Sustainable Investing Landscape for Australian Fund Investors
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Asset Flows to Australian Sustainable Investments Slow in First Quarter 2022

The first quarter of 2022 saw sustainable assets under management decline a little, despite net positive flows, largely because of macroeconomic headwinds that included inflationary pressures, rising interest rates, and market volatility. Retail assets invested in Australasian-domiciled sustainable funds as identified by Morningstar totaled AUD 37.988 billion at the end of the first quarter 2022, which was an 8.59% decline from the previous quarter. The recent market conditions have been difficult for sustainable investors. Many sustainable strategies tend to underweight or not hold the energy sector, which has performed well, and they have been negatively impacted by exposure to technology stocks, which have undergone recent downward pricing pressure after a sustained period of strong performance growth. Despite these short-term market challenges, sustainable assets globally have been more resilient when compared with the broader market. This quarterly paper highlights recent trends within sustainable retail investments in Australia.

Key Takeaways

- At the end of first-quarter 2022, assets invested in Australasia-domiciled sustainable investments were AUD 37.988 billion, equating to an 8.59% decrease compared with the quarter ended 31 Dec 2021. Whilst net inflows into sustainable funds remained positive, the decline in overall total assets reflects volatile market conditions. The decline in sustainable investments' asset values is not unique to Australasia, similar trends have occurred globally. Despite this difficult quarter, total assets invested sustainably have experienced a 41% increase compared with the first quarter of 2021. Further, assets invested in Australasia-domiciled sustainable investments more than doubled in the two years since 31 March 2020.
- Estimated first-quarter flows of AUD 1.122 billion were substantially lower than the previous record-breaking quarter, fourth-quarter 2021, equating to 68% less. Whilst flows were positive, weaker inflows are a trend we observed globally this quarter. Despite this, sustainable funds' inflows have held up far better than their conventional peers.
- Fifty-two percent of sustainable investments with five-year track records outperformed their peers within their respective Morningstar Categories. This is encouraging for investors looking to build environmental, social, and governance portfolios that align with their values, knowing that they won't sacrifice returns when compared with investments in mainstream funds.
- In the immediate-term, sustainable funds faced an extremely challenging first quarter, with only 26% of sustainable funds outperforming their peers within their respective categories. Performance of the broader market provides context; the S&P/ASX 200 Resources Index was up 15.4% for first four months of calendar-year 2022, compared with the broader S&P/ASX 200 Industrial Index, which had a performance outcome of negative 2.2%. With the rally in oil and gas prices, the S&P/ASX 200 Energy Index was up 31.8% year to date. Sectors that ESG strategies have traditionally favoured, such as healthcare and technology, performed particularly poorly. The S&P/ASX 200 Healthcare Index was down 8.0% over the same period, and the S&P/ASX 200 Information Technology Index was down 22.7%.

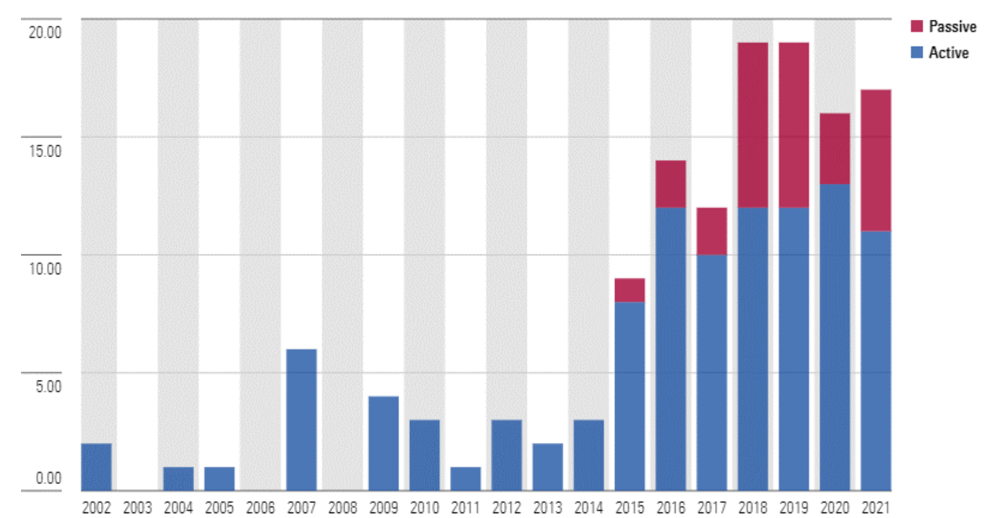
Sustainable investors should expect short-term fluctuations compared with the broader market as portfolios will tend to have certain structural biases in order to meet their sustainable objectives.

- Morningstar has identified 150 Australasia-domiciled (Australia and New Zealand) sustainable investments through our intentionality framework. Of these, 118 employ some form of exclusion from investment in controversial areas, with a high number of funds excluding tobacco (110) and controversial weapons (103 companies that derive a significant portion of revenue from nuclear weapons, land mines, cluster munitions, and so on).
- Compared with Europe and the United States, the sustainable funds market remains relatively small in Australia. No new funds were launched in the first quarter.
- Six fund houses dominated first-quarter flows, with Dimensional (AUD 333.67 million) atop a group that included Vanguard (AUD 262.95 million), Australian Ethical (AUD 216.47 million), BetaShares (AUD 170 million), Alphinity (AUD 118.03 million), and Nanuk (AUD 97 million). All these fund houses apart from Alphinity and Nanuk have multiple sustainable investment options contributing to total flows.
- When it comes to sustainable investing, active strategies are favoured over passive, although in the first quarter of 2022 the passive/active allocations were more evenly distributed, with 53% of flows going to active sustainable funds. When looking at total assets invested, 70% of assets are invested actively.
- The Australian Securities and Investment Commission has identified climate-related disclosures for listed companies and greenwashing as part of their corporate governance priorities in 2022.
- As stated in a recent global research report "Investing in Times of Climate Change 2022," beyond Europe, China, and the United States, Morningstar categorises all other countries as "rest of world." Australia has the most assets invested in climate-related funds in this rest-of-world category, with USD 2,447 million across 18 funds.

Product Launches

Compared with Europe and the US, the sustainable funds market remains relatively small in Australia. There were no new sustainable funds launched in the first quarter of 2022. However, a total of 17 funds were launched in 2021. As of 31 March 2022, Australasian retail investors had access to 150 Australasia-domiciled sustainable funds.

Exhibit 1 Australasia-Domiciled Sustainable Fund and ETF Launches

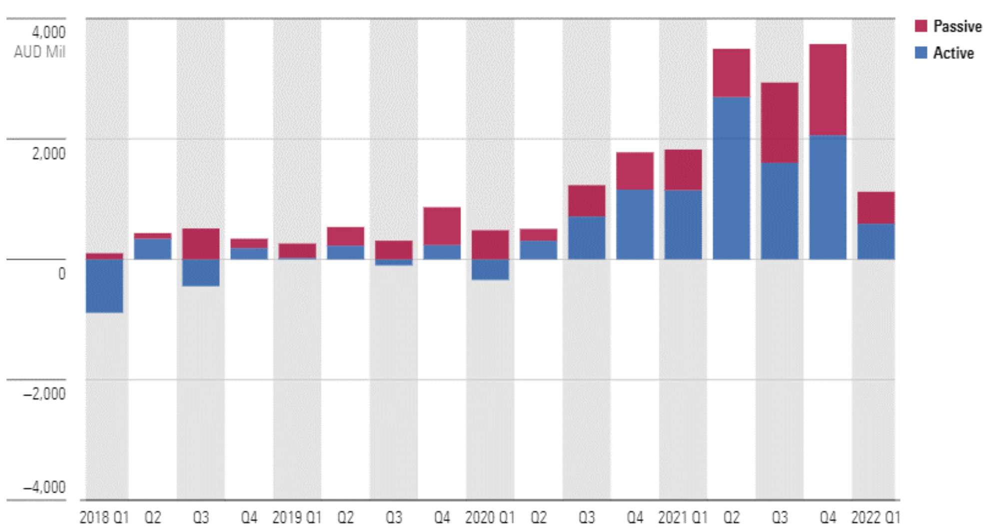


Source: Morningstar Direct. Data as of 31 March 2022.

Despite the lack of new funds launched to date in 2022, the momentum of sustainable fund launches has lifted significantly since 2015. Product launches are typically slower during first quarter of the year, and this metric doesn't capture asset managers repurposing and rebranding conventional products into sustainable offerings. Finally, the sustainable funds universe does not contain the growing number of Australasian funds that now formally consider ESG factors in their security selection.

Asset Flows

Exhibit 2 Estimated Net Flows of Australasian Sustainable Investments (AUD, Mil)

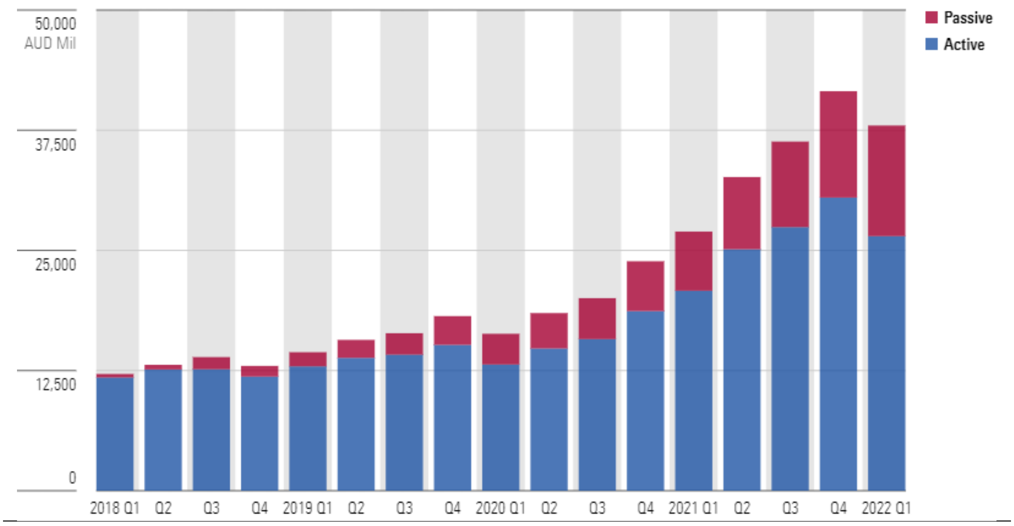


Source: Morningstar Direct. Data as of 31 March 2022. Excludes funds of funds.

- Estimated first-quarter flows of AUD 1.122 billion were 68% lower than the previous quarter. However, the previous quarter was record-breaking, attracting AUD 3.575 billion of inflows. Whilst flows this quarter were positive, the macroeconomic headwinds may be giving investors cause to pause. This is not unique to Australia; global sustainable investment inflows have contracted by almost 36% this quarter, which is the sharpest quarterly slowdown in three years and slightly higher than the 33% decline experienced by sustainable funds at the beginning of the coronavirus crisis. However, sustainable fund inflows have held up better than their conventional peers. Globally, we saw inflows fall 35.7% for sustainable funds, but the overall fund universe saw a significantly larger fall of 73%. Locally, we observed a similar trend, with sustainable fund inflows falling 68.62%, and the broader universe falling 86.20% in first-quarter 2022 when compared with the previous quarter.
- When it comes to sustainable investing, active strategies have consistently been favoured over passive, although in the first quarter of 2022 the passive/active allocations were more evenly distributed; 53% of fund flows were active. When looking at total assets invested, 70% of assets are invested actively.
- Six fund houses dominated first-quarter flows, with Dimensional (AUD 333.67 million) atop a group that included Vanguard (AUD 262.95 million), Australian Ethical (AUD 216.47 million), BetaShares (AUD 170 million), Alphinity (AUD 118.03 million), and Nanuk (AUD 97 million). The fund houses apart from Alphinity and Nanuk have multiple sustainable investment options contributing to total flows.

Aggregate Fund Size

Exhibit 3 Aggregate Fund Size of Australasian Sustainable Investments (AUD, Mil)



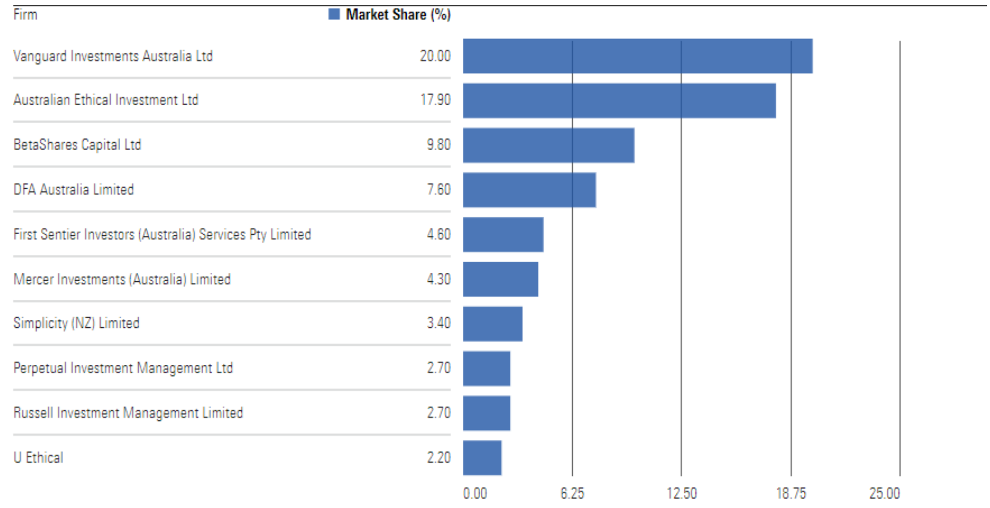
Source: Morningstar Direct. Data as of 31 March 2022. Excludes fund of funds.

- At the end of the first quarter 2022, assets invested in Australasia-domiciled sustainable investments were AUD 37.988 billion, an 8.59% decrease compared with the quarter ended 31 Dec 2021. Whilst inflows into sustainable funds remained net positive, the decline in total assets is a reflection of volatile market conditions. Falling equity markets during the first quarter, such as the technology sector, which is often overweight in sustainable strategies, coupled with a high-performing energy sector, which is typically underweight or not held by sustainable strategies, created a double downward hit. Despite this, total assets increased by 41% compared with the first quarter of 2021, and assets invested in Australasia-domiciled sustainable investments more than doubled in the two years since 31 March 2020.

- Globally, sustainable assets slipped, but the quarterly decline was less pronounced than the broader market, falling 4.0% compared with 5.5% for the market overall.

Asset-Manager Market Share

Exhibit 4 Estimated Market Share of the Top 10 Managers of Australasian Sustainable Investment Funds



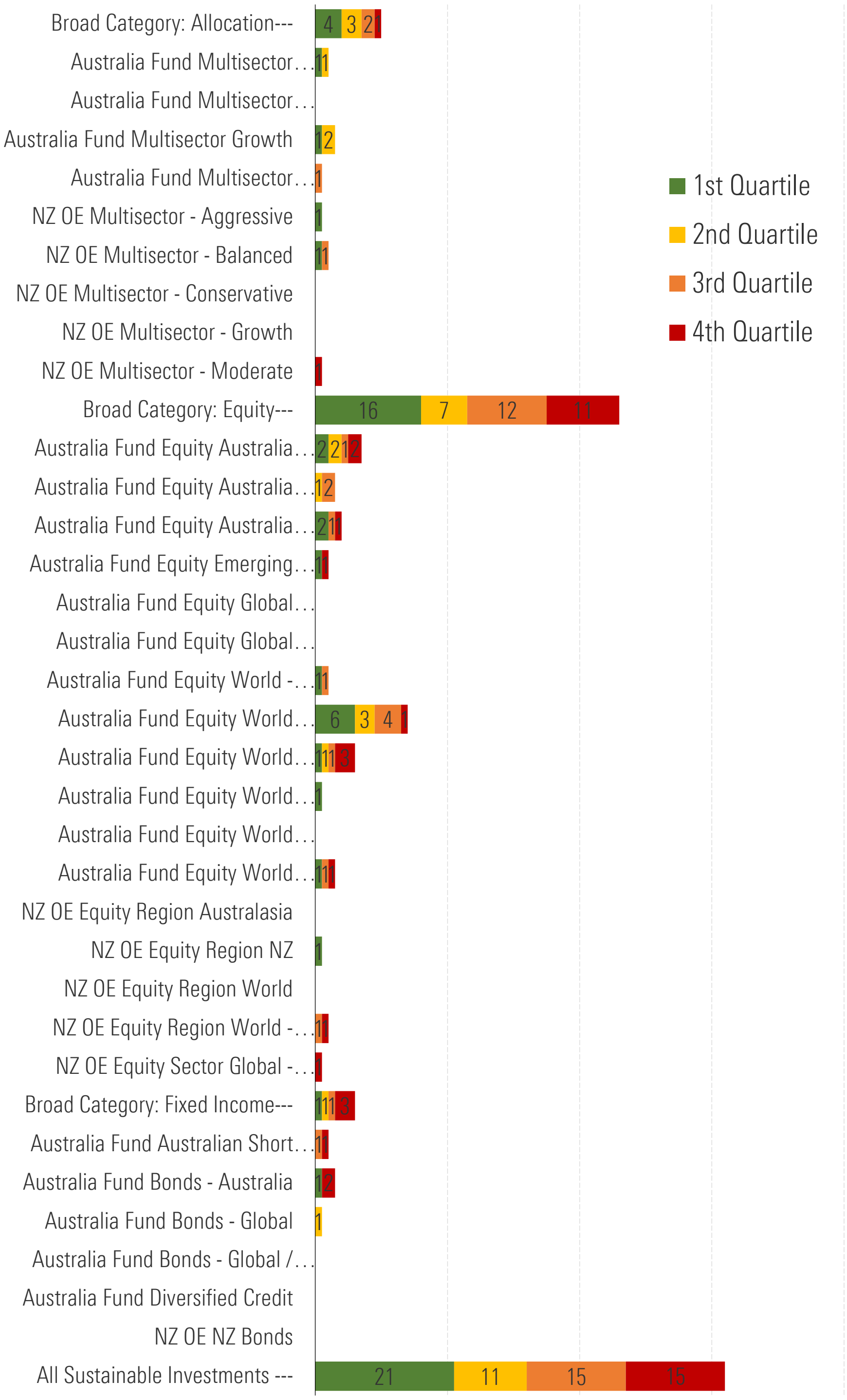
Source: Morningstar Direct. Data as of 31 March 2022. Excludes fund of funds.

- The Australian sustainable funds market remains concentrated, with the top 10 funds accounting for 75.3% of total assets in the sustainable fund universe.

At the fund level, asset managers Vanguard (20.0%) and Australian Ethical (17.9.%) continue to dominate, accounting for 37.9% of all Australasian sustainable fund assets in the Morningstar database.

Performance of Sustainable Investments

Exhibit 5 Total-Return Quartile Ranks of Sustainable Investments by Morningstar Category, 5 Years to 31 March 2022



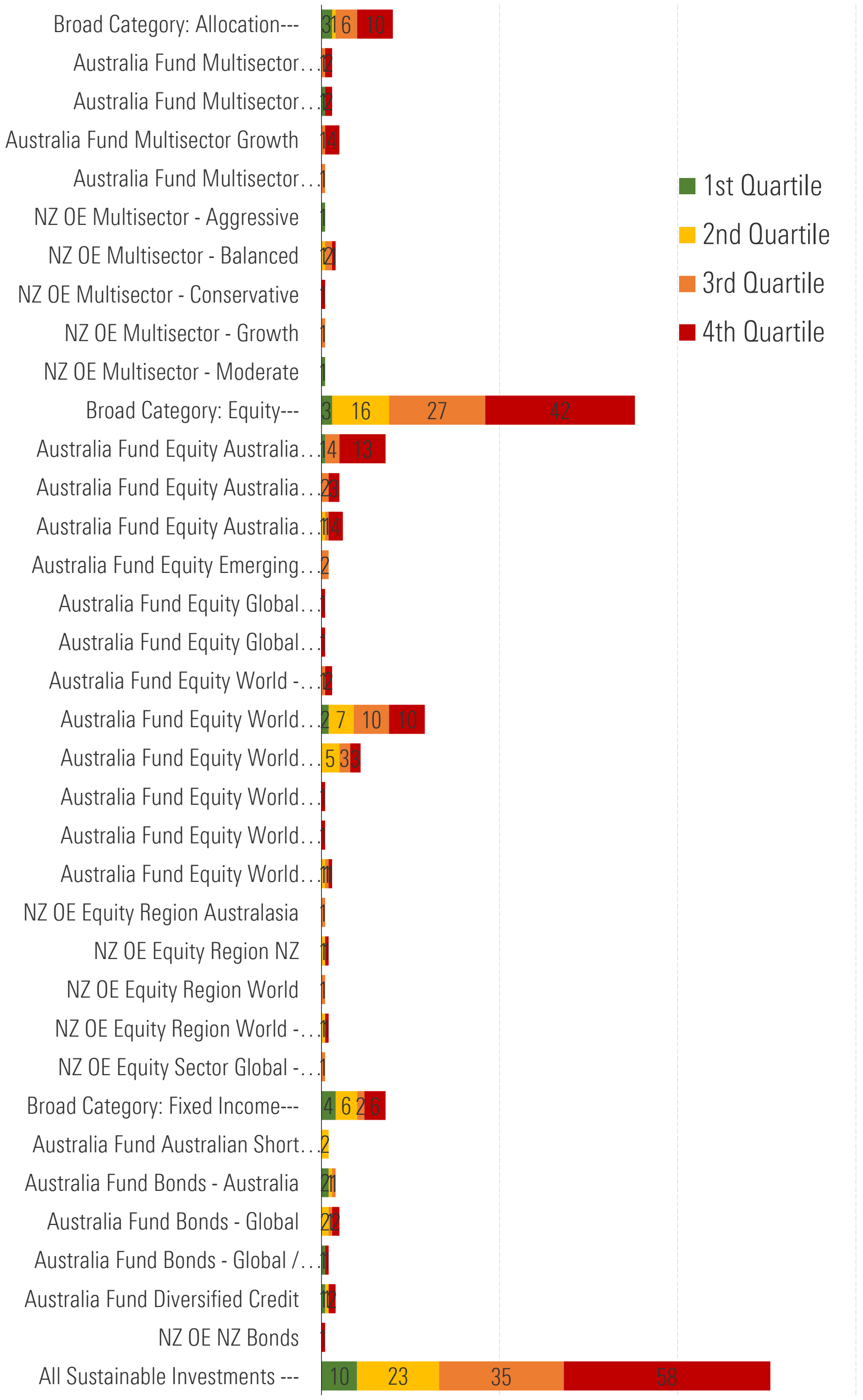
Source: Morningstar Direct. Data as of 31 March 2022.

Over the five years ended 31 March 2022, 52% (32 of 62) of sustainable investments that have a track record that long outperformed their peers within their respective categories. This is encouraging for investors looking to build ESG portfolios that align with their values, knowing that they won't have to sacrifice returns compared with mainstream funds to invest sustainably.

However, looking short term highlights the difficulties that sustainable funds have faced this quarter as only 26% (33 of 126) of sustainable funds outperformed their peers within their respective categories. Performance of the broader market provides context; the S&P/ASX 200 Resources Index was up 15.4% for first four months of 2022, compared to the broader S&P/ASX 200 Industrial Index, which had a performance outcome of negative 2.2%. With the rally in oil and gas prices, the S&P/ASX 200 Energy Index was up 31.8% year to date. Sectors that ESG strategies have traditionally favoured, such as healthcare and technology, performed particularly poorly. The S&P/ASX 200 Healthcare and S&P/ASX 200 Information Technology indexes were down 8.0% and 22.7%, respectively, over the period. Sustainable investors should expect short-term fluctuations compared with the broader market as portfolios will tend to have certain structural biases in order to meet their sustainable objectives. The long-term outcome is what matters, and the five-year data demonstrate that sustainable funds are delivering in line with peers.

Performance of Sustainable Investments

Exhibit 6 Total-Return Quartile Ranks of Sustainable Investments by Morningstar Category, 3 months to 31 March 2022



Source: Morningstar Direct. Data as of 31 March 2022.

Exhibit 7 Exclusionary Attributes: Controversial Products and Industries

Level 1	Employs Exclusions		
Level 2	Norms-Based Screening	Fur & Specialty Leather	Pesticides
	Abortion/Stem Cells	Gambling	Small Arms
	Adult Entertainment	GMOs	Thermal Coal
	Alcohol	Military Contracting	Tobacco
	Animal Testing	Nuclear	Other
	Controversial Weapons	Palm Oil	

Exclusionary Screening by Controversial Area

Morningstar identifies funds that explicitly state exclusions from controversial investment areas, a process that is similar but distinct from our identification of sustainable investments. A fund does not need to mention explicit exclusions to be deemed sustainable, and vice versa. Morningstar looks to regulatory filings to identify funds that use exclusions.

Note that "norms-based screening" refers to the citation of international agreements typically involving human rights, child labor, or exposure to conflict zones (for example, the UN Global Compact and Universal Declaration of Human Rights).

On this basis, nearly all Australasia-domiciled funds that Morningstar has identified employ some form of exclusion from investment in controversial areas, with a high number of funds excluding tobacco (109) and controversial weapons (102)—companies that derive a significant portion of revenue from nuclear weapons, land mines, cluster munitions, and so on. Gambling, adult entertainment, and alcohol are the next largest group of exclusions. Australians have limited choice in funds that exclude animal testing, fur/leather, palm oil, or pesticides.

The Morningstar Sustainability Rating™

Independent from the above taxonomy is the Morningstar Sustainability Rating™ (also known as the globe rating), which is intended as a measure of portfolio ESG risk relative to global category peers. Using country and individual company data from global ESG research leader (and Morningstar subsidiary) Sustainalytics, Morningstar rates the degree of ESG risk found within a fund by looking to the fund's holdings over the trailing 12 months and rolling up individual holdings' ESG risk ratings with emphasis placed on more recent holdings information. The Sustainalytics ESG Risk Rating measures the degree to which a country's and company's economic value may be at risk driven by ESG issues. For a fund to receive a Sustainability Rating, there must be ESG risk scores on at least two thirds (66.7%) of holdings. An investment does not have to be deemed sustainable under the identification framework for Morningstar to provide a Sustainability Rating.

Exhibit 8 Australasia-Domiciled Sustainable Investments

Morningstar® Sustainability Rating ™	Number of Funds
🌐🌐🌐🌐🌐	41
🌐🌐🌐🌐	32
🌐🌐🌐	32
🌐🌐	5
🌐	1
Grand Total	111

Source: Morningstar Direct | Ratings as of 31 March 2022.

Though Morningstar's identification of sustainable investments is separate from the assessment of ESG risk, the above exhibit shows that the majority (66%) of funds identified as sustainable investments (and qualify for a Sustainability Rating) in Australasia also tend to have lower levels of ESG risk and hence higher globe ratings. Only four funds have 2-globe ratings and hence are assessed to have Above Average exposure to ESG risk. Only one fund has 1 globe and is assessed to have high exposure to ESG risk.

Regulatory Update

The Australian Securities and Investment Commission, or ASIC, has identified climate-related disclosure for listed companies and greenwashing as part of their corporate governance priorities in 2022. For climate-related disclosures, ASIC has stated that its "core focus is to foster continued improvement in the standard of climate-change governance practices, to promote the provision of reliable and decision-useful climate-related disclosures by listed companies, and to enable investors to make fully informed decisions." ASIC has confirmed that greenwashing remains an area of interest, and it is conducting a review to determine if there is alignment between the promotion of ESG products and their practices. ASIC has encouraged boards to be on the lookout for greenwashing and to determine whether their companies' ESG disclosures are accurate.

Morningstar's 'Investing in Times of Climate Change 2022' Report

In our recently published global research report "Investing in Times of Climate Change 2022," we found that global assets in climate funds doubled over a 12-month period. There were a variety of reasons why: COP26, an administration change in the US from Republican to Democrat, increased adoption of sustainable funds, and rapid growth in industry collaborations such as the Glasgow Financial Alliance for net zero. Further, increased offshore regulations, such as the sustainable finance disclosure regulation in Europe, increased demand for climate-related investment solutions, and investor demand resulted in more climate-related products coming to market. Beyond Europe, China, and the US, Morningstar categorises all other countries as "rest of world." Australia has the most assets invested in climate-related funds in this "rest of world" category—USD 2,447 million across 18 funds.

Morningstar's 'Q1 2022 Global Sustainable Fund Flows' Report

In conjunction with the release of this Australian sustainable landscape report, we also published the "Q1 2022 Global Sustainable Fund Flows" report, which found that USD 97 billion of net new money was invested into sustainable funds in the first quarter of 2022. Europe dominated, accounting for more than 80% of inflows. The US accounted for 11%, while Australia made up only 1%. In total, Morningstar counted 6,452 funds in the global sustainable funds' universe.

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