
Morningstar Sustainability Rating and Product Involvement: measuring ESG in fund portfolios



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Agenda

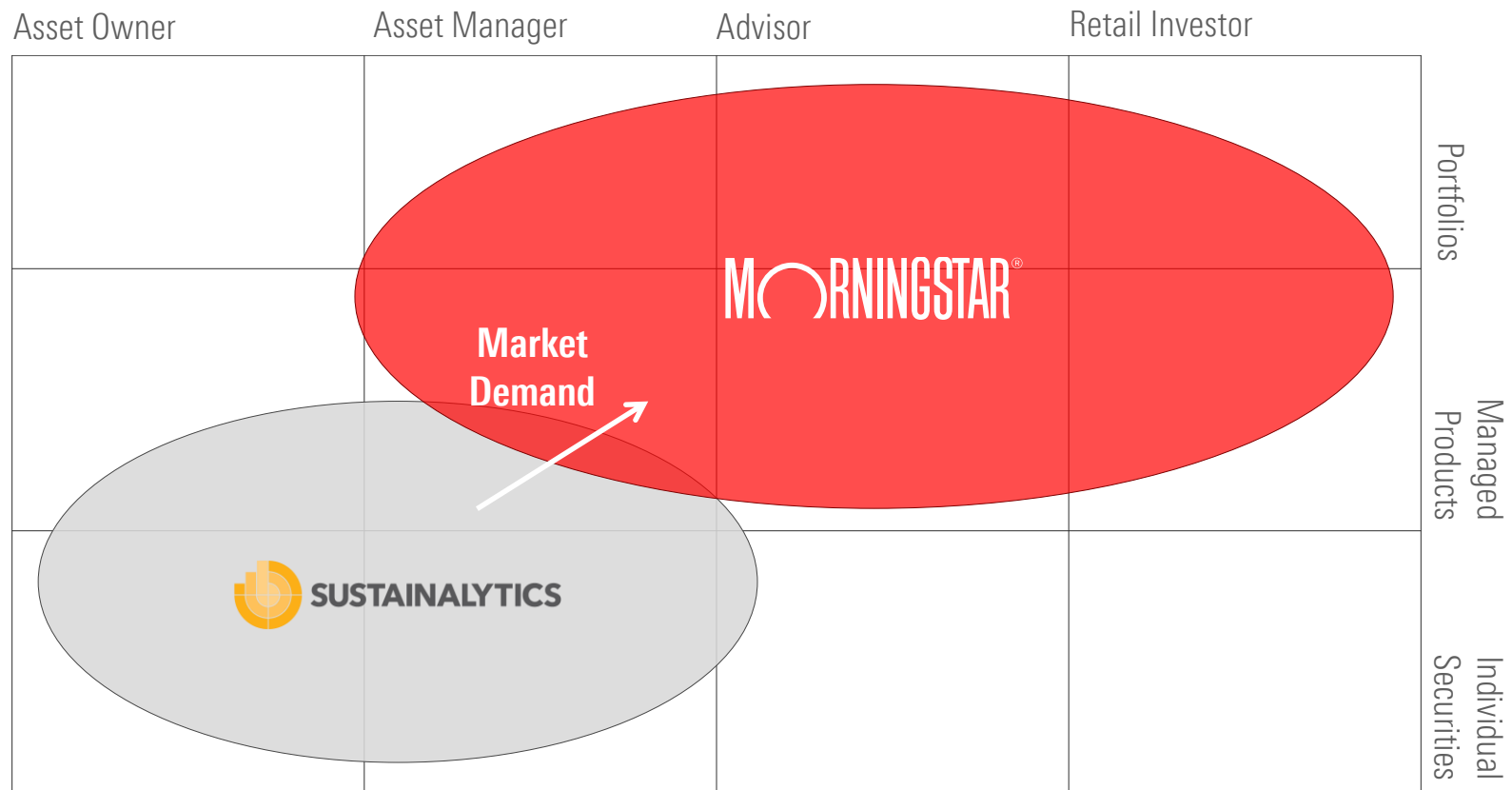
- ▶ What's Sustainable investing
- ▶ Why Morningstar Sustainability Research
- ▶ The Morningstar Sustainability Rating
- ▶ Portfolio Product Involvement
- ▶ The Morningstar Portfolio Carbon Risk Score

Sustainable Investing is a long-term oriented investment process that incorporates **Environmental, Social, and Governance** factors

Environmental Issues	Social Issues	Governance Issues
Climate change and carbon emissions	Product safety	Board composition
Air/water pollution	Data protection/privacy	Audit Cmte structure
Energy efficiency	Gender and diversity	Executive compensation
Water scarcity	Employee engagement	Lobbying
Waste management	Supply chain management	Political contributions
Deforestation	Labor standards	Bribery and corruption

Source: Environmental, Social, and Governance Issues in Investing, CFA Institute, 2015.

A need for **portfolio-level** ESG analytics



Morningstar launched **Sustainability Ratings & Research** based on Sustainalytics' company-level Research. We aim to **create insight, transparency, and comparability** among funds.

We are committed to helping individuals, advisors, and asset managers **invest in ways that create better investment results and are more meaningful** to them.

Morningstar Methodology overview



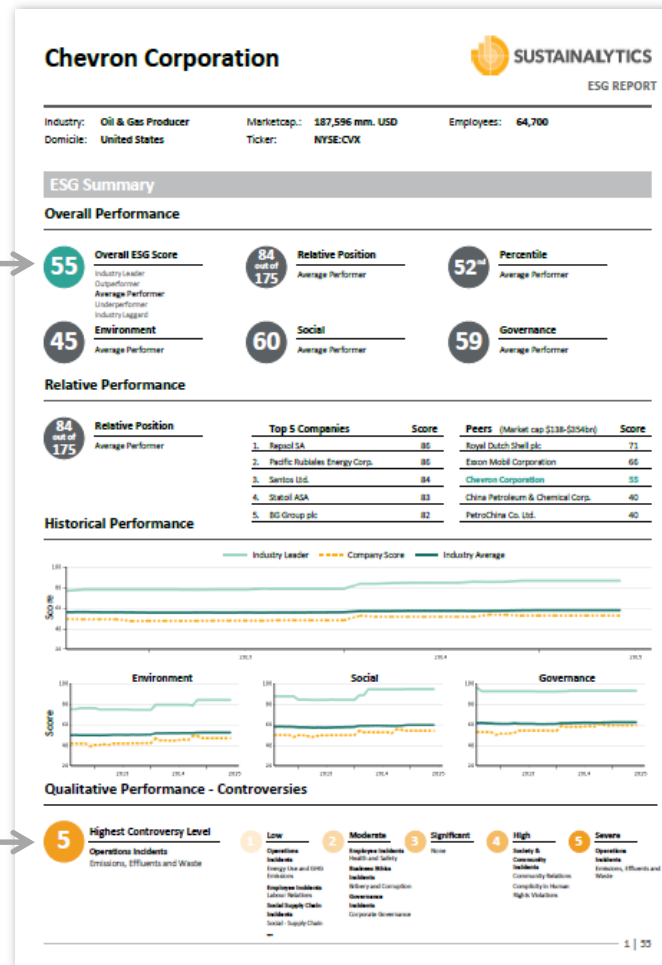
Company ESG Research: Two Signals Used by Morningstar

Company ESG Ratings

- ▶ Overall ESG Score (0–100)
- ▶ Environmental Score
- ▶ Social Score
- ▶ Governance Score

Controversy Assessments

- ▶ Based on 10 issue areas (25 event types)
- ▶ Scored for severity 1 (low) – 5 (high)
- ▶ Outlook



ESG Ratings
4,600 unique issuers

Controversy Research
15,000 unique issuers






Controversies

- ▶ Sustainalytics defines a controversy as any incident that has an impact on the environment or society and poses a risk to the company involved
- ▶ Sustainalytics assesses companies for their level of involvement in major controversies or incidents. Each controversy is categorized from Category 1 (low impact on environment and society, posing negligible risks to the company) to Category 5 (severe impact on the environment and society, posing serious risks to the company).
- ▶ Controversy topics include: business ethics, society and community, environmental operations, environmental supply chain, product and service, employee, social supply chain, customer, governance, and public policy.

Morningstar Portfolio Sustainability Rating

- ▶ **Normalized, asset-weighted ESG scores** = Morningstar **Portfolio ESG** Score
- ▶ **With deduction for controversies** = Morningstar Portfolio **Sustainability Score***
- ▶ Relative to category **percentile ranking** = **Morningstar Sustainability Rating**

Exhibit 5 Morningstar Sustainability Rating

Distribution	Score	Descriptive Rank	Rating Icon
Highest 10%	5	High	
Next 22.5%	4	Above Average	
Next 35%	3	Average	
Next 22.5%	2	Below Average	
Lowest 10%	1	Low	

Criteria

- ▶ A minimum of **ten scored funds per category** required to create rankings, which determine number of Globes received.
- ▶ At least **50% of assets must be covered** to receive a fund level score.
 - ▶ Large caps have broader coverage
 - ▶ The percentage of assets of the covered securities will be rescaled to 100%
- ▶ Rankings, including the Morningstar Sustainability Rating, will be **issued monthly** based on the most recent portfolio sustainability score, provided the portfolio is less than one year old
- ▶ Morningstar will recalculate **historical ranks 120 days after the initial ranking** is released upon receipt of a new portfolio

Possible bias

- ▶ Comparisons of companies in different industries require normalization of scores, but this requires the assumption that an average company in one industry is equivalent to an average company in another industry.
- ▶ Regional bias – Europe scores well to the rest of the world.
- ▶ Size bias – Large cap companies score well relative to small
- ▶ Fortunately, **our categories take these biases into account**, so we will be comparing funds with shared traits. Using z-scores or underlying data without categories is subject to multi-modality.

How to use our Morningstar Sustainability Rating

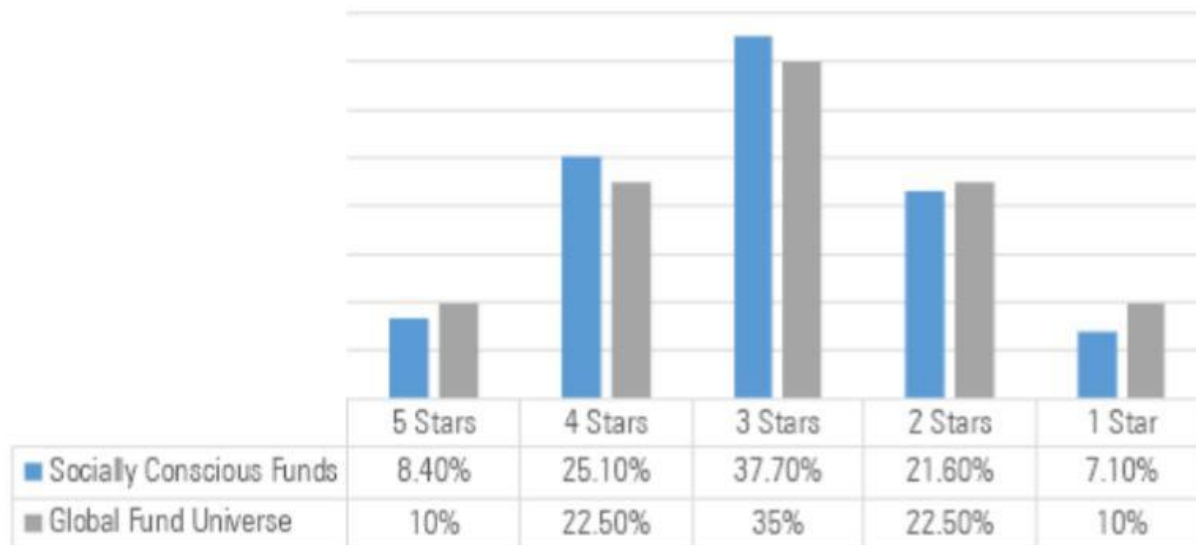
- ▶ Investors can use Morningstar Sustainability Rating and Score in two ways
 - ▶ To find best-in-class funds looking within Morningstar categories using Morningstar Sustainability Rating
 - ▶ To use Morningstar Sustainability Score to assess which funds have constituents you deem are good enough on ESG criteria for your purposes

AUM Covered	Fund	ESG Score – Controversy Deduction = Sustainability Score			Category % Rank	Sustainability Rating
94.7	A	58.1	12.3	45.8	40	
98.5	B	57.2	6.1	51.1	29	

SRI funds performance (Star Rating)

Exhibit 2

Cumulative Morningstar Ratings, 2002-2016 Socially Conscious Funds vs. Fund Universe

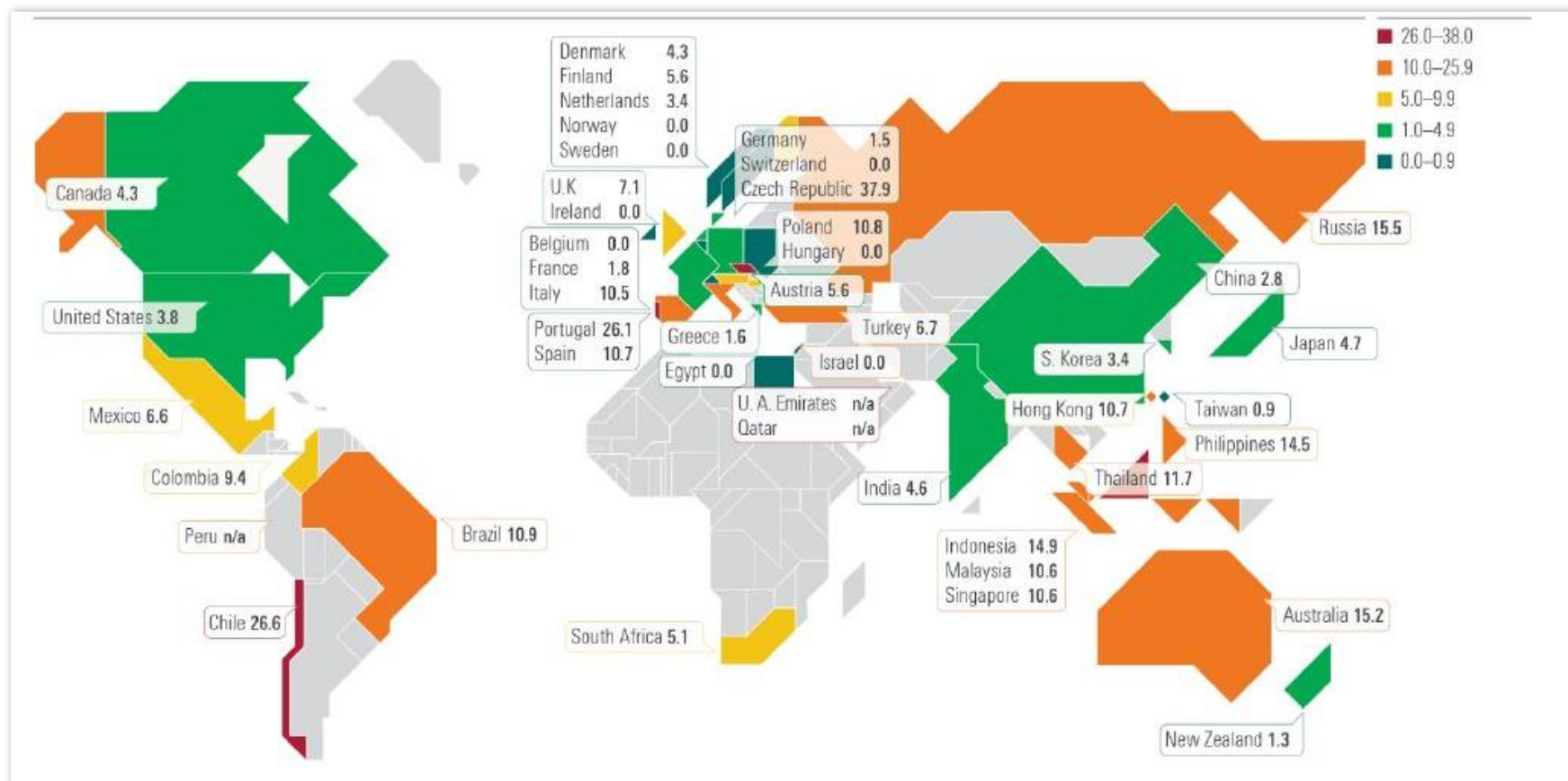


Source: Morningstar Direct

Portfolio Product Involvement

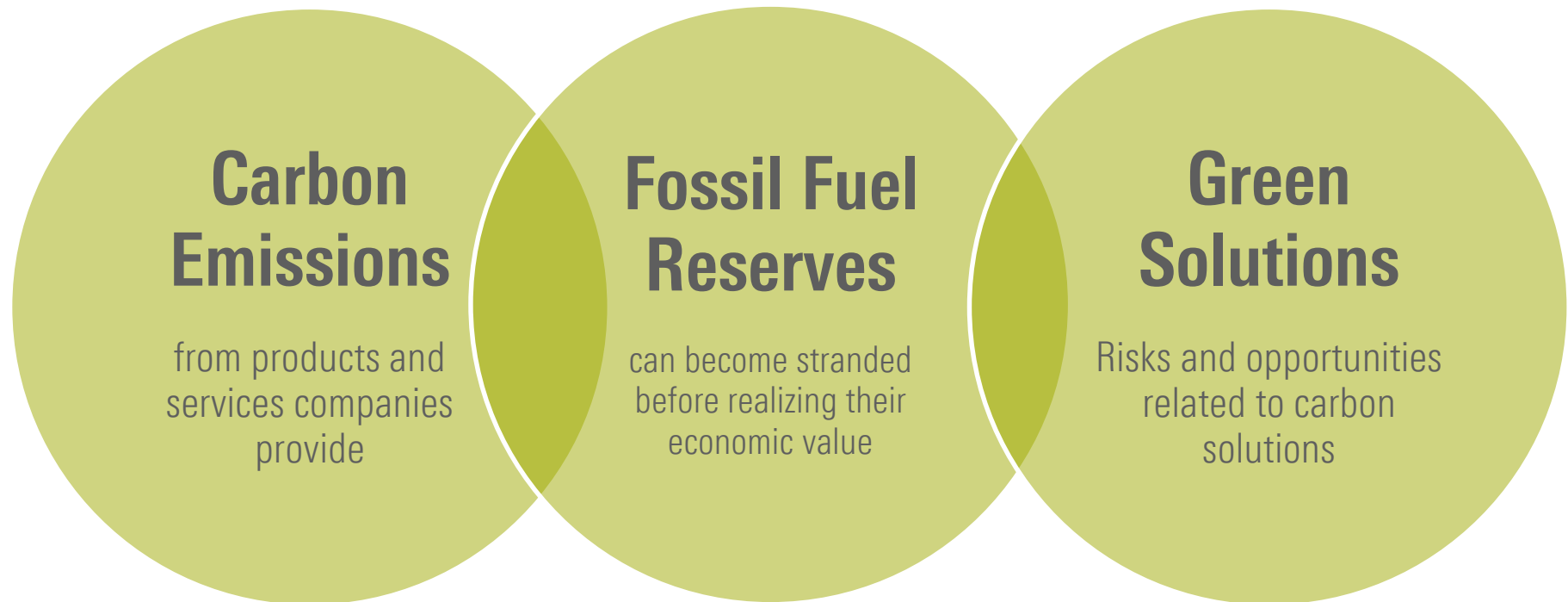
- ▶ The Morningstar Portfolio Product Involvement metrics measure a portfolio's exposure to involvement in a range of products, services, and business activities.
- ▶ The metrics are calculated for managed products globally using Morningstar's portfolio holdings database.
 - ▶ Abortive/Contraceptives/Stem Cell
 - ▶ Adult entertainment
 - ▶ Alcohol
 - ▶ Animal testing
 - ▶ Controversial weapons
 - ▶ Fur & specialty leather
 - ▶ Gambling
 - ▶ GMO
 - ▶ Military contracting
 - ▶ Nuclear
 - ▶ Palm oil
 - ▶ Pesticides
 - ▶ Small arms
 - ▶ Thermal coal
 - ▶ Tobacco

Thermal Coal Product Involvement (Morningstar indexes)



Fonte: Morningstar Sustainability Atlas. Data as 28/02/2018.

Dimensions of Carbon Risk for investors



Morningstar Portfolio Carbon Risk Score

Definition

- ▶ The Portfolio Carbon Risk Score is the asset-weighted carbon risk rating of companies in the portfolio

Details

- ▶ Portfolio scores (lower is better) are ranked against their Morningstar Category and overall universe
- ▶ Portfolio scores are compared with relevant category benchmarks
- ▶ To receive a score, a portfolio must have at least 67% of assets covered by the Sustainalytics carbon-risk score
- ▶ Portfolio scores calculated for most-recent time period and for trailing 12-months

Morningstar Low Carbon Designation



Funds must have a carbon risk score < 10

Carbon Risk Score
(12 Month Average)

Fossil Fuel Involvement
(12 Month Average)

Funds must have <7% exposure to fossil fuels

- ▶ The low carbon designation helps investors **easily identify** low-carbon funds across the global universe and **encourages funds to minimize their carbon risk – it's not a rating**
- ▶ The “low” carbon-risk threshold is consistent with Sustainalytics’ threshold for a low carbon-risk company; it represents managed and unmanaged carbon risk inherent in a firm’s operations
- ▶ Exposure to fossil fuels is the biggest source of carbon intensity; funds with less than 7% of assets are underweight fossil fuels relative to a global universe

Morningstar Portfolio Carbon Metrics

- ▶ 70+ carbon-related fund-level metrics
 - ▷ Metrics include: Low Carbon Designation, Carbon Risk Score, Carbon Management Score, Carbon Products & Service Risk, Carbon Operations Risk, Carbon Intensity, Fossil Fuel Involvement, Stranded Assets Risk, and Green Solutions
- ▶ A portfolio must have at least 67% of assets covered by Sustainalytics carbon research to receive carbon metrics
- ▶ Metrics are calculated four times per year
- ▶ Approximately 30,000 funds globally will receive carbon metrics

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