

SUSTAINABLE EQUITY UCITS

PROMOTING SUSTAINABLE BUSINESS MODELS

INTRODUCTION

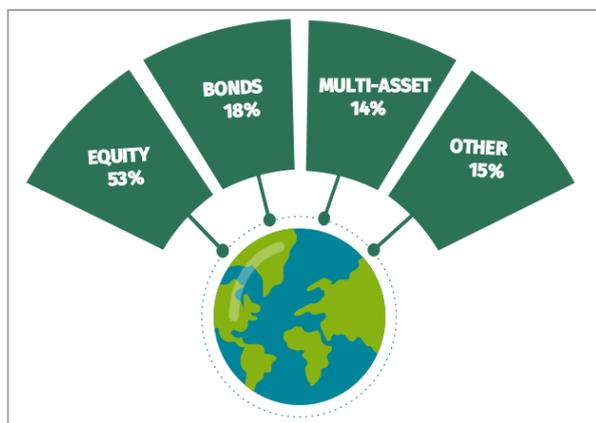
As part of the EU Green Deal, the finance industry is an essential facilitator of the transition to environmental sustainability and climate neutrality by 2050. Private investments are directed toward supporting the transition to a climate-neutral, climate resilient and fair economy, complementing the role of public funding.

For these reasons, the EU recognises that sustainable funds have the power to drive a fundamental change in economic development. At the same time, these funds help promote future growth that is both sustainable and inclusive and, last but not least, in line with the Paris Agreement and the EU's long-term sustainability goals.

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Sustainable UCITS Categories in 2023 (share in total sustainable UCITS)



Source: EFAMA's calculation based on Morningstar data

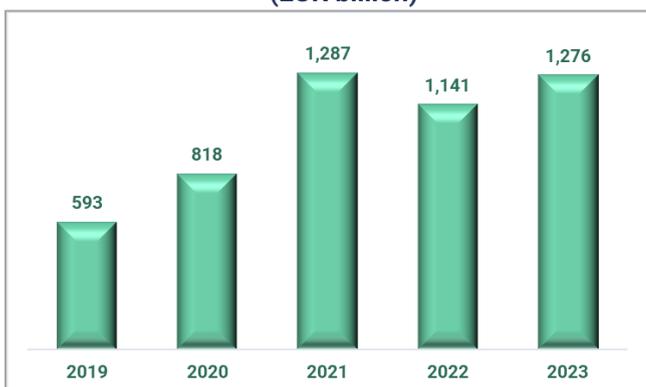
This report looks specifically at the evolving trends of the equity asset class of sustainable UCITS, whose share is the highest (53%) in total sustainable UCITS funds. It highlights their role as investment vehicles in facilitating the green transition. The universe of sustainable equity UCITS funds is defined based on Morningstar's classification of sustainable financial instruments¹. This means funds must claim to have a sustainability objective, and/or use binding ESG criteria for their investment selection. Funds that employ only limited exclusions or only consider ESG factors in a non-binding way are not considered to be sustainable investment products.

GENERAL TRENDS IN SUSTAINABLE EQUITY UCITS

Net assets of sustainable equity UCITS have more than doubled in the last five years, from EUR 593 billion to EUR 1.28 trillion. This corresponded to 24% of total UCITS net assets in 2023, compared to 15% in 2019. The highest net inflows were observed in 2021, amounting to EUR 230 billion.

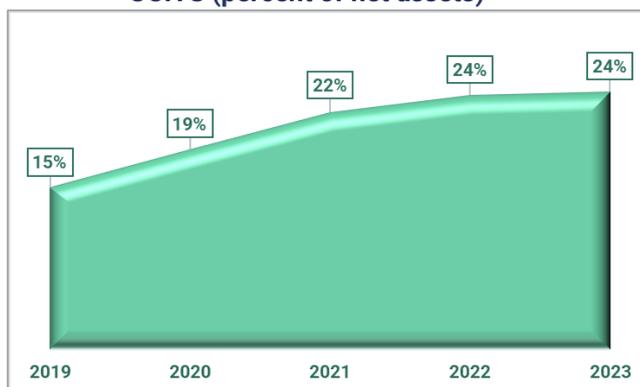
The overall poor market performance of equity UCITS in 2022 led to reduced but still positive inflows of EUR 69 billion in 2022, along with a decrease in net assets due to the fall in stock markets. The 'cooling' effect persisted in 2023, with lower net inflows of EUR 30 billion. The decline in net flows of sustainable equity UCITS can essentially be attributed to the uncertain macroeconomic conditions, characterised by persistently high inflation and interest rates, together with recession fears. These factors prompted investors to favour government bonds over sustainable equity.

Net Assets of Sustainable Equity UCITS (EUR billion)



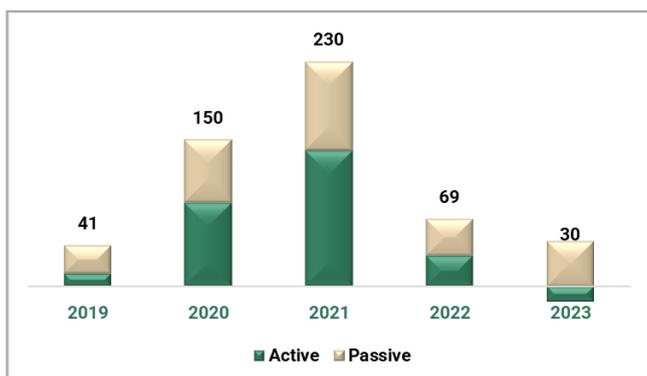
Source: EFAMA's calculation based on Morningstar data

Share of Sustainable Equity UCITS in Total Equity UCITS (percent of net assets)



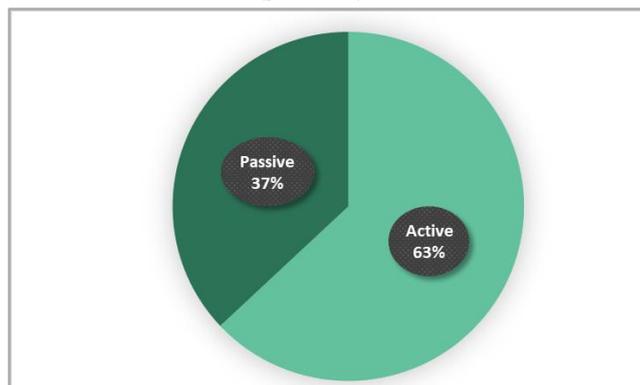
The demand for sustainable equity UCITS in 2023 still proved more resilient compared to the rest of the world², with US sustainable equity funds reporting net outflows of EUR 13.7 billion during the same year³. The inflows into UCITS funds in 2023 were mostly generated by passive sustainable equity UCITS while the active segment experienced outflows.

Net Flows of Sustainable Equity UCITS (EUR billion)



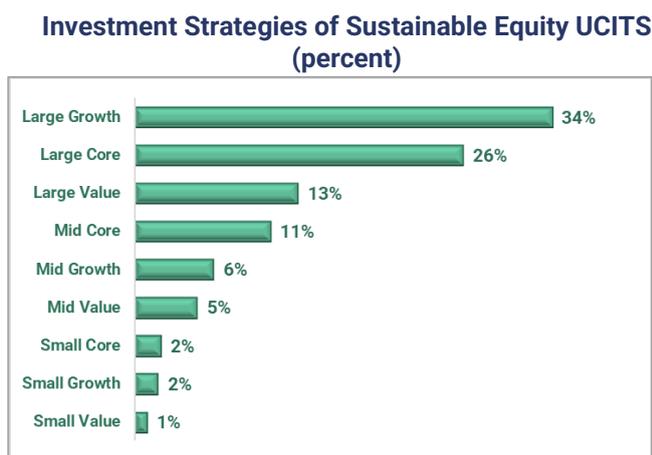
Source: EFAMA's calculation based on Morningstar data

Type of Sustainable Equity UCITS (percent)



63% of sustainable equity UCITS (EUR 804 billion) are actively managed, while the remaining 37% (EUR 472 billion) are passively managed UCITS. Almost 20% of total sustainable equity UCITS are active and passive exchange-traded funds, corresponding to EUR 255 billion, indicating a rising trend in ETFs.

Sustainable equity UCITS tend to concentrate their investments in large capitalisation companies that exhibit either high growth potential through a growth strategy or low-risk stability through a core strategy.

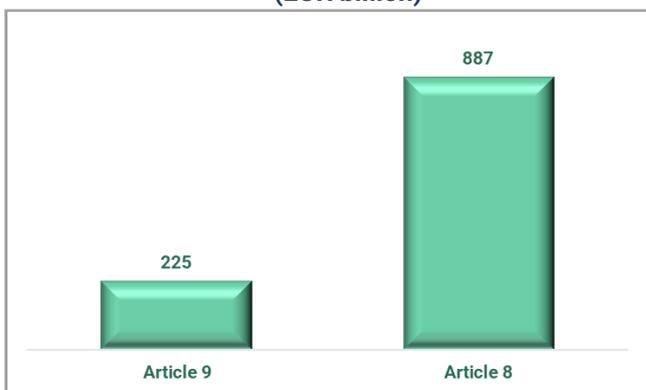


Source: EFAMA’s calculation based on Morningstar data

ALIGNMENT WITH SFDR AND ESG RATINGS

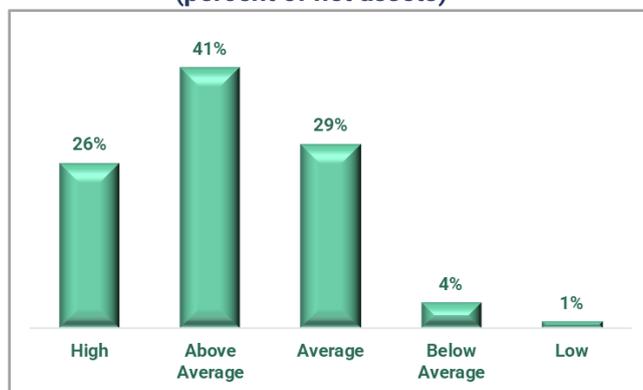
According to the SFDR classification, 18% of sustainable equity UCITS are Article 9 funds, while 70% represent Article 8 funds. In practice, many investments aiming to be sustainable are still in a transitional phase and do not yet meet the high standards required for Article 9 classification. Additionally, the concept of sustainable transition in corporate business models is not yet clearly defined. Many asset managers remain cautious with Article 9 classification due to concerns about greenwashing allegations and the regulatory uncertainty surrounding the SFDR definitions and criteria. They prefer to maintain the status quo while they wait for the ongoing SFDR review to clarify the future of these categories.

SFDR Classification of Sustainable Equity UCITS (EUR billion)



Source: EFAMA’s calculation based on Morningstar data

Sustainability Rating of Sustainable Equity UCITS (percent of net assets)



A substantial number of sustainable equity UCITS (12%) are not classified as article 8 or 9 under SFDR, however they score highly on Morningstar’s sustainability rating and a large majority of them contain sustainability-related words in their name⁴. While most sustainable equity UCITS are rated either ‘High’ or ‘Above Average’ (67%), 33% of these funds have an Average sustainable rating or below⁵. This again highlights the problem of limited overlap between the SFDR classification and ESG ratings and the need for transparency, further explained in our recent Market Insight on ESG ratings⁶. The various approaches used for determining what is “green” is the main impediment to the expansion of the market of sustainable equity UCITS.

PERFORMANCE AND COST

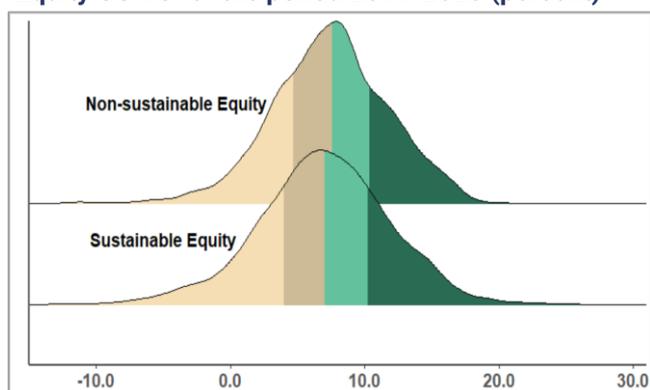
On average, sustainable equity UCITS proved to be a rewarding financial instrument in recent years. They generated positive net performances (net of costs) over the last five years, surpassing the challenge of high inflation. The sole instance of negative average net performance occurred in 2022, a year of global market downturn triggered by the Russian invasion of Ukraine. However, the recovery came quickly, as in 2023, these funds yielded a net return of 14.5%, highlighting their resilience.

Annual Net Performance of Equity UCITS (percent)



Source: EFAMA's calculation based on Morningstar data

Distribution of Average Annualized Net Returns of Equity UCITS for the period 2019-2023 (percent)



Overall, the performance of sustainable equity UCITS is comparable to that of non-sustainable equity UCITS, suggesting an absence of substantial performance trade-offs. In other words, investors do not need to sacrifice a part of their financial returns by choosing a sustainable product. This finding has previously been confirmed in recent research literature⁷.

By looking at annualized net return distributions of sustainable and non-sustainable equity UCITS during the last 5 years, we see that in both groups we have funds performing better and worse, depending on the individual characteristics of the funds, while their distributions are comparable.

The differences in performances between the two groups mainly come from the structural bias within sustainable equity fund portfolios, which exclude traditional energy components. For example, in 2022, the slightly lower performance of sustainable equity funds was due to the energy sector performing particularly well, while the opposite was observed in 2021.

On average, sustainable equity funds are generally more cost-effective compared to non-sustainable equity UCITS, a trend supported by existing literature⁸. This conclusion is confirmed even when the comparison is limited to active UCITS only.

Annual Ongoing Charges of Equity UCITS (percent)



Source: EFAMA's calculation based on Morningstar data

This contrasts with the substantial research required to manage a sustainable fund. The paradox can be explained by the increased market competition pressure in recent years, coupled with the necessity for fund managers to attract new investments, especially for newly launched ESG funds lacking an established track record. As a result, managers may offer lower fees as an incentive. The lower fees benefit investors with sustainability preferences as they can allocate their savings to sustainable products without incurring additional costs. Additionally, the industry has seen a general trend of decreasing fund fees over the past five years, reflecting a broader effort to provide cost-effective investment options, including sustainable funds.

CONCLUDING REMARKS

Achieving a carbon-neutral economy requires significant investments in research, development, and capital expenditure across energy production, construction, and other industries. These investments cannot rely solely on debt financing. They also necessitate substantial equity-based financing. Sustainable equity UCITS have emerged as an important financial instrument that can help support the European Union's green transition.

These funds have demonstrated resilience and significant growth in challenging market conditions. They play an important role in directly financing companies that contribute positively to both society and the planet, or by sending market signals through investments in impactful companies while avoiding those with negative impacts. This improves the liquidity and overall attractiveness of those companies' shares while potentially decreasing their financing cost, thereby rewarding good ESG behaviour. This includes companies transitioning towards more sustainable business models, notably those falling under the scope of Article 8 SFDR funds. While some investors may prefer to support companies already deemed sustainable, it is crucial to recognize the significance of financing companies undergoing transition. Achieving climate neutrality necessitates transforming as many companies as possible towards carbon neutrality. Hence, financing companies in the transition phase is equally as important as supporting those already operating sustainably. Companies with negative ESG impacts ("brown" companies) can also be encouraged to change for the better as a result of investment fund managers engaging with the companies they invest in to improve their ESG performance. This can happen through voting at shareholder meetings, discussions with management, public pressure, and even taking board seats. The impact of the investment will depend on the effectiveness of that engagement and whether the company transitions towards a more sustainable business model.

Sustainable equity funds excel at channeling investments across a wide range of sustainability themes, encompassing environmental, social and governance criteria. Their themes include, but are not limited to, sustainable agriculture, green building initiatives, carbon emission reduction, and promoting gender equity and diversity. These funds also adopt impact investing strategies, aiming to achieve positive, measurable, environmental, or social impacts, while also generating expected financial returns.⁹

This research suggests that investing in these sustainable assets does not necessarily compromise performance and could potentially be more cost-effective compared to traditional investment options.

Sustainable disclosures are crucial for a strong and ambitious sustainable investing framework. While the SFDR represents a significant step forward, it has not yet reached its full potential. Currently, we are facing challenges due to unclear definitions of Article 8 and 9 funds, which heavily rely on issuers' interpretations, and inconsistent data availability across the industry. This results in significant classification discrepancies. The upcoming SFDR review offers an excellent opportunity for the incoming European Commission to address these regulatory challenges. It could make the framework more investor-centric, resolve inconsistencies with other EU regulations, and provide greater support for transition finance. You can find our key policy asks for the SFDR review [here](#).

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ENDNOTES

1. According to Morningstar, a fund will be considered a sustainable investment product if in the prospectus or other regulatory filings it is described as focusing on sustainability, impact investing, or environmental, social or governance factors. Funds must claim to have a sustainability objective, and/or use binding ESG criteria for their investment selection. Funds that employ only limited exclusions or only consider ESG factors in a non-binding way are not considered to be a sustainable investment product. Thus, this universe includes all Article 9 funds and those Article 8 funds that satisfy the criteria. Morningstar classifies only 35% of all Article 8 funds as sustainable.
2. PA Future (2024). [Global sustainable funds see first quarter of outflows](#).
3. Calculated based on Morningstar data.
4. We have analysed the funds that do not report their SFDR classification in order to understand their relation to sustainability goals, based on their sustainability rating and their name.
5. Morningstar's sustainability rating is based on ESG risk. Lower risk results in a higher rating. Higher ratings indicate that a fund is, on average, invested in fewer companies with a high ESG risk.
6. See our Market Insights [ESG Ratings of Article 8 and 9 Funds – Assessing the Current Market and Policy Recommendations for the Future](#).
7. Morningstar (2023). [How Do ESG Funds Perform? The year 2022 was tough, but medium- and long-term performance holds up](#).
8. See our Market Insights [ESG investing in the UCITS market: a powerful and inexorable trend](#).
9. For the different investment strategies and the different types of impact, we refer to the [EFAMA sustainable finance brochure](#).



THE VOICE OF THE EUROPEAN INVESTMENT MANAGEMENT INDUSTRY

EFAMA is the voice of the European investment management industry, which manages around EUR 30 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.

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

EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

More information is available at www.efama.org. Follow us on [LinkedIn](#).

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