European Sustainable Funds Landscape: 2020 in Review
A Year of Broken Records Heralding a New Era for Sustainable Investing in Europe

Executive Summary
The year 2020 was like no other. It will be remembered as the year of the coronavirus pandemic, which rapidly spread across the world, killing over 1.7 million people, and highlighted deep global inequalities and disrupted everyone's day-to-day lives. But, simmering in the background, 2020 was also the year that sustainable investing reached a pivotal point.

Spurred by the COVID-19 crisis, many public companies, asset managers, and governments stepped up their commitment to sustainability in the last year. More asset managers than ever are now incorporating environmental, social, and governance factors into their investment processes and purposefully engaging with investee companies on material issues ranging from climate change to employee treatment, supply chain oversight, and diversity and inclusion.

Meanwhile, demand for strategies that mitigate ESG risks, align with investor values, or focus on a sustainability theme reached new highs. In Europe, flows into ESG funds ballooned to EUR 233 billion in 2020, from EUR 126 billion the year before. Responding to investor demand, asset managers launched a record number of 505 new ESG funds and repurposed more than 250 conventional funds in the last year.

Finally, 2020 was also a pivotal year for the regulation of ESG investing aimed at encouraging the flow of capital into sustainable activities to meet the EU goal of a net-zero economy by 2050. Perhaps the biggest yet-uncertain piece of the EU Sustainable Finance Action Plan that was keeping asset managers busy last year was the Sustainable Finance Disclosure Regulations, or SFDR. Taking effect on 10 March 2021, the new rules require firms to provide information about the ESG risks in their portfolios and classify their products into categories that will dictate additional disclosure requirements.

For investors, the new rules will constitute welcome protections from greenwashing. Investors will get more data on how a fund is doing against its ESG objective. They will also be told not only about the sustainability risks that pose a threat to their investments but also about the negative impacts their investments might have on sustainability factors such as climate, the environment, social and employee matters, and respect for human rights—the so-called double materiality. This regulation is opening up a new era packed with possibilities for investors that will bring confidence to the sector.

This report provides a view of the European sustainable funds landscape as we enter 2021, examining the continued growth in inflows, assets, and the number of sustainable funds available to institutional and retail investors in Europe. We also analyse how European sustainable funds stack up against their...
conventional counterparts in terms of ESG risks, alignment with the low-carbon transition, fees, style factors, and sector exposures.

**Key Takeaways**

- Assets in European sustainable funds surged about 52% in the past year to hit EUR 1.1 trillion in December 2020, driven by significant inflows, repurposed assets, and rising financial markets.
- Flows in 2020 were almost double those of 2019, at EUR 233 billion. After a decline during the COVID-19 market shock in the first quarter, sustainable fund flows recovered strongly to reach record highs in the fourth quarter, with just shy of EUR 100 billion in net new money.
- Climate-change-themed funds were among the best sellers in 2020, while even more funds divested from the highest-carbon emitters. This is evidence that investors continue to prepare for the risks and opportunities created by the transition to a low-carbon economy.
- Product development broke new records, with the launch of 505 new sustainable funds and the repurposing and rebranding of at least 253 conventional funds last year. The fourth quarter hit an all-time high of 147 new offerings. This brings the total European sustainable funds universe to 3,196 funds.
- In 2020, the European Commission laid the foundations for the most groundbreaking suite of regulations for sustainable investing. Investors will begin to reap the benefits from March 2021.

**Defining the European Sustainable Funds Universe**

Defining the sustainable funds universe is complicated because there is no consensus yet on the attributes that sustainable funds should or shouldn’t have and asset managers have launched strategies reflecting their own takes on sustainable investing.

Sustainable investing can be broadly defined as the incorporation of environmental, social, and governance-related issues into investment decisions. For the purpose of this landscape report, like for previous ESG fund flows reports, we categorize as sustainable those open-end funds and exchange-traded funds that, by prospectus, fact sheet, or other available resources, claim to have a primary sustainability objective and/or use binding ESG criteria for their investment selections.

Our European sustainable funds universe does not contain funds that employ only limited exclusionary screens such as controversial weapons, tobacco, and thermal coal, nor does it contain funds that now formally consider ESG factors at some point in their investment process. These are often referred to as funds that take an ‘ESG integration’ approach. They integrate ESG factors into their traditional investment process to better manage risks and improve returns. But because sustainability is not a central feature of their investment strategy and they do not integrate ESG factors in a binding way for their investment selection, these funds are excluded from our universe.

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1 Money market funds, feeder funds, and funds of funds are excluded from the scope of this report.
We recognise, however, that many funds in Europe now follow an ESG integration approach and also employ some level of ESG exclusions. In fact, last year, when Morningstar analysts initiated discussions with asset managers in Europe about the Morningstar ESG Commitment Level, they found that virtually all those included in the first wave of assessments incorporate ESG to some degree across their investment strategies.

The European sustainable funds universe derived using the above definition included 3,196 funds as of December 2020. These funds represent a broad array of strategies that aim to address a variety of sustainability preferences and investment objectives. Their approach to ESG ranges from using ESG exclusions to focusing on impact. Many employ a best-in-class approach and/or focus on specific sustainability themes such as climate transition, water, or the U.N. Sustainable Development Goals, or SDG. Many also use stewardship to nudge companies towards better ESG practices. ESG approaches are often used in combination and are by no means mutually exclusive at the fund level.

In previous research, we shared the ESG fund taxonomy we created to help investors understand the range of sustainable investment options. Going forward, we intend for it to evolve and align with the EU definition and classification of ESG and sustainable funds as prescribed by the Sustainable Finance Disclosure Regulations (see section on Regulation in this report). Under the new rule, the entire universe of European funds will be classified by their managers into one of three following categories:

- Sustainable, or Article 9, funds—so called after the regulation that defines them as those funds that have a sustainable investment objective
- Other ESG, or Article 8 funds, a catchall category of financial products that promote environmental or social characteristics
- All other funds that have no stated ESG ambitions

We will start to provide research on European sustainable funds based on this classification as soon as the information becomes available. Although SFDR takes effect in March, it is unclear how quickly asset managers will comply with the regulation. As we align with the EU classification, our universe of funds may end up looking at least somewhat different from the one presented in this report.

**Assets Smash Through the EUR 1 Trillion Milestone**

Driven by increased interest in ESG issues from both institutional and retail investors, assets in European sustainable funds have grown almost ten-fold in the past decade, from EUR 112 billion at the end of 2010 to EUR 1,101 billion at the end of 2020.

In 2020 alone, assets surged 51.8%. This compares with a mere 3% increase in assets for the entire European fund universe. Excluding new fund launches and repurposed funds, sustainable fund assets in existing sustainable funds grew by 32.4%.
As Exhibits 1 and 2 show, the growth in sustainable fund assets has accelerated in the past couple of years, supported by significant inflows, repurposed assets, and upward-trending markets. Zooming in and looking at quarterly figures, we can see that assets have consistently increased quarter over quarter, with the only blip in the trend coming in the first quarter of 2020. But even then, and to the surprise of many, sustainable funds proved remarkably resilient during the COVID-19 market sell-off. Assets dropped by only 10.6% in first-quarter 2020, while the overall European fund market took a greater hit of 16.2%. The upward trend resumed in the following quarters, with assets hitting the EUR 1 trillion mark in November. Besides, the fourth quarter saw the highest growth figures of 2020 at over 23.2%.

Passive funds have seen their market share increase considerably over the years and already account for 22.5% of the European sustainable fund market, up from 10.3% five years ago.
**Exhibit 2** Quarterly European Sustainable Fund Assets (EUR Billion)


**Sustainable Funds Flows Almost Double in 2020**

The flows picture looks even more striking. European sustainable funds attracted a record-high EUR 233 billion in inflows in 2020. This was almost double the figure for 2019 and 10 times higher than five years earlier.

**Exhibit 3** Annual European Sustainable Funds Flows (EUR Billion)

After the decline in inflows during the COVID-19 market shock in the first quarter, sustainable funds flows recovered strongly to reach never-before-seen heights in the fourth quarter, with just shy of EUR 100 billion in net new money. Flows were up 84% on the previous quarter, giving a strong finish to the year.

Exhibit 4 Quarterly European Sustainable Funds Flows (EUR Billion)

Meanwhile, sustainable funds took a higher share of the overall European funds flows in the fourth quarter, amounting to 45%, compared with 40% in the third quarter.

Exhibit 5 Sustainable Funds Flows Compared With Conventional Funds Flows in the Fourth Quarter (EUR Billion)

<table>
<thead>
<tr>
<th>4Q20</th>
<th>Sustainable Funds AUM</th>
<th>Flows</th>
<th>Conventional Funds AUM</th>
<th>Flows</th>
<th>Overall Fund Universe AUM</th>
<th>Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocation</td>
<td>170</td>
<td>10.6</td>
<td>1,387</td>
<td>3.2</td>
<td>1,556</td>
<td>13.8</td>
</tr>
<tr>
<td>Alternative</td>
<td>6.1</td>
<td>0.1</td>
<td>330.8</td>
<td>6.1</td>
<td>337</td>
<td>6.2</td>
</tr>
<tr>
<td>Convertibles</td>
<td>5.5</td>
<td>0.0</td>
<td>54.9</td>
<td>0.7</td>
<td>60.4</td>
<td>0.7</td>
</tr>
<tr>
<td>Equity</td>
<td>681</td>
<td>68.0</td>
<td>4,066</td>
<td>68.4</td>
<td>4,746</td>
<td>136</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>221</td>
<td>20.2</td>
<td>2,939</td>
<td>37.8</td>
<td>3,159</td>
<td>58.0</td>
</tr>
<tr>
<td>Property</td>
<td>11.6</td>
<td>0.0</td>
<td>163</td>
<td>1.2</td>
<td>174</td>
<td>1.2</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>6.5</td>
<td>0.0</td>
<td>96.5</td>
<td>4.3</td>
<td>103</td>
<td>4.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,101</strong></td>
<td><strong>99</strong></td>
<td><strong>9,036</strong></td>
<td><strong>122</strong></td>
<td><strong>10,136</strong></td>
<td><strong>221</strong></td>
</tr>
<tr>
<td><strong>% Overall Fund Universe</strong></td>
<td><strong>11</strong></td>
<td><strong>45</strong></td>
<td><strong>89</strong></td>
<td><strong>55</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Increased interest in ESG issues, regulation, and the multiple studies showing the outperformance of companies with better ESG profiles, especially during downturns, as experienced in the first-quarter, have all led to a significant boost to the last quarter of the year. We expect this trend to continue in 2021 as ESG truly enters the mainstream. It is likely that changes to MiFID II will encourage more retail flows into sustainable funds as financial advisors are now legally bound to ask a client about their sustainability preferences. This is expected to spur more interest and education around sustainable investing.

**Flows — Leaders and Laggards**

The environment was a popular investment theme throughout 2020 but even more so towards the end of the year. In the fourth quarter, seven funds with an environmental flavour landed in the top 10 funds in terms of flows. Among these, six, including iShares Global Clean Energy ETF, Pictet-Clean Energy Fund and Nordea 1 - Global Climate & Environment Fund, attracted more than EUR 1 billion of inflows each. Clean energy funds were also the big winners of 2020 in terms of performance. The top funds returned between 100% and 200%, driven by expectations of increased long-term demand for alternative energy equipment.

**Exhibit 6 Top 10 Sustainable Funds Flows in Fourth-Quarter 2020**

<table>
<thead>
<tr>
<th>Net Inflows (EUR, Million)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>iShares Global Clean Energy ETF</strong></td>
</tr>
<tr>
<td><strong>Handelsbanken Hållbar Energi</strong></td>
</tr>
<tr>
<td><strong>Pictet - Global Environment Opportunities</strong></td>
</tr>
<tr>
<td><strong>Pictet-Clean Energy</strong></td>
</tr>
<tr>
<td><strong>Nordea 1 - Global Climate &amp; Environment</strong></td>
</tr>
<tr>
<td><strong>CSIF (CH) III Equity World exCH ESG</strong></td>
</tr>
<tr>
<td><strong>BlackRock CCF Dev World ESG Screened Index</strong></td>
</tr>
<tr>
<td><strong>ACS Climate Transition World Equity</strong></td>
</tr>
<tr>
<td><strong>Nordea 1 - Emerging Stars Equity</strong></td>
</tr>
<tr>
<td><strong>BGF Sustainable Energy</strong></td>
</tr>
</tbody>
</table>


In the bottom 10, a few funds experienced large outflows in the fourth quarter, but these can be explained by clients reallocating money within the same asset management firms. For example, NN IP saw several of its clients move assets within its sustainable equity strategy, some from NN IP funds to NN IP mandates, while others switched fund domiciles to better suit their regulatory and tax needs. In its totality, NN IP saw its sustainable equity assets increase in fourth-quarter 2020.
Provider Rankings
Among sustainable fund providers in Europe, BlackRock, which routinely tops the leader board, pulled way ahead in fourth-quarter 2020, garnering more than triple the flows registered by its closest rival, Amundi. BlackRock garnered over an astonishing EUR 15.8 billion of new money in the last three months, helped partly by its ETF business, as we will see in the section "Spotlight on Passive ESG Funds".

Exhibit 7 Bottom 10 Sustainable Flows in Fourth-Quarter 2020

Exhibit 8 Top 10 European Sustainable Fund Providers by Flows in Fourth-Quarter 2020
Over the same period, Unigestion saw the biggest outflows at over EUR 400 million, more than twice the next nearest losses from Fisch Fund Services. Unigestion’s outflows can be partly explained by the investment style of the firm. Unigestion’s strategies have high exposure to the “low volatility” factor, which was among the worst-performing factors in 2020. The firm, however, experienced inflows on the mandate side. Large institutions such as pension plan or sovereign funds usually prefer to invest in mandates rather than in pooled funds. It is often easier for them to negotiate with their custodians and consolidate their portfolios.

![Exhibit 9 Bottom 10 European Sustainable Fund Providers by Flows in Fourth-Quarter 2020](image)

**Fund Launches at New Records**

The European sustainable funds space saw an unprecedented level of product development activity in 2020, with 505 new funds coming to market. Asset managers continued to expand the range of options available to investors in terms of asset class, market exposure, and theme.

Equity remained the source of the greatest product proliferation with 81 new offerings, followed by allocation and fixed income with 39 and 22, respectively. Meanwhile, in terms of investing style, passive ESG offerings represented 19% of total new launches, up from 14% in 2019. This year’s passive launches included iShares $ Corp Bond ESG ETF, Lyxor MSCI World Climate Change (DR) ETF, and CSIF (CH) I Equity Europe ex CH ESG Fund.
European Sustainable Funds Landscape

Exhibit 10 European Sustainable Fund Launches Per Year

While broad ESG funds continued to represent the bulk of new offerings for 2020, funds with an environmental flavour accounted for 13% of new launches. Of these, 66% (42) target climate change. These include UBS (CH) IF Equities Global Climate Aware Fund, RobecoSAM Smart Energy Equities fund, and NN (L) Corporate Green Bond. Funds such as these allow investors to mitigate risk and/or gain exposure to companies that will benefit from, or contribute to, the transition to a low-carbon economy. The range of options for climate-conscious investors is growing.

On the passive side, we saw the launch of nine funds that track Paris-aligned indexes, including Lyxor S&P Global Developed Paris-Aligned Climate ETF and Franklin S&P 500 Paris Aligned Climate ETF. In order to achieve Paris-alignment classification, a fund must invest in companies that reduce their emissions by an average of 7% annually—the pace of phasing-out of fossil fuels set out in the Paris Agreement—and the fund overall must have a carbon-emissions footprint 50% below that of the broader market.

Other sustainability-related themes addressed last year included gender, smart cities, the ocean, and the U.N.’s SDGs. Examples include RobecoSAM Global Gender Equality Impact Fund, Lyxor MSCI Smart Cities ESG Filtered (DR) ETF, BNP Paribas Easy - ECPI Global ESG Blue Economy and NT Europe Sustainable Select SDG Index Fund.
Exhibit 11 2020 European Sustainable Fund Launches Per ESG Theme


The fourth quarter was the most prolific quarter of all times in terms of product development. We have so far identified 147 new sustainable fund launches. This represents the funds currently on the Morningstar Direct database as of the third week of January 2021. This number may increase in the coming weeks as more funds are reported to Morningstar.

Passive products, however, saw a slowdown compared with the previous quarters. Only 15 ETFs and one index fund hit the shelf. Meanwhile, a total of 17 sustainable funds were liquidated.

Exhibit 12 European Sustainable Fund Launches Per Quarter

Most Successful Launches
Among the most successful launches last year, we see again a number of thematic funds, including two from RobecoSAM (Smart Energy and Sustainable Water). At least three of the funds have a climate-change focus, with one SDG focus (where there is also a climate-change focus embedded within).

Exhibit 13 2020 Most Successful Launches by AUM


Repurposed Funds
Launching new funds is not the only way asset managers have been responding to increased investor demand for sustainable investment options. They also repurpose existing conventional funds by adding binding ESG criteria to their investment objectives and/or investment policies. And many reflect the new mandates by rebranding the funds.

Transforming existing funds into sustainable strategies is a way for asset managers to leverage existing assets to build their sustainable-funds business, thereby avoiding having to create funds from scratch. This may also be a way for fund companies to reinvigorate ailing funds that are struggling to attract new flows. Others may choose to "green" their entire range of funds by, for example, expanding their exclusions policies and divesting from the biggest carbon emitters.

Consistent with record numbers of fund launches, repurposed funds hit new highs last year. We identified 253 such funds, 87% of which reflected the change by rebranding. Repurposed funds that rebrand typically add terms such as sustainable, ESG, green, or SRI to their names to increase their visibility among investors who are looking to invest more sustainably. Exhibit 15 provides a sample list of the latest makeovers we have identified based on legal documents and manager information.
Exhibit 14 Newly Launched and Repurposed Funds


Exhibit 15 Examples of Repurposed/Rebranded Sustainable Funds in Fourth-Quarter 2020

<table>
<thead>
<tr>
<th>New Name</th>
<th>Old Name</th>
<th>Additional ESG Language</th>
<th>Inception Date</th>
<th>AUM (EUR Million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assenagon Credit Selection ESG</td>
<td>Assenagon Credit Selection</td>
<td>ESG</td>
<td>19/03/2013</td>
<td>283</td>
</tr>
<tr>
<td>DWS ESG Top World</td>
<td>DWS Top World</td>
<td>ESG</td>
<td>17/01/1997</td>
<td>2,102</td>
</tr>
<tr>
<td>JPMorgan Japan Sustainable Equity Fund</td>
<td>JPMorgan Japan Select Equity Fund</td>
<td>Sustainable</td>
<td>12/11/1993</td>
<td>69</td>
</tr>
<tr>
<td>LBPAM ISR Profil 50</td>
<td>LBPAM Profil 50</td>
<td>ISR</td>
<td>09/04/1997</td>
<td>276</td>
</tr>
<tr>
<td>Mediolanum Flessibile Futuro Sostenibile</td>
<td>Mediolanum Flessibile Globale</td>
<td>Sustainable</td>
<td>27/07/1985</td>
<td>315</td>
</tr>
<tr>
<td>Amundi S&amp;P 500 ESG ETF</td>
<td>Amundi S&amp;P 500 ETF</td>
<td>ESG</td>
<td>10/05/2005</td>
<td>1,141</td>
</tr>
<tr>
<td>Schelcher Prince Obligations Court Terme ESG</td>
<td>Schelcher Prince Obligations Court Terme</td>
<td>ESG</td>
<td>17/10/1997</td>
<td>116</td>
</tr>
<tr>
<td>Xtrackers MSCI UK ESG UCITS ETF1D DISTE</td>
<td>Xtrackers FTSE All-Share UCITS ETF</td>
<td>ESG</td>
<td>15/06/2007</td>
<td>41</td>
</tr>
<tr>
<td>SKY Harbor Global US SD Sustainable High Yield Fund</td>
<td>SKY Harbor Global US SD High Yield Fund</td>
<td>Sustainable</td>
<td>05/04/2012</td>
<td>2,037</td>
</tr>
<tr>
<td>Swisscanto (CH) Equity Fund Responsible Europe</td>
<td>Swisscanto (CH) Equity Fund Europe</td>
<td>Responsible</td>
<td>04/11/2015</td>
<td>85</td>
</tr>
</tbody>
</table>


Repurposing conventional funds into sustainable offerings is no longer the preserve of actively managed funds. Last year saw two large ETF providers, Amundi and Xtrackers, retool plain-vanilla ETFs into ESG offerings by switching indexes. In October, Amundi moved its USD 860 million physically replicated S&P 500 ETF to the S&P 500 ESG index, helping the fund pull more than USD 400 million of new money in the last quarter and finish the year with close to USD 1.4 billion in assets. Other ETF transformations in 2020 include Amundi MSCI UK IMI SRI ETF, which switched from the FTSE 100 to the MSCI UK IMI SRI Filtered Ex Fossil Fuels index, and Xtrackers MSCI UK ESG ETF, which swapped the FTSE-All Share for the UK IMI Low Carbon SRI Leaders Select Index.
As shown in Exhibit 16, sustainable has been by far the most commonly adopted term among European repurposed funds in the past five years, followed by responsible (mainly due to a large rebranded SwissCanto fund range), and SRI. The SRI group includes funds that have added the French ISR label to their names. ESG is also one of the most common name additions.

Thus far, we have identified close to 610 funds in the European sustainable funds universe that have been repurposed from conventional to sustainable since 2016, including 504 (82%) that changed names to reflect their new ESG mandates. The total number of funds repurposed in the past five years accounts for 19% of the European sustainable funds universe. The amount of change applied to these funds can vary greatly, ranging from adding exclusionary screens to a complete overhaul of the investment objective, investment policy, holdings, and manager.

To read more about repurposed funds: Surge in Funds Rebranding as Sustainable

Fossil-Fuel Exclusions

The fossil-fuel divestment movement continued in full swing last year as more asset managers reduced or committed to reduce exposure to fossil fuels in their fund offerings. BlackRock divested from companies generating more than 25% of their revenues from thermal coal in its discretionary active investment portfolios. BNP Paribas Asset Management made a bigger move by eliminating companies that derive only 10% of their revenues from coal production, while also divesting from high-carbon-emitting power companies.
In addition to coal, Robeco also decided to bar companies that derive 25% of their revenues from oil sands or 10% from Arctic drilling. This results in a total of 236 fossil-fuel companies in the energy, mining, and utilities sectors that are excluded from the Robeco’s entire fund range.

Swedbank Robur adopted an even more stringent fossil-fuel policy by eliminating almost all investments in oil, gas, and power production. The firm makes exceptions for transition companies that are judged to be able to meet the goals of the Paris Agreement. Handelsbanken made a similar move in 2019.

Meanwhile, a relatively large number of passive funds, including the suites of UBS MSCI SRI ETFs and Xtrackers MSCI ESG ETFs, also reduced their exposure to fossil fuels, by either switching indexes or tracking indexes that tightened their fossil-fuel screens.

Given the growing investor demand for greener products and asset managers’ desire to step up their efforts to support the Paris Climate Agreement’s goal of carbon neutrality by 2050, we can expect more announcements of fossil-fuel divestment in 2021.

**Asset Class and Category Coverage**
Investors can find sustainable funds in 205 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 337 funds. Fixed-income is the second-largest global category group, closely followed by allocation.

The inherent complexity of bond markets, with their wide spectrum of different debt instruments, issuer types, and maturities, has held back proliferation of sustainable fixed-income products. This has been compounded by concerns over data availability, quality, and comparability, especially sovereign debt issuance. Despite the challenges, ESG integration in fixed income has become more widespread and ESG-focused strategies have proliferated in recent years. Half of the 684 sustainable fixed-income funds currently available have been either launched or repurposed in the past three years, including 148 in 2020 alone. The growing demand for strategies that mitigate ESG risks and align with investor values has encouraged asset managers to develop more specific and targeted ESG approaches in fixed income. Increased interest in impact investing, for example, has translated into more green, social, and impact-focused bond funds.

Meanwhile, with 619 options, sustainable allocation funds are also proving increasingly popular as more investors look to apply the same ESG principles across their entire portfolios.

Investors now have a reasonable number of choices to construct comprehensive portfolios that span all key asset classes. Moreover, many of these funds have long-enough track records and large-enough asset bases to meet fund-selection criteria often used by intermediaries. Of the sustainable funds, 1,506 have three-year track records and 1,103 have five-year track records.
Exhibit 17 European Sustainable Funds Per Broad Asset Class

Provider League Table

Unsurprisingly, the leader board is well-staffed with Northern European asset managers that have championed ESG investing for years. These include banking groups Handelsbanken, Nordea, SPP, and SEB. These firms are structured to serve the Nordic institutional market. French groups Amundi and BNP Paribas have also long been active in the sustainable and responsible investment space. Many large public institutional investors in the Nordics, France, and the Netherlands are required to invest sustainably and responsibly, which has driven ESG measures at a firm level.

Meanwhile, BlackRock, which ranks second in the provider league table, largely benefitted last year from the success of its passive ESG-focused product range, which represented about 80% of the assets accounted for here.
### Exhibit 18 Top 10 Asset Managers by Sustainable Fund Assets

**Source:** Morningstar Research. Data as of December 2020.

<table>
<thead>
<tr>
<th>Asset Manager</th>
<th>AUM (EUR, Billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Handelsbanken</td>
<td>0.0</td>
</tr>
<tr>
<td>BlackRock</td>
<td>20.0</td>
</tr>
<tr>
<td>Amundi</td>
<td>40.0</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>60.0</td>
</tr>
<tr>
<td>Swisscanto</td>
<td>32.6</td>
</tr>
<tr>
<td>UBS</td>
<td>31.9</td>
</tr>
<tr>
<td>Northern Trust</td>
<td>27.6</td>
</tr>
<tr>
<td>SPP</td>
<td>26.8</td>
</tr>
<tr>
<td>Nordea</td>
<td>23.3</td>
</tr>
<tr>
<td>SEB</td>
<td>0.0</td>
</tr>
</tbody>
</table>

**Spotlight on Passive ESG Funds**

Passive funds now constitute about 22% of the European sustainable fund universe. Many are designed to substitute for broad market index funds, while others focus on specific themes or sectors.

As of December 2020, there were 191 ETFs and 177 open-end funds tracking an ESG index. Open-end funds have historically been the passive vehicle of choice for socially conscious investors in Europe, but growth in size and breadth of the offering in the ETF space has begun to redress the balance. Assets in ESG ETFs closed the year at EUR 82.5 billion, up from EUR 32.1 billion in 2019, a staggering 156% increase. Assets in ESG ETFs already account for 8.6% of total assets in ETFs in Europe, up from 4.2% in 2019. ESG remains a top priority for most ESG providers in terms of product development for 2021.
Exhibit 19 Passive European Sustainable Fund Assets (EUR Billion)


In terms of assets, open-end funds dominate the passive ESG fund space; in terms of flows, ESG ETFs appear to be the clear winners (Exhibit 20). Last year, ESG ETFs attracted inflows of EUR 42 billion, 2.5 times the EUR 16 billion of 2019. More so, flows into ESG ETFs accounted for almost half of the total flows for the European ETF market in the fourth quarter of 2020. Most money went into equity ESG ETFs, which remain the dominant asset class in terms of product offering and which account for 84% of total assets in ESG ETFs in Europe. Bond ESG ETFs gathered EUR 3.7 billion of flows in the fourth quarter, up from EUR 1.9 billion in the third quarter.

Exhibit 20 Passive European Sustainable Fund Flows (EUR Billion)

ISHares had a mammoth year in terms of growth in the ESG ETF space, more than trebling assets to EUR 34.3 billion from EUR 10.7 billion at the end of 2019. Dominating the ETF market, the brand owned by BlackRock also offers the most comprehensive range of ESG ETFs. UBS, one of the first movers in the space, claims the second spot with half of the assets, while Lyxor and Xtrackers take third and fourth place, respectively.

One notable absence from the league table is indexing pioneer Vanguard, Europe's sixth largest ETF provider, which hasn't to this day launched a single ESG ETF in Europe.

Exhibit 21 European ESG ETF Provider League Table

In the ESG index fund space, the dominant player is U.S. asset manager Northern Trust. Many large public institutional investors in the Nordics, the Netherlands, and France are required to invest in sustainable funds. This has led to sustainability measures being implemented at provider level rather than at an individual fund level. For example, a fund provider may maintain a companywide stock exclusion list, which applies to all the funds it operates.

Consequently, the leader board is well-staffed with northern European asset managers who have championed ESG investing at a group level. These include Swedish banking group Handelsbanken, domestically focused Norwegian cooperative insurance group KLP, and Dutch asset manager ACTIAM.
**A Pivotal Year for the EU Regulation of ESG Investing**

The year 2020 was pivotal for the European regulation of ESG investing aimed at encouraging the flow of capital into sustainable activities.

The year commenced with two of three headline components of the EU Sustainable Finance Action Plan—the Sustainable Finance Disclosure Regulation and an extended Benchmark Regulation—being finalized and written into the EU Official Journal. They were followed later in the year by the Taxonomy Regulation.

The fourth quarter saw a temporary hiatus in the march of ESG regulations, at least in terms of concrete next steps. Across the EU, the crucial technical standards relating to the SFDR and the Taxonomy Regulations are awaited. Across the channel, the now-Brexited UK is in a wait-and-see mode until proposals start to emerge about its own customized set of sustainability regulations.

The level of uncertainty that remains around the practical application of the SFDR requirements was starkly illustrated by a letter from the European Supervisory Authorities to the European Commission seeking urgent clarifications. With the detailed level 2 provisions that will govern the specific information that investment products must report already delayed, likely until 2022, the level 1 principles based rules, taking effect on the 10 March 2021, are called into question. The letter of 7 January sought clarity about some of the core precepts of the regulation, being the determination of what constitutes promotion of environmental or social characteristics and what is the scope of a sustainable product.
Under SFDR, the entire universe of European funds will be classified by their managers into one of three categories, with the required disclosures tailored to each. All funds will be required to provide some ESG disclosure, as per Article 6, while Article 8 and Article 9 funds will be required to provide more detailed ESG information to investors.

<table>
<thead>
<tr>
<th>Article 6 – All Funds</th>
<th>Article 8 – General ESG</th>
<th>Article 9 – Sustainable</th>
</tr>
</thead>
<tbody>
<tr>
<td>All managed products</td>
<td>Funds that promote environmental or social characteristics</td>
<td>Funds that have a sustainable investment objective</td>
</tr>
</tbody>
</table>

Level of detail in disclosure


The ESAs are questioning fundamental details as whether promoting an environmental or social characteristic could be construed by inclusion of words like “sustainable”, “sustainability”, or “ESG” in a product name; having sustainable investment as its objective; operating an exclusion policy on specific types of investment, for example, tobacco; or by complying with a national legal obligation, such as a ban on investment in cluster munitions. Clarification is also sought about whether an Article 8 product should invest a minimum share of its investments in securities with environmental or social characteristics in order to be considered to be promoting environmental or social characteristics.

Morningstar has been engaging with asset managers to ascertain which funds will fall into which categories. Responses have ranged from conservative to blunt application. Some asset managers want to place only their dedicated sustainable sector funds into Article 9, such as those that invest only in issuers that provide solutions to environmental issues such as climate change, resource scarcity, and pollution. Those same asset managers will include only their broad sustainable fund ranges, those that have been derisked in terms of ESG, into Article 8. Others, however, take a much broader approach, setting ambitious targets to align their entire fund range, some with only some light-touch exclusions, such as tobacco into Article 8. This raises concerns that, although more disclosure will be achieved, Article 8 will quickly become an unwieldy bucket of funds ranging from what we consider conventional funds (funds that only do ESG integration and/or with light exclusions) to more-impactful ESG products.

Whatever clarification the regulator can bring, investment products face a huge ongoing dependency on the reporting by the issuing companies in which they invest. A primary element of these will stem from the Taxonomy Regulation, requiring information on how and to what extent a company’s activities are associated with economic activities that qualify as environmentally sustainable. Toward the end of the
year, the Supervisory Authorities consulted on the advice they are due to provide the Commission in the first quarter of 2021 about three key performance indicators—proportion of turnover, capital expenditure, and operating expenditure—that companies will have to report about their environmentally sustainable activities. The Commission also launched its new Platform on Sustainable Finance, with a mandate to provide ongoing advice in relation to further developing the taxonomy.

More broadly, the fourth quarter saw some potentially promising developments in regard to bringing more standardisation and consistency to company reporting. First, the IFRS closed a consultation that sought input on whether it should seek to establish global reporting standards of so-called nonfinancial data, parallel to its widely adopted International Accounting Standards Board financial reporting standards.

Independently, the European Financial Reporting Advisory Group produced a summary of its ongoing work on nonfinancial reporting standards, as tasked by the European Commission. Encouragingly, the assignment included an explicit requirement that ‘the technical advice must analyse and build on existing reporting standards and frameworks to the greatest possible extent’.

To read more about European Sustainable Finance Regulation:
EU Sustainability Disclosures
EU Taxonomy of Sustainable Activities
Regulating ESG Investing the EU Way

How Do European Sustainable Funds Stack Up?
Morningstar uses information disclosed by asset management firms to identify its universe of sustainable funds, most commonly, the investment objectives and policies found in the fund’s legal filing. It is important therefore to apply some additional layers of analysis, both qualitative and quantitative, to see if these funds deliver on their promises. In the following two sections, we outline some of the avenues available to investors to quantitatively evaluate a product. In the third section, we address the topic of fees: Should investors expect to pay a premium to go down the sustainability route?

Do Sustainable Funds Manage Their ESG Risks Better Than Conventional Funds?
In this section, we look at the extent to which European sustainable funds are actually investing in sustainable companies and the extent to which they differ from the overall fund universe. The Morningstar Sustainability Rating can help answer this question. We’re also looking at the sustainability profile of repurposed funds.

The Morningstar Sustainability Rating—the "globe ratings" as they are widely known—is a measure of how well a fund’s holdings are managing their ESG Risks relative to the fund’s peer group. Globes are awarded based on a normal distribution within each Morningstar Global Category.

Certainly, we should expect sustainable funds to be managing their ESG risks better than conventional funds. As seen in Exhibit 24, that is indeed the case. More than 72% of sustainable funds have 4 or 5
globs (versus a third in the overall universe of funds), and just over 7% have 1 or 2 globes (versus one third in the universe). Repurposed funds also exhibit a high sustainability profile although not as high as existing sustainable funds, with slightly less than 69% of repurposed funds having 4 or 5 globes. This could be partially explained by the methodology of the globe rating, which uses 12 months of holdings data. It may take time for the new ESG approach adopted by the most recently repurposed funds to be reflected in the data. Overall, we can say that these figures should help to alleviate some greenwashing concerns.

Exhibit 24 Globe Distribution for Sustainable and Repurposed Funds Compared With the Overall Fund Universe


Are Sustainable Funds Better Aligned With the Transition to a Low-Carbon Economy?

In this section, we want to find out whether investors are more likely to pick a low-carbon fund in the universe of sustainable funds than in the rest of the fund universe. For that, we compare the proportion of sustainable and conventional funds that have been awarded the Morningstar Low Carbon Designation in five of the largest Morningstar Categories.

To be awarded the Low Carbon designation, a portfolio must meet two criteria: a 12-month trailing average Morningstar Portfolio Carbon Risk Score below 10 and a 12-month trailing average exposure to fossil fuels less than 7% of assets, which is approximately a 33% underweighting to the global equity universe. Not all funds can be assigned a Low Carbon designation because of a lack of data. For the purposes of this exercise, we have chosen to examine only funds that meet the assessment criteria.

From Exhibit 25, we can see that, in each of the five categories under examination, a greater percentage of sustainable funds receive the Low Carbon designation. This is most notable in the Europe large-cap blend equity Morningstar Category, where an estimated 50% of sustainable funds have the badge, compared with only 21% of conventional portfolios. This is because the latter tend to hold more
companies in high carbon-emitting sectors such as oil & gas and utilities. In the global large-cap growth equity category, 99% of sustainable funds have the Low Carbon designation. It is very high but only slightly higher than the percentage for badged conventional funds (94%). This can be explained by the technology bias of all funds in this category.

Overall, it is clear that investors buying sustainable funds are more likely to hold companies that are better aligned with the transition to a low-carbon economy. There are, however, considerable differences across regions and investment styles.

Exhibit 25 European Sustainable Funds With Low Carbon Designation by Morningstar Category

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Do Sustainable Funds Charge a Premium?

In a recent study, Morningstar found that, contrary to common belief, sustainable funds charge lower fees than conventional funds, on average. The asset-weighted average fee for European ESG funds in the most popular Morningstar Categories was 0.57%, compared with 0.71% for non-ESG funds. Meanwhile in equal-weighted terms, the average fee for ESG funds was 0.93%, against 1.21% for non-ESG funds.
Looking separately at active and passive ESG relative to their non-ESG counterparts (see exhibits 27 and 28), we found that, on average, fees for active ESG funds are indeed lower than those for non-ESG funds, while fees for passive ESG funds are higher than those for non-ESG funds. The latter can be explained by the fact that many passive non-ESG funds in popular categories such as U.S. large cap blend equity charge rock-bottom fees as low as 0.05%-0.10%.
Exhibit 28 Change in Asset-Weighted Fees for ESG and Non-ESG Funds by Investment Style

For more on fund fees, see Morningstar’s European Fee Study.

Returns Attribution

Multiple studies found that companies with better ESG profiles outperformed their peers last year. In own performance study, we analysed seven of the most popular Morningstar Categories for ESG investors and found that sustainable funds have delivered superior returns on average relative to their traditional peers in the past 10 years and also during the COVID-19 market selloff. In the following section, we will evaluate the extent to which style factors and sector exposures can explain some of the excess returns last year.

Compared with conventional funds, sustainable funds in Europe have particular stylistic tilts that have largely boosted their performance in 2020. As a group, sustainable funds tend to invest in smaller-cap companies with a growth bias and a tendency to have lower dividend yields. Furthermore, unlike their conventional counterparts, they have not leaned as heavily towards volatile stocks or companies from the energy sector, the latter being perhaps the least surprising.

These averages, however, obscure an interesting pattern in the data best revealed through a distributional chart below. For the ESG cohort, we observe that there are relatively few investment options today that seek to deliver significant multifactor exposure beyond the size and value dimensions. In particular, few of today’s ESG strategies have significant exposures to yield, volatility, liquidity, or momentum factors.
On the other hand, we do observe that there are more sustainable strategies that seek to deliver pure sector exposure at the same time as meeting their ESG mandates. For the most part, however, sustainable strategies are generally well-diversified and their only unique features as a cohort is their significant underweighting to the energy sector and overweighting to the technology sector. While both tilts are notable, the underweighting to the Energy sector resulted in a larger contribution to ESG fund outperformance compared to conventional funds.
Empirically, variations in exposures should lead to variations in investment outcomes. As we have noted in prior work, sustainable funds have generally outperformed their conventional peers in 2020. Part of this outperformance can potentially be attributed to factor exposure differences between conventional and sustainable funds.

Using Morningstar’s Risk Model return attribution component, we examine the average monthly return attribution for style and sector factors for 2020. Included in the ESG cohort are 1,228 unique funds compared with 22,445 unique Fund Identifiers in the conventional fund cohort presented here. We filtered out any results where asset coverage of a fund was less than 80% and idiosyncratic returns were greater than 10% or less than negative 10% to remove any extreme outliers not captured by the model.

We find that the five key factor exposure differences between sustainable and conventional funds highlighted above have generally paid off in 2020, contributing to the former’s outperformance. Relative to conventional funds, sustainable funds have had a smaller-cap, tilt which paid off handsomely during the COVID-19 crisis recovery and has largely held up throughout 2020. Moreover, sustainable funds’ higher exposure to growth stocks and stocks with lower yields has also helped boost relative performance. Finally, the avoidance of energy stocks has generally been a boon to sustainable funds. The only drawback for sustainable funds relative to conventional funds has been their neutral exposure to highly volatile stocks; conventional funds have had a slightly more positive tilt.

**Exhibit 31** Average Monthly Excess Return Attribution for Sustainable Funds Versus Conventional Funds

While these statistics do not necessarily comment on whether or not ESG as an investment style is a unique factor, it is clear that ESG strategies have generally been leaning into well-performing factors and that this, in part, has led to some of their recent investment outperformance.
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