The Rise of ESG in Passive Investments

US SIF FOUNDATION

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EXECUTIVE SUMMARY

Two notable US investment trends in recent years have been the increase in assets to passively managed funds and the growth in sustainable investing. Reflecting both these trends, index-based funds that factor in environmental, social and corporate governance (ESG) considerations have grown in number and assets. While the vast majority of sustainably invested assets are still in actively managed ESG funds, net flows into passively managed ESG funds outpaced net flows into their actively managed counterparts during four of the past five years, according to data from Morningstar.[1] In 2019, net flows into passive ESG funds totaled $12.7 billion compared to $8.7 billion for active ESG funds.

This report explores the growth of passive ESG investing and the debate on the effectiveness of passive ESG funds versus active ESG funds. Best practices for asset managers are also provided to deepen ESG approaches and impact. To prepare this paper, the US SIF Foundation drew on publicly available resources for data and information and gathered additional insights from US SIF's research advisory committee and from asset managers that manage passive ESG funds.

After an **Introduction** highlighting the core approaches to passively managed ESG investing, **Section 2** explores the data on and reasons for its recent growth. **Section 3** discusses critiques of passive ESG investment together with counterarguments. Recommended best practices are presented in a brief **Conclusion**. The report closes with an **Appendix** with short profiles of ESG exchange traded funds (ETFs) and index-based mutual funds that demonstrate a range of approaches to passively managed ESG investments (profiles were provided by asset managers themselves).

1. Morningstar, *Sustainable Funds U.S. Landscape Report: Record Flows and Strong Fund Performance in 2019.* (2020). Available at https://www.morningstar.com/lp/sustainable-funds-landscape-report

1. INTRODUCTION

In this paper, we refer to index-oriented investing that factors in ESG considerations as "passive ESG investing," the term commonly used by the media, data providers and research organizations. However, there is no single term agreed upon in the investment industry. Indeed, some asset managers and financial industry professionals say that a passive ESG investment approach is not truly passive as the incorporation of ESG involves a departure from traditional market cap weighted indexes. Alternative terms for these strategies, which represent a variety of approaches, are optimized index investing and sustainable enhanced indexing, among others. For the sake of simplicity, we refer to all funds incorporating ESG in index-oriented approaches as passive ESG funds.

ESG Index Construction

Passive ESG funds are typically based on ESG indexes.

The first ESG index, developed in 1990 by KLD Research & Analytics, was the Domini 400 Social Index, now called the MSCI KLD 400 Social Index. Since then, there has been a dramatic expansion of indexes, along with hundreds of unique sub-indexes, which incorporate ESG criteria. There are more than 1,000 ESG indexes today, and their creation and growth can be attributed to the rising popularity of sustainable investing.

An array of sustainable investment and financial information firms, such as Calvert Research and Management, FTSE Russell, Impax Asset Management, MSCI, STOXX, Sustainalytics, Thomson Reuters and WilderShares, offer these indexes. Leading global stock exchanges, such as the Nasdaq, NYSE, Deutsche Boerse and the Johannesburg Stock Exchange, have also launched ESG indexes.

The construction of an ESG index begins with a parent index, which provides the initial investment universe of constituent companies.[2] Next, an ESG methodology is applied, which entails exclusionary screens, ESG integration and/or thematic filters, to narrow the investment universe to a smaller set of companies based on defined rules. Once the index constituents are selected, they are weighted following index rules; examples are market capitalization weighting, equal weighting, or "tilting" to underweight or overweight companies based on specific index metric rules.[3]

After the ESG index is constructed, it is maintained over time using consistent rules governing how it is rebalanced as well as how it treats corporate actions such as mergers and acquisitions of constituent companies. Changes based on updated ESG data can also be incorporated during periods of rebalancing.

ESG indexes fulfill several important functions. They establish performance benchmarks and help compare the broad performance of ESG and non-ESG universes, as well as set standards for responsible corporate behavior through their inclusion criteria. Additionally, ESG indexes generate historical statistics that support a deeper understanding of sustainable investing through a data stream that provides objective information on how ESG affects performance, risk and financial fundamentals.

Asset managers can purchase ESG index data from index providers or purchase non-ESG index data to construct their own ESG index. They can also hire index providers to help construct the index or build a custom index based on submitted ESG criteria.

2. For more information, see: Principles for Responsible Investment, *How Can a Passive Investor be a Responsible Investor?* (2019), https://www.unpri.org/download?ac=6729 and Blackrock, *An Evolution in ESG Indexing* (2018), https://www.ishares.com/us/literature/whitepaper/an-evolution-in-esg-indexing.pdf.

3. "Factor tilt" indexes were also created for smart beta strategies in the last decade.

Addressing ESG Issues in Passive Funds—Strategies and Definitions

ESG incorporation

- **ESG integration**: Increasing or decreasing the exposure to specific environmental, social and/or governance factors by adjusting the weights of constituent companies based on their performance on specific ESG issues or on their overall ESG rating.
- **Exclusionary screening**: The exclusion of certain sectors or companies involved in activities deemed unacceptable or controversial.
- **Thematic filters**: The selection of companies based on their exposure to specific themes (e.g. gender equality).

Active ownership

- **Engaging with companies**: Communicating with companies to improve their ESG policies and practices. This occurs through in-person meetings, phone conversations or letter writing/email campaigns, and can take place independently or in collaboration with partners.
- **Proxy voting**: Actively voting proxies in a manner that advances ESG policies and practices of a constituent company. Establishing proxy voting guidelines on how specific ESG issues will be voted can facilitate this process.
- **Filing/co-filing shareholder resolutions**: Introducing shareholder proposals on ESG issues to company management to be voted on at the next annual meeting. Instead of filing a shareholder proposal, asset managers may choose to co-file with other shareholders, adding weight and credibility to a resolution.

Core Approaches to Passively Managed ESG Investing

Once the appropriate index, whether ESG or non-ESG, is selected, an asset manager has three basic routes to creating a passively managed ESG fund.

1. Purchase an ESG index and create a fund to mimic the index.
2. Purchase an ESG index and apply ESG incorporation strategies, such as exclusionary screens, ESG integration and/or thematic filters, to further refine the companies selected for the fund.
3. Purchase a non-ESG index, develop a proprietary ESG index from it, and create a fund to mimic the new index.

The passive ESG fund manager must also determine whether and how to pursue active ownership strategies such as company engagement, filing or co-filing shareholder resolutions and developing and implementing proxy voting guidelines in order to seek improvement in a company's ESG policies and practices. See the side box on this page for information on the various strategies of ESG incorporation and active ownership.

Many observers would like to see greater commitment to improving corporate ESG practices from passive managers entering the sustainable investing space. Particular attention on proxy voting records has been directed to the largest index fund managers—Blackrock, Vanguard and State Street—also known as "the big three." Together they control about $15 trillion in assets under management and hold around 80 percent of indexed assets.[4] BlackRock and State Street each have a number of ESG funds while Vanguard has one. The big three have been criticized for almost always voting in support of management and in opposition to ESG shareholder resolutions.[5] Given the size of their shares, their support is often essential is passing shareholder resolutions. However, the tide is beginning to change. In 2020, Blackrock and State

4. David McLaughlin and Annie Massa, "The Hidden Dangers of the Great Index Fund Takeover," *Bloomberg*, January 9, 2020, https://www.bloomberg.com/news/features/2020-01-09/the-hidden-dangers-of-the-great-index-fund-takeover.

5. See for example: Attracta Mooney, "Big Investors Ignore Proxy Advisers on Controversial Votes," *Financial Times,* February 8, 2020, https://www.ft.com/content/fd275eff-39b9-438d-bf15-31bb242a1924 and "Why do some large asset managers still vote against most climate-related shareholder proposals?" Ceres, March 13, 2020, https://www.ceres.org/news-center/blog/why-do-some-large-asset-managers-still-vote-against-most-climate-related.

Street signaled their intention to use proxy voting to advance corporate ESG practices.[6]

ESG Issue Areas

Passive ESG funds vary in the environmental, social and governance issues they consider. The following are examples of ESG issues addressed by sustainable investors.

- Environmental issues: climate change and greenhouse gas emissions, clean technology, water use and conservation, pollution and toxics, sustainable natural resources and agriculture
- Social issues: human rights, gender and racial equity, workplace benefits, labor relations, tobacco and weapons avoidance
- Governance issues: board independence, executive compensation, anti-corruption, board diversity, corporate political contributions

Some passive ESG funds have a primary focus, such as climate change or gender equity, but the fund may also address other ESG issues. For example, the Etho Climate Leadership ETF and the Pax Ellevate Global Women's Fund utilize other ESG criteria in addition to climate and gender, respectively. Investors should look beyond the fund's name or primary themes to obtain a full understanding of its approach. See Figure 1 for examples of passive ESG funds that have an environmental, social or broad ESG focus.

See the Appendix for further detail on selected index mutual fund and ETF approaches to ESG incorporation and active ownership.

FIGURE 1: EXAMPLES OF PASSIVE ESG FUNDS

	TICKER	FUND NAME	ISSUER
Environmental Focus	ETHO	Etho Climate Leadership US ETF	Etho Capital
	PBW	Invesco WilderHill Clean Energy ETF	Invesco
	SPYX	SPDR S&P 500 Fossil Fuel Reserves Free ETF	State Street Global Advisors
Social Focus	FRDM	Freedom 100 Emerging Markets ETF	Alpha Architect
	NACP	NAACP Minority Empowerment ETF	Impact Shares
	PXWIX	Pax Ellevate Global Women's Leadership Fund Inst	Impax Asset Management, LLC, Advisor to the Pax World Funds
Broad ESG Focus, Including Governance	CISIX	Calvert US Large Cap Core Responsible Index Fund I—Institutional share class	Calvert Research and Management
	GCIFX	Green Century MSCI International Index Fund—Institutional share class	Green Century Funds
	NUBD	Nuveen US Aggregate Bond ESG ETF	Nuveen

6. See Blackrock, *A Fundamental Reshaping of Finance*, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter, accessed May 18, 2020 and State Street, *CEO's Letter on our 2020 Proxy Voting Agenda*, https://www.ssga.com/us/en/institutional/etfs/insights/informing-better-decisions-with-esg, accessed May 18, 2020.

2. THE GROWTH OF ASSETS IN PASSIVE ESG INVESTMENTS

The increasing flow of assets to passively managed ESG funds reflects two ongoing trends—the growing popularity of both sustainable investing and passive investing.

Sustainable Investing Trends

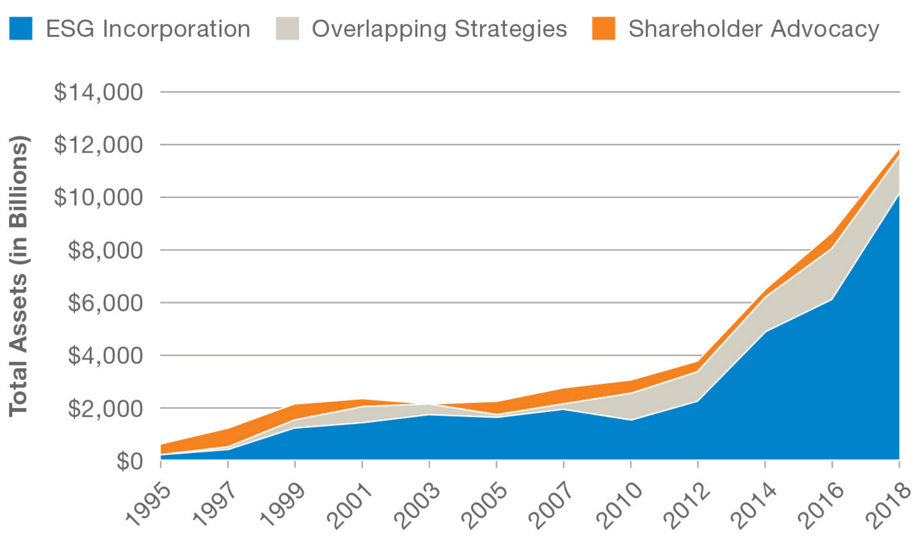
Total US-domiciled assets under management (AUM) using sustainable investment strategies grew from $8.7 trillion at the start of 2016 to $12.0 trillion at the start of 2018, a 38 percent increase.[7] This represents 26 percent—or 1 in 4 dollars—of the total US assets under professional management, up from a 22 percent share in 2016 and an 18 percent share in 2014. Figure 2 shows growth since 1995 based on data from the US SIF Foundation's *Report on US Sustainable, Responsible and Impact Investing Trends.*

The motivations for sustainable investing are diverse and not mutually exclusive.

- **Personal values:** Investors seek to address their personal values and goals in their investments.
- **ESG outcomes:** Investors want to use their investments to contribute to advancements in environmental, social and corporate governance practices.
- **Risk management:** Investors review ESG criteria to assess the quality of management and the likely resilience of their portfolio companies in dealing with future challenges.
- **Fiduciary duty:** Investors consider long-term investment drivers, including ESG issues, as a necessary component of fulfilling their fiduciary duty.
- **Financial outperformance:** Investors seek financial outperformance over the long term. A growing body of academic research shows a strong link between ESG and financial performance.

The Morgan Stanley Institute for Sustainable Investing found that that there is "no financial trade-off in the returns of sustainable funds compared to traditional funds, and they demonstrate lower downside risk." Moreover, during a period of extreme volatility, the study found "strong statistical evidence that sustainable funds are more stable."[8] For a summary of additional studies, see www.ussif.org/performance.

FIGURE 2: GROWTH OF SUSTAINABLE INVESTING 1995–2018



Source: US SIF Foundation

7. US SIF Foundation, *Report on US Sustainable, Responsible and Impact Investing Trends* (2018). Available at www.ussif.org/trends.

8. The Morgan Stanley Institute for Sustainable Investing, *Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds* (2019). Available at: https://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-investing-offers-financial-performance-lowered-risk/Sustainable_Reality_Analyzing_Risk_and_Returns_of_Sustainable_Funds.pdf.

Passive Investing Trends

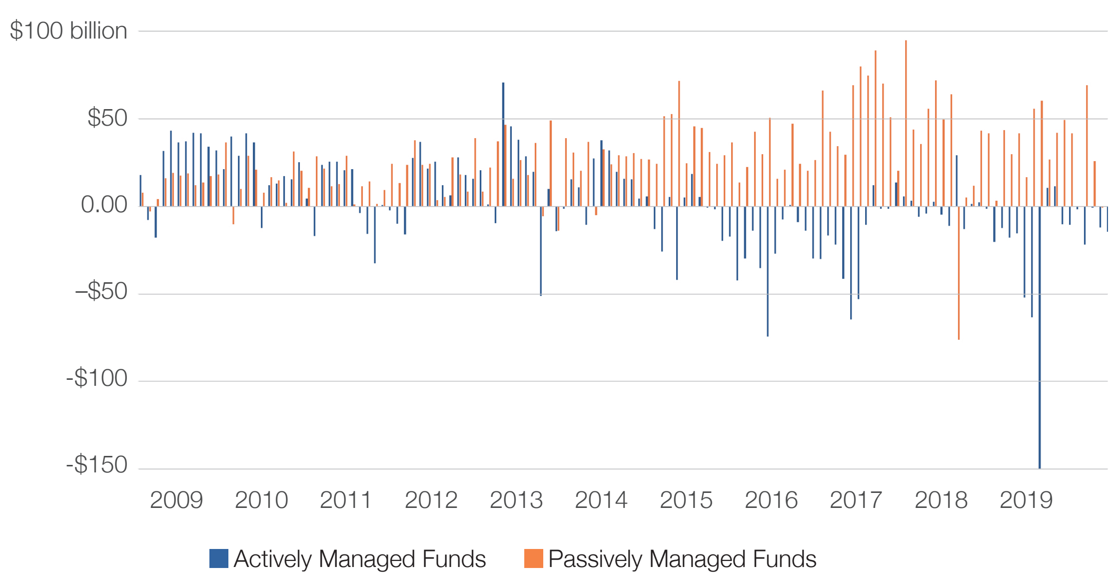
In the United States, most investments, across all asset classes, are actively managed. Of the over $35 trillion in US listed stocks in 2019, actively managed assets across all investment vehicles surpassed passively managed assets by a ratio of eight to one.[9]

However over the last decade, within the narrower segment of mutual funds and ETFs focused on US equities (and excluding other equity pooled products and separate accounts), passively managed funds had almost $1.36 trillion in net inflows, while a net amount of $1.32 trillion left actively managed funds, according to data from Morningstar.[10] See Figure 3. A major milestone took place in August 2019 within this segment, when assets in passively managed funds, at $4.27 trillion, surpassed assets in actively managed funds, with $4.25 trillion, for the first time.[11]

Because passive investment funds are based on indexes, they share certain characteristics that are appealing to many investors, including those who want to use their investments to make positive ESG impacts. Motivations for passive investments include the following.

- **Simplicity:** Passive investment funds, like the indexes they are based on, are transparent and rules-based, and therefore are simple to understand. For example, an S&P 500 index fund clearly seeks to replicate the index of that name, and the companies in the portfolio will change as the constituents of the index are revised.
- **Lower expense:** Passive investment funds require less maintenance than their actively managed counterparts and thus tend to have lower fees and operating expenses than actively managed funds.

FIGURE 3: NET FLOWS FOR US EQUITY FUNDS, MONTHLY



Note: Mutual funds and exchange traded funds
Source: Morningstar Direct

9. The data can be extrapolated from the source is as follows: In 2019, US listed stocks were valued at over $35 trillion. In August 2019, US equity funds held $8.52 trillion, of which $4.25 trillion were in active stock funds and $4.27 trillion in passive stock funds. The $4.27 in passive stock funds is approximately one-eighth of the total $35 trillion. See: Barry Ritholtz, "Passive Investing Hasn't Taken Over the World," *Bloomberg,* October 1, 2019, https://www.bloomberg.com/opinion/articles/2019-10-01/passive-investing-vs-active-investing-which-is-bigger

10. The source does not specify whether the same investors that left actively managed funds went into passive funds. See: Dawn Lim, "Index Funds Are the New Kings of Wall Street," *Wall Street Journal*, September 18, 2019, https://www.wsj.com/articles/index-funds-are-the-new-kings-of-wall-street-11568799004.

11. John Gittelsohn, "End of Era: Passive Equity Funds Surpass Active in Epic Shift," *Bloomberg*, September 11, 2019, https://www.bloomberg.com/news/articles/2019-09-11/passive-u-s-equity-funds-eclipse-active-in-epic-industry-shift.

FIGURE 4: PASSIVE VERSUS ACTIVE ESG ASSET MANAGEMENT BY ASSET MANAGERS 2018

	Number of Money Managers	Affected Assets (in Billions)	Percent of ESG Assets
Actively Managed	129	$3,684	92%
Passively Managed	27	$314	8%
Total Responding	**135**	**$3,998**	**100%**

Source: US SIF Foundation
Note: Some asset managers reported using both active and passive management across their ESG assets, so totals do not sum.

- **Tax efficiency:** Passive investment funds typically have lower portfolio turnover, resulting in better tax efficiency for investors.
- **Better financial performance:** Passive investments tend to achieve a market average return without a lot of work. Evidence shows that on average, passive investment funds have performed better than their active peers over the long term; this is often due to their lower fees and operating expenses.
- **Suitability for retail investors:** The above characteristics often make passive funds particularly appropriate for retail investors.

Looking more closely at financial performance, research from S&P Global found that in the decade to 2018, over 80 percent of US actively managed equity funds underperformed the S&P Composite 1500.[12] Similarly, according to Morningstar's *Active/Passive Barometer*, only 23 percent of all active funds performed better than the average of their passive peers in the 10-year period ending in June 2019.[13]

Passively Managed ESG Investment Trends

Most ESG investments are also actively managed. In 2018, the US SIF Foundation included a question about passive versus active ESG management in its survey for the 2018 *Report on US Sustainable, Responsible and Impact Investing Trends*. A subset of 135 asset managers, with nearly $4 trillion in combined ESG assets in mutual funds, ETFs and a wide array of other products and strategies, responded. Only 27 managers, representing $314 billion, used passive management, while 129 managers representing $3.7 trillion used active management. See Figure 4 for more information. Additionally, according to Morningstar, two-thirds of sustainable mutual funds and ETFs in the United States were actively managed as of year-end 2019.[14]

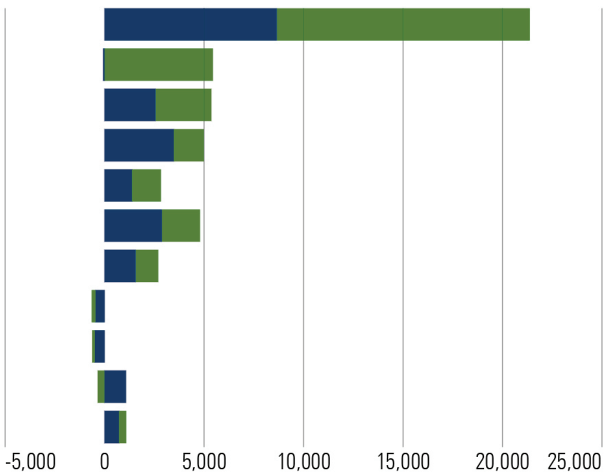
However, the data on asset flows demonstrates the growing interest in passive ESG funds. During four of the past five years, net flows into passively managed ESG funds exceeded net flows into actively managed ESG funds, according to data on US funds from Morningstar.[15] In 2019, net flows into passive ESG funds totaled $12.7 billion compared to $8.7 billion for their active counterparts. In 2018, active ESG funds experienced net outflows of $73 million while passive ESG funds had net inflows of $5.4 billion. See Figure 5.

In the first quarter of 2020, as the COVID-19 pandemic emerged, the S&P 500 dropped by 20 percent. At the same time, passively managed ESG funds within the US equity

12. Dawn Lim, "Index Funds Are the New Kings of Wall Street," *Wall Street Journal*, September 18, 2019, https://www.wsj.com/articles/index-funds-are-the-new-kings-of-wall-street-11568799004.
13. Morningstar, *Morningstar's Active/Passive Barometer* August 2019 (2019), 2. Sourced from: https://www.morningstar.com/lp/active-passive-barometer
14. Morningstar, *Sustainable Funds U.S. Landscape Report: Record Flows and Strong Fund Performance in 2019.* (2020), 12. Available at https://www.morningstar.com/lp/sustainable-funds-landscape-report.
15. Ibid., 16.

FIGURE 5: ESG FUND NET FLOWS (USD MILLIONS)

	Active	Passive
2019	8,655.5	12,713.3
2018	-73.3	5,444.2
2017	2,558.8	2,802.8
2016	3,473.3	1,517.5
2015	1,374.2	1,454.9
2014	2,869.6	1,925.1
2013	1,557.3	1,135.1
2012	-457.8	-194.1
2011	-488.3	-135.1
2010	1,077.3	-347.2
2009	716.9	361.4



Source: Morningstar

segment saw inflows of $4.8 billion (although the largest gain was in January before the global crisis took hold), while actively managed ESG funds gained $233 million in inflows.[16]

The growing popularity—and assets under management—of passive ESG funds demonstrates that the advantages offered by index-oriented approaches—such as lower fees, lower portfolio turnover and generally better returns on average—are appealing to investors interested in the consideration of ESG factors.

According to Morningstar, “[p]assively managed ESG funds are on average three times cheaper than active alternatives.”[17] Additionally, its research found that passive ESG funds on average performed better than their active peers over three-, five- and 10-year periods in their respective categories, according to data as of August 2018.[18] Morningstar similarly found that among the funds it analyzed for 2019 and the first quarter of 2020, the majority of passive ESG funds outperformed their active counterparts.[19]

Investors also have an increasing number of options to choose from. For example, the US SIF Foundation found that the number of ESG-themed ETFs increased from just 25 at the start of 2016 to 69 at the start of 2018. More recent data from Bloomberg Intelligence counts over 100 ESG ETFs.[20] Eighteen new ESG ETFs launched in 2018, according to Morningstar, and 12 in 2019.[21]

16. Jon Hale, “Despite the Downturn, U.S. Sustainable Funds Notch a Record Quarter for Flows,” *Morningstar*, April 9, 2020, https://www.morningstar.com/articles/977328/despite-the-downturn-us-sustainable-funds-notch-a-record-quarter-for-flows.
17. Hortense Bioy, “Behind the numbers: How passive ESG funds really fare against their active rivals,” *Money Marketing*, October 9, 2018, https://www.moneymarketing.co.uk/passive-esg-funds/.
18. Ibid.
19. For 2019 data, see Morningstar, *Sustainable Funds US Landscape Report: More Funds, More Flows, and Strong Performance in 2018* (2019), 23 and 24, https://www.morningstar.com/lp/sustainable-funds-landscape-report. For 2020 data, see Jon Hale, “Sustainable Funds Weather the First Quarter Better Than Conventional Funds,” *Morningstar*, April 3, 2020, https://www.morningstar.com/articles/976361/sustainable-funds-weather-the-first-quarter-better-than-conventional-funds?utm_source=twitter&utm_medium=social&utm_campaign=dotcom.
20. Mark Gilbert, “Blackrock’s Climate Activism has a Passive Problem,” *Bloomberg*, January 14, 2020, https://www.bloomberg.com/opinion/articles/2020-01-14/blackrock-s-climate-activism-has-a-passive-problem.
21. Morningstar, *Sustainable Funds US Landscape Report: More Funds, More Flows, and Strong Performance in 2018* (2019), 3. Available at https://www.morningstar.com/lp/sustainable-funds-landscape-report.

3. THE DEBATE OVER PASSIVE ESG INVESTING

As investor interest in passively managed ESG funds has risen, so have concerns about them, including from some industry practitioners.[22] This section highlights frequently cited challenges and critiques, as well as counterarguments provided by asset managers with passive ESG funds.

The primary critiques fall into three broad categories:

- The indexes on which passive funds are based still largely hew to an unsustainable model of the economy.
- The ESG incorporation techniques to modify these indexes lead to over-concentrations of certain types of companies.
- Passive fund managers lack the resources or incentives to engage with the companies represented in their funds.

An overview of each of these issues is below.

The Nature of Indexes

Some critics of passively managed ESG funds view conventional indexes, such as the S&P 500, as reflecting a fundamentally unsustainable economy. By extension, they view any funds with characteristics inherited from such indexes as inconsistent with the goal of moving the investment landscape—and the broader economy—toward genuine sustainability.

However, today's asset managers can use sophisticated approaches, even within market-cap weighted funds, to ensure that passive ESG funds achieve positive environmental, social and governance impacts. Passive managers of funds tracking broad-based indexes can use ESG integration to overweight companies with stronger ESG policies and performance—for example on human rights and labor rights—and underweight those companies' peers. In addition, some passive managers intentionally depart from conventional benchmarks' industry weights by excluding controversial companies, such as those that produce and distribute fossil fuels and weapons.

Additionally, the concern about index-like characteristics is less applicable to passive funds based on narrower thematic or industry-focused indexes, such as clean energy. (Thematic filters ensure that all companies in a fund contribute to a specific theme, such as clean energy or gender equality.)

Portfolio Skews

Another common critique relates to the potential for over-concentration of certain types or sizes of companies, which can affect portfolios' risk and return profiles. Excluding or re-weighting companies because of ESG scores may lead to an emphasis on certain market capitalizations, industries or geographies.[23]

While portfolio skews are a potential point of concern for ESG funds, that concern is not limited to passively managed products. Actively selected portfolios, too, may tilt toward certain characteristics as their managers seek attractive opportunities with positive ESG factors. In both active and passively managed ESG funds, portfolio skews can often be managed through modified market cap weightings or other methods of optimization.[24]

Resources and Incentives for Corporate Engagement

With respect to whether passive products can be "fully ESG" in their character, a frequently raised critique relates to managers' level of engagement with portfolio companies. Since index-based equity funds typically have many more holdings than their actively managed counterparts, managers of passive

22. For more, see Solutions with Sonya, *Indexing and Interviews*, https://www.solutionswithsonya.com/indexing-impact, accessed December 3, 2019 and Columbia Law Review, Vol. 119, December 2019, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy* by Lucian A. Bebchuk and Scott Hirst, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794.

23. Principles for Responsible Investment, *How Can a Passive Investor be a Responsible Investor?* (2019), 15. Available at https://www.unpri.org/download?ac=6729.

24. Optimization is an approach that seeks to achieve the dual goal of tilting towards companies with higher ESG ratings while achieving a risk and return profile close to the parent index.

funds may be less likely to give time and attention to hands-on engagement with the companies represented in their funds.

A related concern is that passive fund managers may have less incentive to engage with the management of any one company because the engagement is likely to have less positive financial impact on the portfolio overall, given the large number of holdings.

Asset managers interviewed highlighted a range of responses to these points. First, the breadth of holdings in a passive ESG fund, and the consistency of these holdings over time, may actually position these funds as a better platform for engagement.

Second, because studies have shown that companies with strong ESG performance tend to have better financial returns,[25] some passive fund managers believe engaging with companies in their portfolios is worthwhile to move the needle in the right direction for both ESG and financial performance.

Moreover, some fund families have multiple passive and active products and dedicated ESG engagement teams that work across all of them to achieve economies of scale.

As more passive funds are created, having well-publicized engagement policies will help differentiate the funds and attract investors who want positive impact.

25. See: https://www.ussif.org/performance.

CONCLUSION

The growth of passive ESG investing is yet another indicator of the growth and increasing range of the sustainable investing field, which offers products across asset classes, management styles, ESG incorporation techniques and engagement strategies. In fact, some organizations are exploring how the development of new indexes and passive investing options can contribute to pressing issues such as transitioning to a fossil fuel free economy and the UN Sustainable Development Groups.[26]

This report reviewed some of the debates concerning passive ESG investing. As this part of the sustainable investment ecosystem develops further, we encourage funds that may have practices considered "ESG light," such as continuing to invest in companies with poor ESG performance or voting proxies in opposition to their stated ESG incorporation priorities, to take steps towards deeper ESG approaches.

Best practices for asset managers with passive ESG funds include the following.[27]

1. **ESG incorporation**: Fund managers should disclose whether ESG integration, exclusionary screening or thematic filters are applied as well as the ESG criteria used, such as labor rights, executive pay and clean technology. This will provide investors with clarity and confidence in the types of companies in their ESG funds and the type of ESG impact the funds are targeting.
2. **Proxy voting**: Equity fund managers should vote proxies in line with their purported ESG incorporation priorities. A low-carbon index fund, for example, should be voting in favor of thoughtfully crafted proposals asking companies to consider climate risk or reduce their greenhouse gas emissions. Proxy voting by fund managers is receiving heightened scrutiny from sustainable investment organizations, other investors and the media. Fund managers who can demonstrate that they have thoughtful and consistent ESG proxy voting guidelines and practices may have a competitive advantage in attracting clients interested in sustainable investing.
3. **Company engagement**: Passive fund managers can also communicate with companies to improve their ESG policies and practices through in-person meetings, phone conversations or letter writing/email campaigns. Asset managers can collaborate with partners to pool resources and amplify their investor voice. In cases where this engagement is unsuccessful in changing corporate behavior, fund managers may wish to consider filing or co-filing shareholder resolutions at the companies of concern to draw further attention to these issues.
4. **Impact measurement and management**: Passive fund managers should also consider how to measure and report on the impact of their ESG incorporation and engagement activities. A general framework includes steps to establish impact targets, collect and assess data to measure impact and report on results. Track and measure not only activities, such as number of shareholder resolutions filed or meetings held, but also on-the-ground environmental, social and governance impact, for example commitments to phase out use of plastic packaging and the quantity of that reduction.
5. **Field building**: Fund managers can also benefit from joining industry associations to stay abreast of important developments with ESG issues and sustainable investing. They can participate in, and report to, industry initiatives such as the US SIF Foundation's biennial survey of sustainable investing assets and trends in order to contribute to public education and market research that benefits the entire sustainable investing field.

26. For example, the climate activists of The Sunrise Project and the Hewlett Foundation are encouraging the development of fossil fuel-free indexes, while MSCI and the OECD are discussing the construction of indexes to support the UN Sustainable Development Goals. See: The Sunrise Project, *The Passives Problem and Paris Goals: How Index Investing Trends Threaten Climate Action* (2020) https://sunriseproject.org.au/wp-content/uploads/2020/01/Sunrise-Project-Report-The-Passives-Problem-and-Paris-Goals.pdf and The William and Flora Hewlett Foundation, Environment Program Request for Proposal: Aligning Passive Investment with Paris Climate Goals, https://hewlett.org/environment-program-request-for-proposal-aligning-passive-investment-with-paris-climate-goals/, accessed May 18, 2020. Also see: MSCI and OECD, *Institutional Investing for the SDGs* (2018), https://www.msci.com/documents/10199/239004/Institutional_Investing_for_the_SDGs.pdf.

27. These best practices are applicable for active ESG funds as well.

APPENDIX: EXAMPLES OF PASSIVELY MANAGED ESG FUNDS

To help the reader become more familiar with passive funds, this Appendix provides profiles of eight passively managed ESG funds: four index mutual funds and four ETFs.

Asset managers submitted their own fund profiles and the US SIF Foundation edited them for style and consistency. The examples of asset managers and funds presented in the Appendix and throughout the report should in no way be considered endorsements or investment solicitations.

Each profile includes basic fund information such as total assets under management (AUM) expressed in millions of dollars and performance along with the fund's descriptions of its ESG incorporation and active ownership approaches. Some asset managers also provided an example of engagement with a specific company in their fund.

INDEX MUTUAL FUNDS

Index funds profiled are comprised of the largest ESG index fund from each asset manager in US SIF's Mutual Fund and ETF Performance Chart.[28] All the index funds are institutional share class.

Calvert Research and Management

1. Fund name: Calvert US Large Cap Core Responsible Index Fund I – Institutional share class
2. Ticker: CISIX
3. Category: US Fund Large Blend
4. Inception: June 2000
5. Total AUM as of December 31, 2019: $2,200 million
6. Performance available here
7. Parent index: Calvert US Large-Cap Core Responsible Index (CALCOR)
8. Sustainable investment strategy

   ESG incorporation approach
   Calvert's general investment philosophy across all of its strategies is to invest in companies that demonstrate positive ESG performance as they address corporate responsibility and sustainability challenges. Fund management conducts deep, proprietary research across approximately 200 peer groups using over 300 key performance indicators to measure material ESG factors. All firm investment activities are guided by the Calvert Principles toward the goal of earning competitive investment returns while influencing progress and creating a positive impact on society.

   Active ownership approach
   Calvert has a long history of advocacy and engagement. Through this work, shareholders are able to benefit from companies improving their corporate behavior and operations to provide a net benefit to society. Calvert believes that making these improvements on material ESG issues may not only promote positive change, but also drive shareholder value. Calvert actively works with companies to improve in the areas most relevant to them, while also collaborating with a wide range of organizations to improve corporate standards and reporting.

28. Index funds selected based on information as of September 2019.

Example: Calvert engaged with a packaged foods company in an effort to get the company to adopt a water stewardship policy designed to reduce risks related to water availability and water pollution. As a result of Calvert's engagement, the company:

- Shared a draft Water Stewardship Policy, finalized the policy, and posted it to its website.
- Committed to transparency related to water stewardship efforts, including water use, risks relating to water quality and scarcity, water stewardship goals, and progress against goals.
- Intends to gather baseline data from manufacturing facilities and establish and disclose water stewardship goals.
- Intends to report in future years on the performance against its stated goals.

Green Century Funds

1. Fund name: Green Century MSCI International Index Fund – Institutional share class
2. Ticker: GCIFX
3. Category: US Fund Foreign Large Blend
4. Inception: September 2016
5. Total AUM as of December 31, 2019: $77 million
6. Performance available here
7. Parent index: MSCI World ex USA SRI ex Fossil Fuels Index
8. Sustainable investment strategy

ESG incorporation approach
The Green Century MSCI International Index Fund invests in companies that have outstanding environmental, social and governance ratings and excludes companies not following international norms and principles. The fund does not invest in producers of genetically modified organisms, guns and other civilian weapons, military weapons, nuclear energy, tobacco, alcohol, gambling, or coal, oil and gas companies. Specifically, the fund does not invest in energy companies that explore for, extract, process, refine or transmit coal, oil, or gas; burn fossil fuels to generate electricity; or own carbon reserves.

Active ownership approach
Green Century actively engages with companies to improve their environmental performance. It believes that even corporate sustainability leaders have room for improvement, so it pressures dozens of companies each year to adopt stronger environmental policies and practices through their operations and supply chains. The firm votes the proxies of all the companies in the Green Century Funds' portfolios to support more sustainable corporate practices and reduce potential investment risks, but its in-depth shareholder advocacy program goes beyond that to deliver tangible environmental improvements on issues such as tropical forest protection, clean energy, antibiotic misuse, and plant-based protein.

Example: In 2019, Verizon Communications, Inc., the largest telecommunications company in the United States, heeded Green Century's call to source more renewable energy. After Green Century filed a shareholder proposal with Verizon, which has more than 147 million wireless subscribers, the company committed to source the equivalent of 50 percent of its annual electricity usage from renewable sources by 2025. This commitment will prevent the annual release of approximately 2.3 million metric tons of carbon dioxide – the equivalent of taking nearly 500,000 cars off the road. Prior to Green Century's engagement, Verizon's goal was to source 4 percent of its electricity from renewables.

Impax Asset Management, LLC, Advisor to the Pax World Funds

1. Fund name: Pax MSCI EAFE ESG Leaders Index Fund – Institutional share class
2. Ticker: PXNIX
3. Category: US Fund Foreign Large Blend
4. Inception: March 2014
5. Total AUM as of December 31, 2019: $645 million
6. Performance available here
7. Parent index: MSCI EAFE ESG Leaders Index
8. Sustainable investment strategy

ESG incorporation approach

The Pax MSCI EAFE ESG Leaders Index Fund tracks the performance of the MSCI EAFE ESG Leaders Index. The MSCI EAFE ESG Leaders Index is constructed to provide higher exposure to companies across developed markets with favorable ESG ratings relative to their sector and industry peers, as determined by MSCI.

The fund, unlike the MSCI EAFE ESG Leaders Index, is fossil fuel free as a result of Impax's SmartCarbon™ approach. SmartCarbon is a proprietary, risk-based investment approach for managing exposure to companies with fossil fuel reserves on their balance sheet. The approach substitutes energy efficiency companies in place of fossil fuel companies to reduce climate-change related risks and participate in the low carbon energy transition.

Active ownership approach

The fund aims to promote better ESG corporate behavior through proxy voting and focused shareholder engagement. The firm votes each proxy in a way that is consistent with its ESG criteria and has engaged issuers on climate and gender related issues.

Example: Climate change is a priority for engagement for Impax across all its portfolios. In 2019, Impax wrote to materials and utilities companies held in the Pax MSCI EAFE ESG Leaders Index Fund regarding emissions targets and Task Force on Climate Related Financial Disclosures (TCFD) reporting. Impax had five different categories in its ask, depending on where companies were on their emissions journey. For example, for companies that already had certified science-based emissions reduction targets, Impax requested a TCFD report. On the other hand, for companies that didn't report to the CDP (formerly the Carbon Disclosure Project) or didn't make their responses public, Impax asked them to do so and to set an emissions reduction target. Impax wrote to 56 companies, and as of September 2019 received responses from 11 companies.

Praxis Mutual Funds

1. Fund name: Praxis Growth Index Fund – Institutional share class
2. Ticker: MMDEX
3. Category: US Fund Large Growth
4. Inception: May 2007
5. Total AUM as of December 31, 2019: $326 million
6. Performance available here
7. Parent index: S&P 500 Growth Index
8. Sustainable investment strategy

ESG incorporation approach

The Praxis Growth Index Fund is an optimized index fund that incorporates robust ESG data into its Values + ESG screening process by restricting companies with poor ESG scores and those producing meaningful revenue from activities in conflict with the fund's stewardship investing values. The remaining companies are optimized back to index, resulting in a portfolio of companies with better ESG characteristics, a strong values orientation and returns near the public index.

Active ownership approach

The fund's diverse and stable holdings present an ideal platform for an aggressive program of corporate engagement and values-driven proxy voting, designed to leverage the firm's ownership position and encourage positive corporate change across industry sectors. Themes of environmental sustainability/climate change, modern slavery and global inequality are priority themes in this work.

Example: Praxis was part of an investor coalition of Interfaith Center on Corporate Responsibility members who approached JPMorgan Chase (JPMC) about its financing of private prison companies, beginning in 2017. After a series of dialogues centered on human rights policies, JPMC announced in March 2019 that it would withdraw from private prison lending. Nearly all the largest US banks have since followed JPMC's lead and committed to ending their ties to the private prison industry, illustrating the effect that one company's policy can have on an industry.

EXCHANGE TRADED FUNDS

This section includes a sample of some of the largest ESG ETFs identified from the US SIF Foundation's *Report on US Sustainable, Responsible and Impact Investing Trends* 2018. Profiles were requested from 10 distinct asset managers with the largest ESG ETFs. Four of them shared profiles for this report.

BlackRock

1. Fund name: iShares MSCI KLD 400 Social ETF
2. Ticker: DSI
3. Category: US Fund Large Blend
4. Inception: November 2006
5. Total AUM as of December 31, 2019: $1,845 million
6. Performance available here
7. Parent index: MSCI KLD 400 Social Index
8. Sustainable investment strategy

ESG incorporation approach

iShares DSI tracks the first created sustainable index, MSCI KLD 400 Social Index, and as a result provides exposure to higher ESG-rated companies, while excluding those with severe controversies or those engaging in 10 controversial industries. The excluded industries are alcohol, gambling, tobacco, nuclear weapons, conventional weapons, controversial weapons, civilian firearms, nuclear power, genetically modified foods and adult entertainment. The specific exclusion criteria, such as revenue thresholds, vary by industry. Companies must have an MSCI ESG Rating higher than BB (on a scale of AAA-CCC) and MSCI ESG Controversy Score higher than 2 (on a scale of 0-10) to be considered for inclusion. Once included, a company's controversy score must drop to 0 before it is removed.

Active ownership approach
Investment stewardship is an essential component of BlackRock's fiduciary responsibility. BlackRock has the largest and most global investment stewardship team in the industry. They advocate for sound corporate governance and sustainable business practices that result in long-term value creation for its clients. To help clients achieve long-term value, BlackRock Investment Stewardship (BIS) engages company leadership on key issues, casts informed votes aligned with clients' interests, holds directors accountable for their action or inaction, considers ESG factors consistent with its fiduciary obligation to clients, and improves industry and governmental standards and drives adoption by companies. In the last reporting year, BIS participated in 230 unique company engagements with 163 companies in the DSI portfolio on a range of governance and material sustainability topics.

Example: At Starbucks, after several years of sustainability-related engagements, BIS supported a shareholder proposal requesting a report to enhance its sustainable packaging initiatives. Starbucks' recent January 2020 sustainability goals align with the perspectives BIS shared with the company during its engagements and through its vote.

Inspire (CWM Advisors)

1. Fund name: Inspire Global Hope ETF
2. Ticker: BLES
3. Category: US Fund World Large Stock
4. Inception: February 2017
5. Total AUM as of December 31, 2019: $167 million
6. Performance available here
7. Parent index: Inspire Global Hope Large Cap Equal Weight Index
8. Sustainable investment strategy

ESG incorporation approach
Inspire Global Hope ETF is a faith-based ESG fund that follows a biblically responsible investing (BRI) mandate. The fund utilizes Inspire's proprietary Inspire Impact Score methodology and technology to combine inclusionary and exclusionary screens across 29 categories of environmental, social and governance criteria to identify the most inspiring, biblically aligned companies in the world to invest in.

Active ownership approach
The fund engages with corporations to advocate for biblical values within portfolio companies, formally through proxy and resolutions and also informally through direct dialogue with corporate management.

Nuveen

1. Fund name: Nuveen US Aggregate Bond ESG ETF
2. Ticker: NUBD
3. Category: US Fund Intermediate Core Bond
4. Inception: September 2017
5. Total AUM as of December 31, 2019: $79 million
6. Performance available here
7. Parent index: Bloomberg Barclays MSCI US Aggregate ESG Select Index
8. Sustainable investment strategy

ESG incorporation approach

The Nuveen US Aggregate Bond ESG ETF integrates ESG, controversy, controversial business involvement, and low carbon criteria into the investment selection process. The objective is to select best-in-class ESG leaders while minimizing carbon footprint and providing the risk and return characteristics of non-ESG intermediate core bond benchmarks.

Active ownership approach

Nuveen engages with a spectrum of strategies to influence companies and issuers across asset classes. The firm executes thoughtful, case-by-case proxy voting on management and shareholder proposals for publicly traded companies. Additionally, Nuveen engages in direct and constructive dialogue with CEOs, senior management and board of directors.

Van Eck Associates Corporation (subsidiary of Van Eck Global)

1. Fund name: VanEck Vectors Low Carbon Energy ETF
2. Ticker: SMOG
3. Category: US Fund Miscellaneous Sector
4. Inception: May 2007
5. Total AUM as of December 31, 2019: $105 million
6. Performance available here
7. Parent index: Ardour Global IndexSM Extra Liquid (AGIXLT)
8. Sustainable investment strategy

ESG incorporation approach

The VanEck Vectors Low Carbon Energy ETF focuses on the environmental aspect of the ESG spectrum and provides investors with a thematic exposure to global companies that are investing in low carbon technologies. The ETF offers a pure play approach as its underlying index only includes companies that are principally engaged in the field of alternative energy. These include renewable energy companies that engage in alternative energy, which includes power derived mainly from bio-fuels (such as ethanol), wind, solar, hydro and geothermal sources. It also provides exposure to companies primarily engaged in and supporting the various technologies that support the production, use and storage of these sources.

Active ownership approach

None

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