**IIF Green Weekly Insight**  
**ESG funds deliver!**

*June 18th, 2020*

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- 85% of ESG equity indices outperformed non-ESG peers in Q1 2020, as have 80% of ESG fixed income indices in Q2 2020
- Since 2015, the ESG fund universe has tripled to over $1tn—but that’s still only 2.5% of the overall universe of 135,000 funds
- Over half of all ESG funds are domiciled in the Euro Area; 20% in the U.S.; limited uptake in emerging markets to date
- ICMA’s new Sustainability-Linked Bond Principles could encourage issuers to shift towards more sustainable practices; new “transition bonds” offer a greener shade of brown

**Sustainable strategies pay off:** With the COVID-19 pandemic serving as a real-life “stress test” for ESG investing strategies, the relative performance of sustainable assets has been remarkable this year. In our sample of 41 sustainable equity indices, over 75% of sustainable indices have outperformed non-ESG peers year-to-date, by a substantial 8 percentage points for the median fund. The resilience of ESG equity indices was even more striking during the sharp COVID-19 selloff in risk assets in Q1 2020: 85% outperformed their broad market counterparts. While ESG equity performance has been less stellar in Q2, more than 80% of the ESG-focused equity indices in our sample have significantly outperformed their counterparts since end-2015 (Chart 1). ESG fixed income strategies have also proved resilient during recent market turmoil. Across a commonly used set of 10 fixed-income ESG indices, 70% of them have outperformed their non-ESG counterparts this year. While their returns were on par with those of non-ESG benchmarks in Q1 2020, 80% of ESG-dedicated fixed income indices have outperformed during the Q2 market recovery relative to conventional peers (Chart 2).

**Greening the fund universe:** Despite growing evidence that sustainable strategies can offer significant benefits in terms of performance and diversification, ESG funds still represent only a small share of the overall fund universe. Out of over 135,000 funds worldwide, only 3500—or 2.5%—are ESG-focused. However, with appetite for ESG investments growing rapidly in recent years, assets under management of ESG-focused funds have risen from some $340 billion in 2015 to over $1 trillion at present (Chart 3). While equity funds account for over 60% of the ESG-fund universe by asset size, ESG-dedicated fixed income and mixed-allocation funds have more than tripled since 2015. This is in

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<th>Chart 1: ESG-focused stocks outperform their peers</th>
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<td>% of ESG equity indices that have outperformed their non-ESG counterparts</td>
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<tr>
<td>Q2 2020 to date</td>
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<td>Q1 2020</td>
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<td>Since end-2019</td>
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*Source: Bloomberg, IIF; a set of 41 ESG equity indices*

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<th>Chart 2: ESG-focused bonds have also delivered better returns</th>
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<td>% of ESG bond indices that have outperformed their non-ESG counterparts</td>
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*Source: Bloomberg, IIF; a set of 10 ESG fixed-income indices*
line with robust sustainable bond and loan issuance activity since the Paris Climate Agreement in December 2015—see our Sustainable Debt Monitor.

However, growth in ESG assets under management (AUM) has been concentrated in a few regions. By asset size, over half of all ESG funds are domiciled in the Euro Area. The size of U.S.-domiciled ESG funds market has doubled since 2015, and now accounts for over 20% of the universe. In contrast, growth in ESG funds domiciled in emerging markets remains across EM-based funds remains lackluster: with a total AUM of $28 billion, ESG funds represent only less than 3% of the EM-domiciled fund universe (Chart 4).

By fund type, over 85% of ESG-funds are in the form of traditional open-end funds. However, exchange-traded funds (ETFs) are becoming increasingly important. Since 2015, the AUM of ESG-focused ETFs has grown by some 15x, surpassing $110 billion in early June 2015—and now comprising over 10% of the market.

Shift from activity-based to behavior-based finance: With demand for sustainable debt instruments picking up, year-to-date issuance of sustainable bonds and loans has surpassed $200 billion. The launch of new frameworks, including ICMA's Sustainability-linked Bond Principles (SLBP), should add to the momentum. These voluntary guidelines for sustainability-linked bonds, with debt terms tied to specific ESG goals and general use of proceeds, are less restrictive compared to “activity-based” green bond principles and aim to incentivize broad-based behavior change on the part of issuers. Introduced in the H2 2019, this segment of the market has seen cumulative issuance of $5bn to date. Similarly, issuance of sustainability-linked bonds, has reached $200bn since inception—moving more into the mainstream due to the introduction of Sustainability-linked Loan Principles (SLLP) in 2019 (Chart 5).

Transition bonds—a greener shade of brown: Another noteworthy mention is the evolving universe of ‘transition-oriented’ financial products, including transition bonds. Introduced in 2017, transition bonds are designed for firms with high greenhouse gas (GHG) emissions looking to raise funds and transition their business models towards greener or lower-carbon activities or forms of production. A “transition bond” label allows issuers from these industries to fund their transition to a low-carbon economy (bridging the funding gap) and reduce the negative impact of their activities (e.g., deforestation, overfishing, etc.). The transition bond market is still at a nascent stage of development with only a handful of issuers to date—cumulative issuance is around $2bn. Given the broad range and importance of the included industries, this market has significant potential for more growth and development.
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