S&P Dow Jones Indices

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Index Education

The S&P IPSA ESG Tilted Index: A New Benchmark for Measuring Sustainability in Chile

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INTRODUCTION

Indices that integrate environmental, social, and governance (ESG) data are moving from the margins to the mainstream, as market participants increasingly seek to align their values with their investments. A new type of ESG index is emerging to facilitate this change in Chile: the S&P IPSA ESG Tilted Index. Jointly developed by S&P Dow Jones Indices (S&P DJI) and the Santiago Stock Exchange (BCS or Bolsa de Comercio de Santiago), this index not only highlights strong ESG companies, it also enables allocation to such companies while aiming to limit major risks relative to the market.

THE EVOLUTION OF ESG INDICES

In 1999, S&P DJI launched the first global ESG index, the Dow Jones Sustainability™ World Index (DJSI World). It includes the top 10% of companies, industry by industry, according to their ESG performance, as determined by the Corporate Sustainability Assessment (CSA) conducted by S&P Global.[1] This groundbreaking index encouraged companies to incorporate many ESG factors in their decisions, extending them beyond short-term financial considerations.

In the years that followed, other indices, including regional versions of the DJSI World such as the DJSI Emerging Markets, were launched with this same philosophy in mind: to highlight best-in-class companies and thereby inspire firms to improve their ESG approaches in order to qualify for inclusion in these indices.

Though these indices have been successful and have indeed inspired companies to change in positive ways, aspects of their methodologies may present challenges for many investors. Some strategies can be too narrow for investors who want to remain broadly diversified. Though many high-conviction market participants use the narrow, best-in-class indices for investment, we saw a need for ESG indices more in line with the broader market, while providing a more sustainable portfolio of companies.

[1] For more information on the CSA, please refer to https://www.spglobal.com/esg/csa/about/.

Not only does the S&P IPSA ESG Tilted Index highlight strong ESG companies, it also enables allocation to such companies while aiming to limit major risks relative to the market.

With this in mind, S&P DJI launched the S&P 500® ESG Tilted Index, which seeks to encompass a broader market while incorporating a sustainable investor-oriented methodology. As this index series expands to other countries, Chile now has an investor-oriented ESG index of its own, the S&P IPSA ESG Tilted Index. This index maintains a large portion of the companies in its underlying index, the S&P IPSA, thereby staying broad and diverse while still screening out companies involved in certain business activities and controversies, as well as those with sustainability profiles that run counter to ESG requirements.

HOW THE INDEX WORKS

With the launch of the S&P IPSA ESG Tilted Index, Chile now has an investor-oriented ESG index of its own.

The S&P IPSA ESG Tilted Index is designed to measure the performance of the securities in its underlying index that meet sustainability criteria. As shown in Exhibit 1, the first step in the index calculation process is to exclude companies involved in certain business activites that are contrary to ESG values. For companies involved in tobacco, controversial weapons, and thermal coal, certain maximum revenue thresholds are set, as defined in the S&P IPSA ESG Tilted Index Methodology. If a company generates revenue exceeding these thresholds, it will be excluded at the annual index rebalance in June. Companies with business practices that are not aligned with the United Nations Global Compact (UNGC)[2] are also excluded at the annual rebalance. The exclusion criteria used in Step 1 are provided by Sustainalytics.[3]

The S&P IPSA ESG Tilted Index is designed to measures the performance of the securities in its underlying index that meet sustainability criteria.

The remaining companies are then overweighted or underweighted (tilted) according to their S&P DJI ESG Scores and constituent weights in the underlying index, subject to certain weighting constraints defined in the methodology. If a company does not have an S&P DJI ESG Score, it will be assigned the lowest available ESG z-score value from the companies within its Tilting Group. Tilting Groups are defined by the GICS® industry groups or sectors in the underlying index, depending on constituent count and composition. Index weights in the tilted index are determined to maintain overall industry group (or sector) weights with respect to the underlying index.[4]

[2] For more information on the UN Global Compact, please refer to https://www.unglobalcompact.org/.

[3] For more information on Sustainalytics, including the Global Standards Screening Methodology, please refer to https://www.sustainalytics.com/.

[4] See Appendix for more details.

Exhibit 1: S&P IPSA ESG Tilted Index Methodology Summary

S&P IPSA

↓

Exclude companies involved in tobacco, controversial weapons, and thermal coal.*

↓

Exclude companies classified as Non-Compliant according to Sustainalytics Global Standards Screening (GSS).

↓

Overweight (underweight) companies with relatively high (low) S&P DJI ESG Scores based on the underlying index weight. Index constituents are weighted based on the constituents' weights in the underlying index, tilted such that companies with higher or lower S&P DJI ESG Scores are over or underweighted while maintaining Tilting Group neutrality.

↓

Constituent weights subject to a single constituent weight cap of 15%. Enterprise groups, based on data published by the Chilean Commission for the Financial Market, are subject to a weight cap of 25%.

↓

S&P IPSA ESG Tilted Index

* Following the S&P DJI Level of Involvement threshold as defined in the S&P IPSA ESG Tilted Methodology.
** S&P DJI has introduced additional, expanded and revised exclusions based on a company's involvement in certain defined business activities. The additional exclusions cover oil sands, small arms and military contracting; the expanded exclusions cover controversial weapons; and the revised exclusions cover tobacco. The previously described methodology changes were effective in conjunction with the June 2022 rebalancing.
Source: S&P Dow Jones Indices LLC. Chart is provided for illustrative purposes.

The S&P IPSA ESG Tilted Index retains 27 constituents of the underlying index's 30 stocks, representing 96% of the S&P IPSA's market capitalization.

The result is an index that retains 27 constituents (90%) of the underlying's index's 30 stocks, representing 96% of the S&P IPSA's market capitalization (as of June 18, 2021, the most recent rebalance).[5]

ACCOUNTING FOR CONTROVERSIES

At any time, a constituent can be removed from the index if it is involved in a severe enough controversy, as determined by S&P Global's MSA.

At any time, a constituent can be removed from the S&P IPSA ESG Tilted Index if it is involved in a severe enough controversy, as determined by S&P Global's Media & Stakeholder Analysis (MSA). An MSA may be triggered by a wide range of controversies, including those related to economic crime and corruption, fraud, illegal commercial practices, human rights issues, labor disputes, workplace safety, catastrophic accidents, and environmental disasters.

When a severe controversy emerges, the Index Committee meets to review the MSA and to determine whether a company should be removed. If a company is removed, it will not be eligible for re-entry into the index for one full calendar year, beginning with the subsequent rebalancing.[6]

[5] Coverage in previous years was greatly reduced due to lack of coverage of ESG data.

[6] For more information on S&P DJI ESG Scores and the MSA, please see our FAQ.

INDEX CONSTITUENTS

Exhibit 2 shows the top 10 constituents of the strategy by weight as of the June 2021 rebalance, highlighting the under/overweight tilting methodology based on S&P DJI ESG Scores and the benchmark index weight.

The increasing awareness of the relevance of ESG topics for companies and market participants is reflected in the increase in coverage over time and historical constituent count.

Exhibit 2: Top 10 Constituents by Weight

CONSTITUENT	GICS SECTOR	S&P DJI ESG SCORE	INDEX WEIGHT (%)	WEIGHT IN BENCHMARK (%)
SOQUIMICH - Sociedad Quimica y Minera de Chile SA B	Materials	72	13.8	13.7
Banco Santander Chile	Financials	94	12.0	7.2
SACI Falabella	Consumer Discretionary	96	8.4	7.4
Empresas COPEC SA	Energy	80	7.9	7.5
Banco de Chile	Financials	63	6.8	10.1
Cencosud SA	Consumer Staples	87	6.7	6.0
Enel Americas S.A.	Utilities	92	6.1	5.7
Empresas CMPC SA	Materials	70	5.9	5.8
Banco de Credito e Inversiones	Financials	78	5.2	5.2
Enel Chile S.A.	Utilities	95	4.0	3.2

Source: S&P Dow Jones Indices LLC. Data as of June 18, 2021. Table is provided for illustrative purposes.

The increasing awareness of the relevance of ESG topics for companies and market participants is reflected in the increase in coverage over time and historical constituent count (see Exhibit 3).

Exhibit 3: Constituent Count

YEAR	S&P IPSA	S&P IPSA ESG TILTED INDEX
2017	40	31
2018	40	32
2019	29	25
2020	30	26
2021	30	27

Source: S&P Dow Jones Indices LLC. Data from of June 16, 2017, to June 18, 2021. Table is provided for illustrative purposes.

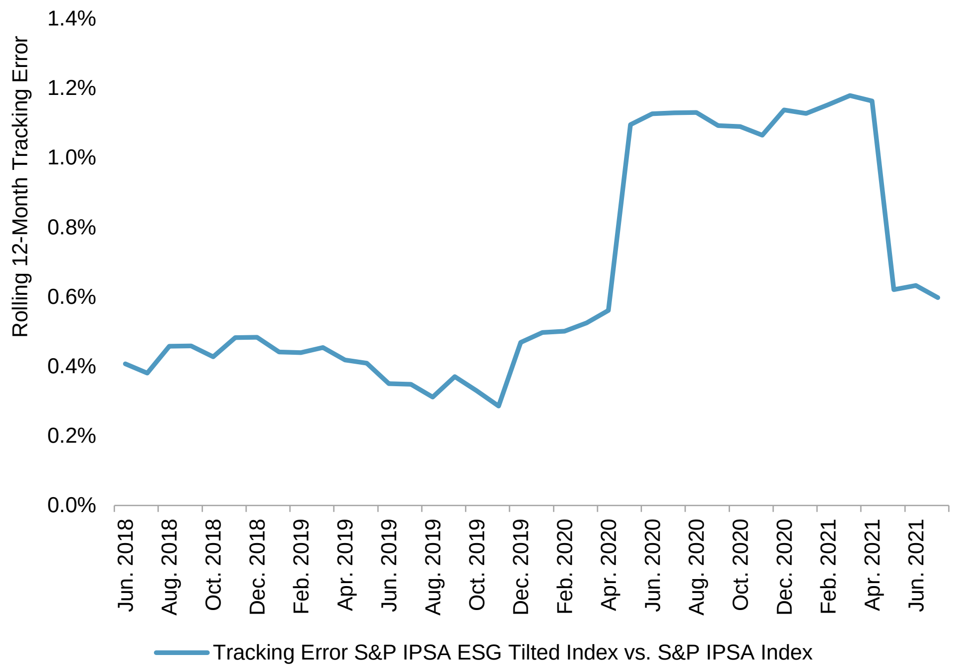
PERFORMANCE OF THE S&P IPSA ESG TILTED INDEX

The S&P IPSA ESG Tilted Index aims to provide both ESG participation and a return similar to the underlying index—and even has the potential for outperformance.

The S&P IPSA ESG Tilted Index aims to provide both ESG participation and has historically provided a return similar to the underlying index—and even has the potential for outperformance—without taking on considerable risk that can be associated with narrower ESG indices. Although the tracking error jumped at the start of the COVID-19 pandemic (early March 2020), it returned to normal levels after Q1 2021 and has historically been relatively low compared with the S&P IPSA, at an average of 0.76% from June 2018 to July 2021.

The index has historically maintained a relatively low tracking error compared with the S&P IPSA, at an average of 0.76%.

Exhibit 4: Rolling 12-Month Tracking Error

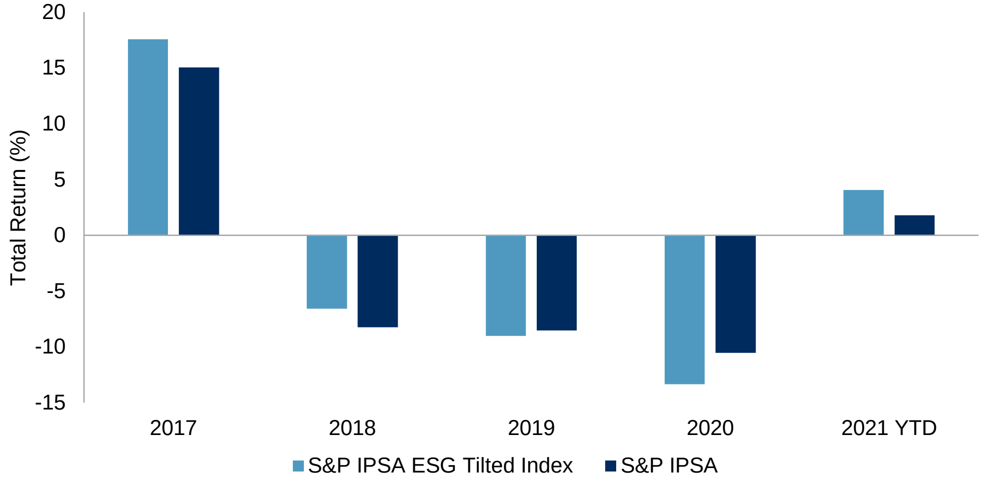


Source: S&P Dow Jones Indices LLC. Data from June 29, 2018, to July 30, 2021. Index performance based on total return in CLP. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

Furthermore, in two of the past four years, the S&P IPSA ESG Tilted Index outperformed the S&P IPSA (see Exhibit 5). Through the first half of 2021, the ESG-tilted index outperformed the S&P IPSA as well.

In two of the past four years, the S&P IPSA ESG Tilted Index outperformed the S&P IPSA.

Exhibit 5: Calendar Year Returns

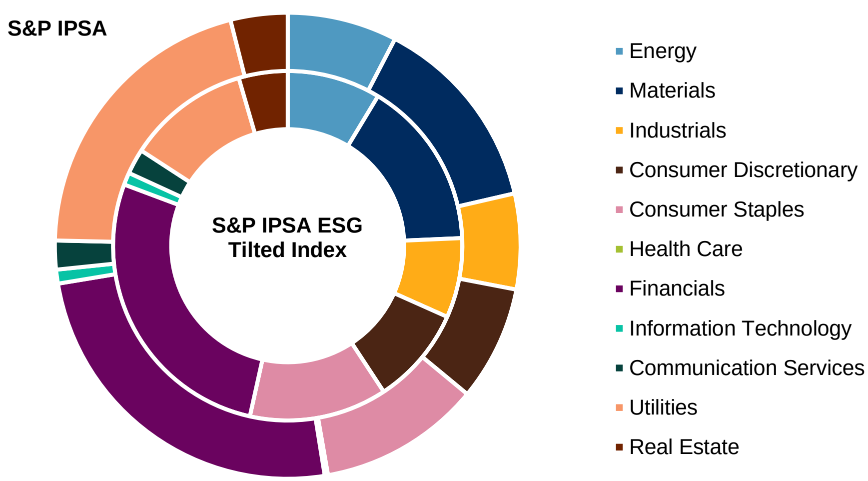


Source: S&P Dow Jones Indices LLC. Data from June 16, 2017, to July 30, 2021. Index performance based on total return in CLP. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

What is the source of this low tracking error and benchmark-like return? A major factor could be the similarity of the sector composition of the ESG tilted index with respect to its underlying index (see Exhibit 6)

A major factor in the ESG tilted index's low tracking error and benchmark-like return could be the similarity of its sector composition to its underlying index.

Exhibit 6: Average Sector Exposure Chart



Source: S&P Dow Jones Indices LLC. Data from June 19, 2017, to June 22, 2021, for average sector weights at rebalance. Chart is provided for illustrative purposes.

ESG IMPROVEMENT

The aim of excluding certain companies involved in less-sustainable business activities and controversies, and tilting the index weights toward those companies with higher S&P DJI ESG Scores, is to ensure the index reflects a more values-focused portfolio. But how is this measured?

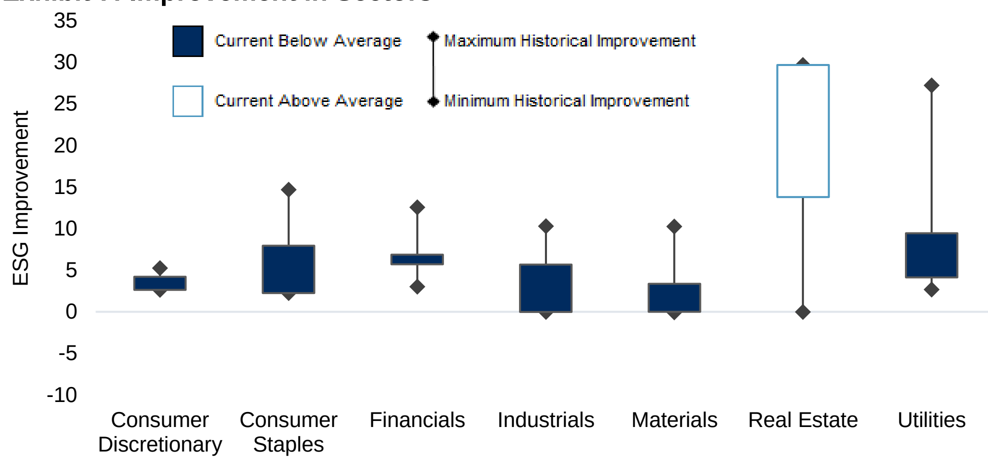
One way to measure ESG improvement is to calculate a composite ESG score for the S&P IPSA ESG Tilted Index and compare this with the composite score for its underlying index.

One way is to calculate a composite ESG score for the S&P IPSA ESG Tilted Index and compare this with the composite score for its underlying index. As of the June 2021 rebalance, the composite ESG score for the S&P IPSA ESG Tilted Index was 82.86, which was 4.18 points higher than the S&P IPSA's 78.68 composite ESG score, representing a 23.6% realized ESG potential.[7]

For sectors historically represented by more than one company, the average ESG improvement was 4.67 over the five-year period starting at the 2017 rebalance.

ESG improvements compared with the benchmark on the sector level over time provide an interesting analysis. For sectors historically represented by more than one company, the average improvement was 4.67 over the five-year period starting at the 2017 rebalance (see Exhibit 7).

Exhibit 7: Improvement in Sectors



Source: S&P Dow Jones Indices LLC. Data from June 19, 2017, to June 22, 2021, for average sector improvement at rebalance. Chart is provided for illustrative purposes.

Exhibit 8 shows a few examples of the numerous ways in which the S&P IPSA ESG Tilted Index offers enhanced ESG representation. Increased allocation to each ESG theme in these metrics is calculated using the most granular question-level data in S&P Global's CSA.

[7] Realized ESG potential is calculated as the percentage difference between the aggregate S&P DJI ESG Score of the S&P IPSA ESG Tilted Index and the S&P IPSA, relative to the strategy's maximum potential ESG improvement based on allocating only to the single highest-ranked ESG scoring company in the benchmark.

Exhibit 8: The Benefits of the S&P IPSA ESG Tilted Index

Environmental

9% More exposure to companies that established absolute or relative climate-related targets combining Scopes 1 & 2 emissions reduction, identified climate change-related opportunities and estimated their costs and positive financial implications, provided low-carbon products, and used an internal price of carbon

8% More exposure to companies that publicly report their Scopes 1 & 2 CO2e emissions, water consumption, waste, and energy consumption data

7% More exposure to companies that have not paid significant environment-related fines in the past four years

Social

7% More exposure to companies that monitor and disclose female representation across their organization, as well as a breakdown of workforce based on other minority groups (e.g., age, nationality, disability) and results of gender pay gap or equal pay assessment

6% More exposure to companies having implemented health and well-being initiatives covering maternity and paternity leaves in excess of legally required minimum for their employees, flexible working hours and working from home arrangements

6% More exposure to companies that have a percentage of actively engaged employees and have implemented a recognized and scaled approach to measuring actively engaged employees, including the breakdown of results based on gender

Governance

8% More exposure to companies that have either a director on the board or someone in the Executive Management team who oversees the company's cybersecurity strategy

8% More exposure to companies that publicly report on key business, financial, and tax information for regions or countries in which they operate

7% More exposure to companies that have a formalized process in place to identify potential sustainability risks in the supply chain, have taken measures to manage sustainability risks among its critical suppliers and has integrated ESG objectives into their supply chain management strategy

Source: S&P Dow Jones Indices LLC. These are just a few examples of the numerous ways in which the S&P IPSA ESG Tilted Index offers enhanced ESG representation. Increased index allocation to each ESG theme in the metrics above is calculated using the question-level data in S&P Global's Corporate Sustainability Assessments (2020 methodology year). These metrics are calculated using index data as of March 31, 2021, as the percentage difference between the performance of the S&P IPSA ESG Tilted Index and the S&P IPSA constituents across these metrics, on a weighted average basis.

CONCLUSION

The S&P IPSA ESG Tilted Index is a benchmark for a new era in ESG, one in which indices are designed not just to measure company performance but also to reflect breadth and diversification. As these indices garner more interest, companies that invest in ESG have the potential to benefit in terms of public perception.

APPENDIX: TILTING METHODOLOGY

Constituents' weights in each Tilting Group are determined using an ESG Tilt Score (S_i).

Each ESG Tilt Score (S_i) is calculated as follows:

a. The S&P DJI ESG Score for each company is transformed into an ESG z-score (Z_i) at the underlying index level by:

   i. Dividing by 100 and taking the inverse of the normal cumulative distribution function with a mean of zero and a standard deviation of one.

   ii. The ESG z-score (Z_i) for each security is re-standardized using the mean and standard deviation of the available S&P DJI ESG z-scores for the unique companies within the index universe before applying exclusions based on business activities and disqualifying UNGC scores.

b. If a company does not have an S&P DJI ESG Score, it will be assigned an ESG z-score (Z_i) set as equal to the lowest available ESG z-score value from the companies within its Tilting Group. If no companies have scores within the Tilting Group, the company will be assigned an ESG z-score of zero.

c. The ESG z-score (Z_i) for each company is transformed into the ESG Tilt Score (S_i) as follows:

   If $Z_i > 0, \quad S_i = 1 + Z_i$
   If $Z_i < 0, \quad S_i = 1/(1 - Z_i)$
   If $Z_i = 0, \quad S_i = 1$

The index is GICS industry group/sector tilted, with the Tilting Groups determined on each rebalancing reference date as follows:

- Where a GICS sector contains any GICS industry group with fewer than two S&P DJI ESG Scores available, the GICS sector is the Tilting Group.
- For the remaining sectors (if any) where all industry groups have at least two S&P DJI ESG Scores, the industry groups each form individual Tilting Groups.

After the Tilting Group(s) are determined as above, the constituent weights are calculated as follows:

1. A Tilting Group's weight in the index is calculated as the sum of the constituents' weights in the Tilting Group divided by the sum of all index constituents' weights.

$$\text{Weight}_{\text{Tilting Group}} = \frac{\sum \text{Index Weight}, \quad \text{for all constituents in Tilting Group}}{\sum \text{Index Weight}, \quad \text{for all index constituents}}$$

2. Within each Tilting Group, constituents' weights are multiplied by their company ESG Tilt Score (S_i). The constituent weights within the Tilting Group are determined by dividing the constituent's tilted weight by the sum of all tilted weights within the Tilting Group.

$$\text{Weight}_{\text{Constituent in Tilting Group}} = \frac{\text{Constituent Index Weight} \ * \ \text{S}}{\sum \text{Index Weight} \ * \ \text{S}, \ \ \text{for all constituents in Tilting Group}}$$

3. The final constituent weight in each index is the product of Steps 1 and 2, with the constraint that no single stock's weight can exceed 15%. In addition, a 25% enterprise group cap is applied, based on data published by the Chilean Commission for the Financial Market. The capping algorithm redistributes the excess weight to the uncapped stocks in the eligible universe in proportion to their ESG tilted weights (pre-capped weights from this step).

$$Weight_{Constituent} = Weight_{Tilting\ Group} * Weight_{Constituent\ in\ Tilting\ Group}$$

PERFORMANCE DISCLOSURE

The S&P IPSA ESG Tilted Index was launched January 11, 2021. 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.spglobal.com/spdji. Past performance of the Index is not an indication of future results. Back-tested performance reflects application of an index methodology and selection of index constituents with the benefit of hindsight and knowledge of factors that may have positively affected its performance, cannot account for all financial risk that may affect results and may be considered to reflect survivor/look ahead bias. Actual returns may differ significantly from, and be lower than, back-tested returns. Past performance is not an indication or guarantee of future results. Please refer to the methodology for the Index 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. Back-tested performance is for use with institutions only; not for use with retail investors.

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Typically, when S&P DJI creates back-tested index data, S&P DJI uses actual historical constituent-level data (e.g., historical price, market capitalization, and corporate action data) in its calculations. As ESG investing is still in early stages of development, certain datapoints used to calculate S&P DJI's ESG indices may not be available for the entire desired period of back-tested history. The same data availability issue could be true for other indices as well. In cases when actual data is not available for all relevant historical periods, S&P DJI may employ a process of using "Backward Data Assumption" (or pulling back) of ESG data for the calculation of back-tested historical performance. "Backward Data Assumption" is a process that applies the earliest actual live data point available for an index constituent company to all prior historical instances in the index performance. For example, Backward Data Assumption inherently assumes that companies currently not involved in a specific business activity (also known as "product involvement") were never involved historically and similarly also assumes that companies currently involved in a specific business activity were involved historically too. The Backward Data Assumption allows the hypothetical back-test to be extended over more historical years than would be feasible using only actual data. For more information on "Backward Data Assumption" please refer to the FAQ. The methodology and factsheets of any index that employs backward assumption in the back-tested history will explicitly state so. The methodology will include an Appendix with a table setting forth the specific data points and relevant time period for which backward projected data was used.

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