



**University of
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What do Sustainability Indices tell us?

A comparative analysis of selected Sustainability Indices

Master Thesis

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Executive Summary

Sustainability indices have developed as a result of the increasing diffusion of Socially Responsible Investments (SRI). The first sustainability index was created in order to offer investors a benchmark against which to measure the performance of their investments, screened according to environmental, social, governance (ESG) criteria. The functions of sustainability indices have evolved, and nowadays they are predominantly used for the creation of financial products, such as index-based Exchange Traded Funds or derivative contracts.

With an increasing amount and variety of organizations launching sustainability indices, concerns regarding their construction rose as well. If the first indices employed exclusionary criteria in determining constituents, now more complex methodologies are adopted. Often these methodologies make extensive use of the so called Expert Judgement, or subjective, human input. The main criticisms to sustainability indices rely on the fact that some indices are no longer rule-based but involve discretionary activity.

Although sustainability indices are widely used, the research conducted so far is limited to examining their performance, usually against traditional indices. The available body of research has not reached an unanimous conclusion on whether sustainability indices and SRI portfolios perform better than traditional indices and portfolios. A possible explanation to these divergent results might be the fact that the compared indices differ in purpose and construction methodology, therefore it is impossible to use a single index as proxy for SRI performance. This hypothesis however, has not been examined in detail.

This thesis aims to fill this gap by trying to find out what are the real functions of sustainability indices and whether their construction methodology allows the fulfillment of these functions.

Chapter 2 presents a brief overview of the history of stock indices, and in so doing narrates how market participants have used these indices over time. It then presents the intellectual property theoretical framework, in which the activity of index providers is to be inserted. Subsequently, section 2.4 shifts focus from the theoretical to the empirical level and examines how the features of the index industry and the business model of index providers changed in response to external events (regulatory pressure, increased competition and evolution of financial markets).

After the above introduction to traditional stock indices, Chapter 3 focuses on sustainability indices. It starts with the evolution of SRI and inserts in this framework the advent of sustainability indices. SRI strategies and indices are then categorized, and a summary of the functions sustainability indices are intended to fulfill is offered. Finally, the last part of the chapter provides a theoretical justification of SRI and sustainability indices and couples it with a brief overview of the available literature on SRI performance.

The last part of the present research examines three major sustainability indices currently available: the MSCI KLD 400 Sustainability Index, the Dow Jones Sustainability World Index and the FTSE4Good Global Index. For each index, an analysis of its provider, of its methodology and a comparison against a selected traditional benchmark is offered.

The comparison against the benchmark is not performed with the aim of finding out whether sustainability indices outperform traditional indices. The comparison is done in order to address the criticism that sustainability indices do not convey useful information about the sustainability aspects of their components. Such objection has emerged since the ESG screening adopted by some indices allows the inclusion of a large number of companies and the resulting indices are not substantially different from traditional indices. To test this hypothesis, the constituents of each of the examined indices are compared against the constituents of the traditional indices.

The findings of the constituents comparison allow us to state that indeed, there is overlap between the indices (from 15% to 83%). However, this thesis suggests that looking at the constituents and methodology alone is not sufficient. The analysis of index construction has to be coupled with the analysis of the uses the index is designed to fulfill, in order to evaluate the utility of an index.

The most diffused sustainability indices seem to pursue the main goal of maintaining market representation, and only secondarily, of offering proper ESG screening. However, one should keep in mind the business model of index providers. First, they are interested in maximizing their profits and to do so they are sensible to investors' demand. Second, indices are intellectual property and index methodology is considered creative input. In light of these considerations, the advanced criticisms acquire new meaning. The perceived lack of transparency is interpreted as protection of intellectual property and prioritizing market representation over stricter ESG integration is IPs' response to market demand.