

ESG vs. Climate-Friendly Investing: What's the Difference?

Why the words we use to describe an investment matter

80%+

of 401(k) investors don't
know what ESG stands for¹

3 in 4

want their investments
to support a better
climate future²

74%

say values-aligned investment
options could lead them to save
more for retirement³

Climate-friendly investing and ESG investing are often treated as the same thing. They are not. ESG investing generally asks how environmental, social, and governance factors may affect a company's financial performance, while climate-friendly investing asks a different question: what impact are the companies in our portfolios having on the world? This distinction matters because investors deserve to understand what their money is actually doing. In this paper, we explain what ESG means, why the term can be confusing for everyday investors, what we mean by climate-friendly investing, and how Sphere puts that philosophy into practice through four principles: avoiding industries incompatible with a climate-safe future, maintaining broad diversification and low fees, using our shareholder votes to encourage long-term climate resilience, and being transparent about every decision we make.

What does ESG mean?

Beyond the acronym, which stands for Environment, Social, and Governance, there is no generally accepted definition of ESG investing. Each index or fund manager that uses the label ESG interprets the term differently.

The most common interpretation of ESG in investing, however, is inward-facing rather than outward-facing. Some of the biggest ESG indexes aim to reduce the risks posed to companies in their portfolios by environmental, social, and governance factors.⁴ For example, they increased the ESG rating of McDonald's when it installed recycling bins in its UK and France locations, because that reduced the risk posed to McDonald's of being sued for not complying with local recycling laws.⁵ The rating did not take into consideration the positive impact on the planet of having more trash directed towards recycling facilities, or the fact that McDonald's greenhouse gas emissions had increased over that time period.

¹ Sphere and Shlomo Benarzi, "ESG in 401(k)s," Research.net Survey, September 27, 2022. https://www.research.net/results/SM-R1hiLJSijdHcMo2rVExTow_3D_3D/

² Sphere and Shlomo Benarzi, "ESG in 401(k)s," Research.net Survey, September 27, 2022. https://www.research.net/results/SM-R1hiLJSijdHcMo2rVExTow_3D_3D/

³ O'Rourke, Jennifer Manser, "More 401K participants say having ESG options could inspire them to increase contribution rate: Participants want their investments to be aligned with their values," Schroders, April 11, 2022.

⁴ Makower, Joel: "The secret life of ESG ratings," Trellis, May 9, 2022. <https://trellis.net/article/secret-life-esg-ratings/>

⁵ Simpson, Cam, Akshat Rath, and Saijel Kishan, "The ESG Mirage: MSCI, the largest ESG rating company, doesn't even try to measure the impact of a corporation on the world. It's all about whether the world might mess with the bottom line," Bloomberg, December 10, 2021. <https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/>

Most ESG funds are not intended to reduce companies' impact on the planet. They are not measuring outward-facing metrics. They look inward to reduce the risks posed to the companies in their portfolios.

Despite this, most financial advisors present ESG funds to clients as being better for the planet. Over 85% of Americans who have 401(k)s believe ESG funds typically focus on the impact companies have on the planet.⁶ Learning that this is not the case often creates an impression among retail investors of greenwashing, when in reality ESG funds were never designed to meet demand for climate-friendly investing.

Most people have never heard of ESG

Beyond the technical definitions of ESG, a bigger issue with the category is that most people have never heard of it. In our survey of Americans who have 401(k)s, we gave them a multiple choice question asking what ESG stands for. Over 80% of respondents got the answer wrong. The most common answer was “Economic Stock Growth.”

ESG has become a charged topic among financial professionals, but the regular people who are their clients more often than not do not even know what it means.

Despite this, most people want to invest in a climate-friendly way. Among the Americans with 401(k) plans who responded to our survey, over three in four respondents cared about investing for a better climate future. In addition, according to a survey by Schroders, 74% of DC plan participants say they would or might increase their contribution rate if they were offered values-aligned options.⁷

What is climate-friendly investing?

There is no single definition of climate-friendly investing, but climate-friendly funds do generally focus on the impact that companies have on the world, rather than focusing inwardly on the impact that environmental risks can have on companies. This is a key distinction. Climate-friendly fund investment methodology typically aligns with how financial advisors present these funds to their clients, in that they work to invest in companies having a positive impact on climate change, or reducing their negative impact from externalities such as pollution.

One common approach of climate-friendly funds is to research stocks and select companies that are leading the climate transition. These funds are typically actively managed, often developing relationships with the management teams of the companies in the portfolio, assessing their likelihood of future growth, and making allocation decisions based on those assessments. These fund managers oftentimes also engage with management teams and the board to encourage them to take more action on climate, and when they are met with resistance, they sometimes submit shareholder proposals to demonstrate to the board how many shareholders care about these issues.

⁶ Sphere and Shlomo Benarzi, “ESG in 401(k)s,” Research.net Survey, September 27, 2022. https://www.research.net/results/SM-R1hiLJSijdHcMo2rVExTow_3D_3D/

⁷ O'Rourke, Jennifer Manser, “More 401K participants say having ESG options could inspire them to increase contribution rate: Participants want their investments to be aligned with their values,” Schroders, April 11, 2022. <https://www.schroders.com/en-us/us/local/media-center/more-401k-participants-say-having-esg-options-could-inspire-them-to-increase-contribute-rate/>

Actively managed climate funds can have a big impact on the planet by influencing companies to do better, by encouraging management teams to pay attention to the risks and opportunities presented by climate change, and by rewarding the companies that are leading the climate transition with more capital. This approach, however, may not be a fit for every investor. It can be an expensive way to run a fund, and these funds are often concentrated in one industry, which can make them prone to the market swings of that industry. It can be rare for them to have the resilience to cyclical industry dynamics that more diversified funds can offer.

How does Sphere invest in a climate-friendly way?

At Sphere, we offer climate-friendly funds that can meet demand for positive impact, while maintaining broad diversification across industries and low fees.

We do this by offering index funds with four core tenets: (1) do not charge a green premium, (2) diversify across all industries whose core line of business is compatible with a climate-safe future, (3) vote our shares at the companies we do invest in to encourage them to set themselves up for financial success given the changing climate, and (4) be transparent in everything we do.

We do not invest in fossil fuel companies

In launching Sphere, we saw demand for climate-friendly investing that could fit in the core sleeve of those saving for retirement. Investors did not want to have to trade off making savvy retirement investment choices with having to invest in companies that are threatening the planet that they plan to enjoy in retirement. Core to making this possible was a commitment to charging low fees.

We started by launching the Sphere 500 Fossil-Free Index. It starts with the 500 biggest companies in the US by market capitalization, and from that list it excludes fossil fuel companies, lead contributors to deforestation, private prison operators, weapons manufacturers, and tobacco companies. Despite older indexes having grown in popularity in recent decades, their default inclusion of harmful industries has hurt their performance. For example, the fossil fuel industry has had some of the worst long-term returns of any sector of the economy over the past 10, 15, and 20 years.

Starting with an index that is different from the status quo enables us to shift the conversation from one where we invest by default in the industries that have dominated the economy in the past, to how we invest by default in the industries that we want to dominate the economy of the future.

The reality is that electric cars are popular. The combination of solar, wind, and batteries is already less expensive than any kind of fossil fuel power generation in the US. These economic realities underlie the long-term decline of the fossil fuel industry.⁸

We found that our exclusions had minimal impact on index returns, and the Sphere 500 is 99% correlated to the S&P 500. Any variance over the long-term was slight outperformance when compared to the S&P 500.

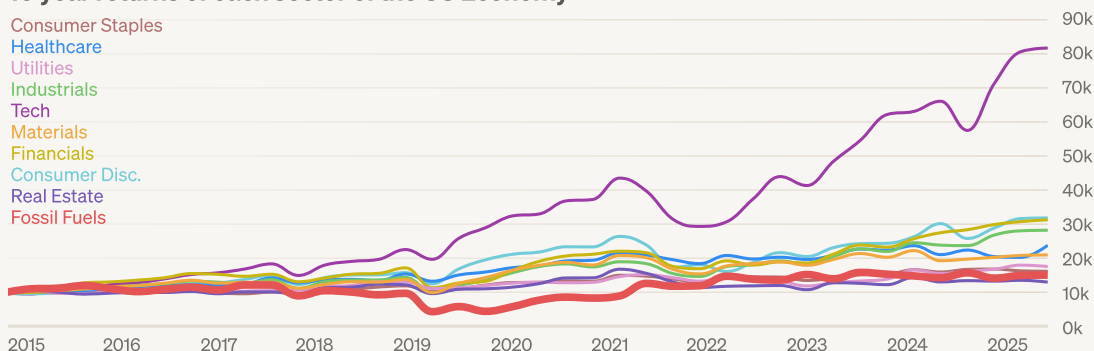
⁸ Chung, Connor and Dan Cohn, "Passive investing in a warming world," *Institute for Energy Economics and Financial Analysis*, Feb 8, 2024. <https://ieefa.org/resources/passive-investing-warming-world>

We vote our shares for the planet

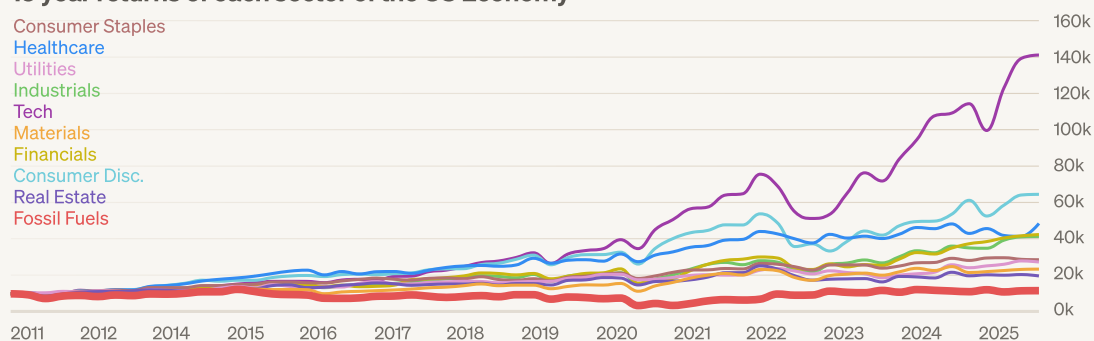
For the companies we do invest in, we vote our shares to set them up for financial success in a changing climate. This can mean encouraging them to install solar panels on facilities to reduce long-term energy costs, electrify fleets to reduce long-term fuel costs, or reassess whether giving loans for new fossil fuel development projects can be profitable over the lifetime of the loans, given the exponential growth in adoption of renewables. In each case, we have found that doing what is right for the planet has aligned with setting up companies for financial success.

Fossil fuels have underperformed

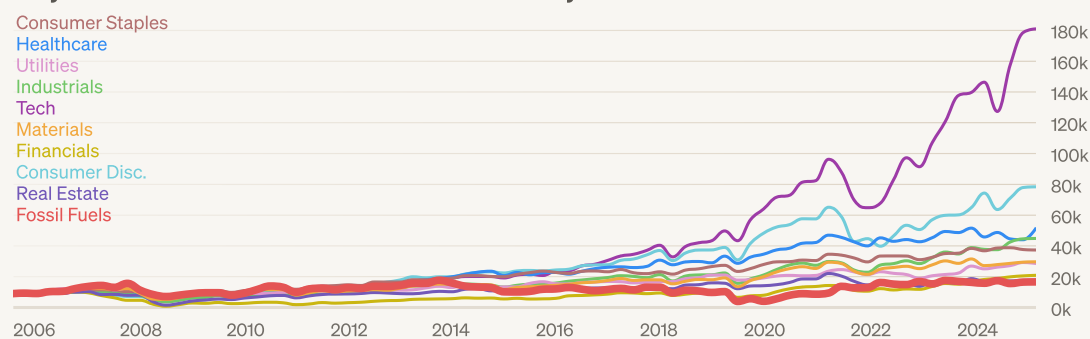
10 year returns of each sector of the US Economy



15 year returns of each sector of the US Economy



20 year returns of each sector of the US Economy



Source: S&P Global sector index total return data with dividends reinvested for the period starting 3/31/2005 and ending 3/17/2025. Fossil Fuel data is S&P Energy Sector data.

It is worth noting that we avoid a key conflict of interest in voting for the planet by not investing in fossil fuel companies. For fossil fuel companies to do better on climate, they by definition must do less of their core line of business. That presents a conflict of interest that we avoid as fiduciaries by not investing in those companies. For the companies that we do invest in, voting for them to do better on climate has meant setting them up for long-term financial success.

Conclusion

Climate-friendly investing does not have to mean choosing between positive impact and sound investment principles. It can mean building a diversified portfolio that reflects the economic realities of a changing climate, while keeping fees low and maintaining the transparency investors deserve.

That is the approach we take at Sphere. We use the word “climate” because it tells investors what they can expect from our funds: we consider the impact that companies have on the climate, not simply the climate-related risks those companies face. We exclude industries that are fundamentally incompatible with a climate-safe future, diversify across the companies and industries that are positioned to thrive in that future, and use our voice as shareholders to encourage the companies we invest in to make decisions that support their long-term financial success.

There is no single definition of climate-friendly investing, just as there is no single definition of ESG investing. What matters is that investors can understand what their money is doing and why. We believe that should be true of every investment product, but it is particularly important when a fund is marketed as reflecting an investor’s values.

Ultimately, climate-friendly investing should not require investors to become experts in financial jargon or to sacrifice the diversification and low costs that make an investment appropriate for a retirement portfolio. It should be straightforward: invest in the economy we want to see grow, avoid industries that are incompatible with that future, and use our ownership to help the companies we do invest in adapt and succeed.

At Sphere, transparency is how we make that commitment real. We want investors to know what they own, what they do not own, how we make those decisions, and how we use their shares once they are invested. For us, climate-friendly investing is not a label. It is a clear and accountable way of investing.

Before investing in the Sphere 500 Climate Fund (“the Sphere 500”), carefully consider the fund's investment objectives, risks, charges and expenses. To obtain a prospectus or summary prospectus which contains this and other information, please visit <https://oursphere.org/fund> or talk to your financial advisor. Read it carefully before investing. The Fund is distributed by Ultimius Fund Distributors, LLC

RISKS AND DISCLOSURE

As with all investments, there are risks involved with investing in the Sphere 500. Climate Investing Consideration Risk-Considerations related to climate risk, such as environmental criteria (e.g., fossil fuel screens), applied to the Index’s construction may limit the number of investment opportunities available to the Fund, and as a result, at times, the Fund may underperform funds that are not subject to similar investment restrictions. For example, the Index may exclude certain securities due to climate-focused considerations when other investment considerations would suggest that investing in such securities would be advantageous. The Fund may also underperform funds that invest in the energy and utilities sectors, particularly in times of rising oil, gas and energy prices. Other risks include, but are not limited to general market risk, small fund risk, large cap risk, common stock risk, sector risk, industry concentration risk, passive investment risk, index calculation risk, limited operating history risk, cybersecurity risk, tracking error risk, operation risk, and third-party data risks as it relates to the composition of the Index. For a detailed explanation of the risks associated with the Sphere 500 and the underlying Index, please read the prospectus.