Vanguard

VANGUARD'S APPROACH TO ESG:

Our investment products and processes

Vanguard's mission is to give our investors their best chance for investment success. Core to that mission is our fiduciary duty to maximize long-term investment returns for our clients. We believe that material environmental, social, and governance (ESG) risks can impact long-term value creation in portfolio companies. We currently integrate ESG considerations into our product design and investment processes in three ways:

We *engage* with the portfolio companies in our index funds.

Index funds have revolutionized investing by providing millions of investors with broad market exposure at a very low cost. They predominantly track benchmarks constructed *without* consideration to ESG criteria. Because material ESG risks can undermine return over the long run and our index funds are essentially *permanent owners* of the companies in which our funds invest, Vanguard's Investment Stewardship team engages with companies to better understand how companies are addressing these material risks. Vanguard expects companies to disclose significant risks to shareholders, such as its carbon emissions; set a goal and strategy for mitigating those risks; and report on progress. The company's board should be fully engaged, monitoring progress and ensuring action. Although we want companies to mitigate material risks, we do not dictate strategy. Doing so would go against the concept of indexing.

The very nature of an index fund requires Vanguard to own *all* companies that compose the benchmark index, so divestment isn't a viable option for our funds and ETFs. Some of those firms will respond to our stewardship activities, adopt best practices, and demonstrate clear and measurable progress toward risk reduction. Other companies will be less proactive in mitigating material risks, but an index fund must hold them all. When a portfolio company has failed to address a material risk, we will use our vote to further encourage action to preserve shareholder value.

Our investment stewardship activities are the principal levers Vanguard uses to keep companies focused on building long-term value for index fund investors. Investment stewardship will remain a core capability for Vanguard, and we are committed to further investment in this critical function.

We *allocate* capital to sustainable returns in our active funds.

Because ESG matters can affect an entity's future revenues and liabilities, we expect managers of our active funds to incorporate ESG into their security selection. Most of our managers consider these factors even for products *without* an explicit ESG investment strategy. The industry regularly refers to this approach as ESG integration, and it is used in both fixed income and equity investing.

Active fixed income

ESG risk assessment is a fundamental element of Vanguard Fixed Income Group's bottom-up financial analysis for potential investments. Our team reviews the financial materiality of ESG risk and assesses whether the security's current valuation properly reflects that risk. Specifically, each investment is assigned an ESG risk rating based on the probability and impact of an ESG event. Portfolio managers use these ratings, along with a number of other factors, as they allocate investor capital to the investments with the best return prospects.

Active equity

The majority of Vanguard's active equity funds are managed by external firms. This approach provides us with diversity of thought and broader access to top talent. Each firm has its own philosophy and process, and most consider ESG factors when selecting securities. Our managers' teams of analysts regularly consider how social and environmental factors might affect a company's future earnings. Some use quantitative scoring models to screen their universe, while others leverage their in-depth interviews with management. For some investments, the "E" is a big factor, for others, the "S," and the "G" is in play for all. Beyond analyzing ESG risk of portfolio companies, our active managers may engage with a company to discuss their material ESG risks and the manager then votes their proxies accordingly.

We regularly assess how our external managers use ESG to inform their investment decisions, and their approaches evolve over time. We review how they gather ESG information, whether they employ dedicated analysts, and how those analysts interact with portfolio managers. All of our fund managers recognize it as a competitive advantage for driving excess return.

ESG-specific active equity

There are also funds that allocate capital to companies considered ESG "leaders" or ESG "improvers." For these portfolios, assessing ESG factors isn't simply part of their investment process, it is often central to the investment objective. Mandates for these funds can be broad or narrow. This type of investing is often called ESG inclusionary investing. Active management is currently our preferred approach for maximizing total return with ESG inclusionary portfolios. For example, Vanguard offers a U.S.-domiciled fund that invests only in companies with a strong return on capital and leading stewardship practices. We will expand our active ESG lineup as we identify active managers with a compelling edge.

We develop products that allow investors to avoid certain ESG risks.

Some investors simply don't want exposure to ESG risks or want to avoid companies that don't align with their values. Vanguard currently offers more than a dozen exclusionary (or negatively screened) ESG products across equity and fixed income across the globe. These products use transparent exclusion measures to remove certain companies from the investment universe based upon predetermined ESG screening criteria. The resulting products are diversified, market-capitalisation-weighted, and low cost, enabling individuals to use them as portfolio building blocks. Historically, the performance of these products tends to differ (positively or negatively) from that of the broad market over the short term, but it has not differed meaningfully over the long term. Not surprisingly, the industry calls these strategies ESG exclusionary investing.

We believe that, if left unchecked, ESG risks can undermine a company's future long-term value. We also believe that, over time, well-governed companies that mitigate material risks will outperform those that are poorly governed. That said, there is no right style of ESG investing, and the landscape continues to rapidly develop. For example, our research shows that historically, no single approach to ESG investing has produced statistically significant positive or negative alpha. Furthermore, currently there is no industry consensus on scoring criteria for ESG. The most important consideration in selecting an approach is unique to each investor. And, the tenets of diversification and low cost should never be sacrificed in building a portfolio. Vanguard will continue to evaluate ESG products while maintaining our deliberate approach to product development.

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ESG funds are subject to ESG investment risk, which is the chance that the stocks or bonds screened by the index provider for ESG criteria generally will underperform the market as a whole or, in the aggregate, will trail returns of other funds screened for ESG criteria. The index provider's assessment of a company, based on the company's level of involvement in a particular industry or the index provider's own ESG criteria, may differ from that of other funds or of the advisor's or an investor's assessment of such company. As a result, the companies deemed eligible by the index provider may not reflect the beliefs and values of any particular investor and may not exhibit positive or favorable ESG characteristics. The evaluation of companies for ESG screening or integration is dependent on the timely and accurate reporting of ESG data by the companies. Successful application of the screens will depend on the index provider's proper identification and analysis of ESG data.

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