Practical Applications of

Comparison of ESG-Mandated and Non-Mandated Funds Using Morningstar Measures of Sustainability and Performance

Practical Applications
Portfolio Management Research

Overview

In *Comparison of ESG-Mandated and Non-Mandated Funds Using Morningstar Measures of Sustainability and Performance*, from the February 2024 issue of ***The Journal of Investing***, **C. Edward Chang** and **H. Doug Witte** of **Missouri State University** and **Thomas M. Krueger** of **Texas A&M University-Kingsville** find that among funds with sustainability mandates in their prospectuses, ETFs were generally cheaper than their mutual fund counterparts. Additionally, mandated ETFs with Morningstar quantitative ratings were projected to outperform both non-mandated ETFs and mandated mutual funds, though Morningstar analyst ratings predicted similar performance for all three.

Practical Applications

- **Morningstar's quantitative ratings (QRs) indicate a stronger outlook for sustainability-mandated ETFs compared with mandated mutual funds.** Mandated and non-mandated ETFs have significantly higher QRs than their mutual fund peers, likely driven by the lower expense ratios of ETFs.
- **Mutual funds with ESG mandates are more likely to receive higher sustainability ratings from Morningstar than non-mandated ETFs or ESG-mandated ETFs.** Eighty-five percent of mandated mutual funds and 60% of mandated ETFs received high sustainability ratings from Morningstar.
- **Despite a greater propensity for charging sales loads, ESG-mandated mutual funds have historically delivered higher risk-adjusted returns than their non-mandated peers.** Average Morningstar star ratings of mandated mutual funds are higher than the average of a matched set of non-mandated peers.

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Key Definitions

Exchange-traded fund (ETF)

An ETF is a type of open-ended investment company. However, unlike a mutual fund, the shares of an ETF trade on an exchange and can be bought and sold throughout the day, just like common stocks. Most ETFs are designed to track an index, such as the Russell 3000 or the S&P 500. However, as with mutual funds, there are also ETFs that have actively managed portfolios.

Mutual fund

A mutual fund is a type of open-ended investment company that issues redeemable shares. The number of outstanding shares can fluctuate as new shares are issued and as shareholders redeem previously purchased shares. Mutual fund share prices are determined daily by reference to the value of the underlying assets rather than by trading. A mutual fund differs from an exchange-traded fund (ETF) in that the shares of an ETF trade on an exchange and can be bought and sold throughout the day, just like common stocks. A mutual fund differs from a closed-end fund (CEF) in that a CEF has a fixed number of non-redeemable shares that trade like a stock on a stock exchange. A mutual fund differs from a unit investment trust (UIT) in that a UIT has a fixed underlying portfolio.

ESG investing

ESG investing considers the environmental, social, and governance activities of investee companies. Environmental criteria evaluate a company's sustainability activities (such as emissions, water, and waste). Social criteria assess a company's management of social relationships (such as

Discussion

The authors compare sustainable mutual funds and ETFs (those with sustainability mandates in their prospectus) with conventional mutual funds and ETFs, using various performance measurements reported by Morningstar. The study complements and builds on the existing research in the ongoing debate about whether mutual funds and ETFs with sustainability mandates outperform comparable conventional mutual funds and ETFs, and the impact of ESG scores on fund performance broadly.

Sustainable investing generally seeks to integrate ESG considerations, including factors like energy efficiency, diversity, and executive compensation into the investment process. Prior research has shown that investors with pro-social attitudes and a belief in the positive impact of ESG efforts tend to allocate more to sustainable funds. Sustainability-minded investors are willing to pay higher fees and tend to be more loyal, as indicated by lower outflows from sustainable funds following negative returns. The popularity of sustainable investing has influenced corporate behavior—social responsibility reporting among S&P 500 companies has increased. However, managers may be increasingly tempted to make green investments of dubious merit or engage in "greenwashing" practices to attract ESG-minded investors.

> "With ESG skepticism growing, it is important to assess the sustainability, past performance, future performance, and cost of investment funds indicating a sustainability mandate."
>
> —Comparison of ESG-Mandated and Non-Mandated Funds Using Morningstar Measures of Sustainability and Performance

A Morningstar summary of over 20 academic articles indicates that sustainable funds perform similarly to comparable conventional funds. Of 20 equity indexes in Morningstar's Global Sustainability group, 16 outperformed their benchmarks during their existence, selecting companies with lower volatility, wider economic moats,

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employees, consumers, and surrounding communities). Governance criteria cover the rights and responsibilities of the company's management (such as board members, shareholders, and stakeholders). ESG investing is sometimes defined more narrowly as considerations of how a company's governance, and its environmental and social impacts, affect its financial performance. In this narrower sense, ESG investing is distinguished from "socially responsible investing" (SRI), which seeks to promote social and environmental good by avoiding investment (through the application of negative screens) in disfavored products or services; and from "impact investing," which aims to achieve positive social or environmental impact by investing (through the application of positive screens) in favored industries or activities.

Morningstar Rating™, Morningstar star rating

A Morningstar Rating™, sometimes called a Morningstar "star" rating, is a quantitative measure of a mutual fund's or ETF's past risk-adjusted performance based solely on historical data. The rating scale goes from one star (★), the lowest rating, to five stars (★★★★★), the highest rating. Morningstar assigns star ratings only to funds that have at least three years of performance history.

Morningstar Analyst Rating™ for funds (AR), Morningstar Medalist Ratings

A Morningstar Analyst Rating™ is a forward-looking assessment of a fund that considers qualitative and quantitative factors. The rating assesses a fund's ability to outperform its peers (or a relevant benchmark) over

and reduced financial distress risk. A Barron's analysis in 2016 showed that 50 out of 200 sustainable funds beat the market in the previous year, with only one explicitly identified as sustainable.

Morningstar-Based Research

The authors use several categories of Morningstar ratings in their analysis. Morningstar's ratings are seen as valuable tools in guiding investment decisions and assessing fund performance, with different ratings providing complementary insights into fund quality and potential returns. Previous research has highlighted Morningstar's global relevance and reliability in assessing ESG factors. The authors note that Morningstar is viewed positively by various industry sources, with Kiplinger ranking it third among research firms, Stock-Trak considering it a top-10 choice, and InvestorJunkie praising it for value investors.

Morningstar's ratings, including traditional star ratings, ARs, and QRs, significantly influence mutual fund flows and performance. Previous studies have illustrated the correlation between Morningstar ratings and fund performance, with higher ratings attracting more investments.

Morningstar introduced its sustainability ratings in 2016 to assess how effectively companies manage their ESG challenges. This rating system begins by assigning a portfolio sustainability score to portfolios with at least 50% of their assets invested in companies with ESG scores from Sustainalytics. Morningstar then compares this score with those of peers in the same Morningstar category to determine a final sustainability rating. Studies have found that funds with high sustainability ratings attracted significant cash inflows, while those with low sustainability ratings experienced outflows. Research has also pointed to a correlation between higher sustainability ratings and favorable Morningstar star ratings and ARs.

> "Investors need a way to gain clarity, cut through the information maze, and make investment decisions that are in line with their principles."
>
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a full market cycle. The rating scale for Morningstar ARs has five steps: negative (the lowest), neutral, bronze, silver, and gold (the highest). The three "medalist" categories—bronze, silver, and gold—indicate an expectation that a fund will outperform its peers. The AR symbols are shown in Exhibit 1. In May 2023, Morningstar combined ARs and QRs into a single rating product called "Medalist Ratings." The Medalist Ratings use the same rating symbols as ARs.

Exhibit 1: Morningstar Analyst Rating Symbols

Morningstar Quantitative Rating™ (QR)

A Morningstar Quantitative Rating™ (QR) is a computer-generated forward-looking assessment of a fund. The process uses an artificial intelligence approach to try to replicate the ratings produced by Morningstar analysts as ARs. Morningstar assigns QRs only to funds that do not receive ARs. The symbols for QRs are the same as the symbols for ARs, with the addition of a "Q" superscript (Exhibit 2). In May 2023, Morningstar combined ARs and QRs into a single rating product called "Medalist Ratings." The Medalist Ratings use the same rating symbols as ARs.

Another focus of research has been on Morningstar's sustainability ratings and moat ratings, with a combination of sustainability and moat ratings improving stock selection, particularly within a high-quality universe based on return on invested capital. The authors extend this analysis to funds, comparing the ratings of mandated and non-mandated funds.

Research Method and Findings

The authors used a data sample from June 4, 2002, reflecting post-pandemic market dynamics. They reached a variety of findings and conclusions.

Sustainability ratings: Both equity and multi-asset funds with sustainability mandates have significantly higher sustainability ratings than non-mandated funds. This suggests that funds with sustainability mandates actually tend to focus more on sustainable investing practices.

Defendable competitive advantage: Multi-asset funds with sustainability ratings show significantly higher moat ratings than their non-mandated counterparts.

Historical and anticipated performance: Funds with sustainability mandates, especially multi-asset funds, have historically delivered higher risk-adjusted returns. ARs projected outperformance for mandated multi-asset funds. However, QRs projected similar prospects for both mandated and non-mandated funds.

Fund fees: Mandated funds are more likely to charge a load, but generally have lower expense ratios than non-mandated funds. The largest difference occurs between mandated and non-mandated multi-asset funds. This suggests that while investors may pay a load to invest in mandated funds, they incur lower ongoing expenses.

ETFs: Mandated ETFs tended to have higher sustainability ratings than non-mandated ETFs, although the difference was not as large as that observed in mutual funds. Sustainability mandates were twice as prevalent among ETFs than among mutual funds. Mandated ETFs had lower expense ratios and higher QRs, indicating projected outperformance.

Greenwashing concerns: The analysis raised concerns about greenwashing, as some funds may have exploited ESG mandates for marketing purposes without implementing significant

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sustainability measures. This was particularly notable among ETFs, where a considerable proportion received lower sustainability ratings despite the mandates.

Understanding the nuances of ESG mandates and their impact on fund performance is crucial in addressing greenwashing and making informed investment choices. The results of the study reveal that mandated funds generally exhibit higher sustainability ratings and better performance metrics, but concerns about greenwashing persist, especially among ETFs. The authors suggest potential further research to explore the interaction of expense ratios and Morningstar ratings, the benefit of consensus ratings from multiple agencies, and the impact of ESG mandates on global funds' performance.

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Exhibit 2: Morningstar Quantitative Rating Symbols

Neutral Q

Negative Q

Morningstar moat ratings

Morningstar moat ratings evaluate the competitive advantage, or "economic moat," of a company. This rating system is based on the idea that companies with strong competitive advantages are better positioned to maintain profitability and fend off competition over the long term. A company with a competitive advantage expected to last for 20 years is said to have a "wide" moat. One with a competitive advantage expected to last for 10 years is said to have a "narrow" moat. One with merely a fleeting (or no) competitive advantage is said to have no moat. Funds can receive moat ratings based on the average moat rating of their constituents.

Morningstar Sustainability Rating™, Morningstar globe rating

A Morningstar Sustainability Rating™ assesses how well the companies whose stocks are included in a fund portfolio manage their environmental, social, and governance (ESG) affairs. The rating scale goes from one globe (🌐), the lowest rating, to five globes (🌐🌐🌐🌐🌐), the highest rating. The ratings are determined using Sustainalytics' methodologies for company and sovereign ESG risk.

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