialogue with the management and boards of companies is a year-round process that goes beyond proxy voting at a company's annual meeting. We represent the interests of our fund shareholders through public advocacy and ongoing engagement and dialogue with companies to understand their governance practices and long-term strategy. Vanguard expects companies to disclose information relating to material risks to shareholders, such as an assessment of the impact of climate-related risks; set out a strategy for mitigating those risks and any related targets or goals; and report on progress.

ADVOCATING

We advocate with groups of constituents in the market to inform and articulate our governance.

To this end, we:

- Publish content to communicate our views.
- Support and participate in industry working groups.
- Speak at industry events/ conferences.
- Comment on regulation, certain reporting frameworks and standards.

ENGAGING

We have ongoing, direct dialogue with companies and other stakeholders about corporate governance topics.

This may include discussions with:

- Corporate board members.
- Company executives.
- Activists.
- Regulators.
- Thought leaders.

VOTING

We vote on behalf of Vanguard's internally-managed funds in support of good governance.

Our voting is based on:

- A thoughtful, considerate process that is used across the global portfolio of funds.
- Policies and guidelines informed by research.
- Knowledge and experience of senior team leaders and analysts.

Fixed income index funds



Fixed income is managed internally at Vanguard with ESG risk assessment analysed by our in-house credit research team. Vanguard's Fixed

Income Group integrates ESG into its investment process by systematically assessing the financial materiality of ESG risk to complement standard credit assessment. This is relevant to fixed income index funds because the portfolio managers aim to reflect the underlying indices through a sampling of securities. Because credit risk assessments (incorporating ESG assessments) are one of the components of the sampling process, ESG considerations can affect investment decisions.

Credit research analysts use third-party data providers as well as public information for detailed metrics related to ESG risk factors. Our credit research analysts also regularly speak with company management teams to discuss a range of issues that might pose a financial or reputational risk, including ESG risk, and integrate this information into our risk rating.

Credit analysts develop independent investment opinions for fixed income issuers. They evaluate the issuer's fundamentals, and provide ratings for credit trend and event risk, as well as assigning Vanguard's internal credit rating and an ESG materiality assessment.

ESG index funds (exclusionary)



Some investors don't want exposure to certain ESG risks or want to avoid companies that don't align with their values. Vanguard currently offers several exclusionary ESG products across equity and fixed income that help investors to avoid certain ESG risks. These products use transparent exclusion measures to remove certain companies from the investment universe based upon pre-determined ESG screening criteria.

Equity ESG exclusions

Vanguard's ESG equity index funds help investors remove exposure to controversial business activities and/or conduct, as outlined below. The index series provides a comprehensive set of rules-based product and conduct screens. The standards for exclusions are determined based on certain criteria and applied across the entire index series consistently.

ESG exclusions across equity:

- Non-renewable energy (fossil fuels, nuclear power).
- Vice products (adult entertainment, alcohol, gambling, tobacco, cannabis).
- Weapons (controversial weapons, conventional military weapons, civilian firearms).
- Controversies¹.

Source: FTSE Russell.

ESG in our active funds

Vanguard assesses ESG risks and opportunities in the context of their potential to affect long-term value for shareholders in our funds. We look to the managers of our active funds to assess companies' ESG risks on a case-by-case basis. Incorporating ESG risk into security selection for active funds without an explicit ESG mandate does not preclude the fund from investing in certain companies or sectors because of their business activities. Rather, it ensures ESG risks and opportunities are considered alongside other factors when selecting investments. Our approach differs for internally managed active funds and those managed externally.

Fixed income ESG exclusions

For Vanguard's ESG fixed income index products, launched since 2020, we use a global corporate float-adjusted liquid bond screened index, which identifies the securities for exclusion from the benchmark at an issuer level.

Vanguard's fixed income products allow ESG-conscious investors to build low-cost, diversified bond portfolios by combining ESG and conventional exposures.

ESG exclusions across fixed income:

- Non-renewable energy (fossil fuels, nuclear power).
- Vice products (adult entertainment, alcohol, gambling, tobacco).
- Weapons (controversial weapons, conventional military weapons, civilian firearms).
- Controversies.

Source: Bloomberg, MSCI.

For more on our approach to exclusionary screening, see: *ESG screening approaches – a primer, Vanguard, November 2021*.

Active fixed income (in house)



Fixed income is managed internally at Vanguard with ESG risk assessment analysed by our in-house credit research team. Vanguard's Fixed Income Group integrates ESG into its investment process by systematically assessing the financial materiality of ESG risk, to complement standard credit assessment.

Credit research analysts use third-party data providers as well as public information for detailed metrics related to environmental, social and governance risk factors. Our credit research analysts also regularly speak with company management teams to discuss a range of issues that might pose a financial or reputational risk, including ESG risk, and integrate this information into our risk rating.

¹ United Nations Global Compact controversies.

Credit analysts develop independent investment opinions for fixed income issuers in support of the active fixed income mandates. They evaluate the issuer's fundamentals, and provide ratings for credit trend and event risk, as well as assigning Vanguard's internal credit rating and an ESG materiality assessment.

For active funds, portfolio managers use Vanguard's internal rating and investment recommendations (into which ESG is integrated), combined with other market factors, as they allocate investor capital to the investments with the best risk-adjusted investment prospects.

Active equity



Most of Vanguard's active equity and multi-asset funds are managed by external firms. This approach provides us with diversity of thought and broader access to top talent. Each firm has its own philosophy and process, and most consider ESG factors when selecting securities. We recognise that each manager is likely to have its own distinct approach for integrating ESG considerations into its research and decision-making.

Many of our managers' teams of analysts regularly consider how social and environmental factors might affect a company's future earnings. Some use quantitative scoring models to screen their universe, while others leverage their in-depth engagements with management.

Additionally, our external managers have full proxy voting responsibilities for the portions of the funds they manage, enabling them to integrate their proxy voting activities and company engagements with their specific investment strategies.

We regularly assess how our external managers use ESG to inform their investment decisions, and their approaches evolve over time. We review how they gather ESG information and how they structure their research process to account for material ESG risks and opportunities.

Conclusion

We believe that, if left unchecked, ESG risks can undermine a company's long-term value. That said, ESG investing is not a single strategy and the landscape continues to develop rapidly. Our research shows that historically, no single approach to ESG investing has produced statistically significant positive or negative alpha².

The most important consideration in selecting an approach is therefore unique to each investor. And the tenets of diversification and low cost should not be sacrificed in building a portfolio. Vanguard will continue to evaluate ESG products while maintaining our considered approach to product development.

² Research originally published in the Journal of Portfolio Management: Plagge, J.-C. and D. M. Grim. 2020. 'Have Investors Paid a Performance Price? Examining the Behavior of ESG Equity Funds.' JPM Vol 46 Issue 3 Ethical Investing: 123-140.

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.

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