Insights
Environmental, Social & Governance (ESG)

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R-Factor™

Leveraging SASB to Build Sustainable Capital Markets

- **The mainstreaming of environmental, social and governance (ESG) investing is hindered by a market infrastructure problem: the lack of standardization and focus on financial materiality in ESG data. The Sustainability Accounting Standards Board (SASB) Materiality Map® and accounting standards are the solution to this challenge.**
- **In 2019, State Street Global Advisors launched R-Factor™, an ESG scoring system that leverages SASB and measures the performance of a company's business operations and governance as it relates to financially material ESG issues facing the company's industry.**
- **By incorporating R-Factor™ into our stewardship program, investment solutions and client reporting, we are using our position as a large global investor and a Principles for Responsible Investment signatory to help create sustainable capital markets.**

Why We Built R-Factor™: The Infrastructure Problem

At State Street Global Advisors, we believe that ESG issues can impact a company's ability to generate long-term sustainable performance. Consequently, we see the consideration of ESG issues as part of our fiduciary duty to clients. This fiduciary lens requires a laser focus on issues that impact companies' ability to create value — those issues that are financially material to the business.

For investment managers to consider ESG, they need access to good data: that which is financially material, consistently disclosed, and comparable within industries.

In 2017, we set out to understand the landscape of ESG data available to us. We found that the availability of high-quality, financially material and consistently reported ESG data represented one of the biggest challenges facing asset managers trying to meet the growing demand for sustainability-focused investing.

At first, we saw this as just a data challenge. We found a proliferation of third-party ESG data providers, each with its own methodology for scoring companies, often based on opaque frameworks. These methodologies were a reflection of the perspectives of each data provider — but differences in what each provider believed to be most important resulted in a low correlation of scores among the data providers. Lack of transparency into the methodologies and materiality frameworks made it challenging for investors to understand what the scores represented, or if their views on ESG aligned with those of the data provider. There was a clear lack of standardization in the market around what was considered financially material ESG information.

The real challenge to the mainstreaming of ESG into the investment process was not a data problem. It was a lack of market infrastructure. Companies and investors needed to agree upon a consistent and commonly accepted framework for which ESG issues were financially material. Additionally, companies needed guidance on how to measure and disclose information about those issues in a way that was standardized and relevant to investors.

Solving the Infrastructure Challenge: SSGA's Commitment to Building Sustainable Capital Markets

The easy way to address growing client interest in ESG would have been to just launch more products with the existing data, despite the challenges. But we wanted to explore whether if we could play a role in solving the infrastructure challenge more directly.

As a member of SASB's Investor Advisory Group (IAG), we saw that SASB was the solution to the infrastructure challenge.

Existing sustainability reporting frameworks that predated SASB were designed in response to ESG's roots in more values-based "socially responsible investing" (SRI). In contrast, SASB's Materiality Map provides guidance on which ESG issues are financially material to each of 77 industries, offering companies a road map of which issues matter most to the business. In addition, SASB's accounting standards provide guidance on the specific accounting metrics companies should disclose for each of those financially material ESG issues, encouraging standard data disclosure in the market. Together, we saw that the focus on financial materiality and accounting standards encourage standard data disclosure in the market, and could build the market infrastructure needed. What was missing was widespread adoption by both companies and investors.

We began to consider how we could amplify SASB's work and catalyze this widespread adoption. We were conscious of the fact that we play a unique role in capital markets. As one of the largest asset managers in the world, State Street Global Advisors has $2.95 trillion[1] in assets under management, a significant global footprint, senior leadership committed to ESG, and a strong stewardship program designed for impact. We knew we were well placed to leverage these qualities to help build more sustainable markets, and that this was a goal of the PRI — and so we began building a tool to do so.

Building R-Factor™

In late 2017, we began working with SASB to design and build an ESG scoring system that could address the ESG infrastructure challenge and bring about more sustainable markets. Because we see ESG as part of our fiduciary responsibility, we called the scoring system Responsibility Factor, or "R-Factor."

To address the existing challenges around ESG data, we designed the score with four foundational pillars:

1 **Focus on financial materiality.** Companies would be scored based only on the issues that matter most for their business.

2 **Build from commonly accepted, transparent materiality frameworks.** We leveraged SASB to help ensure that companies and investors would clearly understand what the scores were based on.

3 **Multiple data sources.** To increase coverage and minimize the bias of any one provider, we drew on the raw metrics of four different ESG data providers, mapping them to transparent materiality frameworks, including SASB's.

4 **Integration with stewardship.** Scores inform our voting and engagement. By providing companies with their R-Factor™ scores, we offer a road map for how to improve management and disclosure of the sustainability issues that matter most.

Together, the R-Factor™ score offers a view of how well a company manages its ESG issues, those that have a direct link to business performance, and are within a company's control.

Anatomy of an R-Factor™ Score

R-Factor™ has two subcomponents: ESG and Corporate Governance. We designed this to reflect the full set of sustainability risks and opportunities facing companies, and the reality that they need to be treated differently. ESG issues are market agnostic and industry specific: The effects of climate change do not stop at geographical borders, but they are likely to affect a consumer goods company differently than an oil company. In contrast, traditional corporate governance issues — things like executive compensation, shareholder rights and board accountability — are the inverse: market specific and industry agnostic. The business practices, governance structures and market expectations of firms vary widely across regions, and we believe it is important to hold companies to the standards appropriate to their market. R-Factor™ takes these nuances into account.

The ESG component of the R-Factor™ score leverages SASB's Materiality Framework by only using the metrics from three different ESG data providers (Sustainalytics, ISS-ESG and Vigeo Eiris) that map to the industry-specific issues identified by SASB as likely to be financially material. The Corporate Governance component leverages transparent region-specific corporate governance codes designed by regulators or investors as its core framework. It draws on the metrics from a fourth ESG data provider (ISS-Governance) and maps the financially material metrics for the company's headquartered region to that region's corporate governance code.

Financial Materiality in Practice

This approach means that scores are based only on financially material ESG information for a given company. R-Factor™ takes in a tremendous amount of ESG data, filtering it according to the ESG issues relevant to that company's industry according to SASB, as well as according to the relevant corporate governance code. Below, we offer an example of how R-Factor™ focuses on financial materiality in practice (see Figure 1).

- In a given month, we receive approximately 180 metrics from one of our three ESG data providers.
- Of these, our team determined that only 91 metrics were considered material according to any part of the SASB framework based on confirming with SASB the meaning and intention of the topics that appear in the SASB Materiality Map.
  - — Of the 91 metrics that are material to some element of the SASB Materiality Map, only 22 are material to the Asset Management and Custody Activities industry: three metrics for "Selling Practices and Product Labeling," four metrics for "Employee Engagement, Diversity and Inclusion," etc. We apply only these metrics to companies in this industry.
- We go through the same process with the two additional ESG data providers, filtering all initial metrics received to score companies only on what is financially material for them.

Figure 1 **Focus on Financial Materiality:** R-Factor™ maps data to SASB's Materiality Map

1. ESG Data[2]	Metrics
Total Number of Metrics Delivered by Data Provider #1	**180**
Number of Metrics Material to the SASB Framework	**91**

2. SASB General Issues[3]	Metrics
Environment	
Green House Gas Emissions	5
Air Quality	1
Energy Management	2
Water & Wastewater Management	2
Waste & Hazardous Materials Management	2
Ecological Impacts	3
Social Capital	
Human Rights & Community Relations	4
Customer Privacy	1
Data Security	0
Access & Affordability	6
Product Quality & Safety	4
Customer Welfare	2
Selling Practices & Product Labeling	3
Human Capital	
Labor Practices	6
Employee Health & Safety	4
Employee Engagement, Diversity & Inclusion	4
Business Model & Innovation	
Product Design & Lifecycle Management	9
Business Model Resilience	3
Supply Chain Management	11
Materials Sourcing & Efficiency	6
Physical Impacts of Climate Change	1
Leadership & Governance	
Business Ethics	4
Employee Engagement, Diversity & Inclusion	4
Competitive Behavior	1
Management of the Legal Regulatory Environment	3
Critical Incident Risk Management	2
Systemic Risk Management	2
Total	**91**

3. SASB General Issues[4]	Metrics
Asset Management & Custody Industry	
Selling Practices & Product Labeling	3
Employee Engagement, Diversity & Inclusion	4
Product Design & Lifecycle Management	9
Business Ethics	5
Systemic Risk Management	2
Total	**22**
Household & Personal Products Industry	
Water & Waste Management	2
Product Quality & Safety	4
Product Design & Lifecycle Management	9
Supply Chain Management	11
Total	**26**

Source: State Street Global Advisors, ESG Investing Team, as of August 20, 2019.
For illustrative purposes only.

Putting R-Factor™ Scores to Use

R-Factor™ scores were launched in April 2019 and are now being integrated across State Street Global Advisors. We use the scores in three main ways — stewardship, investment solutions and client reporting — all with the goal of creating an impact.

- **Stewardship** We screen companies for voting and engagement based on R-Factor™ scores. We also disclose companies' R-Factor™ scores to them, both during engagements and upon request. (Companies may request their score at this website.) Because the scores are based on publicly available frameworks, they provide boards and management teams with a road map for the specific ESG issues they should be focused on managing and disclosing to investors — as well as ideas about how to do so. This is a critical piece of addressing the infrastructure problem and bringing better-quality ESG data into the market for all investors.

- **Investment Solutions** R-Factor™ has been shared with all of our investment teams across equity and fixed income, both active and index. While our teams are integrating R-Factor™ into their investment solutions in a variety of ways, depending on specific investment styles, the score represents one firm-wide view on ESG. In addition, to support our goal of advancing sustainability across capital markets, it was important that we make R-Factor™ available to all investors, not just State Street's clients. That is why we were thrilled to learn that Bloomberg selected R-Factor™ to be the scoring system that powers Bloomberg's equity and fixed-income indices that launched in September 2019. The Bloomberg SASB ESG index family, which includes US large-cap equity and investment-grade corporate bond ESG indices, is designed to enhance capital flows to companies with superior ESG practices.

- **Client Reporting** Building sustainable capital markets also requires investors to develop a deeper understanding of which ESG issues are financially material to their portfolio companies. That is why we are integrating R-Factor™ into client reporting. This is spurring valuable conversations across our institutional client base about the ESG profiles of their portfolio companies and the ways that our clients can be more proactive in managing sustainability risk.

How R-Factor™ Makes an Impact

Since the launch of R-Factor™ in spring 2019, we have already begun to see the impact that it can have on capital markets. Almost immediately, we saw the impact on boards and management teams, as companies reached out to request their scores and information on how they can improve. To date, more than 100 companies across the globe have requested their scores, and we expect a significant increase in this over time. Internally, R-Factor™ has also further strengthened our stewardship program, facilitating richer conversations with portfolio companies. Just as we have in the past with Fearless Girl and our focus on climate, we are able to leverage our role in the market to create unique impact by focusing with companies on what matters.

The systemic impact of R-Factor™ will take longer but be even more profound. We expect that in the coming years, SASB will become a global standard for sustainability disclosure. Consequently, there will be a significant improvement in the quality of ESG data available to investors, as well as in companies' management of the ESG issues that matter most to business. Our clients are already inquiring about how they can show their support for more sustainable capital markets by investing in solutions powered by R-Factor™.

We look forward to the day when ESG investing has become mainstream investing, and we are proud to play a role in bringing this reality to life.

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Endnotes

1 AUM reflects approximately $43.96 billion (as of September 30, 2019), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

2 State Street Global Advisors receives 180 metrics from one of the three data providers powering the ESG component of the R-Factor™ score. (This process repeats for each of the three data providers.)

3 The R-Factor™ score leverages only the 91 metrics from that data provider that are material to the specific industry, according to the SASB Materiality Map.

4 For companies in a given industry, the score is powered only by the metrics relevant to the general issues that are financially material to that industry.

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third-largest asset manager, with US $2.95 trillion* under our care.

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