

# THE MSCI ESG SCREENED INDEXES

An off-the-shelf approach to ESG screens

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## INTRODUCING THE MSCI ESG SCREENED INDEXES

Exclusionary screening remains the investment approach with the largest share of assets under management (AUM) in the environmental, social and governance (ESG) space.<sup>1</sup> In addition, many advanced ESG integration approaches start with an exclusionary screen.

Institutional investors' motivations for exclusionary screens include aligning portfolios with their social values, complying with global norms, such as the UN Global Compact and avoiding reputational risks that can be caused by exposures to investments that may be seen as controversial. Exclusions can also be motivated by the wish to mitigate financial risks, such as stranded assets (fossil fuels) or long-term business risks (tobacco production). Given the increasing utilization of values- and norms-based screens, investors may consider using market-cap benchmarks that leverage some of the most commonly used screens.

The MSCI ESG Screened Indexes are designed to serve this purpose: their index methodology applies the most common exclusions to the underlying market-cap benchmark, as shown on the following page.<sup>2</sup>

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<sup>1</sup> Global Sustainable Investment Alliance. (2016). ["2016 Global Sustainable Investment Review."](#)

<sup>2</sup> We use the MSCI ACWI ESG Screened index for our analysis, which covers global developed and emerging markets. The MSCI ESG Screened Indexes also exist at a regional level, e.g. MSCI USA ESG Screened Index, etc.

### MSCI ACWI ESG SCREENED INDEX

Detail of the exclusionary screen and number of companies removed by each screen

SCREEN	THRESHOLD	STOCKS EXCLUDED (MSCI ACWI)	WEIGHTS EXCLUDED (MSCI ACWI)
<b>ENVIRONMENT</b>			
NUCLEAR POWER	Any tie		
THERMAL COAL	5% revenue from mining of thermal coal or sale; 5% revenues from thermal coal based power generation	100	1.99%
OIL SANDS	5% revenue oil from sand extraction	6	0.33%
<b>SOCIAL</b>			
TOBACCO	All producers, 5% revenue from distribution, retail and supply of tobacco related products	23	1.26%
<b>WEAPONS</b>			
NUCLEAR WEAPONS		19	1.74%
CIVILIAN FIREARMS	All producers; 5% revenue from distribution for civilian use	3	0.21%
CONTROVERSIAL WEAPONS	Any tie	8	0.82%
<b>GOVERNANCE</b>			
UN GLOBAL COMPACT	Any violation	29	2.78%
TOTAL <sup>1</sup>		179	7.93%



<sup>1</sup> Some companies were excluded due to more than one screen and therefore the total is not exactly the sum of the individual exclusions.

Simulated data as of Aug. 31, 2018. Not indicative of future performance. Please see the Notices at the end of this paper regarding the use of backtested or simulated data.

The exclusion of controversial weapons and tobacco<sup>3</sup> is part of the UN Global Compact. The divestment from thermal coal and oil sands is a global trend followed by a number of large investors, including some large global insurers. Divesting from nuclear weapons has been a focus of socially conscious investors since the early days of ESG investing.

### MSCI ACWI ESG SCREENED INDEX PROFILE

In the period of analysis, May 31, 2012<sup>4</sup> to Aug. 31, 2018, using simulated data, the MSCI ACWI ESG Screened Index covered over 90% of the market with a tracking error of 0.5%. Performance and risk figures (such as volatility and drawdown), as well as index liquidity (annualized traded value ratio (ATVR)) and index turnover closely tracked the parent index during this time.<sup>5</sup>

<sup>3</sup> Since July 2017, see <https://www.unglobalcompact.org>.

<sup>4</sup> The index was backtested starting on May 31, 2012.

<sup>5</sup> This report may contain analysis of historical data, which may include hypothetical, backtested or simulated performance results. There are frequently material differences between backtested or simulated performance results and actual results subsequently achieved by any investment strategy.

The average ESG score for the MSCI ACWI ESG Screened Index was the same as in the benchmark, as it does not integrate MSCI ESG Ratings. At the same time, we observed a significant reduction in terms of both actual and potential carbon emissions due to the exclusions screen on thermal coal and oil sands.

#### Key Index metrics comparison

	MSCI ACWI Index	MSCI ACWI ESG Screened Index
<b>Total Return (%)</b>	12.2	12.6
<b>Total Risk (%)</b>	9.7	9.7
<b>Sharpe Ratio</b>	1.21	1.24
<b>Tracking Error (%)</b>	0	0.5
<b>Information Ratio</b>	-	0.80
<b>Max Drawdown (%)</b>	18.9	18.9
<b>No of Stocks*</b>	2476	2295
<b>Parent Index Coverage* (%)</b>	100	90.5
<b>Large* (%)</b>	82.7	81.9
<b>Mid* (%)</b>	17.3	18.1
<b>Turnover** (%)</b>	2.1	2.6
<b>Weighted Average ATVR (%)</b>	97.1	98.6
<b>ESG score</b>	5.7	5.7
<b>Carbon Intensity (t CO<sub>2</sub>e/\$M Sales)</b>	230	158 (-31.3%)
<b>Potential Carbon Emissions (t CO<sub>2</sub>e/\$M Invested)</b>	3072	1840 (-40.1%)

*From May 31, 2012 to Aug. 31, 2018 (\*monthly averages; \*\*annualized one-way index turnover over index reviews)*

In brief, the MSCI ACWI ESG Screened Index was very close to the standard MSCI ACWI benchmark in terms of its financial profile.

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## POTENTIAL APPLICATIONS

Indexes are often used as benchmarks at both a strategic level as well as an implementation level. Investors may use policy benchmarks in their strategic asset allocation to define eligible markets and the universe of eligible securities for their portfolios. At the same time, they may use them to define active or passive allocations when implementing their asset allocation strategies.

Investors who have decided to implement certain norms- or values-based exclusions across their portfolios may want these exclusion screens reflected in their benchmarks for consistency and transparency. After all, exclusions are a form of investment constraint that an institutional investor may want to reflect in the strategic asset allocation framework – especially when defining the universe of eligible securities.

As illustrated in the previous exhibit, as well as the one below, active size and sector weights for the MSCI ACWI ESG Screened Index were fairly small.

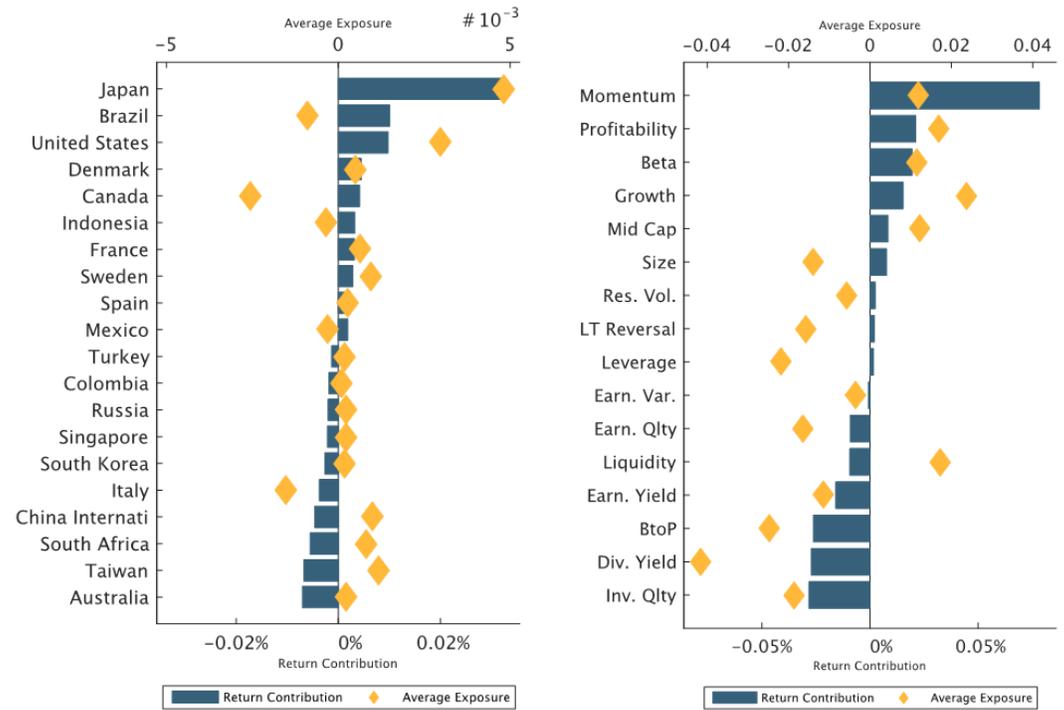
### Active sector weights in the MSCI ACWI ESG Screened Index

Sector	Active weight %
Energy	-1.2
Materials	-0.5
Industrials	-1.1
Consumer Discretionary	0.8
Consumer Staples	-0.9
Health Care	0.6
Financials	1.5
Information Technology	1.7
Telecommunication Services	0.2
Utilities	-1.3
Real Estate	0.3
<b>Standard Deviation</b>	<b>1.08</b>

*Simulated data as of Aug. 31, 2018. Not indicative of future performance.*

In addition, the active exposures and returns due to country and equity style factor shifts caused by exclusions were fairly small during the study period. It is important to mention that these active factor exposures and their performance impact are simulated, unintended exposures and may vary over time.

**Active country (left) and style exposures (right) in the MSCI ACWI ESG Screened Index**



*Simulated data from May 31, 2012 to Aug. 31, 2018*

Exclusionary screening is often an important element of ESG investing for many asset owners and asset managers, and is also a key component of some advanced ESG integration methodologies for active and passive portfolios. Building commonly used exclusion screens into a market-cap index may help institutional investors align their strategic asset management framework with their values or their wish to divest from certain business activities to mitigate long-term financial risks.

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