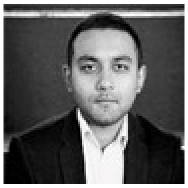
`

Enhancements to MSCI's Fund ESG Ratings

Rumi Mahmood

March 2023



Rumi Mahmood
Head of ESG and Climate Fund Research
MSCI ESG Research

Executive Summary

- Changes to MSCI's Fund ESG Ratings methodology aim to raise the requirements for a fund to be assessed as "AA" or "AAA" rated, improve stability in Fund ESG Ratings and add transparency through simpler attribution analysis. This means the distribution of the fund ratings will shift, and approximately 31,000 funds in our universe will see one-time downgrades as a result.
- The methodology changes were driven by consultations with clients, based on market feedback and are not, as has been reported, linked to regulatory developments in the EU or elsewhere.
- In addition to the ratings shift for existing funds, an estimated 8,200 new fixed income funds will come into coverage, along with their numerous share classes.
- A new approach in rating funds with swap-based strategies will lead to more accurate assessments of the ESG characteristics that end investors are exposed to. We will rate swap-based ETFs based on the holdings of the replicated index instead of the fund's collateral holdings.

Introduction

Institutional investors that have a fiduciary duty to consider significant investment risks now often analyze the ESG characteristics of their funds' investment profiles. Assessments of funds' ESG characteristics can be an important input to the fund selection process, but to be useful for decision-making, assessments need to provide meaningful differentiation and a meaningful reflection of funds' ESG exposures.

MSCI ESG Research's Fund ESG Ratings aim to assess the resilience of a fund's aggregate holdings to long-term ESG risks and opportunities. New enhancements, developed in consultation with clients, will shift the distribution of fund ESG ratings to provide more useful differentiation between funds, bring more funds into coverage and tie the ESG assessment of swap-based funds more closely to their actual exposures.

What's changing

Client feedback is an integral part of methodology decision-making by MSCI ESG Research. In July 2022, we consulted with clients of MSCI ESG Fund Ratings on proposed methodology enhancements. These enhancements were intended to address issues that clients had raised, most notably an upward drift in ratings across the fund universe. We announced the consultation results in September 2022. At the end of April 2023, the following changes will come into effect, reflecting the input we received from our clients.

1. Stability and transparency

The ESG Quality Score that underlies MSCI ESG Fund Ratings will be derived from a simple weighted average of the ESG scores of the underlying holdings. We will no longer apply adjustment factors. The MSCI ESG Fund Rating will purely be a reflection of the holdings' aggregate resilience to ESG risks and opportunities.

The rationale behind this change is three-fold:

1. Raising the requirements to be "AA" or "AAA" rated
2. Improving stability in fund ratings
3. Adding transparency by enabling simpler attribution analysis

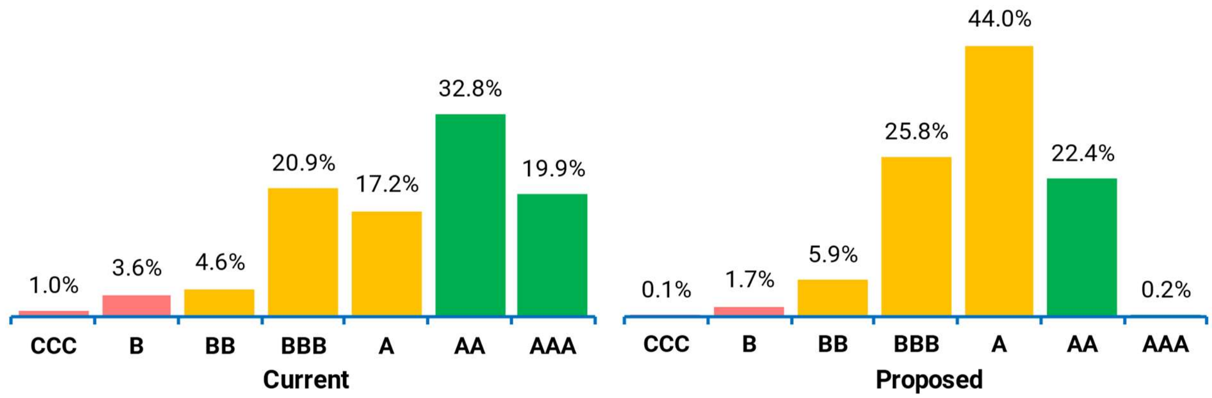
In recent years, companies across the globe, operating under a new environment of increased ESG scrutiny, have been improving and disclosing more of their E, S and G practices. For example, over the past year (period ending Feb. 28, 2023), every Global Industry Classification Standard (GICS®)[1] sector experienced, on average, an improvement in their management of relevant environmental and social risks. The net effect has been more companies receiving ESG rating upgrades than downgrades. At the fund level, the adjustment factor magnifies this effect by rewarding funds for holding companies that are both highly rated and improving their ESG rating. As a result, many funds, including broad-market benchmark-replicating funds, are now highly rated by MSCI, in part driven by the momentum adjustment.

[1] GICS is the global industry classification standard jointly developed by MSCI and S&P Global Market Intelligence.

As of December 2022, approximately 73% of funds in our coverage universe (including ETFs, mutual funds and index funds) had a positive "adjustment factor," meaning that these funds had greater exposure to companies with improving ESG Ratings than worsening ESG Ratings. In this new era where improvement in ESG is the status quo, we believe that the threshold required to receive a top "AA" or "AAA" rating should be more rigorous and ambitious.

As the adjustment factor had a mostly upward influence on funds' ESG Ratings, removing it will lead to more downgrades than upgrades. This is a one-time calibration of the entire universe of funds and not indicative of more downgrades to come. In effect, the goal posts are shifting, rather than any funds becoming worse as a result of their current allocations.

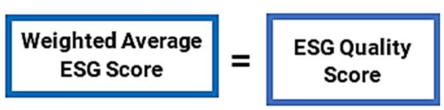
MSCI ESG fund ratings universe, as of March 28, 2023



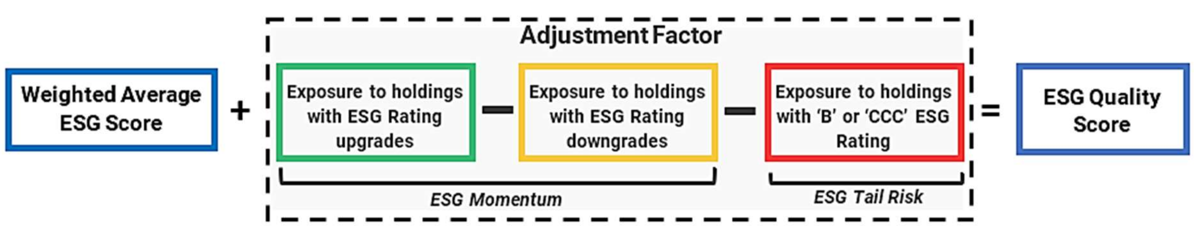
Source: MSCI ESG Research LLC, as of March 28,.2023. The distribution charts illustrate potential impacts of enhancements to its Fund ESG Ratings model, based on simulated ratings on a snapshot of data that will change over time.

As the trend adjustment also magnified the effect of individual company ESG Rating changes on the fund's ESG Rating, removing this will improve ratings stability. This change also leads to better alignment between the Fund ESG Rating and the ESG Rating of the underlying issuers, adding simplicity and enabling easier attribution analysis of the drivers of a fund's ESG Rating.

MSCI ESG Research's new Fund ESG Rating methodology



MSCI ESG Research's current Fund ESG Rating methodology



2. Coverage boost of bond funds

A second methodology change aims to address a structural bias driven by fixed income security types, such as asset-backed or mortgage-based securities that are currently out of scope for ESG analysis. This change means we are reducing the coverage threshold for fixed income funds from 65% to 50% to be included as part of our standard coverage universe. As a result, we anticipate approximately 8,200 unique bond funds will enter MSCI's standard ESG fund ratings coverage, including their numerous share classes.

Our fund ratings universe covers different asset classes and fund types. While equity funds form the bulk of products globally and are straightforward to assess from a company mapping perspective, fixed income funds can pose some unique rating challenges.

Previously, at least 65% of the weight of a fund's holdings (all asset classes) had to have an ESG Rating for the fund to be included in our standard coverage universe. In particular, bond funds can fall below this threshold due to holding asset types that are currently out of scope for ESG analysis — in part due to lack of market consensus on how these securities should be rated and/or data transparency limitations. Such security types include asset-backed, mortgage-backed securities, CLOs and municipal bonds.

We found that certain bond funds can therefore be structurally pre-disposed towards having lower coverage as a result of holding such securities. In the U.S. market, for example, on a market-size-adjusted basis, unrated fixed income securities represented approximately 30% of the aggregate fixed income market. Consequently, broad-based bond funds on average exhibited between 60% to 70% coverage due to allocation to unrated security types, namely securitized debt, making them susceptible to moving out of coverage.

Upcoming developments — synthetic replication strategies

MSCI ESG Research is implementing a solution to rate swap-based funds based on the exposure of the fund to underlying index constituents (rather than the collateral), to better reflect the funds' exposure to ESG risks and opportunities. This solution will enable MSCI ESG Research to continue coverage of swap-based funds by extending the current data submission model with fund managers to provide us with the underlying constituents of the replicating index

We announced to our clients in September 2022 that we plan to remove these funds from ESG Fund Ratings coverage. With this new approach, we are revising that timeline and adding a further six-month period for fund managers to provide the necessary data before removing swap-based funds (without index constituent data) from MSCI ESG Fund Ratings coverage. Further information on the new solution will be provided to MSCI clients in the coming weeks.

Contact us

msci.com/contact-us

AMERICAS

Americas	1 888 588 4567 *
Atlanta	+ 1 404 551 3212
Boston	+ 1 617 532 0920
Chicago	+ 1 312 675 0545
Monterrey	+ 52 81 1253 4020
New York	+ 1 212 804 3901
San Francisco	+ 1 415 836 8800
São Paulo	+ 55 11 3706 1360
Toronto	+ 1 416 628 1007

EUROPE, MIDDLE EAST & AFRICA

Cape Town	+ 27 21 673 0100
Frankfurt	+ 49 69 133 859 00
Geneva	+ 41 22 817 9777
London	+ 44 20 7618 2222
Milan	+ 39 02 5849 0415
Paris	0800 91 59 17 *

ASIA PACIFIC

China North	10800 852 1032 *
China South	10800 152 1032 *
Hong Kong	+ 852 2844 9333
Mumbai	+ 91 22 6784 9160
Seoul	00798 8521 3392 *
Singapore	800 852 3749 *
Sydney	+ 61 2 9033 9333
Taipei	008 0112 7513 *
Thailand	0018 0015 6207 7181 *
Tokyo	+ 81 3 5290 1555

* toll-free

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process.

About MSCI ESG Research Products and Services

MSCI ESG Research products and services are provided by MSCI ESG Research LLC, and are designed to provide in-depth research, ratings and analysis of environmental, social and governance-related business practices to companies worldwide. ESG ratings, data and analysis from MSCI ESG Research LLC. Are also used in the construction of the MSCI ESG Indexes. MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc.

To learn more, please visit www.msci.com.

Notice and disclaimer

This document and all of the information contained in it, including without limitation all text, data, graphs, charts (collectively, the “Information”) is the property of MSCI Inc. or its subsidiaries (collectively, “MSCI”), or MSCI’s licensors, direct or indirect suppliers or any third party involved in making or compiling any Information (collectively, with MSCI, the “Information Providers”) and is provided for informational purposes only. The Information may not be modified, reverse-engineered, reproduced or redisseminated in whole or in part without prior written permission from MSCI. All rights in the Information are reserved by MSCI and/or its Information Providers.

The Information may not be used to create derivative works or to verify or correct other data or information. For example (but without limitation), the Information may not be used to create indexes, databases, risk models, analytics, software, or in connection with the issuing, offering, sponsoring, managing or marketing of any securities, portfolios, financial products or other investment vehicles utilizing or based on, linked to, tracking or otherwise derived from the Information or any other MSCI data, information, products or services.

The user of the Information assumes the entire risk of any use it may make or permit to be made of the Information. NONE OF THE INFORMATION PROVIDERS MAKES ANY EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE INFORMATION (OR THE RESULTS TO BE OBTAINED BY THE USE THEREOF), AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, EACH INFORMATION PROVIDER EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES (INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF ORIGINALITY, ACCURACY, TIMELINESS, NON-INFRINGEMENT, COMPLETENESS, MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE) WITH RESPECT TO ANY OF THE INFORMATION.

Without limiting any of the foregoing and to the maximum extent permitted by applicable law, in no event shall any Information Provider have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential (including lost profits) or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not by applicable law be excluded or limited, including without limitation (as applicable), any liability for death or personal injury to the extent that such injury results from the negligence or willful default of itself, its servants, agents or sub-contractors.

Information containing any historical information, data or analysis should not be taken as an indication or guarantee of any future performance, analysis, forecast or prediction. Past performance does not guarantee future results.

The Information should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. All Information is impersonal and not tailored to the needs of any person, entity or group of persons.

None of the Information constitutes an offer to sell (or a solicitation of an offer to buy), any security, financial product or other investment vehicle or any trading strategy.

It is not possible to invest directly in an index. Exposure to an asset class or trading strategy or other category represented by an index is only available through third party investable instruments (if any) based on that index. MSCI does not issue, sponsor, endorse, market, offer, review or otherwise express any opinion regarding any fund, ETF, derivative or other security, investment, financial product or trading strategy that is based on, linked to or seeks to provide an investment return related to the performance of any MSCI index (collectively, “Index Linked Investments”). MSCI makes no assurance that any Index Linked Investments will accurately track index performance or provide positive investment returns. MSCI Inc. is not an investment adviser or fiduciary and MSCI makes no representation regarding the advisability of investing in any Index Linked Investments.

Index returns do not represent the results of actual trading of investible assets/securities. MSCI maintains and calculates indexes, but does not manage actual assets. The calculation of indexes and index returns may deviate from the stated methodology. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the index or Index Linked Investments. The imposition of these fees and charges would cause the performance of an Index Linked Investment to be different than the MSCI index performance.

The Information may contain back tested data. Back-tested performance is not actual performance, but is hypothetical. There are frequently material differences between back tested performance results and actual results subsequently achieved by any investment strategy.

Constituents of MSCI equity indexes are listed companies, which are included in or excluded from the indexes according to the application of the relevant index methodologies. Accordingly, constituents in MSCI equity indexes may include MSCI Inc., clients of MSCI or suppliers to MSCI. Inclusion of a security within an MSCI index is not a recommendation by MSCI to buy, sell, or hold such security, nor is it considered to be investment advice.

Data and information produced by various affiliates of MSCI Inc., including MSCI ESG Research LLC and Barra LLC, may be used in calculating certain MSCI indexes. More information can be found in the relevant index methodologies on www.msci.com.

MSCI receives compensation in connection with licensing its indexes to third parties. MSCI Inc.’s revenue includes fees based on assets in Index Linked Investments. Information can be found in MSCI Inc.’s company filings on the Investor Relations section of msci.com.

MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc. Neither MSCI nor any of its products or services recommends, endorses, approves or otherwise expresses any opinion regarding any issuer, securities, financial products or instruments or trading strategies and MSCI’s products or services are not a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such, provided that applicable products or services from MSCI ESG Research may constitute investment advice. MSCI ESG Research materials, including materials utilized in any MSCI ESG Indexes or other products, have not been submitted to, nor received approval from, the United States Securities and Exchange Commission or any other regulatory body. MSCI ESG and climate ratings, research and data are produced by MSCI ESG Research LLC, a subsidiary of MSCI Inc. MSCI ESG Indexes, Analytics and Real Estate are products of MSCI Inc. that utilize information from MSCI ESG Research LLC. MSCI Indexes are administered by MSCI Limited (UK).

Please note that the issuers mentioned in MSCI ESG Research materials sometimes have commercial relationships with MSCI ESG Research and/or MSCI Inc. (collectively, “MSCI”) and that these relationships create potential conflicts of interest. In some cases, the issuers or their affiliates purchase research or other products or services from one or more MSCI affiliates. In other cases, MSCI ESG Research rates financial products such as mutual funds or ETFs that are managed by MSCI’s clients or their affiliates, or are based on MSCI Inc. Indexes. In addition, constituents in MSCI Inc. equity indexes include companies that subscribe to MSCI products or services. In some cases, MSCI clients pay fees based in whole or part on the assets they manage. MSCI ESG Research has taken a number of steps to mitigate potential conflicts of interest and safeguard the integrity and independence of its research and ratings. More information about these conflict mitigation measures is available in our Form ADV, available at https://adviserinfo.sec.gov/firm/summary/169222.

Any use of or access to products, services or information of MSCI requires a license from MSCI. MSCI, Barra, RiskMetrics, IPD and other MSCI brands and product names are the trademarks, service marks, or registered trademarks of MSCI or its subsidiaries in the United States and other jurisdictions. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of MSCI and S&P Global Market Intelligence. “Global Industry Classification Standard (GICS)” is a service mark of MSCI and S&P Global Market Intelligence.

MIFID2/MIFIR notice: MSCI ESG Research LLC does not distribute or act as an intermediary for financial instruments or structured deposits, nor does it deal on its own account, provide execution services for others or manage client accounts. No MSCI ESG Research product or service supports, promotes or is intended to support or promote any such activity. MSCI ESG Research is an independent provider of ESG data.

Privacy notice: For information about how MSCI collects and uses personal data, please refer to our Privacy Notice at https://www.msci.com/privacy-pledge.