

MSCI USA ESG Select Index

Methodology

July 2010

1. INTRODUCTION

The MSCI USA ESG Select Index is designed to maximize exposure to positive environmental, social and governance (ESG) factors while exhibiting risk and return characteristics similar to those of the MSCI USA Index. The Index is sector-diversified with high ESG ratings from each sector. Relative to the MSCI USA Index, the MSCI USA ESG Select Index tends to over-weight companies with higher ESG ratings and under-weight companies with lower ratings. Tobacco companies are not eligible for the Index.

2. ESG RESEARCH FRAMEWORK

MSCI's ESG research framework generates an analysis and rating of each company's management of its environmental, social and governance performance. The rating criteria address a company's ESG performance in the context of five categories, covering key corporate stakeholders.

- **Environment** – rate a company's management of its environmental challenges, including its effort to reduce or offset the impacts of its products and operations.
- **Community and Society** – measure how well a company manages its impact on the communities where it operates, including its treatment of local population, its handling of human rights issues and its commitment to philanthropic activities.
- **Employees and Supply Chain** – assess a company's record of managing employees, contractors and suppliers. Issues of particular interest include labor-management relations, anti-discrimination policies and practices, employee safety, and the labor rights of workers throughout the company's supply chain.
- **Customers** – measure the quality and safety record of a company's products, its marketing practices, and any involvement in regulatory or anti-competitive controversies.
- **Governance and Ethics** – address a company's investor relations and management practices, including company sustainability reporting, board accountability and business ethics policies and practices.

MSCI applies its proprietary ESG rating framework to each company by selecting the ESG rating criteria most relevant to each firm. To evaluate a company, analysts review more than 500 data points and score more than 100 indicators. MSCI expresses a company's ESG performance as a numerical score and on a letter-based rating scale. The ratings fall on a nine-point scale from AAA to C. Scores and ratings are not normalized across individual industries or the overall company universe. This means that one industry may have no companies that receive any "A" ratings, while another industry may have no companies with "C" ratings.

For more details on ESG scores and ratings, please refer to <http://www.kld.com/research/>

3. CONSTRUCTING THE MSCI USA ESG SELECT INDEX

Constructing the MSCI USA ESG Select Index involves the following steps:

- Defining the underlying universe;
- Defining the optimization constraints; and

- Determining the optimized portfolio.

3.1 Defining the underlying universe

The underlying universe for the MSCI USA ESG Select Index is the MSCI USA Index, excluding any stocks with Tobacco involvement.

3.2 Defining the optimization constraints

Constituents are selected to maximize exposure to company based ESG scores, subject to maintaining risk and return characteristics similar to the MSCI USA Index. ESG scores are normalized and factored into the optimization process. Optimization is a quantitative process that considers the market capitalization weights from the MSCI USA Index, ESG scores and additional optimization constraints to select and weigh the constituents in the Index.

Normalization of the ESG scores allows the optimization to assess each score in the context of the overall distribution of the ESG scores.

At each quarterly index review, the following optimization constraints are used for replicability and investability:

- The predicted tracking error is restricted to 1.8%
- The maximum weight of an index constituent will be 5%;
- The minimum weight of an index constituent will be 0.1%;
- The number of index constituents is constrained to a maximum of 350;
- The sector weights of the MSCI USA ESG Select Index will not deviate more than +/- 3% from the sector weights of MSCI USA;
- The one way turnover of the MSCI USA ESG Select Index is constrained to a maximum of 15% at Semi-Annual Index Reviews and 10% at Quarterly Index Reviews;
- One way transaction cost is set to 0.5% which aims to achieve a balance between turnover and ESG Scores; and
- An AS/CF (Asset Selection/Common Factor) Risk Aversion Ratio of 10 is applied.

Please refer to the Appendix for the description of the handling of infeasible optimizations.

3.3 Defining the optimized portfolio

The MSCI USA ESG Select Index is constructed using the most recent release of the Barra Open Optimizer in combination with the relevant Barra Equity Model. The optimization uses the MSCI USA Index as the universe of eligible securities and the specified optimization objective and constraints to determine the optimal MSCI USA ESG Select Index.

4. MAINTAINING THE MSCI USA ESG SELECT INDEX

4.1 Quarterly Index Reviews

The MSCI USA ESG Select 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 Indices. The changes are implemented at the end of February, May, August and November.

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. Companies can only be added to the MSCI USA ESG Select Index at regular Index Reviews.

4.2 Ongoing Event-Related Maintenance

In general, the MSCI USA ESG Select Index follows the event maintenance of the underlying MSCI USA Index.

New additions to the underlying index due to corporate events are not added simultaneously to the MSCI USA ESG Select Index, but are considered for inclusion at the following Index Review. Companies deleted from the MSCI USA Index between Index Reviews due to corporate events maintenance are also deleted at the same time from the MSCI USA ESG Select Index.

The technical details relating to the handling of specific corporate event types can be found in the MSCI Corporate Events Methodology book available at:

http://www.msibarra.com/products/indices/international_equity_indices/gimi/stdindex/methodology.html

Appendix: Handling Infeasible Optimizations

During the quarterly index review, in the event that there is no optimal solution that satisfies all the optimization constraints defined in Section 3.2, the tracking error will be relaxed in steps of 0.2% until an optimal solution is found.

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