Summary

In 2016, Morningstar released the Morningstar Sustainability Rating to help investors use environmental, social, and governance, or ESG, information to evaluate portfolios. The rating provided a reliable, objective way to evaluate how portfolios are meeting ESG challenges based on underlying company ESG Ratings from Sustainalytics.

In 2018, Sustainalytics launched a new company-level rating, the ESG Risk Rating, that measures the degree to which a company's economic value may be at risk driven by ESG issues.

In late 2019, Morningstar will enhance the current Morningstar Sustainability Rating methodology by replacing Sustainalytics' company ESG Rating with its ESG Risk Rating. We will also introduce buffers between ratings increments to increase overall stability and establish rules for handling ratings of portfolios with extremely high overall ESG risk.

Background Questions

What is this methodology change about?
Sustainalytics' company-level ESG analysis underpins the fund-level Morningstar Sustainability Rating. Since the launch of the Morningstar Sustainability Rating, Sustainalytics' company-level analysis of ESG factors has continued to evolve, and, in October 2018, Sustainalytics introduced its new ESG Risk Rating.

Morningstar is now incorporating the ESG Risk Rating as the basis for our fund-level Morningstar Sustainability Rating. The ESG Risk Rating is an indicator of a company's material ESG risks measured on the same scale across all economic sectors. The fund-level Sustainability Rating will evaluate how much ESG risk is embedded in a portfolio relative to a fund's Morningstar peer group.

When does the new methodology take effect?
Morningstar Sustainability Ratings calculated after Oct. 31, 2019, will reflect the new methodology. The first calculation will take place on Nov. 8 and will output ratings as of Sept. 30, 2019 (due to the one-month and six-business-day lag schedule of this monthly calculation).
Why is Morningstar making this change?
Sustainalytics’ company-level ESG Risk Rating represents an advance over its ESG Rating, which served as the original basis for the Morningstar Sustainability Rating. The ESG Rating evaluated a company’s general preparedness to address its ESG risks and opportunities on an industry-relative basis. The rating was able to identify “leaders” and “laggards” within an industry; it was not helpful in comparing companies’ ESG risks across industries, even though some industries clearly have more ESG risks than others.

The new ESG Risk Rating focuses on ESG risk using a smaller number of material ESG indicators in each industry. It uses a single ESG risk scale, enabling direct comparisons across industries. We believe this is more useful for end investors who want to better understand and manage the ESG risks of their investments.

The change accomplishes several objectives. First, it will result in a simplified asset-weighted average score for portfolios. Because the previous ESG Rating was industry-relative, we had to normalize the scores to make them meaningful at the portfolio level. Even then, normalization only made it possible to say whether two holdings, for example, were ESG leaders or laggards within their respective industries, not which holding had more ESG risk than the other.

Additionally, it represents a more nuanced approach to ESG-related controversies. Historically, we have calculated a Portfolio Controversy Score based on Sustainalytics’ assessments of the degree to which companies are involved in specific ESG-related problems. Because the new ESG Risk Rating better incorporates controversies and evaluates their contribution to a company’s overall ESG risk, we no longer need to make a controversy adjustment in our portfolio-level scores.

Morningstar made a change to this methodology last year as well. Is this a final methodology, or are you going to continue to make changes at some regular cadence?
Last year, we changed the peer groups used to assign the Sustainability Rating to our Morningstar Global Categories from our more localized Morningstar Categories. This change grouped like funds globally based on their investment focus rather than their domicile, which allowed for more robust comparisons across larger peer groups. With the change, for example, all emerging-markets equity funds are compared with each other regardless of where in the world a particular fund is offered for sale.

This year’s change reflects a shift to Sustainalytics’ company ESG Risk Rating from its older company ESG Rating. While we intend to keep the Morningstar Sustainability Rating focused on the ESG risks embedded in a portfolio’s holdings and intend to minimize ongoing changes, we also recognize that, over time, sustainability research will continue to evolve and we aim for our rating to reflect best practices in ESG evaluations.

We also recognize that there are other dimensions to the concept of sustainability, such as overall impact, engagement, and the degree to which a fund is intentionally pursuing sustainable outcomes. In
the future, we intend to provide investors with additional insight into these dimensions; at this point, we anticipate that the Sustainability Rating will be focused primarily on ESG risk.

**Does this change have anything to do with the Morningstar Analyst Ratings methodology changes?**
No.

**Methodology**

**What is ESG Risk?**
ESG Risk measures the degree to which a company's economic value may be at risk driven by ESG issues. The rating is based on a two-dimensional materiality framework that measures a company’s exposure to industry-specific material risks and how well a company is managing those risks. The ESG Risk Rating represents the remaining unmanaged ESG risk exposure after taking into account a company’s management of such risks.

The rating is rendered on a 0-100 scale, though in practice most scores range from 0 to 50, where lower scores are better and 0 indicates no unmanaged ESG risk. The company risk classification thresholds are shown in Exhibit 1

<table>
<thead>
<tr>
<th>Company Score</th>
<th>ESG Risk Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-9.99</td>
<td>Negligible</td>
</tr>
<tr>
<td>10-19.99</td>
<td>Low</td>
</tr>
<tr>
<td>20-29.99</td>
<td>Medium</td>
</tr>
<tr>
<td>30-39.99</td>
<td>High</td>
</tr>
<tr>
<td>40+</td>
<td>Severe</td>
</tr>
</tbody>
</table>

Source: Morningstar, Inc.

**How do I interpret the new Morningstar Portfolio Sustainability Score? How does it differ from the one that has been in use so far?**
The new Morningstar Portfolio Sustainability Score is the asset-weighted average of the company ESG Risk Ratings for the covered holdings in a portfolio. ESG Risk Ratings from Sustainalytics measure the degree to which a company's economic value may be at risk due to material ESG issues. At the company level, higher scores indicate more ESG risk; lower scores indicate less ESG risk. Likewise, at the portfolio level, higher Morningstar Sustainability Scores reflect more overall ESG risk across the companies in the portfolio and lower Morningstar Portfolio Sustainability Scores reflect less overall ESG risk across the portfolio.
By contrast, the old Morningstar Portfolio Sustainability Score was a combined measure of the Portfolio ESG Score and the Portfolio Controversy score. The Portfolio ESG Score was the normalized asset-weighted average of the company ESG Ratings for the covered holdings in a portfolio. These ratings measured the overall level of preparedness of a company to manage its ESG risks and opportunities using a 0-100 scale, with higher scores being better.

**Will the Portfolio ESG Score still be calculated after this methodology change is implemented?**
No, after Oct. 31, 2019, we will be retiring the Portfolio ESG Score, and the Morningstar Portfolio Sustainability Score will no longer be a combination of the Portfolio ESG Score and the Portfolio Controversy Score. Instead, the Morningstar Portfolio Sustainability Score will be a direct asset-weighted average of the company ESG Risk Ratings for the covered holdings in a portfolio, as explained above. As for the Portfolio Controversy Score, it will also be retired. Controversies are already incorporated in the Sustainalytics company ESG Risk Rating methodology, as explained in an earlier question above.

**Why did you include a buffer between monthly rating changes?**
We want to change a fund’s Morningstar Sustainability Rating only when a portfolio has moved meaningfully within its peer-group distribution. A fund must now move at least one percentile past the rating breakpoints to receive a different rating.

To receive 5 globes, for example, a fund must place in the top decile of its peer group, but before an existing 4-globe fund is upgraded to 5 globes, it would need to improve to the ninth percentile. An existing 5-globe fund would need to decline to the 11th percentile or worse in order to be downgraded to 4 globes.

In Exhibit 2, we provide the upgrade and downgrade thresholds for each rating.

**Exhibit 2 Buffer Sustainability Rating Buffer Thresholds**

<table>
<thead>
<tr>
<th>Sustainability Rating</th>
<th>Initial Breakpoint</th>
<th>Upgrade</th>
<th>Downgrade</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10</td>
<td>9</td>
<td>11</td>
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<td>32.5</td>
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<td>66.5</td>
<td>68.5</td>
</tr>
<tr>
<td></td>
<td>90</td>
<td>89</td>
<td>91</td>
</tr>
</tbody>
</table>

Source: Morningstar Inc.

**Why did you include maximum thresholds for Morningstar Portfolio Sustainability Scores?**
The Morningstar Sustainability Ratings are peer-group-relative so investors can find the next-best option to tilt their portfolio toward a lower ESG investment. Funds that have High or Severe ESG Risk Ratings, however, cannot receive higher ratings (4 or 5 globes) regardless of how well they may rank within their
peer groups. For funds with High or Severe ESG Risk Ratings, we limit the number of globes that can be assigned, as follows:

- If a fund’s Portfolio Sustainability Score is between 30 and 35, it can receive no more than 3 globes depending on its peer group ranking.
- If a fund’s Portfolio Sustainability Score is between 35 and 40, it can receive no more than 2 globes depending on its peer group ranking.
- If a fund’s Portfolio Sustainability Score is above 40, it receives 1 globe.

Can you provide examples of the maximum thresholds?
Below we provide three examples where a fund’s Morningstar Sustainability Rating is affected by the thresholds.

Fund A is a global world resource equity fund with a Historical Sustainability Score of 31.3, which places the fund in the 17th percentile of the natural resources global Morningstar Category. Without any thresholds, this fund would receive a 4-globe Morningstar Sustainability Rating. However, because the fund has a Historical Sustainability Score between 30 and 35 and is classified as High Risk, the fund receives a 3-globe Morningstar Sustainability Rating.

Fund B is a gold and mining equity fund with a Historical Sustainability Score of 35.23, which places the fund in the 15th percentile of the precious metals global Morningstar Category. Without any thresholds, this fund would receive a 4-globe Morningstar Sustainability Rating. However, because the fund has a Historical Sustainability Score between 35 and 40 and is classified as High Risk, it receives a 2-globe Morningstar Sustainability Rating.

Fund C is an energy income fund with a Historical Sustainability Score of 40.12, which places the fund in the 86th percentile in the energy global Morningstar Category. Without any thresholds, this fund would receive a 2-globe Morningstar Sustainability Rating. However, because the fund has a Historical Sustainability Score above 40 and is classified as Severe ESG Risk, we downgrade the fund to a 1-globe Morningstar Sustainability Rating.

Can you provide an example of the buffer thresholds?
A fund cannot be upgraded or downgraded unless it moves 1 percentage point past the rating breakpoint. For example, Fund D’s Historical Sustainability Score ranks in the 92nd percentile of its global Morningstar Category, resulting in a 1-globe rating as of October 2019. In November 2019, Fund D’s Historical Sustainability Score ranks in the 90th percentile, resulting in another 1-globe rating. In December 2019, Fund D’s Historical Sustainability Score ranks in the 89th percentile, resulting in an upgrade to a 2-globe rating.
Does a portfolio need to have 12 months of history before it receives a Morningstar Sustainability Rating?
No. New funds receive an initial rating based on the first portfolio we receive, and over the first 12 months we will use available monthly portfolios to calculate the rating.

How does a monthly portfolio score work for a portfolio that does not report monthly?
We carry forward the most recent portfolio and recalculate the Morningstar Portfolio Sustainability Score using the updated company-level ESG Risk scores from Sustainalytics.

Will the historical ratings change?
No. The methodology change affects the ratings moving forward only.

What will happen to historical data at the time of the release?
All Morningstar Sustainability Ratings already published on products (that is, monthly Morningstar Sustainability Ratings since August 2018) will continue to be available; they will not be removed. Similarly, the Morningstar Portfolio Sustainability Scores and the Morningstar Historical Sustainability Scores that were published before October 2019 will remain. This means the values with an as-of date between October 2018 (when these were first introduced) and August 2019 will be outputs of the current methodology, while anything afterward will be outputs of the new methodology.

When will the Morningstar Portfolio Sustainability Scores and the Morningstar Sustainability Ratings be run?
The Morningstar Portfolio Sustainability Scores and the Morningstar Sustainability Ratings will now be run simultaneously, on a monthly basis. Each sixth business day of the month, the calculation will be run on the previous month end’s portfolio date (that is, with a one-month and six-business-day lag). Previously, each portfolio was scored upon receipt, while the rating was calculated on a one-month and six-business-day lag basis.

When does the new methodology take effect?
The methodology will be in effect Oct. 31, 2019. The ratings are generally run on the sixth business day of the month. This means that the ratings that incorporate the new methodology will be run for the first time on the sixth business day of November 2019—that is, Nov. 8, 2019, for ratings with an as of date of Sept. 30, 2019 (due to the one-month and six-business-day lag nature of the calculation, as explained above).

How will you calculate the Morningstar Historical Sustainability Scores as of October 2019?
To calculate the September 2019 Morningstar Historical Sustainability Score, we use monthly Morningstar Portfolio Sustainability Scores starting in October 2018, which corresponds to the launch of Sustainalytics’ then-new company-level ratings methodology. Sustainalytics has provided Morningstar monthly files containing these company-level scores. The company level scores power the monthly Portfolio Sustainability Scores, which are inputs to the Historical Sustainability Scores, available in early November.
Note that the Morningstar Portfolio Sustainability Scores will be made available on a go-forward basis when the methodology becomes effective.

What portfolio will be used for exchange-traded funds in the monthly production process?
We will use the latest reported portfolio prior to the month-end. For example, the March 2019 Morningstar Sustainability Ratings produced on May 8, 2019, would use the ETF portfolio reported as of March 29.

Coverage

What is the coverage of the Morningstar Sustainability Rating?
The Morningstar Sustainability Rating covers open-end funds, exchange-traded funds, closed-end funds, and separate accounts, and it includes funds of funds. All asset classes are covered, provided that 67% of assets have Sustainalytics’ ESG Risk Ratings.

How will funds’ Morningstar Sustainability Ratings be affected by the new methodology?
Based on historical testing, we expect that 24% of funds will gain or lose 2 or more globes; 43% of funds will gain or lose 1 globe; and 33% of funds will keep the same rating.

Where can I learn more about the underlying company-level ESG risk scores?
Sustainalytics’ company-level ESG risk scores are available in Morningstar products, such as Morningstar Direct. For more information about the Sustainalytics methodology, visit https://www.sustainalytics.com/esg-ratings.

Products

Does the new methodology incorporate additional data points? Which data points disappear?
This methodology change leads to the creation of seven new data points and the retirement of nine data points.

These are the fund data points we are adding: Portfolio ESG Risk Exposure Score, Portfolio ESG Managed Risk Score, Historical Sustainability Score Global Category Average, Historical Sustainability Percent Rank in Global Category, Historical Sustainability Absolute Rank in Global Category, Percent of AUM With High & Severe Controversies, Percent of AUM With NULL ESG Risk Scores.

The fund data points that will be retired are the following: ESG Score vs. Category, Portfolio ESG Score, ESG Percent Rank in Category, ESG Absolute Rank in Category, Controversy Score vs. Category, Portfolio Controversy Score, Controversy Percent Rank in Category, Controversy Absolute Rank in Category, Controversy Category Average.
How will the changes affect the individual Portfolio Environmental, Social and Governance Pillar Scores surfaced today?

We will continue to surface these data points. The methodology for calculating the individual environmental, social, and governance scores at the portfolio level will remain, as it always has been, fully separate from the Morningstar Portfolio Sustainability Score calculation, which drives the overall fund Sustainability (“globe”) rating. That is the reason why the details of the environmental, social, and governance scores are not included in the rating methodology document.

The methodology used to calculate these individual environmental, social, and governance portfolio scores is a simple asset-weighted roll-up of the environmental, social, and governance risk cluster scores Morningstar receives monthly from Sustainalytics. The Sustainalytics methodology for calculating these cluster scores at the company level has changed fundamentally under the company’s new ESG risk framework. The new cluster scores are calculated as linear combinations of company-specific Material ESG Issues, or MEI, unmanaged risk, exposure, and management scores. For more information about the Sustainalytics methodology, visit https://www.sustainalytics.com/esg-ratings.

Note, as explained earlier, that under the new Morningstar Sustainability Rating methodology, company-level scores from Sustainalytics no longer need to be normalized for our portfolio-level calculations and the Morningstar Portfolio ESG Score data point is retired.

Can I access my old ratings? Is the back history of the ratings available?

Yes, Morningstar provides historical Morningstar Sustainability Ratings dating back to August 2018.

Will the Morningstar Portfolio Sustainability Scores from October 2018 to August 2019 be made available?

They will not be surfaced in products at this time. Morningstar Portfolio Sustainability Scores will be made available on a go-forward basis when the methodology goes into effect.
About Morningstar® Sustainability Research
Morningstar Sustainability Research is dedicated to helping investors reflect their beliefs in their portfolios and evaluate the impact of their investments.

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