

# **MSCI ESG UNIVERSAL INDEXES METHODOLOGY**

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**CONTENTS**

- 1 Introduction ..... 3
- 2 MSCI ESG Research ..... 4
  - 2.1 MSCI ESG Ratings ..... 4
  - 2.2 MSCI ESG Controversies ..... 4
  - 2.3 MSCI ESG Business Involvement Screening Research..... 4
- 3 Index Construction Methodology ..... 5
  - 3.1 Applicable Universe..... 5
  - 3.2 Eligible Universe ..... 5
    - 3.2.1 Unrated Companies .....5
    - 3.2.2 Companies having faced Very Severe ESG Controversies.....5
    - 3.2.3 Companies Involved in Controversial Weapons Businesses .....5
  - 3.3 Determination of Combined ESG Score ..... 5
    - 3.3.1 ESG Rating Score .....5
    - 3.3.2 ESG Rating Trend Score.....6
    - 3.3.3 Combined ESG Score.....7
      - 3.3.3.1 Combined ESG Score Capping.....7
  - 3.4 Weighting Scheme ..... 7
- 4 Maintaining the MSCI ESG Universal Indexes ..... 9
  - 4.1 Semi-Annual Index Reviews ..... 9
  - 4.2 Quarterly Index Reviews ..... 9
  - 4.3 Ongoing Event Related Changes ..... 9
- Appendix I: Companies Involved in Controversial Weapons Business  
..... 10

## 1 INTRODUCTION

The MSCI ESG Universal Indexes (the ‘Indexes’) aim to represent the performance of an investment strategy that by re-weighting free-float market cap weights based upon certain ESG metrics seeks to increase exposure to those companies demonstrating both a robust ESG profile as well as a positive trend in improving that profile, while seeking to minimize exclusions from the parent index.

Institutional investors are increasingly looking for ways to integrate ESG into their investment decision-making process. By doing so, they mainly aim to mitigate long-term risks, generate higher risk-adjusted performance and/or align investments with the broader societal objectives. Historically, ESG integration index strategies have relied on an exclusionary approach whereby poor ESG performers would be screened out from an investment opportunity set. However, such approaches may be challenging for large asset owners to reconcile with their ‘universal owner’ position.

The MSCI ESG Universal Indexes are constructed in following steps. First, we exclude the stocks with the weakest ESG profile from an MSCI Index (the ‘Parent Index’). Second, we define an ESG re-weighting factor that reflects an assessment of both the current ESG profile (based on the current MSCI ESG Rating – see section 3.3.1) as well as the trend in that profile (based on the MSCI ESG Rating Trend – see section 3.3.2). Finally, we re-weight securities from the free-float market cap weights of the Parent Index using this combined ESG score to construct the MSCI ESG Universal Index.

## 2 MSCI ESG RESEARCH

MSCI ESG Research provides in-depth research, ratings and analysis of the environmental, social and governance-related business practices of thousands of companies worldwide. It consists of an integrated suite of tools and products to efficiently manage research, analysis and compliance tasks across the spectrum of ESG factors.

The Index uses company ratings and research provided by MSCI ESG Research. In particular, this index uses the following three MSCI ESG Research products: MSCI ESG Ratings, MSCI ESG Controversies Score, and MSCI ESG Business Involvement Screening Research.

For details on MSCI ESG Research’s full suite of ESG products, please refer to: [http://www.msci.com/products/esg/about\\_msci\\_esg\\_research.html](http://www.msci.com/products/esg/about_msci_esg_research.html)

### 2.1 MSCI ESG RATINGS

MSCI ESG Ratings provides research, analysis and ratings of how well companies manage environmental, social and governance risks and opportunities.

MSCI ESG Ratings provides an overall company ESG rating - a seven point scale from ‘AAA’ to ‘CCC’. In addition, the product provides scores and percentiles indicating how well a company manages each key issue relative to industry peers.

For more details on MSCI ESG Ratings, please refer to <https://www.msci.com/esg-ratings>

### 2.2 MSCI ESG CONTROVERSIES

MSCI ESG Controversies (previously known as MSCI ESG Impact Monitor) provides assessments of controversies concerning the negative environmental, social, and/or governance impact of company operations, products and services. The evaluation framework used in MSCI ESG Controversies is designed to be consistent with international norms represented by the UN Declaration of Human Rights, the ILO Declaration on Fundamental Principles and Rights at Work, and the UN Global Compact. MSCI ESG Controversies Score falls on a 0-10 scale, with “0” being the most severe controversy.

For more details on MSCI ESG Controversies Score, please refer to <https://www.msci.com/esg-integration>

### 2.3 MSCI ESG BUSINESS INVOLVEMENT SCREENING RESEARCH

MSCI ESG Business Involvement Screening Research (BISR) aims to enable institutional investors to manage environmental, social and governance (ESG) standards and restrictions reliably and efficiently.

For more details on MSCI ESG Business Involvement Screening Research, please refer to [http://www.msci.com/resources/factsheets/MSCI\\_ESG\\_BISR.pdf](http://www.msci.com/resources/factsheets/MSCI_ESG_BISR.pdf)

### **3 INDEX CONSTRUCTION METHODOLOGY**

#### **3.1 APPLICABLE UNIVERSE**

The applicable universe includes all the existing constituents of the Parent Index. This approach aims to provide an opportunity set with sufficient liquidity and capacity.

#### **3.2 ELIGIBLE UNIVERSE**

The eligible universe is constructed by excluding securities based on the following criteria:

##### **3.2.1 UNRATED COMPANIES**

- Missing Controversy Score – Companies not assessed by MSCI ESG Research on MSCI ESG Controversies.
- Missing ESG Rating – Companies not rated by MSCI ESG Research for an ESG assessment.

##### **3.2.2 COMPANIES HAVING FACED VERY SEVERE ESG CONTROVERSIES**

Companies having faced very severe controversies pertaining to ESG issues in the last three years– Defined as companies with an ESG Controversy Score of 0.

##### **3.2.3 COMPANIES INVOLVED IN CONTROVERSIAL WEAPONS BUSINESSES**

Companies involved in Controversial Weapons (i.e. landmines, cluster munitions, depleted uranium and biological and chemical weapons) – defined by the methodology of the MSCI Ex-Controversial Weapons Indexes. For more details on the controversial weapons exclusion, please refer to Appendix I.

#### **3.3 DETERMINATION OF COMBINED ESG SCORE**

Each company in the eligible universe is assigned a Combined ESG score, which is calculated by taking into account a company’s MSCI ESG Rating and its MSCI ESG Rating Trend.

##### **3.3.1 ESG RATING SCORE**

Using the MSCI ESG Rating, we group companies so as to assign an ESG Rating score to each company in the eligible universe as illustrated in the table below

Rating Group	ESG Rating	ESG Category	ESG Rating Score
1	AAA	Leaders	2
2	AA		2
3	A	Neutral	1
4	BBB		1
5	BB		1
6	B	Laggards	0.5
7	CCC		0.5

### 3.3.2 ESG RATING TREND SCORE

MSCI ESG Rating Trend shows the ESG rating change from prior to current: it is expressed as the number of levels between the current rating and the previous rating. The rating trend is positive for a ratings upgrade (for example, the company’s ESG rating changed from BBB to AAA), negative for ratings downgrade (for example company’s ESG rating changed from AA to A) and zero for no change in the rating.

An ‘ESG Rating Trend Score’ is assigned to each company based on its ESG Rating Trend as per the following table

Trend group	ESG Rating Trend*	ESG Rating Trend Score
1	Upgrade	1.25
2	Neutral	1
3	Downgrade	0.75

\* ESG Rating Trend

- Upgrade – Company’s latest ESG Rating has increased by at least one level compared to previous assessment.
- Neutral – Company’s latest ESG Rating has stayed the same as its ESG Rating from previous assessment or MSCI ESG Research has initiated coverage on the company.

- Downgrade – Company’s latest ESG Rating has decreased by at least one level compared to its previous assessment.

### 3.3.3 COMBINED ESG SCORE

The Combined ESG Score is calculated for each company as follows:

Combined ESG Score = ESG Rating Score \* ESG Trend Score.

#### 3.3.3.1 COMBINED ESG SCORE CAPPING

In order to reduce reverse turnover in the index, the Combined ESG Score of a security is capped between the ESG Rating Scores corresponding to MSCI ESG Rating of ‘AAA’ (best rating) and ‘CCC’ (worst rating).

For example – If in year 1 a company is upgraded to AAA from BBB, then the weight of the company in the index will increase in year 1. However, if the company maintains its rating at AAA in year 2 then since the rating cannot improve beyond AAA, the index would otherwise need to decrease the weight of that company (as the company’s un-capped Combined ESG Score in year 2 will be less than the Combined ESG Score in year 1).

Similarly, in year 2, the index would otherwise need to increase the weight of a company in year 2 which was downgraded to CCC rating (the worst possible rating) in year 1 and then maintained its rating at CCC in year 2.

### 3.4 WEIGHTING SCHEME

At each rebalancing, all the securities from the eligible universe are weighted by the product of their market capitalization weight in the Parent Index and the Combined ESG Score.

Security Weight = Combined ESG Score \* Market Capitalization Weight in the Parent Index

The above weights are then normalized to 100%.

Additionally, constituent weights are capped at the issuer level to mitigate concentration risk:

1. Issuers in the Indexes based on broad Parent Indexes (e.g. MSCI World Index) will be capped at 5%
2. Issuers in the Index based on narrow Parent Indexes will be capped at the maximum weight in the Parent Index.

Narrow Parent Indexes are defined as those indexes for which the maximum market capitalization weight in the Parent Index is more than 10%.

Note that the capping of the issuer weight is done for the pro forma index as of the effective date, based on the closing prices as of the index review announcement date. In cases where the issuer weight breaches the cap as a result of market price movements or corporate events between the announcement date and the effective date, the capping is not applied

again. Similarly, even if any issuer weight breaches the cap as a result of market price movements or corporate events between two Semi-Annual Index Reviews, no capping is applied.



## 4 MAINTAINING THE MSCI ESG UNIVERSAL INDEXES

### 4.1 SEMI-ANNUAL INDEX REVIEWS

The Indexes are rebalanced on a semi-annual basis, as of the close of the last business day of May and November, coinciding with the May and November semi-annual Index Review of the MSCI Global Investable Market Indexes. The pro forma Indexes are in general announced nine business days before the effective date.

The ESG Controversy Score, ESG Rating Trend and controversial weapon involvement are used as of the end of April and October for the May and November Semi-Annual Index Reviews, respectively. This approach aims to capture timely updates to ESG Ratings of the constituents and coincides with the rebalancing of the relevant MSCI Parent Indexes.

### 4.2 QUARTERLY INDEX REVIEWS

The indexes are reviewed on a quarterly basis to coincide with the regular Quarterly Index Reviews of the MSCI Global Investable Market Indexes, as of the close of the last business day of February and August. At quarterly reviews, the indexes are not re-constituted, but an existing constituent may be deleted from the Indexes if they are involved in controversial weapons or have received a red flag based on MSCI ESG Research Controversies research. The ESG Controversy Score and controversial weapon are used as of January and July for the February and August Quarterly Index Reviews, respectively.

### 4.3 ONGOING EVENT RELATED CHANGES

In general, the Index follows the event maintenance of the Parent Index.

New additions to the Parent Index due to corporate events will not be added simultaneously to the Index, but will be considered for inclusion at the following Semi-Annual Index Review. Companies deleted from the Parent Index between Index Reviews due to corporate events maintenance are also deleted at the same time from the 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.msci.com/products/indexes/size/standard/methodology.html>

## APPENDIX I: COMPANIES INVOLVED IN CONTROVERSIAL WEAPONS BUSINESS

Companies which meet the following Controversial Weapons criteria are excluded from the Index

- Cluster Bombs

MSCI ESG Research’s cluster bomb research identifies public companies that are involved in the production of cluster bombs and munitions, or the essential components of these products.

- Landmines

MSCI ESG Research’s landmines research identifies public companies that are involved in the production of anti - personnel landmines, anti - vehicle landmines, or the essential components of these products.

- Depleted Uranium Weapons

MSCI ESG Research’s depleted uranium weapons research identifies public companies involved in the production of depleted uranium weapons and armor.

- Chemical and Biological Weapons

MSCI ESG Research’s chemical and biological weapons research identifies public companies that are involved in the production of chemical and biological weapons, or the essential components of these products.

Involvement criteria:

- Producers of the weapons
- Producers of key components of the weapons
- Ownership of 20% or more of a weapons or components producer
- The minimum limit is raised to 50% for financial companies having an ownership in a company that manufactures controversial weapons or key components of controversial weapons
- Owned 50% or more by a company involved in weapons or components production

Revenue limits:

Any identifiable revenues, i.e., zero tolerance

For details please refer to MSCI Global ex Controversial Weapons Indexes Methodology at <https://www.msci.com/index-methodology>.

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\* = toll free

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