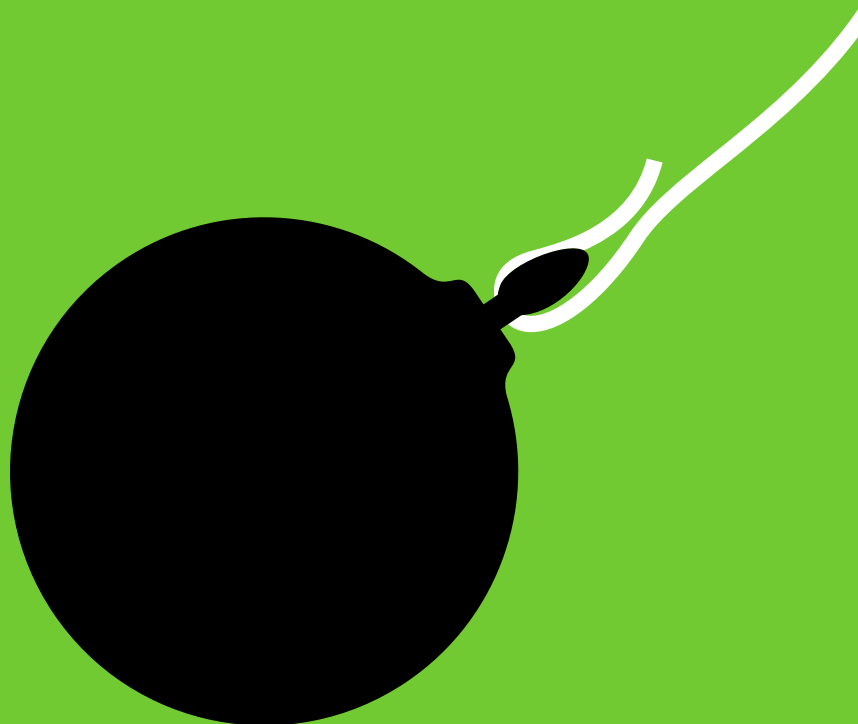




# SUSTAINABLE MYTHBUSTING

Getting the facts straight on sustainable index investing



**Capital at risk.** The value of investments and the income from them can fall as well as rise and are not guaranteed. You may not get back the amount originally invested.

# GETTING THE FACTS STRAIGHT

## Learn more about sustainable index investing

### Myth 1

Sustainable investing lacks a common definition; there are no clear standards for building a sustainable portfolio.

**Fact: There are several standard methods to invest sustainably. Indexing can help you clearly align your investment approach with your sustainable and financial goals.**

### Myth 2

Sustainable investing is too nuanced for indexing and requires active management to express investor values and preferences regarding environmental, social and governance (ESG) factors.

**Fact: Index investing enables investors to implement their sustainability preferences in an explicit and consistent way across exposures.**

### Myth 3

Index fund managers lack the stewardship tools to drive change.

**Fact: Index fund managers deploying active investment stewardship can drive long-term change.**

### Myth 4

Sustainable indexing works for equities but not for fixed income exposures, and fixed income ESG data will continue to lag behind equities.

**Fact: Sustainability preferences can be applied across a range of fixed income exposures, and the drivers of ESG demand in fixed income are similar to those for other asset classes.**

### Myth 5

Sustainability comes at a premium.

**Fact: Indexing is bringing access to sustainable investing at a fraction of the cost.**

### Myth 6

You have to sacrifice performance when using sustainable indexing.

**Fact: Early evidence on ESG index performance strongly challenges the tired misconception that sustainable investing requires giving up financial returns for better ESG outcomes.**

**Source:** BlackRock, as at 30 April 2020. This information should not be relied upon as research, investment advice, or a recommendation regarding any products, strategies, or any security in particular. This is for illustrative and informational purposes and is subject to change. It has not been approved by any regulatory authority or securities regulator.

# Indexing is reshaping sustainable investing

**For decades, investors have been choosing an index approach to actively pursue the goals that matter to them most. Today, as more and more investors are recognising that sustainability-related considerations, such as climate change, can impact long-term returns, indexing is increasingly helping them transition to portfolios that better reflect their sustainable and financial goals.**

This shift is already visible in the accelerated growth of assets under management in sustainable index strategies. Assets in indexed products (ETFs and index funds) as a proportion of the global \$1.4 trillion market for sustainable funds more than doubled to 16% in 2019 from 7% in 2015.<sup>1</sup> We believe the growth of sustainable indexing is just getting started.

Despite this strong growth, sustainable investing remains a nascent category. As a result, questions about the validity of sustainable indexing may be born out of an incomplete understanding or outdated perception of index investing more broadly.

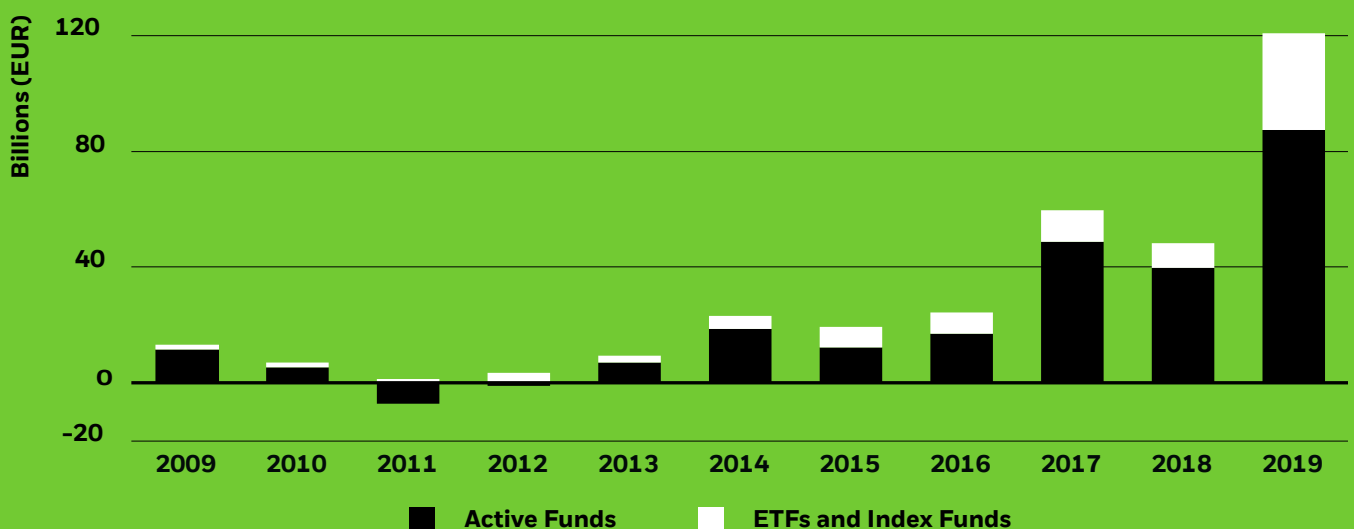
Many misconceptions stem from the notion that ‘sustainable investing is different’, which infers that indexing cannot or should not work in this investment category in the way that it does across traditional equity and fixed income strategies.

We would agree that this relatively new area of investing requires further education and is in its infancy in many regards, but would also argue that indexing is particularly valuable in the context of creating a common language for sustainable investing.

**Indexing is helping to transform a nebulous category, full of acronyms and jargon, by aggregating, standardising, and bringing transparency to sustainability data and investment methodologies.** This transparency creates cost-effective, actionable exposures that make sustainable portfolio construction and management far more efficient.

In the following pages, we debunk the common myths associated with sustainable index investing and provide the facts to help investors build more sustainable portfolios.

## Annual European sustainable fund flows, 2010-19



Source: Morningstar Direct, Manager research. Data as of December 2019. For illustrative purposes only.

<sup>1</sup> Source: BlackRock analysis of Morningstar data, as of March 2020.

# Myth 1

Sustainable investing lacks a common definition; there are no clear standards for building a sustainable portfolio.

**Fact: There are several standard methods to invest sustainably. Indexing can help you clearly align your investment approach with your sustainable and financial goals.**

Sustainable investing is the practice of understanding and incorporating ESG factors into investment analysis and decision making. Historically, the focus has been on avoiding exposure to companies or sectors that pose certain risks or violate commonly-held values, however, investors are increasingly seeking to also advance their ESG objectives, or meet defined, relatable targets, such as a carbon footprint reduction across asset classes. While there is growing consensus on the importance of sustainable investing terminology, definitions and interpretations of this area of investing continue to vary across markets and stakeholders. This lack of common language is now sharply in focus for regulators across Europe and within the broader ESG ecosystem, including ESG data and index providers, stock exchanges, public companies and

auditors. The push towards robust standard-setting, strongly encouraged by BlackRock,<sup>2</sup> will help to eliminate the perceived complexity of this field, counter the perception of “greenwashing”, and accelerate the sustainable finance transition.

BlackRock’s sustainable investing framework applies to both indexed and alpha-seeking products, and allows investors to consider how far they are willing to deviate from a traditional asset allocation model in order to achieve their sustainable investing goals. This framework aims to bring much-needed clarity and enable our clients to match their ESG objectives to clear outcomes. From eliminating certain exposures to focusing on the top-rated ESG performers, there are many different ways to incorporate sustainable investing into the core of a portfolio.

## A framework for sustainable index investing solutions

	Avoid		Advance		
Categories	Screened	ESG		Impact	
		Broad		Thematic	
Examples of sub-categories	ESG Screened	ESG Optimised	ESG Best-In-Class		Public Debt Markets
Definition	Removes exposure to companies or sectors that pose certain risks or violate international norms, or investor values, such as controversial weapons.	Targets the highest possible ESG score while maintaining a limited tracking error versus the parent index.	Multiple social and environmental screens, aligned business involvement screens + severe controversy screens. Selects the top ESG-scored companies within each sector.	Provides targeted exposure to specific E, S, G issues or Sustainable Development Goals (SDGs), based on how a company operates or the products or services it supplies.	Intent to contribute to measurable positive environmental, social or SDGs outcome, alongside financial returns.

<sup>2</sup> Source: BlackRock, January 2020. For illustrative purposes only.

The benchmark index only excludes companies engaging in certain activities inconsistent with ESG criteria if such activities exceed the thresholds determined by the index provider. Investors should therefore make a personal ethical assessment of the benchmark index’s ESG screening prior to investing in the Fund. Such ESG screening may adversely affect the value of the Fund’s investments compared to a fund without such screening.

## How BlackRock thinks about building sustainable portfolios



Source: BlackRock, 30 April 2020. For illustrative purposes only

Investors can use sustainable index products as benchmark replacements, as model building blocks, and as satellite exposures.

Adopting an indexing approach to sustainable investing offers several benefits:

**Access:** Just as investors have embraced index investing for efficient, transparent and scalable market exposures in traditional portfolios, ETFs and index funds are enabling investors to access new ways of investing sustainably. The increasing availability of ESG data means sustainable indexing strategies are becoming more refined and efficient than ever before.

**Choice:** Sustainability means different things to different people and indexing puts investors in control of their desired sustainable outcome. Investors are taking different routes to embed ESG criteria within their portfolios using index investments – from exclusionary screens to

investments with measurable impact. The broad and growing range of sustainable indexing tools available to investors brings a new level of choice and control.

**Clarity:** The transparency of sustainable indexing methodologies empowers asset allocators to build holistic sustainable portfolios with consistent building blocks. This allows investors to articulate their ESG narrative to clients, boards and other key stakeholders while supporting compliance with sustainability-related disclosure requirements and other ESG-focused legislation.

Most sustainable indices are built from the same benchmarks investors already invest in, allowing investors to align their sustainable and financial goals without altering existing asset allocation strategies.

Source: BlackRock as at 22 April 2020

## Myth 2

Sustainable investing is too nuanced for index investing and requires active management to express investor values and preferences regarding environmental, social and governance (ESG) factors.

**Fact: Index investing enables investors to implement their sustainability preferences in an explicit and consistent way across exposures.**

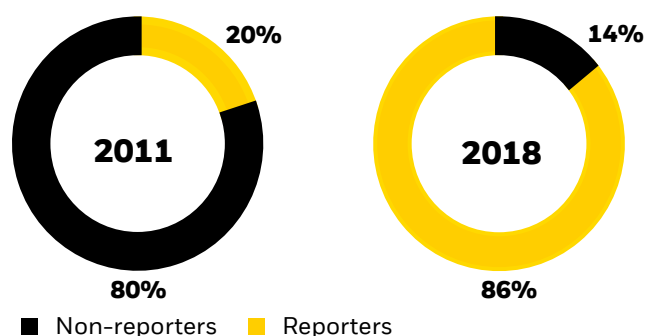
Index investing is often conflated with a perceived dormancy or lack of flexibility that does not truly reflect the wide variety of ways that investors use ETFs and index funds to take control of their investment outcomes. Index investors are active investors and this extends to sustainable investing, where they are able to use index investing tools to actively reflect their sustainability goals. The misperception about a lack of nuance does not fully take into account the following:

- Using indexing to invest sustainably harnesses the **simplicity, optionality and transparency of a rules-based ESG methodology** that delivers measurable, deliberate and predictable outcomes, such as an ESG score improvement or carbon intensity reduction. This outcome-oriented approach benefits from a plethora of choice across ESG strategies. Investors have direct insight into portfolio construction, can understand what drives the ESG methodology, and have instant access to key ESG data.
- **ESG indexing both drives and benefits from better ESG data disclosure.** ESG data underpins all sustainable index products and the awareness of companies about the importance of ESG disclosure is growing. For example, the proportion of S&P 500 companies that published a sustainability or corporate responsibility report rose to 86% in 2018, the most recent year for which data is available, from 20% in 2011. The EU Non-Financial Reporting Directive has required approximately 6,000 EU companies to publish ESG data since 2017 and will keep evolving, requiring more granular disclosures over time. This data, as well as other information coming increasingly from non-traditional

sources, is a key component in building the ESG ratings upon which sustainable indices are based. The ongoing improvement in, and increasing requirements for, ESG data disclosure will in particular:

- Further improve the quality of ESG research and ratings, thereby advancing sustainable indexing, and
- Drive companies to enhance their sustainability credentials.

### More companies are reporting ESG information



Source: Governance & Accountability Institute, 2019, based on companies within the S&P 500. For illustrative purposes only. There is no guarantee that a positive investment outcome will be achieved. To ensure you understand whether our product is suitable, please read the Key Investor Information Document.

- **Sustainable indexing is an effective way to deploy sustainable investments at scale.** While there is a clear value in active management and extensive single name due diligence regarding the impact of E, S and G criteria on performance, indexing provides an opportunity to include these criteria over thousands of companies in a more consistent way.

# Myth 3

Index fund managers lack the stewardship tools to drive change.

**Fact: Index fund managers deploying active investment stewardship can drive long-term change.**

Index fund managers take a long-term view, amplifying the impact of company engagements. Those who are sustainability-minded, like BlackRock, exercise influence with companies through engagements on ESG topics and they stay the course to see change happen. This is the value of patient capital.

Still, some question the impact that index fund managers can have given they cannot sell their holdings. **However, it is precisely because we cannot sell that we are so committed to stewardship activities.** BlackRock can demonstrate a long-term commitment to a company, potentially well beyond the tenure of the current board and management, and can be persistent in encouraging changes in practices that enhance sustainability. This includes how companies are managing, but also reporting on, the material environmental and social impacts of their operations.

There are two main stewardship levers, both of which are crucial to achieving sustainable long-term value creation:

**Engagement** – or direct dialogue – with companies is critical to ensuring that we vote in an informed way and provide timely feedback to companies to protect our clients' long-term economic interests.

**Voting** – at shareholder meetings is the formal mechanism through which we provide feedback to companies on their corporate governance and business practices.

In our engagements, we encourage companies to deliver long-term, sustainable growth and returns for our clients. As a large investor, we are able – and feel a responsibility – to monitor the companies in which we invest and to engage with them constructively and privately where we believe that would help our clients' interests. Engagement helps build mutual understanding on any issues where we are concerned that a company's practices fall short of operational excellence. It also helps us assess a company's approach to governance in the context of its specific circumstances.

Meanwhile, voting is the most broad-based form of engagement we have with companies, providing a channel for feedback to the board and management about investor perceptions of their performance and governance practices. BlackRock votes annually at more than 16,000 shareholder meetings, taking a case-by-case approach to the items put to a shareholder vote. Our analysis is informed by our internally-developed proxy voting guidelines, our pre-vote engagements, research, and the situational factors at a particular company.<sup>3</sup>

**3** Source: [BlackRock Investment Stewardship: Our Responsibility](#). As at 31st May 2020.

# Myth 4

Sustainable indexing works for equities but not for fixed income exposures, and fixed income ESG data will continue to lag behind equities.

**Fact: Sustainability preferences can be applied across a range of fixed income exposures, and the drivers of ESG demand in fixed income are similar to those for other asset classes.**

Indexing can be the starting point for a sustainable fixed income investment solution, and considerations such as sustainable impact and risk-return profile compared to non-sustainable equivalent products resonate particularly well in fixed income.

## Impact

We expect that companies with stronger commitments to sustainability will attract more capital in the decades to come. This will result in better access to financing, fuelling increased demand for bonds issued by more sustainable companies and lowering their cost of capital. This is a key element driving issuers' sustainable considerations and disclosures, and extends beyond the corporate space. Investors' commitments to sustainability and scrutiny of issuers also impact government bonds, with many investors now using climate risk metrics in particular as a measurable way to evaluate a country's sustainability profile. Increased reporting by governments on decarbonisation and other climate-related risks, driven by social and regulatory pressures, has helped to facilitate this evolution in sustainable fixed income investing.

## Performance

The main drivers of return in fixed income remain credit and duration, coupled typically with high diversification across issuers in benchmarks. This leads to sustainable fixed income indices exhibiting similar risk-return profiles to non-sustainable exposures. If, as we expect, inflows into sustainable products continue to account for a growing proportion of all fixed income indexing flows, this will have a positive impact on the capital appreciation of bonds issued by companies with high ESG ratings, but therefore a negative impact on yield expectations for these issuers.

## Data

There are more fixed income issuers than listed stocks, as many issuers are not publicly-listed companies. This poses a potential challenge in transparency and disclosure of sustainable data, but this issue has improved dramatically over the last few years. For example, today MSCI's sustainable data covers 94% of the issuers in the Bloomberg Barclays U.S. Credit Index, versus 75% in 2013.<sup>4</sup>

<sup>4</sup> Source: MSCI ESG Research, as at 31 May 2020.



# Myth 5

Sustainability comes at a premium.

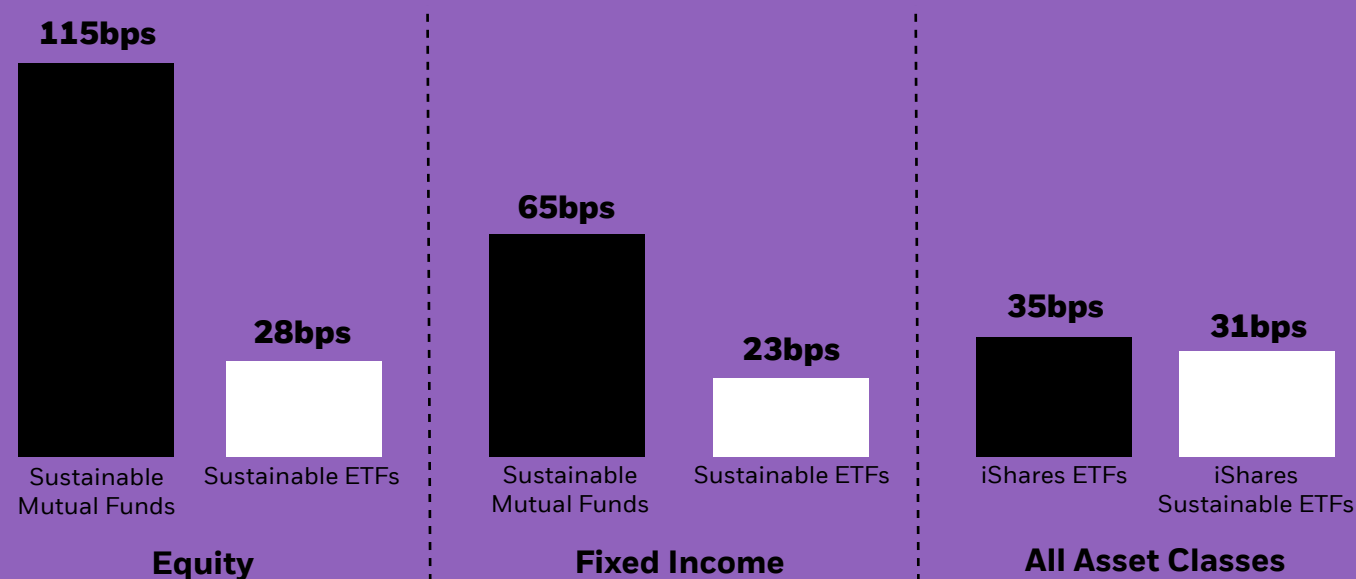
## **Fact: Indexing is bringing access to sustainable investing at a fraction of the cost.**

A few decades ago, investors had limited choice in how to access certain exposures: they could either pick securities themselves or pay a premium for actively managed mutual funds, many of which had inconsistent track records. However, the proliferation of ETFs and index funds lowered the cost of access for all investors while providing transparency and precision. We believe indexing will do for sustainable investing what it did for

traditional stock and bond investing. Until recently, sustainable investment strategies were only available through higher-fee actively managed funds, or highly customised mandates that required in-house ESG specialisation. Sustainable indices are helping drive down the total costs of investing sustainably while broadening the variety of available exposures.

### **Index funds and ETFs can help investors build sustainable portfolios at a lower cost**

Comparing average costs across the industry and within the iShares ETF product offering



For illustrative purposes only. Bps = basis points. A basis point is one hundredth of one percent. Subject to change. All chart data is global and calculated on an asset-weighted basis. Sources: BlackRock, Bloomberg (ETFs); Morningstar (mutual funds) as of 31 March 2020. Mutual fund data calculated based on oldest share class.

# Myth 6

You have to sacrifice performance when using sustainable indexing.

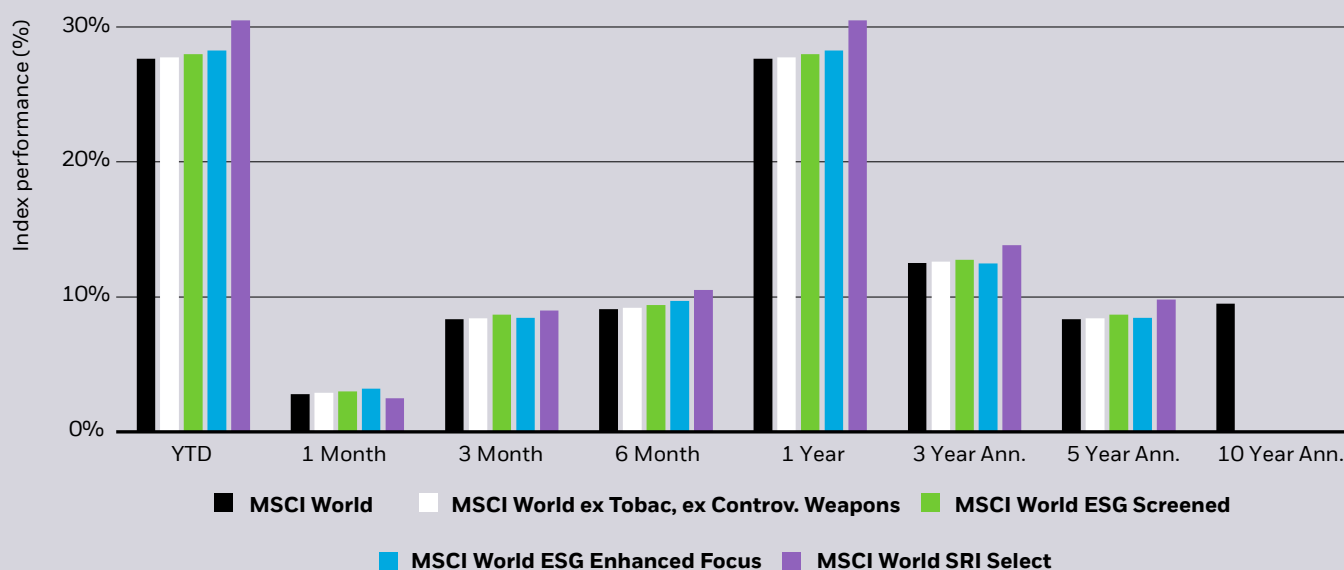
**Fact: Early evidence on ESG index performance strongly challenges the tired misconception that sustainable investing requires giving up financial returns for better ESG outcomes.**

We looked at traditional equity indices alongside ESG screened, ESG optimised and ESG best-in-class versions. Our findings are outlined in the chart below. Since 2012, annualised returns for sustainable indices have matched or exceeded the standard index in both developed and emerging markets, with comparable volatility. Research

indicates that the phenomenon can be explained through better governance, lower regulatory risks and a tilt to companies with healthier balance sheets.<sup>6</sup> The empirical data is clear and objective: **there is no evidence that investing sustainably requires a performance sacrifice** – in fact, the opposite appears to be true.

## Index performance

Comparison of sustainable exposures to the parent benchmark



## Annual performance

Index Name	(May-19 - May-20)	(May-18 - May-19)	(May-17 - May-18)	(May-16 - May-17)	(May-15 - May-16)
MSCI World Index	6.80%	-0.3%	11.6%	16.4%	-4.0%
MSCI World ex Tobac, ex Controv. Weapons Index	7.20%	-0.1%	11.9%	16.3%	-4.3%
MSCI World ESG Screened Index	8.10%	-0.3%	11.7%	16.4%	-4.1%
MSCI World ESG Enhanced Focus Index	8.60%	-0.5%	11.1%	16.1%	-3.1%
MSCI World SRI Select RFF Index	12.60%	1.0%	11.8%	14.8%	-1.7%

**Data Source: Bloomberg as of end 31 December, 2020. Data is based on daily returns.**

**The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns does not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

**6** Source BlackRock as at 31 March, 2020

# CONCLUSION

The rapid growth of sustainable investing, paired with the proliferation of definitions, data providers and regulations, has led to unfounded claims that indexing cannot work in this space and that active management is the only solution. We believe that it is the very nature of sustainable investing, with the push towards increased reporting and standardisation, that makes indexing not only valuable, but necessary to accelerate the sustainable finance transition and empower the construction of sustainable portfolios. Many of the myths surrounding sustainable indices – such as a requirement to sacrifice performance in pursuit of sustainable goals, or the lack of stewardship tools – are simply not true.

The arguments around sustainable indexing are similar in many ways to the old debate around the use of index-based solutions as a means to access

economic exposures. This debate is over 20 years old and now deemed irrelevant by most investment professionals. Similarly, we expect the unfounded reservations about sustainable index investing to soon become a thing of the past.

Myths about performance and costs can be easily challenged through the evidence presented by the growing number of sustainable index strategies, which are made accessible by ETFs and index funds at very compelling prices. Portfolio composition can be adjusted efficiently and scaled to achieve targeted sustainable outcomes. Indexing can be a driver for change when it's patient capital perspective and stewardship approach is fully appreciated. For these reasons, we believe that not only does sustainable indexing work, but that it will become an increasingly indispensable component of investors' portfolios.

## Risk Warnings

**Capital at risk.** The value of investments and the income from them can fall as well as rise and are not guaranteed. The investor may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

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