Introducing the S&P LTVC Global Index

INTRODUCTION

Much has been said about the short-termism in capital markets over the last few years.[1] In the recent past, large institutional investors have expressed concern about short-termism and have proposed ideas to address the fundamental issues.[2] They believe this trend may erode long-term value that is important for such investors, as they rely on robust future growth to meet their liabilities. S&P Dow Jones Indices, in collaboration with CPPIB and RobecoSAM, has created an index that seeks to provide exposure to global firms that are considered on track to create long-term value based on a proprietary scoring system.

The S&P Long-Term Value Creation (LTVC) Global Index is designed to measure stocks ranking highly in global equity markets, using both proprietary sustainability and financial quality criteria. Companies that seek to anticipate and manage current and future economic and governance opportunities and risks by focusing on long-term strategy, innovation, and productivity may be more likely to maintain a competitive advantage and thereby sustain stakeholder value. Companies that have demonstrated a sustained history of financial quality may likewise have the capacity to generate future long-term value. Therefore, the S&P LTVC Global Index has been constructed to identify companies having both of these characteristics—sustainability and quality—according to proprietary methodologies.

INDEX DESIGN: SUSTAINABILITY & QUALITY

The S&P LTVC Global Index combines two measures—one qualitative and another quantitative—into a single metric that seeks to measure the potential for long-term value addition. The index construction is also innovative, as it utilizes a vintage selection and rebalancing approach to stay on track with its stated objective.

For the qualitative assessment, we rely on the Economic Dimension Score provided by RobecoSAM that largely focuses on corporate governance. Corporate governance criteria include board independence, the board's range of responsibilities and involvement, the policies and procedures designed to increase board effectiveness, as well as management incentives and vesting. In addition to corporate governance, the Economic Dimension Score also includes an assessment of risk and crisis management, where risk governance is the key element, as well as policies related to business ethics and customer relationships. Additionally, it looks at supply chain management and tax strategy, which are increasingly sources of substantial legal, business, and reputational risks, even for solid businesses. As such, Economic Dimension

[1] Risk and rewards of short-termism, NY Times, http://www.nytimes.com/2015/11/05/business/dealbook/the-risks-and-rewards-of-short-termism.html, accessed on Jan. 11, 2016.

[2] Dominic Barton, Mark Wiseman, Focusing Capital on the Long Term, Harvard Business Review, January-February 2014. Robert Pozen, *The Role of Institutional Investors in Curbing Corporate Short-Termism*, Financial Analysts Journal, September/October 2015, Volume 71, Issue 5. *Focusing Capital on the Long Term*, Investing for the Future: A Long-Term Portfolio Guide, www.fclt.org, accessed on Jan. 11, 2016.

Score criteria go beyond the traditional ESG meaning of sustainability, as they include elements seeking to account for sustainable business growth and progress assessment.

While corporate governance may be a key element of keeping a firm focused on its goals, it is also key to the index to identify where those policies are reflected in the quality of a company's earnings, balance sheet, and profitability. As S&P DJI has discussed in its other publications,[3] the quality factor, which is measured by a combination of earnings, balance sheet, and profitability, has proved to be a driver of long-term investment returns. Profitability of a firm is measured by its return on equity (ROE), which is one of the most commonly used metrics for such an evaluation. Companies with higher ROE tend to have competitive advantages, whether it is higher pricing power because of brand value or the intellectual property that they own. Quality of earnings, as measured by balance sheet accruals ratio, provides a way to measure how a firm scores in its earnings management (cash/accruals); higher accruals are a potential red flag. Finally, leverage ratio, a measure of balance-sheet robustness, gives an indication of how stable a firm would be in times of crisis.

Besides the use of the combination of these metrics in the selection process, the S&P LTVC Global Index uses a unique vintage-based selection and rebalancing process that tends to keep a firm within the index for at least three years. This is done so as to give firms that have high scores within both metrics some cushion against shorter-term market movements.

S&P DJI's analytical partner for this index (as well as most other S&P Dow Jones Sustainability Indices) is RobecoSAM, a sustainability asset management and research company that has unique expertise in sustainability analysis. RobecoSAM provides the Economic Dimension Scores that are used in the index and gathers data from companies through engagement via interactive questionnaires. Due to a highly detailed methodology in place to convert this information into scores, expert judgement[4] is limited despite the qualitative nature of the information.

INDEX CONSTRUCTION

The index employs the following construction rules:

a. The S&P LTVC Global Index is constructed annually from the constituents of the S&P Global LargeMidCap.
b. For a security to be eligible for inclusion in the index, as of the rebalancing date, it must be an existing member of the relevant index universe for at least three years, with a liquidity of at least USD 5 million three-month average daily value traded (ADVT) in each of those years.

At the annual rebalancing, which is effective at the end of April, eligible stocks meeting both criteria of ranking in the top 50% of the Economic Dimension Scores and the top 50% of Quality Scores (using the minimum three-year historical average) are first selected. These stocks are then ranked by the Combined Score (combination of Economic Dimension Scores and the

[3] Daniel Ung, Priscilla Luk, Xiaowei Kang, *Quality: A Distinct Equity Factor?* S&P Dow Jones Indices, July 2014.

[4] "Expert judgment" refers to the exercise of subjective discretion with respect to the use of data in determining an input. Expert judgment includes extrapolating values from prior or related transactions, adjusting values for factors that might influence the quality of data.

Quality Scores). Annually, the top 150 ranking stocks based on Combined Score are selected as the current year “vintage.” The entire portfolio consists of three such portfolios, one from each of the two years prior and the current year. Each of these “vintages” are equally weighted to form the final portfolio. There is a semiannual review; the only action is the review of membership of constituents with substantially negative corporate-governance-related actions in the prior six months.

Due to overlap, the number of stocks in the index over the three-year time frame, according to backtested data, averages approximately 250 top-ranking companies in sustainability and financial quality. As of Dec. 31, 2015, according to backtested data, there were 246 firms in the index, representing 26 countries. The index has a developed market bias in its representation.

CONCLUSION

As a co-founder of the Focusing Capital on the Long Term initiative, Canada Pension Plan Investment Board (CPPIB) has been instrumental among asset owners in calling for global firms to move away from the singular focus on “quarterly capitalism” and toward a true long-term mindset of “sustainable capitalism.” S&P Dow Jones Indices is proud to collaborate with CPPIB and RobecoSAM to create the S&P LTVC Global Index, an index that is designed to track those companies that seek to create long-term value.