WISDOMTREE'S APPROACH TO BROAD-BASED ESG INVESTING

Alejandro Saltiel — Head of Indexes, U.S.
05/11/2021

ESG investing has been a focus for European institutional investors for more than a decade. Now it's increasingly become an area of conversation for U.S. investors as asset managers expand their product lineup to incorporate "environmental, social and governance" considerations.

Seeing the increase in investor interest for these types of products, WisdomTree began developing its own approach to broad-based ESG investing. As with other asset classes, WisdomTree aims to create a methodology that gives investors exposure to the relevant investment theme while avoiding common pitfalls.

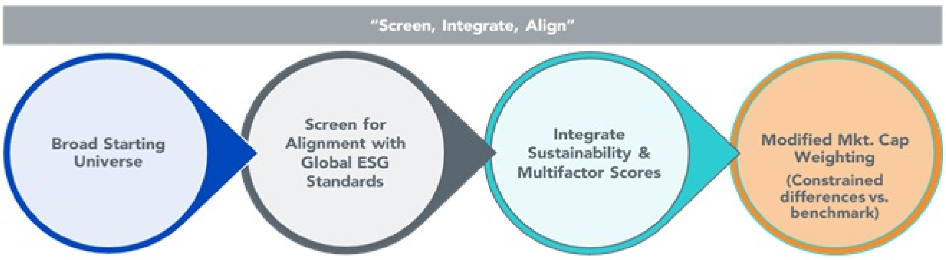
This is not WisdomTree's first foray into the ESG space—since 2014, WisdomTree has offered "governance"-focused Indexes as part of its ex-state-owned enterprises family. These provide investors with broad exposure in the emerging market region while removing the inherent governance risk of state-owned enterprises. In January, we added additional screens to this Index family to enhance its environmental and social considerations. We highlighted these additional ESG enhancements in a post earlier this year.

WisdomTree's Broad-Based ESG Approach

After years of research, WisdomTree restructured three funds in March 2020 to target ESG from a factor-based investing lens. Combined, these Funds would provide investors with a global ESG exposure (and can complement our EM-specific ex-state-owned ESG family):

- WisdomTree U.S. ESG Fund (RESP)
- WisdomTree International ESG Fund (RESD)
- WisdomTree Emerging Markets ESG Fund (RESE)

WisdomTree's multifactor approach to ESG investing includes both a negative screening of companies on sustainability characteristics—such as product involvement and noncompliance with the UN Global Compact—and a positive integration of a sustainability score to determine holdings and their respective weights. The final basket aims to give investors a low-tracking-error portfolio (relative to the broad benchmark) with strong ESG characteristics constraining any significant country or sector differences.



Source: WisdomTree.

This approach was designed to address some of the most common pitfalls found in other ESG methodologies, with the goal of balancing an investor's sustainability objective with superior risk-adjusted returns. WisdomTree uses Owl Shares, a data provider that aggregates ESG scores from a variety of sources, and adjusts these scores to reflect what its model classifies as the most important indicators. Some of these main pitfalls include unintended size (larger companies tend to report more ESG data) and sector and country biases that contribute to active risk and can cause a drag in relative performance in certain market environments.

	Typical Competing ESG Methodologies	WisdomTree ESG Approach
Subjectivity of Ratings	Focused on a single data provider/score that may not align with investor goals	Holistic approach that aggregates ESG scores from primary & secondary sources
ESG Integration	Generally focused on divestment of companies with negative product involvement	Screening of companies on sustainability characteristics and tilts to firms with high aggregate sustainability scores
Concentration	Over-weight: Large-cap, Information Technology, Consumer Discretionary, Japan, Taiwan and Canada Under-weight: Energy, Healthcare, Utilities and U.S.	±5% for sector and country bands with respect to broad market benchmark
Factor Exposures	Over-weight: Correlation, Momentum, Quality Under-weight: Value	Balanced exposure to Correlation, Momentum, Quality and Value factors
Data Access	Generally excludes companies with incomplete data	Maximum flexibility to include or exclude a company based on alternative data sources
Performance	Concentration in sectors/countries increases risk vs. benchmark; can be challenging to enhance returns via divestment	Combines the societal benefits of ESG with the potential outperformance benefits of a factor-based approach

Source: WisdomTree. The attributes provided above are not all encompassing and is based on WisdomTree research. WisdomTree methodology compared to the MSCI Extended ESG Index family and FTSE All Cap Choice Index family which are tracked by the largest ESG ETF's in the U.S. markets.

Investment Process

The investment process for these Funds starts with a broad-based regional universe—U.S., international or emerging markets—and screens out companies that derive revenue from activities related to fossil fuels, controversial weapons or tobacco, or those which do not comply with the United Nations Global Compact Principles, which are focused on human rights, labor, environment and anti-corruption efforts. We then assign a score to each eligible company based on a composite calculation that combines traditional investment factors like value, quality, momentum and low correlation with a sustainability factor made up of environmental, social and governance considerations.

The 300 stocks with the highest composite scores are selected to be in the portfolio, and their weight is determined by combining their market cap and sustainability score in equal proportions. Thus, the sustainability factor plays an important role in both the selection and weighting of companies in the portfolio.

A final adjustment is made to each company's weight to ensure that both the portfolio's sector and country exposures remain within +/-5% of their respective weights in the broad-based starting universe. This investment process is repeated quarterly, resetting portfolios to the desired exposure.

Start with Broad Regional Universe
Screen Out Companies Involved in Certain Activities

Assign Each Stock
a Score based on Fundamentals & Sustainability

Select Top 300 Stocks with the
Highest Score

Weight = 50% Market Cap + 50% Sustainability Factor

Final Portfolio
Sector and Country Neutrality Adjustments to Remove Undesired Tilts
Usually within +/- 5% bands
Rebalanced Quarterly

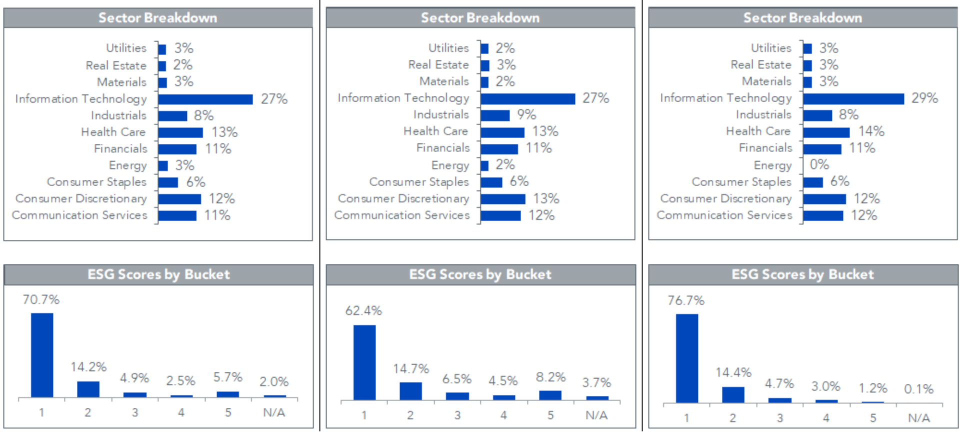
Source: WisdomTree.

Portfolio Construction Example

The chart below exemplifies the investment process and the potential advantages of having an ESG approach that both screens out companies with certain sustainability characteristics and integrates a sustainability factor into the stock selection and weighting.

The starting universe of 800 stocks had roughly 20% of its weight in companies that ranked in the bottom 60% of ESG scores, which is in line with its benchmark, the S&P 500 Index. After screening close to 150 companies based on their sustainability characteristics, the sector composition changes slightly: financial quality (return on equity) improves, but valuation metric price-to-earnings (P/E) and, more importantly, ESG scores stay the same. Finally, selecting the 300 companies with the highest composite scores and implementing the weighting schema results in improved financial metrics (P/E, ROE) and ESG characteristics, versus both its starting universe and the S&P 500.

Characteristics	Market Cap Benchmark	Starting Universe	Final Portfolio
# of Stocks	500	800	301
Median Mkt Cap ($B)	27.0	16.2	18.9
Estimated P/E Ratio	21.7	23.2	18.7
Return on Equity	12.8%	12.2%	15.7%



Source: WisdomTree, FactSet, Bloomberg, as of 2/26/21; holdings subject to change. The above analysis is based on the constituents and weights for the reconstituted WisdomTree U.S. ESG Fund on 3/15/21. You cannot invest directly in an index. Market Cap Benchmark defined as the S&P 500 Index, a rules-based market value-weighted index frequently cited as a proxy for U.S. equities. ESG Score Rank provided by Sustainalytics (1 = Highest Rank). Past performance is not indicative of future results. ESG Score Rank provided by Sustainalytics (1 = Highest Rank, 5 = Lowest Rank).ESG Ranks calculated by partitioning companies in broad regional universes (U.S., Developed ex- US and Emerging Markets) into quintiles sorting by their ESG Score.

For definitions of terms in the chart, please visit the glossary.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. The Funds' ESG investment strategies limit the types and number of investment opportunities available to the Funds, and as a result, the Funds may underperform other funds that do not have an ESG focus. Companies selected for inclusion in the Funds may not exhibit positive or favorable ESG characteristics at all times and may shift into and out of favor depending on market and economic conditions. Investments in non-U.S. securities involve political, regulatory and economic risks that may not be present in U.S. securities. For example, foreign securities may be subject to risk of loss due to foreign currency fluctuations, political or economic instability or geographic events that adversely impact issuers of foreign securities. Investments in emerging markets are generally less liquid and less efficient than developed markets and are subject to additional risks, such as of adverse governmental regulation, intervention and political developments. While the Funds are actively managed, the Funds' investment processes are expected to be heavily dependent on quantitative models, and the models may not perform as intended. Please read the Funds' prospectuses for specific details regarding the Funds' risk profiles.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

Related Blogs

+ Our Take on ESG Investing

+ Boosting the ESG Focus of Our Ex-State-Owned Enterprises Strategies

Related Funds

+ WisdomTree International ESG Fund

+ WisdomTree Emerging Markets ESG Fund

+ WisdomTree U.S. ESG Fund

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu, Brian Manby and Scott Welch are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

ESG : An acronym for environmental, social and governance, ESG standards quantify the degree to which a company is socially responsible. .

Tracking Error : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Low Correlation : Characterized by assets that have a relatively lower correlation vs the market over time. This term is also associated with the Low Correlation Factor which associates these stock characteristics with excess returns vs the market over time.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.