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PERSPECTIVE

Sustainable funds: put your money where your mouth is

Sustainability is a hot topic in the asset management industry. In this article, we show that in 2018 the market for 'sustainable' funds has grown much more rapidly than the market for conventional funds. Yet, as sustainability is such a broad concept with no uniform definition, there is a clear risk of proliferation of allegedly sustainable funds. We plea for more transparency and standardization, to ease the difficult task asset owners have to select from the broad range of funds those that truly correspond with their sustainable investment strategy targets.

GROWTH OF SUSTAINABLE FUNDS

Due to more stringent legislation, an increased focus on risk management, and an expanding view beyond just financial returns – amongst other things – the demand for sustainable investment strategies by asset owners is rising steadily, particularly in Europe. This increasing interest is showcased by the large number of sustainable fund launches (245 new funds in 2018 alone) and re-labelling of existing strategies (e.g. adding sustainable-related words to the fund name) as well as the significant flows of assets towards these funds. With an expanding market, it becomes more and more difficult for asset owners to select the sustainable fund that suits their individual demands.

DEFINITION OF 'SUSTAINABLE'

The difficulty lies first of all in the fact that there does not exist a uniform definition of 'sustainable'. Sustainable means different things to different people and even amongst sophisticated institutional investors no clear definition exists. Various concepts and synonyms are being used in the industry; responsible, ESG, SRI, green, and impact are just a few examples of the diverse landscape of terminology that would fit the broader sustainability concept. And to add to that, the three main data providers in the field of fund information which are generally used by asset owners to select funds – Lipper, Broadridge and Morningstar – all offer a unique and non-standardised classification methodology to identify sustainable funds in the seemingly overcrowded European fund market with more than 30,000+ funds (both sustainable & non-sustainable) offered for sale. This explains why publications in industry papers as well a press articles contain a broad range of market sizing figures, often conflicting each other.

This is a publication of ACTIAM's Sustainability & Strategy team, consisting of 9 professionals with an average of 11 years in the industry.

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This is achieved through actively and passively managed investment funds, via impact investing, mandates and ESG advice (Environmental, Social & Governance).

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MARKET SIZING AND FUND FLOWS

Take as an example, the sustainable funds identified by Morningstar Direct. They identify sustainable funds through their 'socially conscious' fund flag that contains the fund that 'seeks to maximize both financial return and social good'. By the end of the 2018 Morningstar flags 2,049 separate open-end European funds as 'socially conscious' (excluding feeder and fund-of-funds in order to avoid double counting). This group represents a total asset size of €628.5 billion, which indicates a 11.6% increase compared to the market size by the end of 2017 (€563.4 billion). This increase is a result of both market appreciation as well as new money flowing into these funds. Morningstar calculates that out of the €65.1 billion increase in this part of the fund industry €22.0 billion – or roughly one-third – can be attributed to fund flows. In other words, 3.9% of the growth in sustainable fund assets in 2018 originates from fund flows. This increase is higher than the 2.4% growth in assets of the total European-domiciled fund market – regardless if funds are deemed sustainable or not – indicating a trend towards sustainable funds.

"Socially Conscious" funds in Europe

Asset Class	# funds	Fund Size (€ bn)	Fund Flows YTD 2018 (€ bn)
Equity	1,116	334,0	18.2
Fixed Income	419	131,7	2.9
Allocation	373	86,2	1.1
Money Market	32	54,5	-2.1
Other	109	22,1	2.0
Grand Total	**2,049**	**628.5**	**22.0**

Source: Morningstar Direct (January 2019)

Let us look one level deeper, by investigating different asset classes and fund sectors. The largest portion of all assets in sustainable funds proves to be in equity funds, with €334.0 billion in collective assets coming from 1,116 different funds. Interestingly enough, although the number of sustainable equity funds is just over half of the total number of sustainable funds, these equity funds accounted for the vast majority of the total flows in 2018, namely €18.2 billion of the total inflow of €22.0 billion.

The second largest category is fixed income which accounts for €131.7 billion in 419 funds and an inflow in 2018 of €2.9 billion. The Morningstar data suggest that most of the sustainable funds are currently managed actively; only 196 funds with a total assets under Management (AuM) of €77.3 billion are passive funds (both Exchange Traded Funds as well as index funds). These figures are expected to grow significantly now the large, predominantly US, Index houses have announced various sustainable index product launches.

BEWARE FOR GREEN WASHING

Although the presented figures above look promising and encouraging for any (institutional) asset owner or asset manager that actively promotes sustainable investing, we would like to inform readers to exhibit caution. First of all, various industry sources like CityWire have noticed that asset managers are rebranding an increasing number of existing fund strategies to sustainable (or alike) in order to capture the general trend and take their piece of the 'sustainable' pie, but without making many changes in their fund strategy. Notably, some traditional asset managers - without verified track records - are remarketing their strategies with long and so-called credible histories in the field.

Secondly, as the introduction suggests, one should take notice of the importance of the data quality of the source used. In case of Morningstar Direct, a fund is deemed 'socially conscious' if the prospectus contains references to any word or concept related to sustainability. This becomes particularly relevant in case asset managers articulate they incorporate environmental, social and governance factors (so-called ESG integration) in their decision making, which is quickly becoming commonplace and is therefore a non-differentiating factor if they are not clear about how they integrate ESG factors in their investment decisions. These funds are flagged as sustainable investments, whereas they not necessarily should be marketed or themed as such.

Both phenomena could have a severe impact on the presented markets figures of the sustainable fund industry and therefore potentially misinform asset owners on the real interest in sustainable funds. Asset owners should be aware of this phenomenon of 'green washing' where there are differences between what a fund promises to do and what it actually does.

SUSTAINABLE-THEMED FUNDS

In order to be able to make a better selection of sustainable funds we plead for a standardized and more sophisticated classification methodology for identifying sustainable funds – in particular with the large data vendors. What really helps is the recently announced plan of the European Commission to create ESG and green indices. The creation of an EU-wide Index could facilitate greater local and foreign capital inflows from a broad range of investors and enhance access to finance for a larger pool of companies, especially SMEs. The feasibility study would look at the "demand side" of indices, i.e. asset managers, as well as defining the conceptual framework of the mooted index family. It will be explored how the index could be used as the underlying basis for tradeable products.

Sustainable-Themed funds in Europe

Asset Class	# funds	Fund Size (EUR, bn)	Fund Flows YTD 2018 (EUR, bn)
Equity	598	130.1	13.8
Fixed Income	231	58.9	3.3
Money Market	21	45.2	-1.1
Allocation	204	34.9	3.6
Other	54	4.8	0.1
Grand Total	**1,108**	**273.9**	**19.8**

Source: Morningstar Direct (January 2019)

Also, there are various European initiatives which intend to come to a 'taxonomy', yet from different angels. For example EU's High Level Expert Group on Sustainable Finance (HLEG) focuses on climate mitigation and Belgian's Febelfin on minimum requirements for financial products to be called sustainable. A uniform approach would allow asset owners to better compare 'apples with apples'. One idea is to introduce a flag according to whether or not a fund is truly marketed or themed as a sustainable fund. This is now done on a small scale by commercial rating agencies, who each have their own methodology. From our proprietary analysis we found out that out of the 2,049 funds mentioned earlier just half - or 1,108 funds – would qualify for such a flag. Interestingly enough, this classification scheme would more than halve the total sustainable assets to €273.9 billion. Yet, the fund flows for 2018 stay more or less the same (€19.8 billion) indicating a 8.7% sales increase in sustainable funds. A nice growth figure after all! This proves that many asset owners are already capable of separating the wheat from the chaff. Yet, more growth could be achieved if the sustainability market were more transparent. This would be good for the asset market and for sustainability.