Morningstar Sustainability Rating
Methodology

Morningstar Research
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Contents

Executive Summary
In 2016, Morningstar released the Morningstar Sustainability Rating to help investors use environmental, social, and governance, or ESG, information to evaluate portfolios. The rating provided a reliable, objective way to evaluate how portfolios are meeting environmental, social, and corporate governance challenges based on underlying company ESG Ratings from Sustainalytics.

In 2018, Sustainalytics launched a new company-level rating, the ESG Risk Rating, that measures the degree to which a company's economic value may be at risk driven by ESG issues.

In late 2019, Morningstar will enhance the current Morningstar Sustainability Rating methodology by replacing Sustainalytics' company ESG Rating with its ESG Risk Rating. We will also introduce buffers between ratings increments to increase overall stability and establish rules for handling ratings of portfolios with extremely high overall ESG risk.

Introduction
The Morningstar Sustainability Rating is a measure of the financially material environmental, social, and governance, or ESG, risks in a portfolio relative to a portfolio's peer group. The rating is an historical holdings-based calculation using the company-level ESG Risk Rating from Sustainalytics, a leading provider of ESG research. It is calculated for managed products and indexes globally using Morningstar's portfolio holdings database.

The Morningstar Sustainability Rating is the result of a three-step process. First, we calculate the Morningstar Portfolio Sustainability Score for every portfolio reported within the trailing 12 months. Second, we use these scores to calculate a portfolio's Morningstar Historical Portfolio Sustainability Score. Third, we assign a Morningstar Sustainability Rating for a portfolio based on its Morningstar Historical Portfolio Sustainability Score relative to its Morningstar Global Category.

Additionally, we apply ratings buffers to increase the rating's stability, and we make ratings adjustments for portfolios with extreme Morningstar Historical Portfolio Sustainability Scores. The calculations for each step, the buffer rules, and the rules for adjustments are detailed below.

Morningstar Portfolio Sustainability Score

The Morningstar Portfolio Sustainability Score is an asset-weighted average of Sustainalytics' company-level ESG Risk Rating:

$$PortfolioSustainability = \sum_{x=1}^{n} ESGRisk \times Weightsadj$$

The Sustainalytics' company-level ESG Risk Rating measures the degree to which a company's economic value may be at risk driven by ESG issues. To be considered material to the risk rating, an ESG issue must have a potentially substantial impact on the economic value of a company and therefore on the risk/return profile of an investment in the company. The ESG issues that are material vary across industry groups and companies.

The ESG Risk Rating evaluates the remaining unmanaged ESG risk exposure of a company after taking into account its management of such risks. The rating is rendered on a 0-100 scale. Lower is better, with 0 indicating that a company has no unmanaged ESG risk and 100 indicating the highest level of ESG risk. In practice, most scores range from 0 to 50, assigned to five risk categories:

- 0-9.99: Negligible ESG Risk
- 10-19.99: Low ESG Risk
- 20-29.99: Medium ESG Risk
- 30-39.99: High ESG Risk
- 40+: Severe ESG Risk

ESG Risk Ratings are aggregated to a Portfolio Sustainability Score using an asset-weighted average of all covered securities. Covered securities include equity and fixed-income securities issued by companies that have ESG Risk Ratings. Securities issued by companies that do not have ESG Risk Ratings, as well as short positions, options, and derivatives typically issued by third-party financial firms, are not covered.

To receive a Portfolio Sustainability Score, at least 67% of a portfolio's assets under management must have a company ESG Risk Rating. The percentage of assets under management of the covered securities is rescaled to 100% before calculating the Portfolio Sustainability Score.

Morningstar Historical Portfolio Sustainability Score

The Morningstar Historical Portfolio Sustainability Score is a weighted average of the trailing 12 months of Morningstar Portfolio Sustainability Scores. Historical portfolio scores are not equal-weighted; rather, more-recent portfolios are weighted more heavily than more-distant portfolios:

$$Historical\ Portfolio\ Sustainability\ Score = \frac{\sum_{i=0}^{11}(12-i) \times Portfolio\_Sustainability_i}{\sum_{i=0}^{11} i + 1}$$

Where:

$$i = number\ of\ months\ from\ present$$

Combining the trailing 12 months of portfolio scores adds consistency while still reflecting portfolio managers' current decisions by weighting the most recent portfolio scores more heavily.

Morningstar Sustainability Rating

Based on their Morningstar Historical Portfolio Sustainability Score, portfolios are assigned absolute category ranks and percent ranks within their Morningstar Global Categories, provided that a category has at least 30 portfolios with Historical Portfolio Sustainability Scores.

A portfolio's Morningstar Sustainability Rating is its normally distributed ordinal score and descriptive rank relative to the portfolio's global category. Exhibit 1 summarizes the rating distribution.

Exhibit 1 Morningstar Sustainability Rating

Distribution	Rating Icon
Best 10% (Lowest Risk)	
Next 22.5%	
Next 35%	
Next 22.5%	
Worst 10% (Highest Risk)	

Source: Morningstar, Inc.

Buffer Rules

To increase the rating stability for portfolios near the distribution's breakpoints, we use a buffering system. Between each rating, the buffer is 1%. A portfolio near a rating threshold must move past the buffer before its rating changes. For example, a portfolio below the 90.0 percentile will need to move past the 89.0 percentile before the rating upgrades from Low (1 globe) to Below Average (2 globes). Similarly, a portfolio above the 10.0 percentile will need to move below the 11.0 percentile before being downgraded from High (5 globes) to Above Average (4 globes).

Historical Portfolio Scores of 30 or Higher

Because the distribution rules are applied within global categories, portfolios exposed to high ESG Risk could still receive positive Sustainability Ratings. For example, portfolios within the energy category exhibit high ESG Risk levels. Therefore, as a final ratings check, we impose requirements on the level of ESG Risk. Portfolios that have Historical Portfolio Sustainability Scores of 30 or higher are considered to have high levels of overall ESG risk and therefore can receive no better than an Average (3-globe) Morningstar Sustainability Rating, regardless of how well they rank within their Morningstar Global Category. The threshold rules are listed below:

- Portfolios with Historical Portfolio Sustainability Scores ranging from 30 to 34.99 can receive no better than an Average (3-globe) Morningstar Sustainability Rating.
- Portfolios with Historical Portfolio Sustainability Scores ranging from 35 to 39.99 can receive no better than a Below Average (2-globe) Morningstar Sustainability Rating.
- Portfolios with Historical Portfolio Sustainability Scores of 40 or higher receive a Low (1-globe) Morningstar Sustainability Rating.

Frequency of Calculations

The Morningstar Portfolio Sustainability Score is updated once a month with the most recent portfolio. The Morningstar Sustainability Rating and ranks will be issued monthly based on the most recent company data from Sustainalytics. Portfolios will receive a rating one month and six business days after their reported as-of date based on the most recent portfolio. The fund will be ranked relative to peers on the same one-month and six-business-day lag. If a portfolio has not yet been received for the rating date, the most recent portfolio available will be used for score and ranking, provided the portfolio is less than 276 days old.

References

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Appendix A: Pillar Scores

Portfolio E, S, and G Pillar Scores

Sustainalytics' company-level ESG scores can be disaggregated into three pillar scores--environmental, social, and governance. Morningstar calculates portfolio-level scores for each pillar, using the same method for normalizing scores that is used for the Portfolio ESG Score, described above. Scores are aggregated by using the peer group weighted contribution of the pillar, as follows:

$$Portfolio\ Pillar = \sum_{x=1}^{n} Pillar\ Normalized\ \times Weightadj\ \times PeerPillarWeight$$

This is necessary because the contribution of each pillar to a company's overall ESG Score may differ by peer group. Using the peer group-weighted contribution more accurately reflects the overall contribution of each pillar to a company's overall ESG Score.

Morningstar Global Category Rank, Category Percent Rank, and Rank Description

The Portfolio ESG Score and Portfolio Controversy Score will be assigned absolute category ranks, percent ranks, and normally distributed ordinal scores and descriptive ranks within their Morningstar Global Category, as follows:

Exhibit 4 Portfolio ESG Scores

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

Source: Morningstar, Inc.

Exhibit 4 Portfolio Controversy Scores

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

Source: Morningstar, Inc.

About Morningstar Sustainability Research

Morningstar Sustainability Research is dedicated to helping investors reflect their beliefs in their portfolios and evaluate the impact of their investments.

For More Information

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