



Index Methodology

# MSCI Global ESG Indexes Methodology

May 2013

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# 1 Introduction

The MSCI Global ESG Indexes are free float-adjusted market capitalization weighted indexes designed to provide exposure to companies that have high Environmental, Social and Governance (ESG) performance. The MSCI Global ESG Indexes aim to target sector weights that reflect the relative sector weights of the underlying indexes to limit the systematic risk introduced by the ESG selection process. Overall the MSCI Global ESG Indexes target coverage of 50% of the underlying MSCI parent index ("Parent Index").

Currently MSCI constructs MSCI Global ESG Indexes for the Standard size-segment in all Developed Markets and the Small Cap size-segment in the USA.

# 2 ESG Research Framework

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.

## MSCI ESG Intangible Value Assessment

MSCI ESG Intangible Value Assessment (IVA) provides research, ratings and analysis of corporate management of environmental and social risk factors. Through an in-depth comparison against sector peers, MSCI ESG IVA can reveal ESG-driven investment risks or opportunities that may not be captured by conventional analyses.

MSCI ESG IVA identifies key ESG issues that hold the greatest potential risk or opportunity for each industry sector. The product also provides analysis for any impact that these issues and risks may have on corporate financial performance

MSCI ESG IVA scores and ranks company management of key issues relative to sector peers using a best-in-class ratings system, on a seven point scale from 'AAA' to 'CCC'. The model also provides granular scoring on environmental, social and governance metrics.

For more details on MSCI ESG IVA, please refer to [http://www.msci.com/resources/factsheets/MSCI\\_ESG\\_IVA.pdf](http://www.msci.com/resources/factsheets/MSCI_ESG_IVA.pdf)

## MSCI ESG Impact Monitor

MSCI ESG Impact Monitor is designed to provide timely, consistent and extensive assessments of ESG controversies involving publicly traded companies. The evaluation framework used in MSCI ESG Impact Monitor is consistent with international norms represented in numerous, widely accepted, global conventions, including the UN Declaration of Human Rights, the ILO Declaration on Fundamental Principles and Rights at Work, and the UN Global Compact. Investors are able to assess company strategies, policies, systems, and disclosure with respect to these norms and principles.

For more details on MSCI ESG Impact Monitor, please refer to [http://www.msci.com/resources/factsheets/MSCI\\_ESG\\_Impact\\_Monitor.pdf](http://www.msci.com/resources/factsheets/MSCI_ESG_Impact_Monitor.pdf)

## 3 Constructing the MSCI Global ESG Indexes

### 3.1 Underlying Universe

The selection universe for the MSCI Global ESG Indexes is defined by the constituents of the MSCI Global Investable Market Indexes (GIMI).

### 3.2 Eligibility Criteria

Any company that has an ESG rating of ‘B’ or lower or an Impact Monitor controversy assessment of severe or very severe (Impact Monitor score of 2 or below) is not eligible for inclusion in the MSCI Global ESG Indexes. This rating criterion ensures a high minimum level of ESG performance, consistent with the aim of including only the best-in-class companies in the index.

### 3.3 Index Construction

Currently MSCI constructs MSCI Global ESG Indexes for:

- Standard size-segment in all Developed Markets; and
- Small Cap size-segment in the USA.

The MSCI Global ESG Indexes for the Standard size segment are constructed at a regional level, with the exception of North America which is built separately from Canada and the USA. Each regional ESG index targets 50% of the free float adjusted market capitalization of each Global Industry Classification Standard (GICS®) sector of the underlying MSCI parent index (“Parent Index”). The following regional ESG Indexes are aggregated to construct the MSCI World ESG Index.

MSCI Regional ESG Index	Region	Parent Index
MSCI Pacific ESG Index	Developed Asia Pacific	MSCI Pacific Index
MSCI Europe & Middle East ESG Index	Developed Europe & Middle East	MSCI Europe & Middle East Index
MSCI Canada ESG Index	Canada	MSCI Canada Index
MSCI USA ESG Index	USA	MSCI USA Index

The Large Cap and Mid Cap size segments of the MSCI Global ESG Indexes are derived from the Standard size-segment.

The MSCI USA Small Cap ESG Index is constructed by targeting 50% of the free float adjusted market capitalization of each sector of the MSCI USA Small Cap Index. The MSCI USA IMI ESG Index is created by aggregating the MSCI USA ESG Index and the MSCI USA Small Cap ESG Index.

## 4 Maintaining the MSCI Global ESG Indexes

### 4.1 Annual Index Review

The MSCI Global ESG Indexes are maintained with the objective of providing exposure to companies that have high ESG performance while seeking to achieve index stability. The composition of the MSCI Global ESG Indexes is reviewed on an annual basis in May to coincide with the May Semi-Annual Index Review of MSCI GIMI. The pro forma indexes are in general announced nine business days before the effective date. The changes are implemented at the end of May. Ratings used for the Annual Index Review are taken as of the end of April.

At the Annual Index Review, the composition of the MSCI Global ESG Indexes is reassessed in order to target 50% free float-adjusted cumulative market capitalization of each sector of the Parent Index. For each sector, the constituents of the regional Parent Index are first ranked based on the company level ESG Rating, followed by current index membership, ESG Scores and then by decreasing free float adjusted market capitalization<sup>1</sup>. Constituents for the ESG index are then selected in the following order till the 50% coverage<sup>2</sup> by cumulative free float adjusted market capitalization target is reached

- Companies in the top 35%
- 'AA' rated companies in the top 50%
- Current index constituents in the top 65%
- Remaining Companies in the eligible universe

The above rules are applied sequentially so the ESG index includes companies with high ESG performance, while minimizing turnover.

### 4.2 Quarterly Index Reviews

The MSCI Global ESG Indexes are also reviewed on a quarterly basis to coincide with the regular Index Reviews (Semi-Annual Index Review in November and Quarterly Index Reviews in February and August) of MSCI GIMI. The changes are implemented at the end of February, August and November. Ratings used for the Quarterly Index Reviews will be taken as of the end of the month preceding the Index Review, i.e., October, January and July.

At the Quarterly Index Reviews, any existing index constituent whose rating falls to 'CCC' or Impact Monitor Controversy assessment falls to very severe (Impact Monitor score of 0 or 1) is deleted from the MSCI Global ESG Indexes.

Additions to the indexes are only considered in those sectors where the resulting free float-adjusted market capitalization coverage does not meet the 50% target. Market price movements may cause small deviations in the sector coverage between two Index Reviews and so a buffer of 10% [or 5 percentage points] is used on the target coverage of 50% to define under-representation, in order to minimize turnover. Companies are added only in those sectors where the current market capitalization coverage is less than 45%, until the 50% target is reached. A company must have a rating of 'BB' or higher and an Impact Monitor Score of 3 or higher to be considered for addition to the indexes.

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<sup>1</sup> As a reminder, each company's ESG performance is expressed as a numerical score and a corresponding letter rating.

<sup>2</sup> The detailed guidelines for achieving the target sector representation of 50% are listed in Appendix 1.

### 4.3 Ongoing Event-Related Maintenance

The MSCI Corporate Events Methodology is applied for the maintenance of the MSCI Global ESG Indexes between Index Reviews. New additions to the Parent Index due to corporate events will not be added simultaneously to the MSCI Global ESG Indexes, but may be considered for inclusion at the following Index Review. However, companies deleted from the Parent Index between Index Reviews are also deleted at the same time from the MSCI Global ESG Indexes.

Migrations between size segments of the Parent Index in between Index Reviews are simultaneously reflected in the MSCI Global ESG Indexes.

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: Guidelines on achieving the target sector coverage of 50%

The MSCI Global ESG Indexes target 50% of the free float adjusted market capitalization of each Global Industry Classification Standard (GICS®) sector of the Parent Index. The underlying principle in the construction of the index is to achieve sector coverage closest to 50%, while aiming to maintain index stability.

The following guidelines are used in achieving the target sector coverage of 50%:

- For each sector, the constituents of the Parent Index are first ranked based on the company level ESG Rating and then by decreasing free float adjusted market capitalization.
- In case of two companies with the same ESG Rating, an existing index constituent is given preference to maintain index stability. Between two existing constituents with the same ESG Rating, the company with the higher ESG Score is given preference. For two existing index constituents with the same ESG score, the larger company by free-float adjusted market capitalization is given preference.
- The cumulative sector coverage at each rank is calculated.
- All companies classified in a sector for which the cumulative coverage is less than 50% will be considered for inclusion in the ESG index in order of decreasing ESG scores.
- MSCI defines the company that increases the cumulative sector coverage above 50% as the 'marginal company'.
- If the marginal company is a current ESG index constituent, then it is retained in the ESG index even though it may result in a cumulative sector coverage significantly higher compared to the 50% target. This is aimed at ensuring better index stability and lower turnover.
- If the marginal company is a non index constituent, then the marginal company will be included in the ESG index only if the absolute difference between the resulting coverage of including the marginal company and the 50% target is lower than the absolute difference between the resulting coverage of not including the marginal company and the 50% target.
- The minimum cumulative sector coverage is set to 45%.
- The marginal company will be added to the ESG index if its non-inclusion would result in cumulative sector coverage of less than 45%.

## Appendix : Methodology Transition

The MSCI Global ESG Indexes transitioned to the methodology described in this book at the May 2013 Index Review. The MSCI Global ESG Indexes were previously constructed using the Global Socrates ESG ratings. Any company that had an ESG rating of 'CCC' or lower was not eligible for inclusion in the MSCI Global ESG Indexes. The MSCI Global ESG Indexes were constructed by targeting 50% of the free float adjusted market capitalization of each Global Industry Classification Standard (GICS) sector of the underlying MSCI regional ESG Index.



## Client Service Information is Available 24 Hours a Day

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## About MSCI

MSCI Inc. is a leading provider of investment decision support tools to investors globally, including asset managers, banks, hedge funds and pension funds. MSCI products and services include indexes, portfolio risk and performance analytics, and governance tools.

The company's flagship product offerings are: the MSCI indexes with approximately USD 8 trillion estimated to be benchmarked to them on a worldwide basis<sup>1</sup>; Barra multi-asset class factor models, portfolio risk and performance analytics; RiskMetrics multi-asset class market and credit risk analytics; IPD real estate information, indexes and analytics; MSCI ESG (environmental, social and governance) Research screening, analysis and ratings; ISS corporate governance research, data and outsourced proxy voting and reporting services; and FEA valuation models and risk management software for the energy and commodities markets. MSCI is headquartered in New York, with research and commercial offices around the world.

<sup>1</sup> As of September 30, 2013, as reported on January 31, 2014 by eVestment, Lipper and Bloomberg

Feb 2014