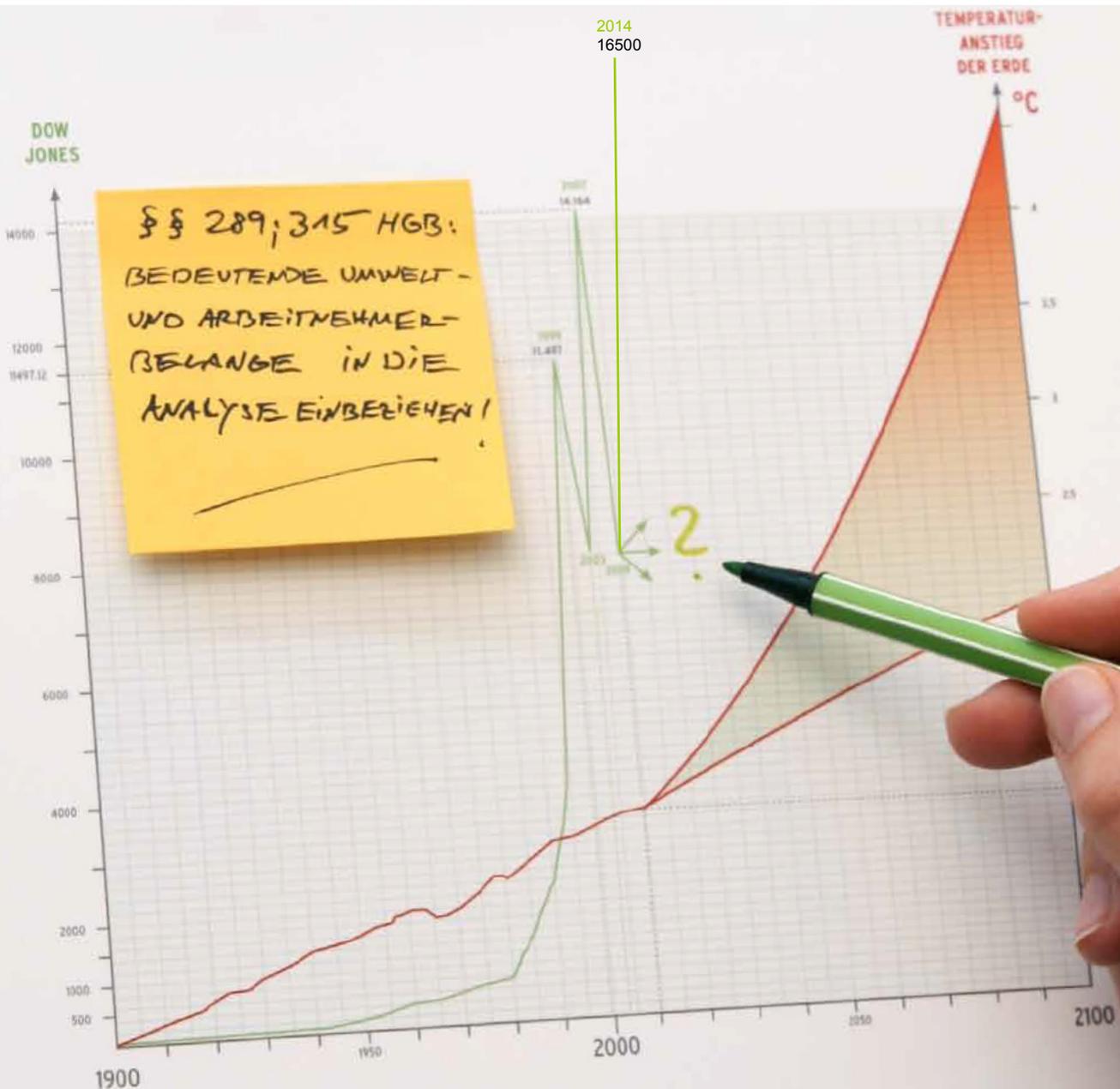


SD-KPIIndex[®]: How to integrate material ESG indicators into mainstream indices and benchmarks



Executive summary

SRI niche indices like the Dow Jones Sustainability Indices often do not meet the needs of institutional investors who would like to incorporate environmental, social and governance (ESG) issues into their investment process, which includes mainstream indices and benchmarks. Such an integration is recommended by the Principle 1 of the UN-backed Principles for Responsible Investment (PRI). This publication analyses the weaknesses of SRI niche indices and defines a copyrighted SD-KPIndex[®] methodology developed by SD-M[®] GmbH, which solves these problems. The methodology entails:

- an incremental change approach (cf. 1.2) based on mainstream equity and fixed-income indices which slightly over- and underweights components according to “Sustainable Development Key Performance Indicators” (SD-KPIs)
- using conventional options and futures (2.2)
- focussing on material ESG indicators (3.2)
- using global consensus-based SD-KPI Standards for the three most material ESG indicators for the expected business performance (4.2)
- avoiding a large cap bias (5.2)
- being transparent regarding indicators and weightings (6.2)
- enabling active ownership (7.2) and
- standardised financial and ESG performance comparisons (8.2).

The first implementation of this SD-KPIndex[®] structure is the iSTOXX SD-KPI index family. The EURO iSTOXX 50 SD-KPI and the iSTOXX Europe 50 SD-KPI indices were launched on 25 September 2013. The adopted indices are STOXX’ leading blue-chip indices EURO STOXX 50 and STOXX Europe 50. For more information please visit: <http://www.sd-m.de/en/sd-kpis.html>

EURO iSTOXX 50 SD-KPI:

http://www.stoxx.com/indices/index_information.html?symbol=SX5ESDM

iSTOXX Europe 50 SD-KPI:

http://www.stoxx.com/indices/index_information.html?symbol=SX5PSDM

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1 Closeness to mainstream investment indices / benchmarks (incremental change instead of radical change)

1.1 SRI niche indices: radical change

1.1.1 SRI niche indices differ too much from mainstream indices

Socially Responsible Investment (SRI) niche indices or benchmarks like the Dow Jones Sustainability Indices or the FTSE4Good Index Series differ too much from mainstream indices.

1.1.2 Exclusions and best-in-class lead to large reductions in the investment universe
In SRI niche indices, the number of index components is radically reduced through exclusions and/or best-in-class strategies.

For example, in the Dow Jones Sustainability World Index only about 333 components are selected in a “best-in-class” approach from the mainstream S&P Global Broad Market Index, which consists of 2500 components. This means a reduction in the investment universe of about 86,7%. Reductions due to exclusions on the basis of negative criteria take place in the “Dow Jones Sustainability World Enlarged Index ex Alcohol, Tobacco, Gambling, Armaments & Firearms and Adult Entertainment”, which consists of 496 out of 2500 components.

1.1.3 SRI niche indices are often not market-capped weighted and not liquid enough

The index components of SRI niche indices are often not market-capped weighted. And even the SRI niche leaders, the Dow Jones Sustainability Indices, which were launched in October 1999, have attracted only about US\$ 3 to 4 billion of investment capital after 15 years. This means that the investment volume and liquidity are insufficient for the needs of many institutional investors in the mainstream.

1.1.4 SRI niche indices have a high tracking error to mainstream indices

The results of the points mentioned above often lead to a high tracking error of the SRI niche indices compared with mainstream indices.

1.2 SD-KPIIndex[®]: Incremental change

1.2.1 The main equity and fixed-income indices/benchmarks are the starting point

The main equity and fixed-income indices/benchmarks have to be the starting point for the integration of environmental, social and governance (ESG) indicators.

Examples for mainstream equity indices are: MSCI World, Dow Jones Industrial Average, Russell 1000, S&P 500, EURO STOXX 50, STOXX Europe 50, STOXX Europe 600, FTSE All-Share Index, FTSE Europe, Shanghai Stock Exchange Composite Index, Hang Seng Index, Tokyo Stock Price Index (TOPIX), Nikkei 225.

Examples for mainstream fixed-income indices are: iBoxx € benchmark and liquid indices for sovereigns, sub-sovereigns, collateralized, corporates as well as Barclays Fixed Income Indices like the Barclays Capital Aggregate Bond Indices and JP Morgan Bond Indices.

The integration of ESG indicators into these indices has to be done carefully.

1.2.2 Avoid a (large) reduction of the investment universe for equity indices (by excluding only cluster bombs and landmines)

In contrast to SRI niche indices, a SD-KPIIndex[®] (for companies) might only exclude producers of cluster bombs and landmines. This is by far the most common exclusion criterion used in Responsible Investment (RI).

1.2.3 Market-capped and liquid SD-KPIIndex[®] through over- and underweighting or through minimum variance strategies

A mainstream index is adopted to a SD-KPIIndex[®] only by slightly over- and underweighting the weights of the components according to the performance in material ESG indicators (SD-KPIs, cf. 3.2) or by similar minimum variance strategies.

1.2.4 Low tracking error to the adopted mainstream index

The results of the points mentioned above lead to a SD-KPIIndex[®] that closely tracks the related mainstream indices. The differences regarding the weights of sectors, countries, regions and/or currencies remain low as well.

2 Availability of liquid derivatives

2.1 No liquid derivatives for SRI niche indices

No liquid derivatives like options and futures are available for SRI niche indices. This is however a *conditio sine qua non* for mainstreaming of ESG.

2.2 Use of conventional derivatives for SD-KPIndex[®] is possible

The low tracking error of a SD-KPIndex[®] in comparison to the adopted mainstream index allows for hedging through futures and options available for the mainstream index.

3 Materiality

3.1 Too many ESG indicators in SRI niche indices

The methodology of SRI niche indices is often determined by ESG criteria and not by market-cap or financial performance criteria. Moreover, too many ESG indicators are used in the analysis for SRI niche indices, e.g. often more than 50 to 200 indicators. This means that the weighting of a single ESG indicator is watered down to, on average, between 0,5% and to 2%.

3.2 A SD-KPIndex[®] focuses on the three most material ESG indicators (SD-KPIs)

Institutional investors have a fiduciary duty to consider environmental, social and governance (ESG) indicators that are relevant to financial performance¹. That's why a SD-KPIndex[®] focuses on the three most material ESG indicators for the business performance of the index components over the next five years. These indicators are called "Sustainable Development Key Performance Indicators" (SD-KPIs)². The over- and underweighting of mainstream index components according to their SD-KPI Total Score leads to the integration of the scientifically expected impact of material ESG indicators on the market-cap in the long-term. This, in turn, should lower financial (and reputational) risks while raise financial returns and performance.

Two examples for material impacts of SD-KPIs on the business performance: The "sub-prime" risks were integrated into SD-KPI 2 for the banking industry in October

¹ Cf. Freshfields Bruckhaus Deringer, 2005, page 13, http://www.sd-m.de/files/Freshfields_2005.pdf.

² Cf. <http://www.sd-m.de/en/sd-kpis.html>.

2006. This was published in January 2007³, or more than a year and a half before the bankruptcy of Lehman Brothers. “Oil spills”, meanwhile, were integrated into SD-KPI 3 of the oil & gas industry in January 2010⁴, or three months before the “BP Deepwater Horizon oil spill” began.

4 Standardisation = more power over the real economy

4.1 SRI nice indices do not follow materiality- and consensus-based standards

SRI nice indices do not follow materiality- and consensus-based standards. The lack of use of such standards makes it difficult to influence the real economy on a broad scale.

4.2 A SD-KPIndex[®] is rule-based on global materiality- and consensus-based SD-KPI Standards

The SD-KPI Standards were developed by SD-M[®] GmbH in cooperation with the German Environment Ministry, accountants, global investors and analysts – the latter two of whom influence EUR 2 trillion in assets. The copyrighted SD-KPI Standard 2010-2014 forms the scientific basis. Its development lasted from 2004 to 2010⁵. The use of consensus-based SD-KPI Standards makes a SD-KPIndex[®] more powerful to influence the real economy.

SD-M[®] GmbH uses its insights for services offered in cooperation with Sustainalytics, one of the world's leading sustainability research providers. SD-M[®] GmbH developed the copyrighted SD-KPI Integration Standards in 2013 to model the SD-KPIs using 42 different peer groups and ESG indicators provided by Sustainalytics. A common database enables asset owners and investment managers to analyse SD-KPIs for more than 4000 companies worldwide.

³ Cf.: http://www.sd-m.de/files/Hesse_SD-M_Deloitte_Sustained_added_value.pdf, page 11.

⁴ Cf. http://www.sd-m.de/files/SD-KPI_Standard_2010-2014_V12e.pdf, page 17.

⁵ Cf. <http://www.sd-m.de/en/sd-kpis.html>.

5 Avoid a large cap bias

5.1 SRI niche indices often have a large cap bias

The main reason for this is that both too many and not material ESG indicators are used for analysis of SRI niche indices. Yet mostly large corporations in developed markets are able to manage and report on so many indicators. This leads to the large cap bias.

5.2 A focus on material SD-KPIs avoids a large cap bias in a SD-KPIIndex[®]

Small and mid-cap companies often manage and report their material SD-KPIs today. This avoids the large cap bias. Indeed, one often notices even higher SD-KPI Total Scores of small and mid-cap companies compared with large-cap companies.

6 Transparency and simplicity

6.1 SRI niche indices are often intransparent and complex

The ESG analysis in SRI niche indices is often either a “black box” or very complex. This is both intransparent and unsustainable.

6.2 A SD-KPIIndex[®] shows transparently and simply how ESG indicators are integrated and weighted

The SD-KPI Standard 2010-2014 transparently defines the three SD-KPIs and their weighting between 0% and 100% of relevance for the expected business performance⁶. The SD-KPI Integration Standards transparently define how the three SD-KPIs were modelled proportionately using ESG indicators from Sustainalytics.

One has to accept the implicit punishment for intransparency among index components based on their ESG data.

⁶ Cf. http://www.sd-m.de/files/SD-KPI_Standard_2010-2014_V12e.pdf.

7 Enable active ownership

7.1 SRI niche indices do not enable active ownership of the enormous number of screened-out components

For example, in the Dow Jones Sustainability World Index only about 333 components are selected in a “best-in-class” approach from the mainstream S&P Global Broad Market Index, which consists of 2500 stocks. This means a reduction in the investment universe of about 86.7%. Hence, the SRI niche investor only has the voting rights for the 13.3% companies deemed sustainable according to the – not fully transparent – Dow Jones Sustainability methodology. Those excluded cannot, however, be influenced through active ownership.

7.2 A SD-KPIndex[®] enables active ownership for all (over- and underweighted) components of the adopted mainstream index

Principle 2 of the PRI states: “We will be active owners and incorporate ESG issues into our ownership policies and practices.”

According to the PRI website, possible actions are:

- Develop and disclose an active ownership policy consistent with the Principles.
- Exercise voting rights or monitor compliance with voting policy (if outsourced).
- Develop an engagement capability (either directly or through outsourcing).
- Participate in the development of policy, regulation, and standard setting (such as promoting and protecting shareholder rights).
- File shareholder resolutions consistent with long-term ESG considerations.
- Engage with companies on ESG issues.
- Participate in collaborative engagement initiatives.
- Ask investment managers to undertake and report on ESG-related engagement.

An investor in a SD-KPIndex[®] invests in 100% of the components from the adopted mainstream index (except for cluster bombs and landmines). This means the investor is able to conduct active ownership for all mainstream components.

8 Enable standardised financial and ESG performance comparisons

8.1 It is impossible for SRI niche indices to analyse the ESG impact on the financial performance in a ceteris-paribus-comparison with a mainstream index

Because SRI niche indices differ too much from mainstream indices (cf. 1.1.1), it is not possible for SRI niche indices to analyse the ESG impact on the financial performance in a ceteris-paribus-comparison with a mainstream index.

8.2 A SD-KPIIndex[®] enables ceteris-paribus-comparisons with the adopted mainstream index for both the financial and sustainability performance

This is the case because only one change is made from the adopted mainstream index to the SD-KPIIndex[®], namely the over- or under-weighting of the components according to the SD-KPI Total Score.

9 The iSTOXX SD-KPI index family marks the first implementation of this SD-KPIIndex[®] methodology/structure, which is copyrighted by SD-M[®] GmbH

The EURO iSTOXX 50 SD-KPI and the iSTOXX Europe 50 SD-KPI indices were launched on 25 September 2013. The adopted indices are STOXX' leading blue-chip indices EURO STOXX 50 and STOXX Europe 50. For more information please visit:

<http://www.sd-m.de/en/sd-kpis.html>

EURO iSTOXX 50 SD-KPI:

http://www.stoxx.com/indices/index_information.html?symbol=SX5ESDM

iSTOXX Europe 50 SD-KPI:

http://www.stoxx.com/indices/index_information.html?symbol=SX5PSDM

About SD-M[®] GmbH

SD-M[®] GmbH, drawing on 19 years of scientific and practical RI work by its managing director Dr Axel Hesse, advises on how relevant ESG indicators can be integrated in the investment process using:

- industry-specific key performance indicators (SD-KPIs)
- or a thematic approach (Big Six[®]);
- and a clear definition based on global standards that are simple, systematic and transparent.

This process is particularly appropriate for active or passive equity and bond investing and does not necessarily entail limiting the investment universe via exclusion. The process also enables the portfolio and the related mandates to remain largely intact, so that the cooperation between asset owners and asset managers may continue.

Dr Hesse worked in the project team at HVB Group in Munich, which launched the world's first investment product linked to the Dow Jones Sustainability Index in October 1999.

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