Integrating ESG Into Morningstar Equity Research: FAQs

How Does Morningstar Equity Research Currently Address ESG Considerations in the Research Process and Why Is a Change Necessary?
We currently address ESG considerations through the valuation model and company report on an as-needed basis based on materiality and probability for risks related to each material ESG issue. However, in order to be consistent across our coverage and best include the valuation impact of ESG risks in our star ratings, we plan to formally capture ESG risks across our entire coverage through the economic moat rating and uncertainty rating.

Our proposed change is necessary to more clearly and effectively implement the valuation impact of ESG in our ratings and more effectively communicate our views on ESG risks. As a part of this charge, analysts will discuss the valuation impact of ESG risks in the same part of every company report.

Why Is ESG Being Treated Differently Than Any Other Risk That Analysts Should Consider?
ESG is an emerging issue for investor focus and concern. Our changes largely focus on ensuring that ESG analysis is addressed in a consistent manner by all analysts globally. Our goal is to ensure a common language and valuation-based process to address ESG risks and to improve communication of our views.

How Will Morningstar Equity Research Address Cases of Dissonance Between the Sustainalytics ESG Risk Ratings and Morningstar’s Economic Moat Ratings and Uncertainty Ratings?
We view the Sustainalytics ESG risk analysis as an important input into our valuation-driven research process. Analysts will address perceived differences between Sustainalytics ESG risk ratings and Morningstar economic moat and uncertainty ratings by focusing on our valuation-driven approach.

Should an analyst come to a different conclusion on an ESG risk than Sustainalytics suggests, the analyst will address why material ESG issues identified by Sustainalytics are unlikely to have an impact on company valuation (for example, if costs can be passed on to end consumers). ESG risk will be a focus in the Risk and Uncertainty section of the company report, where analysts will address any perceived differences between Sustainalytics ratings and Morningstar ratings.

Sustainalytics Suggests Using the Discount Rate to Incorporate ESG Risk. Is Morningstar Equity Research Following This Guidance?
Our assumed discount rates are intended to capture systematic risks that are not diversifiable. For example, we typically increase our discount rate for firms and industries with higher cyclical risk relative to those with lower cyclical risk. We regard ESG risks as idiosyncratic, and, therefore, diversifiable. As a result, we view our uncertainty rating, which is intended to capture idiosyncratic risks, as the best place to capture ESG risks.

Does Morningstar’s Equity Research Methodology Suggest That Investors Are Compensated for ESG Risk in the Form of Higher Expected Returns?
Ultimately, ESG risk is diversifiable, and as a result, we wouldn’t expect higher returns. However, it may require an additional margin of safety given the additional uncertainty surrounding the valuation impact for material ESG issues.

Does Morningstar Equity Research Believe ESG Risks Are Mainly to the Downside? If So, Why Are ESG Risks Captured in the Uncertainty Rating, Which Is Intended to Capture Roughly Equivalent Upside and Downside Risks?
We believe ESG risks skew to the downside. That's because many ESG risks are associated with the economic externalities that firms impose on society. Once society decides that it is no longer willing to bear these costs, it passes those costs along to the company, whether in the form of policy (for example, regulation, taxation) or changing consumer behavior through policies such as subsidies.
Higher uncertainty ratings reflect relatively lower confidence around our fair value estimates due to a number of factors. Analysts are asked to consider many risks, which include a company's cyclical relative to the economy, product concentration, pricing power, financial leverage, and other company-specific considerations. Even if ESG tends to manifest mainly on the downside, a higher uncertainty rating reflects the challenge of appropriately measuring the magnitude of the valuation impact. As such we've added ESG considerations to the scope of our uncertainty rating.

Many companies will have asymmetric upside and downside due to myriad factors, even without incorporating ESG risks, but our uncertainty ratings attempt to harmonize and standardize these into actionable margins of safety to drive our star ratings.

**Would Morningstar Equity Research Consider Upgrading a Firm's Economic Moat Rating Because of Positive ESG Attributes?**

We are not likely to upgrade a company's economic moat solely because of positive ESG attributes. For an economic moat to be present, the firm must have a sustainable competitive advantage. ESG factors would need to be attributable to one of our five moat sources. While positive ESG factors may, at times, provide a temporary competitive advantage, these are likely to be replicated among competitors and competed away over time.

**How Does Morningstar Equity Research View Corporate Governance Risks?**

Our updated capital allocation rating centers on the key areas where Morningstar strives to assess management efficacy; namely, balance sheet, investment, and shareholder distributions. Corporate governance factors are considered in the capital allocation framework if they meaningfully influence our assessment of balance sheet, investment, and shareholder distributions. If not, our attention focuses on the factors we think are likely to be material.

**Over What Time Frame Will the Changes Take Place?**

The new methodology will become effective from Dec. 9, 2020. The assessments and ratings will progressively be incorporated into our research as Morningstar analysts update the company reports for their respective companies. Any company reports dated prior to Dec. 9 will be under the prior framework.
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