
Morningstar ESG Commitment Level Methodology

Morningstar Research

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Overview

Morningstar's manager research team has conducted qualitative, analyst-driven research on active and passive investment strategies and their associated vehicles since 1986. From November 2011, this research has been expressed globally through the Morningstar Analyst Rating™ for funds in addition to an in-depth written report. The Morningstar ESG Commitment Level supplements this work with a separate, qualitative, analyst-driven evaluation of investment strategies and asset managers from an environmental, social, and governance perspective. The Morningstar ESG Commitment Level serves investors by:

- ▶ Defining the features that our analysts believe constitute a strong ESG investment program;
- ▶ Identifying those strategies and asset managers that our analysts see as best-in-class in the context of ESG investing;
- ▶ Calling out strategies and asset managers that are subpar in their approaches to ESG investing;
- ▶ Monitoring strategies and asset managers for changes that could materially affect their Morningstar ESG Commitment Levels.

Independent Research

Morningstar is committed to the principle of independence. We do not charge asset managers to produce the Morningstar ESG Commitment Level, nor do we permit asset managers to commission the Morningstar ESG Commitment Level from us. Morningstar commercializes its manager research by including its work in various products and services and through licensing its intellectual property.

Morningstar manager research analysts produce their analyses for the benefit of investors, advisors, and institutions, not asset managers. Morningstar separates its analyst team from any commercial relationships the company may have with asset managers in order to avoid any real or perceived conflicts of interest. Analysts are focused on providing in-depth, accurate, and useful analysis that will help investors identify best-in-class ESG investments and avoid ones that are subpar. Morningstar analysts deliver their genuine opinions, whether favorable or unfavorable.

How We Decide What to Cover

The Morningstar ESG Commitment Level will ultimately be provided for all strategies for which analysts produce the Morningstar Analyst Rating for funds. In determining that coverage, Morningstar's goal is to ensure that our clients have access to its qualitative analysts' opinions on a broad spectrum of

strategies that are important to them and meet their needs for portfolio construction. Hence, coverage is not determined by quantitative screens on performance or limited only to a “best of breed” universe (although we do endeavor to cover and closely monitor what we believe are the best offerings in each relevant peer group), and analyst teams have ample discretion in determining their coverage universe. In determining coverage, analysts focus on investment merit and client demand.

Although these criteria tilt coverage toward larger strategies, analysts will cover new and/or small strategies if they have merit. In addition, Morningstar frequently canvases its analyst team, internal consulting units, and external users of our research to identify offerings that might merit coverage. Regional coverage committees internal to the manager research team must approve all coverage decisions.

The Morningstar ESG Commitment Level

The Morningstar ESG Commitment Level is provided for investment strategies and associated vehicles and for the asset management firms that run them. It is the summary expression of our analysts’ opinion of the strength of the ESG investment program at the strategy and asset-manager level. Strategy vehicles can include open-end funds, closed-end funds, exchange-traded funds, and separately managed accounts domiciled throughout the world.

The Morningstar ESG Commitment Level for both strategies and asset managers is expressed on a four-tier scale running from best to worst: Leader, Advanced, Basic, and Low. The Morningstar ESG Commitment Level differs significantly from the Morningstar Analyst Rating for funds in that it is focused purely on the ESG capabilities of strategies and asset managers and does not assess the future performance prospects for an investment. Investors can use the two measures in tandem to help identify investment strategies with the characteristics that best suit their needs. The ESG Commitment Level tiers for strategies should be interpreted as follows:

The Morningstar ESG Commitment Level for Strategies

Leader

These investment strategies are considered by our analysts to be the very best ESG investment offerings. As such, they will have top-flight resources available to them in terms of specialist ESG investment professionals and ESG data on securities in their investable universe. They should fully incorporate ESG analysis into the investment process, spanning initial screening, issue selection, portfolio construction, and risk management, and have transparent and well-implemented programs to actively engage with portfolio holdings on ESG issues and vote proxies. To achieve this designation, a fund must also be backed by an asset management firm that earns an ESG Commitment Level of at least Advanced from Morningstar analysts.

Advanced

These investment strategies sit just below funds that earn our Leader designation, but we consider them to be among the better ESG offerings that we cover. These strategies will typically be well-resourced in terms of specialist ESG investment professionals and ESG data on securities in their investable universe. They should incorporate ESG analysis into the investment process to a significant degree and in multiple respects and have a sound engagement and proxy voting program. To achieve this designation, a fund should also be backed by an asset management firm that earns an ESG Commitment Level of at least Basic from Morningstar analysts.

Basic

These investment strategies offer a degree of ESG incorporation that distinguishes them from strategies with no or poor incorporation, but they are lacking in at least one key aspect. They may, for example, not have strong ESG investment personnel or data, or ESG criteria may not be well incorporated into their investment processes. Strategies that simply exclude a few basic areas or otherwise implement lighter-touch ESG processes would likely land here in the absence of other clear strengths.

Low

These are investment strategies that our analysts do not believe will serve the needs of investors seeking offerings that meaningfully incorporate ESG.

Morningstar may also use one other designation in place of these four levels:

Under Review

This designation means that a change at an investment strategy or the firm backing it requires further review to determine the impact on the Morningstar ESG Commitment Level for strategies.

The Morningstar ESG Commitment Level for Asset Managers**Leader**

These asset managers are considered by our analysts to be the very best at incorporating ESG principles into their investment programs. A Leader firm will have a clearly articulated ESG philosophy and associated policies encompassing environmental, social, and governance aspects of investment. This philosophy will be reflected in the ample provision of relevant resources, including ESG specialist investment personnel and a proprietary ESG scoring/ranking system with innovative data from multiple sources. Leaders should both demonstrate ESG incorporation across all asset classes and/or more than 75% of assets under management and run best-in-class engagement and proxy voting programs. ESG analysis should be included in incentive programs. These firms will generally have a long history of ESG investing as it takes enormous time and effort to build a strong ESG program and ingrain it into a firm's investment DNA. Firms earning the Leader designation should incorporate corporate social responsibility practices/principles across their operations and report annually.

Advanced

These asset managers sit just below those that earn our Leader designation, but we consider them to be among the better firms at integrating ESG principles into their investment programs. They will have a clearly articulated ESG philosophy and associated policies encompassing environmental, social, and governance aspects of investment. This philosophy will be reflected in the provision of relevant resources, including ESG specialist investment personnel and multiple ESG data sources. Advanced firms should both demonstrate ESG incorporation across at least two asset classes and/or more than 50% of assets under management and run sound engagement and proxy voting programs. ESG analysis should be included in incentive programs.

Basic

These asset managers offer a degree of ESG incorporation that elevates them above those with no or poor ESG incorporation, but they are lacking in more than one key aspect. They may, for example, not have strong ESG investment personnel or data, or ESG criteria may not be systematically incorporated into their investment processes. This may be either because they are relative newcomers to ESG and still building their capabilities or because ESG is not a strong priority for them. Basic firms should demonstrate ESG incorporation across at least two asset classes and/or more than 25% of assets under management.

Low

These asset managers either do not integrate ESG factors into their investment processes or do so in a very limited way.

Morningstar may also use one other designation in place of these four levels:

Under Review

This designation means that a change at an asset manager requires further review to determine the impact on the Morningstar ESG Commitment Level for asset managers.

Methodology**Morningstar ESG Commitment Level for Strategies**

To arrive at the Morningstar ESG Commitment Level for a given investment strategy, our analysts evaluate three key pillars: Process, Resources, and Asset Manager. Analysts score each area on a four-point scale running from 0 to 3.

The scores are proposed to a ratings committee, which approves the scores and the final ESG Commitment Level.

For active strategies, these scores are combined into an overall ESG Commitment Level according to this weighting scheme:

Actively managed strategies:

Process: 45%

Resources: 35%

Asset Manager: 20%

The weights for passively managed strategies are as shown below. The Resources Pillar is excluded for passives because their ESG characteristics will be determined largely by the properties of the indexes they track rather than by internal ESG experts, data, and systems. The integration of ESG into the index's construction is reflected in the Process score, which is weighted at 80% for passives.

Passively managed strategies:

Process: 80%

Asset Manager: 20%

Morningstar ESG Commitment Level for Asset Managers

To arrive at the Morningstar ESG Commitment Level for a given asset manager, our analysts evaluate three key pillars: Philosophy and Process, Resources, and Active Ownership. Analysts score each area on a four-point scale running from 0 to 3.

The scores are proposed to a ratings committee, which approves them along with the final ESG Commitment Level for Strategies and the ESG Commitment Level for Asset Managers. In both cases, the ratings committee can approve an ESG Commitment Level that differs from the weighted pillar outcome provided its members vote in favor of doing so.

These scores are combined into an overall ESG Commitment Level by weighting them as below:

Philosophy and Process: 40%

Resources: 30%

Active Ownership: 30%

Pillar Evaluation—Morningstar ESG Commitment Level for Strategies

The Morningstar ESG Commitment Level for Strategies is based on our analysts' evaluation of a strategy's ESG process, resources, and asset manager.

Process

In scoring an ESG process, Morningstar analysts evaluate the nature and extent of the ESG process relative to the overall investment process, how well the ESG process is incorporated into investment research and decision-making, and the consistency with which it is implemented. Strategies that score highly should tightly incorporate ESG factors into their investment processes, spanning initial screening, issue selection, risk management, and portfolio construction. Simple screens on their own are unlikely to receive top marks. A well-implemented engagement program is also a must to earn a higher score here.

More specifically, we seek to understand:

- ▶ The philosophy that underpins the ESG process;
- ▶ The extent to which ESG factors are incorporated in each of the following elements of the investment process: screening, security analysis, portfolio construction, risk management, and asset allocation;
- ▶ The extent to which the process is well reflected in the portfolio on a consistent basis.
- ▶ The extent to which the strategy managers are involved with firm-level active ownership (proxy voting and engagement), and the clarity of publicly available reporting on active ownership at the strategy level.

Resources

People

The ability of an actively managed strategy to effectively incorporate ESG criteria into its investment processes depends, in part, on the quality of ESG specialist personnel involved in managing the strategy or available to support the strategy's management and, in the latter case, the extent to which ESG specialists work closely with the investment managers and their research team. If the ESG team is distinct from strategy management and a traditional financial analyst team, it is key to understand how the teams interact and where authority lies when decisions need to be made, in particular, in instances where ESG analysts and traditional financial analysts have different views.

The relevant personnel are judged along several axes:

- ▶ Experience and ability relevant to the process used by the strategy
- ▶ Fit with the strategy and structure/integration with other teams
- ▶ Level of turnover on team
- ▶ Communication/information flow

Data

Asset managers routinely take in masses of traditional financial data on companies from a variety of sources and use this data to create proprietary models, screens, and buy/sell signals tailored to suit the processes of their analysts and portfolio managers. Identifying, sourcing, and incorporating data relevant to ESG decision-making into investment processes, however, is a relatively new task for many. We therefore assess the extent of ESG data available to a strategy's analysts and managers and how it is or is not incorporated into systems that allow it to be readily incorporated in the investment decision-making process.

Specific data characteristics considered include:

- ▶ Quantity of sources
- ▶ Integration of data into systems used for investment decision-making by the strategy's managers
- ▶ Extrapolation of data into proprietary ESG ranks/ratings relevant to the strategy
- ▶ Whether or not the manager collects its own ESG data to supplement any external sources

Asset Manager

The ESG asset manager score for strategies is derived directly from the Morningstar ESG Commitment Level for Asset Managers, as below.

- ▶ Leader = Asset Manager Score of 3
- ▶ Advanced = Asset Manager Score of 2
- ▶ Basic = Asset Manager Score of 1
- ▶ Low = Asset manager Score of 0

Pillar Evaluation — Morningstar ESG Commitment Level for Asset Managers

The Morningstar ESG Commitment Level for Asset Managers is based on our analysts' evaluation of a firm's ESG philosophy and process, resources, and active ownership.

Philosophy and Process

Morningstar analysts evaluate the firm's commitment to ESG investing. While many firms can claim they believe ESG is important, we examine the facts on the ground to make our own determination. We want to see firms articulate a clear philosophy that incorporates ESG into their investing principles. This philosophy should be evident in their application of ESG in their investment processes. Firms should also be transparent about the purpose of ESG in their investment portfolios and how their overall investment philosophy aligns with ESG principles. ESG policies should be clear and detailed, and management from the board level down through investment analysts should understand and implement the policies consistently and effectively. To obtain top marks here, firms should also run their own businesses according to ESG principles.

An asset manager's philosophy and process are assessed along several dimensions:

- ▶ History of ESG investing
- ▶ ESG policies and company culture
- ▶ Sense of responsibility and societal purpose
- ▶ Firm's own ESG credentials
- ▶ Alignment between investment philosophy and ESG principles
- ▶ Level and consistency of ESG incorporation
- ▶ Transparent, public reporting on ESG metrics for its funds

Resources

ESG investing is complex and requires adequate resources, in terms of people, data, and systems. There is no one-size-fits-all organizational structure. In some cases, having separate teams of ESG experts who provide support to investment teams makes sense. In other cases, ESG expertise resides within investment teams. Regardless of the structure, having the right ESG expertise, reliable ESG data, and robust tools and systems in place are essential to good decision-making. The availability and consistency of ESG data are often a challenge. We therefore assess the extent of ESG data available to a strategy's analysts and managers and how it is or is not integrated into systems that allow it to be readily incorporated in the investment decision-making process.


More specifically, we seek to assess:

- ▶ Number and experience of dedicated ESG professionals
- ▶ Stability of central ESG specialist team
- ▶ Level of coordination, support, and training provided by ESG professionals to investment teams
- ▶ Incentives for portfolio managers to incorporate ESG into their investment decisions
- ▶ Number of external ESG data sources and whether these are supplemented via a firm's own ESG data collection efforts
- ▶ Proprietary ESG scoring or ranking systems
- ▶ Whether and how systems ensure effective flow of ESG information throughout the investment organization

Active Ownership

In assessing active ownership, Morningstar analysts evaluate the nature, extent, effectiveness, and transparency of the firm's engagement and proxy voting program to advance sustainability goals. Firms that score highly should have personnel dedicated to active ownership activities and work closely with investment teams to share insights. This does not necessarily mean that all managers should vote in the same way but at least that all the opinions are known and discussed. A solid engagement program should include proactive engagement with companies, be outcome-oriented, and track progress.

The firm's active ownership program is judged along several axes:

- ▶ Quality of proxy voting guidelines
- ▶ Quality of proxy voting in practice, with an emphasis on how well votes align with proxy voting guidelines and ESG principles
- ▶ Quality of engagement policy and practice
- ▶ Level of disclosure around voting decisions and engagement activities
- ▶ Level of collaboration with other investors and stakeholders
- ▶ Public policy advocacy 

About Morningstar Manager Research

Morningstar Manager Research provides independent, fundamental analysis on managed investment strategies. Analyst views are expressed in the form of Morningstar Analyst Ratings, which are derived through research of five key pillars — Process, Performance, Parent, People, and Price. A global research team issues detailed Analyst Reports on strategies that span vehicle, asset class, and geography. Analyst Ratings are subjective in nature and should not be used as the sole basis for investment decisions. An Analyst Rating is an opinion, not a statement of fact, and is not intended to be nor is a guarantee of future performance.

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