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ESG ETFs 2021

State of the market and the potential for sustainable development

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Executive summary

Sustainable funds, which include passively and actively managed mutual funds, ETFs, and other funds, have been growing rapidly since 2015. ESG ETFs are a subset of this market and offer a low cost, accessible route to investing sustainably. Moreover, the market has the potential to contribute to sustainable development in developing countries, and to specific investments in sectors relevant to the attainment of the UN's Sustainable Development Goals (SDGs).

Key findings of the report include:

- In 2020, the number of ESG ETFs jumped 59% to reach a record level of 552 funds, with AUM of over $174 billion. Net inflows to these funds reached almost $79 billion.
- Although ESG ETFs have been growing faster than the growth rate for non-ESG ETFs, their share of the ETF universe remains small at 8% and their share of AUM even smaller at 2%.
- While North America remains the main market for ETFs overall, the picture is different for ESG ETFs where Europe dominates the market in terms of number of funds and AUM. Developing economies now have a significant share of the ETF market but are almost entirely absent from the ESG ETF segment. This raises questions about how these economies can better leverage the potential of ETFs for sustainable development.
- Average 1-year net returns for ESG ETFs were 15%, with positive average net excess returns, versus 9% for non-ESG ETFs, that had negative average net excess returns. This indicates that investors did not pay a systematic 'performance penalty' for pursing a more sustainable investment strategy.
- The average sustainability performance of ESG ETFs, as a group, is higher than for non-ESG ETFs, and their sustainability ratings are positively correlated with the increasing sophistication of ESG strategy. In 2020, the number of funds targeting the SDGs grew to 38% of all ESG ETFs and now represent almost $72 billion in assets allocated to sectors or themes of relevance to the SDGs.
- Going forward, efforts will be needed to improve and expand sustainability ratings to cover, for example, the SDGs. These efforts can help to mitigate the risk of "ESG or green washing" and to ensure that ETFs and the wider fund industry contribute to sustainable outcomes, including the UN's SDGs.
- Measures to enhance transparency include self-reporting, supported by external auditing, as is required for companies. Meanwhile, stock exchanges can put in place relevant guidelines or demand greater sustainability performance and disclosure in their listing requirements. Finally, action will be needed to support the growth of sustainable funds both domiciled in, and with a portfolio exposure to developing countries.

About the UNCTAD Investment and Enterprise Division and the SDG Investors Partnership

The UNCTAD Investment and Enterprise Division is the focal point in the United Nations System for investment and enterprise development. As a global centre of excellence, the Division conducts leading-edge research and policy analysis, provides technical assistance to 160 member States and regional groupings, and builds international consensus among the 196 member States of the organization. Its mission is to promote investment and enterprise for sustainable development and prosperity for all.

The SDG Investors Partnership, initiated by the UNCTAD Investment and Enterprise Division, aims to foster partnerships among institutional investors, governments, and international organizations to facilitate institutional investment in key SDG sectors, in particular in developing countries. The Initiative, in partnership with all stakeholders, seeks to create an enabling environment for SDG-oriented investment by institutional investors through evidence-based research, dissemination of best practices and international standards, consensus building and policy advocacy on strategic issues that are critical for facilitating institutional investment in sustainable development.

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1. Introduction

The past decade has witnessed a surge of sustainability-themed financial products in variety, number and assets. The current global efforts to fight the pandemic are also boosting the growth of sustainability financing, particularly in social and sustainability bonds. UNCTAD estimates that the total value of private sustainability-oriented bonds and funds is now roughly $1.5 trillion (UNCTAD, forthcoming).

Sustainable investment has a long-standing provenance, the scope of which can cover everything from socially responsible investing to the integration of ESG criteria in investment decisions. Today, the UN's Sustainable Development Goals (SDGs) have also added another, broader dimension to the sustainable investment landscape. The growing popularity of sustainability as an investment strategy, the introduction of the SDGs that can function as a benchmark for sustainability performance, and even the impact of the COVID-19 pandemic in 2020, is driving a rapid reorientation of financial markets and products towards sustainable investments, especially in the fund industry (UNCTAD, 2020a).

Investment vehicles with an ESG or SDG dimension that mobilize capital at large scale can make a difference. One such vehicle that offers this potential is ESG ETFs — exchange traded funds (ETFs) based on corporate environmental, social and governance (ESG) factors. In 2020, the numbers of these funds and their assets under management (AUM) jumped significantly from 2019. In recent years, growth of this asset class has been explosive and, as the fund industry and companies increasingly pivot towards sustainability in their asset allocations and activities, the trend looks set to continue - already, forecasts from 2019 hugely underestimated the trend in 2020 (UNCTAD, 2020b)

There are three reasons why ESG ETFs have the potential to be a suitable investment vehicle for sustainable development. First, ETFs are low-cost, mostly passive financial instruments that offer investors different ways to focus on specific sectors, themes or even specific countries or country groups. Second, ETFs that consider ESG criteria in their portfolio are increasing rapidly, with record growth in 2020. Third, the largest group of investors in ESG ETFs consists of institutional investors,[1] ranging from heavyweight sovereign wealth and pension funds to niche investment firms. These investors have significant funds at their disposal and are also increasingly convinced that long-term financial performance is correlated with superior ESG performance.[2]

This paper aims to (1) provide an overview of the ESG ETF landscape in 2020 and identify key trends in the growth and distribution of ESG ETF funds; and, (2) assess their financial and sustainability performance, as well as their contribution to the SDGs.

2. Overview of the ETF universe in 2020

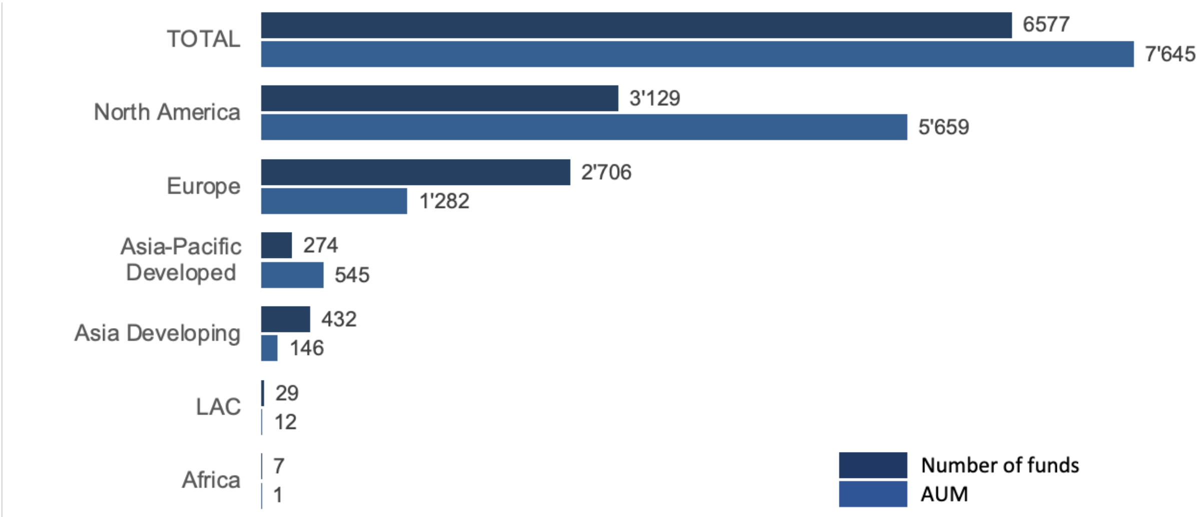
According to data from TrackInsight, the total number of ETFs in 2020 reached 6,577, up 14% from 2019, with assets under management of over $7.6 trillion (figure 1). This represents about

[1] Even though institutional investors make up the largest group of ESG ETF investors, retail investors – especially in the U.S. – play an increasingly important role (Morningstar, 2018).

[2] An increasing share of investors strongly considers ESG criteria because they believe that good sustainability ratings result in superior returns in the long run (BNP Paribas, 2019).

14% of the world's open-ended funds.[3] There has been a steady rise in the number of ETFs and their AUM since 2015, with the number of ETFs created post-2015 growing at a compound annual rate of 14% and now accounting for more than half of all ETFs. Removing ESG ETFs from this picture, which are discussed separately below, net inflows to non-ESG ETFs in 2020 represented 8.5% of total AUM, at $635 billion. This reflects the growing popularity of ETFs as an asset class and the momentum towards greater use of passive investment strategies, especially by retail investors (passively managed funds accounted for 83% of all non-ESG ETFs).

Figure 1. Global ETFs, 2020 (number of funds and billions of dollars)



Source: UNCTAD based on Trackinsight data
Note: LAC – Latin America and the Caribbean

In terms of the regional distribution of the ETF market, the majority of fund issuers, as well as index providers, are domiciled in developed markets. North America, principally the U.S., accounts for almost half of ETF issuers, followed by Europe, which accounts for 41%. Developed Asia-Pacific funds account for 4% of the total. Developing Asia ranks third in terms of number of funds, accounting for 7% of the global total, and the majority of developing economy domiciled funds. However, about 14% of the 213 global index providers are based in developing countries, and almost 280 out of 468 developing country funds use one of these 29 developing country indexes.[4]

However, the geographical landscape of funds changes when looking at the distribution of funds by AUM. North America accounts for a far greater share of total funds, at 74%, compared to Europe at 17% and Developed Asia-Pacific at 7%. Developing countries as a whole account for just 2% of global assets invested in ETFs. North America's proportionately larger share of AUM may be explained by the fact that in addition to institutional investors, retail investors in the U.S. are also actively investing in ETFs (Morningstar, 2018). In contrast, Europe's share

[3] According to the quarterly statistics of the European Fund and Asset Management Association (EFAMA), assets of regulated, open-ended funds worldwide (fund of funds excluded) were about $54 trillion at the end of the second quarter of 2020.
[4] The data may not capture all ETFs in the Asia-Pacific region (developed and developing) due to lack of publicly accessible information.

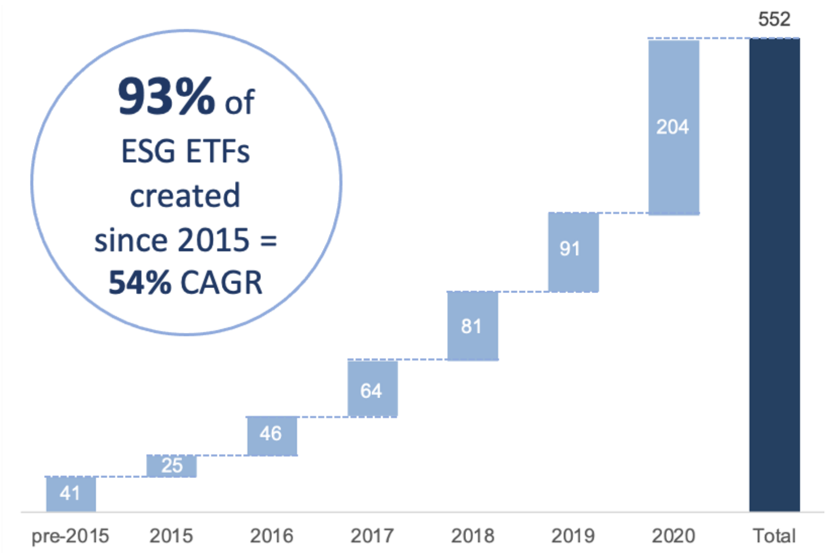
of AUM is proportionately smaller because of Europe's geographically fragmented market, in which fund providers offer the same product on multiple exchanges (Morningstar, 2019). Additionally, its more fragmented and sometimes less beneficial tax treatment of ETFs might further explain the difference.

3. The accelerating growth of the ESG ETF market in 2020

Global and regional trends

ESG ETFs – that have a specific focus on ESG themes, or which integrate ESG factors into their investment strategy – have been growing at a compound annual rate of 54% since 2015 — much faster than non-ESG ETFs (figure 2). Their relative newness explains the fact that more than 90% of ESG ETFs were created since 2015. However, their share of the ETF universe in terms of both fund numbers and, even more so, AUM, remains small.

Figure 2. Growth of ESG ETFs since 2015



Source: UNCTAD, based on Trackinsight data
Note: CAGR is the compound annual growth rate

A subset of the ETF universe, the number of ETFs with an ESG tilt – so-called ESG ETFs – saw exceptional growth in 2020. ESG ETFs jumped by 59% in 2020, from 345 funds to 552 funds, with total AUM reaching over $174 billion. Net inflows to all ESG ETFs in 2020 rose to $78.8 billion, representing 45% of total AUM invested in these funds. This contrasts with the comparatively lower share of net inflows to non-ESG ETFs, at 8.5% of total AUM. Nevertheless, despite the dramatic jump in the number of funds and their assets, the share of ESG ETFs in the ETF universe remains small at just over 8% and 2% respectively.

In a reversal of the picture for the overall ETF universe, the regional distribution of ESG ETFs saw North America account for 29% of funds in 2020, down from 31% in 2019. Europe, accounted for over two thirds of funds, up from 59% the previous year. The picture changes slightly when looking at the regional distribution of assets, where North America's share rises to 38% of AUM, and Europe's falls to 58%. Developing country funds account for less than

2% of ESG ETFs, with none in Africa, and their AUM for less than 1% of all ESG ETF assets. Nevertheless, the AUM of the two Latin American ESG ETFs represent nearly 7% of all Latin American ETF AUM.[5]

Financial performance and costs of ESG ETFs

In the past, funds with a sustainability or ESG tilt were often perceived as being relatively more expensive and having lower returns. An analysis of the 552 ESG ETFs in 2020 reveal that neither of these perceptions is correct with regard to the ETF market (Table 1). Average 1-year net returns for all non-ESG ETFs were 9% at the end of 2020, ranging from a high of 19% for the Developing Asia funds to a low of 5% for Developed Asia-Pacific funds. The average 1-year net excess returns (calculated as the difference between fund performance and index performance) for all non-ESG ETFs was -0.193%, meaning that the non-ESG ETFs underperformed their benchmark indexes.

Table 1. Financial performance of ETFs (1-year net return and 1-year net excess return), to end-2020 (per cent)

	non-ESG ETFs		ESG ETFs	
Region of domicile	1-year aveage net return	1-year average net excess return	1-year aveage net return	1-year average net excess return
North America	8%	-0.427%	25%	0.115%
Europe	8%	-0.262%	11%	-0.131%
Asia-Pacific Developed	5%	-0.315%	9%	0.894%
Asia Developing	19%	1.664%	35%	4.491%
LAC	9%	0.136%	9%	-0.198%
Africa	15%	4.758%	-	-
Developing total	14%	2.186%	22%	2.146%
TOTAL	**9%**	**-0.193%**	**15%**	**0.028%**

Source: UNCTAD, based on Trackinsight data
Notes: The very recent creation date of some funds means it is not possible to make meaningful comparisons over a longer time horizon; LAC – Latin America and the Caribbean; net excess returns are distorted because either there is no data, or the fund is actively managed, or the fund has a dynamic currency hedge.

For all ESG ETFs, the average 1-year net returns were 15%, some 6 percentage points more than for non-ESG ETFs. The returns ranged from a high of 35% for the seven Developing Asian funds to lows of 9% for Developed Asia-Pacific funds and the two Latin American funds, although the small number of funds risks distorting the performance of these three groups. Given the very recent creation dates for a large number of ESG ETFs (see figure 2 above) the returns will be exaggerated. The net excess returns for all ESG ETFs were 0.028%, meaning that, as a group, these funds outperformed their benchmark indexes, although European and Latin American funds underperformed their benchmarks.[6] Nevertheless, they still performed better than their non-ESG ETF counterparts. Data for 3-year average net returns and excess returns, while distorted by the recent creation dates especially of ESG ETFs, nevertheless paint a similar picture of ESG ETFs outperforming their non-ESG ETF peers. However, more

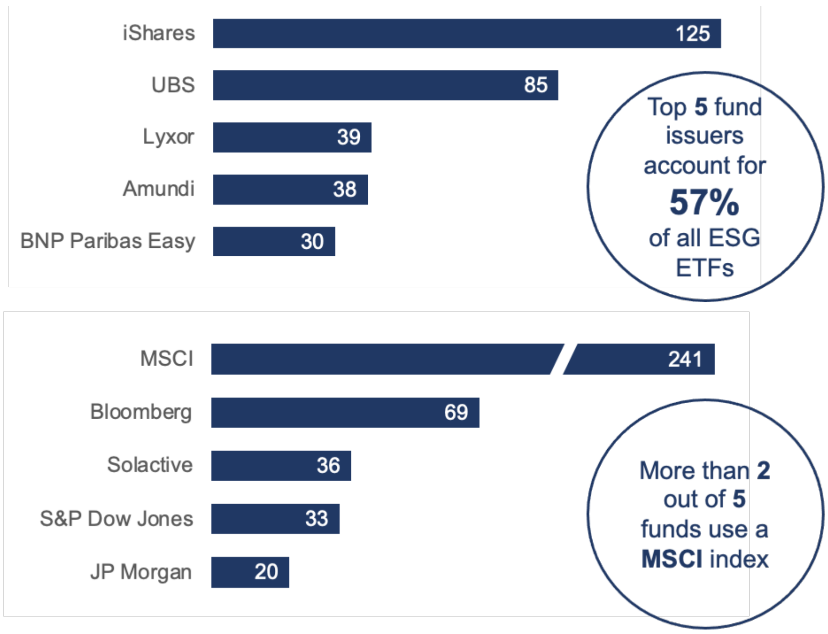
[5] The data may not capture all ETFs in the LAC region due to lack of publicly accessible information.
[6] Strong net excess returns for APAC funds results from the use of price indices that exclude dividends.

research would be needed to better explain the differences between the two groups of funds, perhaps involving among other things exposure to different asset classes, regions or sectors.

In terms of the costs of the funds, the average net expense ratio for non-ESG ETFs, as a group, is higher at 0.46%, than for ESG ETFs, at 0.30%. One reason that might explain this difference is the greater share of ESG ETFs that are passively managed (90%) compared with non-ESG ETFs (84%). However, more research would be needed to better explain the cost differences between the two groups of funds.

Another factor that might be having an impact on cost differences is the apparent reduction in the market concentration of fund issuers and index providers for ESG ETFs. In 2020, a greater range of fund issuers and index providers entered the market reducing the concentration of leaders, such as MSCI or UBS and iShares and, at the same time, illustrating the potential of ESG products for new index and fund providers. This year, UBS and iShares saw their share of the ESG fund market fall from 46% in 2019 to 38% in 2020 in terms of the numbers of funds (figure 3). However, the two fund providers still account for almost 60% of ESG assets under management. MSCI's share of the ESG ETF index market fell from 55% to 44% in terms of the numbers of funds using their indexes. Nevertheless, two out of five funds still use a MSCI index, and five issuers still account for 57% of all funds.

Figure 3. Top 5 ESG fund issuers and top 5 indexes used by ESG ETFs, 2020 (number of funds)



Source: UNCTAD, based on Trackinsight data

Trends and drivers of ESG ETFs

There are several reasons explaining the trend towards investing in ESG ETFs (see for example, UNCTAD, 2020b; UNCTAD, 2020c) and the significant jump in 2020. Some of these reasons are positive, such as the increasing desire by both institutional and retail investors to consider sustainability in their investment decisions and the conviction that this should not entail a financial penalty – indeed, in view of the material risks presented by, for example, 'stranded assets' (Carbon Tracker, 2013), ESG ETFs offer a financial opportunity or hedge. Additionally, as highlighted above, ESG ETFs have performed relatively better than non-ESG ETFs over the past year.

The jump in 2020 requires a moment's pause for reflection. It is possible that the dramatic increase represents a step change or tipping point. Since the announcements by major fund providers like Blackrock and other institutional investors to divest or exclude carbon-related assets, the market for ESG ETFs and sustainable investments more broadly has attracted unprecedented attention – a positive development in the process of aligning all financial markets with sustainable outcomes. However, there is a risk that fund providers have also seized on a market opportunity – not a bad thing in itself – raising the possibility for green or ESG washing. However, TrackInsight data reveals that only 12 ETFs were reclassified as ESG ETFs in 2020 by switching their benchmarks. Reclassification can be legitimate and help identify existing funds as sustainable,[7] but an accurate assessment of the sustainability performance is still necessary, which the next section highlights.

4. The sustainability performance of ESG ETFs

The growth of sustainable financial products, like ESG ETFs, supports a larger trend towards sustainable investing that seeks both to benefit investors and advance wider social, environmental and governance agendas, such as climate change mitigation. However, within these categories there is wide variance of the sustainability performance of the products (UNCTAD, forthcoming). Accurate measurement and assessment of the sustainability credentials of ESG ETFs is therefore essential for directing more inflows to the market, improving the overall sustainability outcomes of the market, and reducing the risk of "ESG washing".

This section analyses the ESG tilt of the 552 funds and assesses their sustainability credentials more closely, including mapping their ESG dimension against the SDGs and their contribution to the goals. By using the sustainability rating scale provided by Conser[8] this section analyses the sustainability of 430 ESG ETFs, for which there are Conser ratings, and by ESG strategy, that is, (i) general integration, (ii) best-in-class, (iii) ESG thematic strategies, and (iv) exclusion screening, as well as the sustainability of 3,041 non-ESG ETFs for which there are Conser ratings. Based on these ratings, the average group score for ESG ETFs is 6.5 out of 10, or B. This compares to an average for the non-ESG ETF group of 4.1 out of 10, or C+ (figure 4). This is slightly down on 2019, where ESG ETFs scored 7.5 as a group, and non-ESG ETFs scored 4.8 as a group, although the sample size for the analysis is significantly bigger for 2020 making the results more robust.

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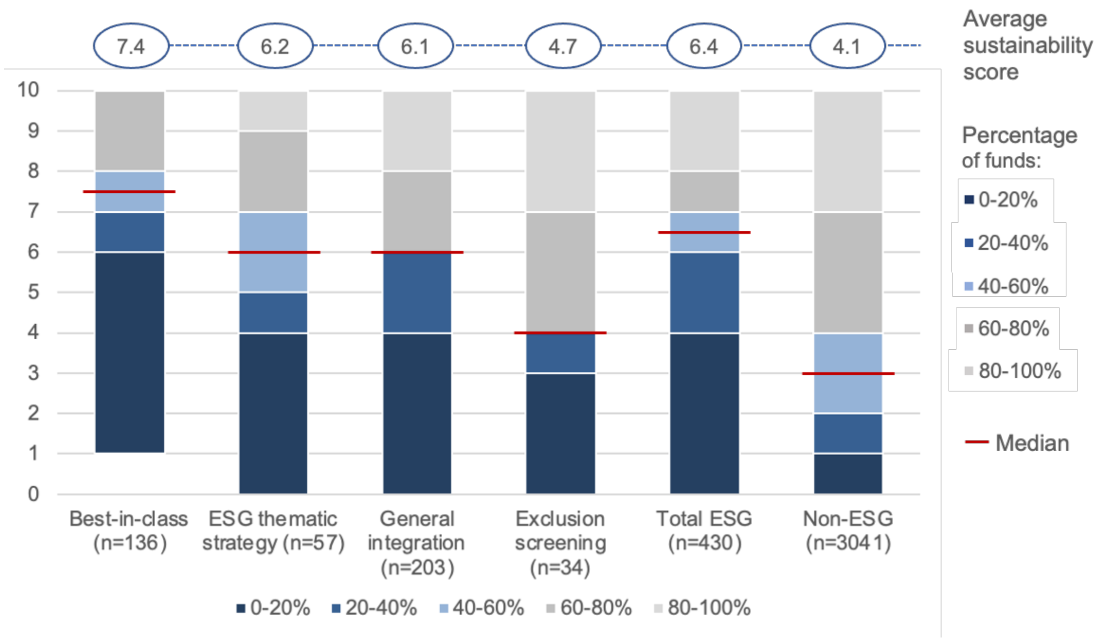
[7] The EU's Sustainable Finance Disclosure Regulation (SFDR), for example, requires all financial market participants in the EU to disclose on ESG issues, with additional requirements for products that promote ESG characteristics or that have sustainable investment objectives.

[8] Conser's methodology provides a holistic picture of the sustainability risks of an investment by conducting a meta-analysis of quantitative and qualitative ESG data based on "collective intelligence", that reflects the implicit evaluations of major ratings agencies and leading sustainable asset managers to arrive at an "average" ESG consensus rating. Conser uses an incremental sustainability score, i.e., a granular scale with 10 levels: A+, A, A-, B+, B, B-, C+, C, C-, and D. For this analysis, the incremental sustainability scores are numerized by equating each of these scores to a number between 1 to 10, e.g., 10 for A+, 6 for B, and 1 for D, to determine average scores and the distribution of the sustainable funds in the sample.

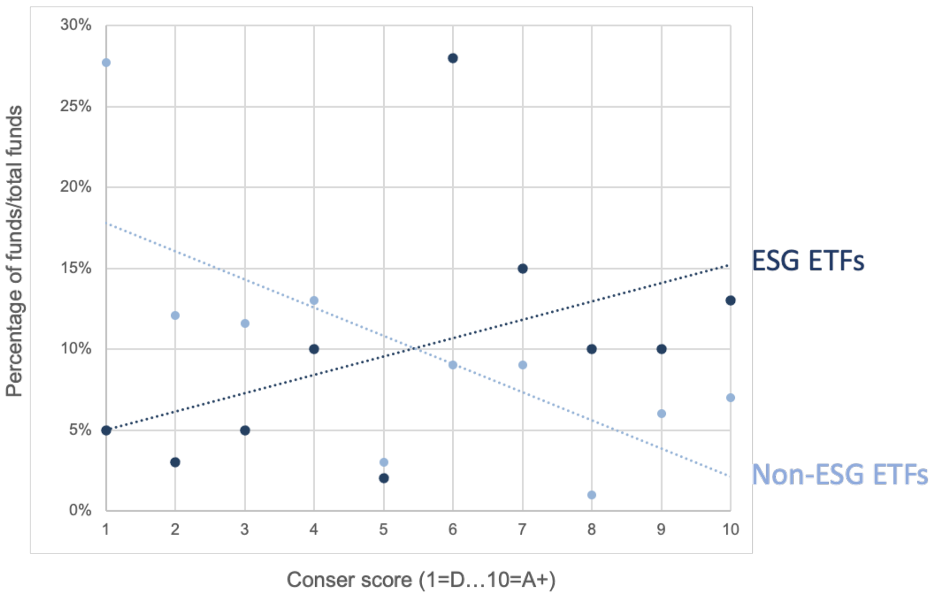
Figure 4. Distribution of sustainability scores by ESG strategy, 2020



Source: UNCTAD, based on Conser and Trackinsight data

The results confirm that ESG ETFs are rated more highly than non-ESG ETFs, in terms of their sustainability performance, with the median score for all ESG strategies higher than for non-ESG. A line of best fit also confirms that more ESG ETFs are distributed towards higher sustainability scores while more non-ESG ETFs are distributed towards lower sustainability scores (figure 5).

Figure 5. Distribution of ESG ETFs as a group versus non-ESG ETFs, 2020



Source: UNCTAD, based on Conser and Trackinsight data

The ESG funds exhibit better sustainability ratings with increasing sophistication of sustainability integration. Best-in-class strategies score the highest with the top 40% of funds in this group scoring A- to A+ and none rating a D. ESG thematic strategies and general integration strategies score similarly but thematic strategies have a larger concentration of top scores, A- to A+. Exclusion screening, which is considered the least sophisticated ESG strategy, has a higher average score than non-ESG, which is an improvement on 2019 when its mean score was lower than for non-ESG funds.

Despite concerns about "ESG washing", the above findings show that ESG ETFs on average have higher sustainability ratings than their non-ESG peers. This conclusion holds true for ESG funds as a group and for all ESG subgroups by strategy, which is an improvement on 2019, when exclusion screening strategies scored lower than the average for non-ESG funds. However, this conclusion does not rule out the fact that even non-ESG ETFs can score higher in terms of sustainability than some of their ESG counterparts on a case-by-case basis. The wide variance in ratings among ESG funds also indicates a large share of underperforming funds in this group that still do not meet their self-declared credentials as "sustainable".

5. The UN Sustainable Development Goals: an emerging benchmark for sustainability

UNCTAD's World Investment Report 2014 estimated that developing countries alone face an annual SDG financing gap of $2.5 trillion (UNCTAD, 2014). The rapid rise of sustainable investment funds, including ESG ETFs, could play an important role in filling this gap. However, the lack of a taxonomy to define what counts as SDG investment as well as the poor quality of existing SDG ratings for individual companies, makes it extremely challenging to measure or assess the SDG alignment of investment funds and how much of their portfolio is invested in assets that contribute to the delivery of the SDGs.

Using Trackinsight data, UNCTAD has helped identify those ESG ETFs that target one or more of the 17 SDGs and to better assess the contribution of ESG ETFs to the goals, in terms of the allocation of their assets and their sustainability ratings. Building on last year's initial assessment, that looked exclusively at 49 funds using a thematic ESG strategy, this year's analysis includes all strategies and finds 208 ESG ETFs that target 11 of the 17 goals (figure 6).[9] This represents almost two out of five ESG ETFs and accounts for more than 40% of their AUM.

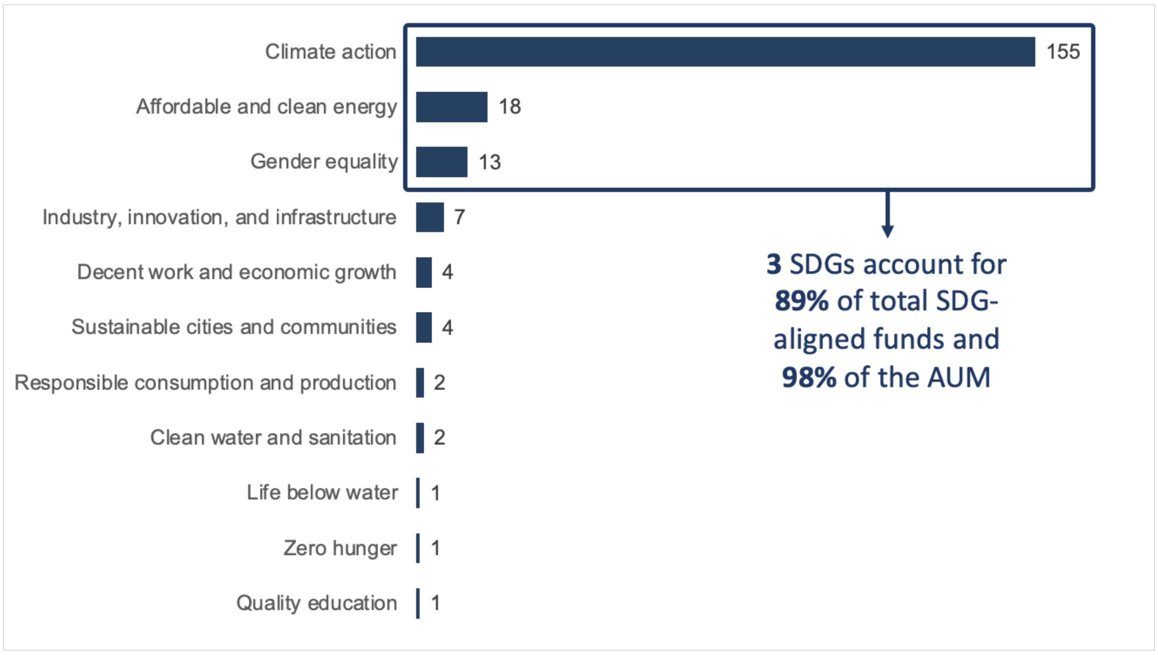
By far the most common goal targeted by these funds is climate action, followed by affordable and clean energy and then gender equality, which together account for 89% of the total SDG-oriented funds and 98% of their AUM, or over $70 billion. In terms of strategies, ESG thematic funds and best-in-class funds represent most of the SDG-oriented funds, with, respectively, 87% and 57% of these funds contributing to an SDG. General integration and exclusion screening strategies account for the least SDG-oriented funds, with, respectively, 16% and 11% of these funds contributing to an SDG. This more or less accords with the sustainability

[9] ESG ETFs are linked to a Sustainable Development Goal if an explicit tilt is included in the index methodology or security selection process. For example, fuel-free, green bond and low carbon are mapped to SDG 13 - Climate Action.

ratings of the funds, by strategy, and highlights the potential of the SDGs as a benchmark for sustainability performance.

Given the broad scope of the goals, they could provide a useful future indicator of sustainability performance that extends current ESG ratings to an ESG+ standard. Already, companies and some institutional investors (UNCTAD, 2020c) are reporting on their contribution to the SDGs and using the goals as a benchmark for a range of ESG-related policies and investment strategies. However, the range of funds specifically dedicated to the SDGs or to an SDG goal remains limited and, as yet, there is only one known company that has developed an index explicitly tracking companies with exposure to the SDGs and the least developed countries. Addressing these issues, among others, will be important to increase the contribution of sustainable funds, like ESG ETFs, to the SDGs, and to enhance the role of the SDGs as a useful benchmark for sustainability performance.

Figure 6. Ranking of SDGs by number of aligned ESG ETFs, 2020



Source: UNCTAD, based on Trackinsight data

6. Conclusions

Last year saw record growth in the number of ESG ETFs and their AUM. Europe is still the dominant market for ESG ETF funds, in contrast to ETFs as a whole, where North America leads. Developing markets represent a much smaller share of ESG ETFs by number and AUM than they do for non-ESG ETFs. The average financial performance of ESG ETFs, over the past year, was better than non-ESG ETFs indicating that investors did not pay a systematic 'performance penalty' for pursing a more sustainable investment strategy. The average sustainability performance of ESG ETFs, as a group, is higher than for non-ESG ETFs, and their sustainability ratings are positively correlated with the increasing sophistication of ESG strategy. In 2020, the number of funds aligned with the UN's SDGs grew to 38% of all ESG ETFs, and now represent more than $71 billion in assets allocated to sectors or issues of relevance to the SDGs.

Despite last year’s rapid growth in ESG ETF numbers and AUM, the broader share of all sustainable investment funds in the fund universe remains small at 2.8% (with ESG ETFs an even smaller subset of this share). The vast majority of these funds are domiciled in developed markets, and the benefits to developing regions have been much less significant. ESG ETFs reflect this broader trend. However, in a year that has seen financing for the SDGs go into reverse (UNCTAD, 2021), sustainable investment funds, including ESG ETFs, offer a potential source of capital that could be used to help fill the widening gap between current and required SDG financing, especially in developing countries.

The growth of the sustainable investment market depends on, and benefits from, enhanced industry standards and transparency. Meanwhile, continuous improvement in the sustainability of the whole fund universe is indispensable to make the fund market work for sustainable development. Therefore, sustainability integration should not be limited to sustainable funds alone. Instead, all market players, in particular index and fund providers, should strive to make all funds meet minimum standards of ESG compliance in the long run, and take actions to channel more investments into SDG-related sectors and issues, especially in developing countries.

Today, more than 90% of the world’s largest companies report on ESG or SDG issues, but very few funds are reporting on their own sustainability performance. By way of illustration, in this study, only 50% of all non-ESG ETFs had a sustainability rating, and even for ESG ETFs, sustainability ratings were only available for less than four out of five funds. The technical quality of funds, with respect to the contents of their underlying portfolio and possible tracking errors, is also not always obvious and changes over time. Fully transparent self-reporting would be a helpful first step towards more transparency and credibility, and the reporting should be further supported by external auditing, as is required for companies. Meanwhile, stock exchanges can put in place relevant guidelines or demand greater sustainability performance and disclosure in their listing requirements. These measures should help mitigate the risk of “ESG washing” and improve the real sustainability contribution of ETFs, and the fund industry more broadly.

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