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# Morningstar® ESG Risk Rating Assessment for Companies

## Frequently Asked Questions

### Morningstar Research

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### Executive Summary

In 2016 Morningstar and Sustainalytics partnered to provide the first-to-market Morningstar Sustainability Rating for funds, known to many as "the Globes," to provide a mechanism for fund investors to evaluate environmental, social, and governance, or ESG, factors across the global universe of managed products. Together as one company, Morningstar and Sustainalytics are introducing the ESG Risk Rating Assessment for companies to offer a way for the whole market to speak a common language about ESG risk—across all audiences, workflows, and investment vehicles. By providing consistent Globes iconography to represent ESG Risk, Morningstar and Sustainalytics aim to strengthen the connection between the company and fund-level ESG ratings, which use Sustainalytics' ESG Risk Rating as the primary input, and provide a simple way to convey ESG risk as a standard part of the investor toolkit.

The ESG Risk Rating Assessment for companies is a visual representation of the Sustainalytics ESG Risk Classification that will allow investors to easily identify securities with low ESG risk. Sustainalytics' flagship ESG Risk Ratings measure the degree to which a company's economic value is at risk is driven by financially material ESG factors. Morningstar will display this information broadly across the key places where investors look for our research intellectual property and independent assessments to evaluate securities, because we believe ESG factors are an important consideration for long-term investors.

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### Frequently Asked Questions

#### What's the philosophy behind the Morningstar ESG Risk Rating Assessment for companies?

Morningstar and Sustainalytics launched the ESG Risk Rating Assessment to define a single market standard allowing for integration of ESG Risk insights across the investing ecosystem. With the introduction of consistent Globes iconography, Morningstar aims to strengthen the connection between the company and fund-level ESG ratings, which use Sustainalytics' ESG Risk Rating as the primary input. This globe visualization will offer a consistent and coherent signal for investors in managed products and equities to understand ESG risk.

Morningstar gained company-level ESG risk rating after our full acquisition of Sustainalytics, and now is one of only a few research providers to provide both fund-level and company-level ESG ratings in one place. While the company-level scores and the fund-level scores are not in perfect alignment (the company-level scores take a more absolute view, while the fund-level is relative to peer group), we're providing a similar signal that, taken together, delivers a quick and digestible perspective on ESG risk.

The Morningstar ESG Risk Rating Assessments are driven by Sustainalytics' ESG Risk Ratings used by institutional asset owners and asset managers.

**How is the rating created for a company?**

The company-level ESG Risk Rating Assessments are based on Sustainalytics' ESG Risk Rating and corresponding ESG Risk Classification. The Sustainalytics company-level ESG Risk Ratings measure the degree to which a company's economic value may be at risk as a result of financially material ESG factors. The central building blocks of Sustainalytics' ESG Risk Ratings are Material ESG Issues, or MEIs. For Sustainalytics, an ESG issue is material if it is likely to have a significant effect on the enterprise value of a typical company within a subindustry, and if the presence or absence of an MEI in financial reporting is likely to influence the decisions made by a reasonable investor. The ESG Risk Score is based on a two-dimensional materiality framework that measures a company's exposure to subindustry-specific material risks and how well a company is managing those risks. The overall scoring output ranges from 0 (no ESG risk) to an open-ended maximum, though, for 95% of cases, the unmanaged ESG Risk score is below 50.

ESG Risk Scores are categorized across five risk levels: negligible, low, medium, high, and severe. These classifications are used in determining the ESG Risk Rating Assessment's 1- to 5-Globes output.

**What determines whether a company gets 1, 2, 3, 4, or 5 Globes Assessment?**

ESG Risk Rating Score	ESG Risk Rating Classification	ESG Risk Rating Assessment
0 - 9.99	Negligible	
10 - 19.99	Low	
20 - 29.99	Medium	
30 - 39.99	High	
>=40	Severe	

**What datapoints should be used alongside the ESG Risk Rating Assessment for companies?**

ESG Risk Score and ESG Risk Score Classification (Category).

**How are Morningstar's ESG Risk Rating Assessment and Sustainalytics' ESG Risk Rating different?**

They are the same in what they signal to investors, financially material ESG risk. They differ only in their visual expression. The Globe iconography is consistent with Morningstar's unique ability to leverage intuitive design to simplify complex data, while for years, institutional asset owners and asset managers have embedded Sustainalytics' numeric rating and severity scale into their workflows.

**How often do ratings change? What causes them to change?**

Sustainalytics' analysts typically perform a thorough qualitative assessment and update the ESG Risk Ratings for companies on an annual basis. However, changes to ratings can occur if a company becomes subject to a serious controversial event (for example, human rights abuses, ethics violations, and so on). Morningstar products update Sustainalytics' company-level ESG data on a monthly cycle, capturing any ratings changes from the previous month. The ESG Risk Rating Assessment will follow the same monthly update cadence for ESG Risk Score and related information available to Morningstar users today.

**How does the methodology for the ESG Risk Rating Assessment for companies differ from the methodology for the Sustainability Rating for funds?**

The ESG Risk Rating Assessment for companies is not the same as the Morningstar Sustainability Rating for funds. The Morningstar ESG Risk Rating Assessment for companies is based entirely on Sustainalytics' ESG Risk Rating, which is an absolute assessment of a company's material risk exposure based on its subindustry and specific business model, and its management of such risk. Whereas, the Morningstar Sustainability Rating for funds is a measure of how well the holdings in a portfolio are managing their ESG Risk, relative to other funds in their global Morningstar Global Category™ peer group. So, while the fund-level ratings use the ESG Risk Scores as an input, the methodologies are not the same.

**Why is the fund Globe Rating methodology relatively ranked, and the company-level methodology an absolute?**

The Sustainability Rating for funds is designed to assess how much financially material ESG risk is embedded in investors' portfolios, across all industries represented in the holdings.

An absolute rating at the company level enables investors to make meaningful comparisons between companies across different industries. At the portfolio level, this helps investors to understand and compare the impact of their portfolios' industry ESG risk, acknowledging that some industries simply have more ESG risk than others.

The category classifications were introduced to help investors make meaningful comparisons between mutual funds by breaking portfolios into peer groups based on their holdings. The categories help investors identify the top-performing funds, assess potential risk, and build well-diversified portfolios. So, as ESG information has become more readily available and comparable across companies, it is logical we would apply the same system to help investors evaluate ESG risks in their portfolios as well.

**Will my fund with a 5 Globe Sustainability Rating have all underlying 5 Globe ESG Risk Rating Assessments on the company level?**

No. The methodology applied to evaluate the ESG risk of a company is different than that of a fund because investing in individual securities is inherently different than managed products. This is similar to our Morningstar Ratings for stocks and funds, which look at performance. The fund Sustainability Rating methodology is relative compared to the fund's category peer group, while the ESG Risk Rating Assessment for companies is an absolute metric. Though a fund may hold mostly low-ESG-risk companies, or those with 4 Globes, it may fall in a Global Category peer group with a low ESG risk

average overall. This means it may have a "higher" ESG risk score relative to the low-risk peer group it is being compared with, resulting in it receiving a low fund Sustainability Rating or 1 Globe.

Though rare, the opposite scenario may also exist. A fund may receive a Sustainability Rating of 5 Globes despite holding primarily medium- and high-ESG-risk companies because the fund's Global Category peer group has a high-ESG-risk average, positioning this fund in the top percentile. These scenarios are more limited, however, because the fund rating methodology has hard limits for high-ESG-risk portfolios. This is described further in the Sustainability Ratings methodology (link here: <https://www.morningstar.com/content/dam/marketing/shared/Company/Trends/Sustainability/Detail/Documents/SustainabilityRatingMethodology2019.pdf>)

#### **Is the ESG Risk Rating Assessment for a company relative to the company's sector or industry?**

Although the determination of material ESG issues is done at the sub-industry level, the company ESG Risk Rating Assessments themselves are an absolute metric based upon ESG Risk Score.

#### **Will there be companies whose ESG Risk Rating Assessments contradict what an investor might expect?**

The Assessments are based on Sustainalytics' ESG Risk Ratings, which measure a company's absolute risk. This might be different from other ratings that compare companies only with their peer groups. Specifically, the ESG Risk Ratings measure the degree to which a company's enterprise value is at risk driven by financially material ESG factors or, more technically speaking, the magnitude of a company's unmanaged ESG risk. In so doing, two dimensions are defined—exposure and management—which jointly support an assessment of how much unmanaged ESG risk is inherent in the company.

A tobacco company, such as Altria, can be exposed to high risk on specific issues like E&S Impact of Products and Services, but have lower exposure and good management of other MEIs, such as Corporate Governance and Human Capital. The combination of its total unmanaged ESG risk for all these issues may result in medium overall ESG risk, or 3 Globes, while the reverse may be true for a company like Tesla. In the case of Tesla, the company has low exposure to Carbon – Products & Services, but higher-than-average exposure combined with weaker management of other MEIs, such as Product Governance (think of its history with quality issues) and Corporate Governance.

#### **How many companies will receive an ESG Risk Rating Assessment?**

Sustainalytics' research universe covers roughly 13,000 global companies at the time of publication. ■■

## About Morningstar Sustainability

Morningstar's Sustainability Solutions help financial professionals make sense of the sustainable investing landscape with differentiated data, research, and analytics for a growing number of applications.

### For More Information

<https://www.morningstar.com/company/global-contacts>



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