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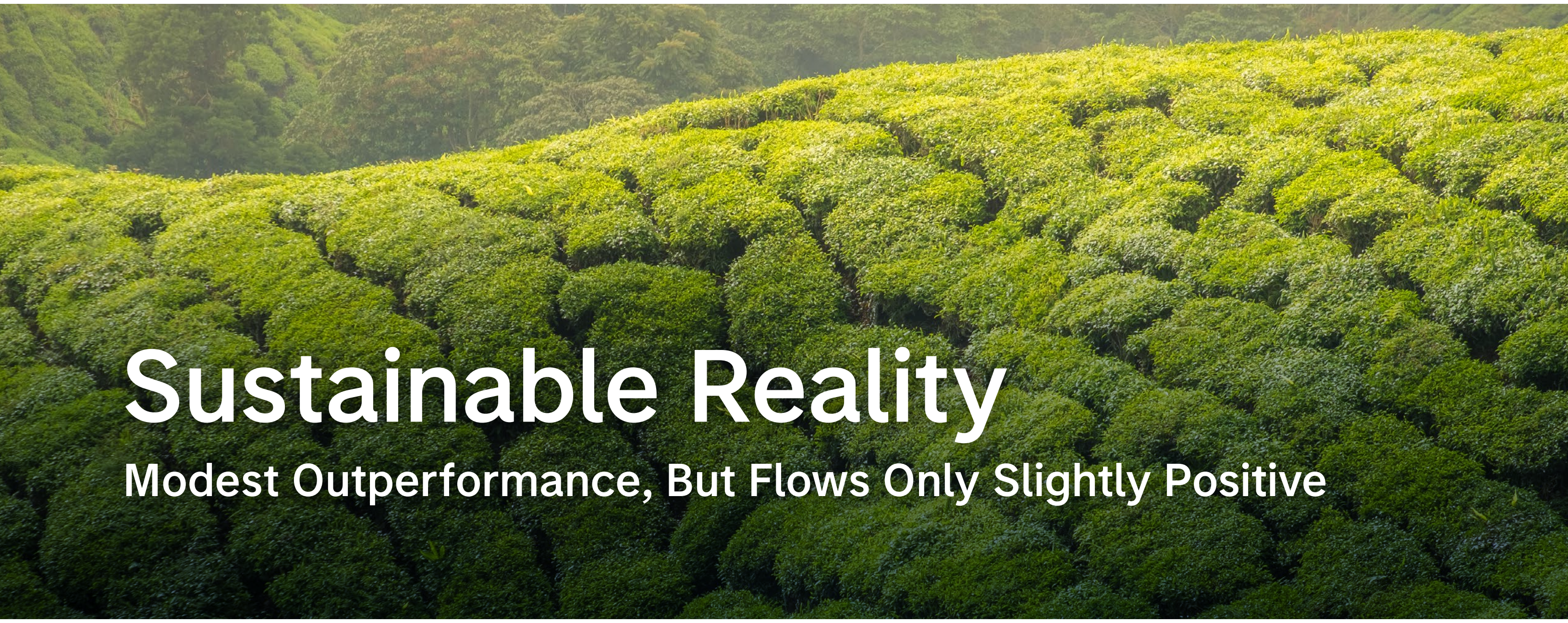
INSTITUTE FOR SUSTAINABLE INVESTING



Sustainable Reality

Modest Outperformance, But Flows Only Slightly Positive

Summary

Sustainable fund assets under management (AUM) globally reached a new high of $3.5 trillion, up 3.9% from the end of 2023. This is 7.0% of total AUM, slightly down on 7.2% at the end of 2023.

Inflows to sustainable funds were overall positive in the first half of 2024, at $20 billion or 0.6% of the prior year-end AUM, according to Morningstar data. However, the second quarter was slightly negative, with outflows in May only partially rebounding in June. This is a departure from a long run of positive quarterly inflows for sustainable funds, although flows data can be subject to restatements due to lagged fund disclosures. It is also in contrast to demand for traditional funds, which saw stronger inflows at +2.5% of prior year-end AUM for the first half.

Regionally, sustainable funds domiciled in North America continued to see outflows (-3.6% of prior year-end AUM), more than offset by inflows to Europe-domiciled sustainable funds (+1.1%, on a much larger AUM base). However, when looking at investment area rather than fund domicile, the regional picture of flows changes: sustainable funds investing globally, as well as in Europe and in the Americas, all saw small inflows of around 1% of prior year-end AUM.

Sustainable funds saw median returns of +1.7% in the first half of 2024, slightly ahead of traditional funds' +1.1%. Sustainable funds' higher exposure to equity funds—the best performing asset class in the period for both sustainable and traditional funds and which make up a larger proportion of the sustainable fund universe—was a key driver of the relative outperformance. Lower volatility, as measured by downside deviation, was also a factor.

The strongest returns, as well as the most significant relative outperformance, were in the Americas,[1] with median returns for sustainable funds investing in the region of +8.8% (traditional peers +3.4%), compared with global funds' +2.2% and Europe focused funds' -0.1%.

KEY TAKEAWAYS

[1] Americas includes both North America and South America.

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–June 30, 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.

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."

This analysis takes each fund's classification as of June 30 (for 1H 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.

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 August 3, 2024.

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.

CONTACT US

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

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AUM in Sustainable Funds Rose to $3.5 Trillion, Although Flows Only Slightly Positive

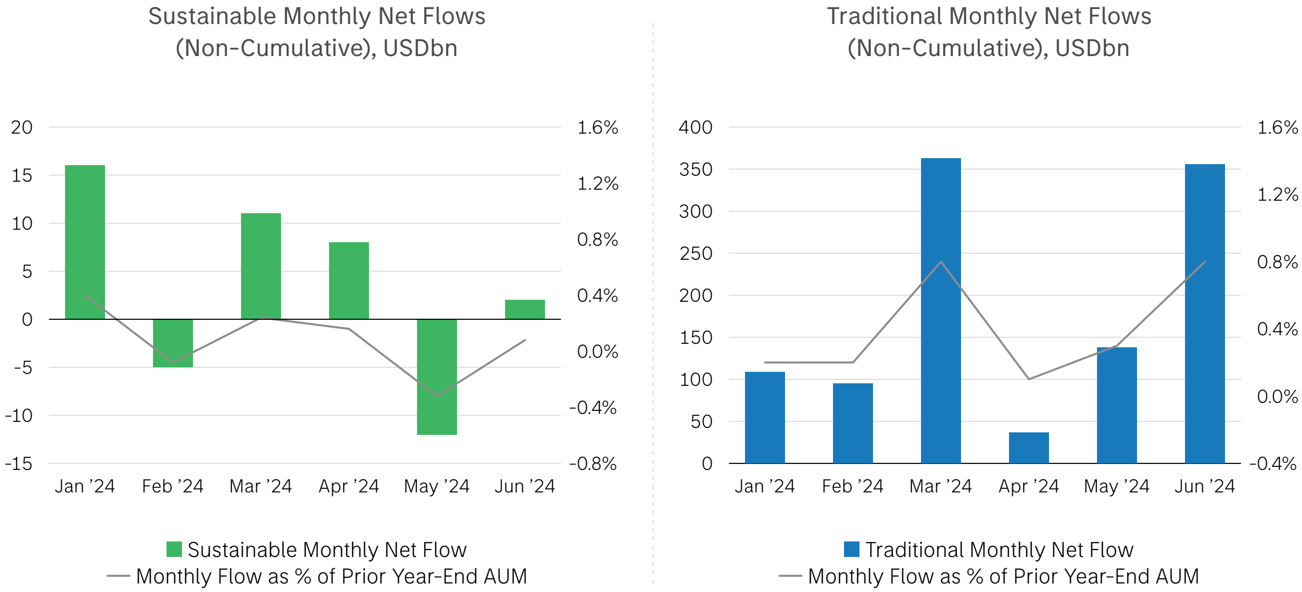
Inflows to sustainable funds remained slightly positive overall, at +0.6% of prior year-end AUM, although Q2 was marginally down (-0.1%). This is a departure from a long run of positive quarterly inflows for sustainable funds, although flows data can be subject to restatement due to lagged fund disclosures. Traditional funds saw stronger flows, at +2.5% of prior year-end AUM. Regionally for sustainable funds, North America-domiciled funds continued the prior year trend of small outflows (-3.6% of prior year-end AUM during the first half of 2024), while Europe- and Asia-domiciled funds saw inflows (+1.1%/+1.2% respectively). Sustainable funds' AUM was $3.5 trillion at June 2024, up 3.9% from the end of 2023 and marking a new high in absolute terms.

Sustainable Flows Slightly Positive, Although Q2 Weak and Outpaced by Traditional Flows

Overall, sustainable funds saw small inflows of $20 billion during the first half of 2024, or 0.6% of prior year-end AUM. This is notably slower than the rate of inflows seen in recent years, where 2022 and 2023 full-years inflows were both over $100 billion. This included slightly negative flows (-$2 billion) during the second quarter of 2024. North America-domiciled sustainable funds continued to see outflows, at -$12 billion during the first half, with Europe-domiciled funds the main driver of inflows (+$32 billion, although all of this was in the first quarter). In a reversal from prior year trends, traditional fund flows outpaced sustainable peers, with inflows at +2.5% of prior year-end AUM in the first half of 2024.

FIGURE 1

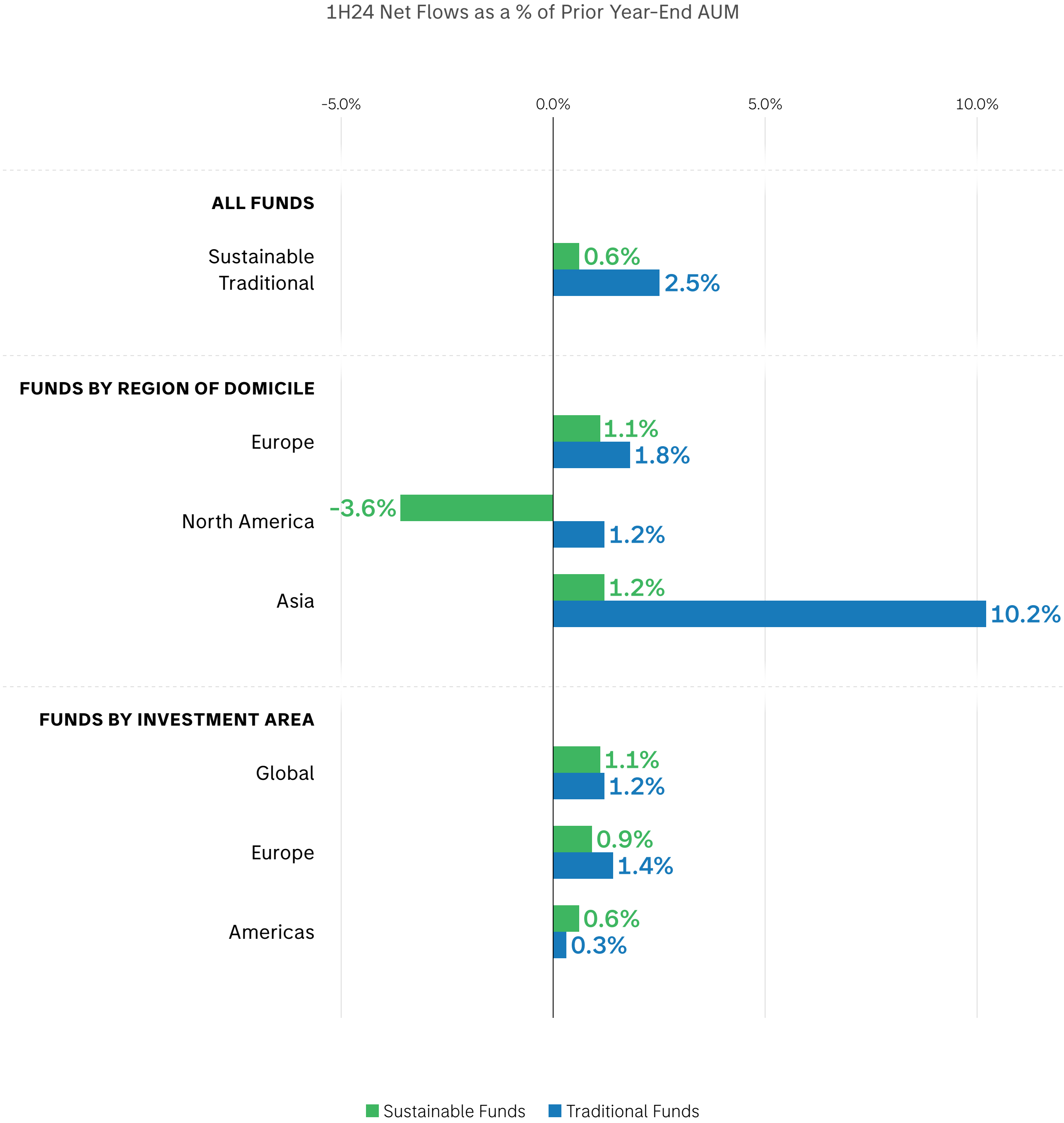
Flows Were Stronger to Traditional Funds Than to Sustainable Funds in The First Half of 2024



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024.

FIGURE 2

Sustainable Funds Saw Small Inflows in Most Geographies, Other Than North America Domiciled Funds



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024.

Sustainable AUM Grew Modestly to June 2024, Marking A New High

Sustainable funds' AUM rose to $3.5 trillion by the end of June 2024, up 3.9% from year-end 2023 and up 7.7% year-over-year, marking a new high. This represents 7.0% of total AUM globally, a little down on 7.2% at the end of 2023 and 7.3% at 1H2023, mostly reflecting stronger inflows to the Traditional fund universe.

7.0%

of total AUM classified as sustainable at June 2024.

FIGURE 3

Sustainable Funds' AUM was $3.5 trillion at June 2024, 7.0% of Total AUM

Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024.

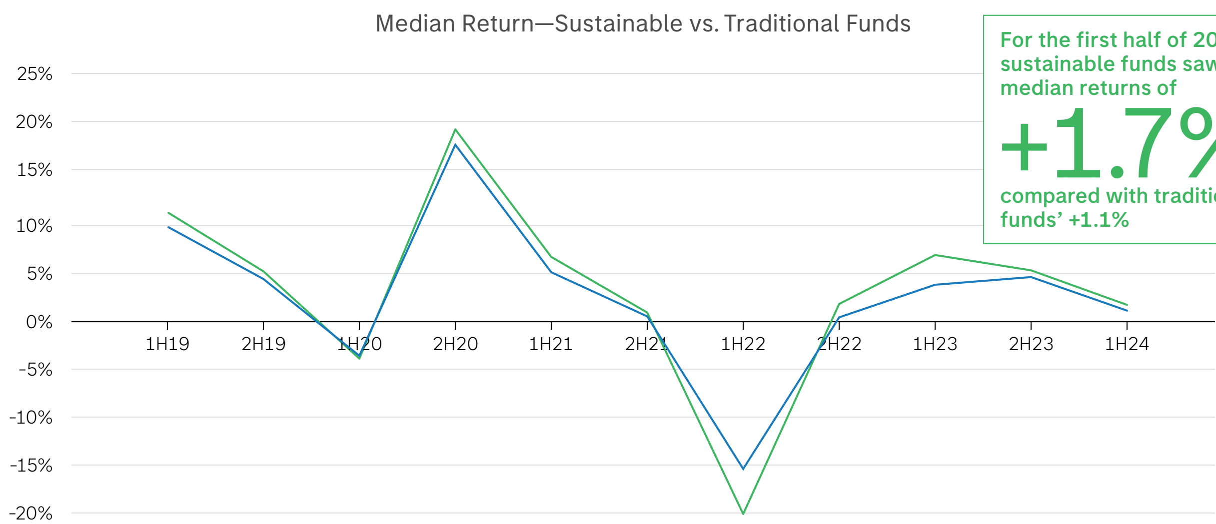
Sustainable Funds Outperformed Modestly on Asset Class Exposure

Sustainable funds modestly outperformed their traditional peers in the first half of 2024. Stronger returns in equities, which are a greater proportion of the sustainable fund universe, were a key driver.

For the first half of 2024, sustainable funds' median return was +1.7% compared with traditional funds' +1.1%. Sustainable funds' outperformance was mostly driven by their skew to equities. For equity funds, sustainable funds had a median return of +5.2% in the period, in line with traditional equity funds at +5.1%. "Other" funds (multi-asset, property, commodities and alternatives) saw similar median returns (+0.3% for sustainable funds and +0.4% for traditional funds). In fixed income, sustainable funds had weaker median returns, at -1.7% compared to traditional peers at -0.4%. However, equity funds make up a larger proportion of the sustainable fund universe, at 57% compared to 39% for traditional funds, so the stronger performance of equity funds contributed to sustainable funds' overall outperformance. Sustainable funds also had more favorable downside deviation—a measure of the likelihood of a set of funds underperforming a chosen benchmark—than traditional funds. For more detail and charts on the distribution of median returns and downside deviation, please see page 9 in the Appendix.

FIGURE 4

Sustainable Funds Modestly Outperformed Traditional Funds in 1H2024



For the first half of 2024, sustainable funds saw median returns of

+1.7%

compared with traditional funds' +1.1%

1H19	2H19	1H20	2H20	1H21	2H21	1H22	2H22	1H23	2H23	1H24
11.3%	5.2%	-3.9%	20.0%	6.7%	0.9%	-20.1%	1.8%	6.9%	5.3%	1.7%
9.8%	4.4%	-3.6%	18.4%	5.1%	0.5%	-15.4%	0.4%	3.8%	4.6%	1.1%
154 bps	77 bps	-35 bps	165 bps	163 bps	41 bps	-468 bps	141 bps	310 bps	66 bps	67 bps

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

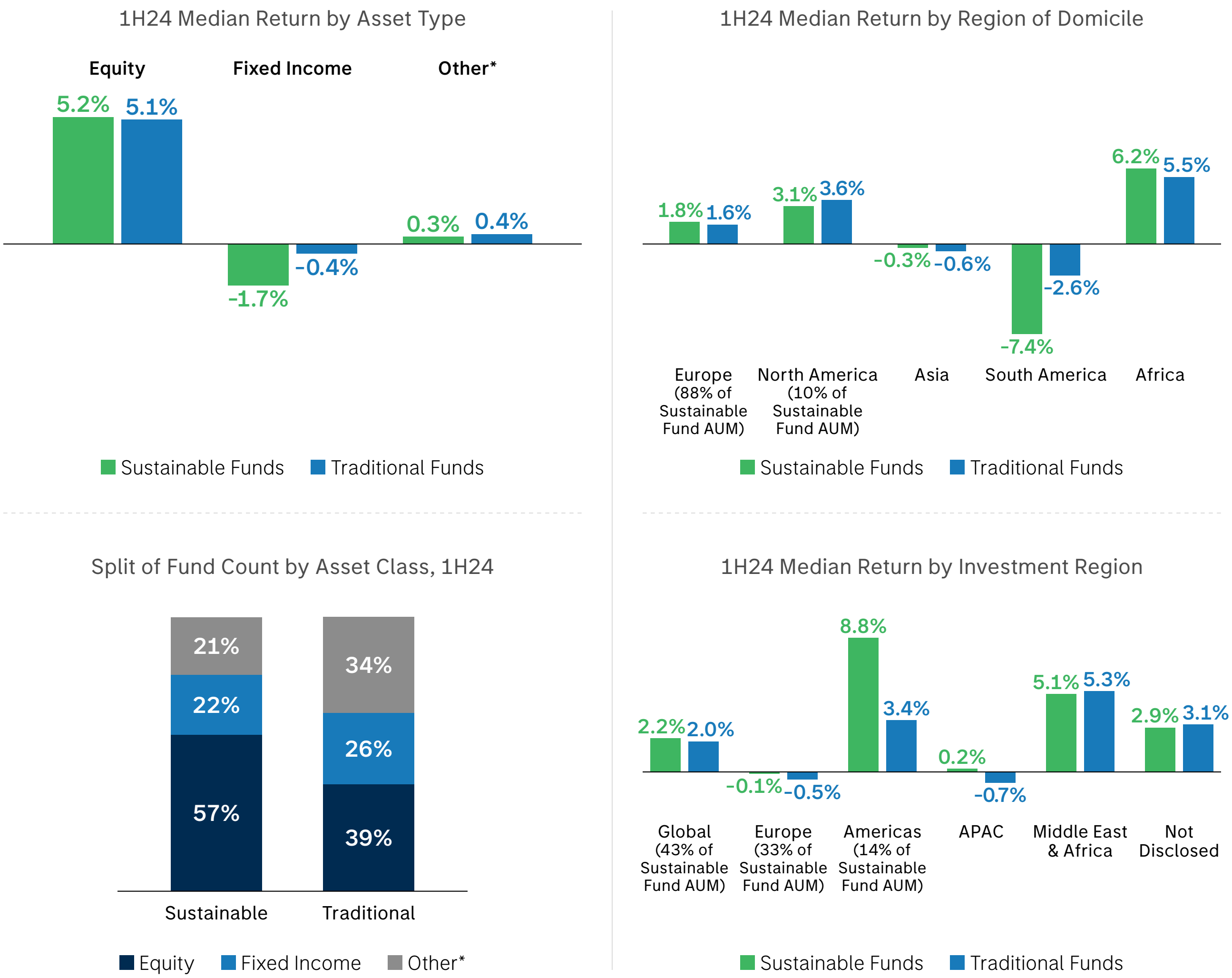
Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024. Table shows data in basis points (bps), 10bps = 0.1%.

Looking at funds by the geography of their investment area, relative performance was similar for sustainable and traditional funds investing globally or in Europe (Figure 5). Combined, these two areas account for over three quarters of sustainable AUM. Differences were more pronounced in the Americas (14% of sustainable fund AUM), where sustainable funds had a median return of +8.8% compared to traditional funds' +3.4%. Prior periods have seen equity and fixed income fund styles, such as value vs. growth, influence relative returns. However, this was not a significant factor in the first half of 2024.

Regional performance was not a major driver of sustainable fund outperformance when considering fund domicile. For Europe-domiciled funds, which are almost 90% of sustainable fund AUM, median returns were +1.8% and +1.6% for sustainable and traditional funds respectively. For North America-domiciled funds (10% of sustainable fund AUM), sustainable funds underperformed slightly, with median returns at +3.1% compared to traditional peers at +3.6%. Other regions saw more material out- and underperformance from sustainable funds, but these make up a very small proportion of the universe (Figure 5).

FIGURE 5

Sustainable Funds' Skew to Equities Helped Relative Outperformance



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024.
*Other includes multi-asset, property, commodities and alternative fund types.

Appendix

Regional Focus: Europe-Domiciled Funds

Europe-domiciled funds account for 88% of global sustainable AUM, although only 33% of sustainable AUM focuses exclusively on Europe for its investments. Europe-domiciled sustainable funds had median returns of +1.8% in the first half of 2024, marginally ahead of traditional peers' +1.6%.

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 Jan. 1, 2023, a fund will either be classified as Article 6 (funds without a sustainability scope), Article 8 (funds that promote environmental or social characteristics) or Article 9 (funds that have sustainable investment as their primary objective).

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 just under one third of Article 8 AUM is classified as "Sustainable" by Morningstar. This means that 20% of European AUM comes under Morningstar's Sustainable classification. Article 8 funds had a median return of +1.6% in the first half of 2024, with Article 9 median return at +1.4% (Figure 6).

During the first half of 2024, Article 8 funds saw small inflows, at $98 billion or +1.4% 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 outflows in Q2. Article 9 funds saw small outflows throughout the period, at -2.9% of prior year-end AUM for the first half of 2024.

FIGURE 6

Europe-domiciled Sustainable Funds Had Similar Returns to Both Traditional Funds and Article 8 / Article 9 Funds

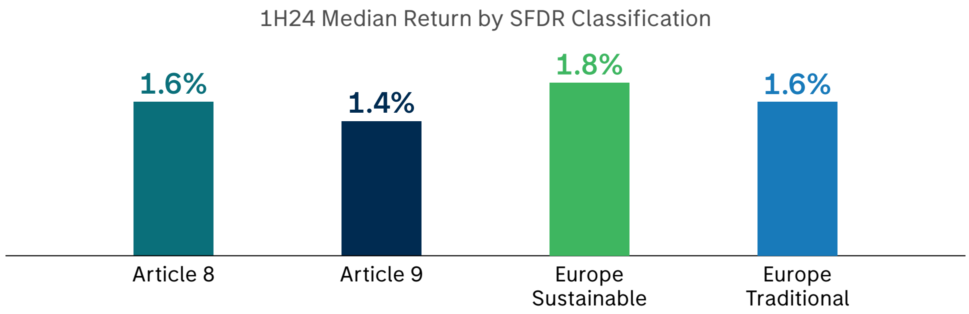
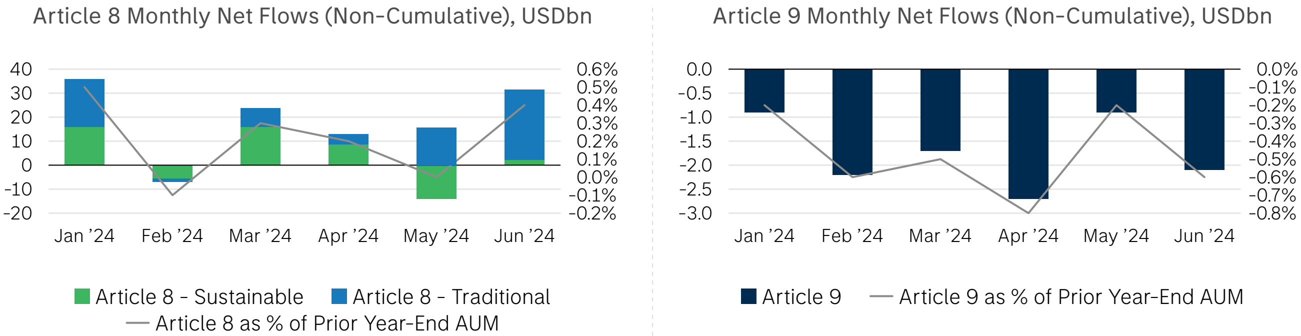


FIGURE 7

Article 8 and Article 9 Fund Flows



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024.

Median Returns, Downside Deviation and Long-Term Returns

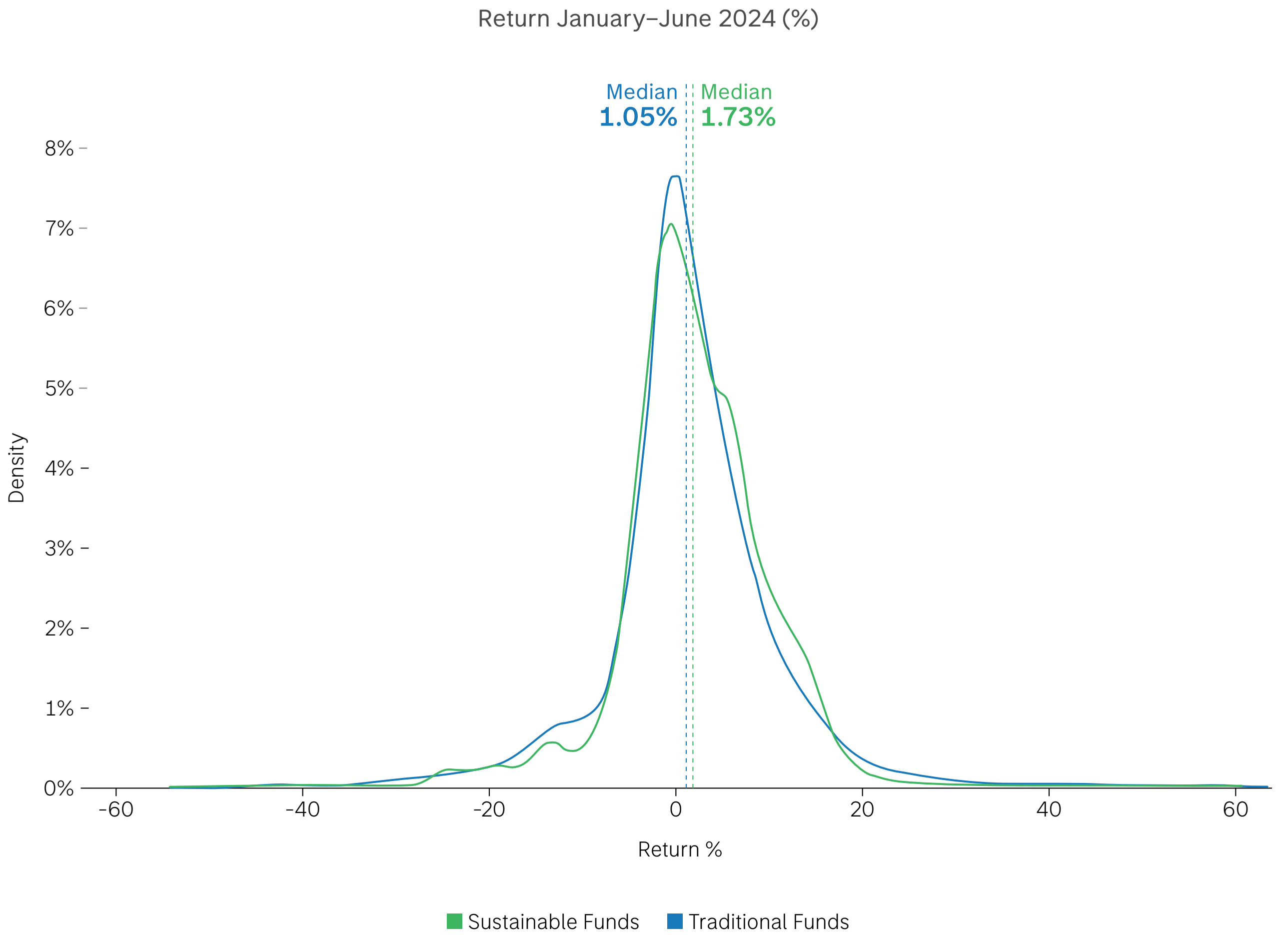
The "Sustainable Reality" series uses median fund returns as the primary metric without any weighting to account for different fund sizes. Median is the more appropriate return value given the non-normal distribution of the entire universe of fund returns noted throughout the Reality series dating back to 2004. The median value also better represents the likelihood of an investor selecting a fund and achieving that specific return value. Figure 8 shows the distribution density curves of median returns for sustainable and traditional funds in the first half of 2024.

Key points to note:

- **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.
- **A slightly larger portion of sustainable funds had positive returns,** at 59% vs. 55% for traditional funds. Investors were more likely to select a better performing fund in the sustainable universe.

FIGURE 8

Density Chart of Sustainable and Traditional Fund Returns

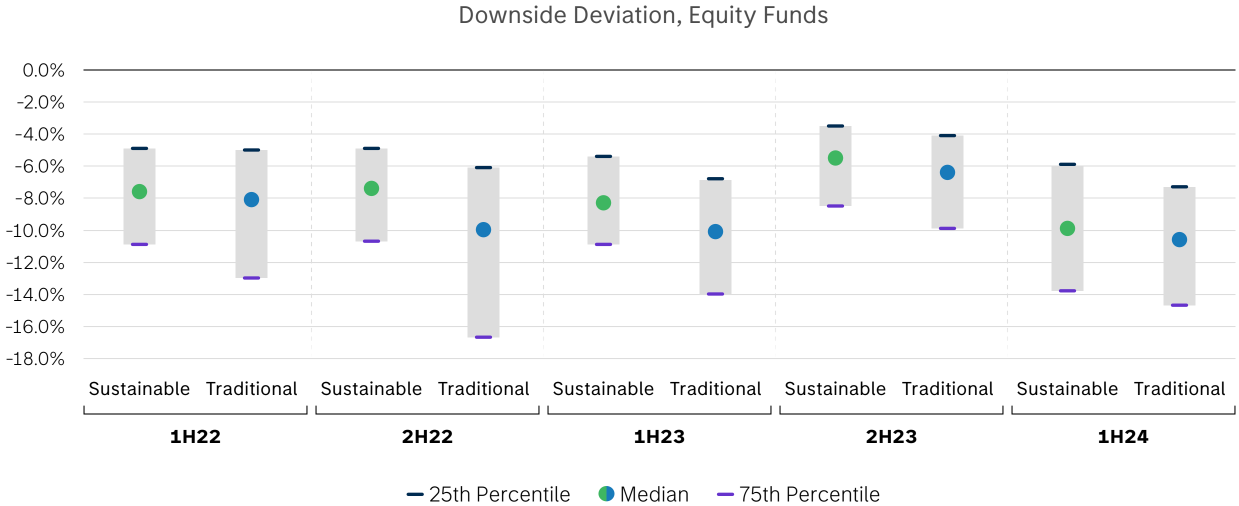


Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024.

Downside deviation is used as a measure of the likelihood of negative returns in a set of funds in the period. A lower number for downside deviation means a higher likelihood of negative returns against a chosen benchmark, for this analysis the S&P 500. For example, for the first half of 2024, sustainable equity funds' downside deviation was -9.9%, while for traditional equity funds this was -10.6%.

FIGURE 9

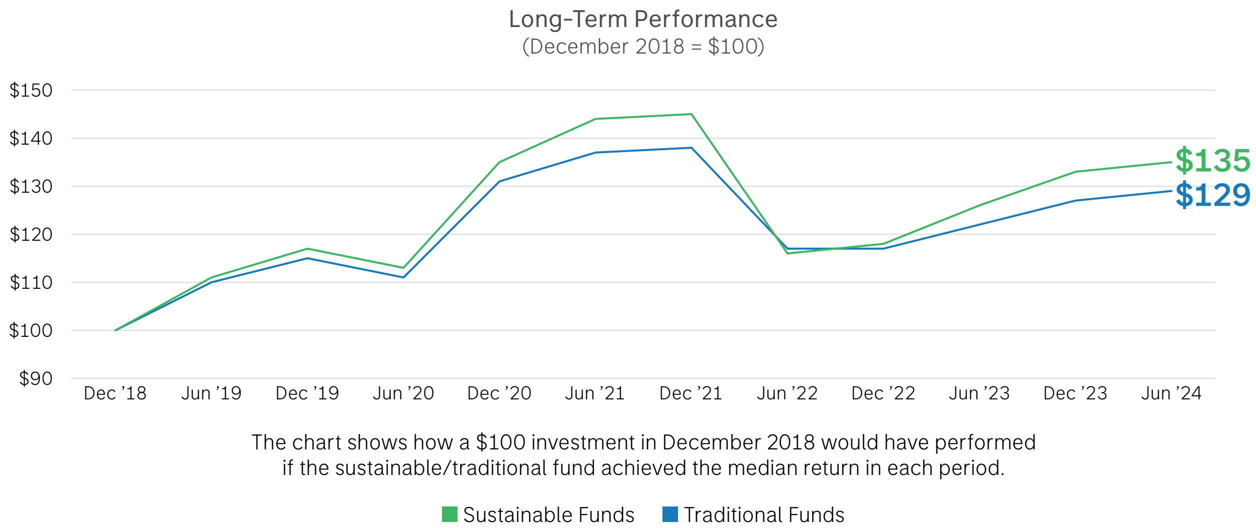
Downside Deviation of Sustainable and Traditional Equity Funds



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024.

FIGURE 10

Long-Term Performance of Sustainable and Traditional Funds

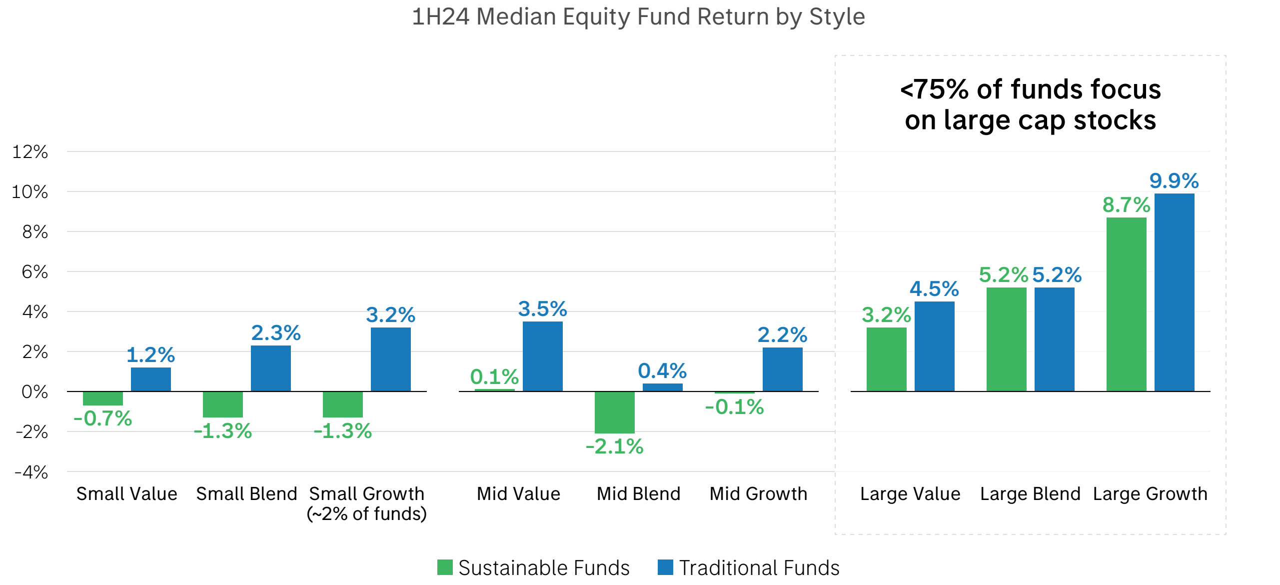


Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024. Starting with December 2018 as $100, the lines show how median returns for sustainable and traditional funds have compounded over time.

Equity and Fixed Income Styles

FIGURE 11

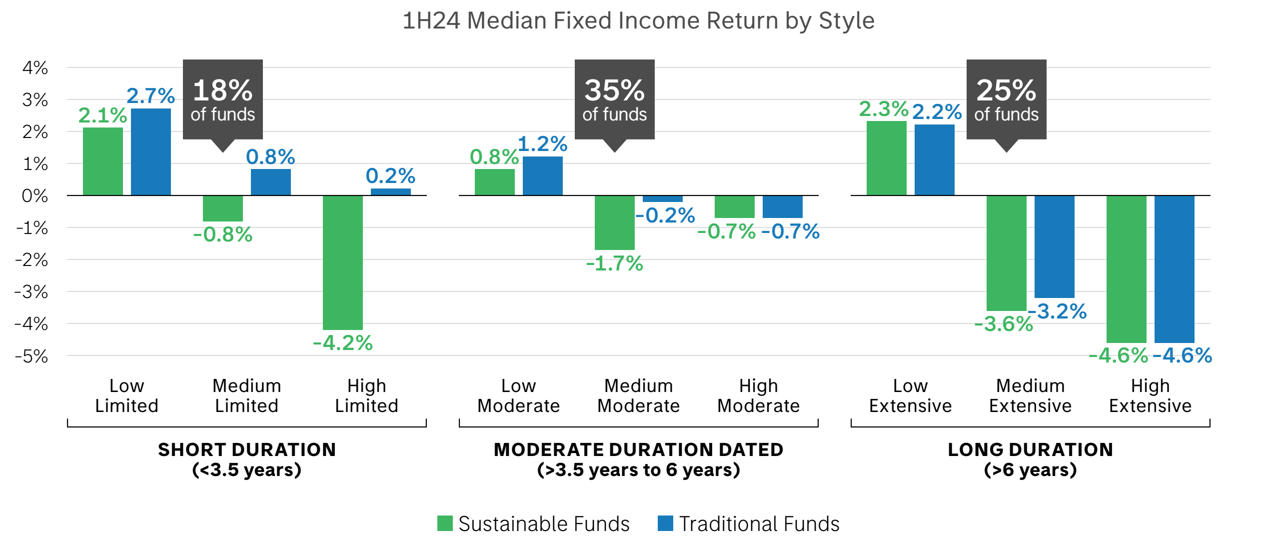
Equity Fund Returns by Style



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024.

FIGURE 12

Fixed Income Fund Returns by Style



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024. High refers to AAA and AA ratings, Medium to BBB to A and Low BB or lower.

Restriction Screening

Updating analysis from the August 2023 edition of Sustainable Reality, Morningstar data on how funds are using restriction screening shows that the proportion of AUM subject to most exclusions has moved modestly higher over the past year.

FIGURE 13

Controversial Weapons, Thermal Coal and Tobacco Are the Most Commonly Used Screens

Restriction Screening at June 2024

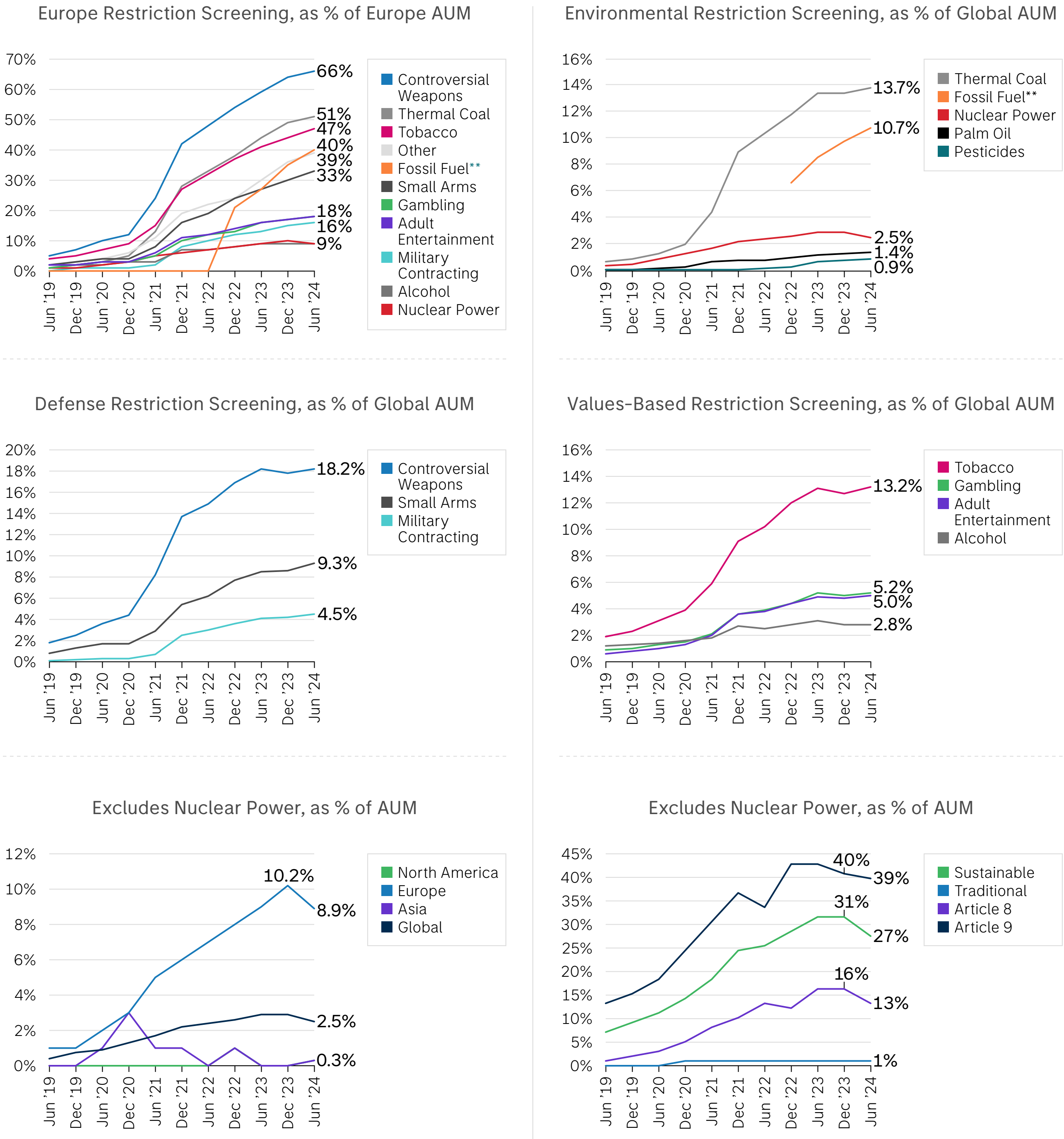
RESTRICTION SCREENING AT JUNE 2024	GLOBAL AUM, $bn	% Global AUM	EUROPE-DOMICILED AUM, $bn	% Europe AUM	NORTH AMERICA-DOMICILED AUM, $bn	% North America AUM	ASIA-DOMICILED AUM, $bn	% Asia AUM
Controversial Weapons	**10,782**	**18.2%**	**10,166**	**66.5%**	**361**	**1.0%**	**254**	**3.5%**
Thermal Coal	**8,127**	**13.7%**	**7,864**	**51.4%**	**197**	**0.6%**	**66**	**0.9%**
Tobacco	**7,823**	**13.2%**	**7,181**	**47.0%**	**379**	**1.1%**	**263**	**3.6%**
Other*	6,435	10.9%	5,997	39.2%	286	0.8%	149	2.0%
Fossil Fuel	6,332	10.7%	6,069	39.7%	211	0.6%	51	0.7%
Small Arms	5,518	9.3%	5,102	33.4%	296	0.9%	120	1.6%
Gambling	3,071	5.2%	2,780	18.2%	206	0.6%	83	1.1%
Adult Entertainment	2,975	5.0%	2,763	18.1%	129	0.4%	83	1.1%
Military Contracting	2,638	4.5%	2,460	16.1%	131	0.4%	47	0.6%
Alcohol	1,670	2.8%	1,400	9.2%	201	0.6%	66	0.9%
Nuclear Power	1,481	2.5%	1,363	8.9%	95	0.3%	24	0.3%
Palm Oil	845	1.4%	812	5.3%	20	0.1%	14	0.2%
Genetically Modified Organisms	634	1.1%	616	4.0%	14	0.0%	3	0.0%
Pesticides	536	0.9%	532	3.5%	3	0.0%	0	0.0%
Animal Testing	288	0.5%	231	1.5%	41	0.1%	15	0.2%
Fur and Specialty Leather	204	0.3%	201	1.3%	3	0.0%	0	0.0%
Abortion	146	0.2%	87	0.6%	57	0.2%	2	0.0%

Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024.

*Other includes any factors not covered by the named exclusions, for example companies with operations in countries whose governments pose human rights concerns.

FIGURE 14

Overview of Restriction Screens by Region and Type



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 3, 2024.
**Fossil Fuel exclusions were introduced as a separate category from December 2022.

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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.

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

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Historical data shown represents past performance and does not guarantee comparable future results.

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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.

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

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