



Sustainable funds in Europe: Benefit of diversification?

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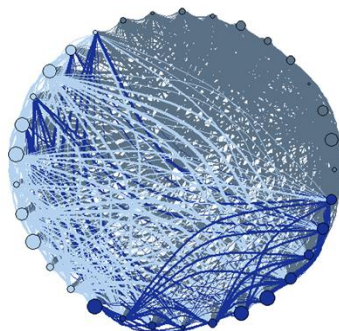
The growing sustainable finance landscape includes an increasing number of sustainable funds with total AuM of USD 2.7 tr currently. Most of these funds are managed actively, even though the market share of passive funds has increased considerably in recent years. In 2022, sustainable ETFs in Europe attracted USD 35 bn in inflows, which was a decrease from the previous year's record high of USD 72 bn. This decline can be attributed to surging rates and the energy crisis. It is worth noting, however, that the figure remains comparable to the 2020 amount, which was the second-best ever recorded.

Can sustainable funds provide a diversification advantage if decoupled from non-sustainable funds? The debate about whether sustainable investments do outperform those without a sustainability mandate is unsettled. But could the former deliver a diversification advantage by being decoupled from the latter? The empirical analysis in this paper includes ETFs traded on European stock exchanges, which are subject to the EU's Sustainable Finance Disclosure Regulation (SFDR) and can hence be grouped into different sustainability categories: Article 9 ("dark green") funds with sustainable investing as an objective, Article 8 ("light green") funds that promote environmental or social characteristics, and Article 6 ("non-ESG") funds with no explicit ESG mandate.

Our analysis shows that sustainable funds are partially decoupled from less sustainable peers. Our analysis of spillover networks shows that Art. 9 equity ETFs tend to be unaffected by price developments in the Art. 8 and Art. 6 markets, potentially allowing investors to improve the diversification of their portfolio. By contrast, these less sustainable equity ETFs are more strongly interconnected and hence more at risk from financial contagion. This analysis, however, is only a preliminary snapshot of the novel and quickly evolving sustainable ETF market.

Article 9 equity ETFs stand apart from
Article 8 and 6 equity ETFs

Equity spillovers



■ Article 9 ■ Article 8 ■ Article 6

Sources: Bloomberg Finance LP, Deutsche Bank Research



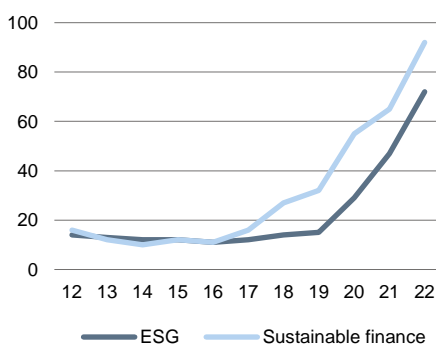
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The transition towards climate-resilient, net-zero economies is gaining momentum, yet the lingering investment gap persists. Investments in clean energy are pivotal and impact all sectors of the economy. They have increased by 42% over the past five years and are set to reach USD 1.7 tr in 2023, according to the International Energy Agency (IEA). This is driven by the fact that clean technologies have become increasingly affordable and are now seen by many countries as a solution to securing energy supply. Moreover, several jurisdictions have launched initiatives to ramp up their green industries (e.g. US Inflation Reduction Act, EU Green Deal Industrial Plan). Still, there remains a considerable gap to the estimated USD 5 tr annual investment in clean energy needed to meet the 1.5°C Paris climate target by 2050.¹

Growing interest in sustainable finance

1

Google Trends index, 0-100



Sources: Google Trends, Deutsche Bank Research

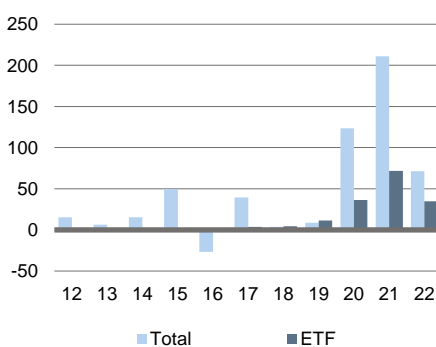
A growing sustainable finance landscape contributes to the green transition. In support of this transition, interest in sustainable finance has been increasing, which is also reflected in rising inflows into sustainable assets (Charts 1 and 2). This includes a growing number of sustainable funds with total AuM of USD 2.7 tr by the end of March, according to Morningstar. Most of these funds are managed actively, even though the market share of passive funds has increased considerably in recent years.² In 2022, sustainable ETFs in Europe attracted USD 35 bn in inflows, which was a decrease from the previous year's record high of USD 72 bn. This decline can be attributed to surging rates and the energy crisis. It is worth noting, however, that the figure remains comparable to the 2020 amount, which was the second-best ever recorded.

In parallel to these market developments, there is a growing number of regulatory initiatives aimed at creating a robust framework for sustainable finance. They notably seek to provide clarity on what constitutes a sustainable investment (taxonomies) and to enhance transparency in the market (disclosure rules).³

ESG fund inflows in Europe

2

USD bn



Sources: Morningstar, Deutsche Bank Research

Sustainable investment – what is in it for investors? Although studies suggest that sustainable investing might be primarily motivated by social preferences and social signaling (“do good” rather than “do well”),⁴ financial aspects matter, too. However, the debate about whether sustainable investments do outperform non-sustainable investments in terms of returns remains unsettled and likely dependent on selected time periods and subject to exposure nuances (e.g. defense during an uncertain geopolitical backdrop). Still, they could be an attractive asset in portfolios, if they provide a diversification advantage by being decoupled from non-sustainable investments. This paper addresses that question by analyzing the financial interconnectedness of ETFs traded on European stock exchanges, which are subject to the EU’s Sustainable Finance Disclosure Regulation (SFDR) and can hence be grouped into different sustainability categories.

In a first part, the paper provides an overview of the SFDR regulation as well as the current sustainable investment fund landscape in Europe. Thereafter, we explore our sample of SFDR-classified ETFs and their interconnectedness. The paper concludes with an outlook on upcoming developments in sustainable finance.

¹ IRENA (2023). World Energy Transitions Outlook 2023. March.

² Deutsche Bank Research (2023). ESG for the Consumer Sector. June 7.

³ For an overview on sustainable finance, see Walther, Ursula, and Jan Schildbach (2022). Sustainable finance – coming of age. Deutsche Bank Research, EU Monitor. September 2.

⁴ Riedl, Arno, and Paul Smeets (2017). Why do investors hold socially responsible mutual funds? In: The Journal of Finance, Vol. 72, p. 2505-2550. Also Maltais, Aaron, and Björn Nykvist (2020). Understanding the role of green bonds in advancing sustainability. Journal of Sustainable Finance & Investment, p. 1-20.



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The evolving sustainable fund landscape in Europe

The EU's SFDR aims to enhance transparency. The SFDR is one of the building blocks of the EU's plan to increase private investment in sustainable economic activities.⁵ It aims to enhance transparency regarding sustainability risks and impact of investment products. In particular, it requires financial service providers to disclose to what extent they consider sustainability risks at both entity and product level. The disclosure requirements entered into force in March 2021 and have been rolled out in phases. Initially, fund managers had to disclose the strategy with which they identify sustainability risks and the extent to which their activities have a negative effect on sustainability (so-called "principal adverse impacts", PAI). Since January 2023, they are also required to provide detailed and standardized product-level sustainability information in accordance with the Regulatory Technical Standards (RTS).

What is behind Article 6, 8, and 9 classifications? Although conceived as a disclosure regulation, in the view of many market participants, the SFDR has emerged as a quasi-classification system⁶ as it asks asset managers to classify funds based on their ESG objectives, differentiating between:

- Article 9 (also labelled as "dark green") funds, which have sustainable investing as an objective,
- Article 8 ("light green") funds, which promote environmental or social characteristics, and
- Article 6 ("non-ESG") funds, which do not have an explicit ESG mandate.

There has been a sequence of regulatory guidances on how to classify the funds under the SFDR. Art. 9 funds are expected to be entirely based on "sustainable investment",⁷ except for investments with a hedging or liquidity purpose that, however, must be in line with the overall sustainability objective. Many Art. 9 funds follow a solution-oriented approach with a thematic focus on specific sectors (e.g. hydrogen, healthcare) or impact areas (e.g. decarbonization, biodiversity). By contrast, Art. 8 funds do not have sustainable investing at their core and often apply more traditional ESG strategies (e.g. general integration, "best-in-class"). As asset managers are free to use their own approach to identify sustainable investment, the strategies applied within both categories can differ substantially.⁸

Before the extension of the disclosure obligations in January 2023, a significant number of funds had been reclassified. In Q4 2022, more than 300 funds were migrated from Art. 9 to Art. 8, according to Morningstar. This was driven by some degree of legal uncertainty primarily about the classification of funds tracking Paris-aligned benchmarks (PAB) or climate transition benchmarks (CTB).⁹ Furthermore, many asset managers were concerned they would be accused of greenwashing, if they failed to meet certain Art. 9 thresholds. In April, the European Commission¹⁰ clarified that such funds can be classified under Art. 9. The analysis in this paper is based on fund classification data prior to this.

⁵ Action plan on financing sustainable growth of March 2018.

⁶ Eurosif (2022). EU Sustainable Finance & SFDR: making the framework fit for purpose. June.

⁷ The SFDR broadly defines sustainable investment as an investment in an economic activity that (i) contributes to an environmental or social objective, (ii) does no significant harm to any of these objectives, and (iii) includes only companies that follow good governance practices.

⁸ Lambillon, Adrien-Paul, and Marc Chesney (2023). How green is 'dark green'? An analysis of SFDR Article 9 funds. SSRN working paper. Also Matter Insights (2023). Dividing lines – sustainability analysis of the largest SFDR Article 8 and 9 ETFs.

⁹ Matter Insights (2023).

¹⁰ European Commission (2023). Answers to questions on the interpretation of Regulation (EU) 2019/2088, submitted by the European Supervisory Authorities on 9 September 2022. April.

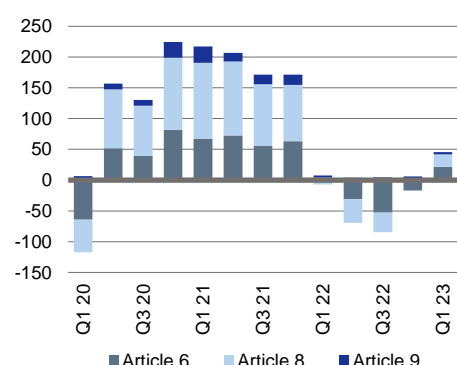


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Inflows into Art. 9 funds despite adverse macroeconomic conditions

3

European open-end funds, net flows in USD bn



Sources: Morningstar, Deutsche Bank Research

Slowing fund growth due to adverse macroeconomic conditions. After the initial pandemic shock, sustainability-oriented funds in Europe (Art. 8 & 9) recorded significant inflows in 2020 and 2021 (Chart 3). Remarkably, the inflows generally exceeded those into non-ESG (Art. 6) funds (in fact, this is even true for Art. 8 alone). Moreover, flows into Art. 9 funds have been quite large relative to their assets under management, which at USD 277 bn make up only around 3% of the assets of all open-end funds in the EU.¹¹

Amid the conflict in Ukraine, surging inflation, rising interest rates and the disappearing effect of excess savings from the pandemic, inflows stopped abruptly in early 2022 and later turned negative. However, Art. 9 funds continued to attract positive net flows albeit at a much lower level, falling below USD 3 bn in Q1 2022 (-84% qoq) and gradually recovering to USD 6 bn in Q4. In Q1 2023, flows into Art. 6 and 8 funds also returned to positive territory, providing a first sign of a possible recovery.

Sustainable and non-sustainable ETFs in Europe: Financially connected?

Sample description. The following analysis includes 853 equity and 433 fixed-income ETFs traded on European stock exchanges (Chart 4). Due to the novelty of the SFDR classification, the sample horizon is rather short. It begins in 2019 for equity ETFs and in 2021 for fixed-income ETFs. With all in all only 25 Art. 9 ETFs, they are a much smaller category compared to their less sustainable counterparts, accounting for only 2% of the total number of ETFs. But together with Art. 8 ETFs, “sustainable” funds make up roughly 40% of the number of ETFs and around 25% of their AuM. Unsurprisingly, Art. 8 and 9 ETFs are usually much younger than Art. 6 ETFs. Moreover, they tend to be smaller with respect to their AuM, particularly Art. 9 ETFs. While individual fund size of Art. 9 ETFs varies, results are not disproportionately shaped by smaller funds as we use AuM-weighted averages. Expense levels seem to be comparable across fund categories.

Sample of SFDR ETFs traded on European stock exchanges (as of May 12, 2023)

4

Type	SFDR classification	Current number of funds	Average monthly return (in %; Jan. 2021-Apr. 2023)	Average expense ratio (in % p.a.)	Average AuM (in USD m)	Average age (in months)
Equity	Art. 9	11	0,13	0,35	176	20
	Art. 8	347	0,32	0,26	629	49
	Art. 6	495	0,36	0,34	1360	127
	Total	853	0,34	0,31	1047	94
Fixed Income	Art. 9	14	-0,15	0,26	348	22
	Art. 8	125	-0,37	0,25	633	49
	Art. 6	294	-0,45	0,21	981	105
	Total	433	-0,42	0,22	860	86

Sources: Bloomberg Finance LP, Deutsche Bank Research

The average sector allocation is largely similar across Art. 6, 8 and 9 ETFs (Charts 5 and 6). One notable difference: Art. 8 fixed-income ETFs are considerably underweight government bonds and overweight bonds of financial corporations. Note, however, that within the respective sectors, the three ETF categories are expected to include different assets based on their sustainability characteristics. This may be particularly true for energy sector exposure which is non-negligible for equity ETFs.

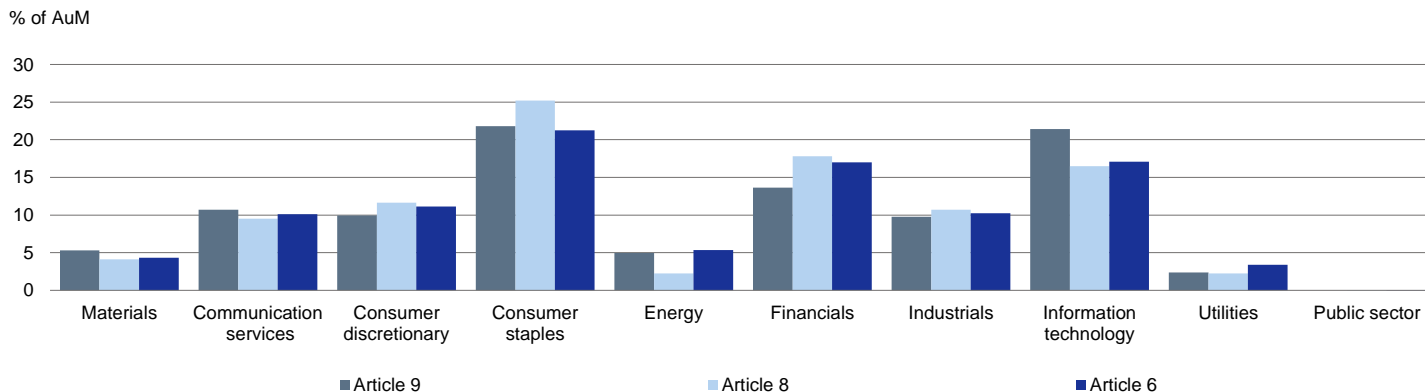
¹¹ Morningstar (2023). SFDR Article 8 and Article 9 Funds: Q1 2023 in Review.



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Equity ETFs: Average allocation by sector

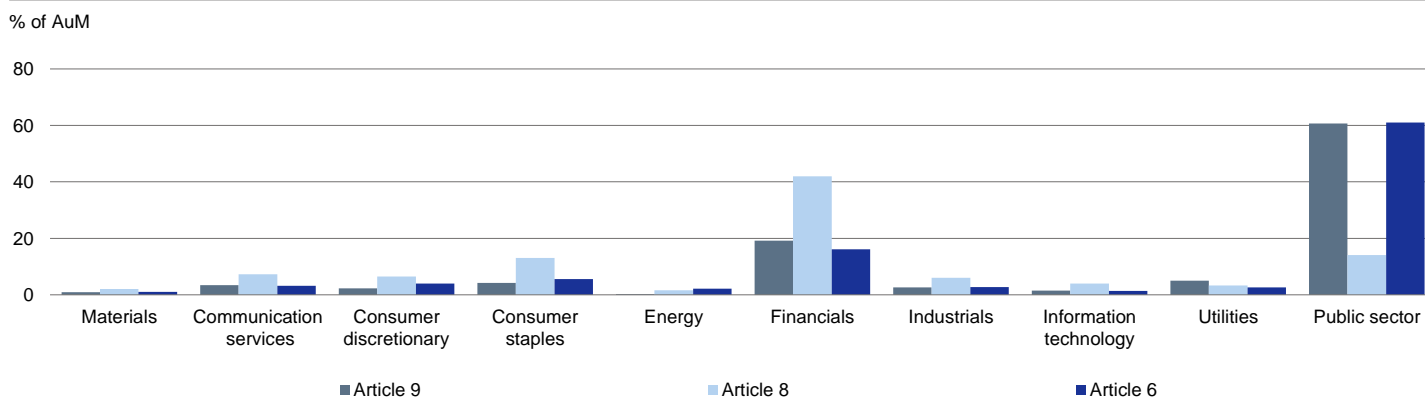
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Sources: Bloomberg Finance LP, Deutsche Bank Research

Fixed-income ETFs: Average allocation by sector

6



Sources: Bloomberg Finance LP, Deutsche Bank Research

Theoretical considerations. With respect to returns, Art. 8 and particularly Art. 9 ETFs could, to a certain extent, be decoupled from Art. 6 ETFs, due to differences in governance and exposure to risk of the underlying assets. Sustainable funds are expected to invest in companies that follow good governance practices, which is often associated with a positive effect on long-term financial performance (e.g., such firms may have a lower litigation or reputational risk).

Evidence from the coronavirus pandemic¹² indicates that sustainable funds are relatively more resilient to the materialization of tail risks. Sustainable and non-sustainable funds are also expected to differ with respect to climate-related risk. Non-sustainable funds are potentially exposed to higher transition risks, which might dampen expectations about their long-term performance.

Moreover, studies¹³ suggest that sustainable funds tend to attract more patient investors who are less sensitive to negative returns. Consequently, such funds could be less prone to large redemptions – demand for them might be less volatile. On the other hand, due to more selective investment strategies, sustainable funds may miss out on some market opportunities. Moreover, they tend to invest to a greater extent in new technologies, which may be associated with higher risk.

¹² OECD (2021). ESG investing and climate transition: Market practices, issues and policy considerations.

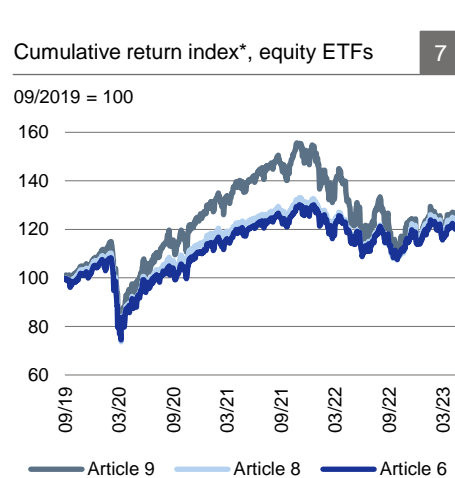
¹³ Capota et al. (2022). Are ethical and green investment funds more resilient? ECB Working Paper No. 2747.



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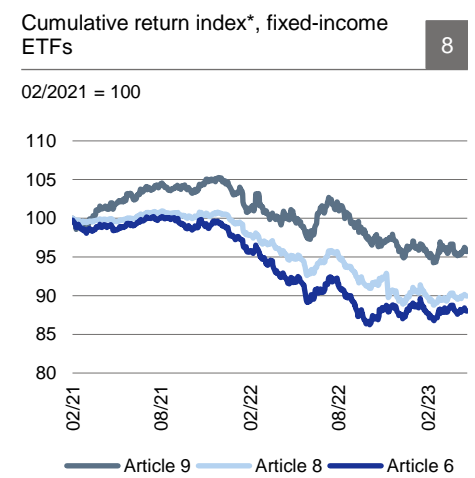
Financial dynamics. Comparing the performance of both equity and fixed-income ETFs, the average Art. 9 ETF¹⁴ has performed better than the average Art. 8 or 6 ETF during the past few years. On the equity side, the average Art. 9 ETF achieved higher returns during 2020 and 2021, but cumulative performance converged towards the other categories in 2022 (Chart 7).

Still, over the entire sample period, Art. 9 ETFs mildly outperformed Art. 6 ETFs by around 6 pp on average. More substantial is the divergence in performance of fixed-income ETFs (Chart 8). While all categories suffered negative returns since late 2021, the decline in Art. 9 ETFs was less than half of that for Art. 8 and 6 ETFs. Considering volatility, defined as the rolling standard deviation of daily returns, we find similar levels for Art. 6 and 8 ETFs, while Art. 9 ETFs tended to experience a slightly higher volatility, for both stocks and bonds.



* Based on AuM-weighted average returns per period.

Sources: Bloomberg Finance LP, Deutsche Bank Research



* Based on AuM-weighted average returns per period.

Sources: Bloomberg Finance LP, Deutsche Bank Research

Dynamic correlations. Dynamic return correlations can give a first idea of the connectedness of sustainable and less sustainable ETFs. Generally, a “low” (absolute) correlation (i.e., different performance patterns) between assets is desirable for a portfolio as it reduces the overall volatility of its returns. Our analysis reveals quite a strong correlation of the average Art. 8 and Art. 6 ETFs, both for equity and fixed income, while their correlation (in the respective asset class) is notably lower with the average Art. 9 ETFs (Charts 9, 10). One possible reason for the higher correlation of Art. 8 and 6 products may be a larger overlap between the underlying assets (likely due to fewer exclusions in Art. 8 compared to Art. 9 funds). Eurosif finds a company overlap of Art. 8 and 6 equity funds of 29%.¹⁵ Overall, as we are comparing ETFs which invest in the same asset class, all of the correlations are fairly high, especially for the equity ETFs, yet Art. 9 funds are clearly distinct.

¹⁴ The indices are computed based on AuM-weighted average returns for each trading day. The results are robust to using a simple average.

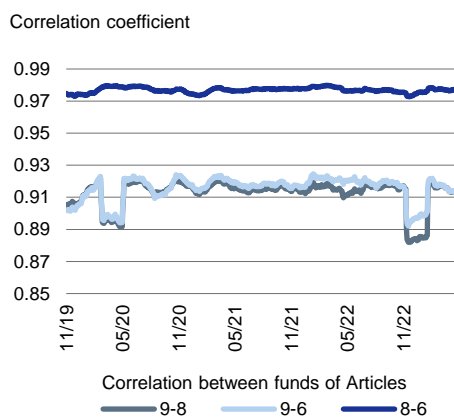
¹⁵ Eurosif (2022).



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Dynamic correlations*, equity ETFs

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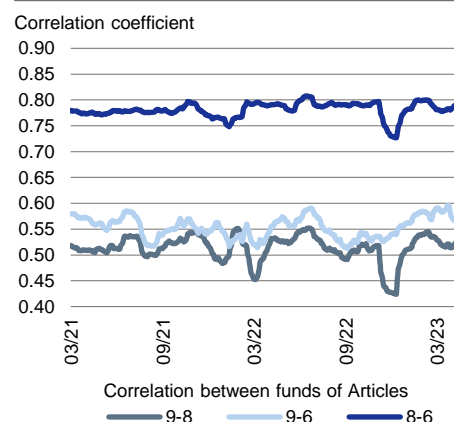


* Calculated using DCC-GARCH model.

Sources: Bloomberg Finance LP, Deutsche Bank Research

Dynamic correlations*, fixed-income ETFs

10



* Calculated using DCC-GARCH model.

Sources: Bloomberg Finance LP, Deutsche Bank Research

An interdependent network? A more comprehensive analysis looks at individual ETFs, rather than the AuM-weighted averages.¹⁶ Using a spillover methodology (see Chart 11) that can account for more intricate dynamics, we find that – similarly to above – Art. 9 equity ETFs tend to be unaffected by price developments in the Art. 8 and Art. 6 markets. The results suggest that these less sustainable equity ETFs are more strongly interconnected and hence more at risk from financial contagion. Amzallag (2021)¹⁷ explains this by arguing that less sustainable funds, for some reasons, tend to distribute their portfolio over a smaller number of companies than more sustainable funds. In particular, “green” funds presumably invest in a wider variety of green firms, whereas non-sustainable (“brown”) funds tend to invest in a very concentrated selection of specific “brown” firms. As a consequence, these highly connected portfolios may be susceptible to systemic risks, where a shock in one asset can quickly spread to others, potentially leading to significant losses. Diversifying across markets that are less connected can help mitigate this risk.

The results of our network analysis – the lower degree of interconnectedness of Art. 9 equity ETFs with Art. 8 and 6 and hence their lower exposure to price disruptions in the other market segments – can be graphically seen in Chart 12: there are hardly any spillovers from Art. 6 or 8 ETFs to Art. 9 ETFs, i.e. almost no light or dark blue lines go to Art. 9 funds (although there are some spillovers in the other direction – the grey lines). The exact opposite is true for Art. 6 and Art. 8 ETFs, which appear strongly connected.

The same, however, cannot be said for fixed-income ETFs where interconnectedness is much more balanced between the different SFDR categories, such that no notable differences can be identified. This may be due to the recent surge in interest rates globally which has dominated price dynamics of essentially all fixed-income investments and affects more than half of the fixed-income sample period. But it is important to note that spillover intensities are normalized at a range between 0 and 1 for equities and fixed income *separately*, hence the strength of the links in the two charts is not

¹⁶ To allow for a better interpretation of the results, we analyze the same number of ETFs for each category. Art. 9 ETFs are the obvious bottleneck, which limits the number of ETFs from the other two categories. Specifically, for equities, we use the 11 largest (by AuM) Art. 6 as well as Art. 8 ETFs (and the 14 largest for fixed income). Note that the described relationship exists regardless of whether we include additional funds.

¹⁷ Amzallag (2021). Fund portfolio networks: A climate risk perspective. In: ESMA Report on Trends, Risks and Vulnerabilities, p. 73-86.



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comparable. Overall, in light of the above correlations, equity ETFs may be more closely connected than fixed-income ETFs.

Methodology

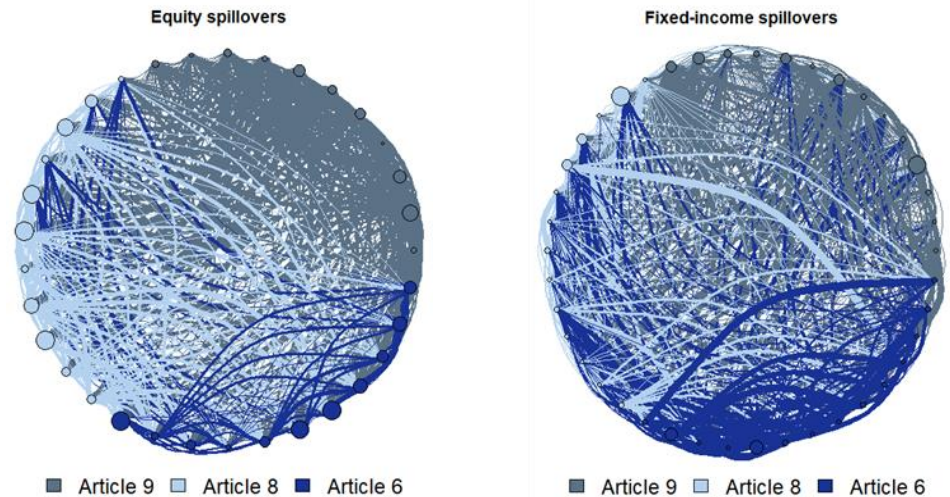
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The spillover networks are computed using the General Forecast Error Variance Decomposition framework developed by Diebold and Yilmaz (2014).¹⁸ In particular, we estimated a vector autoregression for each system of ETF returns, with the optimal lag length being endogenously determined by the Akaike Information Criterion. Based on the VAR model, the static spillovers were then estimated according to Diebold and Yilmaz. The size of the nodes of the network is based on the net spillovers sent into the market by each ETF. The size of the edges is determined similarly as the net pairwise spillover between any two ETFs connected. The larger their link, the more intricately the sender and receiver are connected. More precisely, the larger the link, the better the sender's past returns are in forecasting the receiver's current return. The colour of the edges is determined based on the direction of the spillover, with the colour indicating the sender. Note that edges below a certain weight-threshold are omitted to maintain the legibility of the spillover network charts.

Source: Deutsche Bank Research

Article 9 equity ETFs stand apart from Article 8 and 6 equity ETFs

12



Sources: Bloomberg Finance LP, Deutsche Bank Research

Bottom line – sustainable funds are partially decoupled from less sustainable peers. The emergence of sustainable investments has been accompanied by questions about their performance compared to traditional investments and how these two segments are interconnected. The latter has been in focus in this study, and the results suggest that “dark green” equity ETFs are partially decoupled from their less sustainable counterparts, potentially allowing investors to improve the diversification of their portfolio. In particular, financial dynamics of such funds seem to diverge sufficiently to make them clearly distinguishable from Art. 8 and Art. 6 equity ETFs.

The picture is less clear for fixed-income ETFs, with Art. 9 funds standing out in the pairwise correlation analysis, but no major differences between SFDR categories regarding spillover effects. This analysis, however, is only a preliminary snapshot of the novel and quickly-evolving sustainable ETF market. It is limited by its short time horizon, as the SFDR was adopted only recently, as well as the rigidity of the classification into three discrete categories, which may contain substantial within- and between-category variation.

Furthermore, the concept of “sustainable” investment continues to evolve, and the SFDR framework will change with it. For example, the European (Financial) Supervisory Authorities are currently consulting on technical amendments to the SFDR implementing regulation¹⁹ with respect to the PAI indicators and financial product disclosures. Nevertheless, our analysis provides first insights into possibly diverging financial dynamics of sustainable and non-sustainable investments.

¹⁸ Diebold, Francis X., and Kamil Yilmaz (2014). On the network topology of variance decompositions: Measuring the connectedness of financial firms. In: *Journal of Econometrics*, Vol. 182, p. 119-134.

¹⁹ European Supervisory Authorities (2023). Review of SFDR Delegated Regulation regarding PAI and financial product disclosures. Joint Consultation Paper. April 12.



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Outlook: Fund labelling rules to distinguish more clearly between sustainable and conventional funds

Regulatory initiatives to enhance clarity and transparency of sustainable investments. Across the globe, financial authorities are in the process of creating a robust regulatory basis for the evolving sustainable finance ecosystem. The EU has been among the pioneers with its taxonomy, defining what constitutes a sustainable investment, and with its disclosure regulations (SFDR, CSRD). The SFDR is a first step towards more transparency in the fund sector, as it reduces the information asymmetry between financial firms and investors.

The Corporate Sustainability Reporting Directive (CSRD), which will be rolled out gradually, starting in 2024, may contribute further to a better understanding of the sustainability characteristics of non-financial corporations. The UK has already implemented disclosure requirements for corporates that are aligned with the widely accepted Taskforce on Climate-Related Financial Disclosure (TCFD) framework. Moreover, the country is currently working on a green taxonomy (consultation announced for autumn 2023) and on Sustainability Disclosure Requirements²⁰ for sustainable investment products, with a policy statement expected in Q3 2023.

In the US, in spring 2022, the SEC proposed disclosure rules for both listed corporates²¹ and the investment fund sector.²² The SEC aims to publish the final regulations in October this year.²³

Given the global nature of financial markets, regulatory fragmentation remains a key risk. At least for corporates, the recently published standards on climate and sustainability-related disclosure of the International Sustainability Standards Board (ISSB) could create a global baseline. The first reporting cycle is scheduled to begin in 2024.

Upcoming sustainable fund labelling rules. While the SFDR enhances transparency, the sustainable fund sector remains relatively complex and not easy to navigate for investors. This has prompted major advanced economies to develop labelling rules for sustainable funds:

- In the EU, ESMA has been consulting on guidelines for funds that use ESG-related terms in their name.²⁴ The rules would require such funds to hold at least 80% of their assets in accordance with the sustainable investment strategy they have disclosed under the SFDR. Moreover, at least 50% of the fund assets would need to be in line with the SFDR's "sustainable investment" definition if the fund name includes "sustainable" (or related terms).
- The UK's Sustainability Disclosure Requirements would group sustainable investments into the categories "aligned", "transitioning", and "impact". Environmentally or socially sustainable assets would have to comprise at least 70% of funds with a sustainability focus ("aligned").

²⁰ Financial Conduct Authority (FCA) (2022). Sustainability Disclosure Requirements (SDR) and investment labels. Consultation Paper. October.

²¹ SEC (2022). SEC proposes rules to enhance and standardize climate-related disclosures for investors. Press Release. March 21.

²² SEC (2022). SEC proposes to enhance disclosures by certain investment advisers and investment companies about ESG investment practices. Press Release. May 25.

²³ Office of Information and Regulatory Affairs (2023). Spring 2023 Unified Agenda of Regulatory and Deregulatory Actions. June 13.

²⁴ ESMA (2022). Consultation paper on guidelines on funds' names using ESG or sustainability-related terms. November 18.



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- In the US, the SEC's proposed update of the "names rule"²⁵ would require funds to specify the ESG term used in their name and to ensure that at least 80% of the fund's assets adhere to this definition.

These labelling rules would set clear expectations for the level of sustainable assets included in a fund, while still leaving a certain degree of flexibility to the fund manager with respect to the fund's strategy. This could lead to a more coherent and robust sustainable finance landscape, potentially resulting in an even more clear-cut distinction between sustainable and non-sustainable investments. More transparent and clearly defined investment products could thus add further to the growth of sustainable investment.

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²⁵ SEC (2022). SEC proposes rule changes to prevent misleading or deceptive fund names. Press Release. May 25.



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