Morgan Stanley

INSTITUTE FOR SUSTAINABLE INVESTING

Sustainable Reality:

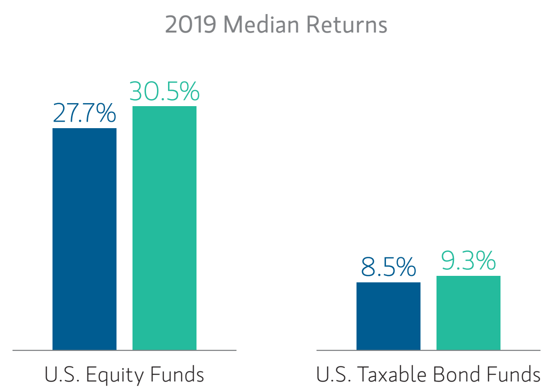
2020 Update

Sustainable investing is proving a rewarding opportunity for investors during times of both market expansion and severe volatility. During the prolonged 2019 boom, sustainable equity and taxable bond funds outperformed their traditional peers. And they continued to do so during the first half of 2020, weathering the unprecedented global shock triggered by the COVID-19 pandemic better than traditional funds. These findings by the Morgan Stanley Institute for Sustainable Investing draw on analysis of more than 11,000 mutual and exchange traded U.S.-domiciled funds. They provide further evidence that funds incorporating environmental, social and governance (ESG) criteria can potentially provide financial returns in-line, if not better than traditional funds, and with less downside risk.

Key Findings

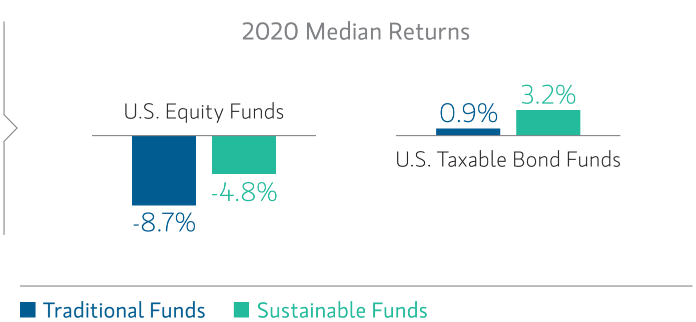
IN 2019:

- U.S.-based sustainable equity funds outperformed their traditional peers by a median of 2.8%.
- U.S.-based sustainable taxable bond funds outperformed their traditional peers by a median of 0.8%.



IN JANUARY–JUNE 2020:

- U.S.-based sustainable equity funds outperformed their traditional peers by a median of 3.9%.
- U.S.-based sustainable taxable bond funds outperformed their traditional peers by a median of 2.3%.



Context

Sustainable investing is now firmly in the mainstream. Half of U.S. individual investors are adoptees and 80% of asset owner institutions are integrating sustainability considerations into their investment process, according to Sustainable Signals surveys conducted by the Morgan Stanley Institute of Sustainable Investing. Factors driving adoption include a growing belief that backing firms with strong sustainability practices may be a better long-term investment than traditional funds.

This update provides further evidence that sustainable funds can indeed outperform traditional funds—as well as reduce investment risk. It builds on our 2019 Sustainable Reality report (see Methodology), which found that in any given year, sustainable funds performed in line with traditional counterparts but provided more downside protection, especially in times of volatility. Our latest findings should further dispel lingering concerns among some investors that sustainable investing requires a financial trade-off.

Methodology

This update builds on our 2019 report, "Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds", which assessed these funds' historical performance against traditional funds from 2004–2018 using Morningstar data. Institute analysts applied the same methodology to evaluate the performance of U.S.-domiciled sustainable funds investing in U.S. equities and taxable bonds active in 2019 against their traditional peers. We then examined the performance of the same asset classes in the first half of 2020 when the coronavirus pandemic induced significant volatility in the capital markets.

This year, we used the new indicator variable in Morningstar "Sustainable Funds" which aims to more explicitly capture funds with a sustainable investing intent. We deployed sensitivity testing to check against the variable, "ESG Focus", used for our 2019 report and found the same pattern of results for 2019 and 2020.

Detailed information on this methodology is available from sustainability@morganstanley.com.

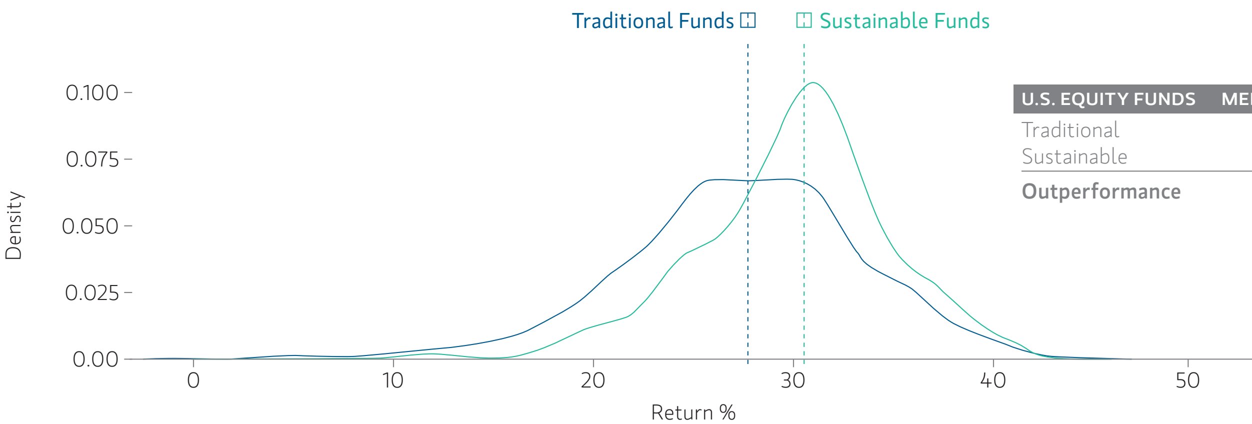
Performance in 2019: Delivering Higher Return for Investors

Our 2019 analysis of U.S.-domiciled mutual funds and exchange traded funds found that both the median sustainable equity fund and the median sustainable bond fund outperformed their traditional counterparts.

In 2019, there were 1,162 traditional and 160 sustainable U.S.-domiciled mutual funds and exchange traded funds (ETFs) investing in U.S. equities with a full year of financial return data. During the year, the median sustainable equity fund returned 30.5%, while the median traditional fund returned 27.7%. The 2.8% difference between these medians, shown in Figure 1, was statistically significant at the 99% level.

Distribution of Total Returns from U.S. Equity Funds in 2019

FIGURE 1

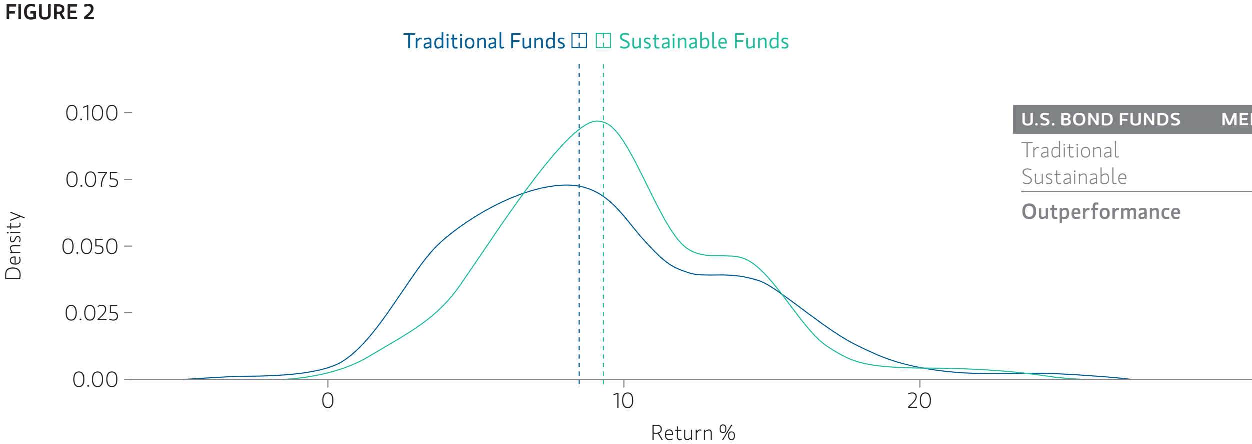


U.S. EQUITY FUNDS	MEDIAN RETURN
Traditional	27.7%
Sustainable	30.5%
Outperformance	**2.8%*** **

In 2019, there were 793 traditional and 91 sustainable U.S.-domiciled mutual funds and ETFs investing in U.S. taxable bonds with a full year of financial return data. During the year, the median sustainable bond fund returned 9.3%, while the median traditional fund returned 8.5%. The 0.8% difference between these medians, shown in Figure 2, was statistically significant at the 90% level.

Distribution of Total Returns from U.S. Taxable Bond Funds in 2019

FIGURE 2



U.S. BOND FUNDS	MEDIAN RETURN
Traditional	8.5%
Sustainable	9.3%
Outperformance	**0.8%***

Statistical Significance: 99%+ *** 95%+ ** 90%+ *

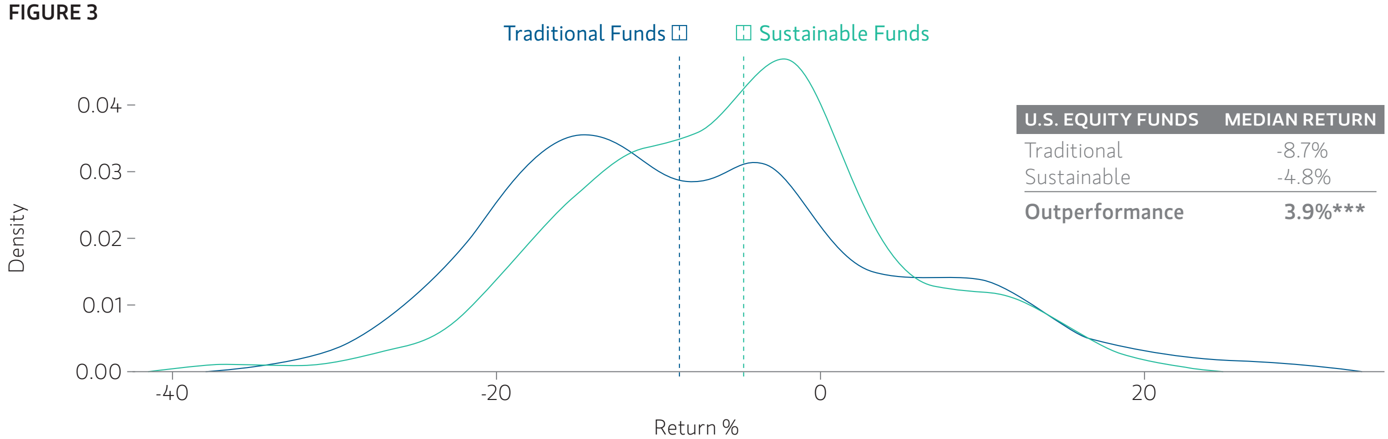
Performance in 2020: Reducing Risk for Investors

In the first half of 2020, the COVID-19 pandemic induced a global recession, causing capital markets around the world to experience the sharpest shock in their history, followed by months of severe volatility. Our analysis of U.S. equity and bond funds found that sustainable funds weathered this difficult period better than their traditional counterparts.

There were 2,401 traditional and 140 sustainable U.S.-domiciled mutual funds and exchange traded funds (ETFs) investing in U.S. equities in the first half of 2020. The median sustainable equity fund lost 4.8% in January–June 2020, while the median traditional equity fund lost 8.7%. The 3.9% difference between these medians shown in Figure 3 was statistically significant at the 99% level. This outcome is consistent with our 2019 findings on the relative performance of sustainable and traditional funds during periods of increased market uncertainty from 2004–2018.

Distribution of Total Returns from U.S. Equity Funds in H1 2020

FIGURE 3

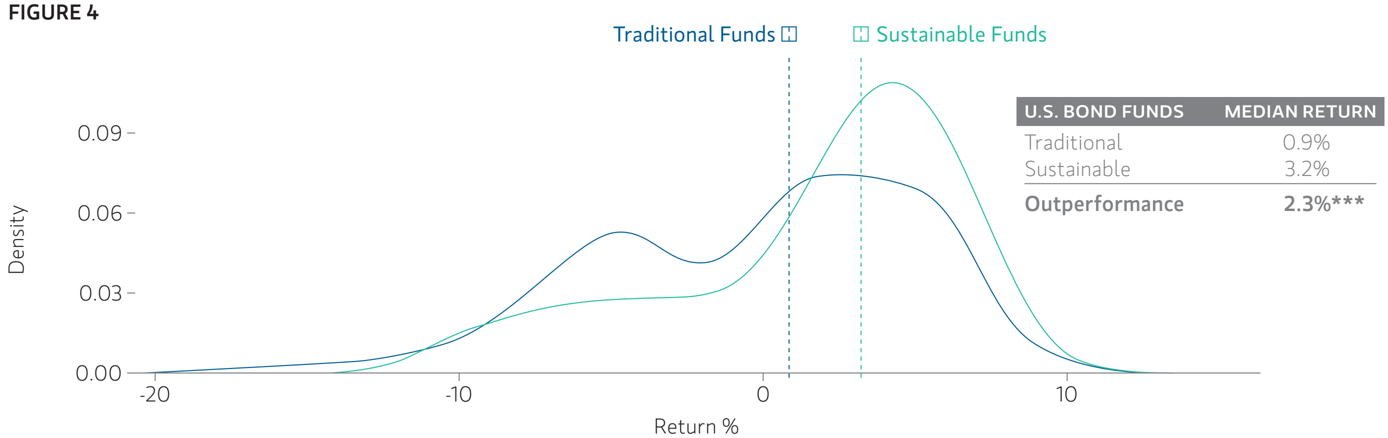


U.S. EQUITY FUNDS	MEDIAN RETURN
Traditional	-8.7%
Sustainable	-4.8%
Outperformance	**3.9%*** **

In January–July 2020, there were 1766 traditional and 67 sustainable U. S.-domiciled mutual funds and ETFs investing in U.S. taxable bonds. Our analysis revealed that during this period, the median U.S. sustainable bond fund gained 3.2%, while the median traditional fund gained 0.9%. Our new analysis also revealed that the median U.S. sustainable bond fund gained 3.2% in January–June 2020, while the median traditional fund gained 0.9%. The 2.3% difference between these medians shown in Figure 4 was statistically significant at the 99% level.

Distribution of Total Returns from U.S. Taxable Bond Funds in H1 2020

FIGURE 4



U.S. BOND FUNDS	MEDIAN RETURN
Traditional	0.9%
Sustainable	3.2%
Outperformance	**2.3%*** **

Statistical Significance: 99%+ *** 95%+ ** 90%+ *

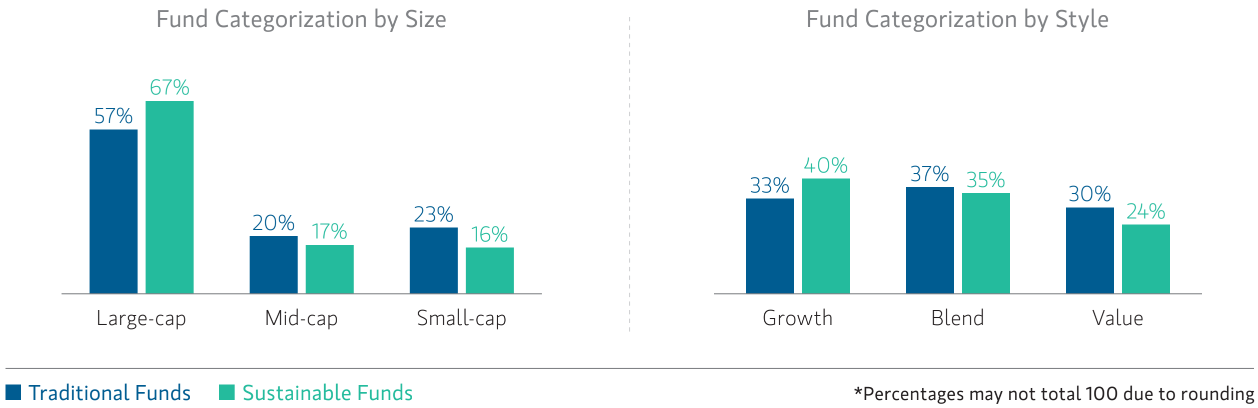
Driving Outperformance: How Sustainable Funds Differed from Traditional Funds in 2019

What explains the higher performance of ESG-focused investments in 2019? Seeking to answer this question, the Morgan Stanley Institute for Sustainable Investing explored both sustainability-related differences and additional factors driving fund manager decision making and financial performance. We found that in 2019, sustainable equity funds on average held larger stocks and growth stocks, with better ESG performance and lower exposure to carbon risk. Together, these investment choices may help explain the performance gap.

Our analysis of the Morningstar categorization of U.S. sustainable and traditional equity funds and ETFs found that sustainable U.S. equity funds tended to prefer larger stocks and growth stocks (see Figure 5).

Categorization of U.S. Equity Funds by Size and Style of Holdings*

FIGURE 5

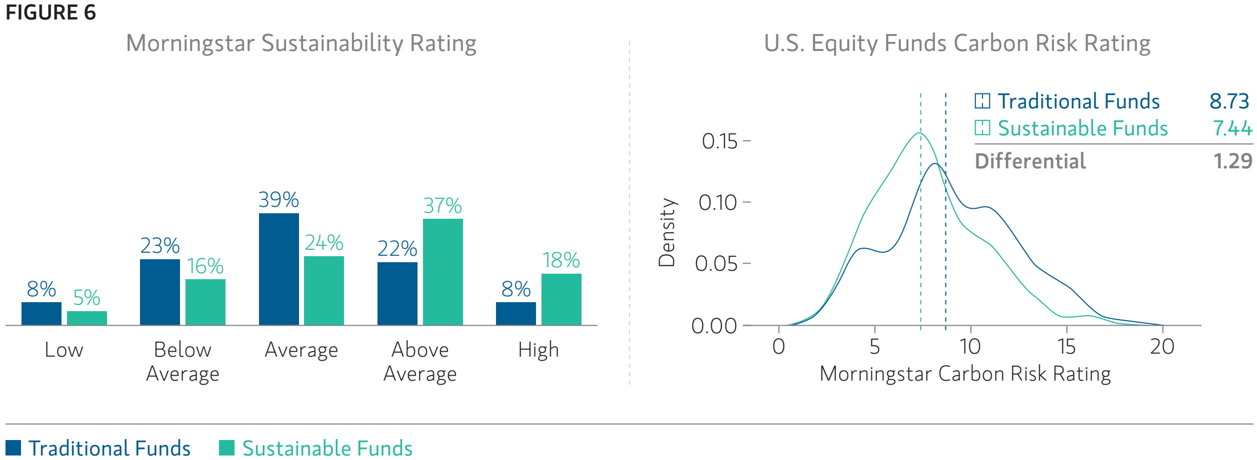


*Percentages may not total 100 due to rounding

To explore the difference in sustainability performance, we examined Morningstar's Portfolio Sustainability Rating, a metric derived from underlying Sustainalytics ratings of issuers of securities held by the fund. Based on this metric, the median sustainable fund rated Above Average, while the median traditional fund rated Average. This implies that—as expected—the underlying holdings of sustainable funds tend to perform better on environmental, social and governance metrics. Sustainable funds also had a lower carbon risk rating than traditional funds, reflecting lower exposure to more carbon intense issuers.

Distribution of Sustainability Ratings and Carbon Risk Ratings of U.S. Equity Funds

FIGURE 6



Conclusion

The last 18 months have seen both tremendous expansion and unprecedented challenges in the capital markets. Sustainable investments have continued to perform well in both environments, reinforcing the value of sustainable investing and further dispelling the myth that investors seeking to "do well by doing good" face a financial trade-off. Against a backdrop of surging interest in and adoption of sustainable investing among asset owner institutions, individual investors and asset managers, the Institute for Sustainable Investing will continue to monitor the performance of sustainable and traditional funds and report on this rapidly evolving field.

See the Institute for Sustainable Investing for our groundbreaking analysis and survey results related to sustainable investing.

Notes

1 "Sustainable Signals: Individual Investors Driven by Impact, Conviction and Choice," Morgan Stanley, 2019 (https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf; accessed on 07/14/2020).

2 "Sustainable Signals: Asset Owners See Sustainability as Core to the Future of Investing," Morgan Stanley, 2020 (https://www.morganstanley.com/content/dam/msdotcom/sustainability/20-05-22_3094389%20Sustainable%20Signals%20Asset%20Owners_FINAL.pdf; accessed on 07/14/2020).

Disclosures

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The returns on a portfolio consisting primarily of Environmental, Social and Governance ("ESG") aware investments may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria.

Diversification does not guarantee a profit or protect against loss in a declining financial market.

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An investment in an exchange-traded fund involves risks similar to those of investing in a broadly based portfolio of equity securities traded on exchange in the relevant securities market, such as market fluctuations caused by such factors as economic and political developments, changes in interest rates and perceived trends in stock prices. The investment return and principal value of ETF investments will fluctuate, so that an investor's ETF shares, if or when sold, may be worth more or less than the original cost.

Investors should carefully consider the investment objectives and risks as well as charges and expenses of a mutual fund/exchange-traded fund before investing. To obtain a prospectus, contact your Financial Advisor or visit the fund company's website. The prospectus contains this and other information about the mutual fund/exchange-traded fund. Read the prospectus carefully before investing.

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Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Debt instruments issued by U.S. corporate and municipal issuers that provide a return in the form of fixed periodic payments and eventual return of principal at maturity. Fixed income investments are advantageous in a time of low inflation, but do not protect investors in a time of rising inflation. Interest income on government securities is subject to federal income taxes, but exempt from taxes at the state and local level.

Bond funds and bond holdings have the same interest rate, inflation and credit risks that are associated with the underlying bonds owned by the funds. The return of principal in bond funds, and in funds with significant bond holdings, is not guaranteed.

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