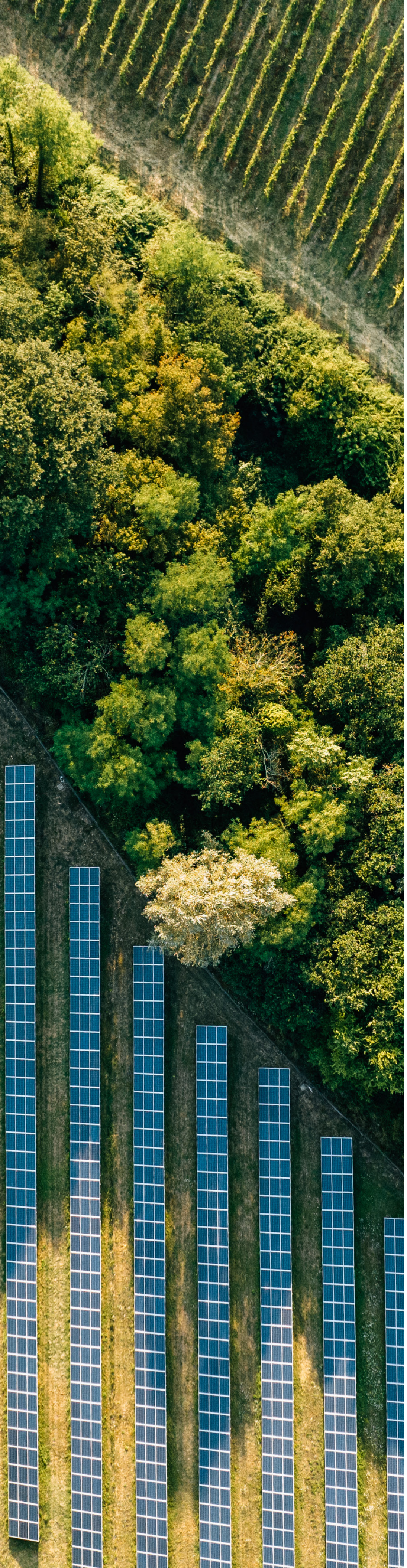

TCW Sustainable Insights

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Changing the Narrative on Sustainable Fund Flows

Recent headlines focusing primarily on significant net outflows from sustainable funds have heralded the apparent demise of sustainable and ESG (environmental, social, and governance) funds but, like many headlines, they do not tell the complete story. While equity-focused sustainable funds experienced roughly $12 billion in outflows in Q1 2024, the full global sustainable fund market recorded net inflows of nearly $900 million. Notably, sustainable fixed income funds attracted more investment than their non-sustainable counterparts in the fixed income universe (excluding the U.S.), indicating a positive trend for the asset class.

So, what is driving the mixed messaging related to sustainable and ESG funds? Definitions of what constitutes a sustainable fund vary, as do global investors' appetites for sustainable assets and strategies. In this edition of Sustainable Insights, we aim to analyze some of the factors that may be underpinning current investing trends within the sustainable fund landscape.

Sustainable Investment Definitions Differ…

As the sustainable investment landscape continues to evolve, there remain varying approaches and interpretations of what constitutes a sustainable investment. From funds that include values-based exclusions, to those that integrate ESG factors for risk mitigation or thematic alignment, the term sustainable investment (or ESG) has become a catchall and, as such, data providers and analysts differ on the definitions they use for what they claim to be a "sustainable fund." At Morningstar, for instance, a fund will be tagged as a "sustainable investment" if the fund, per the fund's prospectus, incorporates sustainability as a central part of its investment process.[1] This classification includes those funds that take an exclusionary or ESG integration approach as well as those that focus on intentionally contributing to defined sustainability themes.

The varying approaches to sustainable investing, coupled with the industry's lack of standardized definitions, makes it difficult to make broad assumptions about the state of sustainable and ESG funds and therefore to accurately interpret investors' appetites for certain strategies and approaches by looking exclusively at the top-line flow-of-funds data.

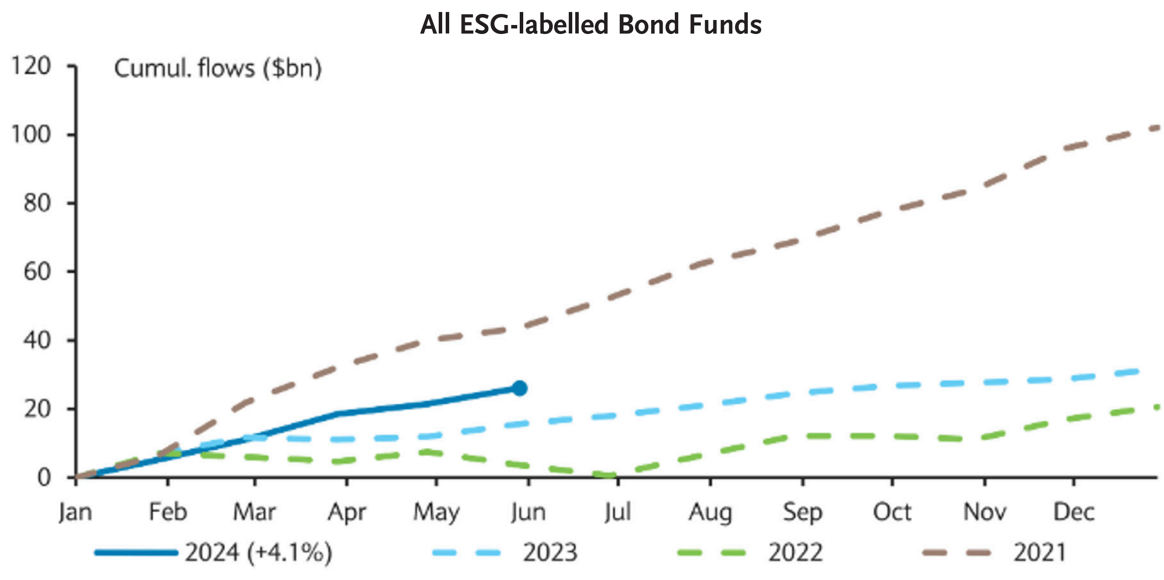
… So Too Do Regional and Asset Class Appetites

Investors' appetites and approaches to sustainable investing also vary greatly by geography. For instance, in Europe, sustainable funds experienced positive inflows in the first quarter of 2024, amounting to approximately $11 billion. This is more than double the amount from the previous quarter and an indication of strong and growing interest in ESG and sustainable investing among European investors. In contrast, the United States faced its worst quarter on record with unprecedented outflows from sustainable funds, signaling a challenging period for sustainable investment funds among U.S. investors.

Across all regions, there is a discernible trend towards passive sustainable investment strategies, particularly in Canada, where passive funds accounted for the majority of inflows. In Europe, passive funds saw inflows of around $22 billion, whereas active funds experienced outflows of $11 billion. It is important to highlight that while recent outflows have been notable, they represent a small fraction of the broader global sustainable fund assets, which has overall increased in the first quarter of 2024 by 1.8% to just under $3 trillion, with passive strategies contributing significantly to this growth.[2]

Remaining positive across all regions during the first quarter of 2024, sustainable fixed income flows were another bright spot at the start of the year.

Fixed Income – Sustainable Flows (YTD as of June 2024)



Source: EPFR, Barclays Research
Based on monthly reporters, one-month lag. Based on fund AUM.

Net flows into fixed income funds also outpaced other asset classes in specific regions. Sustainable bond funds, for their part, experienced net inflows totaling $19.6 billion, soaring by 244% from the previous quarter. In the U.S., sustainable equity funds shed $9.5 billion during the quarter, while sustainable bond funds swung back into positive territory with $774 million in net inflows.[2]

When evaluating flow data within the fixed income fund landscape, it is important not to dismiss investor trends across the broader market. For instance, given the current economic backdrop, it is no coincidence that sustainable fixed income funds saw inflows versus their equity counterparts, as this trend aligned closely with the broader market.

Although fund flows are commonly viewed as a measure of investor interest, it is important to note that the approximately $3 trillion[2] in sustainable funds and ETFs represents just a small segment of the wider sustainable investment landscape, which includes separately managed accounts for institutional investors. While the data can be hard to come by, according to the U.S. Sustainable Investment Forum, there are almost $8.4 trillion in total sustainable investment assets under management, and that just accounts for the U.S.[3]

What is a Labelled Bond?

- Labelled bonds are debt securities whose use of proceeds are earmarked for green, social, or sustainable purposes, in accordance with an issuer's labelled bond framework.
  - Green bonds fund projects or activities with an environmental benefit. A climate awareness bond was the first type of labelled bond issued by the European Investment Bank in 2007.
  - Social bonds fund projects or activities with a social benefit.
  - Sustainable or sustainability bonds fund projects or activities that can flexibly be used for either a green and/or social benefit.
- Labelled bonds can also be sustainability-linked, defined as bonds whose proceeds can be used for general corporate purposes. However, in issuing these bonds, the issuer makes a contractual commitment to investors that they will meet a pre-specified ESG-related performance target over a pre-defined period prior to bond maturity. If the issuer fails to meet this target, a coupon step-up or penalty will apply.
- For further information on these types of securities, please review the International Capital Market Association's sustainable finance resources or learn more from Climate Bonds Initiative's Standard.

Looking Beyond Just Fund Flows, the Labelled Bond Market Continues to Grow
Perhaps driven by investor demand for fixed income or broader investor appetite for targeted sustainable assets, sovereign and corporate issuers have continued to issue into the green, social, sustainability, and sustainability-linked (GSS+) labelled bond markets.

According to the Climate Bonds Initiative, the first quarter of 2024 was the most prolific on record for GSS+ issuance, with over $270 billion issued in the first quarter of the year. Green bond issuance accounted for nearly three-quarters of issuance in the quarter, signaling strong investor and issuer interest for environmentally friendly assets. Sovereigns, government-backed corporates, and local governments issued nearly 40% of the quarter's labelled instruments, with non-financial corporates responsible for another 37% of issuance.[4]

Other estimates from market analysts suggest that overall issuance is on track to exceed $1.1 trillion this year, suggesting that "green" financing momentum persists despite some of the backlash that has deterred issuance growth in the U.S., where issuance in 2024 so far falls short of what was realized last year.

Given all the above, digging deeper than the headlines yields a nuanced picture of the sustainable fund landscape.
Beyond the factors already mentioned, the sustainable fund market has evolved significantly with improved disclosures, clearer definitions, and enhanced transparency for fund managers. While we expect sustainable fund flows to generally follow market trends and track performance, we also foresee the potential closure of funds and the redirection of investments away from offerings that fail to fulfill the criteria of a reputable sustainable product. Considering that the industry has yet to establish universally accepted definitions for ESG or sustainable funds, it is prudent not to assign too much weight to headlines tracking fund flows. ■

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Ms. Franco is the Global Head of Sustainable Investment. In this role, she heads the Sustainable Investment Group and is responsible for leading TCW's sustainable investing efforts, including ESG integration across the firm's investment platform and business strategy. She is also responsible for sustainable investment and ESG integration within fixed income sectors. Before assuming her current role, she was a Senior Account Manager and Fixed Income Product Specialist within the Client Services group. Before joining TCW in 2014, Ms. Franco spent over a decade at the U.S. Department of the Treasury in Washington, D.C., serving in several roles, including as Senior Advisor to Treasury Leadership in both the domestic and international divisions, International Economist, and Deputy Director of the International Banking and Securities Markets Office. Ms. Franco was also an Advisor to the U.S. Executive Director at the International Monetary Fund for several years. Ms. Franco holds a BA in Political Science from Johns Hopkins University and an MA in International Economics from Johns Hopkins School of Advanced International Studies. Additionally, she holds Series 7 and 63 FINRA licenses.

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