The MSCI Principles of Sustainable Investing

Introduction

The world is rapidly changing and its interdependency and interconnectivity are accelerating at an exponential pace. These significant changes require new approaches to investing that seriously take into account notions of sustainable finance.

Holding long term investments requires understanding, identifying and managing long term financial risks and opportunities. For some investment institutions, their investment horizons are often indefinite. Therefore, their asset allocation, portfolio construction and risk management processes and decisions must regularly and rigorously assess whether their investments are resilient and can be sustained indefinitely. We understand today, better than ever before, how Environmental, Social and Governance (ESG) considerations can impact long term risks and opportunities in financial markets.

Climate change is the clearest and most pressing illustration of this urgent reality today. In addition to the life and death risks of increasing temperatures and rising oceans, climate change also highlights the economic and investment risks and opportunities associated with the world's transition to a low carbon economy. An extensive body of scientific evidence has established that man-made factors are driving climate change on our planet. Citizens are demanding action from governments, companies and investors, because we face a catastrophic future unless remedial action is taken swiftly. Investors all over the world need to incorporate this new reality into their investment portfolios.

At the same time as the public is increasingly demanding that all institutions in society integrate ESG considerations, public trust is eroding greatly because progress in these endeavors has been slow and there is a lack of transparency. The Great Financial Crisis revealed an uneven playing field that many believe incentivizes short term profits for the few over long-term sustainable and inclusive value creation for the many. Furthermore, our digitally interconnected world regularly shines an unflattering spotlight on companies and their leaders whose conduct fails to meet the rising expectations of their stakeholders to help sustain an inclusive global economy. Investors, as the primary providers of capital, are increasingly being asked to engage with these companies to find solutions to these pressing ESG issues and to deny capital to those that ignore them.

This rapidly changing world also presents investment opportunities on an unprecedented scale. Development of alternative energy sources could lead to transformative new products that cut our dependence on fossil fuels. Advances in technology could help resolve food and water shortages and enable us to grow sustainably within the limits of the planet's resources. The next phase of the information revolution could lead to quantum improvements in productivity and connectivity in a manner that could enrich the lives of the socially and economically marginalized.

We believe that this convergence of factors (climate change, social attitudes, institutional governance, technological innovation) will significantly impact the pricing of financial assets and the risk and return of investments and lead to a large-scale re-allocation of capital over the next decades. Investors who treat these factors as a fad and continue to operate in a wait-and-see mode could find themselves unprepared for the dramatic repricing of assets that could result.

We urge all investors to integrate ESG considerations throughout their investment processes in order to identify new investment opportunities, manage emerging risks and achieve long-term, sustainable investment performance. This will require innovative and transformational change from the investment industry to embrace and incorporate new information and establish new practices and processes.

These Principles of Sustainable Investing are an urgent call by MSCI to all investment institutions worldwide to embrace this new world, benefit from the enormous opportunities it provides, and mitigate the inherent risks it brings. They set forth MSCI's views and recommendations on the core principles and best practices for ESG integration by investors globally.

Approaches to Sustainable Investing

Incorporating ESG considerations in the investment process has been referred to in many different ways, including sustainable investing, socially responsible investing, mission-related investing and impact investing. MSCI groups the various names and practices into three common approaches that investors have used to achieve distinct ESG objectives: values-based investing, impact investing and ESG integration.

Values-based investing aims to align investments with an organization's or individual's ethical values by expressing preferences for what industries and companies they invest in. These preferences may take the form of values-driven exclusions, whereby these investors avoid companies involved in business activities that conflict with their ethical, religious, environmental, social or other values-based convictions. Values-driven exclusions are not implemented for financial reasons.

Impact investing targets investments to generate positive social or environmental impacts in line with the investor's views or mission. These strategies sometimes put the positive impact at par or ahead of financial returns and, therefore, may not seek to provide superior risk-adjusted returns.

ESG integration aims to assess long-term financial risks and opportunities related to ESG issues as a core component of building a resilient and sustainable portfolio for the specific purpose of enhancing long-term risk-adjusted returns.

Although these three approaches have distinct objectives, they are not mutually exclusive and investors may blend elements of each approach. These Principles of Sustainable Investing focus on the ESG integration approach, which aims to improve long-term risk-adjusted financial returns.

Core Principles of ESG Integration

A substantial body of empirical research has identified examples of meaningful links between company ESG characteristics and financial performance. This research has demonstrated that ESG considerations have affected the valuation and performance of companies, including with respect to their cost of capital and profitability. Given the significant and increasing impact that ESG factors are expected to exert on the pricing of assets and the allocation of capital in the coming decades, MSCI believes that ESG considerations should be integrated throughout the entire investment process.

- **Investment Strategy:** Asset owners should integrate ESG considerations into their processes for establishing, monitoring and revising their overall investment strategy and asset allocation.

- **Portfolio Management:** Portfolio managers should incorporate ESG considerations throughout the entire portfolio management process, including security selection, portfolio construction, risk management, performance attribution and client reporting.

- **Investment Research:** Research analysts assessing companies and issuing investment recommendations to portfolio managers should integrate ESG considerations (including ESG company ratings) into their fundamental company analysis.

ESG Integration in Investment Strategy

Benchmarks are essential tools to enable asset owners to identify and explain their strategic investment objectives and evaluate the performance of their investment strategy.

A **market benchmark** aims to measure the return and risk characteristics of the unconstrained relevant market (e.g., a country, a region, all emerging markets, the world) in an objective and comprehensive manner. Investability is the only criterion affecting the composition of a market benchmark. A market benchmark helps understand the total investment opportunity set and evaluate the performance of a strategy, a manager or a portfolio against this opportunity set. MSCI believes that market benchmarks should reflect the entire unconstrained investment opportunity set and, therefore, should not incorporate ESG considerations.

ESG investment strategies can be measured against market benchmarks or against ESG benchmarks depending on what investors are trying to measure. If the objective is to understand the characteristics of an ESG strategy, then a comparison with a market benchmark would be appropriate. If the objective is to measure the added value of a portfolio manager who is subject to ESG constraints, then a comparison with an ESG benchmark that reflects those constraints would provide a better measure of the manager's performance.

A **policy benchmark** aims to reflect the investment objectives and strategy of an asset owner and typically incorporates many dimensions such as risk tolerance, liability profile and eligible asset classes. It will generally deviate from underlying market benchmarks to reflect the specific investment strategy of the asset owner.

MSCI believes that asset owners who have included ESG considerations in their long-term investment objectives should incorporate them into their policy benchmark. Integrating ESG considerations into a policy benchmark reinforces the asset owner's commitment to sustainable investing and allows for the ESG policy objectives (e.g., setting targets for carbon reduction) to be precisely defined and measured. The policy benchmark can then be compared against a market benchmark to compare the risk and return characteristics, quantify the impact of the strategic ESG decisions and monitor whether the expected ESG outcomes are achieved.

ESG Integration in Portfolio Management

Portfolio managers should incorporate ESG considerations throughout the entire portfolio management process.

Active portfolios should integrate ESG considerations in security selection, portfolio construction, risk management, performance attribution and client reporting. The security selection and portfolio construction processes should evaluate ESG characteristics alongside other strategic, business and financially material company characteristics (e.g., valuations, growth and profitability). The risk management, performance attribution and client reporting processes should measure, attribute and report the exposures of the portfolio to ESG risks and the impact of these risks on portfolio performance. Active portfolio managers should not be constrained by a specific method to achieve ESG integration (e.g., divestment, which is only one of many options and often not the most optimal). The active portfolio management process should also include direct and active engagement with companies on ESG issues.

Indexed portfolios can integrate ESG by replicating indexes that incorporate ESG rules in the index methodology. These rules can also serve as an engagement topic for investors with companies. Company improvement on the ESG issues reflected in the index rules can lead to an increase in company weight in the index, or even the start of index inclusion, resulting in additional capital flows to the company. For indexed portfolios using a market benchmark with no ESG considerations, ESG integration is limited to company engagement and proxy voting. In this scenario, active proxy voting is the only course of action if engagement with the company does not lead to successful outcomes because the portfolio tracking the index cannot dispose of shares of companies that are included in the index.

In areas of the portfolio management process that are common across active and indexed portfolios, a common set of best practices in ESG integration should be observed. First, the ESG strategy should be made explicit and explained clearly. For example, the portfolio management process should specifically indicate whether and how it considers climate risk. The ESG strategy should also include a dedicated section on expected outcomes. There should be regular communication on the strategy, the progress and the measurable outcomes. For example, a climate-related outcome could focus on a specific reduction in the carbon footprint of the portfolio in line with the Paris Agreement. Finally, the risk management function should consider and monitor ESG risks with the same level of scrutiny as financial or operational risks.

ESG Integration in Investment Research

Companies have varying exposures to a broad range of ESG issues, many of which can be significant and financially material. The proliferation of ESG data that is now available provides significant insights that have not previously been possible, which is affecting investor behavior and impacting the pricing of financial assets.

MSCI believes that investment research should include an assessment of a company's ESG exposures in order to effectively assess the long-term resilience of companies to ESG risks and opportunities. Such assessments, including any methodology developed for an ESG score or rating, should reflect the following principles.

- **Industry Specificity:** ESG risks and opportunities differ substantially across industries. A framework and a systematic process should be applied to identify and regularly update the most relevant and material risks affecting companies in a given sector.

- **Company Disclosure:** Self-disclosed information from companies should only be considered if it is publicly available and traceable to the source. Investors should support industry and regulatory efforts to standardize corporate disclosure on ESG topics and they should avoid using private questionnaires or surveys because they exacerbate lack of transparency, comparability and reliability of ESG data.

- **Independent Verification:** The assessment methodology and process should incorporate other available information sources, such as product recalls and legal and regulatory fines from government databases, as they are often more objective and accurate and are independent of companies' self-disclosures.

These three principles apply to all ESG research processes, both in-house and third-party. For investors and managers who use third-party ESG data and ratings, two additional critical principles apply.

- **Feedback Mechanism:** The ESG research and ratings process of third-party providers should incorporate a feedback mechanism for companies to raise issues or share additional publicly available information. This approach improves data quality and transparency.

- **Editorial Independence:** A robust editorial governance framework should underpin the third-party provider's ESG research and ratings process to ensure integrity and independence, including avoiding conflicts of interest.

Conclusion

MSCI urges all investors globally to integrate ESG considerations into their investment processes. There should not be specialized "ESG Investing" on one side and "Non-ESG Investing" everywhere else. ESG integration is a transitional step to full incorporation of ESG considerations embedded as a core component of standard security selection, portfolio construction and risk management practices. We believe this is a permanent change to how investment strategies will be constructed and how investments will be allocated and managed. To that end, we are calling on all investors to embrace fully and rapidly accelerate this evolution. It is the right thing to do, it is the smart thing to do, and it is the right time to do it.

We have highlighted in these Principles a wide range of specific, actionable steps that can and should be undertaken today to improve practices across the investment value chain. Methods and approaches will vary depending on investors' goals and preferences, but integration should be a high priority and the results should be frequently shared with stakeholders. Previously, investors who adopted ESG principles had to justify their decision; today, MSCI believes that any investor who does not integrate ESG principles should have to justify their choice. We are encouraged that a fundamental shift is taking place, and we want to dramatically accelerate that change.

MSCI strongly believes that a systemic and large-scale integration of ESG considerations throughout the entire investment process will enable a more efficient allocation of capital globally towards the most productive assets in the long term and will contribute to a more effective and balanced transition towards a sustainable and inclusive economy.

MSCI's Commitment to Sustainable Investing

MSCI has been at the forefront of providing data, research and other tools to help enable ESG integration across the entire investment process and is committed to further advancing solutions to facilitate and accelerate sustainable investing.[1] Our research, ratings, indexes, models and portfolio analytics empower the world's largest and most sophisticated investors in their drive to integrate ESG considerations into their investment processes. We also promote ESG transparency across the investment value chain by making publicly available our ESG ratings of the most commonly owned companies worldwide, as well as our methodologies for determining ESG company ratings and constructing ESG indexes.

[1] MSCI ESG Ratings are provided by MSCI ESG Research LLC, a wholly owned subsidiary of MSCI Inc. that is registered with the U.S. Securities and Exchange Commission as an Investment Adviser under the Investment Advisers Act of 1940. MSCI ESG Ratings are used in the construction and calculation of MSCI ESG Indexes. MSCI Indexes are products of MSCI Inc. and are administered by MSCI Limited. MSCI Limited is authorized by the United Kingdom's Financial Conduct Authority ("FCA") as a UK/EU benchmark administrator. MSCI Limited is listed on the FCA's register and on the ESMA register for benchmark administrators.