How Much Do Differences in ESG Ratings Matter to Investors?

Comparing Morningstar Indexes' ESG benchmarks to MSCI peers highlights some differences but even more similarities.

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"Dangerous rubbish." "Societal placebo." "Little more than emojis." Environmental, social, and governance research and ratings have provoked an arms race of creative insults in 2021—and the year's not over yet. One popular criticism focuses on the "inconsistent" views of ESG research providers, as if investment analysts coming to different conclusions was novel.[1] Does the fact that Apple is viewed as a growth stock by some and a value stock by others discredit valuation research?

To investigate how meaningful ESG ratings divergence is to investors, we compared Morningstar indexes powered by Sustainalytics' company-level ESG research to peers that incorporate ESG research from MSCI. We looked at both equity and bond benchmarks across four geographies: the United States, emerging markets, the eurozone, and Canada. The Sustainalytics company-level research powering Morningstar indexes and MSCI's ESG research both focus on financial materiality, or ESG issues that have the potential to affect corporate value, so ratings divergence cannot be attributed to different objectives. Returns-based and holdings-based analysis of benchmarks powered by different research providers can illuminate the degree of ESG research divergence and its implications for investors.

Among our findings:

- The Morningstar US Sustainability Index's constituents overlap by roughly two thirds with an exchange-traded fund tracking a comparable MSCI index. Just 59 basis points separate the indexes' five-year annualized returns.
- The Morningstar US Sustainability Index does not currently include Alphabet, Tesla, or Johnson & Johnson, but these companies do appear in an ETF tracking a comparable MSCI index.
- The Morningstar Emerging Markets Sustainability Index overlaps by roughly two thirds with an ETF tracking a comparable MSCI index. Half a basis point separates the two indexes' five-year returns.
- The Morningstar Emerging Markets Sustainability Index does not currently include Alibaba, China Construction Bank, or Gazprom, but these firms do appear in an ETF tracking a comparable MSCI index.
- The Morningstar Eurozone Corporate Bond Sustainability Index does not contain debt issued by Société Générale, Eni, or Bouygues, but these issuers do appear in an ETF tracking a comparable MSCI index.
- The Morningstar Canada Corporate Bond Sustainability Index does not contain debt issued by Rogers Communications or Brookfield Infrastructure Partners, but these issuers do appear in an ETF tracking a comparable MSCI index.

1 See, for example: Shifflett, S. 2021. "How the WSJ Compared ESG Ratings." *The Wall Street Journal*. Aug. 10, 2021. https://www.wsj.com/articles/how-the-wsj-compared-esg-ratings-11628608473 and Berg, F., Kolbel, J., and Rigobon, R.. 2020. "Aggregate Confusion: The Divergence of ESG Ratings." Massachusetts Institute of Technology Sloan School of Management. May 17, 2020. https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID3603032_code3021888.pdf?abstractid=3438533&mirid=1&type=2

ESG Risk Ratings Focused on Materiality

Sustainable investing is still described using terms like *responsible*, *ethical*, and *doing good*—often said to be appropriate for those who want to "align their portfolios with their values." While values remain an aspect of sustainable investing, the field has evolved considerably in recent years, and mischaracterizations abound.

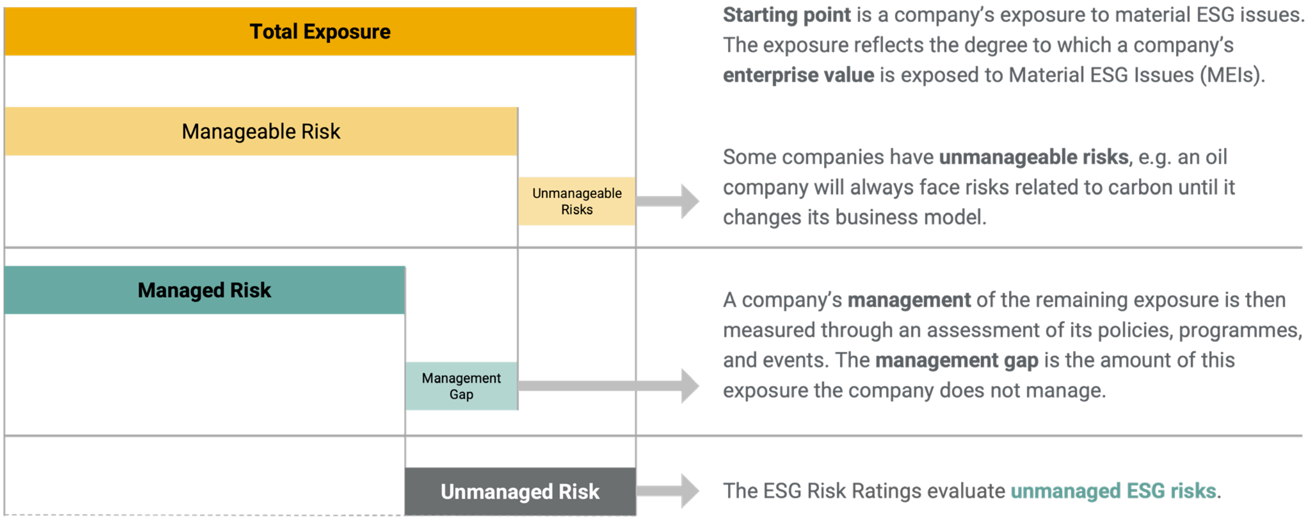
ESG issues are increasingly considered material financial risks. As stakeholder capitalism becomes a more mainstream concept, businesses face rising expectations—not just from shareholders but also consumers, communities, and employees—to address sustainability challenges. Issues like climate change, diversity, and business ethics are seen to have an impact on enterprise value. The CFA Institute "now encourages all investment professionals to consider ESG factors," viewing their integration as "consistent with a manager's fiduciary duty to consider all relevant information and material risks in investment analysis and decision-making."

In a joint statement, some of the worlds' largest asset owners, Japan's Government Pension Investment Fund, the United Kingdom's USS Investment Management, and the California State Teachers' Retirement System, wrote, "Asset managers that only focus on short-term, explicitly financial measures, and ignore longer term sustainability-related risks and opportunities are not attractive partners for us."

Sustainalytics, a Morningstar company and leading global provider of ESG research and ratings, serves investors focused on such risks and opportunities. The Sustainalytics ESG Risk Rating, its flagship analytic, assesses firms' exposure to and management of financially material ESG risks.[2] Key ESG issues and risk exposures vary and can be mitigated by a company's management practices. Risk ratings are absolute, not relative, and are therefore comparable across sector and industry. Roughly 13,000 companies are rated globally.

2 For a full discussion of the rating methodology, see https://connect.sustainalytics.com/esg-risk-ratings-methodology

Exhibit 1 Sustainalytics ESG Risk Rating



Source: Sustainalytics.

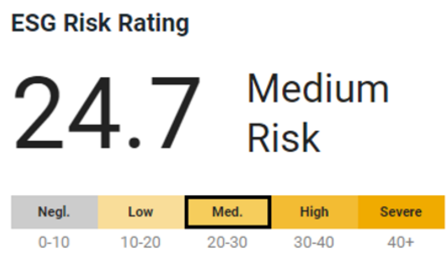
Foundational to the ESG Risk Rating are 20 material ESG issues, or MEIs, that Sustainalytics has identified as capable of affecting a company's value. Examples include:

- Occupational health and safety
- Product governance
- Data privacy and security
- Human rights—supply chain

Exposure to MEIs varies by industry, subindustry, and company. Data privacy, for example, is more critical for a bank than it is for a mining company, for which health and safety concerns are paramount. Product governance is especially germane to pharmaceuticals companies, while human rights in a supply chain is an issue faced by manufacturers.

The ESG Risk Rating is assigned on a scale of 0-100 that is converted into five buckets: (0-10 = Negligible, 10-20 = Low, 20-30 = Medium, 30-40 = High, 40+ = Severe).

Exhibit 2 Sample Sustainalytics ESG Risk Rating

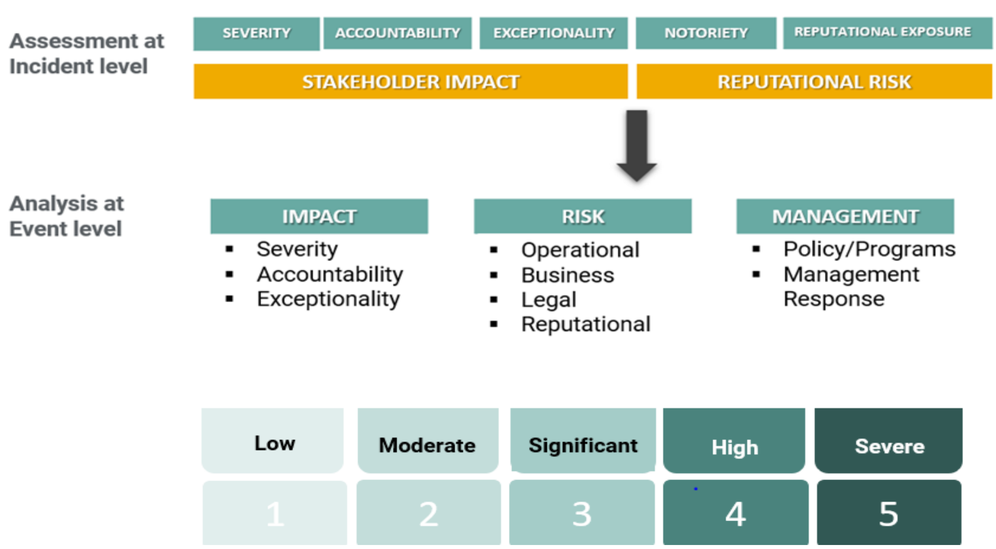


Source: Sustainalytics.

ESG controversies, incidents with material impact, also influence the rating. This runs counter to another misperception about ESG research—that it is a "box-ticking" exercise that rewards companies that make the right disclosures and manage their corporate social responsibility messaging effectively. Sustainalytics' controversy research focuses on actions, not words.

A company with serious ESG controversies will receive a lower management score. The Controversy Rating is expressed on a five-point scale, with 1 representing Low and 5 Severe.

Exhibit 3 Sustainalytics Controversy Rating



Source: Sustainalytics.

MSCI, another leading global provider of ESG research, describes its ESG Rating, which is also focused on materiality, as:[3]

> "*...designed to measure a company's resilience to long-term, industry material environmental, social and governance (ESG) risks. We use a rules-based methodology to identify industry leaders and laggards according to their exposure to ESG risks and how well they manage those risks relative to peers. Our ESG Ratings range from leader (AAA, AA), average (A, BBB, BB) to laggard (B, CCC).*"

Indexing for Sustainability

Morningstar has brought to market a range of index families based on Sustainalytics' company-level data and ratings. This paper will examine two foundational families: the Morningstar Global Sustainability Index Family (equities) and the Morningstar Corporate Bond Sustainability Indexes.[4] Both sets of indexes rely on the Sustainalytics ESG Risk Rating for their core selection criteria.

The Morningstar sustainability indexes launched in 2016 and are intended to serve as replacements for traditional broad equity market benchmarks with significantly lower ESG risk.

Exhibit 4 Morningstar Sustainability Indexes (Equity)

Broad Regional Markets	Developed Markets	Emerging Markets	Single Country
Global Markets	Developed Markets ex-US	Emerging Markets	United States
Global Markets ex-US	Developed Europe	Emerging Americas	Japan
Asia	Developed Markets ex-North America		United Kingdom
Asia ex-Japan			Germany
Asia Pacific			Canada
Asia Pacific ex-Japan			Australia
Europe			India
Eurozone			
Nordic			

Source: Sustainalytics.

The indexes are drawn from the large and mid-cap segments of their equivalent Morningstar equity index. After excluding companies involved with tobacco, controversial weapons, and civilian firearms, as well as companies with serious ESG controversies according to Sustainalytics, the indexes select companies in order of their Sustainalytics-assigned ESG Risk Rating until 50% coverage of the parent index is reached by market capitalization. (The Morningstar US Large-Mid Index is the parent of the Morningstar US Sustainability Index, for example.) Sector and regional weights are kept within 2 percentage points of parent index weight. Constituents are weighted by market capitalization.

3 See MSCI's website: https://www.msci.com/our-solutions/esg-investing/esg-ratings

4 For a comprehensive discussion of the indexes, refer to their construction rules and other documentation posted on the Morningstar Indexes' website: https://indexes.morningstar.com/

Exhibit 5 Morningstar Sustainability Indexes (Equity)

Investable Universe	Sustainability Exclusions	Security Selection	Construction	
• Parent Large-Mid Cap Index (90% market cap coverage)	• Controversy rating of High or Severe • Greater than 50% exposure to tobacco • Production of controversial weapons • Manufacturing and sale of civilian firearms • Manufacturing and sales of small arms components	• Select 50% of parent market capitalization, by lowest ESG Risk Rating	• Region/sector weight constraints at +/- 2 percentage points of parent • 10% individual security weight • 5-10-40 capping	Morningstar Sustainability Index

Source: Morningstar Indexes.

The Morningstar Corporate Bond Sustainability Indexes can be considered fixed-income equivalents of the equity benchmarks. The indexes aim to deliver a similar risk-return profile to their parent indexes, with significantly lower ESG risk.

Exhibit 6 Morningstar Corporate Bond Sustainability Indexes

Index
Global
U.S.
Canada
Eurozone
U.K.

Source: Morningstar Indexes.

The bond indexes exclude companies with Severe ESG Risk Ratings and apply the same product involvement exclusions as their equity counterparts. To achieve marketlike exposure, all securities in the respective parent corporate bond index are divided into 27 peer groups based on common bond characteristics:

- Sector: industrial, financial, or utility.
- Tenor: short, one to five years; intermediate, five to 10 years; and long, 10-plus years.
- Credit quality: AAA/AA, A, and BBB.

Eligible securities are ordered within each peer group in the following sequence:

- ► Ascending order of ESG Risk Ratings (lower scores reflect less risk).
- ► Descending order of par value outstanding.

Securities are selected in this order until the cumulative market value of each peer group reaches 50% of the market value of the parent index. Therefore, the number of index constituents varies.

Exhibit 7 Morningstar Corporate Bond Sustainability Indexes

Investable Universe	Sustainability Screen	Security Selection	Construction	
• Parent Corporate Bond Index	• Severe ESG Risk • Controversy rating of High or Severe • Greater than 50% exposure to tobacco • Production of controversial weapons • Manufacturing and sale of civilian firearms • Manufacturing and sale of small arms components	• Divide eligible constituents into 27 mutually exclusive groups based on sector, tenor, credit quality • Order securities in each group by 1) Ascending order of ESG Risk Rating and 2) Descending order of par value outstanding	• Select 50% parent market capitalization, by lowest ESG Risk Rating	Morningstar Corporate Bond Sustainability Index

Source: Morningstar Indexes.

MSCI ESG Leaders Indexes are methodologically similar to the Morningstar sustainability indexes. According to a Morningstar research report on an ETF tracking the MSCI USA Extended ESG Leaders Index:

> *"The strategy employs full replication to track the MSCI USA Extended ESG Leaders Index. This market-cap-weighted portfolio screens for companies with the best ESG scores from the MSCI USA Index, which captures 85% of the investable U.S. market. The index requires a minimum MSCI ESG rating and controversy score and excludes companies involved in controversial businesses. Companies with ties to civilian firearms and controversial and nuclear weapons face stricter screen. The remainder of exclusions are based on the amount of revenue firms derive from these businesses. The index further enhances its ESG focus by including just the top 50% of eligible securities from each sector by ESG rankings. This approach guarantees best-in-class ESG metrics for the portfolio while accurately representing the makeup of the broader market. The resulting portfolio avoids unintended sector tilts, an issue that ESG strategies often encounter. However, this also means the index will include exposures to more controversial sectors, which might not be suitable for investors with strict ESG screens that require complete exclusion of fossil fuel companies, for instance."*[5]

5 Tran, Lan Anh. 2021. "A Broad-Market Portfolio for Socially Conscious Investors." Morningstar. March 16, 2021. https://www.morningstar.com/etfs/xnas/susl/analysis

On the bond side, the story is similar. According to a Morningstar research report on a corporate bond-focused ETF incorporating MSCI research:

> *"The fund relies on MSCI's ESG ratings. They reflect an assessment of how exposed each issuer is to ESG risks and opportunities that could be relevant to their long-term financial performance and how well it is managing those risks relative to its sector peers. This sector-relative approach helps mitigate unintended bets and improve the efficacy of the ratings. To be eligible for the portfolio, the corporation or sovereign entity must receive an average or higher ESG score. Issuers engaged in certain business lines (including tobacco, firearms, gambling, and alcohol) are excluded."*[6]

Comparing ESG Research on U.S. Equities

The Morningstar US Sustainability Index is intended to serve as a broad equity market benchmark. It offers market-cap-weighted exposure to ESG leaders within each sector, representing half of the starting universe. Comparing the index's constituents to an ETF tracking the MSCI USA Leaders Index demonstrates that shared stock holdings represent 66% of index weight. Of the Morningstar index's top 20 constituents, 13 also feature in the MSCI index.

Exhibit 8 Morningstar's US Sustainability Index Highlights Many of the Same Companies as a Peer

Morningstar U.S. Sustainability Index	ETF Tracking MSCI USA Leaders Index
Microsoft Corp	Microsoft Corp
Apple Inc	Alphabet Inc Class A
NVIDIA Corp	Alphabet Inc Class C
Berkshire Hathaway Inc Class B	Tesla Inc
Visa Inc Class A	NVIDIA Corp
UnitedHealth Group Inc	Johnson & Johnson
The Home Depot Inc	Visa Inc Class A
Procter & Gamble Co	The Home Depot Inc
The Walt Disney Co	Procter & Gamble Co
PayPal Holdings Inc	The Walt Disney Co
Adobe Inc	Mastercard Inc Class A
Netflix Inc	Adobe Inc
Salesforce.com Inc	Salesforce.com Inc
Comcast Corp Class A	Cisco Systems Inc
Cisco Systems Inc	Thermo Fisher Scientific Inc
Thermo Fisher Scientific Inc	Verizon Communications Inc
Verizon Communications Inc	Intel Corp
PepsiCo Inc	Coca-Cola Co
Accenture PLC Class A	PepsiCo Inc
Costco Wholesale Corp	Accenture PLC Class A

Source: Morningstar Direct. Constituent data as of Sept. 30, 2021.

6 Kosciulek, N. 2021. "Exposure to the Investment-Grade Bond Market With a Subtle ESG Tilt.". April 21, 2021. https://www.morningstar.com/etfs/arcx/eagg/analysis

To explore some of the differences between the two indexes, consider Sustainalytics' assessments for three constituents that do not currently feature in the Morningstar US Sustainability Index but that appear in the equivalent MSCI index:

- Alphabet. The parent company of Google was previously included in Morningstar's sustainability indexes but was removed after Sustainalytics assigned it a Controversy Rating of High (4 on a 5-point scale). According to Sustainalytics: "Google remains the subject of multiple anti-competitive allegations and investigations globally. It has received over USD9bn in penalties for antitrust behavior from the European Commission (EC)…As of September 2019, both federal and state-level regulators in the US were examining the company's business practices, contributing to additional uncertainty as to the future risk profile of the company on this issue. Sustainalytics will continue to monitor this controversy, including the expanding geographic footprint of regulatory probes and the company’s response. We will review our rating in the event of significant developments, including, but not limited to, regulatory sanctions, legal decisions or settlements, and clarity on the efficacy of mitigation measures being implemented by the company to address anti-trust concerns." Alphabet receives an MSCI ESG Rating of BBB as of October 2021.

- Tesla. Many may scratch their heads that the world's most scaled electric vehicle manufacturer is not an ESG leader, but that reflects a superficial understanding of sustainable investing. Even though Tesla's electric cars do not produce carbon emissions, Sustainalytics assigns Tesla an ESG Risk Rating of Medium based on a holistic assessment across environmental, social, and governance criteria. Why? First, Tesla's manufacturing operations are energy-intensive. Second is the area of product governance. Tesla's self-driving technology has been at the center of multiple fatal crashes and is currently being investigated by U.S. regulatory authorities. The third issue is corporate governance. Sustainalytics flags executive compensation practices, the company's three classes of directors, and requirements of a two thirds supermajority to make bylaw and charter amendments. CEO Elon Musk's large ownership stake means the share price can be moved by his tweets or his decision to sell stock. Tesla's ESG Risk Rating does not necessarily preclude its inclusion from Morningstar sustainability indexes, but the selection process prioritizing low ESG risk causes it to miss out on eligibility for the Morningstar US Sustainability Index. Tesla receives an MSCI ESG Rating of A as of October 2021.

- Johnson & Johnson. The diversified healthcare firm receives an ESG Risk Rating of Medium and a Controversy Rating of High (4 on a 5-point scale), which excludes it from the Morningstar US Sustainability Index. According to Sustainalytics: "The company has been involved in an exceptional number of controversies spanning all three of its business lines. As of September 2020, there were roughly 76,000 product liability lawsuits pending, a decrease of 25% compared to 2018. Nevertheless, two criminal investigations by the US DOJ into allegations of asbestos in the company’s talc-based body powders and misleading marketing of opioids result in significant compliance risk." Johnson & Johnson receives an MSCI ESG Rating of BBB as of October 2021.

So, how do differences in holdings affect returns? An investment growth chart for the five-year trailing period through the end of 2021's third quarter comparing the Morningstar US Sustainability Index to the equivalent MSCI index displays the two tracking very closely for many years and diverging more recently. Still, five-year trailing returns for the two indexes are separated by just 59 basis points. The Morningstar US Sustainability Index averaged an annual return of 16.605% for the trailing five years through the third quarter of 2021, whereas the MSCI USA ESG Leaders Index returned 17.195%.

Exhibit 9 Morningstar's US Sustainability Index Has Produced Similar 5-Year Returns as a Peer

Source: Morningstar Direct. Five-year trailing returns through Sept. 30, 2021. Morningstar US Sustainability Index TR USD is compared with MSCI ESG USA Leaders GR USD.

Sustainability in Emerging Markets

Emerging markets tend to carry higher ESG risk than developed markets. The Morningstar Emerging Markets Index (equities) held 21% more ESG risk than the Morningstar Developed Markets Index as of the third quarter of 2021, aggregating Sustainalytics' company-level assessments. Company, sector, and country-level norms and regulations are at play. From a sector perspective, the emerging-markets equity universe has twice as much exposure to basic materials and significantly more exposure to energy. Both carry more ESG risk than sectors like healthcare and technology, which represent more weight in the developed-markets index.

Comparing the Morningstar Emerging Markets Sustainability Index to an ETF tracking its MSCI equivalent reveals a similar level of overlap to U.S. equities, at roughly 66% of index weight. Of the Morningstar index's top 20 constituents, 14 also feature in the MSCI index.

Exhibit 10 Morningstar's Emerging Markets Sustainability Index Highlights Many of the Same Companies as a Peer

Morningstar Emerging Markets Sustainability Index	ETF Tracking MSCI EM ESG Index
Taiwan Semiconductor Manufacturing Co Ltd	Tencent Holdings Ltd
Tencent Holdings Ltd	Taiwan Semiconductor Manufacturing Co Ltd
Meituan	Alibaba Group Holding Ltd Ordinary Shares
Infosys Ltd	Meituan
Housing Development Finance Corp Ltd	Reliance Industries Ltd
JD.com Inc Ordinary Shares - Class A	Infosys Ltd
WuXi Biologics (Cayman) Inc	China Construction Bank Corp Class H
Sberbank of Russia PJSC	Housing Development Finance Corp Ltd
NIO Inc ADR	Gazprom PJSC
Hon Hai Precision Industry Co Ltd	WuXi Biologics (Cayman) Inc
SK Hynix Inc	Tata Consultancy Services Ltd
Ping An Insurance (Group) Co. of China Ltd Class H	MediaTek Inc
Pinduoduo Inc ADR	NIO Inc ADR
MediaTek Inc	Ping An Insurance (Group) Co. of China Ltd Class H
Naspers Ltd Class N	PJSC Lukoil
Samsung SDI Co Ltd	NAVER Corp
Hindustan Unilever Ltd	Naspers Ltd Class N
LG Chem Ltd	Samsung SDI Co Ltd
Saudi Basic Industries Corp	Saudi Basic Industries Corp
Kotak Mahindra Bank Ltd	Kakao Corp

Source: Morningstar Direct. Constituent data and ESG Risk Ratings as of June 30, 2021.

To explore some of the differences between the two indexes, consider Sustainalytics' assessments for a few of the constituents that do not currently feature in the Morningstar Emerging Markets Sustainability Index but that appear in the equivalent MSCI index:

- Alibaba. The world's largest online and mobile commerce company receives an ESG Risk Rating of Medium from Sustainalytics and a Controversy Rating of High (4 on a 5-point scale), which excludes it from the Morningstar Emerging Markets Sustainability Index. Alibaba's principal controversy involves China's State Administration of Market Regulation's enforcement of the country's 2008 antimonopoly law. In Sustainalytics' words: "According to the regulator, the company has used its dominant position in China's online commerce market to force merchants to choose its platforms over those of its rivals since at least 2015…Sustainalytics rates this as Category 4 because of the high impact on stakeholders and high risk to the company. The USD 2.8 billion fine is exceptional and sets a new record for anti-monopoly fines in China." Also, the initial public offering of Alibaba affiliate Ant Group was suspended by the Shanghai Stock Exchange. Alibaba receives an MSCI ESG Rating of BB as of October 2021.

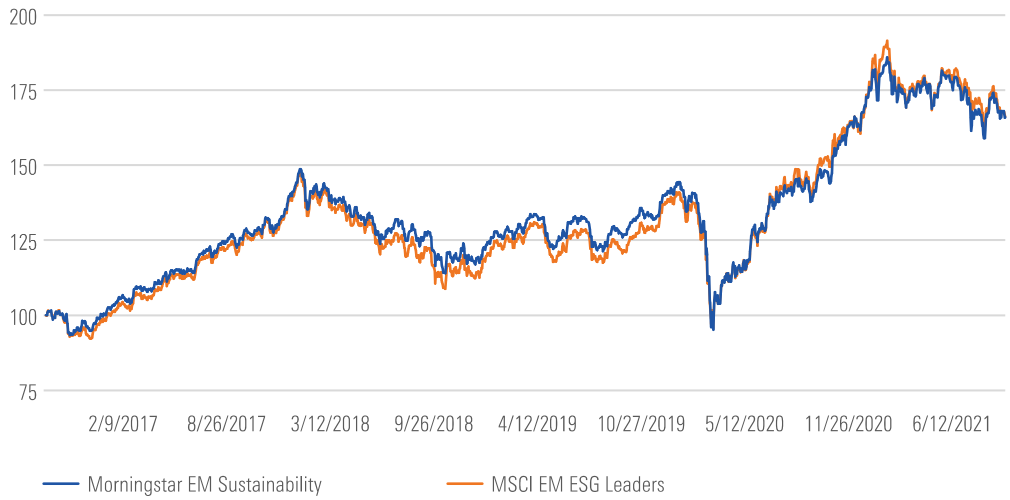
- China Construction Bank has a Sustainalytics ESG Risk Rating of High, which excludes it from the Morningstar Emerging Markets Sustainability Index. The three most important MEIs for CCBC are business ethics, data privacy and security, and product governance. In Sustainalytics' view, "The company has average preparedness measures to address Business Ethics issues and has been implicated in major controversies related to the issue," which includes factors like bribery and corruption policies, whistleblower programs, and accounting and taxation. CCBC's management of risks related to data breaches and privacy concerns is also weak in Sustainalytics' view. Finally, Sustainalytics judges CCBC to be an average performer in its oversight of the "quality of financial products and services they offer, as well as the way they are marketed." China Construction Bank receives an MSCI ESG Rating of A as of October 2021.

- Gazprom, the integrated oil and gas company in which the Russian government is a majority shareholder, has a High ESG Risk Rating and a Controversy Rating of High (4 on a 5-point scale), which excludes it from the Morningstar Emerging Markets Sustainability Index. According to Sustainalytics, "the release of emissions (including GHG emissions) and industrial waste, both of which can create financial and legal liabilities," is a major issue for the company, as its role as a major fossil fuel producer and gas supplier courts major climate change-related risks. Gazprom's Controversy Rating relates to business ethics. Sustainalytics cites claims of price manipulation in Poland, among other charges of anticompetitive practices. Gazprom receives an MSCI ESG Rating of BB as of October 2021.

So, how do differences in holdings affect returns? An investment growth chart for the five-year trailing period through the end of 2021's third quarter comparing the Morningstar Emerging Markets Sustainability Index to the equivalent MSCI index displays a bit more divergence between the two indexes for a few years, with the gap narrowing considerably recently.

Five-year trailing returns for the two indexes are separated by just 0.005 percentage points, which is remarkable for an index containing equities representing more than 25 countries and currencies. The Morningstar Emerging Markets Sustainability Index averaged an annual return of 10.673% for the trailing five years through the third quarter of 2021, whereas the MSCI Emerging Markets ESG Leaders Index returned 10.668%.

Exhibit 11 Morningstar's Emerging Markets Sustainability Index 5-Year Returns Look Similar to a Key Peer



Source: Morningstar Direct. Five-year trailing returns through Sept. 30, 2021. Morningstar Emerging Markets Sustainability Index GR USD is compared with MSCI EM ESG Leaders GR USD.

Sustainability in Eurozone Bonds

The vastness and complexity of the bond market makes comparing fixed-income portfolios a more difficult task than for equities. But comparing the Morningstar Eurozone Corporate Bond Sustainability Index against products using MSCI ESG research reveals some differences in issuer ratings.

Consider Sustainalytics' assessments of a few of the constituents that do not currently feature in the Morningstar Eurozone Corporate Bond Sustainability Index but that appear in indexes using MSCI ESG research:

- Société Générale. The French bank receives an ESG Risk Rating of Medium from Sustainalytics, so the index selection process prioritizes other companies for the Eurozone Corporate Bond Sustainability Index. Sustainalytics notes that SocGen’s exposure to business ethics is significant because of its global reach and operations. The bank is focused on developing its international banking activities in Eastern Europe, Russia, and Africa. It has been the subject of bribery allegations in Libya. Since 2018, SocGen has paid out more than $750 million in fines related to Libor manipulation, anti-money-laundering, and compliance deficiencies. Sustainalytics notes that, "following a number of high-profile incidents in recent years that led to significant fines, SocGen made it a priority to better manage its exposure to business ethics controversies." Time will tell if new programs will prove effective. SocGen receives an MSCI ESG Rating of AAA as of October 2021.

- Eni. The integrated oil and gas company in which the Italian government owns a 30% stake receives an ESG Risk Rating of Medium from Sustainalytics, so the index selection process prioritizes other companies for the Eurozone Corporate Bond Sustainability Index. Sustainalytics writes: "Compared to many of its international peers, Eni’s presence in lower-carbon activities, such as renewables and power generation, is relatively high. Furthermore, natural gas generally represents a significant source of revenue across its overall business model, meaning its immediate exposure to transitional risk is somewhat less than that of its oil-focused peers. However, its conventional exploration and production activities can still generate exposure to ESG risks through spills and other releases, particularly given its presence in the arctic and in Nigeria's Niger Delta. Additionally, given Eni’s notable footprint in emerging markets in Africa and the Middle East, bribery and corruption also remain a significant source of risk exposure." Sustainalytics gives ENI strong marks for managing its ESG risks, noting that "decarbonization efforts are relatively advanced, both in terms of mitigating carbon risk as well as capturing potential climate-related market opportunities," and it scores well relative to many peers. Still, the nature of Eni's business makes ESG risk unavoidable. Eni receives an MSCI ESG Rating of A as of October 2021.

- Bouygues. The French conglomerate has a Sustainalytics ESG Risk Rating of High. The company's construction business is riskier from an ESG perspective than its media and telecom arms. Sustainalytics identifies the company's notable material ESG risks as bribery and corruption; environmental and social impact of products and services; and human capital and considers Bouygues' management average. According to Sustainalytics, "The company has a weak policy addressing bribery and corruption." On the corporate governance side, Bouygues is cited by Sustainalytics for "weakness in its ownership structure/shareholder rights." Bouygues receives an MSCI ESG Rating of AA as of October 2021.

The Morningstar Eurozone Corporate Bond Sustainability Index launched in 2021, precluding returns-based comparisons.

Sustainability in Canadian Bonds

Comparing the Morningstar Canada Corporate Bond Sustainability Index against indexes using MSCI ESG research reveals some differences in issuer ratings.

Consider Sustainalytics' assessments for constituents that do not currently feature in the Morningstar Canada Corporate Bond Sustainability Index but that appear in indexes using MSCI ESG research:

- Rogers Communications. Even before a family rift roiled Canada's largest wireless-services provider, Rogers received an ESG Risk Rating of Medium from Sustainalytics, so the index selection process prioritizes other companies for the Morningstar Canada Corporate Bond Sustainability Index. Sustainalytics writes: "Rogers’ proposed deal with Shaw Communications exposes it to regulatory scrutiny, as it would reduce the number of wireless providers from four to three, hence reducing competition. Once merged, it would have a commanding share of the wireless market in Ontario and BC. Rogers has agreed to a 'hell or high water' clause in the contract, where it takes on all the regulatory risk and is forced to agree to any conditions the regulators impose. It is possible Rogers may need to sell assets, such as Shaw's Freedom Mobile wireless business, to satisfy regulators. While data and privacy security risks are inherent in the industry, Rogers' expansion into the Internet of Things (IoT) will increase this risk, based on the sheer volume of data and ability to track and mine that data along with any new regulation. The reliability of its networks is essential to retaining its customers and reputation." Sustainalytics also notes: "The move towards digital transactions has increased the amount of sensitive data Rogers collects as has its continued expansion into the Internet of Things (IoT), leveraging its growing 5G network, which increases the volume of data that can be tracked and mined for behavior patterns. Rogers is subject to Canadian privacy laws and regulations, including the PIPEDA. The proposed Bill C-11, the Digital Charter Implementation Act, would reform the privacy legislation if implemented, including the introduction of non-compliance penalties of the greater of 5% gross global revenue or CAD 25 million." Corporate governance is another ESG risk for Rogers. Rogers is a family-founded, family-controlled company, with the voting control held by Rogers Control Trust, which can elect all members of the board and control the vote on most matters submitted to a shareholder vote. Rogers receives an MSCI ESG Rating of AA as of October 2021.

- Brookfield Infrastructure Partners. A Bermuda exempted limited partnership that owns and operates utilities, transport, midstream, and data assets, Brookfield Infrastructure receives an ESG Risk Rating of Severe from Sustainalytics, so it is ineligible for the Morningstar Canada Corporate Bond Sustainability Index. Sustainalytics notes Brookfield's high exposure to ESG risks like product governance, ethical breaches, political lobbying, anticompetitive practices, and tax and accounting irregularities. But Brookfield's overall ESG disclosures are weak and not in accordance with Global Reporting Initiative standards, signaling inadequate accountability to investors and the public. Sustainalytics also notes Brookfield's weak environmental policy and corporate governance concerns related to its board of directors. While Brookfield Asset Management is rated by MSCI, Brookfield Infrastructure Partners does not receive a rating of its own.

The Morningstar Canada Corporate Bond Sustainability Index launched in 2021, precluding returns-based comparisons.

ESG Risk Matters, but ESG Risk Rating Differences Are Overblown

It has become popular to discredit ESG research by pointing to divergent conclusions reached by providers. Difference do exist. Two analysts assessing the same thing will inevitably come to different conclusions at times, whether in the investment realm or beyond. ESG research is still evolving. In the words of Sustainalytics founder Michael Jantzi: "[T]he diversity of ratings is the sign of a healthy market." Even Sustainalytics and MSCI, ESG researchers that both focus on financial materiality, have different opinions on some important companies. But at the end of the day, key portfolios of companies selected on the basis of the two providers' ESG research have behaved similarly. Criticism of ESG ratings divergence is overdone.

About Morningstar Indexes

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