

# **MSCI Momentum ESG Reduced Carbon Target Select Indexes Methodology**

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**Contents**

- 1 Introduction ..... 4
- 2 MSCI ESG Research ..... 5
  - 2.1 MSCI ESG Ratings..... 5
  - 2.2 MSCI ESG Controversies..... 5
  - 2.3 MSCI ESG Business Involvement Screening Research ..... 5
  - 2.4 MSCI Climate Change Metrics..... 6
- 3 Index Construction Methodology ..... 7
  - 3.1 Defining the Parent Index and the Base Currency for Optimization  
7
  - 3.2 Defining the exclusion criteria ..... 7
    - 3.2.1 Business Exclusion criteria ..... 7
    - Other Exclusion Criteria ..... 8
  - 3.3 Defining the Security Level Carbon Exposure ..... 8
    - 3.3.1 Greenhouse Gas Emissions ..... 8
    - 3.3.2 Potential Carbon Emissions from Fossil Fuels..... 8
  - 3.4 Defining the Optimization Setup..... 9
    - 3.4.1 Calculation of the Momentum Score ..... 9
    - 3.4.2 Optimization Constraints ..... 9
  - 3.5 Determining the Optimized Index ..... 10
- 4 Maintaining the Index..... 11
  - 4.1 Semi-Annual Index Reviews..... 11
  - 4.2 Ongoing Event Related Changes ..... 11
- Appendix I: The Parent Index and the Base Currency for  
Optimization 13
- Appendix II: Business Exclusion Criteria ..... 14
- Appendix III: Handling Infeasible Optimizations ..... 16

Appendix IV: New release of Barra<sup>®</sup> Equity Model or Barra<sup>®</sup> Optimizer ..... 17

## 1 Introduction

The MSCI Momentum ESG Reduced Carbon Target Select Indexes are designed to represent the performance of a strategy that seeks systematic integration of environmental, social and governance (ESG) norms along with the exposure to a momentum factor.

The Indexes are constructed by selecting constituents of a market capitalization weighted index (the 'Parent Index') through an optimization process that aims to maximize the exposure to a momentum factor, minimize tracking error, reduce the carbon-equivalent exposure to CO<sub>2</sub> and other GHG as well as the exposure to potential emissions risk of fossil fuel reserves by thirty percent (30%) and improve the weighted-average industry-adjusted ESG score of the Index by 20% with respect to their respective underlying market capitalization weighted indexes (the 'Parent Index') under certain constraints.

## 2 MSCI ESG Research

The MSCI Momentum ESG Reduced Carbon Target Select Indexes use company ratings and research provided by MSCI ESG Research. In particular, this index uses the following four MSCI ESG Research products: MSCI ESG Ratings, MSCI ESG Controversies Score, MSCI ESG Business Involvement Screening Research and MSCI Climate Change Metrics.

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/documents/1296102/1636401/MSCI\\_ESG\\_Ratings.pdf](https://www.msci.com/documents/1296102/1636401/MSCI_ESG_Ratings.pdf).

### 2.2 MSCI ESG CONTROVERSIES

MSCI ESG Controversies (previously known as 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/documents/10199/acbe7c8a-a4e4-49de-9cf8-5e957245b86b>.

### 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).

## 2.4 MSCI CLIMATE CHANGE METRICS

MSCI Climate Change Metrics provides climate data & tools to support investors integrating climate risk & opportunities into their investment strategy and processes. It supports investors seeking to achieve a range of objectives, including measuring and reporting on climate risk exposure, implementing low carbon and fossil fuel-free strategies, align with temperature pathways and factoring climate change research into their risk management processes, in particular through climate scenario analysis for both transition and physical risks.

The dataset spans across the four dimensions of a climate strategy: transition risks, green opportunities, physical risks and 1.5° alignment.

For more details on MSCI Climate Change Metrics, please refer to <https://www.msci.com/climate-change-solutions>.

### 3 Index Construction Methodology

Constructing the MSCI Momentum ESG Reduced Carbon Target Select Indexes involves the following steps:

- Defining the Parent Index and the base currency for optimization
- Defining the exclusion criteria
- Defining the Security Level Carbon Exposure
- Defining the optimization setup
- Determining the optimized index

The steps mentioned above are defined in detail in the subsequent sections.

#### 3.1 DEFINING THE PARENT INDEX AND THE BASE CURRENCY FOR OPTIMIZATION

Construction of the MSCI Momentum ESG Reduced Carbon Target Select Index (herein, ‘the Index’) begins with identifying the Parent Index and the eligible universe for optimization to maximize the index-level exposure to the momentum factor while controlling ex-ante tracking error relative to the Parent Index. The Parent Indexes serve as the universe of eligible securities for optimization. The optimization is performed from a base currency perspective and does not allow short selling of securities. The default currency is the US Dollar.

Please refer to Appendix I for more details.

#### 3.2 DEFINING THE EXCLUSION CRITERIA

Securities of companies involved in “Very Severe” business controversies as defined by the MSCI ESG Controversies Methodology are not eligible for inclusion in the MSCI Momentum ESG Reduced Carbon Target Select Indexes. This is implemented by excluding constituents of the Parent Index with ESG Controversy Score = 0 (‘Red Flag’ companies).

##### 3.2.1 BUSINESS EXCLUSION CRITERIA

Companies that are involved in specific businesses which have high potential for negative social and/or environmental impact are ineligible for inclusion in the index.

- Controversial Weapons
- Nuclear Weapons
- Civilian Firearms
- Tobacco

- Thermal Coal
- Oil Sands

In addition to the above, companies that fail to comply with the United Nations Global Compact Principles are also excluded from the MSCI Momentum ESG Reduced Carbon Target Select Indexes.

Please refer to Appendix II for more details on these criteria.

**OTHER EXCLUSION CRITERIA**

- Missing Controversy Score – Companies not assessed by MSCI ESG Research’s MSCI ESG Controversy Scores are excluded from the index.
- Missing ESG Rating or ESG Score – Companies which are not rated by MSCI ESG Research for an MSCI ESG Rating are excluded from the index.

**3.3 DEFINING THE SECURITY LEVEL CARBON EXPOSURE**

The carbon exposure of a security is measured in terms of its greenhouse gas emissions and its potential carbon emissions from fossil fuel reserves. The MSCI Momentum ESG Reduced Carbon Target Select Indexes use MSCI Climate Change Metrics data from MSCI ESG Research.

**3.3.1 GREENHOUSE GAS EMISSIONS**

MSCI ESG Research collects company-specific direct (Scope 1) and indirect (Scope 2) greenhouse gas (GHG) emissions data from company public documents and/or the Carbon Disclosure Project. If a company does not report GHG emissions, then MSCI ESG Research uses its proprietary methodology to estimate Scope 1 and Scope 2 GHG emissions.

For newly added companies to the index which do not report emission data and where MSCI ESG Research has not estimated the greenhouse gas emissions yet, MSCI uses the average emissions per dollar of issuer market capitalization for the companies in the same industry group, multiplied by the market capitalization of the company as the estimated emission for the company.

**3.3.2 POTENTIAL CARBON EMISSIONS FROM FOSSIL FUELS**

MSCI ESG Research collects fossil fuel reserves data where relevant for companies which have reserves, typically in the Oil & Gas, Coal Mining and Electric Utilities industries. Fossil fuel reserves can be used for several applications including energy or industrial (e.g. coking coal used for steel production). For the development of the MSCI Momentum ESG Reduced Carbon Target Select Indexes, only fossil fuel reserves used for energy are taken into account. The data is updated on an annual basis and based on information disclosed by companies. Sources include company



publications, other public records and third party data providers. For newly added companies to the index where data is not available yet, MSCI uses zero fossil fuel reserves. The size of reserves of a company typically influences its market valuation, and hence MSCI normalizes for size by dividing the potential carbon emissions of the company by its market capitalization.

To convert reserves data to potential carbon emissions, MSCI ESG Research applies a formula from the Potsdam Institute for Climate Impact Research<sup>1</sup>.

### 3.4 DEFINING THE OPTIMIZATION SETUP

The optimization objective is to maximize the momentum score, while controlling the ex-ante tracking error relative to the Parent Index at the time of rebalancing.

#### 3.4.1 CALCULATION OF THE MOMENTUM SCORE

The winsorized momentum z-score score for each security is calculated using the formulae defined in Section 2.2 of the MSCI Momentum Indexes Methodology (for details about the methodology, please refer to: <https://www.msci.com/index-methodology>).

#### 3.4.2 OPTIMIZATION CONSTRAINTS

At each Semi-Annual Index Review (SAIR), the following optimization constraints are employed, which aim to ensure replicability and investability.

- The ex-ante tracking error of the Index, relative to the Parent Index will be capped at 5%
- The maximum weight of an index constituent will be restricted to the lower of (the weight of the security in the Parent Index + 2%) and 10 times the weight of the security in the Parent Index. The minimum weight of an index constituent will be restricted to be the higher of the (weight of the security in the Parent Index - 2%) and 0.05%
- The minimum number of index constituents will be set at default value of 100
- For countries with weight greater than 2.5% in a composite Parent Index, the weight in the MSCI Momentum ESG Reduced Carbon Target Select Index will not deviate more than +/-20% from the country weight in the Parent Index

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<sup>1</sup> Malte Meinshausen, Nicolai Meinshausen, William Hare, Sarah C. B. Raper, Katja Frieler, Reto Knutti, David J. Frame & Myles R. Allen. Greenhouse-gas emission Target for limiting global warming to 2 °C. Nature 458, 1158-1162 (30 April 2009) | doi: 10.1038/nature08017; Received 25 September 2008; Accepted 25 March 2009. Supplementary Information, p. 7.

- For countries with weight less than 2.5% in a composite Parent Index, the weight in the MSCI Momentum ESG Reduced Carbon Target Select Index will be capped at 3 times their weight in the Parent Index
- The above country weight constraint will also apply on China A Stock Connect listings as a group separately in addition to the usual country weight constraint on China
- The sector weights of the MSCI Momentum ESG Reduced Carbon Target Select Index will not deviate more than +/-20% from the sector weights of the Parent Index
- The weighted-average industry-adjusted ESG score of the Index will be at least 20% more than the weighted-average industry-adjusted ESG score of the Parent Index at the time of rebalancing
- The minimum reduction in the Carbon Emission Intensity relative to the Parent Index will be 30%
- The minimum reduction in the Potential Emissions per dollar of market capitalization relative to the Parent Index will be 30%
- The one-way turnover of the MSCI Momentum ESG Reduced Carbon Target Select Index is constrained to a maximum of 50% at each SAIR

The Carbon Emission Intensity and the Potential Emissions per dollar of market capitalization of the Index are calculated using the formulae defined in Appendix I of the MSCI Global Low Carbon Leaders Indexes Methodology (for details about the methodology, please refer to: <https://www.msci.com/index-methodology>).

### 3.5 DETERMINING THE OPTIMIZED INDEX

The MSCI Momentum ESG Reduced Carbon Target Select Index is constructed using the Barra Open Optimizer in combination with the relevant Barra Equity Model<sup>2</sup>. The optimization uses the eligible universe as the universe of eligible securities and the specified optimization objective and constraints to determine the MSCI Momentum ESG Reduced Carbon Target Select Index. Infeasible optimizations are handled as explained in Appendix III.

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<sup>2</sup> Please refer to Appendix IV for the detailed information on model usage

## 4 Maintaining the Index

### 4.1 SEMI-ANNUAL INDEX REVIEWS

The MSCI Momentum ESG Reduced Carbon Target Select Indexes are rebalanced on a semi-annual basis, usually as of the close of the last business day of May and November, coinciding with the May and November Semi-Annual Index Reviews (SAIRs) of the MSCI Global Investable Market Indexes. Barra Equity Model data as of the end of April and October are used respectively.

In general, MSCI uses MSCI ESG Research data (including MSCI ESG Ratings, MSCI ESG Controversies Scores, MSCI Business Involvement Screening Research and MSCI Climate-change metrics) as of the end of the month preceding the Index Reviews for the rebalancing of the Index. For some securities, such data may not be published by MSCI ESG Research by the end of the month preceding the Index Review. For such securities, MSCI will use ESG data published after the end of month, when available, for the rebalancing of the Index.

In addition to the two Semi-Annual Index Reviews in May and November, MSCI Momentum ESG Reduced Carbon Target Select Indexes undergo ad-hoc rebalancing subject to meeting certain trigger criteria. The details of the ad-hoc rebalancing are provided in Appendix III of the MSCI Momentum Indexes Methodology. The trigger condition for ad-hoc rebalancing is checked every month as detailed in Appendix III of the MSCI Momentum Indexes Methodology (for details about the methodology, please refer to: <https://www.msci.com/index-methodology>).

The pro forma MSCI Momentum ESG Reduced Carbon Target Select Indexes are in general announced nine business days before the effective date.

### 4.2 ONGOING EVENT RELATED CHANGES

The general treatment of corporate events in the MSCI Momentum ESG Reduced Carbon Target Select Indexes aims to minimize turnover outside of Index Reviews. The methodology aims to appropriately represent an investor's participation in an event based on relevant deal terms and pre-event weighting of the index constituents that are involved. Further, changes in index market capitalization that occur as a result of corporate event implementation will be offset by a corresponding change in the Variable Weighting Factor (VWF) of the constituent.

The following section briefly describes the treatment of common corporate events within the MSCI Momentum ESG Reduced Carbon Target Select Indexes.

No new securities will be added (except where noted below) to the Index between Index Reviews. Parent Index deletions will be reflected simultaneously in the Index.

**EVENT TYPE**

**EVENT DETAILS**

**New additions to the Parent Index**

A new security added to the Parent Index (such as IPO and other early inclusion) will not be added to the Index.

**Spin-Offs**

All securities created as a result of the spin-off of an existing Index constituent will be added to the Index at the time of event implementation. Reevaluation for continued inclusion in the Index will occur at the subsequent Index Review.

**Merger/Acquisition**

For Mergers and Acquisitions, the acquirer’s post event weight will account for the proportionate amount of shares involved in deal consideration, while cash proceeds will be invested across the Index.

If an existing Index constituent is acquired by a non-Index constituent, the existing constituent will be deleted from the Index and the acquiring non-constituent will not be added to the Index.

**Changes in Security Characteristics**

A security will continue to be an Index constituent if there are changes in characteristics (country, sector, size segment, etc.). Reevaluation for continued inclusion in the Index will occur at the subsequent Index Review.

Further detail and illustration regarding specific treatment of corporate events relevant to this Index can be found in the MSCI Corporate Events Methodology book under the sections detailing the treatment of events in Capped Weighted and Non-Market Capitalization Weighted indexes.

The MSCI Corporate Events methodology book is available at: <https://www.msci.com/index/methodology/latest/CE>

## Appendix I: The Parent Index and the Base Currency for Optimization

Momentum ESG Reduced Carbon Target Select Index	Parent Index	Base Currency for Optimization
MSCI USA Momentum ESG Reduced Carbon Target Select Index	MSCI USA Index	USD
MSCI World Momentum ESG Reduced Carbon Target Select Index	MSCI World Index	USD

## Appendix II: Business Exclusion Criteria

MSCI ESG Research has developed a framework designed to define significant involvement in controversial activities. According to this framework, there are three tolerance levels: Zero Tolerance, Minimal Tolerance and Low Tolerance.

Each controversial activity screened by the MSCI Momentum ESG Reduced Carbon Target Select Indexes (except Thermal Coal, Oil Sands and Global Norms) is assigned to one of these tolerance levels:

### Activities classified under “Zero Tolerance”

- **Controversial Weapons**
  - All companies with any tie to Controversial Weapons (cluster munitions, landmines, depleted uranium weapons, biological/chemical weapons, blinding lasers, non-detectable fragments and incendiary weapons), as defined by the methodology of the MSCI Ex-Controversial Weapons Indexes available at <https://www.msci.com/index-methodology>.

### Activities classified under “Minimal Tolerance”

- **Nuclear Weapons**
  - All companies that manufacture nuclear warheads and/or whole nuclear missiles.
  - All companies that manufacture components that were developed or are significantly modified for exclusive use in nuclear weapons (warheads and missiles).
  - All companies that manufacture or assemble delivery platforms that were developed or significantly modified for the exclusive delivery of nuclear weapons.
  - All companies that provide auxiliary services related to nuclear weapons.
  - All companies that manufacture components that were not developed or not significantly modified for exclusive use in nuclear weapons (warheads and missiles).
  - All companies that manufacture or assemble delivery platforms that were not developed or not significantly modified for the exclusive delivery of nuclear weapons.
  - All companies that manufacture components for nuclear-exclusive delivery platforms.

- **Civilian Firearms**

- All companies classified as “Producer” of firearms and small arms ammunitions for civilian markets. It does not include companies that cater to the military, government, and law enforcement markets.
- All companies deriving 5% or more revenue from the distribution (wholesale or retail) of firearms or small arms ammunition intended for civilian use.

- **Tobacco**

- All companies classified as a “Producer”.
- All companies deriving 5% or more aggregate revenue from the production, distribution, retail and supply of tobacco-related products.

**Activities not classified under any specific tolerance level**

- **Thermal Coal**

- All companies deriving 5% or more revenue (either reported or estimated) from the mining of thermal coal (including lignite, bituminous, anthracite and steam coal) and its sale to external parties. It excludes: revenue from metallurgical coal; coal mined for internal power generation (e.g. in the case of vertically integrated power producers); intra-company sales of mined thermal coal; and revenue from coal trading.
- All companies deriving 5% or more revenue (either reported or estimated) from the thermal coal based power generation.

- **Oil Sands**

- All companies deriving 5% or more revenue from oil sands extraction, which own oil sands reserves and disclose evidence of deriving revenue from oil sands extraction. Companies that derive revenue from non-extraction activities (e.g. exploration, surveying, processing, refining) or intra-company sales are not excluded. Additionally, companies that own oil sands reserves with no associated revenue are also not excluded.

- **Global Norms – United Nations Global Compact Compliance**

- All companies that fail to comply with the United Nations Global Compact principles.

### Appendix III: Handling Infeasible Optimizations

During the Semi-Annual Index Review, in the event that there is no optimal solution that satisfies all the optimization constraints defined in Section 3.4, the following constraints are relaxed, until an optimal solution is found:

- Relax the maximum weight multiple in steps of 2 up to a maximum of 5 iterations (up to a maximum of 20 times the weight of the security in the Parent Index)
- Relax the turnover constraint in steps of 5%, up to a maximum of 75%
- The maximum active weight multiple constraint and the maximum turnover constraint are alternately relaxed until a feasible solution is achieved. For example, constraints relaxation is executed in the sequence as illustrated below:

Order of Relaxation	Maximum Asset Weight Multiple	Turnover Limit
1	12 times the weight of the security in the Parent Index	50%
2	12 times the weight of the security in the Parent Index	55%
3	14 times the weight of the security in the Parent Index	55%
4	14 times the weight of the security in the Parent Index	60%

In the event that no optimal solution is found after the above constraints have been relaxed, the ESG score<sup>3</sup> is relaxed in steps of 3%, up to a maximum of 5 iterations (up to a minimum of 5% more than that of the Parent Index).

In the event that no optimal solution is found after all the above constraints have been relaxed, the MSCI Momentum ESG Reduced Carbon Target Select Index will not be rebalanced for that semi-annual index review.

<sup>3</sup> Weighted-average industry-adjusted ESG score of the portfolio



## **Appendix IV: New release of Barra<sup>®</sup> Equity Model or Barra<sup>®</sup> Optimizer**

The methodology presently uses MSCI Barra Global Equity Model for Long-Term Investors (“GEMTL”) for the optimization. A new release of the relevant Barra Equity Model or Barra Optimizer may replace the former version within a suitable timeframe.

**The following sections have been modified since May 2021:**

1. Appendix I: The Parent Index and the Base Currency for Optimization
  - Addition of MSCI World Momentum ESG Reduced Carbon Target Select Index

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The process for submitting a formal index complaint can be found on the index regulation page of MSCI's website at:

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