

Vanguard's approach to ESG

Investors around the world are increasingly interested in environmental, social and governance (ESG) issues as they seek to balance personal preferences and financial goals. Integration of ESG information into investment processes isn't new, but global interest in different approaches to ESG investing continues to grow.

With more than 30 million investors globally who look to us to both safeguard and grow their investments, we think about ESG risks and opportunities in the context of delivering long-term value to our investors and helping them to meet their objectives.

We believe that material ESG risks, if left unchecked, can undermine long-term value in the companies in which we invest. As a result, we integrate ESG considerations into our investment processes and our product design in a number of ways, which we will explore in this document.

What is ESG?

ESG refers to environmental, social and governance considerations.



Environmental

Environmental criteria indicate how a company performs as a steward of the natural environment.



Social

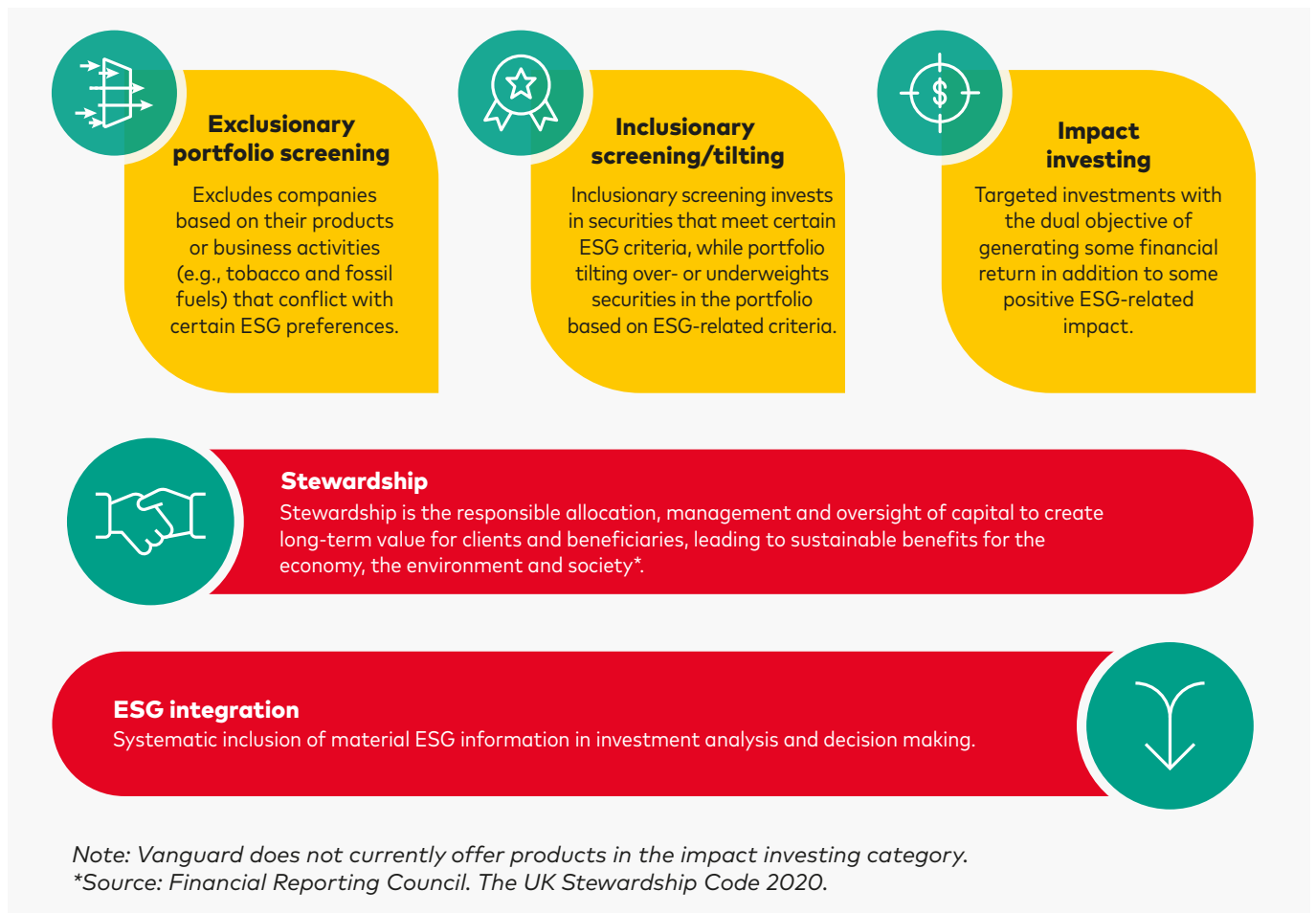
Social criteria examine how a company manages relationships with and impacts on its stakeholders (employees, suppliers, clients, and communities).



Governance

Corporate governance focuses on mechanisms and processes that determine how a company's objectives are set (focus may lie on its board and leadership structure, executive pay, financial controls and shareholder rights).

Different approaches to ESG investing



How does Vanguard approach ESG?

At Vanguard, we take a straightforward approach to ESG that enables investors to create portfolios that reflect their preferences while giving them the best chance for investment success. Our approach starts with the basic belief that environmental, social and governance factors can positively or negatively affect a company's performance over the long term.

Most Vanguard products consider ESG factors to some extent – even the ones that aren't built with specific environmental or social goals. We use **engagement** and **integration** to factor ESG into what we offer.

 **Engage:** Various teams engage directly with the companies held in Vanguard's funds to discuss how they are managing material ESG risks. This includes Vanguard's own global Investment Stewardship teams that represent our investors' interests in Vanguard's internally managed equity funds and ETFs. The Investment Stewardship teams engage with companies on an ongoing basis, and when concerns arise, the team address them through continued engagement and proxy voting¹.

 **Integrate:** Our active fund investment managers work to integrate ESG considerations into their investment process, alongside other financially material considerations. This careful analysis gives managers a more complete picture of a security's risks and opportunities.

¹ 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.

Vanguard also offers investment products that are designed and built expressly with ESG outcomes in mind. We offer investors a choice of ESG products that reflect their investment and sustainability goals through our **avoid** and **allocate** approaches.



Avoid: For investors who want to avoid or reduce exposure to companies involved in certain business activities, we offer broadly diversified, transparent exclusionary funds. These funds are built to filter out certain sectors or industries, like tobacco, fossil fuels or weapons. This has been our longest-standing approach to ESG investing and includes all our ESG exclusionary index products.



Allocate: For investors who are looking for outperformance from ESG investments, our strategy involves low-cost actively managed products that carefully allocate capital to companies with leading or improving ESG practices².

Vanguard is also a member of, or signatory to, a number of collaborative initiatives focused on governance, long-term value creation and climate. These include, but are not limited to, the following:

- Signatory to the **Principles for Responsible Investment (PRI)**, a voluntary set of principles that commit signatories to incorporating ESG issues into investment analysis and decision-making.
- Member of the **30% Club**, a global organisation that advocates for greater representation of women in boardrooms and in leadership roles.
- Supporter of the **Taskforce on Climate-Related Financial Disclosures (TCFD)**. Vanguard encourages companies to disclose climate-related risks in line with the TCFD framework.
- Signatory to the **Net Zero Asset Managers (NZAM)** initiative, a commitment by global asset managers to support the goal of net-zero greenhouse gas emissions, and to support investing aligned with net-zero emissions, by 2050 or sooner.
- Signatory to the **UK Stewardship Code 2020**.

ESG in our index funds

Equity index funds

Our investment stewardship activities are the principal levers Vanguard uses to address material ESG risks within our index funds. Because material ESG risks can undermine returns over the long run, Vanguard's Investment Stewardship team engages with the constituent companies of equity indices to promote effective corporate governance practices and encourage long-term value creation at the companies in which our funds invest.

Our dialogue with the management and boards of companies is a year-round process that goes beyond proxy voting at a company's annual meeting. We represent the interests of our fund shareholders through public advocacy and ongoing engagement and dialogue with companies to understand their governance practices and long-term strategy. Vanguard

expects companies to disclose information relating to material risks to shareholders, such as an assessment of the impact of climate-related risks; set out a strategy for mitigating those risks and any related targets or goals; and report on progress.

ADVOCATING

We advocate with groups of constituents in the market to inform and articulate our governance.

To this end, we:

- Publish content to communicate our views.
- Support and participate in industry working groups.
- Speak at industry events/ conferences.
- Comment on regulation, certain reporting frameworks and standards.

² We look to the managers of our active funds to assess companies' ESG risks on a case-by-case basis. For more on Vanguard's oversight of external advisers, see Vanguard's Report on Climate-related Impacts 2021: https://www.vanguard.co.uk/content/dam/intl/europe/documents/en/climate-change-tcf-report_en-eu.pdf.

ENGAGING

We have ongoing, direct dialogue with companies and other stakeholders about corporate governance topics.

This may include discussions with:

- Corporate board members.
- Company executives.
- Activists.
- Regulators.
- Thought leaders.

VOTING

We vote on behalf of Vanguard's internally-managed funds in support of good governance.

Our voting is based on:

- A thoughtful, considerate process that is used across the global portfolio of funds.
- Policies and guidelines informed by research.
- Knowledge and experience of senior team leaders and analysts.

Fixed income index funds

Fixed income is managed internally at Vanguard with ESG risk assessment analysed by our in-house credit research team.

Vanguard's Fixed Income Group (FIG) continues to refine its approach to evaluating ESG-related impacts. This approach features an integration process to regularly identify and incorporate ESG risk factors—from macroeconomic factors to issuer-specific considerations—into investment decisions, for both internally managed active funds and index funds. FIG systematically assesses the financial materiality of ESG risks, including climate risks, to complement standard credit assessment.

Our fixed income credit research analysts regularly meet with issuers to discuss key credit risk topics and, where applicable, raise ESG concerns. When appropriate, our fixed income team shares input with Investment Stewardship teams and holds joint engagements with portfolio companies.

This is relevant to fixed income funds because the portfolio managers aim to reflect the underlying indices through a sampling of securities. Credit risk assessments (incorporating ESG) are one element of the sampling process.

ESG index funds (exclusionary)

For investors who want to limit exposure to certain industries or business activities that pose heightened ESG-related risks, or conflict with their values, we offer products that avoid or reduce exposure to specific industries. Vanguard currently offers several exclusionary ESG products across equity and fixed income. These use transparent exclusion measures to remove certain companies from the investment universe based upon pre-determined ESG screening criteria.

Equity ESG exclusions

Vanguard's ESG equity index funds help investors to limit exposure to controversial business activities and/or conduct, as outlined below. The index series provides a comprehensive set of rules-based product and conduct screens. The standards for exclusions are determined based on certain criteria and applied across the entire index series consistently.

ESG exclusions across equity:

- Non-renewable energy (fossil fuels, nuclear power).
- Vice products (adult entertainment, alcohol, gambling, tobacco, cannabis).
- Weapons (controversial weapons, conventional military weapons, civilian firearms).
- Controversies³.

Source: FTSE Russell.

Fixed income ESG exclusions

For Vanguard's ESG fixed income index products, launched since 2020, we use a global corporate float-adjusted liquid bond screened index, which identifies the securities for exclusion from the benchmark at an issuer level.

Vanguard's fixed income products allow ESG-conscious investors to build low-cost, diversified bond portfolios by combining ESG and conventional exposures.

3 United Nations Global Compact controversies.

ESG exclusions across fixed income:

- Non-renewable energy (fossil fuels, nuclear power).
- Vice products (adult entertainment, alcohol, gambling, tobacco).
- Weapons (controversial weapons, conventional military weapons, civilian firearms).
- Controversies.

Source: Bloomberg, MSCI.

ESG in our active funds

Vanguard assesses ESG risks and opportunities in the context of their potential to affect long-term value for shareholders in our funds. We look to the managers of our active funds to assess companies' ESG risks on a case-by-case basis. Incorporating ESG risk into security selection for active funds without an explicit ESG mandate does not preclude the fund from investing in certain companies or sectors because of their business activities. Rather, it ensures ESG risks and opportunities are considered alongside other factors when selecting investments. Our approach differs for internally managed active funds and those managed externally.

Active fixed income (in house)

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Our fixed income credit research analysts regularly meet with issuers to discuss key credit risk topics and, where applicable, raise ESG concerns. When appropriate, our fixed income team shares input with Investment Stewardship teams and holds joint engagements with portfolio companies. For active funds, portfolio managers use Vanguard's internal rating and investment recommendations (into which ESG is integrated), combined with other market factors, as they allocate investor capital to the investments with the best risk-adjusted investment prospects.

Active equity

The majority of Vanguard's active equity funds and some multi-asset funds are managed by external firms. In fact, more than 25 different asset management firms serve as investment managers and investment stewards for Vanguard's actively managed funds. Vanguard recognises that each firm brings a different perspective to the way it assesses and oversees ESG risk, even in funds that do not pursue explicit ESG objectives.

We work closely with each of our active managers to understand their process, and we encourage continued refinement as data availability improves and the ESG landscape continues to evolve. Ultimately, we are responsible for assessing how each manager's approach aligns with its investment process, which is designed to deliver strong investment outcomes for our clients. Our approach to fund manager selection centres on what we believe to be the key drivers of investment success—firm, people, philosophy and process—and the resulting broader access to top talent. It also provides us with a unique perspective on the ways in which different active managers approach the investment process.

Vanguard Portfolio Review Department's global Oversight and Manager Search team of more than 20 investment professionals regularly engages with current and prospective external fund managers. As part of these engagements, the team examines how managers incorporate financially material ESG considerations, such as climate change, and diversity, into their security selection processes. The team considers how managers gather information, how their research efforts are structured to account for ESG considerations, the extent to which they consider both quantitative and qualitative factors in their analysis and how they vote proxies.

ESG-specific active funds

Vanguard also offers active funds that allocate capital to companies based on specific sustainability criteria. These portfolios are designed for investors who want to generate long-term growth from their investments, alongside an emphasis on certain ESG considerations. The funds aim to deliver sustainable, long-term growth for investors who have a preference for active management and hope to achieve certain ESG outcomes.

Vanguard offers a suite of multi-asset funds with a targeted allocation to equity and fixed income securities. Or for investors who want pure global equity exposure, Vanguard also has a sustainable equity fund.

Conclusion

We believe that, if left unchecked, ESG risks can undermine a company's long-term value. That said, ESG investing is not a single strategy and the landscape continues to develop rapidly. Our research shows that historically, no single approach to ESG investing has produced statistically significant positive or negative alpha².

The most important consideration in selecting an approach is therefore unique to each investor. And the tenets of diversification and low cost should not be sacrificed in building a portfolio. Vanguard will continue to evaluate ESG products while maintaining our considered approach to product development.

² Research originally published in the Journal of Portfolio Management: Plagge, J.-C. and D. M. Grim. 2020. 'Have Investors Paid a Performance Price? Examining the Behavior of ESG Equity Funds.' JPM Vol 46 Issue 3 Ethical Investing: 123–140.

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.

Important information

This document is directed at professional investors and should not be distributed to, or relied upon by retail investors.

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