

# MSCI ESG Integration & Ratings

INTEGRATION OF ESG FOR FINANCIAL INSTITUTIONS  
USING ESG RATINGS AND OTHER TOOLS

Presented to: JC3 Capacity Building Workshop

Presented by: Miranda Carr, Head of Applied ESG & Climate Research

19 May 2022



# MSCI Overview



**50**

Years in Business



**3,500+**

Employees



**35**

Global Locations



**7,800+**

Active Clients

## Indexes



- MSCI ACWI Index
- MSCI World Index
- MSCI EM Index
- ESG and Climate Indexes
- Factor Indexes
- Thematic Indexes

**230k indexes calculated daily**

**1.3k+ ETFs based on MSCI indexes<sup>1</sup>**

## Analytics



- Risk Management
- Asset Allocation
- Fixed Income Analytics
- Multi-asset Class Factor Models

**1 trillion calculations/day**

**2 million time series**

**70+ million client positions**

## ESG & Climate



- ESG Company & Fund Ratings
- Climate Solutions
- Screening & Controversies
- Sustainable Impact
- EU Sustainable Finance

**1.5k+ ESG & Climate equity and fixed income indices<sup>2</sup>**

**14k+ issuer ESG Ratings<sup>2</sup>**

## Private Real Estate



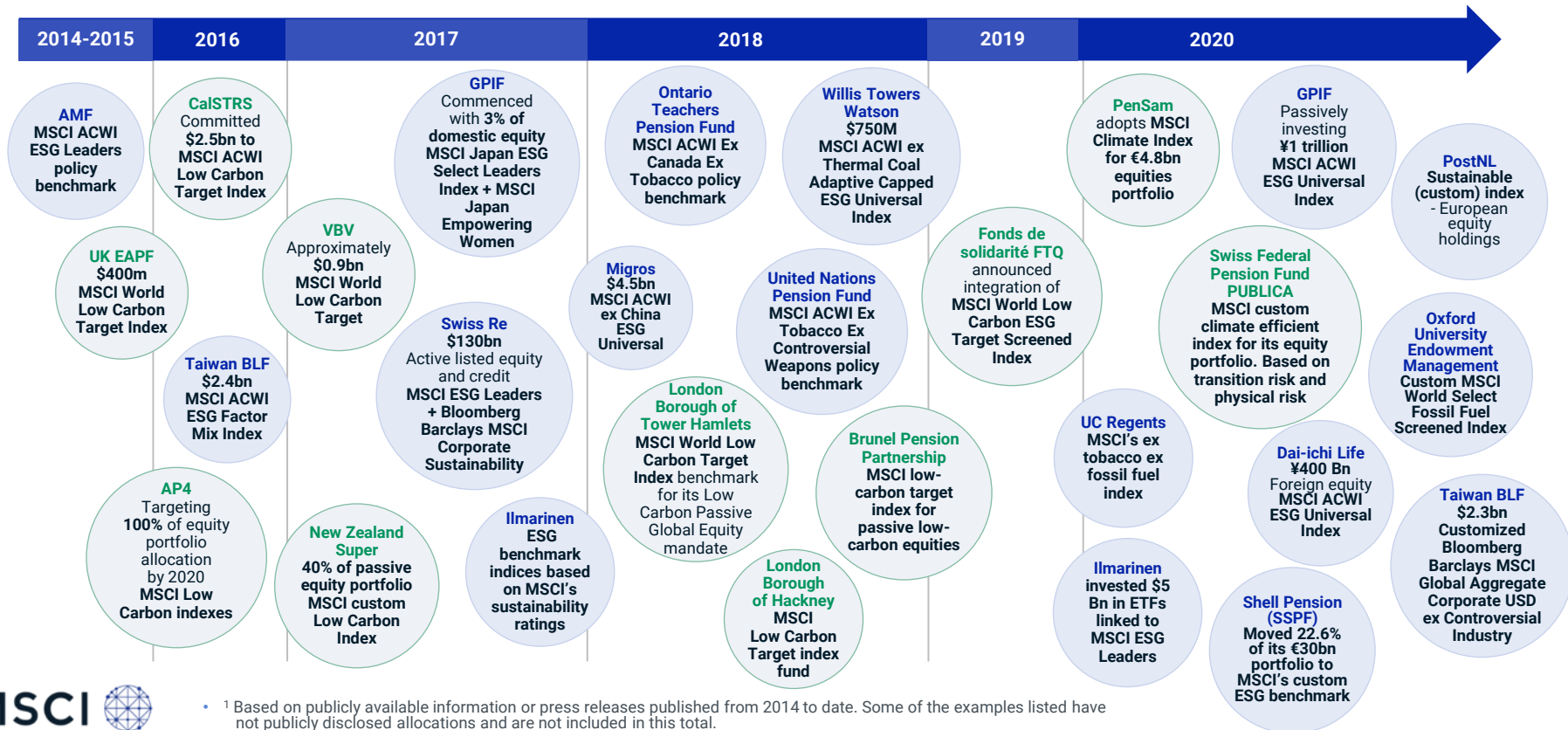
- Performance attribution services
- Risk Analytics
- Global market information
- Indexes

**In over 32 markets worldwide**

**Coverage spanning \$2 trillion of private real estate assets**

# Institutional Investor adoption of MSCI ESG Indexes

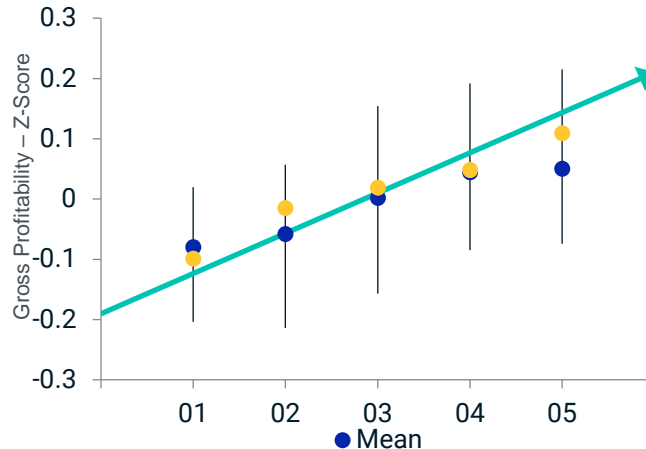
Approximately \$294 bn allocated to investments tracking / benchmarked to MSCI ESG equity & fixed income indexes since 2014<sup>1</sup>



# Greater understanding of ESG's influence on risk and return...

An MSCI ESG Research study<sup>1</sup> found that companies with high ESG Ratings had higher profitability, lower tail risk and lower systematic risk on average based on 10 years of data

Companies with higher MSCI ESG scores had **higher profitability** and were more competitive



MSCI has a broad range of over 1,500 equity and fixed income ESG Indexes with significant live history. The MSCI KLD 400 has the longest track record (30 years).

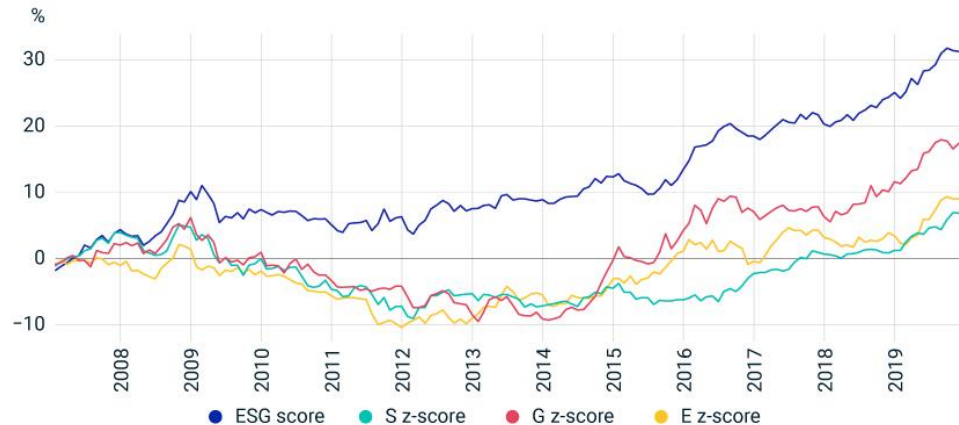
MSCI KLD 400: **30 years** of live history

MSCI KLD 400 Social vs MSCI USA



# ...and the financial relevance of ESG pillars & key issues

## Performance of Q5 – Q1 quintile portfolios in MSCI World Index



Data from December 2006 to December 2019 for MSCI World universe.

- We created equal weighted size- and industry-adjusted quintiles for MSCI ESG scores and E, S and G pillar scores with monthly re-balancing
- We tested Q5 (long) versus Q1 (short) performance:

### Key observations over 13-years horizon:

- All three pillars outperformed, with G ahead of E and S.
- The total MSCI ESG score clearly showed the best performance and the lowest level of cyclicity.

# Our principles of sustainable investing

A framework to help investors incorporate ESG considerations throughout the investment process

MSCI has published “The MSCI Principles of Sustainable Investing,” a framework designed to illustrate specific, actionable steps that investors can and should undertake to improve practices for ESG integration across the investment value chain. The framework includes three core pillars to full ESG integration:

## Investment Strategy

Asset owners should integrate ESG considerations into their processes for establishing, monitoring and revising their overall investment strategy and asset allocation.

## Portfolio Management

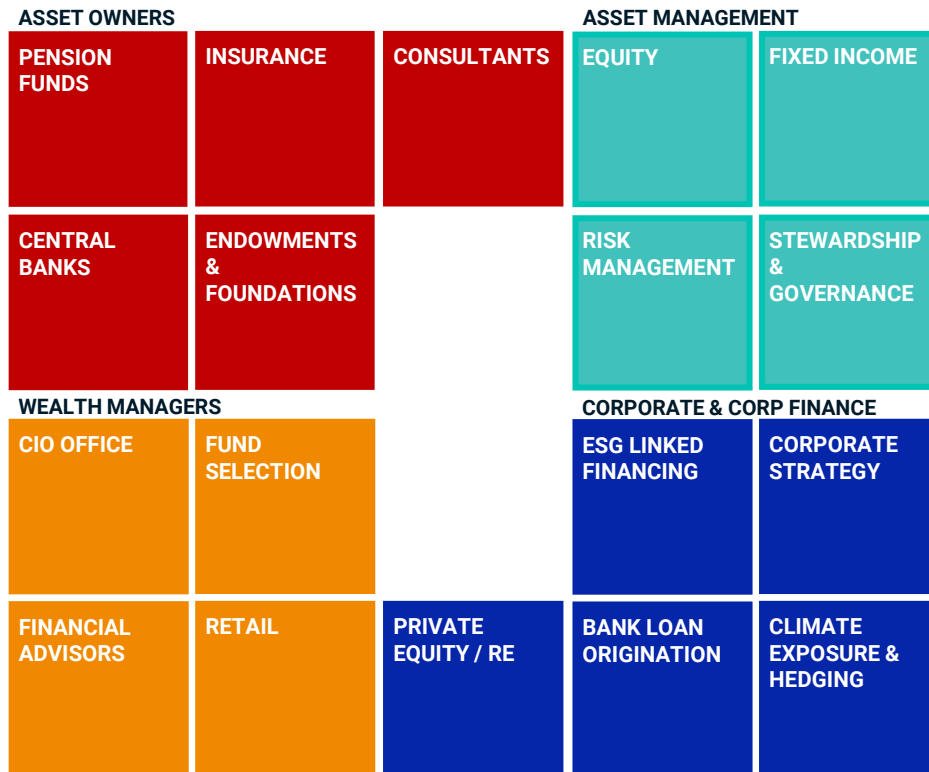
Portfolio managers should incorporate ESG considerations throughout the entire portfolio management process, including security selection, portfolio construction, risk management, performance attribution and client reporting.

## Investment Research

Research analysts assessing companies and issuing investment recommendations to portfolio managers should integrate ESG considerations (including ESG company ratings) into their fundamental company analysis.

Learn more at [msci.com/esg/principles-of-sustainable-investing](https://www.msci.com/esg/principles-of-sustainable-investing)

# ESG leaders have demonstrated increased sophistication across their organizations



Asset Managers are moving beyond fundamental equity and **integrating ESG into fixed income and quantitative** strategies with growing sophistication

**Largest consultants** are **incorporating ESG** dimensions into manager selection in reaction to Asset Owner requests

**Engagement** is becoming an important tool for improving company performance and returns

Risk teams are increasingly **systematically reporting** on ESG risk

Demand for active and passive **ESG Funds across asset classes** for total portfolio exposures

# ESG integration throughout the *investment process*

- 1 Define objectives & policy**
  - Define investment and ESG objectives
  - Set targets and strategies to enhance ESG profile
  - Develop investment policy
  - Select benchmarks
- 2 Integrate** into investment process
  - ESG in portfolio construction
  - Active and index-linked ESG products
  - Scalable risk management reporting
  - Stress testing
- 3 Engage** stakeholders & report
  - Engage companies and external stakeholders
  - Provide transparency through client reporting





# Understanding the most common ESG objectives

1

2

3

Incorporating ESG into investment strategy or creating products typically starts with understanding client objectives, which may combine elements of managing long-term risk, reflecting values and positive impact.

## Investment Objectives

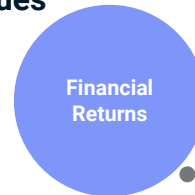
“Incorporating ESG may improve our investment results”



Incorporate ESG criteria to enhance long-term return, manage ESG financial risk

## Individual Objectives

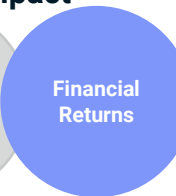
### Values



“Our investments should reflect our clients’ values”

Align portfolio with investor’s ethical or political values

### Impact



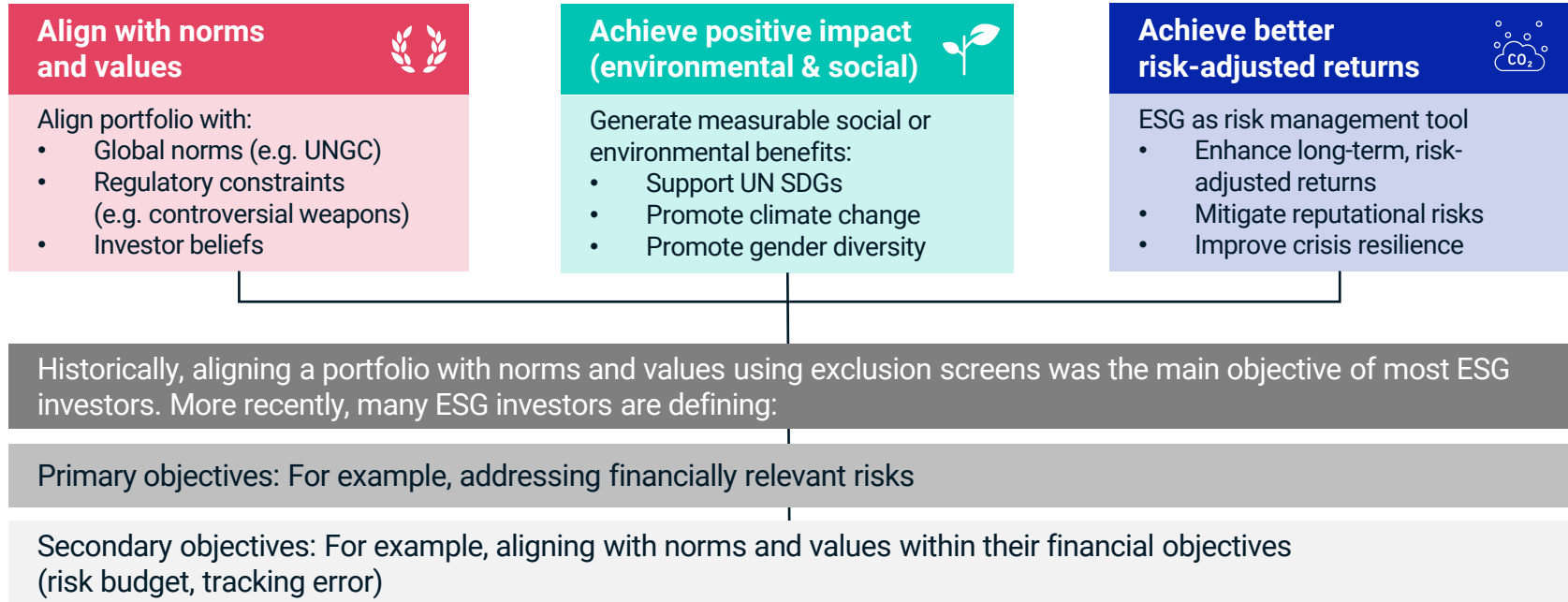
“We want our investments to make a difference in the world”

Generate measurable social or environmental benefits as well as financial returns

# Defining ESG investment objectives

1 2 3

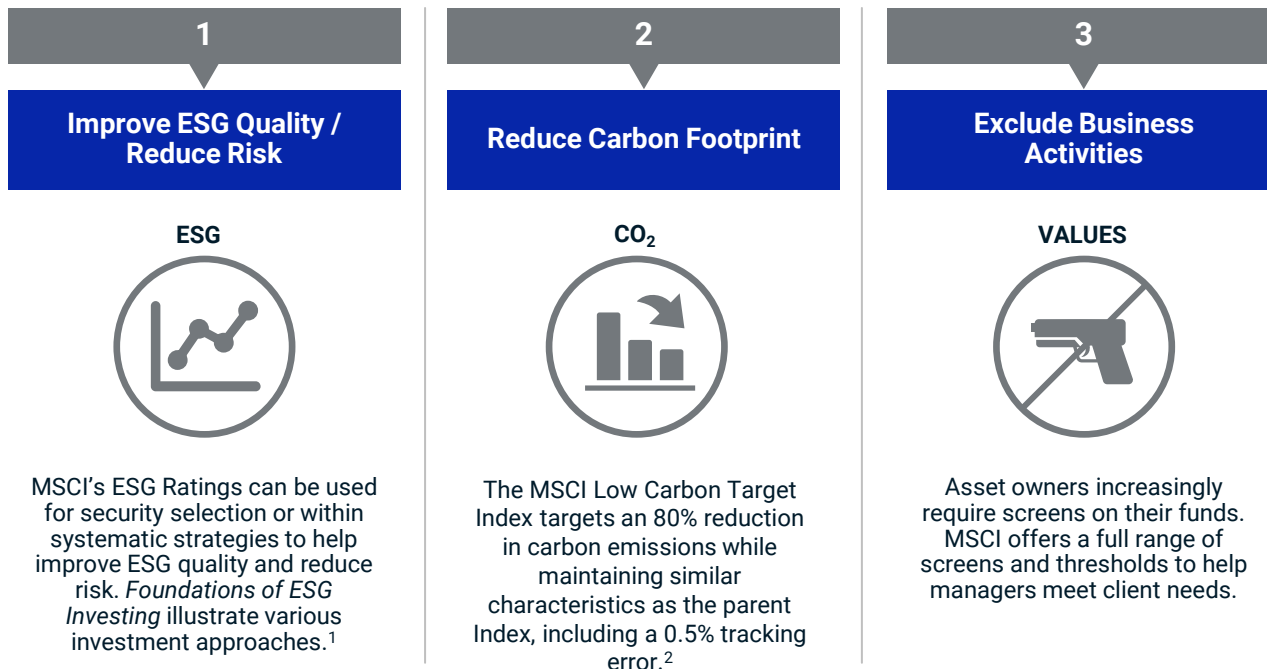
## Common approaches to setting primary and secondary ESG investment objectives



# Integrate ESG into your investment strategy

1 **2** 3

There are numerous approaches for integrating ESG into portfolio construction—whether active or passive strategies—in equities or fixed income. Here are some common approaches.



# Integrate ESG into your risk management

1 2 3

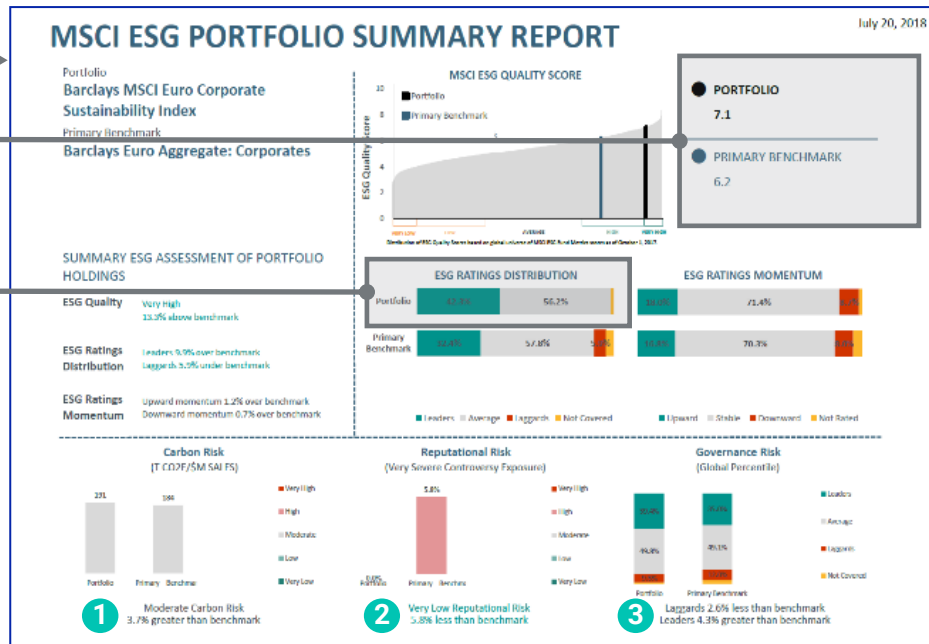
We increasingly see clients incorporating ESG into risk reporting and conversations with portfolio managers.

Sample report used by large fund manager for quarterly risk reporting

Portfolio has a **higher ESG Quality score** than the benchmark

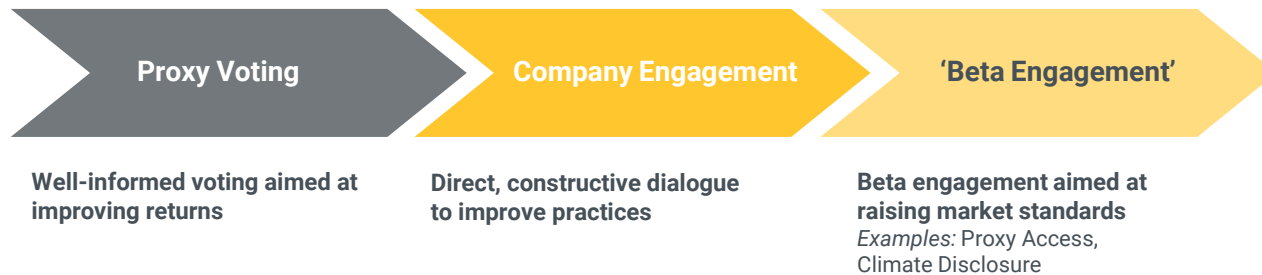
High ESG Quality score coming from **higher exposure to ESG leaders** and lower exposure to laggards

Portfolio has **moderate Carbon Risk (1)** and **Very low Reputational Risk (2)**, as well as **4.3% more exposure to Governance Leaders (3)** than the benchmark



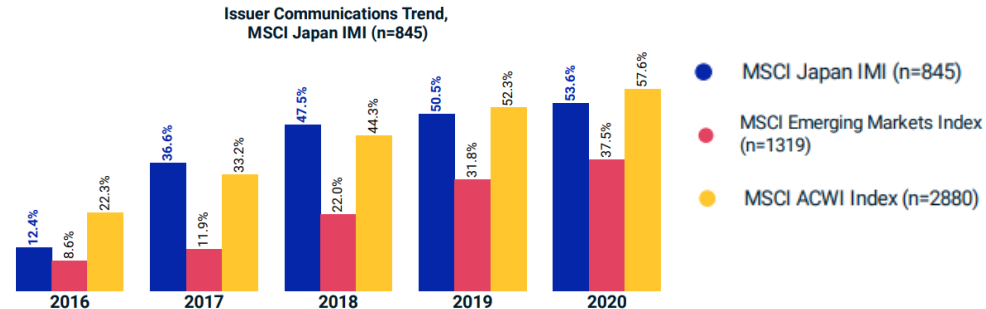
# Engage with stakeholders and communicate

Many asset owners expect managers to be active stewards of capital and to exert oversight and influence on companies they own. Leaders in field use engagement to improve company performance.



As part of Japan's Government Pension Fund (GPIF) allocation to MSCI ESG Leaders Index mandates, MSCI initiated engagements with Japanese corporates in 2017 to raise awareness of ESG best practices. As a result, we have seen a dramatic increase in interest, measured by an increase in response rates from Japanese companies.

## Corporate Inquiries/Feedback from Japanese Companies



# Engage: Provide ESG transparency to investors through systematic reporting

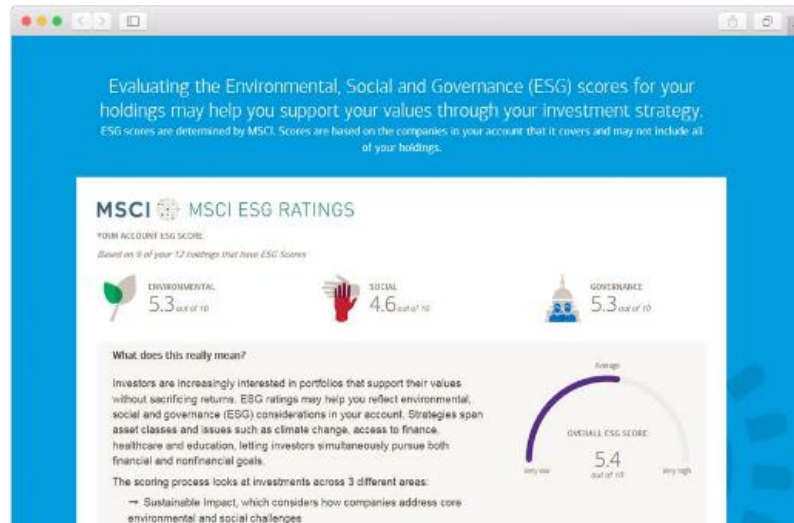
End investors are demanding transparency on ESG portfolio characteristics to ensure that manager claims around ESG integration are translating into investment decisions.

Example of how Merrill is using MSCI ESG Ratings to communicate intuitively with end clients on its online brokerage platform.

Merrill Edge platform hosts 2.4 million accounts and \$184.5 billion in assets<sup>1</sup>

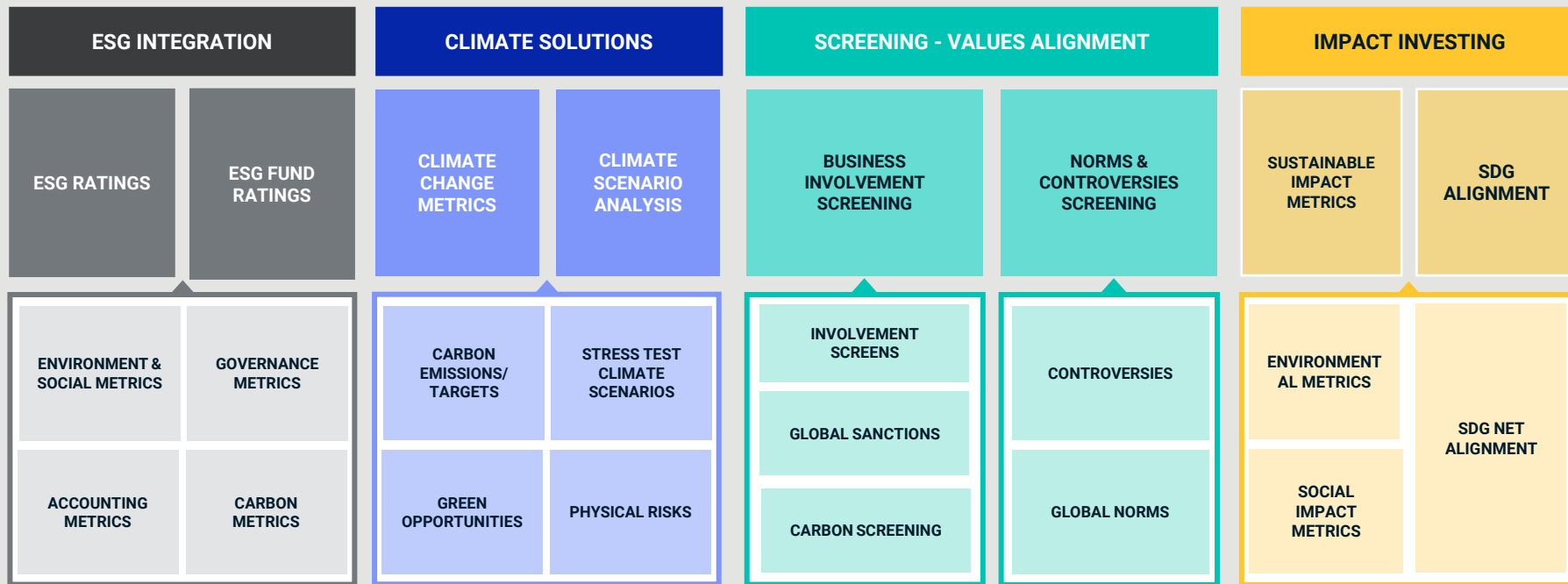
Merrill Edge investors can identify ESG Leaders and Laggards based on MSCI ESG Ratings for clients to make better, more informed investment decisions

## Portfolio MSCI ESG scores



# MSCI ESG Research Product Suite

MSCI ESG Research rates 8,500 companies (14,000 issuers including subsidiaries) and more than 680,000 equity and fixed income securities globally (as of October 2020)



# What are ESG Ratings?

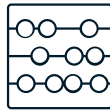
MSCI ESG Ratings aim to measure a company's **resilience to long-term, financially relevant ESG risks**

To do this we measure:

**Robustness of governance controls**, the foundation of good risk management



BOARD



ACCOUNTING



OWNERSHIP AND CONTROL



EXECUTIVE PAY

Exposure to **long-term systematic risk** factors



CLIMATE CHANGE



WATER SCARCITY



DATA SECURITY



DEMOGRAPHIC SHIFTS

**Management quality & ability to limit surprised and event risks**



ACCIDENTS



FRAUD







SHUTDOWNS



STRIKES



# Key research questions

 <p><b>1</b></p> <p><b>Q: How is the company governed?</b></p> <p>How do governance structures impede / enable it to be a long-term steward of capital?</p>	 <p><b>2</b></p> <p><b>Q: What risks does the company face?</b></p> <p>How exposed is its business model to relevant short-, medium- and long-term ESG risks?</p>	 <p><b>3</b></p> <p><b>Q: What does the company say?</b></p> <p>What is its strategy for managing these risks? What measures has it put in place?</p>	 <p><b>4</b></p> <p><b>Q: What does the company do?</b></p> <p>What evidence do we see that these risks are being managed? What is its track record?</p>
<p><b>A:</b> Analyze ownership structure, board, incentives and behavior.</p>	<p><b>A:</b> Map company operations to an extensive proprietary database of ESG risk factors.</p>	<p><b>A:</b> Benchmark company disclosures and policies vs. industry peers.</p>	<p><b>A:</b> Evaluate alternative data from sources outside the company.</p>

# MSCI ESG Rating model key issues

## Example: Soft Drinks Sub-Industry

MSCI ESG Score									
ENVIRONMENT PILLAR				SOCIAL PILLAR				GOVERNANCE PILLAR	
Climate Change	Natural Capital	Pollution & Waste	Env. Opportunities	Human Capital	Product Liability	Stakeholder Opposition	Social Opportunities	Corporate Governance	Corporate Behavior
Carbon Emissions	Water Stress	Toxic Emissions & Waste	Clean Tech	Labor Management	Product Safety & Quality	Controversial Sourcing	Access to Communication	Board	Business Ethics
Product Carbon Footprint	Biodiversity & Land Use	Packaging Material & Waste	Green Building	Health & Safety	Financial System Instability	Community Relations	Access to Finance	Pay	Tax Transparency
Financing Environmental Impact	Raw Material Sourcing	Electronic Waste	Renewable Energy	Human Capital Development	Consumer Financial Protection		Access to Health Care	Ownership	
Climate Change Vulnerability				Supply Chain Labor Standards	Privacy & Data Security		Opportunities in Nutrition & Health	Accounting	
					Responsible Investment				
					Insuring Health & Demographic Risk				

<span style="border: 1px solid blue; display: inline-block; width: 20px; height: 10px; vertical-align: middle;"></span>	<i>Key issues selected for the Soft Drinks Sub-Industry (e.g. Coca-Cola)</i>
<span style="background-color: #cccccc; display: inline-block; width: 20px; height: 10px; vertical-align: middle;"></span>	Universal key issues applicable to all industries

# Governance assessment for all companies

## Detailed analysis of:

- Shareholders and management alignment
- Relationship of governance structures, events, and corporate behavior
- Local market standards
- Business ethics policies and corruption risk
- Tax controversies



### Board

Size, director election standards, tenure and gender diversity  
Assessment of financial, industry and risk management expertise



### Pay

Robust data on CEO pay. Analysis of pay for performance link.  
Assessment of compensation committee independence



### Ownership and Control

Ownership structure, shareholder rights and key takeover defenses  
Major owners and insider holdings



### Accounting

Audit committee structure and fees paid to outside auditors. Transparency metrics tied to revenue, expense recognition, asset-liability valuation



### Business Ethics

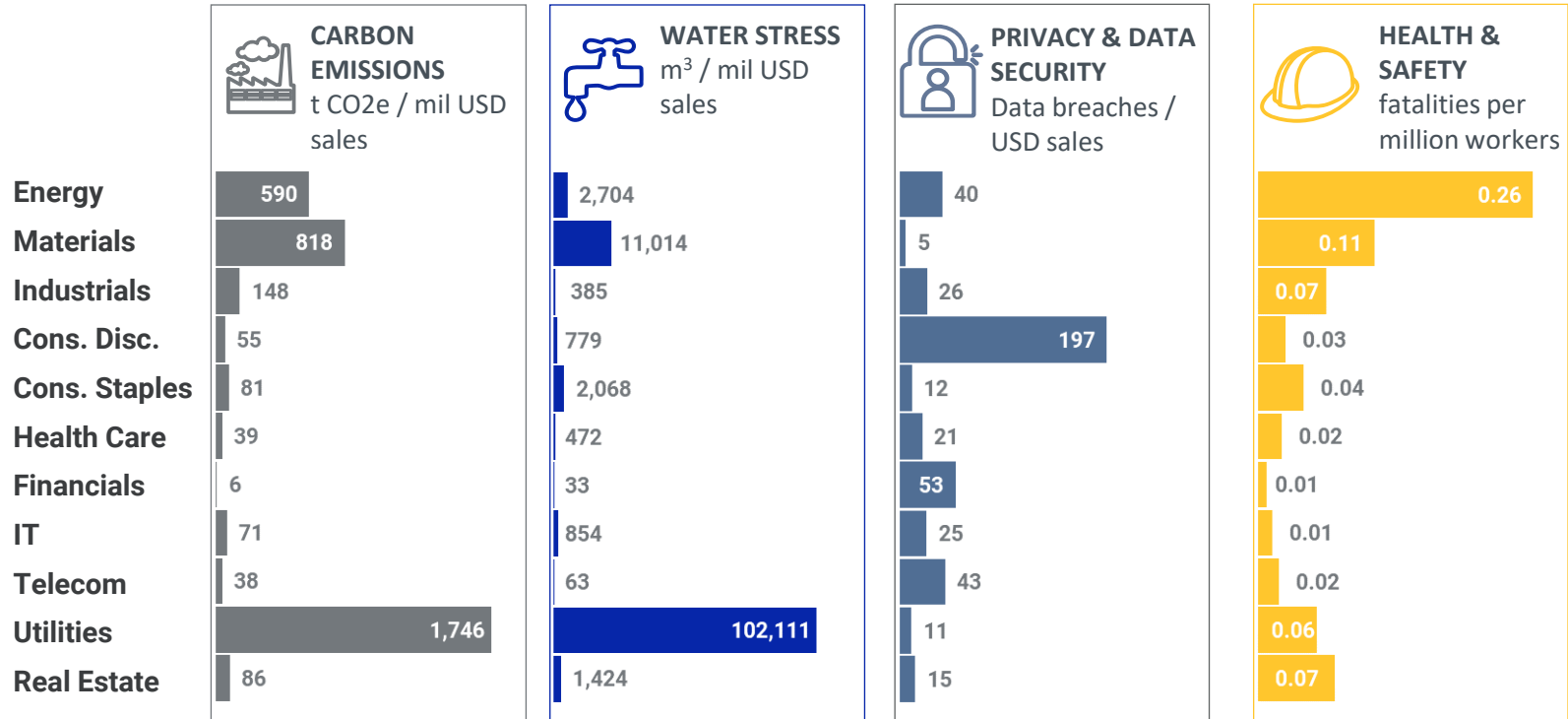
Oversight and management of business ethics issues, involvement in business ethics controversies, and exposure to corruption risks



### Tax Transparency

Estimated corporate tax gap and involvement in tax-related controversies

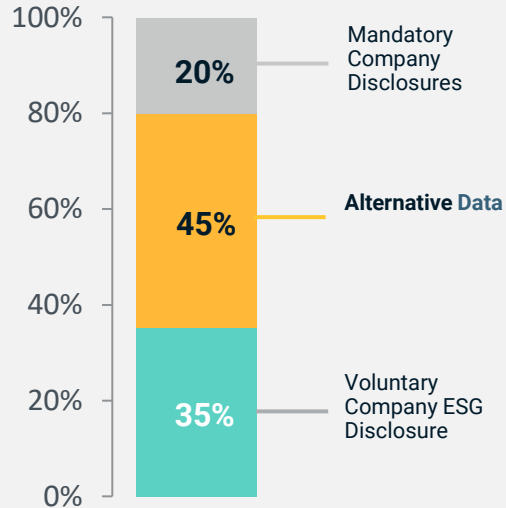
# Environmental and Social Risks are Industry-specific



Sources: Carbon emissions and freshwater withdrawal intensities based on sample of 3,823 and 1,633 companies, respectively as of March 2, 2020. Percentage of companies with active bribery and ethics controversies is based on the number of companies with ongoing bribery & fraud controversies in the MSCI ACWI Investable Market Index (IMI) as of March 2, 2020. Fatalities per million workers calculated based on three-year average fatality rates from the Census of Occupational Injuries (US Bureau of Labor Statistics). Data breach intensity calculated based on three-year average of the number data breaches by sector (Verizon Data Breach Investigations Report) and business segments for companies in the MSCI ACWI Index as of March 2, 2020.

# Alternative data helps minimize reliance on voluntary disclosure to deliver key insights

## Alternative data is a significant input to ESG Ratings model



2,434 constituents of the MSCI ACWI Index as of November 30, 2017  
Source: MSCI ESG Research

## Problems to solve:

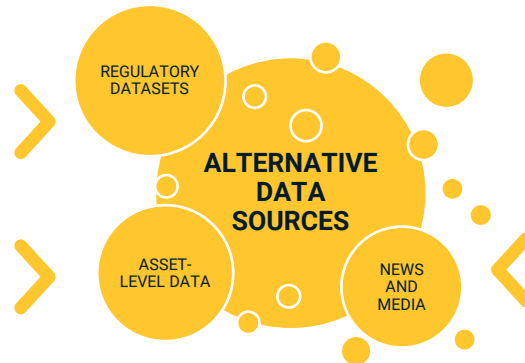
- The company does not self disclose sufficient information to gauge its risk management capabilities on the topic
- Risks may emerge at the macro level, requiring information external to the company

**Alternative data sets** are information about a company published by sources outside of the company. We use them to:

- Deliver insight not captured with voluntary company disclosures
- Identify unexplored risks and opportunities
- Create innovative signals

**Example data:**  
Product recalls  
Consumer complaints

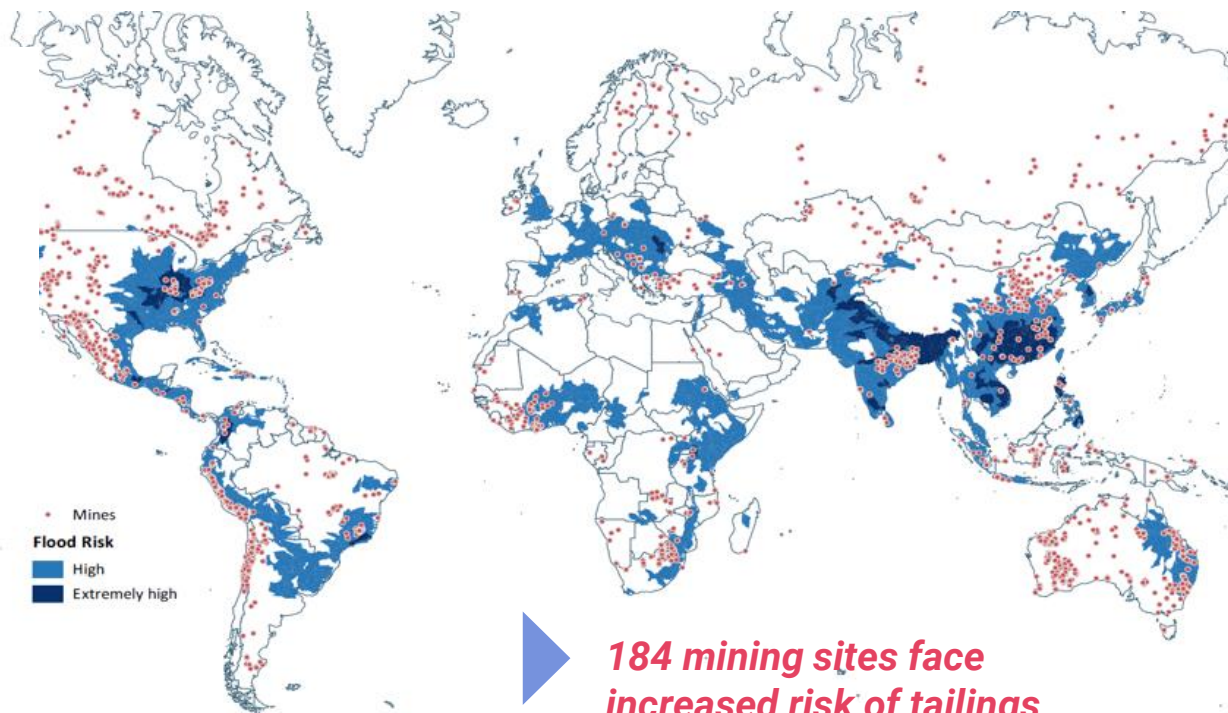
**Example data:**  
Facility locations  
Mine production



**Example data:**  
Controversial incidents  
Director malpractice

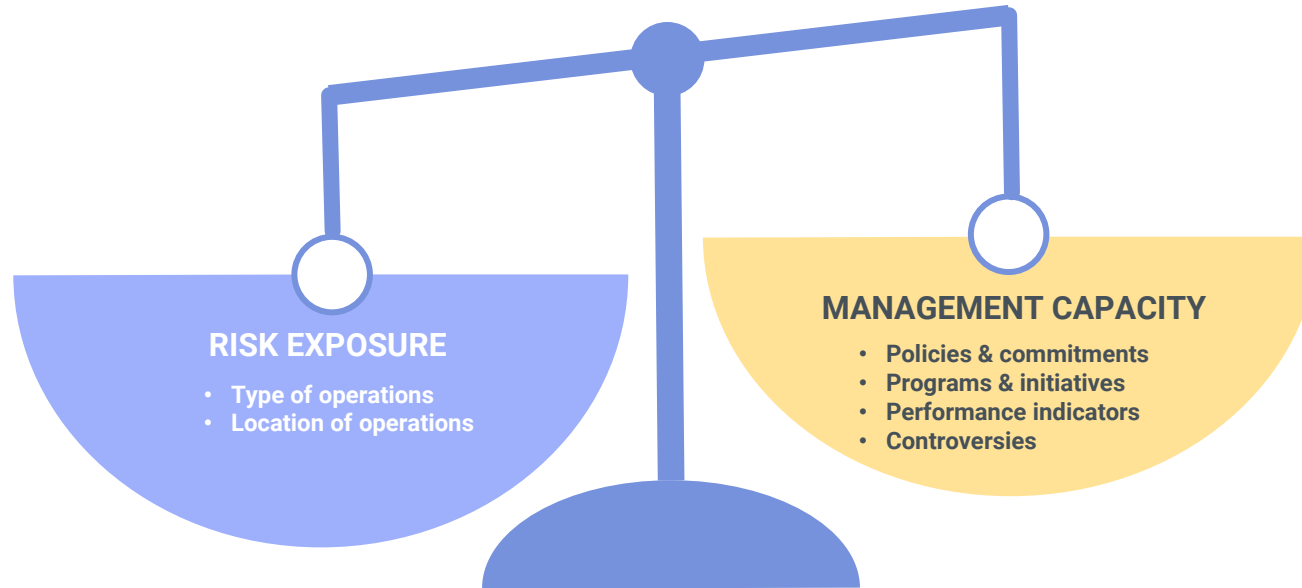
# Example: overlaying flood maps and mining sites can bring new insights into potential future event risks

We identify 371 mining sites (out of 2,554), owned by constituents of MSCI ACWI Index,\* situated within high flood-risk zones. Of these, **184 are hardrock metal mines, which generate more tailings waste than that of coal.**



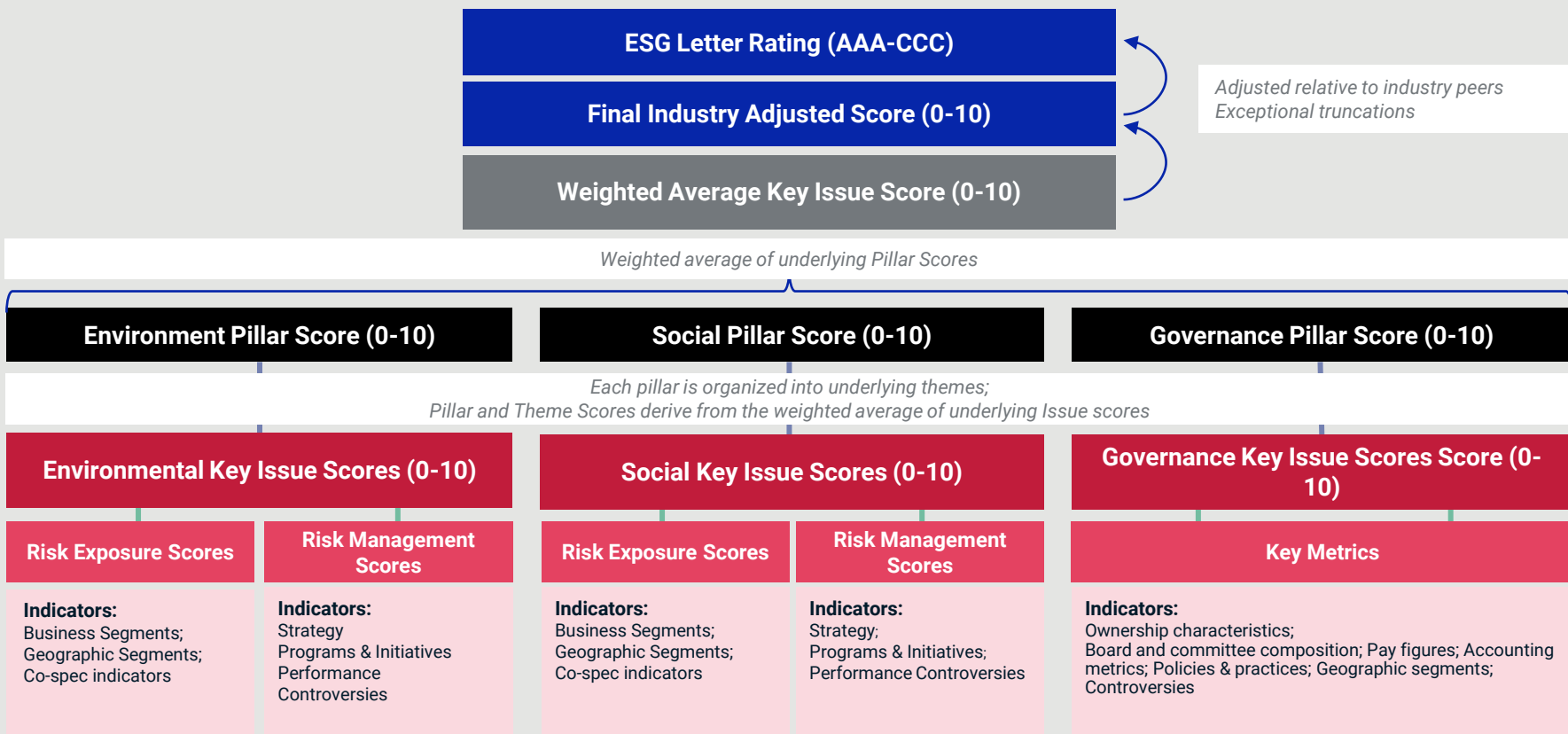
**184 mining sites face increased risk of tailings dam collapse**

# Measuring ESG Risk Exposure



EVALUATE MANAGEMENT STRATEGY IN  
THE CONTEXT OF RISK EXPOSURE

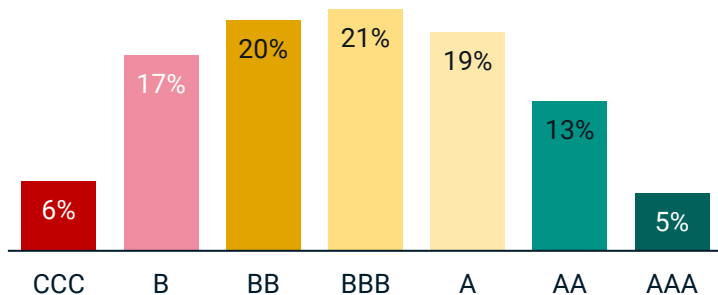
# How the scores roll up to the final ESG Rating



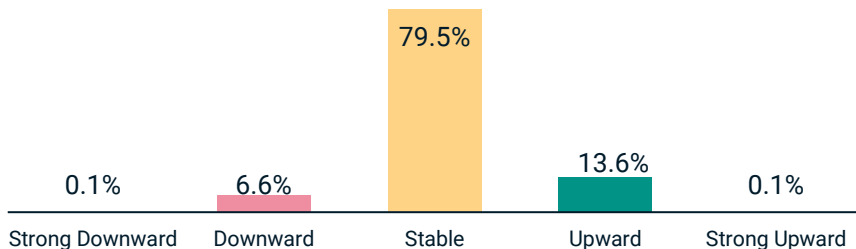


# ESG Ratings: Key statistics – MSCI ACWI

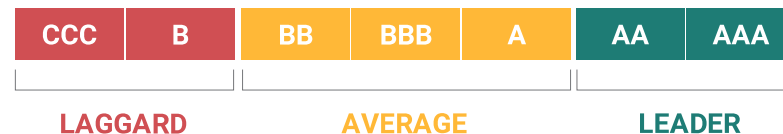
MSCI ESG RATING DISTRIBUTION (%)



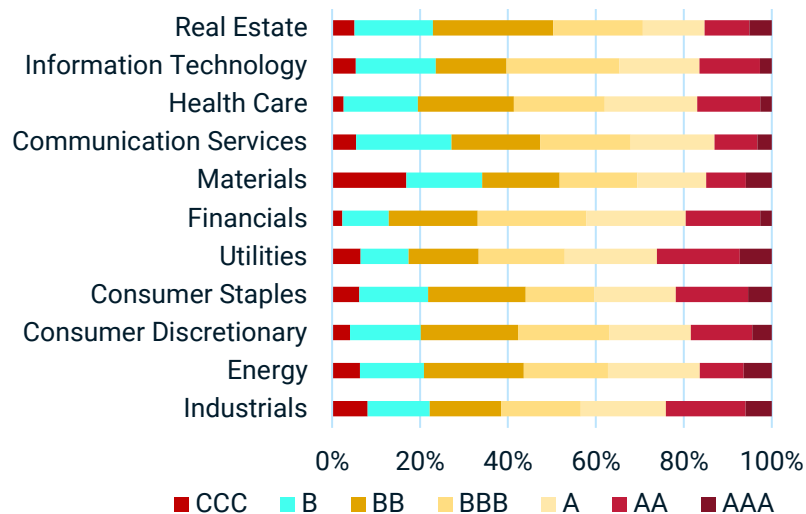
MSCI ESG RATING TREND (%)



MSCI ESG RATINGS



MSCI ESG RATING DISTRIBUTION BY SECTOR



# About MSCI: ESG

## About MSCI ESG Research Products and Services

MSCI ESG Research products and services are provided by MSCI ESG Research LLC, and are designed to provide in-depth research, ratings and analysis of environmental, social and governance-related business practices to companies worldwide. ESG ratings, data and analysis from MSCI ESG Research LLC. are also used in the construction of the MSCI ESG Indexes. MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc.

## About MSCI Inc.

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 45 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process.

To learn more, please visit [www.msci.com](http://www.msci.com).

# Notice and disclaimer: ESG

This document and all of the information contained in it, including without limitation all text, data, graphs, charts (collectively, the "Information") is the property of MSCI Inc. or its subsidiaries (collectively, "MSCI"), or MSCI's licensors, direct or indirect suppliers or any third party involved in making or compiling any Information (collectively, with MSCI, the "Information Providers") and is provided for informational purposes only. The Information may not be modified, reverse-engineered, reproduced or redisseminated in whole or in part without prior written permission from MSCI. All rights in the Information are reserved by MSCI and/or its Information Providers.

The Information may not be used to create derivative works or to verify or correct other data or information. For example (but without limitation), the Information may not be used to create indexes, databases, risk models, analytics, software, or in connection with the issuing, offering, sponsoring, managing or marketing of any securities, portfolios, financial products or other investment vehicles utilizing or based on, linked to, tracking or otherwise derived from the Information or any other MSCI data, information, products or services.

The user of the Information assumes the entire risk of any use it may make or permit to be made of the Information. NONE OF THE INFORMATION PROVIDERS MAKES ANY EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE INFORMATION (OR THE RESULTS TO BE OBTAINED BY THE USE THEREOF), AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, EACH INFORMATION PROVIDER EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES (INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF ORIGINALITY, ACCURACY, TIMELINESS, NON-INFRINGEMENT, COMPLETENESS, MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE) WITH RESPECT TO ANY OF THE INFORMATION.

Without limiting any of the foregoing and to the maximum extent permitted by applicable law, in no event shall any Information Provider have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential (including lost profits) or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not be applicable law be excluded or limited, including without limitation (as applicable), any liability for death or personal injury to the extent that such injury results from the negligence or willful default of itself, its servants, agents or sub-contractors.

Information containing any historical information, data or analysis should not be taken as an indication or guarantee of any future performance, analysis, forecast or prediction. Past performance does not guarantee future results.

The Information should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. All Information is impersonal and not tailored to the needs of any person, entity or group of persons.

None of the Information constitutes an offer to sell (or a solicitation of an offer to buy), any security, financial product or other investment vehicle or any trading strategy.

It is not possible to invest directly in an index. Exposure to an asset class or trading strategy or other category represented by an index is only available through third party investable instruments (if any) based on that index. MSCI does not issue, sponsor, endorse, market, offer, review or otherwise express any opinion regarding any fund, ETF, derivative or other security, investment, financial product or trading strategy that is based on, linked to or seeks to provide an investment return related to the performance of any MSCI index (collectively, "Index Linked Investments"). MSCI makes no assurance that any Index Linked Investments will accurately track index performance or provide positive investment returns. MSCI Inc. is not an investment adviser or fiduciary and MSCI makes no representation regarding the advisability of investing in any Index Linked Investments.

Index returns do not represent the results of actual trading of investible assets/securities. MSCI maintains and calculates indexes, but does not manage actual assets. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the index or Index Linked Investments. The imposition of these fees and charges would cause the performance of an Index Linked Investment to be different than the MSCI index performance.

The Information may contain back tested data. Back-tested performance is not actual performance, but is hypothetical. There are frequently material differences between back tested performance results and actual results subsequently achieved by any investment strategy.

Constituents of MSCI equity indexes are listed companies, which are included in or excluded from the indexes according to the application of the relevant index methodologies. Accordingly, constituents in MSCI equity indexes may include MSCI Inc., clients of MSCI or suppliers to MSCI. Inclusion of a security within an MSCI index is not a recommendation by MSCI to buy, sell, or hold such security, nor is it considered to be investment advice.

Data and information produced by various affiliates of MSCI Inc., including MSCI ESG Research LLC and Barra LLC, may be used in calculating certain MSCI indexes. More information can be found in the relevant index methodologies on [www.msci.com](http://www.msci.com).

MSCI receives compensation in connection with licensing its indexes to third parties. MSCI Inc.'s revenue includes fees based on assets in Index Linked Investments. Information can be found in MSCI Inc.'s company filings on the Investor Relations section of [www.msci.com](http://www.msci.com).

MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc. Except with respect to any applicable products or services from MSCI ESG Research, neither MSCI nor any of its products or services recommends, endorses, approves or otherwise expresses any opinion regarding any issuer, securities, financial products or instruments or trading strategies and MSCI's products or services are not intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Issuers mentioned or included in any MSCI ESG Research materials may include MSCI Inc., clients of MSCI or suppliers to MSCI, and may also purchase research or other products or services from MSCI ESG Research. MSCI ESG Research materials, including materials utilized in any MSCI ESG Indexes or other products, have not been submitted to, nor received approval from, the United States Securities and Exchange Commission or any other regulatory body.

Any use of or access to products, services or information of MSCI requires a license from MSCI. MSCI, Barra, RiskMetrics, IPD and other MSCI brands and product names are the trademarks, service marks, or registered trademarks of MSCI or its subsidiaries in the United States and other jurisdictions. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of MSCI and Standard & Poor's. "Global Industry Classification Standard (GICS)" is a service mark of MSCI and Standard & Poor's.

MIFID2/MIFIR notice: MSCI ESG Research LLC does not distribute or act as an intermediary for financial instruments or structured deposits, nor does it deal on its own account, provide execution services for others or manage client accounts. No MSCI ESG Research product or service supports, promotes or is intended to support or promote any such activity. MSCI ESG Research is an independent provider of ESG data, reports and ratings based on published methodologies and available to clients on a subscription basis. We do not provide custom or one-off ratings or recommendations of securities or other financial instruments upon request.

Privacy notice: For information about how MSCI collects and uses personal data, please refer to our Privacy Notice at <https://www.msci.com/privacy-pledge>.

# Contact us

AMERICAS		EUROPE, MIDDLE EAST & AFRICA		ASIA PACIFIC	
Americas	+1 888 588 4567 *	Cape Town	+ 27 21 673 0100	China North	10800 852 1032 *
Atlanta	+ 1 404 551 3212	Frankfurt	+ 49 69 133 859 00	China South	10800 152 1032 *
Boston	+ 1 617 532 0920	Geneva	+ 41 22 817 9777	Hong Kong	+ 852 2844 9333
Chicago	+ 1 312 675 0545	London	+ 44 20 7618 2222	Mumbai	+ 91 22 6784 9160
Monterrey	+ 52 81 1253 4020	Milan	+ 39 02 5849 0415	Seoul	00798 8521 3392 *
New York	+ 1 212 804 3901	Paris	0800 91 59 17 *	Singapore	800 852 3749 *
San Francisco	+ 1 415 836 8800			Sydney	+ 61 2 9033 9333
São Paulo	+ 55 11 3706 1360			Taipei	008 0112 7513 *
Toronto	+ 1 416 628 1007			Thailand	0018 0015 6207 7181 *
* = toll free msci.com <a href="mailto:clientservice@msci.com">clientservice@msci.com</a>				Tokyo	+81 3 5290 1555