MORNINGSTAR®

Morningstar® Portfolio Sustainability Score ™ Updates
Frequently Asked Questions

Morningstar Research
8 December 2020

Important Disclosure
The conduct of Morningstar's analysts is governed by Code of Ethics/Code of Conduct Policy, Personal Security Trading Policy (or an equivalent of), and Investment Research Policy. For information regarding conflicts of interest, please visit: http://global.morningstar.com/equitydisclosures

Executive Summary

In 2019, Morningstar enhanced the Morningstar Sustainability Rating™ methodology by replacing Sustainalytics' company ESG Rating with its ESG Risk Rating. Full background of this change and details can be found in the methodology document.

In 2021, Morningstar will update what is treated as eligible security types for the coverage threshold step of the calculation in order to better reflect the portion of the portfolio which contributes to the fund's environmental, social, and governance risk.

The Morningstar Sustainability Rating™ of a portfolio is based on a fund portfolio's Sustainability Score within a Global Category peer group distribution. The Sustainability Score is a fund-level data point calculated by a weighted average of the ESG Risk Ratings of its constituent holdings. The ESG Risk Rating is an assessment of a company's exposure to material ESG risks measured with the same scale across all economic sectors.

To ensure we provide sufficiently representative data to investors, funds must meet a Percent AUM Covered threshold to receive a Sustainability Score and Rating. This means 67% of eligible holding types within the portfolio must have a Sustainalytics' company ESG Risk Rating. Historically we have only excluded cash/cash equivalents and rescaled the remainder of the fund to 100%.

With this update, we will be adding in some short-term corporate investment types that were previously excluded as cash and removing derivative holdings:

- Some investments that were previously treated as "cash" and excluded are being included because we consider them to be short-term corporate investments.
- Money Market funds (as a holding within another fund) were previously treated as "cash" and excluded but are being included because they often hold short-term corporate investments.
- All derivative holdings will be excluded, as they were prior to 2019. Although many derivative holding types do hold financial ESG risk, our decision is that they need to be excluded until we can meaningfully represent their exposure

Frequently Asked Questions

General

What are we updating?

Morningstar is revising what is considered an eligible security type within the existing methodology, which takes eligible securities and rescales them to 100%. Currently, "eligible securities" means all security types except for cash/cash equivalents. We are refining this step to instead include short-term corporate investments securities which were previously treated as cash, and to exclude derivative positions.

Why are we making this change?

Morningstar is committed to providing the highest-quality data to power investor decisions. The update to the set of holding types we include in our calculation recognizes where the ESG investing landscape has evolved for certain cash-equivalent securities. It also addresses that increased transparency in the reporting of derivatives makes these holding types less meaningful in our existing methodology, where the most practical solution is to remove them from scope. These revisions both aim to increase the quality and meaningfulness of the Sustainability Score and, by extension, the Morningstar Sustainability Rating.

How does this update relate to the 2019 methodology changes to the Morningstar Sustainability Rating?

The Morningstar Sustainability Rating™ will continue to be based on a portfolio's Sustainability Score. There is no fundamental change to our approach for the Portfolio Sustainability Score, but we are updating what is considered an "eligible security" within the existing steps of the calculation.

How will the coverage of the Portfolio Sustainability Score and Rating be affected?

Based on testing, we expect an overall net increase of approximately 800-1000 funds that will receive a Portfolio Sustainability Score and Rating as a result of this change, a net increase of less than 1%. Within the Global Category peer groups that the Sustainability Rating uses, we see the most significant shifts as a net increase in global fixed-income funds receiving a rating (up approximately 15%), as well as a net increase in funds under our global allocation categories receiving a rating (up approximately 7%-10%). A more significant number of funds may continue to not meet the threshold requirement to receive a rating, but their Percent AUM Covered more accurately reflects the portion of the portfolio which should potentially contribute to a score or rating.

Will the historical values of the Portfolio Sustainability Scores change?

No. This update affects the Portfolio Sustainability Scores moving forward. Historical values will not change, nor will any metrics which use existing historical values.

When are the changes occurring?

The methodology will be in effect Feb. 8, 2021. The Morningstar Portfolio Sustainability Scores and the Morningstar Sustainability Ratings are calculated on the sixth business day of the month. The

calculation will be run on the previous month end's portfolio date (that is, with a one-month and six-business-day lag).

Specific Holdings Types

What specific holding types are changing their inclusion as "eligible securities"?

- Commercial Paper and Certificates of Deposit/Time Deposits will be considered eligible for contribution to the Morningstar Sustainability Score and will factor into a portfolio's 67% coverage requirement.
- Money Market Funds will be considered eligible for contribution to the Morningstar Sustainability Score and will factor into a portfolio's 67% coverage requirement.
- All derivative holding types will be considered ineligible for contribution to the Morningstar Sustainability Score and will no longer factor into a portfolio's 67% coverage.

Why were commercial paper and CDs/time deposits previously considered ineligible, and why is this changing?

Previously, Morningstar did not consider commercial paper and CDs/time deposits to be material drivers of a portfolio's sustainability due to their cash-equivalent nature. As the ESG investing landscape has evolved, the material relevance of certain cash-equivalent securities to ESG strategies and portfolio risk assessment has become more widely acknowledged, as evidenced by the adoption of ESG strategies for short-term cash management and the growth of ESG-focused money market portfolios. While cash and other cash-equivalent holdings are still considered ineligible for inclusion in a risk-based ESG assessment, commercial paper and CDs carry material, financial risk associated with the issuing entity, and will now be considered eligible for contribution to a portfolio's Sustainability Score.

Are other money market or cash-equivalent instruments considered eligible securities?

Other money market instruments such as Stable Value Funds and Repurchase Agreements will continue to be treated as cash and are not considered to be materially relevant to ESG risk. Short-term and near-term corporate bonds are currently considered eligible holdings and will remain included in our coverage. Treasury Bills, notes, and bonds are all considered eligible holdings covered as sovereign debt, and will remain included in our coverage.

How will the inclusion of commercial paper and CDs/time deposits affect my portfolio's coverage?

Currently, commercial paper and CDs have limited ESG risk analysis. As such, portfolios with meaningful exposure to these security types may experience a drop in the percentage of AUM covered. The inclusion of commercial paper and CDs will affect the number of eligible securities for approximately 11% of all portfolios, with less than 1% of portfolios experiencing a drop in the percentage of AUM covered of 5% or more.

How will the inclusion of commercial paper and CDs/time deposits affect my portfolio's Sustainability Score?

While the inclusion of these security types in our analysis may cause some portfolios to see a drop in their percentage of AUM covered, few portfolios that currently receive a Sustainability Score will experience a meaningful impact or drop below the 67% coverage requirement to be eligible for a score, with money market portfolios accounting for the majority of the impact. Portfolios that no longer meet the 67% threshold and therefore no longer receive a Morningstar Sustainability Score either hold a significant portion of their assets in these instruments or have limited coverage of the remaining eligible holdings. For both cases, including these security types in our portfolio calculation more meaningfully reflects the contribution of holdings driving the portfolio's ESG risk, and ensures that a portfolio does not receive a score that may be misrepresentative. Due to the lack of ESG risk analysis of these security types currently, portfolios that experience some drop in percentage of AUM covered but remain above the 67% threshold will not experience a change to their portfolio's Sustainability Score.

Why were money market funds previously considered ineligible securities, and why is this changing?

Money market instruments were previously treated as cash and considered out of scope for inclusion in the portfolio Sustainability Score. Subsequently, by nature of their composition, money market funds held within a portfolio were not in scope for contributing to the portfolio's Sustainability Score. As the ESG investing landscape has evolved, the material relevance of certain cash-equivalent securities to ESG strategies and portfolio risk assessment has become more widely acknowledged, as evidenced by the adoption of ESG strategies for short-term cash management and the growth of ESG-focused money market portfolios. Given the new inclusion of commercial paper and CDs as eligible security types, as well as short-term corporate and government securities already included, money market funds held in other portfolios may meaningfully affect a portfolio's ESG risk, and are now be considered eligible for contribution to a portfolio's Sustainability Score.

Does Morningstar currently "look through" to underlying money market fund holdings?

Due to the highly liquid, ultra-short-term nature of securities typical of money market portfolios, Morningstar does not currently "look through" to the underlying holdings of money market funds when held in other portfolios, with the intent of preventing stale securities past maturity from skewing or otherwise misrepresenting portfolio-level calculations. While we do not perform look-through on money market funds held in other portfolios at this time, Morningstar's portfolio and fixed-income teams are looking into this functionality.

How will the inclusion of money market funds affect my portfolio's coverage?

While Morningstar does not currently look through to the underlying securities of money market funds held within a portfolio, money market instruments tend to have limited ESG risk analysis available. As such, portfolios with a money market sleeve or otherwise meaningful exposure to money market funds may experience a drop in percentage of AUM covered, based on the composition of the money market funds held. The inclusion of money market funds will affect the number of eligible securities for less

than 10% of all portfolios, with less than 1% of portfolios experiencing a drop in percentage of AUM covered of 5% or more.

How will the inclusion of money market funds affect my portfolio's Sustainability Score?
While the inclusion of money market funds in our analysis of portfolio coverage may cause some portfolios to see a drop in percentage of AUM covered, few portfolios are expected to drop below the 67% threshold requirement owing to this change, with impact generally limited to target date, allocation, and fixed-income peer groups. Portfolios that would no longer meet the 67% threshold and therefore no longer receive a Morningstar Sustainability Score either hold a significant portion of their assets in money market funds, or have limited coverage of the remaining eligible holdings. In either case, including money market funds in our portfolio calculation more meaningfully captures the contribution of holdings driving the portfolio's material ESG risk, ensuring that a portfolio does not receive a score that may misrepresent the portfolio's risk. For example, a conservative allocation portfolio with a significant portion of assets invested in money market funds may lose its Sustainability Score; however, a portfolio score that does not account for the ESG risk contributed by the large money market fund exposure may be misrepresentative of the portfolio's true ESG risk. Given that we do not currently perform look-through to the underlying securities of money market fund holdings, portfolios that experience some drop in percentage of AUM covered but remain above the 67% threshold will not experience a change to their portfolio Sustainability Score.

Why are derivatives no longer considered "eligible securities"?
Historically, ESG investing got its start in impact investing, with a focus on long-only, equity strategies. As the ESG investing landscape has evolved and analytics have become more sophisticated, the ability to quantify material, financial ESG risk has become a central tenet of both ESG investing, and fundamental analysis. While the ability to meaningfully and successfully measure financial ESG risk quantitively has grown tremendously, and industry standards and regulations around ESG reporting have begun to take shape, the application of quantitative financial ESG risk metrics to derivatives and short positions, a widely debated topic, remains in its infancy.

While more advanced portfolio-reporting capabilities for derivatives positions have allowed for more accurate holdings views, more meaningful fixed-income analytics, and the addition of new portfolio metrics based on economic exposure, limitations on portfolio ESG risk assessment have subsequently compounded. Though the ability to meaningfully quantify ESG risk of short positions remains its own topic of research, the implications of including the ESG risk of long derivative positions while ignoring short positions has the potential to misrepresent a portfolio's ESG risk.

Although derivatives can be material drivers in a portfolio's ESG risk, the practical ability to measure its risk must be weighed alongside the meaningfulness of such metrics. Given that derivatives are typically unable to be rated, and subsequently so are the relevant portfolios, the Morningstar Sustainability Score and Morningstar Sustainability Rating may be considered agnostic regarding their impact. By treating derivatives positions as ineligible for contribution to a portfolio's ESG risk assessment, the Morningstar Sustainability Score and Morningstar Sustainability Rating remain agnostic about their impact, while

providing a risk assessment of the portfolio's "direct" holdings. In this way, portfolios are neither penalized for reporting their full holdings, nor favored by treating derivatives as risk-free. Rather, a portfolio's Sustainability Score is an assessment of the ESG risk associated its direct holdings, independent of synthetic exposure.

How will the exclusion of derivatives affect my portfolio's coverage?

The exclusion of derivative holdings from eligible security types will increase coverage for many portfolios with derivative exposure, with greater impact for higher derivative exposure. Because Morningstar currently calculates a portfolio's net exposure to individual securities held in both long and short positions prior to calculating portfolio ESG coverage and Sustainability Risk metrics, not all portfolios with derivative exposure will be meaningfully affected by this change. The exclusion of derivatives will affect the number of eligible holdings for around half of all portfolios, though the scope of the impact will vary greatly depending on the strategy. More than 1,000 funds are expected to see an increase in percentage of AUM covered meaningful enough to meet the 67% coverage threshold as a result of this change, with an average increase of 20% to the percentage of AUM covered for eligible securities.

How will the exclusion of derivatives affect my portfolio's Sustainability Score?

For portfolios that previously did not meet the 67% coverage requirement due to large derivative exposure in long positions, the increase in coverage will enable many to now meet the 67% coverage requirements and receive a Sustainability Score, while no portfolios will lose their score owing to this change. Portfolios that were already above the 67% coverage threshold will not see a meaningful impact to their Sustainability Score.

My fund holds derivatives. How will I be affected?

Whether or not an individual portfolio will be affected by this change depends largely upon the type of portfolio strategy employed. Morningstar currently calculates the net exposure to individual securities held in both long and short positions prior to calculation portfolio coverage and aggregating risk. As a result, strategies that hold long and short positions in the same company may not be noticeably affected despite the large portion of assets invested in derivatives. In general, portfolios with significant leverage and multialternative strategies will see the most meaningful impact.

Will a Sustainability Score or Sustainability Rating be meaningful for my portfolio if derivatives are excluded?

The Sustainability Score and Sustainability Rating can be viewed as assessments of the ESG risk associated with the portfolio's direct holdings. Given that derivatives are typically unable to be rated, excluding derivatives means that the Morningstar Sustainability Score and Morningstar Sustainability Rating remain agnostic regarding the impact of derivatives. The Sustainability Score will provide a long-only assessment of the portfolio's direct holdings, such that the relative ratings only compare the ESG risk of direct holdings for long positions across portfolios.

My fund does not hold any derivatives. Will excluding derivatives from the calculation for other portfolios affect my Sustainability Rating?
Portfolios with no derivative exposure will experience no impact to their Sustainability Score.

Because their risk is not typically able to be measured in ESG analysis, the exclusion of derivatives will not meaningfully affect the average Sustainability Score within a peer group or resulting peer group rating breakpoints.

Other Common Questions

How are short positions handled?
Morningstar's Sustainability analytics are currently long-only portfolio metrics. While the ability to meaningfully and successfully measure financial ESG risk quantitively has grown tremendously, and industry standards and regulations around ESG reporting have begun to take shape, the application of quantitative financial ESG risk metrics to short positions, a widely debated topic, remains in its infancy.

Are there plans to cover shorts and derivatives in the future?
Covering shorts and derivatives is a significant area of ongoing research from both the Morningstar and Sustainalytics perspectives.

Does cash have ESG risk?
Cash itself is not considered to carry intrinsic ESG risk. While currency may have inherent ESG risk, and thus ESG risk may relate to cash holdings based on the currency it is denominated in, exchange-rate risk is not specific to cash, and is considered separate from either market value risk or credit risk.

Is cash considered risk-free? Does scaling out cash skew or inflate the Sustainability Score of portfolios with a large cash exposure?
The Morningstar Sustainability Score does not treat cash as zero-risk, but rather as out of scope for ESG risk assessment. Scaling out cash does not "inflate" a fund's ESG risk, as cash can neither decrease nor offset ESG risk. Analogizing with a portfolio's average credit rating, where the average credit rating is an assessment of all holdings which carry credit risk, cash neither increases nor decreases a portfolio's average credit risk, nor is scaling it out considered to "inflate" the portfolio's credit risk. Similarly, a portfolio's Sustainability Score is a portfolio-average ESG risk assessment for all holdings which carry ESG risk.

About Morningstar Sustainability Research

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

For More Information
https://www.morningstar.com/company/global-contacts

22 West Washington Street
Chicago, IL 60602 USA

©2020 Morningstar. All Rights Reserved. Unless otherwise provided in a separate agreement, you may use this report only in the country in which its original distributor is based. The information, data, analyses, and opinions presented herein do not constitute investment advice; are provided solely for informational purposes and therefore are not an offer to buy or sell a security; and are not warranted to be correct, complete, or accurate. The opinions expressed are as of the date written and are subject to change without notice. Except as otherwise required by law, Morningstar shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses, or opinions or their use. The information contained herein is the proprietary property of Morningstar and may not be reproduced, in whole or in part, or used in any manner, without the prior written consent of Morningstar. To license the research, call +1 312 696-6869.