Morgan Stanley

INSTITUTE FOR SUSTAINABLE INVESTING

Sustainable Reality

Sustainable Funds Show Continued Outperformance and Positive Flows in 2023 Despite a Slower Second Half

Summary

Sustainable funds outperformed their traditional peers in 2023 with a median return of 12.6% compared to traditional funds' 8.6%, according to Morningstar data. Outperformance was weighted to the first half of the year (more than 300bps vs. less than 80bps in 2H) with sustainable funds underperforming in September and October.

In line with the broader market, the strongest returns were in the Americas,[1] with median returns for sustainable funds investing in the region at 21.3%, compared with Europe-focused funds' +14.1% and global funds' +12.3%.

Sustainable fund assets under management (AUM) globally grew to $3.4 trillion, up 15% from 2022 and reaching 7.2% of total AUM. Inflows to sustainable funds remained positive overall at $136 billion, 4.7% of the prior year-end AUM. However, this slowed towards the end of 2023, with around three quarters of full-year inflows occurring in the first half. Regionally, flow trends diverged when looking at fund domicile or fund investment area: Europe-domiciled sustainable funds, as well as sustainable funds investing globally and in Europe all had inflows between 4% and 6% of prior year-end AUM. Sustainable funds domiciled in North America saw small outflows (-4.4% of prior year-end AUM) driven primarily by procedural changes at a small number of funds, but funds investing in the Americas overall saw inflows (+6.2% of prior year-end AUM).

The investment strategies of sustainable funds, such as offering low-carbon portfolios, have led to a greater emphasis on some sectors within equity funds compared with their traditional counterparts. Equity funds with a global, Europe or APAC investment focus skew primarily to Industrials and Health Care, while funds investing in the Americas are more overweight Technology. Greater exposure to Technology stocks helped sustainable equity funds investing in the Americas in 2023, but this was not the only factor influencing sustainable funds' outperformance.

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, 2023–December 31, 2023.

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 97,000 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 data) and December 31 (for full year data) in each year; Traditional funds are those classified as 'Not Sustainable' by Morningstar. Morningstar's 'Sustainable' classification 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.

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 cited in the report are 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. Full year figures for 2023 could also be subject to modest revisions in the future. Data in this report were collected on February 9, 2024.

Prior editions of Sustainable Reality have looked at regional data based on the fund's domicile. This edition 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.

Sustainable Funds Outperformed Across All Major Regions and Asset Classes

Sustainable funds outperformed their traditional peers in 2023. Equity funds' outperformance was weighted to the first half of the year, while sustainable fixed income funds were relatively stronger in the second half.

For the full year, sustainable funds' median return was +12.6% compared with traditional funds' +8.6%. Performance was weaker in the second half compared with the first, with sustainable funds still outperforming traditional funds but to a lesser extent (+5.3% vs. traditional funds +4.5%) (Figure 1). Sustainable funds underperformed traditional funds in September and October. For more details on why 'Sustainable Reality' focuses on median returns, please see page 20 in the Appendix.

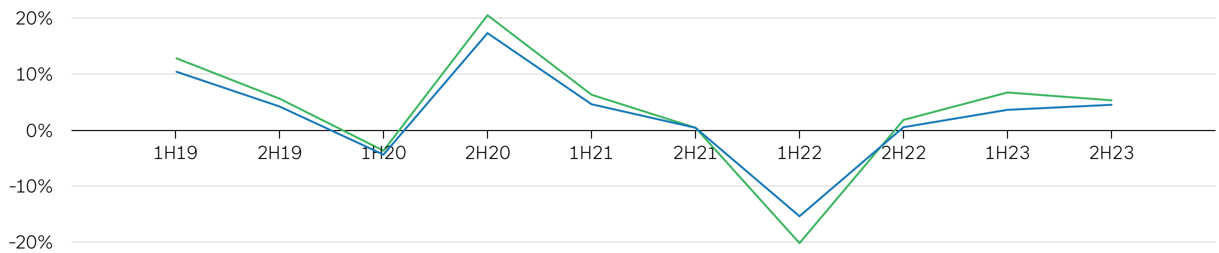
+12.6%

For 2023, sustainable funds saw median returns of +12.6% compared to traditional funds' +8.6%.

FIGURE 1

Sustainable Funds Outperformed Traditional Funds in 2H2023 and FY2023

Median Return—Sustainable vs. Traditional Funds



	1H19	2H19	1H20	2H20	1H21	2H21	1H22	2H22	1H23	2H23
Sustainable Funds	12.8%	5.6%	-3.7%	20.5%	6.3%	0.4%	-20.2%	1.8%	6.7%	5.3%
Traditional Funds	10.4%	4.2%	-4.4%	17.3%	4.6%	0.4%	-15.4%	0.5%	3.6%	4.5%
Difference (bps)	242 bps	141 bps	69 bps	321 bps	169 bps	-1 bps	-481 bps	133 bps	314 bps	78 bps

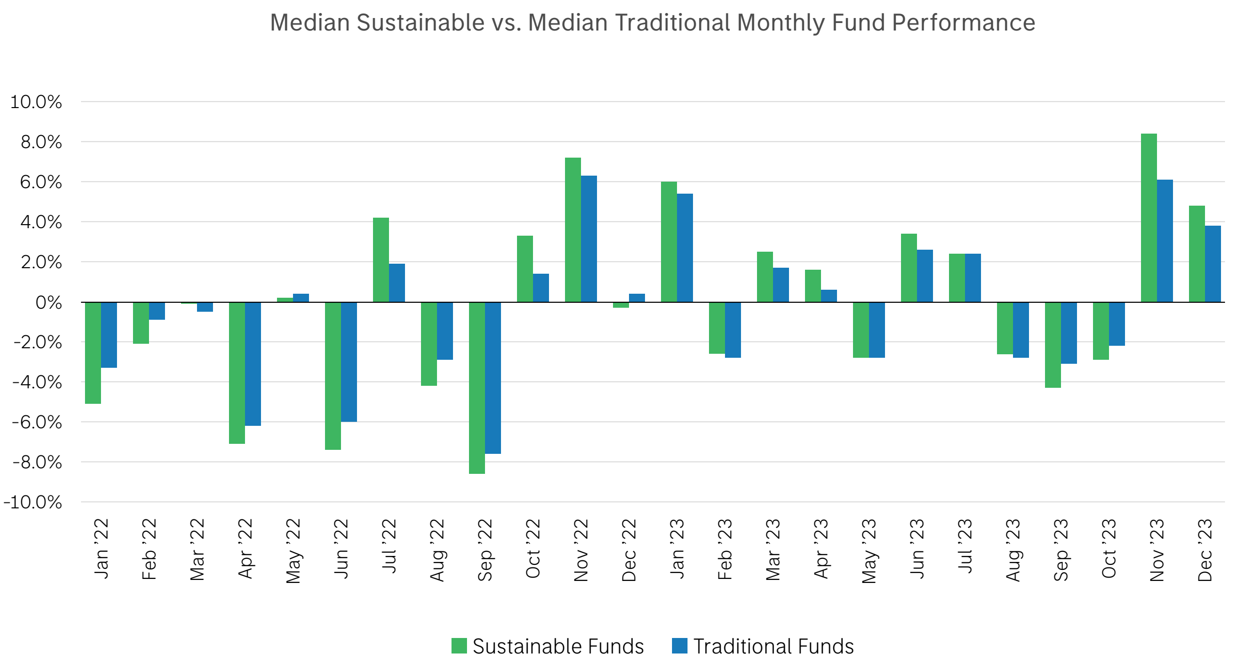
Sustainable Funds   Traditional Funds   Difference Between Sustainable Funds and Traditional Funds (bps)

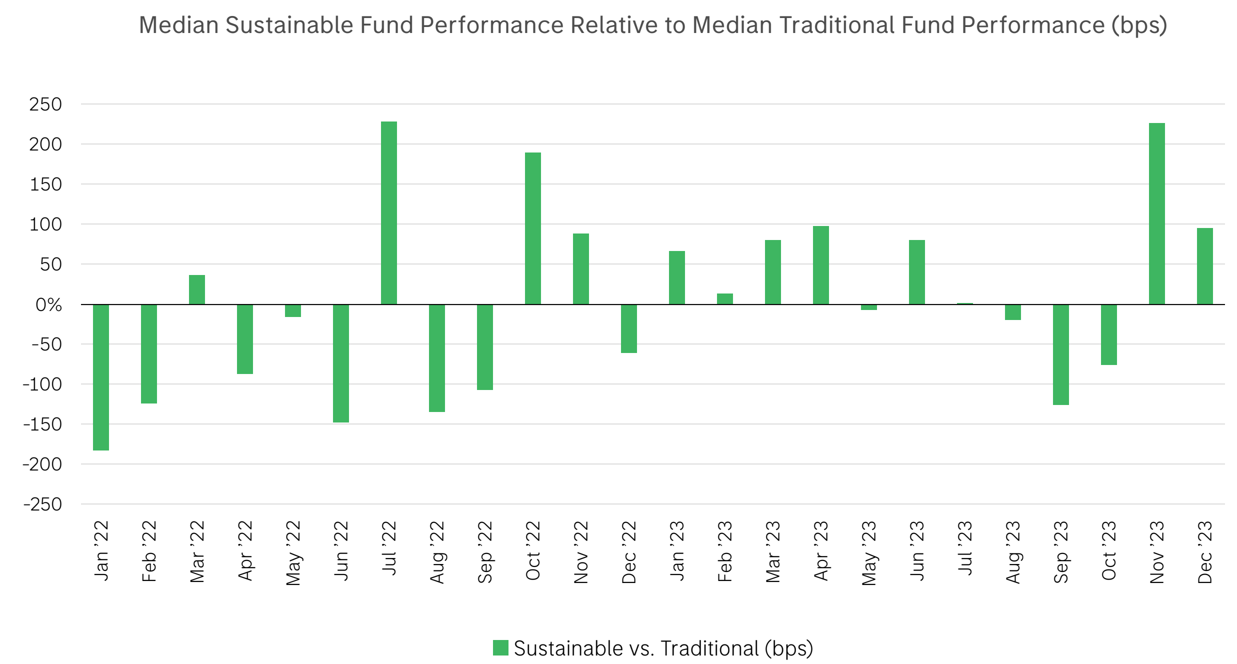
Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024. Table shows data in basis points (bps), 10bps = 0.1%.

The half-year figures for 2023 do not sum to the 12.6% FY2023 median return as 1H and 2H figures represent the medians of each half-year datasets, whereas the 12.6% FY23 figure is the median of the full-year dataset.

FIGURE 2

Sustainable Funds Underperformed in September and October, But Finished the Year Strongly





Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024. Bottom chart shows data in basis points (bps), 10bps = 0.1%.

Sustainable funds also outperformed traditional funds across every domicile on a full-year basis (Figure 3), and by a much greater margin in regions with smaller AUM (Asia, South America). This also slowed in the second half, with sustainable funds underperforming traditional funds in some domiciles (Europe, North America) on a half-year basis.

For the first time, 'Sustainable Reality' also looked at funds by the geography of their investment area. In 2023, sustainable funds outperformed both globally and in all major regions with the exception of the small Middle East and African investment region, which saw sustainable funds underperform slightly (0.4% of total global AUM) (Figure 3).

FIGURE 3

Sustainable Funds Outperformed Across All Asset Classes and Major Geographies

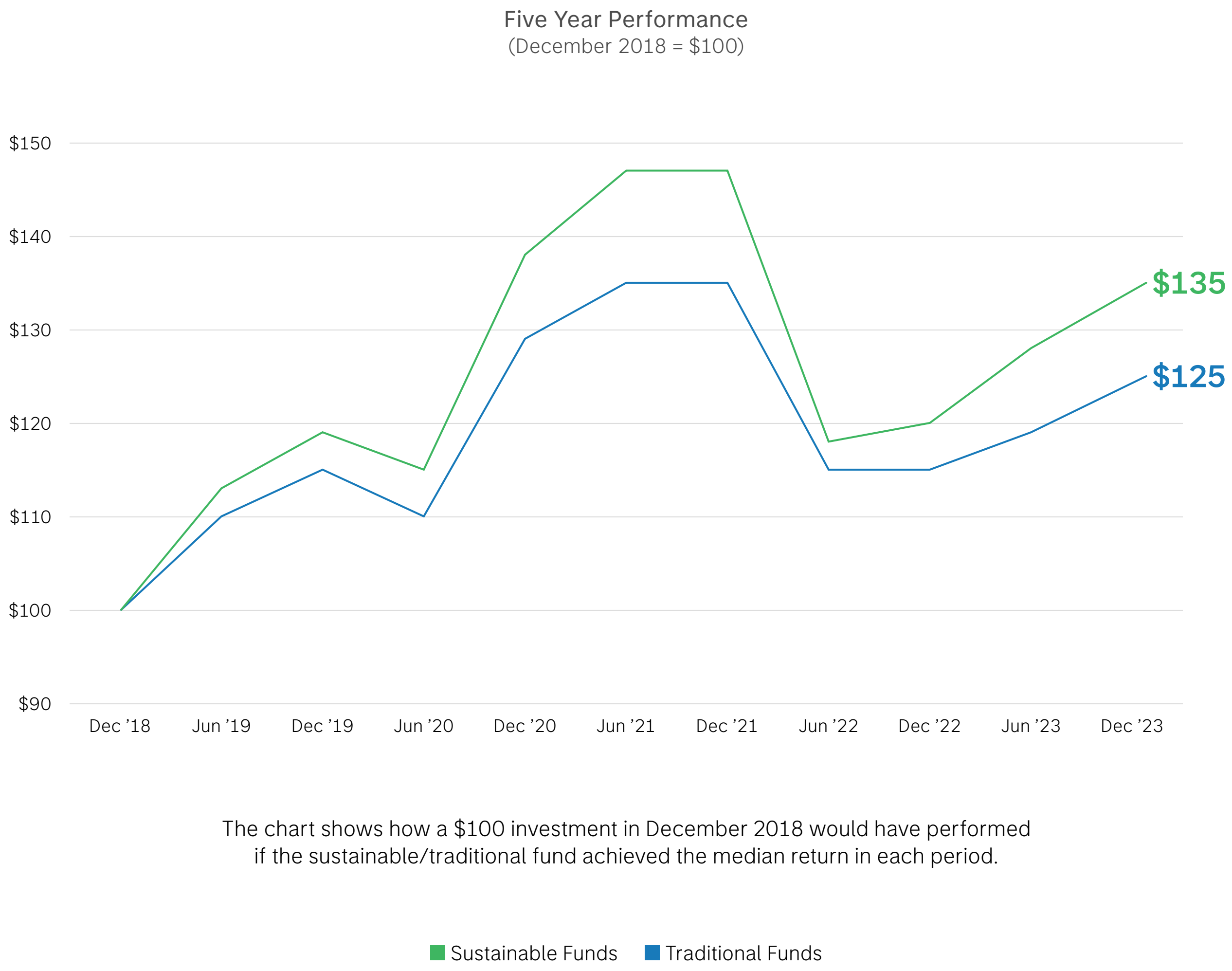
Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.
*Other includes multi-asset, property, commodities and alternative fund types.

How Have Sustainable Funds Performed Over Time?

Figure 4 shows how median returns have compounded over the past five years (December 2018–December 2023).[2] If a hypothetical fund achieved the median return for each of the past five years, a sustainable fund would be up +35% compared with a traditional fund's +25%.

FIGURE 4

Five Year Performance of Sustainable and Traditional Funds



The chart shows how a $100 investment in December 2018 would have performed if the sustainable/traditional fund achieved the median return in each period.

Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024. Starting with December 2018 as $100, the lines show how median returns for sustainable and traditional funds have compounded over time.

[2] This is the longest period of comparable history for Morningstar's Sustainable fund label.

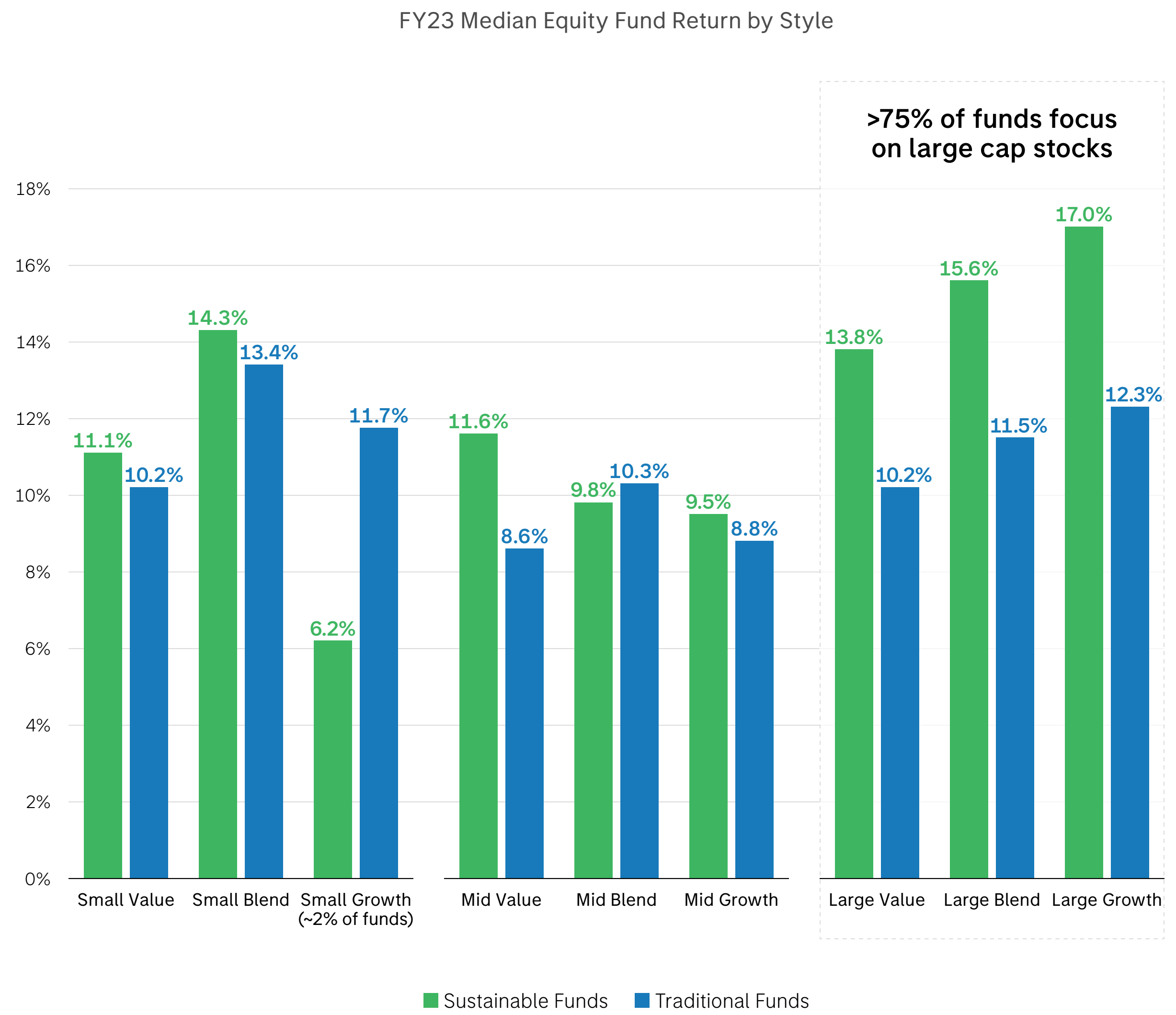
EQUITIES

Sustainable Equity Funds Outperform in All Large Cap Styles

Sustainable equity funds saw median returns of +16.7% for the year, ahead of traditional equity funds' +14.4%. This relative outperformance held true across all equity fund styles and almost all market cap ranges, especially large cap equities (Figure 5), which account for more than 75% of both sustainable and traditional funds. The small cap growth and mid cap blend categories were the only two areas in which sustainable funds were relative underperformers; however, these categories account for just 2% and 7% of the total fund count for both sustainable and traditional funds. In line with the overall trend, most of the sustainable fund outperformance came in the first half of the year.

FIGURE 5

Sustainable Funds Outperformed in All Large Cap Equity Styles

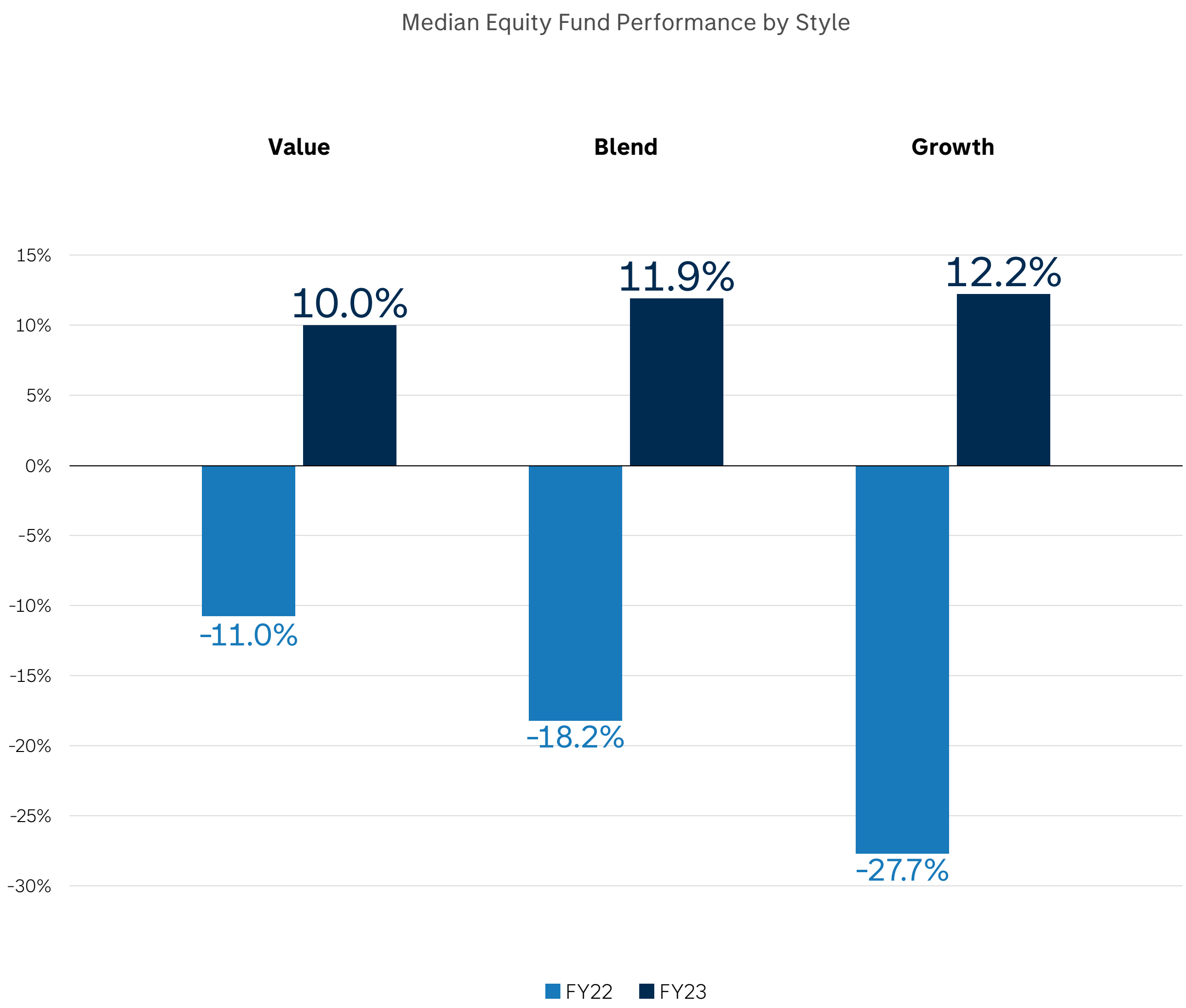


Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

For the broader equity markets, 2023 saw much more consistent returns across the three styles of equity funds (Figure 6). Sustainable funds typically skew away from value and towards growth compared with traditional funds, which hindered their relative performance in 2022[3] as markets reacted to changing macroeconomic conditions. In 2023, sustainable funds' skew towards growth became more pronounced, with 46% of sustainable funds following this style compared with 37% of traditional funds, up from 35% and 32% respectively in 2022. However, since returns were more consistent across value and growth styles in 2023, equity style had much less impact on relative returns of sustainable and traditional funds.

FIGURE 6

Equity Fund Returns Were More Consistent Across Styles This Year



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

[3] Sustainable Funds: Performance & Demand | Morgan Stanley, Feb. 15, 2023

FIXED INCOME

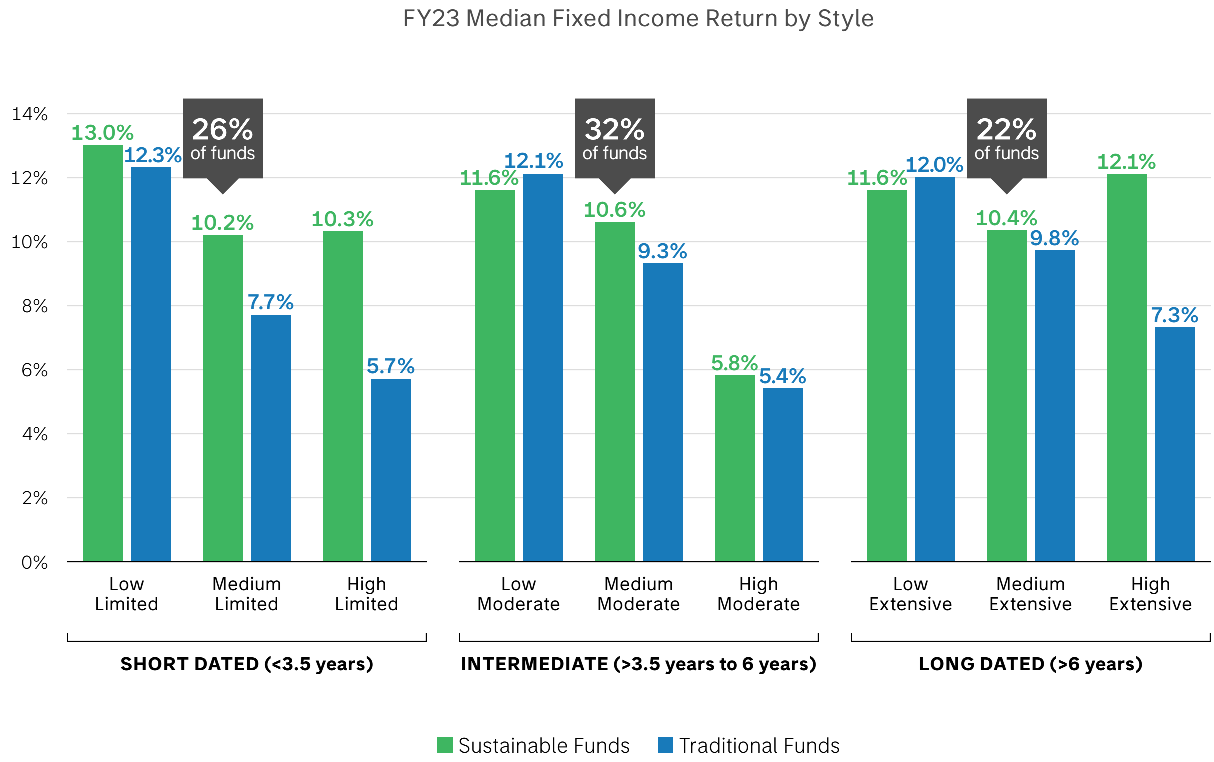
Broad Outperformance with Less Impact from Duration/Credit Quality Skew

Sustainable fixed income funds were up +10.0% in 2023 compared with their traditional counterparts' +6.4%. Unlike for equities, the second half of the year was stronger than the first, both in terms of absolute performance and relative outperformance. By investment style, sustainable fixed income funds notably outperformed in the three medium credit quality categories, which account for more than three-quarters of all sustainable fixed income funds. Sustainable fixed income funds slightly underperformed their traditional counterparts in the Low Moderate and Low Extensive categories, but these two combined represent well under 10% of sustainable fixed income funds.

In fixed income overall, 2023 saw lower credit quality funds outperform across short, moderate and long durations. Sustainable fixed income funds typically skew to the middle of the credit quality spectrum and away from shorter-dated debt compared with traditional fixed income funds, but during 2023 this skew did not suggest a significant impact on relative performance from broader market moves.

FIGURE 7

Sustainable Fixed Income Funds Outperformed in Almost All Categories



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

This model is based on the two pillars of fixed-income performance: interest-rate sensitivity and credit quality. The three duration groups are short, intermediate, and long-term, and the three credit quality groups are high (AA rated and higher), medium (BBB to AA rated) and low quality (<BB, all high-yield bonds). These groupings display a portfolio's effective duration and credit quality to provide an overall representation of the fund's risk, given the length and quality of bonds in its portfolio. Nine possible combinations exist, ranging from short duration/high quality for the safest funds to long duration/low quality for the riskiest.

Investor Demand for Sustainable Funds Grew, But Slowed Towards the End of the Year

Sustainable AUM grew to $3.4 trillion by YE2023 (+15% YoY), mostly driven by returns. Inflows to sustainable funds remained positive overall, at +4.7% of prior year-end AUM, but slowed toward the end of the year. Regionally, flow trends diverged when looking at fund domicile or fund investment area: Europe-domiciled as well as global and Europe-focused funds dominated with positive flows; North America-domiciled funds saw small outflows, while funds investing in the Americas saw small inflows.

Sustainable AUM Continued to Grow in FY23

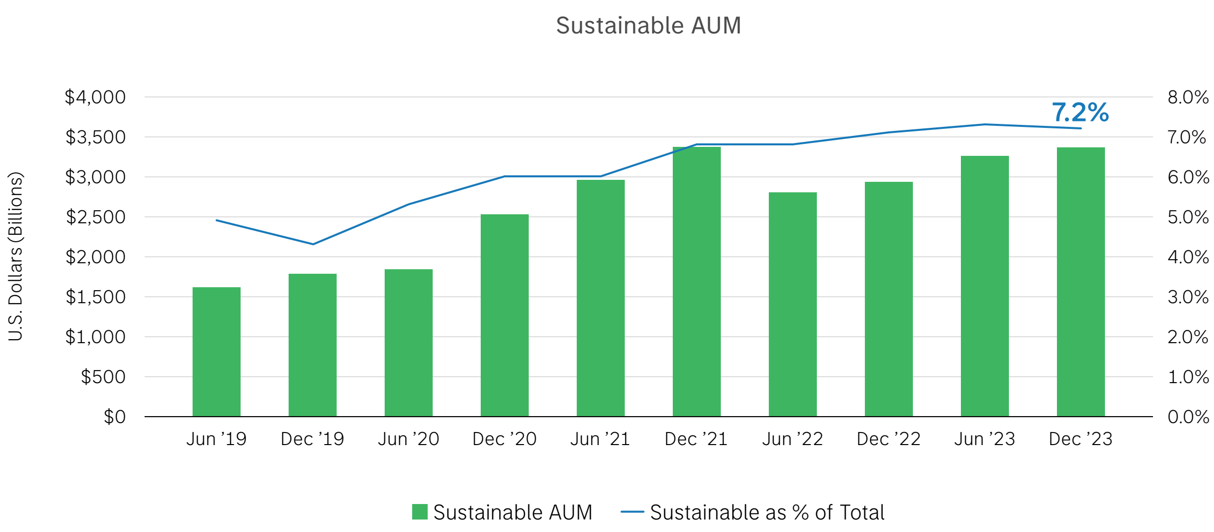
Sustainable funds' AUM rose to $3.4 trillion by the end of 2023, up 15% from year-end 2022 and up 3% from 1H2023 levels. This represents 7.2% of total AUM globally, up from 7.1% at the end of 2022, but slightly down on 7.3% at 1H2023.[4] Most sustainable funds are domiciled in Europe (87%), but this does not mean that European assets are the only focus. A global investment universe is the most popular strategy (42%) followed by Europe only (35%) (Figure 9).

7.2%

of total AUM classified as sustainable in FY2023.

FIGURE 8

Sustainable Funds' AUM was $3.4 trillion at December 2023, 7.2% of Total AUM

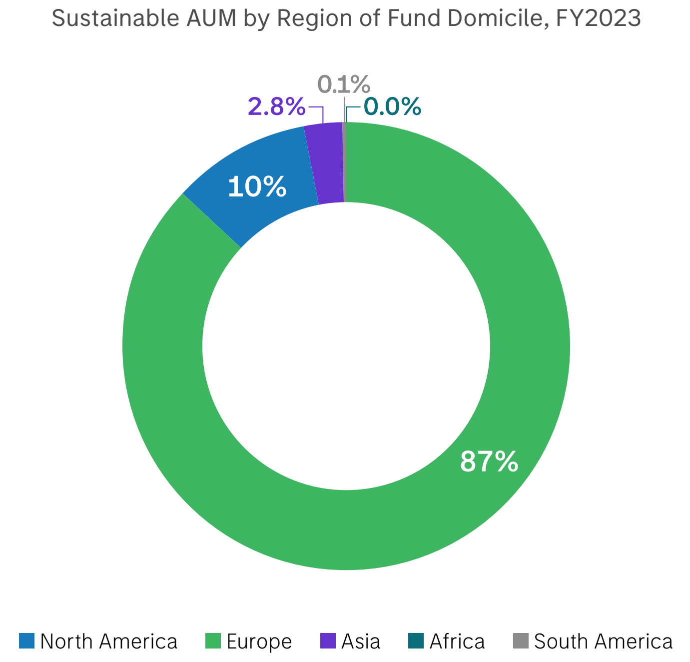


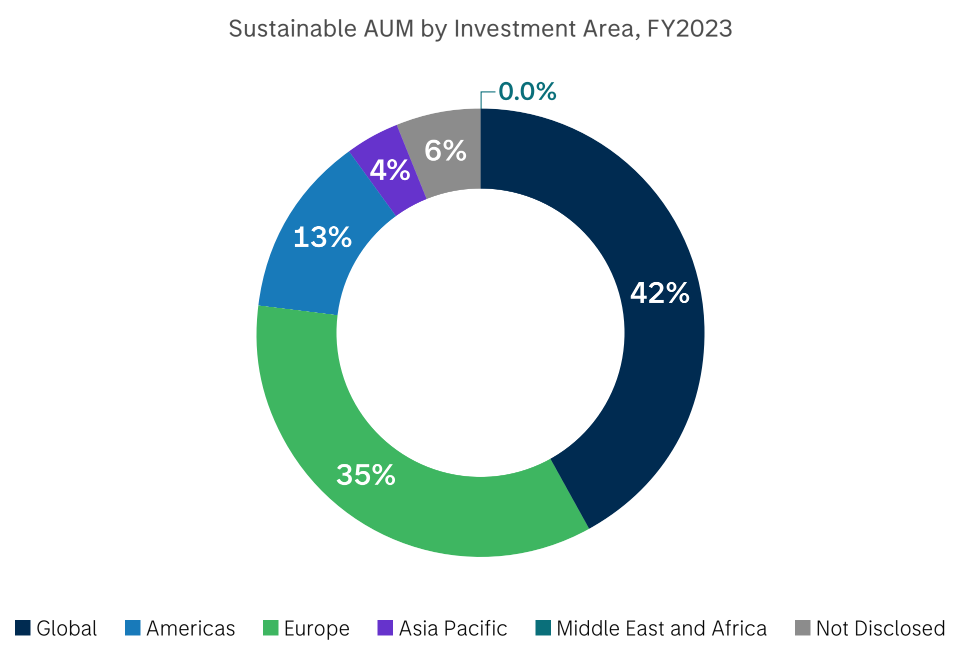
Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

4 The 1H2023 edition of Sustainable Reality put sustainable fund AUM at $3.0trn, 7.9% of total AUM. There can be some time lag in funds reporting data to Morningstar, notably for Asia-domiciled funds. The revised figures here reflect that both sustainable and traditional AUM for 1H2023 now captures disclosures from a larger number of funds. Full year figures for 2023 could also be subject to modest revisions in the future, but should reflect the majority of changes already due to later data collection.

FIGURE 9

Most Sustainable Funds Are Domiciled in Europe, Investing Globally or in Europe





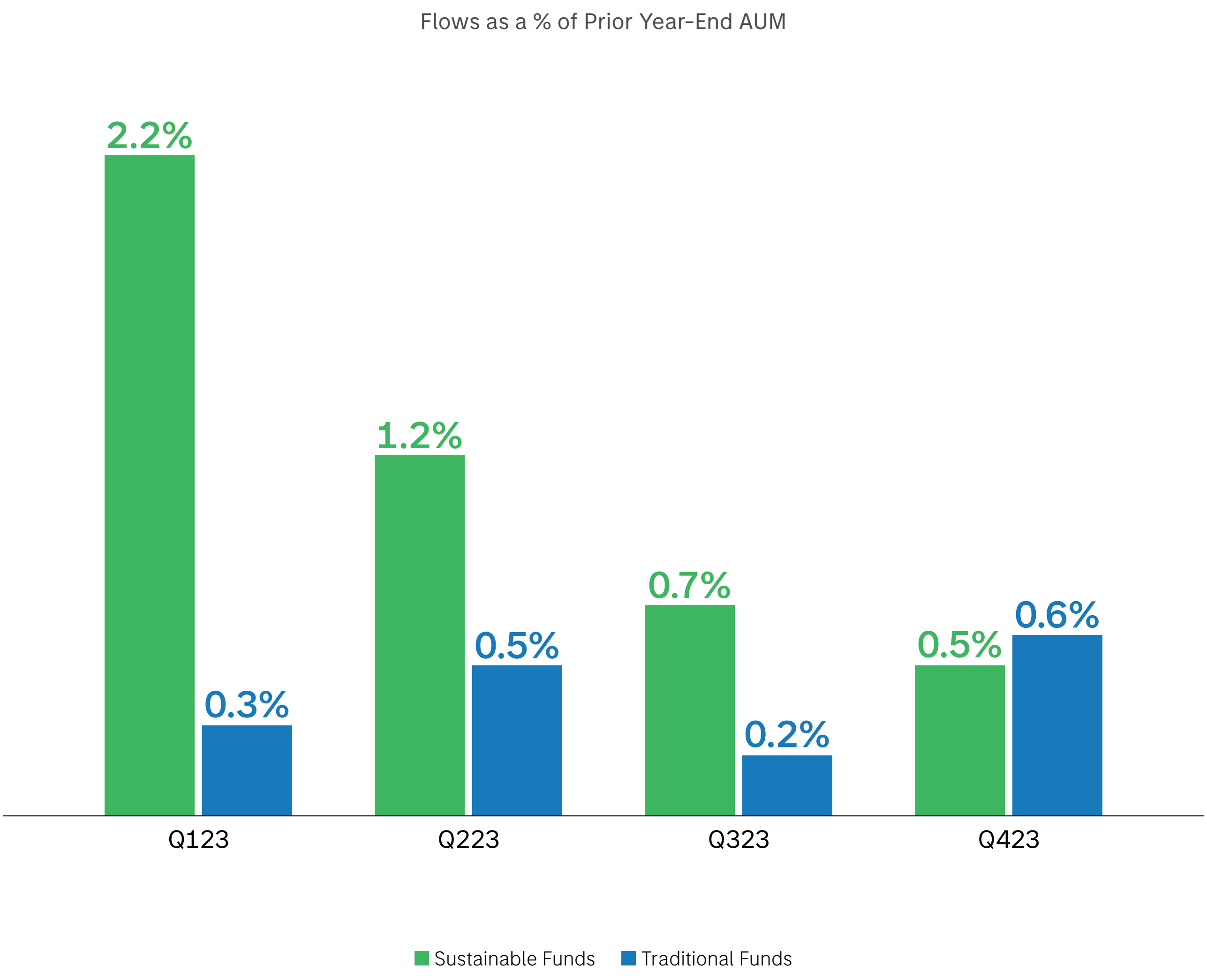
Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

Flows Mostly Remained Positive, With Some Slowdown in the Second Half of the Year

Overall, sustainable funds saw inflows of $136 billion during 2023, 4.7% of prior year-end AUM and a little higher than the $115 billion (3.4% of prior year-end AUM) in 2022. This also outpaced traditional funds, which saw 2023 inflows of $610 billion (1.6% of prior year-end AUM) following outflows in the prior year. Sustainable fund inflows were concentrated in the first half, with three quarters of the inflows between January and May. Traditional fund inflows were more evenly spread across the year.

FIGURE 10

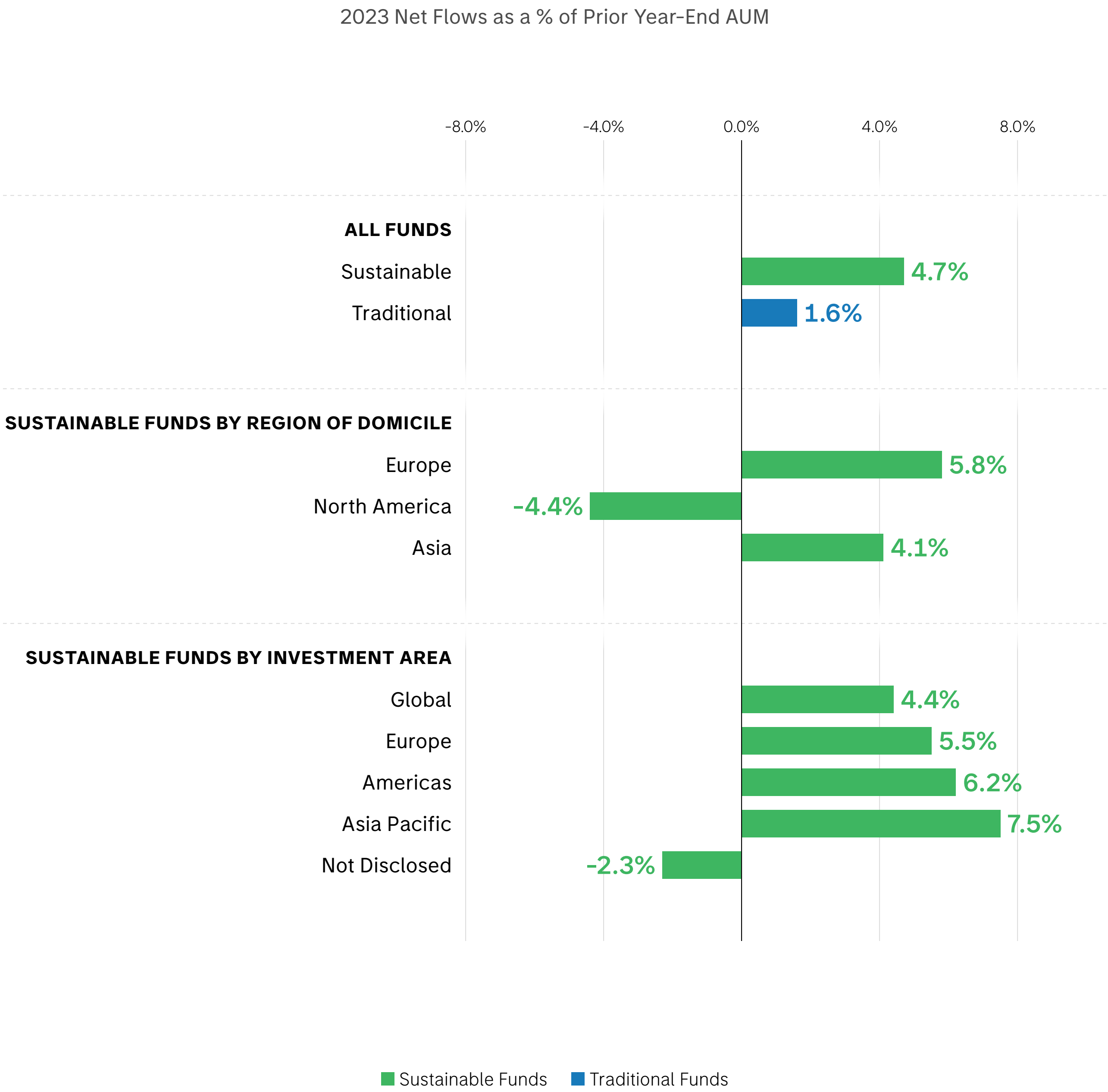
Sustainable Fund Inflows Outpaced Traditional Funds for Most of the Year, But Slowed in Q4



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

FIGURE 11

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



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

By domicile, Europe funds dominated flows at $146 billion (+5.8% of prior year-end AUM), while North America funds saw outflows of $13 billion (-4.4% of prior year-end AUM).

Importantly, Morningstar notes that around three-quarters of the North America outflows were driven by procedural changes at a very small number of funds.[5]

FIGURE 12

Flows Are Dominated by Europe-Domiciled Funds

Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

5 U.S. Sustainable Funds Register First Annual Outflows in 2023 | Morningstar

The Role of Sector Exposures

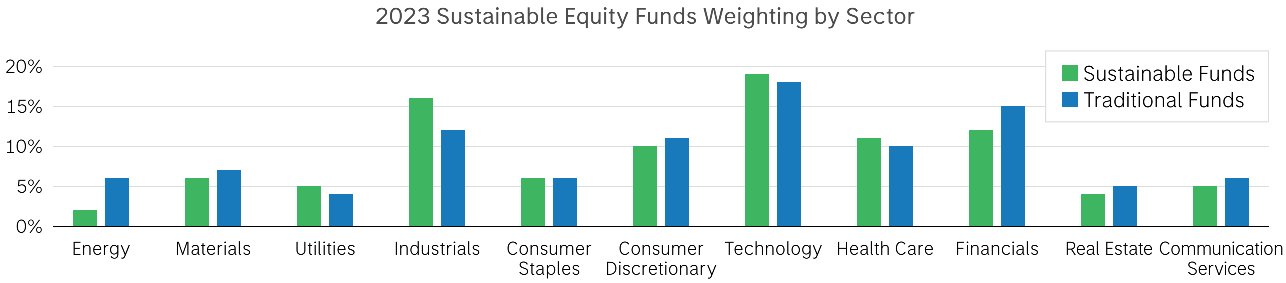
The investment strategies of sustainable funds, such as low-carbon portfolios, have resulted in a greater emphasis on some sectors within equity funds compared with their traditional counterparts. Equity funds with a global, Europe or APAC investment focus skew primarily to Industrials and Health Care, while funds investing in the Americas are more overweight Technology. Greater exposure to Technology stocks helped sustainable equity funds investing in the Americas in 2023, but this was not the only factor influencing their outperformance.

Sector Exposures Vary by Region

During 2023, Industrials remained the sector that sustainable funds are most exposed to relative to traditional funds (+450bps at 16% vs. 12%). This was followed by Technology and Health Care, each with around a +150bps delta. Traditional funds increased their exposure to the Energy and Financials sectors during the year, but sustainable funds did not follow, increasing these funds' relative underweight positions to -400bps and -300bps, respectively (Figure 14).

FIGURE 13

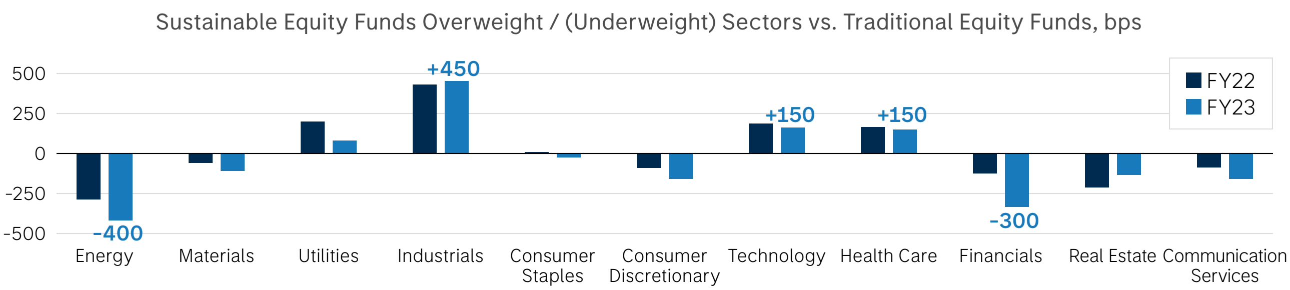
Sustainable Equity Funds are Relatively Overweight Industrials, Technology and Health Care



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

FIGURE 14

Traditional Equity Funds Increased Exposure to Energy and Financials in 2023, But Sustainable Funds Did Not Follow



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024. Positive values indicate that sustainable equity funds are relatively overweight a sector compared to traditional equity funds, and vice versa. Chart is shown in basis points (bps), 10bps = 0.1 percentage point. Labeled values are approximate.

However, equity funds' average sector exposure varies significantly depending on the regions in which they invest.

Global
Sustainable equity funds are most overweight Industrials relative to traditional counterparts (18% vs. 11% on average). Technology is the largest sector for these funds, at over 20%, but this is also true for traditional funds. On average, global sustainable funds are most underweight Energy and Financials (by around -250bps and -290bps respectively) compared with traditional funds.

Europe
For sustainable funds investing in Europe, Health Care skews the most compared with traditional funds (14% exposure vs. 11%), although Industrials is the largest sector. Energy is the most underweight sector, at 2.2% of sustainable portfolios on average vs. 4.4% for traditional funds.

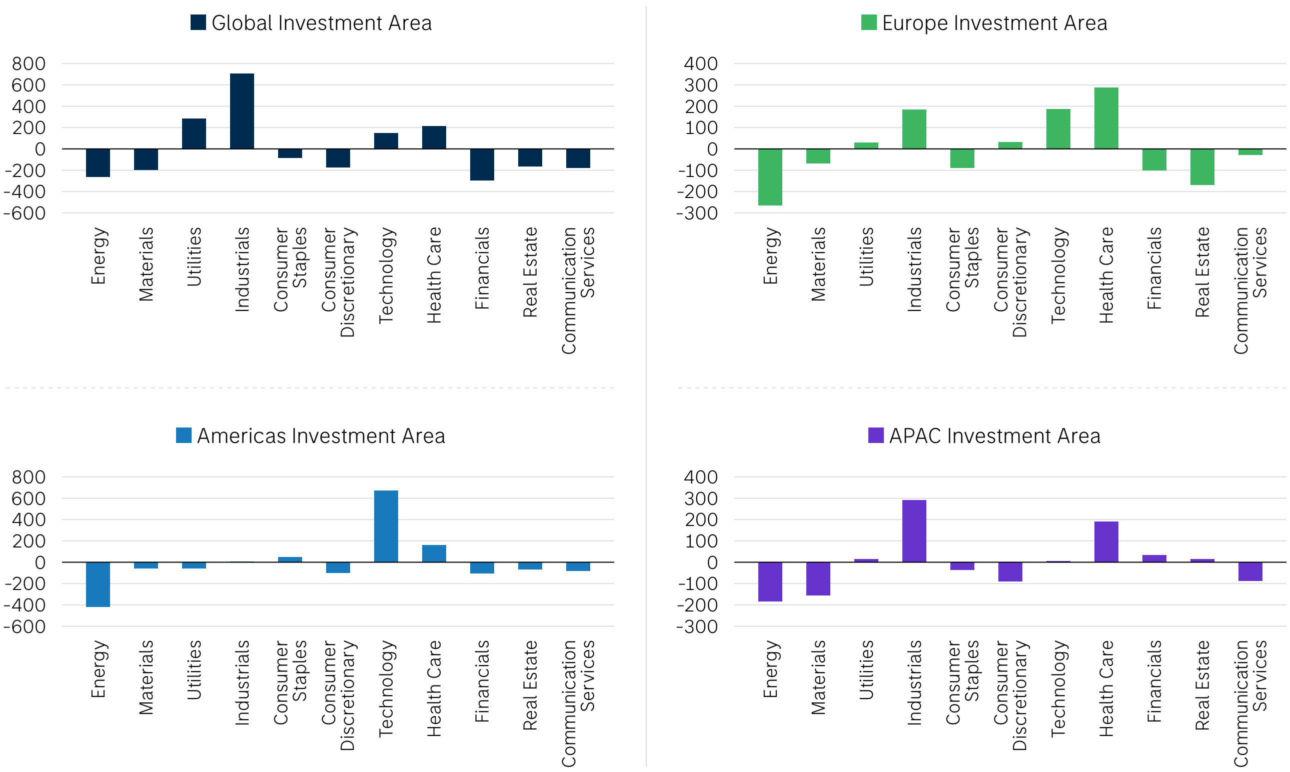
Americas
Sustainable equity funds investing in the Americas are overweight Technology, with this sector making up 29% of AUM on average vs. 23% for traditional funds. Most other sectors have similar average weightings between sustainable and traditional funds, other than Energy where sustainable funds are underweight by around -400bps.

APAC
Sustainable equity funds are most overweight Industrials (around +290bps) and Health Care (around +190bps) relative to traditional equity funds. Energy and Materials are notable underweights, at around -180bps and -160bps respectively.

FIGURE 15

Sustainable Funds' Relative Overweight in Technology Stocks is Most Pronounced in Americas-Focused Funds, While Those Investing in Other Regions Also Focus on Industrials and Health Care

Sustainable Equity Funds Overweight / (Underweight) Sectors vs. Traditional Equity Funds, bps



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024. Positive values indicate that sustainable equity funds are relatively overweight a sector compared to traditional equity funds, and vice versa. Chart is shown in basis points (bps), 10bps = 0.1 percentage point.

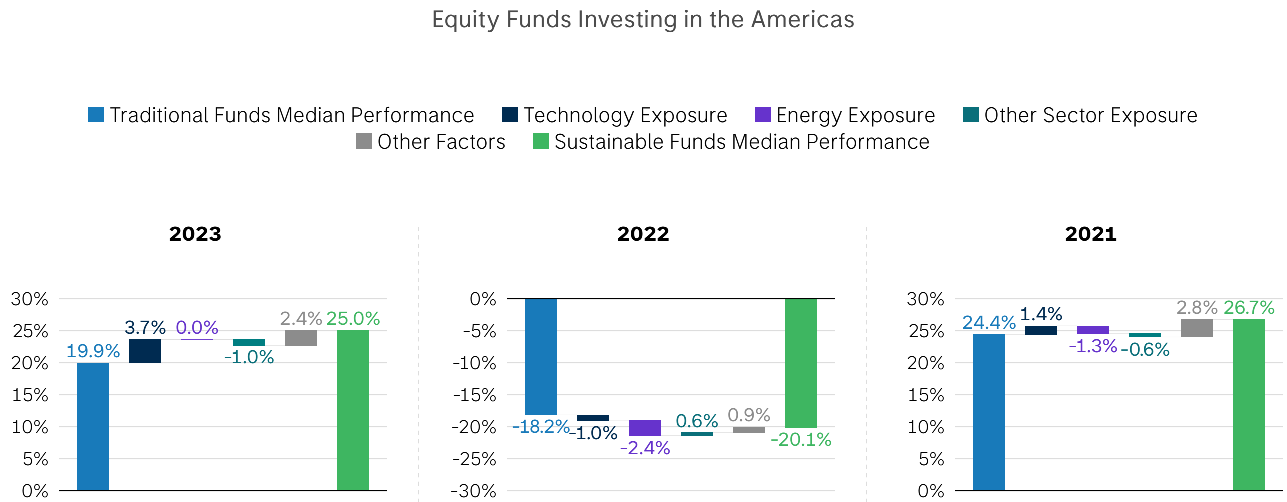
Sector Exposures Are One Part of the Performance Story

To explore how sector exposures might contribute to sustainable funds' performance relative to traditional funds, Figure 16 combines the average sector holdings data above with the actual median returns of sustainable and traditional equity funds investing in the Americas, as well as sector performances of the S&P 500. This illustrates how sector exposures could have influenced returns between 2021-2023.

Broadly, this analysis suggests that sector exposures accounted for around half of the relative performance of sustainable funds compared with traditional peers in 2022 and 2023, with 2021 neutral.

FIGURE 16

Sector Exposures Accounted For Around Half of Sustainable Equity Funds' Performance vs. Traditional Funds in the Americas in 2022 and 2023; 2021 Was Neutral



Tech Positive; Energy Neutral
The sector weightings alone imply that sustainable funds would have outperformed by +2.7%, or 270bps in 2023, with 370bps from the relative Technology overweight partly offset by -100bps from other sectors (mostly sustainable funds' relative underweight to Consumer Discretionary and Communication Services). Morningstar notes that the performance of sustainable indices was held back by a comparatively lower exposure to some of the largest technology stocks in 2023,[6] although this does not seem to have played out for equity funds. The remaining 240bps of outperformance was not sector related.

Both Energy and Tech Negative
The largest single driver of relative performance in 2022 was sustainable funds' relative underweight to Energy, which was by far the best performing sector in the year. On average, sustainable funds allocated 2.7% of their portfolio to Energy, vs. 6.5% for traditional funds, driving 240bps of relative underperformance for sustainable funds. Technology was the third worst performing sector, contributing an additional -100bps, although other sector exposures (mostly Consumer Discretionary) were a small positive, and other factors were positive.

Sector Exposures Neutral Overall
Energy exposure was a positive driver and Technology a negative one in 2021 also, although in this case the impact on sustainable funds' relative performance was close to neutral overall as the +140bps from Technology more than offset the -130bps from Energy. Small differences across most other sectors combined to a -60bps impact, with all sustainable funds' outperformance in 2021 coming from other factors.

Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

[6] Why Didn't Sustainable Investments Thrive Amid 2023's Tech Rebound? | Morningstar Indexes, 23 Jan 2024

Appendix

Regional Focus: Europe-Domiciled Funds

Europe-domiciled funds account for 87% of global sustainable AUM, although only 35% of sustainable AUM focuses on Europe for its investments (Figure 9 on page 11). Europe-domiciled sustainable funds had median returns of +13.0% in 2023, ahead of traditional peers' +11.8% (Figure 17).

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 (48% of total Europe AUM) or Article 9 (2% of total), with the remainder under Article 6 (Figure 18). All Article 9 AUM and around one third of Article 8 AUM is classified as 'Sustainable' by Morningstar. This means that 21% of European AUM comes under Morningstar's sustainable classification. Article 8 funds had a median return of +12.2% in 2023, with Article 9 median return at +11.5% (Figure 17).

For the full year, both Article 8 and Article 9 funds had positive inflows, at 1.9% and 0.8% respectively as a proportion of prior year-end AUM. Article 9 funds started the year strongly but saw outflows in Q4. Within Article 8, funds classified sustainable by Morningstar accounted for more than 80% of all Article 8 flows, at $100 billion (5.1% of prior year-end AUM); those classified as traditional saw outflows in the first half but recovered in November and December, along with the wider traditional fund universe.

FIGURE 17

Europe-domiciled Sustainable Funds Outperformed Traditional Funds, With Article 8 and Article 9 Funds in a Similar Range

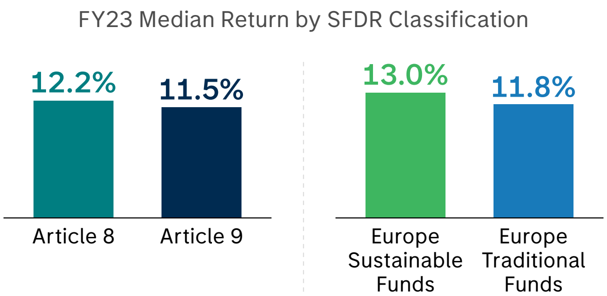


FIGURE 18

Half of Europe-domiciled AUM is in Article 8 and Article 9 Funds, with 21% of the Total Classified as Sustainable by Morningstar

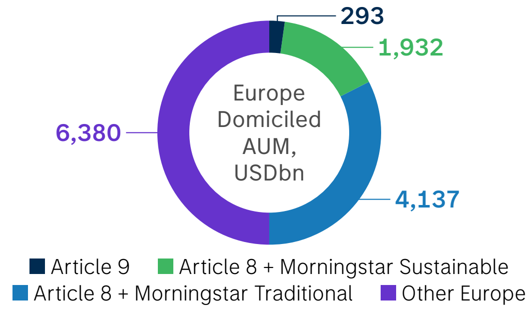
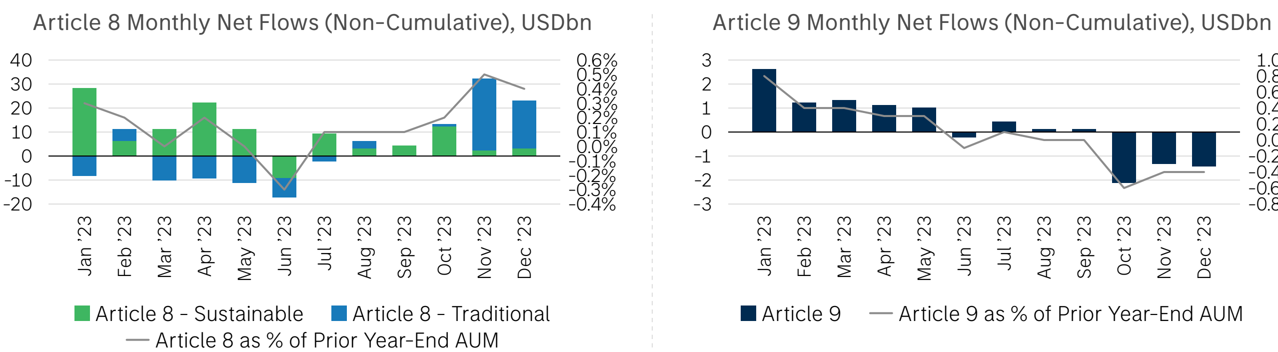


FIGURE 19

Article 8 and Article 9 Fund Flows



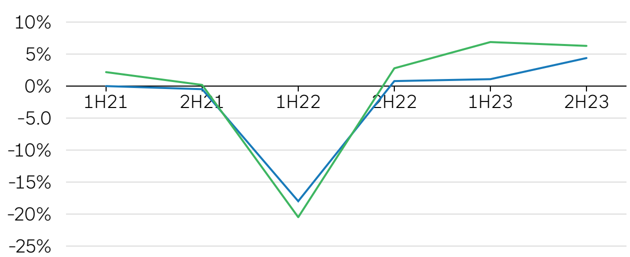
Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

Regional Focus: Japan Sustainable Funds

AUM is Relatively Small But Growing: Sustainable funds domiciled in Japan accounted for $4.4 billion of AUM at the end of 2023. This has doubled over the past three years, ahead of growth in broader Asia-domiciled sustainable funds. However, this still accounts for just 0.7% of all Japan-domiciled AUM compared with broader Asia's 1.7%. For sustainable funds investing in the Japanese market, December 2023 AUM was larger at $32.2 billion, 4.3% of the total. Sustainable funds both domiciled in Japan and those investing in the country are predominantly focused on equities, with fixed income funds making up just 3% of AUM for Japan-domiciled funds. The Japanese government's issuance of so-called GX bonds, climate transition bonds aimed at providing funding to innovative decarbonization technologies, could encourage growth in this area.

Median Returns Have Outpaced Traditional Funds: Japan-domiciled sustainable funds and those investing in Japan have historically outperformed traditional peers. For FY2023, Japan-domiciled sustainable funds saw a median return of +13.7% compared with traditional funds' +5.8%. Over the same period, sustainable funds investing in Japan had a median return of +18.4%, also ahead of traditional funds' +16.1%.

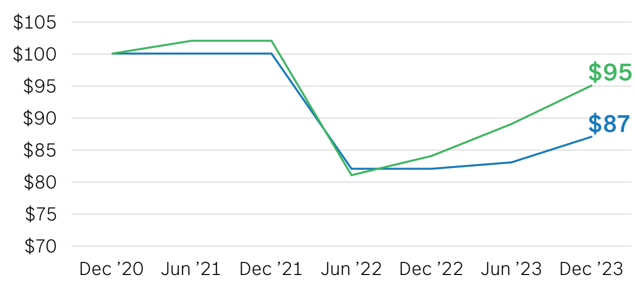
Median Return, Japan-Domiciled
Sustainable and Traditional Funds



1H21	2H21	1H22	2H22	1H23	2H23
2.1%	0.1%	-20.4%	2.7%	6.8%	6.2%
0.0%	-0.4%	-17.9%	0.7%	1.0%	4.3%
212 bps	46 bps	-246 bps	200 bps	584 bps	184 bps

Sustainable Funds Traditional Funds
Sustainable Funds Relative Performance (bps)

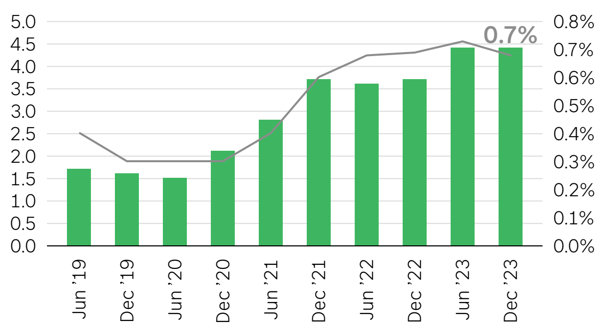
Three Year Performance
(December 2020 = $100)



The chart shows how a $100 investment in December 2020 would have performed if the sustainable/traditional fund had achieved the median return in each period.

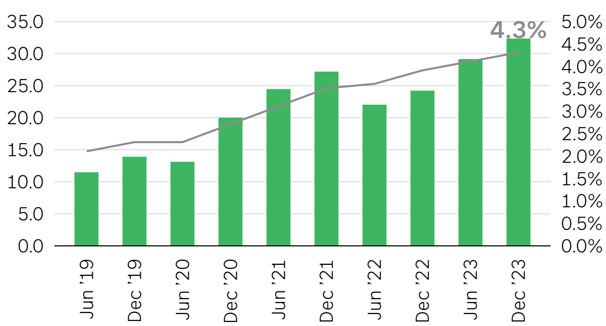
Japan-Domiciled Sustainable Funds
Japan-Domiciled Traditional Funds

Japan-Domiciled Sustainable Funds' AUM, USDbn



Japan-Domiciled Sustainable Funds
Sustainable as % of Total

Sustainable Funds Investing in Japan AUM, USDbn



Sustainable Funds Investing in Japan
Sustainable as % of Total

Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

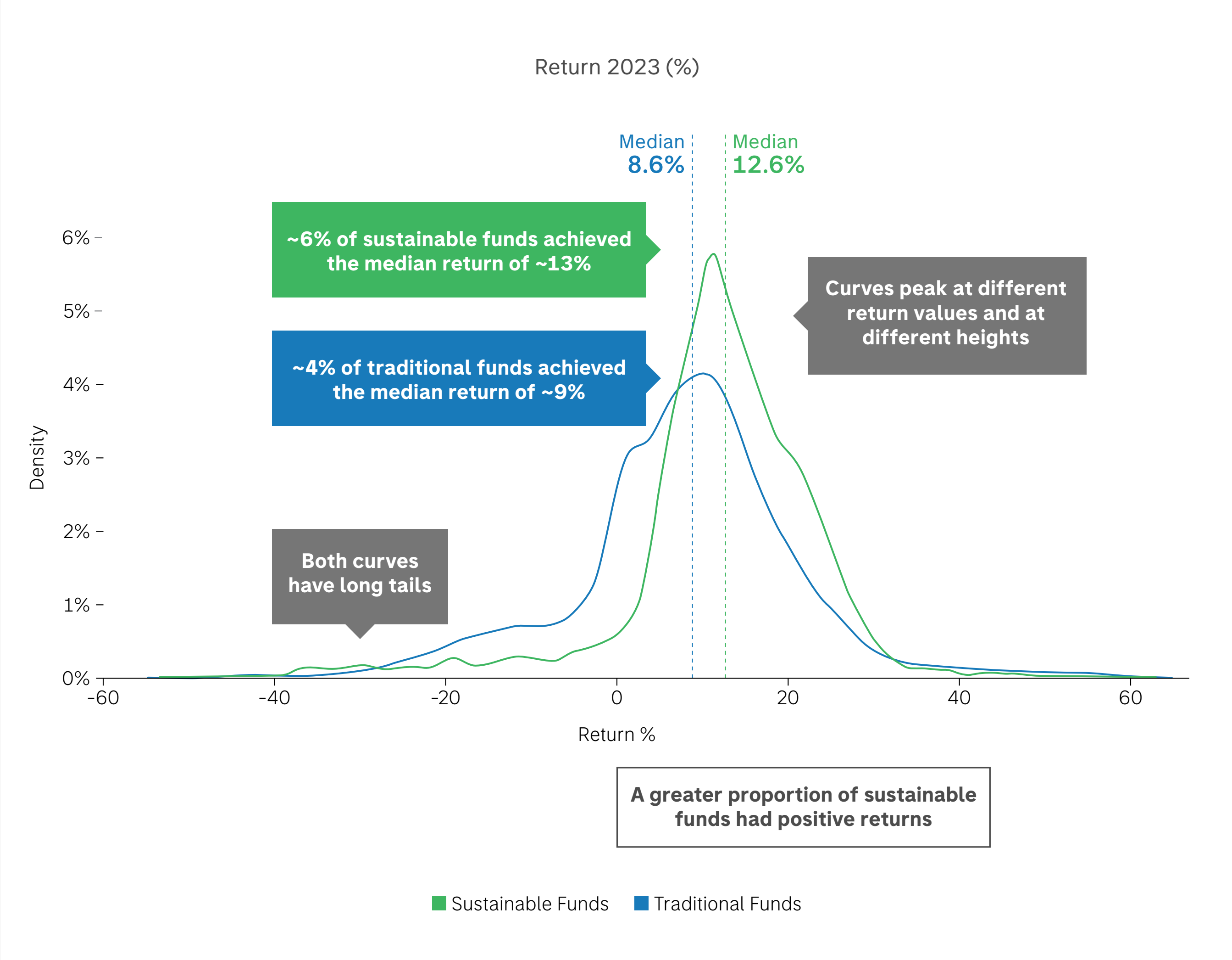
Why 'Sustainable Reality' Focuses on Median Fund Returns

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. The chart below shows the distribution density curves of median returns for sustainable and traditional funds in 2023. Key points to note:

The density curves peak at different return values and at different heights. Around 6% of all sustainable funds achieved the median return of ~12% in the year, compared with 4% of all traditional funds achieving the median return of ~9%. A higher proportion of sustainable funds achieved a greater return than traditional funds in 2023.

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 actually achieving that return across a selection of funds.

A greater proportion of sustainable funds had positive returns, at 84% vs. 72% for traditional funds. Investors were more likely to select a better performing fund in the sustainable universe.



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of February 9, 2024.

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The appropriateness of a particular ESG investment or strategy will depend on an investor's individual circumstances and objectives. Principal value and return of an investment will fluctuate with changes in market conditions.

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