Vanguard

# ESG investing

Helping your clients invest in their values and achieve their goals

# Introduction

With more than 30 million investors globally who look to us to both safeguard and grow their investments, we think about environmental, social and governance (ESG) issues in the context of delivering long-term value and helping them to meet their objectives.

While the topic of ESG investing can often focus on products with an explicit ESG strategy, the underlying risks and considerations involved apply to all investments.

To support clients interested in the real-world impact of their portfolio, it's important to develop a shared understanding of the different ESG investment approaches available, and how a portfolio can align with their personal values and investment objectives.

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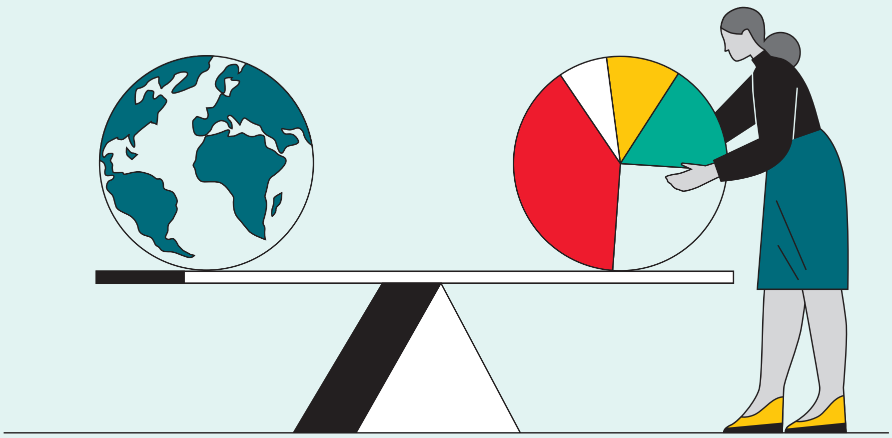


# What is ESG investing?

## ESG investing refers to the inclusion of environmental, social and governance factors in one or more parts of the investment process or product design.

**Environmental:** How companies and industries manage their impact on the environment. This could include climate change, deforestation, pollution and waste management.

**Social:** How a company or industry manages its impact on society. This could include how they treat employees and suppliers, community engagement and health and safety.

**Governance:** Whether a company has good business practices. These could include the diversity of a company's board and leadership team, executive pay or how they handle tax.

Academics, investment professionals and commentators have different viewpoints about ESG and utilise different terminology which can make things difficult for you and your clients. And, naturally, different investors have different values and views about what they consider to be a responsible or ethical way to invest.

When discussing the broader ESG investment landscape there are a variety of approaches to choose from, some having very different objectives.

Understanding these different implementation methods is a critical step in determining what best suits your client's portfolio, investment objectives and values.

### Approaches to ESG investing

**Stewardship**
The responsible use of proxy voting and engagement activities by institutional investors "to maximise overall long-term value including the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend."[1]

**ESG Integration**
Systematic inclusion of material ESG information in investment analysis and decision making.

**Exclusionary portfolio screening**
Excludes companies based on their products or business activities (e.g. tobacco and fossil fuels) that conflict with certain values.

**Inclusionary portfolio screening**
Invests in companies or sectors considered to be more effective in the management of ESG risks, including those demonstrating meaningful improvement in the management of those risks.

**Impact investing**
Targeted investments with the dual objective of generating financial return in addition to positive ESG-related impact.

# Aligning investments with values

**Investors seeking ESG options**
Investor demand for ESG funds is growing, and companies, investment firms and advice practices are taking action.

Four out of five Australians (83%) expect a bank account and their super to be invested responsibly and ethically. 74% of Australians say that they would consider moving to another provider if they found out their current fund was investing in companies engaged in activities inconsistent with their values[2].

Advisers must be able to engage with clients on ESG issues. And from a best interest perspective, they must ensure their clients' ESG preferences are considered when making recommendations.

**The great wealth transfer accelerating ESG investment**
More than $3.9 trillion in wealth will be transferred over the next 20 years, primarily from baby boomers to Generation X and Y family members. This estimate is rising by more than 7% per year[3].

As these new generations of investors look for ways to manage their wealth, ESG factors will play a central role. Advisers will need the right investment solutions to align with their clients' values and expectations.

**67%**

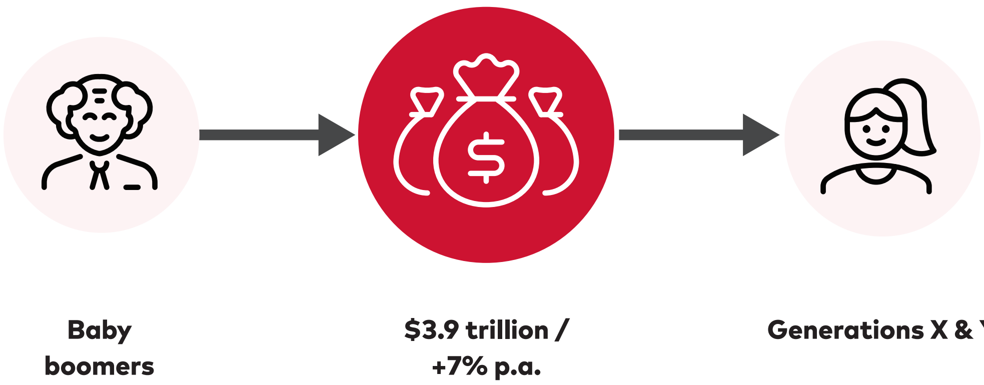
Two-thirds of Australians who don't currently invest in ethical funds would likely consider doing so in the next five years. One-third would like to invest within the next year.

**49%**

Half of Australians expect their advisers to invest in funds which align to their values.

**86%**

Australians believe that it is important their financial adviser asks them about their interests and values in relation to their investments.



**The risk, return and real-world impact of ESG**
Clients considering a shift into ESG investments may have valid questions about the impacts to risk and expected returns. A common misconception is that ESG investment options involve sacrifices in performance and diversification.

Dispelling the underperformance myth, recent Vanguard research[4] suggests that ESG funds have neither systematically higher nor systematically lower returns and risk than the broader market.

Vanguard's research highlights that return and risk differences of ESG funds can be significant compared with the broad market, but importantly this appears to be mainly driven by fund-specific criteria rather than a homogeneous ESG factor.

In addition to considering risk and expected return, reflecting ESG values in an investment portfolio also involves weighing the real-world impact of investments. This desired impact will likely differ among clients, as will the relative importance of 'impact' when weighed against other portfolio considerations or objectives.

Given the variability of ESG strategies and the way they perform, your clients benefit from your understanding of both the potential portfolio implications and alignment to their values.


**Incorporating ESG in client portfolios**
Given the variety of ways to incorporate ESG factors in portfolios, how can you construct an investment solution that's right for your client?

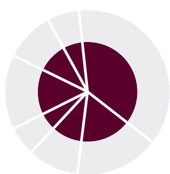
We think about portfolio construction using a core-satellite approach. The core of the portfolio provides broad, diversified exposure to markets. The satellites provide active, targeted exposure in line with the client's objectives.

The same approach can be applied to an ESG portfolio. In an ESG context, the core of the portfolio could consist of low-cost, broadly diversified, ESG-screened investments.

The active satellites may utilise ESG integration or impact funds to target specific exposures or objectives.

## Use ESG to transform a traditional core-satellite portfolio

1. **Determine risk profile and strategic asset allocation**
2. **Determine the investments and size of core vs satellite**
3. **Substitute core and satellite investments with ESG strategies**
4. **Manager and fund selection**



**Core**
**Portfolio screening:**
- Broadly diversified, low cost
- Low tracking error
- Transparent

**+**

**Satellite**
**ESG integration:**
- ESG factors considered during security selection
- Active risk
- May not be ESG branded

**Impact funds:**
- Targeted investments with specific ESG objectives
- Concentrated
- Typically, higher cost

# Vanguard's approach to ESG investing

We believe that material ESG risks, if left unchecked, can undermine long-term value in the companies in which our funds invest.

That's why ESG considerations are important, not just for our range of ESG specific products, but across our entire fund line-up.

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 three ways.

> " …climate change represents a long-term, material risk to our investors' portfolios… "
>
> Tim Buckley, Vanguard CEO

**We engage with the portfolio companies in our index funds**
As pioneers of indexing, we believe in the power of passive investing. But that doesn't mean Vanguard is passive when it comes to ESG risks. Our Investment Stewardship team actively engages with portfolio companies to address material ESG issues. We expect companies to disclose significant risks, develop strategies to reduce them and report on progress, protecting long-term shareholder value.

**We allocate capital to sustainable returns in our active funds**
Many of our active fund managers explicitly consider ESG factors in their investment process. Because ESG factors affect a company's long-term value, they often form an important part of the risk mosaic, even for those funds without an explicit ESG focus. For example, they may consider how social and environmental factors might affect a company's future earnings.

**We develop products that allow investors to avoid certain ESG risks**
We give investors a choice in what they invest in—and what they don't invest in. 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's ESG products track indices that use screens to avoid investing in certain sectors and companies. The result is a low-cost, market-weighted solution that can be used as a building block in your client's portfolio.

# ESG considerations across our full product range

## While not all funds reflect targeted ESG investment strategies, ESG issues that impact investor values are addressed, in different ways, across the full range of Vanguard's managed funds and ETFs.

### Equity index funds

Our investment stewardship activities are the principal levers Vanguard uses to address material ESG risks across our entire range of equity 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 indexes 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.

### 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.

While your clients may hold various personal views on specific sectors or companies, Vanguard's exclusionary ESG products across equity and fixed income that help investors avoid ESG risks that have been identified as relevant to a broad base of investors.

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 by applying exclusionary portfolio screening. The index series provides a comprehensive set of rules-based product and conduct screens which are applied consistently across the entire series which includes both international and Australian equity products.

**Fixed income ESG exclusions**
For Vanguard's ESG fixed income index products we identify the securities for exclusion from the benchmark at an issuer level.

These products allow ESG-conscious investors to build low-cost, diversified bond portfolios by combining ESG and conventional exposures.

## Active equity funds

Most of Vanguard's active equity 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.

## Active fixed income

Corporate credit 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.

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.

# Vanguard Australia's Ethically Conscious funds

Our suite of ESG index funds, offered under our Ethically Conscious banner, apply exclusions to a broad market index, allowing your clients to avoid exposure to activities that don't align with their values. Vanguard's Ethically Conscious line up applies screens across four broad categories:

**Non-renewable energy**

- Fossil fuels
- Nuclear power

**Weapons**

- Controversial weapons (e.g. cluster munitions)
- Conventional military weapons
- Firearms

**Vice products**

- Adult entertainment
- Alcohol
- Gambling
- Tobacco

**Controversies: principles of the UN Global Compact**

- Human rights
- Labour rights
- Environmental issues
- Anti-corruption standards

While many assets are screened out, industry and country weights remain similar to the broader market, preserving the broad diversification benefits of a traditional index fund. This means investors can use our Ethically Conscious funds as core portfolio building blocks.

## Key benefits

**A low-cost broadly diversified solution**
The Funds within the Ethically Conscious suite allow investors to avoid certain ESG risks, while maintaining broad diversification at low-cost.

**Captures the returns of international markets**
Investors in the Funds are able to capture returns that closely match that of the broader market, meaning our investors can continue to use our Ethically Conscious funds as core portfolio building blocks.

**Benefit from Vanguard's proven approach to indexing**
Investment strategy designed to minimise fund turnover and, in turn, minimise transaction costs and tax implications.

**Uses independent and transparent index methodology**
The underlying index providers, Bloomberg Barclays and FTSE Russell, are global leaders in index construction and two of the most widely recognised index providers. We employ a rigorous, disciplined process for developing funds to ensure that they meet the needs of investors.

## Our range of ESG managed funds and ETFs

### Australian shares

| Fund | MER | Lonsec rating | Certification |
|---|---|---|---|
| Vanguard Ethically Conscious Australian Shares Fund<br>APIR: VAN4509AU | 0.20% | Recommended, Lonsec Research | CERTIFIED BY RIAA |
| Vanguard Ethically Conscious Australian Shares ETF<br>ASX: VETH | 0.16% | Recommended, Lonsec Research | CERTIFIED BY RIAA |

### International shares

| Fund | MER | Lonsec rating | Certification |
|---|---|---|---|
| Vanguard Ethically Conscious International Shares Index Fund<br>APIR: VAN8175AU | 0.20% | Recommended, Lonsec Research | CERTIFIED BY RIAA |
| Vanguard Ethically Conscious International Shares Index Fund – AUD Hedged<br>APIR: VAN0848AU | 0.23% | Recommended, Lonsec Research | CERTIFIED BY RIAA |
| Vanguard Ethically Conscious International Shares Index ETF<br>ASX: VESG | 0.18% | Recommended, Lonsec Research | CERTIFIED BY RIAA |

### Fixed income

| Fund | MER | Lonsec rating |
|---|---|---|
| Vanguard Ethically Conscious Global Aggregate Bond Index Fund – AUD Hedged<br>APIR: VAN2989AU | 0.28% | Investment Grade, Lonsec Research |
| Vanguard Ethically Conscious Global Aggregate Bond Index ETF (Hedged)<br>ASX: VEFI | 0.26% | Investment Grade, Lonsec Research |

Vanguard Ethically Conscious Australian Shares Fund and ETF and Vanguard Ethically Conscious International Shares Funds and ETF have been certified by RIAA according to the strict operational and disclosure practices required under the Responsible Investment Certification Program. See www.responsibleinvestment.org for details[5].

# Investment Stewardship: A voice for investors

Vanguard is a steward of assets for more than 30 million investors worldwide. We invest these assets and have a responsibility to monitor material risks that can impact long-term value creation in the companies held in Vanguard funds.

This responsibility is managed by Vanguard's Investment Stewardship team who operate at the intersection of corporate governance, environmental risk, and social risk.

You can think of Vanguard's index funds as permanent investors of the companies in which they invest. This long-term perspective informs every aspect of our Investment Stewardship program. Our team is driven by a clear, consistent, and compelling mandate: to serve as a voice for our investors. Central to this is the promotion of long-term value creation.

The global Investment Stewardship team applies environmental, social, and governance (ESG) oversight to our funds' portfolio companies through three types of activities:

**Advocacy:** We expect companies to take a long-term view when making decisions. We use our voice and brand to promote the highest standards of corporate governance, including sound corporate disclosure and governance practices around ESG risk issues.

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

- Publishing content to communicate our views
- Supporting and participating in industry working groups
- Speaking at industry events and conferences
- Commenting on regulation, reporting frameworks and standards

**Investment Stewardship reporting and insights**
We have a number of materials and insights available on our website relating to Vanguard's practices and approach to advocacy, engagement and voting including:

- Full proxy voting reports by fund
- Annual and semi-annual reports detailing voting and engagement activity
- Thematic Insights highlighting how we approach specific governance topics and share our expectations of company boards
- Voting Insights disclosing our rationale for how Vanguard funds voted on key proposals at specific companies
- Perspectives detailing our views on important governance matters

**Engagement:** We meet with executives and directors to learn about their governance practices. We work with them to ensure their practices align with our long-term view of value.

We have ongoing, direct dialogue with companies and other stakeholders about corporate governance topics. This may include discussions with:

- Corporate board members and company executives
- Regulators
- Activists and thought leaders

**Voting:** Our team votes at shareholder meetings on behalf of our internally managed global equity index funds, in support of good governance and long-term value creation for investors. Companies always know where we stand and have an opportunity to address our concerns before we cast our votes. 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.

In addition to publishing full proxy voting records for Vanguard funds, we also regularly publish Investment Stewardship Insights to promote good governance practices and to provide investors and public companies with timely perspectives on important governance topics, and key engagement and voting activity.

**For more information on Investment Stewardship visit:**
vanguard.com.au/investmentstewardship

## Our four pillars of governance

Vanguard's core values of focus, integrity and stewardship are reflected every day in the way that we engage with our clients, our crew and our community. We view Investment Stewardship as a natural extension of these values and of Vanguard's core purpose. What does great corporate governance look like? Vanguard's four pillars of governance frame our thinking.

**Board composition**
Good governance begins with a company's board of directors. An effective board should be independent, committed, capable, and diverse in personal characteristics, skills, and experience.

**Oversight of strategy and risk**
Boards should work to prevent risks from becoming governance failures. Oversight of a company's long-term strategy and material risks, including environmental, social, and governance risks, can safeguard investors over the long run.

**Executive compensation**
Performance-linked compensation drives sustainable, long-term value. Pay plans should incentivise outperforming versus industry peers over the long-term.

**Shareholder rights**
Shareholders should be empowered through their voice and their vote. We expect companies to adopt governance structures that serve as a safety net to safeguard and support foundational rights for shareholders.

# Partnering with industry on ESG issues

Globally, Vanguard has managed ESG investment products for more than 20 years. And we've advocated on behalf of investors for good corporate governance and effective management of ESG risks for over 40 years.

We're proud to support a number of important collaborative initiatives focused on best practice corporate governance, long-term value creation and climate risk. The table below shows some of the collaborative initiatives we are aligned with.

| INITIATIVE/ ORGANISATION | YEAR JOINED | DESCRIPTION | INVOLVEMENT |
|---|---|---|---|
| **UN Principles for Responsible Investment (PRI)** | 2014 | An organisation that encourages investors to use responsible investment to enhance returns and better manage risks. The PRI promotes six voluntary principles designed to support long-term investment value and a more sustainable global financial system. It also offers guidance to firms about how to incorporate ESG objectives. | Signatory.<br>Vanguard is committed to adopting and implementing the six principles and reporting our progress in an annual transparency report. A copy of Vanguard's latest transparency report can be found on the PRI website. |
| **Task Force on Climate-related Financial Disclosures** | 2017 | An organisation that developed guidelines for voluntary climate-centered financial disclosures for all industries. | Supporter.<br>Vanguard publicly supports the TCFD and encourages portfolio companies to disclose climate-related risks in line with the framework. |
| **Responsible Investment Association Australasia (RIAA)** | 2019 | A responsible investment body, who are dedicated to ensuring capital is aligned with achieving a healthy society, environment and economy. RIAA operate a certification program which is a leading initiative for distinguishing quality responsible, ethical and impact investment products and services in Australia and New Zealand. | Member. |
| **Asian Corporate Governance Association** | 2021 | An independent, nonprofit membership organisation dedicated to working with investors, companies, and regulators in the implementation of effective corporate governance practices throughout Asia. | Member. |
| **Investor Group on Climate Change (IGCC) & APAC Investor Group on Climate Change (AIGCC)** | 2022 | IGCC is a collaboration of Australian and New Zealand institutional investors focused on the impact of climate change on investments. AIGCC is an equivalent organisation covering the APAC region at large. | Member. |

1. Source: *Principles for Responsible Investing*
2. Source: RIAA, *From Values to Riches 2022: Charting consumer demand for responsible investing in Australia*
3. Source: Adviser Ratings, *2020 Australian Financial Advice Landscape*.
4. Source: Jan-Carl Plagge and Douglas M. Grim, 2020. *Have investors paid a performance price? Examining the behavior of ESG equity funds*. The Journal of Portfolio Management 46(3):123-40.
5. The Responsible Investment Certification Program does not constitute financial product advice. Neither the Certification Symbol nor RIAA recommends to any person that any financial product is a suitable investment or that returns are guaranteed. Appropriate professional advice should be sought prior to making an investment decision. RIAA does not hold an Australian Financial Services Licence.

**For more information on Vanguard's approach to ESG and our product offering visit**

vanguard.com.au/ESG

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