Morningstar Sustainability Rating
Frequently Asked Questions

Executive Summary

In 2016, Morningstar released the Morningstar Sustainability Rating to help investors use environmental, social, and governance, or ESG, information to evaluate investments. The rating provides a reliable, objective way to evaluate how their investments are meeting ESG challenges.

In 2018, we enhanced the current methodology by making the following changes:

- ▶ Incorporate Historical Sustainability Scores
- ▶ Expand peer groups by using Morningstar Global Categories
- ▶ Increase peer group size threshold to 30 scored portfolios
- ▶ Increase rating threshold to 67% of portfolio covered
- ▶ Include funds of funds in the sustainability metrics calculations

Changes were effective Oct. 31, 2018 and will be reflected in the Nov. 8 rating calculations.

Frequently Asked Questions

General

Why are we making changes?

Since the launch of the Morningstar Sustainability Rating two and a half years ago, we have provided investors with the means to evaluate the ESG profile of their portfolios and compare them with peer groups. We've seen significant adoption among asset managers, advisors, and end investors.

Morningstar has always planned to make enhancements to the rating based on client and user feedback and evolving trends in the field. The new ratings reflect our ability to assess a portfolio's sustainability over a longer time horizon; our ability to compare portfolios across regions, reflecting the investor opportunity set; and our expanding security coverage. A detailed account of the changes, with accompanying rationale, appears in the table below.

This is the first set of iterative changes that we plan to make to the Sustainability Rating methodology. Additional changes are planned for mid-2019 when we intend to adopt Sustainalytics' new corporate ESG risk rating as the basis for our portfolio methodology.

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

What is the coverage of the Morningstar Sustainability Rating?
The Sustainability Rating covers over open-end funds, exchange-traded funds, and funds of funds. This includes all asset classes, although the fixed-income funds are primarily corporate-bond funds.

What types of funds will no longer receive Sustainability Ratings?
Primarily fixed-income and asset-allocation funds are affected by the threshold increase.

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

How has Sustainalytics' research coverage evolved since the Sustainability Ratings were released in March 2016?
Sustainalytics has significantly improved its ESG research coverage from about to 4,500 large-cap companies to over 12,000 companies of all sizes.

How will funds' Sustainability Ratings be affected by the new methodology?
Based on historical testing, we expect that 7% of funds will gain or lose 2 globes; 40% of funds will gain or lose 1 globe; and 53% of funds will keep the same rating.

Portfolio Holdings
How and why does Morningstar plan to incorporate historical holdings?
We have created a new data point, Historical Sustainability Score, which is a calculation of the trailing 12 months of portfolio holdings instead of simply using the single, most recent portfolio. We will use this data point when calculating our ratings going forward. The most recent portfolio is a snapshot into a portfolio manager's current decision-making process. It is just one data point representing how ESG is incorporated into the portfolio. Adding in the trailing 12 months of portfolio history provides more data to capture the consistency over which ESG research has been applied in the manager's process.

How is the new Historical Sustainability Score calculated?
A brief explanation of the weighting methodology and the equation used can be found on Page 5 of the methodology document.

If a portfolio is received later than one month and six business days after the month-end date, will it be used in the Sustainability Rating calculations?
Yes, that portfolio will be used the next time the Historical Sustainability Score is calculated.

Does a portfolio need to have 12 months of history before it receives a Sustainability Rating?
No, we just need at least one portfolio to calculate the Historical Sustainability Score. If a fund does not have 12 months of portfolio history, we will use the available monthly portfolios to calculate the Historical Sustainability Score, assuming we have at least one portfolio that's less than 276 days old.

How does the weighted average work when a portfolio does not report monthly?
We still use a scale of 1 to 12, and then we carry forward the most recent sustainability score previously available for the months in between.

Why does the methodology change increase the portfolio coverage threshold to 67% from 50%?
The 2018 methodology enhancements were designed to improve upon the 2016 methodology and better target the intentionality of fund managers. Coverage numbers have also been rising since our 2016 launch, and we felt it appropriate to raise our minimums for calculations.

Additionally, Morningstar launched the Portfolio Carbon Metrics earlier this year and chose a coverage threshold of 67%. To keep our sustainability-related calculations consistent, we decided to increase the threshold to a similar value.

With the increased threshold for calculation at 67% of assets under management, how many funds do you anticipate will no longer have a Sustainability Rating?
In isolation, the increased threshold for calculation will cause approximately 10% of funds to lose Sustainability Ratings. This decrease in coverage is partially offset by the increased coverage because of the move to Morningstar Global Categories.

Previously, several portfolios were not covered because of their small peer-group size. We expect this to lead to 3% of the universe receiving a Sustainability Rating for the first time.

How is the 67% of AUM threshold determined?
The most recent portfolio is used to determine the percentage of AUM threshold level for the 12-month average (Historical Sustainability Score) calculation.

What is the average percentage of AUM coverage level for funds?
Approximately 85%.

Peer Groups
What is the Morningstar Global Category classification system?
Morningstar Global Categories are peer groups for managed portfolios domiciled anywhere in the world. The global category is assigned by placing funds into peer groups based on the characteristics of their underlying holdings. The underlying securities in each portfolio are the primary factor in our analysis, as the investment objective and investment strategy stated in a fund's prospectus may not be sufficiently detailed for our proprietary classification methodology. Funds are placed in a category based on their portfolio statistics and compositions over the past three years. If the fund is new and has no portfolio

history, Morningstar estimates where it will fall before giving it a permanent global category assignment. Global categories may be reassigned based on recent changes to the portfolio. Not all funds are available to purchase within your country. Returns-based analysis may not be valid in some circumstances owing to the impact of currencies.

Why did the Sustainability Rating methodology change from using the Morningstar Category classification system to the Morningstar Global Category system?
We decided to use the Morningstar Global Category system as the peer-group system because the Sustainability Ratings methodology is driven by the portfolio. Therefore, the peer group should reflect all portfolios investing in the same type of security. The Sustainability Rating breakpoints for a type of investment strategy should not depend on the region of domicile.

Additionally, one benefit of using global categories is the increased stability of ratings. With small peer groups, slight changes in portfolios can cause the Sustainability Rating to fluctuate. The global category system typically broadens the number of funds within each peer group.

With this switch to global categories, how are ESG scores skewed to certain countries?
At a country level, there will be some countries that are skewed positive and some countries skewed negative. For example, Denmark's distribution is skewed positive.

Overall, the global category system provides new insights. For example, the European single-country funds now roll up into a broader global category, namely the "other" global equity Morningstar Category. Under the Morningstar Category peer group system, the normal distribution was applied, so some funds still received 4 or 5 globes, even though they were not particularly strong on sustainability issues. Now, we can observe which areas of the market are top-performing, like the Nordic region.

Finally, clients can still see which funds are the best options in their market, as the underlying Portfolio Sustainability Score, Historical Portfolio Sustainability Score, and respective ranks are still available.

How many funds are listed in the Morningstar Global Categories compared with the Morningstar Categories?
All funds currently classified in the Morningstar Category system are classified in the Global Category system.

Where could I obtain a list of ESG Global Categories and their constituent funds?
Morningstar Global Categories and their constituent funds are available in Morningstar products, such as Morningstar Direct.

Why did the peer-group size increase to 30 to receive a Sustainability Rating?
We decided to increase the threshold to 30 from 10 for the number of funds in the peer group when we moved from the Morningstar Category system to the Morningstar Global Category classification system. As many categories map to one global category, the peer group threshold needed to increase to mirror

the increase in peer-group sizes. We use n = 30 to reflect the minimum sample size required to draw a normal distribution.

Do funds that have the same portfolio but with a different currency class now receive the same Sustainability Rating?
Yes. Because these cases are now included in the same global category, the Sustainability Ratings will be consistent for a fund.

Morningstar Product Updates
When will we see these methodology changes reflected in Morningstar products?
The Sustainability Ratings and corresponding metrics will reflect the new methodology as of the monthly calculations on Nov. 8, 2018.

All Morningstar software products that surface Sustainability Ratings data will make the necessary updates to add the new Historical Sustainability Score and reflect the Morningstar Global Category peer-group label by mid-December.

About Morningstar Sustainability Research

Morningstar Sustainability Research is dedicated to helping investors evaluate the values and impact of their investments.

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