

# **MSCI WORLD ESG FOCUS LOW CARBON SCREENED INDEX METHODOLOGY**

**February 2024**

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## 1 Introduction

The MSCI World ESG Focus Low Carbon Screened Index<sup>1</sup> (the 'Index') is designed to maximize exposure to positive environmental, social and governance (ESG) factors while minimizing carbon exposure and targeting risk and return characteristics similar to those of the MSCI World Index (the 'Parent Index')

The Index is constructed by selecting constituents of MSCI World index (the 'Parent Index') through an optimization process that aims to maximize exposure to ESG factors under a tracking error budget and reduce carbon exposure by 50% with respect to the Parent Index under certain constraints.

The Index aims to be sector-diversified and target companies with high ESG ratings in each sector.

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<sup>1</sup> The Index is governed by a set of methodology and policy documents ("Methodology Set"), including the present index methodology document. Please refer to Appendix V for more details.

## 2 Constructing the Index

The Index uses company ratings and research provided by MSCI ESG Research<sup>2</sup> for the Index construction.

Constructing the Index involves the following steps:

- Defining the Eligible Universe
- Defining the Carbon Exposure of each security in the Eligible Universe
- Defining the Optimization Constraints
- Determining the Optimized Index
- Treatment of Unrated Companies

The steps mentioned above are defined in detail in the sections below.

### 2.1 Defining the Eligible Universe

The Eligible Universe is constructed from the constituents of the Parent Index by excluding securities based on the exclusion criteria listed below:

- **ESG Controversy:** All companies assessed as having involvement in ESG controversies that are classified as Red Flags (MSCI ESG Controversy Score of 0). A Red Flag indicates an ongoing, Very Severe ESG controversy implicating a company directly through its actions, products, or operations.
- **Tobacco:** All companies classified as “Producer” or deriving 15% or more aggregate revenue from the production, distribution, retail and supply of tobacco-related products.
- **Controversial Weapons:** All companies involved in Controversial Weapons as defined in the description of the screens in Appendix 1.
- **Nuclear Weapons:** All companies involved meeting specific Nuclear Weapons business involvement criteria as described in Appendix 1.
- **Civilian Firearms:**
  - All companies classified as “Producer” of firearms and small arms ammunitions for civilian markets. It does not include companies that cater to the military, government, and law enforcement markets.
  - All companies deriving 5% or more revenue from the distribution (wholesale or retail) of firearms or small arms ammunition intended for civilian use

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<sup>2</sup> See section 4 for further information regarding ESG and climate data used in the Index that MSCI Limited sources from MSCI ESG Research LLC, a separate subsidiary of MSCI Inc. MSCI ESG Research is solely responsible for the creation, determination and management of such data. MSCI Limited is the benchmark administrator for the MSCI indexes.

- Thermal Coal: All companies deriving 30% or more revenue (either reported or estimated) from the mining of thermal coal (including lignite, bituminous, anthracite and steam coal) and its sale to external parties. It excludes revenue from metallurgical coal; coal mined for internal power generation (e.g. in the case of vertically integrated power producers); intra-company sales of mined thermal coal; and revenue from coal trading (either reported or estimated)
- All companies which have been deemed to have failed to comply with the UN Global Compact Principles (which cover human rights, labour standards, the environment and anti-corruption),

## 2.2 Defining the Carbon Exposure of each security in the Parent Index

The carbon exposure of a security is measured in terms of its greenhouse gas emissions and its potential carbon emissions from fossil fuel reserves. The MSCI World ESG Focus Low Carbon Screened Index uses MSCI Climate Change Metrics data from MSCI ESG Research<sup>3</sup> to determine eligibility for index inclusion.

### 2.2.1 Greenhouse Gas Emissions

MSCI ESG Research collects company-specific direct (Scope 1) and indirect (Scope 2) greenhouse gas emissions data from company public documents and/or the Carbon Disclosure Project. If a company does not report GHG emissions, then MSCI ESG Research estimates Scope 1 and Scope 2 GHG emissions. The data is updated on an annual basis. Since the current carbon emissions of a company are directly influenced by its current business activity, MSCI normalizes for size by dividing the annual carbon emissions of the company by the annual sales of the company.

For newly added companies to the Index which do not report emission data and where MSCI ESG Research has not estimated the greenhouse gas emissions yet, MSCI uses the average emissions per dollar of issuer market capitalization for the companies in the same industry group, multiplied by the market capitalization of the company as the estimated emissions for the company.

### 2.2.2 Potential Emissions from Fossil Fuels

MSCI ESG Research collects fossil fuel reserves data where relevant for companies which have reserves, typically in the Oil & Gas, Coal Mining and Electric Utilities industries<sup>4</sup>. Fossil fuel reserves can be used for several applications including energy or industrial purposes (e.g. coking coal used for steel production). For the construction of the MSCI Global Low Carbon Leaders Core Indexes, only fossil fuel reserves used for energy purposes are taken into account. The data is updated on an annual basis based on information disclosed by companies. Sources include company publications, other public records and third party data providers. For newly added companies to the index where

<sup>3</sup> See section 4 for further information regarding ESG and climate data used in the Indexes that MSCI Limited sources from MSCI ESG Research LLC, a separate subsidiary of MSCI Inc. MSCI ESG Research is solely responsible for the creation, determination and management of such data. MSCI Limited is the benchmark administrator for the MSCI indexes.

<sup>4</sup> For more information on MSCI Climate Change Metrics, please refer to <https://www.msci.com/climate-change-solutions>

data is not available yet, MSCI uses zero fossil fuel reserves. MSCI normalizes for the company's size by dividing the potential carbon emissions of the company by its market capitalization.

To convert reserves data to potential carbon emissions, MSCI ESG Research applies a formula from the Potsdam Institute for Climate Impact Research.<sup>5</sup>

## 2.3 Defining the Optimization Constraints

The index is optimized to maximize exposure to positive ESG factors and minimize carbon exposure (carbon emissions intensity and potential emissions) by at least 50% relative to the MSCI World Index for a given tracking error budget and subject to maintaining risk and return characteristics similar to the Parent Index. The ex-ante tracking error target for the MSCI World ESG Focus Low Carbon Screened Index is 0.5%.

ESG scores are normalized and used in the optimization process. The normalization of the ESG scores is designed to allow the optimization process to assess each score in the context of the overall distribution of ESG scores.

Please refer to Appendix 2 for the Optimization constraints.

## 2.4 Determining the Optimized Portfolio

The Index is constructed using MSCI's Barra® Open Optimizer in combination with the relevant Barra Equity Model<sup>6</sup>. The optimization uses a universe of eligible securities and the specified optimization objective and constraints to determine the constituents of the MSCI World ESG Focus Low Carbon Screened Index.

## 2.5 Treatment of Unrated Companies

Companies not assessed by MSCI ESG Research on data for any of the following MSCI ESG Research products are not eligible for inclusion in the Indexes.

- MSCI ESG Ratings
- MSCI ESG Controversies

For the treatment of unrated companies in the calculation of target metrics for the optimization, please refer to Appendix 3.

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<sup>5</sup> Malte Meinshausen, Nicolai Meinshausen, William Hare, Sarah C. B. Raper, Katja Frieler, Reto Knutti, David J. Frame & Myles R. Allen. *Greenhouse-gas emission Target for limiting global warming to 2 °C*. **Nature** 458, 1158-1162 (30 April 2009) | doi:10.1038/nature08017; Received 25 September 2008; Accepted 25 March 2009. Supplementary Information, p. 7.

<sup>6</sup> Please refer to Appendix II for the detailed information on model usage

## 3 Maintaining the Index

### 3.1 Quarterly Index Reviews

The Index is rebalanced on a quarterly basis to coincide with the regular Index Reviews (Semi-Annual Index Reviews in May and November and Quarterly Index Reviews in February and August) of the MSCI Global Investable Market Indexes. Changes are implemented at the end of February, May, August and November. The pro forma indexes are in general announced nine business days before the effective date.

ESG Scores used for the Quarterly Index Reviews will be taken as of the end of the month preceding the Index Review, i.e., January, April, July and October.

At each Index Review, the optimization process outlined in Section 3 is implemented.

In general, MSCI uses MSCI ESG Research data (including MSCI ESG Ratings, MSCI ESG Controversies Scores, MSCI Business Involvement Screening Research, and MSCI Climate Change Metrics) as of the end of the month preceding the Index Reviews. For some securities, such data may not be published by MSCI ESG Research by the end of the month preceding the Index Review. For such securities, MSCI will use ESG data published after the end of month, when available.

### 3.2 Ongoing Event-Related Maintenance

The general treatment of corporate events in the Index aims to minimize turnover outside of Index Reviews. The methodology aims to appropriately represent an investor's participation in an event based on relevant deal terms and pre-event weighting of the index constituents that are involved. Further, changes in index market capitalization that occur as a result of corporate event implementation will be offset by a corresponding change in the Variable Weighting Factor (VWF) of the constituent.

The following section briefly describes the treatment of common corporate events within the Index

No new securities will be added (except where noted below) to the Index between Index Reviews. Parent Index deletions will be reflected simultaneously.

**EVENT TYPE**

**EVENT DETAILS**

**New additions to the Parent Index**

A new security added to the Parent Index (such as IPO and other early inclusions) will not be added to the index.

**Spin-Offs**

All securities created as a result of the spin-off of an existing Index constituent will be added to the Index at the time of event implementation. Reevaluation for continued inclusion in the Index will occur at the subsequent Index Review.

**Merger/Acquisition**

For Mergers and Acquisitions, the acquirer’s post event weight will account for the proportionate amount of shares involved in deal consideration, while cash proceeds will be invested across the Index.

If an existing Index constituent is acquired by a non-Index constituent, the existing constituent will be deleted from the Index and the acquiring non-constituent will not be added to the Index.

**Changes in Security Characteristics**

A security will continue to be an Index constituent if there are changes in characteristics (country, sector, size segment, etc.) Reevaluation for continued inclusion in the Index will occur at the subsequent Index Review.

Further detail and illustration regarding specific treatment of corporate events relevant to this Index can be found in the MSCI Corporate Events Methodology book under the sections detailing the treatment of events in Capped Weighted and Non-Market Capitalization Weighted indexes.

The MSCI Corporate Events methodology book is available at: <https://www.msci.com/index-methodology>.



## 4 MSCI ESG Research

The Indexes are products of MSCI Inc. that utilize information such as company ratings and research produced and provided by MSCI ESG Research LLC (MSCI ESG Research), a subsidiary of MSCI Inc. In particular, the Indexes use the following MSCI ESG Research products: MSCI ESG Ratings, MSCI ESG Controversies, MSCI ESG Business Involvement Screening Research and MSCI Climate Change Metrics. MSCI Indexes are administered by MSCI Limited.

### 4.1 MSCI ESG Ratings

MSCI ESG Ratings aim to measure entities' management of environmental, social and governance risks and opportunities. MSCI ESG Ratings use a weighted average key issue calculation that is normalized by industry to arrive at an industry-adjusted ESG score (0-10), which is then translated to a seven-point scale from 'AAA' to 'CCC', indicating how an entity manages relevant key issues relative to industry peers.

The MSCI ESG Ratings methodology can be found at: <https://www.msci.com/esg-and-climate-methodologies>.

### 4.2 MSCI ESG Controversies

MSCI ESG Controversies provides assessments of controversies concerning the negative environmental, social, and/or governance impact of company operations, products and services. The evaluation framework used in MSCI ESG Controversies is designed to be consistent with international norms represented by the UN Declaration of Human Rights, the ILO Declaration on Fundamental Principles and Rights at Work, and the UN Global Compact. MSCI ESG Controversies Score falls on a 0-10 scale, with "0" being the most severe controversy.

The MSCI ESG Controversies methodology can be found at: <https://www.msci.com/esg-and-climate-methodologies>.

### 4.3 MSCI ESG Business Involvement Screening Research

MSCI ESG Business Involvement Screening Research (BISR) aims to enable institutional investors to manage environmental, social and governance (ESG) standards and restrictions reliably and efficiently.

For more details on MSCI ESG Business Involvement Screening Research, please refer to [http://www.msci.com/resources/factsheets/MSCI\\_ESG\\_BISR.pdf](http://www.msci.com/resources/factsheets/MSCI_ESG_BISR.pdf).

## 4.4 MSCI Climate Change Metrics

MSCI Climate Change Metrics provide climate data & tools to support institutional investors seeking to integrate climate risk & opportunities into their investment strategy and processes. This includes investors seeking to achieve a range of objectives, including measuring and reporting on climate risk exposure, implementing low carbon and fossil fuel-free strategies, alignment with temperature pathways and factoring climate change research into their risk management processes, in particular through climate scenario analysis for both transition and physical risks.

The dataset spans across the four dimensions of a climate strategy: transition risks, green opportunities, physical risks and 1.5° alignment.

For more details on MSCI Climate Change Metrics, please refer to <https://www.msci.com/climate-solutions>.

## Appendix I: Controversial Weapons and Nuclear Weapons Screening Criteria

### Controversial Weapons Involvement

- Cluster Bombs: MSCI ESG Research’s cluster bomb research identifies public companies that are involved in the production of cluster bombs and munitions, or the essential components of these products.
- Landmines MSCI ESG Research’s landmines research identifies public companies that are involved in the production of anti - personnel landmines, anti-vehicle landmines, or the essential components of these products.
- Depleted Uranium Weapons: MSCI ESG Research’s depleted uranium weapons research identifies public companies involved in the production of depleted uranium weapons and armor.
- Chemical and Biological Weapons: MSCI ESG Research’s chemical and biological weapons research identifies public companies that are involved in the production of chemical and biological weapons, or the essential components of these products.
- Blinding Laser Weapons: MSCI ESG Research’s blinding laser weapons research identifies public companies that are involved in the production of weapons utilizing laser technology to cause permanent blindness.
- Non-Detectable Fragments: MSCI ESG Research’s non-detectable fragments research identifies public companies that are involved in the production of weapons that use nondetectable fragments to inflict injury.
- Incendiary Weapons (White Phosphorus): MSCI ESG Research’s incendiary weapons research identifies companies that are involved in the production of weapons using white phosphorus.

Involvement criteria:

- Producers of the weapons
- Producers of key components of the weapons (only applies to cluster bombs, landmines, depleted uranium weapons as well as chemical and biological weapons)
- Ownership of 20% or more of a weapons or components producer

The minimum limit is raised to 50% for financial companies having an ownership in a company that manufactures controversial weapons or key components of controversial weapons.

- Owned 50% or more by a company involved in weapons or components production.
- Revenue limits: Any identifiable revenues, i.e., zero tolerance

For details please refer to MSCI Global ex Controversial Weapons Indexes Methodology at <https://www.msci.com/index-methodology>

### **Nuclear Weapons Involvement**

- All companies that manufacture nuclear warheads and/or whole nuclear missiles.
- All companies that manufacture components that were developed or are significantly modified for exclusive use in nuclear weapons (warheads and missiles)
- All companies that manufacture or assemble delivery platforms that were developed or significantly modified for the exclusive delivery of nuclear weapons
- All companies that provide auxiliary services related to nuclear weapons o All companies that manufacture components that were not developed or not significantly modified for exclusive use in nuclear weapons (warheads and missiles)
- All companies that manufacture or assemble delivery platforms that were not developed or not significantly modified for the exclusive delivery of nuclear weapons
- All companies that manufacture components for nuclear-exclusive delivery platforms

## Appendix II: Optimization Constraints

At each Quarterly Index Review, the following optimization constraints are used to ensure replicability and investability:

### Optimization Constraints

No.	Parameter	Values
1	Ex-Ante Tracking Error	0.5%
2	Min Constituent Weight	0.1%
3	Constituent Active Weight	+/-2%
4	Security Weight as a Multiple of its weight in the Parent Index	20
5	Active Sector Weights	+/-5%
6	Active Country Weights*	+/-5%
7	Minimum Reduction in the Carbon Emission Intensity relative to the Parent Index	50%
8	Minimum Reduction in the Potential Emissions per dollar of market capitalization relative to the Parent Index.	50%
9	One Way Turnover during May and November Index Review	10%
10	One Way Turnover during Feb and Aug Index Review	5%
11	Specific Risk Aversion	0.075
12	Common Factor Risk Aversion	0.0075

\* Active Country Weights – In case there are countries in the MSCI World Index which weigh less than 2.5% in the MSCI World Index, then for such countries the active country upper bound of +5% is not applicable. When a country weighs less than 2.5% in MSCI World Index then the upper bound of country weight in the MSCI World ESG Focus Low Carbon Screened Index is set at three times of the country’s weight in MSCI World Index.

**Infeasible Solution** - During the Quarterly and Semi-Annual Index Reviews, in the event that there is no optimal solution that satisfies all the optimization constraints the following process is followed:

- First, the turnover constraint is relaxed up to a maximum level of 30% in steps of 1% until an optimal solution is found.
- If a feasible solution is not found in step 1, then the turnover constraint is reset to its original level and the predicted tracking error is relaxed by 0.1%.
- If a feasible solution is not found in step 2, then the predicted tracking error is maintained at its level from step 2 and the turnover constraint is relaxed up to a maximum level of 30% in steps of 1% until an optimal solution is found.
- If a feasible solution is not found in step 3, then steps 2 and 3 are repeated iteratively until an optimal solution is found. The predicted tracking error cannot exceed a maximum of 5 times of the original predicated tracking error.
- In the event that a feasible solution is not found at the maximum predicted tracking error and turnover levels, the Index will not be rebalanced for that index review.

The Carbon Emission Intensity and the Potential Emissions per dollar of market capitalization of the Index are calculated using the formulae defined in Appendix III.

## Appendix III: Calculation of Carbon Exposure Metrics

### Greenhouse Gas (GHG) Emissions Intensity

Carbon emissions of a company are normalized for size by dividing annual carbon emissions by Sales. The Carbon Emissions Intensity is calculated using the latest Scope 1+2 carbon emissions, and Sales of a company.

Security Level GHG Intensity relative to Sales =

$$\frac{(Scope\ 1 + 2\ Carbon\ Emissions)}{Sales\ (in\ M\$)}$$

If Scope 1+2 carbon emissions and/or EVIC are not available, the average Scope 1+2 intensity of all the constituents of the MSCI ACWI in the same GICS Industry Group in which the security belongs is used:

Weighted Average GHG Intensity of Parent Index =

$$\sum (Weight\ in\ Parent\ Index * Security\ Level\ GHG\ Intensity)$$

Weighted Average GHG Intensity of Derived Index =

$$\sum (Index\ Weight * Security\ Level\ GHG\ Intensity)$$

### Calculation of Potential Carbon Emissions from Fossil Fuels

Parent Index Potential Carbon Emissions from Fossil Fuels–

$$\sum_i \left( \frac{(Float\ Market\ Capitalization * Absolute\ Potential\ Emissions)}{Issuer\ Market\ Capitalization} \right)$$

Derived Index Potential Carbon Emissions from Fossil Fuels–

$$\sum_i \left( \frac{(Derived\ Index\ Market\ Capitalization * Absolute\ Potential\ Emissions)}{Issuer\ Market\ Capitalization} \right)$$

## **Appendix IV: New release of Barra® Equity Model or Barra® Optimizer**

The methodology presently uses MSCI Barra Global Equity Model for Long-Term Investors (“GEMTLT”) for the optimization. A new release of the relevant Barra Equity Model or Barra Optimizer may replace the former version within a suitable timeframe.



## Appendix V: Methodology Set

Description of methodology set –

<https://www.msci.com/index/methodology/latest/ReadMe>

MSCI Corporate Events Methodology –

<https://www.msci.com/index/methodology/latest/CE>

MSCI Fundamental Data Methodology –

<https://www.msci.com/index/methodology/latest/FundData>

MSCI Index Calculation Methodology –

<https://www.msci.com/index/methodology/latest/IndexCalc>

MSCI Index Glossary of Terms –

<https://www.msci.com/index/methodology/latest/IndexGlossary>

MSCI Index Policies –

<https://www.msci.com/index/methodology/latest/IndexPolicy>

MSCI Global Industry Classification Standard (GICS) Methodology –

<https://www.msci.com/index/methodology/latest/GICS>

MSCI Global Investable Market Indexes Methodology –

<https://www.msci.com/index/methodology/latest/GIMI>

### ESG Factors in Methodology\*

The Methodology Set for the Indexes can also be accessed from MSCI's webpage <https://www.msci.com/index-methodology> in the section 'Search Methodology by Index Name or Index Code'.

\* 'ESG Factors in Methodology' contains the list of environmental, social, and governance factors considered, and how they are applied in the methodology (e.g., selection, weighting or exclusion). It can be accessed in the Methodology Set as described above."

## Appendix VI: Changes to the Document

### The following sections have been modified effective December 2022:

- Updated the Optimization Constraints to reference Appendix IV
- Added to reference formulae used for Potential Emissions per dollar of market capitalization calculation in Appendix IV.

### The following sections have been modified effective December 2023:

- Moved the description of the ESG Screening criteria for all screens except controversial and nuclear weapons from the Appendix to Section 2.1.
- Created a new section for companies not assessed by MSCI ESG Research
- Updated the formulas for the calculation of carbon exposure metrics in Appendix III to reflect the change to weighted average carbon emissions intensity.

### The following sections have been updated as of February 2024:

#### Appendix II: Optimization Constraints:

- Steps clarification for Infeasible Solution

#### Appendix III: Calculation of Carbon Exposure

- The calculation of potential emissions was clarified.

#### Appendix V: Methodology Set

- Added details on the Methodology Set of the Index

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