The Morningstar Sustainable-Investing Framework

Clarifying terms, motivations, approaches, and the role sustainability plays in portfolios

Dec. 2, 2021

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Acknowledgments
The author wishes to thank Catherine Sanders and Jess Liu for their valuable assistance with the paper, Jennifer Gierat for editing and formatting, and John Erdodi for adapting graphics.

Introduction

Sustainable investing has grown significantly in recent years as investors have become increasingly concerned about the many sustainability challenges facing the world today. Assets in sustainable mutual funds have grown to nearly $4 trillion. Assets invested in all types of sustainable strategies now total more than $35 trillion, according to the Global Sustainable Investment Alliance. Investors with more than $120 trillion in assets under management have signed the United Nations-backed Principles for Responsible Investment, committing themselves to the adoption and promotion of sustainable investing.[1]

The growth of sustainable investing reflects investor concerns about the impacts of climate change and other environmental, social, and corporate governance issues on their investments and about the broader impact of their investments on the world. These concerns have been triggered by an onslaught of systemic risks that have emerged so far in the 21st century, which have led to calls for a more sustainable version of global capitalism that encourages a long-term stakeholder-centric approach to corporate management. This approach is finding especially high levels of support among younger generations.[2]

The Rise of Systemic Risks

The first decades of the 21st century have been marked by rising systemic risks. In a highly complex and interconnected world, sudden unexpected events like the 2008 financial crisis and the global pandemic that began in 2020 threaten stability and prosperity. The serious ongoing and interrelated problems of climate change, biodiversity loss, and growing inequality may have even longer-lasting effects as they reach crisis proportions. The growth of sustainable investing reflects an increased concern from investors about the impact of systemic risks on their portfolios and about how their investments may contribute to solving some of these problems.[3]

1 Bioy, H., Jmili, S., Stankiewicz, A., et al. 2021. "Global Sustainable Fund Flows: Q3 2021 in Review." https://www.morningstar.com/lp/global-esg-flows; Global Sustainable Investment Alliance. 2021. "Global Sustainable Investment Review." http://www.gsi-alliance.org; Principles for Responsible Investment. Q4 2021. "PRI Update." P. 31. https://www.unpri.org/download?ac=14962.

2 Henderson, R. 2020. *Reimagining Capitalism in a World on Fire.* (New York: Public Affairs); Polman, P., & Winston, A. 2021. *Net Positive: How Companies Thrive by Giving More Than They Take* (Boston: Harvard University Review Press); Morgan Stanley Institute for Sustainable Investing. 2021. "Sustainable Investing Sentiment Weathers Economic Uncertainty." Oct. 27, 2021. https://www.morganstanley.com/ideas/sustainable-investing-sentiment-covid-19.

3 Burckart, W., & Lydenberg, S. 2021. *21st Century Investing: Redirecting Financial Strategies to Drive System Change*. (Oakland, CA: Berrett-Koehler).

The Failure of Shareholder Primacy and Short-Termism

The dominant investment paradigm of the past 40 years, especially in the United States, has been based on the belief that the purpose of the corporation is the narrow pursuit of profits for shareholders. That notion has been supported, if not enforced, by investors demanding the pursuit of shareholder value through quarter-by-quarter growth regardless of the effects on other stakeholders, such as workers, customers, and communities. But in an era of increased systemic risk and enhanced transparency, it is becoming difficult for companies to always prioritize shareholders over other stakeholders. Investors themselves are shifting toward a longer-term view that is aligned with stakeholders' sustainability concerns, viewing it as an important course correction that can help businesses create long-term value for themselves and society.[4]

The Sustainability Generation(s)

Millennials, the generation born between 1980 and 1996, are beginning to take their place as investors and investment decision-makers. They also stand to inherit trillions in wealth from their baby boomer parents. In survey after survey, millennials have indicated strong support for sustainable investing.[5] Millennials, along with the younger Gen Z cohort, are likely to provide a strong base of investor support for sustainable investing far into the future.[6]

A Framework for Understanding Sustainable Investing

When would-be sustainable investors get down to the business of making investment decisions, they can face a confusing mix of terms and approaches. Because the field has grown rapidly, it lacks consensus on terminology and reflects a variety of ways to apply a sustainability lens to an investment process. Indeed, sustainable investing is not defined by a single, distinct investment approach. Rather, it consists of a range of approaches that has been evolving over the past decade or so. Asset managers and wealth managers have adapted these approaches in various ways to their existing investment processes. These developments have proceeded largely without regulatory guidance, although regulators in the European Union have taken some recent steps in the direction of clarifying terms and the scope of the field. As a result, investors have been left largely on their own to figure out the many facets of sustainable investing.

The Morningstar Sustainable-Investing Framework addresses the critical need for clarity in the field. Our framework MAP describes sustainable investing in terms of *motivations, approaches,* and *portfolios*. It provides a straightforward way to understand investor motivations for seeking sustainable investments and outlines the range of activities associated with sustainable investing.

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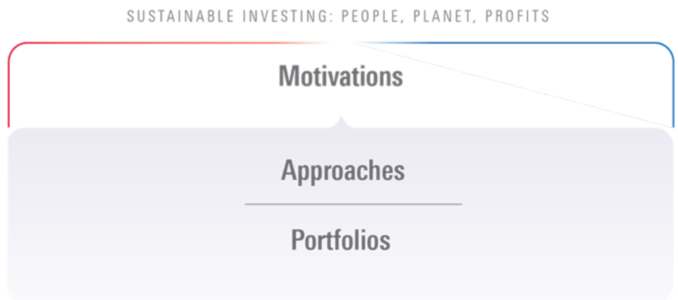
4 Business Roundtable. 2019. “Statement on the Purpose of a Corporation.” https://s3.amazonaws.com/brt.org/BRT-StatementonthePurposeofaCorporationJuly2021.pdf; FCLT Global. “Our Mission.” https://www.fcltglobal.org/mission/.

5 Natixis. 2021. “Values Alignment Is Only the Tip of the Iceberg for ESG: Six Insights From the 2021 Natixis Global Survey of Individual Investors.” https://www.im.natixis.com/us/research/esg-insights-from-2021-individual-investors-survey; Morgan Stanley Institute for Sustainable Investing. 2021. "Sustainable Signals: Individual Investors and the COVID-19 Pandemic.” https://www.morganstanley.com/assets/pdfs/2021-Sustainable_Signals_Individual_Investor.pdf.

6 Choi, A. 2018. “How Young Investors Could Reshape the World.” Morgan Stanley Institute for Sustainable Investing. Jan. 24, 2018. https://www.morganstanley.com/access/why-millennial-investors-are-different. Duggan, C. 2021. “Why You Don’t Have to Convince Gen Z to Invest Sustainably.” Aug. 6, 2021. https://www.morningstar.com/articles/1052512/why-you-dont-have-to-convince-gen-z-to-invest-sustainably.



Defining Sustainable Investing

Let's begin with a definition: *Sustainable investing seeks to deliver competitive financial results, while also driving positive environmental, social, and corporate governance outcomes.*

First and foremost, sustainable investing is investing. For most investors, in most instances, and across most approaches, sustainable investing seeks competitive returns. There is nothing concessionary about this intent when investing in public stocks and bonds. But it also recognizes that investment returns are part of a bigger picture that includes concerns about people and planet, as well as profits.

Sustainable investing differs from traditional investing in two important ways.

First, it aims to improve traditional investment analysis by incorporating ESG assessments to give investors a more complete understanding of an investment. ESG assessments can give investors an early warning of risks and opportunities before they materialize financially. They can also provide insight into intangible assets, which make up a large portion of the value of many public companies today. By one estimate, intangible assets now command 90% of the market value of companies in the S&P 500.[7] ESG assessments can help identify companies that are more likely to thrive, or suffer, in a low-carbon economy as well as those that are more likely to prosper as sustainability becomes increasingly important to more stakeholders. ESG assessments may be incorporated into a wide range of investment strategies.

Second, in addition to assessing the financial materiality of ESG issues on an investment, sustainable investing considers the broader systemic impacts of the investments themselves. This is sometimes called *double materiality* and is useful to investors and other stakeholders who wish to drive positive ESG outcomes in addition to investment returns.[8] The two ideas are linked inasmuch as improving a company's performance on material ESG issues may not only improve company financial performance but also may lead to positive outcomes more broadly for people and planet. Sustainability-focused investors can influence how public companies address climate change and direct capital to projects that are needed to finance the transition to a just, low-carbon economy. They can also encourage public companies to adopt a more stakeholder-oriented, long-term approach to their business.

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7 Ocean Tomo. 2021. "Intangible Asset Market Value Study." https://www.oceantomo.com/intangible-asset-market-value-study/.

8 Adams, C., Alhamood, A., He, X., et al. 2021. "The Double Materiality Concept: Application and Issues." Global Reporting Initiative. May 2021. https://www.globalreporting.org/media/jrbntbyv/griwhitepaper-publications.pdf.

What's in a Name?

While *sustainable investing* is a common umbrella term, others are also used, such as *responsible investing*, *ESG investing*, and *impact investing*.

Responsible investing is an older term, shortened from *socially responsible investing*, or *SRI*, which was used in the 1980s and 1990s to describe the forerunner to today's sustainable investing. SRI did not have the benefit of using ESG data, which was in its infancy, and instead mostly relied on exclusions and limited shareholder engagement. Neither did it attract much investor interest because sustainability issues did not have the urgency they have today, but SRI was still a way for investors to align their portfolios with their values. References to *responsible investing* today typically refer to the same set of practices we call *sustainable investing*.

The other two terms—*ESG investing* and *impact investing*—are also often used interchangeably with *sustainable investing* (and *responsible investing*). We think *ESG* is better suited to describe the issues that are of concern to these investors and the related metrics that have become so widely used. Similarly, *impact* is better suited to describe an approach to sustainable investing that emphasizes the broader effects of investments on people and planet.

Motivations for Sustainable Investing

A range of ESG-related concerns are motivating many people to consider sustainability in the decisions they make. Across multiple facets of their lives, people are considering the systemic impacts of their choices, from consumer and lifestyle choices to longer-term decisions about where to live and work. It only follows that those with sustainability concerns who are fortunate enough to be investors or investment decision-makers also want to apply a sustainability lens to their investments.

Like all investors, they seek competitive returns to help them reach their financial goals, but they also believe that considering sustainability factors can enhance their investment results while also achieving better societal outcomes.

To improve investments, sustainability assessments can help control risk and identify new investment opportunities. To improve the world, an emphasis on sustainability impacts can help investors avoid contributing to negative outcomes, which are often linked to emerging systemic risks, and help advance positive outcomes.

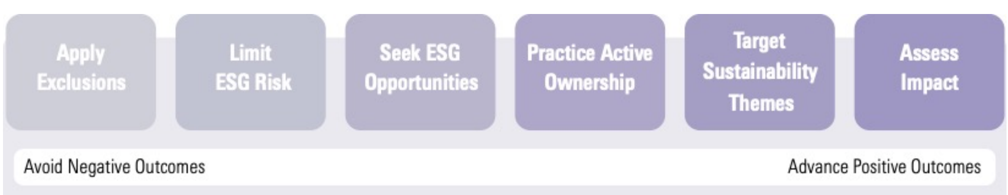
Having an interest in sustainable investing does not imply that the investor prefers to achieve better sustainability outcomes at the expense of investment performance. As the experience of sustainable investing among institutional investors has demonstrated, applying a sustainability perspective to investments need not require such a trade-off. Simply put, people who are concerned about sustainability seek to achieve both through their investments. It only seems logical to consider ESG issues in ways that might improve their investments, by reducing risk or by uncovering promising investment opportunities. The tremendous growth of integrating ESG into investment decisions globally further reinforces this view.

More broadly, because of their concern about sustainability challenges, these investors also want to do what they can to help solve them. They want their investments to address their real-world impact by avoiding negative outcomes or seeking positive outcomes. Incorporating a sustainability lens, of course, does not guarantee either better investment performance or better outcomes for people or planet. In fact, no investment approach can guarantee better investment performance, and traditional approaches do not even attempt to generate better outcomes for people and planet. But the hallmark of sustainable investing is that it seeks to do both.

Simply put, sustainable investors are motivated by their sustainability concerns. To be sure, some investors may prefer to focus their sustainability concerns more on their investment outcomes than on societal outcomes. Others may prefer to maximize the broader impact of their investments. But most will prefer both.

Sustainable-Investment Approaches

Sustainable investing is best understood not as a single, unified investment method but rather as a range of possible approaches. To think otherwise can lead to investor confusion and a mismatch between expectations and outcomes. We have identified six sustainable-investment approaches and placed them along a continuum ranging from those that lean more toward avoiding negative outcomes, be they investment or real-world outcomes, to those that lean more toward advancing positive outcomes. Investors may use any of these approaches or a combination.



Apply Exclusions

This approach refers to excluding sectors, companies, or practices that investors consider harmful or not in alignment with sustainability criteria. Exclusions may range from traditional "sin" stocks (alcohol, tobacco, gambling) to guns and controversial weapons to business ethics (violators of the United Nations Global Compact or companies engaged in major controversies). Many investors today exclude the fossil fuel industry from their portfolios, either entirely or by excluding practices with the worst climate and environmental impacts (such as thermal coal extraction and use, Arctic exploration, or tar sands drilling). Using company ESG metrics, investors can avoid companies that are poor sustainability performers, either overall or in certain areas of emphasis. Portfolio optimization techniques can be used to reduce the impact of exclusions on a portfolio's tracking error to a market benchmark.

Limit ESG Risk

Investors can address sustainability concerns by taking steps to limit ESG risks. 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. Investors may price ESG risk into valuation models or seek to avoid investments with a certain level of ESG risk regardless of valuation. This approach has become widespread among traditional investments as more investors have come to understand that material ESG issues may reflect hidden risks that traditional analysis may overlook. This is especially true of risks associated with climate change.

Seek ESG Opportunities

Investors may also use ESG information to identify companies that are sustainability leaders or those seeking to improve their ESG practices to build competitive advantages. This approach includes what is sometimes called *ESG best in class* or *positive screening* based on ESG ratings. An ESG best in class approach typically favors companies with better ESG ratings on a sector or industry basis. It is a subset of positive screening, which more generally builds portfolios around companies with better ESG ratings. Some investors look for companies with so-called *ESG momentum* that are improving their overall performance on ESG metrics in ways that will enhance their financial performance. Finally, investment approaches focused on quality growth may use ESG performance as a nonfinancial indicator of quality that contributes to a company's competitive advantage, or economic moat.

Practice Active Ownership

Investors may seek positive ESG outcomes via their active ownership, or stewardship, activities, made possible primarily because asset managers are shareholders in public companies. These activities may include direct engagement with companies on ESG issues, proposing ESG-related shareholder resolutions, supporting ESG issues through proxy voting, participating in ESG-related investor coalitions, and advocating for public policy measures that address sustainability issues.

Through these activities, investors communicate not only their specific sustainability concerns but also encourage corporate leaders to focus more broadly on stakeholders and the long term. As corporate managements come to understand that their investor base consists of a growing proportion of sustainability-minded investors, they become more likely to adjust corporate strategy in ways that support stakeholder capitalism.

Target Sustainability Themes

Thematic investing focuses on identifying long-term societal trends and the investments that stand to benefit from those trends. In targeting sustainability themes, investors seek to take advantage of opportunities created as the world moves toward greater sustainability and transitions to an economy driven by renewable energy. Sustainability-themed investments often use the 17 United Nations

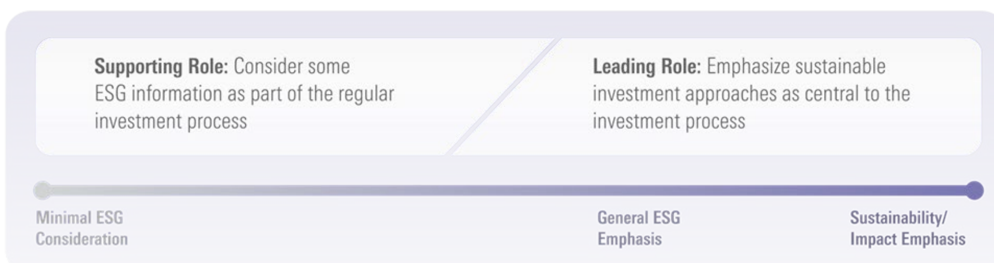
Sustainable Development Goals to identify specific themes to pursue.[9] Such themes may be related to climate action or other environmental concerns, like healthy ecosystems and natural resource security, or they may be related to social issues, like human development, including diversity, equity, and inclusion, or basic needs.

Assess Impact

Investors may wish to integrate impact assessments into security selection and portfolio construction. Fixed-income investors, for example, may consider a bond's use of proceeds, focusing on bonds that finance projects that benefit people and planet. Equity investors may consider whether a company's products and services, as well as its policies and behaviors, support or detract from the U.N. goals, which many investors and companies use as an impact framework. At the portfolio level, investors may assess the overall impact of their portfolio holdings in relation to a goal or benchmark. Impact reporting provides transparency for investors into the societal outcomes an investment has created or encouraged and which social causes an investment is aligned with.

Sustainable-Investment Portfolios

Most of the time, sustainable investors combine these approaches, as they are interrelated and largely complementary. It is not uncommon for an investment strategy in which sustainability plays a leading role to use several, or even all, of these approaches to varying degrees.



An investment portfolio can be defined in terms of a particular strategy or fund, or an end investor's set of investments. Portfolios can be assessed in terms of whether and to what extent they use any of the six sustainable-investment approaches. In any given portfolio, sustainable-investment approaches may play no role, a supporting role, or a leading role. While sustainable-investment approaches play no role for many portfolios, they contribute in a supporting role to a growing number of portfolios, mainly through the use of ESG information to limit ESG risk, by practicing active ownership, or the use of limited exclusions. Portfolios in which sustainability plays a leading role usually combine several, and sometimes all, of these approaches.

For end investor portfolios that consist of multiple underlying investment strategies or funds, the framework can be used to target exposure to the investor's preferred approaches and can be used to evaluate how much exposure an investor has to each approach.

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9 United Nations Department of Economic and Social Affairs. "The 17 Goals." https://sdgs.un.org/goals.

The Framework in Action

The framework can help individual investors, financial advisors, due-diligence teams, and asset managers develop a clear understanding of sustainable investing. Regardless of the audience, leveraging the framework to uncover motivations and better understand the range of possible approaches can help minimize confusion and ensure alignment between investor expectations and outcomes.

It can help individual investors determine whether sustainable investing is right for them.
First, by providing an overall definition and a description of the range of investment approaches that are used to address sustainability concerns within investment portfolios, the framework can help individual investors develop a better, more decision-useful understanding of the field. Second, the framework can help people to examine their own motivations for wanting to invest with a sustainability lens and to determine how far they want to take it in their portfolios. Third, the framework can be used to analyze investment products in terms of the specific sustainable-investment approaches they employ and of their overall commitment as a sustainable investment. This can help individual investors construct their portfolio in ways that align with their preferences.

The framework can be especially helpful to wealth managers and financial advisors. By adopting its overall definition of sustainable investing and using the descriptions of the sustainable-investment approaches, advisors can more easily convey to their clients the meaning and scope of sustainable investing. The framework's discussion of investor motivations can help advisors talk about sustainable investing with their clients and understand how suitable a sustainable-investment portfolio is for them. The framework's treatment of approaches and portfolios can help advisors match investments with investor preferences, helping ensure their clients' expectations are met.

The framework can also be helpful to intermediaries who conduct due diligence on investments. They can identify which, if any, sustainable-investment approaches are being employed by a given investment manager. They can use the language of the framework to more clearly determine the specific approaches being employed and to help determine whether sustainable-investment approaches play no role, a supporting role, or a leading role in an overall investment portfolio. These concepts can be used to compare investments.

Asset managers can use the framework to help clarify the purpose and scope of their sustainable-investing efforts. The framework can help them identify the role that sustainable-investment approaches play in every strategy they offer to investors. The framework can be used to distinguish among their strategies those in which sustainable-investment approaches play a leading role, a supporting role, or no role. Such clarity will go a long way toward enhancing investor understanding of their investments and reducing gaps between expectations and outcomes.

The framework neatly defines and summarizes sustainable investing, providing investors of all types a common reference point for understanding its scope and variety. It can be used to better understand investor motivations, identify the most appropriate sustainable investments for a given investor, and evaluate sustainable funds and portfolios.

The Framework Can Help…

Individual Investors

Examine their own motivations for wanting to invest with a sustainability lens

Define sustainable investing and understand the range of approaches

Determine how to build sustainability considerations into their own investments

Financial Advisors

Understand their clients' motivations for wanting sustainable investments

Communicate the meaning and scope of sustainable investing to their clients

Create and manage appropriate sustainable-investing portfolios for their clients

Due Diligence Intermediaries

Define the scope of sustainable investing

Determine the specific approach or combination of approaches employed in sustainable investments and compare investments on that basis

Determine the extent to which sustainable-investing approaches inform any strategy or any overall investor portfolio

Asset Managers

Clarify the purpose and scope of their sustainable-investing activities

Identify the role that sustainable-investment approaches play in every strategy

Identify leading role sustainable strategies and supporting role sustainable strategies among their offerings

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