Vanguard's approach to ESG

2023

Introduction

Vanguard exists to take a stand for all investors, to treat them fairly and to give them the best chance for investment success. This singular focus on our clients' long-term investment success informs everything we do, including our approach to environmental, social and governance (ESG) investing.

The topic of ESG has garnered much attention, but with varying definitions of what it means, many remain uncertain about how to proceed. ESG investing is a nuanced concept. Thus, many investors and their advisers seek additional perspective to make sense of the topic, and determine whether—and if so, how—to incorporate ESG into their investment portfolios.

In this piece, we explain how Vanguard addresses ESG considerations across our product range and we highlight our select number of funds and ETFs that target specific ESG outcomes. We also provide insight into how we engage with the companies that our funds invest in on our clients' behalf, working with directors and management to discuss material business risks at those companies, including ESG risks.

We have been deliberate in calibrating our response to the rise in ESG investment approaches, given the ever-changing landscape and our long-standing philosophy of offering only products that have clear, enduring sources of investment merit.

Lastly, we offer a straightforward four-step process to help frame ESG conversations with your clients and consider the implications that ESG considerations could have on long-term portfolio performance. How ESG funds perform is likely to be top of mind for many investors.

Ultimately, Vanguard has one overarching and enduring objective—to help investors achieve investment success—and it is from this vantage point that we seek to provide a balanced perspective on ESG investing.

We look forward to engaging with you on the topic.

Principles for investing success

Some suggest that investment decisions that incorporate ESG considerations should be approached differently from those that do not incorporate ESG. We disagree. At Vanguard, we believe that any sound investment strategy rests on four time-tested principles.[1]

Goals

Create clear, appropriate investment goals

The investment process begins by setting measurable and attainable investment goals and developing plans to reach those goals.

Investors without a plan often construct portfolios by evaluating the merits of each investment or fund individually. This can lead to buying funds with good recent performance in the hope that it will continue or trying to time market peaks and troughs to buy and sell at exactly the right time. Our research shows both efforts are extremely difficult to get right, even for professional investors.

Balance

Develop a suitable asset allocation using broadly diversified funds

A successful investment strategy starts with an asset allocation suitable for its objective, using reasonable expectations for risk and potential returns. The use of diversified investments helps to limit exposure to unnecessary risks and drive improved investment outcomes.

Predicting the outperformance of an asset class in the short term and timing investment in any asset class to maximise returns is very difficult to do. The chart opposite shows the performance of various asset classes over the past ten years. You'll see that persistent top performance among asset classes is fleeting, with top performing investments from one year often falling to the bottom of the rankings in subsequent years.

1 Vanguard. 'Principles for Investment Success' 2023.

Key bond and equity index returns (%), ranked by performance

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
28.3	19.6	8.8	35.4	21.1	0.8	26.5	16.4	28.1	0.3
24.0	18.8	5.5	34.1	17.2	0.5	22.3	13.0	20.0	-3.3
21.0	14.6	5.3	29.6	16.9	0.1	21.2	12.8	18.3	-6.4
20.8	12.5	4.0	25.5	13.8	-0.4	19.2	11.9	17.6	-7.3
13.6	11.3	1.4	25.4	13.1	-2.2	15.9	11.3	4.0	-8.8
1.6	7.9	1.0	21.2	11.3	-3.4	14.0	9.1	2.5	-9.4
0.6	7.9	0.7	16.8	4.9	-7.6	11.0	8.9	1.0	-12.2
0.0	2.8	0.5	12.3	2.4	-8.0	7.1	7.8	-1.5	-19.3
-4.2	1.2	-1.1	10.7	2.0	-9.1	6.5	5.0	-3.3	-25.1
-5.3	-1.4	-10.3	3.7	1.9	-9.5	6.3	-9.8	-5.3	-34.5

Top-performing asset class

Bottom-performing asset class

- Global equities
- North American equities
- Emerging market equities
- Developed Asia equities
- European equities
- UK equities
- UK government bonds
- UK index-linked gilts
- UK investment grade corporate bonds
- Hedged global bonds

Past performance is not a reliable indicator of future results.

Source: Vanguard calculations, data from 1 January 2012 to 31 December 2022, using data from Barclays Capital and Thompson Reuters Datastream and FactSet. Global equities as the FTSE All World Index, North American equities as the FTSE World North America Index, Emerging market equities as the FTSE All-World Emerging Index, Developed Asia equities as the FTSE All World Developed Asia Pacific Index, European equities as the FTSE All World Europe ex-UK Index, UK equities is defined as the FTSE All Share Index, UK government bonds as Bloomberg Sterling Gilt Index, UK index-linked gilts as Bloomberg UK Govt Inflation-Linked UK Index, UK investment grade corporate bonds as Bloomberg Sterling Aggregate Non-Gilts – Corporate Index, Hedged global bonds as Bloomberg Global Aggregate Index (hedged in GBP). Performance shown is cumulative and denominated in GBP. It includes the reinvestment of all dividends and any capital gains distributions. The performance data does not take account of the commissions and costs incurred in the issue and redemption of shares.

Achieving long-term financial goals means accepting the trade-off between risk and reward and appreciating the historical characteristics of different types of investments. Everyone is different, so your client needs to be clear on how much investment risk they are willing to take to achieve their goals.

Cost

Minimise cost

No individual can control the markets, but they can control how much they pay to invest. Every pound or euro that an investor pays in costs and charges comes directly out of their potential return.

By minimising costs and charges, your clients get to keep more of their returns. Indeed, research suggests that lower-cost investments have tended to outperform higher-cost alternatives.[2]

Discipline

Maintain perspective and long-term discipline

Investing through different market environments can evoke emotions and reactions that can disrupt the plans of even the most sophisticated investors. But you can help your clients counter these emotions with discipline and a long-term perspective. This kind of behavioral coaching can make a big difference. In fact, Vanguard research has shown that advisers helping investors stick to their plan can significantly improve net returns for those investors.[3]

2 Source: Vanguard. See Plagge and Rowley, 2022, 'The case of low-cost index-fund investing.'

3 *Putting a value on your value: Quantifying Vanguard Adviser's Alpha in the UK*. Vanguard Research, June 2020.

What is ESG?

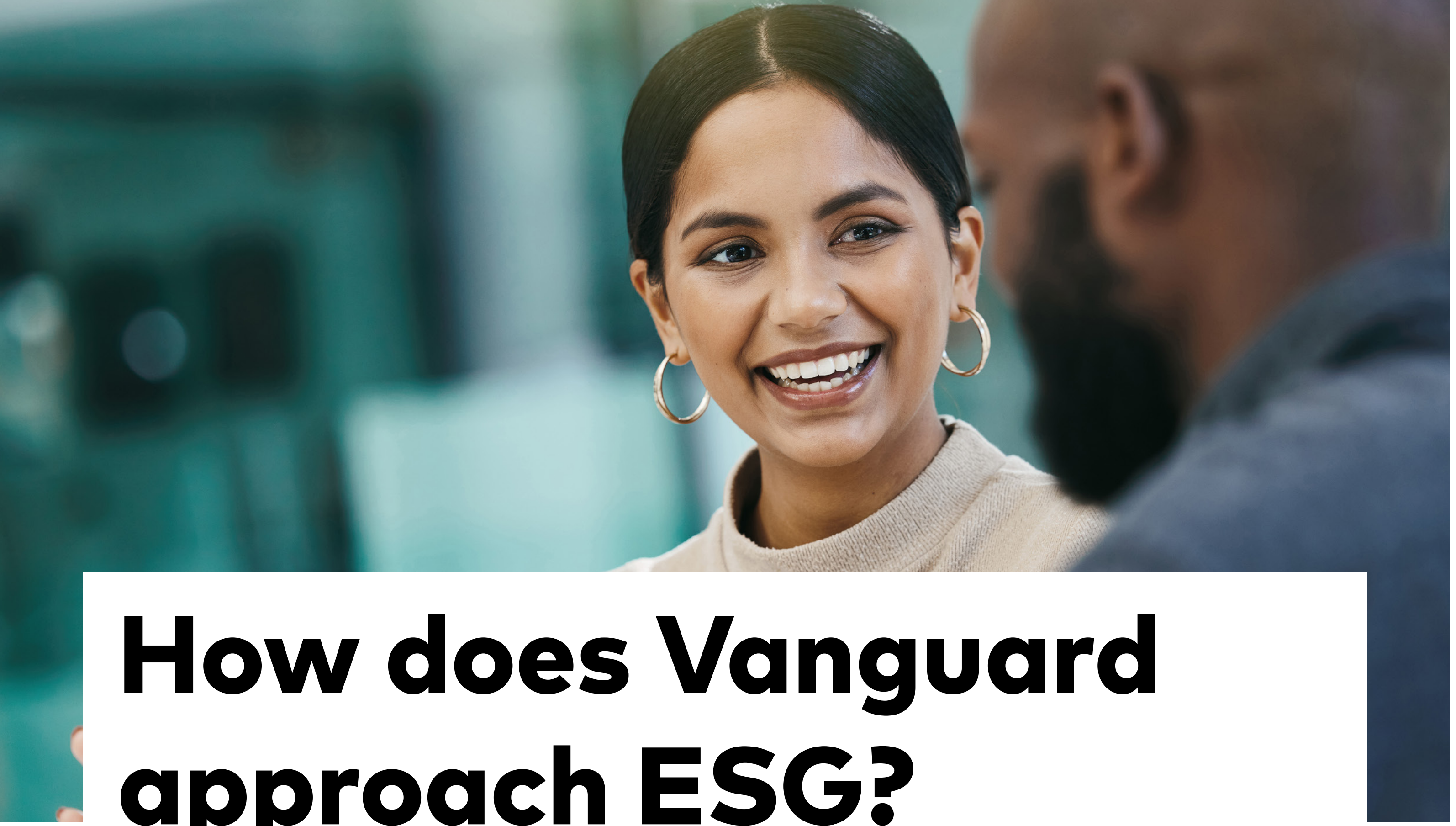
ESG is shorthand for environmental, social and governance. There has been a marked increase in dialogue regarding whether—and if so, how—investors ought to think about ESG. This evolution is being driven by many factors, including the heightened regulatory attention on ESG issues.

So, what exactly do we mean by environmental, social and governance considerations? Here is our straightforward definition of each:

Environmental
Environmental criteria include how a company performs as a steward of the natural environment and how climate change and climate regulation can impact a company's prospects.

Social
Social criteria examine how a company manages its relationships with stakeholders and its impact on those stakeholders – including employees, suppliers, clients and communities.

Governance
Governance focuses on mechanisms and processes that determine a company's strategy, how its objectives are set and how it is most effectively run. This can include a focus on its board and leadership structure, executive pay, financial controls and shareholder rights.



How does Vanguard approach ESG?

Our approach to ESG is multi-faceted. First, we offer a range of high-quality ESG products (both index and active) that aim to enable clients to meet their financial goals and reflect their personal preferences. Second, we integrate ESG considerations into the management of our actively managed products (whether or not the products target a specific ESG outcome). Third, we engage with the boards and senior management of the companies held in our funds to understand how they assess, disclose and oversee material ESG risks.

We offer ESG index products that AVOID or REDUCE exposure to certain ESG risks.

Some investors want to limit their exposure to certain industries or business activities that pose heightened ESG-related risks, or conflict with their ESG preferences. For these investors, we offer products that avoid, or reduce exposure to, specific industries such as firearms, tobacco, fossil fuels, gambling or adult entertainment, while still seeking as much as possible to achieve a market-like return.

Vanguard's current suite of ESG index products, across equity and fixed income, track broadly diversified indices (including FTSE indices for equity index funds and Bloomberg MSCI indices for fixed income index funds) that use transparent exclusion criteria based on a company's involvement in certain business activities or practices. These indices use several screening approaches, including assessing sources and magnitude of revenue (e.g., the percentage of revenue earned via sales of alcohol) as well as participation in certain sectors of the economy (e.g., tobacco, coal).

The indices we choose for these funds apply clearly defined, objective and transparent ESG screens, but importantly also ensure that the funds remain broadly diversified, market-cap weighted and low cost. This ensures the funds continue to capture the benefits of indexing on investment returns over the long term.

Vanguard's active ESG funds ALLOCATE capital to companies with leading or improving ESG practices

We offer a number of actively managed funds that allocate capital to companies based on specific sustainability criteria. These portfolios seek to generate excess return by investing in companies that the managers assess as demonstrating leadership in managing ESG risks, consistent with each fund's ESG mandate. The funds aim to deliver sustainable, long-term returns for investors who have a preference for active management and hope to achieve certain ESG outcomes.

Vanguard's active funds (both with and without an ESG mandate) INTEGRATE material ESG risk and opportunities

Our actively managed funds globally are managed by both Vanguard and by select external investment managers who we have carefully chosen based on their expertise, experience and track record. We pride ourselves on finding, hiring, evaluating and retaining world-class external managers who can deliver value to our investors over the long term.

We know that financially material ESG risks and opportunities can impact long-term value creation in portfolio companies. Vanguard's Oversight and Manager Search team invests considerable time and resources engaging with internal Vanguard investment management teams and external investment managers to examine how those managers incorporate financially material ESG considerations, including climate change, into their security selection processes.

The Oversight and Manager Search team also considers how a manager's research efforts are structured to account for material ESG considerations, the extent to which they consider both quantitative and qualitative factors in their analysis, and their proxy voting processes.

Case study: Wellington Management: Climate science integration in active management[4]

Our largest external investment manager, Wellington Management Company LLP, manages more than $390 billion[5] for Vanguard clients globally. Wellington's approach to managing climate-related impacts is one of the key reasons we believe it demonstrates leadership in ESG integration.

By way of example, Wellington's climate research team conducted a risk-based portfolio review as of October 2021, focused on physical climate risks. One holding identified as having potential risk exposure was HCA Healthcare because of the materiality of its physical assets and the geographic distribution of those assets. Almost half of HCA's revenue comes from its hospitals in Florida and Texas, which face increasing hurricane and flooding risks. With support from the investment team, Wellington's ESG and climate analysts engaged with HCA's management team to discuss how prepared the company was for physical climate risks and its progress on emissions disclosure, both of which are financially material risks that have the potential to affect shareholder value.

Through this discussion, Wellington's ESG and climate team gained conviction in the company's environmental risk-mitigation practices and trajectory towards better disclosure of emissions and transition risk. Wellington plans to continue to review HCA's progress on disclosure of physical risk resilience and emissions reduction plans.

This rigorous analysis by Wellington enables it to identify opportunities with companies that demonstrate leadership in managing ESG risks and opportunities.

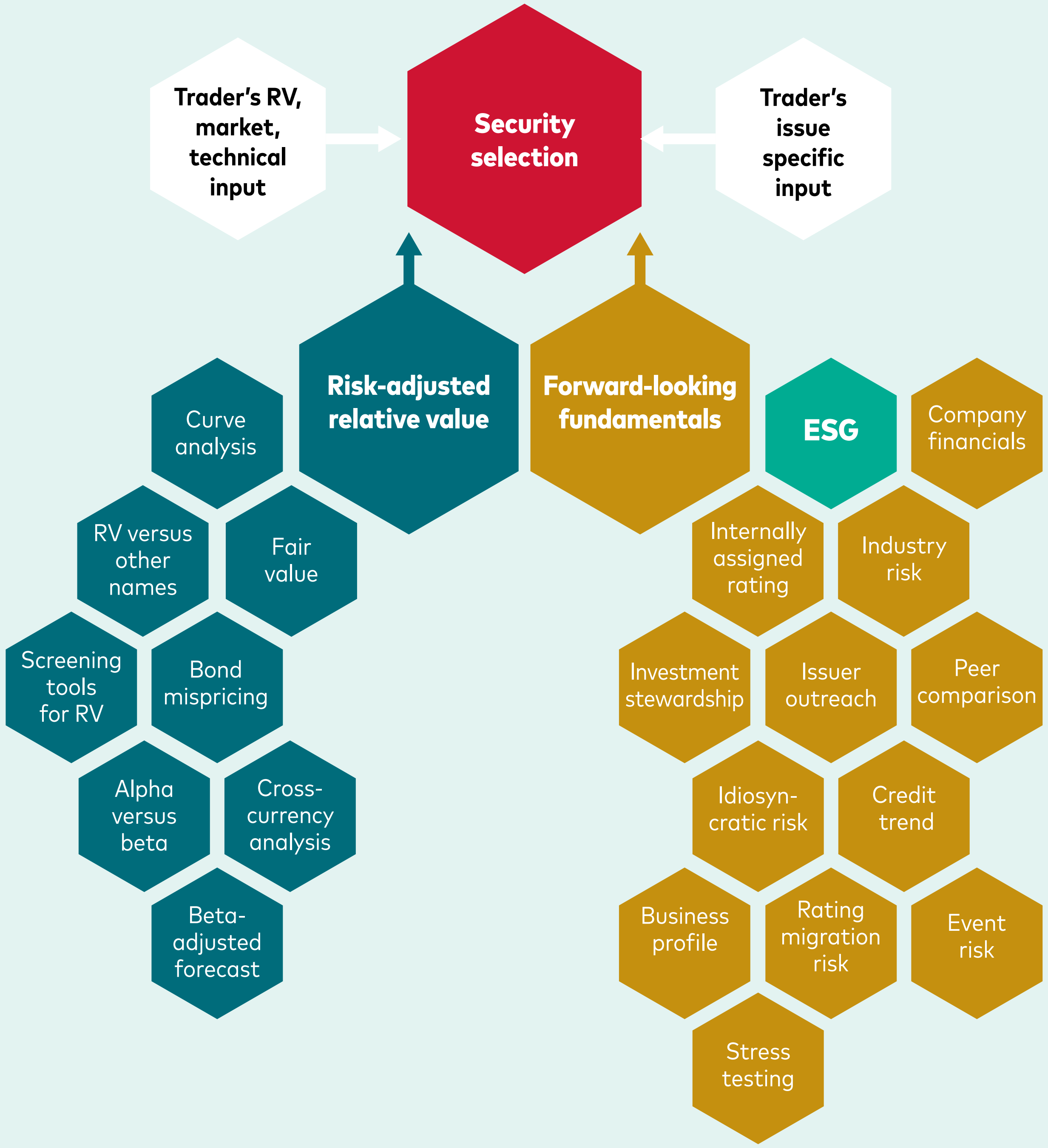
4 Source: Vanguard's Report on Climate-related Impacts 2022.
5 Source: Vanguard as at 31 December 2022.

Case study: ESG integration in our fixed income investment process

Vanguard's Fixed Income Group regularly identifies and incorporates material ESG risk factors into investment decisions, by systematically assessing the financial materiality of an ESG risk factor in the context of other investment risks, complementing standard credit assessments.

Inputs from third-party data providers, where available, are also used to help inform decisions around different types of ESG factors. Vanguard's credit research analysts regularly meet with issuers to discuss key credit risk topics and, where applicable, raise material ESG concerns.

The visual below[6] highlights how ESG is considered alongside many other factors that all contribute to Vanguard's ultimate decision on whether to invest in a given bond, and if so, at what weight in the portfolio.



6 Source: Vanguard. Note: 'RV' refers to 'relative value'.

Vanguard ENGAGES directly with companies held in our funds (with and without a specific ESG mandate) to understand how they are managing material risks

Vanguard's global Investment Stewardship team represents our investors' interests for Vanguard's internally managed equity index funds and ETFs. The Investment Stewardship team engages with companies on an ongoing basis, and when issues arise representing material risks to a company, the team seeks to address them through continued engagement, and occasionally through proxy voting.[7]

The role of our Stewardship team is to engage with companies to understand how boards disclose, address, and oversee material climate risk given the potential harm to long-term investor returns. We seek to understand when issues present material risks to a company and whether company leaders have plans in place to address and oversee those risks.

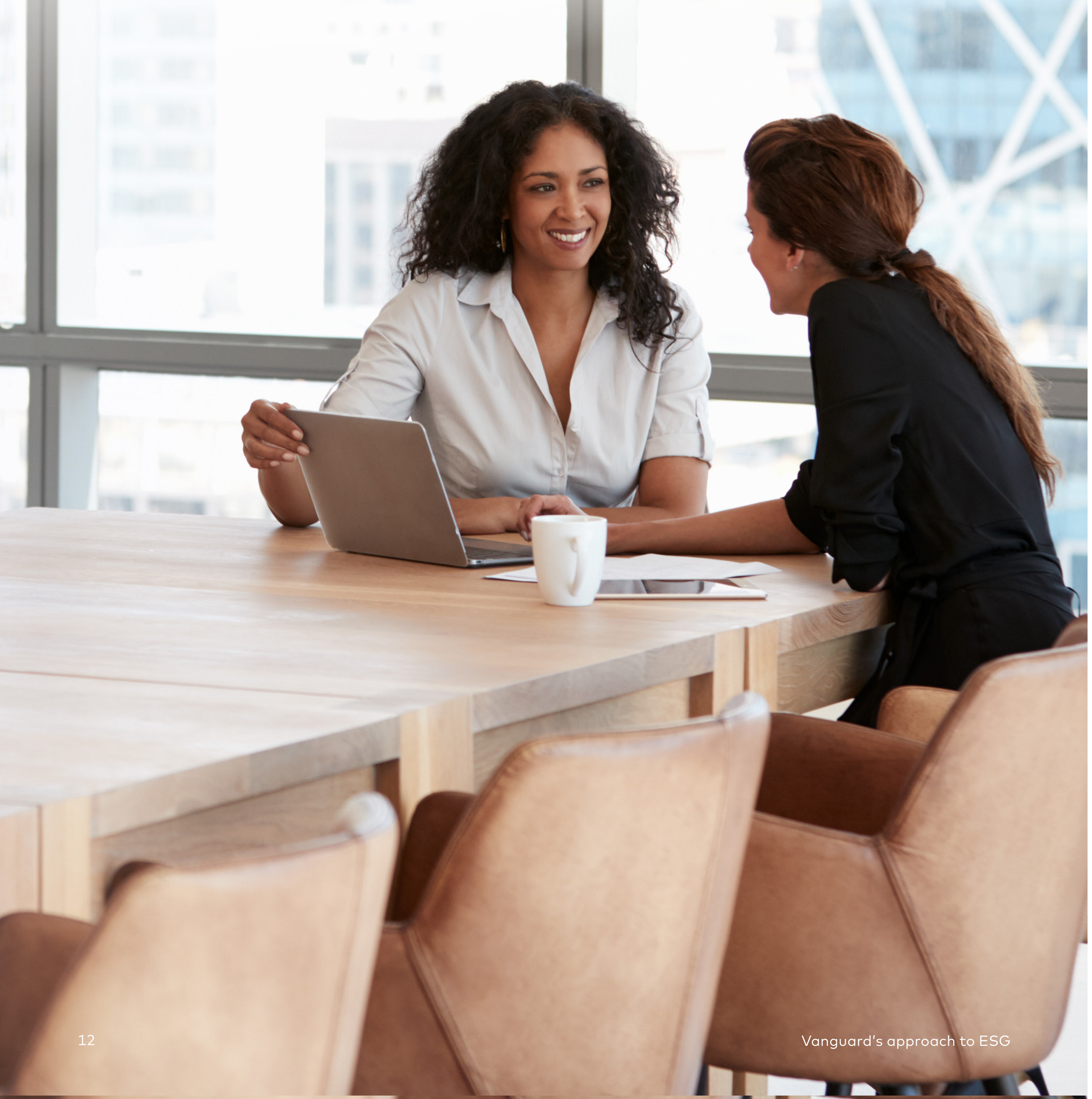
Our team also votes proxies at public company shareholder meetings on behalf of each Vanguard-advised fund. The Investment Stewardship team determines votes at each portfolio company meeting on a fund-by-fund basis and in the best long-term interest of each internally managed Vanguard fund, based on our research and analysis and consistent with our published voting guidelines. Because of our advocacy and engagement efforts, companies should be aware of our position by the time we cast our funds' votes.

Where we have hired external investment managers to manage some of our funds, we have also granted those external managers investment stewardship responsibility and so they proactively engage with companies in the fund on behalf of those funds. Our Oversight and Manager Search team oversees that process to ensure it is operating as intended and in the best interests of investors in those funds.

The vast majority of the matters on which the funds vote relates to routine corporate governance issues. Fundamentally, we believe that well-governed companies have the potential to produce greater returns for investors over the long term. When companies generate returns over the long term, our funds generate value for Vanguard investors.

7 Shareholders can vote by proxy on the issues which affect a company's financials even when they are unable to attend a shareholder meeting in person.

How to frame ESG conversations with clients



There are many ways to approach the topic of ESG in investing, and the right approach—and conversation—will likely be unique to each client.

With this in mind, we have put together a straightforward four-step process for you to help frame the ESG conversation with your clients and ultimately make a prudent investment decision. These steps aim to help you establish your client's specific preferences and goals, and ultimately evaluate and decide on an approach that aligns to those outcomes.

Importantly, these simple steps can be integrated into any investment recommendation, whether ESG or not.

1 Define goals

The first step is to understand your client's ESG-related goals. If your client has an ESG preference, which issues matter the most to them? And what are they trying to achieve by addressing these issues? They may want to satisfy a particular preference (such as reduced exposure to fossil fuels), seek to bring about a positive change (such as reduced carbon emissions) and/or generate a financial benefit (increased return or reduced risk). Helping clients develop a clear objective is an important first step.

2 Evaluate options

Once you have a clear sense of any ESG objectives your client might have, you can then start to evaluate the available investment options for your client and help them understand any inherent trade-off between achieving their ESG goals and achieving long-term investment success. For example, many ESG investments come with higher costs, and all ESG investments, by definition, come with different exposures than the broad market. It is important to consider how the costs and market exposures could affect long-term investment performance to ensure that the client understands the trade-offs and is ultimately comfortable with them.

3 Decide on action

When you have determined the ESG investment options that best suit your client, it is important to look at the impact of those options within their overall investment portfolio. Any investment decision —whether ESG or otherwise—has the potential to change the diversification, exposure, risk and return of a portfolio. Your client should understand and be comfortable with the impact of the options they have selected.

4 Reassess periodically

As with any investment, you should review and reassess your client's portfolio at regular intervals to ensure it continues to meet their needs. The ESG landscape continues to evolve, as do investors' understanding of it. New products continue to come to market. These are all good reasons to periodically review your client's ESG preferences and investment strategy.

How do ESG funds perform?

This question is likely to be top of mind for many clients. Do ESG funds perform better than those without an ESG element? Do they carry more risk?

To answer these questions, we examined the gross (before costs) performance of ESG equity funds with US, European, Asia-Pacific ex Japan, Japanese as well as Global Developed and Emerging Market investment focus.[8]

Our research has shown that the performance of many ESG funds differs, historically, from that of the broader market. What's more, while some funds delivered better returns than the market, others underperformed. So, our research has found that ESG funds not only deviate from the market but also from one another. In many cases, these deviations were due to differences in style and/or industry exposure, suggesting that investors in these funds were likely to bear varying degrees of relative risk.

So, the fact that a fund has an ESG mandate is not in and of itself an indicator of its potential risk or return, relative to the broader market.

Considering our findings, we suggest that advisers and their clients assess ESG funds on a fund-by-fund basis, working through the four-step process we have laid out, to determine what role a particular ESG fund could play in a client's overall portfolio.

8 Plagge et al. (2022). ESG Equity Index Investing: Don't Forget about Factor Exposures, *Journal of Beta Investment Strategies, 13 (4).*
Plagge (2022). Explaining ESG Equity Index Fund Performance – Is it all about Industry Allocations? *Journal of Impact and ESG Investing, 2 (3).*
Plagge and Grim (2020). Have Investors Paid a Performance Price? Examining the Behavior of ESG Equity Funds. *Journal of Portfolio Management, 46 (3).*

Key takeaways

By outlining our approach at Vanguard, we hope that this information has brought a degree of clarity to the subject of ESG. Given our singular focus on client outcomes, we consider the topic of ESG from the perspective of how it could impact the long-term investment returns for the clients we serve.

In summary:

1. **ESG refers to environmental, social and governance considerations.**

   At Vanguard, we consider ESG risks and opportunities in the context of our mission to give investors the best chance of investment success. We provide clients with a choice of ESG products that target specific environmental, social or governance outcomes.

2. **Vanguard's approach to ESG is multi-faceted.**

   We currently offer:

   - A range of high-quality **index ESG products** that seek to avoid or reduce exposure to companies involved in certain business activities.

3. **There is no one-size-fits-all approach to ESG.**

   We know that client preferences around ESG can vary, and there are different ways to incorporate those preferences into an investment strategy.

   We recommend a **simple four-step process** which begins with understanding your client's ESG preferences and goals. This will ultimately help you determine the best investment strategy for them.

4. **Our research suggests that ESG funds neither have altogether higher nor lower risk-adjusted returns than the broader market.**

   The performance of ESG funds relative to the broad market suggests that those funds should be assessed on a **case-by-case basis.** As with any form of investing, the principles of **diversification** and **low cost** are key to investment success.

Support for you

At Vanguard, we are here to offer ongoing support to you, our professional partners.

If you have questions or need further information on the topic of ESG investing, please contact your local sales team.

You'll also find a wealth of professional insights and articles at your local Vanguard website.

We look forward to engaging with you on this topic.

Investment risk information

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested. Past performance is not a reliable indicator of future results.

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