THE MORNINGSTAR SUSTAINABILITY RATING

Helping Investors Evaluate the Sustainability of Portfolios

By Jon Hale, PhD, CFA®

Sustainable investing is experiencing rapid growth. Assets under management in portfolios that use various approaches to sustainable investing have grown to an estimated $22.9 trillion globally, up from $3.8 trillion in 2006.¹ For the United States, sustainable assets have grown to more than $8 trillion from less than $2 trillion in 2006.² That same year, 100 investment industry firms, representing $6.5 trillion in assets, signed the United Nations-sponsored Principles for Responsible Investment (PRI), committing themselves to incorporating environmental, social, and corporate governance (ESG) criteria into their investment processes. Today, the number of asset–manager PRI signatories is more than 1,200, representing more than $60 trillion in assets and virtually all of the world’s largest asset managers.³

Most of the growth in assets over the past decade has come from institutional investors, but individual investors are beginning to increase their investments in the field, and a large and growing number of them are indicating an interest in sustainable investing. A 2017 Morgan Stanley survey of 1,000 individual investors found that 75 percent are interested in sustainable investing. Among millennials and women, interest in sustainable investing runs even higher, with 86 percent of millennials and 84 percent of women interested.⁴ Recent surveys from Schroders,⁵ U.S. Trust,⁶ and TIAA⁷ have reported similar results. As the investor universe transitions toward younger generations and gender parity, overall interest seems poised to remain high.

Interest is one thing, but actually basing investment decisions on sustainability criteria can be difficult for institutional and individual investors alike. Only a small proportion of strategies and funds relative to the overall universe are intentionally sustainable, meaning they have made sustainability criteria an explicit part of their processes. Many of those are recent launches with short performance records and, as with the broader established universe in general, only a subset of the smaller number of established intentional funds have attractive performance records. That often leaves sustainable investors with few intentionally sustainable options. For many investors using defined-contribution retirement accounts, there may be no intentional options at all. And even when considering an intentional fund, there has been no way to evaluate independently how well these funds are actually living up to their sustainability intentions.

THE MORNINGSTAR SUSTAINABILITY RATING

Investors need tools that enable them to evaluate portfolios and funds on the basis of sustainability criteria. More sophisticated institutional investors can partially address these challenges by hiring expert consultants to customize their manager selection and monitoring process. Individual investors face a greater challenge in finding help in the form of online advice or from financial advisors. Perhaps that’s why only a little more than half of those who said they are interested in sustainable investing in the Morgan Stanley survey reported actually making investment decisions based on sustainability criteria. For high levels of interest to result in invested capital, investors, consultants, and financial advisors need tools to help them analyze the sustainability of their portfolios.

Asset managers, meanwhile, already have an important tool to help them evaluate companies: ESG metrics and ratings. Third-party research firms such as Sustainalytics and MSCI ESG Research gather and report data on the ESG practices of thousands of companies and provide ESG ratings of companies relative to their industry peers. This company research provides asset managers with insights that help them incorporate sustainability criteria into their strategies and funds.

The Morningstar Sustainability Rating (MSR) was created to give investors a research tool to help them evaluate portfolios. The MSR uses company ESG ratings from Sustainalytics to evaluate portfolios and then to compare portfolios to their peers. It is based on the simple concept that the sustainability of a
portfolio is the asset-weighted sum of the sustainability of its holdings. It is similar to how Morningstar evaluates style and, more generally, categorizes portfolios, based on the style, market capitalization, region, or, for bonds, the duration and credit quality of their actual holdings. The MSR is a measure of how well the companies held in a portfolio are managing their ESG risks and opportunities relative to portfolios within the same Morningstar category. It is an independent tool that gives investors an easy way to assess the sustainability of the holdings in a portfolio compared with those of similar portfolios.

**HOW IT WORKS**

The MSR results from a two-step process. First, a Portfolio Sustainability Score is calculated. This score is an asset-weighted average of a portfolio’s normalized company-level ESG scores with deductions made for any controversies surrounding the companies owned by the fund. The Portfolio Sustainability Score is calculated as follows:

\[
\text{Portfolio Sustainability Score} = \frac{\sum_{i=1}^{n} w_i ESG_{Norm}}{1 - MContrp} \]

(1)

where:

- \( ESG_{p} \) = the ESG score of the portfolio
- \( n \) = the number of securities in the portfolio
- \( w_i \) = the normalized asset weight on security \( i \)
- \( \sum_{i=1}^{n} w_i = 1 \)

Sustainalytics assesses a company’s performance on ESG issues relative to other firms in the same global industry peer group using a 0–100 scale. Because the relevance of particular ESG issues varies across the peer groups, a unique combination of indicators is used within each peer group to determine the company-level ESG score.

The use of a unique combination of indicators for each peer group means that the same score shared by two companies in different peer groups may not be equivalent; one company’s score may signal that it is an outperformer in its peer group, but the other company’s identical score may indicate that it is an underperformer in its peer group. The peer groups also have varying ESG score ranges and means. To make the ESG scores comparable across peer groups, which is necessary for the evaluation of diversified portfolios, Morningstar normalizes the scores of each peer group using a z-score transformation, as follows:

\[
Z_c = \frac{ESG_{c} - \mu_{PG}}{\sigma_{PG}} \]  

(2)

where:

- \( ESG_{c} \) = the ESG score of company \( c \)
- \( \mu_{PG} \) = the mean of the ESG scores of the companies in the peer group
- \( \sigma_{PG} \) = the standard deviation of the ESG scores of the companies in the peer group

The z-scores are used to create the normalized ESG scores on a theoretical scale of 1–100, with a mean of 50, as follows:

\[
ESG_{Norm_{c}} = 50 \times 10Z_c \]  

(3)

Normalized company ESG scores can be interpreted as follows:

- 70+ = Company scores at least two standard deviations above average in its peer group
- 60 = Company scores one standard deviation above average in its peer group
- 50 = Company scores at peer group average
- 40 = Company scores one standard deviation below average in its peer group
- 30− = Company scores at least two standard deviations below average in its peer group

Most companies score between 30 and 70 on this normalized scale.

Once the company ESG scores are normalized, they are aggregated to a Portfolio ESG Score using an asset-weighted average of all covered securities. Covered securities include equity and fixed-income securities issued by companies that have ESG scores. Securities issued by companies that do not have ESG scores, as well as short positions, options, and derivatives typically issued by third-party financial firms, are not covered. To receive a Portfolio ESG Score, at least 50 percent of a portfolio’s assets under management must have a company ESG score. The percentage of assets under management of the covered securities is rescaled to 100 percent before calculating the Portfolio ESG Score.

### Table 1: Sustainalytics Controversy Score

<table>
<thead>
<tr>
<th>Category</th>
<th>Impact on Environment or Society</th>
<th>Risk to Company</th>
<th>Controversy Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>Severe</td>
<td>Serious</td>
<td>20</td>
</tr>
<tr>
<td>4</td>
<td>High</td>
<td>Significant</td>
<td>16</td>
</tr>
<tr>
<td>3</td>
<td>Significant</td>
<td>Moderate</td>
<td>10</td>
</tr>
<tr>
<td>2</td>
<td>Moderate</td>
<td>Minimal</td>
<td>4</td>
</tr>
<tr>
<td>1</td>
<td>Low</td>
<td>Negligible</td>
<td>0.2</td>
</tr>
<tr>
<td>0</td>
<td>No evidence of controversy</td>
<td>None</td>
<td>0</td>
</tr>
</tbody>
</table>
Sustainalytics also tracks and categorizes ESG-related incidents, referred to as “controversies,” on more than 10,000 companies globally. Each incident is assessed in terms of its level of impact on the environment and society and its material risk to the company itself. While a company may be involved in multiple ESG-related incidents at any given time, a company’s most serious current controversy is used to create its controversy score, on a 0–20 scale, as can be observed in table 1. The Portfolio Controversy Score is an asset-weighted average of company controversy scores.

$$M_{Contr,p} = \sum_{i=1}^{n} w_{Cont,i}$$ (4)

where:
- \(M_{Contr,p}\) = the Morningstar portfolio controversy score
- \(Cont_i\) = the controversy score of company \(i\)

To receive a Portfolio Controversy Score, at least 50 percent of a portfolio’s assets under management must have a company controversy score. Covered securities include equity and fixed-income issued by companies that have controversy scores. Securities issued by companies that do not have controversy scores, as well as short positions, options, and derivatives typically issued by third-party financial firms, are not covered. The percentage of assets of the covered securities is rescaled to 100 percent. The Portfolio Controversy Score is deducted from the Portfolio ESG Score to arrive at the Portfolio Sustainability Score.

In the second step, once the Portfolio Sustainability Score is calculated, it is compared with the scores of other funds in the same Morningstar category (see table 2). A fund’s MSR is its normally distributed ordinal score and descriptive rank relative to the fund’s category. For a fund to receive a sustainability rating, its Morningstar Category must have at least 10 funds with portfolio sustainability scores.

### A SIMPLE EFFICACY TEST

Those familiar with company ESG data know that there is not absolute agreement among research providers on the broad concept of sustainability and how it manifests itself in a company. The two largest providers, Sustainalytics and MSCI ESG Research, do not always agree on their company assessments. This is not surprising because no standard definition of company sustainability exists, firms do not report standardized ESG information, and the two providers use different rating scales, along with somewhat different metrics and analytical frameworks. These differences can lead to differences in how they rate companies. Be that as it may, it’s reasonable to expect general agreement on most companies given that research providers use many of the same metrics and concepts in their company evaluations.

Nevertheless, a lack of complete consensus on sustainability could mean that portfolio ratings constructed from one ESG research provider are substantially different from ratings constructed from another provider. In particular, the MSR for portfolios whose managers use MSCI ESG Research could be lower than they should be because Morningstar uses Sustainalytics.

To assess whether that is happening, I examined the MSRs of funds and exchange-traded funds (ETFs) that replicate MSCI ESG indexes, which are based on MSCI ESG Research’s assessments of company sustainability. We have 28 such funds and ETFs in the Morningstar global database. As figure 1 shows, all but one of those funds, 27 of 28, have the highest possible sustainability rating (5 globes); these top-rated funds include all eight funds and ETFs available to U.S. investors. The sustainability scores of 18 of the 28 funds are in the top one or two percentiles of their respective categories. The list includes funds that invest in all developed-markets regions, emerging markets, and global strategies. These findings suggest that underlying company-rating differences between MSCI ESG Research and Sustainalytics are likely not very meaningful when aggregating company ratings to portfolio scores. They also suggest that the MSR is capturing the essence of ESG performance, even for funds that use a different source for company ESG information.

Before Morningstar began using holdings-based analysis to evaluate manager investment style, investors’ understanding of manager style was based largely on how managers described that style rather than on the securities actually held in their portfolios. Before the launch of the MSR, the same could be said for funds that claimed to be sustainable (or responsible or ESG) funds. Using the MSR, investors have a tool to evaluate whether intentional funds are doing what they claim to be doing.

The Morningstar database includes funds that are tagged as “socially conscious.” Funds in this group must have some indicator in their prospectuses of values-based investing, exclusion of certain products or activities, use of ESG or sustainability criteria, or sustainable investing themes. This group constitutes the broadest swath of intentionally socially conscious funds. Figure 2
As measured by the MSR, the socially conscious funds, for the most part, are doing what they claim to be doing. Funds in this group are four times more likely to have an MSR rating of 5 globes than funds overall. Two-thirds of socially conscious funds have MSR ratings of 4 or 5 globes, and just 11 percent have MSR ratings of 1 or 2 globes. In the normally distributed overall universe, one-third of funds have MSR ratings of 4 or 5 globes and one-third of funds have MSR ratings of 1 or 2 globes. These results suggest that most socially conscious funds are holding companies that are relatively strong sustainability performers but others—a relative few—are not. It turns out that most funds in this latter group are not as fully committed to sustainable investing as others in the socially conscious universe. Several of them use only a small number of social-issue exclusions, for example, and others are primarily faith-based funds with a set of values-based exclusions. Their low MSRs help call attention to their lack of focus on broader ESG criteria.

What about funds that actually call themselves “sustainable” and that claim to be incorporating ESG into their investment processes? I examined the prospectuses of all the funds tagged in the Morningstar database as socially conscious and included at this stage of the analysis only those that describe the use of sustainability, or ESG, criteria in their investment processes or the pursuit of sustainability impact or themes. This narrowed the universe from 220 U.S.-based funds and ETFs to 154. These more-focused sustainable funds garnered even better overall MSRs than the broader socially responsible universe (see figure 3). More than half received 5 globes and just 1 percent received 1 globe. Three-quarters received 4 or 5 globes, and just 7 percent received 1 or 2 globes. Clearly, most of these funds are doing what they claim to be doing.
USING THE RATING TO EVALUATE CONVENTIONAL FUNDS

There may be circumstances when investors want to evaluate the sustainability of conventional funds or existing lineups or portfolios of funds. Many defined-contribution plan lineups, for example, lack intentional sustainable investing options. Plan administrators, consultants, or participants can use the MSR to evaluate existing options, to establish a minimum threshold for sustainability in a plan, or to help them improve the overall sustainability profile of the plan. Financial advisors might use the MSR to evaluate existing portfolios of clients who want to transition to a focus on sustainable investing. Those with lower MSRs may be the first candidates for replacement. Finally, consultants, advisors, and investors can use the MSR simply as a way to add sustainability as an additional factor in their fund selection and monitoring process. We tend to think of those who want to be sustainable investors as wanting to be invested in only authentic intentional sustainable strategies. Yet, in the Morgan Stanley survey referenced above, more than half of those who said they were interested in sustainable investing said they were somewhat interested rather than very interested. Those “somewhat” interested sustainable investors may rather have the concept of sustainability incorporated into a broader fund-selection process than have an all-in sustainable-focused portfolio.

5-GLOBE FUNDS VS. 1-GLOBE FUNDS

Using the MSR, investors can add an ESG perspective to their fund evaluation and selection processes. We know that funds receiving 5 globes hold companies in their portfolios that are better sustainability performers than those held by 1-globe funds. Those receiving 5 globes land in the top 10 percent of their Morningstar Category, and those receiving 1 globe fall into the bottom 10 percent of their Morningstar Category. But what kind of funds are these in other respects? Aside from the sustainability performance of their underlying holdings, are there systematic differences between 5-globe funds and 1-globe funds?

To answer that question, I compared funds with the highest MSR (5 globes) against those with the lowest MSR (1 globe) across U.S. stylebox and international equity categories. I found that 5-globe funds tend to be a higher-quality group than 1-globe funds measured in several ways.

First, 5-globe funds have better Morningstar Ratings. The Morningstar Rating (the star rating) is based on a fund’s risk-adjusted return relative to its Morningstar Category including up to 10 years of performance. Figure 4 shows the star rating distributions of 5-globe funds and 1-globe funds for all U.S. stylebox and international equities categories. Twice as many 5-globe funds have 5 stars (14 percent) than those that have 1 star (7 percent). Among 1-globe funds, slightly more have 1 star (10 percent) than 5 stars (9 percent). In the overall universe, the distribution is normal, such that approximately 10 percent of funds receive 5 stars and 10 percent receive 1 star.

Second, 5-globe funds appear to be more favored by Morningstar analysts than 1-globe funds. This can be observed simply by looking at overall coverage levels, as well as by looking at the Morningstar Analyst Ratings themselves. Numerous factors can come into play in deciding which funds our analyst team covers, but the two most significant are quality and popularity. Our analysts want to point investors toward better
funds and to cover funds that have significant assets. As shown in figure 5, our U.S. manager research analysts cover 73 actively managed funds that have Sustainability Ratings of 5 globes but only 47 actively managed funds with 1-globe ratings.

The Analyst Ratings they give to the 5-globe funds are better than those they give to the 1-globe funds. Among 5-globe funds covered, analysts awarded medals to 53 (73 percent); among 1-globe funds, analysts awarded medals to 28 (60 percent). More 5-globe funds have Analyst Ratings of Gold and Silver, and 1-globe funds tend to have more Analyst Ratings of Bronze (our lowest positive rating) or Neutral.

Third, 5-globe funds are less volatile than 1-globe funds. Figure 6 shows the volatility risk factor exposures from the Morningstar Global Risk Model for 5-globe funds and 1-globe funds across the U.S. stylebox categories and the foreign large-cap and emerging-markets equities categories. Across every category, 5-globe funds have lower exposure to the risk model’s Returns Volatility factor than do 1-globe funds. This shows up in measures of standard deviation and Morningstar Risk as well, as I outlined in an earlier article.8

Fourth, 5-globe funds have more exposure to great companies in their portfolios than do 1-globe funds. One way to define a great company is in terms of its financial health and Morningstar Economic Moat Rating. Again turning to the Morningstar Global Risk Model, as shown in figure 7, 5-globe funds score higher on the Financial Health risk factor than 1-globe funds across every category, indicating that 5-globe funds have greater exposure to financially healthy companies.

Morningstar defines an economic moat as a structural competitive advantage that allows a firm to hold competitors at bay. The Analyst Ratings they give to the 5-globe funds are better than those they give to the 1-globe funds. Among 5-globe funds covered, analysts awarded medals to 53 (73 percent); among 1-globe funds, analysts awarded medals to 28 (60 percent). More 5-globe funds have Analyst Ratings of Gold and Silver, and 1-globe funds tend to have more Analyst Ratings of Bronze (our lowest positive rating) or Neutral.

Third, 5-globe funds are less volatile than 1-globe funds. Figure 6 shows the volatility risk factor exposures from the Morningstar Global Risk Model for 5-globe funds and 1-globe funds across the U.S. stylebox categories and the foreign large-cap and emerging-markets equities categories. Across every category, 5-globe funds have lower exposure to the risk model’s Returns Volatility factor than do 1-globe funds. This shows up in measures of standard deviation and Morningstar Risk as well, as I outlined in an earlier article.8

Fourth, 5-globe funds have more exposure to great companies in their portfolios than do 1-globe funds. One way to define a great company is in terms of its financial health and Morningstar Economic Moat Rating. Again turning to the Morningstar Global Risk Model, as shown in figure 7, 5-globe funds score higher on the Financial Health risk factor than 1-globe funds across every category, indicating that 5-globe funds have greater exposure to financially healthy companies.
HELPING INVESTORS EVALUATE THE SUSTAINABILITY OF PORTFOLIOS
Continued from page 28

at bay while earning above-average returns on capital over the long term. As shown in figure 8, 5-globe funds have greater exposure to the risk model’s Economic Moat factor than 1-globe funds across every category. We find that funds with high sustainability ratings tend to have higher quality holdings.

In addition to identifying funds that hold companies with better ESG evaluations, an MSR of 5 globes tends to point investors to a subset of funds with better Morningstar Ratings (risk-adjusted return relative to category), better Morningstar Analyst Ratings (forward-looking analyst evaluation), lower volatility, and greater exposure to financially healthy companies with economic moats. It suggests that companies that are doing a good job addressing their ESG risks and opportunities tend to be quality companies and that funds that have a lot of those types of companies in their portfolios tend to be quality funds.

CONCLUSION
Investors can use the MSR to evaluate how well the funds they already hold are applying best sustainable investing practices or to evaluate prospective investments through an ESG lens. They also can use the rating to assess how well intentional sustainable investing funds are living up to their mandates. Finally, the rating and supporting analytics afford investors a wealth of data that they can sift through in drawing their own conclusions about the investing payoff—in financial risk and reward terms—of incorporating sustainable principles into a portfolio.

The MSR is not the last word on sustainability, but it is an important first step toward providing investors with better tools to evaluate and compare funds based on sustainable investing principles. The rating helps investors answer fundamental questions such as, how well are the companies that my fund owns managing the risks and opportunities associated with the sustainability challenges they face? And the rating does so objectively and robustly, leveraging fund holdings data, calculating portfolio scores, and comparing funds in a uniform, reliable way.

Jon Hale, PhD, CFA®, is director of Sustainable Investing Research at Morningstar Research Services, LLC. He earned a BA from the University of Oklahoma and a PhD in political science from Indiana University. Contact him at jon.hale@morningstar.com.

ENDNOTES

CONTINUING EDUCATION
To take the CE quiz online, www.investmentsandwealth.org/IWMquiz