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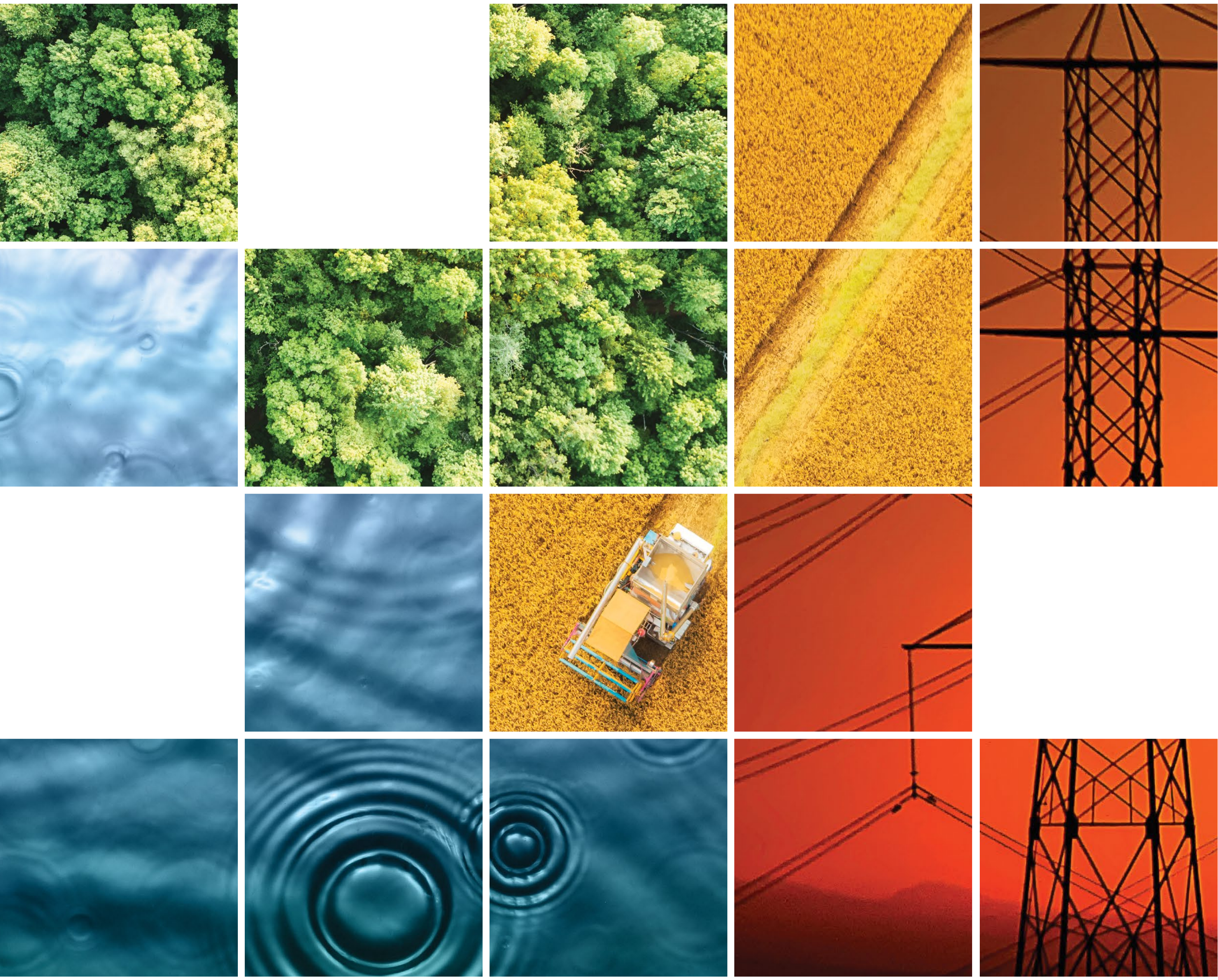
Morningstar's Guide to Sustainable Investing



Adapting to Change

Over the last few years, interest in sustainable investing and demand for environmental, social, and governance, or ESG, information has increased globally. There are several different market drivers behind this trend. Our societal landscape began to shift as investors observed that companies that prioritised their stakeholders were more resilient. Additionally, the media attention on corporate responses to the pandemic and systemic racism has created a greater awareness among investors of the importance of the social dimension of ESG analysis.

Shifting investor preferences increasingly emphasise sustainability considerations like climate impact, diversity, equity, and inclusion, or DEI, and corporate governance as necessary to fully account for investment and reputational risks. Finally, changing policy and regulatory requirements, like the EU Sustainable Finance Action Plan, have prompted all financial-market participants to systematically consider and disclose the impacts of ESG risks on their investments and the impact of their investments on the planet.

Asset managers have already responded to this transition and changing investor preferences by launching a flurry of climate-aware funds. They have tweaked existing strategies to incorporate sustainable objectives such as reduced exposure to fossil fuels and increased exposure to renewable energy opportunities. According to the most recent figures from Morningstar, product development remained steady at the end of H1 2022 with 245 new sustainable funds launched globally as asset managers continue to repurpose conventional products into sustainable offerings.[1]

[1] https://www.morningstar.com/lp/global-esg-flows

Of course, this significant shift in the long-term investment space presents both opportunities and risks for investors. This guide is intended to shed light on the different approaches professional investors and managers can use to make more informed investment decisions that align with investors' sustainability motivations and objectives.

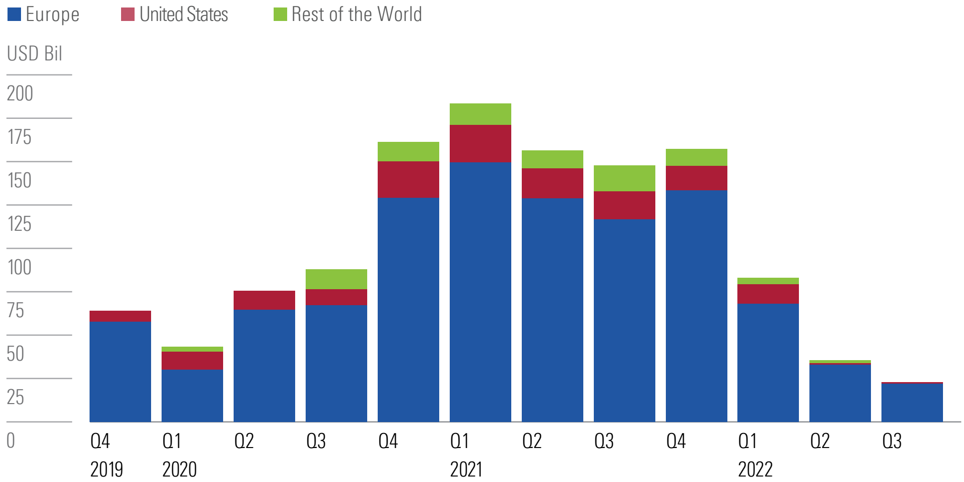
An Introduction to Sustainable Investing

Sustainable investing seeks to deliver competitive financial results while driving positive ESG outcomes. In other words, it considers how investments can impact people, planet, and profits. Rising interest in sustainable investing reflects the broad sustainability concerns held by many people in the world today. In applying these concerns to their investments, investors seek to contribute to a more sustainable future. (Note: an investor's profits are indeed a part of a sustainable investor's motivations.)

Flows into sustainable funds reflect growing investor interest. According to asset flows data from Morningstar, despite inflationary pressures, rising interest rates, concerns of a global recession, and the war in Ukraine, the global universe of sustainable funds still attracted $22.5 billion of net new money in the third quarter of 2022. While this represents a significant decrease from the $142 billion high at the end of 2021, sustainable funds continue to prevail in this period of uncertainty compared to the broader market which has seen outflows of $198 billion in third-quarter 2022 alone.[2]

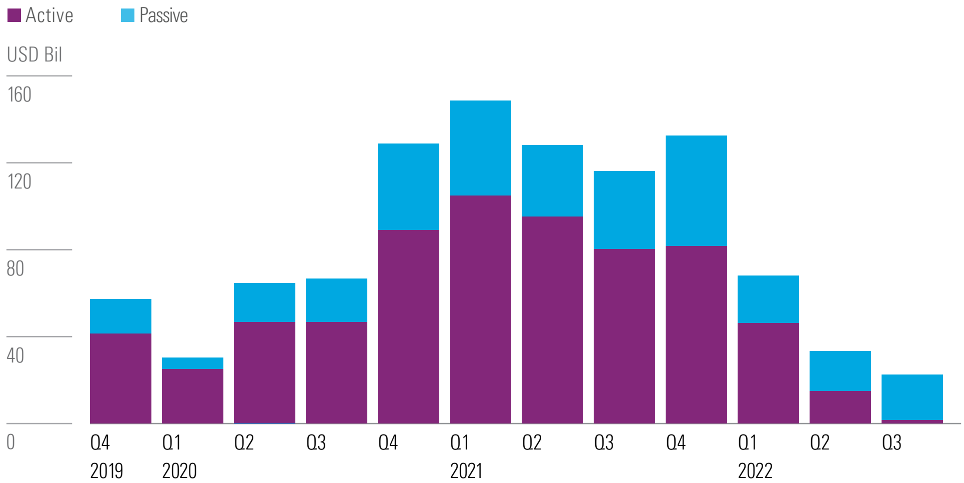
[2] https://www.morningstar.com/lp/global-esg-flows

Quarterly Global Sustainable Fund Flows (USD Bil)



Source: Morningstar Direct, Morningstar Research. Data as of September 2022.

European Sustainable Fund Flows (USD Bil)



Source: Morningstar Direct, Morningstar Research. Data as of September 2022. Data for Q1 and Q2 was retreated using the new framework for ease of comparison. Under the old framework, flows in Q1 and Q2 were USD 71.7Bil and USD 30.7Bil, respectively.

The continued inflows speak of the stickiness of ESG investments. Investors in sustainable funds are typically driven by their values, invest for the long term, and seem to be more willing to ride out periods of bad performance.

Incorporating ESG Considerations Into the Investment Process

At a time when sustainable considerations are becoming a standard part of investment decisions, ESG screening is a way of not only mitigating investor risk (as far as possible) but a method of aligning funds with investor objectives and ethical motivations.

Thanks to a lack of consensus over terminology and a confusing mix of approaches, however, understanding the many facets of sustainable investing can be a daunting challenge for many investors.

Morningstar's Sustainable Investing Framework addresses the critical need for clarity in the field. It provides a straightforward way to understand investor motivations for seeking sustainable investments and outlines the range of activities associated with sustainable investing.

Sustainable Investing Approaches

Morningstar has identified six sustainable investment approaches and placed them along a continuum ranging from those that lean more toward avoiding negative outcomes, be they investment or real-world outcomes, to those that lean more toward advancing positive outcomes.

1. Apply Exclusions

This approach refers to excluding sectors, companies, or practices that investors consider harmful or not in alignment with sustainability criteria. Exclusions may range from traditional, so-called sin stocks (alcohol, tobacco, gambling) to guns and controversial weapons to business ethics (violators of the United Nations Global Compact or companies engaged in major controversies). Many investors today exclude the fossil fuel industry from their portfolios, either entirely or by excluding practices with the worst climate and environmental impacts (such as thermal coal extraction and use, Arctic exploration, or tar sands drilling). Using company ESG metrics, investors can avoid companies that are poor sustainability performers, either overall or in certain areas of emphasis. Portfolio optimisation techniques can be used to reduce the impact of exclusions on a portfolio's tracking error to a market benchmark.

2. Limit ESG Risk

Investors can address sustainability concerns by taking steps to limit ESG risks. Sometimes referred to more generically as ESG integration, this approach uses ESG ratings and data in the risk management process to assess material ESG risks.

Investors may price ESG risk into valuation models or seek to avoid investments with a certain level of ESG risk regardless of valuation. This approach has become widespread among traditional investments as more investors have come to understand that material ESG issues may reflect hidden risks that traditional analysis may overlook. This is especially true of risks associated with climate change.

3. **Seek ESG Opportunities**
   Investors may also use ESG information to identify companies that are sustainability leaders or those seeking to improve their ESG practices to build competitive advantages. This approach includes what is sometimes called ESG best in class or positive screening based on ESG ratings. An ESG best-in-class approach typically favors companies with better ESG ratings on a sector or industry basis. It is a subset of positive screening, which more generally builds portfolios around companies with better ESG ratings.

4. **Practice Active Ownership**
   Investors may seek positive ESG outcomes via their active ownership, or stewardship, activities, made possible primarily because asset managers are shareholders in public companies. These activities may include direct engagement with companies on ESG issues, proposing ESG-related shareholder resolutions, supporting ESG issues through proxy voting, participating in ESG-related investor coalitions, and advocating for public policy measures that address sustainability issues.

5. **Target Sustainability Themes**
   Thematic investing focuses on identifying long-term societal trends and the investments that stand to benefit from those trends. In targeting sustainability themes, investors seek to take advantage of opportunities created as the world moves toward greater sustainability and transitions to an economy driven by renewable energy.

   Sustainability-themed investments often use the 17 United Nations Sustainable Development Goals to identify specific themes to pursue. Such themes may be related to climate action or other environmental concerns, like healthy ecosystems and natural resource security, or they may be related to social issues, like human development (including diversity, equity, and inclusion) or basic needs.

6. **Assess Impact**
   Investors may wish to integrate impact assessments into security selection and portfolio construction. Fixed-income investors, for example, may consider a bond's use of proceeds, focusing on bonds that finance projects that benefit people and planet. Equity investors may consider whether a company's products and services, as well as its policies and behaviours, support or detract from the U.N. goals, which many investors and companies use as an impact framework. At the portfolio level, investors may assess the overall impact of their portfolio holdings in relation to a goal or benchmark. Impact reporting provides transparency for investors into the societal outcomes an investment has created or encouraged and with which social causes an investment is aligned.

   Morningstar Sustainalytics has also developed five Impact Themes—Climate Action, Healthy Ecosystems, Basic Needs, Resource Security, and Human Development—which investors can use as an additional framework, as well as a new set of Impact Metrics, which meet the increasing need for company-level impact data. (You can find out more about Morningstar Sustainalytics impact themes and metrics in our Guide to Impact Assessment.)

Sustainable Investment Portfolios

Most of the time, sustainable investors combine these approaches, as they are interrelated and largely complementary. It is not uncommon for an investment strategy in which sustainability plays a leading role to use several, or even all, of these approaches to varying degrees.

Framework for Building Portfolios

An investment portfolio can be defined in terms of a particular strategy or fund, or an end investor's set of investments. Portfolios can be assessed in terms of whether and to what extent they use any of the six sustainable investment approaches detailed above. In any given portfolio, sustainable investment approaches may play no role, a supporting role, or a leading role.

For end-investor portfolios that consist of multiple underlying investment strategies or funds, the framework can be used to target exposure to the investor's preferred approaches and can be used to evaluate how much exposure an investor has to each approach.

Regulations Are Aiding Decision-Making

Tightening regulations are also helping to hold companies and funds to higher sustainability standards across the board, giving investors greater transparency and confidence that their ESG preferences align with their chosen investments.

Recent amendments to MiFID II mean that asset managers must incorporate sustainability risks into the investment process, and document how they do so across all funds—not just those specifically marketed as ESG. Wealth managers must also obtain sustainability preferences from their clients as part of the suitability process.

Perhaps the most notable step forward has been the European Commission's Sustainable Finance Action Plan. In order to meet its 2050 carbon-neutrality goal, the EU adopted a 10-point action plan on sustainable finance with an aim to channel capital flows toward sustainable investment while managing financial risks stemming from ESG issues.

At the core of the action plan is the Sustainable Finance Disclosures Regulation (SFDR) which took effect on March 10, 2021.

The SFDR raised the bar for financial product providers to promote genuine ESG credentials by setting strict minimum disclosure standards to prevent greenwashing. ESG funds will need to explain what environmental, social, or sustainable characteristics or objectives they are supporting and how; their ESG investment strategy; their binding selection criteria; and how they take into account the adverse impact of investment decisions, among others.

Open-end and exchange-traded funds in scope of the Sustainable Finance Disclosure Regulation are those that state in their prospectuses that they either promote environmental and/or social characteristics—Article 8, light green funds, or have a sustainable investment objective—Article 9, dark green funds. (These funds can be identified using the EU SFDR Fund Type [Article 8 or Article 9] data point in the Morningstar Direct database.)

In conjunction with the SFDR is the EU Taxonomy Regulation. This is essentially a classification tool to help investors and companies make informed investment decisions on environmentally friendly economic activities, based on six environmental objectives:

1. Climate change mitigation
2. Climate change adaptation
3. Sustainable use and protection of water and marine resources
4. Transition to a circular economy
5. Pollution prevention and control
6. Protection and restoration of biodiversity and ecosystems

Starting from January 2023, companies must report on what proportion of their turnover, capital expenditures, and operational expenditures are aligned to the taxonomy's first two environmental objectives climate change mitigation and climate change adaptation.

In 2022, asset managers and other financial market participants started reporting on alignment to the first two objectives for their sustainable products (e.g. Article 8 and 9 investment funds). The screening criteria for the other four objectives are expected to be adopted by the European Commission over the course of 2023.

You can find out more about the EU Action Plan and the relevant solutions from Morningstar by visiting our Resources hub.

How Morningstar Can Help Identify Sustainable Investment Opportunities

At a time when ESG considerations are becoming part of every investment decision, Morningstar has a comprehensive offering to help professional investors and managers successfully consolidate ESG data into the investment process. This has been accelerated by the 2020 acquisition of Sustainalytics, the largest independent provider of ESG research and ratings.

For over 25 years, Sustainalytics has been supporting hundreds of the world's foremost investors, helping them incorporate ESG and corporate governance insights into their investment processes with a dedicated team of 700+ research staff and analysts operating across 17 locations. As the biggest pure-play investment research and ratings firm dedicated to responsible investment, Sustainalytics data and independent ESG Risk Ratings are designed to help investors identify and understand financially material ESG risks at the security and portfolio level.

Together, Morningstar and Sustainalytics are leading the global sustainable investing landscape with ESG coverage on more than 85,000 funds, 13,000 companies, and 172 countries.

Morningstar Direct

Morningstar's flagship investment and research platform, Morningstar Direct, offers instant access to ESG data to help meet investor preferences for sustainable investing. Investors can leverage several key data sets, as well as Morningstar's propriety sustainability ratings across a number of different workflows, which include:

1. Screening

Leverage proprietary research on company, fund, and portfolio levels to screen by ESG risk, carbon metrics, impact metrics, ethical issues, and more.

2. Fund Selection

Create portfolios based on a client's specific preferences using customisable sustainability parameters.

3. Fund Look-Throughs

Gain insight into any portfolio's true exposure with our aggregated 10-level Fund Look-Through.

4. Reporting

Tell investment stories at every phase of a product's life cycle, from product creation to marketing and regulatory compliance.

5. Research and Editorial Reports

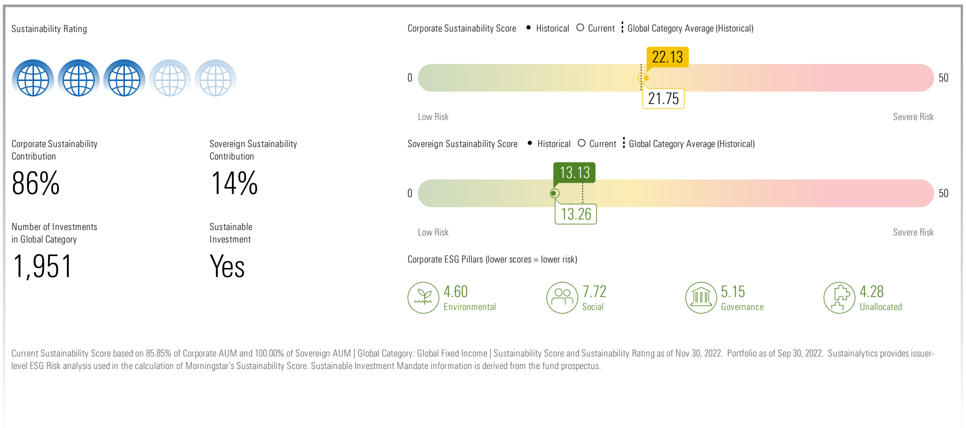
Better understand company ESG characteristics and specific sustainability market trends and themes.

Morningstar's Proprietary Data Sets Include:

ESG Risk

Morningstar is now incorporating the Sustainalytics 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 (a low ESG risk score equals 5 globes, and a high ESG risk score equals 1 globe).

ESG Risk Data

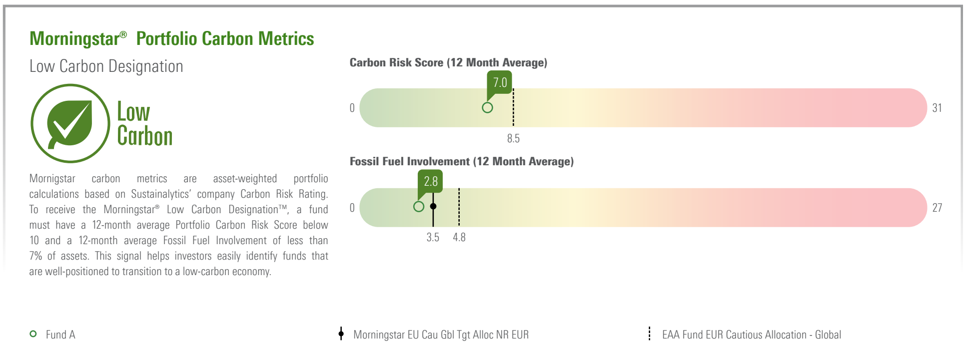


Source: Morningstar Direct

Carbon Risk

The Morningstar Low Carbon Designation helps investors easily identify funds that are well positioned to transition to a low-carbon economy. To receive the Morningstar Low Carbon Designation, a fund must have low exposure to carbon risk and fossil fuel involvement.

Carbon Risk Data



Source: Morningstar Direct

Product Involvement

Assesses a portfolio's exposure to a range of controversial business activities, such as small arms, tobacco, alcohol, thermal coal, and more.

Sustainable Attributes

Allows investors to make better decisions with insights about how fund managers are positioning their funds in terms of their sustainability goals. These attributes reflect the intention of the fund rather than the outcome, unlike our quantitative scores and ratings mentioned above.

Impact Metrics

Fund and company-level metrics offering a systematic way to measure the alignment of funds and portfolios to two trustworthy frameworks: Morningstar Sustainalytics' high-level Impact Themes (Climate Action, Healthy Ecosystems, Basic Needs, Resource Security, and Human Development) as well as the globally accepted U.N. Sustainable Development Goals (SDGs).

European ESG Template (EET) Data

Collected data provided by fund manufacturers to support fund and portfolio assessment on ESG metrics.

Principal Adverse Impact (PAI) Indicators

Morningstar calculates many of the SFDR's Principal Adverse Impact indicators (the adverse environmental or social impacts that investments may have) at a portfolio level and for Morningstar Indexes to allow benchmark comparison.

ESG Commitment Level

Assess the extent to which ESG factors are incorporated into investment processes, fund managers, and firms.

Morningstar Licensed Data Feeds

Our licensed data feeds provide investors and advisors with the ESG data they need to evaluate investment decisions. Wealth and asset managers can use Morningstar Data Feeds to perform research, fund analysis, and look-throughs as well as reporting on these from a sustainability perspective.

Morningstar Publishing System

Morningstar's end-to-end document management service centralises and securely delivers quality factsheets, regulatory documents, and marketing communications. Outsource report production completely or integrate Morningstar Publishing System into your current report generation process for greater efficiency.

Morningstar Direct enables the industry's most comprehensive environmental, social, and governance data set to be incorporated into research, investment analysis, portfolio construction, strategy analytics, and reporting, creating quality ESG portfolios and products that align with investor values.

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