IQ Candriam ESG International Equity ETF (IQSI)

Examining ESG Controversies: Volkswagen's "Dieselgate" Scandal

WHAT IS AN ESG CONTROVERSY?

From time to time, a company may become involved in an "ESG controversy"—an event that occurs when a company's activity produces egregiously negative environmental, social, or governance (ESG) related effects.

Identifying and responding to these controversies can be critical to a portfolios' success. CANDRIAM, a pioneer in ESG and sustainable investing since 1996, uses a proprietary framework to understand ESG risks and identify companies that they believe are positioned to benefit in the future.

In this case study, we explore CANDRIAM's response to the Volkswagen "Dieselgate" scandal and the resulting impact on the IQ Candriam ESG International Equity Index, which serves as the benchmark for the passively managed IQ Candriam ESG International Equity ETF (IQSI) portfolio.

CASE STUDY: VOLKSWAGEN'S "DIESELGATE"

Between 2006 and 2015, Volkswagen faked emissions results, using software intended to enable vehicles to pass regulatory lab tests. The real emissions were several times the permissible limits. This incident affected approximately 580,000 vehicles, and as of June 2020, the company had spent $33.3 billion in fines, penalties, financial settlements, and buyback costs.[1]

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CANDRIAM'S RESPONSE TO DIESELGATE

On September 18, 2015, immediately upon news of the controversy, CANDRIAM's ESG analysts reviewed the facts and **decided to exclude Volkswagen from the IQ Candriam International Equity Index**, reflecting their conviction that this controversy could have fat ranging consequences for the company and auto industry overall.

Fortunately for Volkswagen, Dieselgate occurred just as the industry was undergoing a major transition. Fueled by concerns about CO_2 emissions, interest in electric vehicles began to soar, providing Volkswagen an opportunity to quickly redeem itself in the eyes of ESG investors. **The company responded with a massive investment in battery technology** starting in 2018, including a $300 million investment in U.S. solid-state battery start-up Quantum-Scape,[2] with the goal of overtaking Tesla as the premier electric vehicle manufacturer before 2025.

By 2020, after a careful review of pending litigation and corporate filings, CANDRIAM's ESG analysts determined that Volkswagen had largely put Dieselgate behind it and **decided to return the company to its investment list and reintegrate it into the IQ Cadnriam ESG International Equity Index**, the benchmark for the passively managed IQSI.

A CONTRARIAN VIEW

CANDRIAM decided to no longer exclude Volkswagen from the Index even though most ESG ratings providers still rated Volkswagen as being in violation of the UN Global Compact Principles — why? Aside from Volkswagen's pivot on environmental issues, many other reasons supported the case to not exclude the stock from our sustainable portfolios, including:

A DOMINANT BUSINESS PROFILE:

- The company is the world's largest auto manufacturer, with strong brands (Volkswagen, SKODA, SEAT, Audi, Bentley, Lamborghini, Bugatti, and Porsche).
- The company enjoys a well-established market position in Western Europe and China.
- The company has a strong record of frequent and successful product launches.

POSITIVE ENVIRONMENTAL DEVELOPMENTS:

- 50% of Volkswagen's five-year plan for capital expenditure and research and development is going into electric vehicles.
- Because the company's battery production has a lower carbon impact than its peers, the vehicles' lifetime carbon footprint is also lower.

FAVORABLE REGULATION:

- EU regulation on auto CO_2 emissions has allowed Volkswagen to take the No. 1 spot in electric car sales.[3]
- The U.S. regulatory framework is supportive of Volkswagen's transition to low emissions and electric vehicles.

IMPACT

Volkswagen was added back to the IQ Candriam ESG International Equity Index in December 2020. In contrast, the iShares ESG Aware MSCI EAFE ETF (ESGD) did not reinstate Volkswagen until May 2021. **During the period from December 2020 to May 2021, shares of Volkswagen rose 74%**. IQSI is a well-diversified portfolio, so Volkswagen's impressive run during this period did not have an outsized impact on IQSI's overall performance. However, we believe this example illustrates the potential value of CANDRIAM's proprietary approach.

IQSI CAPTURED VOLKSWAGEN'S RECOVERY AHEAD OF ESGD

August 1, 2020 — July 31, 2021

Source: Morningstar Direct, July 31, 2021. Past performance is no guarantee of future results, which will vary.

Click on the fund names for the most current fund page, which includes the prospectus, investment objectives, performance, risk, and other important information.Returns represent past performance which is no guarantee of future results. Current performance may be lower or higher. Investment return and principal value will fluctuate, and shares, when redeemed, may be worth more or less than their original cost. Visit nylinvestments.com/funds and for the most recent month-end performance. Performance data quoted represents past performance. Past performance is no guarantee of future results.

The Volkswagen example above is shown for illustrative purposes only to provide an example of CANDRIAM'S ESG process. The chart includes the past performance of Volkswagen to illustrate that Volkswagen wasn't held in the portfolio during the listed time period. No comparison should be made between the performance of Volkswagen and the fund listed , which have fees and expenses and multiple holdings that could have helped or hurt performance. IQSU should never be purchased based on an individual holding.

IDENTIFYING ESG CONTROVERSIES

Standards for corporate sustainability are generally set by the United Nation's Global Compact[6] Principles, which focus on:

- **Supporting and respecting human rights**
- **Promoting greater environmental responsibility**
- **Eliminating forced labor, child labor, and discrimination in employment**
- **Opposing corruption in all forms, including extortion and bribery**

ESG controversies arise when a company fails to comply with these principles. In addition to reputational damage, controversies can result in costly product recalls, financial penalties, and remediation. A tarnished reputation can hurt sales: A study of 141 serious ESG incidents found that 49% resulted in slower revenue growth, and 24% produced a revenue decline.[7]

EXAMPLES OF ESG CONTROVERSIES

BRITISH PETROLEUM	CONSEQUENCES
Deepwater Horizon oil spill by a BP-operated oil rig in the Gulf of Mexico (2010)	In 2011, BP agreed to provide up to **$1 billion** for restoration projects in the Gulf of Mexico

WELLS FARGO	CONSEQUENCES
Wells Fargo account fraud scandal (2016)	In 2020, Wells Fargo was forced to pay a **$3 billion** fine to settle a civil lawsuit and a criminal prosecution.

BOEING	CONSEQUENCES
Boeing 737 Max crashes in Indonesia and Ethiopia due to a series of failures in the plane's design and a lack of transparency on the part of Boeing's management (2019)	In January 2020, Boeing estimated a loss of **$18.4 billion** for 2019, and it reported 183 canceled MAX orders for the year.

CANDRIAM'S PROPRIETARY APPROACH TO ESG CONTROVERSIES

While third-party ratings providers such as MSCI and Sustainalytics investigate ESG controversies, CANDRIAM conducts assessments of its own, applying "norms-based analysis"[8] to investment portfolios to determine whether a company's operations, governance practices, or products and services violate national or international laws, regulations, or other commonly accepted global norms.

1. Source: *Volkswagen Probed by States Over Pollution Cheating*, www.bloomberg.com, September 22, 2015.

2. Source: Volkswagen Group, as of June 2020.

3. Source: EU-EVs, as of November 2021.

4. Volkswagen announced the exclusion and subsequent reincorporation themselves; Source: MSCI, *Volkswagen scandal underlines need for ESG analysis,* as of July 31, 2021.

5. Marker represents when MSCI reinstated VW back into the ESGD portfolio. Source: Morningstar Direct, as of July 30, 2021.

6. The UNGC is a strategic initiative that supports global companies that are committed to responsible business practices in the areas of human rights, labor, the environment, and corruption. https://www.unglobalcompact.org/what-is-gc/mission/principles.

7. Source: MSCI Research, *Have corporate controversies in uenced consumer behavior?*

8. Norms based analysis: The purpose of the norms-based analysis is to determine whether a company complies with the universal principles set forth in the United Nations Global Compact (UNGC). Any company which voluntarily complies with the UNGC undertakes to respect human rights, apply labour law standards, protect the environment and combat corruption. This additional analysis makes sure the companies comply with the principal international treaties and conventions.

The IQ Candriam ESG International Equity Index is designed to deliver exposure to equity securities of companies meeting environmental, social and corporate governance (ESG) criteria developed by CANDRIAM and weighted using a market-capitalization weighting methodology. The **MSCI EAFE® Index** consists of international stocks representing the developed world outside of North America. Sustainable equity funds invest in companies that meet certain ESG (environmental, social, and governance) criteria. **ESG Investing Style Risk:** Impact investing and/or Environmental, Social and Governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating. There is no assurance that employing ESG strategies will result in more favorable investment performance.

Top Holdings* (%)	
Nestle SA-Reg	2.51
ASML Holding NV	2.43
Roche Holding AG-Genusschein	2.02
Toyota Motor Corp.	1.58
Novo Nordisk A/S-B	1.24
Astrazeneca PLC	1.19
AIA Group Ltd	1.10
Unilever PLC	1.09
Sony Group Corp.	1.08
SAP Se	1.07

*Data as of 9/30/21. Percentages based on total net assets and subject to change without notice.

About risk

Before considering an investment in the Fund, you should understand that you could lose money. As with all investments, there are certain risks of investing in the Fund. The Fund's Shares will change in value and you could lose money by investing in the Fund.

The Fund is a new fund. As a new fund, there can be no assurance that it will grow to or maintain an economically viable size, in which case it may experience greater tracking error to its Underlying Index or it could ultimately liquidate.

The Fund employs a "passive management" investment approach designed to track the performance of the Underlying Index. There is no guarantee that the Fund's investment results will have a high degree of correlation to those of the Underlying Index or that the Fund will achieve its investment objective.

The Underlying Index seeks to provide exposure to the equity securities of companies meeting environmental, social and corporate governance investing criteria and the Fund may forgo some market opportunities available to funds that do not use these criteria. The application of environmental, social and corporate governance investing may impact the Fund's relative investment performance. There is no guarantee that the construction methodology of the Underlying Index will accurately provide exposure to issuers meeting environmental, social and corporate governance criteria.

Investments directly in foreign (non-U.S.) currencies or in securities that trade in, and receive revenues in, foreign (non-U.S.) currencies are subject to the risk that those currencies will decline in value relative to the U.S. dollar. Investments in the securities of non-U.S. issuers involve risks beyond those associated with investments in U.S. securities, including greater market volatility, the availability of less reliable financial information, higher transactional and custody costs, taxation by foreign governments, decreased market liquidity and political instability.

Small- and mid-capitalization companies may be more vulnerable to adverse general market or economic developments, and their securities may be less liquid and may experience greater price volatility than larger, more established companies.

The IQ Candriam ESG International Index was developed by IndexIQ LLC with Candriam Belgium S.A. acting as index consultant to IndexIQ LLC.

Consider the Fund's investment objectives, risks, charges and expenses carefully before investing. The prospectus and the statement of additional information include this and other relevant information about the Fund and are available by visiting nylinvestments.com/etfs or calling 888-474-7725. Read the prospectus carefully before investing.

Fund shares are not individually redeemable and will be issued and redeemed at their NAV only through certain authorized broker-dealers in large, specified blocks of shares called "creation units", and otherwise, can be bought and sold only through exchange trading. Creation units are issued and redeemed principally in-kind.

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