

Gaining exposure to large cap
companies with superior ESG
risk management



October 2020



Nifty100 ESG Sector Leaders Index

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Introduction

The emphasis on Sustainable and Responsible Investment (SRI) strategies has been steadily on the rise given the increasing awareness towards environmental stability, socio-economic development and adherence to ethical standards. One such strategy that has gradually gained popularity among investors is Environmental, Social and Governance (ESG) investing. The ESG theme is an effective portfolio selection strategy under the broader theme of Sustainable and Responsible Investment. The underlying principle behind ESG based investing lies in identifying & quantifying the intangible value possessed by socially responsible, environmentally friendly firms with robust governance policies in place. These firms are believed to exhibit better risk management measures on ESG parameters, and thus possess long-lasting sustainable business models.

ESG investing aims to go beyond the pure financials of the businesses and develop a more holistic view of the company's operations, management quality and overall impact on society. Accordingly, it is concerned with how companies manage the ESG risks they face, and the sustainability of a company's profit, rather than keeping the sole focus on financial metrics. For example, investors may choose to avoid a company which earns high profits but has other weaknesses within an ESG risk framework - creating addictive and unhealthy products (cigarettes and alcohol), or poor Environmental risk management (mining and logging). Such companies face increased ESG risk of being embroiled in controversies with the government, regulators or other stakeholders. When these risks materialize, company profitability, and shareholder returns often get hurt. Conversely, investors would prefer to invest in companies managing their ESG risks well. Good ethics can mean good business too. Thus, investors can focus on firms with better ESG risk management to generate stable returns with lower company specific risk.

The ESG investment theme continues to gain traction globally. In terms of passive funds, total assets invested in ESG ETFs/ETPs rose to \$101bn as of July 2020, compared to \$22bn as of end-2018.

(Source : *ETFGI.com*)

About the Nifty100 ESG Select Leaders Index

NSE Indices has recently launched a new index on the ESG theme called “Nifty100 ESG Sector Leaders Index”. The Nifty100 ESG Sector Leaders Index gives investors exposure to select large cap companies in the Nifty 100 Index, which have scored well on ESG risk management compared to

their peers and have low involvement in controversies. Companies with low ESG risk rating and low controversy levels have a better chance of index inclusion. The ESG risk rating and controversy levels are provided by Sustainalytics, a global leader in ESG Research.

Highlights

- The index has a base date of January 01, 2014, with a base value of 1000
- The index tracks the performance of the stocks that are part of the Nifty 100 Index and which have scored well on management of Environmental, Social and Governance risk
- Companies engaged in tobacco, alcohol, controversial weapons and gambling operations are excluded
- Companies that are involved in any major Environmental, Social or Governance controversy are not considered for selection in the index. Companies in Controversy category 4 or 5 are excluded
- Companies with ESG risk score greater than the Global Subindustry average ESG risk score are excluded
- Stock weights are based on free-float market capitalization, capped at 10%
- Provides ~75% coverage of Free Float Market Capitalisation within each sector of eligible stocks of Nifty 100
- The index is rebalanced semi-annually

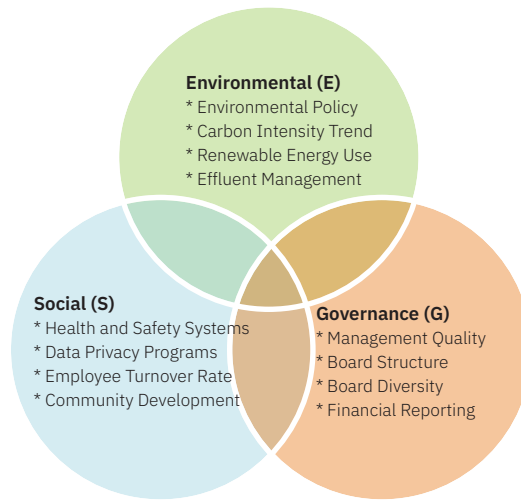
The Nifty100 ESG Sector Leaders Index uses a unique ESG Risk Rating framework for stock selection

The Nifty100 ESG Sector Leaders Index selects stocks from each sector of the Nifty 100 Index based on how well they have scored on the ESG Risk Rating Framework by Sustainalytics. Sustainalytics’ ESG

Risk Rating framework seeks to measure companies’ exposure to financially material Environmental (E), Social (S) and Governance (G) risks. A few examples of these risks are shown in the Exhibits below:

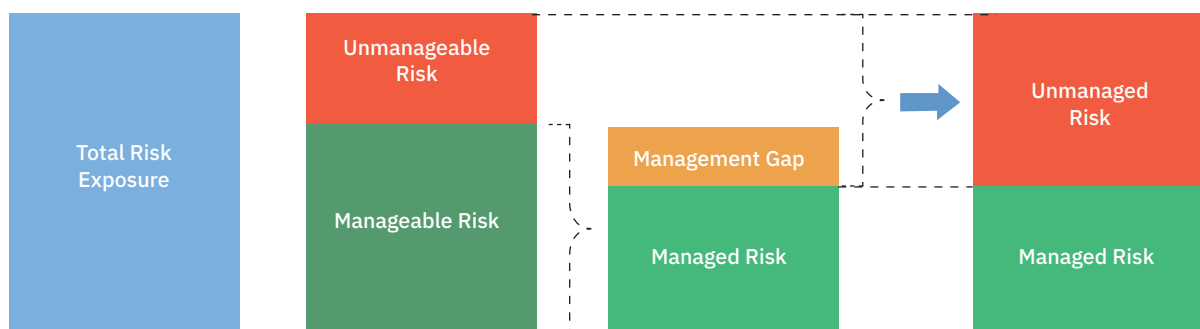


Exhibit 1: Examples of ESG Risks



Source: Sustainalytics, NSE Indices

Exhibit 2: Decomposing Total Risk Exposure into Managed and Unmanaged risk



Source: Sustainalytics, NSE Indices

As illustrated in Exhibit 2 above, the ESG Risk Rating framework includes 3 steps at a company level. First, ESG risks that are financially material to a company are determined and weights to various indicators at a company level are assigned. Next how much of this risk is 'manageable' and is being actively managed through company policies and programs is determined. For example, a material Social risk for airlines is passenger and employee safety. This risk is manageable to a large extent, by hiring well-trained maintenance staff, investing in newer aircraft, having safety drills etc. The part of these manageable risks that management has not mitigated, is termed 'management gap'.

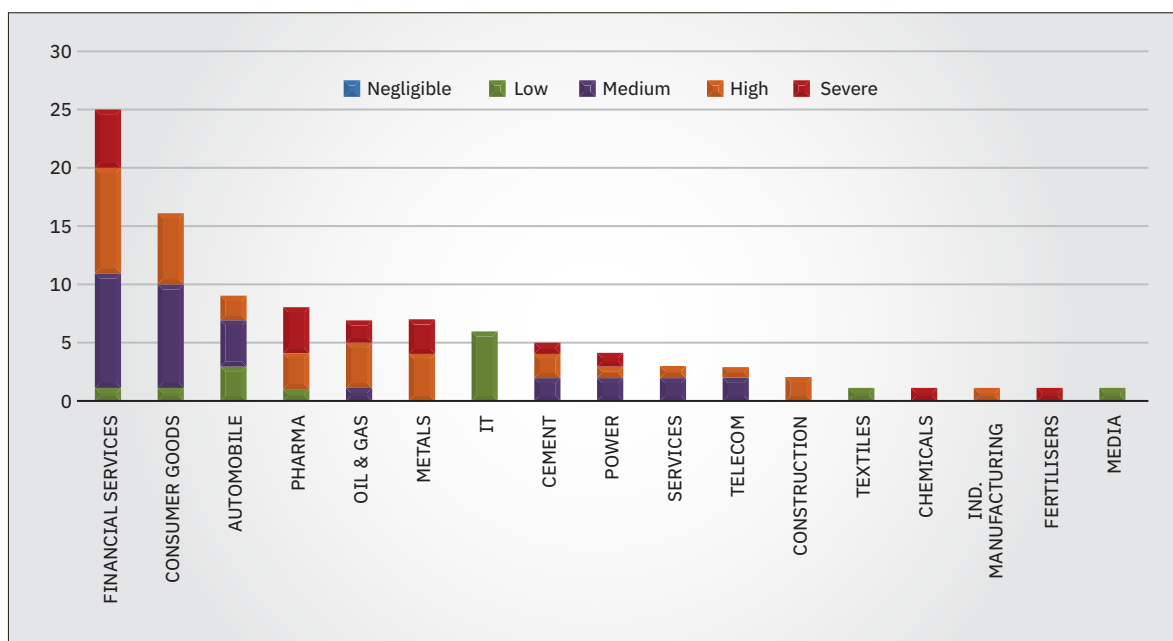
Finally, many firms are exposed to 'unmanageable' risks – ESG risks that cannot be fully managed. For example, an oil company will always face carbon emissions risk until it changes its business model. The Risk Ratings mechanism adds the 'management gap' and 'unmanageable' risk across all material ESG issues to arrive at the total 'unmanaged' risk and the final ESG Risk scores. Companies are then allocated across 5 risk rating categories – Negligible, Low, Medium, High and Severe. As a part of the stock selection criteria for the Nifty100 ESG Sector Leaders Index, stocks in the 'Severe' category of Risk Rating are excluded from the Index.

ESG Risk Ratings of stocks in the Nifty100 ESG Sector Leaders Index vary depending upon the industry in which the stocks operate

The ESG Risk Rating Framework rates a company based on the industry in which the company operates. Companies across different industries have varying exposures to different ESG risks. For example, a chemicals company has more exposure to Effluent Management than a bank. But the bank has more Data Privacy and Security risk, since it stores customers' sensitive financial information. The ESG Risk Ratings framework used by Nifty100 ESG Sector Leaders Index measures companies' exposure to, and management of, such material ESG issues.

Exhibit 3 below shows the total number of companies in each sector in the Nifty 100, and their distribution across various ESG risk categories. For example, the Financial Services sector has the highest number of stocks in the Nifty 100, the majority of which fall in the Medium and High risk category. Similarly, all companies in the IT sector in the Nifty 100 have a Low risk score. For sectors like Pharma and Metals, roughly half the companies are in the High and Severe category

Exhibit 3: Number of stocks by sector, across various ESG Risk categories for the Nifty 100



Source: Sustainalytics, NSE Indices. Data as of April 30, 2020

Companies that are involved in any major ESG controversies are excluded from the Nifty100 Sector Leaders Index

A key component of ESG research focuses on assessing a company's involvement in incidents and controversies which can point to the lack of ESG compliance and imply potentially higher risk to investors. Controversy analysis highlights the incidents that have reputational risk and captures the severity of the event.

Events are classified into various areas across E, S and G categories and as shown in Exhibit 4 below

are scored on a scale from one to five, depending on the reputational risk to the company and potential impact on stakeholders. "Category 1" controversy event has low impact whereas "Category 5" controversy event has the highest, indicating a severe impact on the involved stakeholders. Companies with controversy category 4 and 5 are excluded from the Nifty100 ESG Sector Leaders Index

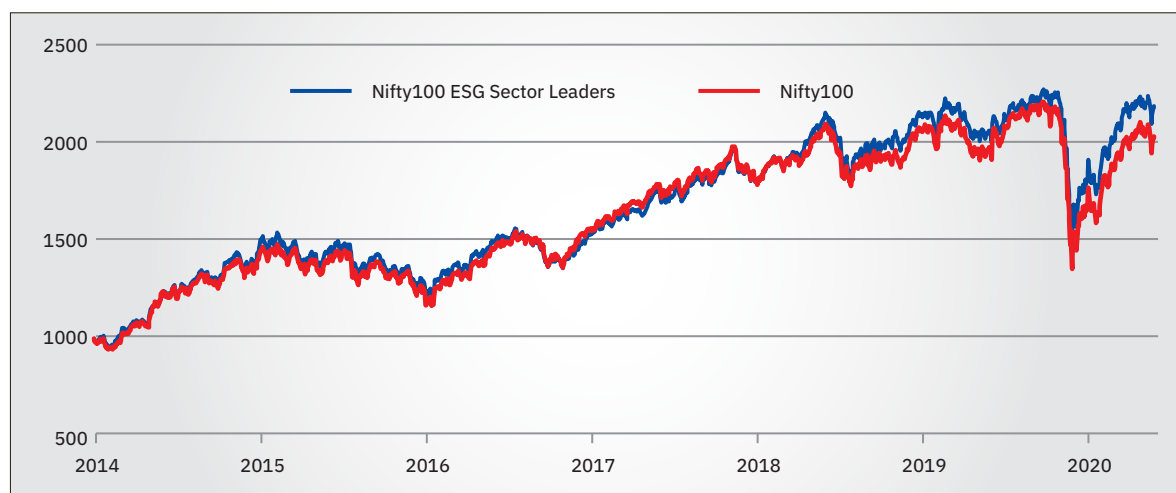
Exhibit 4: Controversy scales



Source: Sustainalytics

The Nifty100 ESG Sector Leaders Index has outperformed its parent index over the long term and recent short-term horizon

Exhibit 5: Nifty100 ESG Sector Leaders Index and Nifty 100 performance



Sources: NSE Indices. Data as of September 30, 2020

Period	CAGR returns		Annualised Volatility		Return-risk ratio	
	Nifty100 ESG Sector Leaders	Nifty 100	Nifty100 ESG Sector Leaders	Nifty 100	Nifty100 ESG Sector Leaders	Nifty 100
Since Inception	12.0%	10.8%	16.9%	17.3%	0.71	0.62
5 years	9.5%	8.5%	17.4%	18.0%	0.55	0.47
3 years	8.5%	5.2%	19.9%	20.7%	0.43	0.25
1 year	3.7%	-1.0%	29.2%	30.4%	0.13	-0.03
6 months	29.5%	31.0%	24.1%	25.0%	1.22	1.24
3 months	8.7%	8.9%	15.0%	16.0%	0.58	0.56

Source: NSE Indices. Data as of September 30, 2020. Inception date: Jan 01, 2014. Returns based on TRI values

The Nifty100 ESG Sector Leaders Index has outperformed the Nifty 100 Index since inception, with a 12% CAGR return against 10.8% CAGR return for the Nifty 100. In the last 3 years, the Nifty ESG Sector Leaders Index has returned 8.5% CAGR compared to 5.2% CAGR for the Nifty 100 Index. The reasons for the same are explained later. The Nifty100 ESG Sector Leaders Index has been

less volatile than the Nifty 100 Index over various time horizons. Since inception, the Nifty100 ESG Sector Leaders Index has had annualized volatility of 16.9% vs. 17.3% for its parent index. It has also stayed marginally less volatile over the last 1 year between September 30, 2019 and September 30, 2020, with annualized volatility of 29.2% against 30.4% for the Nifty 100.

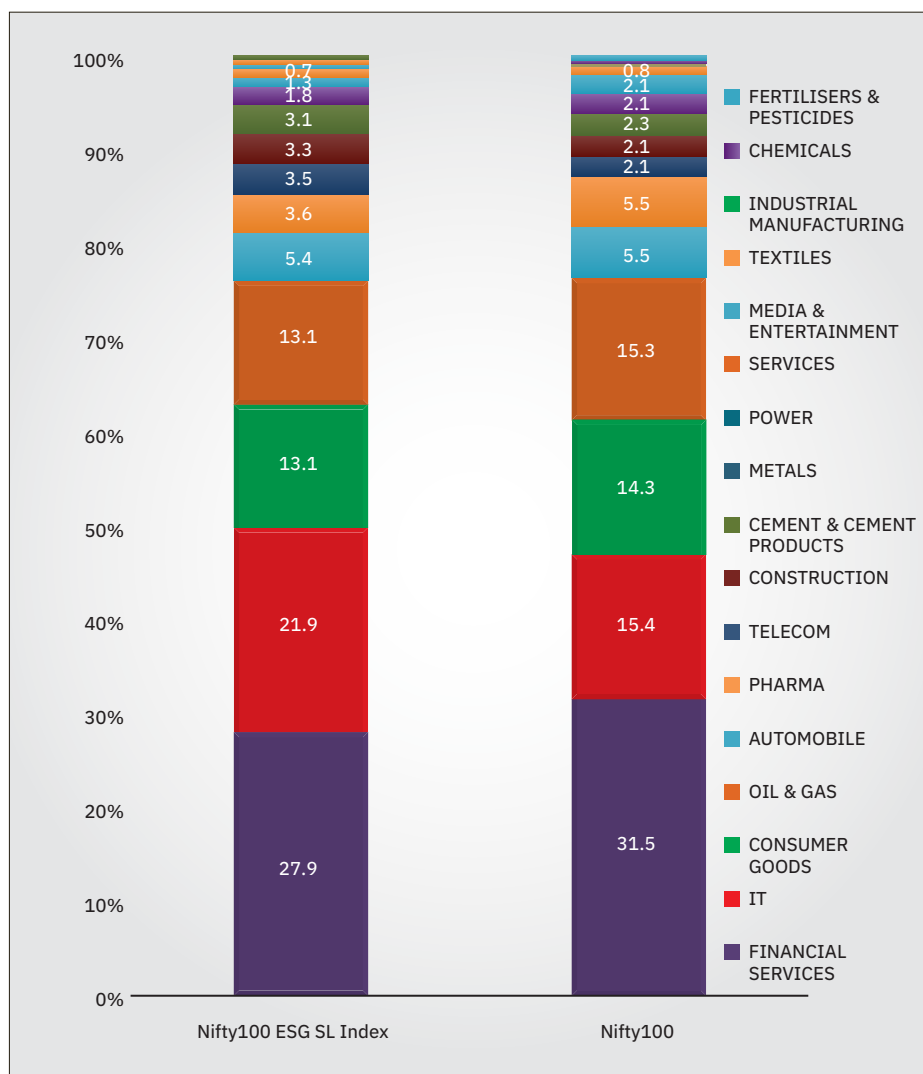
Stock selection criteria of Nifty100 ESG Sector Leaders yields a sector distribution broadly similar to the Nifty 100 Index

Due to selection of stocks with ~75% cumulative coverage of Free Float Market capitalisation within each sector, the Nifty100 ESG Sector Leaders Index has a broadly similar sector composition as its parent index. In fact, the absolute difference in weights

between the Nifty100 ESG Sector Leaders Index and the Nifty 100 Index is greater than 2% for only three sectors (IT, Oil & Gas and Financial Services).

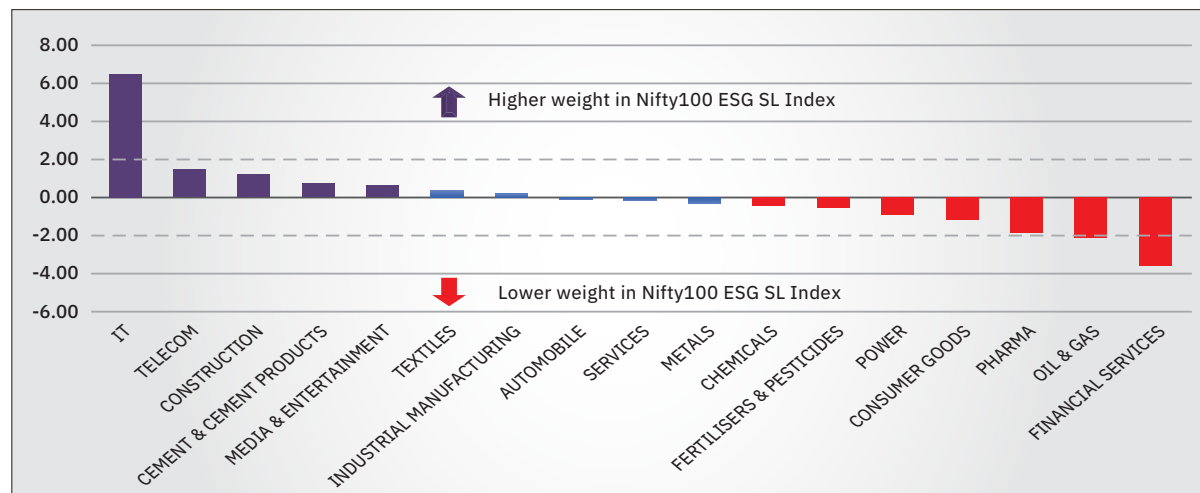
The sector distribution and the difference in sector weights between the 2 indices is shown below:

Exhibit 6: Comparison of sector exposure between the Nifty100 ESG Sector Leaders Index and Nifty 100 Index (%)



Source: NSE Indices. Data as of September 30, 2020

Exhibit 7: Change in Sector weights in Nifty100 ESG Sector Leaders Index vis-à-vis Nifty 100 (%age points)



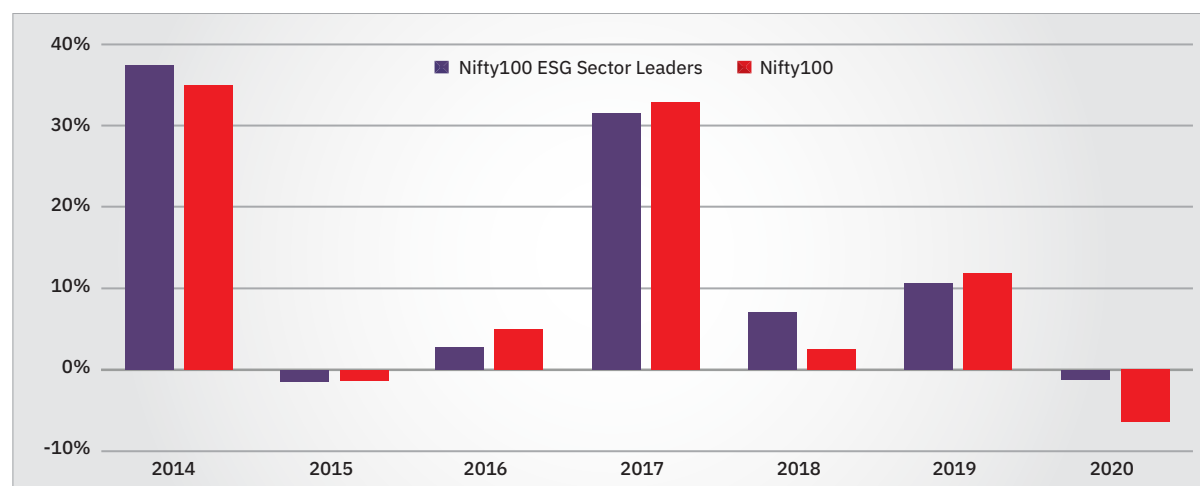
Source: NSE Indices. Data as of September 30, 2020

As observed in the Exhibit above, the Nifty100 ESG Sector Leaders Index is overweight the IT sector by 6.6% and underweight the Financial Services Sector by 3.6%, compared to the Nifty 100 Index.

Nifty100 ESG Sector Leaders Index outperforms the Nifty100 in recent periods due to its overweight in the IT sector and overall better stock selection

The Nifty100 ESG Sector Leaders Index has outperformed its parent index over the last 3 years (8.5% vs 5.2% CAGR for the Nifty 100 Index). The performance by calendar year shows us which years the outperformance occurred.

Exhibit 8: Performance of Nifty100 ESG Sector Leaders Index and Nifty 100 by calendar year



Source: NSE Indices. Data as of September 30, 2020

While the Nifty100 ESG Sector Leaders Index's sector composition was broadly similar to the Nifty 100 Index in May 2017 (3 years ago), the Nifty100 ESG Sector Leaders Index was still ~6% overweight in IT compared to the Nifty 100 Index. The overweight position in the defensive IT sector helped the index during the volatile periods of 2018 and 2020. The Nifty100 ESG Sector Leaders Index also benefitted by avoiding

controversial stocks, and stocks in prohibited sectors (tobacco, alcohol etc.). Several stocks in these categories have underperformed the Nifty 100 Index over the last 3 years. Thus the slight overweight in the IT sector and overall better stock selection has largely caused the outperformance of the Nifty100 ESG Sector Leaders Index against the Nifty 100 Index, over the last 3 years on a point-to-point return basis.

Signing off ...

ESG investing allows investors to gain exposure to companies with sound ESG risk management, and thus seek to generate stable returns with lower company specific risk. The Nifty100 ESG Sector Leaders Index gives investors exposure to select large capitalisation companies, which have scored well on ESG risk management compared to their peers and have no involvement in any major controversies, across various sectors of the Nifty 100 Index. The Nifty100 ESG Sector Leaders Index has a sector distribution similar to the Nifty 100 Index. The Nifty100 ESG Sector Leaders Index has outperformed the Nifty 100 Index since inception and over shorter time horizons as well, returning

12% CAGR vs 10.8% CAGR for the Nifty100 Index since inception. The Nifty100 ESG Sector Leaders Index has been less volatile than the Nifty 100 Index. The volatility since inception has been 16.9% for the Nifty100 ESG Sector Leaders Index vs 17.3% for the Nifty 100 Index. The Nifty100 ESG Sector Leaders Index is expected to act as a benchmark for asset managers, and as a reference index to capture the growing ESG theme, which can be tracked by passive funds in the form of Exchange Traded Funds (ETFs), index funds and structured products.

For information on the Index methodology and factsheet, please visit us at www.nseindia.com



About NSE Indices Limited :

NSE Indices Limited (formerly known as India Index Services & Products Ltd. - IISL), a subsidiary of NSE, provides a variety of indices and index related services for the capital markets. The company focuses on the index as a core product. The company owns and manages a portfolio of indices under the NIFTY brand of NSE, including the flagship index, the NIFTY 50. NIFTY equity indices comprises of broad-based benchmark indices, sectoral indices, strategy indices, thematic indices and customised indices. NSE Indices Limited also maintains fixed income indices based on Government of India

securities, corporate bonds, money market instruments and hybrid indices. Many investment products based on NIFTY indices have been developed within India and abroad. These include index based derivatives traded on NSE, NSE IFSC and Singapore Exchange Ltd. (SGX) and a number of index funds and exchange traded funds. The flagship 'NIFTY 50' index is widely tracked and traded as the benchmark for Indian Capital Markets.

For more information, please visit:

www.niftyindices.com

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