An ESG Framework for Asset Owners

Integrating ESG in Portfolios and Benchmarks

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Powering better investments to build a sustainable future

The world is rapidly changing requiring new approaches to investing that take long-term sustainability into account. We believe ESG and climate factors will significantly impact the risk and return profile of investments and lead to a large-scale re-allocation of capital.

Holding long term investments requires understanding, identifying and managing financial risks and opportunities. Long term investors must regularly and rigorously assess the resilience of their asset allocation, portfolio construction and risk management decision-making processes.

Our rapidly changing world also presents investment opportunities on an unprecedented scale. For asset owners looking to integrate ESG considerations into their investment processes, ESG benchmarks may be essential tools.

Investors can use an ESG equity or fixed income policy benchmark[1], also known as a strategic benchmark, to set a strategic asset allocation, define their reference portfolio, measure performance, and define the eligible universe of investable securities for both the total portfolio and individual allocations.

But how can this be achieved? We developed a six-step framework designed to support institutional investors seeking to integrate ESG & climate into their portfolio construction and benchmarks.

1 *A policy benchmark aims to reflect the investment objectives and strategy of an asset owner and typically incorporates many dimensions such as risk tolerance, liability profile, and eligible asset classes. It will generally deviate from the underlying market benchmarks to reflect the specific investment strategy of the asset owner.*

Our 6-step process for effective ESG integration

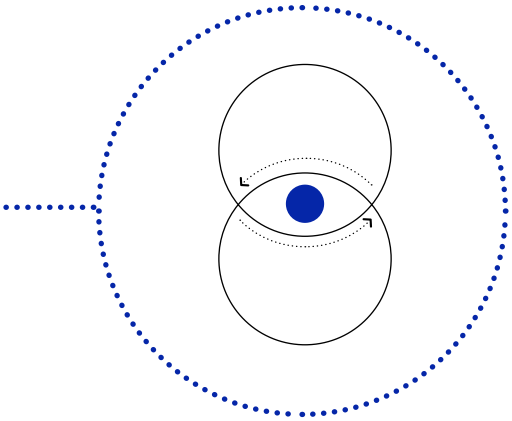
2 MSCI Research Insight, Better Together: Policy Benchmarks, Active Equity and ESG. Rao, A. Giese, G. Subramanian, R. and Nagy, Z. January 2021.

3 MSCI ESG Ratings are provided by MSCI ESG Research LLC. MSCI ESG Indexes utilize information from, but are not provided by, MSCI ESG Research LLC. MSCI Equity Indexes are products of MSCI Inc. and are administered by MSCI UK Limited.

4 Source: Giese, G., L.-E. Lee, D. Melas, Z. Nagy, and L. Nishikawa (2019). "Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk and Performance." Journal of Portfolio Management.

5 As of May 2020. One year, stock-level performance attribution showed the active return when hypothetically excluding a company from the index one date prior to the corporate incident.

6 Approximately $294 bn allocated to investments tracking or benchmarked to MSCI ESG equity and fixed income indexes since 2014. Based on publicly available information or press releases published from 2014 to date. Some of the examples listed have not publicly disclosed allocations and are not included in this total.

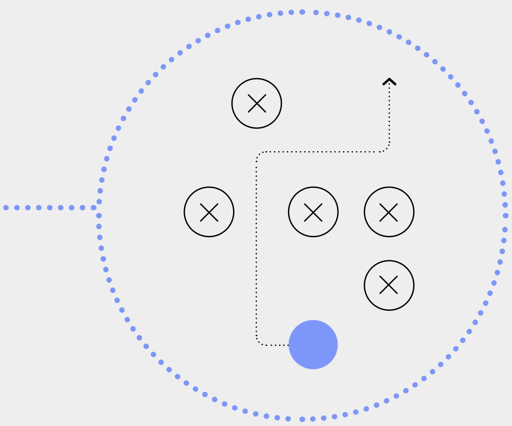


Define your ESG objectives & policy

There is no one-size-fits-all approach to ESG. The first step towards implementing ESG into an asset owner's investment process typically involves setting clear objectives. These may encompass three categories: aligning with values, addressing financially relevant risks, and creating positive environmental and social impact.

It may also be important to shape an ESG policy, which may include:

- Defining a long-term sustainable plan
- Setting targets to enhance the ESG profile of investment portfolios
- Periodic review of the plan

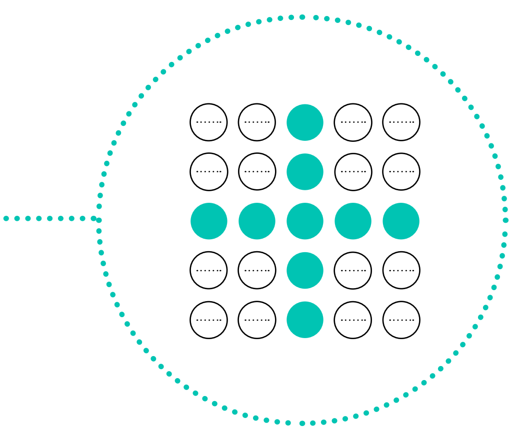


Defining your strategic approach

Once objectives have been clearly laid out, an implementation strategy can be designed covering both active and index-linked portfolios and mandates. Asset owners who have included ESG considerations in their long-term investment objectives may decide to adopt an ESG policy benchmark. MSCI Research has found that certain MSCI ESG Indexes, when considered as a policy benchmark, facilitated both active management and a systematic ESG allocation that improved the overall ESG profile of the portfolio.[2]

Common integration approaches include:

1. A top-down strategy – a holistic approach that applies views across all policy, systematic indexed and active mandates
2. A bottom-up strategy – a gradual, mandate-by-mandate approach that leaves the policy benchmark unchanged
3. A hybrid approach – some ESG criteria are defined top–down at a policy level, and some stricter ESG targets can be defined mandate-by-mandate.



Define your portfolio construction approach

Many investors use MSCI ESG indexes as a portfolio construction tool to help them manage or remove biases (e.g., home or size bias) which could affect long-term performance. MSCI ESG Research and MSCI ESG Index Solutions are designed to support common asset owner objectives. These MSCI ESG index construction approaches may consider the optimal mix of screening and exclusions, weight tilting, positive selection and potential ESG engagement criteria along with advanced climate risk integration beginning with standard universes:

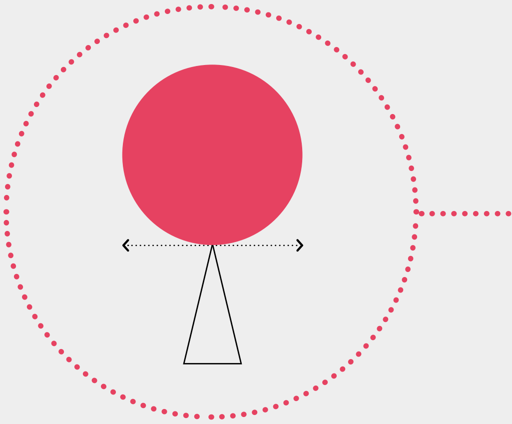
MSCI ACWI Index. Approximately 3,000 large- and mid-cap stocks across 23 developed and 26 emerging markets.

MSCI ACWI Investable Market Index (IMI). More than 9,000 securities across cap size, style and sector segments in 49 developed and emerging markets.

ESG in risk management

A study by MSCI showed that over a 10 year period, companies in certain markets with high MSCI ESG Ratings[3] displayed lower frequency of stock-specific incidents, lower levels of volatility and higher levels of profitability compared to low-rated companies.[4] We also estimated hypothetical performance gain from not being invested in companies which then experienced controversies.[5]

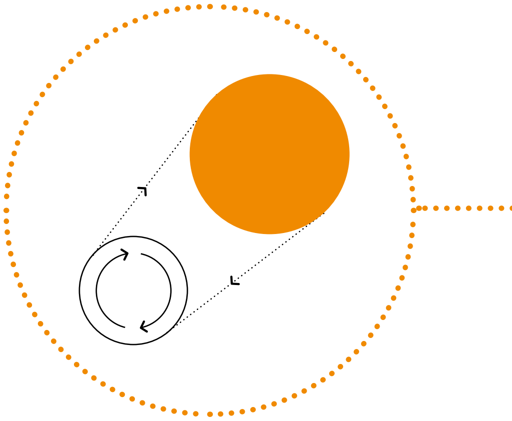
An increasing number of asset owners are incorporating ESG into portfolio construction, with the knowledge that incorporating ESG into risk management and reporting can help identify unintended risk.[6]



Stewardship & engagement

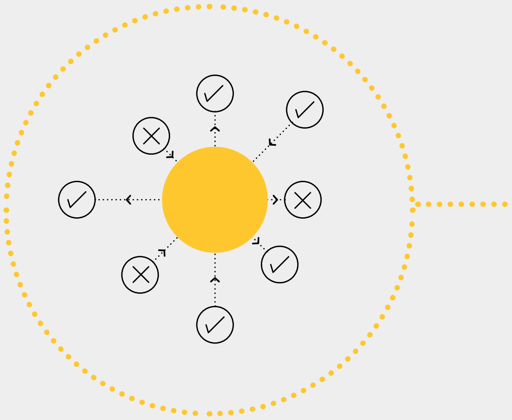
Many asset owners expect investment managers to be active stewards of capital and to exert oversight and influence on companies they own. Leaders in the field can help to move the needle on specific ESG issues through proxy voting, and by constructively engaging with companies and raising market standards through 'beta engagement'.

The need to engage with stakeholders and communicate ESG portfolio characteristics is driving greater transparency. We see more asset owners reporting on climate risk exposure and on alignment with the UN Sustainable Development Goals (SDGs), for example.



Reporting

Reporting requirements continue to grow in importance as new regulations and best practices emerge such as the Task Force on Climate-Related Financial Disclosures (TCFD) and the EU Sustainable Finance Disclosure Requirements. Reporting can offer insights into how portfolios are exposed with regards to ESG performance, climate risk and opportunities, diversity and inclusion, and other metrics.



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About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 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.

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