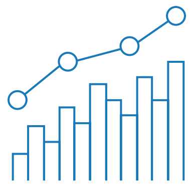
Morgan Stanley

INSTITUTE FOR SUSTAINABLE INVESTING

Sustainable Reality

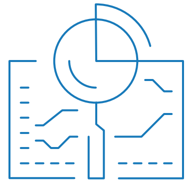
Sustainable Funds Underperformed in H2 2024, But Flows Regained Some Ground

Key Takeaways for H2 2024



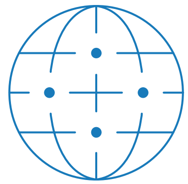
1 AUM in Sustainable Funds Rose to $3.56 Trillion

Sustainable fund assets under management (AUM) globally reached a new high of $3.56 trillion, up +4.8% from December 2023 and +0.9% from June 2024. However, this is only 6.8% of total AUM, down from 7.3% at December 2023, as Traditional funds had stronger net inflows.



2 Flows Regained Some Ground

Second half inflows to Sustainable funds, at $30.6 billion, regained some ground after a weak Q2. However, full year inflows of $54.7 billion (1.6% of prior year-end AUM) were still only half of 2022 and 2023 levels.



3 Sustainable Funds Underperformed

Sustainable funds generated median returns of +0.4% for H2 2024, according to Morningstar data, compared to Traditional funds at +1.7%. This underperformance was partly driven by Sustainable funds' greater exposure to global and Europe investment areas, which saw weaker returns than Americas and APAC, but Sustainable funds also underperformed within geographies and across asset classes. Sustainable funds outperformed in H1 2024, but this was more than offset in the second half, leaving median returns at +0.8% for FY 2024, compared to Traditional funds at +1.5%.

About the Sustainable Reality Series

TRACKING AUM, FLOWS AND PERFORMANCE FOR SUSTAINABLE FUNDS

Sustainable Reality is a long running series from the Morgan Stanley Institute for Institute for Sustainable Investing. It uses Morningstar data to track AUM, flows and performance for Sustainable funds in comparison to Traditional funds across a universe of 99,000 global funds.

TERMINOLOGY

"Sustainable" and "Traditional" use Morningstar's definitions.

MEDIAN RETURNS

We refer to median returns, both because of the very wide range of potential outcomes common for investment funds, but also to reflect the likelihood of an individual investor selecting a fund that achieves the return.

METHODOLOGY

For the full methodology, see page 20.

CONTACT US

For any questions related to the report, please reach out to the Institute for Sustainable Investing team at **globalsustainability@morganstanley.com.**

To get insights like this report delivered to your inbox, subscribe to the Institute for Sustainable Investing's newsletter.

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AUM in Sustainable Funds Rose to $3.56 Trillion

THIS REPRESENTS 6.8% OF TOTAL AUM, DOWN FROM A HIGH OF 7.4% AT JUNE 2023

At December 2024, Sustainable funds' AUM reached a new absolute high of $3.56 trillion (+4.8% YoY and +0.9% from June 2024). The decline as a proportion of total AUM reflects stronger net inflows into the Traditional fund universe.

Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025.

Sustainable Flows Regained Some Ground Following Weak Q2

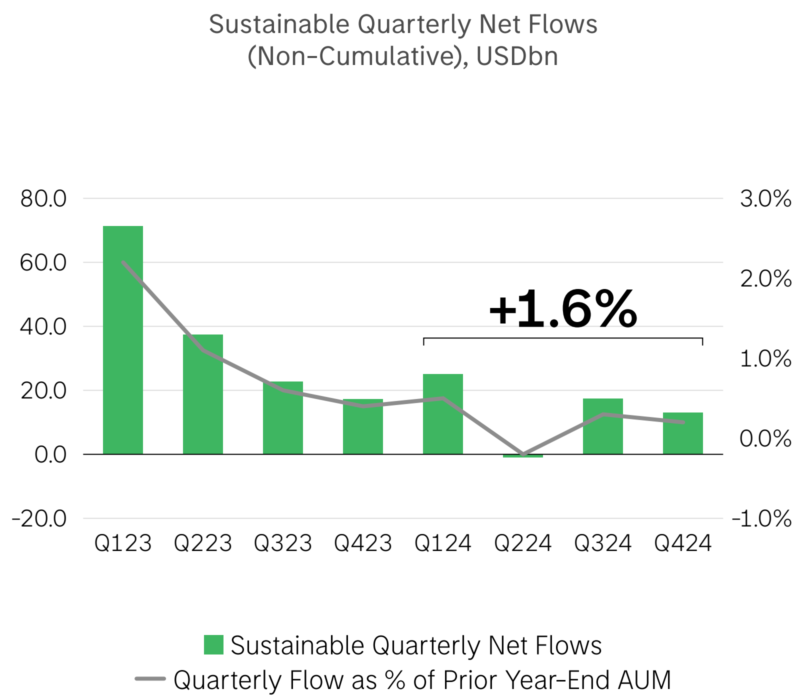
TRADITIONAL FUNDS CONTINUED TO SEE STRONGER INFLOWS THAN SUSTAINABLE FUNDS

Overall, Sustainable funds saw inflows of $30.6 billion during H2 2024. For the full year, Sustainable fund inflows were $54.7 billion, or +1.6% of prior year-end AUM. This includes slightly negative flows (-$1 billion) during the second quarter of 2024.

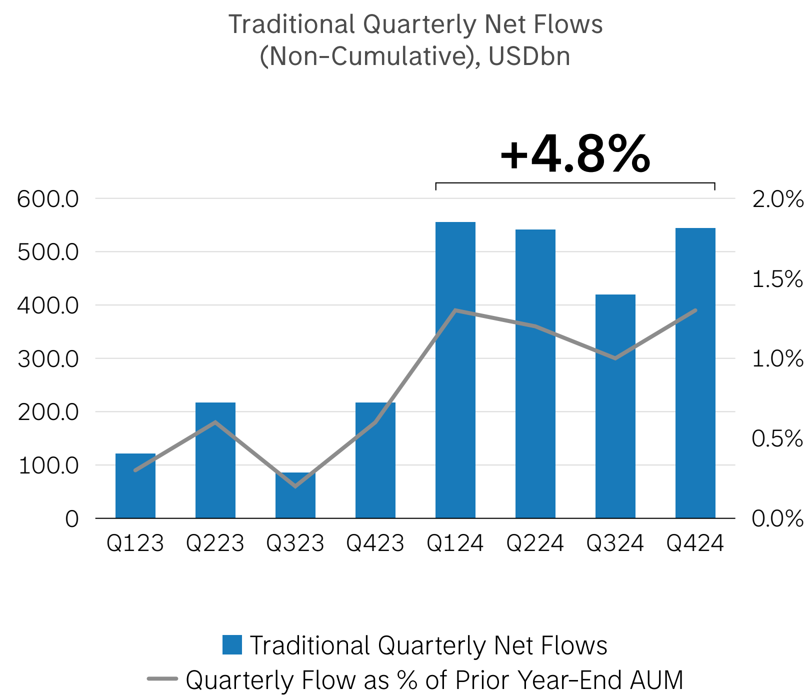
Inflows into Sustainable funds were notably lower than in recent years, with 2022 and 2023 full-year inflows both over $100 billion.

In a reversal from prior year trends, Traditional fund flows outpaced Sustainable peers, with inflows at +4.8% of prior year-end AUM during full year 2024.

Sustainable flows return to positive in Q3 and Q4



Traditional funds saw stronger trends for all of 2024



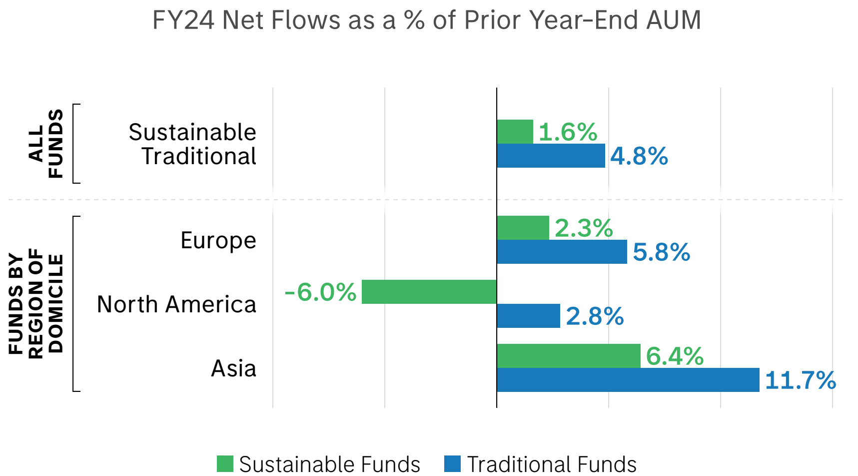
Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025.

Analyzing Flows by Fund Domicile

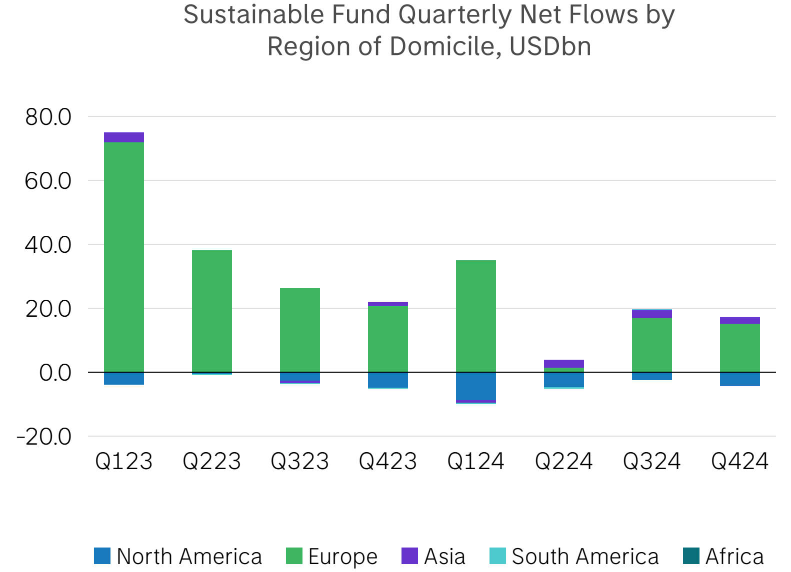
NORTH AMERICA-DOMICILED FUNDS CONTINUED TO SEE OUTFLOWS

- On an absolute basis, Europe-domiciled Sustainable funds dominated, with inflows of $32.3 billion for H2 2024 compared to $4.5 billion for Asia and outflows of $6.3 billion for North America.
- Sustainable funds domiciled in North America have reported outflows every quarter since Q4 2022, marking nine straight quarters of outflows.
- Relative to prior year end AUM, Asia saw the strongest inflows for FY 2024, at +6.4%, ahead of Europe at +2.3% and North America at -6.0%.

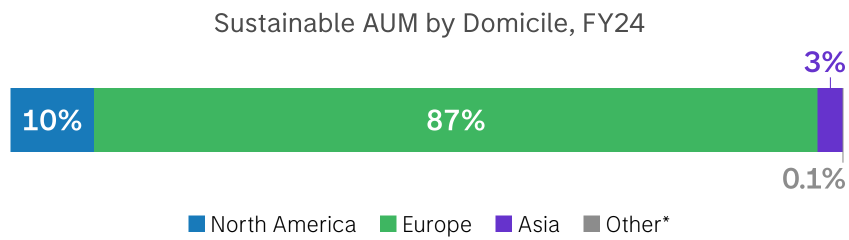
Asia inflows were strongest relative to AUM



Europe-domiciled flows dominated in absolute terms



87% of AUM in Sustainable funds is Europe-domiciled



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025.
*Other includes South America and Africa, which account for 0.08%/0.01% of AUM respectively. Note that a fund can be domiciled in one region but invest globally or in another regions. Investment area refers to the latter.

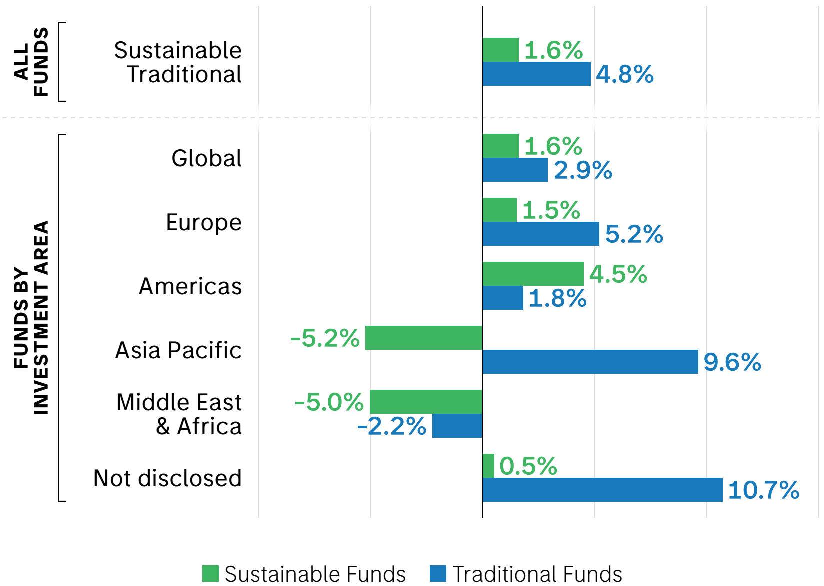
Analyzing Flows by Fund Investment Area

FUNDS INVESTING IN THE AMERICAS SAW THE STRONGEST INFLOWS IN H2 2024

- Funds investing in the Americas had the strongest flows in absolute terms in H2 2024, at $14.5 billion, followed by global funds at $7.3 billion and Europe funds at $5.8 billion.
- Americas was also the strongest region relative to AUM, with inflows of +4.5% for FY 2024, followed by global funds at +1.6% and Europe funds at +1.5%.

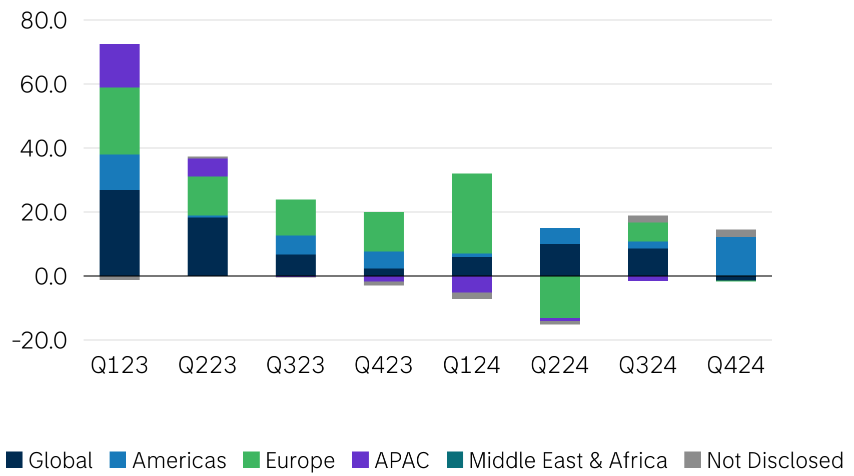
Relative to AUM, Americas saw the strongest inflows

FY24 Net Flows as a % of Prior Year-End AUM



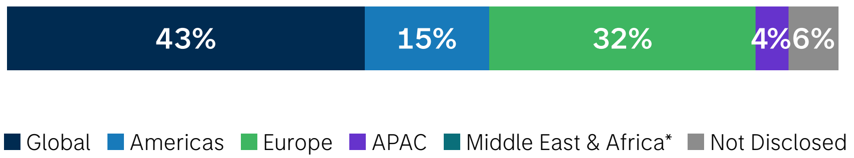
Flows to funds investing in the Americas picked up in Q4

Sustainable Fund Quarterly Net Flows by Investment Area, USDbn



75% of Sustainable funds invest globally or in Europe

Sustainable AUM by Investment Area, FY24



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025.
*Middle East and Africa accounts for 0.002% of AUM. Note that a fund can be domiciled in one region but invest globally or in another regions. Investment area refers to the latter.

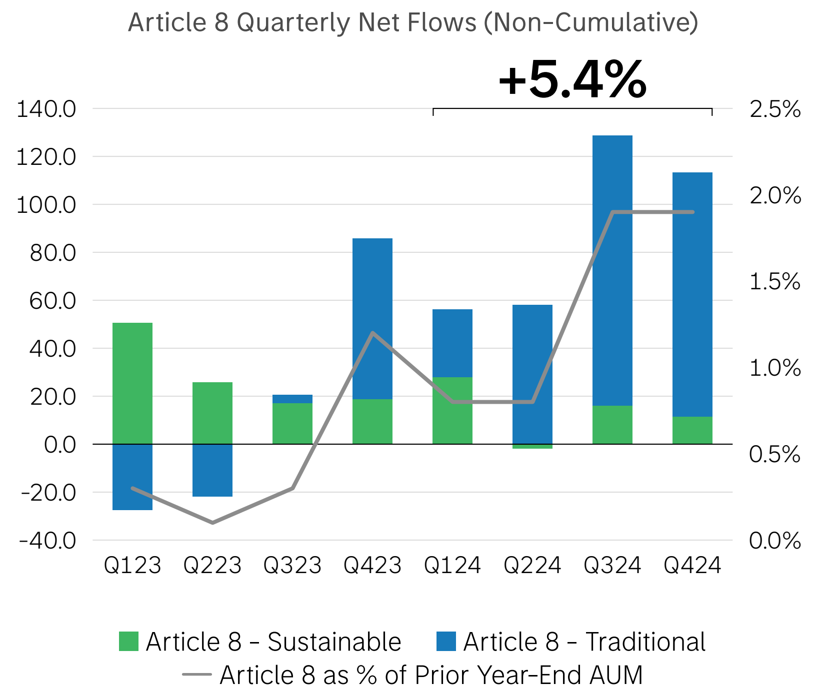
Flows to Article 8 and Article 9 Funds

POSITIVE FLOWS TO ARTICLE 8 FUNDS, OUTFLOWS IN ARTICLE 9 FUNDS

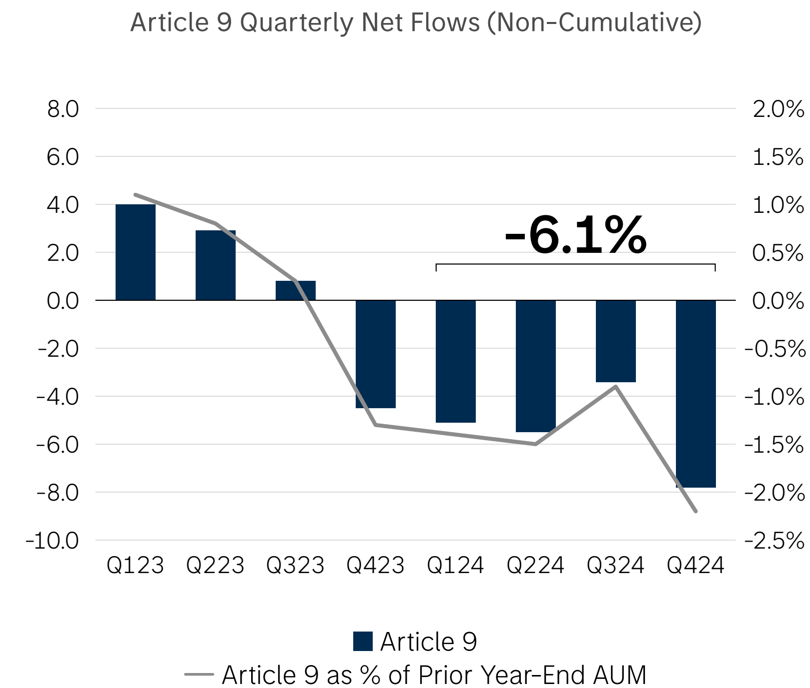
During H2 2024, Article 8 funds saw inflows of $277 billion, taking FY 2024 flows to $389 billion or +5.4% of prior year-end AUM. This was mostly driven by Article 8 funds classified as Traditional by Morningstar, while Article 8 funds classified as Sustainable saw small inflows throughout the year.

Article 9 funds saw outflows of $11 billion in H2 2024, and $22 billion for the full year (-6.1% of prior year-end AUM). Q4 2024 was the weakest quarter, with an outflow of $8 billion, marking five straight quarters of outflows for Article 9 funds.

Article 8 Fund Flows



Article 9 Fund Flows



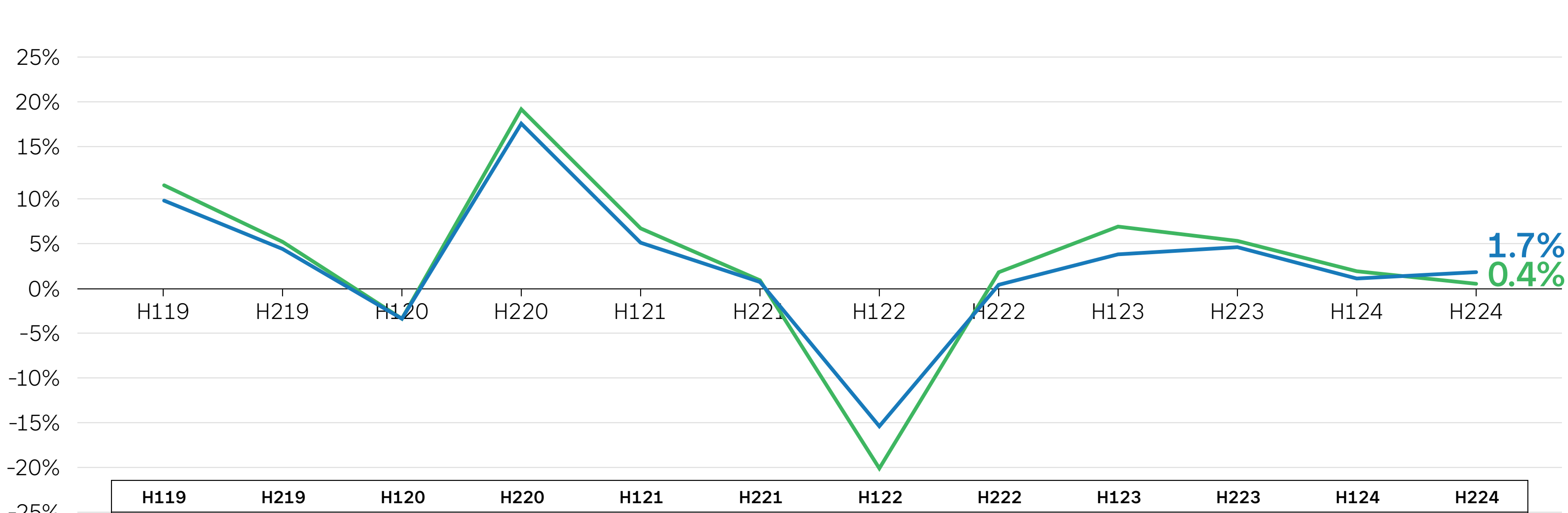
Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025. According to the EU Sustainable Finance Disclosure Regulation's classification system, a fund will be classified as Article 8 if it promotes environmental or social characteristics. If it has sustainable investment as its primary objective, it will be classified as Article 9.

Sustainable Funds Underperformed Traditional Peers

MEDIAN RETURN WAS +0.4% IN H2 2024, VS. +1.7% FOR TRADITIONAL FUNDS

H2 2024 was the first period of underperformance for Sustainable funds since H1 2022. Geographic differences played a role, as Sustainable funds over-index to Global and Europe investment regions, which had the weakest returns. However, Sustainable funds also underperformed within regions, and across all asset classes.

The median return for Sustainable funds modestly underperformed that of Traditional peers in H2 24



H119	H219	H120	H220	H121	H221	H122	H222	H123	H223	H124	H224
11.4%	5.2%	-3.9%	20.0%	6.7%	0.9%	-20.1%	1.8%	6.9%	5.3%	1.8%	0.4%
9.8%	4.4%	-3.5%	18.4%	5.1%	0.6%	-15.4%	0.4%	3.8%	4.6%	1.1%	1.7%
155 bps	76 bps	-37 bps	155 bps	156 bps	34 bps	-471 bps	145 bps	311 bps	67 bps	69 bps	-126 bps

Sustainable Funds ■ Traditional Funds ■ Difference Between Sustainable Funds and Traditional Funds (bps)

Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025. Table shows data in basis points (bps), 10bps = 0.1%.

Sustainable Funds Underperformed in Most Investment Regions

GREATER EXPOSURE TO GLOBAL/EUROPE INVESTMENT AREAS FURTHER EXACERBATED UNDERPERFORMANCE

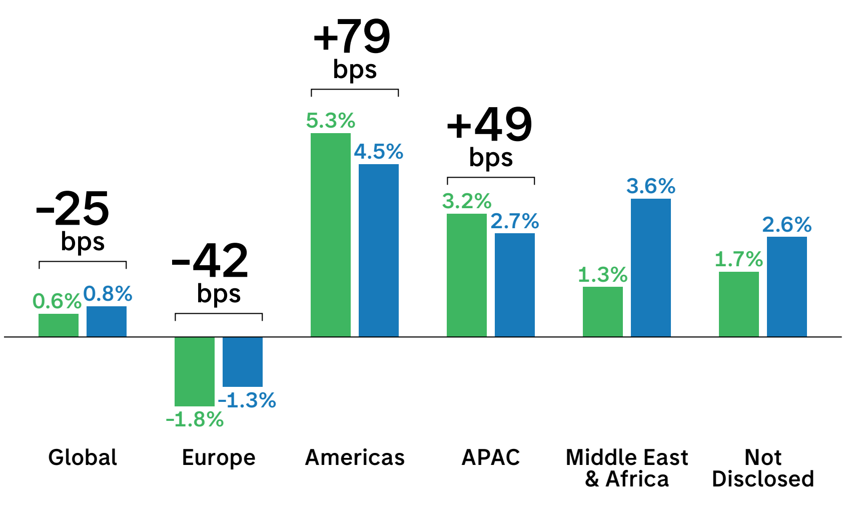
With median returns of +0.6% and -1.8% respectively, Sustainable funds investing globally and in Europe underperformed their Traditional peers by 25bps and 42bps in H2 2024. Sustainable funds outperformed Traditional funds in Americas by 79bps and in APAC by 49bps.

Global and Europe investment areas saw the weakest returns for both Sustainable and Traditional funds. Sustainable funds over-index to these regions, meaning that geographical differences exacerbated the relative underperformance.

This regional skew is not new, but H2 2024 saw both Americas and APAC investment regions outperform global and Europe investment areas, unlike in prior periods where weak returns in APAC offset stronger returns in Americas.

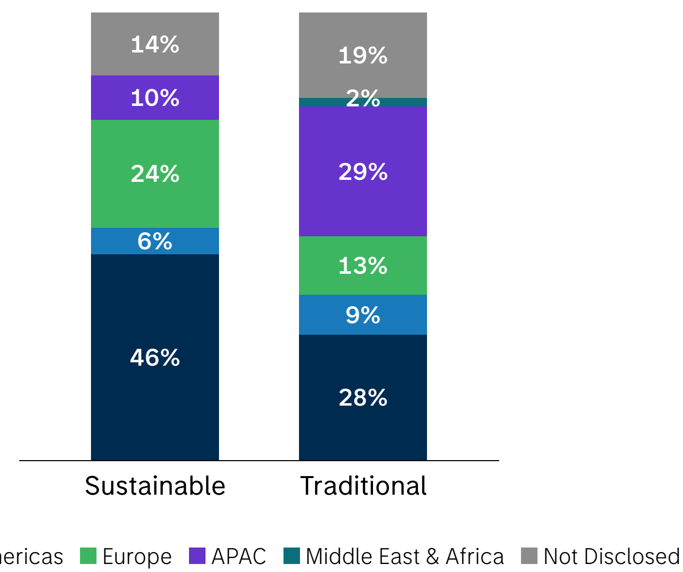
Global and Europe had the weakest returns

H2 24 Median Return by Investment Area



Sustainable funds over-index to Global and Europe

December 2024 Fund Count by Investment Area



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025. Note: bps stands for basis points; 10 bps is 0.1%.

Underperformance Continued Across Asset Classes

SUSTAINABLE EQUITY FUNDS GENERATED THE GREATEST RELATIVE WEAKNESS

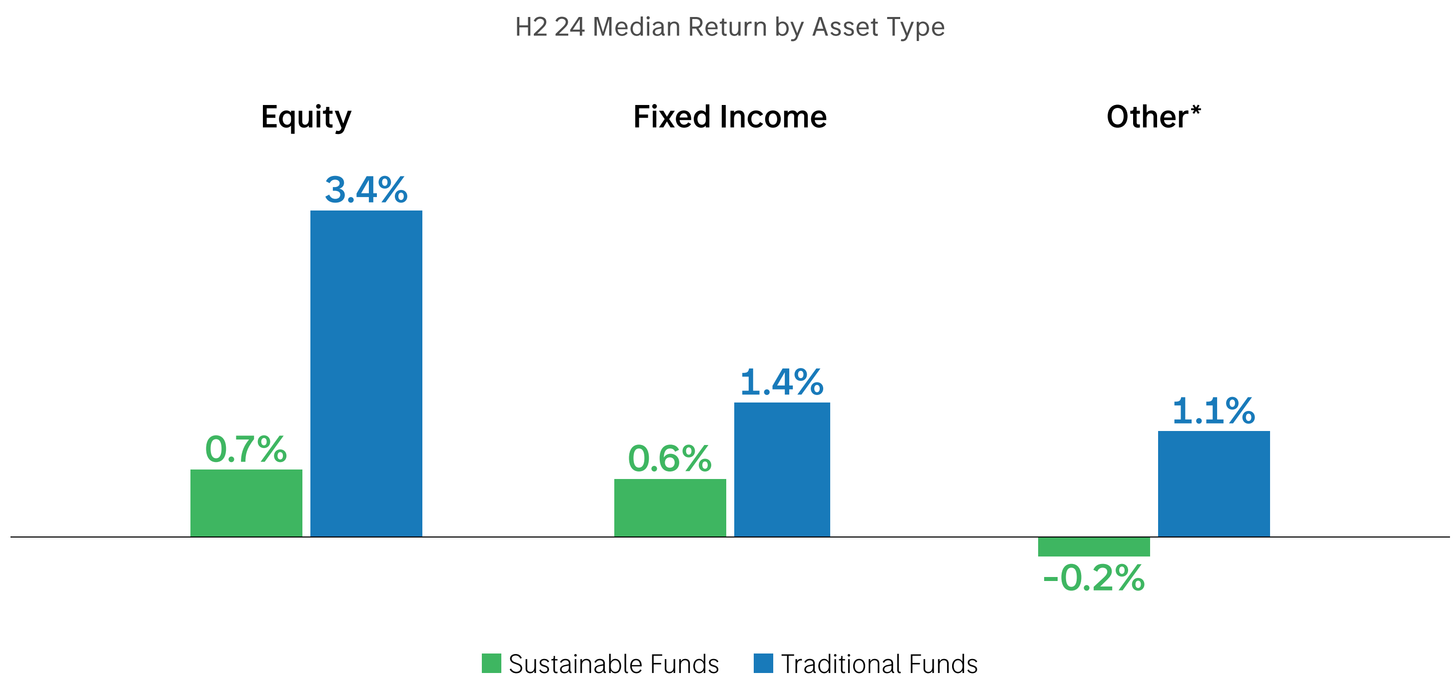
In H2 2024, Sustainable funds underperformed across all asset classes:

Equities: Sustainable funds underperformed by 269bps with a median return of +0.7%, below Traditional equity funds at +3.4%.

Fixed income: Sustainable funds performed similarly at +0.6%, but the underperformance was less with Traditional peers at +1.4%.

"Other" funds (multi-asset, property, commodities and alternatives): Sustainable funds generated median returns of -0.2%, below +1.1% for Traditional funds.

Sustainable funds were relatively weakest in equities



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025.
*Other includes multi-asset, property, commodities and alternative fund types.

Analyzing Performance for Europe-Domiciled Funds

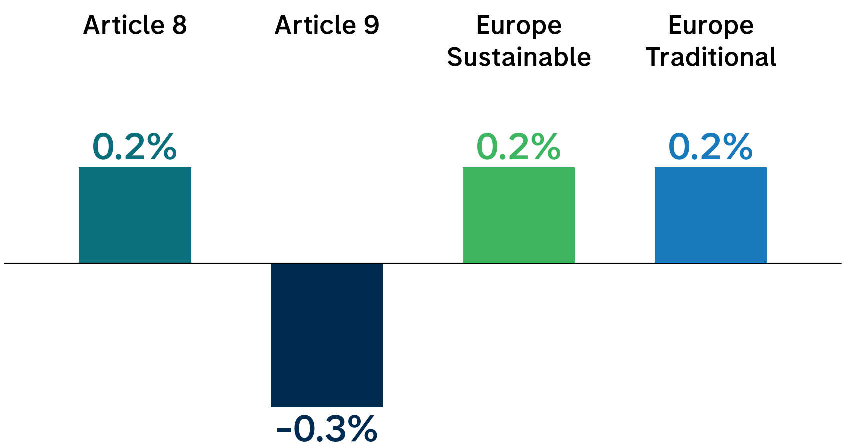
SIMILAR RETURNS FOR BOTH SUSTAINABLE AND TRADITIONAL FUNDS

Europe-domiciled Sustainable and Traditional funds both had median returns of +0.2% in the second half of 2024. Article 8 funds had a median return of +0.2%, with Article 9 median return at -0.3%.

Half of Europe-domiciled AUM is classified as Article 8 (50% of total Europe AUM) or Article 9 (2% of total), with the remainder under Article 6.

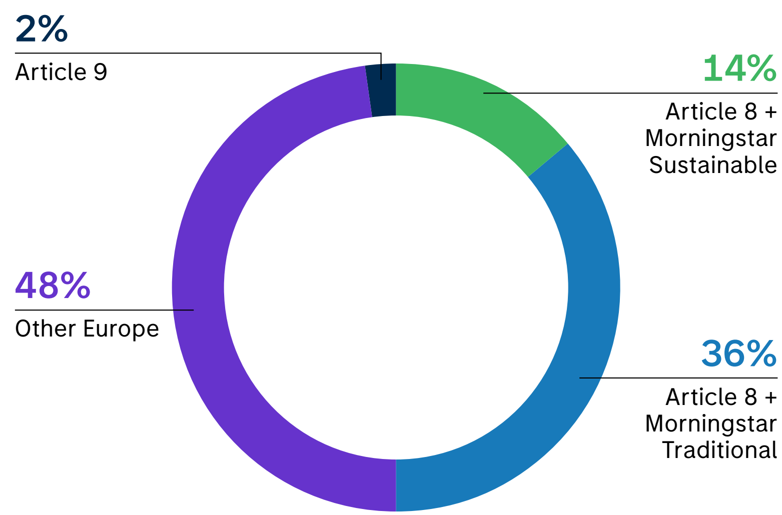
All Article 9 AUM, and 28% of Article 8 AUM, are classified as "Sustainable" by Morningstar, implying that 20% of Europe-domiciled AUM fall under Morningstar's Sustainable classification.

H2 24 median return by SFDR classification



The EU's Sustainable Finance Disclosure Regulation (SFDR) sets out mandatory ESG disclosure requirements for asset managers with the goal of creating more transparency about Sustainable investment strategies. According to the SFDR's classification system, which went into full effect on January 1, 2023, a fund is either classified as Article 6 (funds without a sustainability scope), Article 8 (funds that promote environmental or social characteristics) or Article 9 (funds with Sustainable investment as their primary objective).

Europe-domiciled AUM



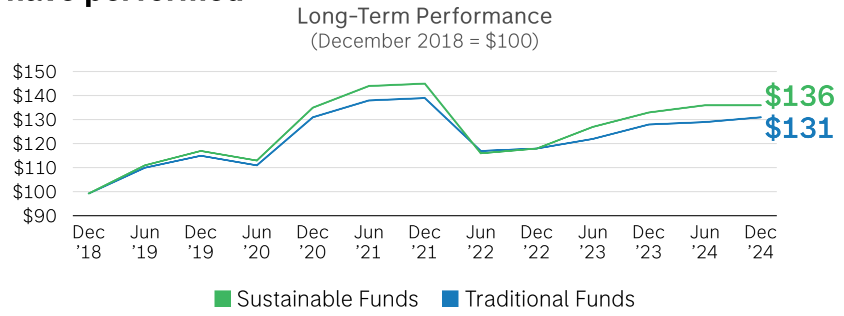
Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025.

Downside Deviation and Long-Term Returns

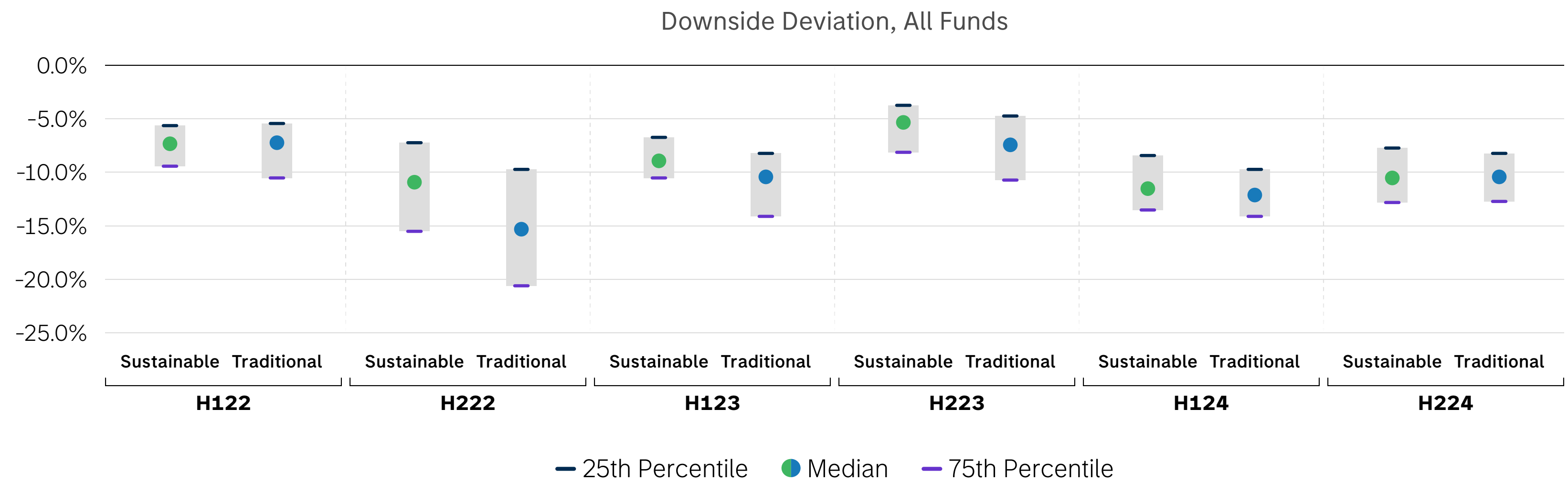
$100 INVESTED IN DECEMBER 2018 WOULD BE $136 TODAY AT MEDIAN SUSTAINABLE FUND RETURNS

Downside deviation is a measure of the likelihood of negative returns in a set of funds in the period. A lower number means a higher likelihood of negative returns against a chosen benchmark, here the S&P 500. For H2 2024, downside deviation was -10.82% for Sustainable funds and -10.76% for Traditional funds, meaning that Sustainable funds had slightly greater potential for relative losses. This is a departure from prior periods, when Sustainable funds have had lower potential for losses against a benchmark even when median returns have underperformed Traditional peers.

How a $100 investment in December 2018 would have performed



Downside deviation measures the likelihood of negative returns against a chosen benchmark



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025. Starting with December 2018 as $100, the lines show how median returns for sustainable and traditional funds have compounded over time. Indices are unmanaged and an investment cannot be made directly into an index.

Median Return Distribution

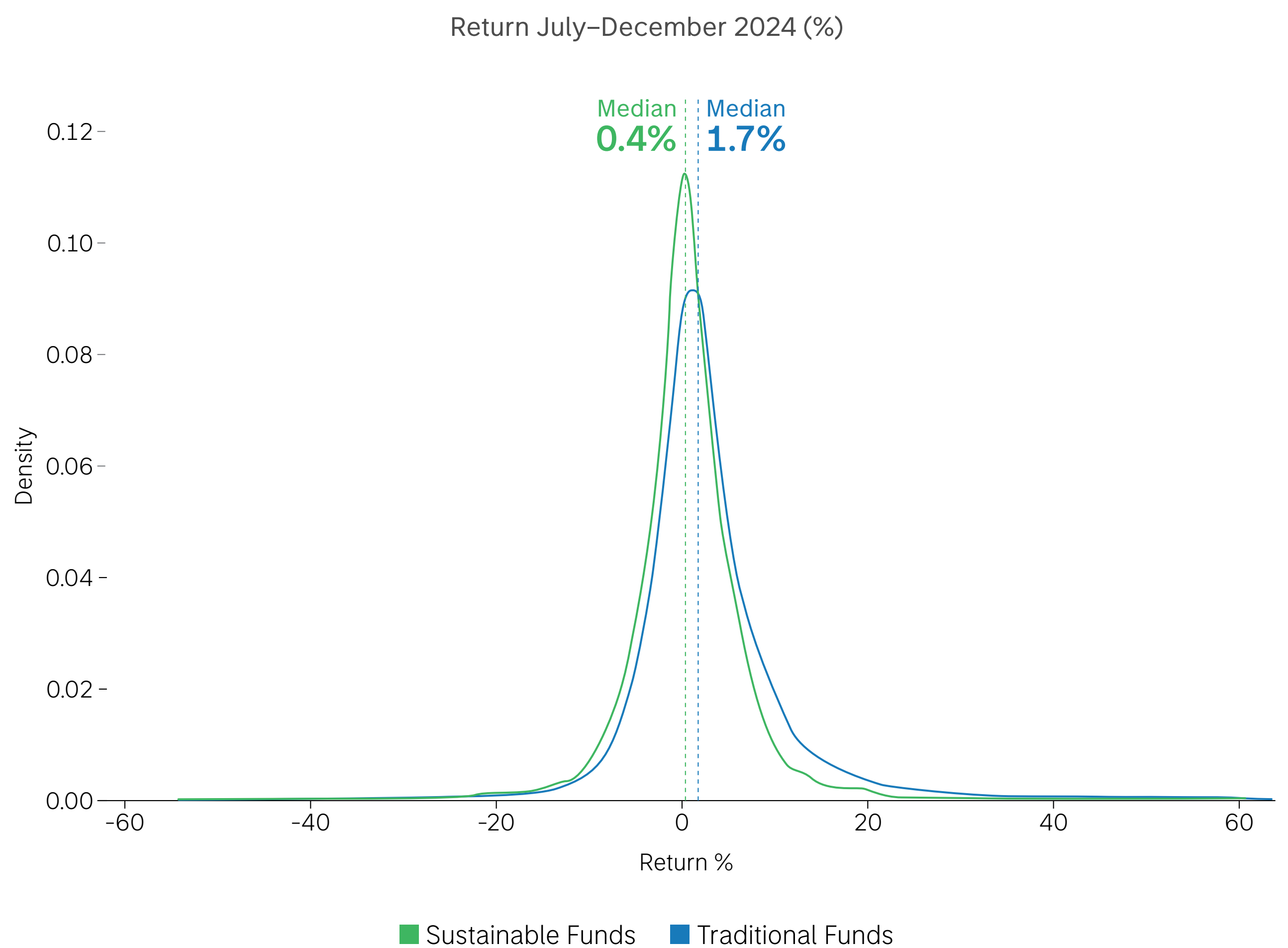
56% OF SUSTAINABLE FUNDS HAD POSITIVE RETURNS IN H2 2024, VS. 68% OF TRADITIONAL FUNDS

A smaller proportion of Sustainable funds had positive returns in the second half of 2024, at 56% vs. 68% for Traditional funds. Investors were more likely to select a better performing fund in the Traditional universe.

Both curves have long tails, with the highest returning funds +60% and the lowest nearly -60%, resulting in a very wide range of fund performance outcomes. Using mean, or simple average, returns would be disproportionately affected by these long tails and not represent the likelihood of achieving that return across a selection of funds.

The "Sustainable Reality" series uses median fund returns as the primary metric without any weighting to account for different fund sizes. Median is the more appropriate return value given the non-normal distribution of the entire universe of fund return. The median value also better represents the likelihood of an investor selecting a fund and achieving that specific return value.

Density chart of Sustainable and Traditional fund returns

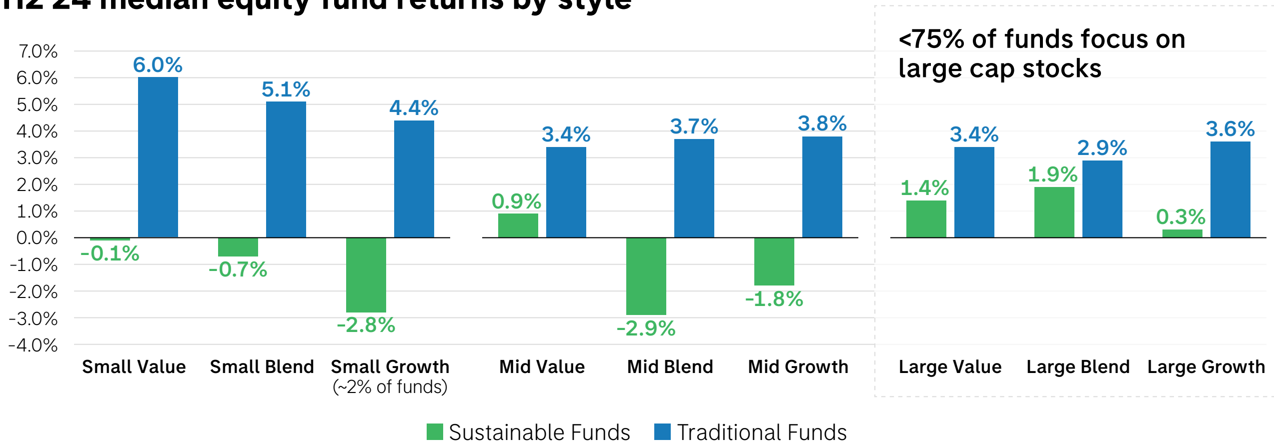


Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025.

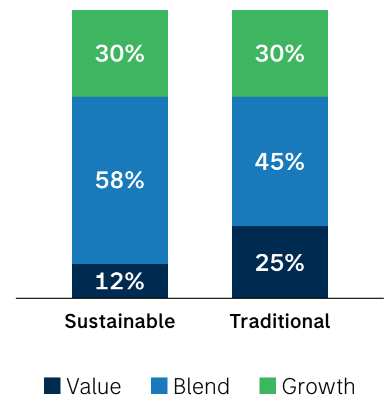
Equity and Fixed Income Returns by Style

EXPOSURES TO BOTH HAVE INFLUENCED SUSTAINABLE FUND RETURNS, BUT NOT MATERIALLY IN H2 2024

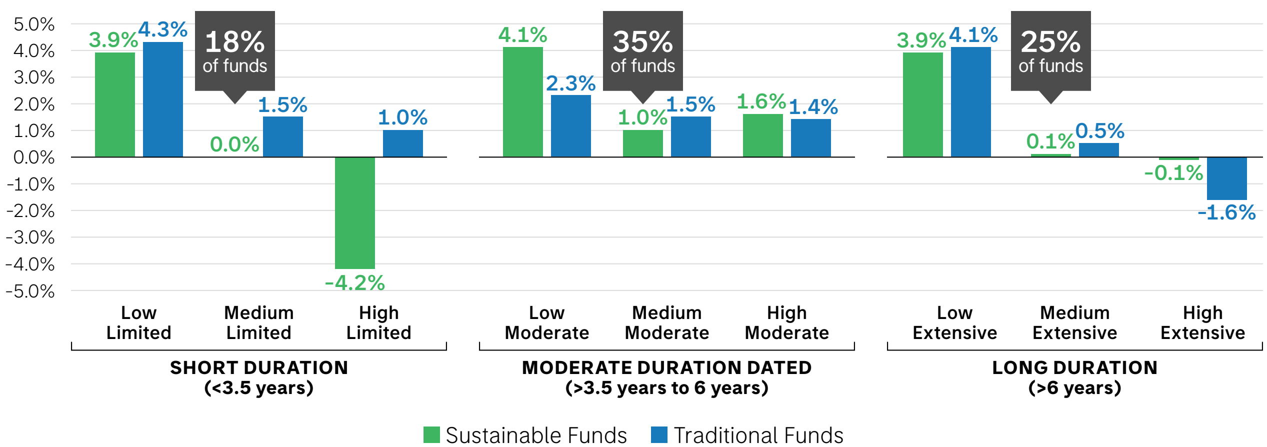
H2 24 median equity fund returns by style



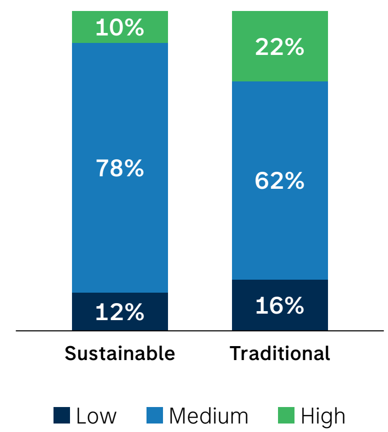
H2 24 Split of Equity Funds Count by Style



H2 24 median fixed income fund returns by style



H2 24 Fixed Income Fund Split by Credit Quality



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025. Low, Medium and High for fixed income refers to credit quality.

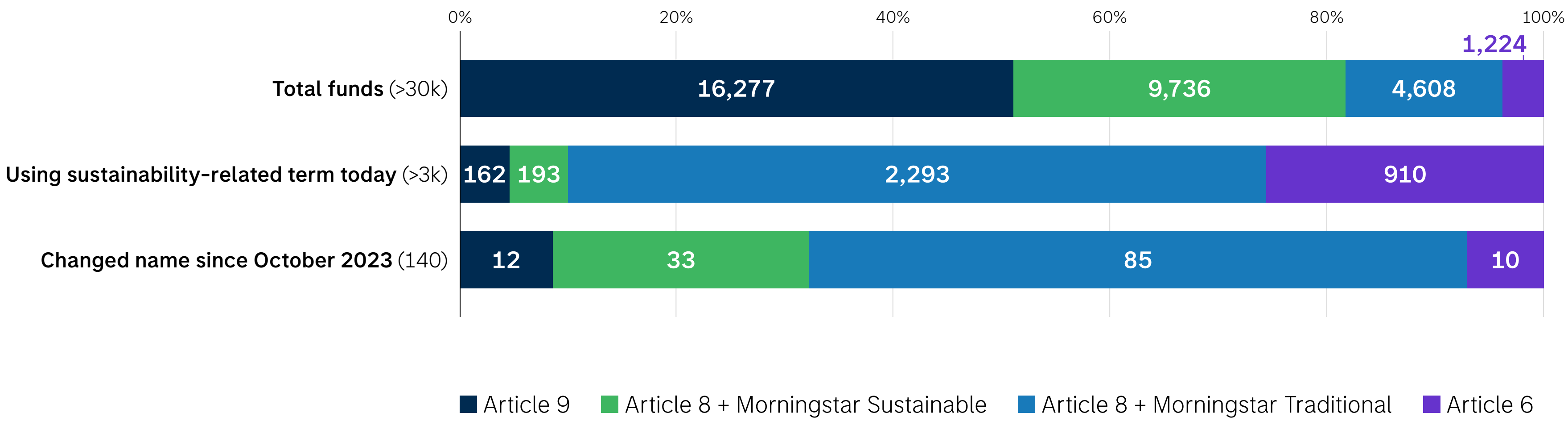
Regional Focus: Impact of New ESMA Fund Name Guidelines

140 FUNDS HAVE CHANGED NAME, WITH MOST DROPPING AFFECTED TERMS

In May 2024, ESMA[1] released guidelines on sustainability terms in fund names, requiring funds to exclude certain investments if using terms like "ESG" or "Sustainable" by May 2025.

- At February 4, 2025, more than 3,000 funds reporting under SFDR use sustainability-related terms in their name. Almost 75% of Article 9 funds use these terms; around half of Article 8/Sustainable[2] funds, just 2% of Article 8/Traditional funds; and 1% of Article 6 funds.
- Since October 2023, 140 funds have changed name, which is around 3% of funds using the terms today. Almost 90% removed a sustainability-related term altogether, with a few changing terms.
- Name changes were mostly among Article 8 funds, with proportionately more in those funds classed as Traditional by Morningstar.

Funds reporting under SFDR



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025.

[1] European Securities and Markets Authority, see their final Guidelines. Funds have until May 2025 to comply.
[2] Sustainable/Traditional classifications from Morningstar.

Restriction Screening

CONTROVERSIAL WEAPONS, THERMAL COAL AND TOBACCO ARE THE MOST COMMON EXCLUSIONS

Updated analysis from the August 2024 edition of Sustainable Reality. Morningstar data on how funds are using restriction screening shows that the proportion of AUM subject to most exclusions has remained similar for most categories over the past year.

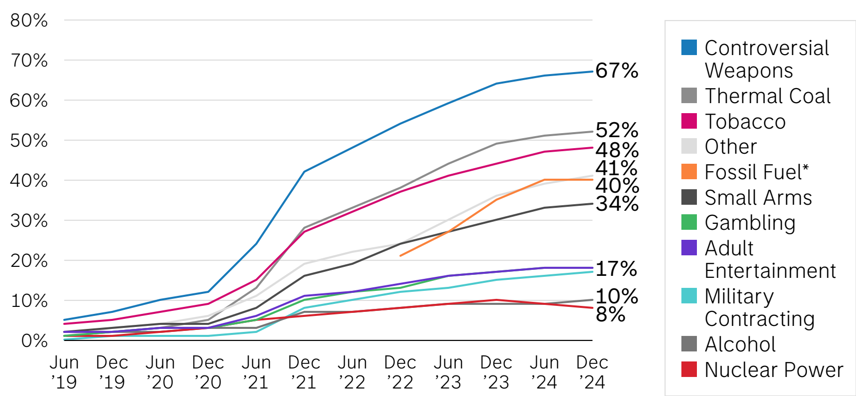
RESTRICTION SCREENING AT DECEMBER 2024	GLOBAL AUM, $bn	% Global AUM	EUROPE-DOMICILED AUM, $bn	% Europe AUM	NORTH AMERICA-DOMICILED AUM, $bn	% North America AUM	ASIA-DOMICILED AUM, $bn	% Asia AUM
Controversial Weapons	**11,180**	**17.9%**	**10,556**	**66.7%**	**372**	**1.0%**	**252**	**0.2%**
Thermal Coal	**8,552**	**13.7%**	**8,282**	**52.3%**	**204**	**0.6%**	**66**	**1.7%**
Tobacco	**8,282**	**13.3%**	**7,638**	**48.3%**	**371**	**1.0%**	**273**	**0.9%**
Other*	6,872	11.0%	6,432	40.6%	304	0.8%	133	0.3%
Fossil Fuel	6,614	10.6%	6,340	40.1%	215	0.6%	58	3.3%
Small Arms	5,838	9.4%	5,407	34.2%	301	0.8%	130	0.0%
Gambling	3,180	5.1%	2,875	18.2%	214	0.6%	89	0.0%
Adult Entertainment	3,027	4.9%	2,809	17.8%	136	0.4%	82	0.0%
Military Contracting	2,923	4.7%	2,739	17.3%	137	0.4%	47	0.0%
Alcohol	1,794	2.9%	1,522	9.6%	208	0.6%	62	1.1%
Nuclear Power	1,450	2.3%	1,325	8.4%	99	0.3%	27	0.6%
Palm Oil	933	1.5%	906	5.7%	22	0.1%	4	1.7%
Genetically Modified Organisms	608	1.0%	589	3.7%	16	0.0%	3	1.2%
Pesticides	535	0.9%	531	3.4%	3	0.0%	0	0.1%
Animal Testing	279	0.4%	226	1.4%	39	0.1%	14	0.8%
Fur and Specialty Leather	209	0.3%	206	1.3%	3	0.0%	0	0.8%
Abortion	149	0.2%	88	0.6%	60	0.2%	2	0.0%

Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025.
*Other includes any factors not covered by the named exclusions, for example companies with operations in countries whose governments pose human rights concerns.

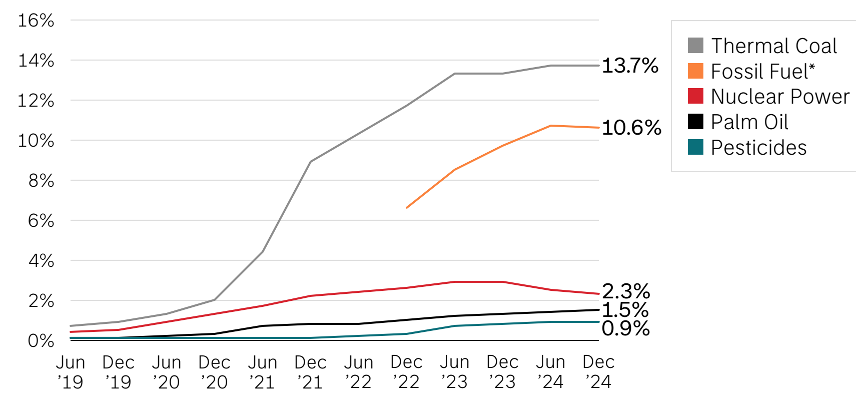
Restriction Screening Over Time

EUROPE-DOMICILED FUNDS ACCOUNT FOR MOST OF THE AUM USING RESTRICTION SCREENING

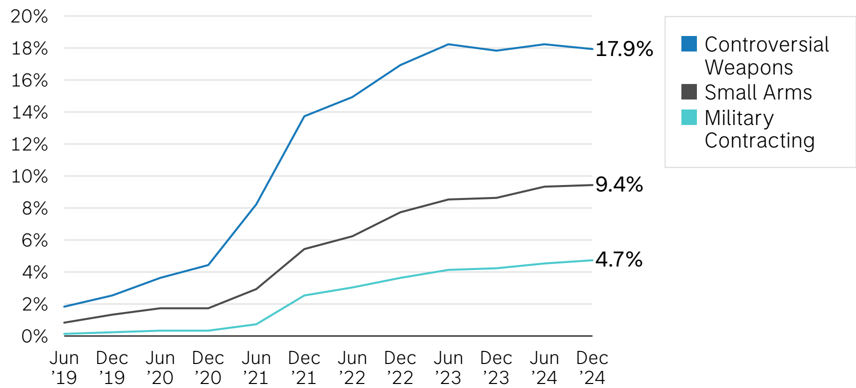
Europe Restriction Screening, as % of Europe AUM



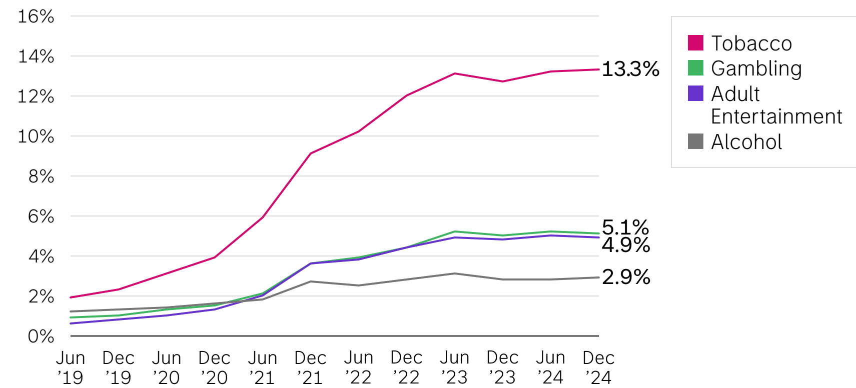
Environmental Restriction Screening, as % of Global AUM



Defense Restriction Screening, as % of Global AUM



Values-Based Restriction Screening, as % of Global AUM



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 4, 2025.
*Fossil fuel was introduced as a separate category starting in December 2022.

Methodology

This report is part of the Morgan Stanley Institute for Sustainable Investing's 'Sustainable Reality' series, which assesses the historical performance of Sustainable funds against Traditional funds over a specific timeframe using Morningstar data. This report analyzes performance for January 1, 2024–December 31, 2024.

The fund universe for this analysis includes closed-end funds, exchange-traded funds and open-end funds, taking the oldest share class, and excludes feeder funds, funds of funds and money market funds. In total, this analysis covered approximately 99,000 funds globally. This analysis takes each fund's sustainability classification as of June 30 (for H1 editions) or December 31 (for full year editions). While the parameters for including a fund do not change, taking the fund's classification at the most recent date means that universe of funds can change for each edition. All historical datapoints are restated based on the current period classification.

Morningstar classifies a fund as Sustainable if "...in the prospectus or other regulatory filings it is described as focusing on sustainability, impact investing, or environmental, social or governance (ESG) factors. Funds must claim to have a sustainability objective, and/or use binding ESG criteria for their investment selection. Funds that employ only limited exclusions or only consider ESG factors in a non-binding way are not considered to be a Sustainable investment product."

Sustainable funds are those classified 'Sustainable' by Morningstar, which can differ from the newer, and still broad, European Sustainable Finance Disclosure Regulation (SFDR) Article 8 and Article 9 definitions. Over 99% of Article 9 funds are also classified as Sustainable by Morningstar, while this only applies for around 30% of Article 8 funds. Traditional funds are those classified as 'Not Sustainable' by Morningstar.

Morningstar's calculation of total return is expressed in percentage terms and is determined each month by taking the change in monthly net asset value, reinvesting all income and capital-gains distributions during that month and dividing by the starting net asset value (NAV). All returns figures refer to median returns, as in prior Sustainable Reality iterations.

There can be a time lag of weeks or months in funds reporting data to Morningstar, notably for Asia-domiciled funds. Some figures from prior periods are revised to reflect the latest disclosures. Where this is material to prior analysis, the impact is noted in the text. Prior period figures could also be subject to modest revisions in the future. Data in this report were collected on February 4, 2025. Older editions of Sustainable Reality have looked at regional data based on the fund's domicile. As with the February 2024 edition, this report retains this breakdown and separately adds data based on a fund's investment area. For example, a fund could be domiciled in Europe but invest in global assets.

Disclosures

This material was published in March 2025 and has been prepared for informational purposes only and is not a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy. This material was not prepared by the Morgan Stanley Research Department and is not a Research Report as defined under FINRA regulations. This material does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it.

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Certain portfolios may include investment holdings deemed Environmental, Social and Governance (“ESG”) investments. For reference, environmental (“E”) factors can include, but are not limited to, climate change, pollution, waste, and how an issuer protects and/ or conserves natural resources. Social (“S”) factors can include, but not are not limited to, how an issuer manages its relationships with individuals, such as its employees, shareholders, and customers as well as its community. Governance (“G”) factors can include, but are not limited to, how an issuer operates, such as its leadership composition, pay and incentive structures, internal controls, and the rights of equity and debt holders. You should carefully review an investment product’s prospectus or other offering documents, disclosures and/or marketing material to learn more about how it incorporates ESG factors into its investment strategy.

ESG investments may also be referred to as Sustainable investments, impact aware investments, socially responsible investments or diversity, equity, and inclusion (“DEI”) investments. It is important to understand there are inconsistent ESG definitions and criteria within the industry, as well as multiple ESG ratings providers that provide ESG ratings of the same subject companies and/or securities that vary among the providers. This is due to a current lack of consistent global reporting and auditing standards as well as differences in definitions, methodologies, processes, data sources and subjectivity among ESG rating providers when determining a rating. Certain issuers of investments including, but not limited to, separately managed accounts (SMAs), mutual funds and exchange traded-funds (ETFs) may have differing and inconsistent views concerning ESG criteria where the ESG claims made in offering documents or other literature may overstate ESG impact. Further, socially responsible norms vary by region, and an issuer’s ESG practices or Morgan Stanley’s assessment of an issuer’s ESG practices can change over time.

Portfolios that include investment holdings deemed ESG investments or that employ ESG screening criteria as part of an overall strategy may experience performance that is lower or higher than a portfolio not employing such practices. Portfolios with ESG restrictions and strategies as well as ESG investments may not be able to take advantage of the same opportunities or market trends as portfolios where ESG criteria is not applied. There is no assurance that an ESG investing strategy or techniques employed will be successful. Past performance is not a guarantee or a dependable measure of future results. For risks related to a specific fund, please refer to the fund's prospectus or summary prospectus.

Investment managers can have different approaches to ESG and can offer strategies that differ from the strategies offered by other investment managers with respect to the same theme or topic. Additionally, when evaluating investments, an investment manager is dependent upon information and data that may be incomplete, inaccurate or unavailable, which could cause the manager to incorrectly assess an investment's ESG characteristics or performance. Such data or information may be obtained through voluntary or third-party reporting. Morgan Stanley does not verify that such information and data is accurate and makes no representation or warranty as to its accuracy, timeliness, or completeness when evaluating an issuer. This can cause Morgan Stanley to incorrectly assess an issuer's business practices with respect to its ESG practices. As a result, it is difficult to compare ESG investment products.

The appropriateness of a particular ESG investment or strategy will depend on an investor's individual circumstances and objectives. Principal value and return of an investment will fluctuate with changes in market conditions.

For more information about the Morgan Stanley Institute for Sustainable Investing, visit **morganstanley.com/sustainableinvesting**.

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