

## Exchange Traded Funds

## Buying like you mean it: initiating on ETFs for ESG with a favorable outlook

Initial Opinion

## Performance with a purpose

ETF investing on the basis of Environmental, Social, and Governance (ESG) criteria is having its best year ever, with \$66bn of inflows (Chart 1). Two of every three dollars invested in ESG ETFs were allocated just this year.

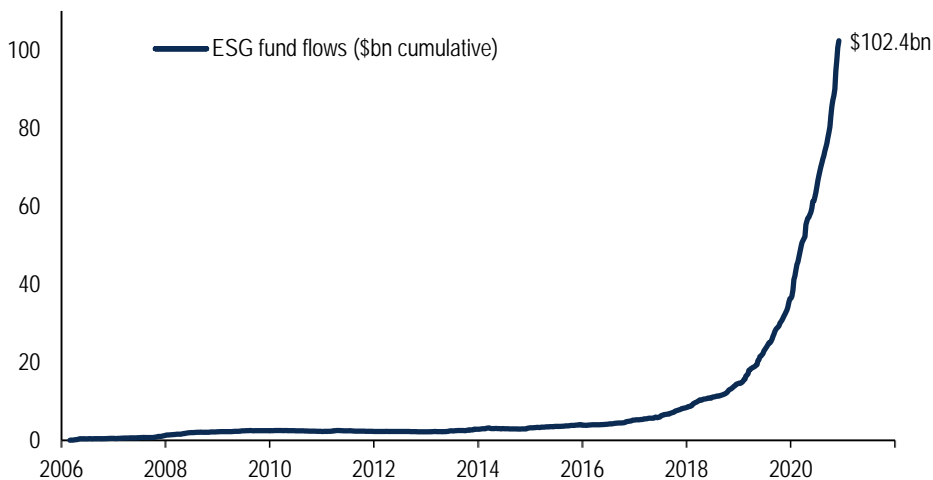
Investors say they buy ESG funds for two reasons: 1. to better align their portfolios with their values, especially around human rights, pollution, and honest corporate governance; 2. because they think better-run companies will be more profitable in the long run.

## ETFs for ESG

We initiate coverage of 8 ESG-related ETFs with ratings based on our criteria for efficiency, risk-adjusted returns, and fundamental composition. Our top-rated funds are the iShares ESG Aware MSCI EM ETF (ESGE, 1-FV; Table 2) and the iShares ESG Aware MSCI USA ETF (ESGU; 1-FV). In recent years, ESG funds have outperformed their traditional peers: ESGE by 325bps, ESGU by 575bps, and ESDG by 220bps.

We have a favorable outlook on the category. ESG ETFs benefit from persistent inflows, growing numbers of institutional mandates, and rising popularity among Millennial and Gen-Z investors, all of which should boost liquidity and efficiency over the medium term. On fundamentals, our [colleagues](#) find that ESG criteria serve as a quality filter, screening out companies with risky attributes like poor governance and volatile earnings. ESG provides investors the unique combination of performance with a purpose.

Chart 1: ESG inflows turned parabolic in 2020



Source: BofA Global Research, EPFR Global

04 December 2020

Exchange-Traded Funds  
United States  
Other Financials

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Table 1: ESG ETFs

Ticker	Price	Rating
ESGE	40.98	1-FV
ESGU	84.50	1-FV
ESGD	72.36	2-FV
SUSA	161.73	2-FV
USSG	33.27	2-FV
ESGV	68.43	2-FV
JUST	53.22	3-FV
VSGX	58.30	3-FV

Source: BofA Global Research, Bloomberg intraday prices as of 12/2/20

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# Why buy ESG?

ETF investing on the basis of Environmental, Social, and Governance (ESG) criteria is having its best year ever, with \$66bn of inflows (Chart 1). Two of every three dollars invested in ESG ETFs were allocated just this year. Investors tell us that they buy ESG funds for two reasons: to match their own values, and as a proxy for quality.

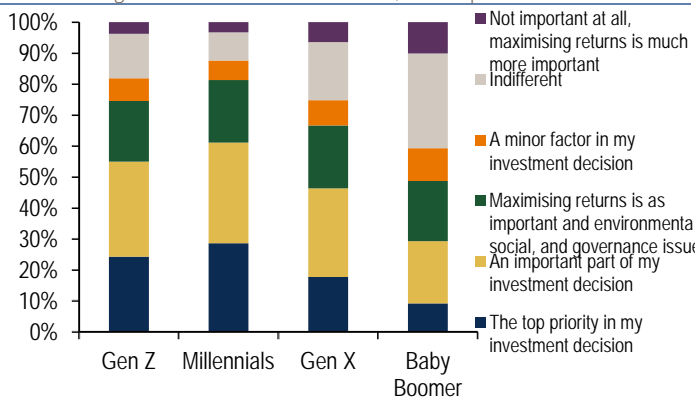
## Values

The growing popularity of these funds is driven in part by investor desires to better align their portfolios with their values, especially around human rights, environmental responsibility, and honest & transparent corporate governance.

ESG criteria are rapidly being incorporated into the decision-making of both individuals and institutions. Younger investors are particularly focused on this theme with 75% of Millennial and Gen Z investors flagging these issues as an important part of their process (Chart 2); likewise over the last several years, the use of ESG criteria in institutional investment frameworks has grown 2X (Chart 3).

**Chart 2: 75% of Millennials & Gen Z think ESG is important**

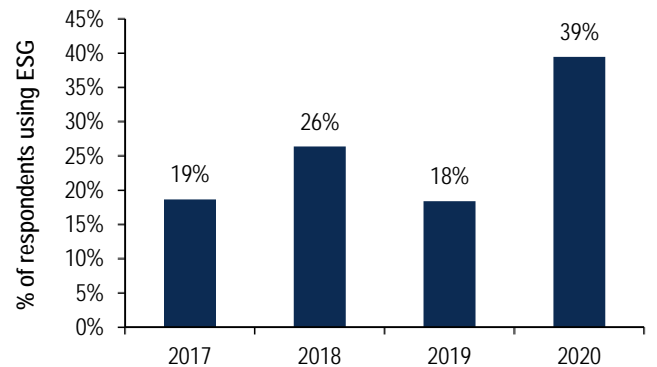
When making investment/financial decisions, how important are ESG issues?



Source: BofA US Equity & Quant Strategy, SimFund

**Chart 3: Our Institutional Factor Survey finds growing ESG popularity**

% of respondents using ESG in their investment process



Source: BofA US Equity & Quant Strategy

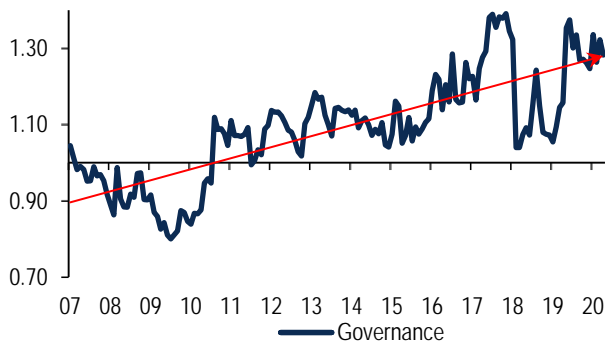
## Quality

The other key rationale for ESG investing is that environmental, social, and governance criteria serve as a filter for quality by excluding poorly-run, unprofitable, and risky firms.

Markets have rewarded good governance and social responsibility. Our [US Equity Strategy team](#) finds that companies with better governance achieve higher forward price/earnings multiples than their peers (Chart 4), as do firms with higher social responsibility scores (Chart 5). High-ranking ESG stocks also have less volatile earnings.

**Chart 4: Markets reward good governance**

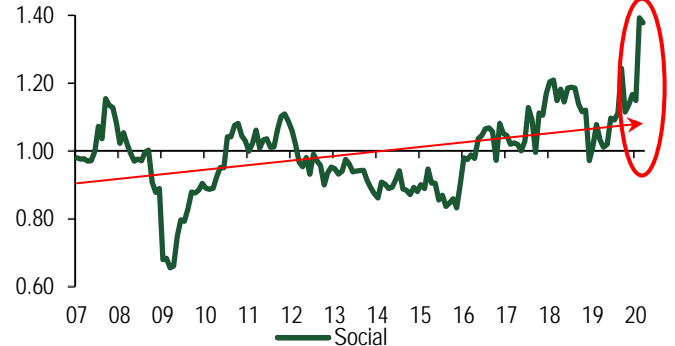
Relative forward P/E of top vs bottom quintile companies based on MSCI ESG score



Source: MSCI, FactSet, BofA US Equity & Quant Strategy

**Chart 5: Markets reward social responsibility**

Relative forward P/E of top vs bottom quintile companies based on MSCI ESG score



Source: MSCI, FactSet, BofA US Equity & Quant Strategy

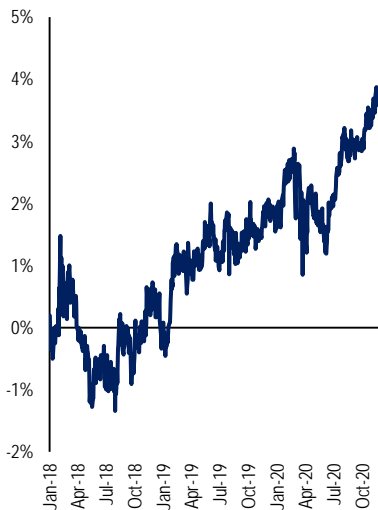


## ETFs for ESG

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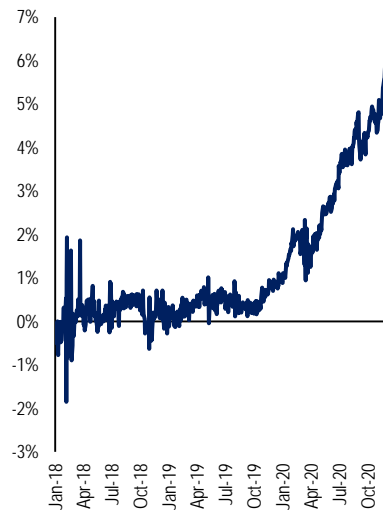
We have a Favorable view on the category. As noted above, ESG ETFs benefit from persistent inflows, growing numbers of institutional mandates, and rising popularity among Millennial and Gen-Z investors, all of which should boost liquidity and efficiency over time. On fundamentals, the “quality filter” function serves to boost performance and in recent years, ESG funds have outperformed their traditional peers: ESGE by 325bps, ESGU by 575bps, ESGD by 220bps (Charts 6-8).

**Chart 6: ESGE vs. EEM**



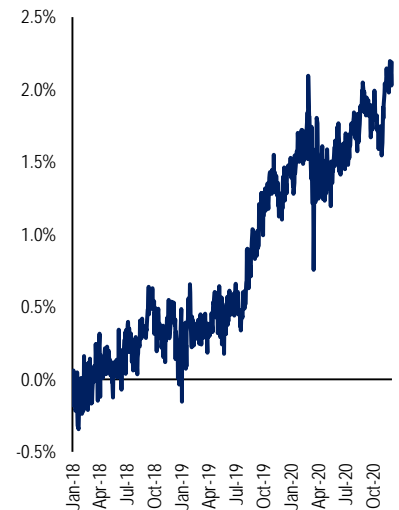
Source: BofA Global Research, Bloomberg

**Chart 7: ESGU vs. SPY**



Source: BofA Global Research, Bloomberg

**Chart 8: ESGD vs. EFA**



Source: BofA Global Research, Bloomberg

## Model Explanation

In addition to Technical and Efficiency characteristics of the ESG ETFs, we also consider Fundamental characteristics, accounting for portfolio exposure differentials based on BofA analyst equity ratings and the views of our strategists.

- **Efficiency:** The Efficiency characteristics that we look for in all ETFs under coverage include low cost, good tracking and deep liquidity.
- **Technical:** In terms of Technical characteristics that we think are important considerations for investors, price momentum and efficiency of historical performance rank among the highest. We tend to prefer ETFs with strong relative price momentum and high Sortino ratios which measures historical performance per unit of historical downside risk.
- **Fundamental:** We consider ETF exposure differentials to be an integral part of our ETF evaluation process. For the ESG ETFs we consider three fundamental factors. Two of these fundamental components are used to level the playing field and provide a fresh view on just how much each ETF is actually levered to ESG. These include the total exposure to stocks identified by BofA Thematic Research as having high exposure to ESG and the total exposure to countries with High ESG Sovereign ranks vs. Low ESG Sovereign ranks. The third is used to gauge the attractiveness of the portfolio relative to peers. For this factor we consider each ETFs total exposure to stocks rated Buy, Neutral and Underperform by BofA Analysts.

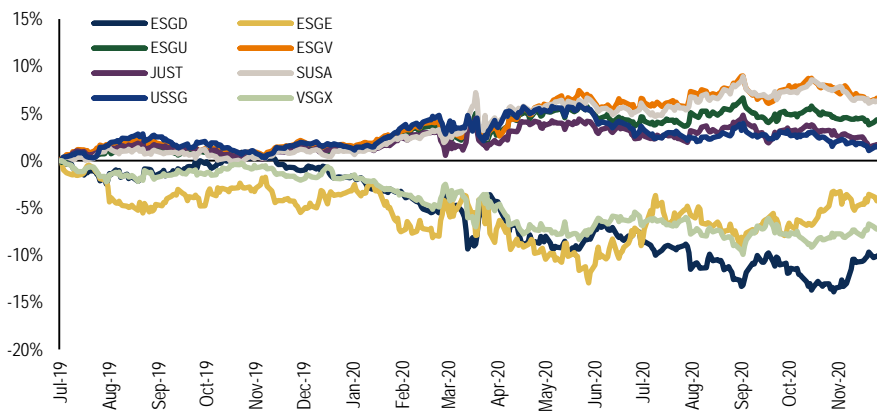


## Taming the Wild West

While ESG investing is growing fast, the standards by which investors measure ESG are hardly well established. Compared to sector classifications to which GICS has been the standard benchmark of for classifying stocks for decades, determining whether or not a stock should be considered within a universe of ESG stocks remains somewhat controversial and certainly not accepted across all investors. This becomes clear by simply examining performance return differentials.

In the last 12 months, the best performing US focused broad ESG ETF (iShares MSCI USA ESG Select Social Index Fund - SUSA) has gained over 24% compared to the worst performing (Xtrackers MSCI USA ESG Leaders Equity ETF - USSG) which has gained only 18%. The 600bp performance differential here indicates the breadth of differences between the two portfolios. And this says nothing to the potential for there to be broader differences related to geographic exposure differences between portfolios that can also be a big factor in relative performance.

**Chart 9: ESG ETFs performance relative to peer average since July 2019**



Source: BofA Global Research, Bloomberg

## The BofA view

For these reasons we leverage the views from BofA Thematic Research on which stocks offer High exposure to ESG, including their themes of Hydrogen, Climate Change, Future Food, Future Mobility, Waste and Water.

We also consider which countries appear to be more levered to ESG as a way to first determine which funds are actually delivering on their claim to provide broad exposure to ESG stocks. The [sovereign ESG rankings scorecard](#) for 34 countries spanning emerging and developed economies indicates BofA Global Research's assessment of a country's exposure to and management of ESG-related risks. It aims to assist investors in their analysis of sovereigns. The Environmental, Social and Governance pillars are classified into six core indicators with 25 attributes: (1) Climate change; (2) Biodiversity and Land; (3) Innovation; (4) Health; (5) People; and (6) Governance.



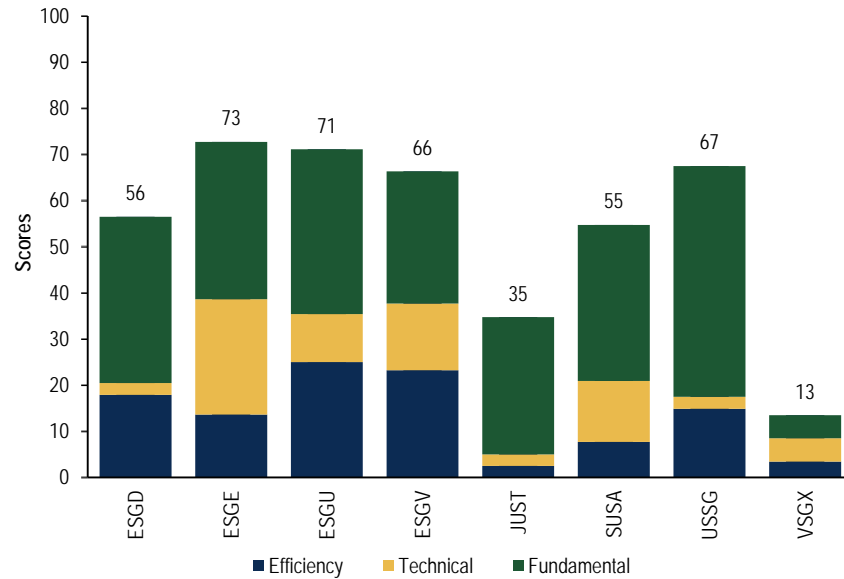


**Table 2: ESG ETFs – Ratings/Scores/Factors**

Ticker	Name	Rating	Total Score	Efficiency				Technical		Fundamental						
				Expense ratio	NAV tracking difference	Bid/Ask spreads	Daily value traded (\$mn)	Price momentum	Sortino ratio	Stock exposure			BofA ESG Primer Pick exposures	BofA Sovereign ESG rank exposures		
										%Buy	%Underperform	Ratio		Total High	Total Low	High minus Low
ESGE	iShares ESG Aware MSCI EM ETF	1-FV	73	0.25%	0.31%	0.04%	49.3	12.5%	0.78	69%	7%	74%	8%	0%	51%	-51%
ESGU	iShares ESG Aware MSCI USA ETF	1-FV	71	0.15%	0.20%	0.05%	69.7	9.7%	0.76	55%	8%	57%	8%	2%	0%	2%
USSG	Xtrackers MSCI USA ESG Leaders Equity ETF	2-FV	67	0.10%	0.10%	0.22%	1.2	8.7%	0.67	54%	8%	57%	12%	2%	0%	2%
ESGV	Vanguard ESG US Stock ETF	2-FV	66	0.12%	0.10%	0.06%	21.8	9.7%	0.86	53%	6%	59%	7%	1%	0%	1%
ESGD	iShares ESG Aware MSCI EAFE ETF	2-FV	56	0.20%	0.05%	0.09%	15.9	11.0%	0.38	56%	10%	57%	7%	80%	0%	79%
SUSA	iShares MSCI USA ESG Select Social Index Fund	2-FV	55	0.25%	0.31%	0.05%	9.8	9.6%	0.84	41%	13%	35%	8%	1%	0%	1%
JUST	Goldman Sachs JUST US Large Cap Equity ETF	3-FV	35	0.20%	0.33%	0.20%	0.6	8.7%	0.67	59%	6%	63%	4%	1%	0%	1%
VSGX	Vanguard ESG International Stock ETF	3-FV	13	0.17%	0.34%	0.24%	10.5	10.4%	0.52	52%	9%	59%	5%	50%	16%	34%
Average		-	55	0.18%	0.22%	0.12%	22.4	10.0%	0.68	55%	8%	58%	8%	17%	8%	9%

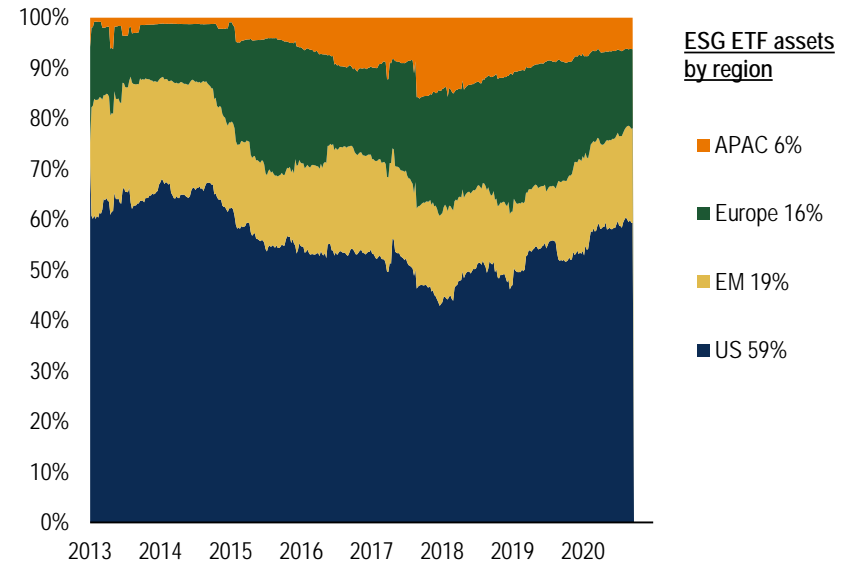
Source: BofA Global Research, Factset  
Data as of 11/30/2020

**Chart 10: ESG ETFs – Scores/Factors**



Source: BofA Global Research, Factset  
Data as of 11/30/2020

**Chart 11: US is the dominant region for ESG investing**

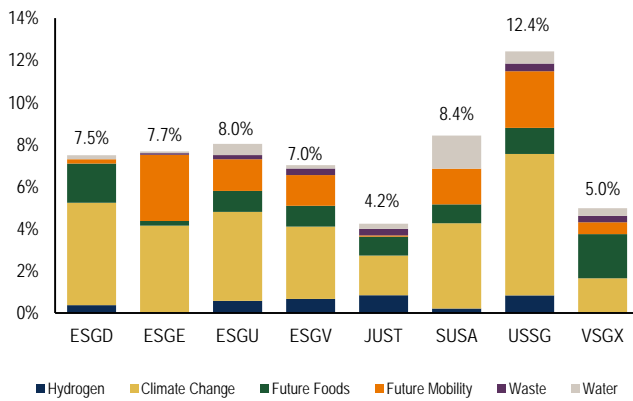


Source: BofA Global Research, EPFR Global

# ESG ETF comparisons

Our ESG ETF coverage of eight funds across four issuers. Key exposure differentials span ESG sub-themes, sectors and geography.

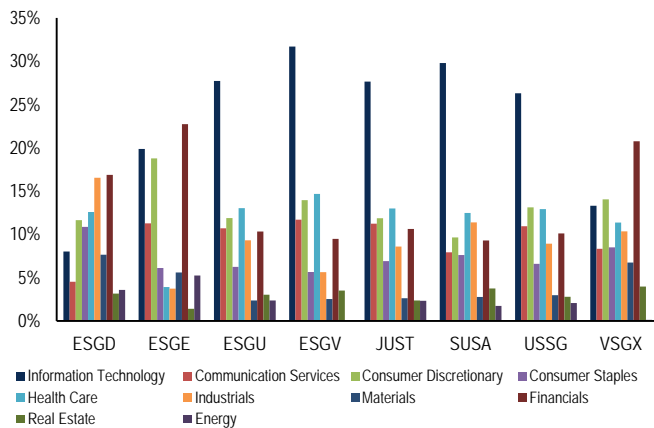
**Chart 12: ESG sub-theme exposures**



Source: BofA Global Research, Bloomberg

Given that most investors' main goal with ESG ETFs is to gain exposure to ESG stocks, we leverage BofA Thematic Research classifications of stocks with high exposure to ESG across sub themes of Hydrogen, Climate Change, Future Foods, Future Mobility, Waste and Water. Total exposure to these themes range from as high as 12% for USSG to as low as 4% for JUST. Each ETF claims to provide focused exposure to ESG. With BofA views, we level the field using a standardized way of evaluating just how levered each fund is to ESG.

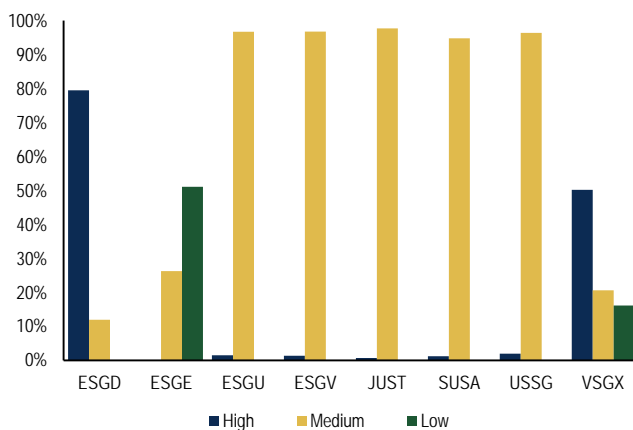
**Chart 13: Sector exposures**



Source: BofA Global Research, Bloomberg

Sector exposure differentials are significant across the category. The largest differentials are in Tech. ESGV has the highest exposure to the sector at over 30% compared to the lowest for ESGE with less than 10% exposure. Financials exposure differentials are also significant. ESGE has 23% exposure vs. SUSA with less than 10%.

**Chart 14: ESG-ranked country exposures**



Source: BofA Global Research

Leveraging the BofA sovereign ESG scorecard, we group ESG exposures by countries with high, medium and low scores. Given that five of the eight ESG ETFs are focused on US stocks, there are clear differentials here. These funds (ESGU, ESGV, JUST, SUSA and USSG) have nearly all their exposures in the US which has a medium sovereign score. International ESG ETFs tend to have more exposure to both high and low scores. ESGD, with nearly 80% in high scoring countries appears the most geared to ESG factors. ESGE, given the fund's emerging markets mandate has the greatest exposure to low scoring countries.

High scoring countries: Denmark, Finland, France, Germany, Japan, Netherlands, Norway, Sweden, Switzerland, UK.

Low scoring countries: Bangladesh, China, India, Mexico, Nigeria, Pakistan, Philippines, Saudi Arabia, South Africa, Turkey.



**Stocks mentioned**

BofA Ticker	Bloomberg ticker	Company name	Price	Rating
JUST	JUST US	GS Just Large Cap	US\$ 53.68	3-FV
ESGD	ESGD US	iSharesESG MSCI EAFE	US\$ 72.32	2-FV
ESGE	ESGE US	iSharesESG MSCI EM	US\$ 41.06	1-FV
ESGU	ESGU US	iSharesESG MSCI USA	US\$ 84.70	1-FV
SUSA	SUSA US	iSharesMSCI US ESG	US\$ 162.23	2-FV
ESGV	ESGV US	Vanguard ESG US	US\$ 68.57	2-FV
VSGX	VSGX US	Vanguard Int'l ESG	US\$ 58.26	3-FV
USSG	USSG US	XtrackersUSLeaderESG	US\$ 33.27	2-FV

Source: BofA Global Research

**Analyst Certification**

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Buy	25	11.36%	Buy	22	88.00%
Hold	185	84.09%	Hold	130	70.27%
Sell	10	4.55%	Sell	6	60.00%

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