EFAMA
European Fund and Asset Management Association

MARKET INSIGHTS

ISSUE #4 | March 2021

ESG INVESTING IN THE UCITS MARKET
A powerful and inexorable trend

ESG investing refers to an approach that integrates Environmental, Social, and Governance criteria in the investment process alongside the more traditional financial factors. This investment approach has been attracting considerable interest from investors, financial institutions and policymakers for the last couple of years. Particularly policymakers in Europe have taken a wide range of initiatives to increase the flow of investments towards sustainable economic activities and projects. This development has led many researchers from both academia and the industry to analyse the growth and characteristics of the ESG market[1] .

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This Market Insights looks at the trends in the ESG UCITS market and specifically:

- contrasts the growth of ESG funds to that of non-ESG funds in the UCITS market since 2016;
- sheds light on the performance and ongoing charges of these two categories of funds;
- analyses the resilience of ESG funds both in terms of investor demand and performance following the market turbulence caused by the COVID-19 pandemic.

For the purpose of our analysis, we define ESG funds as open-end funds and exchange-traded funds[2] that refer to impact investing, ESG criteria or a sustainability strategy in their prospectus or offering documents, as highlighted by Morningstar.

RECENT TRENDS IN THE INDUSTRY

Growth in the number of funds. The number of ESG UCITS in Europe has been rising at a steady rate during the last five years in response to the ever-growing demand for sustainable investing. Based on the Morningstar data, there were 2,873 ESG funds in December 2020 (chart 1a) and 25,718 non-ESG funds[3] . In terms of net assets, passive funds represent 20% of ESG funds, whereas the others are actively managed funds. In the non-ESG universe, passive funds represent 17% and active funds 83% of total funds' net assets. ETFs account for 8% of the total ESG fund universe, compared to 9.2% in the non-ESG fund universe.

During the last five years, the number of ESG funds has grown at more than double the rate of non-ESG funds. Chart 1b shows that the growth in the number of ESG funds has been significantly higher since 2017. This growth reflects both the launch of new funds and the integration of ESG criteria into the investment process of existing funds.

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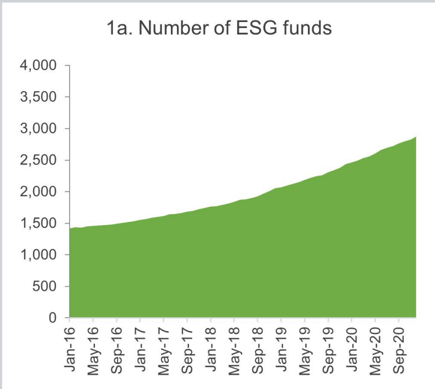
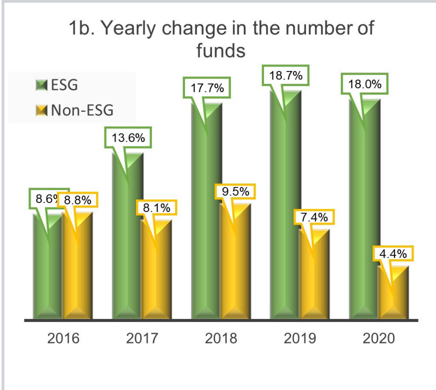


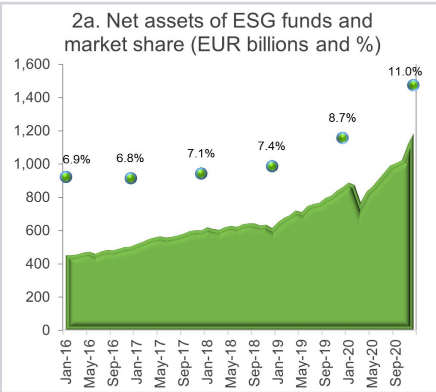
Source: Morningstar Direct platform and EFAMA's calculations.



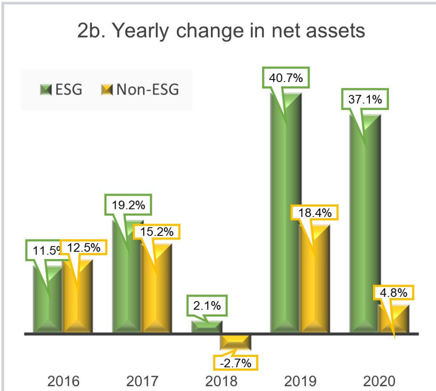
Source: Morningstar Direct platform and EFAMA's calculations.

Growth in net assets. Net assets of European ESG funds have increased significantly over the last five years, and especially in 2019 and 2020. In December 2020, net assets of ESG funds amounted to EUR 1.2 trillion. While non-ESG funds saw a growth in net assets of only 4.8% in 2020, ESG funds recorded a growth rate of 37.1%. The stronger growth of ESG funds reflects in part the higher proportion of equity funds in the ESG universe and the strong performance of equity markets in 2019 and to a lesser extent in 2020. This resulted in the share of ESG funds growing from almost 7% of total net assets in 2015 to 11% in 2020.

The net assets of ESG funds have been growing faster than those of non-ESG funds, reaching EUR 1.2 trillion at the end of 2020.

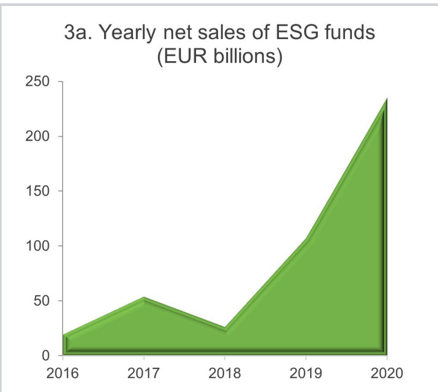


Source: Morningstar Direct platform and EFAMA's calculations.

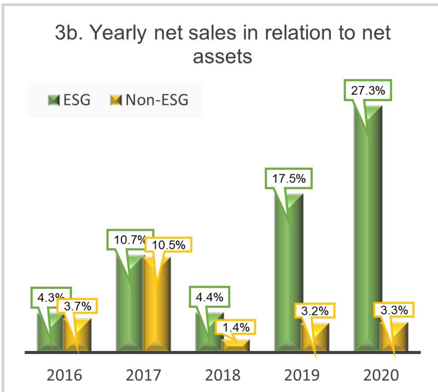


Source: Morningstar Direct platform and EFAMA's calculations.

Growth in net sales. Net sales of European ESG funds increased almost exponentially in 2019 and 2020, despite the COVID-19 pandemic. Net sales of ESG funds amounted to an estimated EUR 235 billion in 2020, which is more than tenfold the net sales recorded in 2016 (EUR 19.5 billion).



Source: Morningstar Direct platform and EFAMA's calculations.



Source: Morningstar Direct platform and EFAMA's calculations.

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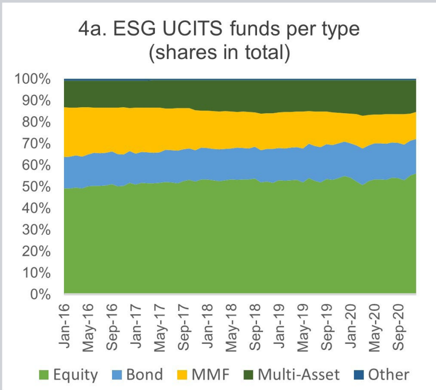
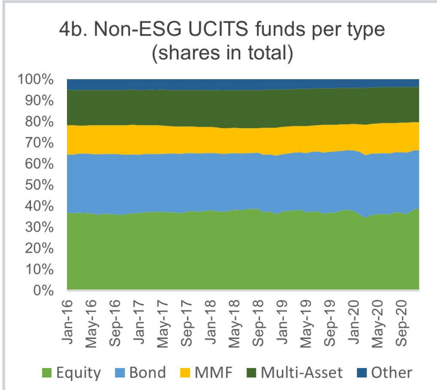
Charts 4a and 4b show the evolution of the shares of different types of ESG and non-ESG funds during the last 5 years. Equity funds are the most dominant ESG fund type, representing 56% of the overall ESG fund universe in December 2020, followed by bond funds (16%) and multi-asset funds (15%). In the non-ESG universe, the share of equity funds was much smaller at the end of 2020 (39%), compared to 28% for bond funds.



Source: Morningstar Direct platform and EFAMA's calculations.



Source: Morningstar Direct platform and EFAMA's calculations.

Despite the fact that equity and bond funds are the largest categories in the ESG universe and have grown massively since 2016 (197% and 181%, respectively), multi-asset ESG funds were the fastest growing fund category in the ESG world, recording a 210% rise in net assets since 2016. Other ESG funds recorded a lower increase of 80%. ESG MMF assets increased by only 40%, in the context of low fixed-income and money market returns.

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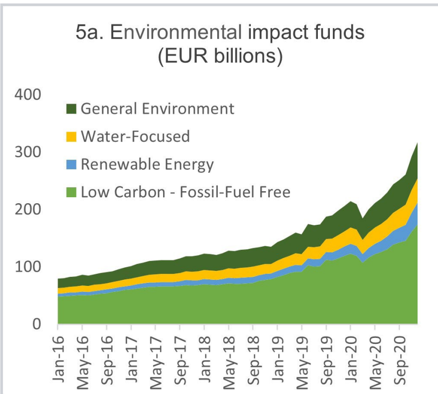
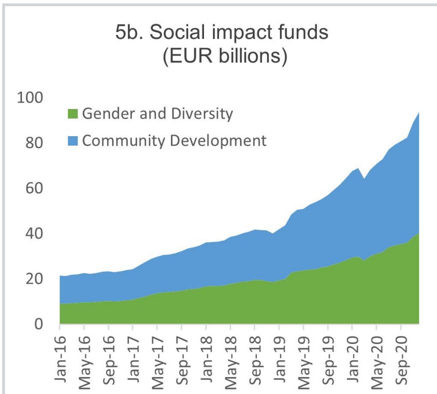
The growth of impact funds. Impact funds constitute a special category of ESG funds that seek to make a measurable impact on specific issue areas. Environmental impact funds saw their assets triple in 2016-2020, reaching EUR 320 billion at the end of 2020. Funds focusing on low carbon emissions make up 55% of these assets. Renewable energy funds exhibited the highest growth (604%) over the same period, albeit from a lower level of net assets.

Although all types of impact funds have shown substantial growth in the last five years, those with an environmental focus have been the clear winner.

Within social impact funds, those focusing on gender and diversity and community development have exhibited growth of roughly 340% since January 2016. Overall, social funds have experienced substantial growth in demand, but environmental funds still hold the dominant position in the ESG universe.





Notes: Charts 5a and 5b report the evolution of net assets of environmental and social impact funds between January 2016-December 2020.

Performance and cost. The gross annual performance of ESG equity funds reached on average 10.4% in 2016-2020. This compares to 9.2% for non-ESG funds. The difference is attributable mostly to the strong performance of ESG equity funds observed in 2020 (8.6%, compared to 4.6% for non-ESG equity funds), as many of these funds were less exposed to sectors that were severely affected by the COVID-19 crisis, in particular energy and financial services.

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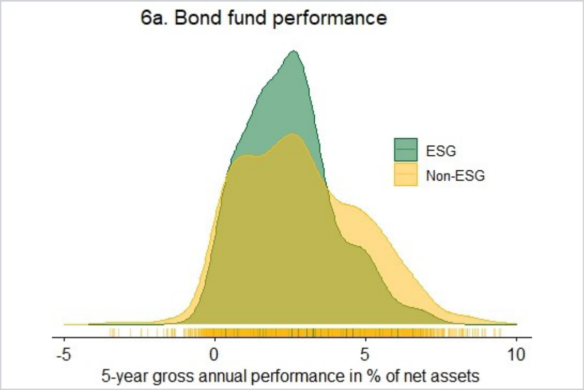
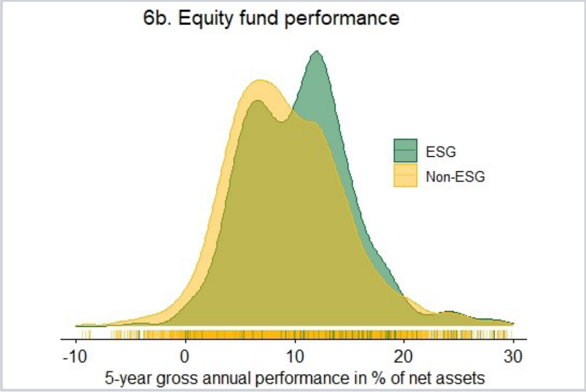
ESG bond funds recorded an average gross annual performance of 2.5% in 2016-2020, compared to 2.9% for non-ESG bond funds. Interestingly, the gross performance was higher for ESG bond funds in 2020 than for non-ESG funds (1.7% compared to a negative return of 0.5%). One possible explanation is that ESG bond funds tend to hold less risky assets than non-ESG bond funds, as illustrated in the Annex. The outbreak of the pandemic led to a flight to safety in the bond market, which negatively impacted the non-ESG bond funds relative to ESG bond funds.

What is also important to note is that the universe of ESG and non-ESG funds is quite large, including a wide variety of different funds in terms of issuers, types of securities, geographical exposure, currency and industrial sectors. These differences explain that the performance distribution is very wide, with some ESG and non-ESG funds reporting relatively low returns throughout 2016-2020 and other funds showing much higher than average returns, as shown in charts 6a and 6b.

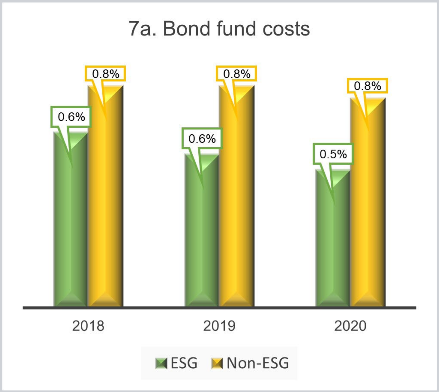


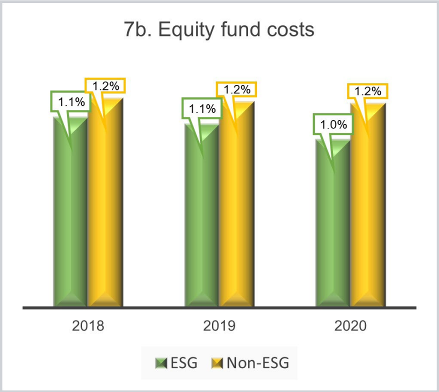


Notes: Charts 6a and 6b display the density distribution of 5-year gross annual performance[4] of ESG and non-ESG bond and equity funds.

Source: Morningstar Direct platform and EFAMA's calculations.

Charts 7a and 7b show that ESG funds, on average, tend to be slightly cheaper than non-ESG funds, despite the extra costs associated with obtaining and analysing ESG data and the costs of adapting the investment management process to the new strategy. This situation can be explained by the fact that many ESG funds have recently been launched in the context of stiff competition among fund managers, who also have a strong incentive to limit ongoing charges to attract investors.





Notes: Charts 7a and 7b display annual asset-weighted average ongoing charges[5]. Source: Morningstar Direct platform and EFAMA's calculations.

It is also interesting to note that the cost of ESG and non-ESG funds has fallen in recent years. Charts 8a and 8b confirm this by showing that the ongoing charges of ESG and non-ESG funds launched in 2019 and 2020 were lower than the average fees reported in charts 7a and 7b, which were calculated for the whole universe of funds offered in 2020, regardless of their launch dates.

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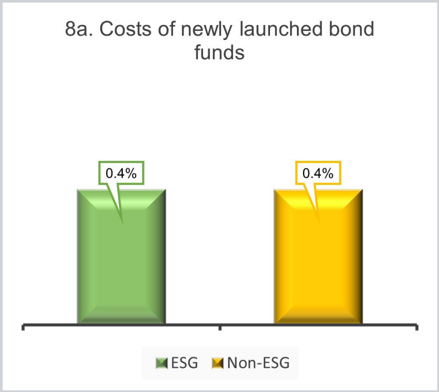

Source: Morningstar Direct platform and EFAMA's calculations.

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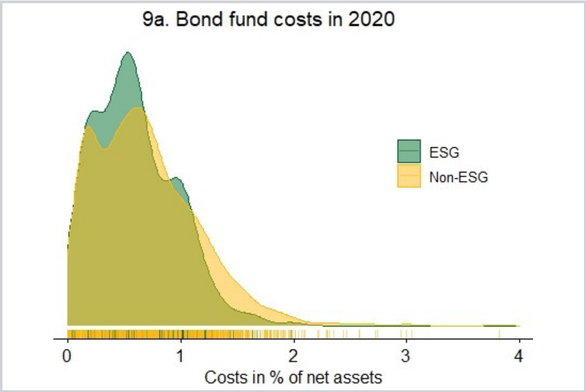
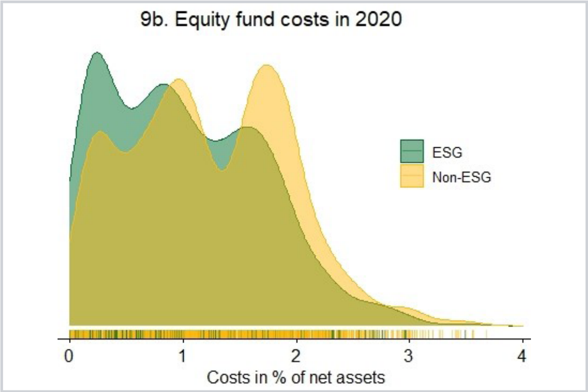
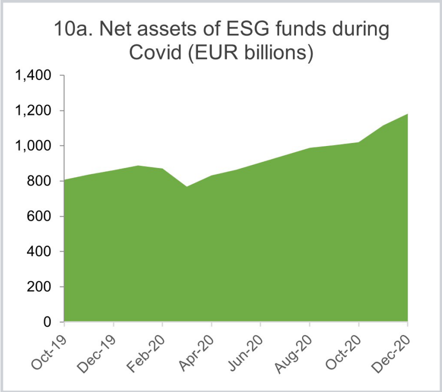
The charts below show the distribution of the ongoing charges of all the ESG and non-ESG funds covered in this report. It can be observed that the charges vary considerably across funds. This dispersion partly reflects the fact that some funds are ETFs and index tracking funds, which tend to have low expenses while others are actively managed funds.



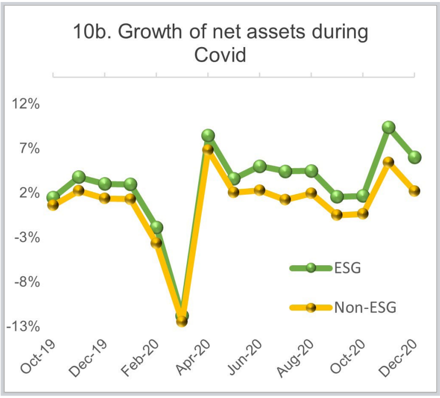


Notes: Charts 9a and 9b display the density distributions of ongoing charges in percent of net assets, which give a precise indication of the relative concentration of funds within a certain range of ongoing charges. *Source: Morningstar Direct platform and EFAMA's calculations.*

Impact of COVID-19 on ESG funds. The COVID-19 pandemic, which led to a sharp fall in global markets in March 2020, did not halt the growth of the ESG market in 2020, quite the contrary.



Source: Morningstar Direct platform and EFAMA's calculations.



Source: Morningstar Direct platform and EFAMA's calculations.

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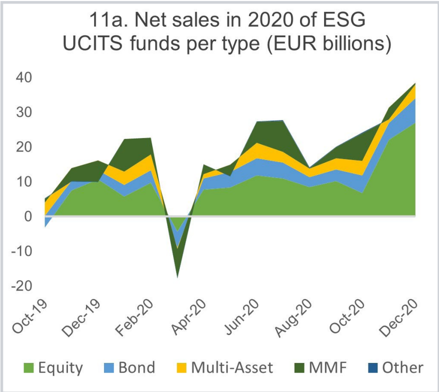
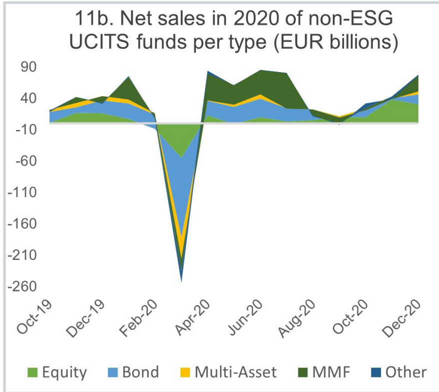
Net sales remained fairly robust in 2020, showing a dip only in March when ESG funds experienced net outflows of EUR 19 billion, mostly due to money market funds (MMFs) (see charts 11a and 11b). This compared to net outflows of EUR 254 billion from non-ESG funds. Concerning net assets, however, these net outflows were roughly comparable -2.1% for ESG and 2.9% for non-ESG funds.

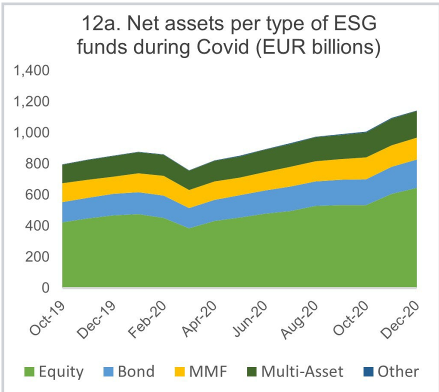


Source: Morningstar Direct platform and EFAMA's calculations.

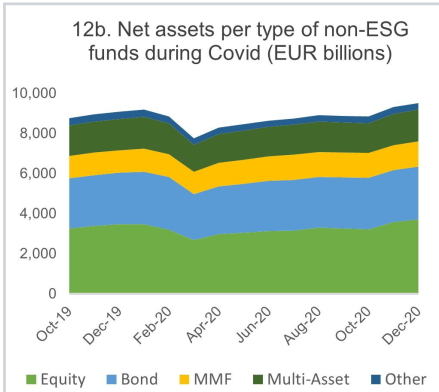


Source: Morningstar Direct platform and EFAMA's calculations.

Net sales of ESG funds bounced back strongly during the spring and at the end of the year. This led net assets of ESG funds to grow at a faster rate than non-ESG funds (see charts 12a and 12b), with the share of each category of funds remaining stable within each fund universe.



Source: Morningstar Direct platform and EFAMA's calculations.



Source: Morningstar Direct platform and EFAMA's calculations.

CONCLUDING REMARKS

This Market Insights analyses the recent trends in the ESG UCITS market, with particular attention given to the impact of the coronavirus pandemic. We find that this market has benefited from strong growth since 2016, in terms of the number of funds, net sales and net assets.

The report also shows that the performance of ESG and non-ESG funds has been broadly similar since 2016, the exception being 2020 when ESG funds recorded a higher gross performance. This finding confirms that, on average, investors do not have to sacrifice long-term returns to support the transition to a more sustainable economy. Equally important, the report shows that the differences between the performance of the top and bottom ESG and non-ESG funds are quite large, reflecting the fact that the universe of funds is made up of many different funds in terms of investment strategy.

Interestingly, ESG funds tend to charge, on average, slightly lower fees than non-ESG funds, despite the added data and research costs associated with ESG investments. This finding suggests that ESG fund managers strive to attract investors and reach a critical size by competing based on reduced fees. Our report also highlights a downward trend in the cost of both ESG and non-ESG funds.

Finally, in our view, the strong investor demand for ESG funds suggests that the COVID-19 pandemic has increased the overall awareness of the relevance of the global sustainability agenda. Hence, the ESG market may have reached a turning point in 2020.

FOOTNOTES

[1] See References for insightful research publications on the topic.

[2] From this point on we refer to the UCITS funds as solely 'funds'.

[3] Non-ESG funds include funds that Morningstar classifies as non-ESG as well as those that are not yet classified as ESG nor non-ESG.

[4] Performance is measured by 5-year gross annualized performance over 90-day T-Bill (5-year Morningstar return).

[5] To account for possible calculation biases, we have also calculated simple averages of ongoing charges and reached similar conclusions.

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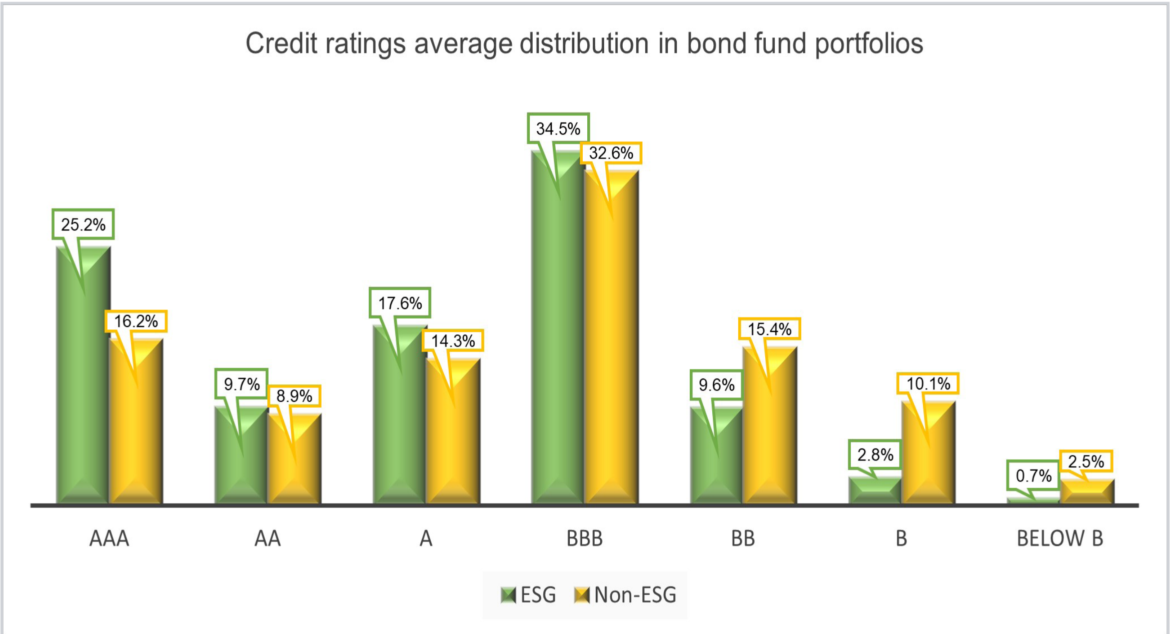
ANNEX



Source: Morningstar Direct platform and EFAMA's calculations.

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