WHAT REALLY MAKES UP A "SUSTAINABLE" ETF?

Throughout 2022, the financial media wrote several pieces about the underperformance of publicly traded ESG-focused companies and the ETFs that allocate capital to these securities. After the highs of 2020 and 2021, there has been an appetite for a negative story regarding the impact investment theme. Articles such as this one in Bloomberg, for example, highlight that “the performance of the 10 largest funds compares with the average 12% decline of ESG-labeled stock funds with more than $500 million of assets.” Or this piece: “The 10 largest ESG funds by assets have all posted double-digit losses, with eight of them falling even more than the S&P 500’s 14.8% decline. The laggards include BlackRock Inc.’s *iShares ESG Aware* MSCI USA exchange-traded fund (ESGU) and Vanguard Group’s *ESG US Stock ETF* (ESGV).”

But the negative views towards major ESG-branded indexes may be based on a fundamental misunderstanding of the ETFs’ construction, investment methodologies, capabilities, and shortcomings. Using these ETFs as a proxy for climate-focused investing could be a flawed premise. The largest ESG-branded ETFs have seen major inflows in the COVID era. To maintain the liquidity and returns promised to investors, the funds have a profile that many experts may not consider climate focused.

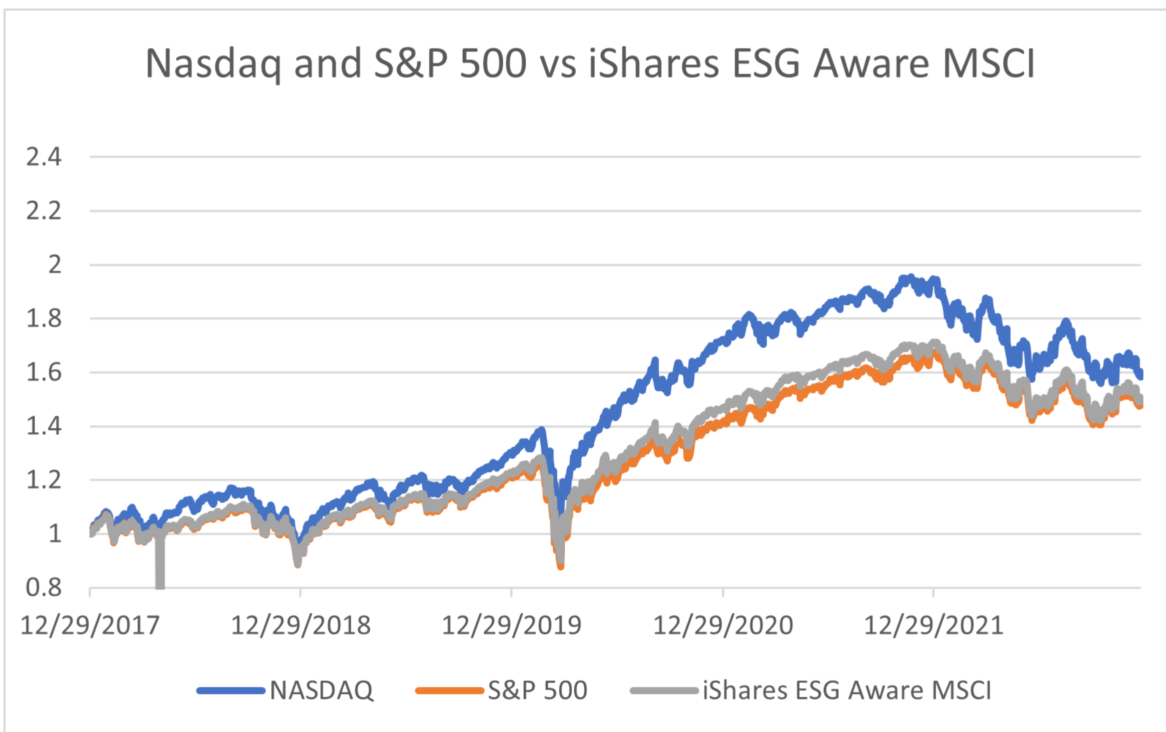
For example, the top holdings of iShares ESG Aware – the largest ESG-branded ETF– are Apple, Microsoft, Amazon, and Google, which make up around 16% of the index. The second largest ETF, Vanguard ESG US Stock ETF, has the exact same top holdings, which constitute 17% of the index. This creates a disconnect between the average investor’s views on the environmental impact of their investment and an ETF’s actual underlying holdings. Since the largest ESG-branded ETFs share many top holdings with the other major indexes – including the S&P 500 and the NASDAQ – the correlation of returns is extremely high. The chart below shows the correlation of monthly returns between the Nasdaq, S&P, iShares ESG Aware, Vanguard ESG, and iShares Global Clean Energy.

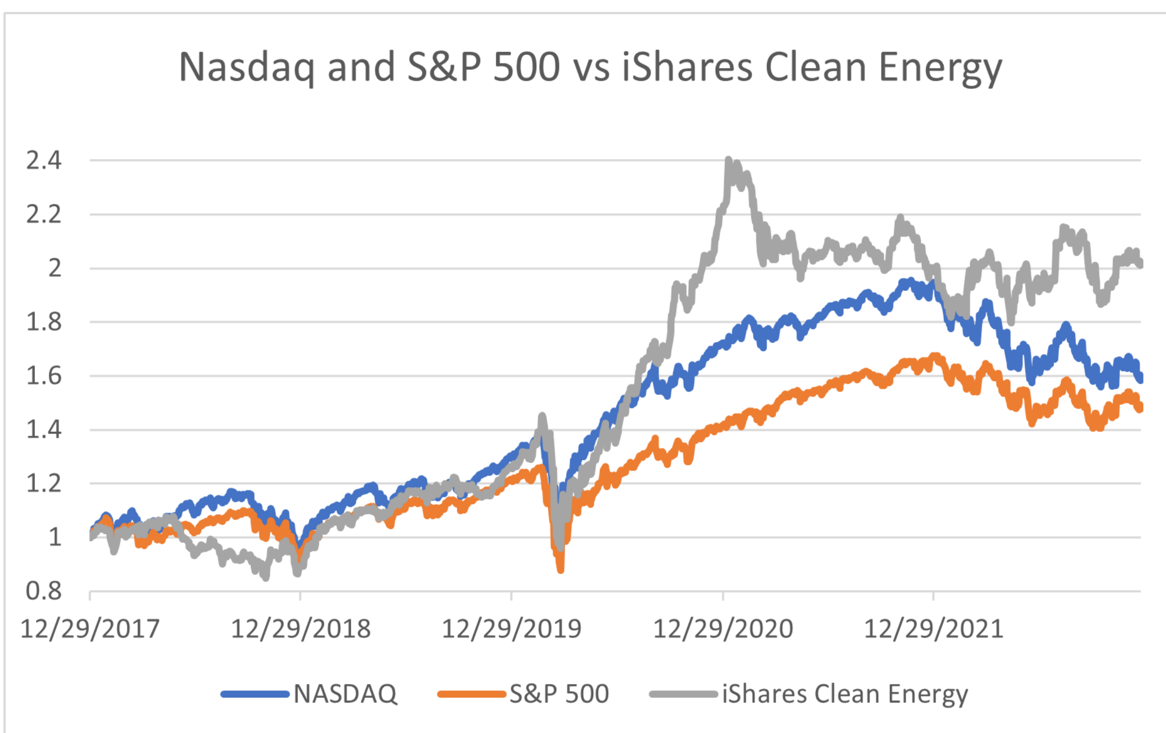
Monthly Return Correlation (5 yr)

	Nasdaq	*S&P 500*	*iShares ESG Aware*	*Vanguard ESG*	*iShares Global Clean Energy*
Nasdaq	1.00				
S&P 500	0.95	1.00			
iShares ESG Aware	0.96	1.00	1.00		
Vanguard ESG	0.97	0.99	0.99	1.00	
iShares Global Clean Energy	0.70	0.64	0.66	0.69	1.00

Source: RockCreek, Bloomberg

This raises the question: how can investors find a more efficient way to invest in companies focused on more sustainable impact while generating differentiated returns with ESG-branded funds tracking major indexes so closely? The one outlier is the iShares Global Clean Energy ETF (ICLN). ICLN focuses on investing in technology, energy, utilities, and industrials and tracks the investment results of an index composed of global equities in the clean energy sector. For example, the largest holding in the ICLN is Enphase Energy, a company that focuses on commercial solar and storage solutions – which most experts would consider an impact investment. Also, as the correlations matrix shows, ICLN offers a return profile that makes it stand apart from other funds and has outperformed both the largest ETF's in this space and the market at large in the last 2 years.





Source: RockCreek, Bloomberg

On a scale of 1-10, with 10 being the best, Bloomberg attempts to use company data to assign a score for the environment, social, and governance of a certain company. Interestingly, the scores for the ESG-labeled ETFs have no significant difference from the other major indexes.

	Environmental	Social	Governance
NASDAQ	3.95	2.84	6.82
S&P 500	3.70	3.65	7.23
iShares Aware ESG	3.96	3.62	7.24
Vanguard ESG	2.27	2.78	6.83
iShares Clean Energy	3.36	3.02	5.62

Source: RockCreek, Bloomberg

Several of these companies score very highly in governance metrics but continue to lack in social and environmental measures. The chart also shows how difficult it is to aggregate scoring data on Impact investing. The top holdings of the iShares Clean Energy Index vs the other major ESG-labeled ETFs is an example of this difficulty. Apple has an Environmental score of 5.65, whereas the iShares Clean Energy top holding, Enphase Energy, has a score of 3.17. Given Enphase's focus on manufacturing critical clean energy infrastructure (solar panels), it is unclear why it's environmental score is significantly lower than Apple.

These factors combine to show the difficulties of investing for impact through large ETFs. The fiduciary responsibility of the Funds, combined with the difficulty in getting accurate scoring, creates an incentive structure that rewards ETFs for investing in companies that have the resources to complete questionnaires and provide details about their sustainability, climate impact, diversity, or governance structure. The Funds also convince investors that they are getting exposure to the impact investment theme, but are instead allocating capital to mega-cap technology companies that are in essence a proxy for the NASDAQ and S&P.

Increasingly, investors are finding those opportunities by working with those who have deep expertise in that realm – especially in active vs. passive equities. It is important to look for the investments that add long term value and have the wind of new economic incentives behind them in order to drive returns.