Integrating ESG and Climate into Portfolios
2. INTEGRATING ESG AND CLIMATE INTO PORTFOLIOS

ESG Factors Have Improved Equity Returns...

While the perception that ESG principles hinder equity performance may linger in places, considerable data shows the opposite.

For example, ESG leaders showed resilience before and during the global pandemic. Worldwide, ESG-focused companies have not only seen higher returns, but stronger earnings growth and dividends.

Dispelling the myth that ESG comes at the expense of performance

![Graph showing decomposition of returns by ESG ratings]

*Top tier: Earnings growth: 2.89%, Active return: 1.31%, Dividends & buyback: 0.28%
*Middle tier: Earnings growth: 1.35%, Active return: 0.12%
*Bottom tier: Earnings growth: -0.02%, Active return: -1.25%, Dividends & buyback: -0.06%

Meanwhile, bottom tier ESG ratings companies significantly lagged in earnings growth.

**Tools and Resources**
- How Have Stocks Responded to Changes in Climate Policy?
- The Truth Behind 5 ESG Myths
- Foundations of climate Investing
Institutional investors made significant progress in incorporating ESG factors into their bond portfolios. Similar dynamics are now impacting retail portfolios and funds. ESG ratings had characteristics distinct from credit ratings and delivered financial value after accounting for credit ratings. The two types of rating systems complemented each other.

MSCI’s analysis found that higher-ESG-rated bond portfolios realized higher risk-adjusted returns. They also exhibited significantly lower drawdowns, reflecting the defensive characteristics of an ESG bond strategy.

Tools and Resources

- Can Green Spreads Uncover ESG’s Influence on Bond Prices?
- What ESG Ratings Tell Us About Corporate Bonds
2. INTEGRATING ESG AND CLIMATE INTO PORTFOLIOS

Financial Differences Between Greenhouse Gas Leaders and Laggards Can Be Significant

MSCI research has shown that higher carbon intensity leads to lower valuations, higher capital costs and a negative impact on stock price. This impact is concentrated in the most carbon-intensive companies.

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Source: Data from Oct. 31, 2013, to Jan. 31, 2021. EPS growth is taken from the GEMLT model and uses 5-year smoothing.

Information Classification: GENERAL
Building an ESG Framework

ESG ratings provide a consistent framework to facilitate comparative decisions. This consistency is the foundation of security analysis and subsequent ESG-driven portfolio construction.

It enables decisions based on factors that go deeper than corporate statements on ESG intent. Experience has shown that these statements have, on occasion, been misaligned from ESG reality (often referred to as “greenwashing.”) Advanced technology, including artificial intelligence, will further reduce reliance on voluntary disclosures from companies.
ESG risks and opportunities can vary by industry and company. Our MSCI ESG Ratings model identifies the ESG risks, (what we call Key Issues), that are most material to a GICS® sub-industry or sector.

MSCI’s ESG ratings measure a company’s resilience to financially material environmental, societal and governance risks. While not a general measure of corporate “goodness” or a barometer on any single issue they provide a window into a critical facet of risk to financial performance.

With over 13 years of live track history we have been able to examine and refine our model to identify the E, S, and G Key Issues which are most material to an industry.

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<td>LAGGARD</td>
<td>A company lagging its industry based on its high exposure and failure to manage significant ESG risks</td>
<td>AVERAGE</td>
<td>A company with a mixed or unexceptional track record of managing the most significant ESG risks and opportunities relative to industry peers</td>
<td>LEADER</td>
<td>A company leading its industry in managing the most significant ESG risks and opportunities</td>
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We assess thousands of data points across 35 ESG Key Issues for more than 8,500 companies globally. MSCI focuses on the intersection between a company’s core business and the industry-specific issues that may create significant risks and opportunities. The Key Issues are weighted according to impact and time horizon of the risk or opportunity. Corporate Governance and Corporate Behavior are typically broadly applied while environmental and social factors can vary significantly by industry.

Tools and Resources

MSCI’s ESG Ratings

As of October 2020
2. INTEGRATING ESG AND CLIMATE INTO PORTFOLIOS

Ratings in Practice: ESG and Working Conditions

Safety protocols are a key sustainability issue for the industrial sector. Here’s how two companies compare. Investors can choose to support companies that take greater lengths to protect their workers.

Tools and Resources
The Power of a Sustainable Dollar

Information Classification: GENERAL
2. INTEGRATING ESG AND CLIMATE INTO PORTFOLIOS

In Practice: Implied Temperature Rise (ITR)

What does it measure?
The Implied Temperature Rise (ITR) metric provides an indication of how well public companies align with global temperature goals.

Expressed in degrees Celsius, it is an intuitive, forward-looking metric that shows how a company aligns with the ambitions of the Paris Agreement.

It covers companies’ Scope 1, 2 and 3 carbon emissions (may include estimates).

Based on data that can be easily examined and traced, together with analysis of companies’ decarbonization targets.

Tools and Resources

- What Implied Temperature Rise Means for Funds
- The Implied Temperature Rise of ‘Paris-Aligned’ Indexes
- ESG Ratings and ITR Search Tool

For illustrative purposes only. Past performance is not a guarantee of future results. There can be no assurance of any investment objective or outcome. Please see disclaimers at the end of this presentation.

As of April 08, 2022
In Practice: Sustainable Fund Selection

Wealth managers are increasingly integrating climate considerations into fund selection and portfolio construction. Data points such as Fund Implied temperature rise can be used to filter the universe in this regard.
In Practice: Direct Indexing

Investors can customize any one of the MSCI Indexes suite to better align a client’s portfolio with their climate preferences, lower risk and reduced tax burden.
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