Morningstar® Sustainability Moat Focus Indexes℠

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Contact us
indexes@morningstar.com

Shaped by the forward-looking insights of Morningstar's equity analysts and Sustainalytics, the Morningstar Sustainability Moat Focus Indexes are designed to deliver portfolios of the stocks with durable competitive advantages, attractive valuations, and reduced exposure to environmental, social, and governance (ESG) risk. They represent high-conviction, style agnostic portfolios that aim to deliver higher returns than the market over the long term by combining fundamental insights with objective portfolio construction, which facilitates consistency and investability.

Measuring ESG risk

The Morningstar Sustainability Moat Focus Indexes assess ESG risk with the Sustainalytics ESG Risk Ratings, which measure the degree to which a company's economic value is at risk driven by the magnitude of its unmanaged ESG risks. The ESG Risk Ratings are composed of three building blocks that contribute to a company's overall rating. These building blocks include Corporate Governance, material ESG issues (MEIs), and idiosyncratic ESG issues. To be considered relevant in the ESG Risk Ratings, an issue must have a potentially substantial impact on the economic value of a company and, hence, its financial risk- and return profile from an investment perspective. The ESG Risk Rating is forward looking in the sense that it identifies these issues based on the typical business model and business environment a company is operating in. The final ESG Risk Ratings score is calculated as the sum of the individual material ESG issues' unmanaged risk scores.

Morningstar Equity Research

The Morningstar Sustainability Moat Indexes also incorporate inputs from Morningstar's equity research team. Morningstar is the largest provider of independent sell-side equity research globally, with over 100 equity research analysts covering more than 1,500 stocks. Morningstar's analysts assign each company a Morningstar® Economic Moat Rating,™ which reflects the strength and durability of its competitive position. Analysts also create fair value estimates for companies based on a three-staged discounted cash flow model that incorporates their in-depth knowledge and expectations for future growth. This forward-looking valuation assessment reflects long-term cash flow forecasts, which many traditional valuation metrics, like price/earnings, may not be as well-equipped to capture.

What is an economic moat?

An economic moat is a durable competitive advantage that allows a firm to keep competitors at bay and generate economic profits over an extended period. To help investors identify companies that possess an economic moat, Morningstar's equity research team assigns one of three economic moat ratings: "wide," "narrow," or "none." There are two major criteria that must be satisfied for a company to earn a moat rating of "narrow" or "wide": 1) it must be likely to generate returns on invested capital above its weighted average cost of capital for at least the next ten years; and 2) it must enjoy one of the following economic moat sources, each of which is a driver of structural competitive advantage:

- Network effect—Present when the value of a network increases for new and existing users as the network grows.
- Cost advantage—Allows a firm to sell at the same price as competition but still enjoy economic profits thanks to lower unit costs of production.
- Efficient scale—When a company serves a market limited in size, new competitors may not have an incentive to enter, particularly when the cost of market entry is high. New entrants would cause returns for all players to fall well below the cost of capital.
- Intangible assets—Brands, patents, and regulatory licenses that block competition and/or convey meaningful pricing power.
- Switching costs—Whether in time or money, the expenses that a customer would incur to change from one producer/provider to another.

Portfolio construction

The Morningstar Sustainability Moat Focus Indexes derive their constituents from the Morningstar Global Markets Indexes. To be eligible for inclusion, constituents from the parent index must, at the time of index reconstitution:

- Have a "wide" or "narrow" economic moat rating (only wide-moat stocks are eligible for the U.S. index).

- Be assigned a fair value estimate by a Morningstar analyst.
- Pass Sustainalytics product involvement screens for tobacco, controversial weapons, civilian firearms, and thermal coal.
- Have a Sustainalytics ESG Risk Rating of Medium, Low, or Negligible, with a controversy score of 4 (of 5) or lower over the past three years.
- Not carry a Sustainalytics Carbon Risk Rating of High.
- Rank in the top 80% of eligible securities by 12-month share price momentum.
- Have three-month average daily trading volume of at least $5 million (new constituents only)

Eligible stocks are ranked on their price/fair value ratios. Those trading at the largest discount to fair value are selected until the index reaches its fixed target constituent count, with buffers applied to favor existing index members. Each Morningstar Sustainability Moat Focus Index consist of two sub-portfolios, and the stocks within each sub-portfolio are equally weighted, subject to sector and country constraints.

Reconstitution

The Morningstar Sustainability Moat Focus Indexes are reconstituted annually on a staggered semiannual schedule in June and December. Therefore, half of each index reconstitutes at a time. This allows for the inclusion of undervalued stocks on a more frequent cadence than an annual reconstitution schedule would provide, while reducing turnover. Because of the staggered reconstitution schedule, the overall number of constituents can deviate from the target count, and the weightings at the portfolio level may not always be equal. The two sub-portfolios are brought back to equal weight in the overall index portfolio every June.

Construction process

Starting universe	Sustainability screens	Additional requirements	Security selection	
• Morningstar Global Markets Indexes • Represents 97% of the investable market	• Exclusions: • ESG Risk Ratings above "Medium" • "Severe" Controversy Ratings • "High" or "Severe" Carbon Risk Ratings • Involvement in the production of weapons, or thermal coal • 50% or more revenue from tobacco	• Must have an Economic Moat Rating of "narrow" or "wide" ("wide" only for the US index) • Must rank in the top 80% of eligible securities by 12-month share price momentum	• Stocks with the lowest price/fair value are selected (based on target constituent count) • If the Morningstar Sustainability Rating of the index portfolio falls below four "globes," the bottom 5% of eligible securities by Sustainalytics ESG Risk Rating are removed and the portfolio is rebuilt	Morningstar Sustainability Moat Focus Indexes

About Morningstar Indexes

Morningstar Indexes was built to keep up with the evolving needs of investors—and to be a leading-edge advocate for them. Our rich heritage as a transparent, investor-focused leader in data and research uniquely equips us to support individuals, institutions, wealth managers and advisors in navigating investment opportunities across major asset classes, styles and strategies. From traditional benchmarks and unique IP-driven indexes, to index design, calculation and distribution services, our solutions span an investment landscape as diverse as investors themselves.

Please visit indexes.morningstar.com for more information.