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Fifty shades of green*

* **SFDR through the lens of ESG Book.**
Portfolio Level Solutions

Steven Edwards

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Portfolio Level Solutions

By Steven Edwards

Introduction

Europe's landmark anti-greenwashing rulebook for the investment industry, the Sustainable Finance Disclosure Regulation (SFDR) has triggered a growing number of investment funds to self-classify as either Article 6, Article 8, or Article 9. Since its implementation in March 2021, every financial market participant operating in the EU must disclose the extent to which their entity and investment products are aligned with the SFDR sustainable investment objectives (Article 6, 8 or 9 funds).

6	8	9
Article 6 ('Other') All	**Article 8 ESG Promotion**	**Article 9 Sustainable Objective**
Funds may integrate sustainability risks into investment decisions.	Funds may promote environmental and social characteristics.	Funds promote specific sustainability objectives.

SFDR has the potential to contribute to strengthening investor protection and reduce greenwashing. Whilst bringing financial institutions under a growing pressure to access comparable and transparent ESG data to evaluate long-term ESG performance.

This white paper contributes to efforts in looking beyond Funds' SFDR Labelling system through the lens of ESG Book's Portfolio Level Solutions. This product offering identifies how funds are positioned to outperform over the long-term by measuring what is financially material for future profitability at three of our ESG Score granularity levels: 1. Overall fund score (Total ESG score) 2. Sub-Pillar score (Environment, Social, Governance dimension scores) 3. Feature score (22 sustainability topic scores).

By analyzing 231 ETF & Indexes from BlackRock iShares, at the i) Aggregate SFDR Label, ii) iShares 'Sustainable' labels and iii) individual fund level, this paper offers transparency and granularity into Total, Sub-Pillar and Feature ESG scores behind SFDR classification.

Ultimately, findings demonstrate a similarity in average ESG scores across the i) Aggregate SFDR Label and ii) iShares 'Sustainable' label levels. Whereas comparison across three iShares MSCI World funds (each with an exposure to a portfolio of global developed market equity securities) demonstrates an improvement in ESG Score for the Article 9 fund across all three levels of granularity. These findings are summarized in the matrix below:

	Total Score	Sub-Pillar Score	Feature Score
Aggregate	9~8~6	9~8~6	9~8~6
Sustainability Label	9~8		
Individual Fund Case Study	9 > 8~6	9 > 8~6	9 > 8~6

Our Portfolio Level Solution offers investors the possibility to look beyond labels, providing a suite of analytics that allows for a granular approach to assessing sustainability risks and opportunities at portfolio level. As disclosure progresses, our solution will allow investors to track progress and position themselves accordingly.

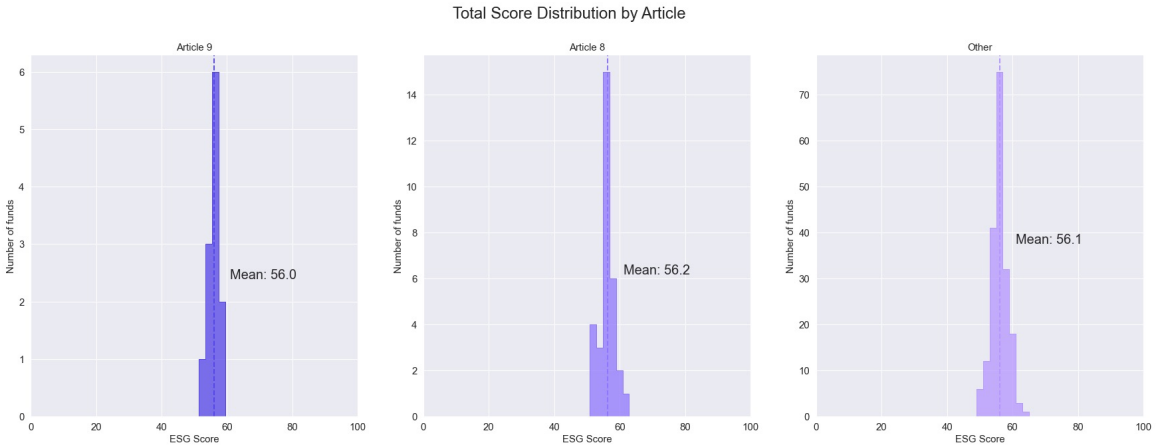
Sustainability within the ETF and Indexing Business

This analysis focuses on ETF and indexes given the relevance of these products. Positioned as an instrument capable of delivering diversified investments at a low cost, global ETF AUM has roughly tripled from $3.4 trillion in 2016 to over $10 trillion in November 2021[1]. iShares by BlackRock is one of the leading forces in global exchange-traded funds (ETFs) with over $5.75 trillion AUM distributed across more than 1,200 ETFs globally[2].

This paper evaluates a sample of 231 iShares ETF & Indexes using SFDR classifications sourced from BlackRoack as of 05/07/2022. 188 funds are classified as 'Other', 31 funds are classified as 'Article 8' and 12 funds are classified as 'Article 9'[3]. We note that the source of SFDR classification may have a significant impact on findings, indeed, Morningstar recently identified that 23% of funds classified as Article 8 don't satisfy ESG principles[4].

Given the difference between ESG integration across SFDR Article 6, Article 8, and Article 9 funds, we would expect ESG credentials to improve as we move from least ESG targeted to more ESG targeted funds. What's our take on this?

Total ESG Score

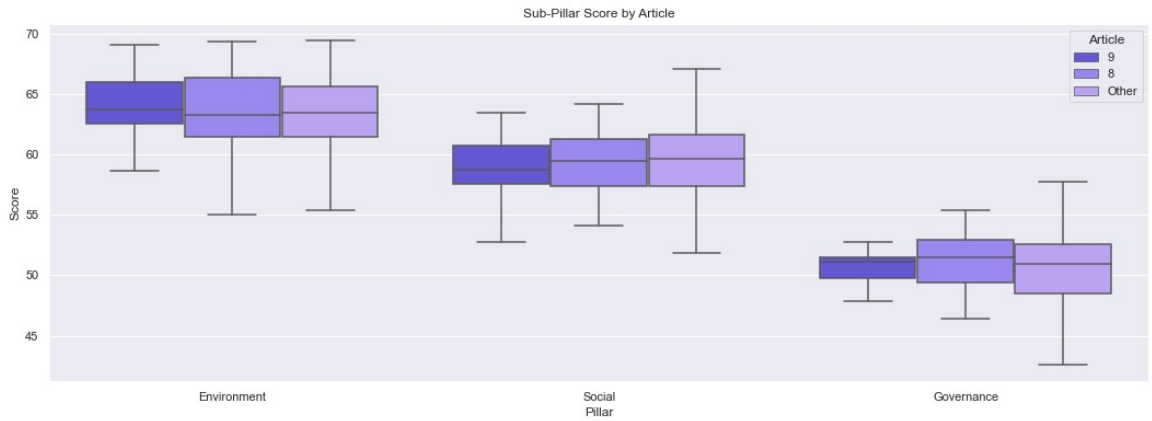


Differentiation across Article 8, Article 9, and 'Other' funds is not conveyed at the Total ESG Score level: on average, scores across iShares ETFs & Indexes within each universe do not change considerably.

This is not in line with expectations given that Article 8 and 9 funds explicitly take ESG criteria into account. Indeed, aggregate findings at the Total ESG Score level indicate that, from a holdings-based perspective, labels should not be taken at face value.

It is important to note that though the Total ESG score provides a succinct measure of ESG performance, exploring Sub-Pillar scores (Environment, Social, Governance dimension scores) is critical to gaining a more nuanced understanding of funds' ESG credentials.

Sub-Pillar ESG Score



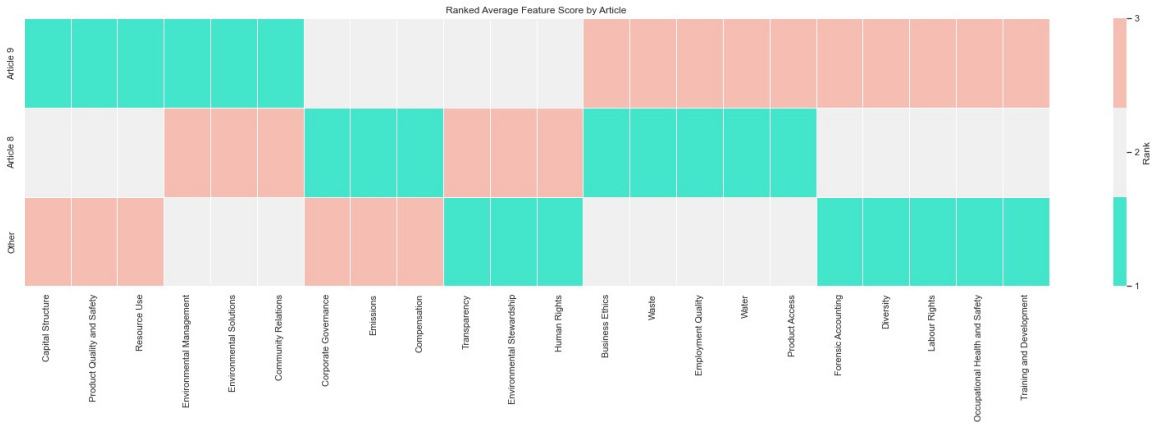
Sub-Pillar Scores also tell a counterintuitive story. Average scores across Environment, Social and Governance sub-pillars do not show any significant differentiation across SFDR labels.

Feature Scores

To get an aggregate view of a company's long-term performance trend per topic, Feature scores pull together available report-based metrics from the input layer. The different metrics are then aggregated based on several considerations. Because the report-based long-term trend is relatively slow to change – since companies typically report on an annual basis – ESG Book also constructs a more frequent short-term signal based on news controversies and NGO campaigns.

For every company, the Features scores represent a credible approximation of sustainability performance across a range of 22 complementary sustainability topics, drawing from a variety of data types and inputs.

Compared to Total and Sub-Pillar scores, Feature scores display more variation between fund SFDR Labels. The graph below ranks the average Feature scores across 'Other', Article 8 and Article 9 funds.



Green, grey, and red cells indicate features that rank first, second and third across the three SFDR Labels, respectively. Here we see that Article 8 and 'Other' funds rank in first, second and third place the same number of times across all features.

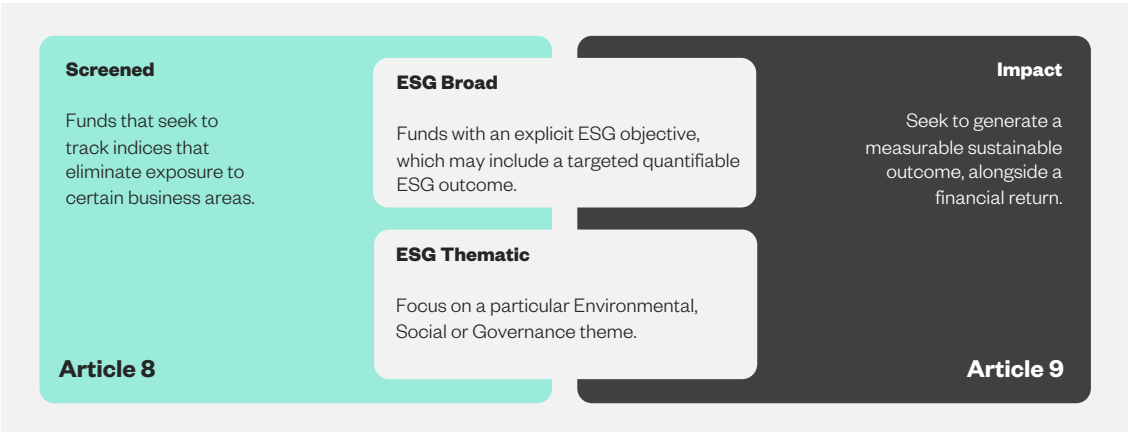
Since Article 9 funds explicitly incorporate sustainability objectives, one would expect the 'Article 9' row to be green, and similarly the 'Other' row, pertaining to funds that do not integrate ESG factors into the investment process to be red.

Empirically, however, the graph shows that Article 9 Feature scores are, on average, the lowest. Indeed, the Feature score for Article 9 ranks third more than 'Article 8' and 'Other' funds (across 10/22 features).
It is important to note that the magnitude of differences between feature scores is not sufficient to drive differences in scores at the Total or Sub-Pillar level.

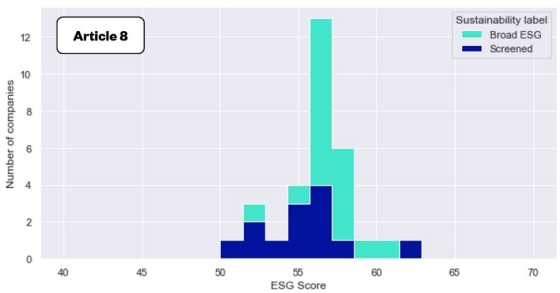
SFDR+

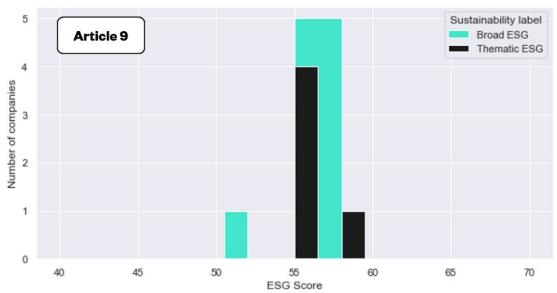
Having unearthed similarities across SFDR classifications, this analysis utilizes the iShares 'Sustainable' labels to explore whether the breadth of SFDR classification obscures score differences present in more granular sustainability labelling. Indeed, discussions surrounding additional SFDR labels proliferate. 'Article 8 plus' funds would offer a subset of a minimum proportion of Taxonomy aligned investments with sustainable objectives[5]. Are we able to identify further SFDR classifications within Sustainable Labels across SFDR funds provided by iShares?

iShares Sustainable Labels Across SFDR Labels



iShares differentiates its Article 8 and Article 9 ETF & index products by 'Sustainable' Labels. These labels include 'Screened', 'ESG Broad', 'ESG Thematic' and 'Impact'. 25 iShares ESG Broad funds (72% Article 8 and 28% Article 9), 13 Screened funds and 5 Thematic funds were analyzed. The graphs below show the distribution of ESG Scores across these sustainable labels:





ESG Scores of iShares sustainable labels don't allow for further differentiation of funds across Article 8 and 9. Average ESG Scores for these categories are:

Article 8	Broad ESG	**56.8**
Article 8	Screened	**55.3**
Article 9	Broad ESG	**56**
Article 9	Thematic ESG	**56**

Once again, similarities across ESG Scores prevail. Neither sustainable label offer, on average, a clear differentiation of ESG credentials across Article 8 and Article 9 funds.

Case Study: iShares MSCI World

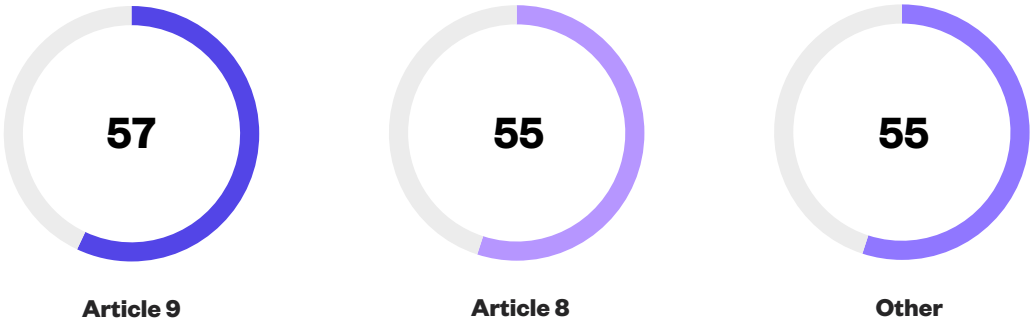
Both the aggregate and iShares Sustainable label findings demonstrate a similarity between the ESG scores of Article 9, 8 and 'Other' funds. However, it is important to understand whether score differences emerge when controlling for attributes such as sector, regional and country development level focuses.

To control for such differences, this analysis takes a detailed view of three funds:

ETF	SFDR Classification	ESG Approach
iShares MSCI World UCITS ETF USD (Dist.)	Other	▪ No reported approach
iShares MSCI World ESG Screened UCITS ETF	Article 8	▪ Screens out exposure to Controversial Weapons, Nuclear Weapons, Tobacco, Thermal Coal, Oil Sands, UN Global Compact violators and Civilian Firearms.
iShares MSCI World ESG Enhanced UCITS ETF	Article 9	▪ Exceed decarbonisation and other minimum standards for an EU Climate Transition Benchmark (CTB) and maximise exposure to issuers with higher ESG ratings. ▪ Excludes Companies that are involved with controversial, conventional and nuclear weapons, civilian firearms, thermal coal, tobacco or unconventional oil and gas ▪ Adopts a best-in-class approach to sustainable investing.

Where each fund has an exposure to a portfolio of global developed market equity securities which are part of the MSCI World Index. For a more detailed description of the ETFs please refer to the appendix.

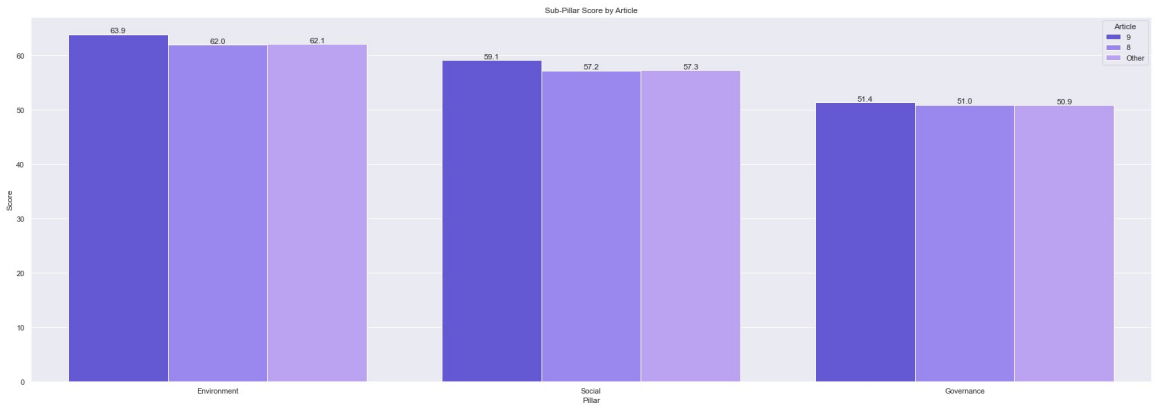
Total ESG Score



Overall, the Article 9 fund shows a 2% increase in score compared to the Article 8 and Article 6 funds, indicating a marginal improvement in its position to outperform over the long term. No discernible difference can be seen between the overall scores of the Article 8 and Article 6 funds.

Sub-Pillar Scores

At the Sub-Pillar level, the Article 9 fund offers higher scores than Article 8 and Article 6 Funds across the Environment, Social and Governance Sub-Pillars. This is contrary to what is seen in the aggregate and iShares Sustainable label findings, and in-line with expectations, since Article 9 funds have sustainable investment as an objective within their investment process.



Feature Scores

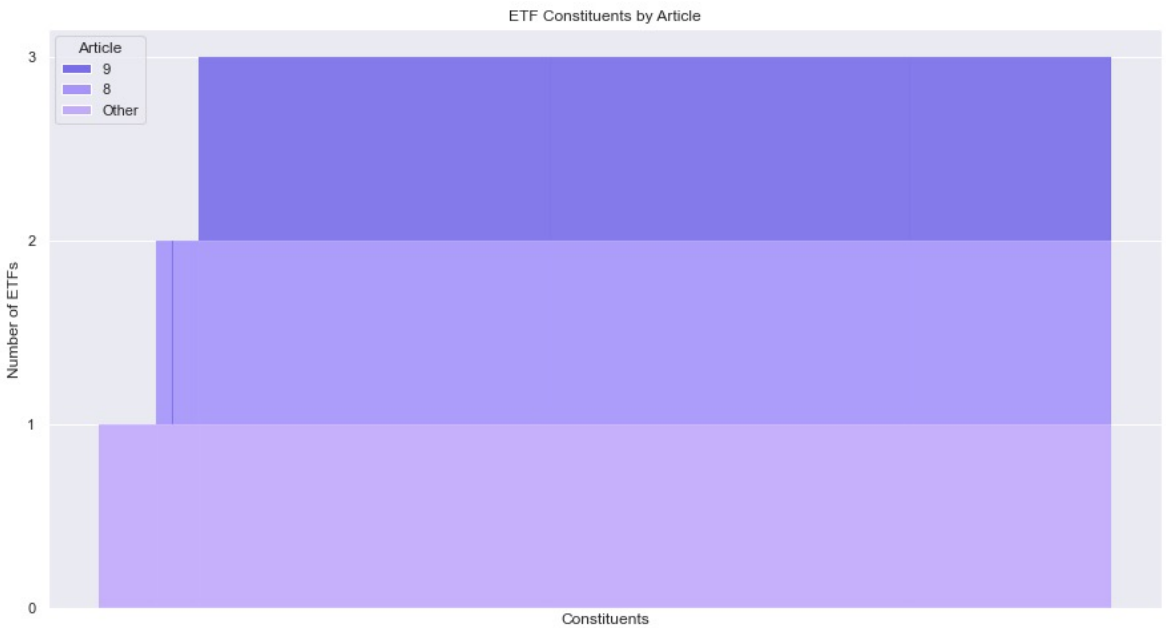
To better understand how Sub-Pillar score differences materialise, this analysis looks at the Feature level. Here, scores for the Article 8 and Article 9 funds have been made relative to the iShares MSCI World ETF (classified as 'Other'). Greener scores are higher relative to iShares MSCI World, while redder scores are lower.

We find that the Article 9 fund exhibits the highest score across almost every feature (with the exception of "Forensic Accounting"). This indicates that ESG score improvements are not simply as a result of strong sustainability credentials in one feature, but consistent improvements across 21 dimensions. In stark contrast, the Article 8 fund does not show any consistent improvement across Feature scores.



Section and Allocation

To gain insight into what is causing differences in scores across funds, the selection (unique set of constituents across all 3 funds) and allocation (weight allocated to selected constituents) has been compared across the 'Other', Article 8 and Article 9 funds.



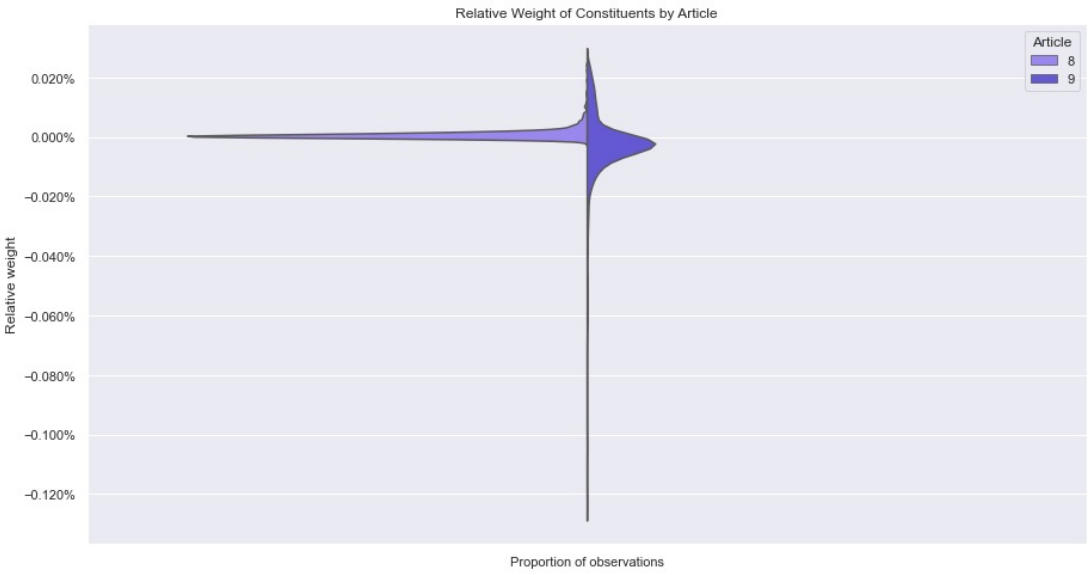
Y axis: 'Other', Article 8, Article 9 funds. X axis: number of constituents. Color brakes: securities in Fund are an incorporation to 'parent' fund.

Selection

Across all 3 funds we find significant similarity in constituents. The Article 8 fund has screening as its main strategy to promote sustainability, dropping companies that are involved in controversial businesses activities. Empirically we find that the Article 8 fund incorporates 94% of iShares MSCI World constituents.

The Article 9 fund on the other hand includes screening of additional controversial business activities and incorporates a best-in-class approach, investing in best ESG issuers. Findings show that Article 9 fund incorporates 96% of the Article 8 fund constituents and 90% of iShares MSCI World constituents.

Allocation



Differences between the 3 funds vary with respect to allocation. The graph (see above) shows a distribution of the relative weight of overlapping constituents between the Article 8 (light green), 9 (dark green) funds and iShares MSCI World.

Relative to iShares MSCI World Fund, the Article 8 Fund weighting strategy is highly concentrated around 0%, suggesting that the weight assigned to constituents is very similar to the weights allocated across iShares MSCI World. This is not the case for the Article 9 Fund where the weight of constituents relative to the iShares MSCI World Fund differs more as it applies: i) additional screening, and ii) a best-in-class approach to the selection of constituents.

This case study provides evidence to suggest that differences emerge in ESG score at the Total, Sub-Pillar and Feature level when controlling for attributes such as sector, regional and country development level focuses. Selection findings demonstrate a similarity in the set of constituents across the three MSCI World funds. Whereas the allocation findings comparing the weighting of overlapping constituents between Article 8 and 9 funds with iShares MSCI World show that the Article 9 fund takes a more active approach to allocation compared to the Article 8 fund. Through this lens it appears that allocation is the driving force behind differences in ESG scores between these three MSCI World funds.

Our Mission

In this white paper we have shown that examining the SFDR Labelling system through the lens of ESG Book's Portfolio Level Solutions exposes a strong similarity between SFDR labels at the Total, Sub-Pillar and Feature level. However, comparing ESG Scores across three iShares MSCI World funds, each with an exposure to a portfolio of global developed market equity securities, shows an improvement in ESG Score for the Article 9 fund across all three levels of granularity.

Overall, findings show that SFDR classification is not to be taken at face value and demonstrates the need for investors to access comparable and transparent ESG data to evaluate long-term ESG performance. From a top-down or a bottom-up approach, PLS allows investors to dissect and assess a portfolio inside out, with a unique level of granularity.

When it comes to SFDR labeling, the debate could be nuanced. Are regulators doing enough to safeguard investors' interest when in fact evidence may suggest that regulation translates into a higher burden for industry participants[6] or is SFDR upside highly overlooked, as it has the virtue of offering flexibility to promote innovation across ESG financial products?

At ESG Book we strive to increase ESG data transparency and availability. Our Portfolio Level Solutions offer clarity and granularity into sustainability scores, metrics, and raw data. We are transforming the industry through our full suite of products that go beyond regulatory and political noise, into sustainability risks and opportunities.

Appendix

Case Study EFT's Detail:

MSCI World	'Other'	Article 8	Article 9
Why?	Broad exposure to a wide range of global companies within 23 developed countries. Covering 85% of the listed equities in each country. Use at the core of a portfolio to seek long-term growth.	Screens out exposure to Controversial Weapons, Nuclear Weapons, Tobacco, Thermal Coal, Oil Sands, UN Global Compact violators and Civilian Firearms. Equivalent cost to the corresponding iShares Core exposure. Designed for investors looking to screen out controversial business areas while maintaining a risk profile similar to traditional benchmarks . Screening	Provides exposure to a portfolio of global developed market equity securities which are part of the MSCI World Index and aims to exceed decarbonization and other minimum standards for an EU Climate Transition Benchmark (CTB) and maximise exposure to issuers with higher ESG ratings. Excludes Companies that are involved with controversial, conventional and nuclear weapons, civilian firearms, thermal coal, tobacco or unconventional oil and gas.
Investment Objective	The Fund seeks to track the performance of an index composed of companies from developed countries.	The fund seeks to track the performance of an index composed of developed market companies. The index screens out companies associated with controversial weapons, nuclear weapons, tobacco, thermal coal, oil sands, civilian firearms and those violating United Nations Global Compact principles.	The fund adopts a best-in-class approach to sustainable investing, this means that it is expected that the Fund will invest in the best issuers from an ESG perspective. The fund aims to achieve a return on your investment, through a combination of capital growth and income on the Fund's assets, which reflects the return of the MSCI World ESG Enhanced Focus CTB Index, the Fund's benchmark index.

References

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2. Source: BlackRock as of 09/30/2019. AUM includes the entire exchange traded product category, which encompasses any portfolio exposure that trades intraday on an exchange. AUM excludes Middle East and Africa. All $ values are in USD.
3. All funds analyzed are categorized as having a "High" score reliability by ESG Book, indicating that in each fund at least 85% of the market value is scored by ESG Book.
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