

## The Many Shades of ESG Integration: A Survey of U.S. Equity ETFs

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*This piece examines the largest segment in passively managed ESG ETFs, U.S. equities, and underscores the importance of the index providers' role in the index construction process, as well as demystifies some of the tradeoffs among the largest ETFs in the marketplace today.*

### Key Takeaways

- In a category where 97% of assets are passively managed, the index provider and third-party ESG data provider rises in importance. MSCI is the dominant player in ESG ETFs, with 87% share of assets in both index and ESG data.
- ESG index construction can vary across the same index provider, resulting in differences in risk characteristics and performance outcomes.
- ESG does not inherently outperform or underperform the market because there many ways to construct an ESG index and strategy. For a given passive strategy, knowing the sources of concentration risk matters most in choosing or constructing ETF portfolios.

An investor searching through ESG ETF options could easily face decision paralysis. Along with the tremendous growth of ESG ETF assets to over \$25 billion in 2020, the number of ESG ETFs has also exploded to roughly 125 in 2020, up from a handful a few years ago.

The primary reason there are so many ESG ETFs available today is that no industry-wide consensus exists about the right way to integrate ESG factors into a portfolio. Oftentimes, two funds with “ESG” in their names could have completely different sector exposures, integration methodologies, exclusions, and levels of concentration. The differences lie in the way they are constructed.

Most ESG ETFs are passive, meaning they follow an index, which relies on various ESG research organizations

to evaluate companies' ESG practices and policies. The index providers create many different ESG indexes simply because there are so many different shades of ESG integration today. Know someone looking to invest in diversity and inclusion leaders? There's an index for that. What about an investor who wants to exclude thermal coal but not nuclear power (and vice versa)? There are indexes for that. There are also indexes that comprise low carbon leaders, green bonds, and women's leadership, to name a few.

Do more choices result in better outcomes for the end investor? Not necessarily. In his 2004 bestselling classic, *The Paradox of Choice – Why More Is Less*, psychologist Barry Schwartz explored the concept that more options do not necessarily increase one's capacity to make a decision; instead they often serve as an obstacle to making a decision.

While the increase in options for ESG ETF investors means they can be very specific about the values with which they align, the other goal of ESG investing – equal or better returns than a conventional fund – can become harder to achieve. This requires a level of active risk management to ensure the ESG ETFs chosen are meeting a strategy's risk/return profile.

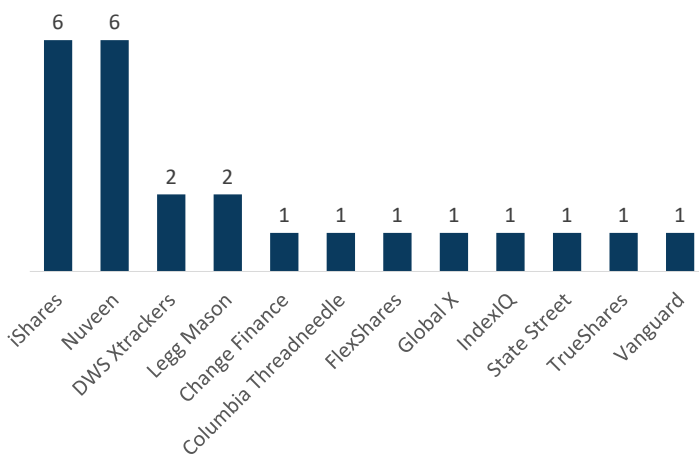
### A Survey of U.S. Equity ESG ETFs

We examined the 24 largest U.S. equity ESG ETFs that have an ESG-integration approach. These ETFs total roughly \$25 billion in assets. iShares and Nuveen are the ETF providers with the largest selection within U.S. equities, with six ETFs each; however, iShares has roughly 70% market share with \$17.5 billion in assets. Most assets (97%) within this category are passively managed, underscoring the importance of the role each index or data provider plays for a given ETF. MSCI has a hold on this market as the No. 1 provider of indexes in this category, as well as being the No. 1 research and data provider that informs those indexes, with \$21.8 billion in assets, or 87% in market share.

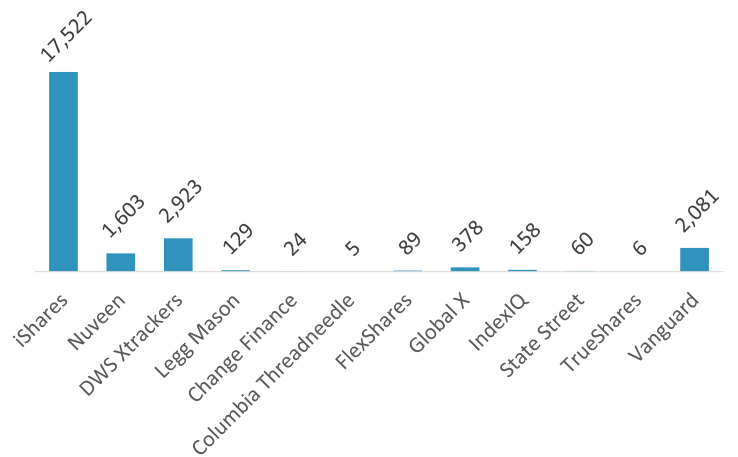
**Table: The 24 Largest U.S. Equity ESG Integrated ETFs**

Ticker	Name	Ticker	Name
CHGX	Change Finance US Large Cap Fossil Fuel Free	NULC	Nuveen ESG Large-Cap
DSI	iShares Trust- iShares MSCI KLD 400 Social	NULG	Nuveen ESG Large-Cap Growth
ECOZ	TrueShares ESG Active Opportunities	NULV	Nuveen ESG Large-Cap Value
EFIV	SPDR S&P 500 ESG	NUMG	Nuveen ESG Mid-Cap Growth
ESG	FlexShares STOXX US ESG Impact Index Fund	NUMV	Nuveen ESG Mid-Cap Value
ESGS	Columbia Sustainable US Equity Income	NUSC	Nuveen ESG Small-Cap
ESGU	iShares Trust iShares ESG Aware MSCI USA	SNPE	Xtrackers S&P 500 ESG
ESGV	Vanguard ESG US Stock	SUSA	iShares MSCI USA ESG Select
ESML	iShares ESG Aware MSCI USA Small-Cap	SUSL	iShares ESG MSCI USA Leaders
IQSU	IQ Candriam ESG US Equity	USSG	Xtrackers MSCI USA ESG Leaders Equity
KRMA	Global X Conscious Companies	USXF	iShares ESG Advanced MSCI USA
LRGE	ClearBridge Large Cap Growth ESG	YLDE	ClearBridge Dividend Strategy ESG ETF

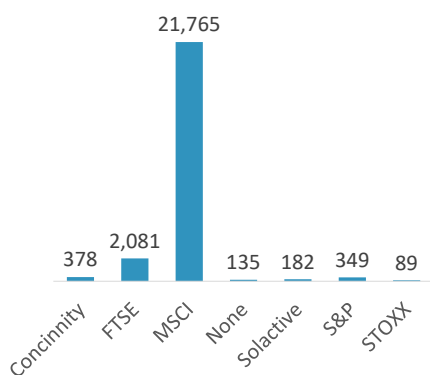
**ESG Integration by Sponsor (No. of ETFs)**



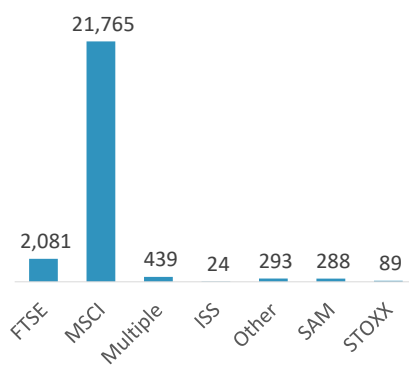
**ESG Integration by Sponsor (AUM, \$ Millions)**



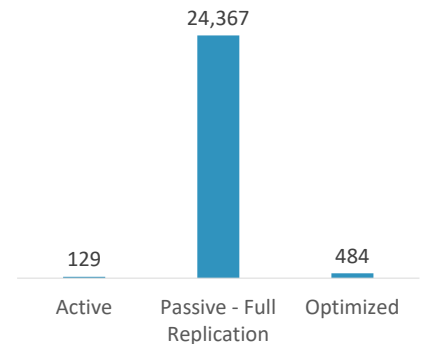
**ESG Integration by Index Provider (AUM, \$ Millions)**



**ESG Integration by Data Provider (AUM, \$ Millions)**



**ESG Integration by Strategy Type (AUM, \$ Millions)**



## An Important Question for ESG ETF Investors

While we chose to look at ETFs that integrate ESG factors into the security selection process, most large U.S. equity ESG ETFs also include restrictions on certain industries that are widely considered to be less ESG friendly. The table below outlines the number of ETFs with restrictions, ranked by the most common issues: controversial weapons, nuclear energy, tobacco, coal, small arms, and fossil fuels.

Issue	Number of ETFs with Restrictions	% of U.S. Equity ETFs
Controversial Weapons	20	83%
Nuclear Energy	14	58%
Tobacco	20	83%
Coal	7	29%
Small Arms	16	67%
Fossil Fuels	13	54%

Exclusionary practices have been around since the early days of socially responsible investing (SRI), but unlike ESG integration, SRI tended to exclude large sectors of the market, making it difficult for investors to achieve a level of diversification that is necessary for returns to outperform over time.

Because of this, one of the most common questions that still exists for ESG today is, do investors give up returns by integrating ESG factors? We believe that this is the wrong question for investors to be asking. The more important question is, *what types of risk relative to the conventional benchmark does one take on because of the ESG methodology implemented in a particular ETF?* This deviation from the benchmark's performance is called tracking error and it can indicate that there's a risk or trade-off in investing in a particular ETF.

As the number and shades of ESG ETFs continues to rise, it's important to note that not all ESG ETFs are created equal, and as most of them passively follow an index, neither are their indexes.

The table on the next page outlines the methodologies of four U.S. large-cap core equity ESG ETFs. The key takeaway is that index selection – especially those tracked closely by passively managed ETFs – matters quite a bit.

All four ESG indexes use some form of ESG score to screen names for the portfolio, and they are constructed using various forms of negative screening. Where they start to diverge is in their levels of security concentration, as seen in the MSCI USA ESG Select with only 157 names, compared to the S&P 500 ESG with 299 names and the MSCI Extended ESG Focus with over 300 names. Those levels of concentrations along with other sector/style tilts result in higher expected tracking error versus a conventional benchmark.

This goes to the heart of the trade-off we posed before – tracking a conventional index versus a higher concentration of ESG names (which would consequently garner a higher ESG fund score from third parties). For a given passive strategy, it is the knowledge of the sources of this risk that matters most in choosing or constructing a portfolio of ETFs. For example, as of this writing, most of the tracking error expected from the MSCI USA ESG Leaders Index comes from its underweight to the FAANMG (Facebook, Apple, Amazon, Netflix, Microsoft, and Google) names. Conversely, the S&P 500 ESG and MSCI Extended ESG Focus indexes have a much higher weight to those names. Given the record market concentration in the largest-capitalization technology stocks, this difference can have a big effect on financial outcomes.

This information is particularly essential to asset allocators because with the knowledge of the sources of tracking risk, the ETFs following these indexes can be used as tools to construct an efficient portfolio for a given client's dual objectives of return and sustainability. Want to closely track the benchmark? Own more EFIV or ESGU. Want to increase third-party sustainability ratings? Own more SUSA and USSG.

**Table: A Comparative Analysis of Four U.S. Large-Cap Core Equity ESG ETFs**

Index Name	ETFs Tracking This Index	Construction Methodology	Number of Constituents	Expected Tracking Error to Non-ESG Index*	Negative Screens	YTD Performance (through 10/30)
MSCI USA ESG Leaders Index	USSG, SUSL	The index targets companies that have the highest environmental, social and governance (ESG) rated performance in each sector. The indexes target a 50% sector representation vs. the parent index, aiming to include companies with the highest MSCI ESG ratings in each sector.	288	2.41%	Alcohol, Gambling, Tobacco, Nuclear Power, Weapons, and Low ESG Score	3.12%
S&P 500 ESG Index	SNPE, EFIV	The index targets 75% of the float market capitalization of each GICS® industry group within the S&P 500, using the S&P DJI ESG scores for constituent selection	299	1.13%	Thermal Coal, Tobacco, Controversial Weapons, Low UNGC Score, Low ESG Score	4.46%
MSCI USA ESG Select Index	SUSA	The index is constructed through an optimization process that aims to maximize its exposure to ESG factors, optimized to an expected tracking error of 1.8% and other constraints. It is sector controlled and is designed to overweight companies with high ESG ratings and underweight companies with low ratings.	157	2.07%	Tobacco, Low Controversy Score	9.06%
MSCI Extended ESG Focus Index	ESGU	The index is constructed by selecting constituents of a market capitalization weighted index (the 'Parent Index') through an optimization process that aims to maximize exposure to ESG factors for a target tracking error budget of 0.50% under certain constraints.	346	0.44%	Tobacco, Weapons, Thermal Coal, Oil Sands, Low Controversy Score	5.64%

Source: Sage, Bloomberg, MSCI, S&P Global, Blackrock, State Street, DWS as of October 30, 2020

\* MSCI Indexes compared to MSCI USA Index; S&P 500 ESG compared to S&P 500

## Index Construction and Performance Observations

Our analysis of the 24 largest ESG-optimized U.S. equity ETFs (listed on pages 6 & 7) revealed a variety of risk and diversification considerations for investors. First, the asset size of the ETFs varied significantly within a range of \$5.7 million to \$11.6 billion in AUM with the average AUM totaling just over \$1 billion as of 10/31/2020. These size differences suggest that investors should weigh the relative liquidity and trading costs associated with each of the ETFs because they can vary significantly depending upon the size and timing of potential transactions. This may also impact each of the ETFs' relative performance and tracking efficiency over time.

We found that most of the ETF providers utilized a variety of different customized indices to reflect their brand of ESG optimization, which may create some confusion for investors when determining a preferred ESG and market risk profile. Knowing and understanding the risk characteristics and sector weightings between the index providers is a key investment consideration, particularly when the complexity of unique ESG screens and exclusion policies are added to the investment portfolio construction and evaluation process.

In our evaluation process, we looked at each of the ETFs' relative performance in comparison to its portfolio construction benchmark as well as the conventional market index that best reflected the risk profile and style of the ETF portfolio. We found that the large

## The Role of an Active Manager

and mid-cap blend category was the dominant style, with 12 of the ETFs utilizing benchmarks oriented this way across three different index providers. The large-cap growth sector was the next largest category with six of the ETFs utilizing a large-cap growth index across two different index providers. There were only two value-oriented ETFs focused on the large and mid-cap sectors and one small cap-oriented ETF.

The actual number of holdings per ETF varied significantly from 42 to 1,460 companies, with an average of 302 companies. Even within ETFs focused on the same market sector and style, we found the number of constituent holdings varied quite a bit despite their similar fund titles. Moreover, the relative return outcomes within this group of ETFs varied significantly despite their similar base index and fund titles. This suggests that investors would be well served to fully understand a given ETF's portfolio construction process relative to its underlying market index and what those differences may imply in terms of tracking error and potential return outcomes relative to its benchmark.

Lastly, it is worth noting that the relative performance of the ETFs in our survey achieved competitive returns versus similar conventional market indexes. Indeed, thru 10/31/20 the 14 ETFs within our survey with a three-year track record generated a weighted average annualized excess return of 45 basis points versus the conventional market indices. Moreover, the entire survey universe generated an impressive average excess return of 127 basis points for the last year compared to their respective conventional market indices.

Constructing a diversified ESG ETF portfolio involves many layers of active risk decisions, including asset class mix, region and style exposures, as well as considering the way in which ESG is defined. It is these tradeoffs that we at Sage are faced with every day – to marry client risk tolerance and ESG values with the growing choices of ETFs in the market.

It is also important for us to consider the ETF provider's stewardship role, which is formally recorded in our [Annual ETF Stewardship Survey](#). Because the ETF providers represent investors in such activities as proxy voting and company engagements, it is incumbent upon them to act in the best interest of their ESG investors. We weigh the effectiveness of an ETF sponsor's engagements with respective portfolio companies to serve as a tie breaker when deciding between two seemingly similar ESG ETFs and to fulfill our engagement role as an independent ETF strategist.

In trying to solve the "Paradox of Choice" that presents itself in the proliferation of ESG ETFs, deconstructing the funds and underlying indexes does not necessarily make the choice easier, but it illuminates the tradeoffs inherent in ESG investing. Understanding the amount and source of tracking error and how it relates to the ESG profile of a fund, then marrying that with an investment and portfolio construction process are the foundations from which an investor can build a portfolio of funds that can achieve the double bottom line of market outperformance and alignment with sustainability values.

### Disclosures

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## ESG ETF Comparative Analysis (as of 10/30/2020)

Ticker	ESGU	USSG	SUSL	ESGV	DSI	SUSA	NULV	NUSC	ESML	KRMA	NULG	SNPE
<b>Name</b>	iShares ESG Aware MSCI USA ETF	Xtrackers MSCI USA ESG Leaders Equity ETF	iShares ESG MSCI USA Leaders ETF	Vanguard ESG US Stock ETF	iShares MSCI KLD 400 Social ETF	iShares MSCI USA ESG Select	Nuveen ESG Large-Cap Value ETF	Nuveen ESG Small-Cap ETF	iShares ESG Aware MSCI USA Small-Cap ETF	Global X Conscious Companies	Nuveen ESG Large-Cap Growth ETF	Xtrackers S&P 500 ESG ETF
<b>Inception Date</b>	12/2/2016	3/7/2019	5/9/2019	9/20/2018	11/17/2006	1/28/2005	12/14/2016	12/14/2016	4/12/2018	7/12/2016	12/14/2016	6/26/2019
<b>AUM</b>	\$11.59 B	\$2.68 B	\$2.64 B	\$2.44 B	\$2.39 B	\$1.99 B	\$598.31 M	\$416.5 M	\$412.08 M	\$391.59 M	\$372.48 M	\$343.00 M
<b># of Holdings</b>	346	289	287	1460	401	157	168	656	1029	168	85	298
<b>Annual Net Expense Ratio</b>	0.15	0.10	0.10	0.12	0.25	0.25	0.35	0.40	0.17	0.43	0.35	0.10
<b>Conventional Benchmark</b>	MSCI USA Index	MSCI USA Index	MSCI USA Index	FTSE USA All Cap Index	MSCI USA IMI Index	MSCI USA Index	MSCI USA Value Index	MSCI USA Small Cap Index	MSCI USA Small Cap Index	S&P 500 Index	MSCI USA Growth Index	S&P 500 Index
<b>ETF vs. Benchmark Performance</b>												
<b>3 Month ETF (%)</b>	0.78	0.90	0.93	1.41	1.37	2.17	-0.45	7.15	4.87	1.23	1.46	-0.03
<b>3 Month BM (%)</b>	0.80	0.80	0.80	0.98	1.13	0.80	-0.63	4.08	4.08	0.37	2.04	0.37
<b>Differential (%)</b>	-0.02	0.10	0.13	0.43	0.24	1.37	0.18	3.07	0.79	0.86	-0.58	-0.40
<b>YTD ETF (%)</b>	5.64	3.12	3.05	8.05	5.33	9.07	-12.65	-1.35	1.93	19.55	4.47	-15.45
<b>YTD BM (%)</b>	4.48	4.48	4.48	3.39	3.36	4.48	-13.50	-5.47	2.76	23.42	2.76	4.48
<b>Differential (%)</b>	1.16	-1.36	-1.43	4.66	1.97	4.59	0.85	4.12	-0.83	-3.87	1.71	-19.93
<b>1-Year ETF (%)</b>	12.88	9.94	10.21	15.49	12.26	16.65	-7.78	4.44	7.66	28.42	11.71	-8.53
<b>1-Year BM (%)</b>	11.58	11.58	11.58	10.37	10.39	11.58	-8.42	0.91	9.70	32.94	9.70	11.58
<b>Differential (%)</b>	1.30	-1.64	-1.37	5.12	1.87	5.07	0.64	3.53	-2.04	-4.52	2.01	-20.11
<b>3-Year ETF (%)</b>	11.53	N/A	N/A	N/A	11.21	12.05	3.08	5.29	N/A	10.58	19.66	N/A
<b>3-Year BM (%)</b>	11.01	11.01	11.01	10.23	10.17	11.01	1.75	3.84	3.84	10.41	20.08	10.41
<b>Differential (%)</b>	0.52	N/A	N/A	N/A	1.04	1.04	1.33	1.45	N/A	0.17	-0.42	N/A



## ESG ETF Comparative Analysis (as of 10/30/2020)

Ticker	IQSU	NUMG	NUMV	LRGE	ESG	EFIV	USXF	CHGX	NULC	YLDE	ECOZ	ESGS
<b>Name</b>	IQ Candriam ESG US Equity ETF	Nuveen ESG Mid-Cap Growth ETF	Nuveen ESG Mid-Cap Value ETF	Clearbridge Large Cap Growth ESG ETF	Flexshares Stoxx US Impact Index ETF	SPDR S&P 500 ESG ETF	iShares ESG Advance MSCI USA ETF	Change Finance Diversified Impact US Large-Cap Fossil Fuel Free ETF	Nuveen ESG Large-Cap ETF	Clearbridge Dividend Strategy ESG ETF	TrueShares ESG Active Opportunities ETF	Columbia Sustainable US Equity Income ETF
<b>Inception Date</b>	12/17/2019	12/14/2016	12/14/2016	5/22/2017	7/14/2016	7/28/2020	6/18/2020	10/10/2017	6/4/2019	5/22/2017	2/28/2020	6/13/2016
<b>AUM</b>	\$236.47 M	\$204.75 M	\$133.90 M	\$121.16 M	\$96.23 M	\$71.27 M	\$58.62 M	\$25.50 M	\$18.48 M	\$12.11 M	\$6.37 M	\$5.72 M
<b># of Holdings</b>	302	59	96	42	271	297	303	100	215	51	76	100
<b>Annual Net Expense Ratio</b>	0.09	0.40	0.40	0.59	0.32	0.10	0.10	0.49	0.20	0.60	0.58	0.35
<b>Conventional Benchmark</b>	Solactive GBS US Large & Mid Cap Index	MSCI USA Mid Cap Growth Index	MSCI USA Mid Cap Value Index	Russell 1000 Growth Index	Stoxx USA 900 Index	S&P 500 Index	MSCI USA Index	Solactive GBS US 1000 Index	MSCI USA Index	S&P 500 Net Total Return Index	S&P 500 Index	MSCI USA Index
<b>ETF vs. Benchmark Performance</b>												
<b>3 Month ETF (%)</b>	0.82	1.07	2.07	0.97	0.68	0.30	1.49	2.31	1.22	0.65	2.70	1.61
<b>3 Month BM (%)</b>	0.73	2.23	1.51	1.56	0.77	0.37	0.80	1.05	0.80	0.25	0.37	0.80
<b>Differential (%)</b>	0.09	-1.16	0.56	-0.59	-0.09	-0.07	0.69	1.26	0.42	0.40	2.33	0.81
<b>YTD ETF (%)</b>	10.90	21.45	-15.06	15.20	3.85	N/A	N/A	7.24	4.36	-3.31	N/A	-15.45
<b>YTD BM (%)</b>	4.49	17.55	-15.42	20.11	4.03	2.76	4.48	4.22	4.48	2.30	2.76	4.48
<b>Differential (%)</b>	6.41	3.90	0.36	-4.91	-0.18	N/A	N/A	3.02	-0.12	-5.61	N/A	-19.93
<b>1-Year ETF (%)</b>	N/A	28.90	-11.11	23.71	11.19	N/A	N/A	15.36	11.43	3.25	N/A	-8.53
<b>1-Year BM (%)</b>	11.56	24.64	-11.33	29.22	10.88	9.70	11.58	11.23	11.58	9.09	9.70	11.58
<b>Differential (%)</b>	N/A	4.26	0.22	-5.51	0.31	N/A	N/A	4.13	-0.15	-5.84	N/A	-20.11
<b>3-Year ETF (%)</b>	N/A	16.88	0.69	18.01	11.44	N/A	N/A	11.91	N/A	8.03	N/A	1.43
<b>3-Year BM (%)</b>	N/A	15.17	-0.07	18.77	10.22	10.41	11.01	10.80	N/A	9.78	10.41	11.01
<b>Differential (%)</b>	N/A	1.71	0.76	-0.76	1.22	N/A	N/A	1.11	N/A	-1.75	N/A	-9.58