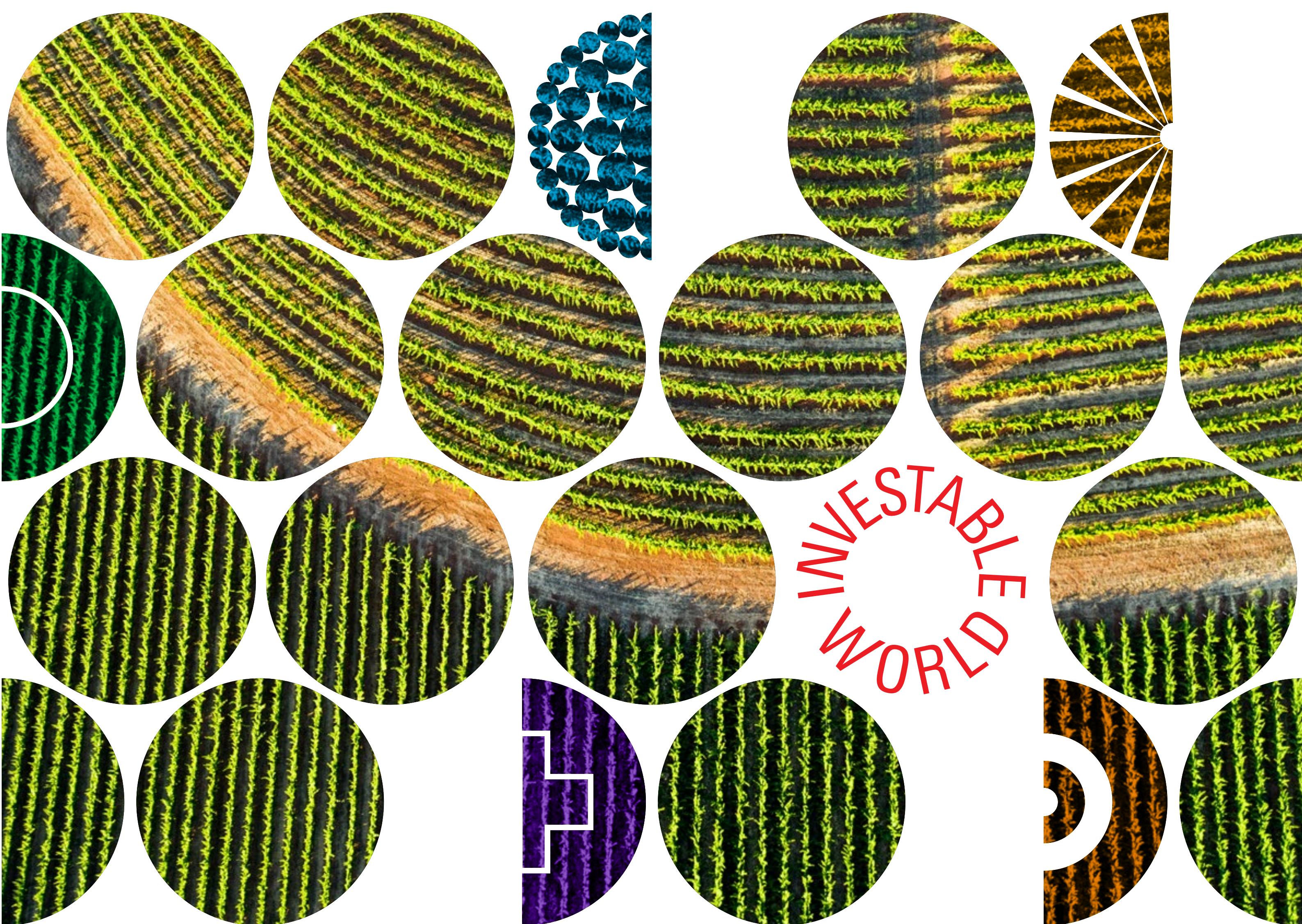
Morningstar's Guide to ESG Risk

How Assessing ESG Risk Can Inform Sustainable Investment Strategies



MORNINGSTAR

Sustainable investing's transition from niche to mainstream over the past decade has brought environmental, social, and governance (ESG) issues to the forefront of the investment process. A growing awareness of the long-term consequences of climate change, coupled with non-climate sustainability risks, has sparked a huge rise in the number of investors who want to assess the impacts of ESG risks on their investments, and the impact of their investments on the planet.

Flows into sustainable funds reflect growing investor interest. According to Morningstar data, assets in European sustainable funds edged towards a historical high in Q1 2023, reaching USD 2.3 trillion at the end of March. This increased the market share of sustainable funds in Europe to 22%. Asset managers are continuing to respond to this transition and changing investor preferences by launching a flurry of climate-aware funds; existing strategies have been tweaked to incorporate sustainable objectives such as reduced exposure to fossil fuels, or increased exposure to renewable energy opportunities, to meet the demands of the market.

As more investors seek to make more sustainability conscious investment decisions, this guide aims to provide an overview of one of the most common sustainable investing approaches: limiting ESG risk. It also introduces Morningstar's ESG data and reporting capabilities that can help to better align end investor preferences with the right sustainable investments.

The Importance of ESG Risk

Today, there is an increasing recognition that ESG factors can have a potential impact 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 labour 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. ESG investors, therefore, seek to avoid these risks by divesting from companies with poor practices, instead choosing best-in-class alternatives during stock selection and portfolio construction.

Regulation Has a Key Part to Play

Increased regulatory interest into sustainability risk has meant companies now have a legal obligation to disclose certain information in their annual reports such as their environmental impact, treatment of employees and communities, and governance practices. Globally, there are multiple approaches with many similarities on how and what must be disclosed by both financial market participants and corporates, but the most advanced body of legislation remains the European Union's Sustainable Finance Action Plan. The 10-point plan introduced in 2018 places extensive ESG reporting obligations on firms through its core components, such as the EU Taxonomy and Sustainable Finance Disclosures Regulation (SFDR).

ESG rating and data providers are also subject to increased regulatory scrutiny. At a global level, the International Organisation of Securities Commissions (IOSCO) issued a set of recommendations in November 2021 on ESG ratings and data to be considered by both local regulators and providers. The recommendations include promoting more transparency regarding the methodologies that ESG ratings and data product providers use in developing their products, managing conflicts of interest, and improving communication without compromising impartiality.

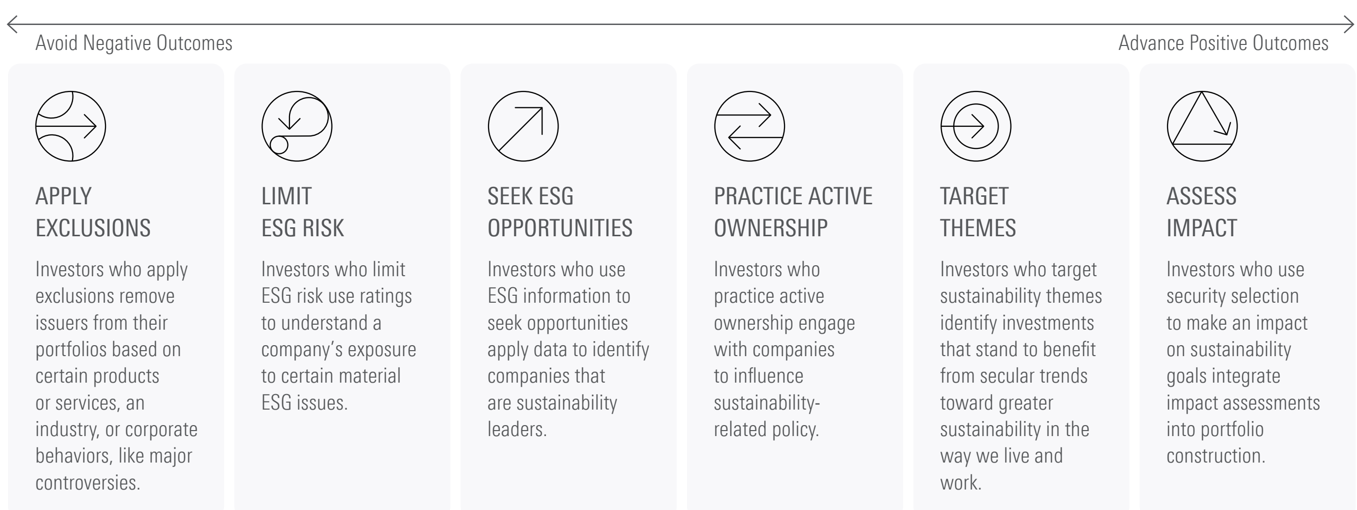
While it is important for firms to be compliant with regulations, increasingly investors and consumers are seeking out companies that go beyond compliance and actively manage and disclose ESG risks and opportunities with a transparent approach to how they do so.

Limiting ESG Risk as an Investment Approach

Sustainable investing encompasses a range of approaches that have continued to evolve over many years. As such, there is no single, distinct investment approach for investors to follow which can result in a confusing, jargon-laden space for many.

Morningstar's Sustainable Investing Framework aims to make things clearer. It provides a straightforward way to understand investor motivations for seeking sustainable investments and outlines the range of activities associated with sustainable investing.

MORNINGSTAR'S SUSTAINABLE INVESTING FRAMEWORK



As shown above, Morningstar has identified six sustainable investment approaches and placed them along a continuum ranging from those that lean more toward avoiding negative outcomes (those toward the left), be they investment or real-world outcomes; to those that lean more toward advancing positive outcomes (toward the right).

Limiting ESG risk as an investment strategy means considering industry-relevant sustainability risks that could materially affect a company's value. 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. It has become a widespread strategy among traditional investments as more investors have come to understand that material ESG issues may reflect hidden risks that traditional analysis may overlook.

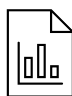
Investor Challenges: Identifying and Understanding ESG Risks

ESG risks are often less tangible and less immediately visible than traditional financial risks. The potential long-term effects of climate change on a company's operations and financial performance, for example, can be difficult to quantify or predict with precision. ESG risks can also vary greatly between different industries and companies making it challenging for investors to compare and evaluate them on a consistent basis.

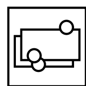
What's more, the sustainable investing universe is expanding and evolving at rapid speed meaning additional material risks continue to present themselves. The Covid-19 pandemic has had a significant impact on the global economy and is a good example of how an unpredictable event such as this can spark a further chain of events affecting multiple geographies and industries. To meet the dramatic increase in demand for online shopping, companies have had to expand their logistics, data servicing systems, and warehouses, in turn increasing their exposure to carbon issues and associated operational costs. From more vehicles to transport goods to more energy to supply warehouses and an overall increase in packaging waste, companies have become more vulnerable to additional ESG risks.

Russia's invasion of Ukraine is another example of this knock-on effect in play – supply chain and logistical risks, reputation risks, and financial risks have all increased for companies operating in the country. The conflict has also had an impact on the transit of natural gas through Ukraine to Europe, which has contributed to price hikes in some countries.

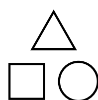
Other challenges include:



Data quality and availability – ESG risk analysis relies on accurate and readily available data. The well-known dilemma of poor-quality data and analytics makes it difficult to verify the consistency, reliability, and comparability of the information that's being assessed. Varying reporting timelines for corporates and asset managers on specific ESG considerations, such as those outlined in the EU Taxonomy for example, adds to the data availability predicament.

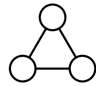


Materiality – Putting ESG risks into context matters. Translating raw non-financial company information (alongside some financial metrics) into structured data to understand the financial materiality of the issues might be easier said than done, but is essential for investor comprehension.



Lack of standardisation – A lack of standardised indicators to compare companies across multiple industries and to analyse portfolio performance adds to the complexity of an already confusing space for many investors and can compound fears of greenwashing.

Short-term focus – ESG risks can be overlooked or ignored by companies and investors who are focused on short-term profits and returns. Many ESG risks, like climate change, can take decades to manifest and their impacts may not be fully understood until it is too late to take effective action.



Interconnectedness – ESG risks are often interconnected and interdependent. Environmental risks can have social and governance impacts, such as increased conflict and displacement of people. Similarly, social risks, such as discrimination and inequality, can have environmental and governance impacts, like reduced economic growth and increased corruption.

Managing ESG Risk in Portfolios

In practical terms, managing ESG risk in a portfolio means taking one or a combination of the actions below. This list is not exhaustive and like all decision making related to investing sustainably, will be guided by an individual investor's priorities and preferences.

"Best-in-Class" Analysis and Screening

Investors can prioritise investments in companies and funds that have strong ESG performance and a demonstrated commitment to addressing ESG risks. Certain companies might be leaders in their industry on a particular ESG issue, or certain funds may be specifically focussed on sustainability concerns. The use of independent ESG ratings, such as those provided by Morningstar, can help to identify top performers in specific ESG areas of interest.

A best-in-class strategy naturally means divesting from companies with poor ESG performance. Investors can filter out companies and funds that do not meet their criteria; an effective way to signal to the company and the market that ESG performance is a top priority.

Engaging with Companies

Investors might choose to exercise their voting right as a shareholder to encourage companies to improve their ESG practices. This might involve voting on shareholder proposals related to ESG issues, or directly communicating with company management about ESG performance concerns.

Diversification

The benefits of diversifying a portfolio are well known. In this case, selecting a range of industries and geographies reduces the risk that a single company or sector will have a significant impact on the portfolio's overall ESG performance.

If we take the renewable energy sector as an example, investing in a range of renewable energy sources rather than one specific technology can help to reduce associated ESG risks. The negative impact on the portfolio if, say solar energy, was to become less economically viable or experience a downturn, would be lessened as the other renewable sources would still be performing well. Similarly, investing across multiple industries can reduce the risk of being negatively affected by an industry-wide crisis, such as a recession.

ESG Risk Assessment Relies on Accurate and Reliable Data

Any of the above approaches 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.

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.

How Morningstar Can Help Identify and Manage ESG Risks

To effectively assess and manage environmental, social, and governance risks within their portfolio companies, investors need access to the right resources that facilitate identification of risks, comparison of companies and industries, and comprehension of the potential magnitude of the risks themselves.

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. Together, Morningstar and Sustainalytics are leading the global sustainable investing landscape with ESG coverage on more than 85,000 funds, 16,300 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 across a number of different workflows including screening, fund selection, and reporting, as well as Morningstar's propriety sustainability ratings.

MORNINGSTAR SUSTAINABILITY RATING™

Sustainability Rating

Corporate Sustainability Contribution	Sovereign Sustainability Contribution
100%	0%
Relative to Category	**Sustainable Investment**
UK Equity Large Cap	Yes

Current Sustainability Scores based on 100% of corporate AUM and - of sovereign AUM. Sustainability Score and Rating as of 30/04/2023. Portfolio as of 30/04/2023. Sustainalytics provides issuer-level ESG Risk analysis used in the calculation of Morningstar's Sustainability Scores. Sustainable Investment mandate information is derived from the fund prospectus.

SUSTAINABILIITY SCORES

Corporate Sustainability Score

Sovereign Sustainability Score

Morningstar Sustainability Rating

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).

MORNINGSTAR© PORTFOLIO CARBON METRICS

No Designation

Morningstar carbon metrics are asset-weighted portfolio calculations based on Sustainalytics' company Carbon Risk Rating. To receive the Morningstar® Low Carbon Designation™, a fund must have a 12-month average Portfolio Carbon Risk Score below 10 and a 12-month average Fossil Fuel Involvement of less than 7% of assets. This signal helps investors easily identify funds that are well-positioned to transition to a low-carbon economy.

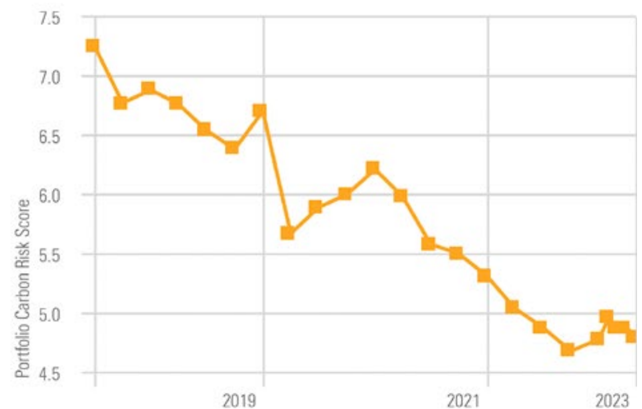
Historical Carbon Risk Score

Historical Fossil Fuel Involvement

FTSE AllSh TR GBP

Miscellaneous Region

MORNINGSTAR© PORTFOLIO CARBON SCORE™ TIME SERIES



Fund ABC

Sustainalytics' ESG Risk Ratings

Sustainalytics' ESG Risk Ratings measure the degree to which a company's enterprise value is at risk driven by ESG factors. The magnitude of a company's unmanaged ESG risks is determined by looking at its exposure, i.e. vulnerability to risk, and its management, i.e. risk mitigating actions.

The risk ratings work by adding up management gaps and unmanageable risks across all material ESG issues.

Sustainalytics Country Risk Ratings

Sustainalytics' Country Risk Ratings assesses countries' prosperity by considering its access to – and management of – natural, human and institutional wealth, which corresponds to our assessment of Environmental, Social and Governance factors in our company ESG ratings.

Investors can use this research to supplement traditional sovereign bond- and macro-economic analyses. The alignment between country and company assessments also simplifies reporting in fixed income portfolios.

Morningstar Carbon Risk Metrics

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.

Company Level Analysis

Morningstar Sustainalytics company level ESG data means that you can drill down into issuer level ESG risk scores using fund look-through capabilitie

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- Start a free trial of Morningstar Direct
  Morningstar's flagship investment and research platform, Morningstar Direct, enables the most comprehensive ESG data set in the industry to be incorporated into research, investment analysis, portfolio construction, strategy analytics and reporting, to create and market quality ESG portfolios and products that align with investor values.
- Discover Morningstar's suite of ESG investing solutions
- Learn more about Sustainalytics ESG Risk Ratings