S&P Dow Jones Indices

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The S&P/ASX 200 ESG Index: Integrating ESG Values into Core in Australia

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EXECUTIVE SUMMARY

- The S&P/ASX 200 ESG Index is designed to align investment objectives with environmental, social, and governance (ESG) values.
- It can serve as a benchmark as well as the basis for index-linked investment products. Historically, the index's broad market exposure and industry diversification has resulted in a return profile similar to that of the S&P/ASX 200.
- The index uses the S&P DJI ESG Scores (see page 4) and other ESG data to select companies, targeting 75% of the market capitalization of each GICS® industry group within the S&P/ASX 200.
- The S&P/ASX 200 ESG Index excludes thermal coal, tobacco, controversial weapons, and companies with low UN Global Compact (UNGC) scores. In addition, those with S&P DJI ESG Scores in the bottom 25% of companies globally within their GICS industry groups are excluded.
- Our methodology results in an improved composite ESG score compared with the S&P/ASX 200.

INTRODUCTION

An increasing number of investors require indices that are aligned with their investment objectives and their personal or institutional values. The S&P/ASX 200 ESG Index was designed with both of these needs in mind.

The S&P/ASX 200 ESG Index is broad and constructed to be part of the core of an investor's portfolio, unlike many ESG indices that have preceded it, which were thematic or narrow in their focus. By targeting 75% of the S&P/ASX 200's market capitalization, industry by industry, the S&P/ASX 200 ESG Index offers industry diversification and a return profile in line with Australia's leading benchmark .

Yet the composition of this new index is meaningfully different from that of the S&P/ASX 200 and more compatible with the values of ESG investors. Exclusions are made related to thermal coal, tobacco, controversial weapons, and alignment with UNGC principles. Furthermore, companies with low ESG scores relative to their industry peers around the world are also excluded. The result is an index suitable for investors moving ESG from the fringe of their portfolio to the core.

KEY OBJECTIVES

The S&P/ASX 200 ESG Index is constructed to be part of the core of a portfolio…

The methodology of the S&P/ASX 200 ESG Index was constructed with two objectives:

- To provide a similar risk/return profile to the S&P/ASX 200; and
- To avoid companies that are not managing their businesses in line with ESG principles, while including companies that are.

…unlike many previous ESG indices, which were thematic or narrow in their focus.

These two objectives run somewhat counter to each other. Eliminating companies from the S&P/ASX 200 naturally results in changes in performance. With further methodological adjustments, however, the industry composition of the S&P/ASX 200 ESG Index is brought back into general alignment with the S&P/ASX 200.

METHODOLOGY SUMMARY

Exclusions

Companies are eliminated that:

The objectives of the index are to provide a similar risk/return profile to the S&P/ASX 200…

- Extract or generate electricity from thermal coal accounting for greater than 5% of their revenue;
- Produce tobacco, have tobacco sales accounting for greater than 10% of their revenue, derive more than 10% of their revenue from tobacco-related products and services, or hold more than a 25% stake in a company involved in these activities;
- Are involved in controversial weapons, including cluster weapons, landmines, biological or chemical weapons, depleted uranium weapons, white phosphorus weapons, or nuclear weapons, or hold more than a 25% stake in a company involved in these activities;
- Have a UNGC score that is in the bottom 5% of scores globally;[1,2] or
- Have an S&P DJI ESG Score that is in the bottom 25% of scores within their GICS industry group globally.[3]

…and to avoid companies that are not managing their businesses in line with ESG principles.

In 2020, S&P DJI underwent a formal consultation process and determined that thermal coal should also be excluded from the S&P ESG Index Series. In the future, S&P DJI may conduct additional consultations regarding exclusions and other methodological points to ensure that the S&P/ASX 200 ESG Index remains highly relevant to a broad array of investors.

[1] The UNGC, which was established in 2000, commits it signatories—companies and nations from around the world—to abide by principles related to human rights, labor, the environment, and anti-corruption. For more information, see www.unglobalcompact.org.

[2] Calculated by Arabesque.

[3] The global universe for this categorization is defined as the combined constituents of the S&P Global LargeMidCap and S&P Global 1200.

Exhibit 1: The S&P/ASX 200 ESG Index Summary

Objective: To target 75% of the market capitalization within each GICS industry group of the S&P/ASX 200, using the S&P DJI ESG Score.

Step 1:

Exclude companies involved in thermal coal, tobacco, or controversial weapons, or with a low UNGC score.

Step 2:

Exclude companies with S&P DJI ESG Scores in the bottom 25% of their GICS industry group globally.

Step 3:

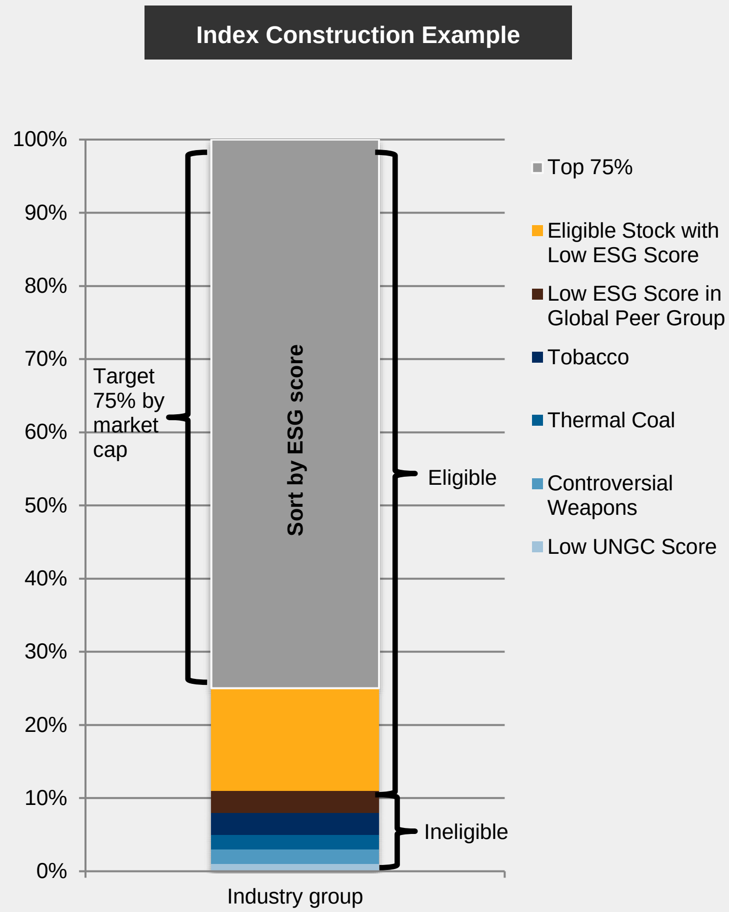
Within the S&P/ASX 200, sort the remaining companies by their S&P DJI ESG Scores within each GICS industry group.

Step 4:

Starting from the company with the highest S&P DJI ESG Score, select companies for inclusion from the top down, targeting 75% of the GICS industry group.

Step 5:

Weight companies by float-adjusted market capitalization.



Source: S&P Dow Jones Indices LLC. Chart is provided for illustrative purposes.

Overall, 98 constituents of the S&P/ASX 200 were excluded from the S&P/ASX 200 ESG Index, totaling 25.4% of the S&P/ASX 200 market capitalization as of April 30, 2020. Exhibit 2 ranks the reasons behind these exclusions.

Exhibit 2: Reasons for Exclusion from the S&P/ASX 200 ESG Index

REASON FOR EXCLUSION	NUMBER OF EXCLUSIONS	WEIGHT IN S&P/ASX 200 (%)
Not Part of the Top 75% of Industry Group Market Cap	63	20.9
S&P DJI ESG Score in Bottom 25% of Industry Group Globally	31	3.3
Involved in Controversial Weapons	0	0.0
UNGC Score Too Low	0	0.0
Involved in Tobacco Production or Sales	0	0.0
Company Not Covered	4	1.2

Source: S&P Dow Jones Indices LLC. Data as of April 30, 2020. Table is provided for illustrative purposes.

Constituent Selection and Weighting

The primary driver for constituent eligibility and selection in the S&P/ASX 200 ESG Index are the S&P DJI ESG Scores…

Once the exclusions are made, the index constituents are selected in the following manner.

1. Within each GICS industry group, companies are selected from the top down by S&P DJI ESG Score until 65% of the float-adjusted market capitalization of the eligible S&P/ASX 200 GICS industry group is reached.
2. Existing constituents within each GICS industry group ranked between 65% and 85% are then selected to get as close as possible to the target 75% threshold.
3. If the combined float-adjusted market capitalization of the selected companies thus far is still under the 75% target for a given GICS industry group, companies not yet selected are added to get as close as possible to the target 75% threshold. This process ends when the addition of the next eligible company would result in the total float-adjusted market capitalization moving further away from the 75% target.

…which are based on data gathered through SAM's Corporate Sustainability Assessment.

The index constituents are then weighted by their float-adjusted market capitalization. Using these rules, the index is rebalanced on an annual basis, after the close of trading on the last business day of April.[4]

SAM, founded in 1995, was the world's first investment company focused on sustainable investment.

S&P DJI ESG Scores

The primary driver for constituent eligibility and selection in the S&P/ASX 200 ESG Index is the S&P DJI ESG Scores. The S&P DJI ESG Scores are based on data gathered by SAM, part of S&P Global, through SAM's Corporate Sustainability Assessment (CSA). The CSA is an industry-specific questionnaire designed to evaluate companies' sustainability practices.

In 1999, SAM partnered with S&P DJI to launch the Dow Jones Sustainability Indices.

Data come from either the companies' responses to the CSA or research done by SAM on publicly available information for companies that do not fill out the CSA. A preliminary score is then calculated for each company as a weighted sum of a number of individual ESG indicators for each company, with each indicator corresponding to a different question in the CSA. The indicators are weighted to eliminate biases among different industries.

This preliminary score is then modified to account for information biases that may exist between companies that complete the CSA (where information is provided directly by participating companies) versus companies that are assessed purely on the basis of publicly available

[4] Please see the S&P ESG Index Series Methodology for more information on the S&P/ASX 200 ESG Index.

The S&P DJI ESG Scores are unique for two primary reasons.

information. In an effort to capture underreported or upcoming sustainability issues, the CSA methodology covers ESG indicators that may not be widely reported in the public domain. Scores are then normalized across individual indicators, and then once more at the final score level based on an "anchor" universe, defined as the combination of the S&P Global 1200 and the S&P Global LargeMidCap, resulting in the S&P DJI ESG Score (see Exhibit 3).

First, they go beyond public disclosure.

The S&P DJI ESG Scores are unique for two primary reasons. First, they go beyond public disclosure. When SAM began focusing on sustainable investment in the mid-1990s, corporate disclosure of ESG issues was minimal. Out of necessity, SAM began prompting companies themselves for data on their sustainability practices, which has become the CSA of present day. In addition, the S&P DJI ESG Scores have been cultivated over 20 years of investment experience (dating back to the original purpose of the CSA and the scores) and focus on the most financially material sustainability issues facing companies today. Criteria within each industry are assessed on their likelihood of affecting a company's long-term financial performance and the magnitude of that impact, ultimately driving how much weight each sustainability factor receives in the overall S&P DJI ESG Score.

Second, the S&P DJI ESG Scores have been cultivated over 20 years of investment experience…

…and focus on the most financially material sustainability issues facing companies today.

Exhibit 3: Description of S&P DJI ESG Scores

CHARACTERISTIC	DESCRIPTION
Underlying Research Methodology	SAM CSA
Calculation Agent	SAM ESG data, ratings, and benchmarking
Review Frequency	Annually (with quarterly controversy updates)
Data Collection	Direct company participation through CSA or assessment of publicly available data by SAM analysts
Question Scoring	Aggregation of data points by predefined CSA methodology; unanswered questions are not scored
Question Weights	Predefined CSA weights by SAM, based on financial materiality of sustainability topics to a specific industry
Criteria Scoring	Question scores are aggregated to a criteria score; weight of unanswered questions is redistributed among other questions within criteria
Criteria Weights	Predefined CSA weights by SAM, based on financial materiality of sustainability topics to a specific industry
Dimension Scoring	Criteria scores are aggregated to a dimension score; if all questions in a criteria are unanswered, the weight of that criteria is redistributed among other criteria within a dimension (economic, environmental, and social)
Dimension Weights	Dimension weights are always preserved according to the original SAM weighting scheme
Total ESG Score	Relative score calculated
Score Type	Relative (scores are normalized within assessed SAM industry)

Source: S&P Dow Jones Indices LLC. Table is provided for illustrative purposes.

When controversies unfold, SAM reviews them to consider whether the ESG score should be reduced…

…and then the S&P DJI Index Committee determines whether the company should be removed.

Controversies

When controversies unfold between annual rebalances of the S&P/ASX 200 ESG Index, SAM reviews these as part of its Media & Stakeholder Analysis (MSA) to consider whether a company's S&P DJI ESG Score should be reduced. The S&P DJI Index Committee overseeing the index then determines whether the company should be removed. Controversies monitored by SAM include those related to economic crime and corruption, fraud, illegal commercial practices, human rights issues, labor disputes, workplace safety, catastrophic accidents, and environmental disasters. Once a company is removed from the index, it is not eligible again for a full calendar year.

COMMONWEALTH BANK OF AUSTRALIA: A CASE STUDY

A unique case study for the S&P/ASX 200 ESG Index revolves around Commonwealth Bank of Australia (CBA) and its exclusion from the index.

By selecting 75% of each industry group's market cap, industry weights are closely aligned with those of the S&P/ASX 200…

Historically, CBA had been a strong performer from an ESG perspective. In 2018, however, in the wake of multiple controversies surrounding breaches of anti-money-laundering laws and complaints of fraud, poor financial advice, and charges for services not provided to customers (all of which were captured by SAM'S MSA), CBA began to see its overall S&P DJI ESG Score—and to a greater extent, its governance dimension score—decline (see Exhibit 4). According to the SAM CSA, the governance dimension makes up the largest portion of the overall S&P DJI ESG Score, so CBA's low score in that dimension resulted in an overall steep decline for the company.

Exhibit 4: CBA's S&P DJI ESG Scores

ASSESSMENT YEAR	ESG	E	S	G
2015	98	97	96	99
2016	99	96	98	99
2017	96	95	96	92
2018	87	93	96	58
2019	73	87	80	59

Source: SAM, part of S&P Global. Data as of April 1, 2020. Table is provided for illustrative purposes.

…which allows the S&P/ASX 200 ESG Index to track the S&P/ASX 200 closely, while offering improved ESG performance across each industry group.

Despite its score trending downward, CBA continued to be eligible for selection under the eligibility criteria detailed in the index methodology. With the annual rebalance of the S&P/ASX 200 ESG Index in April 2020, CBA was ranked fourth in its GICS industry group.

Exhibit 5: S&P DJI ESG Scores of the "Big Four" Australian Banks

COMPANY NAME	ESG	E	S	G
ANZ Banking Group	94	90	96	92
National Australia Bank Ltd	92	90	91	90
Westpac Banking Corp	86	92	95	69
Commonwealth Bank of Australia	73	87	80	59

Source: S&P Dow Jones Indices LLC. Data as of April 1, 2020. Table is provided for illustrative purposes.

Companies are selected top-down by S&P DJI ESG Score to get as close as possible to the target 75% float-adjusted market capitalization threshold.

According to the selection process (see Exhibit 1), companies are selected top-down by S&P DJI ESG Score to get as close as possible to the target 75% float-adjusted market capitalization threshold. In this particular industry group, after selecting the top three companies (ANZ Banking Group, National Australia Bank Ltd, and Westpac Banking Corp), roughly 57% of the float-adjusted market capitalization was accounted for.

The selection process ends when the addition of the next eligible company would result in the total float-adjusted market capitalization moving further away from the 75% target. Upon selecting CBA for the index, the percentage of float-adjusted market cap covered increased to 98% (23% away from the 75% target), and not selecting it would keep the float-adjusted market cap coverage at 57% (18% away from the 75% target). Therefore, CBA did not get selected for the index, and the selection process ended.

Commonwealth Bank of Australia's size played a significant role in its exclusion from the S&P/ASX 200 ESG Index.

This case study was particularly unique as it took into account both the daily controversy monitoring done by SAM (through its MSA) and the application of the selection process. In effect, CBA's size played a significant role in its exclusion.

CHARACTERISTICS OF THE S&P/ASX 200 ESG INDEX

The methodology of the S&P/ASX 200 ESG Index is constructed to be simple, with straightforward exclusions and a selection process meant to keep the index's industry weights in line with those of the S&P/ASX 200. By virtue of targeting 75% of each GICS industry group's market capitalization in the S&P/ASX 200, industry weights are closely aligned with those of the S&P/ASX 200. This allows the S&P/ASX 200 ESG Index to track the S&P/ASX 200 closely (see Exhibit 6), while offering improved ESG performance.

The composite ESG score of the S&P/ASX 200 ESG Index was 73.2…

…over 25% of the possible improvement the index could have compared with the S&P/ASX 200.

Exhibit 6: Fundamental Calculations of the S&P/ASX 200 ESG versus the S&P/ASX 200

CATEGORY	S&P/ASX 200	S&P/ASX 200 ESG INDEX
Number of Constituents	202	102
Float-Adjusted Market Cap (USD Billions)	1,617	1,186
ANNUALIZED TOTAL RETURNS (%)		
10-Year	7.80	7.62
5-Year	5.95	5.63
3-Year	5.19	5.01
1-Year	-7.68	-9.76
EXCESS RETURNS (%)		
10-Year	-	-0.18
5-Year	-	-0.32
3-Year	-	-0.18
1-Year	-	-2.08
ANNUALIZED RISK (%)		
10-Year	13.34	13.36
5-Year	15.02	14.87
3-Year	16.77	16.60
RISK-ADJUSTED RETURN		
10-Year	0.58	0.57
5-Year	0.40	0.38
3-Year	0.31	0.30
REALIZED TRACKING ERROR (%)		
10-Year	-	1.43
5-Year	-	1.55
3-Year	-	1.69
1-Year	-	2.26

Source: S&P Dow Jones Indices LLC. Data as of June 30, 2020. Past performance is no guarantee of future results. Table is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

The composite ESG score of the S&P/ASX 200 ESG Index was 73.2, compared with the S&P/ASX 200's score of 64.5, an increase of 8.7 on the raw ESG score. This composite score is derived by converting each constituent's S&P DJI ESG Score into a z-score, calculating the weighted average of the z-scores within the index, and once again converting that weighted average into an S&P DJI ESG Score, using the cumulative distribution function with a mean of zero and a standard deviation of one.

S&P DJI ESG Scores are designed to be read as percentiles. A score of 70 means that company has a stronger score than 70% of the companies in that particular industry. A score of 64.5 means that the S&P/ASX 200 had a higher score than 64.5% of the companies in the broader universe. As a result, a score increase of 8.7 from the S&P/ASX 200 to the S&P/ASX

200 ESG is over 25% of the possible improvement that the index could have.

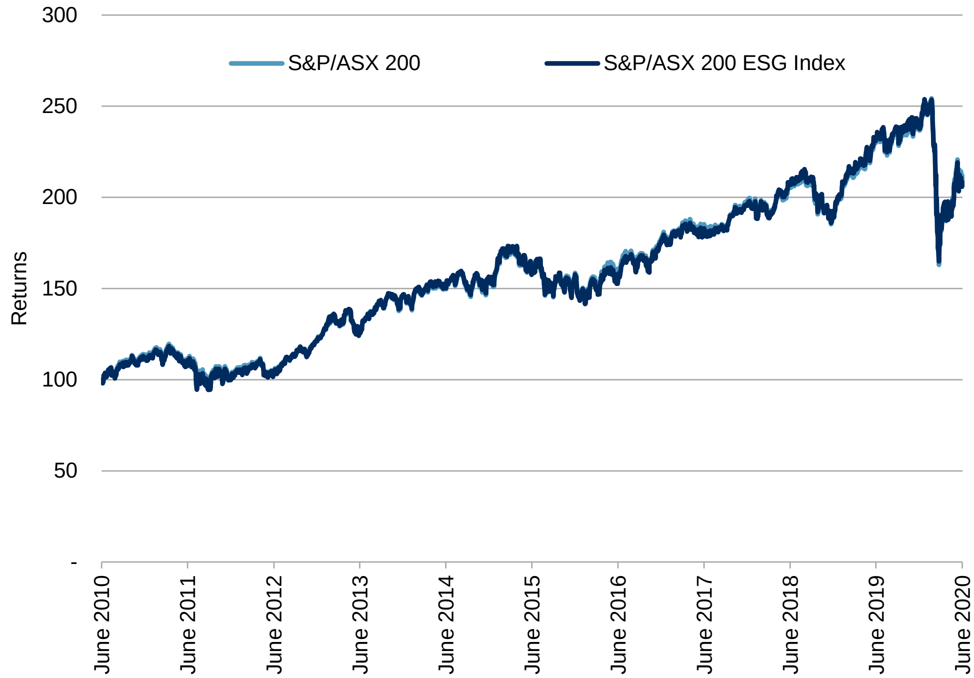
Return Profile

The S&P/ASX 200 ESG Index has tracked the S&P/ASX 200 closely…

Historically, the S&P/ASX 200 ESG Index has tracked the S&P/ASX 200 closely, and it has done so despite excluding nearly one-half of constituents based on the various eligibility criteria (see Exhibit 7). Realized tracking errors for the 3-, 5-, and 10-year periods were consistently about 1.5%, and the risk-adjusted return was nearly identical to the S&P/ASX 200 over the 3-, 5-, and 10-year periods.

Exhibit 7: Historical Returns of the S&P/ASX 200 ESG Index versus the S&P/ASX 200

…and it has done so, despite excluding nearly one-half of the constituents of the S&P/ASX 200.



Source: S&P Dow Jones Indices LLC. Data as of June 30, 2020. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

CONCLUSION

The S&P/ASX 200 ESG Index is designed to integrate ESG factors into core investments, while not straying far from the overall profile of the S&P/ASX 200.

The S&P/ASX 200 ESG Index is designed for investors wishing to integrate ESG factors into their core investments, while not straying far from the overall profile of the S&P/ASX 200. The accessibility of the index methodology, the financial materiality of the ESG data, and the recognizable benchmark set the S&P/ASX 200 ESG Index apart from the rest of the field.

PERFORMANCE DISCLOSURE

The S&P/ASX 200 ESG Index was launched May 6, 2019. All information presented prior to an index's Launch Date is hypothetical (back-tested), not actual performance. The back-test calculations are based on the same methodology that was in effect on the index Launch Date. However, when creating back-tested history for periods of market anomalies or other periods that do not reflect the general current market environment, index methodology rules may be relaxed to capture a large enough universe of securities to simulate the target market the index is designed to measure or strategy the index is designed to capture. For example, market capitalization and liquidity thresholds may be reduced. Complete index methodology details are available at www.spdji.com. Past performance of the Index is not an indication of future results. Prospective application of the methodology used to construct the Index may not result in performance commensurate with the back-test returns shown.

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The back-test period does not necessarily correspond to the entire available history of the Index. Please refer to the methodology paper for the Index, available at www.spdji.com for more details about the index, including the manner in which it is rebalanced, the timing of such rebalancing, criteria for additions and deletions, as well as all index calculations.

Another limitation of using back-tested information is that the back-tested calculation is generally prepared with the benefit of hindsight. Back-tested information reflects the application of the index methodology and selection of index constituents in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. For example, there are numerous factors related to the equities, fixed income, or commodities markets in general which cannot be, and have not been accounted for in the preparation of the index information set forth, all of which can affect actual performance.

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