SPDR Practice Management Team

AIM HIGHER:

Helping Investors Move from Ambition to Action with ESG Investment Approaches

STATE STREET GLOBAL ADVISORS
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CAN ESG INVESTMENTS LEAD TO MORE SUSTAINABLE PERFORMANCE?

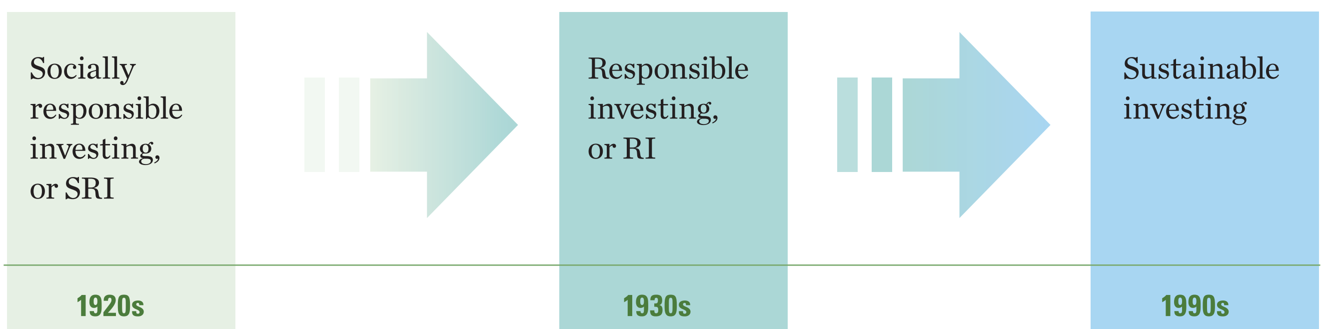
If ESG factors can improve long-term performance, how can we help clients incorporate sustainability into their investments? And if we believe that sustainability practices can add value, are the investment standards of today fit for client goals over the long term?

Traditional metrics such as sales growth, market share and valuation are not enough. There is a growing need to address sustainability factors, alongside conventional securities analysis. A more comprehensive approach to investing includes material, non-traditional issues: environmental, social and governance (ESG) factors.

WHAT'S IN A NAME?

Helping investors identify the right ESG strategy for their goals

The term "ESG" covers several related but distinct concepts, including:



Source: State Street Global Advisors, "Performing for The Future. ESG's Place in Investment Portfolios. Today and Tomorrow," 2017 ESG Survey Report.

The rapid evolution over the past 20 years has resulted in a mix of terminology across the industry. Phrases such as "impact investing" and "ESG integration" have become widespread, but what they actually mean isn't always clear.[1] Lack of clarity can create confusion and impede progress. Establishing a standard language to discuss ESG goals and strategies can help advisors communicate clearly with clients. It helps clients understand the features and benefits of ESG investing. Having a clear and straightforward framework for understanding and comparing options is the first step in guiding clients on ESG investing.

UNDERSTANDING ESG TERMINOLOGY

ESG Integration	Incorporates ESG data, alongside traditional financial analysis, into the securities selection process.
Environmental	Assess how a company performs as a steward of the natural environment, including energy consumption, water management, pollution, and other material issues.
Social	Examine how a company manages relationships with employees, suppliers, customers and the communities in which it operates.
Governance	Deal with a company's management, including executive pay, board composition, transparency and shareholder rights.
Sustainable Investing	Takes into account environmental, social, and governance factors throughout the investment process, in addition to conventional factors. Often referred to as ESG investing, and vice versa.
Impact Investing	Targets a measurable positive social and/ or environmental impact. Investments are generally project specific.
Exclusionary Screening	Excludes from the investment universe those companies, sectors or countries involved in activities that do not align with the moral values of investors or wit global standards around human rights, labor practices, the environment and anti-corruption.
Positive Screening	Tilts portfolio toward one of following: • **Best in class** companies outperforming peers in ESG measures • **ESG momentum** companies improvising ESG measures more quickly than peers • **Thematic investing** companies solving specific ESG challenges (climate change, gender diversity, etc.)
Active Ownership	Entails engaging with companies and voting company shares on a variety of ESG issues to initiate changes in behavior or in company policies and practices.

Source: State Street Global Advisors, "Understanding & Comparing ESG Terminology: A Practical Framework for Identifying the ESG Strategy that is Right for You." 2017 Select terminology, this is not a comprehensive list.

THE WORLD IS CHANGING. INVESTOR ENGAGEMENT IS SHIFTING. DATA AND ANALYTICS ARE EVOLVING.

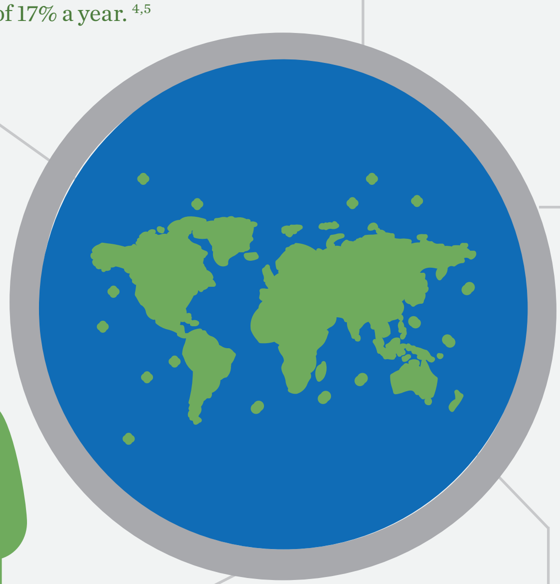
Adoption of ESG investing and asset growth has accelerated. More than a quarter of the $88 trillion assets under management globally are now invested according to environmental, social and governance principles.[2]

ESG is big — and growing.

- Global AUM in sustainable investing: Increased to 26% ($23 trillion in 2016), up from 21.5% just four years prior.[3]
- ESG assets in US ETFs/mutual funds: $216 billion in 2017 (estimated) – with ESG being integrated into portfolios at a growth rate of 17% a year.[4,5]

Two investor segments are influential ESG decision-makers.

- Female investors are nearly twice as likely as male investors to consider both rate of return and positive impact when making an investment.[12]
- 67% of Millennials place a higher value on making an impact and are investing to pursue values over the long term.[13]



This is not about tradeoffs. Performance is paramount.

- 42% of investors agree that the social and/or environmental impact is an important part of their investment decision-making process.[8]
- 69% of ESG investors say ESG has helped manage volatility.[9]

Good ESG practice is good business.

- 50% of ESG investors plan to increase the degree to which they incorporate ESG in their portfolio in the next three years, and 23% of non-ESG investors plan to add ESG.[6]
- 90% of investors who have an advisor guiding them on impact investments are extremely satisfied or satisfied.[7]

Investors want to act today for a better tomorrow.

- 49% of ESG investors and 51% of non-ESG investors want their advisor to speak to them about ESG investing.[10]
- 59% of investors believe that it is important to invest in companies that are trying to make the world better for the next generation.[11]

AIMING FOR SUSTAINABLE PERFORMANCE BY INVESTING IN SUSTAINABLE COMPANIES

Investors are looking for ways to navigate uncertainty, with investment strategies that are sustainable and offer potential for superior risk-adjusted returns.[14]

> "Some investors are focused solely on financial returns — targeting stronger long-term performance by identifying ESG risks and opportunities; others also value non-traditional benefits — targeting specific social or environmental outcomes."[15]

How individuals express their motivation varies. Finding the right solution requires a client-centric approach — to identify suitable strategies, offer useful education, and track progress toward longer-term objectives.

The business case is clear. In the pursuit of better investment outcomes, we have an opportunity to add value by helping clients aim for improved performance and better ESG outcomes. Meeting this growing need for sustainability can foster a powerful investment experience that strengthens client satisfaction in a deeply meaningful and personal way.

MOST IMPORTANT ESG ISSUES FOR INVESTORS

Environmental

Climate change
Resource management
Pollution

Social

Working conditions
Health and safety issues
Impact on local communities

Governance

Executive compensation
Lobbying efforts
Philanthropy

Source: State Street Center for Applied Research Survey of Retail Investors, December 2016.

SUSTAINABILITY IN PRACTICE: AN OPPORTUNITY TO EXPAND INVESTMENT GOALS

Successfully incorporating ESG investing hinges on how well it fits within the client's investments. The increasing number of ESG options reflects the diversity of investor objectives, including:

- Avoiding or reducing ESG risks
- Generating higher investment returns
- Seeking measureable impact.

They also reflect a range of investment and impact considerations that investors should take into account before investing.

Some of these objectives span different ESG strategies, to varying degrees. And they are not mutually exclusive — multiple ESG strategies can be combined within a single investment vehicle to achieve the investor's specific goals. These strategies can be implemented across asset classes, investment styles and investment vehicles.

INVESTMENT AND IMPACT EXAMPLES OF ESG STRATEGIES

IMPACT INVESTING	Community investment fund that provides micro financing to low-income or disadvantaged communities
EXCLUSIONARY SCREENING	Equity fund that excludes companies with more than 5% of revenue generated from the sale of tabacco products
POSITIVE SCREENING	Fixed income fund that holds municipal and corporate green bonds that invest in infrastructure projects to combate climate change
ACTIVE OWNERSHIP	Any type of fund (including those not labled ESG) where the asset manager or asset owner engaging directly with companies to influence positive change
ESG	Actively managed multi-asset fund that considers ESG factors in combination with conventional securities analysis

Source: State Street Global Advisors, "Understanding & Comparing ESG Terminology: A Practical Framework for Identifying the ESG Strategy that is Right for You." 2017

CLEARING HURDLES TO FOCUS ON THE BENEFITS

Despite high overall industry growth rates and satisfaction scores for investors with sustainable investments, ESG adoption among the financial advisor community has been slow. Three key challenges remain:

1

CONFUSION AROUND INVESTMENT PERFORMANCE PARITY:

ESG is not just a "do good" mentality.

2

NEED FOR TRANSPARENCY:

Better data for clearer outcomes.

3

CHOICE OVERLOAD:

Investors need help defining goals and choosing solutions

1

ESG IS NOT JUST A "DO GOOD" MENTALITY

There is a no-compromise approach when it comes to investors' performance expectations for ESG. These are investments, not donations, and financial performance is what keeps clients interested and invested. Sixty percent of ESG investors cite lower volatility and 54% cite lower downside risk as important reasons for incorporating ESG into their investment process. [16]

Industry and academic studies offer empirical evidence for better long-term risk-adjusted returns, lower downside and improved volatility in ESG strategies.[17] Mutual funds and separately managed accounts classified as sustainable investments often meet or exceed broad market performance, both on an absolute and a risk-adjusted basis, across asset classes and over time.[18] Broader meta-analyses by Mercer,[19] Morningstar[20] and the University of Oxford[22] have found mostly favorable or neutral-to-favorable returns on socially responsible investing.

This is backed by sensible economic intuition. From a risk perspective, traditional investments that ignore ESG factors miss capturing information beyond financial statements that indicate higher risk exposure. From a returns perspective, as these strategies continue to expand, a virtuous cycle comes into play where investor interest rewards companies with good ESG scores, motivating other companies toward good corporate citizenship.

69%

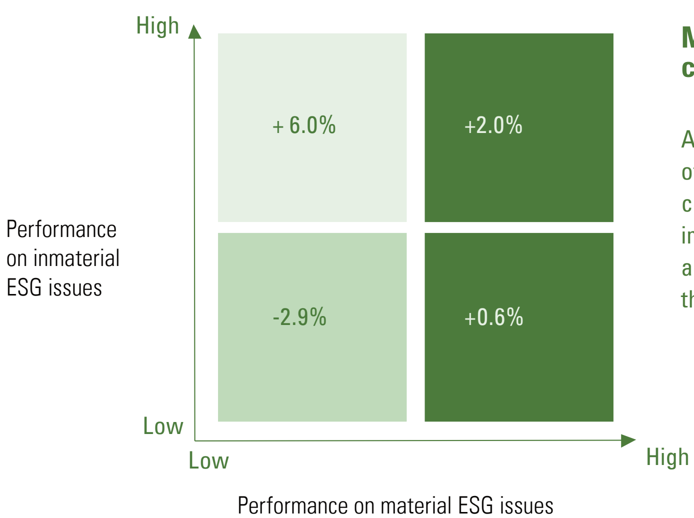
OF ESG INVESTORS SAY ESG HAS HELPED MANAGE VOLATILITY.[9]

2

BETTER DATA FOR CLEARER OUTCOMES

Better company data combined with better ESG research and analytics will lead to more advanced approaches to identifying and addressing material ESG issues. There has been significant progress in the number of companies disclosing ESG data, along with the breadth and depth of their data. But reporting methodologies still vary among companies, index providers and asset managers, creating challenges for investors seeking to compare ESG strategies. Quality and usefulness of data provided is still limited. Continued progress on standardization of reporting for companies should help.

Company-level data on ESG metrics are available from a wide range of providers such as Sustainalytics, MSCI, Bloomberg and Thompson Reuters. Due to the cost of compiling and analyzing data, most company-level ESG information doesn't end up in the hands of advisors or individual investors. Fund-level information on ESG outcomes is improving — particularly for certain sectors, markets, and investment themes.



Material issues affect corporate performance

According to a recent study using the materiality framework of the Sustainability Accounting Standards Board (SASB), companies that address material ESG issues and ignore immaterial ones outperform those that address both material and immaterial issues by 4 percent and outperform companies that address neither by nearly 9 percent.

Sources: McKinsey & Company, "Sustainability: What institutional investors should do next on ESG," June 2016; Mozaffar Khan, George Serafeim, and Aaron Yoon, Corporate sustainability: First evidence on materiality, Harvard Business School working paper, posted March 9, 2015, revised February 1, 2017, hbs.edu

The lack of consistency in reporting on material issues leaves room for some degree of subjectivity. For example, a company's rating on carbon output could be qualitative (management is committed to improving emissions), quantitative (proven reduction in carbon output by 25 percent by 2020), or binary (yes, the company has goals related to carbon emissions). Efforts to improve data are focusing generally on more quantitative data, along with better application of qualitative data.

There is also increasing awareness of how data might differ across sectors and industries, because of how material issues vary with the nature of the business. In the financial sector, for example, governance issues (board representation, ethics, lobbying efforts) may weigh more heavily than environmental or social issues. In the energy sector, environmental issues are key (climate change, waste management, air quality). And in health care, social issues often dominate (human capital, diversity and opportunity, customer welfare).

Clients increasingly want to know what they own. Just as an actively managed fund might not produce alpha consistently, an ESG fund may address fewer material issues than expected. The reverse is also true — a fund or security that doesn't carry an ESG label may actually support positive ESG outcomes. Improved reporting can help advisors be proactive with their communications and more responsive to specific client inquiries. Institutional and individual investor demand is prompting more uniformity of metrics, increased availability and transparency of data, and better methods to address fund survivorship bias (which can distort comparisons of investment options). More work is needed in creating a consistent framework for companies, index providers and asset managers. At the same time, acknowledging this limitation is not a reason to sit on the sidelines. We must not make the perfect the enemy of the good.

Nonetheless, continued challenges in obtaining clear and standardized ESG reporting makes it difficult for investors to determine how their portfolios are doing in terms of the issues they care about. In response, some institutions have embraced the idea of "materiality," derived from the concept of material information in accounting. Much as knowledge that could influence investors' decisions is deemed material, so too are ESG factors, which can have a measurable effect on an investment's financial performance (see previous exhibit). [22]

3

INVESTORS NEED HELP DEFINING GOALS AND CHOOSING SOLUTIONS

While the benefits of ESG investing may be clear, sometimes the best path for clients to take isn't as obvious. Some clients may want to dip a toe into ESG investing; others may want to commit a significant part of their portfolio. A groundswell of investor interest has triggered a large and growing set of ESG options to meet a wide range of investor needs. The investor's need for advice in navigating these options is the advisor's opportunity to add value in a meaningful way.

Whatever the aim, advisors will need to optimize ESG investment opportunities across a range of asset classes and the risk spectrum. Specific, practical portfolio considerations include:

Scope of the portfolio:
Choose exposure across the entire portfolio or by asset class — public equity, private equity, fixed income, alternatives and multi-asset; US only, developed markets, emerging markets or global.

Intended impact:
Define objectives to identify the right ESG strategy — thematic (renewable energy), targeted (environmental) or comprehensive (ESG).

Implementation considerations:
Determine investment vehicles — mutual funds, ETFs, separate accounts, model portfolio, and full integration.

The nature of this conversation is that it's focused on client goals and it highlights the advisor's value-add. It may not necessarily be a linear process, because these considerations are so interrelated. And it's not intended to be a one-and-done achievement, because client motivations will shift over time and portfolios should adapt to changes.

TALKING TO CLIENTS ABOUT ESG INVESTING

Effective integration of ESG principles into a portfolio begins with a client-focused process — not a product-focused process. Our framework below can help advisors focus the conversation on key considerations.

REVIEW ALL THE ANGLES TO IDENTIFY A CLEAR ENTRY POINT

Determine if and how integrating ESG considerations fits the long-term plan.

Educate and confirm comprehension as part of the discovery process. Clarify the motivation to inform the journey, narrow the focus and shape priorities.

Target opportunities to identify resources and ESG investment strategy selection.

What are the client's investment objectives?

What are the client's ESG priorities?

Where are the market opportunities?

KEEP RISK IN PERSPECTIVE

Select degree of portfolio integration.

Assess the broader asset allocation to keep the investment plan level properly balanced. Avoid introducing sector or style biases.

Review prioritary values and risk framework with clients to help them understand ESG investing considerations.

What are the client's desired outcome priorities? (values-based and risk-based aspects of implementation)

Is it all or part of a client's portfolio allocation?

How inclusive do they want to be in applying ESG?

TAKE THE LONG-VIEW

Understand the client's perspective and align expectations on non-financial outcomes and reporting.

Define success as part of the investment plan evaluation. Maintain the principle of high-impact investing. ESG does not require sacrificing performance.

Modify ongoing reporting to address client's priorities. Adapt portfolio as motivations shift.

What is the client's time horizon and intended impact? (identification of tactical opportunities; sleeve of a portfolio or total integration)

How is the client defining and measuring success? (strategies; optimization techniques and expense considerations)

Source: State Street Global Advisors.

KNOWLEDGE IS THE CORNERSTONE OF AN ACTION PLAN

Many resources are available to help the advisory team hone sustainable investing skills, including getting more comfortable having these conversations with clients.

The CFA Institute, The US Forum for Sustainable and Responsible Investment, Money Management Institute, and the United Nation's Principles for Responsible Investment organization offer publications and courses on ESG investing. That includes information on incorporating ESG data into security analysis, academic and industry research, and recent trends. (Some courses include continuing education credit.) The Sustainable Accounting Standards Board also offers a designation for ESG reporting and analysis.

Advisors must be able to provide clients with guidance and solutions on ESG investing. Whether that means building ESG capabilities in-house or outsourcing, effective communication is key. Clients need a solid understanding of the terminology and investment rationale to fully appreciate ESG options and benefits. For example, tangible portfolio examples that are relatable and connect back to the client's motivation bring ESG investing to life.

Investor interest in ESG strategies is strong and growing, while the hurdles to effectively managing an ESG-oriented portfolio are steadily shrinking:

- Companies are adopting more sustainable business practices.
- Data is becoming more robust and transparency is increasing.
- Resources are available to help advisors understand, communicate and implement ESG options.
- Most importantly, the track record continues to show that ESG strategies have the potential for better risk-adjusted returns than conventional strategies that ignore these factors.

The advisory community can be the agent of change with sustainable investing, by harnessing opportunities that focus on the client's financial goals and ESG priorities. Investors need guidance in defining their ESG objectives and implementing the right solutions. They need informative discussions and compelling materials to help them understand the concepts. Advisors can provide the clarity that informs the journey, narrows the focus, and shapes priorities.

[1] State Street Global Advisors, ESG Terminology: What Does It All Mean? October 19, 2017 Blog post.

[2] McKinsey and Company, "From 'why' to 'why not': Sustainable investing as the new normal," October 2017

[3] Global Sustainable Investment Alliance (GSIA), "Global Sustainable Investment Review," 2016.

[4] The Cerulli Report, U.S. Environmental, Social, and Corporate Governance Investing 2017: Addressing True Client Demand for ESG Criteria, 2017

[5] McKinsey and Company, "From 'why' to 'why not': Sustainable investing as the new normal," October 2017

[6] State Street Center for Applied Research Survey of Retail Investors, December 2016

[7] State Street Global Advisors, The Transformative Power of Philanthropy: An Exploration of How the Desire to Make an Impact is Evolving Advisor-Client Relationships, 2016.

[8] State Street Global Advisors, The Transformative Power of Philanthropy: An Exploration of How the Desire to Make an Impact is Evolving Advisor-Client Relationships, 2016.

[9] State Street Global Advisors, "Performing for the Future. ESG's Place in Investment Portfolios. Today and Tomorrow," 2017 ESG Survey Report.

[10] State Street Center for Applied Research Survey of Retail Investors, December 2016

[11] State Street Global Advisors, The Transformative Power of Philanthropy: An Exploration of How the Desire to Make an Impact is Evolving Advisor-Client Relationships, 2016.

[12] Morgan Stanley Institute for Sustainable Investing, "Sustainable Signals: The Individual Investor Perspective," 2015

[13] US Trust, "Insights on Wealth and Worth Survey, 2014; Calvert Investments Survey, 2015.

[14] University of Oxford and Arabesque Partners, "From The Stockholder to The Stakeholder. How Sustainability Can Drive Financial Outperformance," March 2015.

[15] State Street Global Advisors, "Performing for the Future. ESG's Place in Investment Portfolios. Today and Tomorrow," 2017 ESG Survey Report.

[16] State Street Center for Applied Research Survey of Retail Investors, December 2016

[17] The Boston Consulting Group, "Total Societal Impact: A New Lens for Strategy," October 25, 2017

[18] Morgan Stanley Institute for Sustainable Investing, "Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies," 2015.

[19] Mercer, "Shedding Light on Responsible Investment: Approaches, Returns and Impacts," 2009.

[20] Morningstar Manager Research, "Sustainable Investing Research Suggests No Performance Penalty," November 2016.

[21] Gordon L. Clark, Andreas Feiner, and Michael Viehs, "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance," March 2015.

[22] McKinsey & Company, "Sustainability: What institutional investors should do next on ESG," June 2016

About State Street

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we are the world's third largest asset manager with US $2.72 trillion* under our care.

*AUM reflects approximately $32.9 billion (as of June 30, 2018), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

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Our programs are grounded in proprietary research and leverage the latest thinking and trends from both industry and academia. We offer a diverse range of capabilities that address forces shaping the investment landscape; best practices to drive results and optimize your business; conversation starters to guide and engage with clients; and continuing education to hone techniques and accentuate your value.

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