MORNINGSTAR Managed Portfolios

Investment Insights

Sustainalytics: How Combining ESG Risk and Moat Ratings Can Benefit Portfolios

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Introduction

In a research report[1], Sustainalytics, a Morningstar company, combined Sustainalytics ESG Risk Ratings with Morningstar's Economic Moat Rating to examine the relationship between ESG risk and moat ratings.[2] Using backtesting, the report found that the wider the moat and the lower the ESG risk, the higher the average return of the portfolio and the lower its volatility. Also, combining economic moat and ESG Risk delivered better results than did each strategy individually.

Key Takeaways

- In research from Sustainalytics, a wide-moat, Negligible/Low ESG Risk approach would have led to a cumulative three-year outperformance of 70 percentage points over a no-moat, High/Severe ESG Risk approach.
- Wide-moat companies with positive ESG momentum also outperformed in Sustainalytics' tests.
- A wide-moat, low-ESG-risk approach outperformed both a wide-moat-only approach and the S&P 500 over a three-year period.

Combining Moats and ESG Risk

ESG risks and economic moats seem to go hand in hand, based on both economic intuition and empirical evidence. However, does it also pay off to combine them in an investment strategy? That is, can we expect a strategy that seeks to select companies performing well in the Morningstar Economic Moat Rating and in the Sustainalytics' ESG Risk Ratings might outperform?

Researchers at Sustainalytics, a subsidiary of Morningstar, Inc., approached this question by sorting company stocks by ESG risk and economic moat ratings. They tested these combinations over a three-year investment period ended 06/30/2020, looking only at those companies that remained in the same categories for both ESG Risk and economic moat since the launch of the Sustainalytics’ ESG Risk Ratings product in November 2018. This provided a sample size of 799 companies.

1 Garz, H. and Zerter, C. (2020), "Combining ESG Risk and Economic Moat", Sustainalytics.

2 For refer to end disclosures for more information on ESG Risk Ratings and Economic Moat Ratings

Over the three-year period, Negligible/Low ESG Risk and wide-moat companies returned a cumulative 55% to shareholders, while no-moat and High/Severe ESG Risk companies led to losses of 20%.

While three years is too short a period to draw definitive conclusions, the general pattern appears to be: the wider the moat and the lower the ESG risk, the higher the return.

Exhibit 1 Annualized 3-Year Returns of Stocks by ESG Risk and Economic Moat Ratings

ESG Risk Category	Economic Moat Rating			Overall
	None	Narrow	Wide	
Negligible/Low	1.5%	4.9%	15.8%	**5.6%**
Medium	-0.6%	4.0%	8.4%	**3.3%**
High/Severe	-7.0%	4.5%	8.5%	**-1.8%**
Overall	**-2.3%**	**4.4%**	**11.0%**	**2.8%**

Source: Sustainalytics, Morningstar. Annualized three-year return data as of 06/30/2020. Past performance is not indicative of future results.

The outperformance of a lower ESG risk and wide-moat strategy may have root causes that are more general and are at work during different market regimes. This is supported by the clear pattern that emerged when we looked at investment risks over the same three-year period as represented by the volatility of monthly returns. Exhibit 2 shows that both ESG risk and economic moat are clearly correlated with volatility following the intuitively expected pattern.

Exhibit 2 Annualized 3-Year Standard Deviation by ESG Risk and Economic Moat Ratings

ESG Risk Category	Economic Moat Rating			Overall
	None	Narrow	Wide	
Negligible/Low	33.6%	29.0%	24.0%	**29.8%**
Medium	34.9%	30.4%	25.1%	**31.2%**
High/Severe	42.6%	29.9%	27.2%	**36.3%**
Overall	**36.9%**	**29.8%**	**25.1%**	**32.0%**

Source: Sustainalytics, Morningstar. Annualized three-year return data as of 06/30/2020. Past performance is not indicative of future results.

ESG Momentum

Prior research, however, suggests that identifying companies with *improving* ESG ratings may also deliver competitive return and risk characteristics. Sustainalytics also analyzed the relationship between ESG Momentum and Economic Moat Ratings with regards to average returns and volatility for 1,340 companies out of the total sample of 1,500 companies.

ESG momentum was defined as:
Positive--A decrease in ESG Risk score of 3.0 points or more;
Negative--An increase in ESG Risk score of 3.0 points or more;
Neutral--A change in ESG Risk score between -3.0 and +3.0.

Wide-moat companies with positive ESG momentum returned 13.1% per year, where companies with a wide moat and a negative ESG momentum saw a decrease of negative 0.7% (see Exhibit 3).

Exhibit 3 Annualized 3-Year Standard Deviation by ESG Risk and Economic Moat Ratings

ESG Momentum / Moat Category	Number of Companies	Annualized (3YR) Returns	Annualized (3YR) Std. Dev.	Average Change in ESG Risk Rating Score
Wide Moat	**217**	**11.5%**	**24.6%**	**-0.51**
Positive ESG Momentum	35	13.1%	22.6%	-5.42
Neutral ESG Momentum	162	12.7%	25.0%	-0.13
Negative ESG Momentum	20	-0.7%	24.9%	5.04
Narrow Moat	**598**	**5.8%**	**29.6%**	**-0.66**
Positive ESG Momentum	107	8.0%	30.9%	-5.49
Neutral ESG Momentum	446	5.7%	29.3%	-0.06
Negative ESG Momentum	45	0.8%	29.9%	4.89
No Moat	**555**	**-3.3%**	**36.0%**	**-0.70**
Positive ESG Momentum	104	-3.3%	39.5%	-6.17
Neutral ESG Momentum	393	-2.4%	35.3%	-0.16
Negative ESG Momentum	58	-9.1%	34.5%	5.49

Source: Sustainalytics, Morningstar. Returns and standard deviation calculated from 06/30/2017 to 06/30/2020 (market close prices). The average change in ESG Risk Rating is from 12/2018 to 06/2020. Moat Rating is as of 06/30/2020.

All in all, the results suggested that both metrics, ESG Risk and economic moat, work on a stand-alone basis as stock-selection criteria but even more successfully when combined (see Exhibit 5).

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Sustainalytics is an environmental, social, and governance and corporate governance research, ratings, and analysis firm. Morningstar, Inc. acquired Sustainalytics in 2020. Sustainalytics provides ESG risk scores on companies and tracks and categorizes ESG-related controversial incidents on companies. Morningstar uses Sustainalytics' company level ESG analytics to calculate ratings for managed products and indexes using Morningstar's portfolio holdings database.

Sustainalytics' ESG Risk Ratings

Sustainalytics' ESG Risk Ratings are designed to help investors identify and understand financially material ESG risks at the security and portfolio level. The ESG Risk Ratings are 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. ESG Risk Ratings are categorized across five risk levels: negligible, low, medium, high and severe. Ratings scale is from 0-100, with 100 being the most severe.

Economic Moat

The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define excess economic profits as returns on invested capital (or ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (or WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale. Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality no-moat companies will see their normalized returns gravitate toward the firm's cost of capital more quickly than companies with moats.

To assess the direction of the underlying competitive advantages, analysts perform ongoing assessments of the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger; stable where we don't anticipate changes to competitive advantages over the next several years; or negative when we see signs of deterioration. All the moat and moat trend ratings undergo periodic review and any changes must be approved by the Morningstar Economic Moat Committee, comprised of senior members of Morningstar's equity research department.

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Based on a proprietary valuation-driven asset allocation process, our strategies offer investors a range of multi-asset risk- and outcome-based strategies designed to help meet a variety of goals. Also, our separately managed accounts offer concentrated portfolios of our portfolio managers' best ideas. We put more than 35 years of investment experience to work in every portfolio we manage to offer you a better investing experience, because your journey also matters.

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