We sat down with Jon Hale, Morningstar’s director of sustainability research; and Matthew Gries, director of new product development for Morningstar Indexes, to learn more about the Morningstar Sustainability Indexes family.
Jon, what prompted Morningstar to get into the sustainable investing discussion?

Morningstar goes where investors go. We’ve followed the socially responsible investing industry for about two decades—I was an analyst at Domini early on and I covered SRI funds at Morningstar for years. But now SRI has evolved to incorporate sustainability, with a focus on environmental-, social-, governance-based issues that companies have to deal with today. This ESG investing is different in scale and orientation. According to the 2014 Global Sustainable Investment Review, published by the Global Sustainable Investment Alliance, global assets invested with a sustainable mandate reached $21.4 trillion in 2014, a 61% increase in two years. Morningstar tracks SRI assets globally, too, and our data indicates that in both the open-end mutual fund and exchange-traded products universes, sustainability AUM is growing much faster than the rest of the market. For example, in the US, AUM in exchange-traded products grew 66% between May 2012 and 2016; AUM in sustainability or SRI-focused ETPs ballooned by 88% in that time. Similarly, in the open-end universe, AUM in sustainability products grew by 47% versus 29% for the rest of the universe.

And I think it has to do with a convergence of several factors. First, the relative accessibility of information around the globe means that we’ve all got a better sense of the corporate choices that are shaping our world—anyone with a smartphone received minute-by-minute updates on scandals like the BP oil spill or Volkswagen’s emissions-evading technology. Then, there’s a growing sense that corporate profits can’t come at the expense of society or the environment or workers, especially over the long term—that’s a very strong narrative today. Finally, emerging investors—especially millennials and women—see these factors as important. That matters to asset managers and advisors. So I see these trends—information velocity and freedom, an increasingly empowered investor base, and demographics—as drivers for a lot of this.
So sustainable investing isn’t just about values alignment and impact investing?

Jon: That’s an important distinction to make. At Morningstar, we tend to say that sustainable investing is values-based, but it’s also value-driven and impact oriented. Originally, socially responsible investing was more about investors trying to align their investments with their values by excluding companies from investment mandates. Sustainable investing now is more about considering relevant non-financial factors in the search for alpha. There’s a growing body of research that demonstrates that considering sustainability factors doesn’t negatively impact returns. In fact, companies that adhere to sustainable business practices may outperform their peers over the long haul.

Emerging investors are interested in making a difference with their investments. I think there’s an acknowledgment that environmental, social, and governance factors pose opportunities and risks for companies, and how companies contend with them says something about their strategy.
How has Morningstar approached sustainable investing?

Jon: We saw that investors focused on sustainability didn’t have a reliable set of analytical tools when it came to evaluating funds.

Advisors, investors, and asset managers need to be able to evaluate funds on sustainability criteria. Our initial efforts have been directed at helping investors assess their current investments. So earlier in 2016, we launched the Morningstar Sustainability Rating for funds, which measures how well the companies in a fund portfolio are managing their ESG risks and opportunities. It’s a one to five globe system, assessing funds relative to their Morningstar category. We base the ratings on research from Sustainalytics, a leading provider of company-level ESG research. A fund’s Sustainability Rating is an asset-weighted average of the company-level ESG scores with deductions made for holdings involved in controversial incidents.
**Why is Morningstar launching a Sustainability Index family now?**

**Jon:** The industry needs reliable, independent indexes for research purposes. Investors and advisors want transparent benchmarks emphasizing sustainable companies. It’s about defining the ESG characteristics of a portfolio and ultimately quantifying the financial impact of those factors. And with the growth in passive investing and portfolios anchored in exchange-traded products, there’s clearly appetite for more on the ESG index side.

**Matt:** We also found that there’s a need in the market for more investable benchmarks to serve as the foundation for ESG products. We see a need in the market for more ESG building blocks that allow investors to construct a robust strategic asset allocation. There’s also great potential to marry ESG with different investment factors like dividends or value. There’s no reason that ESG investors shouldn’t be able to also access sources of investment return in a low-cost, low-turnover, transparent, and systematic format.
How did Morningstar choose an approach to building a sustainable index family?

Jon: Our indexes team has a strong sense of how individuals are going to view the perceived opportunity cost of committing assets to sustainability indexes. So they’ve worked to create a parent index family that sets the standard for sustainability without veering too markedly from the risk and return profile of the broad market.

Matt: I think we recognize that investors often have a fairly specific asset allocation strategy in place. And it’s probably in place because they’re trying to achieve something, so they can’t really afford to deviate from that. A benchmark that delivers a radically different risk/return profile just isn’t realistic for them.

Our Indexes team is able to draw on Morningstar’s experience serving more than a million individual investors and over 250,000 advisors. So we had a pretty good sense of what kind of performance and risk profile investors are seeking when we built the base Sustainability Indexes family.

Meanwhile, we work closely with asset managers to build indexes used for investable products. So over the years, we’ve developed a sense of what constitutes reliable building blocks for product creation.
How are these indexes constructed? Is there a difference between the Morningstar Sustainability Rating and the indexes?

Matt: Our process begins with accessing Morningstar’s universe of fundamental research. We have a deep equity research bench—we cover 1,500 companies with 100 analysts worldwide. And Sustainalytics, like us, considers both qualitative and quantitative inputs in the security-level research we get from them. They assess 60-80 environmental, social, and governance indicators, producing a series of scores that Morningstar uses for ratings and for indexes. The research Sustainalytics offers was a great foundation for us on the index side. So our indexes are very much aligned with the Morningstar Sustainability Rating.
The company ESG score is the aggregate of all the factors that Sustainalytics examines and is scored between 0 and 100. There’s also a deduction for controversial incidents—things like ethics violations or environmental problems. We select the highest-scoring companies in each industry, sector and region until we reach 50% of market capitalization. We also limit deviation from the market benchmark weightings at the sector and regional level. For example, our sustainability indexes will not exhibit a large underweighting to utilities, or overweighting in Europe relative to a non-ESG counterpart.

When we design benchmarks, we adhere to best practices of index construction. Our indexes are largely reflective of an investor’s complete opportunity set in the market or market segment they’re designed to represent. They are powered by accurate and complete data, have clearly published rules, and exhibit low turnover and transaction costs.
Can you talk more about the ESG selection process for the index?

**Matt:** An example is probably the best way to tell the story. If you consider the U.S. technology sector, Microsoft makes it into our ESG index family, while Apple is excluded right now. Microsoft scores well relative to other software companies, especially on the environmental and governance factors. Microsoft is a leader when it comes to reducing its carbon footprint. It takes data privacy and security seriously. Its board of directors is strong. Apple, by contrast, tallies average scores on environmental and governance factors and is an underperformer on the social side. The issues relate to how Apple deals with some of its labor and supply chain issues.

How does the Controversy Score impact index membership?

**Matt:** The controversy component is important because it gauges a company’s actions and not just its words. Simply put, companies experiencing serious controversies at the time that index membership is reset are not included. Two recent examples from 2016 would be Target and Johnson & Johnson—Target due to legal and reputational fallout from its customer data breach and J&J as a result of serious product safety-related incidents.
Does intentionality matter? In other words, how does intentionality affect the inclusion of industries in the index?

**Jon:** When it comes to the Morningstar Sustainability Ratings, we evaluate all funds on a level playing field, regardless of their mandate. Some “socially conscious” funds receive high Sustainability Ratings, others less so. It’s not about what you say, it’s about what you do. A fund might have “value” in its name, but that doesn’t mean anything. That fund could be in the growth category, because we classify based on holdings, not name or objective.

**Matt:** We think this is something that the financial services industry struggles with. As an index provider, do we exclude certain companies categorically? Do we confine ourselves to companies that have already absorbed and implemented sustainability in their business models? Or should standards be applied more broadly?

We are taking a best-in-class approach for our broad ESG benchmark series. A company might be in the oil business, with all the accompanying environmental stresses, but if it’s got a better score than all the other oil companies, it will find its way into the index. We did ask ourselves a question about the nature of certain products, though: If used as directed, is the impact inherently harmful? So we didn’t screen out alcohol. Used as directed, alcohol doesn’t kill. But when it came to certain other products, we decided to leave them out of the index. So you simply won’t find manufacturers of cluster munitions or biological weapons.
How do Morningstar’s efforts on the ESG index side align with what’s going on in the industry; what’s different?

**Jon:** There are ESG indexes out there from a variety of providers, but there’s room for options that emphasize positive ESG selection and remain flexible and broad enough to serve as portfolio building blocks. We anticipate growth in diversified sustainable investment ETPs because of the ever-expanding interest in passive investing. I think we’ll see a widespread development of strategic beta and growth in demand for sustainable investment from both institutions and retail investors.

At both the portfolio level and individual security level, the market is in need of standards. And investors are looking for a research-driven approach that is consistent and comprehensive when it comes to environmental-, social-, and governance-based investing. Morningstar, through its Sustainability Rating for funds and Sustainable Indexes family, is providing just that.
Learn more about Morningstar’s sustainability efforts at

www.morningstar.com/company/sustainability

Contact us to learn more about the Morningstar Sustainability Indexes family: indexes@morningstar.com or visit: indexes.morningstar.com.

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