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The rise of the sustainable fund market

and its role in financing sustainable development

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Executive summary

Sustainable funds – mutual funds and exchange-traded funds (ETFs) that integrate sustainable development-related considerations in their asset allocation process – have been growing rapidly in recently years. This market has the potential to contribute to sustainable development through investments in sectors relevant to the attainment of the Sustainable Development Goals (SDGs), including in developing countries. This paper aims to analyse the latest developments in the global sustainable fund market, asses its sustainability performance and its alignment with the SDGs, and discuss the challenges and opportunities for the further expansion of this market.

Key findings of the report include:

- The number of sustainable investment funds has almost doubled in the last five years, reaching 3,987 by June 2020, with assets under management (AUM) of over $1.7 trillion, just over 3% of the assets of the world's open-ended funds. Net investment flows to these funds reached $159 billion in 2019 and are estimated to surpass $300 billion in 2020.
- The sustainable fund universe includes 3,435 sustainable mutual funds and 552 sustainable ETFs, with AUM of $1.56 trillion and $174 billion respectively. Equity funds account for about two-thirds of sustainable funds in both number and assets, with the remainder split between fixed income and mixed allocation funds.
- Geographically, the majority of funds are domiciled in developed countries, particularly in Europe, and target developed regions in their portfolio selection. Developing and transition economies host about 5% of the world's sustainable funds by number and less than 3% by assets.
- Based on an analysis of over 800 sustainable equity funds, for which sustainability data are available, sustainable funds on average outperform the overall market in terms of sustainability, and have significantly lower exposure to fossil fuels and controversial sectors.
- On average, these funds deployed 27% of their assets across eight key SDG sectors, such as health, renewable energy and infrastructure. However, the wide variance in sustainability ratings among funds indicates that a large share of underperforming funds may not meet their sustainable credentials.
- Analysis suggests that the funds' returns did not systematically suffer a financial disadvantage for having a sustainable tilt in their portfolios. Over a period of three years, there was almost no difference between sustainable funds and their respective benchmarks in terms of financial performance.
- Going forward, sustainability integration should not be limited to sustainable funds. Instead, the whole fund industry needs to enhance its sustainability disclosure and performance and take actions to channel more investments into SDG-related sectors.
- Actions need to be taken by regulators and the fund industry in both developed and developing countries to support the growth of sustainable funds both domiciled in, and with a portfolio exposure to developing countries.
- In order to address "sustainability washing" concerns, fully transparent self-reporting on the sustainability performance of funds, supported by external auditing and regulation, will be needed. Stock exchanges can also put in place relevant guidelines or demand greater disclosure in their listing requirements, with support from securities regulators.

About the UNCTAD Investment and Enterprise Division and the SDG Investors Partnership

The UNCTAD Investment and Enterprise Division is the focal point in the United Nations System for investment and enterprise development. As a global centre of excellence, the Division conducts leading-edge research and policy analysis, provides technical assistance to 160 member States and regional groupings, and builds international consensus among the 196 member States of the organization. Its mission is to promote investment and enterprise for sustainable development and prosperity for all.

The SDG Investors Partnership, initiated by the Division, aims to foster partnerships among institutional investors, governments, and international organizations to facilitate institutional investment in key SDG sectors, in particular in developing countries. The Initiative, in partnership with all stakeholders, seeks to create an enabling environment for SDG-oriented investment by institutional investors through evidence-based research, dissemination of best practices and international standards, consensus building and policy advocacy on strategic issues that are critical for facilitating institutional investment in sustainable development.

Acknowledgements

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Table of contents

1. Introduction

Capital markets that are aligned with sustainable development can be instrumental in filling the financing gap for the Sustainable Development Goals (SDGs). The pursuit of sustainability in business operations and investment has led to a proliferation of sustainability-themed financial products in recent years. The global efforts to fight the COVID-19 pandemic and climate change are accelerating this momentum, with a surge in climate and social funds and bonds. UNCTAD estimates that sustainability-dedicated investments – investment products targeting sustainable development-related themes or sectors – reached over $3.2 trillion in 2020, with each component – sustainable funds, green bonds and social bonds – almost doubling from their respective 2019 levels (UNCTAD, 2020a; UNCTAD 2021a).

Sustainable funds, including sustainable mutual funds and exchange-traded funds (ETFs), are the largest component of this pool of capital for sustainable investment, with over $1.7 trillion of assets under management (AUM). Nevertheless, given the size of the global open-ended fund market, estimated to be over $50 trillion,[1] the market penetration of sustainable funds remains limited. Moreover, a lack of market transparency and international standards has given rise to "green or sustainability-washing" concerns, and makes an accurate assessment of the market, including its size and impact, challenging.

This study analyses the latest trends in the global sustainable fund market and assesses its sustainability, financial performance and alignment with the SDGs. In doing so, the paper contributes to efforts to better quantify and evaluate the impact of the sustainable fund market and to support its contribution to sustainable outcomes and the achievement of the SDGs.

The report is structured in three sections: first, an overview of the global market for sustainable funds; second, an assessment of their sustainability and financial performance, and their alignment with the SDGs; and third, the challenges for further growth of the market and recommendations for regulators and market players on how to harness the opportunities for sustainable investment presented by the fund industry and minimize the influence of "sustainability washing".

[1] According to the quarterly statistics of the European Fund and Asset Management Association (EFAMA), assets of regulated, open-ended funds worldwide (fund of funds excluded) were about $54 trillion at the end of the second quarter of 2020.

2. The rise of the sustainable fund market

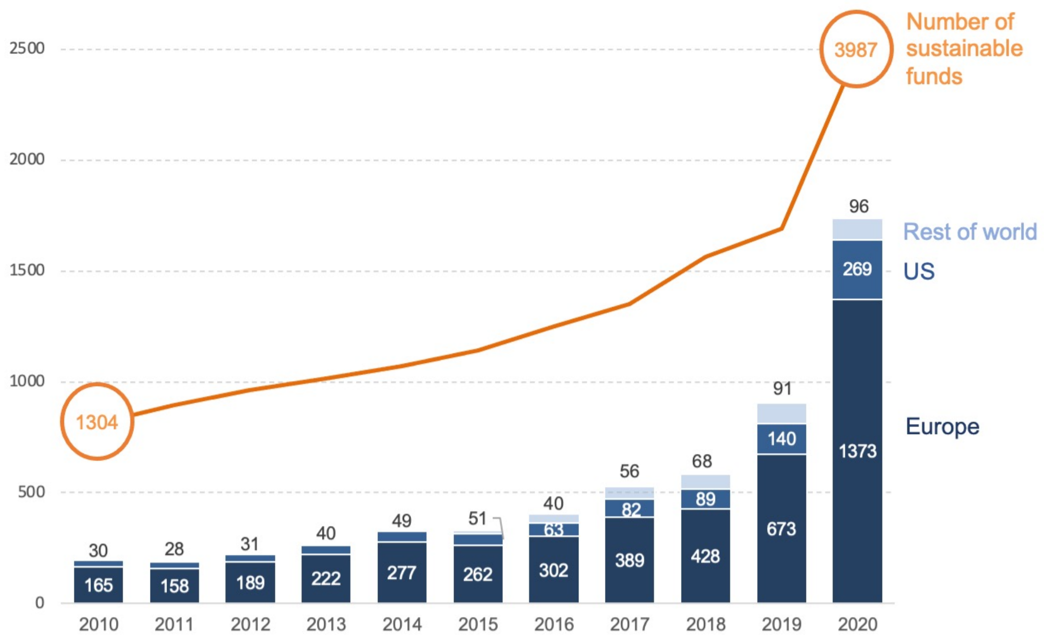
2.1 Global trends

As the fund industry and companies increasingly pivot towards sustainability, recent years have witnessed a surge in sustainable funds, i.e., mutual funds and ETFs that describe themselves as targeting sustainable development-related themes or sectors, or integrating sustainability, impact or environmental, social and governance (ESG) factors in their asset selections in their prospectus or other filings.

According to data from Morningstar and TrackInsight, the total number of sustainable funds reached 3,987 by June 2020, up 30% from 2019 (UNCTAD, 2020a). The AUM of sustainable funds nearly doubled from about $900 billion in 2019 to over $1.7 trillion, representing about 3.2% of the assets of all open-ended funds worldwide. The sustainable fund universe comprises 3,435 sustainable mutual funds and 552 sustainable ETFs, with AUM of $1.56 trillion and $174 billion respectively. Equity funds account for 62% of sustainable funds by number, with the remainder split equally between fixed income (19%) and mixed allocation funds (19%). In terms of assets under management, equity funds account for a slightly greater share of total fund allocations at 66%, or about two-thirds of the sustainable fund universe.

About half of the sustainable funds were launched in the last five years. From 2016 to 2020, the aggregate number of sustainable funds nearly doubled, while AUM more than quadrupled from $405 billion to over $1.7 trillion. This momentum has accelerated significantly in the last two years, in particular in terms of AUM, which grew by over 50% in 2019 and then nearly doubled in 2020 (figure 1). This exceptional growth was witnessed in both sustainable mutual funds and ESG ETFs (Box 1).

Figure 1. Number and AUM of sustainable funds, 2010-2020

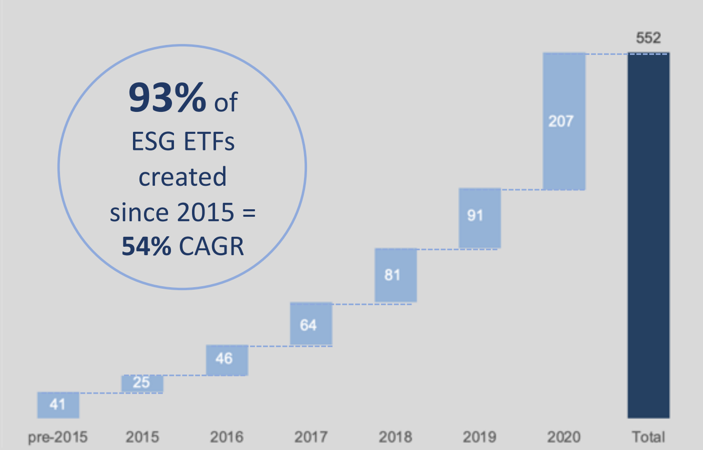


Source: UNCTAD based on Morningstar and TrackInsight data.
Notes: Numbers of funds do not include funds that were liquidated; the numbers for 2020 are as of 30 June.

Box 1. The rise of sustainable exchange traded funds (ETFs)

ETFs with an environmental, social and governance (ESG) tilt are a subset of the sustainable investment funds in this study. Providers of ETFs are increasingly responding to the demand for sustainability-oriented products, with a particular focus on ESG performance. Since UNCTAD's first study on ESG ETFs (UNCTAD, 2020b) the number of such funds increased from 345 in 2019 to 552 in 2020 – a huge jump in annual growth compared to previous years (box figure 1.1).

Box figure 1.1. Number of ESG ETFs, pre-2015 - 2020



Source: UNCTAD, based on Trackinsight data

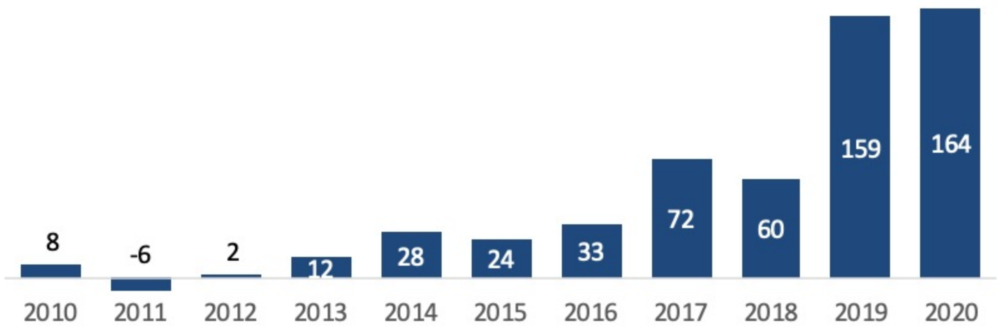
ETFs integrate ESG performance in a number of ways and by using one of several strategies, including: (i) exclusionary screening; (ii) a general integration of ESG performance; (iii) pursuing a best-in-class ESG strategy; and (iv) thematic strategies, specifically targeting a sustainable development-related sector or theme, market, or theme, such as the SDGs. Of the 552 ESG ETFs, 77 followed a themed strategy, up from 49 in 2019. This illustrates the growing attraction of themed strategies that often correspond with, or explicitly target, a specific SDG. Overall, 208 ESG ETFs targeted the SDGs in their investments in 2020, of which almost 90% covered just three goals: SDG 13 (Climate action), SDG 7 (Affordable and clean energy) and SDG 5 (Gender equality).

In terms of the regional distribution of ESG ETFs by domicile, Europe accounted for a greater share in 2020 than in 2019, up from 59% of funds to 67%, reflecting the overall geographic distribution of the whole sustainable fund market (see below). Only seven ESG ETFs, or just over 1% of the total were domiciled in developing countries – the same number as in 2019.

Source: UNCTAD, based on TrackInsight data

Investment flows to sustainable funds exhibit a similar growth trajectory. From 2016 to 2019, net inflows to these funds increased from $33 billion to $159 billion. Despite massive outflows from global capital markets in March 2020 following the outbreak of COVID-19, the total net inflows to sustainable funds in the first half of 2020 recovered to $164 billion, and UNCTAD estimates full year net inflows to have reached well over $300 billion (figure 2). The explosion in flows to these funds demonstrates the rapidly growing popularity of sustainable funds as an investment strategy. However, net inflows to sustainable funds remain relatively small in relation to the size of total AUM of these funds. This shows that the growth in their assets is driven, to a large extent, by the rise in their market value, boosted by ever buoyant stock markets in particular in Europe and the United States in the last two years.[2]

Figure 2. Net investment inflows to sustainable funds, 2010-2020* ($ billions)



Source: UNCTAD based on Morningstar and TrackInsight data.
Note: * Flows for 2020 are as of 30 June

2.2 Regional distribution

The majority of sustainable funds is domiciled in Europe (73%), followed by North America (18%), with other regions, including developing countries, representing less than 10% of domiciled funds. This illustrates the current dominance of Europe in terms of market share of the sustainable fund industry and is a reflection of the maturity of the market and the relatively advanced regulatory environment for sustainable investment in Europe (UNCTAD, 2020c). However, while nine out of the top 10 countries, by AUM, are European, the United States accounts for the second largest share of fund assets after Luxembourg (although domicile does not necessarily mean the fund is managed from that location). In terms of the number of funds, three of the top 10 are not European, including one developing country, China (figure 3).

Developing and transition economy countries host about 5% of the world's sustainable funds by number, and less than 3% by assets, implying that they are missing out in terms of market share (see section 2.3 below). However, a number of developing countries have seen growth in their sustainable fund industry in recent years. In China, the largest developing country host economy, there were 127 sustainable funds, with AUM of nearly $20 billion as of 2020, almost triple its 2019 level.[3] Sustainable funds have also recently experienced rapid growth in developing markets such as Brazil, Singapore and South Africa, albeit from a relatively low level (UNCTAD, 2020a).

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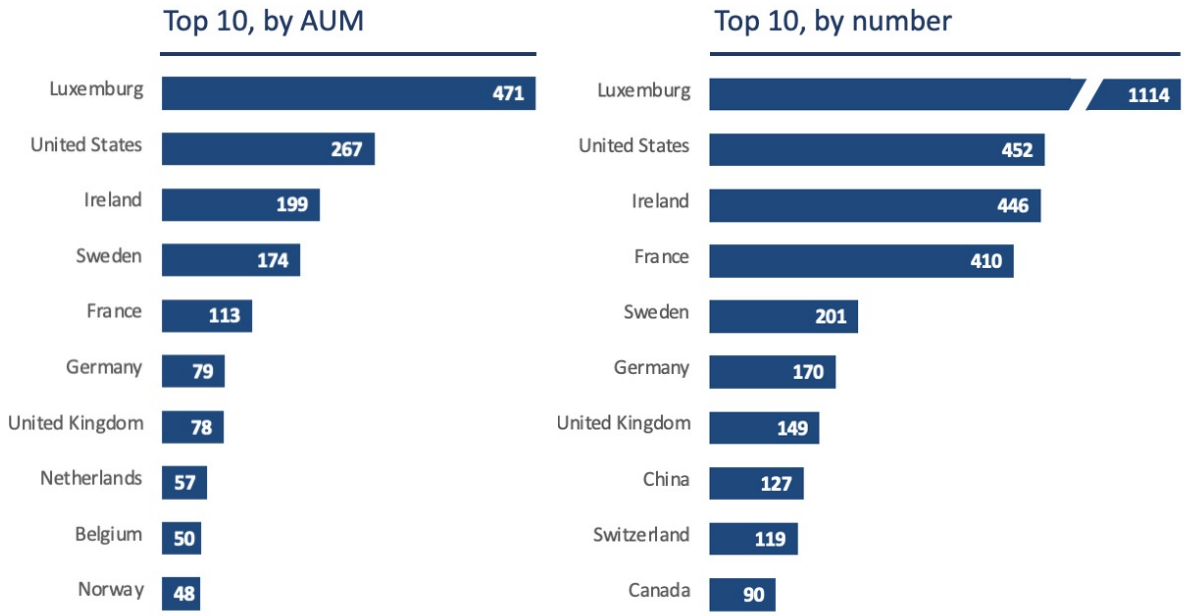
[2] As an example, MSCI ACWI ESG Leaders Index (USD), an index designed to represent a broad spectrum of the global equity opportunity set with over 1,200 high ESG rating stocks in its portfolio, recorded a return of over 40% in the last two years.
[3] China Social Investment Forum (2019), "China Sustainable Investment Review 2019", Beijing.

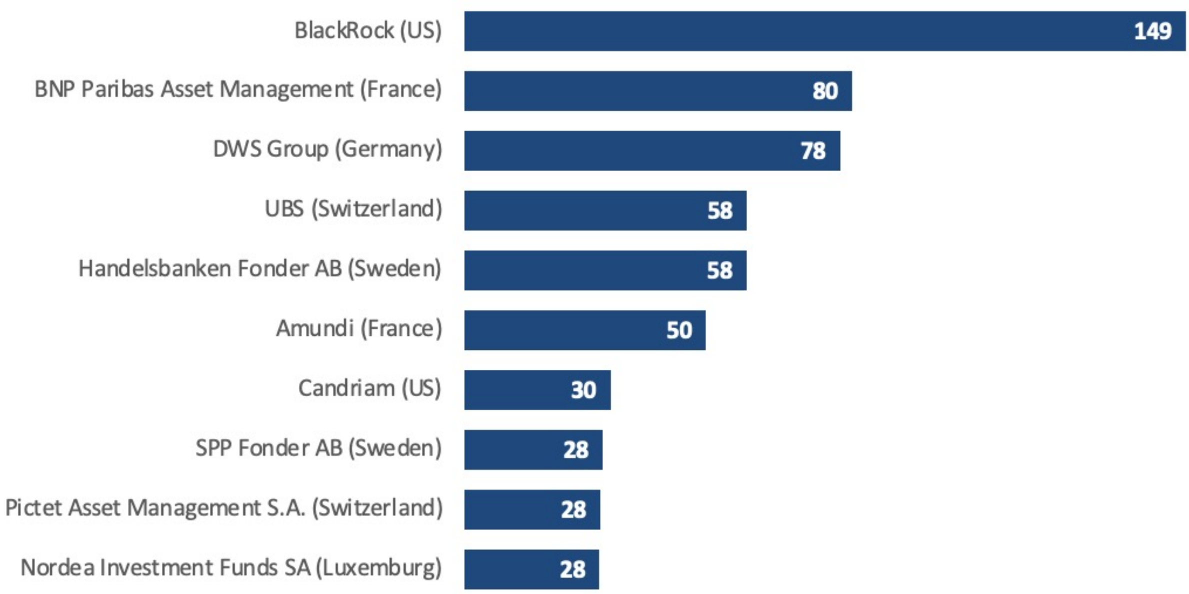
Figure 3. Top 10 domiciles of funds, by AUM and number of funds, 2020 ($ billions)



Source: UNCTAD

With regard to the main providers of funds, the top 10 accounts for 33% of the AUM of all sustainable funds, and reflect some of the biggest players in the fund industry, and the mainly European colour of the sustainable fund market (figure 4). BlackRock (United States) is by far the largest provider, with $149 billion of assets in their sustainable funds, followed by BNP Paribas Asset Management (France) ($80 billion) and DWS Group (Germany) ($78 billion). Given the rapidly evolving sustainable fund industry, it is likely that more traditional fund providers will enter the market, and the current landscape may change over time.

Figure 4. Top 10 fund providers, 2020 (AUM, $ billions)



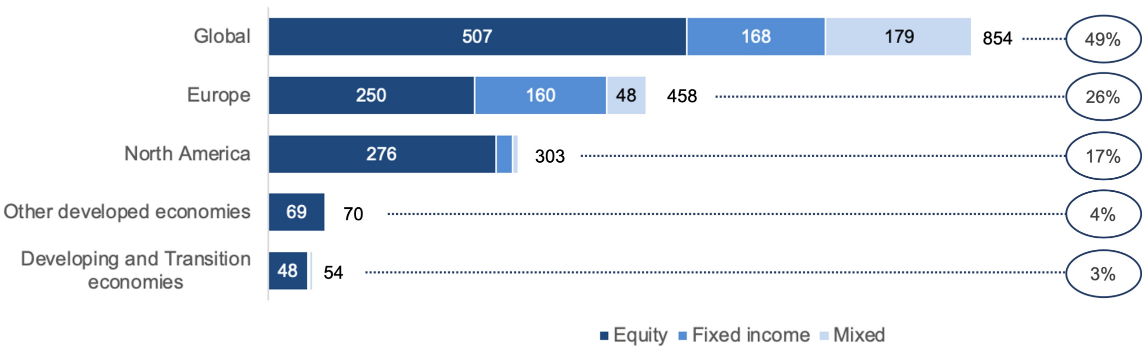
Source: UNCTAD

2.3 Geographical focus of investment

Similar to the domicile of sustainable funds, which are almost entirely concentrated in developed markets, the regional investment focus of funds is primarily targeted at investments in developed economies. However, in terms of the geographical focus of funds, the largest category is "global", which includes investments across developed and developing regions. The allocations of funds (equity, fixed income, mixed) that have a global exposure exceed $800 billion, and represent about half of all sustainable funds (figure 5). With respect to regional funds, Europe dominates in terms of the geographical focus of funds, attracting nearly $458 billion or 26% of sustainable fund investments. North America attracts $303 billion, or 17% of the market.

Developing countries and transition economies again attracted a small fraction of investments in the global sustainable fund market. Although sustainable funds specifically targeting developing and transition economies reached $54 billion in AUM, twice as much as in 2019, they only represent about 3% of sustainable fund investments, and much of them are concentrated in Asia. However, the market capitalisation of listed domestic companies in developing and transition economies was $16 trillion in 2019, or roughly 23% of the global total.[4] This shows that while developing countries and transition economies are currently missing out on opportunities for sustainable investment, there is huge potential for growth in view of the size of these markets and the sustainable investment opportunities in these economies.

Figure 5. Regional focus of funds by asset allocation and global share, 2020
($ billions and per cent)



Source: UNCTAD

2.4 Key drivers

The rapid rise of sustainable funds and the significant jump in 2020 reflect the accelerated adoption of sustainability by the investment community. Institutional investors are increasingly embracing sustainability in their investment decisions, in particular in view of risks posed by climate change and the COVID-19 pandemic, the need to pre-empt the impact of sustainability-related regulations, and the conviction that this does not necessarily entail a

[4] Figures are approximate and not directly comparable: developing and transition economies are "low & middle income" countries and most recent data is for 2019; most recent data for world total is for 2018. https://data.worldbank.org/

financial opportunity cost (Morgan Stanley, 2019). In the last two years, major fund providers and asset owners, such as BlackRock and Norway's Government Pension Fund, have significantly stepped up their efforts to move towards sustainable investment, for example, by divesting or excluding carbon-related assets from their portfolio.[5]

Stimulus packages introduced by several economies in response to the COVID-19 pandemic and climate change have also created opportunities for sustainability-oriented investment. The market for sustainable funds and sustainable investments more broadly has therefore attracted unprecedented attention.

These trends in demand and supply for sustainable fund products have been supported by policy changes from stock exchanges and regulators. For example, the number of stock exchanges requiring ESG disclosure has grown from just 2 in 2009 to 25 in 2020, and exchanges are increasingly offering specialized ESG-labelled products and guidelines (UNCTAD, 2020c). The new EU taxonomy and European Commission regulations on sustainability-related disclosures in financial services recently began implementation, shifting compliance on reporting and disclosure from voluntary to mandatory measures. This will help harmonize regional standards and enhance market transparency. A recent announcement by the US Securities and Exchanges Commission (SEC) may set the US on a similar path.[6] Funds that respond quickly and proactively to regulatory changes around sustainability performance and disclosure will also have a competitive advantage over other players in the market. Thus, regulation also provides a financial incentive for the fund market to embrace sustainability.

In order to fully tap into the potential of sustainable funds as a mass market investment vehicle for sustainable development, both supply and demand of sustainable funds need to be increased significantly, in particular in developing economies. However, the risk of sustainability washing, together with a lack of transparency and standards, constitute a severe challenge for their further growth, and thus an accurate assessment of their sustainability performance is necessary.

3. Sustainability performance and SDG alignment

Sustainability funds adopt a wide range of sustainability integration strategies, such as exclusionary screening, investee engagement, best in class, general integration of ESG performance, thematic investment or a combination of them, and their sustainability performance may vary substantially. Accurate measurement and assessment of the sustainability credentials of sustainable funds is therefore essential for directing more inflows to the market, improving overall sustainability outcomes, and reducing the risk of sustainability washing.

[5] Joanna Partridge "*World's biggest fund manager vows to divest from thermal coal"*. The Guardian. 14 January 2020; Jillian Ambrose "*World's biggest sovereign wealth fund to ditch fossil fuels"*. The Guardian. 12 June 2019.

[6] "A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC". Speech by Allison Herren Lee, Acting Chair, SEC. Washington D.C. March 15, 2021. https://www.sec.gov/news/speech/lee-climate-change

This section analyses the sustainability performance of 818 sustainable funds,[7] for which relevant data are available, including their overall sustainability, their exposure to controversial issues, their positive and negative impact on climate, and their alignment with the SDGs. It also assesses their financial performance to establish whether investors systematically suffer a financial disadvantage for adopting a sustainable investment strategy.

The MSCI ACWI Index, which covers about 3,000 holdings from 23 developed and 27 emerging markets and approximately 85% of the free float-adjusted market capitalization in these markets,[8] is used as the benchmark against which the relative sustainability performance of sustainable funds is evaluated.

3.1 Sustainability performance

Overall sustainability performance

By applying the sustainability rating scale provided by Conser,[9] in collaboration with UNCTAD, the sample of sustainable equity funds has a mean sustainability score of 7.17 out of 10 (figure 6). It is significantly higher than the 4.00 average sustainability rating of MSCI ACWI, when the same rating methodology is applied. Breaking down by sustainability integration strategy, both sustainability-themed funds and general integration funds[10] have better sustainability ratings than the MSCI ACWI. This shows that, on average, sustainable equity funds as a group tend to outperform the sustainability ratings of mainstream equity markets by a significant margin.

Figure 6. Average sustainability rating by strategy, 2020 (average score out of 10)

Source: UNCTAD based on Conser data.

This observation is in line with the findings of a recent UNCTAD study on ETFs (UNCTAD, 2021b). By analysing 430 ESG ETFs and 3,401 non-ESG ETFs, the study found that non-

[7] The sample represents about 40% of sustainable equity funds and 20% of the entire sustainable mutual fund universe, in terms of number of funds.

[8] See MSCI ACWI webpage. https://www.msci.com/acwi.

[9] Conser's methodology provides a holistic picture of the sustainability risks of an investment by conducting a meta-analysis of quantitative and qualitative ESG data based on "collective intelligence", that reflects the implicit evaluations of major ratings agencies and leading sustainable asset managers to arrive at an "average" ESG consensus rating. Conser uses an incremental sustainability score, i.e., a granular scale with 10 levels: A+, A, A-, B+, B, B-, C+, C, C-, and D. For our analysis, we numerized the incremental sustainability scores by equating each of these scores to a number between 1 to 10, e.g., 10 for A+, 6 for B, and 1 for D.

[10] General integration funds refer to those funds that incorporate sustainability or ESG factors into investment decision making and asset allocation in a systematic way.

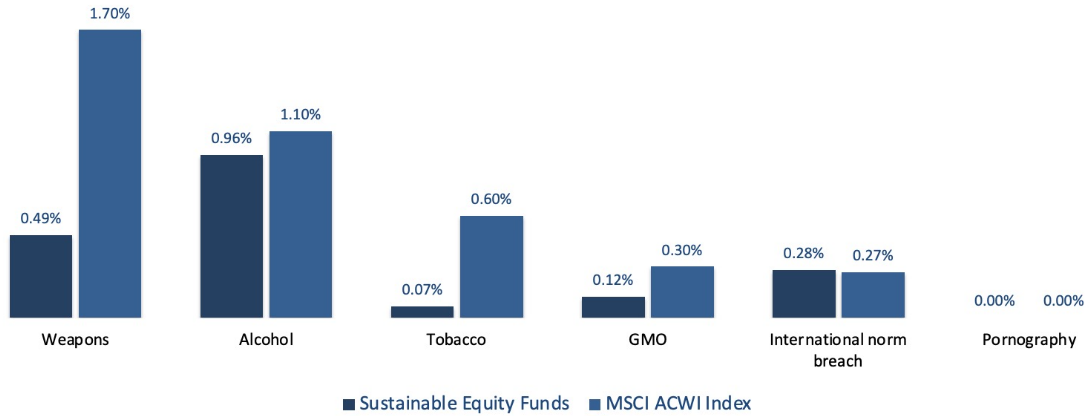
ESG ETFs as a group had an average sustainability rating of 4.1, which contrasted with a mean sustainability rating of 6.4 for ESG ETFs.

Exposure to sensitive sectors

The relative outperformance of sustainable equity funds is also confirmed by their exposure to sensitive sectors (figure 7). Across five sensitive sectors that are widely used by the fund industry for asset screening in due diligence (alcohol, genetically modified organisms (GMO), pornography, tobacco and weapons), sustainable equity funds in the sample had significantly lower exposure relative to the MSCI ACWI index. This may reflect a more rigid policy stance by sustainable equity funds as a group towards sensitive sectors when undertaking due diligence in their asset allocation process. In the case of funds that pursue a negative screening strategy, they may exclude certain controversial sectors from their portfolio. In general, sustainable funds appear to have less exposure to weapons, tobacco and GMO. This may reflect the impact of Europe, the largest host of sustainable funds, which in general has a more regulated stance on these issues.

However, sustainable equity funds as a group do not outperform MSCI ACWI with respect to possible breaches of international norms, such as the use of child labour or other violations of human rights. More efforts need to be made by the fund industry in this area, and international organizations can support this effort through awareness raising and technical assistance.

Figure 7. Exposure to sensitive sectors and breach of international norms



Source: UNCTAD based on Conser data.
Note: Percentages are the holdings in sensitive sectors as a share of the overall portfolio.

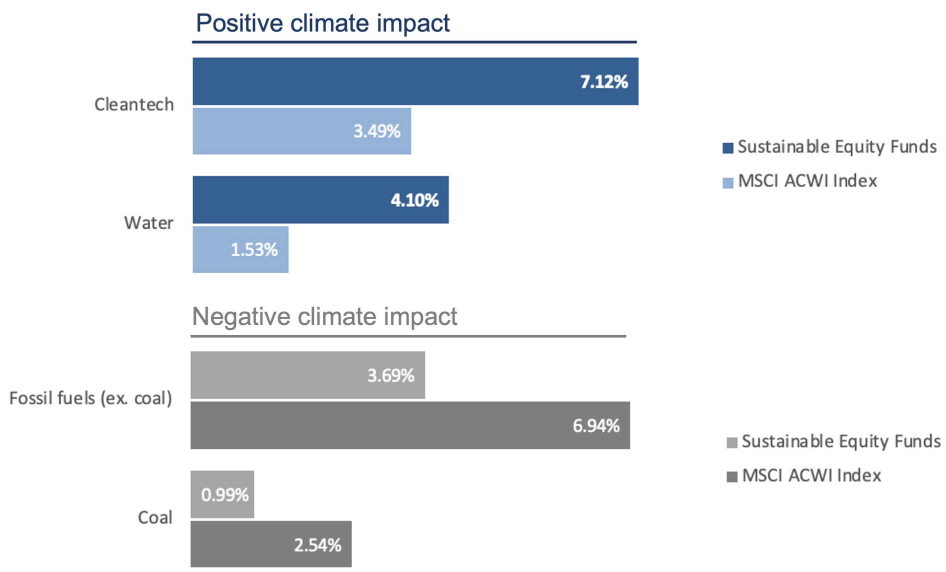
Positive and negative climate impact

With respect to the impact on climate, sustainable equity funds also tend to perform better than the overall fund market. Compared to the MSCI ACWI index, they have higher exposure to cleantech (about 3.5 percentage points higher) and water treatment (about 2.5 percentage points higher), and lower exposure to fossil fuels (excluding coal) (over 3 percentage points lower) and coal (over 1.5 percentage points lower) (figure 8).

According to Morningstar data, sustainable funds appear to be improving their low-carbon performance, and have higher ratings than the overall fund market. For example, in 2019, slightly less than half of 184 U.S. sustainable funds with a Morningstar Carbon Risk Score received the Low Carbon Designation. At the end of 2020, 149 of 203 (73%) such funds received the Low Carbon Designation - a much higher share than the overall universe of U.S. and international funds, in which 43% received the designation.

This trend reflects a steady rise of climate funds in the fund market, given promising opportunities offered by renewable energy, electric vehicles, energy efficiency and storage and other cleantech industries. Meanwhile, an increasing number of sustainable funds are reducing their exposure to fossil fuels, especially coal, or even excluding them from their portfolios. Low-carbon funds are becoming popular in the market, driven by government initiatives and also by pressure from climate-conscious asset owners, such as Norway's Government Pension Fund Global, the world's largest sovereign wealth fund that has decided to divest all its assets in the fossil fuel industry.[11]

Figure 8. Exposure to climate positive and negative sectors



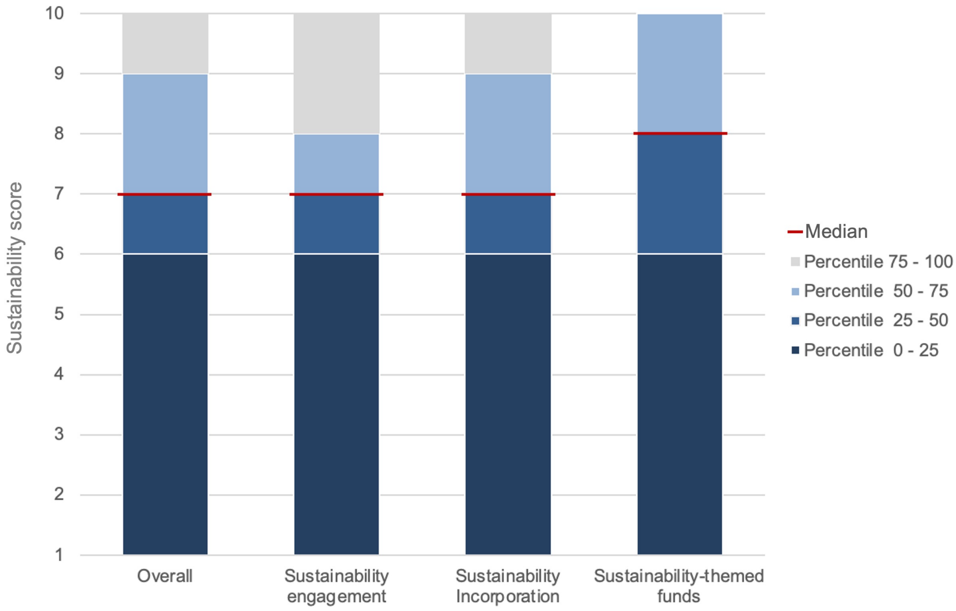
Source: UNCTAD based on Conser data.

Distribution of sustainability ratings and "sustainability washing" concerns

In terms of overall sustainability ratings and exposure to sensitive sectors and fossil fuels, sustainable funds as a group tend to outperform the benchmark in terms of sustainability. However, sustainable funds are highly heterogeneous. Regarding the distribution of their sustainability ratings, the sample as a whole and by strategy has a wide range of numerical ratings from 1 to 10 (figure 9). This is largely due to the wide differences in the sustainability ratings of the underperforming funds in each group (the quartile with the lowest scores), with ratings spread from 1 to 6. This means that the 25% lowest performing funds, with a rating below 6, may not be qualified as sustainable funds, and this raises legitimate concerns about their sustainability credentials. Their sustainability integration practices and performance therefore require careful examination, and external auditing may be warranted.

[11] World's biggest sovereign wealth fund to ditch fossil fuels. The Guardian. 12 June 2019.

Figure 9. Distribution of sustainability score by strategy, 2020



Source: UNCTAD based on Conser data.
Note: the distribution of fund sustainability ratings by strategy is broken into four quartiles, e.g. percentile 0-25 represents the bottom quartile of funds that have the lowest sustainability ratings.

3.2 SDG alignment

As sustainable investment products, sustainable funds can play an important role in filling the SDG financing gap in both developed and developing countries. Leading fund providers, such as BlackRock, Amundi and Robecco, have launched funds dedicated to the SDGs, and some funds have used the SDGs as a framework to evaluate the impact of their portfolio.[12]

However, the lack of a taxonomy to define what counts as SDG investment as well as the poor quality of existing SDG ratings for individual companies, makes it challenging to measure or assess the SDG alignment of investment funds and how much of their portfolio is invested in assets that contribute to the delivery of the SDGs.

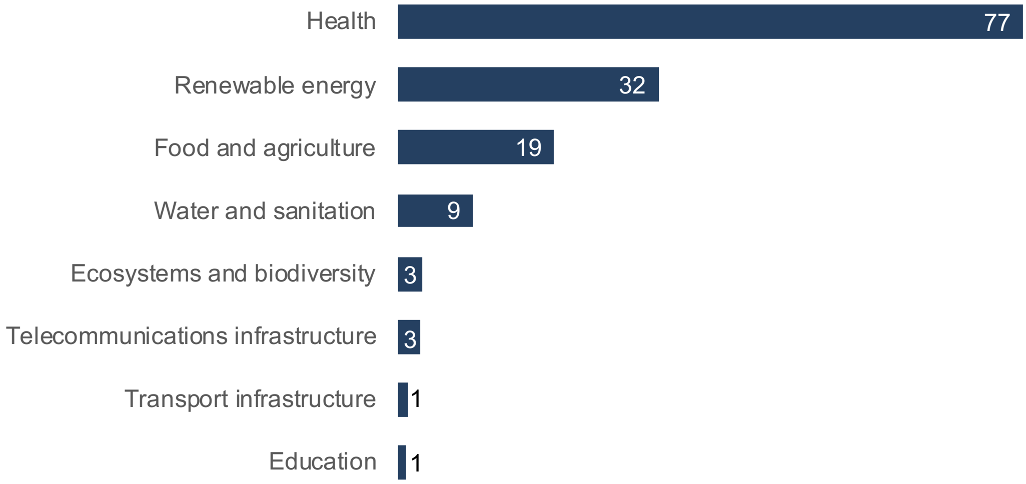
Nevertheless, UNCTAD identified several key SDG sectors (encompassing all 17 SDGs), which are critical for achieving the SDGs and represent the largest investment needs and opportunities in terms of SDG financing (UNCTAD 2014). Accordingly, UNCTAD has been monitoring private sector investments into these sectors (UNCTAD, 2021c).

By examining the holdings of the 818 sustainable equity funds in the sample, this study identified investment by these funds across eight of the key SDG sectors, which include: transport infrastructure, telecommunications infrastructure, water and sanitation, food and agriculture, renewable energy, health, education, and ecosystem diversity (figure 10). This investment totalled $145 billion, or 27% of their total AUM ($540 billion) as of June 2020. Four sectors - health, renewable energy, food and agriculture, and water and sanitation - account for almost 95% of the assets committed to these SDG sectors. The health sector, which covers

[12] Based on information provided by their websites.

health infrastructure, medical services, pharmaceuticals, and medical devices, is the most common and single largest SDG sector for the funds, followed by renewable energy.

Figure 10. Deployed assets by sustainable funds across eight SDG sectors, 2020
(billions of dollars)



Source: UNCTAD

3.3 Financial performance

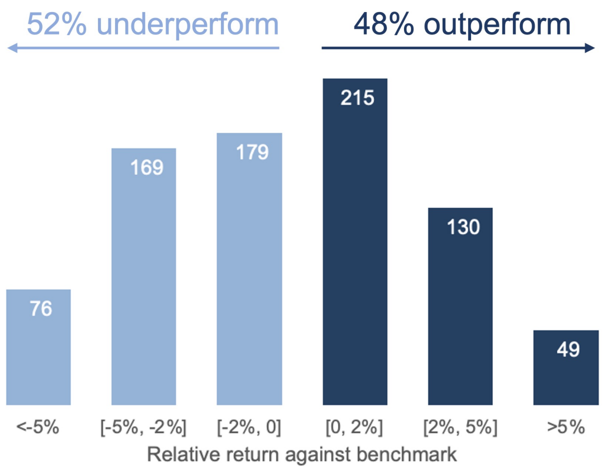
A large number of studies show that sustainable funds can offer market-matching, if not better, returns and demonstrate lower downside risks (see, for example, BNP Paribas, 2019; Morgan Stanley, 2019). Data from ESG index providers have also shown that this is possible. For example, since its launch in 2015, the FTSE Russell's Environmental Opportunities Index, which measures the performance of global companies that have significant involvement (at least 20% of their business) in environmental business activities, has consistently outperformed its benchmark global all-companies index and, even more so, the FTSE Global All Cap Oil and Gas Industry index (UNCTAD, 2020a).

An analysis of the financial performance of the sample of sustainable equity funds suggests that the financial returns of these funds did not systematically entail a financial disadvantage for having a sustainable tilt in their portfolios. Over a period of three years, 48% of sustainable investment funds outperformed their respective benchmarks, while 52% of the funds underperformed (figure 11). On average, there is almost no difference in terms of financial returns between sustainable funds and their respective benchmarks. Interestingly, sustainability-themed funds in the sample outperform general sustainability integration funds (figure 12). The observation also confirms the fact that investment in renewable energy, electrical vehicles and other green sectors has paid off in recent years, with their underlying technologies reaching an inflection point in terms of commercial viability and as financial markets take the energy transition seriously.[13]

[13] For example, in 2020, the top three best-performing ETFs were all green energy ETFs. All of them delivered an annual return of around 200%: Invesco Solar Portfolio ETF (up 234%), Invesco WilderHill Clean Energy Portfolio ETF (up 202%), First Trust NASDAQ Clean Edge Green Energy ETF (up 182%) (Batavia, 2021)

However, the results should be interpreted with caution since the data only cover a relatively short time period of three years and a significant number of sustainable investment funds were only issued in the last five years. A longer time period would be needed to confirm a truly systematic positive relationship between sustainability and the financial performance of the funds.

Figure 11. Distribution of financial performance of funds against benchmarks (number of funds)



Source: UNCTAD
Note: The relative return is measured by annualized return over three years until 30 June to 2020.

Figure 12. Average annualised returns by strategy, 2017-2020 (per cent)

Source: UNCTAD

4. Challenges and the way forward

In a year that has seen financing for the SDGs go into reverse (UNCTAD, 2021c), sustainable investment funds offer a potential source of capital that could be used to help fill the widening gap between current and required SDG financing. By mapping the latest developments in the global sustainable fund market and producing useful information about its sustainability performance and impact, this study contributes to international efforts to assess the contribution of investment to the attainment of the SDGs, as well as identifying potential sources of finance that might be oriented towards sustainable development outcomes.

Following rapid growth in the past five years, sustainable funds have become an important financial product for sustainability-dedicated investment, with hundreds of billions of dollars committed to key SDG sectors. The analysis of over 800 sustainable equity funds, for which sustainability ratings are available, also finds that sustainable funds in general outperform the benchmark by a large margin in terms of sustainability and impact, without any systematic opportunity cost for financial returns. Moreover, about 27% of their total assets are deployed across eight key SDG sectors that are critical for the delivery of the 2030 Development Agenda. The growth of the sustainable investment market is poised to accelerate, with institutional investors increasingly embracing sustainable investment, more sustainable investment products being developed, and the proliferation of green initiatives and regulations.

However, the global sustainable fund market needs to address "a triple challenge" in order to fully unleash its potential to finance sustainable development:

- **The "niche market risk".** Despite a surge in recent years, sustainable funds have a share of 3% of the global fund market. As long as it remains a niche market, there is a risk that sustainable funds become a vehicle merely designed to meet the market need for sustainability-aligned products, while other funds continue investing in not so sustainable but potentially profitable opportunities. This will hold down the sustainability performance of the overall fund market and also calls into question the impact of sustainable funds.
- **The geographical imbalance**. The vast majority of these funds are domiciled in developed markets, and sustainable funds largely remain a developed country phenomenon. Before developing countries are engaged in and benefit from the development of the sustainable fund market, the development impact of sustainable funds remains doubtful.
- **Sustainability washing concerns.** The wide differences in the sustainability ratings of the underperforming sustainable funds (the quartile with the lowest sustainability scores), as revealed by this study, suggest that a large share of these funds may not meet their self-declared "sustainable" credentials. The credibility of sustainable funds needs to be enhanced to attract investment flows to support the growth of the market.

The following three areas of action, and associated measures, could help address the above challenges:

i. The growth of the sustainable fund market depends on, and benefits from, continuous improvement in the sustainability of the overall global fund market. Therefore, sustainability integration should not be limited to sustainable funds. Instead, all market players, in particular index and fund providers, should strive to make all funds meet minimum standards of ESG compliance in the long run, and take actions to channel more investments into SDG-related sectors and areas with an aim to generate positive development impact on the ground.

ii. The market share of developing and transition economies needs to be significantly enhanced in order to fully harness the potential of the sustainable fund market for sustainable development. For this purpose, measures should be taken by developing and transition economies to jumpstart their domestic sustainable fund market. For example, stock exchanges in developing and transition economies could set up a dedicated sustainable ETF segment to support the growth of sustainable funds, as China and India did for green bonds (UNCTAD 2020a). Incentives could be provided for the development of and investment in sustainability-aligned funds. Meanwhile, more funds targeting developing and transition economies need to be launched in developed markets.

iii. The best way to enhance the credibility of the sustainable fund market and thus address sustainability washing concerns is to improve transparency through reporting, not only on ESG issues but also on SDG alignment. Today, most of the world's largest companies report on ESG or SDG issues, but very few funds are reporting on their own sustainability performance. In this report, sustainable data that can be used for in-depth analysis are only available for some 800 of the nearly 4,000 sustainable funds – one fifth of them, highlighting reporting issues even among sustainable funds. Fully transparent self-reporting would be a helpful first step towards more transparency and credibility, and the reporting should be supported by external auditing, as is required for companies, and regulation. Meanwhile, stock exchanges can put in place relevant guidelines or demand greater sustainability disclosure in their listing requirements.

This transformation, from the market of today to the market of the future, entails concerted efforts by all stakeholders, including fund and index providers, institutional investors, stock exchanges and regulators. More work can be done to encourage the integration of ESG factors into mainstream products and indexes. Meanwhile, regulations need to keep pace with market trends to bring transparency, predictability and credibility to the market. Rules and guidelines to establish industry standards and governance requirements are now moving beyond voluntary measures. Slowly, regulation is helping to shape the future contours of the sustainable investment market.

The new EU taxonomy and regulations on sustainability-related disclosures in the financial services, as well as other sustainable investment-related regulations, could serve as examples for other countries. The increased role of IOSCO in sustainable finance and the proposed new Sustainability Standards Board from the IFRS Foundation also point towards the further development of globally harmonized approaches to sustainability reporting standards and the regulation of sustainability-themed financial products.

Much work has been done over the past decade to integrate sustainability into different parts of the financial system, including by asset owners, banks, insurance companies and stock exchanges. Better coordinating these activities and effectively monitoring their impact can help accelerate the transition towards a more sustainable capital market.

With a vision for building a future global financial ecosystem in which sustainability and the SDGs are embedded into the business model and investment culture, UNCTAD will launch a new initiative, the Global Sustainability Observatory, to bring together all the major initiatives to promote and facilitate the transition of sustainable investment from market niche to market norm, leading up to 2030. The Observatory will collectively address the challenges of fragmentation in standards, proliferation in benchmarking and complexity in disclosure. Among other actions, the initiative seeks to build a global database of sustainable investment funds to improve the availability of sustainability data for key stakeholders and the public, provide sustainability assessment and ranking for sustainable funds on the global capital market and promote the integration of SDGs into the sustainability assessment ecosystem (UNCTAD, 2021a).

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