

# PROPOSED METHODOLOGY FOR INDEXES EXCLUDING TOBACCO COMPANIES

April 2018

*This consultation may or may not lead to the launch of indexes that exclude tobacco companies. Consultation feedback will remain confidential. MSCI may publicly disclose feedback if specifically requested by specific market participants. In that case, the relevant feedback would be published together with the final results of the consultation.*

# POTENTIAL INTRODUCTION OF NEW MSCI ESG INDEXES

## MSCI CONSIDERS INTRODUCING A GLOBAL SERIES OF INDEXES THAT EXCLUDE TOBACCO COMPANIES AND SEEKS FEEDBACK ON THE EXCLUSION CRITERIA

On February 1, 2018, in the context of the release of the consultation results on enhancements to MSCI ESG Indexes, MSCI recognized that there was a rising interest from a number of market participants relating to Tobacco divestment.

Hence, MSCI said it would be looking at complementing its ESG index offering by introducing a series of indexes that would exclude Tobacco companies.

MSCI welcomes feedback on the following two approaches:

**PROPOSAL:** EXCLUSION BASED ON ESG RESEARCH METHODOLOGY  
→ *Consistent with new Tobacco screen in MSCI SRI Indexes*

**ALTERNATIVE:** EXCLUSION BASED ON “TOBACCO” GICS SUB-INDUSTRY

MSCI invites feedback from market participants on or before April 26, 2018

# ESG RESEARCH FRAMEWORK: ZERO, MINIMAL, LOW TOLERANCE

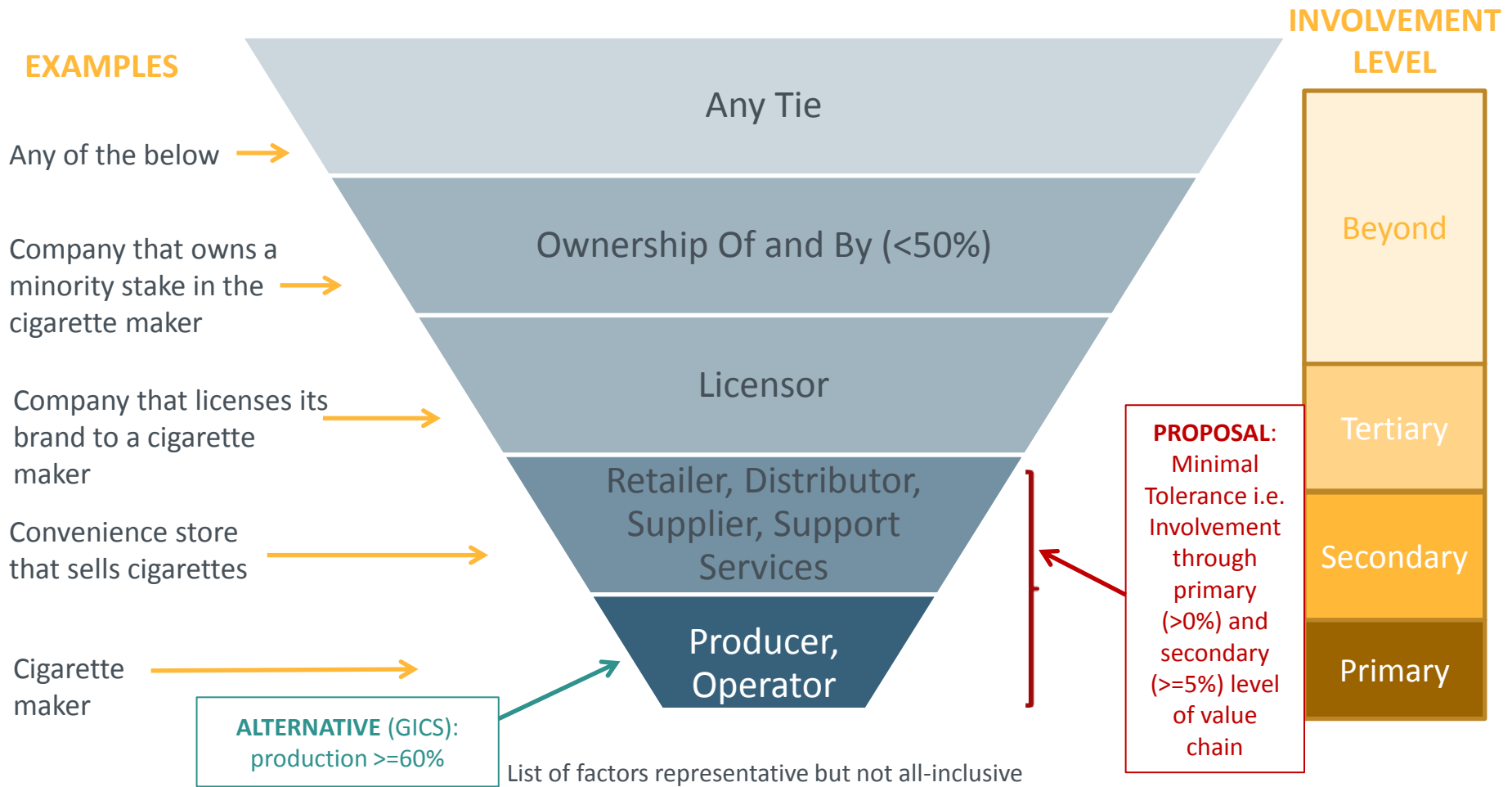
	Zero Tolerance	Minimal Tolerance	Low Tolerance
Unacceptable involvement (aka 'flag' or 'screen out')	Any Tie or equivalent	<ul style="list-style-type: none"> <li>Primary involvement = T (i.e. Revenue &gt;0%)</li> <li>Secondary involvement ≥5% aggregate* revenue</li> <li>Certain secondary involvement with no revenue factors</li> </ul>	<ul style="list-style-type: none"> <li>Most controversial subset of primary involvement = T**</li> <li>Primary involvement ≥5% revenue</li> <li>Secondary involvement ≥15% revenue</li> <li>Aggregate involvement ≥15% revenue</li> </ul>
Acceptable involvement	None	<ul style="list-style-type: none"> <li>Secondary involvement &lt;5% aggregate revenue</li> <li>Tertiary involvement</li> <li>Ownership Of/By</li> </ul>	<ul style="list-style-type: none"> <li>Primary involvement &lt;5% revenue</li> <li>Secondary involvement &lt;15% aggregate revenue</li> <li>Certain secondary involvement with no revenue factors</li> <li>Tertiary involvement</li> <li>Ownership Of/By</li> </ul>
Values based screens for the SRI Index (from May 2018 Index Review)	<ul style="list-style-type: none"> <li>Controversial weapons</li> </ul>	<ul style="list-style-type: none"> <li>Nuclear weapons</li> <li>Civilian firearms</li> <li>Tobacco</li> </ul>	<ul style="list-style-type: none"> <li>Alcohol</li> <li>Gambling</li> <li>Conventional weapons</li> <li>Adult entertainment</li> <li>GMO</li> <li>Nuclear power</li> </ul>

Note that not all screens have revenue factors and not all have the full complement of involvement tiers. The above criteria are applied as applicable.

\* E.g. distributor + retailer combined revenue

\*\* Applies only to certain screens. E.g. within Firearms Producers, only makers of semi-automatic weapons

# LEVEL OF INVOLVEMENT FOR TOBACCO



# SUMMARY OF THE TWO APPROACHES

	PROPOSAL «Minimal Tolerance»		ALTERNATIVE GICS-based Exclusion	
<b>Tobacco revenue thresholds</b>	<ul style="list-style-type: none"> <li>Primary involvement &gt;0%</li> <li>Secondary involvement &gt;=5%</li> </ul>		<ul style="list-style-type: none"> <li>Primary involvement &gt;=60%</li> </ul>	
<b>Exclusions – MSCI ACWI Index*</b>	# of stocks	22	# of stocks	12
	% weight	1.36%	% weight	1.11%
<b>Pros</b>	<ul style="list-style-type: none"> <li>Based on ESG Research Methodology</li> <li>Aligned with UNJSPF tobacco strategy</li> <li>Consistent with MSCI SRI Indexes (new screen applied from May 2018 Index Review)</li> </ul>		<ul style="list-style-type: none"> <li>Based on GICS classification</li> <li>Aligned with other tobacco-free coalitions (AMP AXA)</li> </ul>	
<b>Cons</b>	<ul style="list-style-type: none"> <li>Unaligned with other GICS based tobacco-free coalitions (AMP AXA)</li> </ul>		<ul style="list-style-type: none"> <li>Not consistent with other MSCI ESG Indexes</li> <li>Portfolios not completely tobacco free</li> </ul>	

\* Simulation as of April 3, 2018

# MISSING OUT - CONTROVERSIES THROUGHOUT THE VALUE CHAIN

The alternate proposal (GICS approach) has the risk of missing out on companies that have exposure to other involvement besides production (i.e. retail, supply or distribution) and have been embroiled in controversies up and down the value chain.

For example, **EASTMAN CHEMICAL COMPANY** derives ~11% revenue from supplying tobacco products. It has a controversy score of **4 (Yellow flag)** due to involvement in controversies related to Impact on Local Communities and Toxic Emissions & Waste.

*Further details:*

10,000 gallons of 4-methylcyclohexane methanol (4-MCHM), a coal processing chemical was discharged into the river polluting it with toxic emissions and waste as well as resulting in ~300,000 residents being denied access to potable water for several days along with hospitalizations and temporary closure of local businesses.

**Eastman Chemical was asked to pay USD 25 million in damages.**

# SIMULATED IMPACT – MSCI ACWI INDEX

No	Name	Weight	Revenue from Tobacco related business	Revenue from Tobacco Production	Proposal	Alternative
1	ALIMENTATION COUCHE-TARD INC.	0.04%	9.50		X	
2	Altria Group, Inc.	0.26%	96.73	96.73	X	X
3	AMCOR LTD	0.03%	14.00		X	
4	BRITISH AMERICAN TOBACCO BERHAD	0.00%	100.00	100.00	X	X
5	BRITISH AMERICAN TOBACCO P.L.C.	0.30%	99.00	99.00	X	X
6	CELANESE CORPORATION	0.03%	14.00		X	
7	Dufry AG	0.01%	11.07		X	
8	Eastern Co SAE	0.00%	80.00	70.00	X	X
9	EASTMAN CHEMICAL COMPANY	0.03%	10.99		X	
10	FamilyMart UNY Holdings Co.,Ltd.	0.02%	9.99		X	
11	GRUPO CARSO, S.A.B. DE C.V.	0.00%		0.01	X	
12	IMPERIAL BRANDS PLC	0.07%	95.00	70.00	X	X
13	ITC LIMITED	0.03%	63.09	61.09	X	X
14	JAPAN TOBACCO INC.	0.07%	87.88	87.88	X	X
15	KT&G Corporation	0.02%	59.30	58.00	X	X
16	Lawson, Inc.	0.01%	5.00		X	
17	Philip Morris International Inc.	0.34%	100.00	100.00	X	X
18	PT Gudang Garam Tbk	0.01%	99.99	98.81	X	X
19	PT Hanjaya Mandala Sampoerna Tbk	0.01%	99.90	99.90	X	X
20	Seven & i Holdings Co., Ltd.	0.07%	8.00		X	
21	SHANGHAI INDUSTRIAL HOLDINGS LIMITED	0.00%	15.46	14.47	X	
22	Swedish Match AB	0.02%	86.48	61.48	X	X
					<b>1.36%</b>	<b>1.11%</b>

\* Simulation as of April 3, 2018

# DISCUSSION POINTS

- If MSCI were to launch indexes excluding Tobacco companies, do you agree with the proposal to exclude such companies based on the ESG Research Methodology (“Minimal Tolerance”)?
- Alternatively, should the new indexes exclude Tobacco companies based on GICS sub-industry?

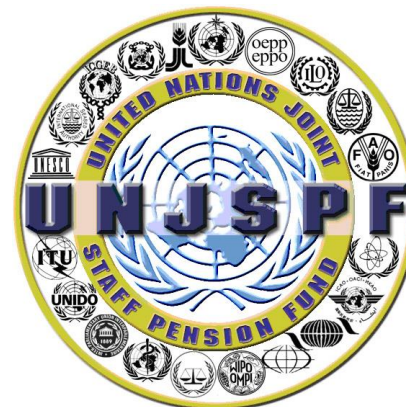


# APPENDIX

# GLOBAL INVESTORS GOING TOBACCO FREE



+35 large Australian Super Funds with total assets of >\$650 Billion are now tobacco-free.



# SHOULD TOBACCO BE PART OF WORST ESG PERFORMERS?

## TOBACCO IS A MAJOR HEALTH ISSUE

- There is no safe level of exposure to tobacco
- 6 million deaths worldwide each year and an estimated 1 billion deaths this century

## THERE IS AN INTERNATIONAL TREATY

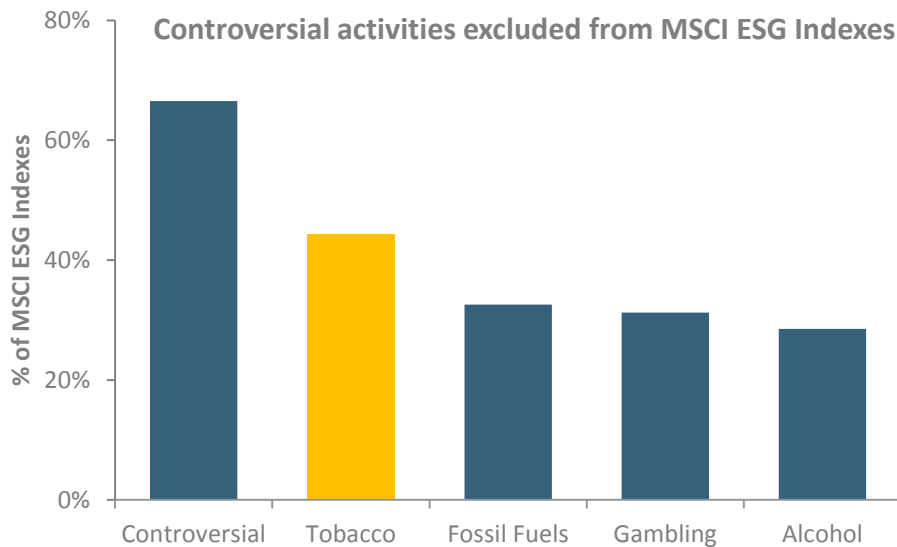
- The Framework on Tobacco Control was established by the WHO in 2004
- In Sept 2017, the UN Global Compact decided to exclude tobacco companies from the initiative

## ENGAGEMENT IS CHALLENGING

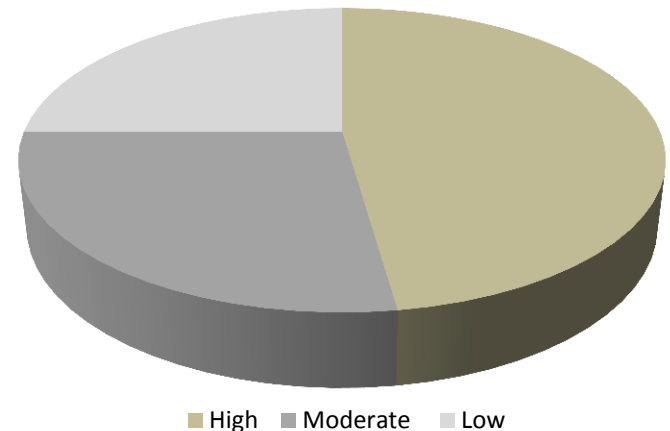
- Most companies are pureplay
- In ACWI IMI, 80% of Tobacco companies generate more than 60% revenue from tobacco production

# HOW DO INVESTORS ADDRESS TOBACCO?

- Major investors have decided to divest from Tobacco including CALPERS, AXA, SCOR, FRR, AP4, Medibank
- About 40% of MSCI ESG Indexes\* exclude Tobacco. Out of them 80% apply a screen based on tobacco production only



**Level of restrictiveness while excluding Tobacco**



# CONTROVERSIES

MSCI ESG Controversies analyses and monitors company management strategies and their actual performance:

MSCI ESG Controversies is designed to provide timely and consistent assessments of ESG controversies involving publicly traded companies and fixed income issuers.

The evaluation framework is designed to be consistent with international norms represented in numerous widely accepted global conventions.

Our global research analysts assess performance, looking for instances where companies are involved in major controversies or have breached the standards set by international bodies.

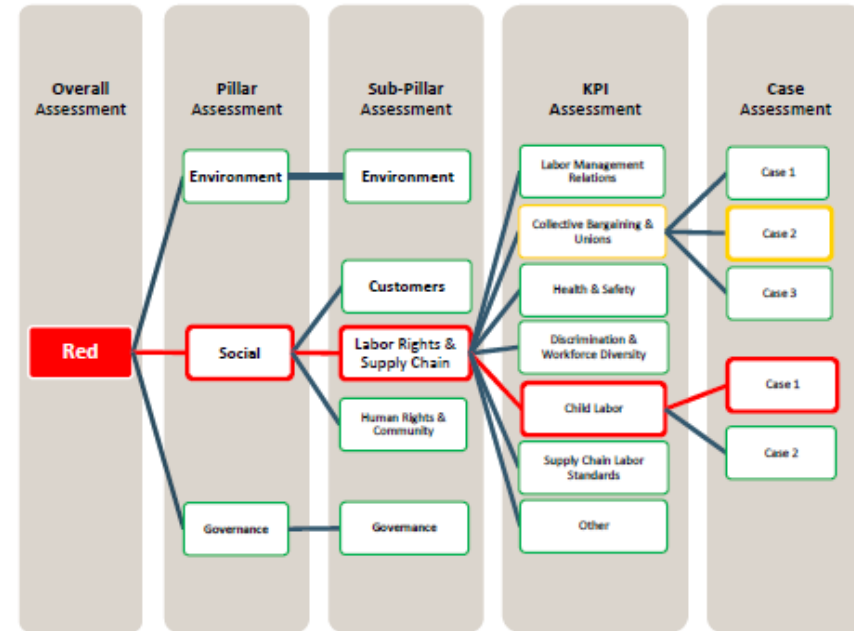
- **RED:** Indicates that a company is involved in one or more very severe controversies.
- **ORANGE:** Indicates that a company has been involved in one or more recent severe structural controversies that are ongoing.
- **YELLOW:** Indicates that the company is involved in severe-to-moderate level controversies.
- **GREEN:** Indicates that the company is not involved in any major controversies.

The MSCI ESG Controversies approach is stakeholder driven and covers the following five categories of stakeholder impact, organized against 28 indicators:

## MSCI ESG Controversies Coverage - Stakeholder 'Pillars' and 'Indicators'

ENVIRONMENT	CUSTOMERS	HUMAN RIGHTS & COMMUNITY	LABOR RIGHTS & SUPPLY CHAIN	GOVERNANCE
<ul style="list-style-type: none"> <li>• Biodiversity &amp; Land Use</li> <li>• Toxic Emissions &amp; Waste</li> <li>• Energy &amp; Climate Change</li> <li>• Water Stress</li> <li>• Operational Waste (Non-Hazardous)</li> <li>• Supply Chain Management</li> <li>• Other</li> </ul>	<ul style="list-style-type: none"> <li>• Anticompetitive Practices</li> <li>• Customer Relations</li> <li>• Privacy &amp; Data Security</li> <li>• Marketing &amp; Advertising</li> <li>• Product Safety &amp; Quality</li> <li>• Other</li> </ul>	<ul style="list-style-type: none"> <li>• Impact on Local Communities</li> <li>• Human Rights Concerns</li> <li>• Civil Liberties</li> <li>• Other</li> </ul>	<ul style="list-style-type: none"> <li>• Labor Management Relations</li> <li>• Health &amp; Safety</li> <li>• Collective Bargaining &amp; Union</li> <li>• Discrimination &amp; Workforce Diversity</li> <li>• Child Labor</li> <li>• Supply Chain Labor Standards</li> <li>• Other</li> </ul>	<ul style="list-style-type: none"> <li>• Bribery &amp; Fraud</li> <li>• Governance Structures</li> <li>• Controversial Investments</li> <li>• Other</li> </ul>

## APPENDIX G – AN EXAMPLE OF CONTROVERSIES SCORING



# TOBACCO SCREENS IN BROAD MSCI ESG INDEXES

	SRI (from May 2018)	ESG Leaders	ESG Universal	KLD 400 Social	ESG Focus
Primary Involvement (producers)	>0% revenue	>=50% revenue or > \$1B revenue	NA	>0% revenue	>0% revenue
Secondary Involvement (retailers, distributors, suppliers)	>=5% revenue	NA	NA	>=15% revenue	>=15% revenue
Other Involvement	NA	NA	NA	NA	Companies classified as “Licensor” or “Ownership by / of a Tobacco Company”

**“Minimal  
Tolerance”**

*Should MSCI consistently use the “Minimal Tolerance” level for the exclusion of Tobacco companies from broad MSCI ESG Indexes?*

# 6-YEAR SIMULATION: KEY METRICS

## Key Metrics

	MSCI ACWI Index	MSCI ACWI ex Tobacco Index (PROPOSAL)	MSCI ACWI ex Tobacco Index (ALTERNATIVE)
Total Return* (%)	12.9	13.0	13.0
Total Risk (%)	9.9	10.0	10.0
Return/Risk	1.30	1.30	1.30
Sharpe Ratio	1.25	1.26	1.26
Active Return (%)	0.0	0.1	0.0
Tracking Error (%)	0.0	0.2	0.2
Information Ratio	NaN	0.28	0.22
Historical Beta	1.00	1.00	1.00
No of Stocks***	2462	2437	2449
Turnover** (%)	2.9	3.2	2.9

Period: 31-May-2012 to 28-Feb-2018

\* Gross returns annualized in USD

\*\* Annualized one-way index turnover over index reviews

\*\*\* Monthly averages

The definitions of all statistical parameters are available in the Appendix

## Performance (%)

	MSCI ACWI Index	MSCI ACWI ex Tobacco Index (PROPOSAL)	MSCI ACWI ex Tobacco Index (ALTERNATIVE)
YTD	1.3	1.4	1.4
1 Yr	19.4	19.8	19.8
3 Yr	8.9	8.9	8.9
5 Yr	10.7	10.7	10.7
10 Yr	NaN	NaN	NaN

Gross returns in USD for the period ending 28-Feb-2018

Returns are annualized for periods longer than one year

# ESG METRICS

## ESG Metrics

	MSCI ACWI Index	MSCI ACWI ex Tobacco Index (PROPOSAL)	MSCI ACWI ex Tobacco Index (ALTERNATIVE)
<b>Integration</b>			
<b>Key Integration Metrics</b>			
ESG Score	5.5	5.6	5.5
ESG Leaders (AAA-AA) (%)	22.6	22.9	22.9
ESG Laggards (B-CCC) (%)	13.5	13.6	13.6
ESG Trend Positive (%)	19.9	19.4	19.4
ESG Trend Negative (%)	7.0	7.1	7.1
<b>ESG Pillars</b>			
Environmental Score	5.4	5.5	5.5
Social Score	4.6	4.6	4.6
Governance Score	5.1	5.1	5.1
<b>Key Governance Metrics</b>			
Lack of Independent Board Majority (%)	15.4	15.4	15.5
Deviation from One Share One Vote (%)	24.8	25.1	25.1
No Female Directors (%)	9.7	9.7	9.8
<b>Values</b>			
Tobacco Producers (%)	1.1	0.0	0.0
Ties to Controversial Weapons (%)	0.8	0.8	0.8
Global Compact Compliance Violation or Watch List (%)	12.3	11.4	11.3
Red Flag Controversies (%)	3.2	3.2	3.2
Orange Flag Controversies (%)	25.0	24.2	24.3

As of 28-Feb-2018

The definitions of all statistical parameters are available in the Appendix



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