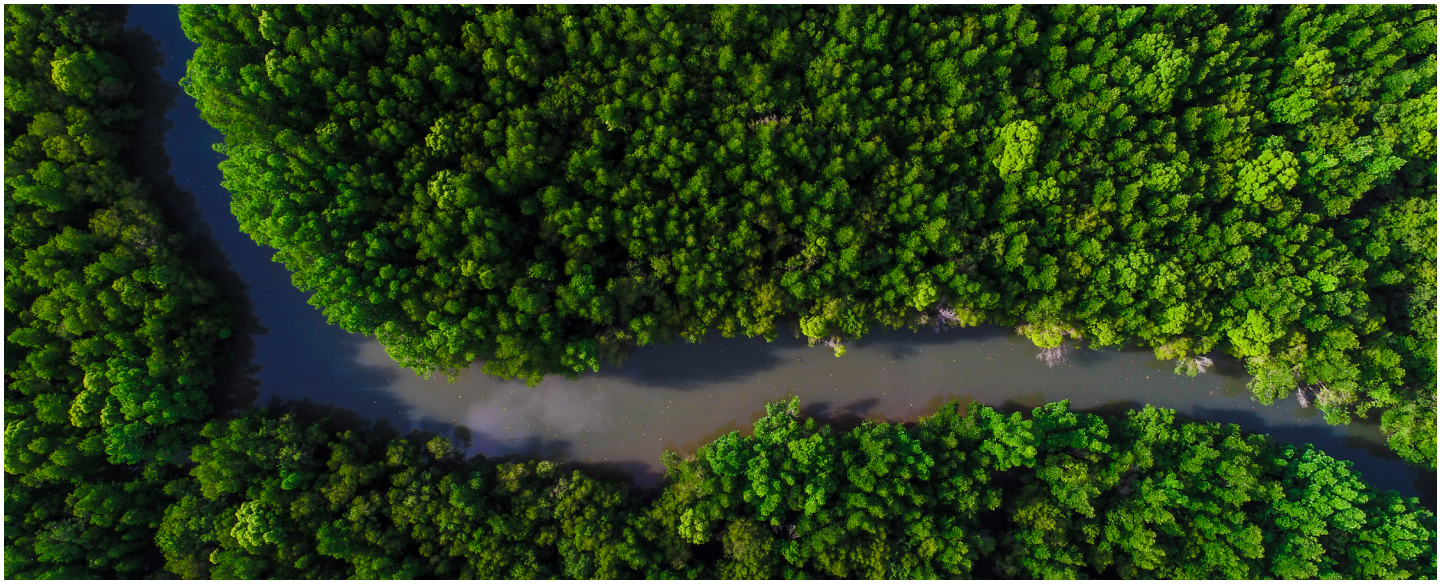

Principles *and* Performance®

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How to Avoid Greenwashing When Choosing ESG Investments

ESG strategies are rapidly gaining popularity as interest in supporting companies that manage their carbon footprints, invest in their employees and promote diversity surges. As more and more funds claim the ESG label, how can investors effectively decide which investments are genuine?

Avoiding Investments that Masquerade As ESG Choices

If you're seeking to align your financial investments with your values, your decisions about which funds to include in your portfolio take on an additional dimension of complexity. Naturally, you should look for funds that most closely align with your own principles. And, above all, you should take steps to avoid any ESG-labeled fund that does not diligently pursue its stated objectives.

A Practical Framework for Evaluating ESG Funds

Here are some steps you can take to perform effective ESG due diligence and avoid being misled by labels:

1. Read the prospectus and review the holdings. The prospectus should identify whether all the fund's holdings are evaluated using ESG metrics, or whether the fund simply employs screens to exclude a few types of companies, such as tobacco or gambling firms, but does not vet each company in the portfolio for broad ESG progress. The prospectus should also reveal whether a fund

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"considers" ESG or fully integrates ESG criteria into its investment process and portfolio construction. In addition, reviewing the holdings can provide insights about whether the Fund's portfolio aligns with the claims made by the fund company.

2. Learn about the fund's investment philosophy and process. Does the fund have a discernable ESG philosophy, and does the investment process include ESG analysis? Does the team perform their own ESG materiality assessment, or do they rely exclusively on third-party research providers for ESG ratings on companies? Do the portfolio managers and analysts actively buy into the ESG process, and are they truly engaged in assessing material ESG risks and opportunities?

3. Investigate what the portfolio managers seek to gain by choosing ESG-vetted investments. Do they consider ESG progress an indicator of company quality? Are they seeking to avoid material ESG risks?

4. Look for markers of stewardship excellence. Does the fund manager disclose their proxy voting decisions, and do these decisions align with their stated ESG values? Does the investment firm encourage positive change in portfolio companies through engagement with senior management? Does the firm maintain memberships in any independent organizations that promote ESG investing, such as Ceres or US SIF?

5. Consult third-party sources. For example, Morningstar has several ESG rating systems. The Morningstar Commitment Level qualitatively evaluates funds' commitments to ESG and rates them on a scale ranging from Leader to Low. The Morningstar Sustainability Rating measures how the companies held in portfolios are managing their ESG risk relative to the fund's Global Category peer group. Funds may also be given carbon scores by Morningstar.

The good news is that there are many more choices for ESG investors than ever before. However, because regulatory standards don't yet exist, it is important to do your own homework to make sure your financial investments match your values.