EVERYTHING GREEN FLOWS

UK ESG MARKET Q1-Q3 2021

Author:
Dewi John
Refinitiv Lipper Head of Research, UK & Ireland
Introducing Everything Green Flows

This is the first in Refinitiv Lipper’s quarterly reports on environmental, social, and governance (ESG) mutual funds and ETFs—their assets, flows, performance, and charges—in the UK market. While we’ve covered ESG flows as part of our monthly review of UK fund flows, the growing importance of ESG merits a more thorough, regular analysis.

Charts 1 to 5 cover areas that will appear every quarter, while the appendix allow us to focus on areas of interest as they arise (and please feel free to contact us if there are any aspects of the UK ESG terrain you’d like to see the spotlight thrown onto).

One thing that’s very apparent from our first data run is that while ESG funds are on the whole cheaper than their non-ESG peers—between 7% and 21% depending on the asset class (see Appendix)—our analysis of the top selling ESG classifications shows that they have clearly outperformed “conventional” funds over three and five years (Chart 3).

This may be simply because of the value bias in markets over the period, and we’d need to see a more sustained value rally to determine whether this is the case, or whether investors really are benefitting from an “ESG premium”. However, between the lower charges and the outperformance, at a very general level it does look like ESG investors are getting something for nothing.
Global Equities Dominate ESG Flows

- **Global Equities** attracted over six times more than the next most popular classification for the first three-quarters of 2021.

- **Asset Class**: Equities display a “churn” between ESG and non-ESG funds, with £26.8bn going into the former and £21.2bn out of the latter.

- **Performance**: ESG funds in the top selling sectors of Equity Global and UK, and Mixed Asset GBP Balanced beat their non-ESG peers over three and five years.

- **Cost**: ESG funds have consistently lower total expense ratios than their non-ESG equivalents across alternatives, bond, equity, and mixed assets.

- **Asset Manager**: Royal London has taken in more than twice the ESG assets than its nearest rival: £6.1bn over the first three quarters of the year.
Over the first three quarters of 2021, equities were by far the biggest gainers of all ESG-badged funds, netting £26.82bn, compared to outflows of £21.22bn for non-ESG equity funds. This is a well-established pattern within equities, as ESG inflows mirror non-ESG outflows. Whether this is a conscious rotation within equities by investors isn’t clear (plausible, but with caveats—see section below), though we do hear that institutional investor demand is predominantly for ESG product. Whatever the drivers, what is clear from these figures that this is largely an equity effect, with non-ESG demand outstripping that of ESG in alternatives and bonds. In part, this may be because investors see ESG as being mainly an equity play and are focusing their energies there. However, there is a recurring complaint of a dearth of ESG product in other asset classes. That’s borne out to some extent by the number of ESG products on the UK market: while there are 237 ethical equity funds, there are 94 mixed assets (the only other asset class where ESG flows exceed those of non-ESG, 42 for bonds and just three for alternatives).¹

¹ UK registered for sale, GBP currency of record, primary share class with Ethical flag
The largest ESG flows for the period—by a country mile—have gone to Equity Global. It saw flows of £16.1bn over the first three quarters of the year, and non-ESG outflows of £17.5bn. The next biggest sector was Equity UK, which netted £2.6bn, as non-ESG Equity UK shed £8.4bn. So, it’s clear from the figures that while equities overall show a rough symmetry between ESG inflows and non-ESG outflows, investors aren’t swapping their “brown” geographical or sector exposures for “green” equivalents. The story is more complicated than that, with global funds seeing all the action, without comparable outflows. There’s a plethora of offerings in this space though, again, it’s not clear whether supply is driving demand or the other way around. What looks more likely is that investors are increasingly choosing to make the switch into ESG products at the time they shift sector focus.

There are only two bond classifications in the top 10, and the flows to the highest placed—Alternative Credit Focus (£1.2bn ESG flows)—is dominated by one strategy, European ABS, with few funds operating in this space. There’s more on offer in the Bond GBP Corporates space, but with slightly less of a take at £1.1bn.
Chart 3: ESG Top-Selling Classification Performance versus Conventional Equivalents, Q1-3 2021 (Percentage Growth)

In Chart 3, we have taken the top-three selling sectors over the first three quarters (excluding Equity Theme—Alternative Energy, where nearly all the funds are flagged as ethical) and compared the ESG and non-ESG performance within these classifications over one, three, and five years.

Over three and five years, all three ESG classifications beat their non-ESG peers. This has been by a significant amount over both periods: for example, almost 10 percentage points for Equity Global over three years and nearly 15 percentage points for Equity UK over five years.

Over one year, Equity Global and Mixed Asset GBP Balanced ESG funds are marginally ahead of their non-ESG equivalents—23.3% versus 23% and 13.8% versus 13.2%, respectively. In the case of Equity Global, this is about the same as the total expense ratio difference between ESG and non-ESG equity funds (see appendix). Meanwhile, non-ESG Equity UK beats its ESG peers by 31.1% to 29.1%.

The latter result is most likely because of the strong rally of value stocks—including oil, gas, and coal—late last year, of which the UK has a relatively high proportion. Which begs the question, how much of the three- and five-year ESG outperformance is due to the ESG terrain being skewed to growth stocks, which have significantly outperformed over the longer term, and how much is due to the existence of an ESG premium?
Despite the still commonly held belief that ESG investing is a predominantly active strategy, passive funds have taken a considerable slice over the first three quarters of the year. Passive bond funds have taken 39% of ESG flows to the asset class, and their equity equivalents have netted 45%.

This is being driven by the growing number of ESG indices: for example, the top-selling bond fund tracks the iBoxx MSCI ESG GBP Non-Gilts Index, while the top-selling equity fund tracks the FTSE Developed ESG Low Carbon Select Index, which (as the name suggests) has a target reduction in emissions below equivalent “conventional” indices while also excluding companies involved in controversial areas such as weapons, thermal coal, tobacco, nuclear power, gambling, adult entertainment, and those involved with controversies related to the UN Global Compact principles.

Source: Refinitiv Lipper
In terms of net flows, Royal London has taken in more than twice the ESG assets than its nearest rival: £6.1bn over the first three quarters of the year, versus £2.9bn for Liontrust. Royal London’s assets break down to: bond (£5.6bn), equity (£2.6bn), mixed asset (£1.6bn), and money market (£1.4bn). Liontrust is slightly ahead of Royal London in mixed asset, with the highest take for the asset class at £1.7bn.

If we set aside money market funds, BlackRock has the lion’s share of funds, predominantly from equities, which make up £8.3bn of its total—by far the highest inflows for this asset class. However, over the year so far, it has seen outflows of £6.1bn from the former.

Further down the table, just Aegon and UBS have a significant portion of their flows in bond vehicles: £66m and £337m, respectively, and only Aegon has a significant take in the alternatives space—some £1.2bn—with the only other member of the top 10 appearing here being Schroders, with £126m.
Appendix: Mutual Fund Charges

Chart 6: Total Expense Ratio, ESG v Conventional by Asset Class (%)

Source: Refinitiv Lipper

In all four of the asset classes covered above, ESG funds are cheaper than their non-ESG counterparts—which is counterintuitive—as the investment process of the ESG funds should include an extra layer of due diligence and research.

As of Q3 2021, the biggest difference between ESG and non-ESG charges per asset class is with mixed assets, where ESG funds are 21% cheaper than their non-ESG peers. ESG equity funds are 16% cheaper, and alternatives and bond ESG funds are each about 7% cheaper than their non-ESG equivalents.

In broad terms, while charges have declined across all asset classes over the past five years, they have declined more quickly for ESG funds, widening the difference in terms of total expense ratio between the two strategies over the period.
For more information, please contact our Refinitiv Lipper Research Team:

**Detlef Glow**  
Head of Lipper EMEA Research  
Phone: +49(69) 75651318  
detlef.glow@refinitiv.com

**Robert Jenkins**  
Global Head of Research, Lipper  
Phone: +1 (617) 856-1209  
robert.jenkins@refinitiv.com

**Xav Feng**  
Head of Lipper Asia Pacific Research  
Phone: +886 935577847  
xav.feng@refinitiv.com

**Tom Roseen**  
Head of Research Services  
Phone: +1 (303) 357-0556  
tom.roseen@refinitiv.com

**Otto Christian Kober**  
Global Head of Methodology, Lipper  
Phone: +41 (0)58 306 7594  
otto.kober@refinitiv.com

**Dewi John**  
Head of Lipper UKI Research  
Phone: +44 207 5423393  
dewi.john@refinitiv.com

Media enquiries:  

**Nsikan Edung**  
nsikan.edung@refinitiv.com

**Lipper U.S. Client Services**  
+1 877 955 4773  
customers.reuters.com/crmcontactus/support.asp

**Lipper Europe Client Services**  
(UK) 0845 600 6777  
(Europe) +44207 542 8033  
customers.reuters.com/crmcontactus/support.asp

**Lipper Asia Client Services**  
+886 2 2500 4806  
customers.reuters.com/crmcontactus/support.asp

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