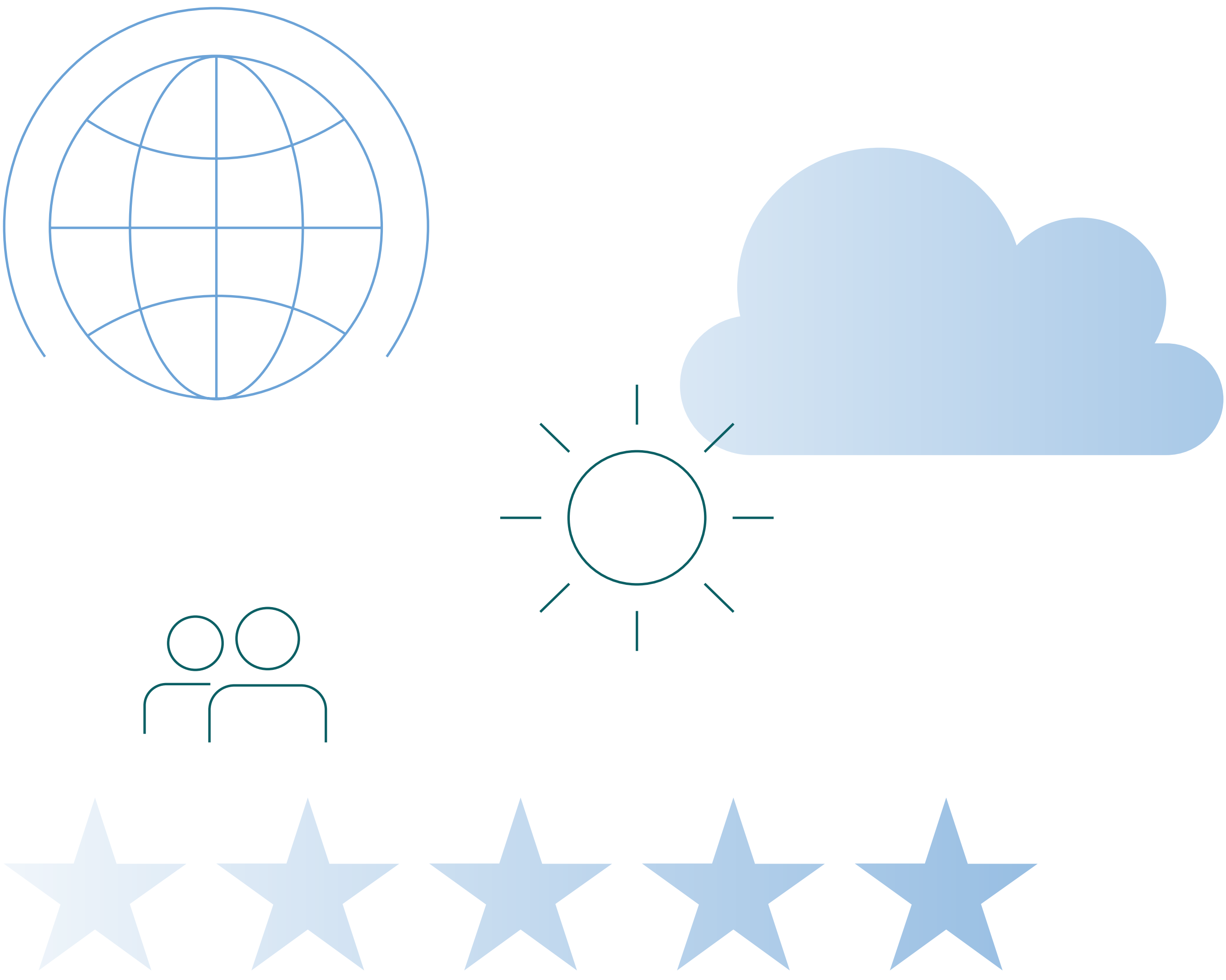
Morningstar's Guide to ESG screening



Adapting to change

Climate change is now widely recognised as a systemic risk that is already having, and will continue to have, a considerable impact on the global economy.

Scientists and economists agree that the changing climate will spark significant changes in labour supply, energy demand, and agricultural production. This will influence investment portfolios in ways we can't yet fully imagine or predict.

As the need for a global transition to a low-carbon economy becomes ever more apparent, the future will be about sustainable investing — investing that marries the traditional economic approach of aiming for the best risk-adjusted returns with a drive to improve corporate practices to protect and, in some cases, benefit society and the environment.

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. In the last decade, over 580 conventional funds in Europe have repurposed into sustainable-focused strategies, including 477 (81%) that changed names to reflect their new sustainable mandate[1].

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 how professional investors and managers can use screening strategies to make more informed investment decisions that align with investor objectives, while reducing the financially material risks that can accompany sustainable investing.

1 https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Global_Sustainable_Fund_Flows_Q2_2020.pdf

An introduction to ESG investing

The hallmark acronym 'ESG' is often used when talking about sustainable investing. (For the purposes of this guide, the two terms will be used interchangeably). It refers to the environmental, social, and governance factors used to evaluate companies and funds during the investment process.

Today, there is a growing awareness of the potential impact that ESG issues can have on investments and portfolio outcomes—performing well in these areas can benefit society, but it can also help reduce the risks a company passes on to its equity and bond investors.

Environmental factors might include how well a company reduces the pollution it creates, the water it uses, or the carbon it emits. Social factors may include labor standards, workplace diversity, or product impacts such as the health implications of tobacco and gambling companies, or data security for big tech firms. Governance might include corporate board structure, executive pay, and prevention of bribery and corruption.

Negative corporate behaviour around ESG issues can hurt shareholder value while creating tangible risks for investors. Many will remember BP's Deepwater Horizon oil spill in the Gulf of Mexico in 2010, or how Volkswagen's diesel emission scandal in 2015 caused enormous financial and reputational damage for the car manufacturing giants. More recently, Facebook's data privacy scandal with Cambridge Analytica led to shares dropping 19% and USD 119 billion wiped off its market value.[2] ESG investors seek to avoid these risks by divesting from companies with poor practices, instead choosing best-in-class alternatives during stock selection and portfolio construction.

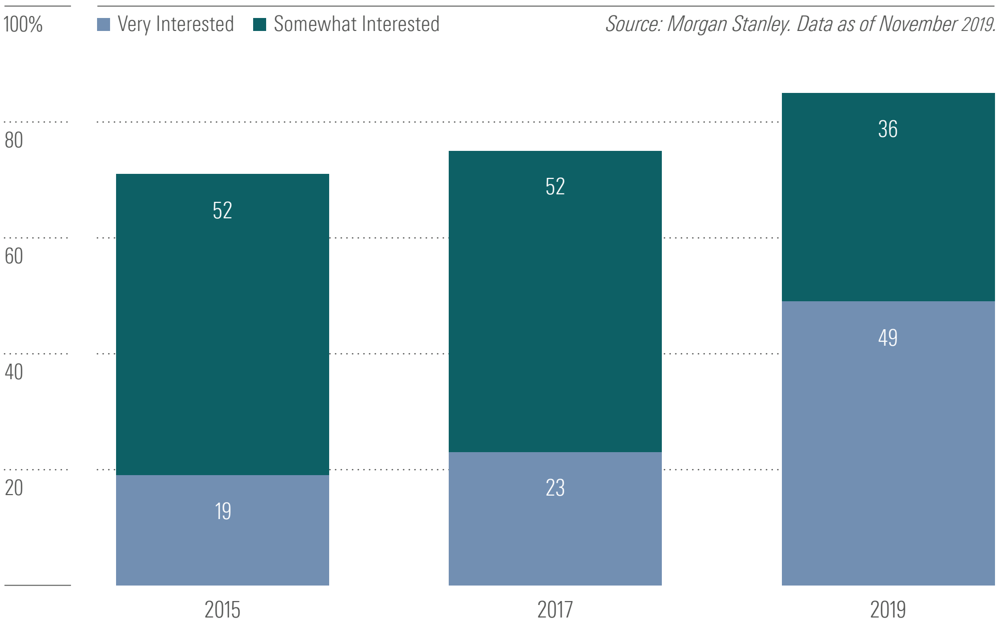
2 https://www.theguardian.com/technology/2018/jul/26/facebook-market-cap-falls-109bn-dollars-after-growth-shock

Interest in ESG investing is accelerating

What was once considered a niche investment area is fast gaining the attention of investors around the globe as the financial impact of ESG risks become more apparent, and the long-term consequences of climate change can no longer be ignored.

In the United Kingdom, researchers found that about 80% of potential investors would be more likely to invest if there was a guarantee they were avoiding unethical companies or that their money could create a positive impact.[3] And in the US, according to a Morgan Stanley poll, 85% of investors expressed an interest in sustainable investing — up from 71% in 2015.[4]

General Population



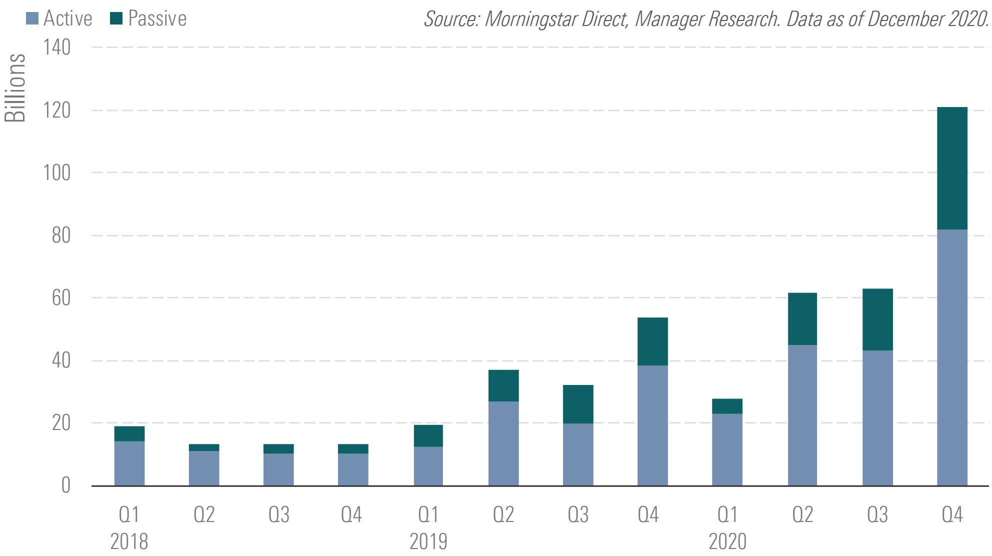
3 Boring Money Insights. 2019. "ESG Investing: The Retail Appetite." September 2019

4 https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf

Growing investor interest is mirrored in sustainable fund flows. 2020 was a pivotal year for sustainable investing and ESG funds in Europe especially. After a decline in inflows during the COVID-19 market shock in the first quarter, sustainable fund flows recovered strongly to reach impressive heights in the fourth quarter, with just over USD 120 billion in net new money. Flows were up 84% on the previous quarter, giving a strong finish to the year. The longer-term flow picture looks even more striking, with inflows into European sustainable funds almost 5 times higher in 2020 than they were three years ago and almost double last year's, at USD 273 billion. Globally, inflows into sustainable funds were up 88% in the fourth quarter of 2020 to USD 152.3 billion.[5]

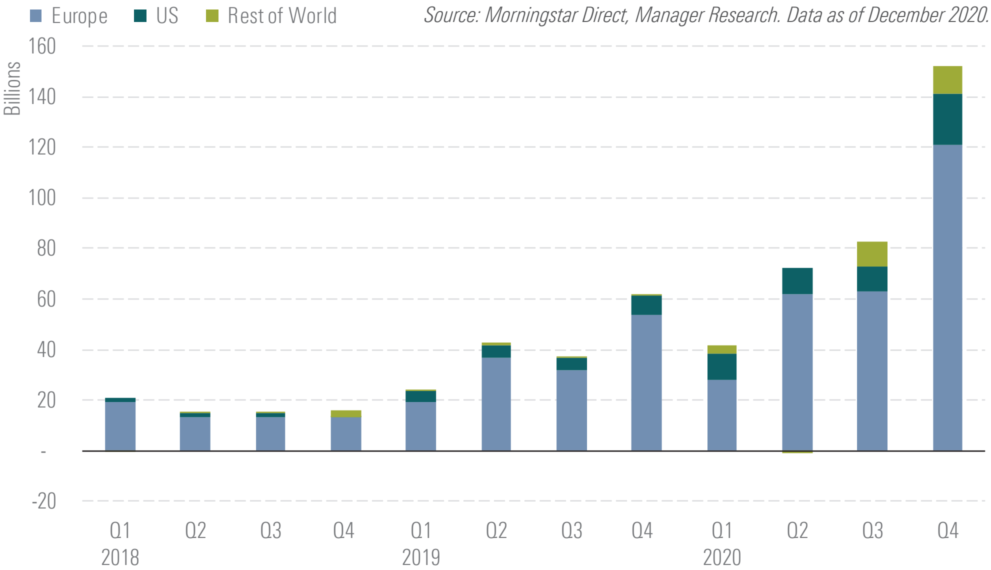
European Sustainable Fund Flows (USD Billion)

Source: Morningstar Direct, Manager Research. Data as of December 2020.



Quarterly Global Sustainable Fund Flows (USD Billion)

Source: Morningstar Direct, Manager Research. Data as of December 2020.



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.

5 https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Global_ESG_Q4_2020_Flows.pdf

How does screening come into play?

Many investors care about ESG issues and want to invest in a way that reflects their views. So 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.

It also brings an important level of transparency and clearer benchmarking to the market, allowing funds specifically marketed as ESG to be compared with relevant market peers. With an increased interest in sustainable investing, some funds may be sold or marketed with a green focus but aren't managed in such a way. This is commonly known as 'greenwashing.'

Screening relies on accurate, reliable data

Sustainable investing requires an additional layer of data and analysis compared to traditional strategies.

ESG analysts evaluate a company on a range of factors, typically rolling up those scores into simple metrics that investors may use when making investment decisions. These independent ESG ratings from specialist providers are a hugely important tool, as companies may have developed their own methodologies and interpretations of what sustainability means, making accurate comparisons virtually impossible.

ESG data is available mostly for public companies, although the quality of data is better in developed markets than emerging ones. The limited availability of good ESG data has been somewhat of a stumbling block for ESG investors in the past, but things have improved greatly.

Today, practically all major asset classes are available to investors via ESG mandated funds. Investment managers also have grown significant in-house expertise, adding ESG-focused analysts and specialists to do proprietary research (in addition to ESG data from providers like Sustainalytics), and help with board/executive engagement and proxy voting. Data in the private equity space has also improved, with companies like PitchBook offering extensive coverage (including ESG data) on every aspect of the public and private equity markets such as venture capital, private equity, and M&A.

Incorporating ESG data into the investment process

There are multiple dimensions to ESG investing, but sustainable funds can typically be categorized into three groups.

❶ ESG incorporation funds

These funds make sustainability and ESG factors a major component of their processes for both security selection and portfolio construction.

ESG incorporation funds might use positive screening, where funds or companies are selected based on both strong performance and ESG attributes such as good corporate governance and positive environmental impact. Commonly, ESG incorporation funds employ a best-in-class strategy for security selection.

An investor who wants to support companies that are doing better in terms of ESG risk management but whose primary concern is returns might use positive screening, for example.

ESG incorporation funds can also use negative screening—a method of filtering out companies and funds based on exclusionary criteria. This could be norms-based where funds and companies are selected based on their compliance with international standards, such as UN treaties, Security Council sanctions, UN Global Compact, UN Human Rights Declaration, and OECD guidelines. (Companies in breach of the UN Global Compact principles on human rights, labour, environment, and anti-corruption would be excluded, for example). Or excluding companies that operate in certain controversial sectors like alcohol, tobacco, arms, gambling, or pornography.

Typical investors using a negative screening approach might be those who want reassurance that they aren't investing in these 'sin stock' sectors, but who are less concerned about specific sustainability issues.

ESG incorporation funds also tend to be active owners, engaging with companies and supporting (and sometimes sponsoring) ESG-related shareholder resolutions.

❷ Impact funds

These funds can vary in focus from broad sustainability themes designed to deliver positive outcomes alongside financial returns, to thematic pursuits targeting one specific area of interest. Themes might include gender equality or low-carbon emissions, for example. Many impact funds use the United Nations 17 Sustainable Development Goals as a framework.

Investors interested in a broad range of sustainability issues and the long-term impact of such investments might screen for these kinds of funds.

3 Sustainable sector funds

These funds focus on companies that are contributing to the transition to a green economy—industries like renewables, water, agriculture/food, and green real estate. Sustainable sector funds typically have a narrower sectoral exposure and target solutions providers or supporting industries such as technology, chemicals, or consultancy.

These funds might attract more sustainability conscious investors who are concerned about their money facilitating environmental solutions, rather than being solely returns focused.

What does ESG screening mean for performance?

While there may be concerns from investors that applying ESG screens is likely to reduce the volume of opportunities on the table, and thereby have a negative effect on returns, there is no evidence to suggest that screening for sustainable attributes means sacrificing returns.

In fact, the opposite appears to be true. Morningstar recently measured the performance of sustainable open-end and exchange-traded funds versus their traditional peers in seven of the most popular Morningstar Categories. Sustainable funds have consistently shown higher survivorship rates than traditional funds—of those available to investors 10 years ago, 72% have survived compared to less than half (45.9%) of traditional funds. Of the surviving sustainable funds, nearly 59% across the categories considered have beaten their average surviving traditional counterpart.

And most recently during the COVID-19 sell-off, sustainable funds also held up better than their traditional counterparts, delivering superior returns in all but one category.[6]

Of course, there is still a degree of manager skill and fund quality which can affect performance outcome in any case. But the good news for sustainability conscious investors is that ethical concerns do not have to jeopardise performance.

Accelerating regulations are aiding the screening process

Tightening regulations are also helping to hold companies and funds to higher sustainability standards across the board, giving investors greater transparency and confidence in their investment decisions. In 2019 alone, there were over 80 new or revised policy instruments relating to ESG risks.

Recent proposed amendments to MiFID II call for asset managers to 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 will also have to understand their clients' ESG preferences—whether they've expressed any interest or not—before offering investment advice. These changes aren't likely to be enforced until the latter half of 2021, but it's another step towards bringing financial service providers in line with the wider EU climate action plan.

6 https://direct.morningstar.com/research/doc/987982/How-Does-European-Sustainable-Funds-Performance-Measure-Up-

The European Commission's Sustainable Finance Action Plan

In order to meet its 2050 carbon-neutrality goal, the EU is further ramping up its sustainable finance efforts. Back in March 2018, it adopted a 10-point action plan on sustainable finance with an aim to channel capital flows towards sustainable investment while managing financial risks stemming from ESG issues. Most of the legislative text was complete by late 2019, with work on implementing measures continuing through 2020.

At the core of the new disclosures is the **Sustainability-Related Disclosures Regulation** 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, amongst others.

In conjunction with the SFDR is the **EU's 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. Water and marine resources
4. Circular economy
5. Pollution prevention and control
6. Biodiversity and ecosystems

From January 2022, companies will need to report on what proportion of their turnover, capex and opex is aligned to the taxonomy's first two environmental objectives — climate change mitigation and climate change adaptation. From the same date, asset managers and other financial market participants will also have to report on the alignment of their ESG funds to the first two objectives.

The screening criteria for the other four objectives are set to be laid out by 2021, with integration by January 2023.

As for the UK, the disclosures won't remain part of 'retained EU law' in the UK from January 2021. It's therefore up to the government to decide whether to align with the EU on these regulations that affect financial product providers in the UK.

How Morningstar can help with ESG screening

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 recent 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 52,000 funds and 11,000 companies.

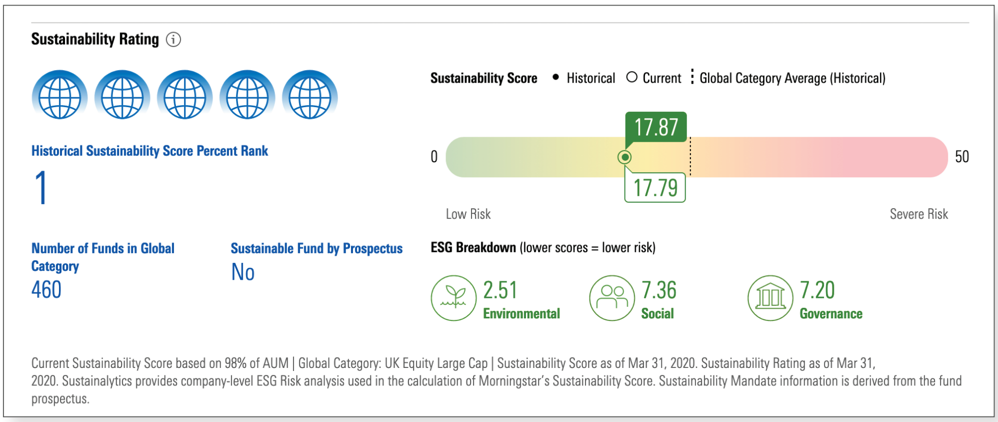
Morningstar Direct

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 screen investments using several key data sets, as well as Morningstar's propriety sustainability ratings.

ESG Risk:

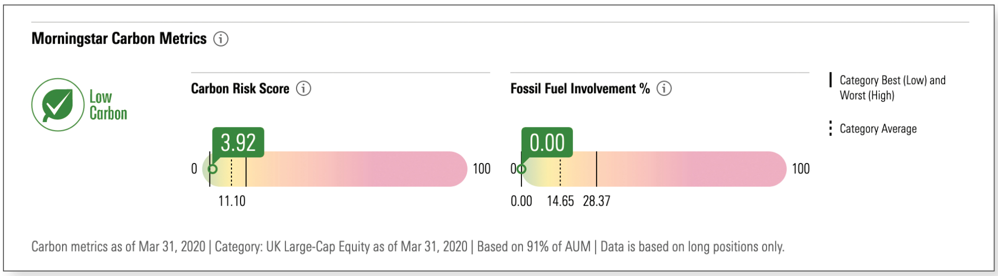
Morningstar is now incorporating the Sustainalytics ESG Risk Rating as the basis for our fund-level Morningstar Sustainability Rating. The ESG Risk Rating is an indicator of a company's material ESG risks, measured on the same scale across all economic sectors. The fund-level Sustainability Rating will 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).



Source: Morningstar Direct™

Carbon Risk:

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.



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.

Morningstar Direct enables the most comprehensive environmental, social, and governance data set in the industry 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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