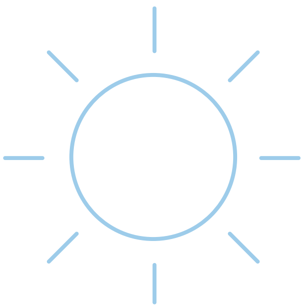
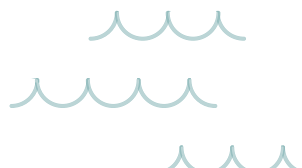
# The Morningstar Sustainable Investing Handbook





Dear Investor,

I founded Morningstar in 1984 because I wanted to make high-quality investment information available to everyday investors to help inform their decisions. As investor needs have evolved over the years, so has our research.

Sustainable investing is no longer a niche activity. New generations of investors around the world are looking for ways to learn whether the investments they own reflect the best sustainability practices, because sustainability aligns with their personal values or simply because they believe it leads to better investment outcomes. That's why we're excited to announce the Morningstar Sustainability Rating for funds, as well as expanded sustainability research, data, and analytics. We think this initiative represents the next frontier of information investors need.

Our ratings measure how well the companies in a portfolio are managing their environmental, social, and governance (ESG) risks and opportunities and provide a basis for comparison across funds. They give investors a new lens to analyze any fund, regardless of whether it has a specific sustainability or ESG mandate. Asset managers, consultants, financial advisors, and individuals can include our ratings in their investment research process to analyze funds they own or are interested in.

So keep an eye out for our new Sustainability Ratings. Our goal is to help investors of all types make better-informed decisions and invest in ways that are meaningful to them.

Best,

**Joe Mansueto**
**Chairman and CEO**
**Morningstar**

## The Emergence of Sustainable Investing

### Sustainable investing is a long-term approach that incorporates environmental, social, and governance (ESG) factors into the investment process.

Interest in sustainable investing is on the rise, as many institutions and individuals seek to express their broad concerns about sustainability issues through their investments, just as they do through their purchases and in the workplace. According to the 2014 Nielsen Global Survey of Corporate Social Responsibility, more than half of consumers surveyed globally said they would be willing to pay more for products and services from companies committed to positive social and environmental impact. Two thirds said they would prefer to work for a socially responsible company. When it comes to investing, a recent Morgan Stanley survey found 71% of respondents indicated they were interested in sustainable investing. Growing interest in sustainable investing can be seen in increased assets under management in sustainable investment portfolios and in the number of asset managers globally that have signed the United Nations-backed Principles for Responsible Investment (PRI). Interest in sustainable investing is especially high among women and younger investors, two groups rapidly becoming influential investment decision-makers.

From a values-based perspective, the thesis behind sustainable investing is that directing capital toward companies that are dealing effectively with sustainability issues will enhance the transition to a more sustainable global economy. By doing so, investors concerned with sustainability may also achieve good performance on their investments because many companies that are effectively addressing the ESG issues facing their businesses tend to be promising long-term holdings. As the ability to analyze ESG issues has become more sophisticated, the mainstream investing world has taken notice. Many traditional investors are recognizing the material relevance of ESG factors and are now including them in their investment process, resulting in a more-complete picture of an investment.

### What's in a name?

Many investors are familiar with the term socially responsible investing (SRI), which is still used today and often shortened to just responsible investing. SRI is a values-based investment process that primarily uses exclusionary screening to weed out exposure to certain types of products or industries.

SRI is customizable, at least for large investors who can list products or industries they want excluded from their portfolios, and for asset managers who build portfolios that avoid those areas. A number of mutual funds use some of the most common exclusionary screens to offer a similar approach to individual investors as well.

Over time, though, many SRI-oriented investors started getting more interested in issues such as the environment, workplace policies, product safety, and the global supply chain. Investors couldn't simply exclude these concerns from a portfolio without more extensive evaluation and analysis. These issues were frequently the topic of dialogue between responsibly minded investors and the companies they held.

Responsible investing evolved to include ESG issues, which led to the development of ESG analysis of companies. As a result, research firms like Sustainalytics—whose company-level ESG data underpins Morningstar's Sustainability Ratings—play an important role in analyzing companies across a wide spectrum of ESG issues. Increasingly, corporate issuers are providing sustainability reporting, making it easier for research firms and investors to evaluate the ESG-related risks and opportunities associated with an investment in a company. That, along with a growing body of academic and professional research that points to the materiality of ESG factors, has more investors adopting responsible investment strategies.

Today, terms like "responsible investing," "sustainable investing," and "ESG" are used in similar or even interchangeable fashion. An even newer term is "impact investing," which refers to attempts to measure the positive environmental or social outcomes of a given investment.
At Morningstar, we prefer the term "sustainable investing" to best capture the essence of both its values-based orientation, as well as the view that it just makes sense to include ESG in a thorough investment analysis.

## The Morningstar Sustainability Rating™ for Funds

### A new lens for sustainability analysis

Given the widespread, growing interest in sustainable investing around the world, investors need better tools to help them determine whether the investments they own or are considering for their portfolio reflect best sustainability practices. That's why we've created the Morningstar Sustainability Rating™ for funds and sustainability scores based on ESG factors.

To date, ESG research has taken place largely at the company level and has been made available to asset managers and large institutional investors to help them incorporate ESG issues into their investment process. Investors wanting to evaluate funds using these same sustainability factors, however, have had no easy way to do so. They can seek out funds with an intentional sustainability mandate, but ultimately must rely on the claims made by asset managers regarding their approach to sustainability. Morningstar's Sustainability Scores and Ratings will provide investors with a new set of tools to view and analyze investment portfolios through an ESG lens.

### Morningstar's Portfolio Sustainability Score and Sustainability Rating: A two-step process

Morningstar first calculates a fund's Portfolio Sustainability Score, which measures how well the companies it holds are managing their ESG risks and opportunities. We are basing the scores on research from Sustainalytics, a leading provider of company-level ESG research and ratings. Sustainalytics delivers company ESG scores along with assessments of companies' involvement in ESG-related controversies. Morningstar's Portfolio Sustainability Score is an asset-weighted average of the company ESG scores with deductions made for holdings involved in controversial incidents, or the Portfolio Controversy Score.

In the next step, we assign a Morningstar Sustainability Rating, which is the Portfolio Sustainability Score relative to Morningstar Category peers. We assign the ratings along a bell curve distribution to five groups—Low, Below Average, Average, Above Average, and High—and depict them with corresponding globe icons (Low=1 globe; High=5 globes).

The scores and ratings are not based on any absolute exclusions of products or industries. We are basing them on Sustainalytics' underlying research on how well companies manage their overall ESG issues relative to their industry peers. For a portfolio to receive a score, at least 50% of its assets must be in one of the more than 4,500 companies covered by Sustainalytics globally. Because Sustainalytics' ESG analytics apply at the company level, Morningstar can score equities and corporate debt found in portfolios. To receive a Morningstar Sustainability Rating, at least 10 funds in a Morningstar Category must also receive a Portfolio Sustainability Score.

## Using the Morningstar Sustainability Rating for funds

Our Sustainability Rating allows investors to assess how well the companies in a fund's portfolio are managing their ESG risks and opportunities. The rating will also allow investors to compare funds across categories and relative to benchmarks using specific ESG factors.

The ratings can serve as an initial screen for investors interested in sustainability and ESG factors. They are also a useful starting point for investors wanting to know more about a manager's investment process and how it relates to sustainable investing.

The ratings will help investors determine both the level of sustainability in their existing portfolios and allow them to set sustainability targets. Some investors, for example, may prefer only funds that have high ratings; others may wish to avoid funds with low ratings. Still others may wish to achieve an above-average rating across all funds in their portfolios.

It is important to note that the ratings are portfolio-based, not performance-based. They do not reflect a fund's performance on either an absolute or risk-adjusted basis, nor are they a qualitative Morningstar evaluation of a fund's merits. They should not be the sole basis for an investment decision.

## Frequently Asked Questions

### What is sustainable investing?

Sustainable investing is a long-term approach to investing that incorporates ESG considerations into the investment process.

### What is ESG?

ESG refers to environmental, social, and governance issues that sustainable investors, and increasingly, traditional investors, consider when making investment decisions.

**Examples of ESG Issues**

| *Environmental* | *Social* | *Governance* |
|---|---|---|
| Climate change and carbon emissions | Gender and diversity policies | Board composition |
| Air and water pollution | Human rights | Executive compensation |
| Energy efficiency | Labor standards | Audit committee structure |
| Waste management | Employee engagement | Bribery and corruption policies |
| Water scarcity | Customer satisfaction | Lobbying activities |
| Biodiversity and deforestation | Community relations | Political contributions |

Source: *Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals*, CFA Institute

### What about other terms like “socially responsible investing” and “impact investing”?

These terms are often used interchangeably with sustainable investing and ESG, but can also have slightly different meanings. Socially responsible investing (SRI) traditionally focused on exclusionary screening to ensure a portfolio reflected the values of an investor. As investors concerned about SRI became more interested in complex environmental and workplace issues, their portfolios increasingly came to include more holistic ESG evaluations of companies, often in addition to exclusionary screening. Impact investing refers to investments that attempt to deliver measurable social or environmental impacts alongside their financial returns.

### Why is Morningstar using the terms “sustainable investing” and “ESG”?

ESG has become the standard way to describe the general approach that sustainable/responsible/impact investors take with their portfolios. Sustainable investing is commonly used as an overarching term to describe the objective of ESG analysis, which is to evaluate how effectively companies are addressing sustainability issues.

## Is interest in sustainable investing really growing?

Investors are placing increasing importance on sustainability issues. In a 2015 survey, the Morgan Stanley Institute of Sustainable Investing found that 71% of individual investors are interested in sustainable investing. During 2015, the number of financial institutions that signed the United Nations-backed Principles for Responsible Investment (PRI) Initiative increased by 29%. As of January 2016, nearly 1,500 firms managing in excess of $59 trillion have joined this global network of investors working to promote responsible investing.

## Why are investors increasingly interested in integrating ESG factors into their investment decisions?

Some investors want to know they are investing in companies with strong sustainable practices and ethical policies. It's a way of aligning their investments with their values. Others see ESG as a set of factors often overlooked in traditional analysis that should be incorporated for a more complete assessment of an investment.

## How does sustainable investing fit with Morningstar's mission?

As part of our mission to create great products that help investors reach their financial goals, Morningstar has a long tradition of innovative research centered on good stewardship, lower costs, and more transparency for investors. Providing Sustainability Ratings and Scores based on ESG factors is a natural extension of our work.

## What is the Morningstar Sustainability Rating?

Morningstar is creating Sustainability Ratings for funds globally. The Morningstar Sustainability Rating will help investors assess how well the companies held in a fund are managing the ESG issues most relevant to their industries, and to compare funds with one another, across categories, and to benchmarks using ESG factors.

## Why is Morningstar launching Sustainability Ratings?

There is a growing level of investor interest in sustainable investing worldwide, but a lack of information and tools that investors can use to help evaluate investments on a sustainability basis, particularly at the portfolio level. We are giving investors a new way to determine how well the companies in a fund are managing ESG factors so more investors can put their money to work in ways that are meaningful to them.

## How does Morningstar calculate Sustainability Ratings?

Morningstar first calculates a fund's Portfolio Sustainability Score, which measures how well the companies it holds are managing their ESG risks and opportunities. We are basing the scores on research from Sustainalytics, a leading provider of company-level ESG research and ratings. Sustainalytics delivers company ESG scores along with assessments of companies' involvement in ESG-related controversies. Morningstar's Portfolio Sustainability Score is an asset-weighted average of the company ESG scores with deductions made for holdings involved in controversial incidents, or the Portfolio Controversy Score.

In the next step, we assign a Morningstar Sustainability Rating, which is the Portfolio Sustainability Score relative to Morningstar Category peers. We assign the ratings along a bell curve distribution to five groups—Low, Below Average, Average, Above Average, and High—and depict them with corresponding globe icons (Low=1 globe; High=5 globes).

Full details are available in our methodology document, found here: www.morningstar.com/company/sustainability

## Why is the Sustainability Rating relative to a fund's category?

Morningstar categories are widely used peer groups designed to provide investors with apples-to-apples comparisons of funds. The Morningstar Sustainability Rating tells investors how well the companies in a fund's portfolio are handling their ESG risks and opportunities relative to those companies held by other funds in the same category.

## Why would Morningstar score and rate funds that don't have a sustainable/responsible mandate?

Funds that have explicit sustainable or responsible investment mandates represent only about 2% of the fund universe. Many investors who are interested in sustainability own conventional funds. Based on our scores and ratings, some investors may discover that their funds are not doing well enough on a sustainability basis and will actively seek out "intentional" ESG funds. Others may find that the existing funds in their portfolios score in a range that is acceptable to them, particularly given the fund's overall quality and performance record. Still others may use the information to dig deeper into whether, and how, a manager is considering ESG issues in the investment process.

## How should investors use our Sustainability Ratings?

The Morningstar Sustainability Rating allows investors to assess how well the companies held by a fund are managing their ESG risks and opportunities. The rating will also allow investors to compare funds across categories and relative to benchmarks.

- **The ratings can serve as an initial screen for investors interested in sustainability and ESG.** They are a useful starting point for investors wanting to know more about a manager's investment process and how it relates to sustainable investing.
- **They will help investors determine the level of sustainability in their portfolios.** Some may prefer only funds that have high ratings; others may wish to avoid funds with low scores. Still others may wish to achieve an above-average score across all funds in their portfolios.
- **The ratings should not be the sole basis for an investment decision.** This is because they do not reflect a fund's performance on either an absolute or risk-adjusted basis, nor any qualitative Morningstar evaluation of a fund's merits.

## Are the Sustainability Ratings a positive or "buy" recommendation for funds?

Absolutely not. Our Sustainability Ratings only reflect information on the ESG performance of a fund's holdings. These ratings are not an evaluation of a fund's performance, on either an absolute or risk-adjusted basis, nor a qualitative evaluation of a fund's overall investment merit.

## Why did Morningstar choose to work with Sustainalytics?

Sustainalytics is an independent firm with a global reach, a reputation for transparent, insightful research, and great customer service. The firm employs 250 people in 14 countries, covering 4,500 companies with its comprehensive ESG ratings and more than 10,000 companies with its controversial incidents indicators. Its transparent ratings methodology is a quantitative indicator-driven approach using 60-80 performance indicators per company. Its ability to update controversial incident indicators in a timely fashion ensures the latest information is incorporated in our ratings.

# Key Definitions

## Portfolio ESG Score

The Portfolio ESG Score is an asset-weighted average of normalized company-level ESG Scores for the covered holdings in the portfolio. Company-level ESG Scores from Sustainalytics reflect companies' management systems, practices, policies, and other indicators related to environmental, social, and governance issues. Their company-level ESG scores use a 0-100 scale.

A high Portfolio ESG Score is better than a low score. At the portfolio level, high scores indicate that a fund has more of its assets invested in companies that score well according to the Sustainalytics ESG methodology.

## Portfolio Controversy Score

The Portfolio Controversy Score is the asset-weighted average level of the seriousness of the controversial incidents related to companies in a fund's portfolio. A low score is better than a high score, as it indicates the absence of controversies.

Company-level controversial incident indicators from Sustainalytics reflect the most severe ESG-related controversy in which a firm is involved, classified as Low, Moderate, Significant, High, and Severe.

## Portfolio Sustainability Score

The Portfolio Sustainability Score is the Portfolio ESG Score minus the Portfolio Controversy Score:

**Portfolio Sustainability Score = Portfolio ESG Score – Portfolio Controversy Score/5**

The resulting score is displayed as a number between 0 and 100. From a sustainability standpoint, a high score is better than a low score. A higher score indicates that a fund has, on average, more of its assets invested in companies that score well according to the Sustainalytics ESG methodology.

## Morningstar Sustainability Rating

Morningstar ranks all scored funds within a category by their Portfolio Sustainability Scores and divides them into five groups along a bell curve distribution. A fund's rating is depicted by one to five globes.

**Sustainability Scores: Groupings**

| *Percent Rank* | *Rating* | *Depiction* |
|---|---|---|
| Top 10% | High | 5 globes |
| Next 22.5% | Above Average | 4 globes |
| Next 35% | Average | 3 globes |
| Next 22.5% | Below Average | 2 globes |
| Bottom 10% | Low | 1 globe |

These are the first of many developments for our Sustainability Ratings and research. We'll make it easy for you to integrate our sustainability information with your investment research process.

## Stay informed about our latest research

Visit www.morningstar.com/company/sustainability
Email ESG@morningstar.com