



HOW FAR IS THE SUSTAINABLE FUND MARKET IN EUROPE?

**On the Competitive Position of the
German Asset Management Industry**

Executive summary

This study provides an analysis of the state of the sustainable fund market in Europe, focused on the retail market and traditional asset classes. The aim is to open a discussion about the competitive position of the German asset management industry. Overall, we find that Germany is well positioned in this increasingly competitive market segment:

1. The German sustainable fund market is large in terms of assets under management, both compared to other European countries and to the total German fund market. This is advantageous, for instance because it allows to do cross-assets transactions and absorb additional costs (e.g., for ESG data and research).
2. On average costs for sustainable funds are lower than for conventional funds in Germany, which tends to increase demand. Our analysis suggests that the core reason for this is the strong growth of the sustainable retail fund market in the last three years: A large proportion of sustainable funds have been issued in a regime of lower fund costs compared to earlier years.
3. German sustainable funds tend to perform well in financial terms and have an above-average sustainability rating. Given that the German market is currently characterized by a strong presence of ESG strategy funds (funds employing sustainability-related exclusions, best-in-class and other similar strategies), we see big potential for impact products. These findings have to be evaluated against the background of a lack of consensus regarding the definitions of sustainable strategies and expected adjustments to the EU Regulation regarding Sustainable Finance.

We also point out that, in order to secure Germany's continuing strong presence, fund providers need to engage in constantly adapting to the changing regulatory framework and market conditions. Only then will the success story of the German sustainable fund market be maintained.

Contents

| | |
|--|----|
| Contents | 3 |
| Tables | 4 |
| Figures | 4 |
| Introduction | 5 |
| 1. The European sustainable fund hubs | 7 |
| 1.1 Commitment to sustainability through legislation | 7 |
| 1.2 Size of the sustainable fund market at the country level | 8 |
| 1.3 Country market share in the European sustainable fund market | 11 |
| 2. Competitive factors | 13 |
| 2.1 Cost structure | 13 |
| 2.2 Type of funds by asset class | 17 |
| 2.3 Exchange Traded Funds | 17 |
| 2.4 Institutional share classes | 18 |
| 2.5 Cross-border funds | 19 |
| 2.6 Economies of scale | 20 |
| 2.7 Performance | 21 |
| 2.8 Time since fund's issuance | 23 |
| 3. Approaches to sustainable investing | 26 |
| 3.1 ESG Engagement | 27 |
| 3.2 ESG Strategy funds | 28 |
| 3.3 Exclusionary Investing | 28 |
| 3.4 Impact Investing | 29 |
| 3.5 Thematic Investing | 30 |
| 4. Challenges and opportunities for the German asset management industry | 32 |
| 5. Conclusions | 34 |
| 6. Annex | 35 |
| 6.1 Dataset | 39 |
| References | 41 |

Tables

| | |
|--|----|
| Table 1.1 Sustainable fund hubs | 12 |
| Table 2.1 Asset class breakdown of KIID OCF in the sustainable fund hubs – relevant statistics, as of July 2020..... | 15 |
| Table 2.2 Country breakdown of the difference in KIID OCF of sustainable and conventional funds in the sustainable fund hubs – as of July 2020..... | 16 |
| Table 2.3 Country breakdown of the average fund size in the sustainable fund hubs – as of July 2020..... | 20 |
| Table 2.4 Standardized Herfindahl Index of the sustainable fund hubs – as of July 2020..... | 21 |
| Table 2.5 Country average of Morningstar rating for sustainable funds | 21 |
| Table 2.6 Country average of Morningstar rating for conventional funds | 22 |
| Table 2.7 Country average of Morningstar sustainability rating in the sustainable fund hubs | 22 |
| Table 2.8 Cumulative frequency of sustainable funds issued since 2015 in the sustainable fund hubs | 23 |
| Table 3.1 Definitions of commonly used sustainable investing approaches | 26 |
| Table 6.1 Overview of the main regulations on sustainability-related investments in Europe and the USA | 35 |
| Table 6.2 Morningstar sustainable investment framework..... | 40 |
| Table 6.3 Morningstar “employs exclusions” framework..... | 40 |

Figures

| | |
|---|----|
| Figure 1.1 Asset breakdown of the European sustainable fund market – as of July 2020..... | 9 |
| Figure 1.2 Domiciles of the European sustainable fund market – as of July 2020..... | 9 |
| Figure 1.3 Sustainable funds domiciled in Luxembourg (left) and Ireland (right) by provenience of the asset management company – as of July 2020 | 10 |
| Figure 1.4 Market share of sustainable funds in selected European countries – as of July 2020..... | 10 |
| Figure 1.5 Market share of the European sustainable fund market by provenience – as of July 2020 | 11 |
| Figure 2.1 KIID OCF of sustainable and conventional funds – European average, as of July 2020..... | 14 |
| Figure 2.2 KIID OCF of sustainable and conventional funds – average of sustainable fund hubs, as of July 2020 | 14 |
| Figure 2.3 Asset class breakdown of KIID OCF of sustainable and conventional funds – average of sustainable fund hubs, as of July 2020..... | 15 |
| Figure 2.4 Types of conventional funds by asset class in the sustainable fund hubs – as of July 2020 | 17 |
| Figure 2.5 Types of sustainable funds by asset class in the sustainable fund hubs – as of July 2020 | 17 |
| Figure 2.6 ETFs in Europe – as of July 2020 | 18 |
| Figure 2.7 Institutional shares in the sustainable fund hubs – as of July 2020 | 19 |
| Figure 2.8 Cross-border funds in the sustainable fund hubs – as of July 2020 | 19 |
| Figure 2.9 Time since issue date of sustainable and conventional funds in the sustainable fund hubs..... | 24 |
| Figure 3.1 Use of ESG strategies in the sustainable fund hubs – as of July 2020..... | 28 |
| Figure 3.2 Use of any sustainability-related exclusions in the sustainable fund hubs – as of July 2020..... | 29 |
| Figure 3.3 Impact Investing in the sustainable fund hubs – as of July 2020..... | 30 |
| Figure 3.4 Environmental sector funds in the sustainable fund hubs – as of July 2020..... | 30 |
| Figure 4.1 Market share of main sustainability fund providers in Germany – as of June 2020..... | 32 |
| Figure 4.2 Fund net assets (left) and net inflows (right) in the German sustainable fund market – as of June 2020.... | 33 |

Introduction

The year 2015 is seen as a turning point in the global trajectory towards sustainable development. In September 2015, world leaders met in New York and agreed on 17 global goals designed to address global challenges including poverty, environmental degradation and gender inequality as part of a UN Resolution called the 2030 Agenda. In December 2015, history was made in the French capital, when more than 190 countries signed the Paris climate protection agreement and committed themselves to take concrete measures against global warming. The agreement is seen as a breakthrough in climate policy. Until then, only a few industrialized countries had committed to reducing CO₂ emissions. Since then, climate policy has become significantly more dynamic, especially in Europe. In December 2019, the EU Commission presented its program to develop Europe into the first climate-neutral continent by 2050 with the help of the Green Deal. The goal is that the economy of the EU member states becomes climate friendly. In practice, this means a huge transformation process that poses new challenges to numerous existing business models and confronts investors with a new set of risks in respect of their investments.

In particular climate regulation will lead to significant reevaluations of companies and their business models across all sectors. The new investment risks associated with the restructuring of the economy in terms of climate policy undeniably also offer opportunities for investors. While some companies are suffering from the consequences of climate policy, there are others that will benefit from the transformation process with the development of new technologies, products and services. Opportunities also arise because governments are ready to support the reorientation of the economy towards a sustainable and climate-neutral path. The EU, for example, estimates a yearly investment gap of 175 to 290 billion euros to meet the envisaged target of a 50% cut in greenhouse gas emissions by 2030 and to be climate-neutral by 2050¹. However, governments will not be able to drive the change on their own. In order to achieve their goals, they need the help of the financial sector and especially of private investors. For this reason, the EU Commission presented the Action Plan for Financing Sustainable Growth in 2018. Some of its building blocks will have to be implemented by the financial sector quickly. The action plan aims mainly to redirect capital inflows towards sustainable investments and to promote transparency in the area of sustainable capital investment.

For investors and asset managers, the question arises of how to deal with these ambitious political plans. For a long time, investors in some countries tended to take the topic lightly. However, this will hardly be feasible in the future, because governments have unambiguously expressed their will to change the economic model not just to embrace environmental challenges but also to encourage better social and corporate governance practices. Against this background, it is necessary to approach the challenges of the change to the economic model proactively. This huge transformation is a collective task that needs the support of many. Asset managers are valuable intermediaries in this context. For the fund industry, the integration of sustainability factors into the investment process represents additional costs resulting from the need to adapt the investment process to the new strategies – which implies additional research costs, sourcing of sustainability-related data and new staff. However, integrating sustainability can also be an opportunity for asset managers to grow, differentiate themselves, diversify their products, and to deal with the dual challenge of growing operational costs (due to excessive regulation and digitalization) and decreasing management fees. It is therefore not surprising that sustainable strategies are one of the most dynamic business lines for asset managers nowadays. This can be seen, for example, in the remarkable growth of assets under management of sustainable retail funds in Europe and the United States in the last years. Moreover, this trend has continued despite the economic crisis triggered by the sudden outbreak of the COVID-19 epidemic.

We feel that now is the time to assess the state of the European sustainable fund market holistically and assess the relevance of sustainable investing across European countries, their market structure and competitive positions and the actual approaches to sustainable investment employed. Of course, we place emphasis on the position of the German asset management industry and discuss its strengths as well as its potential for improvement. To do so, the study is structured as follows:

Section 1 sets up a framework of analysis by identifying the centres in which sustainable investing has become mainstream. To do so, we use three criteria: i) commitment to sustainability through legislation; ii) size of the sustainable fund

¹ EU Green Deal: https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_de

market at the country level; and iii) current market share in the European sustainable fund market. The countries that fulfill at least two of these criteria have been defined as 'sustainable fund hubs'. These are: France, Germany, Sweden, the Netherlands, Switzerland, the United Kingdom and Norway. These countries have put their commitment to sustainability at the top of their political agenda as mirrored by their legislation and/or have significantly grown their market share to the extent that sustainable funds are a relevant sector for their respective financial industries.

Section 2 focuses on the main structural characteristics that define the competitive environment in the sustainable fund hubs in order to establish comparisons with the German market. The competitive factors refer to cost structures, asset-mix, ETF presence in the market, institutional share classes, internationally distributed funds, economies of scale, fund age, financial performance as well as the performance of the respective strategies from the sustainability perspective. We show that sustainable fund hubs exhibit lower fund costs for sustainable strategies compared to conventional funds. Our analysis suggests that the relative time of issuance may be a major factor explaining the differences in fund costs between sustainable and conventional strategies.

Section 3 provides a review of the state-of-the-art sustainable investing strategies that are currently implemented in the portfolio construction across sustainable fund hubs. Although there are no global standards for the definitions of sustainable investing strategies, most practitioners agree that they refer to a range of five overarching investing approaches that embrace ESG engagement, exclusions and other ESG strategies (such as best-in-class), impact investing, and thematic investing.

Section 4 discusses the competitive position of the German sustainable fund market and finds that sustainable investing is the most dynamic business line of asset management in Germany, especially in the retail segment. This development is closely related to the findings of the previous sections.

1. The European sustainable fund hubs

Sustainable investing is a financial area that has been evolving for a long time. In order to set up a framework of analysis, this study aims, as a first step, at identifying the centers that have embraced sustainable investing early in Europe. Data issues pose a huge challenge, not only because the regulation that deals with the elemental definitions on sustainable investment is unfolding now, but also because the term sustainability itself is by nature intangible and difficult to quantify. In this context, transparency on the dataset and on its limitations is particularly important. Therefore, this study includes a detailed description of the dataset used in every section, which can be found in the Annex 6.1.

In order to identify the global centers with relevance for Europe, three criteria have been defined:

1. Commitment to sustainability through legislation. Countries that have anchored the importance of sustainability in their national legislations are the ones that show the highest commitment to the global sustainable goals in the long term.
2. The share of sustainable funds in the country's total amount of fund net assets. It is not enough to have a legislation commitment if the market for sustainable funds has not developed to a significant market segment for the whole asset management industry.
3. The current market share in Europe. Countries in which asset managers have undertaken serious efforts to integrate sustainable aspects in the investment process for a long time should be the ones that have been not only building capabilities for the market of sustainable investments, but also the ones that have developed the market infrastructure that is needed in order to grow the amount of assets in this sector. These efforts are mirrored in the current market share of the respective country. There are only few countries that meet these criteria.

1.1 Commitment to sustainability through legislation

The scope and impact of the national laws regarding sustainable financial products in the European countries and the United States are diverse. Most of the countries aim at the disclosure of non-financial material information especially regarding environmental issues, and in most cases, include also social and ethical aspects. In case of the United States, for example, laws focus on material environmental aspects that threaten financial return. Lately, the focus has shifted to corporate governance issues. A few countries like France, United Kingdom, Netherlands, Sweden and Norway have gone further from disclosure to promote sustainability at the national level and paved the way towards a framework on how to tackle global threats like climate change. (The most remarkable laws on sustainability-related investments in Europe and the United States are summarized in Table 6.1 in the Annex at the end of the study.)

The Socially Responsible Investment movement (SRI) can be tracked back to the 1920s in the British institutional market when the Methodist church started to invest in stocks and wanted to avoid companies involved in alcohol and gambling so that companies of these two sectors were excluded from the portfolio. Since then, the **United Kingdom** has developed laws and regulations beyond the disclosure of ESG aspects. The Climate Change Act of 2008 was one of the first regulations that committed a country to reducing greenhouse gas emissions and was one of the examples taken into consideration for the conception of the United Nations Paris Agreement in 2015. Through its legislation, the United Kingdom also promotes the inclusion of ESG factors in pension funds, gender equality and better corporate governance for listed companies.

The Netherlands and Belgium are within the first countries whose laws promoted the disclosure of aspects related to environmental, social and ethical considerations in Europe. In the Netherlands, the retail market, rather than the institutional market, has been the driver of the responsible investment market. With the foundation of the ASN Bank in 1960 and the Triodos Bank in 1980, that brought ethical savings products to the market, the first milestone in the development of the SRI market was set. The first responsible investment fund in the Netherlands was developed in 1991². The

² ABF - Het Andere Beleggingsfonds / The Other Investment Fund, see Eurosif, Socially Responsible Investment among European Institutional Investors, 2003.

sustainable fund market has been growing rapidly since then. Netherlands has a broader scope of regulations than Belgium promoting sustainability within its pension funds system and accounting disclosures for listed and non-listed companies.

The creation of the rating agency Arese in 1997 was the first milestone that initiated the SRI market in **France** and led to an increase in the volume of funds and assets managed. A further impulse for the SRI market came later with the creation of employee savings plans by the Caisse d'Epargne mutual bank and the Caisse des Dépôts that focused on social issues. More recently, with the article 173 of the French Energy Transition Law in 2015, France paved the way for the regulation on how the financial sector should integrate climate-related issues. The law requires listed companies to disclose how they consider financial risks related to climate change and it requires institutional investors and investment managers to disclose how they consider ESG factors and how their policies align with the national strategy of energy transition. The scope of action of the French laws is very broad including aspects of sustainability, starting from gender equality, inclusion of ESG factors in pension funds, to ecolabels for financial products.

Sweden is another European country that distinguishes itself from the rest in that it has been one of the first countries that developed laws that promote the inclusion of the sustainability dimensions in its pension funds system. The state pension buffer funds, the AP funds, and especially the 7th AP fund, were leaders in developing and adopting norms-based screening³. Norms-based screening have become common practice by institutional investors, and they are also used in the municipal and local government sectors. Remarkably, with its Sweden Accounting Act in 1999, Sweden was the first country that mentions the double directional impact of ESG aspects, which means to identify the impact of material ESG aspects on financial performance as well as the impacts of economic activities on environmental or social subjects.

The SRI market in **Norway** can be tracked back to the late 1980s when the first environmental fund was launched in the market. Especially the SRI institutional market developed steadily since then until the mid-2000s. In 2004 the introduction of ethical guidelines on the Norwegian Governmental Pension Fund (NGPF) gave the SRI market a huge impulse and led to a significant increase of assets under management. The NGPF's mandate is to maximize wealth benefits for future generations, and future financial returns are regarded as contingent on sustainable development in economic, environmental and social issues. The NGPF defines the Norwegian sustainable fund market in terms of guidelines and investment approaches. Sustainable approaches applied by the NGPF are a combination of engagement, negative screening, and exclusion. The NGPF's ethical guidelines serve as a standard for other asset managers and investors in Norway and abroad. Many asset managers and investors around the world base on the NGPF's ethical guidelines to adopt their own policies and practices, especially the NGPF's exclusion list.

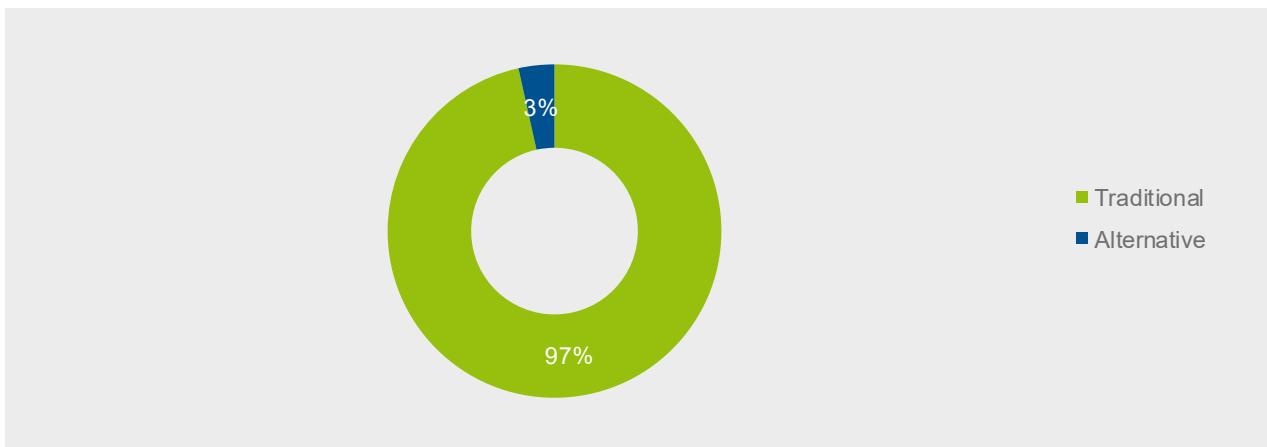
1.2 Size of the sustainable fund market at the country level

The accountability of the share of sustainable funds in the total of assets under management in a country is a difficult task, because there is no consensus worldwide on how to define sustainability. As a consequence, data based on these definitions will be evolving in tandem with the concepts. Europe has been overcoming major tasks in developing a framework for integrating the sustainability dimension in the financial sector. At the time when this study has been written, the EU action plan has not been completed. However, the essential regulations that define sustainable investments have been drawn and will be applicable in the near future. The analysis is based on data from Morningstar⁴. The representative part of the sustainable fund universe on which this study is based (97%) is invested in equities, bonds and balanced funds (see Figure 1.1). Therefore, this study focuses on traditional assets only.

³ See European SRI study, 2008, Eurosif.

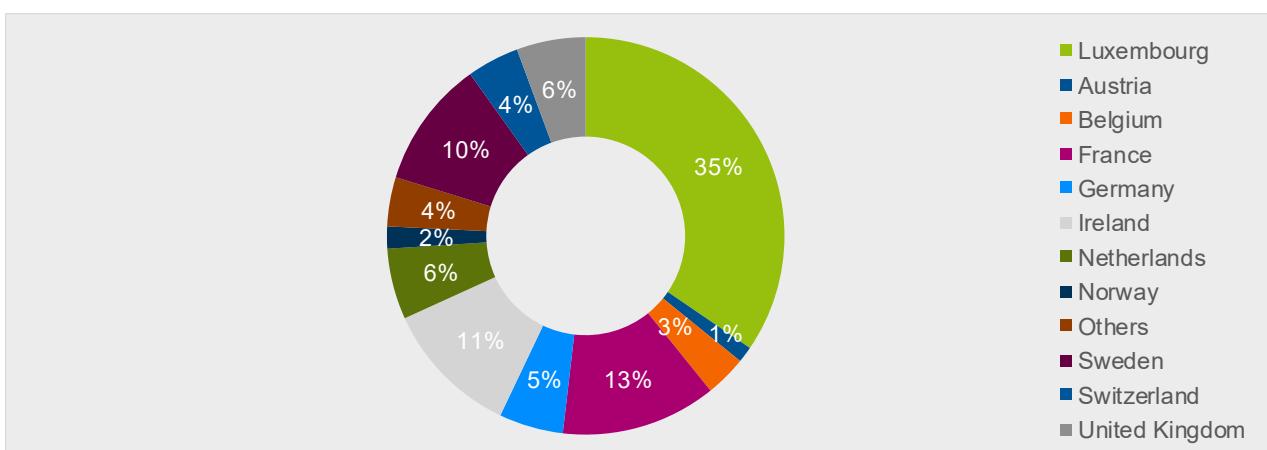
⁴ Despite the challenges and weaknesses that underline dealing with sustainable-related data, Morningstar is the only known provider of global data on net assets at the fund level, which has also developed a framework for definitions of sustainable investments. This framework has been evolving in the last years and currently distinguishes three types of sustainable funds: ESG (strategy) funds, products that focus on sustainability impact and thematic investment funds (that deal with long-term environmental issues like climate change and water conservation). The classification of a fund to one or more of these categories results from the analysis of the fund's prospectus. However, only funds whose core strategy is sustainability-related and /or whose investment policy contains binding ESG factors are included. See a detailed description of the dataset and Morningstar sustainability definitions in the Annex.

Figure 1.1 Asset breakdown of the European sustainable fund market – as of July 2020
Percent of net assets



Source: Morningstar

Figure 1.2 Domiciles of the European sustainable fund market – as of July 2020
Percent of net assets

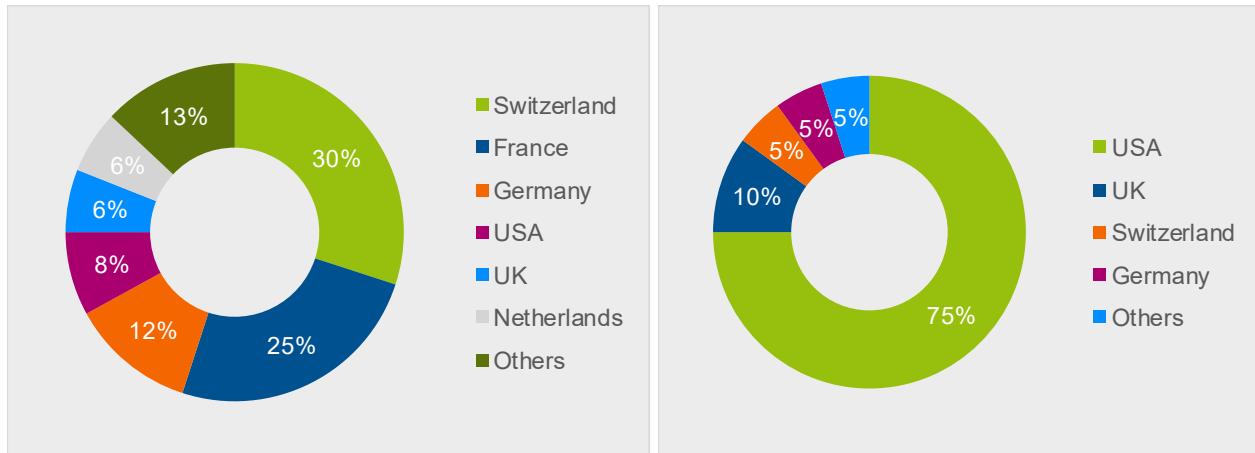


Source: Morningstar, traditional assets

A large amount of funds in Europe are domiciled in Luxembourg and Ireland (see Figure 1.2), but these are funds managed by subsidiaries of asset manager firms that are located somewhere else. The biggest part of the sustainable funds domiciled in Ireland were issued by US asset managers, to a lesser extent by British, Swiss and German firms. Sustainable funds domiciled in Luxembourg originate from the following countries: 30% from Switzerland, 25% from France, 12% from Germany, 8% from the USA and the rest from the UK, the Netherlands and other countries (see Figure 1.3). In this study, the funds issued in Luxembourg and Ireland have been allocated to the country of the global headquarter of the respective subsidiary. Given the relevant role of Luxembourg and Ireland as funds hubs overall, considering the origin of the funds domiciled in Luxembourg and Ireland allows for a clearer picture of the size of the sustainable market in every European country.

Figure 1.3 Sustainable funds domiciled in Luxembourg (left) and Ireland (right) by provenience of the asset management company – as of July 2020

Percent of net assets

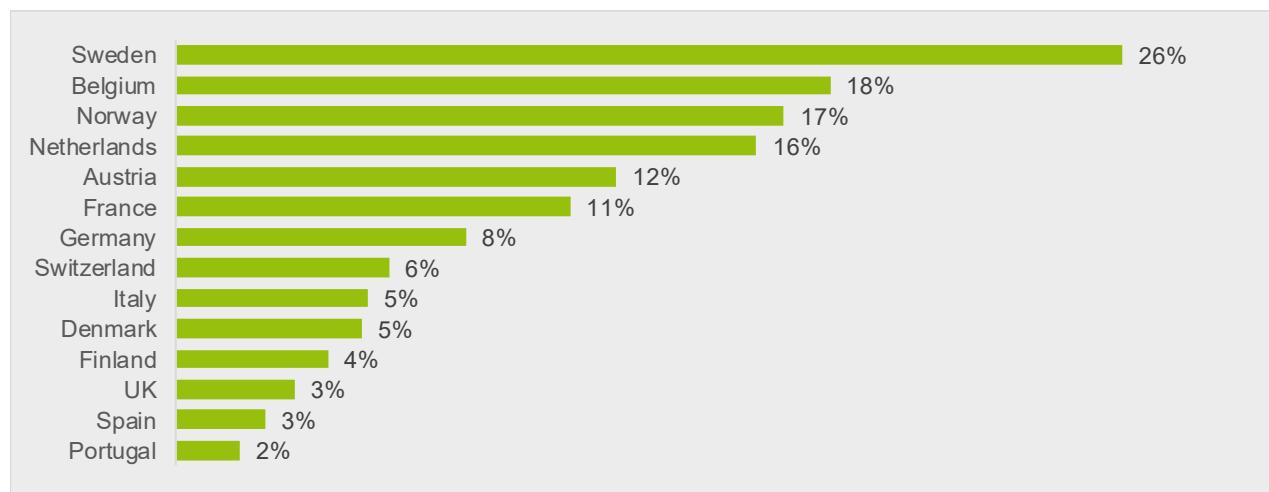


Source: Morningstar, traditional assets, own estimations⁵

As of July 2020, there are few countries in which the market for sustainable funds has developed considerably in the last years. According to this analysis, the countries in which the share of sustainable funds to the total assets domiciled in that country is significant (at least 5%) are Sweden, Belgium, Norway, the Netherlands, Austria, France, Germany, Switzerland, Italy and Denmark (see Figure 1.4).

Figure 1.4 Market share of sustainable funds in selected European countries – as of July 2020

Percent of net assets



Source: Morningstar, traditional assets, own estimations⁶

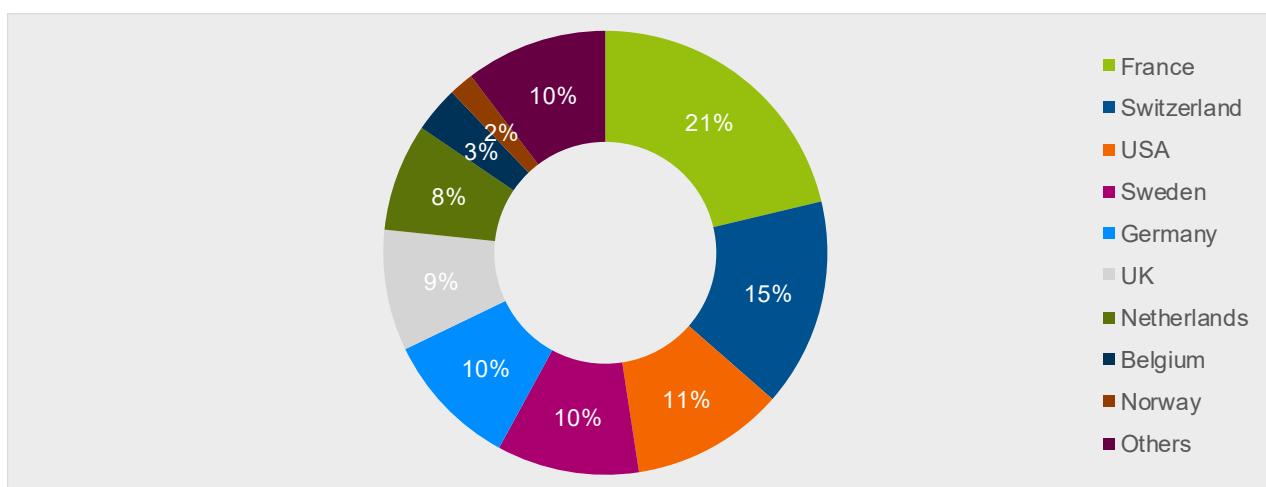
⁵ Other countries that place their sustainable funds in Luxembourg and Ireland are Finland, Italy, Denmark and Belgium, Liechtenstein and Australia. These are summarized in the category “others”.

⁶ This figure considers funds that are domiciled in Luxembourg and Ireland, but the asset management company is originally from a different country.

1.3 Country market share in the European sustainable fund market

Some countries have undertaken serious efforts to integrate sustainable aspects in the investment process for a long time and have built capabilities for the market of sustainable investments. This is reflected in the growth of the amount of assets. At first glance, the sustainable fund market in Europe shows that the countries with a significant market share are France, Switzerland, the United States, Sweden, Germany, the United Kingdom, the Netherlands, Belgium and Norway. These countries account for 90% of the European market as of July 2020. The list of countries that are present in the European sustainable fund market is large. However, many countries have a market share of less than 1%, which is the reason why they were not considered in this study. (see Figure 1.5).

Figure 1.5 Market share of the European sustainable fund market by provenience – as of July 2020
Percent of net assets



Source: Morningstar, own estimations⁷

American asset managers predominantly place their sustainable funds in Ireland to enter the European fund market. The United States have currently a market share of 11% in the European sustainable fund market. However, looking at the domestic sustainable fund market in the United States, one can see that its development has not been as dynamic as in Europe. According to the data provided by the ICI, the amount of assets under management in the sustainable fund market in the USA has been 321 billion USD as of 2019, which represents only 1.2% of the total assets managed in mutual funds und ETF (25.7 trillion of USD)⁸.

According to the analysis outlined so far, seven countries have been identified as sustainable fund hubs: France, Germany, Sweden, the Netherlands, Switzerland, the United Kingdom and Norway. These countries fulfill at least two of the criteria set for this analysis. These countries have put their commitment to sustainability on the top of their country economic agenda as mirrored by their legislation and have significantly grown their sustainable funds market as measured by the local market share of sustainable products and their share in the European sustainable fund market as a whole. Table 1.1 summarizes the results of this analysis.

⁷ The category of “Others” in Figure 5 includes countries with a market share of less than 1%. These are: Austria, Italy, Denmark, Spain, Finland, Portugal, Malta, Lichtenstein, Monaco and Iceland.

⁸ See ICI “Investment company fact book: a review of trends and activities in the investment company industry”, 2020.

Table 1.1 Sustainable fund hubs

| Criteria | Country |
|--|---|
| Commitment to sustainability through legislation | France, Netherlands, Sweden, United Kingdom, Norway |
| Share of sustainability funds to the country's net assets | Sweden, Belgium, Norway, the Netherlands, Austria, France, Germany, Switzerland, Italy, Denmark |
| Current market share in the European sustainable fund market | France, Switzerland, United States, Sweden, Germany, United Kingdom, the Netherlands, Belgium, Norway |

Source: BVI, own definition⁹

⁹ The definition of the sustainable fund hubs is given by the three criteria set in section 1: commitment to sustainability through legislation, significant size of sustainable funds in the respective country and a significant market share in the European sustainable fund market. Note that Belgium is another country that has a reasonably well-developed sustainable fund domestic market, however, the scope of regulations promoting sustainability is not as broad and influential as the seven countries and is therefore excluded from the following analysis.

2. Competitive factors

This section focuses on the main structural characteristics that define the competitive environment in the sustainable fund hubs: France, Germany, Norway, Netherlands, Sweden, Switzerland, and the United Kingdom. The competitive factors refer to the cost structure, fund's asset-mix, ETF participation in the market, institutional share classes, share of cross-borders funds, economies of scale, fund financial fund performance as well as the fund performance from a sustainability perspective. In addition to the factors mentioned before, in the ESG fund space, the time of issuance of a fund appears to be an important factor as well. The following subsections deal with these factors.

2.1 Cost structure

For the cost analysis in this subsection several measures from the database of Morningstar have been considered. In the following, we focus on only one metric: the Key Investor Information Document ongoing charge figure (KIID OCF). The coverage of data for this measure in the database is good and allows to make comparisons¹⁰. The KIID OCF represents all annual fixed and operating charges, as well as distribution costs. This figure does not include performance fees. We have performed cost analysis of simple averages as well as asset-weighted averages and both type of measures lead to the same conclusions. For a more comprehensive presentation, we will focus on simple averages only.

This subsection gives insights into the following questions:

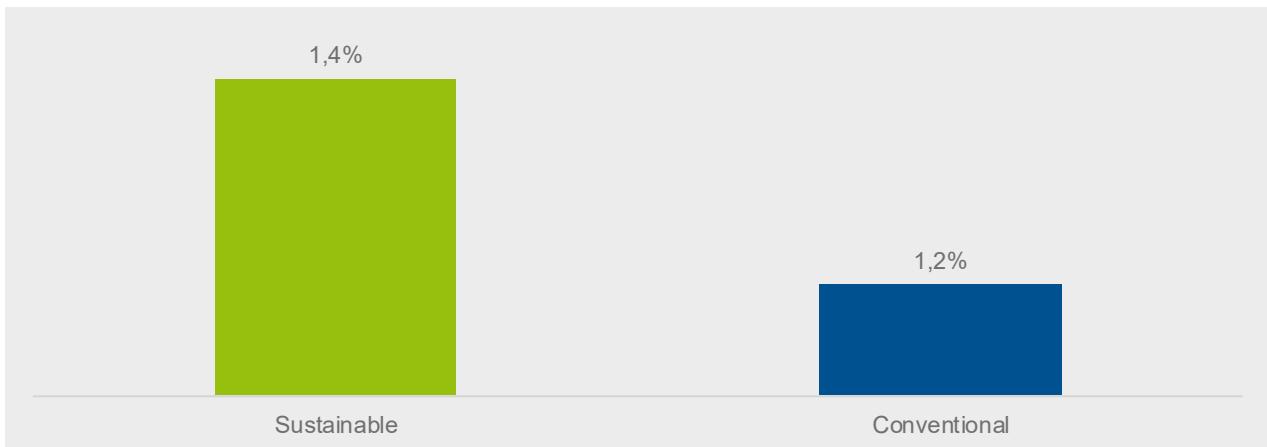
1. How costs of sustainable funds compare to conventional funds in Europe. This question aims at exploring the current impact on the funds' cost structure of following a sustainability strategy.
2. How costs of sustainable funds in the sample of sustainable fund hubs compare to other European countries. Exploring this question helps to gain more insight on any specialization of sustainable fund hubs with respect to other European countries.
3. Any cost differentiation at the country level in the sample of the seven countries that qualified as sustainable fund hubs in this analysis. This question sheds light on the countries' competitive position within the sample of the sustainable fund hubs.

Referring to our first question and looking at the cost structure of sustainable and conventional funds in the European aggregate, one can observe that sustainable funds exhibit higher costs than conventional funds as shown in Figure 2.1. This is quite intuitive since carrying out a sustainable strategy might imply additional costs like, for example, the costs of acquiring ESG specialists and ESG data, costs of adapting the infrastructure to the new strategy as well as regulatory costs in order to adjust the investment process to the new requirements, among other costs.

¹⁰ See the section Dataset in the Annex of this study for more details on the KIID OCF metric.

Figure 2.1 KIID OCF of sustainable and conventional funds – European average, as of July 2020

Percentage of fund net assets value



Source: Morningstar, own calculations

Regarding the second question and focusing only on the group of countries that qualify as sustainable hubs in this study, the picture shows the opposite: the cost structure of sustainable funds is lower than the one of conventional funds (see Figure 2.2).

Figure 2.2 KIID OCF of sustainable and conventional funds – average of sustainable fund hubs, as of July 2020

Percentage of fund net assets value



Source: Morningstar, own calculations

A look at the asset breakdown of the cost structure for both types of strategies reveals that the higher costs for conventional funds are mainly driven by balanced and equity funds and, to a lesser degree, fixed income funds (see Figure 2.3).

Figure 2.3 Asset class breakdown of KIID OCF of sustainable and conventional funds – average of sustainable fund hubs, as of July 2020

Percentage of fund net assets value



Source: Morningstar, own calculations

The fact that costs are higher for equity and balanced funds is not new¹¹. However, it is very surprising that sustainable funds have a lower cost structure than conventional funds in the sample of countries that qualify as sustainable fund hubs. This is against expectations and is different than the previous findings at the European level. The different results can be understood by looking at the country figures. The cost structure for sustainable funds in the seven sustainable fund hubs is very heterogeneous, as can be seen in Table 2.1. For example, while the average sustainable balanced fund costs 0.7% of the fund's net assets in one country, it costs 1.3% in another country. These differences in expenses in the different countries potentially imply competitive advantages. This section analyses various factors that may be the sources of cost differences in the group of sustainable fund hubs.

Table 2.1 Asset class breakdown of KIID OCF in the sustainable fund hubs – relevant statistics, as of July 2020

Percentage of fund net assets value

| Balanced | |
|---------------------|------|
| Average | 1.1% |
| Minimum | 0.7% |
| Maximum | 1.3% |
| Equity | |
| Average | 1.0% |
| Minimum | 0.5% |
| Maximum | 1.7% |
| Fixed Income | |
| Average | 0.6% |
| Minimum | 0.3% |
| Maximum | 0.8% |

Source: Morningstar, own calculations

¹¹ See for example “ICI Research Perspective, Ongoing Charges for UCITS in the European Union”, 2019. Ongoing charges for balanced, equity and fixed income funds were found to be 1.51%, 1.51% and 1.04% respectively in 2018.

Looking at this cost difference at the country level to answer the third question, the countries that exhibit the lowest ongoing charges for sustainable funds vis-a-vis conventional funds across all asset classes are Sweden, Germany and Switzerland (see Table 2.2).

Table 2.2 Country breakdown of the difference in KIID OCF of sustainable and conventional funds in the sustainable fund hubs – as of July 2020

Percentage of fund net assets value

| Balanced | |
|---------------------|--------|
| France | -0.19% |
| Germany | -0.10% |
| Netherlands | 0.78% |
| Sweden | -0.84% |
| Switzerland | 0.05% |
| United Kingdom | 0.26% |
| Equity | |
| France | 0.05% |
| Germany | -0.17% |
| Netherlands | 0.50% |
| Norway | 0.66% |
| Sweden | -0.48% |
| Switzerland | -0.44% |
| United Kingdom | 0.25% |
| Fixed Income | |
| France | 0.03% |
| Germany | -0.09% |
| Netherlands | 0.67% |
| Norway | 0.30% |
| Sweden | -0.13% |
| Switzerland | -0.19% |
| United Kingdom | 0.22% |

Source: Morningstar, own calculations

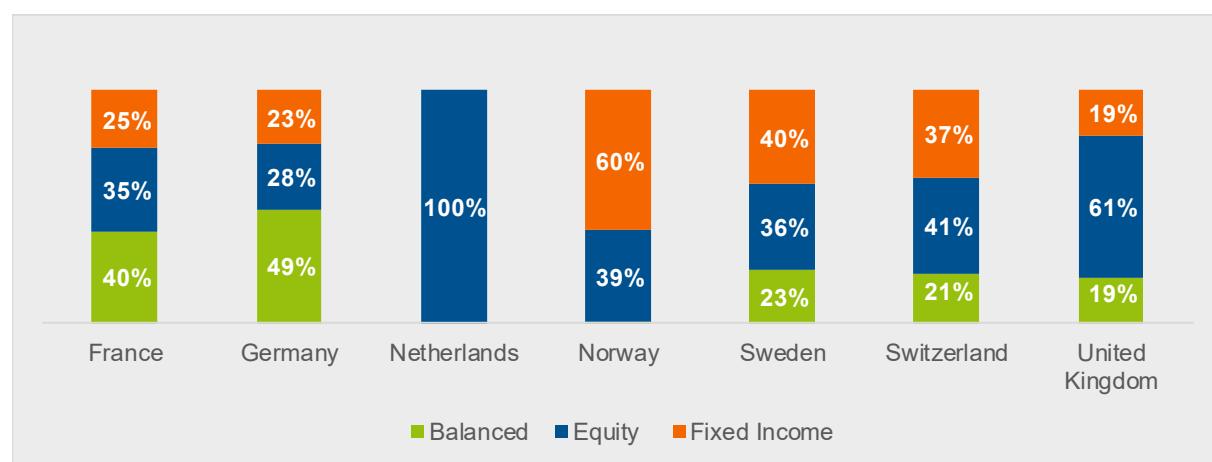
There are several factors that may cause structural differences in costs. The literature that deals with the development of fund costs mentions the following factors: fund's asset-mix, ETF participation in the market, institutional share classes, share of cross-borders funds, economies of scale¹². In addition to these factors, we also analyze the fund financial performance and the performance from the sustainability perspective. In the ESG fund space, the time of issuance of a fund appears to be an important factor as well. The following subsections deal with these factors.

¹² See "ICI Research Perspective, Trends in Expenses and Fees of Funds", 2019; Morningstar, "Europe- Fund Expenses are decreasing in Percentage, but Investors pay in nominal values", 2016; ESMA, "Annual Statistical Report, Performance and Costs of Retail Investment Products in the EU", 2020; European Commission, "Distribution systems of retail investment products across the European Union", 2018.

2.2 Type of funds by asset class

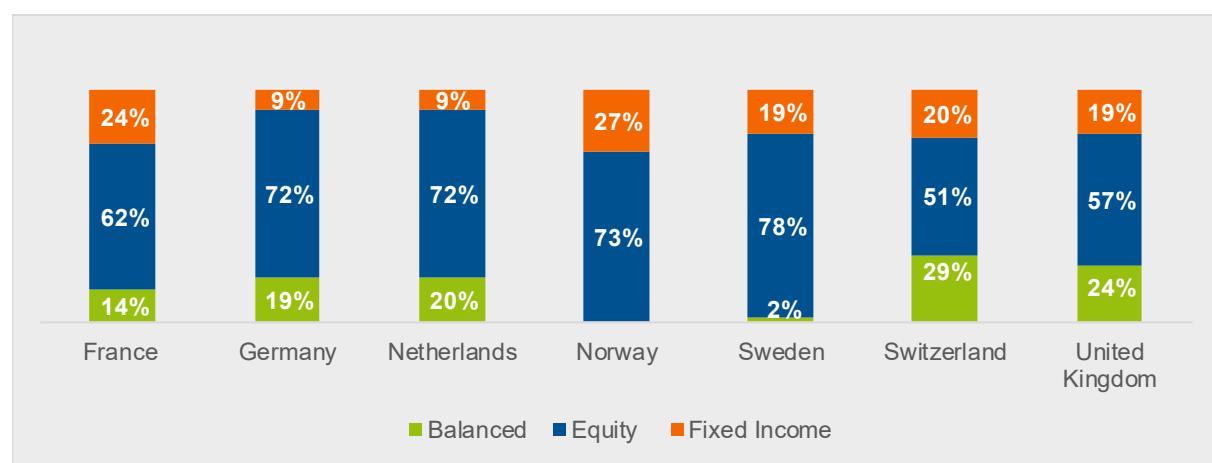
At the current edge, compared to conventional funds, sustainable funds in the seven countries in analysis are concentrated in equity funds. To a lesser extent, sustainable funds take the form of balanced or fixed income funds. Recalling that equity and balanced funds exhibit the highest cost structure, the asset-mix cannot explain the lower cost of sustainable funds (see Figures 2.4 and 2.5).

Figure 2.4 Types of conventional funds by asset class in the sustainable fund hubs – as of July 2020
Share of asset class in the total fund volume



Source: Morningstar, own calculations

Figure 2.5 Types of sustainable funds by asset class in the sustainable fund hubs – as of July 2020
Share of asset class in the total fund volume



Source: Morningstar, own calculations

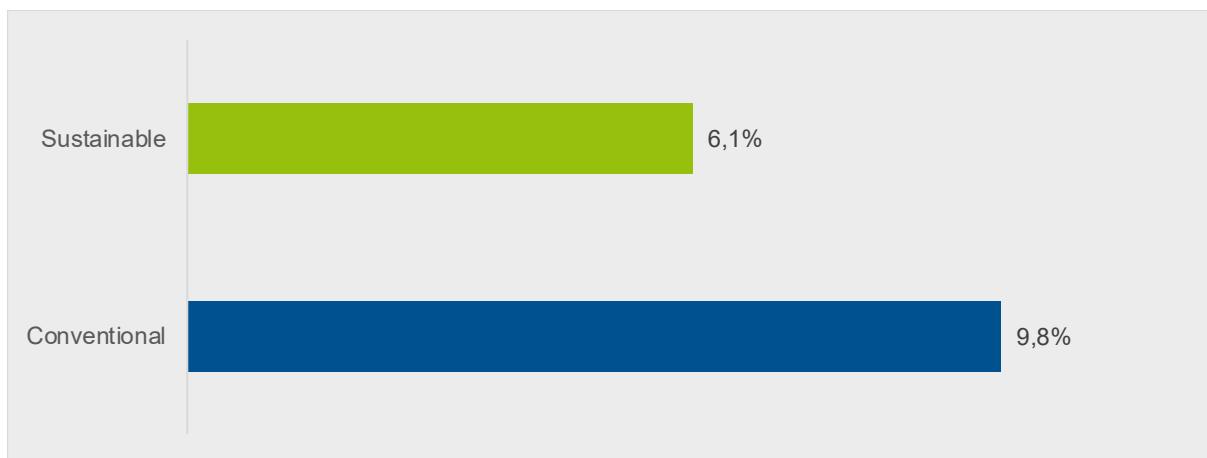
2.3 Exchange Traded Funds

Figure 2.6 shows the participation of exchange traded funds in the European SRI market. Data shows that the portion of ETFs in the sustainable as well as the conventional fund market in Europe overall is low. The participation of ETFs in the sustainable fund market is 6% and about 10% in the conventional fund market. Due to the nature of exchange-traded funds, country-level data is scarce and difficult to interpret. Despite this, we believe the overall low market share of

sustainable ETFs across Europe makes their presence an unlikely explanation for the lower cost level of sustainable funds versus conventional funds in the sample of sustainable fund hubs. Therefore, this factor does not explain why sustainable funds show a lower cost level than conventional funds in the sample of sustainable fund hubs.

Figure 2.6 ETFs in Europe – as of July 2020

Share of ETF in the total fund volume



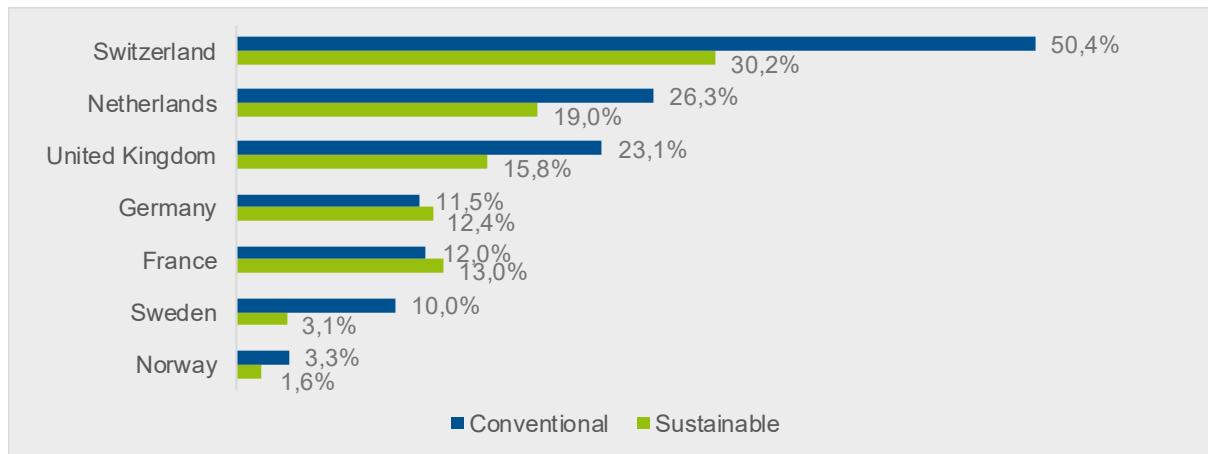
Source: Morningstar, own calculations

2.4 Institutional share classes

Another factor that can potentially explain cost differences between conventional and sustainable funds is the existence of different types of share classes. Ongoing charges are different for different types of investors. Shares designed for institutional investors and wholesale distributors have lower costs than shares designed for retail investors because they profit from a bulk of discounts; distribution costs are much lower, for example. Figure 2.7 shows the participation of institutional share classes in the sustainable fund hubs. In the group of the seven countries in analysis Switzerland and the Netherlands exhibit a significant participation of institutional shares for both types of strategies, sustainable and conventional. For the other countries the participation of institutional shares is lower than 25%. Comparing the participation of institutional shares between conventional and sustainable funds within each of the seven countries, the figures show that there are proportionally more institutional share classes in the conventional fund market of the respective countries than in the sustainable fund market, except for Germany and France, but the difference is minimal. Therefore, the differences in costs between conventional and sustainable strategies in the sustainable fund hubs cannot be attributed to this factor.

Figure 2.7 Institutional shares in the sustainable fund hubs – as of July 2020

Number of share classes as percentage of country's total number of share classes



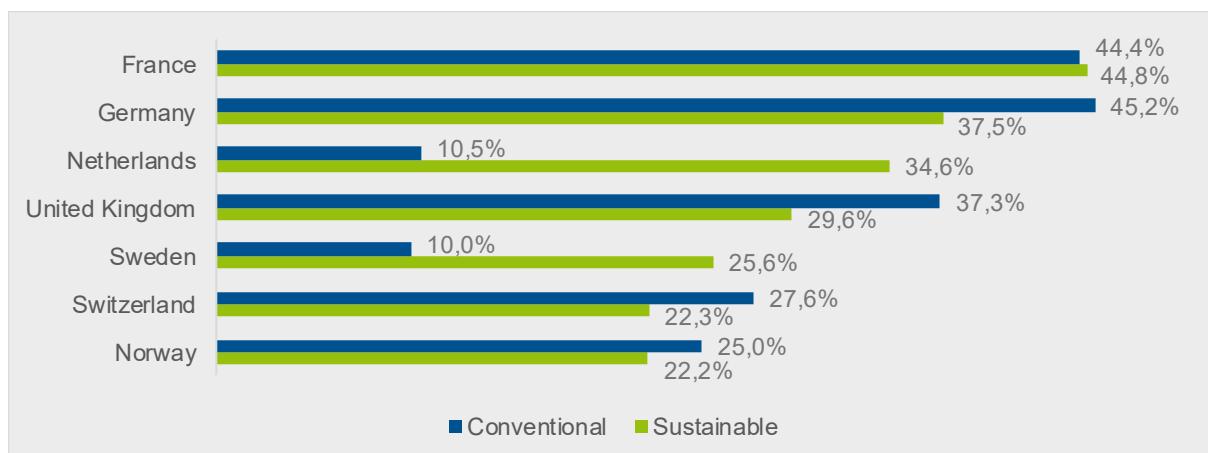
Source: Morningstar, own calculations

2.5 Cross-border funds

Ongoing charges of cross-border funds tend to be higher than for funds that are sold in a single country. These extra costs are associated with the fulfillment of additional requirements imposed by local markets. There are also additional administrative costs to cover the complexity of offering different share classes which are usually necessary in order to offer share classes in different currencies. According to this, the expectation is that a higher participation of cross-border funds should lead to relative higher fund costs for a specific strategy in the respective country. Recalling the results from Table 2.2 in which we showed that the difference in costs between sustainable and conventional strategies is negative for Sweden, Germany and Switzerland, meaning that sustainable funds have lower costs than conventional funds, we see from the results shown in Figure 2.8 that cross-border funds do not offer an explanation for this.

Figure 2.8 Cross-border funds in the sustainable fund hubs – as of July 2020

Number of share classes as percentage of country's total number of share classes



Source: Morningstar, own calculations

Figure 2.8 shows the involvement of cross-border funds in the sustainable fund hubs which is heterogeneous in the different countries. The relative participation of cross-border funds in the SRI market compared to the conventional fund market is higher in the Netherlands and Sweden. Therefore, costs for sustainable strategies should be higher than for

conventional funds in both countries. According to Table 2.2 this is only the case for the Netherlands, and therefore cross-border funds do not offer an explanation for the difference in costs between sustainable and conventional funds in Sweden. In Germany and Switzerland, we observe that the participation of cross-border funds is higher for conventional strategies than for sustainable ones and therefore we should expect higher costs for conventional strategies. These figures do not support the findings of Table 2.2 neither and therefore we can conclude that the role of cross-border funds as a factor explaining cost differences between sustainable and conventional strategies in the sustainable fund hubs and particularly in Sweden, Germany and Switzerland is not significant.

2.6 Economies of scale

The literature that deals with the development of fund costs mentions economies of scale as another factor influencing fund costs. Economies of scale are common with growing fund volumes, since these increasing volumes can absorb fixed costs. Taking a look at the fund size in the seven countries in analysis shown in Table 2.3, one can see that the average fund size is higher for conventional funds than for sustainable funds in Germany, Switzerland and the United Kingdom and the opposite for France, Sweden, Norway and the Netherlands¹³. This means that at least for Sweden economies of scale might play a role in explaining the relative difference between costs of both strategies. Because France, Norway and the Netherlands showed higher costs for sustainable strategies than for conventional ones, we have to look for further explanation.

Table 2.3 Country breakdown of the average fund size in the sustainable fund hubs – as of July 2020

Average of Fund Volume in Million Euro

| | Sustainable | Conventional |
|----------------|-------------|--------------|
| France | 101 | 81 |
| Germany | 86 | 194 |
| Netherlands | 375 | 160 |
| Norway | 422 | 301 |
| Switzerland | 133 | 161 |
| Sweden | 377 | 200 |
| United Kingdom | 153 | 157 |

Source: Morningstar, own calculations

Another indication of potential presence of economies of scale is the degree of market concentration. Economies of scale may lead to lower costs for sustainable strategies particularly in countries where the biggest portion of the sustainable fund market is concentrated in a few market players. We have carried out an analysis of market concentration in the seven sustainable funds hubs. Table 2.4 shows the standardized Herfindahl Index¹⁴ of the sustainable and conventional fund market in the respective sustainable fund hubs. Overall, the numbers denote some degree of market concentration for both strategies in all countries except for France and the United Kingdom. Particularly interesting is the high level of concentration of the conventional fund market in Norway and the Netherlands relative to the sustainable fund market,

¹³ One explanation for this is that sustainable funds in the first group of the mentioned countries have been mostly launched in recent years so that the starting fund volume is still low compared to the second group of countries. We will turn to this aspect at a later stage, but it is worth to mention this at this point.

¹⁴ For comprehensive explanation of the calculation and interpretation of the Herfindahl index see “The CR4 index and the interval estimation of the Herfindahl-Hirschman Index: an empirical comparison”, Naldi and Flamini, 2014. The index showed in the table is the standardized Herfindahl index (H^*) calculated with the formula: $H^* = \frac{H-1/n}{1-1/n}$, where H is the Herfindahl index calculated with the formula $H = \sum_{i=1}^n q_i^2$ where q_i is the market share of company i and n is the number of companies in the industry.

which can be part of the explanation why sustainable funds in these two countries are more expensive than conventional funds.

Table 2.4 Standardized Herfindahl Index of the sustainable fund hubs – as of July 2020

| | Sustainable | Conventional |
|----------------|-------------|--------------|
| France | 0.06 | 0.07 |
| Germany | 0.10 | 0.12 |
| Netherlands | 0.10 | 0.46 |
| Norway | 0.24 | 0.32 |
| Switzerland | 0.16 | 0.13 |
| Sweden | 0.16 | 0.13 |
| United Kingdom | 0.06 | 0.03 |

Source: Morningstar, own calculations. Values of the standardized Herfindahl index are in the range of 0 to 1.

2.7 Performance

Another reason why sustainable funds are less costly than conventional funds in Germany, Sweden and Switzerland may be an inferior financial fund performance. For the comparison of financial fund performance, this study uses the Morningstar Rating¹⁵ for the periods of 3, 5 and 10 years and it compares ratings between the countries defined as sustainable fund hubs as well as between the two different type of strategies: sustainable and conventional. Interestingly, sustainable funds in the sample of countries that are focus of this study show a performance which is between average and above average for the three periods (see Table 2.5). This is higher than the performance of conventional funds, which is rated as average (see Table 2.6). Therefore, we can rule out that financial performance explains the pattern of price differences between sustainable and conventional funds described.

Table 2.5 Country average of Morningstar rating for sustainable funds
Morningstar stars

| | 3 Yr | Coverage | 5 Yr | Coverage | 10 Yr | Coverage |
|----------------|------------|----------|------------|----------|------------|----------|
| Norway | 3.7 | 60% | 3.8 | 50% | 3.9 | 37% |
| Sweden | 3.4 | 79% | 3.5 | 69% | 3.5 | 51% |
| Netherlands | 3.9 | 48% | 3.9 | 35% | 3.5 | 21% |
| Germany | 3.4 | 66% | 3.4 | 56% | 3.4 | 42% |
| United Kingdom | 3.4 | 41% | 3.2 | 35% | 3.4 | 26% |
| Switzerland | 3.5 | 46% | 3.3 | 30% | 3.0 | 21% |
| France | 3.1 | 55% | 3.0 | 48% | 2.8 | 35% |
| Average | 3.5 | | 3.4 | | 3.4 | |

Source: Morningstar, ranking from 1 star “Low” to 5 stars “High”, own calculations. Coverage is the amount of share classes that have a Morningstar rating in the respective country’s fund universe. Obsolete funds included¹⁶.

¹⁵ The Morningstar Rating brings returns and risk together into one indicator. To determine a fund's star rating for a given time period (three, five, or ten years), the fund's risk-adjusted return is plotted on a bell curve: If the fund scores in the top 10% of its category, it receives 5 stars (Highest); if it falls in the next 22.5% it receives 4 stars (Above Average); a place in the middle 35% earns 3 stars (Average); those lower still, in the next 22.5%, receive 2 stars (Below Average); and the bottom 10% get only 1 star (Lowest). See “The Morningstar rating for funds”, 2016, for a more detailed description on how Morningstar calculates its rating.

¹⁶ Obsolete funds are included in these calculations in order to avoid a survivorship bias.

Table 2.6 Country average of Morningstar rating for conventional funds

Morningstar stars

| | 3 Yr | Coverage | 5 Yr | Coverage | 10 Yr | Coverage |
|----------------|------------|----------|------------|----------|------------|----------|
| France | 2.9 | 63% | 3.0 | 57% | 3.0 | 43% |
| Germany | 2.9 | 75% | 3.1 | 65% | 2.7 | 39% |
| Sweden | 2.5 | 100% | 2.3 | 100% | 2.7 | 75% |
| Switzerland | 3.2 | 66% | 3.4 | 64% | 3.0 | 50% |
| United Kingdom | 3.2 | 72% | 3.2 | 68% | 3.4 | 54% |
| Average | 2.9 | | 3.0 | | 2.9 | |

Source: Morningstar, ranking from 1 star "Low" to 5 stars "High", own calculations. Coverage is the amount of share classes that have a Morningstar rating in the respective country's fund universe. Obsolete funds included.

Looking at differences between countries, the best performers are the Scandinavian countries, Norway, Sweden followed by the Netherlands and Germany. However, the data coverage of the Morningstar Ratings is very low for the Netherlands and therefore these results must be interpreted with caution.

Table 2.7 Country average of Morningstar sustainability rating in the sustainable fund hubs

Morningstar globes

| | 1 Yr | Coverage |
|----------------|------------|----------|
| Switzerland | 3.4 | 56% |
| Norway | 3.7 | 80% |
| Germany | 4.0 | 66% |
| France | 4.0 | 61% |
| United Kingdom | 4.1 | 59% |
| Sweden | 4.2 | 74% |
| Netherlands | 4.3 | 69% |
| Average | 3.9 | |

Source: Morningstar, ranking from 1 globe "Low" to 5 globes "High", own calculations. Coverage is the amount of share classes that have a Morningstar globe in the respective country's fund universe. Obsolete funds included.

Also, the sustainability performance of funds in Germany, Sweden and Switzerland could lag behind, making them less attractive investments for sustainability-oriented investors. The measurement of sustainability performance is an area with a great potential for improvement. As data quality and coverage improves and market participants get a better understanding of the sustainability dimensions, accountability for sustainability performance will have to evolve in order to secure the credibility of sustainable strategies. At this point in time, there are just a few options, one of which is the Morningstar Sustainability Rating¹⁷. The coverage of this rating for European countries is relatively high and it allows for comparison between countries. The leading countries in terms of sustainability performance are the Netherlands, Sweden, UK, France and Germany, which share an above average rating. Switzerland and Norway have a sustainability

¹⁷ The Morningstar Sustainability Rating is a measure of the financially material environmental, social, and governance risks in a portfolio relative to a portfolio's peer group. In 2016, Morningstar released the Morningstar Sustainability Rating to help investors use environmental, social, and governance, or ESG, information to evaluate portfolios. The rating provides a way to evaluate how portfolios are meeting environmental, social, and corporate governance challenges based on underlying company ESG Ratings from Sustainalytics. In 2018, Sustainalytics (now part of Morningstar) launched a new company-level rating, the ESG Risk Rating, that measures the degree to which a company's economic value may be at risk driven by ESG issues. In late 2019, Morningstar enhanced the current Morningstar Sustainability Rating methodology by replacing Sustainalytics' company ESG Rating with its ESG Risk Rating. It also introduced buffers between ratings increments to increase overall stability and establish rules for handling ratings of portfolios with extremely high overall ESG risk. For more details see Morningstar sustainability rating methodology, 2019.

rating between average and above average (see Table 2.7) Again, these findings do not give evidence regarding the fund cost differences in question.

2.8 Time since fund's issuance

Table 2.8 Cumulative frequency of sustainable funds issued since 2015 in the sustainable fund hubs

Number of share classes as percentage of country's total number of share classes

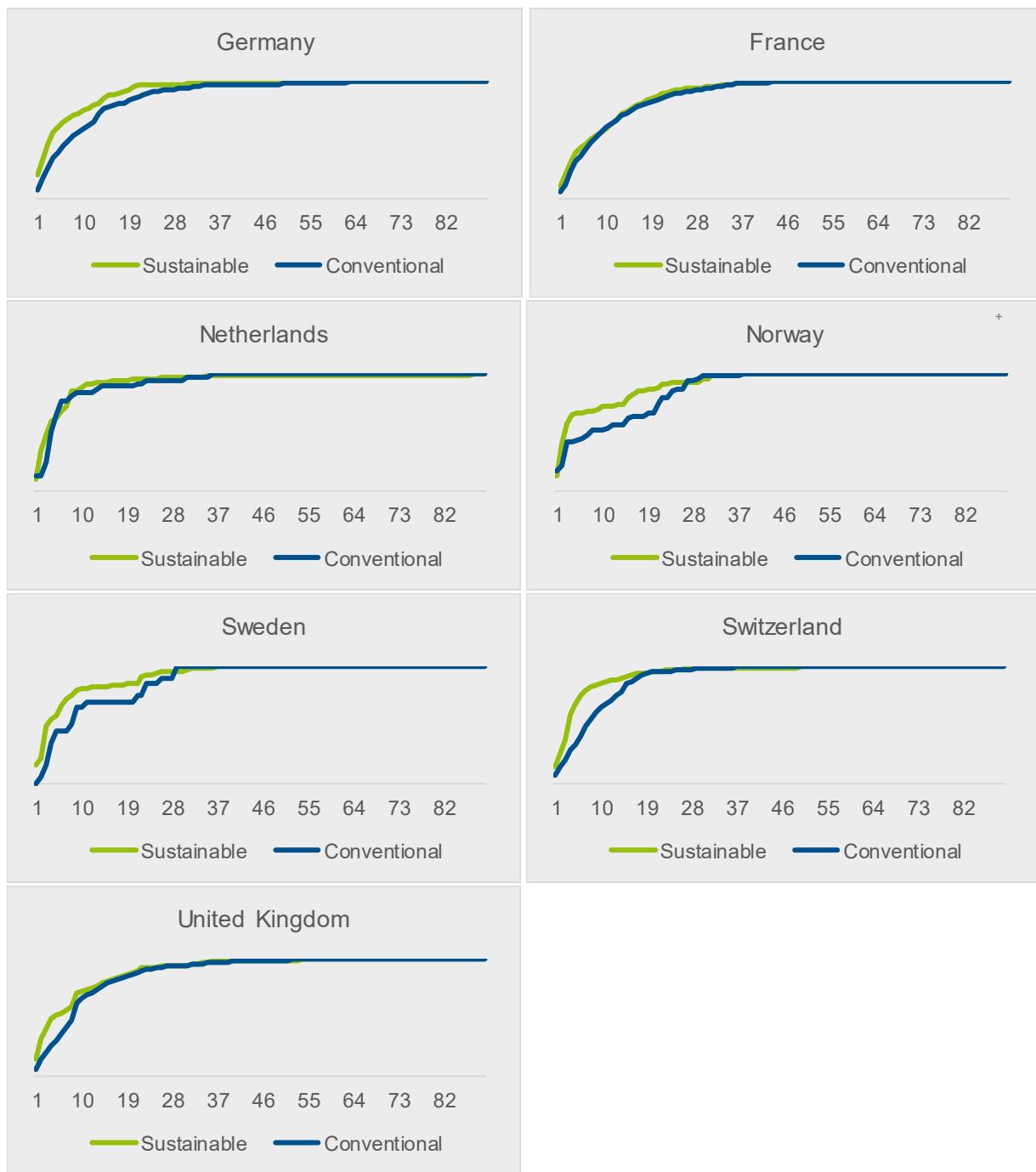
| | Sustainable | Conventional |
|----------------|-------------|--------------|
| France | 47% | 42% |
| Germany | 64% | 44% |
| Netherlands | 69% | 76% |
| Norway | 67% | 45% |
| Switzerland | 76% | 41% |
| Sweden | 67% | 45% |
| United Kingdom | 54% | 36% |

Source: Morningstar, own calculations

The majority of sustainable funds have been issued in the last five years. We can see in Table 2.8. that for example, in Sweden this was true for 67% of the sustainable funds, whereas only 45% of the conventional funds were issued in the same period. In Germany this relative rate of issuance in the same period is 64% to 44%, in Switzerland 76% to 41% and 67% to 45% in Norway. The difference in time of issuance for sustainable and conventional strategies for the seven sustainable fund hubs is also illustrated in terms of cumulative frequency distributions in Figure 2.9 as the difference between the green (sustainable funds) and blue (conventional funds) lines. The biggest gap between both lines can be seen in Sweden, Germany, Switzerland and Norway. This analysis shows that a large portion of conventional funds were issued in times when the funds' cost level was higher than in recent years, whereas the large amount of sustainable funds has been launched in times where the cost structure is lower than it has been in the last years. Therefore, it is plausible to expect that, overall, the cost structure of sustainable funds to be lower than of conventional funds in the universe of sustainable fund hubs and that time since issuance of funds is a relevant factor explaining why overall sustainable strategies are less expensive than conventional in the sustainable fund hubs.

Figure 2.9 Time since issue date of sustainable and conventional funds in the sustainable fund hubs

x-axis: years, y-axis: cumulative frequency of number of share classes – range from 0% to 100%



Source: Morningstar, own calculations

Summarizing the results of this section, it can be pointed out that the countries in the sample of sustainable fund hubs show a competitive advantage with respect to other European countries. This is especially true for Germany, Sweden and Switzerland, where sustainable funds are less costly than conventional funds. Given the additional effort required to build and manage a sustainable portfolio, this finding is unexpected. From all the potential aspects explaining these cost differences, time of fund issuance is the most important. All three countries have issued the greatest bulk of sustainable funds in recent years during a regime of lower costs level compared to conventional funds, for which a large proportion of funds had been issued earlier. Economies of scale are also a potential factor for Sweden. All other factors examined – ie. funds' asset classes, the presence of ETFs, institutional share classes and cross-border funds, market concentration and fund performance – did not offer an explanation.

3. Approaches to sustainable investing

This section focuses on the sustainable investing approaches that are currently implemented in the portfolio construction in the sustainable fund hubs. Estimating to which extent sustainable strategies are used by practitioners is a difficult task given that there is no global consensus regarding their definitions. The implementation of the EU Taxonomy and the Sustainable Finance Disclosure Regulation (SFDR) coming into force next year is expected to bring more transparency and clarity. Particularly important will be to observe how approaches to build financial products according to Article 8 (strategy-based „ESG“ products) and Article 9 („impact“ products) of the SFDR will evolve when the regulation comes into force. At this point, most practitioners agree that they refer to a range of five overarching investing approaches that comprise ESG engagement, ESG integration, screening/exclusions, impact investing and thematic investing. Table 3.1 summarizes these approaches and their representation in the Morningstar database¹⁸. Notably, we follow Morningstar in considering funds as sustainable only if they go beyond the approaches of ESG engagement and basic, ie. non-binding, ESG integration. This is also in line with the spirit of the EU Sustainable Finance Disclosure Regulation. We consider it is worth to make this appraisal before this regulation is implemented in order to observe market developments.

Table 3.1 Definitions of commonly used sustainable investing approaches

| Approach | Definition | Representation in the Morningstar Databasis and in this study |
|--------------------------------------|--|--|
| ESG Engagement / Proxy Voting | The use of shareholder power to influence corporate behavior, including through direct corporate engagement (i.e., communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines. | No meaningful data available as engagement is typically carried out on the company level rather than the fund level. Overview using European figures in section 3.1 |
| ESG Integration | Integration of ESG issues encompasses the use of qualitative and quantitative ESG information in investment processes, with the objective of enhancing investment decision-making. Integration of ESG issues can be used to inform economic analysis and industry analysis. It can be used at the portfolio level, by taking into account ESG-related trends such as climate change, or at the stock, issuer, or investee level. The term is used interchangeably with ESG integration or integrated analysis. | Standard ESG integration not seen as sufficient to qualify as an ESG fund; attribute “ESG fund” for funds whose <u>core</u> strategy is sustainability or whose investment policy includes <u>binding</u> ESG factors. Included in section 3.2 (strategy funds) if product is an ESG fund according to Morningstar. |
| Screening | There are three Screening approaches: a. Negative/exclusionary screening: The exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria; b. Positive/best-in-class screening: Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers; c. Norms-based screening: Screening of investments against minimum standards of business practice based on international norms. Norms-based screening involves | Funds count as “ESG fund” only if their <u>core</u> strategy is sustainability or if the investment policy includes <u>binding</u> ESG factors. Furthermore, dedicated attribute “Employs exclusions” available for additional details. |

¹⁸ Note that the sum of share of fund net assets applying all sustainable investing strategies in each country is higher than 100%. This is because the approaches mentioned so far are not mutually exclusive. It has become common practice to apply more than one approach in order to construct a sustainability portfolio. This feature is also reflected in the way databases like Morningstar classify sustainable funds. For details of the sustainable investing dataset used in this section refer to the Annex of this study.

| | | |
|---------------------------|--|---|
| | <p>either: i) defining the investment universe based on investees' performance on international norms related to responsible investment/ESG issues, or ii) excluding investees from portfolios after investment if they are found following research, and sometimes engagement, to contravene these norms. Such norms include but are not limited to the UN Global Compact Principles, the Universal Declaration of Human Rights, International Labor Organization standards, the United Nations Convention Against Corruption and the OECD Guidelines for Multinational Enterprises.</p> | Included in section 3.2 (strategy funds) if product is an ESG fund according to Morningstar. |
| Impact Investing | <p>Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets and target a range of returns from below market to market rate, depending on investors' strategic goals. The growing impact investment market provides capital to address the world's most pressing challenges in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, and affordable and accessible basic services including housing, healthcare, and education.</p> | Dedicated attribute "Impact fund" available. Results presented in section 3.4 |
| Thematic Investing | <p>Investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture).</p> | Dedicated attribute "Environmental sector fund" (as a proxy for thematic investment). Results presented in section 3.5 |

Source: UN Principles for Responsible Investment and Global Impact Investing Network, Morningstar Sustainable Attributes

For each sustainable investing approach, the data coverage is shown at the bottom of each figure as the percentage of the number of share classes for which a sustainable attribute is provided – for example, “employs exclusions”, yes or no – to the total number of share classes in the respective country’s funds universe. As mentioned at the beginning of this study, sustainable related definitions and data quality is evolving. In this context, data coverage gives an indication of the degree of confidence of the information shown.

3.1 ESG Engagement

ESG Engagement is one key approach to sustainable investing. ESG Engagement, also known as ESG dedicated shareholder engagement, refers to the exercising of voting rights and the active interaction of shareholders regarding ESG themes with the companies issuing the securities in the portfolio.

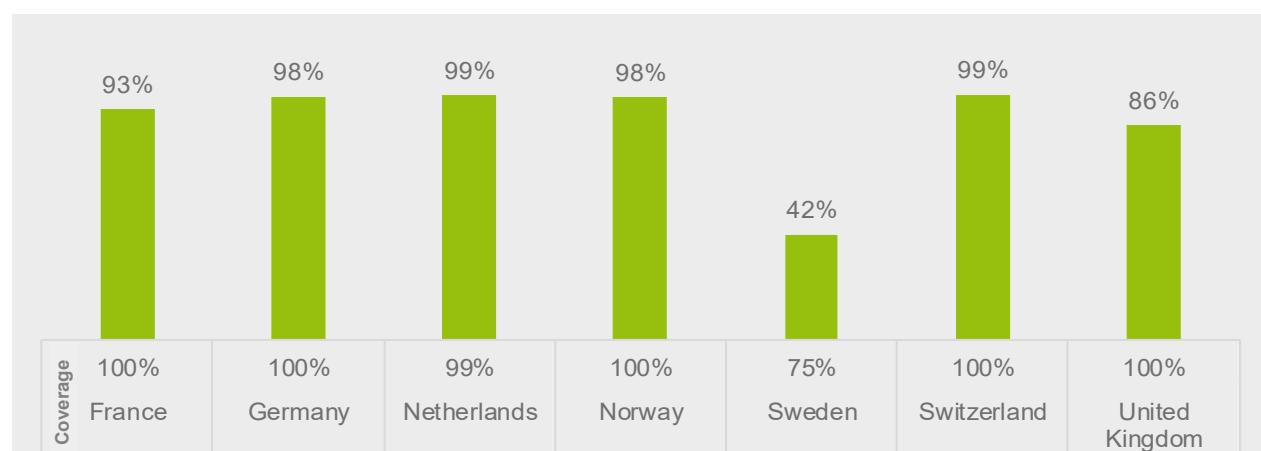
Morningstar bases its ESG Engagement attribute on the review of the fund’s regulatory filings. Due to the companywide nature of engagement methods and their frequent absence from regulatory filings, ESG Engagement data from this source does not look reliable at this point. A survey published recently by the European Fund and Asset Management Association estimates that assets under management of investment funds as well as discretionary mandates in Europe

that employ ESG Engagement sum up to 10.7 trillion Euro in 2019, which correspond to 45% of the total of assets under management in Europe¹⁹.

3.2 ESG Strategy funds

ESG strategies refer to the explicit commitment of inclusion of ESG risks and opportunities as central part of the investment process – security-selection as well as portfolio construction. ESG strategies consist in the combination of other single approaches like positive and/or negative screening and the large widespread strategy of best-in-class. ESG strategies are very common in most of the countries analyzed (see Figure 3.2). All countries show a quota of implementation of ESG strategies of more than 85%, the only country with a lower share of ESG strategies is Sweden (42%). As stated before, since there are no standards and consensus regarding which strategies can be designated to Article 8 of the SFDR, the definitions of this set of strategies as well as the number of funds employing them will most likely change in the future.

Figure 3.1 Use of ESG strategies in the sustainable fund hubs – as of July 2020
Fund net assets implementing ESG strategies as percentage of the country's sustainable assets



Source: Morningstar, own calculations. Coverage is the amount of share classes that have an ESG fund attribute in the respective country's fund universe.

3.3 Exclusionary Investing

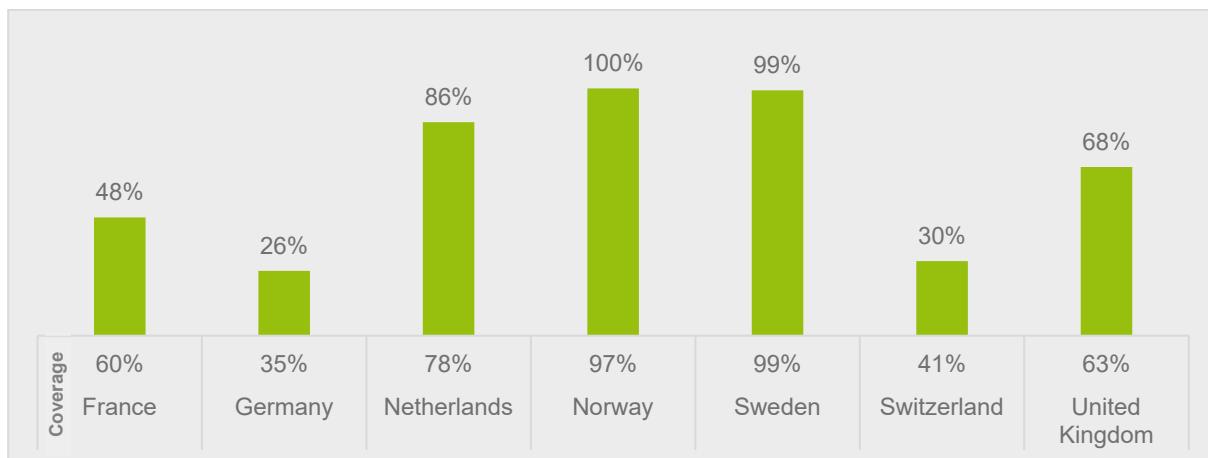
The simplest way to build a sustainability portfolio – and one approach often used by ESG strategy funds – is to apply exclusion lists. Exclusions consist in filtering certain sectors or issuers by some pre-established ethical criteria. These criteria vary depending on investors preferences which depends on the values prevalent in the country where the strategy is used, and it also may change with time. There is no global standard for the definition of most of these criteria, but the most frequently used exclusions are: controversial weapons, thermal coal, tobacco, and in some cases, also nuclear power. A higher degree of global consensus can be found by some corporate governance practices like for example corruption, child work and environmental destruction. The most common used set of norms-based standards is the UN global compact principles for responsible investment²⁰.

¹⁹ European Fund and Asset Management Association, Market Insights, "Sustainable Investment in the European Asset Management Industry: defining and sizing ESG Strategies", 2020.

²⁰ The 10 principles for responsible investment of the global compact embrace four areas: human rights, labor, environment and anti-corruption.

Figure 3.2 Use of any sustainability-related exclusions in the sustainable fund hubs – as of July 2020

Fund net assets implementing any sustainability-related exclusions as percentage of the country's sustainable assets



Source: Morningstar, own calculations. Coverage is the amount of share classes that have a “employs exclusions” overall attribute in the respective country’s fund universe.

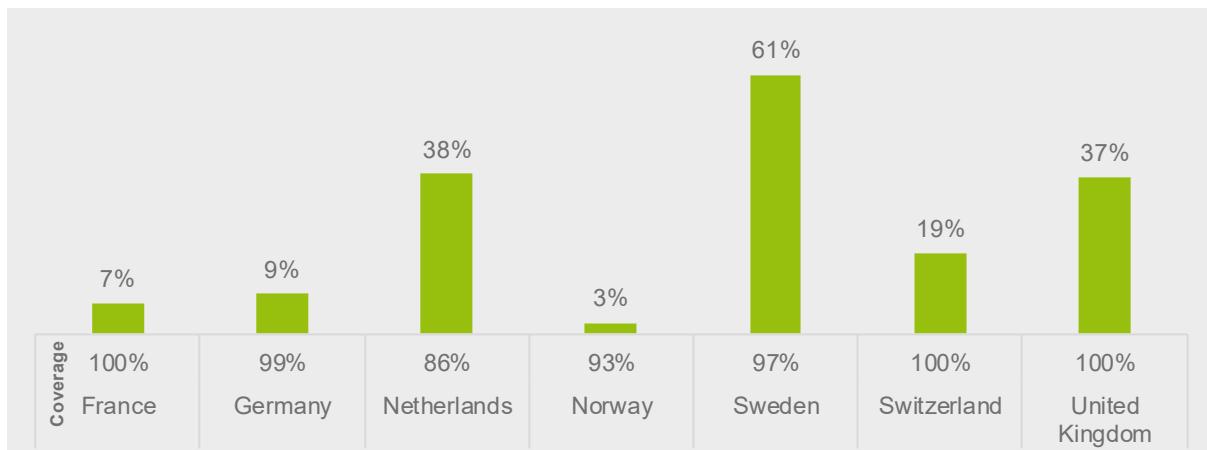
How much of the assets under management in every country of the group of countries that are focus of this analysis is using exclusions is shown in Figure 3.1. Most of the countries are applying exclusions in more than 50% of their funds defined as sustainable. The Scandinavian countries, Sweden and Norway, are taking the lead by applying some type of exclusions in almost all of their funds. These are followed by the Netherlands (86%), the UK (68%) and France (48%). Germany and Switzerland are applying some type of SRI exclusion to a lesser degree (26% and 30%, respectively). However, the coverage of data is low for both countries so this result must be read with caution.

3.4 Impact Investing

Another SRI strategy that has gained big dynamic lately is Impact Investing. It refers to all type of investments that pursue to generate social and environmental impact alongside a financial return. Like ESG engagement, the extent to which the countries in analysis offer impact products is diverse. Compared to other strategies that are widespread in Europe, impact investing exhibits substantial growth potential. Sweden is leading the list of countries offering impact funds, followed by the Netherlands and the UK. Switzerland has also a considerable supply of impact products. France, Germany and Norway are offering impact products to a lower degree (see Figure 3.3).

Figure 3.3 Impact Investing in the sustainable fund hubs – as of July 2020

Fund net assets in Impact Investing as percentage of the country's sustainable assets



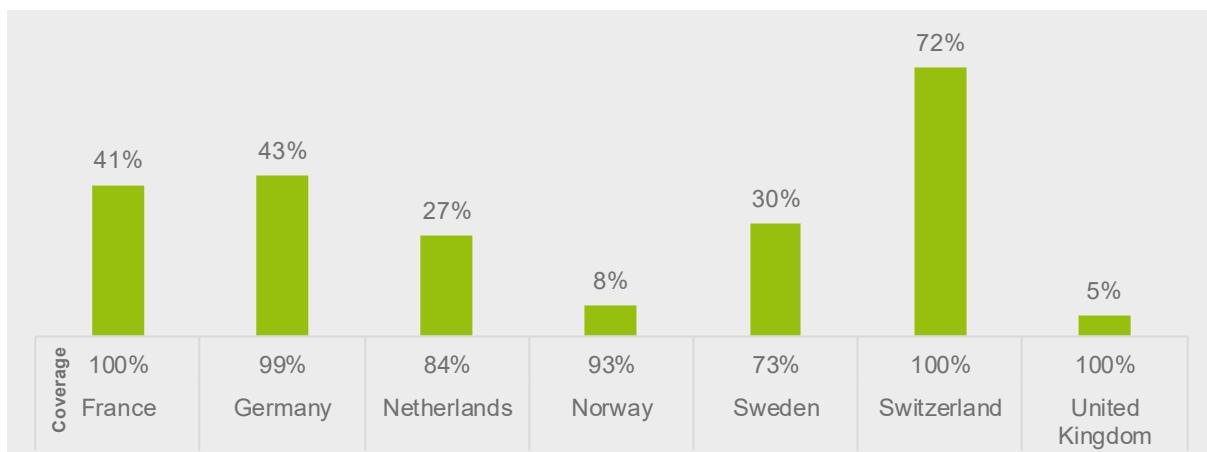
Source: Morningstar, own calculations. Coverage is the amount of share classes that have an Impact Investing attribute in the respective country's fund universe.

3.5 Thematic Investing

The last sustainability approach established in the market is thematic investing. It focuses on specific economic activities that have a potential for sustaining superior long-term growth. When these activities are of a sustainable nature, the theme can be characterized as sustainable – and the approach as sustainable thematic investing. There is no way to identify thematic investing in the dataset of Morningstar as defined above, but there is one definition that is very close to thematic investing and can be used as proxy to identify the funds that fall under the category of thematic investing. This fund attribute is called “environmental sector fund” and includes strategies that invest in environmentally oriented industries, such as renewable energy or water. Applying this attribute to the sustainable funds of the countries in analysis allows to identify Switzerland as the main supplier of environmental funds, followed by Germany, France and the Netherlands (see Figure 3.4). This strategy is less developed in the UK and Norway.

Figure 3.4 Environmental sector funds in the sustainable fund hubs – as of July 2020

Fund net assets investing in environmental sectors as percentage of the country's sustainable assets



Source: Morningstar, own calculations. Coverage is the amount of share classes that have an Environmental sector fund attribute in the respective country's fund universe.

Summarizing the results of this section, ESG strategy funds are currently widespread in the countries of analysis. Norway, Sweden and the Netherlands are leading countries applying any type of sustainability-related type of exclusion in the portfolio construction. Impact Investing is implemented to a lesser degree in all the countries, except for Sweden and the Netherlands – which are the leading countries implementing this more advanced approach of sustainable investing.

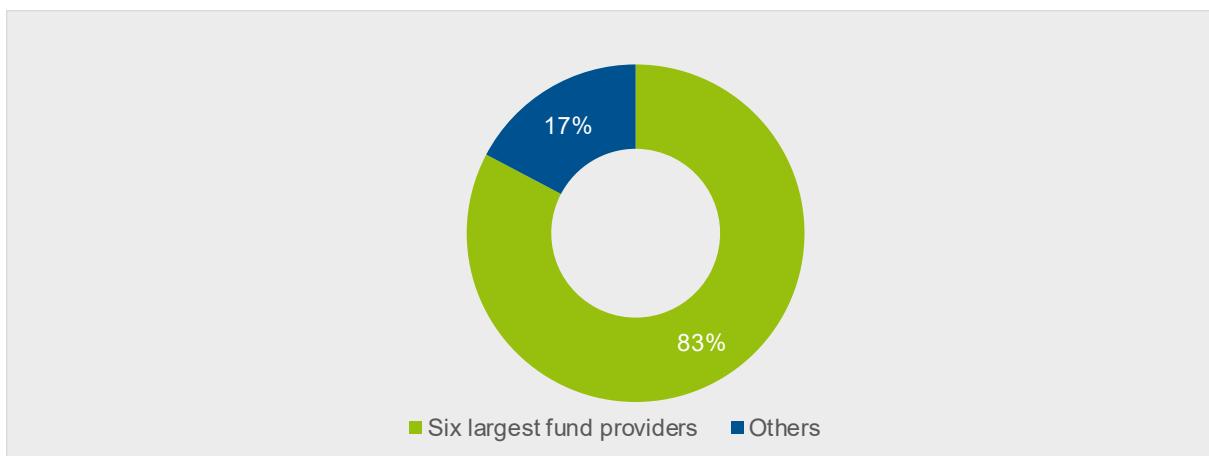
Notice that despite of the heterogeneity of the approaches applied by every country in the group of sustainable fund hubs, their average sustainability performance is in the upper range of the Morningstar Sustainability rating (3.9 of 5, see Table 2.7 in section 2).

4. Challenges and opportunities for the German asset management industry

In section 1 we found that Germany has a big and established sustainability market. In section 2 we have seen that Germany has issued sustainable funds at lower cost than for conventional strategies. Additionally, we showed that the financial performance of German sustainable funds can keep up with that of the most developed markets in sustainability terms. Regarding the sustainability performance of German sustainable funds, we showed that it is above the average of the sustainable fund hubs. In that sense, we see Germany as well positioned in the increasingly competitive market. In section 3 we have seen that asset managers in Germany currently focus on ESG strategy funds (ie., sustainability-related exclusions, best-in-class and other similar approaches).

Due to the size of the German fund market, the asset management industry is capable to implement new strategies, do cross-assets transactions, absorb additional costs (e.g., for ESG data and research). This represents an advantage of the German fund industry. The German SRI market moreover has a strong domestic market characterized by a few market players (see Figure 4.2) that count with stable and secure distribution channels, e.g. through the network of saving and cooperative banks.

Figure 4.1 Market share of main sustainability fund providers in Germany – as of June 2020
Percent of fund net assets



Source: BVI

Current market developments show that the sustainable fund market is the most dynamic business line of asset management in Germany nowadays. It was initially dominated by institutional investors, mainly churches, insurers and pension funds, but this has changed in the last three years. Since 2018, net inflows in the retail market have exceeded the inflows of funds in the institutional segment, so that both segments have equal weight in the complete German sustainable market now (See Figure 4.1). This mirrors, on the one side, the high level of assets under management in the institutional market segment, and, on the other side, the strong growth of the retail segment driven by the EU regulation and the increased investor demand. Another potential factor driving this development is the relative lower cost for sustainable funds, as discussed above. This is also reflected in the high share of retail funds issued in recent years.

**Figure 4.2 Fund net assets (left) and net inflows (right) in the German sustainable fund market
– as of June 2020**

Billions of Euro



Source: BVI²¹

Despite the strong position of the German sustainability market, it is important to raise awareness about the challenge of keeping and expanding market share in the context of the growing market for sustainable funds. The cost differences described in section 2 are a strength, but they will not guarantee the growth of assets under management as the market becomes more competitive. The German asset management industry has to keep up with other countries that have been specializing on sustainable strategies. Whereas the Scandinavian countries and the Netherlands have been implementing sophisticated sustainable investing strategies like Impact Investing to a higher extent, in Germany asset managers primarily use ESG strategy funds (sustainability-related exclusions, best-in-class and other similar approaches). As pointed out in section 3, with the implementation of the Disclosure Regulation and stricter supervision of sustainable funds in order to prevent greenwashing, it will more difficult to justify a broad ESG approach for the classification of a sustainable fund.

To summarize, we see that the German asset management industry is well positioned in this competitive market. However, the conditions for Germany to succeed in this market cannot be taken for granted. In order to defend Germany's presence in the market, fund providers must constantly adapt to the changing regulation framework and market conditions. Only then the success of the German sustainable fund market can be prolonged.

²¹ The BVI statistics include German and foreign open-end and alternative funds (UCITS and AIFs) that are sold in Germany. The funds universe from Morningstar used so far focuses on funds domiciled in the respective countries. The definitions of sustainable funds in the BVI-statistics correspond to the requirements of the BVI Code of Conduct. According to this, funds may only describe themselves as "ecological", "social", "ethical" or similar if their investment policy is set out in the fund documents, in particular in the investment guidelines or the information document.

5. Conclusions

The European asset management industry has embraced the trend of sustainable investing. With the impetus of the 2030 Agenda for Sustainable Development Goals (SDGs) adopted in 2015 and the signing of the Paris climate protection agreement in the same year, the market for sustainable funds has grown and become more diversified in terms of market players. In 2020, the sustainable fund market has shown resilience through the COVID-19 pandemic and has gained more traction, suggesting that there are growth opportunities going forward. For the fund industry, the integration of the sustainability dimension into the investment process represents additional costs. This is because the investment process must be adapted to the new strategies, which incurs additional research costs and requires sustainability dedicated data and new staff. However, sustainability also provides asset managers with the opportunity to offer new products and strategies. Moreover it represents an opportunity for proactive asset managers to differentiate themselves and to succeed against the trend of higher costs as well as the competitive pressure from passive products.

In this context, this study provides an analysis of the current development of the sustainable fund market in Europe with focus on the retail market and traditional assets and, in particular, the competitive position of the German asset management industry. The results of this analysis show that Germany is one of the biggest sustainable fund hubs in Europe together with France, Sweden, the Netherlands, Switzerland, the UK and Norway. Sustainable funds in these countries show cost advantages compared to conventional funds. According to our analysis, the difference in costs can be mainly attributed to the fact that a large proportion of sustainable funds have been issued in recent years, when funds costs were lower than before. For countries like Sweden, economies of scale in the sustainable fund market appear to be another explanation for the difference in costs. Other factors like the asset-mix, institutional share classes, cross-border funds and fund performance do not explain the differences in costs between the two strategies. Notably, we find that the financial as well as the sustainability performance of German sustainable funds is able to keep pace with the most developed sustainability hubs.

In that sense, we see Germany as well positioned in this increasingly competitive market. However, market size and a preferential cost structure are not enough to ensure success in this competitive market. In particular, we see further potential for German asset managers to grow in the area of more sophisticated ESG approaches, such as impact investing. Given the strong domestic market, characterized by market players that rely on stable and secure distribution channels, the foundations have been laid. Now, fund providers must continue to adapt to the changing regulatory framework and market conditions. Only then can the success of the German sustainable fund market be maintained.

6. Annex

Table 6.1 Overview of the main regulations on sustainability-related investments in Europe and the USA

| Country | Name | Issuer | Year | Description |
|---------|---|--------------------------|------|--|
| Austria | Pensionskassengesetz PKG | Government | 1990 | Funds with an ESG strategy must explain how they integrate ESG factors in the investment process |
| Austria | Österreichisches Umweltzeichen (Austrian Ecolabel) | Government | 1991 | Certification of financial products |
| Belgium | The social balance sheet | National Bank of Belgium | 1997 | Companies are subject to file social metrics like breakdown of employees by gender as part of their annual accounts |
| Belgium | Belgium Law on Supplementary Pensions (Vandenbroucke Law) | Government | 2003 | Supplementary pensions should disclose to which extent they integrate environmental, social and ethical factors in investment decisions |
| Denmark | Amendment to the Danish Financial Statements Act | Government | 2008 | Large listed companies should develop Corporate Social Responsibility (CSR) measures and incorporate environmental, social and ethical aspects in their business practices. The same was required afterwards for institutional investors and mutual funds |
| Finland | The Finnish Accounting Act | Government | 2006 | The act requires companies to include material non-financial considerations into their annual accounting files |
| France | Employee saving plans | Government | 2001 | The regulation requires the inclusion of environmental, social and ethical consideration in investment decisions of saving plans and its disclosure |
| France | Law on Public Pension Reserve (LOI 2001-624) | Government | 2001 | The law requires pension funds to report how environmental, social and ethical considerations have been addressed in the fund policy guidelines |
| France | Article 116 of the NRE Act | Government | 2002 | Listed companies should include environmental and social metrics in their annual financial report |
| France | Code de l'environnement - Article L229-26 | Government | 2010 | Companies with more than 500 employees must publish greenhouse gas emissions every three years |
| France | Grenelle Law II (LOI n° 2010-788) Art. 224 and 225 | Government | 2010 | The law requires that mutual funds disclose how they integrate environmental, social and ethical considerations in their investment analysis. Art. 225 requires non listed companies with more than 500 employees to disclose greenhouse gas emissions at least every five years |

| | | | | |
|-------------|---|------------|------|--|
| France | LOI n° 2011-103 du 27 janvier 2011 relative à la représentation équilibrée des femmes et des hommes au sein des conseils d'administration et de surveillance et à l'égalité professionnelle | Government | 2011 | Introduction of 40% board-level gender quotas for publicly listed companies with more than 500 employees |
| France | Décret n° 2015-1615 du 10 décembre 2015 relatif au label "Transition énergétique et écologique pour le climat" | Government | 2015 | The regulation sets out the framework for government-led label for sustainable financial products |
| France | The French Energy Transition Law. Art. 173 | Government | 2015 | The law requires listed companies to disclose how they consider financial risks related to climate change and it requires institutional investors and investment managers to disclose how they consider ESG factors and how their policies align to the national strategy of energy transition |
| France | LOI n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre | Government | 2017 | Requires multinational concerns to take human rights into consideration |
| Germany | Insurance Supervision Act (Section 115) | BaFin | 2002 | Pension funds must issue a statement to its beneficiaries on if and how ESG considerations are considered |
| Germany | Reform Act on Accounting Regulations (BillReg) | | 2004 | The act requires that companies report on financial and non-financial aspects that may affect financial performance |
| Germany | Act on Equal Participation of Men and Women in Leadership Positions in the Private and the Public Sector | Government | 2015 | Introduction of 30% gender quotas for the underrepresented sex for publicly listed companies at the non-executive board level |
| Germany | Remuneration Transparency Act | Government | 2017 | The act enforces transparency regarding remuneration policies of companies with more than 200 employees in order to promote gender equality |
| Greece | Law 3487 | Government | 2003 | The law states that environmental and social aspects should be included in the director's reports |
| Netherlands | The environmental protection Act | Government | 1999 | The act includes a section on environmental reporting for larger polluters in order to provide information to comply with international environmental standards |
| Netherlands | Code of the Dutch Pension Funds | Government | 2014 | The code requires pension funds to define a responsible investment strategy and disclose it publicly |
| Netherlands | Pensioenwet | Government | 2016 | The Act 143 requires pension funds to disclose how environmental, social and governance aspects are taken into account |

| | | | | |
|----------------|---|--------------------|-----------|---|
| Netherlands | The Dutch Corporate Governance Code | Government | 2016 | The Code sets principles of good governance and best practice to be applied by listed companies and large non-listed companies |
| Norway | Government Pension Fund Global Management Mandate | Government | 1990/2004 | The regulation was required to outsource the management of its assets to the Norges Bank which is required to uphold ethical guidance since 2004 |
| Spain | Law of Equality | Government | 2007 | The law requires listed companies to nominate women to 40 percent of all board seats. The government will take compliance into account in the awarding of public contracts |
| Spain | Amendment to the Spanish Company Law of 3 December 31/2014 | Government | 2014 | The amendment requires companies to adhere to the Securities and Exchange Commission a good governance code |
| Sweden | Sweden Accounting Act | Government | 1999 | The act requires companies to report under the Swedish environmental code that accounts the impact of the company on the environment as well as the impact on financial performance of environmental related issues |
| Sweden | Corporate Governance Code | Government | 2016 | The code focuses on the role of the board about relations between shareholders. It requires listed companies to adhere to the code |
| Sweden | New Rules for the AP Fonds | Government | 2017 | This regulation suggest that pension funds should be managed according to responsible investment and stewardship principles without compromising return |
| Sweden | The National Pension Insurance Fund (AP Funds) Act (SFS 2000:192), 2002 | Government | 2000/2002 | The national pension funds system must take environmental and ethical considerations without compromising return |
| Switzerland | Directive on Information related to Corporate Governance | SIX Swiss Exchange | 2018 | This directive requires companies to report corporate governance metrics |
| United Kingdom | Amendments to 1995 Pension's Act | Government | 2000 | This amendment requires pension funds to disclose the extent to which environmental, social and ethical consideration are considered in investment decisions |
| United Kingdom | Climate Change Act | Government | 2008 | The Act ensures that the net UK carbon account for all six Kyoto greenhouse gases for the year 2050 is at least 80% lower than the 1990 baseline |
| United Kingdom | Changes to Companies Act 2006 (Strategic Report and Director's Report) 2013 | Government | 2013 | Mandatory reporting by greenhouse gases, human rights and diversity by all listed companies |
| United Kingdom | Modern Slavery Act | Government | 2015 | The Act requires certain organizations to make a slavery and human traffic statement every year |

| | | | | |
|----------------|--|---|------|--|
| United Kingdom | DC Code of Practice | Government | 2016 | The code requires considerations of material ESG and ethical factors in pension funds investment decisions |
| United Kingdom | The UK Gender Pay Gap Reporting Act | Government | 2016 | The act requires the disclosure of the overall mean and median gender pay gaps across the workforce for companies with more than 250 employees |
| United Kingdom | Clean Growth Strategy (Amendment to Sections 12 and 14 of Climate Change Act 2008) | Government | 2018 | Government strategy to secure economic growth while reducing emissions |
| United Kingdom | The Occupational Pension Schemes (Investment) Regulation | Government | 2018 | The Pension Fund's Statement of Investment Principles must cover ESG aspects and the extent to which the views of all members are considered |
| United Kingdom | The UK Corporate Governance Code | Financial Reporting Council | 2018 | The code sets out standards of good practice in relations between companies, shareholders and stakeholders |
| United States | Securities and Exchange Commission (SEC) Regulation S-K, 17 C.F.R. § 229.101 | Securities and Exchange Commission | 1970 | The SEC requires public companies to disclose the material effects that compliance with environmental laws may have on earnings, capital expense, or competitive positions |
| United States | The Emergency Planning and Community Right-to-Know Act (EPCRA) | Environmental Policy Agency (EPA) | 1986 | The act requires that toxic chemical releases and waste management activities should be disclosed and the EPA to collect this information |
| United States | The Pollution Prevention Act | Environmental Policy Agency (EPA) | 1990 | The act requires industrial facilities to report additional data to the EPA on waste management and source reduction activities |
| United States | National Association of Insurer's Commissioner's' Climate Risk Disclosure Survey | National Association of Insurer commissioners | 2010 | The survey includes eight questions that assess insurers' strategy and risk management towards emissions and carbon footprint. As of 2014, governments in six states require insurance companies with more than 100 USD Million to complete the survey |
| United States | The Mandatory Reporting of Greenhouse Gases rule | Environmental Policy Agency (EPA) | 2010 | The rule requires large emitters of greenhouse gases to collect and report data with respect to their greenhouse gas emissions |
| United States | US SEC Climate Guidance | Securities and Exchange Commission | 2010 | The SEC requires listed companies to disclose financial material risk including those related to climate change |
| United States | CA Senate Bill 185 | California Government | 2015 | The bill prohibits state pension funds from new investments or renewal of investments in thermal coal activities |
| United States | Interpretive Bulletin 2015-01 | Department of Labor | 2015 | The bulletin clarifies that ESG factors can be part of a prudent decision-making process |

6.1 Dataset

6.1.1 Funds analyzed

For this study, two different universes of funds from the Morningstar database were analyzed: European sustainable and European conventional. Each set of data excludes money market funds, fund of funds and feeder funds. They also exclude alternative assets and focus on equity, fixed income and balanced funds. The European sustainable fund universe accounts for 2.781 funds domiciled in Europe of which 60 funds have no data on assets under management and 259 funds are obsolete. The European conventional fund universe accounts for 3.428 funds domiciled in Europe of which 532 funds have no data on assets under management and 197 funds are obsolete. The small amount of funds for which there is no data on assets under management have not been considered. For purposes of counting the amount of assets, obsolete funds have been excluded in order not to inflate the amount of assets in countries where the success rate is mixed. A large amount of funds in Europe are domiciled in Luxembourg and Ireland, but these are often funds managed by subsidiaries of asset manager firms that are located somewhere else in Europe or, indeed, outside Europe. The funds domiciled in these two countries have been allocated to the country of the corresponding headquarter of the subsidiary. This allows a much clearer picture of the provenience of sustainable funds. In order to make the reallocation of assets from Luxembourg and Ireland, the name of the asset management company that issued the fund was identified in order to calculate the share of assets under management of that specific country in the total of assets under management from Luxembourg or Ireland. At the end, this share of assets was added to the total sum of assets under management of the specific country.

6.1.2 Definitions for sustainable funds

The definitions on sustainable funds in this paper are based on fund data from Morningstar. At the time when this paper was written, the EU action plan for sustainable finance had not been completed. However, the essential regulations that define sustainable investments had already been drawn and will be applicable in the short term. The alignment of the Morningstar attributes to the EU action plan has been unfolding since 2019. Currently, Morningstar considers funds as sustainable products for which ESG strategies, such as best-in-class screening, are central to their overall investment strategy, as well as Impact and Environmental Sector funds. This implies that funds where ESG factors are just one of many inputs used in the investment process as well as corporate engagement on ESG issues alone do not constitute a sustainable fund. The classification results from the analysis of the fund prospectus. Section 3 applies the general Morningstar “sustainable fund” definition described above and, in addition to that, it applies the definitions of ESG strategy funds (“ESG funds” in the Morningstar terminology), “Impact funds”, “environmental sector fund” and a subset of the group of attributes in the category of “employs exclusions” (see Tables 6.2 and 6.3). ESG funds are defined as funds that use ESG criteria as a central part or binding factors of their security-selection and portfolio-construction process. Impact funds use strategies that seek to make a measurable impact alongside financial return. Impact funds are often focused on specific themes or use the 17 U.N. Sustainable Development Goals as a framework for evaluating the overall impact of the portfolio. Environmental sector funds refer to funds that use strategies that invest in environmentally oriented industries, such as renewable energy or water. The “employs exclusion” attribute assigns a flag to a fund that employs any kind of exclusion, which means that some issuer, sector or practice according to a predefined set of values is filtered out from the portfolio. The list of exclusions is large, for example, general ethical values or norms like child work, gender issues, environmental destruction, corruption, etc. or the involvement in the production or sale of tobacco, alcohol, controversial weapons, thermal coal, nuclear energy or gambling are just a few examples. The most common set of sustainable investing screens are norms-based, controversial weapons, thermal coal, tobacco and nuclear energy and these were used for the purposes of this study. There is a lot controversy regarding the data coverage and the quality of data regarding sustainability issues. Therefore, in all figures of section 3, the data coverage of the respective sustainable investing metric as the percentage of funds of the total of funds in category, for which the metric is available. This should not only give an idea on what is the current situation regarding ESG data coverage, but also a sense of confidence on the assertions outlined from the data.

Table 6.2 Morningstar sustainable investment framework

| Sustainable Investment | | | |
|------------------------|-------------------|-----------------------------|------------------------------|
| Level 1 | ESG Fund | Impact Fund | Environmental Sector Fund |
| Level 2 | ESG Incorporation | Gender & Diversity | Renewable Energy |
| Level 3 | ESG Engagement | Low Carbon/Fossil-Full Free | Water-Focused |
| | | Community Development | General Environmental Sector |
| | | Environmental | |
| | | Other Impact Themes | |

Source: Morningstar

Table 6.3 Morningstar “employs exclusions” framework

| Employs Exclusions | | | |
|--------------------|-----------------------|--------------------------|--------------|
| Level 1 | Norms-Based Screening | Fur & Speciality Leather | Pesticides |
| Level 2 | Abortion/Stem Cells | Gambling | Small Arms |
| | Adult Entertainment | GMOs | Thermal Coal |
| | Alcohol | Military Contracting | Tobacco |
| | Animal Testing | Nuclear | Other |
| | Controversial Weapons | Palm Oil | |

Source: Morningstar

6.1.3 Data on cost and charges used

For the cost analysis the Key Investment Information Document (KIID) ongoing charges have been used. In 2009, the UCITS IV required the disclosure of an Ongoing Charge Figure (OCF) in the KIID, representing all annual charges and other payments taken from the assets of the UCITS over the defined period, based on the figures from the preceding year. This figure does not include fixed costs like administrator fees, depository fees, audit fees, transfer agent fees, legal fees and regulatory fees. It does not include performance fees either. The section focuses on the European universe of sustainable and conventional funds. The coverage of the metric KIID ongoing charges in the conventional fund universe is 94%. The coverage of the metric KIID ongoing charges is 96% in the sustainable fund universe. All figures correspond to the most recent available. Funds that had no data on assets under management were excluded from both universes, sustainable and conventional, as well as funds that left the market under the same period in order to keep consistence with the first section in which the sustainable fund hubs were determined.

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