



MARKET INSIGHTS

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SUSTAINABLE UCITS BOND FUNDS FOR A BETTER FUTURE

Sustainable bond funds are used by asset managers to meet the growing investor demand for products that help finance environmental- and social-friendly projects by applying some form of ESG criteria in their portfolio selection process.

While numerous academic and professional studies have analysed the market of sustainable bonds, the market of sustainable bond funds remains fairly unexplored. This report sheds light on this type of funds, focusing on their attractiveness to investors with respect to the traditional bond fundsⁱ, their characteristics, performance and fees.

We have carried out this research using Morningstar Direct's database and relying on Morningstar's definition of sustainable bond funds, i.e., funds that explicitly indicate the use of any form of sustainability, impact, or ESG strategy in their prospectus or offering documents.

KEY POINTS

- The demand for sustainable bond funds has been steadily rising in line with the growing interest of investors for sustainable investment.
- Sustainable bond funds have reached a record high AuM of EUR 621 billion in 2021, and have recorded higher net sales than traditional UCITS bond funds for the first time in 2021.
- Sustainable bond funds exhibited, on average, lower returns than traditional bond funds during the last decade, except in 2020, amid the market turbulence caused by the global pandemic.
- Sustainable bond funds have recorded consistently higher risk-adjusted returns than their traditional counterparts during the last 5 years.
- Sustainable bond funds exhibit lower fees than traditional UCITS bond funds, representing an affordable investment tool for a more sustainable future.

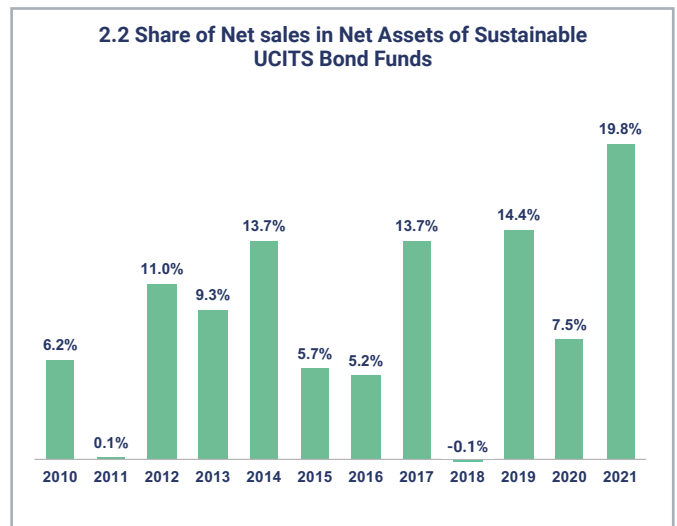
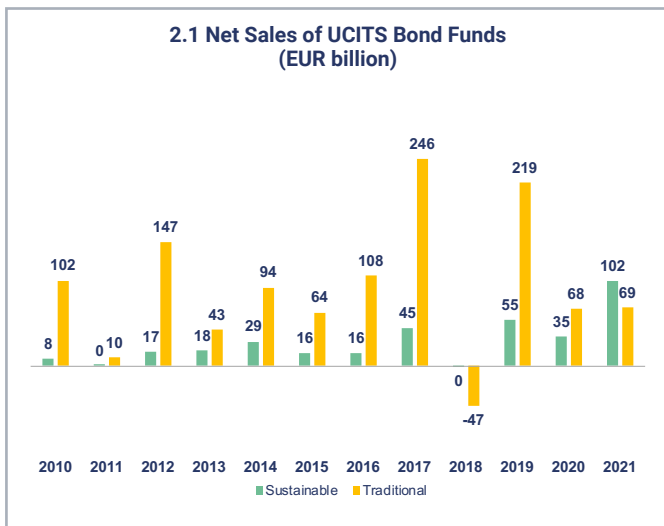
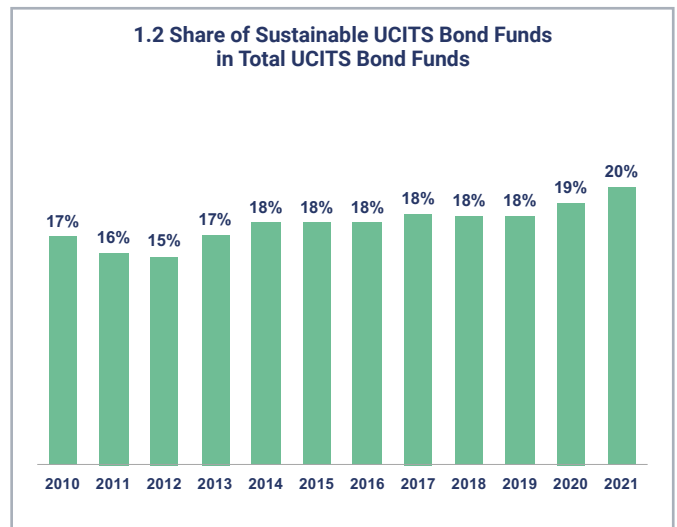
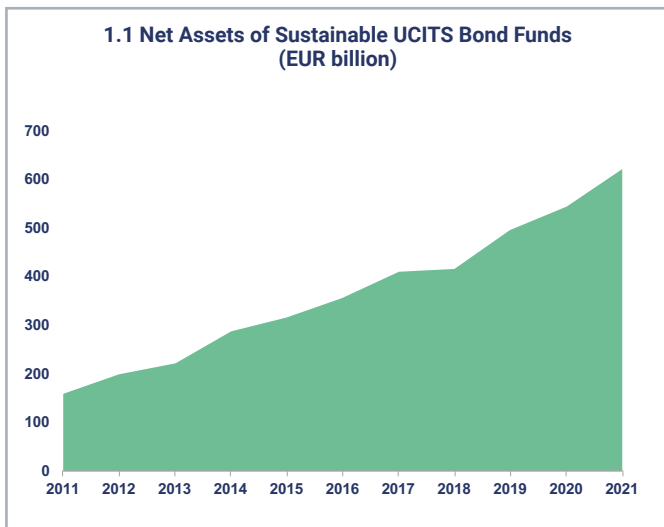
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THE DEMAND FOR SUSTAINABLE UCITS BOND FUNDS

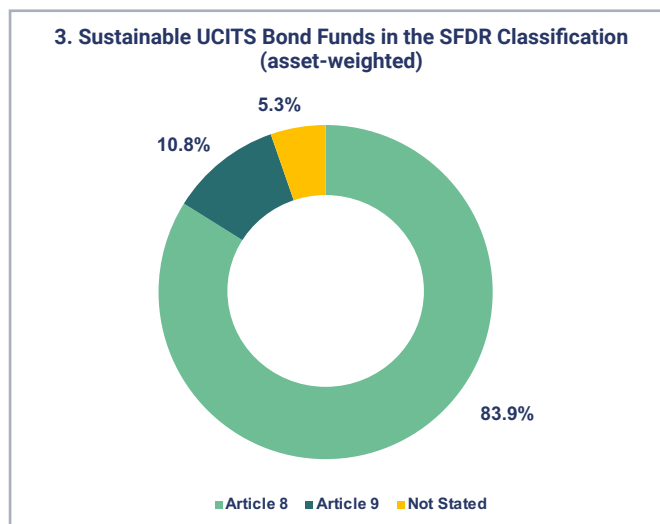
Investing in sustainable bond funds has become increasingly popular. Between the end of 2011 and 2021, net assets of sustainable bond funds have grown by 291%, from EUR 159 billion to EUR 621 billion. The ratio of net assets of sustainable bond funds in the total bond funds net assets has also increased, confirming the shift in investor preference towards sustainable investment solutions. While at the end of 2011 the share of net assets of sustainable bond funds in total UCITS bond funds amounted to 16.5%, this share was 20% in September 2021. Equally telling is the fact that the number of sustainable bond funds amounted to 1,411 at the end of 2020, compared to 4,548 traditional bond funds in the Morningstar Direct database.

Net sales of sustainable bond funds reached a record of EUR 102 billion in 2021, which exceeded the net sales of traditional bond funds for the first time. This outcome highlights the increased interest in sustainable investment solutions. Similarly, the share of net sales in net assets of sustainable bond funds has seen its record in 2021, amounting to 20%.



Source: Morningstar Direct and EFAMA's calculation

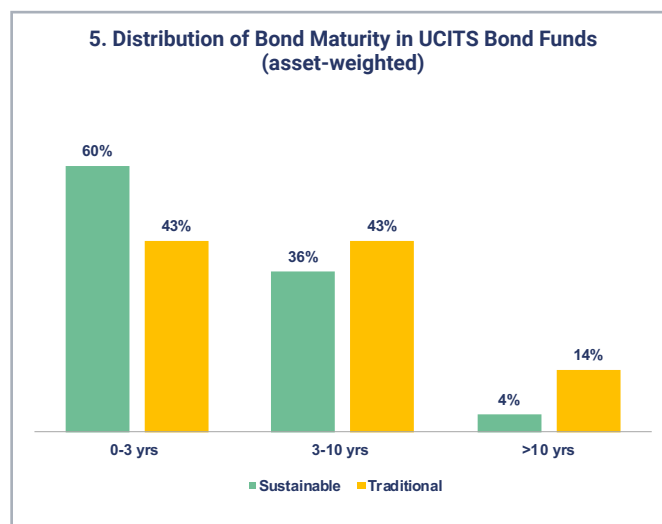
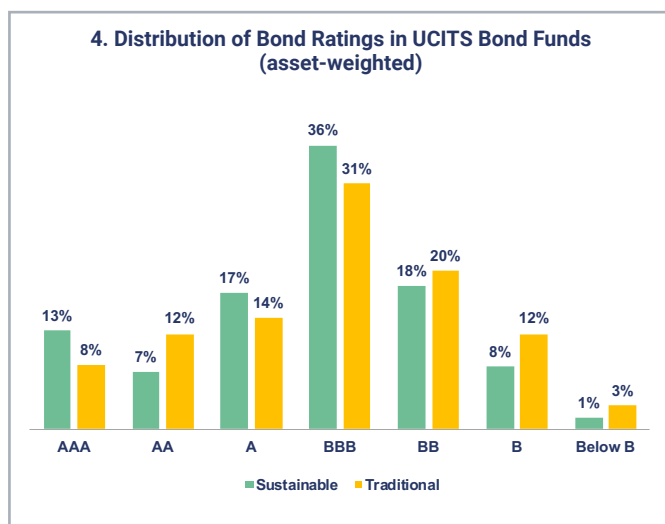
Sustainable bond funds can also be categorized as SFDR Article 8 and 9 funds. Among the group of funds in this study, 84% are Article 8 funds, while 11% represent Article 9 funds, and the remaining 5% are not classified.



Source: Morningstar Direct and EFAMA's calculation

THE INVESTMENT CHARACTERISTICS OF SUSTAINABLE UCITS BOND FUNDS

Sustainable bond funds tend to display low credit riskⁱⁱ, as only 1% of their bond components have on average a rating below B. Overall, they tend to allocate less assets into bonds of lower quality rating (below BBB), compared to traditional bond funds. 60% of bonds held in portfolios of sustainable bond funds are of shorter maturity, up to 3 years, compared to 43% in the case of traditional bond funds.

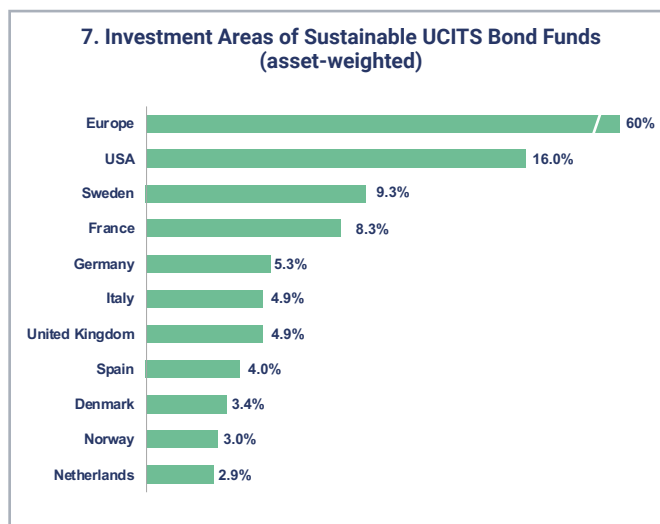
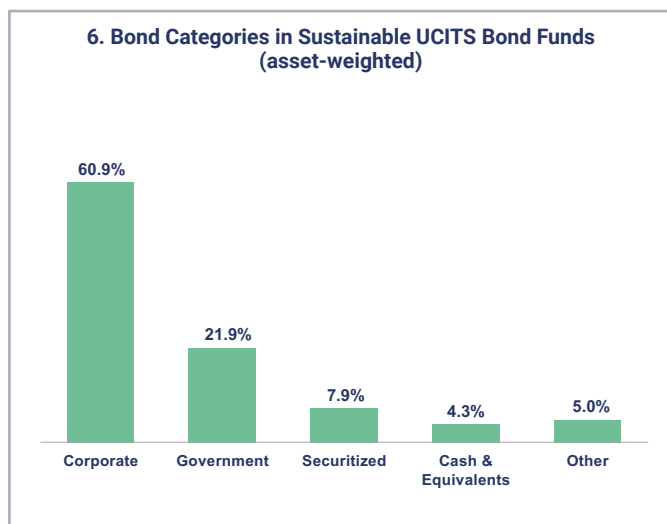


Source: Morningstar Direct and EFAMA's calculation

The share of bonds with mid- (3-10 years) and long-term maturity (> 10 years) in sustainable bond fund portfolios is lower than that of traditional bond funds, which means that sustainable bond funds are less sensitive to changes in interest rate risk.

In the portfolios of sustainable bond funds, on averageⁱⁱⁱ, the highest share is taken by corporate bonds (61%), followed by government bonds (22%), which include sustainable bonds issued by the European institutions in the framework of the Next Generation EU fund.

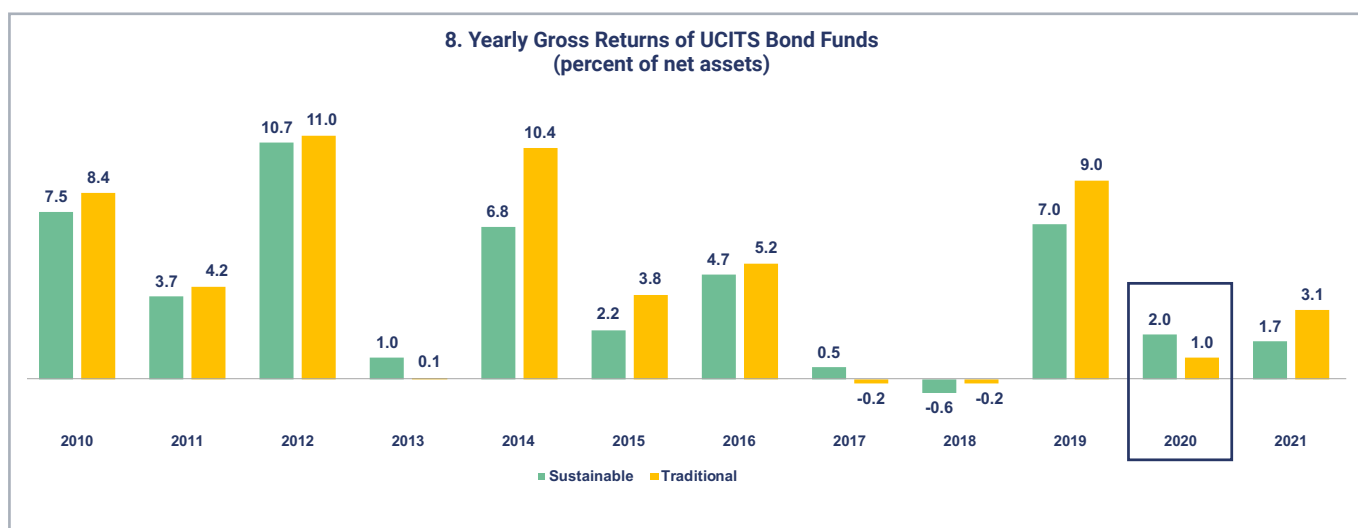
Sustainable bond funds invest an estimated 60% of their portfolio in bonds issued in Europe, compared to 16% in the United States. The share of bonds issued in Sweden and France are the highest among European countries.



Source: Morningstar Direct and EFAMA's calculation

THE PERFORMANCE OF SUSTAINABLE UCITS BOND FUNDS

We analysed the performance of bond funds by looking at the average gross annual returns of sustainable and traditional bond funds since 2010.

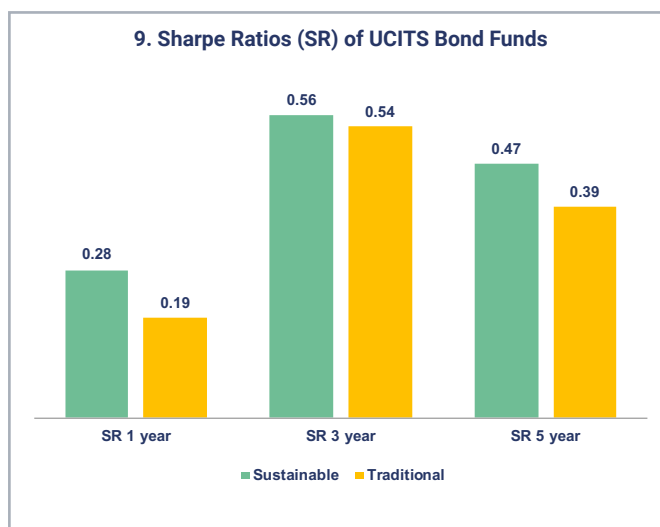


Source: Morningstar Direct and EFAMA's calculation

Sustainable bond funds exhibited, on average, slightly lower annual returns than traditional bond funds (4.0%, compared to 4.7%). We will show below that they also tend to report higher risk-adjusted returns thanks to the lower risk they entail. Interestingly, sustainable bond funds outperformed traditional bond funds in 2020, when the Covid-19 pandemic caused market distress.

There may be several potential reasons why sustainable bond funds outperformed during the risk-off period caused by the Covid pandemic. One reason – probably the most important – is that sustainable bond funds are less exposed to the traditional energy sectors, which suffered the most from the pandemic-induced economic slowdown^{iv}.

We have also calculated the risk-adjusted returns of sustainable and traditional funds over different time horizons, using the Sharpe ratio, which adjusts a portfolio's past performance for the excess risk that was taken by the investor. A high Sharpe ratio is good when compared to similar portfolios or funds with lower returns.^{vvi}



Source: Morningstar Direct and EFAMA's calculation

Figure 9 shows that sustainable bond funds have a Sharpe ratio higher than traditional bond funds. Hence, it can be concluded that sustainable bond funds exhibit, on average, a higher risk-adjusted return than traditional bond funds.

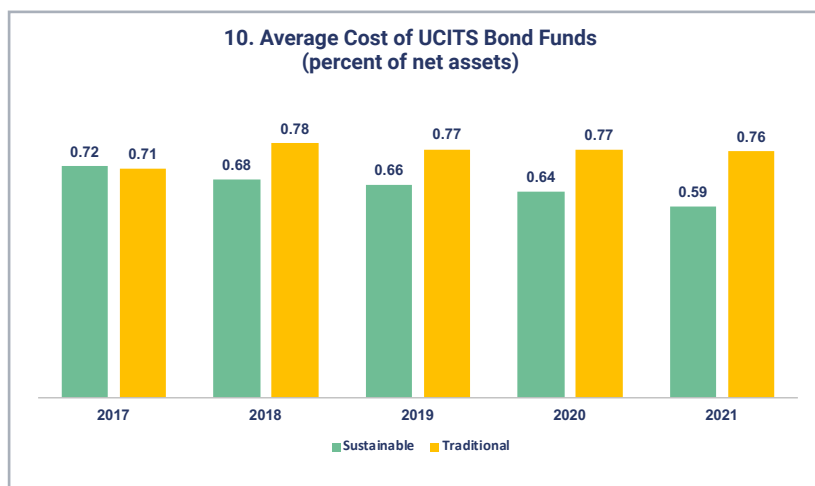
THE COST OF SUSTAINABLE UCITS BOND FUNDS

We have completed our analysis by looking at the evolution of fees of bond funds since 2017. We define the average yearly fee for a bond category as the simple average of all fees in the funds' universe at year-end (in December).

It can be observed that the average fee of sustainable funds has declined from 0.71% in 2017 to 0.59% in 2021. We also observe that sustainable bond funds charge lower fees than traditional funds (0.59% compared to 0.76% in 2021) and that the difference has increased in recent years.

The difference in fees of sustainable and traditional bond funds can be explained by the increasing competition in the fund market in recent years, during which most sustainable bond funds have been launched, as well as by the fact that fund managers offer more competitive fees in order to popularize sustainable funds among their traditional clients.

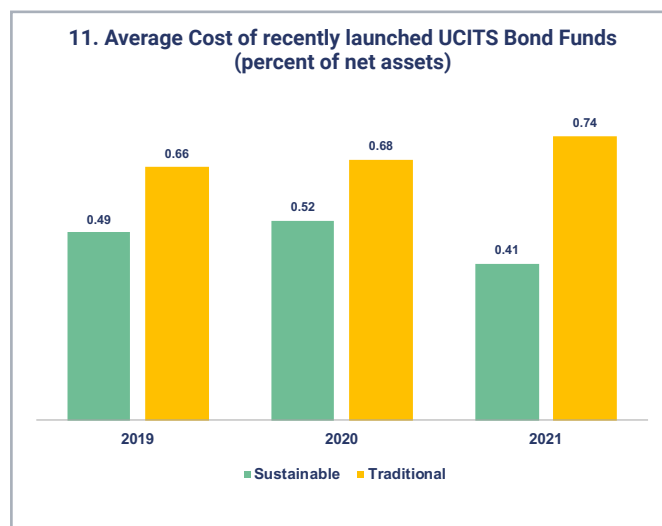
Another factor explaining the lower fees of sustainable bond funds could be related to the need to compensate investors for the fact that these funds tend to offer lower yields to investors due to their lower exposure to credit risk.



Source: Morningstar Direct and EFAMA's calculation

To verify whether the competitive fee environment in recent years has indeed caused the difference in fees between sustainable and traditional bond funds, we have analysed the yearly actual fees of bond UCITS of both categories by taking into account only funds that have been launched after the 1st of January 2018, thereby excluding the possible bias of older funds on fund fees^{vii}. We report those results in the chart below.

The fees of recently launched funds tend to be lower than the average of fees of the whole population of funds surveyed in this analysis. This is particularly true for sustainable funds. This finding confirms that the competition is particularly intense among fund managers who seek to attract investors towards newly launched funds.



Source: Morningstar Direct and EFAMA's calculation

CONCLUSION

The demand for and supply of sustainable bond funds has been steadily rising in recent years, thanks to the growing interest of investors for sustainable investment.

Our analysis shows that sustainable bond funds exhibit, on average, lower returns than traditional bond funds. The one notable exception was 2020 when their returns were higher. At the same time, we found that sustainable bond funds have on average higher risk-adjusted returns and lower fees. From this perspective, these funds appear well suited to meet the needs of investors who are looking for a favorable risk-return profile and sustainable investment solutions.

The analysis in this report represents an initial research study of UCITS bond funds that apply ESG strategies to select their investments. The universe of "dark green" bond funds that have sustainable investment as their objective is smaller than the one analyzed in this report, as is clear from the relatively low share of SFDR Article 9 funds in our sample.

It can reasonably be expected however that the adoption of the European green bond standard and relevant market-led initiatives will boost the supply and demand for sustainable bonds and have a positive impact on the development of Article 9 bond funds going forward.

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FOOTNOTES

ⁱ We define as 'traditional bond funds' all UCITS bond funds that are not categorized as 'sustainable' according to the Morningstar Direct. In the rest of the report, we will refer to bond funds with the understanding that the funds analyzed in this report are all UCITS.

ⁱⁱ MSCI (2021). [How Are High-ESG-Rated Bond Portfolios Distinct?](#)

ⁱⁱⁱ We use the weighted averages when analysing the portfolios of Sustainable bond UCITS.

^{iv} Morgan Stanley (2020). [Sustainable funds outperformed peers in 2020 during coronavirus.](#)

^v The Sharpe ratio is one of the most widely used methods for calculating risk-adjusted return by subtracting the risk-free rate from the mean return and dividing the result by the standard deviation as a measure of risk.

^{vi} Pilotte, E. A. and Sterbenz F.P. (2006) Sharpe and Treynor Ratios on Treasury Bonds. *The Journal of Business*, 79 (1), pp. 149-180. doi.org/10.1086/497409.

^{vii} We measure simple averages of fees at the end of each year of funds that have been launched after the 1st of January 2018, defining them as funds of more recent launch date.



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Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and wellfunctioning global capital markets and engage with international standard setters and relevant third-country authorities.

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