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Update to the Consultation on MSCI USA ESG Select Index Methodology

April 2012

MSCI USA ESG Select Index Consultation – Key Updates

- MSCI launched a consultation on proposed enhancements to the MSCI USA ESG Select Index on February 29, 2012.
- This updated consultation document incorporates the client feedback received so far as part of the consultation. The key updates to the earlier version are highlighted below, while the rest of the document describes the proposed enhancements in further detail
- Methodology
 - MSCI proposes to use a combination of two MSCI ESG Research products for the purpose of index creation – IVA ratings for overall best-in-class ESG company performance and Impact Monitor scores for identifying highly controversial company practices and business activities.
 - Companies with major business involvement in the production of products with high negative social or environmental impacts will also be captured now as part of their Impact Monitor assessment. Consequently, the ESG Screener will not be used in the construction of the MSCI USA ESG Select Index. However, companies with Tobacco involvement will continue to be excluded.
- Transition Timeline
 - Based on client feedback, MSCI proposes to transition to the enhanced methodology starting May 2012 Index Review.

Executive Summary

- The MSCI USA ESG Select Index methodology is currently based on the Global Socrates (GS) ESG ratings. MSCI intends to migrate this index to an enhanced methodology based on a new suite of MSCI ESG Research products available on MSCI ESG Research's new platform - ESG Manager - to increase transparency and granularity of the ESG signals while keeping the philosophy underpinning the index unchanged.
- MSCI proposes to use a combination of two MSCI ESG products for the purpose of index creation – IVA ratings for overall best-in-class ESG company performance and Impact Monitor scores for identifying highly controversial company practices and business activities.
- These proposals are similar to the enhanced methodology proposal for the MSCI Global ESG Indices, on which MSCI is currently consulting with clients.*
- In addition, MSCI also proposes to reduce the current annual turnover budget from 50% to 30% (10% at Semi-Annual Index Reviews and 5% at Quarterly Index Reviews)
- Please note this consultation may or may not lead to the adoption, in whole or in part, of the proposed enhancements described herein.

* The consultation document describing these proposed enhancements in detail is available on the MSCI web site at <http://www.msci.com/products/indices/consultations/>

Current MSCI USA ESG Select Index Methodology

- Currently, the MSCI USA ESG Select Index is based on Global Socrates ratings.
- MSCI USA ESG Select Index is an optimization based index and aims to over-weight companies with higher ESG ratings and under-weight companies with lower ESG ratings and excludes companies with Tobacco involvement
- The index is reviewed on a quarterly basis to coincide with the Semi-Annual Index Reviews in May and November and Quarterly Index Reviews in February and August.
- At each quarterly index review, following are the optimization constraints:
 - The predicted tracking error is restricted to 1.8%
 - The maximum weight of an index constituent is set to 5%
 - The minimum weight of an index constituent is set to 0.1%
 - The number of index constituents is constrained to a maximum of 350
 - The sector weights of the MSCI USA ESG Select Index should not deviate more than +/- 3% from the sector weights of MSCI USA
 - The one way turnover of the MSCI USA ESG Select Index is constrained to a maximum of 15% at Semi-Annual Index Reviews and 10% at Quarterly Index Reviews
 - One way transaction cost is set to 0.5% which aims to achieve a balance between turnover and ESG Scores
 - An AS/CF (Asset Selection/Common Factor) Risk Aversion Ratio of 10 is applied
- The rebalancing results are announced five days before the effective date through Integrated Client File (ICF) and a Global Summary Document.

Proposal for Enhanced Methodology

- ESG performance
 - Use normalized IVA Scores in the optimization process
- Controversial business practices
 - Continue to exclude companies with Tobacco involvement
 - Exclude all constituents in the Parent Index with an Impact Monitor controversy assessment of very severe (Impact Monitor score of 0 or 1)
 - Exclude all non-index constituents with an Impact Monitor controversy assessment of severe (Impact Monitor score of 2)
- Annual turnover budget: 30% (currently 50%)
 - This would help in managing the annual index turnover, with only a very marginal potential reduction in the ESG performance of the index
 - The index turnover over the recent Index Reviews has been well below the current budget as seen in the Appendix

Transition Proposal

- MSCI proposes to transition the MSCI USA ESG Select Index to the enhanced methodology over multiple index reviews starting May 2012 Index Review
- Transition analysis using the enhanced methodology based on data as of the close of November 30 2011 is as below

	#Current*	#Proforma**	#Deletions	#Additions
MSCI USA ESG Select Index	179	155	48	24

* As of 30 Nov 2011

** As of 1 Dec 2011

- The total turnover for the full transition is 33.4%. The turnover constraint (10% at Semi-Annual Index Reviews and 5% at Quarterly Index Reviews) will continue to apply at each Index Review.

Proposed Top weight increases

Name	Sector	GS Rating	IVA Score	IVA Rating	IM Score	Impact Monitor	Current Index (30 Nov 2011)	Proforma Index (1 Dec 2011)	Weight change (Proforma - Current)
BALL CORP	Materials	A	9	AAA	4	Yellow	0.10%	2.19%	2.09%
TRAVELERS COS	Financials	A	7.9	AAA	7	Green	0.18%	2.04%	1.86%
HENRY SCHEIN	Health Care	A	8.4	AAA	10	Green	0.00%	1.73%	1.73%
WEYERHAEUSER CO	Financials	BB	8.9	A	3	Yellow	0.00%	1.72%	1.72%
PROLOGIS	Financials	BBB	8.9	AAA	10	Green	0.00%	1.61%	1.61%
APPLE	Information Technonology	BBB	5.7	BBB	2	Yellow	0.92%	2.36%	1.44%
AMERICAN EXPRESS	Financials	AA	8.1	AAA	4	Yellow	0.66%	2.05%	1.39%
MEADWESTVACO CORP	Materials	B	8.5	A	5	Green	0.00%	1.28%	1.28%
SIGMA-ALDRICH	Materials	BBB	8.4	AAA	5	Green	0.00%	1.21%	1.21%
LIBERTY PROPERTY TRUST	Financials	BBB	8.3	AA	8	Green	0.00%	1.01%	1.01%
PITNEY BOWES	Industrials	A	8	AA	5	Green	0.09%	1.03%	0.94%
KRAFT FOODS A	Consumer Staples	AA	6.8	AA	4	Yellow	0.00%	0.86%	0.86%
VORNADO REALTY TRUST	Financials	BBB	7.9	AA	8	Green	0.26%	1.11%	0.85%
DAVITA	Health Care	A	8	AA	5	Green	0.00%	0.82%	0.82%
ECOLAB	Materials	A	8	AAA	2	Yellow	0.27%	1.05%	0.78%
DISCOVERY HOLDING C	Consumer Discretionary	BBB	8.4	AA	5	Green	0.00%	0.76%	0.76%
PATTERSON COS	Health Care	A	7.8	A	10	Green	0.00%	0.74%	0.74%
LIBERTY GLOBAL C	Consumer Discretionary	BBB	7.7	A	10	Green	0.00%	0.65%	0.65%
INT'L PAPER CO	Materials	BB	8	BBB	5	Green	0.00%	0.63%	0.63%
IBM CORP	Information Technonology	AA	7.8	AAA	2	Yellow	3.40%	4.01%	0.61%
CATERPILLAR	Industrials	B	7.2	A	2	Yellow	0.25%	0.85%	0.61%
LIFE TECHNOLOGIES	Health Care	A	7.9	AAA	5	Green	0.10%	0.67%	0.57%
COVANCE	Health Care	BBB	8	AA	10	Green	0.00%	0.56%	0.56%
CISCO SYSTEMS	Information Technonology	A	8.7	AAA	2	Yellow	1.38%	1.93%	0.55%
DISCOVERY HOLDING A	Consumer Discretionary	BBB	8.4	AA	5	Green	0.00%	0.53%	0.53%
MOTOROLA SOLUTIONS	Information Technonology	AA	7.9	AA	3	Yellow	0.23%	0.71%	0.48%
COCA-COLA ENTRPRS (NEW)	Consumer Staples	AA	7.6	A	7	Green	0.17%	0.63%	0.46%
AMERICAN TOWER CORP A	Telecommunication Services	BBB	7.1	BBB	8	Green	0.12%	0.57%	0.45%
NEXTERA ENERGY	Utilities	A	6.9	AAA	5	Green	0.31%	0.75%	0.44%
IHS INC A	Industrials	A	7.2	BBB	8	Green	0.00%	0.44%	0.44%

* GS (Global Socrates) rating is a bundling of ESG performance and highly controversial business activities represented by Impact Monitor Ratings

Proposed Top weight decreases

Name	Sector	GS Rating	IVA Score	IVA Rating	IM Score	Impact Monitor	Current Index (30 Nov 2011)	Proforma Index (1 Dec 2011)	Weight change (Proforma - Current)
TJX COS	Consumer Discretionary	AA	4.9	BBB	3	Yellow	1.78%	0.00%	-1.78%
DELL	Information Techonology	AA	6.1	A	2	Yellow	2.13%	0.72%	-1.41%
STARBUCKS CORP	Consumer Discretionary	AA	6.5	AAA	3	Yellow	2.91%	1.51%	-1.40%
ESTEE LAUDER COS A	Consumer Staples	AA	5.4	A	5	Green	1.61%	0.23%	-1.39%
PROCTER & GAMBLE CO	Consumer Staples	AA	4.7	BBB	4	Yellow	2.31%	0.93%	-1.38%
JOHNSON & JOHNSON	Health Care	AA	5	BB	2	Yellow	2.72%	1.46%	-1.26%
AFLAC	Financials	A	5.8	A	10	Green	1.69%	0.46%	-1.23%
JOHNSON CONTROLS	Consumer Discretionary	AA	5.1	B	3	Yellow	1.01%	0.00%	-1.01%
EATON CORP	Industrials	AA	7.2	AAA	5	Green	2.96%	1.95%	-1.00%
TEXAS INSTRUMENTS	Information Techonology	AA	5.1	BBB	5	Green	0.86%	0.00%	-0.86%
NIKE B	Consumer Discretionary	AA	6.2	AAA	4	Yellow	2.26%	1.42%	-0.83%
ROCKWELL COLLINS	Industrials	AA	6.6	AA	8	Green	2.00%	1.24%	-0.77%
COLGATE-PALMOLIVE	Consumer Staples	AA	4.2	BB	4	Yellow	0.71%	0.00%	-0.71%
CBRE GROUP	Financials	AA	6	A	10	Green	0.79%	0.10%	-0.69%
BAXTER INTERNATIONAL	Health Care	A	5.2	BBB	2	Yellow	0.83%	0.15%	-0.68%
AGILENT TECHNOLOGIES	Health Care	AA			5	Green	0.67%	0.00%	-0.67%
SARA LEE CORP	Consumer Staples	AA	5.8	A	5	Green	1.32%	0.65%	-0.67%
ALLERGAN	Health Care	CCC	3.9	CCC	2	Yellow	0.66%	0.00%	-0.66%
PG&E CORP	Utilities	AA	5.5	A	3	Yellow	1.47%	0.84%	-0.64%
SYSCO CORP	Consumer Staples	A	4.6	BBB	5	Green	0.57%	0.00%	-0.57%
ADOBE SYSTEMS	Information Techonology	AA	5.1	BBB	5	Green	0.54%	0.00%	-0.54%
KOHL'S CORP	Consumer Discretionary	AA	4.6	BBB	4	Yellow	0.51%	0.00%	-0.51%
NORDSTROM	Consumer Discretionary	AA	5.5	AA	5	Green	0.60%	0.10%	-0.49%
BECTON DICKINSON	Health Care	AA	6.2	A	5	Green	2.14%	1.66%	-0.48%
EMERSON ELECTRIC CO	Industrials	BBB	5.1	BB	3	Yellow	0.43%	0.00%	-0.43%
ADVANCED MICRO DEVICES	Information Techonology	AA	4.9	BBB	5	Green	0.42%	0.00%	-0.42%
AIR PRODUCTS & CHEMICALS	Materials	A	5.4	BBB	5	Green	0.42%	0.00%	-0.42%
STARWOOD HOT.&RES. WORLD	Consumer Discretionary	AA	5.8	BBB	5	Green	0.61%	0.19%	-0.42%
NOBLE CORP	Energy	A	5.1	BBB	5	Green	0.65%	0.23%	-0.41%
PALL CORP	Industrials	A	4.5	BB	2	Yellow	0.40%	0.00%	-0.40%

Discussion Points

- Is the application of a higher Impact Monitor controversy assessment of very severe or severe for non index constituents appropriate?
- Is it helpful to reduce the annual turnover budget from 50% to 30%?
- What would be the appropriate timeline for the transition?

Appendix

Sector-wise breakup

Sector	Weight in benchmark	Current Index (30 Nov 2011)	Proforma Index (1 Dec 2011)	Weight change (Proforma - Current)
Energy	12.8%	9.9%	9.8%	-0.1%
Materials	3.7%	1.6%	6.7%	5.1%
Industrials	10.6%	10.2%	9.6%	-0.5%
Consumer Discretionary	11.5%	14.9%	10.1%	-4.8%
Consumer Staples	9.4%	12.1%	7.6%	-4.5%
Health Care	11.8%	14.5%	14.1%	-0.5%
Financials	13.2%	10.8%	16.2%	5.4%
Information Technology	20.1%	23.0%	22.6%	-0.4%
Telecommunication Services	3.2%	0.3%	0.8%	0.5%
Utilities	3.7%	2.8%	2.6%	-0.2%
Grand Total	100%	100%	100%	

Top Current constituents

Name	Sector	GS Rating	IVA Rating	IM Score	Impact Monitor	current weight	proforma weight	current rank	proforma rank
IBM CORP	Information Technology	AA	AAA	2	Yellow	3.40%	4.01%	1	1
EATON CORP	Industrials	AA	AAA	5	Green	2.96%	1.95%	2	7
STARBUCKS CORP	Consumer Discretionary	AA	AAA	3	Yellow	2.91%	1.51%	3	16
JOHNSON & JOHNSON	Health Care	AA	BB	2	Yellow	2.72%	1.46%	4	18
SPECTRA ENERGY	Energy	A	A	5	Green	2.42%	2.26%	5	3
PROCTER & GAMBLE CO	Consumer Staples	AA	BBB	4	Yellow	2.31%	0.93%	6	37
NIKE B	Consumer Discretionary	AA	AAA	4	Yellow	2.26%	1.42%	7	19
BECTON DICKINSON	Health Care	AA	A	5	Green	2.14%	1.66%	8	13
DELL	Information Technology	AA	A	2	Yellow	2.13%	0.72%	9	53
INTEL CORP	Information Technology	A	A	2	Yellow	2.11%	1.94%	10	8
ROCKWELL COLLINS	Industrials	AA	AA	8	Green	2.00%	1.24%	11	24
TJX COS	Consumer Discretionary	AA	BBB	3	Yellow	1.78%	0.00%	12	
AFLAC	Financials	A	A	10	Green	1.69%	0.46%	13	73
MICROSOFT CORP	Information Technology	BBB	A	2	Yellow	1.66%	1.69%	14	12
ESTEE LAUDER COS A	Consumer Staples	AA	A	5	Green	1.61%	0.23%	15	113

Top Proforma constituents

Name	Sector	GS Rating	IVA Rating	IM Score	Impact Monitor	current weight	proforma weight	current rank	proforma rank
IBM CORP	Information Technology	AA	AAA	2	Yellow	3.40%	4.01%	1	1
APPLE	Information Technology	BBB	BBB	2	Yellow	0.92%	2.36%	31	2
SPECTRA ENERGY	Energy	A	A	5	Green	2.42%	2.26%	5	3
BALL CORP	Materials	A	AAA	4	Yellow	0.10%	2.19%	167	4
AMERICAN EXPRESS	Financials	AA	AAA	4	Yellow	0.66%	2.05%	50	5
TRAVELERS COS	Financials	A	AAA	7	Green	0.18%	2.04%	125	6
EATON CORP	Industrials	AA	AAA	5	Green	2.96%	1.95%	2	7
INTEL CORP	Information Technology	A	A	2	Yellow	2.11%	1.94%	10	8
CISCO SYSTEMS	Information Technology	A	AAA	2	Yellow	1.38%	1.93%	20	9
HENRY SCHEIN	Health Care	A	AAA	10	Green	0.00%	1.73%		10
WEYERHAEUSER CO	Financials	CCC	A	3	Yellow	0.00%	1.72%		11
MICROSOFT CORP	Information Technology	BBB	A	2	Yellow	1.66%	1.69%	14	12
BECTON DICKINSON	Health Care	AA	A	5	Green	2.14%	1.66%	8	13
PROLOGIS	Financials	BBB	AAA	10	Green	0.00%	1.61%		14
ORACLE CORP	Information Technology	A	A	5	Green	1.53%	1.53%	16	15

MSCI USA ESG Select Index – Historical Turnover

MSCI USA ESG Select Index - Historical Turnover

Index Review	Deletions	Additions	Turnover
Aug-10	53	5	15.0%
Nov-10	38	19	14.6%
Feb-11	1	7	2.9%
May-11	17	5	6.8%
Aug-11	5	3	2.4%
Nov-11	11	7	5.6%

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