Executive Summary

In 2016, Morningstar released the Morningstar Sustainability Rating for funds, along with the Sustainability Pillar Scores, to help investors assess how well the holdings in a portfolio are managing their environmental, social, and governance, or ESG, risks and opportunities relative to peers. In late 2019, Morningstar enhanced the Morningstar Sustainability Rating and Pillar Score methodologies by replacing Sustainalytics' company ESG Ratings with their new company ESG Risk Ratings, which measure the degree to which a company's economic value may be at risk driven by ESG issues.

In May 2021, Morningstar introduced several new datapoints to make it easier for investors to use the pillar scores. First, an additional pillar was introduced, the "Unallocated ESG Risk Score." With the addition of the Unallocated ESG Risk Score datapoint, the Environmental, Social, Governance, and Unallocated pillars sum to a portfolio's Sustainability Score. An additional datapoint, the Unallocated ESG Risk Global Category Average, was also introduced to complement the existing category average datapoints for the Environmental, Social, and Governance pillars.

Second, new datapoints were added to represent the percentage contribution of each of the four pillars to a portfolio's overall Sustainability Score. Previously, users would have had to compute these percentages themselves.

Introduction

The Morningstar Sustainability Rating is based on a portfolio's Historical Sustainability Score, calculated as a weighted 12-month average of the monthly Portfolio Sustainability Scores. The Portfolio Sustainability Score represents the asset-weighted average ESG risk of a fund's holdings. The Morningstar Portfolio Pillar Scores are a separate and complementary calculation to the Portfolio Sustainability Score. They provide a reliable, objective way to assess and understand the components of a portfolio's ESG risk through the traditional ESG thematic framework. Cross-portfolio analysis of ESG risk pillars and their contributions to the Portfolio Sustainability Score allows for comparison of the thematic risk drivers of different portfolios, as well as a deeper understanding of the ESG risk composition of individual funds. Like the Portfolio Sustainability Score, the pillar scores are calculated as an asset-weighted average of the corresponding company-level risk scores from Sustainalytics.
Sustainalytics’ Environmental, Social, and Governance Risk Scores

The company-level Environmental, Social, and Governance Risk Scores themselves do not explicitly contribute to the overall ESG Risk Rating for a given company. Rather, they are derived independently as linear combinations of the same company-specific material ESG issue, or MEI, risk scores that compose the company's ESG Risk Rating.

Sustainalytics considers a range of MEIs for each company, mapping each one to relevant ESG pillars. While these MEIs may have a pure environmental, social, or governance character, often they are hybrids. For example, a single issue may have both environmental and governance components. As such, the Environmental, Social, and Governance Risk Scores are linear combinations of company-specific MEIs' unmanaged risk scores. The scores are based on individual indicator weights within the different material ESG issues. These scores give users a sense to what degree environmental, social, or governance issues are contributing to the total unmanaged ESG risk score of a company. Figure 1 demonstrates how MEIs are mapped to relevant Environmental, Social, and Governance pillars.

Note that while a company’s Environmental, Social, and Governance Risk Scores sum to its overall ESG Risk Rating, Sustainalytics provides Environmental, Social, and Governance Risk Scores for a more limited number of companies than their ESG Risk Ratings. The Environmental, Social, and Governance Risk Scores provided by Sustainalytics are only available for companies to which Sustainalytics' so-called "comprehensive" research framework is applied. This is distinguished from the so-called "core" framework, which uses a more-focused set of indicators to arrive at ESG Risk assessments. The comprehensive universe comprises only about one third of the companies that form the overall universe covered by Sustainalytics and, hence, only about one third of the universe that serves as a basis for calculating the Morningstar Sustainability Scores. As a result, the overall Morningstar Sustainability Score cannot be fully disaggregated into Environmental, Social, and Governance Pillars. The remainder of the ESG Risk contributing to a portfolio's Sustainability Score is therefore represented by the Unallocated ESG Risk Pillar, representing the unmanaged ESG risk carried by companies in Sustainalytics' "core" framework, which have an ESG Risk Rating that is not disaggregated into Environmental, Social, and Governance scores.
Morningstar Sustainability Pillar Scores

The Morningstar Sustainability Pillar Scores provide a reliable, objective way to assess and understand the components of a portfolio’s ESG risk through the traditional ESG thematic framework. The scores are an asset-weighted calculation using the corresponding company-level risk scores. They are calculated for managed products and indexes globally using Morningstar’s portfolio holdings database.

While the pillar scores at the portfolio level are calculated independent of the portfolio Sustainability Score that drives the overall fund Sustainability (“globe”) rating, they act as a complementary dataset.

Portfolio Pillar Scores Calculation

The Portfolio Pillar Scores are calculated as an asset-weighted average of the corresponding company-level risk scores. To receive Portfolio Pillar Scores, the fund must be eligible to receive a Portfolio Sustainability Score. This means at least 67% of a portfolio’s eligible assets under management must have a company ESG Risk Rating. Portfolio coverage is calculated as follows:

**Exhibit 1**

\[
\text{Percent AUM Covered} = \frac{\sum_{i=1}^{n} \text{Eligible Holding Weight with Score}_i}{\sum_{i=1}^{n} \text{Eligible Holding Weight}_i}
\]

Eligible assets include long positions, excluding cash and synthetic holdings.

Prior to calculating the asset-weighted average risk for each pillar, covered holdings are rescaled to 100%.

**Exhibit 2**

\[
\text{Rescaled Holding Weight}_i = \frac{\text{Eligible Holding Weight with Score}_i}{\text{Percent of AUM Covered}}
\]

Portfolio-level scores for each pillar are as follows:

**Exhibit 3**

\[
\text{E/S/G Portfolio Pillar} = \sum_{i=1}^{n} \text{Pillar Score}_i \times \text{Rescaled Weight}_i
\]

The Portfolio’s Unallocated ESG Risk Score is an asset-weighted average of the company-level ESG Risk Score for companies whose scores are not further broken out into Environmental, Social, and Governance scores.
Exhibit 4

\[ \text{Unallocated ESG Portfolio Pillar} = \sum_{i=1}^{n} \text{ESG Risk Score}_i \times \text{RescaledWeight}_i \]

Percent of Sustainability Score Pillar Contributions

The Percent of Sustainability Score Pillar Contribution data points supplement the pillar score risk profile by providing measures of how each thematic pillar directly affects a portfolio’s Sustainability Score. The contribution data points reflect the amount of risk in the Portfolio Sustainability Score attributable to each of the four portfolio Pillar Scores, calculated as the percentage of risk of each pillar score relative to the portfolio’s Sustainability Score, as follows:

Exhibit 5

\[ \text{Percent Sustainability Score Pillar Contribution} = \frac{\text{PortfolioPillarScore}}{\text{PortfolioSustainabilityScore}} \times 100\% \]

Frequency of Calculations

The Morningstar Sustainability Pillar Scores are calculated at the same time as the Portfolio Sustainability Scores, on a monthly basis with a one-month and six-business-day lag. The scores will be issued using the most recent company data from Sustainalytics, which is reported on a monthly basis. 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 fewer than 276 days old. [1]

Methodology History

- **August 2016**: Original Sustainability Pillar Score launch
- **September 2019**: Changed underlying company data to E/S/G Risk Ratings
- **May 2021**: Added Unallocated ESG Pillar Score and Percent Sustainability Score Contribution data points
References

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