European Sustainable Funds Landscape

Morningstar Manager Research
August 2019

Contents

Hortense Bioy, CFA
Director of Passive Strategies and Sustainability Research, Europe
hortense.bioy@morningstar.com

Elizabeth Stuart
Analyst
Sustainability Research, Europe
elizabeth.stuart@morningstar.com

Dimitar Boyadzhiev
Analyst
Passive Strategies Research, Europe
dimitar.boyadzhiev@morningstar.com

Executive Summary

Sustainable investing has gained popularity in recent years and is fast becoming a mainstream pursuit. Whether to mitigate risk, identify opportunities, or align values, more investors—institutions and individuals—are incorporating environmental, social, and governance factors into their investment decisions.

Responding to growing demand for sustainable investment strategies, asset managers have ramped up their efforts by launching new funds with sustainable mandates and repurposing existing funds.

Sustainable funds take varying approaches. Some employ specific ESG criteria to narrow their investment universe and/or select securities. Some focus on social or environmental sustainability themes, and a growing number of strategies aim to deliver impact alongside financial return by focusing on companies that have a net positive impact on society. Many use a combination of these approaches.

Meanwhile, conventional funds are themselves becoming more sustainable. Today, more asset managers integrate ESG into their standard investment processes. They complement traditional financial analysis with sustainability-related insights to reduce risk and enhance long-term returns. They also actively engage with portfolio companies to improve business practices. At the same time, asset managers are screening out more controversial sectors and activities from their traditional funds' investment universe. Tobacco and thermal coal, for example, have been added to many exclusion lists.

In short, the line between traditional and sustainable funds is becoming increasingly blurred, adding confusion to an already complex topic. Here, we lay out how we view the space, hoping to help investors navigate the shifting landscape.

For this report, we have defined the European sustainable funds universe as those open-end funds and exchange-traded funds domiciled in Europe that, by prospectus, either state that they use ESG criteria as a key part of their security-selection process or indicate that they pursue a sustainability-related theme or seek measurable positive impact alongside financial return. This definition excludes funds that only use values-based exclusionary screening that is not related to sustainability issues[1].

1 The report excludes funds that simply screen out controversial weapons and so-called "sin stocks" such as tobacco, alcohol, gambling, and pornography because these stocks are typically excluded on ethical, not on sustainability, grounds. Many sustainable funds also use values-based exclusions, but they do so in addition to the application of ESG criteria in their investment process. The report includes funds that apply ESG screening based on international norms like the UN Global Compact principles, which cover the environment, human rights, work conditions, and business ethics.

As of the end of June 2019, we have identified 2,232 open-end and exchange-traded funds domiciled in Europe that fit our sustainable fund criteria.

This landscape report addresses the shape of the sustainable fund universe in Europe as of June 2019. It clarifies the choices currently available to investors, traces the growth and breadth of this group, and evaluates performance, both in terms of sustainability and investment returns. It also proposes a taxonomy of sustainable funds that investors can use to help them navigate this increasingly prominent investment area.

Key Takeaways

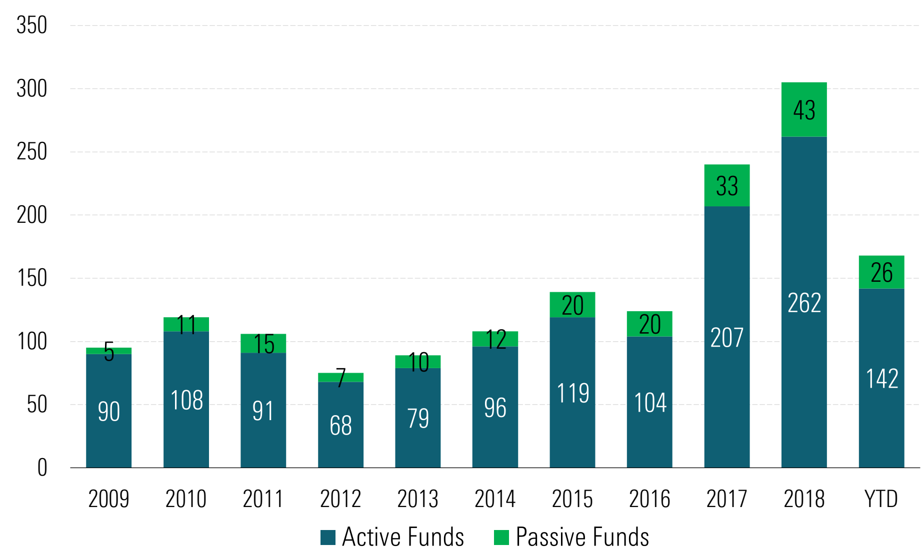
- The universe of sustainable funds continued to grow in the first half of 2019, with 168 new funds launched as asset managers position themselves to take advantage of growing investor demand. This compares with 305 for the whole of 2018.
- Assets reached a record level of EUR 595 billion, supported by six-month record net flows of EUR 36.9 billion and positive stock market returns.
- Passive sustainable funds continued to gain ground. One fourth of new flows poured into ESG index funds and ETFs in the first six months of 2019. In terms of assets, passive funds now represent 17.7% of the European sustainable fund market, up from 10% five years ago.
- For this review, we have grouped sustainable funds into three general types:
    - ESG Focus: Funds committed to using specific ESG criteria in security selection.
    - Impact: Funds aiming to deliver positive social or environmental impact alongside financial returns.
    - Sustainable Sector: Funds focused on activities that participate in the green economy.
- A growing number of conventional funds are incorporating ESG factors into their investment processes, as evidenced by the increased frequency of ESG language in prospectuses and factsheets.
- The information provided in legal and marketing documents about how funds—both sustainable and traditional—use ESG is often incomplete and unclear. This, coupled with a lack of standardised language, makes it difficult to understand the extent to which funds adopt ESG. It also makes categorising and comparing strategies challenging.
- As more conventional funds become sustainable, we expect many existing sustainable strategies will shift toward impact and thematic mandates.
- Regulation will play an important role in shaping the future of this space. European policy makers are taking steps both to increase the role of financial markets and products in meeting macro ESG goals and to ensure that investment products do not mislead investors about the extent and nature of their purported sustainable ambitions.

Growth of the European Sustainable Funds Universe

The universe of sustainable mutual funds and ETFs in Europe continued to expand in the first half of 2019, as asset managers positioned themselves to take advantage of growing investor interest. As of the end of June 2019, we have identified 2,232 funds that, by prospectus, either state that they use specific ESG criteria as a key part of their security-selection process or indicate that they pursue a sustainability-related theme or seek measurable positive impact alongside financial return.

As shown in Exhibit 1, the pace of product development in the sustainable space has accelerated in recent years. A total of 168 new funds were launched in the first half of 2019, of which 142 are actively managed and 26 are passively managed. The industry is on track to match or even exceed the record of 305 new offerings for the whole of 2018.

Exhibit 1 Sustainable Fund Launches: A Recent Acceleration



Source: Morningstar Direct. Data as of 30/06/2019.

Several of the equity launches were impact and theme-oriented with a focus on companies that contribute to the achievement of the UN Sustainable Development Goals. **BMO SDG Engagement Global Equity Fund**, for example, targets multiple themes including poverty, inequality, climate change, prosperity, peace, and justice, while **Mirova Women Leaders Equity Fund** focuses on gender diversity and empowering women.

Amidst growing concerns about climate change, a host of climate-related funds came to market. For example, **THEAM Quant Europe Climate Carbon Offset Plan** invests in European equities with high ESG evaluations, low carbon footprints, and robust energy transition strategies. The fund also aims to offset part of its carbon emissions. Similarly, **UBS Equities Global Climate Aware Fund** overweights companies that are well positioned to transition to a low-carbon economy and underweights those that are not committed to this transition.

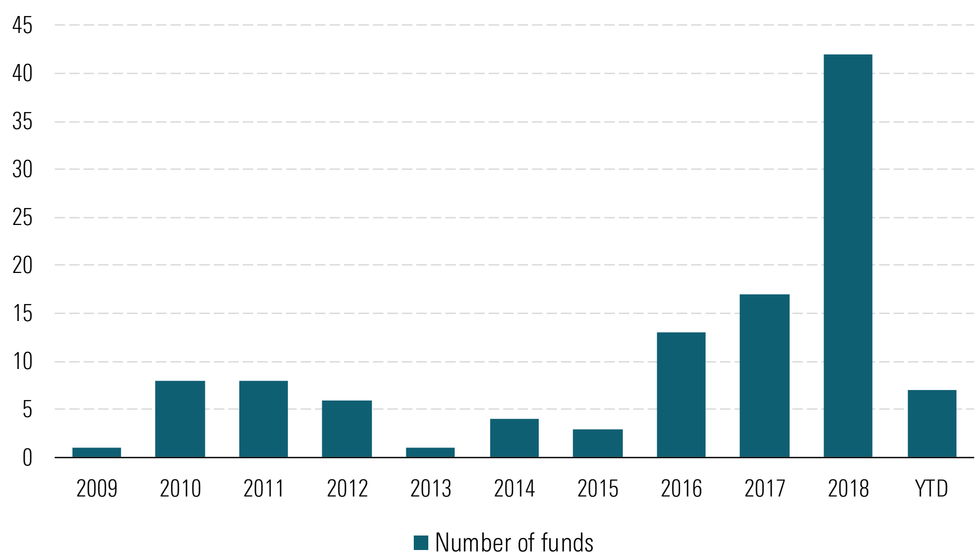
Meanwhile, seven new launches focus on green bonds, including **NN Green Bond Short Duration Fund** and **CSIF (Lux) Bond Green Bond Global Blue Fund**.

In the ETF world, 18 new products hit the shelf. UBS introduced an ESG version of the popular S&P 500 index, **UBS S&P 500 ESG ETF**, while BNP Paribas launched **BNPP ECPI Circular Economy Leader ETF**. BlackRock complemented its extensive passive ESG range with a suite of iShares MSCI ESG Enhanced ETFs that aims to provide market returns while maximising positive exposure to ESG factors and minimising carbon footprint.

Repurposed Funds

While most of the growth in the number of sustainable funds has come from new launches, asset managers have also repurposed and renamed existing funds. Exhibit 2 shows the number of funds that have turned into full-fledged sustainable investment offerings. They changed mandates to make ESG their primary focus and reflected this transformation by rebranding the fund. The largest surge in this activity happened between 2017 and 2018, with a slowdown into the first half of this year. Exhibit 3 provides a sample of recent makeovers.

Exhibit 2 Number of Funds Repurposed From 2009 to Date



Source: Morningstar Research. 30/06/2019.

Converting funds into a sustainable offering is a way for asset managers to leverage existing assets to build their sustainable-funds business, thereby avoiding having to create funds from scratch and, in some cases, accelerating the time frame required to reach scale. This may also be a way for fund companies to reinvigorate ailing funds that are struggling to attract new flows.

Changing the name of a fund increases visibility of a manager's sustainability efforts. However, one must also account for those managers who may have renamed their funds without making significant changes to their investment process or portfolio. This may be because the fund already had an ESG focus and the manager wanted to highlight this. In other cases, the manager may have only added a simple exclusionary screen to the former strategy.

Exhibit 3 Examples of Recently Repurposed Funds

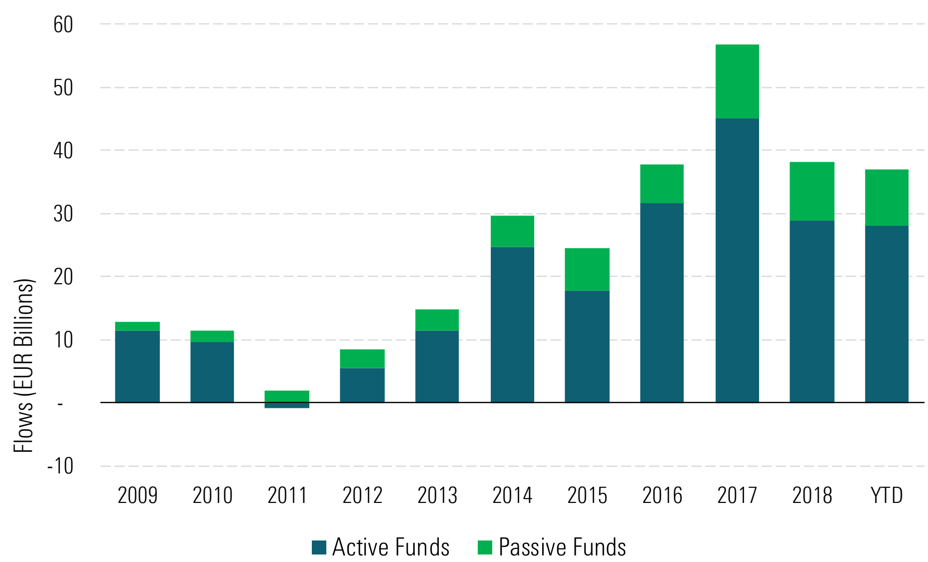
Current Name	Old Name	Language Addition	Inception Date	Est ESG Date	AUM in EUR
Royal London EM ESG Ldrs Eq Trkr R £ Acc	Royal London Em Mkts Eq Trkr R GBP Acc	ESG	12/06/2017	01/02/2019	1,299,641,390
LGT Sustainable Strategy 3 Years EUR B	LGT Strategy 3 Years (EUR) B	Sustainable	10/11/1999	30/04/2018	467,552,384
BL-Sustainable Horizon B EUR	BL-Equities Horizon B EUR	Sustainable	06/03/1997	01/10/2018	33,615,295
Alm. Brand Invest Nordiske Aktier ETIK	Alm. Brand Invest Danske Aktier	Ethical	12/12/1997	12/06/2018	14,900,021
Swisscanto (LU) PF Responsible Sel (EUR) AA	Swisscanto (LU) PF Yield (EUR) AA	Responsible	25/09/2000	15/03/2018	111,467,818
Amundi IS Euro AGG Corporate SRI IE-D	Amundi IS Barclays Euro AGG Corp IE-D	SRI	14/04/2014	29/10/2018	28,267,965
FIM IG Green ESG	FIM Real	Green/ESG	30/04/2004	09/10/2018	118,782,001
AXAWF Glb Sustainable Aggt F Cap USD H	AXAWF Global Aggregate Bonds F Cap USD H	Sustainable	01/04/1988	28/12/2018	127,174
DKB Nachhaltigkeitsfonds Klimaschutz AL	DKB TeleTech Fonds TNL	Sustainable	06/03/2000	07/06/2019	53,066,781
BGF ESG Multi-Asset A2 EUR	BGF Flexible Multi-Asset A2 EUR	ESG	04/01/1999	24/03/2019	41,767,244
Catella Sverige Hållbart Beta A	Catella Sverige Index A	Sustainable	02/10/1998	27/09/2018	148,371,867
Castlefield B.E.S.T Sustainable UK SmComs Instl	Castlefield UK Smaller Coms Instl Inc	Sustainable	01/06/2007	01/02/2018	9,743,221
East Capital Global EM Sustainable A EUR	East Capital Emerging Asia A EUR	Sustainable	09/05/2005	10/01/2019	12,080,186

Source: Morningstar Direct. Data as of 30/06/2019.

Flows

Sustainable funds pulled in record net flows of EUR 36.9 billion in the first half of 2019. It is more than any past semiannual period. It also closes in on 2018's net flows of EUR 38 billion for the full year.

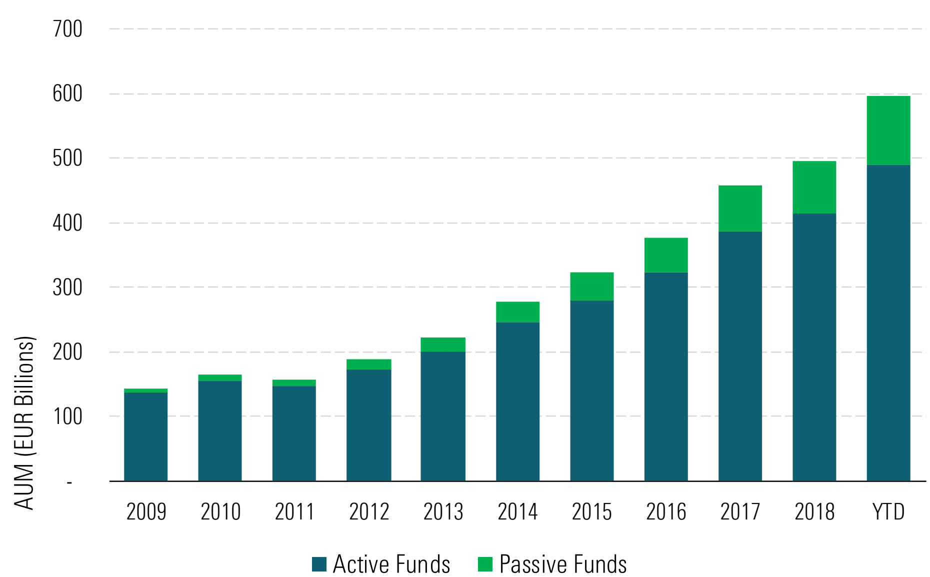
Exhibit 4 Sustainable Fund Flows



Source: Morningstar Direct. Data as of 30/06/2019.

Flows to sustainable funds went mostly to active funds, but passive funds continued to attract a growing share of net new money, in line with the broader market trend. About 24.1% of new flows poured into ESG index funds and ETFs in the first six months of 2019. This levels with 24.3% last year and 20% the year before.

Exhibit 5 Sustainable Fund Assets: A Decade of Growth



Source: Morningstar Direct. Data as of 30/06/2019.

Supported by positive flows and upward-trending markets, sustainable funds reached EUR 595 billion in assets under management at the end of June 2019, a 20.5% growth in six months. This compares with an expansion of total European fund assets of 7.7%.

Passive funds have significantly increased their market share in five years. They now represent 17.7% of the European sustainable fund market, up from 10% five years ago.

Exhibit 6 Top 10 Sustainable Fund Flows in First-Half 2019

Fund	Category	Net Flow (EUR)
Nordea 2 - Global Sust Enh Eq X USD	Global Large-Cap Blend Equity	2,348,557,329
Sustainable Pension Return EUR X Inc	Other Allocation	1,304,076,857
iShares ESG Scrn Euro Corp Bd Idx Q Acc€	EUR Corporate Bond	920,073,463
GALLUS Aktien Welt passiv IB	Global Large-Cap Blend Equity	866,446,999
Vontobel mtx Sust EmMkts Ldrs I USD	Global Emerging Markets Equity	818,040,326
Stewart Inv Asia Pac Ldrs I EUR Acc	Asia-Pacific ex-Japan Equity	713,855,298
State Street ACS Mlt-Fct Glb ESG IdxEqU1	Global Large-Cap Blend Equity	695,767,416
NN (L) Liquid Euribor 3M B Cap EUR	EUR Ultra Short-Term Bond	640,148,717
Northern Trust EMC ESG EI UCITS FGR A €	Global Emerging Markets Equity	599,762,196
Candriam SRI Bond Em Mkts I USD Inc	Global Emerging Markets Bond	549,302,440

Source: Morningstar Direct. Data as of 30/06/2019.

Among the top 10 funds by ESG fund flows in the first half of 2019, three are global equity offerings, including **Nordea 2 – Global Sustainability Enhanced Equity**, which attracted the most flows. Also featured are three fixed-income products, including **iShares ESG Screened Euro Corp Bond Index**, which, since its inception in May, has already collected a whopping EUR 920 million.

Exhibit 7 Bottom 10 Sustainable Fund Flows in First-Half 2019

Fund	Category	Net Flow (EUR)
Nordea 1 - Stable Return BP EUR	EUR Moderate Allocation - Global	- 1,188,260,693
Handelsbanken Räntestrategi Crit A1 SEK	Alt - Long/Short Credit	- 559,054,661
NT All Cntry Asia exJpnCst ESG EqIdx C €	Asia ex-Japan Equity	- 443,026,841
Sycomore Sélection Responsable I	Eurozone Flex-Cap Equity	- 366,777,198
Handelsbanken Kortränta Criteria	SEK Corporate Bond	- 341,461,686
DWS Invest ESG Euro Bonds (Short) FC	EUR Diversified Bond - Short Term	- 319,940,166
Gestielle Cedola Risk Ctrl Enrg Rnnvbl R	Other Allocation	- 319,473,176
BNP Paribas Euro Valeurs Durables C D	Eurozone Large-Cap Equity	- 306,208,453
Afer Actions Euro ISR A A/I	Eurozone Large-Cap Equity	- 301,306,654
Humains Retraite Actions	Eurozone Large-Cap Equity	- 292,065,985

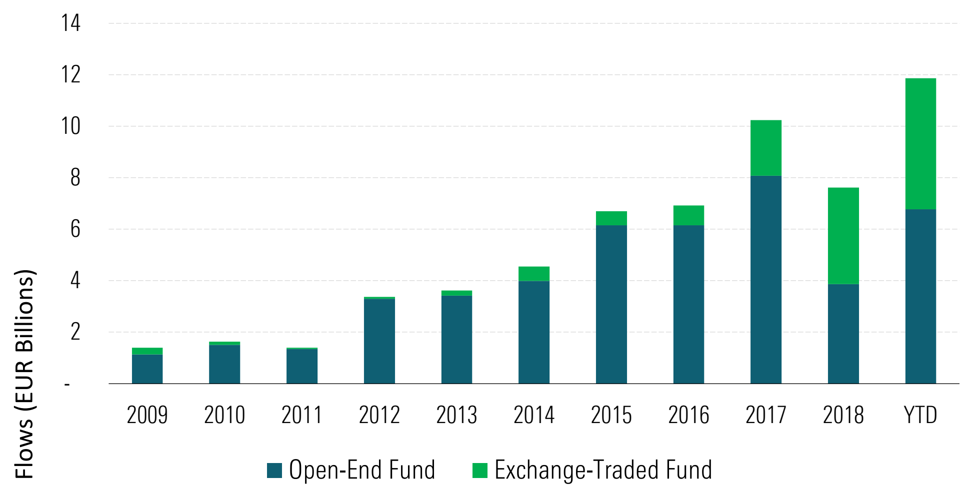
Source: Morningstar Direct. Data as of 30/06/2019.

At the bottom of the flows league table, **Nordea 1 – Stable Return** registered the largest outflows. Four eurozone equity funds also bled assets, which may be attributed to the current pessimism within the eurozone.

ETFs Are Gaining Traction

The ETF universe of sustainable funds attracted over 5 billion in net flows in the first half of 2019, more than in the whole of 2018 and setting a new record. By comparison, index funds collected EUR 6.8 billion over the period.

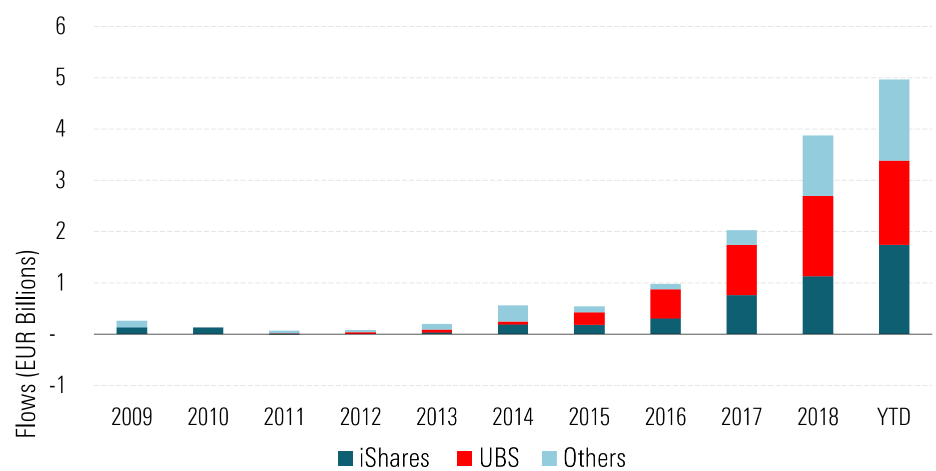
Exhibit 8 Passive Sustainable Fund Flows: ETFs Are Gaining Traction



Source: Morningstar Direct. Data as of 30/06/2019.

Prior to 2017, choice was limited in the sustainable ETF space. But over the past couple of years, the menu of ETF options has expanded dramatically. Today, there are 102 ESG ETFs available to European investors, 88 of which are diversified equity funds and 14 of which are bond funds.

Exhibit 9 UBS and iShares Dominates ESG ETF Flows

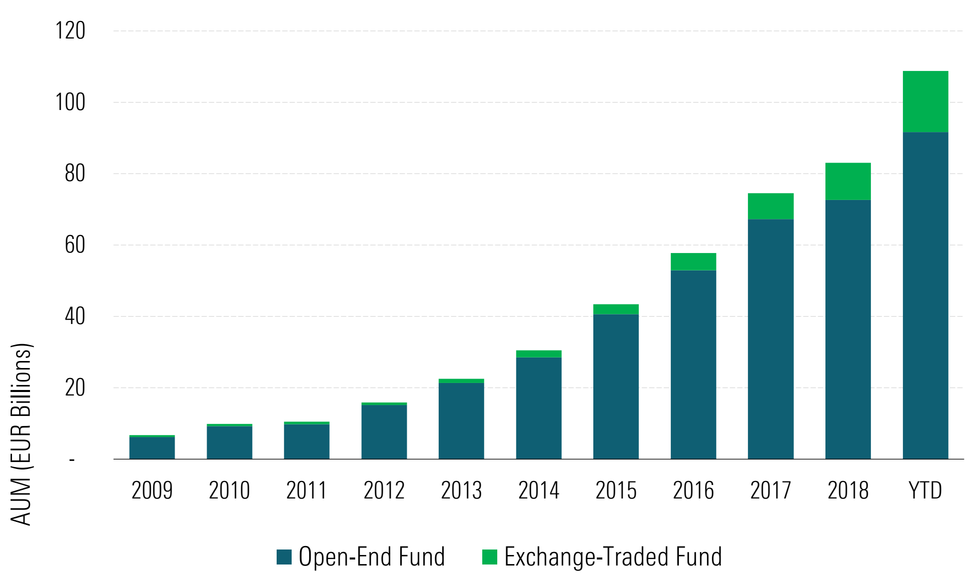


Source: Morningstar Direct. Data as of 30/06/2019.

IShares' and UBS' suites of ESG ETFs drew the lion's share of ETF net flows in the first half of 2019. These providers were also at the top in previous years. They attracted more than EUR 1.74 billion and EUR 1.64 billion in net flows, respectively. IShares, with its five newly added MSCI ESG Enhanced ETFs, has overtaken UBS in terms of its number of products, although not yet in terms of its assets.

Meanwhile, competition continued to heat up in the rest of the ETF market, as evidenced by the fastest-growing share of the “Others” category (all asset managers other than iShares and UBS). In response to growing investor demand, many ETF providers now offer a core set of ESG-focused ETFs, offering varying approaches to ESG integration and hard exclusions, at competitive fees.

Exhibit 10 Diversified Passive ESG Funds Assets (ETFs vs. Open-End Funds)



Source: Morningstar Direct. Data as of 30/06/2019.

ESG ETFs now account for 15.7% of total passive sustainable assets, compared with just 6.5% five years ago. Most broad-market passive funds base their security selection on company ESG ratings along with some exclusions. Broad-based ESG indexes vary in terms of how strictly they adhere to ESG criteria and the degree to which they seek to mimic the risk and return characteristics of their parent index. There is often a trade-off between ESG performance and tracking error.

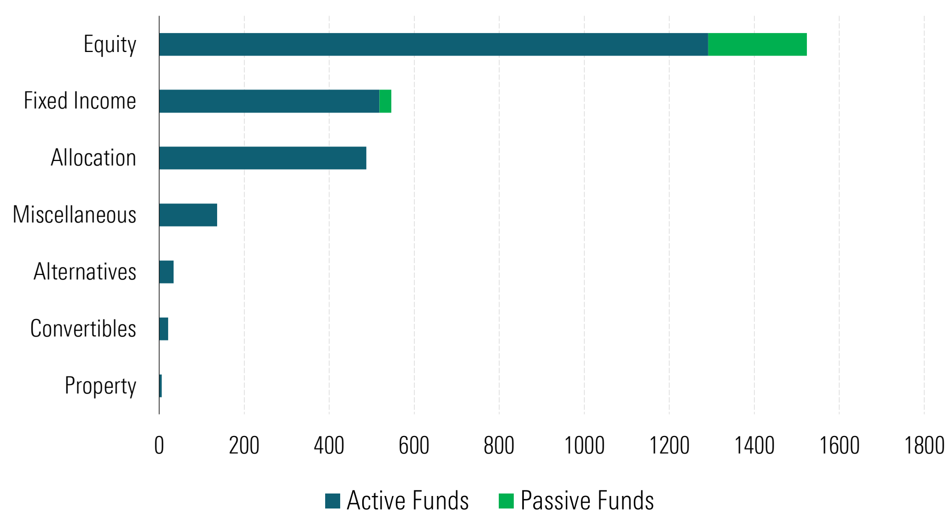
Asset Class and Category Coverage

Investors can find sustainable funds in almost 240 of the 329 Morningstar Categories. Equity funds make up over half of that universe. The biggest single category is global equity large-cap blend, which comprises 425 funds. Fixed-income is the second-largest global category group, closely followed by allocation.

For the purpose of this review, we have excluded money market funds from our sustainable fund universe. Nevertheless, it is an area of growing interest as more investors want ESG factors to be integrated across their portfolios. Historically dominated by French managers, the sustainable cash market is attracting new players. BlackRock, for example, is planning to launch a UCITS equivalent of its US **BlackRock Liquid Environmentally Aware Fund**, or LEAF.

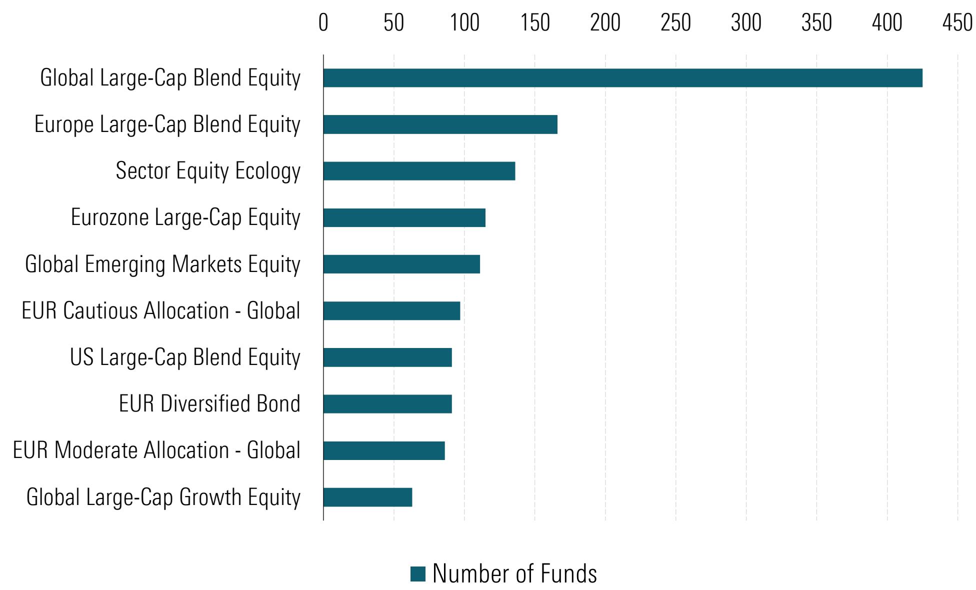
Investors now have a reasonable number of choices to construct comprehensive portfolios that span all key asset classes.

Exhibit 11 Sustainable Funds Broken Down by Broad Asset Class



Source: Morningstar Direct. Data as of 30/06/2019.

Exhibit 12 Sustainable Funds Span a Wide Range of Morningstar Categories



Source: Morningstar Direct. Data as of 30/06/2019.

Exhibit 13 Top 10 Asset Managers by Sustainable Fund Assets

Fund Company	**Country**	**AUM (EUR)**
Storebrand	Norway	33,314,310,644
Amundi	France	30,935,888,774
NN IP	Netherlands	29,963,921,450
BNP Paribas	France	29,192,112,454
Handelsbanken	Sweden	28,308,245,275
Swedbank	Sweden	24,924,246,017
Nordea	Finland	23,104,998,892
KLP	Norway	19,122,455,752
Northern Trust	USA	18,797,575,077
Candriam	Luxembourg	15,520,776,668

Source: Morningstar Direct. Data as of 30/06/2019.

At a provider level, Norwegian savings and insurance group Storebrand leads the league table with its suite of sustainably screened and ESG-integrated funds amounting to EUR 33.3 billion.

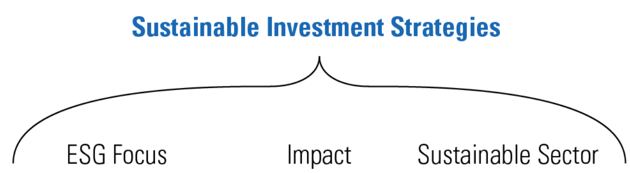
Unsurprisingly, the leader board is well-staffed with Northern European asset managers that have championed ESG investing for years. These include banking groups Handelsbanken, Swedbank, Nordea, and Norwegian cooperative insurance group KLP. These firms are structured to serve the Nordic institutional market. French groups Amundi and BNP Paribas and Dutch manager NN are also among the largest providers of sustainable funds.

Many large public institutional investors in the Nordics, France, and the Netherlands are required to invest sustainably and responsibly, which has driven sustainability measures at a firm level.

A Sustainable Funds Taxonomy

As we have seen, the growth of the sustainable funds universe has been accompanied by the development of a range of specific approaches to sustainable investing. Each of the 2,232 sustainable funds in this report describes its approach to ESG or sustainable investing in its prospectus. Based on that prospectus language, we identified three broad types that we call ESG Focus, Impact, and Sustainable Sector.

Exhibit 14 A Categorisation System for Sustainable Investment Strategies



Source: Morningstar Research.

ESG Focus

The largest number of sustainable funds fall into the ESG Focus category. These are funds committed to using specific ESG criteria in security selection and portfolio construction.

ESG Focus funds are certainly not all alike, but most use a best-in-class approach. This involves assessing companies on certain sustainability criteria and selecting the leaders within a given investment universe, sector, or geography. Some tilt portfolios toward sustainability leaders, while others focus on weeding out laggards. Some target companies that demonstrate improving sustainability characteristics.

ESG Focus funds may be active or passive, concentrated or broadly diversified. They employ a range of specific investment styles.

It is common for ESG Focus funds to use exclusionary screens. These typically avoid investing in companies involved in “sin” sectors such as tobacco, gambling, and pornography, as well as weapons and companies that violate international norms and conventions such as the UN Global Compact principles. Some ESG Focus funds use exclusionary screens as a stand-alone ESG strategy, but for these to be considered sustainable, they have to apply a range of exclusions that go beyond “sin stocks” and include norms-based screening, which covers the environment, human rights, work conditions, and business ethics.

Many ESG Focus funds also actively engage with the companies they own about sustainability issues in an effort to improve business practices.

Most ESG Focus funds are marketed as sustainable offerings and include in their names key terms like "ESG" or "sustainable," but also older terms like “SRI” (socially responsible investing), “responsible,” and “ethical.” Note that far from all the funds that we have categorised as ESG Focus funds can be identified just from their name.

Examples of ESG Focus funds include **Candriam Sustainable Europe**, which in its prospectus states: “*The strategy factors in environmental, social and governance criteria using a form of analysis developed by the Management Company. This consists of selecting companies:*
- which have the best positioning to meet the sustainable development challenges specific to their sector using the best-in-class approach,
- and which conform to the principles of the United Nations Global Compact (human rights, labour rights, environment and anti-corruption), and
- which exclude controversial activities (weapons (the sub-fund will not invest in the shares of a company that manufactures, uses or possesses anti-personnel mines, cluster bombs and/or depleted uranium weapons), tobacco, pornography, etc.)
This analysis is accompanied by active shareholder involvement (voting at meetings, etc.)"

BNP Paribas Obligation Etat Classic is an example of a fund that employs a best-in-class SRI approach but doesn’t indicate it in the name. *“The Fund applies a “best-in-class” SRI management procedure which aims to identify the leading issuers in each category based on the ESG criteria identified by the SRI analyst team. This analysis is adapted to the key issues for each category of issuer.”*

The prospectus of the **AXA (CH) Strategy Fund – Sustainable Equity CHF** doesn’t mention a best-in-class approach but indicates that stocks are selected on the basis of ESG criteria.
“Investments are selected on the basis of the ESG (Environmental, Social and Governance) approach. With the ESG approach, in addition to the criteria applied in traditional financial analysis, investments are selected on the basis of ESG factors, i.e. environmental, social and governance considerations are integrated into the investment process.”

IShares MSCI Europe ESG-Screened ETF and **BlackRock Advantage Europe Equity** are two examples of ESG Focus funds that only use exclusionary screens. One references ESG in its name, while the other does not.

IShares MSCI Europe ESG-Screened ETF tracks an index that *“excludes issuers […] associated with controversial weapons and nuclear weapons; producing tobacco or civilian firearms; deriving their* *revenues (above a threshold specified by the index provider) from (i) thermal coal extraction, sale and thermal coal-based power generation, (ii) the distribution, retail and supply of tobacco related products, (iii) the distribution of civilian firearms, or (iv) oil sand extraction; and companies that are classified as violating United Nations Global Compact principles (which are widely accepted corporate sustainability principles that meet fundamental responsibilities in areas such as anti-corruption, human rights, labour and environmental)."*

BlackRock Advantage Europe Equity's prospectus states: *"The Investment Manager will, in addition to the investment criteria set out above, take into account environmental, social and governance ("ESG") characteristics when selecting the Fund's investments. The Investment Manager intends to exclude direct investment into issuers of equity securities which are engaged in or are otherwise:*
i) exposed to the production of controversial weapons (nuclear, cluster munitions, biological-chemical, landmine, depleted uranium, or incendiary weapons); or
ii) mainly reliant on thermal coal extraction and generation; or
iii) involved in violations of the UN Global Compact as determined by at least three external ESG research providers."

Exhibit 15 The 10 Largest ESG Focus Funds

Fund	Morningstar Category	AUM (EUR)
Nordea 1 - Stable Return BP EUR	EUR Moderate Allocation - Global	10,239,026,462
Opcimmo LCL Opcimmo	Property - Direct Europe	7,916,542,481
KLP Obligasjon Global I	Global Bond - NOK Hedged	5,545,029,892
KLP AksjeGlobal indeks 1 A	Global Large-Cap Blend Equity	5,036,771,287
Star Fund Cap	EUR Flexible Allocation	4,260,321,335
Folksam LO Sverige	Sweden Equity	3,969,164,864
Folksam LO Världen	Global Large-Cap Blend Equity	3,944,010,482
Northern Trust Wld Cstm ESG EqIdx A EUR	Global Large-Cap Blend Equity	3,852,863,459
Vontobel mtx Sust EmMkts Ldrs I USD	Global Emerging Markets Equity	3,523,038,452
Handelsbanken Global Index Crit (A1 EUR)	Global Large-Cap Blend Equity	3,411,582,595

Source: Morningstar Direct. Data as of 30/06/2019

The prospectus language for sustainable funds is not always clear, and in some cases, it is difficult to distinguish an ESG Focus fund from a traditional fund. Many asset managers have launched firmwide sustainability strategies over the past couple of years and have begun integrating ESG into their standard investment processes. Many have also begun adding information in their fund prospectuses about how they use ESG, usually with a short sentence indicating that ESG issues are being formally considered as part of the investment process, which is otherwise unchanged. It would be a stretch to call these funds-considering-ESG as full-fledged sustainable funds, but they do muddy the water. These funds are excluded from the scope of this report, and we only analyze those funds that are committed to using specific ESG criteria in security selection.

Below are examples of traditional funds that state in their prospectuses that they are incorporating ESG considerations into their investment processes.

Aviva Investors Global Equity Unconstrained Fund states that: "*The process for making investment decisions follows detailed analysis based on a wide range of financial metrics and research. This includes consideration of environmental, social and governance (ESG) criteria, but there are no specific ESG restrictions on the Investment Manager's decision making. […]. Decisions are supported by active engagement with companies and use of voting rights, with the intention of positively influencing company behaviour to contribute to competitive returns."*

Comgest Growth Asia ex Japan fund's prospectus states: "*The Investment Manager may include the integration of environmental, social and governance ("ESG") factors into its investment selection process. […] Where applied, ESG factors are incorporated into the valuation models for investee companies by taking the ESG profile of such companies into account.*"

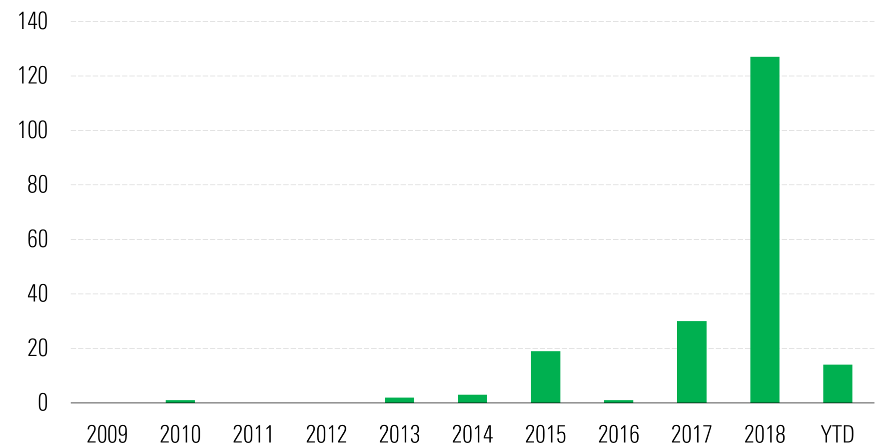
JPMorgan Funds – Euro Corporate Bond Fund uses the following language: *"The Investment Manager also evaluates whether environmental, social and governance factors could have a material negative or positive impact on the cash flows or risk profiles of many companies in which the Sub-Fund may invest. These determinations may not be conclusive and securities of issuers which may be negatively impacted by such factors may be purchased and retained by the Sub-Fund while the Sub-Fund may divest or not invest in securities of issuers which may be positively impacted by such factors.*"

Meanwhile, asset managers have also expanded the list of sectors and activities they wish to screen out from their mainstream funds' investment universe. Controversial weapons used to be the only common exclusion. But today, tobacco and thermal coal have been added to many exclusion lists. These are sectors deemed to present unacceptable harm to society or the environment and where managers believe engagement makes little sense.

Some firms stop short of applying blanket exclusions but encourage their portfolio managers to avoid the worst offenders. For example, BlackRock has introduced a list of exclusions for new strategies being launched, although portfolio managers can opt out.

Through our examination of prospectus language, we were able to identify 197 traditional funds that have altered their prospectuses to include ESG language from 2009 to date. Our sample, depicted in Exhibit 16, reveals a major spike in this activity in 2018, with 127 prospectuses seeing the addition of ESG language that year. This correlates with the uptick in popularity of ESG and asset managers' ambition to make their sustainability efforts more visible.

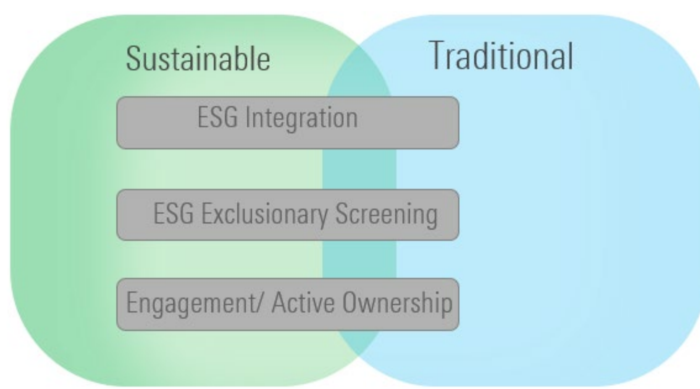
Exhibit 16 Funds That Have Added ESG Language to Their Prospectus



Source: Morningstar Research.

As illustrated by Exhibit 17, the line between sustainable and traditional investments has blurred.

Exhibit 17 The Line Between Sustainable and Traditional Investments Is Blurrier Than Ever



Source: Morningstar Research

Impact

Impact investing is generally defined as "investments made into companies, organizations, and funds with the intention of generating social and environmental impact alongside a financial return."[2] Until recently, it referred largely to direct investments made by high-net-worth and institutional investors in impactful projects (through private-placement fixed-income instruments) or companies (through venture capital or private equity). But the term resonates with fund investors, too, and a number of sustainable funds attempt to generate and measure positive social and environmental returns alongside financial

[2] https://thegiin.org/impact-investing/

returns. This is especially true for fixed-income funds, which can focus on bonds' use of proceeds to direct their assets to green energy, affordable housing, or community-development projects.

Impact funds are often focused on specific themes, such as low carbon, gender equality, or green bonds. Some use the 17 UN Sustainable Development Goals as a framework for evaluating the overall impact of their portfolios.

For examples, the prospectus for **RobecoSAM Global SDG Credits** states: "*The fund applies a screening process to select issuers that contribute to realizing the UN Sustainable Development Goals (SDGs) goals. The methodology used in the screening process assesses the SDG contribution of all companies it invests in to create the fund's investable universe. The fund excludes companies that contribute negatively to these goals. Engagement, ESG Integration and Robeco's exclusion policy also form part of the investment policy.*"

Baillie Gifford WW Positive Change uses the following language in its prospectus: "*The fund invests in the shares of companies globally whose products or behaviour make a positive impact. This will include companies addressing critical challenges in areas such as, but not limited to; education, social inclusion, healthcare and the environment.*"

While some Impact funds downplay ESG evaluation in security selection in favour of impact criteria, most employ ESG integration along with impact objectives. Increasingly, Impact funds are measuring and reporting on their impact to investors[3]. Not surprisingly, many are also using the term "impact" in their names and/or the description of their strategies. The Impact group is also growing, and a number of ESG Focus strategies have added impact criteria.

Exhibit 18 The 10 Largest Impact Funds

Fund	Morningstar Category	AUM (EUR)
BlueOrchard Microfinance P USD	Other Bond	1,812,549,907
BNP Paribas Développement Humain C	Europe Large-Cap Blend Equity	1,125,740,722
ÖkoWorld ÖkoVision Classic C	Sector Equity Ecology	1,027,867,059
Triodos Global Equities Impact EUR R Inc	Global Large-Cap Growth Equity	781,942,617
Parvest SMaRT Food I EUR Cap	Sector Equity Consumer Goods & Services	747,193,954
NN (L) Green Bond I Cap EUR	EUR Diversified Bond	725,644,302
responsAbility Micro &SME Finac B USD	Other	714,745,794
IIV Mikrofinanzfonds I	Other Bond	707,716,000
AB Sustainable Glb Tmtc AXXUSDAcc	Global Large-Cap Growth Equity	675,398,733
Insertion Emplois Dynamique RD	Europe Large-Cap Growth Equity	656,549,665

Source: Morningstar Direct. Data as of 30/06/2019.

[3] See, for example, Baillie Gifford Positive Change Fund's 2018 Impact Report: https://www.bailliegifford.com/en/uk/individual-investors/literature-library/positive-change-impact-report/positive-change-impact-report-full-year-2018/

Sustainable Sector

Offerings that focus on “green economy” industries like renewable energy, energy efficiency, environmental services, water infrastructure, sustainable food production, and green real estate are grouped as Sustainable Sector funds. Green economy companies can be found across a variety of conventionally defined sectors, and, according to an estimate by FTSE Russell, they constitute 6% of global market cap[4].

Examples of Sustainable Sector funds include **Vontobel Clean Technology**, which invests in *“companies worldwide that operate in the clean technology sector. The clean technology sector primarily involves the two main themes of energy efficiency (such as energy security and conservation as well as energy quality and infrastructure, etc.) and future technologies for the environment (such as recycling, waste disposal, filter technologies, etc.).*"

Exhibit 19 The 10 Largest Sustainable Sector Funds

Fund	Morningstar Category	AUM (EUR)
Pictet-Water I EUR	Sector Equity Water	4,672,032,756
BNP Paribas Aqua I	Sector Equity Water	2,343,585,608
Parvest Aqua C C	Sector Equity Water	1,731,744,533
Amundi Fds Glb Ecology ESG A EUR C	Sector Equity Ecology	1,519,954,461
Nordea 1 - Global Climate & Envir BI EUR	Sector Equity Ecology	1,354,469,985
RobecoSAM Sustainable Water B EUR	Sector Equity Water	1,146,836,219
Parvest Global Environment N C	Sector Equity Ecology	1,047,513,462
Pictet - Global Envir Opps I USD	Sector Equity Ecology	996,145,728
BGF Sustainable Energy A2 USD	Sector Equity Alternative Energy	942,727,942
Parvest Climate Impact P C	Sector Equity Ecology	804,193,572

Source: Morningstar Direct. Data as of 30/06/2019.

Comparing the Three Sustainable Fund Types

We sorted sustainable funds into the three groups—ESG Focus, Impact, and Sustainable Sector—based on the investment process described in their prospectuses. In this section, we examine differences between the groups based on their actual behaviour by looking at portfolio holdings. We compare them based on their Morningstar Sustainability Ratings and their Morningstar Low Carbon Designations.

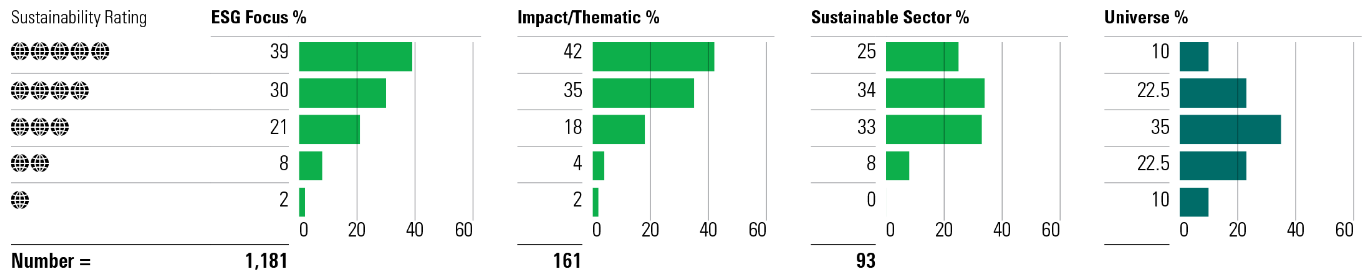
The Morningstar Sustainability Rating evaluates the ESG characteristics of fund holdings over the past year and compares them with funds' global category peers[5]. Globes are awarded based on a normal distribution within each category. Because ESG Focus funds and Impact funds are the most explicit about using ESG criteria to evaluate securities and build portfolios, we would expect them to have better Morningstar Sustainability Ratings than the other fund types.

[4] https://www.ftserussell.com/research/investing-global-green-economy-busting-common-myths

[5] Morningstar Sustainability Rating Methodology, 2018.

As seen in Exhibit 20, that is indeed the case. Nearly 40% of ESG Focus funds have 5 globes (versus 10% in the overall universe of funds), and 70% have ratings of 4 or 5 globes (versus one third in the universe). Less than 10% have 1 or 2 globes (versus one third in the universe).

Exhibit 20 Impact Funds Have Better Morningstar Sustainability Ratings

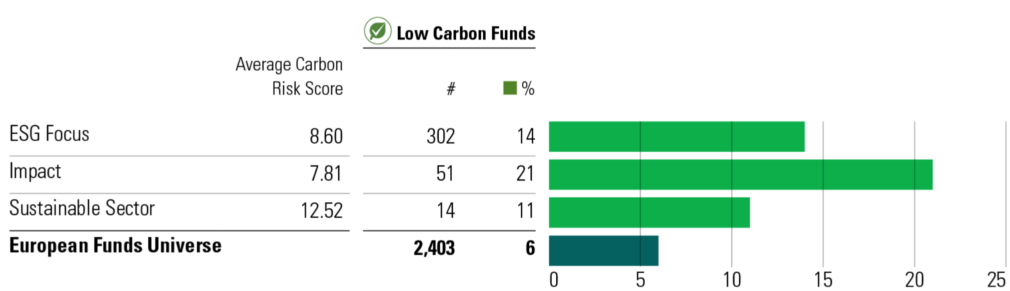


Source: Morningstar Direct. Data as of 30/06/2019.

This pattern is even more pronounced in Impact funds, with over 77% earning 4 or 5 globes. The globe ratings of Sustainable Sector funds also skew positive, but not all these funds are broadly focused on ESG criteria, so the skew is less dramatic.

In May 2018, Morningstar introduced the Morningstar Low Carbon Designation™ for funds that have low levels of carbon risk and low exposure to fossil fuel in their portfolios[6]. All of our three types of sustainable funds fare better than the overall fund universe, boasting higher percentages of funds with the Low Carbon designation. But Impact and ESG Focus funds are more likely to receive the Low Carbon designation than Sustainable Sector funds. A fifth of Impact funds and 14% of ESG Focus funds earn the Low Carbon designation, compared with only 11% of Sustainable Sector funds.

Exhibit 21 More Impact and ESG Focus Funds Receive the Morningstar Low Carbon Designation



Source: Morningstar Direct. Data as of 30/06/2019.

6 Hale, J. "Morningstar Low Carbon Designation." 2018.

Overall, Impact funds get better Morningstar Sustainability Ratings and more Low Carbon designations than the other fund types.

Performance

Sustainable funds, on average, fared well on a relative basis over the past 12 months. As shown in Exhibit 22, the one-year returns of 63% of sustainable funds finished in the top half of their respective categories, including 34.1% in the top quartile. Only 36.9% finished in the bottom half, including just 14.8% in the bottom quartile. Allocation funds had the highest percentage of all—67.6% ranked in the category's top half—while fixed-income funds had the lowest (58.4%).

Exhibit 22 A Majority of Sustainable Funds Ranked in the Top Half of Their Morningstar Category in the Past Year and Five Years

1-Year Quarter End

	All Funds		Equity		Fixed Income		Allocation	
Quartile	#	%	#	%	#	%	#	%
Top	572	34.1	341	35.8	102	26.8	122	38.4
Second	485	29.0	268	28.2	120	31.6	93	29.2
Third	370	22.1	205	21.5	90	23.7	67	21.1
Bottom	248	14.8	138	14.5	68	17.9	36	11.3

5-Year Quarter End

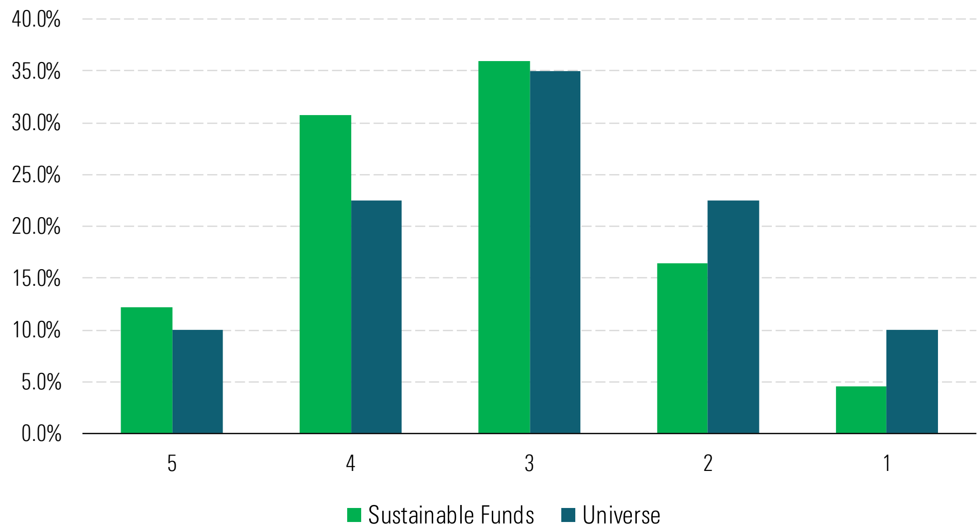
	All Funds		Equity		Fixed Income		Allocation	
Quartile	#	%	#	%	#	%	#	%
Top	332	29.4	200	30.2	52	20.5	71	36.8
Second	338	30.0	197	29.8	86	33.9	51	26.4
Third	270	23.9	147	22.2	69	27.2	50	25.9
Bottom	188	16.7	118	17.8	47	18.5	21	10.9

Source: Morningstar Direct. Data as of 30/06/2019.

For the trailing five years, the returns of 59.4% of sustainable funds landed in their category's top half. These numbers are consistent with evidence from academic research that suggests no systematic performance penalty associated with sustainable investing and possible avenues for outperformance based on reduced risk or added alpha[7].

7 "Sustainable Investing Research Suggests No Performance Penalty," Morningstar, 2016.

Exhibit 23 Sustainable funds' Morningstar Ratings Skew Positive



Source: Morningstar Direct. Data as of 30/06/2019.

Sustainable funds also have Morningstar Ratings ("star ratings") that skew positive. The star rating is a measure of risk-adjusted return relative to Morningstar Category and requires at least a three-year record. For older funds, the star rating is a combination of three-year, five-year, and, if applicable, 10-year records. As of June 2019, 43% of sustainable funds received a rating of 4 or 5, compared with 33% across the entire fund universe. Similarly, 21% of sustainable funds found themselves with only 1 or 2 stars in contrast to 33% across the entire fund universe. This is more evidence that sustainable funds, on the whole, perform on par if not somewhat better than their traditional counterparts.

Conclusion

This review of the European sustainable fund universe has elicited three broad conclusions.

First, fund investors now have a sufficient number of suitable sustainable fund options from which to choose, enabling them to build broadly diversified portfolios. For years, that was not the case. There are 2,232 sustainable funds available in more than 240 Morningstar Categories. Investor choice will only become more robust over the next several years as asset managers continue rolling out new and differentiated strategies and the many recently launched ones establish longer track records.

Second, this report underscores the challenge of identifying and categorising sustainable funds. There is a distinct lack of information in prospectuses, factsheets, and Key Investor Information Documents. The language used in these documents is often unclear and lacks standardisation. Fund names cannot be relied upon in determining whether the underlying strategies incorporate ESG criteria and, if they do, to what extent. Some funds with key terms like "ESG" or "sustainable" in their names don't seem so different from the growing cohort of traditional funds that are now formally considering sustainability issues as part of their investment process, engaging with companies, and screening out the least ESG-compliant companies. Thus, the line between traditional and sustainable investments is becoming blurrier by the day.

Third, sustainable funds come in several types. We have identified three broad categories, ESG Focus, Impact, and Sustainable Sectors. As more traditional funds become sustainable, we expect many existing sustainable strategies will shift to the left, toward Impact. Sustainable Sector funds should also experience growth as more investors see opportunities in the low-carbon transition to a green economy.

Sustainable funds have plenty of room to grow. Their assets under management and flows, though both higher than ever before, remain small compared with the overall European fund universe. Regulation will play an important role in shaping the future of this sector. Policy makers are taking steps both to increase the role of financial markets and products in meeting macro ESG goals and in ensuring that financial products do not mislead investors about the extent and nature of their purported ESG ambitions. While the scope of regulators work varies in countries and regions, the European Commission is taking a leading role with its Sustainable Finance Action Plan. Policymakers' work is broadly focused on:

- A taxonomy or common language
- ESG integration in the investment process and in the advice process
- Disclosure
- Benchmarks
- Governance, stewardship, and voting

Separate Morningstar research looks in detail at the global regulatory landscape,[8] and a forthcoming paper will study the governance and stewardship aspects.

8 "The Evolving Approaches to Regulating ESG Investing," Morningstar, 2019.

About Morningstar Manager Research

Morningstar Manager Research provides independent, fundamental analysis on managed investment strategies. Analyst views are expressed in the form of Morningstar Analyst Ratings, which are derived through research of five key pillars—Process, Performance, Parent, People, and Price. A global research team issues detailed Analyst Reports on strategies that span vehicle, asset class, and geography. Analyst Ratings are subjective in nature and should not be used as the sole basis for investment decisions. An Analyst Rating is an opinion, not a statement of fact, and is not intended to be nor is a guarantee of future performance.

About Morningstar Manager Research Services

Morningstar Manager Research Services combines the firm's fund research reports, ratings, software, tools, and proprietary data with access to Morningstar's manager research analysts. It complements internal due-diligence functions for institutions such as banks, wealth managers, insurers, sovereign wealth funds, pensions, endowments, and foundations. Morningstar's manager research analysts are employed by various wholly owned subsidiaries of Morningstar, Inc. including but not limited to Morningstar Research Services LLC (USA), Morningstar UK Ltd, and Morningstar Australasia Pty Ltd.

For More Information

Michael Laske
Product Manager, Manager Research
+1 312 696-6394
michael.laske@morningstar.com

MORNINGSTAR®

22 West Washington Street
Chicago, IL 60602 USA