



# DISCLOSURE INFORMATION STATEMENT

INFORMATION ON INTEGRATION OF SUSTAINABILITY RISK INTO VANGUARD'S INVESTMENT DECISION-MAKING PROCESS PUBLISHED ON 10TH MARCH 2021

## Background

The aim of this statement is to set out Vanguard's approach to the requirement in the EU Sustainable Finance Disclosure Regulation ("EU SFDR") as to how Vanguard integrates sustainability risks into its decision-making for Financial Market Participants ("FMP").

## Details of Vanguard's policy approach to EU SFDR for out of scope entities (including UK entities)

Despite the fact that EU SFDR does not directly apply to Vanguard's UK entities, given the interconnectivity between the Vanguard entities and the importance of ESG disclosures to Vanguard's clients and stakeholders (as well as client expectations in respect of the same), it has been decided that Vanguard will partially apply the EU SFDR on a voluntary basis to its UK entities, i.e. Vanguard Investments UK Limited ("VIUK") and Vanguard Asset Management Limited ("VAM"), solely in the manner described below. However, Vanguard will keep this under review in contemplation of the UK application of sustainable finance measures.

## VANGUARD EU SFDR IN-SCOPE ENTITIES

Vanguard will apply the EU SFDR as follows:

| Vanguard Entity                           | EU SFDR Scope   | Basis for Compliance |
|---|---|----------------------|
| Vanguard Group Ireland Limited ("VGIL")   | FMP as UCITS Management Company to Vanguard's Irish domiciled funds (the "Irish Funds"). <sup>1</sup>   | Mandatory            |
| Vanguard Investments UK Limited ("VIUK")  | FMP as UK UCITS Management Company to Vanguard's UK domiciled funds (the "UK Funds"). <sup>2</sup>  | Voluntary            |
| Vanguard Asset Management Limited ("VAM") | FMP in respect of its MiFID investment firm portfolio management activities (investment decision making) in relation to the UK Funds and the Irish Funds. | Voluntary            |

Please note that in the rest of this document the term "funds" is referring to both the Irish Funds and UK Funds.

## Definition of Sustainability Risk

It's important to firstly distinguish between different methods of taking account of sustainability risk when it comes to investment products. Sustainability risk is defined as an environmental, social, or governance ("ESG") event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of an investment. The integration of financially material ESG considerations into the investment process ("ESG Integration") can help mitigate sustainability risk. ESG can be a complex subject and there exist a broad range of methods and degrees to which ESG may be taken account of within investment products and services. Vanguard's approach to integration of sustainability risk is outlined in this document under Section A and B.

<sup>1</sup> VGIL delegates the portfolio / investment management activities in respect of the Irish Funds.

<sup>2</sup> VIUK delegates the portfolio / investment management activities in respect of the UK Funds.

## Section A – Integration of Sustainability Risk in the investment decision-making process

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Vanguard categorises its investment funds into three categories with varying degrees of ESG Integration. These categories are 1) investment products which do not promote environmental or social characteristics and do not take ESG characteristics into consideration in selecting portfolio holdings 2) investment products which do not promote environmental or social characteristics but which take ESG characteristics into consideration in selecting portfolio holdings and 3) investment products with ESG investment strategies which promote environmental and social characteristics and take ESG considerations into account when selecting portfolio holdings.

### **1. Investment products which do not promote environmental or social characteristics and do not take ESG characteristics into consideration in selecting portfolio holdings (all investment products that do not fit within categories 2 or 3 below)**

Investment products of this nature do not take account of ESG characteristics in selecting portfolio holdings. Examples of products falling into this category include a number of Vanguard's passively managed index funds that have a primary investment objective of tracking the performance of the stated index which does not capture ESG characteristics. Furthermore, this category of investment products typically seek *full replication* through physically holding most (if not all) of the securities in the stated index. The index in this case is intended to provide a broad representation of investment securities (typically company shares or debt instruments) that make up the target market or sector. In seeking to provide broad representation, the index contains members/constituents on a market capitalization weighted basis and is not screened or adjusted to take account of ESG criteria.

Whilst ESG considerations are not directly integrated in the investment process for this category of investment products, the Vanguard Investment Stewardship team, as described in more detail below under the separate heading "Investment Stewardship," stewards the global equity holdings of the Vanguard managed funds through public advocacy, engagement and voting, which serve as the most important levers Vanguard has to apply ESG oversight to the relevant fund's portfolio companies, to protect clients' investments, and to help build long-term value.

### **2. a) Investment products which do not promote environmental or social characteristics, but take ESG characteristics into consideration in selecting portfolio holdings (all fixed income funds holding credit instruments)**

Investment products falling under this category do not have an explicit investment strategy to either negatively screen out securities with poor ESG characteristics or explicitly target companies with strong ESG practices and do not promote environmental or social characteristics. However, ESG considerations are a factor in the security selection process for fixed income funds holding credit instruments.

Vanguard uses a variety of third party ESG ratings providers to assist in this assessment and determination of materiality. These considerations are factored into the research process for the fixed income funds through analysis conducted by Vanguard's Credit Research team (the "**Credit Research Team**"), with recommendations issued through a consistent approach in the case of both active and passive fixed income fund management strategies. The Credit Research Team is responsible for analysing and making fundamentally driven recommendations around credit instruments and prospects for holding them in the fixed income credit funds.

In analysing credit instruments, the Credit Research Team considers ESG Integration in making investment recommendations through (i) quantifying the financial materiality of ESG risk, and (ii) assessing whether the securities' current valuation is commensurate of the related risk. ESG risk is considered to be one of the core elements that make up the bottom-up fundamental view of a credit instrument, alongside other factors that impact the view on credit trend and event risk. Specifically, each credit instrument under consideration is assigned an ESG risk rating of low, medium or high based on the Credit Research Team's assessment of the probability of an ESG event and the potential magnitude of its impact on the issues credit profile.

All recommendations issued by the Credit Research Team include an ESG score which is considered amongst other factors in determining the overall view on a given security. The Credit Research Team seeks to cover and thereby provide recommendations against a large proportion of the issues across credit sectors of a portfolio's benchmark. However, Vanguard does not guarantee coverage of all securities or thereby consider ESG ratings for every benchmark security. As ESG scores are considered amongst other factors, it also cannot be guaranteed that there will be no exposure to securities which have low ESG ratings.

**b) Investment products which do not promote environmental or social characteristics, but take ESG characteristics into consideration in selecting portfolio holdings (all external managed active funds)**

Products that fall under this category are actively managed investment products that do not have an explicit ESG investment strategy which promotes environmental or social characteristics and are sub-advised by external fund managers. External fund managers take into consideration ESG characteristics and risks as part of their overall investment process. Some external managers may also engage directly with companies if they believe such engagements would contribute to long-term value creation for the company or inform their understanding of material risks, including sustainability risks. Vanguard's Oversight and Manager Search team are responsible for overseeing the external managers' performance and as part of that oversight, review each external manager's sustainability and ESG risk policies and outcomes.

**3. Investment products with ESG investment strategies, which promote environmental and social characteristics and take ESG considerations into account when selecting portfolio holdings**

Vanguard offers investment products that explicitly consider ESG factors as part of their investment strategies. The existing range is made up of both equity and fixed income investment products that depend on exclusion criteria (a process known as negative screening) to remove certain companies from the investment universe based on pre-determined ESG screening criteria.

As indicated below, certain funds (i) provide exposure to indices which exclude securities of issuers that the index sponsor determines do not meet or are inconsistent with the promotion of certain ESG criteria or (ii) apply a screening process which screens out / excludes certain securities from the relevant benchmark index which do not meet or are inconsistent with the promotion of certain socially responsible investing ("SRI") criteria:

*Funds that track an ESG index:* A fund may track an ESG index which screens out possible investments if they do not meet certain ESG criteria. This may affect the fund's exposure to certain issuers and cause the fund to forego certain investment opportunities relative to indices which cover the same broad universes but which do not apply such screens.

*SRI Funds:* Whilst considered here under the same broad category of funds, we distinguish "SRI" funds from funds that track an ESG index. SRI funds apply a screening process to a non-SRI benchmark index, which is then separately screened to exclude certain securities from the relevant index that do not meet certain SRI criteria and the fund therefore does not invest in these securities.

## Investment Stewardship

Vanguard's Investment Stewardship team (the "Investment Stewardship Team") serves as a voice for investors in its funds to promote long-term value creation at the companies in which the equity funds managed by Vanguard invest. When a Vanguard index fund invests in a public company, it could theoretically hold that stock forever or as long as the company is listed in the underlying benchmark. With this indefinite horizon, Vanguard and its funds must focus on how companies are setting themselves up to stay relevant today, tomorrow, and well into the future.

As a long-term investor, the Investment Stewardship Team stay keenly focused on areas such as risk, strategy, executive remuneration, diversity, environmental issues, shareholder rights, and health and safety issues. The Investment Stewardship Team stewards the global equity holdings of Vanguard managed funds in three key ways:

- **Public advocacy.** The Investment Stewardship Team advocates for the highest standards of corporate governance worldwide and the sustainable, long-term value of Vanguard's shareholders' investments.
- **Engagement.** The Investment Stewardship Team conducts ongoing dialogues with portfolio company executives and directors to share its long-term orientation and principled approach, and to understand a company's governance practices and long-term strategy.
- **Voting.** The Investment Stewardship Team votes proxies at public company shareholder meetings on behalf of equity funds managed by Vanguard.

One of the key principles that Vanguard considers foundational to effective corporate governance is the oversight of strategy and risk. The Investment Stewardship Team engages with boards regarding the oversight of material risks that have the potential to affect shareholder value over the long term – from business and operational risks to environmental and social risks. Vanguard believes that companies should disclose material risks to shareholders, explain why those risks are material to their business, and disclose their approach to risk oversight. Vanguard has a responsibility to understand how business activities pose a material risk to the long-term value of its funds.

For example, Vanguard recognises that climate change represents a profound, fundamental risk to investors' long-term success. Vanguard supports climate risk mitigation, acknowledging that the goals in the Paris Agreement are widely accepted for countries and companies seeking to address climate change. Where it is a material risk, Vanguard encourages companies that it holds in its equity portfolios to set targets that align with the Paris Agreement and disclose them.

When the Investment Stewardship Team identifies a concern with how a company in its equity portfolios is overseeing a material risk, including ESG risks, it often seeks to engage with the company in order to enhance their disclosure on risk mitigation and/or encourage them to develop a more appropriate risk mitigation approach. This is all part of the effort to safeguard clients' assets against a full range of short- and long-term risks.

If a company is not receptive to the Investment Stewardship Team's requests, it can escalate this through Vanguard's proxy voting activity at that company's general meetings – either by voting against resolutions proposed by management or supporting shareholder proposals. As a near permanent owner with a long-term perspective, Vanguard is in a unique position to ensure that its investments are well placed to benefit from the sound oversight of ESG risks.

For more information about Vanguard's Investment Stewardship programme and how it engages with portfolio companies, please see Vanguard's Engagement Policy at:

<https://global.vanguard.com/documents/Vanguard-Engagement-Statement.pdf>.

## UN Principles for Responsible Investment Signatory

With the growing importance of ESG issues to investors, Vanguard affirmed its commitment to responsible investment by joining the UN Principles for Responsible Investment (PRI) in 2014. The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories such as Vanguard contribute to developing a more sustainable global financial system. They have attracted a global signatory base representing a majority of the world's professionally managed investments.

The PRI reviews transparency reports and produces assessment reports, which appraise how a signatory has progressed year-on-year and relative to peers. Unlike transparency reports, assessment reports are not available on the PRI website. It is up to individual signatories to share their assessment report to demonstrate their performance or keep it in-house as an internal learning and development tool. Vanguard has elected to share its assessment report with clients upon request.

## Remuneration Policy and Practices

Vanguard Europe's remuneration policy promotes sound and effective risk management, taking into account the risk profile of the Vanguard Europe, the long-term interests and strategy of the business and the risks presented to it, including, sustainability risks. As set out within the remuneration policy, Vanguard Europe's remuneration practices do not encourage risk-taking (including excessive risk-taking with respect to sustainability risks) that exceeds the Vanguard Europe's levels of tolerated risk.

Please see the following for further information:

<https://www.vanguard.co.uk/adviser/adv/investment-information.jsp>

## Section B – Description of Vanguard’s processes to ensure that sustainability risk is adequately assessed, managed and embedded as part of the investment decision making process, including the results of the likely impacts of sustainable risks on financial returns

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### Category 1 and 2 Funds

As outlined in the Sustainable Finance Section A above, because both of these categories of funds do not promote environmental or social characteristics, in certain cases the investment manager of the relevant fund, or its delegate, may not be able to take material sustainability risks (i.e. those that might have an impact on the financial outcomes or returns of a business) into account when assessing whether a fund should be invested in a particular security. Therefore, for such categories of funds the funds’ investments may be exposed to material sustainability risks.

However, Vanguard attempts to mitigate material sustainability risks through the Investment Stewardship activities for equity holdings managed by Vanguard described in the section ‘Investment Stewardship’ in Section A. Additionally, the Credit Research Team’s activities for fixed income funds holding credit instruments consider material sustainability risks, as further described in Section A 2(a).

### Category 3 Funds

#### **Investments products with ESG investment strategies, which promote environmental and social characteristics and take ESG considerations into account when selecting portfolio holdings**

##### Controls for ESG and SRI funds

Vanguard employ an in-house Risk team known as the Risk Management Group (“**RMG**”) to oversee operational risks associated with ESG investment products. RMG are part of a broader network of risk-minded individuals, and are set up as an independent risk oversight and advice team forming part of Vanguard’s “second-line” of defence. RMG maintain the responsibility for operational risk controls surrounding ESG and SRI investment strategies.

RMG’s risk controls surrounding Vanguard’s ESG index tracking and SRI funds rely on a set of compliance rules embedded within its order management and risk systems. The rules are in place to ensure that Vanguard’s investment teams do not unintentionally hold positions in non-ESG or non-SRI securities in corresponding funds, which are not otherwise permitted by the investment permissions of the relevant fund. The setup of these rules differ marginally between investment funds that seek to track the performance of an ESG index through a passive management approach,

compared with SRI funds that use negative screening applied to a non-SRI benchmark (the list of non-SRI securities caught by the screen is often referred to as the SRI restricted list). However, in the cases of both sub-categories of funds the risk controls are intended to pre-emptively ensure unintentional exposure to non-ESG or non-SRI securities. It is important to note that the methodology embedded in ESG indices and behind SRI screens is defined by an independent 3rd party. As such, Vanguard does not determine the ESG or SRI eligibility criteria, or have influence over the construction of benchmarks that incorporate ESG considerations.

### **Sustainability Risk Assessment including the assessment of likely impacts of sustainability risks on financial returns**

#### ESG Funds

A fund may track an ESG index which screens out possible investments if they do not meet certain ESG criteria. This may affect the fund’s exposure to certain issuers and cause the fund to forego certain investment opportunities relative to indices which cover the same broad universes but which do not apply such screens. Therefore, the relevant fund may perform differently to other funds, including underperforming funds that track indices which do not seek to screen investments in this way.

#### SRI Funds

SRI funds may apply a screening process to their non-SRI benchmark index which is then separately screened to exclude certain securities from the relevant index which do not meet certain SRI criteria and the fund therefore does not invest in these securities. This is the risk that, because the fund will not invest in all of the companies that comprise the relevant index, but rather will exclude those securities that do not meet the fund’s SRI screening process, the performance of the fund may be considerably different, and could be lower, than the performance of the index. Therefore, such funds expect to experience a higher degree of tracking error than is normally achieved in index funds since the fund’s screening process will preclude the fund from investing in stocks of certain companies otherwise included in the index and which companies may, or may not, contribute significantly to the index’s overall performance.